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# Managing Reforms for Development

Political Economy of Reforms  
and Policy-Based Lending  
Case Studies

January 2013

By  
George Abonyi, Romeo Bernardo, Richard Bolt,  
Ronald Duncan, and Christine Tang

Edited by Jonathan Aspin and Richard Bolt

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Printed in the Philippines.

ISBN 978-92-9092-945-1 (Print), 978-92-9092-946-8 (PDF)

Publication Stock No. BKK125203

#### Cataloging-In-Publication Data

Abonyi, G. et al.

Managing reforms for development: Political economy of reforms and policy-based lending case studies.

Mandaluyong City, Philippines: Asian Development Bank, 2013.

1. Policy reform.
2. Political economy.
3. Southeast Asia.
4. Pacific.
5. Policy-based lending.
- I. Asian Development Bank.

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6 ADB Avenue, Mandaluyong City

1550 Metro Manila, Philippines

Tel +63 2 632 4444

Fax +63 2 636 2444

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# Abbreviations

ADB	–	Asian Development Bank
DOF	–	Department of Finance
IFI	–	international financial institution
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NSCERD	–	National Steering Committee for Enterprise Reform and Development
PBL	–	policy-based loan or lending
PSC	–	public service commission
PSRP	–	Public Sector Reform Program
RVAT	–	Reformed Value-Added Tax
SBV	–	State Bank of Viet Nam
SCPL	–	State-Owned Enterprise Reform and Corporate Governance Program Loan
SOE	–	state-owned enterprise
VAT	–	value-added tax

# Foreword

Successful reform has to resolve two separate and conflicting dimensions: people and time. Reforms, by their very nature, challenge the status quo, often threatening those with a stake in the current system—from society’s power brokers, to better-off stakeholders who may benefit unintentionally and disproportionately from a policy, through to the intended beneficiaries, even if the status quo is unsustainable over the long term. Their changed influence, incentives, and behavior, as a result of reforms, have to be managed, until the success of the reforms becomes apparent for both them and society more widely.

Time, too, has to be assuaged, in the sense that while technocrats may see cuts are needed in, say, subsidies because of a weak budget, the near-term negative effects on low-income groups will be on the minds of both those supporting the political status quo and reformers. And the technocrats know this, so we come full circle.

This is what the Asian Development Bank (ADB)—and many other development agencies—in an admittedly long process of trial and error have found out over more than 2 decades of supporting reforms. The more deeply these agencies became involved in reform efforts, the more they recognized that, although there is no blueprint for success, there are clues as to what may work in particular situations, and how the reform process can be better managed. This recognition and acceptance of the wider, political economy dimension of reforms began in ADB in the late 1990s and led to early work to better understand reform processes to improve reform outcomes.

The book’s intended readers are development practitioners involved in the policy reform process. It aims to help them understand political economy factors that shape actual outcomes, and to simplify the complexities of policy reform and the loans and technical assistance that support such reform.

It attempts to summarize some aspects of ADB’s experience with the political economy aspects of securing policy and institutional reforms—aspects that can fundamentally affect the “rules” and means through which an economy operates and adjusts. The purpose of its case studies is to highlight applications of earlier ADB operations experience in Southeast Asia and, more recently, evaluations of ADB’s support for reforms in the Pacific.

Chapter 1 provides key concepts in a political economy approach and a framework to show how government commitment, politics more widely, and institutions in the term's widest sense interplay as reforms move through various stages of a process, drawing on examples from ADB experience in supporting policy-based loans.

Chapter 2 provides a case study of the “EVAT” reform process in the Philippines, using the political economy framework. It looks at continuing reform implementation issues, highlighting how an otherwise successful initial reform process needs further iterations to deepen and sustain the original objectives.

Chapter 3 shows how the political economy of reform framework was applied to an evaluation study of ADB support for a series of reforms in Pacific countries between 1997 and 2007. Although many reforms were similar, each had very different outcomes, reasons for which can be identified along the stages of the reform process.

Chapter 4 analyzes reform of state-owned enterprises in Viet Nam and shows how Chapter 1's political economy framework can be applied to understand these complex and fundamental reforms for the country.

Chapter 5 discusses specific factors that influenced reforms and why their identification can help to better manage the reform process. It offers suggestions and lessons on managing reform processes, and provides pointers as to how the framework can be applied in ADB-supported operations, both during implementation and post-implementation to analyze their success—or otherwise.

The publication builds on working papers prepared by ADB's Economics and Research Department over the period 2002–2005. It was a collaborative effort of ADB's Southeast Asia Department, the Pacific Department, and the Economics and Research Department.

The chapters, in order, were written by George Abonyi (visiting professor, Department of Public Administration and Executive Education Program, Maxwell School, Syracuse University); Romeo Bernardo (board member of the Institute for Development and Econometric Analysis and Philippine Partner of GlobalSource, and undersecretary of finance during the Ramos and first Aquino administrations); Richard Bolt (advisor to ADB's Southeast Asia Department); George Abonyi; and Ronald Duncan (emeritus professor, Crawford School of Economics and Government, ANU College of Asia and the Pacific, Australian National University) with Christine Tang (executive director of Lazaro, Bernardo, Tiu and Associates, and advisor of GlobalSource Partners). Juzhong Zhuang (deputy chief economist, Economics and Research Department) provided guidance on preparation of the framework and selected case study chapters. Xianbin Yao (director general, Pacific

Department and former assistant chief economist, Economics and Research Department) provided key guidance in preparing earlier working papers upon which chapters of this book are based and this book. Jonathan Aspin (consultant editor) and Richard Bolt edited the volume.

Changyong Rhee  
Chief Economist  
Economics and Research Department

Kunio Senga  
Director General  
Southeast Asia Department

Xianbin Yao  
Director General  
Pacific Department

# A Framework for Political Economy of Policy Reform and Policy-Based Lending

George Abonyi

## Introduction

### Reforms and Development

The current general approach of the Asian Development Bank (ADB) to policy-based lending (PBL) originated in 1987, signifying a shift from the financing of imported inputs to increase capacity utilization to an emphasis on sector policy reforms to better facilitate growth and development.

The basic rationale for PBL is clear: it is more difficult to have effective projects that meet expectations in the context of a weak institutional or policy environment (Ali 1990). Persistency of a poor enabling environment may reduce real returns to projects, implying that a high rate of return to policy reforms may be generated by correcting distortions in policy environments. Yet the choice between investment projects and policy reforms is inextricably linked, and making choices between the two can use a similar analytical approach. Policy changes relating to market and institutional reforms address the economy- or sector-wide causes of inefficiencies, structural constraints, and failures. Although ADB support for reforms tends to be more focused on sector and institutional reforms, the effects can feed back to have economy-wide impacts.

The practice of PBL has changed significantly with experience. The mixed performance of structural adjustment lending in the 1980s led the World Bank to rethink how to support reforms in its borrowing countries. Following its 2001 review of structural adjustment lending, the World Bank shifted from adjustment lending

to a development policy approach that supports structural, social, and institutional reforms over the medium term linked to country assistance strategies. Development policy support and lending are based on an assessment of the country's economic situation, policies, governance, and institutional capacity, as well as a country policy ownership assessment.

ADB has experienced a similar trend of mixed performance but with recent improvements arising from changing practice. ADB's periodic reviews on the performance of PBL show that policy reforms are relevant and needed instruments to effect development and to complement project financing (ADB 1978, 1987, 1999), but have evolved in response to mixed results and the changing needs, and demands, for more effective approaches to support (ADB 2011).

Reasons for improvements include better practice such as improved sector analysis for policy dialogue, wider use of programmatic approaches reflected in program cluster approaches involving a series of single-tranche loans using prior actions and "triggers" for lending to further address the problems of over-specification and sometimes unrealistic nature and number of post conditions. Despite these improvements in the design of PBL instruments, the implementation of reforms remains challenging for financiers and client governments alike, involving a complex set of issues and processes that fundamentally differentiate PBLs from investment projects.

## The Challenge

Policy reform is about change. It involves changing rules, regulations, laws, institutions—and ultimately changing incentives, expectations, capabilities, and behaviors to bring about improvements in the quality of life. Reform involves government action that addresses specific problems to achieve a variety of societal goals related to issues such as economic growth, poverty alleviation, social services, and environmental protection. The basic challenge of policy reform, and associated PBL, is to design and implement *effective* reform measures—reforms that will address key aspects of specific problems, and do so in a way that will lead to improvements. Reform is about achieving the possible, as distinct from a preoccupation with the "theoretically optimal." PBL, in its various forms (Box 1.1) by international financial institutions (IFIs) such as the Asian Development Bank (ADB), is intended to provide support to developing economies to undertake effective reforms.<sup>1</sup>

Governments and IFIs need to have a clear and shared understanding of the reform process to bring about desired changes. In practice, such understanding is not always complete. A key part of the problem is the very different world views of technical

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<sup>1</sup> In this chapter, support for reform includes policy-based (formerly program) loans; technical assistance; and the dialogue between, for example, international financial institutions (IFIs) and government representatives. As shorthand, the chapter uses "reform," "reform program," and "reform program and related support" (which may be policy-based lending or project lending with policy reform content).

### Box 1.1

#### Policy-Based Lending in the Asian Development Bank

The term policy-based lending (PBL) refers to any initiative by international financial institutions—such as the Asian Development Bank (ADB), the World Bank, and the International Monetary Fund—that is intended to support change, adjustment, or reform in policies, the policy process, or policy-related institutions.

As PBL initiatives usually encounter similar constraints, they can benefit from similar types of concepts, frameworks, and methods aimed at strengthening their design. In ADB, PBL initiatives primarily take the form of policy-based loans and sector development program loans but, in some cases, may also include investment projects that incorporate policy-related measures.

Source: G. Abonyi.

experts and policy analysts (e.g., economists) on the one hand and of politicians and policy makers on the other. Thus, reform measures and related loans are rarely implemented as expected, and are often mired in controversy (Box 1.2).

A central question is: “Why do the seemingly good ideas in policy reform and related support often experience significant difficulties in the real world?” And “What can we do about it—how can we make the process of policy reform in general, and PBL support in particular, more effective?”

Returning to the example in Box 1.2, conceptually, the use of the price mechanism for allocating irrigation water seems to make sense and is consistent with economic theory and international best practice. Yet, as the farmers’ reaction illustrates, presenting the

### Box 1.2

#### Thailand’s Agriculture Sector Reform

A key problem facing the agriculture sector in Thailand at the time of the Asian crisis (which began in 1997/98) was the increasing scarcity of water in the once water-rich country.

There was general agreement that measures were needed to ensure more efficient use of water as part of a more general reform of the sector, triggered by the crisis. Reform measures (based on the principle of cost recovery through the use of markets and prices) were to guide the allocation of water, aimed at strengthening the long-run productivity of farmers. These measures were included in an Asian Development Bank policy loan supporting Thailand’s agricultural reform. However, a coalition of farmers and nongovernment organizations blocked the introduction and implementation of these reform measures.

Source: G. Abonyi.



technical or economic rationale for optimal policy reform is insufficient for persuading policy makers to undertake a policy reform, let alone guarantee its successful implementation. This often results from underestimating the challenges of effectively communicating to the range of stakeholders both the appropriateness of particular policy reforms and what is involved in the associated process of change.

Such stakeholders include public decision makers such as politicians who are involved in key policy decisions and their implementation, and intended beneficiaries such as the farmers in the example who must live with the consequences of such decisions. The technical or economic rationale for “theoretically optimal” policies is not enough: they need to lead *in particular country contexts* to desired and expected results—to sustained, improved performance and to improved quality of life—and key stakeholders must believe in these as the likely outcomes of proposed policies.

There is a tendency to group difficulties with reforms under the umbrella of “implementation problems.” The implication is that the design of particular reforms and related support is generally fine; it is the messy implementation process, involving, perhaps, alleged wavering government commitment, political games, or institutional weaknesses, which throws good ideas off track.

But this perspective is misleading: design and implementation are intimately interconnected in any process of change. They should not be separated conceptually or operationally in the reform process or in the design of reform measures. Difficulties in implementation are the *usual* characteristics of the policy reform process, often caused by political and institutional factors.

The design of reforms and their related support initiatives needs to reflect an assessment and understanding of the policy reform environment *as it is*, including actual implementation conditions, constraints, and requirements. From this perspective, issues such as the politics of the reform process and institutional constraints on implementation are key factors to be identified and addressed at the policy analysis and reform design stages, and monitored and managed as the reform and related support evolve.

Basic and recurring problems associated with reform go beyond issues of implementation. These problems arise because of the very nature of the policy environment—the *political economy* context in which the design and implementation of reforms take place. “Political economy” (as used in this chapter) refers to the *interrelationship between political and economic processes and institutions, particularly as related to policy issues, interests, decisions, and reform implementation*. Considerations of political economy factors need to be explicitly recognized and accommodated in the diagnosis of policy issues and in the subsequent design and implementation of PBLs. This is likely to reduce, even if not eliminate, the gap between expected and actual results in policy reform. *How* we recognize and accommodate such considerations is the subject of the next section.

# A Framework for the Political Economy of Reform

## Introduction

Policy reform involves many groups with a stake in the reform process and its outcomes, with government playing a key role as the formal initiator and implementer of reforms. Perceived government commitment to reform, and its credibility over time, has a central role in the policy reform process and PBL. Government commitment, in turn, is shaped by political economy factors that play a critical role in generally structuring policy reforms and in conditioning the effectiveness of PBL. A political economy perspective signals the central role of *politics* and *institutions* throughout the policy reform process. Reform involves politics, because it requires collective choices in an environment characterized by conflicting perceptions and interests, with no simple unifying incentive scheme for resolving such differences. Policy reform also takes place in a world of institutions that conditions the initiation, design, implementation, and sustainability of such reforms (see Rodrik 2003).

Politics and institutions play a critical role in shaping reforms as they move through various stages of the process. This process, in turn, conditions policy reform in terms of what it is (i.e., reform measures that are selected and their design), and what it does (i.e., the outcome and impact of such reform measures). The stages of the policy reform process, as well as their relationship to the role of politics and institutions in policy reform, and how these core political economy factors constitute key sources of uncertainty and risk in reform—including government commitment—together comprise a useful framework for assessing the political economy dimension of reform (Figure 1.1).

The stages of the policy reform process comprise the following:

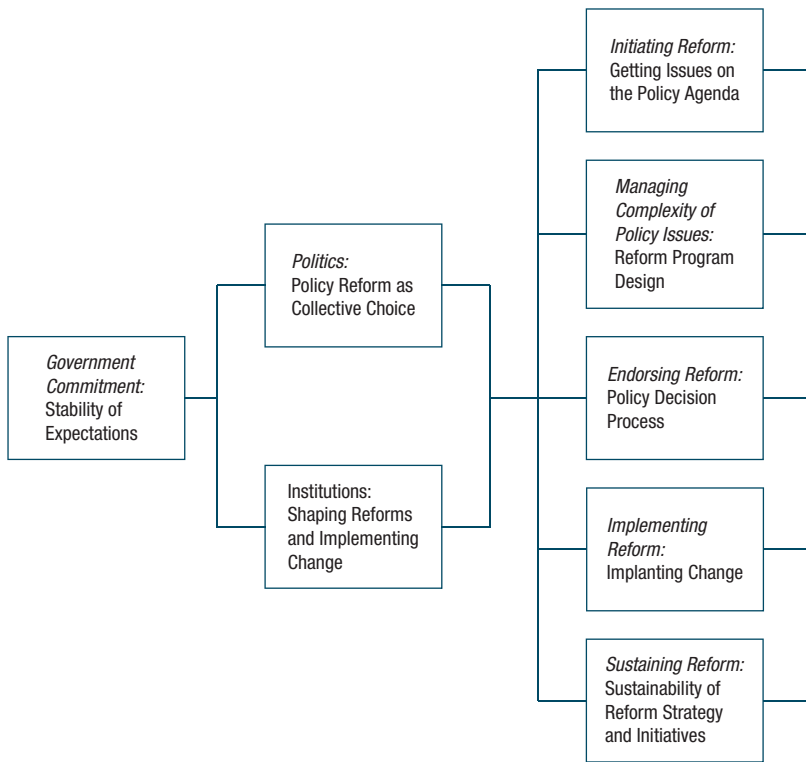
- *Initiating reform*: getting issues on the policy agenda for priority attention;
- *Managing the complexity of policy issues*: giving both policy issues and associated actions tangible shape through the design of specific reforms and PBLs;
- *Endorsing reform*: approving reform measures, leading to issuing related implementation guidelines and allocating necessary resources;
- *Implementing reform*: undertaking reform actions and implanting change; and
- *Sustaining reform*: ensuring that reform measures endure over time.

In practice, the stages of the process are more iterative than sequential given their interplay with the politics and institutions involved in the reform process, which is where the importance of the political economy perspective arises.<sup>2</sup>

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<sup>2</sup> The stages are discussed further in Stages of the Policy Reform Process, p. 15.

**Figure 1.1**  
**Political Economy of Policy Reform and Policy-Based Lending: A Framework**



Notes: The framework draws on a range of developments in the literature, particularly M. Grindle and J. W. Thomas. 1991. *Public Choice and Policy Change: The Political Economy of Reform in Developing Countries*, as well as S. Haggard and R. R. Kaufman. 1992. *The Politics of Economic Adjustment*; D. W. Brinkerhoff and B. Crosby. 2002. *Managing Policy Reform: Concepts and Tools for Decision-Makers in Developing and Transitioning Countries*; A. Drazen. 2002. *Conditionality and Ownership in IMF Lending: A Political Economy Approach*; and G. Abonyi. 1986. Technique, Experts and Planning. *University of Ottawa Quarterly*. 56 (4, October–December). It also reflects the author's discussions with John Thomas of the John F. Kennedy School of Government, Harvard University, on issues related to elements of this framework in the context of joint teaching executive courses on policy analysis and reform at the Asian Development Bank.

## Government Commitment

### *Meaning of Government Commitment*

Since reform involves government action, government commitment plays a central role in the policy reform process. Stakeholders, such as domestic and foreign investors, see government commitment to specific changes as the guarantor that reforms will be implemented as planned, and sustained over time. The implication of such commitment is that government will make the necessary policy approval decisions, issue binding instructions to implementing agencies, and allocate the necessary resources.

Government commitment is a key factor in the reform operations of IFIs, and the degree of government commitment is usually explicitly noted in the loan document. That is why potential changes in government commitment to reforms are key sources of risk and uncertainty in the reform process.

Lagging endorsement or implementation of reforms may mean that government did not have a full understanding of what was actually involved in the reforms in the first place, or that it has a different understanding from IFIs of the operational meaning or implications of particular reform measures.

Or it may involve a lack of sufficient interest in or intention to implement certain reforms—the usual meaning of “(lack of) commitment”—perhaps because they are seen as either not relevant or feasible, and were accepted initially only to secure needed IFI funds and support.<sup>3</sup> What is clear is that simple with and without arguments do not provide sufficiently compelling reasons to embark on a reform path (Box 1.3).

### Box 1.3

#### With and Without Reform: A Better Postreform Scenario— But Worth the Near-Term Trade-Offs?

Many policy makers are aware of the general difficulties inherent in policy reform. They understand that reforms entail economic, political, and social costs, creating losers and meeting resistance. Thus, the basis for initiating and sustaining reforms has to be convincing.

The expected benefits of reform should be clearly reflected in its rationale. One way is through an explicit comparison of scenarios “with reform” and “without reform”—despite the inherent problems in identifying the counterfactual.<sup>3</sup> However, this is a comparative, static formulation focused on the technical analytic dimensions of reforms, and on its own is inadequate for designing a reform with a high likelihood of success. For example, it does not reflect the potentially extensive organizational changes, political negotiations and trade-offs, and consensus building required and/or triggered by proposed reforms.

Policy makers need to move beyond this static approach, and introduce an explicitly dynamic perspective.

<sup>a</sup> Bolt, R., and M. Fujimura. 2002. Policy-based Lending and Poverty Reduction: An Overview of Processes, Assessment and Options. *ERD Working Paper*. No. 2. Manila: ADB.

Source: G. Abonyi.

<sup>3</sup> In practice, a government may agree to policy conditions quickly but seemingly not move effectively to implement them because of political and/or institutional constraints. Alternatively, a government may take a long time in negotiations but, once agreement is reached, move decisively to implement. Furthermore, what seems like “firm government commitment” at the time of PBL agreement may turn into a lack of commitment as implementation evolves.

Yet government may have had both an understanding of the reforms and a genuine intent to implement them, only to find (as the reform process unfolds) that it does not have the capability to do so, either because of strong political resistance or because of constraints on institutional capacity. As this suggests, government commitment is complex and dynamic: it changes over time.

Furthermore, it is likely to differ among countries. Similarly, there may be differences among policy issues: the challenges of reform and therefore of government commitment related to the provision of transport systems may be quite different from reform related to agriculture, finance, or public administration.

But what does “government commitment” mean? Three aspects are central:

- *Understanding*: At the most basic level, commitment relates to the degree of a government’s understanding of policy reforms; and in terms of the support for reform, the congruence or mutual understanding and shared expectations between the government and IFIs on the reform measures in the PBL.
- *Intent*: At a deeper level, and in the usual use of the term, commitment involves the intention or willingness of the government to implement particular reforms.
- *Capability*: Commitment is also a function of the ability to do things. This may be limited in practice by constraints arising from the political and institutional context of reforms. Government commitment requires sufficient *political support* to initiate, implement, and sustain reforms. It also requires the *institutional capacity* to undertake necessary actions by agencies involved in reform implementation. Unless such political and institutional conditions are—and remain—in place, government may have the intention but not the ability to undertake reform measures.

### *Government Commitment and the Ownership of Reforms*

The critical importance of country ownership of reforms is well recognized; policy reform is essentially a domestic “game” where a country’s particular circumstances shape the process and outcomes of reform. It is the responsibility of government to define the direction, scope, and strategy of reform; to balance various stakeholder interests; and to manage the policy formulation and implementation process so that it yields the desired results—that is, to “own” the reform. Even if external stakeholders, in particular IFIs, play a supporting role by providing resources, information, and advice, and policy reform is therefore a partnership between the government and IFIs, the ultimate ownership of the reform and PBL must rest with the government.

Ownership is related to the concept of government commitment. If government is perceived to be committed to reforms in the sense of “intent to implement,” this is often taken to be the same as the government having a sense of ownership of reforms—in effect, a concept of “commitment-as-ownership.” “Ownership” of policy reforms is, to an extent, also a political concept. It means that a coalition

of stakeholders supports a set of reforms and has sufficient power in the context of the country's institutional setting to ensure that these reforms are placed on the policy agenda, endorsed, implemented, and sustained. It is then reasonable to assume government commitment to reforms in terms of intent—as long as such a pro-reform coalition holds.

In cases where reform measures are not implemented as planned, a credible measure of commitment-as-ownership of a government is its track record—the extent to which similar reforms have been implemented in the past (see, for example, World Bank 2005). For IFIs, this suggests that unless a sufficient track record of reform exists for a country, PBL is unlikely to be successful in bringing about change—money cannot buy reform, or so the argument goes.

Yet this view of reform, in some situations, may undervalue the commitment to change in a country that is faced with heavy practical constraints. For example, using the earlier multidimensional concept of commitment, a government may have a genuine intention of introducing reforms, yet be faced with the practical challenges of creating a consensus for change, or with significant institutional constraints on implementing reform measures.

In either case, an IFI may be able to provide key support for inducing change, for example, by helping to demonstrate the expected tangible benefits of reform, perhaps through pilot initiatives, in order to build stakeholder support; or by helping to develop the required institutional capacity necessary for reform implementation. In both cases, an understanding of the political economy factors by the government and the IFI can play a key role in identifying the potential political and institutional constraints on government commitment to carry out desired reforms—a function of the proposed framework. This knowledge can then be used to design a reform and supporting loan that is more likely to bring about the desired changes.

## Politics and the Process of Policy Reform

### *The Role of Politics in Policy Reform*

The process of change that constitutes policy reform is both shaped by politics and is a shaper of politics. As policy reform and associated support aim to change an existing set of policies and the associated distribution of benefits, costs, power relations, and interests, there are likely to be stakeholders who see themselves as “reform losers,” and so resist change. At the same time, there will be stakeholders who see themselves as “reform winners,” and so support the reform process.

Policy reforms rarely involve a single or unitary decision maker such as “the government” (Box 1.4) with a well-defined and stable set of objectives, and the power to control all aspects of the reform process to implement a preferred course of action. Inherently political in nature, policy reform entails a process of collective choice. Such choice involves mutual adjustment among diverse and often conflicting stakeholders,

### Box 1.4

#### Bureaucratic Politics

Government is not a unitary actor. It is composed of multiple agencies with differing roles, perspectives, interests, and incentives. The ministry of finance (MOF) may sign off on the policy-based loan, but is rarely the agency responsible for implementing the reforms. It may be line agencies, state-owned enterprises, different levels of government (provincial, municipal), or even organizations outside government that act on reform, and therefore must have ownership of the reform measures.

Yet these institutions may have little incentive to “own” the reform and associated support, especially if they have limited access to needed resources from policy-based lending that goes to the general budget. This means that, even if the MOF is the policy-based loan signatory and “commits” to the policy reforms, it may be unable to ensure compliance or implementation by relevant line agencies or different levels of government.

For international financial institutions, the result is that a formal commitment by, say, the MOF may not be enough to ensure implementation of required reform measures. There are likely to be constraints on their capacity to deliver on such commitments within the framework of the domestic policy and political process. Reform design, therefore, requires an appreciation of what the government can realistically do over the relevant time horizon, and of who the key decision makers in government are.

Source: G. Abonyi.

through a process of negotiation, bargaining, and consensus building, which shapes and can modify—or even block—reforms at any point in the policy reform process.

The politics of reform may become especially pronounced during implementation. This is when the tangible consequences of reforms—including threats to particular interests—become increasingly clear. More generally, political acceptability plays an important role in influencing any and all the stages of the policy reform process, from inception through implementation and sustainability—hence, the importance of consultations.

Thus, since policy reform and related support may be altered, put on hold, or reversed at any stage by the actions or resistance of stakeholders, including implementing institutions, the sufficient and continuing support of key stakeholders is essential. Otherwise, policy reform measures are unlikely to be implemented or sustained.

Into this domestic political game, support for reform is, in effect, thrown. Unless the specific political context is understood, policy design may include reform measures that are unrealistic for what the government can actually do in an environment of differing and conflicting interests and limited control. This, in turn, could also weaken government ability to introduce the needed reforms at a later stage under

more appropriate conditions, by undercutting the credibility of the reforms and/or the ability of the government to implement them. At the same time, difficult reforms may be introduced deliberately, for example, by reformers in the government, in coalition with external IFI partners, to bring about policy changes that otherwise might not be made.

### *Winners and Losers*

Reform creates “winners” and “losers.” A better appreciation from the outset by those designing reforms and loans of the political dimension of reforms can help to identify both the potential constraints on specific measures, as well as the options for addressing such constraints. In an environment of differences among stakeholders on policy issues and reforms, it may not be realistic or wise for a government or IFI to proceed with a reform design that assumes consensus.

### *Scope of a Reform and Related Policy-Based Loan*

If the scope of a reform and related PBL is narrow (e.g., in terms of the number and range of reform measures), the scope for domestic conflict is also likely to be more manageable, as there are likely to be fewer conflicting interests involved. The policy may involve a simpler political game with fewer players, and it may be easier to build and maintain consensus. This is part of the reason for a preference, often by governments, for a step-by-step approach to reform (Box 1.5; see also Chapter 4).

If the scope of a loan is very wide, more potentially conflicting interests are likely to be involved, especially as each reform measure is, in effect, a “political game” in its

#### **Box 1.5** **Reform in Viet Nam**

A step-by-step, gradual approach has been a characteristic of Viet Nam’s reform process. This is, in part, a reflection of a society where, although the Communist Party holds a monopoly on political power, many stakeholders and different levels participate in a consensus-driven reform process.

For example, reforms of state-owned enterprises involve central authorities such as the State Bank of Viet Nam, ministries, individual enterprises, the Communist Party, provinces, local governments, and workers at state-owned enterprises. Consensus and a shared understanding need to be built among them for reforms to proceed and to be sustained. This takes time, resources, and a process of mutual adjustment among potentially differing interests. In this environment, a reform that begins more modestly, for example, with pilot projects that build support for reforms, may be more effective than an ambitious comprehensive policy of change, even if the latter’s proposed measures are considered relevant.

Source: G. Abonyi.



own right, involving particular stakeholder winners and losers. It may therefore be more difficult to reach and maintain the necessary consensus. IFIs often prefer PBLs with wider scope, to address a greater range of issues simultaneously. In some cases, the government may have an incentive to expand the scope of reforms in order to build additional support by including measures valued by some stakeholder groups.

### *The Role of Consultations*

An important means for both testing and strengthening the feasibility of proposed reforms is stakeholder consultations, but these can be time-consuming, complex, intensive, demanding, and their outcomes not fully predictable. However, they can play an essential role in ensuring the relevance (as perceived by key stakeholders) and the political feasibility of reforms by achieving consensus, or lessening resistance to change. Simplifying, and similar to the scope just above, two basic strategies may be followed: general consultations on broad issues related to policy reform and PBL design, and consultations on specific reform measures (see Elliot et al. 2005).

### *Sources of Reform Measures*

The push for reform and for particular reform measures may arise domestically or externally. If key elements of a policy reform originate domestically—proposed by the government—chances are that the necessary domestic political consensus building has already taken place, or is in progress. There are likely to be domestic supporters of reform (and thus of reform measures) who have an incentive to build and maintain such consensus. Alternatively, if the reforms originate primarily externally—IFI driven—it may be unclear how the domestic political process and consensus building will evolve.

The domestic political process of consultation and consensus building will likely require much more time and effort in the former than in the latter case—which loops back in to the consultation process.

### *Operational Implications for Reform Design*

Operationally, assessment of the political context of reform involves identifying key stakeholders and their likely positions on specific reform measures, and includes the checklist in [Box 1.6](#).<sup>4</sup>

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<sup>4</sup> For a discussion of the method of stakeholder analysis and its applications, see Chapter 6 in D. W. Brinkerhoff and B. Crosby (2002). For a discussion of the relationship between stakeholder analysis and assumptions analysis, see G. Abonyi. 1982. SIAM: Strategic Impact and Assumptions-Identification Method for Project, Program, and Policy Planning. *Technological Forecasting and Social Change*. 22. For a more complex and dynamic analysis of stakeholder interactions that focuses on the stability of agreements see N. Howard. 2004. *Resolving Conflicts in a Tree: Drama Theory in the Extensive Form*.

### Box 1.6

#### Broad Political Economy Questions in Preparing Policy-Based Loans

- What are the boundaries of the proposed reform, as implied by key inputs, core activities, and associated outcomes?
- Given the above, who are the key stakeholders with an interest in the given reform, or who will be affected by and/or likely to affect the proposed reform measures in terms of its inputs, core activities, outputs, or outcomes?
- What must be assumed about the existing or future behavior and preferences of each key stakeholder for the reforms to be successfully approved, initiated, implemented, and led to the desired outcomes?
- What specific elements of the reform are likely to lead to resistance or conflict, or result in perceived decreases in net benefits by particular stakeholders?
- Do these stakeholders have the power and means to influence—or even block—the reform process (e.g., initiation, endorsement, and implementation of the policy or specific reform measures) either individually or in coalitions?
- If yes, do the stakeholders have (or under what conditions are they likely to have) the incentive to do so?
- How can stakeholders with concerns be induced to support, or at least not oppose, the proposed reform measures? For example, how can the design of the reform be modified to account for differing needs and preferences not at present accommodated, while ensuring the basic contribution of the policy-based loan to policy reform?

Source: G. Abonyi.

## Institutions: Shaping Reforms and Implementing Change

### *Role of Institutions in Policy Reform*

Policy reforms are institutional in nature. As used here, the concept of “institutions” has two specific meanings: (i) at the macro level, institutions as “rules of the game” and enforcement mechanisms, for example, in the form of property rights, legal systems, and political systems; and (ii) at the micro level, institutions as organizations that implement policy reform measures, for example, government agencies. Policy reform involves institutions in both dimensions.<sup>5,6</sup>

<sup>5</sup> The first meaning corresponds to the use of the term in “the new institutional economics,” e.g., O. Williamson. 2000. *The New Institutional Economics: Taking Stock and Looking Ahead*. The second meaning corresponds to the traditional use of the term in the management literature.

<sup>6</sup> An interesting discussion of the origins and role of institutions in selected East Asian developmental states can be found in R. F. Doner, B. K. Ritchie, and D. Slater. 2005. *Systemic Vulnerability and the Origins of Developmental States: Northeast and Southeast Asia in Comparative Perspective*.

### Box 1.7

#### A Delicate Balance for International Financial Institutions in Supporting Reforms

Developing country governments in the past used to feel that international financial institutions (IFIs) often attributed unrealistic capabilities to such governments in the policy reform process. IFIs were, thus, often seen to prefer a comprehensive package of reforms which, according to lessons learned elsewhere, should bring about quick change. The implicit assumption is that the government of a given country is robust and strong enough to build and maintain the political stability necessary for reform, and that the institutional capability is there, or can be put in place, to carry out the whole reform quickly. The focus is then on obtaining government commitment to reform, which is generally identified with decisions by the IFI's central agency counterpart, such as the ministry of finance.

An effective strategy of policy reform should ideally draw on both general approaches. In an environment of limited knowledge, uncertainty, change, and diversity, the design of a reform and related loans should not be constrained by the rigid application of general rules, or international best practice that may not fit particular country settings.

At the same time, given accumulated knowledge and experience, neither should policy reform start from scratch. Best practice and experience can provide guidelines for the design of reforms and loans, but measured against a particular country context. Where such best practice guidelines do not fit, appropriate reform measures will need to be devised based on the characteristics of the specific policy issues and particular country circumstances, but also reflecting accepted general principles, e.g., the role of markets and prices.

An important challenge for an IFI is to ensure that the implementation requirements of reform measures in the policy-based support document are fully considered in the loan design by identifying potential gaps and constraints to feasibility.

Source: G. Abonyi.

The effectiveness of reforms will be a function of a country's institutional capacity to formulate, endorse, and implement reforms and related PBLs, including different organizations working together well (Box 1.7). An important objective of reform may be to modify institutions, in either sense (i.e., institutions may themselves be key targets of reform measures).

#### *Ensuring the Institutional Infrastructure for Reform*

For reforms to be effective, the basic institutional infrastructure must be—or has to be put—in place. If it is not, there is a high risk that the reforms will reflect unrealistic expectations and contain unimplementable reform measures. Yet the design of reforms rarely recognizes that policy reforms vary in their organizational intensity and complexity, and therefore in the nature and extent of the skills and institutional capacity required to implement them.

In particular, those who formulate PBLs have often overlooked the fact that reforms demand administrative, technical, and organizational capacities that tend to be in short supply in countries undertaking such reforms. The design of PBLs must, from the outset, consider institutional capacity building, often involving considerable time and resources. Again, if this is not done, problems can surface at the implementation stage, when institutions cannot or do not undertake required activities or deliver the expected outputs—and when compensating for capacity constraints is likely to be harder than earlier in the process.

Beyond individual organizations, policy reform generally involves getting a number of institutions to work together within a common framework. This requires a level of sophistication in coordinating a network of institutions involved in implementing policy reforms. The alignment of incentives and the coordination necessary for implementing reform measures involving multiple agencies cannot be assumed, for example, as following automatically from the establishment of a coordinating committee. It is essential to explicitly identify and assess the relationships among relevant institutions with respect to the implementation of specific reforms, including the associated coordination and cooperation requirements. The design of a reform and related support should reflect the ability of governments to make credible commitments in terms of the implementation capacity of a relevant set of key institutions.

### *Operational Implications for Reform Design*

The assessment of the institutional capacity gap and its implications for reform design requires a detailed analysis of organizations involved with the implementation of the reform measures. The approach is similar in logic to stakeholder analysis, but focuses on institutions. It begins with identifying the set of institutions working with, contributing to, and supporting all the measures in a reform. It then requires identifying the specific role of each institution in key activities and outputs for each reform, as well as tracing the interinstitutional (network) linkages that exist (or may be required) to implement particular measures. Making explicit key assumptions about institutional capacity requirements provides a basis for identifying and assessing potential capacity gaps and resolving them. The institutional analysis involves asking questions systematically (Box 1.8).

