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Governance in Southeast Asia: Issues and Options

Eduardo T. Gonzalez and Magdalena L. Mendoza

PHILIPPINE INSTITUTE FOR DEVELOPMENT STUDIES
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

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The authors, Dr. Eduardo T. Gonzalez and Ms. Magdalena L. Mendoza, are president and vice-president, respectively, of the Development Academy of the Philippines.

Dr. Gonzalez holds a Ph.D. in public policy from the University of Pennsylvania. A Fellow of the Philippine Center for Policy Studies, he has published numerous articles on governance and institutional economics in journals and books.

Ms. Mendoza, who is also managing director of DAP s Center for Governance, has an M.S. in industrial engineering from the University of the Philippines. Her main research areas of interest are transparency and accountability in government, corporate governance, and productivity and quality.

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Please address all inquiries to

Philippine Institute for Development Studies
NEDA sa Makati Building, 106 Amorsolo Street
Legaspi Village, 1229 Makati City, Philippines
Tel: (63-2) 893-5705/892-4059
Fax: (63-2) 893-9589/816-1091
E-mail: publications@pidsnet.pids.gov.ph
Website: http://www.pids.gov.ph

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Abstract

This paper attempts to analyze governance systems in Southeast Asia and proposes some policy suggestions that can improve governance practices in the region. It also discusses the links between governance and official development assistance (ODA) and the role of the Japan Bank for International Cooperation. To put the discussion on governance systems in a proper context, the paper discusses the governance and growth nexus in Southeast Asia; describes the operating governance systems in Southeast Asia; analyzes economic governance, more specifically in the areas of economic management and growth, revenue generation, social spending, access to services, cost of doing business, and corporate governance; and examines political governance, focusing on the rule of law and judicial independence, conflict management, and voice participation.

Regardless of level of development, Southeast Asian countries need to establish and strengthen their transparency and accountability structures, both in the public and private sectors, to continue the momentum for broad-based growth. They must also strengthen the fiscal autonomy of their subnational units, and provide more room for participation by civil society groups. More responsive and simplified regulatory structures are needed, and so are strong law enforcement mechanisms. The rise of ethnic tensions argues for better peacebuilding institutions to narrow the gap between groups. In all these, the ultimate challenge lies in seeking allies and building constituencies for reform.

To make ODA better managed and more effective, donors must work in partnership (that is, have a common basket) rather than in competition. Donors can also enhance the value of aid by increasingly providing ideas and not just goods, untying aid, and allowing recipient countries to take "ownership" and greater flexibility in the use of aid. Japanese aid agencies, in particular, must adopt a strategic approach to assisting poverty reduction in the poorer countries of Southeast Asia, while extending their concessional window to middle-income countries. Japan can do well in providing "ideas aid" based on the Japanese experience. Japanese ODA can have higher leverage if an increasing part of the aid is used for institution building and reforms in governance.

I

Introduction

Until the Asian financial crisis occurred in mid-1997, the high-performing Asian economies were prized 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.

Institutional weaknesses that were overlooked during the "miracle" years surfaced once growth faltered. They were not by themselves the reason for the crisis. But lack of governmental accountability and transparency, corruption through cronyism, too much central control, and poor policy coordination at the highest levels almost surely exacerbated the crisis and could pose a major obstacle to future growth and stability.

"Social software" failures, one of which was poor administration, were well known for years but did not shake confidence in the economy (Sachs 1999). The fault lines looked like the classic symptoms of government failure: weak checks and balances, excessive regulations, archaic civil service rules, policies that handicapped competition, rent-seeking, and poor enforcement of prudential discipline. Poor advice from the International Monetary Fund (IMF)—Asian states applied budgetary brakes and withdrew liquidity from banks that only produced more panic and economic contraction (Yoshitomi and Ohno 1999)—made matters worse for weakened domestic institutions, which were unable to provide guidance in stimulating domestic demand in a coordinated fashion. Authoritarianism, once ignored, was suddenly seen as a risk that could slow down further globalization. The long pre-crisis euphoria had pushed the embryo East Asian model up sharply, such that even after the recent slide, Southeast Asian institutions were no stronger (although no weaker either) than they were a decade ago.

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 sea 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, the path to economic resilience and preventing external shocks from transforming into major crises will need major changes in public governance and institutions.

To be sure, it will not be easy to fix the vulnerabilities of Southeast Asia. Sustaining the reforms would entail painful adjustments. Yet, according to the Asian Development Bank (ADB), several Asian countries are already showing signs of "reform reluctance" or "reform fatigue." If reform exhaustion and policy drift persist, they will constitute additional risks to the region's further advance (ADB 2001). Southeast Asia stands little chance of avoiding a worse fate until it finds some way to lock up an outcome that retains many of the institutional or governance reforms it has staked its future on.

Governance and Institutions

Following the definition set by the United Nations Development Programme (UNDP) (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 three 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 interaction.

Governance also refers to the ability of the state to provide institutions, defined broadly as the "rules of the game." Such rules come from formal laws, informal norms and practices, and organizational structures in a country-specific backdrop. 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 (WDR 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.

The paper examines these concepts using the three dimensions of governance: economic, political, and administrative. It follows the distinctions proposed by UNDP (1998): 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. Political governance is the process of decisionmaking to formulate policy. Administrative governance is the system of policy implementation.

Organization of the Paper

The rest of this paper is organized as follows: Sections 2 to 4 discuss Southeast Asian progress in a global context, the links between governance and economic growth in the region, and the Southeast Asian governance regimes, respectively. Section 5 deals with administrative governance issues: rightsizing governments, civil service performance, and alternative service delivery modes. Section 6 is economic governance—revenue raising and spending patterns, access to basic services, cost of doing business and corporate governance (ownership concentration). Political governance is the theme of Section 7, and includes rule of law and judicial independence, conflict management, and voice and participation. Section 8 explores the scope and extent of localization in Southeast Asia, with emphasis on fiscal decentralization. Section 9 proposes policies that can improve governance practices in the region. A lengthy discussion of the links between governance and official development assistance—and the role of the Japan Bank for International Cooperation—is found in the appendix.

II

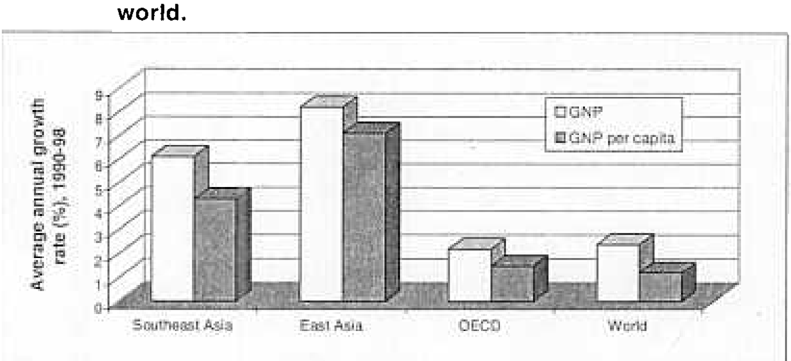
Southeast Asia in a Global Context

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 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 only to East Asia: the average annual growth rate of its GNP as a bloc is nearly 6 percent; that of its GNP per capita about 4 percent (Figure 1). That is about three times the record of the Organisation for Economic Cooperation and Development (OECD) countries between 1990 and 1998.

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,

Figure 1. Southeast Asia is one of the fastest growing regions in the world.



Source: *Human Development Report 2000*

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]

Most Southeast Asian nations are part of a broader set of middle-income countries, which have become important suppliers of global public goods. Fallon et al. (2001) note that middle-income countries are crucial in any collective action to address market failures in the production of such goods as growth, stability, and good governance, all of which have considerable potential benefit for the international community. In the specific case of Southeast Asia, governance reform is needed to recover the momentum for broad-based and equitable growth, and to forestall another financial crisis.

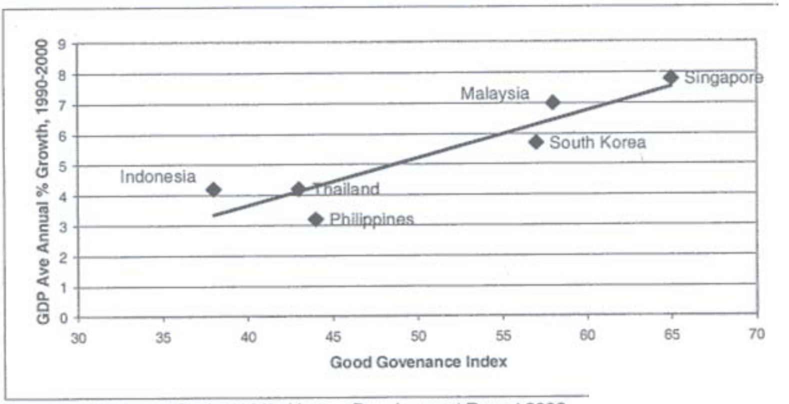
Governance and Growth Nexus in Southeast Asia

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 the high-performing economies—Singapore and Malaysia—have the edge in public management. Those lagging behind, such as the Philippines and Indonesia, 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).

As stated above, there is a strong relationship between good governance and good development outcomes. The slow progress in regulatory reform and still 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—

[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 US consisting of IT products, is the hardest hit ("Asian Economies: The East is in the Red," *The Economist*, May 19, 2001).

Figure 2. Good governance and growth go together.



Sources: Huther and Shah (2000); *Human Development Report 2002*.

principally corruption and high inflation—inflicted harm that greatly affected the poor.

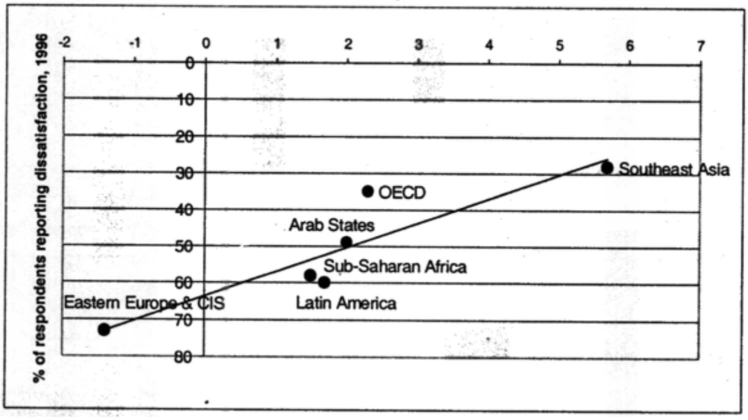
There is also evidence that Southeast Asian economies found strength in some dimensions of good management (even if, in general, institutional weaknesses easily escaped notice amid growth).

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).

The situation is unchanged over a longer period. Figure 4 shows that 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.

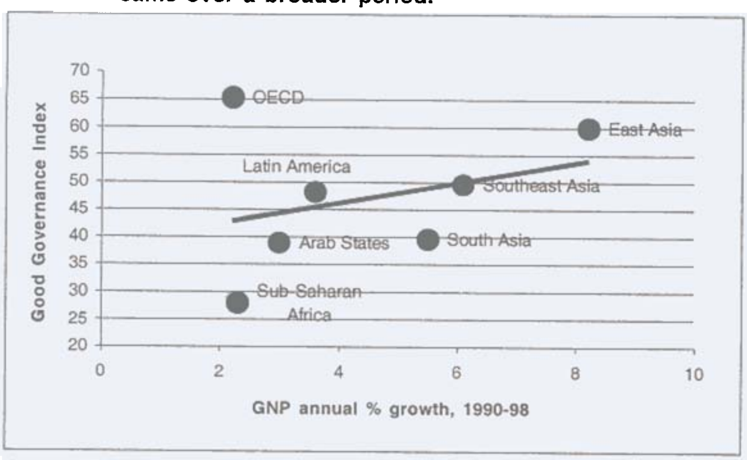
It is true that Southeast Asia's real institutional strength has been overrated. Yet, it is interesting to note that the argument that governance is handmaid to economic performance has never been disputed. This time, however, it is the underlying institutional weaknesses of the region, rather than their 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

Figure 3. Pre-crisis Asia: Fast growth is accompanied by a perceived predictability in laws and policies.



Basic sources: *Human Development Report 1997*; *World Development Report 1997*.

Figure 4. Good governance and growth: the picture remains the same over a broader period.



Sources: *Human Development Report 2000*; Huther and Shah (2000).

recognition that governance does matter. Southeast Asia's hope of regaining momentum will depend, among other things, on (1) salvaging some of the development management values they are built on, and (2) expanding the scope for transparent, accountable, and efficient public administration. Governance will be a major consideration in determining whether Southeast Asia has a bright future.

III

Governance Systems in Southeast Asia

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

This exclusive possession of coercion, when exercised scrupulously gives governments ample ability to do their steering functions effectively, such as maintaining macroeconomic stability and allocating resources equitably. 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.

The exercise of restraint is thus as crucial as the exercise of power in the effectual functioning of the state. Known as checks and balances in political parlance, mechanisms of restraint are present in all states and are often "locked" within institutions. Perhaps the most widely known and most important of these mechanisms is separation of powers. It is inconceivable for any modern state not to have three distinct sets of powers: the legislature (which makes the law), the executive (which implements the law), and the judiciary (which interprets the law). Separation of powers creates constancy and steadiness in governance.

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 (WDR 1997).

