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*The world looks
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Note from the Editors

The mission of the University of Victoria's Bachelor of Commerce program is to give students the essential knowledge and skills they need to be a business leader in the global economy and ensure that our students are given opportunities to support and develop research. At the Peter B. Gustavson School of Business, we also believe that international experience is a necessity in taking the lead in today's interdependent and intercultural world market.

Our international exchange program is the largest in Canada with 75 active partnerships at universities in 36 countries. In the 2010-11 academic year, 158 BCom students (85%) participated in an international exchange. During their time away from UVic, students develop an international management perspective through direct experience with issues in their host country's economy and organizations. Some of these students then enrol in International Business Research (COM 470), a course designed to broaden their knowledge and enhance their research and writing skills by analyzing a business issue relating to their exchange destination. Or, they can focus on a specific aspect that pertains to a particular private, public or not-for-profit organization.

Beginning with the 2007 cohort, we started choosing the top articles to showcase in a published compilation of Best Business Research Papers. The topics range widely from an analysis on diversification of marketing to a focus on identifying ways in which a globally prominent city is leading in environmental sustainability. What the papers have in common, however, is the capacity for interesting and thoughtful research from the best in their class.

While Volume 4 honours a small group of students, there are many people behind the scenes that allow this rather complex international exchange operation to function, including the International Programs team of Dr. A.R. Elangovan, Director; Brian Leacock, Associate Director; Jane Collins, Exchange Programs Coordinator; Ann Peng, Student Advisor; Shawna Hooton, Outgoing Student Advisor; Jennifer Oakes, Academic Advisor and Donna Davis, Programs Clerk. Thanks also go to Shannon Perdigao, Academic Projects Officer, for coordinating and compiling this volume for publication.



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No Invitations: The Difficulties of Climbing the French Managerial Hierarchy

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ABSTRACT

The French model of managerial career development relies heavily on, not surprisingly, their elite educational system. What distinguishes France from other countries is that in order to rise to the upper echelon of management in an organization, graduation from one of the *grandes écoles* is imperative. *Grandes écoles* are universities that fit a specific set of criteria difficult to achieve, and that are primarily reserved for the lineage of families that have already established their status and wealth in French society. This paper analyzes the current state of the French hierarchical structure as it relates to government and management, and the challenges it poses to managers in the international business environment. While the success of companies like Michelin, L’Oreal, and Carrefour have proven that this system reliably produces high quality executives, it presents significant challenges for members of the international business community hoping to do business with French firms or work within a French company. Through the lens of Hofstede’s cultural framework it was found that the Power Distance, Individualism, and Uncertainty Avoidance cultural dimensions support a hierarchical structure that distributes power at the top and rigidly opposes change from the outside and a strong sentiment that differences can be dangerous. The institution of the *grandes écoles*, coupled with Hofstede’s cultural dimensions, creates a business environment that is not only difficult to navigate but makes it very difficult for non-*grandes écoles* executives to advance to higher positions.

INTRODUCTION

Leaders in both the public and private sectors in France are the product of a long-established network of the highly educated and mostly Caucasian male elite. This is largely due to a strong, self-sustaining union of government, management, and education. The impact that this state of affairs has on the system of hierarchy governing these institutions significantly affects global relationships between corporations both foreign and domestic to France. This research paper will analyze how the current state of the French hierarchical structure as it relates to government and management came to be, and will outline the challenges that it poses to managers in the international business environment.

1. THE EVOLUTION OF FRENCH ORGANIZATIONAL HIERARCHY REGIME

The hierarchical structure in the French private and public sectors is not far-removed from the French military hierarchical regime. The word “cadre,” which denotes members of the ruling class, professional elite, was originally used by the armed forces to designate commissioned and non-commissioned officers (Barsoux and Lawrence, 2009). The word itself became rooted in French institutions and organizations predominantly in the 1950s, where it began to form the meaning that it holds today. The cadre group is not officially recognized, but represents an entrenched social division and is unique to France in that it encompasses people of different social upbringing, qualifications, income, vocation, and opinion (Boltanski, 1984).

Though there is no direct translation, the word *cadre* used in the private sector can analogously be taken to mean “manager”. To obtain *cadre* status, one must receive education from one of the select few universities in France known as the *grandes écoles*, or prove their loyalty over several years with a single employer, the latter of the two being significantly more difficult to achieve, even for those brought up in the French educational system. Though companies may not use the same criteria to grant *cadre* status, “membership alone tacitly binds those inside,” publicly validates their ability to think systematically and logically, and effectively distinguishes them from other members of the organization (Barsoux and Lawrence, 2009).

The result is a managerial model that views the organization as a distribution of authority. This contrasts with the North American approach, which tends to focus more on the distribution of roles within the organization. While the French *cadre* system reinforces a vertical distribution of personnel with its separation of upper management from the “collective of persons to be managed,” the North American system is seen as a functional hierarchy of tasks, with individuals taking on the tasks that best suit their competencies (Amado, Faucheux and Laurent, 1985).

Neither methodology necessarily achieves greater returns, but rather each managerial model serves as a different approach of reaching the same goal. However, challenges are sure to arise when these models collide with one another, as is the case with mergers, acquisitions, and foreign hiring between North American and French companies.

2. THE BIAS FOR *GRANDES ÉCOLES*

The intelligence of individuals in the upper echelon of French management is not under scrutiny, however Barsoux and Lawrence (2009) argue that it may not be the primary method of assessment factoring into the recruitment of top management in French companies. Corporate recruiters often favor *grandes école* graduates over those from ‘ordinary’ universities because these graduates have successfully progressed through rigorous admission procedures that focus heavily on mathematics. Carol Crates, a professor at the School of Knowledge Economy and Management (SKEMA) has taught at several schools in France believes that while a few consider *grandes écoles* like SKEMA and others as ‘ordinary’ universities, in her experience, *grandes écoles* are much better organized and students seem to take their work more seriously, resulting in higher performance. Crates also admits that the entrance requirements to the *grandes écoles* are prohibitively expensive despite the availability of scholarships, and that the entrance exams themselves can be quite costly (Crates, 2011).

However, once admitted to a *grandes école*, one is recognized as having the ability to think critically and in the abstract, qualities that are paramount to becoming a *cadre*. It is believed that individuals with these qualities will have no trouble developing a specific expertise through work experience in the company that hires them (Barsoux and Lawrence, 2009).

Graduates of schools other than the *grandes écoles* who demonstrate excellence in their field of study have a difficult time rising through the ranks of management. While problems like this are publicly recognized by both private and public officials, there does not seem to be a movement in place to correct it. As Barsoux and Lawrence (2009) contend, politicians, civil servants, industrialists, and others with the power to push such an agenda have no desire to do so, as they “are themselves products of the system” and the concession that problems exist is of little importance to these people. Furthermore, while an opposition exists outside of the system, the allure of it is felt by all, considering the social status that the alumni maintain. This sentiment is endorsed by Pascal Eyt-Dessus, an executive at L’Air Liquide

who states that “Ninety percent of the population want to abolish the École Polytechnique, but they also want their sons to go there” (Barsoux and Lawrence, 2009).

In addition to these non-*grandes écoles* graduates, graduates with foreign credentials also run into challenges when operating within the French system. As this system recruits and promotes from within, employees with foreign credentials may not get the visibility they need in order to be successful.

3. THE PUBLIC-PRIVATE SECTOR RELATIONSHIP

After graduating from the *grandes écoles* and upon entering the professional life, students are granted near immediate cadre status. A *grandes écoles* degree is recognized by all and is an immediate invitation into the elite network of alumni in the public and private sectors (Crates, 2011). The transition has become so automated that one Renault cadre remarked, “Soon they will be naming them cadre upon admission to the *grandes écoles*” (Barsoux and Lawrence, 2009). Indeed, in some schools this is effectively what happens. At the École nationale d’administration (ENA), a *grandes écoles* that has groomed members of the ruling class elite for decades, students are considered government employees and receive a state-backed salary during their enrollment (Carreyrou, 2006). The environment within the schools remains competitive however, as the most desirable positions in government are reserved for the top graduating percentile.

4. TRANSITIONING BETWEEN THE PUBLIC AND PRIVATE SECTORS

In North America, political motivations and government decisions tend to be motivated by the corporate world, where a corps of individuals and businesses rally for a particular political party and are rewarded along with that party’s success. This political machine does not exist in France, where the “upper bureaucracy doesn’t shift with the moods of the electorate but is permanently controlled by the *grandes écoles* of ENA graduates” (Fraser, 1994). These senior bureaucrats seem to be equally active in government and business due to a process referred to as *le pantouflage*, or revolving doors, where the transition between the public and private sectors is made incredibly easy by the strong network of *grandes écoles* graduates in both arenas. The end-result is a small percentage of the population having dominion over administrative and commercial power (Charle, 1987).

5. HOFSTEDE’S CULTURAL DIMENSIONS

To understand how these factors affect foreign managers and employees in France, it is useful to include Geert Hofstede’s (1980) study of cultural dimensions in this analysis. Hofstede (1980) carried out a comparative study of the relationship between national and organizational cultures in forty different countries. His findings led him to believe that there are four dimensions of culture that affect the behavior of individuals, societies, and organizations, and that these dimensions remain stable over time. The four cultural dimensions that Hofstede identified were Power Distance, Individualism, Masculinity, and Uncertainty Avoidance. Further studies utilizing different research instruments have led Hofstede to incorporate a fifth dimension of Long-term Orientation into his framework (Hofstede and Bond, 1984). Although there are many differences in culture within a nation and individuals vary widely around the norm, Hofstede (2003) argues that cultural dimensions are relevant because they are constant despite these internal fluctuations. A brief discussion of four of the dimensions which are pertinent to our study follows.

5.1 POWER DISTANCE

Of particular importance to this discussion is the Power Distance dimension. The Power Distance Index is a measure of the degree to which individuals in a country's society are equal. This has a dramatic effect on the state of hierarchy within a country and its organizations. According to Hofstede (2003) "a country with a High Power Distance ranking, such as France, indicates that inequalities of Power and Wealth have been allowed to grow within a society". He posits further that it is more likely that a caste system will have formed in these societies, which would prohibit "significant upward mobility of its citizens" (ibid). In France, this high power distance is reinforced by the corporate and government recruitment of *grandes écoles* graduates, and perpetuated by the elite network of bureaucrats and executives it creates. The consequences of a High Power Distance rating results in a high level of polarization between upper and mid-level management, which causes mid-level managers to feel dissatisfied with the level of control they have over relevant work decisions, their level of pay, the ambiguity of their role, and ultimately their career (Hofstede, 2003).

5.2 INDIVIDUALISM

Another important cultural dimension in the analysis of organizational behavior in France is Individualism. Individualism focuses on whether a society emphasizes the importance of individual or collective achievements and interpersonal relationships. With a High Individualism rating, France places the individual above the collective, and individuals within an organization are less likely to take responsibility for other members of the group (ITIM, 2003). This disposition can be observed at the most basic level within the organization, where there is "less asking for the collective sharing of good practice learning" than in countries with a lower Individualism ratings (Keup, 2011). High Individualism coupled with a High Power Distance Index often leads to the mentality that the underdog is to blame (Hofstede, 2003), despite the fact that in a typical hierarchical French organization it is not uncommon for executives to get involved in the most minute detail (Barsoux and Lawrence, 2009). This disconnect created by the paternalistic relationship between upper and middle management could lead to significant resentment on the part of middle managers.

Indeed, in the case of France, Hofstede (2003) found that "there was an extreme diversity of feelings toward superiors" and that "they may be either adored or despised with equal intensity". This could be particularly taxing on North American managers working in France, who by comparison are accustomed to a Low Power Distance rating and a High Individualism rating. Although both societies can be characterized as placing the individual above the collective, the Low Power Distance rating in Canada and the United States means that these workers may have trouble adapting to an environment where it is not uncommon for a superior to oversee and control the most minute detail of their work, and yet still place blame on that worker if something were to go wrong (Barsoux and Lawrence, 2009).

5.3 UNCERTAINTY AVOIDANCE

The next cultural dimension that has a significant correlation with this analysis is Uncertainty Avoidance. The Uncertainty Avoidance Index is a measure of the level of tolerance a society has for uncertainty and ambiguity. A country with a High Uncertainty Avoidance rating has a low tolerance for unstructured situations, whereas a country with a Low Uncertainty Avoidance rating is less concerned with uncertainty and ambiguity and is more tolerant of a variety of opinions (ITIM, 2003). France exhibits a High Uncertainty Avoidance rating in the bureaucratic nature of its public and private sectors, where laws, rules, and regulations form rigid organizational structures and the opinions of subordinates are considered less valuable than those of their superiors. According to Hofstede (2003), countries with a High Uncertainty Avoidance rating are more likely to only take known risks, often consider things that

are different from their norms to be dangerous, and even demonstrate a higher degree of xenophobic behavior.

5.4 MASCULINITY

According to Hofstede, in a country with a Masculinity rating as low as France, gender roles should be relatively more fluid than in a country with a High Masculinity rating. The result is a society that emphasizes the importance of gender equality and egalitarianism in general. Studies have found that women represent forty-seven percent of the French working population, supporting Hofstede's assumptions. However, only seventeen percent of women in the working population are in executive positions, and on average those women make thirty-two percent less than their male counterparts (Evans, 2010).

In 2010, David Evans underwent an analysis of the current state of women in leadership roles in North America and Europe, the trends of their role over the past twenty years, and then compared those findings with France to determine whether or not the country is in line with the general trends. He found that France was by no means a "cultural exception" to the emergence of women in the business community over the past twenty years, but that there were peculiarities: particularly, the discrepancy between the number of women receiving their high school diploma (in 2007 eighty-four percent of women graduated with their high school diploma, an increase from 2006) and the paucity of women executives in the upper echelon of the business community in France (Evans, 2010).

This discrepancy can be traced back to the *grandes écoles* system, where many of the highly respected schools have maintained a strong male admittance rate despite distancing themselves from their military traditions. In fact, some *grandes écoles* have only begun admitting women in the last twenty years and, according to Brasseur and Lawrence (2009) female access remains limited (2009).

A survey carried out by IPSOS in 2008 of over one thousand individuals from various social demographics also found that seventy-nine percent of them wanted to see changes in management practices, with the "reinforcing [of] the role of women leadership in corporate governance" being one of the most cited reasons behind it (Evans, 2010). This lends itself to the idea that, although women in general are advancing in the French workplace, there is still an invisible ceiling for both French and foreign businesswomen. By interviewing several female executives, Evans (2010) found that many women are "relegated to human resource management and communication departments" rather than achieving board level and that "male nepotism and co-opting" factor into the challenges that women, both foreign and domestic, will have to overcome while climbing the managerial hierarchy.

In her experience, Keep (2011) however, did not observe any overt gender discrimination that would impede her working with French companies. It is important to note then, that it is not impossible for women to achieve success in the French business hierarchy, but that it may require them to "make greater efforts, be more self-confident, and have more tenacity" than their male counterparts to reach the equivalent levels (Evans, 2010).

Thus far this discussion has revolved around the challenges that managers will face when doing business with French companies or within France, but it has not distinguished between the sex or ethnicity of those managers. By examining the current state of the *grandees écoles* and their elite graduates in the public and private sectors with respect to gender and ethnic equality, we can see that there may be additional challenges that members of those minorities must overcome to rise through the managerial system.

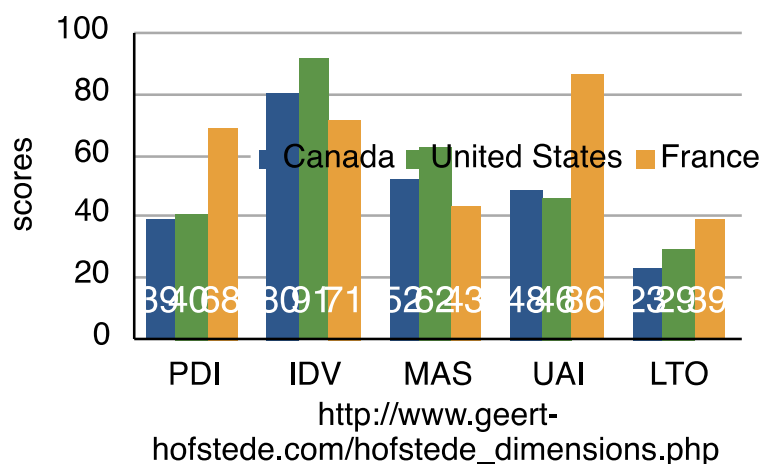
Another factor that may increase the complexity encountered by outsiders when working in France is that of race and ethnicity. In Canada and the United States, citizens are recognized and labeled according to their race and ethnicity. France, on the other hand, officially considers all of its citizens to be French and rejects these concepts entirely. This is due, in part, to Article 1 of the French Constitution, which ensures the “equality of all citizens before the law, without distinction of origin, race, or religion” (Meier and Hawes, 2009). France also strictly forbids the collection of ethnic data and affirmative action based on ethnic or racial distinctions. While the intention behind these laws may be noble, there are consequences that negatively affect equality in France. Meier and Hawes (2009) argue that, “because France as a nation rejects the ideas of race and ethnicity, it also failed to recognize any possible benefits that might accrue from a representative bureaucracy”. Studies in the United States have demonstrated that race is an important determinant of identity, attitudes and behavior. It not unreasonable to assume then, that race and ethnicity have similar effects within the French population. With no structure in place to balance the individuals whose actions are affected by race and ethnicity with equality in the workplace, there is no definitive way of ensuring egalitarianism.

The *grandes écoles* do not help matters with their recruitment process limited in many respects to the sons and grandsons of their alumni. Moreover, this elite selection process is biased in favor of “upper-middle class, male Parisians” and ultimately generates a homogenous group that “may not contain enough racial variation for representative bureaucracy to flourish, particularly at the highest levels” (Meier and Hawes, 2009). Foreign managers in a racial or ethnic minority will face similar challenges to these on top of those already discussed.

6. IMPLICATIONS

Together, the Power Distance, Individualism, Uncertainty Avoidance and Masculinity cultural dimensions create several unique challenges that foreign nationals must overcome if they are to successfully do business in France. Figure 1 below illustrates the comparison of Hofstede’s cultural dimensions between North America (Canada and the United States) and France. The greatest differences can be seen when comparing the PDI and UAI of Canada and the United States, which are virtually identical, to that of France. Not surprisingly then, it is also these cultural dimensions that create the greatest challenges for North American expatriates when doing business in France.

Figure 1: The 5D Model of Geert Hofstede



The Individualism rating presents somewhat of a different challenge. In Hofstede's analysis, he found that in the vast majority of countries there was a negative correlation between the Individualism and both the Power Distance Index and Uncertainty Avoidance Index. This relationship is demonstrated by the United States and Canada in Figure 1. France, on the other hand, is one of the few countries that exhibits a positive correlation between these three cultural dimensions, with individuals that "have a need for strict authority of hierarchical superiors, but at the same time ... stress their personal independence from any collectivity: They are dependent individualists" (Hofstede, 2003). The result is a bureaucratic system that is very different from institutions in North America.

The extent to which the *grandes écoles* in France create a tight network of elite bureaucrats and executives has a profound impact on the way business is done in France for both national and foreign managers. Using Hofstede's framework of cultural dimensions we have seen that there is a huge differential in the Power Distance Index between North America and France. This presents several challenges to international business people who do business with or within French companies.

As a foreign business manager, one challenge that must be overcome is the difficulty of connecting and doing business with those in the top tier of the organizational hierarchy. Mady Keup, a member of British Tourism Association with work experience in six different European countries including France, believes that the French organizational hierarchy made it more difficult for her as an outsider when she was working as a destination marketing consultant. She posited that,

"as a consultant you need to talk to the right people and, without showing any disrespect to the people that are a bit further down, you need to identify those who might be more influential in helping you get information and making sure that your requests are being processed. It's very much about where they're positioned within the company, and how close they are to the highest echelon" (Keup, 2011)

In her experience, the challenge was often about determining how a particular process should proceed and who needs to be contacted for the process to move forward. This is a reflection of France's High Uncertainty Avoidance Index. Figure 1 illustrates that both Canada and the United States have a low Uncertainty Avoidance Index, while France is ranked much higher. Hofstede argues that a High Uncertainty Avoidance rating is characterized by the need for detailed and strict guidelines. Individuals "like situations in which there is one correct answer they can find ... and they expect to be rewarded for accuracy" (Hofstede, 2003).

For foreign business people, this makes it even more difficult to navigate within the French bureaucracy. Keup found that in France more than anywhere else, "you will always get an answer to a question, you just need to know what are the right questions to ask and you may need to go a bit deeper" than you would have to in countries with a lower Uncertainty Avoidance Index. She goes on to state that in other countries, "the discussion starts after a question is asked, and in France (when) the question is answered you (may) have to ask another question" (Keup, 2011).

Furthermore, even if the right questions are asked and the right people are found, the degree to which a foreigner can do business with upper-management successfully comes into question. The tight network of elite individuals, both in commerce and government, is restricted to *grandes écoles* graduates. Utilizing this network would prove incredibly difficult without the backing of a major corporation or an ivy-league education, as priority is given to those operating within the network to maintain strong connections both government and state (Barsoux and Lawrence, 2009).

Another obstacle that may present itself to expatriates working for French companies is the difficulty of being promoted within the organization. If the High Power Distance Index in France makes it more difficult for French citizens that have not graduated from the *grandes écoles* to move through the ranks of management, then it will be just as, if not more challenging for foreign employees that were not educated in the French system to do so. The Uncertainty Avoidance Index also comes into play where a foreign education may not be as well recognized in France as it would be in a country with a Low Uncertainty Avoidance rating due to the sentiment that, “what is different is dangerous” (Hofstede, 2003).

This attitude has an effect on the how the French managerial model operates in the new global environment. The foreign nature of doing business abroad may prevent many French *grandes écoles* graduates from leaving the country. As L’Air Liquide’s Pascal Eyt-Dessus speculated, “*grandes écoles* graduates have resisted moving outside of France because their credentials abroad would not elicit automatic admiration, and they would have to consort with those considered intellectual inferiors” (Barsoux and Lawrence, 2009). If this is in fact the case, then foreigners working within a French organization would likely find it prohibitively difficult to rise into the ranks of upper-management due to the inverse of this sentiment: that their *grandes écoles* education may not be recognized as highly by foreigners.

CONCLUSION

The cultural challenges and obstacles that the international business community must face when engaging in business in France arise from an educational system that succeeds at producing a small number of intellectuals for work in the public and private sectors, but that consequently creates barriers for those who are not bred to join their ruling elite. We have seen that graduation from the *grandes écoles* educational system is entrenched as the primary recruitment method of France’s upper echelon of bureaucrats and executives. This makes it incredibly difficult for managers from France and abroad, who have not been educated in these elite schools, to climb the managerial hierarchy, particularly when it comes to becoming executives themselves.

Furthermore, utilizing Hofstede’s framework of cultural dimensions we can see that France’s unique blend of a High Power Distance rating, High Individualism rating, and High Uncertainty Avoidance rating present foreign managers with other challenges. As a foreign manager doing business with a French company, one must learn who in the managerial hierarchy will be able to help to achieve their goals. This can prove to be difficult in France for several reasons. For one, France has a High Power Distance Index, which suggests that many organizations will be structured vertically with ultimate power distributed at the top. Without offending those lower in the hierarchy, managers must identify who it is that is influential with respect to the nature of their end goal. It is also important to recognize that this approach may require more time and attention than it would in countries with a lower Uncertainty Avoidance Index than France, where more questions may be needed to navigate through the organization as an outsider. In addition to this, even if you make contact with someone influential in a French organization, it may be difficult to leverage their position without being part of the cadre network.

Working within a French organization introduces a different set of challenges. The difficulties that French graduates of ‘ordinary’ universities face as a result of the High Power Distance rating when climbing the managerial ladder will also be present for expatriates. Foreigners working in a French firm will have the added challenge of overcoming issues that arise from France’s High Uncertainty Avoidance rating, such as proving the worth of their foreign education. Gender, racial, and ethnic discrimination also play a role in the hiring and promoting of managers. While France’s Low Masculinity rating suggests that it is a society that promotes egalitarianism as a whole, there are discrepancies related to the lack of

women and members of racial and ethnic minorities graduating from the *grandes écoles* and its direct relationship to the hiring and promoting of individuals into the upper echelon of executive management.

These issues all stem from the entrenchment of the *grandes écoles* as an institution for the recruitment of a powerful elite in French culture, and should be factored into the decision making process of members of the international business community hoping to do business with French firms or from within France.

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Mondragon Cooperative Corporation: Harnessing the Potential of a Human-Based Approach to Business through a Co-Operative Model in the Basque Region of Spain

Andrea Di Lucca
Fall 2010

ABSTRACT

In a world full of conflict, uncertainty, and struggle, the business community is searching for alternative models to address the needs of society and remedy the damage inflicted by irresponsible corporate activity. Offering a source of hope, the co-operative model is resurging as a traditional form of business with great potential for fulfilling these needs. The Mondragon Co-operative Corporation (MCC) is located in Spain's Basque region and is regarded as a world-class example of the co-operative model, with a human-based approach as its defining characteristic. This paper utilizes a three-tiered framework, focusing on co-operation, democracy, and community, to analyze the human-based business approach of the MCC. This exploration is expanded by a SWOT (*Strengths, Weaknesses, Opportunities, Threats*) analysis, through which the impacts of internal and external factors on sustaining the future of the approach in a globalizing world are analyzed. From the factors identified in the SWOT analysis, observations are made on the implications, benefits, and shortcomings of a human-based co-operative approach, including strategic planning recommendations for sustaining the model and optimizing its application and value. Through the SWOT analysis, the Mondragon example highlights the value of alternative business models, and provides guidelines for embracing the potential of co-operation into the future. Managers across the globe can optimize the adoption of components of the Mondragon model and make significant strides towards addressing today's complex business environment through the re-humanizing of both their perspective and practice.

INTRODUCTION

Hand in hand, of one mind, renewed, united in work through work, in our small land we shall create a more human environment for everyone and we shall improve this land. We shall include villages and towns in our new equality; the people and everything else: Ever forward. Nobody shall be slave or master of anyone, everyone shall simply work for the benefit of everyone else, and we shall have to behave differently in the way we work. This shall be our human and progressive union - a union which can be created by the people.

Don José María Arizmendiarieta (cited in CCCBE, 2007)

Throughout history, business models have experienced transformations and adaptations to respond to pressures and maintain alignment with the social, political, and economic contexts of the age. With these structural and theoretical changes in the business world, lessons have been learned and great accomplishments achieved. Notably, the capitalist and profit-oriented approach has gained significant power in the modern world and defined the pattern of development in a business, market, and societal sense. As the interconnectivity and pace of society has continued to heighten in recent decades, changes are occurring at previously unimaginable frequencies and continuous transformation is now a requirement for survival.

In this environment of constant change and conflicting ideas, a return to more traditional concepts of organizing society is beginning to emerge. As if closing the loop of society's process of transformation, innovative and brave individuals are taking a leap and promoting traditional frameworks of the past in an attempt to remedy the damage that modern day trends have inflicted on the world. A prime example of this circular trend is the resurgence of the co-operative model as a source of hope for the future, a model that nurtures and harnesses the potential that is found within the delicate relationship between business and society.

1. CO-OPERATIVE MODEL

The origins of the co-operative model are linked to the concept of "co-operation" itself, which dates back as far as human beings have been organizing for mutual benefit (Wikipedia, 2010). Tribes were organized as co-operative structures and throughout the ages people in many parts of the world developed a wide array of co-operatives to meet a variety of economic and social needs (CCCBE; Wikipedia, 2010). Post-industrial Europe is home to the first co-operatives in an industrial context. In particular, the Rochdale Pioneers are regarded as the model of the modern co-operative enterprise and the founders of the co-operative movement. Today, the principles that lay the foundation for the Rochdale Pioneers' business are still accepted as the basis upon which all co-operatives operate (ICA, 2005; CCCBE).

According to the International Co-operative Alliance, a co-operative is defined as:

"...an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise" (ICA, 2010).

At the heart of the co-operative movement, democracy, values, and a balancing of business, member, and community interests resides. Co-operatives are important primarily because they are a way in which people can more fully achieve their potential as human beings (CCCBE). Ultimately, the co-operative movement has proven to be a significant economic and social actor that has had positive effects on national economies and the wellbeing of their populations (ICA, 2010).

Today, as unemployment surges, job security is influenced by demanding market pressures, and the struggle for personal success overpowers in the corporate world, innovative thinkers are venturing out to find answers to the dilemmas, problems, and catastrophes created by 20th and 21st century corporate models. As demonstrated through various cases throughout the world, the application of the co-operative model, or elements of it, in modern day business can serve as an answer to the increasing pressures and challenges faced today, such as unemployment, worker exploitation, and societal degradation (CCCBE). Essentially, "[c]o-operativism is set within the need for alternative, diverse, creative responses that the current socio-economic situation needs" (Sarasua, 2008: 4). The co-operative model, above all, provides a mechanism to remedy the fear, limited perspective, and lack of social responsibility that has defined corporate activities and can be used as a means to empower workers to drive change through collective efforts.

2. SPAIN AND THE MONDRAGON CO-OPERATIVE EXPERIENCE

In the context of Spain, the co-operative movement has played a significant role in the economic and social history of certain regions. One prominent example is that of the Basque region, nestled in the northeastern corner of Spain. The Basque Country is home to a proud people, vibrant culture, and rich history of industrial activity and hard work (Sarasua, 2008; Irizar, 2010). Losing against Franco in the Spanish Civil War in 1939, the Basques experienced great despair and were left to make the most of all that they had left: the hope in the strength of their values and the wealth of their human resources (MacLeod, 1997). With this, the Basque people dedicated themselves to working for the common good of their society and relied, above all, on the good to be found in all people (MacLeod, 1997). The collective of Basque cooperative enterprises, eventually known as the Mondragon Co-operative Corporation (MCC), emerged in this environment of recovery from the economic and social crisis caused by the Spanish Civil War (CCCBE, 2007) and was set against the backdrop of a changing world.

Over the years, this unique co-operative model has grown into a significant economic player regionally, nationally, and on a global scale. Today, Mondragon is considered a world-class example of the potential of the co-operative model for enterprises of the 21st century (Sarasua, 2008) and is viewed as one of the largest and most successful examples of worker co-operation (CCCBE, 2007), the leading Basque business group, and the seventh largest in Spain (Mondragon Corporation, *Who we are*).

3. DEFINING CHARACTERISTICS OF MONDRAGON

Upon visiting the Mondragon Co-operative Corporation, it becomes clear that the single thread connecting all aspects of this collective of co-operative enterprises is the concept of humanity: the humanity of the workers, the human nature of the relationships within the organizational body, and the human connection to the communities in which the cooperatives are present. This observation is supported and clearly articulated through the corporation's slogan: "Humanity at work", which is the guiding vision and motto by which the organization lives, representing the social identity of the co-operative model in a single phrase (Diariovasco.com, 4 Jan 2008, Economía).

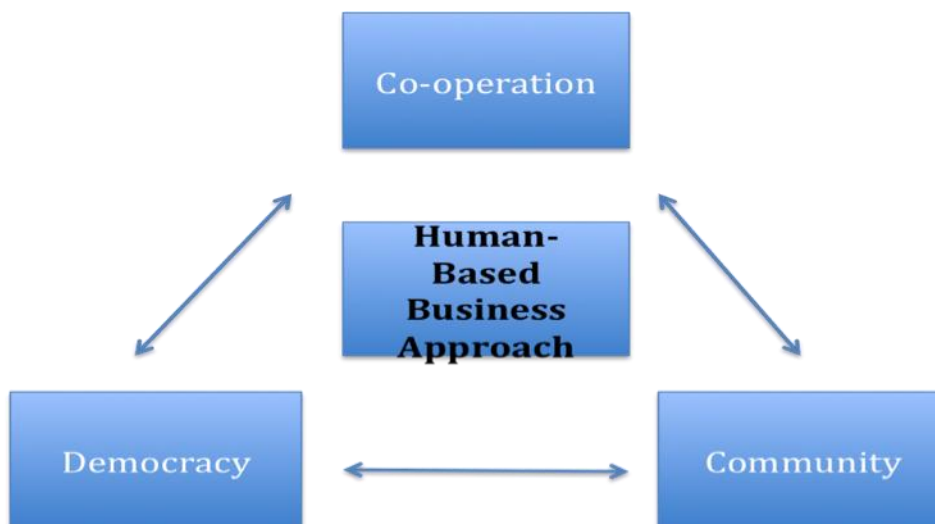
The extant research on Mondragon in the last half-century has focused significantly on a vast assortment of components of the Mondragon experience - from organizational structure, to human resource management, to economic viability and competitiveness, naming a few (Molina, 2008). However the literature has not closely analyzed the fundamental essence of the Mondragon experience and the overriding characteristics that differentiate it from other co-operative models. It is Mondragon's recognition of humanity in its structures, activities, and aspirations that can define the soul of this co-operative corporation and set it apart as the leader and example it has become today.

4. THE THREE PILLARS OF MONDRAGON'S HUMAN-BASED APPROACH: AN ANSWER FOR THE FUTURE?

Mondragon's human-based approach to business is characterized by three pillars: co-operation, democracy, and community (see Figure 1 below). Utilizing these pillars as an analytical framework, an exploration into the depth of the organization can be conducted to further examine the elements comprising the Mondragon business model. This exploration is expanded through a SWOT (*Strengths, Weaknesses, Opportunities, Threats*) analysis. Under the SWOT framework the external and internal factors and their impacts on sustaining the future of the human-based co-operative approach are analyzed. From the factors identified in the SWOT analysis of the three Mondragon pillars, observations can be brought forth to demonstrate the implications of a human-based co-operative model, the

benefits and shortcomings of such an approach, and the strategic planning necessary for assuring achievement of its objectives and overall success. Ultimately, the analysis shaped by the three-tiered framework and SWOT analysis will provide a basis from which to address the future of this business approach and identify areas for development that will influence both its application and value.

Figure 1: Three Pillars of Mondragon’s Human-Based Approach



With careful consideration of these findings, managers across the globe might be able to optimize the adoption of components of the Mondragon model and make significant strides towards addressing today’s complex business environment through the re-humanizing of both their perspective and practice in the corporate world. What follows is a discussion of elements of the three tiered framework of human-based business approach.

4.1 CO-OPERATION

The potential of co-operation and a co-operative approach to business holds significant relevance for the future of business and its relationship to society. According to Jon Sarasua (2008), Mondragon scholar and co-founder of the LANKI co-operative studies institute, the co-operative approach is very much in line with the efforts to realign a global focus on human dignity and make way for the humanization process that is required to address the current inhumanity defining the socio-economic condition of the world.

Co-operation as a model for business and society is being recognized as “...an idea for the future...accompanied by important elements of human dignity” (Sarasua, 2008: 4). Sarasua (2008) also illustrates that the co-operative model itself has the potential to contribute towards the socio-economic understanding of humanity by creating interconnection between the individual and community, harmonizing interests, creating development, connecting to the deep-rootedness of a human geography, and fostering commitments to employment, participation, society, global solidarity, and inter-cooperation.

4.1.1 Co-operative Culture

The significance of Mondragon's co-operative culture in the cultivation of its human-based business approach dates back to the founding years of the co-operative experiment. The co-operative culture has served to support and nurture the focus on humanity that has characterized Mondragon's growth and evolution, ensuring that the founding principles and values are carried into the future.

The flexible nature of the co-operative culture has contributed towards the survival of the human-based approach throughout the decades, as the evolution of the culture has been influenced by societal changes. In his reflection on the co-operative experience of Mondragon, Jose Maria Ormaechea (part of the original Mondragon core group) comments that in fifty years, the Mondragon world has gone through very different phases. From Franco's dictatorship, to a democracy, to today's globalized world, the original idea behind the Mondragon movement has been molded and modified by its environment. Without that ability to evolve and adapt its culture and approach to co-operation, the original Mondragon experience of the 1950s would have disappeared (Ormaechea, 2003).

The history of the Basque society has been characterized by a tradition of various economic activities within the realm of co-operation (Molina, 2008), impacting the development of the Mondragon experience. For example, the term "Hauzo Lan" in the Basque language refers to the carrying out of neighbourhood or community tasks, which were often linked to agricultural work. Some of these community activities developed into official institutions and played important roles in the Basque economy. In the Industrial Revolution, new co-operative activities emerged, including the rise of consumer co-operatives and industrial production co-operatives (Mondragon Corporation, *Historic Background*), which eventually formed the backbone of the Mondragon co-operative experience.

The process of laying ground for these co-operatives and inspiring the Mondragon co-operative experience is directly attributed to the arrival of the young priest José María Arizmendiarieta to the town of Mondragon in 1941. Regarded for his pragmatic and hard-working nature, Arizmendiarieta was the driving force behind the Mondragon co-operatives, as he set out "...to try out a local experience that would work by developing human dignity, by combining freedom and equality through ties of solidarity and by conferring sovereignty on labour" (Sarasua, 2008: 7).

One researcher has noted that part of Mondragon's initial success comes from the founder's ability to allow for the assimilation of peasant principles, based on communitarian orientation in rural work, into the industrial sphere (Molina, 2008). The cultural sensitivity employed and the ability to embrace co-operative qualities already defining the local community demonstrates Arizmendiarieta's efforts to harness the existing human potential, allowing the model to flourish by fitting in "...with the cultural seal of a society and...generation" (Sarasua, 2008: 7).

The subsequent significant step in the development of Mondragon was the establishment of the ULGOR co-operative (now Fagor Electrodomésticos) in 1956 by five young students from the Polytechnic School, founded by Arizmendiarieta. 1956 is regarded as the founding year of what would one day be known as the Mondragon Co-operative Corporation. As was the case with the founding of ULGOR, it has been highlighted that part of Mondragon's unique nature stems from the fact that enterprises were founded with practically no initial investment and, thus, relied solely on the support of the locals to realize the creation of this new, human-based social order:

This is important in the context of Spain where individuals who started most new businesses had access to capital accumulated over several generations. By contrast, the founders of ULGOR

were working class people without great inherited wealth. Their only possibility of raising capital was to go to the people. The unusual result is that we now have a world class, high tech cooperative corporation depending upon the local community for capitalization. It is an international monument to the power of community moral support when it is expressed in the form of financial backing. (MacLeod, 1997: 21)

Throughout the first twenty years of the Mondragon experience, several new cooperatives emerged and support structures such as the Caja Laboral co-operative bank and the Ikerlan Centre for Technologic Research were created, which ultimately served to ensure the sustained livelihood of the co-operative system and its development through sound financial structures and a commitment to innovation. It was the connection between worker, work, and community that was fostered by the creation of these structures and that continued to define the human-based co-operative approach throughout the decades.

In the 1980s, the Mondragon Co-operative Corporation (MCC) was created as a solution to the obstacles stemming from the establishment of the European Economic Community and the general globalization of the economy. With the creation of the MCC, the co-operatives were no longer grouped according to their region but rather by their sectors and production activities (Mondragon Corporation, *Historic Background*). The establishment of the MCC also served to unite Mondragon worker co-operatives, promote the development of more co-operatives, and ensure worker-members were benefiting from co-operation (CCCBE, 2007). This significant development in the Mondragon co-operative experience clearly demonstrates the high degree of value that the group placed on maintaining a human-based approach. In order to compete in modern markets and succeed in a globalizing world, the group was able to re-structure their co-operative model in a way that allowed for competitive activity in the marketplace, while at the same time continuing to nurture the original values that defined the Mondragon experience.

The 1990s were marked by the establishment of the University of Mondragon. Created to help meet the needs of companies in the area, this development demonstrated a genuine concern for the wellbeing of the local community and the potential that lies within its human capital. Today, the MCC is comprised of over one hundred worker co-operatives, in addition to co-operative banking, housing, and social institutions (CCCBE, 2007) and is a significant player in the Basque and Spanish economies (Mondragon Corporation, *Historic Background*).

4.1.2 Solidarity

The concept of solidarity has an essential tie with the recognition of the quality of “humanness”: recognition of the connections that exist between human beings, of the responsibility that one has to foster these connections through relationships, and the potential that lies within collective efforts and community action. Solidarity has been a central component of the Mondragon approach to co-operation since the creation of the first co-operative, and has defined the development of the enterprises throughout the decades.

In his analysis of the Mondragon co-operative model, community economic development scholar Greg MacLeod (1997) states that while conflict is unavoidable when capital is the source of relationships, co-operative relations arise from a different source. MacLeod explains the three dogmas of co-operativism that flow from the concept of ‘person’ and ‘inter-personal relationships’ as: “1) solidarity, 2) priority of the person over the instruments, and 3) the principle of distribution of results” (1997: 82).

In the Mondragon context, solidarity exists on two levels: internally, between the workers in the co-operative corporation, and externally, between the corporation and society. Examples of solidarity are present throughout the structure of the MCC, functioning as an integrated unit of many parts that must generate synergies in order to succeed. With a strong commitment to co-operation and a culture of solidarity, Mondragon has embraced the potential of collaboration and found success in the strength that stems from nurturing the 'whole', rather than the many individual components that make up this collective of co-operatives, a testament to the truth that "...the capacity of the totality is greater than the capacity of the sum of the parts" (MacLeod, 1997: 89).

4.2 DEMOCRACY

The democratic nature of the MCC that has defined the organization since its inception has served the function of 'stabilizer' throughout the decades and is often regarded as the internal differentiating factor of the Mondragon enterprises (Sarasua, 2008). Mondragon scholar Jon Sarasua defines the basic tenet of the MCC co-operative experience as "...an experience in corporate democracy with a social commitment", with "...the sovereignty of individuals forming the bedrock of its organisations" (2008: 2). In his view,

[t]he basis of the co-operative approach goes beyond the very co-operative itself as a corporate formula...the basic idea is about setting up organizations based on the sovereignty of the individual: that the protagonists in any sphere...should be the sovereign agents who...should determine the directions to take when setting up democratically-based organizations (2008: 2).

In 1972, British economist Robert Oakeshott defined Mondragon as an "'oasis of democracy' within General Franco's dictatorship...inspired by a priest and a group of young businessmen 'engaged in an exciting attempt to reconcile modern industry with social justice and democracy'" (Cited in Molina, 2008: 284). What impressed Oakeshott were the principles of founder Arizmendiarieta, including "...his agenda of democratic corporate self-management" (Cited in Molina, 2008: 284).

In his article "Democracy, Cooperation and Business Success: The Case of Mondragon Corporación Cooperativa", Forcadell (2005) discusses how the MCC has made democracy and success compatible in a business organization. Forcadell (2005) highlights that the MCC is also one of the few modern organizations that can be regarded as a true democracy, largely due to its unique application of democratic and participatory methods in management. A publication by the Nova Scotia Co-operative Council (2001) also highlights how Mondragon's success story demonstrates that business management can be efficient within a democratic setting and that the co-operative model as a whole allows for the resolutions of many of the dilemmas of democracy, enabling motivation and efficiency to emerge.

Essentially, Mondragon's co-operative model can be understood as "...a school of democracy oriented towards the transformation of the broad democratic paradigm" (Sarasua, 2008: 5), whose manifestations of democracy are a testament to the concern and respect for the human quality of the organization and its people.

4.2.1 Management Model

One can see that the basis of Mondragon's organizational structure is the democratic nature of its management. The Mondragon reality exemplifies Cloke and Goldsmith's observation that democratic management fosters long term value creation and creates compatibility between economic, social, environmental, and individual objectives (Cloke and Goldsmith, cited in Forcadell, 2005). In fostering synergies and collaboration between these objectives, Mondragon is allowing the true human nature of

its people and its co-operatives to survive. In addressing economic, social, environmental, and individual concerns, the organization as a whole is nurtured.

The MCC Corporate Management Model (Figure 2) below was developed based on its co-operative principles, on modern management practices, and on the experiences of the world’s leading companies. The creation of this model was also focused around elements such as corporate culture, organizational structure, and human resources, with the ultimate goal of implementing a democratic and participatory management (Forcadell, 2005).



Figure 3 Source: Mondragon Corporation

the application of the Management Model (Mondragon Corporation, *Mondragon Corporate Management Model*). The Model recognizes the human-based view that economic results alone are not sufficient when it comes to judging management performance, ensuring that other indicators, such as customer satisfaction, environmental commitment, and people satisfaction, are included within the balance sheet (Forcadell, 2005).

Brought to life through the application of the Basic Co-operative Principles, the MCC values centre the corporation’s ultimate goal around the idea of human dignity. Jesus Larranga, one of the five original founders of ULGOR, accurately synthesizes this point as he quotes Arizmendiarieta:

There are some values that we have promoted too much: efficiency in work with no limits, viability, development, growth, but now is the time for us to put other values in their place and give primacy to friendship, conviviality, and communication. This is to see in the other person something that is above all material values. (cited in MacLeod, 1997: 88)

The Management Model is represented in the form of a circle, illustrating the interrelated nature of the various concepts and the dynamic approach that is required both for its implementation and continuous adaptation (Mondragon Corporation, *Mondragon Corporate Management Model*). The *Basic Co-operative Principles* (Figure 3) form the nucleus of the Management Model and provide the *People in Co-operation* with the necessary guidelines for implementing the MCC values. Together, these people making up the MCC build a *Joint Project* through the process of *Participative Organization*. This project is undertaken along with consideration for the business environment and co-operative format to, ultimately, become an *Excellent Company*. Ultimately, the measurement of *Socio-Entrepreneurial Results* is the fundamental objective of



Figure 2 Source: Mondragon Corporation

While the first set of values should not be disregarded, Arizmendiarrieta's aim (reflected in the Management Model) was to instill awareness that by focusing on the human quality of the business organization, valuable achievements beyond those of a purely economic nature can be realized.

4.2.2 Participation

In the co-operative model, participation is a key characteristic that is reflected in the structure of the business approach. The value of participation in democratic workplaces has been supported by a growing body of evidence that proves its key contribution to success in a rapidly changing world (Nova Scotia Co-operative Council, 2001). Sarasua comments:

Co-operativism has the potential to develop coherent and integral participation in the enterprise as it is one of the only corporate forms in which...the enterprise actually belongs to the workers legally; it is their sovereignty that supports it, and it can bring corporate participation and organizational participation together (2008: 6).

In a Mondragon context, the issue of participation has been at the forefront of management discussions over the years. While the Management Model formed by the MCC is a significant step in enhancing a structure for participation, it has also been noted that there is a potential for so much more – that "...the co-operative reality is bound to have within it sufficient elements in order to be more proactive in thinking, designing, experimenting and applying forms of participation with its own seal" (Sarasua, 2008: 12).

