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Final Submission Deadline (Volume 6, Number 2, Fall 2013), 15 August 2013
# Asian Journal of Public Affairs, Vol. 5 No. 2

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Thank you for your continued support for the Asian Journal of Public Affairs (AJPA). This student-run journal continues to grow and this publication constitutes the tenth issue. This is the longest issue of the journal to-date, and includes some exciting and thought-provoking commentaries and articles as well as case studies and book reviews.

The theme for the commentaries in this issue is Myanmar in transition, with contributions from two experts providing a critical look at recent developments. This theme was chosen by the team to highlight the importance of Myanmar, a member of ASEAN, within the geo-politics of Asia and efforts to integrate it within the international community.

There are contributions from academic-activist Dr Maung Zarni, who examines the geo-political implications of reform measures undertaken by the military junta. Zarni comments on the role of China and the US in the government’s reform efforts and inclusion of Aung San Su Kyi in the decision-making process. He also highlights the junta’s apprehension about the possibility of an Arab spring-style backlash from a population weary from extended international isolation. The second commentary is from long-time Yangon-based journalist Joseph Allchin, who examines the historical ties between the West and Myanmar. He explores the military relationships between the US and regional stakeholders at various periods of Myanmar’s history and the impact of reforms on certain stakeholders.

There is a range of articles from academe and practice examining timely issues in Asia including geo-politics, financial regulatory capture, energy policy, and trade negotiation. Andrew Billo and Jenna Pann examine nationalism and conflict in South China Sea. Khyati Malik looks at the impact of global financial regulatory body capture and the benefits accrued by larger financial institutions. Dr Irvin Studin explains how Australia has used education goals at state level and foreign policy goals at the national level to pivot towards Asia. Titli Basu looks at Japan’s energy policy after the Fukushima Dai-ichi power plant disaster, the possibility of undoing regulatory capture, and a future with clean energy. Lu Feifei uses

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1 Sanjan Haque is a graduate student at the Lee Kuan Yew School of Public Policy. He previously worked for BRAC and DFID for more than five years. He holds a MA in International Studies & Diplomacy from the School of Oriental & African Studies, London. He can be reached via haquesanjan@gmail.com or ajpa@nus.edu.sg
Zartnam’s negotiation theories to examine trade negotiation between China and Taiwan.

This issue showcases two award-winning case studies from the Lee Kuan School of Public Policy’s 2012 case-writing competition. Sarah Bales investigates drug policy in Vietnam and the difficulties of a market-based pricing system. Anisha George highlights the many reform efforts undertaken by the Government of India to support national carrier Air India. There are also three reviews of books focusing on Asia and published in 2011 and 2012.

In December 2012 this journal supported the organisation of the Global Public Policy Network (GPPN) student conference held at the Lee Kuan Yew School of Public Policy (LKY School), and duly launched the AJPA Excellence in Public Policy essay competition 2012/13. The winning essays will be published in the Spring 2013 issue. AJPA stands to support the development of other student-run journals across this network and is eager to help facilitate the collective efforts of GPPN members to improve public policy scholarship across the world.

The theme for the Spring 2013 issue is Territorial disputes in Asia. This includes definitions of and proposed solutions to multi-national claims on maritime territories and borderlands, and other issues of national sovereignty that manifest themselves in spatially focused conflict (physical or diplomatic). The issue will include articles, winning case studies from the LKY School’s 2013 case-writing competition, and book reviews.

The publication of this journal reflects the collective effort of the editorial and administrative teams, and without their unwavering support it would be impossible to publish this issue. I would also like to thank the LKY School for its continued support and the Editorial Board for its steadfast guidance. Please visit www.ajpajournal.org for past issues of the journal. Happy reading!
These days Myanmar’s coming-out party is the talk of the town since President Thein Sein’s government has embarked on reforms, ending the country’s international pariah status and a half-century of isolation, both self-imposed and externally-maintained.

As a welcome gesture, just about every leader of both the “free world” of the West and “un-free and semi-free worlds” of the East, including US President Barack Obama, has hurried their way to Rangoon and/or Naypyidaw, Myanmar’s purpose-built capital replete with N. Korean-designed underground tunnels and bunkers.

Development and humanitarian packages worth hundreds of millions of dollars have been pledged, and a significant quantity of foreign debt to the tune of US$3.7 billion forgiven by Tokyo. Virtually all Western governments have showered the former pariah, whose pervasive rights violations they used to condemn ritualistically, with lavish praise. New offices are springing up in Yangon, the former capital. Every other visitor to the country seems to be involved in ‘institution and capacity-building’ of one kind or another. Investors, insurers and do-gooders alike are all elated.

Myanmar has arrived, finally. But there is more to the hyperboles of this “model transition”, as Washington put it, than meets the eyes.

To Myanmar’s dictators in green uniform, genuine reforms and bringing on board their long-time nemesis, namely Aung San Suu Kyi, as their equal partner, had been the last resort. The now officially retired Senior Than Shwe was then best known for his visceral reaction to any mention of her name. Until recently the generals’ survival strategy was self-sufficiency. They strove to be left alone, regionally and internationally. Myanmar’s opposition to even international emergency aid in the aftermath of the devastating Cyclone Nargis in 2008 was a case in point.

Maung Zarni

Maung Zarni (m.zarni@lse.ac.uk) is a Visiting Fellow (2011-13), Civil Society and Human Security Research Unit, Department of International Development, the London School of Economics. He was founding director of the Free Burma Coalition (1995-2004), then a pioneering human rights network in cyberspace.
Indeed, despite their monopoly control on power, the generals have never really felt either secure or confident about their reign during their half-century rule. They had always felt they were riding on the back of an angry wounded tiger, a metaphor for the oppressed and impoverished population. This is the existential background against which changes in Myanmar need to be understood.

Historically, it was the generals’ fear of the loss of their half-century grip on power and wealth that led to state-ordered chronic waves of bloodbaths against any challenge from the street, for instance, “8.8.88 Popular Uprising” when the entire nation rose up against the one-party military dictatorship of General Ne Win. Now, nearly a quarter century after the country’s greatest revolt in modern history, it is again the same fear factor that has propelled the generals to make moves: reform the institutions and reform the way they rule the unhappy and impoverished population.

Mr Shwe Mann, Speaker of the Lower House, reportedly admitted the generals’ collective fear. Within an hour of his meeting with the visiting US Secretary of State Hilary Rodham Clinton in the parliament in December last year, the former third most powerful general in Than Shwe’s ruling council was telling the Burmese journalists, “we do not want to end up like the Arab dictators. One day they were very powerful. The next day they died ignoble deaths.”

Of course, Washington’s new strategy of “pivoting” back to Asia has also made it possible for the generals to come out of their bunkers, literally and figuratively. The Americans wanted the Burmese to walk away, if not geographically but geo-strategically, from Beijing’s embrace. The Burmese on their part are grateful to the Americans in helping wean them of China’s international protection, ironically, against Washington’s perceived attempts at regime change in Myanmar. This is a classic geo-strategic symbiosis that is looking increasingly promising for the quasi-civilian government in Naypyidaw and the Pentagon.

On the domestic front, ex-military officers and their active-duty brethren retain complete monopoly control over the entire change process, reforms or not. In the new era of democratic transition, these men, in skirts or in green shirts, continue to hold all levers of state power at all levels of administration, including “people’s bicameral parliament”, judiciary, foreign affairs and finance, besides their legitimate domain, namely state security apparatuses. And it is they – not collaborating dissidents or the developmental technocrats – who determine the reforms’ nature, scope, priorities and pace.

This is the picture that really worries the public that have borne the brunt of the military’s policy, leadership and system failures of half a century. In dealing with
unhappy Arab Streets, the House of Saud, for instance, has thrown billions at the Sultanate subjects to placate the latter. Myanmar’s new democrats in Naypyidaw, or “Abode of Kings”, have in part adopted this “buy-the-impoverished-population” approach.

The catch here though is this: unlike the House of Saud which sits on the world’s largest reserve of “black gold”, the officially cash-strapped reformist President Thein Sein – cash-strapped because the senior and junior generals have stashed billions of Myanmar’s oil and gas revenues into their personal off-shore accounts – wants the international community, including UN, international lending agencies and development banks, and “donor” countries, to foot his administration’s bill. The World Bank, for instance, has obliged: it has recently pledged a Myanmar aid package worth US$ 250 million.

Emphatically, the generals are, however, pursuing reforms largely for the wrong reasons – for their own long-term survival, both as powerful military families and as the most powerful institution in the country with ‘a deeply ingrained corporate sense of entitlement to rule’. As a direct consequence, they will remain wholly un-prepared to do the needful in terms of what will really promote public welfare and advance the cause of freedom, human rights and democracy.

As a matter of fact, the generals’ reforms are contradictory, reversible and fragile. They are in fact confined to such narrow domains as freedom of speech, new business regulations and investment laws. That is, the areas important to middle class Western liberals and attractive to venture capitalists and corporations. Importantly, reforms bypass active conflict zones, strategic buffer areas, and resource-rich virgin lands.

When it comes to economically and strategically important regions on the country’s peripheries, that is, the ancestral homes of ethnic minorities who make up 40 percent of the total population, the reforms simply translate into forced displacement, the rise in militarisation, a sharp increase in war-fleeing refugees, loss of livelihoods, and so on. It is indeed not simply coincidental that all fresh waves of violence, atrocities and raging wars happen to be in the zones that are designated to be homes of virtually multi-billion dollar mega-development initiatives, commercial projects, resource extraction, special economic zones and industrial agricultural schemes.

Curiously, both the origin and tail of China’s 2,800-plus kilometre-long twin pipelines bear witness to the unfolding violence: ethnic cleansing of the Rohingya in the coastal region where the pipelines begin and the hot war against the
Kachins in the Sino-Burmese highlands of Northern Myanmar, the pipelines’ tail end, before they snake into Southern Chinese province of Yunnan.

On the Western front, an estimated 110,000 Rohingyas have been caged in new UN-financed refugee camps along the Arakan coast line while a slightly less number of Kachins has fled the war towards the Sino-Burmese borders. On the eastern side of Myanmar along Thai-Burmese borders, donor agencies, for instance, Britain’s Department of International Development (DfID) and the host country of Thailand are preparing to repatriate prematurely another 150,000 Karen and Karenni war refugees back to their regions, despite the absence there of either meaningful and functioning ceasefire or lasting peace.

Because these wars and atrocities are off the beaten-path and largely inaccessible to the UN and other aid agencies, the dark side of Myanmar’s economic reforms by and large go un-noticed. They also lie outside the purview of the growing pool of visiting dignitaries, renowned experts and politicians on their whirlwind visits to Myanmar.

More ominously, many international agencies and national governments by and large view as ‘inevitable’ this ugly side of development – ethnic and class conflicts, large scale displacement, pervasive land confiscation, absence of human and food security, growing income disparity, etc. Seen from this prism of capitalist development, this is part of the process of ‘creative destruction’ and the necessary cost underdeveloped communities must bear if they are to enjoy projected fruits of developmental reforms in some distant future.

Likewise, Burmese developmental nationalism commonly shared among the country’s elites, civilian and soldiers, informs President Thein Sein’s pursuit of peace with armed ethnic resistance communities there. In fact, peace is not a new humanistic value or institutional goal in and of itself as far as the Burmese military. It is simply a strategic means to developmental and commercial ends, including control of land, local population and strategic routes, as well as an ethnic minority region’s bountiful natural resources, above and below the ground.

Myanmar’s reforms are, upon a closer look, more about the interests and longevity of the country’s military, and those of the army-bred cronies than about inter-ethnic and -faith peace, public welfare, or democracy. As such, the hyped-up reform moves lack real potentials to result in a new democratic polity which will build, and feed off, a new and sustainable economic system.
How Long Has the West Actually Been Away?

Joseph Allchin

As reforms have swept Burma, a common theme has been that the West is reengaging after decades in the wilderness. But beneath the surface, almost hidden from view, Western military interests have, in reality, hardly left.

The US, notably, reinstated a position of ambassador in the country in 2012. Derek Mitchell is the first ambassador in Burma since 1990. A policy designed to demonstrate official distaste Washington felt towards the Burmese military after the tumult of the late 1980’s, whilst, strikingly, they also sent a 30-man military delegation to the country which invited the country’s military, the Tatmadaw, to the US’ military drill, Cobra Gold.

However, US intelligence has had a robust programme in Burma since independence in 1948. This year saw the passing of 93-year-old Brigadier General, Kyaw Zaw, one of 30-young men who slipped out of Rangoon in 1941 to seek training from the Japanese, to rid their nation of colonialism. His post-independence career was characterised by an impressive struggle against the Kuomintang (KMT) Chinese nationalists in Northern Burma. The KMT ran guerrilla operations, including alleged production and export of heroin in northern Burma with the help of the US Central Intelligence Agency (CIA) in the KMT’s struggle against communism.

However in more recent times, as Western governments have expressed concern over human rights in the country, the CIA and Burma’s intelligence apparatus have often had a cozy relationship. This was most pronounced under Prime Minister, Khin Nyunt.

Khin Nyunt’s name became synonymous with a sharper Western-friendly form of military rule (Zaw 2008). He was adept at neutralising ethnic rebel groups, by alternatively fighting one group whilst cease firing with another. His attention then turned to neutralising the potency of the democratic opposition, with its principled support in foreign capitals. Whilst arresting domestic activists he also wooed foreign diplomats.

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3 Joseph Allchin is a journalist who has been covering Burma since 2009. His work has appeared in The Economist, Foreign Policy Magazine, The Guardian and The Independent amongst many more. He is now based in Dhaka, Bangladesh where he works for The Dhaka Tribune. Follow him on twitter: @j_allchin
In the 2008 US presidential elections, the Republican candidate, John McCain, had a convention manager named Doug Goodyear of the lobbyists DCI Group. It turned out that the DCI Group had promoted the Burmese junta for a fee of US$348,000 and set about hiring a former CIA station chief (Thompson, 2003). The DCI Group allegedly had a friendly relationship with the Burmese intelligence of the day; then called the Directorate of Defence Services Intelligence (DDSI) which at the time was headed by Khin Nyunt between the early 80’s and his purging in 2004.

Once discovered by the press, McCain sacked Goodyear and said, “I found out that two people had, some years ago, been involved with the government of Burma, so I needed to fix the problem” (Associated Press 2008).

Khin Nyunt found willing allies in Western capitals. Amongst Khin Nyunt’s staff was Major Aung Lyn Htut who defected when Khin Nyunt and his entire intelligence apparatus was purged in 2004. Based in Washington (where he himself was trained in the late 80’s by the CIA) he oversaw surveillance of democrats and also helped with the public relations (PR) campaign.

Aung Lyn Htut also states that the CIA and the DDSI collaborated on “anti-drug missions” which would see the DDSI allow the CIA use of their helicopters to visit the far-flung north, well into the new millennium. The CIA even bugged a fellow US diplomat in the Drug Enforcement Agency (DEA), Richard Horn. One of his sources was detained by the DDSI after the bugging occurred (Allchin 2010).

The DCI’s PR campaign, however, also included recruiting notables such as historian Thant Myint-U, grandson of former UN secretary general, U Thant and Joseph Verner Reed, a Republican-appointed diplomat with a successful career at the United Nations (UN) (The Irrawady 2009). Both prominent men had a personal dislike for Aung San Suu Kyi. Verner Reed even made the trip to Burma for the UN day in 2002, and is said to be close to the current President, Thein Sein.

The year 2002 proved to be a big year in this covert PR battle. Suu Kyi was released from house arrest, which has always been a litmus test for Western politicians about whether the Burmese were misbehaving or not.

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4 Extensive US covert training has never been elaborated but former political prisoner and MP, Khun Myint Htun, claims that during interrogation and torture his assailants claimed they had been trained in the US.
More evidence of the rebranding effort is also to be seen in the wikileaks cables (Allchin 2012). On the October 10, 2002, the US embassy in Rangoon cabled home with intelligence from the Burmese junta. Throughout the treasure trove released by wikileaks, the US Embassy had seldom officially communicated directly with their Burmese counterparts.

The intelligence attempted to link a Rohingya dissident outfit, which were seeking a base on the Thai-Burma border, with Al Qaeda, thereby, in turn, painting the multitude of ethnic rebels in east and northeast Burma as associated with terrorists (Allchin 2012).

The US was not alone. Europe’s industrial powerhouse, Germany, has always bit its lip when it has come to EU sanctions on the country. This was largely because of a very successful industrial relationship between the Burmese military and companies such as Fritz Werner. Fritz Werner has long supplied machinery for the Burmese to manufacture guns and ammunition (Lintner 2011). This, according to Burmese exiles in Germany, included labeling machines for making bullets as machines for making “lipstick casing” (Ganz 2011).

So tight was the relationship that a replica pagoda was built beside one of their German plants (Ganz 2011). In latter times, Western governments and aid agencies had sought the removal of sanctions and supported opposition in the country by funding groups that were tolerable to the regime. These groupings were described as a ‘third force’ and were characterised as pragmatists.

Much of this was to smooth relations and worked in favour of German companies such as Trumpf and Decko Maher Gildemeister, companies who were revealed to be supplying machines to a nascent weapons programs. Major Sai Thein Win, brought the world’s attention to projects secretly occurring in central Burma (Kelly and Fowle 2010). It appeared that the Burmese military were also seeking weapons assistance from North Korea in missiles, bunkers and perhaps even nascent nuclear technology.

The friendship with North Korea was a new one, and can be seen to characterise the post-Khin Nyunt era in Burma, when relations with America were at their lowest. This period can be said to have lasted from 2004 till 2011. As such, the rise of Thein Sein as President has been characterised by a more Western-oriented approach, which mimics in many ways that of Khin Nyunt who wrote the ‘road map to democracy’, which is the basis of Thein Sein’s nominally democratic regime.
As such, northern Kachin state has become somewhat of a fulcrum of his policies. Here the President ‘suspended’ the US$ 3.6 billion Myitsone dam, which was being constructed by the Chinese on the basis that they would use the power for the first ten years, on a build, operate and transfer agreement.

Whilst Thein Sein (or the military) also suspended a 17-year ceasefire with the Kachin Independence Army, it resumed an often-brutal conflict with what is seen as one of the more powerful and least criminal of the ethnic armed groups. The West has been strangely quiet on the plight of a people who are long-time Western allies, despite credible reports of forced portering, rape as a weapon of war and many other horrors (HRW 2012) that characterise civil war in Burma.

Reading through diplomatic cables and the US’ pivot to Asia statements, such as Senator Jim Webb’s fear (Rogin 2010) that Burma would become a province of China; it is easy to see why the US would welcome an exertion of Naypyidaw’s power in this remote region. From telephone signal to currency the economic rise of China has been felt in these parts, in stark contrast to the historically inept military leadership of lower Burma.

The reform process, therefore, is more than a zero-sum game. It is a slight adjustment as part of a deal that the West has struck to balance Burma’s foreign policy outlook towards one, which a traditionally xenophobic elite in Burma feel more comfortable with. It is not an aberration but a return to neutralist-balancing tactics. It is in keeping with the military’s goal, and is fired by historical aspirations of ethnic dominance. Furthermore, it suits the Western powers, whose vision of the region looks like a paranoid chessboard, whether there are shells landing on Kachin villages or not, containment and brinkmanship are the order of the day.

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INTERWOVEN NATIONALISM AND CONFLICT IN THE SOUTH CHINA SEA

Andrew Billo and Jenna Pan

The body of water stretching over 3,500,000 square kilometres from the Strait of Malacca to the Strait of Taiwan in the Pacific Ocean is among the most contested in the world. Brunei, China, Malaysia, the Philippines, Taiwan, and Vietnam each claim overlapping areas in the South China Sea (known also as the East Sea and the West Philippine Sea to Vietnam and the Philippines respectively). Tensions in this area have roiled for decades and, in recent years, have begun to churn with increasing frequency. This brings into question the future of regional cooperation and whether it is still possible to settle these disputes peacefully or if conflict will spiral downwards into protracted military conflict. In this paper, we argue that although current hostilities regarding the South China Sea are largely owed to nationalistic tendencies with respect to three claimants—specifically China, the Philippines and Vietnam—countries in the region also cannot afford more serious conflicts in the next decade both for economic and political reasons. As such, the current spats will continue, presenting a convenient international distraction where tough rhetoric gives the illusion of domestic political strength. However, we assert that the conflict will not escalate to the point of prolonged military engagement in the near future owing to the positive incentives of economic cooperation and relative domestic political stability of claimant countries at present.

Introduction

Nationalism, as defined by scholar Hans Kohn, “is a political creed that underlies the cohesion of modern societies, and legitimises their claim to authority. Nationalism centres the supreme loyalty of the overwhelming majority of the people upon the nation-state, either existing or desired” (Young 1979, 71). It has significant value as a political tool. For instance, nationalism can be used by the state as a means to turn attention away from its inability to meet societal demands, such as those regarding economic development, effective political institutions, and security (Downs and Saunders 1998-1999, 141). It can distract attention from such issues and thus help improve the government’s image. In this

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way, politically frail regimes are able to reinforce their legitimacy and their grip on power (Stephen 1994, 30). In regimes where authority is challenged, nationalistic claims that foreign states are responsible for current problems may be used to deflect hostility away from the government and toward external targets (Stephen 1993, 30). This also creates a dependency on the government for protection and gives it the opportunity to portray itself as a powerful entity. As such, the encouragement of nationalist sentiment can be a powerful device with which to reinforce a regime’s political legitimacy. Scholarship suggests that the most aggressive nationalist movements arise when the state is unable to effectively fulfil its economic, institutional and security goals—or, in essence, when the government appears to be incompetent or untrustworthy (Snyder 1993, 81).

China, the Philippines and Vietnam have all been the focus of remarkable transformation over the past several decades in a push for modernity and global engagement. However, at the same time, elements exist within these countries that have the potential to significantly undermine the legitimacy of their governments as they find it difficult to fulfil their economic, institutional, and security obligations. The result is a turn towards nationalism to regain political support. The South China Sea, as the site of multiple conflicting territorial claims, is an ideal focus of a nationalistic campaign for three interrelated reasons.

First, by asserting sovereignty—even if illegitimate—over a disputed area, the government is able to project an image of power and influence that reinforces its authority. Second, the contradictory assertions of sovereignty by the various claimants help to create an “enemy” of sorts that governments can cast as a scapegoat for certain issues and deflect hostility toward. This also engenders greater appreciation for those in office, as it creates a situation that encourages citizens to rely on their governments for protection. Thirdly, the contentious claims regarding the South China Sea shift focus in the direction of international problems and away from domestic ones. Thus, over the past year, the encouragement of nationalistic attitudes about the South China Sea have emerged in China, the Philippines and Vietnam, as the governments of these states struggle to overcome domestic issues and build a stronger foundation of political legitimacy.

Therefore, we argue that nationalism stemming from the three most aggressive claimants—China, the Philippines and Vietnam—is one of the main driving forces of tensions regarding the South China Sea as it is used to help solidify the political legitimacy of governments that have been subject to domestic challenges. Nationalism is a powerful tool that can be used by governments to garner vital
political support, and each of these three countries has capitalised on it in order to bolster legitimacy. Further, because nationalism gains strength through conflict, it can also simultaneously lead toward the further development of international tensions, as it has in this troubled region.

Despite this, we contend that full-fledged military engagement would undermine these governments’ ability to fulfil societal demands for economic growth, institutions, and security as described above. Protracted military conflict, which we define in this paper as a sustained struggle for a period longer a month with the potential to evolve into a full-fledged war is unlikely owing to the financial costs and risks to property and life. For this reason, we assert that even as nationalist sentiment causes a rise in tensions, greater conflict will not emerge in the near-term.

Policy recommendations

As discussed in this paper, the extent and speed at which China, the Philippines, and Vietnam will increase domestic governance capacity enhance economic security, and thus back away from pro-nationalist policies is not fully known. It is likely, however, that the Association of Southeast Asian Nations (ASEAN) states and China will continue to develop economically and as they do, there will be increasing pressure on the governments in power to attain resources for their populations. Securing domestic energy resources will be critical for curbing inflation. However, when the aforementioned governments are unable to meet their resource needs from domestic sources, maintaining political stability will be a challenge. Factions within the countries, including hawkish leadership in the defence sector, may seek to secure resources through military action. Still, growth and overall wellbeing within these three countries are, at present, mostly on a positive trajectory, despite occasional political and economic threats. There is, therefore, a brief window, perhaps a decade, for relevant actors to pursue actions that quell the dispute and enhance overall regional security. In this interim period, we recommend that the following actions be taken:

1. **ASEAN must be prioritised as a vehicle for dispute resolution.** As a regional cooperation mechanism, is best positioned for resolving conflicts involving China and Southeast Asia. Although the regional body faces external pressures and member states enjoy strong bilateral relations with both China and the US, the organisation can continue to encourage member governments to take a unified stance on territorial claims in the South China Sea, while simultaneously allowing flexibility to pursue bilateral economic relations with key trade partners. Passage of the long discussed Code of Conduct with
respect to the South China Sea will be critical in giving ASEAN teeth to address this issue.

2. *The United States should prioritise a diplomatic, rather than military presence in Asia.* A stronger American diplomatic presence in the region, built upon mutual understanding and trust, would evidence prioritisation of dialogue over military action. Recognising the uncertainty caused by China’s ambiguous stance on the South China Sea, the US should be a role model with an unambiguous behaviour when stating its own economic, political and security intentions in this Asian region, particularly in light of its new “strategic pivot” and the increased US military build up since the strategy was announced.

3. *Determine a legal mechanism for resolving territorial claims.* Senior American leaders have repeatedly emphasised that the US is committed to a rule-based international order (Clinton, ASEAN Forum 2012), but the US has not ratified the UN Convention on the Law of the Seas (UNCLOS). Arguments against the US ratification of UNCLOS frequently cite China’s unwillingness to bring the claims with respect to disputed territory to arbitration: as a Chinese Foreign Ministry spokesman said with regard to the disputed Huangyan Island, “UNCLOS is not the legal basis to determine the territorial sovereignty” (Lei 2012). Still, in the absence of UNCLOS ratification, America is not obligated to enter into “provisional arrangements…in the spirit of cooperation,” as put forth in the convention (UNCLOS 1982).

4. *Pursue joint energy exploration.* Given the unwillingness of parties involved to back down from their territorial claims, serious consideration should be given to possibilities for the private sector and state-owned companies to commence in joint-exploration activities across borders. Even if such activities begin on a limited basis, it would open the door for larger-scale cooperation and secure it as a viable model for overcoming tensions. A Philippine senator stated that this maybe more easily achieved in the short-term, while ASEAN regroups and establishes ground rules for resolving the dispute in the future (Benigno 2012).

5. *Conservation of resources in the long-term.* While energy is not the only cause of the dispute, it is important to each of the claimants’ national development. The countries involved should continue to emphasise energy conservation and the development of clean technologies as parts of their national development strategies. As a long-term regional strategy, it will place the
ASEAN countries and China in a better position to handle the strains of an increasingly resource-strapped world.

