Sector Network Sustainable Economic Development Asia
Division 41 Economic Development and Employment

The Social and Ecological Market Economy – A Model for Asian Development?

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Published by
Deutsche Gesellschaft für
Technische Zusammenarbeit (GTZ) GmbH
Postfach 5180
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Cover Design and Layout:
Kuhrt Kommunikation GmbH, Düsseldorf

Printed by
KlarmannDruck GmbH, 65799 Kelkheim

May 2008

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Foreword

The social market economy – with an increasingly ecological orientation – has proven a successful model for economic development in Germany. It has been the basis for reforms to increase competitiveness and growth, allowing Germany to become world champion exporter while meeting the challenges of strong immigration, reunification, and increased globalization with little social unrest. It reflects a basic set of values, shared by most Germans, which combines free market with social and ecological principles.

In 2007, the German Federal Ministry for Economic Cooperation and Development issued *Social and Ecological Market Economy Principles in German Development Policy*, which details how this successful German and European tradition of economic, social, and ecological policy design can be used to orient German development cooperation.

The GTZ Sector Network Sustainable Economic Development Asia immediately took up the issue, and at their 2007 meeting, GTZ advisors in the field of economic policy and private sector development debated the significance of the model of the social and ecological market economy for various Asian countries. Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH is the technical cooperation implementing organization of German development cooperation and is active in most Asian countries. The sector network offers a forum for GTZ advisors and others in the field of sustainable economic development to exchange experiences and discuss international good practices as well as lessons learnt from practical implementation.

It was at this point that the editors decided to assemble this reader in order to further explore the question which its title poses: "The Social and Ecological Market Economy – A Model for Asian Development?" We feel that the model of the social and ecological market economy can provide a perspective from which to approach the many unresolved questions in the region, and, after many discussions with our partners in government agencies and the private sector, we have come to believe that Asian perceptions of the state, the economy, and social values potentially match the concepts of the social and ecological market economy in many areas.

At the core of the reader are articles by GTZ practitioners, primarily members of the above-mentioned sector network, who provide examples of how elements of the social and ecological market economy are reflected in the portfolio of German development cooperation in the region and also reflect on what needs to be done to develop this further. These articles are complemented by the perspective of German researchers and policy advisors, who reflect on the current reform debate in Germany, and the perspective of Asian partner country representatives, who outline their own understanding of why the German model may be of relevance to sustainable development in their countries – using the model not as a blueprint, but as a starting point for dialogue. An introductory section sets the framework by outlining the different elements of the social and ecological market economy and by reflecting on GTZ's corporate philosophy in relation to the model.

This book could not have been completed without the contributions of the authors; we want to thank them for their readiness to participate in this project. Furthermore, we are very grateful to Katja Röckel, who played an essential role in coordinating the logistics of preparing this reader and contributed substantially to its content. We also would like to thank, in particular, Dr. Marianne Scholte for her tireless and outstanding editorial work. Without these two, this reader would not have materialized.

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Part 1

Overall Perspectives

Social and Ecological Market Economy – A General Overview

Dieter W. Benecke

Introduction – From Political to Economic Competition

The *social* market economy is one in which social concerns are accorded the same importance as economic concerns. Faced with contemporary environmental challenges, the social market economy must of necessity become an *ecologically* oriented economy.[1] But the ecological orientation should not dilute the traditional social market economy "brand". The ecological ingredients of the social and ecological market economy (SEME) are as important as its market elements and social characteristics. However, if the market does not work and if economic policy is not combined with preventive and compensatory social policy, the ecological dimension cannot be effectively incorporated into a social market economy. So, the terms *market*, *social,* and *ecological* should chime with each other as equally essential elements in a melodious triad.

Until the 1980s, the world was divided into competing political and ideological systems. The main question was: Is society better off and more just if the economy is centrally planned – as in the former Soviet Union or in China until 1979 – than is the case in a capitalist market economy? Or could there be a third way[2] in which the state

[1] Market here means as much competition as possible and suitable for society. *Social* means caring for the weaker members of society and keeping in mind the interests of society. *Ecological* means caring for the environment in terms of greenhouse gas emissions, recycling, alternative energies, traditional energy savings, etc. in the respective country and worldwide.

[2] The "third way" was launched as a programmatic approach by the British Labor Prime Minister Tony Blair in 2000. In English-speaking countries, the question is often raised as to the difference between the social market economy and the *third way*. The term third way could mean anything between communism and capitalism, between centrally planned and free market economies. The term *social market economy*, however, contains the clear message that the market elements are at the same level as social care. In terms of content, the third way model, which was above all a political concept for the reform process in Great Britain, is close to the neo-liberal approach (see Fig. 1), because the state increasingly relinquishes the production of public goods like transport, infrastructure, health care, education, and other services, privatizing them. Social subsidies to the weaker members of society are reduced, in an attempt to give them more incentives to care for themselves and release the state from high social costs. Alfred Schueller discusses several third ways to show how ambiguous this concept is. See Alfred Schueller, "Soziale Marktwirtschaft und Dritte Wege" (Social market economy and third ways), *ORDO: Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft*, Band 51 (2000):169-202.

is as important an economic player as the market? Since the collapse of the Soviet Union, the market-oriented model has asserted itself, albeit with different political shades from country to country: greater or less state interference, more or less influence of civil society organizations. The main question today is: which type of market economy is most effective in terms of economic success, social justice, and ecological sustainability?[3] Thus, the debate has moved on from the political to the economic.

Globalization has opened up and accelerated worldwide communication processes. Information about what is going on in different countries has increased enormously. This enables competitors to adapt or imitate successful techniques and products much more quickly than before. Before the 1990s, it was relatively easy to insulate a country from outside influences, to exclude the majority of the population from access to relevant information, and to protect national enterprises from foreign competitors through custom barriers and other means of discrimination. There was scarcely any public discussion at that time about the damaging ecological effects of some types of economic activity.[4]

Today, democratic governments, which by definition are committed to plurality of opinion and freedom of information, neither wish nor would be able to cut the population off from foreign influences. Even authoritarian and totalitarian governments can impede global information flow into their country only by means of strong repression. The internet and international trade agreements, especially the World Trade Organization, and various regional groupings have strengthened international interaction.

In this world of free information, economic competition between countries has become tougher. This has brought about a more intense search for the most effective *economic* system. For about a decade, this competition has been dominated by three issues:

1) How can the wealth and educational level of the population be increased and, if achieved, how can it be sustained?
2) How can economic growth and improved knowledge be distributed in a way that allows as many people as possible to participate?

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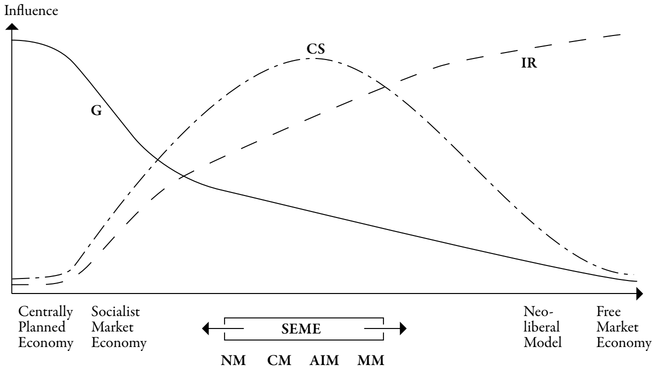
[3]In economic terms, the world is far from the thesis of Francis Fukuyama's *The End of History and the Last Man* (New York: Free Press, 1992). Its validity is doubtful even in political terms, given the Chinese approach or that of the "neo-socialist" Venezuelan President Chávez and his followers Morales (Bolivia), Correa (Ecuador), and Ortega (Nicaragua).

[4]The statement of a former Brazilian minister of economy – "The darker the clouds, the better for our economic growth" – expresses the viewpoint of many developing countries and some industrialized countries, too.

In this contest for the most effective social market economy model, ecological sustainability has gained more and more ground. Possibly – and in my view, ideally – the environmental dimension will come to be recognized worldwide as the third criterion for measuring the effectiveness of any economic system.

Figure 1: Range of Economic Systems and Influence of the Economic Actors



AIM - Anglo-Irish model
CS - Civil society
IR - Individual responsibility
NM - Nordic model
CM - Continental model
G - Government
MM - Mediterranean model

So, current discussion no longer gravitates between the extreme positions of a centrally planned economy linked to authoritarian government and a free market economy associated with liberal government. In most countries today, the discussion revolves around a more neo-liberal or neo-conservative model and a more socialist or social-democratic market economy (see Figure 1). Between those two alternatives lies the social and ecological market economy (SEME), an open and flexible system that may be adjusted according to the time and situation in different countries. That is why SEME is not a fixed point on the scale of economic systems, but rather a range which may move to the left or to the right according to particular needs and circumstances (see Figure 1).[5]

[5]For example, if unemployment increases, the state or its employment agency must become more active (the model moves to the left) than would be the case in times of full employment (the model is situated more to the right). The fluctuation of the SEME model showing the necessary adjustments can be illustrated through many more examples: the effects of a more or less severe economic crisis; higher or lower inflation; needs for greater environmental protection; problems of energy supply; insufficient health care; demographic changes; adjustments of the foreign exchange rate and foreign trade; etc.

In the European Union (EU), which has expanded from an economic community of six founding countries in 1958[6] to 27 countries[7] with about 500 million people, the member states have opted for a market economy molded by more or less important social and ecological elements. In search of the most effective system, one which offers economic efficiency, social justice, and ecological protection, the EU distinguishes four models[8]:

- the Mediterranean model (MM), as found in Greece, Southern Italy, and Portugal;
- the Continental model (CM), as found in France, Germany, Northern Italy, and Austria;
- the Nordic model (NM), as found in Sweden, Finland, and Denmark;
- the Anglo-Irish model (AIM), as found in Great Britain and Ireland.

These models show variations in relation to state influence, tax systems, flexibility of labor markets, pension systems, redistribution instruments, open market competition, environmental protection, etc. The ten states which joined the EU in 2004, as well as Romania and Bulgaria, which joined in 2007, are still experimenting with different elements of the four models. As Figure 1 shows, the SEME model differs from the socialist and the free market economy models by virtue of such factors as the relative influence of government (G), the role of civil society (CS), and individual responsibility (IR) in society and in the economy.

Aims of the Social and Ecological Market Economy

"Welfare for all" as Economic Target

The call for "welfare to all", which provided the title to the book by Ludwig Erhard,[9] the pragmatic pioneer of the social market economy and the first minister of economy

[6]Belgium, France, Germany, Italy, Luxembourg, and the Netherlands.

[7]The six countries named above plus Austria, Bulgaria, the Czech Republic, Cyprus, Denmark, Estonia, Finland, Great Britain, Greece, Hungary, Ireland, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden.

[8]The economic and social situations of the EU member states were analyzed in the Sapir Report. See André Sapir et al., *An Agenda for a Growing Europe – Making the EU Economic System Deliver* (Brussels: the EU Commission, July 2003).

[9]Ludwig Erhard, *Wohlstand für Alle* (Welfare for all) (Düsseldorf: Econ-Verlag, 1957). Erhard became the first minister of economy of the Federal Republic of Germany in 1949. His approach was, at that time, vigorously opposed by the Social Democratic Party, which was in favor of more state planning. Only after the model proved successful did the different democratic parties generally accept it, while frequently debating its different elements.

in Germany after World War II, does not suggest that all citizens are at the same level of welfare. Every country naturally has more and less well-off people, and their condition is not always related to individual effort or merit. However, the social market economy should enable the vast majority of people to participate in the wealth of the nation, either through their own endeavors or with the help of society, thus allowing for a significant level of individual dignity. It should deliver a decent standard of living and open access to education and professional training. Nobody should live in poverty.

Several factors combine to achieve this aim of welfare for all. The creation of wealth, normally measured by *economic growth*, depends greatly on *investment.* This presupposes an adequate *savings rate*, possibly promoted or supported by the state. Savings, however, make sense only if there is *price stability*. Inflation is poison to the enterprise of creating welfare for all. Certainly, investments can be financed temporarily through credit; however, credit must be repaid one day. Individuals normally respect this obligation, while governments often go into debt at the expense of their citizens, sometimes even at the expense of future generations.[10] Therefore a *balanced government budget* is equally essential to the creation of welfare for all. Ideally, all current expenses of the state should be covered by tax revenues.

Economic growth can also be driven by foreign investment. This implies a higher risk of volatility because of speculative capital transfers or withdrawal of profits and/or capital. Thus, solid economic growth leading to welfare for all requires a sound *internal savings rate*.

Innovation is also decisive for economic growth. No country achieves real growth of 5% or more through increased production of traditional goods and services alone. There must also be a qualitative approach. This is apparent from the experience of Germany and Japan after World War II, later on from that of some Asian countries like South Korea, Singapore, and Taiwan, and more recently from India and Chile. Other fast growing countries like China, Vietnam, Brazil, Mexico, and Venezuela, having started with the quantitative approach, are now being forced to pay more attention to innovation if they are to continue playing an important role in the global economy. In Europe, Ireland and Finland have opted very successfully in the last decade for the qualitative approach to economic growth, and Germany, a bit too comfortable in the 1980s and 1990s, now seems to have left its sleeping-beauty period. New products and new technologies are vital to the opening of new markets. This in turn allows for a reduction of costs and

[10]Public debt crises of the last 30 years, like those of Latin America, Asia, and Russia, show how quickly countries can be thrown back. In Germany, the constitution limits the debt that the state can incur. It states that the government should borrow only for investment purposes, not to cover current administrative costs. The EU has established that member states should not contract debts higher than 3% of their GDP.

a concomitant increase in competitiveness.[11] The more productively employed the population, the greater the chance to achieve welfare for all. *Full employment*[12] in the strict sense of the word can hardly be achieved in a dynamic economy, because of the fluctuations within the different economic sectors. This phenomenon is reinforced by globalization.[13] Therefore, workers and managers need to be highly flexible and mobile. The effort to create welfare for all is not confined to the national economy alone. Foreign markets must be considered as well, in terms of both *exports* and *imports,* if countries are to benefit from their comparative advantages. The economic development of China after 1980 shows this clearly. Opening its market to foreign investments and goods, China learned from foreign experience. It imported the raw materials and technology necessary for industrial modernization and became increasingly able to export, to the extent that it is expected to overtake Germany as world export leader in 2008.

Exports increase welfare by creating more employment. Imports increase welfare by bringing new, better, or cheaper products into a country, as well as putting competitive pressure on internal prices and thus raising real income. However, large export or import surpluses that are not accompanied by high capital imports or exports, respectively, disturb the macroeconomic balance and could endanger general welfare. *Foreign trade equilibrium* is therefore another important factor which facilitates welfare for all.

The art of politics is called upon to give effect to the above-mentioned aims and to enable countries to react quickly in the case of imbalance. The achievement of an acceptable level of welfare for all does not justify sitting back or resting on one's laurels. Internal or external influences can disrupt this dynamic equilibrium very easily, if attention is focused mainly on creating wealth and insufficiently on its distribution. Sooner or later, the concentration of wealth in certain echelons of society or in certain regions will engender social conflicts. The social market economy model obliges the state to pay attention to fair *income redistribution*[14]

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[11]Some countries try to innovate through attracting foreign investment, offering tax advantages, low labor costs, less regulations, and lower environment protection standards. But growth created in this way is rather artificial and brings only transitional benefits, especially if the process is not based on well-trained workers, a high level of engineering and managerial skills, the ability to innovate, and the protection of intellectual property rights.

[12]Generally, when the unemployment rate is less than 4%, a country may be said to have *full employment.*

[13]For example, the textile industry, once an important production sector in industrial countries, has been reduced as Asian countries have taken up production of everyday textiles. So workers from this sector have had to look for jobs in other areas.

[14]In many countries which benefited from globalization, a stronger concentration of wealth on fewer persons can be observed. Therefore, a political debate arises as to whether the state should redistribute not only income but wealth, too, for example, by taxation of inheritance.

and balanced *regional policy*. If economic growth is concentrated on a certain region, a "backwash effect"[15] may be expected. This can be observed in China, as dynamic people migrate from backward regions into more prosperous ones, thus hobbling any chance of improvement in the backward regions.

Social Justice as Political and Economic Aim

Social has a double meaning. On the one hand, the term relates to society and on the other, to the concept of welfare services as in social security. Social justice is achieved through social security measures, like health services, pension systems, etc. and the redistribution of income in favor of those who cannot help themselves. This is not the place to discuss the philosophy of justice. In economic terms, social justice means equal opportunities, facilitated by a sufficiently open educational system. It means as well that those who make a greater effort should obtain more benefits. However, the satisfaction of basic needs like food, housing, and healthcare may be taken as a minimum standard. Social justice, in economic terms, cannot be measured exactly.[16] In the end, it has to be judged politically by the majority of the population through the process of democratic elections. The notion of social justice for all is somewhat idealistic because, while human beings are of course all equal under the law, they are unequal in terms of potential, ambition, and expectations.[17]

In spite of this fact, a stable and successful society can be achieved only if it is organized as justly as possible. The best way to realize this aim is through open access to education. Also in this field not everybody has the same ability or willingness to learn and one cannot force people to engage with a lifelong learning process. But it is highly important that the door to education and professional training is open to everybody and not restricted by economic or social background.[18]

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[15] This effect has been analyzed by Gunnar Myrdal, *Economic Theory and Underdeveloped Regions* (London: Duckworth, 1957), contradicting Albert O. Hirschman's plea in *The Strategy of Economic Development* (New Haven; Yale University Press, 1958) for creating development poles and expecting a "trickle-down effect" from these. See Dieter. W. Benecke, *Kooperation und Wachstum in Entwicklungsländern* (Cooperation and economic growth in developing countries) (Tuebingen: Mohr-Siebeck, 1972), 33.

[16] In 2007, the 17th Congress of China's Communist Party, obviously aware of the current concentration of wealth, set a harmonious society as a central goal. Such an aim cannot be achieved without social justice, but might be a step towards the SEME.

[17] The British writer George Orwell, known for his critical view of the almighty state (1984, "Big Brother is watching you") satirizes former communist ideology in his novel *Animal Farm*. While starting the "revolution" of the animals against their farmer with the slogan "All animals are equal", after a short while the pigs in power complement the slogan with the addendum that "some are more equal than others".

[18] The Pisa Study, which regularly analyzes the knowledge level in different countries, shows that the efficiency of the educational system corresponds with the economic and social performance of a country.

Environmental Compatibility of Economic Policy as Ecological Aim

Since the 1970s, the economic and social aims of the social market economy model have been complemented by ecological goals. Although efficient waste disposal or recycling was important even before, the discussion about energy shortages, the expansion of the ozone hole, and climate change have increased ecological awareness of the population and has pushed the state to include environmental elements in the social market economy. Thus, states have passed laws and regulations which limit emissions, require the installation of filters, and enforce recycling and have established tax incentives or subsidies for alternative energies, energy saving, and the development of new environmentally friendly technologies.

In the beginning, industry and households took a defensive approach to ecological needs. This cost factor, however, soon turned into profitable activity, with the production of filter systems and waste recycling and incineration plants, the development of alternative energy sources like solar cells, geo-thermal warming, wind farms, and biofuels,[19] and the promotion of energy-saving techniques. In this way, a huge new market was created with enormous potential for growth.

International pressure has driven the ecological agenda in some countries. The Kyoto Conference[20] in 1997 and subsequent agreements have played an important role in this. In Europe, politicians have recognized that the Kyoto target is insufficient to reduce global warming. At the initiative of the German government, EU member states agreed in 2007 to reduce carbon dioxide and greenhouse gas emissions by 20% and to increase the production of renewable

[19]Meanwhile, biofuel has become a contested international issue. Brazil and the USA have brought their common interest in biofuel production almost in line. Venezuela's President Chávez, together with former Cuban President Fidel Castro and the Movement of Landless People in Brazil (MST), started a campaign against biofuel, arguing that the production of biofuel raw material prevents small farmers from producing food. In the EU currently, the policy of bonuses for agricultural land not used for the production of food has changed. In recent years, farmers used their land, at least partially, for the production of biofuel raw material. Now, as prices for milk products, meat, and flour have increased sharply (in part because of the great demand in China), European farmers once again get bonuses for using their land for food production.

[20]In this conference, the 55 countries which produced over half the worldwide emissions of carbon dioxide agreed a protocol to reduce the 1990 level of emissions by 5.2% by 2012. By 2007, 169 countries had signed this protocol but the USA, the greatest offender, has not yet done so, and China, the second greatest offender, is reluctant to fix quantitative goals for emissions. The Bali Conference on Climate Change in 2007 again demonstrated the confrontation between more progressive countries, for example the EU states, and more reluctant states like the USA, China, India, Russia, and several developing countries. The latter argue – and this is correct – that the industrialized countries have caused a large part of the current ecological damage and that their priority is to reduce poverty and pursue more dynamic development.

energy by 20% by 2020 ("20-20-20"). At the Bali Conference on Climate Change in 2007, the 190 participant states also recognized that the Kyoto aims were insufficient, but could not commit themselves to quantitative aims. However, they agreed to draw up a new international protocol by 2009, which will commit the industrialized country to greater reduction of greenhouse gas emissions, but will also demand more pollution control from the developing countries.

Great political skill and intense dialogue between the state, enterprises, trade unions, and consumer organizations are required to harmonize economic, social, and ecological aims. Once more, it should be emphasized that ecological aims can only be achieved effectively in a dynamic economy that places importance on the future of society. In spite of a certain resistance by some governments, awareness of the need for greater environmental protection has increased.[21] The development of a system allowing firms or countries to buy and sell so-called pollution rights or carbon credits is also welcome.

Sources of the Social Market Economy

As the SEME was developed on the basis of the social market economy, the latter must be explained first. A social market economy is an economic order based on clear principles and therefore offering a reliable orientation for economic actors. Such an economic and social order does not fall from heaven. It is rather the result of scientific research and reflection on ethical principles and the outcome of entrepreneurial and political activities. In addition to its theoretical framework and philosophical underpinnings, positive and negative experiences and trial-and-error processes have helped build up this system.

The social market economy, named as such in Germany from 1949 onwards,[22] is based on a long tradition of socio-economic debate. "Manchester Capitalism," the nineteenth century process of industrialization in England and Germany, generated enormous technical innovations and wealth for some entrepreneurs, but also caused significant worker pauperization. This pushed economists and politicians to think about alternative designs for the economy and society.

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[21]Here we can cite the popularity of the Nobel Peace Prize winner Al Gore and his film *An Inconvenient Truth*. It is notable as well that at the Chinese People's Congress in 2006 and the 17th Congress of China's Communist Party in 2007, different motions proposed more attention to environmental aspects than in the past.

[22]The term is attributed to Erhard's State Minister Alfred Mueller-Armack, *Wirtschaftslenkung und Marktwirtschaft* (Steering of the economy and market economy)(Duesseldorf: Verlag für Wirtschaft und Sozialpolitik, 1947). In many later publications, different aspects of the social market economy were analyzed, for example. Dieter Cassel (ed.), *50 Jahre Soziale Marktwirtschaft* (50 Years of social market economy) (Bonn: Lucius und Lucius, 1998).

Karl Marx correctly described these social problems, but his call for the "expropriation of the expropriators" was not a viable option.[23] Conservative politicians, obviously afraid of a revolution, tried to take the wind out of socialist sails by introducing social relief schemes. The then German Prime Minister Otto von Bismarck pushed very progressive social legislation through parliament in the latter part of the nineteenth century, creating an insurance system for workers that provided health protection, pensions, and unemployment payments. The Catholic and Protestant churches introduced charity activities, but also developed alternative economic concepts: the Catholic Social Doctrine[24] and the Protestant work ethic,[25] respectively.

These political and church activities were important in a pragmatic sense. However, the conclusive model of the social market economy was developed in academic circles, by people who were aware of the positive aspects of a liberal economy, but at the same time conscious of its social downsides. The challenge was to find a system that assured technical progress and dynamic entrepreneurship, while avoiding concentration of wealth and hegemony by few rich persons. Based on the analysis of the economists of the Vienna School (notably Boehm-Bawerk and Schumpeter), the social scientists of the Freiburg School (von Hayek, Roepke, Eucken) developed Ordoliberalism: a regime that combined individual freedom of economic activity ("liberal") with an economic "order" acceptable to society. So, this theoretical approach advocated:

- for open markets and free competition, individual property rights, and contractual liberty;
- against economic concentration, excessive individual liberty, and uncontrolled business cycles.

This ordoliberal concept does not argue in favor of equality for all citizens, but rather for equal opportunity. Everybody should have access to resources which permit a decent standard of living; markets should not be monopolized

[23]Karl Marx recognized the positive role of capitalism, too. Asked by Russian and Indian socialists how to establish socialism in their countries, he stated that capital accumulation and industrialization are preconditions of socialism, because in agricultural societies like Russia and India at that time, there was neither a proletariat ready to fight for the revolution nor sufficient wealth to be redistributed and spent on social services.

[24]See for example Anton Rauscher," Katholische Soziallehre und liberale Wirtschaftsauffassung" (Catholic Social Doctrine and Liberal Economic Concepts), in *Selbstinteresse und Gemeinwohl. Beiträge zur Ordnung der Wirtschaftsgesellschaft* (Berlin: Duncker & Humblot GmbH, 1985), 279-318.

[25]See for example Helmut Thielicke, *Theologische Ethik* (Theological Ethics) (Tuebingen: Mohr/Siebeck, 1958).

nor interfered with by the state and should be open for newcomers to allow for effective competition. These requirements which involve government decisions, at least in part, and the scientific, ethical, and political roots demonstrate that the social market economy is not an economic order alone. It is at the same time a political system, the success of which must be verified periodically. Majority decisions are required to establish if citizens feel that their society is properly organized. This is manifest in the right of the population to re-elect or to change the government that is responsible for shaping the general framework of the economy and society.

The concept of a social market economy was put into practice by Ludwig Erhard. He had learned from the worldwide economic crisis of the 1920s, the experiences of the German war economy (between 1939 and 1945), and the theoretical approaches of the Vienna and Freiburg Schools. Obviously, nothing is more convincing than success, evident in Germany between 1952 and 1990, when the country experienced unprecedented prosperity and social justice.

Several countries bear witness to similar economic success.[26] Although their jump forward deserves great acknowledgement, the real challenge is to improve the standard continuously.[27] One of the great advantages of the social market economy model is that it provides a roadmap for *sustained* wealth creation. Its application makes it possible to overcome economic underdevelopment and to stabilize a level of wealth, combined with a satisfactory component of social justice. This model is not unique to Germany; it may operate in countries with different characteristics. Indeed mere imitation of the German experience cannot promise the same success, given the structural differences. The instruments of the social market economy might be roughly the same, but their application will differ according to the situation in which the country in question finds itself.

Definition of the Social Market Economy

The social market economy, although based on strict principles, constitutes at the same time a very flexible system. This presents a great challenge in terms of entrepreneurial dynamics, consumer vigilance, and attentive governmental policy. The successful application of the model demands rather prompt reactions to internal

[26]Examples worth studying are Ireland, Finland, Estonia, and Slovenia in Europe; Chile in Latin America; South Korea, Taiwan, Singapore and, more recently, India, China, and Vietnam in Asia.

[27]Many Latin American countries, for example, have experienced a quick boom based mostly on the export of raw materials, but they have also suffered deep crises, because they did not succeed in facilitating the participation of the broader population in the newly created wealth.

societal changes as well as to external influences. The fundamental institutional requirements are the rule of law and a democratic order in which the interests of the different social groups are respected. Social partnership between trade unions and entrepreneurial associations is an essential component of labor market design, to allow for entrepreneurial dynamics, investment, high employment rates, and social justice. Through this system of countervailing powers, a dynamic equilibrium is created. Implementation of the social market economy is based on three general principles:

- **Individual spirit of achievement and self-responsibility** of citizens. Obviously the range of individual performances varies: it depends on financial, educational, and physical capacity. Therefore, while everybody does not share the same spirit of achievement and sense of responsibility, people must – to a degree that corresponds with their ability and capability – make the same effort to obtain a good education and adequate welfare and to provide for their pension and their health insurance. A great spirit of achievement is likely only if citizens can acquire *private property* and if they can *compete* with one another.
- **Solidarity** within society. This means that the more capable and wealthier members of society have to contribute more to improve the opportunities and quality of life for people who cannot manage to achieve a proper standard of living. Solidarity is shown for example in the tax system, where people with higher incomes are charged more, or in the social insurance system, where those with higher incomes pay higher contributions, enabling the weaker to avail of a decent level of security. Solidarity expresses itself also in the freedom to form trade unions, associations, cooperatives, and other civil society organizations, which assist those who by individual effort alone cannot participate actively in the economy and society.
- **Subsidiarity**[28] of the state. This comes into play in the case of natural catastrophes, but also in times of economic depression with high rates of unemployment and business collapse. Government subsidiary support may be necessary too if the contributions of tax payers are insufficient to maintain the system of social security, in the case of an aging society, for instance. Government subsidiary support however is not just a *defensive* measure. It can also stimulate innovation. In general, ecological protection needed state intervention at the outset. High-tech areas may also sometimes require state subsidies. It is important to clarify that subsidiary activities should always be

[28] Subsidiarity means in general that the higher level entity only becomes active when the lower level entity cannot solve a problem. In the social market economy, it means that the state only gets involved if individual efforts and community solidarity cannot solve an individual or social problem.

considered *transitional* and concentrated on *public goods*: they should not be designed for individual advantage.

It is self-evident that the social market economy is an open system which requires a high degree of in-built flexibility. Otherwise, citizens, social groups, entrepreneurs, and government will not succeed in achieving an optimal combination of the three principles. If there are too many subsidiary activities, solidarity and self-responsibility will be reduced or even suffocated. If solidarity is too generous, this may be exploited by persons who do not exert effort according to their capability ("social parasites"). If citizens cannot count on solidarity or subsidiary activities, society will be divided into a dominant coterie of the very rich few and a poor and dependent majority.[29]

This can be shown by a recent example of world-wide relevance: the opening of the Chinese economy in 1979. By giving more flexibility and freedom to entrepreneurs, amazing economic growth has been achieved in the last decade.[30] However, the government neglected to dedicate high priority to the social solidarity that is needed in such times of drastic change in the economic structure. Now, special social policy is urgently required to compensate for the loss of social security caused by the demolition of the technologically and economically inefficient big industrial conglomerates, which in former times took care of all the social needs of the workers and their families.[31]

Summing up these remarks, the social market economy can be defined as an economic order based on open market competition with in-built social security factors. This model cannot ever be perfect. But, as it is a flexible system, open to new ideas and developments, it aspires to improve continually by checking its effectiveness and its outcomes through international comparison and citizen satisfaction. Politicians must be ever vigilant as to the balance of the three general principles, and analysis, carried out by independent experts, should advise the

[29]A sad example of a bad mix of the three principles may be observed in many Latin American countries, where 10% of the population have 50 to 60% of the wealth at their disposal, and half the population has only 10% of the wealth. In China, too, this problem of wealth distribution has become a considerable problem, not only in regional terms but also in interpersonal terms. The poverty of small farmers and migrant workers may lead to greater social conflict if more attention is not paid to redistribution issues.

[30]The Chinese government, at the 17th Congress of the Communist Party, recognized that this growth had been achieved, at least partly, at the expense of ecological needs, which must be taken into account if the declared goal of quadrupling the level of wealth by 2020 is to be reached.

[31]Clearly, part of the economic inefficiency of those conglomerates was caused by the high costs of their social functions: organizing health services and childcare, educational facilities, and the pension system for their workers.

government how to react to changes and how to improve the system, especially since politicians habitually are inclined to maintain a more or less satisfactory system, often eschewing timely adaptations.

The social market economy, established in 1949 and further developed since then in Germany and other countries, has been challenged by two important phenomena in the last 20 years: globalization and the issue of environmental protection, both inseparable from the energy crisis and climate change. An adequate response to these challenges demands a shift in individual and social behavior as well a new thrust towards lifelong learning. It also entails a readjustment of the instruments of solidarity and subsidiary measures.

Conditions for Success of the Social and Ecological Market Economy

The SEME has been able to deliver good results in every country. Obviously, as in all economic models, the educational level and the population's access to and willingness to engage in lifelong learning are of decisive importance. Rich natural resources can help but are not a necessary condition for success, as can be seen by the examples of Switzerland or Singapore. In addition, the following four functional requirements are fundamental to achieving welfare for all, social security, and better environmental protection.

Reliable Framework Conditions

Adequate laws and an independent judicial system, respect for individual and social human rights, the possibility of participating in the political decision-making process, and a certain continuity of government policy or at least of the public service, are all indispensable to offering long-term orientation to the different economic actors. If rules are not clearly established and socially accepted, some will try to gain advantages at the expense of others or at the expense of society. Without a clear and reliable framework, the economic actors will strive to maximize short-run profits, placing their savings abroad rather than investing them in the country in which they were generated. If the framework conditions change very quickly, citizens' willingness to participate responsibly in the design of society can hardly be expected. The maintenance of stable framework conditions, however, does not mean eternal devotion to the status quo.[32] The potential for flexibility and change must also be an in-built feature of the framework. Part of the art of politics is to

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[32] In the extreme case, this happens in dictatorially governed countries where the wrong framework is maintained to the disadvantage of welfare for all, human rights, and social justice.

combine stability and flexibility, continuity and innovation. Tardy reactions to internal or external change – as has been the case in different countries' response to globalization – have led to deficits in competitiveness or lack of social security.

This may be observed in Germany, where between 1990 and 2002 economic policy and the social security system were not adjusted to take account of higher unemployment, an aging society, and the problems encountered in incorporating the eastern German population into the western social security system. The measures to reform the system, which began in 2003, caused considerable political difficulties. In this case, the framework conditions of the social market economy were still in place, but politicians did not exercise the flexibility of the model. In fairness to the democratic process, adjustments are more difficult in a multi-party democracy than in an authoritarian system, because interest groups defend their positions and thus render dialogue more time-consuming. However, such dialogue offers greater stability for the future. A strongly structured and institutionalized economy[33] is like a big tanker, changing course much more slowly than a sailing boat.

The specific ecological framework conditions are defined through scientific research and political movements. It has taken some time to recognize them as such and to introduce them in a legally binding way. Nowadays, in Germany and many other countries, environmental protection and energy savings are accorded the same importance as economic and social aims.

State Behavior

The government must clearly espouse the SEME model, expressing its commitment to prosperity, social justice, and ecological protection, while recognizing its own intervention limits. The state's active *economic* role refers, above all, to the production of public goods like health service, education, public transport, infrastructure. The state can privatize these sectors, but then has the obligation to monitor the performance and to regulate the service conditions.[34] As the citizens must behave in accordance with the system, the state, too, in the form of government organizations and the public service at the national and regional levels, must respect the SEME rules established and sanctioned by majority decision. State-owned firms have to be competitive; the public service has to work effectively.

[33]This inflexibility of different highly institutionalized countries has been analyzed by Mancur Olson Jr. in *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven: Yale University Press, 1982).

[34]Examples include the railway system or the energy sector, where the state can intervene if the tariffs exceed a rational limit and where the state can maintain the property of the physical infrastructure.

The state must protect structural plurality and foster the take-off potential of enterprises and individuals. It should offer incentives rather than intervene in the economic process. A preventive social security policy – for example a professional training system – should take priority over subsidies. Indirect transfer measures (taxes, interest rates, etc.) should be favored over direct redistribution. The state should be willing to bolster the self-responsibility of citizens and, as far as possible, to delegate control and decision-making to autonomous organizations.

Typical features of positive state behavior according to the SEME model include: central bank independence; the autonomy of trade unions and employers' organizations to arrange labor market conditions; transfer of control and professional career design to chambers of commerce and industry; delegation of control functions in the banking and insurance sector to autonomous bodies; delegation of the control of economic concentration to an antitrust organization. All these institutions, financed partly or entirely by the state, should perform their public functions independent of state intervention.

The state has a special function in the area of environment. Communication campaigns inform citizens about their obligations and advise them how they can adjust their behavior to meet ecological requirements. In the past people regarded their behavior as rather irrelevant to the world climate. Therefore, to convert the social market economy into a social *and ecological* market economy, the state has had to issue new laws and regulations and determine and implement duties and behavior codes, incentives, and punishments for producers and consumers.

As environmentally oriented activities constitute a relatively new element of the model, the temporary subsidy of activities which are ecologically more effective is compatible with the SEME model. Traditional energy resources like coal, gas, or petrol are still less expensive than energy produced by wind farms, bio-material, thermal heating, and solar cells. The more alternative and renewable energies gain credibility, the closer they get to the break-even point and so become competitive. For the present, environmental protection is of higher priority in the SEME than free competition in the energy sector. However, state support will apply only until companies reach their break-even point.

Independent and Responsible Media

The SEME is a multi-faceted model. It is hard for the average citizen to fully grasp the economic, social, and ecological processes. Therefore, effective information and communication is imperative. In the SEME, this is made possible for consumers by consumer protection associations and state regulations obliging producers to indicate clearly the content of products. Just as for consumers, adequate information is essential for firms. Producers affiliate themselves with chambers of commerce and industry, branch associations, and lobbying institutions in order to get access to relevant, timely information. In this process of communication, independent and pluralist media – newspapers, radio and television programs, and the internet – play a vital role in monitoring and motivating people. Additionally, independent expert committees must find weak points and failures in the system and inform institutions that are affected by these.

An effective communication process also depends on the educational level of the population and their interest in being well informed. If the schooling structure is inadequate or if possibilities for ongoing professional training and adult education[35] are lacking, people can hardly be expected to understand or interpret media messages. According to the SEME model, not only must the state facilitate, but it must actively support freedom of information in its own interest. Independent reporting and journalism can assist the government to recognize and respond faster to system deficits.

Relative Independence and Willingness of the Participants to Compromise

The economic and social actors, meaning the state, entrepreneurs, trade unions, autonomous public institutions, and interest groups of civil society are, in principle, independent in their decision making, while being mutually dependent (Figure 2). No single actor can fully achieve its interests without impacting in some way on the interests of the others. Sometimes there are conflicts of interest, producing winners and losers. The SEME requires, however, that the actors do not regard others as their enemies, but recognize (albeit at times only silently) that the interests of the other actors are equally legitimate. In the end, this obliges the SEME actors to compromise.

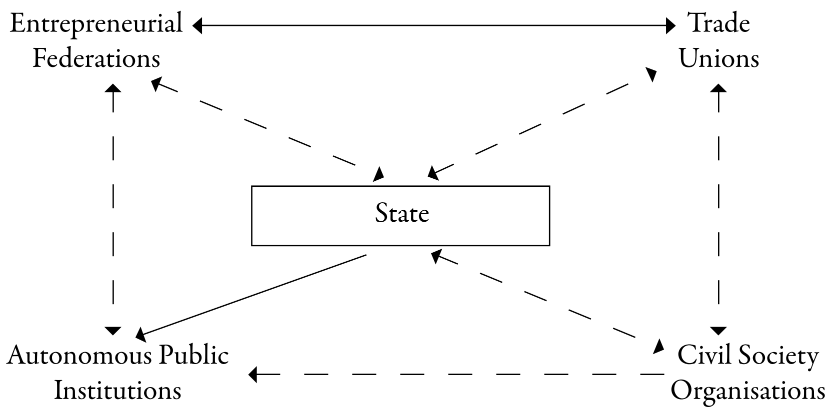
The most frequent example of this struggle for advantages is played out in the controversy between employers' associations and trade unions. While recognizing their mutual legitimacy, both institutions may employ instruments of threat in the form of a lockout or strike. Both sides know that such measures have high costs. Even in the case of widely differing opening positions, a strike would not usually go so far as to destroy the enterprise, since that would not only fail to improve working conditions or salaries, but would destroy the employment itself.

[35]In addition to public and private education in Germany, there is a dual professional education system: apprentices learn the practical requirements of the firm while attending professional schools, where they are given the theoretical background of their activity. Polytechnic schools (Fachhochschulen) offer students a more practical third level education. Adult education schools (Volkshochschulen) offer a great variety of courses for adults, while political foundations, financed mainly by the state, offer courses on political, economic, and ecological matters.

Similarly, in the case of lockout, the firm stands to lose its experienced workers, possibly entailing much more serious costs than a higher salary agreement. Social partnership is an important feature of the SEME model. This does not always imply peaceful understanding and harmony between the actors, but rather the willingness to compromise if negotiation possibilities are exhausted.[36] When both sides have reached a compromise, a truce arrangement applies, meaning that while the negotiated agreement is still in operation, strikes or lockouts are legally forbidden.

Government must also be willing to compromise. Before introducing laws which affect economic, social, or ecological interests, hearings and consultations take place that may lead to modifications of the original plan.

Figure 2: Interest Conflicts, Cooperation, and Compromises



Autonomous institutions like the central bank, the antitrust office, the chambers of commerce and industry, the institutions that regulate banks and insurance companies, the office for environment protection, the central employment agency, the national pension office, etc. are essential elements of the SEME. The state delegates sovereign functions to those institutions, which in turn are bound to show willingness to compromise. So, in its effort to combat inflation, the central bank cannot raise the interest rate to the extent that the cost of credit inhibits investment. The antitrust office has to compromise in terms of concentration issues, given the bigger market in the EU and globalization.

[36]In Germany, an independent expert is often called in as mediator in the case of a very difficult conflict. In other countries, the government intervenes.

But that does not mean that it abandons its general skepticism vis-à-vis the concentration of economic power.

There are many more examples to show how the freedom to build associations and the management of their diverging interests can complicate the process of negotiating and reaching agreements. But this is all part of the dynamic of the SEME model. If the economic, social, and ecological actors demonstrate flexibility and open-minded behavior, if they know that compromise is necessary, then the dynamic and innovative process of the SEME is guaranteed as is the continuity of an effective, partnership-oriented decision-making process.

Shaping the Social and Ecological Market Economy

It is the art of politics to take the right measures at the right time and to the right extent. The same challenge applies to shaping the SEME. In this context, local and national governments have the leading role, since the election process gives them the responsibility for the welfare of society. However, these government institutions can be successful only if they are in dialogue with the other above-mentioned economic actors, such as employers' federations, trade unions, and autonomous institutions. Civil society associations like conservation groups, nuclear power or other protestors can play an important role in this dialogue as well, especially at the local level. Intensive dialogue is also necessary within the political parties to involve the members in the decision-making process. In the case of far-reaching decisions, governments may also benefit from dialogue with the opposition.[37]

The SEME principles are relevant for almost all areas of the economy and society, but there are seven policy fields, where SEME principles particularly influence decision making. Each of these policy fields, which must be carefully analyzed, can be illustrated here only very briefly.[38]

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[37]This political dialogue will not always bring about the intended consensus. However, decisions must be taken. Those groups who feel disadvantaged by a decision have the possibility to seek affirmation or redress through the courts. In Germany, one can also take proceedings against the state to administrative courts (Verwaltungsgerichte).

[38]Several of the following articles in this book will deal with these areas in detail.

Planning and Coordination

The macroeconomic and macro-social framework is at issue here. Planning and coordination of economic, social, and ecological activities refers to the legislative competence of the government on the local, national, and international levels. The state has to clarify what constitutes a public good and consequently set its priorities for action or participation.

In order to establish a reliable reference system, the state also has to declare which of its sovereign control functions are delegated, for example, to the central bank or the antitrust office. It guarantees the freedom to create associations which represent members' interests in the planning and coordination process. It gives autonomy to trade unions and employers' associations in their negotiations on labor market conditions, and to chambers of commerce and industry, but obliges all firms to associate themselves with one of the chambers. Banks and insurance companies are free to regulate their own operations, but have to affiliate themselves with the respective regulatory institutions and solidarity funds. Subsidy priorities are fixed and made public, for example, for firms engaged in environmentally friendly activities and for research and development. Transparency is the necessary condition for clear orientation of the economic, social, and ecological actors.

Property Regime

Private property is one of the pillars of the SEME and is protected in Germany by the constitution. Property rights, both material and intellectual, constitute the basis for planning private activity. In general, private property can be used freely, except where it affects the interests of society or could damage other persons. In the SEME, limitations on the free use of property have to be established very clearly. This can be controversial where there is a social interest. Private owners can go to court if they feel that the social interests are less important than their right to private property.

In the SEME, state property is possible as well. In general, it must serve the public interest, as in the case of land for infrastructure or educational purposes.

The workers' right to codetermination in big firms, allowing representatives of the employees to participate in the board of directors, is a special feature of private property in the SEME. Although they are not the owners, workers participate in entrepreneurial decision making. In medium-sized firms and public institutions, freely elected workers' committees must be informed about the activity of the firm and participate in key decisions, such as, for example, the employment or dismissal of staff. The higher-level aim of social peace and welfare demands this limitation of private property and its free use.

Monetary Order

In general, the state decides on the type of national currency and its convertibility, while the value of the currency is determined in international markets. In the SEME, monetary decisions, originally regarded as proper to the government, have been delegated to the central bank.[39] The central bank's fundamental task is to procure the stability of the currency by using the generally acknowledged money market instruments (interest rates, rediscount rates, deposits of the private banks, etc.).

The capital market, which also serves as a source for government borrowing, is self-regulated. Because of the recent problems created by hedge funds, government circles are considering more state regulation so as to reduce the – often merely speculative – purchase of firms by hedge funds.

A new national and international "capital market" could arise with the trade of carbon certificates between those enterprises or countries whose greenhouse gas emissions are below the nationally or internationally fixed limits and those who have to buy certificates because their production is not yet within the limits. Here a new facet of the ecological enrichment of the social market economy is emerging.

It is important for the SEME shaping of the monetary order that there are alternative bank types. Germany's bank system is based on three pillars; the commercial banks, owned by families or shareholders; the savings banks, backed by a municipal liquidity guarantee; and credit cooperatives, in operation since the nineteenth century when they started to attract small savings and to borrow low cost credits. In order to prevent bank crashes, a bank regulatory institution monitors bank activities. Banks themselves have created a guarantee fund, through which they help member banks which find themselves in difficulties, in order to maintain the credibility of the banking system as a whole.

Enterprise Order

The plurality of approaches in the SEME is also expressed by the diversity of legal forms of enterprises, including shareholder companies, individually owned firms, state enterprises, and cooperatives. For each of these, the legal regulations in terms of minimal capital contribution, liability, publication duties, workers committees, tax burden, etc. are clearly defined.

The treatment and at times the support of small and medium-sized enterprises (SMEs), mostly family-owned, constitute a special case in the SEME. These firms play an important role in the area of innovation as they reach the break-even point quicker than big companies and therefore can pass innovations more quickly to

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[39] Since the introduction of the common European currency, the euro, in 1999, decisions formerly taken by the national central banks, are now taken by the European Central Bank.

the market.[40] In psychological terms, SMEs offer the advantage that workers can identify with the firm more easily than with big companies. This is because production is often more labor oriented than capital intensive and workers can see, for the most part, the final result of their work. Such identification has proved to be a stabilizing factor in times of recession. So, in general, SMEs are more flexible and often more dynamic than big companies. This societal advantage, according to the SEME model, justifies state support of these enterprises through tax reduction, technological and managerial consulting and credit facilities.

Competitive Order

The intensity of competition is the result of market processes, but the rules of the competitive system are established by government. State interventions can be used in special situations like concentration of market power, patent protection, or public interest. In general, however, competition should be as free as possible to strengthen the spirit of achievement and as regulated as necessary in order to avoid social and ecological problems. This combination of freedom and regulation leads to a *functional* competition in SEME terms: resources should be allocated in an optimal way, but not at the expense of society or the environment. Such a situation can be achieved only if markets are open to newcomers and if an official entity – in Germany, the Federal Antitrust Office – monitors the markets. In addition, the media, along with producer and consumer organizations, should strive to ensure transparency. Attempts to agree on market conditions and to control or to fix prices are banned and can attract heavy fines. Market power[41] can be achieved by higher efficiency and lower costs for a certain time, but this will be reduced if the market is open to newcomers. This open market policy is also valid for foreign investors and their products.[42] Imports, however, are subject to the same hygienic, ethical,[43] and other regulations as national products. Although free competition is a priority, it

[40]While SMEs always played an important role in the field of technological progress in Germany, in the last 20 years they have also often become pioneers in the production of ecology-linked goods and services.

[41]The question of whether a firm may be allowed to control a market and the circumstances and length of time in and for which this may apply requires intensive discussion. Market power achieved by buying out one's competitors is clearly banned if one already has a considerable share of the market. In that case, there must be good reasons to allow a merger. Obviously, the dimensions of markets have changed with regional integration, as in the case of the EU market, and with globalization, which have widened many markets and forced some firms to merge.

[42]The WTO strives for maximum freedom of international commerce. In the case of agricultural products and textiles, it has been particularly difficult to overcome national egoism.

[43]In the SEME, obviously exploitation of workers, child labor, lack of work accident insurance, etc. are banned.

is not a contradiction of SEME principles to subsidize certain products for a time and in exceptional cases. This “promotional subsidy” can be observed in innovative areas such as technology or environment protection. In particular, the latter needs subsidy, since the production of renewable energy and climate protection measures still entails higher costs than traditional production. Here, the interest of society justifies interference in the competition process, which is usually self-regulated.

The cooperation of firms on a lower level enabling them to compete on a higher level is also compatible with the SEME oriented competition order. This is typically the case of cooperatives, where, for example, smaller dairy farmers eliminate their potential competition by establishing a commonly owned dairy, which allows them to compete with bigger farmers. Another case of cooperation that eliminates competition is the existence of the trade unions where workers, actually competing with their own labor force, collaborate to form a countervailing power against employers, thus achieving better work conditions. These and other cases of cooperation have a social justification which prevails, too, over the objective of competition.

Increasingly, the national competition system is influenced by international rules. The UN Conference on Trade and Development and, even more, the World Trade Organization (WTO) try to establish rules that facilitate the world-wide commerce of goods and services and reduce the disadvantages of developing countries.[44] The International Labor Organization has influenced social standards for workers and therefore the costs of competitors. International competition is also affected by multinational initiatives like the EU, the Southern Common Market (MERCOSUR), the Association of Southeast Asian Nations (ASEAN); international groupings like the Cairns-Group, oriented to agriculture; the Group of 20, which was formed to reach better conditions in the WTO Conference in Cancun; and the politically more influential Group of Five (Brazil, China, India, Mexico, South Africa). These and other groupings show that globalization not only widens the possibilities for international competition, but also provokes countervailing trends. The same may be said about free trade agreements which the USA and EU have concluded with several countries.

In spite of these international agreements, there are plenty of opportunities for functional competition on the national level where, according to SEME principles, the individual spirit of achievement, solidarity, and subsidiary activities must be brought together in a harmonious balance.

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[44] Numerous multinational agreements have been presented and partly approved: the General Agreement on Tariffs and Trade, the General Agreement on Trade in Services, Multilateral Environmental Agreements, the Convention on Biological Diversity, Agreement on Trade-Related Investment Measures, the Agreement on Trade-Related Aspects of Intellectual Property Rights.

Fiscal Order

Fiscal policy is important in procuring for the state the necessary financial means to produce public goods and pay for public administration.[45] In times of globalization and environmental protection, fiscal policy has an additional international dimension. Corporation and profit tax, as well as the ecological regime in different countries, have influenced, at least in part, the decision of firms about where to locate. That can be seen in the new EU member states, in India, China, Vietnam, and other countries, as they attract investors from Europe and the USA. In Western Europe, Ireland presents a relatively recent example of this.[46]

The state fixes the type and rate of tax for firms and individuals. The distinction between direct taxation like income tax or profit tax and indirect taxation such as value added tax (VAT) is very important to the SEME discussion. On the one hand, direct taxes are politically more problematic because the tax payer feels directly affected and is therefore more likely to sanction those politicians responsible for this tax burden. And indeed, politicians must be careful not to seek too high direct taxation, for fear of suffocating the spirit of achievement and consequently the dynamics of economic development. On the other hand, direct taxes furnish the government with an instrument of redistribution, allowing it to charge the wealthy more than the less well off and thus to subsidize services for the whole society. Therefore the rate of direct taxation is indicative of government willingness to finance social justice.[47]

In the case of indirect taxation, the tax payer can reduce his/her burden by spending less money on the taxed service, as for example in the case of VAT, by buying less. The social problem caused by high VAT is that the less well off are more affected because their consumption quota – the percentage of income spent on consumption – is higher than that of the wealthier population. Indirect taxation can become an instrument of social policy if luxury articles attract higher taxes than basic goods. The same is true for ecological policy: pollution-causing, high-energy-consuming goods (like big cars) could be taxed at a higher rate than more environmentally friendly products.

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[45]In some countries, the central bank is still one of the finance sources of government, not so in the SEME. Here only (part of the) profits of the central bank is transferred to the state budget.

[46]Since 1973, Ireland, one of the poorest countries in the EU, has attracted investors from the USA and the European continent, thanks to lower tax rates, well-trained workers, and less regulation, converting it into the second richest EU country today.

[47]Discussions about flat rate, progressive, or linear tariffs are never ending, as well as the discussion about the top marginal rate and the level of tax-free income. An income tax of 75% (applied previously in Scandinavian countries) seems indicative of a highly socially-oriented approach. However, it also provokes tax avoidance and capital flight. This can mean that the overall tax revenue collected by the state may be lower than if a maximum rate of 42% were applied.

The distribution of tax revenue between the central government and regional or local authorities is also problematic. In Germany, a federal republic, the VAT, which generates the highest single tax revenue, is divided half and half between the federal government and the regional state governments, leaving just 2.2.% for the municipal level. In the case of income tax, 15% of the revenue remains at the municipal level and 85% is divided equally between the national and the regional levels. In order to fulfill the constitutional requirement to establish a more or less equal level of development in the entire republic, a redistribution of tax revenues is undertaken: the richer federal states of Germany have to pass part of their revenue to the poorer states.[48]

Therefore, the design and application of tax policy is a highly sensitive political issue and requires intensive dialogue between economic and social actors. The ultimate decision about tariffs and tax rates resides with the government, which has to consider the revenue aspect, macroeconomic consequences, and social and ecological implications.

Social Order

In the SEME, appropriate behavior of the economic actors should diminish the incidence of social problems. The state fixes the rates and the quota to be paid by employers and employees for pensions, health insurance, and unemployment insurance. Contributions to the social security system are shared by employers and workers according to salary level. These payments, often supplemented by private insurance, contribute to *preventive* social policy. *Curative* social policy constitutes the other element of the social order. By this is meant the pensions, health and unemployment benefits, and contributions to those who cannot maintain a decent standard of living on their income alone.

The social order demonstrates the interlinking of the three general SEME principles: responsibility of citizens to care for their own welfare; solidarity through the higher contributions of those who have higher incomes; and subsidiary activities by employers and the state.

Here education and professional training deserve special mention. Every citizen should do his/ her utmost to be sufficiently well prepared for professional life and for adequate opportunities in the labor market.[49] As education is an

[48]This redistribution process is a very political topic. Of course, the general rule that the richer must help the poorer is accepted. The question, however, is the amount that should be transferred to less developed regions. And the richer states question why the poorer ones are not able to better organize their development.

[49]In times of crisis, usually those who have invested less in their professional qualification are the first to lose their employment. The same can be observed in industrialized countries whose firms loose market share in the less sophisticated production areas taken over by developing countries at lower costs.

expensive commodity, the state must guarantee access to educational institutions. Investment in scientific research, in the different levels of education, and in lifelong learning, whether by the state, private institutions, or citizens themselves, enables countries to respond more effectively to globalization and an aging society.

In a broader sense, the ecological aspects of society are also part of the social order, being indispensable to the living conditions of present and, even more, of future generations.

Current Challenges for the Social and Ecological Market Economy

At present, the design of the SEME at the national level encounters three major challenges, globalization, environmental requirements, and changes in the social structure.

Globalization is not a new phenomenon,[50] but nowadays it presents an even more important challenge for politicians in designing the *national* economic, social, and ecological policy in dialogue with the different groups of the society. While globalization offers wider opportunities for commerce and investment, it also reduces the scope of national politicians to shape proper SEME conditions. However, this does not mean that the economic actors, and above all the state, are relieved of their responsibility to cooperate in the design and tailoring of the economic, social, and ecological order.

The second great challenge lies in the domain of the environment and climate change. Germany has taken a leading role in this field. It had introduced and continues to introduce new laws and regulations,[51] partly because of EU obligations. Germany's ecological orientation has led to high-tech innovations in the production of filters, solar cells, and geo-thermal heating and insulation systems. Far exceeding the already mentioned Kyoto aim of 5.2% reduction of emission between 2008 and 2012, Germany, according to the Ministry of Environment, has already reduced emissions by 19% in comparison with 1990 level. This challenge will remain important for the next 10 years as well.[52] Demographic change constitutes the third big challenge for the future design of the SEME:

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[50]In a certain way, although in a "smaller world", former empires had also created a globalization effect, enriching minorities while impoverishing majority segments of the populations.

[51]Some of the regulations, for example, the separation of litter or deposits for cans, once caused smiles in other countries, but were later introduced there as well.

[52]During her term as President of the EU, the German Chancellor Angela Merkel decreed the mentioned "2020" goals.

- People are now living longer, a factor that has implications for social security and health systems: either older people must get smaller pensions and reduced services or younger people will have to contribute higher amounts to the social system, or the state must fill the gap.
- Women are as well-educated and professionally prepared as men; therefore, in their wish to exercise their profession, many postpone pregnancy. That means that fewer children will be born unless the government makes provision for stronger support for young families.
- The increased migration from poorer countries makes greater demands on social services and calls for more cultural integration efforts with corresponding additional social costs.[53] Aid to developing countries could reduce migration, especially from Africa to Europe, if it is invested in productive activities that create more employment. This international solidarity is another cost factor which may reduce the ability of national governments to tackle social problems at home.

Such challenges, to which some of the EU countries and certainly Germany are exposed, can be managed within an adjusted SEME system, which is, as already pointed out, a flexible and open model, not bound to a rigid ideology. International competition might accelerate adjustments, but even the "tiger" states like China, Vietnam, South Korea, and others will reach a certain saturation point and experience higher costs for employment, social services, and ecological protection.[54]

[53]Migration problems exist in several countries on the national level as well. In quantitative terms, the inner migration in China, from the hinterland to the more prosperous coastal areas, is probably the most problematic. Migrant workers are often employed in very poor conditions and we have already cited the backwash effect. India presents another case of considerable inner migration by better educated persons towards the new centers of high-tech industry like Bangalore. Similarly in Germany, after unification in 1990, there was a notable migration of young people from east to west.

[54]David Ricardo's principle of comparative cost advantages is also valid in a globalized world, although it is no longer as simple as Ricardo's account of the exchange of wine and textiles between Portugal and England in the nineteenth century.

Conclusion

The interaction of the state, entrepreneurial federations, trade unions, and civil society associations is the cement that holds together the different blocks of the SEME edifice. The state influences the other economic, social, and ecological actors as they influence the state. Both the state and the social partners challenge social scientists to analyze their activity and to enable them to look into the mirror that reflects the level of welfare of the society. As the different actors are autonomous and play their role according to their own interests, the shifting balance of their actions can lead on occasion to frictions. Sometimes, considerable conflicts arise between the different interests, and the adjustment may be slow, but the solutions will be found in dialogue between the actors within the framework of the SEME model. To summarize the functions of the SEME actors:

The State and the Public Institutions

- establish SEME-relevant laws and the framework conditions as well as a monitoring system that ensures that the actors obey the rules;
- fix the priorities of the different economic, social, and ecological action fields;
- protect and promote functional competition;
- are vigilant with respect to the social balance in order to avoid or ease social problems;
- offer incentives and support innovations;
- produce public goods;
- set rules for environmentally friendly behavior;
- control and sanction the rules which define the SEME system;
- promote and support educational activities, professional training, and research;
- intervene in a subsidiary way when private initiatives or solidarity cannot solve problems.

The Entrepreneurs and their Institutions

- focus on productivity and competitiveness;
- search for and undertake profitable activities and reinvest – at least part of – the profits;
- monitor national and international markets and search for innovations;
- observe ecological requirements in their production;
- ensure socially acceptable conditions for their workers;
- promote and support professional training of workers;
- facilitate workers codetermination by channeling transparent flows of information;

- participate in social partnership, negotiating labor market conditions with the trade unions;
- invest in research-and-development activities;
- establish federations and pressure groups to present their interests and exchange information.

Trade Unions

- strive for socially acceptable conditions in the labor market;
- negotiate salaries through social partnership with employers' associations, respecting market conditions and the profit interests of firms;
- engage in professional training of their members;
- support worker committees in the firms in the codetermination process;
- seek international contacts as a countervailing power to multinational companies.

The Organizations of Civil Society

- engage politically to influence – at least indirectly – the other SEME actors;
- search for information in order to increase transparency in society;
- demand and support consumer protection;
- promote environmentally friendly behavior;
- support incentives for lifelong learning;
- act on the local level to improve the economic, social, and ecological welfare of individuals.

Social Science Institutions

- analyze the effectiveness of different economic models in general and check the operational efficiency of the SEME in terms of its economic dynamism, social justice, and ecological protection;
- monitor developments inside and outside the country and their influence on the SEME (globalization, demographic changes, environment, cultural changes, psychological factors of economic and social behavior, business cycles);
- analyze the different instruments of the SEME in terms of their effectiveness and dimension;
- offer consulting services[55] to the economic, social, and ecological actors.

[55] In Germany, a group of economists prepares an annual report for the government. In its public presentation, the government representative does not always look very pleased. Additionally, different scientific institutes regularly publish their short- and long-term outlooks.

In synthesis: the SEME, as seen in the experiences of different countries, especially Germany, has proven to be the best of all imperfect economic, social, and ecological systems. It creates prosperity, thanks to entrepreneurial freedom; it allows for interventions to redistribute this wealth and achieve social justice; it has effective in-built instruments of environmental protection. The SEME instruments have to be applied in a manner that corresponds to the conditions of the country in question, incorporating the exigencies of international development. Though aiming at optimal results, the SEME will never be perfect. However, it is flexible enough to allow continuous improvements and to offer solutions to economic, social, and ecological problems which come up unavoidably from time to time.

Contributing to Asian Development – German Technical Cooperation and the Relevance of the Social and Ecological Market Economy

Cornelia Richter

Introduction

The social and ecological market economy, the economic model that has shaped the economic and societal development of the Federal Republic of Germany, has resulted in comparatively stable economic performance, a reasonably equitable distribution of wealth (compared to other countries), and economic convergence between the eastern and western parts of the country. Clearly, the model, which consciously combines economic, social, and ecological goals, has been a success in Germany. In 2007 the German Federal Ministry for Economic Cooperation and Development (BMZ) defined a framework of principles based on the German model of the social and ecological market economy as the basis for economic development cooperation.

As a German-Government-owned enterprise working in international cooperation, the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH supports the German Government in achieving its development cooperation objectives. Therefore, the principles of the social and ecological market are of utmost significance for our work. We believe this model is highly relevant to our work and to future perspectives on development in our partner countries. GTZ accompanies development and transition processes in more than 120 countries in Asia, Africa, Latin America, and Eastern Europe. In Asia, GTZ is active in 15 countries.[1]

This article will describe how the model and the framework defined by the BMZ are embedded in our corporate philosophy, why we think the model is relevant for Asia, and how we translate its principles into our work. Examples of our work will be presented in this reader, focusing on private sector development,

[1]Bangladesh, Cambodia, China, India, Indonesia, Laos, Malaysia, Mongolia, Nepal, the Pacific countries, Philippines, Sri Lanka, Thailand, Timor-Leste, and Vietnam.

economic and social policies, financial systems development, and vocational training and labor market policies. In Asia, the total volume of projects in these areas in 2007 was €208 million.

The Model of the Social and Ecological Market Economy and GTZ Corporate Philosophy

With the adoption of the principles of the social and ecological market economy, the BMZ created a coherent, value-oriented framework for German development cooperation's commitment to *sustainable development*,[2] which constitutes the foundation of GTZ's mission and mandate.[3] The social and ecological market economy is built on the principle that sustainable development is only possible when economic, social, and ecological concerns are taken into account. Thus, the objectives of the social and ecological market economy are welfare for all, social justice, and environmental protection.[4]

The specific relationship among these three dimensions needs to be defined in a process of dialogue and negotiation between the state, civil society, and the private sector. Implementation of the model thus implies (1) a holistic approach that involves support at different levels and cooperation with various stakeholders (multi-level approach: national, regional, local); (2) process-orientation, for example, facilitating processes of negotiation among different stakeholders (public, private); and (3) value-orientation, on the basis of the principles of a social and ecological market economy.

While the original model of the social market economy emerged in the 1950s as an attempt to link the principle of market freedom with social equity, the model has now been expanded to integrate the element of *environmental sustainability*, which is a key requirement for long-term sustainable development. The model is thus clearly flexible enough to change and develop in response to experience and new challenges.

The social and ecological market economy is by no means a purely economic model. It was developed in the specific *social and cultural context* of Germany and Europe and similarly must take into account the societal, cultural, political, and institutional factors that shape the patterns and orientations of development in other economies. We are very much aware that simply transferring the formal institutions of the market economy, without making the necessary adjustments,

[2]See http://www.bmz.de/en/principles/aims/objectives/index.html

[3]GTZ, *Concept for Sustainable Development* (Eschborn: GTZ, 2005).

[4]See Benecke in this reader.

can lead to a loss of credibility and even political instability. The model is thus by no means intended to constitute a blueprint or a straightjacket. Rather, it is a value-based orientation that offers a range of policy options for the very specific economic, political, and societal conditions in each country.

The model of the social and ecological market economy thus takes due account of the diversity of partner countries in Asia. In newly industrializing countries, which have specific priorities and concerns as a result of their integration into global structures and markets, it will take quite a different shape than in the poorer partner countries of German development cooperation. In countries such as India and China, world market integration, reduction of social inequality, and the development of ecologically sound production processes dominate the policy agenda. These countries are thus increasingly requesting GTZ advice in the fields of social security, introduction of ecological and social standards, and the use of renewable energies.

In the least developed countries and in fragile states, on the other hand, issues such as facilitating economic and social participation are the most pressing. Supporting inclusive and pro-poor growth and equality of opportunities in these countries means facilitating productive and equitable integration of marginalized groups into economic growth processes. Innovative concepts are required in these countries, for example, insurance mechanisms that also protect poor people in the informal sector from essential risks (which may be the result of climate change).

The model of the social and ecological market economy also provides orientation in an increasingly *globalized environment*. Globalization and its effects on global structural policies, international trade, regional integration, and environmental and climate problems constitute new challenges for technical cooperation. A new global approach is required to regulate competition in globalized markets, ensure free trade, and address the challenges of climate change. Advisory services on questions of global structural policies, for example, related to the World Trade Organization (WTO) or the Global Environment Facility, must build on clear positions and values, and a clear idea of how to address the global environmental challenges in our partner countries. The model aims to find the best possible match between global challenges, and the specific national and local requirements.

For GTZ, all this implies that the principles of the social and ecological market economy translate into very different forms in our practical work. Their operationalization depends on the specific patterns and stage of development of each country, that country's position in the global economy, but equally its cultural background, traditions, and its own vision for development. For us, successful advisory services, therefore, are value oriented and build on recognition of and respect for the value system and the principles and priorities of each society.

Value orientation, a holistic concept of development, a process- and dialogue-oriented approach to change, and an emphasis on the importance of institutions are also essential underpinnings of GTZ's concept of *capacity development*. A market economy is built on capable and efficient institutions that ensure the functioning of markets as well as social cohesion. Strengthening the capabilities of our partner countries to build the required institutions is one of the basic objectives of GTZ's capacity development support.

Successfully Implementing Reforms: Values and Institutions

GTZ's long experience in technical cooperation has shown that two aspects matter most in achieving development cooperation goals and required reforms: (1) societal values and (2) the quality of institutions (their potential to develop and adjust to new circumstances). This view, which has accompanied our capacity development work for many years, has also been confirmed in economic research, most notably in "institutional economics",[5] which examines the values and institutions of societies that may foster or prevent developmental processes.

According to the institutional economists North and Denzau, not only is formal institutional development important for the development of societies, but also the "shared mental models" within a society.[6] According to them, these mental models tend to change less quickly than the formal institutions (institutions meaning both the regulatory framework and organizations). However, if the reforms and the socio-economic reality created by rapid development processes become incompatible with the mental models, there are losses in welfare and political stability is at stake.[7] Thus, institutional economists claim that development processes are path dependent, because cultural traditions and values determine the development path of a society. Not only do institutions matter, but history matters as well.[8]

This fact tends to be neglected in the world of development projects and programs, which usually have a comparatively short time horizon of two to six years. Changes in the formal institutional setting can be achieved quickly as we have seen in the

[5]International Monetary Fund (IMF), *World Economic Outlook* (Washington DC: IMF, April 2003), 104.

[6]See Arthur T. Denzau and Douglass C. North, "Shared Mental Models: Ideologies and Institutions", *Kyklos* 47, no. 1 (February 1994): 3-31.

[7]See Joachim Zweynert, "Wirtschaftskultur und Transformation" (Economic culture and transformation), *Wirtschaftsdienst* 86, no.12 (2006): 803.

[8]Ibid.

Eastern European transition process, while changes in the mental models often take more time. We also know this from our own experience in Germany, as recent reforms emphasizing the responsibility of the individual and reducing the responsibility of the state in social policies have not been easily accepted by Germans.[9]

Values

In our work, we believe it is necessary to be transparent about the values that we stand for and to enter into a long-term dialogue on principles underlying the institutional reform processes. This dialogue with our partners in Asian countries about mental models – which includes the articles in this reader – brings cultural and historical dimensions to the surface and contributes to better mutual understanding. Thus, such dialogue has a value in itself for development cooperation, but also contributes to the sustainability of our assistance.

The values underlying the model of the social and ecological market economy – our mental models – are best reflected in the principles of:

- solidarity,
- subsidiarity,
- individual spirit of achievement, and
- self-responsibility. [10]

Although this may sound very much like conventional wisdom for any professional working in development cooperation, the relevance of each principle for individual partner countries depends on the respective cultural context in that country. A number of Asian countries are in fact multi-ethnic and multi-religious and therefore have a multi-facetted set of values.

The mental models of Asian culture usually include a much stronger focus on the community and harmony than Western culture. This is rooted in, among other things, Asian religions and ideologies such as Confucianism and Buddhism, which emphasize loyalty towards the family, corporation, and nation and which sacrifice personal freedom for the sake of the society‘s stability and prosperity. Although Asia has a wide range of cultures, values, and religions, a certain level of generalization is possible. The following values are typically considered characteristic for Asia:

- predisposition towards strong and stable leadership;
- respect for social harmony and an inclination towards consensus as opposed to a tendency towards dissent or confrontation;

[9]See Welzel and Vehrkamp in this reader.

[10]See Benecke in this reader.

- acceptance of broad and penetrating state and bureaucratic intervention in social and economic affairs; and
- preference for the welfare and collective well-being of the community over individual rights.

Willingness to compromise is a precondition for the functioning of the social and ecological market economy[11] and has resulted in many consensus-building mechanisms in Germany, which also reflect the division of responsibility between the state, the private sector, and civil society in the model. This has led some to label the German society a "consensus society." The Asian preference for social harmony and non-confrontative solutions creates a common ground and an interest on the part of our partners for further exchange on the many mechanisms of dialogue and consensus building the German model has to offer.

High-Quality Formal Institutions

Clearly, for a development path to succeed, the mental models of a society must be in line or gradually brought into line with the desired reforms. However, high-quality formal institutions (meaning both the regulatory framework and the organizations responsible for designing and implementing that framework) are equally important, as the authors in this reader underline time and again. Least developed countries, but also, to a certain extent, transition countries, need to build up their institutions for economic, social, and environmental policy and regulations. Benecke, in the previous chapter of this reader, outlines seven policy fields that require a regulatory framework and corresponding organizations to define the structure and course of action in the economy: (1) planning and coordination; (2) property regime; (3) monetary order; (4) enterprise order; (5) competitive order; (6) fiscal order; and (7) social order.

One of the most essential institutions in any development process is the state. The government or parliament will usually define a nation's development objectives, and the executive will be active in the implementation of measures to achieve those objectives. We are, of course, aware that there is no agreement in the international discussion on the role of the state – on the areas in which the state should be active or which measures it should employ. In contrast with the Anglo-Saxon countries, the social and ecological market economy promotes an active and proactive state[12] that provides public services, shapes the regulatory environment, and undertakes to reconcile various interests through its interaction with the private sector and civil society.

[11]Ibid.

[12]Ibid.

The belief in an active state is shared by Asian countries – this adding yet another layer to our conviction that the social and ecological market economy is potentially a very interesting model for Asian governments to consider. However, there are also important differences between the Asian understanding of the role of the state and that of the social and ecological market economy: the social and ecological market economy stipulates that state monopolies in areas not characterized by public goods produce inefficiencies and contradict the principle of subsidiarity, while these monopolies can be found in many Asian countries.

Subsidiarity,[13] one of the key values underlying the social and ecological market economy, is particularly relevant to transition countries, because it means that the state should not engage in activities that are more efficiently provided by the private sector. Subsidiarity limits the economic role of the state to providing public goods and setting the regulatory and – to some extent – the incentives framework for the private sector and for civil society. It stipulates that the state should not engage in activities that are more efficiently provided by the private sector. This principle constitutes an important fundamental value underlying our advisory work in countries working to establish a market economy (for example, in the areas of economic policy, financial sector development, and private sector development).

The state in Germany is most active in the areas of social policy, promotion of small and medium enterprises, regional policies, and the promotion of new technologies, particularly environmentally friendly technologies. Approaches in these areas are mainly developed on the provincial level in Germany and are met by a keen interest on the part of our Asian partners, as they seek to find approaches to the challenges that face them today.

Development in Asia – Sharing the Benefits of Growth

Asia-Pacific is a region of contrasts. It has some of the fastest-growing economies in the world and, at the same time, a number of least developed countries (LDCs)[14] that continue to face persistent challenges. As a whole, the region has made significant progress in poverty reduction, already achieving some of the internationally agreed Millennium Development Goals (MDGs). China and India, which together account for nearly 40% of the world's population and rank among the fastest-growing countries in the world, contribute most of this progress, along with the "tiger" economies of East and Southeast Asia.

[13]In general, subsidiarity means that the higher level entity only becomes active when the lower level entity cannot solve a problem. See Benecke in this reader, footnote 28.

[14]Afghanistan, Bhutan, Bangladesh, Cambodia, Lao, Maldives, Myanmar, Nepal, and Timor-Leste.

However, also for those countries that have been successful in reducing their overall poverty levels, poverty remains a problem. Certain groups, mainly in the rural and more remote areas but increasingly also in urban locations, are not benefitting from the growth process:

- Almost one-third of the world's poor live in India, so that MDG 1 of halving poverty becomes very much an Indian challenge.[15] The Indian economy has grown steadily over the last two decades, resulting in a decrease of poverty from 54.88% in the 1970s to 25.7% in 2004/2005 – but this quarter of the population still continues to subsist on $0.40/day. Growth has been uneven with respect to different social and economic groups, geographic regions, and rural and urban areas. The Gini coefficient is at 0.368 (2004/2005).[16]
- High levels of inequality are found especially in China (with a Gini coefficient of 0.469 in 2004[17]), where the eastern coastal areas have witnessed successful, export-driven growth processes, while the other regions of the country increasingly lag behind.[18]
- Even though in Vietnam the Gini coefficient of 0.344 (2004) is not excessively high, distribution of wealth has a clear regional and ethnic dimension. Poverty is increasingly concentrated among the ethnic minorities, where 52.3% remain poor, compared to 10.3% among the Kinh and Chinese majority. Most of the poor continue to live in rural areas (20.4% in rural areas vs. 3.9% in urban areas).[19]

Such rising income inequality is frequently accompanied by tensions. The situation is aggravated even further when ethnic and religious issues also play a role. In many countries in Asia, highly conflictive relationships exist between ethnic minorities and the government, for example, in the case of the Hmong in the Vietnamese Highlands, the Chakma of Bangladesh's Chittagong Hill Tracts, or the Muslims in southern Thailand. While the main objectives of these movements appear from the outside to be political and cultural/religious, the underlying causes are often poverty, discrimination, marginalization, lack of

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[15]Calculated for the 1990s, using the poverty line of US$1 in purchasing power parity. See Hadnes and Klump in this reader.

[16]Indian Planning Commission, http://www.planningcommission.gov.in/news/prmar07.pdf. United Nations Development Program (UNDP), Human Development Report 2007/2008 (New York: UNDP, 2007), 283. Compare with Germany's Gini coefficient of 0.283 (2000).

[17]Ibid., 282.

[18]See Mang and Bonschab in this reader.

[19]World Bank, *Vietnam Development Report 2008* (Hanoi: World Bank, 2007), 3-4. Data is based on preliminary and unofficial information from the Vietnamese General Statistics Office.

access to public goods like education, infrastructure, health, etc., exploitation of the local and regional resources without fair allocation of government budgets, and lack of access to political representation. The governments frequently resort to force in order to handle the situation.

In many developing countries in Asia, a by-product of the impressive (but unequal) growth and job creation is the rise of labor conflicts. So-called wild strikes, motivated by violations of labor laws and workers' rights by the employers,[20] are becoming an increasing problem, also in the export and industrial processing zones. Often, there are institutional deficiencies, including weak or non-existent regulation and a general lack of dialogue mechanisms or social partnership arrangements. Thus, wild strikes are often the only way for workers to express their grievances and to make themselves heard. "Real" strikes are also on the rise as workers push for salary increases.[21]

The strong overall growth performance of Asia tends to hide the fact that the development of the Asian LDCs is lagging behind, especially those in South Asia.[22] Asian LDCs account for almost one-third of the global population in all LDCs. They vary widely. Bangladesh is the largest, with a population of more than 130 million, while Bhutan is quite small with around 750,000 inhabitants. As a result of these differences, the experiences of these countries vary widely. Like the other countries in the region, the Asian LDCs are developing, but from a lower level. Some of these countries are successfully participating in the region's growth (for example, Cambodia with a 5.5% annual growth rate in per capita gross domestic product from 1990 to 2005 and Bangladesh, which is considered one the lead performers among LDCs); others, such as conflict-ridden Nepal, have not been able to stimulate economic growth and thus foster human development.[23] For the region, the extremely dynamic development in some Asian countries represents both a challenge and an opportunity. It may result in increasing inequality leading to regional tensions or it might generate additional resources and opportunities stimulating development in the Asian LDCs.

Challenges for Asia – Ensuring future growth

Those countries in Asia that have already achieved high growth rates now face the challenge of ensuring the continuation of that growth, while also making sure that the benefits of growth are increasingly shared among their citizens. And

[20] Wild strikes are spontaneous work stoppages, implemented without any formal procedures.

[21] See Ho Sy Hung and Meissner in this reader.

[22] UNDP, *Human Development Report 2007/2008*, 247.

[23] Ibid., 279.

those countries that are still LDCs should reflect on the lessons learned from the more developed countries,[24] as they design their development strategies. Issues of competitiveness, financial stability, and the environment are taking center stage for both groups.

The competitiveness of Asian products and services has improved immensely. Globalization and falling trade barriers, however, present a threat to many developing Asian countries (and especially their small and medium-sized enterprises (SMEs) and poorer parts of their population).

- First, industries that until recently were able to survive in markets protected by high tariff barriers will be wiped out if they cannot increase their competitiveness quickly and efficiently or if they cannot move to more prosperous market segments.
- Second, in particular smaller firms may not have access to the know-how, technology, and finance they need to improve their performance.
- Third, competitiveness is often exclusively based on low labor costs, resulting in dependency on external know-how and inputs and often in an unsustainable "race to the bottom", where profit margins are so low that exploitation of workers and resources are unavoidable.

If governments do not react and develop strategies to support certain sectors or regions with effective structural instruments, whole sectors or industries may be wiped out, leading to further unemployment, increasing regional inequality, and migration to urban areas – all of this in countries without functioning social security systems. In these countries, firms need better access to information, know-how, new technology, and innovations,[25] and governments need to develop a clear structural policy[26] to strengthen and sustain the competitiveness of their

[24]For example, Malaysia, Thailand, China, Philippines.

[25]In developed countries of Asia, governments, universities, research institutions, associations, and large and small firms in the private sector work hand in hand in order to make their economic sectors more powerful and more competitive. In addition, there is a range of instruments and programs and huge networks of commercially transferred services that can help a company or an entire sector to improve technology or marketing.

[26]Please note that I am using the term structural policy in the sense of the German term s*trukturpolitik*, which is a collective term to describe all economic policy measures that aim to shape the structure of an economy. Structural policy may target either the sectoral or regional economic structure with the objective of preventing crises, for example, due to globalization. The English term *structural policy* has a different meaning, implying a policy that addresses permanent market conditions; examples include tax incentives or labor market conditions (http://www.fin.gc.ca/gloss/gloss-s_e.html).

industries (beyond low labor costs), support structural change in accordance with WTO regulations, and transfer the workforce from non-competitive to competitive sectors.

In the financial sector, managing financial risks has become more important than ever, given the large volume of financial funds flowing to emerging markets in Asia. This phenomenon, which reflects the success of these economies, also represents major challenges for the monetary authorities who manage monetary and exchange rate policies in these countries. Institutional development, in terms of setting up an effective regulatory and organizational framework for financial market supervision, has not kept pace with these challenges in a number of Asian countries. This institutional deficiency now represents a major risk for the stability of the financial sector and the economy of various countries as a whole.

The problem of climate change must be dealt with on a global scale by all governments, but also at the national level by authorities in each country. South Asia, in particular, will probably be one of the most affected areas worldwide. The coastal population in South and Southeast Asia is already facing the problem of serious flooding due to rising sea levels caused by climate change. Even under conservative assumptions, the sea level could rise to 40 cm higher than the present level by the end of the twenty-first century and submerge a huge area of the South and Southeast Asian coastal belt. Over 70 million people living along the coastal belt may be forced to relocate. In South Asia, the rapid melting of glaciers in the Himalayas is initially expected to cause excessive water flow and flooding in the region. Eventually, the full loss of glaciers would have a severe affect on the availability of fresh water in the Indus, Ganges, and Brahmaputra Rivers, which are the life-line for an estimated 500 million people in India, Pakistan, and Bangladesh, many of them poor. The associated loss of farm production, water for human needs, fisheries, river transport, and livelihood will be devastating and may completely wipe out the progress in poverty reduction achieved so far.

The Social and Ecological Market Economy as a Model for Asia

The extent to which the social and ecological market economy appears attractive to our partner countries in Asia – and thus is considered a potential model with which to address their own challenges – depends on whether or not Germany has been able to implement social, ecological and, of course, economic objectives. Asia, as far as we can see, views Germany with a certain respect due to the fact that Germany is world champion exporter, but also recognizes that there are certain weaknesses in the German model and that there is still room for improvement. However, Asian observers are aware that, during the last two decades, the social and ecological market economy has provided conceptual space in Germany for necessary ongoing reforms – to meet the challenges of reunification between East and West Germany, globalization, and immigration[27] without social unrest.

Furthermore, even though this reader only touches upon the ecological aspects of the social and ecological market economy, it is important to highlight the fact that Germany has been more successful than most other countries in integrating ecological aspects into its regulatory framework. For example, the recent "climate package" of laws (December 2007) aims to increase the percentage of renewable energy used in electricity production, housing, and fuel to 18% by 2020.[28] Industrial policy has been successfully employed in Germany to support the development of environmental technologies, providing the business sector with new markets and new business opportunities. The German example shows that adjustment to the challenges of climate change creates opportunities and does not necessarily harm competitiveness.

The institutions that had been developed on the basis of the model in West Germany, most importantly mechanisms to reconcile and unite different interests, have made these adjustment processes possible. The social and ecological market economy brings together economic, social, and ecological objectives, but the responsibility is shared – for example, the private sector also has a social responsibility, which is embedded in the German constitution.[29] Thus, a system of social partnership unites employers and employees at the enterprise level, where they work together to further the company's welfare – for example, the co-determination system gives employees one-third of the seats in the supervisory board of a firm, which allows them to participate in decision making and at the same time to exercise an important control mechanism over the management board.

Social objectives are not only achieved through social security measures, like health services, pension systems, and the like, but most importantly by providing equal opportunities to all citizens. The German constitution calls for an equal standard of living for German citizens, no matter in which area of the country they live and work. This equality is pursued through the education system (most prominently, the dual system for technical and vocational training, where the

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[27] According to the 2005 Micro-census, 18.6% of the residents in Germany are migrants or children of migrants. See www-ec.destatis.de, Fachserie 1, Reihe 2.2, Bevoelkerung und Erwerbstaetigkeit, Wiesbaden 2007.

[28] http://www.bmu.de/pressemitteilungen/aktuelle_pressemitteilungen/pm/40896.php (29.02.2008).

[29] The German constitution states that "property entails obligations" (Eigentum verpflichtet). See Benecke on the consequences for the private sector.

state and the private sector take on a shared responsibility for educating the country's youth[30]), regional development mechanisms (with the reunification between East and West Germany as the best example), and other instruments.

The specific structure of the German economy, with its multitude of small and medium enterprises (the so-called Mittelstand), is another way that the model attempts to provide welfare for all, one that has greatly interested many of our partners. There is a set of policies in Germany that specifically targets SMEs.

The model of the social and ecological market economy has clearly been successful in Germany, and it is also popular among Germans precisely because it aims to provide welfare for all. However, there is also clearly need for further reform. A recent study on social justice that compared Germany to other groups of countries with a different welfare system shows a mixed picture: Germany is ranked a little higher than the average of the continental European welfare states, much higher than the Anglophone countries, but lower than the Scandinavian countries. The main problem according to the study is the inflexibility in the labor market, which creates high entry barriers for certain segments of the labor force. The debate in Germany focuses on the necessity for further reforms in social policies.[31]

There is a wide range of opinions: Hein and Truger,[32] on the one hand, argue that social achievements (including labor market regulation) do not harm the competitiveness of the German economy, and that unsatisfactory growth performance is mainly the result of strict monetary policies and failure to stimulate economic demand. Welzel and Vehrkamp,[33] on the other hand, point out deficiencies that still need to be addressed to enhance competitiveness, particularly in the area of labor laws and education.

Furthermore, the effects of globalization have led to a widening of the income gap in Germany, refueling the debate on social justice and leading to calls for new instruments to achieve it. Certainly, there is need for further reform, particularly with respect to achieving a new balance between the economic and social goals of the German model. The debate on how to achieve more social justice while maintaining

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[30]See Baur and Pfeiffer in this reader.

[31]See Wolfgang Merkel, "Soziale Gerechtigkeit im OECD-Vergleich" (Social justice compared in OECD countries) in *Soziale Gerechtigkeit – eine Bestandsaufnahme* (Social justice – taking stock), eds. Stefan Empter and Robert B. Vehrkamp (Gütersloh: Bertelsmann Stiftung, 2007), 233-257. Whether or not this level can be viewed as satisfactory is hotly debated in Germany at present. See Benecke in this reader.

[32]See Hein and Truger in this reader.

[33]See Welzel and Vehrkamp in this reader.

competitiveness is ongoing in Germany; however, all agree that for Germany the social and ecological market economy has provided a flexible framework for change. This debate and also the reforms implemented in the last years provide a wealth of ideas and experience that we can share with our partners in Asia.

It is important to underline that the German Federal Ministry for Economic Cooperation and Development's new *Regional Strategy* for Asia explicitly reflects the principles of the social and ecological market economy and specifies them further for the diverse and dynamic Asian context. Socially balanced economic development, ecologically sustainable development, and democratization and human rights, good governance, and conflict reduction are the strategy's three core objectives. In order to promote sustainable economic development in Asia, the German contribution is structured around three modules: (i) strengthening economic competitiveness, especially in smaller and medium-sized enterprises; (ii) developing and upgrading social security and service systems; and (iii) mobilizing the informal sector.

Outlook

The objective of this article has been to reflect on the relevance of the model of the social and ecological market economy for Asia. It has given initial indications of how the model can respond to the challenges of globalization and increasing inequality in Asia, and how values such as equal opportunity, social justice, fair competition, and ecological sustainability can contribute to fair and sustainable development. It has also provided examples of how this orientation is translated into practical approaches to technical cooperation in different country contexts.

The articles in this reader delve into these issues in much greater depth. They endeavor to shed light on the relevance of the model for Asia from the three different perspectives that this article could just briefly touch upon:

1) **From the perspective of academia:** The reader contains contributions from German researchers who reflect on the further development of the social market economy in Germany and the ways in which Germany is dealing with some of the challenges it is facing at present; they also review how key principles and elements of the German experience translate into practical concepts of possible relevance for Asia.

2) **From the perspective of Asian economists:** Another set of articles examines the significance of the model from an Asian viewpoint in the context of different Asian countries. They assess how elements of the model can provide policy options under different circumstances, and how relevant aspects may already be reflected in ongoing debates on societal values in some of their countries (for example,

market economy with a socialist orientation in Vietnam, the harmonious society in China).

(3) **From the perspective of development cooperation practitioners:** Finally, several articles review how the elements and principles of the social and ecological market economy have translated into practical concepts and policy options for implementation of technical cooperation at the country level. These practical lessons from experience have frequently been elaborated in a joint effort between the GTZ advisors and their counterparts. At the same time, these articles reflect the range of relevant GTZ services and the areas which should be developed further in the light of the principles of the German model.