4.2.3 Self-management and sovereignty

A core objective of the Mondragon experience has been described as "...the development of a community basing itself...on the cooperating and self-managing capacity of the individual...[and] as a proposal that endeavours to provide a self-managed response to a range of social spheres" (Sarasua, 2008: 7-8). Because of the MCC's strong democratic base, the concept of self-management has gained great ground and contributed towards the enhancement of the organization's intrinsic connection to the humanity within its organizational walls.

At the base of the Mondragon pillar of democracy is the recognition that "[t]he democratic paradigm means organizing people's lives from the sovereignty of the individual" (Sarasua, 2008: 5). The clear commitment to considering the sovereignty of individuals has even been viewed as one of the main tenets of Mondragon's singularity (Sarasua, 2008). Generating significant synergies with the MCC human-based approach, individual sovereignty within the enterprises opens up a space for celebrating the value that each member contributes and supporting this contribution through organizational structures and democratic practices.

4.3 COMMUNITY

The characteristics of a community encompass what it is, essentially, to be human. In a healthy community, collaboration, cohesion, and interaction abound. The co-operative model is an attempt to create community in the corporate environment that, in today's world, seems to work against community principles. For example, the 'typical' 21st century corporation often thrives on conflict, generates fear to impede awareness, isolates individuals and their ties to the greater purpose of the organization, and creates internal discord through inequality, competition, and an overriding focus on personal success, as opposed to the celebration of collective accomplishments. All of these qualities work against community and create an environment where the concept of humanity is non-existent. As

a shining example of a human-based business, the MCC has used the co-operative model to empower its people and fully realize the potential of the power of a community.

4.3.1 Relationships

Relationships are what shape a community. The relationships fostered through the MCC co-operative model represent a focus on human nature that embraces connectivity between social and economic functions. The MCC has structured itself around the idea that together, the Basque community can make significant strides in addressing job creation, social issues, and improving their own livelihood. Without the community aspect and awareness of the reciprocal nature of relationships in this collective of co-operatives, the collaboration and cohesion that takes place would not survive into the long term, and the results and impact of the MCC efforts (both in an industrial and social sense) would not reach such great heights.

In his reflection on the community element of Mondragon and the value of relationships, MacLeod (1997) comments that “[t]he new corporation is a “community” and communal relationships are taken in the sense of a common will. This unity of wills, rather than a juridical act, is what unites” (pp. 82-83).

4.3.2 Social Commitment

Since its foundation, the MCC has exercised a commitment to the wellbeing of its workers on all fronts. This social commitment has often been identified as the external differentiating factor of the Mondragon experience (Sarasua, 2008). Over time, the MCC has even been referred to as a “social movement enterprise” (Molina, 2008: 298).

Social commitment is carried out in the MCC through the democratically elected social council in each co-operative. The primary purpose of this council is to counterbalance the economic concerns of the governing council and management team with a social vision (Cheney, 2001), illustrating the MCC practice of using democratic and co-operative principles to make social and profitability objectives compatible on the basis of value creation (Forcadell, 2005). However, as indicated by several Mondragon scholars, the social commitment is not limited to the structure of the co-operatives themselves:

This social commitment emanates from the very conception of the cooperative experience as something that goes beyond a corporate formula and which forms part of a community development project rooted in a call for the integral development of the individual (Sarasua, 2008: 8).

Much like the commentary that exists on the MCC pillars of co-operation and democracy, the social commitment embodied in the Mondragon core and the approach to fostering relationships with the community is also reflected in Arizmendiarieta’s words,

“Cooperatives have a community dimension which obliges them not only to give satisfaction to their own membership, but also to fulfill a social function through its structures...” and...individuals within co-operatives have the responsibility to work in collaboration “...to fulfill more perfectly the mission that society has confided to [them].” (MacLeod, 1997: 90).

5. SUSTAINING CO-OPERATION, DEMOCRACY, AND COMMUNITY IN A GLOBALIZING WORLD

Analyzing the current business environment and taking into consideration projections of future trends, it becomes clear that the significant factor in the Mondragon business reality will be the influence of globalization in the subsequent months, years, and decades. In an increasingly globalized world, a vast array of pressures abound and players in the market must undergo adaptations to capitalize on their existing strengths and invest in developing improvements to ensure sustained success into the future. The MCC is not isolated from this reality. Although possessing a unique business model and co-operative approach, adaptations to the globalizing world are critical elements of current MCC management discourse.

It has been suggested that three primary pillars support the MCC's human-based approach to business. In converting these pillars to a business objective (i.e. objective: to achieve co-operation, democracy, and community) in the context of a globalizing business environment a SWOT analysis has been conducted (Table 1). With this analysis, factors that are either supportive or unfavorable in the quest to achieve the three pillars can be outlined.

Table 1: SWOT Analysis of the Three Pillars of the MCC Human-Based Business Approach

<p>Strengths</p> <ul style="list-style-type: none"> • Focus & respect for human dignity • Management Model • Relationships & solidarity 	<p>Weaknesses</p> <ul style="list-style-type: none"> • Crisis in meaning & direction of co-operativism • A need to rebuild co-operative identity • A need to fine-tune participation
<p>Opportunities</p> <ul style="list-style-type: none"> • Job creation • Inter-cooperation • Social transformation 	<p>Threats</p> <ul style="list-style-type: none"> • Expansion pressures • Social - economic tensions • Cultural & ideological diversity

Specifically, the SWOT analysis provides a framework to examine MCC strengths, weaknesses, opportunities, and threats and their implications for sustaining co-operation, democracy, and community in a globalizing world. A detailed discussion on each component of the analysis follows.

5.1 STRENGTHS

Internally, several strengths of the MCC create an environment favorable to the continued fostering of co-operation, democracy, and community in an increasingly globalized world. Primarily, the respect for human dignity possessed by workers and management ensures that decisions and modifications made in business structures or approaches remain focused on the human impact, with sensitivity towards balancing economic and social considerations. The existence of the MCC Management Model (with the Basic Co-operative Principles at its core) provides a structure so that the values and mission of the MCC can always be taken into account.

This ensures that the original essence of the human-based co-operative model is not lost, but rather adapted and enhanced. The MCC's recognition of the value of solidarity and the relationships that exist between worker, management, and community will aid the future development of the organization. The fact that these strengths have emerged from a rich cultural history enhances the commitment of co-

operative members in the Basque region to keep them alive by extracting the potential from these strengths as sources of competitive advantage in an environment of globalization.

5.2 WEAKNESSES

While internal strengths of the MCC ensure that the co-operative corporation and its primary pillars will surely be able to adapt and survive going into the future, an ability to address the existing internal weaknesses determines the *degree of success* that the MCC experiences. A significant weakness in the internal MCC environment is the current crisis in the meaning and direction of co-operativism. As the original founders leave management positions and new generations address the Mondragon of the future, there is an increasing lack of connection to the founding values and driving inspirations of Mondragon co-operativism. This weakening of the co-operative core (Sarasua, 2008) must be addressed with re-education on co-operativism across the corporation (Sarasua, 2010; Cheney 2001) to reignite co-operative motivation and vision. In other words, the key factors of the co-operative fabric should be adapted through education, so that in their application they maintain their original brilliance (Cheney, 2001).

Table 2¹

Name	Interaction
Amigos de Arizmendiarieta Meeting "Friends of Arizmendiarieta"	<ul style="list-style-type: none"> • Attended a meeting with the Amigos de Arizmendiarieta (a group of founding Mondragon members and managers) and students from Mondragon University's Team Academy program. • Purpose of the meeting: to promote dialogue between generations • Outcome: creation of mutual, reciprocal inspiration, serving as a testament to the power of personal connection in fostering a common purpose and rebuilding co-operative identity.
Iñazio Irizar Professor of Organizational Strategy & Entrepreneurship, Mondragon University	<ul style="list-style-type: none"> • Interview* • Focus area: Entrepreneurship, inter-cooperation, recent book published
Jon Sarasua Director, LANIKI Institute for Co- operative Studies; Professor, Mondragon University	<ul style="list-style-type: none"> • Interview* • Focus area: co-operative studies, Mundokide organization, co-operative culture, future of co-operativism
Jose Mari Luzarraga PhD Lecturer, Mondragon University; Mondragon Team Academy coach	<ul style="list-style-type: none"> • Host throughout Mondragon visit.* • Provided extensive background information on Mondragon and assisted with arrangement of visits and interviews. • "Globalization as a trigger of cooperatives competitiveness": Lecture for Masters in Co-operative Management program (attended lecture as a guest)
Mondragon Team Academy Training Session	<ul style="list-style-type: none"> • Attended a training session for the Mondragon Team Academy entrepreneurship program

A unique example of this co-operative re-education was witnessed in a recent encounter between Mondragon generations at a Friends of Arizmendiarieta meeting. As part of the primary research for this paper, a site visit was conducted to the Basque region of Spain in early November 2010. Four days were spent at the Mondragon Co-operative Corporation and Mondragon University to interview contacts and generate an enhanced understanding of the Mondragon Corporation. Table 2 above summarizes the contacts and experiences from the enriching, informative visit to Mondragon.

An additional weakness that must be addressed is the current state of participation. Existing as a fundamental tenet of the co-operative model, the importance of participation must not be overshadowed by the pressures of the modern business environment. It has been noted that there are

¹ Written permission obtained to record and quote interview

disparities in social council participation across the co-operatives (Cheney, 2001) and that perhaps the centralization of decision-making has come at some cost to full democratic participation on the ground (CCCBE, 2009).

Specifically, there is a need to fine-tune participation within the MCC by creating an environment that is more conducive to the dual nature of participation: corporate and operational participation. In order to reap the potential of participation in the co-operative model, MCC can experiment with participatory techniques, continually foster both political and institutional participation, and develop the two sides of participation through Research and Development (R&D), all while developing, updating and visualizing a shared social sense and co-operative identity (Sarasua, 2008).

It is interesting to note that within the aforementioned weaknesses in the internal MCC environment, there is in fact an opportunity to explore. The crisis in the meaning and direction of co-operativism and the issue of participation can offer "...an opportunity to orient oneself with a vision that links [the co-operative soul] with the aspirations of the social base" (Sarasua, 2008: 8), by re-examining the driving forces behind the model and applying them in a modern context. These weaknesses, therefore, can in themselves serve as a wake up call and source of motivation to look after the deep aspects and driving forces of the co-operative experience, adapting and preparing them for a globalizing future.

5.3 OPPORTUNITIES

The external environment in which MCC finds itself has also created opportunities. If the MCC were to invest in these opportunities, the core of the human-based approach to business would be strengthened and appropriately modified for the future. Since its inception, job creation has been at the forefront of Mondragon objectives in a proactive sense, as it is part of the corporation's social aim. In today's turbulent economy, an MCC commitment to job creation could be employed on a broader scale, including an enhanced focus on international competitiveness via job creation and diffusion of the co-operative spirit.

The MCC could develop a competitive advantage through the combination of one of its strengths (respect for human dignity) and an opportunity (international job creation) to make a name for Mondragon across the globe as a leading, human-focused business that is here to stay. Since the definition of the Mondragon community is expanding beyond the Basque region with each international expansion, merger, or acquisition, the MCC should invest in the human capital of this global community to remain true to its human-based approach to business. In the words of Greg MacLeod, "[t]he Mondragon leaders would say that each cooperative has a duty to expand and create jobs as long as there are unemployed people in the community" (MacLeod, 1997: 160) – thus, a broader definition of community signifies a broader responsibility to care for this community.

Inter-cooperation and social transformation are also significant opportunities on the horizon for the MCC (Irizar, 2010; Luzarraga, 2010; Sarasua, 2010). By embracing inter-cooperation or co-operation between co-operatives, the MCC can greatly enrich its commitment to co-operation and solidarity not only within its collective of enterprises, but across the world.

With the establishment of a focus on global solidarity, the MCC also has the potential to nurture relationships and connections that, with time, could result in very positive implications in a business sense. As noted in a personal interview with Jon Sarasua, co-operativism is not a framework, but in fact a culture that needs to grow and develop (2010). By reaching out to the global community in an age where international communication and interaction is no longer a difficult task, the seeds for a wider co-operative community can be planted and great strides made towards social transformation in a global,

inclusive sense. While the transferability of the Mondragon model may not be possible in its entirety (Molina, 2008; Irizar, 2010), the diffusion of the co-operative spirit through inter-cooperation, as a vehicle for harmonizing individual and collective interests and realizing social transformation, presents itself as a very worthwhile opportunity for the MCC.

5.4 THREATS

Finally, it is necessary to consider the threats in the external environment that may hinder the MCC's efforts to maintain its human-based pillars of co-operation, democracy, and community. Primarily, the pressures to continue expanding and growing on a global scale are intensifying. In order to ensure the long-term health of the MCC as a co-operative corporation, measures must be taken to determine how the MCC will remain competitive in an environment of globalization without losing its defining values and co-operative core. As part of these measures, the MCC must begin to look inwardly in order to grow outwardly; to expand in a nature true to its principles, the organization must first be able to grow in depth (Sarasua, 2008).

In addition, the tensions between social and economic forces are heightening, as the globalized economy requires a more aggressive approach towards competition and leaves little room for social considerations. Therefore, it is of great importance that the MCC continues to strive to connect to the social base of the co-operative corporation. In successfully connecting to the social base, the MCC will demonstrate the strength of its alternative business model in order to influence the changes in corporate perspective that are critical to redefining the role of business in society.

Upon considering the expansion pressures faced by the MCC, an additional threat arises from the reality of cultural and ideological diversity that is present in the world. While this diversity is in no way something that should be suppressed, it must be taken into account when the MCC considers its plans and approaches for interacting on an international scale. Due to the varying cultural and political realities throughout the world, the MCC model will have to be adjusted and modified if it is to interact and thrive within a globalized community in a culturally sensitive, respectful manner. Just as adaptations must be made to successfully internationalize aspects of the Mondragon co-operative model, careful consideration must be given to the impact of a global MCC presence on the organization itself. From this consideration, appropriate measures must be derived to ensure that the defining sense of community, solidarity, and social commitment is translated to new geographic locations and not lost along the way.

CONCLUSIONS AND IMPLICATIONS FOR MANAGEMENT

An examination of the Mondragon Co-operative Corporation guided by the pillars of co-operation, democracy, and community highlights significant elements of the human-based approach that defines Mondragon as a business player and fellow citizen of the Basque region, Spain, and society at large. By combining this three-tiered framework with a SWOT analysis, the implications of the MCC approach are elaborated and put into a management context, creating awareness and future opportunities for adoption and adaptation of Mondragon elements in an environment of global business.

Over time, Mondragon's deep-rooted cultural values have sustained a strong sense of interconnection between corporation, individual, and community. The resulting culture of solidarity recognizes the value in reciprocal relationships and embraces human dignity as the driving force behind the business purpose and role in society, creating opportunities for inter-cooperation. By enhancing this commitment to co-operation, the MCC can strengthen the meaning and direction of co-operativism through proactive measures and enrich its co-operative identity. The historic progression of the MCC's co-operative nature

demonstrates the great potential that lies within co-operation, along with the sensitive nature of a co-operative core, a core that must be nurtured in order to flourish.

Democracy in the MCC has fortified the existence, growth, and future aspirations of the co-operative enterprises. Within a democratic frame, efficiency and opportunities for social transformation have flourished. The Management Model has reflected a democratic approach that creates harmony between economic, social, environmental, and individual objectives through the application of co-operative principles and promotion of participation. With self-management and sovereignty integrated into the approach, a respect for human nature emanates from the organizational core. Presently, the MCC must optimize participation corporation-wide to remain committed to its democratic principles. This caution reminds managers that a healthy democracy thrives off of an integrated, participatory culture and identity.

As a community-based business, the priority placed on fostering and maintaining relationships demonstrates the MCC's willingness to empower individuals and unite through collective efforts. The resulting cohesion allows for a social commitment to be exercised, ultimately functioning as the organization's external differentiating factor. This community focus allows the MCC's social commitment to go beyond a corporate formula and fulfill the group's obligation as a co-operative to create value through humanizing efforts. Today, the MCC should consider expanding on this obligation by refocusing on global solidarity and international job creation via the co-operative model, since fostering inter-cooperation in an environment of globalization is key to mitigating the threats of socio-economic tensions emerging from expansion pressures.

For managers, an analysis of the MCC can illustrate the potential of alternative business approaches and the capacity within these unique approaches to add value, address threats, and make the most of opportunities. The co-operative model is not the only option for the future of business, but significant lessons can be learned from the Mondragon cooperative experience and, in particular, the human-based approach to business that has defined the organization since its early years. Above all, Mondragon offers an example of an alternative business approach that is dedicated to humanizing the economy and harnessing the potential of its most valuable asset: its human capital. The overall aim of Mondragon, defined in the words of Arizmendiarieta as "...the economic, political, social and cultural improvement of the workers and society in general" (cited in MacLeod, 1997: 91), is an example and inspiration for the future of business in a world that is yearning for transformation and hope – a hope that can be fulfilled by embracing the potential of humanity through co-operation.

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More Than Just a Trend: Defining Sustainability and Corporate Social Responsibility in the Italian Fashion and Luxury Sectors

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ABSTRACT

Italian fashion houses have long been heralded as leaders in the fashion and luxury markets with brands such as Versace, Prada, Missoni and many others at the forefront of the industry. In recent years however, consumer preferences have shifted and the fashion industry as a whole has been slow to adapt. Increasing concerns over environmental sustainability and human rights by average consumers mean that companies must think seriously about their corporate social responsibility (CSR) strategies. The fashion industry presents challenges to adapting CSR largely because of the lack of consensus over what constitutes social responsibility in fashion and luxury as well as issues of sunken CSR and the consumption driven nature of the business. This paper critically evaluates the existing competing definitions for sustainable fashion, addressing the issues with each by employing a triple bottom line analysis. Additionally, consumer preferences in sustainable fashion are determined using a web based survey completed by one hundred respondents. In order to contextualize these results, the unique business environment of the Italian fashion and luxury sectors is examined as well as views on CSR in Italy. The paper proposes that a definition of CSR in fashion must include all aspects of the triple bottom line, while also addressing issues of sunken CSR and transparency. The paper also suggests that the innovative capacities of the Italian fashion industry award it a prime position to become an early adopter of CSR in fashion and luxury and it can gain a competitive advantage enabling it to retain the key leadership position that Italy has long enjoyed in the high end market.

INTRODUCTION

“Sustainability is really, really sexy right now.” This statement by futurist Henrik Good Hovgaard (2010) at the Culture: Futures conference in Milan, Italy highlights the marketability of sustainability and corporate social responsibility (CSR) for fashion and design based industries. Sustainability has become an important topic around the world and across industries. As consumers become more concerned with environmental and social issues it is becoming increasingly important for companies to demonstrate their sustainability efforts in both of these arenas. As sustainability and corporate social responsibility (CSR) have become mainstream ideas, many companies in various industries are implementing CSR strategies not only to improve their operations, but also to use as marketing tools in order to appear more attractive to customers and potential investors. Some industries have been faster to implement these strategies out of pure necessity (e.g., oil and gas) while others have been slower to adapt.

Among the industries that have fallen behind in CSR implementation are the fashion and luxury goods sectors. There are certainly some companies and designers that have advertised products using eco-friendly materials (Stella McCartney's vegan friendly line [Anaya, 2010], Diesel's 1% carbon jeans [Diesel, 2010]) or sustainability initiatives (GAP recycle your jeans program [Bates, 2010]) however, the industry as a whole is distinctly lacking in visible CSR. There are several explanations for this, one of the most

cited being that the majority of fashion and luxury companies are not listed on stock exchanges (Kaiser, 2006) and thus do not publish information regarding their operations. Other issues, however, that are not to be ignored are the distinct lack of consensus over what constitutes sustainable fashion (if such a thing exists), the issue of sunken CSR that is common among Italian companies and the nature of the fashion industry as seasonal and consumption-driven.

The fashion industry presents particular difficulties for companies planning to put a CSR strategy into place. By definition the fashion industry survives on unnecessary consumption; something that seems to go against the principles at the very core of sustainability. However, as reducing consumption is, for obvious reasons, not the goal of fashion and luxury companies, the key will be to make existing operations as environmentally and socially sustainable as possible without sacrificing the economic dimension. That is, fashion houses will need to find a way of implementing triple bottom line strategies in order to maintain profit margins, while appealing to increasingly sustainability conscious consumers.

The fashion industry in Italy is in a unique position to be an early mover in the area of CSR and thus potentially gain a competitive advantage due to the innovative capacities that its business environment nourishes and its strong emphasis on local production. However, the ability for the Italian fashion and luxury sectors to adapt to these changing global consumer preferences must start from an understanding of what exactly it means to be sustainable or socially responsible in fashion. There are currently a number of competing definitions over what social responsibility looks like in the fashion industry. This paper attempts to define corporate social responsibility and sustainability in fashion and luxury through the lens of the consumer and the unique positioning of the Italian fashion industry.

This paper also seeks to understand the consumer perspective on sustainability in fashion, what it means and how important it is? In order to put these findings into the context of the Italian fashion industry we first discuss the unique history and business environment of the Italian fashion sector, followed by the opinion in Italy regarding corporate social responsibility. After gaining a contextual basis, we look at the survey findings in terms of what sustainable fashion means to the consumer, the importance of different factors in CSR, the positioning of Italy with regards to sustainability in the consumer mindset, and finally, discuss the implications of these findings for the Italian fashion and luxury goods sectors.

1. THE ITALIAN FASHION INDUSTRY

Italy is one of the most renowned and established countries in the fashion world today. Italian design houses such as Prada, Valentino and Armani are world leaders in fashion and luxury goods production. However, the Italian fashion industry is much more than just big name designers; Italy has a network of design companies and textile and apparel manufacturing that includes over fifty thousand firms and employs more than six hundred ninety thousand workers (Guercini, 2004). The apparel industry alone makes up more than 10% of the manufacturing done in Italy (ibid). These figures place Italy's fashion industry as the largest in Europe. Although this may seem strange for a country that is lacking in both natural fibres and natural resources for creating manmade fibres, other factors have contributed to making the Italian fashion industry unique (ibid). The history of fashion in Italy and the unique business environment in which the industry grew have played important roles in giving the country a competitive advantage in the high-end apparel and accessories markets.

The Italian fashion industry traces its origins back only as far as the 1950s; it was born not out of an artistic designer's vision, but from industrial production. In 1950 a company called Gruppo Finanziario Tessile (GFT) was the first to bring standardized sizing into Italy (Corbellini & Saviolo, 2009). Standard sizes allowed for mass production of clothing which had not previously been possible. At this time, the

majority of clothing was basic and fashion was only important to the very wealthy who generally had their clothing tailor made. This changed quickly with the introduction of industrially produced and thus, more accessibly priced fashionable apparel. In 1951 the “Italian Look” was presented for the first time in a fashion show organized by Gian Battista Giorgini. The innovative pieces of young Italian designers were immediately successful and the Italian “pret-a-porter” industry was born (Corbellini & Saviolo, 2009).

The social changes of the 1960s and 1970s saw tremendous changes in the apparel industry. Small firms, which were and still are a common model in Italy, had more flexibility and were able to act quickly to meet new consumer demands but had difficulty with distribution (Corbellini & Saviolo, 2009). At this time, like many other industries in Italy, the Italian apparel and textiles industry started to organize into industrial districts. These districts were clusters of small firms working in related or even competing areas, of the fashion industry (Guercini, 2004). By clustering together, small firms were able to achieve economies of scale while also maintaining flexibility and innovative capabilities. Porter considers this clustering an important factor (along with distribution capabilities) accounting for the competitive position that Italy enjoys in the fashion world (Porter, 1990, cited in Guercini, 2004).

In addition to clustering, many Italian firms engage in a cooperative strategy, which gives them a unique advantage over their international competitors. An example of this can be seen in the AltaGamma group, which includes members from all luxury industries including, of course, fashion and apparel. Group members meet and discuss strategy on topics such as entering new markets – although they do not share proprietary information and trade secrets, in the interest of competition – the companies involved in such a cooperative agreement gain a significant advantage over those outside (Branchini, 2010).

The shift in consumer values during the 1970s and the strategic organization mentioned above allowed Italian firms to move quickly to meet demand played a significant role in the shifting of the “pret-a-porter” capital from Paris to Milan (Corbellini & Saviolo, 2009). During this period, most major designers engaged in licensing deals with large industrial firms to improve distribution capabilities. The licensing system was in place until recently for apparel, but is now common only for accessories and beauty products (Corbellini & Saviolo, 2009). The Italian fashion industry today is characterized by vertically integrated companies (both up and downstream), directly operated retail outlets, and high entry barriers. Companies operating in the Italian fashion industry today can be classified into four separate groups: industrial companies born out of textile production, entrepreneurial designers entering many sectors of the luxury market, multi-brand conglomerates such as Gucci group which own a number of labels in different sectors, and pure designers (Corbellini & Saviolo, 2009).

Currently, Italy enjoys a high position in the global fashion and luxury market. Products designed and manufactured in Italy are known for high quality craftsmanship and materials. They are considered functional, bringing a dimension of beauty into daily routine as opposed to works of art in themselves (Corbellini & Saviolo, 2009). Italy can no longer call itself the leader among countries in the fashion industry, as with globalization there is no longer one definite country leader; each national model presents different specialized offerings.

With the global financial crisis the fashion industry has seen a number of setbacks. Most notably the closing of small-scale materials producers worldwide has had an effect on even the largest of fashion houses (Sartori, 2010). Yet, despite the crisis, many fashion and luxury houses have actually seen growth; one example is Prada which in 2007 at the start of the crisis saw growth of 17% (Kapner, 2008). There are however, three main issues facing the industry in Italy at the moment. These issues are designer succession, the advent of the “fast fashion” business model, and many competing nations moving to cheaper offshore production.

Designer succession is becoming important in Italy. As many of the original designers retire or pass away, new designers are brought into the business to carry on the name. The main issue here is credibility – it is a lengthy and expensive process to gain credibility in the press and with key opinion leaders to new designers taking over from a name as big as (for example) Valentino (Riva, 2010).

The advent of “fast fashion” on the other hand is something largely out of the control of the fashion houses. Companies such as Zara and Hennes & Mauritz (H&M) have developed business models that allow them to assess trends from the catwalks (presented in Milan in September and February) and get them into the stores much faster and at much lower prices than the designers and fashion houses are able to. Many high end companies consider this the biggest challenge they are currently facing. This increases the importance of emphasizing quality and craftsmanship in their promotional materials (Sartori, 2010).

Several nations have shifted production offshore to offset increasing labour costs. Italy however, has a strong tradition of local production and places a great deal of importance on the “Made in Italy” label. By maintaining production in Italy the Italian fashion industry loses cost advantages to their competitors. This disadvantage is however, offset by government support to the industry (Taplin & Winterton, 2004) and the benefits associated with an increase in perceived quality of “Made in Italy” products.

The aforementioned issues, which are currently at the top of the agenda for most fashion executives, may cause sustainability and CSR to become an afterthought. However, with the importance of CSR growing in consumer preferences every year it will be important for the Italian fashion industry to address these issues sooner rather than later. The meaning of CSR differs across countries and industries. It is important when speaking about fashion houses, as global businesses, to look at their CSR strategy in both an Italian context and a global context.

2. CORPORATE SOCIAL RESPONSIBILITY IN ITALY

The European Commission defines Corporate Social Responsibility (CSR) as "A concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis" (European Commission, 2010). However, in order to effectively analyze the Italian fashion industry we must examine CSR not only in its official meaning but also in the context of Italian corporate culture. Notions of what it means for a company to be sustainable or socially responsible are in a constant state of change (Assadourian & Prugh, 2003). Even within industries there is rarely consensus on what constitutes best practices in these areas. As such, an analysis of CSR in an Italian industry requires an understanding of the various measures used in the country, the reasons for companies to adopt CSR strategies and the importance placed on different CSR related issues.

The most common approach for measuring CSR is the “triple bottom line” method of analysis. This measures the sustainability of a corporation's practices in three key areas: environmental, social and economic. Other approaches which have widespread diffusion in Italy include The European Union green paper approach which utilizes two dimensions: Internal and External, and another approach, developed by the Italian organization ORSA, which uses nine dimensions each of which is linked to one of the triple bottom line areas (Maccarrone, 2009). For the purpose of this paper we will focus on the triple bottom line method, which is the most globally diffused measure of CSR.

Motivations for Italian managers to adopt CSR strategies are generally concerned with company image and stakeholder relations. An interesting feature found in the study conducted by Tencati (2006) is that pressure from NGOs, clients, and suppliers are rarely cited by Italian managers as unique reasons for

adopting CSR policies. The topics of CSR and sustainability are regularly discussed in Anglo-Saxon corporations and often used as marketing tools. This practice tends to be less common in continental European countries. This does not imply that European companies are less sustainable or socially responsible but speaks instead to a cultural element. In many European countries, companies are not generally accustomed to broadcasting those practices that have been implied codes of conduct from the companies' origins (SA-Rete, 2010). It is because of this that many Italian companies experience a phenomenon known as "sunken CSR." Sunken CSR, refers to "those actions and interventions concerning workers and the local community that businesses and entrepreneurs traditionally have performed in time without even considering them as elements of CSR and without fully enhancing them" (SA-Rete, 2010).

Attention to CSR can be considered as moderately high among Italian managers especially in the social dimension. Areas such as stakeholder engagement and community initiatives are treated with great importance. In fact, in a country where many companies are so closely tied to the communities in which they were founded (Ducati to Bologna, Dolce and Gabbana to Sicily, Ferrari to Modena), informal relationships and social capital are some of the most important managerial tools. As such, stakeholder engagement is not only an important part of a company's CSR strategy but an essential, historical business practice. This is one of the reasons why such actions easily become unrecognized, sunken CSR practices. The development of these informal relationships has also caused, historically, the diffusion of managerial practices in Italy to develop apart from the rest of the continent (Tencati, 2006).

As a result, issues that are most prominent in Italian companies in terms of CSR differ slightly from those commonly seen in other nations. The issues of primary concern in Italy include employee welfare, health and safety, community and cultural initiatives, and product safety (Tencati, 2006). The key issue of community and cultural initiatives relates back to the importance placed on social capital in the Italian corporate culture, which relies much more on relationships and reputation than it does on contracts when compared to most developed countries.

In some areas of CSR, Italian managers can be viewed as less progressive than their contemporaries in other nations. Italian companies tend to pay less attention to issues such as child care, equal opportunity employment, assistance to disabled and disadvantaged persons, ethical aspects of products, carbon neutrality and fair trade initiatives (Tencati, 2006). Of course, each industry sector has its own primary concerns and other factors such as company size, degree of internationalization, and firm history can have an effect on their CSR priorities.

3. DEFINING CSR IN THE ITALIAN CONTEXT

Corporate social responsibility is a large field comprised of more than just environmental and social sustainability. Important aspects such as stakeholder engagement and transparency play key roles in a socially responsible corporation, and many would argue that in order to be sustainable in the true sense of the word, a company must first be socially responsible. For the following discussion we will utilize the triple bottom line as a tool to view the three key issues of environmental, social, and economic sustainability with regards to the fashion industry before discussing the issues of transparency and stakeholder engagement.

The importance of the triple bottom line is evident in a world that is becoming increasingly conscious of social and environmental issues. Although sustainability is high on the agenda of major luxury goods groups (Anaya, 2010), one of the key barriers in the Italian fashion industry to increasing CSR and harnessing its potential to boost sales and improve company image stems from the distinct lack of consensus over what it means to be sustainable in fashion. Many companies and opinion leaders have

put forward ideas of what sustainability looks like in fashion, however, these have generally been used to justify the company's current position rather than as a goal to move towards. In this paper we identify six competing definitions of sustainability in the fashion and luxury goods sectors, namely heritage sustainability, artisanal production, sustainable communities, fast fashion affordability, efficiency of factories (Starbuck, 2010) and materials based sustainability. The first five were originally published by Eliza Starbuck founder of the Uniform Project but are further discussed here, and the sixth has been added as a result of more recent research.

3.1 HERITAGE SUSTAINABILITY

Heritage sustainability is an idea supported mainly by luxury goods producers. This definition proposes that timeless design is the most important factor in sustainable fashion. The idea behind it being that a particular piece, passed on for generations is more sustainable than something purchased and thrown away the next season (Starbuck, 2010).

Although this is certainly true, the heritage sustainability model fails to address several key aspects including environmental impact in production, fair trade, and materials. It also seems to be somewhat counter-intuitive when thinking about the economic goals of fashion and luxury companies. Even those companies that are not engaging in planned obsolescence strategies encourage repeat purchases by customers and have some degree of seasonality ingrained in their business model. Without this strategy the companies would be unable to remain economically sustainable.

While the heritage model presents an interesting hypothesis in eliminating the planned obsolescence found in many of the companies that compete at a lower price range, its failure to address several important factors shows that this cannot stand alone as a definition of sustainable fashion.

3.2 ARTISANAL PRODUCTION

The artisanal or local production view has been used by companies both as a standalone definition as well as an improvement on the heritage model. This definition emphasizes the sustainability associated with skilled artisans producing lower quantities of goods (Starbuck 2010). This model is highly popularity in Italy as it places significance on local production. Proponents of this view also cite a reduction of shipping related environmental impacts (Starbuck, 2010). Here we begin to see aspects of both environmental and social sustainability. The environmental aspect comes into play with the lower emissions associated with small scale/handmade production and reduced shipping activities while the social aspect can be seen in the emphasis on skilled artisans implying treatment of workers as a high priority.

Although this definition shows obvious potential for environmental and social sustainability, the economic benefits are much more questionable. This definition is difficult to apply to any large company as the importance of reduced shipping costs presents difficulties in international expansion. As a majority of modern fashion companies sell worldwide, Italian companies are no different. However most of the production is carried out in Italy and shipped overseas. Reducing shipping cost would mean either opening production facilities in other parts of the world (which would cause them to lose the exclusivity associated with the "Made in Italy" label) or reducing international sales – which is not economically viable. If the reduced shipping effect is disregarded the environmental dimension becomes weak and must be improved upon via initiatives or other activities.

3.3 SUSTAINABLE COMMUNITIES

The sustainable communities model is used here as a reference point. This definition is not particularly relevant as an effective model in an already established for-profit company as it is more of an example of social entrepreneurship. However, the lessons from this model, which emphasizes the social dimension, may be useful for companies looking for initiatives to make improvements in the area of social sustainability or adapt the idea into a for-profit company.

The idea behind the sustainable communities model is to support people in impoverished or war torn areas by employing local craftspeople at fair wages to produce apparel or accessories and then using the profits to improve conditions in the area (Starbuck, 2010). A strong example of a company using this model is Irish label Edun, started by Bono (of U2 fame) and his wife Ali Hewson. At Edun the first priority is the social dimension, that is, improving the lives of third world farmers, while environmental considerations, while still important, are secondary (Belli, 2007). The sustainable communities model is probably the strongest in terms of social sustainability, however, the environmental dimension is somewhat lost due to the increase in transportation related emissions.

3.4 & 3.5 FAST FASHION & FACTORY EFFICIENCY

The fast fashion and factory efficiency views are largely at odds with the three previously discussed definitions. These fast fashion and factory models have been put forward by companies working in fast fashion or with large production facilities. The fast fashion view states that the most sustainable fashion is based on consumer affordability (Starbuck, 2010). Although affordability is a key concern of many consumers, this is a clear manipulation of the term sustainability. Affordability of apparel encourages the disposable model that the fashion industry has been so heavily criticized for. This is not to say that fast fashion companies cannot be sustainable. Many in fact have produced lines using recycled materials and are actively involved in educating the public on sustainable fashion.¹

The view of factory efficiency implies that by employing economies of scale large factories are able to produce larger quantities with lower emissions per unit than smaller scale facilities (Starbuck, 2010). Although there may be some truth to this view, large factories have long been criticized for poor working conditions, substandard wages and poor waste disposal techniques.

A possible way to improve upon this would be green or fair trade certified factories. Unfortunately there is no single measure that covers environmental certification, workplace safety, workers rights, and product quality at this time (Starbuck, 2010).

3.6 MATERIALS SUSTAINABILITY

Finally, an emerging definition is that of materials sustainability. This relates to the raw materials and textiles used to produce garments and accessories. Popular with new and emerging designers, this definition emphasizes environmental sustainability as dependent on the materials used to create the clothing. Designers today are using a variety of organic, renewable, and recycled resources such as organic cotton, bamboo, milk proteins, and recycled plastics to create high fashion pieces (Sivertsen, 2010). The prices for these garments are often much higher than their counterparts due to the difficulty in sourcing the materials (especially for emerging companies).

¹ H&M is an excellent example of this using organic cotton in many garments and even presenting a line made from recycled materials in the spring of 2010 (Brones, 2010).

A number of established fashion houses have also started to produce pieces or whole lines using recycled materials and organics. Italian menswear line ZZegna recently showed a suit made of recycled paper (Sartori, 2010) while British fashion designer Stella McCartney produced an entire line in organic cotton (Anaya, 2010). This definition is strong in the environmental aspect, however, much like the other definitions found above, it is unable to satisfy all aspects of the triple bottom line.

The problem in finding an effective definition for sustainability in the fashion industry is one of fractured sustainability, whereby people place concern on one or two aspects of sustainability but fail to see the whole picture (Belli, 2007). As we have seen above, most companies seem to focus on a definition which places them in the best light possible as opposed to seeking improvements across the three dimensions.

In the last decade, the food industry went through a phase similar to what the fashion industry is now experiencing, where consumers were first concerned about organic growing techniques, then fair trade, and finally the whole picture (Belli, 2007). Fashion consumers are moving in a similar direction and although there is no universal measurement or definition currently in place, companies that are making a sincere attempt towards ethical progress and triple bottom line sustainability will be recognized for their efforts if they remain committed to transparency in their operations and are able to engage all stakeholders to build consumer confidence.

4. METHODOLOGY

In an effort to understand consumer preferences with regards to sustainable fashion, research in the form of a detailed web based survey was undertaken (Table 1). The survey was distributed via internet to one hundred respondents of various origins, ages, and income brackets. The questions sought to establish whether or not consumers consider sustainability an important undertaking for a fashion or luxury company, what consumers consider the most important aspects of corporate social responsibility with regards to the fashion and luxury, and finally, whether the Italian fashion industry is viewed to be more or less sustainable than other national models.

This information is of use not only in establishing a definition of sustainability and CSR for the fashion industry but also to fashion and luxury companies looking to establish a CSR strategy, marketers looking to use CSR to communicate to the consumer, and the national fashion organizations in Italy to understand what is missing from the Italian model and where improvements can be made in order to maintain their position as a key player at a global level.

The surveys were completed anonymously. However, demographic information was also collected in order to identify any trends or biases in attitudes towards CSR. Survey respondents were 27% Italian, 47% Canadian and 26% of other nationalities including American, Australian, British, Spanish, German, Japanese, Thai, Swiss and Irish. This allowed for a more international view of attitudes towards sustainability while still giving a clear picture of the Italian response. The majority of respondents to the survey were female (77%) this may be indicative of interest level in the topic of fashion and luxury products as most fashion companies target the female consumer in their marketing strategies. This may cause data collected to be more reflective of the female opinion potentially making it less useful for companies working in the menswear segment.

The results were then translated into a series of graphs which are discussed in the following section on results. Respondents were also given the option of adding personal comments, which provided

additional information about views towards sustainable fashion, many of which could be of use to any fashion or luxury company looking to develop and market a CSR strategy.

Table 3: Sample Survey Questionnaire

1. What is your nationality/ Quale la vostra nationalità:
 - a) Italian/ Italiana
 - b) Canadian/ Canadese
 - c) Other/Altro

 2. What is your age range/ Quale la vostra età?
 - a)10-15 years
 - b)15-20 years
 - c)20-25 years
 - d)25-35 years
 - e)35-45 years
 - f)45+ years

 3. Average annual household income
 - a) < \$ 20 000 (15 000 Euros)
 - b) \$ 20 000 – 40 000 (15 000-30 000 Euros)
 - c) 40 000 – 80 000
 - d) 80 000 – 100 000
 - e) 100 000- 150 000
 - f) > \$ 150 000

 4. How often do you purchase fashion or luxury items?
 - Weekly/ settimanale
 - monthly/ mensile
 - 2-3 times per year/ 2-3 volte per anno
 - 1 x per year/ 1 volta per anno
 - rarely/ raramente
 - never/mai

 5. Do you feel it is important for companies to take responsibility for the environmental and social effects of their operations?
 - Yes/Sì
 - Usually/Generalmente
 - Sometimes/ Qualche volta
 - No

 6. Do you view Italian fashion as being more or less responsible (in terms of environmental and social issues) than other national models?
 - Much more responsible
 - More responsible
 - About the same
 - Less responsible
 - Much less responsible

 7. When purchasing fashion or luxury items (Clothing, jewellery, watches, sunglasses, leather goods etc.) :
Rate importance from 1 to 5, 5 being highest of the following
 - Low Price
 - Famous Brand name
 - Durability of product/item
 - Local Production
 - Ethical Sourcing of materials
 - Artisanal means of production
 - Fair treatment of employees
 - Low Carbon emissions of company
 - Environmental Initiatives of company
 - Community initiatives of company
 - Environmentally conscious Waste disposal

 8. Would you be more inclined to purchase a product bearing the label Made in Italy than a similar product bearing a different label?
 - More inclined
 - Consider them equal
 - Less inclined

 9. Why/Perchè?

 10. Further comments/ Altri commenti:
- Thank you for your time./ Grazie per la disponibilità.

5. RESULTS

In order to define sustainability in the fashion industry it is important to consider the consumer perspective on the issue. As we have seen, the industry has been unable to come to a consensus on what the most important aspects are in sustainable fashion, proposing a multitude of models, none of which are able to satisfy triple bottom line criteria for sustainability. Thus, we can look at the consumer perspective both as an indicator of the direction in which sustainable fashion should be focusing and as a guideline for establishing a definition that allows fashion companies to view sustainability in terms of the social, environmental, and economic bottom lines.

When considering the consumer perspective it is important to note that it is in a constant state of change. As the results will show, certain aspects of sustainability are only just beginning to gain attention in the minds of consumers while others rank highly on a list of priorities they consider when purchasing a fashion or luxury product. We will also note that the vast majority of consumers consider CSR of high importance regardless of company or industry (Figure 1) demonstrating that this is not a topic that can be set aside. Finally, the positioning of the Italian fashion industry among consumers will be discussed with qualitative statements from survey respondents supporting their points of view on the issue.

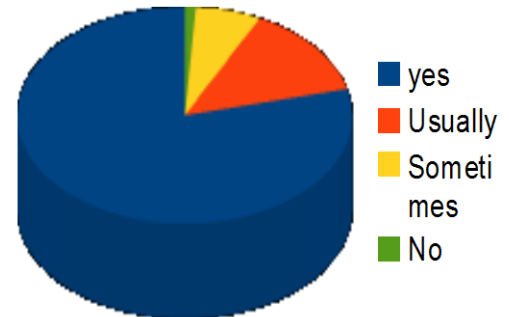


Figure 1: Should Consumers consider CSR?

When respondents were asked to rank a number of CSR related product and company features by degree of importance (Figure 2), four features were immediately visible as key factors for purchase decisions.

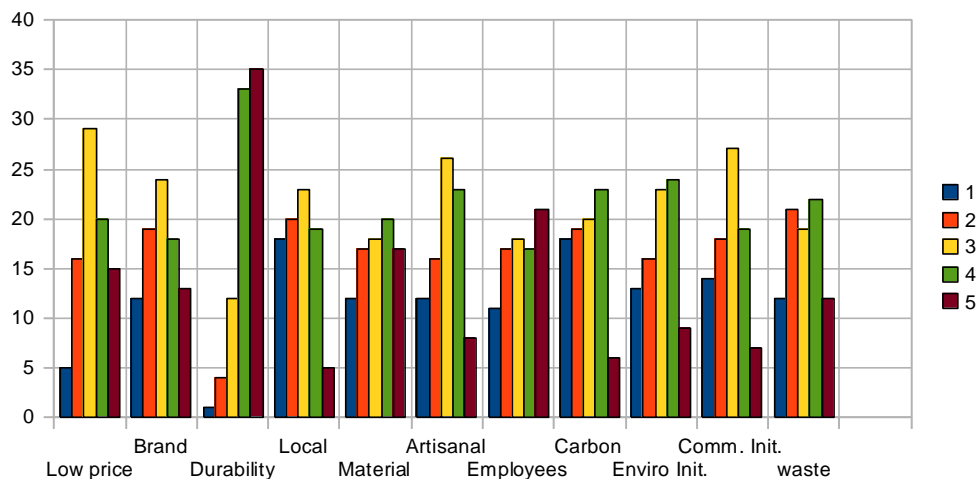


Figure 2: Level of importance for CSR in fashion and luxury companies

Those that emerged were product durability, fair and equal treatment of employees, reducing carbon emissions, and environmental initiatives. Each of these features can be readily included into a CSR strategy however, in order to benefit economically from these activities, it would be crucial to effectively inform the consumer of the features. One respondent emphasized the importance of this by adding to the additional comments section that in the moment when you are in the store making a purchasing decision, the best you can do is examine the product for quality and potential durability. That is, in the

store you cannot see whether or not a company is ethical or environmentally friendly. It is thus, up to the company to utilize their communication activities to inform the customer of their CSR activities.

The importance placed on product durability and employee treatment is largely in line with the heritage and artisanal production definitions mentioned earlier. However, by adding the reduction of carbon emissions and environmental initiatives to these definitions we start to increase the environmental dimension. Furthermore, if we assume that consumers consider these features in their purchase decisions, increasing communication efforts around these issues could also have a positive impact on the economic bottom line.

Other aspects such as low price, brand name and community initiatives ranked consistently as moderately important to consumers. By ranking durability and employee treatment above low price we are able to see that consumers are becoming more conscious of social issues as well as viewing apparel as less disposable than it was thought to be in the past. This further limits the use of fast fashion as a definition for sustainability (a definition which was already clearly manipulating the term sustainability).

As mentioned previously the factory efficiency model is somewhat limited especially due to the perception in the minds of consumers of factories as treating employees poorly. Sweatshop scandals are still fresh in the minds of consumers and prevent companies using large factories from legitimizing factory efficiency as a model for sustainability in the fashion industry. Given that employee treatment was rated especially high in this survey, we are able to see that without certification of factory conditions it is unlikely that this definition could ever be used in a marketable CSR strategy regardless of any reduction in emissions that said factories could potentially achieve.