Southeast Asian countries in general have many effective checks and balances on the actions of political leaders, as Table 1 shows.[2] To begin with, the form of state varies—from the Philippines' presidential democracy to the

[2] The discussion in this and succeeding paragraphs is mainly culled from the 2001 "Country Profiles" of *The Economist*.

Table 1. Governance systems in the Southeast Asia 5.

Country	Form of state	Chief executive	Form of legislature	Nature of political forces	Depth of judiciary	Electoral cycle
Indonesia	Republican	President (w/ legislative power)	Unicameral	Multi-party; Golkar dominance ends	Multi-tiered	Every 6 years
Malaysia	Federated constitutional monarchy	Prime Minister	Bicameral	Multi-party; UMNO dominant; opposition weak	Multi-tiered	Every 6 years
Philippines	Presidential system	President (has legislative veto power)	Bicameral	Multi-party(w/ fluid membership)	Multi-tiered	Every 3 years
Singapore	Parliamentary democracy	Prime Minister	Unicameral	Multi-party; People Action Party dominates	Multi-tiered	Every 5 years
Thailand	Constitutional monarchy	Prime Minister	Bicameral	Multi-party; Thai Rak Thai dominates	Multi-tiered	Every 4 years

Source of basic data: *The Economist Country Briefings 2001.*

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 US-modeled setup ties down the Philippine president. Singapore and Malaysia, on the other hand, have the stronger executives. Backed up by ruling parties, their prime ministers dominate the legislature.

That 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 role in the party mean domination and little scope for effective opposition, thus weakening a veto point. In Singapore, 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. This practice fortifies their hold on political power, but raises hard questions on propriety and vested interests. 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 liberalized somewhat 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.

In all of the Southeast Asia 5, judicial oversight is present, in several tiers, from local courts handling "first instance" cases to appeals court and the Supreme Court. But the effectiveness of the judiciary is often compromised by its own weaknesses and vulnerability to executive pressures.

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). But 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. Table 2 summarizes the governance features of these states.

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

Table 2. Governance systems in Indochina and Myanmar.

Country	Form of state	Chief executive	Form of legislature	Nature of political forces	Depth of judiciary	Electoral cycle
Cambodia	Constitutional monarchy	Prime Minister	Bicameral	Multiparty; Cambodian People's Party, FUNCINPEC, is dominant	Multi-tiered	Every six years
Lao People's Democratic Republic	Parliamentary socialist state	Prime Minister	Unicameral	Multiparty; Lao People's Revolutionary Party dominates	Multi-tiered	Every five years
Union of Myanmar	Military regime	Military General is head of state and prime minister; State Peace and Dev't Council is ruling junta	Unicameral (Pyithu Hluttaw)	National League for Democracy (NLD) is biggest party (it won in the 1920 election) but ruling junta refuses to hand over power	Multi-tiered	None
Vietnam	One-party rule	3-person collective leadership: Communist Party General Secretary, Prime Minister, and the President	Unicameral	Communist Party remains dominant; party and government overlap extensively	Multi-tiered	Every five years

Sources of basic data: *The Economist Country Briefings 2001; CIA World Factbook*

agers often double as party secretaries in state enterprises, which helps explain resistance to reform. A reformist "government bloc" in the party argues for separation between party and government and greater role for the private sector. The rapid growth of the private sector provides an alternative means of advancement for people who are unable to secure choice places in the party. Economic liberalization is slowly eroding the grip of the party.

In Myanmar, a military ruling junta holds sway despite the convincing victory of the National League for Democracy (led by Aung San Suu Kyi) in the 1990 multiparty elections. There is substantial state-controlled activity in most sectors of the economy (energy, heavy industry, rice trade), and the business environment is generally unfriendly. Poor government planning capacity and political pressures to open up the political system exerted by western governments pose major challenges to the ruling junta. According to the CIA *World Factbook*, narcotrafficking and money laundering are rampant and are the major manifestations of corruption.

Cambodia's progress has been thwarted by civil violence and political infighting. While the political conflict has subsided, Cambodia's institutions of governance are still weak. This issue overshadows almost all of Cambodia's development problems. The caliber of public governance is poor as a consequence of the destruction of Cambodia's educated elite in the 1970s and of years of political uncertainty. Fear of renewed political instability and corruption in government discourage foreign investment and slow reform.

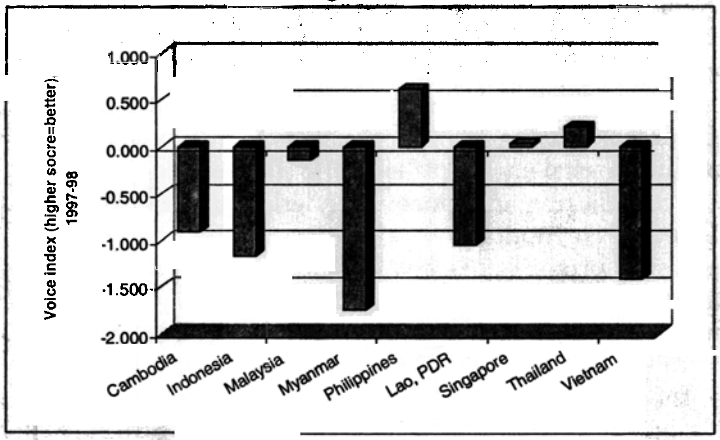
The judiciary in Laos, Vietnam, Cambodia and Myanmar are hardly independent of the executive branch. In Vietnam, people's courts and military tribunals act as courts of first and second instance, and are hamstrung by underdeveloped jurisprudence. Elections are nonexistent in Myanmar; elsewhere in Indochina they are virtually under the thumb of the ruling parties.

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 5. 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 5. Voice: Can Southeast Asian citizens freely select and monitor their governments?



Source: Kaufmann et al. (1999).

Veto Points Over a Longer Period

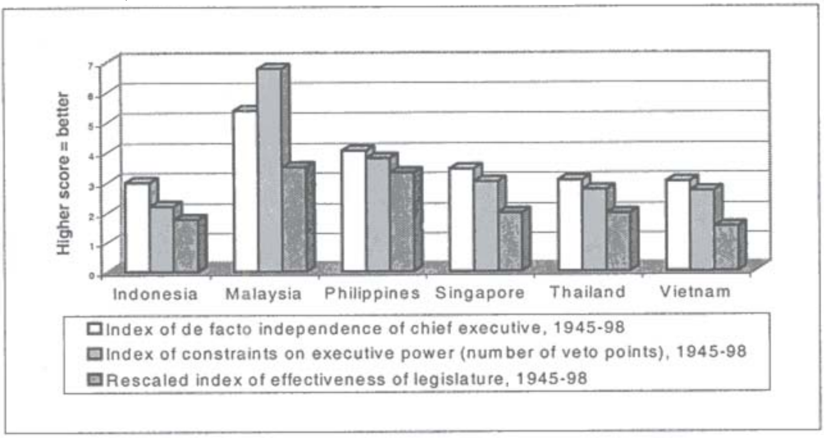
Instead of just a snapshot in time, a picture of Southeast Asian governance structures within a longer time frame should yield richer insights. That is what is presented in Figure 6, which represents averages of the years 1945 through 1998. The data were compiled by Djankov et al. (2001). The indicators include (1) executive de facto independence, (2) constraints on executive power, and (3) effectiveness of the legislature.

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.

Legislatures mediate differing interests and debate and establish policies, laws and resource priorities that directly affect growth and development. Electoral bodies and processes ensure independent and transparent elections for legislatures. Judiciaries uphold the rule of law, bringing security and predictability to social, political, and economic relations (UNDP 1998).

Figure 6 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

Figure 6. An autonomous executive and veto points complement each other.



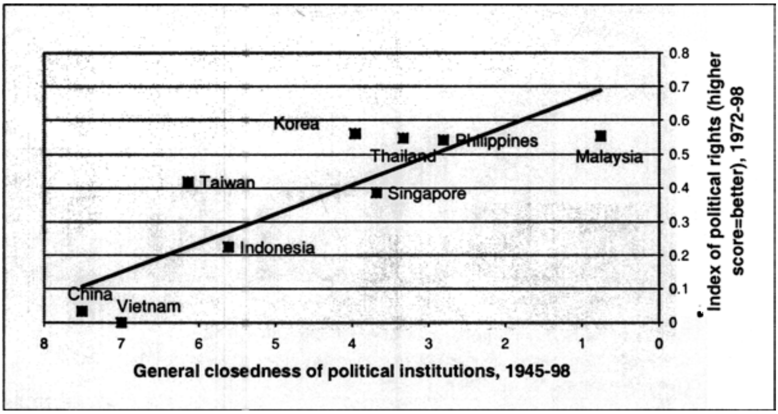
Source: Djankov et al. (2001).

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. Institutions tend to store up power and authority, and in a number of states, give rise to autocracies. Citizens, however, generally yearn for free and fair elections, and want competitive parties and political groupings, an opposition that has an important role and power, and institutions that have self-determination or an extremely high degree of autonomy (Djankov et al. 2001).

Figure 7 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 that its elections are freer, but because in the period under study (1972-98), 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 7. Autocracy and political freedom move in opposite directions.



Source: Djankov et al. (2001)

IV

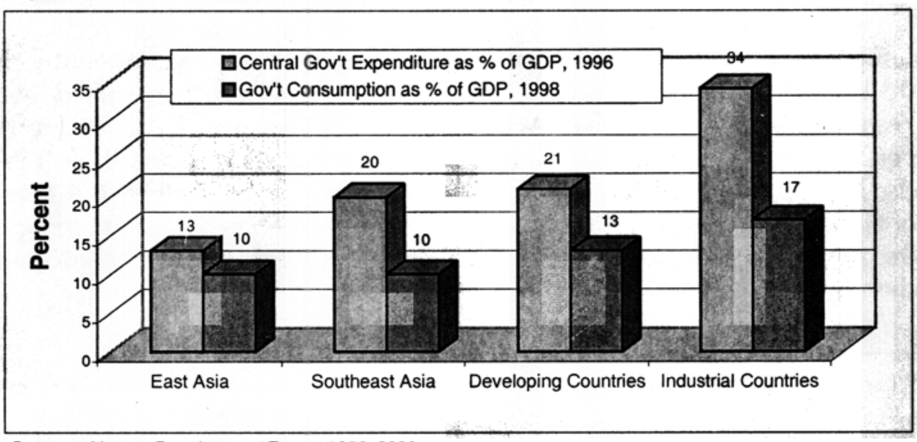
Administrative Governance

Rightsizing Asian Governments

Southeast Asian governments are small compared with OECD governments and those of developing countries as a whole (Figure 8). Government spending in Southeast Asia, which includes the Philippines, stood at 20 percent of GDP in 1996, quite far below OECD central state expenditure (34 percent). Admittedly, the measure of government size—ratio of government expenditure to the economy's total output—is not extensive in scope and ignores important off-budget items (WDR, 1997). Regardless of the measure's weakness, Figure 8 suggests that Asian economies have successfully made government, a key element of governance, slimmer.

Consumption—that part of government expenditure other than investment—tells the same story but the gaps between Asia and the industrial countries are closer. Government consumption in East Asia and Southeast Asia had been around 10 percent of GDP, while that of the OECD countries was 17 percent of GDP. Government consumption has a more limited scope—a large chunk is the public wage bill—but is a more accurate yardstick of what the consumers gain from government spending (WDR 1997). Regional cross-comparisons indicate that Asian governments have somewhat

Figure 8. Governments in Asia are smaller than those in the rest of the world.



Sources: *Human Development Report 1996, 2000.*

bridged the consumer welfare gap between the region and the highly developed economies while maintaining reduced proportions.

It is easy to see why Southeast Asia (to a certain extent) could claim success in shrinking governments. Unlike the industrial states, the region's governments did not have to wrestle with the stubborn difficulties of the welfare state, which has seen decades of uncontrollable expansion in the West. Unlike the rest of the developing world, Southeast Asia (along with East Asia) had come a long way from years of post-colonial nation-building, with its undue emphasis on expansive state-dominated development strategies (WDR 1997). It is true that developmental statism still abounds in Asia in general, but that by itself could not prevent governments from shifting from quantity to quality in providing public goods. As states take on more market-friendly approaches to public provisioning, they often pass along more arduous "rowing" tasks to the private sector and civil society, leaving themselves free to pursue more critical "steering" chores.

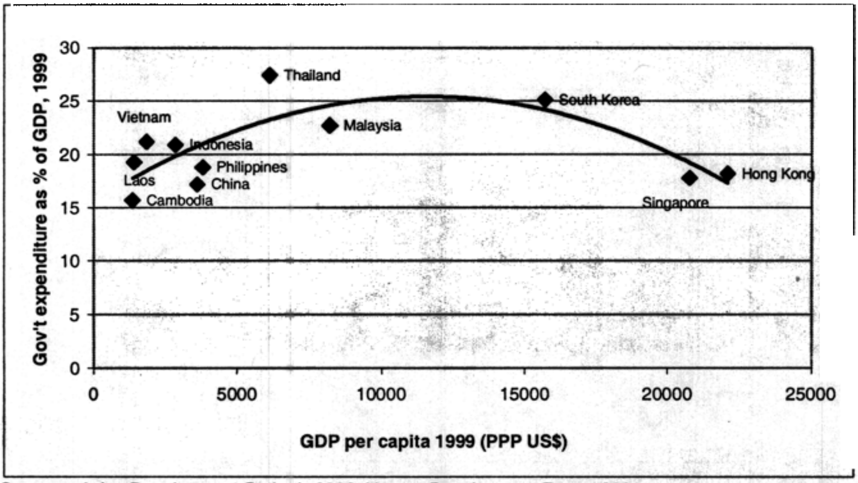
But is a lean state the courier of both growth and welfare? While as a whole Southeast Asian governments are small, Figures 9 and 10 show a much more varied pattern within the region, and imply that a bit of an expansion takes place before governments settle to a slimmer size, as both incomes and human development improve. The order of appearance of the countries is not exactly identical, but the following picture should hold:

Hong Kong SAR and Singapore were clearly the benchmarks in size and scope of government, having generated the highest growth rates in per capita incomes[3] and human development. For Thailand, Malaysia, and the Philippines, government spending was good enough to reach high human development but 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 medicine. Rightsizing is not made easier when a vicious cycle sets in.