In a nutshell, the overall objective of this reader is to create a platform for dialogue and exchange between different perspectives, visions, and experiences. The concept underlying this reader thus immediately reflects a fundamental principle of the social and ecological market economy and equally of GTZ's approach: the importance of stimulating processes of dialogue and exchange, and creating forums for a sustainable and effective discussion between the state, the private sector, and civil society.

In GTZ's understanding, technical cooperation can only be effective and lead to sustainable results if it is based on a cooperative and dialogue-oriented approach between all partners involved. While official agreements on development cooperation are generally concluded between the German and the partner governments, effective implementation must involve and ensure ownership by all relevant stakeholders, including the private sector and civil society. Furthermore, cooperation with Asia increasingly builds on a two-way dialogue, in which Europe has as much to learn and benefit from Asian experience as vice versa.

To innovate further and hone its approaches, GTZ engages in an extensive exchange with academia and applied researchers, both nationally and internationally. We believe that only through close exchange with the research community can we develop our work in line with the best international thinking and research – and also critically reflect upon our approaches. For this purpose, GTZ has joined hands with leading development economists to create the Poverty Reduction, Equity, and Growth Network (PEGNet). The PEGNet brings together researchers with an interest in issues revolving around the poverty-inequality-growth nexus in developing countries, and links them to the German development policy bodies.

Furthermore, we are also deeply engaged in international forums and networks with other development agencies and donors, for example, the Donor Committee for Enterprise Development, where GTZ plays an active role on behalf of the BMZ. These allow us to learn from each other and harmonize key principles and approaches, but they also constitute a platform for bringing crucial concerns into the international discussion, for example, the issue of whether or not there is a proactive role for the state to play in creating the preconditions for competitiveness in globalized and knowledge-intensive markets and in ensuring a pro-poor orientation of growth.

While this reader presents a range of cases where the principles of the social and ecological market economy have effectively helped to address key challenges and requirements of our partner countries and have been translated into sustainable policy options, I would also like to highlight a few areas which, in my opinion, deserve more attention in our work.

This article has already referred to the importance of specific cultural and historical patterns, in other words, the shared mental models, within each society. We need to pay even more attention to this field, and deepen our understanding of these models. A systemic and value-oriented approach to capacity development must systematically consider the respective societal values and institutions and integrate the specific cultural, societal, and historic values and development patterns.

We have seen the importance of dialogue and cooperation mechanisms for ensuring ownership and inclusion. So far, the emphasis has been on dialogue between the public and the private sector and, to a lesser degree, on ways to involve civil society. The experience of the social and ecological market economy teaches us the importance of involving representatives of the workers and trade unions; mechanisms of co-determination constitute an essential building block of the success of the German social market economy. Capacity development in shaping social partnerships as well as approaches for corporate governance, which include elements of co-determination, for example, should therefore be integrated in private sector development.

Given the environmental challenges Asia is facing, supporting ecological sustainability is a clear priority. The lack of contributions to this reader on the environmental dimension indicates that economic development approaches need to consider environmental sustainability in a more integrated and systematic manner. For example, more thought should be given to ways to address ecological aspects within the framework of economic policy, perhaps by supporting partner countries in designing ecological tax reforms on the basis of the German experience and establishing a regulatory environment compatible with ecological sustainability.

To conclude, I would like to underline that I am convinced – and this reader fully supports my conviction – that for GTZ, the model of the social and ecological market economy constitutes a solid framework for our advisory services and for cooperation with our partner countries. For our partners, it hopefully presents a model that can help them reconcile the objectives of growth and welfare with their respective culture and value system.

We look forward to further developing this approach in close dialogue with our partner organizations as well as our international partners, both in the academic and the donor communities. In particular, we hope to continue the dialogue which has been initiated through this reader in an Asia-wide conference on the social and ecological market economy scheduled to take place at the end of 2008.

Part 2

Academic Perspectives

German Economic Policy at a Crossroads

Eckhard Hein and Achim Truger

Ever since the mid-1990s, the German economy has performed far worse than the economy of the euro zone as a whole.[1] However, public awareness only really focused on this lag after the 2000/2001 downturn. From 2001 to 2005, real gross domestic product (GDP) growth rates were low, at times even negative. The economic stagnation led to a significant radicalization of the economic-policy debate. The overwhelming majority of German economists, journalists, and business representatives maintained that Germany was undergoing a deep "structural crisis" as a result of over-regulated labor markets and employment-adverse social security systems. Radical "structural" reforms therefore appeared to be the only way out of the crisis. By the second legislative period of the Social Democrat-Green government, proponents of radical reform managed to also push through corresponding economic policies, the AGENDA 2010 and the Hartz Laws. The grand coalition in power since the end of 2005 has not deviated from these policies to any significant degree.

In 2006 Germany experienced an unexpectedly strong expansion. In international comparison, German's economy grew at the same rate as the economy of the entire euro area. Nevertheless, warnings still persist that the reform efforts must not be relaxed, so as not to endanger the results of past efforts and cutbacks. This point of view is astonishing and – if it has economic policy consequences – dangerous. It is astonishing because it does not ask why the German economy stagnated for more or less five years, while most of the euro zone economies and also those of very different countries like Great Britain, Sweden, and the USA recovered quickly after the 2000/2001 downturn and had significantly higher growth and lower unemployment rates than Germany.[2] And such a standpoint is dangerous, because a continuation of "structural reform" policies threatens to further burden economic developments in Germany.

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[1]See Eckhard Hein and Achim Truger, "What ever happened to Germany? Is the Decline of the Former European Key Currency Country caused by Structural Sclerosis or by Macroeconomic Mismanagement?" *International Review of Applied Economics* 19 (2005): 3-28.

[2]For a comparison of Germany with Great Britain and Sweden, see Eckhard Hein, Jan-Oliver Menz, and Achim Truger, "Warum bleibt Deutschland hinter Schweden und dem Vereinigten Königreich zurück? Makroökonomische Politik erklärt den Unterschied," *IMK Report* Nr. 15 (2006), Düsseldorf.

In this article, we call into question the diagnosis of "structural sclerosis" of the German economy and the resulting strategy of "structural reforms." In our opinion, the German stagnation from 2001 to 2005 cannot be explained by the failure to implement structural reforms of the labor market and the social security systems or delays in implementation of such reforms, but by macroeconomic mismanagement, in other words, by misguided monetary, wage, and fiscal policies, imposed, in part, at the European level (European Central Bank – ECB, Stability and Growth Pact – SGP) and promoted, in part, by the mistaken German reform zeal.

Germany's Stagnation from 2000 to 2005

Compared to the euro zone average and to the USA, Germany was particularly hard hit by the downturn of 2000/2001 (Table 1). While average annual real GDP growth of the euro area (including Germany) was 1.4% and thus significantly less than that of the USA in the period from 2001 to 2005, Germany's average annual growth in that period was 0.7%, just half of the euro area's growth rate.

In contrast to the euro zone as a whole, the weak German growth was carried exclusively by the export surplus. Domestic demand, on average, had a negative impact on growth from 2001 to 2005. Overall, the German economy was characterized by a high degree of international competitiveness, on the one hand, and considerable weakness of domestic demand, on the other hand. Because of the weak growth, employment declined in Germany from 2001 to 2005, whereas it increased in the euro area and in the USA. The German unemployment rate, which had always been below the euro area average before 2002, rose above it. German inflation, on the other hand, was well below the euro area average, as it had been since the mid-1990s.

Table 1: Real GDP Growth, Growth Contribution of Demand Aggregates, Unemployment Rate, and Inflation Rate in Germany, the Euro Zone, and the USA
average value for 2001-2005 (in percent)

	Germany	Euro zone	USA
Real GDP, annual growth rate	0.7	1.4	2.6
Growth contribution of domestic demand including change in stocks	-0.2	1.3	3.0
Growth contribution of private consumption	0.2	0.8	2.2
Growth contribution of public consumption	0.0	0.3	0.5
Growth contribution of fixed capital formation	-0.4	0.2	0.5
Growth contribution of balance of goods and services	0.9	0.1	-0.5
Employment, annual growth	-0.2	0.8	0.7
Unemployment rate	8.7	8.5	5.4
Inflation rate[1]	1.6	2.2	2.5

Notes: [1]Germany and euro zone: Harmonized Consumer Price Index (HCPI), USA: national Consumer Price Index (CPI)
Source: European Commission, annual macro-economic database (AMECO), 2006, http://europa.eu.int/comm/economy_finance/indicators/annual_macro_economic_database/ameco_en.htm (February 8, 2007). OECD (2006), Economic Outlook, 2006, http://www.oecd.org/document/61/0,2340,en_2649_201185_2483901_1_1_1_1,00.html (February 8, 2007). Authors' calculations.

Reform Deadlock?

For most German economists, the explanation for the growth and employment problems at home is clear and simple: rigid and over-regulated labor markets, as well as employment-adverse social security systems are held responsible for the German crisis. This viewpoint is based on a simple neo-classical model, according to which (long-term) unemployment can only be caused by disruptions to the labor market that prevent a market-clearing real wage from emerging.[3] Collective wage bargaining (for example, sector-wide wage agreements), labor-market

[3]See, for example, Horst Siebert, "Labor Market Rigidities: At the Root of Unemployment in Europe", *Journal of Economic Perspectives* 11 (1997): 37-54.

regulations (for example, employment protection, minimum wages), and the social security systems (for example, unemployment benefits, tax wedge) have been identified as the cause for long-term unemployment and therefore also for weak growth. In this view, there is only one solution for the problems: reduction of labor-market rigidities through more flexibility and decentralization of collective wage negotiations (for example, through company-level pacts), deregulation of the labor market (for example, by dismantling employment protection), reduction of unemployment benefits (for example, Hartz IV), and lower non-wage labor costs.[4]

We have elsewhere explored at length the general theoretical and empirical deficiencies of such a viewpoint.[5] However, far more important for the German discussion is the fact that even if the "institutional sclerosis" view were theoretically and, in general, empirically convincing, it would not be applicable to developments in German labor market institutions, social security systems, and unemployment. Looking at the indicators usually cited for the rigidity of the labor market and social security systems (employment protection, unemployment benefit replacement rate and duration, union density, bargaining coordination, tax wedge) in Germany, one finds that these have not worsened, either absolutely or relative to the European Union (EU), the euro area, or the Organization for Economic Cooperation and Development (OECD) countries, since the slump in growth and employment during the mid-1990s. Table 2 demonstrates this by way of an aggregate indicator for institutional sclerosis and its development from the beginning of the 1980s until the end of the 1990s, which we calculated from the individual indicators. It shows that Germany reduced "institutional sclerosis" more clearly than all other countries or groups of countries, significantly reduced the gap vis-à-vis the OECD countries, completely overcame the gap vis-à-vis the EU average, and even did better than the euro area average.

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[4]See, for example, the majority view in German Council of Economic Experts, Annual Report 2005/2006, *Seize the Chance – Boldly Advance the Reforms*, Berlin, 2006, as well as the Joint Forecast of the Working Group of German Economic Research Institutes, "Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 2005," *DIW Weekly Report* 43/2005: 605-655. See also Deutsche Bundesbank, "Ways Out of the Crisis", Frankfurt, 2003; European Commission, "Germany's Growth Performance in the 1990's," Economic Paper Nr. 170, Brussels, May 2002; and *OECD, Economic Survey – Germany 2004*, Paris, 2004.

[5]See Hein and Truger, "What ever happened to Germany?" (Footnote 1).

Table 2: Aggregate Indicator for "Institutional Sclerosis"[1] 1980-84 and 1995-99

	1980-84	1995-99
Germany	57	52
OECD[2]	49	47
European Union[3]	53	52
Euro zone[3]	52	53
USA	20	18

[1]Arithmetic mean of the indicators for employment protection legislation, unemployment benefit replacement rate, unemployment benefit duration, union density, bargaining coordination, and tax wedge, each scaled to the interval [0;100].
[2]Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, The Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, USA.
[3]without Greece and Luxemburg.
Source: Dean Baker, Andrew Glyn, David R. Howell, and John Schmitt, "Labor Market Institutions and Unemployment: A Critical Assessment of the Cross-Country Evidence", in *Fighting Unemployment. The Limits of the Free Market Orthodoxy*, ed. David R. Howell (New York: Oxford University Press, 2005). Authors' calculations.

The conclusion that structural reforms in Germany have proceeded at an above-average pace in international comparison – particularly in the last ten years – is also supported by two newer studies: first, a study by Deborah Mabbett und Waltraud Schelkle of reforms in employment protection legislation and unemployment benefits to the end of 2002 (Table 3)[6] and secondly, the recent "OECD Jobs Strategy Reassessment." The OECD, which has been one of the most prominent proponents of the need for structural reform, in general and particularly in Germany,[7] certifies that Germany's reform activity was well above the average from 1995 to 2005:[8] according to its "reform intensity indicator," Germany places fourth among the 30 countries studied and third within the euro zone, behind the Netherlands and Finland.

[6]See Deborah Mabbett and Waltraud Schelkle, "Bringing Macroeconomics back into the Political Economy of Reform: the Lisbon Agenda and the 'Fiscal Philosophy' of EMU," *Journal of Common Market Studies* 45, no.1 (2007): 81-103.

[7]OECD, *The OECD Jobs Study: Evidence and Explanations* (Paris: OECD, 1994).

[8]OECD, *OECD Employment Outlook: Boosting Jobs and Incomes – Policy Lessons from Reassessing the OECD Jobs Study* (Paris: OECD, 2006).

Table 3: Reform Intensity[1] in 14 EU Countries

	1987-1994	1995-2002	1987-2002
Belgium	5	7	12
Denmark	4	10	14
Germany	**-2**	**17**	**15**
Finland	4	16	20
France	-3	-12	-15
Greece	0	9	9
Great Britain	5	5	10
Ireland	5	3	8
Italy	1	13	14
The Netherlands	2	24	26
Austria	-1	13	12
Portugal	0	-3	-3
Spain	5	0	5
Sweden	4	15	19

Note: [1]Sum of the two reform intensity values assigned by Mabbett and Schelkle, i.e. the sum of the reform intensity value of reform measures in the areas of employment protection and unemployment benefits for each country in the respective period on the basis of the Fondazione Rodolfo Debenedetti Social Reforms database. Positive values signal "increasing flexibility" (i.e. less labor protection and lower benefits). Negative values indicate "decreasing flexibility" (i.e. more labor protection and higher benefits). Mabbett and Schelkle measure the reform intensity of a reform package by assigning a value of 1 to reforms the databank classifies as "marginal," and 2 to those classified as "structural". Reform packages with more than one measure receive an intensity value of 2 if they contain two or more marginal measures and an additional 2 for including a structural measure (thus 4 is the maximum value for any one reform package, while 2 is the maximum value for packages that contain only marginal measures).
Source: Deborah Mabbett and Waltraud Schelkle, "Bringing Macroeconomics back into the political economy of reform: the Lisbon Agenda and the 'fiscal philosophy' of EMU", 2005, http://eprints.bbk.ac.uk/archive/00000259/01/BringingMacroeconomicsBackIn.pdf (February 8, 2007). The Fondazione Rodolfo Debenedetti Social Reforms Database, http://www.frdb.org/documentazione/centro_doc.php (February 8, 2007). Authors' calculations.

Given the background of this empirical evidence, it is very difficult to attribute the German growth and employment problems to overly rigid labor markets and a lack of structural reforms. The suspicion thus arises that the diagnosis behind the current economic policies was and is wrong.

Table 4: Indicators for Monetary, Fiscal, and Wage Policies in Germany, the Euro Zone, and the USA
average 2001-2005

	Germany	Euro zone	USA
Monetary policy			
Short-term real interest rate, percent	1.2	0.6	-0.2
Long-term real interest rate, percent	2.6	2.1	1.9
Short-term real interest rate minus real GDP growth, percentage points	0.5	-0.7	-2.8
Long-term real interest rate minus real GDP growth, percentage points	1.9	0.7	-0.7
Fiscal policy			
Government budget balance, percentage of GDP	-3.5	-2.5	-3.5
Structural budget balance as a percentage of potential GDP, annual change, percentage points	-0.1	0.0	-1.0
Output gap as a percentage of potential GDP, annual change, percentage points	-0.8	-0.6	-0.3
Number of years with pro-cyclical fiscal policy during an economic slowdown	3 (2003-5)	3 (2003-5)	0
Negative fiscal stimulus in an economic slowdown, cumulative, percent of potential GDP	1.7	1.1	--
Wage policy			
Compensation per employee, annual change, percent	1.8	2.5	3.9
Nominal unit labor costs, annual change, percent	0.2	1.7	1.7
Labor income share,[1] percent	64.9	65.3	67.2
Change in labor income share to previous year, percentage points	-0.6	-0.3	-0.4

Notes: [1]Compensation per employee divided by GDP at factor costs per worker.
Source: European Commission (Table 1). OECD (Table 1). Authors' calculations.

Macroeconomic Mismanagement

A macroeconomic explanation for the weakness in German employment and growth can be based on both Post-Keynesian and New Keynesian theory. The latter now comprises the new international mainstream in macroeconomics.[9] According to these theories, an inadequate or uncoordinated use of macroeconomic instruments, that is, monetary, wage, and fiscal policies, can easily be the explanation for low growth and high unemployment over a longer period.

Monetary Policy

With the start of the European Monetary Union in 1999, Germany lost the status of a regional key currency country in the European Monetary System (EMS) and the related interest-rate advantages. Because nominal interest rates have converged since 1999 while the inflation rate in Germany is below the euro zone average, Germany now has significantly higher real interest rates than the rest of the euro area. On average for the years 2001-2005, the policies of the ECB resulted in a short-term real interest rate of 1.2% for Germany, although it was only 0.6% for the euro zone as a whole (Table 4). And while the short-term real interest rate in the euro zone was positive throughout the 2001-2005 period, the Federal Reserve pushed through a negative short-term real interest rate of -0.2% in the USA. This expansive monetary policy contributed to the rapid recovery of the US economy after the 2000/2001 slump. The difference between short-term real interest rates and real GDP growth, as an indicator for the growth friendliness of monetary policy, was on average clearly negative for the years 2001-2005 in the USA. The ECB reacted much more hesitantly and less expansively to the growth downturn and thus contributed to the weak growth in the euro zone and particularly in Germany since 2001. While the difference between short-term real interest rates and real GDP growth was slightly negative on average in the euro area between 2001 and 2005, it remained positive in Germany.

The German economy thus not only suffered from the loss of the interest rate advantage as a result of the currency union, but was also especially affected by the growth-unfriendly policies of the ECB after 1999. However, Germany's poor performance from 2001 to 2005 can be attributed only in part to these factors, given that monetary policy in a currency union can take into account only average inflation and GDP developments, and not the special situation of an individual country.

[9] Eckhard Hein, Arne Heise, and Achim Truger (eds.), *Neu-Keynesianismus – der neue wirtschaftspolitische Mainstream?* (Marburg: Metropolis Verlag, 2005).

Fiscal Policy

Given that the ECB was neither willing nor able to stabilize the German economy after 2000, German fiscal policy should have worked to counteract the macroeconomic shock. However, it did exactly the opposite: it attempted to consolidate the budget pro-cyclically and thus worsened the crisis. One reason for this was the pressure from the Stability and Growth Pact (SGP), as Germany's budget deficit continually exceeded the 3% limit from 2002 to 2005. On the other hand, however, it was also the result of the economic policy recommendations of the German economics mainstream, which pushed for expenditure consolidation of the government budget, regardless of the cyclical situation.[10] The attempt was obviously unsuccessful (Table 4).

The actual budget balance is not an appropriate indicator with which to evaluate the cyclical orientation of fiscal policy, because it cannot be controlled by economic policy, but is the result of the overall macroeconomic process. We therefore use instead the structural budget balance, in other words, the cyclically adjusted budget balance in relation to potential GDP, and compare its development with movements in the output gap, in other words, the difference between actual and potential output.[11] If there is a positive change in the output gap, the economy is in an upturn; a negative change indicates a downturn. The change in the structural budget balance indicates the direction of fiscal policy: if there is a positive change, structural deficits fall or surpluses increase and fiscal policy has a restrictive impact. If there is a negative change, structural deficits rise or surpluses are reduced and fiscal policy is expansionary.

Measured in this way, German fiscal policy from 2001 to 2005 was pro-cyclically restrictive in three of these years and thus intensified the downturn (Table 4). The cumulative negative fiscal impact amounted to 1.7% of potential GDP over the entire period. Fiscal policy in the euro zone was also pro-cyclically restrictive in three of the years, although the cumulative negative fiscal impact was only 1.1%

[10]See, for example, the majority view in German Council of Economic Experts and the Working Group of German Economic Research Institutes (Footnote 4).

[11]The cyclically adjusted budget balance is the budget balance that would have resulted if actual GDP were exactly equal to potential GDP (output gap = 0). If capacity is outstripped (output gap > 0), i.e. a cyclical upturn, actual tax receipts are greater than potential tax receipts, and because of low unemployment, actual public expenditures are less than potential public expenditures. If capacity is not fully utilized (output gap < 0), the reverse is true. Through this cyclical adjustment, the cyclical elements of the budget balance are calculated out. The resulting cyclically adjusted balance can be interpreted as a measure of the true influence of fiscal policy on the economy, while policy and cyclical factors are mixed in the actual budget balance. Of course, short-term cyclical and long-term structural influences cannot be statistically separated with absolute certainty.

of potential GDP. Thus, although the cyclical downturn was much stronger in Germany than in the entire euro area – the output gap declined annually by 0.8 percentage points in Germany versus 0.6 percentage points per year in the euro zone – German fiscal policy was considerably more restrictive. The fiscal-policy response in the USA, in contrast, was strongly anti-cyclical between 2001 and 2005: the structural budget balance was reduced by one percentage point per year on average. In the euro area and in Germany, this balance was maintained or reduced by only 0.1 percentage point a year, although both experienced a much steeper decline in the output gap.

The restrictive and destabilizing orientation of German fiscal policy becomes even clearer, when the development of individual expenditure categories is examined (Table 5). Real total government expenditures fell by 0.2% per year from 2001 to 2005, while they increased by 1.4% a year in the euro area and, even more sharply, by 3.6% per year in the USA. Real public consumption in Germany declined by 0.3% a year; real public investment fell dramatically by 4.0% a year. The ratio of public investment to GDP was therefore only 1.5% in the 2001-2005 period and thus a good percentage point below the values for the euro zone and the USA. This development is particularly alarming, given that public investment is not only an essential component of effective demand in the short term, but also a key prerequisite for private investment and economic growth, through the related provision of public infrastructure.

Table 5: Annual Growth Rates of Selected Fiscal Policy Aggregates in Germany, the Euro Zone, and the USA
average 2001-2005 (in percent)

	Germany	Euro zone	USA
Real total government expenditure[1]	-0.2	1.4	3.6
Real government consumption[1]	-0.3	2.0	4.3
Real government fixed capital formation[2]	-4.0	1.5	3.2
Real government revenue[1]	-1.3	0.8	0.3
Government gross fixed capital formation (percent of GDP)	1.5	2.5	2.7

Notes: [1]deflated using the HCPI; [2]deflated using the deflator of gross fixed capital formation.
Source: European Commission (Table 1). Authors' calculations.

Wage Policy

The development of wages, measured as compensation per employee – compared with the rest of the euro zone or the USA – was also particularly restrictive in Germany from 2001 to 2005, as it had been already since the mid-1990s (Table 4). Growth in German unit labor costs was therefore well below the euro area average, which was the main reason for the below-average inflation. In 2004 and 2005, unit-labor-cost growth was even negative, so that wage developments represented a significant risk of deflation, in other words, the risk of falling output prices and rising real debt, particularly of businesses, with the corresponding negative effects on investment. Falling output prices did not materialize because the prices for imported energy as well as government fees and taxes rose, and firms could also increase their profit margins.

Although German below-average wage developments, compared to the rest of Europe, were dominant for long phases even before the currency union, at that time they were the basis for the German position as key currency country in the EMS, which allowed the German Bundesbank to set lower nominal and real interest rates than prevailed in the other countries.[12] In contrast, after the monetary union, German wage restraint, as the basis of the below-average inflation rate, was penalized by above-average real interest rates. The moderate wage movements in Germany also contributed to a greater fall of the labor income share. Together with the general uncertainty caused by the structural reform policies, the massive redistribution to the detriment of workers was the main reason for the everywhere bemoaned weakness of consumption and internal demand. The trend of falling labor income share continued also in the entire euro zone in the 1990s, although with a slower speed than in Germany since 2001. In the USA, in contrast, it proved possible to the arrest the tendency towards falling labor income shares in the 1990s, so that this share now lies around two percentage points above that in the euro zone or Germany.

Wage restraint in Germany certainly increased the international price competitiveness of German firms, so that export surpluses almost quadrupled between 2001 and 2005. Nevertheless, this export success was not enough to compensate for the weakness in domestic demand. Because over 40% of German exports go to the euro zone, the growing German export and current account surpluses are accompanied by increasing current account deficits or declining surpluses in the partner countries within the monetary union. Since the other countries can no longer use a nominal devaluation to defend themselves, they are under growing pressure to also pursue wage moderation and demand-dampening

[12]See Hein and Truger, "What ever happened to Germany?" (Footnote 1).

policies in order to improve their competitive position. The deflationary risks emanating from wage developments in Germany therefore increasingly threaten to radiate into the euro area. German wage movements have thus become a dangerous powder keg for the currency union.

Final Remarks and Conclusion

The essential causes of German stagnation from 2001 to 2005 are not found in over-regulated labor markets and employment-adverse social security systems. On the contrary, unmistakable macroeconomic mismanagement, in part at the European level (ECB, SGP) and in part homegrown, was responsible for weak growth and high unemployment. The fact that there was an upturn in 2006 and that the five-year stagnation did not continue is the result of the reform pause and the less dampening position of the public budget in that year, which made it possible for the foreign trade stimulus to spring over to internal demand, especially to investment. However, the recovery has nothing to do with the reform policies of previous years; these explain only why the recovery in Germany was so long in coming.

The continuation of structural reform policies and attempts to consolidate the government budget by means of expenditure cuts would again destabilize the economy. What is required instead is macroeconomic policy reorientation, in other words, more expansive monetary and fiscal policy and stabilizing wage developments, which again make use of the room to maneuver between the target inflation rate of the ECB and long-term national productivity growth.

Social Market Economy 2.0 – An Appraisal in the Light of Current Reforms

Carolin Welzel and Robert Vehrkamp

Introduction

The social market economy is considered one of the central pillars of Germany's political and economic post-war architecture. The formula for success of the subsequent world champion exporter can be summed up as "prosperity for all" (Erhard 1957) based on a market economy and the maintenance of a social – and later also ecological – balance. Almost 60 years after its inception, however, the concept of the social market economy is facing a double challenge arising primarily from changed economic and social conditions in an era of economic globalization.

Despite – or perhaps precisely because of – these challenges, now, after 60 years, the social market economy still appears a reasonable means of achieving a balance within society that is capable of tempering the ecological and social burdens of increased international competition. In particular, Asian countries with rapidly growing and increasingly liberalized economies and totalitarian pasts are considered likely candidates for the introduction of social market economy principles. That would enable the social market economy to remain a leading export – at the very time when its future viability in Germany is the subject of highly critical and controversial debate.

One side of this domestic German debate focuses on a crisis of the social market economy and the need for a new social market economy in Germany. Warnings that the concept of the social market economy needs to be revised and updated are expressed above all because social security systems are under great pressure as a result of demographic change and globalization. The social[1] component of the social market economy is seen as an obstacle and a competitive disadvantage and condemned as a domestic policy burden on a government overstretched by redistributive duties (Papier 2007, 3).

[1]The German term *sozial* is translated as social throughout the text. The authors are aware of discussions regarding an adequate translation into English, which according to many experts would lie somewhere between "social" and "welfare."

On the other hand, a majority of the population increasingly doubt whether Germany's social market economy still merits the designation *social* at all and whether its social aspirations have not fallen victim to the supposed challenges and constraints of global "predatory capitalism." The latest Bertelsmann Stiftung surveys show that only 15% of Germans consider economic relations in Germany fair, whereas a clear majority of the population (56%) believe them to be unfair (Vehrkamp and Kleinsteuber 2007a, 6-7). The social security reforms implemented during the years of the SPD[2]-Green coalition are mainly criticized as threats to the social component of the social market economy and are rejected as socially inequitable, not only by broad sections of the population but also by many politicians (Vehrkamp and Kleinsteuber 2007b, 299-300).

Against this background, the following essay will primarily examine the social market economy's need and capacity for reform in Germany, whereby the possibility of transferring the concept to the Asian region should be understood as the underlying question behind the text. In any event, we shall be focusing on the current state of the social market economy in Germany and the extent to which it provides adequate answers to the pressures of global competition. After all, the social market economy will only be considered a potential model for Asia if it proves sustainable in Germany and sufficiently flexible, adaptable, and reformable to meet the challenges of demographic change and globalization.

We shall therefore begin with an analysis of the current situation: What is the situation in the areas that influence the social market economy in Germany? Where do the greatest weaknesses lie, and where are reforms most needed? In examining these questions, we shall be focusing particularly on the areas of employment, taxation, social security systems, and education. Additionally, attention will be directed towards the development of German "social capital." According to Putnam and Goss, a society's social capital is a crucial factor in its coherence, creativity, and competitiveness (Putnam and Goss 2001, 15 ff.). We wish to include this new field in our analysis because social capital appears to us to be an essential quality of societies that are renewable and flexible and nonetheless demonstrate fundamental agreement on certain identifying characteristics.

In the second part of this essay, we shall be taking a closer look at selected reforms of two legislative periods with regard to whether or not they are able to contribute to modernizing the concept of the social market economy in Germany.

The essay then concludes with a short outline of the reformability and future viability of the social market economy in Germany against the background of the challenges of globalization.

[2]SPD = Social Democratic Party of Germany

An Outline of the Current Situation in Germany

A comparison of Germany's position in the most important international economic rankings provides an initial appraisal of the German economy's international competitiveness. At first glance, the results present a rather mixed picture. Although the World Economic Forum's Global Competitive Index puts Germany among the world's top ten, in 8th place out of a total of 125 countries surveyed, the same study ranks Germany only 14th in its Growth Competitiveness Index, which means it is in the lower middle range within the smaller group of comparable OECD[3] countries (Lopez-Claros 2006, xvii). This assessment is also confirmed by the Bertelsmann Stiftung International Business Site Ranking, which puts Germany in 15th place out of a total of 21 OECD countries in its Activity Index and last in its Success Index[4] (Bertelsmann Stiftung 2007, 14 ff.). An examination of other international comparative studies, even considering the sometimes great difference in methods, questions, and results involved, still presents a rather consistent and clear picture: Germany only manages a lower middle ranking among a comparable group of highly developed OECD countries.

This picture is also confirmed by international growth comparisons, in which Germany demonstrates only below-average performance. Germany was long able to live from the high productivity increases of the phase of reconstruction during the 1950s and 1960s, but since the first oil crisis in the early 1970s, the German economy has only been growing at a below-average rate compared with its international competitors. Thus, for example, the average annual growth in Germany's real gross domestic product amounted to only 1.6% in the 1990-2000 decade; that is just half as much as the USA and significantly lower than the average growth rate in the 15 core countries of the old European Union, which was at least 2.0%.

Still, Germany is world champion exporter and has a highly competitive export business sector. But since Germany's macroeconomic performance has remained below average, we would like to formulate four hypotheses which will be reflected throughout this essay (Empter and Vehrkamp 2006, 14):

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[3]Organization for Economic Cooperation and Development

[4]The Success Index provides information about the country's current situation in terms of its employment situation and economic growth. The Activity Index addresses the most important factors behind these two dimensions. It measures and evaluates the specific steps the country has taken to influence the target dimensions. Both indices are complemented by detailed comments on the latest developments in economic, financial, collective bargaining, and labor market policy, allowing the International Business Site Ranking to identify successful strategies and tools for greater employment and economic growth.

- The initial concept of the social market economy was a factor behind Germany's political stability and the resulting economic growth after World War II.
- Although Germany is the world's leading exporting nation and has powerful and globally competitive export companies, it now suffers from considerable competitive weaknesses and disadvantages compared to its international competitors.
- The concept of social market economy was not adapted to the changing business environment in the 1970s and 1980s. Germany's current weaknesses as a business location are primarily due to elements of the economic and social policy framework of the social market economy that are no longer conducive to international economic competitiveness.
- The problems cannot be met by simple "too much social policy" or "not enough social policy" solutions, but require a differentiated look at the set of institutions and organizations in Germany. The example of the successful reconfiguration of the Scandinavian welfare economies is proof that it is possible to be internationally competitive while preserving important national standards.

Employment

In international comparisons, the German labor market presents a few strengths, such as a low level of youth unemployment and the relatively rapid increase in women's employment. Its marked weaknesses are far more numerous. In addition to generally high unemployment and a comparatively low employment rate, these weaknesses become most obvious in that it has the OECD's highest levels of unemployment among older employees and low-skilled workers as well as a proportion of long-term unemployed of more than 50%. Moreover, numerous indicators show that the German labor market has become institutionally ossified and is characterized by a high level of inflexibility (Thode 2006, 250-251):

- With regard to working times, Germany has a comparatively low number of average annual working hours per employee. According to OECD calculations, the average actual working time in Germany in 2004 was 1443 hours. That means employees in Germany worked some 200 hours less than their counterparts in Great Britain and Finland, for example, and almost 400 hours less than their colleagues in the USA.
- In the case of the average length of company employment among permanent employees, Germany remains one of the countries with comparatively long periods of employment. In 2000, the average duration of employment with an employer was 10.5 years. That represented only a marginal decrease compared with 1990, but was significantly higher than the values for less regulated labor markets, such as those in Denmark, Great Britain, and the USA.

- The level of regulation of the German labor market continues to be high in comparison with other OECD countries. Although a number of deregulatory measures have been implemented in recent years – not only in protection against unfair dismissal, but also in the regulation of temporary employment and temporary staffing – the level of German labor market regulation nevertheless remains practically unchanged.

Taxation and Social Insurance Systems

Compared with other countries, the tax and social insurance systems also present competitive disadvantages that partially explain Germany's below-average growth performance:

When you evaluate the quality of a taxation system on the basis of its effectiveness, efficiency, and simplicity, then the German taxation system fares badly (Fuest and Becker 2006, 335 ff.). It is not very effective, as demonstrated above all by the fact that backward-looking tax load measurements put the actual tax burden on companies active in Germany at the middle of the international ranking, while forward-looking calculations put German at the head of the international tax burden list. Furthermore, the German taxation system is considered bureaucratic and opaque. To sum up, as a result of relatively low tax revenues, significant tax behavior distortions, and the high bureaucratic cost, it can be said that the German taxation system is very inefficient, complicated, and only moderately effective.

Financing social insurance systems through non-wage labor costs also leads to lower domestic demand, despite rising unit labor costs as a result of the growing tax wedge between gross and net income. One traditionally important component of Germany's social market economy – the pay- and performance-based financing of social insurance systems – is therefore increasingly proving to be an international competitive disadvantage. As a result, many experts have long been calling for a shift in the funding of social insurance systems away from non-wage labor costs towards stronger and allocation-neutral tax-based financing (Blum and Ludwig 2006, 274-275).

Education

Another crucial factor for success in a globalized world is a competitive and powerful education system. Here, too, the OECD's comparative educational indicators reveal significant deficiencies at all levels of the German education system:

PISA comparisons[5] since 2000 have revealed a number of things about the German school system. Compared with other OECD countries, the performance of 15-year-old students in Germany is at most middling in a number of important areas. Furthermore, performance differences between individual schools in Germany are greater than in any other OECD country. Especially disconcerting, however, is the fact that individual educational opportunity in Germany is still relatively strongly determined by the social background of a child's parents. The factors contributing to this include the early and inflexible performance-based selection process for different school types after the fourth year of compulsory education and the lack of personalized learning support for students (Schleicher 2006, 433 ff.).

In the higher education sector, Germany is conspicuous for its comparatively low level of participation and its very low proportion of graduates, above all in the natural sciences. Thus, for example, the number of students successfully completing a higher education program in Germany in 2004 was just under 200,000, which corresponds to a graduate ratio of only roughly 20% of the respective age group. The average proportion of higher education graduates within the OECD came to 32%. Globalization and technological progress are generating strong growth in the demand for graduate employees. On the German labor market, however, they are in far too short supply for demographic reasons and as a result of excessively low participation in tertiary education.

The position of German universities in international rankings also seems to suggest that they are not among the world's best institutions of higher education (Müller-Böling 2006, 457 ff.).

Moreover, the German higher education system is also underfunded. In 2002, the overall share of gross domestic product (GDP) invested in public and private education in Germany was 5.3%, which was significantly less than the OECD average of 5.8%. The list of education spenders is led by Iceland (7.4%) and the USA (7.2%), followed by Denmark and Korea (7.1% each). Germany fares even worse in a comparison of public spending on education. While countries like Denmark, Iceland, Norway, Sweden, and Belgium invest more than 6% of GDP in their education systems from public funds, Germany's share of public education spending amounts to only 4.4% of GDP. As a result, Germany only reaches 20th place in the ranking of all OECD countries. This is an indication not only of underfunding, but also of an imbalance in the funding of the German education system overall. While the proportion of private education spending is lowest where the private benefits of education are highest, namely in the higher

[5] Program for International Student Assessment, carried out every three years by the OECD.

education sector, preschool education in Germany is predominantly privately financed: until now, tuition fees in Germany have primarily been charged for kindergarten rather than university.

Social Capital and Cooperative Partnerships

Social capital and economic performance are mutually interdependent. On one hand, strong economic performance can be a prerequisite for a well-developed civil society, because financial security gives members of society time to engage in activities not solely oriented to economic gain. On the other hand, however, a strong civil society can become the starting point for economic prosperity, because people collaborate and form networks to compensate for economic deficiencies (Offe andFuchs 2001, 492-493).

Quantifying social capital is rather difficult since it does not involve an immediately and easily recognizable "hard currency." Membership in clubs, political parties, and associations can provide an initial indicator here, but the situation is much more complicated in the case of networks, neighborhood groups, or participation in public events.

In Germany, following the end of the Second World War and the country's moral and economic collapse, people initially showed a great aversion to joining associations. The economic upturn, however, brought a heyday of associations, which were mainly thematic and leisure related. Membership in clubs and associations and the number of people engaged in voluntary work have remained surprisingly constant since the 1980s, and some surveys have even registered a slight increase, mainly in the voluntary sector. According to a poll by the Germany Federal Ministry of Family Affairs, Senior Citizens, Women, and Youth, 36% of over 14 year olds in Germany are actively involved in an association, which represents a 4% increase compared with 1999 (Ministry of Family Affairs, Senior Citizens, Women, and Youth 2004). The number of associations in Germany is also steadily increasing in absolute terms, with the establishment of new sport associations continuing to dominate.

A boom is also emerging in the foundation sector. More foundations were established in the years between 2000 and 2005 than during the entire decade before. The 2000 and 2002 reforms of the laws governing foundations may have been partially responsible for this development, but it is certainly also a result of social changes, global influences, and, not least, the large inheritances being left to the current generation.

Lastly, in connection with social capital, we should not forget voluntary business contributions to a functioning society. For some years now, companies in Germany have been increasing their social activities under the heading of corporate social responsibility or corporate citizenship. In the process, they are often able to build on a solid foundation of good neighbor relations and orient their social and ecological activities in an increasingly strategic way. According to a 2006 Bertelsmann Stiftung survey of 500 entrepreneurs and decision makers, some 60% of businesses are making an active commitment in one or more areas.

All these figures are encouraging. However, several important factors for social capital's impact on society should not be overlooked. Obstacles to cooperation between different players within German society remain. Above all, improvements could be made in multipolar cooperation between politics, business, and civil society on urgent contemporary issues. The second area in which Germany needs to catch up with other countries is the informal and formal recognition of civil society as an equal player and its corresponding integration into political processes (Maecenata Institut 2006).

A Policy of Reform: Modernizing the Social Market Economy

Following this outline of the policy areas that are important for the concept of the social market economy, we shall now take a look at current developments and trends. Germany in the years between 1998 and 2007 was a country very much characterized by political reform. Systemic structural reforms largely failed to materialize in the 1990s following German reunification. Thus, for several years now, there has been a tangible and significantly increased need for reform – which is also recognized by the population and political decision makers in Germany – due to the pressures of demographic change and economic globalization. A number of far-reaching reforms, primarily of social security systems, have had a significant impact on the social market system. Following an initial mood of renewal, however, in recent years the dominant impression among Germany's general public has been one of increasing unfairness in economic and social relations, which is also reflected in the recent strong showing of the Left Party. In the following section, we shall attempt to describe selected areas of the recent reform policy and examine their contribution to a renewal of the social market economy.

A debate on a renewal of the social market economy, like the one that has been conducted in Germany over recent years, frequently overlooks one important aspect: the fact that *the* social market economy does not actually exist as a homogeneous entity. Instead, this term entails a flexible concept that seeks to combine its two elements – social and market economy – and in the past, during the time of Erhard and Müller-Armack, largely involved a regulatory policy framework for market-economy-based competition. Essentially, it attempts to reconcile the concept of the welfare state and the performance principle of the market economy.

Accordingly, the goals and instruments pursued by the two aspects of the social market economy are variable and the balance between the two elements *social* and *market economy* also depends on a country's political traditions, societal preferences, and central goals. Thus, the understanding of the social market economy by Ludwig Erhard, an ordoliberal economist, is rather different from that of later politicians who attempted to establish a welfare state under the same label (Dietzelbinger 1998, 235ff.). In a nutshell, it could be said that the fixed element of this dual concept is the *market economy* as the substantive system designation, while the flexible *social* element is influenced by the current situation, by the financial and social possibilities, and by the greatest challenges facing the respective country. Therefore, to varying degrees, the properties of competition, solidarity, subsidiarity, and individual responsibility are constitutive attributes of the social market economy.

To what extent and in which areas governments exert influence through substitution, allocation, or supplementary policies is not predetermined. Ralf Dahrendorf thus very pertinently characterized the fundamental regulatory policy question of the social market economy in terms of its adaptability to different contexts as follows: "How much social good can a competitive market economy tolerate?" (Dahrendorf 2004, 10).

Viewed against this background, Germany's reform policy of recent years presents itself in a different light. By no means did it represent the end of the social market economy, but a flexible adjustment and modernization of the principle. A major factor behind this development was the global triumph of the market economy and capitalism – in its most diverse forms – during the 1990s. The others catalysts are to be found more in the domestic policy domain. The German welfare state is under substantial financial pressure and does not appear to have appropriate instruments available for dealing with a number of current problems. The attempt to improve competitiveness through the reform of central systems can also be viewed as an effort to preserve the tradition of the social market economy, while also adapting it to face new challenges in a flexible way and thereby making it viable for the future.

Because the response to the changed conditions resulting from globalization largely involved a redefinition of the social component, a readjustment is required in the balance between social and market economy. We need safety mechanisms on the margins of society to ensure that social coherence is not threatened by the impoverishment of large sections of the population. Overall, however, individual initiative, responsibility, and motivation should be strengthened rather than weakened. An examination of the individual areas of reform below should demonstrate whether and how far this adjustment process has been successful in recent years.

Employment

It is a fundamental tenet of the social market economy that gainful employment which enables a decent living should always receive precedence over subsidized unemployment. However, disagreement exists on how to achieve the fullest possible employment even among advocates of the social market economy. As a result, the reforms of the SPD-Green government in this area found both supporters and opponents in all political camps.

Hartz I-IV

The labor market reforms of 2003 to 2005 are generally known as the Hartz reforms, taking the name of one of their main authors, Peter Hartz, the chairman of the expert commission established by the Schröder government and former Human Resources Director of the Volkswagen Group. The designation *Hartz I to IV* encompasses a raft of measures, restructuring proposals, and ideas primarily aimed at reducing unemployment. The Hartz Commission developed a three-pronged strategy that combined deregulation of the labor market, reduction of non-wage labor costs, and increased mobilization of jobseekers themselves, as well as more dynamic job placement. Central elements of the reform package included the introduction of new employment relationships, a reorganization of job placement, and the amalgamation of *sozialhilfe* (social welfare benefits) and *arbeitslosenhilfe* (unemployment assistance). The introduction of the Hartz reforms was greeted by surprisingly large popular protests – by German standards – involving many different groups within society. The reforms were and still are often equated with the renunciation of welfare state principles. The most frequently raised criticisms have been impoverishment as a result of excessively low benefits, pressure to take badly paid or inappropriate work, social hardship as a result of the demand for mobility, and, finally, the decline of normal employment relationships subject to compulsory social insurance contributions.

On the other hand, the backers of these reforms – for example, the group associated with former Bundesbank head Hans Tietmeyer and the *Initiative Neue soziale Marktwirtschaft*, the campaign he is supporting for a new social market economy – stress that these changes strengthen individual initiative, flexibility, and competition in the labor market and are thus precisely what is needed to preserve the social component of the social market economy in the twenty-first century. As proof, they cite one of Ludwig Erhard's fundamental ideas on employment: "The ideal I have in mind is based upon the strength that allows an individual to say: I want to prove myself by my own efforts, I want to cope with the risks of my life myself and want to be responsible for my own destiny" (Tietmeyer 2001).

This aspiration makes it impossible to confuse the social component of the social market economy with a nanny welfare state; instead, very much in tune with the recent labor market reforms, the social market economy combines a safety net for the weakest members of society with an activating framework for everyone who is able to work. According to this view, the earlier "glut" of government redistribution measures has paralyzed the market and its participants and reduced individual enterprise.

Today, researchers are still arguing about whether there is a real link between these reforms and the decrease in unemployment in Germany since 2007 or whether macroeconomic developments such as monetary policy are the actual driving force behind the improved situation on the German labor market (Bontrup 2007, 25 and Jacobi and Kluve 2006, 3), An accurate evaluation is made difficult by the fact that individual, highly controversial aspects of the Hartz reforms have meanwhile been modified, watered down, or abolished and that the next generation of welfare state reforms, for example, in the shape of government-subsidized minimum wages, are already being discussed. Here, too, opinions do not necessarily divide along party lines. A debate is currently taking place on whether minimum wages represent dangerous ballast that will hamper the labor market, whether they should be established as part of a social security package, or whether they will make many other benefits obsolete as a form of basic social provision (Dahrendorf 2004, 11).

Minimum Wages

From the perspective of the social market economy, labor market reform must not restrict the freedom of movement and individual initiative of employees and entrepreneurs. What is more, any reform must be oriented towards the goal of creating income through employment. That is why the primary concern of labor market reform is achieving a balance between individual elements. A possible statutory minimum wage, for example, does not in itself represent a danger. In order to prevent job losses in the low-pay sector, however, a minimum wage must be low enough to make it acceptable to businesses on a broad front. Furthermore, it ought to be so much higher than government welfare payments that accepting work remains attractive (the precept that there must be a gap between wages and social welfare benefits). Such a minimum wage would then, however, not meet the social policy demand for a living wage. One solution to this dilemma could entail an appropriate combination of a minimum wage with government wage subsidies for low-pay sectors in which productivity is beneath the level of a living wage. This kind of combination wage would secure and also create employment in the low-pay sector and simultaneously guarantee the level of living wage sought by social policy. The introduction of such a coordinated model of minimum and combination wages is one of the greatest challenges of German labor market policy in the next few years.

Social Security and Taxation

Retirement Pension Reform

When it comes to pension reform, significant advances have been made in recent years that have contributed to the long-term stabilization of the German retirement pension system, which is now much more resilient to demographic change than it was at the beginning of the 1990s. This has mainly been accomplished by three reform measures:

- the introduction of a supplementary private, funded pension insurance scheme (*Riester-Rente*);
- the introduction of a "sustainability factor" in the calculation of pensions to guarantee that if the number of contributors decreases, pension levels will be adjusted to ensure contributions remain stable on a long-term basis; and
- an increase in the retirement age to 67.

Health Care Reform

While labor market reforms were the trademark of the SPD-Green government, the health care reform of 2006 can be considered a central project of the CDU[6]-SPD grand coalition. After the last substantial changes in this area were undertaken at the beginning of the 1990s, the 2006 reform represents an attempt to adapt the German health care system to cope with demographic changes and medical progress in order to avert eventual system overload. Studies by the OECD and the German Advisory Council for Concerted Action in Health Care increased the pressure for reform because they showed that, compared with other systems, the German health care system is too expensive for the quality offered and therefore not internationally competitive (Greß 2006, 39).

The health care reform represents a compromise between the two contrary positions of the SPD and CDU, and – perhaps precisely for that reason – it has been criticized by all political camps and numerous experts as incoherent and an inadequate solution to this problem. There are plans to establish a health care fund into which payments will flow from employees and employers and from which statutory health insurance plans will receive their funding. This has been criticized from all sides as bureaucratic and anticompetitive – in other words, detrimental to the idea of the social market economy.

[6]CDU = Christian Democratic Union, in other words, the Christian Democratic Party of Germany

The extension of health insurance to all citizens is certainly compatible with a reinterpretation of the social market economy. When understood as the basic provision of essential health care, such a move is not only financeable, but also socially desirable. What is problematic, however, is the fact that the range of benefits provided by health insurance funds was also extended and contribution rates will presumably have to be increased. That would lead to a further rise in non-wage labor costs in Germany, tend to make labor more expensive, and threaten international competitiveness. Stronger tax financing for health insurance is also being discussed as a means of avoiding the negative impact of social insurance contributions on the labor market and employment.

Tax Reform 2000

From the viewpoint of the social market economy, taxes are an important means of financing basic public duties, but they must be related to economic performance and not threaten it. Additionally, taxes have also become an important means of influencing the international competition between business locations. Direct and indirect taxes give governments some scope for influence here, but this is a very delicate area that requires great sensitivity and dialogue.[7] The intellectual fathers of the social market economy were not generally concerned about high or low taxation, but considered it important that taxes take the appropriate form for the relevant situation. Alfred Müller-Armack, one of the inventors of the social market economy, summed up the situation as follows, "...if the right form of taxation is selected, high taxes for the benefit of welfare and government consumption can be an entirely neutral matter with regard to the market economy, because although it may have a major effect on demand, its satisfaction does not infringe market economy rules." Recent reforms of the German tax system have attempted to lower the direct taxation burden on citizens and companies, and they have also succeeded in achieving considerable relief in that area. The reduction of the entry and highest tax rates in 2000 were appropriate and did not contribute to the delayed upturn in Germany. This was much more a result of the economic stagnation of previous years. Domestic demand only rose when the labor market figures gave grounds for greater optimism, and it was also not – as widely feared – completely neutralized by the recent increase in value-added tax.

[7] See Benecke in this reader.

Business Tax Reform 2007

In addition to the income tax reform, the reduction of corporation tax to 15% has pushed the overall corporate taxation burden to below 30% and is expected to particularly alleviate the situation for the medium-sized private business sector, a traditional target group of the social market economy. However, there has been criticism of counter-financing measures – for example, stricter write-off regulations increase the administrative burden on businesses (Institut der deutschen Wirtschaft Köln 2008).

Overall, these taxation reforms show that tax reductions on a meaningful scale and at the right time can create new scope for investment and employment – both important factors for the success of a social market economy, which should not be endangered by excessively high taxes and surcharges.

Education

In a globalized world, however, perhaps the most important subject for the present social market economy is not the tax burden or labor market reform, but the strength of the education system. This is because the pressures of demographic change and economic globalization necessitate a redefinition of the welfare state and demand that individuals assume more responsibility for their own financial security. That, in turn, is only possible if they have acquired a solid foundation of education and training that empowers them to independently shape their own lives. Furthermore, a well-trained workforce is becoming increasingly important in the international competition for the best minds and talents.

Many aspects, developments, and debates in the German education system are not easy to communicate because the individual German *Länder* (federal states) have a great deal of scope to shape the education landscape. Nonetheless, we shall examine three examples of educational reform to ascertain their contribution to a renewal of the social market economy: the Bologna reform of German higher education, the regional introduction of higher education tuition fees, and the nationwide parental allowance.

Bologna Process

Major impetus for improvement in the international competitiveness of German higher education is now coming from the European level. The so-called Bologna Process has initiated the most far-reaching structural reform in German higher education for more than three decades (Petzina 2005). The greatest challenges exist in the following areas (Vehrkamp 2006):

- the internationalization of German universities is inadequate;
- the level of participation in higher education is too low when compared with other countries; and

- the higher education sector is underfunded and also suffers from a structural imbalance in funding when compared with other countries.

Measured against these challenges, the Bologna Process[8] is better than its reputation. Its implementation can contribute to restoring German higher education's international competitiveness. That applies especially to increasing the participation in tertiary education, where the introduction of the two-tier degree system of Bachelor studies followed by Master's courses can make a major contribution. Additionally, the two-tier degree course structure facilitates a substantial shortening of the duration of study and makes the higher education system more pervious.

Tuition Fees

As a rule, a higher education offers the best possible opportunities for achieving a high personal income and individual financial security. Despite the high level of personal benefit accruing from a higher education, studying in Germany remained largely free of charge for the individual concerned. In other words, it was financed by the general public as a whole.

Since 2006/2007, tuition fees have been levied in seven German *Länder*. At the same time, at the national level, new models of student funding have been introduced – for example, study credits aimed to ensure that tuition fees do not become a social selection criteria. Students have to pay up to €500 a semester, which is still a below-average sum when compared to fees in other countries. Nevertheless, the level of protest, particularly on the part of students, has remained high.

In principle, however, German education experts mainly see advantages in the introduction of tuition fees – provided that they are levied and used in a meaningful way. It is stressed that universities should be granted the greatest possible autonomy in their organization and use, should embed the levying of fees in a meaningful overall strategy of quality assurance and development, and should waste as little money as possible on bureaucracy (Müller 2008).

Tuition fees should aim to again make degree courses at German universities internationally more competitive in qualitative terms, to simultaneously relieve the financial pressures on budgets, and to strengthen individual responsibility not only of universities but also of students. If socially acceptable models of

[8] In 1999 the education ministers of 29 European countries signed a declaration to create the European Higher Education Area by making academic degree standards and quality assurance standards more comparable and compatible throughout Europe. The process thus started and later opened to members of the Council of Europe. It was named the Bolgona Process after the place of signature.

student funding can be found and the money is invested in better teaching, then tuition fees are also compatible with the principles of a social market economy.

Parental Allowance

Against the background of a recent steady decline in the number of births, the grand coalition government has taken up the challenge of reconciling having children and a career as a crucial area for increasing the birth rate in Germany. It is assumed that female graduates and other highly qualified women frequently decide not to have children because they result in financial losses and career disadvantages primarily for women. The new family policy under CDU Minister von der Leyen relies on improved child care for infants between the ages of one and three as well as comparatively high allowances for mother and fathers during the first year after birth. An initial assessment shows that this government policy seems to be bearing fruit ("Von der Leyen zieht positive Bilanz" 2007). For social market economy advocates who think in more ordoliberal terms, however, government intervention in this area represents an interference in individual freedom and autonomy. Nonetheless, Germany very obviously lacked incentive structures for young men and women to found a family and the resultant aging of society is already having dramatic consequences, for example, for the funding of social security systems.

Financial support during the first year of a child's life and improved chances of finding child care services after that will at least partially cushion the personal risks of founding a family. Money, however, is not everything when it comes to government solidarity. These family policy reforms also demonstrate that a certain amount of imagination is required in applying instruments of social regulation in order to achieve modern interpretations of the social market economy model. The introduction of "fathers' months," which extend payments for two months if fathers also take parental leave and look after their children for this period, initially gave rise to extremely hefty debate. Yet, it is precisely this instrument that is contributing to the required change in attitudes, because it goes beyond a purely financial measure and has social implications. Far more fathers than expected took up this opportunity in its very first year, thereby exceeding the parental allowance budget initially allocated by the family affairs ministry. The more fathers avail themselves of this right, the sooner businesses and society as a whole will become accustomed to "parenting" fathers. This will reduce the pressure on highly qualified women to bear almost sole responsibility for the upbringing of their children and increase their willingness to raise a family.

Social Capital and Cooperation

One important characteristic of the social market economy, alongside individual responsibility, competition, and the principle of subsidiarity, is social solidarity. It encompasses not only the independent actions of individuals, but also the community's general solidarity with the individual. The activities of individual citizens within a state can make a significant contribution to reducing the transaction costs in industry and politics and thereby positively influence a country's overall performance. The three decisive components of this are attention, trust, and commitment (Offe and Fuchs 2001, 417). The strength of these three qualities within a population determines the level of social capital and therefore a society's capacity to develop solutions for current problems through cooperation, responsibility, and organization. The level of social capital is composed partially of the individual characteristics of citizens and partially of the collective and institutional characteristics of the society as a whole (Offe and Fuchs 2001, 499).

Social capital is important for a modern social market economy, because it shifts attention away from government activities towards an appropriate balance of individual responsibility and solidarity. The original idea of the social market economy actually envisaged that government would only intervene in a stimulative, distributive, or supportive way where the market and its mechanisms did not function adequately or fairly. The level of social capital is particularly important at a time when governments find it difficult to provide balanced financial support for all areas of activity and population groups. Yet civic activities should not be viewed as a kind of emergency fill-in in the event of government weakness. Strictly speaking, they represent an important and indispensable contribution to the stability and innovative ability of a country.

Although in essence these activities involve a contribution from the population, government also has a specific role to play here by creating "structures of opportunity" for civic activities (Braun 2001, 3). After all, the level of education and prosperity, the statutory framework, and other incentives provided by public policy contribute to social capital and actually make it possible in the first place. This is evidenced by the example of Great Britain, one of the few industrialized nations with an enduringly high level of social capital. Among other things, this is attributed to the fact that policymakers have been promoting social commitment and voluntary work since the welfare reforms of the early twentieth century and continue to do so today.

In conclusion, let us take a closer look at two areas that can contribute to social capital and, at least in part, have also been the subject of reforms in Germany: civic activities and corporate social responsibility (CSR).

Civic Activities

In 1999, the German Federal Government gave the newly founded Study Commission on the Future of Civic Activities the task of designing "concrete political strategies and measures to encourage voluntary civic activities in Germany, which are for the common good and are not intended to produce material gain" (Enquete Kommission 2002, 2). The proposals made by the study commission in its final report included an institutional structure for promoting civic engagement at the federal level, improvement of fiscal regulations, and simplification of the law governing foundations. Political action has been taken on a number of points since then. For example, the law governing foundations has been simplified, volunteer agencies have been granted charitable status, and a law was passed and came into force on January 1, 2007 with the goal of encouraging voluntary civic activities (Müggenburg and Potocki, 2008). The *Bundestag* (German parliament) subcommittee on this subject founded in 2003 comes close to meeting the demand for an institutional structure for the promotion of civic engagement, but it has not yet been able to effect a fundamental change in public attitudes.

Corporate Social Responsibility

Political support is also an important factor in promoting corporate activities. Although this publication contains a separate contribution on the relationship between CSR and the social market economy,[9] we should still examine the role of businesses in the social market economy from the perspective of social capital.

In addition to their central role in the market economy and their contribution to tax revenue and social insurance systems, businesses have often developed extensive activities in the social and ecological domain. Although the goal and scope of these activities are determined by the businesses themselves and are thus voluntary, here, too, the impetus for this increasingly important contribution to the common good originates from society and government (Roome 2005, 323).

Corporate social responsibility can be considered Germany's great undiscovered reform area. Neither of the last two governments developed significant activities here. Conventional wisdom says this is an area in which businesses must act independently and without incentives or support from government – that argument certainly has some validity, but it falls short of the mark. Corporate commitment can be prompted by appropriate government backing. Even more importantly, political restraint in this area can waste significant synergies generated mainly by the cooperation of all sectors of society. Above all, cooperation between business, civil society, and government can give

[9] See Finkel and Fleischer in this reader.

rise to viable solutions to current problems (Welzel et al. 2007, 5). The creation of a framework for commitment and cooperation should be at the very top of the agenda of a policy seeking to modernize the social market economy.

Outlook – No "One-Size-Fits-All" Solutions

After many years of economic prosperity, Germany was rather late in recognizing the changing environment of global competition and new demands for skills and institutions. Of course, the tremendous task of unification and internal adaptation processes on every level kept Germany very busy throughout the 1990s. But the example of Scandinavian countries as well as recent success stories in some fields in Germany show that the right policy ideas combined with effective implementation can lead to economic prosperity and social justice.

A look at the reform agenda and the list of reforms already implemented in Germany shows that important initial successes have been achieved in the past 10 years mainly in stabilizing the pension system and increasing the flexibility of the labor market. The goal of again making the social market economy in Germany a successful model that can also serve as an example of effective economic and social policy for Asian countries has, however, not yet been fully reached. Major tasks still remain to be completed, above all, in the reform of other social security systems (health care, long-term care, and unemployment), the creation of a viable low-wage sector for the low-skilled and long-term unemployed, as well as a sustainable consolidation of public budgets and the reform of the regionally structured federal decision-making system. Education on all levels is perhaps the most important area that must be addressed; recent developments in Germany give reason for some optimism.

Most important, however, is development that people can relate to. Shared visions and goals which can very well lie within the concept of a renewed, globally competitive social market economy should serve as a common foundation on which change can be built. In our view, the current creative challenge for politicians but also for other leaders in society lies in translating and transforming globally discussed success factors into locally successful structures.

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Pro-poor Growth in Asia – Conceptual Debates, Empirical Evidence, and Some Lessons Learnt

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1. Introduction

For at least a decade, the relationship between economic growth and rising inequality has been discussed by development practitioners and researchers with reference to the concept of "pro-poor growth." The simple but appealing goal behind pro-poor growth is to enable the poor to participate in the benefits of economic growth. While the general concept refers to both high growth rates and poverty reduction, an emerging consensus suggests that growth alone is a rather insufficient tool for poverty reduction. Even though the term *pro-poor growth* has been around since 1997[1] (and the previous idea of "shared growth" for even longer), there is still no consistent definition of it. There is not yet a meaningful theory available which explains how the same rate of aggregate growth can be achieved with different rates of poverty reduction (Klump and Miralles 2006). Furthermore, on the empirical side, differing definitions and measurement tools for poverty, inequality, and growth impede comparison of the abundant research on the impact of economic growth on poverty. Comparing empirical (cross-) country studies investigating the impact of growth on poverty reduction is extremely helpful for learning more about the mechanisms and causalities at work; however, one should also be aware that the conclusions drawn depend to a great extent on the concept of pro-poor growth employed.

This article gives an overview of the debate about the relation between economic growth and inequality, with a special focus on the developments in South, East, and Southeast Asia. It is organized as follows: Section 2 gives an overview of the debate about what constitutes pro-poor growth and how different understandings affect the measurement outcomes of the impact of economic growth on poverty. Section 3 studies the links between economic growth and inequality. Section 4 provides examples of how some Asian countries translated economic growth into poverty reduction, considering their specific conditions and the implemented policy

[1]The concept of shared growth was first denoted "pro-poor growth" in the UK White Paper on International Development 1997: "Eliminating World Poverty: A Challenge for the 21st Century."

interventions. Section 5 derives effective policy recommendations from the lessons learnt in the country studies. Section 6 presents some concluding remarks.

2. Measuring Pro-poor Growth – A Matter of Definition?

The way the impact of economic growth on poverty is measured often dictates the chosen policy intervention. The measured degree of pro-poorness of growth depends to a large extent on the underlying concept. While the World Bank defines growth as pro-poor when the increase in gross domestic product reduces poverty (however small the reduction) (Ravallion 2004), the United Nations Development Program (UNDP) only regards growth as pro-poor if the poor benefit proportionally more than the non-poor (Pasha and Palanivel 2004).

White and Anderson (2001) subsume the different meanings of pro-poor growth by comparing the variance of the poor's share of income to (1) their previous share, (2) their share in the population, or (3) some international norm (for example, a pre-specified poverty threshold). The first definition is equivalent to that of the World Bank and is usually considered the absolute definition of pro-poor growth. In that sense, growth must only fractionally reduce poverty to be called pro-poor even though the poor might benefit proportionally less from growth than the non-poor. Policy intervention concentrates on the macroeconomic level in order to directly influence gross domestic product (GDP). The second meaning of pro-poor growth is used by UNDP and includes an equality approach. It is usually considered the relative definition and aims to minimize the gap between the mean income of the poor and mean overall income. Hence, growth is pro-poor, relatively speaking, if it benefits the poor proportionately more than the non-poor (Zepeda 2004). This view generally favors microeconomic policies that reduce inequality rather than a concentration on overall economic growth. Consequently, the measured effects of policy interventions vary with the definition of pro-poor growth. Recent empirical studies show how a decrease in relative inequality is regularly accompanied by an increase in absolute inequality.

In order to emphasize the dependence of outcomes on the definition of pro-poor growth, McKay (2007) draws on the case of Vietnam. During the period from 1992 to 2003, the drop in overall poverty is considered to be pro-poor according to the absolute definition. Using the relative definition, the same growth process cannot be deemed pro-poor, since high income groups benefited relatively more than low income groups. The reverse is true for the case of Indonesia during the period after the financial crisis (1996-2002). There, albeit negative, growth was pro-poor in a relative sense as inequality fell and, hence, the poor suffered relatively less than the non-poor. However, it was not pro-poor with regard to the absolute definition, since growth was negative and poverty increased.

Clearly, different definitions of pro-poor growth lead to different assessments of growth processes. Furthermore, the definition affects its quantification directly by setting the explicit measurement tool. Recent studies employ different concepts and thus define varying tools to quantify the impact of growth on poverty. Among the concepts, the measurement tools of UNDP and the World Bank are considered the most advanced. They have also been the most influential for recent empirical research.

While the growth elasticity of poverty (GEP)[2] only relates changes in poverty with changes in per capita income, the poverty equivalent growth rate (PEGR) and the rate of pro-poor growth (RPPG) include the dimension of the equality of growth.[3] PEGR captures the change in poverty when inequality changes without affecting the real mean income. Thus, the estimated growth rate gives more weight to the incomes of the poor (the weight depending on the specified threshold). The RPPG is based on the concept of a "growth incidence curve" (GIC) and marks the area under the GIC up to the headcount ratio.[4] If the RPPG exceeds the mean growth rate, growth is judged to be pro-poor in its relative meaning.

Hence, the measured effects of a policy intervention not only vary with the definition of pro-poor growth but even more with the applied measurement tool: While the RPPG judges Thailand's growth experience pro-poor for the period from 1990 to 1996, the PEGR only does so for the last four years. Hence, according to Zepeda (2004), RPPG overestimates Thai pro-poorness and therefore tends to falsely judge poverty reduction strategies successful. In contrast, Ravallion (2004a) highlights the case of Chinese growth that reduced absolute poverty[5] notably in the period from 1980 to 2001. According to the PEGR, the Chinese experience is judged more anti-poor than pro-poor. Hence, PEGR tends to underestimate the Chinese pro-poorness and therefore tends to falsely spurn successful policy strategies.

While development practitioners and researchers suggest multidimensional policy strategies to achieve pro-poor growth, only few academic attempts have been made to integrate the multidimensionality of poverty in its measurement. Grosse et al. (2005) recently identified the exclusiveness of income as an indicator for poverty as the crucial shortcoming of current pro-poor growth concepts. They define

[2]GEP is defined as the percentage change in the incidence of poverty (measured by the headcount index) associated with a 1% increase in per capita income.

[3]While the PEGR was defined by UNDP (Kakwani and Son 2006), the RPPG was developed by the World Bank (Ravallion and Chen 2003).

[4]The headcount ratio commonly denotes the proportion of the population living under the poverty line.

[5]Measured as the population living below the poverty line of US$1 in purchasing power parity.

poverty as a multidimensional phenomenon including social indicators and then suggest, following Ravallion and Chen (2003), a non-income growth incidence curve (NIGIC) that indicates the improvement of non-income indicators (health, education, nutrition, and mortality) between two periods for each percentile.

3. The Interdependence of Inequality and Growth

Can growth still be judged pro-poor if it simultaneously increases inequality? The analysis of the effect of growth on distribution thus leads to Kuznets and the hypothesis of the "Inverted U." In his 1955 article, Kuznets argued that, in the process of development, economic growth modifies the personal distribution of income. In the early stages of industrialization, a developing country first suffers from increasing inequality. After this transition period, the return rates between the sectors adjust, and accrued inequality declines. The increase of inequality is attributed to the sectoral shift from agricultural to non-agricultural sectors and, hence, migration from rural to urban areas.

The "Kuznets process" was for almost four decades one of the most cited and least disputed assumptions within the theory of income distribution (World Bank 2005). Most work on the relationship between growth and income disparity still focuses predominantly on testing the Kuznets hypothesis (for example, Deininger and Squire 1996, for cross-country regressions). However, still today, the possible trade-off between growth and equality is not thoroughly understood.

Although the Kuznets process promoted the analysis of distributional change considerably, Anand and Kanbur (1985) miss a plausible explanation for the population shift within the concept. An emergent consensus suggests that the underlying assumptions concerning migration processes and sectoral developments do not hold for the majority of the developing countries. Even Kuznets (1955) admits the meagerness of his data set on developing countries, which included only India, Ceylon (today: Sri Lanka), and Puerto Rico. As more and better data sets became available, it became apparent that the empirical relationship he found does not fit the subsequent evolution of research.[6]

While Kuznets looked at the impact of growth on distribution (albeit somewhat neglecting country-specific conditions), Bourguignon (2004) suggests a two-way relationship between growth and distribution. He states that (1) growth impacts the distribution of income and wealth (as previously described by Kuznets) and (2) country-specific conditions, in terms of initial distribution of factors of production, affect prospective economic growth.

[6] In line with that critique, Wan et al. (2006) and Wan (2004) reject the Kuznets hypothesis for China, after having found a U pattern during the period of strong economic growth.

The most recent contributions focus on the second link more than on the first, namely how initial distribution shapes the growth process and its subsequent effects on poverty (Ravallion 2004, Kakwani and Son 2006). According to Datt and Ravallion (2002), distribution matters for poverty reduction. Decreasing inequality entails the participation of a higher share of the poor population in economic growth. Poverty, therefore, will be more responsive to growth the more equal the initial distribution is. Datt and Ravallion substantiate this proposition with a study comparing the impact of growth on the different regions of India. They show that higher initial inequality in Indian states hinders growth benefiting the poor. According to Qiao et al. (2008), the same is true for China, where they find a substantial trade-off between growth and regional equality.[7]

Existing theories implicitly or explicitly relate inequality to economic growth through four major impediments of inequality on physical and human capital formation: (1) Imperfect capital markets limit prospective chances of growth. With high inequality of access to capital, poorer individuals face credit constraints restricting them in their investment decisions. (2) Unequal income distribution weakens domestic demand and slows down the economy (as observed in China since the late 1990s). (3) Increasing inequality is often accompanied by a destabilization of the socio-political environment, which is detrimental to investment and growth. (4) An unequal initial distribution of income and wealth leads, in the democratic context, to more redistribution and therefore less private capital accumulation. The significance of inequality reduction is highlighted by the World Bank (2005), stressing its twofold return: First, a reduction of inequality will most likely enhance a simultaneous decline in poverty. Second, the consequent lower level of inequality will lead to faster poverty reduction through the prospective economic growth.

Despite these arguments, the effect of inequality on economic development continues to be hotly debated. Forbes (2000) points to the confusion of causality within most of the empirical studies. Recent contributions show that low inequality countries tend, in the long term, to grow faster. However, these studies fail to explain how a change in a country's level of inequality (for example, by government reforms) will affect its growth process. According to Forbes, the derived negative impact of inequality on growth is basically due to exogenous factors. By analyzing the effects of changes in distribution on growth in a given country, Forbes finds, in contrast to most empirical work, a strong positive effect of inequality on economic growth.

[7] A closer look at these results will be taken in the following section.

By accounting for initial inequality, Easterly (2007) derives contrary statements. He distinguishes initial disparity with regard to its roots in (i) structural and (ii) market inequality. The first results from historical events as colonization or discrimination (in other words, from non-market mechanisms) brought forth an elite. In contrast, market inequality arises from the uneven distribution of success in free markets or from market failures. Previous studies had derived lower per capita income from initial inequality in terms of schooling and institutions. However, inequality also affects such non-monetary development outcomes. Thus, inequality is only a proxy for other exogenous factors like ethnic fractionalization, legal origin, and tropical location. Controlling for the exogenous factors, Easterly tests the inequality relationship and detects that higher structural inequality aggravates the reverse effects of growth on poverty (albeit with a slightly lower impact than previous regressions). Easterly points out that countries affected by structural inequality cannot be unconditionally pooled with countries suffering market inequality.[8]

These results show once again that no universal pro-poor growth strategy can exist. However, one can learn from country studies to what extent initial conditions and explicit policy interventions have to work together in order to promote growth and poverty reduction simultaneously. In the following section we will therefore focus on results from panel data studies on specific Asian countries.

4. Empirical Evidence from Country Case Studies in Asia

This section focuses on the impact of growth on poverty and inequality in several countries of South, East, and Southeast Asia. Most notably, East Asia experienced exceptionally high average per capita growth rates during the 1990s, so that the incidence of poverty declined sharply (for example, in China the rate of change in incidence of poverty declined from -0.8% per year in the 1970s to -9.8% in the 1990s). In contrast, South Asia could not translate growth into poverty reduction to such a degree (for example, in India the rate of change in incidence of poverty declined only from -1.7% per year in the 1970s to -2.8% in the 1990s).

However, the Indian and the Chinese economies are larger and much more diverse than most of the other countries in South, East, and Southeast Asia. Looking only at India or China as a whole will surely lead to premature or biased conclusions. Nevertheless, as provinces in China and states in India operate under

[8] According to Easterly (2007), structural inequality is clearly bad for subsequent development, whereas market inequality might be good or bad.

one central government, many of the unobserved factors can be controlled. The limits of an encompassing analysis and a general statement should nevertheless be kept in mind.

The following section will examine the experiences in five Asian countries. Bangladesh, China, India, Vietnam, and Indonesia were chosen, since they hold a focal position within the German development strategy. In addition, these countries were chosen as eminent Asian country cases in a recent research project on pro-poor growth undertaken by an international partnership of European development agencies, including the German Federal Ministry for Economic Cooperation and Development (BMZ), the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, and KfW Entwicklungsbank for Germany, together with the World Bank.[9]

The Case of Bangladesh

Although Bangladesh has long been considered to be locked in a poverty trap, it today plays the role of the lead performer among the least developed countries. After independence in 1971 and a phase of recovery and reconstruction in the post-war period, Bangladesh entered a period of stable economic growth. Three decades ago, Bangladesh was still characterized by high population density and a scarcity of natural resources, as well as by an environment of weak institutions, socio-political instability, and economic mismanagement. Today, Bangladesh is an example of how a country can succeed despite extreme vulnerability to natural disasters and a bad initial position.

Until 1990, the pattern of Bangladesh's Gini coefficient[10] traces the Kuznets Inverted U. In the early 1970s, 74% of the population lived below the poverty line. The pace of poverty reduction increased in the 1980s and accelerated even further in the 1990s (per capita income growth rose from 2.2% a year in the 1980s to 3% in the 1990s and the rate of change in incidence of poverty decreased from -0.6% to -2.4% per year within the same period). During the 1990s, per capita income increased by 3% per annum. Nevertheless, the pace of rural poverty reduction

[9] OPPG (Operationalizing Pro-Poor Growth) is a research project initiated in 2003 by a partnership of French (AFD), German (BMZ, KfW, and GTZ) and British (DFID) development agencies and the World Bank. The aim was to derive further insights into the concept of pro-poor growth and sound operationalization of pro-poor growth policies by analysing 14 countries in four continents.

[10] The Gini coefficient is given by the (household-size weighted) mean absolute deviation between all pairs of a suitable measure of living standards, typically per capita household real income or expenditure. The Gini coefficient lies between zero and one, where zero means that everyone in the economy has the same share and one means that one individual owns everything.

was lower than the pace of urban poverty reduction during the 1980s and 1990s alike. From 1991 to 2000, rural-urban inequality rose further, so that the ordinary growth rates in rural and urban areas differed by almost one percentage point (with a rate of 1.4% for rural and 2.3% for urban areas, respectively). The Gini coefficient rose in rural areas from 0.27 in the early 1990s to 0.35 in 2000, while, during the same time period, the urban Gini coefficient rose from 0.33 to 0.44. The analysis of the RPPG makes the rise in inequality even more apparent: Within the same period, the RPPG rose, by 0.8% in the rural but only by 0.37% per year in the urban regions of Bangladesh. However, the share of the population below the poverty line dropped from the initial 74% in 1971 to only 40% in 2000. Today, Bangladesh is approaching a stage of self-sufficiency in rice production.

At the beginning of the period of economic growth in the 1980s, the pace of poverty reduction was partly absorbed by economic instability. An unsustainable public deficit impeded the launch of crucial reforms, and natural disasters regularly destroyed agricultural output, all of which weighed down the process of overall economic growth during the 1980s. Since the 1990s, damage by natural disasters could be reduced significantly for the rural population. The decrease of exposure to natural disasters led to an acceleration in poverty reduction. Sen et al. (2007) emphasize the stabilizing economic environment as the engine for pro-poor growth, because it made possible important pro-poor expenditures.

Within the framework of a stable macroeconomic environment during the 1980s and 1990s (favored by the positive effects of the Green Revolution), Bangladesh was able to use the additional fiscal resources for public expenditures and pro-poor reforms. Sound family planning programs reduced population growth continuously so that the total fertility rate decreased from 7 in 1975 to 3.2 in 2000. The simultaneous increase of productivity through the use of modern technologies led to significant per capita income growth. The period of economic growth notably favored the increase in poverty reduction during the 1980s and 1990s (average annual economic growth increase from 3.7% in the 1980s to 4.8% in the 1990s). However, the urban-biased growth strategy, which favored the non-agricultural sector, absorbed further capacity for higher poverty-reducing effects at the national level.

Sen et al. (2007) highlight a policy mix that notably favored pro-poor growth for the last two decades: (1) Macroeconomic stability, including a policy of low inflation, a stable exchange rate, and low current account and fiscal deficits. The double-digit inflation rate characteristic of 1970s dropped to a single digit rate of 5.6% in the 1990s. (2) Economic openness through the liberalization of external trade and foreign exchange regimes. The resulting export growth fostered substantial employment generation (export growth even increased from 10.4%

a year in the 1980s to 11.7% in the 1990s). (3) Public expenditures that focus on pro-poor benefits in: (i) rural infrastructure and (ii) human development. After a period of high budget deficits in the 1980s, Bangladesh was able to benefit from economic stabilization and invest in pro-poor expenditures. Rural infrastructure development and particularly road projects connected rural growth centers and helped increase farm as well as non-farm output. By employing predominantly the rural poor for the projects, unemployment was reduced and additional purchasing power was created. Furthermore, the roads increased the possibilities of trade between rural and urban areas, and new small-scale roadside shops sprouted up. Investment in basic education with a special focus on girls' education was realized through an increase of public resources on the one hand, but especially through efficient public private partnerships, notably for secondary education programs, on the other hand. (6) Primary and preventive health care. This investment policy led to significantly lower child mortality and greater access to drinking water and sanitation during the 1990s. In combination with an increase in education, the share of skilled labor rose, enhancing a rise in productivity.

As a last resort for the poorest and most vulnerable of the society and in order to face the calamitous natural disasters, additional pro-poor reforms were carried out. Increased disaster preparedness and safety nets in terms of expanded transfer programs helped ensure food entitlements for the poorest. By increasing grain production during the dry seasons and diversifying income by further engagement in the non-farm sector, the poor were enabled to better deal with exogenous shocks. The development during the 1990s in which the poor were less likely to be hit disastrously by the regular floods marks one example of an efficient policy intervention on the level of safety nets in Bangladesh.

The Case of China

Until the beginning of the period of major reforms in 1978, China was basically an egalitarian society, with the exception of the rural-urban disparity. The country was marked by central planning: strict government control of an important share of national industries and of all productive assets distorted prices and led to a misallocation of resources. The reforms introduced a free market economy by gradually removing price controls. The position of the Chinese economy today demonstrates the spectacular results of this strategy.

Since the start of the economic reforms in the late 1970s, China has experienced rapidly increasing economic growth (the rate of per capita growth increased from 4.4% a year in the 1970s to 7.8% in the 1980s and even to 9% during the 1990s).

The years between 1979 and 1994 were marked by a continuous increase of the capital stock. While almost 80% of the Chinese worked in agriculture before the reforms in 1978, only 50% remained there in 1994. In line with economic theory, fast economic growth involved the largest increase in income inequality of all countries for which comparable data is available. In the period from 1981 to 1995, the Chinese Gini coefficient rose from 0.28 to 0.38.

The major source of China's economic boom lay in its opening towards competitive markets. The increase of competition led to a rise in workers' efficiency that accelerated the growth process. The increasing productivity was in fact supported by the inflow of capital investments. The additional resources allowed the introduction of new machinery with better technology. Widespread reforms facilitated investments in infrastructure so that productivity further increased.

Within their reform project, Chinese policy makers made rapid growth their top priority, well aware of the trade-off between growth and inequality that had been experienced in most developing countries. As low national inequality was for a long time identified as a strain on economic growth, Deng Xiaoping summarized the national strategy with the famous words: "Let some get rich first."

One focus of the 1978 reforms that enhanced the economic boom was (fiscal) decentralization leading to a shift of tax revenues from the central to regional governments. Simultaneously fiscal decentralization was to some extent responsible for the increase of geographical disparity. Zhang (2006) explains increasing inequality with the fact that farmers and firms in poorer regions pay heavy taxes, while those in rich regions benefit from generous public expenditures and lower tax burdens. During the pre-reform period, all taxes collected by local governments were shared with the central government and then redistributed. Hence, local governments that aimed at promoting growth reduced taxes at the expense of the national economy. The reform allowed regional governments to keep their revenue and decide whether to follow (i) a strategy of low taxes in order to attract investment or (ii) a strategy of higher taxes to invest in public goods and services. According to Qiao et al. (2008), the less equal distribution of fiscal resources slowed economic growth in some disadvantaged regions. Nevertheless, regional governments, infused with new revenue, gained the opportunity to invest in local infrastructure and, thus, attracted non-state as well as state-owned enterprises (SOEs).

Yang (1999) identifies urban-biased centrally planned policies as primarily responsible for the increase in rural-urban disparities. The preferential treatment of the urban sector within the reforms in terms of (i) labor mobility restrictions (from rural to urban areas), (ii) welfare systems, and (iii) financial policies of inflation subsidies[11] and investment credits caused the rising inequality between rural and urban China. In the post-reform period, heavy industrial development was favored which, hence, justified the drain on agricultural surplus in order to support urban capital accumulation and subsidies.

On the other hand, the process of decentralization can burrow major roots of economic growth. Six aspects are identified that supported the favorable economic developments in China: (1) In general, decentralization improves allocative efficiency. Resource allocation fostered an increase in investment in efficient non-state firms and promoted a further increase in productivity. The actual productivity boom was also encouraged by decollectivization and the introduction of profit incentives to collective, private, and foreign enterprises and investors. State authorities were withdrawn from many enterprises. The withdrawal led to a major decrease in the output of state-owned enterprises. Simultaneously, the share of private enterprises and joint ventures rose from 2 to 10% from 1978 to 1992. (2) Foreign trade and investment was liberalized so that the annual increase of foreign direct investment (FDI) rose from below 1% in the late 1970s to 18% in 1994. Especially coastal provinces decided to reduce taxes in order to attract foreign investors. Hence, the favored coastal areas grew faster so that inequality between the provinces increased. (3) State control over some prices was relaxed (especially for consumer goods and agricultural products), enhancing the opportunity for the increase of exports. With rising foreign trade, Chinese enterprises were able to earn hard currency and gain more flexibility on the world market. (4) Investments in industrial production further increased the Chinese position on the world market, but simultaneously increased regional disparity as investments in the industrial sector were made at the expense of the rural areas and the agricultural sector. (5) Through investment in the education of the Chinese workforce, the shift from agriculture to non-farm industry could be enhanced.

The Case of India

Almost one-third of the world's poor[12] live in India, so that the goal of halving poverty becomes very much an Indian challenge. India achieved independence

[11]The period of high inflation during the 1980s was caused mainly by the increase in government expenditures and investments disproportionately in favor of the urban sector. As the rural population accounted for over 75% of the national population and rural wages were, in contrast to urban wages, not subsidized by the state, consistently higher inflationary taxes were imposed on rural earnings, leading to a further increase of rural-urban disparities.

[12]Calculated for the 1990s, using the poverty line of US$1 in purchasing power parity.

and set up a federal democracy in 1947. Regarding economic reforms, India is rather a latecomer. An extensive reform program only followed India's balance of payments crisis in 1991. Until then, India had adhered to a regime with strict government control over private sector participation and investment, foreign trade, and FDI. Starting in 1991, significant reforms led to an opening of the economy and transformed India into one of the fastest growing economies in the world. However, the period of fast economic growth was accompanied by rising inequality which is, still today, especially felt in the remote rural regions. Striking (cross-state) heterogeneity characterizes today's Indian economy and population to a large extent. The heterogeneity also impedes drawing conclusions from all-India aggregates.

India's success story is reflected by the significant decrease of the population remaining below the poverty line. While in the 1970s almost 56% were forced to survive with less than US$1 per day, in 2000 only 28.6% remained there. The rate of annual per capita income growth increased from 0.8% in the 1970s to 3.6% in the 1980s and 1990s. In the 1990s, average consumption per capita grew at an annual rate of 3% (a one-third increase in consumption per capita over the decade). The gradual decrease of the incidence of poverty (from 54.88% in the 1970s to 26.10% in 2000) suggests that India's growth process had a positive impact on poverty reduction. Compared to the 1980s, poverty reduction even accelerated in the post-reform period after 1991 (during the 1980s GEP was at -0.6 and the elasticity, with a value of 0.77, became more negative during the 1990s).

Comparing sectoral patterns of growth shows that overall growth was particularly driven by the industrial and service sectors, that is, by non-agricultural factors (while aggregate GDP grew at a rate of 6.7% annually from 1993 to 2000, agriculture grew at only 3.2%). Different growth patterns thus explain the substantial differences in growth rates among Indian states during the 1990s. Datt and Ravallion (2002) show that the most successful states in the 1990s (in terms of GDP per capita growth) used to be middle income states in the 1980s. The statement that a higher initial level of per capita GDP favors further economic growth holds for all states but the two richest. As higher or middle income states tend to have higher literacy rates, they are also more likely to be affected by non-agricultural growth (that particularly relies on skilled labor). Two main reasons for regional differences in the dimension of poverty reduction appear to be: (1) the state's initial level of inequality (for example, in terms of credit market imperfections, access to education, and inequality of assets like land) and (2) the sectoral and geographic composition of growth. As economic growth was particularly driven by the industrial and service sectors, it seems that the initial literacy rate is crucial for the explanation of pro-poor growth in India. Economic reforms that started in 1991 had a major impact on the further expansion of the Indian growth process.

Besley and Cord (2007) emphasize insights from previous studies and derive six policy propositions essential for relating poverty reduction to economic growth in India. (1) The circulation of regional newspapers must increase in order to give the poor a voice and enhance the responsiveness of the government. (2) The investment climate must be improved so that policies can impact the poor directly. Empirical evidence highlighted the uselessness of some labor regulations. Within the manufacturing sector, regulations that were meant to strengthen the workers left rural poverty untouched and even increased urban poverty. By improving the investment climate rather than putting forward useless reforms, the poor can be directly involved in the economy. (3) Access to capital must be improved. This encourages the creation of non-agricultural activities. The expansion of bank branches to remote areas was shown to have a strong positive impact, first, on rural poverty reduction and, second, on the wages of agricultural labor. (4) Education conditions, especially those empowering women, must be improved to enhance economic growth. The less basic education one receives, the greater the impediments to participation in economic growth. The levels of literacy vary widely throughout India, as education is the responsibility of the states. (5) Property rights must be improved and land reforms must be designed efficiently to substantially reduce rural poverty. Evidence shows that moderate reforms that improved the bargaining power of tenants had positive outcomes after independence, although direct distribution of land showed no effect. (6) Women must be empowered, since the costs of high gender inequality and low female participation turned out to be particularly high in India.

The engine for pro-poor growth in India was the right mix between human resource development and economy-wide policies favorable to the poor. Pro-poor policies imply higher development spending and the implementation of policies that lead to higher output per capita as well as to a higher level of education. Datt and Ravallion summarize these findings by stating that non-agricultural economic growth is more effective in reducing poverty in states with more developed initial conditions (in terms of, for example, share of the landless population, infant mortality, and literacy rate).

The Case of Indonesia

Indonesia is one of the few countries where a strategy of pro-poor growth has been purposely designed and implemented over many years. Despite the weak economic starting conditions, the effort has translated into success. The two decades after independence in 1945 were marked by political and economic instability with a serious decrease in income and hyperinflation. For most development economists, the situation in Indonesia seemed desperate. However, over the following three decades, Indonesia experienced sustained economic growth, which is considered today to be the major source of its poverty reduction. That growth period is held responsible for Indonesia's transformation from a poor economy to a relatively prosperous middle-income country.

