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Current graduate students and recent alumni are invited to submit papers, case studies, and book reviews for the seventh edition of the *Asian Journal of Public Affairs.*

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NOTES FROM THE EDITOR'S DESK

Dear Reader,

The 6th Issue of the *Asian Journal of Public Affairs* presents a range of policy articles for your potential interest.

Two articles, *Plurilateralism and Trade Facilitation* and *Japan's Regional Economic Integration Strategy*, focus on regional trade and economic integration. The first considers the South Asian trading bloc providing a series of recommendations on improving intraregional trade, while the second analyses the motivations behind Japan's policy on economic integration.

Government intervention in fiscal reform and other policymaking decisions can sometimes have unintended consequences. This is evident in the paper on *Inefficient Parastatal Agencies and the Growing Modern Food Market in India*, which discusses the reasons why India suffers from large food shortages. The paper identifies and attributes poor government policies as well as implementing agencies as the root cause of the issue, and calls for private sector participation in this sector. Another paper provides a critical analysis of how *China's Fiscal Budget and Pension Reform* resulted in deficits and funding gaps in public pensions and put significant pressure on local governments' budgets.

The Impact of Corruption on Growth is investigated in the Indian context, with a look at how this has had a negative impact on investments. The paper calls for a strengthening of weak social and economic institutions, in order to curb the impacts of corruption, and improve the investment climate in the country. *What's Wrong with ODA Today?* assesses the effectiveness of Official Development Assistance (ODA) in the EU's 'Asia Urbs' Project in Cambodia, and the paper on *The Rule of Law in Managing God* examines the legal framework in the management of Singapore's religious politics.

In addition to these articles, we have three interesting book reviews, two of which focus on international relations. The third provides an interesting take on how design thinking can be applied by public policy individuals in the course of their work.

This note would not be complete without a heartfelt thank you to our contributing authors, for their support and cooperation; our faculty advisors, Prof. Mukul Asher and Prof. Darryl Jarvis, and our administrators, Prof. Ora-Orn Poocharoen, Ms. Ruth Choe and Ms. Dorine Ong, for their continued guidance and encouragement.

Yours Sincerely,

The AJPA Editorial Board
April 2010

Plurilateralism And Trade Facilitation: The Way Ahead For Intraregional Trade In South Asia

Kanika Dua and Seher Abbas

Trade between members of the South Asian Association for Regional Cooperation (SAARC) accounts for only 5 percent of their total trade. This abysmally low level of intraregional trade is a matter of concern for policy-makers in South Asia, considering the large number of trade complementarities that exist between SAARC member nations.

The aim of this paper is to explain the reasons for this problem and discuss possible solutions. Firstly, the paper provides the rationale behind improving intraregional trade in South Asia, using existing literature and trade theory, and discusses the historical background to trade in South Asia leading up to the signing of the South Asian Free Trade Agreement (SAFTA).

The paper recommends a two-pronged approach to improving trade in the SAARC region. In the short term, it proposes trade facilitation with the aim of improving existing infrastructure and administrative procedures, as well as amendments to SAFTA based on its performance since its implementation in January, 2006. In the long term, the paper takes into account the political hostility between the two largest economies and the uneven balance of power in the region and recommends plurilateralism as the way ahead.

It is anticipated that with the realisation of economic benefits through plurilateralism, doors for negotiations and dialogue will open up which may further facilitate regional economic integration.

Introduction

> *Today, intraregional trade accounts for 67 percent of the total trade volume for the European Union; 62 percent for Canada, Mexico, and the United States, members of the North America Free Trade Agreement (NAFTA); and 26 percent for members of the Association of Southeast Asian Nations (ASEAN). (USAID 2005)*

With Regional Trade Agreements (RTAs) taking centre stage in world trade, the above mentioned figures for intraregional trade are not very surprising. The

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European Union (EU), NAFTA and ASEAN are examples of RTAs that were successful in bolstering of both inter and intraregional trade. However, for the South Asian Association for Regional Cooperation (SAARC) – a relatively younger economic bloc – intraregional trade accounts for only 5 percent of total trade. Taking into account the similarities in the colonial history, culture, natural resources and economic situation of SAARC nations, such low levels of intraregional trade are dismal, to say the least.

The 2004 World Bank Report titled 'Trade Policies in South Asia: An Overview' discusses the high levels of intraregional trade in the South Asian subcontinent during the 'British Raj'. While in 1948 – just a year after India and Pakistan (including present day Bangladesh) gained independence from its colonial rulers – intraregional trade accounted for 19 percent of the total trade in the region; in 1967 this figure declined to a mere 2 percent. This abrupt decline was attributed firstly to the post-1947 hostility between India and Pakistan, and secondly to the emphasis on import substitution and protectionist trade policies as a means to achieve economic growth by most countries in the region. This, however, does not explain why intraregional trade in the region accounts for only 5 percent to date.

The aim of this paper is to explain the causes of low intraregional trade within SAARC nations and propose policy recommendations for increasing intraregional trade. The paper is divided into four sections: the first section uses both economic and political reasoning to explain the need for regional economic integration in South Asia; the second section explains the geo-political dynamics that have existed in the region and highlights some of the important events leading to the signing of the South Asian Free Trade Agreement (SAFTA); the third section discusses various factors that have impeded the growth of intraregional trade within SAARC; and the fourth section suggests some policy changes that could help increase intraregional trade.

Rationale for greater economic integration in South Asia

Regional economic integration can take one of various forms, usually classified into the following stages: a Preferential Trading Area (PTA), where member nations agree to reduce tariffs, not necessarily remove them; a Free Trade Area (FTA), where member nations agree to eliminate tariffs and quotas; customs union, an FTA where members have a common external trade policy; common markets, which are customs union which also permit free movement of factors of production; and, an economic and monetary union, where member economies function as a single market with a common currency. SAARC, at present, is transitioning from a PTA to an FTA.

Various economic theories justify the need for higher regional economic integration and its effects on economic development and welfare.

The Gravity Model of Trade in international economics, which was first applied by Tinbergen (1962) and Poyhonen (1963), provides an important basis for intraregional trade. (Wall 1999) According to this model, trade between two nations is a function of their Gross Domestic Product (GDP) levels, the geographical distance between them, their population sizes and a set of institutional characteristics. The simplest form of the model can be represented by the following equation:

$$F_{ij} = M_i \, M_j / \, D_{ij}$$

where F_{ij} refers to trade flow among nations; M_i and M_j refer to the respective economic masses of countries *i* and *j*; and, D_{ij} represents the geographical distance between these nations. This form assumes that there are no transaction costs and no barriers to trade, whether they are geographical or artificial (such as tariffs or other policy induced barriers). (Martinez-Zarzoso 2003)

The Gravity Model predicts that the trade between two nations is inversely related to the geographical distances between these two nations. Thus, it can be drawn that since proximity increases trade, nations closer to one another should trade more hence making a case for higher regional trade.

According to the results of studies conducted by Research Information Systems (RIS) in the framework of the augmented Gravity Model[1], 74 percent of the potential of intraregional trade in SAARC still remains to be to be realised. (RIS 2008)

Similarly, a study by United Nations Conference on Trade and Development (UNCTAD) and Asian Development Bank (ADB) used the General Equilibrium Model to show that regional trade liberalisation among SAARC nations would lead to positive welfare effects for all members and that SAFTA would be 'trade creating'. (UNCTAD and ADB 2008) The results of the study are listed in Table 1.

Table 1: Impact of SAFTA on welfare

Countries	Welfare Effect (in million US$)	Welfare Effect (as % of GDP)
Bangladesh	265.8	0.44
India	366	0.05
Pakistan	82	0.08
Sri Lanka	13.8	0.06
Rest of South Asia	130.7	0.77
Rest of World	-438.8	

Source: RIS (2008)

[1] Augmented Gravity involves use of more variables, apart from those mentioned in the basic augmented model which determine trade flow between nations.

As you can see in the table above, the welfare effect as a proportion of GDP is highest for the Least Developed Countries (LDCs) at 0.76 which shows that SAFTA has the potential to become an "engine of growth in a balanced and equitable manner." (RIS 2008, 66)

However there have often been doubts regarding the success of intraregional trade within South Asia due to the uneven 'balance of power' in the region. India's economy is a lot larger when compared to other economies in the region. Siriwardana and Yang (2007) used the data from the study by UNCTAD and ADB to show that with the implementation of SAFTA, India would serve as the 'growth-pole' for South Asia.

According to Venables' econometric analysis, India serving as a growth pole can have some positive implications as an RTA between one high income country (relative to other countries in the group and the world average) and other lower income countries is likely to lead to GDP per capita convergence of low income nations with the high income member. It also mentions that benefits from spatial clustering of economic activities resulting from trade can be better realised if the flow of goods and services takes place between one relatively high income country and many low income countries. (Venables 1999)

Hence India being a relatively high income country (and huge in size) amongst all SAARC nations, has the potential of reducing economic inequalities and creation of regional production clusters. One example of potential production network can be in the apparel industry between Sri Lanka, Bangladesh and India. Sri Lanka which enjoys expertise in manufacturing of apparels can buy raw materials from Bangladesh at a cheaper cost and sell the final product in Indian markets.

A 2001 empirical study by Baier and Bergstrand tested the growth of trade among countries and presented some interesting results. Based on the data of 16 Organisation for Economic Co-operation and Development (OECD) countries, they found that approximately 67–69 percent of trade growth could be explained by real GDP growth, 23–26 percent by tariff-rate reductions and preferential trade agreements, 8–9 percent by transport-cost declines, and virtually none by real GDP convergence. (Bergstrand 2001) It can be derived from this study that GDP convergence is not essential to increase trade and accrue its benefits, which reaffirms the argument that difference in India's GDP and the rest of the SAARC countries should not be a hindrance in increasing trade ties. However, one should be careful in relying totally on this study because the sample data is that of OECD countries and the context here is very different.

Trade theories, such as the theory of comparative advantage further strengthen the case for more intraregional trade. This is especially true for South Asia where there are high trade complementarities between countries. For instance, the opportunity for LDCs to gain access to large and diversified markets would enable them to exploit the benefits of economies of scale. A good example of this is the bilateral trade treaty between India and Nepal, which has spurred Indian investment in Nepal leading to many Indo-Nepal joint ventures in industries producing export goods for Indian markets, such as fruit juices, toothpaste and other toiletries. (Mukherji 2008)

Another important advantage of a stronger SAARC is avoiding the possibility of an 'FTA noodle-bowl'. FTA noodle bowl refers to an unorganised tangle of multiple bilateral trade deals among economies in a regional bloc resulting in same commodity being subject to different tariffs and tariff reduction trajectories.

Higher intraregional trade among SAARC will also help increase the possibility of a future ASEAN-SAARC FTA. Increased regional cooperation also increases SAARC members' ability to negotiate as a regional bloc at international forums like the World Trade Organisation (WTO) and the International Monetary Fund (IMF).

Finally, and most importantly, increased regional economic integration among countries can be an important force in promoting peace and stability in the region. Wallace (1999) uses the Western Europe experience to show that 'trade talks allow political and economic elite to form coalition for subsequent collaboration and consensual action'. Similarly, Anwar (1994) uses ASEAN as an example to illustrate the importance of regional integration in solving intraregional conflicts. Politics and economics are not mutually exclusive domains and hence if the trade ties between the SAARC countries become strong and mutually beneficial they will restrain from damaging such ties by aggravating political tensions and would rather take steps to avoid political constraints in hampering economical benefits.

Before explaining the reasons leading to low intra-regional trade in the SAARC region, it is important to understand the region's economic history, especially the events leading to the signing of SAFTA.

Historical background

After gaining independence from the colonial rulers, most nations of the region chose to develop their economies by import-substitution and many treaded the socialist path to economic development. This began to change in the late 1970s, starting with Sri Lanka, where in 1977 the United National Party government started encouraging privatisation and deregulation, to wide-ranging economic reforms in both India and Pakistan in early 1990s – South Asian economies moved from autarkic policies to those of relative openness. This phase also saw the removal of protectionist trade policies in many countries in the region. In 2000, Sri Lanka was the most open economy in the region with a trade-to-GDP ratio of 77 percent, followed by Nepal with 44 percent and both Bangladesh and Pakistan with 33 percent. (USAID 2005)

The idea of regional cooperation in South Asia first surfaced in early 1980s when Foreign Secretaries of seven South Asian nations met in Colombo in April 1981. In

1983, at the first meeting of Foreign Ministers of these countries in New Delhi, the Declaration for South Asian Association Regional Cooperation (SAARC) launched the Integrated Program of Action (IPA), which focussed on agriculture, rural development, telecommunications, meteorology, and, health and population activities. (USAID 2005)

Following events led to a meeting of the Heads of State of all founder members – Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka in December, 1985, where the SAARC was formally established. While this was a historic step towards regional economic integration in the South Asian region, the focus still remained on social, political and cultural cooperation. (Naik 1999)

The first steps towards economic integration were taken at the Seventh SAARC Summit held in December 1993 when the member nations signed the SAARC Preferential Trade Agreement. The aim was to promote and sustain mutual trade and economic cooperation within the SAARC region by agreeing to exchange concessions in the form of tariff negotiations. Since then, there have been four rounds of trade negotiations covering nearly 5000 commodities. (USAID 2005)

More progress was made in the Twelfth SAARC Summit held in January, 2004 when member nations signed an agreement to create SAFTA with the aim of achieving zero customs on trade of all products by 2016. However, SAFTA has failed to deal with certain loopholes which have been responsible for low trade among SAARC nations and have prevented creation of a freer trade region. Some of these include absence of provision for simplification and harmonisation of customs procedures, and to deal with non tariff barriers. (USAID 2005)

Reasons for low levels of intraregional trade

Since the time of SAARC's inception regional trade among its member countries has not shown much growth. While growth in exports within SAARC declined by 3.33 percent between 2000 and 2008, growth in imports increased by 0.62 percent. Also, while growth of total trade within SAARC countries declined by 1.2 percent, the total trade between SAARC nations and the rest of the world increased by 9.47 percent over the last decade. (ADB 2009)

The figures mentioned above clearly depict the declining importance of intraregional trade within SAARC and at the same time improving trade relations of SAARC countries with the rest of the world, especially the EU, the United States (US), China and United Arab Emirates (UAE). Following are the factors responsible for the discrepancy.

Industrial disparity within SAARC nations
An important factor which hinders growth of intraregional trade among SAARC nations is the industrial disparity that prevails between India and the rest of the SAARC countries. A prominent comparison is that between India and Pakistan – the

two largest economies of the region. Both countries started industrialising around the same time, but the Indian industries developed an edge in terms of size, diversity and competitiveness which was primarily due to the emphasis laid by Indian planners on the development of large scale, capital intensive industries. Pakistan's industrial development took off during 1960s under the military regime of General Ayub Khan, which was a decade later then the major industrial growth experienced by its Indian counterpart. Other factors responsible for the huge industrial disparity between India and the rest of the SAARC nation are the sheer size of the Indian economy and the strong government support that Indian industries received which lead to cheaper input costs. These disparities between SAARC nations can be seen in the following table:

Table 2: Disparity among SAARC nations

	India	Pakistan	Nepal	Maldives	Bhutan	Sri Lanka
Population (in million)	1124.78	162.48	28.1	.31	.67	20
GDP in billions (constant 2000 US$)	771.09	106.2	6.93	1.07	.75	22.8
FDI, net inflows, in million (BoP, current US$)	22950	5330	5.74	14.98	78.31	603
Market capitalisation of listed companies (% of GDP)	155	49	48	…	…	23

Source: World Development Indicators (2007)

The reforms in early 1990s, aimed at liberalisation, privatisation and globalisation also played an important role in giving India an edge over other SAARC countries in terms of industrial development. Not only did this openness help India get access to more markets but it also allowed for large flows of Foreign Direct Investment (FDIs).

Given these conditions, there is a fear among SAARC member countries that trade promotion within South Asia would give India a chance to exercise its economic dominance over the smaller economies. According to Jain, this concern has played a major role in restricting the realisation of potential benefits of trade among SAARC nations. (Jain 1999)

High tariffs and other trade barriers

The presence of high tariffs and other trade barriers have also played an important role in discouraging intraregional trade. According to Banik and Gilbert (2008), while Sri Lanka, Bhutan and Maldives – with trade-GDP ratios of 178, 93 and 81.73 respectively – had been more open, the larger economies of India and Pakistan had trade-GDP ratios in the SAARC region of only 38.22 and 46.14. It is important to note that the sizes of the economies vary and these ratios do not mean that the volume of trade in Maldives is more than that of India.

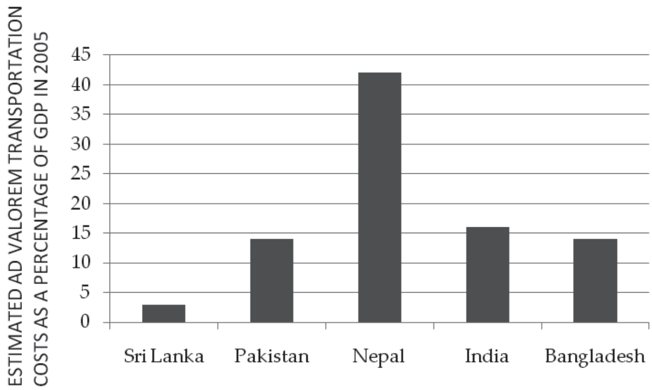
Intra-regional trade in South Asia shows significant variation between countries. For example, trade between India and other SAARC members' accounts for only 3 percent, while trade between Nepal and other SAARC members' stands at 35 percent. (Saxena 2005) These figures, however, are not very representative of the actual trade between these nations considering a substantial proportion of the illegal trade between them is not accounted for. For example, a study conducted by Taneja revealed that the Indian industry's informal exports to Sri Lanka account for 29 percent of the total trade of India while the corresponding figure for Sri Lankan territory is 31 percent. (Taneja et al. 2002)

A good example of the high tariffs and duties imposed by these countries are duties on non-agricultural goods which range from 10 percent in Sri Lanka to 21 percent in Bangladesh. The level of protection for agricultural goods is even higher and ranges from 25 percent in Pakistan to 100 percent in India. (Panagariya 2003) India has the largest number of tariff peaks among the South Asian region which are concentrated among the agriculture, automobile, textile and garment sectors. Banik and Gilbert (2008) argue that higher tariffs within the region have neutralised the benefits that could have been gained from having common cultural affinity, common geography and the advantage of common borders.

Though the SAFTA Treaty provides a timeline for removal of tariffs, which spreads over 2006-16 with different time frames for LDCs and other members, it has never been adhered to.

An important reason for low trade among SAARC countries is high trade costs. In spite of the fact that the proximity criterion of the gravity model is present for South Asia, high trade costs act as a major obstacle to the growth of intraregional trade. Important contributing factors to these costs are the poor and inadequate physical infrastructure, the lack of trade-related information, excessive regulations imposed by most governments in the region and prevalence of a 'negative list'[2] of items. The statistics from the World Bank's 'Doing Business' Report show that the 'average time to trade' for South Asia is one of the highest when compared to other regional groups.

Figure 1: Transport costs in South Asia



Source: (Banik & Gilbert 2008)

An example of high trade costs leading to lower trade is that of poor use of pre-partition infrastructure that connects India and Pakistan. All roads linking India and Pakistan have been closed for security reasons and most trade takes place via rail routes. Trade costs are higher for landlocked countries as shown in Figure 1. Stringent travel restrictions between countries like India, Bangladesh and Pakistan have worsened the situation even further. Importers, as a consequence, are forced to import goods from other countries such as Iran and Indonesia.

Also "unlike other regions where trade facilitation challenges may vary considerably by economy or sub-region, the economies of South Asia all face common logistics-related challenges." (Taylor and Wilson 2009, 2) A telling statistic is the cost of logistics in India which stands at 13 percent of GDP and is responsible for reducing the country's GDP by 2 percent. (Banik and Gilbert 2008)

Absence of trade related information is another major impediment for intraregional trade in South Asia. A certain degree of information is needed to carry out trade effectively, such as product specification, technology, prices, tariffs industrial trends, trade regulations and procedures. There is no contract or agreement among SAARC nations which facilitates smooth exchange of information.

[2] A negative list of items has been mentioned under SAFTA. The intention has been to eliminate import quota on all other tradable goods except for those mentioned under the negative list. Negative list is created to restrict trade in certain goods which can impose potential threat to trading partners from the point of view of religion, security or domestic industry.

Poor institutions and excessive government regulations have also reduced the ease of doing business in South Asia, which has lagged behind in implementing technology systems in customs and administrative procedures. Until recently customs procedures in South Asia were primarily focused on revenue collection and trade protection – there was no strong drive for increased efficiency and transparency. Steps have been undertaken to simplify and harmonise trade procedures, but South Asia still requires the most number of documents for cross border trade. (Taylor and Wilson 2009) The best example of this is the 'red-tapism' that exists at the India–Bangladesh border where a consignment needs at least 22 documentations, more than 55 signatures and a minimum of 116 copies for final approval. (Banik and Gilbert 2008)

Corruption is also of vital importance in explaining low intraregional trade in South Asia. According to a study the size of an average bribe in the region was reported to be between 2.2 percent and 2.5 percent of an average firm's sales. (Ahmed and Ghani 2007) The graph below depicts that South Asia fares poorly as compared to other regions in terms of corruption. The higher the number the more clean the government operations in the region.

A number of items have not been included as part of trade activity among nations which has further increased the trading costs. As has been mentioned before, the existence of a 'negative list' has barred the nations from full realisation of potential benefits of trade and thus has accentuated the average cost of trading. For example, India and Pakistan import a list of common items from each other, but 45 percent of common imports have not been included in Pakistan's positive list and hence their imports from India have not been allowed. This has resulted in high trade costs for Pakistan which has been losing US$ 400 million to US$ 900 million by importing those items from alternative sources. (Suleri 2007)

Political factors

The political differences between India and Pakistan have also been a major obstacle in all attempts to increase economic integration in South Asia.

It has been observed that industrial disparity among nations, existence of trade related barriers, high trade costs and political differences are some of the other dominant factors responsible for the low intraregional trade among South Asian nations. With disparity in the levels of development, a general sentiment prevails among poorer nations (Nepal, Bangladesh and Bhutan) that promotion of trade will benefit the richer countries (India, Pakistan and Sri Lanka) at the cost of the poorer nations' development. As mentioned above, the mere size of the Indian economy has been a dominating factor and has led to a disproportionate arrangement among the South Asian countries.

It has been established that trade needs of South Asian nations are highly complementary with each other. Moreover, potential for reduction of trade cost prevails. However, the continued prevalence of political hostility has prevented nations to effectively implement steps which would lead to increased economic integration within the region.

Policy recommendations

In the last section we saw that despite having many trade complementarities and an immense potential as a regional trading bloc, South Asia still lags behind in intraregional trade. While signing of SAFTA was a step in the right direction, there are some flaws in the Agreement which, if these are rectified soon, it can lead to better outcomes in the long-term.

In this section we propose a short-term and a long-term approach to improving intraregional trade in South Asia. In the short-term the focus is recommended to be on amending the SAFTA and improving trade facilitation, and for the long-term, we propose a model of regional integration based on 'plurilateralism'.

Amendments to SAFTA

When SAFTA was signed, many important aspects of intraregional trade were overlooked. We propose the following additions to SAFTA:

Phasing out of negative lists

A body comprising of officials from the Ministry of Trade and Commerce of each of the SAARC nations should be formed which aims to remove items from the negative list in a phased manner. Currently, most countries have many agriculturally based commodities that are listed under negative lists. While this is not surprising considering most economies rely on agriculture for exports and employment, in the long run it would hamper prospect of countries specialising in the goods in which they have comparative advantage.

Expediting the timeline for reducing tariffs

SAFTA's timeline for the phased removal of tariffs is being spread over too long a time period, which means that other bilateral and multilateral FTAs between SAARC members and non-SAARC members may take precedence over it. Hence, there is a need for an amendment in the SAFTA for removal of tariffs to introduce a new timeline with a shorter time frame of 3-5 years. Also, to ensure higher degree of mutual trade amongst SAARC nations, steps should be taken to ensure strict adherence to the timeline. In this context it is worth mentioning that ASEAN was able to expedite the schedule for implementation of ASEAN Free Trade Agreement from 2000 to 2008.

Inclusion of services in trade

SAFTA includes no provision for trade in services. As services form an important part of GDP of many SAARC members – especially in India where services account for nearly 60 percent of GDP – inclusion of this important sector is vital to the success of any intraregional trade agreement within the region.

Liberalisation of investments

An independent regulatory body comprising of officials of Ministry of Trade and Commerce of SAARC member countries should undertake steps to ensure higher capital mobility between SAARC members. Higher flow of investments from capital-surplus to capital-deficit SAARC nations can contribute significantly to economic development in the region. For example, India, which has high FDI flows, can channel investments within the region which could in turn lead to trade creation.

Geographical expansion

With Afghanistan getting membership to SAARC, it should also be included as a member of SAFTA. Inclusion of Afghanistan would ensure higher gains from trade for three member countries – India, Pakistan and Afghanistan. With trade between India and Afghanistan taking place via Pakistan, all three member nations stand a chance to gain since India would get access to markets, Afghanistan would get cheaper imports and Pakistan could earn by charging transit fees.

Trade facilitation measures to reduce trade costs

In the short term, a regulatory body should be formed which would be responsible for initiation and effective implementation of trade facilitation measures at the intraregional level. The body should comprise of officials from each SAARC nation and entrusted with the task of promoting and regulating intraregional trade by improving trade facilitation between member nations. Some of the specific steps that should be undertaken by this body include:

Strengthening of physical infrastructure

An efficient and integrated transport network is vital to reduce trade costs and achieve competitiveness in exchange of goods and services. To create a multimodal transportation network, a South Asian Common Transport Policy (SACTP) should be initiated. This can be used for rebuilding comprehensive transport linkages with the aim of optimal utilisation of existing utilities as well as expansion of new facilities in the region. Some of the priorities that SACTP should have are listed below:

- Linking of Central Asia with East Asia by the Afghanistan, Pakistan, India, Bangladesh and Myanmar corridor.
- Improving railway networks in LDCs. Here, India can play an important role by providing rolling stock as well as training personnel.
- Improving sea-connectivity between Maldives, Sri Lanka, India, Pakistan and Bangladesh.

Exploiting complementarities in energy needs

South Asia is an ideal case for trade in energy. While nations such as India, Pakistan and Bangladesh experience enormous energy deficits, Nepal and Bhutan are developing additional capacity leading to power surpluses. While India has signed some treaties to develop hydroelectric power projects with Nepal and Bhutan, an enormous potential still remains untapped.

An important case for regional cooperation between the two largest economies in the region includes the Iran-Pakistan-India gas pipeline. This has been under negotiation since 1994 with no consensus being achieved.

Harmonisation and simplification of trade procedures
Cumbersome document procedures at the time of transit constitute a huge portion of the trade costs. For the purpose of harmonisation of trade procedures, the proposed body should work towards implementation of a common document which would help facilitate quicker clearance of documentary requirements. It should also explore the possibility of creating a single SAARC window for cargo clearance.

Long-term approach: Plurilateralism
The long-term approach to improving intraregional trade is to promote 'plurilateralism' which would help create a congenial environment for complete economic and regional integration in South Asia in the future.

According to USAID (2005, 12) "a combination of politics and protectionism' has led to such low levels of intraregional trade." While ways to improve the latter have been discussed in the preceding sections, it is addressing the former that holds the key to solving the deadlock in achieving a consensus among South Asian nations. The political situation in South Asia is the greatest hindrance to the integration of the region, hence it would be unrealistic to assume that trade facilitation and amendments to SAFTA alone will increase intraregional trade. The need for regional integration can only be realised if there is political will among decision-makers to make positive changes.

The major political standoff in the region is between the two largest economies, India and Pakistan, and it would be very optimistic to think that the situation between the two nations will improve in the coming decades. Therefore, a possible solution to improve intraregional trade, without relying on trade between India and Pakistan, is that both these countries sign plurilateral agreements with other SAARC countries, which would also be significantly better than bilateral trade agreements.

While this might sound unrealistic, an excellent example of such an arrangement in South Asia is that of the South Asia Sub-regional Economic Cooperation (SASEC) Program between Bangladesh, Bhutan, the Eastern states of India and Nepal. SASEC was initiated in 2000 by the ADB with the aim of integrating these four regions together so as to allow them to benefit from the trade complementarities that exist between them. (ADB 2009) Some of these complementarities include:

- A large workforce which earns relatively low wages. By developing their skills, this work force could offer the region a major competitive advantage.