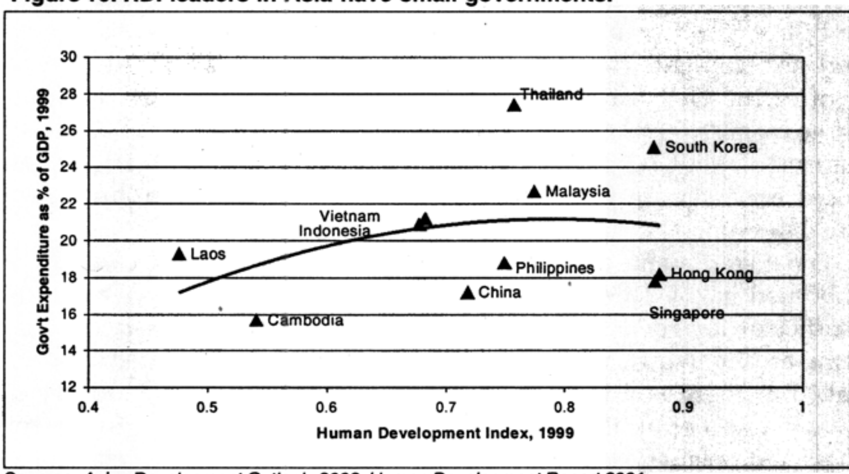
[3] Whenever available, purchasing power parity (PPP) values are used for ratios to facilitate cross-country comparisons. The use of comparable international prices noticeably increases the ratio for developing countries.

Figure 9. The Asian experience suggests that governments expand, then shrink, as income rises.



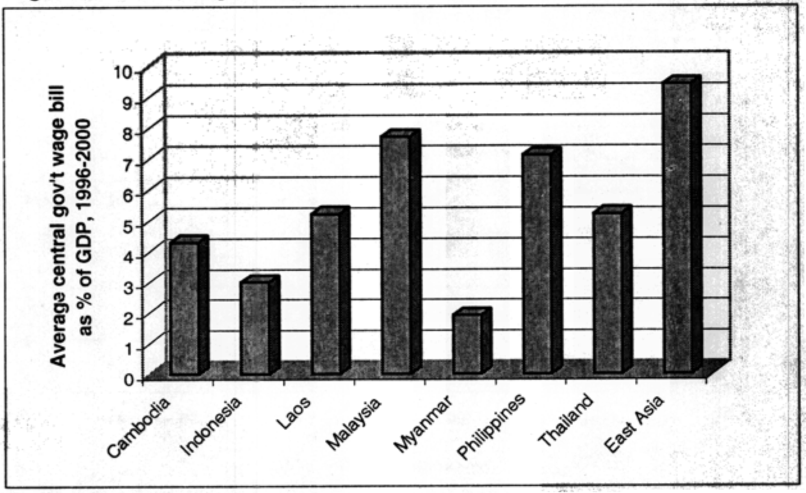
Sources: *Asian Development Outlook 2002; Human Development Report 2001.*

Figure 10. HDI leaders in Asia have small governments.



Sources: *Asian Development Outlook 2002; Human Development Report 2001.*

Figure 11. Central government wage bill: low fiscal burdens.



Source: World Bank Public Sector and Employment Survey.

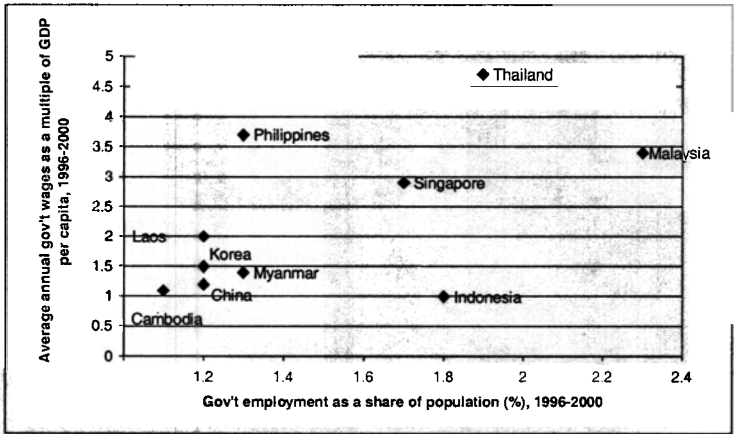
Performance Management: The Civil Service

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 11 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 11.

Lean governments in general suggest high administrative capacity, which is embodied in the civil service. A good civil service is necessary although not sufficient for good governance. In East and Southeast Asia, civil service systems are known as relatively strong, competent, motivated, and professional.[4] But there is a twist to this. In an extensive cross-country study, Schiavo-Campo et al. (1997) have suggested that although greater responsiveness and openness can rightfully be asked of public management in some Asian countries, the region's strong civil service systems are an important reason why in much of the region, authoritarianism has co-existed with excellent economic performance.

[4] Underneath this overall picture of competence are weaknesses. In Cambodia, for instance, technical and managerial skills are frail, particularly in the areas of implementation planning and financial management. Functional responsibilities, formal accountabilities, and integrity structures are skimpily defined (World Bank 2000a).

Figure 12. The global trend of higher public employment going with lower wages is not evident in SE Asia.



Source: World Bank Public Sector and Employment Survey.

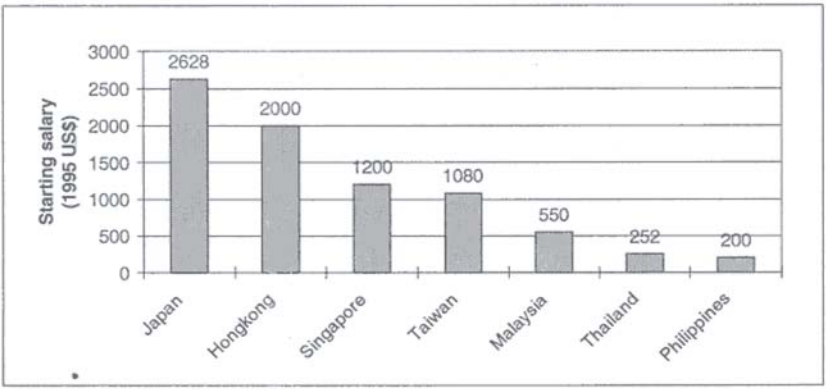
That does not mean that no downsizing of governments in Southeast Asia is needed. Globally, the tendency is to match high wages with a lean workforce (WDR 1997). That is, government employment is negatively associated with wages. A highly paid, high-quality civil service, which is small in number, means 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 12, 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, have slim civil service structures, but the workers are lowly paid too.[5] 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 12 shows average measures, which make it necessary to look at how the upper layers of the bureaucracies in Southeast Asia are faring. The higher the number of senior civil service personnel a country has, the better are the expertise and skills available and the greater the ability to implement

[5] For 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).

Figure 13. Within Asia, salaries of top civil servants vary.



Basic source: Gonzales III (1996).

policies and development programs. But the top echelon must be highly motivated and salary a key variable for keeping it within the fold and preventing high turnovers.

Figure 13 shows the variation in starting pay for senior civil servants, circa 1995. Although on average, the public workforce in the Philippines, Thailand, and Malaysia is better paid than the rest, their top civil servants obtain relatively low salaries. Singapore, which is not even the benchmark in Asia, offers the upper crust of its bureaucracy starting salary levels that are about twice those in Malaysia, four times those in Thailand, and five times those in the Philippines.

Such pay differentials are only one reason for dissatisfaction in higher ranks. In addition, enforcement of wage compression in many countries has meant greater-than-normal cuts at higher levels (and/or salary caps), further affecting top civil servants. (The Salary Standardization Law in the Philippines is one such pay compression measure.) This progressively leads to loss of employees with options, that is, the more skilled members of the workforce (Schiavo-Campo et al. 1997).

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 cross-country studies find only a weak link. So do most anecdotal researches.

In Indonesia, for instance, a scrutiny of individual and household data indicates that the earnings of government workers, on average, are comparable to what they might be paid in the private sector. The results of the relationship between private and public compensation make low pay as an explanation for government corruption doubtful (Filmer and Lindauer 2001).

Table 3. How high should civil servants' pay be to curb corruption?

	Public sector relative to manufacturing sector wage, 1997	
Economy	Actual	Calibrated ratio to reduce corruption to Singapore level
Singapore	3.49	3.49
Hong Kong	1.79	2.85
Korea	1.91	7.08
India	1.09	5.40
Sri Lanka	0.85	5.07

Source: Van Rijckeghem and Weder (1997).

Indeed, high pay does not necessarily lower corruption. As Table 3 demonstrates, some Asian countries like South Korea and India already offer their civil servants salary levels higher than those in the manufacturing sector, but that has not deterred corruption in the public sector in these nations.

Wei (1998) estimates that to reduce corruption to the Singapore level (considered the benchmark for low corruption levels), public sector pay will have to be hiked by a minimum of 60 percent, as in the case of Hong Kong, and by as much as 500 percent, as in the case of Sri Lanka. These increases, suggests Wei, are simply "fiscally infeasible."

According to Schiavo-Campo et al. (1997), the key measures needed for improved civil service performance are rightsizing, incentives, and accountability. Lean size and high-quality sector workforce, plus new institutional rules that guide its behavior, should go together in creating a competent and honest civil service. Adequate compensation is necessary but should not be viewed as the chief tool for combating corruption. Decompression in salary structure (in Laos, for example, the compression ratio has changed from 3:1 in the late 1970s to 7:1 in the early 1990s) is also an important goal. The overriding goal, taking into consideration country-specific circumstances, is "to achieve a civil service of the size and skill-mix, incentives, professional ethos, and accountability needed to provide public goods, help formulate and enforce the rules, and intervene to remedy market failures."

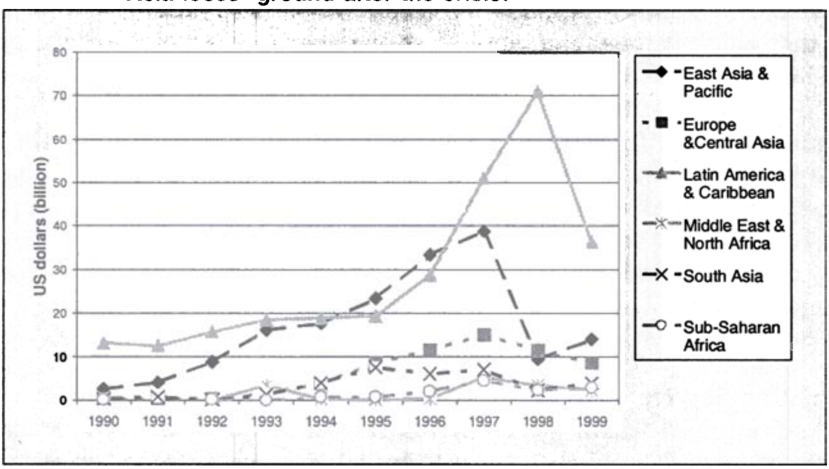
Alternative Service Delivery Modes

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.

In the recent past, government provision of infrastructure services was considered the only way to prevent monopolistic abuses and the whims of the market. The energy and telecommunications subsectors, for example, have long been considered "natural monopolies." The whole infrastructure sector, because of scale economies and demand externalities, became the deviation to the rule that competition enhances the quantity and quality of provision. As a result, private infrastructure providers were heavily regulated for years (WDR 2002). However, government failure substituted for market failure: government-provided infrastructure were often of poor quality and insufficient coverage.

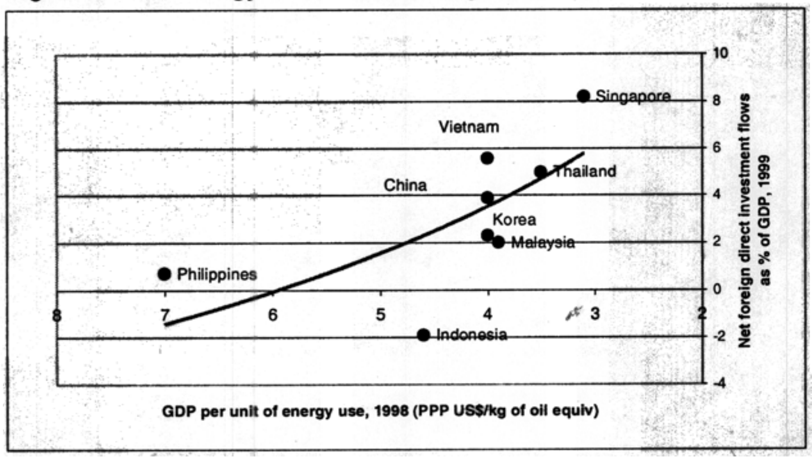
But times are changing, at least in some regions such as East and Southeast Asia and Latin America. As Figure 14 shows, private participation in infrastructure services has been on the rise in these parts of the world, particularly in the 1990s. It will be noted, however, that East Asia (which includes Southeast Asia in the figure), as a result of high perception of risk after the 1997 crisis, has been losing ground to Latin America, which captured the largest chunk of investment commitments with private participation. Nevertheless, such "shedding" by national governments has raised efficiency and abated the pressure on public finances (WDR 2002), while tremendously improving the quality of infrastructure in the region.