**Background: Conflict in the South China Sea**

Many countries, both in Asia and around the world, possess substantial interests in the South China Sea. These interests include freedom of navigation of its waters, claims to territorial sovereignty over its islands and coral reefs as well as rights to develop its vast maritime resources. However, it is China, the Philippines, and Vietnam who have made the most significant as well as the most forceful claims over territory in the region (ICG 2012). China’s claims, marked by the ambiguous nine-dashed line first drawn in the 1930s (Fravel 2011a, 295), encompass about 90 percent of the South China Sea. It bases these claims of sovereignty on the Exclusive Economic Zone (EEZ) and continental shelf principle as well as on historical records from the Han (110 AD) and Ming (1403-1433 AD) Dynasties (US Energy Information Administration 2008). The Philippines also claims sovereignty over a large portion of the South China Sea, which includes the Spratly Islands and Scarborough Shoal, based upon the same EEZ and continental shelf principles as well as on the historical expedition of a Philippine explorer in 1956 (US Energy Information Administration 2008). Vietnam claims all of the Spratly and Paracel Islands as well as the Gulf of Thailand based upon the EEZ and continental shelf principles (US Energy Information Administration 2008). The claims of these three countries overlap in multiple places, and the resulting tensions over conflicting territorial claims have had a significant impact on regional stability over the past several years.

The geostrategic significance of the South China Sea is evident. It is a chokepoint of sea routes and a trade hub. More than a quarter of the world’s total commerce passes through it every year (Ba 2011). Furthermore, the South China Sea holds vast resources within its waters. Approximately 10 percent of the annual global fisheries catch comes from the area (Storey 2012, 55). Furthermore, the sea is believed to hold billions of barrels of oil; however, estimates vary significantly, ranging as high as 213 billion barrels (US Energy Information Administration 2008), in addition to even greater reserves of natural gas. Estimates made by the US Geological Survey indicate that anywhere from 60 to 70 percent of the South China Sea’s hydrocarbon resources consist of natural gas (US Energy Information Administration 2008).

Although tensions regarding the South China Sea have begun to heat up over the past several years, this is by no means a new issue. Disputes over sovereignty of the South China Sea have led to recurring flashes of conflict between Asian
countries for centuries. The issue reignited in the 1970s, 1980s and early 1990s as China became more aggressive in asserting its claims of sovereignty. Notable incidents during this period include the Chinese attack on Vietnamese forces in the Paracel Islands in 1974 in which China took control of the islands chain, the clash between Chinese and Vietnamese forces near Fiery Cross Reef in 1988, and China’s military ousting of Philippine forces from Mischief Reef in 1995.

After these events, tensions subsided for a time due to the coalescence of a politically unified ASEAN and the Chinese adoption of Deng Xiaoping’s guideline ‘sovereignty is ours, set aside disputes, pursue joint development’ in the 1980s (Dutton 2011, 43). According to this Chinese concept, although China would by no means give up sovereignty of the disputed territory, it should delay attempts to resolve contested claims in favour of focusing on cooperative development in order to deescalate the situation and prevent further degradation of its relations with other Asian nations (Cronin and Kaplan 2012). Although tensions regarding the South China Sea cooled to a low simmer for a time, they have begun to boil over once more during the course of the last few years, particularly with the renewed US diplomatic and military focus in the region.

Stirring the pot: Nationalism in three countries

The South China Sea dispute presents an opportunity to engender nationalist feelings in all three countries discussed in this paper, particularly considering mounting pressures to create economic opportunity and the need to draw attention away from issues plaguing domestic governance such as corruption, income and social inequality, and rising inflation. However, to understand the formulation of present policy on the South China Sea, it is necessary to understand the specific country context of each of the three claimants.

Taking China first, the seeds of the government’s reliance on nationalist sentiment for political support sprouted in the aftermath of the Cultural Revolution and the death of Mao Zedong on September 9, 1976. These two events propelled the Chinese political system into a state of crisis, threatening the long-term viability of the Chinese Communist Party’s (CCP) control. At that time, the CCP’s prestige had declined significantly following the disastrous Cultural Revolution and the growing belief that there existed corrupt capitalists within the party itself (Lieberthal 2004, 125). The communist ideology emphasising class warfare was no longer able function as the core of the CCP’s legitimacy as a regime as it had in the past, and a new framework was needed to become the rallying point of public approval and support (He 2007). Gradually, nationalism replaced communism as a major portion of the ideological foundation of the
Chinese government’s political legitimacy (He 2007). This dependence on nationalism has persisted into the present time as the CCP increasingly relies on nationalism for its legitimacy as China’s ruling body (Gries 2005, 112).

Recently, China has faced a series of issues that have made its reliance on nationalist sentiment as a means for legitimacy even more important. In the short term, the country has had to deal with domestic political issues receiving prominent coverage in global media outlets. These include the incident in which activist Chen Guangcheng took refuge inside the US Embassy in Beijing and the Bo Xilai political scandal. In the long term, after years of fast-paced growth, China’s economy has become sluggish; in the past year, the economy reached its slowest pace since the global financial crisis (Orlik and Davis 2012). As China emerges from the 2012 leadership transition, the CCP cannot afford to appear as weak to its domestic constituency. As such, China is likely to be increasingly assertive on issues of sovereignty and to further emphasise nationalist loyalty in order to portray an image of strength during the transition period and to divert attention away from its own domestic problems.

The current tensions about the South China Sea make it an extremely timely distraction from the aforementioned issues. Chinese newspapers, often considered mouthpieces of the CCP, have been inundated with titles such as “China defends its sovereignty over Nansha Islands” and “China pledges to protect maritime sovereignty” that emphasise Chinese predominance and a willingness to defend its perceived territory (Xinhua 2012). In addition to this, China has roused nationalist sentiment by vilifying other countries in these articles, emphasising China’s past humiliation and mistreatment at the hands of other nations (Global Times 2012a).

China has also moved to physically project power into the South China Sea region. For instance, as tensions rose between China and Vietnam over the Paracel Islands, Chinese authorities detained 21 Vietnamese fishermen working in the surrounding waters in March 2012 (BBC 2012a). Defending these actions, Chinese Foreign Ministry spokesman Hong Lei stated that China possesses “irrefutable sovereignty over the Paracel islands” (BBC 2012a). The Chinese government once again moved to defend its territorial sovereignty in an incident beginning in early April 2012, when it dispatched two marine surveillance ships to the Scarborough Shoal in order to block the arrest of Chinese fishermen by the Philippines’ largest warship, the Gregorio del Pilar. This incident was followed by a decision on the part of the CCP to deploy troops to establish a garrison on one of the islands claimed by China in the South China Sea in order to defend its claims (Perlez 2012a).
Like China, Vietnam has also historically relied on appeals to nationalism. The Vietnamese Communist Party (VCP) derives much of its authority from the period following the Second World War during Vietnam’s three-decade-long struggle with France and the US. It portrays itself simultaneously as the victim of foreign aggression and as the valiant vanguard opposing foreign domination, providing justification for its continued leadership and endowing it with a “mandate from heaven” (Sutherland 2009, 325). This image has all the seeds of nationalism as it makes the VCP an icon that demands loyalty and creates a traditional enemy—foreign oppressors—for the Vietnamese people to unite under the country’s government. As such, there exists a legacy in Vietnam that relies on nationalism as a basis for political legitimacy. Vietnamese nation building in the present day has evolved to emphasise regionalism, particularly the establishment and maintenance of sovereign territorial boundaries (Sutherland 2010, 50).

Historically, Vietnam and China have had the largest conflicts with respect to the South China Sea. In both 1974 and 1988, China and Vietnam clashed over the Paracel Islands, in which dozens of Vietnamese troops were killed. This historical narrative of violent conflict has left a legacy of deep-seated animosity toward China among many Vietnamese that has prompted Vietnam’s government to take a stronger, more nationalistic stance against the other country’s claims in the South China Sea in order to bolster political legitimacy.

Contemporary issues in Vietnam also threaten the VCP’s political legitimacy. Dissidents have periodically challenged the VCP, each challenge more vociferous and threatening to the VCP’s cohesiveness than the previous. Nevertheless, nationalism has become an ideal political tool that the VCP can exploit in order to strengthen its foundation of political legitimacy. As Time put it, in spite of extensive domestic corruption allegations, “nationalist demonstrations against neighbouring China’s investments in Vietnam and its territorial claims in the South China Sea outnumber protests against official corruption or in favour of democracy” (Boehler 2012). Current tensions in the South China Sea in conjunction with the historical importance placed on the protection of sovereign territorial boundaries make it a convenient focus of attention.

As such, in the past year, the Vietnamese government has made an effort to stand firm against China, denouncing its movements in the region. It has repeatedly accused China of “seriously [violating] Vietnam’s sovereignty, rights and jurisdiction” and has also portrayed the larger country as an offender breaking international law, raising anti-Chinese nationalist sentiment (BBC 2012c and BBC 2012d). Protests against the Chinese at present are officially “unsanctioned” by
the Vietnamese government. However, the government’s actions in the weeks following Chinese vessels cutting the cables of Vietnamese survey ships in May and June 2011 are telling as they allowed large-scale anti-China demonstrations to be held in the capital for 12 weeks. By encouraging anti-Chinese sentiment, the Vietnamese government caters to old hostilities toward the other country to create a ‘rival’ of sorts that it can ‘heroically’ oppose. However, Vietnam also balances close diplomatic and economic relations with China that keep it from allowing antagonistic feelings to go too far.

The Philippines suffers from a legacy of inefficiency, corruption, and cronyism although the country has shown resilience in the past two years in reversing this trend (Voigt 2012). Still, the country has room to improve further. In the World Bank’s Worldwide Governance Indicators (WGI) project, the Philippines ranked in the bottom half of all countries in five of six indicators of government performance. In two other categories examining government stability, lack of violence and control of corruption, the country performed even more poorly (World Bank 2010). Unlike the conservative, top-down, ‘official’ nationalism such as that in China and Vietnam, a distinctly popular form of nationalism emerged in the Philippines out of the anti-Marcos struggle of the 1970s and 1980s, Philippine pop culture, and the struggles of overseas contract workers (Sidel 2012, 126). However, it should also be noted that nationalism in the Philippines also has deep roots in anti-colonialism and places a heavy emphasis on sovereignty (Easley 2007).

The Philippines has also asserted its territorial claims more boisterously in the last two years. President Benigno Aquino III came to office in 2010 with a pledge to battle political corruption and poverty, which have plagued the country for years. However, reform is a slow process. On July 23, 2012 as President Aquino gave his annual State of the Nation Address, 5,000 protestors attempted to march to Congress in criticism of inequalities in the country (Philippine Star 2012). Considering the tumultuous nature of the Philippines’ politics, although largely seen as improving under President Aquino, protection of a nationalist identity serves as a convenient political tool that can be used by the government to help build a stronger foundation for political legitimacy.

In order to stimulate nationalist feelings about the Philippines’ claims in the South China Sea, the country’s government has repeatedly emphasised its sovereignty over the islands within its EEZ as well as its willingness to defend its territorial rights. For instance, in June, 2011, the Philippine government renamed the South China Sea the ‘West Philippine Sea’, making an obvious statement regarding its perceived territorial claims in the region and heightening tensions
with China (Channel NewsAsia 2011). Other, more overt, statements of strength have involved using the presence of Philippine vessels in the waters of the South China Sea. In December 2011, the Philippine warship the Gregorio del Pilar was sent to lead patrols. In April 2012, the warship was sent to the Scarborough Shoal to arrest Chinese fishermen, leading to a prolonged standoff between the Philippines and China (Hookway 2012). This decision was perceived as a demonstration of military power on the part of the Philippines and representative of a much harder stance toward China than traditionally undertaken by the country. In the words of President Aquino, the Philippines is “always ready” to defend its territories (Pilapil et al. 2012).

The potential for military conflict

While we have stated that there is a possibility that nationalism can influence governments toward more aggressive foreign policy as officials are forced to accommodate popular sentiment, we simultaneously argue that it is unlikely for relations to degrade to the point of direct military conflict within the near future (Gries 2005, 111-112 and He 2007, 3). China, the Philippines and Vietnam have all at one time or another threatened to resort to military means in order to defend their claims, but they have nonetheless deliberately moved to deescalate tensions over the past year or so. Each country holds that the tensions over territorial claims in these waters should be settled peacefully (OOP 2012 and Viet Nam News 2012a).

For instance, China’s detainment of 21 Vietnamese fishermen in the South China Sea in March 2012 caused significant friction between the two countries. However, China then deescalated the situation when it freed the fishermen in late April (BBC 2012e). The release was followed by bilateral negotiations in late May 2012, which further reduced tensions (Viet Nam News 2012b). The negotiations were considered a success as the two sides reached a consensus on several topics and emphasised a lasting relationship based on equality, mutual benefit and respect, improving relations between the two countries.

Additionally, although nationalism has repeatedly driven up hostilities between China and the Philippines at the Scarborough Shoal in the past, the two countries have made efforts to prevent tension from increasing too much. A noticeable effort by the Philippines to reduce stress was evidenced when the largely state-controlled Global Times newspaper headlines changed from “Peace will be a miracle if provocation lasts” to “Cool heads must prevail in Huangyan [Scarborough Shoal] spat” in the course of just two days (Global Times 2012b). Furthermore, China also restrained itself to using only civilian maritime law
enforcement instead of navy forces in order to assert its claims (Fravel 2012b). These vessels, most of which did not appear to boast any mounted weapons, asserted Chinese sovereignty in the area, but simultaneously also limited the potential for escalation (Fravel 2012b).

On the Philippines’ part, the presence of its warship the Gregorio del Pilar at the Scarborough Shoal initially strained the already precarious situation as it represented the potential for escalation into military conflict. However, the Philippine government substantially reduced tensions when it withdrew the warship from the area, taking along with it one of the largest potential causes for the outbreak of the use of military force (BBC 2012). In late June, inclement weather provided China and the Philippines with a face-saving opportunity to withdraw ships from the area (Perlez 2012b). Although the territorial disputes are by no means resolved, it is apparent that the three claimants discussed in this paper have successfully moved to deescalate tension in instances when they have come to a tipping point.

**Estimating the costs and benefits of conflict: Stabilising factors**

The primary reason these countries have thus far refrained from using military force in defence of their territorial claims is that engaging in military conflict has costs that exceed any benefit that may be derived from doing so. Even as governments use nationalism as a means to strengthen their own hold on power, there exist limits to the lengths they are willing to go to in order to protect these territories.

Chinese nationalism can be characterised as “pragmatic”, measuring costs and benefits against one another (Shen 2007, 177). With respect to the South China Sea, at this point China would lose too much and gain too little to justify the use of military force in asserting its claim. As China has continued to grow economically over the past several decades, it has repeatedly emphasised its “peaceful rise.” The senior Communist Party official Zheng Bijian first used the term in 2003 to describe the development of China’s influence and power over rest of the world (Economy 2010, 183). It stresses that China’s rise will rely upon nonviolent means and that it will benefit both the Chinese people as well as the rest of the world (Economy 2010, 183). This concept has since become a central part of China’s international image. Hand in hand with China’s “peaceful rise” is China’s “charm offensive” in Southeast Asia. Following the death of Mao Zedong and Deng Xiaoping’s rise to power, China began to extend its influence in Southeast Asia, seeing it as a natural and rightful extension of its influence. It has done this through what has been referred to as a “charm offensive” in which
China has presented itself as a benign neighbour, gradually coming to a place of significant presence within the region, a “dominion of Confucian harmony and benevolence” (Ott 2011, 237).

Therefore, although China has the military strength to win a confrontation with both the Philippines and Vietnam, direct military conflict in the South China Sea would seriously undermine the international image it has worked so hard to promote over the past decades. Furthermore, despite the US’ traditionally neutral stance on territorial disputes and its vague rhetoric regarding its future role as either an arbiter or a participant in the South China Sea dispute, there always looms the potential for conflict between these two global superpowers should China choose to pursue military means to consolidate its claims. As such, the presence of the US acts as a deterrent to Chinese assertiveness.

Additionally, the Chinese government has also developed significant trade and investment ties with the Southeast Asian nations over the past decade. 2009 was a significant year in ASEAN-China economic relations as China became ASEAN’s largest trading partner and ASEAN became China’s fourth largest partner, contributing 10.2 percent of China’s total trade (Sheng et al. 2012, 2). Then, in the first half of 2011, ASEAN became China’s third largest trading partner, overtaking Japan (Sheng et al. 2012, 2). Engaging in military conflicts with the Philippines and Vietnam would fray these ties and be detrimental to the Chinese economy. In light of China’s relative economic slowdown and the recent leadership change at the end of 2012, further economic issues may undermine the continued stability of the Chinese government, thus limiting China’s escalation of tensions in the South China Sea.

Like China, the Philippines has also refrained from allowing nationalism to push it toward military conflict because the incentives favouring direct confrontation are not yet great enough. On its own, the Philippines has a relatively weak military force, which lacks a credible air defence capability and has only an outdated navy. Without US backing, it is currently in a poor position to engage in a large confrontation with China (Fisher 2012). As such the Philippine government is hesitant to instigate direct conflict because it is uncertain whether its mutual defence treaty with the US would be upheld in the event of a clash in the South China Sea.

Furthermore, the Philippines has significant economic ties to China that would be extremely problematic if cut. China is the Philippines’ third largest trading partner, and in 2011, trade between the Philippines and China (excluding Hong Kong) grew by 17.9 percent, faster than the growth in trade between the
Philippines and both Japan (5.5 percent) and the US (1.7 percent) (ICG 2012, 9; Lum 2012). The influence China possesses over the Philippine economy was demonstrated when in response to the dispute over the Scarborough Shoal the Chinese government imposed stricter regulations on imported fruits from the Philippines and warned its tourists away from travelling to the country. In May, 2012, losses in banana exports were estimated to total around US$ 34 million while the tourist industry reported lost almost US$ 1 million in cancelled Chinese visits (Thayer 2012a). Cutting ties with China would be economically devastating for the Philippines, thus tempering the government’s handling of the South China Sea situation.

Vietnam finds itself in a similar position to the Philippines in the South China Sea: it is militarily too weak to confront China and also has significant economic incentives to maintain close relations. Over the past several years, the Vietnamese government has made a concentrated effort to modernise its military and bolster its capacity to defend its interests. However, despite this, the Vietnamese military still lags behind China’s. For instance, Vietnam’s although overall defence budget in 2012 rose 35 percent from its level in 2010 to US$ 3.3 billion, it is still far outstripped by China’s US$ 106 billion (Thayer 2012b, 10). While Vietnam just launched its first domestically built gunship in January 2012, China unveiled its first aircraft carrier in 2011 and also began work on its first indigenously constructed carrier in 2012, demonstrating an imbalance in regional military capacities (Burns 2012).

Since the late 1980s, China has increasingly influenced the Vietnamese economy, which now depends heavily on its economic ties to the larger nation. China is quickly becoming Vietnam’s largest trading partner, giving China significant economic leverage in the territorial dispute. According to a report by the International Crisis Group, the import-export average growth rate between the two countries is 33.9 percent (Regional Responses 2012, 3). However, these trade relations are severely unbalanced since China has emerged as Vietnam’s main source of imports, accounting for almost a quarter of the Southeast Asian country’s import turnover in 2010, while Vietnam’s exports to China accounted for only a small portion of China’s overall imports (Hiep 2011).

China is also a major driving force boosting Vietnam’s agricultural and industrial sectors, granting it preferential loans and trade deals that Vietnam would prefer not to lose (Regional Response 2012, 3). Moreover Vietnam’s trade deficit with China has risen eight-fold between 2001 and 2011, swelling to a value of US$ 12.7 billion (Regional Response 2012, 3). Put together, this leaves Vietnam in an economically vulnerable situation should it be forced to oppose China militarily.
while protecting its own claims in the South China Sea. It would be strategically sound for Vietnam to avoid escalation of tensions if possible.

The importance of the US’ strategic pivot to Asia can also not be emphasised enough. While both the Philippines’ and Vietnam’s militaries are dwarfed by China’s, the US is still the leading spender on defence at US$ 600 billion annually (The Economist 2012). However, The Economist predicts, China may have a larger defence budget than America’s by 2035. Whether or not this becomes reality, it is certain that an increased US military presence in the Asia Pacific could further empower smaller regional claimants to take more aggressive military action. Although the US has said it will not take sides on territorial disputes, the possibility of intervention remains possible, given the country’s obligations to uphold mutual defence agreements in the region, including with the Philippines.

Conclusion

In this paper, we argued that nationalism is one of the strongest drivers behind brewing conflict in the South China Sea as relatively weak governments in China, the Philippines, and Vietnam try to build stronger foundations of political legitimacy. However, while nationalism has been a significant force in stirring up tensions in the region, so long as the costs of extended military conflict exceed the benefits of economic relations, engagement is not likely to escalate further. China, the Philippines, and Vietnam, while frequently blustering over the issue, have all moved to prevent conflict escalation. As such, we believe that it is unlikely that the events will spiral downward toward direct military conflict during the next decade so long as economic progress maintains a growth trajectory.

Still, a growing resource scarcity in the years to come could serve as a flashpoint for conflict. As of now, since sufficient energy resources support growing consumerism throughout the region, the oil and gas reserves in the South China Sea are not yet worth fighting over. However, as pressure on energy resources mounts, this will become a critical strategic issue in Asia and territorial claims in the South China Sea will become more significant. The relationship between China and the US, as they vie to win the favour of Southeast Asian governments, will further determine the likelihood of escalation. It is, therefore, reasonable to consider that at the juncture of resource scarcity and the formation of alliances along US–Sino lines hostilities over the South China Sea may reach a boiling point and the potential for direct military conflict will be the greatest.
To reduce the likelihood of further conflict, we recommend:

1. Empowering ASEAN to resolve territorial disputes by providing the body with the financial and human resources necessary to be more effective;
2. Encouraging US diplomatic action ahead of a stronger military presence;
3. Emphasising opportunities for resolution using international legal mechanisms;
4. Joint energy exploration between countries in disputed territories;
5. Develop strategies that prioritise long-term energy and resource conservation.

The opportunity exists to resolve issues concerning the South China Sea peacefully, which will be to the benefit of the global community. However, many significant challenges lie ahead. Transparency in US strategy, both in terms of rhetoric and action, would lessen China’s concerns with regard to America’s overall Asia strategy, and mitigate the extent to which Southeast Asian governments might feel assured about receiving US military assistance. It is most critical that measures for resolving disputes be put into place while economic growth in the region remains positive. If Asian governments reach a point where their economic futures are seriously threatened, finding a solution through dialogue will become much more challenging.

References


The Effects of Regulatory Capture in the Finance Industry

Khyati Malik

The last two decades have seen a significant growth of the financial sector in many economies around the world. This paper argues that financial bodies pursue regulatory capture to ensure unhindered growth. The paper explores tools of regulatory capture among colluding bodies with common interests, types of collusion, and intended regulatory changes. It explains why regulatory capture benefits larger financial institutions, leading to absorption of smaller firms. Finally, this paper discusses the impact of these finance industry dynamics on national and global economies. It concludes with suggested policy recommendations to ensure effective financial regulation that prevent regulatory capture by financial bodies.

Introduction

Sub-prime mortgage securitisation in the United States was not solely responsible for the global financial crisis of 2007-2009. There have historically been numerous revisions to financial regulation, with the goal of greater financial stability. For example, the various versions of Basel accords addressed the overall risk calibration of capital requirements, with the goal of attuning regulatory capital to actual risks in the banking sector.

As noted by Hellwig (2009), “the Basel committee is right in finding that many of the risks that were realised in the crisis had not been properly accounted for in the various risk models that were used to determine regulatory capital”. However, the technical flaws pointed out by the Basel committee may only be a part of the story, as these deficiencies may as well be symptoms of a much more fundamental problem of governance resulting from a misalignment of private

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7 For a systematic account of the crisis, see Hellwig (2009).

8 For example, the Basel III accord, introduced after the 2007 – 2009 financial crisis, suggested several changes to bring greater regulation in the financial system. It suggested increasing the minimum requirement for common equity from the current two percent to 4.5 percent level. It also suggested measures to strengthen the bank leverage and liquidity requirements.
and the public interests. The suggestions by the Basel committee may only be fruitful in a political environment where government regulators are able to overcome the influence exerted by the financial oligarchy blocking essential reform. At present, this environment does not exist. Several authors, like Ramirez (2000) and Etzioni (2009), have argued that the collusions formed by financial bodies have been able to significantly influence regulatory bodies to serve special, rather than public interests - a state of affairs that exists in the world’s most advanced economies as well.

This paper will analyse the efforts of the financial industry to capture domestic regulation and how this contributes to the amplification of the problem at the global level. On the basis of this analysis, this paper will suggest specific measures to control regulatory capture. Section I discusses the literature pertaining to regulatory capture. Section II provides a review of regulatory capture in the finance industry, with the United States as an illustrative case. Section III specifies how this problem exists at the transnational level. Section IV concludes with policy recommendations.

**Regulatory capture**

Broadly defined, ‘regulatory capture’ refers to a process in which the state’s intervening efforts to impose rules, regulations, and guidelines are influenced by private bodies for their benefit, often at the expense of the public. More specifically for the financial industry, this phrase refers to the process in which financial bodies collude to form a political lobby to influence financial regulations by the state for their own gain. (Dal Bo 2006, 203)

**Models of regulatory capture**

There are various theories and models associated with the concept of regulatory capture. In the private interest view, a natural monopoly or oligarchy, for example utilities, enables a firm to improve its position regardless of social costs. A complementary argument to this, known as the public interest view argument, states that in dealing with a monopoly or oligarchy, regulators will be motivated to protect society from monopolistic abuse (McCraw 1975). However, the motivations of the regulator are not always benevolent, as they can be captured by the firms that the regulator is supposed to regulate. This view was articulated by Stigler (1971) for the first time.

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9 See Joskow (2005) for a more comprehensive explanation of the private interest view.
Stigler's ideas were further refined by Peltzman (1976), who proposed a formal model focusing on price-entry regulation. This model concentrates on three classes of players: politicians, producers and consumers. The basic propositions of the model are as follows: Politicians need to maximise public support, which is represented by a function $M(p, \pi)$, wherein $p$ is the price of goods available to the consumers (general public) and $\pi$ is the profits of the producers (industrialists). $M(p, \pi)$ decreases if $p$ increases, whereas it increases as $\pi$ increases as the producers can mobilise voters through their financial power. Peltzman shows from his model that the public support of the politicians, $M(p, \pi)$, is maximised when the price of the goods is set somewhere between the purely competitive and the truly monopolistic price. According to the model, the price of goods set by the politicians, or the ‘political price’, would usually result from a compromise between perfect consumer protection and perfect producer protection. Hence, regulatory entry in monopolies, such as utilities, would reduce the price from the monopolist to the political price.