- Fertile rice fields of the Ganges-Brahmaputra basin, which constitutes one of the largest granaries in the world. Efficient water management and improved agricultural productivity could help increase yield and at the same time bring down prices.
- Energy resources such as hydropower (Nepal and Bhutan), coal (Indian states of West Bengal and Bihar), and oil and gas (Bangladesh).
- The ports of Chittagong (Bangladesh) and Kolkata (India).

This combination of resources makes a perfect case for intraregional trade. Bangladesh and the Eastern States of India face significant power deficits while Nepal and Bhutan have immense hydropower potential which can be exploited by India and Bangladesh. Nepal and Bhutan, on the other hand, are landlocked countries and they can gain access to the ports in Eastern India (Kolkata and Haldia) and Bangladesh (Chittagong and Mongla).

An indirect approach to facilitate trade amongst SAARC countries can be the creation of production networks within the region. India, being the strongest economy in the region, can create a production network, by establishing backward linkages with other SAARC countries. For example India can import raw materials at cheaper rates from SAARC countries and use these to produce goods demanded in the international market. This can be particularly possible in case of garments, where India can import cotton from Bangladesh and sell manufactured garments to international markets in the US.

Also trade complementarities can be exploited by creating a production-sharing network through vertical specialisation. Vertical specialisation allows countries to reap economies of scale by concentrating on a specific production process in the value addition chain. For example, trade can take place if one country specialised in yarn and fabrics, while another specialises in finished garment products. In the case South Asia, regional cooperation in primary commodity exports will allow greater value addition because the region is exporting these commodities in bulk, and value addition takes place in importing countries, thereby resulting in lower value realisation. A good example of such cooperation and joint venture was the jute industry in which Bangladesh produced the jute and West Bengal had the processing mills. (Ghani, Kelegama, and Ahmed 2010)

Furthermore South Asia should also link with East Asian production networks and promote trade so that demand for South Asian intra-regional trade remains strong. (Rana 2009)

Although it is argued by economists that free trade is a zero sum game leaving all the parties with gains, it is important to state that there could be potential losers in South Asia. SAARC as a regional bloc has nations which differ in the extent of economic development, particularly the size of their economies. Hence, India – which has a GDP that is 17 times that of Pakistan, the second largest economy of the region, can end up economically dominating the region. This has been a significant fear for Pakistan and Bangladesh. It is proposed that establishing production networks throughout SAARC would enable smaller countries to benefit from production in larger countries as they can supply raw materials and intermediate goods, leading to the creation of a favourable trade environment.

We believe that such measures will reap high economic benefits which will eventually outweigh the political costs that have hindered progress towards more economic cooperation in the region. In the long term it will be mutually advantageous for all the countries to increase intraregional trade in SAARC hence leading to stronger economic regionalism in South Asia.

Conclusion

SAARC differs from other regional trading blocs due to the uneven balance of power – with India as the dominant power, and the political hostility between two of its largest economies, India and Pakistan. Any solution to the problem of intraregional trade will have to take these factors into account.

Keeping this in mind, this paper proposed a two-pronged approach to increasing intraregional trade within South Asia. In the short term, SAARC members should encourage trade facilitation and make amendments to SAFTA. While trade facilitation should focus on improving infrastructure and creating a favourable policy environment for trade, by removing bureaucratic hurdles and simplifying trade procedures; the amendments to SAFTA should take into account the shortcomings in the Agreement from the experience so far. In the long term 'plurilateral' trade agreements would incentivise members to overcome political hurdles in order to achieve gains from trade. This is especially true in the context of India-Pakistan relations where, India can focus on furthering SASEC and Pakistan Pakistan can focus on developing a similar arrangement with Sri Lanka and Maldives.

To conclude, it is not realistic or necessary to expect that all political and social conflict will have to be resolved first before meaningful cooperation can happen. Indeed economic cooperation is a powerful means to resolve political and social conflict. Therefore once economic benefits from greater regional economic integration are realised, it will pave the way for stable political relations among SAARC nations.

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JAPAN'S REGIONAL ECONOMIC INTEGRATION STRATEGY: A NASCENT AND COMPETITIVE FTA DIPLOMACY

Jose Guerra Vio

In the last decade Japan has changed its restricted focus on multilateral trade for a recent pursuit of Free Trade Agreements (FTAs), which reflects a change in its policy towards economic integration. This paper offers an analysis of Japan's regional economic integration strategy, with consideration to the strategies of other actors, particularly China's role as a major balancing power for Japan in the region. This article aims to unravel and understand the possible motivations behind Japan's strategic shift and the reason why this has only happened in recent years. Additionally, it examines why Japan has chosen partner countries like Mexico and Chile, or selected ASEAN members like Singapore, Malaysia and Thailand individually as opposed to a multilateral regional arrangement.

Besides stating the economic motivations implicit in any kind of FTA, the emphasis is on two particular ideas: the possible unspoken political motivations of competing against China for regional leadership, and the embedded leverage motivations of achieving an FTA as a way to build Japan's negotiation capacity as a latecomer in regional integration. In the first section, after providing a general overview of the Japanese FTA approach, the particular case of the Japan-Mexico Economic Partnership Agreement is examined, since it is recognised as the agreement that gave birth to Japan's FTA diplomacy. The second section focuses on Japan's strategy towards the building of a regional bloc through economic integration, paying specific attention to the Japanese position when trying to balance China. A preliminary analysis shows that competitive pressure both economic but especially political seem to be the driving force behind Japan's nascent FTA policy.

Introduction

The simultaneous processes of globalisation and regionalisation have certainly brought about a frenetic interest in economic integration in most parts of the world. The importance given to trade liberalisation within and across different regions has come to alter the manner in which nations interact, and the ways in which the great powers exert their influence and plan their international strategies. Nowadays regionalisation and regionalism have to be considered as key aspects of any country's developmental strategy. In this context, the Asia-Pacific region has shown in the last twenty years the most admirable signs of growth and development, especially after the People's Republic of China (PRC) initiated its economic reforms thirty years ago. This new scenario has dramatically changed the way economic and political relations are undertaken in the Asia-Pacific, making evident the necessity of

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regional institutional frameworks to design an integration process suitable for the region.

In the meantime Japan, which had traditionally inclined towards the General Agreement on Tariffs and Trade (GATT) and the World Trade Organisation (WTO) processes, witnessed a change in the regional integration carried out in East Asia. FTAs and other bilateral economic arrangements became the new trend, and the (initially) ASEAN-centric process later took a more China-centric orientation. (Kasahara 2004) In the last decade Tokyo too has changed its restricted focus on multilateral trade for its recent pursuit of FTAs, which reflects a change in its policy towards economic integration. "The 2003 white paper on international trade published by Japan's Ministry of Trade and Industry emphasised the need for pursuing a multi-track approach," (Urata 2008, 71) mainly due to slow progress of trade talks in the WTO Doha Round. Regarding these developments Japan certainly lags behind others. This aspect is not a minor issue since bilateral trade agreements are believed to serve as the base for building regional blocs. (Corning 2009)

The paper analyses Japan's regional economic integration strategy, considering also the strategy of other actors in these regards, particularly China as a major player and balancing power for Japan in the region. The primary purpose is to unfold and understand the possible motivations behind the country's shift in strategy, from favouring multilateralism to an active engagement of bilateral FTAs within Asia and the Pacific. Why has Japan decided to pursue an active economic integration strategy on a bilateral basis just in recent years? And why has it chosen to begin this new wave of Japanese FTAs with partners like Mexico and Chile, or with some individual members of ASEAN like Singapore, and later on Malaysia and Thailand, as opposed to a more conventional strategy of entering into multi lateral regional agreements?

While attempting to answer these questions, besides stating the economic motivations which are implicit in any kind of FTA, the emphasis will be on two particular sets of ideas. These are 1) the possible unspoken political motivations of Japan competing against China for regional leadership, and 2) the embedded leverage motivations of achieving an FTA as a way to build Japan's negotiation capacity as a latecomer in institutional regional integration. Altogether, this paper will put more emphasis on the possible non-economic motivations of Japan's new FTA strategy. In the first section, after providing a general overview of the Japanese FTA approach, the particular case of the Japan-Mexico Economic Partnership Agreement (JMEPA) will be analysed, since it is recognised as the agreement that gave birth to Japan's FTA diplomacy. In the second section this paper will focus on Japan's strategy towards the building of a regional bloc through economic integration, paying specific attention to the Japanese position when trying to balance China.

A preliminary analysis of the research shows that competitive pressure, both economic but especially political, seems to be the driving force behind Japan's nascent FTA policy. On one hand, the private sector is worried about the losses

Japanese firms have witnessed due to the trade diversion effect of unequal market access created by other FTAs elsewhere. On the other hand, the Japanese government is worried about its ability to exert its weight and be a leader in East Asia through the different regional integration processes. These two sides have influenced and pressured each other in order to promote the necessary domestic reforms that Japan needed to formally establish active FTA diplomacy.

From multilateral cooperation to bilateral competitive agreements

The financial crises effect

More than ten years ago, the Asian Financial Crisis (AFC) marked a turning point in Asia-Pacific integration, and changed the way the process had been carried out up until 1998; namely a market-driven integration characterised by the so-called "Flying Geese" developmental model. As authors, like Kevin Cai (2005) and also Naoko Munakata (2002) have emphasised, the AFC left an acute sense of regional interdependence, and convinced not only the affected ASEAN nations but also the Northeast Asian countries that they needed a regional mechanism in order to avoid another economic debacle.

The political economy in the Asia-Pacific region changed dramatically as a consequence of the AFC. According to Richards Stubbs (2002), "the AFC left the governments of China, Japan and South Korea with the sense that the three of them should develop their institutional links, so as to better cooperate on economic issues. Moreover, it left an awareness that increased investment in trade with Southeast Asia meant that the economic health of the ASEAN members was very much in their interests. In addition, for many ASEAN members the crisis underscored the benefits of establishing formal economic links to the more developed economies of Japan and South Korea, and the dynamic market of China as a means of averting possible future crises." (Stubbs 2002, 449)

Particularly regarding China, there is a consensus among scholars to admit that the country was largely capable of withstanding the AFC thanks to the high trade surplus and consequent strong financial power it possessed (and still possesses) when the crisis broke. According to experts, (Cai 2005, Peng 2004) China emerged from the AFC almost unscathed, hence its rise as a strong player within regional economic affairs. This was possible since China was among the top six holders of foreign reserves in the world in 1997. As it is widely acknowledged, these reserves prevented China from devaluating its currency and helped it to protect the Hong Kong economy, which had just experienced a transfer of sovereignty. (Peng 2004, 440) This also allowed China to show itself as a regional powerhouse interested in furthering its ties with its neighbours, especially when assisting the damaged ASEAN and Korean economies and strengthening economic cooperation and regional political integration. China also benefited from the post-AFC shift in Asian integration, from the Southeast focus led by ASEAN, to a Northeast focus; China led this shift by offering various schemes of economic cooperation, trade liberalisation and integration to its neighbours. Since the AFC broke out and particularly since its

WTO accession in 2001, China, with its huge economy and its new assertive role on economic integration, has replaced ASEAN's position as the new hub for economic integration in the East Asian region. Firstly, this is because ASEAN countries rely more on regional production networks than China. Secondly, as Peng (2004) points out, many Japanese, Taiwanese and Hong Kong firms withdrew from Southeast Asia after the crisis broke out and moved to China. Subsequently, within the last decade, achieving different kinds of economic cooperation agreements with China looks apparently more appealing for many East Asian countries.

Moreover, "the lack of a coherent and unified regional voice and institutionalised mechanisms for cooperation in the Asia-Pacific added concerns to the crisis aftermath, particularly across East Asian governments. This has been compounded by the recent stagnation and weaknesses of the two major regional groupings, APEC and ASEAN." (Stubbs 2002, 447) A widespread sense of disillusionment over those two integration processes carried out during the 1990s in the Asia-Pacific, together with the deceleration of the WTO process, triggered a race for bilateral FTAs in the region. These initiatives started among the much damaged East Asian members, and propagated quickly to Australia, New Zealand and certain North and South American countries that suffered after the AFC because of their partial dependence on trans-Pacific trade, such as Mexico, Peru and Chile. Japan was definitely no exception and moreover, it realised the necessity to catch up quickly to these regional developments; thus in the early years of this decade it launched its first FTA with Singapore.

As it was addressed, the crisis stirred up a sense of urgency among East Asian countries about the domestic and regional economic and financial reform necessary to cope with future common crises. The Japanese hoped that an FTA strategy would help to solve this situation, while the ASEAN members turned to China in the hope it will develop a more significant role in the regional economy. (Cai 2005) Consequently, South East Asian vulnerable post-AFC economies found shelter under Chinese leadership when Beijing offered them the financial support denied by the IMF, through the creation of the Chiang Mai Initiative.[1] Within the context of the ASEAN plus China forum, the Chinese proposal in 1999 for an FTA was thus immediately accepted by the Southeast Asian countries. South Korea, for its part, hurried to initiate free trade talks with different members of APEC and it also got involved in the ASEAN Plus Three economic integration initiative created in the midst of the AFC, which also include China and Japan.

Today, in face of the Global Financial Crisis (GFC), China's regional strategy seems to follow the same logic it did ten years ago. The formula that worked so well for

[1] Signed in May 2000 in the City of Chiang Mai, Thailand, this initiative created a network of bilateral arrangements China, Japan and the Republic of Korea with the ASEAN countries. This pact provided financing for members which may encounter liquidity problems. China's participation in this framework was a determinant factor in the consolidation of the Chiang Mai Initiative, due to its enormous amount of foreign exchange reserves that allowed the PRC not to devaluate its currency, while undertaking financial reform, and to assist some of the damaged economies in the South East.

China during the AFC can bring again new benefits: economic integration as a means to sustain stability, while restoring confidence, by assuring China's peaceful rise and the possible benefits of it for the whole Asia-Pacific region. China sees the current GFC not just as "a test for the readiness of the international community to enhance cooperation," as Wen Jiabao (2009) has referred to it, but also as an opportunity for upgrading its regional status, to which the Chinese Premier believes, political leaders must be 'forward-looking'."We should not only take more forceful and effective steps to tide over the current difficulties, but also push for the establishment of a new world economic order that is just, equitable, sound and stable." (Wen Jiabao 2009) This comment suggests that not only does China seek to be the leader of Asian economic integration, but that it is also using international agreements, such as the one with ASEAN and others in the Asia-Pacific, to break barriers to the fulfilment of its leadership aspirations.

Now China wants to make up for the costs of this new global instability and take it as an opportunity to position itself definitively as a great power. This time, the benefits can be tremendous if Beijing makes the right moves, as they did after the AFC.

Japanese approach to FTAs

The Japanese are aware that "the deepening of economic interdependence gives rise to a sense of political trust among countries that are parties to these agreements, thereby expanding Japan's global diplomatic influence and interests." (MOFA 2002) Authors like Mireya Solis have worked extensively on this particular issue; she gives a very comprehensive analysis of Japan's FTAs strategy, arguing that it is mainly competitive dynamics that can best explain Japan's sudden change of approach to bilateral FTAs. "Japan has used its FTAs to meet three main challenges: 1) to restore or advance the competitive advantage of internationally-oriented business sectors in selected overseas markets; 2) to disseminate a distinct Japanese approach to preferential economic integration different from both the American and Chinese FTAs; and 3) to hone its regional leadership credentials vis-à-vis China by reaching out to Southeast Asian nations, and inviting extra-regional partners to integration talks in order to balance China's influence." (Solis 2008, 2) This approach helped to establish the theoretical and argumentative basis of this paper.

Japanese MOFA has acknowledged that economic integration talks means much more than a reduction of tariffs. In the negotiations it expected that "some issues regarding various areas of regulatory control, including movement of natural persons, as well as the opening of markets and the implementation of structural reforms in the agricultural sector arise." (MOFA 2002) The Japanese stance towards FTA policy-making pays special attention to these aspects, emphasising that unless they can actively link these trade agreements to a process of domestic reforms in the country, "it will not succeed in making them a viable means of improving Japan's international competitiveness." (MOFA 2002) That explains the high quality used to describe Japanese FTAs, since it includes both the reduction of tariffs and non-tariffs as well as the liberalisation of foreign direct investment (FDI).

In its FTAs, Tokyo has also sought to include commitments in other areas of cooperation related to WTO-plus commitments like intellectual property rights, customs facilitation or government procurement.[2] However, the economic cooperation chapter is the issue that makes Japanese trade agreements the most attractive for some less developed partners. This chapter covers areas ranging from science and technology, to cooperation in the development of the business climate and human resources. (Solis 2008) This chapter would also explain why the Japanese government prefers the term Economic Partnership Agreements (EPAs) to refer to their approach to preferential bilateral trade arrangements. On the other hand, the less attractive aspect of Japanese FTAs could be identified in their asymmetric liberalisation commitments, where industry is highly liberalised,[3] but some agricultural products, however, are entirely excluded of the negotiation or have differentiated calendars for liberalisation. (Solis 2008) The latter is the most contentious matter for Japan when negotiating an EPA.

Several analysts have identified determinant domestic actors within Japan pushing for a review of Tokyo's traditional trade policy. These are the trade bureaucrats of the Ministry of Economy, Trade and Industry, (METI)[4] and Japanese big business association "Keidanren." (Solis 2008, 4) These main players intense lobbying within Japan was oriented in response to the increasing amount of preferential trade agreements achieved by other countries in the world, threatening to put Japanese internationalised business in a disadvantageous position abroad. Solis explains that it was particularly the North American Free Trade Agreement (NAFTA) that sent a powerful message to the Japanese government on the negative effects of trade and investment diversion proliferating FTAs elsewhere in the world. "Competitive pressures, therefore, provided the essential stimulus for FTA diffusion in Japan." (Solis 2008, 5)

Interestingly, being the region where Japanese products account for the highest percentage of trade, East Asia is also the region where these products face the highest tariffs as compared to the low rates imposed by the United States and the European Union (3.6 percent for the US and 4.1 percent for the EU while in China tariffs rise to 10 percent, 14.5 percent in Malaysia, 16.1 percent in South Korea, 25.5 percent in the Philippines, and 37.5 percent in Indonesia) Thus, the government of Japan

[2] The obligations of a WTO Member can be divided into two categories: (a) the general obligation to comply with WTO rules of conduct (the rule obligations); and (b) the individual obligation to reduce trade barriers with respect to specific goods and services (the market access obligations). While all market access obligations are country-specific, the rule obligations of WTO Members are uniform: all WTO Members are, in principle, bound by the same set of rules of conduct under the WTO Agreement. In addition, some commitments that exceed the requirements of the WTO Multilateral Trade Agreements have been added in areas related to privatisation, government procurement, trade in civil aircraft and publication. Such obligations have become known as "WTO-plus" obligations. (Qin 2003)

[3] As evaluated by the percentage of tariff lines to be eliminated or reduced.

[4] In some literature METI was previously known as Ministry of International Trade and Industry (MITI).

decided to place priority on negotiating FTAs with countries in East Asia. (MOFA 2002)

Consequently, "liberalisation of trade with East Asia will help facilitate the activities of Japanese businesses, which are facing competition from ASEAN and China and which, in many cases, have shifted their production bases to locations in East Asia." (MOFA 2002) Therefore according to MOFA the selection of EPAs partners include (a) economic, (b) geographic, (c) political and diplomatic, (d) feasibility, and (e) time-related criteria.

> *When Japan promotes FTAs, we must pay attention to securing political and economic stability within the larger context of the construction of a regional system. East Asia is the region with the most promising counterparts for negotiations, and in light of the feasibility criteria and political and diplomatic criteria (...) the Republic of Korea and ASEAN are the most likely partners for negotiations. (MOFA 2002)*

However, neither ASEAN nor Korea were the initial partners chosen by Tokyo to launch its nascent FTA diplomacy.

The Mexican precedent

After Singapore, Mexico became the second nation to sign an FTA with Japan in 2007. Mexico appeared to be a good partner in the initial stage of Japan's FTA policy even though at the time many scholars questioned the decision to negotiate. Their primary concern was why Japan would invest so much "political capital in the negotiation of a complex FTA in a nation that accounted for such a minuscule share of its international economic exchange," (Solis and Katada 2007, 279) especially considering the perceived lack of security motives. These authors have challenged this interpretation arguing that the stakes were actually high in Japan's second FTA. The cross-regional FTA with Mexico or JMEPA signified a big step forward for Japan in the direction of economic regionalism, giving birth to the current Japanese FTA diplomacy.

> *Japan had first negotiated a FTA with Singapore, a country which is already quite liberalised with low or no tariffs on most manufactured goods, and with a very limited agricultural sector. Therefore, many saw the FTA with Mexico as the first 'real' negotiation since it included a substantial agricultural component, essential to establish Japan's credibility for future FTA negotiations. (Solis and Katada 2007, 291)*

Unquestionably, economic motives were taken into account by the policy-makers in Tokyo when considering the JMEPA. Even though this member of NAFTA individually does not heftily account for a big share of Japan's international economic exchange, the trade diversion created by the North American economic integration arrangement made the Japanese business community suffer from unequal competition. Both the Japanese private sector represented by Keidanren and the

METI trade bureaucrats played a decisive role in promoting this controversial FTA within Japanese domestic politics. (Keidanren 2000) "For a number of Japanese industries, notably automobiles, electronics and government procurement contractors, negotiating with Mexico was essential" (Solis and Katada 2007, 279) to be able to compete against American or European companies that benefited greatly from the NAFTA (in effect since 1994) and the EU-Mexico FTA (in effect since 2000). Keidanren and METI estimated that the absence of a trade accord with Mexico was costing Japan around US$ 3.2 billion due to the trade diversion effect. This represents a GDP decrease of near US$ 4.3 billion, and could add 31,824 more people to Japan's already burgeoning unemployed population. (METI 2000, Keidanren 1999, Solis and Katada 2007)

METI was indeed a determinant player pushing for Japan's FTA initiatives, giving the priority to an agreement with Mexico early on. (Solis and Katada 2007) By emphasising the negative effects of lacking these kinds of bilateral agreements, METI put forward the notion of "defensive FTA" as Solis and Katada explain.

> *For METI, the distance and weak political connections of this extra-regional partner were not central to the FTA initiative (...) METI's strong political commitment to the negotiation with Mexico derived from its estimation that this agreement was vital for the pro-FTA forces within the Japanese government to demonstrate Japan's seriousness and ability to engage in FTAs with the rest of the world. (Solis and Katada 2007, 291)*

Hence, these authors put the emphasis on two key aspects behind Tokyo's motives to achieve the JMEPA. The first one has to do with countering trade diversion, an important aspect for Japanese companies operating abroad. The second aspect relates to the leverage motivations of Japanese trade officials, since they sought to use the negotiations with Mexico as a way to advertise Japan's regional FTA, while acquiring trade negotiation capacity and at the same time setting precedents for future agreements. (Solis and Katada 2007)

Furthermore, since it accounts with a large network of trade agreements, Mexico is a skilful and experienced FTA negotiator that served well Japanese the rationale of "learning by doing." (Solis and Katada 2007) This prepared Japan for future trade talks with other agricultural exporters in East Asia, like many ASEAN members, thanks to an intense process of "training" that was reported by Mexican and Japanese officials during the negotiation process, "whereby Mexico transferred a fair amount of 'FTA know-how' to Japan." (Solis and Katada 2007, 300)

For a traditionally protectionist country like Japan, the JMEPA's quest to promote domestic reform and to favour some other sectors of its economy was difficult since it had to compromise on some sensitive areas. According to authors like Shujiro Urata (2008) the main difficulty encountered by the Mexican team in the negotiations was the strong Japanese opposition to liberalise their domestic agricultural sector, particularly products such as pork, beef, chicken and oranges.

> *After a strong request from the Mexican government, Japan opened up these markets by increasing import quotas rather than removing tariffs. Mexico agreed to liberalise steel and automobile markets within ten to seven years, responding to Japan's strong request. As a result, Mexico agreed to open its market to all imports from Japan, while Japan agreed to open its market to only 84 percent of its imports from Mexico. (Urata 2008, 73)*

However, this outcome encouraged some analysts to develop a much more critical point of view arguing that Japan gained substantially through the JMEPA, but did not give much on agricultural liberalisation. Indeed, this agreement was a victory for trade negotiators in particular, since it helped to build up Japanese FTA negotiation capacity. Some authors argue that it could be also considered as a defeat for those pushing for further structural reforms in the Japanese domestic economy. (Urata 2008, 73)

Table 1: Japan's FTA network

Partners	Status	Export Share*	FDI* Share	Issue Scope**
Singapore	In force (Nov. 2002)	3.6%	1.8%	Investment, Services, Economic Cooperation
Mexico	In force (April 2005)	1.0%	0.7%	Investment, Services, Economic Cooperation
Malaysia	In force (July 2006)	2.6%	0.6%	Investment, Services, Economic Cooperation
Chile	In force (Sept. 2007)	0.1%	0.1%	Investment, Services
Thailand	In force (Nov. 2007)	3.1%	2.1%	Investment, Services, Economic Cooperation
Philippines	Signed (Sept. 2006)	2.0%	1.1%	Investment, Services, Economic Cooperation
Indonesia	Signed (August 2007)	1.5%	1.4%	Investment, Services, Economic Cooperation
Brunei	Signed (June 2007)	Not available		Investment, Services, Economic Cooperation
ASEAN	Signed (April 2008)	13.3%	5.7%	Economic Cooperation***
Korea	Negotiation suspended	6.7%	1.6%	Not available
GCC	Negotiation (Sept. 2006)	Not available		
Switzerland	Negotiation (April 2007)	0.4%	0.2%	Not available
Australia	Negotiation (April 2007)	2.0%	2.5%	Not available
India	Negotiation (January 2007)	0.5%	0.4%	Not available
Vietnam	Negotiation (January 2007)	0.5%	0.2%	Not available
ASEAN + 6	Initiative only (May 2006)	Not available		

Notes: (*) Trade and FDI shares represent averages for the years 1999-2004. (**) None of the Japanese FTAs include labour and environmental clauses. (***) The Japan-ASEAN FTA does not provide new and binding obligations on investment and services, but a committee to explore these issues is to be formed one year after enactment. (Solis 2008, 26)

Taking into account the previous arguments, this article adheres to Solis and Katada's (2007) proposition that the Japanese impetus to negotiate "an FTA with Mexico went much beyond the absence of structural trade barriers. It also responded to the necessity of protecting the interests of Japanese industries, while gathering the reluctant domestic support" for a nascent FTA diplomacy that Tokyo lacked. (Solis and Katada 2007, 284) Once the JMEPA was achieved, Japan had the confidence to further engage in more imperative negotiations, from a geopolitical perspective, with ASEAN members. It also gave Tokyo the green light to explore FTAs with other important trading partners, like Chile or even Australia – considered a bold move for Tokyo's since Australia is a major supplier of agricultural products for Japan, representing 10 percent of all Japanese's agricultural imports. (Solis 2008, 7) Currently Japan is in a much more advanced stage of FTA and EPA negotiations as seen in Table 1.

Regional FTA strategy: Balancing China

A matter of competitive leadership
The AFC affected the way trade flows are conducted in Asia-Pacific, and it illustrated the urgent need for institutionalised mechanisms to further economic and political cooperation in the region. As highlighted earlier, China's economic and political performance during the crisis signified that the leadership role of Japan was partially lost, while China gained more respect on a regional stage. The crisis caused the East Asian countries to run into each other's arms, and China seemed to offer the most comfort. The Japanese FDI to East Asia declined, while China's economy rose. By the year 2000, a certain recovery in the regional economy was indeed registered, with positive per capita growth rates among the crisis countries, with 5 percent in Malaysia, 3 percent in Thailand, and 1 percent in the Philippines and Indonesia. With the exception of South Korea, which equalled China's growth at an impressive 8 percent during this period, China's economic performance outshone those presented by others in the region, especially the modest 1 percent registered in Japan in 2000. Thus, as many authors have agreed, the 'flying geese' pattern ceased to be the dominant model for division of labour in East Asia. (Peng 2004, 441)

In light of Japan's decade-long stagnation, according to Naoko Munakata, (2002) the Japanese capacity to lead East Asian economic integration has been brought into question. Japan's problematic history with its neighbours has come in the way of developing institutional frameworks to promote economic integration within East Asia. In this aspect, China's image among its neighbours, on the contrary, is more positive.