Figure 14. Investment in infrastructure with private participation: Asia loses ground after the crisis.



Source: World Bank PPI Project Database.

Figure 15. Low energy costs attract foreign investors.



Source: *Human Development Report 2001.*

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 15 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.

V

Economic Governance

Economic Management and Growth

A country needs an enabling environment to achieve stable economic growth, a goal it is expected to pursue irrespective of its level of development An index that captures some key observable aspects of economic governance is presented in Figure 16.

Huther and Shah (1998), who constructed the composite measure, argue that "the quality of a government's economic management (can) be assessed through performance indicators of fiscal policy (debt-GDP ratio), monetary policy (central bank independence) and trade policy (outward orientation)."[6] Following their ranking scheme, a score between 51 and 75 is good economic management; between 41 and 50, fair economic management; and between 0 and 40, poor economic management. Thus, Malaysia, Singapore, and the Philippines are well managed; while Thailand and Indonesia are fairly managed. Huther and Shah find a high correlation between governance quality (wherein economic management is embedded) and per capita income, but also suggest that the causality runs both ways, since higher incomes raise the demand for higher-quality management.

In a related study, Grigorian and Martinez (2000) applied a two-stage least squares test linking good governance and industrial performance in Asian and Latin American countries. Employing indices of institutional quality (government repudiation of contracts, risk of expropriation, corruption, rule of law, and bureaucratic quality) from a data set assembled by the IRIS Center of the University of Maryland, the two find that institutional quality turns out to have a very strong positive impact on the rate of industrial growth. Their findings also suggest that the more developed the legal and regulatory framework, the stricter the enforcement and the lower the administrative barriers, the greater the volume of investments made available in the economy and the more efficient the allocation of resources.

[6] The economic management index is a component of a broader indicator, quality of governance (utilized in other sections of this paper), which includes citizen participation, government orientation, and social development. See Huther and Shah (1998) for details.

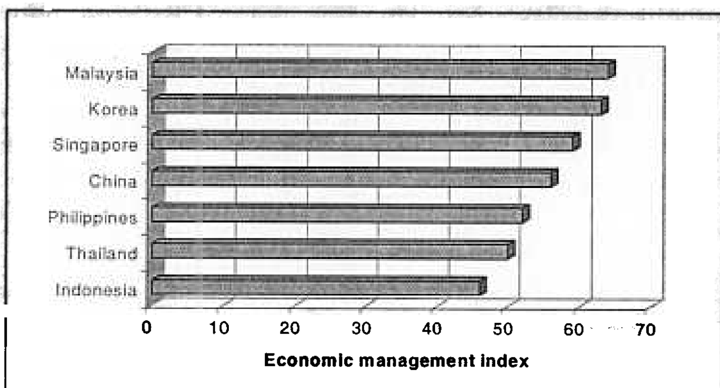
Revenue Generation

Since fiscal management is part and parcel of economic governance, it is important to focus on a country's ability to achieve balance between government spending and revenue generation, or "between politically popular expenditure programs and politically unpopular taxation." Good fiscal outcomes come from the skill of governments to marshal political support for essential taxation and withstand pressures for the expansion of spending favoring certain constituencies (WDR 2002), who manage to capture concentrated benefits but pass on the burden to the public in the form of diffused costs.

For starters, revenue effort rises with per capita income, as Figure 17 indicates. Yet Figure 18 illustrates the difficulties of Southeast Asian countries in balancing tax revenues and expenditures. In all cases, tax revenues fall short of the amount needed to support government expenditures. Ordinarily, this is to be expected, and nations can fall back on domestic and international borrowing to fill the gap. But when the difference between tax revenue and expenditure is upwards of 3 percent of GDP, the gap is not easily closed, as in the case of the Philippines, Thailand, Vietnam, and Myanmar. Weak revenue performance in Cambodia (9 percent of GDP in 1998) is largely due to excessive tax exemptions and a narrow tax base (World Bank 2000a). Similarly, a small tax base hounds Myanmar's recurrent fiscal underperformance (ADB 2000).

How creditable are the institutions of taxation of Southeast Asian economies? These institutions do seem to function fairly for some countries, like Malaysia, the Philippines, Vietnam and Indonesia, where the average tax revenue as a share of GDP is greater than 16 percent. Yet there is considerable room for improvement in these cases. But when tax collection is appreciably

Figure 16. Economic management in Asia: not too good, but not too bad either.



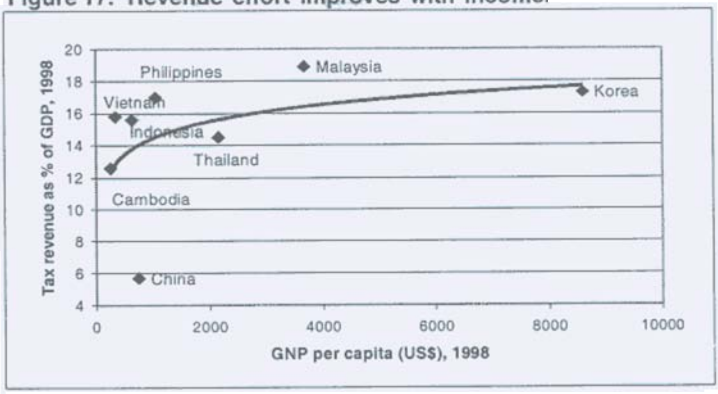
Source: Huther and Shah (2000).

low, as in Cambodia, it is clear that the state cannot provide enough resources for vital government expenditure.

It matters a great deal also what kind of taxes governments focus on. Heavy reliance on easily collected taxes, such as international trade taxes, is a sign of weak tax management. Vietnam and the Philippines may score highly on revenue collection, as shown in Figure 19, but a large proportion of it is in the form of customs duties and other taxes on trade, which are quite distortionary. In Laos, an adjustment of the exchange rate applied to the valuation of import duties accounted for much of the increase in tax revenues (ADB 2001a). Such dependence on customs taxes implies a high degree of protectionism, as these taxes tend to shelter inefficient domestic producers (WDR 2002). But changes are in the horizon. In Cambodia, for instance, the government plans to gradually reduce the tariff rate (an average of 15 percent) to 0 to 5 percent in 10 years, which should spur efforts to develop alternative revenue sources to offset such customs revenue losses. A similar move is happening in Indonesia, where greater domestic tax effort has actually resulted in slight improvement in domestic resource mobilization (ADB 2001a).

Maintaining fiscal balance likewise implies achieving discipline on the expenditure side. Not much progress is being registered in this aspect. The Philippines, for one, is still troubled by allocative and operational efficiency problems—weak capacity to make expenditure plans in line departments, and persistence of line item budgeting. The focus now is on expenditure bids being relayed upwards rather than on resource ceilings being transmitted downwards. On the bright side, its auditing capacity remains relatively high. It has also been shifting to a "performance budget," and has refocused on programs rather than on line items. However, these changes in the budgetary decisionmaking process are more formal than real (JBIC 2001).

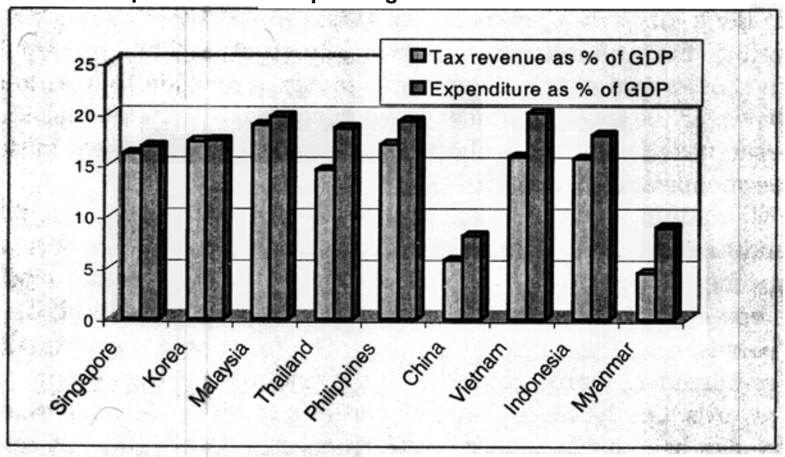
Figure 17. Revenue effort improves with income.



Source: *Human Development Report 2000.*

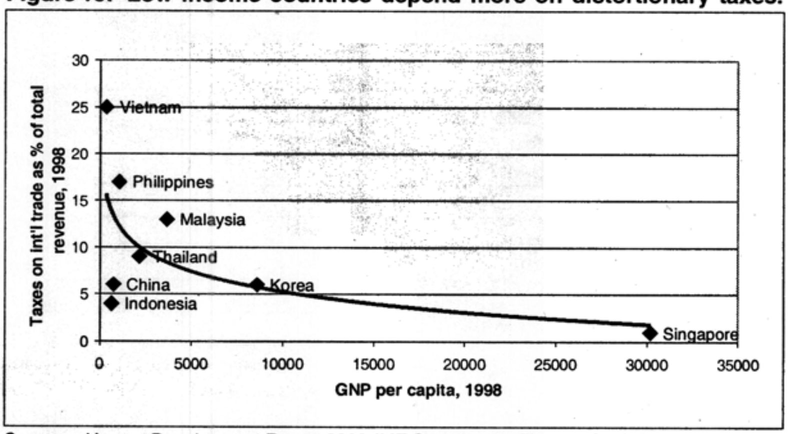
In Thailand, public expenditure management is confronted with a number of issues: expenditure administration is too centralized and often dispersed among different agencies, frequently resulting in lengthy delays; the recurrent and capital budget process does not fully reflect policy priorities; and mechanisms for ex-post evaluation are weak (ADB 2000a). Meanwhile, in Laos, the prioritization of each project in a single year budget is often decided by political expediency rather than objective analysis, creating distortions in the resource allocation process (JBIC 2001).

Figure 18. Central government's budget blues: can revenue effort put a brake on spending?



Source: *Human Development Report 2000.*

Figure 19. Low income countries depend more on distortionary taxes.



Sources: *Human Development Report 2000*, IMF Government Finance Statistics.

Social Spending

The Southeast Asian high-performing economies, principally Singapore, Thailand, Malaysia, and Indonesia (along with East Asia) became the toast of the world because they shattered the Kuznetsian inverted-U hypothesis: the inevitable tradeoff between growth and equity. What the Asian experience proved was that good economic management could underwrite growth that is both market-friendly and equitable.

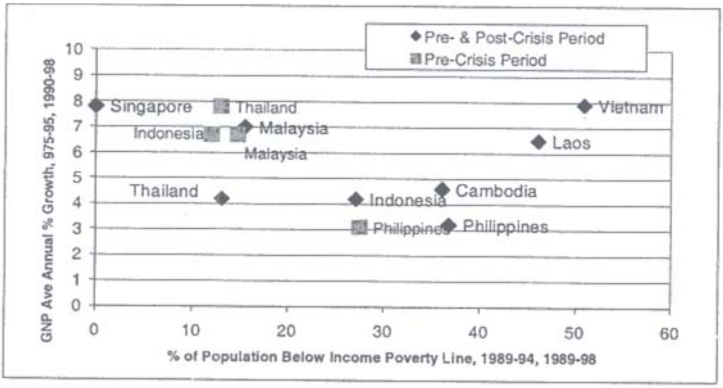
This was not an easy thing to do, since it required bold policy stances in both the economy and the social arena. Macroeconomic policymaking in an era of globalization was of recent vintage, a whole new field that entailed risks as well as opportunities. When the high-performing Asian economies took chances, they made themselves highly exposed to destabilizing shifts in capital flows. This later on hit them hard during the Asian crisis, but fueled phenomenal growth rates of up to 10 percent yearly throughout the pre-crisis period. But the key was that these governments put the social fundamentals high on their agenda and made large spending on basic health and education.

Figure 20 depicts the situation in Southeast Asia in the 1975-95 pre-crisis period and in a later time frame, 1990-98. In the pre-crisis era, Thailand, Malaysia, and Indonesia made significant headway in both growth and equity, proving that appropriately designed expenditure policies in basic education and health care could break the stranglehold of poverty in an environment of heady economic performance.[7] Note that the Philippines was left behind on both counts. When the crisis is factored in, poverty reappears dramatically. But the pattern is not uniform between 1990 and 1998. The increase in poverty in Indonesia was significantly sharper and more pronounced (from about 26 percent in 1996 to 37 percent in 1999)[8] than in Thailand. Malaysia's level of poverty incidence in 1998 was almost negligible (0.74 percent) (Deolalikar 2001). Thailand managed to keep the number of poor people from growing considerably, a commendable record for an economy

[7] To illustrate how fast poverty was reduced in the region, consider Indonesia. In the two decades leading up to the Asian crisis, poverty levels fell from over 60 percent to less than 12 percent of the population (World Bank 2001). For Vietnam, although not shown in any chart, rapid growth in the 1990s induced a sharp decline in poverty incidence: from about 70 percent in the late 1980s, the proportion of the population living below the official poverty line declined to about 58 percent in 1992/93, and further to 37 percent in 1997/98 (ADB 2001b).