## Stages of the Policy Reform Process

Politics and institutional factors influence each stage of the policy reform process, as well as the outcome of the process as a whole, through the participation of multiple stakeholders and institutions. What happens in practice can, therefore, often be quite different from any expected optimal outcomes—for example, in terms of initiating or endorsing reform, and in constraining available policy options. For this reason, the preparation of a reform and related support should reflect a realistic appreciation in the particular context and constraints of the policy process, and their implication for reform design and implementation.

### Box 1.8

#### Key Questions for Assessing Institutional Factors in a Political Economy Context

- Which are the core institutions involved in implementing each reform measure?
- What are the key decisions and actions required from each of these institutions for each measure?
- What are the key assumptions about the implementation capacity of each institution implicit in the proposed reform measures?
- Are these assumptions about institutional capacity realistic in light of the existing capabilities of these institutions?
- How do decisions/activities of individual institutions necessary for implementing each reform measure relate to each other?
- What are the significant gaps between the existing and required institutional capacity that could constrain implementation of particular reform measures—at the level of each individual institution, and in terms of coordination and cooperation requirements among the network of institutions?
- What is required to reduce each gap—in organizational capabilities, resources, time, or institutional linkages and coordination; or alternatively, how can the reform measures be modified so they are more in line with existing institutional capacity, yet stay relevant?

Source: G. Abonyi.

This appreciation should begin with how policy issues get on the policy agenda—the set of issues that key public decision makers regard as problems—for priority attention, including the steps and actors involved in endorsing reforms. It can help identify key issues and constraints early so that they may be accommodated in the design of the reform (such as how specific reform measures are structured) and what supporting activities may be required (such as capacity building) in estimating the time required for the reform and related support.

The policy reform process, which is often both sequential and iterative, involves a set of interrelated decisions and activities. Its five stages—outlined in [Figure 1.1](#) and highlighted in [Box 1.9](#)—are now discussed in more depth.

#### *Initiating Reform: Getting Issues on the Policy Agenda*

Just because a policy issue is seen by some stakeholders as not meeting its expectations does not mean that it will be seen as a collective (or societal) priority and addressed through the policy reform process. Policy reform tends to involve readily understandable costs for identifiable groups—the “reform losers”—who therefore have the incentive and may have the means to block or blunt proposed change.

### Box 1.9

## Stages of the Policy Reform Process

- *Initiating reform.* The following questions need to be answered. How did the issues addressed by the reform get on the policy agenda as priorities, particularly as there are generally many policy issues competing for attention at any given time? Were they put on the agenda primarily by domestic stakeholders or pushed by external interests (e.g., international financial institutions)? And through what means, in what forums?
- *Managing the complexity of policy issues.* Since policy issues are inherently complex, the *design* of a reform involves reducing this complexity by the selection of certain aspects of the policy issue for attention—the diagnosis—so that policy makers and implementing agencies can act on such issues. Questions include: What is involved in this selection or diagnosis process? What is the subsequent design process used to generate a policy-based loan? Who are the participants? How relevant is the resulting policy-based loan in addressing the policy issue? How feasible in terms of implementation in the country context?
- *Endorsing reform.* Reforms need to be legitimized, through endorsement or approval. Questions include: Where and when in the policy process are such endorsement decisions made? By whom? Do they credibly signal the government's binding commitment to these reforms, for example, issuing guidelines/instructions for implementation and allocating required resources? What is the relationship between endorsing and implementing reforms: What is actually needed for implementation to proceed?
- *Implementing reform.* This involves institutions that transform proposed reform measures into organizational actions. Questions include: Can the issuance of a decree or law—"stroke of the pen reforms"—assumed to be the same as implanting lasting change? What else is involved or required in implementing reform measures? And in practical terms, what is the meaning of "policy implementation" in a world of politics and institutions?
- *Sustaining reform.* Policy reform entails a process of change over time. Sustaining reform is particularly important when fundamental institutional changes are involved, such as judicial reform or introducing a value-added tax.

Source: G. Abonyi.

The expected benefits, on the other hand, often take longer to materialize and are therefore less certain, providing less of an incentive for prospective "reform winners" to mobilize support. Furthermore, multiple issues are competing for the attention and resources of policy makers at any given time.

For these reasons, reforms are rarely made simply because they are a good idea. They are pushed through because evidence accumulates about perceived policy problems, or about the expected benefits of change. But reform also usually requires deliberate actions to initiate change on the part of key public decision makers, including politicians, legislators, and senior government officials. They control the necessary

### Box 1.10

#### A Note on Crisis Versus Noncrisis Conditions

Given the challenges of change, a crisis may create conditions and pressures for policy reform.<sup>a</sup> A crisis can provide an opportunity for reforms that may be far more difficult to put on the policy agenda when there is no sense of urgency. In practice, reforms initiated in crisis conditions may or may not be linked to the nature of the crisis.

However, from a process perspective, unless the necessary conditions, such as political support and institutional capacity, are put in place to sustain reform measures beyond the crisis, reforms initiated in such conditions may be temporary at best. When the sense of crisis is over, opposition to reforms may strengthen, and government commitment may weaken.

The challenge is to ensure that reforms introduced in crisis conditions are sustained, particularly given the extended period involved in the reform process. Care is needed in using crises as an opportunity for policy reform, as the implementation and sustainability of reforms are conditioned by the general political and institutional environment of a country. Crisis conditions may therefore be used to initiate reforms, but it is essential to ensure that conditions, e.g., political and institutional factors, are in place such that the reforms are likely to persist beyond the crisis.<sup>b</sup> Although there are important differences in reform in crisis and noncrisis conditions, from a process perspective the core issues for an effective reform and policy-based loan are similar.

<sup>a</sup> For an excellent discussion of this general issue, see M. Tommasi. 2004. Crisis, Political Institutions and Economic Reforms: The Good, the Bad, and the Ugly. In *Toward Pro-Poor Policies: Aid Institutions and Globalization*. Copublished by the World Bank and Oxford University Press, pp. 135–164.

<sup>b</sup> This general issue is often reflected in “second-tranche problems.” This involves difficulties in a borrowing country meeting conditions for disbursing the second tranche of a policy loan, often attributed to a lessening sense of urgency for change (and financing), and thus weakening government commitment to reform.

Source: G. Abonyi.

resources and can influence the actions and outputs of key institutions, e.g., the implementing agencies of government.

In addition, an issue needs to be placed on the policy agenda, since so doing transforms it from the private concern of particular stakeholders to one that is formally recognized in the policy process as requiring a collective response.<sup>7</sup> Getting an issue on the policy agenda may be the result of domestic pressures, for example, from a coalition of sufficiently influential interest groups, e.g., civil society organizations, business associations, or political parties, and brought to public attention through forums such as the media, legislature, or even street demonstrations. Alternatively, issues may end up on the policy agenda because of pressure on government from external agents with sufficient leverage, such as IFIs, which may control access to resources.

<sup>7</sup> An extensive literature discusses policy agenda setting. See, for example, J. W. Kingdon. 1995. *Agendas, Alternatives, and Public Policies*; and F. R. Baumgartner and B. D. Jones. 1993. *Agendas and Instability in American Politics*.

### Box 1.11

#### Questions for Initiating Reform

- How did the policy issue come to be recognized as a “problem”? By whom?
- How did the policy issue get on the government agenda, e.g., through what channels—in what forums; brought by which stakeholders?
- Which additional stakeholders exercised strong influence on setting this agenda? What has been the role of external stakeholders, e.g., international financial institutions?
- Are there stakeholders with an interest in the policy issue that feel excluded from the agenda-setting process? What is their interest in the policy issue? What is their power to influence other stages in the policy process, e.g., endorsement, implementation? What reform-blocking or reform-delaying coalitions among such stakeholders are possible?
- In light of opposing stakeholders, how strong or stable is the coalition of interests (stakeholders) to keep the issue on the policy agenda?
- How is the issue framed on the policy agenda, e.g., stressing more the expected benefits of reform, or alternatively the costs of not initiating change?

Source: G. Abonyi.

Given the uncertainties and risks associated with policy reform and an understandable reluctance of public decision makers to undertake such changes, particular factors tend to influence how the policy agenda is set. Crises may provide a window of opportunity for focusing attention on issues (Box 1.10). Alternatively, there may be trigger events, such as changes in the external context, that give a policy issue priority. Or there may be individuals—policy champions—who are particularly effective in getting issues on the agenda.<sup>8</sup>

Furthermore, *how* issues are framed also influences the perception on relative priority and acceptability they are likely to be accorded. Issues framed as problems—stressing the expected rising costs of no reform—are likely to be given greater and earlier attention than policy issues framed as opportunities, focusing on the expected benefits of reform.<sup>9</sup> It is important that those involved in preparing a reform and its related support understand the nature of the agenda-setting process. This involves asking questions, as exemplified in Box 1.11.

Once the issues have been placed on the reform agenda, agents need to focus on how to simplify the complexity involved in the proposed policy reform.

<sup>8</sup> Some of whom appear in Chapter 3.

<sup>9</sup> The pioneering work in this area is that of D. Kahneman and A. Tversky. 1979. *Prospect Theory: An Analysis of Decision under Risk* that shaped the field of behavioral economics. See also D. Kahneman. 2003. Maps of Bounded Rationality: Psychology for Behavioral Economics. *The American Economic Review*. 93(5). pp. 1449–1475. December.



### *Managing the Complexity of Policy Issues: Why Policy-Based Lending Design Matters*

How an issue is posed or structured on the policy agenda plays a significant role in shaping the response. PBL design defines the scope (the range and number of reform measures) and focus (the specific aspects of the policy problem to be addressed) of the reform, setting its political and institutional boundaries and characteristics. This also determines the associated gains and losses from specific reform measures, and therefore potential reform losers and reform winners. In turn, this shapes the political debate. Similarly, setting the scope and focus of reforms delineates the set of institutions and institutional relationships that will have a role to play in policy reform.

Political decision makers at the outset of the reform process may have a broad understanding of the issues and needs for reforms but need much advice on articulating the policy problem and required solutions. This often gives the IFI-led PBL design teams latitude, early in the reform process, to define the boundaries of the policy issues, as well as scope for specific reform initiatives. The design process may also include some form of public participation or consultation that may touch key reform measures prepared by the design team. However, in practice, the design of a PBL is often controlled by a small group of technocrats or policy planners, and, if IFI financed, international experts and IFI staff as well.

The scope, focus, and structure of a reform and related loan reflect the diagnosis of the initial policy issue. The diagnosis involves constructing a “model” in some form, even if only a qualitative or verbal representation of the policy issue, to identify where specific reform measures are likely to be most effective in bringing about desired outcomes.

Given the complexity of policy issues, defining the scope, focus, and boundaries is a balancing act. Traditionally, this has involved the technical and economic analysis of the policy issue to ensure the relevance of proposed reforms, e.g., identifying key variables, relationships, and possible areas where reform measures are likely to make a difference. To ensure the feasibility of reforms, it is equally important to include analysis of the political and institutional dimensions of both the policy issue and policy-based design options. This will reveal the gains and losses associated with the initial problem and with alternative reform measures considered—thus reform losers and reform winners—as well as the set of institutions and institutional relationships related to loan implementation. Thus, the design of the reform and loan should reflect both the technical and economic relevance, and the political and institutional feasibility of proposed reforms.

Indeed, understanding such feasibility is essential in order to assess, in advance, the likely effectiveness of reform. Technical analysis is just one key input. Whatever their technical or economic merits, if reform measures are politically unacceptable,

they will be difficult to implement and sustain. Therefore, governments generally need to have—as should IFIs—a level of confidence that reform measures will be able to command and sustain the minimum necessary political consensus to be implementable.

Thus, the reform and loan design process and its participants are crucial in shaping the content and outcomes of policy reforms. Policy-based design decisions (Box 1.12) then shape the subsequent policy reform debate and implementation.

### Box 1.12 Policy-Based Design Decisions

- The design stage (and later as the policy reform unfolds) requires an appreciation of the time required, sequencing, and capacity requirements for undertaking implementation actions by particular stakeholders and organizations.
- The role of political and institutional assessments is to link explicitly the design of the reform and loans to their implementation; that is, they need to be made at the design stage in order to identify potential constraints on implementing reform measures.
- The design stage should explicitly consider the fact that reform implementation involves (i) consensus-building and mutual accommodation among key stakeholders, changing systems, processes, structures, incentives, behaviors, and cultures in organizations; and (ii) the development of effective interlinkages among implementing agencies.
- The design phase has to explicitly consider sustainability, including issues such as budget implications, staffing capacity, and institutional considerations.

Source: G. Abonyi.

### *Endorsing Reform: The Policy Decision Process*

The policy decision process has both formal and informal dimensions. The formal dimension depends on a country's existing institutional framework. For example, in a parliamentary setting, it will include political parties that discuss, debate, and vote in a legislature on the reform and PBL. In a non-parliamentary setting, it can involve a specified procedure for the executive or presidential endorsement of proposed reforms. The informal dimension can include lobbying, informal bargaining and negotiations, use of the media, as well as public demonstrations by stakeholders to influence the actions of policy makers.

Understanding a country's policy decision process involves these two dimensions. It requires knowledge of the government structure, systems, and functions—the formal policy decision process in general, and agencies and requirements related to specific policy areas in particular. It also needs an appreciation of the informal process likely to be operative on endorsing policy reforms (Box 1.13).

### Box 1.13

## Endorsing Conditions in Policy-Based Lendings

In policy-based lending (PBL), certain reform measures are given special significance and are designated as “conditions” that must be met for money from such loans to be disbursed. Conditions link or intermediate the policy issue and PBL design, defining the primary operational focus of PBL. They simplify the complexity of policy issues by specifying key actions expected to be of particular importance in resolving the policy issues addressed by the reform.

The concept of conditions implicitly assumes a great deal of knowledge about the policy issue and its relationship to development—about effective actions for bringing about reforms and desired results. The greater the number of conditions or of details (or both), the greater the assumed knowledge about the policy issue, its development context, and the feasible means for its effective resolution.

In an environment of complexity and uncertainty, care should be taken not to include too many conditions and excessive details in specific conditions. “Overdesigning” reforms has generally not been the most effective means for PBL to support implementable and sustainable reform, prompting international financial institutions to reduce the number of conditions in PBL and to shift toward outcome-based approaches. Yet results to date have been mixed.

Still, it is essential not to lose sight of the basic intent of PBL in the number and details of conditions. The purpose of PBL is to contribute to effective policy reform. What is essential is to make explicit the assumed logical relationship between the policy context and PBL; to ensure that proposed reform measures in general, and conditions in particular, are anchored in (and responsive to) key elements of the policy issue; and that the measures and conditions are clearly linked to the expected outcomes. This can also provide a clear, common frame of reference for discussion among stakeholders, including international financial institutions and the government.

As a rule of thumb, the following questions can be asked to test the relevance of each proposed reform measure that is selected as a condition:

- What is the logical relationship between it and particular elements of the policy issue to which it is intended to respond? What is their relevance and importance to the rationale for policy reform?
- What is the logical relationship between it and particular expected outcomes, and in what particular ways do these outcomes contribute to the broader purpose and desired results of the policy reform?
- What difference to the policy reform results would be seen if it was left out of the PBL? Is that difference significant?

Source: G. Abonyi.

Stakeholders (such as domestic and foreign investors as well as IFIs) expect the output of the policy decision process at some “stopping point” to lead to a decision endorsing a PBL, signaling the binding commitment of the government to undertake the approved reform measures. They then expect this endorsement to become the basis for instructions for implementation to, for example, government-related agencies, and for allocation of required resources, as through the budgetary process.<sup>10</sup>

Stakeholders often take this stopping point and associated binding commitment as having been reached when the head of government formally announces a reform, or in the case of a PBL, when the minister of finance or head of the central bank commits in writing to the IFI-financed loan. However, in practice, the output of the policy decision process as a binding commitment to reform can prove illusory.

The policy decision process (Box 1.14) can be represented as a sequence or network of linked decisions and actions that result in particular policy outputs (such as a bankruptcy decree or law, or a policy to remove fertilizer subsidies).

### Box 1.14 The Policy Decision Process

This process entails

- *Key decisions or actions required*, as related to the endorsement of specific reform measures, and to the reform as a whole, and associated inputs needed for such steps to be taken;
- *Actors*: institutions, groups, roles involved in each decision or action;
- *Sequence*: logical precedence relationships among decisions or actions and associated institutions and roles, e.g., what step is required to be completed before another step can begin, and by whom;
- *Time frame*: estimates of the time required for key decisions or actions for each reform measure, and for the reform as a whole; and
- *Potential constraints* that could have a heavy impact on the process, including timing or content, of key decisions or actions, and factors likely to influence the occurrence of such constraints.

Source: G. Abonyi.

<sup>10</sup> See, for example, Brinkerhoff and Crosby (2002), Grindle and Thomas (1991), and Grindle (2002).

Detailed information on the policy decision process provides inputs essential for the design of an effective reform and related loan.<sup>11</sup> For example, it allows the identification of a “critical path” for the policy process (e.g., critical steps, key institutions, key stakeholders, associated time frame) and potential constraints that could affect the approval, content, and initiation of the reform—for example, key legislation. Such information can be used to assess the feasibility of proposed reform measures, including their timing, in order to identify additional supporting activities and resources that may need to be accommodated in the design of the reform and related support. Alternatively, this information can also be used to modify proposed reform measures to increase the likelihood of their timely endorsement and implementation.

The formulation of public policy in general and the design of PBLs in particular do not automatically result in successful implementation. Once a reform has been put on the policy agenda, designed, and then endorsed, its success lies in how well it is implemented by relevant stakeholders and institutions, and whether it endures over time. The following section discusses some of the aspects seen in successful reform implementation, while the one after that looks into sustainability.

The more general the focus of stakeholder consultations, the easier will consensus likely to be reached, and the less time may be needed. However, the risk is of differences emerging as the details of reform measures and, in the case of a PBL, associated conditions are revealed during the policy-making process and implementation.

The more specific the focus of stakeholder consultations, as on particular reform measures, the more difficult it may be to reach consensus, and the more time is likely to be needed. However, once such consensus is reached, there may be less risk of differences emerging later, during policy making and implementation.

### *Implementing Reform*

Implementing reform successfully involves introducing reforms and ensuring that their core elements are undertaken as planned and that the reform measures are accepted by key stakeholder groups and institutions. Such success largely rests on the ability to implant change through the cooperation and collaboration of key stakeholders, and the actions of relevant organizations.

There are two general types of policy reforms: changes in rules and regulations, or “stroke of the pen” reforms; and changes in stakeholder and organizational behavior and performance—implanting long-term change. Both are important, but have different implications for implementation.

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<sup>11</sup> Information on the details of the policy decision process may be summarized in a “process map.” There are a range of tools and extensive experience with process mapping. For an introduction and examples, see Process Mapping Associates. 2007. *Process Mapping*. <http://www.processmaps.com/mapping.htm>

Implementation of reforms may involve the issuing of decisions, decrees, and regulations by the government. These are often the types of measures that are included in the first phase of a reform as they are often easier to manage. Examples include a bankruptcy decree or law, an executive decision to establish a commercial court system, and the development of a comprehensive program for watershed protection. In each of these cases the reform is a type of decision or a plan of action. These reforms are important in initiating change and in signaling to government agencies and the general public the direction of further changes. However, they do not automatically lead to the implanting of reforms in terms of basic changes in incentives, behavior, organizational activities and performance, or outcomes.<sup>12</sup> **Box 1.15** outlines the factors that relate to the implementation of reforms as implanting change.

### Box 1.15 Reform Implementation

- Reform implementation is generally not a linearly sequential, coherent, or predictable process. Implementation-related activities may move in many directions and in many forums at the same time; may be fragmented; interrupted by technical, political, or organizational factors; unpredictable; uncertain; and long term.
- Implementation of reforms and policy-based loans generally involves many stakeholders and organizations of different types that need to change individually and collectively.
- An important dimension of implementation and sustainability then involves aligning incentives, tasks, and activities of multiple organizations that are collectively involved in reform implementation. This requires an analysis of these organizations—individually and as a group—to identify existing and required task-related linkages and potential constraints on cooperation.
- Policy implementation is political not only among stakeholders and institutions but also within organizations. For example, redefining an organization's role, strategy, activities, and associated resource and power distribution creates winners and losers in the institution.
- Policy implementation at the institution level is fundamentally about organizational change. It involves the need to motivate change, to manage the transition or change process within the organization in terms of expected performance, and to understand and shape the political dynamics of organizational transformation.

Source: G. Abonyi.

<sup>12</sup> The following is based, in part, on Brinkerhoff and Crosby (2002), which takes an explicitly implementation-based perspective on policy reform.

### *Sustaining Reform*

The challenge of sustainability is to ensure that reform endures over time in a complex and dynamic environment. Meeting this challenge requires maintaining the core purpose and wide acceptance of the reform against pressures that seek to block, erode, and reverse such changes, and against constraints on organizational effectiveness that may emerge. This is of particular importance when a reform is introduced under crisis conditions and must be sustained in a postcrisis environment. Since the pressures that emerge against reform are largely political (such as opposing stakeholder coalitions) and institutional (including capacity constraints on maintaining the reform measures), sustainability is primordialy shaped by political and institutional factors.<sup>13</sup>

Furthermore, reforms must persist against basic changes in the environment of reform that are not directly related to PBL but that condition its sustainability, including a fundamental shift in the country's political system.

Sustainability often requires introducing new measures that were not part of the original reform or PBL but emerge as supplementary initiatives essential for protecting the core purpose of the reforms—for example, for ensuring that watersheds are maintained for the common good and not for private exploitation by particular stakeholders.

Sustainability involves a political and institutional assessment of planned reform measures over an extended time to identify and anticipate potential pressures. Since such pressures often arise from changes in the broader environment of reform, this assessment requires an explicit analysis of the country context. It also requires building into a PBL an effective monitoring system that can identify changes in the immediate and larger policy-based environment that may require adapting the original reform measures, while maintaining their core integrity and purpose.

Finally, sustainability involves an appreciation at the design stage that enduring reforms are built on changes in culture—of stakeholders and of institutions involved in the reform process. This, in turn, requires developing incentives and building capabilities that provide opportunities for stakeholders and institutions involved in reforms to learn and change over time.

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<sup>13</sup> An important book that looks specifically at the sustainability of reforms and focuses on the political economy dimension is E. M. Patashnik. 2008. *Reforms at Risk: What Happens after Major Policy Changes are Enacted?* See also J. R. Century and A. J. Levy. 2002. *Sustaining Change: A Study of Nine School Districts with Enduring Programs*.

## Conclusion

This chapter suggests that the design of effective policy reforms in general, and PBL by IFIs in particular, requires a more fundamental and explicit recognition and accommodation of political economy factors that condition the reform process. It presents a framework for the analysis of the political economy dimension of reform, in order to strengthen the loan design and implementation process. Understanding the implications of the political economy factors in policy reform, through the application of such a framework, is unlikely to eliminate all the difficulties associated with policy reform and PBL, given the nature and challenges of policy issues and the characteristics of the reform process. However, with better understanding and explicit consideration of such factors, the frequency and intensity of the problems associated with policy reforms may be substantially reduced. The result is likely to be more relevant and feasible reform initiatives, and a strengthening of the contribution of PBL by IFIs to the development process.

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# Political Economy of the Reformed Value-Added Tax in the Philippines

Romeo Bernardo and Christine Tang

## Introduction

Using the framework in Chapter 1, this chapter zeroes in on the political economy aspects of the reformed value-added tax (RVAT)—a critical reform underpinning the program of the Asian Development Bank (ADB) for the Philippines—in the context of government efforts to achieve fiscal consolidation. For a time perceived as hostage to political events, the law’s eventual implementation unlocked donor financing, restored market confidence in the country, and placed the government in a position of strength to manage the impact of the 2008 global financial crisis.

Reflecting the seriousness of the reform situation, when ADB unveiled its 2005–2007 country strategy and program for the Philippines in July 2005, political economy concerns were plainly at the forefront of program designers’ minds. In a “clear break with past practice,” it announced that “new lending could range from zero to as much as US\$1.5 billion” as “the strategy acknowledges the complex political economy of the Philippines and how this affects the pace and quality of reforms.”<sup>14</sup>

The shift in lending approach came just 2 years after the Philippines’ first country assessment program evaluation where a third of completed projects reviewed were rated *unsuccessful* on a host of political economy factors, such as lack of institutional capacity, inadequate budget allocations, and lack of political will. The country strategy and program also came at the height of a politically turbulent period in the

<sup>14</sup> www.adb.org/media, “ADB’s Three-Year Lending Program for the Philippines will Depend on Pace of Government Reforms,” 13 July 2005.

country that cast a cloud over the dialogue between the government and the donor community and palpably reminded reform workers of the need to tread carefully in pushing change.

The chronicle presented in this chapter supports some stylized facts about reform in a developing country context, such as crisis as trigger, political change as window of opportunity, sound economic analysis as guideposts, and information campaigns as awareness tools to garner public support. It also brings out challenges to committing government to reform in a politically charged environment and to sustaining reforms in a young democracy where politicians' motivations are dictated by the electoral cycle, where this policy myopia allows institutional deficiencies to fester, and where, therefore, civil society becomes an active player to fill institutional or governance gaps and complement efforts of reform-minded civil servants in securing needed change.

In contrast to the other chapters, the authors here approach the subject from an outside observer's perspective, melding firsthand insights of key players, observations of other experts in the field, and records of facts in publicly available documents. An account of the historical and institutional contexts of value-added tax (VAT) reform in the Philippines begins the story. To guide readers, Annex 1 provides a timeline of events and Annex 2 outlines the Philippines legislative process through which the reforms had to pass.

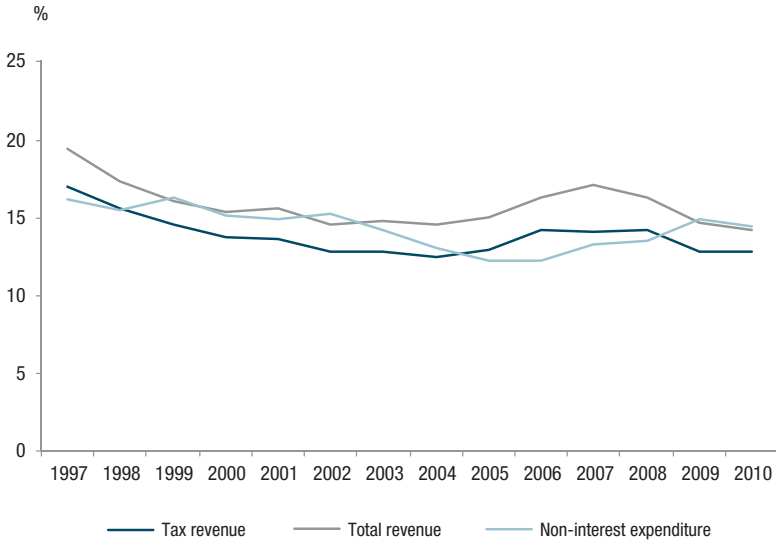
## Political Economy Context

The revolutionary government installed following the 1986 People Power Movement carried out an extensive program to restructure the Philippines tax system. The VAT was introduced under the 1986 Tax Reform Package and, after a massive information drive, was implemented at a 10% rate in 1988 to replace a number of sales taxes on goods.

With democratic institutions restored under the 1987 Constitution, subsequent efforts to expand the VAT base to enhance its efficiency became a harder struggle as sectors falling outside the VAT net lobbied Congress to keep them exempt. Hence, Republic Act (RA) 7716 passed in 1994, which sought to expand VAT coverage, was challenged in the Supreme Court and the amended law, RA 8241, passed in late 1996, expanded anew the list of items exempt from the VAT (the list used up all the letters of the alphabet). Moreover, a provision in the law to impose the VAT on professionals, supposed to take effect in 1998, was deferred thrice by three separate pieces of legislation (RA 8424, RA 8761, and RA 9010), with images of the country's top actors and television personalities demonstrating outside Congress still vivid in people's minds. The exemption accorded to professionals expired in 2003 when they were finally subjected to the VAT. Unfortunately, another law (RA 9238) came into effect the following year, restoring the VAT-exempt status of doctors and lawyers.

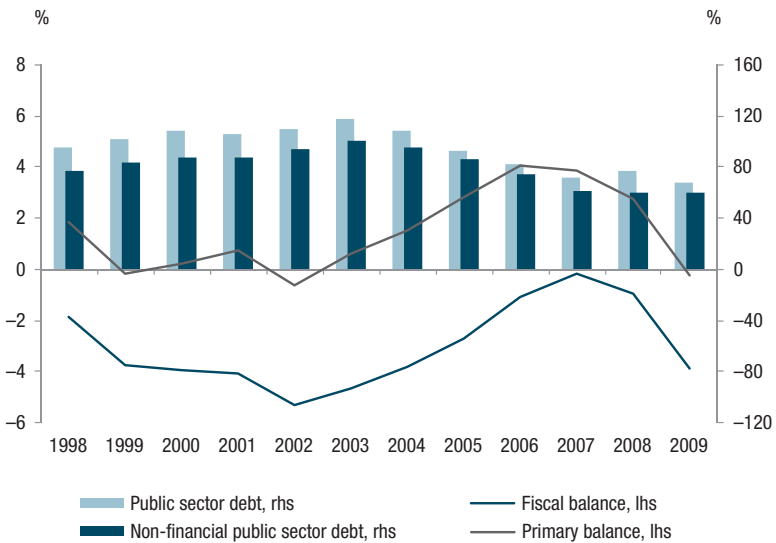
**Figure 2.1**  
**Public Sector Financial Performance**

Steady decline in revenue effort pre-RVAT, % of GDP



GDP = gross domestic product, RVAT = reformed value-added tax.  
Source: BTr and NSCB.

Increasing public debts pre-RVAT, % of GDP



GDP = gross domestic product, lhs = left-hand side, rhs = right-hand side, RVAT = reformed value-added tax.  
Source: BTr, DOF, and NSCB; 2009-Public sector debt latest data.

Similar defects elsewhere in the tax system (such as non-indexation of excise taxes and proliferation of tax incentives), traced partly to a weak tax reform law in 1997 (RA 8424), coupled with the changing domestic economic structure (growing sectors lightly taxed) and persistent difficulties in tax administration (linked to resource and capacity constraints in collection agencies), saw the government tax effort (defined as tax receipts as a share of gross domestic product [GDP]) on a steady downtrend starting the late 1990s, from 17% in 1997 to 12.4% in 2004 (Manasan 2002).<sup>15</sup>

Initially, the need to engage in stimulus spending after the late 1990s' Asian crisis increased the government's budget deficit. However, as tax and revenue effort continued to decline (due also to fewer privatization deals given reduced investment appetite for Asian assets), concerns over fiscal sustainability started to threaten macroeconomic stability, and the government resorted to significant expenditure compression to rein in the deficit and avoid a debt spiral, something that markets were closely monitoring in light of Argentina's 2002 debt default. As the government continued to miss deficit targets and pushed out the date for balancing its budget, international rating agencies downgraded the sovereign credit and, as part of its postprogram monitoring, the International Monetary Fund (IMF) urged the government to consider raising the VAT rate. Soon after Finance Secretary Jose Camacho resigned in November 2003 after roughly 2.5 years in office, he warned of a fiscal crisis (Figure 2.1).

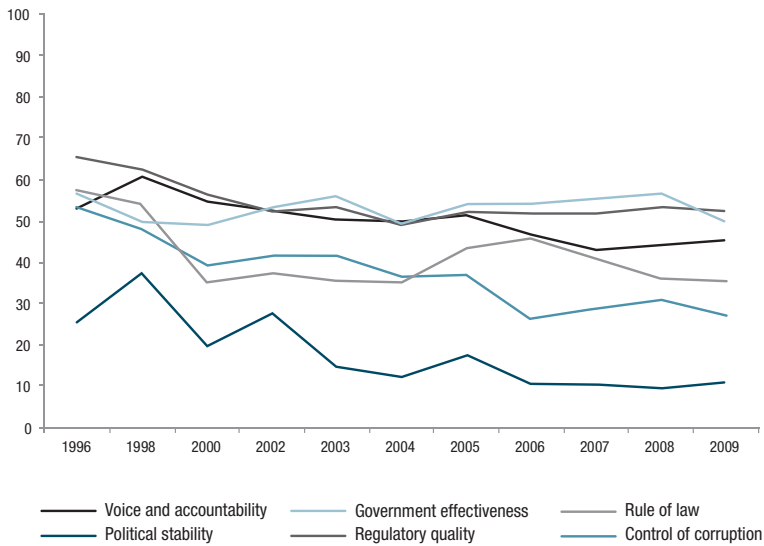
All this coincided with a politically tumultuous period in the country sparked by another people power uprising in early 2001 that forced the popularly elected President Joseph Estrada from office. In contrast to the 1986 revolution, the 2001 movement alienated a large segment of society—the lower class that formed Estrada's support base—which at one point attempted a people power of their own to oust Gloria Macapagal-Arroyo, Estrada's vice-president who succeeded him. International and local experts likewise saw the Philippines' failure to follow constitutional processes in removing a misbehaving president from office as an indictment of the country's formal political institutions, revealing an immature democratic system.

In light of the manner in which President Macapagal-Arroyo assumed office, legitimacy issues hounded her as she served out the remaining 3 years of her predecessor's term. The situation made it very hard for her to push any reform,<sup>16</sup> much less one that would raise people's tax burden. Governance, particularly in terms of indicators of political stability, control of corruption, and the rule of law, suffered as well (Figure 2.2), as she was seen as pulling all the stops to stay in power, employing populist measures that worsened the fiscal situation (by not, for example, increasing electricity tariffs).

<sup>15</sup> Data are computed using 1985-based GDP series for comparability with earlier years (data for new series start only in 1999).

<sup>16</sup> Notable economic legislation passed in the early years of the administration included the Electric Power Industry Reform Act (which was started under Estrada's term) and the Anti-Money Laundering Act in 2001, and the Procurement Reform Act and Special Purpose Vehicle Act in 2002.

**Figure 2.2**  
**Philippines Governance Indicators**



Source: World Bank's World Governance.

To her credit, realizing that raising taxes was not an option, she tried early on to improve tax administration by appointing, in late 2002, Guillermo Parayno as Commissioner of the Bureau of Internal Revenue, which accounts for roughly 80% of government's tax revenues. Commissioner Parayno's systems-driven approaches (such as improving input VAT audit trails) and high-profile enforcement programs,<sup>17</sup> which were intended to raise the risk-reward equation for tax evasion, were widely commended. But revenue gains from introducing administrative changes take time, and this was evident in the flattish change in the tax effort at that time, despite the reforms.

Still, despite the deteriorating fiscal situation, economic growth even accelerated from less than 2% in 2001 to 6.4% in 2004, albeit not quite enough to make a significant dent on poverty. Growth was propelled by rising overseas workers' remittances, which cushioned the country's external payments position and were a source of comfort to jittery investors. However, given risks to macroeconomic stability from weak government finances, businesses held off new investments and the economy became stuck in what analysts regarded as low-level equilibrium.

<sup>17</sup> These are Run After Tax Evaders (RATE), Run After the Smugglers (RATS), and Revenue Integrity Protection Service (RIPS).

## Explaining the Odds: Reform Process of the RVAT

Even with the fiscal problem simmering, as various parties inside and outside the public sector prodded the executive to fix its weak finances, the government could not immediately do so. A basic lesson from past experience with tax—or any—reform in the Philippines is that presidential leadership is a necessary ingredient for pushing change. This meant that any initiative to impose new taxes would have to wait until after the 2004 elections. Given a fresh mandate, the President could rely on her goodwill to secure public support for an unpopular tax increase, which would also be needed to convince legislators.

Even as she pulled together resources within the executive to craft reform legislation and see reform implementation through, she could, apart from applying moral suasion and expending political capital, use the vast powers of her office and control over budget disbursements, including congressional allocations and civil service appointments, to secure legislative support. At the same time, political economy considerations required the President to draw on personal relationships to remove or reduce resistance from reform losers, especially when these belonged to politically and economically powerful groups who could block or influence the direction of reform, including through direct ties with members of the legislature.

However, just because the political environment was ripe for reform did not mean that new tax measures could easily be pushed, especially an indirect tax like the VAT that was widely regarded as regressive. Not only was the issue of fiscal sustainability too technical and uninteresting to the person on the street but popular sentiment, based on various estimates of tax leakages reaching as much as 8% of GDP,<sup>18</sup> was that the government needed to direct efforts at catching tax evaders first. Even the President, who at the time wanted to repeal the VAT, apparently needed a fair amount of convincing before she finally embraced the measure.