Furthermore, and against conventional expectations, Japan has not played the leading role in regional integration that many expected. This is primarily a consequence of its protectionist standpoint. The idea of trying to gain dominance on the integration process in Asia-Pacific might be seen as an implicit incentive for Japan, as a natural requirement for its position as a regional power. Nevertheless, China's rise changes the regional setting for Japan in two ways: "China's new role as a link in the production network has contributed to the growth of intra-regional trade; and China has become an active player in developing institutional frameworks to promote regional integration." (Munakata 2003, 6) Beijing's enthusiasm and self-proclaimed leadership in regional integration efforts has been undeniably followed by Japan's move to explore FTAs as a trade policy option instead of reliance on the WTO in the wake of the AFC. This seems to be Japan's reaction to maintain its position in the regional hierarchy.

Munakata adheres to the rising awareness among scholars that see Japan and China involved in an implicitly declared FTA race, not only for economic gains, but also to acquire leadership dominance in the region. Hidetaka Yoshimatsu has coined the concept "competitive leadership" (Yoshimatsu 2005, 228-230) to describe in positive terms the Sino-Japanese rivalry, since it could act as a powerful engine necessary for furthering regional integration in East Asia.

Tokyo's rapprochement to ASEAN would follow this logic – responding to worries that an ASEAN plus China FTA could place Southeast Asia too much under China's sphere of influence, potentially altering the balance of power in East Asia and the Pacific. On the 14th of January 2002, Prime Minister Koizumi clarified the basic direction Japan's East Asian economic integration strategy was taking. Using the Japan-ASEAN EPA as the core of this policy, Tokyo is aiming to form an "Expanded East Asian Community," with expanded economic links to countries outside the region, like Australia and New Zealand, and using the ASEAN Plus Three framework (APT). This scheme, according to analysts, is unmistakably a counter-proposal to China's strategic moves. (Yun 2002) A couple of months before this Japanese offensive, China had already convinced ASEAN to achieve an FTA in the span of ten years.

Strategic competition with China may also explain Japanese interest in the inclusion of extra-regional members to balance China's rising influence in the APT process. (ASEAN + 6 including Australia, New Zealand, and India) For Richard Stubbs, the APT process has now the potential to become the dominant regional institution in East Asia. "The APT process is in many ways simply the latest manifestation of the evolutionary development of East Asian regional cooperation". (Stubbs 2002, 440) When the first APT leaders' informal gathering took place in the 1997 ASEAN meeting in Kuala Lumpur, China's initiative to take up the invitation made by ASEAN to consider a regional FTA was the key aspect that forced Japan's initial reluctance. Parallel to these processes, "Japan has also decided to establish FTAs bilaterally with selected members of ASEAN due to the realisation that it cannot establish speedily an ASEAN-wide FTA due to extensive differences in economic and non-economic conditions among ASEAN members."[5] (Urata 2008, 74)

The Japanese way vs. The Chinese way

Tokyo's initial choice to begin negotiating its first FTA with Singapore immediately triggered reactions in Beijing. It was actually a month later that the PRC proposed the FTA with ASEAN as a whole – the race between the two regional powers for

[5] Some of these selected partners for Japan in South East Asia that followed Singapore are: Malaysia, Thailand, Indonesia and Brunei, while negotiations with Vietnam are in an advanced stage. (See Table 1)

bilateral trade agreements had started. From an economic point of view, this situation may suggest "competitive liberalisation is at work in Asia-Pacific, with one preferential trade agreement prompting another in order to reduce the margin of discrimination of the former." (Munakata 2003, 7)

However, other analyses emphasised that Tokyo's intention to compete against China for becoming the new hub of regional integration in East Asia appears to be evident in its pursuit of a distinct model of economic cooperation agreements. As an industrialised country, Japan's strategy when trying so sell its EPAs in South East Asia stresses the higher quality of Japanese FTAs, especially on its binding obligations and their capacity to promote development. (Solis 2008) China has also turned to FTAs as instrument in regional politics and it has moved swiftly since November 2000 when it first offered a trade agreement to ASEAN. Solis explains that:

> *Japan's FTA outcomes reflect these multi-faceted competitive pressures. Japanese FTAs are selective in that the choice of partners, timing of negotiations, and market access commitments reflect the attempt to restore and/or advance various competitive advantages. For instance, the FTA talks with Mexico and Thailand aimed to level the playing field for Japanese companies; the timing of the ASEAN-Japan FTA is explained by the desire to neutralise the political gains China made by initiating talks with ASEAN first; and the ASEAN + 6 initiative reflects Japan's strong desire to influence the membership and nature of regional integration in East Asia. Japan's FTA policy is indeed heterogeneous in that Japan is pushing for an FTA approach different both from the NAFTA model and the more informal Chinese FTAs. (Solis 2008, 20)*

Solis also recognises, however, that Japan's FTA formula may be a hard sell in East Asia where further agricultural concessions are expected, and where some WTO plus commitments are not that much welcome. "Japanese FTA policy is undercut by the Chinese FTA approach, which does not comprise of binding new rules on trade and investment, and may be more attuned to the traditional ASEAN way." (Solis 2008, 20) In fact, China's FTAs are much more flexible and less inclusive than the Japanese concept of EPA, and as a result, are much easier to negotiate and much more attractive for other regional actors that want to engage China's economy and huge market access in a swift way.

Some analysts argue that when it comes to economic integration the strategies followed by Beijing and Tokyo are very different.

> *Japan and China are the exact opposites of each other in terms of their priorities and behaviour. (...) China's moves are mainly driven by a political agenda of reassuring ASEAN and expanding its political influence in the region. Japan's moves are primarily motivated by an economic agenda of reducing transaction costs of production networks and other business operations in the region and of adding stimulus to domestic economic reform. (Munakata 2003, 7)*

This author also points out Beijing's advantage over Tokyo since it is free from bureaucratic processes that involve having a democracy. It is true that, while China's leadership can make bold moves once the political elites have agreed on something, without having to sell the policy to the general public or particular sectors, the leaders in Tokyo are "caught up in the details and find it hard to make bold moves in the face of resistance from politically powerful sectors, like agriculture." (Munakata 2003, 8) This may serve a one of the reasons behind Tokyo's difficulties to launch an FTA strategy and also explains why Japan has been slower than China in accomplishing trade talks with regional partners in Asia-Pacific.

However, those resisting forces to regional economic integration in Japan, that many considered negative since they have posed obstacles for the METI and business lobby, are now gradually being overcome. What is more, as Munakata emphasises, "they actually help to anticipate that legally binding international agreements, once concluded, would be enforced" in any case. (Munakata 2003, 8) That is not entirely assured in the case of China, which in contrast remains in a very early stage of WTO rules implementation, and considering that the ability of local or provincial governments to impose international trade regulations across all the territory is questionable. This is a significant issue for the trade bureaucrats in Tokyo. Urata points out that during a meeting of APT leaders in 2002 it was Japan who rejected China's informal proposal for the creation of a trilateral North East Asian FTA including the two countries plus South Korea. "Japan did not accept China's proposal by indicating that Japan would like to make sure that China, a new WTO member, abides by the WTO commitments and rules before discussing an FTA." (Urata 2008, 74) Nevertheless, China is indeed harvesting the benefits for its regional status that an economic agreement with ASEAN has signified, which in turn fosters Japan's resentment.

Munakata proposes that the differences between the two major regional East Asian economies may have both positive and negative implications for the current integration process in the region. "On the one hand, differences could deepen mutual mistrust and bilateral relations could deteriorate. On the other hand, differences offer them a unique opportunity for cooperation. Beijing's fast moves prompt Tokyo to react and try to nullify the discriminatory effects that an FTA without Japan could create. These challenges are acting as a healthy stimulus for Japan to accelerate its domestic reforms. In addition, the goodwill that China wins provides a positive atmosphere in the region that will encourage further cooperation to build regional institutions." (Munakata 2003, 8) This author assigns Tokyo the arduous task of reminding China to abide by the rules and responsibilities of engaging in international agreements, especially WTO related commitments.

Conclusion

The race to conclude FTAs with its neighbours has just started for Japan, and it has to catch up fast, considering the global trend among great powers to compete for economic agreements in the last decade. China, as the other major player in the region, stands in a much better position than Japan. This is especially evident in the current financial turmoil, when Japan's economy is in recession, and has performed poorly compared to China. It remains central to clarify, however, that the Sino-Japanese antagonism is not enough of an argument to allow the understanding of Japan's policy options.

In 2005 the Congressional Research Service (CRS) Report for the US Congress identified the three most important goals in Japan's FTA program, consisting of a combination of economic and political objectives. These are 1) to avoid becoming isolated as other major trading countries actively pursue FTAs, 2) to energise domestic economic activity, and 3) to promote Japanese influence in Asia-Pacific.[6] (CRS Report for Congress 2005) As it was exposed in this article, the failure of WTO negotiations in 1999 brought down the traditional confidence in multilateralism among Japanese policy-makers. The Chinese initiative to negotiate an FTA with ASEAN in 2001 had, in addition, a great impact for Japan. Economic opportunities and competition within the Asia-Pacific region was also a determinant factor that triggered Tokyo's development of a novel FTA network. The great support that reform-minded trade bureaucrats in Japan have given to an FTA-EPA strategy has to do with their conviction in the capacity to promote domestic reforms that these kinds of agreements have. Japan was able to launch its FTA strategy thanks to the initiation of trade talks with partners that demanded liberalisation of Japan's protected agricultural sector, as was the case with the Japan-Mexico agreement.

Finally, as this article emphasises, while new FTAs are allowing Japan to increase its bargaining power and leverage within the different integration practices in East Asia, they are also helping Japan to balance China's influence in the neighbourhood. Solis and Katada (2007) constructed an analytical framework to understand East-Asian cross-regionalism, in which they explain that "the use of economic diplomacy to serve larger political and security interests is an old practice (...) since FTAs are intergovernmental negotiations, they not only reflect policy-makers' response to the demands of business lobby groups but can also be guided by non-economic state priorities." (Solis and Katada 2007, 249) In fact these authors stress that FTA mechanisms often serve as useful instruments to improve a country's position by displaying what they denominate "benign leadership." (Solis and Katada 2007) As noted previously, China appears to be in a much better position than Japan in these regards.

This review of Japan's regional integration policy has illustrated the economic and political competitive pressures that constitute the major driving forces behind Tokyo's switch in its approach towards bilateral FTAs. These pressures came mainly from flourishing FTAs within the Asia-Pacific, and from other regional actors as well, particularly China. This process was consolidated with the JMEPA, where

[6] According to the Upper House Diet Member, Kenzo Fujisue, from the Japanese Democratic Party. Interview performed for the CRS Report RL33044, 2005. Japan's Free Trade Agreement Program, by Raymond J. Ahearn.

internationalised Japanese business sectors and trade bureaucrats in Tokyo helped to influence the policy-making and the necessary reforms for the creation of Japan's nascent FTA Diplomacy.

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CHINA'S FISCAL BUDGET AND PENSION REFORM

Magnus Young

The People's Republic of China instituted a major tax reform in 1994, promptly followed by reform in public pensions in 1997. The tax reform recentralised the majority of tax revenues following two decades of decentralisation, while most fiscal expenditure – including pensions – remained the responsibility of local governments. Resulting deficits and funding gaps in public pensions put significant pressure on local governments' budgets, and constitute a significant obstacle for further expansion of pension coverage. To plug the funding gap, local governments accumulate arrears on wages and pensions, and are often forced to resort to extra-budgetary financing. The central government is likewise trapped with implicit guarantees for pension liabilities – to the detriment of budgetary discipline. If public pensions are to foster better social security and decrease the need for private savings, further budgetary reform is needed. China must either match local government revenues and liabilities by redrawing the fiscal sharing system or by formalising central government transfers, or move towards centralising the entire public pension system.

Introduction

In 1994, The People's Republic of China (China) underwent one of the largest structural tax reforms in modern history. Contrary to the global trend of decentralisation and fiscal federalism, the reform recentralised fiscal revenues and increased vertical control of the Central Government over sub-national governments. This article examines these structural changes and their implication for the expansion of the Chinese welfare state in terms of funding public pensions. The author argues that current problems of local level funding gaps, poor budgeting practices, poor accountability, and structural implementation jeopardises the sustainability of their pension system, and proposes specific areas of reform to strengthen the system.

This paper looks into the public budgetary framework in China and its implications for implementation and delivery of publicly administered pensions following the pension reform of 1997. The structure of the paper is as follows: Firstly, it outlines the budget structure and revenue sharing in China, focussing in particular on the division between revenues and liabilities accruing to the Central Government and those accruing to lower-level governments. For the local governments, it looks at the provincial level, for which data is more readily obtainable than at a prefecture level and the many tiers of county and

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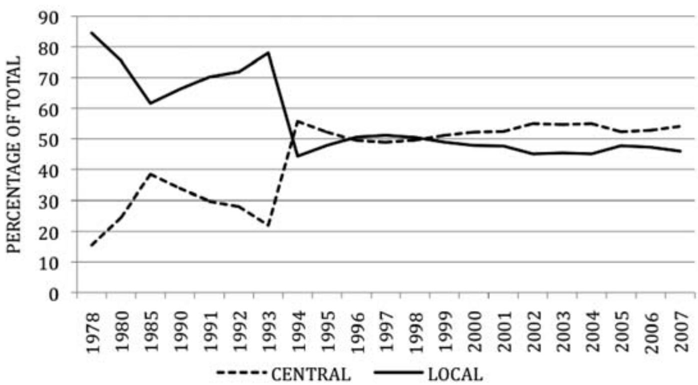
township levels of government. It will rely on official statistics up to 2007, for two reasons: to make sure the data is as reliable as possible; and because the most recent available International Monetary Fund (IMF) Article IV consultation paper on China was published in 2006, thus permitting official data to be supplemented with IMF observations and analyses. After looking at the budget, the paper will outline the structure of the publically administered pension system in China and how it is administered through the fiscal budget. Finally, drawing on political science and economic theory, the current delivery of pensions is critically examined, focussing on how the centralisation of revenues and decentralisation of liabilities affect efficiency and equity in the process. The paper concludes with some tentative policy recommendations.

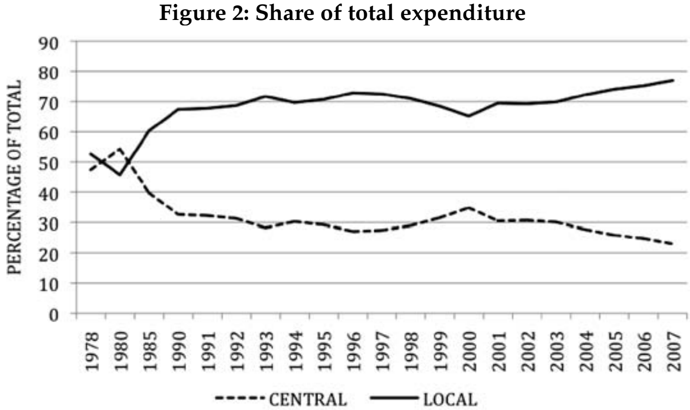
Fiscal reform and the tax sharing system

Figure 1: Share of total revenue



Source: Chinese National Bureau of Statistics

Figure 2: Share of total expenditure



Source: Chinese National Bureau of Statistics

China implemented a major tax reform in 1994, aiming to redress fiscal imbalances by "granting the Central Government additional powers of regulation and control needed to foster a 'socialist market economy'." (Herschler 1995, 239) Growing imbalances between provincial and Central Governments' tax revenues were constraining the ability of Central Government to implement their economic development programmes. In addition, there was a growing recognition that much of what market reforms introduced by Deng Xiaoping in 1978 were trying to achieve, was undermined by the poor incentive structure of the 'fiscal contract' system that had been introduced in the 1980s. The hierarchical structure of the fiscal contract system was innately inefficient, proving to be an administrative nightmare; different provinces had contracted to remit different percentages of their revenues to the Central Government, whilst different counties had in turn contracted to remit different percentages of county revenues to their respective provincial governments. Under such a system, the Central Government retained only minimal control over inter-provincial differences, and the vast majority of revenues remained in the provinces, thus reducing the efficacy of the Central Government's fiscal tools towards implementing economic and social development reform. The primary aim of the 1994 reform was to address these issues by re-centring fiscal revenues. Simultaneously, however, decentralisation of most expenditure liabilities was maintained in an effort to increase local government spending prudency and efficiency, drawing on local governments' perceived greater efficacy in local level policy implementation resulting from better and more complete information. Figures 1 and 2 illustrate the fundamental shift in revenue streams and the sustained decentralised expenditure streams following the 1994 reforms.

One of the key problems with the fiscal contract system had been that many provinces had very little incentive to improve revenue collection efficiency. For example, Jiangsu province had contracted to remit 69 percent of total tax directly to the Central Government. Similar problems persisted at lower levels of the governmental hierarchy. Some counties remitted as much as 85 percent of their fiscal revenues directly to provincial governments. (Herschler 1995) Fiscal reform was thus justified in order to address this 'imbalance'. Firstly, the very low central fiscal receipts relative to China's GDP (14.1 percent, in 1993, down from 34 percent in 1978) compared to other large countries such as the United State (US) (32-35 percent), France (45-48 percent), India (18-21 percent), and Japan (24-30 percent) indicated fiscal decentralisation was seriously compromising the Central Government's ability to implement reform. (Herschler 1995) Secondly, over the 1980s the ratio of Central Government to local government receipts had become the inverse of that observed in other countries with significant devolvement, such as India and the US. While there is no immediate reason why China should follow a similar fiscal budgetary model to these other countries, such arguments were readily used to justify reform.

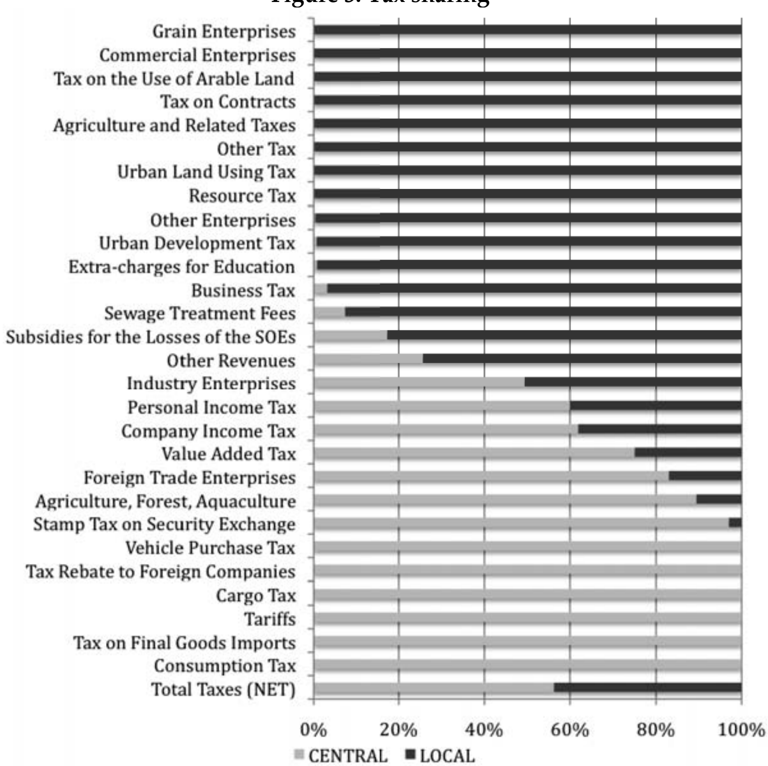
In response, the tax sharing system (*fen shui zhi*) was devised. In addition to the overall aim of reversing fiscal balance in favour of the Central Government, along the lines of a proposed 70:30 split with local governments, the reform introduced a range of specific measures to be implemented within three months: (Herschler 1995)

1. The number of different tax types was reduced from 32 to 18.

2. All enterprises were to pay a standardised income tax at 33 percent, though preferential treatment was preserved for joint ventures.

3. A three-category system of taxes was devised, defining all taxes as either national (e.g. consumption tax), joint (e.g. VAT), or local (e.g. enterprise tax (*yingye shui*)). Figure 3 illustrates how different types of taxes accrued to central and local governments under the tax sharing system in 2006.

Figure 3: Tax sharing



Source: Chinese National Bureau of Statistics

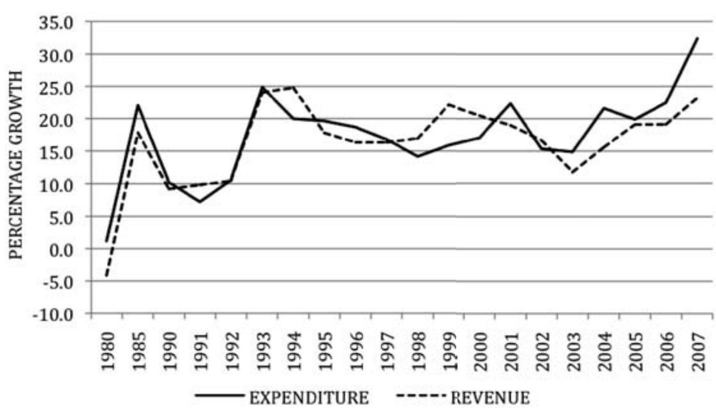
4. A new consumption tax was introduced on certain goods including alcohol, cigarettes and specific luxury goods such as cosmetics.

5. Importantly, the tax bureau was split in two, with the National Tax Bureau (*Guojia Shui Wuju*) establishing offices at local level to oversee collection of national and joint taxes, and the Local Tax Bureaus (*Difang Shui Wuju*) as a separate organ collecting local taxes.

In addition, the 1994 reform introduced a new category of 'specific purpose grants' that Central Government may give to local governments, but that have to be matched by the local government. The policies for which the grants are given are set by Central Government, further expanding Central Government control over local development. In practice, they are often used for capital expenditures on infrastructure improvements as part of regional development efforts. The reform also introduced a 'transitional transfers' category for redistributing tax revenues across provinces. (Fraschini 2006)

Following the 1994 reforms, there has been some anecdotal evidence that the splitting up of the tax collection bureaus caused problems for tax collection at local levels. According to local officials, this was due to the Local Tax Bureaus being responsible for collecting many more types of tax than the National Tax Bureau, many of which are more laborious and difficult to collect, whilst the National Tax Bureau has had far greater resources available to them to perform their work. According to the logic of the Central Government, however, this should give the local official greater incentives to increase efficiency and efficacy in their tax collection than the old fiscal contract system, especially since the taxes collected by Local Tax Bureaus accrue directly to the local governments. (Herschler 1995)

Figure 4: Annualised growth rate



Source: Chinese National Bureau of Statistics

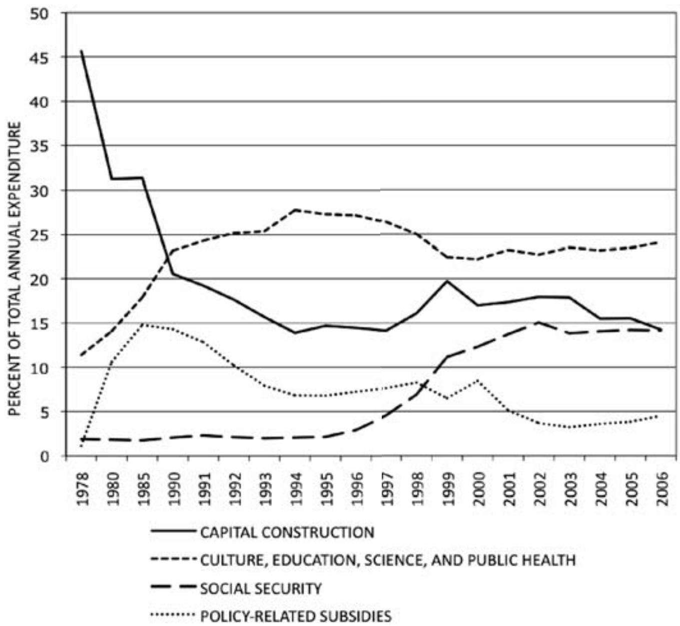
In terms of aggregate tax collection, there is no evidence of the new tax system significantly affecting efficiency or revenue growth. Figure 4 illustrates annualised growth rates in aggregate tax revenues and government expenditures calculated from government statistics. Despite the fact that detailed data is not available prior to 1990, the annualised figures indicate that growth rates may have stabilised at a slightly higher level than what was experienced under the old system, though it would be foolish to conclude that there is a causal relationship. Without doing a probing analysis – which is outside the scope of this article – the fact that fiscal revenue growth has consistently been nearly twice the level of GDP growth rates may indicate some efficiency gains were made.

The IMF Article IV report of 2006 finds China's government budget has been appropriately balanced, further indication of what the budgetary reforms have achieved. (IMF 2006) Government revenues exceeded budget expectations in both 2004 and 2005 with windfall gains from the explosion in export revenues, and excess revenues were used on social programmes. Over-performance brought down the fiscal deficit to a meagre 1.25 percent of GDP. The better-than-expected performance was largely attributed to increases in VAT and income tax receipts. (IMF 2006) However, despite the celebratory macro-economic indicators, there are several specific concerns tied to China's fiscal budget and public finance. These concerns are by and large consensual, in the sense that they are often shared by external commentators such as the IMF and the Chinese authorities, as in recent years the Central Government has also openly expressed the need for further reforms. The concerns particularly relate to the observation that the present central-local fiscal divisions are not working as well as intended – nor as well as aggregate statistical data may indicate at first glance. There is therefore a growing realisation that further significant reforms are needed, in particular in light of the rapidly growing unequal inter-provincial benefits derived from the country's overall economic growth, which is largely centred along the coast and in certain central economic zones such as the inland municipality of Chongqing. Both the IMF and the Chinese government agree that better fiscal management and more effective budget formulation and execution are necessary as coincidental changes to the broader economic and welfare reforms introduced recently, if these are to be successful. This is especially so for the increased social spending observed in recent years and the further reforms announced in the Government's 11th Five Year Plan (2006-2010). (IMF 2006)

With the rapid government revenue growth observed in China since the market reforms introduced by Deng Xiaoping (cf. Fig. 4 above), averaging 17.6 percent from 1990-2006, the Chinese government has had to find new avenues of spending to focus on. Sounding like a 'luxury problem', the question as to how to spend the increased government revenues has been very real. Figure 5 tracks changes in official sector spending as a percentage of total annual expenditure for six key items. It is clear that one of the items with the greatest increase in relative spending since the 1994 budget reforms is social security.

The increased focus on social spending is a welcome development, both as a tentative measure to rebalance aggregate growth of the country towards domestic consumption, as well as towards fostering more equitable growth. Along these lines, the IMF proposes that social spending should continue to grow steadily over the medium term, as opposed to large-scale, ad hoc and immediate increases. They would in particular like to see increased government spending in areas such as health care and education and pensions (included in social security).

Figure 5: Item expenditure as percentage of total of government expenditure



Source: Chinese National Bureau of Statistics

1997 Pension reform

The focus on pensions is particularly important in the case of China, which has had exceedingly high rates of private savings. Buttressing social security and building a reliable and sustainable pension system may help reducing such high rates of precautionary household saving, all the while boosting domestic consumption – thus further contributing towards the goal of realigning China's growth away from exports-orientation.

Positive externalities from a well functioning pension system with broad coverage were a key desirable behind the pension reforms introduced in China in 1997. These included defined benefit pension, health care, and education for children, and were subsidised by fiscal allocations wherever needed. (Dunaway and Arora 2007) In this system, there was zero employee contribution, although economic theory tells us the incidence of the 'tax' by which the pensions were funded under the old system ultimately fell on the employees. Following market reforms from 1978 onwards, SOEs' budgets were significantly tightened to increase their competitiveness and efficiency. Explicit guarantees by governments to plug the funding gap in the iron rice bowl were largely drawn back, though the implicit liability was still there. The present pension system in China was therefore introduced following the relative success of a few pilot projects in 1995. Based on the experience from these pilot projects, the 1997 reform moved pensions away from enterprises to a "countrywide social insurance system that would also be responsible for providing health, unemployment, disability, and maternity benefits." (Dunaway and Arora 2007, 6)

If we look at how the Chinese public pension system works today, however, we find that despite significant increases in public spending over the last decade or so, there are significant shortages at present. Providing previously promised benefits has proven both difficult and straining on the public finances, as the so-called 'legacy cost' of the old iron rice bowl system persist. Ten years after reform, only an estimated 25 percent of the total workforce was found to have formal pension cover in 2006, most of which were lower-level government officials. (IMF 2006) Implementation has been patchy and gradual at best. Coverage is inefficient, inadequate, and in many cases unavailable. The problem is especially bad for the vast rural population who still live in areas where no formal institutions for income smoothing exist. Only 12 percent of the rural population was covered in 2007. Overall, this amounts to the fact that less than one in four workers in China has recourse to pensions of any kind. (Dunaway and Arora 2007) The IMF understandably also highlights the need to increase the retirement age, towards which work should start immediately, as the inevitable gradualism of such a reform will result in a lengthy process. A well-functioning pension system with broad coverage is essential for any country's population to achieve effective "consumption smoothing, [longevity] insurance, income redistribution and poverty relief." (Asher et al. 2005, 1) A sustainable system of public pensions provides an institutional framework for pooling the risk of outliving one's personal or family savings, which is an essential feature of longevity insurance and, in particular in a vast middle-income country like China, or poverty relief.