Prior to the Asian financial crisis, the incidence of poverty dropped to an astonishing extent. Starting from a situation in 1966 in which almost 70% of the population was absolutely poor, the incidence of poverty decreased to 60% in the 1970s and further to 15.1% in the 1990s. The rate of pro-poor growth had an average value of 6.56 per year during the period from 1965 to 1990 (compared to 2.37 from 1950 to 1965). The remarkable economic development came to an abrupt end with the Asian financial crisis in 1997, dramatically exposing Indonesia's vulnerability. The proportion of poor people rose from 17.7% in 1996 to 24.2% in 1998. However, just as the economic crisis led to a sharp increase in the poverty rate, the rebound in 2000 led to a renewed drop in poverty to almost its pre-crisis level. These figures suggest that poverty responds to a major extent and relatively quickly to economic shocks.

The Indonesian growth process mainly relied on changes in domestic policies and the gradual development of institutions, with the support of a favorable external environment (including the availability of new technologies). Since the late 1960s, almost 80% of the changes in Indonesian GEP is explained by changes in real rice prices. Hence, the adoption of new agricultural technologies counts as the major engine of Indonesia's pro-poor growth.

According to Osmani (2004), the favorable environment, namely, the Green Revolution and the windfall of oil wealth, encouraged the Indonesian government to embark upon a program to promote rice cultivation. The program was based on four pillars: (1) the introduction and diffusion of the new agricultural technology in order to make it available for everyone; (2) the subsidization of agricultural inputs (such as fertilizers); (3) investments in infrastructural development (irrigation and roads); and (4) regulation of the price scheme. Hence, especially small-scale rice farmers were enabled to increase their productivity to an important extent, so that millions of people could be raised above the poverty line in only a few years.

A shift in the structure of the economy and thus of the pattern of growth occurred when Indonesia started a policy of market liberalization. The large inflow of foreign capital (especially from Japan) increased manufactured and labor-intensive exports and, consequently, generated employment on a large scale (the share of manufacturing in GDP rose from 16% in 1985 to 25% in 1996).

Correspondingly, the engine of Indonesia's favorable pro-poor development included political, market-driven, and institutional processes. In combination with a favorable external environment and the conscious and gradual inclusion of the poor, the growth process became pro-poor. Timmer (2007) explains Indonesia's success as the result of a "three-tiered strategy of pro-poor growth" which combined (i) efficient macroeconomic policies with (ii) market activities (translated through the reduction of transaction costs to facilitate operations in the factor and product markets) and (iii) household decisions (regarding labor supply, agricultural production, and investments in non-tradables) stimulating aggregate demand.

The process of pro-poor growth was further promoted by (1) a twofold pro-poor policy intervention and (2) a rise in public expenditures in human development. The twofold strategy focused on investments in rural infrastructure such as roads. The work was carried out primarily by the rural poor who were employed on low wages. Thus, an important part of the abundant rural labor force was absorbed and further productivity gains were stimulated by raising employment. Consequently, the spending capacities of the rural poor were raised simultaneously with the improvement of infrastructure.[13] In addition, the oil revenues were used to invest in education and rural public health in order to further increase productivity in the long-run.

The period of booming economic growth ended with the contraction caused by the Asian economic crisis in 1997. This crisis was reinforced by the unprepared government, which was unable to cope with the situation. The depreciation of the rupiah caused major disruptions in the rice market and, hence, a sharp increase in poverty, resulting in riots. Fortunately, the rural economy played a major role as a safety cushion. The impact of the crisis could be mitigated as the agricultural sector absorbed much of the workforce.

The Case of Vietnam

After years of war, Vietnam was reunited in 1975. The post-war communist period was marked by years of suppression and policies of collectivization of land and factories. The Socialist Republic of Vietnam was hit by political and economic instability, poverty, and war. National poverty stood at over 75%. A political shift only came in 1986, when the government embarked on reforms implementing a free market with private ownership of farms and companies within the socialist regime. Since the introduction of *doi moi* – meaning renovation – Vietnam has

[13]The financial resources for these pro-poor strategies came mainly from additional World Bank funding and oil revenues in the late 1970s.

been undergoing a gradual economic transformation from a centrally planned to a market-oriented economy.

Since the 1990s, the Socialist Republic of Vietnam emerged as a star performer among the Asian economies. At first glance, the growth period might resemble a miracle (Klump 2007), but, at a second glance, it will definitely serve as a showcase for pro-poor growth.[14] Through an efficient policy mix within *doi moi*, Vietnam achieved a reduction of the poverty headcount from 58.1% in the early 1990s to below 25% by the end of 2004.

Since the onset of Vietnam's *doi moi* reforms, the country has experienced a period of remarkable success in economic growth and development. Kakwani and Son (2006) point to a PEGR consistently higher than the growth rate of per capita expenditure during the period from 1992 to 1997. The GEP and RPPG tools yield the same result for the late 1990s: the poor benefited proportionally more than the non-poor from the Vietnamese growth process during the 1990s (from 1993 to 2002, GEP had a yearly average of -0.77 and RPPG an annual average of 4.1). Neither the Asian economic crises that hit most of the other East Asian countries nor the SARS epidemic in more recent times could stop Vietnam's outstanding development, although the very high growth rates of the early 1990s could not be sustained. Between 1992 and 1997, per capita real expenditures still increased by approximately 1.4 times in real terms.

The increase of per capita real expenditure levels is true for rural and urban areas. However, the pro-poorness of Vietnamese growth is tarnished by strong spatial disparities, as the gap between the wealthiest and the poorest regions widened between 1992 and 1997. While some urban areas managed to efficiently translate the periods of strong economic growth into poverty reduction, other, mainly remote rural areas that are to a great extent home to ethnic minorities still suffer from high poverty rates.

Aggregate income inequality did not increase very much between 1993 and 1998 (the Gini coefficient went from 0.34 to 0.35 and only climbed to a value of 0.37 in 2002). Analyzing regional poverty measurements highlights the spatial disparities: average annual growth rates varied within the country between 1.64% (along the north-central coast) to 6.95% (in the northeast) in the period from 1998 to 2002. In 1992, almost 88% of the poor in Vietnam lived in the rural area. While poverty declined by 66.67% in the urban areas between 1992 and 1997, it decreased by only 48% in the rural areas.

[14] Klump (2007) referred to it as a miracle because of the highly beneficial external circumstances which helped Vietnam grow at the given rates. He highlighted the Vietnamese growth experience as a showcase mainly because of the particularly effective internal policy measures.

The pro-poorness of the growth process in Vietnam has been attributed primarily to *doi moi*. The government's reform efforts focused mainly on decollectivization, the abolition of price controls and subsidies, streamlining of the public sector, and macroeconomic stabilization and opening. Bonschab and Klump (2007) identify unskilled labor as the most abundant factor of production. As there is a shortage of arable land, another strategy of poverty reduction than increasing employment of unskilled labor in the agricultural sector had to be found. In this context, Bonschab and Klump suggest the following policies as most beneficial for pro-poor growth:

1) Reduction of population growth in order to slow the increase of unskilled labor. The slowdown in fertility was mainly achieved through the economic reforms that raised the opportunity cost of having children, higher mobility of the population, and the introduction of a widespread family planning program (for example, introducing a two-child-policy in 1988).
2) Decollectivization of farm land by granting land-use rights to individual households in a most egalitarian way. The improvement of land-related property rights had strong pro-poor effects, since it contributed to greater diversification of rural incomes: farmers invested in a more long-term manner. Subsequently, productivity increased and farmers got further involved in non-farm activities. Of the people escaping poverty from 1993 to 1998, 63.4% had previously worked in the agricultural sector. Fourteen percent of those who worked in agriculture and escaped poverty in 1993 had changed occupation by 1998.
3) Pro-poor spending through investments in human capital and public health. By further investments in the main components of the human capital of the poor, the share of skilled labor in the Vietnamese economy can be improved and productivity increased.
4) Facilitation of access to capital through availability of formal credits. In 1993, 73% of all households relied on informal credits with high interest rates that absorbed the impact of private investments. In combination with the implementation of the Enterprise Law, which facilitated the process of licensing, the start up of new private enterprises was encouraged. This led to a shift in the employment structure, away from household enterprises and the agricultural sector, towards the manufacturing and service sectors.[15]
5) Opening the economy to foreign trade. The reform policy was marked by (i) a major shift in the rice policy and (ii) the creation of focal economic areas intended to improve external trade with direct neighbors. Reforms

[15]In the period from 1995 to 1999, private firms created only 4-5% of jobs, whereas they created between 15-30% in the period from 1999 to 2000 (Bonschab and Klump 2007).

in the rice policy relaxed restrictions on rice exports and removed internal barriers to trade, thus leading to an increase in the real price for rice. With the simultaneous abolishment of several constraints on the import of fertilizers and the resulting fall in prices for chemical fertilizers, the overall output of rice increased by more than 20%. In order to support the overall growth process, the Vietnamese government created focal economic areas. The areas were created in order to produce above-average economic growth leading to further industrialization and modernization. The design of high-tech parks and investment in infrastructure facilitated the connection with direct neighbors and trading partners and attracted FDI.

6) Macroeconomic stability, in order to counteract the upward pressure on prices caused by market liberalization. The macroeconomic reform program included a devaluation of the currency, a reduction of subsidies to state-owned enterprises, tougher budget constraints, restructuring of the tax base and administration, and encouragement of the private sector. The strict reform program was successful, and inflation was significantly reduced.

5. Lessons Learnt: Is There a Recipe for Miraculous Pro-Poor Growth?

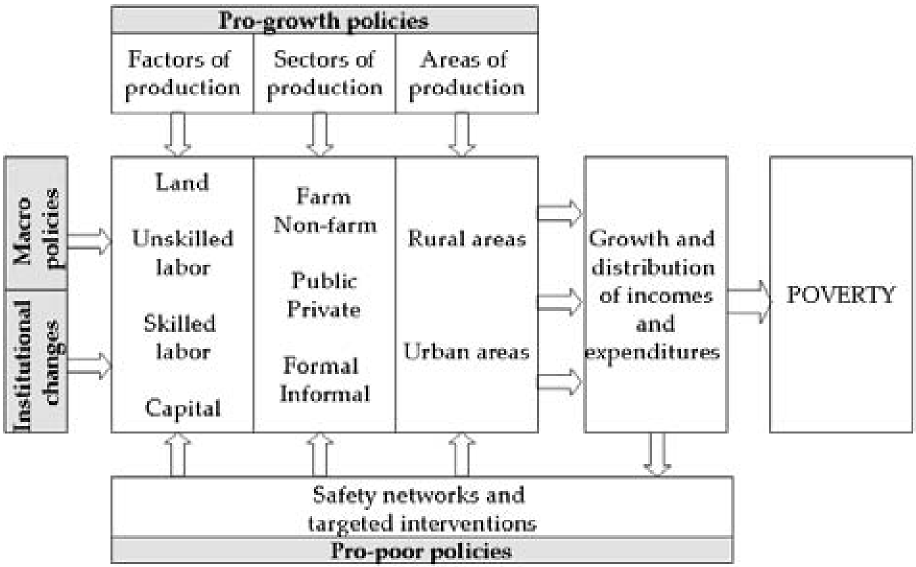
The five country case studies reinforce the conclusion drawn in the introductory section: There seems to be no unique recipe for successful pro-poor growth, but initial conditions, explicit policy interventions, and incidental external developments have influenced the aggregate pattern of growth and poverty reduction. Nevertheless, some particular policy interventions appear fruitful in general terms and thoroughly adaptive to differing environments. Therefore, the following section aims to derive some general lessons learnt from the case studies. In addition, the aim of this section is to overcome the "missing theory problem" by drafting a general conceptual framework in which results from the country analyses can be translated into pro-poor growth policies.

In a general perspective, explicit pro-poor growth intervention can focus on (i) microeconomic policies designed to induce an equitable growth process, (ii) macroeconomic policies devised to create a stable economic framework for the increase of GDP, and (iii) the creation of a system of transfers and safety nets as a last resort for those people who are not able to actively participate in the growth process.

Starting from a simple analysis of the process of production and income generation, Bonschab and Klump (2004) identify three major blocks of direct microeconomic policies that need to be stressed in order to make a policy strategy explicitly pro-poor, namely policies influencing (1) the factors of production,

(2) the economic sectors, and (3) the geographic areas of production. According to the country-specific conditions, the different blocks have to be approached differently, but with the same goal of combining growth with poverty reduction. Thus, the specific country context must be examined carefully beforehand. Therefore, these should be understood as a toolbox for decision makers at the micro-level. In addition, governments can influence pro-poor growth by using the set of existing institutions, through macro policies or by direct pro-poor spending. Public transfers can influence the wellbeing of the poor directly or by impacting the availability of productive assets indispensable for the poor to escape poverty (such as education and health) and the sector and area composition of production (for example, by investing in infrastructure or reforming ownership rights). In general, the economic process of production, income generation, and (re)distribution is affected by policy interventions in each block.

Figure 1: A General Conceptual Framework for Pro-poor Analysis



Source: Based on Bonschab and Klump (2004) and Klump and Miralles (2006)

Depending on the abundant factor of production, land, capital, or skilled or unskilled labor will be determined as the starting point for efficient factor-market-policy interventions (for example, land reforms, education policies, or capital market reforms). By increasing those factors of production which are complementary to the abundant factors, an efficient poverty-reducing strategy can be designed. Since unskilled labor is usually the abundant factor of production in developing countries, the strategy should aim at increasing skilled labor (by investment in human capital) and land (for example, by decollectivization, the increase of property rights, or investments in rural infrastructure). Such a strategy will not only increase labor productivity, but will simultaneously increase the productivity of the complementary factor, land. This will translate into higher agricultural employment and higher agricultural income. The effectiveness of such a strategy is highlighted by the success stories of Bangladesh, Indonesia, and Vietnam that have been enhanced by the Green Revolution and the resulting increase in productivity. All governments of the countries examined in this article showed that the combination of investment in human capital with land reforms and investment in rural infrastructure resulted in an acceleration of economic growth that benefited the poor at least proportionally.

The elementary factors of production (such as land, (un)skilled labor, and capital) are used in different proportions in the production processes in the farm and non-farm sectors, the private and public sectors, and the formal and informal sectors. In line with the concept of Bonschab and Klump, Pasha and Palanivel (2004) suggest addressing the microeconomic reforms to the poor population by directing the resources straight at them. That is to say, sectoral policies should direct resources to sectors in which the poor work. If growth is concentrated in sectors in which most of the poor work, then employment generation will most probably have a positive impact on poverty reduction.

The case studies reveal the significant impact of agriculture on economic growth and, most notably, on poverty reduction. It was shown that agricultural growth generally has a major effect on poverty reduction in combination with a reduction in inequality. Through the liberalization of agricultural exports and the import of fertilizers, especially Bangladesh, Indonesia, and Vietnam were able to encourage pro-poor growth. Non-agricultural growth tends to benefit the economy in a faster way, but usually at the expense of the poor (as shown by the cases of Bangladesh, China, and India).

An important segment of the rural poor is concentrated in the non-farm rural sector and produces non-tradable goods and services. As local demand is essential to the growth of this non-farm sector, rising agricultural income provides it with additional demand. Hence, the impact of agricultural growth on poverty reduction is indirect, since it is mainly through increased spending in the non-farm rural sector. Through the creation of backward and forward linkages between the agricultural sector and the non-farm sector in rural areas, agricultural growth is further strengthened and a virtuous circle of growth and income develops.

The direct impact of agricultural growth is shown by the Green Revolution, which reduced poverty through a significant increase in productivity and, hence, the shift of poor farmers above the poverty line. However, country cases highlight that agricultural growth must be accompanied by constant attention to the profitability of labor-intensive activities (for example, investments in rural infrastructure like roads) in order to have a direct impact on poverty reduction. Otherwise, the rural poor stay poor despite agricultural growth.

If the nature of growth is not to be agricultural, then, policy strategies must be designed differently, as the case of India shows most clearly. Countries and regions with lower literacy rates will face difficulties, as non-agricultural growth mainly benefits skilled labor – in contrast to agricultural growth, which affects unskilled labor. The country case studies show that employment growth remains one of the main channels through which economic growth and poverty reduction are linked. Since poverty can most efficiently be reduced through income generation and income is generated through employment, the key to sustainable poverty reduction lies in the expansion of employment opportunities.

With a higher level of development, the industrial and service sectors become more relevant to the poor. Since the public sector generally lacks the flexibility to absorb the poor, the domestic private sector needs to expand and be strengthened. The examples of China and Vietnam show how policy reforms can create profit incentives in order to attract private investors and encourage the start up of new enterprises. Through the facilitation of access to private credits and licensing of private firms, investors can be supported in their investment plans. The cases of China and Vietnam show that an efficient resource allocation through decentralization and decollectivization further accelerates the development of the private sector. Sound reforms also prevent the workforce from rushing from the agricultural into the industrial sector only to become informal workers.

Much evidence shows that the poor of a country can only benefit from microeconomic policies if they have the opportunity to operate in a well-functioning macroeconomic framework. Only within a country that guarantees a certain economic stability will development strategies take. Within a stable economy, the likelihood of financial and socio-political crises can be minimized. However, the impact of the different macroeconomic variables on growth and poverty reduction is still strongly debated. Nevertheless, the country cases show that some macroeconomic policy interventions turn out to be especially efficient in supporting and enhancing the pro-poor growth process. The cases of Bangladesh and Vietnam reveal that low inflation and a low public deficit create a favorable environment for pro-poor growth. By increasing economic openness through liberalization policies and the devaluation of the currency, foreign investors can be attracted and will fuel the national economy. The potential impact of trade liberalization on poverty reduction is one of the most prominent elements within the pro-poor growth discussion. The cases of Indonesia and Vietnam show its positive impact principally on rural economic growth. However, the rising rice prices for Vietnamese consumers should not be neglected. According to the World Trade Organization, a general consensus suggests that expansion of exports (through trade liberalization) contributes to faster economic growth. During the 1990s, the individuals who benefited from trade liberalization were either directly involved in export activities or operated in limited auxiliary service functions that developed around export activities. Hence, to ensure that trade liberalization benefits the poor, backward and forward linkages must be implemented. Through those linkages, larger-scale economic sectors can participate in export activities.

The macroeconomic rationale for keeping budget deficits low is also highly controversial. On the one hand, governments are generally urged to keep deficits small in order to support macroeconomic stability. Large budget deficits increase the danger of a crisis which will affect the poor disproportionately (as was shown in the case of Bangladesh). However, government expenditure in the form of public investment in human development and infrastructure can particularly support the poor, as the country cases of Indonesia, Bangladesh, and India show. Expenditures are most efficient if they are financed through additional resources and not through the public deficit (as highlighted by Bangladesh and Indonesia). Within the country case studies, public investments in rural infrastructure display a positive impact on rural poverty reduction. However, the impact seems even more pro-poor if the road work is carried out by hired rural laborers (employment growth).

The importance of public investment is highlighted by the evidence from China and Vietnam, where a crowding-in of private investment followed increasing public investment. However, this cannot be generalized. In cases of governance failure, corruption, and problems in the implementation of public sector projects, budget deficits can, in contrast, harm the economy to a significant extent. Only when GDP growth is significantly lower than the potential long-run growth rate, is there a possibility of making use of expansive fiscal policy. However, it must be kept in mind that in the case of government expenditures targeting human resource development (such as, for example, education or family planning programs), the positive impacts on poverty might not be apparent in the short term. These investments impact the long-term poverty pattern. It is therefore possible that the actual impact of such investments only becomes apparent through the measurement of non-income factors.

All policy recommendations stress the importance of empowering the poor and making them a productive part of society. However, some individuals are more vulnerable and not able to actively participate. Because of illness, age, or discrimination, some individuals rely on further support. Others rely on temporary help because of natural disasters or unforeseen threats (for example, floods in Bangladesh). The resulting inequality can be addressed by complementary interventions, such as transfers, on the one hand, and the creation of safety nets, on the other.

Transfers do not target the active inclusion of the poor, but rather their embedding in the growth process through redistribution. By direct (conditional) payments or subsidies to certain individuals, transfers can reallocate a share of the growth dividend. The group of temporarily disadvantaged can be helped through safety nets. Safety nets have two main functions: (1) redistributing income and resources to help the poor overcome short-term poverty, and (2) helping households to manage risks. The most efficient instruments for coping with risk are insurance systems that are available to and affordable for the poor. The country cases demonstrate the importance of such safety nets. Because Bangladesh benefited from an efficient policy to deal with risks, especially regarding natural disasters, efficient poverty reduction was possible despite poor initial conditions. In contrast, Indonesia suffered intensely and lost an important share of the growth dividend in the financial crisis because of the lack of formal safety nets.

6. Concluding Remarks

The debate on growth with poverty reduction in general and the analysis of selected Asian country case studies has raised the question whether a unique recipe for pro-poor growth exists. Instead of providing a short and misleading answer to the question, this article aimed, first, to point out the important definition and measurement problems with pro-poor growth and, second, to build on country experiences to develop a consistent conceptual framework for the analysis of appropriate policy interventions given the heterogeneity of initial country conditions.

Our lessons can be summarized as follows:

1) Before implementing a pro-poor growth strategy, policy makers must first define the goal to be achieved. Depending on the absolute or relative understanding of pro-poor growth, policy interventions differ, as was seen in the introductory part of this article. Hence, policy makers must decide whether they want to concentrate on economic growth or on including equality in the development process.

2) In order to actively design growth policies, decision makers must pay attention first of all to a sound macroeconomic framework in order to implement appropriate microeconomic policy interventions. By analyzing the specific country conditions, the areas of intervention can be determined and then approached through policies targeting the relevant factor markets, sectors of production, or areas of production and income generation.
3) In order to ensure that no part of the population is left behind in the growth process, policy makers should implement an efficient system of transfers and safety nets to support the disadvantaged and help people cope with disasters when necessary.

Making use of the available country resources to foster growth, while at the same time spreading the growth dividend among the whole population, is a concept which became popular in post-war Germany under the name of the "social market economy." In the view of Ludwig Erhard, the first Federal Minister of Economics in the Federal Republic of Germany and its second Chancellor, the social market economy relies on free markets, a sound macroeconomic environment, and social safety nets, which provide the necessary social balance of growth. Given the remarkable conceptual proximity between the strategy of pro-poor growth and the model of the social market economy, the German experience of achieving a sustainable and balanced economic miracle in the 1950 and 1960s might provide a further interesting case study from which developing countries could learn today – not with the aim of copying a specific country model, but in order to discover how specific country conditions can be used most efficiently for a highly successful development path.

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Industrial Policy – A Key Element of the Social and Ecological Market Economy

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Introduction: Industrial Policy in the Social and Ecological Market Economy

Neoliberal models of economic development have not been able to achieve persistent economic growth. This became especially evident in Latin America and Africa in the 1980s and 1990s. Furthermore, rapid and undifferentiated economic liberalization, in combination with a movement to downsize government programs, has increased the social imbalances between and within societies and made it more difficult to deal with the ecological threats to humanity. On the other hand, state-led development models that tried to replace market-based resource allocation with heavy-handed government planning and implementation often fared even worse. The social and ecological market economy (SEME) provides a promising, pragmatic alternative to the neoliberal and the state-led development models, as it aims to reconcile the propelling function of markets with the checks and balances provided and executed by the state as the entity responsible for safeguarding (social) equity and (ecological) sustainability. It is therefore gaining credibility, especially among developing countries of Asia that traditionally assign an important role to government intervention, but seek to avoid the errors of manifold non-capitalist experiences in the region.

The concept of SEME, however, is not very well defined, and those countries that claim to have developed some kind of SEME (Germany, the Scandinavian countries, the Netherlands, New Zealand) have implemented different policy mixes to balance efficiency with social and ecological goals. Moreover, these strategies have changed over time, not least in response to the challenges of globalization. The common denominator of SEME is that the state, within a market-based and competitive economy, seeks to ensure equal opportunities for its citizens to participate in the economy. Social security systems also help ensure inclusion in societal life. Furthermore, environmental protection is pursued by internalizing environmental costs in the market economy. State intervention is based on the principle of subsidiarity, whereby local authorities and non-government organizations play an important role in providing public goods. Industrial policy played and plays an important role in forming and maintaining SEMEs. Successfully implementing industrial policies requires a careful balancing of market forces and state intervention to achieve optimal results in terms of economic efficiency, social equity, and environmental sustainability.

This article presents lessons learnt from the successes and failures of industrial policy. Chapter 1 provides a definition of industrial policy and shows how it usually pursues various objectives. Chapter 2 discusses the theoretical underpinnings of industrial policy, in particular the concept of "market failure" that is used to justify government intervention in markets and its counterpart, "government failure," which addresses the risks that are necessarily involved in any intervention. Chapter 3 then reviews the existing empirical evidence with particular emphasis on Asia. Finally, Chapter 4 distills lessons from theory and from Asian practice. It summarizes how industrial policies should be designed and implemented so as to preclude government failure and to achieve the intended outcomes effectively and efficiently, and it identifies principles that should guide "smart" industrial policy in line with the framework of the social and ecological market economy.

1. Industrial Policy: Definition and Targets

Industrial policy comprises any deliberate state activity that stimulates specific economic sectors and activities and thereby promotes structural change (Rodrik 2007, 3). Although traditionally its main aim was to spur the transition from agrarian to industrial, that is, manufacturing societies, the term *industrial policy* refers more broadly to any public support for structural change. In recent years, industrial policies more and more often aim to build competitive advantages in knowledge-intensive services. In other cases, especially in developing countries, industrial policies also support non-traditional primary activities, such as salmon farming or viniculture.

Very diverse policy measures may directly or indirectly affect and alter the sectoral composition of the economy. Industrial policy therefore overlaps with manifold other policy areas including trade policy, financial policy, competition policy, infrastructure policy, education policy, and employment policy.[1]

[1] See, for example, Meyer-Stamer 1998, 2 ff. Especially in development cooperation, the terms *private sector policy* or *SME policy* are commonly used. In practice, these concepts largely overlap with *industrial policy*. What characterizes the latter concept is its emphasis on structural change without ex ante privileging certain firms due to their ownership (private vs. public) or size (small vs. large) structure.

Industrial policies are mostly geared towards increasing economic efficiency and competitiveness. In practice, however – and particularly in a SEME – efficiency gains are not pursued exclusively, but social inclusion and cohesion and environmental sustainability are also taken into account.[2] Four different objectives may be distinguished. The first three reflect traditional key objectives, whereas the fourth objective has gained in importance since the 1980s:

1) strengthening competitiveness of existing industries and stimulating the development of new ones to seize new economic opportunities, for example, through subsidies for research and development (R&D) or through support for start-ups in promising new activities;
2) cushioning the social effects of the decline of mature industries, for example, through specific policies for regions which depend on declining industrial activities, where unemployment rates are increasing to a disproportional degree;
3) balancing regional inequalities, for example, through special incentives for investments in less developed regions; and
4) counteracting negative externalities of economic activities on the natural environment, for example, by establishing tariffs above market equilibrium level for renewable energy fed into the power grid.

The logic of industrial policies may differ. *Selective* policies target specific sectors, such as coal and steel, electronics, or biotechnology. *Horizontal* policies support a specific range of activities that are considered important for competitiveness across sectors; examples include subsidies for R&D and industrial training or finance for innovation. Neoclassical economists in most cases reject selective policies, arguing that they distort competition and channel resources towards less efficient activities. Horizontal interventions, in contrast, are widely accepted, because the existence of market failures in R&D, for example, is generally recognized. In practice, however, the distinction is not as clear cut as it may seem. Governments often try to influence the broad direction of structural change without favoring specific industries, for example, by providing support for *innovative* activities (thus discriminating against well-established types of enterprises) or fostering the *use of ICT* (which is more relevant in some activities than in others). In other cases, local clusters of specialized firms are supported, in other words, incipient patterns of specialization are further strengthened.

[2]See, for example, the European Union's Lisbon Strategy (European Union 2004, 6, 8, 16, 31). The strategy calls for "removing disincentives for female labor force participation," "eradicating poverty," and "addressing specific target groups' issues." Moreover, "it aims for growth to be environmentally sustainable." Meyer-Stamer (1998, 13-14) calls for an "industrial policy for sustainability." See also Aigingers' concept of "dynamic competitiveness" (Aiginger 2007, 313).

In practice, industrial policy serves not only to achieve any of the above mentioned four objectives. Rather, politicians sometimes use industrial policy instruments to satisfy particular demands of their respective electoral constituencies.

2. Market and Government Failures – Theoretical Underpinnings of Industrial Policy

According to neoclassical economic theory, market forces should lead to the best possible allocation of available resources, thereby enhancing the specialization of countries according to their comparative advantages (Pareto efficiency) and inducing growth. There are mainly two reasons why markets may fail to deliver these outcomes predicted by the neoclassical framework (see, for example, Chang 1996, 7 ff. on *market failures*):

1) The existence of economies of scale or collusive behavior may lead to *imperfect competition* (for example, monopolies or monopsonies where individual market agents may affect quantities and prices in the market). Governments may need to regulate markets under conditions of imperfect competition.
2) Decisions and action of individuals generate costs or benefits for other stakeholders (*externalities*). As a result, private cost-benefit structures deviate from the social cost-benefit structure. In such situations, governments may be well advised to provide (or create incentives for the provision of) goods in the public interest.

The assumptions underlying the neoclassical approach are restrictive. Even neoclassical economists themselves admit that their assumption that markets function on the basis of perfect competition among actors with full information about all relevant parameters and with completely rational preferences is an abstraction of the real world situation. This is especially the case with regard to most developing countries, where market-enabling institutions are deficient and basic public infrastructure as well as high-level technical training is lacking.

This mismatch between simplified models and complex reality has led some authors to reject the concept of market failure as the rationale for industrial policy (for example, Cimoli et al. 2006). However, accepting the difference between model and real world, the concept of market failure can be an important analytical tool to analyze critical weaknesses in markets and to target policies accordingly.

One essential field where market forces alone will lead to underperforming economies is innovation and technological learning (Rodrik 2004, 6 ff.).

Technology and innovation are key drivers of productivity growth. Productivity growth, in turn, is necessary to enable local producers to cope with increasing international competition, while allowing salaries and social welfare to rise. As evolutionary economics teaches, technological learning is a complex process. It involves the skillful recombination of knowledge that is partly bound to individuals and/or organizations and therefore requires a high degree of interaction, trust-building, and coordination. Moreover, learning processes are cumulative, often with uncertain economic outcomes and multiple externalities (see, for example, Lundvall 1992). The development of new technologically relevant knowledge suffers from problems of non-appropriability. While the actor investing in knowledge creation inevitably has to bear the sunk costs and the risks of innovation failure, in most cases he will only be able to appropriate part of the benefits in case of innovation success. This is all the more the case in societies where institutions for the protection of intellectual property and enforcement of contracts are weak.

In sum, innovation and technological learning are highly prone to market failure, while bearing a huge development potential. Public support to R&D, human capital formation, and technology transfer is thus an essential element of industrial policy in practically all high performing economies. World Trade Organization (WTO) rules explicitly exempt support to research activities, including those carried out by private firms, from the list of prohibited subsidies, provided that it does not exceed certain levels.[3]

Probably the most serious negative externalities of purely market-driven development are the degradation of natural resources and damage to the environment that affects all stakeholders in a given territory alike, independently of whether or not they benefit from the economic returns of an activity (as entrepreneurs, workers, or consumers). The reports by the Intergovernmental Panel on Climate Change (IPCC) and the Stern Review on the Economics of Climate Change (Stern Report) have recently emphasized that external environmental effects go far beyond national boundaries and that the costs will largely be borne by segments of the global population that have not benefited from economic growth to any relevant degree.

The need to incorporate environmental and, in particular, climate-related externalities is not yet fully reflected in industrial policymaking, neither in developed nor in developing countries. Fostering competitiveness, on the one hand, and environmental policy, on the other hand, are in most cases still being handled by separate and often competing political entities and stakeholder groups.

[3]WTO, Agreement on Subsidies and Countervailing Measures, Article 8.2 (a), http://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm#articleVIII (January 4, 2008).

It should be noted that industrial policy is not always geared towards enhancing national competitiveness. Instead, governments in social and ecological market economies may also pursue industrial policies in order to maximize social and environmental spillovers from economic activities. They may, for example, link innovation policy with efforts to improve resource productivity and ecological performance. Public procurement may be employed to purchase ecological "best-practice technologies," and prizes may be offered for innovative technologies that secure particular environmental objectives (Gross and Foxon 2003, 125-128).

While the inclusion of the environmental dimension in industrial policy is quite recent, the social dimension has for quite some time been integrated in the discussion on industrial policy. Two examples are given below to illustrate how industrial policy can contribute to achieving socially desired outcomes:

- Policies to alleviate regional disparities. Market forces usually lead to increased power concentration and spatial polarization. Once regional disparities exceed acceptable limits, social cohesion is endangered, and political unrest (or radicalization) may be induced. In Germany, the constitution obliges the government to ensure equivalent living conditions in all parts of the national territory. Likewise, in most other industrialized countries, governments pursue programs to reduce spatial polarization, often including significant transfers of public financial resources.[4]
- Policies to shape urban space. Market forces induce the concentration of retail services in large super- and hypermarkets, often greenfield investments outside of the urban core areas, where land prices are lower. In many countries across the developed and developing world, this has led to loss of infrastructure and decaying downtown areas. As a consequence, in many countries, among them the USA with its market-liberal tradition, urban revitalization programs were set up, including tax incentives and grants for companies wishing to invest in the inner cities.

Summing up, these observations on innovation and learning processes, environmental externalities, and regional disparities show that market failures are common and justify public intervention. On the other hand, critics of industrial polices point to the risks of *government failure*. Even if markets fail to provide the best possible solution for certain problems, government interventions may do more harm than the actual market failures. Five arguments are put forward by critics of industrial polices:

[4] As in the case of public support to research, the relevant WTO agreement (see footnote 3) exempts from prohibition "assistance to disadvantaged regions within the territory of a Member given pursuant to a general framework of regional development."

First, the state is composed of politicians and bureaucrats who, at least partly, pursue their own personal interests rather than working in the best interest of the public. Individuals enter the bureaucracy in order to achieve reputation and power, to enjoy the perquisites of the office and, most importantly, to draw a good salary. All of these variables are affected by the size of the total budget of the bureau. Bureaucrats thus benefit from the size of their institutions and the available resources. The bigger the budget, the higher are the salary and reputation as well as the opportunities to satisfy clientelist networks. Therefore, it is rational for bureaucrats to attempt to extend their responsibilities and to produce goods and services in more than a socially optimal quantity (Chang 1996, 22-23 and Fritsch, Wein, and Ewers 2007, 407). Even if an agency's work is not successful, it may try to hide its inefficiency in order to ensure further allocation of funds.

Second, bureaucrats, unlike private investors, do not bear the full risk of their decisions. Incentives for civil servants are determined by the civil service career law and informal patronage norms. Usually there are few provisions to reward good or penalize bad performance (Fritsch, Wein, and Ewers 2007, 406). This implies a considerable risk that less care is taken when public funds are invested.

Third, governments are not insulated from the specific interests of pressure groups. The state can be seen as "an arena, within which economic interest groups or normative social movements contended or allied with one another to shape the making of public decisions" about "the allocation of benefits among demanding groups" (Skocpol 1985, 4). Since the most powerful groups will be most effective in influencing relevant decisions, state policies and regulations reflect the interests of these powerful players. For example, private sector groups may seek privileged access to subsidies or protection from more efficient competitors.

Fourth, the fact that governments allocate benefits to pressure groups creates an incentive for private agents to divert efforts away from productive purposes (for example, to enhance productivity and competitiveness) towards influencing state policies and capturing the rents emanating from these state interventions (Krueger 1974 and Chang 1996, 27-28).

Fifth, even if all state actors were benevolent and tried to improve the efficiency of the economy and overall welfare, they may lack the ability to achieve their well-intended objects. It is doubtful whether the state is better informed than markets, which would be a prerequisite for correcting markets. Of course, firms may also take wrong decisions, but this is part of a competitive dynamic of entry and exit that permanently drives innovation. In contrast, governments that channel resources towards certain industries and "pick winners" may distort market signals and thus make resource allocation inefficient (see Pack and Saggi 2006, 281 ff.). In addition, collecting and processing the necessary information is a cost-intensive exercise for the state. These costs may exceed the benefits of correcting market failures and result in a waste of resources needed for other policies (Chang 1996, 26).

3. Empirical Evidence: Lessons from the "Asian Miracle" Experiences

South Korea, Taiwan, and Singapore are the countries whose development trajectories most seriously challenge conventional economic wisdom regarding the power of the "invisible hand" and the superiority of non-interventionist over interventionist policies. The three (formerly developing) countries managed to catch-up with the OECD[5] world in terms of economic dynamics and social welfare within only a few decades. Catching up was a consequence of interventionist policies to help create comparative advantages. When looked at in more detail, the policies adopted by the three countries were quite different. While Korea used subsidized credit and rationed it in a highly selective manner to favor sectors and companies investing in strategic industries, the most important instruments in Taiwan were selective fiscal incentives (Etzkowitz and Brisolla 1999). Later, other Asian countries – Malaysia, Indonesia, China – tested different interventionist strategies, with some remarkable successes (for example, building up competitive advantages in different sub-sectors of the electronics industry in Korea, Taiwan, Malaysia, China, and Singapore) and some costly failures (for example, the national car in Malaysia, aircrafts in Indonesia). In sum, however, the region, on the basis of relatively interventionist policies, fared much better in terms of industrialization and the creation of knowledge-based competitive advantages than any other region in the world.

Since the early 1990s, many studies have tried to explain the factors behind the success of the Asian miracle countries, often comparing it to the failure of interventionist policies in Latin America (for example, World Bank 1993; Nelson and Pack 1999; Lall 2006). While the debate around some issues is still going on, there are several elements of Asian industrial policies that are mentioned rather undisputedly as critical success factors (see, for example, Westphal 2000 and Wade 1990):

- Macroeconomic stability, reflected in relatively low inflation rates, positive real interest rates, fiscal balance, and properly valued real exchange rates, allowed for rapid and effective responses to disruptive shocks.
- Factor inputs rose quickly, physical and human capital were rapidly expanded.

[5] Organization for Economic Cooperation and Development

- Even if the strategic goal was industrialization, the expansion of the manufacturing sector was paralleled by successful agricultural development.
- Competent bureaucracies were able to orchestrate the development process, without succumbing to lobbying or pressures by strategic interest groups.
- Incentives for new industries were tied to performance, for example, special concessions were handed out on the condition that export targets be met.
- Compared, for example, with Latin America, these Asian economies were quite open, both with regard to trade and to ideas. The emerging manufacturing sectors were export oriented from the very beginning, and exports grew much more rapidly than gross domestic product (GDP) over long periods of time.
- In all Asian miracle countries, governments fostered the transition towards knowledge- and technology-driven economies by emphasizing primary and secondary education as well as technical training on vocational and tertiary levels.
- Government spending on R&D was also a strategic asset of Asian industrial policy, enabled by the high export revenues. South Korea, in particular, is today among the world's leaders in R&D spending as a percentage of GDP.
- Openness, however, was by far not complete: on the import side, Korea and Taiwan imposed differential tariffs and sometimes even quantitative restrictions on trade.

Apart from these commonalities, each successful catching-up process was based on a unique development trajectory, and industrial structures as well as policy mixes varied quite strongly. For example, Korea, Taiwan, Singapore, and Hong Kong adopted very different strategies for dealing with foreign direct investments. More recently, the success stories of industrial development in China and India again build on specific strategies (Altenburg, Schmitz, and Stamm 2008). Also, each successful country and sector benefited from certain windows of opportunity. Hence there is no "one-size-fits-all" concept for successful industrial policy.

Nevertheless, three general lessons may be drawn from this brief sketch of the Asian miracles, specifically compared to less successful or failed policies in other developing regions:

First, selective industrial policy can be successful if carried out by competent governments. Bureaucracies need to be sufficiently independent from interest groups that may distort the process in their favor. While state intervention can be assessed as greatly successful, government failure always was a problem. Quite often, consumers had to purchase overpriced goods to sustain less efficient industries for prolonged periods of time; also, banks sometimes accumulated non-performing loans due to errors in directing credit to supposedly "strategic," but actually inefficient, industries.

Second, export orientation had important stimulating effects on economic growth and productivity. International trade allowed the Asian countries to specialize in their respective comparative advantages and to increase their welfare. At the same time, export revenues allowed for the import of intermediate goods needed to utilize existing capacity and of machinery and equipment needed to modernize the industrial infrastructure and expand capacities. Whereas import substitution strategies in most developing countries led to severe balance of payment problems, the newly industrializing Asian economies managed to match their increasing technology requirements with higher levels of exports. Furthermore, importing and applying increasingly sophisticated capital and intermediate goods triggered technological learning on the company and the national levels. At the same time, exposure to demanding and rapidly changing competitive markets obliged companies to continuously upgrade their technological capabilities.

Third, export-driven industrial development can rapidly expand the employment opportunities of the poor and even help to achieve equity goals. Labor-intensive export industries helped many Asian economies to manage the transition from low productivity agrarian to more productive urban and industrial economies. Today, income distribution in these countries is atypically equitable, especially if compared to most Latin American countries. Furthermore, the strong emphasis on education at all levels further helped to make the development trajectories of Asian catch-up economies not only more competitive but, at least compared to other developing regions, more inclusive.

4. Smart Industrial Policies: Lessons Learnt

The previous chapters have shown that market failures call for and justify state intervention. Asian governments in many cases managed to build up successful and internationally competitive industries that would hardly have emerged without targeted government action. At the same time, state intervention carries substantial risks of government failure. As in any other policy field, it is therefore necessary to abandon the futile ideological discussions about markets *versus* states. Rather, one should ask *how* industrial policies should be designed and implemented so as to preclude government failure and to achieve the most appropriate balance of competitiveness, social inclusion, and environmental protection in an effective and efficient way.

In this final section, we will therefore attempt to give some answers to this question, drawing on practical lessons learned from industrial policy successes in Asia and elsewhere as well as on insights from different bodies of literature, including general literature on political economy and more specific studies on new public management as well as donor guidelines on best practices in service provision.

First, when *choosing sectors and activities for governmental support*, a number of issues should be kept in mind:

Although the primary goal of industrial policy is to alter the sectoral composition of the respective economy in a way that enhances its competitiveness and allows for higher per capita income, it should always balance economic with social and environmental goals. Ensuring equal opportunities for all citizens to participate in the economy is of particular relevance in countries where a large portion of the population is poor and economically and socially marginalized. Also, it is necessary to make sure that environmental costs are internalized in the market economy as much as possible – something that the Asian tigers have greatly neglected. Social and environmental impact assessment should therefore be part and parcel of any new industrial policy initiative.

Asian countries have shown the importance of focusing on sectors and activities that are innovative and expand existing markets. As Rodrik notes, the "first order of business in development is to learn how to do new things, not to focus on what one already does well" (Rodrik 2006, 5). Taking up new activities creates new product or process technologies and facilitates organizational learning at the firm level as well as human capital at the level of the individual worker. Innovation in this broad sense is critical for productivity growth, product differentiation, and sectoral diversification. These productivity enhancing and learning effects cannot be fully internalized by firms and workers and generate positive externalities for the whole economy and society; it is therefore justifiable to target public support at innovative activities.

Innovation and learning may be particularly strong in the area of emerging frontier technologies, but especially in developing countries they can also be triggered by imitating technologies that are already being applied elsewhere (Lall and Teubal 1998, 1375, 1378). Producers in developing countries are often trapped in a vicious circle, where they are unable to achieve economies of scale because the quality of their product is low, their knowledge about markets is limited, and marketing channels are weak. This results in low productivity, low returns, and little reinvestment. Barriers to entry for such activities are low, and new producers regularly move into the same type of activities. As long as the market does not expand, this will only result in cut-throat competition and decreasing returns. Hence, it is crucial for industrial policy to promote the development of products that are new to the local environment and would allow producers to access new, less oversupplied markets with higher returns (Altenburg and Eckhardt 2006, 21, 28 ff.). This should be done by encouraging search processes (for example, rewarding new business ideas or non-traditional exports) rather than letting policymakers define what they regard as promising activities.

Although new trade and growth theories have shown that comparative advantage is not predetermined by the given factor endowments, but can be "created" through deliberate efforts by firms and supporting institutions (Porter 1990), a note of caution is necessary in light of scarce public resources: Before entering into innovative markets, search processes should consider the economic viability of the sector or activity by assessing the current base of capabilities, feasible rates of improvement, and the expected evolution of demand. Moreover, they should try to assess the cost-benefit ratio of support, even though the benefits include environmental and social externalities that often cannot be measured in economic terms (Lall and Teubal 1998, 1379).

Second, there are a number of lessons learnt with regard to the *process of designing public support policies*:

Many problems cut across the boundaries of sectors and cannot be overcome by actors from a single institution. Therefore, it is necessary to transcend bureaucratic boundaries and design joint working arrangements and coordination mechanisms (Bullock, Mountford, and Stanley 2001, 14). Importantly, cooperation and coordination among government agencies requires that mandates, competences, and responsibilities are clearly defined and agreed. Vague, conflicting, or contested competences lead either to inaction or to fragmentary or opposed actions – all of which waste public resources and prevent public actors from being held accountable (Rodrik 2007, 43-44). In particular, unbundling the roles of the government as an entity that defines targets, rules, and regulations, on the one hand, and provides services, on the other hand, is recommended. Separation of regulatory and operational functions creates clearer lines of accountability. Furthermore it gives service providers the autonomy to use flexible means to reach their goals without undue political interference in decisions (World Bank 2006, 51).

As governments are not market actors, they lack information about constantly changing market dynamics – the most promising sectors and activities, the most significant bottlenecks for market actors, and the most effective interventions to tackle them. These structural information gaps cannot be overcome if they are left to the lobbying and rent-seeking activities of the strongest individual actors. Therefore, policy making must involve a wide range of both public and private actors in a transparent manner. Possible mechanisms for collaboration with the private sector are deliberation councils, supplier development forums, investment advisory councils, sector roundtables, and private-public venture funds. Furthermore, care must be taken to obtain and integrate the views of other stakeholders and other directly or indirectly affected persons in a systematic manner (Bullock, Mountford, and Stanley 2001, 14). Trade-offs may emerge between the need to draw on scientific expertise, on the one hand, and social inclusiveness and participation, on the other hand. Not listening to those at the receiving end, however, does not pay, as it leads to bad results, implementation problems, and loss of public legitimacy. Collaboratively, these actors should seek to assess and address problems in a comprehensive way, and to avoid unintended negative side effects, for example, regulations that crowd out poor producers or scare away investors. Value chain and sub-sector analyses are useful approaches that help to detect such interdependencies.

When designing targeted support policies, policy-makers should take specific care that the complexity of policies does not overwhelm the implementation capacities of governments and bureaucracies. Even with regard to the Asian tigers, the existence of a "highly capable, coherent economic bureaucracy closely connected to, but still independent of the business community" has been called a "myth" (Evans 1998, 66, 79). Simple, uniform, and non-bureaucratic support schemes may, in certain conditions, be preferable to highly complex and differentiated measures, because they are easier to implement and provide less scope for arbitrary interventions and corruption.

Moreover, if the addressed market failure is not of a permanent nature, conditionality and sunset clauses should be made part and parcel of each intervention, so that barriers to removing benefits will not emerge and policies remain flexible to changing needs.

All policies should be subject to continuous monitoring and independent third-party evaluation. Monitoring and evaluation systems should measure outputs and outcomes rather than inputs. Hence, expected outcomes need to be defined in measurable and monitorable terms.

Monitoring and evaluation (M&E) should include the views of all stakeholders. In addition to traditional M&E procedures, it is therefore in some situations advisable to set up mechanisms for social monitoring. The general public, especially those affected by a certain policy, are likely to hold public service providers accountable if they receive information about how well these agencies are performing and if they have feedback systems at their disposal. Holding service providers accountable is easier if these operate at a decentralized level. This calls for a greater implementing role for local governments.

Last but not least, policies should be designed in a flexible way. The steps from policy design to implementation are usually not unidirectional. Instead, policy processes are search processes that necessarily build on trial and error and on feedback loops between implementation and (re)design.

Third, there are some best practices for *service provision*, which will briefly be recounted here.

As a rule, state intervention should aim at strengthening or developing competitive markets. However, if a market does not develop because of coordination failures, the public sector may have a role in facilitating collective efficiency (Schmitz 1999) among state and non-state actors. Collective efficiency results from external economies of proximity – which accrue to firms quasi automatically, for example, through the existence of local labor pools and supplier networks – and from the potential gains of consciously pursued joint action, such as initiatives to introduce a certifiable quality standard. Governments may facilitate dialogue, help to build trust, and promote information sharing and mutual learning among market actors in order to exploit the advantages of collective efficiency (Neuchâtel Group 2002, 13).

Financial and non-financial enterprise support services are crucial "for effective market-oriented innovation to take place" (Neuchâtel Group 2008, 14), as they are geared to overcoming coordination failures and information deficits. At the same time, these services are themselves subject to market failures: if left to the market, these services will not always be provided or they may not reach out to specific groups of entrepreneurs and producers. Enterprise support services are placed on a continuum of private and public goods. Whereas some enterprise support services relating to day-to-day activities of businesses and farmers bear a strong private goods character, the outcomes of other services relating to "strategic," long-term activities are less easily predictable and appropriable by individual actors and therefore will not be demanded by the poorer segments of entrepreneurs and farmers (Altenburg and Stamm 2004, 11ff.). Services with a strong public goods character therefore require public investment. This holds even more if they serve the public interest by enhancing environmental sustainability or public health (Neuchâtel Group 2006, 26-27). The extent and duration of public funding therefore depends on the degree to which benefits are privately appropriable or public, as well as on the capacity of those at the receiving end to pay for them. In the case of non-permanent market failures, it is advisable to install conditionality and sunset clauses before funding starts. Funding of services with a strong private goods character should also be based on a realistic cost-benefit analysis, so that costs of services do not exceed the amount that the users are able to pay in the future when their capacities are fully developed (Neuchâtel Group 2006, 26). In general, the decision to fund a specific intervention should be taken on the basis of long-term financial planning rather than in an ad-hoc, reactive manner.

Even in the case of services with a strong public goods character, donors and governments should avoid directly providing services whenever possible, but rather support market-based service providers, be they public, semi-public, or private. Having the same organizations managing the funds and providing services is bound to lead to inefficient use of funds, crowding out of private suppliers, as well as to lack of accountability to users. There are several ways to separate the institutions: (a) "Service mandates" allow the use of public funds without maintaining a public delivery system, but are susceptible to the same problems as public provision of services: inefficiency and crowding out. (b) In order to prevent political capture and to elicit private-sector needs and priorities, contests that allow private sector firms to bid for public resources can be particularly useful (Rodrik 2007, 39). (c) Another possibility is demand-side financing via grants or a voucher system – however, the administration of such systems is fairly complex (Neuchâtel Group 2002, 24). The last two options can be used to stimulate the development of a diversity of different service providers. If users are able to choose between different providers, competition will press providers into good quality services and promote more specialized services. Users will be able to demand the services that suit their needs best.

In addition, public service providers should be obliged to measure the cost and income generated by each service, and mechanisms for gathering and feeding back users' opinions of the services delivered should be developed. Performance results must be the basis of future funding. However, when setting criteria and measuring performance, it must be clear that there may be trade-offs between different objectives, for example, between financial sustainability, on the one hand, and impact, on the other, or between outreach and impact (Altenburg and Stamm 2004, 24).

Another important instrument for making service provision more market based is co-financing by users, even if (in the case of poor target groups) it is only a small part of the total cost. This serves a double purpose: Paying for services increases the pressure to improve service quality and the accountability of service providers to the users. At the same time, it prevents crowding out of commercial providers by subsidized programs and increases efficiency of resource allocation, as users will only avail those services for which they actually see a demand (Altenburg and Stamm 2004, 25). Co-financing can take many forms: payment in installments and deferral until harvest time, payment in kind, or financing through member organizations (Neuchâtel Group 2002, 60, 20).

Lastly, in order to ensure sustainability, governments and donors should facilitate the development of permanent local institutions and mechanisms that raise awareness among entrepreneurs and farmers about the benefits of services and help to exchange information on the quality and outcome of specific services. It is equally important to facilitate long-term links between service providers and professional and up-to-date backstopping institutions, so that suppliers are able to react to changing demands.

5. Conclusions

This article has shown that industrial policy has an important part in developing social and ecological market economies. There is now a broad consensus that unregulated markets are unable to achieve optimal results in terms of economic efficiency, social equity, and environmental sustainability. Government interventions are needed to correct market failures, but the public sector often intervenes in ways that generate new problems of mismanagement and corruption. Governments should therefore adopt "smart industrial policies" that are light-handed, build on market forces wherever possible, and ensure accountability where the public sector directly engages in service provision. In this way, it is possible to combine the creativity inherent in markets with the checks and balances provided and executed by the state in a way that ensures more balanced socioeconomic and environmental development trajectories.

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Part 3

Partner Country Perspectives

Social and Ecological Market Economy – The Future for China?

Feng Xingyuan

Introduction

This paper will compare the model of the social and ecological market economy in Germany with the Chinese vision of a market economy reflected in the laws and regulations governing the Chinese socio-economic system and in the relevant ongoing debates. It analyzes the differences in social values between Germany and China, assess the significance of the model for Chinese reforms, and, last but not least, makes some policy recommendations for the reforms. Thus, the author will analyze how Chinese social values are imbedded in the constitution, the changing role of the state in socio-economic planning, and reforms in the regulatory framework and state institutions in China in the context of globalization.

Features, Achievements, and Problems of the Social Market Economy in Germany: A Chinese Perception

The social market economy in Germany is perceived by the government and the general public in China as a successful market economy, in contrast to the common view that a laissez-faire economy in its true and original sense is actually not acceptable anywhere in the world, including Germany and China.

According to a recent survey conducted by the author,[1] the general public in China appreciates highly the role of the European (including German) governments and enterprises in promoting environmental protection and admires the social welfare and high living standard in the EU-15, including Germany. Although very few Chinese have heard the term social and ecological market economy, labeling the German social market economy in this way is understandable and acceptable to the Chinese, given that many Chinese not only regard Germany and the Nordic countries as special types of market economies that emphasize the social dimension of their economies, but also take them as examples of best practice in environmental protection.

[1] As part of an European Commission Project on "Perceptions of the EU in China and of China in the EU," September 2007-March 2008.

Many Chinese take the real-world socio-economic system of Germany as the ideal and normative model of a social market economy and as the model for the Chinese economic system, as well. However, one must make clear exactly what one is referring to when speaking of a social market economy, as there are big differences between that real-world socio-economic system, on one hand, and the normative model of a social market economy as conceptualized in the early stages, in the 1950s and 1960s (hereafter model I), or as now conceptualized in Germany (hereafter model II), on the other hand.

The model of a social market economy in the early stages is best described in the famous book *Wohlstand für Alle* (Wealth for all) by Ludwig Erhard, the first Economics Minister of the Federal Republic of Germany, published in 1957 in German, and in English in 1958 as *Prosperity through Competition*. In his book, wealth or prosperity is generated through competition, not redistribution, and this wealth or prosperity is the foundation of welfare for those disadvantaged in the market economy, or redistribution. Erhard made a further distinction between wealth creation and redistribution. According to Erhard, social policy should not harm the productivity of the national economy in any way, and it should not counter market economy principles. For him, the welfare state was a modern illusion. The "Wirtschaftswunder" (economic wonder) of Germany in the 1950s and 1960s can be traced, to a great extent, back to the practice of social market economy in line with its model in this early stage.

The current model of a social market economy (model II) corresponds neither to the early one (model I), nor to status quo of the socio-economic system in Germany. This becomes clear when one examines the rigid labor market, the coercion by trade unions of non-members in the same sector or region, and the excess burden of the social safety net imposed upon the economy in contemporary Germany. In general, many people in Germany understand their problems well and wish for reform towards a more free market economy and less social burdens, although in concrete situations, they as individuals tend to protect their vested interests and are often not willing to draw back from their status quo. The expansion of social policy towards a welfare state in the 1970s and 1980s resulted in a ratchet effect, which has been detrimental to the incentives for entrepreneurs to innovate and increase productivity. However, no one is able to draw back easily.

Over time, many people in Germany have come to take their social benefits for granted and they have increasingly forgotten the market economy principles to which the founders of the social market economy in Germany, including Walter Eucken and Andreas Müller-Armarck, held. They also make little distinction between social entitlements and basic individual rights. Furthermore, since the

1970s, in contrast to the earlier period, the state and society in Germany have made significant efforts in the area of environmental protection, which have proven to be useful. So the present model of a social market economy (model II) lies somewhere between that of its early stage (model I) and the status quo of the socio-economic system in Germany today, with somewhat more emphasis on market economy principles, less rigid labor markets, and leaner social safety nets than in Germany today, and with a stress on environmental protection perhaps as strong as that at present. It seems that the Chinese people have no reason to refuse to adopt such a model in China, since it reflects an optimal combination of economic efficiency and social balance which would be highly valued by both the Chinese and German people, if a fair competition order is well preserved and property rights are well protected.

New Model of the Social and Ecological Market Economy in Germany

In July 2007, the Federal Ministry for Economic Cooperation and Development (BMZ) announced that the guiding principles of social and ecological market economy would serve as the overall orientation for German development cooperation.[2] These principles for shaping the social and ecological market economy (hereafter "model III") in Germany are:[3]

1) Promote the rule of law;
2) Strive for growth that benefits the broad population (involve the poor in the growth and wealth creation process);
3) Strengthen the private sector;
4) Improve the framework for the functioning of a market economy (promote competition);
5) Make the economy forward looking and viable (promote innovation);
6) Commit to social partnership (protect labor rights);
7) Align the economy with ecological protection;
8) Secure equal opportunity.

[2]German Federal Ministry for Economic Cooperation and Development 2007.

[3]Author's translation.

In comparison with model II, the only controversial principle for shaping the social and ecological market economy in model III might be the sixth principle: commit to social partnership. The shaping of real-world social policies based on this principle goes in two directions: On the one hand, the policies create an enabling environment for growth and employment, and therefore also for employment and redistribution. On the other hand, they produce a disabling environment for growth and employment, and are therefore also detrimental to employment and redistribution. A rigid labor market impedes many newcomers and unskilled workers from entering it. Thus, we need a set of principles or rules to concretize the principle of social partnership in order to ensure that an enabling environment is the result. In a modern society, factors such as rule of law, proper social security, a safe working environment, a dynamic labor market, and proper ecological and environmental protection (as referred to under the principle of "align the economy with ecological protection") belong to the framework for sustainable economic and human development, and thus deserve special attention.

The Chinese Transition towards a Market Economy

The Chinese economic transformation began in 1978. However, it was not until 1992, during its 14th Party Congress, that the Chinese Communist Party (CCP) set the "establishment of a socialist market economy" as the final goal of the Chinese economic system reform. It was then even written into the 1993 amendment of the Chinese constitution, article 15, that "the state enforces a socialist market economy." [4] Both steps reflected the CCP's commitment to fostering and furthering the economic reform course in China, after the stagnation of economic reform for several years following the 1989 Tiananmen Square turbulence. In 2003, the Third Plenary Session of the 16th Central Committee of the CCP passed a "Decision on Some Issues Relating to the Perfecting of the System of the Socialist Market Economy in China." It declared that a rudimentary system of the socialist market economy had been established.

However, a market economy needs to have at least two basic properties: private ownership and competition order. Since there has been a system of private ownership from (and even before) the very beginning of the founding of the Federal Republic of Germany, the release of the Restraint of Competition Act in 1957 roughly marked the establishment of the system of the social market

[4] In this paper, the English formulations of Chinese laws, regulations, and policy documents are in part the author's own translations.

economy in Germany. Hong Kong is also a market economy: it enforces private ownership and a competition order without an explicit competition law, but with a set of common law rules and an open market which makes monopoly impossible in the long run.[5]

In comparison with Germany and Hong Kong, China obviously has not permitted sufficient private ownership, although great progress has been achieved up to now. It has not established a fair competition order either. China is still an economy in transformation.

In the above mentioned 2003 decision, the CCP announced its intention to "perfect the basic economic system, keeping public ownership as the mainstay of the economy and allowing diverse forms of ownership to develop side by side." The constitution provides better protection for public ownership, that is, state and collective ownership, than for private ownership. For instance, article 6 affirms that "the state practices the basic economic system keeping public ownership as the mainstay of the economy and allowing diverse forms of ownership to develop side by side"; article 7 asserts that "the state economy is the sector of the socialist economy under ownership by the whole people; it is the leading force in the national economy. The state ensures the consolidation and growth of the state economy."

The 2003 decision also announced the intention to "construct a unified, open, competitive, ordered, and modern market economy system" while at the same time to "perfect the macro-control system." The exact formulation of the latter phrase can be found in article 15 of the constitution. Article 12 asserts that socialist public property is "sacred and inviolable" and that the state protects socialist public property, while according to article 13, private property is not protected as much as the public property: "The legal private property of the citizens is not to be violated. The state protects by law the citizens' private property and the right of its inheritance" (article 13).

In 2007, China passed the Property Law. It provides that "the state protects the equal legal position and development rights of all market actors" (article 3), thus including state, collective, and private actors. This is a degree of progress in comparison to the constitution. But the rule of "protection of the equal legal position and development rights" is not strong enough since the state and

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[5]This insight is attributed to the Austrian economists. See especially von Mises 1927. The Hong Kong Special Administrative Region government has been considering passing a general competition law. This trend fits with the general trend of switching from a free-market port to an administration-dominated polity in Hong Kong, which has occurred gradually since its handover to mainland China. It also reflects the Hong Kong government's distrust of the power of civil society in enforcing self-regulation in competition issues. In an economy of common law tradition, business society is indeed very creative in making and enforcing informal merchandise laws (internal rules).

collectively owned economy is backed by the state and collectives, and can easily constitute an anti-competition force and crowd out the private economy.

As is provided in the new Anti-monopoly Law released in 2007, the legal business activities in the state-controlled branches that have direct bearing on economic lifelines and national security or are subject to exclusive sale are protected. This is a clear signal that industrial policy has priority over competition policy. Also the so-called macro-control includes instruments such as planning, direct administration, monetary policy, fiscal policy, land use control, industrial policy, etc. This involves many more instruments than the classical instruments of modern market economies that in general include only monetary and fiscal policy. There has been a clear "spiral of intervention" in market processes since 2003.[6] The central bank and Ministry of Finance have opened and have been jointly running a giant state-owned controlling company, the Hui Jin Company. A fair competition order is absent in this regard.

Recent Chinese Strategies Relating to Social Security and Environmental Protection

Although marketization in China has been set forth gradually, the social and ecological dimensions of the socio-economic system had been neglected by and large until several years ago. Consequently, while China has been admired for its high-speed economic growth since 1978, on the one hand, it has also been frequently accused of practicing "social dumping," on the other hand. The move to greater emphasis on the establishment of a social safety network for all just started in recent years. At the same time, environmental protection has also been put on the policy agenda of the central government. In 2006, Premier Wen Jiabao admitted that the government had not fulfilled the target of reducing the energy consumption per unit of gross domestic product (GDP) by 4% and the emissions of main pollutants by 2% within that same year. In 2007, the government defined this reduction task as a main criterion for measuring the performance of local governments. Before that time, economic growth was the sole criterion for measuring their performance.

Several recent strategic developments related to the shaping of Chinese policies on social and environmental protection in China should be noted. First, China put forward a new development concept during the Third Plenary Session of the 16th Central Committee of the Chinese Communist Party in 2003, later dubbed the "scientific development concept." The concept places high priority

[6]Von Hayek points out how government action on an ad hoc basis will result in its being driven to further actions that were not contemplated nor desired. See Von Hayek 1960.

on the needs of human beings and pursues "comprehensive, coordinated, and sustainable development."[7] The main elements and basic requirements include: 1) economic development as the central task; 2). coordinated economic and social development; 3) coordinated urban-rural development; 4) coordinated regional development; 5) sustainable development; 6) reform and opening up; and 7) high priority to the needs of human beings. The 17th Party Congress reemphasized the importance of the concept.

Second, China firmly endorsed the concept of a "socialist harmonious society" in the Fourth Plenary Session of the 16th Central Committee of the Chinese Communist Party in 2004 (Hu 2005). In February 2005, Hu Jintao, the Secretary-General of the CCP, enumerated the six basic requirements of the concept as follows: democracy;[8] the rule of law; equality and justice; dynamism; peacefulness and order; harmonious coexistence of human beings and nature. In October 2006, the party passed a resolution on building a socialist harmonious society which reemphasized these requirements.[9] Hu Jintao's speech at the 17th Congress of the CCP on October 15, 2007 not only reemphasized the building of a socialist harmonious society, but also put forward the building of an "ecological civilization." Such a civilization should have a basic sectoral structure and a growth and consumption pattern that saves energy and protects the ecological environment, a relatively large scale circular economy, a significantly increased share of renewable energy, effective control of emissions of the main polluters, and a significantly improved ecological environment. At that time, awareness of an ecological civilization should have been soundly anchored in the whole society.

Third, the CCP put forward the full-scale building of the "well-off society" at the 16th Party Congress in 2002 and set the goal of quadrupling 2000 GDP by the end of 2020. According to the party resolution of the 17th Party Congress, the party also called for a quadrupling of 2000 per capita GDP (RMB 7078) by the end of 2020 (to around US$3,500. US$1 = RMB 8.56 in 2000).

In line with all the above-mentioned strategic concepts, the party and the central government launched the "new socialist countryside construction" campaign at the end of 2005, addressing problems of rural socio-economic development. The

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[7]Communique of the 3rd Plenary Session of the 16th Central Committee of the CCP, October 14, 2003; and Hu 2007.

[8]However, in contrast to "democratic socialism" or "liberal democracy," the full formulation is still "socialist democracy," which is manifested in a so-called "system of democratic centralism."

[9]The Resolution of the Central Committee of the Chinese Communist Party on Several Major Issues Relating to the Building of a Socialist Harmonious Society, passed at the 6th Plenary Session of the 16th Central Committee of the Chinese Communist Party, October 11, 2006.

basic requirements include: advanced production, improved livelihoods, civilized social mood, clean and tidy villages, and democratic management.

Furthermore, all these concepts are reflected in the outline of the 11th Five-Year Plan for National Economic and Social Development of the People's Republic of China, passed on March 16, 2006. In line with this outline, the 11th Five-Year Plan has specific outlines for the different areas at each administrative level, such as labor and social security, health care, education, environmental protection, energy, etc.

Up to now, the government departments in charge of these various areas have been responsible for designing specific reform concepts for their own areas, which can easily lead to protection of their vested interests. Consequently, such reform concepts tend to maximize the budget at their disposal. This is exactly the case predicted by Niskanen in his model of a budget-maximizing bureaucracy (Niskanen 1971). For example, the Ministry of Health intended to propose a reform concept similar to the British National Health Service System, based on a tax financing principle. In such an overall "reform strategy," government departments have no incentive to reduce their budgets; they tend to enlarge them instead, especially in the areas of social security and environmental protection.

Significance of the Model of the Social and Ecological Market Economy for Chinese Reform

The principles for shaping the social and ecological market economy have great significance for Chinese reforms:

1) Promote the rule of law: Although China is striving to enforce the rule of law as a component of the "harmonious society" concept, a mixture of rule of law and rule of man prevails. In many fields, including social security, labor protection, environmental protection, and the internal market, there are a set of laws and regulations. However, there are severe problems with law enforcement, for instance, regarding the protection of intellectual property rights (IPRs).[10]
2) Strive for growth that benefits the broad population (Involve the poor in the growth and wealth creation process): China made great efforts to alleviate poverty. But, according to the China Poverty Alleviation and Development Association, there were still 23.65 million absolutely poor people in 2003 in the rural areas, and 28 million in urban areas, measured by a per capita

[10]With regard to the protection of intellectual property rights, China tends to rely on special campaign to crack down on piracy. In March 2006, the Ministry of Public Security launched the campaign "Eagle II" (*shan ying dong er hao*). By the end of 2006, more than 3,700 cases of IPR violations were discovered, involving a total amount of RMB 2.6 billion. In these cases, over 5,600 suspects were detained. See Zhang and Yong 2007.

income of less than RMB 683, the 2003 poverty line, and around 50 million at the hunger fringe, measured by a per capita income between 683 and 882 yuan. If they are economically weak or disadvantaged, these poor people should be supported so that they can participate in the growth and wealth creation processes. If they are socially weak or disadvantaged, they should also be covered and empowered by a basic social safety network.

3) Strengthen the private sector: Chinese economic success can be largely attributed to development of the private sector. By the end of 2006, there were 498.1 million private enterprises (*siying qiye*) and 25.96 million individual industrial and commercial households (*geti gongshang hu*). There are 12.7 million investors and 53.1 million employees in private enterprises, and 46.4 million employers and employees within individual industrial and commercial households. The non-state sector comprises ca. 65% of total GDP in China.[11] Beside the urban unemployed and newcomers in the labor market, there will be around 150 million surplus workers from rural areas who need to find employment in the non-agricultural sector in urban areas. The private sector is almost the only sector that could absorb this labor force. It is thus very important to boost private sector development. However, many hindrances remain.
4) Improve the framework for the functioning of a market economy (promote competition): A competition order is essential in a market economy. But as mentioned above, China does yet not have a fair competition order. In China, the state-controlled branches are exempted from the new anti-monopoly law. Macro-control and industrial policy have priority over competition policy.
5) Make the economy forward looking and viable (promote innovation): In China, "dynamism" is one of the core components of the "harmonious society" concept; it means full of creativity and vitality. Although it does not directly refer to competition, such a status can only be attained through competition. Currently, there are still large hindrances to innovation, and innovation is lagging behind in China; thus an enabling environment should be created.
6) Commit to social partnership (protect labor rights): As above mentioned, China is often criticized by the international community for "social dumping." Labor protection laws and regulations are not yet enforced. For instances, most of the employees in private enterprises and the individual

[11] All-China Federation of Industry and Commerce 2007. Non-state enterprises (*minying qiye*) refer to domestic enterprises, excluding state-owned or state-controlled enterprises.

economy are not insured, or not properly insured. There is still child labor. In 2007, the media publicized the fact that some coal mines in Shanxi province use slave labor. On the other hand, some clauses in some laws and regulations might constitute overregulation and need to be reviewed.

7) Align the economy with ecological protection: Environmental and ecological protection is an urgent and long-term issue in China. It also has a central position in the new "scientific development concept." According to the World Bank, air pollution alone is costing China 3.8% of its GDP, causing much disease and claiming many lives.[12]
8) Secure equal opportunity: It is very important to empower economically and socially disadvantaged people in China through equal opportunity. Basic education and health for all and poverty alleviation, vocational training, etc. are all important for this purpose.

Although these principles are acceptable in the China context, one must first protect property rights. Only then can the property owner be also required to shoulder his social responsibilities, which should, however, be defined very carefully after considering the whole set of the above mentioned principles for shaping the social and ecological market economy. It would be one-sided to only stress the basic principle of model III, "Eigentum verpflichtet" (property entails obligations), which is detrimental to a free and open society with growth dynamics, equality of opportunity, and proper social and environmental protection. We need a basic principle which explicitly states that: "Eigentum ist geschützt, aber verpflichtet" (property is protected, but entails obligations). In a broad sense, this reflects a basic principle of human action: Freedom implies responsibility.

Concluding Remarks

In summary, we can conclude that the new model of social and ecological market economy is very significant for Chinese reforms. But this doesn't mean simply copying the current German social, environmental, and economic system in China. Some relevant German laws constitute overregulation. In development cooperation, it is essential not only that knowledge of the Germany model and its real-world system is transferred, but also that the historical background of the German system, the relevant interest conflicts, their positive and negative consequences, etc. are made known and discussed in China.

[12]See "World Bank Says Air Pollution Alone Costs 3.8% of China's GDP" 2007.

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Market Economy with Socialist Orientation in Vietnam and the Concept of the Social and Ecological Market Economy

Le Dang Doanh

Historical Background and the Doi Moi Process in Vietnam

As Vietnam gained independence on September 2, 1945, Ho Chi Minh, in Vietnam's Declaration of Independence, quoted Thomas Jefferson in the American Declaration of Independence: "All men are created equal." The official names of the new state, the Democratic Republic of Vietnam and, later, the Socialist Republic of Vietnam, reflected the ideals of "independence, freedom, and happiness" of the *san min*[1] doctrine of the Chinese leader Sun Yat Sen, instead of socialist ideals.

However, various historical circumstances led Vietnam to follow a Soviet-style economic model of central planning, with a brutal land reform (1954-1956) and "socialist reconstruction" (1957-1960) in North Vietnam. Despite serious criticism, after reunification in 1975, the Fourth National Congress of the Communist Party of Vietnam (CPV) decided to lead the whole country to socialism (1976). The Sixth Party Congress identified bureaucratic over-centralization and lacking material incentives as the main weaknesses of the economic system; economic growth had been stagnant or negative as the following table illustrates:

Table 1: Sectoral GDP Growth Rates
chain-linked index, base year 1975

Year	Total GDP	Agriculture	Industries	Services
1977	105.3	100.7	113.2	104.9
1978	101.1	93.6	107.5	109.0
1979	98.2	103.3	95.4	92.4
1980	96.4	105.6	88.7	87.8
1981	102.3	104.3	99.9	100.7

Source: Dang Phong 2002, *Economic History of Vietnam 1975-2000.*

[1] Chinese, means literally "three (time) peoples."

With an acute scarcity of all basic necessities, the dream of equality and fairness in distribution of food and goods was unrealistic, as the following table shows:

Table 2: Food Rations for Monthly Consumption in North Vietnam 1963-1989

Categories	Class of Rations	Meat (kg)	Sugar (kg)
Special	A1	More than 7 (not specified)	More than 3.5 (not specified)
Minister and equivalent	A	6	3
Vice Minister and equivalent	B	5	2
General Director	C1	3	1.5
Dep. Gen. Director	C	2	1
Director	D	1	0.5
State employee	E	0.3	0.25
Special worker	DB	2.5	0.75
Hard worker	I	1.5	0.75
Worker	II	1.2	0.5
Light worker	III	0.3	0.35
Children under 6 years	TR	0.3	0.5
Children 7-16	TN	0.3	0.35
Population	N	0.3	0.1

Source: Dang Phong 2002, *Economic History of Vietnam 1975-2000.*

Children and older, vulnerable citizens were the main victims of the many years of extreme hardship indicated by this rationing and coupon system. Moreover, in the 1980s, inadequate policies led to rampant inflation of 700% per year, the supply of basic rationed foodstuffs and goods could not be sustained, and Vietnam was in a deep socio-economic crisis.

This internal situation and the collapse of the Soviet Union were the driving forces behind the *doi moi* reforms begun by the Sixth National Congress of the CPV: gradual transition to a market economic system, acceptance of a domestic private sector, and foreign direct investment, as well as development and diversification of international economic relations.

The *Doi Moi* Process and the Market Economy with Socialist Orientation

After more than twenty years of *doi moi*, Vietnam has established the main elements of a "market-economy with socialist orientation," which has some parallels to the social market economy in Germany. The *doi moi* process introduced the most glorious development period in Vietnam's modern history, with high economic growth, rapid poverty reduction, and improved human development. A new private sector is emerging.

Vietnam is an active member of ASEAN and APEC and joined the World Trade Organization in January 2007. Vietnam is now generally better placed to reach its declared aims through this path of market economy and international integration instead of central planning and autarky. However, socialist orientation is not only – and not mainly – a matter of the market economic system; it is an orientation of the whole social and political system intended to unfold the strength, dynamism, and creativity of the people and compensate for the weaknesses and failures of the market economy. In a globalizing world, the state and the market must work hand in hand to seize the opportunities and overcome the challenges.

How successfully Vietnam will be able to implement the socialist orientation will depend on how efficiently market-economic principles and institutions can be established in Vietnam, how well they function, how market friendly the state is, whether red tape, bureaucracy, and corruption can be eradicated, to what extent freedom, democracy, and civil society can be developed, and if the socialist orientation can be sustained.

In 1991, the Seventh Party Congress adopted a new party program to build up socialism in Vietnam, a mixture of Ho Chi Minh ideology and the orthodox socialist model. Socialism was declared to be "a society with a prosperous nation, a strong state, a democratic society in equity and civilization." The aim was to provide a broad-based platform for national unity and to strive for a bright future for the whole nation. The party program and the party statutes, adopted by the Seventh Party Congress, specified five characteristics and seven fundamental orientations for the socialist society in Vietnam.

The five characteristics are:

- a society where the working people are the master;
- a highly developed economy based on modern production forces and national ownership of the main means of production;
- an advanced culture with deep national characteristics;
- people are liberated from repression, exploitation, and injustices;

working according to their abilities and consuming according to their work contributions; enjoying a prosperous, free, and happy life with the possibility of developing their full potential; ethnic races in the country enjoy equality, solidarity, and mutual assistance for common progress;
- friendly and cooperative relations with all nations in the world.

The seven fundamental orientations are:
- build up a socialist state of the people, through the people, and for the people, based on the alliance between the working class, farmers, and intellectuals, under the leadership of the Communist Party;
- develop production forces, industrialize the country, and build up the material-technical basis of socialism by steadily enhancing social productivity and improving the living conditions of the people;
- develop an economy with multiple economic sectors operating according to the market mechanism with socialist orientation; the state-owned and cooperative sector is to increasingly provide the foundations for the national economy;
- conduct the socialist revolution in ideology and culture, with Marxism-Leninism and Ho Chi Minh ideology as the guiding perceptions of the world;
- exercise the policy of national unity;
- construct socialism and defend the fatherland are two strategic tasks;
- build up a party, which is clean and strong in politics and ideology, as a leading force for the socialist revolution.

In 2006, the Tenth National Congress of the CPV (April 18-25, 2006) included some important changes in the program: it stopped requiring that party members not be exploiters, thus allowing party members to open private businesses, accepted that the "private sector plays an important role and is one of the driving forces of the economy," etc. These pragmatic changes bring the concepts of market economy with socialist orientation in Vietnam and the social market economy in Germany closer together.

The Tenth National Congress also adopted various important and progressive measures to "realize social progress and justice in every step of economic development as well as in every economic policy," to "provide social equality in education," develop a "learning society and provide education and training for the whole life," and to "establish and consolidate the social safety net, providing equal basic public services in education and training, employment, health care, culture and information, physical exercise, and sports etc." These aims are similar to the principles of the social market economy, as well.

As an economy in transition from central planning to market economy, it was never possible for Vietnam to embrace a liberal economic model; a market economy with socialist orientation was an appropriate choice for Vietnam.

Ecological Market Economy

Vietnam is at the beginning of the industrialization process, but environmental damage is already severe: deforestation, erosion in mountainous regions, water pollution due to rapid increase of aquaculture, abuse of fertilizers, insecticides, and herbicides, uncollected solid waste, lacking ecological control in so-called handicraft villages and industrial villages in rural regions, industrial pollution in urban regions, increased dust, and alarming increases of toxic gases are widespread. Environmental degradation is becoming an increasing problem that is undermining agricultural productivity, reducing the availability of clean water for the rural population, causing health problems in rural and urban areas, and leading to a deterioration in living conditions in both urban and rural areas. Air quality is worsening in urban areas and in some industrial centers, resulting in increased respiratory problems. All solid waste cannot be collected and processed. Industrial pollution is widespread. Deforestation is aggravating flooding and landslides in mountainous areas. Flooding badly affects even several districts of Ho Chi Minh City. These are the outcomes of both market failures and the weakness of the state. The Law on Environmental Protection was promulgated in 1993, but more efforts are needed to actually implement it.

Climate change and a rising sea level could have major adverse impacts in low-lying river deltas of Vietnam. According to the Report of the Organization for Economic Cooperation and Development on Global Warming, Vietnam will be one of the countries most affected by global warming. If temperatures rise by two degrees Celsius, 22 million Vietnamese will lose their home and land, and 43% of the Mekong River Delta will be flooded over. If the sea level increases by 0.2-0.6 meters, 1708 square kilometers of the Mekong River Delta will be lost and more than 100,000 people will be affected. Vietnam is actively participating in world efforts to stop global warming.

While it may not be the major immediate bottleneck to investment, deteriorating environmental conditions already impose social and economic costs, and any further deterioration will eventually discourage new investment (tourism, ship-building, cement, and high-tech industries could be among the worst affected by any further deterioration in the environment).

The government has had some success with its reforestation programs, but more needs to be done to improve water management in river basins and to better manage effluent from all sources. Accelerating urbanization and industrialization needs to be reflected in public investment plans and other policies to ensure that secondary cities and towns have the infrastructure and services to attract those leaving farming, and to attract business investors who will generate the employment needed for an increasingly urbanized population. Failure to adequately develop secondary urban areas will lead to increased environmental and social pressures in the major urban centers. Increased investment in mass transport systems and other public services will also be needed to minimize congestion and other environmental problems in Ho Chi Minh City and Hanoi. More environmentally friendly sources of power need to be developed. In brief, an ecological element must be added to the Vietnamese market economy with socialist orientation.

Institutional Issues

The final aim formulated by the program of the CPV, to build a society where "people are liberated from repression, exploitation, and injustice, and are enjoying a prosperous, free, and happy life" is not different from the aim of the social market economy concept in Germany. This declared aim is universal; it does not relate to specific national conditions, and is appreciated. The problem lies in the implementation, for which the differences between the two systems in terms of history and specific national characteristics, such as development levels, political systems, and the roles and functions of the state, must be analyzed in detail.

Vietnam has fifty-four different ethnic groups and various religions. The Viet or the Kinh account for 87% of the population; they live mainly in the delta and urban regions, while the ethnic groups are scattered in various mountainous regions from north to south. The Government of Vietnam has paid great attention to the problem and continues its efforts to reduce poverty, with success. However, pockets of poverty persist in mountainous regions occupied by various ethnic groups.

Table 3: Poverty Rate across Regions
in percent

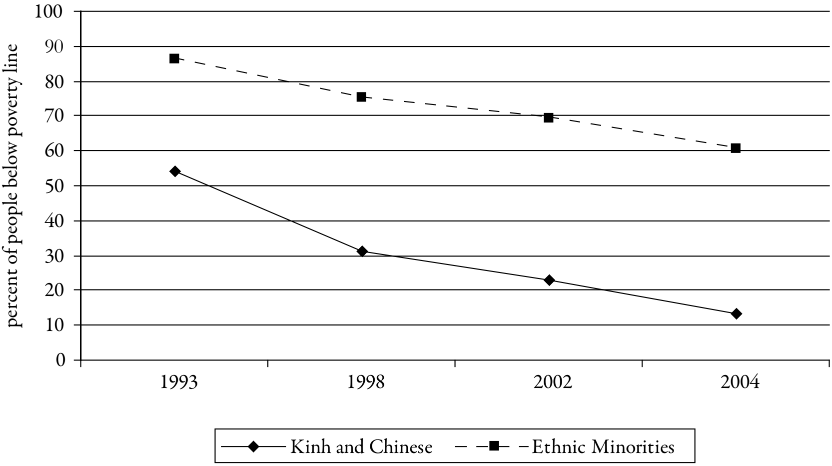
	1993	1998	2002	2004	2006
Northern mountains	81.5	64.2	43.9	35.4	30.2
Northeast			38.4	29.4	25
Northwest			68.0	58.6	49.0
Red River Delta	62.7	29.3	22.4	12.1	8.8
North central coast	74.5	48.1	43.9	31.9	29.1
South central coast	47.2	34.5	25.2	19.0	12.6
Central highlands	70.0	52.4	51.8	33.1	28.6
Southeast	37.0	12.2	10.6	5.4	5.8
Mekong Delta	47.1	36.9	23.4	15.9	10.3
Vietnam	58.1	37.4	28.9	19.5	16.0

Source: World Bank, *Vietnam Development Report 2008.*

In 2007, the average poverty rate in Vietnam was 14.8%; the rate was 32.36% in the northwest; 23.4% in the northeast; 23.4%, in north central Vietnam; 21.34% in the central highlands; and only 5.1% in the southeast.[2] This gap should not be underestimated, and the greatest efforts must be mobilized to provide infrastructure and education for these groups and include them in integrated market economy activities. The various poverty reduction programs must be institutionalized and given legal backing in order to have durable and efficient impacts in the long term.

[2]Ministry of Labor, War Invalids, and Social Affairs, http://www.vietnamweek.net (December 30, 2007).

Figure 1: Percentage of People below the Poverty Line



Source: World Bank, *Vietnam Development Report 2008*.

Table 4: Poverty Rates and Poverty Gap
in percent

	1993	1998	2002	2004	2006
Poverty rate	58.1	37.4	28.9	19.5	16
Urban	25.1	9.2	6.6	3.6	3.9
Rural	66.4	45.5	35.6	25.0	20.4
Kinh and Chinese	3.9	31.1	23.1	13.5	10.3
Ethnic minorities	86.4	75.2	69.3	60.7	52.3

Source: World Bank, *Vietnam Development Report 2008*.

Equality and prosperity must be shared by all ethnic groups as well by different religious communities. Social consensus and solidarity must also include the relations between employers and employees and between farmers and the state.

A New Challenge: Increasing Labor Conflicts

In the past, under the centrally planned economic system, strikes were unknown or extremely rare in Vietnamese society. However, according to a report by the Institute of the Vietnamese Trade Union at a workshop on August 14, 2007 in Hanoi, there were 1333 strikes in Vietnam from 1995 to 2005; of these, 878 strikes or 66% took place in foreign direct invested enterprises, mainly in smaller ones. This share increased to 70.7% in 2006. Most, if not all, strikes were spontaneous, in other words, not organized by the trade union. They were thus illegal according to Vietnamese labor law. More seriously, some of the strikes were violent and destructive of property. Seventy-seven percent of the strikes were related to salary payment: employees believed that their salary was too low, bonus and over-time payments were not paid as promised or were delayed, etc. (Institute of the Trade Union Vietnam 2007).

The report revealed a huge gap of mutual understanding between foreign employers and Vietnamese employees: 45% of the interviewed employees expressed dissatisfaction with payment, working conditions, and others matters. Foreign investors complained about undisciplined behavior, high turnover of employees, etc. Poor information exchange between the two sides, inefficiency in the work of related local state agencies, trade unions, and others have been named as causes of the strikes. Proposals to amend the labor law have been made. If no appropriate and efficient actions are taken soon to reduce wild strikes to a tolerable minimum, strikes could harm the business environment and turn some foreign investors away.

Industrialization: Not Always a Benefit to the Rural Population

Urbanization and industrialization have taken their toll on rural and arable land. In the period from 2000 to 2005, 366,000 hectares of arable land were converted into construction land, affecting at least one million rural people or 13% of total farmer households (Dang Kim Son 2007). The farmers received lump sum compensation according to a state-fixed price and realized later that the very same piece of land had been leased for ten times the so-called market price. The frustrated farmers were dissatisfied with the compensation and held several demonstrations in big cities like Hanoi and Ho Chi Minh City. The landless farmers became unemployed, which created social problems, an issue that remains unresolved. Due to the large income gap between the urban and rural regions, young workers migrate to urban regions, either seasonally or permanently, creating problems for both rural and urban regions. In the period between 2000 and 2004, the agricultural labor force declined by 2.17% (Dang Kim Son 2007). In the province of Thai Binh, 45% of the rural labor force has migrated to urban regions, adversely affecting agricultural production as well as social and familial development (Tuong Lai 2007).

The migrants do not have the same legal status in the new regions as the original residents: without residential registration *(ho khau)*, they cannot access public services; they cannot even obtain a legal marriage registration, and their children cannot attend public schools, etc. This discrimination is so serious that the National Assembly decided in 2007 to change *ho khau* registration, but implementation takes time.

These examples illustrate the fact that there are many development problems that need to be addressed in order to implement the socialist orientation and create equal opportunities for all.

Legal and Regulatory Reform

The principles of the market economy, such as the freedom to engage in business, equal footing, and competition, have been only gradually accepted in Vietnamese official documents through a long and difficult internal discussion in the last twenty years. The Enterprise Law of 1999 and 2005 has successfully implemented the freedom to engage in business according to law, as provided by article 57 of the Vietnamese constitution, and has helped develop the private sector in Vietnam. But several market economy practices like auditing, accounting, and credit rating of companies are under-developed and insufficiently implemented. The Competition Law was promulgated in 2005, but its implementation in practice so far has been insufficient and has had no tangible impact on business life. To date, no anti-monopoly law has been promulgated, and the state-owned monopolies in public utilities like electricity, airlines, and telecommunications are not sufficiently controlled and monitored. There is no redistribution of monopolist profit; the Law on High Income Tax has led to redistribution of only a very small share of real income.

Corruption – A Persistent Problem

There is little transparency or openness; there is no independent, private press. A right-to-information law, as proclaimed in article 69 of the constitution, has not yet been promulgated and is still under preparation. Different interest groups, such as the major state-owned conglomerates, influence political decisions and enjoy excessively high profit, especially through access to lucrative land plots, credits, and investment projects.

The declared principle of equal footing was and continues to be overshadowed by the "leading role of the state sector." State-owned enterprises produce 38% of GDP, but use 70% of the economy's total assets, 60% of the total credit supply, and 70% of official development assistance and have privileged access to land and big state investment projects.