[8] Suryadahi et al. (2000) note that if the official figure of 11.34 percent for February 1996 is accepted, poverty in Indonesia increased from the immediate pre-crisis rate of about 7-8 percent in the second half of 1997 to the post-crisis rate of about 18-20 percent by September 1998 and 18.9 percent in February 1999. Since then, Indonesian poverty seems to have gone down but is still substantially higher than what it was immediately before the crisis.

Figure 20. Poverty reduction: good governance matters.



Sources: *Human Development Report 1998, 2000, 2001.*

that suffered a great fall. The Philippines, again, did not cope well. While its economy was not badly affected by the crisis, the number of poor Filipinos rose greatly. The Philippines joined the likes of Vietnam, Laos, and Cambodia in the high-poverty column.

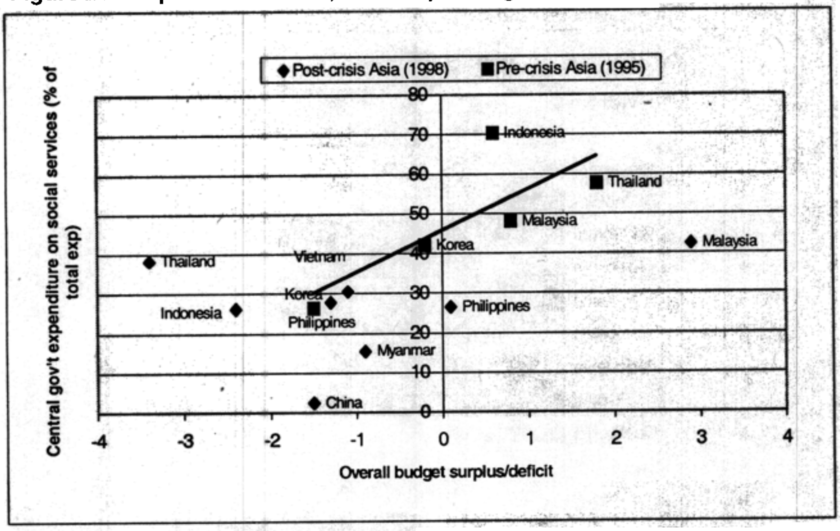
The vulnerability[9] of the nonpoor also increased in the region. Estimates of household level vulnerability using cross-sectional data suggest that the proportion of the population that is at risk of falling below the poverty line is considerably higher than the fraction observed to be poor. In the Philippines, some 40 percent of the population was vulnerable in 1997, compared with 25 percent that was observed to be poor (Chaudhuri and Datt 2001). In Indonesia, 45 percent was found vulnerable in December 1998, while 22 percent was observed to be poor (Chaudhuri et al. 2001). In Thailand, 35.2 percent was highly vulnerable in 1999, while 14.7 was observed to be poor (Bidani and Richter 2001).

The antipoverty effort plunged because social spending in Southeast Asia also nose-dived after the crisis. In the pre-crisis period, Indonesia won praises for being good at allocating resources to protect basic social services and reduce poverty during tight fiscal periods. Thailand, too, was seen as reasonably effective in instilling fiscal discipline, even if its overcentralized system failed to take advantage of useful information from national agencies and lower levels of government (Campos and Pradhan 1996).

The crisis changed all that. Indonesia and Thailand experienced sharp budget shortfalls and consequently, made drastic reductions in government

[9] Within the framework of poverty reduction, vulnerability is defined as the ex-ante risk that a household will, if currently nonpoor, fall below the poverty line, or if currently poor, will remain in poverty. It is the likelihood that a household, regardless of whether it is poor today, will be poor tomorrow.

Figure 21. In post-crisis Asia, social spending takes a dive.



Sources: *World Development Report 1997, 2002.*

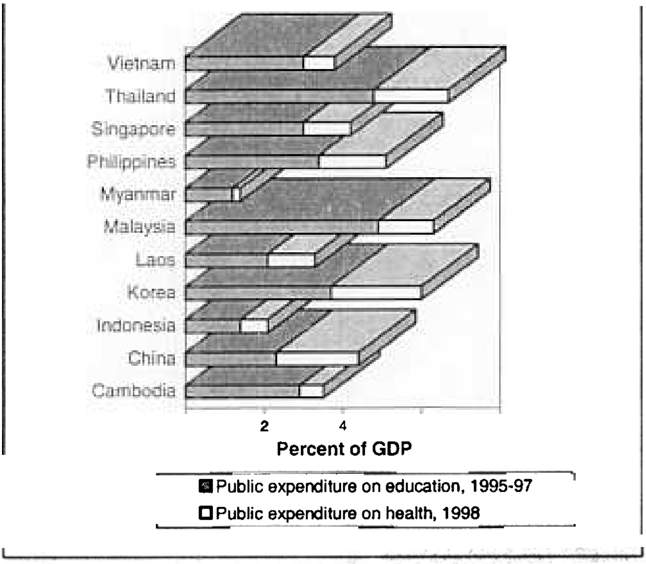
expenditures on social services (Figure 21). Malaysia slightly improved its finances but also reduced its social spending. The Philippines managed somehow to keep the same proportion of public spending on social services. It registered a budget surplus in 1998, but like the rest, contractions in the economy probably meant that social expenditures were less in absolute terms. Vietnam's and Myanmar's budget deficits after the crisis hit also meant fewer resources for social services.

When spending on health and education alone is taken into account, Malaysia, Thailand, and, to a certain extent, the Philippines seem to do better than the rest in providing for the needs of their respective populations, as Figure 22 shows. That means that in these countries, social safety nets are in place to cushion the impact of shocks, and the presence of some social risk management instruments may be contributing a lot to mitigate the worst features of poverty.

Several factors have influenced the amount of public spending on health and education in Southeast Asia: distorted priorities (high defense spending in Cambodia, Laos, and Myanmar crowd out the social sector), internal pressure not to cut despite high budget deficits (Thailand, Philippines, and Indonesia), safety nets (policy and structural adjustments included funding for the social sector in Indonesia and Thailand), and dependence on aid (direct assistance to Myanmar for social services).

The case of Cambodia is an illustration of a country said to have "distorted" priorities. Excessive public expenditure on defense from 1994 to 1998

Figure 22. Whose priority is public spending on health and education?



Source: *Human Development Report 2001*.

(between 3.3 and 5 percent of GDP annually) crowded out the social sectors. In 1998, public spending on health and education accounted for only 0.7 percent and 1.3 percent of GDP, respectively[10] (World Bank 2000a). This trend in spending has not changed much in the following years. To make matters worse, actual expenditure for education—and even more so for health—falls short of budgeted levels.

Myanmar's military spending is also high. In 1997, for instance, public expenditure on defense accounted for 7.6 percent of GNP (WDR 2001). On the other hand, past spending on health and education had averaged about 0.5 percent of GDP. Myanmar's budget deficit has strained social sector provisions, resulting in low educational attainments and inadequate healthcare. Like Indonesia, Myanmar has to rely on donor assistance (particularly from the European Union) to support basic social service provision (ADB 2001b).

Laos' public expenditure for defense is similarly high at about 3.4 percent of GNP in 1997 (World Bank undated2).

In Indonesia, the government tried to maintain the same real level of spending for basic education as in pre-crisis years through a "stay in school"

[10]Public spending on health of Cambodia is among the lowest in the world (World Bank undated).

campaign in 1998, which includes targeted scholarships for the poorest children; block grants to schools to compensate for reduction in parental contributions and increases in costs of inputs. Some donors also sought to protect the social sectors through adjustment loans. The Indonesian government used part of the Policy Reform Support Loan from the World Bank in 1998 to support the purchase of food and essential drugs, including vaccines and drugs needed for communicable diseases control (World Bank undated2).

Due to a big revenue shortfall in 1998, following the Asian financial crisis, the Philippine government imposed austerity measures, cutting allocations by as much as 25 percent. But mindful of possible adverse effects, it exempted the basic social services sector (basic education and primary health). Despite this favorable policy, the social sector failed to maintain its share in the national budget (Manasan 2001). Trends in education financing in the Philippines are likewise not encouraging. With rapid expansion of publicly funded state colleges and universities, tertiary education is crowding out the budget for elementary education (World Bank 1999a). In a similar vein, Vietnam has protected social sector spending even if the overall budget has fallen (World Bank 2000b).

Malaysia's relatively strong fiscal and debt management policies allowed it to weather the early effects of the financial crisis, slowing down contraction. Malaysia has run budgetary surpluses for the past five years, sheltering social sector expenditures. The impetus for this is reliance on a regulatory regime that expands private provision of social services (World Bank undated1).

Among the Southeast Asian countries, Thailand has been spending the highest in public health, roughly about 6 percent of GDP compared to less than 3 percent for Indonesia, the Philippines, and Malaysia. To preserve the gains in health status, the Thai government increased the budget for health welfare by 10 percent in 1998, although it still represented a fall in real health expenditures. There were budget cuts in other areas, such as the program on AIDS (World Bank undated2). In the education sector, the financial crisis had induced a slowdown in the external training of leading science and engineering educators, considered key to quality improvement (World Bank undated1). Donor assistance (e.g., ADB student loan fund) has also helped the Thai government step up social spending.

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, they have also ensured greater coverage of poor people within the Southeast Asian region. The quality and coverage of infrastructure services such as electricity, water, telecommunications and transport have a major impact on living standards (WDR 2002).

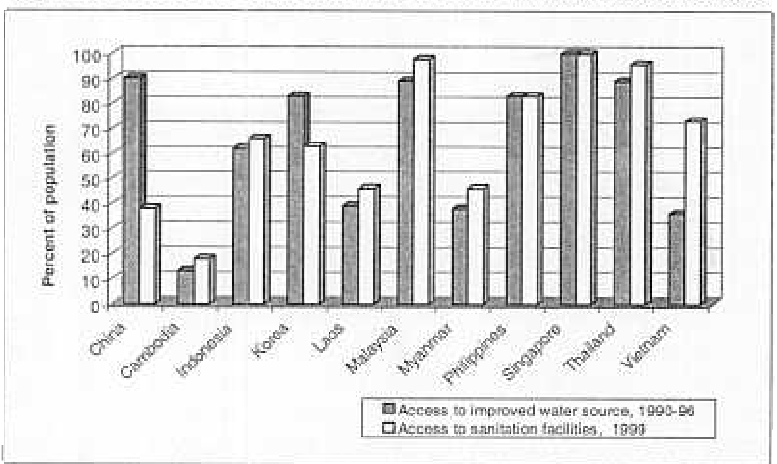
But the record is mixed, on a rundown by country. The governments of Singapore, Thailand, Malaysia, and the Philippines have apparently spent well for water and sanitation services, which remain as government spending items. As Figure 23 shows, some 80 percent or more of the population, including the poor, had access to improved water source and sanitation facilities in the 1990s. Vietnam, Laos, Cambodia, Myanmar, and even Indonesia have not done as well during the same period.

In enlarging access to electricity, the region's governments have a much better record, with Malaysia, Thailand, Indonesia, and Singapore leading the way (Figure 24). Surprisingly, Myanmar has an edge over the Philippines. The broad approach that has been successfully adopted by the region's pacesetters is to combine participation by the private sector, incorporation of coverage targets, and effective regulation that cuts costs, making the services more affordable (WDR 2002).

The Philippines did the reverse by heavily regulating power distribution in the country and maintaining its monopoly over power generation. It also failed to encourage investments in the area, precipitating a power crisis in the late 1980s, when infrastructure deteriorated rapidly. Power generation was subsequently restored to its previous level, but at considerably high costs and with grave distributional and welfare effects. Much of the effort to lift anticompetitive regulations will have to come from the enforcement of a new power reform law.

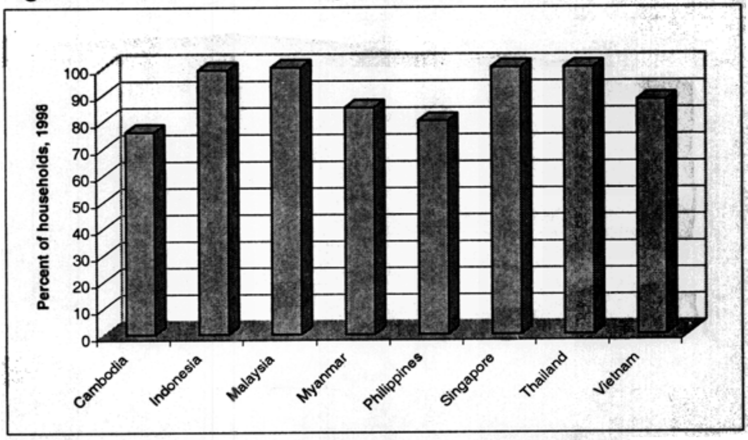
The presence of public and private providers is seen to add to high institutional quality. In Malaysia, a reliable system of public clinics has maintained pressure on the private sector to keep prices reasonable (van de Walle

Figure 23. Access to basic services: a lot of infrastructure shortfalls.



Sources: *World Development Report 2001; Human Development Report 2001.*

Figure 24. Access to electricity: not a bad record.



Sources: UNC Global Urban Indicators; World Bank 2001 World Indicators.

and Need 1995; World Bank 1992). But such competition is possible only in areas that are heavily populated enough to sustain multiple providers. In remote areas largely inhabited by the poor, provision still rests with government (WDR 2002).