With the President on board, the next challenge was Congress, which under the Constitution has the exclusive power to tax, that is, reforms in taxation should emanate from the House of Representatives. Past reform efforts that involved securing legislation from the over 200-member House of Representatives and the 24-member Senate showed that navigating the complex legislative environment introduces tremendous uncertainty into the reform process in terms of time, reform features, and policy trade-offs. The difficulties stem from the narrow interests<sup>19</sup> driving individual

<sup>18</sup> Department of Finance estimate for 1997 covering the collections of both the Bureau of Internal Revenue and the Bureau of Customs.

<sup>19</sup> By putting together information on submitted statements of assets of members of the House of Representatives at the time and property records available publicly, Eric Gutierrez (2000) found “a House of Representatives drawn from an elite that has wealth, education and political pedigree.” Moreover, he noted that many wealthy families with the economic resources to help politicians win public office “tend to back politicians they can trust to protect their interests.”

legislators' assessments of reform measures, which can be based on economic and political considerations rather than intellectual conviction (Gutierrez 2000). Thus, increasing the odds of legislative success requires bringing broad political support for reform from within and outside government to bear on members of Congress (Box 2.1).

### Box 2.1

#### Key Lessons from the 2003 Procurement Reform Experience

1. The need to create a “well-oiled machine” capable of responding to unanticipated events as the reform process unfolds. This requires a cadre of reformers within the executive, armed with sufficient technical knowledge and tools, who enjoy support from well-organized allies in civil society and the business community and have developed a strategic and sustained media campaign.
2. The executive branch had to be unified in the effort.
3. Influential legislators had to be recruited to champion the bill in their respective chambers.

Source: Campos and Syquia (2006).

Even then, the risk of narrow interests intruding on legislation remains. Quite apart from individual motivations of members of Congress, lobbying of vested interests (publicly or privately) and vocal stance of mass-based groups using media to turn public opinion in their favor can influence the final shape and form of a bill. The presence of media—with its demonstrated power to shape public views on issues and personalities—raises the stakes, particularly for members of the Senate who are elected nationally. Given the multitude of players, there is therefore a high likelihood that a final bill approved by Congress will include second-best solutions and policy trade-offs needed to make incremental reform possible. These changes to the executive's proposal, in turn, affect reform outcomes.<sup>20</sup>

A bill passed by Congress is transmitted to the President, who can veto it or sign it into law. Once signed, less controversial measures are typically carried out after drawing up the Implementing Rules and Regulations and due notice to the public, in which case, the challenge is enforcement—“the Achilles heel of Philippine legislation” (Campos and Syquia 2006)—and ensuring that the department responsible for implementing the law is equipped to do so properly. In the Philippines, resource and capacity constraints are perennial problems of the Bureau of Internal Revenue and the Bureau of Customs, the government's two main collection agencies (and

<sup>20</sup> Congress has, in the past, passed watered-down versions of tax measures proposed by the executive, e.g., the 1997 Comprehensive Tax Reform Program and the 2004 excise tax adjustment.

perceived quite negatively by the public, according to corruption surveys).<sup>21</sup> Still, it has been shown in the past that putting the right person with the skills and integrity in charge of these bureaus can raise the chances of reform success, despite constraints.

For more controversial laws, seeking judicial intervention to rule on constitutionality has become part of the playbook of parties opposed to the reform. The Constitution grants the Supreme Court the power to review tax laws, a process with uncertain time frame, resulting in delays in implementation or worse—if it deems certain provisions of the law unconstitutional—a repeat of the legislative process to cure infirmities, which opens the door for opposition groups to try to block passage anew.

An unpopular law, even if unchallenged by the Supreme Court, is constantly at risk of reversal from populist elements in Congress. The risk is highest at times of stress from external shocks, as when international oil price hikes are passed through to domestic prices, or close to elections (when initiatives dealing with tax exemptions for favored sectors proliferate).

## Getting Reform on the Agenda

Timing reform is crucial and the chance for a new beginning came after the 2004 elections. As it turned out, putting fiscal consolidation on the reform agenda was not the challenge. The President, a trained economist and at the time mindful of her economic legacy, did this immediately after winning the elections. In her first State-of-the-Nation Address in July 2004, she identified the budget deficit as the country's "most urgent problem" and asked Congress to pass revenue measures that would raise P80 billion annually and balance the budget by 2010.

Rather, the challenge was to convince the President to endorse the VAT which, contrary to the position of the Department of Finance (DOF), she curiously wanted to repeal. Moreover, the President's reform package included various measures that tax experts found odd, e.g., adoption of a gross income tax system and a windfall tax on telecommunications companies' (telcos) income or steps that were thought to have an uncertain immediate revenue impact, e.g., a tax amnesty and a performance-driven system for retiring nonperforming employees in revenue agencies despite protected civil service tenure (the lateral attrition bill).<sup>22</sup>

Public debate on the President's measures moved in parallel, largely revealing, as noted by a group of economists from the academe, "broad opposition and deep resentment"

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<sup>21</sup> For example, in the 2009 SWS (Social Weather Station) Surveys on Corruption, the Bureau of Internal Revenue and the Bureau of Customs scored -57 and -69, respectively, in terms of "net sincere" in fighting corruption (Mangahas 2009).

<sup>22</sup> While the State-of-the-Nation Address itself did not list the measures, the President identified them in a speech before the business community 4 days earlier and posted on the website of the Office of the Press Secretary on 22 July 2004.



and raising doubts whether the urgency of the problem “has been truly understood and internalized by the political elite and public alike.” This group, composed of 11 professors from the University of the Philippines (UP) School of Economics who were highly respected in domestic and international policy circles, had at one time or another held various senior government positions, and regularly wrote opinion pieces in the country’s top newspapers, became the beacon for relieving public ignorance about the “deepening crisis” through a 26-page discussion paper on “the real score on deficits and the public debt” (De Dios et al. 2004).

The main challenge was to translate this arcane subject into language that would raise public awareness and impress policy makers, the business community, civil society, and media with the severity of the problem and the limited time left for the country to act to avert a crisis. Using personal networks, the group approached the news editor of the country’s leading broadsheet, the *Philippine Daily Inquirer*, which on 23 August 2004 bannered the headline “UP economists warn of RP crash in 2 years.” This drew immediate reaction from the President, an alumnus of the school, who for the first time acknowledged that the country was “in the midst of a fiscal crisis.”

A flurry of activity from Congress followed. News reports suggested that congressional efforts, reportedly based on the President’s guidance, were directed at a tax amnesty bill, the lateral attrition bill, the indexation of specific taxes on cigarettes and alcohol (“sin tax” bill), and some form of tax on telcos. But no VAT. Even within the DOE, which advocated expanding the VAT to oil and power and raising the VAT rate, the general sentiment appeared to be that the VAT proposal was a desirable measure with little chance of passage.

The final outcomes of this initial set of measures would eventually lead the President to endorse the VAT. In the particular cases of the sin tax bill (the only tax measure passed in 2004) and the telco tax (abandoned), press stories revealed the President’s involvement to lessen resistance put up by the economically powerful groups that would lose from the measures. These stories also demonstrate the role of high-level consensus-building interventions for reforms.

The proposal for the indexation of sin taxes was among the first measures tackled by Congress after the President acknowledged a fiscal crisis. This is an area that involved powerful vested interests from cigarette and alcohol manufacturers. The DOE proposal was for (i) a 37% one-time increase in the specific taxes to preserve their real 1997 values coupled with (ii) automatic biennial increases in line with actual inflation and (iii) simplification of the tax structure. Amid lobbying pressure from the losing groups, the President reportedly called for a private meeting in her home with key officials of the major producers, after which she announced a compromise formula and certified the bill as urgent. The final law signed in December 2004 continued to have multiple tax rates and provided only for fixed peso biennial increases in the specific taxes with the last adjustment ending 2011, a year after the President’s term

of office. At the time, estimated revenues from the law were less than P7 billion versus the original P14 billion estimate (De Dios et al. 2005).

With the passage of sin taxes, the President reportedly instructed the House of Representatives to prioritize the proposal for a telco tax,<sup>23</sup> which took various forms, including a windfall tax, a franchise tax, an excise tax, and a tax on text messaging. Opposing the proposals in all their forms were the telecommunication companies who felt singled out for no other reason than that the two leaders, Globe Telecoms and PLDT-Smart Communications, were reporting high incomes at the time. Moreover, unlike sin taxes, respected economists, including the UP economists, also spoke up against the tax, arguing that communication services, unlike smoking and drinking or oil consumption, imposed no negative externalities on society. Nevertheless, the press again reported of a meeting between the President and officials of the leading telcos<sup>24</sup> in early December 2004 after which she dropped the proposal and started to favor the VAT. Apparently, despite the presence of leading members of Congress pressing the telcos to accept higher taxes, they stood their ground and during the negotiations (and reportedly with the strong endorsement of the head of the President's economic team), VAT reform emerged as a better alternative.

Hence, with only two of her proposed eight measures green-lighted, several others crossed out as unworkable (e.g., gross income tax, tax on telecoms), or delayed (e.g., tax amnesty, rationalization of fiscal incentives) and with expected revenues far below target, the President, on 7 January 2005, certified as urgent a bill to reform the country's VAT system.

## Managing the Complexity of Reform Issues

The basic policy objective was straightforward: raise P80 billion in revenues from a number of new measures to enable the government to balance the budget by 2010. The VAT bill by then was the only remaining measure that promised enough new money to make a dent on the budget deficit—according to DOF estimates, P35 billion from the existing VAT base for a 2% rate hike. The challenge was to do it in the spirit of “burden sharing,” while considering broad equity issues. The threat of crisis and the absence of workable alternatives made the reform an easier sell (i.e., the pain of higher taxes is much less than the pain of economic collapse), speeding up consensus building with members of Congress, the business community, and civil society gravitating toward the VAT.

<sup>23</sup> Judy T. Gulane. 2004. Tax on Telecom Firms Said Next on Congress' List. *BusinessWorld*. 11 October.

<sup>24</sup> See *Philippine Inquirer* (2004) Palace Opts for Hiked VAT over Franchise Tax. 6 December; *BusinessWorld* (2004) Palace Scored for Watering Down Tax Bills. 8 December; and *BusinessWorld* (2004) Finance Unaware of Meeting with Telcos. 7 December.

### *Program Design Options*

Even before the elections, many local and international economists had advocated an increase in the VAT rate as a way out of the fiscal bind. While theoretically inferior to direct taxes, the self-policing feature of the VAT was thought to provide tax authorities a good handle to overcome institutional limitations in tax administration and resistance of the elite that had made it hard for Philippine governments to rely on direct taxation of the wealthier class. The argument was that the VAT was the lesser evil and, rightly implemented, could be more progressive in practice than poorly collected direct taxes (De Dios et al. 2005). The challenge was thus how to make the VAT right by keeping exemptions to a minimum so that a broad section of the economy shares the burden and at every stage of the production chain, has the incentive to track VAT payments on inputs and outputs (Box 2.2).

The first major issue raised against the proposal was that a higher VAT rate, which would directly feed into prices of goods and services, would hurt the poor—as much, if not more, than the rich. Calculations by the National Tax Research Center, showing at the time that the VAT was regressive,<sup>25</sup> were used by militant groups to claim that the VAT was anti-poor. This tended to raise the emotional timbre in public discussions and was exploited by interest groups opposing their proposed coverage under the VAT net. Some of the options proposed in one of the House bills, supposedly to provide the poor with adequate safety nets, included a multitiered VAT structure and exempting very specific manufactured products that the poor favored, e.g., sardines, instant noodles, and generic medicines. Both were dropped during discussions at the bicameral conference committee.

The second issue was the VAT's low revenue productivity, defined as VAT revenues as a percentage of GDP divided by the VAT rate, which was only 0.31 versus the 0.37 average for developing countries of Asia and the Pacific (Newhouse and Zakharova 2007). This was traced to the many zero ratings<sup>26</sup> and exemptions not typically found in other countries that have limited tax authorities' ability to take full advantage of the audit trail to improve VAT administration and raise the revenue potential of the VAT.

The DOF's position was to repeal all these nonstandard exemptions and zero ratings, which included two sectors that proved politically problematic—petroleum and power. Quite apart from some tax trade-offs written into the law itself to make the changes more acceptable, this decision meant that the executive had to (i) temporarily shelve another one of the eight proposed tax measures, i.e., a

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<sup>25</sup> The calculations showed that those earning P20,000 or less pay 5.2% for VAT out of their income versus 3.7% for those earning P500,000 and up. The UP-11, however, argued that the more relevant base is expenditures rather than income and, on this basis, showed that the VAT is mildly progressive (De Dios et al. 2005).

<sup>26</sup> Zero-rated firms, unlike VAT-exempt firms, are allowed to claim input VAT credits.

## Box 2.2

### Features of the Reformed Value-Added Tax

1. Value-added tax (VAT) rate increased from 10% to 12% by 1 February 2006
2. Additional goods and services that became subject to VAT
  - a. coal, natural gas, and other indigenous fuels
  - b. petroleum products and their raw materials
  - c. power
  - d. electric cooperatives
  - e. domestic transport of passengers by air and sea
  - f. medical services
  - g. legal services
  - h. cotton and cotton seeds: nonfood agricultural products
  - i. works of art, literary works, musical composition
3. Good and services that became zero-rated
  - a. Transport of passenger or cargo by air or sea to a foreign country
  - b. Services rendered to aircrafts and vessels engaged in international transport
  - c. Sale of goods, supplies, and fuel to aircrafts and vessels engaged in international transport
4. Other VAT-related reforms
  - a. 5-year spread out crediting of input VAT on capital equipment
  - b. Cap on input VAT crediting at not more than 70% of output VAT for the same quarter
  - c. Removal of 1.5% presumptive input VAT on public works contractors
  - d. Uniform 5% VAT withholding on government purchases of goods, services, and public works contracts
5. Mitigating measures
  - a. Reduction of excise tax on kerosene, diesel, and bunker fuel oil
  - b. Removal of franchise tax on power distribution utilities
  - c. Removal of franchise tax on domestic airlines and common carriers tax on domestic shipping
  - d. Increases presumptive input VAT of agro-processors from 1.5% to 4%
  - e. Increase in marginal threshold from P550,000 to P1.5 million per annum; rental threshold from P8,000/month to P10,000/month; and real property threshold from P1 million to P2.5 million
6. Non-VAT-related reforms
  - a. Increases corporate income tax rate to 35% up to end-2008, rate automatically reduced to 30% by 2009
  - b. Increases gross receipts tax from 5% to 7% on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income, of bank and nonbank financial intermediaries
  - c. Removal of income tax exemption of the Philippine Amusement and Gaming Corporation (PAGCOR)

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## Box 2.2

(continued)

7. Earmarking of incremental VAT revenues
  - a. 50% of local government units' share in incremental VAT collections was earmarked for
    - i. Public elementary and secondary education, to finance construction of school buildings, school furniture, and in-service training of teachers
    - ii. Health premiums of enrolled indigents
    - iii. Environmental conservation
    - iv. Agricultural modernization, to finance construction of farm-to-market roads and irrigation facilities

Sources: Department of Finance. *Briefer on VAT Reform Law*. [www.vatreform.gov.ph](http://www.vatreform.gov.ph); D. Newhouse and D. Zakharova. 2007. Distributional Implications of the VAT Reform in the Philippines. *IMF Working Paper*. No. 07/153. [www.imf.org](http://www.imf.org)

P2 increase in the excise tax on petroleum products<sup>27</sup> and (ii) in light of the high cost of power in the Philippines (the highest in Asia), delay anew a provision of another law, the Electric Power Industry Reform Act, to impose a universal charge on power to cover for stranded costs that could no longer be passed on to the national government.<sup>28</sup>

A third issue had to do with VAT enforcement, which was based on allowing firms that have paid VAT on their inputs to credit these against their output VAT assessments. The observation at the time was that there was rampant abuse of the input VAT crediting system, such that many firms ended up with negative net VAT positions. While many argued that this was an enforcement rather than a policy issue, Congress decided to place limits on the crediting system through imposing a 70% cap on input VAT credits and spreading over 5 years the input VAT credit for capital equipment, which had been criticized as a tax on investment (De Dios et al. 2005).

Finally, a number of unrelated provisions, including a time-bound increase in the corporate income tax rate and a 2 percentage point increase in the gross receipts tax, were included when the bill reached the Senate. These were initially introduced, despite protests from businesses, because the Senate was reluctant to raise the VAT rate. Their inclusion in the law enhanced its revenue impact, helping to take government tax receipts above the P80 billion target.

<sup>27</sup> Taxing the negative externality from oil use through increased excises remains a policy challenge to date, especially with high world oil prices.

<sup>28</sup> The Electric Power Industry Reform Act was intended to restructure and privatize the power sector, which had been a major cause of the swelling public sector deficit and debt.

### *Reform Design Process*

The final bill passed by Congress differed markedly from the executive's proposal (Table 2.1). The DOF proposal started out seeking only to remove the VAT exemption of oil products. Following increasing support for the VAT during DOF presentations to the House Ways and Means Committee started as early as November 2004, the reform evolved into one seeking to increase the VAT rate and expand its coverage. The broader scope meant that this one measure alone would allow the government to meet its revenue target.

The championship of the chairs of the Ways and Means Committee of the two chambers backstopped by bureaucrats in the DOF and other oversight and line agencies was necessary for garnering lawmakers' support for the measure. So was the participation of vocal civil society groups, the academe, donors, and even the business community, all of whom came out with statements of support, advocacy pieces, or promises of more aid that were published in national daily newspapers. Members of these groups also served as resource persons during congressional hearings to help clear up issues that had been muddied by populist rhetoric. Many of these were seen as nonpartisan and thus lent credibility to the need for the measure.

With the President's urgent certification of the measure by the start of 2005 and the House conducting marathon hearings (33 in 40 days according to the chair of the House Ways and Means Committee), a bill to address government's revenue requirements by raising the VAT rate to 12% was transmitted to the Senate within 3 weeks, while a twin bill focusing on enhancing the VAT's equity was transmitted a month later. Until then, the DOF's proposal had largely been kept intact except for the various complications introduced (such as a multitiered rate structure, exemptions of very specific manufactured goods consumed by the poor, and a "no pass-through" provision imposed on oil companies).

But the major design shift occurred in the Senate. Unlike members of the lower House whose electoral chances within their districts are more dependent on presidential political largesse, nationally elected Senators have more reason to be viewed as independent of the executive, party affiliations notwithstanding. Thus, especially for an issue under the glare of media, securing Senators' buy-in was going to be a big challenge. Again, the President had a crucial role in persuading the chair of the Ways and Means Committee to champion the proposal in the upper House.

Even then, Senate deliberations took longer. The most basic issue was the Senate's position to retain the VAT rate at 10%, which detractors charged was to safeguard many senators' electoral chances 2 years down the road. To make up for lost revenues, several other provisions were introduced, notably a temporary increase in the corporate income tax rate (from 32% to 35%)<sup>29</sup> and the limitations on creditable

<sup>29</sup> With a sunset provision to reduce the rate to 30% after 3 years, i.e., by 2009.

**Table 2.1**  
**Changes in Reform Features through the Reform Stages**

Pre-RVAT Law Regulations (RA 8424)	DOF Proposal	HB 3555 and HB 3705	SB 1950	RA 9337
VAT rate, %				
10%	2-step increase conditional on VAT effort	12% <sup>a</sup>	10%	12% by 2007 if: a) VAT effort exceeds 2.8% b) NG deficit ratio exceeds 1.5%
Initial VAT exemptions and zero-ratings, VAT exemptions repealed, Additional zero-ratings				
<p>VAT exemptions: 26 items including non-standard exemptions such as legal and medical services, power and petroleum</p> <p>Zero-ratings:</p> <p>a) Export sales, sale of gold to BSP and those considered export sale under EO 226 of 1987</p> <p>b) Foreign currency-denominated sale</p> <p>c) Sales to entities whose exemption is under special laws or international agreements to which the Philippines is a signatory</p> <p>d) Services rendered to international shipping industry</p> <p>e) Services to entities doing business outside the Philippines</p> <p>f) Services to entities exempted under international agreements to which the Philippines is a signatory</p> <p>g) Services to entities whose export sales exceed 70% of the annual production</p>	<p>RA 8424 exemptions repealed:</p> <p>a) Coal and natural gas</p> <p>b) Petroleum products and their raw materials</p> <p>c) Importation of passenger and/or cargo vessels of more than 5,000 tons, including engine and spare parts</p> <p>d) Sale, importation, printing, and publication of books</p> <p>e) Medical services</p> <p>f) Legal services</p>	<p>RA 8424 exemptions repealed:</p> <p>a) Generation of power</p> <p>b) Petroleum products and raw materials used in making them</p> <p>c) Medical and legal services<sup>b</sup></p> <p>Special VAT rates and multi-tiered VAT rates:</p> <p>a) 6% for "selected food items" (mackerel and sardines, milk, refined sugar, cooking oil, packed noodle-based instant meals, miki, miswa, sotanghon, pancit canton, and bihon)</p> <p>b) 6% for locally produced generic medicine</p> <p>c) 8% for imported "selected food items" and imported generic medicine</p> <p>d) Power generation (both private and government-owned) and petroleum products—4% on 1st year, 6% on 2nd year, 8% on 3rd year, and 12% on 4th year</p> <p>New exemptions:</p> <p>a) Passenger or cargo vessels and aircrafts</p> <p>b) Medical services to indigents and legal services to clients belonging to marginalized sectors</p> <p>c) Fuel, goods, and supplies for use in international shipping/air transport operations</p> <p>d) Pan de Sal</p> <p>e) Power generated through biomass, wind, and solar energy</p> <p>f) Educational services rendered by TESDA</p> <p>g) LPG</p> <p>Zero-ratings added to RA 8424 list:</p> <p>a) Services rendered to international air transport operations</p>	<p>RA 8424 exemptions repealed:</p> <p>a) Coal, natural gas, and petroleum products</p> <p>b) Petroleum products and their raw materials</p> <p>c) Importation of passenger and/or cargo vessels of more than 5,000 tons, including engine and spare parts by electric cooperatives</p> <p>d) Medical and legal services</p> <p>e) NPC, Meralco, and all the power generation companies</p> <p>f) Art, literary works, and musical compositions</p> <p>g) Cotton and cotton seeds</p> <p>h) Non-agricultural food products</p> <p>i) Air and shipping passenger fares</p> <p>j) Sales by electric cooperatives</p> <p>k) Export sales by persons who are not VAT-registered</p> <p>Zero-ratings added to RA 8424 list:</p> <p>a) Services rendered to international air transport operations</p> <p>b) Transport of passengers and cargo by air or sea vessels from the Philippines to a foreign country</p> <p>c) Indigenous and renewable energy sources: solar, wind, natural, gas, hydroelectric, and geothermal</p>	<p>RA 8424 exemptions repealed:</p> <p>a) Coal, natural gas, and other indigenous fuels</p> <p>b) Petroleum products and their raw materials</p> <p>c) Power</p> <p>d) Electric cooperatives</p> <p>e) Domestic air and sea transport</p> <p>f) Medical services</p> <p>g) Legal services</p> <p>h) Cotton and cotton seeds; non-food agricultural products</p> <p>i) Works of art, literary works, musical composition</p> <p>New exemptions:</p> <p>a) Medical, dental, hospital, and veterinary services not rendered by professionals</p> <p>b) Educational services by schools accredited by TESDA</p> <p>c) Lease of residential houses not exceeding P10,000 monthly</p> <p>d) Sales of persons and establishments earning not more than P1.5 million annually</p> <p>e) Fuel and goods by entities engaged in international shipping or air transport operations</p> <p>Zero-ratings added to RA 8424 list:</p> <p>a) Services to entities engaged in air transport operations</p> <p>b) Transport of passenger or cargo by air or sea to a foreign country</p> <p>c) Renewable sources of energy</p>

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Table 2.1

(continued)

Pre-RVAT Law Regulations (RA 8424)	DOF Proposal	HB 3555 and HB 3705	SB 1950	RA 9337
Other VAT-related reforms				
		<p>a) Sellers of petroleum products cannot pass on to the consumers the VAT burden</p> <p>b) The input tax credits shall be equally distributed over the depreciable life of the capital goods<sup>a</sup></p> <p>c) Tax credits (ex capital goods) shall not exceed 5% of the total value of the goods/services<sup>a</sup></p> <p>d) Input taxes from purchase of transport equipment used in business are allowed as input tax</p> <p>e) Presumptive input taxes of processors of mackerel, sardines, milk, refined sugar, and cooking oil are repealed</p> <p>f) Public works contractors have the option between a presumptive input tax amounting 1.5% of contract price and actual input taxes</p>	<p>a) For a person making sales that are zero-rated, the input taxes shall be allocated ratably between VATable and non-VATable business</p> <p>b) Transitional input tax credit lowered to 2% from 8%</p> <p>c) Presumptive input tax of firms engaged in processing of sardines, mackerel, and milk raised to 4% from 1.5%</p> <p>d) Presumptive input tax of public works is repealed</p> <p>e) 5-year spread out crediting of input VAT on capital equipment if cost &gt; P660,000</p>	<p>a) Cap on input VAT crediting at not more than 70% of output VAT for the same quarter</p> <p>b) Uniform 5% VAT withholding on government purchases of goods, services, and public works contracts</p> <p>c) Transitional input tax credit lowered to 2% from 8%</p> <p>d) Removal of 1.5% presumptive input VAT on public works contractors</p> <p>e) Presumptive input tax of firms engaged in processing of sardines, mackerel, and milk raised to 4% from 1.5%</p> <p>f) 5-year spread out crediting of input VAT on capital equipment if cost &gt; P1 million</p>
VAT Earmarking				
No specific provision for VAT revenue earmarking	No specific provision for VAT revenue earmarking	No specific provision for VAT revenue earmarking	<p>a) 10% of the total VAT collection shall be allocated and divided equally between (1) public elementary and secondary education and (2) public health services to sustain the goal of universal coverage of the National Health Insurance Program</p> <p>b) P15 million (of the incremental revenues) shall be allocated for public information and education program to be administered by the Bureau of Internal Revenue (BIR) in the period to 31 December 2005, explaining clearly business and reporting requirements under the VAT rules</p>	<p>Of incremental revenue from VAT, 50% will be the share of local government units. Portions of which will be allocated and used exclusively for the following:</p> <ul style="list-style-type: none"> <li>• 15% for public elementary and secondary education, to finance construction of buildings, purchase of school furniture, and in-service teacher training;</li> <li>• 10% for health insurance premiums of enrolled indigents;</li> <li>• 15% for environmental conservation, in particular, to fully implement a comprehensive national reforestation program;</li> <li>• 10% for agricultural modernization, to finance construction of farm-to-market roads and irrigation facilities.</li> </ul>

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**Table 2.1**  
(continued)

Pre-RVAT Law Regulations (RA 8424)	DOF Proposal	HB 3555 and HB 3705	SB 1950	RA 9337
Non-VAT-related reforms and mitigating measures <sup>c,d</sup>				
			<ul style="list-style-type: none"> <li>a) Raises corporate income tax to 35% from 32% until end-2008 but brings it down to 30% thereafter</li> <li>b) Repeals franchise tax on IPPs, electricity distributors</li> <li>c) Reduces excise tax on socially sensitive products</li> <li>d) Zero excise tax rates on the following goods and services: (1) kerosene, (2) diesel fuel, and (3) bunker fuel</li> <li>e) Franchise tax of domestic airlines is abolished</li> </ul>	<ul style="list-style-type: none"> <li>a) Corporate income tax rate of 35% by end-2008 and to 30% by end-2009</li> <li>b) Increases gross receipts tax from 5% to 7% on royalties; rentals of property, real or personal; profits from exchange and all other items treated as gross income, of bank and non-bank financial intermediaries</li> <li>c) Removal of PAGCOR income tax exemption</li> <li>d) Reduction of excise tax on kerosene, diesel, and bunker fuel oil</li> <li>e) Removal of franchise tax on power distribution utilities</li> <li>f) Removal of franchise tax on domestic airlines and common carriers tax on domestic shipping</li> <li>g) Increases presumptive input VAT of agro-processors from 1.5% to 4%</li> <li>h) Increase in marginal threshold from P550,000 to P1.5 million per annum; rental threshold from P8,000/month to P10,000/month; and real property threshold from P1 million to P2.5 million</li> </ul>

RA 8424 = National Internal Revenue Code of 1997.

<sup>a</sup> Provision of HB 3555; Note: HB 3555 covers only the increase in the VAT rate (10 to 12) and certain limitations to input tax credit; HB 3705 covers the rest.

<sup>b</sup> Collection of VAT from services by professionals, registered general professional partnership, actors, actresses, talents, singers and emcees; radio and television broadcasters, choreographers; musical, radio, movie, television, and stage directors; and professional athletes was suspended until 31 December 2002. Collection of VAT from legal and medical services was suspended until 31 October 2005.

<sup>c</sup> Manasan, Rosario G. 2002. Explaining the Decline in Tax Effort. *PIDS*. December.

<sup>d</sup> Bureau of Internal Revenue. EVAT Primer.

Sources: RA 8424, HB 2555, HB 3705, SB 1950, RA 9370, and news reports.

input VAT, both of which the business sector denounced.<sup>30</sup> It was also at this stage that various policy trade-offs to mitigate the impact of the reforms on the poor were introduced.

The bill stayed in the Senate for about 2.5 months, at the end of which (mid-April) was a product that differed markedly from the House version, albeit both were expected to meet the government's revenue target.<sup>31</sup> The challenge was for the bicameral conference committee, composed of 9 Senators and 28 Members of Congress, including the two chairs of the respective committees on ways and means, to reconcile the two versions without sacrificing revenue potential.

While the bicameral conference committee intended to have a bill ready for the President's signature by the end of April, negotiations on raising the VAT rate dragged. This prompted the President to drop her initial noninterventionist stance and urged Congress to approve the increased VAT rate, with the DOF warning of forgone revenues from delays in passage. The impasse was broken only in May after both houses agreed to give the President standby authority to increase the VAT rate subject to specific conditions identified in the law.

Thus, the final bill approved by the two chambers in the latter part of May and signed by the President on 24 May 2005 included the provision granting the President the authority to raise the VAT rate to 12% by January 2006 if VAT collection exceeded 2.8% of GDP, or if the government's budget deficit exceeded 1.5% of GDP. Other changes introduced by the Senate were also incorporated, and the House's "no pass-through" of the VAT on oil was dropped. The law was scheduled to take effect in July 2005, starting with the broadening of the VAT base to include various previously exempted sectors, notably oil and power.

### *Handling Reform Gainers and Losers*

There were two evident losing groups, the consuming public and the newly covered sectors—with the oil and power companies posing the strongest challenge. The first group was dispersed and not organized to block the reform. This may be seen in the results of a March 2005 Pulse Asia nationwide survey revealing that 66% of respondents admitted to having "a little knowledge" or "almost none or no knowledge at all" of the VAT issue. However, there were genuine concerns about the VAT's adverse impact on low-income segments that in the Philippines and elsewhere were often dealt with by excluding basic commodities<sup>32</sup> that form a large part of the poor's

<sup>30</sup> Including the Joint Foreign Chambers of Commerce of the Philippines, which issued a statement on 15 April 2005. The stock market also fell the day after the Senate approved its version of the bill on fears that it might not raise the needed revenues.

<sup>31</sup> At the time, the reported DOF estimate of revenues from the House and Senate versions of the proposal were P88 billion and P80 billion, respectively. (*BusinessWorld* [2005] House Speaker Claims 'Creative Compromise' on VAT Near. 19 April.)

<sup>32</sup> Including agricultural products, educational services, and sales of low-cost housing.

consumption basket. In this instance, while the inclusion of petroleum products and power services aimed to make the system more progressive (as these are consumed more by the rich), additional price pressures from this move, which in the past had set off street protests and transport strikes, were expected.

The most radical (and unworkable) solution agreed in the lower House was to let oil companies absorb the cost of the VAT through a “no pass-through” condition that the oil companies opposed. Instead, the bicameral conference committee opted to adopt lower excise taxes on three socially sensitive oil products—kerosene, diesel, and bunker fuel oil. Similar lobbies put up by other sectors relying on the VAT’s adverse impact on the poor resulted in other mitigating measures as well, including the removal of franchise tax on power distribution utilities.<sup>33</sup> In the fray, power and fuel sales sourced from renewable energy were zero-rated as part of the policy trade-offs. These reliefs, shown to be poorly targeted at the needy (Newhouse and Zakharova 2007) translated into forgone revenues of about 0.25% of GDP and would appear unnecessary in light of the government’s continuing struggle for Congressional approval of higher excise taxes on polluting oil products.

A third area of mitigating measures involved the earmarking of incremental VAT revenues accruing to local government units. This was intended to pass some of the social spending burden onto the country’s subnational administrative units, which were then enjoying budget surpluses and under the law were to receive annual, formula-based transfers from the national government based on the latter’s tax collections. Despite a number of press reports about public spending on education and health in later years, it is unclear how effectively this stipulation was carried out. The failure to directly link the pain and benefits of the VAT reform may have also contributed in time to the public’s opposition to the VAT.

## Endorsing Reforms: Committing Government to the RVAT

From the time she certified it and for the entire duration of the legislative exercise, the President stood firmly behind the measure, clearly signaling the urgency for Congress to pass the bill and deliver on promised revenues. But while legislation was a necessary step, it was only one hurdle. Following its enactment, various groups challenged the law’s constitutionality before the Supreme Court. On the day the RVAT law was supposed to have come into force and despite arguments that “collection of taxes cannot be enjoined being the lifeblood of the nation,”<sup>34</sup> the Supreme Court issued a temporary restraining order delaying its implementation.

<sup>33</sup> Although Newhouse and Zakharova (2007) noted that the repeal of the franchise tax on power and the reduction of gasoline excise tax also helped improve the structure of the tax system, the former by removing a potential double taxation problem, the latter by equalizing tax treatment of regular and unleaded premium gasoline.

<sup>34</sup> Dissenting opinion of two Supreme Court judges on the 1 July 2005 temporary restraining order issue.

The petitioners, including opposition members of Congress and petroleum dealers, questioned the constitutionality of the law on procedural and substantive grounds. Procedural issues included the bicameral conference committee's authority to insert and delete provisions and the Senate's power to introduce new provisions into the House bill (considering that the Constitution provides that revenue bills must originate from the House). Substantive issues included the standby authority given to the President (argued to be "undue delegation of legislative power"), the 70% cap on input VAT (argued to be arbitrary, oppressive, and confiscatory), and, more generally, the inequity of the VAT and unfairness of the increased rate.

By itself, the restraining order would just have had been another bump on the road for state lawyers to handle.<sup>35</sup> However, the Supreme Court decision came just weeks after the "Hello Garci" election fraud scandal broke,<sup>36</sup> which revived the President's legitimacy issue (with an impeachment case filed against her in Congress) and plunged the country into another political storm. It was around this time that reports of the President's wavering commitment to the VAT started to come out, showing how quickly politicians' changed incentive structures can affect their appetite for reform (even reforms that they themselves had pushed) and thus how quickly the reform window can close. It seems that if the political crisis had happened a mere 2 weeks earlier, the RVAT law in all likelihood would not have passed.

The first sign of trouble emerged a week after the Supreme Court issued the restraining order. Ten members of the President's economic team, led by the finance secretary, resigned after calling a press conference, triggering renewed calls for the President to step down and prompting external monitors, including rating agencies and ADB, to issue statements about the unpredictability of the reform environment.

News stories at the time connected the economic team's resignation to their suspicion that the President had a hand in the Supreme Court restraining order on the RVAT.<sup>37</sup> In response to a "show-cause" order issued by the court against him following these reports, the recently resigned finance secretary denied claiming that the court was influenced by the President in issuing the restraining order but revealed that the President had "on several occasions discussed with the economic team the possibility of postponing the implementation of the RVAT" and that he felt that the executive branch "was not doing enough to have the [temporary restraining order] lifted."<sup>38</sup>

<sup>35</sup> In this case, the DOF undersecretary charged with pushing the RVAT, himself a lawyer, was on hand to make the tax and constitutionality arguments before the court.

<sup>36</sup> The scandal involved wiretapped conversations between the President and a senior official of the Commission on Elections that suggested the President manipulated the 2004 elections in her favor. Following the President's public apology of her "lapse in judgment" in speaking with the election official, calls mounted for her to resign. At that juncture, her entire cabinet still stood behind her.

