



Governance in Southeast Asia: Issues and Options*

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Until the Asian financial crisis occurred in mid-1997, the high-performing Asian economies were dubbed as the new crown jewels of governance. With public institutions believed to be functioning remarkably well, good governance was seen as partly responsible for the region's phenomenal economic strides. A half decade of turbulence, however, beginning with the financial meltdown, followed by a severe recession in 1998, and continuing with the sharp slowdown today, has made this view quite untenable. The governance gains turned out to be a little overblown.

The crisis left the public sector with new governance pressures. With increased debt levels and ballooning budget shortfalls, and the real possibility that social spending would be sacrificed in favor of interest payments, Southeast Asian governments have been forced to practice greater efficiency in the use of public resources. Soaring contingent liabilities, the result of moral hazard (implicit guarantees) in the financial system and the infrastructure sector, have raised demands for greater transparency and accountability in government transactions, and a clamor for more reasonable regulatory practices. Civil society initiatives in combating corruption have brought about changes, especially in political leadership, in a number of Southeast Asian countries (World Bank 2000).

In short, the economic downturn uncovered dormant afflictions (for example, corruption), intensified others (such as poor resource management) and provoked new ones (such as political instability). Overall, such pressures have raised the stakes for better public management throughout the region. Thus, in order to

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attain economic resilience as well as prevent external shocks from transforming into major crises, Southeast Asia will need major changes in public governance and institutions.

DEFINING GOVERNANCE

Following the definition set by the United Nations Development Programme (1998) and Huther and Shah (1998), governance refers to the exercise of economic, political and administrative power in the management of the resource endowment of a state. Its practice requires mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise legal rights, meet their obligations and mediate their differences.

Good governance, among others, is:

- ◆ *Transparent.* Free flow of information is guaranteed; processes and institutions are directly accessible to those concerned with them.
- ◆ *Accountable.* Decisionmakers in government, the private sector and civil society organizations are accountable to the public, as well as to institutional stakeholders.
- ◆ *Based on the rule of law.* Legal frameworks are fair and enforced impartially.
- ◆ *Efficient and effective.* Processes and institutions produce outcomes that meet needs while making the best use of resources.
- ◆ *Participatory.* Differing interests are mediated and broad consensus is reached on political, social and economic priorities (UNDP 1998).

Governance includes the state, the private sector and civil society, all of which are critical to sustainable growth and human development. The state creates a favorable political and legal environment. The private sector generates jobs and income. Civil society expedites political and social interactions.

Governance also refers to the ability of the state to provide institutions, defined broadly as the "rules of the game." Rules create incentives that shape the actions of public officials. They vary because of differences in social and economic structures (World Bank 2000).

Institutions are key to governance in the following ways: They can (a) channel information about public goods and in the process help government regulate well; (b) reduce the likelihood of disputes and help enforce contracts or agreements through the judicial system; (c) provide clear and transparent mechanisms governing businesses, thus reducing corruption and bureaucratic obstacles; (d) facilitate competition through a good regulatory structure; and (e) ensure, through a system of rewards and penalties, that resulting incentives lead to the desired behavior (WB 2002; Grigorian and Martinez 2000).

This paper examines governance mechanisms and institutions in the context of the following:

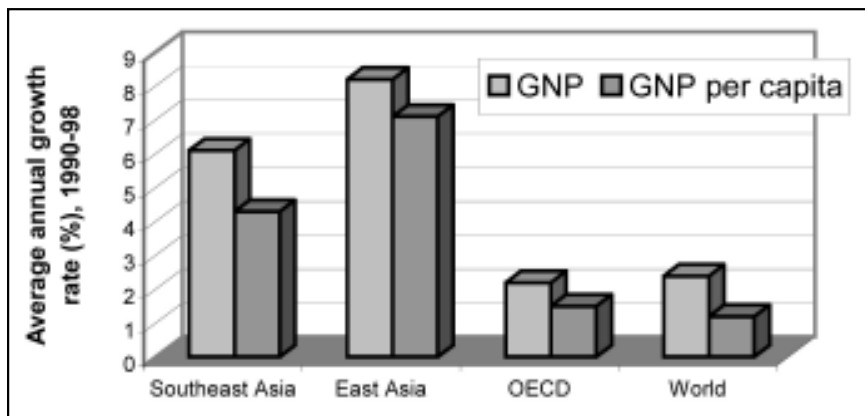
- ◆ *Internal rules and restraints*—constraints on executive and legislative power, independence of the judiciary, civil service and budgeting rules and regulatory mechanisms.
- ◆ *Competition*—private participation in infrastructure, yardstick competition and privatization of certain market-driven activities; and
- ◆ *“Voice” and partnership*—decentralization to empower local governments and spur civil society participation.

SOUTHEAST ASIA IN A GLOBAL CONTEXT

Southeast Asia is a heterogeneous regional setting comprising a number of countries with differing sizes, levels of development and governance systems. The Southeast Asia 5—Singapore, Malaysia, Indonesia, Thailand and the Philippines—are generally more endowed with managerial capacity and systems, and farther along the route to liberalization. By contrast, the transition economies of Vietnam, Laos and Cambodia, plus Myanmar, still have much to learn in terms of public management and are also behind in the path toward open and competitive societies.

As a group, these countries are an increasingly important force in the world economy. Their collective weight in global economic activity has been rising. Southeast Asia is fast growing, next to East Asia: the average annual growth rate of its gross national product as a bloc is nearly six percent; that of its gross national product (GNP) per capita is nearly 4 percent (Figure 1), which is about three times the record of the Organisation for Economic Co-operation and Development (OECD) countries between 1990 and 1998.

Figure 1. Southeast Asia's annual growth



Source: Human Development Report 2000

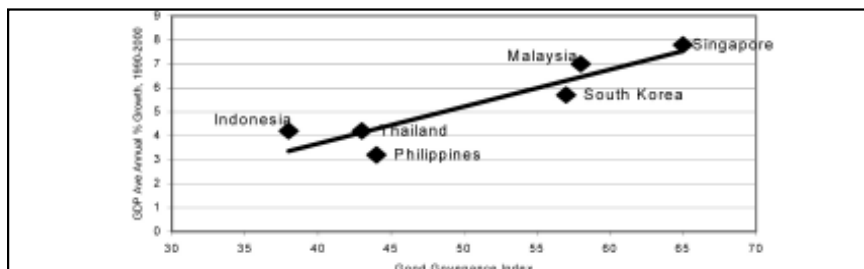
Many of these nations have embraced trade liberalization as a means to progress. Some—like Singapore, Thailand and Malaysia—have become benchmarks in key areas with characteristics of global public goods, including poverty reduction, health care and education. Southeast Asian countries invest selectively in priority areas such as information technology, biotechnology and worker training to become fully networked, knowledge-intensive economies (ADB 2001).

Many parts of Southeast Asia are also being carefully watched, because of their known weaknesses in the areas of financial stability, protection of environmental commons and movement of capital. It must be remembered that the 1997 Asian financial crisis, which infected the entire world, began in Thailand. Its increasing reliance on exports (at a time when global trade is contracting and domestic demand continues to be stagnant) makes Southeast Asia highly vulnerable to a global economic downturn.¹

GOVERNANCE AND GROWTH NEXUS IN SOUTHEAST ASIA

Southeast Asia provides ample evidence that there is a remarkable connection between administrative guidance and economic upturn. Good governance and growth go together (Figure 2). When the average growth rate of national output during the last decade is charted against the quality of country governance, it becomes apparent that high-performing economies—Singapore and Malaysia—have the edge in public management. Those lagging economies, such as the Philippines and Indonesia, meanwhile, have poor management structures. Governance quality in this case is a composite measure that has the following elements: economic management, income distribution, human development, absence of corruption, bureaucratic efficiency, judicial efficiency, political stability, and political freedom (Huther and Shah 1998).