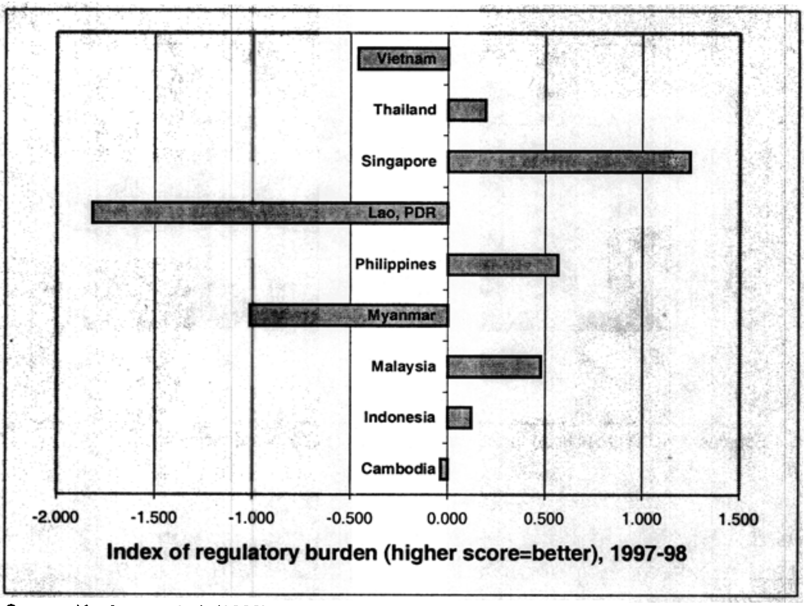
Data on what causes the differences in access and level of infrastructure services in Southeast Asia are hard to come by, but a few anecdotal facts might be useful. Lack of clear-cut rules on how to mobilize private investment is apparent in Vietnam (World Bank 2000b) and Laos (World Bank 1999). Institutions 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 (*Asian Development Outlook* 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

Despite decades of progress, Southeast Asian economies are still hedged in by regulations that waste resources and stymie competition. To be sure,

Figure 25. Are market-friendly regulation existent in Southeast Asia?



Source: Kaufmann et al. (1999).

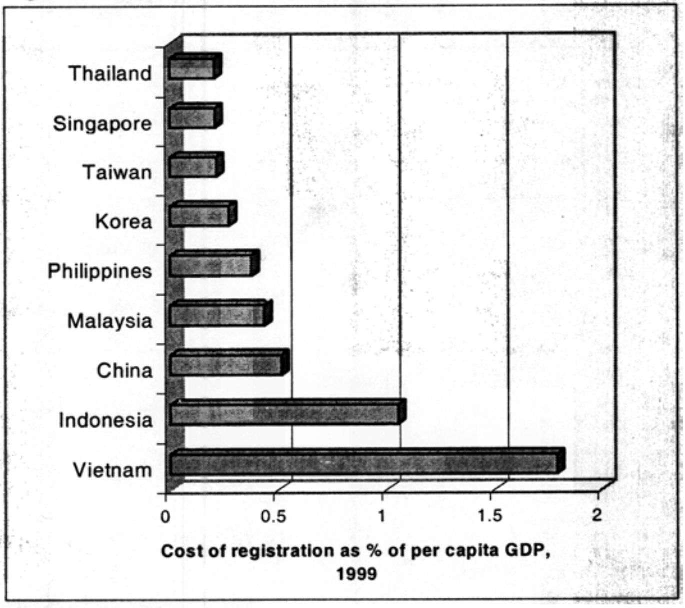
government interventions can lessen market failures, but governments may also inflict harm by imposing regulations to compensate for market failures. Government failure occurs when administrative capacities are weak, in which case the tendency is to overregulate activities (WDR 2002).

Excessive regulations undermine trade and business development. Wage and price controls, anti-competition 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 (Figure 25). 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.

When it comes to regulations for business entry, the cost of business registration as a fraction of GDP per capita varies widely in Southeast Asia. The cost of obtaining legal status to operate a business enterprise includes costs of procedures, legal and notary charges, and the monetized

Figure 26. The cost of registration in Asia varies.



Source: Djankov et al. (2001).

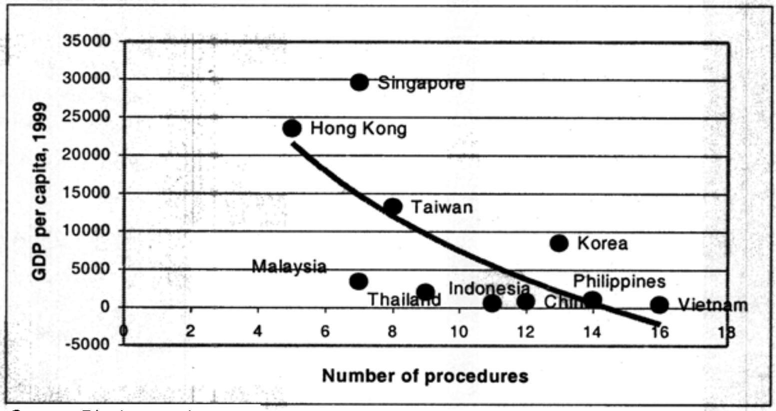
value of the entrepreneur's time (Djankov et al. 2001). In Thailand and Singapore, registration costs are comparable to those in OECD countries, elsewhere in the region they are more expensive (Figure 26). Vietnam has the highest business entry costs; Indonesia is not far behind. Stricter regulations, such as those found in Vietnam, are thus associated with higher costs.

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 27 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).

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

Figure 27. Lower income economies have more procedures.



Source: Djankov et al. (2001).

regulation of entry also brings about sharply higher levels of corruption, and a greater unofficial economy.

In public choice theory, more procedures and longer delays spawn bribery and/or make entry less appealing to potential competitors (Djankov et al. 2001). Regulation becomes an instrument to create rents for bureaucrats and/or incumbent firms. Stricter regulation should then be associated with greater corruption and less competition (Claessens et al. 1999). In Vietnam, the Philippines, and Indonesia, overregulation of entry produces more corruption revenues (Figure 28).

Figure 29 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.

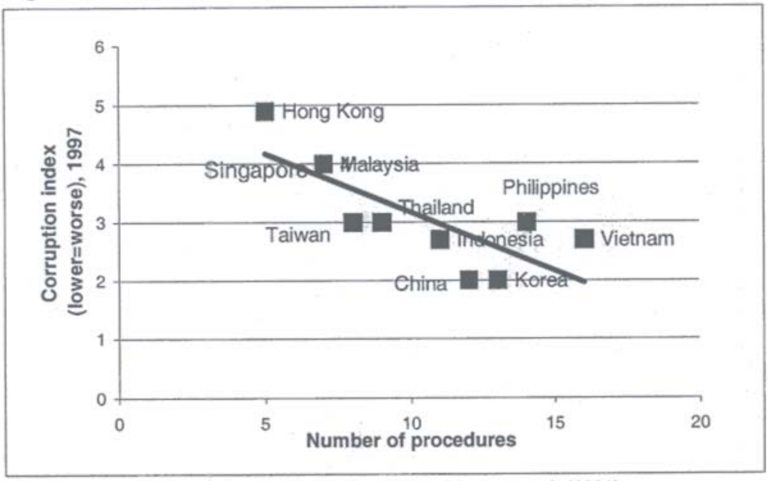
A turnaround in the regulatory systems in Southeast Asia would require simpler procedures and more responsive regulatory institutions.

Corporate Governance

Policies and rules adopted by governments guide the behavior of firms, which, in turn, may influence the economic policies of governments. In East and Southeast Asia, companies tend to have a concentrated ownership structure, which can be both beneficial and greatly harmful to efforts at accountable governance. This section briefly examines the links between ownership concentration and the strength of legal institutions across Southeast Asia.

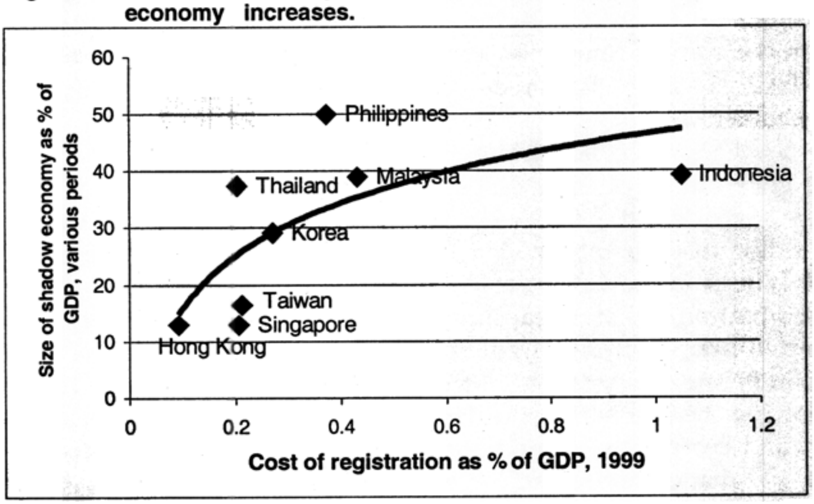
The World Bank suggests that concentrated ownership is a substitute for weak legal protection. Information asymmetry associated with concentrated ownership favors investors: control of information ensures that their

Figure 28. More corruption comes with more procedures.



Sources: University of Maryland IRIS data (2000); Djankov et al. (2001).

Figure 29. Unofficial economy rises as cost of entry into formal economy increases.



Source: Djankov et al. (2000).

resources are in their interests. Because of this control, a small number of owners can stop the diversion of corporate resources without having to deal with courts. A recent study showed that investors favored Asian firms whose controlling shareholders had larger equity stakes. Concentrated ownership seemed to provide the assurance that investor rights over the allocation of resources and returns would be protected (WDR 2002).

But ownership concentration can also put a country's legal institutions in harm's way. Numbers are important: for instance, the largest ten families in Indonesia, the Philippines and Thailand control half of the corporate sector in terms of market capitalization. In Indonesia, a single family (the Suhartos) has ultimate control over 16.6 percent of the total market capitalization. The same is true in the Philippines, where the Ayalas control 17.1 percent of the same (Claessens et al. 1999).

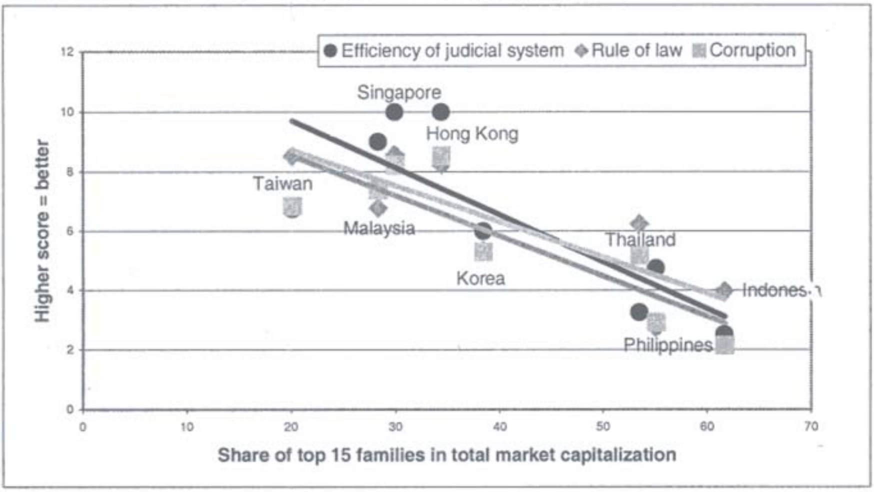
In empirical tests, using assorted measures of ownership concentration, Claessens et al. (1999) find that a relatively small number of families have a strong influence on the economic policy of governments. Anecdotal evidence confirms the undue influence. The Suharto family in Indonesia, which has close links to some 417 listed and unlisted companies, has obtained preferential treatment from government; many family members (besides Suharto himself) had served in some government functions. One quarter of the value of these firms was directly attributable to their political connections (WDR 2002). Indirect control of companies by ruling political coalitions—such as the UMNO in Malaysia—is another mode by which business receives policy favors from government.

Such wealth concentration and the interlocking links between owners and government officials cast doubts on the independence of legal institutions in Southeast Asia. According to Claessens, Djankov and Lang, they raise the prospects that the legal systems in some parts of the region may be endogenous to the variety and strength of control over the corporate sector. In a situation of "state capture," legal institutions are subverted and less likely to promote transparent and market-based activities.

In Figure 30, the share of the largest 15 families in total market capitalization, on the one hand, and the efficiency of the judicial system, the rule of law, and corruption, on the other hand, are very strongly correlated. This indicates that ownership concentration in East and Southeast Asia determines the level of institutional development of the legal system.

The higher the share of the top 15 families and the lower the level of efficiency of the judiciary, the weaker the rule of law and/or the higher the judicial corruption. Thailand, Indonesia[11] and the Philippines seem to have the lowest level of legal institutional growth because of heavy ownership concentration in the corporate sector.

Figure 30. Are Asian judicial systems endogenous?



Source: Claessens et al. (1999).