<sup>37</sup> Among those cited by the Supreme Court were: SC Denies Palace Pressed Issuance of EVAT TRO (*The Daily Tribune*, 10 July 2005); Palace Debunks Purisima Claim on EVAT (*Philippine Star*, 11 July 2005); The Last Straw that Broke a Cabinet (*Philippine Star*, 11 July 2005); No GMA Influence on EVAT Freeze—SC (*Philippine Daily Inquirer*, 12 July 2005).

<sup>38</sup> Supreme Court En Banc Resolution: Former Finance Secretary Cesar V. Purisima Indirect Contempt of Court, 1 September 2005. <http://sc.judiciary.gov.ph/jurisprudence/2005/sep2005/168056a.htm>

Some analysts surmised that the economic team's resignation forced the President's hand, pushing her to demonstrate commitment to the reform by implementing it. Nevertheless, as the President's popularity fell, press reports suggested a continuing desire to delay implementing the law, or parts of it. Following the Supreme Court's 1 September ruling on the constitutionality of the RVAT and despite the dropping of the impeachment case, there were reported moves spearheaded by the President's allies in Congress to pass a joint resolution suspending the VAT on oil and power, ostensibly because of rising world commodity prices.<sup>39</sup>

Statements she made to investment bankers during a trip to the US in mid-September—essentially saying that the executive would respect Congress's vote on the resolutions and that the government could afford the lost revenues if the resolutions passed—raised worries that the President might be less than 100% committed to the VAT.<sup>40</sup> Legislators also complained of mixed signals from the executive<sup>41</sup> and, in frustration, the chair of the Ways and Means Committee of the Senate purportedly told the President, “You wanted me to vomit this and now you want me to swallow my vomit.” As media headlined “Arroyo open to delaying VAT on oil and electricity” and a government official, conferring with a credit rater, was told that suspending the VAT would be “very, very unfortunate,” the President clarified that she remained committed to implementing the law fully.<sup>42</sup>

By then, the RVAT reform had become the investment community's gauge of the Arroyo administration's political will to address the country's fiscal problems. Hence, as the political crisis abated, the law was allowed to go into effect.

## Implementing Reforms

The law took effect on 1 November 2005 with little fanfare, largely because of the delay in implementation that gave the government—the Bureau of Internal Revenue in particular—time to prepare the implementing rules and conduct information campaigns. Government officials recall little resistance during these road shows given the message of burden sharing and the package of measures to mitigate the price impact on the poor. On the part of the bureau, except for long-standing enforcement

<sup>39</sup> *BusinessWorld* (2005) Mixed Signals on VAT. 19 September.

<sup>40</sup> In a forum, the President said, “If the resolutions [in Congress] don't pass, then we will proceed with carrying out with the reforms and if the resolutions are passed, we will respect Congress' advice to us, but it does not take us away from our deficit reduction program ... We respect their wisdom.” (*Philippine Daily Inquirer* [2005] Arroyo Open to Delaying VAT on Oil, Electricity. 17 September.)

<sup>41</sup> *BusinessWorld* (2005) Mixed Signals on VAT. 19 September; *BusinessWorld* (2005) VAT Freeze Order Stays. 20 September.

<sup>42</sup> In a statement the next day, she said, “Let me put into the proper context some statements I made regarding proposals to exempt power and fuel from the value-added tax. My position remains consistent: the VAT Reform Law should be implemented in its entirety if we are to achieve our economic reform and deficit reduction goals in a timely manner.” (*Philippine Star* [2005] EVAT Approval Must Be in Toto. 18 September.)

issues, the key challenge was the expansion in the VAT's scope, which required it to issue some 17 industry-specific memorandum circulars. The bureau's long experience in collecting the VAT helped.

On the whole, the RVAT experience demonstrated that when crisis looms and incentives align across broad segments of society, institutions function to ward off the crisis, with key public institutions (the civil service, legislature, and judiciary) and private agents (civil society, the media, and businesses) performing their roles. This good sense to do the right thing to avoid economic collapse prevailed despite widespread sentiment to withdraw political support for the President, the principal champion of the reform. This suggests some degree of maturity and progress in the workings of the country's democratic institutions.

Yet once the reform urgency passed, interests started to diverge and institutional flaws emerged. Inability to sustain the gains from the RVAT reform can be traced to failings across the three branches of government—evident in the country's relatively poor scores in governance indicators for corruption, rule of law, and political stability<sup>43</sup>—weaknesses that constrain effective policy formulation and implementation.

At the operational level, Tanzi and Shome (1992) had observed as early as 2 decades ago that “the Philippines is one case in which taxation will be ineffective unless major administrative improvements are made.” However, experience over the years with efforts to upgrade systems and procedures, including donor-assisted computerization initiatives, has met with resistance from within the tax bureaus; hence achieving limited success. Likewise, intensified efforts to prosecute tax offenders have had to contend with a court system overburdened by case backlogs and lacking transparency in case management that has led to long delays and inability to show actual imprisonment of large offenders, thus impairing the credibility of government programs aiming to raise the risks of tax evasion.

Added to these are systemic corruption and varying degrees of high-level political support for anticorruption initiatives and programs to run after tax evaders and smugglers. With efforts to plug tax leakages dependent on the character, drive, and integrity of politically appointed senior bureau leadership, reform efforts tend to backslide. This explains the increasing preference of policy makers and advisors for easy-to-collect indirect taxes rather than more progressive direct taxes.

In truth, the revenue targets from the RVAT law were relatively easy to realize given that the first phase—widening the tax base—involved two major industries that have only a limited number of visible firms that can easily be tracked, while the conditions triggering the second phase—the 2 percentage point increase in the VAT rate—were low hurdles. The difficulty was enforcing the 70% cap on input VAT credits. While the executive had already tried to soften the provision in the implementing rules

<sup>43</sup> <http://info.worldbank.org/governance/wgi/resources.htm>

and regulations<sup>44</sup>—a common way for the executive to influence reform direction—numerous small and medium-sized firms opposed it, arguing that it disadvantaged low-margin industries. The Bureau of Internal Revenue commissioner at the time<sup>45</sup> sided with them, calling for repeal of the provision, which was achieved by law in late 2006.

From a macro viewpoint, in terms of meeting the government's fiscal consolidation objective, the RVAT law may be deemed successful. The wider VAT base brought in about 1% of GDP, while the higher VAT rate produced about 0.5% of GDP when implemented fully. Total revenues from the measure, after netting out the costs of mitigating provisions, reached 1.3% of GDP, helping raise the government tax effort to 14.3% by 2006 and bringing the overall budget deficit down to almost balance by 2007. The measure helped to put the government in a good position to respond with countercyclical fiscal spending to the shock from the global financial crisis. The downtrend in the government debt ratio also helped increase the economy's resiliency and, in time, contributed to better credit ratings for the country.

The broadening of the VAT base, expected to improve VAT administration by strengthening the audit trail, indeed improved VAT productivity from only 0.29 in 2004 and 2005 to 0.36 by 2006 when the law was fully implemented. Newhouse and Zakharova (2007) also found the law to be progressive in its overall distributional impact due to the mitigating measures and coverage of petroleum and power, though noting substantial leakages to the wealthy due to the energy tax cuts.

Unsurprisingly as well, the study noted that the reform had “a moderate adverse effect on poor households” as seen in reduced real income and consumption. This, coupled with seeing the full 12% VAT burden reflected in the receipts of their purchases—a requirement of the new law—contributed to open public resentment toward the tax. Because of its unpopularity, the VAT became an easy target of politicians wanting to curry public favor. This was especially true when economic conditions deteriorated, for example, during periods when oil prices rose, which in light of the absence of oil subsidies in the Philippines were relatively quickly passed through to domestic pump prices. During these times, there would be rising clamor for the government to suspend the VAT on fuel products, which populist elements in Congress would respond to by sponsoring bills to do this. To its credit, the government remained steadfast in keeping the oil sector under the VAT net, despite persistent high oil prices.

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<sup>44</sup> Applying only the rule to firms with input VAT exceeding output VAT.

<sup>45</sup> Jose Mario C. Bunag.

## Sustaining Reforms

While the core reform itself—expanding VAT and raising the VAT rate—has not been reversed, once the crisis passed and fiscal statistics improved, waning commitment to the broader goal of fiscal consolidation became evident. After reaching 14.3% of GDP in 2006, the tax effort started to slide anew. In part, this was due to built-in sunset provisions in the law, mainly a reduction in the corporate income tax rate from 35% to 30% by 2009 that was deemed consistent with declining business taxes worldwide.

Unfortunately, the temporary corporate income tax increase apparently failed to achieve lawmakers' intention to buy time for the Bureau of Internal Revenue to improve tax administration. A decomposition of the sources of change in the bureau's tax effort showed that there was, in fact, some relaxation in tax administration after the RVAT law came into effect. The calculations suggest that had the bureau maintained its collection efficiency at the 2004 level, the improvement in the overall tax ratio would have been higher (Manasan 2008). (The commissioner appointed during the President's first term to spearhead systems improvements in the bureau was one of the 10 officials who resigned in July 2005.)

Another problem with sustaining the benefits of reform was politicians' penchant to chip away at the government's tax base in order to win votes as the 2010 election neared. On the VAT itself, electricity transmission (a monopoly) was the first to be exempted in December 2009, followed by selected purchases of senior citizens in February 2010, both of which were signed by the President. These translated into an estimated P10 billion revenue loss for the government and a weakened VAT system, as seen in the decline in VAT productivity from 0.36 in 2006 to 0.32 by 2010. Other newly legislated non-VAT revenue-eroding measures included individual income tax relief and tax incentives for retirement accounts and real estate investment trusts. These were passed despite DOF's objections. In these instances, the bureaucrats' recourse was to impose strict conditions in the implementing rules to limit revenue losses.

There have also been no further initiatives since the RVAT law to pass other tax-related measures despite broad recognition of the need to increase the tax system's buoyancy and equity. In fact, "no new taxes" became a campaign slogan of the winning President in the 2010 elections. Proposed measures in Congress, such as rationalizing fiscal incentives, indexing specific taxes to inflation, raising oil excises, or simply restraining Congress from enacting new expenditures without matching revenues, have failed to move forward for many years now.

The failure to maintain the tax effort at desirable levels—at least the 17% achieved in 1997—has translated into suboptimal allocations for public spending in education, health, and basic infrastructure compared with Asian peers. In turn, failure to upgrade basic levels of social services and physical infrastructure has not only capped the economy's growth potential but also limited the scope for growth to be more inclusive.



At the policy-making level is the seeming lack of coordination between the executive and the legislative branches and thus coherence in their pursued agendas. This leaves concerned parties free to pursue their own narrow agendas, as may be seen in the many revenue-eroding measures that Congress passed even as the executive struggled with its pronounced fiscal consolidation thrust. While a formal process for executive–legislative dialogue was instituted in 1992 through the Legislative–Executive Development Advisory Council,<sup>46</sup> the efficacy of this mechanism in ensuring shared priorities depends on the frequency of meetings called by the President. In comparison to the 6-year Ramos Administration when it met 81 times, this council was convened only 25 times during the almost 10-year Arroyo Administration.<sup>47</sup>

Without these regular, senior-level consultative sessions between the two branches that promote deeper understanding of both parties' policy objectives and, more important, individual motivations, reviews of proposed bills at the technical level face greater risk of being ignored. Worse, there may be instances when Congress forgoes altogether soliciting inputs from executive departments for proposals that may derail the executive's programs and when political circumstances rule out the use of the presidential veto.

But perhaps the basic missing ingredient for sustaining policy reform in the Philippines is the lack of effective political parties that take the long view of national development. As it is, reform efforts are centered on the President whose commitment to any particular reform cannot but be influenced by his or her changing political fortunes. The "Hello Garci" election fraud scandal illustrates this. Even absent external political pressures, the prospects for reform are still dependent on the person—*gravitas* on the one hand and popular support on the other—and willingness to exercise political will and spend political capital to push reform within a single, 6-year term.

In light of this, policy making can well degenerate into *quid pro quo*, transactional collaboration with members of Congress that results in policy myopia, especially since lower House members have to go through an electoral challenge every 3 years.<sup>48</sup> Indeed, the incentive structure is skewed toward reforms that can show immediate benefits that the incumbent can claim as his or her own, with lengthier institutional-type reforms—that threaten established privileges—left to the future.

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<sup>46</sup> It is chaired by the President with members drawn from the Cabinet and Congress leaders.

<sup>47</sup> Joint Foreign Chambers (2010), p. 322.

<sup>48</sup> Members of the Senate hold 6-year terms.

## Conclusions and Lessons

The Philippine tax system has been likened to a leaky bucket designed by law and exploited by everyone to extract private gain. From time to time, when the water in the bucket dips to critical levels, holes are selected for repair, using at times only plaster with no lasting impact (e.g., the amendments on sin taxes). The VAT reform is a higher-quality, more permanent repair that was supplemented by turning the tap more to raise the water level faster. It is notable in that it may well have been the first time that the country managed to avoid an economic collapse by achieving broad consensus for reform in time (De Dios et al. 2004).

While the ideal reform would involve changing the bucket altogether, the last such attempt met with dismal results. When Congress tackled a comprehensive tax reform package in 1997, the outcome—a less buoyant system that led to a steadily declining tax effort—demonstrated the dangers of such efforts in an environment where private interests dominate public choice. For sure, as past reform experiences, including the RVAT, showed, such should not be attempted without a strong and credible leader who can neutralize influence of the elites and can spearhead the change.

For now, it would appear that the country is stuck with the leaky bucket. The problem, of course, is that without continuing efforts to plug the holes, the Philippines will likely just go from one crisis-induced reform to another. Current initiatives to improve tax administration are a good start but need to go beyond what has been described as “hunting in the zoo,” or targeting the existing narrow tax base to pay more.

As it is, finance officials perceive resistance within the tax bureaus for more strategic audit measures, either because the tools are not well understood or because they disturb ingrained bureaucratic setups. Finance officials recognize that such behavioral changes have to be pursued on a continuing basis, but that they will take time and will require a more concerted effort to professionalize the revenue agencies and institute greater accountability within the bureaus. An information database that has integrity and is outside the control of tax authorities also has to be built. In the meantime, because of the long lag for such reforms to bear fruit, other complementary reforms are needed to bring the tax effort up.

Unfortunately, with the sovereign credit's recent rating upgrade and general sentiment of having put the fiscal problem behind it, how can the Philippines pass reforms without the threat of another crisis? The following ingredients in the reform process, culled from the RVAT law experience, may help raise the odds of success, although they do not, of course, guarantee success.

### *One*

To get reform on the government's agenda, presidential endorsement is necessary. Without it, reforms in taxation will have no chance of passing. Ideally, the President

is one who is newly elected, allowing reform to be timed immediately after the receipt of a fresh mandate when the chances of securing reform buy-in from different segments of society are highest. To secure the President's backing for an unpopular measure, technocrats need to be armed with sound diagnostic studies by credible domestic groups, such as the academe, that clearly spell out the problem, its causes, consequences of doing nothing, and options and time frame for reform. An identification of reform players (especially in Congress if reform requires legislation), their motivations, and how to overcome any resistance needs to be done, and a measurable policy objective (such as the P80 billion revenue goal) needs to be targeted to frame negotiations on alternative reform measures and possible trade-offs.

## *Two*

The elements that go into convincing the President to endorse reform assume even greater importance when managing reform complexities, as the parties that need to be convinced multiply and the robustness of technical analyses are scrutinized under real-world conditions, and facts are filtered through the biased lenses of interested groups. Hence, reformers should maintain the flexibility to accommodate hard demands—keeping in mind that the perfect is the enemy of the good—and be sensitive to any adverse impact of reform on marginalized sectors that needs to be tackled at program design stage. This will help in securing reform buy-in and in increasing the chances of sustaining reform.

At this stage, leadership becomes crucial given that in the Philippines, the only reforms that happen are those that the elites can live with. Hence, the President needs to stand ready to use the vast powers of the office and spend political capital to ensure that the incentives of key actors in the reform process are broadly aligned with his or hers.

The President and team need to be clear-minded about how to approach various groups that can influence reform, including understanding the motivations of Congress, collectively and individually (regular legislative–executive consultations are ideal), and initiating dialogue with entrenched interests to reduce or turn resistance around. Reform champions in Congress, who can steer proposed bills through their respective chambers without losing sight of reform objectives, need to be drafted into the effort.

Likewise, senior managers in the executive department need to act as a second-tier support group for the reform and carry the ball from start to end. In a politically unstable environment, this group can provide technocratic stability. Absent continuity at the cabinet level, committed and knowledgeable civil servants in lower rungs also have a role in providing institutional memory for successive leaderships, as was shown in the case in the RVAT.<sup>49</sup>

<sup>49</sup> In the 3 years reforming the VAT (2004–2006), the DOF had three secretaries.

Nonpartisan groups outside government, echoing the reform message, can help in creating awareness of the need for reform and, in the case of civil society groups, demonstrate domestic ownership for the drive for change. Media that are kept informed of the complexities of reform issues and can be trusted to present a balanced view of the issues can help in articulating the rationale for reform in simple messages to a wide, nontechnical audience.

### *Three*

In committing the government to reform, as legislation is just one hurdle in the reform process, the President needs to remain steadfast in supporting reform and intervene as needed to build consensus and clear roadblocks, including in hastening the resolution of any legal challenges. The role of civil society, media, and external monitors such as donors and credit raters in applying pressure on government at critical junctures to keep to the reform path can help in tipping the balance for reform, especially when presidential commitment shows signs of wavering.

### *Four*

Once reform gets to the implementation stage, institutional weaknesses become the enemy of reform. Thus, for reform to succeed, these weaknesses need to be considered at the design stage, exploring alternative solutions that try to go around institutional obstacles (hence the push for the VAT), while taking steps to overcome them, even incrementally.

The incentive structure facing bureaucrats tasked to carry out reforms should be well understood and, if needed, additional resources need to be deployed to minimize leakages and safeguard timely reform execution. It is also at this stage that reform losers start realizing fully the adverse impact of reform, particularly when unexpected external shocks happen, requiring a quick demonstration of reform benefits to counter any moves for reform reversal. Again, presidential leadership and commitment to stay the reform course are crucial in blocking such attempts. Effectively showing after the event how increased tax revenues directly went into funding earmarked or promised public goods and services may also help increase the acceptability of future reform programs.

### *Five*

While individual reforms are seldom reversed once the promised benefits are realized, it is very hard for a President to sustain the reform environment, especially in a country like the Philippines with a short, 3-year electoral cycle where institutions that have a long-term stake in development are also lacking. Thus, responsible civil society that can take a longer view than politicians (and hold them accountable) has taken a more prominent role in pushing for reforms, helping to prop up the reform agenda of change agents in government.

The RVAT was a crisis-induced, stroke-of-the-pen reform that changed tax rules to meet macroeconomic objectives without changing the government's and the public's attitude toward tax compliance. The latter is needed to minimize reversals and backsliding but involves a lengthy and knotty process of governance and institutional reforms, not just within the executive's tax bureaus but with the courts' handling of tax cases and Congress's approach to tax legislation as well. Whether such reforms are possible depends on the intersect between governance and politics (David 2010), and ultimately, how Philippine society chooses its leaders.

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## Annex 2.1

### Timeline

25 July 1987	VAT (EO 273) adopted in the Philippines
January 2002	Argentina debt default
April 2002	IMF urges government to consider raising the VAT rate.
February 2003	Government postpones balanced budget target from 2006 to 2009.
April 2003	S&P downgrades sovereign credit from BB+ to BB.
30 November 2003	Finance Secretary Jose Isidro Camacho resigns, later warns of a fiscal crisis.
1 December 2003	Juanita Amatong assumes the post of DOF secretary.
January 2004	Moody's downgrades the sovereign credit from Ba1 to Ba2.
May 2004	Presidential election
June 2004	GMA declared President; IMF proposes increasing VAT rate to 15%
22 July 2004	PGMA speech before business community—government considering repeal of the VAT
26 July 2004	PGMA SONA—chronic budget deficit the country's "most urgent problem"; proposes eight revenue measures
23 August 2004	PDI banner story, "UP economists warn of RP crash in 2 years"
24 August 2004	PGMA—"we are in the midst of a fiscal crisis"
September 2004	DoF proposes to Congress to (a) remove VAT exemptions for six sectors, including oil and medical/legal professions; and (b) two-step hike in the VAT rate (to 12% in 2006 and 14% in 2007).
6 December 2004	PDI story—"Palace opts for hiked VAT over franchise tax"
21 December 2004	PGMA signs RA 9334 increasing excise taxes on tobacco and alcohol.
7 January 2005	PGMA certifies as urgent HB 3555, withdrawing certain VAT exemptions.
17 January 2005	S&P downgrades the sovereign credit from BB to BB-.
27 January 2005	House of Representatives approves HB 3555, 126 in favor/11 against; bill transmitted to the Senate.
8 February 2005	The President certifies HB 3705 as urgent.
14 February 2005	Juanita Amatong resigns as DOF secretary.
15 February 2005	Cesar Purisima takes over finance department.
16 February 2005	Moody's downgrades the sovereign credit to from Ba2 to B1.
28 February 2005	House of Representatives approves HB 3705 on the third reading following a 156-30-3 (Yes-No-Abstain) voting.
7 March 2005	The Senate Committee on Ways and Means approves Senate Bill No. 1950.
13 April 2005	Senate approves its version of VAT bill (2nd and 3rd readings), 14 in favor/6 against.
15 April 2005	Bicameral conference committee starts to reconcile House and Senate versions of the VAT bill.
12 May 2005	EVAT bill passed giving PGMA "standby power" to raise the VAT rate by January 2006.

*continued on next page*

## Annex 2.1

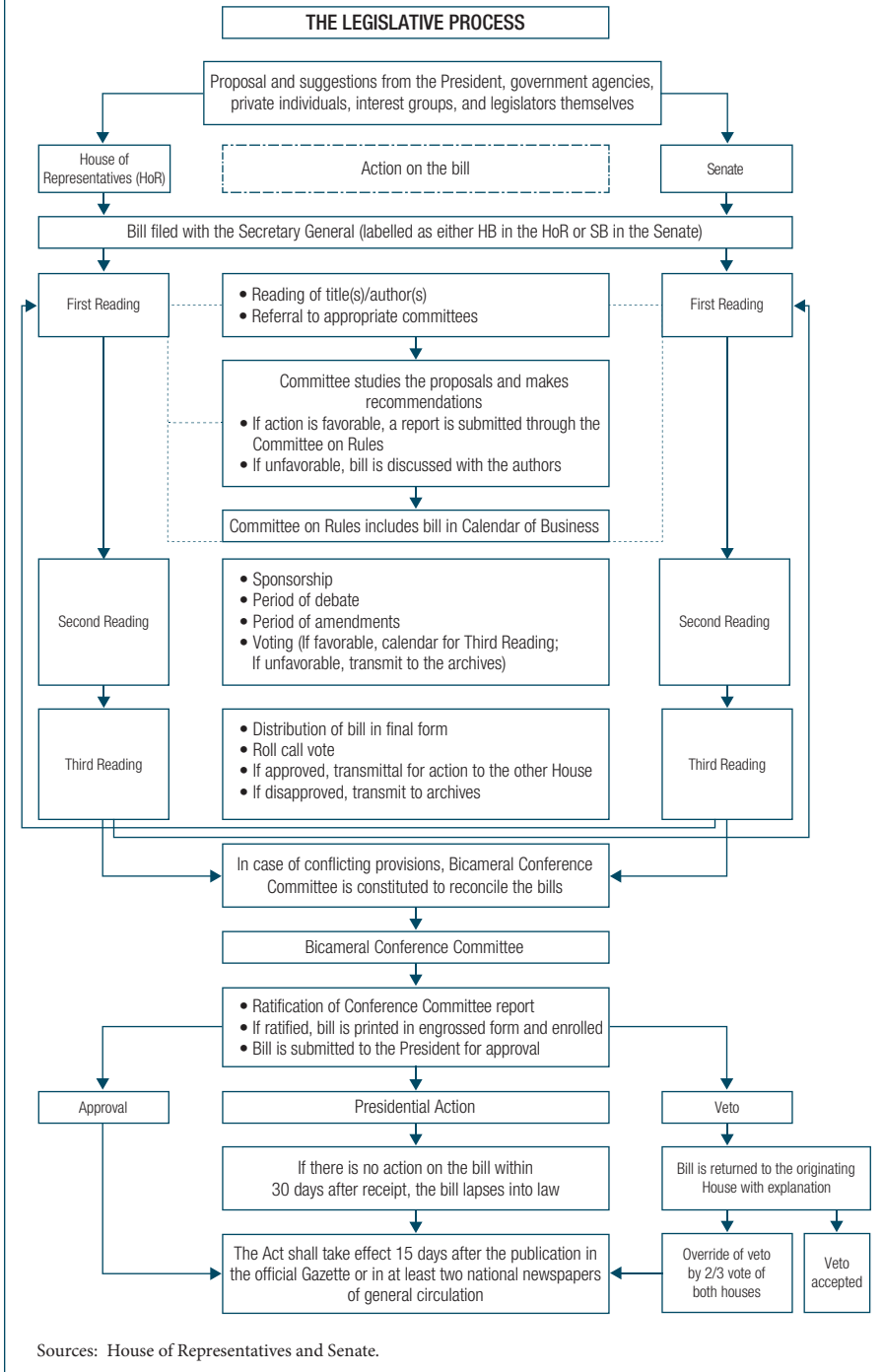
(continued)

24 May 2005	PGMA signs RA 9337 (EVAT Law) to take effect 1 July.
6 June 2005	“Hello Garci” controversy breaks.
30 June 2005	Opposition members of Congress ask Supreme Court to stop implementation of EVAT.
1 July 2005	SC issues stay order against implementation of EVAT law.
8 July 2005	10 Cabinet members, including key economic managers, resign.
11 July 2005	S&P changes Philippine ratings outlook from stable to negative.
12 July 2005	PGMA appoints Margarito Teves as finance secretary.
13 July 2005	Demonstrations demanding PGMA to resign; Moody’s changes Philippine ratings outlook from stable to negative.
1 September 2005	SC declares EVAT law constitutional while keeping restraining order.
18 October 2005	SC lifts restraining order.
1 November 2005	VAT law implemented—first phase covers the expansion of coverage including oil and power sectors.
1 February 2006	VAT second phase, VAT rate increased to 12%
9 February 2006	S&P changes Philippine rating outlook from negative to stable.
2 November 2006	Moody’s changes Philippine outlook from negative to stable.
21 November 2006	PGMA signs RA 9361, repealing the 70% cap on creditable input VAT.
14 May 2007	Legislative and local elections; Senator Recto lost bid for reelection
28 January 2008	PGMA approves P75 billion economic stimulus package.
1 December 2008	PGMA signs RA 9511 (Transco franchise law).
23 July 2009	Moody’s upgrades Philippine rating from B1 to Ba3.
15 February 2010	PGMA signs RA 9994 (Senior Citizens law).

Source: Reports from major Philippine newspapers, studies and official documents of the House of Representatives and the Senate.



## Annex 2.2 Philippines Legislative Process



# Reforms in the Pacific

Richard Bolt<sup>50</sup>

## Introduction

This case study focuses on reforms and policy-based loans to the Pacific developing member countries (DMCs) of the Asian Development Bank (ADB) during 1997–2007, as well as related advisory assistance. It is largely based on a special evaluation study of these reforms by ADB’s Independent Evaluation Department (ADB 2009). Expanding on an application of the reform framework used in Chapter 1, it also shows how an understanding of the political economy of reform can be applied in postevaluation.

## Subregional Context for Pacific Reforms

The Pacific island countries supported by ADB are located in the vast expanse of the Pacific Ocean from the western–central to the south Pacific. Some are fragile states, and they generally exhibited slow, and even negative, economic growth in the 1990s.<sup>51</sup> Average annual gross domestic product (GDP) growth during the 1993–1997 prereform period was 1.1%, compared with 2.6% during 2002–2007. GDP per capita varied from about \$803 in Vanuatu to \$5,584 in the Cook Islands (see also [Box 3.1](#)).

<sup>50</sup> The author acknowledges the significant contributions from Graham Walter and Benjamin Graham as co-authors of the evaluation study (ADB 2009) on which this chapter is based.

<sup>51</sup> In 2007, seven Pacific DMCs were categorized as weakly performing countries—Kiribati, the Republic of the Marshall Islands, the Federated States of Micronesia, Papua New Guinea, Solomon Islands, Timor-Leste, and Vanuatu (ADB 2008a).

### Box 3.1

## Country Contexts

The Federated States of Micronesia (FSM) attained independence in 1986 under a Compact of Free Association with the United States (US). The FSM's 107,000 people inhabit its confederation of four States—Chuuk, Kosrae, Pohnpei, and Yap. Each state has its own government, languages, culture, and identity. The FSM is heavily reliant on external assistance, especially through the Compact with the US, which accounts for more than half of government revenue.

In the early 1990s, the governments of the FSM expressed their concern over near-term fiscal sustainability, size of the public sector, and debt obligations stemming from the bonds that the government had issued using guaranteed future economic assistance payments under Compact agreements. Compact funding step-downs in fiscal year (FY)1997 and the possible end to Compact funding in 2001 exacerbated these concerns. Analysis supported by the Asian Development Bank (ADB) confirmed that Compact step-downs had left the governments facing fiscal deficits and that the solution needed to extend beyond the governments' initial idea of expenditure management such as wage cuts, to deeper cuts in public services and a reduction in state-owned enterprises, and revenue-side solutions such as tax reforms.

The Republic of the Marshall Islands (RMI), also in the central Pacific, similarly attained independence in 1986 under a Compact of Free Association with the US. As with the FSM, the RMI government shared similar concerns over near-term fiscal sustainability and size of the public sector, and even greater debt obligations, the effects of Compact funding step-down in FY1997, and a possible end to Compact funding, also in 2001. Analysis confirmed the government's growing unsustainable public service size, the drain on public resources of SOEs, and the low tax effort.

Unlike other Pacific island countries, Papua New Guinea has a large land area with a population of 5.3 million. It is characterized by wide linguistic and cultural diversity and has many natural resources. Rugged terrain, however, makes for high infrastructure costs and low population densities, hampering resource exploitation. Complex customary land tenure systems, a peace-and-order problem, poor human resource development, and an annual population growth rate of more than 3% also constrain development.

The need for improved public sector performance in Papua New Guinea was a subject of analysis and discussions between ADB and the government since early 1998. However, it was not until a reformist-minded government came to power in 1999 that the impetus to undertake significant public sector reforms was created. ADB provided technical assistance to help develop a governance and public sector reform agenda, with the new government recognizing that the country's weak economic performance was the result of poor governance.

Vanuatu is in the South Pacific, west of Fiji. Some 80% of the population of about 200,000 lives on the eight largest islands. The economic base is agriculture, fisheries, and tourism, with offshore financial services contributing. The economy began to deteriorate in 1989, and the government's precarious financial situation, looming fiscal difficulties, and declining reserves, as well as weak government service delivery, led the government to recognize the need for reforms.

*continued on next page*

### Box 3.1

(continued)

Vanuatu adopted the Comprehensive Reform Program (CRP) developed by ADB, largely as it concluded that it had no choice if it wished to obtain ADB support, but the reforms were relevant to its needs. Preparation of the CRP began in February 1997, and the proposed CRP document was presented to a national summit in June that year, and received bipartisan support.

The 15 islands and atolls of the Cook Islands lie west of Tahiti. The Cook Islands faced a severe fiscal crisis in the early 1990s, which was not made public until it was imminent. In 1996, the government adopted a reform agenda called Pathway to Recovery. The objectives of the reform targeted restructuring the economy as a whole, with expectations of transformation to private sector-led growth, as well as correction of fiscal and external deficits. This was a high expectation, given the scale of the reforms and resource constraints. Restructuring included reducing the size of the public sector by more than half.

Tonga acquired its independence in 1970, and is the only remaining monarchy in the Pacific. Diagnostic work identified concerns over the stagnant economy and a deteriorating fiscal and foreign exchange reserve position in the early 2000s, and the need to improve the efficiency of the public sector and SOEs, but the government did not see the need for major reforms. Features of the subsequent reform program included revenue-raising measures such as value-added tax, and achieving sustainable fiscal balances, strengthened public expenditure management, and improvements in public sector efficiency and resource use.

Samoa began its process of economic reform in the late 1980s and was revitalized in 1996 (following recovery from the 1990–1991 cyclones) through the Statement of Economic Strategy, later renamed the Strategy for the Development of Samoa. The performance of the economy was buoyant in 1995–1997, with medium-term growth coming from reforms that were expected to increase private activity through rationalizing the public sector; privatizing SOEs; and improving the economic, financial, and social infrastructure. This reform agenda was expected to result in enhanced private sector capital formation and foreign direct investment. ADB's prior involvement in the finance sector provided the institutional experience and a sound basis for supporting the reforms.

The key objectives, scope, and duration of each loan are provided in the Annex.

Source: Asian Development Bank. 2009. *Special Evaluation Study: ADB Support for Public Sector Reforms in the Pacific: Enhance Results through Ownership, Capacity and Continuity*. July. Manila.

Pacific DMCs were highly constrained by their small land-resource base and economic size, remoteness, and dispersed populations, giving rise to diseconomies of scale, adding to the high costs of accessing markets. Pacific DMCs had limited access to finance and traditional land-rights systems—a frequent disincentive to investors.

These shortcomings often provided the rationale for government intervention in private-goods provision which, in many cases, created inefficient public enterprises that crowded out private initiatives and further limited the development of already

limited markets. Economic structures were dominated by the public sector, and the private sector was largely limited to services and primary production with little value added. Large trade deficits were the rule.

Diseconomies of scale from the narrow production base, small domestic markets, and limited access to resources and export markets were the key constraints to private sector opportunities and growth. Contributions to growth from agriculture and industry were low, although subsistence activities continued to play a role in most countries. Value addition from primary commodities (such as fish and other agricultural commodities) tended to be low, while tourism could be a good revenue source but was a localized employment generator (as in the Cook Islands, Samoa, and Vanuatu).

At the same time, public goods investments and delivery were costly to provide, with mixed efficiency and relatively limited outreach and provision to rural and outer islands. Government investment in social infrastructure was low, with most revenues spent on government operations, especially salaries and wages. Income tax revenues were generally insufficient to finance investment in social infrastructure and improve public services because of the thin, formal income tax base. And as public sector wages exceeded those of equivalent private jobs, most of the scarce, skilled employees worked in the public sector.

Inexperienced and weak institutions, as well as political swings, constrained policy responses and service delivery. The result was often imbalanced and inefficient public expenditure allocations, with emphasis on recurrent versus capital expenditure. Cultural diversity in each country could also hold back modern institution strengthening.

Given the limited public finances and restricted access to local private financial capital and limited investment, Pacific DMCs often relied on other external sources, including development partners, to finance growth and development. But most of the Pacific countries supported by ADB in the 1990s and early 2000s did, in fact, recognize that they were facing severe and unsustainable fiscal situations, largely owing to oversized public services, underperforming state-owned enterprises (SOEs), heavy debt burdens, and weakly performing public services and private sectors. Yet, beyond that, many problems—and many solutions—were country specific.

## Policy Reform Processes

### Initiating Policy Reform

#### *Crisis and the Reform Agenda*

Individual reform programs and related policy-based loans varied in detail but generally they addressed three areas.

The first area addressed macro-level economic management, which was a relevant response to a current or imminent fiscal crisis or deteriorating budget, and sluggish economic growth. All countries, except Samoa, were faced with persistent budget deficits, some of which had reached crisis proportions (e.g., the Cook Islands). Most of the Pacific DMCs had a large public service that budgets could no longer accommodate, and most programs included downsizing of the public sector to lessen expenditure burdens. This was a priority problem of most of the countries in the evaluation, requiring immediate action to address or avert a deeper problem. The exception was Samoa where the policy problem was more related to monetary and finance sector policy.

The second broad area entailed measures to improve public sector productivity and quality. In part, this was related to the worsening fiscal situation, but even prior to the reform programs, the provision of most public services in the study DMCs were deemed inefficient by, for example, ADB, and improving public service efficiency and delivery of services as part of government rightsizing was widely seen by DMC leaders in particular as a relevant agenda item.

The third area was to reduce the role of the public sector in the economy; the public sector traditionally dominated the economy, particularly in Micronesia and in small countries such as the Cook Islands.