One of the most interesting points that comes out in this ranking is the opinion on materials used in production. In fact, when looking at the graph we can see that there is significant difference of opinion in the importance of this factor among consumers. This shows us that the use of organic and renewable materials is only just beginning to enter the consumer mindset and has not become an issue of widespread importance. Interestingly, this is also true within the fashion industry where use of these materials is largely seen as a niche market. However, this niche is constantly growing and becoming more mainstream; in the coming years sustainable materials use is likely to become an important part of any definition for sustainable fashion. Much as organic foods began as a niche market and expanded, experts believe that consumers will begin to think of clothing differently in the near future, expanding the use of organic and renewable textiles (Belli, 2007).

When speaking specifically about the Italian fashion industry, respondents were asked to indicate whether they would be more inclined to purchase, less inclined to purchase, or consider equal items bearing a “Made in Italy” label. As we can see in the graph (Figure 3) the majority were more inclined or considered the products equal.



Figure 3: More of less inclined to purchase “Made in Italy.”

Figure 4: Is Italian fashion more of less sustainable than other national models?

Of those who selected less inclined the main reasoning given was a preference for purchasing local products (by non-Italian respondents) and concern over fraud of “Made in Italy” goods.² Nearly all Italian respondents indicated they would prefer to purchase “Made in Italy” goods due to the associated quality and in order to support the national economy. Foreign respondents that selected this were more likely to chose “Made in Italy” goods because of artisanal production and the implied fair treatment of workers. It is important to note that most respondents felt that the Italian fashion industry was approximately equal in terms of sustainability to other national models (Figure 4).

The Italian fashion industry is strong in terms of artisanal production, product durability and employee treatment which were considered by consumers to be some of the most important aspects of sustainability in the fashion industry. These aspects provide the possibility of a strong social dimension without sacrificing the economic bottom line as long as they are not allowed to fall into the category of sunken CSR which is so common among Italian firms. On the other hand, the importance of environmental initiatives and reduction of carbon emissions is a field where Italian companies are not currently competing effectively. As we have seen, an important emerging area is the use of organic and renewable materials. By entering this area as an early adopter, Italian fashion and luxury houses could gain competitive advantages while also increasing the environmental dimension of their triple bottom line.

CONCLUSION

The importance of sustainability is more than just a passing trend, it is a complete change in the consumer mindset – a paradigm shift (Good Hovgaard, 2010) that is growing stronger and creating demand for social responsibility from companies in all sectors. As this research has shown, the majority of consumers consider CSR an important factor when making purchasing decisions in the fashion and luxury goods areas. The Italian fashion industry's history and unique business environment award it with the innovative capacity to become early movers in the area of truly sustainable fashion. However, in order to do so they must move in the direction of agreement on what constitutes sustainability in fashion.

Having examined the most popular definitions of sustainable fashion (heritage, artisanal, sustainable communities, fast fashion affordability, factory efficiency and sustainable materials) we have seen that the proposed definitions have focused more on highlighting what companies already do rather than seeking improvements. This method of justifying current practices does little to inspire consumer confidence or move the fashion industry in the direction of CSR that other industries have already taken.

If Italian fashion houses wish to gain consumer confidence in the area of CSR they must take a proactive stance, utilizing the unique structure of the Italian industry to gain advantages over other national models. The Italian business culture and structure with its industry clusters and cooperative organizations has long encouraged innovation and allowed for best practices to diffuse quickly throughout the nation's industries (Guercini, 2004).

Each of the proposed definitions for social responsibility in fashion and luxury that were discussed in this paper address some aspects of social responsibility, yet in order to view fashion from a triple bottom line perspective these definitions must be combined. The consumer research conducted suggests that an effective combination could be found between the heritage, and artisanal views if additional attention is paid to emissions reductions and increasing the use of renewable materials. This would allow for strong

²Fraudulent labelling of goods as Made in Italy has become widespread in areas dominated by organized crime.

social, environmental and economic dimensions to emerge and be marketed to the increasingly CSR aware consumer.

Even without a universal definition for social responsibility in fashion and luxury it is important for companies to consider the issues and examine how they can actively improve upon their triple bottom line. There is no perfect model company in this sector but it is increasingly important for companies operating in fashion and luxury to openly discuss their commitment to ethical progress and sustainability. In order to succeed in light of these changing consumer preferences companies must strive for accountability and transparency in their operations. Consumer confidence must be earned through communication and a commitment to constant improvements in all three dimensions of the triple bottom line.

The Italian fashion industry has historically been strong in the social dimension with ethical treatment of workers, product quality, and community involvement as priorities among companies (Tencati, 2006). Unfortunately, this commitment often goes unnoticed by the consumer causing it to fall into the category of sunken CSR. In order to benefit economically from all CSR initiatives, Italian companies in the fashion and luxury goods segments will need to be more active in communicating their position and efforts. By taking such a proactive stance on CSR the Italian fashion industry has the potential to move ahead of other national models and maintain the competitive advantage that they have long enjoyed in the fashion and luxury sectors.

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Pan-European Energy: Jolting Spain out of the Financial Crisis

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ABSTRACT

Spain's current economic situation as it passes through the global financial crisis has produced a series of significantly detrimental economic circumstances. This has left Spain with a record high unemployment rate, banks floundering in the stagnant real-estate market, and the need for a possible bailout in its future. These economic afflictions have created a necessity for Spain to develop new economic fortes and form a farsighted economic plan of action. Meanwhile the European Union (EU) has made the goal to reduce CO₂ emissions 80% by 2050. The European Climate Foundation has been tasked by the EU to formulate a Roadmap that eliminates Europe's dependence on carbon energy through the mixture of a pan-European switch to less carbon intensive technologies and the development of a European energy grid based on the flow of renewable power from country to country derived from supply and demand.

This paper examines the complementary opportunities and weaknesses present in Spain's economic situation and in the goals specified in the Roadmap. It is shown that Spain can utilize its comparative advantages towards become a leading supplier of renewable energy, which can lead to resolution of some of the problems caused by the economic crisis while provide a competitive advantage for Spain in years to come.

INTRODUCTION

*Don Quixote: Dost thou not see? A monstrous giant of infamous repute whom I intend to encounter.
Sancho Panza: It's a windmill.
Don Quixote: A giant. Canst thou not see the four great arms whirling at his back?
Sancho Panza: A giant?
Don Quixote: Exactly*

Miguel de Cervantes (1605) – Don Quixote de la Mancha

This quote from the famous Spanish novel Don Quixote de la Mancha brings to mind the vast history Spain has with the use of wind power in its industry. Of course, the industrial use of wind power has changed immensely since Quixote's squire Sancho Panza tried desperately to keep his knight from attacking a pesky windmill. Spain is the fourth largest producer of wind power in the world after the USA, China and Germany, an impressive feat when considering that Spain had relatively no industry prior to 1996 (Gutiérrez, 2010).

As Spain's economy has followed the rest of the world into the financial crisis over the last three years, a startling reality has become apparent. The core sectors of the economy, responsible for Spain's fruitful economic development over the last thirty years, have become obsolete and are not recuperating successfully from the consequences of the crisis. Spain's principal economic focus over the years has

traditionally centred on the automobile, tourism, construction, and public sectors - arguably those most affected by the economic crisis.

The European Union (EU) has designated the objective of having a minimum 80% reduction in usage of carbon energy by the year 2050 throughout the entire continent, replacing future demand with renewable resources. This undertaking will require an immense pan-European cooperation effort to reach development landmarks. Spain is one of the leading countries in renewable energy. The European Climate Foundation (ECF) has been tasked by the EU to formulate a Roadmap that eliminates Europe's dependence on carbon energy through the mixture of a pan-European switch to less carbon intensive technologies and the development of a European energy grid based on the flow of renewable power from country to country derived from supply and demand. Spain may therefore view the ECF Roadmap as an opportunity to continue expanding its capacities to augment and reinvent its struggling economy.

Political policies, pan-European cooperation, and a focus on energy efficiency and renewable energy, in conjunction with the targets of the ECF Roadmap 2050 will enable Spain to address its economic weaknesses revealed by the economic crisis through innovative opportunities as a supplier of renewable energy for all of Europe.

1. THE ECONOMIC CRISIS IN SPAIN

To examine solutions that the renewable energy market offers to the problems of the economic crisis in Spain, it is paramount to foremost investigate the negative effects the crisis is having on the Spanish economy. To analyse this, the history leading to the crisis, the obstacles to the housing and labour markets and the need for financial reform must be examined.

1.1 PREFACE TO THE ECONOMIC CRISIS

Over the last thirty-five years since the end of Francisco Franco's dictatorship, Spain has rampantly invested in its economy reaching the ninth highest GDP in the world in 2009 (International Monetary Fund, 2009). With economically sound countries such as Germany, France, and the United Kingdom facilitating efficient progress, Spain quickly underwent bountiful economic growth, making it a significant power in the European Union. The funds for the intense investment in Spain came from the country's wise management of savings and the accumulation of substantial trade deficits, making up 11% of GDP by 2009 (Shuman and Mateo-Yanguas, 2010).

The investments made throughout these years led to the now highly trained and technologically competent Spanish workforce; however, the trend of indebtedness has led to a requirement for the government and national banks to provide subsidies conservatively and procure finance externally to afford the high interest rates on debt formed by the recession (Shuman & Mateo-Yanguas, 2010).

Leading up to the international economic crisis Spain's forefront economic industries were the public sector, tourism, and construction (Royo & Manuel, 2003). While the Spanish public sector went through significant salary cuts and layoffs after the crisis began, it has altogether continued to be relatively stable. Spain is the second most popular holiday destination, which is generally a huge driver of the Spanish economy. However, since nearly all developed countries are currently experiencing the financial crisis, tourism has decreased significantly in Spain and these adverse effects are reflected as such in its GDP (Shuman & Mateo-Yanguas, 2010). As the world's economy recuperates tourism will indisputably increase once again; however, other economic weaknesses in Spain require that alternative economic growth opportunities be established.

1.2 CONSTRUCTION INDUSTRY

Spain's housing bubble grew seemingly endlessly up to the year 2008. Prime real estate along the expansive Spanish coasts attracted the attention of developers and investors, foreign and local alike. Rising housing prices did not deter the accumulation of billions of Euros of debt throughout the real-estate industry, and lax political and private regulation of the investment market led to the trend of speculation on risky mortgage-backed securities (Gutiérrez, 2010). When the housing bubble finally burst in late 2007 with several owners left with negative equity, the construction and housing industries halted almost instantaneously. This created a shockwave of investment default considered to be even more damaging than the bubble in the United States. High housing prices left as many as 800,000 properties unsold, a figure that Spanish banks are still trying to recuperate from (Shuman & Mateo-Yanguas, 2010). Companies defaulting and poor hiring policies have led to the abnormally high unemployment rate in the construction industry in Spain over the last two years.

1.3 UNEMPLOYMENT RATE IN SPAIN

The global economic crisis has affected the employment rate in Spain profoundly. In 2007 before being augmented by the financial crisis the unemployment rate was still quite high at 13%; however, recent reports have stated the rate to be at an astronomically high 19.1% (Kirby et al, 2010). The unemployed segment is made up alarmingly of recent university graduates, who are unable to find suitable employment opportunities. This is due in part to the trend of temporary contract position, and not promoting employee or employer investment in training, creating a toxic employment market with a multitude of chronically inexperienced and disloyal new entrants. As a result, an exodus of highly trained Spanish talent to other countries where lasting careers are more abundant has begun (Gutiérrez, 2010).

The decline in employment opportunities in Spain has been attributed to a market saturation of highly trained talent, financing difficulties requiring companies to act frugally and limit costs, and incompetent corporate regulations causing poor hiring criteria (Shuman & Mateo-Yanguas, 2010). Future political and corporate policies should include the implementation of programs that encourage stable employment in growing sectors that provide jobs for an educated workforce.

1.4 FINANCIAL MARKETS IN SPAIN

Spain was in a relatively healthier position financially than Greece, Portugal and Ireland prior to the beginning of the financial crisis. Amid the financial crisis, Spain is being fiscally compared to these countries and considered for a potential European Central Bank bailout. The single currency unit in the European Union has created a disparity in competitiveness throughout Europe; while some countries show high economic surpluses, others have continued significantly indebted. This economic inequality has enabled the rampant indebtedness and lack of financing that has obliged some European countries to require bailouts. Jennifer Blanke, a senior economist at the World Economic Forum, sums up that "Being a member of the euro zone isn't related to competitiveness. At the end of the day, they need all of the economies making stuff that other countries want to buy (Shuman & Mateo-Yanguas, 2010)." This demonstrates the need for financial reform in the euro zone to foment pan-European integration and create a more unified European market that stimulates economic growth in all member states.

2. RENEWABLE ENERGY INDUSTRY IN SPAIN

With non-renewable resources being consumed rampantly throughout the world, renewable energy is arguably the future fuel of the global economy. As carbon fuel prices meet and then surpass the cost of everyday more affordable renewable energy, the enterprises and countries with the foresight to

conduct the astounding research being done in wind, solar, geothermic, and biomass energies will receive the spoils. The history of this reputable industry in Spain, its component companies and the contribution it makes to the Spanish economy will preface the discussion of the future economic capabilities of this sector.

2.1 EVOLUTION OF SPAIN'S RENEWABLE ENERGY SECTOR

Francisco Franco's dictatorship wreaked havoc on Spain's economic development. After World War II, while the rest of Europe rebuilt and began industrializing, Spain's borders remained closed. This severely impeded economic progress due to repressing and viciously regulated dictatorial policies. In 1975, Franco's government finally lost power after his death and barriers with the rest of the world were lowered (Royo & Manuel, 2003). Spain's lack of technological prowess and low productivity compared to the rest of Europe required large investments in economic growth and efficiency. From an international perspective this coincided with the 1973 Oil Embargo by the Organization of Arab Petroleum Exporting Countries (OAPEC) and later with the 1979 Energy Crisis (EIA, 2009).

The two crises and the need for widespread development in Spain led to an extensive increase in the demand for energy throughout the country. As such, the Spanish government, led by the Socialist Party, created an economic plan which relied heavily on foreign investment and indebtedness to industrialize Spain (Gutiérrez, 2010). This led to difficulties for Spain in supporting its growing economy and equalizing levels of wellbeing with the rest of Europe with an economy based solely on carbon based energy.

Starting in 1976 multinational energy companies such as Gamesa Corporación, Acciona Energy and Iberdrola emerged and began renovating Spain's energy market. Gamesa Corporación began developing new technologies in robotics and energy production and has now achieved multinational success as an exporter and producer of wind energy products (Gamesa, 2010). Acciona became a forerunner of the renewable energy sector predominantly in solar and biomass energy (Acciona, 2010). The Bilbao based Iberdrola has been an energy producer in Spain for over a century. It made the change from a heavily carbon-based energy focus to its current role as a leading producer of renewable and nuclear energy (Iberdrola, 2010).

2.2 RENEWABLE ENERGY STRUCTURE AND COMPANIES

The Spanish Gamesa Corporation is considered a world leader in wind energy technology and production. Gamesa operates in five countries and boasts a research and development average of 150,000 engineering hours annually (Gamesa, 2010; Donoso, 2010). Gamesa, along with fellow renewable energy companies Iberdrola and Acciona energy, is one of the companies that will have an effect on the future of renewable energy in Spain and Europe.

These enterprises, among others, have solidified Spain's position as a forerunner in the renewable energy market. Due to the economic crisis, however, there has been increased pressure for these companies to halt production in Spain and focus their efforts on exportation and international investments (Donovan, 2010). This is in part due to decreased government subsidies to support growth, and more diverse opportunities abroad.

The United States, China and Latin America offer profitable opportunities for Spanish energy companies to export their renewable products. Brazil and China are progressively becoming economic powerhouses but face the difficulties of developing industrious countries while upholding international environmental standards throughout (García Mezquita & Sánchez Díez, 2003). These countries require substantial

amounts of energy to sustain their economic development, which means profitable prospects for Spanish energy companies, who are taking advantage of the opportunities and investing and exporting accordingly. Iberdrola has traditionally focused around one third of its investments externally to Spain since 2001; however, in the years since the start of the economic crisis the rate has increased to closer to half of all Iberdrola investments (Iberdrola, 2010). The problem caused by these types of investments is that they do not enhance the Spanish GDP more than through imported profits. The job creation and economic growth created are both offsets of the initial investments that take place in the venture country (García Mezquita & Sánchez Díez, 2003). As the Spanish Economy is currently facing a crisis, it is imperative that these companies focus on internal development to ensure that Spain does not miss profitable internal investments and is able to meet European standards (Gutiérrez, 2010).

3. EUROPEAN UNION ECF-ROADMAP 2050

The European Climate Foundation (ECF) was founded by the European Union to research and plan the reduction of the economic reliance on carbon energy by at least 80% by the year 2050, an aim set in 2009 at the G8 conference in L'Aquila, Italy (European Climate Foundation, 2010). In Figure 1 the breakdown of the current and predicted energy requisites in Europe is shown; to attain the 80%¹ renewable energy goal, 90-95% decreases in carbon-based energy used in household, transportation, and buildings must be made.

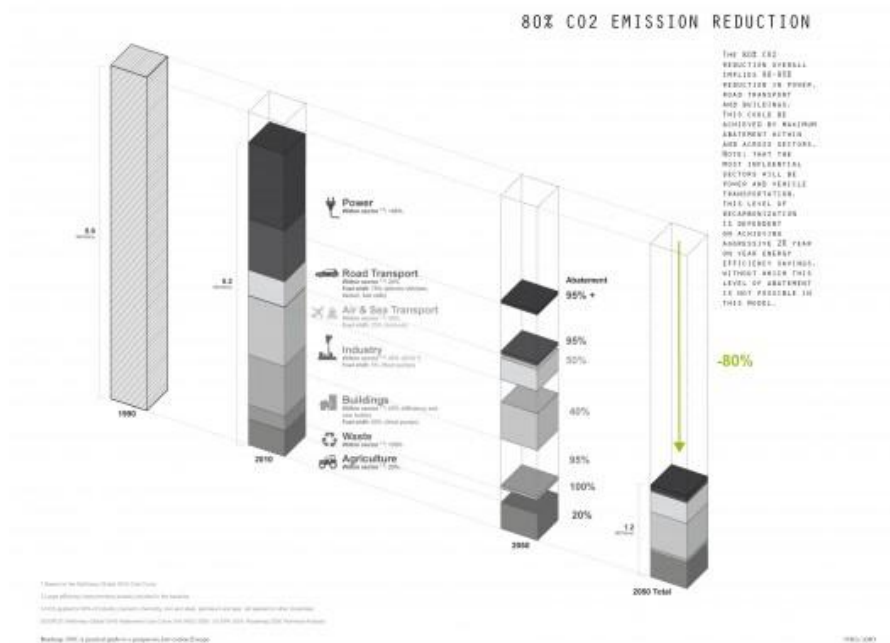


Figure 1- Breakdown of current CO2 emissions in Europe and 2050 required breakdown.
 (Source: European Climate Foundation, 2010).

This assessment makes the assumption that energy consumption in industry and agriculture will remain at the same relative level, as the result of a balance of energy efficiency developments and future demand.

¹ Note that research has been conducted for results between a 40-80% decrease in carbon energy reliance. This report will utilize the 80% data for the scenario that meets European Union goals.

A mixture of a pan-European switch to less carbon intensive technologies and the development of a European energy grid based on the flow of renewable power from country to country derived from supply and demand will be needed for the success of the Roadmap (European Climate Foundation, 2010). This will ensure that there is a consistent energy flow throughout Europe to maximize efficiency and demand needs; on a windless Saturday, a household in the United Kingdom could be supplied with solar energy from sunny southern Spain. To examine the economic capabilities of the Roadmap for Spain, it is necessary to investigate current and required pan-European political policies, and the economic challenges and opportunities of the Roadmap.

3.1 POLITICAL POLICIES

“Energy market mixes... are always the result of public and political choices”

- Van Jones, *The Economist* May 9th, 2009

In order to adhere to the ECF Roadmap’s timetable, the European Union must ensure that necessary investments can be made pre-emptively by negotiating policies over the next two to three years. The long-term planning involved in the implementation of a forty-year energy strategy requires present commitment from political affiliations throughout Europe (Sweatman, 2010). This means that European politics must assume a fully cooperative approach to energy policy development that considers the future wellbeing of Europe as a whole as opposed to continuing a country specific self-governed system. This is a present challenge for the European Union as the young confederation must contend with the difficulties of political collaboration without causing cultural stagnation or amorphism.

Figure 2 shows the current and projected energy grid transmissions throughout Europe to ensure a sustainable energy flow. In Spain’s case, this will require intensive collaboration with France to plan and construct the forty-six new grid lines between northern Spain and France (and through France with the rest of Europe). While construction will be required throughout the majority of pan-Europe transmission connections, the Iberia-France connection is clearly the most pressing site for collaborative expansion (European Climate Foundation, 2010). This connection will ultimately create a connection for Spain’s vast solar energy capabilities to be conveyed to the rest of the European Union, a vital transmission link for the successful supply and demand flow of energy throughout Europe.

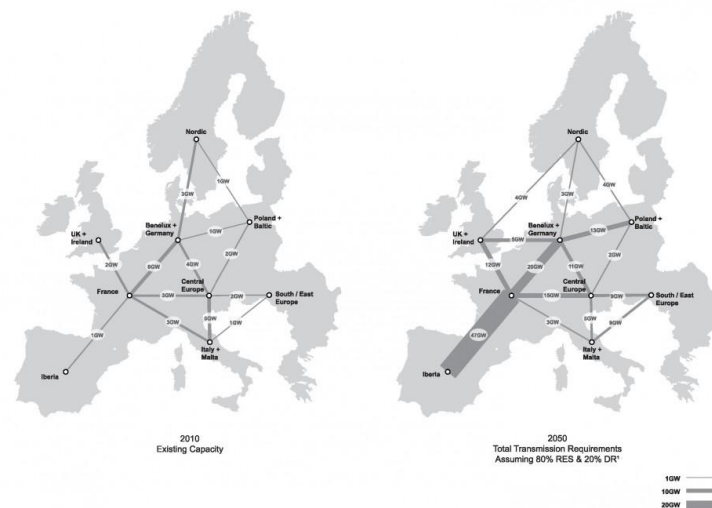


Figure 2 – Current existing energy transfer capacity in Europe and 2050 requirements.

(Source: European Climate Foundation, 2010).

Capital investment for the next years is the most exigent of the entire Roadmap. The political regulation of the energy sector could create delays in implementation by driving up capital costs through lack of incentives when trial energy efficiency methods fail (European Climate Foundation, 2010). Renewable energy construction requires high investments and has a long-term rate of return; the start-up costs to erect wind and solar farms are high, and financial returns are gained gradually over years of marginal gains on energy output (Donoso & Sweatman, 2010).

Improvement in energy efficient is inclined toward breakthrough innovations and long-term economic gains which are easily overlooked by short-sighted political reigns. Political nearsightedness entails the sole consideration of the necessary strategies to ensure re-election instead of what is perhaps best for the future of the country. As the European Union becomes more integrated politically, commitment to pan-European initiatives will be straightforwardly managed from an international level. Ideally, economic policies will begin to naturally regulate themselves through fiscal cooperation within the Union.

Unsuccessful implementation of energy efficiency policies could lead to an estimated loss of €300 billion in GDP for Europe by 2050 due to the volatile effect of carbon fuel prices. This figure depends heavily on the increase in carbon fuel prices and relative costs and innovations in energy efficiency. To put this in perspective, consider that €300 billion is nearly a third of the necessary initial investment for the 60% carbon-based energy reduction pathway (European Climate Foundation, 2010). Political concordance for the Roadmap must be managed from the pan-European perspective to ensure that continent wide regulations are met and the economic benefits of the Roadmap are achieved.

The Spanish government is in the process of detailing its *Reformas para la Economía Sostenible*² which will entail the position to be taken towards the implementation of European Union and G20 mandated sustainable protocols. The Spanish government has taken the Keynesian stance that political policies and fund injections must be made to stimulate the economy using Plan E to support the economy (Gutiérrez, 2010). While Plan E is a beginning for Spain's involvement in the Roadmap, it fails to fully take advantage of matching long term economic opportunities with current internal strengths. The renewable energy sector will receive mediocre stimulus packages from the government and funding will be provided to private sector enterprises with sustainable focuses (Gobierno de España, 2010; European Climate Foundation, 2010). However, energy policy landmarks fall short of those necessary to reach the Roadmap's goals and maximize Spain's potential in this sector.

3.2 PUBLIC OPINION

Lack of public support is another political risk that must be contended. There is an estimated fluctuation of €250-300 per month in energy cost for every European household by 2050 based on assumed increases in carbon fuel price and renewable energy innovation expectations (Figure 3). Taking into consideration natural inflation costs and that the average European household currently spends €1200-1300 per month on energy, even the possible increase of €300 Euros per month is only a negligible 4.3% price increase over 40 years for the renewable energy benefits of the Roadmap (European Climate Foundation, 2010).

² Translates to Reforms for a Sustainable Economy and is abbreviated Plan E.

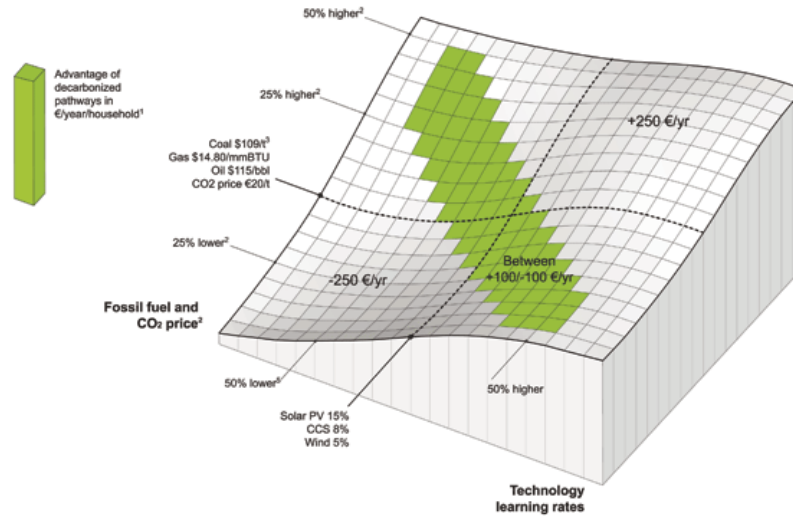


Figure 3 – Estimated household cost fluctuation based on technology learning rates and predicted fuel prices. (Source: European Climate Foundation, 2010).

A well-informed populace should be able to appreciate and support the socio-political benefits of this price increase. However there is considerable public resistance to expansive construction of wind farms, solar farms and energy transmission due to the potential scenic and ecosystem damage. In particular, the construction of renewable energy resources in areas that may affect animal migratory patterns in the north of Spain and the impediment of several significant historical landmarks have been polemic (Estefanía, 2009). In order to counter this, information campaigns and educated and informed consent must be obtained to discourage extreme forms of protest (European Climate Foundation, 2010). Large-scale and countrywide changes require positive public opinion; this will ultimately determine the success of the ECF Roadmap. If the European public as a whole are inspired and committed to liberate their economy from carbon reliance, the venture will flourish.

3.3 ECONOMIC CHALLENGES WITH THE ROADMAP

The projected investments provided by research conducted for the Roadmap are considerable to meet the milestones set out. The predicted cost for the enhancement of the grid connection from 1GW to 47GW between Iberia and France will depend on the manner in which the grid is laid out. The challenge of maintaining a mutual flow of energy from Iberia to France through the Pyrenees Mountains through Andorra creates the need for heat pumps to maintain solar energy (European Climate Foundation, 2010). Solutions to this problem could mean the extra investment to lay the energy lines underground or undersea or the possible loss of solar capacity in Spain, requiring a larger expansion of wind energy capabilities (Sweatman, 2010). Though this seems to be a costly venture, when taken in the context of the ECF Roadmap's entire scope, it is one of an array of difficult obstacles to be overcome.

Due to the volatility of renewable energy, backup energy production with 10-15% of the capacity of transmission must be taken into consideration. This means that in order to ensure the ability to maintain a dependable flow of energy throughout Europe, additional energy will be needed in extreme weather circumstances and during unexpected peaks (European Climate Foundation, 2010).

Germany recently decided to maintain nuclear power plants functioning until 2040 to ensure that the energy mix continuous to have a reliable backup power. Spain will expectedly have to follow Germany's lead, keeping only a relatively trivial percentage of its energy supplied by nuclear means to serve as a stable backup for the planned 2050 energy grid (Donoso, 2010).

The ability to sustain technological growth and learning at the necessary level to sustain the energy efficiency and renewable energy needs for the success of the Roadmap could be lower than predicted (European Climate Foundation, 2010). In order to meet the goals set out by the ECF, large subsidies must be made toward the development of clean technologies, energy efficient goods, and renewable energy technology. Educational reform to inspire the study of professions related to energy efficient "green" careers and Spanish companies' continued prioritizing of research and development will encourage the required technological growth (Gutiérrez, 2010).

The effects of the global economic crisis in Spain have created unforeseen challenges for the implementation of the ECF Roadmap. This has created a necessity for external financing in order for the Spanish government to meet costs, triggering partial cuts in subventions to the renewable energy sector (Donoso, 2010). This is the opposite of what the ECF requests that government policy reform entails over the next years, which are crucial for the initial development of the pan-European grid. Renewable energy companies in Spain are now procuring financing outside of the country to continue progressing (Iberdrola, 2010). Delays in the commencement of the construction of necessary infrastructure to keep up with the timeline set out by the Roadmap will possibly augment the burden placed on the Spanish economy and construction industries when investments are finally made (Sweetman, 2010).

Investments in renewable energy sources remain an uncertain venture in the private sector. This must be remedied to avoid sharp increases in capital cost investment delays in funding will cause. It has been calculated that currently investments throughout Europe of €30 billion per year are required to begin developing renewable infrastructure to sustain the Roadmap's goals; however, the investment necessary per year increases dramatically in the event of delays to €90 billion per year in 2035 (European Climate Foundation, 2010). This quantity of investment will not only be much more difficult to obtain at that point, but does not comprise the necessary scale augmentations of supply chains to attain the 80% less carbon energy reliance goal.

3.4 ECONOMIC OPPORTUNITIES WITH THE ROADMAP

Within the challenges presented by the ECF Roadmap are opportunities for economic, social and environmental benefits beyond solely supporting energy demands for the European Union. Spain's current position in the renewable energy market is favourable for it to play a lucrative role as a major supplier (ABC, 2010). The abundant population of educated graduates that are unemployed will offer a steady input factor for the successful Spanish renewable energy companies. To meet the Roadmap's demands these companies will require new talent as they make the necessary growths to accommodate emergent market demands (European Climate Foundation, 2010). This coincides with the calculated demand for the construction of an estimated 5000 square kilometres of solar panels and 100,000 wind turbines by the year 2050. With existing technology and production rates, an objective of this magnitude is entirely possible for the European Union; and Spain is in an opportunistic position to economically and socially benefit (Brown, 2010).

The rate of innovation of new technologies by the ECF has the potential to be an underestimate. Novel methods of producing clean and renewable energies are being piloted continually; therefore possible breakout technologies may emerge unpredictably (European Climate Foundation, 2010). Spanish companies are leading the way in this sector as research and development is often found to be their

second or third largest internal investment of capital. Innovations in renewable energy often lead to further sustainable advances in other energy-intensive industries. There is promise, therefore, to develop chain reactions and spill-over effects of energy efficient products and strategies throughout the implementation of the ECF Roadmap (Sweetman, 2010). Historically, the effect of innovation can additionally affect future GDP growth rates by as much as 1% based on the development of breakthrough technologies (European Climate Foundation, 2010). An example of a multiple use innovation in solar architecture is technology for storing solar energy using materials that are also utilized as heating sources in homes and buildings.

With an annual average of 2600 hours of sunshine per year, it is no surprise that Spain has one of the strongest solar energy industries in Europe. Aside from some potential in southern Europe, Iberia will be the prime resource for Europe in the Roadmap. Vast amounts of solar energy capabilities are available in Africa and the Middle East; however, potential expansion of gridlines into these areas has not been calculated at this point (European Climate Foundation, 2010).

Spain is therefore in an excellent position to utilize its climate advantage to construct the necessary solar energy capacities to supply northern Europe with the majority of the required 300 terawatt capability.

The ECF Roadmap has stated that there is a high priority to reach price convergence for electric and petroleum vehicles in Europe. Price convergence in the automobile industry will improve the case for European carbon neutrality because demand for electric vehicles will approach and later surpass that for the more costly carbon-fuel based ones. To put the impact of this shift into context, if price convergence between conventional and electric cars were to occur today, it would connote an improvement in the decarbonised case of €500 billion over the next forty years (European Climate Foundation, 2010). Support for the automotive industry will ensure that beneficial GDP effects of the implementation of infrastructure to support electric and hydrogen fuel cell transportation remain in Spain (Burdick, 2009). However, in order for this shift to be beneficial, in the long run the electrical energy being consumed by vehicles must not be drawn from carbon-based sources.

4. THE SPANISH CONTEXT TO THE ECF ROADMAP

Through examination of the current economic ambient in Spain and quantifying Spain’s upcoming challenges to attain the landmarks of the ECF’s renewable energy Roadmap, the correspondence between the opportunities presented and the current challenges being faced by Spain are clear. Through the use of a SWOT (*Strengths, Weaknesses, Opportunities, Threats*) analysis (Table 1), it is apparent that employment formation, innovative markets, Europeanism, and financial prospects are the most beneficial correlations.

Table 1 – SWOT Analysis for Spanish Involvement in the ECF Roadmap 2050*

SPAIN			
Strengths	Weaknesses	Opportunities	Threats
<ul style="list-style-type: none"> -Highly educated workforce - Renowned renewable energy sector - Climate, more annual hours of sunshine than any other EU Country - New generation with pan-European identity 	<ul style="list-style-type: none"> - Current economic reputation in the EU, high debt cost - Unemployment rate higher than in 16 years - Lack of financial support from EU members in more financially stable positions 	<p>ECF Roadmap:</p> <ul style="list-style-type: none"> - Large scale construction - pan-European cooperation -Employment creation -New market creation, especially electric vehicles and energy efficiency 	<ul style="list-style-type: none"> -Lack of economic concordance within the European Union -Difficulties in financing - Poor political planning from government -Lack of public support for Roadmap

SPAIN	Opportunities	Threats
Strengths	<ul style="list-style-type: none"> - Workforce needed to achieve Roadmap goals for energy efficiently and technological development - Necessary to produce 5000km² of solar energy farms by 2050, majority in Spain. Competitive advantage for Spain and opportunity for companies to invest internally - New generation of Europeans will be more inclined to collaborate productively within the Union 	<ul style="list-style-type: none"> - Inclination toward Europeanism will counter any current nationalistic selfishness over the years. - Spanish renewable energy sector will be able to fund itself, and can accept cheaper debt from abroad if needed.
Weaknesses	<ul style="list-style-type: none"> - 300.000 – 500.000 jobs produced throughout the roadmap - Spain may improve its financial reputation through leadership in the Roadmap - Development of electrical vehicle infrastructure will stimulate internal demand, creating a stronger electrical vehicle industry 	<ul style="list-style-type: none"> - Public support may be easier to gain during a crisis if informed of direct benefits - Lack of financial support from the EU will make countries take more radical steps to recuperate their economy, this can be beneficial in the case of extreme projects like the Roadmap

* Uses a match and convert method

4.1 EMPLOYMENT CREATION

The high unemployment rate of post-secondary educated graduates and construction industry workers will be able to fill the hundreds of thousands of employment positions developed by the renewable energy sector’s growth throughout the Roadmap. This figure includes both job replacements for layoffs from the carbon energy industries as well as innovative “green” careers (European Climate Foundation, 2010). Generating this employment will start to halt the exodus of young Spanish talent, keeping their salaries in Spain to stimulate economic growth (Bush, 2010). The scope of the venture to build forty-six new gridlines connecting Spain with France will provide construction employment to replace work lost after the housing bubble burst. Spain has followed Germany with building code reforms that require all reconstituted and new properties to include solar panels on the roofs, producing additional labour and architectural employment necessities (Bush, 2010). By continuing to invest heavily in research and development and education, Spain will create national experts in the renewable energy field, which will create competitive advantages throughout the execution of the ECF milestones.

4.2 ELECTRIC VEHICLE MARKET

The vehicle sector, which makes up 25% of Spain’s exports, is a prospective industry for Spain to concentrate on and become a leading producer of electric vehicles in Europe. This would contribute to the ECF’s goal of reducing carbon usage and provide Spain a niche market that is currently growing in Europe. There are few Spanish vehicle companies; however, historically lower labour costs relative to the rest of Europe have acted as incentive for foreign companies to produce in Spain (Estefanía, 2009). The Spanish ministry of industry created Proyecto Movele in which infrastructure to support the sale of electric vehicles is supported and subsidized. By providing infrastructure that supports electric vehicles,

the Spanish government will create incentives for vehicle companies to innovate energy efficient vehicles to be produced and sold in Spain (Burdick, 2009).

In the middle of an economic crisis, focusing on new markets like this can save companies and create employment (European Climate Foundation, 2010). Proyecto Movele is a great example of the way political policies and subsidies are able to stimulate economic growth and sustainable energy practices that will reach the ECF Roadmap's goals simultaneously.

4.3 PAN-EUROPEAN IDENTITY AND COOPERATION

The current generation of European citizens is growing up with a different set of values than those of their ancestors. European youth tend increasingly towards identifying themselves not as a collective of different countries, but as a unified political system of unique cultures working together. Creating a pan-European identity was an ideal produced by Winston Churchill shortly after World War II, who suggested the visionary concept of a United States of Europe that would unify and politically regulate the member states (McCormick, 2010). This started the European Union down the path towards its inauguration in 1993 after years of sluggish enlargement and membership planning. It has since steadily grown to its current twenty-seven member countries.

A unified Europe is, therefore, a relatively novel principle. Ideals that primarily supported the unification of countries, such as prevention of war and the maintenance of democratic processes, are now being overshadowed by more polemic economic and social unification (McCormick, 2010). In order to successfully achieve extensive initiatives like the ECF-Roadmap, it is advantageous for the new generation of European politicians to support Europeanism in order to stimulate the necessary social and economic change that must take place. European youth are growing up in a united Europe in which they have opportunities to create a unified identity beyond their own national one.

The Erasmus program is an example which encourages the sharing of multicultural and scholarly resources throughout Europe and has been attributed to contributing to creating a pan-European identity. Erasmus was not implemented until 1987; however, the lasting advantages of the program will not be felt until the current generation enters the world of business and politics (McCormick, 2010).

Political and social unification of the member countries in the European Union will be vital to the ultimate success of the initiatives of the ECF Roadmap and ridding Spain of the effects of the financial crisis. A Eurocentric mindset will endorse the betterment of the European Union as a whole, as opposed to disparagement between countries in stronger and weaker economic situations (Gutiérrez, 2010). The ECF Roadmap suggests a novel approach to energy markets that requires pan-European cooperation and the emergence of the concept that the European Union's success as a whole is more important than that of any single member country.

4.4 FINANCING THE ROADMAP

In order to finance the necessary developments of the Spanish renewable energy sector to meet the Roadmap's goals, the Spanish government will have to subsidize so far as possible to make long-term return. Otherwise, foreign investment will be essential to ensure that ECF milestones are met. It is ideal for Spain's government to attempt to invest as much as possible in its successful renewable energy enterprises to maximize public revenues; however, the benefits of foreign investments will nevertheless continue to stimulate economic growth as the employment and infrastructure created will be in Spain regardless of where investments are from (Gutiérrez, 2010).

Political reform will need to be performed in the European Union to integrate the energy market into a single market. This will require overcoming resistance from dominant energy enterprises by making them compete throughout the continent, essentially ruining monopolistic advantages. Successful implementation of the Roadmap over the next years will in great part rely on countries within the European Union that have financial surpluses reinvesting their capital in weaker EU economies to stimulate domestic demand (Schuman & Mateo-Yanguas, 2010).

CONCLUSION

The lasting socio-political effects of successful implementation of the ECF Roadmap would mean the dawn of a new era of cooperative European politics. The international implications of this could mean the eventual envelopment of northern Africa and the Middle East into the European grid. The notion of successful international cooperation of this magnitude could funnel into other global communities: NAFTA, UNASUR, and ACD power grids could follow not only encouraging global unity but stimulating worldwide sustainability. This would essentially remove carbon energy dependence from the global economy.

Demand for renewable energy will only increase as renewable investments and energy efficiency improve, while non-renewable carbon resources are exhausted. Although Spain is yet enduring the symptoms of the global financial crisis and requires further political progress than has been obtained, there are strong incentives to alleviate current weaknesses by taking advantage of emergent opportunities in the renewable energy market set forth by the Roadmap.

Spain is in an excellent position to utilize its climate advantage to attract foreign funding to augment its solar energy capacities to supply northern Europe with the majority of the predicted 300 terawatt capability. With the right mix of political policies, public support, subsidies, and foreign direct investment Spain can recover itself from the challenging position created by the financial crisis and act as a leader for Europe, and possibly the world into a new age of renewable energy.

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Water Management in Singapore: Is NEWater a Feasible Option for Securing Self-Sufficiency in Addressing the Issue of Water Scarcity?

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ABSTRACT

Current global environmental conditions place increasing social, political and economic importance on the supply of clean drinking water. In the future it is predicted that countries with a self-sustained and autonomous supply of water, both potable and non-potable, will hold the key to economic and political power. The thriving economy of Singapore, ranked 7th in terms of GDP per capita worldwide, is no exception to the universal stress on clean water supply. This paper discusses the four national taps that currently supply Singapore with potable water and analyzes the feasibility of the small island city-state harnessing the technology of wastewater reclamation through NEWater production to achieve self-sufficiency in sourcing water. Analysis of current position and future water strategy reveals that Singapore does hold the ability to sustain itself if water is no longer imported from Malaysia. If Singapore is able to successfully harness the advanced technology it presently holds and become entirely autonomous in securing its water supply, it will enjoy considerable economic and political power in the future.

INTRODUCTION

Currently, potable and non-potable water supplied in Singapore is provided through four sources. These include local catchments and reservoirs, desalination, water reclamation and imported water. Historically, a large fraction of Singapore's water supply, roughly 50 per cent, has been delivered through contractual Water Agreements with Malaysia. The binding legal documents between these two South East Asian countries have been the root of occasional political and economic tensions since their inception in 1961 and 1962. As Singapore's first contract with Malaysia will run out in 2011, with the second one expiring in 2061, Singapore is faced with the challenge of securing its water supply before these contracts are up.

The pressing question is whether the wastewater-recycling program that produces NEWater will be a viable option for Singapore to be autonomous in generating and controlling a sufficient source of water to sustain its population in the future. The Singaporean government, led by Prime Minister Lee Hsien Loong and the People's Action Party (PAP), must determine if the benefits of being self-sufficient in sourcing potable water outweigh the costs of forfeiting the economies of importing. In addition, the social stigma associated with the consumption of recycled wastewater poses a major barrier that could stand in the way of Singapore's goal of self-sufficiency.

1. OVERVIEW OF WATER SUPPLY AND SCARCITY ISSUES

1.1 GLOBAL CONTEXT

Increasingly, water scarcity is becoming a worldwide threat, not only in developing countries, but also in many developed and wealthy countries. According to Professor Siegfried (2010) of Singapore Management University (SMU), water scarcity is a global mega trend that is rooted in one of two phenomena; economic or physical water scarcity. In countries that lack a sufficient amount of disposable income to afford potable water, particularly developing countries, economic water scarcity is the main threat. In other words, economic water scarcity means that the water supply is physically available, but because of other demographic factors, such as high population, high unemployment and low GDP per capita, the water is not available for consumption by everyone. On the other hand, the occurrence of physical water scarcity emerges when a region is unable to produce potable water due to the lack of physical availability of the resource. This could be an issue in both developing and developed countries and, regardless of a country's having the financial resources to procure water, there is no local accessibility.

The challenging issue is determining which is worse: economic or physical water scarcity? Seemingly, financial barriers preventing basic access to drinking water that is readily and physically available seems like the more unfortunate option. However, it can be argued that physical water scarcity is far worse because economic problems can be solved in the long-run through financial stimulation and the eventual economic development of countries, whereas physical water scarcity is not a situation that can be solved using such strategies; it is a much more serious issue. It is this issue of physical water scarcity that many countries today, including Singapore, are faced with.

Global water supply considerations include both the sourcing of potable water for domestic consumption as well as non-potable water for industrial and agricultural processes. The World Business Council for Sustainable Development (WBCSD) (2010) suggests most businesses are just beginning to realize the dire consequences that water scarcity entails: "everyone understands that water is essential to life. But many are just beginning to grasp how essential it is to everything in life – food, energy, transportation, nature, leisure, identity, culture and virtually all products used on a daily basis." Agriculture makes up 70% of global water usage and industry uses 22%, with domestic water use accounting for only 8% (WBCSD, 2009). These figures reinforce the importance of water in all facets of life, not just for domestic consumption. Proper management of water for agricultural and industrial use will be just as important, if not more important, than focusing solely on potable water supply.

In the future, countries that act proactively to secure both economic and physical water supply will be at an advantage on the world stage, politically and economically. Autonomy in sourcing water is becoming a crucial component in generating power and influence for such countries. According to the video "Blue Gold: World Water Wars" (2008), having control over a self-sufficient and privatized water supply will inevitably be a major source of power, security and wealth for countries and corporations. In the future it is predicted that every single drop of water will be commoditized and leveraging of water sources will be an influential means of gaining political and economic power.

1.2 SINGAPORE'S CONTEXT

Being a small water-locked nation located on the southern tip of the Malaysian Peninsula, most would assume that consideration of water scarcity is an issue far removed from the minds of Singapore's politicians and inhabitants. This couldn't be further from the truth. Although Singapore has consistently

provided 100 per cent availability of fresh potable water to the population, there is a looming undercurrent of shrinking resources and time winding down on the Water Agreements with Malaysia. Ranked 170 out of 190 countries in terms of fresh water availability, Singapore “has been rated a highly water stressed country given its high domestic consumption and lack of natural resources” (Choong, Jau and Ruay, 2002, p. 48). Compared with Malaysia, with a population of 28 million that has 580 km³ of fresh renewable water available each year, the 4.7 million inhabitants of Singapore only have 0.6 km³ available (CIA World Factbook, 2010).