[11] Indonesia, surveys suggest, ranks high among countries with the worst corporate governance in East Asia. In the words of the World Bank, "There is a lack of transparency and financial disclosure, accounting and auditing systems are weak, rights of minority investors are insufficient, and interlocking ownership between banks and corporations have contributed to the collapse of the bank and corporate sector during the crisis. Lack of transparency and weak regulatory frameworks also continue to impede private investment in infrastructure and other public services" (World Bank 2001).

VI

Political Governance

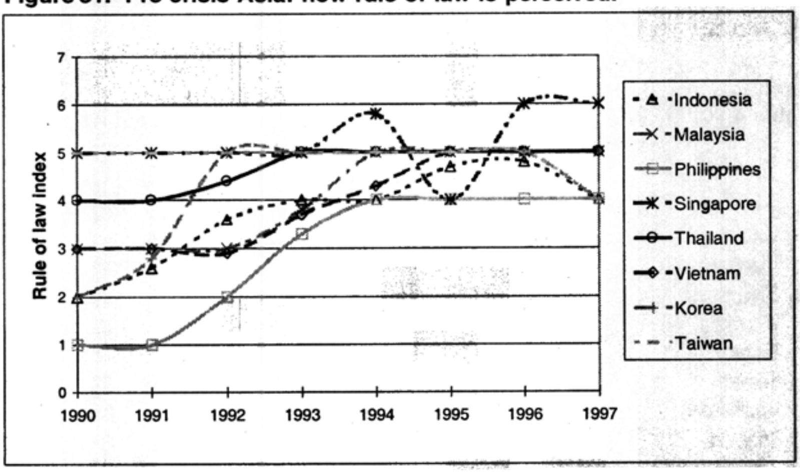
Rule of Law and Judicial Independence

Prior to the Asian crisis, there was a positive perception of rule of law in the region. Data from the University of Maryland's IRIS Center suggest that as the East and Southeast Asian countries experienced tremendous growth, confidence in their legal institutions also rose (Figure 31). From 1990 to 1997, there was an upward trend in the perceived strengthening of the rule of law.

Yet 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).

Table 4, drawn from 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 have pulled down the overall ranking of Asia. Indonesia and the Philippines are among the bottom dwellers worldwide, indicating that in these countries, economic

Figure 31. Pre-crisis Asia: how rule of law is perceived.



Source: University of Maryland IRIS Center.

rent-seekers are perceived as often having a heyday undermining the institutions designed to keep them out.

When a country's institutional defenses are relatively weak, such as when the judiciary fails to keep its place as a central pillar of the rule of law, or when regulatory agencies become the nesting place for corrupt practices, there are telling effects on economic governance. Unreliable institutions force entrepreneurs to either "hit and run," that is, invest in risky, speculative activities that offer high returns but allow them instant exit once they sense trouble; or "play it safe," that is, invest in long-term projects with lower returns but require less capital outlay. In the pre-crisis period, most of the Southeast Asian economies had plenty of both, with most short-term capital inflows directed at superfluous purposes (such as real estate which generated asset bubbles) and long-term inflows generally going to trade and services. Corruption is also linked to lower spending on health and education, which in turn narrows opportunities for poor people to invest in their human capital.

Thailand had been cited for its judicial autonomy and lower corruption levels. Clearly, it was the exception in Southeast Asia rather than the rule, as shown in Table 4. Yet, ironically, it took the center stage for excessive investments in less important sectors, and was the first Asian country to suffer a sharp reversal of fortune. Other governance factors were at work.

Vietnam's legal framework still causes problems in key areas such as property rights and the development of "due process of law." Competition is hamstrung by the lack of an independent judiciary, certain uncertainties in property law that limit the evolution of financial markets, and the inherent bias of the system in favor of the state sector (and collective ownership). Policy changes to reverse the former command system may be enough to initiate the transition. But without an appropriate legal framework, they will be insufficient to facilitate long-term development (Thuyet 1995). Woo-

Table 4. Civil institutions take the beating in East and Southeast Asia.

	Ranking out of 53 countries worldwide	
	Judicial independence	**Corruption**
Indonesia	51	52
Philippines	47	51
Malaysia	30	45
China	29	41
Taiwan	16	33
South Korea	15	28
Thailand	13	23

Source: *World Competitiveness Report 1998.*

Cummings (2001) argues, however, that in countries with strong state traditions, states can "create" the rule of law and coerce better governance. She cites the case of Malaysia, where the state, through executive fiat, compromised the power of the judiciary by redirecting it toward its own "developmental" ends.

The "killing fields" in Cambodia in the 1970s also all but extinguished the country's judicial institutions. Naturally, the present legal and regulatory structure is weak and invariably incomplete, incapable of being enforced or lacking in internal coherence, thus contributing to overall uncertainty (World Bank 2000a). In Indonesia, Sissyphean efforts to bring to justice past corruption cases, mainly involving the rich who raked in illegal gains during the Suharto regime, have been in part responsible for its consistent low scores in surveys on rule of law, corruption and business environment (ADB 2001b; World Bank 2001).

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 (WDR 1997).

Conflict Management

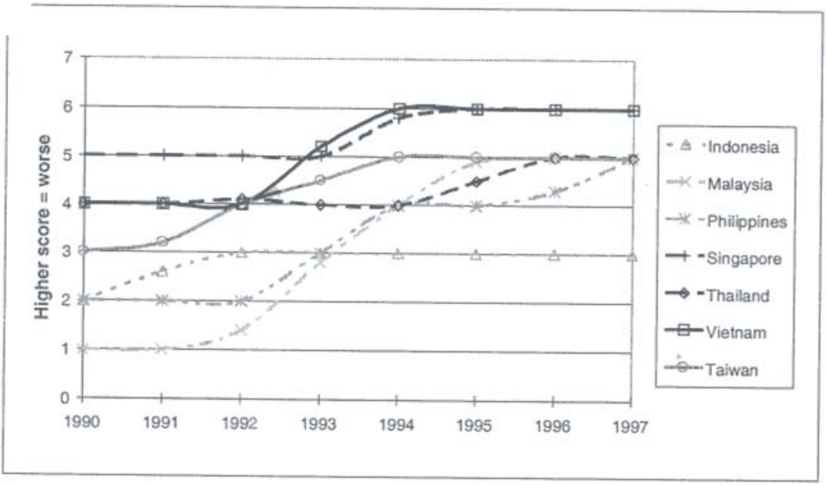
Growth and poverty outcomes in Asia (as well as in other regions) since the mid-1970s have banked on the quality of institutions for conflict management, a recent study revealed. In divided societies, such as those with ethnic fragmentation, low-quality institutions for managing conflict—including government institutions and inadequate social safety nets—magnify external shocks, inducing distributional conflicts and delaying policy responses. Shifting social balances are in turn affected by a government's institutional reform efforts (WDR 2002).

Ethnic tensions have been rising in Southeast Asia in the last decade, as Figure 32 shows. 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 33 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. Govern-

Figure 32. Ethnic tensions are on the rise in Southeast Asia.



Source: University of Maryland IRIS Center.

ment 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).

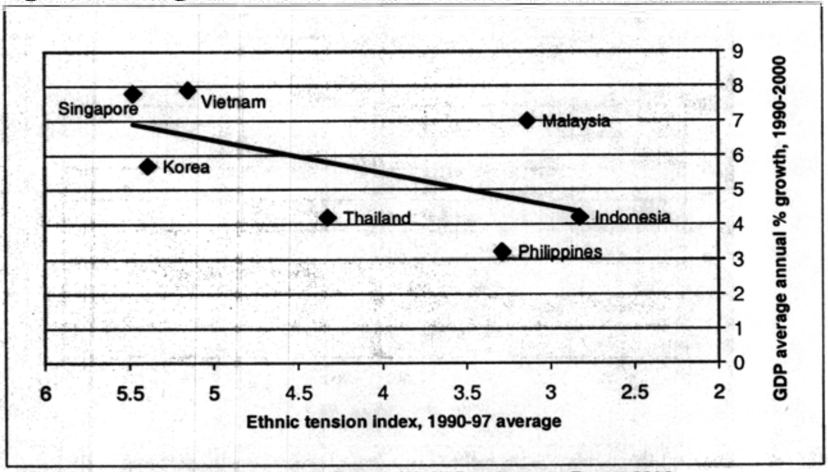
As a result, conflict intensifies the difficulty to establish institutions that benefit broad segments of society. To begin with, ethnic groups tend to have lower living standards than the majority. In Vietnam, for instance, these groups live in less productive areas characterized by difficult terrain, poor infrastructure, limited access to off-farm work and the market economy, and inferior access to education. Large differences in returns to productive characteristics also explain ethnic inequality (van de Walle and Gunewardena 2000). Institutions that benefit the poor are thus needed to ensure successful conflict management.

Voice and Participation

In theory, a strong civil society comes in handy as a companion to continued growth and development. Broader participation energizes people, bringing social capital into play in economic development, and makes the government more responsive to people's needs.

A strong civil society has noteworthy governance features as well: it wins legitimacy for macroeconomic decisions from society more broadly, increases the number of veto points that can counter inconsistent state action (WDR 1997), and brings public pressure to bear on the quality of government service. Some ineffective institutions may exist in part because there are no civil society groups pressing for change.

Figure 33. The greater the ethnic tensions, the lower the rate of growth.



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

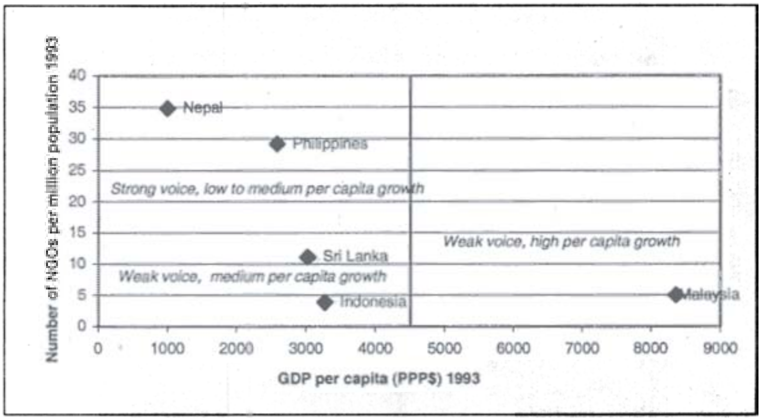
In practice, participation is distributed as unequally as income and human development. Indeed, as Figure 34 indicates, civil society gains were prominent in Asian countries with slow economic pickup. In the Philippines, for example, nongovernment organizations[12] registered a powerful presence as a voice mechanism, even in the absence of high growth. Voice and growth were thus not positively correlated.

Some caveat is in order. Institutional barriers facing civil society might be of a different nature altogether, compared with institutional obstacles to growth, such as regulatory excesses. Examples of these barriers are the absence of freedom of expression (as exemplified by authoritarian states like Indonesia and Malaysia) or of a functioning feedback mechanism (even in countries where voice is strong, such as the Philippines, the government is not quite well equipped to listen). Then there is the problem of collective action: the cost of organizing coalitions can be quite frustratingly high. These factors should explain in part why the connection between voice and growth is not well established at the ground level.

Hirschman's exit/voice pairing (with "exit" referring to the ability of the public to choose from alternative suppliers of public service when dissatisfied with government providers) may also turn up to be a good source for

[12] The Fifth Asian Development Forum gave two estimates of the number of NGOs in the Philippines, circa 1993: 2,000, according to CODE-NGO (a national coalition of development-oriented NGOs) and 18,000, a NEDA estimate. This paper used the more conservative figure of 2,000.

Figure 34. Voice and growth in several Asian countries move in opposite directions.



Basic sources: Fifth Asian Development Forum 1996; *Human Development Report 1996.*

explaining the poor correlation. Paul (1991) suggests that the use of voice would improve accountability most when public service operates as a monopoly and when incomes are low. In this case, the intervention of agents outside of the community (that is, NGOs) would be the antidote to slow growth. On the other hand, when public service can be differentiated and there are fewer constraints on income, the use of exit is preferred and serves as the stimulus for growth. Public pressure is less needed when people can turn to other providers.

VII

Decentralized Governance

Decentralization 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 (WDR 1999/2000).

It is widely held that decentralization improves the quality of governance. A government that is closer to its people works best, since it has a better feel of the concerns of local constituents. In turn, citizens and community groups can better participate in the affairs of government under a decentralized system. Proximity serves to enhance preference matching for public services. Moving the decisionmaking closer to people who are affected by those decisions lowers both information and transaction costs. Conversely, a centralized approach to management of the economy stymies development at the local level. Thus, a decentralized form of governance is as much valid in less developed public sector environments (such as those in Southeast Asia) as in advanced, highly industrialized settings (Huther and Shah 1998).

Southeast Asian countries carry out decentralization in various ways. *Deconcentration* is the path of least resistance. Here, central governments grant autonomy to their own branch or district offices without altering the hierarchical relationship between field and central offices. An example is the Philippines' Department of Health, which is now undergoing a painful transition to a more regionalized structure. *Privatization* in varying degrees is taking place in Indonesia, Malaysia, Thailand, and the Philippines as part of a "shedding" of functions of overly burdened central governments. Often the targets of privatization are state-owned enterprises. *Localization*, on the other hand, altogether shifts authority, responsibility, and accountability to subnational/local governments elected by constituents. A form of this, devolution, has taken place in the Philippines with the transfer of public service provisioning in health and to a lesser degree, social welfare and agricultural extension, to local governments. Another type, *delegation*, in a real sense, is not decentralization, since subnational governments are merely asked to act on behalf of the higher levels. *Decentralization* implies that local governments should be principals acting on their own rather than agents of the central government.