Regulatory intervention in competitive industries such as finance, however, would lead to an increase from the competitive to the political price. The loss of votes from the consumers would be more than compensated by the gain in support from the producers, in terms of increased political donations and support. However, the Peltzman’s model suffers from many limitations. First, it assumes that regulations are introduced only for maximising political gains and not for social reasons. Second, it treats the consumers and the producers as passive players; the politicians are the only active player in the model. Third, it fails to illustrate the effects on the mood of consumers and producers on regulating prices when supply and demand of goods fluctuate.

To improve upon the limitations of the Peltzman’s model, Tirole (2006) developed a model called “Private Information and Collusion in Hierarchical Agency”. This model helps in understanding the role of asymmetric information as a source of regulatory discretion, enabling capture. It is based on a three-tier hierarchy comprising the government, a regulator and a firm. For a monopolist firm, the production cost is not known to the government. The government would like the firm to produce the quantity of goods desired by the public. Therefore, it provides remuneration to partially mitigate the production cost. Thus, the firm has an incentive to overstate its production cost in order to maximise government remuneration. The government appoints a regulator to determine the production cost and the remuneration to the firm. The firm may try to collude with the regulator for higher government remuneration, even when the production cost is low. This capture of the regulator depends on the ability of the regulator to obtain information and the existing culture of corruption.
Instruments of regulatory capture for individual regulators

Several instruments can be used to influence the behaviour of a regulator. Positive incentives include bribes, monetary payments influencing political motivations (campaign contributions), and lucrative employment offers in the industry (Ramirez 2000 and Etzioni 2009). In some instances, regulators come from the industries they regulate, and they may be hired back in the same industry after discharging their responsibilities. This is known as the ‘revolving door’ policy and can exhibit its influence in multiple ways (Dal Bo 2006). The regulators that have come from industry may take pro-industry positions. Employment opportunities beyond the regulatory sphere may motivate regulators to reward an industry with lenient regulations.

Negative incentives include intimidation and dissemination of rumours about the regulator. The use of negative instances is widespread in economies where the rule of law is not well established and may help the firms save money used for rewards (Dal Bo 2006).

Instruments of regulatory capture for collective bodies

When regulations are imposed by a decision-making body or a legislature composed of many members, instead of a single regulator, a firm attempting regulatory capture (lobbyist) would need to decide how much to bribe some members to influence the decision of the legislature in its favour. Shubik and Young (1978) and Young (1978a, 1978b) have analysed the relationship between the size of the bribe a lobbyist would offer a member of the legislature and the relative power of the member in the decision of the legislature. For example, a member with veto power may command a higher bribe than a member with only voting power.

Snyder (1991) studied a case in which each member of the decision-making legislature has a vote and the decision is taken based on simple majority. The key result of his study is that the members of the legislature who are slightly opposed to the decision favouring the lobbyist command largest bribe as opposed to those strongly opposed or strongly in favour of the decision. Snyder (1991) also shows that if lobbyists are willing to cooperate with each other, an equilibrium set of bribe policies exists.

Regulatory capture by the finance industry

The financial industry is one of the most regulated sectors for both developed and developing economies. Strict regulations are often imposed and a significant share of the operating costs of financial institutions is for regulatory compliance.
The finance industry needs regulation because of many of its unique characteristics.

First, the externalities from an individual bank's failure both to other banks and to the wider economy are greater than other industries. If a bank fails, it creates a sense of fear and uncertainty among investors, which affects their willingness to invest in other banks. This may result in liquidity problems in other banks. In an environment of fear and panic, the banks may also start lending credit at higher rates, which may slow down the recovery of the economy (Brunnermeier 2009). The second unique characteristic of the finance industry is how the collective behaviour of individual banks can undermine the industry. For example, selling an asset when the risk increases is prudent behaviour for an individual bank, but if many banks do the same thing, the asset price may crash (Brunnermeier 2009).

The characteristics of the financial sector, which make regulation especially susceptible to capture by the financial industry are the presence of asymmetric information between financial institutions and their clients, systemic effects, prevalence of risks, and possibility of collusion among different institutions. In addition, the industry keeps innovating complex financial instruments. Since the regulatory framework does not already exist for these instruments, their market remains unregulated (Ramirez 2000, Sherman 2009). For example, the derivatives market in the United States remained largely unregulated before the financial crisis of 2007-2009 (Sherman 2009).

The financial industry includes large institutions and these often form strong trade associations capable of supporting powerful lobbies to influence legislative debate about regulatory measures. Financial institutions also have access to various channels of influence through political connections. In addition to organisational aspects such as supervisory access to data and documentation, insider updates on new products and operations, and lucrative job offers within regulated financial institutions, the complexity of financial regulations facilitates capture. Their length and intricacy, specialised skills, and maintenance of confidentiality complicate the process of determining whether regulation and supervision have been unduly influenced.

Implications of regulatory capture in the finance industry

Amid risk and asymmetric information, regulatory capture has distinct implications. Hardy (2006) models the effect of regulatory capture by banks on the risk-weighted capital adequacy requirement, CAR or Cooke ratio, set by a regulatory body. He discusses a scenario in which the CAR is decided by
collusion of large and medium-sized banks. This is realistic as the large and medium-sized banks can have more resources to influence regulatory bodies.

However, this CAR value influences the investment decisions of small banks more strongly as they do not have access to large amounts of capital. In the collusion of banks, the participating banks tend to set a value $\chi$ (CAR) for which their risky investment decisions are not curtailed. That is, the colluding banks decide on a value of $\chi$ such that:

$$L_{\text{medium}} > K_{\text{medium}} / \chi$$

where $L_{\text{medium}}$ is the amount that the medium-size banks would like to invest in risky assets and $K_{\text{medium}}$ is the total capital held by the bank. Based on this model it is possible to estimate how the expected bank net worth ($E(\pi)$) of a small bank would be effected if there were an increase in CAR because of regulatory capture. As per the model, the $E(\pi)$ of a small bank is given by:

$$E(\pi) = \int_{r} \left( \frac{rK}{\chi} + s(D + K - \frac{K}{\chi}) - iD \right) f(r) dr$$

where $K$ is the total capital held by the bank, $r$ is the return on investment of risky assets, $\chi$ is the CAR value, $s$ is the return on investment for stable, non-risky assets, $D$ is deposits, $i$ is the interest rate on deposits, and $f(r)$ is the distribution function of $r$.

Investments in risky assets are limited by the ratio $K/\chi$. If the banks invest the maximum allowed amount in risky investments, then the return on riskier investments for small banks is given by:

$$I_r = \int_{r} r f(r) dr \frac{K}{\chi}$$

Therefore, an increase in $\chi$ severely limits the return on investments for small banks, whereas, the large and medium-sized banks face fewer restrictions in investment. As a result, if the risky investments have a good return, large and medium-sized banks benefit much more than small banks. Further, the small banks would seek to invest in regions where $\chi$ is smaller. This will further increase the dominance of large and medium-size banks in a region, where financial regulation has been captured. This is one example of how regulatory capture can alter the operating conditions and playing field of the banking industry within a region. Large banks, once labelled “too big to fail” benefit from
government bailouts in the event of financial distress; this was the case in the United States in 2008.

The remuneration practices of private finance institutions have so far remained largely outside the aegis of government regulations. However, the remuneration practices of many financial institutions often adversely affect the stability of the financial industry (Brunnermeier 2009). This happens because, in many financial institutions, the financial decision makers receive a portion of the profits generated in a time period but they do not absorb losses generated in other time periods. This encourages the decision makers to knowingly undertake risky trades. Private institutions strongly oppose the regulation of employee salaries and bonuses by government bodies, stating this to be against free market economics.

The finance industry in the United States

Since World War II, the financial industry in the US has grown rapidly because of many regulatory changes, such as the removal of interest rate ceilings and withdrawal of the Glass–Steagall Act. In 2008, the total outstanding derivatives trading market in the US was estimated to be of the nominal value of $531 trillion, whereas GDP in 2008 was $14 trillion (Sherman 2009). A growing financial industry was seen as important for rapid growth of the economy. Today, the US has one of the most advanced financial systems in the world.

The American finance industry gained political power due to its significant role in supporting domestic financial interests in a global economy. The most prominent channel of influence is the exchange of personnel between the huge financial firms and the financial regulatory bodies. “It has become something of a tradition for Goldman Sachs employees to go into public service after they leave the firm. The flow of Goldman Alumni – including Jon Corzine, the former New Jersey governor and former US Treasury Secretary Henry Paulson – not only placed people with Wall Street’s worldview in the halls of power, it also helped create an image of Goldman as an institution that was itself almost a form of public service” (Johnson 2009).

Another channel by which the finance industry is able to make political connections is by funding election campaigns for national, state and local offices. There is strong evidence that once elected, those in office reward those who supported them with legislations that favour their interests (Etzioni 2009). These relationships, along with the favoured status of the industry, have a potential of generating policies, which favour less strenuous regulations in the financial industry.
Regulatory capture by the finance industry at a transnational level

The problem of capture at the domestic level is amplified at the transnational level. The highly technical nature of financial regulation provides privileged access points for the players of the finance industry at the transnational level. For instance, “the Institute of International Finance, a leading global association of various financial organisations, worked closely with the Basel Committee on Banking Supervision,” thereby suggesting the utilisation of several risk models devised by these firms (Helleiner and Porter 2009). These risk models proved to be inadequate in identifying several implications pertaining to the crisis. Also, other representatives besides those from the financial industry did not participate actively in this consultative process.

Further, there was a lack of sufficient representation from developing countries in the formation and modification of these transnational regulatory networks. Representatives from the industry state that it is essential for financial firms from advanced economies to be involved due to the sophistication of the industry in those economies and the expertise these institutions can lend. However, this privileged access may contribute to undue influence of such regulations, encouraging reckless behaviour rather than mitigating it. The passive involvement of non-financial actors and lack of representation from developing nations have enabled an environment in which the views of the finance industry of developed countries dominate at the transnational level.

Another problem emerging from regulatory capture of transnational networks has been the inability of non-financial actors to endure the repercussions of such reckless endeavours. Capture of transnational networks is a severe problem because the activities of these networks are not under the complete jurisdiction of their home governments.

Policy recommendations

The main lesson from the issues mentioned in Section I is that there is a high probability of regulatory capture in the finance industry as financial organisations tend to have informational advantage over the public and political representatives. The regulatory agencies associated with monitoring the informational advantage of the firms can be influenced. Since the capture of regulations undermines their purpose, what actions can be taken to make regulations more resistant to capture and more likely to serve the public interest?
The policy actions to prevent regulatory capture can be divided into two groups: (a) creating an environment that discourages or makes regulatory capture difficult; and (b) creating regulatory machinery more resistant to capture. Policy recommendations that may discourage regulatory capture will be discussed first.

As suggested by Etzioni (2009), the most effective way to prevent regulatory capture is to limit the private money involved in political campaigns by reducing campaigning time and reforming campaign-finance laws. However, overhauling the election mechanism in a country may not be always feasible.

Another mechanism that may reduce the susceptibility of regulatory capture by the financial industry would be to develop effective ways of facilitating sharing information amongst stakeholders of the firms. This may include releasing documentation of complex financial instruments developed by a firm; providing break-up of sectors in which investments are done and so on. Financial institutions regularly develop new complex instruments. New instruments can inject further uncertainty into an already unstable financial environment. As many regulatory professionals and stakeholders may not understand their effects, these instruments work against the principle of transparency essential for a stable financial market. To ensure more transparency on these instruments, documentation as well as their analysis via simulations should be provided to the regulators and stakeholders.

Regulations may also mandate changes to the remuneration process of employees. Instead of allowing bonuses based on the performance of their trades, they could be offered future stocks options of the firm so that they not only absorb the profits made by the firm but also its losses. This will discourage risky trades and hence regulatory capture to deregulate such trades. Practically, regulating the remuneration process can be complicated as most of the funds are generated through unregulated private hedge funds as well as private equity firms.

To stabilise the finance industry, it may be prudent to limit the size of individual banks so that their failure may not significantly impact the entire industry. One way to do this could be to decrease the credit-to-liquidity ratio permitted to each bank. Furthermore, to ensure that the large and medium-size banks do not collude to capture the regulator to fix the credit-to-liquidity ratio in their favour, this ratio should be decided by the size of an individual bank. For example, the ratio may be fixed to a higher value for small banks in comparison to that for large banks. Measures that promote the growth of the finance industry also promote the growth of rent seeking activities, which may be profitable for the actors involved but not contribute to the welfare of the state. Smaller financial
institutions also means an industry with less political power as oversized institutions with more capital have the potential to exert more influence in the government. Hence, private banks should be subject to size limitations. This will require an overhaul of existing regulations and a systematic break-up of banks, which implies division by region or function. In such a scenario, it will be easier to maintain a regulatory structure less influenced by the finance industry (Baker 2009).

Policy changes to make the regulatory machinery robust to regulatory capture are equally important. Solutions such as linking regulators’ pay to their performance, use of above-market wages for the regulators, and regular scrutiny of regulators’ reports have been studied by many researchers (Becker and Stigler 1974). However, they concluded that such solutions are not feasible: above-market wages may become astronomical and scrutiny of documents may not be perfect (Dal Bo 2006).

To discourage the revolving door phenomenon, anti-poaching laws should be introduced to prevent individuals working in regulatory bodies for long terms to seek employment in the financial industry. In the case of short-term employment, banning post-regulatory employment in the finance industry may not be a very effective solution, as individuals with technical expertise would not want to lose their position within the industry to assume a short-term assignment. Furthermore, short term periods are not effective even if a regulator is permitted to undertake post-regulatory assignments in the finance industry, as the regulator would have reputational concerns and may turn a lenient eye towards the industry. To ensure a robust regulatory mechanism, apart from a local regulatory body, government may consult an independent, international regulatory body to ensure that there is no collusion between the regulators and financial institutions.

Furthermore, in cases where financial regulatory commissions are run by boards instead of an individual regulator, influencing the other party becomes easier for the powerful lobbies representing the interests of the finance industry, as they can ensure capture at low costs by targeting board members with “minimum prices”. The protection against this vulnerability is the enforcement of cooperation among board members and board accountability to other parties.

The accountability of the Central Bank to democratically elected officials should be enhanced. In developed as well as emerging economies, the trend has been to promote independence of the Bank to resist pressures pertaining to pursuing an inflationary monetary policy. However, this is not its sole responsibility. The institution is also entrusted with the responsibility of maintaining the stability of the financial system. While it is not desirable for the Bank to be politically
manipulated by the governing party, the rules, which guarantee independence of
central banks from political manipulation, have come under influence by the
financial sector. By their nature, central banks are very closely associated with the
finance industry. While this close association helps central banks curb inflation, it
may reduce their ability to discharge the other responsibility of sustaining
employment and maintaining systemic stability.

If a Bank is closely tied to the finance industry, it may display leniency towards
financial institutions. Such a scenario can cause instability in the finance industry.
This is because the Bank may not attack this source of potential profitability due
to its close ties with the latter. This regulatory oversight had a major role to play
in the recent global financial crisis. As such, central banks should possess greater
independence from the finance industry and increase accountability to elected
officials.

While there is no simple method to achieve the desired degree of independence
of the Central Bank from the financial sector as well as from the political
manipulations of the governing party, various measures can be taken to move
towards the right balance. A new motivation for accountability should be created
for public officials occupying prominent economic policy positions in
government departments as well as in various international finance
organisations.

Finally, solutions to regulatory capture at the transnational level may involve
initiatives like the construction of a wider set of global public policy networks
with involvement of non-governmental organisations as well as international
organisations. These bodies are equipped, to a certain extent, to manage such
problems at a broader level. Another arrangement can involve a peer review
process in financial regulatory networks. It might also be useful to create a small
multilateral body responsible for finding problems with transnational financial
regulatory networks. In addition, a set of actors interested in systemic stability
and stronger regulation, with the power to lobby against the financial actors
benefiting from excessive risk-taking, like the insurance industry, could be
fostered. Finally, these networks can also be subject to a private sector audit
ensuring compliance with to process standards.

Conclusion
The finance industry engages in regulatory capture because of many of its unique
features, such as the presence of asymmetric information between financial
institutions and their clients, systemic effects, prevalence of risks, and possibility
of collusion among different institutions. Often, large and medium-sized financial
institutions collude to form strong lobbying groups to create favourable regulations, which hurt the investment decisions of small institutions, leading to the merger of small firms with the medium and large finance institutions.

This trend is dangerous as the failure of large financial institutions can severely impact the economy. Policies have been recommended to create an environment, which discourages capture, such as limiting private money in political campaigns, promoting information sharing with the stakeholders, modifying the remuneration process, keeping a check on the growth of financial institutions, and careful scrutiny of the impact of new innovative financial instruments.

Furthermore, policies have been recommended for making the regulatory bodies more robust to capture, such as, introducing anti-poaching laws to prevent the “revolving door” policy, auditing the performance of the local regulatory body and finance institutions by an independent, international body, and making the central bank independent from the finance industry and accountable to the government.

References


The chief strategic paradox at the heart of federal systems of government is that while a federal government may be constitutionally responsible for foreign policy, it often has little control over the ‘talent’ produced to populate the principal instruments of national power, including defence and diplomacy. This is because in most federations, it is typically the states or provinces or Länder that have the constitutional lead, in division of legislative power terms, in educating citizens. Federal governments are therefore often passive or quasi-passive recipients of the talent produced ‘upstream’, as it were, by lower levels of government that seldom think (or think properly) about foreign policy (Studin 2011). If such talent is, in the final analysis, ill-suited to the strategic goals or orientations set by the national government, then a country may indeed find itself in a quandary of generational proportions.

Now we might understand why Australia’s 2012 white paper on Asia (Australian Government 2012) is so strategically remarkable. Whether Australia is able to achieve its stated objectives of permanently and powerfully ensconcing itself in the Asian continent and century has yet to be seen. Still, Canberra has proven that it probably understands better than any other federal capital in the world

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11 Defence and diplomacy, in their broadest conceptions, may in principle be thought to include such ‘sub-instruments’ of national power as intelligence and development assistance. We might define a state’s (external) power as its capacity to intentionally make a foreign party – usually another state or group of states, and non-state affiliates – do (or not do) something, which that party would otherwise not have done (or would have done).

12 Of course, provinces and States and Länder often do engage in ‘foreign policy’ as an extension of their domestic activities, as is authorized constitutionally, and indeed often spend money in areas of foreign policy (e.g. external lobbying or international development and trade) – even if, strictly speaking, they may not be constitutionally competent to pass laws on foreign affairs.

13 Asia is not explicitly defined as a region in this document, but it does not include Western Asia (including the Middle East) and Central Asia. Russia is clearly not considered part of Asia in the white paper. In section 1.1 of the white paper (p. 30), ‘Asia’ is defined as including “India through Southeast Asia to Northeast Asia, including Indonesia, other Association of Southeast Asian Nations (ASEAN) members, China and Japan.”

14 Of the 25 “national objectives cited for 2025” outlined in the Gillard white paper on Asia, at least six objectives (numbers 2, 9, 10, 11, 12 and 14) rely prima facie on the States’ lead in educating Australians for strategic effect.
what type of strategic logic is required in order to systematically torque an entire federation for meaningful performance in international affairs – that is, to overcome the said strategic paradox of federalism. In aligning educational goals at the state level with foreign policy goals set at the national (Commonwealth government) level, Australia is arguably at least a decade ahead of more capacious federations – including Canada, the United States, Germany and Brazil – in its thinking.

Of course, much of the credit for this strategic logic must go not to Prime Minister Julia Gillard but to former Prime Minister/Foreign Minister Kevin Rudd. This is not because Rudd is, as is well established, a Mandarin speaker or Sinophile, but because, when a top official in the Queensland state government in the early 1990s, having just returned from diplomatic posting in Beijing, he was able to combine a technocrat’s mastery of the machinery of the Australian federation (the different levels of government and their respective constitutional responsibilities and levers) with a linguist’s and sociologist’s appreciation for the plain fact that a country and its people are most effective in an entirely alien land – nay, alien continent – when they speak its languages, understand its cultures, have first-hand work and travel experience of the continent, and can cultivate and profit from deep personal relationships and shared histories with its denizens (Studin 2012a; Rudd 1994). (After all, as the late great Australian wit Donald Horne once wrote in respect of Australian-Asian relations, “assimilation is best done in bed.”)

The original Rudd Report (Rudd 1994) championed Asian literacy for future Australian generations through, among other things, a national Asian languages
strategy, including the study of Bahasa Indonesia, Mandarin, Japanese and Korean in Australian schools. (The Gillard white paper of 2012 repeats this push for languages, but replaces Korean with Hindi.) Rudd drove this Asian languages strategy, from his base in Brisbane (not Canberra), through the Council of Australian Governments (COAG) machinery – the impressive federal-state intergovernmental forum that, with its vast web of subcommittees and robust reporting relationships to the top levels of government, makes Australian federalism so much more administratively cohesive and strategically coherent than that of say, the ‘competitive laboratory’ federalism of America or the ever-decentralizing federalism of Canada, where there has long not been a standing first ministers’ forum or conference to coordinate or bind the efforts of different levels of government (Studin 2008) for effect beyond Canada’s borders, and where, quite unusually, there is no national ministry or department of education. Indeed, Canada’s historical inability to negotiate the strategic paradox at the heart of federalism is, by contrast with Australia’s, instructive. In principle, Canada is a much larger, older, wealthier, more internally complex

priority Asian languages. We are working to make this access a core requirement through new school funding arrangements between the Australian Government, the States and Territories and non-government education authorities.”

16 In the United States, constitutional powers not explicitly granted to the federal government, and not otherwise prohibited, are reserved to the States and the people under the 10th Amendment. Specifically, States under this amendment have a ‘police power’ – that is, the authority to make laws for the protection of the health, morals, safety, and welfare of the people. [This is loosely analogous to Canada’s constitutional granting of powers to the provinces in “property and civil rights in the province” and “generally all matters of a merely local or private nature in the province” in sections 92(13) and 92(16), respectively, of the Constitution Act, 1867.] As education is not explicitly granted to the federal government, it is considered a plenary power of the States. The federal government as a result manifestly has fewer ‘ins’ into education policy than do national governments in unitary states, and therefore less control over the ‘talent’ produced across the States over time to populate key instruments of American national power. Consider the famous counterpoint in defence of the strategic legitimacy and necessity of the federal government of foreign policy in “Federalist No. 70” (Hamilton, 1982, 426). Hamilton (1982: 427) argues: “The ingredients, which constitute energy in the executive, are first unity, secondly duration, thirdly an adequate provision for its support, fourthly competent powers.”

17 Both Australia and the United States have national departments or ministries of education. So too does Brazil.

18 In territory and population, Canada is, respectively, almost 70 percent and 30 percent larger than Australia.

19 Leaving aside the far earlier European landing in North America vis-à-vis Australia, in purely political terms, Canada was federated, in its final form, in 1867; Australia in 1900.

20 Canada’s nominal GDP in 2011 was about 16 percent larger than that of Australia.
federation, with deeper and more formidable intellectual traditions than Australia. And yet, in foreign policy, Canada has proven itself patently incapable of even imagining its federal structure as a ‘system’ that can be made to advance national strategic objectives. Case in point: in 2007, borrowing from Australia’s paradigm of regional leadership in the South Pacific (Australian Government 2006), Canadian Prime Minister Harper declared that Canada intended to become a strategic leader in the Americas region (Harper 2007). The ambition was serious, but nowhere in the accompanying strategy was there any evidence of understanding of what would seem an obvious need for Canada’s provinces

21 Aside from the larger number of provinces – that is, coordinate levels of constitutionalized government – in Canada as compared with Australian states (ten to six), the Quebec question is arguably the major factor that makes internal governance of Canada more complex than that of Australia. See Studin (2012b).

22 See the author’s writings on what the ‘Strategic Constitution’ is in Studin (2013 (forthcoming); 2012c; 2010). The Strategic Constitution is a construct that posits the effective strategic power of a state as suggested by the ‘strategic sections’ of its constitution (treated textually, jurisprudentially and doctrinally). These sections fall under the following categories, called ‘factors of power’ of ‘elements of power’: military, diplomacy, executive potency, natural resources, economy, transportation, communications and, finally, national population. (Education is arguably another factor of power that is not explicitly treated as such in the Strategic Constitution construct.)

23 In Canada, the provinces having sole legislative power in respect of education via section 93 of the Constitution Act, 1867 – something affirmed in section 29 of the Charter of Rights and Freedoms. Of course, the federal government may constitutionally involve itself in education via the spending power, which is chiefly a function of sections 91(1A) and 91(3) of the Constitution Act, 1867. In Australia, the federal spending power in its conditional form – sometimes called a “tied grant” – is given expression in section 96 of the Commonwealth of Australia Constitution Act, 1900.

24 I happen to have been principal author of this Australian counter-terrorism policy, written while I was on secondment to the Australian Department of the Prime Minister and Cabinet in Canberra from the Canadian Privy Council Office in 2005-06. Australian strategic leadership in the South Pacific and even in Southeast Asia was central to the logic of that document.

25 The Harper strategy sought to position Canada to advance three strategic goals or interests in the Americas: economic prosperity, security and democratic governance, all broadly conceived. See also Studin 2009.

26 In respect of constitutional jurisprudence, Canadian commentators like H. Scott Fairley have suggested that “[i]n the absence of textual guidance, notions of divided autonomy gleaned from the jurisprudence of Canadian federalism, not the implications of national sovereignty [or national strategic power, for that matter], came to dominate the judicial interpretation of constitutional principle in relation to the subject of external affairs” (Fairley 1987: 6).
to create Spanish (and even Portuguese) speakers for this ambition to be assessed as credible by outside analysts.  

Unitary states like Singapore, Japan, South Korea, Vietnam, Ukraine, France and even Russia (not a real federation) may not fully appreciate the constitutional and administrative back-flipping that Australia is undertaking in order to become a real player in Asia. For in unitary countries, the national or central government has, as a rule, full constitutional authority to write and rewrite the national academic curriculum as national goals dictate and change. Historically, this is manifestly a prerogative that revolutionaries have fought tooth and nail to wield – the ability to control the national government in order to teach their subjects what they fancy to be proper and appropriate, and in order to shape national narrative and identity. And it is one of the key stakes in the current revolutions comprising the Arab Spring, where all of the relevant states, from Tunisia to Egypt, Syria, Bahrain, Kuwait and Jordan, are unitary, if not hyper-unitary.

Even if it is on paper and through jurisprudence a reasonably centralised and symmetrical federation, Australia has long recognized that, in respect of the

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27 Most of the countries in the Americas follow the civil law tradition. Most of the Caribbean countries, however, follow the common law tradition. English is evidently the official languages in most of these common law jurisdictions – the observation plainly being that Canada would, on its current pedagogical structures, have greater ease in ‘leading’ strategically in English-language jurisdictions in the Americas; all the more because of the common law and comparable Westminster-style political institutions. French-language-cum-civil law jurisdictions like Haiti would also be reasonably amenable, other things being equal, to Canadian strategic leadership, but there are very few other such countries in the region (e.g. Guadeloupe and Martinique); that is, the overwhelming majority of the countries in the Americas have Spanish (or Portuguese) as the official language, and have civilian legal systems.