Singapore’s rapid economic and industrial growth over the past 40 years, leaving the country’s free market economy ranked as 7 out of 229 countries in terms of GDP per capita, has not come without increasing needs for potable and non-potable water (CIA World Factbook, 2010). In Asia, where water has always been regarded as an abundant resource, per capita availability “declined by 40 to 60 per cent between 1955 and 1990” (Choong et al., 2002). This trend will only increase as Singapore continues to expand industrially. Particularly in the prosperous industries of semiconductor and wafer production in Singapore, “high-grade water for industrial use [is required], which is reclaimed water with a purity level higher than that of normal potable water” (Solid State Technology, 2010). Analyzing the water supply for semiconductor production becomes even more interesting when examining the bilateral relations between Malaysia and Singapore.

Malaysia is beginning to establish itself as a major competitor in semiconductor production, making their water exporting agreements with Singapore more unappealing. Essentially the Water Agreements are providing cheap resources needed for semiconductor production to Singapore, Malaysia’s direct competitor in the industry. In the future the competitive stance that Malaysia asserts in the semiconductor industry will certainly play a role in pricing and contractual agreements surrounding their exporting of water to Singapore.

1.3 HISTORY OF SINGAPORE’S WATER SUPPLY

The absence of a major water supply shortage in Singapore can be accounted for by the governmental policies that have been in place since the city-state gained independence from Malaysia on 9 August 1965. The government’s proactive long-term strategy toward providing safe water supply for all inhabitants has not only sustained the population’s health needs, but has also produced positive economic externalities by avoiding the basic water deprivation issues that most developing countries face.

The initial water agreements between Singapore and Malaysia began when the “Johor government entered into two long-term agreements in 1961 and 1962 with Singapore’s Public Utilities Board” (MICA, p.4, n.d.). These agreements provide for Singapore to draw raw water and for the Public Utilities Board (PUB) in Singapore to supply treated water back to Johor (MICA, p.4, n.d.). The Water Agreements contain measures for pricing revisions through bilateral consultation and, failing which, through arbitration. In addition to the Water Agreements with Johor, Singapore has relied on local rainwater catchment in reservoirs to satisfy nearly half of their water demand. Only recently in the past decade has Singapore tapped into the technologically sophisticated water sourcing processes of desalination and wastewater reclamation.

1.4 SINGAPORE’S “FOUR NATIONAL TAPS”

In Singapore’s attempts to “move towards long-term self-sufficiency and to reduce its reliance on foreign supply, the board developed a strategy called the Four National Taps” (Net Resources

International, 2010). The four taps include the two traditional domestic water sources, rainfall and imported water, as well as the recently introduced taps, desalination and reclamation.

1.4.1 Imported Water

Water imported from Johor, Malaysia accounts for half of Singapore's daily consumption of water, some 520,000 cubic meters (Choong et al., 2002). Under the Water Agreements between these two countries, "Singapore can transfer water from Johor for a price of less than 1 cent per 1000 gallons until the years 2011 and 2061, respectively" (Tortajada, 2006, p. 227). The agreements also require Singapore to provide treated water back to Malaysia after processing. The overwhelming figures on water provisions from Malaysia serve as a backdrop to bilateral relations between the two nations.

The Water Agreements cannot be viewed as merely a business transaction. There are a variety of implications and externalities generated through the agreements, both helping and hindering relations between Malaysia and Singapore. As the agreements expire in 2011 and 2061, Singapore must carefully assess whether new contracts with Malaysia should be drawn up to continue importing or if it will be economically and environmentally feasible to become self-sustaining. Presently, however, imported water from Malaysia is "one of the most cost effective sources of water supply" (Choong et al., 2002, p. 44).

1.4.2 Local Catchments

Given that average annual rainfall in Singapore is about 2400 mm, well above the global average of 1050 mm, the country is "not short of fresh water, but short of catchments and storage" (Choong et al., 2002, p. 109). Currently, there are 17 reservoirs in Singapore used to collect storm water (PUB, 2008). According to Choong et al. (2002), building more reservoirs and damming the sea between islands would not provide a big enough catchment area for rainfall to meet Singapore's future water needs. Herein lies the greatest challenge for Singapore to utilize the water yield from the abundant hydrological cycle. Space constraints of the small island nation do not present an unlimited area for capture with, "two-thirds of Singapore's land area" already providing water catchment areas (PUB, 2008). After storm water is captured through urban runoff and reservoir catchment systems it is processed to meet global Drinking Water Standards mandated by the US Environmental Protection Agency (USEPA) and the World Health Organization (WHO).

1.4.3 Desalination

Desalination is a relatively new process that Singapore is tapping. The country has effectively taken advantage of recent technological advancements that have made desalination more efficient and cost effective (Soon, 2009). Desalination uses reverse osmosis via membranes to filter salt water from oceans into potable water. The strategic position of Singapore's 193 km of coastline presents few difficulties in acquiring seawater to process in Singapore's desalination plants (CIA World Factbook, 2010). Along with ease of access, "desalination provides a steady source of water, unaffected by variations in rainfall" (Loong, 2005). The first municipal-scale desalination plant, the Tuas Desalination Plant, was opened in 2005 (Tortajada, 2006). The membranes used in desalination are easily scalable, meaning they "can be implemented in modules and can easily accommodate technological advances" (Soon, 2009, p. 240). These same membranes are also used in the production of NEWater, which is described below.

1.4.4 Reclaimed Water

Singapore's first pilot water reclamation plant was built in 1974, but was decommissioned within one year. PUB continued to monitor developments in membrane technology and during the 1990s was able to capitalize on the opportunity to reinstate the water reclamation project when membrane prices dropped. In 1998, a NEWater plant was again commissioned in Singapore proving that it was "economically viable to produce NEWater on a large scale"



(Soon, 2009, p. 239). NEWater is projected to account for 30 per cent of Singapore's water supply by 2011, just in time for the expiration of their first water contract with Johor (Onn, 2003). The NEWater produced caters mainly to industries that require high-quality water, such as semiconductor production and wafer fabrication plants.

NEWater goes through three stages of filtration beginning with conventional treatment that meets globally recognized standards. Following initial treatment is the first step unique to the NEWater treatment involving micro-filtration through a membrane. The second phase uses a membrane with even smaller pores to conduct reverse osmosis (RO). Finally, to provide a safety back up to the RO stage, the third stage involves high-intensity ultraviolet disinfection; this is the stage that adds considerable expense (Soon, 2009). Although NEWater is widely accepted for use in industrial processes, there remains to be an overall consensus that it is unacceptable for household use, despite it being well within, and even exceeding, the WHO guidelines for safe potable water.

1.4.3.1 Benefits of NEWater

Harnessing the use of water reclamation addresses the threat of water scarcity in its entirety by eliminating the need for fresh water resources that Singapore lacks. As mentioned above, the membranes used to filter reclaimed water are scalable making the technology cost effective and easily adaptable to change. The three treatment stages of NEWater are responsible for "NEWater quality [falling] well within the USEPA and WHO drinking water standards" (Soon, 2009, p. 144).

Aside from these benefits, other positive externalities include the prospect of being a self-sustaining nation in terms of water supply and easing any tension between Singapore and Malaysia over the Water Agreements. NEWater also creates a "multiplier effect" on water supply. The multiplier effect suggests, "if 50 per cent of water is recycled, the water supply could theoretically be doubled" (Soon, 2009, p. 147). This means that instead of building up new capacity through catchment expansion, which is difficult in the small area of Singapore, or desalination, which is costly, Singapore can generate all the water it needs through the multiplier effect of recycling.

1.4.3.2 Perceived problems with NEWater

In essence, there is only one major barrier that stands in the way of piping NEWater on a national scale, and that is the psychological stigma surrounding the consumption of reclaimed wastewater. At present, NEWater is not piped through faucets for direct potable use regardless of the safety standards it meets for human consumption. NEWater has only been bottled for public sampling, reaching a total of 10 million bottles in 2008 (Soon, 2009). In order to circumvent this psychological barrier, treated NEWater is injected into reservoirs and mixed with captured water, which then goes through additional treatment. Aside from the challenge of gaining societal consensus on consumption of recycled water,

the only remaining barrier to NEWater production is the added cost involved in treatment using ultra-violet filtration. Treatment of NEWater is, however, a less costly option than desalination.

1.4.3.3 Distribution/Pricing Policies

Currently, distribution policies regulate that NEWater can be supplied for both indirect potable use and direct non-potable use. NEWater can be piped for use directly though taps in industrial processes that require high-grade water, but is not piped to households for domestic use. At present, indirect potable consumption of NEWater is only available through purchase of the bottled product.

Pricing policy of NEWater is not static, but rather is a function of the raw water supply. It is more costly to produce than Public Utilities Board (PUB) water (basic treatment of storm water collected in reservoirs) but less costly than desalination. That being said, “NEWater is priced at a cheaper rate than PUB water because it does not attract water conservation tax” (PUB, 2008). The combination of higher production costs and lower selling price, presents an interesting problem for NEWater in profit generation. PUB’s reasoning behind this cost-price trade-off is that production could effectively close “the water loop through recycling of used water to produce NEWater” (Soon, p. 147, 2009). The number of consumers and relative cost of producing NEWater is demonstrated in Figure 1. According to Tortajada (2006), the cost of producing NEWater is S\$0.30/m³ and sells at a price of S\$1.15/m³, which covers production, transmission and distribution costs (p.232).

	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995
Employees at the end of the year	3125	3232	3333	3426	2143	2116	2163	2138	2190	2219
<i>Customers (Number of accounts at the end of each year)</i>										
Water	1 173 434	1 153 195	1 129 815	1 108 255	1 063 331	1 049 438	1 013 495	974 467	942 925	910 712
NEWater	51	24	-	-	-	-	-	-	-	-
Used water	1 173 462	1 153 196	1 129 792	1 108 232	-	-	-	-	-	-
Domestic Water Consumption (lpcd)	162	165	165	165	165	165	166	170	170	172
Number of accounts served per PUB employee at the end of the year	376	357	339	324	496	496	468	456	431	NA
<i>Capital expenditure</i>										
Water	95.8	214.8	88.0	115.6	144.0	197.4	108.7	84.0	50.5	43.7
NEWater	58.4	89.6	96.5	12.8	-	-	-	-	-	-

Figure 1- Statistical Summary of Consumers and Relative Cost of Producing NEWater (1995 – 2004)
 Source: Tortajada, p. 231, 2006.

**2. LOOKING AHEAD – FUTURE OF WATER SUPPLY IN SINGAPORE:
 Is NEWater Alone a Feasible Solution?**

The previously discussed data shows that NEWater is a feasible option for sustaining Singapore’s direct non-potable and indirect potable usage in theory. According to Soon (2009), the multiplier effect NEWater creates is strategically significant and can be ramped up in times of need to boost water supply. The main barriers that impede the successful full-scale implementation of NEWater as a direct potable source that could be tapped for domestic use in all Singaporean households are psychological stigma and high costs.

Response Summary

Total Started Survey: 7
Total Completed Survey: 7 (100%)

PAGE:

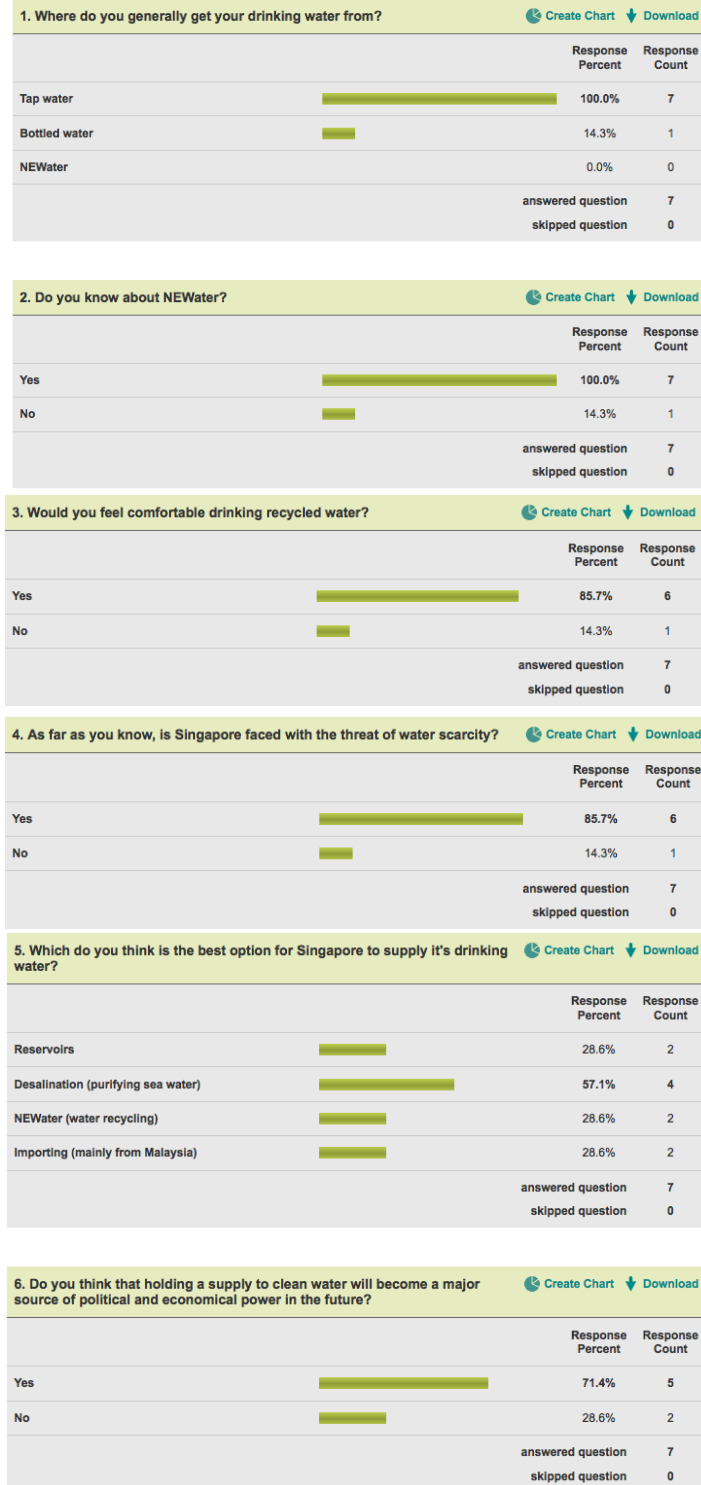


Figure 2 - Drinking Water In Singapore Survey Results

Source: Survey conducted by Suzanne King, (2010)

Various sources have different figures relating to the public acceptance of NEWater and water recycling in general. Results from a small-scale survey conducted among local Singaporean university students demonstrated that 86 per cent of respondents would feel comfortable drinking recycled water as their primary source of potable water (Figure 2). A different survey carried out on a much larger scale in Singapore pointed towards an a similar overwhelming public acceptance of NEWater, “with 82 per cent of respondents indicating they were prepared to drink it directly and 16 per cent prepared to drink it indirectly, after mixing with reservoir water” (Soon, 2009).

In order to determine the economic viability of NEWater, a detailed cost-benefit analysis would have to be conducted, which is beyond the scope of the research conducted for this report. It will be the duty of the Singaporean PAP government to carefully assess the public acceptance rate, risk and accompanying costs associated with NEWater production to determine if an acceptable price for NEWater can be implemented to ensure viability.

2.1 COMBINATION OF WATER SOURCES

In the long run, the most attractive option for Singapore will be a continuation of its policy toward sourcing multiple water supplies. The city-state should, however, consider eliminating imported water as one of their national taps. In theory, Singapore does hold the ability to be entirely self-sufficient through NEWater production, but it will be essential to maintain back-up sources in the form of rainwater catchments, reservoirs and desalination plants. Soon (2009) states clearly, “a combination of more than one option may have to be pursued simultaneously to ensure redundancies and safeguard the interests of Singapore due to the strategic importance of water to the security of Singapore” (p. 42).

Future plans for NEWater will involve increasing the initial blending of 3 mgd of NEWater (about 1% of total daily water consumption) into raw water reservoirs to about 2.5% of total daily water consumption by 2011 (PUB, 2008) for the time being, until Singapore can sway public mentality in favor of direct consumption of reclaimed water. Perhaps the higher cost may be an impediment; the process of blending NEWater with reservoir water may be the most effective method. Figure 3 highlights PUB’s plans for a closed water loop using a combination of NEWater, storm water treatment and desalination, omitting the need for imported water, which would render Singapore self-sufficient.

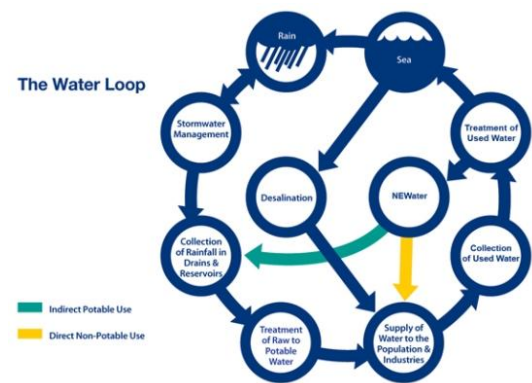


Figure 3 Source: PUB (2008)

3. MANAGING WATER DEMAND

Up until this point, the reported information has mainly pertained to the management of water supply in Singapore. However, the demand for water and the behavioral water usage patterns must be analyzed to further ascertain the true feasibility of NEWater as a component in Singapore’s future water supply strategies.

3.1 MENTALITY TOWARD CONSERVATION

Historically, Singaporeans do not hold the reputation of being a population that is proactive in terms of conservation. According to PUB, past behavior patterns must be fundamentally altered in order to

curtail the demand for water (2008). Because of the Singapore government and PUB's active presence in altering the stance on water conservation, "domestic water use per person has fallen from 165 litres a day in 2003 to 155" in 2010 (The Economist, 2010). Even though domestic consumption is trending toward a steady decrease, industrial water usage is a large source of wasted water in Singapore.

3.2 MEASURES TO CURTAIL WATER DEMAND

The Ministry of Environment and Water Resources (MEWR), as well as PUB, are working toward altering the behavioral patterns of water consumption in Singapore through a variety of sustainability measures. As Singapore's population and economy continue to expand, the demand for water can be moderated through education and persuasion, fiscal incentives and disincentives and by administrative and legislative control (Choong et al., 2009). Most notably MEWR has designed a "Sustainable Singapore" program, which is widely promoted to individuals, companies and the government alike (MEWR, 2009).

PUB is working toward the same goal through initiatives to educate the public on the realities and benefits of NEWater's role in water conservation. The survey conducted for the purposes of this report reveal that 100 per cent of respondents know what NEWater is but, of the four national taps that provide water to Singapore, 57 per cent believe desalination should be the primary source to Singapore, with only 27 per cent choosing NEWater (Figure 2). These figures demonstrate the need to further educate the public about NEWater. According to Soon (2009), if people understand the safe technology behind the production of NEWater it will lead to a greater public acceptance of recycled water.

In support of this, the intensive publicity programme promoting NEWater launched in 2002 by PUB gave a boost to the public acceptance of reclaimed water. Figure 4 above outlines a seven-step water conservation process that PUB promotes to the public. PUB must continue with these measures as well as begin to promote the use of water-efficient household appliances and water saving devices to further curtail water demand and effectively change usage patterns. The positive correlation between these educational and promotional conservation programmes and the steady pattern of decline in domestic water consumption is clearly evidenced in Figure 5.



Figure 4 - Campaign Poster created by PUB to Promote Water Conservation
Source: PUB, (2008)

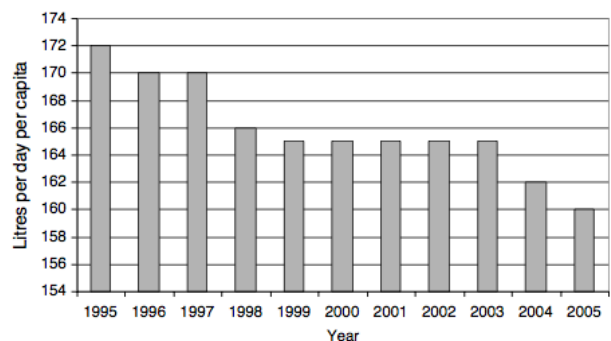


Figure 5 - Domestic Water Consumption in Singapore (1995-2005) Source: Tortajada, p. 235 (2006)

3.3 WATER TARIFFS

In a further effort to reduce the demand for water in Singapore, the government holds the option to augment taxes and tariffs on water based on supply and demand. Appendix F outlines the current tariffs on water in Singapore. When pricing water, Singapore applies a water tariff and the water conservation tax (WCT). The water tariff is explicitly set to recover the full cost of production and supply, while the WCT reflects the higher cost of alternative water supplies (Soon, 2009). The WCT is the main disincentive levied by the Singaporean government to reinforce water conservation measures.

Effective in 2000, the WCT rose from 15 per cent to “30 per cent of the tariff for the first 40 m³/month for domestic consumers and all consumption for non-domestic consumers” (Tortajada, p.234, 2006). Additionally, there is a fee for various sanitary applications and industry faces even higher charges (The Economist, 2010). Comparing the figures from Figure 5 and Figure 6, the time period when the Singapore government began raising the WCT correlates positively with the gradual decline of domestic water consumption.

These statistics demonstrate just how effective tariff and tax increases can be in moderating water demand. However, there must be a careful balance when setting taxes, because if set too high they could put national potable water supply out of reach for those inhabitants with lower income.

Water Tariff

Tariff Category	Consumption Block (m ³ per month)	Tariff(\$/m ³) [before GST]	Water Conservation Tax (% of tariff) [before GST]
Domestic	0 to 40	1.1700	30
	Above 40	1.4000	45
Non-Domestic	All units	1.1700	30
Shipping	All units	1.9200	30

Tariff Category	Consumption Block (m ³ per month)	Waterborne Fee (\$/m ³) [before GST]	Waterborne Fee (\$/m ³)* [after GST]	Sanitary Appliance Fee [before GST]	Sanitary Appliance Fee * [after GST]
Domestic	All units	0.2803	0.30	\$2.8037/- per chargeable fitting per month	\$3.00/- per chargeable fitting per month
Non-Domestic	All units	0.5607	0.60	-	-
Shipping	All units	-	-	-	-

Industrial Water Tariffs (inclusive of GST)

Tariff Category	Consumption Block (m ³ per month)	Tariff (cents/m ³)	WCT (% of tariff)	WBF (cents/m ³)
Industrial Water	All units	43	-	-

Figure 6 – Water Tariffs established by Singapore Government (2008)

Source: PUB, (2008)

4. WATER BECOMING “BLUE GOLD”

According to Siegfried (2010), the global trend of water scarcity is creating a situation where holding a definite supply of water will be a source of great economic and political power. Additionally, 72 per cent of survey respondents believe that holding a supply to clean water will become a major source of political and economical power in the future (Figure 2). The video “Blue Gold: World Water Wars” (2008), highlights just how critical this claim is becoming. The video suggests that water privatization is becoming a trend of the future with water increasingly being viewed as a commodity and a function of supply and demand, rather than a precious resource to life. Controlling water will be critical to success and large corporations are handed power when they control the resource. These companies aim to create a type of water cartel so that one day every single drop of water will be owned and controlled (Blue Gold Video, 2008).

Singapore cannot overlook these consequential facts when strategizing the future of its water supply. Particularly in the vein of the Water Agreements with Malaysia, Singapore is not secure from potential conflict and security disputes with its neighbor over water. This is one of the most alarming issues that recently surfaced in water management, not only in Singapore, but also on a global scale. The intensifying importance of water as a key to political and geographical security and power makes Singapore’s efforts to become self-sustaining all the more pressing.

According to Financial Times Columnist, John Burton (2005), “Singapore *wants* to be self-sufficient in water by 2061, when its water agreements with Malaysia expire.” It is clear that Singapore is doing all it can to become autonomous in water sourcing, not only for future capitalization on the privatization of water, but also to insure its security against Malaysia and other South East Asian nations. In support of this, Choong et al. (2009) state, “from a security viewpoint, Singapore should be as totally self-sufficient as possible in water” (p. 44). The challenge, therefore, lies in the conflicting economic viewpoint arguing that the most cost-effective water supply system should be adopted, which in fact is imported water from Malaysia.

5. IMPLICATIONS OF WATER MANAGEMENT IN SINGAPORE

5.1 BUSINESS IMPLICATIONS

As the “Blue Gold: World Water Wars” video suggests, corporations that successfully control water will hold a great deal of power that can be leveraged in business. However, it will be the responsibility of these corporations to re-evaluate the externalities they generate when controlling and commoditizing water. All industries are affected by water in one way or another due to the costs passed on to them from water suppliers. Siegfried (2010) argues that business opportunities lie in the creation of water treatment companies and water-saving devices. An example is the Singapore firm Hyflux Ltd., which specializes in reclaimed water treatment using membranes.

Hyflux is the company that currently produces NEWater in Singapore. Because of the success that Hyflux has achieved in Singapore it is planning to expand Singapore’s water industry abroad (Hyflux, Ltd, 2009). This global expansion “will test Hyflux’s ability to maintain the rapid growth that made it a favorite on the Singapore stock exchange” (Burton, 2005). Analysts remain sceptical about whether Hyflux has sufficient financial resources to compete against larger and more capital intensive international rivals such as General Electric and Siemens (Burton, 2005). Companies that take advantage of water treatment business opportunities, like Hyflux, are able to gain a competitive advantage and most likely generate a monopoly on the water reclamation processes in Singapore.

5.2 POLITICAL IMPLICATIONS

Due to the new business opportunities presented in the era of water scarcity and in Singapore’s attempts to become self-sufficient, it will be the responsibility of the Singapore Government to keep such corporations in check. The government must put firm regulations and legislation in place to monitor the amount of water they control. It will also be responsible for initiating and funding conservation programmes and implementing incentives and disincentives to conserve water and alter the public’s consumption behaviors. The PAP government is already on the right track through the application of Water Conservation Taxes and tariffs. In the future it should continue to ramp up taxes in industries where high quality water usage is highest. Evidenced below is the important role that government plays in water pricing:

Correct pricing of water has been touted as the best policy to ensure its proper use. Current pricing levels in most countries are far too low to cut down on wastage. On the other hand, high water price could lead to protests and even riots (Soon, 2009, p. 31).

Recognizing that water is essential to life, the Singapore government should also adopt a program of aid for citizens with lower incomes to ensure the entire population has access to safe drinking water. Currently the government has policies in place that provide tax rebates for 1- and 2- bedroom flats

during difficult economic times (Tortajada, 2006). In addition, the government can further assist those with lower incomes by subsidizing water supply.

In the immediate future the government of Singapore must come to a decisive conclusion whether to extend the water agreements with Malaysia. Analysis of costs and gains from self-sufficient water production should be conducted and the government must develop a long-term water strategy. It has been proved that NEWater is physically feasible, but the government must determine whether it is economically viable as well. Moreover, the government has to perform risk analysis before continuing to contract and open more NEWater treatment plants. If millions of dollars are spent on construction of new plants without a majority public acceptance of NEWater, Singapore could fall deeply into debt.

5.3 SOCIETAL IMPLICATIONS

The major societal impacts of implementing NEWater as a main measure for Singapore to become self-sustaining include difficulties in creating fundamental behavior change in water usage, overcoming the psychological barrier to consuming recycled water and, finally, having to pay higher prices for water, at least in the short-run. Reclaimed water will also have a number of positive benefits on society and can “even improve the public health and food supply” (Huebsch, *n.d.*). Mainly, the Singaporean population will have to be prepared for “continual initiatives and efforts at the community level” (Soon, 2009) in order to educate and alter their behavior patterns. In addition to increasing awareness of water conservation, energy conservation and environmental sustainability measures should also be channelled through the same processes, because of the close interaction between these global trends (Siegfried, 2010). In order to further these measures, PUB is working on initiatives to encourage residents in their constituencies to install water-saving devices and adopt good water-saving habits (Soon, 2009).

CONCLUSION

Drawing from the primary and secondary data analyzed in this report it is evident that “greater self-reliance in water is the way to go” (Onn, 2003). Singapore has ideally positioned itself to take off in the direction of complete self-sufficient water supply. The young city-state’s efforts in reducing its dependence on Malaysia for water by diversifying its sources of supply and managing demand are collectively inducing an opportunity to become entirely self-sufficient and eliminate the current threat of water scarcity. It will not only ease bilateral relations with Malaysia, but autonomous water supply through recycled water will effectively reduce the water stress Singapore is faced with.

It remains to be seen if the Singapore government will officially take on the challenge, but it is currently in the process of conducting large-scale long-term cost-benefit analyses and risk assessment to determine viability. According to the data in Figure 7, Singapore is able to produce an excess of the projected amount it requires through eliminating water imports and harnessing the three remaining national taps, which are NEWater, desalinated water and storm water collection.

Total Water Requirement for Singapore		1.2 to 1.3 million m ³
Domestic Reservoirs and Catchments (a)	0.68 million m ³	
Desalination (b)	0.40 million m ³	
NEWater (c)	0.25 million m ³	
Total: a+b+c		1.33 million m ³

Figure 7 – Major Water Sources in Singapore
 Source: Long (2002), The Straights Times, Various Issues

If Singapore is able to effectively implement wastewater reclamation as a long term, large-scale solution to water sourcing and sway its population to overcome the accompanying psychological barriers, self-sufficiency in water supply will be attainable for the small city-state. Additionally, NEWater as a

component of the autonomous water supply in Singapore will serve as an important base of political power as the country continues to grow rapidly and water becomes the new blue gold. In the future we can only wait and see what the Singaporean government decides, but one would hope that they take advantage of their thriving economic and technological capacity to tap into the most sustainable water supply process in the world to become entirely self-sufficient.

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One Country, Two Systems: The Economic Integration between Hong Kong and China

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ABSTRACT

Hong Kong has enjoyed political and economic development after being ceded over to the British in 1842. Even while being a British Colony, Hong Kong has managed to maintain an intimate relationship with China, partly due to history, culture and language similarity, and geographic proximity. This also resulted in a highly integrated economic relationship between them, even if there was no governmental intervention since the beginning. The relationship never ceased after Hong Kong was returned to China, and all the while with Hong Kong preserving its political and economic system under the 'One Country, Two Systems' policy. The introduction of the Mainland and Hong Kong Closer Economic Participation Agreement (CEPA) signifies the official start of a co-operative relationship. Hong Kong's and China's economies were able to mutually benefit from the agreement, especially for businesses in both regions. Not only was there exchange in physical goods and labour, there was also an exchange of skills and knowledge as well. CEPA was also able to bring upon a further increase in foreign direct investments into Hong Kong, benefitting the economy. Furthermore, the intention of the Chinese government in making the RMB an international currency gave Hong Kong the opportunity to further develop its position as a major international financial centre. The potential of an offshore RMB trading centre is huge and Hong Kong has been able to gain a first-mover's advantage into that market.

INTRODUCTION

On the campus of the Chinese University of Hong Kong, there stands the statue of the "Goddess of Democracy". It was at first rejected by the school authorities. However after strong student opposition towards that decision, the school authorities relented, and the statue now stands proudly in front of the University Mass Transit Rail (MTR) station. Recently, the statue received a bright red banner, congratulating Mr. Liu Xiaobo on winning the Nobel Prize. This is obviously a display of freedom of speech and democracy. Being officially a part of China, Hong Kong however has managed to preserve its political and economic system inherited from its British Colonial days. This would not have been possible were it not for the introduction of the 'One Country, Two Systems' policy.

The Hong Kong of today underwent significant transformation from the barren land it was when great kings and dynasties still ruled over Ancient China. This changed with the arrival of the Portuguese, led by Jorge Álvares, who also established a trading post in what is now Tuen Mun, Hong Kong. Even though under the rule of Emperor Qianlong during the Qing Dynasty (1644 – 1911) and the number of trading ports was greatly reduced, foreign trade still increased. It was also during that time that the Chinese view foreign trade with suspicion, thus they were reluctant to trade with the British. This also created a favourable trade balance for the Chinese, as the European market had a high demand for Chinese goods, whereas the Chinese were less interested in what the European traders had to offer. Opium was then smuggled in by the British to offset the trade situation. The Chinese government tried to curb the spread of opium within China, but failed as soon many able men were reduced to being slaves of the drug.

Tensions grew and soon the First Opium War erupted in 1839. The defeat of the Chinese resulted in the signing of the Treaty of Nanking in 1842, which is also when Hong Kong Island was ceded to the British. This will soon be followed by a number of treaties in 1860 and 1898 whereby Kowloon and the New Territories were also ceded to the British.

After being ceded over to the British, Hong Kong has benefitted a lot through the economy and political reforms introduced, becoming a major trading port for the British in the Asian Pacific region. It has also developed a significant manufacturing industry, with clothes and textile production being a major motivator of the economy. Due to Hong Kong sharing similar ancestry and roots with Mainland China, Hong Kong was highly affected by things happening in China. The economic reform in China during the 1980s opened up the Chinese market, and many manufacturing firms in Hong Kong relocated their factories to China to take advantage of the lower labour wages. Nevertheless, many still chose to have their service-related portion of the business remaining in Hong Kong. This caused the service industry to take hold of Hong Kong and to transform Hong Kong into mainly a service industry country, and also a major financial centre.

Colonial Hong Kong underwent major development, facilitated by Hong Kong's role as a main entrepôt for the Asian Pacific region. British rule in Hong Kong halted for a few years during World War II when the Japanese overtook it. This signalled the start of a miserable period that lasted '3 years and 8 months' for the Chinese in Hong Kong. Hong Kong experienced hyper-inflation under the Japanese Occupation. After the Japanese surrendered, only then did the British regain sovereignty over Hong Kong. Under British colonial rule, decisions made in London were implemented in Hong Kong through a selected British Governor.

The start of the 20th century also marked the start of the decolonisation movement by the European powers. The movement ended in 1997 with Hong Kong being returned to China. Many concerns were raised regarding the handover. After so many years of being governed by the British, Hong Kong had developed a highly dissimilar economy and political system from Mainland China. These concerns were addressed when Deng Xiaoping proposed the idea 'One Country, Two Systems', guaranteeing that Hong Kong will retain their current economy and political system after the return and it will remain unchanged for 50 years (Welsh, 1997).

In fact, most of the concerns were proved incorrect, especially under the 'One Country, Two Systems' policy. For one, Mainland China was developing fast after its economic reform in the 1980s. Hong Kong was able to take advantage of this fact by still having retained its capitalistic economy. On top of that, Hong Kong's close ties with China allowed it to perform the role of 'gateway to Mainland China'. This is also partly due to the fact that Hong Kong shared many similarities with Mainland China. A majority of the population in Hong Kong are Chinese, who have their ancestry roots in China. They also share a similar language and culture, assisting the building of strong business networks between the two regions. This paper serves to analyze this relationship, with focus on the signing of the Closer Economic Partnership Agreement (CEPA) and the recent announcement by Beijing to make Hong Kong into an off-shore Renminbi (RMB) trading centre. Furthermore, the significant impacts and implications for local businesses and international firms will also be highlighted in this paper.

1. MAINLAND CHINA AND HONG KONG CLOSER ECONOMIC PARTICIPATION AGREEMENT (CEPA)

On 29 June 2003, the Mainland China and Hong Kong Closer Economic Participation Agreement was signed. This represents a momentous occasion for both Hong Kong and China. CEPA's main objective is to promote free-trade between the two regions, and it mainly covers 3 areas: 1) Trade in Goods; 2)

Trade in Services; and 3) Trade and Investment Facilitation (Trade and Industry Department of Hong Kong, 2008).

1.1 TRADE IN GOODS

Under CEPA, goods that are listed and certified as 'Made in Hong Kong' will be exempted from any tariffs upon entering China. As of 31 May 2010, there is a total of 1,592 goods listed (Trade and Industry Department of Hong Kong, 2010). For Chinese exporting firms located in Hong Kong, they will have to acquire a 'Certificate of Hong Kong Origin – CEPA' for their goods in order to enjoy the tariff preference. Those firms also have to have a 'Factory Registration' issued by the Trade and Industry Department before they can acquire the 'Certificate of Hong Kong Origin – CEPA' (Trade and Industry Department of Hong Kong, 2008).

Table 1: Hong Kong's external trade with Mainland China (HK\$ Million)

Year	Imports	Domestic Exports	Re-exports
2000	714,987	54,158	488,823
2001	681,980	49,547	496,574
2002	717,074	41,374	571,870
2003	785,625	36,757	705,787
2004	918,275	37,898	850,645
2005	1,049,335	44,643	967,923
2006	1,192,952	40,268	1,115,941
2007	1,329,652	40,610	1,267,722
2008	1,410,735	34,758	1,335,687
2009	1,249,374	26,672	1,236,577

Source: Census and Statistics Department of Hong Kong

A reduction in tariffs serve as an incentive for firms to export their goods to Mainland China, for now they will have an increase in their profit margins. This is the first and most obvious benefit of CEPA. Figures provided by the Hong Kong Census and Statistics Department in Table 1 above clearly showed an increase in the total imports and re-exports to Mainland China, especially for re-export in 2003, the only exception being 2009 which can be explained by the overall decrease in global consumption resulting from 2008-2009 financial crisis. The figures also established the fact that Hong Kong has a competitive advantage in providing higher added value business activities. This can be seen from Table 2 below whereby raw materials and semi-manufactures consist of an average of 36% of its total imports.

Table 2: Hong Kong Imports by End-use Category (HK\$ Million)

Year	Foodstuffs	Consumer goods	Raw materials and semi-manufactures	Fuels	Capital goods
2000	3.84%	33.91%	35.01%	2.05%	25.19%
2001	3.85%	34.30%	32.61%	1.94%	27.30%
2002	3.65%	33.54%	34.46%	1.93%	26.41%
2003	3.23%	31.89%	36.24%	1.96%	26.68%
2004	2.85%	29.93%	38.14%	2.30%	26.78%
2005	2.63%	29.10%	37.31%	2.60%	28.36%
2006	2.52%	26.82%	38.20%	2.85%	29.62%
2007	2.69%	26.58%	38.31%	3.07%	29.35%
2008	3.20%	26.80%	36.13%	3.69%	30.18%
2009	3.94%	25.63%	36.47%	3.34%	30.63%

Source: Census and Statistics Department of Hong Kong

The data in the above tables is indicative of the fact that Hong Kong imports raw materials from China, which are then processed and re-exported to China.

China undertook major economic reforms in the late 1970s. By opening its doors, it has caused a major exodus of labour intensive production processes from Hong Kong to China. This is due to the fact that firms want to take advantage of the lower labour and production costs in China. However this did nothing to decrease Hong Kong's competitive edge, and in fact led Hong Kong into transforming itself into the Hong Kong it is today. While the relocation of Hong Kong's manufacturing sector caused unemployment problems, it has also allowed firms to focus more resources on higher value added-business processes, such as accounting, finance, management, or even manufacturing activities that require higher labour skills (Tao & Wong, 2002).

The British colonization enabled Hong Kong to develop a higher skilled labour pool, through modernization and exchange of knowledge. On top of that, Hong Kong has better intellectual property rights protection when compared China, again the inheritance of its British colonial ruler. Combining all of these elements, Hong Kong became the best environment for businesses that require higher skills and knowledge to thrive, for example, watchmakers (Chiu, 2006). The move of labour intensive businesses processes to China created a metaphorical 'bridge' or business network connections between firms in Hong Kong and their Mainland associates, allowing it to play the role of the intermediary between China and the world (Tao & Wong, 2002). Also, due to its history of culture and economic relationship with China, Hong Kong was able to maintain an informal network of friends and relatives that facilitate the emergence of more business relationships between the two regions. The geographic proximity of Hong Kong with China also helps to ease the transfer of resources between the two regions.

This state of affairs should not be ignored by overseas firms interested in entering the growing Chinese market. Additionally, Hong Kong's unique blend of Eastern and Western culture is another added competitive advantage for Hong Kong playing the role as 'gateway' to China. Moreover, the business environment in Hong Kong is closer to the Western model due to the long period governed by the British. For this reason alone, foreign corporations may find it more comfortable setting up in Hong Kong or partnering with a local firm, and reduce their risk. Therefore it is not surprising that Hong Kong is the top choice for foreign companies interested in setting up their Asian headquarters (Meyer, 2008). A recent study by HSBC (2010) indicated that China is the top choice by US mid-sized firms for long-term prospects. Those firms can take advantage of this bond between Hong Kong and the People's Republic of China (PRC) and also CEPA to explore further opportunities and prospects for growth in the fast-emerging Chinese market.

1.2 TRADE IN SERVICES

While the trade in goods portion of CEPA emphasizes the free trade for physical goods and manufactured products, the trade in services portion gives focus to the transfer of 'juridical persons' and 'natural persons' between Hong Kong and China. 'Juridical persons' consists of companies, partnerships and sole proprietorships, while 'natural persons' refers to any citizens of Hong Kong (Trade and Industry Department of Hong Kong, 2010). CEPA allows access to the listed service sectors shown in Table 3 (Trade and Industry Department of Hong Kong, 2010).

Beijing has goals to make the service sector a major contributor to China's GDP. Currently, the service industry contributes to only 40% of China's GDP (National Bureau of Statistics of China, 2009), whereas it is closer to 70% or more in other advanced economies (Commerce, Industry and Technology Bureau,

2007). Therefore, it can be expected that China's service sector to grow even further in the near future. This represents a huge market potential.

Table 3: List of Service Sectors for CEPA

▪ Accounting	▪ Photographic
▪ Advertising	▪ Placement and Supply Services of Personnel
▪ Air Transport	▪ Printing
▪ Audiovisual	▪ Public Utility
▪ Banking (Updated)	▪ Rail Transport
▪ Building-cleaning	▪ Real Estate
▪ Computer and related services	▪ Related Scientific and Technical Consulting Services
▪ Construction and Related Engineering	▪ Research and Development
▪ Convention and Exhibition	▪ Road Transport
▪ Cultural	▪ Securities and Futures
▪ Distribution	▪ Services incidental to Mining
▪ Environmental	▪ Services related to Management Consulting
▪ Freight Forwarding Agency	▪ Social Services
▪ Individually Owned Stores	▪ Specialty Design
▪ Insurance	▪ Sporting
▪ Legal	▪ Storage and Warehousing
▪ Logistics	▪ Technical Testing, Analysis and Product Testing
▪ Management Consulting	▪ Telecommunications
▪ Maritime Transport	▪ Tourism
▪ Market Research	▪ Trade Mark Agency
▪ Medical	▪ Translation and Interpretation
▪ Patent Agency	

Source: Trade and Industry Department of Hong Kong

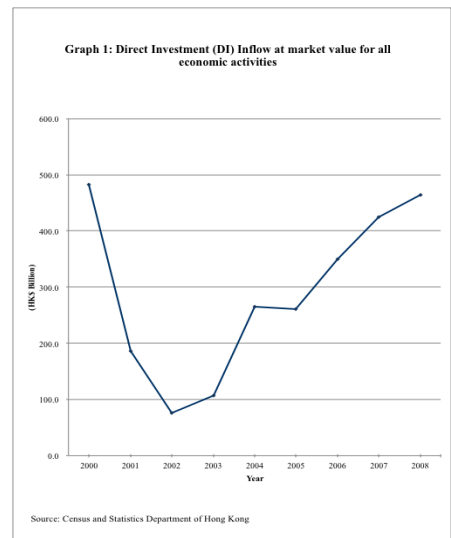
A further liberalization under this area in CEPA is the mutual recognition of professional certificates from both regions. Professionals who have already acquired the relevant certificates from their relative issuing boards in Hong Kong and is approved under CEPA, will be able to also provide their services in Mainland China, and vice versa (Trade and Industry Department of Hong Kong, 2008). Removing unnecessary steps and regulations for service providing professionals in both regions will help with the exchange of skills and knowledge between China and Hong Kong. In fact, the high level of exchange of information, human resources, and capital is unprecedented in the world, and mainly due to the unique relationship that Hong Kong and China shared (Fu, 2003). Chinese firms benefit from Hong Kong's management expertise, while Hong Kong benefits from China's growth. This is especially true in recent years as China starts to emerge as a major global economic power. Therefore foreign firms should know to take advantage of this bilateral flow of resources.

1.3 TRADE AND INVESTMENT FACILITATION

Co-operation in ten areas of economic development were agreed upon by both parties under CEPA. One area that stood out was the co-operation of Small and Medium Enterprises (SMEs) (Trade and Industry Department of Hong Kong, 2010). SMEs are the focal point in economic development, especially for the case of Hong Kong where SMEs constitute 98% of the business establishment in Hong Kong (Trade and Industry Department of Hong Kong, 2010). This is due to the potential benefits that they bring, for example, employment opportunities, supply base for large firms, source of innovative and new industries or areas of business (Pollard, 2005). However according to Pollard (2005), it falls short in the determination of the implementation process. It is important to provide support for SMEs to ensure their viability, as they are an important source of employment opportunities.

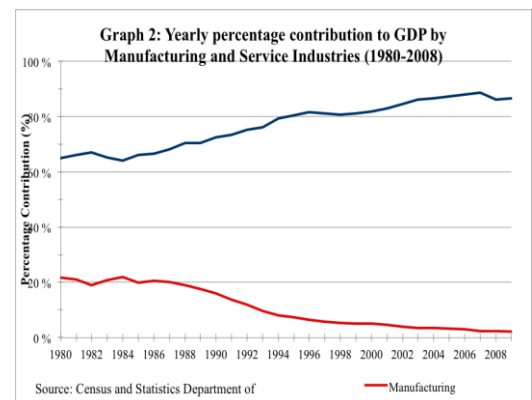
While at first glance CEPA seems to only benefit local Hong Kong firms, especially with the requirements needed to be fulfilled to enjoy the benefits, it however opens up another new opportunity for Hong Kong as an attractive place for foreign direct investments (FDI). Firms interested in taking advantage of CEPA but do not fulfill the requirements can think of partnering with or investing in local Hong Kong firms, as CEPA is “nationality blind” and many firms seemed to have done that (Hong Kong SAR Government, 2010). As shown in Graph 1 below, the total amount of direct investment flowing into Hong Kong has increased after the introduction of CEPA in 2003. However this did not continue into 2005 due to the Severe Acute Respiratory Syndrome (SARS) outbreak in 2004. Nonetheless, FDI picked up after 2005 and has continued to increase well into the year 2008. Due to the importance of SMEs to the local economy, it is important to give more support for them, as mentioned above. CEPA will also be able to introduce FDIs into local SMEs, representing an opportunity for them to be exposed to the global economy, enhancing their competitive advantage.