Signs of crony capitalism instead of a free market economy are visible everywhere, including in the real estate market and in the equitization of state-owned enterprises (SOE); the impact of this phenomenon is still emerging and developing. Inequality between different social groups and regions is rising. In an economy where cash payments comprise an estimated 80% of total transactions, according to various estimates, including by the State Bank of Vietnam, control of income is only symbolic and redistribution from high-income to low-income groups through income tax will only start in 2009. The outcome is obvious: in 2007, 68% of companies reported that they have to make extra-legal payments to operate their business. This figure has remained stable since 2005, when the Provincial Competitiveness Index started (Vietnam Competitiveness Initiative and Vietnam Chamber of Commerce and Industry 2007).

In 2005, for the first time, the Central Commission of Internal Affairs of the Central Committee of the CPV permitted a study on corruption Sixty-three percent of the interviewed entrepreneurs admitted that they frequently paid bribes. This is so-called small-scale, daily corruption, which affects all people and enterprises, as Table 5 indicates.

Table 5: Most Corrupt Government Agencies

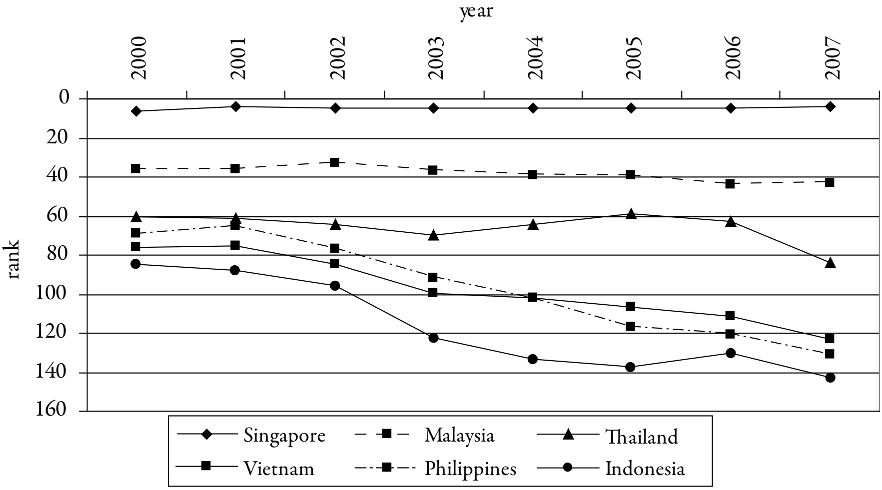
Investment Climate Survey	Diagnostic Study on Corruption
Traffic police Customs department Tax department Land administration agency Market controller Construction permit authorities Import/export license authorities	Land administration agency Customs department Traffic police Tax department Regulators in construction Construction permit authorities Health care Planning and investment agencies Regulators in transportation Economic police

Source: Based on data from the World Bank *Investment Climate Survey* (ICS) *2005* and on a report presented at the workshop of the Central Commission of Internal Affairs of the Communist Party of Vietnam on November 30th, 2005 in Hanoi. In the case of the ICS, rankings are based on the share of respondents declaring that corruption is widespread or gifts are required to get a favorable decision. Only agencies with a share in excess of 5% are reported.

An anti-corruption law was promulgated in 2006, and a high-ranking National Committee to Prevent and Fight against Corruption, chaired by the Prime Minister Nguyen Tan Dung, was established in 2006. Sixty-four such committees at the provincial level, chaired by the chairman of each provincial peoples committee himself, were established in 2007. The real impact of this anti-corruption campaign has so far been limited. It should be noted that daily corruption affects poor people the most, because they have to pay a disproportionately high share of their income for bribes.

In the last few years, Transparency International has included Vietnam in its world ranking, the Corruption Perception Index (CPI), as the following graph shows:

Figure 2: Corruption Perception Index



Source: Transparency International, http://www.transparency.org/policy_research/surveys_indices/cpi

According to Transparency International, the ranking of Vietnam in the CPI has declined, as an increasing number of countries have been included in the survey: Vietnam's position went from 102th among 144 in 2004, to 111th among 163, to 123th among 180 in 2007.

Competitiveness

The Global Competitiveness Report of the World Economic Forum (Lopez-Claros et al. 2006) could provide a comprehensive and reliable basis for evaluating the business environment and thus the efficiency of the market-economic institutions and the government. The gap between the Global Competitiveness Index (GCI) ranking of Vietnam and that of other Asian economies is widening: Singapore ranked 7th, Malaysia 21st, Thailand 28th, and China 34th, while Vietnam ranked 68th, indicating that other economies in the region are more efficiently reforming than Vietnam. Following are the World Economic Forum rankings for Vietnam since 2005:

Table 6: Vietnam's Competitiveness

	2000	2005	2006		2007	
	Out of 59 countries/ economies	Out of 117 countries/ economies	Out of 125 countries/ economies	Score (out of 7)	Out of 131 countries/ economies	Score (out of 7)
Global Competitiveness Index	53	81 (3.37)	77	3.89	68	4.04
Institutions			74	3.62	70	3.78
Infrastructure			83	2.79	89	2.80
Macroeconomic stability			53	4.63	51	5.08
Health and primary education			56	6.43	88	5.14
Business Competitiveness Index	53	80	82		76	
Sophistication of company operations and strategy	50	81	83		79	
Quality of the national business	52	77	77		78	

Source: Lopez-Claros et al. 2006, World Economic Forum.

Table 7: Key Components of the Global Competitiveness Index for Vietnam

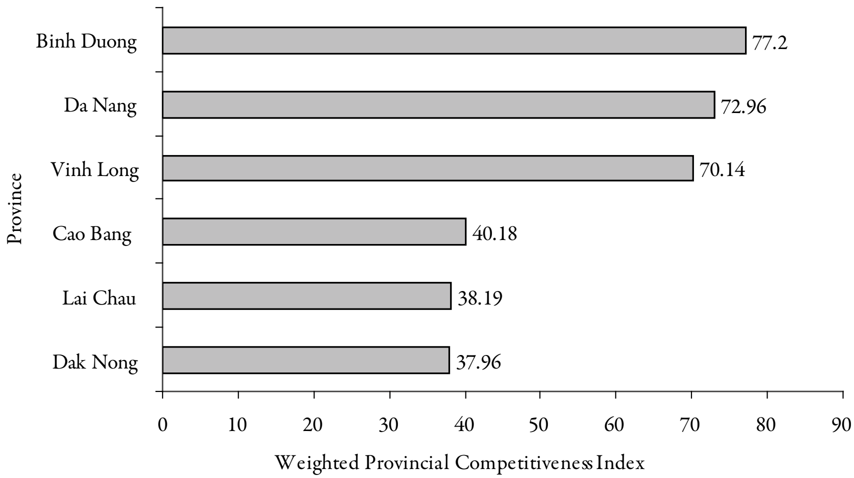
Indicators	Ranking
Group of basic components	77
1. Institutional organization	70
2. Infrastructure	89
3. Macroeconomic stability	51
4. Primary education and health care	88
Group of efficiency components	71
5. University education and training	93
6. Efficiency of goods market	72
7. Efficiency of labor market	45
8. Sophistication of financial market	93
9. Technology readiness	86
10. Size of the market	32
Components of business innovation and sophistication	76

Source: Lopez-Claros et al. 2006, World Economic Forum.

Efficiency of the public administration is a major factor in developing a business environment and providing support for people. Since 2005, the Vietnam Competitiveness Initiative (VNCI), in cooperation with the Vietnam Chamber of Commerce and Industry (VCCI) and with the support of the United States Agency for International Development (USAID), has issued an annual report on the Provincial Competitiveness Index (PCI) in Vietnam. It is based on surveys conducted on ten indicators (market entry, land access, transparency, time costs, informal payments, SOE bias, proactivity of provincial leadership, private sector development policy, labor training, legal institutions). The PCI focuses on private domestic small and medium-sized enterprises (SMEs) only; no SOEs or foreign-invested enterprises have been included. It can provide a basis for comparative analysis as well as an indicator of the dynamism of reforms since 2005.

In 2007, 6700 registered companies from all 64 provinces replied to the survey. An appropriate number of manufacturing, fishery, and service SMEs were selected. There were at least 50 answers from every province, which provided a statistically significant basis for analysis. The outcome was very interesting as following graph illustrates.

Figure 3: Provincial Competitiveness Index 2007 (first and last three ranks)



Source: Vietnam Competitiveness Initiative and Vietnam Chamber of Commerce and Industry 2007, http://pcivietnam.org/reports.php.

Despite the fact that Vietnam has a centralized state with a unified legal system, there are huge differences between the provinces when it comes to implementing this legal system. The best province, Binh Duong, has a score (77.20) twice as high as the worst province, Dac Nong (36.19). This means that the market economy with socialist orientation operates much more efficiently in Binh Duong than in other provinces and that there is enormous potential for the public administration in Vietnam to apply best practices from the province of Binh Duong to the other provinces. Some provinces, such as Ha Tay, have been progressing rapidly, while the capital, Hanoi, has occupied a very modest position for two consecutive years.

Whether Vietnam will be able to achieve its declared aim of developing the economy to a middle-income and then to a high-income economy and eradicate poverty depends on the role and function of the government, its efficiency and professionalism, the fight to reduce corruption, improvement of education and training, and last, but not least, the continuing reforms of the SOEs. The predominance of resources in the state sector, in general, and the state-owned conglomerates, in particular, are the focal points in this process.

Privatization – a Slow Process

While the equitization process has progressed very slowly (in 2007 only 21% of the planned equitization of SOEs were implemented), establishment of state-owned conglomerates proceeded quickly. To date, the following eight conglomerates have been created:

1. Vietnam Coal & Minerals Group;
2. Electricity Vietnam Group;
3. Vietnam Post and Telecommunications;
4. Vietnam Shipbuilding Industry Group;
5. Vietnam Rubber Group;
6. PetroVietnam;
7. Vietnam Insurance (Bao Viet);
8. Vietnam National Textiles and Garment Group (VINATEX).

These conglomerates control a very high share (80%) of the total assets of the SOEs. They enjoy a monopoly position (for example, Vietnam Coal & Minerals Group, PetroVietnam) or de-facto monopoly position, by controlling the predominant share of the market (for example, Electricity Vietnam Group, Vietnam Post and Telecommunications).

The legal framework and criteria for an "economic conglomerate" is not clearly defined. Article 149 of the 2005 Enterprise Law defines an economic conglomerate as a large-size corporate group. Conditions, organizational management, and operation of economic conglomerates are to be stipulated in detail by the government, but so far, no guidance from the government has been available. After establishment, the conglomerates quickly expanded their activities into banks and securities companies, and diversified into hotels, real estate, power plants, etc. by establishing holding companies. Former Premier Minister Vo Van Kiet warned against careless handling of these state-owned conglomerates by making a comparison with the South Korean *chaebols*.

By the end of 2007, the State Bank had allowed the establishment of four joint-stock banks that report to these state-owned conglomerates. There is concern that the state-owned conglomerates could use their power to arbitrarily impose their will and restrict the duties and responsibilities of the banks with respect to project evaluation, credit risk rating, etc. It would be a major systemic failure to allow such conglomerate-dominated banks to mobilize financial resources for the seemingly boundless ambitions of these conglomerates. Even without their own banks, the South Korean chaebols destabilized the South Korean economy in 1997.

Subsidiarity

The subsidiary principle underlying Germany's social market economy is similar to the concept employed in Vietnam. The Tenth Congress of the CPV "encourages all peoples to get rich according to laws" and urges them to "overcome the tendency of passively relying on state subvention." Because of limited resources and nearly unlimited demand, the state is unable to provide subsidies to all needy people. Fortunately, traditional family cohesion and solidarity and the dynamism of most of the Vietnamese has meant that they have mobilized their own ability to help themselves instead of relying on the expected subsidy from the state.

Economic Outlook

Vietnam's economy achieved high growth rates in the last decades, but the efficiency and competitiveness of the economy are low.

Table 8: GDP Growth Rates and its Contributing Elements
in percent

	Malaysia (90-03)	Korea (90-03)	Hong Kong (90-03)	Singapore (90-03)	Taiwan (90-03)	Thailand (90-03)	Vietnam (96-05)
GDP growth rate	6.48	4.89	3.96	6.27	5.30	5.13	7.23
Contributed by:							
· Capitalized asset	40.28	38.24	45.20	40.51	56.42	34.11	60.11
· Labor force	39.20	25.15	27.27	35.73	16.04	51.66	20.51
· Total factor productivity	20.52	36.61	27.53	23.76	27.55	14.23	19.38

Source: General Statistics Office of Vietnam 2007.

The contribution of total factor productivity to the Vietnamese economy is the lowest among the economies of the region; most of the growth has been contributed by investment and the increase of capital assets. Despite high economic growth in the last decade, Vietnam is still a low-income economy, with GDP per capita at US$835 in 2007. Vietnam aims to leave the ranks of low-income economies in 2009 by reaching US$960 (Ministry of Planning and Investment 2007).

There is no doubt that Vietnam will soon become a middle-income country, but it remains an open question whether Vietnam can then overcome the so-called "middle-income trap," which is also faced by other South East Asian countries such as the Philippines, Indonesia, and others. Crony capitalism and vested interests could produce low efficiency, a high income gap, financial instability, etc. The triad "miracle–nightmare– crisis," which periodically affects these South East Asian economies, could be repeated in different forms in Vietnam. There is no guarantee yet that Vietnam's economy is immune to this trap. It is obvious that such crony capitalism is hardly compatible with the socialist orientation.

The Vietnamese population increases by 1.1 million each year and will reach 86 million in 2007. Moreover, the rapid increase of the population in the Mekong River Delta and in mountainous regions increases the burden on education and health care tremendously. This demographic pressure complicates the rapid improvement in wealth and human development as the following table illustrates:

Table 9: World Ranking of Per Capita GDP

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Singapore	9	6	7	9	18	21	24	24	25
Hong Kong	14	14	17	19	15	15	19	23	26
Taiwan	30	31	33	32	33	35	37	39	41
South Korea	35	37	44	44	43	45	43	38	39
Malaysia	54	54	64	68	62	62	58	61	64
Thailand	69	72	79	82	81	83	84	82	85
Philippines	98	97	102	105	106	110	105	108	112
Indonesia	103	103	118	118	115	118	116	113	107
China	116	114	115	111	112	112	108	105	101
Vietnam	150	148	145	138	132	131	129	130	132

Source: The Economist, *Pocket World in Figures 1999-2007*.

Education[3]

Vietnam had a long tradition of valuing education. Article 59 of the Vietnamese constitution provides a clear statement: "Primary education is compulsory and free." Under the centrally planned economy, education was generally free to university level, but access to universities was limited through selection exams. Health care was also free for those who could get access to public hospitals. Education and health care are considered the main pillars of the socialist orientation in the market economy of Vietnam.

The Government of Vietnam steadily increased the education budget by 27% per year, to 20% of total budget expenditures, equivalent to US$3.45 billion or 6% of GDP, in 2006 and to 22% of total budget expenditures in 2007. The following table shows the total expenditure on education in Vietnam in absolute terms and as a share of GDP, as well as government expenditure for education as a share of GDP.[4]

[3]See also Vu Quang Viet 2006 and www.thesaigontimes.com , World Bank, *Vietnam Development Report* 2005, 2007, and Harvard 2008.

[4]See Vu Quang Viet 2006 and www.thesaigontimes.com (December 2, 2008).

Table 10: Education Financing in Vietnam in the Period between 2000-2005

	2000	2001	2002	2003	2004	2005
Total education expenditure in billion VND	23,219	25,882	34,088	37,552	54,223	68,968
As a share of GDP (%)	5.3	5.4	6,4	6.1	7.6	8.3
Gov't budget expenditure for education as share of GDP	3.2	3.2	3,8	3.7	4.6	5.0

Source: Vu Quang Viet 2006.

Estimates indicate that the population must spend at least US$1.3 billion additionally, which is equivalent to 2.3% of GDP, for education (Vu Quang Viet 2006). According to following comparison, Vietnam spends the highest share of GDP on education:

Table 11: Education Financing in Vietnam and Selected Economies

	Vietnam	USA	France	Japan	Korea	OECD
Total expenditure on education as share of GDP (%)	8.3	7.2	6.1	4.7	7.1	6.1
From gov't budget	5	5,3	5.7	3.5	4.2	4.9
From the population and other sources	3.3	1.9	0.4	1.2	2.9	1.2
Share of education expenditure (%)						
From gov't budget	60	74	93	74	59	80
From population and other sources	40	26	7	26	41	20

Source: Vu Quang Viet 2006.

Since 2000, the government has intensified the so-called socialization of education, health care, cultural activities, etc. For the ordinary citizen, socialization has meant a greater financial contribution to education. Indeed, the press has reported on 30 to 100 items for which money is collected from the parents of students from kindergarten to university. The outcome is worrisome: families with many children can hardly afford to send all their children to school. For example, for a primary school student in Hanoi, a parent must pay at least VND 500,000 per month.[5] With an average monthly income of VND 2.5 million, the parent could not send two children to school for twelve years, because the payment increases progressively with the level of the school class.

Vietnam's education record is poor and lags behind the regional average, despite the high level of education expenditure as a share of GDP. Only 12% of the population has completed 13 or more years of education. In the Mekong River Delta, 5.4% of the adult population are illiterate; 25.8% are literate, but could not finish their primary education (four years); 41% finished primary school; 16.4% finished their secondary education (eight years); 11.4% completed high school (twelve years) (Institute of Development and Strategy Studies 2006). Only 10% of Vietnam's young people between 20 and 24 are able to attend university, while this ratio is 15% in China, 41% in Thailand, and 89% in Korea.

The quality of education and training is below that required by the business community. Nearly all foreign investors have to invest in re-training of recruited staff (World Bank 2007a). According to the Ministry of Labor, War Invalids, and Social Affairs (MoLISA), only 32% of the labor force have been trained and 14.4% had only short-term (three months) training courses (MoLISA 2007). According to a survey by JETRO published in May 2007, an acute shortage of highly qualified workers in information technology, finance and banking, auditing, law, etc. has been reported by foreign investors.

Health Care System

Before 1975, Vietnam succeeded in establishing a three-tier (commune, local, and central) health care system, which operated efficiently during the war. Health care was generally free in all public health care centers, but depending on one's position in the political system, the quality of health care was drastically different.

Given the low GDP per capita, the performance of Vietnam's health care system, measured by childhood mortality and life expectancy, is relatively good. Between 2000 and 2005, the infant mortality rate declined from 36.7 per

[5] See http://www.vietnamweek.net (December 30, 2007).

thousand to 17.8; the mortality rate for children under five fell from 42.0 to 27.5 per thousand. Accordingly, life expectancy at birth increased from 67.8 to 71.3 years (World Bank 2008).

In 2007, there were 1030 hospitals run by different levels of government and an additional 49 hospitals owned and operated by the private sector – a total 16.3 beds for every 10,000 persons. There are now 200,000 health staff of all categories for 86 million Vietnamese. About 70% of the doctors working in private hospitals are employees in state-owned hospitals, too. The salaries of the publicly employed doctors are too low, around US$100-150 per month, which is under the subsistence level (World Bank 2007b). Public hospitals, especially well-known central clinics, are desperately over-crowded; two patients (or even more for children) must share a hospital bed, and family members must take care of the patients and must fight for reasonable service. This imbalance between demand and supply provides fertile soil for bribery and abuse of power by the hospital staff. Illness is one of the major causes of poverty or misery in Vietnam and is one of the most serious concerns of the population.

Government health care spending constitutes 1.8% of GDP, while total health care spending reached 6.2% of GDP in 2006. This means that the patient and the family had to make payments equaling 4.4% of GDP, more than double government spending on health. Per capita health spending increased from US$25.4 in 2003 to US$45 in 2006, but the government pays only US$12 of that US$45 (World Bank 2008).

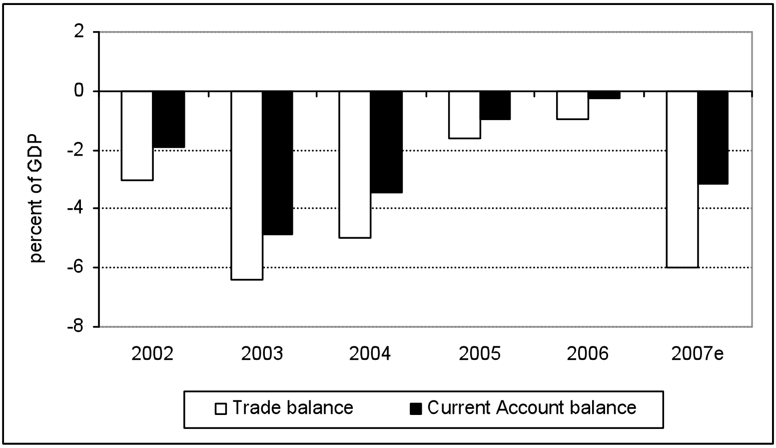
The public hospitals in Vietnam receive their income from three different sources: the central or provincial budget, payments from patients and their family, and heath care insurance. By 2000, around 60% of budget spending for health care was undertaken by provincial governments, leading to significant differences between better-off and poorer provinces. Most troublesome are the direct out-of-pocket payments from patients to the hospital staff for quasi-legal or completely illegal fees: there are no norms or standards, no regulations, no receipts for these payments. According to various surveys, these payments comprise 30% of total household spending on health care, the remaining 70% is for medicines or technical charges for X-rays or scanning, etc. (World Bank 2008).

Health care insurance covered 25% of the population in 2004 and has now increased to around 40%. There are programs for free health care services for the poor, but considering the huge imbalance between demand and supply, the likelihood that the poor (non-paying patient) can access the same quality health services as the paying patient is quite small (World Bank 2007b). Vietnam's health care system must be further reformed to implement the socialist orientation for the poor.

Emerging issues in 2007

In 2007, the year that it began to implement its commitments to the World Trade Organization (WTO), Vietnam achieved a GDP growth rate of 8.44% and attracted US$20.25 billion in foreign direct investment (FDI). Exports grew by 20.4% and reached US$48.5 billion, but imports grew by 35% and reached US$60.83 billion. The trade deficit reached a record high of US$12.45 billion, and the current account deficit rose to an alarming level.

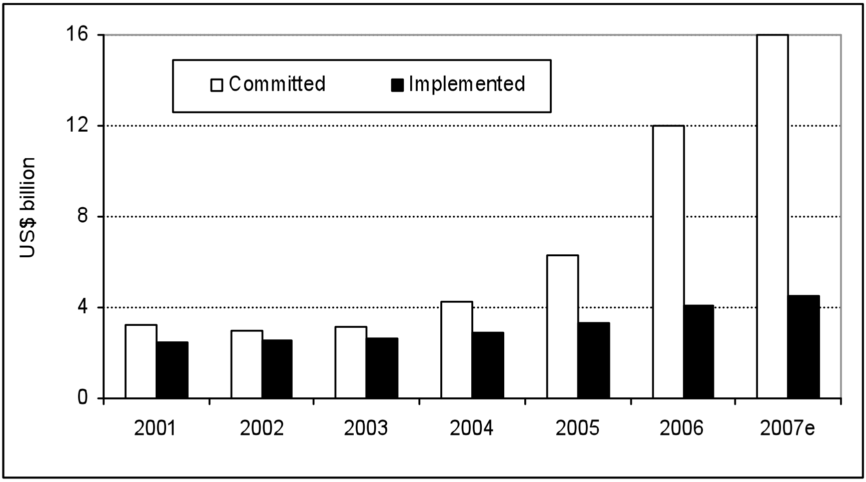
Figure 4: Trade and Current Account Balances



Source: General Statistics Office of Vietnam 2007, www.gso.gov.vn.

The high FDI inflow reflects the increasing expectation of foreign investors that the Government of Vietnam will implement the WTO commitments and the business environment in Vietnam will steadily improve. As the following graph shows, the disbursement of committed FDI is slowly increasing in absolute terms, but declining in relative terms, from around 90% in 2000 to 25% in 2007. The positive development is that more FDI is being attracted to central Vietnam than previously.

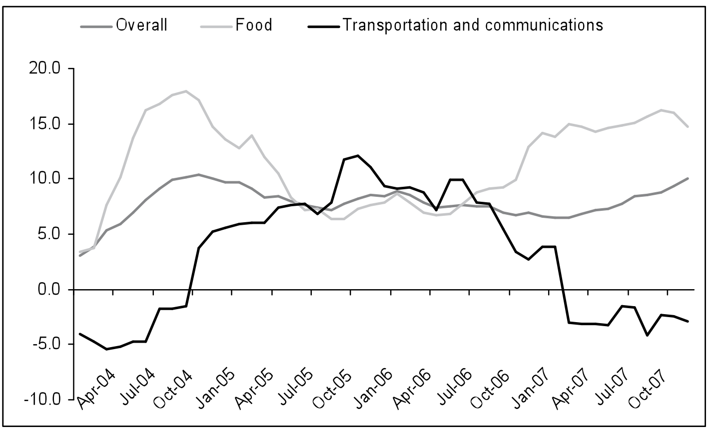
Figure 5: FDI Commitments and Disbursements



Source: Ministry of Planning and Investment of Vietnam 2007.

Inflation in 2007 was 12.6%, the highest in 20 years, negatively affect the living conditions of vulnerable groups of people. Especially the food price increase of16.8% has had a tangible impact on living conditions of the poor. The year 2007 was typical in the sense that various social groups did not equally benefit from the high economic growth rate.

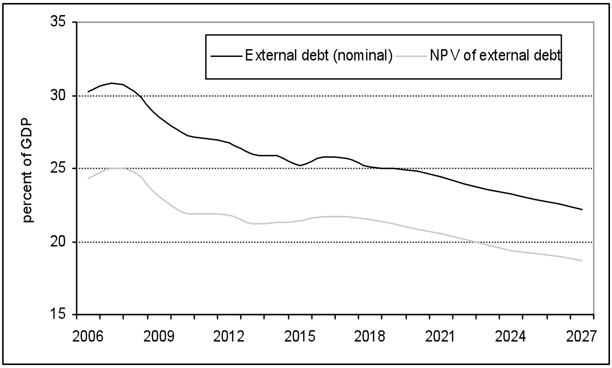
Figure 6: Components of Inflation in 2007



Source: General Statistics Office, www.gso.gov.vn.

The external debt to GDP ratio reached 31% in 2007, but has declined again since then. As two-thirds of this debt is on highly concessional terms, the debt service to export ratio remained stable at 5%.

Figure 7: Vietnam's External Debt



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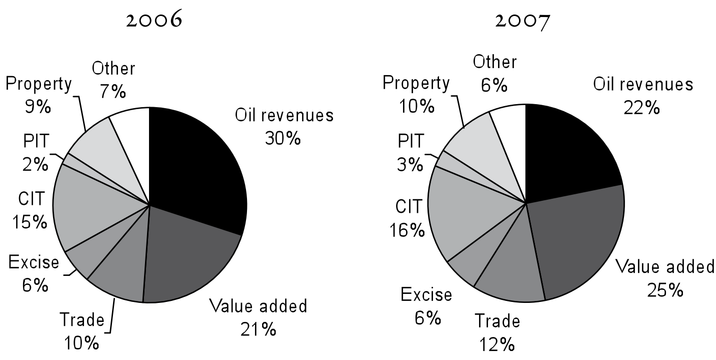
Source: International Monetary Fund 2007a, *Country Report No. 07/387*.

In 2007, Vietnam reduced 1800 different taxes, resulting in a relative decline of income from import tariffs, which was, however, over-compensated by the rapidly increasing trade volume.

Figure 8: Sources of Budget Revenues in 2006 and 2007



Source: Ministry of Finance of Vietnam, Budget Plan 2006 and 2007, www.mof.gov.vn.
PIT: personal income tax; CIT: corporate income tax.

Budget revenue was relatively unaffected in the first year of WTO membership, but was still very dependent on crude oil, while the share of personal income tax as a means of income redistribution was very modest. The revenue from property rose by only 1%, not at all proportionately to the high increase in real estate prices of 10-40% (depending on location), and the real estate market grew strongly.

The income gap widened in the first year of WTO membership: salaries for professionals in banking and securities soared by 60-80% (VND 6-7 million a month), while salaries for workers in the garments industry increased by 10% and net income of farmers in central Vietnam declined (MoLISA 2007).

Conclusion

Vietnam's market economy with socialist orientation has many parallels and similarities to the concept, principles, and final aims of the social and ecological market economy of Germany. There are problems in the institutional arrangements and functions of both the market economy and the role of the state in Vietnam. Despite impressive economic growth and social progress, there are many crucial issues in education, health care, and environmental protection.

As the preceding outline of emerging issues has indicated, the social and economic situation in Vietnam remains fragile. Vietnam is not yet immune to the trap of low wages or to the trap of middle-income economies. It is thus imperative that the reforms required to fully implement the market economy with socialist orientation be pushed quickly and decisively forward.

Through efficient implementation of reforms to unfold the freedom, creativity, and dynamism of the Vietnamese people and by sustaining macroeconomic stability in a globalizing world, Vietnam will hopefully continue its progress in implementing a market economy with socialist orientation.

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Significance of the Model for Thailand – Role of the State, Constitutional Values, and Planning Models

Visoot Phongsathorn

Introduction

GTZ has been working in Thailand for almost 30 years. It has supported a number of technical cooperation projects addressing a wide range of issues. Since 2004, GTZ has put all its technical cooperation efforts funded by the German Federal Ministry for Economic Cooperation and Development (BMZ) under a single program – the Thai-German Program for Enterprise Competitiveness (T-G PEC) – to create a singleness of purpose and a consistent approach. The goal of the T-G PEC is to improve the competitiveness of small and medium-sized enterprises (SMEs) in the Thai agro-industry sector and, by doing so, to provide Thailand with an alternative approach to ensure prosperity for its citizens.

Thailand's competitive advantage as a low wage country in the region is eroding. Many businesses are working with outdated production technologies that are both uncompetitive and environmentally unsustainable. The Thai government recognizes the problem and has assigned high policy priority to SMEs, in particular. However, the government's SME promotion policies and programs are government-centric, subsidy oriented, and not demand driven. Promotion of environmentally friendly production methods is rarely integrated into SME promotion programs. If these problems persist, poverty alleviation and an improvement in living conditions will be difficult to achieve.

The alternative development approach that the T-G PEC is demonstrating focuses on improving the institutional environment for specific value chains[1] in the Thai agro-industry sector, although the applicability of this approach is not limited only to the agro-industry sector. The agro-industry sector was chosen because it offers the greatest potential to extend the prosperity provided by Thailand's rapid industrialization to the rural population, which is being left

[1] The terms *value chain* and *subsector* are used interchangeably in the T-G PEC.

behind. More than 60% of Thais still live in rural areas. And more than two-thirds of this rural population is still engaged in agriculture, which produces a mere 10% of national income. In the other words, Thais working on farms are earning, on average, 85% less than their counterparts in the other economic sectors.

Adding value to agricultural products through environmentally sustainable industrial processes will contribute enormously to bridging the income gap between rural and urban Thais. Neither a laissez faire approach nor central planning is able to advance the Thai agro-industry sector. Only policies in line with a social market economy can do so. However, introducing social market economy ideals to Thailand is not without its complications. Thailand has its own institutional setting and its own constitutional values, results of a long evolutionary process.

This article will elaborate on some of these complications. First, it will lay out the institutional setting in Thailand. Then it will discuss how the T-G PEC is introducing social market economy ideals to Thailand and some of the difficulties that it is facing. Lastly, the article will describe two recent Thai economic models – "Thaksinomics" and "sufficiency economy." Examining them may shed some light on the future of the social market economy in Thailand.

Institutional Setting

Thailand is a very hierarchical society. *Giving* is a great social virtue. The masses are kept poor. The elites enrich themselves. The elites maintain their spiritual prestige by way of giving either directly to the poor or indirectly through religious institutions. Being poor is deemed to be the result of lacking spiritual accomplishment. This ethos is very deep rooted.

At the height of the Angkorean kingdom in the twelfth century, a king portrayed himself as an embodiment of Avalokitesvara, a deity in Tantric Buddhism. Statues of Avalokitesvara built during Jayavarman VII's reign bore a resemblance to himself. To project his love and care for his subjects, as he perceived that Avalokitesvara would, he built and supported 102 hospitals and 101 rest houses for pilgrims. His self-glorifying projects laid a heavy burden on the state's economy. By the end of his reign, the Khmer state was mortally weakened. The Thais, who adhered to Theravada Buddhism, did not accept the divinity of the Khmer king; they declared independence upon Jayavarman VII's death in 1218 and established their own state with Sukhothai as its capital.

Having rejected the Khmer state's hierarchical rule, the Thai state remained egalitarian for about a century. By the mid-fourteenth century, Ayutthaya rose as a new Thai polity in place of Sukhothai. Early Ayutthaya kings relied on Khmer scholars of Lopburi, which had been the administrative center of the Khmer state for the Chao Phraya Basin. Khmer administrative and legal systems were re-adopted by the Thai state.

Thailand's *ancien régime* crystalized a century later under King Paramatrailokanat. The king consolidated centralized bureaucratic rule. Every stratum of the kingdom's subjects was assigned to its appointed place in a bureaucratically organized and well-coordinated polity. State functionaries were allotted fixed areas of land in accordance with their rank and remuneration. Their lands were to be returned to the crown upon their death or dismissal. The commoners between 18 and 60 were obligated to give three months of their time each year to cultivate the local lords' lands or participate in public works.[2] Local lords, in return, were to provide protection and legal representation for their subjects. State functionaries and monks were exempted from these corvée obligations.

State administration was divided into provincial and central administration. Major towns were ruled by the king's sons. Minor ones were ruled by bureaucrats appointed by the king. Tributary states were self-administered. The king reserved the right to interfere with their internal affairs. They were expected to pay tributes and provide the king with corvée laborers and soldiers. The central administration was divided into a military and a civil administration, with the civil administration composed of four ministries. The Ministry of Finance was in charge of harbors and customs. The crown participated directly in trade. Most ships, excluding foreign vessels, were registered in the king's name.

The regime lasted for the remainder of the Ayutthaya period and survived the sacking of Ayutthaya by the Burmese in 1767. Early Chakri kings still followed the regime set up by King Paramatrailokanat. Only the encroachment of the Western powers in the nineteenth century convinced the Chakri kings to change their ways; however, what followed was not democracy, but absolute monarchism and military dictatorship.

Prior to the reforms, Thai kings were not lawmakers. The kings only enforced laws passed on to them from previous generations. The law was ultimately based on the Code of Manu.[3] Occasional codifications of the law were done by Brahmans. A king's conduct was governed by *Rajashastra* and *Nitiprabani*. King Rama V, however, influenced by Bodin and Hobbes, among others, saw it differently. In his own words, he described his authority as follows:

> "The sovereignty of the King of Siam is not prescribed in any law,
> for it is absolute and cannot be restrained by anything or anybody.

[2]Corvée tax was later introduced in the early-seventeenth century.

[3]An ancient Hindu text that lays down the principles, laws, and rules governing society.

Nevertheless, in reality, the King's conduct must be in accordance with reason and equity."

Despite its absolutist nature, King Rama V's reform brought many positive changes. One of the most far reaching was the abolition of slavery and corvée labor service. Government officials were paid wages instead of being accorded temporary rights to the production and labor service of the inhabitants of parcels of land. The apparatus of the state became centrally administered. The judiciary became independent. Laws based on European models replaced ancient laws. A large number of students, including the sons of the king, were sent to study in Europe.

Absolute monarchism in Thailand was, however, short lived. It came to an end on June 24, 1932. A group of mid-ranking military officials carried out a bloodless coup ostensibly to introduce democracy and a constitutional monarchy.[4] The country has since been dominated by the military. The written constitution has been, by and large, disregarded and was suspended 12 times in the past 75 years. Legal positivism[5] reigns supreme. John Austin's jurisprudence was introduced to Thailand by Prince Rabi, a son of Rama V. He studied law at Oxford in 1888-90. He opened a law school in 1897. The teaching of legal positivism as the authoritative school of legal thought remained unchallenged until the 1970s. Opening up the legal curriculum eventually bore results. Other schools of legal thought began to make inroads. Inspired by *rechtsstaat*,[6] the judicial review of government decisions has become feasible since 1999. Nevertheless, the intellectual and moral dominance of legal positivism can still be clearly felt.

The encroachment of the Western powers and the associated treaties that opened up trade in the nineteenth century also brought about a commercial society. Rice became an important trade commodity. Rice trading created a new commercial class comprised mainly of Chinese migrants.[7] Their commercial

[4]The Great Depression created serious difficulties for the state's finances. King Rama VII decided to cut salaries and lay off government officials. Discontent among the officials was also a major factor behind the coup.

[5]Legal positivism holds that the law is nothing but a command issued by the sovereign. The law owes its validity to neither religious principles nor judicial precedents.

[6]*Rechtsstaat* holds that the state must be subject to the law. Citizens must be furnished with a remedy for any violation of their legal rights. In practice, this means that citizens can bring court cases against their own government.

[7]Initially, most Thai commoners were still subject to slavery and corvée labor service, which were not completely abolished until six decades after the signing of treaties with the Western powers. Massive migration of Chinese to Southeast Asia was also fueled by political turmoil in China at the time.

success made them the target of discrimination, which worsened significantly after the 1932 coup. Their opportunity came with World War II, which disrupted the trading activities run by European companies and allowed Chinese merchants to step into their place. Some made enormous fortunes. Plaek Pibulsonggram, the pre-war, anti-Chinese prime minister, was removed toward the end of the war for his allegiance to Japan. The business environment became friendlier for Chinese merchants. They began branching into manufacturing and banking. Four years after his removal, Plaek staged a coup and came back to power. To safeguard against discrimination, the Chinese merchants began inviting government officials to sit on the boards of their companies. In 1957, Plaek was removed by a coup, and Sarit Dhanaraj replaced him as prime minister.

Sarit's rule marked the beginning of Thai corporatism. Under him, the National Economic Development Council was set up.[8] With the help of the World Bank, the Council prepared and implemented a series of five-year plans. Import substitution was heavily promoted and tariff barriers were put up. A large number of internally traded items were put under price controls. Chinese merchants, enjoying the economic rents provided by these tariff barriers and price controls, deepened their close relationships with the government. The initially informal relationships finally turned formal: The Joint Government-Business Committees were set up in 1981. The business sector was represented by the Federation of Thai Industries, the Thai Chamber of Commerce, and the Thai Bankers Association. There were committees at both national and provincial levels. The National Economic and Social Development Board (NESDB) acted as the secretariat for the National Committee.

The prominence of the committees came to end under the premiership of Chatichai Choonhavan (1988-1991). Chatichai pursued an export-oriented economic policy, fueled by the relocation of the Japanese manufacturing base that resulted from the massive yen appreciation after the Plaza Accord.[9] Anand Panyarachun, the prime minister after Chatichai, dismantled most protectionist barriers and anti-market price controls. Without economic rents, the relationship between the Chinese business community and the government became less cozy. The influence of the business community on the government has been further counterweighted by the growing prominence of NGOs.

[8]The National Economic Development Council was transformed into the present-day National Economic and Social Development Board (NESDB), which continues to draw up five-year plans today.

[9]The value of the yen against the US dollar doubled over the two-year period after the Plaza Accord. Many industries in Japan became uncompetitive. Japanese companies responded by moving manufacturing facilities to countries with weaker currencies, such as Thailand.

The relationship between the business community and the labor movement has also been hierarchical; they have never formed a close social partnership. Business owners have always relied on the government to deal with the labor movement. Initially, the government used force to deal with industrial actions. In the 1970s, the government began to cultivate labor leaders who were willing to ally themselves with the government. A number of labor organizations were set up under the government's initiative.

In sum, the defunct Thai corporatism was a government-centric and authoritarian arrangement. The existence of a pluralistic and self-regulating corporatism is essential to the effective functioning of a social market economy, and the weakness of the pluralistic and self-regulating corporatism in Thailand is a major challenge for the T-G PEC's efforts to enliven social market economy ideals in this country. This will be discussed in further detail below.

Thai-German Program for Enterprise Competitiveness

Following a program approach, the Thai-German Program for Enterprise Competitiveness has the flexibility to design its underlying projects when and as needed. The designs of the projects are driven by key performance results specified in the program proposal drawn up with GTZ support and accepted by BMZ. It is also driven by a set of guiding principles. These guiding principles are:

1) Make markets work.
2) Improve business performance by improving framework conditions and the markets for relevant business services.
3) Be results oriented and use value chains as units for measuring competitiveness results.[10] and
4) Partners[11] must make significant contributions to the projects.

The rationale behind the adoption of these principles and the complex implications of implementing them will be discussed next. Specific case examples will then follow.

[10]In other words, the impacts of the T-G PEC's interventions must reach a significant percentage of SMEs in the value chains.

[11]The T-G PEC's partners are from both the public sector and the private sector.

Guiding Principles and their Complications

Make Markets Work

Ludwig Erhard expressed quite succinctly why we need to make markets work. In a crucial debate in the Bizonal Economic Council on June 17, 1948, he argued:

> "We must find our way back to a market organization free from controls. In place of interventionism, we must insist on personal responsibility and performance. The market is not a diabolic invention to subdue particular classes. On the contrary, it is the only organization of economic life which creates a just and optimal distribution, a function which no collectivist authorities can replace... we must eliminate uneconomic enterprises and cannot carry lame ducks indefinitely. Individual risk bearing must be rewarded, yet the penalties of mistakes cannot be shouldered by the community... Profitability must be restored in order to steer capital into the appropriate channels... Inflation must be squeezed out through strict monetary disciplines making the individual to run after money and not after goods. Only such policies will raise the national product and enable us to carry out our social responsibilities."

Properly functioning markets not only "enable us to carry out our social responsibilities," but also enable us to carry out our environmental responsibilities. Emissions trading is a well-known case in point. Less glamorous examples abound.[12] This is why the social market economy principle of *marktkonform* is very important. Working against the market is not only anti-market; it is also anti-social and anti-ecological.

In Thailand, however, this principle is rather alien. Social responsibilities[13] mean "giving" – and giving without regard to the impact on the functioning of the markets. Thais expect their governments to give, just as their ancestors depended on their sovereigns' and overlords' giving. If a cluster of small cottage-industry producers pollute the local watercourses, the government's most likely reaction will be to give a wastewater treatment plant free of charge. What, therefore, is the incentive for the

[12] Scavenging for recyclables is probably the least glamorous example. People scavenge garbage dumps because there are markets for recyclables. Still, the markets can be made more efficient and the practice less health hazardous. GTZ's cooperation with a local government and the private sector in Thailand's province of Phitsanulok is a case in point (see www.gtz.de/de/dokumente/en-factsheet-solid-waste-management-thailand.pdf).

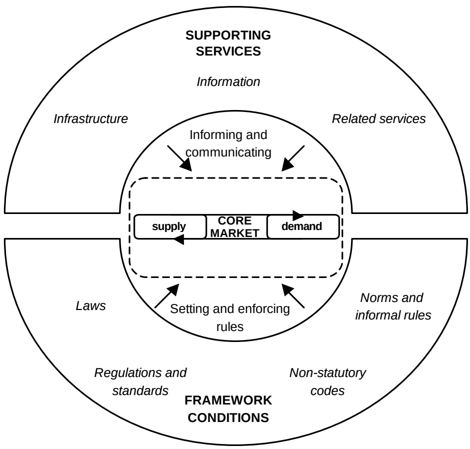
[13] While the definition of "social responsibilities" is still a subject of open debate, we can all agree that enabling others to carry out their own social responsibilities is socially responsible. On the contrary, hindering others from carrying out their social responsibilities is socially irresponsible.

producers to connect to a wastewater collection system, or even take responsibility for their own waste? Who will bear the costs of running and upgrading the plant? These are the kind of questions that often slip Thai government officials' minds. The small producers do not care one way or the other. They often accept that polluting the local watercourse is bad. But what can they do? They think of themselves as poor and incapable of dealing with the problem.

Business Environments[14]

All, however, is not lost. Not all cases of giving are bad. There are cases where giving can make markets work better. The givers, however, need to be clear in their own minds which weaknesses in the markets they are trying to fix. First, they need to understand what a market is. A market is not just buyers and sellers. All markets operate within their specific business environments. On the one hand, there are framework conditions that govern all transactions. These framework conditions can be formal or informal. They can be explicit or implicit. They can affect supply and demand in a dramatic way. At the same time, there are services that make transactions affordable or, in some extreme cases, possible. Telephone directories and telephone services are obvious examples. Unlike phone calls, many services are not generic. Some are even specific to individual value chains and not marketable elsewhere.

Figure 1: Elements of a Market[14]



Source: Springfield Center, modified using GTZ terminology

[14]Within GTZ, another commonly used term of an equivalent meaning is *meso level* or *mesoebene*.

When a giver, be it a national government or an international development agency, decides to give to a market, it can give directly to the buyers for their immediate usage or directly to the sellers to lower their prices, even to zero. But what impact will that make? Most likely the market will be distorted. When the giver stops giving, what the buyers need will no longer be available at the price that most of them can afford. Nevertheless, there are cases of increasing returns to scale where initial subsidies can be beneficial to the markets. Except for such exceptional cases, the givers should focus on making changes to the framework conditions or the service markets or both, in such a way that the core market functions better. This approach follows the social market economy principle of *ordnungspolitik* and takes it one step further.[15]

Walter Eucken's position on framework conditions or *wettbewerbsordnung,* as he called it, still serves as a good guide for anyone working in this area. Eucken asserted that framework conditions for a properly functioning market must comply with the following constituent principles:

- Prices must be free from any controls.
- The freedom of contract must be safeguarded by the government, as must the sanctity of contract.
- Markets must be open. New entrants must be able to enter the market. Existing competitors must be free to leave the market. No one should have the power to prevent market mobility – neither the government nor the dominant player in the market.
- Private property is inalienable. Ownership must come with responsibilities. All social and environmental costs should be internalized to the greatest extent practical.
- Policies must be reasonably constant.
- The currency must be stable.

Following Eucken's advice in this regard presents a major challenge for anyone working on market framework conditions in Thailand. Over 200 products are still subject to price controls. The concept of private property is weak. Private properties are protected against outright expropriation, but, owners have no remedy if the usefulness or value of their properties is undermined by actions of the government, except in some rare and specific cases. In a way, the spirit of the old landholding rights from the days before passage of the Civil and Commercial Code in 1925 is still alive. Lastly, there is no constancy of policies. Policies can

[15]When the principle was conceived, transaction cost economics was not as well developed as it is now.

change at the whim of not only elected policy makers[16] but also unelected bureaucrats. Public consultation is now being encouraged but, in most cases, not required.

On the positive side, almost all markets are open. New products and new services can be introduced by new providers most of the time without any consent from the government. This is very important to the T-G PEC, as one of its main tasks is to promote new services to help the Thai agro-industry sector to be competitive. Another positive factor is that the government has no intention of using inflation to facilitate its deficit spending. Nevertheless, the currency has been mishandled occasionally. The last time was in December 2006, but its impact was not as devastating as in 1997.

Subsidiarity

Subsidiarity goes beyond federalism. At its core is respect for human dignity. Institutions, whether they be the government, the market, the community, membership organizations, or other types of institutions, exist only to allow persons to realize their full humanity. In other words, they exist to serve human beings.[17] The choice of an institution's form should be made with the people to be served at its heart. Subsidiarity and ordnungspolitik go hand in hand. On the one hand, whatever institutional form is chosen, all institutions need well-ordered institutional environments in which to operate. On the other hand, the maintenance of specific institutional environments should be in the hands of the bodies that are best suited to do so. Self-regulation can be effective and efficient, but self-regulation is only possible in the context of strong pluralistic corporatism. Self-regulation does not mean that the government has no role. Self-regulation requires a strong super-ordinate regulatory regime administered by the government. Without this, corporative bodies would turn themselves into cartels. They would use regulations to unduly limit competition by blocking new entrants from the market.

Subsidiarity drives the way the T-G PEC implements its program. Prior to starting any project, value chain analyses are conducted. All the key players in the value chains are identified. So are the key constraints and opportunities in the value chains. Next, the T-G PEC considers what changes in the framework

[16]Thailand has changed its prime minister 20 times in the last 50 years.

[17]The term *subsidiarity* was coined by Pope Pius XI. He used it in the encyclical *Quadragesimo Anno* to designate the principle that social and political institutions only existed to serve human beings, either directly or indirectly, through other institutions. The encyclical was ghost-authored for the Italian Pope by Oswald von Nell-Breuning, a German Jesuit.

conditions and service markets serving the value chains are needed to unlock the constraints or capitalize on the opportunities. The potential owners of these changes are identified and engaged in discussion. Willingness to contribute to the changes is the crucial test of the commitment of potential partners to the issues at hand. In this way, the T-G PEC is able to identify the institutions that will be responsible for improving business environments. The last step before implementation of the project is formulation of the project plan with clear exit strategies to ensure the sustainability of the changes beyond the life of the project.

The main challenges that the T-G PEC is facing here are twofold. On the one hand, the government often feels that it is its duty to improve the competitiveness of the value chains. It sees its role as that of giver, as discussed above. On the other hand, Thai corporative bodies are very weak. Business and labor organizations have been set up mainly to work with the government, not with each other. Value-chain-level business organizations are often poorly managed. It is not unusual to find a business organization being managed by just one of its members, who uses his or her own company as the secretariat of the organization. Consequently, the state has locked itself into the role of giver and is not an enabler, and the private sector is encouraged to be a passive and grateful recipient, as opposed to being a confident, active, and efficient producer for a dynamic market.

Case Examples

Palm Oil Industry

Palm oil is the second most consumed vegetable oil globally; current production of palm oil is 32 million metric tons, and its market share is 29% (compared to 30% for soybean oil). It is also the most traded edible oil, with a global market share of 56%. Historically, palm oil has enjoyed the fastest growth of all major vegetable oil products. Globally, the palm oil market has been growing at the rate of 8% a year compared to 4% for the overall vegetable oil market. However, Thailand hardly participates in the global market; it has a market share of only 3%.

The Thailand palm oil industry is protected: the average price of crude palm oil (CPO) in Thailand is 12% higher than in neighboring Malaysia. Inefficiency spans across the entire value chain. The production cost of oil palm fruit is 29% higher than in Malaysia, due principally to poor farm management by its 67,000 smallholders. The oil extraction rate is 25% lower, due to poor harvesting and post-harvest handling practices. Overall, both oil palm growers and palm oil millers in Thailand are making less money than their counterparts in Malaysia. The government's response to the situation is rather amazing: It announced that it would promote an expansion of oil palm cultivation from the current 0.3 million hectares to 1.3 million hectares. It planned to absorb the increased production by promoting the use of bio-diesel through preferential tax treatment. After a change in government in 2006, the idea of importing bio-diesel from Malaysia instead of producing it locally was floated and received strong opposition from the industry. Only one shipment of 60,000 tons was allowed to be imported.

The T-G PEC believes that for the Thai palm oil industry to be able to develop downstream processing, including bio-diesel and oleochemicals, it needs to reduce the cost of CPO to the same level as in Malaysia. This can only happen if oil palm growers can deliver better oil palm fruit to the mills at a lower price. Oil palm plantations in Thailand are not as well managed as those in Malaysia. Plantations in Malaysia are very large and managed by big companies with all the necessary know-how and supporting technological facilities. Plantations in Thailand are owned and managed by smallholders who lack know-how and laboratories. The solutions for the Thai palm oil industry lie in the service markets – the market for training and the market for soil and leaf testing. Mills are willing to buy training services for the growers supplying them. Each mill has very few competing buyers of oil palm fruit, as it cannot be transported very far before it become rancid.

A team of university professors developed the training course with the assistance of T-G PEC. The professors have been providing consultancy services to one of the very few big plantations in Thailand, to provide them with practical know-how. But, they did have the ability to train small farmers with limited education. The T-G PEC arranged experts in micro-enterprise training to help them tailor courses for small farmers. Once the growers understood the benefit of soil and leaf analysis, they were willing to buy the service. The T-G PEC also helped a mill upgrade the equipment and management of its defunct laboratory to the level where its services could be sold. Simple as it may sound, this will help lower the cost of CPO at participating mills close to Malaysia within two years' time. All this operates against the backdrop of the free training and free soil analysis offered by the government, but not utilized by the growers. That which is free frequently has no value!

This is one of many projects that the T-G PEC is carrying out in the palm oil industry.

Fruit and Vegetables

Thailand is growing and exporting a large variety of fruits. Longan is one of the most interesting examples, both for its taste and for its politics. It is one of the few products that still requires export permits. China is by far the largest buyer of longan, purchasing half of the fresh longan exported and three-quarters of the dehydrated longan exported. The import market in China is highly concentrated. Importers buy from only a few exporters. This causes the export market on the Thai side to be highly concentrated as well. Growers have always complained about manipulations in the market. They allege that the exporters and the government officials handling export procedures have been intentionally causing occasional gluts and shortages of longan by manipulating the timing of export permit issuance. Whether this is true or not, longan is a fruit that is naturally prone to gluts and shortages due to its seasonality: almost all longan is harvested between July and September. The government's usual response to the problem has been to step in and buy longan at above-market prices. This has led to a worsening of the oversupply and a larger price-support scheme. It took a major corruption scandal to stop the price-support scheme, but export permits are still required.

It does not take much to break a cartel. In case of an oligopsonistic cartel such as this one, falling supply, increasing demand, or the entry of non-cartel buyers with significant buying volume will break the cartel. The T-G PEC is therefore promoting a market for pruning services and adoption of a GLOBALGAP standard for fresh fruit and vegetables. Pruning longan trees will reduce overall production, but increase the yield of larger, better-priced longan. GLOBALGAP certification will expand longan markets in Europe from the ethnic market to the retail chain market, where volume is potentially much larger. The promotion of a production standard is a rather complex undertaking and cannot be explained here in its entirety. But it is important to point out that GLOBALGAP is owned by its members, who are buyers and producers of agricultural products, and is administered by a nonprofit private sector organization. By promoting its adoption in Thailand, the T-G PEC is working with the Thai Fruit and Vegetable Producer Association and the Thai Chamber of Commerce as the standard owner and administrator, while keeping the Thai government informed. This is a clear example of the subsidiarity principle in action.

In both cases, the goal is to stimulate private actors to take on the role of "social entrepreneurs" in order to create changes in business environments and introduce services that will close the efficiency gap between them and their competitors.

Recent Economic Models in Thailand

The year 1997 marked another major point in Thai economic history. The baht collapsed, and the economic bubble burst; the International Monetary Fund led a rescue mission. Thailand moved from a currency regime that pegged the baht to a basket of currencies weighted heavily towards the US dollar to one of inflation targeting. The baht was allowed to float freely. The government also introduced an austerity program and a package of laws to further liberalize the economy. A new Competition Act and a new Pricing Act were promulgated. The number of products under price controls came down to 16.

The austerity program proved immensely unpopular with the local populace. In 2002, Thaksin Shinawatra came to power promising to stimulate the economy. His economic policy was later branded as "Thaksinomics." Thaksinomics is a combination of grassroots economic stimulation, a Japanese MITI-style industrial policy, heavy investment in infrastructure projects, and bilateral trade promotion. The "Bht 30 Healthcare Program," village funds, farm debt relief, and One Tambon One Product made up the cornerstones of his grassroots economic package.

- Healthcare was made available at Bht 30[18] per visit to all those not covered by social security. Farmers, who make up over 40% of the labor force, are outside the formal employment arrangement and therefore outside the coverage of social security. Given their low income, healthcare expenditures can be quite burdensome.
- A micro-credit scheme was set up in each of the country's nearly 80,000 villages with an endowment of Bht 1 million[19] per fund. Loan amounts were capped at Bht 20,000 per loan.[20] Over 5 million people took out loans from the funds. The funds are supposed to be managed by the people within the village. At first, young university graduates were hired and trained to be advisors to the villagers. Over time, the quality of credit management has not been maintained across the board. Some funds are still very well managed, while a large number of them have delinquency rates of over 50%.
- Debt restructuring with a three-year repayment grace period and sometimes with debt reduction was offered to farmers. The offer was terminated in 2004 after 2.4 million farmers had participated in the program. The total amount restructured was Bht 94 billion.[21]
- The One Tambon[22] One Product (OTOP) program was modeled after the successful OVOP Movement in Japan. The idea was to have local communities develop local specialty products that could be sold at a premium. The implementation in Thailand was overly ambitious. Around 36,000 OTOP groups were created in less than five years.

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[18] Approximately €0.60.

[19] Approximately €20,000.

[20] Approximately €400.

[21] Approximately €2 billion.

[22] A tambon is roughly equivalent to a civil parish in England. Each tambon covers 10-20 villages.

Thaksin's style of governance, which he billed as "CEO style," was very interventionist. He pushed to see results in a very short period, without much regard to the means of achieving such results.[23] The funding of the above-mentioned programs was partly off-budget; they are still being fiscalized.

Under Thaksin, Thailand's competition policy suffered. The Competition Act was never enforced. Over 200 products were put back under price controls. The WTO process was by and large disregarded. The government opted for preferential bilateral trade arrangements, euphemistically billed as "free trade agreements."

Thaksin was ousted by a coup on September 26, 2006. The government appointed by the incoming junta needed to come up with a rallying cry that could rival Thaksinomics, which was still very popular among the rural populace. They chose "sufficiency economy" – a philosophy that has been advocated by the present king for a number of decades. The government heavily promoted a large number of sufficiency economy projects around the country. These projects amounted to no more than small-scale integrated polyculture farming with a bit of puritanical Buddhist ethics thrown in. The king's philosophy is, however, much more than that. The king stresses that large-scale undertakings are not against his philosophy; he often uses the 785 million cubic meter Pasak Jolsit Dam, which could not have been built without his moral support, as a prime example. He also stresses that the possession of luxury goods is not against the sufficiency economy philosophy, so long as the goods are not ill-gotten.

It is not possible to say what precisely the sufficiency economy philosophy is. The king has never put his thoughts into one single treatise. There have been several attempts by scholars to distill the king's thought from a large number of his speeches, but these attempts have not been entirely satisfactory. There are a number of claims about features of the sufficiency economy in these works, but these cannot be attributed directly to the king's speeches. This does not mean that these features contradict the king's thoughts. Whether or not they do, only the king knows, and he does not often contradict other people in public. Moderation, prudence, and not being destitute are the only features of the sufficiency economy that he has personally laid out.

Thaksinomics and the sufficiency economy philosophy show that there is growing concern for the well-being of less-well-off members of society. Rapid growth and industrialization have greatly benefited those who can participate. The number is not small: tens of millions of Thais now have a very high standard of

[23] The epitome of his style of governance was his war on drugs, where almost 3,000 people were shot dead in a space of a few months. Most of the incidents were extrajudicial executions. Only one case was brought to court.

living. But tens of millions are also being left behind. These two economic models try to tackle this same problem in their different ways. Both have their weaknesses. Thaksinomics' grassroot economic package could be much strengthened if it were grounded in the principles of the social market economy, namely: *marktkonform*, *ordnungspolitik,* and subsidiarity. The sufficiency economy philosophy, on the other hand, focuses exclusively on consumption and production. How the philosophy is applied to exchange has not been elaborated lucidly. The sufficiency economy philosophy may be able to draw from the social market economy with its emphasis on the market's central role to enable social progress when guided by the right principles and rules. Both Thaksinomics and the sufficiency economy philosophy share a common strength: both aim to empower the disenfranchised so that they can become more prosperous by participating in the modern market – which will also make the Thai market economy more social.

Ways Forward

The T-G PEC is the last Thai-German technical cooperation funded by BMZ. The funding is foreseen to end in 2011. Thailand is graduating from the ranks of developing countries. Thai-German technical cooperation will have to enter into a dramatically different phase. A few modes of funding have been explored. One of the more likely possibilities is trilateral cooperation whereby Germany and Thailand work side by side to provide technical cooperation to a third country. GTZ would be working on the German government's behalf. A variation of this is trilateral cooperation in which Thailand's donor partner is a multilateral agency. The Thai government has been interested in technical cooperation with less developed countries. Thailand is currently working with Lesotho on the sufficiency economy philosophy and with Tanzania on rain making. Officials from Afghanistan, Bangladesh, Bhutan, Burkina Faso, Cambodia, Colombia, Djibouti, Egypt, The Gambia, Guatemala, Laos, Madagascar, Mali, Mozambique, Nepal, Papua New Guinea, Senegal, Sri Lanka, and Timor-Leste also came for week-long visits to Thailand at the invitation of the government to study development projects in Thailand.

In the technical cooperation game, Thailand is very much a novice donor. It has no established system and procedures to efficiently and effectively implement technical cooperation. It will soon realize that working alongside established players like Germany will provide it with valuable on-the-job training. For Germany, this will be an opportunity to convey the social market economy ideals to Thailand in a potentially more favorable environment. Most professors learn new ideas when they are teaching their students. Both Thaksinomics and sufficiency economy can be developed to their full potential if they draw from the social market economy.

Developing a social market economy is more than getting the macro economic "levers" –interest rates, currency rates, and fiscal prudence – to function; it involves allowing markets to operate in a way that encourages the emergence of entrepreneurs from all classes of society. In principle, it is a meritocracy. Thailand has done well in achieving greater economic growth in the past two decades, so that many millions have found a way out of poverty. This effect, however, was a byproduct of growth. It was not the aim of this economic policy. To build up a more mature economic policy founded on the philosophy of "growth with equity," Thailand has played with a few variations of its own. But, because they have not been rooted in a culture that rewards "tough love" or in a re-definition of the relationship between Thailand's state and its people, these experiments have been short lived and far from successful. Is there a way out? Certainly, but that is the subject of another article!

Social Security in India – A System in the Making

Rolf Sülzer[1]

Introducing the Setting

Asia is the fastest developing continent in the world today. Rapid growth and rising inequality, among other divides, are proceeding hand in hand, diminishing further the potential for rapid poverty reduction on the basis of pro-poor growth or shared growth, called "inclusive growth" in India – the hallmark of the upcoming 11th Five-Year Plan for 2007 to 2012.[2] India is recognizing that it has "failed to provide a comprehensive national scheme in order to protect 93% of its workforce"[3] of about 400 million[4] workers. These 93% or about 370 million unorganized workers contribute about 60% of Indian gross domestic product. Despite this overwhelming importance for the national product, economists, using economic terms, often refer to these workers – the backbone of rural and urban India – as the "residual sector."

In the Indian context, the term *social security* encompasses social assistance, social safety nets, social insurance, micro-insurance or "insurance for the poor," social protection, and any other preventive, promotional or protective measures.[5]

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[1]The author is grateful for the overviews, synopsis of schemes, and insights into the actual debate provided to GTZ India by the consulting company Diaspora – Social Development Consultants, New Delhi, who undertook a great deal of background research for this article.

[2]The comprehensive 11th Plan is still under discussion; however, the following document is available: Government of India, Planning Commission, *Towards Faster and More Inclusive Growth. An Approach to the 11th Five-Year Plan Government of India*, New Delhi, December 2006.

[3]Mridula Ghai, "The Coverage Gap: Informal Labor Markets in the Developing World with Special Reference to India," (paper read at the 5th International Research Conference on Social Security, Warsaw, March 5-7, 2007).

[4]Figures related to the workforce in India and the unorganized sector are quoted from S. Sakthivel and Pinaki Joddar, "Unorganized Sector Workforce in India: Trends, Patterns, and Social Security Coverage," *Economic and Political Weekly* (May 27, 2006): 2107-2114.

[5]Uday Kumar Varma, "Social Security for Unorganized Sector – Some Issues," (paper read at the Seminar on Social Security for Workers in the Unorganized Sector, Shri Ram Centre for Industrial Relations and Human Resources, New Delhi, November 25-26, 2004).

Despite the broad coverage of the term *social security* in India, the policy is not coherent, and "spending" on these measures is extremely low and extremely scattered, if not paltry, as will be outlined below. According to the World Labor Report 2000, public expenditure on social security in India is 1.8% of GDP, against 4.7% in Sri Lanka, or 3.6% in China. In view of the interesting social assistance programs emerging in rural China, India and China recently (October 2007) renewed the memorandum of understanding of September 26, 2000 on broadening exchange and extending cooperation in the field of employment, vocational training, and social security for another three years.[6]

At the same time, in a multi-polar approach, India is discussing and exchanging views on social security issues with institutions in Europe and in the Americas. Especially the discussions with European institutions give rise to the question if Europeans and Germans will ever fully comprehend the dimensions of social security in India and the meaning of the terms *unorganized workers, unorganized sector*, or *informal sector* as commonly used in India's debate. We would have to go back more than 150 years in our history to find a remotely similar situation – when the majority of workers in Germany were working as day laborers without any formal contract with their "employer," as some 370 million Indian workers are doing today – or working as bonded laborers (that is precisely what more than 2.6 million Indian workers[7] are still today).

The terms unorganized *sector workers, informal sector workers*, or *residual sector workers* hide the fact that these individuals have almost no legally enforceable rights vis-à-vis their "employers," have almost no voice in their dependency on employers and, more often than not, on money lenders or landlords, have no direct contractual relationship with the employer, and depend largely on charity for "social security measures" through social assistance that is granted but not a legal entitlement.

On the eve of independence, 60 years ago, Jawaharlal Nehru in his famous "Tryst with Destiny" speech stressed the creation of "social, economic, and political institutions which will ensure justice and fullness of life to every man and woman." These objectives have been embodied in the Constitution of India: The Directive Principles of the constitution direct that "the State shall strive to promote [...] a social order in which justice, social, economic, and political, shall inform all the institutions of the national life" and, in particular, shall ensure "that the citizens, men and women equally, have the right to an adequate means

[6]Signed by Chinese Vice-Minister of Labor and Social Security, Wang Dongjin, and Union Labor and Employment Secretary, K.M. Sahani.

[7]Government of India, *Report of the National Commission on Rural Labor*, New Delhi, 1991.

of livelihood." This was a visionary statement that could have led to the model of a social market economy. It was however never realized, as the social programs in India developed rather late and became charities. The predominant provider of social security until today remains the family.

It is extremely difficult to imagine the living conditions and the resulting resilient attitude of the urban and rural poor who form the majority of people in the unorganized sector – many of them living "below the poverty line" (BPL – a famous term in Indian social assistance programs).[8] The Government of India has defined the poor as those who do not get the minimum required daily calorie intake of 2400 (rural) or 2100 (urban) Kcal per capita per day. In order to get the minimum food to obtain these calories, the estimated income requirement is Rs. 229 or Rs. 264, respectively, per capita per month at 1993-94 prices – that is an income of at least Rs. 1150 (rural) or Rs.1300 (urban) per month for a family of five.[9] Those who have less are considered to be living below the poverty line – though highly segregated into four strata: 2% of poor households, having no earning family member, are classified as destitute, 14% as paupers, 38% as very poor, and 46% as poor. And one has to recognize that those rural and urban households above the poverty line are by no means rich. The majority of workers in the unorganized sector living above the poverty line are surviving on an annual household income of Rs.13,000 to Rs. 20,000 – and at any time, catastrophic spending can push them below the poverty line.[10]

India, the World, and the Differences

India of today fascinates the world and makes headlines every day. It is growing stronger internationally, but this is very deceptive, as India simultaneously occupies what are almost parallel universes – three or four different centuries in numerous

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[8]According to international statistics, over 300 million people in India live in extreme poverty on less than US$1 a day, and over 500 million on less than US$2 a day. Only half of the population has access to piped water, and most health services (in fact about 92%) are paid for out of pocket, making India's health system the biggest private health service in the world.

[9]Rs. 1300 cash income per month for the average family of five persons equals about US$26 per month. In terms of purchasing power parity (PPP), this US$26 equals about US$156 a month for a family of five in the USA or about €106 for a family of five in the euro zone, the PPP conversion factor between US and India being 6. In some international publications, the PPP conversion factor between the USA and India is between 4 and 6, depending on the formula being used and data availability and reliability in averaging prices from all over India, with its huge differences.

[10]Vivid details about this issue and living conditions can be found in the article of Ghanshyam Shah, "Poverty Alleviation Programs in India," in *Contemporary India – Transitions,* ed. Peter Ronald de Souza (New Delhi: Sage, 2000), 150-172.

stages of development.[11] For decades it was believed that industrialization, modernization, and development would come about through investing in state-owned heavy industries and by isolating the Indian market through protective measures; India today is clearly moving away from the earlier model of import-substitution towards deregulation and export-promotion, swiftly adding the manufacturing sector to the already famous service industry/information technology sector. The messages in all these trends and developments seem to be clear: the frontiers of the public sector will recede, the private sector will become the engine of economic growth,[12] and the question will arise whether the welfare state will continue to be the guiding model or whether "social security" and "social safety nets" will be left to the private sector and the few (approx. 27 million or 7% of the total workforce) organized sector workers, who enjoy the benefits of secure jobs, price-adjusted salaries, sufficient and reliable access to multiple social security instruments, and protection under the law against loss or stoppage of income on account of illness, disability, maternity, old age, or death.[13]

Whereas in industrialized countries the controversy over how growth and the welfare state relate has intensified over the last two decades, the question is just emerging in India. Many economists, also in India, argue that globalization is making the welfare state unaffordable, citing conflicting goals of social justice and economic efficiency. On the other hand, one sees a worldwide trend of disintegrating traditional informal systems of social safety nets (families, social relations), so that the need for reliable and accessible social security systems is becoming even greater.

The debates on these subjects are often not well grounded in empirical evidence and tend to mute the historically crucial role of coherent social welfare policies in boosting growth by:

- compensating for negative effects of private sector developments (liquidation of companies, downsizing, exploitation of workers, etc.);

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[11]The Department for International Development (UK) published its strategic development program with India under the title "Ending Poverty in India: Consultation on DFID's Plan for Working with Three Indias." The three Indias are global India, developing India, and the poorest India.

[12]The issues of democracy, a free market system, and globalization are debated in the article of S.S. Bhandare, "Economic Progress: Industrialization, and Globalization," in *Contemporary India – Transitions,* ed. Peter Ronald de Souza (New Delhi: Sage, 2000), 75-107.

[13]D. Rajasekhar, "Social Security in India," (paper presented to the International Conference on Social Security Systems in Developing and Newly Industrializing Countries, Germany, September 18-19, 2007). Mimeo: ISEC Centre for Decentralization and Development, Bangalore, 2007.

- cushioning structural changes when whole sectors disappear from a country's economy;
- promoting human capital accumulation, the true essence of growth; andsharing and covering risks, thus enabling individuals and groups to turn to otherwise "risky" opportunities. [14]

In India today, one needs a strong orientation and a good compass in order not to go astray in the diversity and complexity of the simultaneously existing, distinctly different realities. For the author of this article, the Prime Minister of India, Dr. Manmohan Singh, provided the compass in his inspiring inauguration address to the National Rural Health Mission (NRHM, 2005-2012) on April 12, 2005. He emphasized the social reform agenda by stressing the point that India has "devised a system that fragments resources" – a situation that has to be overcome.

Taking a closer look into the realities of fragmentation (numerous programs of different ministries at the union and state levels – literally hundreds of programs in the realm of social security or the social safety net in general), one realizes that in each of these numerous fragments only a fraction can and do benefit, only a fraction is aware of these programs, and only a fraction finally has access to these programs, and this again differs from region to region, from pocket to pocket.

An indicative, very detailed analysis was provided by a survey of 1356 sample households in the states of Orissa, Madhya Pradesh, and Karnataka, on the outreach and effectiveness of various safety net programs. The survey demonstrated a variance in program access by intended beneficiaries (targeted families) between 10% and 70%.[15]

A further illustration of the often very limited coverage is given by D. Rajasekhar in this publication, citing the case of the national old age pension scheme implemented in the state of Karnataka, which has a population of about 53 million. The amount of old age pension, which was only very recently adjusted from Rs. 75 per month to Rs. 200 per month,[16] was originally made available to about 800,000 persons in the year 1996-1997. It declined steeply thereafter. The reason for this decline was that financial constraints[17] compelled the state

[14]See Michael von Hauff, "Growing Safely," *D+C Development and Cooperation* (November 2006): 408-410, for a more detailed discussion.

[15]S. Mahendra Dev, K. Subbarao, S. Galab, and C. Ravi, "Safety Net Programs: Outreach and Effectiveness," *Economic and Political Weekly* (September 1, 2007): 3555-3566.

[16]One has to imagine what Rs. 200 per month will pay for in a couple of years even under a modest inflation rate of around 5% to 8% a year.

[17]In budget debates around the world, these are generally given as "neutral" facts, rather than admitting that priorities for spending lie elsewhere.

government to tighten the eligibility criteria by restricting old age pensions to only the destitute (see above) among BPL households and thus excluding a large number of unorganized workers living in vulnerable conditions.

This anecdotal evidence and citations from empirical studies are glimpses that allow one to more easily follow the more abstract, generalized discussion of social security issues in India below, in which inequality, denial of access, severe problems of service delivery, and high delivery costs as well as highly fragmented social security systems are discussed.

Key Areas of Social Security in India – The Context

Social security systems are a critical part of the public policy of any country and its development agenda. Policies are crucially linked with the country's economic growth and human development. It is not just the "welfarism" of a nation being displayed by its social security system; it is also a performance and governance index of the state as a whole and of its mechanisms and ability to delivery well-being to the poor, the marginalized, and the vulnerable.

The Indian Minister of Finance P. Chidambaran recently "admitted that the performance of the United Progressive Alliance government was below expectation on two fronts. One was its inability thus far in pushing ahead with further reforms in financial services, especially in banking, pension, and insurance. The other was the failure to improve the delivery mechanism for the social security programs. [...] for the setback in social security programs, he blamed the rigidity of the bureaucracy, which still remained a hurdle in achieving inclusive growth."[18]

Furthermore, observers of contemporary Indian polity attribute the continued deterioration of India's public sector – yet to be an important and reliable deliverer of social assistance and social security programs – "to the failure of accountability mechanisms in current governance structures. [...] In a country such as India, where the poor rely on the state for basic survival and protection, the consequences of weak accountability are particularly debilitating. In the absence of accountability mechanisms, the poor are unable to interact, influence, or exercise enforceability upon the state (outside of electoral politics). Thus when government teachers and doctors do not come to work or when social security schemes do not cover intended beneficiaries, the poor have no recourse."[19]

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[18] Ashok Dasgupta, "Chidambaran Regrets Delay in Reforms," *The Hindu,* December 3, 2007, 1.

[19] Yamini Aiya, "Salimar Samji: Improving the effectiveness of National Rural Employment Guarantee Act," *Economic and Political Weekly* (January 28, 2006): 320.

International bodies such as the International Labor Organization (ILO), the World Health Organization (WHO), and the United Nations Children's Fund (UNICEF) have, time and again, emphasized the significance of social security. The Global Social Summit held in Copenhagen in 1995 also placed social policy at the center of the development debate and called for the formulation and strengthening of national policies and strategies to reduce inequalities and eradicate absolute poverty. However, there seems to be a risk of an international race to the bottom, as labor markets become excessively deregulated (although not yet in India) and social systems are trimmed down worldwide.[20] In such a situation, it is extremely difficult to establish a convincing, meaningful, and trustworthy dialogue on social security[21] or concepts of the welfare state between developed and developing countries, because of the entirely different stages they are in.

Nonetheless, social security arrangements have a comparatively long history in India. From early on, India extended social protection measures to workers in the organized sector,[22] which is about 7% of the total workforce. For workers in the unorganized sector and other poorer sections of population, the emphasis was on promotional measures through special programs and later on through social assistance programs.

Social security is a relatively neglected area in terms of both research and policy in India. For two to three decades after independence, there was hardly any discussion in this area in the Indian five-year plan documents, until the Ninth Plan. They were silent on social security planning and did not even take cognizance of the prevailing schemes.[23] The turn around, or so it was believed, came with the 1991 economic reforms. They were regarded as a watershed, since these reforms paved the way for a beginning of debate, formulation, and visioning of viable social security programs in India. Sad to say, they are still based largely on social assistance rather then contributory programs, with the effect that the beneficiaries feel and are seen as petitioners rather than rightful claimants to whom the state, the public service utilities, or the village *panchayat* (village institution) must deliver.

[20]See von Hauff, "Growing Safely."

[21]Or on emission reduction or energy conservation or ecological development, to add to the list.

[22]Shortly after independence, almost 90% of industries were state owned (public service utilities), emulating the USSR model.

[23]Varma, "Social Security for Unorganized Sector," 6.

With decreasing productivity in agriculture and depleting livelihood options, the fact that increasing migration[24] is serving as a social security buffer for millions of families and leading to increasing inequalities as well as the deprivation of different factions in society – encompassing millions – and the issues surrounding social security programs and their administration have of late come to center-stage in India. This occurred especially in the wake of the labor market trends resulting from the neo-liberal economic reforms. India at present is witnessing tough debates on deregulation of the labor market, further economic liberalization, and strengthening of social security programs. This debate suffers from the fact that it is segregating the interlinked problems associated with responsibility, accountability, coverage, delivery, legality, affordability, and sustainability of these programs – in the absence of any compulsory, uniform identification card in the country or a uniform social security number. All agencies roll out their very own peculiar and particular program and means of verification or registration of individuals.

The debate in India is heated, rightly so, but also extremely fragmented, and the core issues of any comprehensive discussion about social security or the establishment of a social (and ecological) economy seem to be understood only in a few academic pockets. The main shortcoming is still the predominant influence of the "welfare state" concept, by which the state, the benevolent patron, grants social assistance to its clients. Given the fragmentation and the societal factions on top, the typical problems of "defunct" social security systems prevail:

- corruption in complex programs resulting in payment for access or entitlements;
- "creaming of the poor" – excluding beneficiaries, combined with low credibility of programs or "service providers";
- poor transparency, little "marketing" effort, and resulting high information deficits;
- exclusion of rural areas because of their poor accessibility (difficult road connectivity as well as low penetration of monetary systems and few "pay points");

[24]India is now the largest recipient of remittances in the world, according to the World Bank. With US$25.7 billion in remittances from workers overseas in 2006, the annual inflow of remittances from the Indian diaspora is equivalent to about five times India's annual expenditure on education and is roughly equal to total revenues from income and wealth taxes. On the macroeconomic level, remittances lend crucial support to the current account. At 3% of GDP in 2006, they offset much of India's large and rising trade deficit. For many Indians, remittances are the only way out of extreme poverty. And in some states in the south, Kerala, for example, the remittance economy contributes to the economic success stories.

- in general, high transaction costs in reaching the poor;
- overambitious, too finely developed targeting of the beneficiary population resulting in exclusion;
- unsustainable calculation and projections of programs;
- low impact of programs on effective poverty reduction.[25]

These issues should be regarded as the cornerstones of an international dialogue, as different countries worldwide at various historical moments found different solutions to overcome these hurdles.[26] There has never been a blueprint solution anywhere. It was and is experimenting, adjusting, and piloting that works in a given context, borrowing from elsewhere or inventing a fresh approach – provided vision and strategy are in place.

How the System Has Been Structured so Far – A Glimpse and an Overview of the Institutions

In the Indian context, various authorities define the concept of social security differently and hence there is no commonly accepted definition of the term. Recently some new concepts such as safety nets, social protection, and social funds have emerged. Broadly speaking, all these concepts are part of the all-pervasive term social security, which comprises mainly two elements: security related to jobs or work in general and income security.[27] In view of this, a broad concept of social security in India includes: the sum of all government regulations and provisions that aim at enhancing the people's living conditions, including legislation/acts/laws, regulation, and planning in the fields of old age, wage, unemployment, and social exclusion, sickness and health care, and also income security measures such as food security, employment, education and health, housing, social insurance, and social assistance.

The Indian social security system is very complex in terms of its evolution, expansion, administration, and coverage – from several million under the old age

[25]See the interesting examples given in Lutz Leisering, Petra Buhr, and Ute Traiser-Diop, "Soziale Grundsicherung in der Weltgesellschaft," (Bielefeld, 2007, transcript).

[26]One could raise an interesting issue in a dialogue between India and Germany on the degree of centralization and decentralization of programs. The trend in the debate in India on the issue of social health insurance is moving in the direction of a centralized system, whereas in Germany at the beginning of the twentieth century social health insurance was provided through almost 11,000 different service providers – the consolidation and concentration process to about 600 providers happened much later.

[27]Government of India, Planning Commission, "Working Group Paper on Social Security," New Delhi, 2007.

pension scheme for destitute BPL families (see above) to the minuscule coverage under the Universal Health Insurance Scheme. Despite the literally hundreds of programs for social protection of the underprivileged, the social security situation in India is characterized by lack of policy.[28] Until the1960s, granting social welfare was the cornerstone of social policy in India, with some concrete provision of security for workers in the formal sector. It was followed by a series of social assistance programs, which continued later complementary to wide-ranging social-sector development programs.[29]

At present, India has not only social security laws, but also a number of social assistance, welfare, and social sector development programs and schemes. At one level, there are protective social security schemes, which address contingent poverty or employment-related poverty, and, at another level, there are promotional social security schemes, which address immediate economic needs of the population. The majority of promotional social security schemes are social assistance programs. Cash, subsidy, and in kind are prominent modes of assistance. Promotional measures include financing and provision of education, health, nutrition, employment, etc, whereas protective measures comprise pension and provident funds, maternity benefits, sickness allowance, employees' state insurance, etc. Protective measures are largely available for central and state government employees and for the minuscule organized workforce in India in general.[30]

The other feature of social security programs in India is that a large number of programs and schemes are cross sectoral in design, involving various ministries, boards, and departments. The number and diversity of such schemes[31] and initiatives are mind-boggling and have grown significantly, with the state governments also paralleling their own programs with the centrally sponsored schemes funded from the union budget. While there is somewhat of a social security framework in place for the organized sector, there has been a serious gap in social security policy for the unorganized sector (see above). Summarizing the situation, one can say that out of 399 million workers in 1999-2000, it is estimated that 371.2 million (nearly 93% of

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[28]Further details can be found in the article by Varma, "Social Security for Unorganized Sector."

[29]Typically, in India integrated rural development programs were also regarded as contributions to social security.

[30]The coverage figures (up to 98% of the unorganized workers are *not* covered) are explored and covered in detail in the account by Sakthivel and Joddar, "Unorganized Sector Workforce in India."

[31]Add to that the complex application forms (numerous copies) to be filled in (pages and pages of details to finally avail of Rs. 200 monthly), a process that siphons off a considerable amount of money for the illiterate poor who have to pay for the service of getting the forms filled in.

the entire work force) were employed in the unorganized sector, as compared to only 27.8 million (7%) in the organized sector.[32]

In general it is possible to structure and cluster the social security programs in India into four categories:[33]

- contributory social security schemes;
- welfare schemes;
- social assistance;
- promotional social security.

Contributory schemes are generally statutory, administered by the governments (except insurance schemes). These schemes cover accident insurance, medical facilities, old age pension, gratuity, provident fund, maternity benefits, income security, and unemployment allowance. Many of these are operated by boards at the state level. The government of Karnataka, for example, has set up more than twenty welfare boards for the benefits of agriculture workers, cashew workers, coir workers, handloom workers, construction workers, fishermen, motor transport workers, etc. Not surprisingly, the neighboring state of Kerala, with a similar multiplicity of boards, has even established an apex body to coordinate, regulate, streamline, monitor, and control activities under the many schemes of the different boards.[34]

Still, part of the contributory schemes were and are subsidized insurance schemes of earlier governments, for example, Landless Agriculture Laborer Group Insurance, Group Insurance for the Beneficiaries of IRDP (integrated rural development programs), Personal Accident Social Security for Poor Families, Rural Group Insurance, Group Insurance for Weaker Sections, Railway Passengers Insurance Scheme, etc.

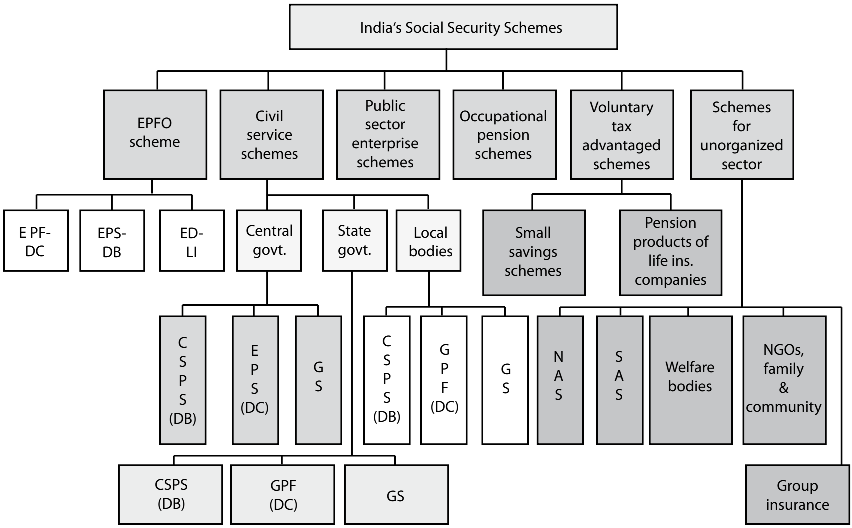
Under the *welfare* schemes, the central government imposes a cess on employers for workers engaged in, for example, lime-stone, dolomite, iron ore, manganese, chrome, and mica mines, the beedi (local cigarettes) industry, and

[32] Sakthivel and Joddar, "Unorganised Sector Workforce in India."

[33] See also R.S. Tiwari, "Existing Schemes of Social Security for Workers in Unorganised Sector," (paper presented at the Seminar on Social Security for Workers in the Unorganized Sector, Shri Ram Centre for Industrial Relations and Human Resources, New Delhi, November 25-26, 2004) and Rajasekhar , "Social Security in India."

[34] The question "who controls the controller" is a serious, not a sarcastic, question and must be discussed in earnest. This is a vital institutional issue in a country where the concept or idea of self-regulatory mechanisms is probably still inconceivable, as almost everything is controlled by "Inspector Raj" – this, indeed, a sarcastic term for the prevailing accepted state control mechanisms rooted in old British arrangements.

the film making and theater industry, serving definite and distinct geographic pockets of the country and its population and entailing the major problem of identifying the beneficiaries and issuing separate identity cards.



Legend: CSPS – Civil Service Pension Scheme; EPFO – Employment Provident Fund Organizations; EPS – Employees Pension Schemes; DB – Direct Benefit; DC –Direct Contribution; EDLI – Employees Deposit Linked Insurance; GS – Gratuity Schemes; GPF – Gratuity Provident Fund; NAS –National Assistance Schemes; SAS – State Assistance Schemes

The *social assistance* programs (protective measures) are, in part, centrally sponsored schemes like the National Social Assistance Program (NSAP)[35] with its three components of an old age pension scheme,[36] national family benefit scheme,[37] and national maternity benefit scheme.[38]

Finally, *promotional* social security led to nationwide programs such as the public distribution system, the Integrated Child Development Program (ICDS), the Mid-

[35]The NASP came into effect on August 15, 1995.

[36]Coverage of 7.28 million beneficiaries (2005) – benefits: Rs. 200 per month after the age of 65 for destitute BPL individuals having little or no regular source of income or support through family members.

[37]Coverage of 2.11 million beneficiaries (2005) – benefits: Rs. 10,000 in case of accidental and natural deaths.

[38]Coverage of 1.15 million beneficiaries (2005) – benefits: Rs. 500 given 8-12 weeks prior to delivery.

Day Meal Program in primary schools, the Supplementary Nutrition Programs, the Rural Employment Programs (*Sampoorna Grameen Rozgar Yojana*, SGRY), and the most recent innovation of the National Rural Wage Employment Guarantee Act 2005 (NREGA), which aims to provide 100 days per year of guaranteed employment (unskilled manual work) to one person of each rural household in India, with the panchayati raj institutions (PRI, village level institutions, last tier of government) as the key implementing body – about 3.2 million men and women are now formally part of the government all over India.[39]

Are Conclusions Premature – Where is the Trend Going?

Over the last few decades, India has witnessed a shift in the social security discourse. The policy debate seems to be moving from the welfare notion towards social security and, furthermore, to its closer link with economic growth and an improved labor market. However, two major issues remain unresolved and partly undisputed as the enormous pressure to come forward with reforms brings about yet more schemes, tied together to win additional voters. The two major issues relate to (a) funding of social security measures and (b) the availability or rather unavailability of reliable data.

The debate about funding mechanisms covers a wide range and touches on issues such as:

- imposing a special cess of 1 to 3% on the income of the top 12% of households;
- specified central-government taxes setting aside 1% of GDP[40] as the initial amount for the proposed National Workers Welfare Fund;
- pooled social security trust funds;
- individually owned and managed social security funds in the name of a worker (IRA system - individual retirement account).

This debate is so far (not only in India) inconclusive and, in practical terms (apart from the booming life insurance business, called "life" in India), the majority of schemes rely on state grants, in other words, social assistance or charity with very questionable sustainability.

Part of the debate is going in the direction suggested by Uday Kumar Varma, the Director of the V.V. Giri National Labor Institute (NOIDA). He points out that at least three pillars must be systematically employed for social security

[39]Result of the 73rd amendment to the constitution in 1993.