Figure 2. Good governance and growth



Sources: Huther and Shah 2000; World Development Report 2002

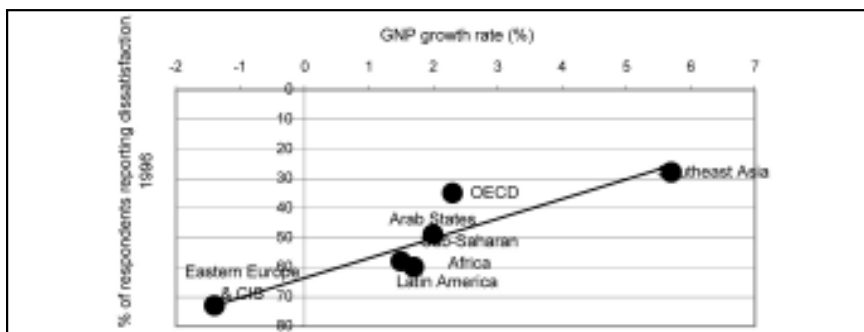
¹ Outside of Japan, Asian exports—which depends on sales to the US technology industry—account for as much as 37 percent of the regional GDP. Malaysia, with 80 percent of its exports to the United States consisting of IT products, is the hardest hit (Asian Economies: The East is in the Red, *The Economist*, May 19, 2001).

As stated above, there is a strong relationship between good governance and good development outcomes. The rigid regulatory structure and restrictive trade regimes in the Philippines and Indonesia, for example, have hurt their economic performance. In Singapore and Malaysia, good management—improved tax effort, high priority given to public spending in health and education—has been central to substantial poverty reduction. Some poor governance aspects in Indonesia and the Philippines—principally corruption and high inflation—inflicted harm that greatly affected the poor.

There is also evidence that Southeast Asian economies found strength in some dimensions of good management (even if, in general, institutional weaknesses easily escaped notice amid growth).

For instance, were Southeast Asian governments good at establishing the rules of the game and playing by those rules? Yes, said investors who gave Southeast Asia fairly high scores for providing credible rules and consistently enforcing them. In a 1996 World Bank survey of some 3,600 firms worldwide, fewer than 30 percent of entrepreneurs were worried about policy surprises in Southeast Asia. As Figure 3 implies, predictability in rulemaking builds market confidence that induces fast growth. Southeast Asian countries were quite ahead of even the OECD in this regard. The 1997 World Development Report survey of businesses ranked East Asia Pacific (which includes Southeast Asia) as among the best-performing regions on measure after measure (World Bank 2000).

Figure 3. Fast growth vis-a-vis perceived predictability in law and policies



Basic sources: Human Development Report 1997, World Development Report 1997

The situation is unchanged over a longer period. Southeast Asia remained convincingly ahead of the other regions (excepting East Asia) in combining both good governance and high growth between 1990 and 1998. This suggests the robustness of the outcomes detailed above.

It is true that Southeast Asia's real institutional strength has been overrated. Yet, it is interesting to note that the argument that governance is handmaid

to economic performance has never been disputed. This time, however, it is the underlying institutional weaknesses of the region, rather than their depth and power, that have come under intense scrutiny. In the final analysis, and for purposes of this paper, what is really important is that across wide differences over the role played by Asian institutions stretches the recognition that governance does matter.

GOVERNANCE SYSTEMS IN SOUTHEAST ASIA

The state, within the context of public management and governance, is defined as a set of institutions that possesses the means of legitimate coercion, exercised over a defined territory, referred to as a nation or country whose population comprises what is called society. This suggests that in the context of an organized government, the state has a monopoly of rulemaking within the nation or country (WB 1997).

This exclusive possession of coercion, when exercised scrupulously, gives governments ample ability to do their steering functions effectively. Yet it can also lead to arbitrary state action or create opportunities for abuse of authority by public officials. Capricious intervention weakens the very institutions that are set up to preserve state power.

In the context of public management, veto points help to regulate officials' exercise of power. Veto points ensure that no policies are adopted and implemented by one party without undergoing scrutiny by a third party. The wider the separation of powers, the greater the number of veto points to be navigated to reverse any rule-based commitments. But veto points can also be a drag on the successful carrying out of policies; they can make it difficult to alter harmful or outdated rules (WB 1997).

Southeast Asian countries in general have many effective checks and balances on the actions of political leaders. To begin with, the form of state varies—from the Philippines' presidential democracy to the parliamentary systems of Thailand, Singapore and Malaysia. Thailand and Malaysia are constitutional monarchies, but the latter also has a federal structure, which gives it a "vertical" (intergovernmental) veto point. Thailand's monarchy has been key to ensuring political continuity in the face of recurrent changes in its civilian government.

In form, Indonesia and the Philippines have powerful chief executives. The Indonesian presidency has direct legislative powers, although the president is accountable to the People's Consultative Assembly, not directly to the electorate. But a more assertive legislature (after the fall of Suharto) and demands for more local autonomy (which is intertwined with separatist violence) have constrained the powers of the chief executive. The Philippine president, directly elected by voters, possesses veto powers over laws passed by the legislature. Yet the system

of checks and balances in a setup modeled after that of the United States (US) ties down the Philippine president. Singapore and Malaysia, on the other hand, have stronger executives. Backed up by ruling parties, their prime ministers dominate the legislature.

The above suggests that the character of a country's political party also affects the degree to which political power is concentrated or diffused. In Singapore, Malaysia and Thailand, the sheer size of the ruling majority in the legislature (People's Action Party or PAP, UMNO and Thai Rak Thai, respectively) and their prime ministers' dominant and unifying roles in the party mean domination and little scope for effective opposition, thus weakening a veto point. In Singapore, the PAP has brought to heel, through tough legislation, some nongovernmental veto points, such as labor unions and professional groupings, which now nominally follow the party line. But at least political parties in these countries are nominally based on ideologies, unlike those in the Philippines, where members' constantly shifting allegiances always favor the incumbent administration.

Some multiparty coalitions, such as UMNO, own large businesses as a way of obtaining party funds. Both PAP and Golkar in Indonesia have strong links with the military, a veto point whose role in any civilian government is often under question because it reduces accountability (Kaufmann et al. 1999). But it is in Indonesia where the army has had a formal role in governance, as part of the consultative assembly. Popular pressure for reform, however, has somewhat liberalized the Indonesian political structure, in the process downgrading the army and strengthening the hands of the legislature, which now constantly challenges the president and her policies.

Elections, another veto point, vary in frequency. Short electoral cycles, such as those in the Philippines, give the voters more opportunities of replacing the legislature (lower house). However, there is a tradeoff: to bolster their reelection chances, Philippine legislators often favor government programs with visible short-term results, at the expense of sustainable and better projects. Ironically, frequent electoral veto has not stopped the country from ousting presidents through extra-constitutional means. Lower frequency of elections, such as those in Malaysia and Singapore, offers more political continuity for incumbents.

Indochina and Myanmar are governed quite differently from the Southeast Asia 5. Vietnam and Laos are socialist states while Myanmar is a military regime. All three have centralized planning structures although Laos is probably the least bureaucratized. Cambodia has opened up a bit, but is still saddled with its socialist past. Naturally, veto points come few and far between.

In Vietnam, government and the ruling Communist Party overlap extensively: party committees exist at every level of the bureaucracy and public man-

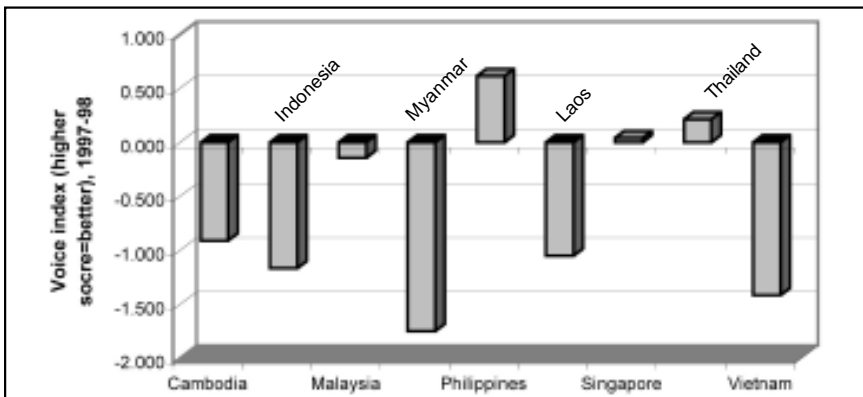
agers often double as party secretaries in state enterprises, which helps explain resistance to reform.