28 We might even call Singapore a ‘hyper-unitary’ state, given that there is effective identity between the national and local levels of government, whereas larger unitary states have degrees of decentralization that may, in extreme cases (e.g. Indonesia) approximate federal systems.

29 The ‘power vertical’ that is driven down from the Kremlin in Moscow to the lowers levels of government, especially through the President’s appointments power, makes it difficult to categorize the Russian Federation as a real ‘federation’. See for instance Protysk (2004).

30 Even if residual powers are with the state governments in the Australian Constitution and with the federal government in Canada’s Constitution, the state of the Canadian federal treaty power stands in marked contrast with that of the Australian Commonwealth (federal) government – as mentioned, a government highly comparable to that of Canada – for which the Commonwealth of Australia Constitution Act, 1900 provides an explicit external affairs power in section 51(xxix), and for which the Australian High Court decided favourably in two landmark cases involving treaty powers in the early 1980s: Koowarta and, most importantly, Tasmanian Dam. In both cases, the High Court affirmed that the Commonwealth government had constitutional authority,
Asian imperative, if New South Wales, Queensland, South Australia, Western Australia and Victoria (leaving aside Northern Territory and the Australian Capital Territory) are all allowed to teach as they see fit, according to goals and narratives established strictly in state capitals, with no conspicuous regard for, or accountability to, national strategic objectives, then Australia is, in strategic terms, going nowhere fast. For the ‘Lucky Country’, which until fairly recently

under section 51 (xxix), to unilaterally implement international treaties, even those affecting areas of State responsibility. Suffice it to say that the Commonwealth government has since been very activist in strategically – on occasion, some might suggest even colourably – leveraging the external affairs section and the concomitant expansive treaty power. (Such ‘colourable’ use of the treaty power by the Commonwealth government may well extend into education policy, thereby giving Canberra an ‘in’ into this area of state affairs.) By contrast, as a practical example of the strategic weakness of the Canadian federal executive in respect of treaties, even at the negotiation phase, the Government of Canada has to date had considerable difficulty agreeing on a consolidated ‘Canadian’ or whole-of-Canada position in respect of a number of major trade deals, including with the European Union, as a result of the need to regularly consult with the provinces on jurisdictional matters that would presumably affect the implementability of an eventual agreement. This is on account of the controversial Labour Conventions case of 1937 in which the Judicial Committee of the Privy Council, in interpreting the imperial treaty implementation provision of section 132 of the Constitution Act, 1867, conceived of the division of powers between the federal and provincial governments as “watertight compartments,” and thereby distributed treaty implementation power between the federal and provincial legislatures and governments, depending on whether a treaty subject matter falls under federal, provincial or joint jurisdiction. The critics of this decision continue to denounce it as having emasculated not only the federal treaty implementation power, but also, in practice, the federal capacity to negotiate international treaties purposefully and efficiently – a power formally and exclusively reserved for the federal government under the royal prerogative – because the federal government is often forced to pre-consult extensively, and sometimes unsuccessfully, with provinces.

Note also that the expansive interpretation given by the courts in Australia to the so-called corporations power in section 51(xx) of the Commonwealth of Australia Constitution Act, 1900, like the commerce clause in Article 1, section 8 of the U.S. Constitution, has greatly facilitated the erection of a more cohesive economic union within the Australian federation than is the case in Canada.

A scenario in which each Australian state maximizes its own legislative interests (or, say, welfare) is not necessarily conducive to the maximization of pan-Australian or federal interests (or welfare, or, ultimately, strategic power). A presumption to the contrary would be a patent fallacy of composition; that is, a false presumption that something that is true of the part is necessarily true of the whole. In the Canadian federation, such a fallacy of composition is suggested in another strange paradox that issues from the divided nature of the treaty power in Canadian constitutional law, as discussed above in note 22. Let us call this the constitutional paradox of (Canadian) strategic defeat in the context of war. We may envision Canada, for instance, negotiating an end of hostilities treaty with a victorious adversary, but not being able to implement it! This would bring new meaning to Trotsky’s famous aphorism of “neither war nor peace.” We might ‘game’ the paradox as follows: Canada loses a war. The federal government signs a surrender treaty, but is unable to implement parts of it over provincial objections. Other things being equal, the victor resumes war in order to force implementation of the agreed treaty.
had a White Australia policy, is not, contrary to conventional wisdom, necessarily in Asia. Asia is not, by history, culture and strategic imagination its ‘natural’ or ‘self-evident’ region. But if Australia is to really be in Asia, then the country’s federal structure and systems must be reconfigured for integration into the Asian theatre, and the mentality of Australians must migrate in order to accept and understand this reconfiguration.

The Rudd Report was ultimately unsuccessful in generating large-scale literacy in Asia among Australia’s leaders across the sectors. Enrolment in Asian languages at advanced secondary school and university levels across Australia’s universities is at present poor, and in many cases declining (Australian Government 2012, 168). The Gillard strategy is giving this another go, with the stated national objective of giving all Australian students access, for purposes of continuous study, to at least one priority Asian language throughout their years of schooling. It aims to ensure, as a result, that at least one third of all Australian senior civil servants (and directors of the leading 200 Australian public companies) have deep knowledge of Asia by the year 2025. The Prime Minister is to be commended for repeating what has already been tried, for it is, in the end, the only way to go for a federal system. She and subsequent prime ministers will to apply tremendous pressure on this system over time, and will have to lever COAG, Canberra’s spending power, the bully pulpit and every law, trick and stratagem available to them and their cabinets if they are to succeed in truly making Australia and Australians ‘Asian.’

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Protecting Australia Against Terrorism. Canberra: Department of the Prime Minister and Cabinet, 2006.

The federal government surrenders again, signs a new treaty, but is again unable to implement it. War resumes. And so on.

32 See the Nez à Nez debate between Hugh White and David Skilling on the degree of preparedness of Australia and New Zealand for the Asian century in the Fall 2012 issue of Global Brief, “When Surrounded by Four Millions Asians.”


"Reflections on the Quebec Question." Policy Options, February 2012b.
The nuclear disaster at the Fukushima Dai-ichi power plant in March 2011 marked a defining moment in the energy policy landscape of Japan. Following the nuclear accident, Japan is remodelling its energy policy architecture. Weighing the potential energy mix options unfolded a dynamic policy debate where stakeholders are fiercely competing for space. The role of nuclear and renewable energy in the future energy matrix constitutes the nucleus of this debate. In shaping the future energy strategy, the policymakers are battling gargantuan challenges including resource deficiency, offline nuclear reactors, electricity demand-supply gap, shooting energy import bills, augmenting emission from thermal power substitution, limited scope for energy efficiency, and stern anti-nuclear sentiments as opposed to the once invincible nuclear village. The nuclear accident has led to an energy deficit within the country, amidst escalating economic pressures arising from sharp appreciation of the yen, high corporate tax, labour cost, emission standards and delays in free trade agreements. At this critical juncture, Japan can hardly afford immediate elimination of nuclear energy from her electricity mix without mapping a realistic plan to bridge the shortfall. However, drawing from the Fukushima catastrophe, energy administration should not miss this opportunity to undo the regulatory capture by parting ways with the nuclear village and making tangible efforts to gradually reduce nuclear dependence and create space for safer and clean alternative sources.

Introduction

The nuclear disaster at the Fukushima Dai-ichi power plant in March 2011 marked a defining moment in the energy policy landscape of Japan. Following the nuclear accident, Japan is remodelling its energy policy architecture. On 14th September 2012, eighteen months after the Fukushima nuclear catastrophe, the Energy and Environment Council (EEC) presented the Innovative Strategy for Energy and Environment (ISEE). The ISEE redefined the contours of Japanese energy policy post-Fukushima accident. It aims at mobilising all policy resources to “realize a society not dependent on nuclear

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power in earliest possible future.” The Strategy, which manifests several discrepancies, aims at “zero operation of nuclear power plants in 2030s.” The policy direction apparently marks a departure from the 2010 Basic Energy Plan (BEP), which engraved nuclear as the core of energy policy. Nevertheless, on 19 September 2012, ISEE encountered impediments in managing endorsement from the cabinet. Avoiding any reference to the zero-nuclear commitment deadline, the cabinet spelled out that Japan will put the strategy into practice “by constantly reviewing and re-examining policies with flexibility” (National Policy Unit, September 2012).

The latest development in the energy policy domain is not well-received by either the anti or pro-nuclear interest lobbies. The zero-nuclear reliance goal vexed the pro-nuclear clusters including business groups, host prefectures and international partners. On the contrary, the continuation of the nuclear fuel cycle program, considering the reactivation of offline nuclear reactors as an “important power source” and resumption of unfinished construction of J-Power’s Ōma nuclear plant, failed to placate anti-nuclear groups and dilutes the spirit of ISEE. Following the Fukushima accident, public disenchantment with nuclear safety culminated into wide anti-nuclear mobilisation. However, the business lobby astutely manoeuvred the restart of reactors at the Ōi nuclear plant (reactor no. 3 and 4) in July 2012 to help rescue the economy. This development happened two months after Japan went zero-nuclear with the shutdown of Tomari nuclear plant, the last of the 50 reactors, for routine maintenance in early May 2012.

The review of possible energy mix options has unfolded a fierce debate involving the national and local governments, business lobbies, political parties, academia, and civil society. At the epicentre of this debate is the fundamental question about the role of nuclear energy in the future energy matrix. What are the possible options for bridging the energy deficit created by the offline reactors? What is the complex web of pressures shaping the future of Japanese energy policy? Will Japan be able to seize the opportunity offered by the on-going crisis to craft an energy policy for a sustainable future? The paper concludes that the challenge of fuelling the economy impedes immediate elimination of nuclear energy. However, Japan should not miss this opportunity to make tangible efforts to gradually reduce nuclear dependence and shift to safer and cleaner alternative sources.

Existing literature offers a dynamic analysis of Japan’s energy policy (Vivoda 2012; Takase and Suzuki 2011; Takubo 2011; Scalise 2011; Duffield and Woodall 2011; DeWit 2011; Uchiyama 2002; Perkins 1994; Murota and Yano
1993; Eguchi 1980; Sakisaka 1975). Some research focuses on critically evaluating the role of nuclear energy (Koide 2011; Aldrich 2011; Valentine and Sovacool 2010; Pickett 2002; Suzuki and Suzuki 1986), other research dwells on nuclear politics (Dewitt, Iida and Kaneko 2012; Hasegawa 2012; Carpenter 2011; Kingston 2011; Kanie 2011; DeWit and Kaneko 2011; Lesbirel 2003) and renewable alternatives (Iida 2012; Ayoub and Yuji 2012; Moe 2012; Ida 2011; Maruyama, Nishikido and Iida 2007). This paper contributes to the post-Fukushima energy literature by analysing the challenges and the opportunities offered by the nuclear accident in shaping the course of future policy.

The following section of the paper describes the impact of the Great East Japan Earthquake (3/11) and the subsequent Fukushima nuclear accident on the Japanese economy and environment. The third section contains two subsections documenting developments in the energy policy landscape pre and post-Fukushima disaster, in order to comprehend the origins of energy strategy choices. The fourth section analyses the challenges that shape Japan’s future energy policy direction, including resource deficiency, shooting energy import bills, offline nuclear reactors, electricity demand-supply gap, augmenting emission from thermal power substitution, limited scope for energy efficiency, and stern anti-nuclear sentiments as opposed to the powerful nuclear village. The fifth section discusses the opportunity offered by the on-going crisis to correct some of the flaws in the Japanese energy regime.

The impact of the great East Japan earthquake

The 3/11 “triple disaster” (earthquake, tsunami, and nuclear disaster) was an historic moment in Japan. The nuclear catastrophe at Tokyo Electric Power Company’s (TEPCO) Fukushima Dai-ichi plant was worse than the 1986 Ukraine’s Chernobyl disaster, and is rated as a “major accident” at Level 7. The 3/11 has been touted as the world’s costliest disaster. The World Bank estimates the earthquake damages at US$225 billion, 4 percent of GDP. The Japanese Government estimates the damage between US$195 to 305 billion, 3.4 percent to 5.3 percent of GDP. The disaster generated an estimated 22.5 million tons of debris in Miyagi, Fukushima, and Iwate prefectures. The Ministry of Environment (MOE) estimates 28 million cubic meters of contaminated soil in Fukushima prefecture. The Ministry of Economy, Trade and Industry (METI) decided to decommission all four damaged reactors in Fukushima over a period of 30-40 years.
Natural disasters are not aberrant in Japan. Japan survived the 1923 Great Kanto Earthquake and the 1995 Great Hansin Earthquake. Furthermore, Japan is not new to nuclear accidents. While the Fukushima disaster is considered a major accident, Japan battled several nuclear accidents including the Tsuruga (1981), Tokaimura (1999), Mihama-3 (2004) and Kashiwazaki-Kariwa (2007). However, the scale of the 3/11 disaster is unmatched in recent times. All of Japan's 50 commercial nuclear reactors have gradually been taken offline since the disaster, for routine maintenance. Public anxiety over nuclear safety has made re-starts enormously challenging. On 5 May 2012, Japan became nuclear free for the first time since 1970, as the last operating reactor no. 3 at the Tomari nuclear facility went offline. However, on 16 June, Prime Minister Yoshihiko Noda, after much persuasion, managed to garner favourable support from local authorities to restart two reactors at the Ōi plant in Fukui Prefecture to prevent an electricity shortage in western Japan. Before the disaster, all 54 nuclear power units had a total capacity of 48.96 GW. The offline reactors have presented Japan with the challenge of an energy deficit. Following the disaster, the Japanese economy faced a sharp downward turn with a supply side shock (Bank of Japan 2011, 1). The Ministry of Finance (MOF) confirmed that Japan posted a record trade deficit of US$55.26 billion in fiscal year 2011 and US$ 36.54 billion in the first half of the current fiscal year. This is primarily due to the sluggish recovery of exports post disaster, world economic slowdown amid the European crisis, yen appreciation, and a surge in fuel imports for power generation due to idled nuclear plants. Exports decreased 3.7 percent from the previous year to US$ 817.97 billion and imports expanded 11.6 percent to US$ 873.22 billion (IEEJ 2012a, 1). Former Prime Minister Naoto Kan described the 3/11-disaster as the toughest crisis the nation has confronted since World War II. The 3 E’s – economy, energy security, and environment – are the fundamental pillars of energy policy and were shaken by the disaster. The task of rebuilding Tohoku and critically rethinking the national energy policy presents a significant responsibility for Japanese policy makers.

Overview of Japanese energy policy

In order to enable a comprehensive understanding of the energy policy landscape that is currently under review, the following subsections briefly trace the pre and post-Fukushima policy trajectory.

Pre-Fukushima energy policy course

Post-war reconstruction was sustained by domestic coal as Japan opted for a coal-first/oil-second policy. The energy policy of the 1950s reflects preference
to guard the coal mining industry. However, in the 1960s cost-effective overseas oil made inroads into the energy mix to fuel the rapidly growing economy. In 1967, Japan formulated the first “long-term energy supply and demand outlook” report (Fukasaku 1995, 1064; Fujime 2000, 1). The 1973 oil crisis had deep repercussions on energy-intensive, export-centric manufacturing sectors in Japan. Japan became conscious of the significance of energy security for future economic progress. Dynamic strategies were initiated by the government to reduce energy consumption and reliance on imported oil. The decrease of oil was substituted by nuclear power and natural gas (Perkins 1994, 597).

Figure 1: Japan’s primary energy supply

![Energy Supply Graph]

(Nota) 1PJ (=1015 joules) is equivalent to approx. 25,800 kilolitres of crude oil in calorie
Source: Agency for Natural Resource and Energy

Energy conservation immune to international political instability was advocated as a means to secure energy supplies. With the second oil crisis, laws to “rationalize the use of energy” and “promote the development and adoption of alternative energies” were enacted in 1979 and 1980, respectively. The government instituted the New Energy and Industrial Technology Development Organization (NEDO) to support research on oil-alternative energy and energy efficient technology (Fukasaku 1995, 1066-1067). Japan made progress since the first oil shock by reducing dependence on oil as
primary energy supply from 77 percent in 1973 to 42 percent in 2009 (FECP 2012a).

Japan outlined a comprehensive energy framework with the enactment of the “Fundamental Law on Energy Policy Measures,” commonly known as the Basic Act on Energy Policy in July 2002. The Act outlined the 3 E’s as the broad goals of energy policy. The Act requires preparation of a BEP and revisions every three years to adjust the existing policies according to the changing politico-economic dynamics. Accordingly, the BEP was prepared in 2003, 2007 and 2010. Additionally, with spiralling energy prices, METI released the New National Energy Strategy (NNES) in 2006, keeping energy security concerns at the nucleus.

Figure 2: Balance of primary energy supply

![Image of Figure 2: Balance of primary energy supply](image)

Source: The Strategic Energy Plan of Japan, METI June 2010
Policy developments post-Fukushima crisis

Following the Fukushima catastrophe, then Prime Minister Naoto Kan appealed for an immediate revision of the 2010 BEP, which underscored that Japan will depend on nuclear energy for more than half of its power generation in 2030. The 2010 BEP was otherwise scheduled to be revised in 2013. The on-going policy deliberations witnessed a vast array of arguments ranging from no-nuclear and gradual phasing out of reactors to maintaining the status quo. Kan voiced his commitment to gradually reduce reliance on nuclear energy and aim for a nuclear free society. At the G-8 meeting in Deauville, pushing the target ahead by a decade, Kan pledged to accelerate renewable energy's contribution to the overall electric power supply to 20 percent by 2020s. Japan cancelled the construction of 14 planned reactors by 2030. The decision to suspend operation at Hamaoka Nuclear Power Station due to safety concerns was not well-received by the business lobby. Kan’s energy vision cost him his office. However, Kan succeeded in transforming the Japanese energy policy landscape with the Diet’s enactment of “The Act on Purchase of Renewable Energy Sourced Electricity by Electric Utilities,” effective from 1 July 2012.

The revised energy policy direction intends to ensure S+3E (safety and economy, energy security, environment). In September 2012, the EEC presented the ISEE. Prior to that, the EEC issued two reports in July 2011 titled “Immediate Supply-Demand Stabilization Measures” and “Interim Compilation of Discussion Points towards the creation of Innovative Energy and Environment Strategy”. The EEC established a Cost Review Committee to re-evaluate the electricity generation cost by source. The new estimated power generation cost considers social costs, which include future risk, CO\text{2}, and policy costs. The revised estimates are critical in determining the shape of the new energy mix.

Table 1: Electricity generation cost by source

<table>
<thead>
<tr>
<th>Source</th>
<th>2004</th>
<th>2010</th>
<th>2030</th>
<th>Operation Duration</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nuclear</td>
<td>5.9</td>
<td>8.9+</td>
<td>8.9+</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Coal</td>
<td>5.7</td>
<td>9.5</td>
<td>10.3</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>LNG</td>
<td>6.2</td>
<td>10.7</td>
<td>10.9</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>Oil</td>
<td>16.6</td>
<td>22.1</td>
<td>25.1</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Wind (Onshore)</td>
<td>9.9~17.3</td>
<td>8.8~17.3</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Wind (Offshore)</td>
<td>9.4~23.1</td>
<td>8.6~23.1</td>
<td>30</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Geothermal</td>
<td>9.2~11.6</td>
<td>9.2~11.6</td>
<td>80</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>PV(Residential)</td>
<td>33.4~38.3</td>
<td>9.9~20.0</td>
<td>12</td>
<td>35*</td>
<td></td>
</tr>
</tbody>
</table>

Source: Cost Verification Committee, National Policy Unit (2011)
Building on the proposals from the Japan Atomic Energy Commission (JAEC), the Advisory Committee for Natural Resources and Energy (ACNRE) and the Central Environment Council (CEC), the EEC presented options for the nuclear policies, energy mix and global warming prevention. In June 2012, the EEC presented ‘Options for Energy and the Environment’. Three scenarios to reduce nuclear reliance are proposed, based on ensuring nuclear safety, energy efficiency, reducing CO\textsubscript{2} emission, and restraining cost and hollowing out. The alternatives include 0 percent, 15 percent or 20-25 percent nuclear dependence in 2030. Intense national discussion unfolded, weighing the proposed options to garner a national consensus on the most feasible alternative. Drawing from the popular outlook, EEC outlined the ISEE, which aims at establishing a society independent of nuclear power in earliest possible future based on three guiding principles: (a) applying the policy concerning forty-year limitation of nuclear power plant operation; (b) restarting the operation of nuclear reactors once the NRA gives safety assurance; (c) shelving all plans relating to the new and additional construction of a nuclear plant. The strategy aims to achieve green energy revolution by boosting renewable energy over 300 billion kWh by 2030 from 110 billion kWh in 2010.

The Noda administration is confronting the critical challenge of escalating electricity demand-supply gap caused by offline reactors and spiralling trade deficit particularly due to soaring energy import bills. Japan’s most influential business federation, the Keidanren, called for a “realistic discussion” in crafting the new energy mix. The Keidanren underscored the challenges faced by businesses due to the power deficit, as the authorities imposed constraints on electricity consumption under Article 27 of the Electricity Business Act, and voiced its fears that continuing concerns over power deficit may trigger hollowing-out of the economy. Under severe pressure from the business lobby to revitalise the economy fuelled by stable energy supply at a feasible cost, Noda reiterated that nuclear power will be necessary to support the Japanese economy (The Yomiuri Shimbun June 2012). However, the Noda administration had to adjust this policy position following the national discussion which reflected strong zero-nuclear reliance preference.

Since the nuclear disaster, Japan has embarked on a path of reviewing its energy policy from a clean slate. Following the erosion of the credibility of the Nuclear and Industrial Safety Agency (NISA), Japan instituted NRA in September 2012. NRA replaced NISA (METI) and Nuclear Safety Commission (Cabinet Office). While the NRA is affiliated with MOE, it is expected to maintain objectivity, unlike its predecessor. The commission will institute new
safety principles for nuclear plants and administer the reactivation of reactors. However, the decision for reactivating two Ōi reactors 15 months after the Fukushima catastrophe reflects the desperation of the administration to partially bridge the electricity demand-supply gap to fuel the economy. Anti-nuclear enthusiasts interpret it as a first step to succumb to the pressure from the Keidanren and getting back to business-as-usual. Since the oil crisis, nuclear energy has been carefully nurtured and gradually promoted to constitute the core of Japanese energy policy. It served Japan’s environmental commitments while enhancing energy security. However, the disaster made it increasingly difficult for the government to continue with its nuclear energy ambition. Consequently, renewable alternatives and energy efficiency are mapped by policy makers. Even as the energy policy is being designed from scratch, the factors which shaped Japan’s pre-Fukushima energy landscape continue to present an enormous challenge to policymakers.

Challenges in crafting the new energy policy course

One of the innate problems that have continued from pre-Fukushima days is Japan’s low energy self-sufficiency. It is four percent self-sufficient without nuclear power and 17 percent if nuclear energy is considered as an indigenous source. Given the stressed situation, it is in the national interest for Japan to cultivate resource diplomacy and rely on massive imports to fuel her economy. Japan has grown to be the world’s biggest importer of Liquefied Natural Gas (LNG), second largest importer of coal, and the third largest net importer of oil (EIA 2012). Drawing from these facts, the 2010 BEP outlaid major acceleration of nuclear energy to enhance self-sufficiency. Pre-Fukushima, Japan was world’s third largest nuclear power consumer behind the USA and France (EIA 2012). However, Japan’s nuclear expansion agenda was shelved after the Fukushima disaster. Nuclear energy comprised about 28.6 percent of electricity source in 2010 (FEPC, 2012b, 3).

Figure 3: Japan’s energy self-sufficiency ratio (2009)

Figure 3: Japan’s energy self-sufficiency ratio (2009)
Decommissioning four reactors at Fukushima reduced Japan’s installed nuclear generating capacity from 48.96 GW (54 reactors) to 46 GW (50 reactors) (EIA 2012, 12). Moreover, the uncertain future of the offline reactors will continue to make Japan further dependent on import resources in the short term. In 2011, Japan’s LNG imports rose 17.9 percent to 83.18 million tonnes, primarily to cater to the energy deficit created by offline nuclear reactors. Crude oil import bills are impacted by international geopolitical instability, as witnessed during the first oil crisis (1973-74), second oil crisis (1978-85), gulf crisis (1990-91), and more recently the “Arab Spring” and political volatility in Iran. In 2011, despite a 2.4 percent decline in crude and feedstock oil import volume compared to previous year, there was an import value swell by 21.9 percent (IEEJ 2012a, 1-2).

Figure 4: Crude oil import by sources (Unit 1,000kl, percent)

Source: Petroleum Association of Japan 2011
Figure 5: LNG imports by sources (Unit: million tons)

Source: Japan Gas Association 2011

Figure 6: Diversification of power sources in Japan

Source: Federation of Electric Power Companies of Japan 2012
As Japanese policymakers contemplate the future energy policy course, they must reflect on the economic and environmental repercussions of energy options. Estimates hint that a nuclear free scenario may cut Japan’s economic growth between 1.2 and 7.6 percent by 2030 (The Japan Times August 2012). The Japanese government estimates that in case of zero nuclear reliance, the electricity bill of a family may inflate from US$ 211.75 in 2010 to US$ 404 in 2030. All the utility companies intend to raise rates to partially share with customers the burden of expensive fuel and mandatory purchase of renewable energy. Utilities suffered a US$ 18.8 billion loss in 2011 while replacing nuclear energy with high fuel costs for thermal power generation. METI speculates that the figure will rise to US$ 33.83 billion in 2012 in the event that nuclear reactors are not brought back online (The Asahi Shimbun May 2012). TEPCO has raised the corporate consumer rate by 17 percent and household rates by 8.47 percent. Furthermore, cutting back on emission is an enormous challenge with escalating thermal power generation fulfilling the deficit created by suspended reactors. An estimated 430 million tons of CO$_2$ was emitted between June 2011 and 2012 by nine power utilities, indicating an increase of 17 percent from the previous year (NHK August 2012). This makes it difficult for Japan to meet international commitments, including the Kyoto and Copenhagen obligations.

Electricity demand-supply instability and anxiety over power outages due to offline reactors including spiralling electricity costs might trigger overseas relocation of industries, which will have adverse impacts on employment rates. However, hollowing-out would not be prompted solely by post-Fukushima instability. With offline reactors and mandatory power saving orders, there is an urgent push to enhance energy conservation measures. However, it will be a challenge for Japan to further improve its existing energy efficiency accomplishment. Since the oil crisis, Japan has maximized efforts to achieve 30 percent improvement in energy efficiency and is one of the most energy efficient nations in the world. METI cultivated energy efficiency as a tool to augment energy security resorting to cutting-edge technologies. The energy consumption per unit of output in America and Europe are roughly twice that of Japan’s, and China and India are eight times as high (The Economist 2011; Vivoda 2012, 140).