[40]This would amount to Rs. 11,000 crore or approximately €1.1 billon.

schemes: "(1) a comprehensive package of social assistance and welfare financed by the exchequer and wholly based on tax revenue for the poor,[41] (2) a means-tested contributory scheme of social insurance[42] financed by a cess for selected occupations for people belonging to lower-income strata, but not below the poverty line, and (3) market-oriented voluntary schemes to be managed by private players for those who can afford to pay."[43]

It is, however, very difficult at this moment to forecast in which direction the debate may go. The approach paper to the 11th Five-Year Plan has missed the opportunity to go beyond "inclusive growth" – the common term of today's discussion – and subsequently no chapter on social security was inserted into this important document of the Government of India. The outcome of the five special commissions established as working groups of the Planning Commission to develop chapters (directives and plan figures) of the 11th Five-Year Plan related to social security remains to be seen. Their results are yet to come. The high-ranking and high-powered commissions have been established to help draft the 11th Five-Year Plan, which is supposed to be out with a delay of about a year in early 2008 (instead of April 2007, the beginning of the planning period of the 11th Plan and the beginning of the Indian fiscal year):

- the Steering Committee on Social Welfare and other Special Groups;
- the Working Group on Health Care Financing including Health Insurance for the 11th Five-Year Plan;
- the Working Group on Social Security;
- the Working Group on Social Protection Policy – National Social Assistance Program (NSAP) and associated programs for the 11th Five-Year Plan;
- the Steering Committee for Strengthening Monitoring and Evaluation System for the Social Sector Development Schemes in the Country during the 11th Five-Year Plan.

It cannot be expected that these committees, accountable to distinctly diverse institutions, boards, and ministries, at both the union and state levels, will provide the much needed comprehensive picture. It seems far too early to expect a concise debate on social security, as even more fundamental issues are still dominant – the decision

[41]A uniform, universal social assistance approach that can be combined with a means-tested social assistance approach targeting people who are most vulnerable, having little or no income.

[42]Contributory social insurance approaches financed through earmarked payroll taxes or contributions – the social security benefits being proportionate to the contributions, that is, the wages – a severe problem when it comes to informal enterprises with the problems of identifying, registering, and taxing "their" workers (day laborers); for a mote detailed discussion see Mridula Ghai of the Employees' Provident Fund Organization, India and her contribution, "The Coverage Gap," *op.cit*.

[43]Varma, "Social Security for Unorganized Sector."

between a socialist or capitalist approach to the economy, as the Indian Ambassador to Germany, Meera Shankar, recently framed it.[44] The fragmentation of subjects, governance, interest, portfolios, budgets, and implementation responsibilities is still too strong to allow for a more focused and coordinated approach that could bring together the vital components of any strategic sustainable development perspective: the interlinkage and interlocking of economic policies, social policies, and environmental policies – issues which were and partly are dominant features in the debate in Europe.

What is probably hindering a more inclusive debate is, indeed, a very common feature hitherto in India: the lack of involvement (participation through hearings, for example) of the people in designing the packages of the diverse schemes. The professionals and actuaries of the insurance business and social welfare boards will have to go out to meet with the people, as their living situations, demands, needs, and willingness to pay[45] fundamentally differ in India from the world of the administrators.

For the Indo-German technical cooperation programs and the German ministries, we do see a role in this field, if India wishes to engage in an even deeper dialogue concerning issues such: starting from the local level, keeping schemes diversified, maintaining multiplicity, coping with local risks, speaking with the people, and responding to their needs. These methods should take center stage. One would then probably encounter quite a few surprises in openly discussing management of mandatory or voluntary schemes when it comes to coverage and delivery, performance and governance, and matching the actual living situations.

Secondly, a wide variety of new delivery mechanisms with innovative and revolutionary approaches, including public-private partnerships, must be developed: use of digital devices, smart cards, the comparatively inexpensive RFID[46] technology, mobile telephones for payments and claims, internet hubs in villageinternet kiosks, the *eChoupals*[47] or the innovative employment of

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[44]"Welcome Speech by H.E. Meera Shankar, Indian Ambassador," in *International Dialogue, Social Security: Summary Report* (Berlin: InWEnt and BMZ, 2007), 11.

[45]A concept developed and tested by D. Rajasekhar and the ISEC team. See his contribution in this reader about social security in Karnataka and Indo-German technical cooperation through GTZ and the Department of Labor, Karnataka.

[46]Radio-frequency identification, a tag system being widely used today even for money transfers, bank operations, fee and tax payments, etc. – very innovative usages are under way in Asia, for example, South Korea, Malaysia, Singapore.

[47]And people are increasingly demanding their constitutional rights when it comes to social security. A strong movement of 500 civil society organizations under the umbrella of the consortium *Social Security Now* www.socialsecuritynow.org is demanding that the Government of India earmark at least 5% of GDP for the social security needs of unorganized workers.

dabbawallahs[48] and postmen in delivering bank services to the doorstep with hand-held devices. Given the dimensions of India,[49] one must anticipate various technology "revolutions" – skipping development stages experienced elsewhere and jumping to new dimensions, also in the most remote rural areas, as the success stories of contract farming for high-value products and the marketing via Internet kiosks in villages clearly demonstrate.

And if the Indo-German technical cooperation program[50] on Social Security Benefits for Unorganized Workers, Karnataka (21 million in the state) succeeds, it will do so because of the priority set to establish modern and advanced workers' facilitation centers at the village and community levels. Their ultimate goals are to bring awareness to all, to set up exhibits on transparency and accountability, and to create demand from below based on the understanding of what is out there in the market and available from the government through easily accessible instruments. Only such experiences could stimulate the debate about the seemingly inconceivable: universal social security for all.

The Bread and Butter Approach – First Things First

In the last decade, the country has witnessed important assessments of social security needs that led to the introduction of:

- new, additional social security schemes;
- implementation of innovative methods of effective identification and enrollment of beneficiaries;
- contemplation of comprehensive legislation; and
- development of a more effective framework to ensure social security of unorganized sector workers.

These debates have shifted the paradigm of the conventional development discourse. The government and its agencies have come forward acknowledging that the existing legal and protective frames are inadequate. In view of the growing

[48]Dabbawallah is an institution in Mumbai: the men who ferry hot lunches to office workers across the city. They and vegetable street vendors and postmen are now being commissioned as correspondents by the Corporation Bank, the Union Bank of India, and others, with the approval of the Reserve Bank of India (RBI). The novel idea was for a consortium of banks to set up the Financial Operation Network and Operations Ltd (FINO) in 2006 to find technological solutions that would help the spread of banking to the rural areas. Gargi Banerjee, "Dabbawallahs , Postmen Helping Banks Extend Access to Services," LiveMint.com – The Wall Street Journal, Mumbai, December 3, 2007.

[49]...and also China.

[50]Committed by the German Federal Ministry for Economic Cooperation and Development (BMZ) end of 2006 and about to commence in early 2008.

fiscal deficit scenario, they also bemoan that it is extremely difficult to sustain even the existing social security provisions. This has initiated debates among economists, social development experts, and politicians especially concerned with adverse labor market implications in the current phase of globalization.

The present phase of the debate on social security for unorganized sector workers mainly focuses on labor market transformations, which include:

- shrinking employment in the organized sector and unprecedented growth of the unorganized sector;
- deterioration in the quality of employment in terms of job security and terms and conditions of work;
- weakening of collective bargaining institutions and workers' organizations; and
- a marked decline in social security while prices of common goods and services are rising.

In September 2004, the Government of India constituted the National Commission for Enterprises in the Unorganized Sector (NCEUS). The commission submitted its report along with a draft bill, called the Unorganized Sector Workers Social Security Bill, in May 2006. The recommendations of the commission have generated many debates on the draft bill since then:

- It recommends covering all unorganized sector workers as well as those in the organized sector having no social security cover.
- It stipulates the monthly income limit for qualifying as an organized worker at Rs. 6500 per month.
- It foresees 300 million workers to be covered in five years.
- It asks for health insurance cover for hospitalization of up to Rs. 15,000, maternity benefits of up to Rs. 1000 per delivery, disability allowance of up to 15 days at Rs. 50 a day, life insurance at Rs. 15,000, and accidental death cover at Rs. 25,000.
- It would introduce old age security for all workers above 60 belonging to BPL households at Rs. 200 per month as pension.
- It would introduce a contributory provident fund with a contribution of Rs. 1 per day for 365 days per year by workers, employers, and government.
- In view of the difficulties in identifying employers among the informal enterprises, it suggests the government also pay employers' contribution, meaning Rs. 730 per year in the ratio of 3:1 by central and state governments.
- It suggests the contribution of the BPL workers be paid by the central government.
- As a means of financing, it foresees levying a cess or social security tax with additional commitments by central government departments.

- The management is to be given to a national social security board at the central level to handle a national social security fund; state level boards to manage state social security funds.
- Workers' facilitation centers are to be established at the local level for registration.
- Contributions are to be collected and the bookkeeping done through the universal post offices of the Department of Posts.

Some have hailed the recommendations described as the first ever comprehensive social security scheme for the unorganized sector in India. They believe that this proposal will develop a healthy workforce, which, in turn, will have a positive impact on national income and economic growth. They also believe that the recommendations have a "rights-based perspective" as the NCEUS report envisages the scheme in the form of legally enforceable entitlements, unlike the many schemes floated by the central and state governments in the past.

There are still discussions going on indicating some of the shortcomings of the proposal and suggestions for further refinement of the proposed plan of action:

- actual need to focus first on promotional security measures rather than rushing into protective measures;
- impracticability of the recommended contributory model;
- meagerness of the benefits envisaged;
- exclusion of some vital segments such as unpaid women workers.

Recently, in September 2007, the Unorganized Sector Workers Social Security Bill was introduced in the *Rajya Sabha* (upper house) by the Minister of State for Labor and Employment. If enacted, it would provide legislative backing to all social security schemes.

Prior to parliamentary debate of the bill, three schemes[51] (out of the eleven to be introduced once the bill is enacted) were announced by the Prime Minister on August 2007 and launched on October 2, 2007[52] and November 17, 2007:

1) The Health Insurance Scheme for BPL workers will cover 60 million families progressively in the next 5 years. Ultimately, more than 300 million workers will benefit. A provision has been made for issuing a smart card, carrying a unique identification number, to each of these families. Both public and private health facilities will be utilized to provide medical services and there

[51]See the press release of the Ministry of Labor and Employment, September 10, 2007, Press Information Bureau, www.pib.nic.in.

[52]M.K. Gandhi's birthday in 1869.

would be cashless transactions to ensure that there is no harassment of the beneficiaries. Each family would be entitled to health care worth Rs. 30,000 per annum.[53] Under the scheme, expenditures of about Rs. 700 crore (about €140 million) are estimated during the first year.

2) The existing National Old Age Pension Scheme will be extended to all persons below the poverty line above the age of 65. A pension of Rs. 200 per month will be provided and states will be requested to add another Rs. 200 to this scheme.[54] An amount of more than Rs. 4000 crore (about €800 million) per annum will be spent under the scheme, administered by the Ministry of Rural Development.
3) Under the Common Man Insurance Scheme (*Aaam Admi Bima Yojana*), all the rural landless households in the country will be provided life and disability insurance cover. This cover will be for Rs. 75,000[55] upon death and permanent disability due to accident. In case of partial disability due to accident, the insurance cover would be Rs. 37,500. The premium to be charged under the scheme will be Rs. 200 per annum per member. Fifty per cent will be contributed by the central government and the remaining by the state governments. The finance minister has already committed Rs. 1000 crore (about €200 million) for this scheme in the 2007-08 budget.

As the mechanism must be implemented through the states, it is hoped that some states go ahead and start piloting measures to test practicability. Karnataka will likely be among them, joining hands with the Indo-German technical cooperation program. This would be rather important "as the central government has been passing the various welfare fund acts from as early as 1976, but only a handful of state governments have actually brought these acts to the ground level in their states. [...] The point therefore is that no matter what legislations are passed, unless there is a sincere effort on the part of the state governments, there are bound to be endless delays".[56] Here, the dialogue that started between the Department of Labor, Karnataka, and German institutions in Berlin in January 2007 might be supportive.[57]

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[53] About €550 per annum for the average family of five.

[54] Eventually a monthly pension of about €7.

[55] About €1360.

[56] D. Rajasekhar and J. Y. Suchitra, "India. Showing the Way Forward: India's Redistribution Experience in Extending Social Protection to all," (ILO, Plan, Care, New Delhi, 2006).

[57] *International Dialogue, Social Security: Summary Report* (Berlin: InWEnt and BMZ, 2007).

Part 4

Practitioners' Perspectives

"Learning Does Not Mean Copying" – Supporting Macroeconomic Reforms in Vietnam

Nguyen Thanh Hai and Ulrike Maenner

Introduction: Vietnam, a Transition and a Developing Country

Since the introduction of the *doi moi* (renovation) policy 20 years ago, Vietnam has been both a developing and a transition country. Gross domestic product (GDP) has quadrupled, and poverty has been greatly reduced from 58% (1993) to less than 20% of the population.[1] Vietnam's growth path has thus been viewed as strongly pro-poor (Klump 2007). Vietnam wants to achieve middle income country status by 2010. Having been transformed from a socialist country to a "socialist market economy," the structure of the economy has changed in favor of the private sector, but the share of the state sector is still high, as the following table shows:

Table 1: Structure of the Vietnamese Economy

Sector	Thousand billion VND	Share of GDP (%)
State sector	415	36
Cooperative sector	70	7
Private sector	453	40
FDI sector	197	17
Total GDP	1,138	100

Source: General Statistics Office (GSO), estimates for 2007.

[1] This is on the basis of the international poverty line. Based on preliminary GSO data; estimates for 2006 are unofficial. See World Bank 2008 on social security.

The core of the transition process is the so-called equitization (part privatization, whereby government and employees still keep an important share of the total assets). A large number of companies have been equitized, but only very few large ones. Only 17% of the total capital of state-owned enterprises (SOEs) was equitized from 1992 to 2006. In important sectors of the economy, for example, telecommunications, railways, oil, energy, steel, coal, cement, banking, and insurance, etc., SOEs still play a dominant role. After accession to the World Trade Organization (WTO), the government aimed to equitize the 100 biggest joint stock companies by 2010. However, the start of this ambitious process in 2007 was slow (only two large companies in 2007). As a result, major trading partners like the European Union, the United States of America, and thus the WTO have not yet approved the status of a market economy for Vietnam. Also, there are delays in implementation of a legal environment in conformity with a market economy, there is no independent judiciary, and the administrative structure has not been fundamentally reformed either.

An important component of a modern society is the establishment of a social protection system. So far, only a pension system (not yet covering the total population) and a health insurance scheme exist. However, important risks are not yet covered, namely, disability, unemployment, and basic welfare for the poorest.

Global climate change and the rapid growth process have created severe environmental problems. The number of floods, strong storms (typhoons), and droughts, as well as water and air pollution are fast increasing, while shortages of energy will soon become a serious problem for the industrialization process. According to a study by the World Bank, Vietnam will be the one of the countries in Asia most affected by a rising sea level (Dasgupta et al. 2007, 27). Awareness among politicians and in academia is increasing, but no strategy exists yet for designing environmentally compatible economic policies. The transition process in Vietnam towards a market economy with a social and ecological face will still take a number of years.

German Technical Cooperation in the Vietnamese Reform Context

Over ten years ago, in the context of Vietnamese-German development cooperation, the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH provided information to interested Vietnamese academics on the model of the social market economy and supported an initial debate on the significance of the model.[2] Vietnam has developed its own model of the socialist market economy (Dinh Van An 2003), reflecting the fact that both socialist and market economy elements are supposed to comprise the foundation of Vietnam's development path.

However, with the accession of Vietnam to the WTO and even before, globalization has been challenging the traditional socialist role of the state vis-à-vis the private sector and other parts of society. Keeping extensive control over private sector activity seems to be no longer feasible, particularly in the government's planning process. Maintaining large shares in economic sectors and companies and subsidizing them, for example, via credits extended by state-owned banks, may guarantee a certain degree of state control over economic activity, but creates inefficiencies, drains scarce public resources, and is not compatible with WTO regulations. Social and environmental challenges also require state action in new areas. It is in this very fundamental context of seeking an appropriate model for Vietnam that the German model has recently regained significance for the work of the GTZ in the area of economic policy, because the German model represents a flexible framework that promotes an active role of the state and a balance between economic, social, and ecological goals.[3]

Technical cooperation in the area of economic policy started already in the first half of the 1990s and is still ongoing. German development cooperation has accompanied the transformation process through GTZ, specifically in helping to modernize the role of the state in line with the requirements of a market economy. A number of projects were set up in the early 1990s, during the transformation process, helping to reshape state functions in conformity with the requirements of a market economy. The selection of the areas of assistance was, to a certain extent, guided by the policy fields of the social market economy,[4] which together form the regulatory and organizational framework necessary in a social market economy:

1) planning and coordination;
2) property regime;
3) monetary order;
4) enterprise order;
5) competitive order;
6) fiscal order; and
7) social order.

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[2] Environmental goals were not felt to be significant at the time and did not formally enter the German model.

[3] See Benecke in this reader.

[4] See Benecke , Section VI: Shaping the Social and Ecological Market Economy, in this reader.

Although some of the projects never got off the ground or came to a quick end, an attempt was made cover most areas except for the competitive order and the social order, because it was too early for these areas at the time. Long-term assistance was directed towards the monetary order, planning and coordination, the enterprise order, and the fiscal order. From this starting point, the cooperation has evolved, although its main characteristics have remained: provision of long-term advisory services through practitioners from the respective German public administration or occasionally also from other countries, in order to provide state-of-the-art expertise. This profile is quite different from that of most other donors who came to Vietnam much later: they are often involved on a much shorter-term basis and do not deal with state economic reform in such a comprehensive manner, incorporating the most important actors and institutions in Vietnam.

At present, the support is combined in a single Macroeconomic Reform Program[5] and one project supporting the State Audit Office, thus covering planning and coordination; monetary order and financial systems development; the fiscal order; and, to a lesser extent, the enterprise order. The focus has moved from establishing basic state functions and the respective regulatory environment in line with the requirements of a market economy (for example, the role of the State Bank of Vietnam, which is Vietnam's central bank, vis-à-vis the banking sector was defined) to modernizing state functions in accordance with international standards and strengthening core functions (for example, banking supervision or government audits), while further reducing direct state control over private sector activities, as required by WTO rules.

The following sections of this article will describe the main thrust of the support to macroeconomic reforms provided through GTZ in the areas of planning and coordination, financial systems, and public finance, while pointing out the underlying principles guiding our work.

Planning and Coordination

The planning system in Vietnam reflects the transformation towards a market economy. The role of the state in the socialist-oriented market economy has been described as follows: "To move from command planning and subsidy-based centralized bureaucratic management to the system of market economy with socialist orientations, with the state assuming the new role of initiating, facilitating, guiding, and regulating the economy in an appropriate manner, mainly by economic means, while bringing into full play various forces of the market and overcoming its weaknesses" (Dinh Van An 2003, 5).

[5] www.macroreforms.org

Five-year plans are highly significant for policy making in Vietnam; they are ratified by both the party plenary and the National Assembly. They contain the main strategic orientations, including changes in the regulatory framework, for a period of five years, after which a new five-year plan is drawn up. The plan thus represents a fairly rigid framework. Five-year plans are broken down into annual plans and investment budgets. It is the function of the Ministry of Planning and Investment or the respective departments on the lower level to elaborate the plans, monitor their implementation, and decide upon investment projects and official development assistance projects. Five-year plans and annual plans can be found on all levels of government, namely, central, provincial, district, and municipal.

While the five-year plan of the central government is a strategic document, other planning documents are of lesser quality. Annual plans focus very much on fulfilling targets in the economic sphere by means of public investment (including investment in state-owned enterprises), and very little on strategies and policies. This approach is particularly problematic for "planning" in the private sector, as it calls for state interference in private economic activities, outside of the state's functions as regulator, provider of incentives for private activity, and provider of public goods. Although the socialist-oriented market economy calls for reduced state activity and a state that sets the framework and provides incentives, the actual planning framework and the way it is executed and monitored produces a tendency to keep public ownership of enterprises at a high level, particularly in the so-called strategic sectors, namely, telecommunications, railways, oil, energy, steel, coal and banking, in order to give the state the control and leverage to fulfill the targets. In addition, data for realistic targets and for monitoring them is not always available or of adequate quality, particularly on lower government levels. As a result, the quality of the exercise is often debatable.

The government and the party still view planning as necessary for Vietnam. In order to address the problems, the Ministry of Planning and Investment (MPI) intends to draft a law on planning or, if this is not possible, a regulation that would bring the planning system closer into line with the requirements of an open and quickly developing economy for a more modern system of addressing social problems. The reform, therefore, aims to reduce the complexity of the planning process by granting more authority to the provinces and local levels; reduce the rigidity of the planning process; and ensure that actual planning is focused on strategic issues. The elements of the reform include:

- redefining the role of the MPI and the Departments of Planning and Investment at the provincial, district, and municipal levels to that of drawing up strategies;
- adopting a flexible, multi-annual rolling plan framework;

- linking planning, especially medium-term fiscal planning, more closely with budgeting;
- including more participatory elements to involve the private sector and civil society;
- reducing the number of sectors in which government needs to be involved;
- defining a larger role for the private sector (public-private partnerships and build-operate-transfer models for various sectors);
- defining a new format for results-based monitoring;
- improving the statistical data base for monitoring; and
- reinforcing the capacity and the mandate for strategic planning at the provincial level and especially at the district and local levels.

The support by the Macroeconomic Reform Program is mainly directed at:
- supporting the partner's own analysis of the shortcomings of the system;
- providing information on the global debate surrounding the role of the state in planning and policy coordination vis-à-vis the private sector and civil society;
- building capacity in macroeconomic analysis and forecasting with the aim of linking planning with forecasting and improving macroeconomic management;
- fostering public and academic debate on the socio-economic situation; and
- commenting on the partner's reform concept on the basis of German and international expertise.

The German transformation process was a rapid exercise; in most areas, the approach of western Germany was simply transferred to the former socialist east. This had a number of advantages, specifically fostering efficiency in the markets, but also had very high social costs in terms of unemployment. However, the transformation process proceeded quickly and without political unrest, this being a strength of the German model, both in the east and the west. These results were achieved without a planning system for overall socio-economic development like that in Vietnam, albeit not without planning in specific areas, for example, regional planning, infrastructure planning, and sectoral planning. While Germany has no equivalent to the Vietnamese planning system, support of planning system reform in Vietnam via the Macroeconomic Reform Program draws on certain elements of the German political system closely linked to the model of the social and ecological market economy, for example, subsidiarity[6] and participation through political dialogue and partnership between the state, the private sector, and civil society organizations.

The rather gradual transformation process that Vietnam has been undergoing requires that the roles of actors in the economy and the society be constantly redefined. The model of the social and ecological market economy contains certain elements that are relevant for this process, particularly the shared responsibility between state, the private sector, and civil society and the mechanisms of dialogue that are an important element of the political culture and institutions in Germany. While this contrasts with the present political culture and system in Vietnam, it provides a perspective for further reform. The principles and elements of the model are used as an input into the advisory process, but not as a blueprint for Vietnam's further reform path. Information is also provided on the transformation process in Germany, which can point to successful avenues of transformation and pitfalls that should be avoided. This was the understanding expressed when Deputy Minister for Planning and Investment Cao Viet Sinh stated that: "learning does not mean copying."

Germany is a country with strong coordination mechanisms, particularly in the sphere of macroeconomic management. This is a result of the belief shared by most citizens that macroeconomic stability is absolutely necessary for the welfare of society. Stability has thus been a top priority of German policymakers and has been based on very powerful institutions, for example, the German Bundesbank, one of the most independent central banks in the world. The law on stability and growth, passed in the late 1960s, sets out what constitutes stability and how the government and other relevant institutions must achieve macroeconomic stability. Low inflation rates were more important to the Bundesbank than high growth rates, an approach quite different from other industrialized countries and one that has been repeatedly criticized by some German academics.[7] This same emphasis, however, has found its way into European Central Bank policy.

Strengthening institutions responsible for macroeconomic management and stability has been at the core of German technical assistance support, implemented by GTZ since the early 1990s and directed at the main players, the Ministry of Finance and the State Bank of Vietnam. The next sections describe financial systems reform and the approach to building the fiscal order in Vietnam.

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[6] As Benecke states in his article in this reader: "Subsidiarity means in general that the higher level entity only becomes active when the lower level entity cannot solve a problem. In the social market economy, it means that the state only gets involved if individual efforts and community solidarity cannot solve an individual or social problem."

[7] See Hein and Truger in this reader.

Financial Systems Reform as an Important Element of the Transition Process

The financial system in Vietnam has developed rapidly during the last 10 years: Monetization[8] increased from 23% in 1997 to 110 % in 2007, representing a significant financial deepening. Market capitalization[9] jumped from 0.5% in 2000 to 45% in 2007. Institutional development in terms of the regulatory and organizational framework (especially financial market supervision), as well as equitization, have not kept pace, albeit to varying degrees in the different market segments. This institutional deficiency represents a major risk for the stability of the financial sector and the economy as a whole.

Banking Sector Reforms

The first important reform step was taken in 1991 when the two-tier banking system (de-linking the role of the central bank from the role of commercial bank) was established: The State Bank of Vietnam took over the role of central bank and five state-owned commercial banks were established. To date, 36 private joint-stock banks have been set up, some very small.

German development cooperation in the banking sector started in 1993 when GTZ supported the State Bank of Vietnam (SBV) in establishing and using modern monetary policy and foreign exchange management instruments, thus building the monetary order. The support was provided by international and German experts, many from the German Bundesbank. The impact of the application of these instruments by the SBV was significant: inflation, which was 70% per annum in 1994, was reduced (to less than 9% in 2005, although it has increased again since then). The banking association was also founded with GTZ support. Thus, while supporting the establishment of the monetary order, the project took up two themes incorporated in the model of the social market economy: macroeconomic stability as a precondition for citizen welfare and creation of a representative structure for commercial banks, as the foundation for dialogue between the state and the private sector.

In other areas, reform was slow until 2005, despite continued support by German development cooperation.[10] Amendments to the two main laws governing the banking sector, namely, the SBV Law and the Law on Credit Institutions, in 1997 and 2002, did not represent a major step forward towards a modern regulatory framework for the banking sector (which requires an independent central bank).

[8]Measured by the ratio of M2 to GDP.

[9]Measured by the ratio of all shares officially listed on the capital market to GDP.

[10]...and other development partners who came later.

The SBV continues to function like a ministry, with the governor of the SBV as a member of the cabinet. According to the constitution, the National Assembly decides on monetary goals, and the SBV implements the decisions taken by parliament and the government. Branches exist in most of the over 60 provinces and are heavily influenced by the provincial people's councils (elected bodies at the provincial and municipal levels) with respect to personnel and credit policy. Banking supervision is carried out by several overlapping departments within the SBV and by provincial branches,[11] and basically continues to function as part of state inspection (like all ministries) on the basis of the Inspection Law. Modern risk-based techniques are not applied in banking supervision, in contradiction to the Basel recommendations, which constitute the international standard.

In addition, state-owned commercial banks continue to maintain a high share in the market (63% of the credit market and 69% of the deposits market), while private joint stock banks (with 21% of the credit market and 22% of the deposits market), foreign banks (with 8% and 7%, respectively) and people's credit funds (a cooperative banking system serving mainly rural areas and holding only 1% in both markets)[12] still have a much smaller share, even if taken together. Only after WTO accession did the pace of equitization (part privatization) accelerate. Plans for 2007-2008 are ambitious and include all five state-owned banks. The start has been slow, however,[13] and will be limited to 51% of total assets of these banks.

The year of WTO accession, 2006, also marked a change with respect to regulatory reform in the banking sector. The revisions of the SBV Law and the Law on Credit Institutions planned to bring the regulatory framework in line with market development and WTO accession requirements and would, if carried out consistently and not diluted, bring the reform standstill of almost 10 years to an end. The core of the reforms contains three elements:

1) a more independent modern central bank,[14] with a clear mandate for monetary policy and with only a few regional offices under the roof of the SBV, concentrated at locations with a strong banking presence;
2) effective banking supervision in line with international standards through creation of a general directorate under the roof of the SBV, with

[11]At present the supervision division is organized under the director of the SBV branch office.

[12]Figures are from the 2006 *Annual Report* of the State Bank of Vietnam.

[13]In 2007, only the largest bank, the Vietcombank, was able to carry out a first initial public offering, with only 6.5% of its total assets; equitization of other banks has been postponed.

[14]Independence potentially means operational, institutional, and financial independence and independence in personnel policy and human resource development.

representation in regional offices and a direct reporting line to the general directorate – a structure which would apply modern risk-based supervision techniques; and

3) a regulatory framework for modern corporate governance in the banking sector, in the revision of the Law on Credit Institutions.

The debate on an adequate framework for financial sector supervision has advanced further. It has become obvious that all segments of the financial sector, namely, the capital market, banking sector, and insurance companies, are strongly interlinked.[15] Therefore, there is agreement within the government that Vietnam should aim for an all-finance supervision model in the medium term. For the short term, the establishment of a national all-finance supervisory committee is planned as an umbrella organization for the different supervisory authorities in order to coordinate their activities.

In spite of good intentions and respective decisions both by the party (in 2005) and the prime minister (in 2006), there may be substantial resistance against core elements of the regulatory reform planned for 2008: independence of the SBV from the government may be opposed from within the SBV, which fears to lose influence in the government if it is no longer represented there; a clear mandate for monetary policy conflicts with the constitution and it may be difficult for the National Assembly to accept delegation of power to the SBV; and creation of regional offices directly under the SBV may be resisted by provincial authorities who stand to lose power over financial operations. While aspirations are high, there is the danger that the reform standstill in the banking sector may not be over yet.

Regulatory reform of the banking sector has been supported by GTZ for a long time through numerous expert missions, a number of study tours, and provision of training and advisory services to the highest level of Vietnam's decision makers. Many elements of the framework broadly outlined above can be attributed to this advisory work. However, the decision to upgrade the framework to meet international standards and agreed best practices can only be taken by Vietnamese decision makers themselves.

In the last five years, the Vietnamese banking sector has not only grown tremendously, but it has also become more diversified in terms of products. These developments are creating new challenges for financial sector stability. Dealing with financial risks in the banking sector has become more important than before. The GTZ-supported program has therefore not only focused on

[15] The capital market and the insurance companies are under the jurisdiction of the Ministry of Finance.

banking supervision, but also on the establishment of instruments for banks to deal with risks, namely, internal audit and internal control (for a number of years now) as well as risk management (more recently); these instruments complement modern banking supervision from the commercial banking side. The support has been provided on two levels simultaneously: (1) working with SBV in creating the necessary regulations and (2) working with pilot commercial banks to show what implementation of the regulations can look like in practice. This approach has been successful: the regulations for internal audit and internal control have been in place since 2006 and are now being implemented by the commercial banks. For risk management in banks, regulations exist in draft form.

Vietnam has become fairly open to financial inflows and outflows. With large inflows not only of foreign direct investment but also of foreign indirect investment, it has become increasingly difficult if not impossible for the SBV to sterilize (absorb) these inflows, while maintaining the existing exchange rate regime (constant slow depreciation against the US dollar). This development creates new challenges for monetary and macroeconomic stability, specifically with respect to inflation,[16] and requires a review of monetary policy operations and the exchange rate regime, as well as an examination of means to better control capital inflows and outflows. Therefore, monetary and exchange rate policies have regained importance within the program supported by GTZ, and adjustment of the monetary order to open-economy requirements in order to maintain macroeconomic stability remains a significant theme.

Institution Building for the Capital Market

To ensure long-term mobilization of capital for investment, the Government of Vietnam has established the State Security Commission (SSC), now the supervisory structure under the Ministry of Finance. Since the establishment of the first securities trading center in Ho Chi Minh City in 2000, market development has been rapid, although daily trading volume is still small (between US$70 and 140 million), compared to other countries in the region. Since 2006, a securities law has regulated trading of listed companies (250), but trading of shares of non-listed joint stock companies (around 1200) has not yet been regulated. The bond market is still underdeveloped (around 5% of GDP), especially corporate bonds, which comprise only 15% of the total bond market. It is further restricted by the policy of the Ministry of Finance to define upper ceilings for interest rates, although inflation has been on the increase in recent

[16] A development which had been predicted by the key financial sector adviser of the project.

years. At present, capital market supervision through the SSC is not in a position to prevent insider trading, as staffing levels are extremely low and transparency regarding market developments is inadequate.

GTZ has supported the establishment and development of the capital market since 1997 through advisory work on the regulatory framework and training of the executive staff of the SSC. Support for institutional development will continue in the future (development of the bond market, creation of an independent depot and clearing center; and the transfer of securities trading settlements from a state-owned bank to the SBV). This work is directed at a modern institutional environment for the capital market, thus contributing to financial sector and macroeconomic stability, a recurring theme as pointed out in previous sections.

Institution Building for the Cooperative Sector of the People's Credit Funds

A main source of finance for people in rural areas (still around 75% of the population in Vietnam) is the People's Credit Fund (PCF) system, which goes back to the credit cooperative system of the planned economy. The system underwent major crises and changes, first during the high inflation years and later during the Asian financial crisis, which revealed the weaknesses and risks in the system. A large number of funds had to be closed down, causing unrest in the population and forcing authorities to put the system on a sounder footing. The PCF association, which was set up in 2005 and today has almost 1000 members, is about to establish an institutional basis to better deal with risks and ensure stability, namely, a safety fund (which will get initial funding from the government) and a system of internal and external audits to better detect risks.

A major part of these features can be traced back to the advisory support of GTZ. Germany has an existing cooperative structure in the banking sector (seen by many as part of the institutional structure of the German social market economy), which has helped recruit expert practitioners from among its member institutions to advise the Vietnamese PCF association since 1999. Present support focuses on setting up the audit system in combination with the future establishment of the safety fund, thus contributing to stability in a segment of the financial sector that is highly significant for poorer parts of the population.

Public Finance Reforms

In 1993, when GTZ began supporting budget reform, there was no fiscal order, that is, no legal framework for public finance and no government audit function. Creating this order for budget planning, budget execution, including the treasury function, and external audit was the focus of technical cooperation advisory services on preparation and implementation of the first State Budget Law in 1996 and its revision in 2002. In 2005, a separate project began providing advisory services on the legal framework of the highest audit institution of Vietnam, the State Audit Office of Vietnam (SAV).

The State Budget Law of 1996 defined, for the first time, the structure of the budget, the process of planning and executing the budget, and the roles of all branches and all levels of the state, including:

- the role of the National Assembly and the people's councils in the planning, approval, and oversight of the budget;
- the execution of the budget on all levels;
- the establishment of a treasury office; and responsibilities of budget offices, treasury offices, and spending units.

In terms of content, three themes linked to the German model[17] (but of course also found in other countries) found their way into the legal framework:

- macroeconomic stability through the introduction of certain budgetary rules;
- subsidiarity through strengthening of the local level and decentralization; and
- accountability and transparency.

Following the theme of macroeconomic stability, the State Budget Law stipulates that the budget must be balanced according to the principles that expenditures plus debt service may not exceed revenues and a deficit is only allowed to finance investment and will be strictly monitored. The State Budget Law also limits the budget deficit, including debt repayments, to 5% of GDP. To achieve this, basic principles of modern budgeting were introduced, such as annuality (one budget for one year), anteriority (the budget is passed before the beginning of the budget year), and completeness (all expenditures are covered in one budget [only partially achieved until now]). There were incentives for local levels to keep certain revenues and manage their budget proactively. The accounting functions of the state budget were improved step by step. The introduction of a treasury system for cash and liquidity management in 1996 completely eliminated the previous problems with illiquidity of spending units. The budget was publicized for the first time in 1997, making it more transparent to the citizens.

[17] See the section on Planning and Coordination in this article.

The revisions of 2002 made further advances in key areas:

- The role of the National Assembly and the people's councils was significantly strengthened. Instead of the so-called standing committee of the National Assembly, it is now the National Assembly itself which passes the budget for the coming year, providing more accountability.
- Budgets on all levels must be publicized, and publication is monitored by the Ministry of Finance, resulting in more accountability and transparency than before.
- Budget decentralization advanced further, providing more budget autonomy to the local level in line with the principle of subsidiarity. Sub-national units are now responsible for a substantial share of overall public expenditures, particularly in health, education. and social spending.
- In stark contrast to earlier years, spending units have considerable freedom in budget execution and can shift expenditures between four broad categories of current spending.

German development cooperation implemented by GTZ has for a long time been the only development partner working on building the fiscal order. Advisory services, including orientation and practical inputs, were provided to accompany the process of drawing up the two budget laws and the regulations and guidelines to implement them. The achievements outlined above reflect the main elements of the assistance provided. To build capacity for implementation of the regulations, a substantial percentage of the staff of the budget office at the Ministry of Finance and of the National Assembly's budget committee participated in training on the application of the Budget Law. With support from GTZ, about 4000 participants were trained in various aspects of budget management between 1994 and 2005, and many study tours were carried out.

In 2005, a law on the State Audit Office of Vietnam (SAV) was passed in the National Assembly. This law is in line with international standards represented by the Lima Declaration of Supreme Audit Institutions (World Bank 2007), and provides the SAV with an independent status, as it now reports to the National Assembly. Again, GTZ provided the primary support for preparation of this law. In 2006, the SAV made public its annual audit report summary. Today, the accounts of all public entities, including state-owned enterprises, must be audited by the SAV, thus strengthening the financial accountability of government activity.

The commitment from the German side was much longer term and started much earlier than that of most other development partners in Vietnam. This allowed the Vietnamese and the Germans to build a trusting relationship and to maintain a dialogue on what constitutes a fiscal order in a market economy in general and also on the relevance of German experiences and institutional characteristics for the Vietnamese fiscal order. The budget and external audit reform process was accompanied by practitioners from the respective German institutions. The same advisors offered pragmatic advice over a number of years, staying with the process in order to ensure continuity. A former budget director characterized the German contribution as follows: "Multilateral institutions provide us with theoretical know-how, showing us where we should go in the longer term, but the approach is often very theoretical. The German assistance helps us to get from here to there."

The progress in establishing a modern fiscal order is reflected in the World Bank's 2007 *Vietnam – Country Financial Accountability Assessment*, which contains a thorough appraisal of the degree to which Vietnam's public finance system is in line with international best practices and standards. The document rates the fiduciary risk for budget aid[18] in Vietnam as moderate. Also, in terms of fiscal risk, the deficit as a percentage of GDP remains low in spite of massive investment in infrastructure development. According to the Economist Intelligence Unit, this ratio (excluding debt repayments) is estimated to be slightly below 2% for 2007 (Economist Intelligence Unit 2007, 15) – a fairly low ratio, which is, however, expected to increase with major increases in personnel expenditure.

The reform process is by no means complete. While in the past the focus was on establishing the basic features of the fiscal order, further steps are needed to ensure that international standards are established, for example, for budget classification, reporting, and management and for treasury functions, medium-term fiscal planning, and dealing with extra-budgetary funds. The State Budget Law will be revised again, most likely in 2009, and a law on treasury operations may be tabled to the National Assembly in 2012. Bringing the legal framework into line with international standards has been the focus of German technical cooperation since 2006 and will continue to be so. On the basis of the federal tradition of the German fiscal order, subsidiarity and decentralization will continue to be important themes, both in terms of finding a scheme for the highly complex system of aggregating the budget into one including all levels of the state and in terms of providing a better and more stable revenue base to the provinces, particularly poor provinces.

[18] "Fiduciary risk is defined as the risk that funds are not properly accounted for, are not used for the intended purposes, and do not represent value for money" (Welton 2005, 3). Thus, the level of fiduciary risk reflects the quality of the fiscal system.

Perspectives

Vietnam has been extremely successful in reducing poverty, largely as a result of its pro-poor growth policies, rather than of the social protection system. In line with the level of development of the country, the focus was initially on targeted poverty reduction programs and not so much on a formalized system of social security. In recent years, a health card for the poor was introduced, thus providing health insurance for large parts of the population. However, the social protection system is by no means complete. It still must be complemented by modern, affordable, and universal old age and unemployment insurance and by mechanisms for insuring citizens against other risks, increasingly also environmental risks, for example storms and flooding.

Thus, the transformation of social systems in Vietnam will continue to gain prominence as a major challenge for the country in the coming years. The experience of the German social system, which has undergone major changes during the last 15 years, in order to create more intergenerational justice with respect to old age pensions and to increase efficiency in the labor market through changes in unemployment insurance, may prove useful to Vietnam. A strategy paper by the German Federal Ministry for Economic Cooperation and Development lists social protection as one of the fields of cooperation on the basis of the model of the social and ecological market economy.

Environmental issues will also take center stage. Vietnam is an oil-producing country; revenues from oil exports represent a comparatively large share of the budget (about 25%). To make sure that these resources can be used for more than just one generation's needs, other revenue sources need to be found in order to change the revenue composition.[19] Furthermore, imminent domestic shortages of energy will be a major impediment to further industrialization and development. These energy shortages and the specter of global warming suggest that energy efficiency is one of the most important future themes for Vietnam. Pollution of the air and the water is also a significant and increasing problem in the cities and in industrial areas, creating serious health hazards for the people.

The ecological part of the German model is therefore becoming increasingly relevant for development cooperation in Vietnam in the area of economic policy issues Energy prices in Vietnam need to be increased further to provide an incentive for more energy efficiency in production regardless of the type of energy used. It is time to support Vietnam in designing environmentally compatible economic policies and developing the respective tools. It may soon be the moment to introduce an energy tax.

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[19] The Income Tax Law, which is expected to generate more direct tax revenue, was passed by the National Assembly in 2007.

At present, prices for gasoline in Vietnam are subsidized and thus do not reflect the true market value. The government has lowered the subsidies, with adverse effects on inflation, demonstrating that there is a trade-off and that no decision is without adverse effects. The macroeconomic implications of such decisions need to be thoroughly analyzed and evaluated. Recently, the National Assembly asked the Ministry of Finance to submit a proposal for a comprehensive tax approach to ecological problems. There are very few examples of such a comprehensive approach. The German ecological tax, which taxes energy and thus results in more energy efficiency, is one of the few successful schemes worldwide to achieve greater ecological sustainability by way of the tax system.

German development cooperation has already contributed to the reform process in Vietnam with a number of interventions based on the concept of a social market economy. In the future, the German model of the social and ecological market economy could therefore play a renewed role in German technical cooperation with Vietnam, including, as today in China,[20] the theme of the ecological compatibility of economic policies[21] and the establishment of some aspects of the social order.

[20] See Juergen Steiger on economic policy advising in China, in this reader.

[21] At present and until end 2008, the ecological tax is covered by a project supported by the European Union and advised by a team of German experts.

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Social and Ecological Market Economy in Advisory Services – Providing Economic Policy Advice to China

Jürgen Steiger

Introduction

For almost 30 years, the People's Republic of China has been undergoing a process of economic reform and opening. The introduction of a "socialist market economy with Chinese characteristics" in 1992/1993 signified the transformation from a planned economy to a market economic system, which was initially characterized by the dominance of public property and was several years later based on the coexistence of various forms of property. German development cooperation, through the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, has accompanied the Chinese reform and transformation process since 1987. The German model of the social market economy, the economic success of Germany after the Second World War, and especially the economic and political experiences of German reunification – these were the areas in which the Chinese were particularly interested and in which they requested advisory services in the early years of cooperation. In the last few years, however, the Chinese partners have also shown an increasing interest in the experience of implementing socio-political reforms in Germany and, above all, in implementing the foundations of sustainable development. Thus, the new model of social and ecological market economy underlying German development policies will play a leading role in the future design of economic policy advisory services provided to the People's Republic of China.

This article will begin by outlining the model, development, and implementation of the socialist market economy in China and by highlighting the challenges facing Chinese leaders today. It will then describe the changes which economic policy advisory services underwent in the past decades, and present concrete examples from the current portfolio of Sino-German technical cooperation in the area of economic and structural reform.

Model and Doctrine of the Socialist Market Economy in China

When Deng Xiaoping initiated the policies of reform and opening in 1978, the People's Republic of China crossed the threshold to an open-ended transformation process. At that time, however, the Chinese leadership was only certain that the Chinese planned economy should be carefully supplemented by a few market elements. But how that should be implemented remained unclear and subject to a trial-and-error process. Only in 1992 did the 14th Communist Party Congress define China's economic system as a "socialist market economy with Chinese characteristics." In the following years, market forces were to play a fundamental role under the macroeconomic guidance of the Chinese state. This economic system was initially characterized by the dominance of public property, several years later by the coexistence of various forms of property. Nevertheless, it was explicitly accepted that only part of the population could profit from the prosperity in the beginning.

It took almost another ten years until the model of the socialist market economy was gradually adapted and expanded to include social and ecological aims and principles. In 2002, the political leadership at the 16th National Party Congress of the Communist Party of China decided to establish a "moderately well-off society for all," assuming an equal distribution of wealth. In November 2003, the Politburo of the Communist Party endorsed the "scientific development concept," which sought qualitative growth as well as "comprehensive, coordinated, and sustainable development," and placed "people in the center." In September 2004, the Fourth Plenary Session of the 16th Central Committee of the Communist Party endorsed, for the first time, the concept of a "socialist harmonious society." This concept entails the improvement of the social situation in the rural areas under the slogan of the "new socialist rural development," the reduction of regional disparities between the wealthy east coast and the poor hinterland, the decrease of income disparities, the provision of better access to education, the establishment of a solid social and health care system, and the goal of harmony between people and nature. The Sixth Plenary Session of the 16th Central Committee passed a comprehensive catalogue listing 14 measures to achieve such a harmonious society.

Given that all these goals are to be achieved by 2020, they may be referred to as the Chinese "social and environmental agenda 2020." The current 11th Five-Year Plan for the years 2006 to 2010 incorporates all these concepts and adds the goal of building a "resource-conserving and environmentally friendly society" by 2010. The 17th Communist Party Congress in October 2007 not only underlined the above-mentioned goals of the 2020 agenda, but also elaborated its key points in greater detail. Viewing this concept in its entirety, the outline of a model very similar to the German social and ecological market economy can clearly be envisioned.

Reality of the Socialist Market Economy in the People's Republic of China

The reality of the socialist market economy diverges considerably from this model. If we examine China's recent development process, the economic system can best be described as a transformation economy with ideological restrictions: On the one hand, the political leadership made very pragmatic and often non-ideological decisions in the course of implementing the reforms. On the other hand, China undertook a gradual and rather experimental reform process, which can hardly be described as a coherent strategy. This approach, which Deng Xiaoping famously described as "groping for stones to cross the river," did not correspond to a search for optimal economic efficiency, but rather took into account political resistance at various government and party levels. China thus followed a two-track reform process, in which plan and market coordination coexisted side by side. Economic reforms were initiated at different times and with varying urgency depending on the sector and branches; when the central leadership met resistance, the reforms were put on hold up to the point where the reform deadlock became so unbearable that the central government was forced to take decisive action again. In this process, reform efforts were blocked time and again when they threatened to endanger the ideological foundation and thus the legitimacy of the Communist Party. This approach became apparent just recently with the reform of property rights, which, for ideological reasons, still do not allow private ownership of agricultural land. As a result, the Chinese leadership faces a fragmented economic system today, which does not lack complexity.

Although party and state undoubtedly dominate the political management process, these forces are decreasingly able to control the development of the society in all its aspects. In the increasingly materialistic and individualistic society of China, the Communist ideology is hardly attractive, especially among younger people. Unable to fill this growing ideological vacuum, the Communist Party desperately needs to sustain economic growth and the prospect of enjoying a more prosperous life than previous generations in order to preserve its legitimacy. At the same time, the interest of the population in religion and spiritual experience has recently been growing, particularly among the wealthier classes in China. At the administrative level, important responsibilities for steering economic policy were transferred to regional governments. Within this decentralized public sector of the economy, it is therefore difficult today for the central government to push through economic policy reform initiatives against opponents at the provincial and local level. Corruption and arbitrariness are widespread among officials, especially at the local level; this leads time and again to, at times violent, protests against local decision makers.

To manage economic and structural reforms in China is thus not without risk for the political leadership: They have to generate rapid economic growth while at the same time taking into account social demands and environmental costs. Their decisions need to be effective from the central government level down to the local level. If they do not succeed, there is the real danger that the potential for social conflict is no longer controllable, thus threatening the political stability of China.

Despite its economic success in the past, its high growth rates of 10% on average since 1978, and immense foreign exchange reserves of US$1.4 trillion, China continues to face enormous economic and social challenges. Even as the world's fourth-largest economic power, the People's Republic of China remains a developing country with an average annual per capita income of US$1740. Over 135 million people still live under the poverty line of US$1 per day. Central China, the northeast, and above all the 12 western provinces are developing very slowly, have low growth rates, and are losing their existing competitiveness potential and thus also their ties to the world market.

The regional disparities between the wealthy coastal provinces and the poor hinterland as well as between urban and rural areas are growing. At the same time, migrant workers coming from rural areas put increasing pressure on the urban centers and intensify social polarization there. China's ailing government enterprises have to increase their competitiveness, which often results in massive lay-offs. This, in turn, requires a basic social security system that cushions the unemployed and other losers to growth. The Gini coefficient, a measure for the equality or inequality of income distribution, is estimated to be at least 0.46, significantly higher than Germany's 0.27. The Chinese leadership has also recognized that energy consumption and the utilization of natural resources needs to be more efficiently organized and that climate change will entail high economic and social costs for China.

Thus, the Chinese leadership is confronted with a plethora of complex, urgent problems that must be resolved without delay. In order to deal with these challenges, they need access to scientific expertise, high-quality advisory services, and, above all, international exchange.

Changing Economic Policy Advisory Services

GTZ has accompanied the Chinese reform and transformation process since 1987. The initiation of cooperation in the area of economic policy was characterized by a high-level reform dialogue between the Chinese planning administration and German institutions such as the German Council of Economic Experts, the German Central Bank, line ministries, and economic research institutes. At a time when the Chinese economic system was still dominated by government planning elements, over 70 young managers in the Chinese planning administration were offered training in the theory and practice of the social market economy in Germany between 1988 und 1995. Since their return to China, the recipients of these fellowships have played a very important role in the establishment of market economy structures in China. The Chinese were particularly interested in the German model of the social market economy and the economic reconstruction of Germany after the Second World War.

In the transitional phase from the planned economy to the socialist market economy between 1993 and 2001, GTZ concentrated its advisory services on questions of transformation, sectoral policies, and the establishment of market institutions. In addition to the former government planning commission, the China Institute for Reform and Development (CIRD) in Haikou (Hainan) and the structural reform commission were included in the economic policy cooperation. Key topics covered in the advisory services, for example the reform of state enterprises, were guided by the German experience of economic transformation during reunification.

After China joined the World Trade Organization (WTO) in December 2001, the economic policy advisory services of GTZ focused primarily on the alignment of economic reform with WTO rules and principles and on China's accession to WTO membership. As part of German technical cooperation, the WTO Secretariat set up an official WTO Center at CIRD in Haikou, which concentrated, above all, on capacity development in WTO areas.

Beginning in 2003/2004, the cooperation was expanded to new partners, for example the economics office of the prime minister (State Research Office, SRO), and the previously rather isolated economic policy advisory projects were consolidated in a Sino-German Economic and Structural Reform Program, running from 2004 to 2007. This allowed for networking among the different Chinese partners and for a new flexibility that enabled quick responses to current advisory needs. The demand by the Chinese side for exchange among experts in this phase was directly related to the new goals, concepts, and themes of the Chinese government (well-being for all; scientific development concept;

harmonious society) and ultimately to substantive and strategic preparation of the 11th Five-Year Plan. However, the advisory services also addressed further development of market economy structures that were accompanied by the reorganization of the Chinese economic and planning administration.

In addition to socio-political topics, questions of sustainable development have recently been brought into the Chinese discussion process. Consultations with experts have touched upon the areas of environmental, resource, and energy economics, which are particularly relevant for the establishment of a resource-conserving and environmentally friendly society.

The changes in economic policy advisory services can also be observed in the adaptation of employed instruments: in the initial phases, as outlined above, various capacity building activities were at the center of cooperation. Today, the focus is primarily on high-level economic, social, and regional policy dialogues on an equal footing. By providing access to German and international expertise, GTZ assists the Chinese partners in solving complex problems. Today, capacity development is only offered to new partners. Current cooperation concentrates instead on guaranteeing the sustainability of previous measures for institutional reform and training, for example through follow-up programs.

With the new model of social and ecological market economy, German development cooperation offers a concept with very attractive principles, especially for economic policy reform advisory services: as mentioned above, the Chinese partners have shown particular interest in Germany's experience in establishing a social market economy after the Second World War and the process of transformation in the wake of German reunification. Today the economic power Germany is admired and respected in China for its relatively equal distribution of income, the great sensitivity of its people to environmental matters, and, more recently, for its pioneering role in climate issues. Its recent experiences with the implementation of economic and social structural reforms make Germany an interesting discussion partner for Chinese authorities. In the daily work of GTZ, Chinese partners often regard Germany as the ideal model for the envisaged Chinese harmonious society.

An essential prerequisite for the willingness to cooperate in the area of economic and social reform policies is the basis of trust that was created 20 years ago and was continually deepened. It has given Germany and German technical cooperation a unique position in economy policy advisory services.

The Sino-German Economic and Structural Reform Program

The Sino-German Economic and Structural Reform Program of technical cooperation in China, which was launched in 2004, has been continually developed, and runs until 2011, is building on 20 years of experience in the area of economic policy advising. It is a program at the macro level that aims at deepening the economic, social, and structural reforms in China. It is designed as a topic-oriented exchange on economic policies with various high-level partners in China, each of which has different mandates for reform. The partners include, among others, the State Council, represented by the State Research Office (SRO) with access to the prime minister, and the National Development and Reform Commission (NDRC), which is responsible for the implementation of development, reform, and adaptation strategies. The Office of the Leading Group for Financial and Economic Affairs (OLGFE) plays a special role since it reports directly to the president and party chairman. The independent China Institute for Reform and Development (CIRD) as well as other specialized and research institutes are also involved.

The program focuses its work mainly at the central government level. At the same time, case studies and regional analyses in selected pilot provinces, primarily in the western region and in central China, are also being prepared.

Key cooperation instruments, which are applied in a flexible way, include the implementation of high-level economic, social, and regional policy dialogues for the exchange of expertise with representatives of the German Government, the European Union, countries of other regions, and international organizations. In addition, consultations with experts, reports, position papers, and briefs on reform topics are offered as is the establishment and maintenance of networks with national and international economic and social research institutions. Capacity development measures are employed with new partners, but also instruments, methods, and processes of market-oriented analysis on macroeconomic and regional economic development.

The program, with its five components, is thematically, instrumentally, and institutionally connected: the guiding principle is the social and ecological market economy, which fits into the priority area of "sustainable economic development" as defined by the German Federal Ministry for Economic Cooperation and Development (BMZ). All individual interventions of the program deal with partial aspects of the social and ecological market economy and are in full compliance with China's reform strategies and initiatives. The program cooperates with the Chinese partners particularly with respect to the issues of structural change, sustainability, regional development, and social reforms. Issues of rural development are dealt with in all program components in a complementary manner so that concentrated experience can be offered to the Chinese counterparts and increased policy coherence can be achieved. The thematic corridors of the program are in line with the short- and long-term goals of the Chinese government set out in the 11th Five-Year Plan and the so-called social and environmental agenda 2020. At the same time, new development and reform topics are also addressed, such as economic aspects of climate change, development of rural distribution systems, technology and innovation policy, and relevant financial policy. Additional current topics include good governance at the local level and the inclusion of civil society in the Chinese development and reform process. These concern reforms with regard to the integration of disadvantaged social groups, such as poor people, labor migrants, minorities, and farmers.

The Sino-German Economic and Structural Reform Program plays a significant role in the implementation of the BMZ's anchor country concept. This concept supports the integration of key players in certain regions into global and regional governance structures, for example China in East Asia and India in South Asia: For several years, the program has been organizing dialogues between China and other anchor countries like India, Argentina, Brazil, and Mexico in order to start an exchange on social policy and sustainability. In Latin America, the program works closely with the Economic Commission for Latin American and the Caribbean (ECLAC) in Santiago, Chile. Building on the exchange between China and Vietnam on issues of economic transformation, economic policy dialogues have been initiated with Asian transformation countries of the Greater Mekong Subregion (GMS), the Central Asian Regional Economic Cooperation (CAREC) Program, the Association of Southeast Asian Nations (ASEAN), the East Asia Summit, and recently the Pan Beibu Gulf Economic Zone (South China Sea) in order to begin a regional integration process. Within this context, the program also addresses issues that are relevant to the solution of global issues such as the economic consequences of climate change and WTO-related topics, such as the advancement of the Doha Round.

In order to guarantee the desired scientific foundation of the cooperation, the Sino-German Economic and Structural Reform Program works closely with German and international institutions and economic research institutes and universities. There has been long-standing cooperation with the German Council of Economic Experts. German practical experience is brought in by the Federal Ministry of Economics and Technology, the Federal Ministry of Education and Research, and the Federal Ministry of Labor and Social Affairs, but also by state agencies, for example the Bavarian Ministry for Economy.

International cooperation is continually expanded. A positive example of cooperation is the regional policy dialogue with the Organization for Economic

Cooperation and Development (OECD) and the European Commission, which also includes the United Nations Industrial Development Organization (UNIDO). Traditionally, there has been an constant exchange of information and ideas with the World Bank, the Asian Development Bank (ADB), the United Nations Development Program (UNDP), and the WTO, and also with other EU member states and bilateral donors, for example Canada and Australia, whenever feasible, depending on the specific topics.

The Sino-German Economic and Structural Reform Program has exclusive access to influential decision-makers in China's economic policy. Regular discussion partners include Minister Wei Liqun from the economics office of Prime Minister Wen Jiabao, Vice Minister Liu He from the economics office of the President Hu Jintao, and the leadership of the influential NDRC, which draws up and implements the Five-Year Plan. This access to the highest political level provides GTZ with the potential to have a real impact on the formulation of market framework conditions in China, the design of sustainable reform strategies in economic, social, and regional issues, and the implementation of structural change processes.

Improving market framework conditions, liberalizing economic sectors, and opening up, for example, the service sector, also serve German interests. Of particular importance is ensuring China's compliance with international rules and norms, but also with the WTO principles set out in the Doha 2001 protocol. The protection of intellectual property rights and the reduction of protectionist measures should be mentioned in this regard. Ultimately, the program contributes to the promotion of China's regional and global responsibility, the search for viable solutions to environmental problems, and the preservation of social stability in China, and thus regional stability in East Asia.

Conclusion

The Sino-German Economic and Structural Reform Program supports Chinese partners in the development and implementation of economic, social, and structural policy concepts, policy recommendations, reform proposals, and strategies in the context of China's development strategy as defined in the 11th Five-Year Plan, the reform agenda 2020, and government reform initiatives. The overall goal is to design reform policies of the Chinese Government is such a way that they are guided by the basic principles of a sustainable social and ecological market economic system and increasingly rely on scientific foundations and international experience. The new guiding principle of a social and ecological market economy serves as a reference for the implementation of these goals.

Competition Policy in Southeast Asia and German Technical Cooperation

Frank Tibitanzl

This contribution will focus on competition policy as an element of economic policy advisory services. It comprises a short description of the importance of competition policy in developing and transition countries and its relevance for the social market economy (Section 1). After that, a case study (implementing the competition law in Indonesia) is presented in order to describe the GTZ approach to technical cooperation in this area (Section 2). The contribution will close with an outlook on the potential for additional German technical cooperation in the area of competition policy and related subjects in Southeast Asia (Section 3).

1. Competition Policy and its Relevance for the Model of the Social and Ecological Market Economy

Functioning competition is an essential prerequisite for growth and employment in a market economy. Competition promotes innovation, an efficient allocation of resources, and consumer sovereignty; it limits economic power and also produces positive social results. Competition in free and open markets makes markets work much better and is the basis of the social market economy.

However, private companies always have an incentive to maximize their profits by squeezing their competitors out of the market and increasing their market share and power. In a market economy, there is always the risk of concentration and monopolization, which often lead to inefficiencies (for example, high prices and low product quality). Furthermore, especially in developing countries, heavy state intervention in the market also hampers competition, for example, through privileged state enterprises with high levels of market power, protectionist measures (subsidies, etc.) to selected private enterprises (national champions), or long-term market entry barriers to protect new (foreign) investment.

Another threat to functioning competition are unfair business practices. In order to ensure fair competition, certain business activities (for example, misleading information to consumers, disparagement of competitors, psychological obligation to buy, etc.) are prohibited in many countries.

Competition policy is an element of economic policy.[1] Using a broad definition, it can be described as all rules and interventions that are designed to prevent all restraints on market competition that have negative impacts on economic welfare. Hence, competition policy comprises all activities of the government to ensure fair competition as a fundamental element of the social market economy. Coherent and consistent competition policy benefits consumers through wider choice and better product quality at a lower price, but also it helps promote innovation and entrepreneurship. In a globalized world with growing international trade and investment, competition policy becomes even more important. Anti-competitive behavior in a market of one country may cause negative effects on the markets of other countries through international trade and investment. In many countries, the legal framework for competition policy consists of unfair competition law (dealing with the unfair business practices mentioned above) and antitrust law (often called simply "competition law").

The protection of competition is regarded as one of the key regulatory policy objectives of the social market economy in Germany. One antitrust law is the Act against Restraints of Competition (ARC),[2] which came into effect in 1958 and assigns antitrust enforcement to the *Bundeskartellamt* (Federal Cartel Office) and to the *Landeskartellämter* (State Cartel Offices). The relevant areas regulated by the ARC are: (1) the ban on cartels, hence agreements between companies on prices and quantities are prohibited in principle; (2) prevention of the abuse of a dominant market position by single companies, for example, the fixing of extraordinarily high prices or unjustified limitations against competitors; (3) control of mergers in order to prevent an "unhealthy" concentration of market power in certain markets.

Another important act dealing with competition policy is the Law Against Unfair Competition,[3] which aims to protect competitors, consumers, and other market participants against unfair competition (excluding cartels and mergers, which are governed by the ARC), and to protect the interests of the general public in undistorted competition.

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[1]In Germany, competition policy is regarded as an essential part of the so-called *Ordnungspolitik,* which is a special German term signifying the need for the state to guarantee the legal framework of the economy (for example, property rights, enforcement of contracts) and for state intervention to avoid anti-social outcomes.

[2]Gesetz gegen Wettbewerbsbeschränkungen (GWB). The GWB was regarded by its founders as the "constitution of the social market economy."

[3]Gesetz gegen unlauteren Wettbewerb (UWG).

On the European Union (EU) level, competition policy was set out already in the Treaty of Rome (1957), which gave the EU wide-ranging powers to oversee and prevent activities that restrict competition between firms. The EU Commission (Directorate General for Competition) is empowered to investigate price fixing, the abuse of market power, and agreements that fix market share, limit production, or prevent technical development. Furthermore, the EU is allowed to intervene against governments who attempt to provide state aid to uncompetitive companies. If several EU member states are affected by a competition case, the European Commission will be responsible, whereas the national cartel offices focus on the investigation of cases with merely national scope. Another example are mergers that extend beyond the national borders of a member state. These are investigated at the European level.

In the development policy context, a sound and effective competition policy (antitrust policy) is highly important for economies in transition to a market economy, where the role of the state has to be redefined. In the early 1990s, many Eastern European countries and countries of the former Soviet Union privatized their state-owned companies very quickly, assuming that competition would develop automatically if former state-owned companies were privately owned. However, in many of these countries, this strategy failed as the privatization process did not lead to more efficient economic structures, but often resulted in private monopolies with few incentives to improve their services or decrease prices. The lessons learnt here are that a privatization strategy always has to be accompanied by improvements in the institutional framework that make it conducive to competition. Hence, powerful competition policy together with market regulation (in case of natural monopolies like electricity, railways, telecommunications) are needed to really encourage functioning competition.

In developing countries, competition policy has to ultimately address the needs of consumers. This is because poverty reduction is the major objective on the development agenda (Millennium Development Goal 1). Thus, competition policy has to show clear evidence that it can contribute not only to economic development but also to poverty reduction. Developing countries increasingly recognize the importance of competition policy. At the beginning of 1990, there were only about 30 countries that had introduced a competition law, while currently the number exceeds 100.

GTZ has been engaged in technical cooperation in the area of competition policy for many years in countries like Albania, Croatia, and Morocco. A prominent example of this engagement is its long-term cooperation with the Government of Indonesia, helping it set up and implement the competition law (or antitrust law) which will be described in the next section.

2. The Reform of Competition Policy in Indonesia

During the last decades of the twentieth century, the Indonesian economy was dominated by highly concentrated industries, large state-owned sectors, and inefficient firms operating behind various kinds of barriers to entry. Due to very strong ties between business and the political elite, a few huge conglomerates controlled a large market share in several sectors, creating disadvantages for other enterprises that did not have the same opportunities and for consumers, who paid high prices but often got low product quality. The development of private business during that period was characterized by all kinds of inefficient government policies that caused market distortions. This kind of crony capitalism and lack of competition had its origin in the interest of the Indonesian Government during that time to maintain political control over the business sector and was also regarded as one of the factors facilitating the Asian Financial Crisis in 1997. Dismantling restrictions on competition was, therefore, an important condition of the support provided by international institutions to overcome the crisis. The new government under Jusuf Habibie (President of Indonesia from 1998 – 1999) realized that Indonesia urgently needed a competition law and a strong implementing agency to systematically deal with unfair business competition; it asked the German Government to provide technical assistance through GTZ.

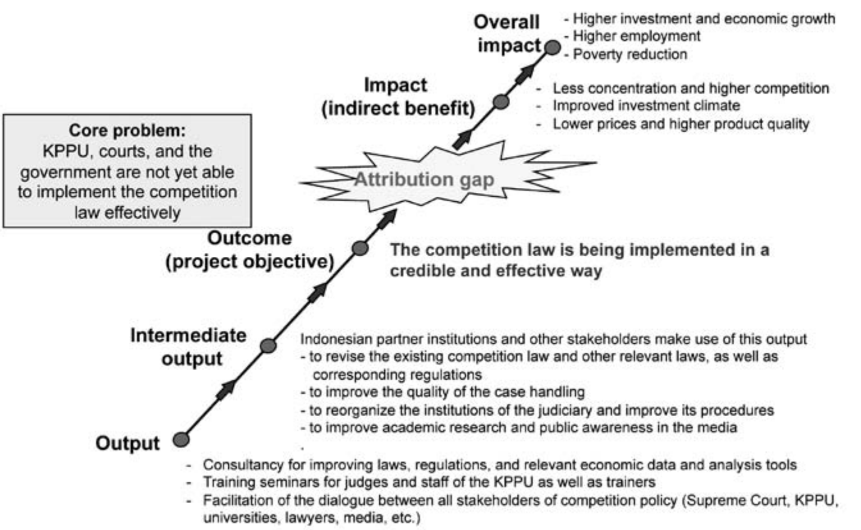
The cooperation started in 1998 with a high-level dialogue, facilitated by GTZ, between representatives of the Indonesian government and parliament and Prof. Wolfgang Kartte (a former president of the Bundeskartellamt) and his team. The talks led to a common understanding about the philosophy and principles of the new competition law: It was agreed that under the new competition law all national and international enterprises should be treated equally; hence, no discrimination against single enterprises or groups of enterprises would be allowed. It was also agreed that the Indonesian competition law would be drafted according to a Model Law for Competition provided by UNCTAD[4] to make sure that widely accepted international standards were met. Many developing countries, including Indonesia, are members of UNCTAD.

The German team's contribution was to provide comments on the draft law written by Indonesian experts. The Indonesian Competition Law was finally introduced in March 1999 and incorporates three key principles of competition policy that are part of German Competition Law, as well: (1) the existence of market power is not a violation of the competition law, but its abuse is; (2) the

[4]United Nations Conference on Trade and Development.

creation of an independent competition authority (KPPU[5]) enforcing the law; and (3) no discrimination against any enterprises or persons is allowed.

In June 1999, a GTZ-supported project was launched to intensify the cooperation, focusing mostly on capacity development in order to establish the new KPPU as quickly as possible. The main activities were: (1) drafting a legal commentary on the new competition law (in Indonesian as well as in English), (2) training KPPU staff (in Jakarta as well as at the Bundeskartellamt in Germany), and (3) consultancy services for KPPU staff to help them handle their first cases. Furthermore, training for members of civil society (entrepreneurs, lawyers, NGOs, etc.) on the legal framework of a market economy in general was provided. During that period, considerable technical assistance was also provided by other development partners, especially the World Bank, JICA/JFTC,[6] US FTC,[7] ELIPS/USAID,[8] and the EU.



Results Chain of the GTZ-Supported Project "Implementation of Competition Law" (2005-2009)

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[5]Komisi Pengawas Persaingan Usaha.

[6]Japan International Cooperation Agency/Japan Fair Trade Commission.

[7]US Fair Trade Commission.

[8]Economics Law, Institutional, and Professional Strengthening/United States Agency for International Development.

Despite this initial success, it became clear that to effectively implement competition law the assistance could not be restricted to KPPU, but had to involve the courts in charge of dealing with competition cases. Therefore, the Governments of Indonesia and Germany agreed to continue their development cooperation in the field of competition policy. In December 2005, the Government of Indonesia and GTZ began a new project to assist in implementing the existing competition law credibly and effectively (project objective) for five years. The following results chain describes the output and impact of the project.

The new GTZ-supported project has two Indonesian partner institutions: in addition to KPPU, the Indonesian Supreme Court *(Mahkamah Agung)* also joined the project. Furthermore, the project cooperates with selected district courts responsible for competition cases. The activities also address lawyers, representatives of the police, the public prosecutor, and law faculties at universities. Civil society is targeted through public hearings and intensified public relations work.

Support from the Bundeskartellamt has been continued during implementation. In addition, cooperation between the *Bundesgerichtshof* (BGH – German Federal Court of Justice) and the Indonesian Supreme Court has been started. In May 2007, the presidents of both institutions signed an agreement at the BGH in Karlsruhe (Germany) to intensify their cooperation.

Other partners of the GTZ-supported project are the Friedrich Naumann Foundation (FNS) and the German Academic Exchange Service (DAAD). There is also close coordination and cooperation with other development partners, for example with UNCTAD and the Asian Competition Forum (ACF).

Until now, long-term German development cooperation (together with the support of other development partners who joined at a later stage) was highly effective and had great impact: During the first years of implementation, a competition law was endorsed and the KPPU was established as an independent authority for implementing this law. Whereas in many other developing countries, the commission authority (if there is any) is more or less a toothless tiger, the rulings of the new KPPU became, after initial reputation problems, more and more accepted by the responsible ministries and courts. Since its establishment, the KPPU has identified or received over 300 cases and has ruled on 33. The first rulings, which were not accepted by the corporations and were therefore appealed to the Supreme Court, were all refused by the Supreme Court, often due to procedural violations. However, the KPPU and the Supreme Court have improved their ability to handle the competition law, and today the Supreme Court now affirms more than 75% of the KPPU rulings. Better enforcement of the law has already helped improve business competition in shipping and airline services, benefiting the public with cheaper fares. The decisions and recommendations of KPPU have also had an impact on consumer prices (reduction of prices for flight tickets) through increasing competition (rising number of airlines).

For the success of German technical cooperation in the area of competition policy, several factors are highly important:

- **High-level dialogue** in the beginning to create a common understanding about the principles of competition policy. Here an explicit link to elements of the model of the social and ecological market economy was made and accepted by the Government of Indonesia. This high-level dialogue has continued throughout the project implementation and is now being continued by Prof. Bornkamm, the leading judge of the Cartel Senate of the BGH.
- **Long-term technical cooperation mobilizing all relevant stakeholders** provided a holistic approach with a clear priority on appropriate advocacy and adequate sustainable capacity development to enable the relevant Indonesian partner institutions to design, draft, and implement the new competition law. Many partner institutions and other stakeholders have been involved in this project: policy makers (for concept development), executive bodies (competition authorities, relevant line ministries), the judiciary (judges and lawyers), the media (to generate awareness and support among the wider public), private business (to ensure their compliance with the law), and academia (universities and research institutes).
- **Involvement of high-level experts and practitioners of German institutions** in charge of competition policy, the Bundeskartellamt, Bundesgerichtshof, and recently also the *Bundesnetzagentur* (Federal Network Agency). Hence, the long-term, trusting, and effective institutional cooperation between the two countries is still ongoing.
- **Assisting the KPPU in regional activities:** This contributed to greater ownership of competition policy by the Indonesian Government, as Indonesia took on a leadership role among the ASEAN countries[9] by organizing the first regional conferences on competition policy.

These success factors are essential elements of the holistic approach that GTZ advocates. Furthermore, a cost-efficient mix of resources has been used. The project not only had a remarkable impact; it was also cost-efficient. Until now, the project has not employed long-term international experts, but only

[9] Association of Southeast Asian Nations.

local advisers, for project management. To reduce expensive travel, cross-country video conferences were organized, during which KPPU staff were able to discuss with experts from the Bundeskartellamt and the BGH.

However, a lesson learnt is also that for such a politically charged and controversial issue like competition policy, progress is not a linear process. There are always periods of frustration without any steps forward.

3. Future Options for German Technical Cooperation

German technical cooperation in the area of competition policy in Indonesia will phase out in 2009. Therefore, the next steps in the ongoing project will concentrate on sustainability, including improvement of the interplay between the relevant institutions (especially KPPU and the Supreme Court) and improvement of the methodology (market definition, measurement of the impact of competition policy on social welfare, etc.) to improve the reputation of all institutions in charge of competition policy. All competition authorities share the problem of legitimacy, as the impact of improved competition on social welfare is not easy to demonstrate. The benefits are widespread and distributed among many companies and consumers. Furthermore, big companies always have an interest in a less powerful competition law and try to lobby against competition policy. Even in Germany, it took the Bundeskartellamt more than 10 years after its establishment in 1957 to become an effective and widely accepted institution.

Thus, the importance of functioning competition for the development process in Indonesia must be continually emphasized. There has to be a broad consensus in the society that the success achieved so far must be protected against the interests of a few powerful companies.

The successful methodical approach of German technical cooperation in strengthening competition policy in Indonesia should be repeated in other countries of the region: So far, only four (out of 10) ASEAN member countries have introduced a competition law (Indonesia, Singapore, Thailand, and Vietnam). Indonesia is the only ASEAN member that has a really independent competition authority and has started to restructure its judicial system to competently handle competition cases. However, implementing an effective competition policy is an important issue for all countries of Southeast Asia. Apart from Laos, which is still in the accession process, all ASEAN countries are already members of the World Trade Organization (WTO), which recommends the implementation of competition policy and law for each member country.

GTZ has sufficient knowledge and experience for technical cooperation in competition policy, especially through its collaboration with German practitioners from GTZ's strategic partners (Bundeskartellamt, Bundesgerichtshof, and Bundesnetzagentur). More support in competition policy and related areas like consumer protection policy could easily be provided to other ASEAN countries and to the ASEAN secretariat within an integrated approach. Especially the ASEAN secretariat should be strengthened in its role of advocating and harmonizing competition policy within member countries in the framework of the ongoing economic integration. This is the lesson learnt from the process of European Integration: From the beginning, the European Union has dealt extensively with antitrust and unfair competition. Article 85 of the 1957 Treaty of Rome sets out the basic parameters; these basic parameters of competition policy are still missing in ASEAN.

Private Sector Development, Labor Conflicts, and Corporate Governance in Vietnam – The Search for New Models

Ricarda Meissner and Ho Sy Hung

Executive Summary

Vietnam is undergoing a rapid transition from a centrally planned economy to a free market economy, which is being accelerated by global integration and accession to the World Trade Organization (WTO). While the government has introduced important changes to the legal framework, there are still many reforms required to ensure proper functioning of the market and the private sector. However, besides liberalizing, Vietnam also needs to think about steering the new market economy into the right direction in order to avoid polarization of society, new poverty, and increasing dissatisfaction by segments of society that may be left behind. The Vietnamese constitution clearly aims at an economic model in which the state has the role of ensuring that the entire society is uplifted and that economic growth will sooner or later ensure access to education, health services, and social security for all citizens of the country.

While the economic performance of Vietnam in the last few years has been impressive, there is growing concern about labor conflicts and strikes, which are on the rise all over the country. This paper looks more closely at the factors behind those strikes and argues that one of the main causes is the fact that Vietnam, with its current legal framework, is moving, more or less involuntarily, towards an economic model clearly biased towards shareholder interests and has not yet built up structures allowing stakeholder influence, participation, and control. The paper looks then at instruments of the social market economy and discusses whether some of these may offer interesting ideas or solutions to Vietnam's current problems. As a conclusion, several approaches are identified which would constitute an appropriate next step for Vietnam. They combine a free market economy and dynamic growth of the private sector with a legal framework that responds to stakeholder values, leading to social justice, balanced growth, and improvement of living conditions for all.

Private Sector Development in Vietnam

Since the mid-1990s, Vietnam has undergone rapid economic growth. Impressive changes have been made by the government to move the country towards a free market economy. The National Assembly reformed the constitution, making the private sector a key pillar of the economy, and confidence in the private sector has substantially improved since then. Significant legal reforms have helped establish a sound framework for dynamic development of the private sector. Integration into the world economy has been one of the main drivers of economic reform in Vietnam, and more profound changes need to take place in the next years in order to comply with WTO requirements, but also in order to support the domestic private sector in its efforts to become globally competitive.

One of the most important milestones for private sector development was the Enterprise Law of January 2000, which combined the previous Company Law and Private Enterprise Law. It represented a radical change in approach to private sector activities. Until then, private enterprises had been "allowed" to operate, if they obtained government approval and complied with special government controls. It was only the Enterprise Law that gave citizens the right to establish and operate private businesses without unnecessary intervention from government officials. Since the beginning of 2000, enterprise creation has increased continuously at an average pace of 1600 new companies per month. In addition, the Investment Law resulted in an immense increase of foreign investment, and state-owned enterprises started to be privatized.

The private sector now accounts for 33% of the value of production in manufacturing, and provides wage employment to 21% of Vietnam's labor force. Massive job creation has allowed 1.4 to 1.5 million entrants to be absorbed into the labor market every year. In addition, the average wage has grown at around 7% in real terms over the last decade. In 2006, annual GDP growth reached 8.2%, and around 8.3% is expected for 2007. New commitments for foreign direct investment (FDI) reached US$3.7 billion in the first five months of 2007, an increase of 25% over the same period in 2006.

In general, the dynamic business development has resulted in rapid poverty reduction in Vietnam and has allowed a large part of the population to raise their living standard. A very positive effect of the Vietnamese growth miracle is reflected in the poverty index: while real GDP per capita has increased by 5.9% per year on average since 1993, the Gini index (measuring inequality) has increased only slightly, reaching 0.37 in 2004. In total, the poverty rate fell from 57% to less than 20% during that period (World Bank 2005).

New Problems: Labor Conflicts and Strikes

The Current Situation

There is an expression in Vietnam comparing the ongoing reform process to "jumping on a driving train and changing its direction." This image illustrates very well the current conditions under which reforms must be made: in the middle of a fast and dynamic process, struggling to keep pace, but often running a few steps behind. Thus, reforms have been completed successfully in some areas, while in other closely interlinked areas the necessary reforms have not yet been implemented – sometimes because there has been no strong lobby fighting for it or because there just has not been sufficient time. This results in a certain "bumpiness" of the reform process, which is normal, but becomes worrying when the lack of appropriate legal reform negatively affects the livelihood of people and in particular those who are in a rather vulnerable situation. This is exactly the case with regards to labor issues in the dynamic private-sector development process in Vietnam.

One of the few negative by-products of the impressive development of the private sector in recent years has been the increasing number of labor conflicts, strikes, and violations of labor laws by foreign and domestic employers.

From 1995 to 2006, there were 1250 strikes in the country, 66.8% in companies representing foreign direct investment and 26.2% in domestic private companies, not one of which was called in accordance with the legal procedures. In general, there has been a 7% annual increase in the number of strikes since 1995. In 2007 there was a steep increase: already in the first six months there were 300 strikes, involving 200,000 strikers (Nguyễn Bá Ngọc et al. 2007).

According to official information sources, the cause of the large majority of the strikes (80%) is legal violations by the employers. Almost all of these strikes are, therefore, "walk-outs" or work stoppages rather than strikes: workers refuse to continue working due to accumulated violations of their rights by the employer and with the objective of forcing the employer to comply with his obligations.

"Real" strikes, during which employees collectively fight for higher wages or other benefits in addition to those in their current labor contracts, have started only recently. This is related to the fact that inflation has been eroding the workers' standard of living. Living space all over the country has become more expensive, as have other necessities. Workers have also become more aware of new opportunities and increasing demand for labor. There is strong pressure on the labor market from the lack of skilled workers, which increases workers' bargaining power.

Typical violations which led to strikes or walk-outs included:

- issuance of no or only temporary labor contracts, in violation of labor regulations and labor contracts. This allows the employer to avoid payment of social security and allows flexible lay-offs, but leaves workers completely unprotected;
- failure to pay salaries in a timely manner or reduction of salaries without proper justification;
- excessive overtime: in some enterprises workers put in around 1000 hours of overtime a year, while the legal maximum is 300 hours per year. A new way of forcing workers into overtime is to set high targets that workers can only fulfill by staying longer.
- inadequate or no payment for overtime;
- failure of the employer to increase wages as contractually agreed upon;
- lack of payment for social security and other legal obligations;
- failure to allow sufficient rest and breaks, in particular for sick workers (in one case, striking workers demanded 30 minutes rest for sick workers instead of 12 minutes);
- frequent lay-offs without giving a reason and without paying the legal compensation; and
- low quality of accommodation and food, which in some cases is so bad that workers get sick.

A good overview of how labor regulations are currently implemented is a study of the labor inspection department in 2006, which listed 12,720 cases of violation of labor regulations in 3998 companies – 3.18 violations per firm. These numbers were obtained from a "self-test" and via questionnaires sent to enterprises (Nguyen Ba Ngoc 2007).

Around 75% of the strikes have occurred in FDI enterprises, where the highest rate was among the Asian investors. The strikes usually took place in labor-intensive industries with a low level of technology, mainly footwear, textiles, garments, and processing sectors and often in provinces which are "hot spots" of industrial development, leading to high demand of labor and the employment of migrant laborers (Clarke et al 2006).

The real number of violations of labor regulations is surely much higher than 3.18 per enterprise, as most take place on a more individual basis. As long as an employer does not violate the rights of a critical mass of workers, an individual has very little recourse. Thus, most violations are unreported and do not have any negative consequences for the employer.

Negative Effects of Strikes and Government Measures to Improve the Situation

Strikes in general have a negative impact on the reputation of Vietnam as a place to do business. The problem is still moderate, but is starting to lead to frustration in the business community, in particular among foreign direct investors. While the government steps in and tries to solve the conflicts that cannot be solved through legal procedures, the question sometimes arises why the government is not more active in preventing strikes. International chambers in Vietnam have already jointly made public "their grave concern over the potential impact on Vietnam's reputation as an investment destination" (Schaefer 2006). Workers, on the other hand, wonder why more effective methods to sanction violation of their rights are not in place.

The government is worried that strikes may become "standard procedure" for workers and may lead to social unrest and a climate of rioting, which could become difficult to keep under control in the long run. Larger strikes often spread to neighboring companies and may end in destructive behavior. In addition, strikes may also be supported by surrounding villages that have problems with the company, often related to pollution, additional traffic, wrecking of their infrastructure, waste water, or other kinds of damages.

From the private sector's point of view – whatever the reason for the unrest – strikes mean loss of time and money, may prevent deadlines from being met and thus result in penalties from international trading partners, and destroy a good working climate, the work ethic, and productivity. Besides that, the firms also end up with the negative image.

The government has in the mean time issued several decrees which should help to improve the situation. For example, one recent decree instructs the government and the Vietnam Chamber of Commerce and Industry (VCCI) to enhance regular dialogue between the government and enterprises, with the objective of informing foreign direct investors about the situation of the workers and improving the firms' voluntary commitment to comply with regulations and possibly to increase salaries.[1]

In addition, new incentives have been launched for investors, in particular tax breaks when they improve the living conditions of their workers by supporting the building of living quarters. Furthermore, the government itself started to invest more into improving the houses of workers in export processing zones.[2]

Nevertheless, all this will not improve the situation significantly as long as no sustainable mechanism for communication, cooperation, and partnership among workers and firms has been institutionalized.

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[1] Decree 6/2006/CT-TTg.

[2] Decree 133/2007/ND-CP.

The Legal Framework

Vietnam has a comprehensive legal framework for labor relations: The Labor Code of 1994, amended in 2002, gives a framework for labor contracts and collective agreements and provides a basis for protection of employees. It specifies details such as duration of rest and meal breaks, maximum length of the working week, and minimum wage. A limit is set on overtime, and guidelines are given for payments for night and holiday work, social insurance contributions, and benefits (Clarke et al. 2007). The Labor Code also restricts the ability of the employer to impose fines on employees or to dismiss them, provides relatively generous redundancy payments, gives the trade union considerable rights to consultation, in addition to its role in collective bargaining, and requires the employer to provide facilities and time for union work. In addition, the 2002 amendment required all employers to establish a trade union organization within six months.

According to the Labor Code, responsibility for monitoring the enforcement of labor legislation is shared between the Ministry of Labor, Invalids, and Social Affairs (MOLISA) and the labor union, the Vietnam General Confederation of Labor, but in practice the main responsibility falls to MOLISA, since the union has almost no power outside the state-owned sector. The sanctions on employers who violate the Labor Code are minimal. What the labor department or the union can do is to refer an employer to the People's Committee or the relevant ministry, which could make life very difficult for an employer, in the last resort even stripping the company of its investment licenses. However, in reality, it is very rare for sanctions to be imposed on employers who violate the law.

Enterprises should be inspected at least once a year. However, MOLISA has only 350 inspectors and the union has 100 inspectors. In the Hanoi Department of Labor, there are 11 inspectors responsible for 700 state enterprises, 600 foreign-invested enterprises, and over 20,000 private enterprises. The Ho Chi Minh City Labor Department has five inspectors for more than 30,000 enterprises.

The Department of Labor, Invalids, and Social Affairs reintroduced labor inspections in 2005 and found in one survey that 14 out of 16 enterprises inspected in the Export Processing Zone had very poor working conditions and violated the labor law. The department's conclusion was that the zone trade union had failed to enforce the labor law and was "too pro-company." There are no consistent statistics on the number of legal violations uncovered by the labor inspectors. It is obvious however, that the inspectors have very little time to make routine inspections, as they are already overwhelmed with cases of industrial accidents and strikes (Clarke et al. 2007, 550).

Mechanisms for Conflict Resolution

Conflict Resolution as per the Labor Code

The Labor Code provides a system for the resolution of individual and collective labor disputes through conciliation and arbitration and gives employees the right to strike in the case of a collective labor dispute, once these procedures have been exhausted, provided the strike decision is made by the trade union and endorsed by a majority of employees. Employees in certain essential industries and enterprises are prohibited from striking (Labor Code of the Socialist Republic of Vietnam).

The procedures described in the Labor Code demand that enterprises with trade unions should set up a labor conciliation council with an equal number of employee and employer representatives. If a conflict arises, the labor conciliation council shall commence the conciliation within three days of receiving a request for conciliation. If the labor council cannot find a solution, the dispute is referred to the *provincial arbitration council.* If still there is no solution, the trade union can either go to court or officially call a strike (Nguyễn Bá Ngọc et al. 2007).

In reality, these procedures are almost never applied because:

- They are too complicated and take too much time.
- They apply only to enterprises with trade unions. In firms that do not have a union – and usually the FDIs do not – strikes are theoretically illegal anyway and there is no official conflict resolution procedure.
- The conciliation council includes the same number of representatives of employees and employers. Negotiations such as these are only bilateral and will often end without finding a solution.
- The labor arbitration councils do not have sufficient power. Their decision can be rejected by any of the parties.
- If there is a trade union, its representative is usually appointed by the provincial union branch or the employer and is not elected by the workers. Thus, he/she often does not have the trust of workers. In addition, he/she is usually not even a worker, but one of the managers, usually the human resource manager.

In fact, since their set up, the labor arbitration councils have received very few requests for settlement of dispute. The labor arbitration council in Ha Noi has settled only two cases since its establishment in 1997, while the labor arbitration council in Ho Chi Minh City has settled just one case since 1998. Almost all labor disputes have been settled by fire-fighting interventions of the local labor departments.

… and Conflict Resolution in Practice

As legal procedures are obviously inadequate, a "firefighting" approach has been developed to allow quick reaction in case of a strike and has proven quite effective in resolving conflict. When a strike breaks out, the local government is called in and will usually send officials from the provincial labor department to the strike-affected enterprise. Sometimes, a task force is also set up by the people's committee, comprising, besides the local government, the union and in some provinces also the chamber of commerce (VCCI).

Negotiations start, and in most cases the strike is called off after a few days when the demands of the workers are met by the employer. This often happens quickly after the governmental task force has stepped in, as the firm prefers to keep a low profile if it has violated the Labor Code.

However, this procedure has a few structural problems:

- First, legal regulations are based on the assumption that workers/employees feel and are indeed represented by the enterprise unions in labor conflicts. This is obviously not the case.
- Second, while the legal regulations foresee a period of formal negotiation to settle a conflict and avoid a strike, strikes and walk-outs seem to be the only means workers have to pressure their employer to listen and/or to accept their requests, even if their demands are within the law, as they usually are. Effective dialogue or compliance enforcement mechanisms are absent.
- Third, protecting the rights of the labor force does not seem to be a priority of local governments at the moment. This may be related to the importance given by the national government to the attraction of foreign investment and the intention (strongly pushed by almost all donor agencies) to be as "business-friendly" as possible. The priority given to business friendliness may, however, lead to overexploitation of the labor force, if they do not have a powerful lobby to fight for their rights.
- Fourth, labor inspections are not effective. Labor inspection departments are seriously understaffed and cannot cope with the number of cases they need to look after. Instead of proactively pursuing compliance with regulations – which the Vietnamese Government does in other areas – the role of the department is only reactive.