Electoral participation

In a recent study of governance in some 85 countries, Kaufmann et al. (1999), drawing from a large data set of investor surveys, came up with an aggregate index on “voice and accountability,” which partly gauges the extent of the electorate’s participation in selecting and replacing public officials. Among the concepts measured by this indicator are change in government, orderly transfer, free and fair elections, free vote, representative legislature and political parties.

The results for Southeast Asia are illustrated in Figure 4. If the resulting picture is indicative of how freely the citizens of Southeast Asian countries can choose their political leaders, then only the Philippines and Thailand seem to provide a good environment for free and accountable elections. Malaysia and Singapore, perhaps because of their autocratic setups, have lower ratings, as does Indonesia, which scores badly. The transition economies of Southeast Asia—Vietnam, Laos and Cambodia—are, of course, still under a command-and-control governance framework, appear to deprive their citizens of truly representative voting. Myanmar seems an electoral basket case.

Figure 4. Voice index in Southeast Asia

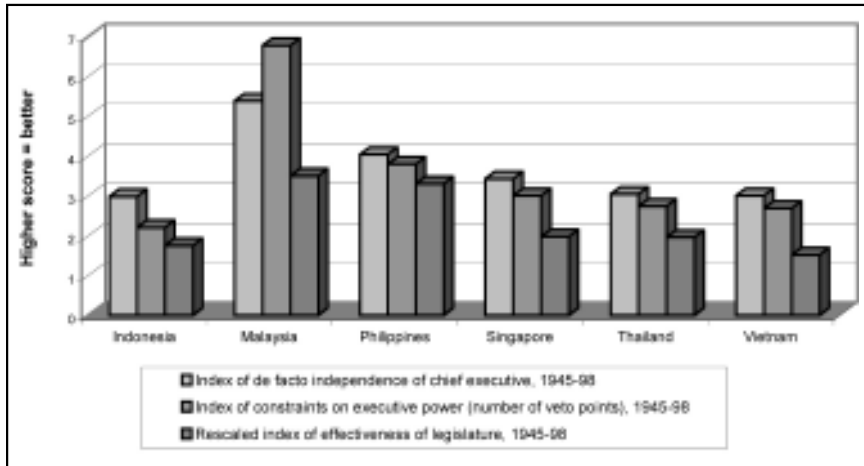


Source: Kaufmann et al. 1999

Veto points over a longer period

Instead of just a snapshot in time, a picture of Southeast Asian governance structures within a longer time frame should yield richer insights. Figure 5 represents averages of the years 1945 through 1998. The data were compiled by Djankov et al. (2001). The indicators include (a) executive de facto independence; (b) constraints on executive power; and (c) effectiveness of the legislature.

Figure 5. Southeast Asia's governance structure



Source: Djankov et al. 2001

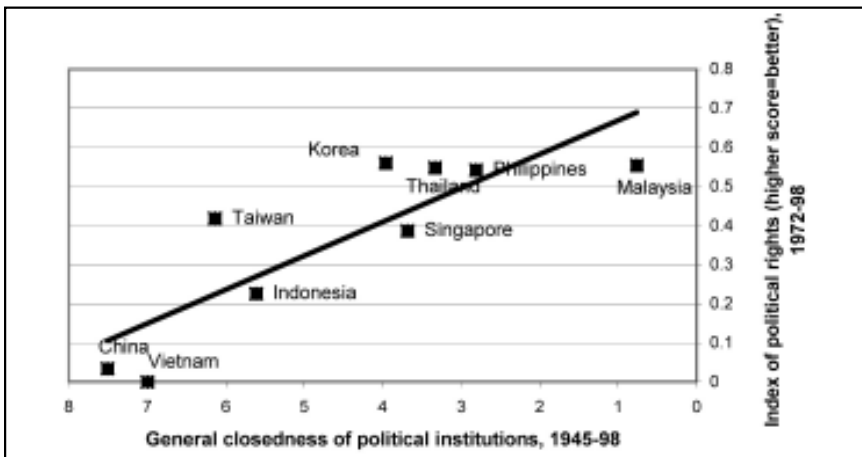
The first index measures the degree of independence of the country's chief executive, that is, whether he or she experiences substantial autonomy or severe limitations. The index of constraints on executive power measures the number of veto points in the country. The veto points include (a) an effective legislature (a bicameral system gets more points); (b) an independent judiciary; and (c) a strong federal system. Effectiveness of the legislature, the last index, determines how capable and responsive the legislature is.

Figure 5 shows how strongly correlated the three indicators are, suggesting that the strength of the executive is always matched by the number of veto points and the efficacy of the legislature. Note that over a broader period, Malaysia's executive turns out to be the most powerful. But the veto points are also quite numerous. Its 13 states—each with its own constitution, a council of state, a cabinet and executive authority and a legislature dealing with matters not reserved for the federal parliament—represent a formidable set of constraints on the federal system itself. The Philippines' presidency comes in second, but again, the veto points, especially a bicameral Congress and a largely independent judiciary, restrain its actions. Vietnam is seen as weaker in both executive power and institutions intended to dilute it. But weaknesses sometimes translate into an advantage: Vietnam is less handicapped by checks and balances, which one finds in open political systems. Its command-based planning system, as the World Bank (2000) suggests, can advance (and control the pace of) all-embracing reforms, once decisions are taken.

Finally, it is useful to see how states maintain a delicate balance between rights and institutions. Figure 6 suggests that autocracy and political rights move

in opposite directions. Malaysia again leads the pack, not necessarily because it is less autocratic than the rest, or because its elections are freer, but because in the period under study (1972-1998), circumstances in the two most democratic nations in the region, Philippines (martial rule in the 1970s) and Thailand (recurrent coups), did not augur well for both political rights and open political institutions. The current liberalizing trend in Indonesia likewise is not enough to offset the long years of autocracy under Suharto. As expected, Vietnam does not fare well because of its closed political system.

Figure 6. Autocracy and political freedom in Southeast Asia



Source: Djankov et al. 2001

THREE DIMENSIONS OF GOVERNANCE

The section examines Southeast Asia's three dimensions of governance following the distinctions proposed by UNDP (1998): administrative governance is the system of policy implementation; economic governance includes decisionmaking processes that affect a country's economic activities and its relationships with other economies. It clearly has major implications for equity, poverty and quality of life; and political governance is the process of decisionmaking to formulate policy.

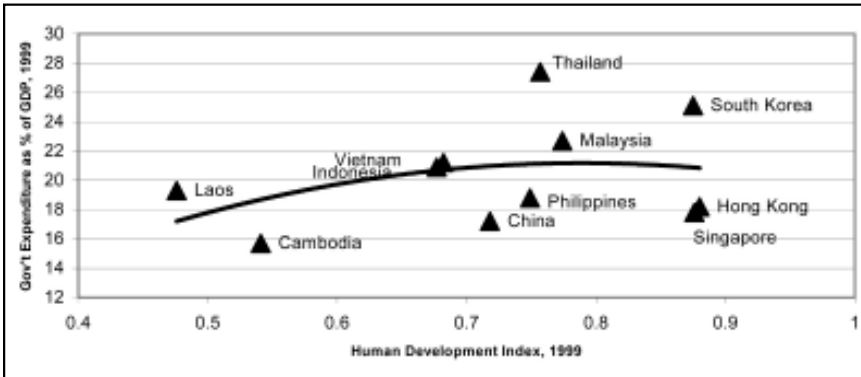
Administrative governance

The right size for Asian governments

Is a lean state the courier of both growth and welfare? While as a whole Southeast Asian governments are small, Figures 7 and 8 show a much more varied pattern within the region, and imply that a bit of an expansion takes place before governments settle to a slimmer size, as both incomes and human development improve.