The current pension system is a tripartite system with basic pensions providing poverty alleviation and longevity insurance, individual accounts linking pensions to earnings and providing consumption smoothing for the individual, and voluntary pensions such as individual plans and enterprise annuity schemes. (Asher et al. 2005) Conceptually, that is a complete package and provides coverage and adequate customisation options for every individual. However, as it often is the case in welfare economics, the devil is not only in the detail, but significantly also in implementation. The new system was intended as a mandatory pay-as-you-go (PAYG) social pension system combined with individual accounts. Contributions to the basic pensions are to sit at the enterprise level (17 percent of wages), and benefits defined as 20 percent of average local wages – provided contributions were made over at least 15 years. The individual accounts are financed by 3 percent of wages at the enterprise level and 8 percent of wages from the individual – thus intended to provide a fully funded monthly paid annuity equal to 1/120th of contributions plus interest earned. The implicit assumption is thus that each individual shall live for an estimated 11 years after he commences collecting retirement benefits, whilst in reality life expectancy at the point of retirement is in the range of 20 to 27 years. (Dunaway and Arora 2007)

Having provided a suitable institutional structure upon which to build and further develop their pension system, the key obstacle for an effective system of public pensions in China is the way in which it is administered, and specifically the way in which it is funded and how coverage is made available to the public. The three main problems at present are administrative fragmentation and patchy implementation; system deficits and funding gaps; and, problems related to the administration of individual accounts.

Central government efforts to organise the pension system around consolidated budgets at the provincial level have not been successful, and responsibility for pensions still remain chiefly at the municipal level. Municipal authorities still rely on enterprises for the funding of pension liabilities in many provinces. Tied to this organisational fragmentation are the gaps in coverage from system deficits inherited from the old system and universal coverage being mandated by the Central Government. As discussed above, large portions of the population are still without recourse to formal pensions, and increased access is unlikely until the fragmented organisation and funding gaps are resorted. Because pension spending in the majority of the provinces far exceeds governments' ability to collect contributions, there are systemic deficits in China's pension funding scheme. Unless significant further reforms are introduced the deficits can be expected to rise incrementally, especially in light of the increasing ratio of retired people to workers. Meanwhile, the individual accounts have their own problems that are largely interlinked with the issues of fragmentation and deficits. Funding gaps have made it literally impossible to simultaneously fund current retirees whilst accumulating funds in the individual accounts that were introduced in 1997. Such problems may be expected, however, when a large country such as China aims to move from a universal PAYG system to one with fully funded individual accounts without significant buffer investments being made up front. (Asher et al. 2005)

In terms of resolving the funding gap, the key problem to address pertains to the unfunded liabilities inherited by the old system and consequent gaps between pension payouts and contributions. The IMF estimates these liabilities amount to around seven percent of GDP, and such estimates are obviously volatile to changes in life expectancy at retirement – even more so if universal coverage is to be achieved in the medium term. The pension plan of 1997 has consequently been modified in such a way that the funding gap could be filled by the contributions made into the individual accounts. As a result, the individual accounts are not at all fully funded any more, and a system of notionally funded accounts is probably a more accurate description. Furthermore, to internalise the cost of social insurance an entity called the National Social Security Fund (NSSF) was set up in 2000 to provide adequate capital reserves, aiming thus to cover deficits in the pension system. "The NSSF was entitled to receive 10 percent of the proceeds from equity sales of State Owned

Enterprises (SOEs) in initial public offerings. (This practice was suspended in 2002.) Lottery ticket sales serve as an additional source of revenue." (Dunaway and Arora 2007, 8)

In setting up the NSSF, the apparent problem of implicit government liabilities with respect to plugging the funding gap for social services is officially recognised. The true size of these liabilities is perhaps best illustrated in the value of extra-budgetary activities pertaining to pensions. While extra-budgetary funds are poorly accounted for in China, it is estimated that they may amount to 70-125 percent of the budget. The fact that "most of these extra-budgetary activities are at the sub-national level since sub-national governments are responsible for providing significant expenditures, including social safety nets" (Wong 2005, 19) shows that the problems of funding pensions remain, even following the establishment of the NSSF. As the local level disparity between fiscal revenue and liabilities prevails, local governments often accumulate arrears on wages to civil servants, teachers, medical personnel, and on pensions and insurance. To plug this gap, extra-budgetary financing has sometimes become the norm rather than the exception, as local level governments borrow unofficially or illegally, thus forcing SOEs, directly or indirectly, to fund the deficit. (Wong 2005)

Much of the persisting problems are the result of poor budgeting. Despite sweeping pensions reform, spending is still poorly matched to explicit policy. At the local level, the implicit guarantee from the Central Government and numerous bailouts, typically using extra-budgetary funds, have created severe problems of moral hazard in local governments. Too much autonomy for spending units, without adequate central oversight and very little accountability on the part of local officials, only exacerbate these problems. While sizable reserves and incredible growth in government revenues, both on and off the fiscal budget, gives the Central Government a lot of leeway in policy implementation, this is not a sustainable approach in the long run. Furthermore, there is legitimate concern that poor budgeting from central level may cascade to provincial to city to county to township levels. If this is the case, the funding gap will also prevail, and local officials' disincentive to improve collection of contributions will persist.

Policy recommendations

To resolve these problems, budgetary reform is needed – not further creativity in the pension system per se. At present, spending on all social support and public services provision is assigned to local governments' at all three levels. This includes, but is not limited to, pensions and unemployment benefits. As discussed above, the assignment of spending responsibility of these very costly services is commonly justified to increase prudency in local government spending and incentivise greater efficiency in revenue collection from local taxes. However, given structural deficit and the implicit guarantee from Central Government, pension is one of the spending areas that local governments allow themselves to neglect.

To remedy the prevailing problems, there are many areas that need to be addressed. Policy changes that are likely to positively impact the issues of deficits and moral hazard, and foster sustainability in the pension system include:

1. Insufficient revenue collection is assigned at local levels; approximately 70 percent of budgetary spending is at three local levels, compared to an average of 13 percent for other developing countries and 35 percent for developed countries. This compares to less than 50 percent of fiscal revenues accruing to local governments. Furthermore, an estimated 20 percent of GDP is raised informally by the public sector, including disguised public spending, often in the form of spending by banks directed by the Central Government. This implies that unless certain public services are paid for and micromanaged by the Central Government, accrual of arrears is inevitable. As such, the formal revenue system in China is weak and in need of reform. (Wong 2005)

2. The lack of a consistent, nation-wide pension scheme means benefits from pooling remain largely untapped. Local authorities in regions that may have a *de facto* surplus on their pension accounts often choose to lower the contribution rates of enterprises and individuals. With a nation-wide scheme of accounts, resources could be pooled such that surpluses in one region plug the deficits in other regions. (Dunaway and Arora 2007) Instead, the present system has fostered geographical discrepancies that often track pre-existing income inequalities, thus exacerbating regional inequity. Given the importance of positive externalities from a well-functioning pension system, these discrepancies also promote growth in already privileged regions whilst discouraging growth prospects in low-income areas as private individuals must self-insure. Introducing a system for national pooling would also reduce the implicit liabilities of Central Government, thereby improving budgetary consistency and reducing the need for extra-budgetary bailouts.

3. To achieve the above, local discretion in interpretation and implementation of the pension framework must be curbed. A stricter legal framework for pensions coupled with greater oversight of pension accounts and budget allocations by central authorities is therefore needed.

4. To remedy the problems of adequate contributions, the National Tax Bureau should administer collection. Since pension contributions are to be shared by local and central pension authorities (if budgetary reform according to the above pooling recommendations is implemented), it is appropriate that the agent responsible for collecting shared taxes such as personal and enterprise income tax also collected pension contribution. This would also increase efficiency in collection, since contributions are made by private individuals and enterprises based on their income.

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INEFFICIENT PARASTATAL AGENCIES AND THE GROWING MODERN FOOD MARKET IN INDIA: THE NEED FOR PRIVATE PARTICIPATION

Yugank Goyal

The issue of food security is pivotal to the sustenance and growth of any economy. India's case in this respect has been particularly depressing. This article attempts to identify problems relating to food security in India, many of which can be attributed to government intervention in the food market through both its policies and agencies. In doing so, it also observes the ongoing trends in urban food markets and builds a case for increased private participation in Indian food sector.

The article begins by illustrating the alarming picture of food insecurity of India, using several quantitative parameters. Next, it shows that India actually does not suffer from shortage of food production. Therefore, in spite of being food-rich, India figures as one of the hungriest nations in the world. The article attempts to explore the causes of this food security paradox and shows how poor government policies implemented through parastatal agencies are to blame for the crisis. In doing so, several government policies that have intensified food security problems in the country are discussed and the need for their redesign is emphasised. One of the possible and efficient solutions, the article suggests, is to bring private players into the market.

The following part of the article reinforces the above suggestion. Today's food economy in India is rapidly transforming itself due to the changing food patterns and habits across growing urban India. By examining how the components and contents of the food supply chain have shifted, the article suggests the opportunity to improve food security by attracting private investments in the food industry, notably in food processing, cold chains and other allied infrastructure-demanding industries. Before concluding, suggestions for possible changes in the existing policy regime are enumerated.

Introduction

The issue of food security is pivotal for the sustainable growth of any economy. Although India has successfully embarked upon its journey of economic reforms over the last eighteen years, positioning itself as the world's fourth largest economy by purchasing power parity (Central Intelligence Agency 2010), continuing problems of persistent hunger, malnutrition, and food insecurity call for urgent attention from policy makers to carve out effective strategies in order to rectify the situation. For instance, between 1989 and 2005, per capita availability of food grains reduced from

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495 grams to 422 grams. (Saxena 2009) India has resolved to reduce hunger levels by half by 2015 as stated in the Millennium Development Goals (MDGs). But ongoing progress shows that the target is too ambitious. Amongst other things, India has a few serious problems. The government intervention in production, procurement and distribution of grains and foods has been massively inefficient, as shown in the paper. In addition, the government has not paid due attention to the rising modern food market channels, which have transformed the food habits of educated middle and upper class urban populations. Further, the structural imbalances of government policies have made it very difficult for household food security to be achieved. These structural imbalances result from ignoring the root causes of the problem and trying to fix the visible using quick-fix and myopic methods. Also, the imbalance emanates from indifference institutionalised in the system, where there is a gap between need and supply, compounded by over-staffing.

This article is divided into two broad parts. The first part discusses heavy government intervention in the Indian food sector, and how it is responsible for this sector's stunted growth. Part two explores the situation prevalent in increasing urban population's food habits and examines what possible policy steps can help allay the food insecurity fears that are present in the country.

Food security paradox in India

If one of the simplest definitions of food security is considered to be appropriate[1] – stating that food security is one's availability and access to food – India's situation is grim even when looking at the brightest view of the canvas. On 16th October, the World Food Day, ActionAid declared in a report that since mid 1990s, an additional 30 million people joined the ranks of the hungry and that 46 percent of children in India are underweight. (BBC 2009) Alarming as it may be, it does not come as a surprise to those living in India.

The problem of food insecurity is a paradoxical one. Although India does not have a deficit in food production, it is home to one of the largest hunger stricken populations in the world. To compound this paradox, the trade indicators for India show that net exports have exceeded net imports over the last decade. In July, 2002 the Food Corporation of India (FCI) had 63.1 million tonnes of food grain stocks (Patnaik 2003), which means total available stock had exceeded the total food requirements by about 20 million tonnes. This exceeded the requirements of food security by around 20 million tonnes and still above 200 million people were hungry and about 50 million on the edge of starvation. (Chakravarty and Dand 2005) Also, between 1998 and 2006 there was hardly any change in 47 percent of children (0-3 years old) being underweight. (Sinha 2009)

[1] Several definitions of Food Security exist. See for example, USAID's paper on "Policy Determination: Definition of Food Security" (1992). The definition used here is from World Bank.

Table 1 illustrates in particular the absolute and relative grading of where India stands with regards to food and agriculture, across the previous and latest decade for which data is collected. If we look at the agricultural import and export values, we notice that exports have always been higher than corresponding imports. Since agricultural trade is not contributed by food alone, I have recalculated the figures by adjusting them by the ratio of food export-import in total agricultural export-import and presented them in the same table. It does not show any remarkable change either. This essentially implies that the net trade value of agriculture (exports less imports) is positive.

Table 1: Agriculture and food export-import illustration for India

	Imports (US$ million)				Exports (US$ million)			
	1994-96	2004	2005	2006	1994-96	2004	2005	2006
Value of Agricultural Imports/Exports	2,212	5,124	5,360	7,067	4,861	7,058	9,020	11,265
Share of agricultural imports and exports in total imports and exports	6.46	4.85	3.58	3.90	15.45	8.84	8.71	9.05
Share of food in agricultural imports and exports	71.47	77.69	73.47	79.13	71.47	63.85	56.69	55.24
Value of Food Imports/Exports	1,581.2	3,981.2	3,938.6	5,591.9	3,474.6	4,506.7	5,113.4	6,222.3
Share of Food imports and exports in total imports and exports	4.62	3.77	2.63	3.09	11.04	5.64	4.94	5.00

Source: Computed by author from FAO, 2007-08

This is shown in Table 2, which also shows how India is markedly better placed in the import-export rubric when compared to other South Asian economies. Note that while net total trade is negative for India (and even other South Asian economies), it is remarkably positive for net agricultural trade. Clearly, India cannot be considered to suffer from a food deficit.

Table 2: Net total trade value and net agricultural trade value (Exports – Imports)

	Net Agricultural Trade (US$ million)				
	1994-1996	1999-2001	2004	2005	2006
Bangladesh	-847	-1,619	-1,914	-1,887	-2,314
India	2,649	1,352	1,934	3,659	4,198
Nepal	-121	-151	-269	-258	-135
Pakistan	-993	-801	-954	-1,196	-1,450
Sri Lanka	29	215	217	389	-355

Source: Statistical Division FAO, 2009, Table 3: Global Hunger Index and its components in South Asian countries, across a decade

Even after this impressive show in food and agricultural trade, a World Food Program (WFP) study conducted in early 2009 noted that more than a quarter of world's hungry people live in India (230 million). (Sengupta 2009) China has sharply reduced malnutrition to around 7 percent of its children (under five years of age), compared to India's 42.5 percent. The Global Hunger Index (GHI)[2] ranks India a dismal 66th out of the 84 developing countries studied.

Look at Table 3 to assess the Indian problem from a comparative South Asian standpoint across a decade span. Notice that as far as (a) percentage of population undernourished, (b) percentage of children dying before five, and (c) GHI is concerned, India's improvement is better than only Pakistan's. While GHI of Bangladesh and Sri Lanka has improved by 31 and 35 percent respectively, India shows a mere 28 percent improvement. In almost the same period, when these countries have been able to reduce the percentage of undernourished population by 6-9 percent India has been able to reduce it by only about 3 percent. This shows the lackadaisical approach towards combating the problem of hunger in the country. India's low score and lack of improvement exhibit a depressing picture of an undernourished, underweight population, with distressingly high rates of infant mortality.

Table 3: Change in GHI (with its components) for South Asia in varying periods

	Undernourished population (%)		Change (%)	Underweight children under five (%)		Change (%)	Children dying before five (%)		Change (%)	GHI (on a scale of 0-40)		Change (%)
	1990-92	2003-05		1988-92	2002-07		1990	2007		1990	2009	
Bangladesh	36.0	27.0	25.0	56.5	41.0	27.4	15.1	6.1	59.6	35.9	24.7	31.2
India	24.0	21.0	12.5	59.5	43.5	26.9	11.7	7.2	38.5	31.7	23.9	24.6
Nepal	21.0	15.0	28.6	47.6	38.8	18.5	14.2	5.5	61.3	27.6	19.8	28.3
Pakistan	22.0	23.0	-4.5	39.0	31.0	20.5	13.2	9.0	31.8	24.7	21.0	15.0
Sri Lanka	27.0	21.0	22.2	33.2	18.1	45.5	3.2	2.1	34.4	21.1	13.7	35.1

Source: von Grebmer et al. (2008)

India's model presents a complex picture. We know India does suffer from food insecurity, from Global Hunger Index Report and other articles mentioned above. But looking at its Gross Domestic Product (GDP) per capita, it fares better than many of those countries which have a stronger position in the GHI (see Table 4). This means that while India's GDP per capita is higher, its GHI is low.

Table 4: GHI and GDP per capita

Country	GHI 2008	GDP per capita*
Nigeria	18.4	1977
Cameroon	18.7	2124
Kenya	19.9	1535
Sudan	20.5	2088
India	23.7	2753

**GDP in US$ estimated at Purchasing Power Parity per capita*

[2] GHI (von Grebmer et al. 2008) is a tool adapted and further developed by International Food Policy Research Institute, for describing the state of global hunger; and is based on proportions of (a) under five mortality rate, (b) prevalence of underweight in children and (c) proportion of undernourished.

Source: World Bank (2007)

So we have identified two baffling observations, (a) India does not have a food deficit, and (b) India's GDP per capita is better than many less hungry nations. Even then, India has a serious, rather alarming food security problem. Perhaps, it needs to be seen whether there is a difference between the amount of food grains produced and the amount that reaches the concerned population. Table 5 shows this dichotomy, and the next section attempts to identify the problem.

Table 5: Summary of annual per capita food grains output and availability in India in last decade

Three Year Periods	Average Population (million)	Net Output per head (grams/day)		Net Availability per head (grams/day)			Change in per capita Availability from 1991-92 (%)		
		Cereals	Food grains	Cereals	Pulses	Food grains	Cereals	Pulses	Food grains
1991-92	850.7	447.8	489.8	446.0	38.9	484.9			
1994-95	901.0	456.8	497.5	440.5	37.0	477.5	-1.23	-4.93	-1.53
1997-98	953.1	446.5	484.4	442.7	34.5	477.3	-0.74	-11.27	-1.58
2000-01	1008.1	451.6	486.9	415.6	31.5	447.1	-6.82	-19.01	-7.80
Individual Year									
2000-01	1027.0	432.3	458.7	387.5	26.4	413.9	-13.13	-32.11	-14.66
2001-02	1046.4	453.2	485.0	402.1	31.8	433.9	-9.85	-18.24	-10.53

Source: Ministry of Finance, Economic Survey for various years, supplemented by Reserve Bank of India, Report on Currency and Finance for various years, quoted in Patnaik (2004)

Where is our food?

An important take-away from the above discussion is that the problem is not *food production*, but *food availability*. While India has been food secure at the national level (Jha and Srinivasan 2004), the situation at the household level is appalling. This means, there is something in the transfer between the producers and consumers, which gobbles up part of what transits through it. This 'Great Indian Leakage' is the result of the massive Public Distribution System (PDS) of India.

India's food policy has aimed to stabilise grain prices and supplies over time and across regions by procuring grains from surplus areas and supplying them to deficit areas. (Jha and Srinivasan 2004) In the days of food shortages, this essentially meant heavy government intervention in pricing, stocking, marketing and distribution of food grains. Historically this made sense, but in today's world of cheaper modes of transport and easy access to communication technologies, public intervention has only become redundant. (Jha and Srinivasan 2004)

This interventionist approach by the government is carried out by the FCI, which is the principal parastatal agency, controlling nearly 50 percent of the grain markets. Its cost of operation (minus sales) is reimbursed by the government in the form of food subsidies. The figures are mind-boggling. Notice in Table 6 that in 1990-91, the total grain price subsidy plus buffer stock subsidy was 2.33 percent of total central government expenditure (US$ 528 million). This increased to US$ 3.5 billion (reaching 0.77 percent of GDP and 4.41 percent of government's expenditure in 2001-02) (see Table 6 for enormously mounting subsidies doled out to FCI by the government). In addition, government also provides financial assistance to states for godowns (warehouses) construction, purchase of trucks and vans, and for training, research and monitoring. (Jha and Srinivasan 2004) This expenditure was appropriate if FCI and its policies were efficient. Unfortunately, this is not so.

Table 6: Food subsidy of Government of India*

Year	Total price + Buffer stock subsidy (US$ Billion)	Of which subsidy on buffer stock (US$ Billion)	Buffer stock subsidy as % of total food subsidy	Rate of increase of the Price + Buffer stock subsidy (%)	Share in total GOI expenditure (%)	Share in GDP (%)
1990-91	1.42	0			2.33	0.48
1991-92	1.43	0		1.02	2.56	0.48
1992-93	0.97	0.16	16.11	-32.32	2.27	0.41
1993-94	1.65	0.39	23.96	69.79	3.90	0.70
1994-95	1.44	0.59	40.87	-12.20	2.80	0.49
1995-96	1.62	0.45	27.94	11.93	2.78	0.46
1996-97	1.51	0.22	14.77	-6.89	2.46	0.42
1997-98	2.09	0.26	12.49	39.06	3.23	0.54
1998-99	2.19	0.40	18.34	4.69	3.11	0.53
1999-00	2.15	0.44	20.59	-1.91	3.03	0.51
2000-01	2.34	0.97	41.37	8.98	2.88	0.53
2001-02	3.43	1.21	35.35	46.6	4.41	0.77

** For various years*
Source: Recalculated from Jha and Srinivasan (2004)

A strong instrument in the hands of FCI is the Minimum Support Price (MSP) for 24 major crops. Although the MSP is supposed to take into account genuine economic factors, thereby protecting producers, in the past its determination has been influenced by political factors like the nexus between Chief Ministers and rich farmers' lobbies in surplus states. (Rao 2001) This has (a) increased the MSP enormously[3], and (b) given strong incentives to farmers to switch from cereals, pulses, oilseeds (whose supply fell) to 'MSP crops'[4], (whose supply increased so much that its demand fell considerably). In 2001-02, because of high MSP, the government was forced to buy and stock astronomical quantities of these crops. (Chand 2003) The FCI had led to a situation where their food stocks rose, while people in India were starving! It is no surprise that several researchers have expressed their disapproval of the way the MSP functions. (Parikh et al. 2003)

Another inefficient and expensive instrument in the hands of FCI is the Targeted Public Distribution System (TPDS), started in 1997. Its predecessor, the Universal Public Distribution System was heavily criticised for its failure to serve populations living below poverty line (BPL). (Dreze 2001; Dutta and Ramaswamy 2001; Shariff et

[3] According to the Government of India (2001), the annual average increase in MSP of rice and wheat was higher than average inflation during 1992-93 to 1999-00.
[4] This has happened especially in Punjab, one of the richest-farmers states in the country. (Jha and Srinivasan 2004)

al. 2002) TPDS mandated a 2-tier structure for families based on the level of their poverty. Special White Cards were given to people living BPL, and a Yellow Card to people above poverty line (APL). White Cards entitled 10 kg of food grains per family per month at subsidised rates.[5] The Yellow Cards had no such subsidies.[6] The procurement and distribution was executed by a plethora of hierarchies both at the Central and the State level executing agencies, adding to the confusion of arrays of implementation.[7] Research has indicated that the PDS has been an expensive and poorly targeted social safety net program. (Rashid, Gulati and Cummings 2008)

The biggest failure has been the lack of effective identification of BPL families and issuance of ration cards to them.[8] Other problems were intrinsic to the design of the scheme. Ten kilograms per family, and going by an average family size of five members, meant 2 kg per member per month. This is infinitesimally small compared to the recommended figure of 11.25 kg per person per month.[9] Faulty design stemmed from working through disarranged indicators – population was based on March 2000 estimates, average size of the household by 1991 figures and poverty ratio of the states as in 1993-94. Added to this, there is evidence of high leakages in the programme too. (Jha and Srinivasan 2004)

Limited distribution to BPL coupled with inflated MSP, the stocks of food grains in the FCI posed serious cost implications. The government has since then revised its maximum allocation of food grains to BPL as well as APL families.[10] In 2002, when the FCI stocks rose to an all-time-high of 63.5 million tonnes (much more than the capacity of godowns), and 250 million people were languishing in hunger, the government desperately increased the allocation of food grains to both BPL and APL families to 35 kg per month for one year. It also reduced the issue price for APL families, rice and wheat by US$ 0.02 (Indian Rupees 1) per kg for three months. This did reduce the stock amount, but showed myopic policies and interventions on the part of government.[11]

Traditionally the FCI purchased around 15 to 20 percent of India's wheat and 12 to 15 percent of its rice production. While this stock quantum has increased substantially (to the tune of seven times), the off take (sale) through distribution has

[5] Set at half the economic costs of FCI.

[6] The idea was to direct the benefits to 60 million BPL population.

[7] The procurement is done by Central government, and distribution is the prerogative of respective state governments, which, in turn either provide additional subsidies on the centrally issued (already subsidised) prices, or impose an additional taxes.

[8] In a three year period after introduction of TPDS, (1998 to 2001), BPL household cover increased marginally from 63.2 million to 65.2 million. By 1999, 18 states and Union Territories had not completed the process of identifying BPL. This resulted in 18 percent of deserving population not owning ration cards. (Jha and Srinivasan, 2004)

[9] In fact GOI, 2002 estimated monthly requirement of 73 kg per family.

[10] Government also introduced a discounted 70 percent of economic cost for allocation of food grains to APL families in 2001-02.

[11] There are however, some indications to show that while TPDS shows poor showing at national level, it did increase shares of food grains reaching poor states. (World Bank 2002)

not been proportional. (Jha and Srinivasan 2004) The degree of intervention has also increased. In wheat markets, FCI's market share increased from 4 percent in 1967-68 to 25 percent in 2004 and in the rice market, the corresponding increase has been from 9 percent to 22 percent. (Minten et al. 2009) In addition, the operating costs of FCI are unbearably high, which are again subsidised by the government of India, and increasing over the years. The mounting cost alone, in late 1990s was increasing at 15 percent per annum. This also accounts for the high cost-benefit ratio of the PDS. (Jha and Srinivasan 2001) The government has given sufficient autonomy without commensurate accountability to the FCI, which, coupled with the moral hazard problem[12] has made operations inefficient at high costs. (Gulati et al. 2000) Much of the procurement has been sold at heavy losses as cattle feed. (Jha and Srinivasan 2004) In spite of getting special treatment from the government,[13] FCI has shown suboptimal performance. It is characterised by low capacity utilisation of warehouses, 70 percent higher storage costs in owned godowns compared to hired godowns, unscientific and inadequate storage, 10 to 15 percent higher marketing costs compared to private traders, development wages 4 to 5 times higher than market rates and finally, high leakage. (Jha and Srinivasan 2001)

Why the entry of private players makes sense?

The government has assumed that private players in food market can prove to be destabilising elements owing to a strong possibility of their "colluding and speculating behaviour". With this historical view, government has restricted[14] their entry in the food sector by way of several inefficient policies and rules. This in turn has placed a heavier burden on the FCI, leading to high inefficiency and wastage.

However, several studies have indicated that private traders stabilise prices over time and across regions and if a favourable environment for them is created, they will bring overall gains to the social welfare in Indian economy. (Umali-Deininger and Deininger 2001) It has been established that private traders move grain from surplus to deficit areas and store grain from peak to lean season to take advantage of arbitrage benefits arising from price difference, thereby bringing spatial and time stability. (Jha and Srinivasan 2004) Private traders are able to operate at lower costs too (Jha and Srinivasan 2001) and even incur lower costs of storage, even when private players do not operate at level playing margins. Government has, unfortunately, failed to recognise the complementary role that private players can play in the food sector.

[12] The knowledge that government will cover the costs, if necessary, has made FCI complacent.

[13] FCI get commercial borrowing rates 3-6 percent less than private traders. They get subsidised rail freight, and exemption from Selective Credit Controls.