The most important issue, however, is the role of the unions, which will be discussed in the next chapter.

The Role of the Labor Unions

Status of the Vietnamese Labor Unions

The Vietnam General Confederation of Labor (VGCL) is a powerful organization with around 5.5 million members. Traditionally, the role of labor unions in Vietnam was to help the government achieve production plans by strengthening labor motivation and discipline and by providing social welfare, sports, cultural, and entertainment facilities to its members. Many unionists and employees still see their organization in this way (Clarke 2006).

The main tasks of the labor union were not considered to be in the workplace, but rather on a national level, where they represent workers' issues within the political system. Thus, unions are considered to be institutions which secure laws, decrees, and regulations that ensure better working conditions for workers, and, as a matter of fact, they have been successful in their role as lobbyist for the general interests of workers.

However, unions are not what they are actually supposed to be and what is urgently needed in a free market economy: they are not the elected representatives of the workers! The primary reason for this is that labor unions operate under the leadership of the Communist Party and are therefore ruled from the top. The subordination of the union to the party demonstrates the subordination of the immediate interests of union members to the wider social, economic, and political goals of the party, and at the enterprise level these generally coincide with the interests of management (Clarke et al. 2007).

This means that labor unions are acting more like a governmental agency, department, or even ministry, but not like an institution that represents workers' interests against the interests of their employer.

The Enterprise Unions

According to the Vietnamese Labor Code, the regional branches of the labor union must establish labor union branches in all private and foreign-invested enterprises that have more than ten employees. The Labor Department recognizes that unions do not do much to prevent strikes from happening, but sees that it is much easier to settle a strike in an enterprise with a trade union.

When planning to set up a labor union branch in a private or foreign-invested enterprise, the provincial union will normally approach the employer and asks for his consent to establish a union. The provincial union does not approach workers directly, as "this would infringe on the rights of the employer." If the employer does not want to permit a trade union, even though by law he is obliged to do so, it seems that there is neither any pressure on him, nor any sanction prescribed by the law. As a result only very few enterprises in the Export Processing Zones have a union at all.

After it is set up, the union will usually appoint a temporary president and will set up a provisional standing committee through agreement with the employer. Elections to these positions are supposed to be held a year later. The president appointed by VGCL is usually not worker, but in most cases a manager, often the human resources manager of the company. Also the enterprise standing committee is usually dominated by line managers and white-collar workers, with fewer than one in five committee members being production workers. The appointment of managers is often justified by the fact that he/she would be more knowledgeable. Once set up, the enterprise unions are basically left alone and receive little backstopping from the VGCL. Performance is therefore very dependent on the personal capabilities and commitment of its leaders.

In enterprises with more than 500 employees, there is supposed to be one or two full-time officials appointed and paid by the higher union, but the VGCL does not have the funds to cover this. Therefore, most enterprises do not have any full-time union staff, and in others full-time officers are usually paid by the employer.

The main expenses covered by the labor-union budget are for weddings, funerals, sports, and entertainment events. These activities are considered to be more important than proper trade union activities, as, according to some union leaders, "without these activities the union will not be able to attract members" (Clarke 2006).

Union leaders have only weak protection from victimization. According to the law, a trade union president cannot be dismissed without the permission of the higher union body, but in practice it seems employers ignore this restriction and are never sanctioned for violating the law (Clarke 2007). Moreover, there is no requirement that an employer renew the contract of a trade union activist who is employed on a fixed-term contract. Accordingly, a recent study found that most union presidents accepted nominations only under pressure from the employer. Provincial unions state that it is extremely difficult to find people who are willing to take up trade union positions.

Corporate Governance and Stakeholder Interests

The Vietnamese Enterprise Law has been one of the most progressive laws in the country's transition process and has had immense influence on the development of the private sector. Endorsement of its first version in 2000 led to a boom of new firm start-ups and opened up the way to fully independent operation of private enterprises. In its revised version of 2006, the Enterprise Law established greater equality of legal treatment among state-owned enterprises, FDIs, and private companies. Although the Enterprise Law was an important step forward for Vietnam, it has room for improvement with regard to stakeholder interests and rights.

In European countries, stakeholder participation is a key instrument of corporate governance. The stakeholder model has basically the following advantages:

- greater commitment and ownership by employees;
- joint decision making by employer and employees, leading to a joint vision within the firm;
- higher investment in areas which ensure long-term prosperity of the firm and sustainable jobs; and
- better control against mismanagement via supervision of stakeholders.

When screening the Enterprise Law and other related laws on stakeholder representation, it quickly becomes obvious that European practice is not at all reflected in Vietnamese laws – they neither provide a legal framework for employees nor give stakeholders a role in supervision of the management board. Thus, Vietnam joins the group of countries applying a neo-liberal model of corporate governance that leaves decision-making power and supervision exclusively to the shareholders.

When comparing the OECD Corporate Governance Principles to Vietnam's legal framework on the role of stakeholders in corporate governance, the result is not very impressive:

Principle IV A, which recommends that *"the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises"* is only partly observed. Under the Enterprise Law of 2005 and the Model Charter of 2002, stakeholders, including employees, labor unions, suppliers, and creditors, do not participate in the internal corporate decision-making process. Party organizations, women's unions, former line ministries, and people's committees – all state bodies – are considered stakeholders and only they have a certain role to play in the decisions of corporations. Furthermore, no specific codes of conduct or recommendations for the treatment of stakeholders have been developed, and the level of awareness of corporate social responsibility is low (World Bank 2006).

Principle IV B, which states that *"where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights,"* is also only partially observed. Employees and creditors can in theory seek redress through the courts. Employees are protected by the Labor Code, a collective labor agreement (if any), and the Law on Bankruptcy. Creditors are protected by the Civil Procedure Code and the Law on Bankruptcy. In practice, however, there have been few cases that have demonstrated the effectiveness of current mechanisms.

Also the principle which recommends that *"performance-enhancing mechanisms for employee participation should be permitted to develop"* is fulfilled only in individual cases as there are no formal rules for this. In practice, very few listed companies have obtained shareholders' approval to issue convertible preferred stock as a performance bonus for their management or employee stock options. However, this practice has become more common in the last two years.

Information access is not as open as it should be: The principle that *"where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient, and reliable information"* is "materially not observed." The stakeholders' special access to information is not regulated by law and stakeholders are not allowed to access corporate information beyond what is available publicly. The only exception is that creditors may have special access to information under the loan covenants.

And – most importantly – stakeholders have no role in controlling the activities of the board: the principle that *"stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board, and their rights should not be compromised for doing so"* is "*not observed*."

Whistleblowers (employees who report misconduct of their management) are required to provide concrete evidence, rather than just voice their concerns before authorities can accept their concerns as a valid case for further processing. A "Whistleblower Rule" similar to the one stipulated by the Sarbanes Oxley Act in the US is unknown in Vietnam. Stakeholders, particularly employees, may articulate their concerns to the control committee and ask them to act in the company's interests. In practice, whistle blowing outside of official channels does not exist.

Technical Cooperation for Private Sector Development in Vietnam

Assistance by bilateral and multilateral donor agencies for private sector development (PSD) in Vietnam has been extensive in the last years. Important contributions have been made to support the economic transition process, in particular with regards to legal and administrative reform, institutional strengthening, and building capacity of the private sector for global competitiveness.

Donor-funded PSD programs in Vietnam typically focus on improvement of the business climate, legal and administrative reform, investment promotion, public-private dialogue, and competitiveness. Via the SME Partnership Group, there is a strong mechanism for coordination among donor-funded programs under the leadership of the Agency for Small and Medium Enterprise Development, which reports to the Ministry of Planning and Investment.

Looking at donor approaches to PSD development, it is obvious that these approaches generally reflect the point of view of owners and shareholders – as it is normal in PSD activities. While, for example, a large number of public-private dialogues and consultation forums are held every year to provide feedback on laws and regulations, representatives from the unions or at least the local labor departments are never invited. Donors have also not promoted ideas of stakeholder representation in corporate governance or a specific role of stakeholders in the supervision of management.

This is strange, in particular when considering the fact that in most cases bilateral donors active in Vietnam do not follow shareholder oriented and neo-liberal economic models in their own countries, but instead often have highly redistributive and socially oriented economic systems. And it becomes even stranger, when considering the Constitution of Vietnam, which does not seem to call for a neo-liberal economic model:

The Constitution of Vietnam states that *"the State ensures and constantly fosters the people's rights as masters in all spheres, realizes the targets of building a prosperous life for its people, a strong country, and an equitable, democratic, and civilized society, ensuring the well-being, freedom, and happiness of all citizens as well as conditions for their all-round development"* (Constitution of the Socialist Republic of Vietnam 2001).

As per its constitution, Vietnam aims to establish an economic system in which a free market is combined with equality and "well-being" for all citizens and in which the state plays a prominent role in providing access to health, education, and social services" (article 59ff.). However, while the country and its main development partners are preoccupied with the important task of liberalizing the economy, insufficient thought is given to the question on how to "balance" the economy and how to steer it into the right direction.

When discussing the actual components of a "socialist-oriented market economy" with government officials, party members, or political researchers in Vietnam, it becomes obvious that the ideas are not very clear, but that an intensive search is underway for adequate models.

In this situation, on the one hand, technical cooperation is required to present the values and instruments of the social market economy to Vietnam and thus offer strategies for a transition to a market economy that do not create disparities and new poverty. On the other hand, the government and the party should proactively seek to create awareness and familiarize itself and its senior levels with instruments of the social market economy.

In the following paragraphs, instruments of the social market economy that may be of great relevance and interest to the Government of Vietnam in its current endeavor to push forward private sector development are presented (Roesner 2003). In addition, strategies with which technical cooperation could support promotion of the social market economy are discussed.

Introducing Concepts of the Social Market Economy in PSD in Vietnam

Creating Awareness of the Social Market Economy

An important task for the Vietnamese Government is to first make itself and its relevant political decision makers familiar with values and instruments of the social market economy. The issue of how to combine a rapid transition to a market economy with establishment of a proper social system and the promotion of social values is a hotly discussed topic and arouses great interest within the government and also within the party. Regular discussion groups, seminars, and workshops on this topic should be organized.

Development partners involved in this area should view the Communist Party as a new and important partner, as it is currently seeking appropriate instruments with which to make its socialist-oriented market economy more meaningful. As an example, the party could include elements of the social market economy in its regular training programs for their senior government officials, where "capitalist" and "socialist" models are usually discussed, but where insufficient information is provided on more modern forms of social and economic order. Cooperation partners here could be the German and other political foundations, which usually have extensive experience with capacity building in these areas.

Promoting Workplace Representation: Building Capacity of Grassroots Organizations and Workers' Representation at the Enterprise Level

Structures to represent employees at the workplace level exist in almost all member countries of the European Union. Workplace representation is usually manifested via works councils or board-level representation (Joerges and Roedel 2004).

Because unions cannot be considered to be a real form of employee representation at the enterprise level in Vietnam, certain parts of the government are currently seeking ways to build the capacity of the workers to better represent their interests and manage a dialogue with their employers. At the moment, capacity building of labor unions will not solve the problem, given the factors mentioned above. The social market economy and its instrument of social partnership offers many models for building a joint vision of employees and employers, for building capacity of employees in negotiation, collective bargaining, and representation, and for raising management awareness of stakeholder values, building employee commitment, etc., also in the case that labor unions are not fully functional.

Promoting Employee Representation at the Board Level/Co-determination

Co-determination or employee representation at the board level is a widely discussed issue in European Union countries at the moment and is an important pillar of a stakeholder oriented economic system. While opponents usually claim that co-determination would scare off investors[3] (which does not seem to be verified by recent research), its supporters emphasize the many positive effects it has, including higher commitment of employees, higher productivity, and more investment in long-term strategies (over against a model where the firm is used as a cash-cow) (Trade Union Advisory Committee 2005). In particular, co-determination is effective in preventing labor conflicts and strikes: countries with a functioning system of co-determination have on average many fewer annual strike days. One of the most important advantages of co-determination is, however, that employee representation on the board is a mechanism by which to control management, thus greatly restricting options for misconduct and fraud.

Eleven states of the European Union have legally ensured that employees have a representative on the board, both in the public and private sectors. The basic threshold above which employees must be on the board in a private company ranges from 25 employees in Sweden to 1000 in Luxembourg. In most cases, the employee representatives are on supervisory boards in a two-tier board structure, but in some countries they are on the management board in a one-tier structure.

As mentioned, employee representation on the board does not exist in Vietnam, but may be a valid model for the future, when real worker representation can be ensured. In the meantime, the government could look at different models of co-determination and develop a specifically Vietnamese model of worker representation. Technical cooperation from relevant countries of the European Union could offer Vietnam information about specific models and provide insights into the advantages and disadvantages of each. Unions should be assisted to lobby for inclusion of co-

[3]See Bundesverband der Deutschen Arbeitgeberverbaende (Confederation of German Employers' Associations) 2004.

determination into the relevant laws. Awareness of co-determination should be enhanced in the relevant government think-tanks, chambers, and the Communist Party, which could become a powerful promoter of this model.

Awareness should also be created of the important function of workers' representation on the board as a control mechanism – a valid alternative to the currently ineffective and understaffed regulatory agencies of the government.

While the United States' Sarbanes-Oxley Act allows control over the management board and protects whistleblowers against retaliation, an instrument like this is not really required in a functioning co-determination system, as whistleblowers can report cases of fraud, misconduct, or violations of the law to their representatives in the supervisory board. However, as long as co-determination is not in place, the government of Vietnam might consider a special law to protect whistleblowers.

Promoting Concepts and Instruments of Social Partnership

Concepts of social partnership – cooperation between employer and employee organizations for the common objective of economic growth and social justice – should be promoted throughout the private sector and the labor force and should be included in capacity building programs, not only for unions but also for parts of the government.

The government should ensure that tripartite dialogue and cooperation for promotion of economic and legal reform is organized, in addition to the usual public-private dialogue forums. On a national and political level, the unions may be valid promoters of the concept of social partnership and should be helped to understand this concept and to promote it in consultations on new laws and regulations.

Promoting Corporate Social Responsibility

Even if Corporate Social Responsibility (CSR) cannot and should not be seen as a replacement for legal rights, it is an important voluntary instrument with which to improve working conditions and enhance commitment by the labor force.

CSR is already extensively promoted by many donors, mainly via their public-private-partnership programs in Vietnam. Multinationals are the most active players in CSR and are usually used as benchmarking examples or linkage partners for local firms in their supply and distribution chains. However, CSR should also be promoted as a strategy for domestic firms, which then would not be only recipients but also initiators of CRS plans.

The government and the chambers might also consider setting up annual awards for the best domestic CSR program or could launch major public relations campaigns promoting the idea that CSR is a valid instrument with which firms can demonstrate their commitment to the community (Eigentum verpflichtet - property entails obligations). Tax breaks for specific CSR measures or other incentives could also be considered in the future.

Improving the Labor Code and Ensuring its Implementation

As seen above, the Labor Code needs to be amended if it is to be relevant to resolution of current labor conflicts. Legal procedures should be drafted on the basis of the fact that the union may have a role in lobbying but cannot replace elected workers' representatives. If this fact is continuously ignored, the situation will not improve. Donor agencies could support the process of dialogue among local and national governments, grassroots organizations, FDI representatives, and chambers, with the objective of working out realistic procedures for the resolution of labor conflicts.

The labor standards that have been adopted by the Government of Vietnam can theoretically be considered a model for other countries in the region – if they are implemented. As mentioned above, due to the current importance given to the attraction of FDI, there seems to be little enthusiasm for making sure that they are implemented, as this may frustrate investors. In addition, agencies in charge of inspections are seriously understaffed.

Technical cooperation can support the Ministry of Labor and its departments in their efforts to improve labor inspections and thus avoid labor conflicts and strikes caused by violations of the law. This should be done with sensitivity to the potentially negative impacts of inspection on private enterprises with regards to bribery and unjustified harassment of firms, and/or high administrative burdens. Technical cooperation can assist the government in making labor inspections business friendly and service oriented. The labor inspection departments could become a source of information for firms and workers, holding regular information seminars and public relations events and disseminating guidelines on labor standards for employers and workers, self-assessments, and all kinds of other informational materials.

Legal Protection against Dismissal of Worker's Representatives

Employee and union representatives need legal protection against dismissal, if they are to take up their tasks correctly and in an unbiased manner. As per the German labor law,[4] elected worker representatives enjoy special protection against dismissal during their term and a period of one year after that. The fact that Vietnam also has a law protecting union representatives from dismissal is rather unknown in Vietnam among both managers and respective officials. The Ministry of Labor could aim to raise awareness of this law and find strategies to ensure compliance with it.

Conclusion

Mainstreaming social market economy values in private sector development in Vietnam is an urgent task for the economic and social development of the country. The social market economy offers many potential solutions for the growing tensions and problems accompanying Vietnam's transition process.

The government, the party, and the private sector alike are highly interested in the concepts of the social market economy, as its values correspond very well to the objectives of the Vietnamese constitution, in combining a free and dynamically growing market economy with improvement of living conditions and access to security, health care, and education for all Vietnamese citizens. For Vietnam, the social market economy is therefore an important alternative to a neo-liberal system, with its limited trickle-down effects that sooner or later create deep inequalities and serious ruptures within the society.

However, the concepts of social market economy are not yet sufficiently well known in Vietnam, and where they are know, then mainly on the level of theoretical concepts, but not with regards to its practical instruments. The Government of Vietnam should proactively examine this model and use it as a source of inspiration and practical guidance to further strengthen and deepen their vision of a socialist-oriented market economy. The Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, together with other European agencies, would have a competitive edge in promoting this economic model and its methodologies in Vietnam, thus providing practical solutions for many current problems in the transformation process of the country and ensuring that the transition to a market economy results in social justice and improvement in the living condition of all Vietnamese citizens.

[4] § 15 Absatz 1 Satz 2 KSchG (Employment protection act, paragraph 15, clause 2).

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Cambodia: Corporate Social Responsibility and the Cambodia Business Initiative in Rural Development (C-BIRD)[1]

Peter Bolster and Peter Brimble

Introduction

Corporate Social Responsibility (CSR) is becoming an important instrument to link profit-oriented operations with social engagement. Thus, CSR is responding to one of the main principles of the social market economy, the principle of *Eigentum verpflichtet* (property entails obligations).[2] Firms are beginning to acknowledge a certain responsibility for their social environment, even in the absence of a corresponding legal framework. CSR does not replace a proper legal framework and cannot in general replace the state as the guarantor for balanced growth. However, the CSR approach can be particularly significant in countries where state structures that would allow the introduction of proper social systems by the government are not yet set up. CSR has up to now been familiar as an instrument of multinationals that would like to improve their image as socially and ecological responsible entities. In the meantime, however, CSR is becoming more important as an instrument for larger or even medium-sized domestic firms, which are increasingly seen as potential partners in the search for greater social equality. These firms also view their engagement as a way to increase the commitment of their employees and thus improve the overall performance of their operations.

Corporate Social Responsibility in Cambodia

Because of the low level of business and private sector development in Cambodia, the level of CSR remains at a nascent stage. This is perhaps compounded by the extensive number of non-governmental organizations (NGOs), which might appear to make it unnecessary for firms to undertake

[1]The presentation draws on Brimble and Kang 2006 and Brimble 2007.

[2]Article 14, paragraph 2, German constitution.

significant CSR-type activities. In addition, there are no policy measures designed to promote business CSR activities as a tool for rural development, indicating a critical need to advocate for more promotional and proactive policies to support CSR, in particular, and business involvement in rural development, in general.

CSR has become extremely popular in developed economies in Europe and North America over the past decades. However, in developing countries in East Asia, such as Cambodia, CSR is a relatively new concept, and the implications of developments in CSR for local companies are still being explored.

The Kenan Institute Asia (2005) provides a useful summary of why corporate citizenship is particularly important for East Asian corporations at the present time: "Over the last five years, there has been increasing pressure for corporations to be better corporate citizens. This pressure has come from customers, buyers, investors, employees, governments, the news media, NGOs, and local communities. The corporate scandals of Enron, WorldCom, etc. have drawn attention to corporate failures and led to greater government scrutiny. In response, forward-looking companies are strengthening their corporate governance, improving labor conditions, exceeding environmental standards, and positively engaging their communities in order to build trust with their stakeholders. Many business managers have concluded it is no longer sufficient for companies to have simply philanthropic mechanisms; they must become active partners in helping prevent and solve social problems."

In Cambodia, the size of the industrial base and the extent to which the industrial structure offers potential for CSR activities are limited. At present, most businesses are concentrated around Phnom Penh and urban and other provincial or district centers, and appear to take little interest in rural development issues. There seem to be few businesses interested or willing to be involved in CSR-type projects in Cambodia.

However, it is important to emphasize that the private sector generally has an entrepreneurial way of operating that is based on vision, innovation, and planning. This business know-how is traditionally lacking in rural societies, in NGOs, and in the public sector. For example, farmers are eager to grow food and vegetables, yet they are disconnected from the information and resources needed to develop their activity so that it becomes a strong and sustained source of income. With the business sector's expertise, farmers can learn the skills needed to create more profitable and sustainable enterprises and activities and generate income.

The following examples demonstrate the potential for CSR activities in Cambodia, especially those that connect businesses and rural society through innovative partnerships which leverage resources from both sides to develop sustainable income-generating activities for rural areas:

- **Total (Cambodge) Company:** As part of the UNDP Growing Sustainable Business for Poverty Reduction Program, Total Company carried out a project called "Promoting Energy Entrepreneurship in Cambodia's Rural Areas," which promoted four rural electricity entrepreneurs directly supplying electricity to rural villagers in four provinces: Battambang, Banteay Meanchey, Prey Veng, and Kampong Cham. The project aimed to support the development of rural electricity enterprises by building up the capacity of entrepreneurs. The project was conducted from May to December 2005 with an amount of US$40,000 spent on training in accounting software, business plan development, electrical techniques, etc. This project is part of a global Total CSR program.
- **British American Tobacco (BAT) Company:** In 1997, BAT set up an extension service program to support tobacco farmers in Kampong Cham province, with the mission to improve product quality, reduce production and maintenance costs, as well as to be socially responsible. BAT supports tobacco farmers in Kampong Cham by supplying seeds, training, and quality control. The company's staff supervises and provides technical information to farmers on how to improve the quality of production and also encourages them to take up new techniques. At the start of project, BAT focused on capacity building for the farmers. The initial goal was to substitute local products for around 10% of imports in the first few years. BAT has contracted with around 350 farmers, mainly in Kampong Cham, to grow tobacco with new seed varieties. Their yield per hectare has increased to 1.7 tons from just 750 kg in 1996. The programs undertaken by BAT illustrate the significant role of BAT in poverty alleviation through corporate social responsibility.
- **Manhattan Textile Company:** Manhattan Textile initiated a cotton project in Koh Sotin district, Kampong Cham province, to support cotton farmers by providing seeds, training, and quality control. Through the project, Manhattan Textile is looking at long-term investments and encouraging government ministries and agencies, as well as authorities at all levels, to work closely with it in order to rehabilitate cotton production. The company's cotton project is a campaign to promote cotton plantations. The main thrust of the project is to invigorate and modernize the agricultural sector, generate employment, enhance household incomes, and improve access of the less privileged to food.
- **Les Artisans D'Angkor:** Les Artisans d'Angkor was established to provide sustainable and fair development for arts and crafts in Siem Reap province. It offers young artisans a job on-site or in its rural workshops in Siem Reap surroundings. In addition, Artisans d'Angkor is a center for vocational

training where young people can express their talents and continue to develop their skills. To date, Artisans d'Angkor is completely self-financed. It continues to invest in new apprenticeships and skill creation by providing on-going training, setting up new rural village workshops, and participating in major promotional events to help promote Cambodian culture and handicrafts (for example, 2005 World Expo). At the core of the company's activities are ideas for the social, economic, and professional advancement of Cambodian artisans. The company guarantees fair pay as well as social and medical welfare. The artisans have formed an association and have a 20% stake in the company.

CSR and the Thai Business Initiative in Rural Development (TBIRD)

The Population and Community Development Association (PDA), one of the largest NGOs in Thailand, initiated the Thai Business Initiative in Rural Development (TBIRD) in 1996 to complement PDA's core activities in family planning. The experience of TBIRD in Thailand proves to be an invaluable guide for possible CSR activities in Cambodia.

TBIRD's overall concept is to encourage the private sector to help improve the quality of life of rural people throughout Thailand. The basic idea is to mobilize relatively untapped private-sector resources and recruit successful businesses to participate actively in rural development. Ideally, each company would "sponsor" a village and help villagers to develop the business skills necessary for successful income generation activities. Long-term sponsor involvement is important to sustain the village development. Two pioneering TBIRD companies were Swedish Motors Co., Ltd. (Volvo), which started a project in 1988, and the Bangkok Glass Co., Ltd., which got involved in 1989. The Ford Foundation was the first donor to support TBIRD; its assistance was in the years 1990-1993. German Agro Action (GAA) started to provide assistance to PDA's TBIRD Bureau in 1994 and continued the funding until 2003.

TBIRD has proved that it is possible to recruit businesses to transfer business skills to villagers, establish income generation activities in the villages, slow down migration to urban areas, and improve the quality of life of rural people. TBIRD is a partnership involving the government, the private sector, and the villages; the villages are the focus of the projects and the main actors in implementing the specific activities. The government builds up the infrastructure and plays a supporting role. The private sector takes the lead in providing business skills, appropriate technology, market opportunities, and business networks. A well-established NGO creates awareness of business social responsibility and serves as a facilitator. Key strategies are resource mobilization, integrated development, human resource development, and local institution building. There are a number of key lessons from TBIRD that are relevant for Cambodia and other developing countries:

- There appears to have been considerable discussion within TBIRD and PDA on present and future directions – especially regarding corporate social responsibility and its implications for TBIRD-type projects. Indeed, the TBIRD Division has recently been renamed as the CSR Division.
- The government has put in place generally supportive policies for industrial decentralization – in particular, the additional benefits provided by the Thailand Board of Investment for investors locating their factories far away from Bangkok, as well as certain policies of the Ministry of Industry.
- Recruiting companies to actively participate in rural development is not an easy task.
- A critical facilitating role was played by the PDA, which is a strong NGO with strong outreach into Thailand's rural areas and with sufficient financial and related resources.
- Dynamic leadership with a clear vision and strong networks in the business and political communities is required to attract sponsoring companies. It should be noted that the initial concept of TBIRD was actually developed by the chairman of PDA; this doubtless contributed to the successful development of a dedicated unit within PDA.
- The TBIRD project developed an innovative project implementation process that emphasizes inclusiveness – involving all stakeholders. This has been critical in creating ownership among the rural villagers and contributing to sustainability.
- The previous experience of PDA in rural areas before TBIRD had resulted in the perception that PDA and its staff had high levels of integrity and a clear mandate to contribute to rural development through building linkages between business and the village communities.

The Cambodia Business Initiative in Rural Development

In an effort to stimulate CSR in Cambodia, the Asian Development Bank supported a technical assistance project in 2005 to facilitate the establishment of the Cambodia Business Initiative in Rural Development (C-BIRD) project, drawing on the experiences of TBIRD, similar projects in Cambodia, and additional research.[3] Supported by a task force of business and government leaders, NGO representatives,

[3]see Brimble and Kang 2006 and Brimble 2007.

and selected donors, the Ministry of Rural Development and a team mobilized and financed by the Asian Development Bank worked from July 2005 – March 2007 to develop the C-BIRD concept and implementation methods.

In particular, a C-BIRD Public-Private Partnership Task Force, chaired by H. E. Lu Lay Sreng, Deputy Prime Minister and Minister of Rural Development, was constituted to support the project implementation. It comprised: (a) senior representatives from Cambodia's main business associations – the Phnom Penh Chamber of Commerce, the Garment Manufacturers Association in Cambodia, the International Business Club, the Cambodia Hotels Association, the Association of Banks in Cambodia, and the Cambodian Federation of Employers and Business Associations (CAMFEBA); (b) senior representatives from the Ministry of Commerce, the Ministry of Industry, Mines, and Energy, the Ministry of Women's Affairs, the Ministry of Agriculture, the Ministry of Economy and Finance, and the Council for the Development of Cambodia; (c) representatives from interested NGOs; and (d) donor agencies as needed. The overall role of the task force was to steer the C-BIRD initiative, provide overall guidance on policy and institutional issues, facilitate the capacity building exercises, assist in developing pilot partnerships, and generally support project implementation.

The Cambodia Business Initiative in Rural Development developed as a program to connect businesses and rural society through innovative partnerships that leverage resources from both sides to develop sustainable income-generating activities for rural areas. C-BIRD provides benefits to the business side as well as the rural community. First, the involvement of staff members from the business enterprise has resulted in higher levels of morale. Second, the company has been able to achieve higher levels of corporate social responsibility. And third, to the extent that the C-BIRD activities relate to the core business of the company, either through deepening the supply chain or supplying raw materials or products to the company, the profitability of the company may also increase.

In the development of the C-BIRD project business plan, some critical lessons were derived from previous experiences in Cambodia:

- **Lesson 1: Business commitment is required.** The importance of business commitment cannot be overstated, and will depend, to some exten, on the type of C-BIRD modality being considered. Firms that develop activities that strengthen their supply chains – like BAT – are likely to have a strong commitment to the activity, as are firms that see C-BIRD activities as major elements of their corporate philanthropy programs.
- **Lesson 2: C-BIRD projects are not easy to implement.** C-BIRD projects often are complex, involve many stakeholders, and require considerable resources –

both financial and human – for successful implementation. This is especially the case in an environment like that in Cambodia – where business impediments are numerous and infrastructure is rather weak. In that case, a strong facilitator and high levels of awareness of the importance of C-BIRD type projects among the business community and the rural communities are required.
- **Lesson 3: A participatory approach is important.** Since C-BIRD projects are the initiatives of businesses from outside the village, using a participatory approach can help ensure that such projects fit the needs and demands of local people. In addition, a participatory approach is a tool that includes the needs of both men and women in the village.
- **Lesson 4: The village information base is critical.** Rural development is an erratic process. To eliminate or minimize the losses incurred by certain groups as well as to avoid misunderstanding among groups, it is critical to have a reliable, updated, and accessible information base in the village that communicates to both villagers and external stakeholders (businesses, government, NGOs, donors, etc.).

In order to meet the objective of developing C-BIRD and related activities, mainly through developing the structure of a business plan for the most suitable institutional mechanism, the following institutional options for the C-BIRD initiative in Cambodia were considered:
- Option 1: Form a new C-BIRD institution or NGO as the facilitator;
- Option 2: Use an existing NGO (or NGOs) as facilitator; and
- Option 3:Use a public agency as facilitator.

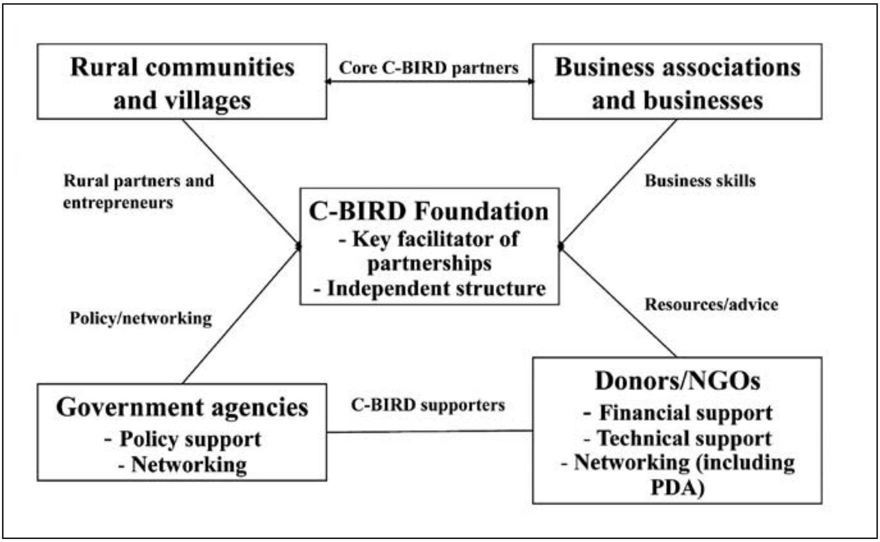
In the Cambodian context and on the basis of numerous interviews and deliberations in the task force meetings and a major national stakeholder meeting held in November 2005, option 1 was selected as being the most suitable. The Ministry of Rural Development was to play a transitional role in facilitating the formation of the new institution and in facilitating the implementation of selected sample C-BIRD projects. The project team therefore proceeded with this element of the project – the formation of the C-BIRD Foundation.

To guide the preparation of C-BIRD, a second phase of technical assistance commenced in December 2006 to prepare a draft C-BIRD business plan, a draft C-BIRD governance framework and strategy, a C-BIRD Foundation briefing paper, and some notes on fund raising. In addition, a C-BIRD retreat was held on January 18, 2007 to review the range of issues to be covered in the business plan and the governance framework, and then the first meeting of the C-BIRD Foundation was held on February 27, 2007.

A number of factors critical to success were identified to guide the achievement of the C-BIRD Foundation's principles and objectives:

1) Strong leadership with a business orientation;
2) Top-level commitment for C-BIRD;
3) Clear focus, mandate, objectives;
4) Need to engage business;
5) Development of information and capacity to interface with rural areas;
6) Good governance;
7) Networking with NGOs, donors, and other key stakeholders, likely through involving them on a board of directors;
8) Support from donors or other sources of finance for certain institution and project activities; and
9) Starting with manageable projects and with initial successes.

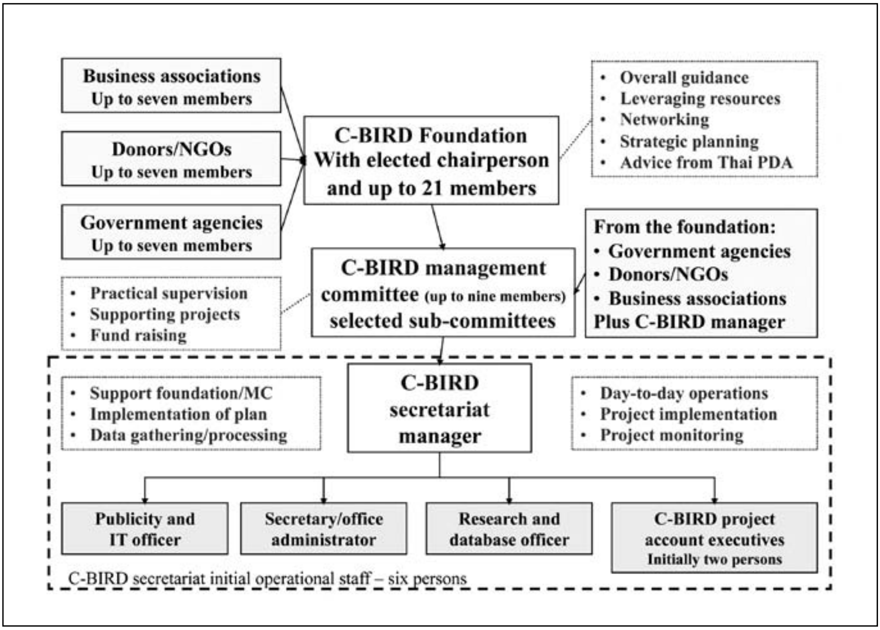
Figure 1: C-BIRD Institutional Context



The C-BIRD Foundation, as a newly created institution under the umbrella of NGO status, is intended to play a critical role as the facilitator of activities and resource mobilization among four key groups of players (and stakeholders) in Cambodia: the two key partners in any C-BIRD project – rural communities and villages, and business associations and businesses; and the two key supporters of such projects – government agencies, and donors and NGOs. These groups are illustrated in the institutional context chart presented in Figure 1, drawn from the C-BIRD Foundation business plan.

All key groups and stakeholders will be explicitly involved in the activities of the C-BIRD Foundation, either through direct involvement in the foundation or through proactive efforts to create additional mechanisms to link them into foundation activities. Figure 1 presents the roles and activities of key stakeholders and the contributions expected from each.

Figure 2: Structure of the C-BIRD Foundation



The proposed organizational structure for the C-BIRD Foundation is shown in Figure 2, drawn from the C-BIRD Fou ndation business plan. This structure is designed to support the full range of activities required to facilitate and support C-BIRD type projects in Cambodia, and to involve all key stakeholders explicitly in the C-BIRD Foundation implementation process.The C-BIRD Foundation comprises three levels as indicated:

First, the C-BIRD Foundation, with up to seven members from three of the key stakeholder groups: (a) business associations; (b) donors/NGOs; (c) government agencies. The C-BIRD Foundation will be a relatively large group in order to mobilize resources, networks, and influence. A chairperson will be selected by all members to provide direction to and lead the C-BIRD Foundation.

Second, the C-BIRD management committee, with nine members selected from the C-BIRD Foundation as well as the manager of the C-BIRD secretariat. The C-BIRD management committee will be more closely involved in the activities of C-BIRD and will establish a number of sub-committees to deal with specific issues. These sub-committees will be chaired by a management committee member, but could involve additional resources from the C-BIRD Foundation or from outside, if required and deemed suitable.

Third, the C-BIRD secretariat, which will be responsible for day-to-day operations of the C-BIRD initiative and will support the foundation and management committee in their activities. Figure 2 indicates an initial proposed staffing of the C-BIRD secretariat of six persons: the manager (who will play an especially critical role in running the C-BIRD Foundation), the publicity and IT officer, the secretary and office administrator, the research and database officer, and two C-BIRD project account executives.

C-BIRD Foundation Next Steps and Lessons Learned

A number of critical next steps need to be carried out in order to ensure that the C-BIRD Foundation achieves its ambitious objectives. At the present time, the project has not made the rapid progress that was anticipated at the first meeting of the C-BIRD Foundation. The critical issues are as follows:

- Urgent attention must be paid to raising funds to support the establishment of the C-BIRD Foundation and other matters (funding for basic setup and six months running costs should be a minimum – around US$50,000). This task appears to be difficult, with all parties waiting for the first move from another party.
- Immediate efforts must be undertaken to identify possible candidates and recruit the C-BIRD secretariat manager. This person will play a key role in moving all aspects of the C-BIRD Foundation ahead, including fund-raising.
- The structure of the management committee and sub-committees and definition of their roles must be finalized. Suggestions for possible sub-committees are presented in the draft business plan.
- The offer of the Population and Community Development Association (PDA) in Thailand to provide financial (US$10,000) and related support to the human resource development activities of the C-BIRD Foundation and related projects must be followed up.

Indicative Lessons Learned: Although it is a relatively small project, a number of useful lessons were learned from the implementation of C-BIRD activities:

- The initial C-BIRD task force was a valuable tool with which to mobilize a broad range of stakeholders to play a role in the innovative C-BIRD initiative. These included businesses and business associations, donors and development partners, and government policy makers.
- An innovative concept like C-BIRD has the potential to draw together a unique group of public and private institutions and individuals to focus on poverty alleviation, rural development, business linkages and skills, and related matters.
- There is strong potential for injecting valuable experiences from other countries through direct institutional involvement, as was done with the Population and Community Development Association from Thailand.
- It is important to allow for carefully selected pilot projects (such as the Business Guide for Emerging Entrepreneurs) to demonstrate the basic concepts of a project model, create greater awareness, and show the potential for scaling up project activities.

In order to provide a indication of the kinds of projects that C-BIRD could carry out, two sample *C-BIRD projects* are presented here – one of which (the business guide book) has already been completed with financial support from the Association of Banks in Cambodia and the Asian Development Bank.

Garment Remnant Utilization Project: The Garment Remnant Utilization or Creating Village Workshops and Income Generating Opportunities Project aims to take advantage of the willingness and ability of garment factories to make available remnants, scraps, machinery, and training to help groups of villagers set up small workshops that can make products from these materials – such as toys, cushions, children's clothes, etc. The Garment Manufacturers Association of Cambodia (GMAC) and selected garment factories and other groups would provide finance and training to the village groups, likely through micro-credit and small training programs. The project involves the provision of materials and equipment to the villagers, as well as assistance in identifying what types of products to produce and ways to market them. This project seeks to increase incomes in selected villages, create job opportunities in rural areas that will reduce migration to cities, link garment workers and their home villages, and create value-added applications for waste products and old machinery from garment factories. Garment factories and the GMAC will benefit from an image of corporate social responsibility.

Business Guide Book for Rural Communities: The Business Guide Book for Rural Communities or Promoting Understanding of Business among Rural Communities Project produced a written resource that assists rural communities in developing a better understanding of key business concepts and how to establish and run small businesses. The guide book was based on existing materials from the Stock Exchange of Thailand and other books and manuals on doing business, in particular for small and medium-sized enterprises. In a broader sense, the project aims to increase credit extension from financial institutions to rural micro enterprises/entrepreneurs and to strengthen the confidence of financial institutions in providing credit to rural micro enterprises/entrepreneurs. Project activities included the production and dissemination of a business guide book for rural communities. The expected impacts of the project are:

- Greater awareness among rural communities of business concepts and practices;
- Publicity for the Association of Banks in Cambodia and for C-BIRD among rural communities; the guide book will be a flagship project of the association; and
- Support to all rural communities that will become involved in C-BIRD type projects.

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Corporate Social Responsibility in Practice – Improving Working Conditions in Bangladesh

Peter Roggekamp

Bangladesh and its Economy

Bangladesh has made remarkable progress since its independence less than 40 years ago. The country produces enough food to feed its population; agriculture has diversified in recent years, improving the nutrition of the poorest part of the population, of which two-thirds live from agriculture. The other main drivers of the economy are the readymade garment (RMG) industry, which employs over 1.5 million workers, and remittances, mainly from the Middle East. Bangladesh is an important exporter of shrimps and has some emerging industries like pharmaceuticals.

According to official statistics, 40-50% of the population live below the poverty line. The growth that has changed countries like Thailand or Korea and is now changing China and India is not present in Bangladesh. The state is weak and only partly able to fulfill core tasks like security or basic education. This weakness has led to an economy where corruption and distortion rule and where regulation and direct stimulation of certain sectors is almost absent.

These unfavorable economic foundations have created industries that are not able to compete with the regional giant, China. Small workshops produce products that are inferior in quality and price. The majority of the 18 million inhabitants of the capital Dhaka earn their income from these small workshops, from trading and distribution, or from transport and construction.

Bangladesh is a perfect example of what happens in an economy when the state fails to regulate externalities. Investment and innovation are very limited and entrepreneurs are not really held accountable when they degrade the environment or create dangerous and unhealthy working conditions. This results in an economy where child labor is more the rule than the exception, where labor is a commodity that can be replaced if workers fall ill or injured, and where pollution of all kinds is visible everywhere.

Corporate Social Responsibility in Bangladesh

Companies in Bangladesh cope with the adverse conditions by staying small and invisible, or by becoming large economic conglomerates.

- But how do they deal with social and environmental externalities?
- Can these externalities be integrated voluntarily into enterprises' daily business operations in the Bangladesh reality?
- What are the incentives for companies, large and small, to do so?
- Can development partners like GTZ stimulate companies to do so?

The next pages will give some answers to these questions.

Social and family networks play an important role in the Bangladeshi society. Aided by strong religious principles, the networks raise expectations for people to act socially and responsibly in their private lives. Once people enter the economic world, these forces seem to largely disappear.

Pressure from consumers has become a strong force in reducing socially and environmentally undesirable behavior of enterprises in western counties. This pressure has spread to the two Bangladeshi export sectors, RMG and shrimps. Codes of conduct regulate working conditions and environmental impacts. German development cooperation, through the project for the Promotion of Social, Environmental, and Production Standards in the Readymade Garment Sector (PROGRESS), is active in improving the working conditions in the RMG sector, by using this western consumer pressure.

However, consumers in Bangladesh mainly worry about how to feed their families. Consumer pressure is rare, though some pressure is starting through the media. Katalyst, a program funded by three European donors and co-implemented by Swisscontact and GTZ, is assisting the media to play this role better. The program supports newspapers and television stations in their efforts to report on business issues by training journalists and by increasing the capacity of the media.

Awareness creation is a first step towards motivating companies to adopt a more socially responsible attitude. Katalyst has supported the creation of a forum on corporate social responsibility (CSR), where large companies interact and receive training on issues related to CSR. This CSR forum is funded by its private sector members and is operational. It is too early to say to what extent the center can motivate its member companies to deal with all their stakeholders in a socially responsible way, rather than simply "giving charity."

Child Labor and Working Conditions in Dhaka

Katalyst is working to stimulate pro-poor growth in many sectors of the economy by increasing the competitiveness of the private sector and supporting micro and small enterprises in a number of urban industrial sectors. However, it soon became apparent that by stimulating growth, Katalyst was also indirectly responsible for increasing child labor and negative working conditions. Over the last three years, the program has experimented with ways to reduce child labor and improve working conditions by way of sustainable mechanisms.

In the workplace improvement initiative, the program focuses on a few sectors in Old Dhaka, where there are tens of thousands of small workshops with old, dangerous machines. The workers rarely use protective gear and the workshops are full of half-finished products and waste. Bare electric cables often crisscross the rooms, and lighting is dim. Clean drinking water and sanitation are normally not available. Most workshops employ young boys.

As already mentioned, the state does not view it as a priority to improve working conditions, nor does the general public. However, most owners of workshops are worried about the working conditions in their workshops. Many are still working themselves or have worked in similar conditions in the past. A large number have had serious injuries, and they do not want their workers, often friends or family, to suffer a similar fate. How can these good intentions be translated into action?

Approaching the issue from a productivity angle could be an entry point. A number of studies have clearly confirmed the hypothesis that better working conditions can lead to higher productivity, so that improvements pay for themselves. Three mechanisms could be employed here:

- Workers are more productive in a positive environment.
- Better working conditions could attract better workers and keep them with the company longer.
- Better working conditions make it easier to control and improve quality.

However, Katalyst found that in most cases entrepreneurs in small manufacturing workshops in Old Dhaka are not willing to invest in protective gear or in other measures to improve safety and working conditions, even when they understand the benefits. If their financial situation allows, they would rather invest in equipment that has a higher return on investment. It is therefore not enough to simply raise awareness or to show entrepreneurs the way.

Katalyst has found a potential solution by looking at the incentives of other players in the value chain, by analyzing who else would benefit from improved working conditions in small workshops in Dhaka. Many small enterprises have relationships with larger enterprises. It was found, for example, that around half of the small workshops in Old Dhaka have a working relationship with large garment companies. If the garment companies benefit from better working conditions in their own factories, then they would also benefit from improved working conditions in their backward linkages – this would give them an even cleaner image.

Other players include the suppliers of inputs. These are often large companies that sell tools or products like welding electrodes. This group could embed safety information in their sales and in this way benefit from a safety image.

Katalyst looks for opportunities where the mechanism that improves the working conditions is sustainable in itself – where others are interested to improve the working conditions in small shops. These could be large companies who buy from the small shops or vendors of safety equipment; they could be trade associations or financial institutions. Below are some examples:

Rahimafrooz Batteries

Rahimafrooz is a company with a good reputation when it comes to working conditions and the environment. However, it took an intervention from Katalyst to make them realize that their supply line was not so clean. The top management was not even aware that most of the supplies and repairs came from small workshops. Rahimafrooz agreed to help some of its suppliers improve working conditions and to share the cost with the suppliers. Ventilation and lighting were improved, as were the layout of the machinery, housekeeping, and safe electrical wiring. The workshops agreed not to hire young children. All the companies gained. The suppliers got better working conditions, higher productivity and quality, as well as a more reliable client. Rahimafrooz gained reliable suppliers and, not unimportantly, a better reputation. Rahimafrooz may extend this arrangement to other suppliers. Other larger companies have also shown interest in similar plans.

The main role of Katalyst was opening the company's eyes to opportunities and match making.

Down-to-Earth Working Conditions

When asked, most workers in small workshops in Old Dhaka put a toilet and safe drinking water on the top of their priority list. The government never managed to place toilets in the hundreds of markets in Dhaka, but why do owners fail to build and maintain a toilet in their workshops? Here again, Katalyst was able to play the role of a catalyst. With its help, owners built a toilet and a safe water facility, but more importantly, owners were also helped to jointly maintain the facility. The first toilet was built in the Golden Park Market. So far, five nearby markets have followed this example and taken the initiative to install toilets and safe drinking water facilities that serve more than 1000 workers.

Safety as Part of Skill Development Training

The light engineering sector, one of the government's thrust sectors, is facing problems related to skilled lathe and milling machine operators and inefficiency due to machine related accidents. It therefore has problems producing quality products. Katalyst helped the Bangladesh Engineering Industry Owners Association (BEIOA) to arrange low-cost training for workers at their respective workplaces on the weekends. Through this arrangement, 250 workers from 20 workshops attained technical skills and better understanding of safe machine operating procedures. Based on the positive response, BEIOA has decided to continue this training.

Safety Fair

Many owners and workers may see the need for improvements in working conditions, but do not know where to start. Vendors of safety equipment normally sell to large companies only. With the sponsorship of two large companies, Katalyst organized a road show, through which 12 safety and health product vendors met with around 10,000 workers and owners of small workshops. The show was made more attractive through comic skits, a photo booth, first aid instruction, and celebrity guest speakers.

Working Conditions attached to Loans

Owners are often more interested in loans than in working conditions, but these do not need to be mutually exclusive. The Sajida Foundation, a micro finance institute in Old Dhaka, now appraises aspects of the working conditions of its borrowers. As a startup activity, a day-long workshop organized by Katalyst acted as an eye opener for 23 loan officers of the Sajida Foundation. The workshop explained the importance of assessing safety, health, and environmental aspects to reduce occupational-hazard-related risks and so to maximize loan recovery. The Sajida Foundation has the vision to incorporate working conditions as one of the prime loan eligibility criteria and to discuss these issues during weekly meetings with its 1300 enterprise borrowers.

Safe Food for All

The quality and hygienic standards of the food stalls where workers get their lunch and dinner are not contributing to a healthy and productive workforce. In general, small confectionaries, bakeries, and restaurants in Bangladesh are not aware of and therefore do not practice safe food handling procedures. In 2006, the government created a mobile court that has fined many of them. Together with a non-governmental organization called CaP & HuRDI, Katalyst has supported two restaurant and food producer associations in training 200 owners of food outlets and organizing a safe food fair.

Final Remarks

Poverty and a weak state are two key obstacles to corporate social responsibility in Bangladesh. Owners of micro and small enterprises in Dhaka are in favor of improving working conditions, but have other priorities. With some creativity, however, there are many ways to reduce child labor and sustainably improve working conditions in these workshops.

There are ways in which corporate social responsibility instruments can be used in cases where the state is too weak to set up proper systems for social balance, as the above examples show. Social values among the owners of small and medium-sized enterprises could very well provide the required readiness for strategies that support a better integration of the poorer parts of society into the growth process. Even if CSR may not be an alternative to institutionalized government systems of wealth redistribution, these are very promising examples of potentially powerful instruments that combine economic growth with social responsibility within the domestic sector of developing countries.

Social Security in Karnataka

D. Rajasekhar and Namerta Sharma[1]

Introduction

The Indian state of Karnataka is not only known for its famous capital city of Bangalore –Indian's Silicon Valley; it has also earned a good name for passing path-breaking legislation on democratic decentralization in the mid-1980s, thus creating space for civil society institutions to emerge and make a positive impact at the national and international levels, and for the formation of a large number of people's organizations (such as self-help groups [SHGs[2]], water-user groups, etc.). But, compared to its neighboring states of Kerala and Tamil Nadu, Karnataka is not well known when it comes to the provision of social security to unorganized sector workers, despite the fact that Karnataka has been one of the fastest growing Indian states in the recent past.

The state domestic product in real terms grew at 8.7% in 2005-2006 and at 11.4% in 2004-2005. This translates into 10.8% per capita growth in 2004-2005 and 7.7% in 2005-2006. Between 1993-1994 and 2004-2005, real growth in Karnataka was almost 9%, largely on account of the growth of industry and services. Industrial growth was led by rapid expansion in manufacturing; growth in services, which was high across the board, was led by software exports. Karnataka has also been one of largest recipients of foreign direct investment among major Indian states.

However, the high growth has not been equitably distributed among all the sections. Although Planning Commission figures show that the incidence of poverty in Karnataka has declined from around one-third in 1980s to 17% in the year 2000, the poverty incidence was considerably higher among Scheduled Caste households (26.2%) and among Scheduled Tribe households (25.5%). Although some of the

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[2]SHG is a small (with around 15 members) and homogenous (members belonging to similar socio-economic background) group often undertaking micro-finance (small savings and loans) activities in India. The group will enable the members to undertake planning, implementation, and monitoring of development activities including micro-finance. The potential for self-management, good governance, and self-reliance is known to be high among SHGs because of their small size and homogeneity.

industries in Karnataka have registered significant growth in terms of export earnings, the workers have not been paid statutory minimum wages and social security benefits (Rajasekhar and Suchitra 2006 and Rajasekhar and Manjula 2006). The workers have, therefore, been finding it difficult to meet livelihood needs and maintain safeguards against contingencies that result in stoppage or loss of income. In fact, the recourse to practices of informal work contracts with laborers has intensified since the liberalization policies introduced in 1991; manufacturers justify such practices on the grounds that they need to have a competitive edge in the international market.

As a result, the unorganized worker component in the labor force has been growing in the last one-and-a-half decades. In 2001, the total workforce in Karnataka was 23.5 million. As is the case elsewhere in India, much of the workforce is in the unorganized sector. Unorganized or informal workers in India do not have formal contact with the employers and/or are characterized by an absence of an employer-employee relationship. Further, they do not often obtain minimum wages and social security benefits.

Unorganized workers comprised 91.9% of the workforce in 2004-2005. While the proportion of unorganized male workers to total male workers was 90%, that of unorganized female workers to total female workers was 95.3%. The incidence of poverty was higher among urban unorganized non-agricultural workers (31.1%) as compared to their rural counterparts (7.7%). The mean years of schooling were 3.6 for female rural unorganized workers, while it was 5.4 for male rural unorganized workers. The mean years of schooling were higher for their urban counterparts; 7.3 for males and 4.5 for females (NCEUS 2006). Thus, not only is the number of unorganized sector workers large in Karnataka, but they also suffer from widespread poverty and human development deprivation. This was especially the case with women unorganized workers.

Thus, although the growth rates in Karnataka have been very high, they have not resulted in trickle-down effects and improvement in the livelihood of poor unorganized workers. Further, the workers do not have any safety and security against contingencies (such as illness, accident, old age, maternity, and death) that result in the loss and stoppage of income. In this context, an effective and efficient social security system would be a key instrument of the social market economy to improve this situation. In line with the values of the social market economy, the Karnataka government has been making efforts to soften income gaps, redistribute income, and ensure that social harshness is avoided for the vast majority of the unorganized workforce.

The program *Social Security Benefits for Unorganized Workers, Karnataka* to be implemented by the Karnataka government with support from the German

Federal Ministry for Economic Cooperation and Development, is one such effort. This program, based on years of preparatory work, promises to be different in its approach and institutional mechanism. The experience gained through this program will be relevant for other states in India and other developing countries.

Against this background, the present paper examines the formal social security schemes in Karnataka state, social security needs and contribution capacity of unorganized workers, as well as an Indo-German technical cooperation program that will be implemented jointly by the Department of Labor, Karnataka and the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ). This program will be introduced in the state from 2008 onwards.

Formal Social Security Benefits for Unorganized Workers in Karnataka

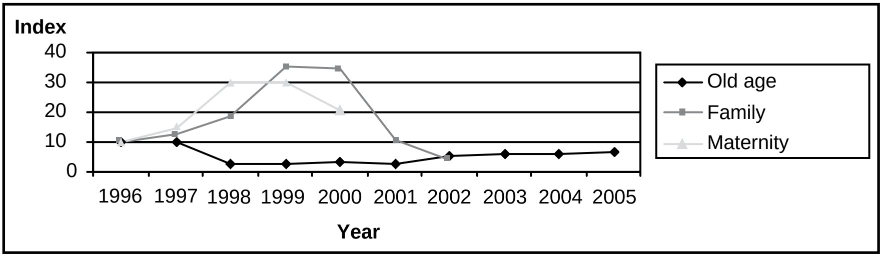
The social security benefits provided by the Karnataka government can be divided into three types: social assistance, social insurance, and other programs. In this section, we take a critical look at the first two.

Social Assistance

Five social assistance schemes in Karnataka are being implemented for households living below the poverty line (hereafter BPL households); old age pensions, maternity benefits, family benefits, disability pensions, and widow pensions. While the first three are central-government-sponsored schemes, the last two are state schemes. The amount of old age pension, which until recently was Rs. 75 per month, went up to Rs. 200 per month in 2006-2007. An amount of Rs. 10,000 is provided as family benefit to households that lose the principal income earning member in an accident or through natural death. The amount of maternity benefit is Rs. 500 per birth up to two live births. The widow pension is Rs. 75 per month per beneficiary. The amounts of the benefits are, thus, paltry – ranging from as low as €1.5 in the case of old age and widow pensions to €9 in the case of maternity benefits.

Figure 1 shows that the performance of social assistance schemes in Karnataka, in terms of number of persons assisted, varied over the period. Old age pension has been the largest program. The number of persons assisted, which was about 800,000 persons in 1996-1997, declined steeply in the late 1990s and picked up from 2001-2002. In contrast, the number of persons assisted under family

Figure 1: Index Values of Number of Beneficiaries under Assistance



benefit and maternity scheme, 1146 and 11,730, respectively, in 1996-1997, increased in the late 1990s and declined thereafter.

Which factors influenced access to social assistance schemes in Karnataka? First, financial constraints compelling the state government to tighten the eligibility criteria resulted in restriction of old age pensions to only the destitute among BPL households and exclusion of a large number of unorganized workers living in vulnerable condition. Second, the poor access to old age and widow pensions was due to low levels of awareness of the schemes – eligibility conditions, whom to approach, and how to approach – and difficult documentation requirements. These, together with poor responses from the concerned officials and the high opportunity cost of wage labor income foregone in going around the government offices, forced unorganized workers to depend on middlemen and spend considerable amounts in the process. Third, the access to maternity benefits has been adversely affected by the mandatory rule of institutional delivery. However, accessing institutional delivery of meager amounts of maternity benefits is costly for the poor, as it involves costs of travel and accommodation at a distant place for a few days. Finally, weak bargaining power on account of limited membership in trade unions and people's organizations such as SHGs has adversely affected access to social assistance schemes.

Social Insurance

In the year 2000, a group-based social insurance scheme, called the Janashree Bhima Yojana (JBY), was introduced in Karnataka for persons in the age group of 18 to 60 belonging to BPL households. The insurance cover provided is up to Rs. 20,000 in case of natural death, Rs. 50,000 in case of accidental death or permanent disability, and Rs. 25,000 in case of partial disability. An innovative feature of the scheme has been that two school-going children of insurers are provided with scholarship of Rs. 100 per month to complete school education. Of the Rs. 200 annual premium, 50% is a subsidy from the central government.

Two striking positive features of the scheme are improved coverage of unorganized workers (Table 1) and an over 60% renewal rate (Rajasekhar and Suchitra 2006). These can be attributed to the following: First, being a group based scheme, it is largely SHGs which have accessed the scheme in the state. While the motivation and follow-up work by NGOs contributed to improved coverage, peer pressure in the group improved renewal rates. Second, the scholarship scheme has been the principal mover to sustain the renewal rates. The lower and declining claim ratio (Table 1) can be attributed to the responsibility given to SHGs in assessing the claims and submitting the same to the higher level authorities. Two lessons can be learnt in this regard. First, social security schemes implemented through SHGs are likely to result in good outcomes in terms of improved coverage and lower incidence of adverse selection and moral hazard problems. Second, social security products need to be innovative, as in the case of JBY, which sought to combine life and disability insurance with scholarships for school-going children.

Table 1: Progress in the Coverage of Social Insurance Scheme in Karnataka

Years	Number of lives	Number of claims	Claim ratio	Amount (Rs. 1000) claimed	Per capita benefits (Rs.)
2002-2003	38,470	518	1.35	10,720	20,695
2003-2004	68,511	608	0.89	12,540	20,625
2004-2005	168,231	880	0.52	18,035	20,494
Total	275,212	2006	0.73	41,295	20,586

The scheme would have had better coverage if the following problems have been taken care of: First, awareness of the program has been found to be low. Rajasekhar, Manjula, and Suchitra (2006) found that only less than 5% of a sample of unorganized workers in Karnataka were aware of it. Second, by extending the benefits only to BPL households, the scheme ignored heterogeneity among unorganized workers. While all the BPL households are likely to be in the unorganized sector, the reverse is not necessarily true. The BPL criterion is a very minimalist and inappropriate approach to extending social security to unorganized workers (Rao, Rajasekhar, and Suchitra 2006). Finally, the poor are skeptical of contributing to a scheme when they realize that they will not get any returns unless and until the eventuality for which they have taken the insurance occurs. Since the JBY is not designed as a money-back scheme, the people prefer savings elsewhere.

Social Security Needs and Contribution Capacity of Unorganized Workers

The state of Karnataka has been showing interest[3] in initiating appropriate, effective, and sustainable social security benefits for unorganized workers. The state government prepared the Karnataka Unorganized Workers Welfare Bill in 2002, but this could not be implemented[4] as the policy makers felt that they did not have adequate information on appropriate social security products, how to initiate and strengthen effective social security systems, and how to sustain the same.

The Karnataka government has, therefore, requested GTZ to undertake studies on design and management of social security benefits for unorganized workers. GTZ initiated three studies and the results of these studies are available in Rajasekhar, Suchitra, Madheswaran, and Karanth (2006); Rajasekhar, Manjula, and Suchitra (2006); and Rajasekhar, Suchitra, and Manjula (2006). These studies collected primary data from 505 agricultural laborers, 301 construction workers, 104 garment workers, 151 *agarbathi* (incense stick) rollers, and 152 domestic workers, and covered both female and male workers belonging to rural as well as urban areas.

The data collected by these studies are used here to show the priority social security needs of unorganized workers. Using participatory rural appraisal techniques, the workers were asked to prioritize the needs. As evident from Table 2, unemployment benefits, old age pensions, and medical benefits (sickness) were the three key needs, but the priority assigned to each of these needs differed across the occupational groups. Old age pensions were preferred by agricultural laborers, agarbathi rollers, and domestic workers, while construction workers assigned priority to unemployment benefits[5] and garment workers to health insurance (sickness).

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[3]For example, the Yeshaswini Health Insurance Scheme, which was introduced in Karnataka in the year 2002, successfully covered over two million agricultural laborers and small and marginal farmers under contributory health insurance in 2004-2005. The International Labor Organization is providing some support to this. The World Bank is also planning to introduce a contributory health insurance scheme in the state.

[4]The Karnataka Legislative Council referred the bill to the select committee of the legislature to discuss and recommend whether the bill in its present form could be enacted in the legislature. The select committee, after detailed deliberations, could not reach a decision on this.

[5]Unemployment benefits here do not mean doles to workers during times of unemployment. Unorganized workers interpreted this benefit to mean an employment guarantee. And rightly so, since for these workers, unemployment was not really a contingency but rather a way of life. Not surprisingly, between 25 and 32.48% of workers across work categories assigned highest priority to this need.

Table 2: Distribution of Unorganized Workers (%) by Highest Priority Assigned to Social Security and Worker Category

Social security needs	Agricultural workers	Construction workers	Domestic workers	Agarbathi rollers	Garment workers
Unemployment	32.48	29.90	25.00	25.00	33.33
Sickness	9.50	12.29	11.54	17.57	49.33
Employment injury	7.72	22.92	5.77	2.70	4.67
Old age pensions	35.64	24.92	36.54	39.86	12.67
Death	5.15	6.64	10.58	14.86	0.00
Did not rank	9.51	3.33	10.57	0.00	0.00
Total	505	301	104	148	150

The above studies also found differences in preference for social security across regions, sex, age, and occupational groups. A greater proportion of workers from backward districts preferred unemployment benefits, while those from developed areas preferred old age pensions. The need for unemployment benefits was greater for women workers than for their male counterparts. Old age pensions were preferred by workers in the above-40 age group, while unemployment benefits were more highly preferred by younger workers. Households with higher education levels showed a higher preference for old age pensions, while the less educated households indicated a higher preference for unemployment benefits. Benefits for employment injury were strongly preferred by construction workers – a highly risk-prone group.

More than 60% of the workers were willing to contribute to social security benefits, if they were reliable, effective, and efficient (Table 3). The proportion of workers willing to contribute varied across the different sectors, depending on economic conditions of households and coverage under existing insurance schemes. The minimum, maximum, and average amounts that workers were willing to contribute towards their first priority social security need also varied across work categories.

Table 3: Willingness to Contribute to Social Security and Amount of Contribution

Worker categories	Proportion of workers willing to contribute	Amount (Rs. per annum) that workers were willing to contribute towards first priority social security need		
		Minimum	Maximum	Average
Agricultural laborers	67.30	25	3000	624
Construction workers	82.00	100	9600	1092
Domestic workers	73.00	100	2400	906
Agarbathi workers	68.42	240	6000	1106
Garment workers	78.15	240	12000	1246

A good number of workers were unwilling to contribute to social security, as they belonged to households whose basic needs had not been adequately met. Such households were often the poorest and headed by women. For these workers, therefore, there is a need to facilitate reliable access to state social assistance and insurance programs, as well as ensure satisfactory fulfillment of basic needs, both of which are currently lagging, in part due to the poor institutional mechanisms for implementing the schemes.

Important social security needs among unorganized workers in Karnataka are, thus, old age pensions, employment injury assistance, and health insurance. A significant proportion of the workers were willing to contribute towards social security, as against the widespread belief that they are not keen to join in a contributory social security scheme and that unorganized workers want free social security benefits. Rajasekhar, Suchitra, Madheswaran, and Karanth (2006) suggest that unorganized workers can be divided into two categories based on willingness to contribute and amount of contribution: first, those who cannot contribute to social security or need subsidies and, second, those who are in a position to join contributory social security schemes initiated by private insurance companies.

Indo-German Technical Cooperation Program on Social Security Benefits for Unorganized Workers in Karnataka

The foregoing discussion on the existing social assistance and insurance schemes, and findings of studies initiated by GTZ suggest the following:

- A fragmented approach has been adopted to provide social security benefits (both promotional and protective). Social assistance and insurance schemes have been made available only for the BPL households. As Rolf Sülzer's paper in this reader shows, the households above the poverty line are not "rich" either. This implies that there is a need to cover all unorganized workers, whether they are in BPL households or not. The poorest unorganized workers may not be in a position to join in contributory schemes in the short-run; but, a viable strategy would be to include them in a social security system to bring them to threshold income levels and enable them to join the contributory social security schemes. As the funds allocated to social security are spread out across the departments and schemes, there is a need to converge the resources.
- The discussion on social security needs showed that unorganized workers have diverse social security needs and are willing to pay for social security if it is relevant, reliable, effective, and efficient. This implies that diversity in terms of social security needs and contribution capacities has to match with social security interventions that are flexible, relevant, and effective – and that one-size-fits-all policies and implementation procedures would not work. Here lies the crucial challenge: Which organization at the local level can partner with the government to capture the social security needs of the workers, present them to higher levels, and secure them? This can be done better by people's organizations such as SHGs and village level decentralized governments (called *gram panchayats* in India), which have considerable informational advantages.
- Our analysis of social insurance programs in this paper showed that when multiple actors (government, insurance companies, people's organizations such as SHGs, and civil society organizations such as NGOs) are involved in the planning, implementation, and monitoring of the program, the outcomes tend to be good. People's organizations such as SHGs and civil society institutions such as NGOs, trade unions, etc. have better information with which to organize the unorganized workers at the local level, motivate them to join in a contributory scheme, and facilitate the provision of social security (both promotional and protective). The government can provide an appropriate legal framework and viable institutional structures and can manage the programs. The involvement of insurance companies would enable private-public partnerships to be created and ensure that the needed technical expertise is incorporated into the social security systems.

- As Rolf Sülzer argues in his paper included in this reader, the success of social security systems will depend on how well they use the information technology (for which India is now famous) for the management and delivery of social security benefits. The issues of lack of information on schemes, inadequate coverage (across social groups, rural and urban areas, accessible and inaccessible villages), inappropriate benefits, limited access to benefits, etc. can be dealt with very effectively by providing social security numbers, facilitating smart-card based registration, making information accessible through internet, etc.

Learning from the above and positively influenced by the willingness of unorganized workers to pay for social security, the Department of Labor, Government of Karnataka, approached the German Government about funding a pilot project to introduce social security benefits for unorganized workers. The German Government (BMZ) has agreed to provide technical cooperation to the Karnataka government through GTZ. A pre-appraisal mission (consisting of representatives from the Karnataka government and GTZ) was constituted to refine the project proposal of the Karnataka government. After careful consideration of the situation of unorganized workers with regard to accessing existing formal social security schemes, the findings of GTZ-initiated studies, and the macro environment with regard to social security provision in India, the pre-appraisal mission designed a five-year program, Social Security Benefits for Unorganized Workers, Karnataka. This program will be implemented by the Department of Labor with technical support from GTZ, Germany, while InWEnt, Germany, will provide support for capacity building activities.

About the Program

The overall goal of the program is that "selected groups of unorganized workers in selected districts in Karnataka have access to efficient and improved social security systems." Key outputs expected from the program are:

1) Appropriate social security products for the unorganized sector are developed.
2) Delivery structures for implementing social security systems are established and working efficiently and effectively.
3) All actors involved in the program are qualified to implement social security systems.
4) Social security products for unorganized workers reduce their vulnerability and improve their living standards.
5) A comprehensive concept of social protection is developed for Karnataka.

The target group (in other words, *direct beneficiaries)* of the program will be unorganized workers in the selected districts and occupations in Karnataka. The program has recognized that unorganized workers are heterogeneous and that it is illogical to assume that a particular type of policy would be applicable to all these workers. Therefore, the program will concentrate on different *worker groups* and develop social security products/packages that are most suited to their needs. During the first phase of the program, social security products/packages will be developed and subsequently promoted for construction workers, domestic workers, agarbathi rollers, garment workers, and agricultural laborers. The risks of health, accident, disability, and old age will be covered.[6]

The *organizational structure* to implement the program includes public and private organizations at different levels – the state, district, and gram panchayat level. While the Department of Labor will be the counterpart of GTZ in this program and the main implementing agency, the other stakeholders will also find a prominent place in the implementation structure. The social security program will work closely with representatives of relevant government departments such as the Rural Development and Panchayat Raj Department, Health Department, Employees State Insurance Corporation, and Employment Provident Fund. *Intermediaries* will be trade unions, non-governmental organizations (NGOs), insurance providers, microfinance institutions, etc. At the village level, the main actors implementing the program will be local decentralized governments and SHGs. The program will also cooperate with academic and training institutions in undertaking policy-oriented research studies and in providing capacity building inputs.

Apart from the steering committee at the state level and workers' facilitation centers that will be established at the district and gram panchayat levels during the first program phase, most of the stakeholders are already active and willing to support the program measures.

Having provided a brief note on the program, let us now discuss the key design features. We shall show below that the program has taken the key debates relating to social security provision in the country into account and considered the lessons that have emerged.

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[6]Maternal and unemployment benefits have also been considered by the program. However, as Karnataka is pushing for implementation of the National Rural Employment Guarantee (NREG) Act, tackling the risk of unemployment in this program might interfere with this highly welcome initiative. The need for maternal benefits was ranked surprisingly low among the women of the cohort study, underlining the fact that other risks were considered more important threats.

Target Group

The program plans to work with about 600,000 unorganized workers and about 20,000 SHGs in five districts of Karnataka. The program localities are diverse in agro-climatic endowment factors – one is a coastal district, while another is a semi-arid district. A third is a highly irrigated district, with better possibilities for workers to contribute, the fourth is a transient district with less possibilities for contributions. The fifth district is Bangalore city itself with a high concentration of unorganized workers. The diversity in these districts will provide an ideal situation for piloting the social security program.

The unorganized workers to be covered under the program would mostly belong to five occupational categories – agricultural labor, construction worker, domestic help, garment worker, and agarbathi roller. There will be equal focus on male and female unorganized workers in the program. While most of the agricultural laborers and garment workers are women, a majority of the construction workers are men. Domestic work and agarbathi rolling is almost entirely confined to women.

The program will cover both rural and urban unorganized workers. While agricultural laborers are predominantly from rural areas, other categories of workers are mainly or solely from urban areas.

There is a good mix in the target group in so far as the contribution capacity and levels of organization are concerned. The proportion of agricultural laborers and agarbathi rollers willing to join in a contributory scheme has been low compared to construction and garment workers. The amount of the contribution is also less in the case of agricultural laborers, while it is more in the case of construction and garment workers. The other two categories fall in between. Construction workers are better organized as compared to the other worker categories.

Program Approach

Unorganized workers are divided into two groups on the basis of their capacity to contribute to social security. The first category consists of those workers who have potential to contribute to social security and join in the schemes implemented by insurance companies. The second category consists of those who cannot afford to contribute to social security or have limited ability to contribute.

The program will cover both categories. The program will improve access to appropriate social security products in the case of workers in the first category and establish social security delivery structures which are efficient and effective. The program will assess their priority social security needs, develop suitable social security products/packages, link them with insurance companies, etc.

In the case of the latter category, the program will identify and organize the workers. The program will subsequently link them with the existing government social assistance programs and improve their economic status by enabling them to access promotional social security. It should be noted that this group has not succeeded in meeting basic needs such as subsidized food, housing, education, access to public health, etc., due to factors such as lack of information and organizations among them. Their livelihoods are also affected by unemployment, low wages, and lack of opportunities to diversify into non-agricultural activities. The program will seek to link them with the National Employment Guarantee Program that is being implemented by the government to promote employment among them. By providing information and converging resources at the village level, the program will strive to link workers with the existing programs that aim to help the poor start income-generating activities and provide social assistance/insurance. Once this group succeeds in improving its access to government programs that provide basic needs, social assistance, and insurance, workers will be in a position to join contributory social security schemes.

The approach is, thus, to enable the second category to reach a stage at which they can be linked to protective social security schemes offered by the insurance companies. This approach will contribute toward the coverage of most of the unorganized workers and will also overcome the weakness of the earlier approach of covering only the unorganized workers belonging to BPL households.

Implementation Structure and Arrangement

The implementation structure and arrangements are such that the government, civil society, and the private sector will be involved in implementation of the program. The Department of Labor will implement the program in collaboration with different stakeholders such as trade unions, NGOs, SHGs, employer organizations, insurance companies, academic and training institutions.

At the state level, a steering committee will be formed to undertake the functions of overall implementation of the program, overall monitoring, negotiations with insurance companies, and facilitation of a congenial convergence of existing government schemes for social security in the unorganized sector (such as social assistance and social insurance schemes). The steering committee will include representatives from the relevant government departments, insurance companies, employers' associations, trade unions, academic institutions, etc.

In line with the draft national bill on social security benefits for unorganized workers, the program has made provision for workers' facilitation centers at the district and village levels.

The District Workers' Facilitation Center, which will to be formed in the first phase of the program, will undertake the functions of registering unorganized workers, facilitating favorable conditions for convergence of resources, facilitating the provision of training, and signing social insurance contracts with public or private insurance companies. It will be a working unit attached to the district administration. The center will work in close collaboration with stakeholders like the Workers' Welfare Board, civil society organizations, trade unions, and NGOs. There are plans to staff the center with representatives of these stakeholders. Moreover, these stakeholders will be provided with a statutory confirmation of their functions. The center will maintain working relationships with line departments and the insurance companies as additional stakeholders.

At the village level (gram panchayat – the last layer of local governance), the workers' facilitation centers will be established as a sub-committee of the gram panchayat (GP). Since the start of decentralization in the early 1990s, the GP has gained momentum and importance in India as a service provider for the rural population. GPs are responsible for preparing their own budget plans and implementing them in their areas of jurisdiction. On average, a GP is responsible for 5000 inhabitants in Karnataka. They implement various anti-poverty programs initiated by central and state governments. They also have a constitutional mandate to provide social security to workers. In the context of the program, the GP will become the main direct provider of social security services to its population. This is important in the Indian context because this will provide the needed constitutional backup and sustainability to the workers' facilitation centers. This is also in line with the decentralization reforms occurring in India.

Key Functions to People's Organizations

The representatives of SHGs (consisting of unorganized workers) will be members of the workers' facilitation center at the village level. SHGs can be understood as informal groups of workers that negotiate with manufacturers, employers, and salespersons of different products (agarbathis, beedis [local cigarettes], etc.) or services (construction, domestic services, etc.). It is estimated that the program will work with around 20,000 SHGs in the program area.

The Department of Labor-GTZ program will not spend resources for the formation of SHGs; in stead, it will utilize the SHGs that have already been formed by the government and NGOs in the program localities. It is important to be familiar with the SHG movement in the state to understand the density of SHGs in the state. Many NGOs have been making efforts to form SHGs in Karnataka since the mid-1980s. The SHG movement received considerable support through the NABARD SHG-Bank Linkage Program, which was piloted in the state in the early 1990s. The number of SHGs in each district registered significant increase during the decade of 1990s, largely on account of NGO efforts. The micro-finance program started by the state government in 2000 aimed to form 100,000 SHGs in the state. It has been estimated that there are 3000 to 10,000 SHGs in each of 29 districts in the state today. A recent study of 80 villages and urban wards in Bidar and Chamarajanagar districts showed that there are 5 to 50 SHGs in each of these villages (Rajasekhar et al. 2007). Thus, the number of SHGs has rapidly increased in the state, and the incidence of SHGs at the village level is high.

The SHGs will be the basic group interface of unorganized workers with the upper layers of the workers' facilitation structures and with insurance companies. Insurance will be provided as a group policy. The SHGs will keep the records, collect the contributions, send them through commercial banks to the insurance companies, and receive claim payments. Transaction costs for these services are expected to be low for the following reasons:

- Each SHG has a bookkeeper, the services of whom can be availed of for this program as well.
- As it is planned to collect contributions in group meetings, costs of collection are expected to be minimal.
- The cost of sending the premium to insurance companies via bank accounts is again expected to be minimal, because SHG members will in any case have to visit banks to deposit their savings.

The functions of the workers' facilitation center at the village level are:

- identifying and enrolling unorganized workers;
- categorizing the workers into two groups, namely, those who can contribute and those who cannot;
- facilitating participatory decision-making processes;
- facilitating collection and deposit of contributions;
- collecting claims and facilitating timely settlement of claims;
- providing social assistance and social insurance schemes in a timely manner;
- facilitating convergence of resources; and
- addressing grievances and resolving conflict (arbitrage).

E-governance

It is important to institutionalize and strengthen transparent mechanisms for putting effective and sustainable social security systems in place. Towards this end, the program will adopt e-governance (including smart cards and unique social security numbers) for the identification and enrolment of unorganized workers, and also in the provision of social security benefits.

Knowledge Centers at the Village Level

We noted in the first section of this paper that unorganized workers do not have adequate information on the existing social assistance and insurance schemes. Consisting of representatives of village level organizations (most of whom are illiterate), gram panchayats and others, the workers' facilitation center at the village level is expected to facilitate a process in which unorganized workers are empowered to obtain resources provided by the government, not only for social security (promotional and protective) but also for their economic development. Towards this end, the village level workers' facilitation center will provide information to unorganized workers on all social assistance and insurance schemes as well as poverty alleviation programs and schemes. It will also strengthen their capacity to access these schemes by strengthening their skills through need-based training programs.

Such information centers will not only provide information on what schemes and programs are already available, but will also help the workers access these as a matter of right. This will facilitate transparency and help develop voices for accountability from below.

Role of Civil Society Organizations

In this program, NGOs will provide services to the SHGs and function as intermediaries between unorganized workers/SHGs, on the one hand, and the state administration and insurance companies, on the other. The NGOs perform advocacy functions on behalf of the unorganized workers with regard to state policy, legislation, regulations, and enforcement. The NGOs operate primarily at the district and village levels. In the program context, they are likely to become the signatory partner for insurance companies in respect of micro insurance policies for different groups of unorganized workers.

Trade unions will also be involved in the program. They are expected to undertake advocacy functions on behalf of unorganized workers with regard to state policy and the legal framework for social security.

Public-Private Partnerships

Public-private partnership is an important feature of the program. Insurance companies are stakeholders in the program with regard to product development and delivery. The steering committee at the state level will negotiate best products and prices with the insurance companies. NGOs and SHGs will be the partners of insurance companies for operational issues.

Conclusion

In the design of the program on social security benefits for unorganized workers in Karnataka, the Karnataka government and GTZ have taken into account the factors that constrain the access of unorganized workers to the existing formal social security schemes, as well as diversity in social security needs, contribution capacity, and amounts of contribution. The program, thus, has all the ingredients to become a successful pilot program and influence policies relating to the provision of social security to unorganized workers.

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The Role of Social Protection within a Social Market Economy

Katja Bender

Social protection refers to the entire system of protective measures that assist individuals, households, and communities to better manage risks and economic shocks and that provide support to the critically vulnerable. Among the major risks covered are illness, accident, death, unemployment, or old age. Social protection includes public as well as private approaches.

Insufficient social protection can have a disastrous effect and impoverish people – or drive them deeper into poverty. However, especially in developing countries, the majority of people do not have adequate social protection coverage.

Improving social protection coverage has the potential to contribute to poverty reduction in many ways: Social protection *protects* individuals from the adverse financial consequences of the above mentioned calamities. It thus prevents people from becoming poor or falling deeper into poverty (protection function). In addition, social protection entails an income generating effect and reduces prevailing poverty by *enabling* productive investments in human capital (investment function). For example, social health protection allows individuals to invest in health by facilitating access to health services. Another example are cash transfers, a form of basic social protection, which help to break the vicious intergenerational cycle of poverty by improving the health and nutritional status as well as education level of beneficiaries, thereby increasing the likelihood of better future employment opportunities for children. By reducing the existential fears of members of society, social protection policy encourages individuals to take risks which otherwise they would not be willing to take, like investing in new business opportunities. Further important benefits of social protection accrue from a reduction in the use of inefficient risk-coping methods like selling productive assets or taking children out of school. Finally, mutual protection against social risks strengthens the bonds of cooperation and reciprocity, thereby enhancing social stability and social cohesion.

A system for social protection is inevitably linked to the concept of a social market economy. The social market economy aims to achieve a synthesis between efficiency and equity by combining the efficiency gains of a free market economy with a publicly induced social balance. In this context, the constituent feature of a social market economy is the complementary character of two distinct orders: the economic and the social order. The economic order provides the institutional framework for a free market economy (including, for example, private property rights, competition policies). It emphasizes the individual responsibility of all members of a society, who participate in society's wealth according to their individual contributions to its creation. The economic order is complemented by the social order. The provisions of the social order are oriented towards the needs of society's members and also attempt to provide equal opportunity. Besides solidarity with the needy, the principle of individual responsibility justifies only subsidiary public action. A system of social protection forms an integral component of the social order.

Subsidiarity, which combines individual effort and self-responsibility with collective (societal) support guided by solidarity, is the overarching principle of the social market economy. This major principle is also reflected in the setup of social protection within a social market economy: generally speaking, provisions against risks should always be the responsibility of the most basic unit possible, ranging from the individual and the family up to the different levels of the state.

Social protection within a social market economy is usually characterized by the so-called "social state model." Within the social state model, social protection is based on (a) statutory social security comprising the key social insurances, including health insurance, old age insurance, unemployment benefits, work injury insurance, long-term care, and disability benefits (mainly contribution financed); and (b) complementary means-tested social assistance, meaning residual economic or social support for poor and needy individuals or vulnerable groups of society, which is financed by taxes.[1]

Social insurance is the major pillar of social protection within the social state model. Self-responsibility is reflected by the fact that membership relies on individual contributions/payments; solidarity, in turn, is incorporated by either

[1] The social state model is one of the two main approaches to public social protection. The second approach is commonly denoted by the welfare state model, in which comprehensive social protection against existential risks is primarily based on universal provision of public care financed by taxes and, only to a lesser extent, contribution-based. Some non-targeted tax-financed elements of the welfare state model are often also taken up by societies where social protection is primarily organized via the social state model (for example, family or housing benefits). The main difference between the two approaches is the relative weight they assign to individual and societal responsibility: the social state model stresses the primacy of individual responsibility and subsidiary societal support, whereas the welfare state model particularly emphasizes societal responsibility.

income-related contributions (considering the individual ability to pay) and/or an at least partial de-linking of the size of benefits from the level of individual contribution paid, thus involving a redistributive effect. The shared financing of contributions by employees and employers is another expression of solidarity. On the provider side, subsidiarity is reflected by the principle of self-administration: insurance funds are self-governing corporations under public law. Public social assistance is essentially subsidiary assistance which is principally provided as a "measure of last resort" to the most needy groups within a society. It enables all eligible persons to live a life in accordance with human dignity. At the same time, social assistance does not aim at simply providing a form of alimentation, but rather it pursues the objective of strengthening people's self-help capacities. In addition, providing incentives for promoting private social protection forms another important component. Last but not least, public social protection measures should be tied to the economic capacity of a society in order to guarantee their sustainability.

Social protection is on the political agenda in many low- and middle-income countries. However, the objective is not and should not be to simply "transplant" concepts from high-income countries. Rather, tailor-made solutions adapted to specific national contexts need to be developed. This involves taking the specific characteristics of these countries and their impact on social protection into consideration while developing a social protection system. Among those characteristics are, for example, low coverage and fragmentation of existing systems, restricted contributory capacities and impaired tax systems, large informal labor markets, and confined administrative capacities. In this context, technical challenges for national policy makers and for development cooperation include the following:

- defining an "optimal benefits package" that provides adequate protection but is financially sustainable;
- developing approaches that fit prevailing labor market characteristics in developing countries, where labor markets are often characterized by a high percentage of informal sector activities; and
- linking access to social protection with quality improvements in service delivery.

Social Protection Reform in Indonesia – In Search of Universal Coverage

Katja Bender and Johanna Knöss[1]

The Reform Context

Indonesia has achieved remarkable progress in its transition to democracy and its economic recovery from the Asian financial crisis of the late 1990s. Indonesia is now characterized by a young and growing democracy with a decentralized government in a vast archipelago of different cultures and a population of 230 million people. Poverty levels that had increased by over one-third during the crisis are now back to pre-crisis levels. Indonesia has once again become one of the world's emergent middle-income countries. The Indonesian Ministry of Finance estimates the country's economic growth wil be around 6.6% in 2008.

Despite this encouraging success and the ambitious development goals of the Government of Indonesia, the number of people living under US$2 a day is at an alarming 49% of the total population. Around 40 million people, nearly 10 million households, are clustered around the lowest two of the three national poverty categories with an average income between Rp. 125,000 and 150,000 per month per person These figures are exacerbated by the fact that many households are close to the national income poverty line and are defined as near-poor, indicating an even larger number of Indonesians who are vulnerable to poverty. Second, poor human development outcomes and lack of access to basic services for many Indonesians makes non-income poverty as serious, if not more serious than income poverty. Third, given the vast size and varying conditions in Indonesia, regional disparities are a primary challenge for the Indonesian Government. Poverty incidence is far higher in eastern Indonesia, but most of the population lives in the densely populated western regions. Recent poverty developments in Indonesia have been significantly affected by large increases in the price of rice and a rise in fuel prices in 2005. The latter has had a mixed

[1] The authors thank Franz von Roenne and Thomas Wiechers, Health Policy and Social Health Insurance, GTZ Indonesia, for their valuable comments and suggestions.

effect, as the price of fuel increased because fuel subsidies were scrapped in part to mobilize the funding for Askeskin, the new government program to provide basic health services free of charge to the poor strata of the population.

Thus, persistent efforts are clearly required to ensure that economic growth benefits the majority of the population, the poor, and the near-poor. This is crucial for achievement of the ambitious goals laid down by the government for social development. For example, the mid-term plan (RPJM) for 2005-2009 and the national poverty reduction strategy (SNPK) aim to reduce the poverty rate from 18.2% in 2002 to 8.2% in 2009, in other words, to a rate below pre-crisis levels. The Government of Indonesia is also dedicated to achieving the Millennium Development Goals (MDGs) by 2015.

A social protection system that enables the population to cope with risks and vulnerabilities is especially important in Indonesia, due to the high movement in and out of poverty among households and the large number of households clustered around the poverty line. These specific characteristics of Indonesia justify the decision of policy makers to develop a well-designed social protection system to safeguard citizens from risks and vulnerabilities such as income loss, illness and out-of-pocket health expenditures, a poor harvest, or the rise in commodity prices. Thus, given the well-established links between human capital and economic wellbeing, the Government of Indonesia recognizes social protection as a core part of development policies to prevent people from falling into poverty, combat existing poverty, and increase equity.