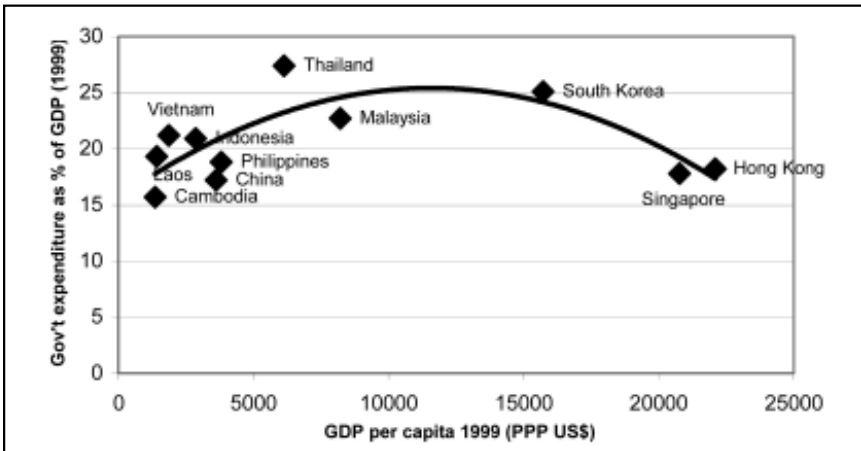
The order of appearance of the countries is not exactly identical, but the following picture should hold:

Figure 7. Government expenditure vis-à-vis income



Sources: Asian Development Outlook 2002; Human Development Report 2001

Figure 8. HDI leaders in Asia



Sources: Asian Development Outlook 2002; Human Development Report 2001

Hong Kong SAR and Singapore were clearly the benchmarks in size and scope of government, having generated the highest growth rates in per capita incomes² and human development. For Thailand, Malaysia and the Philippines, government spending was good enough to reach high human development but

² Whenever available, purchasing power parity (PPP) values are used for ratios to facilitate cross-country comparisons. The use of comparable international prices noticeably increases the ratio for developing countries.

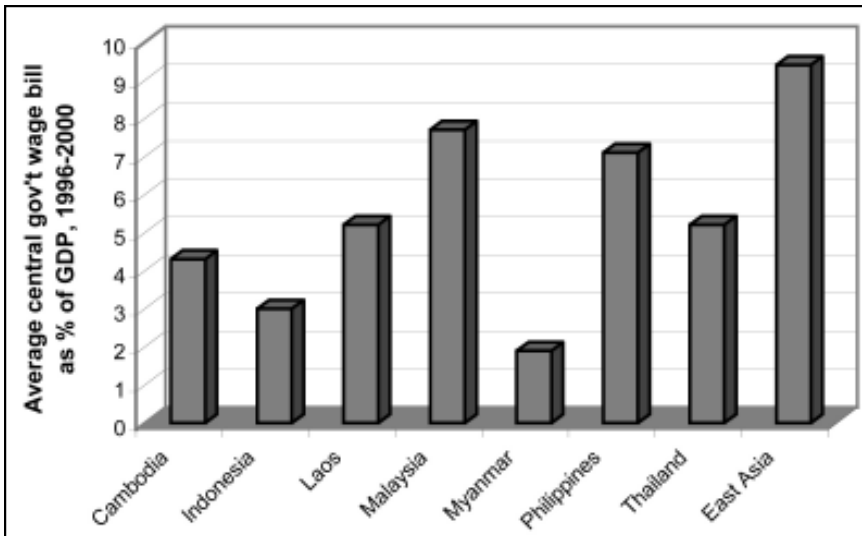
would need a boost to catch up with the leaders on the income side. Indonesia, Vietnam, Laos and Cambodia were still struggling to balance size with growth and human welfare, and their governments would probably have to expand a little to provide more public goods.

Still, as the World Bank suggests, big governments tend to be quite inefficient—they imply costly government programs—and consequently may add little to growth. But in the same breadth, when growth is stalled, social pressures for spending rise. Again, inordinate government consumption spending, unless the aim is to build social safety nets during difficult periods, is basically a net tax with questionable benefits to society. But cutting consumption aimlessly may also cut deeply into items that make people's lives better, say, teachers' salaries or medicines. Rightsizing is not made easier when a vicious cycle sets in.

Performance management: the civil service

With relatively small governments, the fiscal pressure exerted by the wage bill is considerably low. Between 1996 and 2000, the average annual central government wage bill within East Asia and the Pacific is only 9.4 percent of the GDP, and, as Figure 9 shows, it is even less in Southeast Asian economies. The range is from an abnormally low 1.9 percent in Myanmar to about 7.7 percent in Malaysia, way below the total central government expenditure for Southeast Asia, shown as the rightmost bar in Figure 9.

Figure 9. Wage bill of central governments in Southeast Asia

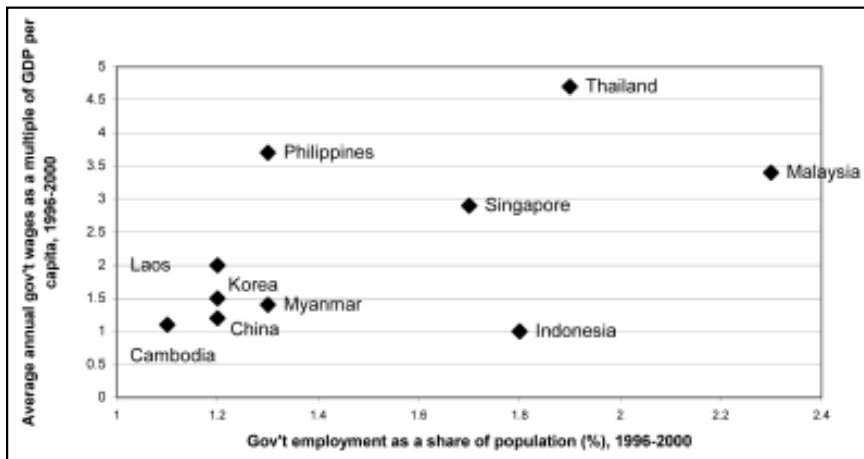


Source: World Bank Public Sector and Employment Survey

This means that downsizing of governments in Southeast Asia is not needed. Globally, the tendency is to match high wages with a lean workforce (WB 1997). That is, government employment is negatively associated with wages. A highly paid, high-quality civil service, which is small in number, means substituting quality for quantity. But Southeast Asia has defied this trend.

When the government wage to per capita GDP ratio is plotted against government employment, as in Figure 10, Malaysia and Thailand are seen as having a huge number of high-salaried public employees. The Indochinese trio of Vietnam, Laos and Cambodia (and Myanmar), on the other hand, has slim civil service structures, but the workers are lowly paid too.³ Only the Philippines combines high average pay with a trim civil service. Overall, the situation calls for intelligent ways to reduce the number of public employees. A cautionary note is that the right size of the workforce depends on the roles assigned to government; while wage adequacy depends on private compensation levels (Schiavo-Campo et al. 1997).

Figure 10. Public employment vis-à-vis wages in Southeast Asia



Source: World Bank Public Sector Wages and Employment Survey

But does high salary go with high accountability? Or is poor accountability, expressed as corruption, more closely associated with low wages? Anecdotal proof suggests that poor pay compels civil servants in developing countries to accept bribes to augment their incomes. Most crosscountry studies find only a weak link. So do anecdotal researches.

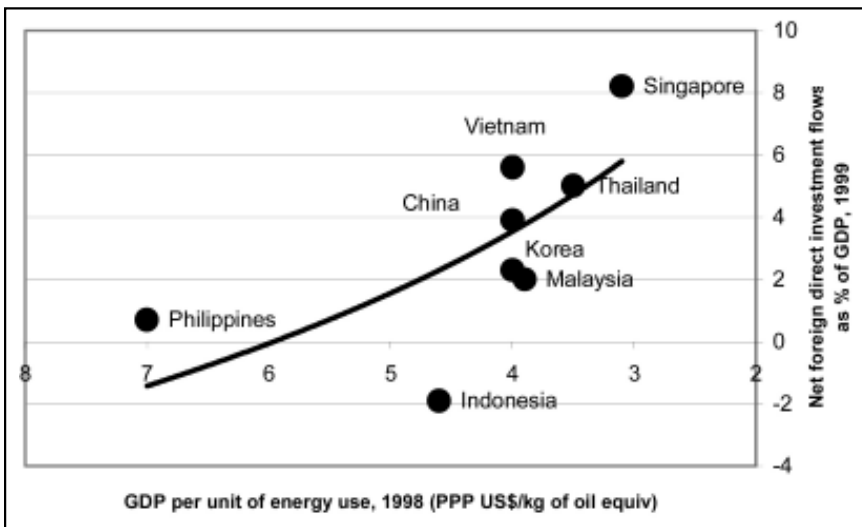
³For instance, in Cambodia, real wages in the public sector (US\$20/month on average) have fallen sharply in recent years, as they are outside the capacity of national budget resources to pay (World Bank 2000a).