One of the major challenges for policymakers is to balance the mounting public trust deficit on nuclear safety vis-à-vis the influence of the once invincible “nuclear village.” The socio-economic-psychological cost of the disaster has eroded people’s confidence in atomic energy. Japan is witnessing a well-organized civil society activism against nuclear energy. Restarting the
Ôi reactors to protect the lives of the people has provided momentum among the anti-nuclear interest groups, such as the Sayonara Genpatsu 1000 (日・核の廃絶千年万) Nin Akusho led by Nobel laureate Oe Kenzaburo. People’s discomfort with nuclear energy is echoing in the corridors of power, which was traditionally the domain of the “nuclear village.” This is evident from the fact that despite having the stress test reports in March, Noda had a difficult time persuading the local authorities hosting the nuclear reactors about safety and to restart reactors no sooner than July. The union of Kansai governments, which includes seven prefectures (Osaka, Hyogo, Kyoto, Shiga, Wakayama, Tottori, Tokushima and the cities of Osaka and Sakai), posed formidable opposition to reactivate the offline Ôi reactors (The Japan Times April 2012). Toru Hashimoto, the mayor of Osaka and Yukiko Kada, the governor of Shiga prefecture, initially demonstrated anxiety over nuclear safety before succumbing to the pressure exerted by the Kansai business lobby which feared an adverse effect on economy inflicted by electricity shortages and possible blackouts (The Japan Times June 2012). With Ôi reactors restarting, there is growing public anxiety over resumption of other reactors.

Figure 7: Public opinion poll on restart of the Ôi reactors

The “nuclear village,” which carefully nurtured a closed opportunity structure promoting the pro-nuclear interests of METI, Keidanren, Liberal Democratic Party (LDP) and power utilities, is widely perceived to be responsible for the Fukushima catastrophe. However, the powerful pro-nuclear nexus exerted immense power and successfully managed to overwhelm the popular opinion...
against the reactivation of Ōi reactors. The village vociferously argued in favour of nuclear energy as a stable and cost effective alternative critical for economic development and combating climate change. Policy favours by LDP were traded for massive individual donations from the utilities, *amakudari* and *amaagari* involving METI-NISA-ANRE and the utilities, networks of power between the heavy machinery manufactures, banks, media, academia and the utilities; this diluted the credibility of the energy administration. Between 1970 and 2007, nuclear energy subsidies amounted to US$ 120 billion as compared to renewable energy subsidies totalling to US$ 20 billion. Japanese nuclear R&D in 2005 was double that of other 25 IEA nations and 61.4 percent of total Japanese energy R&D (Moe 2012, 270).

Figure 8: Government spending on energy research and development between 1996 and 2006

*estimated

Source: International Energy Agency 2008

In 2009, the fundraising division of LDP, People's Political Association (PPA), received individual political donations worth US$ 0.81 million, of which 72.5 percent or US$ 0.59 million were sourced from executives of the nine utilities. TEPCO executives’ individual donations amounted to US$ 0.18 million. Additionally, in 2007 and 2008, PPA received US$ 0.71 million and US$ 0.734 million as donations from utility executives respectively (Kyodo News July 2011). The symbiotic relation reflects in political favours given by way of easing the regulatory pressures and issuing party tickets; for instance, the election of ex-TEPCO executive Tokio Kano to the Upper House in 1998. Takeo Ishihara, an ex-vice industry minister, held the office of vice president of TEPCO after his retirement. More recently, Toru Ishida epitomised
amakudari. Furthermore, reciprocal obligation is served through amaagari. Often in the pretext of lack of technocrats at the regulatory agencies or government advisory committees, industry professionals are appointed who previously served at the power utilities. This underscores the collusive interest that lies at the centre of the nuclear village.

Amakudari-amaagari mutual reinforcement has fostered structural corruption. The TEPCO has a legacy of showing scant respect for nuclear safety. The NISA’s failure to verify TEPCO’s tsunami memo in 2001 which claimed the waves are unlikely to reach beyond 5.7 meters reflected a negligent regulatory ethos. Had NISA been vigilant, TEPCO could have been better prepared for the 3/11-disaster. In 2002, based on the actions of whistle-blower Kei Sugaoka, an investigation uncovered 29 false reports by TEPCO between late 1980s-early 1990s (The Yomiuri Shimbun August 2002). Moreover, just a month before 3/11 disaster, NISA granted an operating license extension beyond the 40-year statutory limit until 2021 to the aging reactors of the Fukushima Diichi plant, despite stress cracks in back-up diesel generators and a proven record of irresponsibility towards nuclear safety.

The nuclear lobby has a strong influence on sections of media through massive advertising funds and by manipulating the kisha clubs (press clubs). Nikkei Advertising Research Institute estimates that the power-supply industry’s annual advertisement expenditure is US$ 1.1 billion, of which TEPCO alone boasts of US$ 305.72 million. Furthermore, influential segments of academia form an integral part of the village by aligning their research with the interests of the nuclear industry. People belonging to the other side of the debate are often deliberately shunned by the powerful nexus.

Opportunities emerging from the disaster

The oil shocks of the 1970s triggered policies endorsing energy resource diversification and efficiency. Nuclear energy was aggressively promoted over the decades as quasi-indigenous to enhance energy security that aligned well with environmental sensitivity. However, the nuclear disaster has raised severe concerns about nuclear safety and has prompted a national debate on fresh energy policy. This raises the prospects of instituting a sustainable energy system. Immediate discarding of nuclear energy is easier said than done. However, it will be a mistake if Japan maintains the status quo (pre-Fukushima) as desired by the nuclear village, and misses this opportunity to genuinely rethink the restructuring of the energy mix. Gradual reduction of the nuclear dependence from the energy mix, replaced by smarter energy options within a set timeline, is desirable. Constructive initiatives in this
direction did unfold in terms of the feed-in-tariff (FIT) regulation championed by Kan. However, saving the purpose of the regulation from being eclipsed by the vested interests of the nuclear village is critical. FIT has potential as a policy tool in easing cost and disseminating renewable energy technology. Renewable energy targets set by Kan project a contribution of 20 percent by 2020s to the overall electric power supply. As unrealistic as it appears, it is symbolic of the renewed enthusiasm.

In order to obligate utilities to purchase electricity generated by renewable sources including solar, wind, geothermal and medium-to small-scale hydropower and biomass at fixed prices for up to 20 years, the Japanese government ratified the “Act on Special Measures concerning the Procurement of Renewable Electric Energy by Operators of Electric Utilities.” The opportunity put forward by anti-nuclear sentiments and a robust FIT raised momentum of the renewable energy investments. In case of zero nuclear reliance by 2030, Japan requires an estimated US$ 626.49 billion investment in renewable energy. A FIT system came to effect on 1 July 2012 with a relatively high electricity purchase price to facilitate investments in renewable sector. Critics expressed reservations over the renewable sector as the burden of the utility bill is passed on to the consumers. However, renewable advocates argue that the purchase price will eventually shrink as the market expands. Moreover, the long-term merit of reduced reliance on fossil fuels to ease import bills is underscored (Iida 2012, 13-14).

Renewable energy sources are weighed for supply stability, electricity quality, and expense, due to high investment cost compared to decarbonisation potential and decreasing fuel imports. Despite its potential, renewable energy efforts have often been compromised when competing for space with the nuclear village. However, as Japan is redesigning its energy landscape, policymakers need to exploit this opportunity to correct the constraints hindering the prospects of alternative energy sources. The monopolistic structure of electric utilities is under critical review and electricity market reforms are desired. Separation of power production from distribution and transmission is a pressing need (Iida 2012, 14). Japan’s 10 electric utilities represent regulated regional monopolies. At present the electricity industry structure reflects vertical integration including power generation, transmission, distribution, and retailing. Attempts were made at deregulation in 1995, 2000, and 2005 with the goal of lowering prices. While partial deregulation was achieved in generation and retailing, unbundling of transmission and distribution failed to succeed because of lack of political will, resistance from the utilities unwilling to dilute their monopoly, and the California electricity crisis (Ito 2012, 4-6). In July 2012, METI instituted a panel

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to evaluate the electricity industry, which proposed complete liberalization of
the domestic retail power market, reforming the present electricity price
setting system and revamping power grid structure (Kyodo News July 2012).
The ISEE proposed brave reforms to the electric power system through (a)
promotion of competition in the market and (b) neutralisation and widening
of the transmission and distribution sectors. A Strategy for Reform of
Electricity Power Systems will be presented by end of 2012.

At this critical juncture, policymakers need to make tangible efforts to link
renewable energy to the power grid and facilitate the transmission and
distribution infrastructure that can endure the intermittency caused by
renewable resources in grid supply. Japan has two frequency regions
including eastern Japan (the 50Hz region spanning from Tokyo to Hokkaido)
and western Japan (the 60Hz region covering the rest). Inter-regional transfers
are restricted because of under-investment in transmission infrastructure (Ito
2012, 10). Massive investments to enhance the grid interconnectivity among
regions are necessary to transfer renewable power from remote areas to urban
centres. Smart grids and smart metres should be extensively adopted to
promote energy efficiency by shifting peak demand and to support renewable
energy, which will help in global warming mitigation (Ida 2011, 2).

The TEPCO is scheduled to install 27 million smart metres by 2023 to facilitate
electricity conservation. Pre-Fukushima, utilities were hesitant to introduce
renewable alternatives, which they feared would dilute the high standards of
stability. The utilities provided high quality, reliable, yet expensive electricity.
Power reliability in Japan is among the highest in the world with average
interruptions of as low as ten minutes per year (OECD 2008, 138). However,
electricity prices in Japan are among the highest in the OECD countries.
Deregulation initiatives were expected to ease the price by letting fresh
players into the market. However, the Japanese electricity market lacks
genuine competition (Scalise 2009). Though 63 percent of the retail market is
deregulated, the Power Producer and Supplier’s (PPS) share is about two percent
(Ito 2012, 11). Japan needs to revamp the electricity sector to promote
competition, innovation, efficiency and cost-cutting.
The future trajectory needs to undo the nuclear village and evolve into a responsible regulatory system underpinning accountability and transparency. NRA should serve its responsibility and instil public confidence. NISA and the NSC were futile in battling the crisis and revealed the deep roots of the village, which manipulated any constructive reforms in power industry over the decades. Lack of separation between industry promotion (METI) and safety regulation (NISA) is the structural predicament underlying nuclear governance, which led to regulatory capture. To shun regulatory capture, a nuclear regulatory body must be independent from financial and political influence of utilities (Kushida 2012, 36-40, 67-68). The restart of the reactors...
against public discomfort is indicative of difficult choices facing the administration and the influence of the village. The village, though punctured to a certain degree by the disaster, continues to remain unyielding. Critics expressed reservation over the appointment of Shunichi Tanaka to lead the NRA. The anti-nuclear lobby perceives the former deputy head of the Atomic Energy Commission as an affiliate of the nuclear village. However, drawing lessons from the Fukushima catastrophe, policymakers should take this chance to part ways with the village and make genuine efforts to liberate nuclear safety regulation from the regulatory capture of the utilities. The legacy of vested interests need not be inherited by the new regulatory framework.

Conclusion

While the anti-nuclear protests are growing in strength since the disaster, they have failed to reflect on the local elections. The defeat of renewable energy enthusiast Tetsunari Iida in Yamaguchi and the success of pro-nuclear candidates in Kagoshima and Kaminoseki prefectures in gubernatorial election emphasize the difficult journey ahead for the anti-nuclear lobby. Moreover, incumbent Governor Issei Nishikawa in Fukui prefecture, home to 14 nuclear reactors, won a third term in April over Kunihiro Uno who proposed ending reliance on nuclear energy. Additionally, the critics argue that the recent adoption of the populist zero-nuclear dependence policy goal is to achieve political mileage before the approaching Lower House election on 16 December 2012. Gauging the overwhelming anti nuclear sentiment, Noda’s slim chance to appeal to the electorate (who is already disappointed with his decision on consumption tax and reactivation of Ōi reactors) is through zero nuclear policy. However, it will be difficult for Noda to score political points with vague and inconsistent policy guidelines such as the ISEE.

The national discussion on nuclear energy options marks the deep fault line between popular sentiment and the business lobby. The primary duty of the government is to deal with the erosion of public trust in an energy administration whose integrity was compromised with the arrogance and irresponsibility of the nuclear village. Revised energy policy needs to reflect objectivity in balancing public anxiety over nuclear safety and corporate concerns over economic health. The government ought to respect public sentiment and no longer compromise safety by returning to business-as-usual. Instituting an independent, competent, responsible, and transparent regulatory mechanism will be a step forward in dismantling the regulatory capture and thus reclaiming the public trust. The political class must find the will to design an energy policy based on the national interest.
Lessons learnt from Fukushima should lay the foundation for a sustainable energy future. The core argument advanced by the nuclear village about providing high quality, stable, reasonably priced, non-carbon energy resource lost its credibility with the Fukushima disaster. On the contrary, despite being safe and clean, the heart of renewable energy argument thins out with the critique of being a relatively expensive and unstable energy source. Given these facts, this paper has analysed the critical challenges Japanese policymakers face to lay out a blueprint for the future of energy. The leadership shoulders the enormous responsibility of stimulating the economic engine which lost steam after the disaster. The urge for reactivating the nuclear reactors to fuel the economy is high among the corporate giants. The Keidanren and Japan Chamber of Commerce and Industry (JCCI) conveyed discontent with the three proposed nuclear energy options floated by the EEC. They perceive these options to be incompatible with the government’s growth strategy to attain annual economic growth of three percent nominally and two percent in real terms through fiscal 2020. At this crucial juncture, while the energy and trade deficits are pressed by offline reactors and soaring energy import bills, Japan can hardly afford immediate elimination of nuclear energy from her electricity mix without mapping a realistic plan to bridge the shortfall. However, Japan should make earnest efforts to gradually reduce nuclear reliance while elevating safety and filling the energy vacuum with safer and clean alternative sources.

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This paper analyses the Economic Cooperation Framework Agreement (ECFA), similar to a free trade agreement, between Mainland China and Taiwan. Due to the historical segregation and political tension between the two negotiation bodies, ECFA bears mixed and twisted political and economic pursuit from both parties. After introduction of ECFA, negotiation phases and political opposition in Taiwan, Zartman’s negotiation theories, including formula-detail negotiation approach, concession-convergence resolution and negotiation between strong and weak parties, are adopted as analysing frameworks. This paper covers the complex conditions of the Ma Ying-jeou’s political support, the political environment in Taiwan, the competition of ASEAN FTA, the background of Asia’s economic integration and the overwhelming political pressure from Mainland China. In the on-going second round negotiation, this paper argues that each side should loosen the economic and political pursuits respectively to make the negotiation reachable and sustainable.

Introduction

Under today’s global economic integration background, trade has become a major driver for a country’s economic growth. Thus, after the deadlock of World Trade Organization (WTO) Doha round negotiation a decade ago, regional Free Trade Agreements (FTA) have become a favourable choice to further tie the relationship between important trading partners and promote regional cooperation. However, sometimes FTAs or similar negotiations are conducted under high political pressure that carry not only economic incentive, but are also accompanied with narrow political objectives. This paper is intended to examine the negotiation case of Economic Cooperation Framework Agreement (ECFA) between Taiwan and Mainland China, applying the theories of Ira William Zartman (1977, 1991 and 1997) on international negotiation: formula-details negotiation approach, resolution to conflict (contest, cost, and change), and how

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the weak confront the strong in a negotiation. The framework can be used to observe and analyse the shifting bargaining power from Taiwan to Mainland China due to international relations and regional FTA integration; the political conflicts between Pan-green and Pan-blue coalitions in Taiwan and political pressure from national owned enterprises in Mainland China’s influence on ECFA negotiation; and insufficient preparation for the negotiation by the Mainland China government.

Background of the Economic Cooperation Framework Agreement (ECFA)

Aiming to reduce trade tariffs and commercial barriers between Taiwan and Mainland China, and with strong support by Ma Ying-jeou, the President of Taiwan, the Economic Cooperation Framework Agreement (ECFA) was signed in Chongqing on 29 June 2010 after one year of negotiations, and went into effect on 12 September of that year. The content of the framework is similar to a Free Trade Agreement (FTA), but it is called as ECFA due to the fact that China does not recognise Taiwan as a state.

The Cross-Strait Economic Cooperation Committee is a semi-official body that provides institutional mechanisms to deal with upcoming Mainland-Taiwan economic negotiation. The cooperation was formed by the two governments to facilitate bilateral negotiation of the ECFA (Tien and Tung 2011: 81; G. Wang 2011: 511). Vice-ministerial officials and members of the Committee were designated by both governments. By regulation, the Committee itself is not a decision-making body. Instead, it negotiates the activities related to ECFA through semi-annual meetings that promote the negotiation process.

Political tension and a brief history between Taiwan and Mainland China

The political tension between Taiwan and Mainland China is essentially a conflict between two parties. Founded by Sun Yat-sen, Kuomintang (KMT) established the Republic of China (ROC) in 1912. It was one of the earliest political parties in China. KMT had maintained its rule over Mainland China until being defeated by Chinese Communist Party (CCP) in the Civil War of 1949. In the same year, CCP established the People’s Republic of China (PRC) in Beijing and ROC moved its capital to Taipei. The segregation between the PRC and the ROC continues to exist today.

Taiwan gradually developed into a democratic society and achieved great economic development. Taiwan is considered to be one of the “four tigers” in the

35 Due to the sensitive political relationship across the straits, the Mainland and Taiwan have no direct official link.
East Asia Miracle – the others being Hong Kong, Singapore and South Korea. In thirty years, Taiwan’s real GDP per capita increased from US$ 2,324 in 1965 to US$ 15,191 in 1995. Its annual GDP growth rate between 1965 and 1980 averaged 7.5 percent, but gradually slowed to 6.3 percent between 1980 and 1995, and 5.7 percent between 1990 and 1995 (The World Bank, 1997).

However, military tensions have always loomed above the Taiwan Straits. After the first and second Taiwan Straits crises that occurred in 1954 and 1955, a third crisis happened in 1995. Lee Teng-Hui, considered the “spiritual leader” of the Taiwan Solidarity Union, formed the Pan-Green Coalition with Taiwan’s Democratic Progressive Party. Being the presidential candidate at the time, Lee publicly announced to move ROC’s foreign policy away from a “One-China policy”. In response, the PRC enhanced military exercises. The tension gradually subsided after the presidential election in early 1996.

Although the bilateral relationship improved after Ma Ying-jeou won the Presidential election in 2008, the public and government’s attitude towards the future across the Straits differs. In 2010 and 2011 consecutively, public surveys showed that more than half of the Taiwan people wanted to maintain the status quo. (United Daily, 2011) The PRC, on the other hand, had never given up the political will to reunite Taiwan. (Taiwan Affairs Office of the State Council PRC)

The conflict across the Straits has also affected Taiwan’s official status in international organizations and diplomacy. In 1971, the PRC replaced the ROC in the UN and its agencies, including the United Nations Security Council. Since then, Taiwan has been unable to send permanent representatives under ROC affiliation to the UN. In 2002, Taiwan became a WTO member, only under the name of “separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu”, also known as “Chinese Taipei” (WTO 2012). The PRC has continuously opposed any attempt to recognize or endorse ROC as an independent sovereign state. Due to the PRC’s firm position and foreign policy with respect to the ROC, until today, only 23 countries in the world have established official diplomatic relationships with ROC (Ministry of Foreign Affairs, Republic of China (Taiwan) 2012).

**Political objectives and conflict in Taiwan over ECFA**

Signing the ECFA is a strategic pre-condition for Taiwan to sign other FTA agreement with countries, which have signed FTAs with PRC. This is due to

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KMT is part of Pan-Blue Coalition.
Taiwan’s territory representative, and not country status in the WTO, which does not allow Taiwan to enter into direct FTAs with other countries. Official FTA agreements with countries that have not signed FTA with PRC is illegal (Tien and Tung 2011, 81, WTO 2012).

However, within the island, there have been constant debates between Pan-Green and Pan-Blue coalitions over the costs and benefits of signing ECFA with China. In April 2010, two months prior to the signing of ECFA, President Ma Ying-jeou won a majority of the public’s support against the Democratic Progressive Party (DPP) Chairperson Tsai Ing-wen, in an open debate over the ECFA. Facing the public’s concerns over the shock to the poor and low-value added industries, Ma assured the public that:

“If the ECFA talks do not secure overall economic benefits for Taiwan, I would not accept it [the agreement] and would rather let it fall apart.” (Taipei Times, 2010)

The debate reveals the dichotomy between the between the Pan-Green and Pan-Blue factions. Ma’s emphasis on the importance of signing an ECFA with China was based on a belief that “Taiwan can only gain access to the world via China.” Tsai, on the other hand, emphasized the possible shock of labour unemployment in Taiwan if the ECFA were signed. Through the debate, Ma successfully obtained more than 60 percent of public support over the ECFA (Taipei Times, 2010).

The Pan-Green coalition made the argument that ECFA benefited the Mainland more than Taiwan, with support from some industries. For instance, after one year’s implementation of ECFA, the automobile parts industry in Taiwan only exported NTD 5.7 billion to the Mainland and imported NTD 8.9 billion. Overall, however, Taiwan enjoys greater trade surplus with the PRC.37

Wang Guiguo proposes that the political and economic objectives of the two sides are that the ROC seeks to increase close economic relations with Taiwan under the ECFA to gradually reunite with Taiwan, whereas Taiwan wishes to take advantage of the PRC market and economic integration without surrendering its own autonomy (G. Wang 2011, 505).

37 The trade deficit of the Mainland to Taiwan reached NTD 78.44 billion in 2010, of which the Mainland imports NTD 105.1 billion from Taiwan and NTD 26.66 billion exports. Imports were almost four times exports. For more information, refer to http://www.caijing.com.cn/2010-12-24/110601169.html
Negotiation phases of the Economic Cooperation Framework Agreement

**Early harvest list**

Prior to the completion of the trade negotiation list, both governments agreed to an “Early Harvest Program” of tariff-free products under the ECFA, which shows the eagerness for cooperation by both parties. This programme went into immediate effect on 1 January 2011 (Tien and Tung 2011, 81). Four negotiations were expected to be followed within the six months after, covering commodities, services sector, investment, and dispute settlement, but were delayed due to Taiwan elections at the same time.

In the “Early Harvest Program”, not characteristic of a usual FTA, Taiwan was expected to benefit more economically from the agreement. An estimation made by Taiwan Chung-Hua Institution for Economic Research showed that the ECFA was expected to increase Taiwan’s GDP growth by 1.72 percent, and generate between 257,000 to 263,000 jobs. In the “early harvest list,” the PRC agreed to lower tariffs amounting to US$ 13.83 billion, almost four times Taiwan’s US$ 2.86 billion (Sun 2011, 37). PRC agreed to tariff reductions on 539 items, while Taiwan agreed similar reductions on 267 items, covering ten categories of products: agriculture, chemical, mechanical, electronic, automobile parts, textile, light industrial, metallurgical, instrumentation and medical.38 Tariffs on those 806 items would gradually reduce to zero in three years (Sun 2011, 36). Moreover, Chinese officials consented to Taiwan’s request of not opening the agriculture market, at least temporarily, to address the concerned Taiwanese farmers who feared that the ECFA would harm their livelihood (Tien and Tung 2011, 80).

The outcome of the program so far has confirmed the original estimation. As reported on April 26, 2012, the ECFA Early Harvest Program benefited Taiwan more than Mainland China on trade in goods, and generated more opportunities to Taiwan service industries and financial industry. Between January 2011 and March 2012, on the Mainland China side, the ECFA Early Harvest Program reduced a total tariff by US$ 230 million from US$ 5.89 billion worth of imported products from Taiwan. According to Taiwan’s customs statistics, Mainland China’s exports to Taiwan on ECFA Early Harvest Program amounted to about US$ 1.33 billion with approximately US$ 33.56 million tariff reductions. Besides direct tariffs, it also benefits the service industry and financial institutions with less entry barriers and grants qualifications on Renminbi business (Chen and Liu 2012).

38 See Appendix 2: Taiwan and Mainland China Early Harvest items
Second round of negotiation agenda

Further negotiations on the ECFA were temporarily delayed due to elections in Taiwan, but reassumed and accelerated after Ma Ying-jeou’s re-election. In April 2012, he reinforced his political support to the ECFA, aiming to accomplish the negotiation process in two years, covering four sub-protocols: the trade in goods, trade in services, investment protection agreement, and dispute settlement. He believed that Early Harvest Program, which negotiated only 20 percent of the total ECFA items, has only revealed part of the ECFA outcome. On the other hand, Ma also recognized that although the agreement terms are more favourable to Taiwan, the export growth of the PRC is higher than that of Taiwan (Want Daily 2012).

The political support from the PRC is strong, but with a more political rather than economical objective. Premier Wen made several encouraging remarks regarding negotiations of ECFA at all stages, indicating the firm political will in support of ECFA. Even though the negotiation and collaboration across the Straits has been processed rapidly, the political sensitivity has never faded away. Beijing, as always, stood firm with its one-China principle and left little room for its own negotiators to maneuver (Tien and Tung 2011, 80; Y. Wang 2012).

In March 2012, the new round of ECFA negotiations started and was expected at the beginning to be more difficult than “Early Harvest Program” by both sides along with the deepening of cooperation. The second round of negotiation covers up to 5,824 items in Taiwan and 6,727 in Mainland China with priority on petrochemical, textile, machinery, automobile parts, and liquid crystal display (LCD) etc. (Economic Daily 2012). In Taiwan, the Chairman to the Council for Economic Planning and Development (CEPD) Yin Qiming believed that the second round of negotiation would be very difficult as the strategy of the PRC changed from unilateral benefit to mutual benefit. While on the Mainland side, the State Council’s Taiwan Affairs Office Director, Wang Yi, has announced publicly that large-scale negotiations must be carried out (Want Daily 2012).

This round of negotiations is still continuing, and the information released indicates the difficulties and sophistication in the process as the cooperation extends further. For example, the PRC takes a firm position on LCD panels of zero-tariff. Another focus is on petroleum by-products. Yin Qiming stated that after China-ASEAN FTA, Singapore’s petrochemical products flowed into the PRC market without any barrier. It takes the PRC domestic enterprises and market some time to buffer the shock from the cheap FTA imported products, thus causes the PRC government a more cautious attitude on the negotiation table (Want Daily, 2012).
The services industry in the PRC, identified as a source of growth by both parties, encountered strong opposition from the dominant national owned enterprises. Despite the strong political support of the ECFA from the central government of the PRC, state-owned enterprises, accounting for 45 percent of the Mainland economy, have strong lobby power in the government, affecting negotiators on the table (Y. Wang 2012; Want Daily 2012).

Viewed as an ECFA highlight, the future direction of economic cooperation should focus on industrial cooperation as Taiwanese companies’ high technology advantage matches the urgent need of PRC’s industrial upgrading demands. Taiwan believes that it can promote cross-strait industrial cooperation, but requires a more hands-on approach. (Sun 2011, Liu 2012) Scholars from both Taiwan and the Mainland are studying the possible matches of new industries, including information technology, new energy, energy saving, environmental protection, biotechnology, new materials etc.39 (Sun 2011, Liu 2012).