The current form of publicly provided social protection in Indonesia is based on two kinds of public interventions, namely (a) contributory social insurance or mandatory savings for civil servants (covered by PT TASPEN and PT ASKES), the armed forces (covered by PT ASABRI), and formal-sector employees (covered by PT JAMSOSTEK) and (b) targeted efforts to provide economic or social support for poor or vulnerable groups of society. The Government of Indonesia has undertaken several steps to increase coverage specifically for the poor. In the aftermath of the Asian crisis of 1997/1998, previous downtrends in poverty levels dramatically reversed, especially in the considerable near-poor segment of the population. As an immediate response and following recommendations of the World Bank and the Asian Development Bank, several social safety net programs (JPS) to help especially poor people cope with their steeply declining purchasing power were hastily implemented by a wide array of government agencies providing health services (Kartu Sehat), subsidized rice (Raskin), fuel subsidies, and scholarships for poor children (Sumarto et al. 2005) as well as a multitude of small social assistance programs for specific target groups (abandoned children, disabled persons, poor elderly, etc.) operated by the Ministry of Social Affairs (Weber 2006, 107).

Early assessments of these ad hoc measures revealed low coverage, poor targeting, and, in general, little coordination.[2] The fuel subsidy, which disproportionately benefited the medium-income and rich households and at the same time was one of the centerpieces of the Indonesian social protection system until 2005, was reduced in 2005, although the move generated intense political controversy (World Bank 2006, 181). Further, the Government of Indonesia recently launched several pro-poor programs to buffer the increased cost of living for the poor, reallocating Rp. 17 trillion for health, education, and village infrastructure programs and cash transfers to 19.2 million poor and near-poor households from 2005-2006. The government has further declared that it will bring in rice imports if the harvest is not sufficient, thus stabilizing prices of this important commodity.[3] It also recently began a pilot household and community conditional cash transfer scheme targeting the extreme poor in order to improve human development outcomes. In addition, the long existing Kecamatan Development Program (KDP) will be scaled up to a National Community Empowerment Program, or Program Nasional Pemberdayaan Masyarakat (PNPM), to provide block grants to some 2800 rural and urban sub-districts, with full national coverage of 5360 sub-districts by 2009 (World Bank 2007).

These efforts to provide increased support to the poor were complemented by the government's decision in October 2004 to implement Law No. 40 concerning the National Social Security System (*Undang-Undang Sistem Jaminan Sosial Nasional* or SJSN), which foresees reforming the existing social protection system towards universal coverage. A task force appointed through the Vice President's Office, first created by Presidential Decree (Kepres) No. 22/2002, drafted the law. The key feature of the new law is that it mandates the creation of several social security schemes for citizens: old-age pension, old-age savings, national health insurance, work injury insurance, and death benefits for survivors of deceased workers. Law No. 40/2004 is an important milestone, because it stipulates that the existing social security programs in Indonesia will be expanded so as to cover all Indonesian citizens, including those who are working in the informal sector, the unemployed, and the poor.

[2] Although the intended beneficiaries of these programmes are in the poorest quintile, they have access to only 31% of health cards, 39% of scholarships, and 29% of RASKIN benefits (Lindenthal 2004, 21). Tambunan and Purwoko (2002) present similar conclusions.

[3] http://news.tradingcharts.com/ futures/4/8/91679784.html (April 19, 2007).

The implementation of Law No. 40/2004 on the National Social Security System is currently bringing about a comprehensive reform of the existing system. Law No. 40/2004 provides the legal basis for the above-stated objective of social protection coverage for all. A task force, headed by the Coordinating Ministry of People's Welfare, is working on the introduction of new regulations as well as the mapping and harmonization of existing regulations relevant in the context of Law No. 40/2004. A great deal has been achieved since its enactment: the mapping and extensive review of existing laws has been finalized, and so has a comprehensive design of a harmonized legal and regulatory framework. Based on the latter, there is now a roadmap for implementation in place, and technical sub-groups are working on new laws – most importantly, the "carrier law" and government regulations. The whole process has been aligned with Law No.10/2004 that stipulates how laws are to be drafted. It has recently been formally endorsed by the president and now looks set to be completed by the legal deadline in October 2009.

Although some important initial reform steps have been taken, several major challenges lie ahead:[4]

- **Low coverage:** Coverage by the existing contributory social insurance system is still low: only about 16 million workers are covered by Taspen, Asabri, and Jamsostek schemes, out of a total labor force of about 101 million people, including job seekers (Angelini and Hirose 2004). This means that only 16% of workers are currently covered by formal social security schemes. Health insurance coverage by public schemes is slightly higher, with around 18 million insured. Extending coverage in terms of both organizational as well as sustainable financing options will be based on a comprehensive strategy that is currently being prepared by the ministries charged with building the new social security system (Jaminan Sosial Nasional, JAMSOSNAS). This requires detailed conceptual work and decisions on, for example, benefit package(s), contribution rates, and necessary institutional reforms. It also requires deciding on appropriate social protection instruments with regard to some specific risks such as old age and unemployment.
- **Fragmentation:** One objective of the reform is to build a coherent system of social protection and reduce the high degree of fragmentation that so much characterizes the current system. Benefits of streamlining include improved allocative efficiency of administrative resources. Coordination between the various programs that are targeting the poor needs to be enhanced. The cooperation and communication between different government ministries

[4]For a more detailed treatment, the interested reader is referred to Bender et al. 2008.

and service and insurance providers will be facilitated by a new statutory body, the National Social Security Council, soon to be installed by the president.

- **How to cover the informal sector?** The present system excludes the non-poor in the informal sector from any arrangement: they are not covered by the contributory social insurance and are not eligible for any form of social assistance. Considering the fact that the informal sector in Indonesia comprises a substantial part of the working population,[5] with a high proportion of them being considered non-poor, developing an effective strategy on behalf of this population group is crucial for realizing the goal of universal coverage.

As already mentioned, a crucial reform issue is the streamlining of the numerous bodies that make up the current system and the defragmentation of their functions: at present, a relatively small part of the population is covered by public social security, namely employees of the military (through PT Asabri, PT Askes), civil servants (through PT Taspen, PT Askes), and those employed in private enterprises above a certain staff size and total payroll (through PT Jamsostek). The latter are insured against work accidents, illness, death, and funeral risks, but not against unemployment. In case of retirement, they receive a lump sum payment from a mandatory saving scheme (provident fund) related to their contributions plus interest. Members of the armed forces and civil servants are insured against illness (PT ASKES) as well as old age, in case of which they receive lump sum payments as well as annuity benefits for life after retirement (through PT ASABRI and PT TASPEN, respectively). Thus, the institutional setup of social security is mainly organized according to group affiliation. The responsibilities for programs of social assistance are vested within different ministries and different adminstrative structures. In addition, programs are operated at the central and local level.

From a technical point of view, there are two basic options for organizing the administration of social protection: (1) integration of all risk-related activities under one specific administrative body for each risk; (2) separation of all risk-related activities for certain groups of society and their specific administrative bodies. There is also a third, more pragmatic approach: (3) harmonization and rationalization of regulations between existing administrative bodies.

[5] According to the National Labor Force Survey (2007), the informal sector in Indonesia comprises a substantial and growing part of the working population, currently with 69% of the total labor force.

Focussing on the technical efficiency of a public social protection system with integration of carriers is an appropriate option for social insurance, whereas social assistance is best provided within a framework of (broad) separation: Insurance works by pooling risks across a large population. The larger the risk pool, the smaller the volatility of claims, thereby facilitating the management of the insurance. However, an insurance risk pool must not necessarily be as large as the entire population to effectively reduce volatility,[6] and the positive returns to size diminish beyond a certain threshold. Yet for social insurance to work, a balanced composition of the risk pool is essential. This is achieved by integration, but not by separation.

In contrast, social assistance is, generally speaking, best provided within the framework of a (broad) separation: Firstly, by definition, it targets specific groups within a population, namely the poor and other specific needy groups. Secondly, again by definition, all social assistance benefits are targeted benefits. As targeting methods involve non-negligible transaction costs, subsuming social assistance under one administrative body provides the opportunity for exploiting economies of scope. In the third option of harmonization, institutional path dependencies are taken into account, and the existing institutional framework for social protection is gradually adapted where this is required by new or changing needs.

Harmonization is the option that Indonesia has chosen at present; it aims to harmonize all laws and regulations by 2009. Harmonization provides an important first step. However, given the limited technical benefits of harmonization in comparison to the other two options, the country may consider going further in the medium term. Options for later reforms are: (a) institutional integration of risk-related activities under one specific administrative body for each risk in standard social insurance and (b) institutional separation of activities for the poor and other vulnerable groups – in other words, social assistance – could offer an overall guiding framework. In this context, responsibility for social assistance should then be centered on a newly founded institution, perhaps under the umbrella of the Ministry of Social Affairs.[7]

Social health insurance is one of the major components of the social security system. This fact is also reflected by the priority this component is given within

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[6]If this were the case, private insurances would not be not able to operate.

[7]With regard to certain social insurances, the question arises if the poor or other specific needy groups should be included within the general insurance framework or covered separately. This is particularly relevant for social health insurance. In this case, the poor should be included within the specific social insurance, and the administrative body responsible for social assistance could remit the contributions on behalf of the poor to the respective social insurance administrative body, which would then be responsible for delivering the benefits/services to the poor.

the overall reform process in Indonesia. With regard to social health protection, the systemic question of which instruments to apply seems more or less settled with the plan to combine social insurance and tax-financed, means-tested social assistance for the poor. At present, PT Askes and PT Jamsostek provide social health insurance to civil servants and formal sector employees, respectively. In addition, the ASKESKIN scheme, managed by PT Askes, provides tax-financed healthcare to poor households. With ratification of Law No. 40/2004 on the National Social Security System, the basic principles of universal social security and a timeframe for the work necessary for the new system to be implemented throughout Indonesia were established. Within the boundaries already set by Law No. 40/2004 and the reform and implementation steps taken since then, however, many decisions still need to be made. For example, the choice about how to pool funds, namely, single or multiple funds, is currently under scrutiny.

Besides social health protection, the issue of old age protection is gaining increasing attention within the Indonesian context. Formal sector workers receive a lump sum payment from a mandatory savings scheme (provident fund) related to their contributions, plus interest. Thus, longevity risks are not covered. Members of the armed forces and civil servants receive a lump sum payment as well as an annuity benefit for life after retirement. In the absence of a comprehensive social insurance scheme providing life-long old-age benefits, the reform agenda for pensions in Indonesia is still open to innovative solutions.

To obtain prevention against demographic risks, one option would be to combine funding elements with pension insurance in a new national pension scheme. Subsequently, once the new national pension scheme is fully established, the share of pay-as-you-go financing could be reduced gradually in favour of the funding principle. Low-income earners could be supported to a certain extent by tax-financed instruments. A second option would be to introduce a tax-financed universal basic pension scheme with pensions based on a fixed percentage of local minimum wage.

However, in this option there are certain drawbacks to consider: first, like all universal schemes, it could be very costly to guarantee such a basic pension, considering the high percentage of the poor and near-poor population; second, a non-contributory pension scheme could create negative incentives for participation in contributory social insurance, so this solution could endanger moving from informal to formal employment. Another approach to solving the problem of old age poverty could be seen in the future role of social assistance, which would be subject to means testing and targeted to all persons with income below the national poverty line. However, this alternative is not a substitute for the previous options, but rather a complement to the first option.

Unlike social health protection, the issue of unemployment compensation and the instruments to employ is still strongly debated at present. Currently, only severance pay plays an important role in Indonesia. Alternative instruments such as unemployment insurance, unemployment assistance, individual saving accounts for unemployment benefits, and mandatory saving accounts for severance payments do not exist in Indonesia. Preliminary recommendations for unemployment compensation in Indonesia include a combined system of mandatory individual savings accounts and mandatory savings for severance pay, both of them complemented by solidarity funds.

One of the crucial questions remains how to extend social protection coverage to the non-poor in Indonesia's large informal sector. The non-poor among informal sector workers are the population segment currently suffering the highest degree of exclusion from social protection: they are not covered by contributory social insurance and are not eligible for any form of social assistance. The legal postulate of universal coverage will have to bring about fundamental changes in order to provide social security to this group. Whereas standard contributory social security is designed for formal sector employees and the poor are targeted by tax-financed and means-tested social assistance mechanisms, only few programs are directed towards the non-poor in the informal sector. Considering the enormous size of the informal sector in Indonesia, the overall integration of the informal into the formal economy should be the ultimate long-term objective. To include it in the social protection system in the medium term, specific social security programs will have to be designed and implemented, as standard social insurance with its defining characteristics of statutory membership and income-related contributions is not appropriate for reaching out to the informal sector. Due to the special characteristics of the heterogeneous and poorly defined group of people living in the informal economy and the resulting specifities of social security schemes for the informal sector, schemes for this group carry a variety of risks that endanger their effectiveness in terms of coverage and financial sustainability. Reliable data for planning, a careful design, and skilled administrative personnel for implementation are therefore necessary preconditions.

Linkages to the Concept of a Social Market Economy within the Indonesian Context

Social protection *per se* is an indispensable element within the concept of a social market economy. The structure of social protection within a social market economy is guided by the overarching principle of subsidiarity, which translates into a specific approach to social protection often referred to as the social state model. This model combines statutory social insurance with means-tested and targeted social assistance for specific vulnerable groups as well as incentives for private measures. To what extent could this model be of relevance within the Indonesian context?

The outline above demonstrated that the current social protection system in Indonesia is based on two kinds of public interventions, namely contributory social insurance or mandatory savings for specific population groups, and confined targeted efforts to provide economic or social support for poor or vulnerable groups of society. Further, as mentioned, the Indonesian system displays a high degree of fragmentation and is currently undergoing a process of harmonization and consolidation. It is the stated objective of the government to achieve "universal coverage" and to take decisions on the policy issues relevant to this objective. At the present stage of the reform process, not all steps necessary for the operationalization of this objective have been fully developed yet.

In this context, the social state model has the potential to offer a unifying and guiding framework to provide orientation for extending, coordinating, and consolidating the current system, while matching existing structures. However, such a model should be used as a guiding model, not as a blueprint: Any model represents but a stylized and abstract representation of the real world. With regard to the social state model, this means for example that – at least to a certain extent – non-means-tested universal elements can easily be incorporated into the system.[8]

GTZ Activities

The Governments of Indonesia and Germany are currently collaborating on social protection in the following, complementary areas:

1) Policy advice and support, also on the implementation of a national social security system in the context of the implementation of Law No. 40/2004. Together with its implementing partner, the Ministry of Health, GTZ is working with the National Social Security Taskforce under the leadership of the Coordinating Ministry of People's Welfare. This taskforce is responsible for all aspects of the implementation process: formulation of new laws, presidential and government regulations, review of existing laws and their harmonization with the reformed social security system, and the government and public consultation processes required for the reform.
2) Furthermore, GTZ is providing advice to the Ministry of Health on specific questions arising from the introduction of universal social health insurance. The issue has far-reaching implications for the health system and

[8] Housing and family benefits are prominent examples in this context.

is therefore intertwined with most current priority health-policy questions. In its role as a member of the national taskforce, the Ministry of Health is responsible for drafting a presidential regulation on social health insurance. This will regulate all questions of membership, benefits, and service provision. It implies that a number of important health policy questions must be answered; furthermore, around 15 national laws will have to be harmonized so that the regulation can meet the regulatory requirements of Law No. 40/2004.

3) Policy advice to BAPPENAS, the Indonesian National Planning Authority, on strategic planning of the reform process: GTZ is providing BAPPENAS with international expertise for the development of strategies and policy recommendations for the Five-Year Plan 2010-2015 regarding the further development of the social protection system that will be launched at the end of the current legislative period in 2009. When asked by BAPPENAS to prepare a comprehensive report on options for social protection reform in Indonesia, GTZ assembled a team of academic and policy experts. A draft version was presented and discussed with various national and international stakeholders in a workshop held in August 2007; the final report will be published in early 2008 (Bender et al. 2008).

The Way Forward

As shown above, there has been remarkable progress in Indonesia's social protection system from the financial crisis of 1997/1998 to date. By passing Law No. 40 in 2004, the Government of Indonesia initiated a comprehensive process of reforming the existing system towards universal coverage, aiming to improve access as well as enhance quality of service delivery.

The reform process implies a multitude of policy decisions and legal and regulatory adjustments that are currently being addressed by the various stakeholders to the process. In this context, the incorporation of the non-poor in Indonesia's large informal sector, as well as the provision and financing of basic social assistance to the high number of poor or near-poor are two of the most crucial challenges on the way to universal coverage.

In addition, in many reform areas such as administration and institutionalization of the entire system of social protection, political decisions on options to be implemented have still to be made. The government is currently working on reaching a political consensus on these open policy questions as well as on securing the space crucially required to manoeuvre in face of the multifold and diverse interests of stakeholders involved.

BAPPENAS is involved in the ongoing reform process and is committed to accompanying the process and further developing strategies to optimize the process and work out and support the implementation of suitable options based on international experience. In this context, the joint BAPPENAS-GTZ report, *Options for Social Protection Reform in Indonesia,* is one contribution to the reform process. It analyzes visionary, but feasible options for the future of social protection within the Indonesian context.

The report also provides an important contribution to strategic planning of the overall reform process. In this process, BAPPENAS is charged with the task of preparing a draft version of a mid- and long-term roadmap for social protection reform. The roadmap will provide guidance on the timing and sequencing of reform steps and will be discussed among relevant political stakeholders. GTZ will continue its support and assist BAPPENAS in the elaboration of the roadmap.

Reviewing the current situation and analyzing the options for the various social protection schemes for citizens also reveals that the efficacy of ongoing and future reforms depends greatly on developments and progress in other sectors. Most prominently, it will depend on private sector development and the expansion of the formal sector and attendant reduction of the informal sector, tax system reforms, and sustained efforts in decentralization reforms. Further, reform options need to be carefully designed in order to prevent adverse impacts on the labor market. As economic growth clearly impacts on the feasibility and outreach of publicly provided social protection, continuing efforts to promote an enabling environment for economic growth are essential. This includes, among other things, the creation of a conducive and investment-friendly business environment.

Further, reform efforts should be realistic and consider prevailing constraints. For example, given the unfortunate relation between the number of poor and near-poor persons in Indonesia and given the limitations of tax resources, the potential outreach of social assistance is limited, and ad-hoc measures should be avoided. Basically, the decision is either to provide a relatively broad range of social assistance measures to a very limited group of persons, or to focus on a reduced number of measures (such as health services or modest forms of income support via cash transfers) provided to a wider share of the poor population.

Last but not least, it must be pointed out that achieving universal coverage, as intended by the Government of Indonesia, is a lengthy and incremental process – especially in a vast and heterogeneous population like that of Indonesia. With its long-term political commitment to achieving social security for all, the Government of Indonesia has met a pre-condition for success.

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Social Market Economy and Voluntary Social and Ecological Standards

Thomas Finkel and Christiane Fleischer

Introduction: Globalization, Social Market Economy, and Voluntary Social and Ecological Standards

Globalization – and climate change which is often described as its by-product – have been among the most discussed topics of the last decade. Associated with globalization is the opening up of emerging states such as many Asian countries and, in this context, the transition from a planned economy to a free market. These countries are looking for ways to smooth out the transition, in other words, to make the most of globalization's benefits without leaving behind too many of their people. After years of tremendous growth in the region, the social question is becoming ever more important for the region's governments as they attempt to deal with social disparities, ecological threats, and increasing allocation struggles (Andes et al. 2007). The anti-globalization movement (and the interested public) has long demanded a social cushioning of globalization's worst effects.

In this context, Germany's social market economy appears to many to be a valuable model and has attracted the attention of some of the region's governments. Although it is almost 60 years old, it is still achieving positive results with its mixed economy approach – a clearly market-based economy combined with social as well as environmental protection. In this model, the state aims to maintain a balance between a high rate of economic growth, low inflation, low levels of unemployment, good working conditions, social welfare, and public services. While basically respecting the free market, the social market economy is opposed to both central planning and laissez-faire capitalism. Due to the increasing pressure on natural resources and the negative impacts on consumers' health of many industrial and agricultural production processes, the ecological aspect is given high priority – also in order to address the climate change agenda.

While many countries have taken up the idea of the social and ecological market economy, there are different ways to achieve the three main goals of public prosperity, social justice, and environmental sustainability. Regarding social and environmental standards, in practice there are two complementary approaches. One is to make use of the regulatory authority of the government by setting up and enforcing standards through the government and its many bodies, which is what is done by states trying to put the philosophy of a social and ecological market economy into practice. This distances these governments from a purely free-market-based philosophy, which maintains that the market is a better regulator, even when it comes to social and environmental practices.

Nevertheless, many problems still remain, even where the government has set up standards. Enforcement is a major issue. The lack of adequate control systems and the weakness of regulatory and enforcement authorities stand in the way of better implementation of and adherence to obligatory standards. In addition, many Asian countries lack government consumer-rights policies and have no or only weak civil-society organizations, which are needed to push forward continuous improvements in social and environmental protection. The absence or failure of government standards has therefore given rise to a second approach: a movement by industry to set up and enforce voluntary standards.

Multinational companies have become a driving force behind voluntary standard initiatives. As will be explained below, they do this either because of increased pressure from NGOs and consumers in their home country or because their supply chains become more sustainable and efficient in the long run if they pay more attention to social and environmental standards throughout the chain. Because of the increased importance of multinational companies in trade with developing and emerging markets, this article will focus on voluntary social and ecological standards and their (potential) contribution to the creation, implementation, and success of a social and ecological market economy. Before discussing this issue in more detail, we need to differentiate between the various types of standards.

Generally, we have to distinguish between product, process, and behavioral standards: *Product standards* are the simplest form of standards since they basically refer to specific attributes of the product. *Process standards,* on the other hand, regularize the production process which, in turn, has consequences for the product itself (for example, banning certain pesticides or chemicals used in the production process). Finally, *behavioral standards* relate to the design of internal operating procedures (for example, freedom of association). The latter two cannot always be differentiated, but as a rule of thumb, process standards are more quantitative-technical whereas behavioral standards tend to be more qualitative in nature. Standards hence refer to both quantitative-technical as well as quality features that can be described, measured, and controlled (Reichert 2002).

Environmental standards belong to both product and process standards. They address the question of the product's environmental risks and usually delineate minimum and maximum values of hazardous residual in the final product (product standard) as well as environmentally negative impacts of the production process on the environment (process standard). Thus, they reflect the potentially negative impacts on both the environment and the consumer. In the case of organic products made of dairy products or meat, regulation of the treatment of animals could even be put in the category of behavioral standards.

Social standards aim at improving work and trade conditions and hence are process standards. Companies that aim to offer safe products and organize their processes in a socially and environmentally friendly way may wish to be certified[1] in order to be able to penetrate a specific market, better position themselves in a market, or create a better image. They can obtain a statutory inspection label, which describes the (technical) quality features a product needs in order to enter a certain market. These labels are based on international (ISO), European (EN), or national (DIN, etc. in Germany) norms. In addition, there are state-approved cachets, which are not binding but aim to provide orientation for consumers (for example, the RAL label in Germany[2]). Finally, there are those labels created by standard initiatives (for example, the Fairtrade label) that act as a credible marketing tool for social and ecological responsibility, as well as a tool to improve the sustainability of the business.

It is exactly the latter argument that is driving more and more companies to certify their products and processes according to internationally recognized social and environmental standards, as they see this as a fundamental way to improve the sustainability of their business model.

This leads us to the main question: Can standards be used as a vehicle for German development cooperation to contribute to the creation of a social and ecological market economy in our partner countries?

Theoretically, they can. Thus, our first hypothesis is that *voluntary social and ecological standards – below referred to as standards – contribute to sustainable development,* as they help to:

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[1] Certification describes a process through which compliance with certain standards can be verified. Certificates are usually temporary and controlled by an independent body. Accreditation is an audit and authorization of certifiers. It is hence a certification of certifiers.

[2] RAL labels indicate products and services that are produced according to highly specified quality criteria. RAL accredited organizations make up the RAL quality association, which implements and monitors quality assurance. Currently there are more than 160 quality labels for thousands of products and services that are monitored by over 130 quality associations with approx.10,000 member organizations from all sectors in Germany and abroad. For details, see http://www.ral.de/de/ral_guete/ home/index.php.

- foster competitiveness;
- improve working conditions; and
- conserve natural resources.

These three issues, as well as the advantages and disadvantages of standards, will be discussed below.

Discussing the Advantages …

The issue of *competitiveness* is probably the most fervently discussed, as opinions differ substantially here. On the one hand, many governments, especially those of developing countries, accuse governments and trading blocks that promote standards of creating another instrument of protectionism. They claim that developed countries use standards as a market barrier against cheap import goods and hence abuse them for political reasons. To a certain extent, they seem to be right. Recently, at the Asia conference prior to her visit to India, the German Chancellor Angela Merkel announced that "we in Europe can only remain competitive when minimum standards apply elsewhere as well."[3] Although there surely is some protectionism in this argument, the clear objective of the Government of Germany is to make the commitment to and enforcement of social and environmental standards a global goal that benefits all nations. As in all trade issues, unfair competition through dumping prices (in this case through exploiting workers and the environment) is a short-sighted strategy that will cause more harm than good in the medium and long term to all trading partners and stakeholders involved.

On the other hand, however, most of the standards are based on the norms of the International Labor Organization (ILO), which bar gross forms of exploitation of labor and human rights abuse that can never be justified (see below). These norms have been agreed upon by the great majority of governments worldwide. In additional to this political commitment to human rights, studies by the ILO and the Organization for Economic Cooperation and Development show that firms invest mainly in those countries that abide by minimum labor standards and provide legal security for the standards and for their employees, as this significantly increases productivity and hence long-term economic success (Kürschner-Pelkmann 2006).

Furthermore, for companies from both developing and emerging economies, adhering to standards can also be a chance to enter new markets and thus steal

[3] *Süddeutsche Zeitung 248*, October 27/28, 2007 (author's translation).

the protectionists' thunder by producing the quality products that are more and more being demanded by consumers. Thus, it seems that both governments and companies benefit from fulfilling at least minimum environmental and social standards. Nevertheless, many companies still prefer to short-sightedly exploit both workers and the environment, cashing in on quick returns, often in cooperation with local governments that pursue their own wellbeing more than that of the population and the environment.

However, introducing and implementing standards is always linked with costs of certification, verification, capacity building of management and employees, and sometimes investment in infrastructure and equipment. Nevertheless, in the long run, the benefits seem to outweigh these costs: Improvements in the quality of products and services can bring about higher sales, often at higher prices. Better management of resources will bring down costs. Improved working conditions and enhanced safety will lead to greater motivation of staff, fewer accidents, and, in return, increased productivity. Furthermore, higher product quality and better treatment of workers will improve the image of the company, which, in turn, will attract better employees and pave the way for greater access to markets and stable trading relations. The reduced environmental damage further contributes to the sustainability of the business model as a whole.

An example of the problems that stem from a lack of product quality and safety is the case of toys made in China that erupted in 2007.[4] After inspectors found excess lead content in some toys, several major retail chains in the USA and the European Union (EU) had to recall their products made at Chinese factories. Since China is the largest toy exporter worldwide (with approximately 60% of global production), quality deficits pose a great risk and can lead to major market disturbances and economic loss to all businesses involved. The negative image created can even have a negative impact on the whole economy, as consumers start to mistrust the quality and safety of all products from a certain region.

Calls for stricter controls and compliance with European (or at least uniform) standards are thus on the rise. Although these labels focus on technical quality aspects (for example, equal statutory inspection labels, see above), some experts argue they should cover the whole production process and even include the working conditions in firms, because there often is a direct link between degrading working conditions and product quality (Haas 2004). It is clear that both suppliers (the Chinese factories) and buyers would benefit economically from improved product and process quality.

[4] See Haas 2004, AFP/AP 2007, AFP/ DPA 2007, and "Mattel Entschuldigt sich" 2007.

The second point, *the improvement of working conditions,* is explicitly mentioned in most standards and codes of conduct that originate from corporate social responsibility (CSR) policies.[5] The ILO norms on decent work form the backbone of codes of conduct and standards relating to working conditions. The four main areas addressed by the ILO Declaration are:

- freedom of association and the right to collective bargaining;
- elimination of forced and compulsory labor;
- abolition of child labor; and
- elimination of discrimination in the workplace.

While these aspects are seen as minimum requirements, most standards focus on improving working conditions in more detail and include decent payment, fair working hours, overtime compensation and vacation allowances, paid maternity leave, health insurance, and work safety equipment and measures, among others.

Also here, China, as an example of the ambitious and rapidly growing economies of the BRIC states (Brazil, Russia, India, and China), can underline the necessity for standards.[6] To fuel its fast-paced growth and its booming industrialization, it needs energy, and 70% of this energy comes from burning coal. China's coal belt, ranging from Manchuria in the east to the border of Kazakhstan in the west, is the largest coal mining area in the world. One-third of the coal deposits are in the province of Shanxi with approximately 15,000 mines operating. The number of workers is unknown. Working conditions are dramatic: China's mines are known to be the most dangerous in the world: almost 60,000 miners were killed in Chinese mines from 1992 to 2002, compared to approximately 1000 in Indian mines during the same period. In 2004, 6027 workers died in the mines, 17 per day. Still, productivity lags far behind that in industrialized coal countries: China produces 35% of global coal (approximately 321 tons per year per Chinese miner – only 2% of a miner's output in the USA). The death rate, in contrast, is a hundred times higher than in the USA and 30 times higher than in South Africa (80% of all global mining deaths happen in China). Especially migrant workers from poor rural areas work under slave-like conditions to earn money for their families. Trade unions or associations do not exist in most cases. The boom seems to be taking place at the expense of the workers.

The same applies to other industries, especially manufacturing and the textile industry. In the two biggest industrial quarters of Shenzhen, 27 workers lose a

[5] For example, 4C, Fairtrade, BSCI, Cotton Made in Africa, Better Cotton Initiative, Flower Label Program, etc.

[6] All figures are from Vougioukas 2005 and Landwehr 2004a.

hand, arm, or leg in workplace accidents every day. Each year, 136,000 workers die in industrial accidents. Additionally, employees regularly report bad food and accommodation, unpaid overtime (up to 50 hours per week), and no vacation allowance (Schepp 2004). The Chinese government is starting to recognize the importance of worker protection only slowly. Standards could regularize conditions for workers and close loopholes in security regulations.[7] This would, again, also contribute to an improved competitive edge of the economy, as improved working conditions and the reduction of accidents have a direct impact on the productivity of firms. Besides, it would help to put the moral values of protecting workers and society into practice, making the harmonious society more than an empty promise.

Some initiatives from developed countries are trying to improve the situation. Voluntary social standards initiatives like one by European retailers that was supported by the German Federal Ministry for Economic Cooperation and Development (BMZ) through GTZ are all heading in this direction. This initiative attempted to improve working conditions in the garment, textile, and toys industries in 12 producing countries, including China, as it is by far the biggest producer. Recently, a bilateral project focusing on corporate social responsibility was also set up in China, addressing similar issues. Another bilateral CSR project is set to begin soon in India.

The third aspect of our hypothesis – that voluntary social and ecological standards contribute to sustainable development as they help *conserve natural resources* – is becoming ever more important. Natural resources are under considerable strain. Pollution is increasing tremendously throughout the region, with its attendant high social costs and economic losses due to increased health care expenses. Additionally – and particularly important from our perspective – is the fact that many business models and thus companies depend on a sustainable supply of natural resources and the quality of these natural resources. To give an example: The rapidly growing aquaculture sector in Vietnam is seriously threatening the ecosystem of rivers and coastal areas. If the ecosystem collapses and fails to provide enough fresh water for the fish ponds and river cages of the fish farmers, the whole sector will collapse, causing severe economic loss to fish farmers, the processing industry, and trade, as well as other directly related industries such as feed supply. In this case, taking better care of the natural resources is indispensible if the long term sustainability of the aquaculture sector is to be guaranteed.

Also from a pro-poor perspective, the sustainable management of natural resources such as forests becomes crucial, as the poor typically depend heavily on natural resources for their livelihood.

[7] For more detailed information see Landwehr 2004a, 2004b, 2005, and Schepp 2004.

All of these aspects call for increased efforts to introduce and improve compliance with social and environmental standards, which would contribute to better economic performance, lessen the pressure on the environment, and improve working conditions.

Our second hypothesis, then, is that *poverty alleviation is a middle- and long-term impact of the introduction and implementation of standards.* Poverty alleviation is an urgent challenge, especially in emerging Asian countries, where the gap between rich and poor, urban and rural populations is widening significantly.

While Chinese industrial zones along the coast (Shanghai, Shenzhen, etc.) are booming and producing a small caste of super rich, the majority of the population in mainly rural areas is being left behind. Thus, migrant workers are streaming to the cities hoping to find work and a better living for their families, but they are extremely vulnerable in the current situation. They often have no rights, working long hours in factories that do not even pay their wages or only after long delays (AFP/DPA 2007). The situation is similar in other countries, as well. Standards can buffer the process by securing, for example, minimum wages, better working conditions, and job security.

Thus, improving the sustainability of natural resources in the rural areas as a means of livelihood for the rural poor, as well as improving working conditions of migrant workers are two important pillars of poverty reduction and achievement of a more inclusive or – as the Chinese would say – harmonious society.

The introduction of environmental and social standards is a good way to contribute to this goal. Fostering these standards should thus be a priority of both local governments and donors trying to support sustainable development.

... and Discussing the Disadvantages

All these arguments seem to suggest that the question is not *if* standards should be supported and implemented on a broad scale, but rather *how* this can best be done.

Still, we should also discuss some major drawbacks of standards, especially for those who will have to comply with them: (often small-scale) producers and suppliers in developing and emerging countries who supply large retail chains or international firms sourcing from them. These drawbacks have to be considered carefully when we intend to promote standards.

First of all, there are many different, often competing standards in all kinds of value chains. In textiles there are, among others, BSCI, ETI, and SA 8000. Additionally, many retailers have their own codes of conduct. In the forestry/

wood sector, FSC and PEFC compete. The highest concentration of standards can be found in the coffee market where the Common Code for the Coffee Community (4C), Utz Certified, Rainforest Alliance, Fairtrade, and own-brand standards like C.A.F.E. of Starbucks and others co-exist. Since these standards are not always harmonized and often do not mutually accept each other, many producers are confronted with a whole range of different guidelines and regulations if they wish to continue business relationships with their partners in Europe or the USA. Although in principle a certain degree of competition, even among standards, may not be bad, it is highly confusing, especially for small-scale producers of agricultural products, and entails significant expenditure of time and money if a supplier sells to multiple buyers whose standards are not harmonized or reciprocally recognized.

Certification costs and the question of who should bear these costs play a role here, too. Usually costs for first-time certification are fairly high. Subsequently, independent auditors verify compliance with the standard at regular intervals. Small-scale producers, unless they are organized and able to achieve some economies of scale, are often not in a position to meet these expenses. Consequently, management of the cost-related aspects of certification schemes needs to be carefully analyzed before promoting standards.

What Does this Mean for German Technical Cooperation?

If German development cooperation decides to actively continue its policy on standards, the following are some practical suggestions for the technical cooperation of the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH with partner countries.

To begin with, GTZ must tackle the urgent problems associated with standards described above. Standard harmonization requires the willingness of all stakeholders (especially those of competing standards) to sit down and start negotiating. While it is not in the interest of single standards to be dissolved, mutual acceptance would significantly ease the life of those trying to comply with standards. These multi-stakeholder processes could be moderated by GTZ, which has the relevant moderation and mediation know-how, as well as detailed knowledge of the topic as a result of German involvement in many different standards initiatives such as 4C, Cotton made in Africa, and organic agriculture.

As to the costs of certification, GTZ should help build up local certification bodies, in order to keep down costs and foster long-term local structures. One successful example is Nairobi-based *AfriCert,* the first certification company in eastern Africa, which has obtained international ISO 65 accreditation. *AfriCert's* seal of approval confirms that producers subscribe to good agricultural practices.[8] "Rather than spending a lot of time and money for European companies to come, assess, and certify them, the growers are now able to receive the same service at much lower cost from a local company," reports GTZ expert Doris Günther, who helped develop *AfriCert* on behalf of BMZ.[9]

Similar efforts are now being undertaken by other GTZ-supported projects in Asia, such as the Small and Medium Enterprise Development Program in Vietnam. GTZ's contribution in this field could be training and advice to local certifiers in their efforts to become accredited and to improve their performance as service providers. Additionally, GTZ could promote collaboration and networking between local and international certification bodies.

Besides addressing problems related to the introduction of standards, GTZ can also assist in further developing their advantages. Since standards are related to business operations, GTZ can engage with private companies that have an interest in improving their supply chain, thus making use of their market influence. One promising instrument of such a joint venture is the public-private partnership (PPP) model. A successful example underlines its practicability: Cotton made in Africa (CmiA), a standard established to improve living conditions of small-scale cotton farmers in Africa by supporting the sustainable production of cotton through capacity building of farmers. The set target is one million direct and indirect beneficiaries. The project does not aim to be another higher-priced niche product like organic cotton, but to generate its benefits (higher income for farmers and higher quality of cotton) in a cost-neutral manner by creating a demand alliance of large (European) retailers for cotton from Africa.

In Zambia, CmiA is implemented by the world's largest cotton trader, Dunavant. Through their program, tens of thousands of small-scale cotton farmers can be reached with capacity building on good agricultural practices, helping them increase their productivity and ultimately their output and income. Alongside the training program, the private company introduced an award-winning HIV/AIDS prevention program, adding the social aspect of standards to the approach.

In addition to their market influence, private enterprises often have an extensive infrastructure at their disposal (for example, local offices, cars, trucks,

[8]Resource conservation, safe use of pesticides, good post-harvest protection, hygiene, and occupational health and safety.

[9]See "First Certification Company in Kenya," http://www.gtz.de/en/praxis/9479.htm or the AfriCert homepage, http://www.africert.com /.

trained and motivated staff, local knowledge, and contacts, etc.) (Peltzer 2007). Consequently, by using the PPP constellation, market forces and the expertise of private companies are linked to development know-how, jointly benefiting a large number of small-scale producers or workers. This applies to all businesses, not only those in the agriculture-based value chains, but also, for instance, retailers introducing standards into textile supply chains. While they use their power to push standards into the market, development cooperation can moderate among different stakeholders in order to develop standards. In this way, the standards introduced into the market would be adjusted to target-group needs and local conditions.

This is the case of the Small and Medium Enterprise Development Program in Vietnam, which has successfully moderated development of a GLOBALGAP (formerly called EurepGAP) standard for catfish among different private and public stakeholders. This standard is now being piloted in cooperation with international buyers and local fish farmers. It is anticipated that as other firms become aware of the successful implementation of the standard and its positive effect on product quality and sustainable management of natural resources, it is likely to spread throughout the whole industry.

Another point of discussion is outreach. CmiA can be classified as one of the so-called mainstream standards that are highly effective when it comes to outreach, as large numbers of small-scale producers or workers benefit from these schemes. However, their innate nature of compromise between many different stakeholders limits them to minimum standards. On the other hand, it is this air of compromise that makes them acceptable in developing countries, as well. 4C, for instance, is a social and environmental code for the mass coffee market that is accepted even by the very skeptical Association of Brazilian Roasters, the world's largest coffee supplier (Peltzer and Zahmt 2006). GTZ's role should be to enable multi-stakeholder dialogue and act as a driving force behind standard design, in both conceptual development and preparation for introduction of the standard, so that broad outreach can be achieved.

Other opportunities on the other side of the spectrum are niche-market standards, such as those for organic food. This can have direct or indirect economic benefits. Fairtrade, for instance, pays an additional premium of US$0.15 per pound for organically produced Arabica coffee. Yet again, indirect benefits accrue as well. The organic Pangasius (catfish) initiative in Vietnam, for example, helped local fish farmers by providing stable trading relationships as well as more security, thanks to improvements in product quality that make it less vulnerable to external influences such as bad weather conditions or diseases. Furthermore, the improved quality has eased access to the European market by diminishing the problem of rejection of "unclean" (containing excess amounts of antibiotics and bacteria) fish. GTZ successfully formed part of a PPP project; it supported implementation of the pilot organic production and used the concept of a value chain in order to bring all stakeholders together to seek joint solutions to the problems that arose.

Thus, there are benefits to both mainstream standards as well as niche-market standards. GTZ therefore has to consider broad effectiveness versus in-depth impacts. A balanced approach supporting both cases seems to be the most adequate solution.

Besides working with target groups directly or via private enterprises within value chains, GTZ can attempt to engage on the macro level by supporting national governments in creating framework conditions for the successful introduction of standards in their respective countries. Government backing of such initiatives is a necessary precondition for success. Although voluntary standards never replace national laws and regulations, in many countries (especially those with weak law enforcement) they can serve as a minimum basis and as a starting point for further development. In the above-mentioned case of Vietnamese catfish, the TC-supported project attracted the attention of central and local authorities. After understanding the preconditions for success in international food markets, the government launched a series of policies, campaigns, and decisions to support the production of "top quality Pangasius" and provided quality control systems. The local Department of Fisheries is directly involved in the pilot projects, and the national Ministry of Fisheries is directly involved in setting standards. Consultancy and moderation of stakeholder processes by GTZ can jump-start these developments. German development cooperation, however, also has to push the topic on the international agenda. This includes dialogue within the EU about trade restrictions. Developing countries will only be willing to enforce standards on a large scale when developed countries in turn allow them unlimited access to their markets. As Peltzer and Zahrnt (2006) put it: "Global implementation of social and ecological minimum standards is not compatible with protectionism."

Finally, raising consumer awareness is another on-going process worthy of support. By funding and designing campaigns like "fair feels good" in Germany,[10] consumers can be profoundly informed about standards, their impacts, and what they can do to support the improvement of the lives of those who produce their daily goods. This also increases pressure on brand firms or retailers to supervise

[10] For detailed information see: http://www.fair-feels-good.de/

the production processes of their suppliers and only buy from those suppliers that comply with certain (at least minimum) standards.

Summary

While standards are not a panacea for all the evils of globalization, they seem to be a realistic way to buffer its most severe effects on people and the planet.

Cooperation of all stakeholders involved is a necessary precondition for developing, introducing, and implementing standards in the most successful way. The same is true for the smooth functioning of a social and ecological market economy. This underlines the interdependence between standards and the social and ecological market economy. Standards need certain governmental and societal preconditions in order to be implemented and function properly. Once they are implemented, they in turn foster a competitive social and ecological market economy where all stakeholders cooperate.

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GTZ's Approach to Supporting Private Sector Development in Asia – Underlying Principles and Practical Experience

Corinna Küsel[1]

Introduction

The discussion on the relevance of the model of the social and ecological market economy for German development cooperation has recently intensified significantly. This discussion has been triggered, among other things, by the policy paper on its key principles recently issued by the German Federal Ministry for Economic Cooperation and Development (BMZ).[2] The policy paper builds on German and European traditions of designing economic and social policies in a way that ensures a balance between free market competition and the regulation of key aspects necessary to guarantee social equality and equal opportunities. It has led to systematic reflection on the foundations as well as the values and positions shaping the approaches of German development cooperation in different fields.

The policy paper has also further spurred the ongoing international debate on the role of the state. This debate deals in particular with the question of whether reforms of the regulatory framework alone suffice to create the basis for the private sector to unfold, or whether they need to be complemented by selective and targeted promotional approaches to strengthen the competitiveness of specific sectors or regions via industrial policy.

The purpose of this article is to review the background and conceptual underpinnings of private sector development (PSD) approaches of German development cooperation (and in particular German technical cooperation)[3] in

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[1]The author wishes to thank Anke Petersen and Peter Sommer for putting together the case studies for this article, as well as various colleagues for comments and suggestions.

[2]See German Federal Ministry for Economic Cooperation and Development 2007a and 2007b.

[3]This review will refer in some instances to German development cooperation in general, for which the overarching orientation and guidelines are set by the German Ministry for Economic Development and Cooperation. However, it will more specifically assess how the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, as an implementing organization for German development cooperation, has translated the overall framework and the guidelines into specific concepts and practical instruments for implementation.

the framework of these debates, and to assess how they have been implemented in the specific socio-economic context of Asia.

The article will outline different concepts that have influenced the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH's approach to private sector development, in particular, how it builds on the German experience of a strong *Mittelstand,* but also how it has both contributed to and incorporated international debates. The article will then review in more detail how these concepts are put into practice in GTZ work in Asia. Lastly, it will make some recommendations for reform and further development of GTZ's approach.

Foundations and Key Principles of GTZ's Private Sector Development Approach

The purpose of this chapter is to show how GTZ's approach to private sector development builds on Germany's own experience of developing a competitive small and medium-sized enterprise sector within the overarching context of the social and ecological market economy, as well as how it has been shaped by the international discussion on the most effective approaches to stimulating economic development.

The Relevance of Small and Medium-Sized Enterprises in the Context of Germany's Social and Ecological Market Economy[4]

Strengthening the private sector is one of the BMZ principles,[5] because a strong and competitive private sector is a constituent element of the social and ecological market economy. It is one of the most essential levers for overall economic and social development and for sustainable poverty alleviation; it creates jobs and income, and also contributes to the overall state budget and thus to public expenditure in social and other domains.

Germany's own experience of successful economic development strongly builds on the dynamism of efficient and internationally competitive medium-sized businesses, many of them world leaders in their industries. Innovative and successful small and medium-sized enterprises (SMEs) have been and continue to be a growth and job

[4] This section builds strongly on Meyer-Stamer and Wältring 2000.

[5] The principles of the social and ecological market economy are: 1. Supporting the rule of law; 2. Striving for broad-based growth; 3. Strengthening the private sector; 4. Improving conditions for the market economy; 5. Making an economy viable for the future; 6. Creating a social partnership; 7. Shaping the economy based on ecological concerns; and 8. Ensuring equal opportunities.

machine.[6] The relevance of the SME sector in Germany goes beyond its economic importance and builds on the historical and societal role of the *Mittelstand,* which has its historical roots in the social order of the Middle Ages, where the estates (*Stände,* that is, citizens grouped according to socio-economic status, for example nobility, craftsmen, traders, farmers, etc.) were assigned special responsibilities.[7]

The success of Germany's small and medium-sized enterprises builds on a sophisticated and systemic structure, different elements of which have been taken up by GTZ's private sector development approaches.[8] At the policy level, the development of the private sector and specifically of SMEs builds on a setting of stable macroeconomic, political, and regulatory framework conditions. Care is taken that policies and regulations have few discriminatory effects on SMEs.[9] To create room for the creativity and initiative of SMEs, the German Federal Government launched the so-called Initiative for Small and Medium-Sized Businesses in July 2006.[10]

The development of SMEs also builds on a highly differentiated system of organizations and institutions which offer services at the municipal, regional, and national levels. This institutional set-up includes public and private institutions as well as public-private partnerships. Research and training institutions like the dual vocational training system, higher education institutions (universities, etc.), and specialized R&D institutions play a key role in strengthening the competitiveness of the private sector. SME support distinguishes between regional policy (with a view to reducing disparities between German regions)[11] and *Mittelstand* and technology policies at the national and *Länder* (federal states) levels.

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[6]The approximately 3.4 million small and medium-sized businesses represent 99.7% of all businesses in Germany, produce 40.8% of the taxable turnover, provide 70.5% of jobs, and train 83.4% of all apprentices, see http://www.bmwi.de.

[7]See Meyer-Stamer and Wältring 2000, 7.

[8]It is important to point out that there has been a shift from a focus on small and medium-sized enterprises to a more generic orientation to development of the private sector. To reach the overarching objectives of economic development and poverty alleviation, the competitiveness of the entire sector and the linkages between smaller and larger companies need to be addressed.

[9]See Meyer-Stamer and Wältring 2000, 53.

[10]Some of the key elements of the SME initiative include creating a favorable environment for small and medium-sized enterprises, reducing bureaucracy, initiating a business start-up campaign as a catalyst for more start-ups, strengthening the innovativeness of SMEs, modernizing vocational training, improving the funding situation for SMEs, and mobilizing venture capital for innovation and stronger support for SMEs in overseas markets. See http://www.bmwi.de.

[11]The concept of regional policy as a "joint task" of the federal government and Länder (federal states) to improve the regional economic structure is explained in detail by Hutter in this reader.

At the firm level, cooperation between SMEs and between SMEs and large enterprises has gained in importance as a result of the globalization process and the more knowledge-intensive production needs. The phenomenon of clusters and industrial districts in countries like Italy has received a lot of attention and underlines the importance of different forms of cooperation and supplier relations.

Most important for the development of the German private sector is, however, probably a value system which encourages entrepreneurship and achievement, and consensual relationships between major societal groups: in general, German institutions base their operations on a fundamental consensus that leads to a problem-solving-oriented style of negotiations between the private and public sectors as well as between unions and employers associations. The German political economy – with its foundation in the social market economy – is strongly shaped by regulatory constraints on employers in the remuneration, use, and dismissal of labor. This includes binding industry-wide agreements on wages and working conditions, a high level of mandatory or state-provided social security benefits, and substantial constraints on layoffs. Complementary to the collective bargaining model on the supra-firm level, works councils that represent employees at the shop-floor level have wide-ranging information, consultation, and co-determination rights within a firm.[12]

The German experience of private sector development is thus, on the one hand, related to the systemic institutional structure and has an overall orientation conducive to enterprise development at different levels. It is also based on the specific societal model of the social (and increasingly ecological) market economy, which is the basis for the consensus-oriented relationship between capital and labor, as well as between the public and private sectors. This is a characteristic example of the importance of societal values and "shared mental models," which Richter highlights in her essay in this reader as essential for understanding specific development patterns. On the other hand, international discussions and conceptual trends have influenced private sector development approaches.

International Discussion on Private Sector Development

Two of the most influential paradigms that are shaping the international discussion and influencing the intervention approaches of GTZ are "business development services" and "business enabling environment."[13] The platform and

[12] See Meyer-Stamer and Wältring, 21 ff. On labor relations and co-determination, see also Meissner and Hung in this reader.

[13] This is necessarily a very selective view, which leaves out various other concepts of relevance in the international PSD debate.

the instrument for this discussion has been the Donor Committee for Enterprise Development (DCED) and its working structures.[14]

Business Development Services (BDS)[15]

Since the late 1990s, the BDS concept has exerted significant influence over approaches to private sector development. In particular, it has induced a shift away from a traditional, rather supply-driven approach, in which donors and public sector institutions provided services – mostly training and consultancy, often free of charge – to enterprises. One of the key results of the BDS discussion was thus that it has led to a much more business-oriented and market-led approach.

Over time, the BDS perspective has undergone significant development. The first generation approach still followed a rather narrow concept and focused mainly on the delivery of business services, mostly offered on a commercial basis by private providers. The second generation thinking already reflected a more comprehensive and systemic understanding and had a more appropriate consideration of the different roles of the public and the private sectors. Market development principles increasingly became integrated into more comprehensive private sector development projects.[16] Internationally, market development as the overarching paradigm has in the meantime further developed to an (at least) third generation approach, which has been adopted by many agencies.

Overall, the BDS concept has been used to further develop GTZ's approach to private sector development: It stresses principles of market and competition *(Leistungswettbewerb)* that are essential ingredients of the social market economy, but were previously mainly addressed at the level of individual companies. It has brought about a shift to market and demand-oriented thinking, with an emphasis on the principle of subsidiarity and a focus on outreach, impact, and economic sustainability. Tools and instruments to develop business service markets and, specifically, to build both demand and supply in a sustainable manner have also been increasingly integrated into

[14] The Donor Committee for Enterprise Development (www.enterprise-development.org), formerly called the Committee of Donor Agencies for Small Enterprise Development, is a forum for international conceptual development and coordination in private sector development. It comprises a large number of bilateral donors, development banks, and international agencies. It develops best practice guidelines based on practical experience gained in the field; it provides a forum where innovative thinking and approaches can be articulated and discussed and offers institutional memory to members and others in private sector development. It was informally established as early as 1979, but has since then continuously expanded and formalized its activities.

[15] Various papers and case studies on practical experiences in the field of BDS market development can be found at www.bdsknowledge.org.

[16] See Wältring 2006.

approaches like value chain promotion and local and regional economic development. Over time, the BDS concept has also progressively reflected a systemic way of thinking and has at least partly considered the roles of the public sector in service provision.

On the other hand, the concept and implementation of BDS have, in hindsight, suffered from a too narrow interpretation and a too strong focus on strengthening the market for services offered by private providers. BDS has often been implemented as a micro-level approach, which in itself cannot do justice to the complex challenges of PSD. At the same time, it has not paid enough attention to the role of the state in creating the necessary preconditions for economic development and has lacked clarity on what can be considered public goods.

Business Enabling Environment (BEE)[17]

The most recent – and still very valid – paradigm that is both shaping the international discussion and influencing intervention approaches of GTZ is related to the business enabling environment. Since the beginning of this decade, increasing attention has been given to the political, legal, and institutional framework conditions which constrain private sector development in many countries. It is in this context that the Business Environment Working Group (established in 2001) of the DCED has addressed the subject, also by organizing three international conferences and preparing "donor guidance," with a view to agreeing on common principles and best practice orientations.[18]

An enabling business environment refers to a legal, political, and institutional framework which favors the unfolding of private initiative and investment. The aim is to eliminate unnecessary regulations and red tape that hinder the development and performance of businesses. This relates, among other things, to the costs of compliance with regulations. It refers not only to direct costs, such as license fees, but also to indirect costs resulting from expenditures and time spent for – often unnecessary – transactions.

[17]For further information on concepts, research results, and field experiences, as well as the papers from the international BEE conferences, see www.businessenvironment.org.

[18]The "donor guidance" defines the business environment as a "complex of policy, legal, institutional, and regulatory conditions that govern business activities. It is a sub-set of the investment climate and includes the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate." It emphasizes, in particular, that a "healthy business environment is essential for growth and poverty reduction. Business environment reform is needed where inappropriate regulation, excessive taxation, lack of fair competition, lack of voice, and an unstable policy environment restrict investment and the development of markets, and force many businesses to operate in the informal economy." See Donor Committee for Enterprise Development 2008.

An intensive discussion on the effective contribution of business environment reforms to economic growth and the development of the private sector and, specifically, to poverty alleviation is going on. Its advocates emphasize that business environment reforms constitute the most effective and efficient as well as cost-saving means (in contrast to promotional tools) to strengthen private sector development. They also claim that removing administrative obstacles enables particularly the poor to participate in business activities.

Its critics, on the other hand, underline that BEE reforms may be important, but are by no means sufficient for achieving the above-mentioned development goals. Questions raised are, in particular, whether business environment reforms allow for the creation of competitive advantages in increasingly globalized and knowledge-intensive markets, and whether they really have pro-poor outcomes (Altenburg and von Drachenfels 2008). GTZ's practical experience also underlines that policy reforms will not be successful if they are not sustained by support to implementation and capacity building of stakeholders.

For German development cooperation, in general, and GTZ, in particular, this debate on the relative importance of business environment reforms has helped develop and sharpen the conceptual understanding and practical implementation capacity of a systemic approach to private sector development. The discussion on business environment reforms has led to an increasing recognition of the relevance of macro-level reforms and improvements of the regulatory environment within GTZ private sector development approaches. This has in particular highlighted and specified the role of the state as an important partner within PSD approaches – in contrast to earlier cooperation approaches which focused mainly on private sector players and addressed policy aspects only indirectly, for example, by supporting business membership organizations in their government lobbying function. Addressing regulatory obstacles has increasingly become part of different service fields of GTZ: approaches such as local and regional economic development and value chain promotion integrate a BEE perspective in their toolbox for analysis and intervention.

GTZ's Approach to Private Sector Development[19]

GTZ's concept of private sector development builds on these various ingredients: It is based on the German and European tradition with its strong and competitive sector of private small and medium-sized enterprises and the diversified institutional set-up which has been bolstering private sector development in Europe. It has been informed by the conceptual debate and

[19]See Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH 2001 and Miesner 2004.

exchange at the international level, which has helped hone its market orientation. It has also learned from the discussion within the research community.

Among the concepts which have significantly contributed to shaping conceptual discussions and practical approaches within GTZ has been the concept of systemic competitiveness,[20] based on the work of the German Development Institute in the 1990s. The understanding of competitiveness within GTZ has evolved notably over the past years and decades, from a focus on the competitiveness of individual companies and the strengthening of specific institutions to an increasingly comprehensive and systemic perspective.

As a result, the following are essential elements of GTZ's approach to private sector development:

- GTZ's approach to private sector development builds on a systemic perspective and addresses different intervention levels. It focuses on the interlinkages between the regulatory framework (at the macro level), the institutional environment (meso level), and inter-firm relationships (micro level) as a basis for the competitiveness of an economy. Among other things, this approach has been informed by the systemic and diversified institutional set-up that has shaped private sector development in Europe.
- In particular, GTZ's PSD approach increasingly emphasizes the reform requirements of the regulatory environment and thus the macro-level perspective. This focus and the toolbox of analysis and intervention approaches have been developed in close interaction with the international discussion on the business enabling environment.[21]
- GTZ's approach gives special attention to a differentiated perspective on the responsibilities and the subsidiarity of different legal entities at the national, sub-national, and local levels. In this perspective, the interlinkages between national level policy orientations and regional development approaches are addressed.
- The systematic involvement and participation of multiple stakeholders is of particular relevance within GTZ's systemic PSD approach. This is also based on the German experience, which underlines the importance of a close and consensus-oriented dialogue and cooperation between the state, the private sector, and labor representatives.
- The approach also builds on the interlinkages between enterprises of different sizes: A systemic perspective of the economy emphasizes the linkages

[20] See Eßer et al. 1994.

[21] This increasing integration of a macro-level perspective is also reflected organizationally in GTZ in the merger of the Private Sector Development and Economic Policy Sections.

between enterprises of different sizes that are integrated in local, national, and global value chains – in contrast to earlier approaches which focused mainly on micro and small enterprises. In this context, the involvement of big international companies is increasingly recognized as a prerequisite for developing the competitiveness of local producers.
- Social and ecological principles constitute an integral part of GTZ's PSD approach, as an essential element of an integrated concept of sustainability, but also in response to the requirements of globalization and international production standards.

Private Sector Development Approaches in Asia

The objective of this chapter is to assess how the key principles and conceptual elements that have been outlined are translated into practical approaches and results in the context of German development cooperation in Asia. It will present practical examples of how GTZ approaches to private sector development are taking up the current challenges of economic development in the region and the demand from partner countries.

In this context, it is important to underline that these private sector development approaches are based on priorities of and demands from the partner country. Governments and other stakeholders in Asia constitute strong and self-conscious partners who clearly articulate their demands and their specific requirements. They choose donors and concepts based on the specific solutions that these can offer to their problems and the objectives they want to achieve. The programs and approaches to be reviewed below thus always constitute the result of a dialogue and consultation process between the development partners involved.

Framework for GTZ's Private Sector Development Approaches in Asia

Economic liberalization as well as the rapid spread of new technologies are making the business environment in Asia continuously more competitive and demanding. WTO membership, competition from China and India, etc. imply steadily increasing adjustment requirements for Asian economies. Structural change in Asia is taking place at a rapidly increasing pace.

At the same time, socio-economic development in Asia is characterized by a significant level of heterogeneity: while many countries in Asia have been successfully integrating into the world economy, others lack the requisite preconditions and suffer from high poverty levels, in some cases exacerbated by conflict situations.

Despite this high level of heterogeneity among Asian countries, there is an overall understanding that economic growth is a key element of development. Most Asian countries – rich and poor alike – have recognized private sector development as a core element of approaches to strengthen competitiveness, employment, and income generation. Overall, across most Asian countries, balanced and broad-based economic growth is seen as crucial to poverty alleviation, despite some differences in thrust.

At the same time, the rapidly industrializing economies face increasing challenges in relation to environmental and social aspects. As they pass into the stage of industrialization at quick-motion speed, they are already now facing social and environmental challenges similar to those of industrialized countries. In some countries, rapid growth has led to rising inequality, which may cause tension and result in political unrest. The key question is how to achieve fast growth as a basis for poverty reduction while ensuring equality of opportunities and inclusive development at the same time.[22]

Sustainable economic development as a path to broad-based economic growth constitutes a main concern for most Asian countries and is accordingly also high on the agenda of German development cooperation. In most countries in Asia, therefore, "sustainable economic development" constitutes one of the priority areas of German development cooperation, with private sector development constituting a key part in most cases.[23] Under the BMZ Regional Strategy for Asia which defines (1) socially balanced growth, (2) ecologically viable development, and (3) good governance as priorities, the approach of sustainable economic development gives special emphasis to social inclusion.[24]

[22]On the challenges for Asian development, see Richter in this reader.

[23]Sustainable economic development has been agreed upon as a priority area of cooperation between Germany and China, India, Indonesia, Laos, Mongolia, Philippines, Sri Lanka, Thailand, and Vietnam. In Bangladesh, Cambodia, and Nepal, there are significant private sector development programs within other priority areas. On the approach of the priority area "Sustainable Economic Development," see German Federal Ministry for Economic Cooperation and Development 2006a and 2006b.

[24]See German Federal Ministry for Economic Cooperation and Development 2008a and 2008b on the strategic framework for German development cooperation with Asia and the approach to socially balanced economic development in Asia, respectively.

Key Elements of a Systemic Approach to Private Sector Development in Asia

A systemic perspective structures the approaches of German development cooperation in the field of economic development, in general, and private sector development, in particular. Most programs of German development cooperation in Asia thus include interventions at the institutional and the policy levels and at the national and sub-national levels, and involve stakeholders from the public and private sectors. Additionally, support to the private sector is often complemented by vocational training programs, regional development, or programs to strengthen the financial system or address ecological concerns.

The following section will review how some of the key aspects of the systemic approach are practically addressed and implemented in the Asian context.

The Multi-level Approach: Business Environment Reforms in GTZ-Supported Programs in Asia

Business environment reforms have increasingly become an integral element of private sector development programs supported by GTZ in Asia. Experience underlines the importance of an integrated approach, which links interventions at the policy level to practical implementation and capacity development and complements policy advice with support to specific regions or sectors.

Over the past years, it has increasingly been recognized by most governments and development partners in Asia that an enabling business environment is one of the foundations of effective private sector development. Policy reforms are thus high on the agenda of development cooperation, both as an element of policy conditionalities of larger often multi-donor-supported reform programs and credits and also supported directly by technical assistance programs.

While other development partners frequently focus their support on policy reforms at the national level, German development cooperation generally addresses regulatory reform aspects as an integral part of broader and more integrated private sector development programs.

The experience of GTZ emphasizes the importance of linking business environment reforms at the national level with support to capacity development of institutions and to the effective implementation of reforms. In many countries, ineffective implementation of reforms is one of the biggest shortcomings, resulting in only limited impacts of policy level changes. This also underlines the need to involve various stakeholders in the reform process.

Support for capacity development is essential to enabling partners to work towards sustainable development.[25] The promotion of capacity development builds the capability of stakeholders to effectively combine and coordinate political will, interest, knowledge, values, and financial resources in order to achieve their own developmental objectives. GTZ considers capacity development a prerequisite to any integrated approach to furthering development processes. Its approach to capacity building is therefore based on an in-depth understanding of partner structures, process-orientation, and systemic thinking.[26]

Programs in Asia, for example, in Vietnam, the Philippines, and Indonesia, emphasize support for the implementation of reforms at the sub-national level. In *Vietnam,* GTZ works with the stakeholders in selected provinces to sensitize them to the reforms of the national policy framework and to build their capacity to effectively implement these reforms. For example, business registration procedures have been simplified by establishing one-stop shops and an IT-based registration system in several provinces. In most provinces, the time required for registration has been shortened from several weeks to 10 working days. The focus is thus on translating an increasingly favorable business environment at the national level into practical results at the provincial level by building the required institutions, implementation mechanisms, and personnel capacities.

Experience in the *Philippines* has shown how practical results of reforms in selected localities may create momentum for horizontal transfer and replication. The program initially focused on helping selected cities to streamline their business registration process. This allowed companies to obtain business permits faster and at a lower cost; as a result, the number of registered companies increased in these localities. On this basis, good practices of simplified and faster business registration could be transferred to further localities. Additional learning and replication may ultimately lead to improved business registration procedures throughout the country.

Overall, GTZ's experience in integrating policy-level reforms in private sector development approaches underlines the following aspects:

- Addressing the macro-level and reforms of the regulatory environment as an integral part of a systemic PSD approach is an important pillar of effective and sustainable support to the development of a competitive private sector.

[25] "GTZ's specific approach to capacity development support is rooted in our concept of sustainable development." See Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH 2007.

[26] Organization for Economic Cooperation and Development, Development Assistance Committee (OECD-DAC) 2006.

- Experience strongly underlines the importance of linking policy reform interventions with support to implementation and capacity development of institutions, both at the national and the sub-national levels. This practical experience from implementation also enables GTZ as well as its partner organizations to provide well-founded and thus more effective inputs to the debate on policy reforms at the national level.
- Regulatory and administrative reforms thus need to be complemented by support to specific sub-regions (in the context of local and regional economic development approaches) or sub-sectors (in the context of value chain approaches) in order to be effective. The reverse is also true: experience shows that local economic development or value chain approaches will be less effective if specific bottlenecks and constraints at the policy level are not addressed.

Addressing Local and Regional Economic Development in a Systemic Manner

GTZ's approach to local and regional economic development (LRED) attempts to strengthen locational factors and the competitiveness of a region or a locality. Its systemic conceptual framework integrates support to the implementation of policy reforms as well as selective promotional tools. It particularly emphasizes a participatory and dialogue-oriented process to engage the various relevant stakeholders in problem analysis and planning and to mobilize their participation in implementation. There is increasing recognition that this approach needs to be inserted into a national perspective of regional or territorial development policies.

In the context of decentralization processes in many Asian countries, support to economic development at the sub-national level is gaining attention. With its approach of local and regional economic development, GTZ offers a comprehensive toolkit to support countries with quite different framework conditions.[27] LRED strategies are designed in a participatory process involving the relevant stakeholders; this entails a joint participatory analysis of the main bottlenecks and constraints and coordinated planning of practical initiatives.

The goal of local and regional economic development is to strengthen locational factors and competitive advantages of sub-regions or localities within a country as well as to enhance cooperation between different sub-national entities. To improve the investment environment for both existing companies and new investors, it aims to create an appropriate policy

[27] LRED approaches are currently pursued in most GTZ programs in Asia, for example, in Indonesia, Vietnam, Philippines, Cambodia, Nepal, Sri Lanka, India, Laos, and China.

and institutional framework and strengthen the availability of demand-oriented services. The establishment and support of cooperation networks and clusters of enterprises, research institutions, and local authorities within a region helps to link existing potentials in a bid to increase regional competitiveness.

At the same time, there is increasing recognition that sub-national development needs to be inserted into a national policy perspective. Territorial (or regional) development policies include all the policies undertaken by public authorities (central, regional, and local authorities) with the explicit goal of enhancing the growth of specific geographical areas. While aiming to strengthen competitiveness, the objective is also to achieve a sustainable development pattern as well as balanced growth among different regions of a country. This also builds on the German approaches of regional policy and the promotion of selected regions with a view to enhancing economic growth and facilitating structural change.[28]

The Regional Development Program (RED) in *Indonesia* exemplifies the systemic LRED concept. The program aims to build the capacity of decision makers at the regional but also at the national level to manage an integrated regional economic development approach. To improve the business environment in the region of Central Java and to simplify administrative processes, the provincial government has introduced one-stop services in all districts in the province; regulatory impact assessments have been conducted in a number of districts with a view to adjusting or abolishing regulations that negatively affect economic activities. Forums for economic development and employment promotion serve to facilitate the dialogue between relevant stakeholders from the public and private sectors as well as members of civil society, and are the forum for jointly designing local economic development initiatives. Regional marketing activities play an essential role in the project approach: Internal marketing activities attempt to reduce disparities between districts; they motivate local actors to think and act beyond their district boundaries on a regional scale. External marketing activities advertise the strengths of the region to potential external investors. By integrating all determinants of successful enterprise promotion, RED creates an enabling and efficient system for sustainable development of the private sector in Central Java. Practical experiences are then transferred to the national level.

In *China,* the Sino-German Economic and Structural Reform Program is currently supporting the drafting of a comprehensive strategy for regional

[28] See Hutter in this reader.

development. In its recent five-year plan and its vision for a harmonious society, the Chinese government has recognized the need for a systematic approach to strengthen development in backward regions: While 37% of Chinese gross domestic product is created in three provinces (Yangtse, Pearl River, Beijing/Tianjin), approximately 750 million Chinese continue to live in the less developed regions of western, northeastern, and central China. This has led to an increasing income gap (Gini coefficient 0.45). The aim is thus to develop a comprehensive policy for coordinated, balanced, and sustainable regional development in China. This builds on so-called territorial reviews, which are conducted by OECD experts with state-of-the art analytical tools for regional development strategies. GTZ, as a long-term partner of high-ranking Chinese decision-makers, supports the process and ensures that the findings are incorporated in the process of drafting new laws. It will also support capacity development and implementation of reform processes to ensure the impact of the law on regional development.

In a nutshell, the LRED approach thus translates and operationalizes the systemic perspective to the sub-national level:

- GTZ experience emphasizes the importance of a consultative and participatory approach which integrates the perspective of all stakeholders, both from the public and the private sectors. Consultation and participation are important to mobilize the involvement and active contribution of all relevant parties.
- Major emphasis is on developing an institutional framework that builds on regional and inter-regional cooperation between enterprises, research institutions, business membership organizations, and local authorities.
- Increasing attention is given to linking local and regional initiatives with policy reforms at the national level. This relates, on the one hand, to the implementation of national level policy reforms at the sub-national level. On the other hand, territorial development approaches aim to provide orientation to regional development decision makers from a national perspective, with a view to reducing regional disparities and increasing regional competitiveness.[29]

[29] See Mang and Bonschab in this reader.

Public-Private Cooperation and Dialogue

An integrated and systemic PSD approach builds on the involvement of multiple stakeholders. Of particular importance in this context is the facilitation of a structured exchange and dialogue involving representatives of both the public and the private sectors. Institutionalizing public-private dialogue processes is important both at the national and the sub-national levels.

Many developing and transition countries in Asia have little tradition of constructive dialogue between the government and the private sector; many believe that consultation on law and policy making is only pro-forma or superficial. Often, there is no experience with and no tradition of structured consultation mechanisms such as regular forums at the national or local levels, expert consultative groups, or focus group discussions.

The importance of strengthening the dialogue between public and private sector stakeholders is thus increasingly high on the agenda of development partners. The World Bank, for example, has prepared a comprehensive toolkit, including case studies and monitoring mechanisms, for such dialogues.[30]

German experience strongly emphasizes the importance of such dialogue mechanisms between different stakeholders, including the public and the private sectors and trade unions as labor representatives. Within Germany, there is a tradition of round tables which play an important role in many federal states and constitute a structure for consultation and joint decision making on strategies for regional economic development. GTZ has always given high priority to enhancing the articulation of entrepreneurs' interests, also, for example, by strengthening the role of business membership organizations.

In *Vietnam*, GTZ has supported the drafting of the Enterprise Law and the Investment Law by introducing a set of systematic consultation mechanisms and has helped to establish structured exchange processes. This has included direct support to the organization of policy dialogues between government agencies and the private sector, involving both foreign and local business associations. GTZ has also helped to carry out regulatory impact assessment exercises that engage stakeholders in a systematic analysis of the effects of regulation. Involving the press and media helped to bring the issues discussed in policy dialogue forums to the public, resulting in wide civil society discussion of many critical issues surrounding the laws. As a result, support for reforms and "public ownership" of the laws has greatly increased. These two laws have been the most widely debated ones to date and have set an example for wide participation of the private sector in lawmaking in Vietnam. Based on the success of the consultation processes for

[30] see www.publicprivatedialogue.org

these specific laws, GTZ has worked with key agencies to institutionalize these mechanisms. As a result, the government is now intending to introduce regulatory impact assessments as a standard tool for consultation on law projects.

GTZ's experience thus shows that:

- Structured dialogue processes require more than occasional meetings between the relevant stakeholders; for an effective and efficient organization of such dialogues, clear mandates and defined roles of the stakeholders involved, a focus on tangible outputs, as well as follow-up and monitoring are necessary.
- Facilitating the dialogue between the public and private sectors plays an essential role, not only in policy reforms, but also in order to effectively involve the relevant stakeholders in the development of coordinated intervention strategies, for example, for specific regions or sub-sectors.
- Dialogue mechanisms so far have engaged mainly the public and private sectors in joint strategy development; worker representatives have not yet been systematically involved in these processes.

Strengthening the Integration of Local Firms in Global Value Chains in Cooperation with International Lead Firms

Finding ways to effectively cooperate and join forces with the international private sector is gaining increasing attention in the international discussion on economic development, in particular in the context of value chain approaches. Development partnerships with the private sector or public-private partnerships give German development cooperation an effective tool to involve big international companies in contributing to sustainable development.[31]

For GTZ, an integrated view of a sub-sector that addresses the interlinkages between enterprises of different sizes is an important element of a systemic approach. Earlier approaches which focused exclusively on small companies fell short of addressing the challenges of world market orientation and the need for structural change. Cooperation with international lead firms is essential for enhancing the ability of regions or sub-sectors to comply with requirements of the world market.

This is even more important in Asia, with its vigorous private sector development and the significant presence of international firms. In many programs in Asia,

[31] German development cooperation has always highlighted the significant contribution of private sector engagement to development objectives. Earlier approaches of integrated advisory services were converted to the Public-Private Partnership Program in the 1990s.

particularly in those with value chain components, for example in Bangladesh, Vietnam, Sri Lanka, Philippines, Thailand, and Nepal, international players are involved in the development of local value chains.

In *Vietnam*, GTZ systematically engages international firms in the development of different agricultural value chains. In the fruit and vegetable value chain, for example, GTZ has cooperated with the Metro Cash and Carry Group to train more than 8000 farmers, collectors, and retailers in measures to improve quality and hygiene. They jointly invested in upgraded washing, sorting, and packaging infrastructure. As a result, the previous losses of about 50% of fruits and vegetables between the farmer and the retailer have been significantly reduced, resulting in higher income for the farmers and better quality products. Furthermore, Metro and GTZ are cooperating in advising Vietnam's Ministry of Trade in order to strengthen local retail and distribution networks.

Such public-private partnerships thus involve international companies in building the capacity of small local companies to improve production standards and compliance with international standards and may ultimately contribute to increased sales and higher income. They also strengthen the impact and sustainability of value chain initiatives, as they increase the leverage of the interventions. These partnerships not only enhance the competitiveness of local enterprises, but also help sensitize both local and international companies to issues of ecological sustainability and corporate social responsibility (CSR). The adoption of social and ecological responsibility is increasingly recognized as the foundation for sustainable corporate management; in other words, CSR, not as charity, but as a basis for generating a competitive advantage.

In a nutshell, the involvement of international players:

- introduces the perspective of world market requirements into strategies for the development of selected value chains; it induces small producers to orient local production to market demand;
- sensitizes companies to an overall orientation of sustainable development; corporate social responsibility is increasingly recognized as an element of competitiveness by big international companies as well as by Asian governments; and
- provides additional resources for sustainable economic development, as companies see the advantages of engaging in partnerships with development cooperation efforts.

Addressing Social Aspects

The social impacts of global production patterns are gaining increasing attention in development cooperation, but also from governments and the international private sector. Practical support for the introduction and observance of social – as well as environmental – standards leverages the principles of social and ecological sustainability among all involved stakeholders, but is also essential in order to strengthen the international competitiveness of the local industry.

Social and ecological concerns are receiving growing attention from governments in Asia, and also from the Asian private sector. In particular, in the fast developing countries of Asia, societal change and environmental risks increasingly place these concerns at the forefront of attention. For the private sector, increasing international attention to production standards and pressure from consumers has put social and ecological production standards on the agenda.

In *Bangladesh*, for example, social concerns have seriously called into question the competitiveness of the ready-made garment industry – the country's chief source of employment and export revenues. Collapsing or burning garment factories with hundreds of victims are only the tip of the iceberg of extremely poor labor conditions, which have resulted in uncontrolled labor strikes. Therefore, GTZ's PSD program (PROGRESS) in Bangladesh has been reoriented to promote observance of social standards, while at the same time building up the competitiveness of the garment sector. The program cooperates with local suppliers, international buyers, government, non-government organizations, and business associations to strengthen the economic, social, and ecological sustainability of the garment sector. Among other things, it has supported the revision of labor and environmental legislation, which now constitutes the basis for social and ecological standards that are commonly accepted by all national and international stakeholders. Round tables involving German and European companies contribute to greater coordination among international buyers and local producers. Inspectors from the Ministry of Labor and Employment and employees of the two largest industry associations have been trained to more effectively promote the enforcement of standards. The intensive debate on labor conditions in the Bangladeshi garment industry has resulted in an increase of wage levels and improved working conditions, as social standards are increasingly accepted by entrepreneurs.[32]

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[32] Further examples on how social aspects can be addressed as part of GTZ-supported programs are found in this reader; see Roggekamp on KATALYST in Bangladesh and Finkel on Vietnam.

The following conclusions can be drawn from this example:

- While social aspects are becoming a concern for the private sector for different reasons, most often this is a result of pressure from the inside (strikes and social unrest, as in the case of Bangladesh) or from the outside (international buyers).
- Development cooperation can make use of this pressure and support the practical development and introduction of social standards. It can sensitize and advise the various stakeholders on the relevance of corporate social responsibility.[33]

Integration of Environmental Issues into PSD Approaches

Environmental aspects are of crucial importance in the context of Asia's development pattern. Strengthening environmental sustainability has high priority for German development cooperation in general and specifically in the context of its cooperation strategy with Asia. Still, for a number of reasons, there is limited integration of environmental aspects into private sector development approaches.

Environmental – as well as social – concerns are moving up the political agenda in Asia. To some extent, this is a result of the globalization process, where the observance of social and ecological standards is increasingly a precondition for competing globally. Environmental sustainability is receiving growing attention from governments in Asia, in particular in the fastest growing countries of Asia. At the same time, ecologically sustainable development is one of the main priorities of German development cooperation in Asia, with a focus, for example, on eco-efficiency, reduction of emissions, and natural resource protection.

Most private sector development projects in Asia have therefore to some extent integrated concerns of ecological sustainability into their intervention strategy. The section above has highlighted how private sector development approaches are addressing social and environmental production standards as an integral part of their approach. Private sector development projects in Asia have also supported the introduction of related business services based on the concept of profitable environmental management (PREMA), a tool which is adapted to the specific requirements of small and medium-sized enterprises. It emphasizes in particular the reduction of non-product outputs as a means of cost-reduction, on the one hand, and the improvement of environmental performance, on the other.

The Thai-German Program for Enterprise Competitiveness is probably the first program in Asia that has integrated eco-efficiency and economic

[33] This is outlined in more detail by Finkel in this reader.

development in a comprehensive and systemic manner. It has reacted to a strong demand from the Government of *Thailand*, which has put priority on the introduction of eco-efficient and sustainable production. The program addresses environmental issues at different levels and in a number of fields: It provides advice to relevant ministries and business associations with regard to the development and implementation of SME promotion policies and works with a wide range of intermediaries, especially in the fields of management and eco-efficiency, so that they can improve their capacity to offer more relevant services to SMEs. The project aims, for example, to improve the competitiveness of the agro-industry through the implementation of cost-effective production process technologies and professional management techniques. Estimations indicate that the Thai agro-industry could generate an additional annual income of US$1 billion through waste-to-energy and energy-efficiency improvements. After only one year, more than half of all Thai palm oil mills, representing more than 60% of production capacity, are participating in these activities.

However, the efforts of the Thai program to systematically integrate economic and environmental concerns constitute an exception among private sector development programs supported by German development cooperation in Asia. Even though various programs have supported the development of business services in relation to social and ecological standards, as shown by the examples above, or have contributed to the establishment of eco-industrial zones, ecological aspects have not been integrated in a sufficiently systematic way.

GTZ experience thus underlines the significant demand and potential for better integration of environmental and eco-efficiency aspects into PSD approaches. However, so far progress is slow; fuller integration of these aspects thus constitutes a key requirement for the further development of PSD approaches in Asia and also in other regions.

Requirements for Further Development

The above review has already given some indication of areas where private sector development concepts and approaches of GTZ are not yet sufficiently addressing major current challenges of Asian development, and where they should build more systematically on the principles of the social and ecological market economy. It has identified some fields of intervention which need to be better integrated into private sector development approaches, in order to face up to the requirements of Asia's rapid industrialization process.

Asia's high-growth countries are increasingly faced with the social and ecological effects of their fast development. They must rapidly adjust their development patterns and the ways in which they deal with ecological sustainability and social equality. At the same time, they must continue to expand their competitive advantages in an increasingly knowledge-based development path. While some Asian countries have integrated into the international knowledge economy faster than countries in other regions of the world, many less developed countries in Asia are lagging behind. Surprisingly, however, innovation and technology issues and support to the development of national innovation systems have not yet played a significant role within GTZ's private sector development approaches in this region. Additionally, the highly industrialized countries – among them the strategically important so-called anchor countries – play a particular role in bilateral cooperation and are of growing relevance also for other German policy fields and ministries.

In the least developed countries of Asia, sustainable patterns of pro-poor growth and inclusive development are still a major concern. New answers need to be found to deal with the effects of climate change, demographic change, and international migration. While Asia is the top destination of remittances (an estimated US$114 billion in 2006), the loss of highly qualified labor represents a major challenge for many – particularly the poorer – countries in Asia. Other regions are affected by escalating conflicts, which, particularly in several South Asian countries, limit their development perspectives. In the least developed countries, integration into overall government programs and cooperation with other donor initiatives (in the context of the Paris Declaration[34] and program-based approaches[35]) are additional requirements for further development of PSD approaches.

German technical cooperation in the field of private sector development will only be able to make a sizeable contribution to Asian development if it constantly adjusts and sharpens its concepts in the light of these trends and modernizes its technical concepts and approaches. The following will highlight just a few areas where GTZ private sector development approaches need to innovate in order to be better able to address these key challenges together with partner countries:

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[34] The Paris Declaration (endorsed in March 2005) is an international agreement to increase efforts to harmonize, align, and manage for development results.

[35] Program-based approaches are a way of engaging in development cooperation based on the principle of coordinated support for a locally owned development program. The approach includes four key elements: (1) leadership by the host country or organization; (2) a single program and budget framework; (3) donor coordination and harmonization of procedures; and (4) efforts to increase the use of local procedures over time with regard to program design and implementation, financial management, and monitoring and evaluation.

- **Industrial policy elements should be more systematically developed and addressed as part of GTZ's advisory approach:** Asian countries have been relying more than countries in other regions of the world on selected industry-specific public interventions, and have emphasized education and skills development, as well as investment in research and technology. German development cooperation needs to sharpen its concepts and instruments to provide the required specific advice on how to further develop these approaches, including furthering ecologically sustainable production patterns, strengthening innovation policies, and developing territorial development approaches with a view to increasing regional competitiveness. At the same time, industrial policies must consider the restrictions on subsidies and promotional policies under WTO requirements.[36]
- **Innovation policy should become a major field of GTZ advisory services in Asia:** Innovation and support to R&D as a basis for the further integration of Asian countries into the knowledge economy is of particular relevance in the Asian context. Improved access to knowledge about markets and new technologies and processes is as essential for innovation as better framework conditions. This calls for the creation of an environment that enables innovation. GTZ can build on the approaches and experiences it has developed in this field in other regions, which must be adjusted to the specific requirements and circumstances of Asia. It should also seek to cooperate with the German Ministry of Economics and Technology and join up with the ministry's activities in some Asian countries. The German system of promoting innovations is of specific interest in this context.
- **Ecological aspects must be integrated and linked with PSD approaches:** The above review has shown that PSD programs are not yet addressing ecological aspects properly; environmental impacts of private sector development are not sufficiently taken into account. More needs to be done, therefore, to systematically incorporate elements of environmental sustainability in PSD. Specifically, this requires developing linkages between the respective instruments and approaches and better integrating economic development and environmental programs.
- **The partnership between capital and labor should be addressed in advisory strategies:** This implies more systematically including the perspective of workers in policy reform, for example, through tripartite dialogue processes. Based on the German experience, approaches that ensure labor involvement

[36] See Altenburg et al. in this reader, who elaborate on an approach of "smart industrial policies" with a view to addressing these demands and requirements.

in corporate governance and build a consensus-oriented relationship between capital and labor will, in the long run, be the basis for sustainable and balanced development. An integrated approach to strengthening labor standards and corporate social responsibility should involve government, the private sector, and civil society and should become an integral element of PSD approaches.

Apart from technical concepts and approaches, cooperation with Asia also requires review and adjustment of methods and modes of delivery. In the developed Asian economies, cooperation will be characterized by exchange and mutual learning, even more than now. At the same time, Asia is gaining relevance as a partner for Germany and for the European Union in fields outside classical development cooperation, as other ministries and institutions (apart from BMZ) increasingly engage in cooperation with Asia. For example, the Federal Ministries for the Environment and of Economics and Technology attach high importance to cooperation with the newly industrializing countries of Asia. For GTZ, this presents new demands, but also new opportunities to support the implementation of programs of other German ministries as well as of the European Union.

On the other hand, in the less developed countries of Asia, the further development of technical cooperation approaches will have to take place in close cooperation with other development partners and in the context of program-based approaches. This implies new challenges and opportunities with a view to ensuring a harmonized approach, while at the same time emphasizing key principles of German development cooperation.

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Strengthening Regional Competitiveness in Vietnam

Angelika Hutter

This article will give a brief overview of German regional policy and its historical background and then introduce the local and regional economic development approach advocated by the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH in Vietnam.

Regional Policy in Germany

The German constitution stipulates that equal living conditions be created throughout the national territory. The state thus must balance locational disadvantages and further the integration of structurally weak regions into overall economic development. Policies for this purpose are regional policy and the promotion of selected regions in order to enhance economic growth and ease structural change.

The most important regional policy instrument is the so-called joint task of the German federation and the *Länder* (regions) to "improve regional economic structures," effective since 1969. Cooperation between the federation and the regions/states on this joint task is regulated by article 91a of the constitution and is elaborated in the law on the joint task.

The joint task is more than just a promotional tool. In the context of national German regional policy, it is a strategic as well as a coordinating and a regulatory framework, ensuring implementation of German as well as European law, with special regard to subsidy entitlement. Each year, the federation and the regions/Länder draw up a plan defining the provisions for support, the subsidy level, areas, and regional support programs.

However, despite this national framework between the federation and the Länder, article 30 of the German constitution stipulates that the Länder are responsible for regional economic development. Thus, implementation of the joint task is strictly a Länder affair. In the frame set jointly by the federation and the Länder, the state government can prioritize spatially or sectorally, it can determine support projects and entitlements, and it will also confirm and control support.

Joint task support is purposefully restricted to structurally weak regions, in line with the principle of "help for self-help." The objective is the creation of competitive jobs in the regions through increased regional investment. There is no support for structurally strong regions, which are expected to keep up their competitiveness and manage structural change by their own means.

The joint task supports investment in private businesses and local economic infrastructure. Supporting private business investment creates and ensures competitive jobs and employment in structurally weak regions. Investing in local infrastructure attracts investors and enhances regional competitiveness.

Support is provided via integrated regional development approaches and regional management projects, as these will strengthen ownership and responsibility of local governments for regional development and enhance bottom-up development approaches. Cooperation network and cluster management approaches to promote regional and inter-regional cooperation between enterprises, research institutions, and local authorities help to better link existing potentials and increase regional competitiveness.

The joint task is an instrument for both equalization and growth. According to the principle of subsidiarity, it is an equalizing instrument, as it is restricted to structurally weak regions. At the same time, it is also an instrument for growth, using an investment, not a consumption approach.[1]

Historical Background to Current Regional Policy in Germany and the EU

The crisis of industrialized regions (coal, steel, textiles) in Western Europe from the 1970s onward led to a search for new competitive advantages and new concepts for economic policy. At the same time, the financial crisis of the welfare state led observers to question its performance and capacity. New ways to alleviate this public sector burden were sought. In Germany, ideas of endogenous, self-reliant development were combined with ideas of comparative and competitive advantages as well as federal traditions to create innovative concepts of local and regional cooperation between various stakeholders from the public and the private sectors. From the 1980s onward, enormous financial resources channeled from the European Union (EU) to European regions via the so-called structural funds supported these developments. Nowadays, there is fierce competition for investors, visitors, and skilled labor among European cities and regions, as can

[1] Further information can be found at http://www.bmwi.de/BMWi/Navigation/Wirtschaft/Wirtschaftspolitik/Regionalpolitik/gemeinschaftsaufgabe,did=151120.htm.

be seen in the intense marketing efforts everywhere. The so-called soft locational factors, such as business climate and quality of life, have become much more important than in the past, since hard locational factors such as infrastructure do not differ much any more throughout Western Europe.

Local and Regional Economic Development – The GTZ Approach

Strengthening competitiveness is at the core of GTZ's approach to local and regional economic development (LRED). The approach draws on German as well as international experiences with local economic development policies. These experiences have shown that competitiveness is an issue that reaches far beyond the natural endowments of a location or the strength of certain enterprises or even sectors (as the traditional understanding of competitiveness suggests). It has been shown that competitiveness depends a lot more on the performance and capacities of stakeholder collectives than on individuals: among private sector stakeholders, it is no surprise to see that widespread entrepreneurial thinking is a relevant element of private sector competitiveness. More than that, it has become clear that the willingness and the capability to cooperate and to create networks among firms – the ability to build and to use social capital for innovation – is an important element of competitiveness.