Alternative service delivery modes

As Southeast Asian governments rightsize, many of the services that they provide will inevitably have to be taken over by other entities. Most countries in the region have pushed for some form of privatization in key areas of the economy. Even the infrastructure sector, which has proven to be impervious to change, has yielded to privatization.

One consequence of private participation has been to lower the cost of infrastructure services, with spillover effects on other services, such as those in the energy sector. Figure 11 shows what happens when costs are lowered: more foreign investments come in (as they did in Singapore, Malaysia, Thailand and Vietnam), inducing a virtuous circle where more firms participate in various sectors, principally in infrastructure.

Figure 11. Energy cost and foreign investment in Southeast Asia



Source: Human Development Report 2001

Economic governance

Access to services

Government policies that combine public spending and private participation in cost-effective ways in infrastructure services have not only increased tremendously the flow of investments in this sector; it has also ensured greater coverage of poor people within the Southeast Asian region. The overall quality and coverage of infrastructure services such as electricity, water, telecommunications and transport have a major impact on living standards (WB 2002).

Data on what causes the differences in access and level of infrastructure services in Southeast Asia are hard to come by, but a few anecdotal facts might be useful. Lack of clear-cut rules on how to mobilize private investment is apparent in Vietnam (World Bank 2000b) and Laos (World Bank 1999). Institutions in Laos are relatively weak, given its low level of development. On the other hand, Cambodia suffers much from inadequate capacity to plan, manage and implement water services. In fact, there is no institutional structure that can do it, resulting in unreliable service and poor quality of water (ADB 2000). It also has no framework for public-private participation in electricity supply (World Bank 2000a).

Even if rules exist in Indonesia, the private sector remains hesitant to participate, while the public sector is inefficient in maintaining water supply and sanitation, roads and urban services (ADB 2001b). In the Philippines, nonurban electricity is provided by rural electric cooperatives, most of which render unsatisfactory services. Partly as a result, electrification in rural areas is less than 65 percent. Philippine tariffs are also among the highest in the region and have discouraged foreign investment (World Bank 1999a).

Cost of doing business

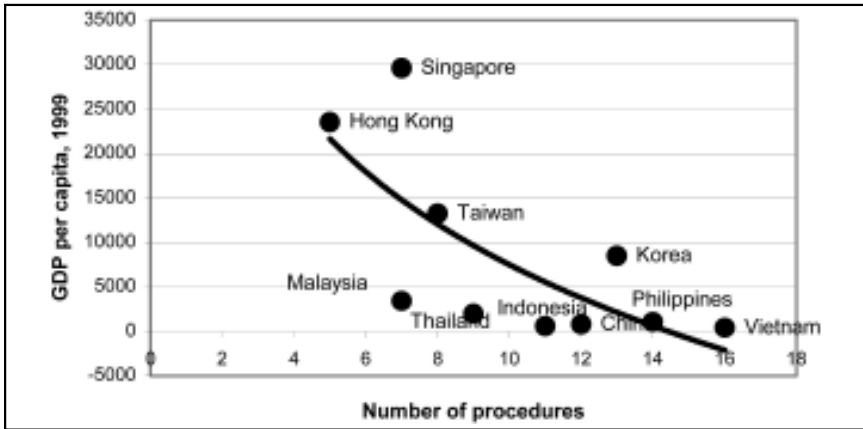
Excessive regulations undermine trade and business development. Wage and price controls, anticompetition policies, barriers to entry in major economic sectors and weak antitrust policies combine in diverse ways to discourage the flow of investments, thus hindering growth.

When all these factors are measured, the result is a composite index of regulatory burden (Kaufmann et al. 1999). For Southeast Asian nations, the regulatory picture is varied. Singapore stands out as the economy with the friendliest regulatory structure. The Philippines, Malaysia and Thailand to lesser degrees have likewise relaxed many of their stringent market-unfriendly policies. As expected, the command economies in the region, chiefly Laos and Vietnam, are still weighed down by a host of regulations.

The number of procedures required to register a business is also higher in Southeast Asia compared to industrial countries. In Canada and Australia, for instance, it takes only two steps to complete the registration.

The number of procedures correlates with income per capita, as Figure 12 shows. Lower income economies such as Vietnam, the Philippines and Indonesia have more procedures. The number of procedures is also associated with time and cost variables, implying that entrepreneurs pay a steep price in terms of fees and delays in countries that make intense use of ex-ante screening. As an example, in Vietnam, completing 16 procedures demands 112 business days and 1.78 percent of GDP per capita (Claessens et al. 1999).

Figure 12. Registration procedures and income in Southeast Asia

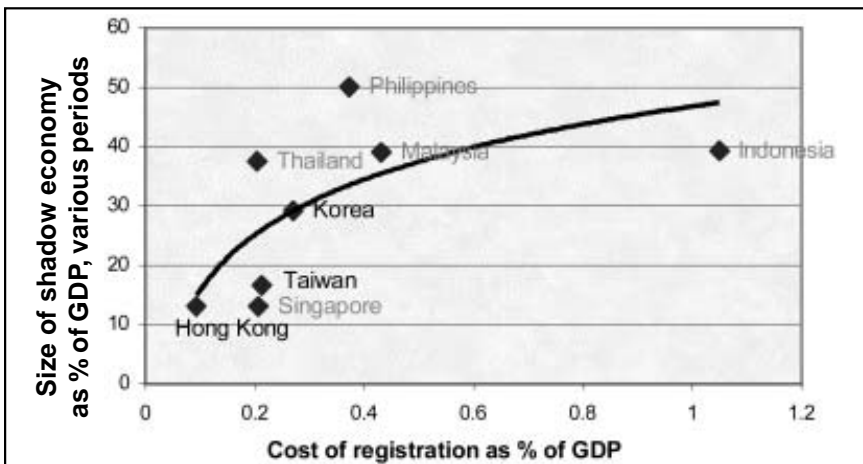


Source: Djankov et al. 2001

Claessens et al. (1999) argue that while stricter regulation of entry is associated with higher quality of products, better pollution records, or keener competition (as suggested by data in a cross-section of countries), stricter regulation of entry also brings about sharply higher levels of corruption and a greater unofficial economy.

Figure 13 shows that the high costs of regulation also give rise to a larger unofficial economy. This is true in Indonesia, and to a lesser extent, the Philippines and Malaysia. Costly regulations deter entry into the formal sector and reduce competition.

Figure 13. Effect of cost of entry on unofficial economy



Source: Djankov et al. 2000

Political governance

Rule of law and judicial independence

Even as the high-performing Southeast Asian economies registered record-breaking growth rates, signs of weak points within the region had emerged: judicial independence was grossly compromised and corruption rose to unprecedented levels. Corruption and a weak judicial system are likely partners in crime, so to speak, feeding on each other to erode a country's institutional defenses (Mauro 1997).

The *1998 World Competitiveness Report* suggests that as a whole Asia is not rated highly on both counts, although it is the ASEAN trio of Indonesia, Malaysia, and the Philippines, plus China, which has pulled down the overall ranking of Asia. Indonesia and the Philippines are among the bottom dwellers worldwide, indicating that, in these countries, economic rent-seekers are perceived as often having a heyday undermining the institutions designed to keep them out.

High levels of public corruption undermine the legitimacy of the state itself and weaken its capacity to provide institutions that support growth and development. Corruption reflects a distorted policy environment, where public officials are likely to manipulate rules to pursue their self-interest. It weakens the judiciary so much that it is unable to provide a credible threat of punishment when official misconduct is discovered (WB 1997).

Conflict management

Ethnic tensions have been rising in Southeast Asia in the last decade. This trend implies poor conflict management on the part of these countries and argues for better public institutions to bridge the gap between groups.

Economic growth in countries whose current levels of ethnic tension are highest (Indonesia and the Philippines) is in a precarious state. Figure 14 indicates that a high degree of ethnic hostilities can affect the rate of growth. The concern is that these economies will go into a steeper tailspin if international investors equate ethnic conflict with political instability and pull out from the region.