Analysis framework: Zartman’s negotiation & conflict theory

Ira William Zartman’s theory development on International Negotiation and Multilateral Negotiation studies the negotiation process at the country and international relations level (SAIS 2012). He defines negotiation as:

“Negotiation, in theory, is seen as a positive-sum exercise, as both parties prefer the agreed outcome than status-quo. The final decision is made by persuasion, coercion or force, combining conditions into a single package and is able to change parties’ assessment of their values.” (Zartman 1977, 622)

Negotiation approach: Formula-details

Based on the concession-convergence approach developed by Siegel and Fouraker in 1960 (Siegel & Fouraker, 1960), Zartman further developed a formula-details approach and suggested that rather than a process of convergence, negotiation is a matter of finding a formula and implementing details that can be accepted by both parties. Most of the decision-making modes cannot properly explain real practice. Experienced negotiators tend to find out a formula encompassing the optimum interest combination of both parties. The negotiator, under common notion of justice or fairness, seeks a general definition, conceived and grouped the conditions in a joint agreement. Zartman argues that all well-known negotiations, such as the Cuban Missile Crisis and the Paris

39 See Appendix 1: Connections to the New Industries in Taiwan and the Mainland
negotiation to end the Vietnam War, finally went to details to be settled within the formula. In that sense, Zartman suggests that in a negotiation, an incoherent agreement and some symbolic concession behaviour can be explained by formula-details even better than the concession-convergence model. (Zartman 1977, 628-631)

The formula-details approach, by recognizing the real negotiation process, has the following advantages. First, the approach shows that negotiation, for conceptual reasons, is not a determinant process. It does not only react to past moves from the other party, but also the ‘initiation for forward-oriented moves’ that can guide the other party to future preferred target. Second, the proposed formula is usually challenged by questions like “why this” and “why now”. Thus it is important to decide the right timing and hold out further proposals. Third, it forms a general approach that covers both psychological and concession-convergence to certain extent, and at the same time, reflects more accurate portray of real practice. Fourth, the approach views the ‘analysis of power as added value’. It explains the process of a selection of values into the proposal and a modification of values through persuasions, coercion, and force. Fifth, it allows a more healthy and constructive public attitude towards negotiation (Zartman 1977, 628-631). However, Zartmart feels the theory needs further development, and has not addressed certain problems nor provided rigorous solutions. In a social science aspect, those drawbacks are not major. (Zartman 1977, 628-631)

Resolution to conflict: contest, cost and change

Zartman suggests three different approaches of conflict resolutions: contest, cost and change. The first is a clash of conflicting unilateral solutions. This requires a formula for a joint or multilateral agreement that is satisfactory to both parties. The resolution is to find a more attractive multilateral solution to the problem and replace the attempt of each to impose its will on the other. The second is a solution of concession based on calculation of cost benefit analysis. It requires a ‘ripe moment’ at which both hostile parties become mutually disadvantaged under the current status quo and so are willing to work together for a way out. This solution is more time-oriented on viewing the conflict. The third approach is that the event is seen as a process of change and the solution would be a new regime to replace the old one, carrying certain expectations and behaviours (Zartman 1991, 13-19).

In successful cases of conflict management, incentives like preferable alternative and time framework are not drawn from the outside, but generated from the internal willingness to talk and pull the other party into negotiation. Zartman points out that when a painful status quo makes the preferable alternative an
attractive solution, a door to solutions opens. Again, the time frame is important to such incentives. Putting cost and benefit analysis into the time frame would make the future incentive grounds for current cooperation (Zartman 2001, 297-298).

Negotiation: When the weak confront the strong

In Zartman’s political analysis of the outcome of the weak confronting the strong, in international negotiation, the weak side cannot overcome its weak economic position and remained dependent on concession made from the strong party. His case study on the trade negotiation between four groups of African countries and six member countries of the European Economic Community (EEC) supports his argument. Despite the skillful efforts made by African negotiators to get most from the bargain, African countries could not overcome their economic weaknesses after all. (Zartman 1971, Andrews. G 1972)

Contrary to common wisdom, Zartman further argued in 1997 that the actors with overwhelming resources often do well in general, but poorly in negotiation. The power leaves the stronger party many, or too many, alternative approaches, various security points, large reservation price area and unexplained negotiation results that may lead to unsatisfactory results. (Zartman 1997, 122).

Application of Zartman’s theories to ECFA negotiation scenario

Application of formula - negotiation approach to ECFA negotiation

In the second phase of ECFA negotiations, as more controversial items were put on the negotiation table, both sides realized the importance of finding a formula that would satisfy the optimum interest combination of both parties. After the “Early Harvest Program”, the on-going second phase negotiation concerning items such as petrochemical products, machinery, and automobile parts became even more difficult. At the beginning of the negotiation, comparing with PRC.’s total GDP, Taiwan as a small economy was more cautious about the tradeoffs in agreement and was provided with more benefits in the negotiation. Hence, with thousands of items to be negotiated,

“Negotiators seek a general definition of the items under discussion, conceived and grouped in such a way as to be susceptible of joint agreement under a common notion of justice.” (Zartman 1977, 628)

40 It includes EEC associated with eighteen African states, three East African states of Kenya, Uganda and Tanzania, three Maghreb states of Morocco, Algeria and Tunisia, and Nigeria.
Thus, partial sacrifice and trade-offs had to be made in these grouped negotiation process to reach an agreement. Taiwan originally stood firm, not opening the agriculture market in order to protect its local farmers. However, in its recent discussion on opening RMB operations to Taiwanese financial institutions, the negotiator and scholars of Taiwan’s negotiating team indicated the possibilities of opening agriculture partly in reaction to the strong call from the PRC (Lin 2009). The PRC also faced trade-offs. With the strong lobbying power of national-owned enterprises and certain protective industries, the PRC surrendered some of the other items in the negotiation to be able to continue (Want Daily, 2012). The details of the trade-off can be further studied after the release of the new negotiation results.

During the ECFA negotiations, the bargaining power gradually shifted from Taiwan to PRC, corresponding to the formula-detail theory suggesting that a negotiation should not only react to past moves from the other party, but also the “initiation for forward-oriented moves” (Zartman, 1977) that can guide the other party to future preferred targets. With four times greater reduced total tariff amount than Taiwan, the PRC had revealed sufficient sincerity and willingness to cooperate in the first Early Harvest Program. In reaction to that, Taiwanese negotiators, bearing the pressure of the Pan-green coalition, received Ma’s strong political support to finalize the ECFA negotiation in two years. Taiwan’s negotiators therefore understood that to be able to achieve the “preferred target” (Zartman, 1977) of both sides, certain trade-offs, like the low-value added industries (automobile parts), needed to be made.

Considering competition from ASEAN and Asia region, the ECFA came at a right time for negotiation to include Taiwan in the regional economic integration trend. After several years of preparation, the China-ASEAN FTA went into effect on January 1, 2010, which partly explained the eagerness of Taiwan to promote ECFA with the PRC. Without this agreement, Taiwan’s business and trade would have lost its advantage in the Mainland’s market. (G. Wang 2011, 508) Currently, the PRC has 15 FTA agreements with 28 economies. Meanwhile, the PRC has completed regional trade agreements with India and South Korea and is exploring the possibility of establishing a Japan-ROK Free Trade Area (China FTA Network 2012). Other East Asian states had aspired to strengthen regional economic ties. In August 2006, South Korea signed an FTA with ASEAN, Japan completed its Comprehensive Economic Partnership with ASEAN in April 2008, and India formed a Trade in Goods Agreement in 2009 (G. Wang 2011, 508).

From Taiwan’s perspective, it did not sign any FTA or similar form of agreement with ASEAN, which harms Taiwan products’ competitiveness and decreases the country’s inward and outward trade and investment. During 2004 and 2006, the
average annual growth rate of Taiwan’s exports to ASEAN was 20.1 percent, which was 1.8 percent higher than that of South Korea. However, after the South Korea and ASEAN FTA went into effect in 2007, Taiwan export rate to ASEAN dropped to 11.8 percent and South Korea increased significantly to 24 percent (M. Wang 2011, 49).

With the context of Asian economic integration, Taiwan’s economic integration has remained relatively small. Despite the fact that the ECFA requires trade-off and contains high political and economic risks, the Taiwanese government cannot afford the cost of economic segregation due to higher tariff rates in the region. In addition, as a pre-condition to initiate the FTA negotiation with other countries and regions, the ECFA has become more essential to Taiwan.

Application of resolution to conflict theory in ECFA

Among the three resolutions to conflict – contest, cost and change – the most probable resolution to ECFA is a solution of concession based on a cost benefit analysis. Under the background of Asian economic integration since year 2006, Taiwan cannot afford the cost to wait longer for the “ripe moment” and needs to free itself from economic isolation in Asia.

The third solution is to have a new political regime come to power as the ECFA bears political objectives and risks in the economic agreement. In this case, the probable condition would be that the alternate ruling party in Taiwan wins the next election. The ECFA terms contain mixed objectives on both sides. Although the ECFA itself is an economic trade agreement based on purely economic terms, it carries a strong political motive from the PRC that is to reunite Taiwan by strengthening economic ties. Taiwan, being completely aware of that motive, intends to take advantage by having more favourable conditions in ECFA, but without losing independent autonomy. These motives place too much emphasis on the ECFA itself. Bearing in mind these political motives, the negotiator of the PRC took a disadvantageous position even before the negotiation started. Taiwan’s negotiator, with the attitude of taking benefit from the ECFA negotiation easily, would face resilience as the negotiations discussed deeper integration. Covered by PRC government’s overwhelming political motives of reuniting Taiwan, the economic cost that PRC side bears in the ECFA may be underestimated (Lianhe Zaobao 2009). On the other hand, due to the poor performance of the Pan-green coalition in the public debate and difficulties to predict and quantify, the political cost to Taiwan may also be miscalculated. To lower the internal political risk in Taiwan, Ma’s administration can set up a backup plan to the affected industries and labour to help them go through the adjustment process (The Liberty Times 2012).
The weak confront the strong: Taiwan vs. Mainland China

Taiwan cannot overcome its weak economic and internationally fragile political position, and therefore it remains dependent on concessions made from the strong party, PRC side. The two economies have very different size, population, and international political power. China is Taiwan’s largest trade partner, but Taiwan is only Mainland China’s seventh largest partner (China FTA Network 2012). Strongly influenced by political will, the strategy that Mainland China adopts is to provide more benefits to Taiwan. Taiwan, which has a relatively small market and no FTAs at hand, has limited bargaining power.

According to the Zartman negotiation theory, the actors with overwhelming resources often do well in general, but poorly in negotiations due to various reasons, such as insufficient preparation. In this case, the PRC is no exception. In Taiwan, the questioning of ECFA had never stopped. However, no publications or media report had touched upon any disadvantage of ECFA in the PRC. The overwhelming political support resulted in an inadequate study of the real costs of ECFA. In preparation for the ECFA, facing public accusation from Pan-green coalition that ECFA may bring more cost than benefit to Taiwan, Ma’s administration was pressured to have a thorough understanding of ECFA and strived for more benefits in the negotiation. Whereas, in the case of Mainland China, the excessive concern of unpredictable political consequences, insufficient preparation, and lack of rational thinking may cause China side’s negotiator less prepared than Taiwan side. Moreover, China’s market and enterprises is not yet recovered from the shock brought by recently signed China and ASEAN FTAs. Chinese enterprises are still dealing with the direct competition from ASEAN. Immediate adoption of another FTA added more pressure to the local business sectors, particularly the infant industries (Lianhe Zaobao 2009). For instance, the high-tech industry is the targeted industry of the Taiwanese business community. Chinese local companies face serious challenges from mature Taiwan competitors carrying preferential tariff terms.

Conclusion

The ECFA between Mainland China and Taiwan went into effect on September 2010. This paper, adopting Zartman’s negotiation theory, attempts to analyse the negotiation strategies and power of balance between two sides.

The agreement carried both economic and political motivations from both sides. Taiwan, as a small economy, faced fierce competition from neighbouring countries, could not afford the economic cost of not signing ECFA with mainland
China. Additionally, due to its unrecognized sovereignty, the ECFA has become a pre-condition for Taiwan to initiate any regional economic integration. On the other side of the negotiation table, carrying strong political will, the PRC sees the ECFA as a mechanism to strengthen the economic ties across the Strait that will aid in reuniting Taiwan to the mainland in the long run.

The initial Early Harvest Program in general painted a promising blueprint to the business communities in Taiwan. ECFA is now entering a more difficult second negotiation round. The outcomes of the second tariff reduction list remains to be seen. As the collaboration gets deeper and wider, more problems float to the surface. To achieve optimum interests and preferred results of both parties, Taiwan is preparing to compromise certain positions in the new negotiation round for future cooperation. The PRC is also facing lobbying and objections from its economic stakeholders and stated-owned-enterprises to protect certain industries. Resolution of the conflict relies on the concession of cost benefit analysis. Both sides have to pay economic and political costs to reach their objectives. However, due to the complex objectives embedded in the ECFA, both sides underestimated their economic or political risks. Lastly, echoing Zartman’s theory that a strong negotiation body usually does poorly when against a weak one, the PRC misses a rational understanding and a comprehensive study of its economic costs under the ECFA. It is mainly caused by prohibition of objected voices considering political reasons, insufficient preparation to negotiation, and accumulated pressure from other FTAs in the region.

As an on-going negotiation, the ECFA requires continued rational studies and comprehension from both sides in order to be sustainable. The discontinuity of the agreement may deviate from its original economic cooperation perspective, to even harm bilateral relationship across the straits. As an economic framework, the imposed political will from Mainland China and unreasonable economic pursuit from Taiwan will eventually deviate the ECFA’s original purpose of common economic prosperity. To achieve the ECFA’s original goal, decreased political pressure from the Mainland and less demand in economic return on the Taiwan side is the essential prerequisites to future negotiation.

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DRUG POLICY IN VIETNAM:
LETTING THE MARKET SET PRICES IS NOT AS EASY AS IT SEEMS

Sarah Bales

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Introduction

Mr. Cao Minh Quang, head of the Drug Administration of Vietnam and now Deputy Minister of Health, had learned a lot about drug markets and prices over the years. One thing was for sure, the invisible hand did not always work the way he wanted it to. Clearly, by 2012 there had been a huge improvement in the situation compared to the shortages and rampant speculation, black markets and counterfeit drugs that had characterized the central planning period. Now people could be pretty sure about the quality and safety of the drugs they used, and not have to worry so much about whether the drugs they needed were available. But high and rising drug prices were another story, and had given Mr. Quang endless headaches.

Drug prices were not only a problem for Mr. Quang. Mr. Pham Luong Son, head of claims processing for Vietnam’s Social Health Insurance Agency, was also keen to reduce drug prices to reduce payments for pharmaceuticals that in 2010 had accounted for 61 percent of total health insurance reimbursements (Bác 2011). Patients were also concerned, especially those with chronic illnesses. One example reported in the local media was that of a Mr. Pham. He was 41 years old, and had

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undergone seven months of treatment for hepatitis C, but now he had to stop treatment because he was out of money. He had already used his house as collateral for a loan for treatment of his illness, and borrowed from his relatives, but after seven months of treatment, his illness was not responding well to the drugs. With no more money to pay for treatment, he lamented “I’ll just have to trust in God come what may” (Phú 2012). Another example was the case of a woman who had been receiving treatment for breast cancer for nearly a year. Fortunately, she had health insurance and only had to pay 50 percent of the cost of chemotherapy and 20 percent for other drugs. Despite insurance, the total cost of treatment for the year was almost US$5000, high for a country with a per capita GDP of only US$1191 in 2011. Now the drug prices were going up, so she expected that she would have to sell her house in order to continue treatment (Hang 2003).

But there were also those who were happy to see high drug prices. Foreign drug companies enjoyed a revenue premium not only because of their patent protection giving them monopoly prices, but also because doctors believed that imported drugs were more effective and preferred to prescribe them. It was well known that under-the-table commissions for prescribing imported drugs were higher than those of domestically-produced drugs (Lâm 2008; Le 2008). For a cash-strapped hospital director trying to retain his underpaid staff, income supplements to his staff paid in the form of drug commissions could be easy to overlook. For those running a private pharmacy, the high price of drugs was not really a problem. Even consumer preference played a perverse role, as Vietnamese, over much of this period, tended to believe foreign brands were of better quality and more effective, and had little sense of benchmark prices, so it was easy to sell more expensive brand-name drugs than cheaper domestically produced or international generic drugs (Nguyen 2012).

The dilemma for Mr. Quang was to formulate a policy that could strike a balance between consumers’ interest for affordable drugs and pharmaceutical companies’ interest for profits in tandem with the macro-level governmental policies on social health, insurance fund and boosting domestic drug industries.

Background

Before the Renovation policy had transformed Vietnam into a market economy, pharmaceuticals were being produced and distributed according to a central planning mechanism.  

42 The ‘Renovation policy’ began in 1986 and involved transforming the economy from central planning to the market mechanism.
planning mechanism. Drug prices were set by the State Pricing Commission or the Ministry of Health. Many drugs were being imported from the Soviet Union to meet Vietnam’s medical needs. But in the early 1980s, the Soviet Union had begun to go through its own transformation. Aid to Vietnam, including pharmaceuticals, had dropped sharply. This had led to severe shortages of pharmaceuticals while demand was growing. The result had been an increasing role for black markets, smuggling, speculation, counterfeit production and theft of drugs from public health services. The Government had tried to regain control over the production and distribution of pharmaceuticals using administrative mechanisms, trying to expand production and supply in a setting with no incentives for production and low access to affordable pharmaceutical ingredients. Desperate calls for officials to have integrity in their pharmaceutical production, distribution and utilization activities seemed as ineffective as asking a child alone in a candy store not to eat any candies.

The failures of central planning had more widely culminated in the 6th National Party Congress in 1986, which had opened the way for a new paradigm – the so-called socialist-oriented market economy. According to the Resolution of the 6th National Party Congress (18 December 1986), all forms of direct subsidies that hindered business development were dropped, prices were set based on production costs and reasonable profit levels, and subsidies to producers were eliminated.

Drug prices continued to be set by the State Pricing Commission and the Ministry of Health until 1989. In August 1989, the State Pricing Commission and the Ministry of Health issued Circular No. 440, which could be considered Vietnam’s first explicit drug price policy. According to this policy, drug prices would be set by demand and supply in the market in each locality and for each type of drug. No production subsidies would be provided to cover losses in production. Competition and competitive bidding would be applied and there would be market protection for domestic production of drugs, although precise measures were not mentioned in the national drug policy.

To increase competition, in the early 1990s, private pharmaceutical sales and imports of drugs were allowed and regulations put in place regarding the


44 A summary of drug price policies is found in Exhibit 2 at the end of this case study.
conditions to be met in order to register the business and obtain licences for
drugs to be sold. Pharmacies were required to post prices of the drugs they sold.
Efforts for inspections and penalties for violations of these regulations were
introduced to reduce the nagging problems of smuggling, counterfeit and
substandard pharmaceuticals in the market. Individual hospitals were allowed to
organize competitive bidding to procure the drugs required by their patients.

information available in Vietnamese to users of pharmaceuticals. Material and
financial benefits to influence doctors or pharmacists to prescribe or sell
particular drugs were strictly forbidden. A major emphasis was put on policies to
improve the quality of pharmaceutical products, including Good Manufacturing
Practice (GMP) standards and laboratory quality testing before licensing drugs
for use in Vietnam.

To improve coordination of drugs policies under a common framework, in 1996,
after several years of technical assistance for its development, a National Drug
Policy was promulgated. In the same year, the Drug Administration of Vietnam
(DAV) was set up under the Ministry of Health with responsibility for state
management of pharmaceuticals. (See Exhibit 1 for a list of organisations
involved in drug pricing policy).

In 2002, Ordinance No. 40 on prices was issued covering most goods including
pharmaceuticals and confirmed the new perspective on pricing – “the State
respects the right of organisations and individuals involved in production or
trade to set prices and compete based on price”. The Ordinance stipulated that
the State could implement price stabilisation by influencing demand and supply
for essential goods or to control inflation including measures such as adjusting
demand and supply of domestically produced and imported goods or adjusting
demand and supply across regions. Other price stabilization methods included
use of national reserves of goods, control over inventories, setting price
maximums and minimums, controlling price determination factors, and
subsidizing essential goods, if necessary. This set the legal basis that constrained
future price policies for all goods, including pharmaceuticals. Transparent
posting of prices at point of sale was also an integral part of the Ordinance on
prices, ostensibly to help consumers in the market to choose the drugs with the
lowest price. In 2002, the Ministry of Health added the requirement that drug

45 GMP refers to guidelines specifying principles of the manufacturing process required to ensure
quality.
46 Exhibit 3 contains the full set of World Health Organization recommendations for measures to
include in a National Drug Policy.
prices be listed on the application for approval of both domestic and imported drugs for sale in Vietnam. In 2002, a new Circular on registering a pharmaceutical establishment required that they post prices and sell according to the posted prices.

Supply measures to ensure stability of drugs included the regulations on drug reserves promulgated in 1998, which could be relied on to increase supply and prevent price rises due to shortages in the market. The Prime Minister approved a strategy in 2002 for the development of the pharmaceutical manufacturing and distribution sectors till the year 2010. This included objectives related to ensuring adequate and regular supplies of essential drugs for the people. Increasingly, pharmaceutical state owned enterprises were being reformed and shares were sold to the private sectors to increase their efficiency.

**Pharmaceutical price shock and drug price policies**

The relative stability of drug prices with the market reforms was disturbed in 2003. In the first three months of the year, drug prices increased nine percent compared to general inflation of less than two percent (General Statistics Office 2012). A meeting was held on 27 March 2003 between two of the Deputy Prime Ministers and the leadership of the Ministry of Health, Ministry of Finance, Ministry of Trade and other related agencies at the Office of the Government to contain the rapid increase in drug prices. The Ministry of Health was assigned to be the agency accountable for investigating and analysing the recent rapid price rises and to lead the process of putting in place measures to prevent any future large increases in drug prices. Within the Ministry of Health, this task was assigned to the Drug Administration of Vietnam and became Mr. Cao Minh Quang’s migraine.

In the meeting, the Deputy Prime Minister assigned responsibility to the Ministry of Health and the Ministry of Finance to develop a joint circular on essential drug price management to ensure stability of drug prices by April, and later to develop a Government Decree for a pharmaceutical price stabilization policy.

Analysis of the causes of the rapid price rise initially pointed blame at prices of imported drugs, especially those from Europe and the recent change in import tariffs for pharmaceuticals from 10 to 20 percent. Some blamed the multiple layers of intermediaries between importers and retailers.

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Circular No. 8 on drug prices was eventually passed in July and came into effect in October. The contents of this circular were constrained to following the principles of the 2002 Ordinance on Prices, in which prices were to be set by the manufacturer or importer based on the market. The price (CIF⁴⁸, wholesale, retail) had to be officially declared when the pharmaceutical product was registered for sale in Vietnam. Prices had to be posted at the point of sale and printed on packaging. Pharmacies and other pharmaceutical establishments were not allowed to sell at a price higher than the published price on the packaging.

The Ministry of Finance, collaborating with the Ministry of Health to develop a Government Decree on managing drug prices, responded to criticisms of the weakness of Circular No. 8 by stating that it was inadequate to manage drug prices and an effective policy to stabilise drug prices would be needed to control price margins (TD 2003). In 2004, Decree No. 120 was passed including ceilings on mark-ups, and requirements that declared prices be compared to international reference prices to determine reasonableness.

A 2005 study discovered another problem with drug prices – not only was there rapid inflation, but drug price levels in Vietnam were found to be extremely high. Mr. Quang co-authored the study and was involved in adapting the World Health Organization (WHO) methodology to the Vietnamese pharmaceutical context. The prices of 42 drugs were compared to international reference prices for the same drugs using data available from Management Sciences for Health (MSH). Results found that in publicly procured drugs, innovator brand drug⁴⁹ prices in Vietnam were 8.3 times higher than international reference prices for the same drugs, and for lowest price generics they were 1.82 times higher. Not only had prices risen rapidly, but drug price levels in Vietnam were ‘considerably’ higher than international reference prices (Nguyen et al, Medicine Prices, Availability and Affordability in Vietnam, 2009). Evidence from this study was used to tighten up the drug price policy, replacing Decree 120 with Decree 79 in 2006 and Circular 11 (2007) to guide its implementation. The revisions dropped ceilings on drug price margins, which had proven difficult to implement, and clarified which kinds of prices should be used for comparison.

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⁴⁸ CIF designates import prices and stands for Cost, Insurance, and Freight.
⁴⁹ Innovator brands are the first version of a drug with a given active ingredient to receive FDA approval and benefit from patent protection. Generic drugs are equivalent to innovator brands but are only allowed for sale after the patent protection expires.
Conflicting objectives

While the drug price policy was being formulated and passed, other developments were occurring in the health sector. World Trade Organization (WTO) negotiations were underway and there was strong pressure from developed countries on the Government to put in place strict controls on intellectual property rights in exchange for freeing up export markets for Vietnamese goods (Love 2011). Vietnam agreed to data exclusivity regulations, which could extend patent protection and delay introduction of cheaper generic drugs (Kılıç & Maybarduk 2011). Vietnam’s market was large in terms of population, but small in terms of purchasing power. Hanging over the head of the Drug Administration of Vietnam was the threat that if policies put too much downward pressure on innovator brand drug prices, the foreign drug companies would simply decide not to supply Vietnam’s market.

Decentralisation of public finance and granting of autonomy to public hospitals had been taking place in the first decade of the new millennium. There was increased pressure for hospitals to increase their revenues to cover their costs, but also to pay adequate supplementary incomes to retain and motivate their staff. With government user fees as the main official source of revenues, but fees set since 1995, and regulations requiring that pharmaceuticals for hospital inpatients be sold at cost, hospital directors faced a difficult challenge to ensure adequate surplus revenues to pay staff. In 2007, the Ministry of Health and the Ministry of Finance promulgated a joint circular regulating competitive bidding of pharmaceuticals in hospitals in line with the Law on Competitive bidding. In 2008, regulations were put in place to regulate operations of hospital outpatient pharmacies including encouragement of joint ventures with private parties. Competition should have pushed drug prices down to make them more affordable to patients and to the health insurance fund.