[14] Restrictions come in various forms. To note a few, under Essential Commodities Act, private traders cannot hold more than a certain amount of stock (so they cannot reap economies of scale), credit availability to private traders is heavily restricted, they require permits to operate outside one state (domestic trade is difficult), zonal restrictions, etc.

Labour, statutory, interest and administrative costs are a huge burden on the FCI. Surprisingly, the FCI exhibits diseconomies of scale despite the gigantic volume they deal with. Private traders on the other hand work on lower operating costs. Private traders buy directly from the farmers and thereby avoid *mandi* (wholesale) charges, unlike the FCI, which is mandated to buy from wholesale markets and has to pay those charges. Private traders employ innovative ideas to reduce costs, like using gunny bags more than once, carrying out transportation by trucks instead of trains, and keep the transit losses at a minimum.[15] And above all, private traders get good quality produce because (a) they have business interest to buy only good quality grain, and (b) farmers themselves want to avoid levy on sale to FCI, sell good quality to private traders.

Moreover, the argument that private traders may collude and destabilise the price due to their speculative behaviour, is not robust enough. Studies have found (especially in Africa) that famines were averted because of private involvement to supplement government's efforts. (Drèze and Sen 1993) In fact there is little evidence that manipulation and speculation is a natural attraction for food markets in India. (Drèze 1990) There are however, certain specific instances when government's role is pivotal and essential. For example, during market failures or famines, private traders may take advantage of spatial arbitrage; and their intentions should be counter-influenced by public intervention.

Given the huge disparity in surplus and deficit areas in India, in terms of carrying cost, the FCI faces tremendous hurdles. Around a decade ago, it moved about 22 million tonnes of food grains over 1500 km. This amounts to around 12 million bags of food grains transported every month by road, railways and inland waterways. (Jha and Srinivasan 2004) Imagine the collection of wheat, 90 percent of which is concentrated in UP, Punjab, Haryana and Rajasthan (northern part of the country) and then transporting them to every corner of the country. This gives a tremendous scope to private players to enter and assist public distribution channels and ease the FCI's burden. But private players face heavy barriers to inter-state trade, in terms of terrible road infrastructure, archaic constitutional provisions[16], practice of detention of vehicles at police check posts, requirement of permits (which is again saddled with numerous bureaucratic hassles) and complex paperwork.

A serious case for entry of private players in the food industry of India is built by carefully looking at the modern Indian food market. The next section discusses how changing patterns of food consumption in a growing Indian urban class have led to tremendous scope for private players to rope in their expertise and contribute to the

[15] The rail freight subsidy is not given to private traders and their transportation costs form a major share of total costs. See for example, Jha and Srinivasan (2004).

[16] Article 301 allows State legislature throughout the territory of India to impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within the State as may be required in the public interest. Article 304 provides for a state to impose, by law, any tax on goods imported from other states that is also imposed on goods produced in the state concerned.

growing Indian economy by way of their transformative ideas of products and services in food industry.

The modern Indian food market

Over the past few years, food supply chains from rural producers to urban[17] consumers have witnessed a dramatic change in most developing countries, and notably in India (and China). The food consumption is increasing and inclining from traditional staples towards more high valued products. (Pingali 2007; Gulati et al. 2007)

Table 7: Urbanisation in India

Census Year	Urban Population (million)	Urban population (%)
1961	78.93	17.97
1971	109.11	19.91
1981	159.46	23.34
1991	217.17	25.72
2001	286.20	28.54
2011*	354.94	29.92
2021*	429.61	32.20

**projected*
Source: Government of India (2001)

Table 8: Average value of expenditure of urban India (per person per month)

Year	Current Expenditure (US$)			Real Expenditure (US$)*		
	Food	Total	Food Expense (% of total)	Food	Total	Food Expense (% of total)
1972-73	5.10	7.92	64.47	11.90	19.90	59.78
1977-78	7.04	11.73	60.03	10.59	18.57	57.04
1983	9.90	16.75	59.10	10.82	19.58	55.25
1987-88	10.81	19.17	56.39	11.83	22.07	53.59
1993-94	7.97	14.57	54.70	11.95	23.41	51.04
1997	8.92	17.98	49.62	10.65	23.22	45.87
2000-01	8.63	20.01	43.10	11.00	26.24	41.92
2006-07	11.69	29.68	39.41	11.69	29.68	39.41

**deflated by average Consumer Price Index for industrial workers (Indiastat.com), with 100 = 2006-07; the Rupee exchange rate with US$ is taken on 1st January of succeeding year*
Source: National Sample Survey, various rounds, in Minten et al. (2009)

The urban food demand in India is driven mainly by increasing urbanisation (Table 7 shows how in 40 years, urban population percentage in India has increased from 17 to 29 percent), which in turn is dependent on various correlated factors, such as increasing income levels and poverty reduction. India has experienced strong GDP

[17] According to Government of India (2001), among other things, an urban area should have (a) a minimum population of 5000, (b) at least 75 percent of male working population engaged in non-agricultural pursuits, and (c) population density of minimum 400 per sq. km. (1000 per sq. mile).

and income growth in the past few years and reducing poverty levels post liberalising its economy in 1991-92. Table 8 shows that the total (real) expenditure of urban Indians are increasing, reflecting the high economic growth and increasing income levels. Although the real expenditure on food has not increased much in the last 35 years, if we compare this with growth in the urban population in Table 7, we find a threefold increase in expenditure on food items too. Additionally, there has been an increased access to modern food-related technologies like microwave ovens, refrigerators etc., thereby altering the purchasing behaviour of urban consumers enabling them to stock processed food or other items which can be stored over longer periods of time.

These changes have led to differences in urban (as well as rural) food consumption baskets. Consumers who can afford to do so are shifting away from grains and choosing higher valued products like fruits and vegetables, dairy products, meat, fish etc. and more processed foods. This trend is illustrated by the fact that the share of cereals in total food expenditure has declined from 36 percent in 1972-73 to 24 percent in 2006-07 in urban areas and from 56 to 32 percent in rural areas. (Minten et al. 2009) Another important change seen is that of richer households switching to processed foods with the richest and poorest groups spending around 58 percent and 30 percent of their food budget into relatively highly processed foods respectively. (Minten et al. 2009) Table 9 illustrates the share of food budget in urban and rural India's food expenditure in 2004-05. It shows that there is a high demand in both urban and rural areas for processed food, which comes as a surprise especially for rural areas. It is only for second processed foods that rural India has yet to improve. Therefore, when income rises, consumption of processed foods gains importance.

Table 9: Indian food expenditures according to level of processing (%)

	Urban	Rural
Primary Products	16.8	15.3
First processing - low value added (0 - 5%)	34.8	43.9
First processing - low value added (5 - 15%)	38.2	35.1
Second Processing	10.2	5.7
Total	100	100

Source: Minten et al. (2009)

Traditional food supply chains in India, closely associated with the FCI, have been characterised by highly unorganised and disarrayed functional methodology. Government regulates agricultural sales through Agricultural Produce and Marketing Committee (APMCs) establishing large number of market yards.[18] Typically, farmers bring their produce to these wholesale markets and to the shop of the broker whom they would like to transact with. The brokers – perfectly legal entities who charge some commission, also called commissioning agents – set out an

[18] These wholesale markets in India totaled around 268 at the time of independence, and have reached around 6300 in 2007. (Chauhan 2008) There are also around 21,000 rural primary/temporary markets which supply the wholesale markets in urban centers.

open-outcry auction, and prices are set. There have been studies illustrating that these markets are inefficient and highly wasteful (Matoo, Mishra and Narain 2007), ailed by trader collusion (Banerji and Meenakshi 2004), and extremely poor infrastructure. (Fafchamps, Vargas-Hill, and Minten 2008) APMC creates barriers to entry for newcomers, impedes innovation, prohibits farmers from buying outside the market area and increases the importance of bureaucrats. (Acharya 2004) These markets are regulated by Agricultural Produce and Marketing Act. The government is mindful of the problems in the Act and has therefore formulated an Amended Act, 2003. However, only 11 out of 28 states have amended the Act. (Chauhan 2008)

As a result of changing food patterns in urban India and dysfunctional traditional food supply chains, modern food marketing channels have emerged in last decade at a phenomenal pace in the country. Table 10 indicates growth in modern supply chains against food consumption in India. It is observed that modern private-sector-led growth is substantially higher than overall food expenditure growth. The table highlights growing importance of modern channels.

Table 10: Growth in modern food marketing channels versus food consumption in India

	Annual Growth Rate (%)	Unit	Period
Modern-public-sector-led			
Parastatal procurement	6.59	tonnes	1996-2006
Modern private-sector-led			
Modern food retail	65.50	real $*	2001-08
Processing sector overall	6.75	real Rs.**	2002-06
Food service sector overall	9.20	real Rs.**	2001-06
Food Consumption			
Total urban food consumption	3.41	real Rs.***	1997-2006
Total food consumption (Rural + Urban)	2.47	real Rs.***	1997-2006

**deflated by urban consumer price index (CPI) (US Department of Labor)*
***deflated by Reardon, Gulati and Minten (2008), referenced in source document*
****deflated by CPI for industrial workers, India (Indiastat.com)*
Source: Minten et al. (2009)

Modern retail food outlets, characterised by supermarkets, have shown high real growth rates of around 65 percent, yet it is currently a small player in terms of total food retail in India. In 2006-07, total food and grocery sale was valued at US$ 191.6 billion (Joseph et al. 2008), of which the share of modern retail was only 3 to 5 percent. This supply chain merits special attention because large Indian players (Reliance and ITC, for example) – owing to their huge requirements which cannot be fulfilled by traditional wholesale markets – are looking forward to the setting up of collection centres where traditional market channels are bypassed. This will reduce the transaction costs heavily, and farmers will gain in the process. Another important feature is that these supermarkets act as outlets for most processed foods. Therefore, they are drivers of food processing sector's success. So a rise in supermarkets has a positive influence on the food processing sector. This calls for renewed private sector participation.

The reason why food processing sector's growth is important is easy to understand. There are several reasons to believe that food processing industry shows robust signs of taking a lead in solving household food insecurity in India. Food processing can create multiple layers of products catering to an exhaustive set of separate classes of population. It inherently employs the most efficient distribution channels, and since foods are processed, it takes much longer time for food to perish, hence avoiding the 'Great Indian Leakage.' Food processing also utilises economies of scale and it is entirely possible to produce processed foods under the affordability limit of most of the urban households. Food processing fulfils multiple goals. Apart from feeding millions with a variety of easy to use and affordable products, it boosts infrastructural growth of a country and provides huge employment. According to the Confederation of Indian Industry, the food-processing sector has the potential of attracting US$ 33 billion of investment in 10 years and generating employment of 9 million person-days. (Ministry of Food Processing Industries)

With private players' participation, food processing can act as an important tool in fulfilling multiple roles in food security issues. Food processing chains develop a vertical integration of agri-food supply chains and create robust backward (from farmers) and forward (to markets) linkages. Major benefits are enumerated below:

a. India has vast resources of raw materials which are typically suited for food processing. A large part of it gets either wasted or inaccessible due to low affordability of poor population. Food processing, employing economies of scale and strong linkages with farmers and markets can produce affordable products from such raw materials.

b. A growing food processing sector fuels demand-driven growth for high value food production.[19] High value food consumption has been rising and they promise higher return per unit of land and labour compared to food grains. (Joshi et al. 2004) This high-value produce also generates higher employment and incomes for smallholders, who own less than 2 hectares of land.[20] In this way, food processing sector puts pressure on smallholders to diversify. A derivative of this is relative reduction in production of food grains, which will impose lesser burden on storage houses of the FCI.

c. Food processing creates firms with a vertical integration structure, thereby reducing transaction costs.[21] This is a result of strong backward and forward linkages. Backward linkages with farmers are developed through

[19] High value food mainly comprises of fruits, vegetables, milk, meat, egg and fish.
[20] These smallholders comprised around 58 percent of rural households in 2003. (Government of India 2006) So their well being is paramount for nations' welfare.
[21] For detailed understanding of transaction costs, see Williamson (2002).

cooperatives, panchayats[22] and other institutions. Processing centres have integrated cold chains for perishable products. By creating robust forward linkages to markets, avoidable intermediaries are bypassed. The retail food chains are directly contracted and transaction costs are reduced.

d. The food processing industry attracts huge employment because of the diverse nature of its supply chain. It encourages skill development, training, entrepreneurship, investment, institutional development and providing a liberal policy environment.[23]

e. The food processing sector encourages contract farming. Contract farming is a valuable and practical system of in which both production and market risks are shared, especially for perishable goods. This sharing mitigates risks through support services. This also reduces transaction costs to a large extent. The buyer/firm gets assurance of supply and greater integration of another leg of production, the farmer/grower gets reliability of outlet, capital and protection against risks. (Birthal et al. 2008)

Policy recommendations

It is important that we pay due attention to two vital facts that surfaced in this discussion. *Firstly*, FCI's inefficient system should be supplemented by private players, and this should be an important determinant of any new policy. *Secondly*, due to emerging demand-driven food business and inherent benefits of private sector participation, private players should be given incentives so as to attract them to this sector. Since food processing essentially falls in the domain of private players' activity, this article argues in favour of carving out policies to support private entry in Indian food markets. In pursuance of achieving these objectives, following policy recommendations are given:

a. Private sector purchasing should be encouraged. Such a move will lift up market prices and in turn reduce the requirement of price support. Consequently government costs would fall. (Jha and Srinivasan 2004)

b. The costs of operation of the FCI can be reduced by decentralising procurement and storage and avoiding cross hauling of grain that takes place in the current centralised system.

c. In the current system, there is a lot of conflict between the state and central government. State governments come up with complains of inadequate food allotments from the Centre. The Centre on the other hand blames State governments for not being able to fully utilize their existing allotments.

[22] Local self governing bodies.

[23] These benefits are based on author's visits to Mega Food Parks and farmers interviews.

(Drèze 2001) Decentralisation with respect to such allotments would put an end to this unnecessary blame-game, while increasing efficiency.

d. One good way to promote privatisation while still keeping substantial control is to let the FCI maintain a minimum level of buffer stock and then undertake open market operations in a dynamically established price band. (Jha and Srinivasan 2004) In fact, support price need not be determined by FCI at all, since its hoarding will anyways result in high inflation.

e. FCI urgently needs to adopt the principle of "early-in and early-out" for consistent stock disposal and introduce modern and computerised system of inventory control and disposal. This means, instead of hoarding old stock, the FCI should release the older stock before releasing new grains.

f. Internal audit division should focus its priorities in budgetary control, external trade and open market operations.

g. A radical idea would be to give away long hoarded grains to marginalised sections of society for free (in food-for-work or anti-poverty programs). This is because when food stock is excess, there is no opportunity cost of releasing this stock.

h. The FCI needs to be leaner than it actually is, in terms of over staffing. It is saddled with several layers of hierarchical organisational problems, and it needs to declare redundancies and cease to act as financial burden on state exchequer. In essence, the bureaucratic organisation has been over-staffed and inefficient. There is a growing need of more computerised, mechanised and e-commerce driven organisation.

i. The high costs of maintaining public stocks can be reduced through encouraging private storage, which plays a complementary role to public storage. (Jha and Srinivasan 2004)

j. Transportation of grains by the public sector basically follows the principal of transfer from surplus to deficit states. However, it has been shown that it is possible for a deficit state to import grains from a neighbouring deficit state, which in turn could import from another deficit or a surplus state or even from abroad depending on arbitrage benefits. (Jha and Srinivasan 2004) This is possible only through a more flexible environment for domestic trade, where markets are expected to reveal all information needed by private players who have to select the least cost options of trade.

k. In terms of altering food habits and changing food processing sector in India, food processing sector needs to be institutionalised in mainstream economic policies. It has been done to a large extent through Mega Food Park schemes of the Ministry of Food Processing Industries, under the advice of the Reserve Bank of India. However, a lot needs to be done to bridge the gap between rules/guidelines and implementation, along with creating more policies that are ingrained within the larger rubric of governance. This will help sustain and institutionalise the process of carrying the concept of food parks forward.

l. Incentives need to be provided not for investments in food parks and food processing industry. The incentives can either be in form of grants/aids or discounts to attract private players or in the form of assurances with regard to the laws and policies, say, simplifying the procedures required to buy or sell raw materials.

In essence, to build a resilient food industry, it is important that both public and private interventions develop synergy amongst them. This is possible by allowing and incentivising private initiatives in the sector.

Conclusion

The paper has tried to explore the policies in India, and critically examined two issues, (a) the role of parastatal agencies and their inefficient system of managing food resources, and (b) modern food supply chains, affected dramatically by changing lifestyles of urban India. Both issues, however different they may seem, hold onto a single common thread – need for private initiatives. Historically government intervention has called upon de-regulation of food supply in the country. Now, with increasing effects of globalisation and urbanisation, the modern food market has created a need for attracting further private players. Put together, both issues are interwoven deeply by way of their aims and needs. Both aim at improving food security, and both need private players. And hence, both couple with each other in suggesting important policy changes, affecting more than a billion of mankind's elements.

We can look at it in the following manner. India suffers from food insecurity. This means access/availability of food is less than the requirement. However, at the same time, India is a net agricultural trade exporter. In other words, the amount of food produced is more than the food required. But even then, the amount of food available is much inferior to food required. And so, the difference between food produced and food available amounts to food shortage. This food shortage is absorbed in the poor distribution and inefficient channels of FCI. Furthermore, it is contended that policies today need to take into account the rapidly changing urban food consumption scenario. This is important because once this is recognised, policies need to be aptly designed and re-designed to suit the needs and demands of the industry. This industry acts as a valuable fill-in component in the gap of food produced and food available, owing to its efficient retail and distribution chains, long perish-period, extended catering to varied class of population and affordable range (due to economies of scale). Therefore, to synchronise policy steps towards achieving food security in India, the principle should be (a) to improve state of parastatal agencies and (b) to take due cognisance and implement favourable policies in transforming modern food retail chains. Apart from recognising the potential of food processing, policy steps need to ensure greater impetus on changing the structure and functional methodology of the FCI. The strongest way to observe both is to increase private participation in food policy sector.

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THE IMPACT OF CORRUPTION ON GROWTH: AN EMPIRICAL ANALYSIS IN THE INDIAN CONTEXT

Keshav Choudhary

Amid growing realisation of the detrimental impact that corruption has on society and calls for greater action to curb it, it is firstly important to quantify this impact. This paper investigates whether corruption has had an impact on growth in India and if so, the channels through which this has occurred. The existing empirical literature on corruption, though not very recent, has analysed corruption almost entirely using cross country data sets prepared by organisations such as the World Bank and Transparency International, which provide perception-based rankings of countries on corruption. Country specific analyses have not received much attention. This paper aims to contribute to the literature by providing a country specific analysis in the context of India. It also tries to move away from perception-based measures by using data on actual convictions and crimes registered under the Prevention of Corruption Act. Using panel data for the Indian States and Union Territories for the years 2000-2005, the paper finds evidence that corruption has had a significant negative impact on economic growth in India and the adverse impact on investment is a plausible channel through which this impact occurs. The paper also finds evidence that corruption has a more pronounced impact in states with relatively weak social and economic infrastructure. The findings of the study thus put the speculation on the impact of corruption on firm empirical ground. Policy action against corruption is warranted and strengthening institutions and infrastructure in backward states emerges as a policy recommendation. Furthermore, a reduction in the levels of corruption is likely to have not only a direct impact on growth but also an indirect positive effect through the impact on investment. Immediate policy action against corruption is likely to bolster growth and improve the investment climate in India.

Introduction

> *Just as it is impossible not to taste the honey or poison that one may find at the tip of one's tongue, so it is impossible for one dealing with government funds not to taste, at least a little bit, of the king's wealth.*
>
> – Arthashastra Kautilya, 4 B.C.

The phenomenon of corruption is centuries old. Kautilya wrote about it in 4th century BC in his treatise on statecraft, economic policy and military strategy. (Kangle 1972) However, it has attracted the attention of economists only in recent years because of two reasons. The first is a growing awareness or recognition of the persistence and widespread nature of corruption. According to the World Bank

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Institute, the total amount of bribes paid in a year is about US$1 trillion. (Rose-Ackerman 2004) Transparency International (TI) calls corruption one of the most serious obstacles to the removal of poverty. Examples abound all over the world, from those of petty corruption such as shopkeepers bribing the local inspector not to create trouble, to more severe ones. A Turkish civil engineer stated that the number of deaths due to the 1999 Kocaeli earthquake could have been much lower had construction firms not used substandard materials and bribed officials to escape regulation standards. (Lewis 2005) The TI India Study, 2005 reports that as many as 62 percent of the citizens surveyed had a 'first hand' experience of bribery and the amount they paid in total was approximately US$ 4.5 billion (roughly 0.7 percent of India's GDP in that year). (CMS TI India 2005) No matter where one looks, corruption is almost certainly viewed to be an impediment to development today.

Corruption is also of interest to economists due to its impact on macroeconomic indicators such as growth, income, investment and trade. At the micro level, theories that study agents' incentives like the principal-agent structure, allow corruption to fit in neatly with a little modification and hence make it amenable to analysis within existing theoretical frameworks. (Tirole 1986) Empirically too, corruption has begun to be addressed by economists, though there are acute issues with data availability and other problems (which have been discussed later in the paper). The following paragraphs summarise where the literature currently stands while throwing light on some issues which will form a backdrop as well as the theoretical underpinnings of the study.

The empirical literature

To understand corruption, one must begin by defining it. This is not always a trivial problem since there can be many alternative forms of corruption such as bribery, graft, nepotism, extortion, embezzlement etc. A plausible definition of corruption could be the 'misuse of public office for private gain'. Though this does not capture corruption in the private sector, it is a definition followed by most authors such as Shleifer and Vishny (1993), and Jakob Svensson (2005) among others. Clearly, the operative word in the definition – *misuse* – also implies a notion of legality. This brings us to an inherent problem in cross country analyses of corruption where what is legal in some countries may well be illegal in others.[1]

The empirical literature on corruption was pioneered by Paolo Mauro (1995) who estimated the impact of corruption on growth and investment using a cross country data set and found a significant negative relationship. The measure of corruption he used was a ranking of countries on an index prepared by *The Economist Intelligence Unit*. Since then, most studies on corruption have followed this track with studies such as Brunetti and Weder (2003), Meon and Sekkat (2005) reporting similar

[1] For instance, large campaign donations and the practice of lobbying government officials by firms, as is prevalent in the US may sometimes be viewed as corrupt in countries like India.

findings and using similar corruption measures such as the *Corruption Perception Index* provided by TI and an index provided by the World Bank.

However, there are problems with such measures. While they differ in methodology and countries covered, they are all perception-based ordinal rankings[2], in which different firms and business executives are surveyed. Hence they may suffer from a severe perception bias. Such rankings may also wrongly reflect the levels of corruption in a country since most of these surveys question executives in multinational companies who may have an incorrect view of the ground reality in a country. The survey-based nature of the data is also problematic since many respondents may misreport bribes paid, or not report them at all. Data issues have been a problem with nearly every empirical research on corruption – how does one collect data on a variable that is by its very nature a secret? Some studies such as Bhattacharya and Ghose (1998) find ways around the problem by hypothesising that in order to recover the costs of bribery, firms hide output. Their basic premise is that in an economy, corruption is mainly generated due to regulatory conditions. By hiding production output which goes unrecorded in official statistics, firms can reduce the costs of bribery. Thus, by trying to estimate the total unrecorded output in a sector, one may get an estimate of the level of corruption present. However, their study is informative in nature and does not quantify the impact on growth.

Is the impact of corruption necessarily adverse?

The debate on corruption is not one-sided. There is a branch of literature which suggests that corruption may actually be *beneficial* to growth. This view has been propagated by Huntington (1968) and Leff (1964) who argue that in a society in which inefficient laws and regulations are already in place, bribery may 'grease the wheels' and help reduce inefficiency. There is some support for this view theoretically as well. Lui (1985) used a game theoretic model to show that in a queue, it may be optimal to allow bribes to jump the queue. It could also be argued that if firms were to bid competitively or bribe an official for a permit, the firm with the lowest cost of production (i.e. the most efficient firm) would be able to pay the highest bribe and would get the permit. (Lien 1986)

This argument however, seems to take a limited view of the problem. While it assumes that inefficiencies exist, it does not question why they do so. A plausible reason is that they exist to allow opportunities for rent extraction. Shleifer and Vishny (1992) claim that firms might create artificial shortages and then gather a large surplus by collecting bribes. Banerjee (1997) also argues that bureaucrats may artificially create red tape in order to screen potential bribers according to their willingness to bribe. Those with a high willingness to pay often do so and overcome the red tape, while those who are unwilling tend to get enmeshed in it, thereby ensuring an effective mechanism for screening the willing from the unwilling. Thus corruption might be a symptom or cause of inefficiency rather than something which

[2] These often tend to be wrongly used as cardinal measures in studies. Mauro (1995) for example, states that if the corruption index of Bangladesh were to increase by 1 standard deviation, the rate of growth would go up by half a percentage point.

circumvents it. As far as 'greasing the wheels' goes, where is the guarantee that the work for which the bribe is paid gets done and that further bribes are not asked for? Moreover, firms that bribe the highest amounts may not be the most efficient ones since they may pay large bribes and later simply reduce the quality of goods to recover the cost of the bribes. Some empirical studies such as Mauro (1995) and Kaufmann and Wei (1999) also refute the 'grease hypothesis'. However, as Meon and Sekkat (2005) note, there is not enough evidence to systematically reject this hypothesis. By examining the impact of corruption on growth, this paper tests the validity of the 'grease hypothesis'.

Other questions to be examined

This study also tests whether the social and economic infrastructure in a state affects the impact that corruption has on growth. Intuitively, if the impact of corruption on growth is adverse, then it should be felt more in areas where institutions are weak and more susceptible to corruption. Poor infrastructure would translate to weak enforcement by the authorities and weak social institutions like the media would be unable to deter corruption effectively. It is also highly likely that the effectiveness in governance, of political institutions such as legislative assemblies and *panchayats*, is correlated with the social and economic infrastructure in a state. Thus states with poor infrastructure are unlikely to exhibit effective political action against corruption, which worsens the problem. Furthermore, corruption might be present at various levels in these places. One can also think of this in a game theoretic situation wherein if an agent believes that everyone in the bureaucratic hierarchy is corrupt it then pays to be corrupt as well, due to the low probability of getting caught. The equilibrium of this game (in the Nash sense) is then a situation in which corruption persists at multiple levels. This could lead to severe inefficiencies since firms might have to devote a lot of resources bribing officials at multiple levels and this could severely impact growth. This study includes a dummy variable that distinguishes states with weak infrastructure from those that have relatively strong social and economic infrastructure. This allows us to examine whether corruption impacts growth more severely in the 'weak states'.

Another question that needs to be examined is that of the channels through which the impact of corruption on growth occurs. Mauro (1995) and Meon and Sekkat (2005), both report that investment could be a plausible channel. It could be argued that entrepreneurs who have to pay a large amount of bribes (which implies lower potential profits for the firm), may tend to distort production to reduce their dependence on public services. This could be done by expanding less rapidly or lowering the scale of production. (Svensson 2005) Evidence in favour of this hypothesis is provided by De Soto (1989) for the case of Peru. Such distortions could introduce inefficiencies which could affect growth. Firms might also adopt 'fly-by-night' technologies – i.e. technologies with a high degree of reversibility[3] to respond appropriately to future demands by corrupt officials – and this could again cause inefficiencies. (Svensson 2003) Mauro's study finds an insignificant impact of

[3] For instance, a firm might devote resources to establish the capability to quickly dismantle and recover its investment when faced with a high degree of bureaucratic corruption.

corruption on investment but when he uses a broader measure of 'Bureaucratic Efficiency', the results become significant. These claims need to be verified in a country-specific context. In the study, we do this by estimating the impact of corruption on the investment ratio – i.e. investment as a proportion of the GDP of a state.

The rest of the paper is organised as follows. The next section discusses the data and methodology used in the study. We then discuss the empirical results of the estimation and examine the validity of the hypotheses mentioned above. The subsequent section discusses some implications of the results obtained and concludes by highlighting policy implications and directions for further research.