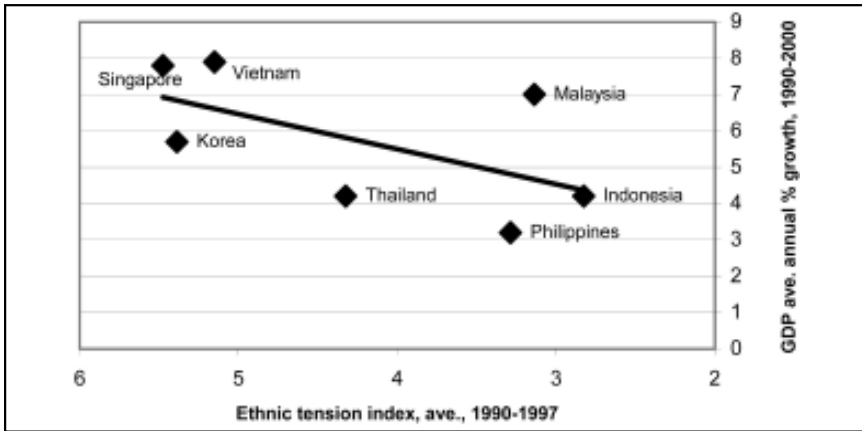
When conflict is prolonged, access to social services and economic opportunities is severely curtailed. In Cambodia, for instance, some parts of the country are still inaccessible even as the security situation has eased. Government is unable to provide health and education services, or basic physical infrastructure. This, as a consequence, has exacerbated poverty and retarded growth (World Bank 2000a).

Decentralized governance

Localization and corruption

Corruption can reduce the gains from decentralization. But decentralization can reduce the risks and benefits of corruption. In a decentralized system, citizens can

Figure 14. Ethnic tension and growth



Sources: University of Maryland IRIS Center 2000; World Development Report 2002

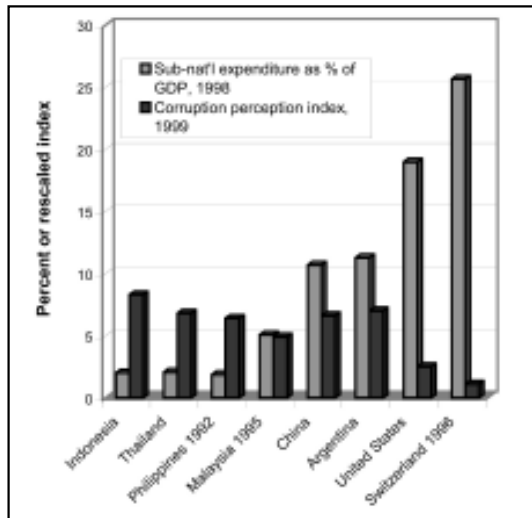
curb the incentives for corruption by learning about government activities and filing complaints (voice). They can also counter bribery demands by moving out of the system or “voting with their feet” (exit) (UNDP 1997).

Decentralization here means shifting a substantial block of political, fiscal and administrative powers held by central governments to subnational public authorities. It assumes that subnational governments, once autonomous, are capable of taking binding decisions in at least some policy areas. In more practical terms, decentralization expands the resources and responsibilities of existing subnational government units (WB 1999 and 2000).

Fisman and Gatti (2000) find that fiscal decentralization is consistently associated with minimal corruption. Countries with more decentralized expenditure have better corruption ratings, specifically, the size of the coefficient implies that one standard deviation increase in decentralization is associated with an improvement in the country’s corruption rating equal to 40 percent of one standard deviation of the corruption index.

Figure 15 validates this result. When the extent of decentralization is matched with Transparency International’s corruption perception index, what becomes apparent is the negative association between them, at least in certain parts of Southeast Asia. Indonesia, which has the worst corruption rating in the region, is also the least localized. At the other end of the spectrum is Malaysia, which combines a higher level of decentralization with a lower level of corruption. In the Philippines, corruption is less pronounced in lower levels (Azfar et al. 2000) and the expenditure system is fairly decentralized. Notice that in highly developed systems such as Switzerland, the perception of corruption is at its lowest level. The same is true with the United States and Argentina, to a lesser extent.

Figure 15. Localization and relation to corruption



Sources: Transparency International, IMF Gov't Finance Statistics

POLICY RECOMMENDATIONS

Improving governance in Southeast Asia requires a reform agenda that is directed at broad-based development and designed based on the peculiarities of Southeast Asian economies. While considering good international practices, governance reforms in Southeast Asia must build on the unique historical and cultural make-up of the region and must be mindful of the level of political and economic development of each country.

The key to successful interventions on governance effectiveness in Southeast Asia also lies in the phased introduction of reform packages. Reforms in the public sector must target the core institutions: public finance, civil service, legal institutions and the judiciary.

Sponsors and implementors must likewise bear in mind that they cannot introduce more hard-hitting reforms in Southeast Asia than have been prescribed by international financing institutions like the International Monetary Fund and World Bank, leaving the region under tremendous pressure to effect political stability and revive their sluggish economies. They must also take precautionary measures to protect the poorest and marginalized segments of the region's population from bearing the brunt of radical reforms.

The nature and extent of necessary reforms in governance will differ across Southeast Asia. The Southeast Asia 5—Singapore, Malaysia, Indonesia, Thailand and the Philippines—is farther along the route to liberalization and tripartism (i.e., participation of three key actors: the government, the private sector

and civil society in governance). They are generally more endowed with managerial capacity, have more developed democratic systems and governance structures, and thus would mainly need assistance in institutional strengthening.

Younger democracies and transition states like Vietnam, Laos, Cambodia and Myanmar are trailing in the path toward open and competitive economies. They still have much to learn in terms of private sector and civil society participation in governance. Thus, they will benefit from assistance in developing new institutions, transfer of public management and participation technology.

Public sector reform will only take place when a country's leaders are committed and occupy the driver's seat. No amount of help will strengthen governance and institutions in Southeast Asia without political will.

Southeast Asia's hope of recovering and accelerating growth momentum depends on measures to be instituted to increase transparency and accountability, make regulations and incentives more responsive, enhance the efficiency and effectiveness of enabling and transmission mechanisms and build constituencies for reforms.

Regardless of their individual levels of development, Southeast Asian countries need to establish and strengthen their transparency and accountability structures.

Transparency and accountability

Southeast Asian central governments need to define the boundaries of their functions to determine their accountabilities. The key assignment roles of central governments are to ensure provision of public goods and handle macroeconomic management. That suggests that each central government should limit itself to steering while letting the other key players in society, such as the private sector and civil society, do the rowing. Operationally, this means rightsizing governments, which in part is accomplished by pushing privatization. Accelerated privatization in Indonesia and reforms in state-owned enterprises in Vietnam are examples of recent donor-supported moves along these lines.

By shedding provisioning functions and allowing markets to work, Southeast Asian governments can raise public sector efficiency and reduce the strain on public finances, thus promoting greater accountability. Rightsizing of Southeast Asian governments is in order but must be done cautiously. For some, like Thailand and the Philippines, a bit of expansion may have to take place before Southeast Asian governments settle to a slimmer size and achieve a balance between size of government, growth and human welfare.

While pushing for greater private sector participation, reforms in provisioning public goods must consider the capability of the market to provide these goods. Governments will have to take ultimate responsibility, but government

intervention should not be worse than what the market is inefficiently or ineffectively providing. For example, the record of Southeast Asian governments is better in enlarging access to electricity through greater participation of the private sector. The presence of multiple providers adds to high institutional quality in highly populated areas. In remote areas with many poor people, where private entry is not forthcoming, the provision of these services must rest with the state.

If privatization makes central governments do their job better, so does transfer of functions to subnational governments, which is another shedding mode. The aim is to decongest the central government of direct service provision. The World Bank, for instance, recommends reforming the management of education in Vietnam by appropriate decentralization. In many Southeast Asian countries, a corollary objective of decentralization is to remove concurrency, which raises hard questions on which level of government has true accountability. Specifically, services assigned as joint responsibility of central and subnational governments like industry and agriculture, education, health, social welfare, police, environmental management and even public works need to be clear-cut. Exceptions are cases where subnational government capacity is weak (e.g., construction of massive infrastructure like farm-to-market roads, bridges, telecommunication facilities and the like). In these instances, the central government cannot immediately relinquish its responsibility; concurrency is necessary while the central government is devolving. Handholding ensures that subnational units are able to absorb the functions corresponding to their capacity levels. Decentralization in Southeast Asia must proceed with economies of scale in mind and caution to forestall reversals or recentralization, as in the case of Laos.