### *ADB's Role in Setting the Policy Agenda*

Turning to the Cook Islands first, there had been concerns within the donor community since 1993 over the capacity of the government to finance the size of the public sector and public services. The Government of New Zealand, the Economic and Social Commission for Asia and the Pacific (ESCAP), and ADB had all provided assistance in analyzing underlying structural problems in the economy, weaknesses in financial and economic management, and the looming crisis, helping the government develop a reform program. In 1996, the Government of the Cook Islands adopted the “Pathway to Recovery” reform agenda, largely developed by consultants, in collaboration with the government. Further loans in other countries also tended to follow the Cook Islands approach.

The governments of the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM) requested ADB assistance for policy advisory teams. These teams helped develop detailed reform programs, in consultation with the governments. In the RMI, the ADB-financed team revised and augmented an existing government reform agenda (focused initially only on public sector downsizing), although these discussions proved to be insufficient, particularly between the executive branch and the Nitijela (National Parliament). The President of the RMI was the main reform champion and driving force behind the initial Public Sector Reform Program (PSRP) reforms and relied heavily on the team and a Rationalization Committee's recommendations.

In Samoa and Solomon Islands, reformist governments had developed reform agendas, and ADB worked with them in preparing each country's reform program loan for loan approval.

In all other countries, consultants were largely responsible for the analysis and development of reform agendas, often adding to existing reform agendas. Consultation with government and stakeholders varied widely. In Vanuatu, the government recognized the need for reforms due to imminent fiscal difficulties and the drop in foreign exchange reserves, and adopted the comprehensive reform program (CRP) developed by ADB.

ADB worked closely with the Ministry of Finance (MOF) in Tonga to develop the reform program but had less consultation with officials of other ministries and hardly engaged with the public at large. The program was driven by the MOF, with other agencies and the public informed during implementation. The narrowly focused consultation process had implications for reform implementation; while measures under the responsibility of the MOF were effectively implemented, other agencies showed less ownership and understanding of other measures.

In Samoa, the program was similarly driven by the MOF; the government's reform agenda was broad ranging, but the ADB-supported loan was restricted to finance sector reforms (including SOEs).

In all of the reforms mentioned, a key factor in ADB's influence that affected reform relevance was appropriate in-depth analysis of the economy and looming crisis, which was shared with, at least, technocrats in oversight agencies. These analyses included gaining an understanding of government priorities, and involved varying degrees of consultation with officials, politicians, and the public: the extent of consultations in respective cases, and acceptance among affected stakeholders, later had a bearing on the extent of political and institutional feasibility and sustainability.

## Managing Complexity of Reform Issues

In response to external and internal imbalances, the intended effect of macroeconomic stabilization is usually to restore balance as a step toward rekindling economic growth. At the sector and microeconomic levels, low domestic and international market competitiveness—due to chronic inefficiencies in factor use and low productivity, falling export prices, or rising costs of imported raw materials—may require more specific structural reform action as a subset of first-round reforms.

Similarly for public services, improvements to allocative and expenditure efficiency, as well as to benefit incidence, often require far-reaching human and organizational change and capacity development. The sequence, timing, and optimal pace of specific macroeconomic and structural reforms and their interrelationship are important for both conceptual and practical reasons. To take an example: in the finance sector,

fiscal imbalance and control should be addressed as a prerequisite to attending to sector reforms (such as liberalization of the domestic financial system and removal of capital flow restrictions) to avoid the risk of inflation and debt overhang resulting in capital flight (Agenor and Montiel 1999).

### *Complexity of Policy Issues and Program Design*

The sequence of reform steps, albeit described above in line with the framework, was evident and largely accomplished in Samoa, mainly because the government had its own reform road map. For other countries facing fiscal constraints, the reform programs' focus on downsizing the public sector to reduce expenditure, on revenue-raising measures, and on tax administration improvements—designed with external advice—was also deemed appropriate given the urgency of the problems to be addressed.

But it is also apparent, now, that several program loans had a complex agenda that tried to accomplish too much at the same time. Reform programs were generally planned for implementation over 3 years, and while some measures could be accomplished in the short term, such as budget cuts to quickly reduce budget deficits, institution-related reforms necessarily needed a medium- to long-term perspective. The heavily loaded program loans also gave the impression of a one-size-fits-all ADB model for economic management and reform.

For example, the economic management model was appropriate in the case of the Cook Islands where it was essential to downsize the public sector, but during interviews carried out as part of ADB's Independent Evaluation Department's assessment of reforms in the Pacific (ADB 2009),<sup>52</sup> survey respondents considered that the scale was too broad and the pace too fast. The reform program, as a whole, was overly focused on financial recovery, which drove the downsizing program; it gave a lower priority to social and cultural responsibilities. The pressure for financial recovery also led to a lack of in-depth analysis of some measures.

On the positive side, the reform program focused on three reform pillars of legislation, and this was the key to success in that country. The legislation institutionalized reform principles and gave the reform program lasting impact. But the analysis of the likely impact of downsizing on the outer islands was insufficient, and it became apparent that the downsizing should perhaps have been delayed to prevent migration to Rarotonga and abroad.

Improving the efficiency and effectiveness of the public service was a feature of reform programs in other countries too (Samoa excepted). However, service delivery

<sup>52</sup> As part of the special evaluation study of Pacific reforms by the Independent Evaluation Department, semi-structured interviews were conducted for a range of stakeholders, including present and former ministers, officials, politicians, nongovernment organizations, and business groups, by the evaluation team. "Respondents" refer to the generalized views of those interviewed.



improvement is a complex task and requires time and inputs tailored to each country. Almost all programs set targets for downsizing, but in cases of reductions there were insufficient agency-specific analysis and consensus as to which core activities government should engage in and thus which activities could be reduced without affecting service delivery, and consequently what the right size of the public service should be.

In Vanuatu, for example, program targets were set at a 10%–15% reduction in public spending, but without the benefit of analysis as to which core activities government should remain engaged in and which activities could be reduced. Implementation experience revealed that identifying the government activities that can be reduced needed more careful assessment and planning, as some valued services were excessively reduced or eliminated. In addition, there was an apparent contradiction in reducing government expenditures and the number of public servants while expecting improved service delivery without marked improvements in the productivity of the remaining employees and institutions. Introducing a performance orientation into the public service requires attitudinal changes that take time to come about. Notwithstanding the pressures of the crisis situation, insufficient analysis and planning was made of how to implement such reforms.

Improving the regulatory environment for the private sector was also a feature of all reform programs and was appropriate given the need to encourage private sector growth. However, expectations of the private sector absorbing retrenched public servants, and the ability of former public servants to become entrepreneurs, turned out to be unrealistic. Privatization and reform of SOEs was likewise a common feature of the reform programs, but again respondents (in the Cook Islands, Tonga, Samoa, and Solomon Islands in particular) indicated that too much was expected too quickly, with too fixed an idea of what the solution should be. Respondents in the Cook Islands, Samoa, and Solomon Islands believed that pressure from the treasury to raise cash through sale of SOEs, together with pressure from ADB to remove these operations from the public sector, led to this rush.

Reform attempts also came up against influential members on the boards and management of SOEs. Greater flexibility was, therefore, needed in designing reforms to fit each SOE's circumstances. Tonga, where reform of SOEs was slow, later saw a more tailored approach to SOE reform.

In the FSM, the structure of government—with four state governments and one national government—added complexity to both the analysis and consultation process. Again, much of the reform agenda was prepared with the assistance of an ADB-financed policy advisory team, but economic summits (see next section) were held at the national and state levels in 1995 to discuss the need for reform which, with prereform analytical and consultative work by the team that year, helped raise wider public awareness on the issues. Specific components of the PSRP were customized to reflect the circumstances of each government (national and regional).

State governments (through internal deliberations) decided in their own different ways how to cut wage bills. Although this was a desirable approach, it would also have benefited from a systematic institutional analysis. However, two state legislatures had not officially endorsed their reform programs before the reforms began as consensus had not been reached. There was less consultation and public dialogue for the follow-on Private Sector Development Program, although the goal of growth in the private sector had been clearly and consistently articulated since the mid-1990s, and a private sector development strategy was prepared and presented at a second economic summit (in 1999). Thus, in the FSM, the follow-on Private Sector Development Program loan was a timely intervention following commitments made at that summit to accelerate private sector development. However, approval and implementation were delayed until the end of 2001 by the fast-tracking of another loan in 2000.

### *Program Design Process*

In addition to offering analytical support through technical assistance, ADB used large public meetings or summits to varying degrees to help build awareness of the need for reform and the reform agendas themselves. The approach and effectiveness of these meetings varied, but in the FSM, the wide and public consultation process is credited as being the major reason behind the initial success of the reform program. In Vanuatu, public consultations were held, but the views from these consultations were that insufficient time was given to wider stakeholder groups to consider the reforms, which also gave the impression of an ADB-driven model for reforms in the Pacific. However, the provision of large technical assistance projects covering 3 years, as in the FSM, was also a new and widely welcomed approach given the extent of assistance needed, as was the alternate approach in Samoa of providing a series of projects that provided technical support and capacity development over several years, which was regarded by the government as key to providing continuity in technical support and led to a more effective capacity development outcomes.

In terms of ADB's approach to support institutions involved with designing reforms, within each country the reform programs were developed and coordinated with the MOF, the focal point of contact for ADB. These ministries generally had sufficient capacity and understanding to carry out the fiscal reforms. Understanding and capacity outside the key ministries such as finance, however, varied. Line agencies in Tonga and Samoa noted that the reform agenda and implementation were too focused on, and driven by, the MOF, with other agencies inadequately involved in concept and design. Overall, short-term public sector downsizing measures in Vanuatu were relatively straightforward to carry out and, according to the surveyed respondents, were sufficiently well understood by stakeholders, despite reservations among particular groups.

Longer-term fiscal adjustment measures were more complex and challenging to manage within the program loan time frame, but where the MOF was leading the

reform (as in the Cook Islands, Samoa, and Tonga), these measures were understood and pursued, the MOF having the capacity to implement them, although as was found later, the same understanding was not necessarily shared among line agencies.

### *Balancing Gainers and Losers in the Reform Design*

The near-term adverse social and economic effects of reform measures were generally acknowledged by both reformers and vested interests. But, addressing current or looming crises with the need to secure stabilization of government finances—as in the Cook Islands, the RMI, the FSM, and Vanuatu—there was little, if any, option but to move ahead with reforms. The nature of reforms involved public spending cuts and changes in the control of public and private assets, such as highly political public sector workforce reductions, SOE reform, and a shift to more open trade and investment regimes.

All program loans attempted to identify gains and losses. For example, in the RMI, the anticipated short-term gains from the PSRP were relatively clear: stabilization of government finances through reductions in expenditure and increased revenues; a smooth fiscal adjustment to the dramatic second Compact step-down and other fiscal pressures; and better positioning for the renegotiation of Compact economic assistance beginning in 2001. It was clear that with these gains would come some pain in the form of adverse socioeconomic impacts. Almost all the reform programs included downsizing the public sector, which had immediate social impacts, although mitigation measures, such as lump-sum payments, were included.

In the cases of the FSM and the RMI, the reform programs, as explained in program loan documents, also assumed that the private sector would be able to absorb some of the retrenched public servants. Nevertheless, because the scale and scope of reforms made under the PSRP were significant (especially the reduction-in-force component to cut the wage bill), it was recognized that the near-term social and some economic impacts would be swift and heavy. Coalition governments were aware of this and governments with slender majorities had to be cautious, needing to keep coalition partners on side, and softening reform impacts to keep the public on side.

Most governments—in particular oversight agencies—accepted that to achieve the short-term gains of attaining fiscal balance and longer-term fiscal sustainability, there would be hardships, particularly for those retrenched from the public service. They generally recognized that these costs had to be borne if the economies were to at least achieve macroeconomic stability and to establish a basis for growth. To mitigate the negative socioeconomic impacts and, in some cases, to create fiscal space for improved public spending, program loan funds were provided. For example, a program loan provided funds to help repay short-term debts to domestic creditors (the Cook Islands), and to help pay for the social costs of the reform programs, such as retrenchment of some public servants.

Thus, governments recognized the policy-based loan as an appropriate reform-financing modality. Program loan tranching provided incentives for continued reform progress through the promise of additional funds, while for ADB it enabled continued policy engagement. MOF officials also felt that the loan sizes were sufficient to effect identified reform measures, but indicated that more support, and funding, was needed for technical assistance support in implementing reform programs, especially given the new experience of reform events and their consequence. [Table 3.1](#) summarizes the size and specific use of loan financing.

Stakeholders, particularly line agencies, showed less understanding and buy-in of public service reforms targeted at improving efficiency and effectiveness, especially of measures to introduce performance-oriented contracts for agency department heads, and performance assessments of staff. Effective implementation of this required the public service commission (PSC) in each country to be the key agency for reforms. However, in most countries, the PSC had inadequate capacity to do this. Development and application of administrative rules and procedures (e.g., codes of conduct) were inadequate, with insufficient attention in particular paid to developing understanding in line agencies. Some political interference in appointments continued.

On another level, in some countries (e.g., Solomon Islands, the RMI, and the FSM), restructuring plans designed to reduce the number of ministries—amalgamating and eliminating functions to improved efficiency—were impeded by political requirements relating to the number of ministers needed for the government to remain in power. The postevaluation of the RMI public sector reform program concluded that the most significant weakness in the program was the failure to get widespread community participation or support, and that the need for reform was seen as being imposed from outside, with ADB responsible for the resultant hardships. Stakeholders recognized obtaining wider community understanding and support for reform as a major constraint, especially where governments relied on coalition partners to remain in power. It raises the question as to how reform programs can be aligned with the political cycle in democratic governments (see also Chapter 5).

Although program loans covered key adjustment costs of reforms and support for pro-reform governments and champions, they did not always overcome the political inertia against reform. Governments at the time of reforms in Solomon Islands were indeed reformist, but a change precipitated by other events led to a new administration that did not support them. In the FSM, some politicians (who initially supported reforms) lost their seats in the next election and were replaced by less reform-minded leaders. In the Cook Islands, the coalition governments formed from 1999 have not demonstrated the same commitment to reform as they did earlier. Thus, political value of such adjustment payments can be short-lived if the intended effects of reforms do not materialize as expected. The Cook Islands also saw little consultation on the pace of reform, or of alternatives. The government, opposition, and the private sector had indicated favoring the reform agenda, especially with the introduction of the Ministry of Finance and Economic

**Table 3.1**  
**Estimated Reform Costs in Pacific DMC Program Loans**

Loan	Objectives	Key Reform Measures	Loan Amount Justification
COO: Economic Restructuring Program (\$5 million)	<ul style="list-style-type: none"> <li>Public sector reform</li> <li>Promote private sector growth</li> <li>Social equity and sustainability</li> </ul>	<ul style="list-style-type: none"> <li>Retirement of a part of government's short-term liabilities to domestic private sector creditors</li> <li>Establishment of Business Ventures Development Corporation under Cook Islands Development Bank (CIDB)</li> <li>Equity injection in CIDB</li> <li>Given the outstanding government arrears and other external debt totaling NZ\$200 million, the loan size of NZ\$7.2 million would not have bridged the gap (Knapman and Saldanha, 1999, p. 34)</li> </ul>	<ul style="list-style-type: none"> <li>The loan size was based on "the significance of the policy changes and economic restructuring being pursued and the historical levels of Bank lending to the Cook Islands" (RRP, para. 75)</li> </ul>
RMI: Public Sector Reform Program (\$12 million)	<ul style="list-style-type: none"> <li>Stabilize government finances in the short run</li> <li>Ensure long-term structural stability of government finances</li> <li>Create an improved environment for the private sector</li> </ul>	<ul style="list-style-type: none"> <li>Retirement-in-force (RIF) program (\$5.5 million)</li> <li>Pay off Air Marshall Islands' commercial debt (\$4 million)</li> <li>Seed injection to Financial Reserves Trust Fund (\$2.5 million) (Knapman and Saldanha, 1999, pp. 89–90)</li> </ul>	<ul style="list-style-type: none"> <li>Based on salaries paid in the civil service and average length of service, and expected number of retrenchments (RRP, para. 69)</li> <li>Two-thirds of Air Marshall Islands' outstanding commercial debt</li> </ul>
FSM: Public Sector Reform Program (\$18 million)	<ul style="list-style-type: none"> <li>Reduce size and operating costs of civil service</li> <li>Increase domestic revenue generation</li> <li>Restructure government operations and public enterprises</li> <li>Mitigate social and economic impact</li> <li>Foster development of private sector</li> </ul>	<ul style="list-style-type: none"> <li>Direct costs of early retirement schemes for the national and four state governments (\$3 million for the national; \$5.3 million for Chuuk, \$4.2 million for Pohnpei, \$3.5 million for Yap, \$2 million for Kosrae)</li> </ul>	<ul style="list-style-type: none"> <li>No detailed documentation in the RRP, but the EMPAT team (ADTA consultants) did the detailed estimation and also developed monitoring schemes for the retirement program</li> </ul>

*continued on next page*

Table 3.1

(continued)

Loan	Objectives	Key Reform Measures	Loan Amount Justification
SAM: Financial Sector Program (\$7.5 million)	<ul style="list-style-type: none"> <li>• Deepen financial markets</li> <li>• Strengthen Central Bank of Samoa (CBS) and enhance its operational autonomy</li> <li>• Strengthen prudential and regulatory framework</li> <li>• Strengthen the National Provident Fund and Development Bank of Samoa</li> <li>• Privatize and corporatize public enterprises and utilities</li> </ul>	<ul style="list-style-type: none"> <li>• Incremental budgetary cost of issuing CBS bills (\$1.9 million over a 3-year period)</li> <li>• Temporary compensation for the loss of revenue from elimination of the foreign exchange levies (\$1.3 million annually)</li> <li>• Temporary compensation for the loss of revenue from the planned corporatization of the Posts and Telecommunications Department (\$5.72 million annually)</li> </ul>	<ul style="list-style-type: none"> <li>• A loan of \$7.5 million is aimed at covering a major share of these costs to the government, with the remaining part coming from other sources, including revenue from privatization of state-owned enterprises (RRP, paras. 101–104)</li> <li>• Short- to medium-term costs of the reform program were estimated in fiscal and balance-of-payments terms</li> <li>• Incremental cost of issuing CBS bills was calculated as the total incremental interest rate costs associated with interest rate differential</li> </ul>
VAN: Comprehensive Reform Program (\$20 million)	<ul style="list-style-type: none"> <li>• Redefine the role of government, and enhance the quality and delivery of its policy, regulatory, and development services</li> <li>• Increase the productivity and growth of the private sector in both urban and rural areas</li> <li>• Support social development of the disadvantaged and rural population</li> </ul>	<ul style="list-style-type: none"> <li>• Restructure and right-size the public sector</li> <li>• Restructure and rehabilitate government-owned financial institutions</li> <li>• Fiscal stabilization (reduce the need for an inflationary domestic financing of budget deficit)</li> <li>• The loan amount (\$20 million) was to cover 35%, 40%, and 25% of the above three adjustment costs (Knapman and Saldanha, 1999, p. 152)</li> </ul>	<ul style="list-style-type: none"> <li>• Fiscal outlook covering 1997–2000 and government funding plan 1998–2000 formed the basis of external financing need for the reform program (RRP, paras. 73–83)</li> </ul>

ADTA = Advisory Technical Assistance, COO = Cook Islands, DMC = developing member country, EMPAT = Economic Management and Policy Advisory Team, FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands, RRP = Report and Recommendation of the President, SAM = Samoa, VAN = Vanuatu.

Source: Bolt, R. et al. 2003. *Economic Analysis of Policy-Based Operations: Key Dimensions*. Manila: ADB.

Management Act, the Public Expenditure Review Committee and Audit Act, and the Public Service Act, but later coalition governments (not foreseen at the time of the crisis) have not viewed continued reform as a priority on their agendas. The need for deepening reforms also lessened as the economy grew, following the initial reforms.

The need to clarify donor coordination and relative roles became key as reforms progressed. In Micronesia, for example, payments to retrenched public servants as a result of the downsizing program could not be funded under provisions of the Compact, even though the Compact reductions led to the need to reduce the size of the civil service. ADB policy-based loan funding thus became key to financing civil service downsizing as part of reforms. To address the need for enhanced donor coordination, ADB introduced donor and recipient government consultative group meetings. The first such meeting for the Pacific was held in Manila in December 1995 to discuss the first reform program loans in the RMI and the FSM, help donor partners understand the need for reforms and identify funding support from respective donors. Consultative group meetings were subsequently held for the Cook Islands in June 1996, at which the government presented its reform agenda, and, in June 1997, to gain funding support. A meeting was also convened for Vanuatu in June 1997. A further complication and need for coordination arose when new donors (such as Taipei, China in the RMI and Papua New Guinea) entered the scene with aid packages that apparently attached no conditions. This additional assistance helped ministries of finance to balance or boost their budgets, but also served to undermine reform efforts by reducing the need and pressure for reforms requiring budget discipline.

### *Post-Program Views on the Design Process*

At the time of preparation, most program designs facilitated needed reforms, but key stakeholders considered that the preparatory work was too focused on macroeconomic aspects and that the micro issues of private sector and public service improvements needed further preparatory work to secure the necessary local understanding and buy-in to enable implementation. For example, redundancy exercises were driven by the need to reduce the burden on budgets of relatively large civil services, but were also generally unconnected to the needed reforms and parallel strengthening of key public service agencies such as public service commissions and line agencies. It is now recognized that even lower subsequent institutional performance risked undermining otherwise successful, short-run macroeconomic reforms.

In addition, the reform program designs generally paid insufficient attention to their social and wider impact. For example, reducing the size of the public sector had impacted on the market for the private sector in most of the countries, as private sector activity often catered to the needs of both government and individual public servants. Smaller government and fewer civil servants reduced the demand for private sector goods and services.

In all eight countries, ADB helped develop the reform agenda, providing consultant advice through technical assistance. Governments' own efforts—advised by consultants—also helped build on an existing reform agendas as well as ownership and commitment by reformers. As noted in ADB (2009), most Pacific DMCs recognized and owned the need for reforms, notably in the Cook Islands, Samoa, and Vanuatu, and initially in Solomon Islands before the change in government. Commitment and ownership of the reform design continue to be key factors in the success and sustainability of the reform agendas and actions. But, as implementation realities emerged, significant challenges to political commitment and ownership arose.

## Endorsing Reforms: Commitment or Complying with Conditions?

Conditions in the program loans supported in the Pacific constituted the primary means of ensuring that reforms in government policies have a good chance of being undertaken. Conditions were the outcome of consultations—some extensive, some less so—that resulted in the setting out of a package of measures to achieve the chosen objectives of the program. Government-agreed and -approved conditions could be seen by the borrowing government and ADB as an endorsement of reforms. Conditions also have an administrative function for loan implementation, including preconditions or actions for loan release compliance that trigger access to the next credit tranche. Used carefully, conditions could also help reformers follow a sequence of changes, ensure consistency over time, and strengthen the hand of reform champions over vested interests within national governments. Against this, excessive use of fixed versus flexible conditions, or target triggers for loan funds release which are now used, and a rigid implementation time frame may not provide a realistic perspective for implementation, and do not necessarily gauge the success or failure of a policy change.

ADB's 1996 review of program lending found that many policy conditions included in program loans incurred implementation delays relative to the original schedule. Second-tranche releases were delayed, by an average of about 1 year, in two-thirds of cases where target dates had been set. The review's key recommendations were as follows: (i) each tranche release should be based on a certain number of specific, time-bound, and objectively monitorable conditions; (ii) covenanted conditions should relate to essential policy objectives only; and (iii) distribution of conditions among program loan tranches, including front-loading of key reform measures should be balanced. In the Pacific program loans, tranches were generally front-loaded, but a key feature was the large number of conditions: given that ADB-wide program loans since 1987 had, on average, 38 conditions, their proliferation was particularly excessive in the Pacific (with the Cook Islands' reform program having ADB's largest number of conditions in a program loan).



The conditions in policy reform packages focused on strategic issues (such as the preparation of plans) to fiscal management issues (such as budget realignment, cuts, and new taxes) to changes in the formal rules of sector operation (such as changes in laws and regulations) that can fundamentally change the way of doing business, whether inside government or the private sector. As experienced elsewhere in ADB program lending, second and third tranches tended to experience delays, in part because of realizations of the implications of reforms that causes hesitancy or because of the complexity of the steps needed to fulfill a requirement, such as passing legislation. The deeper the change in the rules and incentives, the longer the time needed to meet the condition, let alone realization of a behavioral response. Further, the second- and third-tranche conditions met greater delays, waivers, or cancellations. This suggests that the second and subsequent tranche requirements, which are predetermined in multiple-tranche program loan designs, needed to better consider the realities of reform implementation.

## Implementing Reforms

### *Operational Complexities Emerge*

Immediate fiscal stress required quick-acting fiscal reforms to reduce or reverse budget deficits. Short-term fiscal targets, as given in the program loans, were generally achieved, and by downsizing government improved the budget situation. Approaches included both revenue-raising measures and expenditure cuts.

Measures to increase domestic revenue generation were generally implemented expeditiously, with regulations being developed and passed relatively easily, and in fact have been the more resilient part of the reforms in most countries, helping increase fiscal sustainability. In the FSM, for example, the valuation basis for import duties was changed from free on board (FOB) to cost, insurance, and freight (CIF), pushing up receipts by 69%. However, budget deficits reemerged in the FSM, and in the RMI, the current surplus is unstable, and both countries remain grant dependent. In contrast, the Cook Islands, Samoa, Tonga, and Vanuatu have made substantial improvements, and maintained surpluses (in contrast to Micronesia, taxes are the main source of revenue in these countries, as well as in Papua New Guinea). Nevertheless, a wide difference between Micronesia and the rest of the Pacific is the continued dependence on grants as the main source of government revenue. Longer-term fiscal sustainability is not so assured.

Delays emerged in reforms that addressed more complicated laws relating to foreign investment, taxation, and privatization, all of which took much longer to be passed than expected (and in any case were reversed). Geographic spread and multiple subnational legislatures (e.g., the FSM) also caused further delays in coordinating and realizing compliance, sometimes because of different local government views on reform measures. In the case of the RMI, delays were caused by tardiness in preparing the detailed steps and legislation needed for consideration by Parliament, as well as exogenous developments, such as droughts, that resulted in a declaration of emergency, as well as issues with debt repayments on bond issuance in the United States.

In Samoa, the approval of reform measures leading to condition compliance was slow, but well managed. The main delay in Samoa, as elsewhere, was in meeting tranche-condition compliance on SOE privatization due to greater-than-expected resistance from SOE employees. In part, this stemmed from the government's and SOEs' lack of access to continuing technical advice on how to prepare SOEs for privatization options (e.g., corporatization, sale, or liquidation). In all cases, conditions that required organizational change involved often-painful remedies, the principle of which took time to be accepted, in particular downsizing. In addition, legislative changes and regulation promulgation involved extensive interagency coordination and legal expertise that had to be sourced and often complex drafts explained (in cases, if at all) to legislatures. In general, protracted legal procedures outside the control of governments slowed a number of policy changes—and thus condition compliance, especially those involving the private sector.

Fiscal management measures also involved public service downsizing, mainly to help reduce expenditure, and were also generally met in the short term in the Cook Islands, the RMI, the FSM, and Vanuatu. However, in all cases, targets were not based on strategic plans for a future public service focused on core activities and, while the targets were met within 1 or 2 years, employment and wage bills have generally crept back up, in cases exceeding previous levels (the RMI and Vanuatu). In the case of the RMI, for example, some 400 positions were shed as part of the reform program, reducing the wage bill by about \$1 million a year. But over the period 2000–2008, the public service increased by nearly 1,000 employees, with an increased wage bill of \$13.5 million. Some of this reexpansion was justified as necessary given that some essential services and positions were eliminated, but much of the rehiring was not clearly justified.

In addition, the Government of the RMI unraveled a number of organizational reforms, reestablishing some enterprises that had been handed over to the private sector. “RMI government budget largely depends on foreign assistance and, despite annual decrements in compact funding to support budgetary expenditures, is characterized by a growing wage bill” (US Government Accountability Office 2007). The public sector wage bill, as a share of GDP in Tonga, was one of the highest in the region. The 2005 civil service strike pressured the government to agree on a substantial civil service wage increase of 60%–80% to be paid in two tranches—fiscal year (FY)2005/06 and FY2006/07. Despite a major voluntary redundancy program in April–June 2006 reducing personnel by 18%, the total cost of the wage settlement, including one-off payments (severance packages), accounted for about 9% of GDP (IMF 2008).

### *Nominal Reform versus Implanting Change*

Strengthening public expenditure management was a component of most of the reform programs in each country, with several governments introducing some form of performance or output budgeting. While macro-level and function

expenditure, in particular wage bills, were addressed, at least in the short term, budget realignment and reallocations needed for service delivery through line agencies was not significantly addressed. Furthermore, it is now apparent that a voluntary retrenchment approach can undermine a reform agenda for public service improvement, as was demonstrated in Pohnpei State and the national government in the FSM and in Tonga where many skilled and experienced public servants left the service, reducing its effectiveness.

The Cook Islands, Samoa, and Tonga have introduced a form of output or performance budgeting. But few efforts have met expectations. There were different perspectives among countries and stakeholders as to what performance budgeting actually is, and few governments were aware at the time of what was involved in setting up a performance-based budget system—the “how to.” In the Cook Islands, output budgeting was introduced, following the New Zealand reform model. While somewhat rudimentary and variable in quality across ministries, it has been introduced and is the basis for moves to develop a 3-year medium-term budget framework. In Tonga, a form of output budgeting has replaced line budgeting; however, while requisite skills exist within the Ministry of Finance (MOF), capacity in line agencies is much weaker, inhibiting the devolution of output or performance budgeting to them. Thus, the first steps in improving allocative and expenditure efficiency were attempted. It is now recognized that to analyze, plan, and budget for budget realignments require time and skills, and significant sector policy and service-specific improvements.

The introduction of regulatory and legislative changes associated with the PBL needed to improve government efficiency, and the functions of product and factor markets, including privatization efforts, were generally accomplished. However, while the legislation could be drafted and enacted in a relatively short time, its effectiveness was dependent on institutional capacity to implement, and ultimately the behavioral response by markets, people, and interest groups.

In the Cook Islands, for example, three key laws—the Ministry of Finance and Economic Management Act, the Public Expenditure Review Committee and Audit Act, and the Public Service Act—which became the pillars of the reform program were passed. The first two acts were effective given the strengths of the agencies concerned, but the Public Service Act has had lesser impact due to the weaknesses in the PSC and unwillingness to effectively implement a performance-based public service assessment system. Political interference in appointments can be a weakness, undermining the authority of the PSC. The same weakness was apparent in Papua New Guinea, but in Tonga, strong measures were subsequently taken to remove such interference and strengthen the PSC. These cases illustrate the fact that it takes time to introduce a performance-oriented public service.

Except the loan to the Cook Islands, 11 reform program loans were approved between 1997 and 2007 to help address and avoid an imminent crisis and as such were timely

in that the reform agenda was finalized and approved prior to any crisis actually eventuating. In the Cook Islands, an earlier response might have helped lessen the depth of the crisis facing government. Nevertheless, technical assistance provided in the year prior to loan approval did help the country in developing reform measures to address the crisis. In all cases except Samoa, however, officials and others reported that the reform time line was too tight given the complexity of reforms. In particular, it did not allow sufficient time for effective consultation during detailed design at implementation stage. As in other cases, there was insufficient time to analyze core areas which government should remain active in, and to develop strategic plans for the future operations of the public service.

The FSM Private Sector Development Program faced a different situation: too much time for deliberation. This program was designed to follow on from the PSRP, reinforcing the reforms while providing greater focus on private sector development. However, the 3-year delay in approval and implementation meant that much of the reform momentum was lost. On eventual commencement, it met resistance and interruptions on issues such as land and foreign investment reforms. Some respondents suggested that it might have been better to have taken a two-stage approach in sequencing, where fiscal crisis was not so pressing, and getting key fiscal concerns sorted out first before moving on to large-scale downsizing and reorganization of the public service. In fact, this happened in Tonga, where public service reforms were delayed until after the main revenue-raising measures had been introduced and budget surpluses achieved.

### *Institutional Capacity Development*

An institutional constraint in Pacific DMCs is their limited capacity in economic, financial, and development planning, although the Polynesian countries fare better than those in Melanesia and Micronesia. There was wide recognition across all of the countries that local capacity would have to be strengthened if the reform efforts were to be effectively carried out and sustained. Capacity development, therefore, formed a critical component of the reform programs and related technical assistance.

While some immediate individual-level capacity improvements were seen in most of the countries, structural capacity development efforts (targeting organizational and institutional levels) were limited, apart from the Cook Islands and Samoa. Stakeholders interviewed in the RMI, the FSM, and Vanuatu held the impression (in hindsight) that the reform programs and related technical assistance had generally limited impacts. Respondents in these three countries generally felt that neither personnel capacity nor that of oversight and line agencies had dramatically improved as a result of the reforms. Respondents in the Cook Islands, Samoa, and Tonga were generally more positive on the impacts of the capacity reforms.

All program loans had prior, parallel, and, in some cases, postprogram technical assistance provided to assist with policy analysis and implementation. Despite the

technical assistance, a shortage of local expertise remains in high-quality economic policy advice, creating problems for ADB and consultants in developing local understanding of the macroeconomic reforms proposed.

A general criticism was made over the lack of attention given to capacity building. Ministers in the RMI felt that they had enough reports analyzing problems and that more were not needed, but that more “how to” assistance was required. In some cases, this was due to the lack of counterparts for the consultants to work with, but a focus of consultant inputs was on analyzing, resolving issues, and building awareness rather than on capacity building. In the Cook Islands, the severity of the crisis led to consultants initially working in fire-fighting mode, with no time for longer-term strategic planning or capacity building, although this was in their terms of reference. Indeed, team problems developed because of the conflict between providing specific policy advice and longer-term capacity development needs. In Solomon Islands, respondents noted that assistance was initially late in being provided, but then too much was provided, overwhelming the administration.

By comparison, in the Cook Islands and Samoa, ADB-funded policy advice and capacity building through a series of separate technical assistance projects, spread over 4–5 years. In the Cook Islands, they were provided policy advice prior to the loan approval, while two were attached to the loan. However, much of this support took on a fire-fighting role rather than focusing on original targets of improving policy and planning, and capacity building. The use of both external consultants and local skilled people to facilitate some of the change processes was critical in managing and communicating the reform change process but fell short in building lasting capacity. Nevertheless, in the Cook Islands, legislative reforms did have positive impacts on raising overall structural capacity (discussed earlier). Together, the passage of these three laws institutionalized reform principles and gave the reforms more lasting impact.

In Samoa, advisory and capacity development technical support was attached to the loan to strengthen the Central Bank of Samoa, the National Provident Fund, and the Development Bank of Samoa. Four further technical assistance projects were given over 4 years to provide policy advice and to help strengthen the MOF. The technical support projects were presented as phases of a comprehensive program to strengthen the macroeconomic analysis, planning, and policy formulation capacity of the Treasury Department. A difference in Samoa with other countries was that the MOF always had a sufficient cadre of counterparts for consultants to work with and train. Furthermore, when ADB technical support projects were completed, there was substantial complementary support from the Australian Agency for International Development (AusAID) and the European Union, and the MOF was clear on its own needs for capacity development which, in turn, helped guide subsequent design of technical assistance.

### *Pro-reform Advocates and Leadership*

A feature of the reforms outside ADB influence that affected the ownership and commitment to reforms, and hence the manageability and ultimately the effectiveness of the process, was the presence of a strong pro-reform advocate or leader—“champion.” In the Cook Islands, the Prime Minister championed reforms, and led the program through its implementation period, helping ensure reforms were persevered with. He took responsibility for the crisis, assumed leadership of the reform effort, and constantly encouraged implementation. When he lost the premiership in 1999, the commitment to reform waned under the subsequent series of coalition governments.

In the RMI, the President was the champion of reform, but died before implementation, and commitment subsequently weakened. In the FSM, where the reform program covered the four state governments and the national government, progress was good at the national level and in Yap State, where leadership was committed to reform, but not elsewhere where there was no real champion. In Tonga, the Minister of Finance led the reform effort, which initially focused on revenue generation and expenditure controls; progress on public sector and public enterprise reforms only really got under way due to changing social circumstances (civil disturbances, public service strike) demanding political change, which led to pressures for wider reforms. The impetus increased from 2006 with the appointment of a new Prime Minister, who then took a lead role in this process. However, the public sector reform process has now become intertwined with the political reform agenda, the latter providing a sense of urgency for progress before the 2010 elections.