Another point to take note of is Hong Kong’s logistics capabilities, especially for firms interested in manufacturing in Hong Kong to take advantage of its highly-skilled labour workforce. Hong Kong has been operating as a free port and has traditionally been an important trading port for the British. On top of that, the construction of the Hong Kong-Zhuhai-Macau Bridge will also reduce transportation time between Hong Kong, Macau and Mainland China from 3 hours to half an hour (ARUP, 2010). The Guangzhou-Shenzhen-Hong Kong Express Rail Link will also ease transportation time between Guangzhou, Shenzhen and Hong Kong (Hong Kong SAR Government, 2009). The construction of those two transportation systems is set to further increase the economic integration between Hong Kong and Mainland China. The increased flow of people into both regions will mean that there will be an increase in services demanded as well, and this represents an opportunity for the small and medium enterprises (SME) especially.



1.4 CEPA AND HONG KONG’S ECONOMY

Ever since China opened up its market, the close relationship with Hong Kong has with China allowed it to become a service-oriented industry. This is due to Hong Kong’s relatively higher labour wages compared to China. While CEPA promotes zero-tariffs trade for ‘Made in Hong Kong’ goods and to also attract international manufacturers interested in selling their goods in China to produce in Hong Kong (Chiu, 2006), it did not help to improve Hong Kong’s manufacturing industry. As seen in Graph 2 below, ever since the 1980s, the manufacturing industry percentage contribution to GDP has steadily decreased while the service industry increased.



The huge Chinese consumer market remains a very attractive option for businesses. However it seems that the reduction in tariffs is not enough to offset the difference between Hong Kong labour wages and productivity with China, resulting in the ever declining manufacturing sector in Hong Kong. On the other hand, for goods that require a higher level of skills,

such as watches, Hong Kong still has the upper hand (Chiu, 2006). Nevertheless, the return of higher value-added manufacturing firms to Hong Kong is still not significant enough to see Hong Kong return to a pre-1980s situation.

With the eventual opening up of the vast Chinese market, foreign firms taking advantage of CEPA to enter China, using Hong Kong as a stepping stone, will now have gained some form of competitive advantages over other firms. Once China fully opens up, they would already have gained a better understanding of the Chinese market, an established presence and also valuable business networks, or a first-mover advantage. Latecomers will find it hard to compete against those foreign firms already established in China, be it through partnership or FDI investment in a Hong Kong firm.

On the other hand, according to Krugman (2009), a bigger market size implies that there will be more firms and more sales per firm. It would also mean that consumers now have a greater variety of products to choose from, and not to mention, lower prices. Comparatively, the Hong Kong market is marginally smaller when compared to the Chinese market. If we consider that the size of the population is equivalent to the size of the consumer market, then the Chinese consumer market will roughly be around 1.3 billion people, while Hong Kong has 7 million people (CIA, 2010). In other words, the Chinese consumer market is almost 190% larger. CEPA will be beneficial to the overall economic development of the two regions, for it opens up a bigger market which will support more firms. On the other hand, due to the increase in the number of firms and higher competition, consumers in both Hong Kong and China will now be able to have a greater variety of products and lower prices.

One main concern for firms interested in entering the Chinese market might be about the availability of funds. Doing business with China would mean that the preferred currency of exchange will be in RMB. However, the lack of a proper RMB settlement facility in Hong Kong could act as a deterrent. On top of that, there is a lack of RMB financial instruments for corporations to raise funds in RMB. While CEPA encourages the economic and business integration between Hong Kong and China, and that Hong Kong can benefit from inward direct investments, it is important that firms have easy access to RMB fund, which will further increase the effectiveness of CEPA.

2. HONG KONG'S ROLE AS AN OFFSHORE RENMINBI (RMB) TRADING CENTRE

Historically, there is no existing official RMB settlement channel between Hong Kong and China. Exchange of RMB in Hong Kong was limited only to cash, and most currency exchangers have to physically carry RMB cash over to Mainland China to be deposited into a Chinese bank account. The opening up of China and CEPA also encourages the flow of Chinese tourists into Hong Kong (Chiu, 2006) which would mean an increase in foreign spending in Hong Kong. The absence of a proper mechanism to redirect the RMB back to Mainland China usually discourages people from spending too much in Hong Kong. Additionally, there is an active market of RMB business in Hong Kong and the sum may be huge, but its activities are limited and it is also regarded as a 'grey market' (Fu, 2003).

In terms of trade, only 1% of Chinese trade is denominated in RMB, and given that the volume of Chinese trade is not small, that other 99% also represents a significant size. All businesses, be they international or based in Hong Kong and Macau, have to convert their local currencies into US dollars when settling import trade with Mainland China. Chinese exporters then convert those US dollars into RMB. This whole process incurs more transaction and conversion cost, representing smaller profit margins. Firms also suffer more foreign exchange risk. This also means that the Chinese traders have a stronger reliance on the US dollar as trade payments (McMahon, 2010). This is not something that Beijing wants especially when they are planning to make the RMB an international currency (Daniel, 2010). As a result in 2003, a memorandum was signed between the Hong Kong Monetary Authority

(HKMA) with the People's Bank of China (PBOC), signalling the start of a cooperative relationship between them to transform Hong Kong into a major offshore RMB trading centre.

2004 marked the beginning of a pilot RMB business program in Hong Kong. Participating Hong Kong banks are now able to offer RMB deposit, remittance, exchange and credit services for personal customers (Fan, Leung & Yim, 2010). The memorandum also established the People's Bank of China (Hong Kong) as an official settlement facility for RMB circulating in Hong Kong, and the RMB funds are deposited back into a capital account back in Mainland China. Additionally, consumers from Mainland China did not have a limit on their credit/debit card spending in Hong Kong, and the same applied to ATM withdrawals. Banks were also allowed to directly deposit RMB into a deposit account for remittances (Fu, 2003). The pilot program was further expanded in 2005 to seven designated service industries, including retail sales, beverage and transports, allowing them to open RMB deposit accounts. In 2006, another relaxation in regulation came, allowing Hong Kong residents to open RMB cheque accounts (Fan, Leung & Yim, 2010). A regulated market was established which paved the way for Hong Kong to become the first offshore RMB trading centre. This has been the case when in 2007 the Chinese government started allowing Chinese banks in Hong Kong to issue Renminbi within annual quota restrictions. While still requiring official approval for remittances back to Mainland China, it represents an opportunity for retail investors in Hong Kong to finally raise RMB funds officially (Russell-Walling, 2010).

The further freeing up of regulations in July 2009 came as further good news for participating banks and businesses in Hong Kong. They were able to perform RMB transactions with businesses located in Shanghai and four other Chinese cities in Guangdong without needing approval of the Chinese government. Then in February 2010, banks in Hong Kong were allowed the freedom of determining the use of their RMB funds with the condition that the funds will now flow back to Mainland China (Fan, Leung & Yim, 2010). What this means now is that any party eligible to issue bonds in Hong Kong will now be able to issue RMB denominated bonds, so long as the funds raised will not be sent back to a Chinese account. More recently in June 2010, the plan introduced in July 2009 expanded to include 20 provinces in China and international banks. What is more is that the scope was also extended to include services and current account items when it previously only allowed cross-border transaction in goods (Russell-Walling, 2010). This came as good news to businesses and banks that were interested in participating in the Chinese market. Despite the fact that CEPA encourages economic integration, it is still lacking in the finance area. The freeing up of offshore RMB regulations attempts to cover this area.

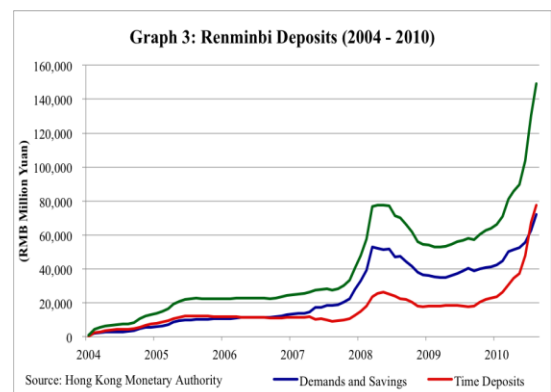
One might ask, what will be the purpose of raising RMB funds when they are not able to utilize it in the Chinese market, referring to the relaxation of regulations introduced in February 2010. However, this step should be viewed as an experimental step Beijing is taking. China would not want to run the risk of liberalizing the RMB too soon and too fast, or even before the financial system is fully developed to handle the kind of risks and shocks that come with freeing up a currency. In the views of the Chinese government, it would ideally be the best to only take small steps and see how the market reacts to it before taking the next step. It will also allow the domestic financial market more time to adapt to the increase in market demand. On the other hand, for firms to be able to utilize this fund back in the mainland is not at all that hard. All it needs is governmental approval for remitting those funds back to China. Once a firm is able to gain the approval from the central government, it will be good for them to use that fund for business activity in China (Russell-Walling, 2010). It can also be predicted that once the RMB becomes fully convertible, it will be a less troublesome process, and the full convertibility of the RMB is only a matter of time. It will be better for firms to take advantage of this right now, when the market is still in the beginning stages.

2.1 CHINA, HONG KONG AND THE RENMINBI

Beijing is determined to raise the RMB's status to a level equivalent to the US dollar, a major international currency. However, it is also important that this process is not happening too fast, as it will overwhelm the market, and could potentially cripple the market should it not have the proper facilities and preparation to handle such a sudden surge in demand. Hong Kong is in fact acting as a testing facility for Beijing, taking advantage of the unique 'One Country, Two Systems' policy that allowed Hong Kong to retain its capitalistic market. The world in its entirety is a capitalist market, while China is operating under a socialistic system. By using Hong Kong as a testing ground, Beijing can keep a close eye on market developments and respond to issues effectively, making any necessary adaptations to their policy. Conversely, as long as the 'One Country, Two Systems' policy is in effect, Hong Kong still does not have full control over its destiny. No matter what, Hong Kong is still considered part of the sovereignty of China, and what is more, the intimate relationship both shared results in Hong Kong having most of its political and economic development highly influenced by China. Beijing's determination in being a true participant in the global market is undeniable. Even now, China is already a formidable global economic power, unlike its status pre-reformation. Once again, as with the economic integration under CEPA, this relationship is a mutually beneficial one. The growing Chinese market however represents a threat to Hong Kong's position as a leading international financial centre as well. Financial analysts are predicting the rise of Shanghai and Shenzhen that will come to compete with Hong Kong as the leading financial centre in the Asian Pacific region. In fact, it is the goal of China's State Council to develop Shanghai into a global financial centre by 2020 (Cheng, 2010). Still, as Hong Kong financial institutions gain more experience in this area, the regulators in Beijing are also gaining experience at the same time (Cheng, 2010).

Hong Kong is a well-established international financial centre, and China would stand to benefit to utilize this in their plan of making the RMB a major international currency. To begin with, Hong Kong is a well-known international financial centre, and it has recently been ranked third on the Global Financial Centre Index, after London and New York (Z/Yen, 2010). Secondly, Hong Kong has the necessary knowledge and workforce in the financial sector. Hong Kong also stands to benefit from China as well. In fact, the Hong Kong Hang Seng Index enjoyed the fastest comeback post-financial crisis in 2008 to 2009, raising 52 percent (Cheng, 2010).

Yet a major obstacle that must be solved beforehand is the issue of RMB liquidity in Hong Kong. So far all those measure introduced by the HKMA and the People's Bank of China should be able to raise the level of RMB liquidity in Hong Kong, which should then facilitate Hong Kong's role as an offshore RMB trading centre. Being a Special Administrative Region of the People's Republic of China, Hong Kong is allowed to have its own currency, the Hong Kong dollar. The increasing importance of the RMB and Hong Kong's role as an off-shore RMB trading centre might slowly erode the importance of the HKD in Hong Kong, as many believe. However it is important to note that the RMB will gain popularity in Hong Kong due to increase trade between China and the preferences of businesses in using RMB as the main trading currency to decrease transaction costs. In fact, ever since Beijing started loosening up on off-shore RMB regulations in Hong Kong, the amount of RMB deposits in Hong Kong increased significantly towards the end of 2007 (see Graph 3). This was however slowed down by the global financial crisis in the second half of the year 2008. Slowly in 2009 and 2010, it has picked up its pace, increasing evermore after the change in regulations in June 2010.



2.2 FURTHER RMB MARKET DEVELOPMENTS IN HONG KONG

On August 19, 2010, a change in regulation came again, and now participating banks in Hong Kong were allowed to invest their RMB in both the on-shore and off-shore bond markets (Wright, 2010). This move had big implications, especially for businesses in Hong Kong. What was previously limited only to retail investors now became open to the bigger corporations. Furthermore, this also acted as an encouragement for businesses in Hong Kong to accept RMB as well, making RMB less of a one-way trade settlement instrument. This is because corporations in Hong Kong now have more options in using their RMB besides saving it in a RMB deposit account. They are now able to invest that money and gain some return on it. In October, ICAP and Thomson Reuters started to allow the RMB to trade on their electronic-trading platforms, only limited by the size of RMB pool circulating in Hong Kong (McMahon, 2010). This move represented another step in making the RMB a major international currency, and with the entry of ICAP and Thomson Reuters, it meant that interest rates and trading amounts were now to be freely available. The more information the market has, the more efficient it becomes.

The next obvious step for Hong Kong and China to take advantage of this fledging offshore RMB trading centre is to further relax regulations on the use of the RMB, especially in Hong Kong. This will allow banks and financial institutions the freedom to offer more variety of RMB denominated securities and investment products, attracting more investors. CEPA acts as encouragement for foreign firms to set up in Hong Kong and trade with the Mainland Chinese market. However, should the number of MNCs increase its presence in the region, there will also be a rise in demand for better financial management strategy, especially for the RMB which will be a major currency used. This represents a business opportunity for banks in Hong Kong to start coming up with innovative and efficient financial instruments for the increasing number of corporate clients.

CONCLUSION

The relationship between Hong Kong and China has come a long way, so has the political and economic development of both regions. It has gone off into separate directions at the beginning, but has slowly come together ever since China's economic reform. Hong Kong, while being a major international financial centre, is still highly affected by China. The financial crisis of 2008-09 shows this exactly. The overall decrease in global consumption affected Hong Kong greatly for it is a major entrepôt of the world. However, the decrease was offset by the economic growth in China that shows no signs of slowing down, having being only marginally affected by the downturn.

The introduction of CEPA, China's entry into the World Trade Organization (WTO) and most recently, the move to make Hong Kong into a major RMB offshore trading centre, indicates the desire of the Chinese central government to slowly transform China into a global economic power. Further loosening up of regulations can be expected, and if recent trends are indicative of the future, the pace is likely to pick up as well. Therefore, it is important that businesses in the Asian Pacific region, or even all over the world, to realize this and take advantage of it. By gaining first-mover advantage, firms will be able to unlock the hidden potential of the emergent Chinese market.

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Achieving a Sustainable Competitive Advantage through People: AB InBev's Performance Culture

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ABSTRACT

The rapid growth of globalization and the subsequent increase in international competition have resulted in a number of companies searching for new sources of competitive advantage. There is much research on how firms can utilize their human resources in differentiating themselves from their competition, yet many of these companies still see their employees as expendable resources. This research paper identifies several competitive strategies, competitive advantage models and human resource practices that can have a significant impact on employee and organizational performance. Specifically, I will look at why international conglomerates should use their organizational culture and human resource policies to achieve a sustainable competitive advantage through their employees. AB InBev, headquartered in Belgium and the largest beer company in the world, will be used to exemplify the benefits of utilizing a firm's workforce in achieving organizational effectiveness. The company has been able to recruit, develop and train a highly competent workforce that is committed to the organization and its goals. They have also created a corporate culture that has catapulted them to the top of the industry; a performance that has not been matched by their major competitors. This paper will ultimately conclude that developing a sustainable competitive advantage through people is necessary for long term success and lists important criterion that managers should apply when developing their human resource strategy.

INTRODUCTION

AB InBev is a company that has always differentiated itself on two platforms: the competence and skill of their employees and a deep cost effective culture. The workforce is seen as their main source of maintaining a sustainable competitive advantage and the driving force behind AB InBev's successful beer brands around the world. The company uses cost effectiveness to stay ahead of its competitors, re-inject freed resources within the organization and fund future expansions. AB InBev uses these two components to create massive changes in newly acquired companies, achieved through the fundamental restructuring of the company's internal composition and culture.

History of Beer in Belgium

Beer is the first alcoholic beverage known to civilization, which can help explain humankind's fondness of the drink. The brewing of beer has a rich history and can be traced back more than ten thousand years to the time of the Sumerians and Babylonians, where the privileged in society offered it to the gods (AB InBev, 2010c). As time passed, the popularity and integration of beer into modern civilization grew considerably. Nearly every culture has developed their own particular beer using different grains, climates and brewing techniques native to their region.

Beer was introduced in Belgium around two thousand years ago, when women in the cottage industry started the brewing of barley beer. The church took control of Belgium after the fall of the Roman Empire and the monks set up breweries in every abbey. This tradition is carried on today by the extremely popular Trappist Monks in Flanders: their beer has been named the best in the world (Castle, 2005). There are approximately 125 breweries in the country, ranging from small microbreweries to international conglomerates. Beer is deeply embedded in Belgium pop culture; many residents have strong feelings and take great pride in their prestigious brewers (Miller, 2010). In the past decade, beer companies in Belgium have become global leaders in the industry. The largest beer company in the world, which is headquartered in Leuven, is AB InBev.

History of AB InBev

AB Inbev's roots can be traced back to the Den Hoorn Brewery in Leuven, which began making beer in 1366. Den Hoorn was acquired by Sebaastian Artois in 1717 and the company name was changed to Artois. Artois was a privately owned company held for centuries by a local family, the De Spoelberch Clan (AB InBev, 2010c).

The firm's domestic expansion began in 1954, soon followed by international mergers with breweries in the countries surrounding Belgium. Artois had developed an effective multi-brand strategy by buying competitors, yet retaining the subsidiaries' divergent cultures and brands, a strategy that is still used today. The year 1995 marked Interbrew's entrance into the highly competitive North American market through the acquisition of Labatt, a major Canadian brewer (AB InBev, 2010c).

In a few short years, the company transformed itself into one of the largest beer companies in the world. Their strategy was to operate as a local brewer in every country by decentralizing power and decision making. The company took advantage of their international presence by recruiting and hiring the best employees around the world.

The beer industry was consolidating fairly rapidly at this point due to the effects of globalization and increase in competition. To continue their sustainable growth, Interbrew invested heavily in their employees while increasing its cost effectiveness throughout their operations. In 2004, Interbrew and AmBev (Brazil) merged, creating the world's second largest brewer: InBev (AB InBev, 2010c). The deal brought together centuries of brewery experience with a highly successful Brazilian executive team; the merger created enormous potential for the company. They began refining their corporate culture: aggressively reducing costs while attracting the world's best and brightest people.

On November 18th, 2008, InBev acquired Anheuser-Busch in a hostile takeover. The deal was highly leveraged, valued at fifty two billion USD. Carlos Brito, current CEO of AB InBev, said "[by] bringing together these two great businesses, we created a stronger, more competitive global company...we look forward to leveraging the operational and cultural strengths of both companies" (AB InBev, 2010d). AB InBev is now the largest brewer in the world. They have managed to make it to the top of a very aggressive industry through their cost effectiveness and performance culture.

The following is an analysis of AB InBev and how they have used their workforce in producing a sustainable competitive advantage. I will use Porter's theory on competitive strategy to illustrate how the company is able to defend its positioning in the highly aggressive beer industry. CEO Carlos Brito's performance culture illustrates the importance of having a good executive team and strong leadership. His performance culture is broken down using Jeffery Pfeffer's (1994) sixteen practices for achieving a competitive advantage through people and why they are effective in building a strong organization. The recruitment, training and development programs of AB InBev are explored in depth; they are the

foundation of their human resource (HR) policies. Finally, I will use the Harvard Model (Beer, Walton and Spector, 1984) to demonstrate the importance of using short term measurement tools in achieving long term success.

1. PORTER'S COMPETITIVE STRATEGY

The beer industry is extremely competitive, with competitors ranging from small microbreweries to a number of large international conglomerates. In recent years, success has shifted from depending solely on financial or technology resources to the utilization of human capital. Human assets are a key source of competitive advantage because their causal ambiguity and systematic information make them inimitable (Barney, 1991). Success in this highly aggressive industry now depends on a firm's ability to innovate its current processes in order to produce a competitive strategy.

Porter defines an organization's competitive strategy as "the positioning of a company in its competitive environment" (Porter, 1985). There are five competitive forces which play a major role in AB InBev's ability to succeed in the beer industry. Figure 1 illustrates the five forces that AB InBev has to contend with. While the collective strength of these five forces determine the performance levels of AB InBev, Porter noted that a business can develop a sustainable competitive advantage by following a cost leadership strategy. This does not simply mean cutting production and manufacturing costs, but involves additional investments in employee skill and development in order to make the workforce more efficient (Porter, 1985).

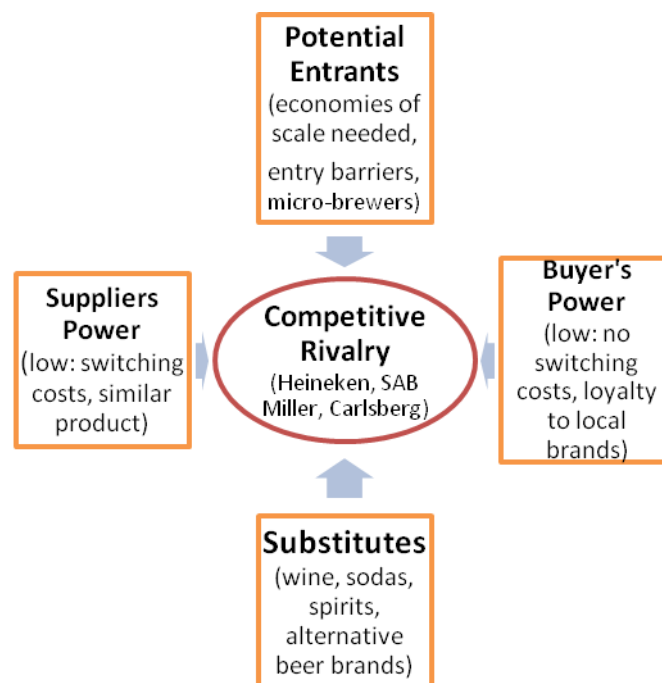


Figure 1 – AB InBev's competitive positioning using Porter's five forces model (Porter, 1985).

I had the pleasure of talking with Al Mitschke, who has worked with Labatt¹ for 29 years. He was the Director of Sales for the Labatt's Western Region before he decided to step back to the regional sales position. His comments reinforce Porter's thoughts on producing a competitive advantage through cost leadership and employee skill development. While discussing AB InBev's strategies, he said:

¹ Labatt has been a subsidiary of AB InBev since 1995.

“The second platform [competitive advantage] is the people side: it’s called zero based budgeting, and they [AB InBev’s management] apply it in strict science. You need to justify from the bottom up all your costs. I’ve never been in a culture where you’ve had to justify your internal costs so religiously, so the company can strategically allocate those resources to people, sales and marketing” (Mitschke, 2010a).

AB InBev has been able to successfully implement a cost reduction strategy, simultaneously developing its human resources and employee capabilities. The organization has innovated the process of selecting and recruiting future employees, thereby creating a unique improvement. Main competitors, such as Coors or SABMiller, have difficulty replicating AB InBev’s processes and its employees’ attitudes, competencies and skills (Exame, 2009). This results in a sustainable competitive advantage. AB InBev has been able to differentiate itself from its major competitors through Carlos Brito’s performance management.

2. PERFORMANCE CULTURE

In order to truly understand the success behind the world’s largest beer company, one does not need to look far. The forces that have moved the company through centuries of historic and cultural evolution are the same ones that are contributing to the accomplishments of AB InBev today: the people. The monks demonstrated the importance of passion, hard work and dedication in crafting quality beer in Belgium hundreds of years ago. This is a tradition the employees at AB InBev carry forward throughout the world. AB InBev has created a performance culture for all of its employees and expects them to follow the standards set by the executive management. The performance culture at AB InBev and the factors influencing it are graphically represented in Figure 2 below.

Carlos Brito (CEO) has created a performance culture at AB InBev to manage the approximately 116,000 employees under his direction (AB InBev, 2010c). A strong leader, his culture provides individuals with a sense of purpose and direction within a larger organization. It impacts what they should do, how they behave, their values and personal performances. It also influences their attitudes and actions within a company. According to Hofstede (1980), culture has two basic meanings: First, it is a way of civilization where peoples’ minds are trained or refined; second, culture is a collective way of thinking, feeling and acting. It is a ‘collective programming of the mind’ (Hofstede, 1980). The practices at AB InBev follow Hofstede’s definition of culture as they actively seek to guide their employees to a common purpose. The aggressive training and development program established around the world is where the company is able to educate its employees on their individual roles; the second function is meant to instil a sense of unity within each worker. AB InBev uses three key elements to achieve their collective goal: dream, people and culture (AB InBev, 2010a).



Figure 2 – Performance culture at AB InBev.

The three pillars of AB InBev support the company and its goal to continually attract, hire and retain a competitive work force. Mr. Brito told a group of Chinese students in 2007 that, “People are the most valuable assets of our company and our long-term competitive advantage. With faith, we have built diversified ways of talent employment and we keep optimizing our talent pipeline” (CEIBS, 2009a).

The next section will focus on AB InBev's HR practices and policies and how they contribute to its competitive advantage and overall effectiveness. I will use Jeffery Pfeffer's principles of effective management to demonstrate how closely Carlos Brito follows strategic human resource management.

3. COMPETITIVE ADVANTAGE & JEFFREY PFEFFER

In 1994, Jeffery Pfeffer released an article titled *Competitive Advantage through People*, which presented sixteen practices that should be used for achieving competitive success and enabling firms to realize the true potential of their workforce. Essentially, this is done by working with people and not seeing them as cost that can be minimized or avoided. AB InBev's culture is strongly supported by Pfeffer's theory on the effectiveness of managing people and its implication for an organization. "It [competitive success] entails seeking the workforce as a source of strategic advantage, not just as a cost to be minimized or avoided. Firms that take this different perspective are often able to successfully outmanoeuvre and outperform their rivals" (Pfeffer, 2005, p.96). The following is an analysis of AB InBev's use of Pfeffer's practices.

3.1 OVERARCHING PHILOSOPHY

Having an overarching philosophy, or goal, is essential for giving a sense of direction and purpose within an organization. It provides the workforce with an underlying framework for making decisions and doing business. Pfeffer (2005) suggests that a firm's mission provides a way of connecting the various individual practices into a coherent whole. AB InBev uses its goals as a way of communicating and motivating everyone within the company to perform to their best abilities. When everyone is unified and working towards the same goal, it increases efficiency and creates synergies within the organization. During a presentation to MBA students at Stanford last year, Mr. Brito said the following about his company's goals: "Our dream is to become the best beer company in a better world. This dream attracts and energizes the most talented people to come join us, and leads those talented people working together to achieve the dream" (Chandler, 2008). It is evident that AB InBev's corporate mission is very important for reaching organizational effectiveness; dreaming is one of the three pillars to their performance culture.

Dreams are also used as a way of challenging the company. AB InBev has lofty dreams, but they are credible, so the employees will be able to commit. As I mentioned earlier, the leveraged buyout of Anheuser-Busch has left InBev in a lot of debt. The company's new goal is to have the fifty-two billion dollars paid off in five years. It is a very aggressive move, but it inspires their employees to take on the challenge. Mr. Mitschke explained how the dream pushes everyone to work harder, "Our intent is to have that [52 billion] paid off in five years. We will get it done because it's our culture; our stated goal. It is the type of organization that says 'that is the goal, find the way,' and you go at it, go at it, and go at it" (Mitschke, 2010a). Although there is scepticism about the reality of this dream, it motivates internal support and gives everyone a positive mindset on reaching their targets. This is an excellent example of how a goal can be used to create a competitive advantage; specifically, how AB InBev uses its dreams to create a cost effective culture.

3.2 SELECTIVITY IN RECRUITMENT

AB InBev places great importance on hiring the right people, at the right time and for the right reasons. To be effective as an organization, it is important to hire employees who are productive and suit the characteristics of the job. This is why AB InBev has a comprehensive recruitment program in all the countries it operates. The company aggressively recruits younger people, usually in their last year of

undergraduate studies or completing their MBA (CEIBS, 2009a). They search for the brightest and sharpest minds from the top universities around the world. The company focuses a lot of energy on the recruitment of young talent because they want people who have the potential to build a better company with their fresh ideas.

Mr. Brito emphasizes that recruiting the very best talent and building a talent pipeline is a critical factor to AB InBev's sustainable success and advantage over its competitors.

"Our dream attracts and energizes the most talented people to join us [...]. We generally recruit final year MBA students who can't wait to make a difference in a dynamic company with a long heritage, yet a completely fresh approach" (CEIBS, 2009b).

Al Mitschke stressed the importance of having the right human resource flows, achieved through their managerial program, to make the company successful over the long term. The rigorous selection process at AB InBev has a symbolic aspect as well: it makes the person feel that they are joining an elite organization and high expectations are created (Pfeffer, 2005). AB InBev has developed a comprehensive recruitment strategy that is very hard to imitate, which is an element in their competitive advantage over their competitors.

3.3 INCENTIVE PAY

AB InBev is a company that has an aggressive cost-cutting culture and demands a certain level of performance from its employees. Meritocracy is deeply embedded in the organization's culture because it rewards those who work hard and acts as an incentive for everyone else. The recent success of AB InBev cost cutting culture has been driven from its management team who receive bonuses based on their lofty bottom-line goals (DeMoss, 2009).

To keep the organization motivated and moving forward, they reward the employees who perform the best. For example, "the maximum bonus a sales representative on the street [in the industry] can earn on their salary was 20%. Now, it's 45% - the salary base is a bit less, but you're paid on results" (Mitschke, 2010a). If people are responsible for enhanced levels of performance and profitability, they will want a share of the profits. Furthermore, it encourages employees to identify with the whole firm. The evaluation methods used at AB InBev allow for a fair allocation of bonuses. This creates an effective organizational culture as the employees are motivated to achieve the company's long-term goals.

3.4 SYMBOLIC EGALITARIANISM

Carlos Brito made it a priority to decentralize decision-making, break down any barriers to communication and seek help from his employees in an effort to move the company forward. His efforts in creating an open environment are connected to the notion of symbolic egalitarianism, which Pfeffer defines as a "way of signalling to both insiders and outsiders that there is a comparative equality and it is not the case that some think and others do" (Pfeffer, 2005). Carlos has created an informal environment by removing obstructions and flattening the organizational hierarchy. Mr. Mitschke discussed the effect of symbolic egalitarianism on the organization:

"It's a different culture. In our national office it's a completely open environment; everyone is side by side. You could be sitting at a desk next to the president of the company. The goal is to break down the walls – it's not about 7000 emails and hiding behind your desk – you walk up to anyone and ask them the question. It's meant to foster synergies. All the top offices were

dismantled and put into an open environment. It is a very informal structure; our corporate culture wipes out the mentality of hierarchies.” (Mitschke, 2010a)

Carlos Brito leads by example: he has no personal secretary, desk or company car. He also wears jeans and a polo shirt to work every day (St. Louis Post-Dispatch, 2009). After the merger with AB, one of his first orders was to dismantle the fancy executive offices in St. Louis in an effort to remove power distances.

Hofstede (1980) identified a number of cultural dimensions that exist around the world. One of the cultural dimensions was power distances and the amount of perceived equality within an organization. Removing the hierarchical structure at AB InBev creates an environment where everyone is treated as an equal. This has differentiated them from a number of their competitors and it is another element in their ability to use people as a competitive advantage.

3.5 PROMOTION FROM WITHIN

AB InBev has a very aggressive succession plan, where almost all management positions are replaced with people from within the company. This facilitates decentralization, participation and delegation while providing extrinsic motivation to the employees. At any given time, AB InBev has 20% of its people who are mobile and actively pursuing a more senior position within the company (Mitschke, 2010a). This strategy means that people taking on new management positions know a lot about the business, the operations and what needs to be done; there isn't a need to re-train someone.

3.6 TRAINING AND SKILL DEVELOPMENT (cross-training and utilization)

The people who are selected for a position with AB InBev will go through a comprehensive training and skill development program, which is an integral part of their work systems. Job training provides numerous benefits when employees are given the opportunity to use what they learned. Recruits for management positions spend an entire year in every single department: finance, production, sales, marketing and logistics, to name a few (Mitschke, 2010a). Even summer students are put through a comprehensive training program. I had a chance to talk to Madison Mitschke, who worked with Labatt for two years as a summer sales representative (Appendix B). Afterwards, she worked as a promotions coordinator with Mosaic doing promotions for Labatt. Madison's training ensured that she would be highly qualified for her job:

“For the summer sales rep I was flown out to Edmonton with people from across Canada. We had a variety of different training while at this retreat. We had presenters come and motivate us, we performed group activities and had classroom sections. We were encouraged to ask lots of questions – it was very interactive. In Toronto, they taught us broad skills that can be applicable to a wide variety of things: we learned how to time manage ourselves, manage other people, and organize events. This was effective in making me perform better because it motivates you.” (Mitschke, 2010b)

The training at AB InBev is meant to enrich their work experience and foster commitment to the company; training and development never stops. Employees participate in a very deep and aggressive mentorship program and have access to subsequent training on a regular basis. Madison had a lot of freedom with what she did, but there was always someone there that provided advice and assistance. Talking about her experiences at work, she said:

“They [her mentor] let you run with it, but if they see you slipping they’ll coach you and develop you to give you guidance. Once a week we would have meetings just to address questions, such as ‘how are you doing? What do you need help with? What can I do?’ Sometimes my boss would tell me about a seminar going on that she thought would help me.” (Mitschke, 2010b)

Through Madison’s experience with Labatt, it is evident that AB InBev places a high priority in ensuring their employees have the best tools and resources available and at their disposal. Furthermore, training and development is never a one-time thing; they are continually shaping and improving the capabilities of their workforce. Wright, McMahan and McWilliams (1994) have showed that one of the human resource practices for competitive advantage is investing and continuing investing in skill development of its human capital. AB InBev’s employees are its greatest assets and not considered an expense; development is a core strategy for creating and improving their sustainable competitive advantage.

4. COMPETITIVE ADVANTAGE & THE HARVARD MODEL

The Harvard Model, developed by Beer et al. (1984), illustrates the immediate effect that AB InBev’s stakeholders and situational factors have on the company, what human resource policies are used and what are the immediate and long-term organizational outcomes. The Harvard Model will be used to analyze the effectiveness and appropriateness of their human resource strategy and its long term consequences.

4.1 STAKEHOLDERS

AB InBev has many different stakeholders that they need to consider when implementing their HR strategy. Particular importance is placed on those that have the greatest amount of power, urgency and legitimacy with the organization. Management, employees and shareholders hold the most power with AB InBev because their decisions guide the future direction of the company. A number of shareholders at AmBev are comprised mostly of cut-throat Brazilian investment bankers. These shareholders demand exceptional cost effectiveness throughout the company’s operational areas which have a large impact on their HR policy choices and outcomes (Exame, 2009).

Beer et al. (1984) argued that human resource policies should be influenced by all stakeholders; if not, the enterprise will fail to meet the needs of their stakeholders in the long run and it will fail as an institution. For the largest beer company in the world, AB InBev must find harmony between their divergent interests groups and the company. They engage their stakeholders through their corporate social responsibility reports, involvement in many communities and participation in national programs (AB InBev, 2010b). This extends the scope of the firm and puts its managers in a position to integrate the knowledge they acquire into practical HRM strategies. Managers can proactively use this knowledge in deciding what policies to implement and their long term consequences, effectively solving any issues before they become major problems.

4.2 SITUATIONAL FACTORS

Situational factors are internal and external to AB InBev and influence its HRM policies. Figure 3 provides a road map of the various internal and external forces on a company’s human resource policies and outcomes. AB InBev has aligned these forces to create synergies between different working groups and enforce its sustainable competitive strategy. In the previous section, I discussed the workforce characteristics, management philosophy, business strategy and labour markets.

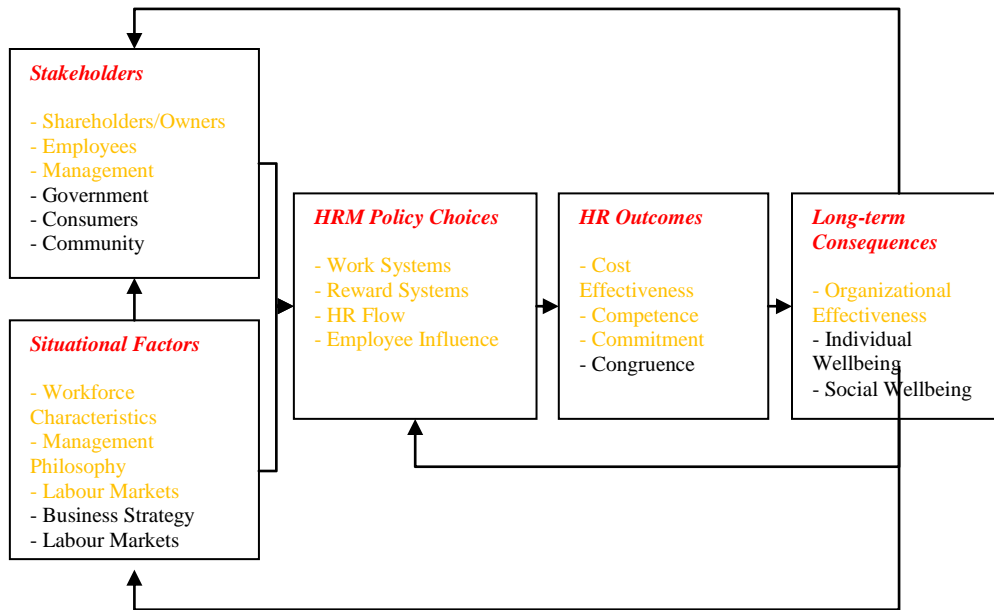


Figure 3 – Beer et al. (1984) developed a map of the human resource territory. External factors, such as an organization’s stakeholders and situational factors, have an impact on the various policy choices a company makes. These in turn affect the short and long term effectiveness of these policies. The orange highlights what is most important for AB InBev.

Unions are another interest group that AB InBev must actively engage. Last year, AB InBev workers went on strike for a week in Belgium due to the company’s intentions of cutting 10% of its workforce in Western Europe (Miller, 2010). This could be a potential problem in the future, as the organization’s cost effective culture can clash with the employees. Consequently, this can also have a negative effect on employee morale and the company’s vibrant culture. Management at AB InBev needs to mitigate these types of actions through their HR policies.

4.3 HRM POLICY CHOICES

The Harvard Model (Beer et al., 1984) outlines four key policy areas that managers should pursue and that have an effect on the future of the firm: human resource flows, reward systems, employee influence and work systems (Figure 4). The human resource system is important because the company would not be successful without its employees. I have discussed AB InBev’s human resources flows and reward systems using Jeffery Pfeffer’s practices. There is a high level of employee influence, seen through their decentralized power structure and a performance culture that gives its employees the freedom and flexibility to achieve their goals. Employees have a union that will bargain collectively on their behalf. Work systems at AB InBev are aligned to create synergies, facilitate development and reduce cost. Management achieves this through the quality of their decisions, coordination between functions and tasks and commitment to employees, among other things.

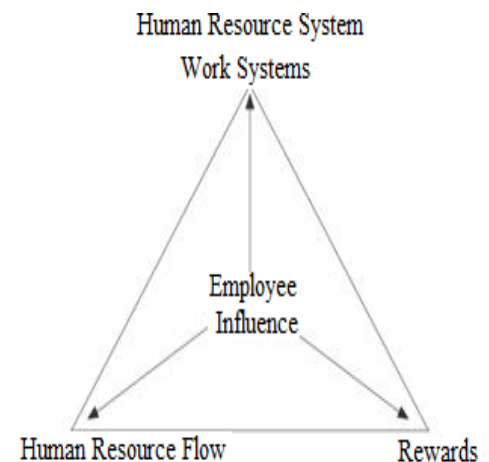


Figure 4 – Human resource systems (Beer et al., 1984).

4.4 MEASURING PERFORMANCE & LONG TERM CONSEQUENCES

In the long run, is important to have high levels of: commitment, competence, congruence and cost effectiveness. These areas will have a profound effect on organizational effectiveness and individual and societal wellbeing:

4.4.1 Commitment

Employee commitment is essential in developing a sustainable competitive advantage. AB InBev has a high level of commitment from its employees, achieved through the amount of energy and resources they invest in their workforce. Mr. Mitschke confirmed his commitment while discussing the restructuring that took place within Labatt in 2007, "Sometimes we stretch them [employees] a bit too much, but you will want to be with the organization. It's been bumpy, I'm not saying it hasn't. Three years ago I was doing a lot of training on the side, but that was my commitment to the organization" (Mitschke, 2010a).

4.4.2 Competence

AB InBev actively seeks out the brightest and best from the top universities around the globe. They seek out specific characteristic traits and analytical abilities to ensure they will fit well with the organization and their assigned roles. Each employee at AB InBev is subject to bi-yearly performance reviews to determine where the best fit is within the organization (AB InBev, 2010a).

4.4.3 Cost Effectiveness

Cost effectiveness is at the core of AB InBev's performance culture. They have a highly trained and skilled workforce that is very dynamic. Numerous studies have shown that the most productive employees are about twice as good as the least productive (Schmidt and Hunter, 1983). Although AB InBev uses a lot of resources in attracting and developing their workforce, they gained a long run competitive advantage through cost effectiveness and a capable team.

4.4.4 Congruence

High congruence implies that AB InBev has shaped its policies to coincide with the interests of their various stakeholders. They are able to manage their internal and external climate quite effectively.

AB InBev provides an excellent example of how an organization can mobilize its workforce into a dynamic, well-organized and cohesive work group. They were able to integrate their HR policies within the organization's cost-cutting culture; maintain a level of consistency throughout the organization with their recruitment and training processes; most importantly, treat their employees as valued assets and a source of competitive advantage. AB InBev has found a way to link its performance culture with its HR policy choices by building a committed, competent and cost effective team.

5. IMPLICATIONS

Through my research of AB InBev and various HR tools, models and strategies, I have concluded that the following are essential criteria for managers wanting to achieve competitive advantage through their employees:

5.1 GOALS & DREAMS

Managers need to provide direction and motivation for their teams. Goals need to be clear, have a plan and ensure the workforce has the capabilities necessary to achieve their tasks.

5.2 RECRUITMENT

It is important for managers to look for new human talent that will add value to their organization. Using detailed job analysis and descriptions helps attract the right people to the job.

5.3 TRAINING & SKILL DEVELOPMENT

People are a company's greatest assets and should be treated accordingly. Managers can use training to enrich the workforce and foster commitment to the company. Commitment improves communication, participation and builds trust between an organization and its employees.

5.4 PERFORMANCE MEASUREMENT

This provides managers an opportunity to measure current performance levels and make changes accordingly. Performance measurement also opens communication channels as management can give and receive feedback from employees and improve their current practices.

5.5 COMMITMENT

Managers need to ensure that they and their employees are committed to the organization and its success. This requires a high degree of employee involvement for better decisions and more effective performance.

5.6 REWARD SYSTEM

Managers should design an award system consistent with their responsibilities and design incentives to encourage strong performance.

5.7 POWER DISTANCES

Minimizing the power distances between executives and lower level employees enhances communication and creates an open atmosphere. Managers should show their employees that there is equality in the organization.

5.8 LEADERSHIP

It takes strong executive leadership to bring about positive patterns of employment relationships. The manager must continue to develop himself and also have a commitment to help his employees develop their full potential.

If HR is integrated into strategic plans and its policies are coherent, if line managers have recognised the importance of HR and this is reflected in their behaviour, if the team's aspirations and motivations are considered, if top management are committed, if the business is integrated into a global network and if

employees identify with their firm, then the firm's strategic plan can be implemented successfully (Boxall, 2003).

CONCLUSION

The analysis of AB InBev's HR strategies and policies has demonstrated that it is possible to gain a successful competitive advantage through a company's employees. In order to do so, a firm must start by aligning the firm's competitive strategy and HR policies. Using a HRM model, such as the Harvard Model, can enable the company to focus on their long-term vision while taking into account the impact of their HR policies and external forces. The future is unpredictable, but being well prepared with a competent and committed workforce will give the organization greater flexibility to react to changing market conditions.

Once a HRM model is established, the right people and employee programs must be chosen so that employees are enthusiastic and motivated with their work. Jeffery Pfeffer's sixteen practices can be used in achieving competitive success and realizing the potential of a firm's workforce. As seen by AB InBev and the various theories on strategic human resource management, a competent leader is needed to motivate employees towards the goals and dreams of the organization. The leader must reduce power distances to increase communication and trust between different work groups. The organization must choose the right employees, empower them through training and development, pay them well and promote from within. This increases the competency, productivity and overall effectiveness of a firm's workforce. With the proper work systems, HR flow and reward systems in place, management will be able to face future challenges with a dynamic and capable team.

In an increasingly globalized world where there are many similar products and services, the one factor that can differentiate an organisation from its competitors is employees; they have a significant impact in all of the firm's operations. Consequently, it is vital that they are given the tools and opportunities to make a difference within the organization. As illustrated by AB InBev, people make a positive impact when they are placed in a dynamic environment and given the right skills. Human resources can be used as a long term competitive advantage by effectively using people's talents to achieve the organization's goals and objectives.

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APPENDIX A

Interview with Al Mitschke. The following is a written out version of my Skype conversation with Mr. Mitschke, Labatt Regional Sales Director for British Columbia, dated November 21, 2010.

Lack of understanding of a culture even to newly acquired companies. Acquiring AB is a once in a century opportunity that they took advantage of. Corporate culture did not change whatsoever. The culture has always been a cost culture that's been very deep and that's what has made them so successful. AB was an acquisition. AmBev out of Brazil and Interbrew merged – it wasn't an outright takeover but a merger that can be bust apart in 20 years. It was the culture from AmBev that was instilled in the rest of the company – from the very bright people from Brazil. When they've taken over any other company, it's been a myopic focus on internal cost and remove internal waste. To spend back into the market place to win the market place. It's not taking costs out for all purposes. In NA, there's an entitlement mentality with big corporate board rooms. It's very hierarchal. The second platform is the people side: it's called zero based budgeting, and they apply it in strict science. You need to justify from

the bottom up all your costs. I've never been in a culture where you've had to justify your internal costs, so the company can strategically allocate them into the sales and marketing.