Once central government responsibility is defined, it should have the resources required to discharge its streamlined functions. The state has to generate revenue to fulfill its responsibility. As the findings indicate, most Southeast Asian governments are saddled with unbalanced budgets—revenues are not sufficient to support vital expenditure, especially spending for basic social services. Even domestic and international borrowings are not enough to close the financing gap. Hence, tax reform is an indispensable component of the governance improvement package in Southeast Asia. The urgent need is for more efficient and more accountable tax management. At the very least, eliminating individual discretion and defining taxing authority more clearly in tax agencies would be a step in the right direction. Tax reform also means shifting from international to domestic taxation, a move that would place a heavy burden on domestic tax collection agencies. To prepare for such eventuality, these agencies must be able to expand their domestic tax bases, a shift that would require increased answerability for high collection efficiency.

As Southeast Asian governments fulfill their obligations, they must avoid wastages in procurement and tendering processes, the sources of leakages on the expenditure side. The more advanced countries in the region have made progress in public expenditure management. The Philippines, for instance, has adopted electronic bidding, allowed civil society groups to organize procurement watchdogs, revised rules to make the procurement transactions more transparent and forged integrity pacts with private firms. Southeast Asian countries where corruption in public procurement is perceived to be rampant (e.g., Indonesia and Thailand) can benefit from these experiences.

As the private sector increasingly becomes involved in the provision of goods and services erstwhile supplied by government, it must improve its own public accountability structure. Establishing and strengthening the accountability of the private sector means enhancing its readiness to absorb risk. Private sector risk-taking, in which obligations are self-guaranteed by the sector, would keep the government from providing bailout options in cases of default, thus reducing moral hazard.

Another critical area for reform is corporate governance. A key step is to increase disclosure and protect the public interest in publicly listed corporations (in the case of Southeast Asian countries with working stock exchanges) and state-owned enterprises (especially in the transition economies of Vietnam, Laos and Cambodia). In Vietnam, for example, what is urgent is to accelerate the reform of state-owned enterprises, especially debt-strapped parastatals that drain public funds. Public accountability of firms participating in the provision of public goods must be strengthened through transparent rules and independent auditing and accounting procedures.

Fair governance requires increasing access to basic services by the deprived and disadvantaged segments of the populations of Southeast Asian countries. Problems of access to basic services are more severe in the transition states (e.g., Laos, Cambodia) and those with high levels of ethnic conflict (e.g., Indonesia). Yet, paradoxically, the solution is to widen the access to these services. The governance perspective permits shifting of focus to the poor and disadvantaged sectors of Southeast Asian societies, since part of overall accountability is to promote social equity as a corollary to economic growth. To enlarge coverage, the less developed Southeast Asian countries burdened by revenue shortfalls must allow flexibility in quality and price of provisions, especially in water supply and sanitation. They should likewise encourage liberal entry of informal providers at levels where high standards are not required, as long as users and informal providers agree on set standards that do not compromise quality and safety. Public spending on social services must be high on the agenda of both donors and the governments of Southeast Asian countries.

Laos, Cambodia and Myanmar need to put more of their resources in social services. Vietnam needs reforms to widen access to basic social services, especially among the disadvantaged groups. Provision of education is urgent to meet the high-level manpower needed for the transformation of its economy. To be able to increase public resources going to preventive health care, Vietnam must encourage private provision of curative health care.

Subnational governments in Southeast Asia need to strengthen their autonomy to bolster overall government accountability in achieving broad-based growth. Making subnational governments more independent and accountable requires fiscal decentralization—that is, the ability to finance their expenditures with revenues within their control. A clearer definition of accountabilities is needed, such as determining tax and expenditure assignments across levels of government. Allocation and spending rules, for one, must be clearly set, such as those for social expenditure and the 20/20 initiative. Such accountability measures are important as central government functions are devolved to prevent decentralizing even the failings of governance, such as corruption. Efforts to increase autonomy of subnational governments must not be devoid of reforms in intergovernmental fiscal relations to close the vertical imbalance, which is persistent in Indonesia and the Philippines.

Eliminating vertical imbalance in many Southeast Asian countries calls for a transfer of more taxing powers to subnational governments. That way, decentralization can proceed with equity in terms of allocation of resources and responsibilities. Subnational governments will be motivated to take on tax assignments and increase tax collection efficiency if they are allowed to keep the taxes they collect.

As government functions are decentralized, the complexity by which these functions are discharged must be removed. Without losing controls, rules corresponding to these functions should be made simpler. The level of sophistication of rules to be enforced by subnational governments should match the level of sophistication of their capacity. Even when expenditure functions are substantially decentralized, certain instruments such as matching grants must be introduced to allow the central government to muster local resources in line with national priorities and to influence the spending patterns of subnational governments.

Flexibility also means that rules can be adapted to respond to unique situations. For example, in cases where there is civil unrest and or ethnic tension, rules must give subnational governments more leeway in governing ethnic regions.

Civil society organizations (CSOs) working in partnership with the government must be made accountable for their actions. Right now, it is hard to make CSOs accountable, as they are not governed by rules and institutions that are

found in government or in the private sector. Unlike government agencies or private firms, CSOs may not have long shelf lives. They can easily abandon their public responsibility. Thus, they must draft their own partnering rules, entry and exit regulations, rules on information provision and disclosure, and sanctions for misbehavior. In the Philippines, a large CSO coalition, the Caucus of Development NGO networks (CODE-NGO) has adopted an accountability framework by crafting its own code of ethics.

CSOs articulating certain issues are increasing in number. With the rise of civic movement and proliferation of NGOs, CSOs and people's organizations in Southeast Asia, some kind of accreditation may be called for to separate groups who cannot be held accountable for their action or nonaction and thus betray public trust.

The independence of the judiciary—the ultimate guarantor of accountability—must be secured. The judiciary in any country is the last bastion of good governance. When all else fails, the judiciary is the only recourse for arbitration and mediation. Prior to the Asian crisis, there was a positive perception of the rule of law in the region. Yet even as the high performing Southeast Asian economies registered record-breaking growth rates, signs of weak points in the judicial system emerged. Today, judicial independence is grossly compromised while judicial inefficiencies continue to hurt the flow of investments. The ownership concentration in Southeast Asian firms is also a telling sign of the low level of institutional development of the legal system. A turnaround in Southeast Asia would require further development of the legal systems and reforms to enhance judicial independence and raise judicial efficiency.

The transparency of the judicial processes also needs to be increased. This can be done by providing civil society and media with timely judicial information. Likewise, setting up reliable and up-to-date judicial data bases will make cases easy to track and hard to manipulate.

The concept of a court watch—civil society as monitors of judges' performance—can be adopted by Southeast Asian CSOs to increase pressure for change in the behavior of erring judges.

An anticorruption action plan will provide relief where corruption is pervasive. High levels of corruption undermine the legitimacy of a number of Southeast Asian countries and weaken their capacities to provide institutions that support growth and development. To remove this obstacle to growth, Southeast Asian countries must seriously implement counter-corruption measures. A national anticorruption plan, owned and sponsored by central government officials, can help prevent wastage of government resources and "state capture." It is also a strong accountability mechanism.

A more thorough and country-specific analysis of the factors that engender corruption is essential in designing responsive national anticorruption plans. Such plans must have both punitive and preventive measures and must engage the general public in the campaign. Southeast Asian countries need not reinvent solutions since a menu of anticorruption instruments is readily available. The World Bank has been instrumental in the Philippine government's efforts to develop a National Anticorruption Plan in 2000. The World Bank is also assisting Indonesia and Thailand in this regard.

Regulations and incentives

A turnaround in Southeast Asia would require more responsive regulatory institutions and further development of incentives.