In Solomon Islands, the Prime Minister also led the reform effort, but not all his colleagues shared the understanding of the need for reform, and the change in government following civil unrest (not related to the reform program) led to the reform program and loan being canceled. In Samoa, the government itself was a reformist government, and while the Prime Minister and Minister of Finance in a way were champions of reform, there was a broader acceptance in government as a whole of the need for reforms to continue and embrace different aspects of the economy. Thus, broad-based support is a more effective way of maintaining commitment than reliance on an individual advocate or champion.

## **Sustaining Reforms**

### *Macroeconomic Outcomes and Sustainability*

Most reform programs supported by ADB focused on the immediate need to stabilize finances at the macroeconomic level and often achieved the key short-term reform outcomes, but the reforms’ sustainability over the medium and longer term was more mixed.

Budget deficits continued in the FSM and the RMI, but the Cook Islands, Tonga, Samoa, and Vanuatu saw improvements, with budget surpluses maintained. Revenue increased, and while the RMI and the FSM remain grant dependent, tax income is the main source of revenue in Polynesia and Melanesia. Savings–investment gaps are unchanged, trade deficits persist in Micronesia and Polynesia, but external debt has fallen in all countries. Transfers by remittances have become important in Samoa and Tonga. Government expenditure, as a proportion of GDP, has seen a small decline in most countries, although government wage bills—after initial reductions—have, in cases, risen again.

In Micronesia, the reform program loans helped the governments to undertake (and finance) major reform and fiscal adjustment processes that allowed the countries to avert what would have been a more serious fiscal crisis. A component was the establishment of trust funds for the FSM and the RMI, which ensured that a proportion of Compact funds were paid for future drawdown to finance government operations. The sustainability of the reforms has, however, been put into doubt by the reemergence of fiscal deficits and reversals in the size of the public sector. These reform programs were less than transformational, particularly in terms of sustained economic growth and development, improved public sector financial management and overall productivity, and private sector growth. Improvements to the overall fiscal balance were made, but these proved to be short-lived. The objectives of reducing the size and costs of the public service were achieved, but subsequently reductions were reversed, particularly in the RMI.

The programs in Polynesia were better sustained at the macroeconomic level than elsewhere. For example, in the Cook Islands, the reform program—particularly the downsizing of the public service and sale of government assets to the private sector—enabled the government to pull back from bankruptcy and move on to a renewed growth path. Cash liquidity was restored within 9 months. In Samoa, the program, which addressed aspects of monetary policy to effect finance sector reforms, including the introduction of market-based interest rates and other liberalization measures, has increased availability of finance for business. Samoa is also making progress in reforming and privatizing SOEs.

In Tonga, progress in fiscal reforms was sound, but little happened on public sector reforms until the public service strike in 2005 and the reforms in 2006. Civil strife in 2006 created a greater urgency for reform. Vanuatu's economy has been growing (though not in the rural areas), and the government remains committed to a reform path, but fiscal structural reform has been minimal.

### *Institutional Impact and Sustainability*

While programs supported reforms to improve public sector efficiency and enhance the environment for private sector development, outcomes were generally modest. Downsizing the public service was largely achieved, but subsequently reversed in



cases such as the RMI. Improved public sector efficiency and effectiveness were generally not achieved. Some legal and policy improvements were made to improve the enabling environment for private sector development, but effects have had a limited overall impact on private sector growth, although there were some sector-specific improvements.

Changes in the government disrupted reform progress in the RMI, the FSM, and Solomon Islands, and while seen as exogenous, in fact are endogenous in that ADB and the government could have involved opposition parties much more in policy dialogue and consultations, both during reform agenda preparation and implementation. A champion for a reform program is often a key factor in reform success—though reliance on a single champion can have a negative impact if that champion is replaced. The most dramatic example was in the RMI where President Amata Kabua passed away in 1996 before the reforms were fully implemented, which at the time had a detrimental impact on commitment to and implementation of reforms.

Efforts to introduce forms of performance budgeting in Polynesian countries had limited results, systems largely being partially implemented with links not established to planning and public expenditure management. Assessments of financial management were largely tracked through the Public Expenditure and Financial Accountability (PEFA) indicators in public financial management reports.<sup>53</sup> Although the ministries of finance in Polynesian countries were relatively sound, institutional capacity for policy making, planning, and service delivery, as a whole, remained weak.

In the Cook Islands, idle government assets were sold, and some started to generate immediate returns. The New Zealand reform model had a significant influence on reform program design in that country, reflected in the three key acts mentioned earlier. The leadership in the Cook Islands was replaced in 1999 by a coalition government, but many reforms had become imbedded in the government system and were not reversed. While the principles of accountability, transparency, efficiency, and effectiveness as the underlining core principles of the three acts have become accepted as core values within the Cook Islands government, public service employment has been rising, and performance measures introduced in the public service have not had the desired results.

Throughout the Pacific, during and after reform efforts (at the time of the Independent Evaluation Department's assessment), there was a shortage of local

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<sup>53</sup> The PEFA Program was founded in December 2001 as a multi-donor partnership between the World Bank, the European Commission, the United Kingdom's Department for International Development, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, and the International Monetary Fund. Public financial management reports available at the time of the evaluation for the Cook Islands, Samoa, Tonga, and Vanuatu noted that, generally, the budget preparation and economic planning processes were handled well, but there was room for improvement in timeliness and accuracy.



expertise in high-quality economic policy advice. While having some effect at the time, technical assistance was generally insufficient to significantly improve the situation.

Polynesia is better off than Melanesia and Micronesia. In Polynesia, capacity in economic management is greater, as is continued commitment to reform. Samoa remains committed to its reform agenda and probably has the greatest capacity in financial and economic management in the countries covered. In Tonga, the government is a demonstration of the major changes in society and in the democratic process, and is committed to reform. The MOF has capable staff, but there was limited capacity in line agencies for improved financial management and for the introduction of a performance-oriented public service. The PSC has been given greater authority, however, and the government is committed to improving public service delivery.

In Papua New Guinea, traditions, such as the *wontok* system of obligations and patronage, have constrained the anticipated adoption and acceptance of Western-oriented public sector behavior and standards, thus inhibiting progress in reforms (ADB 2008b).

In the FSM and the RMI, the impacts of efforts to strengthen public sector productivity and effectiveness were very limited. Poor education outcomes in the RMI are especially alarming despite expenditure increases. Public enterprise reforms have not been implemented as envisaged. Both countries committed large resources toward improving the environment for private sector development and shifting the economic balance toward the private sector, but without much success, as shown by the decline in performance in areas such as foreign direct investment in the FSM.

While some growth has occurred in the private sector since the reforms, the sector's contribution to economic output remains flat, and the public sector continues to dominate the economy. The amended Compact, with its new 20-year funding program (which is again front-loaded, but with more modest step-downs this time), continued confusion over the proper role of the state, and perhaps even reform fatigue may have contributed to this eroding of commitment to reforms. The continued shortage of skilled economic managers and advisors is another factor, and basic economic literacy among policy makers is also a likely cause. The reforms focused on reducing the size of the public sector and this was largely achieved in the short term, but as noted, there have been reversals, with increases again in the FSM and the RMI. The public sector remains dominant in Micronesia. Political patronage is a likely factor in the strong expansionist fiscal policies of some of the FSM states.

The reduction in the size of government may have lessened crowding-out effects in some economic sectors, but efforts to stimulate the private sector through specific institutions and incentive improvements yielded modest results overall. Polynesia generally has a better climate for investors with a few key success stories, but major

constraints—such as small markets, lack of resources, high electricity costs, and inadequate port services—remain.

In Samoa, the move to market-based interest rates and other financial liberalization measures helped the business sector, though the constraints mentioned earlier remain. In Vanuatu, the creation of the Vanuatu Investment Promotions Authority increased investor confidence. In the FSM, on the other hand, liberalization measures seem to be in reverse, with foreign investment apparently discouraged in Pohnpei State. Foreign direct investment remains relatively low in all countries. The structure of the economies has not changed significantly despite the reform programs, again suggesting that assumptions were not realistic.

At the time of the ADB evaluation, evidence was limited in any of the countries that there had been significant improvements in public service delivery, and modest change in the balance of economic activity between the public and private sectors, or growth in the private sector—apart from tourism in the Cook Islands, Samoa, and Vanuatu, which became their growth driver. Such changes take time and, while appropriate parts of a reform agenda, need to be looked at as medium to long term.

Key constraints remain. The evaluation concluded that program loans insufficiently examined or considered the institutional conditions that ultimately determine how macroeconomic policy improvements are channeled through to microeconomic agents. For example, policies that increase total government expenditure on services may not achieve much in terms of household improvements in accessing service, or improvements in interest rate policies may not lead to increased household and business investment unless other constraints are removed.

Poverty impact assessments of the reform programs were carried out as part of program preparation and were a concern. However, priority was accorded to fiscal problems as they were the immediate issue, and as micro and social concerns could be better addressed later once the government was in a viable financial position. Nevertheless, it is evident now that reform programs needed to take full account of the social impact as well as structures and systems that may influence the actions of politicians and public service staff. In the Cook Islands, for example, the costs to households and communities of reform were much bigger than anticipated as reflected in the population's flight overseas—the public service was cut by more than half, and while some retrenched public servants were anticipated to go overseas, the massive migration experienced was not expected, with whole families departing, not just working-age people. Many outer islands have lost half their population, raising doubts on their viability as self-sustaining communities.

Indeed, a major regional influence on the reform programs is the degree of mobility of the population and labor, with countries, such as the Cook Islands, having free access to move to New Zealand (and on to Australia), while the FSM and the RMI having free access to Guam and the United States. This is not formally the case in

Tonga and Samoa, although many people have moved to Australia and New Zealand. For Papua New Guinea, Solomon Islands, and Vanuatu, new migrant labor laws allow temporary seasonal employment in Australia and New Zealand under a quota system. For the reform programs in the Cook Islands and Micronesia, this was initially seen as a safety valve, but the scale of migration from the Cook Islands, and particularly the outer islands, was far greater than expected.

An unanticipated outcome of the reform process was the monopolistic behavior of now-private firms. Some monopolies were created in disposing of government assets—again, partly a reflection of small market size. Nevertheless, regulatory concerns were often overlooked, which is important where a private monopoly is created and market size prohibits more than one company (such as power or water utilities in small populations). In the FSM, two pro-reform governors lost elections during the implementation of the PSRP. Data also show that migration increased, rather than redundant workers being absorbed by the private sector. Civil disturbances in Solomon Islands led to the fall of the reformist government and the end of the reform program (the program loan was canceled).

## Influences on the Commitment to Reform: Improving the Odds

At the time of the Independent Evaluation Department's assessment, the status of commitment to reform can be summarized by country as follows:

- Cook Islands—commitment to fiscal reforms remained strong, although some uncertainty arose under subsequent coalition governments; commitment to institutional reforms in the MOF stayed strong, but under weak support from the PSC, public service reform was stagnant.
- RMI—after a strong start, commitment to fiscal and public service reforms wavered, then progressed, then reversed again over the span of a decade, but with a generally more open policy for private sector development. With the return of fiscal pressures, a revival of reform efforts began again shortly after the evaluation was completed.
- FSM—the country continued to be committed to fiscal reforms, despite individual state wavering, while lower indications of commitment to public service reform and private sector development implied uncertainty over further progress.
- Papua New Guinea—frequent political changes, weak institutions, and pervasiveness of the *wontok* system presented significant risk and uncertainty for furthering reforms.
- Samoa—commitment to finance sector and other reforms was unwavering with a substantially strengthened MOF and central bank, but less progress was seen in line agencies where there was more uncertainty over furthering reforms.

- Solomon Islands—strong initial commitment but weak institutions, the change in government, and reversal of reforms followed by civil strife further weakened institutions, making for a risky and uncertain reform environment. After the need for external assistance to stabilize the country, the environment was more conducive to reestablishing public sector services.
- Tonga—commitment to fiscal reform remained strong and had widened to a broader reform program following civil unrest. Later moves to change democratic processes facilitated wider acceptance of the need for public sector reforms, including reform of SOEs.
- Vanuatu—government commitment to fiscal reform remained, and public and private sector reforms stayed strong, but weak line agency institutions and noninclusive growth raised risks of political interference and uncertainty.

The status of these reforms reflected a range of results, from steady progress in Samoa, to belated but sound progress in Tonga, to pronounced wavering in the RMI. Both the sound progress and fluctuations for this complex set of reforms in each Pacific country reflected the importance of ownership, institutional capacity to implement reforms, and the need for follow-through support from development partners. Overall key findings and lessons identified and cited in the evaluation on the reform process were as follows (ADB 2009):

- *Initiating reforms:* (i) an existing government reform agenda facilitated quicker development of a program, but substantial addition to the agenda by, for example, ADB complicated preparation and apparent commitment; (ii) large and fiscally unsustainable public provision of goods and services had an important influence on raising the need for private sector development, but where private sectors were dominated by nontraded goods and services, potential opportunities were likely overestimated.
- *Managing reform complexity:* (i) a single, strong reform champion helped to advance reforms, but unless the support had depth among pro-reform stakeholders, a change in leadership slowed or reversed the commitment to reform; (ii) wide coverage of enabling environment issues was relevant and appealing, but a focus on achievable reforms and institutional capacity development was more feasible.
- *Endorsing reform:* (i) crisis helped to accelerate reform endorsement and acceptance by the public, but fiscal gains were in cases reversed by political leadership changes; (ii) broad, early support for private sector development measures was not always met with endorsement once the full legal implications became clear to legislators, or passage took much longer than expected.
- *Implementing reforms:* (i) technical assistance (analytical, advisory, and capacity development) during implementation was important and needed but, as observed by client governments, was generally insufficient to develop capacity on “how to” aspects of needed institution building, especially in areas such as performance-based budgeting; (ii) fiscal consolidation and government

downsizing were often incompatible with public service delivery improvements objectives within program loans, emphasizing the need for better sequencing of reform measures.

- *Sustaining reforms*: (i) bilateral aid and grants (e.g., the US Compact transfers) could have a crucial influence on reform effectiveness, and their effects needed to be fully understood for ADB to add value and be complementary; (ii) complementary investment in systemic, sustained capacity development of public agencies and service providers through government systems (e.g., PSCs) was essential for sustained capacity development; (iii) ADB's sustained engagement in regular policy dialogue and client relationship building was crucial to improve the prospects for sustaining reform initiatives.

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### Annex 3.1 Program Loan Summary

Item	Cook Islands ERP	RMI PSRP	RMI FFMP	FSM PSRP	FSM PSDP
Loan Amount (tranches)	\$5 million OCR (\$3 million; \$1.83 million)	SDR8.4 million—\$12 million equivalent (\$5.5 million, and \$3.5 million, and \$3.0 million)	SDR6.32 million—\$8 million equivalent—plus \$4 million OCR (\$4.3 million, \$5.4 million, \$2.3 million)	SDR12.979 million—\$18 million equivalent (\$10 million, \$8 million)	Program loan SDR3.912 million—\$5 million equivalent; Project loan SDR6.273 million—\$8 million equivalent
Approval Date	September 1996	January 1997	May 2001	April 1997	December 2001
Objectives	<ul style="list-style-type: none"> <li>• Macroeconomic stability, particularly fiscal and external balance</li> <li>• Reduction in government role and increased private sector activity—agriculture, fisheries, tourism</li> <li>• Mitigation of social costs resulting from downsized public sector and rise in emigration</li> </ul>	<ul style="list-style-type: none"> <li>• Fiscal stabilization and sound fiscal policies</li> <li>• Privatization of public enterprises</li> <li>• Public sector reform</li> <li>• Stimulate private sector development</li> </ul>	<ul style="list-style-type: none"> <li>• Ensure sustainable income flows for future generation</li> <li>• Strengthen public sector financial and economic management</li> <li>• Stabilize fiscal position</li> <li>• Improve effectiveness of public service</li> <li>• Enhance private sector policy environment</li> </ul>	<ul style="list-style-type: none"> <li>• Reform and reduce the size of the public sector to adjust to declining external resource transfers</li> <li>• Shift balance of economic activity away from the public sector to the private sector</li> </ul>	<ul style="list-style-type: none"> <li>• Develop a sound economic and legal environment conducive to private sector development</li> <li>• Improve access to and competitiveness of land, labor, and capital resources to increase business prospects and performance</li> </ul>

*continued on next page*

## Annex 3.1

(continued)

Item	Samoa FSP	Vanuatu CRP	PNG PSP	Solomon Islands PSRP	Tonga EPSRP
Loan Amount (tranches)	\$7.5 million (\$4 million, \$3.5 million)	SDR14.977 million—\$20 million (\$10 million + \$5 million; \$5 million)	\$70 million (two tranches of \$35 million—2nd tranche canceled)	SDR18.8 million—\$25 million equivalent (\$15 million, \$10 million)	SDR8.02 million—\$10 million equivalent
Approval Date	February 1998	July 1998	December 2001	August 1998	May 2002
Objectives	<ul style="list-style-type: none"> <li>Promotion and establishment of sustainable market-based finance sector policies</li> <li>Privatization or corporatization of SOEs</li> </ul>	<ul style="list-style-type: none"> <li>Public sector reforms: redefine role of government; enhance regulatory and public services</li> <li>Financial and economic reforms: increase productivity and growth of private sector</li> <li>Support improvement of social development indicators, particularly for disadvantaged, rural population</li> </ul>	<ul style="list-style-type: none"> <li>Improve public service delivery in key sectors</li> <li>Increase private sector-led economic growth</li> </ul>	<ul style="list-style-type: none"> <li>Reform and reduce size of public sector, partly to adjust to economic contraction</li> <li>Shift balance of economic activity away from the public sector to the private sector</li> </ul>	<ul style="list-style-type: none"> <li>Fiscal reform</li> <li>Improved public sector service delivery</li> </ul>

CRP = Comprehensive Reform Program, EPSRP = Economic and Public Sector Reform Program, ERP = Economic Restructuring Program, FFMP = Fiscal and Financial Management Program, FSM = Federated States of Micronesia, FSP = Financial Sector Program, OCR = ordinary capital resources, PNG = Papua New Guinea, PSDP = Power Sector Development Program, PSP = Public Service Program, PSRP = Public Sector Reform Program, RMI = Republic of the Marshall Islands, SDR = special drawing right, SOE = state-owned enterprise.

Source: Asian Development Bank database in Bolt, R. et al. 2003. *Economic Analysis of Policy-Based Operations: Key Dimensions*. Manila: ADB.

# Policy Reform in Viet Nam and the Asian Development Bank's State-Owned Enterprise Reform and Corporate Governance Program Loan

George Abonyi

## Background

On 31 December 2002, the \$100 million State-Owned Enterprise Reform and Corporate Governance Program Loan (SCPL) of the Asian Development Bank (ADB) to support the Government of Viet Nam's reforms in the state-owned enterprise (SOE) sector was closed.<sup>54</sup> This chapter, based on Policy Reform in Viet Nam and the Asian Development Bank's State-Owned Enterprise Reform and Corporate Governance Program Loan,<sup>55</sup> discusses the political economy of reform of the SCPL, which aimed at supporting key reforms in Viet Nam's transition. Since the preparation of the original working paper, Viet Nam's economic performance was affected by the onset of the 2008 global financial crisis, which also highlighted the need for structural reforms, including SOEs, and have taken on further urgency to improve economic efficiency and resilience. Rather than addressing current needs, the case study highlights the complex set of factors that influence the road to reform.

<sup>54</sup> The program loan itself was for \$97 million, supported by two technical assistance (TA) loans, TA 3353-VIE: *Corporatization and Corporate Governance*, \$1.6 million, and TA 3354-VIE: *SOE Diagnostic Audits*, \$1.4 million, bringing the total package to \$100 million.

<sup>55</sup> G. Abonyi. 2005. Policy Reform in Viet Nam and the Asian Development Bank's State-Owned Enterprise Reform and Corporate Governance Program Loan. *Economics Working Paper*. Manila.



# Setting the Stage

## Viet Nam in Transition

From the late 1980s, Viet Nam has been successful in achieving and sustaining impressive economic growth, combined with significant gains in poverty reduction. The economy has been transformed from inward looking and stagnant to a rapidly growing and diversifying “economy in transition,” while maintaining macroeconomic, social, and political stability. In this, Viet Nam outperformed all other transition economies except the People’s Republic of China. For example, during 1991–1995, the economy grew at an average of 8.2% a year.

Viet Nam took a comparatively “slow boat to reform,” implementing a selective, “step-by-step” approach that included acting decisively in some areas while moving cautiously in others, in a process called *Doi Moi* initiated in 1986. Market mechanisms replaced, step by step, the command style of production and resource allocation, while significant structural reforms were implemented in the management of the economy. From an institutional perspective, reforms were aimed at making existing institutions work better, while gradually introducing new market institutions. From a political perspective, reforms were the outcome of domestic debates on economic strategy and related institutions, within the framework of the existing one-party (Communist) political system.

Reform came as a pragmatic response to deep-seated economic problems. The reunification of Viet Nam in 1976 was followed by a difficult decade with periods of economic stagnation and macroeconomic instability. The central planning system proved to have failings in responding to these problems, leading to tentative experimentation with reform. For example, in 1981, reform measures included a partial contract system for agricultural production, along with some autonomy for SOEs to sell on the open market and set salaries; and between 1979 and 1985, administrative decentralization was initiated.

When *Doi Moi* was launched at the Sixth Party Congress at the end of 1986, Viet Nam was facing an emerging economic crisis: annual inflation was over 700%, exports were less than half of imports, budget resources were strained by high military expenditures and support for loss-making SOEs, there was virtually no foreign direct investment (FDI), and official development assistance was very limited. The Sixth Party Congress agreed to abolish the system of bureaucratic centralized management based on state subsidies, and to move to a multisector, market-oriented economy with a role for the private sector to compete with the state in “nonstrategic sectors.”

The scale of reforms that followed was very wide, with no clear pattern of sequencing or coordination, and was largely driven by pragmatic experimentation and learning by doing. The strategic building blocks of *Doi Moi* that emerged after 1986 included rural, price, trade, and exchange rate reform; a macroeconomic stabilization program; and opening up to foreign investment.

Two key areas of reform that proceeded more cautiously and where significant differences emerged with key development partners, in particular international financial institutions (IFIs), involved the expansion of the private sector, and the related reduction of the role of the State in the economy, particularly in terms of SOE reform. Private sector development began with the introduction of measures such as the 1990 Law on Private Enterprise and Law on Companies, which provided important legal basis for the establishment and operations of private firms, and the key revision of the Constitution in 1992 allowing individuals to exercise property rights over income-producing assets and personal property.

Over time, private sector growth made notable contributions to Viet Nam's economic performance, particularly to employment growth. However, the movement has been gradual toward the acceptance of a significant active role for the private sector and private property in the economy (e.g., through privatization, deregulation of the role of the state, and facilitating the establishment and operation of private firms), as distinct from a more rapid and less ambiguous acceptance of the role of markets in economic governance and in mediating the flows of goods and capital (e.g., through the elimination of price support, freer trade, and market-determined exchange rates).

With respect to SOEs, issues of enterprise management, control, and—particularly—ownership were approached cautiously. SOEs therefore continued to retain a relatively important role in production and trade, and as recipients of financing. Underlying the more measured approach to both private sector development and SOE reform was partly the intent of key political stakeholders to retain a significant role for the state in the economy, and the domestic debate over what that role should be.

Still, the Vietnamese approach to reform was largely effective. The period 1986–2001 saw rapid and sustained economic growth; inflation was brought under control; poverty was substantially reduced; the traded sector (exports and imports) expanded significantly; FDI inflows increased substantially; and the economy underwent considerable structural transformation with a large contraction of the relative share of agriculture, and a corresponding expansion of industry's.

Policy and institutional reform through *Doi Moi* is generally seen as having played a central role in Viet Nam's rapid and sustained transformation and development, aided by improved incentives, increased competition, reduced trade barriers, import/adoption of new ideas and technology, and the creation of new market institutions.

However, substantial challenges remained at the time of the SCPL, including

- weak law enforcement, particularly as related to property rights and business-related dispute resolution, leading to continuing constraints on the further development of markets and the expansion and performance of firms;

- lack of transparency and cumbersome administrative procedures resulting in a proliferation of new and changing legislation, decrees, and regulations issued by numerous agencies and local authorities, creating a confusing and at times contradictory tangle of requirements for private business that left considerable discretion for authorities at various levels, contributing to a rising incidence of corruption, recognized and increasingly addressed by the government; and
- finance sector problems, including a still heavily regulated financial system with a segmented credit market dominated by four large state-owned commercial banks, with considerable barriers to entry through licensing control by the State Bank of Viet Nam (SBV), and a significant share of credits still channeled to SOEs by the four main banks.

One persistent and widespread problem in the reform process was the gap between policy decisions—directives, regulations, legislation—and their implementation. The capacity of central agencies to ensure and monitor such implementation by various levels of government and implementing agencies was limited within the framework of Viet Nam’s political and economic management system.

## Political Institutions and Economic Management

A key characteristic of the Vietnamese reform process has been the continuity of political institutions and an orderly, if bureaucratic, administrative system.<sup>56</sup> This has provided a relatively stable environment for policy decisions, enabling the government to make decisive macroeconomic decisions and implement significant reforms, despite limited development of a formal legal system.

But a significant institutional change at the time of the SCPL involved the growing importance of the National Assembly—defined by the 1992 Constitution as the highest organ of the state—in the policy decision process. Specifically, for the 1999/2000 Enterprise Law (related to key reform measures in the SCPL), the National Assembly played a strong role in shaping the details of the legislation.

The government operates at four levels: the central government, and three local governments (provinces, districts, and communes). There is a large degree of autonomy extended to local administration on implementing economic decisions and spending allocated budgets.

The formal system notwithstanding, unambiguous statements of policy direction, to the time of the SCPL, had been relatively rare. The policy reform process in Viet Nam may be described as “behavior led” rather than “rule led.” That is, in practice, many formal reforms and regulatory changes often tend to formalize what is, in effect, already happening in practice in some parts of the country, or that have initially been implemented as “experiments” on a pilot basis.

<sup>56</sup> This section is based on Arkadie and Mallon (2003) and Doan (2004).

The corresponding policy decision system emphasizes collective leadership and consensus. This leads to a sharing of responsibility, as well as of political risk. It also means that the policy-decision process is often opaque in that it is difficult to identify clear decision makers or decision points. Central agencies, however seemingly powerful (SBV, the Ministry of Planning and Investment) are generally not in a position to impose policy decisions for which a broad consensus does not yet exist.

Within this framework, implementing policy decisions requires a buying in by relevant state bodies before a designated agency takes action. Yet individual agencies can be quite decisive in matters they see as lying within their mandate. As a consequence, cooperation/coordination between line agencies and/or different levels of government can be challenging. The implementation of reforms even after high-level (including prime ministerial) policy pronouncements and directives therefore often has to be negotiated with and among implementing agencies—and associated vested interests.

In this domestic-driven process of policy reform, external input—for example, from IFIs—was generally limited either to the presentation of international experience, or to assistance in analyzing the potential impacts of new types of policy options.

## Overview of State-Owned Enterprises

Viet Nam's economic transition had mixed results by the time of the SCPL. In certain areas such as price liberalization, exchange rate unification, tax reform, and the liberalization of the trade regime—in the development of the role of market mechanisms and related institutions—progress had been substantial. But the government made much less progress in transforming the ownership structure of the nonagricultural economy in general, and SOEs in particular. Since the start of economic reforms in the late 1980s, the share of the state sector in gross industrial product had declined only slowly.

Historically, SOEs had played an important role in the economy of Viet Nam, but less so than in other transition economies such as the former Soviet Union, the People's Republic of China, or the countries of Eastern and Central Europe. Therefore, the consequences of a slower pace of SOE reform in Viet Nam were less significant as a constraint on economic growth and development than some external commentators, in particular the IFIs, initially predicted.

Around the time of the SCPL, SOEs still accounted for a significant share in national income, averaging about 30% of gross domestic product (GDP) between 1986 and 2000, with non-oil SOEs contributing about 23% to the state budget (40% including oil SOEs). The share of SOEs in industrial output was about 50% in 1991, falling to about a still considerable 36% by 2000. The relative share of employment by SOEs was historically modest, employing about 7.5% of the total labor force in 1990, falling to about 5% by 2000. Large-scale, capital-intensive SOEs were relatively few, and the

vast majority of enterprises employed less than 500 people, with many employing less than 100. Generally sound macroeconomic management, particularly since the initiation of *Doi Moi*, limited government budget resources used to subsidize SOEs, thus hardening the budget constraint. However, a significant share of state-linked bank credits continued to be channeled to the SOE sector in 2000.

## Key Elements of the SOE Reform Process up to the SCPL

The need to strengthen the performance of SOEs was a recurring subject of debate well before *Doi Moi*.<sup>57</sup> However, fundamental to this debate was a continuing commitment to a key role for the state in the economy, and therefore for SOEs in economic development. Over time, there was increasing focus on the role of the private sector in long-term economic development, and on the relationship between SOEs and private enterprises. SOE reform and the development of the private sector were interrelated in Viet Nam's reform and transition process. SOE reform had a dual purpose: strengthen the performance of SOEs so that they can perform more efficiently and effectively in an increasingly market environment and, at the same time, reduce the burden on government finances; and help develop the private sector by shrinking—within limits—the scope of SOEs in the economy.

*Private sector development and SOEs.* SOEs were seen as a key constraint on private sector development, a central feature of *Doi Moi*. The government gave preferential treatment to SOEs and, in effect, restricted private enterprise from moving much beyond smaller businesses that could compete with SOEs. Constraints on the development of private enterprise included lengthy, cumbersome, and expensive business registration procedures; licensing requirements from the Ministry of Trade, including needed support from local “people’s committees”—who often had a stake in maintaining the dominant position of local SOEs as, for example, a source of revenues, and were therefore threatened by potential new private entrants; preferential access of SOEs to land and foreign investment; and preferential lending by state-linked banks to SOEs. An important dimension of SOE reform therefore related to “leveling the playing field” between state enterprises and private business through effectively reforming the SOE sector and formulating and implementing measures facilitating private business.

Viet Nam had taken a cautious approach to SOE reform, involving two tracks. Along one track, the focus was on exposing SOEs to the pressures of markets—termed in the reform process “commercialization”—by forcing them to compete, on a gradually more level playing field with each other, with imports, and with a growing private sector. At the same time along the second track, the focus was on developing a new policy and regulatory framework for the SOE sector to force individual enterprises to restructure, and to alter the landscape of the SOE sector as a whole through

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<sup>57</sup> This section is based on Arkadie and Mallon (2003).

ownership reform measures such as “equitization” and liquidation. This second track stood in marked contrast to the rapid privatization in the former Soviet Union and in Eastern and Central Europe.

*Commercialization of SOEs.* In late 1987, the former Soviet Union and Eastern and Central Europe drastically reduced trade and financial flows to Viet Nam, causing SOE performance to deteriorate. This triggered a focus on shifting SOEs to a more commercial (market) basis, with greater autonomy and increased responsibility for their own financial viability. Decision 217/HDBT, in November 1987, marked the first post-*Doi Moi* step toward a broad-based SOE reform program. It involved giving SOEs the autonomy to formulate their own operating plans, within the framework of broad government guidelines on development priorities. The key operational change involved a shift to market-based relationships with suppliers and customers through the introduction of economic contracts as the basis for transactions among enterprises and businesses. Within this framework, SOEs now had to purchase inputs directly from suppliers, and could sell their products in the open market.

*Reregistration, reorganization, and liquidation.* Decision 217/HDBT also allowed for the decentralization of authority to establish SOEs. This, in turn, led to a proliferation of new SOE registrations, particularly at the local level. By 1991, Viet Nam had about 12,300 SOEs with a total capitalization of 34,000 billion dong (D), or approximately \$2.4 billion at the current exchange rate. This helped trigger a second round of reforms focusing on reorganizing and consolidating SOEs. The government issued a decree in November 1991 requiring all SOEs to reregister or close, and made commercial viability as the main criterion for establishing SOEs. As a consequence, by April 1994, the number of SOEs shrank to about 6,300 enterprises through liquidations (about 2,000) and mergers (about 3,000). Total capitalization of new SOEs increased to about D53,000 billion (about \$3.8 billion). In practice, most liquidated and merged SOEs were small, locally managed enterprises with fewer than 100 employees and D500 million in capital (about \$45,000); and the total assets of liquidated SOEs accounted for less than 4% of total SOE assets. Following government instructions in March 1994 for a second phase of reregistration, a new wave of mergers and liquidations reduced the number of SOEs to about 5,500 by the end of 1997. This led to the retrenchment of more than 1 million SOE workers, many of whom were absorbed by private businesses.

*Equitization and divestiture.* Following the Seventh Party Congress' call for the dissolution or change of ownership of SOEs not seen as essential for state ownership, the National Assembly approved a pilot equitization program in December 1991, which was implemented by the government. Equitization was a politically sensitive concept, in effect, a form of partial privatization (though not explicitly stated so), with the state in most cases to retain a share in the enterprise and, in principle, a commitment to worker control through share ownership. Operationally, SOEs were to be transformed into joint-stock companies, with a proportion of state shares in the enterprise required to be sold, and with employees given preferential access to such

shares. The objectives of SOE equitization were to create a new type of enterprise with diversified owners, leading to a more efficient use of state assets, and the mobilization of investment in the new types of SOEs. However, progress was very slow, despite follow-up policy directives. For example, although the Prime Minister issued another decree in March 1993 to accelerate the pilot equitization program, nearly 3 years later at the end of 1995, only five SOEs were equitized.

To accelerate the process, in May 1996, the government issued a further directive to extend the scope and scale of equitization, requiring SOE-controlling agencies to select enterprises for equitization. This was further strengthened by subsequent decrees and decisions in 1997 and 1998, including listing steps that had to be followed in the equitization process. Nevertheless, the pace of equitization during 1998–2000, although much faster (it increased to about 550 enterprises from just 17 in 1992–1998),<sup>58</sup> remained slow at the time of the SCPL. However, in practice, equitization generally targeted only smaller SOEs with capital less than D10 billion (or \$700,000).

*Legal framework for SOE activities and corporate governance.* This framework evolved slowly, but gradually reduced differences in treatment between SOEs and private businesses. Steps in this direction included National Assembly approval of the Laws on Foreign Investment in 1987, and on Private Enterprise and on Companies in 1990. A key measure was the inclusion in the Constitution in 1990 of the rights of the nonstate sector to operate alongside the state sector. To facilitate improved corporate governance and closure of nonviable SOEs, the 1993 Law on Bankruptcy and the 1995 Law on State Enterprises were introduced. The latter provided the first legal basis for the operation of SOEs, including rights and responsibilities of enterprises with respect to equitization and divestiture; and it legitimized the autonomy of SOEs in making business-related decisions.

In practice, however, implementation of these laws was limited. For example, up to the time of the SCPL, few bankruptcy cases were brought to the economic courts, and the law was seen as providing little protection for creditors. Similarly, few SOEs published financial reports as required under the Law on State Enterprises. One perspective on the poor implementation was that understanding was limited of the purposes of these laws, with little real domestic consultation or sense of ownership.

*State corporations.* In March 1994, government instructions for reregistration also issued instructions for consolidating SOEs into two categories: state enterprises and state corporations. This was a categorization of enterprises, and did not involve changes in enterprise behavior or incentive framework (as distinct from “corporatization,” a concept introduced under the SCPL). It was intended, in part, to streamline SOE administration, separating state ownership from state regulation—a key issue in the domestic SOE reform debate. The administrative

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<sup>58</sup> The exact figures vary among different sources.



grouping of enterprises under umbrella organizations was intended to help facilitate this separation. The further grouping of SOEs with similar orientation was intended not only to rationalize SOE supervision but was also aimed at creating competitive advantages, especially in international markets, through increased scale. However, there was considerable debate about both the desirability and the utility of the state corporation model in the context of SOE reform.

## Key Issues at the Time of the SCPL

By the time of the SCPL, the SOE sector had seen many changes and much progress in its structure and operations from pre-*Doi Moi* days. But several key problems remained.

*Financial constraints.* Given the slow pace of reform, the burden of financing SOEs (especially those with deteriorating performance), although off the books of the state budget was now borne by the weak, state-linked banking system—an issue of particular concern to the International Monetary Fund (IMF). For example, in 2000, SOEs still absorbed approximately 45% of the total credit to the economy. Furthermore, by the end of 2000, roughly 20% of bank loans to SOEs were estimated as nonperforming.