The people side is the next largest part of their platform they have not changed. Every year the company goes to all the universities in the companies we operate in and we aggressively recruit the brightest minds from the top universities in a management trainee program. For example, 2 years ago we brought in 25 people into a 70hour selection process. The people have to be intellectually bright but they have to have the whole element side of the people side. Leadership, it's not all about academics. Last year we did 12. The goal is to have the best and brightest minds but still social (it's our business) because our culture isn't just about costs, but it's about succession.

Six Sigma methodology is used for control management, and it's called the Toyota way. That's another huge part of our cost management and the way we run our companies. It involves deep analysis of problems and it needs to be white, green and black belt certified in statistical analysis – Plan, Do, Check, Act. You need to have the intellectual capacity to do 6sigma in your analysis.

Those trainees spend an entire year in every single department in a training capacity. It's an entire year where they are paid to do this: finance, production, sales, marketing, and logistics. At the end of that period they are placed and it is an expectation within a year and a half (management role) they are moving through the company. That is the basis of their succession plan. It doesn't rely solely on these - Of course we hire other people externally, but they bulk of them come from within. People, training – I've never seen a more aggressive approach to people recruitment (evidence of the management trainee program) and commitment to the training but also by subsequent training that we put people through. It's not just MBA students, but usually undergrads. It's a 70hour – group interactions, 1on1. They have engineering and business backgrounds.

2011 planning meetings and I haven't seen such a commitment to our sales and marketing group in terms of new marketing dynamics going – they are putting the money and talent to it. People misunderstand a bit of the culture: my personal insight is that the US is biased. Where the US is right now is where Canada was 4 years ago. AB was acquired in 2008 via a hostile takeover – the bring minds of Brazil and the Interbrew families out of Belgium orchestrated this. Smaller company acquiring a world leading company. Knowing the US culture it's all about the show, the corporate fancy office, the perks, it's about the things that have gotten the US into the difficulty they're in now. They lost their American Identity, they aren't to happy about that. The corporate culture that exists in every other country has been imposed in the US and they haven't bought into the country yet. When you talk about lack of communication – it was different in the hierarchal structure. It's a different culture. In our national office it's a complete open environment. It's a side by side. You could be sitting at desk next to the president of the company. The goal is to break down the walls – it's not about 7000 emails and hiding behind your email – you walk up to anyone and ask them the question. It's meant to foster synergies but some people can't work like that. There is also the senior management who was used to the perks getting their dry cleaning done, the private driver and people getting their coffee: those are the people most pissed off.

The cost management part – the same thing happened with AB. All the top offices were dismantled, and put into an open environment. I would say 25% of the people working there haven't bought into the culture. Because of the current market conditions they won't leave, even if they don't like their job. InterBrew acquired Labatt in 1995 and that was through a hostile takeover bid, but InterBrew came in as a white night. There are 2 families that own InterBrew brewing beer since the 13th century. All they did at that point in time was install a FO. Fast forward, the one place InterBrew didn't have a presence in the world was South America. AB was going to buy AmBev, but the deal didn't happen and AB walked out

with AmBev laughing and saying 'we're going to buy you! In 2003, InterBrew and AmBev came together in a joint merger to get scale. Ambev were effectively losing control of their company because Interbrew had more shares. What were they getting out of this deal? Labatt was a standalone entity but it reverted back to control to Ambev. AB ImBev is controlled by 51% of InterBrew and the core investment bankers in Ambev.

They are a performance company. For example, for a sales rep on the street, before the maximum bonus you can earn on your salary was 20%. Now, its 45% - even though the base salary is a bit less, but your paid on results. You need to be a part of the performance culture. In the past it didn't matter if you were busting your tail or lollygagging, the difference in your pay wasn't that much different. People were getting pissed off.

There is no time for people who want the perks of the job, they want to be there because they want too. We have a very aggressive succession planning in place. Every year during performance reviews we look at where people's interest lie and we look to remove the lowest 10% of the organization; we replace them with our management training program. Particularly if their attitude isn't correct – sometimes you don't have a fit. We need to have 20% of our people who are mobile and aggressively pursuing a more senior position within our company. If we don't have that, it changes our recruitment a bit. We want 70% of the people who stay in their current roles and our constantly learning.

I've been with Labatt for 29 years – 2 years ago I saw more than half the management team in BC leave because they didn't buy into the culture. I've been through 17 restructuring, I know that change is required. It's around because now what we have are people that want to be here – it's the Brazilian style management. In order to restructure and change people's roles and tasks, we stretch young talent. Sometimes we stretch them a bit too much, but you will want to be with this organization. It's been bumpy, I'm not saying it hasn't, but we're settling down now. 3 years ago it was a guy like me doing a lot of training on the side, but that was my commitment to the organization. Training: we have a very deep and aggressive mentorship program, there's also training and identifying where the gaps are. For example, we had a lot of new managers who had never done interview skills: it was my role to fill these gaps.

I used to be director of sales for the western region, but I took a step back to the regional sales position. Our director positions are training positions for future succession candidates globally. I've taken a step back; I'm the teacher, mentor, and coach for BC. I prefer to be on the street and working with our young people/talent. I'm also on a lot of special projects.

Going back to what you're seeing in the news articles you've read, I challenge you to find it anywhere else. They are not happy to have all their private offices taken away, their coffee runners are taken away. It's a very informal structure and they're not used to it. Our corporate culture wipes out the mentality of hierarchies. They are at a very tough time within the organization because a tremendous amount of people will be leaving because they're not buying in. People who should leave aren't because they're scared they'll have nothing else to go too. It's making it hard to weed out those people; you need to get rid of those people. They are in a very difficult time as an organization. We went through this around 2006-2007 through our culture change. They're pissed off because they were bought out and secondly this is massive corporate change for them. They've taken the internal stuff away, but they're spending more than ever on marketing, corporate presence, sports teams.

A lot of people are worried about cost management platform – but make no mistake, it is always people first. Management training programs, the 10 principles, we focus on these 10 principals and what they mean to us. What is leadership? This makes us the most powerful organization. When you can get rid of

a lot of those internal costs, it makes you stronger. A lot of companies have taken our lead. Miller. When we're in a global down turn, we're in a better position because we've done our due diligence, it makes us far better surviving going forward – because we have the money.

This leveraged buyout – 52 billion buyout – our intent is to have that fully paid off in 5 years. We will get it done because it's the culture. Think about it, that is our stated goal. Paying of 52 billion dollars in 5 years. We will be in the countries we need to be in, we sold off the theme parks and other non-essentials because those aren't our core competencies. We don't know how to run theme parks. We make beer. It's not in our long-term interest. We've sold off some brewery operations, but those were not in our long-term interest. We will be in China, India and other emerging markets. We don't know if we'll get it done, but it is that type of organization that says "that is the goal, find the way" and you go at it, go at it, go at it. Other people just say it can't be done. Our mindset is "here's the stated goal", we'll do it. It will free up a lot of resources after 5 years. It's aggressive. It is necessary to do it (in America).

Keep the US section in there. Managerial Program – in every country we operate – hiring the brightest and sharpest minds. It's still the people platform that will make us successful over the long-term. Hire the right ones out of the gates first and pay them meritocracy.

APPENDIX B

Interview with Madison Mitschke. The following is a written out version of my Skype conversation with Madison Mitschke, Labatt Sales Representative and Promotions Coordinator, dated November 14, 2010.

I worked for Labatt for two summers as a summer sales representative and then last year I was a Coordinator working for Mosaic, but I was doing Labatt promotions.

For the summer sales rep I was flown out to Edmonton with 15 other people from across Canada with the same roles. We had a variety of different training while at this seminar. We had presenters come in and motivate us, we performed group activities such as skits, we were encouraged to ask lots of questions – it was very interactive. In Toronto they taught us broad skills that can be applicable to a wide variety of things. We learned how to time manage yourself, how to manage people, organize events.

I would start out my mornings at 6am where I would be making calls to Toronto and checking my emails. I would have meetings with my boss in the morning, with my employees and girls. There are lots of training and development sessions you can voluntarily join. Sometimes my boss would be like "hey listen, there's this seminar going on and I really want you to join it because I think it would help you." Then at night you're going out at 5 until who knows when, depending on how many events you're doing. You need to be with the girls to coach them at night, give them direction. I worked a lot of hours in a day – at least 12. I worked on weekends too; it's hard because you're supposed to take days off but it's hard too.

I was given lots of freedom with what I can do. It was effective in making me perform better because it motivates you. The managers managed me by doing a little bit of everything. They let you run with it, but if they see you slipping they'll coach you and develop you to give you guidance. Once a week we would have meetings just to address questions such as "hey how are you doing? What do you need help with? What can we do?" They make themselves available to you all the time. There was 1 manager I reported to. She helped with my professional development through mentoring me.

They are definitely people oriented – work hard play hard environment. The managers have to manage everything, there's so much admin work that you have to do – which I hate – but understand what they have to do. Processes are necessary. There are certain steps they do things, such as the 8 steps to the sales call. They let reps do their own thing but they come back to these steps. Results matter – every morning at Labatt they have sales calls, conference calls and they're going over number and how they're going to reach their targets, how far away.

Reduce costs: A lot of people want to get their events sponsored, but Labatt will only sponsor those events that will be the most beneficial to them. Even materials for merchandising you need to justify. They watch everything and it's up to you to choose how you allocate your resources.

Results matter. Wake up early, meetings with bosses, employees, lots of training and development sessions to join. Optional but some were recommended. At night your going out at 5 – 1 am depending on how many events. You need to coach the girls.

Worked a lot of hours – at least 12 hours. This includes weekends and weekdays – supposed to take time off. People oriented – work hard play hard. Lots of freedom in choices. Increase effectiveness and motivates. They did a little of everything – run with it, they see you sleeping they'll coach you and develop you. Make themselves available. 1 manager. Mentorship and professional development.

Stiegl:

Next on the Agenda

Simon Monk
Fall 2010

ABSTRACT

This objective of this paper is to gain an understanding of how Stiegl has risen to become the largest privately owned brewery in Austria and develop potential consolidation and growth strategies for Stiegl to remain competitive in the future. This will be done by first utilizing the Strengths, Weaknesses, Opportunities, and Threats (SWOT) analysis. Next, an analysis of both Stiegl's positioning strategy and marketing mix will be undertaken. The analysis would help us frame the recommendations for Stiegl., including potentially partnering with an established multinational corporation in order to expand substantially outside the borders of a saturated Austrian market.

INTRODUCTION

The Austrian beer market is well established and very saturated with hundreds of breweries currently in operation. The country indeed offers some of the best customers in the world. In 2006, Austrians were third in the world in terms of beer consumed on an annual basis at approximately 108.9 Litres of beer per capita. The only people that drank more were people from Germany who drink about 115.8 Litres of beer a year and the Czech Republic who drink an impressive 160 Litres of beer (IRUE, 2010). In 2008, however, Austria took over Germany to be "crowned the second-biggest beer drinkers in the world" (Austrian Times, 2010).

To help quench the thirst of the approximately 8.4 million Austrians breweries produced around 9 million hectolitres of beer in 2006. There is approximately one brewery per 56,860 people in Austria, which is one of the highest ratios in the entire European Union. Of course, not everyone in the country wants to drink the same beer; between these breweries they provide over 600 kinds of beer for their loyal customers (IRUE, 2010). These beers come in all kinds of shapes and sizes with the predominant drinking vessels being .5 Litre bottles and .5 Litre cans which accounted for 48% and 18.1%, respectively, of all beer sold in 2003 (Pattinson, 2010).

As one can imagine, the Austrian beer industry is very competitive. There are 146 establishments currently brewing beer, almost all of which are privately owned and 90 of which that are home breweries (IRUE, 2010). The 116 breweries that employ less than 20 people account for just 1.8% of the beer sold in Austria. The 10 slightly larger breweries of 20 to 50 people account for 3.9% of the total market share. 23.6% of the beer consumed can be credited to the nine breweries that have 100-500 workers. Finally, the 7 breweries that have 500-1500 employees have the majority of the market share at about 67.6% (Pattinson, 2010).

There are several significant points about the Austrian alcohol regulations worth mentioning that differ from that of North American countries such as the United States and Canada. Indeed, many of the people accounted for in the ratio of breweries to people are underage in the North American context;

however, similar to many other European countries, the drinking age in Austria is 16. Clearly, for beer companies this means a larger proportion of the population are potential customers. When one also considers that drinking age limits are very rarely enforced, the market becomes even bigger.

In 2006 a European Union commissioned report stated that “on average, [students] now start [drinking] when they’re just 12 and a half years old” (Oleksyn, 2008). The fact that beer in Austria is sold in vending machines further illustrates this point. In addition, there are no limits to what time alcohol can be served at. This means that bars and restaurants are open much earlier, often 6 o’clock in the morning, and that other places such as gas stations and other food establishments can sell alcohol all night.

Stiegl was established in 1492 in Salzburg, Austria. The company is such a significant part of the history of the city that when school children study the year 1492 they learn both about the founding of Stiegl and the discovery of America. However, the company only really started to emerge as a national contender when Dr. Heinrich Dieter Kiener became the owner in 1990; the brand quickly grew into the largest privately owned brewery in Austria. The company motto of “Whatever you do, do it fully,” still guides the company and illustrates their commitment to uncompromised quality (Stiegl Website 2010).

Under Dr. Kiener the Stiegl brand has grown to represent 13% of the entire Austrian beer market. With nine beer storage points strategically placed throughout Austria, there is no region hidden from Stiegl’s distribution channels (Rainer, 2010). Not surprisingly, the company has become a point of pride for not only the residents of Salzburg, but to anyone that calls Austria their home. There is still a lot of potential for growth of the Stiegl brand and market share.

This objective of this paper is to gain an understanding of how Stiegl has risen to become the largest privately owned brewery in Austria and develop potential consolidation and growth strategies for Stiegl to remain competitive in the future. This will be done by first utilizing the Strengths, Weaknesses, Opportunities, and Threats (SWOT) analysis. Next, an analysis of both Stiegl’s positioning strategy and marketing mix will be undertaken. The analysis would help us frame the recommendations for Stiegl.

1. SWOT ANALYSIS

The SWOT analysis matrix (Table 1) is given on the following page. I have utilized questionnaire survey data as well as company/industry reports for analysis. A discussion of each element follows.

<p>Strengths Most modern brewery in Europe - Able to use much less water Brews after the Bavarian Purity Law - People know it is a quality product It is a local company - People see it as a point of national pride - Can use this as strategic advantage of largest competitor</p>	<p>Weaknesses Funds are more limited than that of its biggest competitors - Harder to compete for market share when budget is more limited comparatively Costs more to produce beer - Because costs are higher they have less money to spend elsewhere</p>
<p>Opportunities Environmentally friendly company - Can market themselves as more environmentally friendly than competitors Large competitor bought by Heineken in 2003 - Has recently started to lose customers due to declining quality International expansion</p>	<p>Threats Austrian beer industry is saturated - Less room for growth and expansion Barley prices rapidly rising - Making it more expensive for them to brew compared to breweries that do not use barley</p>

Table 1: Stiegl SWOT analysis

1.1 STRENGTHS

Since the establishment of a new brewery in 2005 in Salzburg, Stiegl has owned the most modern brewery in Europe. Compared to its competitors, this means that they can produce much more efficiently and quickly. In terms of efficiency, they can actually produce one litre of beer using just four litres of water. To provide some perspective, the majority of breweries are usually using eight to ten litres of water per litre of beer (Rainer, 2010). This comparative advantage saves Stiegl money and makes them a more environmentally friendly brewery.

The beer at Stiegl is brewed using the Bavarian Purity Law. This law states that “just barley, water, hops, and yeast can be used” (Toronto Star, 2001) as ingredients. Together these ingredients make the highest quality and best tasting beer (Rainer, 2010). As not all beers are brewed using this law, many people look for the “brewed according to the Purity Law” (Carlsberg, 2010) label on a beer before they buy it. Due to this fact, people know they are getting a high quality product when they purchase Stiegl and are therefore willing to pay a premium to get it.

Stiegl is well established in the Austrian market. In 2001 it had a market share of approximately 9.3% of beer sold in Austria (Pattinson, 2010). Since then it has risen to take over approximately 13% of the Austrian beer market (Rainer, 2010). This figure makes it the single largest private brewery in the country and the second largest beer company overall. Another strength is that it is the largest local beer company. Some of its largest competitors cannot make this same claim because they are owned by Brau Union which is owned by Heineken, a large multinational from the Netherlands. Being such a well-known and popular beer means that Stiegl has a strong platform to start from in pursuing any of its opportunities.

1.2 WEAKNESSES

One of the weaknesses of Stiegl is that it does not have the same funds as that of the Brau Union. Since Brau Union owns and operates several of Stiegl’s direct competitors, including the Gösser, Zipfer, Schwechater, Wieselburger and Puntigamer breweries, this is one disadvantage that they must endure while they compete for further market share.

One of the consequences of Stiegl producing very high quality beer is of course that it costs them significantly more. For instance, many beer companies worldwide buy rice as a substitute for barley in their beers because it saves them a lot of money; however, to maintain their premium status, Stiegl continues to use barley even as the price is constantly rising.

1.3 OPPORTUNITIES

In a survey conducted at Johannes Kepler University to help with my research, I was curious to find the answer to the yes or no question: “if you know a certain beer company is environmentally friendly, does it increase your chances of buying from them?” A majority of the 43 respondents, at 58.7%, answered yes (Please refer to Appendix 1 to see the rest of the survey questions and results). This is not surprising considering that more and more awareness is being created about the significance of human effects on the environment and the consequences they will and are having. Another one of the questions I asked was whether they had any idea Stiegl as a company was more or less sustainable than other beer companies in general; possible answers included “yes”, “no”, or “I don’t know”. Interestingly, 100% of the people surveyed answered with “I don’t know”. As a large number of the respondents were not from Austria and have only been in Austria for a few months, it is to be expected that the majority of them would not have any idea of this answer; however, the most unexpected part was that all of the

Austrians that filled out the survey also did not know. It is unexpected because Stiegl is very enthusiastic about how environmentally friendly the company is as compared to its competitors (Rainer, 2010).

Here Stiegl may have an opportunity to enter a potential market segment of environmentally conscious consumers. The company, as previously stated, uses less than half of the water that the average brewery uses. This is very significant because “water scarcity, not future oil shortages or global warming, is the greatest crisis facing humanity in the 21st century and possibly beyond” (Singh, 2008). In addition, “according to the UN, 1.2 billion people currently do not have access to clean drinking water, and half of the world’s population lacks adequate water purification” (Singh, 2008). If Stiegl can increase the awareness of their dedication to reducing water usage then they will be able to capture a larger part of the Austrian market that is concerned about the environment. Moreover if the company raises awareness of the crisis of water in general, it will complement their environmental marketing strategy.

Stiegl is also proud that they predominantly use glass for their beer containers. In fact 95% of their beer is sold in glass bottles; this is as opposed to the average of 70% for the other Austrian beer companies. This is significant because it is more environmentally friendly to manufacture glass bottles than cans; glass is highly recyclable and new bottles often contain a “significant percentage of post-consumer salvage” (Portland Tribune, 2009). This is as opposed to aluminum which during production can produce around 5 times its own weight in caustic waste. In addition, for whatever reason, people tend to recycle glass bottles much more than cans. In 2005 “more than half of the 100 billion cans sold in the United States...ended up incinerated or in the landfill” (Portland Tribune, 2009).

Stiegl also has the opportunity to further promote its organic products such as its Paracelsus Zwickl brand. The organic ingredients are grown by very tightly monitored, 100% organic farmers. However, although many people know that organic farming is a good thing, many people do not know exactly what it is and what the benefits really are. Since “organic farming practices are designed to encourage soil and water conservation and reduce pollution” (Mayo Clinic, 2008) it is another factor that can definitely bolster Stiegl’s reputation as an environmentally friendly brewery. One way that farmers do this is by using natural fertilizers, such as manure or compost, to feed soil and plants; this is as opposed to the chemical fertilizers used by conventional farmers. Further, organic farmers use “beneficial birds and insects, mating disruption or traps to reduce pests and disease” (Mayo Clinic, 2008) rather than simply spraying insecticides to achieve the same goal. They also manage the threat of weeds by avoiding herbicides all together, opting instead to use the old fashioned method of rotating crops, till, hand weed, or mulch (Mayo Clinic, 2008). Therefore, the other opportunity that is presented by these facts is that Stiegl can market itself as a healthier product.

The acquisition of Brau Union by Heineken in 2003 has slowly decreased the quality of the beer at each of their breweries (Rainer, 2010). This has opened up a window of opportunity for Stiegl to steal away some more of the market share. Although there is some brand loyalty for beer companies, it is relatively low; in the end people simply want to enjoy the best beer in their price range. That being said, there is enough brand loyalty that it takes time for customers to start consistently drinking a different beer if they have been drinking the same brand for years, even decades. The approximately 4% increase in market share since 2001 for Steigl can definitely be, in part, attributed to Heineken’s purchase of Brau Union and there is still room to capture more (Rainer, 2010).

1.4 THREATS

The rising price of barley is a major threat. Since April 2008 the price has risen from approximately \$82.80 US dollars per metric ton to \$174.60 per metric ton (Monga Bay, 2010). Stiegl uses approximately 20,000 tons a year of barley a year. This means that compared to two and a half years ago, they spend

approximately \$1,836,000 more per year (Rainer, 2010). Clearly this is a figure that cannot be ignored. The question for Stiegl then becomes: when is it no longer worthwhile for them to stay committed to the Bavarian Purity Law? That is, when does it become more economical for them to sacrifice quality and start using rice? One way to help answer this question is to perform a cost-benefit analysis of the two options and see which one proves to be the best option. There are also many qualitative factors to consider in making such a decision. In the survey question that was posed for respondents that gave them the chance to select from a list of options to explain why they buy Stiegl, the majority weighed in at 35.5% and claimed it was because of its quality taste. Indeed, this would be a difficult decision and one that Stiegl may have to face in the not too distant future considering that barley prices are still consistently and quickly growing (MangoBay.com).

2. POSITIONING STRATEGY

2.1 SCOPE

Stiegl is a premium beer brand catering to the portion of the Austrian market that wants a high quality local beer in terms of taste. Although they still do all their brewing in Salzburg, they have expanded their reach across all of Austria by building eight other large storage points in Wien, St. Stefan, Flachau, Traun, Neuhofen, Bruck, Wörgl, and Inzing. Although this gradual expansion has vastly increased Stiegl's capacity and is a large reason for why they are the largest private Austrian beer company, they are able to maintain their competitive advantage of being a local Austrian company. The company has also relatively recently entered into the international market; however, thus far only 2.7% of its total sales are outside of its home country (Rainer, 2010).

2.2 STRATEGIC ORIENTATION

Stiegl's products are offered as premium quality refreshments. The company is a well known local brand from Salzburg city offering its customers high quality beer. Their beers are available in supermarkets, restaurants and other food related establishments, and bars and pubs, which make them accessible and convenient for their customers. Since their target market is simply Austrians, a very wide customer segment, Stiegl has decided that the best way to reach their customers is by offering their beers in as many locations as possible.

2.3 DIFFERENTIATION

Stiegl beers are brewed using unique recipes that have been perfected over hundreds of years. They claim to have a beer that is less bitter than their competitors which people like and are able to drink more of. Being a premium brand, the company brews using the Bavarian Purity Law. They are marketed as being a very local and traditional Austrian beer and are identified by their very familiar red staircase (Rainer, 2010).

2.4 DEFENSE

Beer recipes and brewing techniques have been mastered since the brewery's establishment and therefore cannot be copied by competitors. My survey revealed that 58.1% of people rate Stiegl as having an "above average" taste as compared to other beers and the majority of people, at 32.6%, buy Stiegl because it tastes the best. The evidence based on the survey states that a large percentage of people enjoy Stiegl's beer. In addition, the brand is clearly established and recognized for their quality and for being a local Austrian company. They also have well established distribution channels.

2.5 BRAND PERSONALITY

Stiegl is a local Austrian product. When a thirsty customer is looking up and down the aisle of his local supermarket he knows that “it has to be a Stiegl”. The products stand out as being premium with their famous red staircase which has come to be “an unmistakable symbol in Austria for “the art of brewing at the highest level”” (Stiegl Website 2010). The product is associated with being some of the best that Austria has to offer and is a point of national pride.



Figure 1: Famous red staircase logo

3. MARKETING MIX

3.1 PRODUCT MIX

3.1.1 Concept

The core product that Stiegl provides is partly comprised of the feelings that the customer experiences during the purchase and consumption of the beer. The company’s customers feel a sense of national pride when they drink Stiegl because they know it is a local product and because of the unique and vivid red and white logo. In addition, the customer feels satisfied that their thirst is quenched with a delicious tasting beer. Finally, the core product also provides the customer the benefit of having a beer that is a status symbol in Austria as it is a premium product. The value that Stiegl provides is derived from its ability to elicit these feelings of pride, satisfaction, and status.

The actual product is very simple and can be described as being a beer that comes in several containers, including .33 and .5 Litre bottles or .5 Litre Cans, and is made using quality ingredients that abide by the Bavarian Purity Law. The labels spell out Stiegl in large red letters that incline from left to right up the red staircase and includes “Salzburger” across the top. The brand name, Stiegl, is enough to make customers confident that they are going to get a quality product because of the company’s hundreds of years of experience in the art of brewing beer. All of these aspects of the actual product are carefully designed to deliver the desired core product.

3.1.2 Mix

The product mix consists of one brand, Stiegl. Under this brand umbrella is a width of 10 products including individual beers, packs of six, twelve, and eighteen, and miniature kegs, each of which comes in either cans or bottles. The length of each of these 10 products is 6 and consists of Goldbräu, Paracelsus Zwickl, Leicht, Pils, Radler, and Weizen Gold beers.

3.1.3 Service Strategy

Since Stiegl’s products are tangible goods and in general they do not sell them themselves, their service strategy is not very extensive. However, they do interact directly with the public through hosting tours of their state of the art brewery and Museum, both of which are located in Salzburg. The museum gives its customers an idea of the rich history that is behind the Steigl brand. It gives visitors the chance to see how the business began and how it has



Figure 2: Stiegl museum in Salzburg

evolved over time. The brewery on the other hand gives customers the opportunity to see how Stiegl is operated and performs in the present. At the end of each of the tours, visitors are given a free gift and three free beers from the Stiegl pubs. Both experiences give the customer a chance to identify more closely with Stiegl, essentially creating or strengthening brand loyalty to the company.

3.2 PRICING

3.2.1 Objective

The main pricing objective of Stiegl has been the image enhancement objective. They would have chosen this objective because it supports their premium product brand image. They would not have chosen profit maximization because their goal was to make Stiegl known for being a high quality beer rather than just a cheap beer that is no different than any other on the shelf. Similarly, the high volume objective would not have suited Stiegl because they again want to be known for being a high quality beer rather than a beer that people buy on any occasion.

3.2.2 Strategy

To support their image enhancement objective Stiegl implemented a premium pricing policy that they still maintain. In addition, the brand uses uniform delivered pricing, meaning that a uniform shipping cost is added to the price regardless of where the product is distributed to in Austria. The goal of the former pricing strategy is to ensure that people actually perceive the company's beer as being of a very high quality; of the latter it is to make sure that people know how much they will pay no matter where they are in the country. This pricing strategy makes sense because people are willing to pay for the quality they perceive Stiegl as offering and because the brewery already has a strong customer base. As a bonus, Stiegl prices, although more expensive than the majority of its domestic competitors, is just under most of the prices of imported beers. Since people know that imported beers are always more expensive, regardless of quality, simply because they are imported, they know that they can pay a bit less and get a very high quality Stiegl beer.

3.3 PLACEMENT & DISTRIBUTION

Stiegl uses a variety of channels to get their products into the hands of the customers, including supermarkets, bars, pubs, restaurants, gas stations, and virtually any type of establishment that sells drinks and food. The company's channel design approach is therefore primarily traditional. The company does have a relatively small novel approach as well; Stiegl has a variety of souvenirs that can be bought through their website.

Stiegl has a strong distribution system established and uses a manufacturer-retailer-consumer indirect channel design. The product is delivered to the retailers who then sell to customers. The company has made it easy to maintain this type of channel by building nine storage points throughout Austria. The company delivers beer to these storage points from their brewery in Salzburg primarily using their own trucks. From these points the beer can be delivered to local retailers as needed (Rainer, 2010).

3.4 PROMOTION & COMMUNICATION

Stiegl has invested heavily in many different kinds of promotional tools in order to effectively advertise and promote the brand image it wishes to convey. The majority of this is done using television, radio, flyers, magazines, the internet, and banners and billboards. Potential customers do not have to travel far before they see an advertisement reminding them that Stiegl is the beer they should buy. The company

does not engage in promotional activities that relate to reducing the price of their beer (Rainer, 2010). This is because by doing so the company is essentially telling people that, if you want the quality product that is Stiegl, you have to pay for it, effectively supporting their premium product status.

Sponsorship is another form of promotion that Stiegl is heavily invested in. Their two biggest sponsorship contracts are with the Austrian Nordic ski team and the Austrian football team (Rainer, 2010). Since football is not only the most popular sport in all of Austria, but also Europe and the rest of the world, this is a very significant sponsorship deal. Stiegl's trademark red and white logo perfectly fits in with the sea of red and white fans that appear at any given Austrian sports event. As Brau Union sponsors the Austrian slalom ski team, the rivalry is heated not only by the competition to be the best between the ski teams, but also by the competition of their sponsors. Fortunately for Stiegl, the Nordic ski team has for a long time been much more successful (Rainer, 2010).

RECOMMENDATIONS & CONCLUSIONS

It is recommended that Stiegl increase the general awareness of their dedication to reducing water usage; by doing so they will be able to capture a larger part of the Austrian market that is concerned about the environment. Based on the survey results, this part of the Austrian market is large; 89% of the Austrian respondents said they would be more likely to purchase from a brewery if they know that they are more environmentally friendly than their competitors. In addition, if the company raises awareness of the crisis of water in general it will complement their environmental marketing strategy. This can be done for instance, through their website or briefly on some of their products; or Stiegl could invest in a full marketing campaign that raises this awareness. In addition, the company should raise awareness of its commitment to using the more environmentally friendly glass, as opposed to aluminum. Stiegl can eventually eliminate cans from its production altogether.

It is also recommended that Stiegl further promote its organic products such as Paracelsus Zwickl. Indeed, Stiegl has its own biological farm in Upper Austria where they grow their own organic wheat, hops, and barley. Therefore, the other opportunity that is presented by these facts and that Stiegl should capitalize on is that Stiegl can market itself as a healthier product than its competitors.

Stiegl up until now has made a point not to use promotional techniques that give discounts or “freebies” to customers as they do not want to take away from their image as a premium product; however, this mindset limits their possibilities for effectively engaging customers through Customer Relationship Management (CRM) programs. It is recommended that Stiegl invest in a customer loyalty program that rewards customers for purchasing any Stiegl product. Since Stiegl only sells its beers through retailers, it makes most sense to put codes on the inside of boxes. Customers could then take these codes to the website in order to enter them and earn points. Of course, beforehand they will have had to have created an account at their website. This approach offers several advantages. First, customers can be informed of upcoming events that Stiegl may be sponsoring. This information could be customized based on the information that the customer has provided. For instance, a university student might be told about a party at a night club on campus whereas an older customer may have a restaurant recommended to them. Next, when customers visit the website and login to their account they can have information pushed onto them that they may not otherwise see such as information about how Stiegl is environmentally friendly or how they are involved with the community. Finally, the prizes they receive



Figure 3: Stiegl advent calendar

can also be based on the customer information. Based on site preferences the website can recommend products that they might also enjoy and also offer these recommended products as prizes so that the customer is more likely to try them. In the end, this CRM strategy will promote customer loyalty to a level beyond that which would have ever been possible in the past.

Stiegl already has a popular Christmas item that packages several of their beer products together. It is the Stiegl advent calendar and, as one would guess, it contains a different beer for each day that the customer opens it. It is recommended that the company take this proven idea of packaging products together and put on promotions where they package souvenirs with their beers. They already have an array of souvenir products; however, they are only available online or in the store in Salzburg. If the company starts packaging these products with their beers or giving them out at bars and pubs then they will benefit in two ways: firstly, potential customers will be more likely to purchase Stiegl beer; secondly, these products provide for an easy form of relatively cheap marketing. An example of this cheap marketing is when customers wear Stiegl clothing in public.

A final recommendation for Stiegl is that they expand beyond the borders of Austria in a more significant way. Although they have begun to expand slightly, exports still only account for 2.7% of their total revenues and have not increased significantly in recent years. It is important for Stiegl to do this because, even though they can steal away market share from their competitors in Austria, it is a saturated market, meaning their growth potential is limited. It is recommended that Stiegl consider partnering with a large multinational so that they can reasonably compete on an international stage.

The important point here, however, is that Stiegl has to make sure that they do not make the same mistake Brau Union did when they were bought by Heineken; they must hold on to their national identity and be proud of it. Although Brau Union and all of its subsidiaries are very popular in Austria, Stiegl's competitive advantage over them is that they are a local brewery. They can hold on to their national identity in a few ways. First, they must ensure that people know worldwide that Stiegl is an Austrian beer. They must make sure that "Salzburger" remains at the top of their logo and that their international advertising campaigns are centered on their Austrian heritage. The Molson Brewing Company of Canada proved that this type of international expansion is possible while still maintaining the feel of a local brand. In 2005, it partnered with Coors, an American company, and risked losing its local appeal; however, it maintained a large part of its competitive advantage by using the "Canadian" marketing campaign. This campaign has been very successful at fostering feelings of national pride, especially through its television commercials. If Stiegl can put on a similar campaign in Austria that elicits feelings of national pride after they partner with another company they will be able to maintain most of their competitive advantage.

Stiegl is well established in the Austrian beer market; they have a strong customer base that has been built on their commitment to quality and the competitive advantage of being a local company. This market is saturated, with over 140 breweries providing roughly 600 beers for customers to choose from; however, if Stiegl can implement the aforementioned recommendations regarding marketing their relative sustainability, implementing a CRM system, and providing more packaged products, the company will be able to continue their trend of gradually increasing their market share. In addition, in the long run, if they can strategically partner with a multinational without sacrificing their competitive advantage of being perceived local company, then they will be able to drastically increase profits in the long run.

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APPENDIX 1

1. How often do you consume beer per week?

Never	Once	2-3 times	4-7 times
0%	32.6%	53.5%	14.0%

2. Which of these Austrian beers do you usually buy?

Egger	Stiegl	Gösser	Ottakringer	Zipfer	Other
2.3%	48.8%	4.7%	20.9%	11.6%	11.6%

3. How do you rate Stiegl, based on these attributes, compared to other beers in general?

Attribute	Poor	Below Average	Average	Above Average	Great
Taste	2.3%	4.7%	20.9%	58.1%	14.0%
Value	2.3%	2.3%	53.5%	37.9%	14.0%
Quality	2.3%	2.3%	37.2%	44.2%	14.0%
Can/Bottle Design	0%	14.0%	44.2%	30.2%	11.6%

4. Why do you buy Stiegl?

Best taste	Best value (best taste for price)	It is a status symbol	Most visually appealing	Other
32.6%	23.3%	16.3%	4.7%	23.3%

5. Where do you most often purchase Stiegl?

	Most Often	Second Most Often	Least Often
Supermarket	74.4%	11.6%	14.0%
Restaurant	4.8%	33.3%	61.9%
Pub or Bar	20.9%	55.8%	23.3%

6. When you buy Stiegl from the supermarket, which of these products do you most often purchase?

Can	Small Bottle (.3L)	Large Bottle (.5L)	Other
14.0%	11.6%	69.8%	4.7%

7. How do you drink Stiegl? (May select multiple answers)

Casually/Socially	Binge Drinking	Special Occasions	Other
72.1%	37.2%	18.6%	7.0%

8. If you know a certain beer company is environmentally friendly, does it increase your chances of buying from them?

Yes	No
58.7%	41.3%

9. Do you think of Stiegl as being more or less environmentally friendly than other beer companies?

More	Less	I Don't Know
0%	0%	100%

Competitive Advantage at BMW: An Analysis

Kurtis Morrison
Fall 2010

ABSTRACT

BMW is one of the world's most successful auto-manufacturers, and is one of Germany's most important companies. Success or lack of success at BMW dramatically affects the automotive industry, specifically the premium segment, and would also affect the German economy's current account. I reviewed several dozen sources, and conducted personal interviews with those knowledgeable on the topic. As a result, the paper is able to provide an understanding of competitive advantage at BMW. It proposes four advantages that BMW holds which allow the company to compete, and identifies four critical sources of these advantages. It then considers the sustainability of these sources and is able to identify two sources as key strategic sources of sustainable competitive advantage: the ability to create an emotional connection with consumers, and the organizational behaviour characteristics (informal employee networks, cross-functional teams, and organizational culture) that facilitate innovation at BMW.

INTRODUCTION

Iconic German auto-maker Bayerische Motoren Werke AG, known worldwide as BMW, is a global force in the market it refers to as "individual mobility". Over the past five fiscal years, the company has amassed revenues of more than €250 billion – roughly \$350 billion USD. As one of the world's biggest players in its market, BMW's strategies, successes, and failures heavily impact the luxury car market, the automotive industry, and the German economy. Like many successful companies, BMW appears to have multiple sources of competitive advantage that have contributed and are expected to continue contributing to the company's success.

Some other successful carmakers have some particular source of competitive advantage that seems to be the crown jewel of the company. For example, the pull-model of production at Toyota that made its production processes far more efficient than its competitors, vaulted Toyota to the status of largest carmaker in the world, and the darling of business school case-studies internationally. Hyundai and Kia follow a cost-minimization strategy that allows them to keep prices lower than those offered by competitors.

BMW, which mainly competes with other *luxury* producers like Audi and Mercedes, does not have such an obvious source of advantage. This paper will examine and analyse some of the sources of competitive advantage that BMW has. It will argue that BMW possesses sources of competitive advantage related to: marketing, quality level, innovation, and production processes. The paper will argue that the sources of these advantages are engineering, organizational behaviour characteristics, the company's ability to create an emotional connection with its customer, and its attempt to become a mass customizer. The impact and more importantly, the sustainability of these advantages vary. As such, the overall purpose of this paper is to determine which sources of competitive advantage BMW should base its strategy

upon moving forward. These critical sources of advantage will be an emotional connection with the customer, and organizational behaviour characteristics.

1. COMPANY PROFILE

While it is expected that the reader is familiar with BMW, I felt that a brief profile of the company's operations is appropriate. BMW, founded in 1917, is the largest luxury car manufacturer in the world. The BMW group, in addition to the BMW brand itself, also produces the Rolls Royce and MINI brands, and a line of motorcycles. The company is able to generate high returns focusing on the premium segment of the automobile market, and the brand is associated with "high performance, engineering excellence and innovation" ("BMW Company Profile", n.d.). BMW's most known vehicles are luxury sedans and coupes, such as the 3, 5, 6, and 7 series.

However, with car enthusiasts, it is most well known for its "M" models. Cars bearing the "M" badge are high performance versions of existing series. The company has also been successful with the Z series of convertibles, made famous by its role as James Bond's car in the film *The World is Not Enough*. In 2008, BMW released its 1 Series in the United States ("BMW 1 Series Pre-Launch Consumer Survey Results Released by Pasch Consulting Group", 2008), a slightly more affordable version of the 3 Series. BMW's production facilities are located in Germany, although it has one American plant in Spartanburg, South Carolina. This factory, which was the fastest factory start-up in automotive history (23 months from groundbreaking to first automobile built), produces the X series for worldwide distribution ("Production Overview", 2010).

2. THE CONCEPT OF COMPETITIVE ADVANTAGE

Before continuing with this analysis, it is necessary to clarify the definition of competitive advantage I used in this analysis. This is because there are several varying definitions of the terms "competitive advantage" and "sustainable competitive advantage". For the purpose of this paper, I have chosen to define the term competitive advantage as "any factor that allows a firm to make profits greater than other firms in its industry; the reason for a customer to choose the product of one company over another".

Sustainable competitive advantage, when referenced in this paper, refers to a competitive advantage that can persist indefinitely in the absence of major systematic changes to the industry. The phrase "without major systematic changes to the industry" refers to the fact that no competitive advantage is absolutely sustainable in all contingencies. For example, the government could easily legislate away any kind of competitive advantage if it chose to do so.

As an example of competitive advantage based on these definitions, a firm that persistently achieves high profits might do so because they have a better marketing department than competitors. In this case, marketing would be the competitive advantage. It is a sustainable competitive advantage if there is no particular reason to expect that the advantage will be eliminated in the foreseeable future. The *source* of the competitive advantage is whatever factor causes the company's marketing department to be better than that of other firms in the industry.

2.1. DEFINING THE MARKET AND THE COMPETITION

Before this paper discusses possible reasons how BMW has a competitive advantage, it must define who the competition is. The "big three" competitors in the luxury car market are the German companies BMW, Audi (a Volkswagen brand), and Mercedes. Within Europe, these three producers compete

primarily against each other. Reiter (2010) provides the most recent market information -- October, 2010 monthly sales data -- which puts Audi's European sales at 52,181 units (up 2.2% from last 2009), BMW's at 51,863 units (up 6.2%), and Mercedes' at 50,855 units (down 2.5%) (Reiter, 2010). BMW is still the largest worldwide luxury car producer, however. Outside of Germany, BMW also competes fiercely with Lexus, Toyota Motor Company's premium brand.

In the US, Lexus and Mercedes' sales have been higher than BMW's through the first nine months of 2010, which saw BMW's sales grow at nearly 10% while Mercedes and Audi's US sales grew at rates higher than 20% ("BMW setting up for US luxury car market recovery," 2010). The big-three German automakers are also competing in developing markets. In fact, Matthias Wissmann, President of the German Car Industry Association, said in July 2010 that "[t]he drivers of growth are above all Asian markets" (as cited in "German luxury car sales to China boom", 2010).

2.2 COMPETITIVE ADVANTAGE THEORIES

2.2.1 Product Quality

As a premium product that clearly follows a differentiation-based competitive strategy, it would make sense if the company's competitive advantage was in quality. Internationally, BMW is praised for its engineering. However, in 2010, JD Power ranked BMW *below* Lexus and Mercedes in initial overall quality, and on-par with Audi. These rankings are determined by:

"owner-reported problems in the first 90 days of new-vehicle ownership, this score is based on problems that have caused a complete breakdown or malfunction, or where controls or features may work as designed, but are difficult to use or understand (Quality Rankings by Brand, 2010)."

However, JD Power has an entirely separate category called "Performance and Design". I prefer to define quality as "the ability of a product to meet the needs, wants, and expectations of the customer". Using this definition, performance and design should be considered when discussing quality. In this category, BMW, Audi, Lexus, and Mercedes were all given a score of 4/5, which means "better than most" ("Performance and Design by Brand," 2010). The JD Power method of ranking has been criticized, however. For example, Strategic Vision (2010), a firm that conducts its own auto rankings, communicated in a press release that "Simply counting how many problems a vehicle has or design characteristics that buyers do not find 'completely satisfying' or 'excellent,' is inadequate when determining why people spend tens of thousands of dollars on a new vehicle".

Regardless, even in Strategic Vision's 2010 rankings, BMW was not recognized as excelling in overall quality. This suggests that overall quality is not necessarily an advantage for BMW versus other luxury carmakers, but that a quality advantage at BMW must be in a specific area of quality. This paper will attempt to show that BMW is said to have a quality advantage in two specific areas: engines and technology. The company is a perennial contender in the International Engine of the Year awards, winning in four categories in 2010 ("International Engine of the Year Awards," 2010), and its new 7 Series was named the World's Most Technologically Advanced New Car of 2009 by iSuppli (as cited in "BMW 7 Series tops iSuppli's automotive technology scorecard," 2010). This was the fourth consecutive year in which BMW won this recognition.

Thus, BMW does have a quality advantage in some areas, both driven primarily by the talent of its engineering team. Please note that in the high-end automotive sector, which has had to adapt to the rapidly changing pace of computer technologies, quality and innovation seem to go hand-in-hand., and at times the line between the two is blurred.

2.2.1.2 Engineering

Burkhard Goschel, at the time a member of BMW's board of directors, stated in a 2004 interview that the "BMW Group knows what are its strengths. In concrete terms, this means that we know what we do best: we are best at the 'Premium' level" (as cited in "BMW on Innovation," 2005, p. 1). Goschel goes on to say that this understanding of its strengths has helped BMW become a market leader, with a focus on uncompromised engineering and new technology. As a company that seeks to sell cars based on differentiation, profits at BMW depend on high quality engineering. While design processes and organizational behaviour characteristics facilitate innovative, high quality engineering, Goschel points out that "processes are no replacement for ideas, since the process does not think of anything for itself", (p. 3) and believes that the fundamental source of BMW's innovative, high quality engineering stems from four characteristics of the people within the company: "courage, creativity, freedom and enthusiasm for new things" (p. 3). These qualities have led BMW to winning 25 Engine of the Year Award Categories in the past 5 years (see Table 1).

Table 1: International Engine of the Year Awards 2006-2010

Automaker	Category wins at International Engine of the Year Awards
BMW	25
Mercedes	5
Audi	2
Lexus	0 (although parent company Toyota has won several)

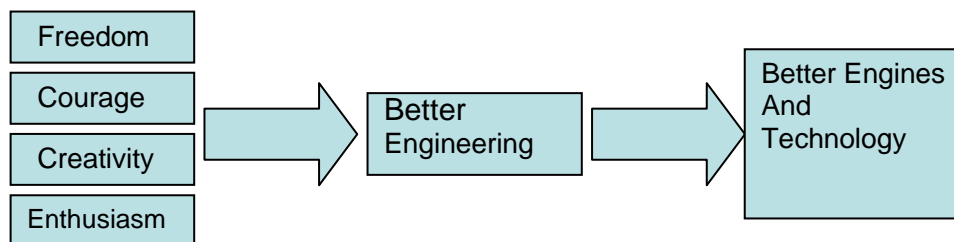
Source: "International Engine of the Year Awards" and "Previous Winners," 2010

What makes BMW's engine special? Speaking on the company's 3.0 litre twin-turbo engine which won Engine of the Year in the "2.5-3.0 litre" category for 2010, Jason Cammisa of Automobile Magazine said that "[w]ith refinement that no V6 engine can match, BMW's holdout in-line six is still the gold standard for power delivery and response – not to mention efficiency" (as cited in Horatiu, 2010). Judges at the International Engine of the Year Awards consider factors like "fuel economy, smoothness, performance, noise and drivability" ("International Engine of the Year Awards," 2010). Joseph (2010) claims that it is the fuel injector, ignition coil, thermostat, and oxygen sensor in a BMW that provide the truly superior efficiency of a BMW engine.