Concrete actions include deregulating, generating positive incentives, and simplifying transactions and entry procedures. There is overwhelming evidence that excessive regulation and weak incentives thwart economic growth in Southeast Asia. The regulatory burden stalls trade and business development, especially in command economies in the region (e.g., Laos and Vietnam). While regulation for business entry is less restrictive in some Southeast Asian countries like Thailand and Singapore, overregulation (e.g., higher cost of registration and complex procedures for registering a business) in the rest of the region discourages business entry.

Revitalizing economic activities is of paramount importance in reducing poverty in Southeast Asia. Making the cost of doing business in Southeast Asia more competitive requires removal of barriers on firm entry and less restrictive entry procedures. Actions of Southeast Asian governments must proceed along deregulation, development of incentives and simplification of government requirements and procedures. Cambodia, for instance (according to the ADB), has considerable potential for further private sector growth in manufacturing and services, as demonstrated by the proliferation of micro enterprises, small and medium enterprises and multinational companies. The manufacturing and services sector will prosper with less restrictions and better incentives.

The priority of policymakers in Southeast Asian economies, weighed down by overregulation, must focus on facilitating the entry of more players in the market and alternative providers of public goods and services. Standardization of laws and regulations to reduce enforcement cost of transactions across borders (e.g., rules on entry of products) will stimulate free flow of goods and services in the region thus invigorating Southeast Asian economies. When not standardized, the goods or services will seek their own levels and turn to areas with lesser restrictions.

Rewriting exit rules may also be necessary to prevent "hit-and-run" investments. Southeast Asia must tighten such rules so that private providers of public goods will not readily pull out investments in long-term projects with lower returns, or exit in cases of default. An appropriate measure toward this end is setting investment targets and making private providers commit to providing electricity or water supply coverage within a certain period.

Regulatory reform in Southeast Asia must also look into rule simplification (e.g., international and domestic taxation rules to facilitate collection of taxes). When state enforcement capacity is weak, simpler and less discretionary regulations are less likely to be undermined by corruption. The Philippine government, for instance, is trying to simplify taxation by reformulating the corporate tax code. Under this scheme, firms will pay a 20 to 26 percent tax on gross income instead of the current 32 percent tax on net income. The ADB supports improvements in tax administration, elimination of leaks and loopholes, and stricter enforcement of existing tax laws.

High dividends, especially for the underserved segments of the population, are also expected if Southeast Asian governments can adopt more flexible rules in the provision of basic services. Unbundling the setting up of infrastructure for basic services, permitting entry of informal providers and allowing "mix-and-match" arrangement, such as local communities providing labor in exchange for lower connection fees, will widen access to needed services. Such demand-responsive approaches, however, need to be linked to an effective regulatory framework for private-public collaboration.

Southeast Asian governments, however, must pursue deregulation balanced by consumer protection and in consonance with international rules. It is acknowledged that while international rules assume a level playing field, Southeast Asian countries are at a disadvantage in terms of developed institutions. Deregulation must thus proceed with caution in areas where Southeast Asian states have weak institutional defenses.

Regulations are likewise needed to break interlocking patterns of business-government relations and/or business-political party relations—a practice that constitutes grand corruption and spawns state capture in some Southeast Asian countries. Examples of reforms in this sector are ADB-funded programs that cover improvement of corporate governance, reinforcement of regulatory and supervisory arrangements, and expansion of investor base. Such reforms also call for upgrading of standards of corporate disclosure and transparency.

In all of Southeast Asia, the effectiveness of the judiciary is important to ensure fair governance. What is urgent and easily doable is to reform litigation procedures to fast-track resolution of pending and new cases. Deregulation can

help reduce the caseload of the judiciary, since less regulation means fewer burdens on the courts. A performance-based merit system and competitive pay for judges will likewise go a long way in improving the integrity of the judiciary.

Enabling and transmission mechanisms

Transmission mechanisms can work effectively through good enforcement, innovation in delivery and by encouraging decentralization.

Curbing arbitrariness in government actions requires strong enforcement mechanisms. Good governance means predictability. Governments have been known to impede the development of markets through arbitrary exercise of power. Institutions that limit the state's capacity for arbitrary action will improve its ability to provide institutions that support broad-based markets.

As Southeast Asian countries, especially the transition economies, move toward greater liberalization and people participation, new institutions are needed. While new institutions are being developed, Southeast Asian countries would also need interventions to enhance existing mechanisms such as civil service and administrative systems. Reforms in civil service can include meritocracy, the development of management cadre and the inculcation of quality orientation for frontline service personnel. The public sector in some Southeast Asian countries, especially those with long "command-and-control" history may need to be imbued with client orientation to make them more responsive to their constituents.

The Southeast Asia 5 in general has many effective checks and balances on the actions of political leaders (e.g., separation of powers and the presence of veto points). In Southeast Asian economies under a command-and-control governance framework, however, the extent of the electorate's participation in elections is perceived to be less truly representative of the citizens' voice. Voice mechanisms that could be strengthened include representation in subnational bodies, using civil society as pressure point, allowing users to determine/influence the delivery structure of government services. Mechanisms must also equip various sectors, especially ethnic groups, with veto powers.

Southeast Asian governments can adopt alternative delivery mechanisms to widen people's access to basic services. In areas where they do better than government, private sector can participate in the provision of public goods. Civil society organizations can also serve as government substitute in providing services (e.g., community managing infrastructure and maintenance). Governments may also include mechanisms that enable informal providers to serve areas not covered by major providers.

Delivery mechanisms can also be enhanced by devolving the provision of basic services like basic education and health to subnational governments. Gradual takeover of functions must be done to prevent severe disruption of the existing

mechanisms that could worsen the situation. Simply decentralizing the provision of basic services to lower levels of government may exacerbate existing inequities or shift failings to levels even less capable of resolving them.

Subnational governments need additional instruments such as a mechanism for subnational borrowings to discharge the functions devolved to them. Subnational borrowings to augment local expenditure remain a major issue in many Southeast Asian countries. Most of these countries are still developing subnational borrowing instruments and regulations. They would benefit from assistance in developing local debt service arrangements. Assistance to improve revenue generation at the local level can yield high decentralization dividends.

The rise of ethnic tensions in Southeast Asia implies poor conflict management and argues for more efficient public institutions to bridge the gap between differing groups. Reforms are urgently needed in regions where ethnic tension is at its peak (e.g., Indonesia and the Philippines). To complement peacebuilding efforts, reforms are imperative in areas where ethnic groups are generally disadvantaged due to poor living conditions, poor infrastructure, lack of nonfarm work, inferior access to education, lack of access to water, sanitation and electricity. Negotiations and peace talks are critical but access to basic services and resources will accelerate the peace process and make peace enduring.

Final word: on constituency building

In gearing up for more transparent, accountable and fair governance in Southeast Asia, the challenge lies in seeking allies and building constituencies for reform.

The first step in building constituencies is to identify those who have the incentives and influence to undertake the reforms. Constituency building, in conjunction with public pressure and private sector participation, is essential to tip the scale in favor of regulatory reform, institutional changes and the development of more effective transmission mechanisms. The constituencies of governance reforms in Southeast Asia comprise the following players:

- ◆ *Government career executives and frontline service personnel:* They have the incentive and influence to support the reform in civil service. Career executives are instrumental in improving the quality of public management. Frontline service personnel can guarantee quality, consistency and the timely discharge of government service at the point of delivery.
- ◆ *Private sector:* This sector stands to benefit as government sheds its functions. Private entities offer alternative mechanisms in the delivery of public goods. But they ought to be able to take risks as they absorb government functions.
- ◆ *Subnational governments:* They are the stalwarts of fiscal decentrali-

zation. They have high stakes in providing basic services according to local needs and preferences.

- ◆ *Central government:* Governance reforms would have to start from national governments. Central governments have the overall responsibility of ensuring adequate provision of critical public goods and maintaining social order. The initiative to devolve functions and support decentralization must come from them. Regulatory reform and development of positive incentives rest on central government.
- ◆ *Local communities:* They are the source of demand-led activity. They can help ensure quality of public goods by complementing government in managing local infrastructure projects and maintaining common facilities at the local level.
- ◆ *Civil society:* This serves as strong pressure point for reforms. Civil society organizations can be the watchdog of government decisions and actions. They enhance accountability by keeping government and the private sector on their toes.

One way to build constituencies is by supporting the interest of the majority. Another is by connecting the community of reform actors through free flow of information.

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