Data and methodology

The data

The source of the data on corruption used in the study is The National Crime Records Bureau at the Ministry of Home Affairs, India. It consists of a state-wise compilation of the number of cognizable crimes registered, as well as a record of the number of persons under trial[4] under the Prevention of Corruption Act, 1988 and related sections of the Indian Penal Code for all the states and union territories of India from 2000 onwards. This data allows us to avoid the potential problem of defining corruption appropriately since the definition adopted is automatically that of the Indian Penal Code (the Prevention of Corruption Act does this in great detail with many sections devoted to carefully listing what constitutes an offence under the law; National Crime Records Bureau). The data on Gross State Domestic Product (GSDP) and the population levels in each state comes from a list of key indicators for states compiled by the EPW Research Foundation. The figures for GSDP are reported at constant prices with 1999-2000 as the base year. In order to control for economic infrastructure in the states, we use data for the total electricity available in each state, compiled by the Central Electricity Authority. These values are reported in Gigawatt-Hour for the states. The Eleventh Finance Commission Report of the Government of India contains a ranking of states on an index of social and economic infrastructure over the period 2000-2005. Using this index, we construct a dummy variable that distinguishes between states that perform better than average on this index and those that perform worse.

The data for state-wise total government expenditure comes from the Planning Commission. These are reported as a percentage of GSDP and hence this data too is at constant (1999-2000 as the base) prices. Investment data is obtained from the Annual Survey of Industries (ASI). The relevant category is the Invested Capital in major states. This data is reported at current prices. In order to convert it into constant prices, the Index of Industrial Production provided by the Central Statistical Organisation is used, treating 1993-94 as the base year. This difference in base year

[4] Data on persons under trial, as well as cognizable crimes registered, provide two alternative measures of corruption. Estimation has been done with both in order to provide a robustness check for the results.

(1999-2000 vis-à-vis 1993-94) does not create problems since it amounts merely to a rescaling and meaningful inferences may still be drawn.

Some data limitations need to be pointed out. The ASI data is by no means an exhaustive measure of total investment. It covers only the manufacturing sector and within it too, only the organised sector. However, it remains the only state wise source of investment data available and this study could have generated much stronger results had such data been present. The investment data also restricts the time series dimension of the data set to 2005 when data on the other variables is available up to 2007.

Model specification

The following log-linear specification is estimated for growth:

$$\log(pcgsdp)_{i,t} = \beta_1 + \beta_2 \log(pcinv)_{i,t} + \beta_3 \log(pcgovt)_{i,t} + \beta_4 \log(pcelec)_{i,t} + \beta_5 (pcundetrial)_{i,t} + \beta_6 (dummy * pcundertrial)_{i,t} + \epsilon_{i,t}$$

The same specification is then estimated by replacing *pcundertrial* by *pccogcrimes* above. Here:

- *Pcgsdp*: is the per capita Gross State Domestic Product in Rupees (at constant 1999-00 prices)
- *Pcinv*: is the per capita Investment in Rupees as measured by the ASI data (at constant 1993-94 prices)
- *Pcgovt*: is the per capita Government Expenditure in Rupees (at constant 1999-00 prices)
- *Pcelec*: is the per capita availability of electricity in kWh
- *Pcundertrial*: is the number of persons under trial in corruption cases measured in per crore (per 10 million) person terms
- *Pccogcrimes*: is the number of cognizable crimes registered in corruption cases measured in per crore (per 10 million) person terms.
- *Dummy*: takes the value 1 for 'good states' and 0 for 'bad states'
- ε: is the error term
- *i,t*: is the index the states and years respectively

In order to study the impact of corruption on investment, the specification is:

$$\begin{aligned} log(invratio)_{i,t} &= \alpha_1 + \alpha_2 log(pcgovt)_{i,t} + \alpha_3 log(pcelec)_{i,t} \\ &+ \alpha_4 (pcundertrial)_{i,t} + \alpha_5 (dummy * pcundertrial)_{i,t} + \mu_{i,t} \end{aligned}$$

Again, the same specification is estimated by replacing *pcundertrial* by *pccogcrimes* above. Here:

- *Invratio*: is the ratio of the Investment (measured by ASI data) to GSDP for a given state in the relevant year
- μ: is the error term

Other issues

The log-linear specification allows us to study the impact of an absolute change in the corruption measure on relative changes in income – i.e. growth and the investment ratio. The per capita values for the variables are calculated by dividing the value of the variable by the population in the state in the corresponding year. This is done to ensure that the results are not driven by the sheer size of a state.

The dummy variable is determined as follows: The index of social and economic infrastructure contained in the Finance Commission Report as mentioned earlier, takes values from 69.7 to 200.57. The mean value of this index is 103.5 and this is taken to be the cut-off value. States with an index number greater than average (103.5) are labelled 'good' since they perform better than a hypothetical average state, on the index. The rest of the states are labelled 'bad'.

Table 1: The index of social and economic infrastructure

States	Index
Andhra Pradesh	103.3
Arunachal Pradesh	69.71
Assam	77.72
Bihar	81.33
Goa	200.6
Gujarat	124.3
Haryana	137.5
Himachal Pradesh	95.03
Jammu & Kashmir	71.46
Karnataka	104.9
Kerala	178.7
Madhya Pradesh	76.79
Maharashtra	112.8
Manipur	75.39
Meghalaya	75.49
Mizoram	82.13
Nagaland	76.14
Orissa	81
Punjab	187.6
Rajasthan	75.86
Sikkim	109
Tamil Nadu	149.1
Tripura	74.87
Uttar Pradesh	101.2
West Bengal	111.3

Source: Finance Commission, India (2000)

It is also important to note the difference between *Pccogcrimes* and *Pcundertrial*. Cognizable crimes refer to cases where the police is empowered to file a First Information Report, investigate and arrest without a court warrant. Under the Indian

Penal Code these refer to more serious violations since under normal procedure the express permission of the courts is needed. (Vadackumchery 1986) *Pcundertrial* would measure the total number of cases registered (both cognizable and non-cognizable) that actually proceed to trial.

Another important fact implicit in the formulation of the model is the assumption that changes in the corruption measure indicates changes in the incidence of corruption. Strictly speaking, this may not be entirely correct since changes in the corruption measure could reflect an improvement in the enforcement by agencies instead (greater number of convictions and trials for the same level of corruption). These agencies refer to the judiciary, police departments in states, investigating agencies established by central and state governments such as the Central Bureau of Investigation, Central and State Vigilance Commissions, and other bodies empowered under the Prevention of Corruption Act. Change in enforcement occurs when these agencies become more effective at catching and punishing anti-corruption activities. This happens as transparency increases in public life, new legislation is enacted giving these bodies more investigative powers and resources, and as these resources trickle down the different hierarchical levels. This process is undoubtedly a long run phenomenon which can take decades. By contrast, the period under consideration is 6 years (2000-2005) and it is thus reasonable to assume that enforcement has remained unchanged over this period. This allows us to interpret changes in the corruption measure as changes in the incidence of corruption and not enforcement by agencies.

We expect the signs of β_2, β_3 and β_4 to be positive. This is to say that investment (the component captured by the ASI data), government expenditure and the infrastructure (using a proxy of the electricity available) have a positive impact on growth. If the hypothesis that corruption affects growth adversely, then β_5 (impact for 'bad states') and $\beta_5 + \beta_6$ (impact for 'good states') should both be negative, otherwise positive. Moreover, if there is a differential impact of corruption on growth in 'good' and 'bad' states then β_6 should be significant.

Methodology

Ordinary Least Squares (OLS) estimation by pooling the data points together is unlikely to be effective in this setting due to the presence of both heteroscedasticity and autocorrelation which are a feature of panel data.[5] To test this, White's test for heteroscedasticity was run on pooled OLS data and the null hypothesis of no heteroscedasticity was rejected (p-value = 0). Furthermore, the Breusch-Pagan Lagrange Multiplier test which tests the null hypothesis of pooled OLS data being sufficient for our model against the alternative of a random effects method also rejects the null hypothesis (p-value = 0) which indicates that using pooled OLS will give biased and inconsistent estimates.

[5] For the general reader, the presence of heteroscedasticity means that the error term in the regression does not have constant variance. Autocorrelation implies that the error terms are correlated. Panel data sets which have both a cross sectional as well as a time series dimension, usually exhibit both.

However, this is still not sufficient to proceed with the random effects method since there is a competing fixed-effects estimation method. In both the fixed-effects and random-effects methods, the intercept term in the regression is allowed to vary (as opposed to OLS where the intercept is a constant). In fixed-effects, this is done by including a dummy variable for each state to capture any state specific effects. In random effects, this is done by assuming a fixed intercept term plus a random term. The random effects estimator generally yields estimates with a higher precision. However, if this random term happens to be correlated with any of the explanatory variables, the estimates turn out to be both biased and inconsistent. By contrast, fixed-effects always yield consistent estimates. It is standard practice to use a Hausman test to determine which one of the competing estimation methods is appropriate. For our model, a Hausman test rejects random effects estimation in favour of fixed-effects. Hence all relationships are estimated using fixed-effects. In addition, to account for autocorrelation, we assume an error term with AR(1)[6] disturbances.

Estimation results

Estimation for growth

Table 2 lists the estimates for the specification with log(*pcgsdp*) as the dependent variable.

The estimation results show that the coefficients of log(*pcinv*), log(*pcgsdp*) and log(*pcelec*) are all positive and significant at the 1 percent or 5 percent significance level. Thus all these factors have a positive impact on growth in the model. When the interactive dummies for the corruption variables are not included, the coefficients of the corruption variables tell us the average impact on growth for a state. For *Pccogcrimes* this coefficient is -0.003 and significant at 1 percent. We interpret this as saying that a unit increase in the number of cognizable crimes registered per 10 million persons in a state, affects growth adversely by 0.3 percent. For *Pcundertrial* this coefficient has a positive sign but is insignificant.

When the interactive dummies are included in the estimation, then the coefficient of the corruption measure tells us the impact on growth for 'bad' states (*dummy* = 0) while for 'good' states (*dummy* = 1), the impact on growth is given by the sum of the coefficients of the corruption measure and the interactive dummy. For *Pccogcrimes*, the coefficient for 'bad' states becomes more negative at -0.004 and remains significant which indicates that for 'bad' states, corruption has a more adverse impact than average at 0.4 percent. The coefficient on the interactive dummy has a positive sign which indicates that the impact on 'good' states is less adverse but it is insignificant.

With the interactive dummy, *Pcundertrial* also confirms this result. Now, the coefficient on the interactive dummy is significant. For 'good' states the coefficient is

[6] AR(1) denotes an Autoregressive process of order 1.

-0.00015 which is consistent with the hypothesis of corruption having an adverse impact on growth. For 'bad' states, the coefficient is -0.0011484 which is more negative indicating that the impact is even more adverse.

Table 2: Estimation for growth (fixed-effects with AR1)

Dependent Variable: log(*pcgsdp*)	**Coefficients**			
Explanatory variables	-1	-2	-3	-4
Constant	1.943 -0.137 (***)	2.021717 -0.13351 (***)	2.505299 -0.15828 (***)	2.450571 -0.137284 (***)
log(*pcinv*)	0.498 -0.076 (***)	0.542937 -0.08404 (***)	0.522565 -0.10006 (***)	0.50397 0.081194 (***)
log(*pcgovt*)	0.217 -0.051 (***)	0.203188 -0.05215 (***)	0.227376 0.06437 (***)	0.214998 0.052226 (***)
log(*pcelec*)	0.44 -0.095 (***)	0.386706 -0.10303 (***)	0.280087 0.122333 (**)	0.309805 0.100222 (***)
pccogcrimes	-0.003 -5E-04 (***)	-0.00399 -0.00125 (***)		
dummy*pccogcrimes		0.001385 -0.00151		
pcundertrial			0.000155 -0.00014	-0.001148 -0.000225 (***)
dummy*pcundertrial				0.001 -0.000201 (***)
	N=78	N=78	N=78	N=78

Standard errors (s.e) reported in parentheses. (***) indicates significance at 1 percent level, (**) indicates significance at 5 percent and (*) indicates significance at 10 percent level.

Estimation for investment

We now explore the plausibility of investment being the channel through which corruption affects growth. The estimates for the second specification are:

The coefficients for log(*pcgovt*) are negative in all cases and significant in 3 cases. Since the ASI data on investment considers private investment only in the organised manufacturing sector, the negative sign implies that government expenditure crowds out private investment. This leads to the debate on the crowding-out versus crowding-in effects of government expenditure. (Ahmed and Miller 2000) The coefficient of *Pcelec* is positive though not always significant indicating that infrastructure positively affects private investment. The coefficient on *Pcundertrial* when the interactive dummy is absent is negative and significant which implies that corruption adversely affects investment. Even with the interactive dummy present, it is negative for both 'bad' states (-0.00114) and 'good' states (-0.000065) and is much more negative for 'bad' states indicating that corruption affects private investment more adversely in these states. We thus find support for the hypothesis mentioned earlier, that in states with weak institutions, firms would possibly spend a lot of time haggling and paying bribes to officials perhaps at multiple levels, and this could reduce their incentives to invest.

Table 3: Estimation for investment ratio (fixed-effects with AR1)

Dependent Variable: log(*invratio*)	Coefficients			
Explanatory variables	**1**	**2**	**3**	**4**
Constant	-1.427741 -0.133223 (***)	-1.863154 -0.132815 (***)	-2.074388 -0.136606 (***)	-1.976909 -0.130715 (***)
log(*pcgovt*)	-0.118092 -0.063658 (*)	-0.095479 -0.058785	-0.125493 -0.07162 (*)	-0.113088 -0.065192 (*)
log(*pcelec*)	0.0075693 -0.082957	0.0499633 -0.077719	0.1550137 -0.088056 (*)	0.1430493 -0.080213 (*)
pccogcrimes	0.0029178 -0.000704 (***)	0.0062853 -0.001346 (***)		
dummy*pccogcrimes		-0.004745 -0.001624 (***)		
pcundertrial			-0.000313 -0.000155 (**)	-0.001145 -0.000266 (***)
dummy*pcundertrial				0.0010849 -0.000297 (***)
	N=78	N=78	N=78	N=78

Standard errors (s.e) reported in parentheses. (***) indicates significance at 1 percent level, (**) indicates significance at 5 percent and (*) indicates significance at 10 percent level.

The coefficient on *Pccogcrimes* however, is positive and significant when the interactive dummy is absent (0.0029). Even when the interactive dummy is present, the coefficient for bad states is positive (0.0063) and so it is, even for good states (0.00158). This is a puzzling result. However, recalling that *Pccogcrimes* as mentioned earlier is a measure of serious violations of the law, it is plausible that many of these cases involve large payments by firms in order to secure contracts and other big favours. There is anecdotal evidence to support this view. According to media reports (CNN-IBN 2009), many US based firms pleaded guilty to making improper payments of a large magnitude to Indian officials in order to secure contracts and this constitutes a cognizable offence. Thus if a high proportion of cognizable crimes represent such cases then firms could actually increase private investment on being awarded such contracts and entering the market.

The impact on investment is thus mixed, depending on which measure of corruption one is willing to follow. If one believes in a broader measure, which would include petty corruption (*Pcundertrial*), then the impact on investment is negative, and if one follows *Pccogcrimes* then the impact is positive. It is tempting to accept the broader measure here since it captures the various forms of corruption better. It should also be noted that the negative impact of *Pccogcrimes* on growth indicates that there must be some other effect at play which is not adequately being captured in the model and this is likely to be the total investment in a state. It might be possible that the other components of private investment move in the opposite direction. Public investment too may shift resulting in a negative impact on growth. Mauro (1998) provides evidence that public investment in education tends to get lowered with higher levels of corruption. These distortions will have an impact on human capital and could adversely affect growth. However, in the absence of state-wise data on total investment, this cannot be verified.

Conclusion

This study has analysed the impact of corruption on growth and attempted to identify possible channels through which this effect operates. It uses data on corruption crimes registered and actual convictions, as a measure of corruption. The coefficients in the estimation for growth indicate evidence that corruption does adversely impact growth. We thus reject the 'grease the wheels' hypothesis of corruption which claims that corruption could be beneficial to growth (Meon and Sekkat 2005). The adverse impact holds on average (when the interactive dummy is absent) as well as when a distinction is made between 'good' and 'bad' states on the basis of social and economic infrastructure. It is also seen that the impact of corruption on growth is more pronounced in states with weak infrastructure. The paper then tries to identify the possible channels through which this effect operates and hypotheses that investment could be one of them. We carry out a similar estimation for the impact of corruption on investment. It is found that this effect is harder to identify. As observed, the impact of corruption on investment is not necessarily adverse, and depends on the measure of corruption used. This paper tries to justify why this could be happening. However, it is to be noted that the measure of investment used in the study is inadequate as mentioned earlier. Even the positive effect of corruption on the private investment (for *Pccogcrimes*) ultimately translates into a negative impact on growth. This is probably due to other factors at play which have not been captured in this model due to data restrictions.

This suggests some directions for further research. As better data on total investment in states becomes available, it should be incorporated into the analysis to identify these factors at play. It would also be useful to extend the model to study the impact of corruption not just on growth and investment, but also on how it distorts public expenditure, affects capital inflows, international trade and so on. Quantifying these impacts in a country specific context would be valuable in the fight against corruption. The analysis could also be extended to identify factors that could be *causing* corruption. These factors could be transparency and accountability in public institutions, historical factors such as colonial history (Leite and Weidmann 1999), and social and economic infrastructure (as we have considered), among others. Identifying other causes could perhaps also result in more effective ways of tackling corruption.

There are some policy recommendations that emerge from the paper. As observed from the estimation results, there is evidence of a differential impact of corruption on growth as well as investment. States with poor social and economic infrastructure feel the impact of corruption more adversely. It is thus critical for these states to upgrade their infrastructure if they are to deal with corruption effectively. This would have a reinforcing effect on growth by not only making the investment climate more favourable, but also through its impact on reducing corruption. The enforcement by police and other vigilance agencies also needs to be made more effective. Given the enormous judicial and administrative delays that are common in the Indian setting, corruption cannot be deterred effectively if this continues. As mentioned earlier, corruption could persist in the bureaucracy at multiple levels if the chances of getting caught are low, thus introducing severe inefficiencies. Both the central and state governments should hence devote additional resources to make the enforcement agencies more efficient at detecting and punishing corrupt practices. The detrimental impact of corruption on growth, and its persistent nature, calls for immediate policy action to curb it – status quo would literally result in our paying the price for it.

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WHAT'S WRONG WITH ODA TODAY? THE PARIS DECLARATION AND LESSONS LEARNED FROM THE EU 'ASIA URBS' PROJECT IN CAMBODIA

Martin Stavenhagen

This essay examines the effectiveness of Official Development Assistance (ODA) by example of the European Union's Asia Urbs project in Cambodia, which focused on decentralising Cambodia's political administration and promoting good governance by building capacities for delivery of transparent and client-oriented public services. The Asia Urbs project is assessed by applying the five overarching goals of the Paris Declaration on Aid Effectiveness: Ownership, Alignment, Harmonisation, Managing for Results and Mutual Accountability. It appears that these goals are not only difficult to achieve, but can be inherently contradictory, particularly concerning the improvement of good governance as one of the key prerequisites for development. Trade-offs include the possibility of too much ownership impeding project effectiveness. When dealing with the dilemma of how to include the government in good governance efforts, ODA actors must maintain a careful balance between political ideals and practical solutions for the problems of the poor.

While acknowledging the difficulty in evaluating projects aimed at promoting good governance, three factors are identified as essential for successful ODA: client satisfaction, since citizens can best assess what they need; sustainability, since only projects that continue after donors have left create lasting public value; and transparency of project results, since ODA actors can learn from previous mistakes only if evaluations of what worked and what did not are documented and made widely available.

What is Asia Urbs?

Asia Urbs was a multilateral development project aimed at promoting political decentralisation and building regional capacities for good governance in Cambodia. It involved various key players: on the one side, the main financier - the European Commission, together with two European local administrations, the Rhein-Sieg district of Germany and the city of Spoleto in Italy; on the other side, the two Cambodian pilot districts, Battambang and Siem Reap and various national authorities of the Royal Government of Cambodia, and as support, the German Konrad Adenauer Foundation (KAS) and the consulting firm BBJ Consult Inc. from

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Berlin. The entire project spanned eight years, from 2000 to 2008. 'Asia Urbs III: Strengthening Pilot Administrations' was the second extension of the original project. Its objective was to further decentralise the Cambodian political system by assisting the transfer of political power and decision-making authority to local governments, building up capacities inside the two district administrations, and creating various instruments for people's participation.

The two pilot districts that the Asia Urbs activities focused on, the district administrations of Battambang and Siem Reap, are the two biggest and most important cities and districts in Cambodia, after the capital Phnom Penh. Each of these cities has a very different appearance and faces its own distinctive private sector development.

Although Battambang seems like a sleepy Cambodian town to the few tourists who come to visit, with its 150,000 inhabitants it is the country's second largest city and an important hub for transport and all kinds of local businesses. Named 'the Rice Bowl of Cambodia,' the district also boasts a strong agricultural sector, producing 300,000 tons of rice for sale in 2007, next to various subsidiary and industrial crops, livestock breeding, and fishing.[1] (Battambang District Administration 2008)

Siem Reap has a totally different make-up; the world-famous Angkor Wat, said to have been the world's largest human settlement one thousand years ago, attracts more than a million tourists a year, and the number is still growing. The tourism industry is by far the most important employment sector here, and construction of new hotels and restaurants has occurred at a rapid pace. The community of expatriates who have generally settled to run their own bars, guest houses or NGOs is also far bigger here than in Battambang.

The main goals of the Asia Urbs project were to achieve "more democracy and good service for the citizens" as well as "socio-economic development in Province and District through local self-administration." (Asia Urbs 2008) New instruments have been developed in each district to reach this goal, with varying success. The post of an *ombudsman,* whom citizens can turn to with complaints about their government, has been created. A *district council* has been formed that works together with the district governor and the district administration and thus ensures more people's participation. The council functions as the voice of the locals and brings these together with their district authority to create better communication and accountability for the district administration's decisions. For this purpose, a *spokesperson* has been appointed who is responsible for ensuring a better flow of information to the citizens about the political process and ongoing activities in the

[1] The Asia Urbs project's website (www.cambodiantowns.net) has unfortunately not been maintained since last year; this is another indicator of the lack of sustainability of ODA efforts.

district. A *Job Placement Agency* has been established to promote employment opportunities and bring together job seekers and employers, and to train young Cambodians in job application skills. Workshops have been held to introduce a new, more transparent and more efficient district budgeting system. A *master plan* for the district's future infrastructure development on the local level has been developed – and so on. (Asia Urbs 2008)

Asia Urbs' mission in its second and final extension was to foster the proper functioning and further development of these newly implemented facilities. The plan was to build the district administration's capacity to provide good governance to its citizens in the form of more transparent and efficient public services, and thus reinforce the exchange between, and the participation of, the governed and the governing at a district level. Until then, the relationship between citizens and their local government had often been characterised by a feeling of distrust – citizens perceived to be neglected, not cared about or even looked down upon by their representatives; this relationship had to be changed. The underlying idea was to reintroduce the concept of citizens as customers and the administration as the agency whose role it is to serve them, while enabling them with the capacity to do so.

Consequently, Asia Urbs' most successful achievement was the creation of the new One Window Service Office (OWSO) in each of the pilot districts, which allows citizens to receive government services such as registration of motor vehicles, shops or restaurants as well as official certifications and notarisations directly from their local district administration. Furthermore, these services are offered for a publicly displayed set price, which does not change according to the mood of the processing officer. The OWSO was to finance itself by keeping the fees it collects and reinvesting these back into the respective district administration, instead of handing revenues further up to the national government in Phnom Penh. However, this issue had not been resolved by the end of the project in 2008. In addition to the OWSO's very satisfied clients, the World Bank's intention to finance the establishment of more OWSOs in every district in Cambodia in the coming years is yet another indicator of the success of this new institution. (World Bank 2008)

What is ODA? Has it worked so far?

The Organisation of Economic Co-operation and Development (OECD),[2] defines Official development assistance (ODA) as follows:

> *Flows of official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 percent (using a fixed 10 percent rate of discount). By convention, ODA flows comprise contributions of donor government agencies, at all levels, to developing countries*

[2] The OECD comprises of thirty high-income countries committed to the principles of representative democracy and free-market economy.

> *("bilateral ODA") and to multilateral institutions. ODA receipts comprise disbursements by bilateral donors and multilateral institutions (OECD Glossary 2003).*

Thus, ODA comprises of three main elements: first, it must come from the official sector; second, its main goal must be to promote economic development and welfare; and third, it must be concessional in nature – i.e. loans must include a grant element of at least 25 percent.

Unfortunately, despite all the good efforts of donors and some success stories – in particular in the health sector[3] – many problems remain with ODA today. Statistical data about its usefulness is contradictory. Easterly (2006), found that although aid as a percentage of average African national income has increased from just over 5 percent to more than 15 percent from 1970 to 1999, economic growth fell from a healthy 2 percent to below zero – negative growth – in the 1980s and only rose to a meagre 0.1 percent by the late 1990s. Another study has found a significant correlation between aid levels and economic growth in Sub-Saharan Africa up to the 1980s Levy (1988), but the concurrent capital accumulation was not a sufficient condition for raising growth rates. Recent research by the IMF found clear adverse impacts of aid on growth rates, but could not establish if these negative effects were offset by positive impacts. (Rajan and Subramanian 2005) In comparison, today's economic success stories, particularly in Asia – the four so-called 'tiger states', India and, of course, China – have enjoyed rapid economic growth while aid flows have decreased over the same time period. Booth (2005) finds that from 1970 to 2000 aid was roughly halved in Asia and the Pacific. At the same time, "national income per capita has grown fourfold in South Asia … and about eightfold in East Asia and the Pacific… Growth was highest when aid was falling most quickly."

Critics of ODA are not only sceptical about its effectiveness of ODA, but speculate that it might be harmful in its current form. Some critics even question the underlying assumption of ODA – that it can promote economic growth and development and thus raise the standard of living of the poor. In some respects, economist Peter Bauer (in Blundel et al. 2005) summed up the distrust towards ODA best when he claimed "government-to-government transfers … are an excellent method for transferring money from poor people in rich countries to rich people in poor countries."

While not calling for its complete abolition, William Easterly (2006), one of today's most prominent critics of ODA, criticises current unsuccessful ODA practices of developed countries. He sees colossal deficits in donors' feedback mechanisms, which do not take into account the needs of the poor as their 'clients'. He highlights a lack of accountability, since projects are shared among many different aid agencies, so that nobody in particular is responsible for results, and he warns against crafting

[3] E.g. the near-elimination of smallpox, mass vaccinations against measles, water blindness etc. (Easterly 2006, 213)

utopian grand plans instead of implementing practical piecemeal solutions. In his view, donors need to experiment more and change aid concepts according to a more rigorous external evaluation. Also, development agencies should take into account what has worked and what has not. A more radical approach is presented by Dambisa Moyo who argues that the overdependence on aid by most African countries has resulted in a vicious circle of corruption, and market distortions – that ODA achieves nothing except for accelerating the 'need' for further aid. (Moyo 2009)

Main areas of ODA in need of improvement

In the wake of the United Nations Millennium Declaration and the Millennium Development Goals (MDGs) and possibly also because of the criticism national ODA agencies have faced, there has been a lot of talk among donors about how to make ODA more effective.

The Paris Declaration on Aid Effectiveness from the Second OECD Development Assistance Committee High Level Forum in 2005 (OECD 2005) defines the main goals of improvement in five areas (Ownership, Alignment, Harmonisation, Managing for Results, and Mutual Accountability) and specific indicators to measure the success of their implementation.

1. *Ownership* means that "partner countries exercise effective leadership over their development policies" and thus make them their own. This should prevent development strategies from being forced upon countries from outside.
2. *Alignment* should ensure that development strategies "fit" the partner country. "One size fits all" development policies should be avoided in favour of country-specific capacity building that strengthens public financial management capabilities and the national procurement system. Furthermore, "tied aid" should be freed from overly specific purposes so that development partners can decide where assistance is most needed.
3. *Harmonisation* means the "donor's actions are more… transparent and collectively effective." This includes the donor's implementation of common arrangements, simplifying procedures, and a more effective "division of labour" towards mutual development goals.
4. *Managing for results* embodies the commitment to improve resource management and enhance decision-making through better information. In practice, this means more effective evaluation procedures based on cost-effective indicator measurements in order to make better decisions based on the specific circumstances on the ground.
5. *Mutual Accountability* means "donors and partners are accountable for development results." This includes partners strengthening the role of parliaments in devising development policies and budget decisions, and including various development actors in the decision-making process. Donors commit to "provide timely, transparent and comprehensive

information on aid flows so as to enable partner authorities to present comprehensive budget reports to their legislatures and citizens."