As for the public sector, it is a rather new insight that it needs to be competitive, too. The competitiveness of the public sector manifests itself in the customer and service orientation of the civil service, readiness for dialogue with the business community, the proactivity and management abilities of political leaders, the business friendliness of the regulatory framework, and the quality of promotional policies – in short: the design of local or regional economic policy. These capacities are essential in shaping the soft as well as the hard locational factors that often appear as objective, given features (infrastructure, labor, natural conditions). Finally, good cooperation and dialogue between the private and the public sector in a certain territory have turned out to be critical elements of local or regional competitiveness.

There are a handful of additional principles that characterize the GTZ LRED approach:

- Each locality or region has potential that can be identified and used to improve local economic performance, increase competitiveness, and reduce poverty. To identify the potential, a mix of participatory as well as expert-driven methods has proven to be effective.
- Local enterprises are the drivers of local economic development. Their business activities and investments create employment, income, and economic growth.

- Local governments have an important role in creating favorable conditions for local and regional economic development through appropriate regulation, policies, and strategies.
- Local governments and the local business community are partners in local economic development. Local enterprises know local (and wider) markets, and they understand the constraints of doing business in a certain locality or region. Therefore, they are valuable dialogue partners for local authorities. Local enterprises can even become contributing partners in jointly funded public-private initiatives.
- There is no blueprint solution as to how LRED should be done. Each locality or region is unique and needs to develop its own approach.

Local and Regional Economic Development in Vietnam

In Vietnam, LRED is taking place in the context of Vietnam's transformation from a centrally planned to a market economy that is now, after its accession to the World Trade Organization in 2006, integrated into the global economy. Vietnam's economy has been growing strongly since 2000; however, the sustainability of that growth and the competitiveness of Vietnam's businesses are still unresolved issues.

Along with an ongoing process of political, administrative, and fiscal decentralization in the country, this situation poses huge challenges. It requires new types of political thinking and policy-making, both at the national and the sub-national levels, new ways of interaction between the state and the citizens, new management styles, and new ways of problem solving in the public and the private sector alike. Reforms are needed in terms of content and coherence of policies, political processes (coordination between agencies, priority-setting, and consensus-building), and institutional and organizational set-up and performance. If state reform follows international practice, state functions will have to be redefined and condensed, allowing other stakeholders in society to participate more in decision making and service provision.

Although decentralization creates favorable conditions for LRED, it is difficult to introduce new institutional arrangements that rely on public-private cooperation, such as the ones applied in German regional policy described above. More so than in a social market economy of the European type, the state is still very active in the economy in Vietnam, as an entrepreneur in state-owned enterprises and as a planning agency. There is still a strong belief throughout society that the government has to manage the economy, in other words, make decisions that in a market economy would be left to entrepreneurs and market forces. This means that LRED processes are strongly dominated by local governments, while the local business community is not encouraged to actively contribute to policies and initiatives on the local level. For many provincial government leaders, local economic development is still more about lobbying successfully for centrally funded, large-scale infrastructure projects than about developing local economic potential and local enterprises (a province is an administrative unit of about one million inhabitants). This is in contrast to the situation at the national level, where public-private dialogue has developed into forums where representatives from the domestic and foreign business communities communicate openly and frankly with government representatives. The situation in the provinces still lags far behind, and the traditional gap between authorities and citizens is far from being closed.

Competitiveness Issues on the Provincial Level

Currently, the strongest competition between the 64 provinces in Vietnam centers on attracting foreign direct investment, for which three factors are decisive: the quality of labor, the quality of infrastructure, and the investment climate. Attention to the local business and investment climate has been heightened since 2005, when USAID started to conduct annual rankings of provinces according to their business friendliness in the Vietnam Competitiveness Index. The ensuing public debate has created a high level of awareness about competitiveness issues among political decision makers in the provinces. A positive impact of this provincial competition regarding the local business and investment climate is the fact that between 2006 and 2007, the number of "bad performers" was halved (21 to 10), while the number of "good performers" almost doubled (9 to 17). The negative side is that provinces are also competing in terms of large infrastructure investments such as harbors, airports, industrial zones, etc. Since there are no intermediary administrative levels mandated with regional coordination, the risk of uncoordinated duplication of projects and waste of public funds is high.

Conclusion

In Germany, Western Europe, and currently in Eastern Europe, EU structural fund resources linked to regional policy instruments such as regional management, clusters, or regional marketing have eased structural change. The strength of these approaches lies in the fact that they make use of local resources, empower local stakeholders, help develop social capital, and enhance innovation in local contexts.

In Vietnam, structural change is in full swing now. If regional policy instruments that emphasize cross-sector cooperation, dialogue orientation, and networking approaches were adopted, this could certainly greatly facilitate that process of structural change and even reveal unforeseen opportunities. However, the competitive advantages brought about by effective vertical coordination in the political and administrative system as well as by strong horizontal coordination between the public sector and other sectors in society still need to be discovered in Vietnam.

Mind the Gap – Regional Disparities in China

Moritz Mang and Thomas Bonschab

Introduction

Regional policies aim to mitigate regional disparities and contribute to the equality of living conditions among citizens. This goal is enshrined in the German constitution and is intrinsically tied to the principles of the social and ecological market economy. The relevant principles are equal opportunity, distributive justice, and the principle of solidarity. China too is striving to provide more equal opportunities for its citizens or – to use the Chinese phrase – to build up a "harmonious society." However, the previous attempt of the Chinese Government to achieve that goal triggered economic development in the coastal region, which led not only to a relative regression of the interior provinces in terms of employment, income, resources, and education, but also to massive environmental degradation. The current policies embraced by the Chinese Government to counterbalance regional disparities between the coastal and interior provinces and between urban and rural areas, as well as to promote social cohesion and environmental protection, consequently show clear similarities to the basic principles of the model of a social and ecological market economy.

Recent Chinese policies in this area demonstrate a fundamental shift in the country's regional development approach, from temporarily counter-balancing regional disparities by means of subsidies and the redistribution of income, towards policies convergent with the strategies in the European Union (EU) and the Organization for Economic Cooperation and Development (OECD) member countries. Based on observations in China and the EU as well as on surveys conducted by the OECD, this paper will raise some of the regional policy issues discussed on both sides and thereby identify a corridor where the EU, the OECD, and China can enter into a policy dialogue and a process of mutual learning. It will then draw some conclusions for German technical cooperation for regional development in China.

The European Commission has already been conducting a dialogue with China on regional policy for several years. The Sino-German Economic & Structural Reform Program, supported by the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH on behalf of the German Federal Ministry for

Economic Cooperation and Development, officially launched a component on Sustainable Regional Development in January 2008. Within this project, GTZ is also cooperating with the OECD, in particular with the Territorial Development Policy Committee.

Background

From Subsidies to Investments

In recent years, regional policies of the EU as well as of OECD member states have increasingly focused on the exploitation of a region's endogenous assets and its under-utilized potentials.[1] Rather than providing direct government subsidies to particular sectors, these policies facilitate investment that strengthens regional competitiveness and mobilizes the region's latent capacity to provide a sound business environment, relying on local potential to attract and maintain firms and labor.

The comprehensive character of this approach, however, requires policies to respond to the respective region's characteristics (problems and potentials). Regional competitiveness results from a multitude of complementary factors, going beyond what is commonly conceived as a factor of production. In this context, Kitson et al. identify the factors infrastructural capital, knowledge/creative capital, productive capital, human capital, social-institutional capital, and cultural capital (Kitson et al. 2004). It is suggestive to add geographical capital to this list, referring to climate conditions, proximity to natural transportation opportunities (rivers, ports), soil fertility, etc. All these factors define a region's development potential and determine the best policy to strengthen regional competitiveness. There are many "soft" assets which play a decisive role in "the bundle of actions to increase the performance of local firms and to improve the attractiveness of a region as a place to work and to invest" (Davies 2004).

We can leave open the question whether this way of thinking about regional development is true rocket science and justifies the talk of a "new" approach or even a "paradigm shift." What it does stand for, however, is a renunciation of abstract redistributive and sectoral policies defined at the national level and an embrace of a more holistic approach that takes account of local conditions and a proactive involvement of the private sector. It expresses a turn away from top-down policies – often adopted by states and development organizations – which effectively propose the same measures for every country and every region. In this recent approach of the EU and OECD member states, sectoral policies

[1] Exemplified by the Lisbon Strategy (European Commission 2005) and observations of OECD (OECD 2005).

are still an important element, but they are better integrated into comprehensive strategies for regions.

Challenges in Regional Development in EU and OECD Member States

Based on observations from the OECD, various persistent and newly emerging problems can be identified with regard to different types of regions: rural, intermediate, and metropolitan.[2]

As a result of an increase in productivity in the agricultural sector during the last decades, employment in rural areas dramatically decreased. Because most industries settle in or near urban regions or industry agglomerations in intermediate locations, rural regions are often faced with the problem of insufficient employment opportunities. These conditions, amplified by a lack of sufficient educational and cultural facilities, induce younger people to migrate to other regions – thus leading to an aging society. In turn, rural regions fail to provide the required business infrastructure necessary to attract firms.

The link between rural and metropolitan regions is set up in small and medium-sized towns (SMTs), where economic activities are mainly conducted by small and medium-sized enterprises (SMEs). Although these intermediate regions are able to provide a more comprehensive business environment than predominantly rural regions through the provision of the required physical infrastructure and services, there is a noticeable decline in economic development and a fall in the employment rate due to industrial restructuring. Intermediate regions often fail to provide the training facilities necessary to retrain the highly specialized, yet laid-off workforce that is increasingly common in these areas. Shortages of finance often prevent SMEs from conducting research in order to increase innovative capacities. Firms in existing clusters are often unable to utilize the advantages of agglomerations, such as spill- over effects, access to modern infrastructure, and common learning by networking as well as through sharing services or outsourcing them to other companies. However, these advantages are crucial to dealing with the challenges of globalization and increasing competition from new emerging nations that build their competitiveness on low labor costs but also on strong innovative capacity. Furthermore, a lack of tertiary education facilities in SMTs often results in out-migration of younger people and thus in the inability to provide skilled labor.

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[2] In order to enable comparisons between regions, the OECD established a standard typology separating (predominantly) urban, (predominantly) rural, and intermediate regions. The classification is based on the share of the population living in rural communities. For rural regions, the share is higher than 50%; for urban regions, less than 15%; and for intermediate regions, the share is between 15 and 50%. See OECD 2006, p. 36. There is, of course, an extensive discussion of alternative ways to define a region, but we cannot embark on this discussion here.

As regards metropolitan regions, they face competition from other major cities on the regional, national, as well as the international level. Metropolitan regions have to make sure that they prevent labor from migrating to proximate intermediate regions, and attract further investments and labor to the area. This is crucial in order to maintain their roles as economic hot spots, centers of decision making, attractive places for headquarters of multinationals, as well as logistic gateways for international trade.

In summary, industrialized countries are confronted with specific challenges. Their economies face competition from "new emerging countries" such as China, India, Brazil, and Russia, which are able to produce at lower costs and ever higher quality. In order to maintain economic growth, rural regions must overcome a lack of required services for business and the resulting scarcity of employment opportunities. Intermediate regions, in turn, have to increase support to existing and potential agglomerations, providing an attractive basis for the regional economy. Metropolitan regions, on the other hand, have to strive for inimitability in national and global competition by distinguishing themselves from other metropolitan areas.

Disparate Regional Development in China

Since China embarked on reforms opening the country to international trade and investment in 1978, it has been able to generate unmatched economic growth. As a result, China has caught up with other nations and has improved the overall situation of its population.[3] Nevertheless, the strategies implemented in the past also had the result of creating extensive disparities at the sub-national level: The economy of the coastal region in eastern China developed at an extremely fast pace, due to its advantageous geographic location and the supporting preferential policies. The interior provinces, on the other hand, had to support the economic rise of the east. In the process of ongoing internationalization, the interior region was additionally burdened with an unprofitable industrial structure. Expected spill-over effects failed to appear, which resulted in the inland provinces lagging even further behind the coastal region (Demurger et al. 2002).

The Chinese Government has long understood the risk that economic growth may not be sustainable if regional disparities continue to increase. Since 2000, the Chinese Government, therefore, in a first step, implemented a strategy aiming to develop China's west and subsequently introduced an equivalent strategy for northeast China. However, because they failed to build up the business environment

[3]In terms of the Human Development Index (HDI) of the United Nations Development Program (UNDP), China improved from 0.525 (1980) to 0.755 (2003), ranking 85th among 177 assessed countries (UNDP 2005).

necessary to attract domestic and foreign investment, these policies have not been sufficient to help the regions catch up with the coastal region thus far.

One of the reasons that inland provinces failed to become competitive and make use of their comparative advantages is the lack of coordination among the different bodies and levels of government responsible for drafting and implementing the policies. As a result, the regional gaps in terms of income, poverty, education, health care, and employment continue to increase (UNDP 2005). Taking this flip side of the economic boom period into account, China's spectacular growth rates have to be revaluated. Against the background of the short-term character of China's previous approach, the constant transfer of fiscal funds necessary to counterbalance disparities is significantly holding back the national economy, as the subsidies are merely used to plug and camouflage existing holes instead of providing a sustainable solution. Furthermore, compensation for environmental pollution is confronting China with enormous economic losses.[4] One may well argue that the best use for China's current huge foreign exchange surplus would be investment in policies to reduce regional imbalances and environmental degradation. After all, it is in the interest of the Chinese and the entire international community to ensure sustainable social, economic, and ecological development in China.

The latest strategy papers of the Chinese Government, namely the 11th Five Year Plan (FYP) and the findings of the 17th Congress of the Communist Party of China (CCPC), consequently represent a shift in the approach of Chinese regional development policy away from the previous persistent major focus on overall economic development towards support of the different regions' potentials. By including reforms such as improving access to education, promoting environmental protection, utilizing cultural amenities, improving social cohesion, restructuring the administration, and encouraging public participation as well as more involvement of the private sector, the new approach tackles the problem of regional and social inequality with a view to more balanced and comprehensive development, resulting in the building of a "harmonious society."[5] However, the directives are formulated very vaguely and neither a comprehensive overall regional development strategy nor the modes of implementing the vision are available to date.

[4] In 2005, China became the second largest producer of greenhouse gases in the world. Twenty-five percent of Chinese territory suffers from acid rain and, consequently, suffers huge economic losses from environmental pollution (Beech 2005).

[5] See Communist Party of China Central Committee 2005 and Hu Jintao 2007.

Methodology

Observations in Developed Countries

Both the EU and OECD have developed and evaluated concrete strategies to cope with the regional problems that member countries are struggling with. As strategies have to be developed according to the respective requirements of a region, integrated solutions must focus on the nature of the problem as well as on the respective region's characteristics.

Implications for Rural Regions

As illustrated above, a region's ability to improve its economic performance is dependent on the availability of the factors of regional competitiveness. In the case of rural regions, the OECD, in particular, specifies i) (natural/man-made) amenities, ii) transport facilities, and iii) cultural identity as the factors crucial to an enhancement of competitiveness. Furthermore, the survey identified four main modes that have a positive impact on regional development (Pezzini 2003):

- Amenity-focused development (for example, scenery landscapes, a high quality environment or rich cultural heritage) in order to create new employment opportunities and increase the quality of life in a region. Although employment is constantly declining in rural areas, it plays a very important role in maintaining rural amenities.
- Diffusion of industries is a necessary step towards independence from proximity to markets. Enterprises in certain fields (for example, information and communication technology) do not rely on being close to markets. The regional standard of living consequently plays an increasing role for such firms when deciding where to locate their business. It remains very difficult to create agglomerations of industries and improve networking, because rural regions often cannot offer the necessary proximity to consumers and suppliers, as well as the education and training facilities that favor industrial diffusion.
- Exploitation of natural, but unfortunately often non-renewable, resources (for example, gasoline, coal, and natural gas).
- Public expenditures (using the area as a location for superficially unfavorable facilities, such as waste dumps, prisons, power plants, etc.).

As the latter two of the given approaches are not sustainable, OECD policy recommendations focus on close linkages between amenity-focused development and the creation of industrial clusters for most rural regions, together with the promotion of agro-tourism and environmental protection.

Implications for Intermediate Regions[6]

In order to respond to the challenges caused by globalization, firms in intermediate regions have to move from price competition to competition based on quality, creativity, and skills. The creation and design of business agglomerations is thus crucial. The benefits of such networks are shared R&D facilities and services and therefore the ability to increase innovative capacity without increasing costs. To stay flexible and be able to react to changes in markets as well as to innovations in technology, intermediate regions have to put considerable weight on intangible (non-physical) assets through:

- deregulation of SME investments;
- business training;
- programs to promote and support start-up companies;
- encouraging cooperation and networking among SMEs; and
- encouraging inter-city networks to offer common services and skilled labor.

Implications for Metropolitan Regions

Urban regions can enhance local competitiveness by applying policies aimed directly at specific "commodities" (such as investment, tourism, labor, national funding, etc.) as well as comprehensive actions focusing on improving a region's competitiveness by a system of tangible assets (for example, physical infrastructure) and also intangible assets (such as human resources, networking, and innovation capacity). Nevertheless, experience shows that marketing strategies, incentives, and other policies aimed merely at obtaining such specific commodities will not be successful if a region is not able to provide an attractive business environment. Against this background, OECD policy recommendations provide four areas of activities in urban regions to support private and public investments for the creation of regional competitiveness (Dubarle 2003 and Kamal-Chaoui 2003):

- Promotion of clustering and specialization to exchange knowledge through common learning, to reduce costs and to develop new markets and therefore overcome challenges caused by a strong economic dependence on traditional but declining sectors.
- Increase of innovative capacity and mobilization of labor skills by linking learning and widening labor markets. The latter is an often applied means to prevent brain drain (outflow of skilled workers) and bottlenecks. The concept of learning regions also includes the idea of knowledge spillovers between public institutes (education and research facilities) and private enterprises.

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[6] See Kamal-Chaoui (no date) and Pezzini (2003).

- Strengthening physical infrastructure, including accessibility of assets like cultural and recreational facilities, to ensure the accessibility of a region. Nevertheless, physical infrastructure cannot drive economic growth on its own.
- Strengthening the social capital to ensure social harmony. Since globalization additionally furthers diversity, policies have to counter these problems (such as unemployment, crime, drugs, poverty, and even racism) by integration activities to prevent a strong loss of quality of life.

Implications for Governance

Up to now, development theories have often focused on central government policies of investment in specific sectors or geographical areas. With the aim of spreading the benefits and thus helping other areas ("trickle-down effect"), these policies are often drafted without consulting local governments or stakeholders. As a consequence, back-wash effects – resources and capital flowing back from the periphery to the core – were generated, contrary to the original intention.

In contrast to traditional top-down approaches, assessments conducted in EU and OECD countries show a transfer of responsibilities to governments on the regional or local level (bottom-up approach). Well-organized vertical cooperation among the different levels of government consequently plays a crucial role in this process. Given the higher complexity, horizontal cooperation is also essential in order to utilize local knowledge and improve collaboration with the private sector. Furthermore, the provision of public goods and services is a challenging task for governments (OECD 2005, 69 ff.).

In addition, many of the tasks and responsibilities of the government are transferred to the private sector (for example, the production of certain goods and provision of specific services), as this often increases the access of the more disadvantaged social groups. Despite this more liberal approach, the state still bears the responsibility of providing common goods (such as education, water, etc.), and, moreover, is accountable for the final outcome of the policies. According to the subsidiarity principle, the state merely fulfills those tasks that cannot be performed by the private sector.

China's Rocky Road to Regional Balance

Since the 1980s, China's unbalanced economic development policies were mainly focused on the promotion of the coastal region's development, encouraging some regions to get rich first. Aware that the interior provinces were lagging behind, the Chinese Government began to concentrate on counterbalancing these disparities in the second half of the 1990s. The approach was based on the perception that the differences among provinces were not caused by stagnation in development, but by a different speed in the regions' growth.

The 9th FYP (1996-2000) stressed the importance of coordinated regional economic development in order to narrow the gap between the different regions (Wang Xinhuai 2006). This should be done by policies focusing on supporting the interior provinces through:

- preferential treatment concerning resource allocation;
- improvement of infrastructure;
- price optimization for resource-based products; and
- increase in financial support by reforming the central fiscal transfer system.

In the beginning of the twenty-first century, the Chinese Government committed itself to a plan to establish a "moderately well-off society" *(xiaokang shehui)* by 2020. This expression refers to a society that is not really wealthy, but possesses all the necessities for a decent standard of living (food, clothing, education, health, etc.). As the population in the coastal areas is already quite prosperous, the task to be fulfilled, therefore, was to improve the standard of living in the inland area (Jiang Zemin 2002).

Earlier strategies divided China into the coastal and interior regions. The opening-up process and market-oriented reforms allowed for the separation into east, central, and west China. The recent approach of the Chinese Government provides for four zones, the coastal, the northeastern, the central, and the western regions, in which the Chinese Government began implementing the following strategies by 2005:

The Great Western Development Strategy

Launched in January 2000, this strategy focuses on increasing international trade and foreign direct investment (FDI) in the area, raising the living standard of the population, and counterbalancing interregional disparities through:

- the construction of infrastructure facilities;
- the improvement of the ecological environment;
- the improvement of the investment environment;
- the promotion of specific industrial sectors (primarily energy, minerals, tourism, and human resources; and
- ensuring access to education (China Internet Information Center 2007).

Revitalization of Northeast China

As China's rust-belt, the region has to cope with the problems of unprofitable state-owned enterprises (SOEs), a poor management structure, and nearly depleted resources. Efforts to reform the SOEs have resulted in a large number of laid-off workers, raising the unemployment rate above the national average. As a consequence, the Strategy for Revitalizing Northeast China and Other Old Industrial Bases launched in October 2003, focuses on the following measures:

- transforming and restructuring resident SOEs;
- pushing forward the opening-up (internationalization) of the region;
- developing the private sector;
- expanding the labor market;
- supporting the agricultural sector; and
- improving the social security system (World Bank 2006).

Rise of the Central Region

At the end of 2004, the Chinese authorities started to discuss a strategy aimed at the central region of China, which was less and less able to keep up even with the western region. The central region is characterized by the predominant role of agriculture and heavy industry – primarily SOEs in the field of energy resources – and its geographical location in between China's different regions. The topic was put forward throughout 2005 and was finally also strongly represented in the 11th FYP, focusing on:

- investments in infrastructure;
- enhancing the region's comparative advantages (resources, skilled labor, and geographic location);
- modernizing the agricultural sector with special focus on grain production;
- strengthening key industries (energy, mineral extraction, production materials);
- promoting the foundation of high-tech industries;
- modernizing the market system;
- creating a circular economy;
- restructuring the SOEs;
- increasing the positive effects of urban areas on the development of the surroundings; and
- enhancing inter-regional cooperation (Wu Xinmu 2006).

Although there was a discernible positive impact of the strategies aimed at western and northeastern China (mainly in the field of infrastructure), assessments of the strategies have shown a number of deficits (Wei Houkai 2006 and Wang Shengijn 2006):

- **Lack of coordination**
The strategies lack a conductive major orientation that clarifies goals, indicators, modes, and most importantly, the role and responsibilities of the different levels of government. Critics thus fear that the lack of coordination and the policies deriving from different administrative levels focused on their own respective advantages will weaken the strategies' success.
- **Lack of industrial support and innovative capacity**
The basis for industrial development still has to be improved extensively. In this context, policies will have to encourage firms to increase investments in R&D, cooperate with other companies and research institutions to produce technology-intensive products, increase development potentials, and build up supplier networks, while at the same time promoting low-technology and labor-intensive industries.
- **Large state projects fail to integrate the local economy**
Companies from the west and northeast often are not able to compete with coastal firms in the process of bidding for implementation of the projects. Consequently, the projects' multiplier effects impact economies of other areas.
- **Insufficient participation of private investors**
The share of FDI in western and northeast China is continuously falling, as the regions fail to provide an attractive business environment. Companies located in the coastal region tend to invest in neighboring provinces instead of shifting towards the western and northeastern regions.

Both, the latest 11th FYP and the findings of the 17th CCPC try to tackle the existing problems and the deficits of the prevailing regional development strategies by placing a great deal of importance on comprehensive and balanced development based on international expertise (scientific view of development), sustainability in terms of balanced economic, social, and ecological development (development in four aspects, including culture as one factor)) and innovative capacity (innovative country) in order to create socialism with Chinese characteristics.

However, due to their vague character, the plans of the Chinese Government fail to provide answers to questions essential for future (regional) development. In this context, the following issues must be resolved (Mang 2006):

- **Lack of an overall regional development strategy**
The 11th FYP as well as the 17th CPCC is more of a rough idea of how to proceed during the next years than a strategy in this case. However, a comprehensive and coherent national regional development strategy is crucial for the coordination of regional development. As the hitherto conducted approach is too general to respond to the different needs of the sub-regions

(rural, intermediate, and urban), the definition of regions and sub-regions has to be reconsidered. Furthermore, comparable and detailed information on the respective regions' characteristics have to be compiled and evaluated through an analysis of regional strengths and weaknesses.

- **Lack of coordination**
  The prevailing lack of coordination not only prevents synergies among the different public and private actors, but also causes new problems and thus is counterproductive to the development of regional competitiveness. As a consequence, obscurities concerning the existing strategies must be eliminated, and explicit indicators, goals, and tools necessary for the implementation of the strategies must be defined. Also, there is no general administrative body responsible for coordination of the respective offices and departments. However, such a body is necessary to guarantee the implementation of an overall strategy, with the different offices cooperating instead of competing. The existing institutional arrangement thus has to be improved and optimized.

Against the given background, it is not possible to prevent duplication in the regions, as they seek to achieve competitiveness. The instruments applied by one region to make its business environment more attractive to investors, therefore, are not guaranteed exclusivity. As a result, the implemented instruments might fail to provide a local competitive advantage. Instead of building unique competitive regions, such a diluting process causes homogeneity.

Implications for German Technical Cooperation

The recent EU and OECD approach in regional policies and China's current reform agenda for regional integration are, by and large, compatible. To be sure, China's less developed regions are further behind than any region within OECD countries has ever been; its rural, intermediate, and metropolitan characteristics are unique; and the scale of social and environmental challenges necessitates reforms barely feasible in the context of OECD member states. But there is a strong drive on both sides to embark on a process of policy dialogue and mutual learning. After all, China's development has a significant effect on the opportunities and troubles of rural, intermediate, and metropolitan regions in European and other OECD member states. China, in turn, can benefit from the good and bad practices of regional integration elsewhere and the policy instruments employed in the context of German reunification, as well as from the experience of integrating new member states into the EU, which may be even more relevant.

Germany is in the best position to play a major role in this dialogue between China, the EU, and other OECD member states. More than any other country, Germany is associated with the principles of the social and ecological market economy, which fit so well with the reform agenda in China. In line with these principles, Germany can both provide abundant experience from its own history and build the bridges to expertise from other European countries. Among the topics in this dialogue are:

- integration of social and ecological aspects into economic development strategies;
- (public) participation of non-government stakeholders in the decision-making process and implementation of sustainable development strategies (for example, social partnership);
- transparent and accountable governance; and
- solidarity-based transfer of financial and human capital.

This dialogue takes place by cooperating with various German government bodies at the national, Länder (states), and municipal level. The main modes of delivery in this context are fact-finding missions, expert hearings, and workshops. The main topics include:

- regional development and structural planning;
- revitalization of old industrial areas;
- rural-urban development;
- transformation to a knowledge-based economy;
- local governance;
- local economic promotion;
- counterbalancing regional disparities; and
- interregional cooperation.

To deal with these topics, partnerships have been established at the national level with the Federal Ministry of Economic Cooperation and Development (BMZ), the Federal Ministry of Economy and Technology (BMWi), and the Federal Ministry of Transport, Building, and Urban Affairs (BMVBS). At the state level, respective partnerships have been built up with the Ministries of Economy as well as the Ministries of the Environment in Bavaria, Baden-Württemberg, and Saxony. In order to convey local experiences and expertise, cooperation with various municipal governments and respective bodies (such as agencies for economic promotion, start-up services, etc.) in numerous German cities has been established. Furthermore, experts from German research institutions and universities frequently contribute to program activities, either in Germany or China.

What, then, is the particular opportunity for German technical cooperation? First of all, GTZ has been present in China for more than 20 years, under both easy and difficult conditions for technical cooperation. During this time, Germany has proven itself a reliable partner and has gained access to high-ranking institutions, often as the only bilateral or multilateral donor organization.

For the optimal profile of Sino-German technical cooperation on regional policies, this background has a couple of implications:

- Given the access to high-ranking decision-making institutions, technical cooperation is expected to facilitate a policy dialogue between China, Germany, and other OECD member states.
- Cooperation with relevant German federal ministries and other high-ranking international bodies like the OECD Directorate for Public Governance and Territorial Development or the Directorate General for Regional Policy of the European Commission is indispensable, because this is where policy dialogue takes place and where the required technical expertise is available.
- Technical cooperation is becoming part of a more general dialogue between China and Germany. Recognizing that China and Germany have mutual interests, for example, in China's social stability and environmental protection, is essential for the cooperation. Once again, collaborating with German federal ministries like the Ministry of Economics and Technology and the Ministry for the Environment, Nature Conservation, and Nuclear Safety is not a nice "add on," but indispensible to the success of this dialogue.

To sum up, German technical cooperation in the field of regional development, in particular based on the principles of the social and ecologic market economy, has great potential to facilitate sustainable regional development and, consequently, to narrow interregional gaps in China by bringing German and European expertise into this field. In return, negative global economic and environmental impacts of disparate development in China could be massively reduced.

Nevertheless, there is no "one-size-fits-all" way to achieve regional competitiveness. Although China shares the problem of regional disparities with numerous other countries, the respective solution has to be in line with China's specific conditions (economic, social, environmental, but also geographical, political, and institutional) in order to achieve sustainable development in the long run.

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Twenty-Five Years of Sino-German Development Cooperation – Qualified Human Resources as a Key Factor of Chinese Sustainable Development

Michaela Baur and Antje Pfeiffer

Introduction: China – A Vast Country with Endless Human Resources?

According to a recently conducted survey among German companies in China, 88% of the respondents rated human resource issues as the greatest bottleneck in their business in China.[1] By far the most serious headaches are caused by problems in finding qualified workers and keeping them once the contract is signed. A majority of the companies saw problems as well in the area of staff qualifications in general and their motivation and commitment.

This might seem amazing, but only at first glance. Certainly, China is a vast country with a huge work force. And in the last two decades, when China's development and its integration into the world economy were based mainly on labor-intensive mass production, the labor force really did seem endless. It was easy to find workers without specific qualifications to do monotonous work on an assembly line and easy to replace them. Finding suitable staff at the middle and higher level has been much more difficult, and companies have had to compete intensely to attract "grey collar" or "white collar" talent.

Now China is setting out for new horizons: In addition to mass production industries, business leaders and politicians now aim for sound economic development based on innovation and high levels of technology. China intends to catch up with the rest of the world, not only in terms of quantity, but in terms of quality, as well. The human resource factor will be crucial for that objective.

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[1]See Ulf Borsch, "Mastering the Growth Imperative: Strategic Drivers and Bottlenecks for German Multinational Companies," Business Forum China 6 (2007): 38.

Certainly, the universities and vocational training institutions produce more graduates each year. But also here, it is obvious that quantity alone is not the solution. More important is whether jobseekers match concrete demand and whether they are good enough – compared to their international counterparts.

The following article begins with an overview of the situation in the labor market and the vocational training system in China, and also describes the impact of Sino-German cooperation in these fields. In Chapter 2, we discuss current developments, as well as relevant governmental policies, their objectives, and their impact. Chapter 3 is focused on the 25 years of Sino-German technical cooperation. Whereas the joint projects in the field of vocational training look back on a broad and long history, the gradual shift to explicitly labor-market-oriented projects started only in the 1990s. They were a reaction to the remarkable changes in the labor market that accompanied economic reform. To give an overview of the relevant policies in Germany that serve as the foundation for cooperation, German labor market policy and the German vocational training system will be briefly described. Based on that, the gradual shift in Sino-German technical cooperation is further analyzed. Chapter 4 gives an outlook on the major challenges for the Chinese labor market and vocational training. Success or failure in that policy field will greatly influence the entire transformation. China must keep its growth rate high in order to absorb at least a large part of the job seekers. According the 11th Five-Year Plan, the government is seeking to create 24 million new jobs a year. At the same time, there must be a reduction in the significant mismatch between the profiles of jobseekers and the skills demanded in the vacancies. According to estimates, there is demand, for example, for at least one million additional computer specialists and 300,000 car mechatronics. A further challenge is the ongoing urbanization, which is expected to reach 57% in 2020, meaning that the greater part of the rural population has to catch up with the required qualifications. Today, less than 20% of the rural population have more than a junior middle school education. The challenges affect not only economic restructuring and sound development, but also social cohesion and inclusion of weaker groups. The Gini coefficient grew rapidly in recent years to the disconcerting figure of 0.49 and already shows the heavy burden of social injustice. Besides the ecological issues, this social aspect may be the major obstacle to sustainable development. The social and ecological market economy in Germany is therefore a model that is evaluated with great interest by Chinese leaders, as it reflects, in many ways, the concept of a harmonious society which is the officially defined goal of the Chinese transformation.

The Labor Market and Vocational Training in China

"I hear and I forget. I see and I remember. I do and I understand." This famous saying of Confucius shows that action-oriented vocational training looks back on a long history in China. Indeed, in the pre-socialist era before the 1940s, it was quite common to find a master training his apprentices and, by doing so, ensuring the availability of skills actually demanded in the labor market. Today, this traditional approach has vanished almost completely. One can find only very few people looking for such a master in the countryside; the existing apprentices are usually working without pay for a carpenter in order to learn his profession. Technical and vocational education and training (TVET) today relies mainly on vocational schools. These vocational schools are a comparatively new development; they were initiated at the beginning of China's opening-up policy that began in the late 1970s. Until 1980, students entered the workplace after having graduated from middle school without any previous work experience. Only a small number of middle schools had a special focus on some sort of basic technical training.

When the central government first embarked on its economic reforms, it realized that in order to develop China's economy and to succeed in transforming a planned economy into a market economy, the country needed a qualified workforce and, consequently, a sound vocational education system. Since then, China has established a framework of laws, regulations, and standards for vocational education. In 1980, the State Council ordered about half of the country's senior middle schools to convert into vocational and technical schools teaching crafts, mechanics, animal husbandry, or commercial subjects. However, generally these schools were inadequately equipped and focused on rote and theoretical learning. In most schools, teachers lectured on how to use certain machinery in front of a class consisting of at least 40 to 50 students who were not actively involved. These schools did not have the machines and materials to allow their students to apply their theoretical knowledge in practice.

Since then, the TVET system has been undergoing reform. The Chinese Government has put remarkable effort into this reform process; however, two main obstacles are apparent. On one hand, vocational training still suffers from its second-rate image. In China, academic ambitions are very high: parents want a reputable university degree and a subsequent career as a white collar employee for their children. In particular, the one-child policy increased parents' ambitions for their child's academic career, unfortunately also the pressure on the children. On the other hand, the deeply rooted preference for academic education in Chinese society has led to constant underfunding of the TVET system by governments at different levels. Thus, it is an undeniable fact that the quality of vocational training – buildings, equipment, training material, and teachers – is of lesser quality than that of universities. China still faces the challenge of breaking this doom loop. But, despite this underlying structural problem, there were certainly significant changes and major improvements in the TVET system. The following table shows the most important milestones of the reform.

Table 1: Important Milestones in China's Vocational Education Policy

Year	Milestone	Result
1978	National Conference on Vocational Education	Resolution to create more vocational schools and to modernize the educational system
1980	Structural reform of the vocational education system	Half of China's senior middle schools were transformed into vocational schools
1985	Resolution of the Central Committee of the Communist Party of China about reform of the education system	Vocational education should be given priority and no longer be regarded as the weakest link in the educational system
1996	Law Regarding Vocational Education in China passed	Opening of the education sector for private institutes, integration of companies into the learning process in order to enhance practical experience, general guidelines for curricula
1999	Ministry of Education Resolution	Vocational education to be increasingly workplace oriented, provinces are allowed to design their own curricula
2000	Ministry of Education issues catalogue of vocational education curricula	Categorization of professions and standardization of educational training, identification of necessary qualifications
2005	State Council Resolution for Vocational Education	New emphasis on practical orientation, modernization of school administrations, increase in number of students, greater investment in programs for vocational education

Today, there are more than 15,000 secondary vocational schools with more than 16,000,000 students, and the number is increasing every year. Additionally, there are more than 6,000,000 students in more than 1000 tertiary vocational schools. All in all, more than 60 million students have graduated from China's TVET system in the last 20 years, and each year there are more graduates of the TVET system, just as there are more university graduates. Despite the fact that growing and newly established companies have an enormous demand for qualified staff, many of these graduates fail to find suitable jobs. According to official statistics, more than 30% of the graduates from the TVET system or universities do not find a proper job in the first year after graduation.[2] There are a variety of reasons for these placement problems and the difficulties in vocational training in general.

- The examination system is rigid and the permeability of the professional system is low. Once a student fails to pass university entrance exams, his or her chances for an academic profession are small.
- Because of its second-rate image, students in the TVET system often lack motivation and enthusiasm. Their dream of a bright career is already over.
- Despite the fact that vocational training is under constant, gradual reform, some changes are slow and cumbersome.
- Establishing practical training alongside theoretical studies has only just started. Trainees mainly study in schools and learn little about the reality of the workplace. Schools rarely teach key qualifications such as the ability to communicate, team work, or independent decision making.
- Classes in many schools are oversized. Teachers are overworked and therefore unable to address pupils' individual needs. The technical equipment available, such as machines and appliances, is often inadequate and outdated.
- Vocational training is not yet sufficiently linked to the requirements of the labor market, so many graduates cannot find any appropriate work. Many employers still prefer hiring university graduates, although they then complain about their lack of practical skills.

As a result, the Chinese labor market faces serious problems of mismatch. But this mismatch relates not only to the graduates; the wider labor supply also fails in part to meet labor demand. The impact of the economic reform on the labor market in general was of great significance and may be the single most important factor today in Chinese people's lives and their attitude towards life.

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[2] The picture is probably not much better for the second year, but unfortunately there are no specific figures available. It is very likely that more of these graduates found a job in the second year after their exams, although many of these jobs did not match their original qualifications.

After 1980, China's government started the ongoing process of dismantling the so-called iron rice bowl, a system in which work units were responsible for supplying their workers with everything from medical care to pensions. Until then – as in many socialist countries – people were members of their work unit for their whole life and could not lose their job. Workers' qualifications tended to be low, as most industrial work was simple and people did not have to compete for jobs. The government's reform policy forced state-owned companies to face competition for market share and to make a profit, so they had to adopt leaner structures in order to survive. As a result, many companies were restructured, many went bankrupt, and more or less all companies laid off large parts of their workforce. To give an example of the dimensions of this situation: In the mid-1990s, some 20 million employees in China's cities lost their jobs due to restructuring, closure, or privatization of state-owned enterprises. People had to compete against each other for the remaining jobs. Pre-job qualifications, long neglected, became an issue. The demand became even stronger when private enterprises entered the market and started to create new employment opportunities. Although these companies offered jobs, they usually searched for a more skilled and enthusiastic workforce than the one left behind by crumbling state firms. Gradually, a mismatch between the skills of jobseekers and requirement profiles emerged.

The problems in the labor market put a lot of pressure on individual people and the society as a whole. Acceptance of the open-door policy with all its implications and the legitimacy of a government based on a one-party system were put to the test. Therefore, the government tried hard to relieve the pressure on the labor market and to make it more inclusive, especially for weaker groups. However, at the same time, the government tried to take advantage of the low salaries and quite poor labor security conditions in order to attract foreign direct investment on the highly competitive international market. This conflict of aims led more than once to incoherent and inadequate labor market policies. Before we take a closer look at these policies, some important characteristics of the Chinese labor market should be noted:

- The economic and social disparities in China are extraordinary. Whereas the coastal regions in the east are now rather prosperous and have experienced double-digit growth rates for many consecutive years, the central and western parts, like the northeast, face severe development problems.[3]

[3]Certainly the weaker regions can be distinguished. The northeast provinces are called the rustbelt of China, as they still rely on heavy state-owned industries undergoing a painful transition. In comparison, the western and central parts of China are based on agriculture.

- Inner-Chinese mobility is rigidly restricted. Migrant workers (up to 200 million people, according to estimates) actually do move to more promising areas of China, but changing their official residence is almost impossible.[4]
- The infrastructure, institutions, and social services in rural areas have been underfunded for decades; therefore, disparities continue to grow.
- As mentioned, the mismatch in the labor market is extreme with respect to regions and qualifications.
- Some groups of people in the labor market were gradually marginalized: peasants, migrants, the elderly (a term that is often used for people over 30), those with poor qualifications, and women. They face deep-rooted discrimination.
- The labor market is under demographic pressure. Today, there is still little awareness of the comprehensiveness of the demographic challenge which will affect not only the labor market, but also the social security system and the society as a whole.

When it comes to the labor market, the life of people in China today could not be more different than 20 years ago. Within only one generation, the changes have been profound, comprehensive, and complete. Many people seized the opportunity; their lives became easier and they became wealthier. Besides the few who have become ultra-rich, a relevant middle class is emerging with all the typical middle class demands and desires. Nevertheless, there is a very large group of people that is being left behind. The social systems are not in place, so unemployment generally means poverty, if other family members do not help out. Long-term unemployment in China is not as prevalent as in other societies, but China now stands at a crucial point, and only a capable and effective labor market policy, combined with regionally balanced economic development, can prevent a perilous situation. The following table shows how the Chinese Government has tried to handle the labor market issues:

[4] This fact has great impact on the living conditions of the people with respect to schooling, property ownership, social insurance, etc.

Table 2: Milestones for Employment and China's Labor Market Policy

Year	Milestone	Result
1978-1984	First relaxation of the state-run allocation of jobs	Increase in unemployment and new ownership structure of former state-owned companies
1984-1992	Gradual introduction of regular employment contracts	End of the lifelong employment guarantee
1994	First Labor Contract Law passed	Introduced flexibility in the labor market, official introduction of temporary contracts
1995-2002	Waves of dismissals by state-owned enterprises	About 20 million urban workers were made redundant
1995	The Ministry of Labor and Social Security assigned priority to labor market policy and re-employment	According to official statistics, about 70% of those laid-off during the period mentioned above were re-employed
2002	White Paper on Employment	The Ministry of Labor and Social Security introduced preferential policies that are now diversified in relation to specific target groups
2005	Draft of Employment Promotion Law introduced	Promotion of job creation and anti-discrimination on all levels of the government
2006	Draft of a new version of Labor Contract Law	Employees' rights strengthened
2007	Revised Labor Contract Law and Employment Promotion Law passed	Strengthened employee and trade union rights, banned discrimination of job seekers, encouraged local governments to create jobs

Compared to other countries in transition, the Chinese approach is often described as incremental and cautious. This is surely correct in terms of political reforms, and partly right in terms of economic and social reforms. It is less the case for labor market reform. The labor market policy can be described as follows:

- It is generally a political decision whether a government favors market forces or attempts to cushion the blow. In China, the people bore the brunt of the reforms; the government did not attempt to interfere with free market forces too much.

- On the other hand, the government knew that without any cushioning, social unease and even upheavals were even more likely. The basic tools of labor market policy like benefits, training, placement, and counseling were focused on quantitative goals, attempting to reach as many people as possible, but there was hardly any real impact in terms of (re-)employment.[5]
- Impact monitoring is weak, and labor market statistics do not give a realistic picture. The official unemployment rate is 4.5%; the real rate varies from 10 to 30%, depending on the region.
- The institutional setup for labor market policy is still not reasonable. Too many players (Ministry of Labor and Social Security, Ministry of Education, Ministry of Personnel, and several other ministries) act with overlapping or unclear responsibilities.
- The government cleared the labor market by excessive early retirement, imposing a heavy burden on the already weak social security system,[6] which must also cope with the demographic challenge.
- Interregional financial compensation is generally weak in China and basically non-existent when it comes to labor market policy. Thus, wealthier provinces with less pressure on their labor markets have more funds available than poor provinces with heavy labor market problems.

The Labor Contract Law and the Employment Promotion Law, which went into effect in January 2008, are strong evidence that the labor market will be more regulated and the interests of individual workers and weaker groups will be better protected in the future. Companies have already started to complain about the Labor Contract Law, which is not necessarily a bad thing. The laws makes hiring and firing (in particular the latter) not only more difficult, but also more expensive. Fixed-term labor contracts are much more restricted than before and have to be changed into unlimited contracts after a certain time period. That is perhaps unpleasant for some companies, but in fact it balances power in the labor market in a reasonable way. And not only that: it is also an important step towards fair competition on global markets, because dumping prices and dumping standards will gradually decrease.

[5]For example, training was rather short and not demand oriented. Job counseling took place at the placement counter in five to ten minutes.

[6]Female civil servants could leave for retirement at the age of 45.

The Technical Cooperation of China and Germany in the Field of TVET and Labor Market Policy

In 2007, the Chinese and German Governments and the related institutions celebrated the 25th anniversary of their cooperation. Development cooperation between China and Germany began at the beginning of the 1980s. On the one hand, the People's Republic of China needed to improve its vocational training system. On the other hand, Germany was widely known as a leading country in the field of vocational training. Thus, vocational training became the focus of Sino-German cooperation. At that time, assisting China in building up a sound vocational education system was an implicit contribution to poverty alleviation as well. Educating people is also an important tool for empowering them to take their lives into their own hands, thereby improving human rights. By training officials or teachers who can act as multipliers, GTZ has also helped to educate many individuals who took the lead in China's transformation from a largely rural country dominated by state dirigisme into a modern market economy with booming industrial and later on service sectors.

Altogether, GTZ China and its partners have implemented 25 related projects and programs in different locations across China. A further five are currently being implemented. These projects have established educational institutions, organized re-employment for laid-off workers, and advised government institutions at all levels. Numerous Chinese laws, regulations, and practices have benefited from German ideas and experiences, such as the vocational education norms and standards promulgated in 1985 or the Law Regarding Vocational Education in China passed in 1996. In the early phase, three-quarters of GTZ-supported projects in China were devoted to vocational training. Over the years, this prominence has subsided, because other fields of cooperation, such as energy, environmental issues, and legal and economic advisory services, were added to the GTZ portfolio in China, reflecting their rising significance for the Chinese development process.

A main objective for Sino-German technical cooperation has always been to ensure that the programs' achievements could be easily multiplied and transferred to other regions, ministries, and institutions. Thus, the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH cooperates with many different partners, ranging from relevant ministries such as the Ministry of Labor and Social Security (MoLSS), the Ministry of Education (MoE), and the Ministry of Commerce (MOFCOM) to labor bureaus at all levels, training institutions, the Women's Federation, tax offices, labor service providers, and trade unions in China.

Moreover, close cooperation with private companies is a must, as they are constantly demanding a qualified workforce. Therefore, projects supported by GTZ China cooperate with enterprises such as BMW-Brilliance, MAN Roland, Fischer Group, Putzmeister, Festo, Mennekes, Suning House Appliances, and Golden Needle. The cooperation with a large number of partners greatly enhances the effect of GTZ China's efforts and ensures that the new concepts not only work in theory, but are also adopted in practice.

During the past 25 years, the mode of cooperation has gradually shifted, from setting up facilities for training and research, to providing policy advisory services at the decision-making level and combining training with stimulation of the economy. The cooperation has always been based on mutual trust and interests and has benefited both countries. Of course, neither China nor Germany nor any other country in the world has solved all the challenges of their labor market; there is always a great deal to be learned from each others' experience.

The Concept of the Social and Ecological Market Economy

The experience of Germany with the social and ecological market economy plays an important role in Sino-German development cooperation. Although it was not explicitly brought in at the beginning, one can clearly see that the evolution of Sino-German projects has been influenced by this concept. To clarify how this concept is related to German development cooperation, the core principles of the social and ecological market economy will be presented briefly. However, it is not Germany's aim to hand this concept over to China as a blueprint, but to offer valuable experiences which can be adapted to the Chinese situation.

Core principles of the social and ecological market economy:

1) Ensure the rule of law. Economic development needs legal framework conditions that are transparent and effective. This includes binding laws and a government which acts accordingly. The judiciary must be independent of government influence.
2) Aim for pro-poor growth. The extent to which economic growth reduces poverty depends upon employment and income generation. To ensure fair distribution of the benefits of economic growth, policies need to be designed in such a way that poor people benefit over-proportionally and get the chance to become fully integrated members of a balanced society.
3.) Strengthen the private sector. Generally this means following the subsidiary principle which ensures that roles are distributed according to efficiency. The production of goods and services should mainly be the responsibility of the private sector with the objective that it contributes to pro-poor growth. Therefore, privatization of state-owned enterprises must be embedded in a coherent

development strategy and combined with regulations that cushion potential negative employment effects. In regard to public goods like education, water, and health, the government has to ensure the inclusion of vulnerable groups.

4) Improve market-oriented framework conditions. Competition is the most effective instrument with which to limit economic power. Therefore the government has the responsibility to ensure framework conditions that facilitate fair competition. This includes institutions that hinder market cartels and ensure that markets are transparent and accessible.
5) Ensure economic sustainability. Successful economic growth is increasingly based on knowledge, technology, and innovation. The government, therefore, has the responsibility to establish a dialogue between economic, scientific, and civil partners to identify future challenges and develop strategies for dealing with them. Industries with high growth potential in the future but low competitiveness at present can be given infant industry protection.
6) Establish a social partnership. Capital and labor have a complementary relationship. This means that not only employers' associations but also employees' organizations and civil society should participate in an economic policy dialogue. The right to free speech and freedom for trade unions to organize are necessary for a fair balance of interests and thus contribute significantly to social peace. Furthermore, enterprises have the responsibility to consider their corporate social responsibility and respect core labor standards.
7) Aim for ecological sustainability. Economic growth must not be promoted at the expense of the environment. Sustainable use of resources contributes to ecological and economic sustainability alike. The government's responsibility in this regard is to establish a preventive environmental policy in such a way that there are economic incentives for respecting international environmental agreements.
8) Ensure equal opportunities. Economic development must be pro-poor, thus contributing to poverty reduction. The government has to ensure that market results are distributed equally and that vulnerable groups (e.g. women, youth, the elderly) are empowered to improve their own situation.

In Germany during the last 60 years, the social market economy has proved to be an economic model which can achieve a balance between the interests of different stakeholders, even in times of deep-rooted change and transition. At the same time, it has contributed to pro-poor growth that has enabled all population groups to participate in this growth process by way of employment and income. However, achieving balanced growth still is and will continue to be a challenging task.

In Germany, it was in the 1970s when awareness of environmental damage and the need for the ecological use of resources first appeared, but it took until the 1990s for the concept of an ecological market economy to be formalized, thus creating the social and ecological market economy.

Furthermore, in Germany there is also a long tradition of balancing responsibilities and rights between employers and employees in the development process. This has been institutionalized in the German constitution as the principle that "property entails obligations," which means that companies have the right to make a profit but also have social responsibilities, while employees have the right to freely choose their work but also the responsibility to perform it properly. In this way, Germany tries to create a harmonious society.

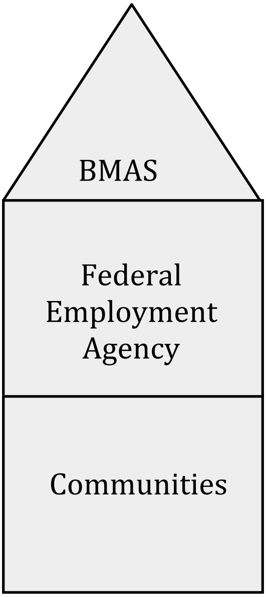
China has incorporated the aim of establishing a harmonious society into the present five-year plan. This essentially means that social and regional disparities are to be reduced considerably. In regard to the proposed development path, the idea is to first achieve a society with modest wealth for all before actually solving the problem of disparities. As the five-year plan does not make entirely clear how this can be achieved, the Chinese Government has been looking for suitable concepts in different countries. However, the German social and ecological market economy is a model that not only potentially helps reduce disparities, but also combines socialism and a market economy in a favorable way, thus mirroring the very different starting points in China.

Two important elements of the social and ecological market economy that have influenced Sino-German development cooperation are German labor market policy and the German "dual system." Both elements will be briefly described below.

German Labor Market Policy – To Assist and Activate

In Germany, labor market policy is implemented on three levels, the political, the institutional, and the local levels. On the political level, the German Ministry for Labor and Social Security (BMAS) is the responsible entity. The BMAS is responsible for implementation of the European employment strategy and labor regulation in Germany, for example, labor contract law. On the institutional level, the Federal Employment Agency is responsible for implementing active and passive labor market policy measures. On the community or city level, where local labor market policy is implemented, it is possible to directly engage public institutions and private companies in a dialogue with the aim of improving the employment situation in the region. One advantage of the multi-level approach is that experiences which are made on the local level can be transferred to other regions via the institutional or policy level.

Besides public institutions, there are private organizations like trade unions and employers' associations. During collective bargaining processes, employers' associations represent their member companies, while trade unions mostly act for their individual members. The autonomy and independence of these organizations is protected by the German constitution. The government cannot influence the process or its results.



In general, labor market policy can be divided into active and passive labor market policies. While active measures have the objective of (re-) integration into the labor market through, for example, further training, passive labor market policy aims at ensuring a minimum level of income for the unemployed person until he or she has found a new job, keeping in mind that the unemployment period should be as short as possible.

From the beginning of the 1990s until 2005, Germany had a quite high overall unemployment rate. This situation led to the so-called Hartz reforms, which attempted to make German labor market policy more efficient in terms of (re-) employment. The theme of the reform has been an activating social state which focuses on the balance between assisting and activating. Unemployed people are assisted according to their individual needs and the demands of the labor market, at the same time. All labor market measures were evaluated and, if they were inefficient, they were revoked or reformed. The Federal Employment Agency was restructured, and a monitoring and evaluation system which allowed the management to continuously monitor the efficiency of the reformed measures was introduced, meaning that these measures are not permanent, but can be further developed. As a result of the reforms and the present positive economic developments in Germany, the employment situation has improved considerably.

The German Dual System

In Germany, the dual system is far and away the largest educational area within the secondary sector: two-thirds of each age group undergo formal training to acquire the skills for a recognized occupation. The great majority of graduates of dual-system training then work as skilled employees – and many later make use of opportunities for further vocational training. Under certain circumstances, graduates of such training can also acquire a university entrance certificate and then go on to university studies.

On the whole, there are many possibilities for transition between school-based and dual system vocational training and for transition from vocational training to higher education. Some 20% of all first-year students come to higher education after having completed training in the dual system. Completing university after graduation from the dual system offers students the chance for a successful and profitable career, regardless of their background. In this way, vulnerable population groups can make use of the opportunities offered by higher education. This contributes to greater equality in German society.

The dual system does not have any formal admission prerequisites: by law, all school leavers, regardless of the school-leaving certificate they have, can learn any recognized occupation requiring formal training. In actual fact, however, opportunities for admission and the actual numbers of people who enter certain occupations depend on pre-qualification.

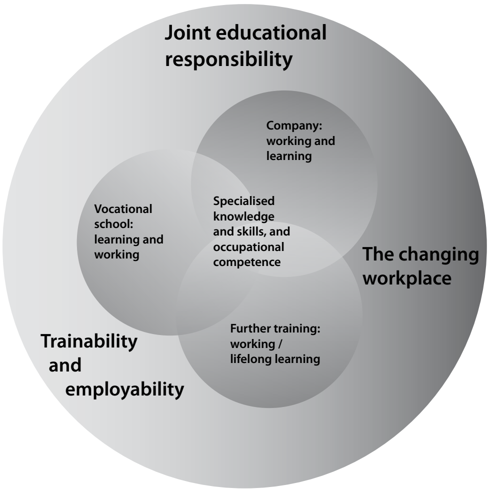
In the dual system, a combination of learning and working provides the basis for acquiring vocational skills. The system seeks to teach theory and practice, and to impart structured knowledge and active competence in their proper context. The different learning sites involved, the company and the vocational school, interact in keeping with their different emphases, but their tasks are not rigidly divided: school is not reserved solely for teaching theory, and in-company training involves more than practice.

Under the dual system, vocational schools and companies have a joint educational responsibility. Trainees spend one or two days in vocational school and three or four days in their company. Vocational schools also establish specialized classes oriented to the various relevant occupations – and they do so at a supra-regional level for less-popular occupations. The state coordinates its framework regulations for training in the companies and vocational schools. In final examinations, trainees must show that they have acquired the necessary skills – the required practical and theoretical knowledge –from their companies and that they have mastered the course material relevant to their occupation as taught in the vocational school.

Vocational training in the dual system is based on the occupational concept: formal training for a particular occupation is oriented to the qualifications that are typical for the relevant work processes. Specialization is permitted, as a complement to the basic qualifications required for each occupation in question, but only within an occupation context. Vocational training should prepare people for specific occupations, to be pursued immediately after the completion of training, but it should also prepare people for further learning. For this reason, promoting willingness to learn and fostering personality development are two of its important components. To work in the knowledge society, people must be able to plan, carry out, and check their work independently. Vocational training within the dual system is oriented to this aim. Additional qualifications, beyond regular training, can also support this aim.

The system's central aim is to promote employability in a changing workplace – a workplace that is shaped both by technical development and by the people who work in it. For this reason, state-accredited occupations requiring formal training and federal regulations on examinations for further training are designed in cooperation with the social partners (employers' and employees' representatives). This applies to overarching structural issues as well as to individual legal provisions. This approach thus fully reflects workplace requirements and the need to foster learning and personal development.

Figure 1: Basic Elements of the Dual System[7]



How can the concept of the social and ecological market economy serve as a background for Sino-German development cooperation? In the following paragraphs we try to elaborate on the evolution of Sino-German projects and programs while showing how the concept of the social and ecological market economy has influenced this cooperation.

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[7] See German Federal Ministry of Education and Research (BMBF), *Germany's Vocational Education at a Glance* (Bonn: BMBF Publik, 2003), 4.

The projects and programs supported by GTZ China can be divided into four modes which reflect this gradual shift from setting up training facilities to implementing integrated approaches with greater employment impacts.

First Mode: Setting up Training Facilities

During the initial period of cooperation, the typical goal of a project was to create and develop new training institutions at the grassroots level. The former senior middle schools that were transformed into vocational training schools were clearly inadequate as they had no workshops and only taught theory. Thus, it was more useful to build new schools from the ground up rather than trying to impart new methodologies to existing schools. All schools founded by the Sino-German projects – for example, a welding technology school in Harbin or an aviation technology training centre in Beijing – offered workshops and rooms for practical assignments, using modern machinery for students to acquire skills. Thus, combining practical training with theoretical learning was one of the first German practices that was implemented in China. Although the training in these schools was much more hands on, stimulating, and learner centered, there were still some differences between this training and the German dual system. In contrast to Germany, Chinese companies have no tradition of taking responsibility for the vocational training of their employees. Instead, all formal education is organized exclusively by schools. Thus, projects run by GTZ and their partners linked up with cooperating companies as a place for practical training. Nevertheless, the responsibility still remained with the institutes. As a result, the schools started to build up strong links to companies – something entirely new for China. These contacts not only increased the schools' awareness of the needs of the labor market, but also contributed to an improved dialogue between public training institutions and companies – although on an informal basis. In addition to the training facilities, the joint projects set up two regional research institutes for vocational education (RIBBs) in Shanghai and Shenyang as well as a central institute (ZIBB) in Beijing. These think tanks support the vocational training program with research and policy advice. ZIBB, for example, advised the Chinese Government on drafting the Law Regarding Vocational Education passed in 1996 and successfully advocated for an opening of the educational sector to private institutions. In line with the principle of subsidiary – one of the core principles of the social and ecological market economy – private training institutions can be a good supplement, especially for courses in certain areas like IT, thereby enforcing competition, which will – if properly monitored – raise quality standards.

Second Mode: Improving the Quality of Institutions and Human Resources

The dialogue that developed between companies and training institutions made it increasingly obvious that the lack of appropriately qualified teachers and trainers was a serious bottleneck for educational development. Trainers and teachers did not receive any specific training and often lacked practical knowledge; they were thus not able to offer practically oriented education. Only very few of them had ever seen private companies from the inside or had sufficient knowledge of the daily work and its demands. In order to address this problem, projects supported by GTZ and its partners placed greater emphasis on the qualification and practical knowledge of teachers through intensive cooperation with companies. This was the beginning of a dialogue that included scientific institutions and universities. A prominent example of this approach is the Institute of Vocational Training (IBB), established at Tongji University in Shanghai as an academic institute for vocational teachers and supported by a Sino-German project launched in 1997. IBB emphasizes not only theoretical learning, but also diverse opportunities for students to acquire practical skills through internships, modern learner-centered teaching methods, and so on. There were two multiplier effects: First, trained students graduating from the institute became teachers at technical colleges. Second, the institute's methods were transferred to universities and schools in three provinces of western China in order to reduce regional and social disparities and to promote equal opportunities.

Third Mode: Orientation towards the Labor Market

Faced with mass layoffs in the 1990s, China had to improve the quality of training programs for unemployed workers. The large number of jobseekers did not match new job opportunities, because they required special skills and qualifications which these jobseekers did not have. At the same time, it became obvious that some groups were more at risk than others of losing their jobs and having difficulties in finding a new one. These weak groups included the unqualified, women, people over 35, the handicapped, and others. The gender gap on the labor market grew significantly, because women were among the first to be laid off and were often discriminated against when seeking placement in new jobs. As there was no coherent labor market policy in place to tackle these issues, Germany's experience in this area proved to be valuable to the Chinese, and Sino-German projects started to systematically combine TVET with labor market policy measures. Up to that point, labor market policy in China had not used the potential of socially oriented market instruments, so the challenge was to generate a development strategy that would not just take advantage of low salaries and weak regulation of labor security, but would give laid-off people new opportunities. In 1999, GTZ and the MoLSS began a project that supported the reintegration of unemployed women into the labor market. This project developed and implemented different labor market policy concepts for women in Nanjing and Benxi, for example, training female candidates in different professions and enabling them to set up their own businesses. New placement concepts were also introduced. On the policy level, the project supported the drafting of the Employment Promotion Law which went into effect in January 2008. Finally, Sino-German programs tried to reduce discrimination in the labor market with measures that were targeted especially at vulnerable groups such as women, the elderly, and the handicapped, thereby increasing equality.

Fourth Mode: Combining Labor Market Policy with Regional Economic Development

Labor market policy measures cannot be fully effective if they are not directly linked to business promotion activities, particularly in regions with high structural unemployment. Only successfully operating companies can create jobs. Therefore, Sino-German projects started to implement an integrated approach, which not only matches TVET measures with labor market policy, but also integrates business promotion measures. Thus a new GTZ-supported project situated in China's northeastern rustbelt of Liaoning Province addresses the issues of companies' requirements and qualifications of the unemployed, while exploring new ways to improve the investment climate in the province. For example, the project currently compiles data for labor market statistics and assesses the success of various development zones in the province, thereby tackling labor supply and demand simultaneously. It is working in a multi-partner structure that includes the Provincial Labor Office, the Provincial Reform and Development Commission, and the local Department of Commerce in Liaoning, which ensures that these agencies will be able to coordinate their strategies later on. Other Sino-German projects incorporate not only questions of property rights, labor legislation, and decent work requirements, but also product standards and ecological considerations.

Moreover, a number of public private partnerships (PPP) were set up as part of these projects. As the lack of qualifications in the workforce has surfaced as a major problem for German and Chinese companies, both sides profit from cooperation. The corporations involved not only contribute financially, but also commit themselves to hiring staff which has undergone the respective training.

GTZ China has taken great care to preserve the knowledge and experience gained in the Sino-German programs through various knowledge management tools that were developed and emphasized. One important outcome of this process was the Knowledge Management Library of Vocational Training at the Sino-German Vocational Training Center (AFZ) in Tianjin, a project which was originally established in 1986. The Knowledge Library is open to the public so that interested institutions or partners from other projects can learn from each other's experience or exchange ideas. In order to keep the community of old and new partners as well as other stakeholders lively and vibrant, GTZ has initiated conferences with Chinese and German organizations such as the Hanns Seidel Foundation and InWEnt. These biannual conferences on vocational education have turned out to be an ideal setting for networking and catching up with new developments.

Challenges for the Chinese Development Process and Potential Fields of Cooperation in the Future

Although very successful thus far, the Chinese development process will remain challenging. While in the past the most important objective was double-digit growth rates, China now has to address the ecological and social sustainability of its development. Regarding the social situation, it needs to be said that China's Gini coefficient – an important measure for inequality –is now higher than that in countries like Ivory Coast, Uruguay, and Bolivia. This inequality has led to demonstrations and social unrest – an estimated 70,000 such incidents a year. Thus, in order to move towards a harmonious society, it is necessary to reduce inequality substantially and open up opportunities for a wide range of the labor force to participate in the economic growth path. This also includes improving the permeability of the technical vocational and education system, so that vulnerable population groups have the chance for a successful career.

However, the pressure on the labor market will remain high, not only because people are looking for a job, but also because most of these jobs require skills. According to estimates, China will need at least one million additional computer specialists, 300,000 additional car mechatronics, 150,000 additional nurses, and a few hundred thousand computer numeric control specialists in the next few years. As China anticipates an urbanization rate of 57% by 2020 – compared to about 40% now – the growing cities will also need large numbers of construction workers and transport personnel, as well as staff for businesses, offices, and modern services such as tourism.

However, at the moment, China classifies only 4% of its workforce as highly qualified, while 36% have a middle school education. The remaining 60% have few or no skills and are regarded as "elementary workers." A large part of this group is comprised of approximately 200 million rural migrants currently working in cities. More than 80% have only graduated from junior middle school, and only 2.4% hold certificates that certify a formal vocational education.

According to the present five-year plan, China's government plans to create around 24 million urban jobs each year, while around the same number of people will be seeking a job. This number includes migrants coming in from the countryside, people who have been laid off, and new job market entrants such as university graduates. Therefore, China needs to keep gross domestic product growth high in order to allow job creation to keep pace with demand. Meanwhile, the government is in the process of creating a social security system through a national social security fund that has taken over the payment of pensions and unemployment benefits from work units. Yet, this system is not fully established. So far, it exists only in urban areas and, even there, not all urban residents are covered. Currently, creating a social security network for rural areas is a huge challenge for the Chinese Government.

The main objective for such a social security system is to offset the risks people face in their working life, such as unemployment, sickness, work accidents, and age. Against the background of the one-child policy, the establishment of a pension system will be an especially enormous challenge. The probability of having to deal with these risks has increased with the structural transition that has been taking place in China in the last 20 years. China has embarked on a quite liberal path when it comes to cushioning the negative employment aspects of the ongoing structural change.

In conclusion, it is clear that several topics in the field of TVET and labor market policy remain important or are becoming even more so: To further address the mismatch on the labor market, improvements in the coordination between educational and training institutions and the private sector must continue. Growth needs to be more labor intensive; this could be promoted by the appropriate framework conditions. A special focus should be laid on the development of private small and medium-sized enterprises, which were the job motor of the transformation in recent years, but still face discrimination with regard to access to credit and other resources as well as administrative procedures. Here the cooperation field of TVET and labor market policies has already been expanded to include business promotion measures, programs which support the improvement of the business and investment climate, and advisory services in the field of economic policy and the legal framework. Corporate social responsibility and environmental aspects also need to be emphasized further.

Another field of future cooperation will be passive labor market policy measures, such as unemployment assistance and other social security schemes – both within the framework of the demographic challenge in China. Here again, Germany has valuable experience in establishing and reforming such a social security system.

Technical and Vocational Training in Thailand

Peter Pozorski

Introduction

The German system of vocational education, known as the dual system, is the product of a long development process, which was influenced by changing and very different political and economic conditions. The system in its present-day form is based on a specific interconnection of the private and the public sectors. This particular character is only superficially indicated by the learning sites: the private company and the state vocational school. In fact, the system is supported by a sophisticated distribution of roles and responsibilities among political, economic, and social stakeholders.

The German dual system of vocational education is often mentioned in the same breath as the social market economy as an important factor in the recovery of the country after World War II. However, the interconnections with the newly established and successful post-war economic system were at least twofold: On the one hand, the indisputable capability of the dual system to produce occupational qualifications demanded by the surging economy indeed contributed significantly to the economic success. On the other hand, the social market economy provided the basic values for the establishment of a coherent legal framework for vocational education, replacing the former fragmented legislation. In this regard, the German system of vocational education is part of the social market economy. The legal basis enacted in 1969 and the following years finally established vocational education as a common good. The state sets reliable framework conditions for the cooperation of all stakeholders in order to pursue objectives of common interest in three fields:

- economic: to supply the required quantity and quality of occupational qualifications to the employment systems;
- social: to provide access to occupational qualifications for employment as a condition for income and social integration; and
- educational: to support the personality development of individuals in order to strengthen civil society.

The high level of public appreciation for the dual system might lead observers to lose sight of its complex structure, which is determined by and dependent on the political, economic, and social environment in Germany. The possibilities of transferring this dual system to the different environments of other countries are overestimated, and attempts to implement dual structures in vocational education have to take into consideration a context broader than vocational education as such.

Vocational Education and Training in Thailand

In Thailand, as in many other countries in the region, the system of vocational education and training consists of two different sectors. The first is formal vocational education, carried out as a fulltime school scheme. Graduates are awarded a certificate, which is on par with that of graduates of general upper secondary education. Therefore, only graduates of lower secondary education have access to this educational path. The other sector, non-formal vocational training, offers many social groups open access to the training programs; graduates are awarded internationally recognized certificates of skills development on different levels. Since the 1960s, both sectors have been extended continuously and in parallel by government funds and with support of international development cooperation. Today both sectors have a dense network of institutes that stretch across the whole country.

The segmentation is based on regulatory policy. Occupational training is regarded as a task of the government and is, consequently, placed under the jurisdiction of certain government bodies. Primarily, it is the task of formal vocational education, which is under the jurisdiction of the Office of Vocational Education Commission (formerly Department of Vocational Education) in the Ministry of Education to produce qualified staff for public establishments, administration, and state enterprises, where personnel are classified for grade and pay scales according to educational qualifications. The vocational training of staff for private companies and of workers to be sent abroad under the scheme of bilateral labor exchange is the responsibility of the Department of Skills Development in the Ministry of Labor.

The great number of private vocational schools, where around 35% of all students in formal vocational education on the upper secondary level are enrolled, are not in conflict with this system, because they must follow the guidelines given by the Ministry of Education pertaining to duration and contents of courses and awarded certificates.

Formal vocational education of this kind is closer to the educational system than to the labor market. Since the awarded certificate is of the same level as the certificate of general upper secondary education, achieving this certificate has greater importance for a successful entry into employment than acquiring occupational skills and knowledge. Private sector organizations have no function in this government-controlled system, and private companies are only involved as providers of internships that form part of study programs driven by educational requirements rather than by labor-market demand.

This division of labor began to soften more and more at the end of the 1980s, when economic growth was gradually accelerating. The demand of the public sector for personnel declined significantly, and private companies, which were becoming larger in number mainly due to foreign direct investment, were increasingly recruiting graduates of formal vocational education. Since the growing national economy offered more jobs in their home country, Thai workers began to loose interest in being sent abroad for work. As a result, a main incentive to undergo skills development was lost. At the same time, the holders of certificates of skills development fell behind graduates of formal vocational education in competition for well-paid jobs in the surging industry.

Efforts to Reform Vocational Education and Training

At the end of the 1980s, the private sector became the main employer of graduates of Thailand's system of vocational education and training and insistently demanded that the government make more efforts to improve vocational education, namely to orient it more closely to occupational practice in companies. The thrust was directed mainly towards formal vocational education, which was far from the reality of the workplace and did not impart occupational competence relevant for the companies. Although non-formal vocational training was performing much better in practical training, it did not attract much interest. Employers did not regard skills development graduates as promising human resources because of their generally lower educational qualifications.

During the period of political change in the 1980s, committees for cooperation between the public and private sectors were created in different sectors and on the regional and national levels. Private-sector representatives in the Committee for Public-Private Cooperation in Human Resource Development succeeded in convincing the government of the necessity to reform vocational education and training and to involve the private sector in its design. However, there was dissension between the public and private sectors and also between the different participating private-sector organizations about the future structure of a system that would be able to produce the qualified workforce required by the companies.

Approaches of German Development Cooperation

Even before the committee was created, large Thai enterprises expressed their interest in the German system of vocational education and subsequently urged the Ministry of Education to submit a request to the German Government for a development project to implement dual vocational training (DVT). About the same time, the Ministry of Industry, in tune with an initiative of private Thai enterprises, mainly of the manufacturing sector, also came forward with a request for the establishment of a high-tech training institute. Similar German technical and financial cooperation projects in Singapore and Malaysia inspired the concept and later the name, the Thai-German Institute (TGI). Because of the German vocational education system and a number of reference projects, Germany was regarded as the most competent partner in the field of vocational training. German development cooperation responded positively to both requests, not least because the demand initially came from the private sector, but also because of the convincing commitment of the relevant government and private sector organizations to future cooperation in vocational education and training.

The Thai side, namely the Ministry of Industry, the partner of TGI, was driven by the conviction that improvement of vocational education and training is essential for the development of existing companies and for continued success in attracting national and foreign direct investment and, therefore, for sustainable economic growth. For the same reason, the Board of Investment (BOI) began to develop an increasing interest in both projects. After a period of observation, the BOI advocated the approaches in public discussions and later referred to the projects in its publication for investors as examples of advanced human resource development and a location factor.

The DVT project attempted to bring about structural change by training organizations and developing occupational skills in order to make the initial vocational education practice oriented and relevant to the needs of the companies. The TGI project worked to create an exemplary institute that provided further training in modern production technologies for qualified staff already working in manufacturing companies. The focus was set on production automation and key technologies in manufacturing, such as mechatronics and tool and die making. As a result, German development cooperation was directly involved in the process of reforming vocational education in Thailand with two different technical cooperation approaches, in order to increase the availability of qualified labor and strengthen the competitiveness of Thai companies by improving their human resources in the areas of production and service.

The first years of implementation of the DVT project yielded three general insights:

- It is feasible to have an initial vocational education system in which state vocational schools and private companies share specific tasks in terms of the organization of the training process and contents of the courses. A strong job orientation in the schools and the companies can produce the type of qualifications demanded by the private sector.
- The nationwide extension of a model of cooperative training depends only on a decision of the national authority of vocational education, the Department of Vocational Education (now Office of Vocational Education Commission). DVT can be implemented without a prior revision of the legal framework, because the existing laws on education, labor, and protection of young persons provide enough leeway and do not pose impediments. Only decisions pertaining to operational procedures in vocational schools and companies and an adjustment of existing regulations issued by the national authority are necessary.
- A law on vocational education that provides specific regulations for DVT is not a precondition for its introduction. In fact, it became obvious that regulations specific to a cooperative model can only be appropriately designed after experience has been gained with the cooperation. This applies particularly to the allocation of roles and tasks among the acting stakeholders.

These findings explain the redirection of the project's approach towards consultancy on the meso level, the national authority for vocational education. After a rather short time, the decision for a nationwide introduction of DVT was made and underpinned by orders to the state vocational schools. Private sector organizations supported this action of the national authority and made recommendations to their member companies. Their participation was meant to be voluntary, not only because there were no legal means to force them, but also because of the intention to make an appeal to corporate social responsibility.

During the pilot phase of the project, DVT graduates were only awarded a non-formal qualification. The adjustments of regulations, mainly those for curricula and examinations, finally put the DVT certificate on par with that of formal vocational education on the upper secondary level. DVT became more attractive to students and their parents as well as to companies, which likewise attached high importance to the fact that their DVT graduates could be awarded a certificate with formal and social recognition. Subsequently, the number of students enrolled in DVT and the number of cooperating companies started to increase year by year. Furthermore, the application of DVT expanded from the manufacturing sector, where it was introduced initially, into the commercial and service sectors.

In order to set up the TGI, it was necessary at the beginning to create a suitable regulatory basis that provided the institute's management room to maneuver in creating and carrying out programs of further training that keep pace with the dynamic development of technology in industrial manufacturing. To this end, the Ministry of Industry, under whose authority the TGI was placed, issued bylaws on the management of assets, finance, and personnel that clearly went beyond the restrictive boundaries set for the management of government institutions. This greater freedom of action made it possible to develop and offer a variety of demand-driven further training, consultancy, and other industrial services to manufacturing companies.

The strong expansion of DVT and the positive reception of the cooperative model, which also specifically formed the basis of the concept for further training at TGI, did not make a decisive impact on the progress of the public-private dialogue on reform of vocational education and training in the Committee of Public-Private Cooperation in Human Resource Development. Both sides became more and more set on debating different types of qualification systems, instead of entering into negotiations on the distribution of roles and tasks in a cooperative vocational education system.

After the Asian Crisis, the quickly rebounding economic growth ultimately weakened the pursuit of reform. In 2001, the work of all the committees was terminated, and all the committees were dissolved. The Thai-German development cooperation in DVT and demand-driven training in manufacturing technology at the TGI remained practically unaffected. In fact, both projects attracted increasing attention, while the partners intensified their participation and ownership. Enrollment in the DVT reached almost 10% of all students in formal initial vocational education and the Bureau of Budget established a proper budget item for DVT within the budget of the Ministry of Education. During the last two years of the project, the Thai partners, public and private, spent DM 2.20 on DVT related activities for each DM 1 spent out of the German DVT project budget. The TGI consolidated a prime position in technology transfer and training with an expanded program of technology services to companies.

Within the objectives and implementation of the two projects, German development cooperation also pursued a strategy to demonstrate the effectiveness of basic principles of the social market economy and to suggest to the partners that these principles could orient regulatory policy for reform. For vocational education and training, this means the creation of framework conditions conducive to decisive participation and responsibility of the private sector for the design and organization of recognized processes of occupational training.

In Germany, the existence and effectiveness of the legal framework and institutional structure for cooperative vocational education is based on a consensus that has been gained through a long process of negotiation on all the relevant political, legal, social, and economic issues, which is still ongoing. In countries where close public-private cooperation in vocational education is in the making and is the subject of a reform process, similar commitments of relevant stakeholders need to be obtained and comparable structures need to be established from scratch or by changing existing structures. Actually, the Thai partners of both projects remained reluctant to create new institutions or to make structural changes to existing institutions. In particular, the private sector organizations did not show great interest in formally assuming an active role in the design and organization of DVT. The main reason might have been that these tasks would have required building up more capacity within their organizations and there was no readiness to assume the related risks.

Therefore, the formal integration of DVT did not make substantial progress. It was de facto introduced and functioning as a model of public-private cooperation in vocational education and training, but neither the government nor the private side started to make preparations for an appropriate joint organization on the level above schools and companies. When work on a new law on vocational education began in the year 2000, only regulation of the status quo that had been achieved so far by the implementation of the DVT project on the micro level was taken into account. Also the organizational development of the TGI in the direction of more institutional independence based on public-private partnership remained stagnant. The Ministry of Industry, instead, took steps to bring the dynamic TGI under closer governmental control again.

Results and Lessons Learnt

The explanation for the lack of progress can be found in unchanged mindsets. On the government side, influential decision makers in the partner organizations continue to adhere to the position that vocational education and training is in principle a task of the government, and vocational institutes are instruments of government policies. This seems to be indirectly justified by a private sector that prefers to remain in an observing and accompanying position instead of contributing to the establishment of an institutionalized structure to guide and organize vocational education and training, as a clear statement of formative intent.

A transfer of mandatory tasks from the public sector to a private sector body, which may receive appropriate government subsidies in return, is neither common in the political and administrative traditions of the country nor completely compatible to the mindset of the main stakeholders. To establish an institutionalized partnership in vocational education, both sides have to overcome their conventional positions and the traditional delineation from each other. The final version of the draft Vocational Education Act, which was submitted to the parliament in 2007 for approval, may prepare the ground for a progressive alignment of both sides in the future by making it obligatory for state vocational schools to seek cooperation with private companies.

German development cooperation with Thailand in the area of vocational education has demonstrated that the instruments of financial and technical cooperation can sustainably improve vocational education in terms of modernization, quality, and relevance to company workplaces This impact was mainly limited to the operational level of vocational schools and companies, where procedures and regulations for effective public-private cooperation could be established jointly and successfully. For the TGI project, this applied to the level of management, development, and realization of all the different types of activities in training, consultancy, and industrial services. On the meso level, in the national organization of the partners, only a minimum of structural change for steering and control, necessary for maintaining public-private cooperation on the micro level, has been achieved.

However, the introduction of basic elements of public-private cooperation into the new Vocational Education Act shows that the DVT project ultimately left some modest traces on the macro level of national policy and provides good preconditions for the further development of public-private cooperation in vocational education and training. Straightforward implementation of the mandate of the new law by state vocational schools will eventually make it necessary to develop an organizational setup for the coordination and support of participating companies. Since participation of the private sector is a crucial factor for the functioning of such a body, the government-driven approach cannot avoid conceding a degree of influence and some responsibilities.

In Thai society and particularly among entrepreneurs, an ethical communitarian commitment is quite common. This attitude combines social responsibility and economic usefulness. It was, in many cases, the final decisive factor that moved a company to join the DVT program, which was understood as a scheme beneficial to the personal development and employment of young people. Thus, this social commitment constitutes an important starting point for involving the private sector in a matter of such high social and economic relevance as vocational education.

The impacts achieved in Thailand indicate that the existing instruments are working well for the micro level, but are not entirely suitable to achieving and securing ambitious objectives on the meso level, such as structural change in governing bodies, public or private. Therefore, these instruments have to be combined with a specific advisory and promotional approach on the meso and macro levels that increases the partners' understanding and support of necessary changes. An implementation concept designed in such a manner can take on the objective of achieving an essential turn in regulatory policy, namely the establishment of a robust agreement on a controlled transfer of a certain range of government tasks in vocational education to a public-private body above the level of schools and companies. This will lay the foundation for an institutionalized and hence sustainable cooperation in vocational education and training.

Appendix

Social and Ecological Market Economy Principles in German Development Policy (Strategy 158)[1]

Federal Ministry for Economic Cooperation and Development

German development policy bases its international role and responsibility on the following goals: reducing poverty, securing peace, achieving justice in globalisation and protecting the environment. The BMZ is committed to the ideal of sustainable development in the pursuit of these goals. Sustainable development entails balancing people's economic, political and social living conditions on the one hand with the long-term preservation of vital natural resources on the other. Protecting the environment is seen as an inherent element in a development process that allows us to satisfy current needs without endangering the development opportunities of future generations. Sustainable development demands that ecological, socio-cultural and political aspects receive the same attention as economic ones.

For the field of fostering economic growth, the model of sustainable development assumes a definite shape through the principles of the social and ecological market economy. In following this approach, German development cooperation is drawing upon a successful German and European tradition of economic and social policy design. German development cooperation thus offers its partner countries an alternative to the extremes of radical market liberalism on the one hand and highly interventionist market regulation on the other. In doing so, German development policymakers are establishing their position in the international dialogue on shaping globalisation and are assuming responsibility within the framework of global structural policy for key issues relating to the social and economic future of humanity.

The principles of the social and ecological market economy illustrate the most important fundamental economic policy tenets of German development cooperation, indicating the special experience and institutions that Germany can contribute in its cooperation with partner countries. These tenets provide the

[1]Source: BMZ. 2007. Social and ecological market economy principles in German development policy. Strategies 158.

framework for shaping the content of German development cooperation and thus represent the specific German approaches available to Germany's partner countries in development cooperation. This orientation towards a social and ecological market economy does not, however, mean that German institutions and its market system serve as a blueprint for Germany's partner countries.

The social and ecological market economy stands for competition, and economic and fiscal stability, as well as social balance and sharing. This is not about specifying concrete economic policies for achieving these goals. In fact, the strength of the social and ecological market economy lies in its ability to react flexibly to the conditions in Germany's partner countries. Certainly, the state and its constitutional institutions have an active role to play in shaping economic and social life.

The first and foremost aim of German development cooperation is shaping overall conditions so that they support sustainable development in Germany's partner countries. This also means influencing the social and political views of economic players by using appropriate incentives, so that solidarity and participation are supported and encouraged. In accordance with the principle that ownership entails responsibilities, private wealth does not only serve the purpose of individual enrichment; it also implies responsibilities towards the community.

German development cooperation is committed to implementing the United Nations Millennium Declaration and achieving the Millennium Development Goals. The principles of the social and ecological market economy acknowledge the special role of economic, social and cultural human rights and gender equality.

The guiding principles for the design of German development cooperation are as follows:

1. Supporting the rule of law: Economic development requires the creation of a legal framework, which includes binding legal standards and state action that is guided by the principles of the rule of law. Sustainable economic activity presupposes a commitment to law and order. A functioning judicial system gives all private sector players an equitable framework in which to engage in the economic process. Human rights, equal opportunities and participation are integral components of a social and ecological market economy.

2. Striving for broad-based growth: Economic growth is necessary in order to reduce poverty. The size of the impact which economic growth has on reducing poverty depends quite crucially on its positive effects on employment and income. In order to guarantee equitably distributed economic development, the growth process must be designed in such a way that the poor benefit from it to a greater degree. Policy approaches aimed at broad-based or pro-poor growth therefore seek to increase both economic growth and the participation of poor population groups in its fruits. Poverty reduction cannot be achieved by "trickle-down" effects alone; it is fostered first and foremost by improved access to employment and income, resources, goods and services for poor and disadvantaged population groups.

3. Strengthening the private sector: A social and ecological market economy is built on private sector initiative. The provision of goods and services should be left to private enterprises wherever they can provide better access to them for poor and disadvantaged population groups. Thus, the privatisation of services traditionally provided by the state is not an aim in itself. It must be part of a coherent development strategy that is tied to the installation of pertinent regulatory competence. In the case of public goods in particular – such as education, water and health – the state has to ensure that poor people have access to these goods and must, if necessary, take responsibility for providing them with these services. The state also continues to bear the political responsibility for the outcome of any reform or privatisation of public delivery structures. The principle of subsidiarity must be born in mind in all cooperation between state, associations and businesses: basically, the state should only take on those tasks that the private sector is not able to carry out more efficiently.

4. Improving conditions for the market economy: Competition is the most effective instrument when it comes to limiting economic power. Creating suitable conditions for a market economy to prevail is a vital responsibility for governments. In order to counteract the tendency of the market to dissolve into a series of cartels and/or monopolies, the state or the international community must create an institutional framework that particularly encourages market transparency and free and open market access. It is also important to take into account the legitimate interests of consumers in product quality. Consumer protection is therefore just as much a key task for the state as developing an effective administration and effectively fighting corruption.

5. Making an economy viable for the future: The successful growth of national economies is increasingly based on knowledge, technology and innovation. Thus, the government's job is to conduct a dialogue with society on the challenges of the future. This dialogue has to be realised in cooperation with industry, science and civil society. It is important that governments recognise anticipated structural change and future patterns of specialisation at an early stage and channel public resources into these fields (e.g. research and development, infrastructure and access to capital). Sectors with great future potential that are not yet internationally competitive or sensitive products may constitute an exception to a government's essentially liberal foreign trade policy, with temporary measures being employed to protect them from the pressure of world markets.

6. Creating a social partnership: Two important aspects of social partnership are capital and labour. Therefore the labour force and civil society should also have a say in the economic policy dialogue, alongside business associations. The right of free speech and freedom to organise trade unions are vitally important for balancing conflicting interests and play an important role in preserving social harmony. Achieving a balance of interests between providers of capital and employees must be taken into account in the management of private sector enterprises. This can be done by means of active co-determination by the workforce and by allowing collective bargaining. On the other hand, when business decisions are taken solely on the basis of the often short-term interests of capital investors, this is incompatible with a social and ecological market economy. Germany is promoting efforts to increase corporate social responsibility, whereby companies are encouraged to act in a socially responsible manner and to ensure that international core labour standards are adhered to.

7. Shaping the economy based on ecological concerns: Economic development must not be allowed to take place at the expense of the environment; it must be directed towards preserving the natural resource base. Governments must create economic incentives to preserve the environment through forward-looking policies and ensure that international standards are observed. Appropriate measures have to be taken to ensure the future viability of local and global eco-systems. This implies protection and sustainable use of vital natural resources by means of resource-efficient production methods. Eco-efficient economic activity and the use of renewable energies are more than just an increasingly important competitive advantage. They are a prerequisite for sustainable value added and thus also for an economy that is fit for the future.

8. Ensuring equal opportunities: Economic development must serve poverty reduction and should not exclude anyone. The state should ensure equal opportunities for all and improve the distributive impact of market processes for the benefit of poor and disadvantaged population groups; to achieve this, the tax structure should also take into account people's differing levels of disposable income. Equal opportunities also means empowering previously disadvantaged groups and particularly capable groups – especially women – groups whose potential has so far not been used adequately in the economic process. A well developed school and education system is vitally important here. In addition, solidarity should also be practised in the case of risks that are too much for the individual to cope with (e.g. illness, old age and handicap), following the principle of social protection. The cycle of poverty must be broken.

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