To gain more insight on the difference between BMW engines and those of their competitors, I interviewed Daniel St. Denis, a sales representative at Victoria BMW in Victoria, British Columbia. He says that the biggest engine difference is that BMW typically "uses an inline 6-cylinder engine, as opposed to a V-shape", which is the cylinder formation used by rivals. These engines allow for smoother, more responsive engine that wears easier and smoother (St. Denis, 2010). "BMW invests a huge amount of money, time, and research into these engines so that they can use the same one across the product line" (St. Denis, 2010), which means that more time can be spent on fine-tuning and trouble-shooting each engine. St. Denis (2010) also mentions that BMW is a leader in engine-turbo technology, allowing for increased efficiency. Asked if he thinks these factors affect the purchase decision on the sales-room floor, St. Denis (2010) said "Yes, depending on how you [communicate] them to the customer", as sales professionals can relate these characteristics to key purchasing criteria. For example, St. Denis (2010)

says that the fact he can tell a customer that a particular engine “is in five different [BMW] models” is a testament to the reliability of the engine. In this way, excellent engineering by BMW’s talented team drives sales at BMW.

Figure 1: The Source of BMW’s Engine & Engine Technology Advantage- Better Engineering¹



2.2.2 Innovation Process

One of the most common words describing BMW is “innovative”. In 2004, BMW was named Germany’s most innovative company (“BMW on Innovation,” 2005, p. 1) - impressive considering its rivals included Audi and Mercedes., and a supplier study in the US named BMW the most innovative automaker in America (Lago, 2009). In this study BMW far outperformed Mercedes, and Toyota (which is responsible for the Lexus brand). According to Merriam -Webster’s dictionary (n.d.), to innovate is to “make changes: do something in a new way”.

Although the quality of the engineering team at BMW helps create an advantage in engine and technology quality, we cannot overlook the fact that the innovation process, and the context for the innovation provided by top management, contributes to the product as much as the engineers do. BMW’s innovation advantage also lies with the environment created by managers for people at BMW to do their work. A set of organizational characteristics are the source of BMW’s competitive advantage in innovation processes.

2.2.2.1 Organizational Behaviour Characteristics: Informal Employee Networks and Cross Functional Teams

In 2006, BusinessWeek published a fascinating article by Gail Edmondson entitled “The Secret of BMW’s Success” which argued that innovation is the ticket to success in the auto industry, and that BMW has succeeded as an innovator because of organizational behaviour characteristics. The article argued that the company’s success is driven by informal employee networks and cross-functional teams. BMW encourages employees to engage in these informal networks across functional areas of the organization, and form self-directed teams.

Impressive levels of communication and innovation have resulted. James Manyika, who was a partner at McKinsey & Co. at the time, said that “cross-functional teams look messy and inefficient, but they are more effective at problem solving,” (as cited in Edmondson, 2006) which in his opinion is why companies like BMW are “widely ahead of their competitors”. This is a philosophy shared by management at the company. BMW executive Richard Gaul suggested that “discipline and creativity are not a paradox, there is a borderline case of self-controlling systems” (as cited in Edmondson, 2006). Edmondson (2006) argued that this ability to strike balance between discipline, traditionally associated with hierarchy and rigidity, and creativity, which is traditionally associated with chaos, would be the automotive industry’s

¹ “Freedom, Courage, Creativity, and Enthusiasm” suggested by Goschel ” (as cited in “BMW on Innovation,” 2005, p. 3)

next “kaizen”, Toyota’s continuous improvement philosophy which revolutionized automotive manufacturing. In agreement, Harvard Professor Karen Stephenson added that “a network is the only way to effectively manage BMW’s kind of complexity” (as cited in Edmondson, 2006). This is one area where it is clear that there *is* in fact a competitive advantage.

Indeed, if these organizational characteristics are the engines of innovation at BMW, then they create a massive competitive advantage. Edmondson (2006) compared BMW to less profitable companies in the industry such as Ford or General Motors (GM), noting that a critical difference is that the two Detroit-base automakers are criticized for a lack of innovation. Edmondson (2006) writes that GM in particular has been criticized for its rigid and hierarchical structure, which has stifled innovation and therefore left the company at a competitive disadvantage.

For further insight, I interviewed David Laubner, a graduate student at the HHL Leipzig Graduate School of Management, who has worked in benchmarking and competitive intelligence at Audi Consulting. Laubner (2010) agrees that BMW uses more cross-functional teams than its rivals, saying that “Project I is a great example of BMW’s use of cross-functional teams. They take people from all functions in separate departments and put them together to work on anything they want related to electromobility”. Laubner (2010) believes that having multiple departments working together ensures the best overall product, although he cautions about overestimating the difference between the premium carmakers: “there is so much benchmarking going on that it makes the premium brand cars such as BMW and Audi very similar”. Laubner (2010) describes the organizational culture at BMW as being much like a “family business”, that is very “passionate about being there for employees”. As a result, “someone who has made it to BMW will stay there very long” (Laubner, 2010), suggesting that this family-like culture helps the company retain top talent, which contributes to both innovation and quality.

Indeed, it appears that organizational behaviour characteristics such as informal networks, cross-functional teams, and organizational culture have created a competitive advantage for BMW.

2.3 MARKETING

For any product, physical characteristics alone are not enough to drive sales – the entire marketing process is crucial, from positioning strategy, to product design through to promotion. All of these factors affect the value of the brand. Interbrand, a consulting company focusing on brand management, ranked BMW as the 15th most valuable brand in the world. Mercedes, however, was 12th (“Best Global Brands Ranking for 2010,” 2010). The same rankings placed Audi placed 63rd overall, while Lexus did not make the top 100. One marketing aspect BMW does seem to do better than its competitors, however, is evoking an emotional response from people, and creating an emotional connection with consumers.

2.3.1 Emotional Connection with the Customer

BMW clearly thinks that having an emotional connection with customers is key to their success moving forward. The latest BMW branding activities are related to the “Joy is BMW” campaign, which seems to be aimed at evoking an emotional response from consumers. The people at BMW have a way of provoking passion and excitement in a way few others can. Helmut Panke, former Chairman of BMW, said that “[t]he BMW brands stand for a promise of *fascinating* individual automobiles – a promise we do and will keep” (as cited in Franzen, 2010, p. 1). Instead of focusing on how fast the car can go, how safe it is, or how luxurious it is, BMW ads are now focused on how it will make you *feel*. An excellent example of BMW’s appeal to the emotions of the consumer is found on the company’s website:

Joy. From this word a company has been built that is totally independent and committed to just one thing—the driver. We don't just build cars, we create emotions. We are guarantors of enthusiasm, fascination and goose-bumps. We compose new forms of Joy for which there are no words to describe. We are sheer driving pleasure ("Joy is BMW," 2010).

Jack Pitney, VP of Marketing for BMW, spoke on this strategy, saying that BMW wants to focus on the end-result of a BMW purchase: "it's the way the cars make you feel. Really, the "Ultimate Driving Machine" is about bringing the joy of driving to life" (as cited in Greenberg, 2010). Pitney continued that the focus on emotion, a clear difference from the strategy of Mercedes, Audi, and Lexus, is based on research showing that in a tough economic climate, like the one faced currently, "brands that do the best are those that are authentic, purpose-driven brands that have defined themselves over decades as being true to their core purpose". This led the marketing team at BMW to conclude that "if ever there has been a time to remind people what the BMW is about, now would be the time" (as cited in Greenberg, 2010). While the "Joy" campaign is new, BMW's ability to connect emotionally with consumers is not.

In 1999, an article by Hazlett and Hazlett (1999) was published in the Journal of Advertising Research that discussed the results of a study where the emotional reaction of consumers when they watched a particular commercial. BMW, Nissan, and Ford Mustang advertisements were shown, and BMW appeared to elicit the greatest emotional response from males that watched the commercial, as measured by facial Electromyography (EMG) and self-report from the viewer. Facial EMG is a "precise and sensitive method to measure changes in facial expressions" ("Emotional Activation and Facial EMG Measurement", n.d.), and is commonly used in scientific research to measure emotional expressions in advertising research ("Commercial Applications," n.d.). Later, it was shown that men who watched the automobile commercials had the highest recall of the BMW ad (Hazlett & Hazlett, 1999). Hazlett and Hazlett (1999) also point out that previous researchers have concluded that "consumer's emotional response toward the brand and/ or the ad can be a powerful motivator of consumption behaviour".

An example of how BMW uses its superior ability to create emotional connections with the consumer is its leadership in the field of green technologies. According to emotionalbranding.com -- a self-described "experimental think tank" for consumers and marketers alike -- "the single most important emotion in marketing right now is specifically related to people's passion to do something positive for their planet" ("Green Emotions," n.d.). BMW appears to be aware of this and has been on top of this trend for several years now -- in fact, in 2007 the company was criticized by some for spending *too much* money on green technology investments, after having increased Research and Development spending by 14% to \$645 million in the 2nd quarter of 2007 (Edmondson, 2007). While short-term profit margins may have been hurt, BMW is poised to reap the rewards of being associated by the customer with environmental friendliness after winning several awards such as 2008's World Green Car of the Year ("BMW 118d wins World Green Car of the Year," 2008), and maintaining its position on the DOW Jones Sustainability Index as the World's Most Sustainable Car Maker (Tay, 2010).

This emotional connection with the consumer is not just important in the promotion stage of the marketing process. It begins with the design, and continues to the experience customers have when driving a BMW for the first time. St. Denis (2010), the sales representative at Victoria BMW, says that the "joy of driving" motto is more than just an advertising method: "BMW is all about the joy of driving...from the engine, to the interior, and the suspension...everything is designed with a focus on the driving experience". He compares BMW to Mercedes, saying that Mercedes strives to build a car that is "pleasant, easy to drive, and has a beautiful interior", while BMW focuses on "how much fun the driver is having", noting that the interior of a BMW is comparatively "spartan".

While a slick communication strategy might get the customer inside the dealership door, the consistency of the philosophy from factory floor to the consumers' garage seems to be what really creates the emotional connection, because in St. Denis' opinion, the bulk of the emotional connection occurs when the customer drives a BMW for the first time. He says that most customers, once they've had a BMW, do not want to drive anything else, noting that he's "had some customers that have owned five or six BMWs in their life". Clearly, then BMW does have a marketing advantage based on its ability to create an emotional connection with consumers that is created by its consistent focus on the driving experience, and in the communication of that experience.

2.4 PRODUCTION PROCESSES

Toyota has garnered extreme praise for its Toyota Production System (TPS), the pre-cursor to the modern Integrated Production Management framework. The process by which cars are produced is critical both for keeping costs low and ensuring quality consistency.

BMW competes fiercely with similar German automakers like Audi and Mercedes. These rivals could also claim that their models are high quality, innovative, and expertly marketed. The real difference maker then could be in the production process – just like Toyota in the economy car market space. Indeed, BMW has a large project in the works, which may revolutionize the production process –and the way cars are made and sold in general: Mass Customization.

2.4.1 Mass Customization

James O'Donnell, BMW US's most senior executive, has set a goal of producing 40% of BMW's to exact specifications of customer orders by 2015 – bringing mass customization to the auto industry the way Dell brought it to the computer market (as cited in Muller, 2010). Although the execution of mass customization is difficult, its concept is quite simple. If production occurs only after an order is received, there is less-work-in process inventory at a given point in time and the time it takes to produce a given unit is shorter because it does not wait in an inventory build up at process bottlenecks.

The result is lower costs and higher profit margins. Muller (2010) says that O'Donnell is convinced that the new customization program will be a source of competitive advantage versus Audi and Mercedes in the future by taking "slack out of the production process, reduce inventory carrying costs for dealers and avoid hefty rebates on cars that aren't selling." (p. 1). Muller (2010) writes that the company is unrolling a customization push that promises customers who custom-order their BMW will receive their brand new car after two to six weeks. Compared to its US competitors, BMW has a much better chance of making a success of mass customization. Muller (2010) also points out that:

BMW's factory is already equipped to handle complex car production. It exports 70% of the vehicles it makes to more than 130 countries, each with its own regulatory requirements and consumer tastes. Also, instead of grouping features in a handful of popular packages like most carmakers, BMW sells many options à la carte. Thus, the plant could run two shifts seven days a week for six months and never build the same vehicle twice. (p. 2)

Muller (2010) also points out that one of the simplest and most profitable points of the mass customization push is that BMW allows customers to change their order up to six days before their car is scheduled for production and as a result, BMW customers each year change their order a million times. While this is convenient for customers, the important point for BMW is that these changes are usually additions of high-margin options that add revenue for the company (Muller, 2010). Peter Schmidt, a British auto-industry consultant, likens this additional revenue to "a big dollop of cream on the cake" (as

cited in Muller, 2010, p. 2). This customization is made possible by flexible labour agreements at plants such as the one in Leipzig, Germany (Muller, 2010). BMW's labour contracts allow it to operate in such a way that plant operation is dictated by demand. The Leipzig plant, for example, can run between 60-140 hours per week (Muller, 2010).

This customization strategy makes production more complex, and is certainly not the most efficient method. Muller (2010) also writes that metrics such as the number of cars produced per day per worker, for example, are lower. Garel Rhys, an auto-industry expert at Cardiff University, says that the revenue gains from customization outweigh the costs of a less efficient production line (as cited in Muller, 2010).

3. BMW AND THE CONCEPT OF SUSTAINABLE COMPETITIVE ADVANTAGE

For a competitive advantage to be sustainable, it must be difficult for competitors to copy. The sources of competitive advantage argued in this paper achieve varying degrees of sustainability. They will now be analyzed in this context.

3.1 SUSTAINABILITY OF ENGINEERING AS A COMPETITIVE ADVANTAGE SOURCE

While BMW's consistent domination in the field of Engine design, it is hard to argue that this could not be copied by Audi or Mercedes. All of the German companies are known worldwide for their engineering abilities, and if they desired to compete with BMW in this arena, they probably have the resources to do so. The reason they do not already match BMW's reputation in engine building is that it would not provide the best return on investment given the positioning strategy of the companies. For example, Mercedes, which focuses on the luxury aspect of the product, probably would not gain much in sales by improving the engines because its target customer cares less about such features than a BMW customer. However, were Mercedes or Audi to undertake a long-term brand positioning change, this competitive advantage created by superior engine design would likely be weakened or even overtaken.

3.2 SUSTAINABILITY OF ORGANIZATIONAL BEHAVIOUR CHARACTERISTICS AS A COMPETITIVE ADVANTAGE SOURCE

Organizational Behaviour characteristics at BMW such as informal networks and cross-functional teams might be difficult to copy exactly, but other Premium car companies can and do also use similar methods for innovation. While competitors might be able to copy the processes at BMW, they cannot completely capture the cultural input into these processes. The unique mix of organizational behaviour characteristics at BMW would be exceedingly difficult to mimic, and thus this advantage is comparatively very sustainable.

3.3 SUSTAINABILITY OF AN EMOTIONAL CONNECTION WITH CONSUMERS AS A COMPETITIVE ADVANTAGE SOURCE

This particular source of competitive advantage is an important one. As mentioned by St. Denis (2010), BMW buyers are commonly repeat buyers. This ability to turn a person into a "BMW person" is based on a philosophy that is as old as the company itself, and stems from the core values of the company. As core values cannot truly be imitated, it is difficult to imagine Audi, Lexus or Mercedes take this advantage away from BMW.

3.4 SUSTAINABILITY OF MASS CUSTOMIZATION AS A COMPETITIVE ADVANTAGE SOURCE

Because Audi, Mercedes, BMW, and Lexus all follow a differentiation strategy and compete in the luxury car market, BMW's competitors should be able to make the transition towards customization in international markets. Laubner (2010) says that in fact, BMW, Audi, and Mercedes produce *most* of their cars to custom orders within Germany, saying that "88 or 89 percent of new cars are built to custom order – if you want to be a premium brand, you have to offer customization". He suggests that one reason BMW might be making the biggest push towards customization in North America is that it has a plant in Spartanburg, South Carolina – making wait times for customers shorter if the cars had to be shipped from Germany.

In fact, the BMW Manufacturing Company's webpage boasts that 80% of cars produced at Spartanburg are produced to a custom order ("Production Overview," 2010). Laubner (2010) points out, however, that Mercedes also has a plant in the US. Thus, while BMW appears to be making the biggest push towards customization in the US, and as the company has achieved positive results already, the company's competitors have much of the know-how to do the same and likely will in the future having seen positive results at BMW. While being the "first to market" in a sense is certainly an advantage in the medium term and will create wealth for shareholders, this strategy should not be seen by BMW as a core competitive advantage source in the long term.

4. BMW'S COMPETITIVE STRATEGY MOVING FORWARD

Based on the different degrees of sustainability of the competitive advantage sources examined in this paper, BMW's long term competitive strategy should focus on two key points: the emotional connection with the customer, and organizational behaviour characteristics mentioned above: cross functional teams and informal employee networks.

4.1 STRATEGY REGARDING EMOTIONAL CONNECTION WITH THE CUSTOMER

The emotional link with the consumer is the most important part of BMW's future marketing success because it puts people in a BMW for the first time, and most importantly keeps them there for many years. The key to success is to further ingrain the "Joy is BMW" philosophy, where the focus is on the driving experience, in all of the company's marketing processes (from product design to communication). While the company already has implicitly held this "joy of driving" value for many years, it could be taken even further. Every aspect of BMW's business should focus on the emotions of the driver when they see, hear, and test-drive the car. Also critical to the emotional connection between the company and the car-owner will be BMW's customer relationship management initiatives. While there are of course unlimited possibilities for succeeding according to this strategy, it may seem vague without an example.

One way BMW can get a further emotional reaction from the consumer is by launching a "my first drive" campaign, featuring real customers' stories about their first experience in a BMW, focusing on the emotions they felt at the time, along with the appropriate footage and sound of a BMW in all its glory. The ad could explicitly encourage the viewer to test drive a BMW. The ad, focusing on human emotion, would likely appeal to the emotions of the viewer and thus begin this emotional connection to BMW. The focus on the "first drive" coupled with explicit encouragement to try a test drive could increase the number of viewers (especially having created an emotional connection with them) to visit a BMW dealership and test-drive a car. This first-driving experience is what really evokes emotion from the consumer and causes them to buy – repeatedly. The campaign would also strengthen the bond current

BMW owners have with the company as they get to submit their stories and share their experience with the company and potentially the world.

4.2 STRATEGY REGARDING ORGANIZATIONAL BEHAVIOUR CHARACTERISTICS

While the emotional connection to the customer gives BMW identity, innovation is what allows the company to continually improve the driving experience – so the two are interlinked and to an extent interdependent. Key organizational behaviour characteristics at BMW -- informal employee networks and cross-functional teams -- are what drive innovation at the company. One reason innovation is so important in terms of competitive advantage, is that it has the potential to uncover new sources of advantage. For example, a cross-functional team at BMW, using knowledge disseminated through informal employee networks, might develop an innovation that leads to new patents and access to new markets. Because customization and engine quality may not be truly sustainable sources of advantage at BMW, staying competitive means replacing them with new advantages, and this is done through innovation.

CONCLUSION

This paper has focused on four current sources of competitive advantage at BMW. They are: engineering quality with regards to engines and technology; organizational behaviour characteristics such as informal employee networks, cross-functional teams, and organizational culture; the company's ability to create an emotional connection with the consumer; and mass customization. These sources give BMW competitive advantages in the areas of quality level, innovation, marketing, and production processes. Of these competitive advantage sources, the emotional connection with the consumer and organizational behaviour characteristics were identified as the most sustainable sources of advantage, and thus it was suggested that these two sources be the focus of BMW's competitive strategy moving forward. Examples were given for how these sources could be even better utilized, including a "my first drive" campaign to push consumers to experience the joy of a BMW for the first time while concurrently strengthening the emotional bond with current BMW owners that submit their stories.

While this paper synthesized, analyzed and furthered the available information about the source of BMW's competitiveness, future research could look at the strength of the emotional connection between the customer and BMW; the individual impact of several organizational behavior characteristics, and possibly BMW's sustainability strategy and its impact on competitive advantage.

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Singapore Venture Capital Industry: A Study of Potential Long Term Challenges

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ABSTRACT

The Singaporean government has aggressively attempted to build a thriving venture capital industry over the past several years. This paper attempts to explain why venture capitalism is important to Singapore and how the industry has evolved to its current state, and to look at the challenges faced. A Strength, Weakness, Opportunity, Threat (SWOT) analysis was utilized to assess the current integrity and future potential of the industry. During my SWOT analysis, I also sought the advice of regional industry experts to help generate recommendations. Subsequently I investigated the assumptions that Singaporean people are not well-suited to the risk-taking culture associated with the venture capital industry. This paper concludes with the understanding that substantial potential exists within Singapore's venture capital industry, and its success hinges on changes of both its people and its government.

INTRODUCTION

Singapore is a unique modern nation that it has managed to sustain impressive economic growth without a significant source of natural resources. Singapore's government plays an active role in promoting economic growth through many social and economic initiatives. In the last several decades, the Singaporean government has made investments to promote the venture capital industry¹. After witnessing the success of Silicon Valley U.S.A, Singapore was eager to replicate a similar domestic version (Barkoczy & Sandler, 2007). The government was able to grow the industry at a phenomenal rate but critics question whether growth relied on too much subsidy. After fighting through a global credit crisis, Singapore's venture capital industry and domestic entrepreneurs continue to rely on subsidy as they move toward an uncertain future.

1. THE IMPORTANCE OF THE VENTURE CAPITAL INDUSTRY IN SINGAPORE

Venture capitalism has proven to be an important catalyst for economic growth. The success of new ventures creates jobs, supports innovation, and promotes entrepreneurship (Barkoczy & Sandler, 2007). According to a study by Barry, Muscarella, Peavy and Vetsuypens (1990), 30% of the market value of firms going public between 1978 and 1987 had received venture capital financing (Koh & Koh, 2002). This statistic helps emphasize the economic relevance of this industry to any country. When looking at Singapore's unique economy, the importance of venture capital becomes even more important.

¹ Within this paper, the venture capital industry will be referred to as a sub category of the private equity industry with several unique characteristics. The unique characteristics that differentiate the venture capital industry from the more broadly defined private equity industry are:

(i) Investments are made at the early stage of a businesses' life cycle; (ii) the venture receiving financing usually operates within a dynamic industry with potential for rapid growth; (iii) the venture receiving funding must have relatively few assets to support conventional means of funding; (iv) venture capital investors typically seek higher returns while taking on more risk.

In the essay called “The Myth of Asian Miracle”, Krugman (1994) discusses the parallels between economic growth in Singapore and Russia. Although the two countries starkly contrast one another in many ways, both countries had seemingly miraculous growth that can be attributed to the mobilization of resources (Krugman, 1994). From 1966-1990, Singapore raised the employment rate while drastically improving the education of their workforce and made massive investments in physical capital (Krugman, 1994). These all caused Singapore’s economy to grow faster than the most developed economies in the world, however, this type of growth could not be expected to continue. Eventually, economic growth of this nature slows as new capital provides diminishing returns and as more of the potential workforce is utilized and educated. Since Singapore’s prior growth was largely the result of one-time actions, future growth needs to take a new approach. Venture capitalism is one such method countries have adapted as an alternative to capital-intensive growth methods like the ones discussed above.

Developed economies like the United States have managed sustained growth by making capital more efficient through technological advances. The famous MIT professor Robert Solow once concluded that 80% of long-term per capita income growth in the United States can be attributed to technological progress (Krugman, 1994). For Singapore to continue growth at a rate that mirrored more developed nations, they would need to ensure they could continually innovate technology to more efficiently use the nation’s physical capital. From the perspective of the Singaporean government, a healthy venture capital industry could be seen as a way to develop technological innovations and foster a system of sustainable economic growth.

The job-creating potential of a healthy venture capital industry is especially appealing to Singapore. By 1960, in an effort to stimulate the economy, Singapore shaped their policies to attract large multinational firms (Vandenborre, 2003). This action worked well to educate domestic employees and stimulate firms that contracted with multinationals, but there were several problems with having an economy so reliant on supporting multinationals. First, multinationals had limited room for upward movement for domestic employees (Tan & Phang, 2004). Singaporeans found it difficult to move up to upper management positions as the multinationals usually had a well-established upper management. Second, multinationals were helping Singapore mobilize their resources but the strategy did not guarantee any hope for sustained economic growth.

The venture capital industry on the other hand could serve to address these two issues. Domestic ventures would allow Singaporeans access to upper management positions in new firms while innovations in technology could give an opportunity to mimic the more sustainable economic growth of Western nations.

2. THE TWO-WAY RELATIONSHIP BETWEEN SUCCESSFUL VENTURES AND THE SUPPLY OF VENTURE CAPITAL FIRMS

A successful domestic venture capital industry relies on two key factors. First, a country needs to be able to promote the kind of entrepreneurship and high-tech innovation characteristic of most ventures. The link between the venture capital firm’s success and innovation is clear. New innovations create the high-growth potential opportunities that venture capital firms thrive on. Second, the country needs to be able to fund new ventures with necessary capital and skilled professionals. Typically, banks do not fund high-risk ventures with high growth potential. Instead, ventures seek funding from venture capital firms who often lend skilled advice and guidance to the ventures they invest with.

The quality of support offered by venture capital firms is partially a function of the quantity and respective specialties of venture capital firms operating in the region. When a venture is conceptualized in a region without a qualified venture capital firm, it will be tempted to leave that region taking with it

many of the associated positive societal contributions. To prevent such a tragedy, it is important to have a sufficient domestic supply of venture capital firms to supply new ventures with the new capital and skilled advice they need to be successful. However, venture capital firms are less eager to enter a region unless it is located in close proximity to a source of new venture opportunities. Here the problem begins. Without ventures, there can be no venture capital firms and vice versa. Keeping this in mind, the Singaporean government’s initiative to support this industry to get it off the ground was started.

Singapore’s small size causes what is known as a “deal flow issue”. In the venture capital industry, deal flow is a term used to describe the number of venture deals coming from a particular region and low deal flow regions will be less appealing to foreign venture capital firms. To lessen the negative effects of weak deal flow, Singapore has made it a top priority to promote the kind of entrepreneurship that venture capital firms seek to invest with.

3. THE FUTURE OF VENTURE CAPITALISM IN SINGAPORE

Predicting the future is problematic at the best of times. After examining the past and present states of the venture capital industry, the future still remains unclear. Problems facing the industry have no clear remedy as some of the nation’s most powerful minds search for solutions. To analyze the future of such a thoroughly studied industry, my conclusions will rely not solely on my analysis and research, but the first-hand knowledge of local subject matter experts as well. To avoid making recommendations that have already been implemented but failed, I documented a history of the industry and its evolution in Singapore. This summary can be found in Appendix 1. Additionally, a summary of incentive schemes currently being used by the Singaporean Government is also included in Appendix 2. I have also undertaken a Strength, Weakness, Opportunity and Threat (SWOT) analysis of Singapore’s Venture Capital Industry.

3.1 SWOT ANALYSIS

SWOT Analysis is a useful tool typically used to assess the strengths, weaknesses, threats, and opportunities facing a firm. Rather than focusing at the firm level, I will use SWOT Analysis on a macro scale to perform a situational analysis on Singapore’s venture capital industry. I have captured my observations in Table 1 and a discussion of each quadrant follows.

Table 1. SWOT Analysis of Singapore’s Venture Capital Industry

Strengths (Internal)	Weaknesses (Internal)
<ul style="list-style-type: none"> -Strong Government incentives aim to attract VC firms and encourage start-ups -Promotion of institutional networks -Attractive domestic business climate -Educated population capable of research -Asian/Western skill sets and proximity to large Asian markets 	<ul style="list-style-type: none"> -Conservative and risk adverse citizens -Misalignment of interests between Government and a healthy venture capital industry: <ul style="list-style-type: none"> - Products vs. intangibles - Divestiture plans and intentions -Key performance indicators and the Governments system of industry control -Existence of a creativity gap. (Debatable)
Opportunities (External)	Threats (External)
<ul style="list-style-type: none"> Use <u>corporate</u> venture capital firms to realign the value-chain -Testing parks -Singaporean perspectives aligning with foreign outlooks on entrepreneurship, risk and failure 	<ul style="list-style-type: none"> -The crowding out of Singapore’s niche by other evolving Asian markets

3.1.1 Strengths

3.1.1.1 Strong Government Incentives Aim to Attract VC Firms and Encourage Start-ups

As mentioned previously, Singapore has made numerous attempts to boost its appeal for venture capital investors and prospective entrepreneurs. Although the net effects of these efforts have been arguably unsuccessful, Singapore has set up the infrastructure to theoretically encourage venture capitalism. The question remains, why, despite heavy incentives relative to other nations, do Singaporeans not participate eagerly in entrepreneurial endeavors?

3.1.1.2 Promotion of Institutional Networks

Within the venture capital industry, financial institutions, professionals, venture capital firms, new businesses and researchers all collaborate to help one another achieve their respective goals. Typically strong networks rely on the existence of a strong supply of venture capital firms. Without access to a healthy supply of venture capital firms, these networks are eroded (Siegfried, 2011). In recent years, the People's Action Party (PAP) has put extra effort into promoting networks to discourage informational asymmetries that occur between institutions in the absence of a solid source of venture capital firms. Specifically, the PAP has used websites and ran marketing campaigns to improve networks (SPRING, 2011). The promotion of networks also helps venture capital firms gain information about their investments limiting their risk exposure (Koh & Koh, 2002).

3.1.1.3 Attractive Domestic Business Climate

Singapore is regarded as having a highly efficient business environment. Singapore finds itself in a stage of transition as it switches from an efficiency driven model of economic growth to an innovation driven growth model (Tan & Phang, 2004). Since inception in 1960, Singapore's government (PAP) has recognized its comparative disadvantage as a minute economy with a low population and small domestic markets (Ibid). To compete globally, the nation's leaders tried to promote efficiency at every turn in an effort to transform Singapore into an efficient business center. The nation's land planning, transportation, logistics, energy, water use, Internet, telecommunications, and education were all developed with great care to promote efficiency (Vandenborre, 2003).

Many of these efficient sectors/areas translate into strong points for Singapore's venture capital industry. By improving local business conditions, foreign venture capital firms along with prospective entrepreneurs and ventures are attracted to Singapore. Singapore has had a stable institutional regime for decades and this is unlikely to change in the foreseeable future. The PAP has always been an uncorrupt government keen on attracting foreign business. Strong intellectual property laws and a predictable legal system, has made Singapore the kind of business climate that should theoretically be well-suited to new ventures.

3.1.1.4 Educated Population Capable of Research

Education and research promote innovation in a general sense but are especially critical to high-tech innovations. Singapore has an extremely educated population and research intensity has been rising in recent years (Ministry of Trade and Industry, 2010).

3.1.1.5 Asian/Western Skill Sets and Proximity to Large Asian Markets

In addition to education, Singaporeans are culturally in tune with both China and Indian cultures offering foreign ventures a strong stock of suitable professionals to expand into these large economies.

3.1.2 Weaknesses

3.1.2.1 Conservative and Risk-adverse Citizens

Despite having many positive aspects, Singapore's venture capital industry has a number of weaknesses, many of which, are problematic to correct over the short-term. Singapore's ranking as an entrepreneurial society lacks consistency. On one hand, the Economist Intelligence Unit has ranked the nation as the most entrepreneurial society in Asia and twelfth globally (Vandenborre, 2003). Contrastingly, the Global Entrepreneurial Monitor gave a more modest appraisal as Singapore was ranked twenty-first out of thirty-seven nations. The roots of Singapore's entrepreneurial problems seem to be societal (Vandenborre, 2003).

Each year, as the number of PhDs and Masters degrees continually rise along with the country's research intensity, another trend seems to be limiting the potential of Singapore's venture capital industry. Singaporeans seem to have developed a fear of failing and prefer the security of non-entrepreneurial careers (Vandedborren, 2003). Many researchers and policy makers point their fingers at society and Singapore's culturally engrained social values.

Singapore's venture capital industry was modeled after Silicon Valley of the United States and one of the main success factors within Silicon Valley was the existence to a risk-taking culture (Koh & Koh, 2004). Despite extensive planning and funding, incentive structures have not been able to sufficiently mobilize Singaporeans to accept the risks associated with entrepreneurial pursuits. As Singaporean policy advisor Alain Vandenborre puts it, "at the fundamental level, we need to inculcate a culture in which Singaporeans want to be entrepreneurs." He later argues that the societal values of Singaporeans directly encumber entrepreneurial pursuits as they discourage risk taking and free thinking.

3.1.2.2 Misalignment of Interests between Government and a Healthy Venture Capital Industry

In a face-to-face meeting with local venture capital expert Frank Siegfried, I was able to investigate new aspects of the Singapore's venture industry that had previously been a mystery to me. Mr. Siegfried has experience working for privately run venture capital firms and acts as an advisor for the Monetary Authority of Singapore. Additionally, he has experience working for government-run venture capital departments all over the world including The National Venture Capital Association in the United States.

It was Mr. Siegfried's opinion that Singapore's Government, keeping with its character, has been getting involved in an industry that should be free from many types of state interference. Both issues discussed here arise from poor alignment of interests between the government and the rest of the venture capital industry. The misalignment of interests caused from Government interference creates problems in two key areas:

- The Singaporean government has made incentives and policy to promote services and knowledge-based growth in the venture capital industry but venture firms have a strong "hardware bias" toward investing in tangible products. Additionally, while the Singaporean Government is mostly interested in promoting domestic start-ups, the majority of big global venture capital funds are more interested

in the international market potential of start-ups. The misalignment of interests only widens when one looks at how conventional venture capital exit strategies affect the domestic economy of Singapore (Siegfried, 2011).

- Generally speaking, a venture capital firm will invest with a business and actively try to grow that business with an intention to divest its ownership shares at a later date. During the phase of divestiture, Singapore faces another perplexing problem. The nation's own domestic exchange (the SGX) and foreign exchanges (like the NYSE) value divesting ventures at different values and almost always offer higher returns to sellers if sold on foreign exchanges (Ibid). The reasons for exchange pricing discrepancies are complex but partially have to do with the existence of foreign infrastructure like testing parks². With higher pricing being offered outside the SGX, divesting venture capitalists will sell for the higher price on foreign exchanges and money will shift offshore from the domestic economy. In a highly subsidized industry this trend becomes especially problematic because the initial economic growth was not a result of the free market (Ibid).

3.1.2.3 Key Performance Indicators and the Government's System of Industry Control

Singapore's publically operated venture capital firms operate differently than conventional privately run venture capital firms. Instead of being motivated through profits, Singapore's state-operated venture capital firms are motivated through what are referred to as Key Performance Indicators (KPIs) (SPRING, 2011). With different goals driving public and private venture capital firms, the two types of firms behave differently in many regards. For example, state-run venture capital firms are focused on domestic effects of growth while privately run venture capital firms are more keen to grow globally without excessive care for domestic effects on host nations (Siegfried, 2011).

3.1.2.4 Existence of a Creativity Gap

Singapore has a highly educated population and dumps billions of dollars into research projects designed to stimulate innovation. In light of these efforts, when one thinks in terms of the marketable products coming from Singapore, the results are not very impressive.

Following these results, one may think Singaporeans are suffering from an innovation drought. Whether walking down the street or through the halls of domestic academic institutions, anecdotal observation suggests there has been a tremendous effort to boost the innovative capacity of Singaporean citizens. Classes, clubs, workshops, and seminars designed to foster innovative thought are offered to all who are interested. Such classes, clubs, and seminars exist in many countries but the prominence and frequency in Singapore is notably high.

3.1.3 Opportunities

3.1.3.1 Use Corporate Venture Capital Firms to Realign the Value-chain

Corporate venture capitalism³ has taken off in the United States and Europe and involves a different kind of value-chain than conventional venture capitalism. The traditional venture capital industry

² Test parks are places where venture capitalists can test the "street application" of their products on real sample target audiences. The data is valuable in the eyes of potential investors and can often influence selling prices of ventures. Singapore has no such facility but facilities exist in the U.S.A and Europe.

³ Corporate venture capitalism uses businesses in the place of venture capital firms. This trend has picked up in the U.S.A where businesses like Google and Cisco use their skills and investing power to coach and nurture new start-ups operating in their respective industries. In Singapore, this style of venture capitalism could help give new start-ups alternatives to state-run venture capital firms.

involves a close link between institutions like venture capital firms, banks, and new businesses. In Singapore, Government involvement has disrupted the ordinary system in which venture capital firms and investors provide each other value. One way to restore a more classic venture capital industry would be to introduce what is known as corporate venture capitalism. With a corporate venture capital system, businesses play the role ordinarily played by venture capital firms and seek to invest in and grow new ventures that spring up in their respective industries. Corporate venture capitalism has a proven track record in other countries and coexists well with a more traditional venture capital industry (Siegfried, 2011). Singapore has not sufficiently utilized “corporate venture capitalism” and this method of venture growth could potentially coexist well with Singapore’s unique venture capital industry.

3.1.3.2 Testing Parks

Testing parks help ventures raise capital by allowing them to test the street applications of their products and gain value in the eyes of investors. Currently, Singapore has no such facility. In the United States, testing parks allow venture owners to test the “street” application of their products and develop a case for profitability. The existence of value adding infrastructure like test parks in foreign countries is one of the reasons Singaporean domestic ventures are divested for a higher price when listed on foreign exchanges (Siegfried, 2011). The introduction of test parks in Singapore may give ventures trading on the SGX more internationally competitive prices.

3.1.3.3 Singaporean Perspectives Aligning with Foreign Outlooks on Entrepreneurship, Risk and Failure

In this age of globalization, an opportunity arises as Singaporean societal values shift from their current state, to a more global perspective. When it comes to having the kind of society-wide risk taking attitude that is attributed to the success of Silicon Valley, Singapore has a long way to go. However, this country has changed tremendously in a very short period and its people have proven to be adaptable. Opportunities could unfold as Singapore shifts from a risk-averse society to adopt a more globalized outlook on entrepreneurial risk.

3.1.4 Threats

3.1.4.1 The Crowding Out of Singapore’s Niche by Other Evolving Asian Markets

Singapore is dwarfed in size by the surrounding mega economies of India, China and Japan. Close proximity to these large economies has been long considered a gift as western firms have used Singapore to get a foothold in Asian markets before further expansion. Singapore’s proximity to these large economies has also helped generate informational advantages that have helped the development of its financial sector. However, as China and India become more developed, Singapore’s position as an attractive entry point into Asian markets becomes weakened. Maturing nearby economies directly affect the venture capital industry when international venture capital firms overlook Singapore in favor of growing their ventures in China and India where markets have more growth potential.

4. ANALYSIS AND RECOMMENDATIONS

After carrying out a SWOT Analysis, it is clear that Singapore’s venture capital industry is in trouble. Based on my SWOT, I suggest three ways Singapore could utilize its strengths and avoid its weaknesses while seeking opportunity and warding off threats.

First, the government of Singapore needs to encourage citizens to develop a stronger entrepreneurial thirst. However, this first suggestion is already being implemented to some degree. From my own anecdotal observations, it seems clear that the government has made attempts to spawn innovation and entrepreneurship in society. Within academic institutions like Singapore Management University (SMU), the message could not be stronger as students are encouraged to think entrepreneurially and innovatively. Tax incentives and loan schemes are also aligned to promote entrepreneurial pursuits. After assessing all the incentives and pondering the absence of entrepreneurship, one begs the question, how quickly can a society shift? Improved innovation would help the venture capital industry along with the rest of the economy.

Second, it is important to maintain Singapore's position as a "stepping-stone" into Asian markets. This boosts the country's appeal in the eyes of international venture capital firms and could help attract expanding ventures developed elsewhere. To enhance the country's positioning, Singapore could utilize its educated workforce with a cultural aptitude for Western, Indian, and Chinese cultures. Building these cross-country networks now will help ensure Singapore's future venture capital industry is not forgotten when the surrounding mega markets develop to be more accommodating to expanding ventures.

My third suggestion is perhaps the most important as it addresses what may be the main issues facing Singapore's venture capital industry. Firstly, the Government's interference with the venture capital industry has led to a misalignment of interests between new ventures and venture capital firms. To realign interests to resemble those typically found in a healthy venture capital industry, I suggest Singapore utilizes corporate venture capitalism. In the United States, corporate venture capitalism has proven to work well alongside a traditional venture capital industry. For Singapore, the benefits are numerous. Corporate venture capital would introduce more alternatives to new ventures seeking funding. It would improve the growth potential of established businesses and new ventures by connecting established businesses and their skilled professionals with new fresh ideas within the industry.

Another major issue arises from not being able to keep foreign venture firms from divesting their investments in foreign markets. To counter this issue, Singapore needs to be able to generate value in the eyes of investors trading new ventures on the SGX. One way to test the potential real value of a venture and improve investor impressions is to test the products of a venture in a test facility. Test facilities like this already exist in the United States and Europe. These tests can determine the value of products to consumers and the data can be used to generate more accurate profitability forecasts. Test facilities could focus on consumers in Singapore as well as other nearby Asian mega economies and would ideally raise the value of ventures on the SGX.

After completing the SWOT analysis, one issue facing Singaporean society appears especially important going into the future. Specifically, how are Singaporean societal perspectives going to change to better suit the risk-taking attitude essential to a successful venture capital industry? Before concluding this paper, I will present the results of my test of the assumptions made about Singaporeans' risk-taking attitudes.

5. CONSERVATIVE AND RISK-AVERSE CULTURES AND ENTREPRENEURSHIP

According to SMU professor and venture capital industry specialist Winston TH Koh, thriving innovation relies on an economy open to trade and investment, a sound infrastructure, sensible approach to intellectual property rights, a culture open to risk-taking and achievement, an open-door policy toward global talent, as well as a robust financial system which includes private equity and venture capital (Koh & Koh, 2002). This list of criteria is largely present in Singapore but a culture of risk-taking is certainly

absent. As Singapore tries to promote a culture of innovation and entrepreneurship, how are the perspectives of their citizens changing? I decided to test Singaporean business student’s outlooks on accepting risk and pursuing entrepreneurial careers.

5.1 MY TEST

Hypothesis: When compared to foreign exchange business students, I suspect Singaporean Business students will be less interested in entrepreneurial pursuits and more risk-averse.

Process: I designed a five-question survey and surveyed 25 male and 25 female Singaporean students. I then surveyed 25 male and 25 female exchange students. I repeated this process for two universities and surveyed a total of 200 students. My survey questionnaire can be found in Appendix 3.

Methods: My test compares Singaporean students with foreign exchange students and examines their perspectives on risk-aversion and entrepreneurship. Samples were limited to business students from Singapore Management University and National University of Singapore. My samples represent both genders and schools equally.

Findings: The findings are given in Table 2 below.

Some findings correspond with the hypothesis. For example, Singaporean business students expressed a 62% preference toward conventional employment and only 38% were interested in a career in entrepreneurship. The results are nearly reversed when looking at foreign exchange students with only 32% preferring conventional employment to entrepreneurial careers.

Table 2. Aggregated survey results from SMU and NUS

	SINGAPOREANS			FOREIGN EXCHANGE STUDENTS		
	Female	Male	Combined	Female	Male	Combined
Preference to conventional employment over entrepreneurial pursuits	62%	44%	53%	34%	30%	32%
Scale of risk-aversion. (1=risk averse) (5=not risk averse)	1=12%	1=10%	1=11%	1=20%	1=12%	1=16%
	2=34%	2=36%	2=28%	2=22%	2=18%	2=20%
	3=28%	3=24%	3=22%	3=38%	3=48%	3=43%
	4=16%	4=16%	4=27%	4=12%	4=12%	4=12%
	5=10%	5=14%	5=12%	5=8%	5=10%	5=9%
Mean risk-aversion score	Mean=2.78	Mean=2.88	Mean=2.83	Mean=2.66	Mean=2.92	Mean=2.78
Biggest hurdle preventing entrepreneurial career	A=42%	A=38%	A=40%	A=28%	A=38%	A=33%
	B=22%	B=40%	B=31%	B=54%	B=36%	B=45%
	C=36%	C=22%	C=29%	C=18%	C=26%	C=22%

When testing risk aversion, Singaporeans scores surprisingly indicate they are more willing to accept risk than exchange students as given in Table 3. However, when scores are separated by gender, foreign male exchange students are more willing to accept risk than Singaporean male students. The reverse trend exists for women, with Singaporean women having a higher tolerance for risk.

Table 3. Mean scores on risk aversion survey.

Risk-averse=1 Accepting of risk=5	SINGAPOREANS			EXCHANGE STUDENTS		
	Female	Male	Combined	Female	Male	Combined
Risk aversion mean score between (1-5).	2.78	2.88	2.83	2.66	2.92	2.78

I tried to determine what students considered the biggest obstacles blocking an entrepreneurial career. Singaporeans appear to consider the biggest obstacle getting sufficient knowledge of an industry to be a successful entrepreneur. Exchange students viewed a lack of quality ideas as the biggest hurdle. Lastly, Singaporeans considered the fear of failing to be a more significant problem than foreign exchange students did. The scores are displayed in Table 4 below.

Table 4. Biggest obstacles preventing entrepreneurial pursuits where:

- a=Lack of knowledge about industry.
- b=Lack of relevant entrepreneurial idea
- c=A fear of failing

	SINGAPOREANS									EXCHANGE STUDENTS								
	Female			Male			Combined			Female			Male			Combined		
Biggest obstacle preventing entrepreneurial goals	a	b	c	a	b	c	a	b	c	a	b	c	a	b	c	a	b	c
Percentage	42	22	36	38	40	22	40	31	29	28	54	18	38	36	26	33	45	22

CONCLUSION

The nature of Singapore’s venture capital industry is unique. Heavy government interference has helped get the industry off the ground but it now faces a number of complex problems. Change is needed for the industry to ever live up to its once dreamed potential. The first change needs to come from the Singaporean people. The Singaporean venture capital industry was modeled after Silicon Valley U.S.A, which relied heavily on the entrepreneurial spirit of Americans. The people of Singapore need to adopt an entrepreneurial spirit that resembles that of western societies.