Applying the Paris Declaration's Goals in the Asia Urbs Project

Ownership
It is desirable to give partners a sense of belonging in a development project, on an institutional as well as individual level. As World Bank president Robert Zoellick said in his speech at the Lee Kuan Yew School of Public Policy: "Only if people feel it's theirs are they going to make it work." (Zoellick 2008) But here a problem arises: if the subject is good governance, how is one going to make a government 'own' a project if the decision-makers are a significant part of the problem in the first place? Shouldn't the donor's goal rather be to ensure that there are effective and desirable results? It seems as if donors always face a trade-off – which is, in fact, quite common in public policy in general – between democracy (in the process of developing and implementing the program) and efficiency (of the program's outcome itself).

In the Asia Urbs project, this became visible when Asia Urbs was negotiating the financial authority of the new OWSO. The national authorities responsible for regional administration and development were not willing to grant these new agencies the right to keep the new revenues as a source of income for local administration in order to increase the range of services and the administration's quality in general. They claimed that the OWSO staff's expertise in handling these revenues was not adequate, despite specific budget management workshops conducted by Asia Urbs for regional administration officers. The issue could not be resolved by the end of the project, so the local administrations' capacity to provide public services to its citizens was diminished.

Furthermore, the success of these agencies and their apparent freedom from corruption also depended on an ODA-backed competitive salary, which would not have been available had the Royal Government of Cambodia implemented the program by itself.[4] Again, the partner's 'ownership' of good governance instruments financed by ODA seems to increase the likelihood of abuse and often diminishes its effectiveness.

Alignment
One of the key areas of alignment is capacity-building for public financial management. This was also one of the priorities of the Asia Urbs project. Officials from German and Italian local governments carried out various budget management

[4] These ODA-backed salaries again constitute a trade-off, this time between short-term efficiency (freedom from corruption) and long-term sustainability (how long do donors intend to back up salaries?).

and public financing workshops for regional administration officers. Unfortunately, the problem here was not with education or technical implementation, but political will. As mentioned above, the national authorities were not willing to grant the regional administration financial authority. The development of good governance practices through political decentralisation was the main goal of the donors – i.e., the European Commission and local authorities in Germany and Italy. But the Cambodian partner authorities had very different ideas and interests concerning the matter and were not willing to give up additional revenues at the national level.

Furthermore, the Paris Declaration calls for aid to be 'untied'. But how can this work when the donor and partner do not follow the same strategy? Does the donor impose the desired use for funds after all? Or does the donor trust in the partner to decide what matter deserves the most urgent attention? This problem of different interests is even more difficult to resolve if the aim is to promote good governance in a country with a huge corruption problem – as is the case in Cambodia, which ranked 162nd among 179 countries on Transparency International's Corruption Perception Index in 2007. (Transparency International 2008)

Another goal of alignment is the country-specific approach. As desirable as e-governance might be from the donor's perspective, in Cambodia the use of information technology is still limited, especially in the public sector. The web portals of both Battambang's and Siem Reap's district administration are online, but do not show much activity apart from a few tourism-oriented event updates – and exhibit even less participation from citizens and the business sector, for whom the special services and online marketplaces have been installed.[5] Unfortunately, the project's very own website is not being administered and has not been accessible for almost a year now. A key component of successful development, which is admittedly difficult to achieve, is sustainability – the continuation of new institutions or technological installations after the donor has left. In terms of public online activities and the provision of online information and evaluation data about the Asia Urbs project to the interested public, this goal of sustainability has not been met.

Harmonisation

It is important to avoid 'double work' by two agencies that are not cooperating with each other, so that resources can be used efficiently. The Asia Urbs project cooperated with various experienced German actors in the area of development in Cambodia and elsewhere including KAS, the Gesellschaft für Technische Zusammenarbeit (GTZ), BBJ Consult Inc., and various officials from the German and Italian district administrations. Headquartered in the KAS office in Phnom Penh, Asia Urbs drew on the support of all these institutions to keep administration costs low and permanent foreign staff small (only the Project Director herself and some of the interns were non-Cambodian).

[5] See www.battambang-town.gov.kh and www.siemreap-town.gov.kh

The Asia Urbs project did not strategise closely with any other specific foreign aid agency. In general, this approach should have decreased aid effectiveness, since benefits and possibly economies of scale from cooperation have not been utilised. However, the project staff did cooperate on the ground with some agencies, for example, Deutscher Entwicklungsdienst (DED) experts working on a district-wide land-use master plan for Battambang and Siem Reap. But at the same time, limited cooperation with other agencies could also have increased effectiveness, since Asia Urbs was the only good district governance project in Battambang and Siem Reap. Consequently, Asia Urbs staff did not need to divert attention and valuable resources to monitor and discuss other development areas covered by other aid agencies.

Managing for results

ODA agencies and partner countries should be able to objectively evaluate whether their programs are genuinely 'delivering development'. Since this term could be interpreted in many different ways, clear, precise and quantifiable indicators are needed to ensure that the project is on the right track and to see whether the chosen development policies are resulting in positive changes.

However, to measure if it is on the right track is extremely difficult in the area of good governance, since clear indicators are difficult to measure. It seems as if the only straightforward cost-effective way of measurement is 'client/customer satisfaction' – which Asia Urbs did in fact measure. Citizens who had used the OWSO expressed their satisfaction with the new public service. However, there was very little feedback from clients about the new service of the *ombudsman* and the new public information services for the citizens, since public awareness of the existence of these services has remained low. The usefulness of the establishment of these underused services is unclear, since there might be more demand for these institutions in the future.

Mutual accountability

Donors and partners should be held responsible for results. How can ODA work if no one is responsible for the results in the end? Rigorous, objective evaluation should ensure this accountability for the outcomes of ODA, and this should be made transparent by allowing access to information on previous, present and future efforts. But how is evaluation conducted effectively? Who shall carry it out, to whom will it be delivered, and for whom shall it be accessible? What are the consequences of these evaluations? These are important questions that need to be addressed.

Outcomes of the Asia Urbs Project

The Asia Urbs project was extended twice – eventually operating for a total of eight years. On the one hand, many piloted services failed. According to the author's observations, the *ombudsmen* went largely unnoticed, or were not trusted enough to be approached with criticism of the local government. Better communication between district administrations and citizens was also difficult to achieve, although two spokespersons were elected. The job placement agencies were not able to attract employers and thus could not effectively connect job-seekers to jobs. Some instruments were introduced only during the last year of the project, making their continuation after its end highly unlikely – although sustainability is the key principle of successful good governance measures.

On the other hand, the resulting OWSOs were highly acclaimed, and the World Bank, which will provide US $20 million through its Demand for Good Governance project, will finance their extension to other districts in Cambodia (World Bank 2008). District councils that meet regularly have been formed, and citizen meetings including the district governor, the *ombudsman* and the council have been introduced. Many public administration workshops on topics ranging from budget financing to micro-project management have been conducted, bringing administration officials from Germany, Italy and Cambodia together to learn from one another. The job placement agencies held well-received job application seminars for young Cambodians with a mixed staff of Cambodian officials and European interns.

This shows that the evaluation of the Asia Urbs project is complicated, since clear measurements of success are very difficult to devise. Governance is a process rather than a static picture with clearly visible indicators that can measure and 'quantify' the situation on the ground. Furthermore, since the Asia Urbs staff itself does much of the evaluation, this could create the dangers of moral hazard – if the continuation of the project depends on internal evaluation, the results might be presented in a more favourable way. However, viewing this situation from the other side, it would be difficult for externals to evaluate Asia Urbs at all since there is no clear story 'told' by statistical data, the possibilities of external evaluation are limited, which is not to say that this would make objective review any less important or critical.

What is missing, however, is accessible documentation of the project results that is available online to an interested public or academics worldwide. The only source of online information on the entire project is the short overview of EuropeAid (2008), which lacks any kind of rigorous data on the extent to which the original project objectives were achieved, what these objectives were, how they were quantified and measured and, most importantly, which policy strategies worked and which did not. If this information is not made transparent and accessible for anybody who is interested – which is a requirement of good governance implementation, other ODA actors in the field or even the agency itself cannot 'use' this project to improve the next development undertaking. This decreases the effectiveness as well as the sustainability of ODA.

What can we learn?

The practical experience of promoting good governance in the Asia Urbs project in Cambodia puts the Paris Declaration's goals into perspective. While acknowledging their desirability, it will greatly improve aid effectiveness if ODA actors and institutions are clear not only about what they would like to achieve, but also what goals are possible and realistic. As can be seen in the area of ownership, any ODA donor must honestly face the trade-offs between democracy/ownership of the project process and the efficiency of its implementation when considering how much government cooperation is desirable to reach results for their clients. In the area of delivering good governance, this presents a particularly paradoxical dilemma, since the government itself might impede an improvement in governance. When governance reform seems unlikely to happen, it might be wise to help poor individuals directly instead of wasting resources attempting to transform the political system. In any case, a careful balance must be maintained between political ideals and practical solutions for the problems of the poor.

It is difficult to measure results in the area of good governance, since the endeavour to improve the quality of policies and public services and increase people's participation is a dynamic process without definite quantifiable stages of development. However, three criteria play an important role in success.

1. *Clients' satisfaction.* This is central to the evaluation of public sector reform. Who can assess the value of public services and the degree of citizen participation better than the citizens themselves?
2. *Sustainability.* Only if the project can be continued after the donors have left is the lasting public value created. This includes extensive capacity-building and a sober financial plan for the project's maintenance.
3. *A creative approach.* A trial-and-error approach to ODA projects should be embraced. However, it must include *transparency* in the sense that results are made easily available to the interested public and academic researchers online – and it is imperative to include what did not work and the resulting conclusions, so that other ODA actors can learn from the mistakes made by others.

The lesson to be learned here is not how unfruitful or unsuccessful ODA is (although it certainly can be). It is to show how a pragmatic approach, with realistic goals and honestly faced trade-offs, coupled with a carefully evaluated trial-and-error method with documented results which are acted on. This will increase the effectiveness of ODA to stimulate economic growth, create good political frameworks and raise the standard of living for the poor.

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The Rule of Law in Managing God: Multi-Religiosity in Singapore

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This paper examines the legal framework in the management of Singapore's religious politics. We will briefly discuss the place of religion in secular Singapore, and we will then look specifically at several key pieces of legislation that deal with religious individuals or groups that may pose a public threat. Public threat constitutes anything that may undermine national interests, thus legislation in place is intended to preclude more than religious discord. This leads to the question of the legislative framework's adequacy in the management of religion. The paper concludes by discussing how Singapore should move forward from hard, coercive legal instruments that maintain a disquieting silence on the issue of religion to a framework of voluntary engagement in fostering understanding of religious harmony.

Introduction

Following Singapore's separation from the Malaysian Federation in 1965, the Government of Singapore was faced with the enormous task of state-building. Amidst the multitude of pressing problems, race was a particularly delicate matter that commanded the careful attention of the government. Fresh in the memory of the unceremonious separation was the issue of race – one of the key points of contention that had aggravated tensions between the two governments. Disagreements over the position of Malays[1] during the merger period (September 1963 to August 1965) spilled over to the public sphere, playing out in the Malaysian and Singaporean press, eventually culminating in the 1964 racial riots that saw clashes between the Chinese and the Malays.

The imperative of establishing Singapore as a multi-racial society was outlined at the First Session of the First Parliament on December 22, 1965 by then Minister for Law and National Development, Mr E.W. Barker. He stated that:

> *One of the cornerstones of the policy of the government is a multi-racial Singapore. We are a nation comprising people of various races who constitute her citizens, and our citizens are equal regardless of differences of race, language, culture and religion… To ensure this bias in favour of multi-racialism and the*

[1] The Malaysian Federal government was greatly in favour of enshrining the special position of Malays in the Constitution that would have granted them preferential treatment. Across the causeway, Singapore represented by Lee Kuan Yew was strongly against such a move and called for a creation of a "Malaysian Malaysia" state that would have granted all race equal opportunities and access.

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> *equality of our citizens, whether they belong to majority or minority groups, a Constitutional Commission is being appointed to help formulate these constitutional safeguards. (Report of the Constitutional Commission 1966)*

Multi-racialism was eventually implicitly constitutionalised[2] through the Official Languages and National Languages Act [Article 153A]. Malay, Mandarin, Tamil and English were instituted as the four official languages in Singapore; the first three languages being the mother tongue of the Malays, Chinese and Indians respectively. Thus, it effectively incorporated the recognition of the three major races into the Singapore Constitution. In addition, there was the 'Others' category created by the government to include the Eurasians and other smaller racial communities.[3] English was the language of commerce and more importantly, the common tongue that sought to facilitate inter-racial communication.

Race[4] in Singapore is strongly conflated with religion. This is especially so for the Malays, 99.6 percent of whom are Muslims. The Indians and the Chinese are also closely identified with their respective religions – Hinduism for the Indians (55.4 percent) and Buddhism/Taoism for the Chinese (64.4 percent). (Singapore Department of Statistics 2000) The perception of this race-religious conflation is further perpetuated by government statements and frequent reminders to Singapore citizens that they are part of a multi-racial and multi-religious society.

But in reality, race and religion are two very separate issues. The government has arguably taken a softer stance in the management of race, choosing to adopt a more communitarian approach in getting the different races to engage with each other. Religion, however, is an entirely different dilemma for the Government of Singapore. A 'hard' stance is taken in its management, and a host of legislative measures are at the government's disposal. The authoritarian stand taken by government may be due to the nature of religion. The authority of a divine being supersedes that of the government, and deeds done in the name of religion are often intractable. Hence, the government can only rely on the State mandate that the Constitution bequeaths them and lays out clear legislation in defining what is

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[2] Chua Beng Huat argued in his paper "*Taking group Rights Seriously: Multiracialism in Singapore*" (2005, 4), that the Constitution of Singapore gave explicit recognition to race by declaring Singapore a 'multi-racial nation'. However, in my analysis of the Singapore Constitution, this phrase was nowhere to be found in the *Constitution of the Republic of Singapore*. I therefore argue that multi-racialism is implicitly recognised through the Official Languages and National Languages Act.

[3] A recent innovation to Singapore's racial policy was the introduction of the double-barreled race category in January 2010. This would allow children of mixed parentage to take on both of the parents' race, for example Malay-Chinese. The former would reflect the race of the father, and the latter reflecting the mother's. Previously, the child would follow the father's race by default.

[4] The term "race" and "ethnicity" is often used by the government interchangeably. However, these two terms are in fact different. "Race" has strong primordial connotations and is a fix construct. In defining race, biological characteristics are often used as a key marker. "Ethnicity" contains a certain level of fluidity, as there can be many markers in the definition of one's identity. These markers often include language, religion, history, culture and topography. In government communiqué, race is the predominant term used.

permissible for the nation. It is a pre-emptive approach that spells out the 'Out-of-Bound markers' for religious groups in Singapore.

The slew of legislation aimed at managing religious harmony can thus be argued as legal ammunition for the government to guard the fragile social fabric in Singapore. This is reflective of "the tremendous care, effort and pre-emptive prudence invested in nurturing multi-religiosity as an integral part of Singapore's multi-racialism framework." (Tan 2008, 55) However, the arsenal of legal instruments directed at containing potential enmity between different racial and religious groups has led some to comment that it is a veiled attempt by the government to curb political expression and political activity in the name of racial and religious harmony. (Tey 2008)

The Government versus the Divine

Though not written in the Constitution, the Government of Singapore has adhered to the principle of secularity in its style of governance. This was a fact clearly established by then Prime Minister Lee Kuan Yew in the early days of Singapore's independence that "we are a State without an established church." (The Straits Times 1967) It was more recently reaffirmed by then Minister for Information and the Arts, George Yeo, (present Minister for Foreign Affairs) that "Singapore's government is secular, but it is certainly not atheistic. It is neutral. This is an important principle because all the major religions of the world are represented here." (The Straits Times 1992)

Despite being a secular government, the state recognises that Singapore is by and large a religious society.[5] The presence of political leaders at many community religious events signals the government's receptiveness to the role of religion in Singaporeans' lives. And in 'walking the talk' of being a multi-racialism and multi-religious society, leaders would appear at these community events of various religious groups regardless of their race or religion.

The freedom of religion is also enshrined in Article 15 of Singapore's Constitution. However in multi-religious Singapore, this right is by no means absolute. It is subordinate to the clause in Article 15(4) that religious activities must not be in "contrary to any general law relating to public order, public health or morality." A clear distinction needs to be made between action and belief: religious beliefs are respected; however actions motivated by belief must not undermine Singapore's national interests. (Tan 2008) By defining the State's interests broadly as "public order, public health or morality,"[6] this gives the government a broad scope of interpreting these interests and thus a greater leeway for intervention.

[5] Only 14.8 percent of Singaporeans (age 15 and above) reported that they had no religion. Source: Singapore Department of Statistics

[6] Art 15(4) of the Constitution of the Republic of Singapore.

However, we have to acknowledge that the Government of Singapore has so far provided a very conducive environment for religions to flourish. The principle of secularism practiced by the government has not been biased against any group, leaving no grounds for complaint of being unfair. (Thio 1995) The government's approach to religion can best be captured in the famous Biblical phrase, "Render unto Caesar the things which are Caesar's, and unto God the things that are God's." (Matthew 22:21) The phrase suggests a clear separation of the state from the civil where both will mutually not intervene in each other's affairs. Religious groups have therefore chosen to remain unobtrusive, which is the best strategy for these groups to 'survive' in Singapore.

The legislative framework

Over the years, the Government of Singapore has created or inherited a set of laws that has allowed them to deal substantively with race and religion. These laws were not all targeted at dealing explicitly with race. Apart from the Maintenance of Religious Harmony Act, most of these laws were directed at forestalling actions that may become a threat to national interests such as the Penal Code and Sedition Act. Others, like the Societies Act, were simply regulatory in nature and served to keep track of the type and number of societies in Singapore. However, these laws have the effect of deterrence and serve as a stark reminder of the dire consequences that may arise if one were to transgress against them. In the following section, we shall examine several key legislations that deal with religious individuals or groups that may pose a public threat.

The Societies Act

This Act requires all religious organisations that seek to represent, promote or discuss theological matters to be registered with the Registrar of Societies. Any society that is unregistered will be deemed unlawful. This is a powerful legislation as there are clauses that prohibit the registration, or allows for the dissolution of any society that is "being used for unlawful purposes or for purposes prejudicial to public peace, welfare or good order in Singapore."[7] The government is further empowered by a broadly ambiguous clause that allows it to refuse registration of any society that would be "contrary to the national interest."[8] This gives the government full coverage in determining what is permissible and has the effect of forcing out any religious groups that may pose a threat to the national interests of Singapore.

The Jehovah's Witnesses were made an example in 1972 when they were deregistered under the Societies Act.[9] Their struggle against the Government of Singapore has been a well-documented battle that led to debate over the

[7] Section 24-(1)a, 2(b), 2(d) of *Societies Act* (CAP 311).
[8] *Ibid*.
[9] This essentially is a euphemism for banning societies. The Jehovah's Witnesses were made to go underground, congregating in private homes in small groups for worship. Critics argue that this is violation of Art. 15 of the Constitution that enshrines the freedom of religion.

constitutionality of such a move which impinged upon their religious freedom. A key tenet of the Jehovah's Witnesses' doctrine required believers to set themselves apart from this world - secular society is regarded as corrupt and hence they should limit their social interaction with non-Witnesses. This belief prohibited them from saluting flags, participating in national elections and performing military service. This was deemed detrimental to "public order"[10] given the national security imperatives that required every able-bodied Singaporean man to undergo two year of military training; and this subsequently resulted in the group's dissolution.

The government subsumes racial and religious harmony under the overarching concept of 'national interests'. Although the acts of the Jehovah's Witnesses did not pose a threat to the racial and religious harmony of Singapore, they were viewed as religious dissidents who undermined national interests and had to be dealt with severely.[11] However, I would argue that there is a degree of legitimacy in the clamp down on Jehovah's Witnesses. Pursuant to most religions, there are tenets exhorting peace and avoidance of discord. Concession to one religious group may see others coming forward with similar appeals on the grounds of religion to be exempted from national service. Given the small population and strategic imperatives of the nation, this is a situation that Singapore certainly cannot afford. The government is unable to grant deference to the beliefs of one religious group[12] without showing the same deference to another. Thus, with the consideration of religious harmony in mind, the government could have exercised their discretion and evoked the law in dealing with the Jehovah's Witnesses.

Penal Code and Sedition Act

The criminal justice system also provides for recourse in dealing with offences relating to both race and religion. Chapter 15 of the Penal Code (CAP 224) has provisions against acts or words that promote "enmity between different groups on grounds of religion or race and doing acts prejudicial to maintenance of harmony."[13] Individuals can be charged under the Penal Code if they are found to have injured or defiled a place of worship, disturbed a religious assembly or uttered words with deliberate intent to wound the religious or racial feelings of any person. The Sedition Act (CAP 290) works in a similar vein but is targeted at dealing with acts, words, speech or publications that may be seditious. "(To) promote feelings of ill-will and hostility between different races or classes of the population of Singapore"[14] is considered, *inter alia*, one of the seditious offences that are punishable.

[10] Colin Chan v. MITA, supra note 402 at 619D-E.

[11] Jehovah's Witnesses who refuse to carry out their National Service are court-martialled.

[12] This is not to be confused with the government's decision to exclude the Malay-Muslim community from National Service in the early period (1967-1977). The Malay-Muslims were excluded as there were concerns about their loyalty to the nation vis-à-vis their loyalty towards the global Muslim ummah. The decision was made out of geo-strategic imperatives (Singapore being a Chinese-majority nation in a Malay Archipelago), not out of purposeful discrimination against the religion. Malay-Muslims are now mandated to do their National Service, however they are usually posted to the non-militia wings such as the Police Service and the Civil Defence Service.

[13] CAP 224, 1985 Rev. Ed. Sing.

[14] Section 3-(1)e of the *Sedition Act* (CAP 290).

In 2005, the Sedition Act was invoked for the first time since 1966 when three bloggers made inflammatory remarks against the Malay-Muslim community. Two were given a jail sentence while one was given probation. Senior District Judge Richard Magnus, while deciding on the sentence, took into account of the sensitivity of racial and religious issues in the Singapore society, and made references to the Maria Hertogh Riots and the July 1964 race riots. He also expressed that young Singaporeans should not forget about the racial and religious sensitivities of the nation, and that the anonymity that cyberspace affords should not be mistaken as an outlet for diatribes against another race or religion.[15] As recently as 2009, a Christian couple was also convicted under this Act for distributing seditious publications that denigrated the Catholic Church and Islam.[16] The publications were deemed as likely to cause feelings of enmity, hatred, ill-will and hostility between different racial or religious groups. It was thus irresponsible social behaviour on the Christian couples' part to distribute them, and even more so for them to plead defence on the grounds of ignorance of the publication's content.

Internal Security Act (ISA)

The Internal Security Act (ISA) (CAP 143) was inherited from Singapore's British colonial authorities. It was originally directed at dealing with the communist insurgency in Malaya following World War II. This Act is widely encompassing and provides for more draconian measures that the government can apply. Of interest is Section 8 of the Act, which grants the government pre-emptive power by allowing them to detain a person who may act "in any manner prejudicial to the security of Singapore … or to the maintenance of public order"[17] without trial for up to two years. This is subject to renewal on a biannual basis and can go on indefinitely. In 2001, this was applied to Jemaah Islamiah suspected-terrorists who plotted to attack American establishments and public services. They were deemed a threat to the security of Singapore and, given the global sentiments following 9/11, there were concerns that their actions could have fanned hostility among the races and religions.

In 1986, this Act was also used against an alleged Marxist conspiracy to overthrow the government and establish a communist state. A group of Catholic social activists thought to have spearheaded the movement were detained under the ISA and subjected to physical duress. In retrospect, this has been criticised by some as a poorly veiled attempt by the government to keep the Church out of the State. (Barr 2008) This was reaffirmed by government records of a private meeting with then Prime Minister Lee Kuan Yew and the Archbishop Gregory Yong; Lee stated that "he was not interested in Vincent Cheng and his group," but rather was concerned by the "involvement of several priests."[18]

[15] [2005] SGDC 272 (Sing Dist. Ct) [*Koh Song Huat Benjamin*].

[16] [2009] SGDC 163 (Sing Dist. Ct.) [*Ong Kian Cheong and Another*].

[17] Section 8-(1) of *Internal Security Act* (CAP 143).

[18] Report of Lee Kuan Yew's words in a meeting between the PM and Catholic Church leaders on 2 June 1987. This document was marked 'SECRET' but was released to the court as Exhibit 85(d) during the government's suit against the Far Eastern Economic Review in 1989. Vincent Cheng was marked as one of the participants of the conspiracy.

Maintenance of the Religious Harmony Act (MRHA)
The alleged Marxist conspiracy of 1986 and the rising religious fervour in the 1980s trained the government's eyes on matters of religion. MRHA (CAP 167A) was enacted to legislate religious harmony and provided for the creation of the Presidential Council for Religious Harmony. The Committee advises the President on matters affecting religious harmony and is given the power to make recommendations on restraining orders brought forward by the Minister for Home Affairs. The Act allows for the Minister to "make a restraining order against any priest, monk, pastor, imam, elder, office-bearer or any other person who is in a position of authority in any religious group or institution or any member"[19] who are deemed to have trespassed the rules of engagement in their religious, social or political causes.

As compared to the ISA, the MRHA is a less-severe route for dealing with religious matters, and enables proceedings to take place discreetly behind doors. The secrecy [Section 7] it affords prevents religious tension from spilling over to the public sphere, hence removing the opportunity for religious passions to be fanned or exploited. It is also an important piece of pre-emptive legislation, allowing the government to act before the threat unravels.

The MRHA has also been seen as an attempt by the government to maintain political control under the cover of religious harmony. However, this should be viewed more positively as the Government's commitment to maintaining a secular public arena. In multi-racial and multi-religious Singapore, the beliefs and values of a particular religious group cannot be allowed to dominate or imposed upon the public. It is therefore imperative that the line between religion and politics be carefully delineated, and that the two should not be allowed to mix. In a statement made by then Prime Minister Lee Kuan Yew during the 1987 National Day Rally, he said: "Churchmen, lay preachers, priests, monks, Muslim theologians, all those who claim divine sanction or holy insights, take off your clerical robes before you take on anything economic or political." (Lee Kuan Yew 1987)

This has been the position adopted by the government over the years, and this principle was recently reiterated in a government statement on the AWARE (Association of Women for Action and Research) saga[20] that unfolded during 2009. Deputy Prime Minister Wong Kan Seng in the government's response to the saga stressed that a common set of values should underlie all public discussion and activism, and these should not be the values of any religious group. While religious groups are welcomed to make their stand on social and moral issues, religious groups or individuals have to tread the thin line between discussion and lobbying.

[19] Section 8-(1) of *Maintenance of Religious Harmony Act* (CAP 167A).
[20] A takeover bid at the organisation was mounted as a group of Christians disagreed with the pro-homosexuality stance that they deemed AWARE was campaigning. The group of Christians were members of the same church, and the pulpit was used by their church pastor in an attempt to lobby support for them. The public unsuspecting of the conspiracy then was initially irked by the abrasiveness of the takeover. When the group's affiliation was revealed, the issue took on a religious-political dimension. The group eventually backed down under strong public pressure.

(Chua 2009) The secularity of the state cannot be influenced by religious values, or it runs the risk of losing its objectiveness and equidistance from all religious and racial groups. The MRHA is therefore a critical legislation in reminding religious groups of the need to keep God[21] out of the state.

The adequacy of Law in managing God

For all the rhetoric about Singapore being a multi-racial and multi-religious society, there runs an undercurrent that suggests ethnic differences are inherently difficult to resolve. About 85 percent of Singaporeans profess a religion, and given the trend of rising religiosity (Prime Minister's Office 2009), it potentially may lead to conflicting situations between religious groups that legislation cannot contain. The use of legislative instruments in managing religion therefore commands examination about their adequacy.