However, a 2010 Government inspection found evidence of substantial irregularities in bidding leading to losses of 22 billion VND. In the provinces of Phu Tho, Dong Thap, Bac Lieu and Hanoi, the winning tender price was higher than if the hospital simply went to the retailers to buy drugs. In Nghe An, Thanh Hoa, and Hai Phong, they found the bid invitation prices higher than the actual winning bids from 47 percent to 357 percent and the winning tender prices higher than prices offered by competing bidders. A political cartoonist illustrated this cleverly, showing the two losing bidders from Pharmaceutical Companies A and B with lower prices losing to Drug company B with higher prices for Drug X (See figure). In Hanoi, Hai Phong and Nghe An, they found the winning bid prices for 75 drug
items at 130 percent to 245 percent higher than CIF import prices. In the province of Thanh Hoa, they found 161 drug items sold without going through the competitive bidding process (Quang 2011). Another article found that prices for the same drug procured through competitive bidding at different facilities varied substantially. They also found evidence of public-private collusion in informal discussions that if a hospital wanted the prices low, competitive bidding would yield low prices, but if the procurement committee of the hospital wanted the prices high, so they could receive ‘commissions’, then the winning tender would be high. Pharmaceutical companies that wanted to survive had to go along with what the procurement committees wanted (Ha 2010). Hospitals that wanted to survive needed to find additional sources of income to supplement staff salaries.

Another major problem often cited in news articles was that drug representatives paid hefty commissions (called ‘roses’ in Vietnamese) to doctors to prescribe their drugs. As the illustration on the right shows, Doctor X is prescribing medicines and the patient has to bear the burden of a heavy ‘rose’ of commission percentages that would be paid to the doctor (Ha 2008). While there had been explicit regulations forbidding any material or financial rewards to influence prescribing practices of doctors since the 1990s, no effective policies had been put into place to prevent this behaviour. A recent scandal uncovered two doctors in the prestigious HCMC Medical-Pharmaceutical University hospital earning billions of VND in commissions for sales of expensive hepatitis drugs, with commission rates of 30 percent (Chuong 2010). Pressure for action was mounting, but low official salaries made commissions quite tempting.

Social health insurance under Vietnam Social Security, with its huge outlay on drugs each year, was keen to have greater control over drug prices and volume. There was a tendency for doctors to overprescribe for insured patients as the insurance bore the cost. But Vietnam Social Security was severely restricted in what it could do since health insurance policy was determined by the Ministry of Health, while the Health Insurance Agency only implemented the policy. Measures in place to restrict spending on pharmaceuticals such as limiting the
value per prescription, or only dispensing low price generic drugs were not popular. Patients and doctors both wanted greater freedom to get the best drugs available, especially if health insurance was paying. Medical facilities got around the regulations by recording more than one visit per patient in order to provide a higher value of pharmaceuticals, or by requiring that patients pay out-of-pocket for alternative, ‘better quality’ drugs on the market (Khanh 2007). In addition, fraud was prevalent, with a recent case of a group of doctors making up false patient records to obtain health insurance reimbursements cumulating to over US$ 200,000 (Quang 2011).

Many patients and doctors believed that imported drugs were of better quality and more effective than domestically produced generic drugs (Chuong 2011). The doctors, with their greater knowledge of pharmaceuticals compared to the patients, and their hidden incentives to overprescribe expensive drugs, would not always make the best choice in prescribing drugs for the patient. Both when self-medicating and when seeking care at a medical facility, patients considered the price a symbol of better quality so they were willing to pay more money for imported than domestically produced drugs, even though the drugs had the same active ingredients and met good manufacturing practice (GMP) standards.

The local pharmaceutical industry had continued to develop and gradually increased its market share with an explicit policy goal to reach 60 percent of market share by 2010. Most of its production consisted of low-priced generic drugs, although the Government was providing some assistance for innovation, especially for industrialising production of traditional herbal medicines. All domestic pharmaceutical companies producing modern drugs had to meet WHO good manufacturing practice standards, while herbal medicine producers were striving to achieve appropriate international standards. Government procurement of drugs for reserves and national programs favoured domestic producers.

The Vietnamese Government was very concerned about poverty reduction. Market prices of pharmaceuticals could reduce access to drugs among the poor, especially those living in remote areas where transport costs were high. Several policies had been put in place to continue the market price policy for drugs, while ensuring access for the poor through subsidising transport of drugs to remote areas, providing free health insurance to the poor and setting up revolving drug funds at commune health station pharmacies. Nevertheless, price continued to be a barrier for the poor to obtain drugs and health insurance co-payments were increasing, especially for chronic illnesses. Sales of drugs turned out to be an important income generation mechanism for commune health stations, and margins allowed on drugs could influence over prescription.
Have drug prices been controlled?

Mr. Quang had reported numerous times to the Minister of Health and in press conferences that drug price policies had been effective, based on evidence of consumer price inflation (See figure below). According to this indicator, after the major jump in drug prices in 2003, drug price inflation had been kept below general price inflation, especially in the most recent years when electricity and gasoline prices had pushed general inflation to high levels. In October 2011, the new Minister of Health stated that Vietnamese drug prices were only slightly higher than international prices.

But the Government, Legislature and the people were not satisfied that drug prices were under control. In a meeting with the National Assembly Committee for Social Affairs on 18 October 2010, the Ministry of Health and other ministries committed themselves to submitting revised drug price management policies. Many problems remained in the existing policies.

Under the existing policy, hedging was common, in which pharmaceutical companies declared a very high price when registering their drugs to avoid the paperwork of having to re-declare the price when they wanted to raise retail prices. As long as price rises were below this high-declared price they were not punished. But these artificially high prices declared in the licence led to stickiness, and when drugs went off patent, it was hard to reduce the price. It also made it harder to monitor increases in medicine prices when increased prices were below the inflated declared prices (Nguyen et al, Medicine Pricing Policies 2010).

Figure 1: Consumer price inflation, 1996-2012

The hospital pharmacy policy was replaced by two new circulars on hospital pharmacy departments and hospital outpatient pharmacies in 2011. These new regulations required that hospital pharmacy prices neither exceed the prices in local retail pharmacies, nor the competitive bidding prices of pharmaceuticals procured by the hospital inpatient pharmacy department. The policy stipulated clearly the allowable profit margins for drugs sold through the hospital pharmacy. The policy encouraging private contractors to run hospital pharmacies had now been replaced with a policy banning this practice in central hospitals and discouraging it at other levels. The drug price management policy was replaced in December 2012 stipulating authority over key drug distribution intermediaries previously neglected in the regulations, and clarified the responsibility between the Ministries of Health, Finance and Trade and Industry for assessing bid prices, and penalizing violators. The decree and circular on competitive bidding for pharmaceuticals were finally revised and came into effect in mid-2012, with hopes that they would overcome some of the more blatant abuses in bidding for pharmaceuticals.

The drug price policies made the implicit assumption that managing information about drug prices was the key to effectively manage drug prices. While the Drug Administration of Vietnam had placed winning bid prices and CIF import prices on its website (www.DAV.gov.vn), this information was still inadequate to assess whether the winning bid prices were lower than alternative bids, and the final retail prices could be substantially higher than CIF import prices. In addition, as part of the Government’s paperwork reduction policy in 2010, the forms for declaring prices no longer required the applicant to record CIF prices for neighbouring countries, which could be used for assessing reasonableness of prices declared.
The result of the policy revisions

High societal spending on pharmaceuticals was not only because of high prices. The types of drugs selected for use (brand name versus generic), and the overuse of drugs that were not necessary also strongly affected total drug spending. These issues were not in the scope of Mr. Quang’s work. They fell in the jurisdiction of the Medical Services Administration. Progress in developing standard treatment guidelines and enforcing prescription practices had been very slow. Reforms in the mechanisms to pay providers aimed at reducing incentives for over prescription were also in the pipeline, but under the jurisdiction of the Planning and Finance Department.

In 2012, despite implementation of new policies, drug prices continue to be criticized in the news and National Assembly continues to ask the Ministry of Health what they are doing about it. Obvious wide differentials across facilities in prices of drugs with the same active ingredient and dose are leading to calls for returning to the abandoned policy of regulating drug mark-ups with regressive margins. In addition, Vietnam Social Security and many provinces are building capacity to move away from fragmented competitive bidding at each facility towards pooled procurement through competitive bidding at the provincial level. Both of these approaches were recommended by WHO.

Many measures had been put in place; some had failed, while others had shown promise at controlling drug prices. While overall pharmaceutical and medical consumer price indexes (CPI) indicated that drug prices were not rising faster than inflation, the picture was much more complex than trends in the CPI. As drugs went off patent, substantial price reductions should be seen, yet seldom did drug companies actually reduce prices. While prices of some drugs did not rise, if the prescribers continued to prescribe different therapies with higher priced drugs, the overall costs for drugs would still continue to rise.

Mr. Quang had been quite successful at achieving improvements in the quality of pharmaceuticals, an issue that lay entirely within his jurisdiction. But drug prices required collaboration with multiple agencies, with competing and often hidden agendas and he himself faced conflicting objectives. Despite recent new initiatives, the problem has not been resolved. Would Mr. Quang be able to meet the challenge?
**Exhibit 1: Main government agencies currently involved in drug pricing policy**

![Diagram of government agencies involved in drug pricing policy]

**Exhibit 2: Summary of main legislation on drug market price policy in Vietnam**

Resolution of the 6th National Party Congress (18 December 1986) – General prices to be set based on production costs and reasonable profit levels.

Circular No. 440 (1989). Drug prices would be set by demand and supply in the market in each locality and for each type of drug. No production subsidies would be provided to cover losses in production.

Ordinance No. 40 (2002). General prices to be set by producers with competition based on price. Government price stabilisation by influencing demand and supply for essential goods.

Announcement No. 41 (2003). Deputy Prime Minister called for urgent action to stabilise drug prices.

Circular No. 8 (2003). Drug prices set by producers based on market competition, posted at point of sale, printed on packaging.
Circular No. 120 (2004). Drug prices set by producers, but ceilings on mark-ups, requirement that declared price be compared to international reference prices for reasonableness.

Decree No. 79 (2006) and Circular No. 11 (2007). Dropped ceilings on price margins, clarified reference prices. This is the current drug price policy.


Exhibit 3: World Health Organization and Health Action International Recommendations on Component of medicines policy

The following list of actions to influence price, availability and/or affordability is based on the 2008 version of the WHO recommendations on National Drug Policy. An earlier version was available to Vietnamese policymakers at the time of the 2003 drug price shock. Changes between 2003 and 2008 versions are marked in italics.

1. Selection of essential medicines
   - Formulation/updating of essential medicines lists and institutional formularies
   - Development and use of Standard Treatment Guideline
   - Development of quality-assured therapeutic substitution policy
   - Requiring the inclusion of medicines on the national Essential Medicines List in health insurance reimbursement lists with minimal co-pay

2. Procurement/purchasing
   - Competitive procurement (in 2003 tender) with price transparency
   - Use of pharmacoeconomics or international price comparisons as guidelines for fixing prices of originator products
   - Pooled procurement with other national buyers, such as hospitals or health authorities
   - Examination of purchasing practices in other sectors to ensure best practice
   - For single-source products, pressure for differential prices and exploration of possible parallel importation and the use of TRIPS flexibilities to stimulate generic competition (seek the advice of an intellectual property expert, review the experiences of countries that have implemented TRIPS flexibilities, and/or consult the Guidelines for price discounts of single-source pharmaceuticals (5).
• Assurance of transparent and quality price monitoring and public information
• (Create incentives and education for making procurement savings; give margin of preference for local suppliers - dropped after 2003 version)

3. Distribution system
• Analysis of efficiency, transparency (in 2003 - probity), competitiveness and intervention to correct, e.g. by contracting to private and not-for-profit logistics and security organisations with target-setting and performance monitoring
• Monitoring and regulation/control of mark-ups with fixed fees and regressive margins

4. Generic competition
• Assurance of effective quality assurance capability and promotion of generic substitution at all levels
• Promotion of generic acceptance by professionals, patients and the general community
• Prequalification of generic manufacturers and publication of the quality assurance of such manufacturers
• Fast-tracking of regulatory approval of generic medicines

5. Prescribing and dispensing
• Assurance that consumers, the private sector and NGOs are informed about and involved with generic and therapeutic substitution, where allowed
• Building of incentives to prescribe and dispense generic medicines
• Encouragement of separation of prescribing and dispensing, including banning dispensing doctors
• Assurance of unbiased consumer medicine information
• Assurance that promotion of products by pharmaceutical companies is strictly regulated according to WHO Ethical Criteria and prevention of direct-to-consumer advertising of prescription medicines
• Monitoring of prescribing and dispensing practices, using WHO Drug Use Indicators

6. Financing
• Encouragement of pooled and prepaid financing of medicines, e.g. through employment-based or social insurance schemes
• Support of community-based insurance initiatives focused on improved access to essential medicines
• Assurance of exemptions or differential fee systems to protect access by indigent and disadvantaged groups
• Monitoring of prices and access; for example, routine monitoring of medicine prices and availability
• Assurance that health insurance schemes use limited formularies, based on cost-effective therapeutic guidelines.

References


Introduction

On a warm, sunny day in December 2011, the Bhaidas Auditorium in the western suburbs of Mumbai city was thundering with laughter and applause of a packed audience. On stage was the country’s popular comedian and magician, Ranjeet.

The occasion was the Annual Children’s Merit Award Function organised by the Aviation Industry Employees Guild (AIEG), the largest trade union of India’s state-owned air carrier, Air India, felicitating the academic achievements of the wards of its union members. Meanwhile, George Abraham, the General Secretary of AIEG, was impatiently pacing up and down the entrance of the auditorium.

Abraham’s face was curled in a half-smile. He was thankful for the brief comical relief to his fellow union members and their families who were suffering from the turned fortunes of their company that had defaulted on nearly three-four months of wage payments. The man of the moment, however, Abraham knew, was the Chief Guest for the occasion, Minister Vayalar Ravi, who had recently been appointed Minister of Civil Aviation. Ravi was received with an even bigger applause as he assured the eager audience of his commitment to securing their interests. Abraham recounts Ravi saying that he was ‘pressing hard and (was)
hopeful that the bailout package presented by AI to the Government (would) be approved by the Cabinet’.

Air India today had existed as two separate airlines: Air India (operating international air services) and Indian Airlines (servicing domestic routes and neighbouring countries), denoted as AI0 and IC respectively. In the early 2000s, the two airlines had run into rough weather following a global aviation slump. In an unexpected move, Ravi’s predecessor, former Minister Praful Patel, had decided to merge the two airlines in 2007, in a bid to galvanise commercial prospects. The winter of 2011 marked four and half years of the merger. However, the fortunes of the now single merged national airline had only further deteriorated since its unification.

As of March 2011, Air India’s cumulative loss and debt burden stood at US$ 12.6 billion (Sanjai 2011). The carrier had begun defaulting on payments of staff salaries and allowances. The credit rating of its lenders’ was plunging by the week. The potential collapse of AI would have severe political ramifications for the government. The resulting collateral loss would have an adverse impact on the economy and the lives of the 27,000 workers employed with the airline. Patel had come under severe criticism for his alleged role in steering the airline into disarray from the media, civil society, opposition parties, and, most of all, the Airline’s labour unions. Following this public outrage, Ravi was brought in by the government in January 2011 to resurrect the national carrier and convince the unions of the government’s intentions to save the Maharajah.

Abraham, a close acquaintance of Ravi, realised that he had an exceptional opportunity to rally the support of the government along with the new minister in steering the airline back to stability. In AI’s fragmented trade union scape, Abraham headed the largest union with nearly 10,000 workers under his wings. Abraham was the preferred negotiator for management, and, to a lesser degree, the government too, among all of the trade union leaders for his perceived reasonableness and pragmatism.

The three major options before the Government to avoid the airline’s imminent collapse were capital infusion, privatisation or selling off of suitable assets and shrinking the airline to ensure survival and manageability. AI’s trade unions, backed by the larger, national labour movement along with the socialist elements in both the Government and Opposition were in favour of a Government bailout.

51 Pre-merger, Air India will be denoted as AI0 implying Air India (old) and the merged entity will be referred to as AI.
The private and foreign competitors of Air India were in favour of outright sale of the airline or, less preferably, shrinking of its operations, and were critical of the Government’s role in upsetting competitive conditions by constantly supporting AI.

Abraham and Ravi were most keen on the first option, but realised the necessity for the government to take a definitive decision. Air India’s losses and labour tensions were mounting by the day. The duo were up against a formidable challenge with little or no public support for an airline that was largely perceived, quite simply, as an inefficient public-sector enterprise and a relic of India’s socialist past long overdue for sale or closure.

The take-off period

The history of civil aviation dates back to 1903. Air services, then, were entirely in private hands free from any form of regulation. This free reign, however, had ended soon enough as states had begun to see civil aviation as critical to national, economic and defence interests. Accordingly, the first inter-Governmental regulatory authority, International Civil Aviation Organisation, was established in 1944. Civil Aviation had been brought under state control world over and most airlines nationalised.

In the mid-1900s, aligned with international trends, the newly independent Government of India had nationalised its air transportation industry under the Air Corporations Act, 1953, and established two autonomous corporations, Air India (AI) and Indian Airlines (IA). The two carriers had gone on to register swift growth in fleet and network expansion and soaring profits. Air India (AI), in particular, had come to be known for its superior and hospitable in-flight service internationally.

In the late 1980s, the civil aviation industry worldwide began a process of liberalization. Indian domestic skies, too, were opened up in tandem to the liberalization of the Indian economy in the 1990s. In 1994, the Air Corporations Act was repealed and the Open-Sky policy announced. This broke the monopoly of the domestic national carrier as more than 15 private airlines sprung up in the aftermath. However, most of these airlines collapsed in subsequent years, with the exception of two major private airlines, Jet Airways and Sahara Airlines, leaving behind huge amounts of unpaid debts to oil companies, airport authority, employees, and various other vendors.

52 Sahara was bought over by Jet Airways in 2007.
Into the 2000s, international bilateral\textsuperscript{53} air traffic rights were diluted by the Government of India. Indian air carriers’ inability to exploit the increased seat capacity had made way for the entry of foreign players. Indian carriers took a further beating with the slump in civil aviation business worldwide following the terrorist attacks of September 11, 2001, and the onset of global recession. Competition in the domestic arena had only intensified with the proliferation of low-cost airlines in the early 2000s. These developments had given civil aviation in India a new lease of life as air travel rendered much cheaper for the growing percentage of middleclass Indians who were turning to air travel as an alternative to rail transport.

AI had hit an extreme capacity constraint with only 23 aircrafts that had an average age of 18 years in 2001. In the light of a shortfall of US$ 2 billion, the government opted to consider part privatisation of the airline with management control. A consortium of Tata Group and Singapore Airlines had been shortlisted. However, the bid was aborted at the last minute after the ruling government, the Bharatiya Janata Party-led coalition Government, failed to secure the consent of its coalition allies and the selected consortium withdrew its bid. Despite all these challenges, the two airlines continued to hold their own under the new competitive conditions since liberalisation.

The dark horse

George Abraham had joined AI in 1981 as a fresh graduate. Having been a university student leader, he had soon begun to take up employee concerns with the management of his new company. Within three years, he was elected as an independent candidate to one of the nine posts reserved for employees on the Labour Welfare Board tasked with representing a 20,000-strong workforce. Three years later in 1986, he was elected chairman of the Board. In 1989, he was invited by the company’s biggest trade union, AIEG, to join them and instantly elected to the post of Assistant Secretary. He had also been inducted into the ranks of the International Transport Worker’s Federation (ITF—a global federation of trade unions in the transportation industry worldwide). Abraham was elected and re-elected consecutively as the General Secretary of AIEG since 1996 and Country Representative as well as Chairman of Civil Aviation Section in ITF’s Asia Pacific

\textsuperscript{53}Bilateral rights refer to the agreements between two countries on the number of passenger seats transacted between them. For instance, if a bilateral agreement between India and Singapore is to operate 1,000 seats back and forth, then it implies that Indian airlines can operate 1,000 seats a week to Singapore and vice versa. No other airline can bring passengers between these two countries.
Region since 1998. He was also nominated to the Think Tank Committee on Civil Aviation constituted by ILO consequent to the crisis in the industry post-September 11.

Abraham explained his approach to trade unionism:

“Set aside traditional trade union thinking and look at every issue from the company’s perspective along with labour’s perspective. A responsible trade union must partner the company and keenly follow affairs and prospects of the company apart from protecting employee welfare. If the company does not do well, employees also do not fare well. The company is not our enemy. If we kill the company, then we will be dead too.”

This company-centric approach had been particularly on display when Abraham had rallied his union base in support of the company’s privatisation bid in 2001. He had come under severe criticism from trade unions all over the country for selling out to the management and private sector interests. He had insisted, however, that in the context of an impending collapse and the government’s adamant refusal to infuse funds, privatisation was unavoidable. He saw no merit in fighting the decision on purely ideological grounds and had chosen to work with the management to ensure protection of employee interests in the event of privatisation. He had argued, “If the company survives and grows, the employees survive and grow too”.

In his 24-year long stint at AIEG, Abraham had come to be known as a moderate and pragmatic trade unionist with desirable negotiation skills. Key to Abraham’s success, however, was his unsuspectingly friendly nature and charming wit. He seemed, for the most part, to enjoy the confidence of the airline’s management, which at times even sought Abraham’s help in resolving stand-offs with the Ministry. Abraham had also become a reasonable point person among the multiple and divided union leaders for the Government to engage with. Notably, Abraham’s union was not affiliated to any political party unlike other unions in the airline, which lent it a relative position of non-partisanship in the political sphere. Enjoying a relatively high degree of confidence, even among his opposition, put him in a favourable position to negotiate for the interests of the employees effectively and that of the company at large too.

Turbulent skies: The fall of the Maharajah

The national elections of 2004 saw a change in the government as the Indian National Congress party-led coalition Government came to power. The Ministry
of Civil Aviation (MoCA) was assigned to one of the major coalition partner’s elected Member of Parliament, Praful Patel. Patel, a successful industrialist and ambitious politician, had publicly taken it upon himself to give the national carriers a makeover and restore them to their former glory.

The labour unions, including Abraham’s AIEG, however, were uneasy about Patel’s appointment. It was rumoured that the owners of the major private, domestic carriers, Jet Airways and Kingfisher Airlines, had lobbied hard for Patel’s appointment to the Ministry to further liberalise the air transport sector and open up new destinations through increased bilateral allocation. Rumours aside, Patel was known to be a strong-headed go-getter with little patience for extensive consultations with various stakeholders. Abraham was wary about forming quick judgements of Patel. He realised that a shrewd entrepreneur like Patel was both an opportunity and threat for the airline. Abraham worked skilfully with Patel, but their relationship soured due to Abraham’s allegations of the Minister’s continued disregard for the concerns of the unions, but more interested in the sale of AI’s strategic interests to private and foreign airline carriers.

Within a week of his arrival, Patel had announced a host of major initiatives including the launch of an international low-cost subsidiary of AI, IA’s fleet-purchase order, and the creation of a new civil aviation policy. Patel also went on to merge Air India and Indian Airlines.

Of these initiatives, Patel launched Air India Express, the international, low-cost arm of AI in 2004. It mostly operated flights from South India to the Middle East and Southeast Asia targeting the significant Indian labour and expatriate population settled in these regions. Despite the diminishing fortunes of its parent airline, Air India Express had been a profitable enterprise for AI since inception. The revision of the fleet purchases, however, would become a source of high financial vulnerability for AI. Furthermore, the new aviation policy, which significantly increased bilateral seat capacity to accommodate Indian private carriers and foreign carriers and the merger of the two national airlines, would come under severe criticism.

A massive shopping bill
Following the collapse of the privatisation bid in the early 2000s, the Board of AI considered and approved a proposal to purchase 28 aircraft (10 aircraft from Airbus for AI and 18 from Boeing for Air India Express) in late 2003 and was pending at the MoCA for approval. At a later stage was IA’s proposal for 43 planes that was approved by its board in March 2002 and passed by two Public Investment Boards. This was before the general elections of 2004. After his
induction as Minister, Patel had requested a revision of AI\textsubscript{0} and IA’s fleet acquisition plan, which was met with resistance from the airlines’ Boards. Shortly thereafter, AI\textsubscript{0}’s proposal was increased to 68 aircrafts (50 for AI\textsubscript{0} and 18 for Express) and was confirmed despite harsh criticism from certain members in the Ministry given the absence of a corresponding business plan to justify the figures (Donthi 2011).

The final purchase order of 111 aircrafts (68 for AI\textsubscript{0} and 43 for IA) exceeded the airlines’ own fleet plans. This had resulted in capital expenditure exceeding US$ 8.7 billion; the combined airlines’ annual sales turnover of US$ 3.1 billion could not support such a purchase (Patel 2009). The Government had refused to finance the acquisition and instead had suggested raising capital through a public offering for the airlines. This never materialised because Patel explained “analysts said the airline would not get a proper valuation because of the negative net worth” (Patel 2009).

Another controversial aspect of the final purchase was the decision to award AI’s entire order to Boeing elbowing out Airbus at the last minute. Airbus had demanded an investigation into the deal, which never came about. Moreover, the purchase order was financed by a large loan with an interest rate of 11.75 percent from a Public Sector Bank instead of the option of “backstop” financing at 4 percent interest with Airbus (Donthi 2011). Backstop financing is an arrangement where the Airline makes a small down payment and the manufacturer covers the rest. In a performance audit of the deal in 2011, the Comptroller and Auditor General (CAG) estimated that the losses caused by this single decision of the MoCA would amount to an approximate US$490 million (Donthi 2011).

This deal haunted Patel long after it was approved. He came under severe allegations from the media and parliamentary that the deal was hurried without due diligence. In 2009, the Parliamentary Standing Committee on Transport, Tourism and Culture released a report, which criticised ‘the unwarranted hike and lack of transparency in the fleet acquisition’. The CAG had expressed concern at the Ministry’s decision to brush aside the objections raised by the Planning Commission (who had found the Ministry’s future projections unreliable) and the Department of Expenditure (questioning the assumption that higher capacity would automatically result in higher market share) before approving the deal (Donthi 2011). In response to all these allegations, Patel argued that a fleet upgrade was long overdue and vital to remaining competitive and that the final purchase was made on the basis of projections made by the airlines’ managements after following due processes. The Minister, however, escaped media furore given the surfacing of other, bigger corruption scandals that had hogged public attention.
Bilateral bonanza

Around the world, air traffic agreements between countries are negotiated bilaterally between governments. For an airline to operate air services into another country, the government of the airline had to negotiate a treaty with the destination government. These treaties contained agreements on traffic rights over routes and destinations, capacity in terms of the number of passenger seats and flights, tariffs, competition policy, and security. Liberalisation of air transport continued to entail substantial government intervention.

Bilateral agreements added to the controversies surrounding Patel’s actions at the MoCA. Once approved, Air traffic agreements become ‘grandfather rights’ in the airline industry; they could not be withdrawn. Hence, the general practice in granting traffic rights was to protect the interests of the home carriers (whether government-owned or private). The critical factor was whether home carriers could mount incremental capacity to utilise their share of additional traffic rights. Following AI’s aircraft purchase and whilst the aircraft were being inducted, overall seat capacity by way of bilateral agreements was increased dramatically. Between 2004 and 2008, total capacity grew by more than 300 percent in India.