My survey showed that even in business schools, the Singaporean interest in entrepreneurship lags considerably behind that of exchange students. As the government places effort on innovation and idea generation, Singaporean’s unwillingness to take ideas to market is hurting the venture capital industry.

Other major changes need to come from the government. PAP has recognized the complex implications that can arise from having an over involvement in the industry. Singapore's venture capital industry is no exception, as the interests of state-run venture capital firms don't always align with the interests of new ventures. Furthermore, private and state-run venture capital firms often have different agendas with regard to exit strategy and investment interests.

Despite these numerous problems, the future of the industry does have hope. Building domestic infrastructure, like test parks, could help boost the value of new ventures in the eyes of investors trading on the SGX and prevent divestiture on foreign exchanges. To address the misalignment of interests within the industry, corporate venture capitalism could be introduced and promoted on a large scale. Corporate venture capitalism has proven to work well alongside conventional venture capital models and could realign the interests of institutions within Singapore's industry. With these changes in place, Singapore may better utilize its strengths to help grow a strong venture capital industry.

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APPENDIX 1

Evolution of the Venture Capitalism in Singapore

Today, Singapore is recognized as being heavily involved in the promotion of venture capitalism (Bartzokas & Mani, 2004). However, this was not always the case. Before 1980, Singapore was uninvolved in the world of venture capitalism. With the entry of the South East Asia Venture Investment (SEAVI) and the construction of the Singapore Science Park, the country's journey into venture capitalism began. In an effort to replicate the economic success of Silicon Valley U.S.A, Singapore's Economic Development Board (EDB) created the Singapore Science Park to promote R&D in the region. Almost simultaneously, the SEAVI started up Singapore's first venture capital fund focusing on investments in small to medium sized ventures with high growth potential. Venture capitalism was off to a booming start as the new fund's capital under management, and Singapore's total venture capitalism pool at the time grew from S14 million to S94 million in just two years (Bartzokas & Mani, 2004). After 1985, the EDB's subsequent nurturing of the venture capitalism industry helped to grow the country's venture capitalism pool to more than S1 billion. The EDB influenced growth of the venture capital industry by making direct investments in ventures and by setting up strategic programs designed to grow the industry (Bartzokas & Mani, 2004).

During the 1990s, venture capitalism in Singapore continued to boom. During this time, the government continually directly invested in new ventures with the intention to promote new industries and develop innovative technologies. During the 1997 Asian financial crisis, growth slowed only to rapidly increase in 1999. New venture capital investments in Singapore grew from S100 million in the year of 1992 to over S1000 million of new investment in 1999. Consequently, Singapore's venture capitalism pool grew at an average rate of 28% per annum from 1992-2000. In 1999, venture capitalism in Singapore underwent its biggest year of growth. This growth can be largely attributed to government promotion of information technology and biotechnology (Bartzokas & Mani, 2004).

By the beginning of year 2000, Singapore's position as a global financial hub allowed it to easily transition to become a hotspot for absorbing overseas venture capital funding. By 2001, Singapore-based venture capital funds were only invested in 16 % ventures operating out of Singapore. Other Asian countries and non-Asian countries accounted for the other 67% and 17% respectively (Bartzokas & Mani, 2004). Venture capital firms continued to invest in nearby markets when faced with a drying supply of domestic new ventures. The venture capital industries domestic investing drought would prove to be a problem in the years to come.

By 2004, the Singapore venture capital industry was suffering at the seed level. That is to say the venture capital firms were reluctant to invest in firms at the earliest stages of development and preferred to invest with more established ventures. The industry was also hampered by an insufficient supply of local venture deals. Entrepreneurship was on the decline in Singapore as evidence showed Singaporeans preferred conventional employment over entrepreneurial pursuits (Goliath, 2008). With a lack of domestic investment opportunity, venture capital firms increasingly looked to invest in nearby non-domestic markets.

Significant public funding had pushed the venture capital industry to grow at a phenomenal rate. Singapore now had to find a way to grow and support this industry without such heavy government subsidy. By 2008 the government had not made significant progress cutting back on subsidizing the venture capital industry (Goliath, 2008). Furthermore, despite government-run promotions and

incentives designed to entice entrepreneurs, entrepreneurial spirit was down in Singapore. The global credit crunch of 2008 did not help the industry and deals slowed only to begin to rise in 2009 when venture capital firms were becoming more willing to invest in higher risk seed staged ventures (Silicon India, 2010). Currently Singapore has to re-evaluate the sustainability of their venture capital industry.

APPENDIX 2

Government Incentives In Singapore's Venture Capital Industry

Currently, Singapore has many tax incentives, loan schemes, grants, and programs aimed to promote a healthy venture capital industry. In an effort to attract foreign venture capital firms, encourage entrepreneurship, and promote innovation, the Singaporean Government has made a number of catered tax incentives. Some of the major tax incentives affecting the venture capital industry are: the pioneer industries incentive, the pioneer service companies' incentive, the development and expansion incentive, the investment allowance incentive, the enterprise investment incentive, and the venture company tax incentive (Barkoczy & Sandler, 2007). The "pioneer industries incentive" aims to promote the growth of important pioneer industries by allowing a fifteen-year income tax free period. To qualify for this incentive, a firm has to prove that it is both producing a pioneer product and operating in an industry that is not yet meeting the country's economic needs. The "pioneer service companies' incentive" has similar tax incentives as the "pioneer industries incentive" but applies to pioneer service companies. Companies waiting to qualify for one of the above tax incentives may apply for a "development and expansion incentive" pending approval of a Minister. The "development and expansion incentive" gives a tax reduction on income tax down to a minimum of 5% for a maximum of 10 years. Other tax incentives aim to protect those who invest in new ventures. The "enterprise investment incentive" allows investors to deduct losses accrued from the investment in or liquidation of qualifying shares from approved start-up companies.

Another tax incentive aimed at attracting venture capital firms is the "venture company incentive." This tax incentive gives a reduced tax rate (between 0% and 10%) to approved venture capital firms. In 2010, the productivity and innovation tax credit (P.I.C) was introduced. The P.I.C was geared to promote innovation by giving a tax rebate of 25% on all expenditures classified by the minister as innovative. Lastly, the "investment allowance incentive" further improves a new venture's ability to access capital by allowing companies to deduct up to 100% of capital expenditures on projects approved by the Minister. In addition to tax incentives, the Singaporean Government also offers other subsidy aimed to promote new ventures (Barkoczy & Sandler, 2007).

Singapore's economic development agency, known as SPRING, has developed a series of loan schemes to promote the growth of new ventures. SPRING offers several loan schemes through a network of financial institutions that may be used to fund the growth of qualifying SMEs. Other loan schemes offer funding to SMEs trying to internationalize. All loans are subject to approval and firms must meet specific criteria to qualify. To limit the risk exposure of lenders, both the borrowing companies and the Government evenly pay a risk premium to participating financial institutions (SPRING, 2011).

Singapore also subsidizes growth of the venture capital industry through programs such as the SPRING Seeds Program, the Growth-Financing Program, and the EDB Investment Funds. The SPRING Seeds program basically funds new start-ups by matching every dollar of equity raised by a third party for a new start-up. Similar to the SPRING Seeds program, the growth financing program funds start-up ventures but focuses on new ventures intending to expand overseas. Lastly, the EDB operates several venture capital funds through EDB Investments Pte Ltd. These funds frequently invest in high-tech

biotechnology ventures, pharmaceutical ventures, and medical technology ventures (Barkoczy & Sandler, 2007).

There are more than six grants aimed to further promote the industry and many have similar effects as the already mentioned subsidies. The “Local Venture Technical Assistance Scheme” reimburses ventures that seek help from external experts. The “Training Assistance Scheme” assists ventures needing to train their employees with specialized skills. Other unique grants include patent protection grants and grants designed to fast track the commercialization process (Barkoczy & Sandler, 2007).

The Singaporean Government has set up Enterprise Development Centers to consult new ventures with their financing, growth or marketing needs. Additional support has also been given through the Government’s website called DEALS where new ventures are matched with venture capital firms for investment funding. Despite Singapore’s venture capital industry’s growth, many argue it has been over-subsidized (Barkoczy & Sandler, 2007).

APPENDIX 3

Sample Survey for Students

i) Your gender?

Male Female

ii) Please state your nationality: _____

1.) Are you currently or have you been a student in the past 3 years?

- a) Yes
- b) No

2.) When it comes to your career path, what choice do you prefer?

- a) You aspire to follow entrepreneurial pursuits?
- b) You aspire to follow traditional employment streams?

3.) With respect to entrepreneurial endeavors, which of the following is a greater concern?

- a) A lack of necessary knowledge about the industry in which you plan to operate
- b) A lack of good business ideas for a business
- c) A fear of failing

Corporate Social Responsibility (CSR) Reporting in Japan: Effects of Government Guidelines and Initiatives

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Fall 2010

ABSTRACT

This paper explores the influence and effects of government guidelines and initiatives on corporate social responsibility (CSR) reporting in Japan. It begins with a brief overview of past and present reporting trends and also explains Japan's government-business relationship. Findings from interviews and surveys conducted with Japanese business professionals and CSR reporting companies are presented, as well as observations from forty Japanese CSR reports currently following the Global Reporting Initiative's (GRI) G3 reporting guidelines. Current challenges facing materiality and assurance were identified and possible solutions were explored. A cost and benefit analysis of Japan's mandatory environmental reporting law was also conducted. Lastly, this paper summarizes the pros and cons of implementing a CSR reporting requirement in Japan. Results from the studies described above demonstrate that government initiatives have a strong influence on Japanese reporting trends and that the Government of Japan should maintain an active role in shaping the future of reporting.

INTRODUCTION

Since the 1970s there has been a significant change in attitude towards information disclosure by businesses in Japan and the rest of the world. With the shift from a business community that only reports financial information to one where businesses actively disclose economic, environmental and social information, the *Triple Bottom Line (TBL)*, Japan has emerged as a world leader in *Sustainability or Corporate Social Responsibility (CSR) Reporting*. In the past decade Japan has demonstrated a substantial increase in the percentage of companies reporting on non-financial information. A large portion of Japan's success has been credited to government guidelines and initiatives.

Regardless of overall reporting figures continuously rising, there are still mixed opinions from businesses and professionals about the effectiveness of the government's role on CSR reporting. Japanese companies are consistently criticized on the same aspects of reporting and significant challenges have been presented. Nonetheless, the recognition of a nation that excels in environmental reporting and accounting exists. Although there are evidently multiple factors influencing reporting, this paper will focus on evaluating the influence the Japanese government has on CSR (primarily environmental and social) reporting and evaluate costs and benefits of mandatory reporting in Japan.

1. METHODOLOGY

The study was carried out during Fall 2010 (September - November) while participating in an international exchange with Akita International University (AIU) in Japan. In addition to analyzing information found in secondary sources, primary data was collected through personal interviews and surveys, and reviewing published CSR reports in Japan. The objective was to gather information from

different sources and arrive at a supported conclusion on the influence the Japanese government has on CSR reporting. Findings from the study have been analyzed and presented throughout this paper.

1.1 PERSONAL INTERVIEWS

During November 2010, personal interviews and discussions were held with two well-experienced Japanese businessmen. The first was a former executive for *Nippon Keidanren*, Japan's most influential business organization, who currently serves as the Program Director for the Global Business program at AIU. The second individual previously served as the Vice President and a board member of *Hitachi Chemical co., Ltd.* These personal communications provided me with a better understanding of government-business relationships in Japan.

1.2 SURVEYS

Thirty-six Japanese companies committed to the GRI G3 reporting guidelines were contacted to fill out a survey about their CSR reporting practices. The survey comprised ten multiple choice and rating scale questions. It experienced a response rate of 16.7% with six companies completing the survey. The purpose was to gather companies' opinions on CSR reporting and influences affecting reporting practices.

With an objective of gathering professional insights and thoughts on current trends, challenges, and possible solutions, a short questionnaire was sent to the *Big Four* audit firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PWC) in Japan. Two professionals representing the firms responded - one was a *Consultant* and the other was a *CSR Professional*.

In both studies, participants were not asked to personally identify themselves or which company they represented. Survey confidentiality was emphasized in hopes of yielding the most honest and accurate responses.

1.3 REVIEWING PUBLISHED CSR REPORTS IN JAPAN

A random sample of forty CSR reports published by Japanese companies following the GRI G3 guidelines (as of November 8, 2010) were reviewed to determine the usage of government guidelines and find any relationship between the guidelines used and the contents reported. Each report was searched for keywords and variations of keywords to identify whether or not specific guidelines were referenced or mentioned.

2. AN OVERVIEW OF JAPANESE GOVERNMENT-BUSINESS RELATIONSHIPS

Japan has a very unique business environment that most foreigners and many of Japan's own citizens do not understand. During industrialization after World War II, the world witnessed an "economic miracle" as Japan continuously "posted annual growth rates exceeding 10 percent in the 1960s" (Kohama, 2007, p. 1). Since then Japan has transformed from a third-world country to a developed country with one of the world's best economies.

Until the late 1980s Japan's business community gathered a substantial amount of global attention from its government's unusually close relationship with the business community. This relationship where the government and businesses acted as if they are one company was coined "Japan Incorporated" in the mid 1960s by James C. Abegglen (2001). However, due to international efforts and criticism the Government of Japan ended this relationship in the late 1980s. Today, the 1990s is known as the "lost

decade,” as massive legal and corporate governance change took place and economic growth slowed (Blomström & La Croix, 2006, p. 114). Since 2000, Japan has managed to rebuild some of its government-business relationships through economic organizations such as Nippon Keidanren, which is comprised of 1,281 companies, 129 industrial associations, and 47 regional economic organizations (Nippon Keidanren, 2010). Although the relationship is not as close as before, meetings with top executives and government officials are still held to discuss business practices and regulations.

In an interview, the former Vice President of Hitachi explained that without this close relationship the economy would never have seen such growth (G. Sato, Personal Communication, November 17, 2010). It was also clarified that this collaboration naturally resulted in more consensus and the identification of common goals between businesses and the government (H. Ichikawa, Personal Communication, November 11, 2010). For these reasons government initiatives and regulations have been very influential in bringing about change in businesses; although this relationship has been partially dissolved, the business community and the government’s strong history and mutual understanding continues to play a role in Japanese business.

3. THE DISCLOSURE OF NON-FINANCIAL INFORMATION BY JAPANESE BUSINESSES

3.1 A BRIEF HISTORY OF ENVIRONMENTAL REPORTING (1950-1999)

Japan’s disclosure of non-financial information can be linked back to the mid 1960s to mid 1970s when the country was facing massive protest and international pressures to re-evaluate its environmental policies. Following the *Big Four Pollution Diseases* of Japan in the 1950s to mid 1960s (post-war industrialization) caused by little environmental restrictions and businesses paying no attention to ecological problems, businesses began to be pressed to release environmental information and take responsibility for the negative externalities created by their operations. Originally in a state confronted by corporate denial (Desai, 2002), the gradual advancements towards the availability of environmental data was making progress as Japan experienced tremendous policy reforms.

Although Japan became a leader in comprehensive environmental legislation by the 1970s (Desai, 2002), the nation experienced scepticism and negative attitudes towards releasing non-financial information (Bennett & James, 1999). Coupled with a Japanese government that was reluctant to participate in global affairs addressing environmental problems until the late 1980s, it appeared environmental protection had become less of a priority in Japan. As a result, because the country faced considerable international criticism for its passive role, Japan eventually adopted a refreshed position towards environmentalism and increased its participation as a global player in the 1990s. Though economic growth slowed during the last decade, government and third party environmental initiatives that encouraged transparency and prompted environmental reporting were materializing.

During the 1990s environmental disclosure trends were beginning to emerge, as observed in surveys conducted in 1992 and 1997 by the Valdez Society (founded by the Coalition for Environmentally Responsible Economies) analyzing environmental disclosure in Japan. Despite being a new practice, information could be found in published action plans, annual reports, and in the latter half of the decade, formal environmental reports. With attitudes varying from industry to industry, companies with products closer to the end consumer had more positive attitudes towards reporting. There was also the tendency for the manufacturing industry to publish more environmental reports than the service industry (Bennett & James, 1999). Nearing the late 1990s the electricity generating and utility industry demonstrated great enthusiasm and began publishing annual environmental reports. By the end of the decade, reports demonstrated greater emphasis on quantitative and realistic targets (Ibid). At this point Japanese companies predominately addressed environmental issues but began to report on some basic

social issues (Contreras, 2004). In 1999, thirty-seven and a half percent of Japanese companies listed on the *Global Fortune 250* released Corporate Environmental (predominately) or Health, Safety and Environment (HSE) reports (KPMG, 1999).

3.2 CSR REPORTING IN THE PAST DECADE (2000-2010)

After the Japanese government published reporting guidelines and established new regulations in the early 2000s, Japan experienced a large influx in the number of companies reporting on CSR. Companies demonstrated increasingly positive attitudes towards disclosing information as the percentage of the *Top 100* companies in Japan publishing stand-alone CSR reports increased from 72% to 80% to 88% in 2002, 2005, and 2008 respectively (KPMG, 2005; 2008). Moreover, witnessing “99 percent of its [Top] 100 companies reporting on corporate responsibility issues” in 2008, Japan has now become a world leader in CSR reporting (KPMG, 2008, p. 86). As of November 2010 Japan has the highest number of companies in the world registered under and following the *GRI G3 Reporting Guidelines* (GRI, 2010).

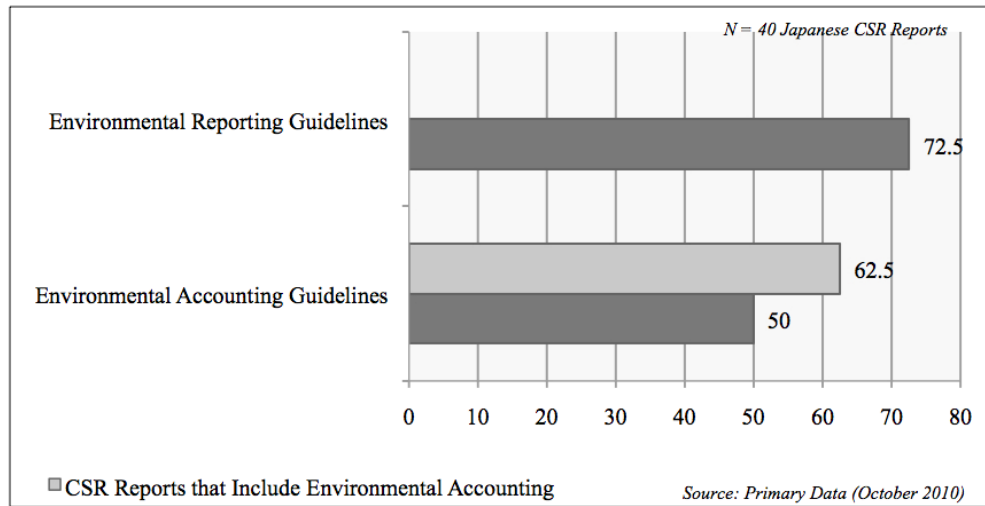
The contents covered by CSR reports in Japan have expanded in the last ten years to include a wider scope of topics on environmental, social, and economic issues. However, as environmental issues forms the core of most CSR departments in Japan (Contreras, 2004), environmental reporting has continued to receive the most attention. Among some of the topics that have been integrated into many CSR reports is supply chain risk, the financial values of corporate responsibility, and social issues such as employee satisfaction. The inclusion of third party comments and assurance has also developed throughout the years, but has recently been criticized by industry professionals. Nonetheless, the aforementioned topics are included in most other developed nations reports. In fact, when compared to Europe and the United States, Japan has struggled to broaden its reports to cover social issues (Kolk, 2005).

4. GOVERNMENT REPORTING GUIDELINES AND INITIATIVES

The Ministry of Environment (MOE) has taken on a proactive role in encouraging reporting. Since 2001 it has published and revised documents on environmental performance indicators, reporting, and accounting. It has also set an objective of having 50% of corporations listed on the stock market and 30% of corporations employing 500+ people not listed on the stock market publish environmental reporting (Ministry of Environment, 2004). Many academics and experts agree that the publication of these guidelines have a significant role in stimulating CSR and other related reports. This argument can be supported by an observation found by Ans Kolk (2009) who noticed that there was 22% increase in the number of Japanese *Global Fortune 250* companies publishing CSR reports from 1999 to 2002, following the publication of the environmental reporting guidelines in 2001. Although there are other factors influencing reporting in Japan, this section will further demonstrate that the Japanese government is an important one.

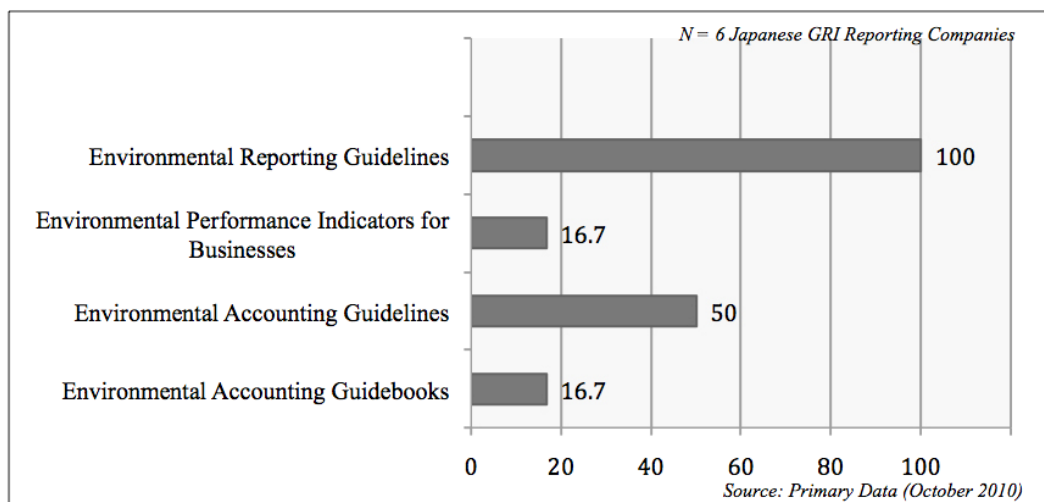
After analyzing the forty CSR reports published by Japanese companies registered under the GRI G3, there appears to be a positive relationship between the use of government guidelines and the preparation of CSR reports. Seventy-two and a half percent of companies explicitly referenced the MOE’s Environmental Reporting Guidelines in their reports (Figure 1). Furthermore, all respondents of the CSR survey sent to Japanese companies acknowledged using or referring to the same guide when writing CSR reports (Figure 2). Based on these results it is evident that the guideline is widely being used across reporting businesses in Japan.

Figure 1. Government guidelines referenced in CSR reports by GRI reporting companies in Japan. (Percentages)



Currently among the documents mentioned in Figure 1, the MOE’s Environmental Reporting Guidelines are the most frequently used; however, through further analysis it appears that insufficient guidance pertaining to all TBL sections is provided. Although the environmental reporting guideline is meant to explain “social and economic aspects, or a social and environmental (CSR) [report],” the majority of the fifty-five page guideline focuses on environmental reporting with only four pages dedicated to social reporting. Economic reporting is accounted for in other publications but will not be analyzed throughout this study. This distinct imbalance in coverage can also be observed across many government reporting guidelines. This kind of discrepancy may explain why “environmental reporting and accounting have rapidly taken root in the 21st century, but where a real broadening to include social issues is much more in the initial stages” (Kolk, 2005).

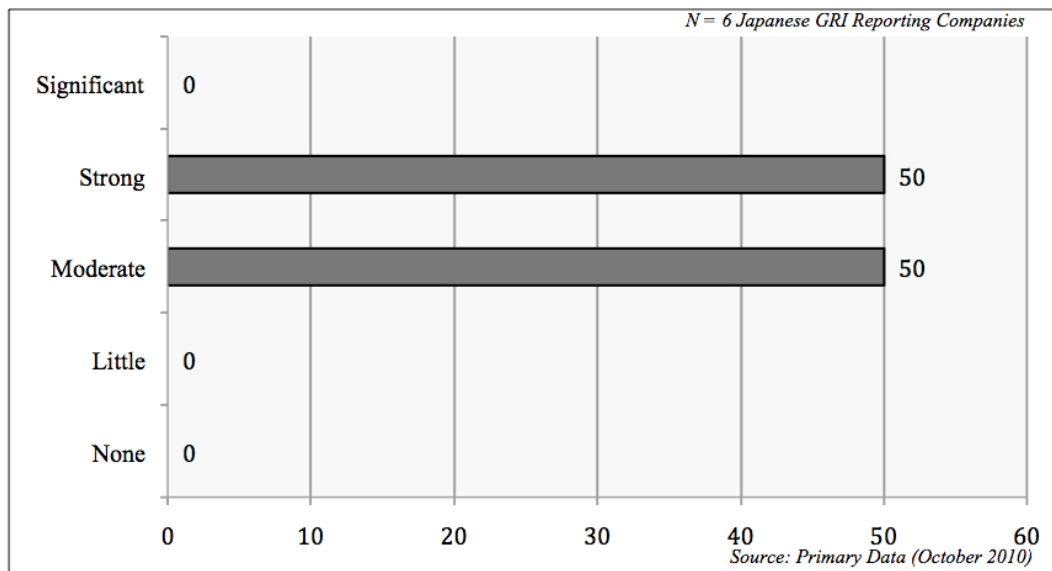
Figure 2. Survey results for government reporting guidelines and documents used by GRI reporting companies in Japan. (Percentages)



Although it is difficult to determine the extent to which government guidelines influence the content of CSR reports, the consistency of reporting environmental issues and inconsistency of social reporting in Japan suggests a rather strong one. Furthermore, a consultant in Japan stated in a questionnaire that he believes these guidelines significantly affect the contents of CSR reports in Japan (Consultant, Personal Questionnaire, November 2010). It was also explained that businesses like to make minimal effort and report only on the details specified when the government introduces guidelines and new regulations (H. Ichikawa, Personal Communication, November 11, 2010). For this reason, the introduction of reporting guidelines may have been successful in stimulating the practice of CSR reporting, but may have also heavily influenced the current reporting trends.

Additional results from the CSR survey also suggest that the contents of reports are influenced by government guidelines. All respondents stated that government guidelines have either moderate or strong influence on the contents of their CSR reports (Figure 3).

Figure 3. Survey results for GRI reporting companies in Japan's responses to the question: Please rate the influence that government documents have on the contents of your companies CSR report. (Percentages)



Taking into consideration that companies responding to this survey are committed to following the GRI G3 Guidelines, other companies might be more influenced by government documents since they have no prior obligations to which they have to abide.

More specifically, while Kolk (2005, p. 39) noticed that in 2005 "75% of large Japanese multinationals mentioned explicit environmental accounting indicators in their reports, [when] this was just below 30% for their US and European counterparts," I found that a large portion of the sample of forty GRI reporting CSR reports referenced the *Environmental Accounting Guideline* published by the MOE. With a majority of the companies that reported environmental accounting in their CSR reports directly referencing the Environmental Accounting Guideline (Figure 1), it can be inferred that the guideline is one of the major factors influencing environmental accounting.

Overall the Japanese government's proactive approach to CSR reporting has been effective. Although there is room for improvement, the publication of these guidelines can be given a substantial amount of

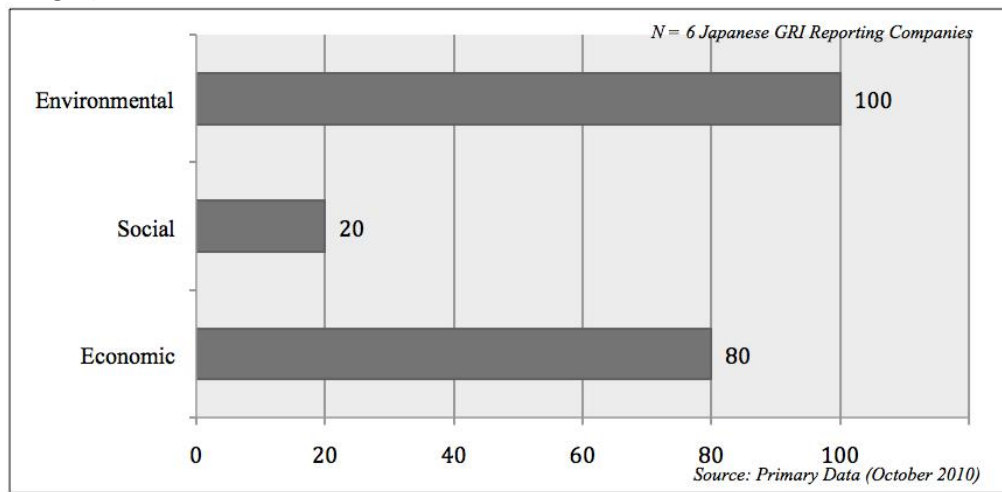
credit in enhancing CSR reporting in Japan. By realizing these areas of improvement, the Government of Japan can greatly strengthen CSR reporting practices.

5. CURRENT CRITICISMS AND CHALLENGES FACING JAPAN

During the past decade Japanese companies have consistently been criticized on the same aspects on CSR reporting. Although it is entirely up to individual companies to respond to these problems, they could also be addressed through government initiatives. The most prominent issue is the struggle for the Japanese to broaden the scope of reporting to include more comprehensive social issues. Recently it is observed that companies are responding to this criticism and exerting more effort towards reporting on social issues with the expansion to include community involvement, employee satisfaction and parts of the supply chain but it is still not as widely reported on as other countries (Kolk, 2005). With 100% of survey respondents selecting *social* as their weakest section of reporting, it is clear that this criticism is coming from both in and outside of Japan. Additionally, only 20% of respondents believe that the government provides sufficient guidance in social reporting (Figure 4), so a potential link between guidance provided and quality reporting is emerging.

Figure 4. Survey results for GRI reporting companies in Japan’s responses to the question: Please select the CSR section to which you believe the Government of Japan provides sufficient guidelines and documents pertaining to reporting.

(Percentages)



In an interview with the former executive at Nippon Keidanren, I learned that unless top executives and the business community as a whole are enlightened about the reasons of first practicing social sustainability and then reporting on it, the Japanese will continue to be Japanese and not change (H. Ichikawa, Personal Communication, November 11, 2010). For this reason, government guidance may strengthen social reporting among Japanese businesses.

Taking into consideration that companies have the tendency to follow guidelines without further expansions (Ibid), and they have demonstrated a tendency to report well on topics with sufficient guidance, the inclusion of more comprehensive social issues has the potential to tremendously benefit reporting. However, simply adding to the guideline will most likely not suffice. The government of Japan should take on a stakeholder engagement approach just as they expect businesses to do and collaboratively develop a suitable guideline. With this approach, businesses may feel more inclined to expand on a guideline that they helped develop. Such a guide may be easier to achieve in Japan given

the closeness between the government and the business community, though assistance from economic organizations such as Nippon Keidanren will most likely be required.

Another area of criticism that has emerged is verified assurance. KPMG (2008, p. 85) stated in its *International Survey of Corporate Social Reporting* that “external assurance has not yet taken a hold in a significant way” in Japan. If Japan wants to increase the credibility of its CSR reports and “improve stakeholder confidence in the information provided” this is a critical aspect that they need to address (AssureView, 2008, p. 5). Although Japan has already written a document entitled “Assurance standard on the Environmental Report (Draft)” to be used as a standard for CSR reports (JICPA, 2010), it is only in the development stages. The Japanese Institute of Certified Public Accountants (JICPA) currently offers assurance services for CSR reports; however, because there is no legal requirement related to comprehensive CSR disclosure, most companies utilize third-party comments instead (Ibid).

Third-party comments is a questionable practice that deserves more attention because they are not benchmarked on any standards and there is the possibility that individuals providing comments are still within arms’ length of a company. In this situation, a requirement to have non-financial reports assured in a manner similar to financial reporting can significantly increase the credibility of CSR reports. To face this challenge, top executives need to recognize the importance of verified assurance and be given incentives to take on an additional expense. In the questionnaire the consultant stated that Japan needs to obtain a better understanding of assurance and discuss the ambiguities of CSR reporting before establishing reporting requirements.

Lastly, volume of reporting has been an emerging challenge during the past decade as environmental reporting has shifted to CSR reporting. For example, Mitsubishi Corporation’s reports changed from a 21-page *Environmental Report* in 1999 to a 60-page *Sustainability Report* in 2005. Although much of the expansion is due to reporting on a broader topic, industry professionals believe companies need to focus on downsizing reports (questionnaire responses). In the last few years companies have tried to address this, as Mitsubishi Corporation’s *2010 Sustainability Report* is now 36-pages, but the question of what to report still exists. Without detracting from the idea of disclosing non-financial information, companies need to ensure information provided is significant and relevant to their stakeholders. For this reason, it appears a suitable solution would be for the government to develop general guidelines covering the commonalities across all businesses and encourage companies to further expand on areas to address its stakeholders’ needs, similar to financial reporting where there are standard statements and additional notes are provided to explain relevant information. Companies are ultimately the best judges for what information is useful for their stakeholders.

6. MANDATORY REPORTING IN JAPAN

The establishment of a CSR reporting standard takes years to be fully integrated into any nation’s system. Every nation has unique characteristics governing its business norms, for which universal criteria cannot accommodate. Although many professionals argue that a global standard is ideal, it makes sense for countries to develop their own national standards. For these reasons, a variety of CSR practices exist around the world. Denmark and Sweden are two examples of countries that currently have mandatory CSR reporting laws. Japan has yet to establish such comprehensive requirements, but it has taken a significant step by requiring specified businesses to publish environmental reports.

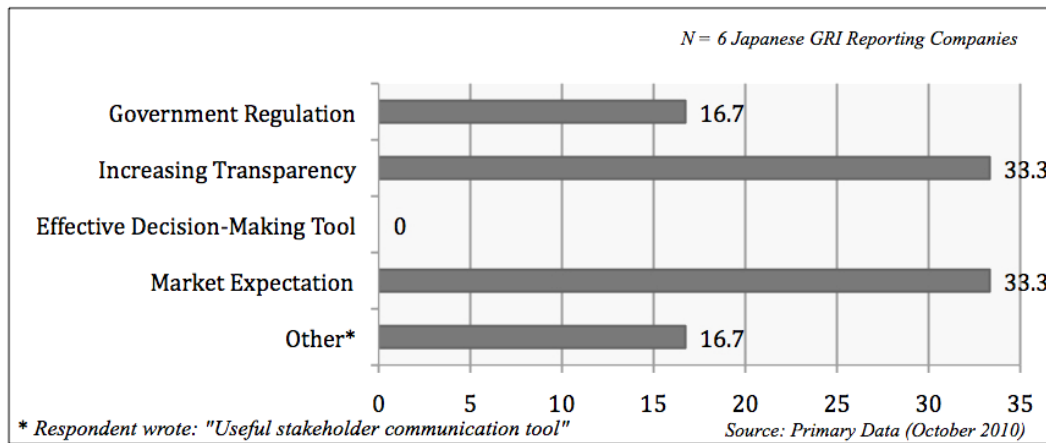
Currently Japan is at a stage where costs have emerged and benefits have developed from the role the Japanese government has chosen to take. Though there are many factors influencing reporting such as national crises, and the globalization of reporting, this section will address costs and benefits associated

with mandatory environmental reporting in Japan and explore potential pros and cons of adopting a comprehensive CSR reporting requirement.

6.1 MANDATORY ENVIRONMENTAL REPORTING

Upon establishing a mandatory environmental reporting law in 2004¹, the percentage of Japan’s Top 100 companies that released CSR reports increased from 80% to 88% from 2005 to 2008 (KPMG, 2008). Though it is difficult to determine whether or not this was a result of the new law or the continuation of an upward trend observed before 2005, survey responses demonstrate that there are some Japanese companies whose primary reason for reporting is government regulation. With 16.7% of the respondents selecting government regulation as their primary reason for reporting (Figure 5), it can be inferred that this law has increased environmental reporting numbers in Japan. However, because the requirement was introduced when a large percentage of companies were already reporting, Japan may not have experienced as much of a change as countries where reporting is less common.

Figure 5. Survey results for GRI reporting companies in Japan’s responses to the question: What is your primary reason for reporting on CSR? (Percentages)



Another inherent benefit is the restructuring of companies to integrate CSR into company strategies by developing CSR departments. With an obligation to ensure proper environmental reporting, Japan experienced a large influx in the number of CSR departments in 2004 (Mullerat & Brennan, 2005). Mandatory reporting may not have been the primary reason creating these departments, but it has greatly affected how these departments and companies operate. The legal requirement forces specified companies not already reporting to increase their focus on environmental sustainability. As a result, new systems such as environmental accounting have evolved to meet criteria. Today environmental accounting is the practice that sets Japan apart in the realm of sustainability reporting. Although companies incur more costs, the potential to bring inefficiencies and areas of concern to management’s attention can result in long-run cost savings.

Japan’s business community has also benefited from the growth of socially responsible investing (SRI) opportunities. Since most companies required to report are listed on the Tokyo stock exchange, investors looking to practice SRI can find necessary information in published environmental or CSR reports. Furthermore, financial service companies benefit because they can analyze reports to compile SRI portfolios. Since 2005 Sampo Japan has offered a *SRI Open Fund* which had a net asset value of ¥1.12

¹ Law No. 77 of 2004 requires specified Corporations, in accordance with the Ministerial ordinance, must prepare and publish an environmental report each business or financial year (Article 9, Section 2).

billion in 2009 (Sompo Japan, 2010). This appears to be a win-win situation, stimulating a new field of business, providing companies with new opportunities for funding, allowing investors to support socially responsible companies.

However, in an interview, H. Ichikawa explained that SRI is not yet a dominant practice in Japan and has only gained popularity in the past decade. In order for SRI to become prominent in Japan, companies need to demonstrate that they are thinking about all aspects of the triple bottom line. SRI investors are more willing to invest in companies reporting on the environment and society because they associate this with long-term stability, therefore sustainable income (Personal Communication, November 11, 2010). The recognition of SRI opportunities is also mentioned in the MOE's Environmental Reporting Guidelines with the statement:

It is expected that environmental reporting will play a significant role as information media for labor market and capital market such as stock market, while eco-labelling plays an important role in the market of goods and services. This is gradually becoming the reality as SRI, such as the eco-fund in Japan, is rapidly becoming popular (Page 9, Paragraph 4).

Considering this statement, it is evident that the Japanese government is aware of the benefits environmental reporting can bring in the area of SRI.

When Japan decided to make environmental reporting mandatory, it created an imbalance in the topics covered under CSR. While this law may have stimulated better environmental reporting and practices, it has detracted necessary attention from other issues such as social reporting. As I mentioned earlier, Japan currently faces criticisms for a lack of social reporting. Japanese companies are encouraged to expand beyond the required guidelines but many experts believe that when given a set of key performance indicators, companies simply "check the boxes rather than thinking through which issues their stakeholders care about most" (BSR, 2010). A failure to sufficiently report on social issues has the potential to affect companies' images and therefore performance. This is particularly important in Japan where citizens are known to pay close attention to CSR activities and base purchasing decisions on companies' actions (Murakami, 2009). However, the Japanese also think about the environment, thus this increase in environmental reporting does serve a purpose in maintaining an *eco-friendly* company image and tailoring to a specific set of stakeholders. Ideally, companies should address both topics.

As with all new laws and regulations, there are both direct and indirect costs associated with compliance. Companies must use more resources to collect required data and compile information in accordance with government regulations. This process can be very strenuous and often requires continuous monitoring. Thus the aforementioned benefit of an increased CSR focus with the development of new departments is evidently a cost that companies may not have incurred before being required to report. There also exists the contemplation of whether or not the new process (regulation) is best for the overall business. A state-owned business in Sweden stated the following in a questionnaire reviewing the nation's new mandatory CSR reporting law:

The sustainability reporting requirement has hindered rather than encouraged efficient activities [...] sustainability reports take too much time that could be devoted to more remedial activities instead (Borglund, 2010, 17).

While this is a very reasonable argument, the costs associated with not reporting can also greatly affect companies' overall performance (as mentioned above). A key aspect of reporting is that the short-term costs associated with compliance usually result in long-term benefits and cost savings.

6.2 MANDATORY CSR REPORTING

Two years after requiring specified corporations to publish environmental reports, Japan demonstrated signs of expanding the law to encompass the entirety of CSR. JICPA prepared a proposal concerning non-financial CSR disclosure in 2006 and further explored the challenge of CSR assurance in a research study conducted with the MOE in 2007 (JICPA, 2010). Both of these documents provided detailed outlines of possible CSR reporting topics and criteria for verified assurance. This section will discuss the pros and cons of making CSR reporting mandatory in Japan and summarize effective reporting practices that can be utilized in Japan.

Denmark and Sweden are two countries that have effectively implemented comprehensive CSR reporting requirements. Demonstrating positive responses from businesses, similar regulations in Japan may help address many of the previously mentioned challenges and criticisms. First it would address the current challenge of reporting on social issues. While it is not ideal to force companies to report this may be a necessary step to encourage other companies to broaden their areas of reporting. Companies tend to follow industry trends, thus if a select group of companies are required to report, a bandwagon effect might occur. Moreover, with new legal leverage, company departments can prod top management to report a more holistic view on CSR and further integrate it into business operations (Borglund, 2010,). While many argue that new reporting requirements are costly for companies not experienced in CSR, Japan may be able to avoid some of this transition costs since CSR has already emerged as a dominant concept in most organization. In fact, Japan's CSR challenge is rather unique. Though companies struggle to formally report on the social issues in conventional ways (Davies, 2000), corporate citizenship, employee well-being, and philanthropy are well recognized and practiced by businesses in Japan (Ibid, 111).

Readily available information in the form of CSR reports can also better educate consumers, investors, employees, and other stakeholders. This can lead to better reputations, the stimulation of SRI, and a better understanding of corporate thought by employees. Many of these are noticeable effects mentioned in the mandatory environmental reporting section. However, a distinct advantage is the likelihood that companies develop better internal cohesion as they work together to discuss CSR practices for the company as a whole; this is something that was noticed by a business in Denmark (Danish Commerce & Companies Agencies, 2010).

Evidently additional costs include the use of company resources to prepare the report. During the pilot year companies can be expected to spend seven to eight times more effort on preparing the report and becoming familiar with the regulation than normal (Danish Commerce & Companies Agencies, 2010, p. 19). However, the costs associated with meeting reporting requirements will decrease in the following years as companies develop a solid base and approach to meeting requirements. Other short-term costs such as assurance, if used, and consultation fees will be outweighed by long-term benefits such as increased confidence from stakeholders and the development of more credible reports.

Costs and challenges will also emerge for the Government of Japan. The first challenge for the government is to develop suitable criteria to which reporting is evaluated. This process would include research into other reporting criteria, holding discussions with relevant entities, and introducing the criteria to companies being affected. Closely tied to this criterion is also the development of an assurance system. Although Japan has demonstrated that they do not see assurance as a necessary tool (KPMG, 2008), it is a necessary characteristic that needs to be utilized if CSR reporting is made mandatory. Without verified assurance there is no way the government can know if companies are reporting truthful information. Moreover, there is the possible occurrence of:

a phenomenon known as de-coupling which means that the organization, consciously or unconsciously, builds up an outer façade that reflects the way the organization wishes to be perceived but not the way it actually does things (Borglund, 2010, 11).

In other words, there is a risk that reports do not reflect the whole truth. As a result the connection between mandatory reporting and required assurance appear to complement and are necessary tools that should be utilized together.

7. HOW TO IMPLEMENT MANDATORY CSR REPORTING

Survey responses have yielded mixed opinions towards mandatory CSR reporting in Japan and the manner in which it should be conducted. When asked, “to what extent do you support the idea of making CSR reporting mandatory in Japan?” Our participating CSR professional selected “strongly do NOT support” whereas the consultant selected “strongly support.” Disregarding these differences in opinions, there are a few characteristics that experts in the field agree that mandatory reporting should exhibit. A list of recommended characteristics compiled from personal observations when reviewing questionnaire responses, other reporting requirements, and analyzing Japan’s current CSR reporting situation is presented in Figure 6.

Figure 6. Characteristics that should be exhibited if Japan chooses to implement a mandatory CSR reporting regulation (Source: Borglund, 2010; Danish Commerce & Companies Agencies, 2010)

Consider company size	Only companies with enough resources should be required to report. This usually means larger and more influential businesses. This may be particularly effective in Japan where companies tend to follow other companies in the industry.
Be flexible in formats	Flexibility allows companies to tailor reports to desired stakeholders. It also allows for personalization leading to an increased sense of ownership. If a standardized criterion is used, such as the GRI G3, allowing companies to tailor performance indicators to their companies increases the possibility for providing stakeholders with relevant information.
Negotiate requirements	Working together with participating companies can greatly improve the likelihood of the acceptance of a new regulation. Increased familiarity with the criteria may also lead to better reporting and less time spent.
Require external assurance	Assurance significantly increases the credibility of reports. This will result in more confidence from stakeholders and can also help improve reporting practices as professional review the report.
Integrate revised guidelines with examples	Including examples of reporting techniques in guidelines can significantly improve the quality of CSR reports.
Conduct a follow-up study	Important information can be discovered in the form of surveys and interviews. This data can be used to make regulations for effective.

CONCLUSION

In the past decade there has been a noticeable shift from environmental reporting to comprehensive CSR reporting in Japan. Much of this success is credited to the Government of Japan with the publication

of various reporting guidelines. However, while the government's emphasis on environmental issues has caused Japan to excel in environmental reporting and accounting, its lack of guidance in social reporting has resulted with a struggle to broaden reporting to include social issues. A variety of studies demonstrated that these government guidelines have a strong influence on the contents of CSR reports in Japan.

In order to address current challenges, top management needs to be enlightened on the benefits of reporting social issues and including external assurance in their reports. If current criticisms are addressed, stakeholder confidence will increase, inter-departmental cohesion will be built, and identification of company inefficiencies may emerge. Although there are also short-term costs associated with CSR reporting, the long-term benefits a company can experience greatly outweigh them. Mandatory CSR reporting is a possible method to bring out change but specific considerations need to be made if this path is chosen. Before establishing any regulations, the issue of materiality needs to be addressed and further studies on CSR assurance need to be conducted. Ideally the government should take on a proactive approach and discuss the criteria with participating parties such as assurance providers, and economic organizations representing the business community. In conclusion, because government guidelines and initiatives have a strong influence on reporting in Japan, it is evident that the Government of Japan should maintain an active role in shaping the future of reporting; however further deliberation and research needs to be conducted in the areas of assurance and materiality.

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