In a recent development (February 2010), a Pastor was called up by the Internal Security Department (ISD) for his insensitive remarks made over Buddhism and Taoism. Video clips of him mocking the two religions during a sermon were posted on the church's website. These were rapidly circulated around cyber space, and soon drew public complaints and the attention of the government. The ISD, in a statement on the issue, said that "Pastor Tan's comments were highly inappropriate and unacceptable as they trivialised and insulted the beliefs of Buddhists and Taoists. They can also give rise to tension and conflict between the Buddhist/Taoist and Christian communities." (Ministry of Home Affairs 2010) The ISD's intervention saw Pastor Tan back down immediately, and a statement of apology was issued on the church's website. This was significant as no legislation was officially invoked, but the mere intervention of the ISD – the department responsible for implementing the ISA – was enough to cause an about-turn. The threat of the legislative stick worked well in this instance, but such coercive measures may not always work and are certainly not sustainable in the long-run.

As Christensen described, "race and religion are viewed as primordial essences of an irrational and highly combustible nature." (Christensen 2007, 4) These markers create an inexplicable bond that transcends objective blood ties, but creates a group consciousness that sets themselves apart from the others who do not bear the same traits. These are irreconcilable differences that cannot be overcome; the law is but a weak weapon in face of this powerful kinship.

The Maria Hertogh Riots of 1950 serve as an excellent historical reminder of how law broke down in the face of racial and religious affiliations. The case involved a dispute over the custody of a young Dutch-Eurasian girl (Maria Hertogh) who was raised a Muslim by her guardian. Her Christian biological family tried to file a claim for her return, while her adopted Muslim family argued that Maria had been given to them. The court proceedings were played out in the public, and insensitive media

[21] The word "God" in this essay shall be used generally as a reference to all God(s)/Goddess(es) of various religions – whether monotheistic or polytheistic.

coverage inflamed racial and religious tensions. This led to friction between the Muslim (Malay) and Christian (Europeans and Eurasians) community, and eventually culminated into riots. Following the incident, the Riot Commission in their report (1951) concluded that the Police Force, which was 90 percent Malay had "failed lamentably." It was found that

> *[The Police] were "ineffective throughout the crucial stages of the disorder" and had "engendered" strong sympathies with their co-religionists" over the months of publicity and discussion. The Commission found many instance of "deliberate inaction" by the Malay Police in the face of threatening or violent actions by the mob. (Hugh 1980, 54-55)*

Law and order lapsed as the Malay-Muslim community became strongly galvanised over the issue, media pictures of Maria kneeling before a Christian altar in prayer had incensed many of them. Conversion was inconceivable and highly sensitive. It was a key rallying point for many of the Malay-Muslims, and it was such a compelling force that the Malay Police were aberrant in their professional duty as purveyors of law. This particular point in history has therefore demonstrated that the law is not the consummate safeguard for racial and religious matters.

Moving forward to the present, the government's hold over religion has shown signs of slipping. The Government of Singapore has typically managed religion through the use of religious organisations that are officially recognised as representatives of the community. But there have been cracks within the community as members are unwilling to recognise the religious leadership given by the government. In what is the government's standard-operating procedure for dealing with religious matters, religious leaders are usually called for discussions with the government behind doors. Dissensions take place, but most are kept away from the public sphere. A 'consensus' is expectedly achieved as there is little that religious leaders can do with the arsenal of legislation aimed at them. They would then come forward to make a statement of support for the government's stance, and the religious community would typically be mollified. This would have worked in the past; however signs of its effectiveness seem to be slipping as followers have become increasingly fearless in their own pursuit of the truth.

Religious leaders/religious organisations can no longer serve as an effective mouthpiece for their members, and this is particularly worrying in the case of Majlis Ugama Islam Singapura (MUIS)[22] whose leadership is faced with challenges at various fronts. The *tudung*[23] controversy in 2002 epitomised the split within the community over religious interpretations of wearing the headscarf. State policy prohibited the wearing of religious dress in public schools as there were concerns

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[22] The Majlis Ugama Islam Singapura (MUIS), also known as the Islamic Religious Council of Singapore, was established as a statutory body in 1968 when the Administration of Muslim Law Act (AMLA) came into effect. Under AMLA, MUIS is to advise the President of Singapore on all matters relating to Islam in Singapore. Source: MUIS.

[23] '*Tudung*' is the Bahasa Melayu word for the Muslim headscarf.

that it would heighten religious differences. However, the Muslim parents of four primary school girls insisted on their religious right to do so and argued that the state policy was an infringement upon their religious freedom.

MUIS came out with a statement of support for the government's stance, urging the girls' parents to prioritise their child's education over wearing the *tudung*. The parents remained firm on their stand, and were publicly backed by PERGAS (Islamic Scholars Association of Singapore) – an organisation of religious teachers who had conservative leanings. The Muslim religious authorities were split in different directions over the issue, and MUIS's credibility as the leading religious organisation for the Muslim community in Singapore was sorely tested.

The incident revealed the limitations of state-controlled religion in the face of rising religiosity. The top-down approach adopted by the government is increasingly an unviable strategy as it can only subject a small group of religious individuals within their jurisdiction. Though this group of individuals may be the leaders of their respective religious communities, they are unfortunately unable to represent the diversity of opinions and beliefs of the community.

There has also been criticism that legislation only seeks to maintain the religious harmony of the society, but lacks the capacity to promote it. Legislation is fundamentally a coercive instrument that seeks to instil fear into an individual out of a concern of the repercussions. But in the face of God, legislation lacks the legitimacy as there is a higher system of beliefs and behaviours that an individual may choose to subscribe to. Interfaith engagement needs to be fostered to develop a genuine understanding of other faiths. This would be a far more transformational method in the promotion of religious harmony than the utilisation of legislation.

Moving forward from the Law

In recent years, there have been attempts by the government to take on a more communitarian approach in the management of religious issues. One attempt in such a direction was the introduction of the Declaration of Religious Harmony (DRH) in 2003 that encouraged Singaporeans to pledge their commitment to religious harmony. The DRH is an implicit rule book on how members of religious communities should conduct themselves in secular Singapore, encapsulating the usual government rhetoric of the need for mutual tolerance and understanding in a multi-racial and multi-religious society. However, efforts to move towards non-coercive approach have appeared to peter out and inter-religious engagement has since been scant. The DRH has also failed to filter down to the ground level, being little more than part of the annual ritual during Racial Harmony Day.

Unknown by many, there is also a non-governmental organisation in Singapore that is dedicated to interfaith work. The Inter-Religious Organisation (IRO) was established in 1949 to improve ties among members of different faiths. Membership is opened to imams, ministers and priests in their personal capacities, but it has tended to draw the involvement of senior leaders and the heads of religions and religious organisation. Despite the symbolic power and religious-moral authority IRO holds in the society, its efforts at promoting interfaith engagement and understanding have been lamentable. “A pattern of sporadic involvement in public issues appears to have been characteristic throughout its existence.” (Lai 2008, 608) It is largely a reactive organisation, coming only into the fore when the government requests a response from them to specific events such as the 1964 riots, the September 11 attacks, and on issues of proselytisation. The government’s move to do so is encouraging, however they should seek to explore greater ways of tapping upon IRO’s potential in facilitating interfaith engagement. Greater ‘nannying’ of the NGO from the state may not necessarily be a bad idea. Left alone, the organisation tends to stand immobile and its potential gone to waste.

On the surface, the present state of religious affairs can be said to be relatively placid. The secularity of state has provided a fertile ground for religion to flourish, though this is on the condition that religious groups keep away from the political arena. This comfortable climate has also led religious groups to remain in their respective silos, and has discouraged inter-faith engagement. Apart from the Malay-Muslim community which has a vested interest in improving the image of Islamic faith post-9/11, the other religions have remained relatively aloof. Government and religious leaders have to take their efforts down to the grassroots level and seek to foster understanding bottom-up. Religious harmony cannot be achieved by concentrating its management in the hands of a few, but it requires the involvement of broad masses to truly achieve a cohesive racial and religious society.

The regulatory approach undertaken by the government is reflective of their view of religion’s position in public domain that, though permissible, is to be kept within prescribed confines. The government had numerous occasions to recognise the good work done by religious bodies and view them as a quintessential partner in the provision of social services. Prime Minister Lee Hsien Loong has also pointed out that “religion is a positive force in human societies. It provides spiritual strength, guidance, solace, a sense of support for many people, especially in a fast changing and uncertain world.” (Prime Minister Office 2009) But at the same time, he cautioned for a greater management of religious fervour in Singapore’s multi-racial and multi-religious society. Therefore, there is a certain degree of receptiveness as long as religions do not trespass their bounds, they would still be allowed to survive in the religious marketplace.

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REVIEW OF FAREED ZAKARIA'S *THE POST-AMERICAN WORLD*

Reuben Hintz

Every foreign affairs commentator dreams of having five minutes alone with the President of the United Sates (US). When the *The Post-American World* was published in May 2008, Fareed Zakaria got something much better: photos of then Presidential Candidate Barack Obama carrying a copy of *The Post-American World* on his campaign trail, which rocketed around the Internet consolidating Zakaria's position as one of the most important pundits in contemporary media.

Without Obama's endorsement, many potential readers might have been reluctant to add this book to their collection of volumes on the rise of Asia. This would be unfortunate, since the book manages to succeed where many others in the genre have failed; it eloquently explains how the United States can respond to Asia's economic resurgence rationally and still have a bright future in the emergent world order.

When it comes to the part where Zakaria has to explain to his audience that American dominance of the international stage is ending, his true talents as a writer emerge. Instead of simply regurgitating the standard statistics about the rise of Asia that so many conservative writers have used to put Americans on the defensive, he first takes care to use a series of less well known examples to reassure his American audience that while Asia is indeed rising, America still has a critical role to play in global affairs. For instance, to counter the now proverbial statistic that universities in China and India are producing more than 10 times as many engineers as the United States, Zakaria first reminds the reader that many of the Chinese 'engineers' are in fact auto mechanics. Then drops his real bombshell: "In India, universities graduate between 35 and 50 Ph.D.'s in computer science each year; in America, the figure is 1,000."[1] For an American population that is being reminded of their imminent demise on an almost daily basis, the importance of hearing that America is still on top, at least in some categories, is enormous.

Reassurances aside, the core message of *The Post-American World* is that time is running out for the American hegemony and it is time for her political leaders to start planning for what comes next. Zakaria draws on the historical parallel with the declining British Empire in the late 19th and early 20th Centuries. He argues that the most important decision the British made was to accommodate the United States' rise instead of fighting it. Similarly, the US will have to decide between accepting the rise of China and learning to coexist, or pursuing an antagonistic relationship which could

[1] Fareed Zakaria, *The Post-American World* (Penguin Books, 2008), 191.

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potentially lead to another Cold War and stifle much of the worldwide political and economic progress of the past several decades.

One of the more noteworthy proposals by Zakaria, and something that should probably give pause to anyone who would describe him as an unbiased observer of the international scene, is that the US should forge ahead its embryonic alliance with India. The United States and India, he argues repeatedly, are natural allies in the long run. Both are ethnically diverse and possess messy political systems that still manage to remain democratic decade after decade. The growing closeness between the two governments is also a reflection of the fact that both societies are large democratic powers that have more similarities than differences. By working together, they can do much to assuage concerns that each has about a rising China. To a critic, however, Zakaria's strong and repeated arguments for collaboration between the US and India might raise questions about whether this Indian-American immigrant is allowing his own background to unfairly bias his analysis of contemporary geopolitics.

The book's climax occurs in the form of a list of six recommendations for the US to follow. First, the US must learn to choose; it can no longer get involved in every active conflict and will have to learn how to prioritise which international crises it wants to play an active role in. Next, the US must learn to be more careful about espousing a set of values that it rarely lives up to; thus creating a perception of hypocrisy which becomes increasingly harder for other countries to accept. The US should also seek to emulate the German leader Bismarck and work to engage other countries to the point where they are more comfortable dealing with the US than with their geographical neighbours. Zakaria further argues that the US must learn to use every institution at its disposal in an à la carte fashion, in order to find the best mechanism for solving each problem that arises. In responding to new potential threats to stability, the US must learn to become more asymmetric in its approach and rely less on the standard 'hard power' techniques that are not always as effective as hoped. Finally, it is argued that the US should make every possible effort to get back on the moral high ground as a critical step towards regaining the perception of legitimacy that makes its actions more palatable to the rest of the world.

For a book that is subtitled "And the Rise of the Rest," there is notably little discussion of the world outside the United States, China, and India. The reader is left wondering what the role the other 190 countries and over four billion people of the world will have in this new world that Zakaria envisions. This absence is unfortunate. Zakaria's present popularity means that this book will almost certainly be read by a large foreign audience. By not explaining how smaller states should respond to the changing global dynamic he misses an important opportunity to influence the predominant thinking in this part of the world.

Despite these minor omissions, *The Post-American World* is an important addition to the American current affairs discussion and should be a required reading for any up and coming American public servant. The decades ahead will produce many tests for the United States' long stated commitment to promoting economic and political development around the world. As other countries begin to catch up to the US, there will be enormous domestic pressure to close up and retreat from these perceived adversaries, instead of continuing the policy of engagement with the World that has benefited America so much up to now. In *The Post-American World*, Zakaria shows Americans how they can overcome these fears and greet the new global landscape with confidence and optimism.

REVIEW OF YONG DENG'S *CHINA'S STRUGGLE FOR STATUS: THE REALIGNMENT OF INTERNATIONAL RELATIONS*

Ryuta Ito

For academics who specialise in international relations, the most pressing question of the day is not how to win the War on Terror or restore order in Iraq, but rather how the developed world should respond to China's emergence as a great power in the twenty-first century. With its rapidly developing economy, China seems set to challenge the economic dominance of the United States (US) and other powers within a few decades, and while these nations crave the business opportunities presented by China's development, they also fear growing Chinese competition for market share and critical raw materials such as oil. Furthermore, the authoritarian nature of the Chinese Communist Party and its ambitious military modernisation program fuel suspicion about China's strategic objectives. For some observers, an increasingly powerful China seems to have the ambition for pushing the US out of Asia in order to dominate the region the way the US has done in the Western Hemisphere before. Only the naive imagine that China's rise can be thwarted indefinitely, but there are many who hope it can be managed in a way that will largely preserve the world system in its current form or at least minimise the likelihood of a mutually disastrous conflict between China and one or more of the other powers. An understanding of China's motivations is essential to this project, and China's Struggle for status is a welcome addition to the already large body of literature on this topic.

Many of the books currently in the market purport to provide objective assessment of Beijing's foreign policy. But in fact they do nothing of the sort – often being little more than updated versions of Cold War "yellow peril/red menace" scaremongering, aimed at convincing a primarily American audience that China is the next great threat. Happily, the author of *China's Struggle for Status* resists the temptation to pander to such fears and instead provides a balanced and comprehensive analysis of the complex motives behind Beijing's foreign policy. This is not a book for the newcomer to foreign policy affairs; the authors lace their contributions with an intimidating variety of acronyms and frequently make passing references to international relations theories (especially realism) that are likely to be unfamiliar to those outside the field. Nevertheless, the collection of papers is well worth reading, for the book brings together a number of leading scholars and their contributions do much to make sense of Beijing's motives. Moreover, they base much of their work on a careful reading of Chinese sources, opening a much-needed window into the thought processes of Chinese leaders and academics for those who cannot

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read such material in its original language.

The chapters discuss a wide variety of topics, including Chinese views on China threat theories, independent rivalry with Japan, Taiwan independence, US domination of the post-Cold War world, globalisation, emerging multipolarity, international institutions, multilateral security, human rights, and great power politics. Given the limitations on chapter length and the fact that each of these topics is worthy of its own book-length treatment, the authors do an admirable job in cutting to the heart of the key issues. While the Beijing regime is recognised for what it is – an authoritarian party-state that presides uneasily over an economy and populace that threaten to outgrow it – it is never demonised or accused of harbouring plans for world conquest. Instead, the authors dwell on the practical difficulties Beijing faces in pursuing its three potentially conflicting goals of regime stability, economic development and great power status. The contributors agree that so long as the current international system allows Beijing to make real progress in achieving the latter two goals – themselves increasingly seen as essential to the regime's stability – China will seek to work with the status quo rather than risk challenging it. At the same time, however, they warn that if stakeholders in the current global order move to thwart rather than accommodate China's rise, conflict might well prove unavoidable.

Summarising this review, *China's Struggle for Status* is a genuine attempt to provide a full picture of the complexity of Chinese foreign policy especially after the Cold War. It serves as a good starting point for academics who wish to better understand the trends that shape the evolution of Chinese foreign policy as well as the attitude and perceptions of policymakers in the world. Furthermore, it provides valuable insight into frameworks and sources for further research, including empirical research to be carried out. This could include investigations of China's Korea policy and the Six-Party Talks, the forum on China-Africa cooperation and so on. At the same time, it also makes a useful read for those who would like to satisfy their curiosity regarding contemporary Chinese foreign policy.

REVIEW OF TIM BROWN'S *CHANGE BY DESIGN*

Justinas Pagirys

Change by Design is not a course book for public policy students. In fact, it does not even introduce new theories, frameworks or guidelines for public management.

Nevertheless, Brown's volume is fundamentally about change – an important concept to public policy students. Design thinking advocates a conscious technique to facilitate change in products, markets, countries and societies. The book provides insights and tips on how innovation and creativity can be enhanced and applied across sectors to serve human needs in a better and more sustainable manner. This makes *Change by Design* an extremely practical and inspirational read.

Interestingly, the book begins with two tables of contents. The 'decent' one – a linear table of contents most people are used to – follows an alternative, a mind-mapped illustration of the concepts covered in the book. Using a diagram to represent ideas author finds more palatable; it also introduces a type of thinking commonly used at IDEO, a famous design firm headed by Tim Brown. Mind-maps invite readers to reiterate, jump to particular areas of interest, and retrace steps taken - thinking across rather than along ideas.

The book is partitioned into two big themes: the first one explores the nature of design thinking, while the second half is dedicated to addressing the issues of applicability and implementation – 'where do we go from here?' The chapters of the first half are packed with examples from IDEO projects which make the book sound more oriented towards the market and industry than policy. While touching upon the public sector in the beginning, the second part sees the author diving much more into the social realm, discussing issues of social contract, corporatism, civic activism and design thinking at length.

The prerequisites for design thinking

The book begins with an explanation of design thinking – the latest buzzword for all kinds of enterprises. The concept is illustrated by products and practices that IDEO has gone through in their years of delivering solutions for clients from both private and public sectors. Generally, design thinking is depicted as a human-centred exploration, an interdisciplinary, holistic approach that aims to address the human experience first.

As an essential design thinking exercise, the author calls for converting need into demand by observation, insight and empathy. A good starting point for a change-maker is to go out in the world and observe the actual experiences people have every day. The solution, however, is

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not necessarily there, waiting to be discovered. As Henry Ford put it, "If I'd asked my customers what they wanted, they'd have said 'a faster horse'."[1] Design thinking, therefore, tackles the capacity to notice issues beyond articulated needs.

Pursuing unvoiced insights in the same vein, the kitchen tools development project at IDEO was started by studying both children and chefs, instead of everyday users. The experiment turned out to be worthwhile: children highlighted issues of physical control that adults have learned to disguise and shortcuts used by professionals yielded other insights to possible improvements.

Innovator's empathy for the user is well underscored in the book and is seemingly critical for converting need into demand. The mental ability to put one's self in the shoes of others, thinking beyond the lab and focusing on human experience is the crucial catalyst for the final stage of design thinking. To back this argument, the author tells a story on designing health centres at IDEO. One of the team members feigned a foot injury to capture the patients' experience in the hospital which included frustration of waiting in the queue, anxiety of being wheeled down an anonymous hospital corridor and other negative emotions. Most importantly, the experiment revealed that hospitals are being designed solely to suit staff needs compromising patients' experience.

Designers in Tim Brown's book are not exclusive creators from the upper crust. Design thinking advocates breaking the scope of usual analysis and beginning an inquiring, iterative and practical journey of innovation. In the process, the sense of empathy and efforts to convert need into demand are vital.

Where do we go from here?

Firstly, 'change-conscious' management should become the core business strategy in current turbulent markets. Thus design thinking stands for a systemic approach to innovation and goes far beyond conventional R&D labs into services, customer support and bottom-up innovation. Companies should become focused more on introducing and nurturing the culture of innovation.

Secondly, there is a need to engage participation of the 'users'; the market has already become a two-way street. Treating customers as participants rather than end users – a new social contract - will translate into better products and services. Taking global environmental challenges into account, this process might have potential to alter the vicious design-production-marketing-consumption circle.

Thirdly, human-centred design thinking should be used to unleash the tremendous potential of social enterprises globally. Great examples of social entrepreneurship in both developed and developing countries illustrate that problem-focused design thinking enhances service innovation, recreates cost management and funding models. Rethinking the process by which goods and services

[1] Tim Brown, *Change by Design: How Design Thinking Transforms Organizations and Inspires Innovation* (New York: HarperCollins Publishers, 2009): 40.

are being produced can provide entrepreneurs with completely new solutions such as the famous Aravind Eye Hospital in Madurai, India. Their innovative assembly-line management allowed the slashing of costs per operation dramatically; currently the hospital treats 250,000 people per year and for about a third of the patients' services are free.

Tim Brown's book could be accused of restating the known or even the obvious. The personal tone in which the story is told, however, makes it an amiable read. Real-life illustrations and the individual designer's perspective highlight the everyday essentials of innovation and change. Furthermore, the underlying human-centrism makes *Change by Design* an inspiring work.

Certainly, innovation is no longer a luxury for the leading companies: it is a survival strategy. For navigating through the global challenges ahead, similar notions have started to penetrate the realm of public policy and social innovation might soon become a survival kit for the entire society.

This makes *Change by Design* highly relevant for public officials. It calls for a final embrace of design thinking and using practices that have been applied by day-to-day innovators – the change makers, uncommon heroes, change agents, "the crazy ones, the misfits, the rebels, the trouble makers, the round pegs in the square holes, the ones who see things differently".[2]

[2] Apple. 1997. "Think Different." http://web.archive.org/web/20010228171255/www.apple.com/thinkdifferent/.

ANNOTATED LIST OF BOOKS

Editor's Note

The Asian Journal of Public Affairs annotates all books sent to us for review. Currently, we are able to do so only for books published in the English language.

I

STIGLITZ, JOSEPH and LINDA BILMES. *The Three Trillion Dollar War: The True Cost of the Iraq Conflict*. The United States of America: W.W. Norton and Company Limited, 2008. Pp 311. US$ 15.95 Paper. ISBN 9780393334173.

"This is a catalog [of costs] the Bush team never looked at. It's a catalog that they still don't want you to see."—James Galbraith

America has already spent close to a trillion dollars on the wars in Iraq and Afghanistan, but there are hundreds of billions of bills still due—including staggering costs to take care of the thousands of injured veterans, providing them with disability benefits and health care. In this sobering study, Nobel Prize winner Joseph E. Stiglitz and Harvard University's Linda J. Bilmes reveal a wide range of costs that have been hidden from U.S. taxpayers and left out of the debate about our involvement in Iraq. That involvement, the authors conservatively estimate, will cost us more than $3 trillion. "Stiglitz and Bilmes have clearly demonstrated the need for Congress and the administration to ensure that those making sacrifices today will see those sacrifices honoured in the future."—Dave W. Gorman, Executive Director, Disabled American Veterans

Winner of the 2001 Nobel Memorial Prize for Economics, Joseph E. Stiglitz is the author of Making Globalization Work; Globalization and Its Discontents; and, with Linda Bilmes, The Three Trillion Dollar War. He was chairman of President Clinton's Council of Economic Advisers and served as senior vice president and chief economist at the World Bank. He teaches at Columbia University and lives in New York City.

II

LAWSON, NIGEL. *An Appeal to Reason: A Cool Look at Global Warming*. Gerald Duckworth and Co., 2009. Pp. 160. US$ 28.08. Paper. ISBN: 0715638416.

In recent years, sensational warnings about climate change have dominated the headlines. In this hard-hitting response to the scaremongering of climate alarmists, Nigel Lawson, former Chancellor of the Exchequer and Secretary of State for Energy, argues that it is time for us to take a cool look at global warming. Lawson carefully and succinctly examines all aspects of the global warming issue – the science, the economics, the politics and the ethics – concluding that conventional wisdom on the subject is deeply flawed. He asserts that, even if the majority view of the science is correct, the proposed solution to the problem would be more damaging than the threat it has been designed to avert - and, in any case is, for very good reasons, not politically attainable. Insightful, brilliantly reasoned and thoroughly researched, this is a much-needed corrective to the barrage of hype and spin surrounding a subject that affects every one of us.

Nigel Lawson began his career as a financial journalist and progressed to the position of editor of The Spectator before becoming a Member of Parliament in 1974 till he retired in 1985.

III

EMMOT, BILL. *Rivals: How the Power Struggle Between China, India and Japan will shape our next decade*. Houghton Mifflin Harcourt Publishing Company, 2009. Pp. 352. US$ 15.95. Paper. ISBN: 9780156033626.

The former editor in chief of the Economist returns to the territory of his bestselling book The Sun Also Sets to lay out an entirely fresh analysis of the growing rivalry between China, India, and Japan and what it will mean for America, the global economy, and the twenty-first-century world.

Though books such as The World Is Flat and China Shakes the World consider them only as individual actors, Emmott argues that these three political and economic giants are closely intertwined by their fierce competition for influence, markets, resources, and strategic advantage. Rivals explains and explores the ways in which this sometimes bitter rivalry will play out over the next decade--in business, global politics, military competition, and the environment--and reveals the efforts of the United States to manipulate and benefit from this rivalry. Identifying the biggest risks born of these struggles, Rivals also outlines the ways these risks can and should be managed by all of us.

Bill Emmott is a writer, speaker and consultant on global affairs, with an expertise in Asia. Until 2006 he was editor in chief of The Economist, where his thirteen-year tenure was marked by many awards. He is the author of six previous books and writes regularly for several international publications. He lives in London and Somerset.

IV

WALKER, GABRIELLE and DAVID KING. *The Hot Topic: What We Can Do About Global Warming Harcourt*. Houghton Mifflin Harcourt Publishing Company. 2008. Pp. 288. US$ 12. Paper. ISBN: 9780156033183

Last year, awareness about global warming reached a tipping point. Now one of the most dynamic writers and one of the most respected scientists in the field of climate change offer the first concise guide to both the problems and the solutions. Guiding us past a blizzard of information and misinformation, Gabrielle Walker and Sir David King explain the science of warming, the most cutting-edge technological solutions from small to large, and the national and international politics that will affect our efforts.

While there have been many other books about the problem of global warming, none has addressed what we can and should do about it so clearly and persuasively, with no spin, no agenda, and no exaggeration. Neither Walker nor King is an activist or politician, and theirs is not a generic green call to arms. Instead they propose specific ideas to fix a very specific problem. Most important, they offer hope: This is a serious issue, perhaps the most serious that humanity has ever faced. But we can still do something about it. And they'll show us how.

Gabrielle Walker earned a Ph.D. in chemistry from Cambridge. She is a contributing editor at New Scientist magazine and has taught in the science-writing program at Princeton. She lives in London.

Sir David King, until the end of 2007, the UK’s chief scientific adviser, is widely credited with persuading the British government to take the lead on climate change. He is currently Professor of Chemistry at Cambridge University and Director of the New School for Enterprise and the Environment at Oxford University.

V

HASAN, SAMUIL and JENNY ONYX. (Eds.) Comparative *Third Sector Governance in Asia: Structure, Process and Political Economy (Nonproft and Civil Society Studies)*. Springer Science + Business Media, 2008. Pp. 341. US$ 12. Paper. ISBN: 9780387755663.

Non-profit organizations, NGOs and other third sector organizations are increasingly playing a central role in achieving and sustaining a prosperous economy and a just civil society in countries around the world. While their importance is widely acknowledged, their sustainability is not guaranteed and depends to a large extent on effectiveness and accountability of their governance.

In Europe and North America, the governance of these organizations (setting directions and strategies; identifying and ensuring type and quality of goods and services; defining and maintaining relations among the stakeholders; relating the organization to its wider society) is generally seen as the role of the board of directors or the governing board. In of other parts of the world, specifically Asia, not much is known about the organization and running of these groups.

The book – the first of its kind – establishes new theory and knowledge in the area of third sector organizations (TSOs) in Asia. The main purpose of this book is to draw the attention of Asia's TSOs on the importance of good governance. It documents variety of approaches, and identifies socio-cultural, economic, and political dynamics and impacts of different models of TSO governance. The combined information from the contributions in this work will ensure the sustainability of TSOs throughout Asia.

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