Table 1: Total seat capacity between 2004 and 2008

<table>
<thead>
<tr>
<th>All sectors</th>
<th>December 2003</th>
<th>June 2008</th>
<th>Absolute Increase</th>
<th>Increase (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>404,508</td>
<td>1,440,838</td>
<td>1,036,330</td>
<td>356</td>
</tr>
</tbody>
</table>

Foreign airlines gained a competitive advantage of early market entry, resulting in higher entry costs for the home carrier deploying capacity at a later stage. Ironically, this action had unwittingly rendered the aircraft purchase of Air India unviable.

During Patel’s tenure, bilateral agreements were granted to foreign airlines to operate into 13 interior points, including the four metropolitan cities to international destinations. This adversely impacted AI’s competitive advantage of operating exclusively from the country’s interior points. AI’s market share of the home market fell from 38 percent in 2004 to 18 percent in mid-200854. While private, domestic carriers benefited a little from the increase in bilateral agreements, the net outcome of the bilateral policy was largely in favour of

54 Presentation on The Present Financial Crisis in NACIL (Air India), Civil Aviation Joint Action Front, 7 July, 2009.
foreign airline, resulting in the marginalization of Indian carriers. In early 2011, Jet Airways and Kingfisher Airlines, two of the leading private Indian carriers, joined with AI to protest against the expansion of capacity entitlements, which they argued had destroyed the domestic aviation industry.

Patel was harshly criticised for awarding bilateral agreements to four specific foreign airlines: Emirates, Etihad Airways, Qatar Airways and Lufthansa. Abraham’s union accused the Government of making these four airlines, with more than 350 flights a week to and from India, the new de facto national airlines of the country. Multiple official inquiries requested an explanation to the generous increase in capacity granted to foreign airlines able to operate in India without corresponding agreements of national carriers. The CAG report particularly decried the “disproportionate economic advantage” accorded to foreign airlines through the sale of traffic rights. The CAG report named Emirates as one of the beneficiaries and questioned the Ministry’s disregard of AI’s protests over the absence of reciprocity in the terms of the bilateral agreements.

An unhappy merger
The two national airlines merged in August 2007. Patel planned the merger with the objective of creating the largest airline in India. Such a move, the Minister suggested, would not only improve the global ranking of the airline in revenue terms (to number 31 from the original 48 of AI and 67 of IA) but also make it eligible for entry to the elite Star alliance of international airlines. Furthermore, the merger would facilitate resource maximization and provide the platform to leverage each airline’s business strengths. Mergers were not entirely uncommon in the civil aviation industry. The most famous and successful merger was that of the British Overseas Airways Corporation (BOAC) and British European Airways (BEA) in the mid-1970s to form British Airways. However, some mergers in this industry had failed and did so because of issues of integration of the merging entities (Steffy 2010).

Patel’s decision to merge the two airlines caught everyone by surprise. Of the various reform documents authored on the carriers, none had suggested the possibility of a merger. To the airlines’ managements, labour unions and some quarters in the Ministry too, the merger seemed to be a counterintuitive move. However, Patel appeared before the public and other stakeholders to try to convince them that this was the best option. The trade unions of both the airlines were angry at this utter disregard. The unions’ main concern was the incompatible labour terms and services in both the carriers and the protection of workers’ interests. Abraham recounted that Patel had calmed the feverish tempers of the union leaders promising that in the process of integration of the
two labour forces the ‘best of both will prevail at all levels’ (in respect of service conditions and emoluments).

Following the merger, the unified entity was sliced up into five subsidiary units: Passenger Services, Cargo, Ground Handling, Maintenance, Repair and Overall (MRO) and Air India. Each of these units was to be headed by a dedicated CEO who would be accountable to a Group Chairman and Managing Director. This was common practice where large and ailing companies were bought and divided (and generally resold to other private bidders). Accordingly, in 2007, AI0 (along with Air India Express) and IC were merged into a new company that was called the National Aviation Company of India Limited (NACIL). In 2011, NACIL, along with the subsidiary units of the erstwhile airlines, formed Air India Limited (AIL).

Despite adverse competition, AI0 and IC posted healthy profits up until 2004-05. However, after that, signs of the airlines’ turning fortunes became visible. Prior to the merger in 2007, IC had registered losses up to US$ 54 million and AI0 up to US$ 88 million. Their aggregate losses amounted to US$ 142.5 million (Donthi 2011). This figure rapidly escalated in the next three years of the merger to an estimated US$ 3.1 billion. As of March 2011, Air India had accumulated a debt of US$ 8.3 billion and an operating loss of US$ 4.3 billion (Saha 2011). Apart from a backlog of approximately three months of salary payments and six months of allowances, it had also begun missing interest payments, which hurt the credit ratings of its lenders. The CAG identified the major causes of the merged Air India’s financial woes to be the failed idea of the merger itself and the decision to finance the inflated aircraft purchase order with debt. The report explained that post-merger, “they were just too many ill-suited aircraft for ill-suited routes.” It alleged that the benefits of the merger were foregone due to the lack of route and capacity optimisation.

Thus, NACIL was plagued with problems since its inception. All projections given by MoCA proved to be wrong. Employees’ unions were kept out of the entire amalgamation process. According to an infuriated Abraham, “all promises (given by Minister Patel) were to con us into agreement.”

Poor integration
Prior to the merger, nine committees were commissioned to study several issues of integration in the new company, including seniority and career progression, computerised systems, common code, welfare, etc. The merger was to have taken place on the basis of the findings of these committees’ reports. However, even before the reports could be submitted, the merger was finalized. As a result, for
nearly three years after the merger, the two airlines continued to operate as separate entities for all practical purposes. Crucial synergies such as route rationalization, IT integration, pooling of resources, manpower, equipment, bulk purchases and office spaces, among others were not coordinated. The merger had run into trouble from the start due to the lack of systematic integration with persistent clashes between organizational structures and functional responsibilities.

AI0 and IA had entirely different organizational cultures based on different operating conditions. IA was a purely domestic airline, which enjoyed monopoly status on its serviced routes until mid-2000. AI0, on the other hand, was well-versed with the international aviation trends having competed intensely to maintain a frontrunner position in its days of glory prior to the 2000s. A failure to integrate disparities in service conditions of AI0 and IA employees post-merger became the cause for much labour discontent. Personnel across ranks and hierarchy fought over placements, positions and promotions while the government chose to turn a blind eye to this unexpected hostility. The merged entity was plagued with one-upmanship at the cost of the company. In a particularly acrimonious meeting in the aftermath of the merger, union leaders of erstwhile AI0 and IA were fuming over the incomplete processes of integration. In a bid to break the tension in the room, Abraham narrated a story of two divorcees, each with kids from their previous marriages, who got married to each other and went on to have two more kids together. One day, they returned home from work to find their kids fighting and the wife quipped to her husband, “my children and your children are fighting with our children!”

The labour integration issues had come to the fore of public attention in the summer of 2011, when 700 IA pilots had gone on strike for more than a week because of wage disparities with their AI0 counterparts in the merged carrier. This single event had piled on losses to the tune of US$40 million (Economic Times 2012). An inconvenienced public vented its ire on the inefficiencies of the state carrier, which only further discredited the company. Despite repeated requests, Patel failed to initiate action on the integration front, causing the unions to suspect him of having vested interests in the status quo.

Routes discrepancies
Patel was accused by the unions of “transferring several highly lucrative routes from AI0 and IA to the domestically-owned private and foreign airlines in an arbitrary fashion thereby resulting in heavy losses to the two national airlines” (AIEG 2011). In a bid to reduce operating losses, several routes had been abandoned by the airline on the instructions of the MoCA. Ironically, AI forfeited 32 of its profitable routes on most of which the load factor was approximately 80-
100 percent, primarily in the Gulf (Middle East) sector which provided a ready market to private airlines (Saha 2011). These routes were immediately grabbed by Jet Airways, Emirates and Etihad Airways. Abandoning profitable routes had become even more contentious in the face of the airline’s continued operation on loss-making routes despite its distressed financial conditions. The CAG had reported that the operating losses of the airline on the New York sub-route itself had jumped from approximately US$15 million in 2005-06 to US$300 million in 2008-09 due to an increase in the number of flights from 725 to 2,183 (Kaul 2011). Another route, Chennai-Bangkok with 95 percent passenger load capacity, was abandoned, making way for Thai Airways to grab the market. No legitimate explanations were provided by the airline or the Ministry in support of the above decisions.

**In the Maharajah’s Kingdom**

**Government patronage**

The national carrier fulfilled crucial national and socio-political responsibilities apart from being the proud flag-bearer of the country. This included operating flights to remote and far flung areas to foster economic development and national integration, operating subsidised flights for Haj pilgrims and providing capacity for evacuation from war zones and disaster affected-areas. It was also the official carrier of the Heads of State. The carrier incurred significant losses on most of these operations by disrupting its own scheduled operations and damaging its own image and operational reliability with passengers. Furthermore, successive governments routinely defaulted on payment of dues to the Airline for the above-mentioned services.

In the 75-year long history of Air India (pre and post-merger), the airline never once sought financial support from the government. Until financial year 2004-05, it had consistently recorded profits with the exception of two years. In fact, the airline had contributed significant gains to the national exchequer on a meagre equity base of US$30 million. Until 2010, Air India had been one of the most undercapitalised Airlines in the world owned by a national government. Given this context, Abraham questioned the government’s repeated hesitation to bail out the airline whenever it was in dire need. The first occasion was in the early 2000s when the airline hit extreme capacity constraints and the government was ready for privatisation but not capital infusion. In 2011, the government never seriously considered saving the airline, alleged Abraham. In the civil aviation industry, countries were known to protect home airlines due to national strategic interests allied with air transport. Abraham pointed out that where the market share of national airlines in most countries was around 45 percent, in India it was a mere 17 percent.
Restricted management
A major area of concern over the years had been the politicisation of the management of AI. The management heads of the airline were members of the Indian bureaucracy who were mostly appointed by political heads. This resulted in the absence of a clear and consistent leadership at the helm of the airline. The CEO and MD were frequently changed resulting in little continuity in company policies and absence of long-term corporate vision. Abraham cited that in the fifteen-year period 1996 to 2011, AI and then Air India had seen around 10 Managing Directors, 10 Secretaries at MoCA and 10 Ministers. With the exception of Praful Patel, who had a six-year long stint at the Ministry, every other minister had only lasted a year. Moreover, the appointees were neither well-versed with industry specifics nor the airline’s requirements. This left the management in a weak position to steer the airline out of its crisis. Furthermore, constant political intervention in business decisions (which employees claimed increased in the course of Patel’s tenure) left the management with little autonomy. Mr. Abey George, the Public Relations Executive of Air India asserted that the “turnaround plan prepared by the company was sound. However, it had been around for three years and far from execution. Any turnaround plan would require management comprehension levels at par with industry standards” (Abbey 2012). He suggested that the current middle management, most of who were close to retirement, were an old and lethargic bunch. Coupled with rigid bureaucrats, George explained, this combination was only likely to slow down the process of company reform.

Little public support
India was keen to complete its integration into the global liberalised economy and shed the baggage of its socialist past. Air India was such a baggage in modern India. The Airline was a long-standing joke among urban and cosmopolitan travellers for its old ‘aunty’ air hostesses dressed in traditional Indian attire. They saw little merit in sustaining a public airline wherein ‘public’ was generally associated with inefficiency. Negative media coverage only fed into this notion. The public display of differences between political and management heads and the unions of AI did not help in garnering public support for the carrier. The general urban middleclass seemed to be of the view that there couldn’t be any good in the national airline being artificially sustained at the cost of taxpayers’ money.

Divided union front
A significant challenge faced by Abraham was the fragmentation of the labour representation in the company. This was due to the poor industrial relations policy to control the power of the labour unions, which turned out to be counter-
productive. The managements of both airlines and even the merged entity had encouraged the rise of craft unions in a bid to ‘divide and rule’. Both AI and IA had multiple unions within the same company, which continued onto the integrated carrier that had 12 unions in total. Certain employee categories in the merged AI were even represented by more than one union. In April 2011, the management announced a ‘one craft, one union’ policy but promoting craft unions was against Indian state policy (Phadnis 2011). The airlines had run themselves into greater trouble by promoting political unions (unions affiliated to mainstream political parties) that were even more difficult to negotiate with given their primary allegiance to the political patron.

In the absence of a solitary, unified union of employees for the entire carrier, Abraham was left to leverage his moderate image to bargain with the Ministry and the management. The more difficult task was to bring the other unions around. His more aggressive counterparts from the IA unions accused him of being hand-in-glove with the management. Abraham explained that given the government’s hostility for trade union agitation, an excessively aggressive stand would be counter-productive. In mid-2011, one of the major IA unions was banned following what the management called an illegal strike. This event had further damaged the credibility of the airline’s trade unions in the public eye and only increased animosity among employees in the airline.

**The way ahead**

AI’s quick descent to chaos and mounting losses in the aftermath of the merger had led to the commissioning of restructuring plans by experts in 2009. AI had gone on to sell three Airbus A300 and one Boeing 747-300M from its fleet for approximately US$ 19 million to cover financial losses (Donthi 2011). A turnaround plan, prepared by Air India and approved by Deloitte Consultants, was stuck in a situation where it could neither go forward nor backward.

Following the scathing reports of the CAG and Parliamentary Committees on Patel’s tenure in MoCA and his decisions of merger and fleet purchase, the Government decided to transfer Patel out of the Ministry bringing in Vyalar Ravi. Ravi, basically a trade unionist, had been President of the Port and Dock workers Union in Cochin, Kerala (a province in South India) for many years. He was a Congress Party loyalist and a staunch socialist. He pledged to save the airline and

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55 Craft unionism, as opposed to industrial unionism, refers to the organization of workers within an industry along the lines of their specific craft. For instance, the erstwhile AI had not one labour union but, instead, a union for each class of workers such as the pilots, cabin crew, ground staff, engineering services, cargo, etc.
rally the necessary Government support in ensuring this. His entry relieved the unions and employees across the board in the company. However, Ravi’s entry was rather late in the day. AI had suffered substantial damage by that time and was in need of a major overhaul to ensure survival.

At the time of Ravi’s arrival at MoCA, AI has asked the government for financial recapitalisation of US$ 8.3 million to write off its debts. Abraham argued that government capital infusion was long overdue and the equity base had to be enhanced. However, the government seemed reluctant to finance the airline. Minister Ravi was the brightest hope for the unions, but he, too, was constrained by the compulsions of coalition politics and staunch dissenters within the party. Privatisation was the least attractive option to the unions and employees. Unlike in the early 2000s, when Abraham had extended his support to the airline in a bid for part privatisation, he was not too keen to support the same in the post-merger scenario. He reasoned that AI’s conditions had been brought on by the government and, therefore, it had to pay the price for its own follies instead of threatening the jobs of AI’s 27,000 employees. He further explained that airline carriers around the world were experiencing extreme fiscal constraints with rising fuel prices and falling yield margins. India’s two major private carriers Jet Airways and Kingfisher Airlines had also been in the red for a while. They, too, had begun registering recurring losses since 2008-09.

A third option that had been adopted in a few failed mergers, internationally, was the shrinking of the airline. This would entail the sale of suitable assets to cover debts and losses and shrink operations to make the carrier smaller and more manageable. This was the likely option in the absence of any external assistance to guard against the airline’s collapse. In such an event, the airline would be declared sick, come under the jurisdiction of the Board for Industrial and Financial Reconstruction (BIFR), and be subsequently dissolved.

Abraham realised that the real task at hand was to push the Government to action. The price of delayed action or even inaction would, indeed, be the life of the airline itself. Ravi was considered an ally by the unions and the management in its efforts to seek the commitment of the government in ensuring AI’s survival. However, AI was of little priority to the government embattled with controversies of corruption in other higher-profile cases in 2011. Furthermore, several sections of the public and the business community saw any extension of financial aid by the government to the airline as further corruption as artificially sustaining an inefficient airline through taxpayer’s money.
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Indonesia is the largest country, in terms of area and population, in Southeast Asia. It is a founding member of the Association of Southeast Asian Nations (or, ASEAN) and has always been a vital player in the region. Indonesia is also expected to be among the top 10 major economic players in the world by 2020. However, its development is the least exposed compared to other countries in the region.

In this book, Novotny attempts to illuminate one important issue which plays a critical role in Indonesia’s development, particularly its foreign policy. Shaped by the Cold War perspective, Indonesia’s relationship with the United States has always been better than its relationship with China. After the failed coup attempt by the Indonesian Communist Party in 1965, supported by the Chinese Communist Party, Indonesia’s relationship with China was halted until the end of 1980’s.

However, the United States’ embargo policy on Indonesia for military support to East Timor has shaped a negative opinion of the US. This was exacerbated during the Bush administration, resulting in escalated tensions with Islamic countries. Through this book, Novotny highlights the pertinence of Indonesia’s foreign policy in relation to US and China for countries within the region.

Novotny provides an in-depth analysis on how Indonesia’s elite policymakers engage the US and China. His analysis is primarily based on the Balance-of-Threat Theory. The author finds that Indonesia’s foreign policy decision-making in the post-Suharto era is made more complex because of the diversity of the players. This diversity poses great challenges in building a unified national interest.

The author also draws from historical perspective, including Indonesia’s relationship with China in the past and the US’ involvement in Indonesia’s independence movement. The author makes an interesting point – the former President of Indonesia was never concerned about US dominant role in the

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region because it has provided stability in the region since the Cold War. The author supports this with a comment from an Indonesian in exile. According to the former President, Indonesia elites are confident that the US foreign policy is very likely to change, citing the Vietnam War. As a democratic country, it is easier for Indonesia to deal with US as long as Indonesia can provide a good reason in each of its policy relevant to US.

Novotny describes Indonesia’s relationship with the US relation as a “love-hate” one, while its relationship with China is purely pragmatic. Indonesian foreign policies are designed to keep China at arm’s length and to keep its power in check. Fifty-one percent of the leaders interviewed think that the US negatively affects Indonesia’s national interests and security, followed by 33 percent and 27 percent for Australia and China (respectively).

The author also finds that Indonesian elites consider internal factors as the main threat to Indonesia. However, they also perceive that traditional external security threats come from the US and China. The elites also assert that George W. Bush policy was the most significant factor affecting Indonesia’s national security negatively. They view China’s growing influence positively, as it perceived to balance US’ power. However, in the long run, the Indonesian elites believe that China’s growing power should be constrained.

Indonesia’s foreign policy sticks to its principle of “politik luar negeri bebas aktif” or “free and active foreign policy.” This position will not change in order to maintain equal footing with the US and China for the purpose of preserving its economic, political and military interests. However, with its robust growing economic power, matured democracy and its history for not entirely bandwagoning to any superpower, Indonesia foreign policy will still be unpredictable.

“Torn between America and China” draws on information and linkages from a wide array of Indonesian policymakers and historical facts. It draws a clear picture on how Indonesia is handling its relationships with China and US. Anyone who wants to get up-to-date information on Indonesia’s foreign policy should read this book, especially since it plays a leading role in ASEAN, and vital to the stability of Southeast Asia.

REVIEW OF FRANCIS FUKUYAMA’S THE ORIGINS OF POLITICAL ORDER: FROM PRE-HUMAN TIMES TO THE FRENCH REVOLUTION

Reuben Hintz

No shortage of ink has been spent on efforts to explain the divergent paths that political development has taken in different parts of the world. Why has China, arguably the world’s longest continuous civilisation, relied on strong autocratic emperors to hold its numerous dynasties together? Why has democracy, despite being a remnant of British colonialism, been so resilient in India? Why was Europe, a cold and isolated corner of the world for most of human history, the first place where democratic governments really took hold?

As Francis Fukuyama readily admits, the development of human society rests on so many variables that we will probably never be able to ascertain the real answer to these questions. However, in this 483-page volume he does manage to produce some interesting explanations for why different parts of the world diverged, and how they might once again converge. This convergence is the result of what the author sees as the essentially universal quest of “getting to Denmark”; that is, creating a state that is “stable, democratic, peaceful, prosperous, inclusive, and has extremely low levels of political corruption.” (Fukuyama 2011) The problem, as Fukuyama goes on to point out, is that collective amnesia prevents even the Danes from explaining how they got to Denmark.

Fukuyama begins by explaining how multidisciplinary approaches and modern science have changed the way we look at political science. He begins by discussing how the seminal thinkers - Thomas Hobbes, John Locke, and Jean-Jacques Rousseau - all believed that the default human state was one of isolated individuals; only over time did social groups emerge. However, Fukuyama points out that modern scholars have crucial evidence that was not available to their predecessors; in this case decades of research on the behaviour of chimpanzees and other apes which share 99 percent of their DNA. Primatologists have discussed that these species are inherently social creatures; they invariably spend most of their lives in tightly knit, very hierarchical, groups. This evidence would seem to contradict the notion that humans themselves were ever really

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58 “Getting to Denmark” was the original title of a paper: Pritchett, Land and Michael Woolcock. “Solutions When the Solution Is the Problem: Arraying the Disarray in Development.” Center for Global Development Working Paper 10, 2002.
individualistic. A relevant finding is that groups of chimpanzees are also violent; males not only fight for control of their own group but also make a habit of raiding other groups.

So how did human societies evolve from simple social groupings to more complex forms like modern-day states? Fukuyama weighs various theories and readily admits that he is unable to actually disprove or prove any of them. However he repeatedly comes back to Charles Tilly’s oft-repeated statement that “war made the state, and the state made war.” (Tilly 1975) This process is perhaps first clearly seen in early China where 468 wars took place during the appropriately named Warring States period. At the same time the number of states dropped from sixteen to one and the emperor remained.

This brings us to the critical question of why China, having constructed an effective centralised bureaucratic state over a millennium before any European state, failed to develop democracy. Fukuyama spends much of the book extolling his primary hypothesis: in order to develop an accountable government, a country needs to have balance among various groups in society. In China the emperor was all-powerful. He was both the head of the state and a walking deity; there was no existing religious establishment with which he had to contend. In Europe, on the other hand, the Catholic Church provided a powerful check on power. No monarch in Europe could ever truly dismiss the clergy without the risk of jeopardising his hold on power. Along similar lines, India also developed an independent Brahmin caste that was able to provide a check on local rulers; as such, the subcontinent never really developed any strong monarchs like China did. Furthermore, religion in Europe and India differed in another crucial aspect. Where the Brahmins in the subcontinent were only loosely connected to one another, in Europe the Vatican gradually centralised its operations, to the point where monks could draft a universal code of law consistent with church dogma but also useful in the day-to-day proceedings of courts throughout Europe. While the presence of a strong unified religious authority did not make the development of democratic institutions inevitable, it does seem to have played a crucial role in setting the precedent for an effective system of checks and balances.

As the book ends, Fukuyama tells readers that they should be cautious in trying to apply the lessons of previous states to their modern day counterparts. In particular he emphasises that while it took centuries for democratic and accountable governance to develop in Europe, there is no reason why the same process cannot happen more quickly in the contemporary world. While in past centuries information travelled no faster than the speed of a horse, when it travelled at all, today almost all of the world’s information is no further away
than a few taps on a smartphone. As a result, good governance strategies can spread rapidly and replace obsolete models.

Fukuyama is quick to point out several barriers, which still make political reform difficult to achieve. Societies have a tendency to cling to their existing institutions, even in cases where it is obvious that they are outdated or not functioning as well as alternatives. Effective governance also requires a stable equilibrium in society. The government must be accountable to the citizenry and provide the necessary services. The citizenry in turn must respect the legitimacy of government and abide by its laws, including the enduringly unpopular payment of taxes. At the same time all groups of society must respect each other. Efforts to use the existing political order to promote one ethnic, religious, geographic, socioeconomic, or other group at the expense of others can quickly destabilise the entire system. While written constitutions can be quickly “copied and pasted” into place, creating a civil society where all social groups are in equilibrium is a much more difficult task. The author states that this is only the first book in what will become at least a two-volume set. Hopefully the second volume will offer tangible suggestions on how modern day policy makers can avoid these pitfalls and move faster down the path of “getting to Denmark.”

The third edition of Saw Swee Hock’s book, “The Population of Singapore”, is the latest version of Saw’s comprehensive work on population trends in Singapore. The book is a trove of information on the country’s demographic trends, gathered from the 1800s to the present. In this updated version, “The Population of Singapore” features the demographic developments and population concerns that have arisen in Singapore since the second edition was published in 2007. Of particular significance is the inclusion of findings from the country’s 2010 census.

In the book, Saw covers three broad categories of population issues. First, the book offers a broad perspective of the country’s demographic composition and population structure. It then looks at population growth through the lenses of marriage, fertility and mortality. Finally, issues pertaining to labour force composition, such as migration and immigration, are discussed.

The book is a rare find: its discussion of Singapore’s population trends is comprehensive but clear, presented with a factual, information-centric approach to the subject matter. It is, in many ways, a puzzle that has been painstakingly put together from myriad sources on the reader’s behalf. Presented chronologically, the strength of this text is its ability to connect the dots between different population trends and policies, allowing interesting findings that may not have been immediately noticeable to surface.

Saw’s work is particularly relevant at this point in Singapore’s history. As population issues like fertility, immigration and labour surface as hot button topics, this book will serve as a useful overview of all the policies pertaining to Singapore’s population. The book covers a wide-range of policies: the maid levy, voluntary sterilisation and adoption policies are but a few of the policies that are discussed.

Accounts of these policies are accompanied by data that illustrate their policy implications or lack thereof. The findings that the book presents are varied, ranging from the annual total fertility rate compared against the Chinese zodiac calendar to the changing distribution of total population by geographical region.

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and the educational qualifications of brides vis-à-vis their husbands. For its depth and breadth of coverage, one might even venture to say that this book is an authoritative work on population trends and policies in Singapore.

The chapter on future population trends, in which the author proposes a set of updated projections on population and labour force, will be of particular interest to those with a more forward-looking bent. These projections are made through the prediction of the movement of migration, mortality and fertility trends. While these projections will not be new to readers who have been following Singapore’s population issues closely, they remain sobering – all the more so when backed up by a host of factual support.

Saw also makes interesting contrasts across different demographic groups, along indicators like age, race and residential status. These comparisons allow for a more detailed understanding of the social fabric. He discusses the nature of social interactions between the demographic groups and the tensions that may exist in the undercurrents of Singapore society.

That said, readers looking for fresh insights on how to address problems in Singapore may be disappointed to learn that the book does not provide many ground-breaking opinions on population solutions, nor offer revolutionary perspectives on matters like fertility trends, foreign labour or the ageing population. In many ways, the strength of the book is also its limitation: it delivers the facts and does not deviate far from what the numbers show to be true. Yet, in the face of numerous voices calling out to make their opinions on population policies heard, it is refreshing to read a book like this one, that lets its readers draw their own conclusions.

On the whole, “The Population of Singapore” is basic enough for people who want a primer on past policies in Singapore and have an interest in joining in ongoing conversations on national population issues. Yet, it is comprehensive enough for researchers with a desire for detailed data and factual accuracy. Even those with little specific interest in the demographics of Singaporean society will benefit from the author’s meticulous documentation of population policies and their implications on the social landscape of a nation.

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