*Slow pace of liquidation.* Limited progress was made in liquidating nonviable SOEs. This was due, in part, to a cumbersome legal framework and procedures for liquidation that made it difficult to enforce creditor rights and for the authorities to declare bankruptcies. This reflected government concern about the impact on social stability of higher unemployment, likely to result in the short term from the liquidation of the worst-performing enterprises, especially larger SOEs. The resistance of powerful vested interests both within and outside particular SOEs was also important.

*Slow pace of equitization.* The pace remained slow, constrained by an administrative process that was cumbersome; some SOEs were not suited to equitization given that they were not commercially viable enterprises; others were too small to operate under a joint-stock management structure; there were difficulties in the valuation process and in resolution of enterprise debts; and vested interests—including controlling agencies, SOE managers, and SOE workers who feared loss of control, revenues, and jobs—offered resistance. In addition, poor accounting and auditing standards made the scrutiny of many enterprises' financial performance difficult, further discouraging potential investors.

*Constraints on restructuring larger SOEs.* A key part of SOE reforms were measures to encourage large enterprises to restructure and downsize in order to reduce losses and unserviceable debts, and to improve competitiveness. However, restructuring large SOEs that were under state control had been addressed in only a limited way.



*Role of the state in the economy.* Perhaps the most fundamental factor in the limited scope and slow pace of SOE reforms related to a continued commitment by the Communist Party to the role of the state in the economy and, consistent with this, maintaining a significant role for SOEs. Official commitments to accelerating SOE reform notwithstanding, resolutions of both the Eighth (1996) and Ninth (2001) Party Congresses maintained that the state was to continue to play a leading role in economic development. At the same time, national consensus was lacking—the Party had basic disagreements—on the relative roles of the state, markets, and private enterprise in the economy. This was reflected in the gap between policy pronouncements and change in the operations or status (or both) of particular SOEs.

## The Policy Reform Process and the Viet Nam State-Owned Enterprise Reform and Corporate Governance Program Loan

### Initiating Policy Reform: Getting on the Policy Agenda

The need to strengthen the performance of SOEs and to reform the SOE sector was on the government's policy agenda as a priority issue well before the *Doi Moi* reforms, and remained on it throughout the reform process. However, although there was a basic consensus on the need to reform SOEs, the scope and focus continued to be debated as the reforms evolved, and there was no domestic consensus on what reform entailed, especially in a context of continuing deep commitment in the political system to a key state role in the economy, and therefore to maintaining a significant, if evolving, role for SOEs. Although a stated and demonstrated priority of the government, SOE reform has proven to be a complex and sensitive issue that touches the core of Viet Nam's economic, social, and potentially political transformation.

Reform and restructuring of the SOE sector also emerged as an area of attempts by IFIs to shape the definition and scope of the issue, as well as associated reforms. However, the policy agenda, as related to SOE reform, remained firmly domestically driven. Although the SCPL seems to have been initiated as part of ADB's interest in providing financial and technical support for Viet Nam's reforms,<sup>59</sup> the government saw it as generally responding to a key issue on the domestic policy agenda where external support was useful—as long as it conformed to domestic definitions of relevance and feasibility.

The policy decision process in Viet Nam was domestically driven and the resulting decisions reflected national priorities and ownership. External financial assistance

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<sup>59</sup> Based on interviews with ADB staff and management, key ADB consultants, and senior government officials.

had played a negligible role in the critical initial stages of reform in the late 1980s and early 1990s. National policy makers did not therefore see external policy advice as the means to external financing, but assessed it based on relevance to domestic priorities, and likely feasibility given domestic conditions and constraints. This general attitude did not change substantially as interaction with key IFIs increased in the mid-1990s.

The experience of three IFIs before the SCPL illustrates that the policy reform process was under strong domestic control, with national ownership. Reforms that were part of policy-based lending by IFIs were likely to be agreed to and implemented only to the extent they were seen as relevant and feasible by the government, and subject to a domestic consensus being in place. Following normalization of relations, negotiations between the IMF and the government on policy reform were held in 1998. SOE reform was a key part of the IMF agenda in Viet Nam because of the macroeconomic significance, in particular the fiscal implications, of financing SOEs.

The strong advocacy position taken by the IMF, for example, in May 1999's Article IV consultations, emphasized the need to reduce the role of the state in the economy; the requirement for a comprehensive reform framework; and a wider and faster SOE privatization program, with particular emphasis on the larger SOEs. By contrast, the government's position was one that advocated a continued sustained role for the state in the economy, and therefore a gradualist approach.

The government's general approach to SOE reform focused on improving enterprise performance, creating greater autonomy and accountability particularly of the larger SOEs, divesting itself of smaller SOEs, and leveling the playing field between private firms and SOEs. A key concern of the government was ensuring that jobs existed in the emerging private sector to accommodate workers released by downsizing the public sector (through SOE reforms), in order to maintain social and political stability. Furthermore, the lack of consensus and expected political resistance by vested interests (such as SOE workers and management, and controlling institutions) were additional key factors in a need for slower SOE reform.

The World Bank's approach to policy reform in general—SOE reform in particular—evolved in Viet Nam (as with the IMF), increasingly accommodating the domestic reform process. Emphasis shifted from an emphasis on the scope and pace of SOE privatization toward private sector development. It stressed the demonstration effects of privatizing medium-sized SOEs. The World Bank's first Poverty Reduction Support Credit (PRSC I) focused on enhancing transparency of SOE operations and the effectiveness of the SOE equitization process. The World Bank's approach continued to evolve under PRSC II, approved in May 2003, partly reflecting a tacit acknowledgment of the continued resistance by the government to externally pushed privatization, and the practical difficulties of implementing enterprise reforms.

ADB's experience with the loans supporting policy reforms, before the SCPL, seemed to indicate that Viet Nam was likely to implement measures that it saw appropriate, and often already in the reform pipeline before the loan—for example, the Agriculture Sector Program Loan, where domestic consensus was already in place. The timing of the implementation of reforms also could be uncertain, given Viet Nam's consensus-based approach to policy decisions. Reforms where domestic consensus was not yet in place were unlikely to be rushed because of loan funds, particularly with measures involving legislation—for example, the Financial Sector Program Loan.

## Managing Complexity: Design of the SCPL

### *Complexity of Policy Issues and Program Design*

Improving the efficiency of SOEs is a function of factors such as the structure of the industry within which enterprises operate, systems and procedures that relate to enterprise operations, the quality of personnel, operations management, and the broader environment that constrains or facilitates SOE performance. These factors also represent different leverage points where reform initiatives may focus. Similarly, improving the efficiency of the SOE sector as a whole could involve focusing primarily on larger SOEs through measures such as equitization or on smaller SOEs through measures such as divestiture and leasing—with potentially different outcomes. The many interconnections can make it difficult and somewhat arbitrary to define boundaries for what should be part of a particular reform program. As introduced in Chapter 1, how a policy issue is posed or structured has a major role in shaping the reform measures intended to address it.

### *Selected Reform Issues*

The design of the SCPL took place against a backdrop of complicated discussions between the government, the IMF, and the World Bank, reflecting fundamental differences between the government and the IFIs. These differences had not been resolved when the SCPL was prepared, and were also reflected in design-related discussions and negotiations between the government and ADB.

At first, ADB pushed for expanding the scope and accelerating the pace of equitization-as-privatization—much along the lines of the other IFIs—but this was unacceptable to the government. ADB then spent much time clarifying and trying to reach common understanding and agreement on key policy issues and reform measures. The design of the SCPL took almost 4 years from the inception of the project preparatory technical assistance from ADB in 1996 to the finalization and approval of the design of the SCPL. The actual design-related discussions between the government—led by SBV and ADB—took almost 2 years, with ADB Board approval of the SCPL in December 1999 and loan “effectiveness” declared in October 2000.

Learning through the program design process, ADB shifted its position from treating the transfer of ownership as the core issue in SOE reform. In particular, the concept of corporatization emerged as an important focus in the design of the SCPL. Corporatization had been introduced earlier in the context of SOE reform, including support by other donors, but with slow progress in implementation. ADB proposed it as a core focus of the SCPL as a kind of intermediate stage toward possible equitization, divestiture, or liquidation of selected enterprises. It was aimed at changing the status of SOEs classified as state corporations that were not subject to the earlier provisions of the Law on Companies. The concept implied the incorporation of these enterprises as a state-owned joint-stock company or state-owned limited liability company, requiring an amendment to the Law on Companies. Operationally, transforming state corporations into joint-stock companies meant subjecting them to hard budget constraints, corporate governance requirements, and market-related incentive structures. It also aimed to separate ownership (by the state) and management functions, so as to provide for greater management autonomy and flexibility.

The government regarded corporatization as sensitive and complex. It and ADB took much time in reaching agreement on the relevance, role, and operational meaning of corporatization. In these discussions, at first there were basic differences between the two sides' approach to the issue, and more generally to the SCPL design. The government saw ADB as generally taking a very bureaucratic and legalistic approach to key issues, not appropriate to the reality of Viet Nam.<sup>60</sup> In particular, the government initially viewed ADB's approach to corporatization as very similar to equitization, that is, an attempt at pushing backdoor privatization. The government, however, wanted a less legalistic approach, focused more on the kind of behavioral changes it wanted to induce in relevant SOEs. It therefore wanted a more flexible definition of the concept, and focused more on consistency with local conditions and constraints, with particular attention on existing institutional capabilities, rather than focusing on conformity with international best practice.

Key issues in SCPL design, in particular the concept of corporatization, were in fact so complex and politically sensitive that they required resolution at the party level. Government participants felt that ADB did not fully appreciate the full implications of these issues. Thus, the issues touched the very core of the domestic debate on Viet Nam's transition and reform strategy. The overall approach taken and the core measures in the SCPL had to be consistent with the more gradual, step-by-step approach to SOE reform, and with existing or emerging domestic consensus on issues. Similarly, a critical dimension of reform measures in the policy matrix such as corporatization required—in the eyes of the government—an accommodation to the realities of the political and institutional preparation needed for effective, nondisruptive change.

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<sup>60</sup> From interviews with senior government officials and ADB staff and management, and key consultants.

Differences over the meaning of “satisfactory progress” as related to implementation of measures in the policy matrix also took time to resolve. In this case, it was the government that wanted a clear and relatively precise definition of the term, while ADB wanted to leave it more open-ended and discretionary. This led to government concerns of potential future problems relating to differing interpretations of what was effective implementation and compliance.

Many key senior government participants in the SCPL design felt that there were initially fundamental differences between ADB and the government on key issues in the program design, feeling that ADB (including international consultants, who are important sources of knowledge on “international best practice”) did not often fully understand the Vietnamese context—for example, in terms of the constraints it placed on implementable reform measures. Over time, however, what started as a wide gap narrowed through an iterative process of discussion and mutual adjustment.

An important issue in the design of the SCPL, against the background of the decentralized Vietnamese context, was the limited involvement of implementing agencies. The design process involved central agencies primarily, particularly SBV and ADB, and therefore the organizational requirements and potential institutional constraints on implementation were not a key focus in preparing the policy matrix. This led to implementation and sustainability issues (discussed later).

Still, corporatization was an important breakthrough in the government–ADB joint design of the SCPL, and in the approach to SOE reform in Viet Nam. It was consistent with the government’s step-by-step approach to SOE reform, and provided a preparatory or transition stage between commercialization (implemented under the State Enterprise Law) and equitization/divestiture/liquidation (implemented under the Law on Companies and the Law on Private Enterprise).

### *Outcome of Program Design*

The SCPL was formulated by ADB as a \$100 million loan to be disbursed in two tranches of \$50 million each, and supported by two technical assistance projects. The first tranche was to be released on loan effectiveness (actually disbursed on 8 December 2000), and the second tranche was planned to be released about one and a half years from the initial disbursement (actually disbursed on 18 December 2002).

The overall objectives of the SCPL were to “promote industrial growth by restructuring the industry sector to (i) facilitate FDI inflows, (ii) support the development of private enterprises, and (iii) accelerate industrial SOE reform and improve corporate governance of enterprises.” To achieve these objectives, the SCPL was very comprehensive, including a wide range of measures, many with sub-measures, and involving a number of implementing agencies. There were 15 first-tranche conditions, and 13 second-tranche conditions that had to be met for funds disbursement. The SCPL timetable required the government to implement the program of reforms within some 36 months.

The policy matrix generally addressed important issues in Viet Nam's reform process. The core focus of the SCPL was on industrial SOE restructuring, that is, on improving the policy and institutional framework for SOE reform. Particularly important was the introduction of the concept of corporatization and related measures, including enactment of the revised Enterprise Law. These were potentially significant contributions that addressed important gaps in the SOE reform process, and facilitated private sector development.

At the same time, there was a view that the SCPL design was overly ambitious: too wide in scope, with too many conditions, and included measures whose feasibility was likely to be uncertain. For example, issuing a policy directive—Prime Ministerial Decision (No. 833/CP-QHQT)—for the corporatization of 60% of the medium-sized and large SOEs under the SCPL was one thing, implementing such wide-scale changes at the enterprise level—given the sobering experience with actual SOE reform to date—was likely to prove to be a rather different matter. The inclusion of measures requiring approval by an increasingly active National Assembly—such as revised bankruptcy procedures and a law on accounting—was also a potential source of uncertainty in both timing and final content of reform measures.<sup>61</sup>

## Endorsing Reforms: Approval of SCPL Reform Measures

Policy reforms are usually endorsed through a process of political decision making within a country's existing institutional framework. This has both formal and informal dimensions. In Viet Nam, such endorsement is a multilevel and multi-stakeholder process involving, formally, the Communist Party, the National Assembly, the central government, and lower levels of government. Informally, given the consensus-based decision process, implementing agencies and key enterprises generally also need to buy into proposed reforms—indicating their actual endorsement. All these levels were relevant to the endorsement of the SCPL reform measures.

The government's signing of the SCPL (technically, SBV, on behalf of the government) signaled its official endorsement of the reform measures in the policy matrix. However, as a practical matter, the reform measures in the SCPL could be seen as falling into three categories. First, to the extent that policy measures are consistent with the existing domestic reform program and are within the powers of the central government to approve, agreement by the government to the SCPL can be seen as constituting endorsement in the sense of a commitment to implement, e.g., the Prime Minister issuing Decision 36/2003 to allow foreign investment in equitized SOEs (first-tranche condition). As noted, the concept of corporatization, as reflected in the SCPL, required prior approval at the party level—involving significant time, effort, and discussion within the political system, given the complexities and sensitivities involved, before the government could endorse it in the SCPL.

<sup>61</sup> Based on interviews with senior government officials, and ADB consultants and staff.

The second type of reform measure requires endorsement or formal approval ultimately through the political decision system, in particular, involving the National Assembly. Here, the government can “endorse” in the sense of agreeing to submit such measures but cannot, in practical terms, approve these measures nor guarantee their ultimate form. The power to approve, modify, or even reject the actual reform measures rests with the National Assembly, as for example, in the requirement for the People’s Supreme Court to submit the revised Bankruptcy Law to the National Assembly (second-tranche condition). Even the National Assembly’s endorsement of a measure such as the revised Bankruptcy Law should not be interpreted as necessarily leading to effective implementation.

The third type can be endorsed by the government, but such endorsement—even with the best of intentions—cannot guarantee that the reform will be implemented as planned, by particular agencies and enterprises (or even by different levels of government), such as the government issuing a policy directive aimed at corporatizing 60% of SOEs by 2005 (first-tranche condition). However, this type of endorsement cannot be taken to mean that implementation will then follow, given the gap between government intentions and enterprise behavior in SOE reform. Effective implementation of this reform measure would require actual agreement by individual enterprises and the agencies controlling them (such as ministries, provinces, and districts).

The preceding discussion suggests that even if policy reforms are formally endorsed by the government, it may not be certain that all the reform measures will have the necessary formal and informal approval at other points in the policy decision system. Furthermore, as the examples suggest, endorsement and implementation of reforms are closely intertwined. In practice, it may be difficult to identify in the policy decision process a “stopping point” that results in a binding or irreversible commitment to reform. In some cases, only when reforms are actually implemented, e.g., SOEs are corporatized not only in terms of legal status but also in terms of their operational performance, can it be concluded that they have (or had) the necessary endorsements at key points in the policy decision process. The implication is that the endorsement of reforms is a continuing activity throughout the policy reform process, including and even beyond implementation, giving the possibility of reversal of reform measures.

## Implementation

### *Implementing Measures in the Policy Matrix*

ADB’s internal review concluded that almost all of the specific reform measures of the SCPL were implemented satisfactorily, including the 15 first-tranche conditions, and 12 of the 13 second-tranche conditions. Given the progress in implementing the SCPL measures, the program was closed a year earlier than planned, in December 2002.



Implementing these measures made several important contributions to the country's reform process. The adoption of the Enterprise Law (in 2000) was a fundamental reform that greatly improved the institutional environment for private business, for example, by greatly reducing the cost and time needed to register new businesses. It also provided the necessary legal framework for transforming SOEs into shareholding/joint-stock and limited liability companies, allowing key corporatization measures.

The SCPL also supported the establishment of the National Steering Committee for Enterprise Reform and Development (NSCERD) to oversee the formulation and implementation of the SOE reform strategy. Further contributions were the introduction of the concept of corporate governance through the drafting of model corporate charters by selected enterprises, and the strengthening of accounting and auditing standards for all enterprises through the preparation of the Accounting Law.

The government did not implement one measure on eliminating the minimum wage differential between domestic and foreign-invested enterprises. The design of the measure had ambiguities—should, for example, the gap be eliminated by raising the lower minimum wage of domestic enterprises or by lowering it for foreign enterprises. This turned out to be a politically more sensitive and difficult measure than anticipated, since increasing the minimum wage—the measure favored by the government—by applying it to SOEs, as well as private businesses, had potentially significant budgetary implications. ADB eventually waived this condition after it was satisfied that the planned reform measure of the government of gradually increasing the minimum wage was relevant and appropriate.

Another measure not implemented at the time of the closing of the SCPL related to the requirement for the Ministry of Labour, Invalids, and Social Affairs to submit a Social Securities Act for approval to the National Assembly. This related to a critical issue in SOE reform, that of putting in place an effective social policy to address the impact on workers of enterprise equitization and divestiture. The social impacts of SOE reform was an important concern to SOE labor unions and a key source of resistance to reform.

The delay associated with the Social Securities Act is an example of a wider issue—where reform measures in the SCPL involved new or amended legislation requiring approval by the National Assembly, significant delays were often involved. For example, while the SCPL closed in December 2002, in addition to the delay in the approval of Social Securities Act, the Law on Accounting was approved in June 2003 and came into effect on 1 January 2004; implementation of land-use rights measures under the Land Law became effective in July 2004; the revised Law on Business Bankruptcy was approved on 15 June 2004 and came into effect on 15 October 2004; and the law related to the collection of uncontested debt was approved in 2004 and came into effect in January 2005. Although the reform measures in the policy matrix related to such legislation were implemented on time in terms of the



government submitting proposed legislation, the actual approval of the legislation often took considerable time, and involved extensive consultations, modifications, and political debate.

### *Nominal Reform versus Implanting Change*

The SCPL took significant steps to support SOE reform, though the actual implementation of measures prompts a more cautious attitude. Many of the measures involved issuing directives, and drafting laws, decrees, and regulations. But the fundamental challenge in policy reform is the implementation and enforcement of such measures, which generally involve a long-term process of institutional change.

For example, issuing a policy directive to corporatize 60% of SOEs by 2005 followed the policy matrix, but this was not the same as changing the fundamental behavior and operational performance of a large number of often powerful enterprises—a task that is likely to (and did) prove to be more challenging over an extended period.

The limited participation of implementing agencies (SOEs) and related institutions in the design of the SCPL was likely to provide a further constraint, given the need for SOEs and agencies that control them to buy into the reform process for effective implementation. The resistance by SOEs to be placed on the audit list in preparation for corporatization—a key activity under an SCPL technical assistance project—for fear of this leading to privatization is an illustration of the challenges of implementation at the enterprise level. Setting up the NSCERD provides a further example. Although this institution was nominally established to oversee the SOE reform process as required under the SCPL, its actual capabilities and power to ensure and monitor compliance of enterprises were limited.

## Sustaining the Reforms

To sustain reforms implemented under the SCPL, challenges since the completion of the SCPL involved operationalizing and enforcing enacted decrees, legislation, and regulations so that they lead to changes in incentives, behavior, and performance of enterprises. Given the track record of implanting changes among individual SOEs before the SCPL, this implied the need for continued strong political support. This, in turn, needed continuing attention to implementation, organizational capacity of enterprises to implement reform measures, and the buy-in of individual enterprises.

Equitization and divestiture reduced the number of SOEs from almost 6,000 in 1997 to about 4,000 by mid-2004 (further reduced to about 3,000 by 2005). However, these reforms mainly involved smaller SOEs. Furthermore, the total capital of SOEs involved was minimal. Still, reforms seem to have led to improvements in SOE performance, largely attributable to the success of the commercialization and corporatization measures that led to the hardening of the budget constraint and forced greater competition in product markets.

More fundamentally and over the longer term, SOE reform measures through corporatization, equitization, and divestiture should be seen not as end points but as initial steps in their transformation (ADB 2004). Sustaining reforms by creating vibrant and competitive enterprises from previously state-nurtured SOEs requires ongoing efforts at organizational change and business development, particularly in the case of the larger SOEs.

An important issue addressed in the SCPL relates to the impact of SOE reform on workers—critical stakeholders in the reform process—and more widely, the need to build consensus. The SCPL recognized the problem of labor mobility, and focused on making the social insurance system more flexible. This was important since SOE reform meant that workers at the majority of SOEs were threatened by retrenchment or the loss of a range of critical social subsidies and health care benefits. However, as the delay in carrying out relevant measures in the SCPL (such as the Social Securities Act) indicates, this was a complex and sensitive matter. Labor mobility is part of a larger and deeper problem with important political and social implications, involving significant social impacts of reform measures such as equitization and divestiture. The majority of SOEs in 2004/05 were small and labor intensive, involving limited technology. An estimated 1.6 million people worked in this sector, and most were unskilled women with low levels of education (see Evans 2004).

Trade unions played an important role in drawing attention to the social costs of equitization, providing strong political opposition to the SOE reform process. Their concern was with what they saw as an absence of an effective social policy to address the impact of measures such as equitization, such as the government's failure to effectively implement the Labour Code, the requirement for new types of skills, and difficulties of workers transferring pension rights from the state to the private sector. These related to the delayed measure in the SCPL.

Furthermore, surveys indicated that a majority of workers in equitized enterprises did not understand the conditions of their new employment, revealing a basic need for more effective public education of the implications of reform, including the behavioral changes needed for adjusting to a market-based economy. The sustainability of SOE reform requires addressing effectively the social impacts of key measures.

SOE reform is also a function of the wider reform process. Viet Nam is a success story—but with significant remaining challenges. Despite considerable policy, legal, and institutional changes in 2 decades of reform, important constraints on enterprise development remained in Viet Nam at the conclusion of the SCPL, including weak law enforcement, lack of transparency, and cumbersome administrative procedures.

To address remaining challenges—to sustain and accelerate reforms—there is a view that the historical approach to policy reform needs to change. This view asserts that further development of Viet Nam's economy in the 21st century will likely require substantial fundamental reforms aimed at creating more effective institutions

necessary to support markets and the increasing role of a diverse private sector in the economy. The implication is that the “step-by-step,” experimental approach to institutional reform may not be as effective in the future as in the past—that it would unduly constrain further private sector development by creating uncertainty and discourage large, longer-term private investment. This view stresses the need to focus on the implementation and enforcement of existing rules to create a stable business environment that will lead to competitive domestic enterprises, rather than creating yet more laws and regulations (see Doan 2004).

### *Subsequent Developments in SOE Reform Relevant to the SCPL*

By mid-2007, the number of SOEs was reduced to about 2,000, with a total capital of approximately \$31 billion, or about 31% of GDP. However, the SOE reform process reached a critical phase, involving the restructuring of large SOEs. The government, at this stage, planned to retain about 550 SOEs as wholly state-owned entities, and equitize the remaining ones, with an “equitization pipeline” for 2007 estimated at \$10 billion. A plan to equitize and list 71 large SOEs by 2010 was approved by the Prime Minister. “Strategic economic groups” were to be created in key sectors.

By 2007, the government was aware that a reform strategy of creating general corporations from large SOEs was not as effective as had been hoped. Therefore, the next major step in the SOE reform process was to group these corporations, along with various other SOEs, into 19 large conglomerates. In many cases, these conglomerates had a near monopoly in their product markets, particularly in the heavy industry sectors. This strategy also reflected a concern by SOEs of competing under World Trade Organization (WTO) rules that removed various government support to SOEs (including high tariffs, subsidies, and local content requirements) once Viet Nam joined the WTO in January 2007. At that stage, it was not clear that a conglomerate-based approach would result in competitive SOEs.

The more recent SOE reforms took place in a Viet Nam that was facing an overheating economy before the global economic crisis—challenges of success through rapid sustained growth—reflected in high and rising inflation, and a widening trade deficit driven by surging imports. The SOEs played an important role in this through aggressive investment that has contributed to a sharp increase in public sector borrowing in 2007, and crowding out what are seen as potentially more productive private sector borrowing and investment.

Accelerating SOE reform, including equitization and improved corporate management, was therefore seen as potentially improving the efficiency of public sector-related investment and the scaling back of unproductive projects. This was consistent with the basic objective of SOE reform and of the SCPL—to transform state enterprises into “competitive enterprises” accountable for their own operations and profitability, through reorganization, corporatization, and ownership diversification, including equitization. This remained a challenge, as reflected in the

poor profitability of SOEs. Furthermore, although larger SOEs soaked up as much as half of all business investment, they created far fewer jobs than either the nonstate sector (which also includes a large number of partially state-owned firms) or the foreign-invested sector.

Still, the government remains committed to retaining a key role for the state in the economy. However, there is also an awareness of the need to continue to improve the efficiency and productivity of SOEs. The long-term sustainability of reforms initiated under and linked to the SCPL is a function of continuing strong political support. This, in turn, requires building and maintaining a national consensus on a continuing reform strategy and its key measures—and the institutional capacity to implement change.

## Bumps on the Road to Reform: Politics and Institutions

Political acceptability and institutional feasibility play a central role in shaping reforms throughout the policy process. It is this role of politics and institutions that transforms the reform process from an exercise in technical problem solving, or “optimal policy design,” into a process of long-term societal change shaped by political economy factors. Many key political and institutional issues related to SOE reform in Viet Nam have already been noted at various points in the chapter. Based on the above discussion, this section highlights key issues related to the role of politics and institutions in SOE reform. These factors are also sources of uncertainty and risk in “government commitment,” the assumed guarantor of reform in policy-based lending (PBL), and the focus of the last part of this section.

### The Politics of Policy Reform

*Policy reform as consensus building.* SOE reform touches the very core of Viet Nam's transition to a market-based economy. In managing this transition, there has been a continuing commitment to retain a key role for the state in the economy, and therefore for SOEs in economic development—but there have been sharp differences and debate among key stakeholders over what that role should be. SOE reform involves political decisions—a problem in collective choice. From this perspective, as discussed, Viet Nam is a politically complex society: a multilevel, “multiplayer” environment for SOE reform, where key decisions based on national consensus are made. The politics of reform involves as players not only the government—meaning, central agencies such as SBV—but also the Communist Party, the National Assembly, different levels of government (provinces, districts, and communes) and ministries that control particular SOEs, as well as SOE management and labor (trade unions).

In addition, some of these players may themselves include differing perspectives that need to be reconciled, for example, different positions in the party on the role of the state in the economy and, therefore, on SOE reform. Within the policy decision process these players, singly or in combination, may be able to delay, block, or even reverse enterprise-level reforms. It is necessary to build and maintain consensus for change at various levels in shaping the endorsement, implementation, and sustainability of SOE reforms; where consensus has the game-theoretic meaning of ensuring either a preference for or indifference to such reforms by all players (and coalitions of players) with the power to block proposed reforms. This takes time and resources, and the outcome of the process, in terms of both the design and the implementation of particular reform measures, may be uncertain. In sum, SOE reform in Viet Nam is an extended—and continuing—exercise in political consensus building.

*Political ownership of reform.* The concept of ownership of policy reforms, as a fundamentally political concept, is reflected in the SCPL case. Given the multiplayer, consensus-based environment of reform in Viet Nam, the concept of “ownership” of reforms is complex and potentially uncertain. It requires that all key players with the interest and power to influence policy reform decisions and their implementation buy into the reform process. Ownership of reforms by government represented by a central agency such as SBV or even by prime ministerial decrees is necessary, but far from sufficient. Ownership of reform in this environment requires a collective ownership of reforms by all relevant political players with the power to shape outcomes.

*Role of bureaucratic politics.* The role of bureaucratic politics requires emphasis. The SCPL design reflected a bias toward high-level political decisions on reform in the form of specified government decrees and approvals by the National Assembly. However, an equally important factor in SOE reform related to the role of lower-level bureaucratic politics associated with the preferences, behaviors, and relative influence of both individual state enterprises—particularly the larger SOEs—and the institutions that control them (ministries, provincial and local governments). These agencies, through their actions, can modify, or even block, the implementation of high-level policy decisions. Effective reform requires ensuring in practical terms their support for particular measures at the enterprise level, or creating conditions under which they cannot exercise an actual veto over planned change. In the SCPL, setting targets for the corporatization of SOEs without an appreciation of the likely position of the enterprises involved introduced uncertainty and risk. Similarly, the limited involvement of state enterprises and associated agencies in the SCPL design process led to a lack of cooperation in the audit process required in preparing for corporatization.

*Politics as preparation for change.* People react to perceived threats to their quality of life; and what they do not understand they often see as threatening. Politics (formal and informal) is a way for groups in society that feel threatened by particular developments to attempt to exercise a veto over proposed changes. Therefore, a

lack of understanding of the implications of SOE reform and the corresponding behavioral adjustments needed in a new type of economy is an important factor in opposition to reforms. As noted earlier, surveys indicated that perhaps a majority of workers in equitized enterprises did not understand the conditions of their new employment. Confusion over the implications of equitization should not be surprising given the complexity of the changes involved, as reflected in higher-level political debates or in the extended negotiations over corporatization between ADB and the government.

## Institutions: Shaping and Implementing Change

*Institutions as rules of the game.* The SCPL was aimed, to a large extent, at helping change the rules of the game of economic management in Viet Nam. Many of the reform measures involved introducing new regulations and laws intended to change the institutional foundations of the economy. A key issue from this perspective is ensuring that the new rules of the game are effectively implemented to bring about desired changes in behavior over the long term. While the focus was on introducing institutional changes as new rules of the game, there was relatively less attention in the design of the SCPL on the behavioral and organizational requirements for implanting such change over time.

*Institutional capacity constraints.* A critical success factor in policy reform involves assessing and building the necessary institutional capacity for implementing change at the level of specific institutions and organizations. From this perspective, corporatization or equitization is, in effect, the end of the beginning of an extended process of organizational change required for transforming an enterprise (from its previous state as an SOE) into a viable firm. Change in legal status or transfer of ownership rights does not automatically bring about the necessary organizational skills needed for success in increasingly competitive product markets. Additional support may be required to build the necessary organizational and business-related capabilities that transform a former state enterprise into a competitive enterprise that must function in a new environment.

*Institutional design and uncertainty.* Policy reforms often involve the creation of new institutions, or the extensive redesign of existing institutions (or both). Although this may be an important and necessary part of the reform process, new institutions and institutional redesign involve significant uncertainty and risks. The establishment of the National Enterprise Reform Committee in 1998 (transformed in 2000 into the NSCERD to oversee SOE reform) was an important element of both the SCPL and the reform process, and an example of the issue. Although in principle, the overall role of NSCERD was clear (as reflected in the SCPL, for example), its effectiveness in practice was uncertain. As a new institution with a mandate to oversee overall SOE reform, it met resistance from institutions (government agencies and local governments) that had controlled particular SOEs, as well as from powerful SOEs.

It was also constrained in its technical and organizational capacity to address key issues related to reform, in particular, in its capabilities to monitor and enforce change at the level of implementing agencies and enterprises.

Creating new institutions or modifying significantly existing institutions involves an extended process of organizational design/change that requires building the requisite capacity for expected performance, and negotiating the effective role of the organization in the context of the existing network of related institutions.

## Government Commitment: Stability of Expectations

Government commitment is assumed to be the guarantor that planned reforms will be implemented and sustained, providing a level of stability of expectations and reducing risk and uncertainty for stakeholders such as investors and for IFIs in their PBL. Changing government commitment to reforms is a key proximate cause of risk in policy reform and in PBL. Changes in commitment can result from shifts in government *intent* to implement reforms, or from constraints on its *capability* to do so. These are very different in nature, as illustrated in the SCPL case.

Government commitment is usually used to refer to the intent of government to carry out reforms. In the case of the SCPL, indications are that the (central) government was committed to the reform measures in terms of the intent to undertake them. In fact, it was not prepared to commit to any proposed reforms until it felt politically ready to implement such reforms. The debate with ADB over corporatization is an example, as are the extended negotiations with the IMF over structural reforms. In both cases, the government was not prepared to agree to proposed reform measures until it felt they were consistent with its own reform agenda—the product, to a large extent, of a process of national consensus building—and therefore ready to act on them. At that point, government commitment—as formal endorsement of the SCPL with the intent to implement its reform measures—was perceived as generally credible.

With respect to government commitment as the capability to undertake reforms, the SCPL example suggests that different types of reform measures can have widely differing implications. One type of policy reform involves actions that are within the power of the central government and its agencies to fully implement. An example of this is the issuance of prime ministerial decrees. A second type of reform measure is dependent on the formal political decision process. In this case, government commitment means submitting measures to this process, but it cannot guarantee the outcome (such as the time taken for approval, or the ultimate form of the reform measure). An example is the submission of draft legislation to the National Assembly. A third type of reform measure is where government can enact reforms but cannot guarantee, even with the best of intentions, that these will be implemented as planned at the level of particular agencies and enterprises. This uncertainty arises either because political power related to the implementation of particular measures



(ministries, lower levels of government, individual enterprises) is diffused or because the institutional capacity to implement is not in place. The unmet targets for SOE corporatization and equitization provide a recurring example.

Overall, even if government commitment is in place in terms of intent, it is essential to understand commitment also as the capability to implement with respect to particular reform measures. The central issue is the extent to which the government can control the policy reform process sufficiently to act as a guarantor that specific reforms will be endorsed, implemented, and sustained, particularly as circumstances change. In the case of the SCPL, SOE reform is politically sensitive and institutionally complex and, therefore, government commitment has to be carefully assessed and monitored over time.

## Lessons Learned: Improving the Odds

The SCPL case presents relatively few “bumps along the road to reform” for a specific loan. However, in the broader context of SOE reform in Viet Nam, the bumps become more visible, and are, to a large extent, related to broader political economy factors conditioning the policy reform process. What general lessons may be drawn from the SCPL case with respect to the political economy of reform to improve the odds for design and implementation of reforms and, in particular, lead to more effective PBL supporting such reforms? The lessons from the case may be grouped into three general categories, as now discussed.<sup>62</sup>

### Preconditions for Policy Reform and Policy-Based Lending

*Understanding the players and the game.* As stressed throughout the case, SOE reform in Viet Nam touches the very core of the country's economic and social transformation. Therefore, it is politically sensitive and institutionally complex; and policy reform decisions are the outcome of a distinctly national process of consensus building and mutual adjustment. It is therefore essential to understand the policy reform process as it operates in Viet Nam with respect to SOE reform. This includes an appreciation of the key stakeholders—their potential power (individually and in coalitions), motivations, capabilities, constraints, and interrelationships—as relevant to SOE reform issues and potential reform measures; the political decision process, including how issues related to SOE reform are placed on the policy agenda, and endorsed for implementation; and how the implementation and the sustainability of SOE reforms are facilitated or constrained by the existing political and institutional environment.

<sup>62</sup> These are meant to be general lessons related to policy reform. For lessons specific to ADB, and perhaps of wider relevance to IFIs in approach policy-based lending, see ADB (2004).



*Scope and focus of policy reform program and related diagnosis.* Program design defines the scope and focus of reform, and sets both its political and institutional boundaries. Given the complexity of policy issues, defining program scope and focus—what to include and exclude, where to concentrate attention and resources—is a balancing act that requires effective diagnosis of the policy issues and identification of potential leverage points where reform initiatives can make a difference.

In the case of the SCPL, the policy matrix embodies a very wide, diverse, and ambitious reform agenda. There can also be advantages to focusing on fewer essential reforms in defining the scope and focus of a program to ensure both relevance and feasibility of reform measures from the longer-term perspective of effective implementation and sustainability. A variety of program designs are likely to be consistent with a given set of reform objectives. In the SCPL case, an alternative formulation of the program could have led to a different scope and focus (on removing domestic impediments to private sector development arising from a large number of small SOEs), with different political and institutional implications for implementation. It is advisable to explore explicitly alternative program designs, particularly from the perspective of implanting feasible and sustainable reforms under existing conditions in a given setting.

*Timetable for reform.* Formulating, implementing, and sustaining policy reform generally involve a complex, uncertain, and long-term process of change. Given the particular political and institutional complexities of SOE reforms in Viet Nam, time is an especially critical variable in the reform process. Time is needed to build political consensus, to strengthen institutional capacity, and to put in place necessary enabling conditions for SOE reform in a transition economy (such as changes in the tax system and a social safety net). If the objective of reform and associated PBL is to implant change, as distinct from simply putting in place stroke-of-the-pen reforms involving changes in rules, regulations, and decrees, program design has to reflect the long-term and uncertain nature of the reform process.

## Political Acceptability

*Assessing political acceptability.* In the case of the SCPL, there were uncertainties about the political acceptability of core reforms. As a consequence, the endorsement, implementation, and sustainability of key reform measures—in the sense of implanting change—were uncertain. Examples include the enterprise corporatization targets, effectiveness of the NSCERD in managing the SOE reform process given powerful competing interests, and implementation and enforcement of various legislation. A key requirement for effective reforms and supporting PBL is to assess the political acceptability of specific proposed reform measures, e.g., who are the key stakeholders and coalitions likely to support particular reforms; and who are the stakeholders and potential coalitions likely to attempt to block such reforms, with what options for action, and under what conditions. This is not a one-time task. As the experience with corporatization and equitization illustrates, political support

for particular reform measures may fluctuate over time. Within this context, as reflected in the SCPL case, implementing agencies are also important stakeholders in the reform process, and may have the incentive and even the power to modify or block particular reform measures.

*Promoting public awareness.* As reflected in the case, there was limited public understanding of the implications of key reforms such as equitization, and of options for adjustment to their impacts. A requirement for feasible reforms is to promote effectively public awareness and understanding of both the nature of the policy issues and of the implications of proposed policy responses (reform measures). This is particularly important when reforms change the rules of the game in a society with respect to jobs, incomes, and social services. Certain vested interests—reform losers—are inevitable in a process of change. However, it may be possible to expand the base of support—or at least reduce the resisters to change—through effective public education, supported by appropriate economic and social adjustment programs.

*Linked nature of policy issues and political sequencing of reform.* Policy issues are often interrelated, or linked. Touching the very core of the economic transition in Viet Nam, the SOE reform program is intertwined with a wide range of policy issues and reforms. For example, reform of the financial system has direct implications for SOE reform given the role of state bank–related SOE debt, while the implementation and reform of the Labour Code and social safety net legislation has important implications for the social impact of measures such as SOE equitization and divestiture. In addition to technical sequencing of reforms in economic adjustment, political sequencing is as important. That is, if certain conditions are needed to be in place for particular SOE reform measures to be politically acceptable, introducing the SOE reform measure prematurely is unlikely to be effective and may undermine introduction of those reforms again at a more appropriate time.

## Institutional Feasibility

*Assessing institutional feasibility of proposed reforms.* As the SCPL case illustrates, policy reforms are generally “institution intensive,” requiring institutions/organizations that have both the capability and the incentive to implement such reforms. A key challenge in designing feasible reforms is to assess the institutional requirements for implementation, and to ensure that the necessary organizational capabilities are there (or are put in place in time). If institutional analysis reveals significant gaps between existing and required capacity, either the program design needs to be adjusted to reflect such constraints, or the capacity of implementing agencies needs to be strengthened.

In the case of SOE reforms and the SCPL, examples of institutional constraints relate to the capabilities and intentions of individual enterprises to implement planned reforms such as equitization, and to make the transition to market-driven organizations, as well as the capabilities of NSCERD to manage the implementation

of the SOE reforms at the enterprise level. Policy reform is fundamentally about ensuring that the requisite institutional capacity is in place in time, which in turn, may require time and resources, particularly if it involves significant changes to existing organizations or the creation of new institutions.

*Participation of key central and implementing agencies in program design.* Reform is ultimately about implementation and sustainability. In this context, it is essential to ensure that key central agencies with the power to influence outcomes are part of the design process. Furthermore, the institutional feasibility of program design can be significantly strengthened through participation of key implementing agencies that must, ultimately, undertake the proposed actions.

In the case of the SCPL, the primary participants in the program design process involved SBV and the ADB team. Powerful central agencies—the Ministry of Finance, the Ministry of Planning and Investment, and line ministries that controlled particular SOEs, as well as key enterprises responsible for implementing specific reforms, were generally not core participants in the program design process, although they were consulted. Thus, the likelihood of effective and timely implementation of core reforms at the enterprise level was uncertain, as reflected in the corporatization targets for example. There was evidence of resistance to change based, in part, on insufficient understanding of planned reforms, as in the reluctance by some SOEs to participate in precorporatization audits. Considerable time and resources, to a large extent insufficiently anticipated at the program design stage, were needed to enlist the necessary cooperation of individual enterprises and related agencies. The implication is that it is important to involve organizations with key roles in the implementation of policy reforms early in the design process to ensure that the planned reforms are feasible and that the implementing organizations understand—and do not block—reforms.

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# Assessing the Political Economy Factors Important for Economic Reform

Ron Duncan

## Introduction

The need to understand the political economy context of a country in order to design and implement economic reform effectively is now fairly widely accepted. Much progress has also been made in identifying the political economy issues that need to be understood to achieve effective reform design and the important factors in achieving effective implementation of economic reforms.

Chapter 1 described a framework to assist policy makers in understanding the political economy context and process to help in designing and managing policy reforms. Chapters 2–4 used country case studies to illustrate how the framework can be applied in ADB operations.

This final chapter outlines ways in which practitioners looking to design and implement reform can assess the importance of specific political economy factors of an industry, sector, or country to give priority to those factors most likely to inhibit or promote reforms at each stage of the process. Whether assessed in quantitative or qualitative terms, having a better understanding of specific factors that make up the political economy of a country can help inform judgments as to whether reform is possible, and to focus on what can be done to improve the chances of adopting and implementing reform. The chapter draws on selected economics literature and studies carried by the Australian Agency for International Development (AusAID), the Department for International Development (DFID) of the United Kingdom (UK), the United Kingdom's Overseas Development Institute (ODI), and the World Bank.

## Understanding the Political Economy of Economic Reform

Over the past decade or so, development agencies have expressed awareness of the need to undertake development assistance—especially assistance involving economic reform—only when it is underpinned by a good understanding of the local context. However, they placed little emphasis, until recently, on appreciating a client country's economic, political, social, and cultural characteristics and the interactions among them. They gave even less emphasis to understanding the political economy of economic reform processes.

Understanding the economic, political, social, and cultural characteristics of a society and the interactions among them is broadly the field of political economy—an area of interdisciplinary study that draws mainly on the disciplines of economics, politics, and law to explain how institutions, politics, and the economic system interact, whether nationally or internationally, to produce economic outcomes. Other disciplines, such as sociology, anthropology, and human geography, also make contributions to political economy.

Economic reform can mean changing existing institutions, policies, laws, and regulations. Such change will rarely be easy, since these elements have been shaped by existing political, economic, and cultural forces. Hence, understanding the local context to provide assistance in designing, getting accepted, and implementing reform also implies some knowledge of how to change the status quo.

### Early Research

Two early political economy research projects on the success of economic reform in developing countries were Williamson (1994) and Bates and Krueger (1993). The Williamson volume concluded that the evidence strongly suggested the need for a strong political base, for visionary leadership, and for a coherent economic team for reform to succeed. It also concluded that authoritarian or right-wing governments are not necessary for successful reform. However, Williamson offered few insights into the political processes or the institutional arrangements that make possible effective implementation of reform (Duncan 1995).

The Bates and Krueger volume was somewhat more insightful. They suggested that the outcome of reform is subject to such uncertainty that interest groups' decisions are influenced more by ideology than by statements about the incidence or impacts of policies. They concluded that, because of uncertainty over the future size and distribution of the benefits of reform, and the more immediate and concentrated nature of reform's costs, the status quo is likely to be maintained unless there is a change of government. They pointed to exceptions, however, such as Mexico. They

suggested that in countries with one-term presidents, such as Mexico, reforms may be undertaken that would not be considered if the president was running for office again—different from those democracies where the political term is not fixed and leaders struggle to remain in power.

Bates and Krueger also pointed to the importance of a well-trained team of policy advisors who are somehow protected from interest-group pressure. This conclusion highlights the importance of education in developing cadres of highly skilled, local advisors, as well as the need to understand countries' political, cultural, and institutional systems.

Following the Bates and Krueger and Williamson studies, there was little in the way of political economy research of the factors underpinning economic reform and why some reform attempts succeed and some fail until, following the seminal work on institutions by North (1990), there was more widespread realization of the importance of state institutions in explaining behavior related to development, and of understanding the local context, for development assistance to succeed.

The new institutional economics (NIE) approach pioneered by North has played an important role in studies of the political economy of developing countries with respect to economic reform. The NIE approach focuses on the basic institutions of a society and the rules of behavior that they establish. These rules provide the incentives to which the various stakeholders involved in the process react. Institutions may be formal, such as constitutions, electoral systems, and property rights, or informal, such as the norms of traditional societies or the behavioral norms of groups such as accountants and real estate agents.

Linked to the NIE approach has been extensive study of the political economy of economic reform in developing countries over the past decade or so. Initially, the studies focused on the interactions between economics and politics in the reform process. But these studies led to staff frustration in the development agencies, particularly officers in the field, who argued that these political economy issues were reasonably well understood; what staff really wanted to know was how to bring about change. The most recent studies have been more focused on this particular question.

The World Bank began its institutional and governance reviews in 1999. These were relatively narrowly focused on the institutional roots of government performance, although still taking account of the country's political realities. In 2002, DFID published its first study on drivers of change (DOC). Around the same time, ODI began studies of reform processes using a framework that it described as a blend of political science, sociology, and anthropology. In 2005, ODI also initiated studies of reform using the DOC framework. The DOC analysis was seen as a way "to describe in a robust, evidence-based way the underlying factors which shape the incentives for economic, social and political change" (Booth et al. 2005). In particular, it was seen as an attempt to explain the "lack of political will" commonly identified as being the

main obstacle to economic reform (Booth et al. 2005). However, the DOC analysis offered no suggestions as to priorities for action or for how progress in any one of the political or economic DOCs could be brought about. In fact, it presented no analytical basis from which to identify priorities for action or the means to bring about changes—a reason for operational staff frustration.

A 2006 World Bank study of a successful effort to reform the legal infrastructure governing public procurement in the Philippines—the Government Procurement Reform Act 2003—generated useful operational recommendations (Campos and Syquia 2006). While this reform related to passing a law, it had lessons for how to generate successful policy reform, the main one being the need to create a coordinated team capable of responding to problems—unforeseen or anticipated—as the reform process unfolded, including mechanisms to deal with obstacles on a daily basis. Other elements important in getting the law passed were the production of in-depth technical studies of the implications of the law, a well-thought-out communications strategy to mobilize public action, and the fostering of support from knowledgeable legislators.

The year 2007 saw a larger number of development agencies become interested in these political economy issues. For example, AusAID commissioned a DOC study on Vanuatu (Cox et al. 2007), which identified various economic and political obstacles to better economic and development performance, but without any prioritization of the changes needed or advice on how to achieve them. Also, under a regional technical assistance project, Strengthening Country Diagnosis and Analysis of Binding Development Constraints in Selected Developing Member Countries, ADB initiated a series of studies on binding constraints.

## Where Are We Now?

In 2008, the World Bank hosted a workshop on sequencing public financial management reform. Edward Hedger of ODI summed up what that organization had learned from its many political economy studies about the factors contributing to the success of such reform. He identified six success factors: political commitment (leadership), senior technocratic leadership, organizational strategic management capability within the public sector, domestic demand for reform from outside the executive, appropriate and coherent external technical advice (and pressure), and logic and coherence of technical reforms.<sup>63</sup>

Except for the fourth factor (domestic demand for reform from outside the executive), these lessons replicate those that can be drawn from Bates and Krueger (1993) and Williamson (1994). The fourth factor is now generally understood as the necessity of promoting domestic “ownership” of reforms if they

<sup>63</sup> <http://blog-pfm.imf.org/pfmblog/2008/07/from-diagnosis.html>

are to be successful. The World Bank study on the passage of public procurement legislation in the Philippines (Campos and Syquia 2006) confirms the success factors identified by ODI, as well as the need for a well-developed communications strategy to mobilize public action.

A more recent study by ODI, funded by DFID, illustrates the progress that has been made in thinking about the role of political economy analysis in assisting with the implementation of economic reforms (Booth and Golooba-Mutebi 2009). This study adopted what it called a “layered” approach to the political analysis of road reform in Uganda, and added a wider range of political economy tools than DOC analysis had previously used. The layers were

- identification of systemic constraints, through the use of, say, binding constraints analysis or DOC analysis;
- analysis of the pattern of stakeholder interests, direction, and extent of their influence, and the factors influencing their choices (essentially, what incentives are they responding to?); and
- assessment of the “room for maneuver,” or scope for different outcomes.<sup>64</sup>

This approach recognized that political economy analysis must go beyond describing the relationships between economic, political, social, and cultural factors, and move toward identifying the incentives to which the stakeholders are responding and determining whether the incentives can be changed in order to generate different behavior.

Booth and Golooba-Mutebi (2009) examined whether there was scope for movement on the needed reforms with respect to (i) a shift in presidential priorities, (ii) recent institutional changes opening opportunities for reform, or (iii) the dynamics of the reform process. They decided that (iii) offered the most realistic possibilities for donor-supported action to “tip the balance in a pro-reform direction.” While they made no formal analysis of the incentives that the various stakeholders were responding to, the authors’ overall approach took research in this area closer to the goal of generating operationally useful recommendations.

The point that political economy studies reached in Booth and Golooba-Mutebi (2009) is similar to that reached by Duncan (2009) in an ADB report on Kiribati. An earlier study carried out for the World Bank (Duncan and Nakagawa 2007) had identified the binding constraints to economic growth in Kiribati as being clientelist politics, resulting in nepotism, corruption, and conflicts of interest in contract awards rather than the provision of widespread public goods. Duncan and Nakagawa (2007) argued that politicians operating in such an environment prefer not to support security of property rights and contract enforcement—institutions that encourage private sector development—as establishing them will undermine the payoff from rent seeking.

<sup>64</sup> This layer draws on the work of Grindle (2002).



In the Duncan (2009) study, the Institutional Analysis for Development (IAD) framework developed by Ostrom et al. (2001) was used to investigate the role of political economy in preventing collective action leading to the provision of public goods. In an effort to understand how it may be possible to bring about economic reform, Ostrom et al. (2001) placed the new institutional economics into an IAD framework to gain an understanding of the behavior of the groups that have an influence—for better or worse—on economic development in a country.

The IAD framework is based on the assumption that most problems in development result from the inability of a society to take the necessary collective action to deliver public goods and manage common-pool resources effectively. However, if the established incentives, or “rules of behavior,” of the society provide weak or perverse incentives to individuals or groups to act collectively for their common good, the delivery of public goods and management of common-pool resources will be adversely affected.

As Ostrom et al. (2001) correctly point out, it is difficult, if not impossible, to change the characteristics of public goods or services or to change the culture of a society. Trying to change the incentives faced by the stakeholders involved is usually the only avenue open to achieve a different outcome. But as they also point out, any transformation of the incentives needs to take full account of the characteristics of the community and its physical, economic, political, and social circumstances. Most important, it must be understood that those currently advantaged by the status quo will resist any changes in the rules that do not benefit them.

Duncan (2009) finds that, in Kiribati, the full range of economic binding constraints to growth appear to be in place: access to credit is limited, returns on private investment are very poor, and there are constraints on the scope for firms to acquire the full value of any returns on private investment. However, these are clearly not the primary obstacles to better economic growth. These obstacles are dominated by the welfare-dependency mind-set that prevents collective action from adopting economic policies that would lead to improved economic performance. The necessary collective action is not taking place because the costs to individuals from collective action to adopt reform policies—which entail forgoing dependence on the state—are perceived as outweighing the benefits of the reforms. Moreover, the costs to individuals of giving up their dependence on the state are very obvious, while the benefits of economic reform in terms of more jobs, higher incomes, and improved public services are highly uncertain.

Similar to Booth and Golooba-Mutebi (2009) on Uganda, Duncan (2009) identified that “room for maneuver” for reform in Kiribati was provided by the President’s interest in reforming some of the many state-owned enterprise (SOEs) dominating the economy and the presence of a small group of senior public officials who understood and sympathized with the need for reform. Duncan (2009) also recommended the provision of technical assistance to develop material to promote

public understanding about the reforms as well as provide continuing support to the President and his team.

ADB has noted these political economy studies and in 2010 took a political economy approach to evaluating its support for public sector reforms in Pacific developing member countries (see ADB 2010; and Chapter 3, this book). The analytical approach adopted for the evaluation followed the five-step framework outlined in Chapter 1 of this book. The evaluation of public sector reform in the Pacific confirmed many of the lessons identified such as the importance of identifying leaders of the reform and the need to build lawmakers' understanding of the reform; the need to promote public ownership of reforms; the pursuit of moderate, sequenced reform may be the most realistic approach where institutional capacity is limited; consideration of the cultural context is important in the Pacific; and there may be the necessity for continuous support from appropriate development agencies over a long period.

A report from the World Bank (Beuran, Raballand, and Kapoor 2011: 3) recognized that translating political economy analysis into action "remains a challenge." It examined the outcomes of the many political economy studies carried out by the World Bank in Zambia through interviews with World Bank task managers to assess the relevance of the studies to the design and implementation of policy reform. The study showed that reform of the telecommunications and energy sectors was enhanced by changing the focus of the policy dialogue.

In telecommunications, the focus of the policy dialogue was changed from an emphasis on how the reforms would enhance the efficiency of the sector to emphasizing that the high utility costs were hurting consumers and Zambia's competitiveness. In the energy sector, the policy dialogue was changed from an emphasis on the need to increase the low electricity tariffs to the objective of improving access for a large part of the population, especially rural. Hence, understanding the political economy can help in "selling" reforms. In both these cases, it appears that a focus on the distributional impacts of the reforms was more helpful than a focus on the resource allocation impacts (but a somewhat esoteric issue as far as the noneconomist is concerned).

A research project funded by ADB on the political economy of economic reform in the Pacific (Duncan 2011) confirmed and added to the earlier lessons. It confirmed the importance of political and senior civil service commitment (leadership); organizational, strategic management capability within the public sector, such that it can respond to events as the reform process unfolds; a well-constructed communication strategy designed to inform the public and develop and sustain its support ("ownership") of the reform; and appropriate and coherent external technical advice (and pressure).

The experience of successful reforms in the Pacific demonstrates the importance of reform champions in both the political and bureaucratic arenas, according to Duncan (2011). Moreover, stability in this leadership during the lengthy reform

processes was critical, as was leaders' influence in widening support among the various stakeholders. The reform leadership also benefited from having a support team capable of responding to events over the life of the process; in-depth studies to support the reform leadership; and comprehensive communications strategies to generate public understanding of the reforms, allow concerns to be expressed, develop ownership of the reforms, and mobilize public action. National summits, or retreats, involving all stakeholders have also featured prominently in public consultations in the Pacific.

Duncan (2011) draws additional reform lessons: the reform champion need not necessarily be an individual—the champion may be an organization, as in the case of the Papua New Guinea telecommunication reform where the champion was the PNG Independent Consumer and Competition Commission; an international treaty with “teeth” (such as those of the World Trade Organization) can be a useful mechanism for initiating and sustaining (locking in) reform; local actors may well perceive the changes involved in reforms as much larger than do the development agencies or consultants providing technical assistance, and so consideration must be given to local perceptions of reforms, and it may be helpful to take a piecemeal approach; the demonstration of widespread consumer benefits from earlier reforms or reforms in other countries can stimulate current reform efforts, a point that ties in with the importance of generating in-depth studies to demonstrate the benefits of the reform; it may be important to ensure that the reforms are in harmony with cultural practices. This last lesson was also identified in ADB (2010). Although it may be possible to bring about some change in culture, expectations about the extent of such change should be realistic—thus, reforms should give thought to adapting institutions and policies to fit with the existing culture.

## Assessing Political Economy Factors

We now have a good idea of how to go about implementing an economic reform. But we still do not have a good idea of the political economy factors that will be important in whether or not an attempt at reform will be successful. These are the factors that are identified through analysis such as the IAD framework of Ostrom et al. (2001). In particular, how intense is the resistance to the reform by the various stakeholders likely to be? Stakeholders include politicians, bureaucrats, businesses, unions, SOEs, nongovernment organizations, and society at large (as consumers, taxpayers, and special interest groups) (see [Table 5.1](#)). Further, where does most effort have to be given in influencing the views held by the various stakeholders or to eliminate or offset the perverse incentives to which stakeholders resisting the reform may be responding?

If we are to have measures of the factors influencing the depth of support for—or resistance to—a reform, we need to be able to measure these factors in some

quantitative or qualitative manner. For example, on the position of governments and politicians to a reform, do they have a direct (pecuniary or other) interest in the status quo; or is their resistance due to an ideological or philosophical position? There is, of course, the possibility that the current government will not remain in power. This problem of time inconsistency with respect to governments is an issue that is never absent and therefore it may well be an issue that reformers should, in the end, ignore.

As far as bureaucrats are concerned, to what extent do they exercise salutary control over the public's behavior as regards the status quo—for example, regulations provide a “lever” for bureaucrats to extract monetary or other rewards from the public. Businesses may benefit from the status quo through the provision of monopoly positions as a result of government policies—for example, the establishment of tariffs or other barriers to imports. Businesses may have relationships with politicians that benefit both parties. Unions may also benefit from the establishment of monopoly business positions, as through import restrictions. They, too, will thus share a common interest in maintaining the status quo. SOEs are usually already in privileged positions as the result of government restrictions on the entry of private investors into the sector. Unions associated with labor employed in SOEs will usually support the continuation of the restricted entry.

As far as consumers/taxpayers are concerned, what is the extent of public understanding of the benefits and costs of the status quo and of the potential benefits and costs of the proposed reform? Is there a perceived lack of society support for the reform for cultural reasons or for other ideological reasons? The resistance to a reform by politicians, businesses, unions, SOEs, and other pressure groups will likely only be overcome through societal pressure. Therefore, a judgment will have to be made as to the likelihood that societal resistance to the reform can be overcome through the provision of information about the potential benefits and costs of the reform. But how likely is it that the government will respond to societal pressure? In a society where decision making is a top-down process, with people generally unwilling to challenge the government or other elite, there may be less room for optimism about influencing reform through societal pressure.

In assessing the acceptability of the reform to society as a whole, consideration will also need to be given to the social context of the reform. For example, are the costs of the reform likely to be concentrated by region or by industry? Will the reform improve income equality in any way? Further, as seen in Zambia (Beuran, Raballand, and Kapoor 2011), it may be important to assess how best to “sell” the reform to the various stakeholders (promoting the reforms in terms of improving income distribution rather than resource allocation).

To take another example, the experience with tax reform in the Philippines (Chapter 2) pointed to the difficulty of promoting tax reform to the public on the basis of the existing fiscal unsustainability as being “too technical and uninteresting to the man on the street.” The popular sentiment, as often the case, was that the tax

deficiency could be overcome by the government directing its efforts toward catching tax evaders. It was not until a group of highly respected economists from a leading university publicized the critical nature of the fiscal problem that the public began to change its mind about where attention should be directed.

Therefore, for a particular reform, it would be highly desirable to undertake an IAD analysis to identify the stakeholders likely to be involved and the incentives determining their present behavior. Such analysis will also help in identifying the changes that may be needed in the stakeholder incentive structure to generate support for the reform. The attitudes of the various stakeholders toward a proposed reform could be measured by means of opinion surveys of the stakeholders themselves.

We can see from SOE reform in Viet Nam (Chapter 4) how numerous important stakeholders may be and the variety of incentives involved. In that case, the design and implementation of the reform program had to take into account the Communist Party of Viet Nam, the National Assembly, the central government, the three levels of local government, the managers and workers in SOEs, the unions, the many implementing agencies, as well as the private sector. But too little attention was given to the views of the implementing agencies (including the SOEs), which eventually caused difficulties in carrying out the reforms. Also, the incentives that had to be taken into account ranged from the ideological position of the Communist Party on the role of the state in the economy to the social issues concerning workers likely to be displaced by the reform.

It is important that all interested reform stakeholders be identified and the strength of their resistance to, or support for, the reform be measured. Failure to do this underlies many of the difficulties experienced in implementing and sustaining reforms. For example, Chapter 3 on reform in the Pacific notes that the design team worked closely with the ministry of finance in developing the reform program but had limited consultation with other ministries and with the public. The lack of ownership by other ministries had adverse implications for the implementation of the reforms for which they had responsibility. By contrast, the use of widespread public consultation in the Federated States of Micronesia is credited with the initial success of the reform program.

It is anticipated that a good understanding of the political economy factors that will be important in determining whether a reform will be successful will influence the five steps in the policy reform process—initiating reform, managing the complexity of policy issues, endorsing reform, implementing reform, and sustaining reform. The understanding of stakeholder interests in the reform should allow anticipation of the problems likely to be faced in each of these steps and assist in devising ways to overcome the resistance.

## Indicative Measures of Political Economy Factors

For a general assessment of the likelihood of policy reforms being accepted, it is proposed that the attitudes of the various stakeholders (governments, politicians, etc.) to the policy reform process be assessed by the use of proxy, or indirect, measures that are hypothesized to test whether they are likely to be in favor of or opposed to reform (Table 5.1).

**Table 5.1**  
**Changes in Reform Features through the Reform Stages**

Stakeholders	Indicators of Potential Resistance
Government/Politicians	Extent and level of trade restrictions Barriers to foreign investment Extent of licensing of businesses Number of SOEs Political stability Governance indicators on Voice and Accountability and Rule of Law
Bureaucrats	Share of public service employees in total employment Extent and cost of regulations applying to business and other private activities Capacity of the public service to design and implement reforms Governance indicators on Corruption and Rule of Law
Private businesses	Extent and level of trade restrictions Barriers to foreign investment
SOEs	Number of SOEs Share of SOE employment in total employment
Unions	Extent and level of trade restrictions Barriers to foreign investment Involvement in SOEs
Nongovernment organizations	Media freedom Voice and accountability Recognition of such organizations by government
Society (consumers, taxpayers)	Voice and accountability Distributional impact of reform (by region/industry/income category) Media freedom

SOEs = state-owned enterprises.

Source: R. Duncan.

The selection of these measures is based on the proposition that most stakeholders respond to incentives—usually monetary incentives of some form. These general measures could also give some guide to the ways by which to assess the likelihood of adoption of a specific reform. These measures are only indicative and the analyst should choose measures that appear to be appropriate for the kind of reform considered.

*Governments/Politicians:* It is proposed that the more widespread the use of government intervention in what is usually considered to be private sector activities, the less interested politicians and governments will be in economic reform. Areas where such restrictions may be applied are the following: trade, investment, SOEs, and business licensing. Restrictions in all of these areas create “rents” that governments and politicians can distribute to curry favor with selected special interests. Restrictions on imports create monopoly power for local firms; these may be domestically financed firms or they may be established foreign firms that wish to have a monopoly position against the threat of other foreign firms entering the market. For small, developing countries, where most goods used by consumers and producers are imported and where administrative costs of most taxation measures are high, a case can be made for the use of a low tariff applied to all imports. In these cases, the tariff is essentially the same as a value-added tax but without the much higher administrative costs of levying the tax.

Barriers to foreign investment are established primarily to protect domestic interests—whether financed by local or overseas investors—against competition from other foreign investors. Such barriers foster unhealthy relationships between existing investors and politicians/governments. Licensing businesses can also create rents for politicians in much the same way as barriers to trade and foreign investment. Conflicts of interest between ministers’ responsibilities and their personal affairs should also be scrutinized.

Arguments for setting up SOEs to undertake activities that the private sector is well equipped to carry out have been widely negated, and the continued use of SOEs is now seen essentially as a rent-creating device. This is even true of the use of SOEs to continue what were once seen as natural monopolies. However, even for such utilities (power, water, and telecommunications), the economic arguments for the state undertaking these activities have largely disappeared given that the “unbundling” of the activities and the introduction of competition have led to the proper role of government being seen as solely that of regulator. Still, politicians and governments are usually supportive of existing SOEs as they usually have some control over the activities of the enterprise. As well, board and managerial positions of the SOE are usually filled by government appointees, which means that the government is thereby able to reward supportive behavior.

As seen, political stability is a positive factor. On the other hand, coalition governments—which are often unstable—can lead to poor governance and to difficulty in introducing economic reforms, as observed in the Pacific (Batten 2011).

Minor parties or individual politicians who can exercise some control over a coalition government can exercise undue influence over the policies adopted. As seen in Chapter 3 (the Pacific), the high incidence of changes in governments due to no-confidence votes and slender majorities or minority governments has put on hold or reversed many of the reforms undertaken. Ultimately, however, the sustainability of governments and therefore of reforms cannot be guaranteed.

The level of “voice and accountability” in a country is now recognized as an important indicator of the ability of broader society to have influence over government policies. The greater the power exercised by elite groups, the less will society’s voice be heard in discussions of possible change from the status quo.

*Bureaucrats:* A large share of public service employees in total employment is usually a sign of significant intervention in an economy’s activities. Such employees and their unions will usually be resistant to any policy change that threatens their number or influence. For bureaucrats, regulations can establish beneficial control over the activities of businesses and society more generally (such as licenses to establish a business or to license and drive a motor vehicle) and thereby provide scope for monetary or other reward. Bureaucrats can be expected to be reluctant to give up any such “levers.”

The capacity of the public service to implement reforms must also be considered. For example, in the small Pacific states, the personnel and skill levels available in the public service are often very limited. The migration of one or two skilled personnel can devastate a ministry’s ability to carry out reform in, for instance, legislation or SOEs under their jurisdiction. Chapter 3 noted that weaknesses in the Public Service Commission in the Cook Islands lessened its ability and willingness to implement a performance-based public service assessment system. Capacity development and/or capacity supplementation may therefore be necessary before reforms are attempted. And as seen in Chapter 2 on tax reform in the Philippines, difficulties were experienced in implementing the reform due to governance failings in the public service because of the high level of corruption and poor adherence to the rule of law. Institutional reform to overcome such problems may be essential before implementing reforms that depend upon good governance in the public sector.

*Private sector businesses:* The higher the level of trade restrictions and the more extensive they are, the more likely will existing local businesses resist reform, particularly of trade policy. Existing businesses are also likely to be less supportive of reform, the more that use is made of barriers to foreign investment and licensing of businesses, as such regulations generally act to protect existing businesses.

*State-owned enterprises:* SOEs can be expected to oppose any reforms that introduce competition into their area of operations. The number of SOEs and the share of SOE employment in total employment are good indicators of the power that SOEs will be able to exert over changes in policies related to their area of operations.



*Unions:* Unions affiliated with businesses that benefit from trade or investment barriers or business licensing requirements will usually resist changes in these policies. Therefore, measures of the level and extent of trade and investment barriers and use of business licensing requirements will give a good indication of the resistance likely to come from such unions.

*Nongovernment organizations:* The greater the media freedom and the more open and transparent the government, the greater the ability of nongovernment organizations to influence the government. Of course, not all these organizations favor the economic reforms proffered by policy makers. For their part, some governments are unfavorable to these organizations' activities and place restrictions on them. Such restrictions can be seen as a measure of the government's attitude toward openness.

*Society (consumers/taxpayers):* Similarly, society's ability to influence debate over economic reforms will depend, to a large extent, on its access to government as measured through indicators such as voice and accountability and media freedom. The likely distributional impacts of the reform (both costs and benefits) will point to where resistance to the proposed policy change is likely to come from and where support may be found. Measuring the likely distributional impacts will generally require some in-depth study, but this should also be an integral part of the analysis of the reform proposal.

## The Influence of Culture

Cultural characteristics heavily affect a society's attitudes toward policies and changes in policies and indeed on many of the stakeholder indicators listed in [Table 5.1](#). How can we classify societies with respect to how culture may affect attitudes toward reform? Some of the most useful writings in this field are by Geert Hofstede on the classification of societies by cultural characteristics. The fact that the classification is operational is appealing. Moreover, it is consistent with the views of economists, such as North (1990), on the role of institutions in economic development.

Hofstede (1980) classified societies along four cultural dimensions: uncertainty avoidance—a society's tolerance for risk and uncertainty; power distance—the extent to which members of a group will accept that power is distributed unequally; concepts of masculinity and femininity—the expected gender roles in a society; and individualism versus collectivism—the degree of individual or collective orientation. In later work (Hofstede and Bond 1988), a fifth dimension was added after studying successful East Asian economies: long-term versus short-term orientation—long-term orientation values thrift and future rewards, short-term orientation values the past (respect for tradition) and social obligations.

All these “dimensions” or characteristics of a culture have implications for its economic development and for its attitudes toward policy change; there is also interaction among them. A culture that has a higher risk preference is more likely to invest in new ideas and be more willing to undertake policy change. One can think of Chinese culture with its very high savings rate as valuing thrift yet tolerating high levels of risk in undertaking policy change.

A society that has a higher tolerance for hierarchical inequality will likely tolerate more income inequality and will probably have more difficulty in achieving good governance because of its unwillingness to sanction the politically powerful. Societies that tolerate men having a more powerful role than women in society will suffer because, in doing so, they forgo the full value that women can offer. One can think of Pacific island societies as conforming to these characteristics.

Whether a society is basically individualistic or collectivistic will also have an important impact on acceptance of change. This is not meant to imply that some societies that are essentially individualistic may not also have some more sympathy for collective action than others. But if a society is essentially collectivistic, the value placed on sharing is uppermost. On the other hand, we associate an individualistic society with personal achievement, saving and investing, and individuals looking after their own families. The differences between the indigenous Fijian and Indo-Fijian peoples of Fiji with respect to these cultural characteristics are quite obvious, with, for example, Indo-Fijians being more willing to save and invest in their children’s education and indigenous Fijians being less willing to save but focus instead on current consumption, often following cultural traditions.

Reference to the cultural characteristics of a society is important because it has always to be kept in mind that culture changes only very slowly. Therefore, the adoption of a reform should not be based on an assumption that the society’s culture can be changed.

## Measuring Indicators of Stakeholder Behavior

Many of the stakeholder behavior indicators discussed are amenable to direct quantitative measurement, such as level and extent of trade barriers, number of SOEs, and share of SOE employment in total employment. Single indicators are not available for others, such as political instability or conflicts of interest with respect to ministerial responsibilities, but these may be assessed through reports, for example, on the number of changes in government or the difficulties experienced in getting legislation through parliament.

Qualitative measures of other indicators, such as voice and accountability, media freedom, and extent and cost of business licensing, are available through published information such as the Governance Matters Indexes and the Cost of Doing Business Indexes periodically published by the World Bank Group. For example,

the World Bank's annual Cost of Doing Business Index provides assessments of the costs of starting a business, registering property, and closing a business.

We have seen that it is important to understand the stance that will be taken by various stakeholders to proposed economic reforms if the chances of successful design and implementation are to be maximized. Moreover, it is desirable to be able to measure, in some way, the attitudes that stakeholders are likely to adopt toward reform. This will show where most effort will need to be directed in attempting to influence the uptake of the reform.

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## **Managing Reforms for Development**

### **Political Economy of Reforms and Policy-Based Lending Case Studies**

Reforms challenge the status quo, often threatening those with a stake in the current system, even if the status quo is unsustainable. Institutions also need the capacity to implement and sustain reforms to meet expectations from change. The political and institutional changes resulting from reforms have to be managed until the success of the reforms becomes apparent. The Asian Development Bank, for more than 2 decades of supporting reforms, has found that no blueprint for success exists; however, there are clues as to what may work, and how the reform process can be better managed. The book aims to help those involved in the policy reform process to understand the political economy factors that influence the change process and of the assistance to support reforms.

### **About the Asian Development Bank**

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.7 billion people who live on less than \$2 a day, with 828 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

Asian Development Bank  
6 ADB Avenue, Mandaluyong City  
1550 Metro Manila, Philippines  
[www.adb.org](http://www.adb.org)