Extent of Localization in Southeast Asia: The Broad Canvas

The extent of subnational responsibility differs everywhere because of varying country-specific circumstances. If subnational expenditure as a proportion of GDP represents the size of subnational governments (which in turn measures the degree to which local tiers are responsible for public service provision), Southeast Asian subnational units (for which data are available) are in the lower rungs. In Figure 35, the Philippines, Indonesia, and Thailand are shown to be the least decentralized. Malaysia has a bit more elbow room for local-level provisioning.

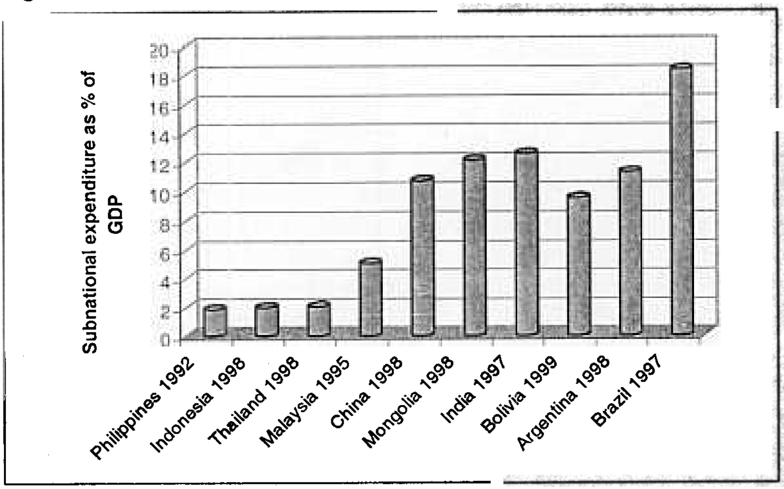
Elsewhere in Asia, it is Mongolia, China, and India where subnational governments are bigger, at about 20 to 22 percent of GDP. These compare favorably with those of Latin American countries like Brazil, Argentina, and Bolivia, considered frontrunners in the decentralization race in the developing world (WDR 1997).

Another way of looking at rough orders of magnitude of subnational governments is to check out the size of their bureaucracies (Figure 36).[13] The command economies of China, Vietnam, Laos, and Cambodia have huge subnational government workforces, far exceeding their own central bureaucracies. In Malaysia, Thailand, and the Philippines, the number of public employees at lower tiers is smaller than that in the central governments. In these three countries, size measured by the number of employees correlates with size measured as expenditure per GDP. This is to be expected, since a huge chunk of public expenditure goes to payment of wages. Singapore has no subnational bureaucracy—because of its smallness, it has no need for it. No data are available for Myanmar.

Size, however, is not necessarily correlated with either extent of authority or degree of independence from the central government. Shah (1994) argues that many Asian governments were formed from unitary constitutions, and thus, for a time, followed a path of centralized planning and decisionmaking, regulation and provisioning of public services (on the grounds of promoting national unity and uniformity, and preserving internal markets). Singapore, China, Indonesia, Korea, and the Philippines are examples of unitary Asian countries, where effective control of government still rests with the central authorities (regardless of size of subnational governments). A federal form, however, does not mean loose control of central governments. Malaysia and India are federal states whose central government wields considerable power over subnational units. The style of governance that is common in many Southeast Asian nations, because it concentrated power in central governments, nurtured authoritarian regimes.

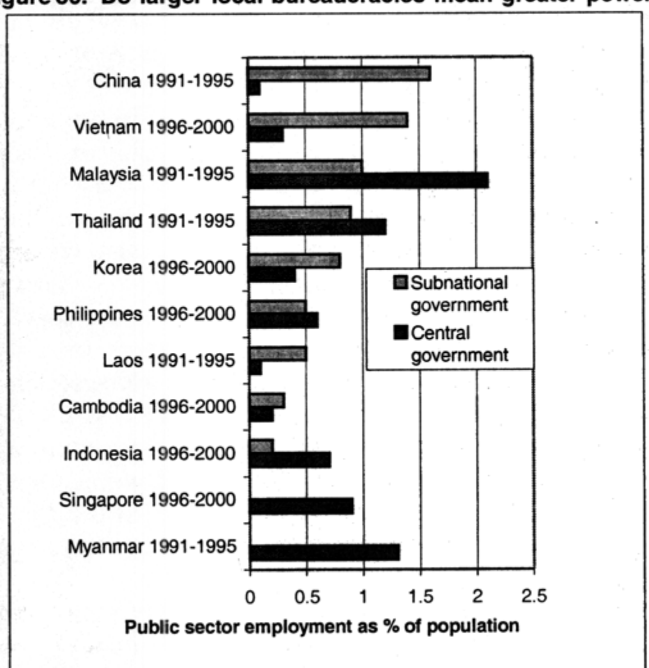
[13] The count for both central and subnational personnel, as a proportion of the population, excludes health, education, and police personnel.

Figure 35. The size of subnational governments varies in Asia.



Source: IMF Government Finance Statistics.

Figure 36. Do larger local bureaucracies mean greater power?



Source: World Bank Public Sector Employment and Wages Data.

Paradoxically, however, subnational governments in neighboring China—widely held to be highly centralized—may have more authority. During the 1980s, local governments secured a significant degree of autonomy from the central government. Today, China retains the unitary structure of government but is classified as a "decentralized federation" (Shah 1994). In the Philippines, too, decentralization has occurred because of the passage of a local autonomy act in 1991, which led to the devolution of basic services (health, social welfare, agriculture, public works) to local jurisdictions. Political pressures for subnational autonomy, as well as separatist demands, have also forced the Indonesian central government to hand over more authority to local units. To a certain extent, decentralization in Southeast Asia is also a response to failures of some national governments (e.g., the Philippines) to achieve broad-based growth and development.

Structure and Forms of Multilevel Governments in Southeast Asia

Except for Singapore, Southeast Asian countries have adopted multitiered systems with one or two elected subnational governments. Although most have unitary backgrounds, owing to the greater premium on uniformity and equal access to public services, many of them have tried to recast their structures to promote decentralized decisionmaking. Some kind of federalism is evolving, which is more open to greater freedom of choice, political participation, innovation, and accountability (Shah 1994).

This multilayering is not just an idiosyncrasy: each tier of subnational government is expected to provide only those services that benefit residents of the jurisdiction. Such "fiscal federalism" assigns a significant role to subnational governments in allocating resources. When the benefits of particular services have no substantial spillovers to residents of neighboring jurisdictions, the appropriate levels and mix of services can complement local preferences. If local consumers are dissatisfied with the service provision, they can express their displeasure by voting incumbents out or by moving to other jurisdictions. In this respect, local politics can approximate the efficiencies of a market in the allocation of local public services (WDR, 1999/2000). But there is a caveat: in many Southeast Asian countries with autocratic setups or where land and labor markets are constricted, people may not participate meaningfully in the political process or "vote with their feet." Such representation may be further constrained by poor capacity to manage multilevel governments.

Table 5 provides a rough portrait of the depth of subnational representation in Southeast Asia. The number of subnational tiers of government established suggests how responsive the setup is to local needs and preferences. Needless to say, the number of layers also says much about a country's political make-up and constitution. Malaysia, a federation with a population

Table 5. Structure of subnational governments in selected Asian countries

Country	Intermediate tiers	Local tiers
Lao, PDR Population: 5.3 million	16 provinces	141 districts, 11,293 villages
Malaysia Population: 21.8 million	13 states	143 cities, municipal and district councils
Philippines Population: 74.2 million	76 provinces	64 cities, 1,541 municipalities 41,924 barangays
Thailand Population: 62.0 million	75 changwats Bangkok	149 municipalities and cities 1,050 sanitary districts 7,823 tambon administrative organizations

Source of basic data: *World Development Report 1999/2000.*
Source of population data: *Human Development Report* 2001.
Source of data on Lao PDR: Das Gaiha (2001).

of 21.8 million, has two tiers and about 156 subnational bodies. That is about seven local bodies per million population. Malaysia is divided into 13 states, and under the state governments are city, municipal, and district councils. That may seem a large set of jurisdictions, but it is leaner when compared with say, India, which has 240 bodies per million population.[14]

In full-fledged decentralized countries, such as those belonging to the OECD, the number of subnational tiers and jurisdictions is considerably less.[15] By contrast, Thailand and the Philippines have more numerous, and therefore, deeper and smaller, subdivisions. Both have almost the same number of intermediate governments: the Philippines has 76 provincial governments

[14] India, with a population of 992.7 million, has about 237,696 subnational bodies. It has 25 states and seven urban territories. Its urban local bodies consist of 95 municipal corporations, 1,436 municipal councils, and 2,055 *nagar panchayats*. In rural areas, 474 *zila parishads* wield some authority over the 5,906 *panchayats samithis*. The *panchayats samithis* in turn have some authority over the 227,698 *gram panchayats*.

[15] A strong economy like Japan has two subnational tiers with 47 intermediate and 3,233 local bodies. Canada has 12 intermediate governments and 4,507 local bodies. The United States has 50 states and 70,500 local bodies.

while Thailand is divided into 75 *changwats*. At the local level, the Philippines is subdivided into city/municipal governments. Each municipality is further subdivided into *barangays*. The number of subnational bodies in the Philippines is six times more than that of Thailand. The latter currently has 149 elected city governments, 1,050 sanitary districts in thickly populated suburban areas, and about 7,823 *tambon* administrative organizations, which are the standard form of government in rural areas (Das Gaiha 2001).

Laos had a fairly decentralized government until early 1991 when it decided to revert to a more centralized setup. Now the central government organizes, directs and supervises the operations of state services in all sectors, including local administrative organizations. Before 1991, the state administration consisted of five tiers: central government, provinces, districts, *tassengs* (subdistricts), and villages. With the abolition of *tassengs*, the number of subnational tiers has been reduced to three. There are now 16 provinces, 141 districts, and 11,293 villages.

The recentralization has adverse distributional consequences. The decision to aggregate services, administration and infrastructure—ostensibly to make management easier—clashes with the harsh realities of rugged topography and ethnic diversity, and the need for community involvement, all of which favor smaller local administrative units. As a result, a large number of villages have weak government presence (Das Gaiha 2001).

The Laotian case illustrates the need for smaller districts for better governance, but it does not lend itself to generalization. The cost-effectiveness of public provision of services may depend on how size of jurisdiction is determined. In the Philippines, the process of district multiplication is more the result of exogenous gerrymandering maneuvers of legislators (which in many cases disregard economies of scope) than of endogenously determined social benefit-cost outcomes.

Fiscal Decentralization

Economist Wallace Oates has held that responsibility for providing each public service should be exercised at the level of government having control over the area that would assume the benefits and costs of such provision. The jurisdiction which decides how much of a public good ought to be provided should include precisely the set of individuals that consume it. In a related fashion, the principle of subsidiarity states that service delivery functions should be made at the lowest level of government unless a persuasive case can be argued for assigning them to a higher level of government (Shah 1994).

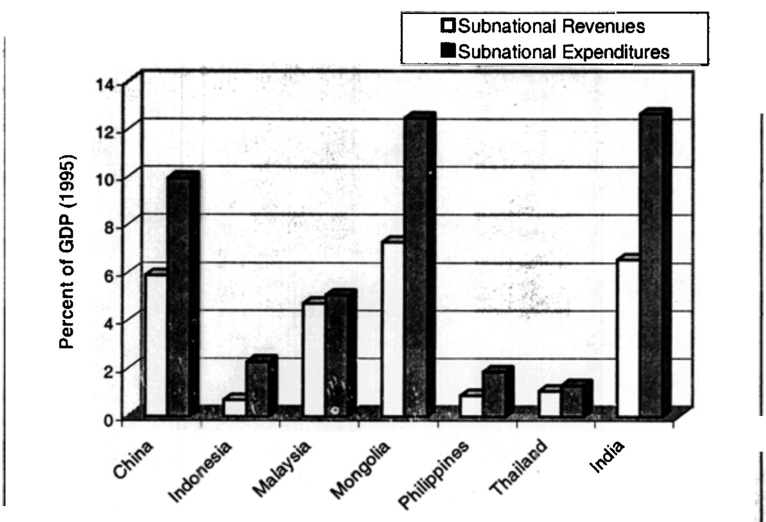
To allocate responsibility efficiently in the delivery of local public goods is to match local expenditures more closely with local priorities and preferences. It also means making sure responsibility is accompanied by authority to raise the revenues required to meet the local government's obligations.

That entails devolving the powers of expenditure and revenue collection to subnational governments.

To begin with, Asian subnational governments have a hard time financing their spending. All the countries shown in Figure 37 have income shortfalls at subnational levels, although Malaysia and Thailand come close to a more balanced relationship between revenue and expenditure below the central government. If revenue means are not matched closely with expenditure needs at subnational levels, the central government must close the gap through fiscal transfers. But each national government faces its own fiscal constraints and can in extreme cases simply pass on its fiscal deficits to subnational units. But even without the constraints, central to local transfers can be quite distortionary in nature.

Expenditure assignment. Some public goods can be provided less expensively on a larger scale. Centralized provision benefits the entire economy, creates economies of scale, achieves "equalization of access," and captures spillovers. Yet there is a tradeoff. Centralization imposes a *single* policy on jurisdictions with *varied* needs and preferences. Moreover, some public goods are of a localized nature, with limited externalities. Thus, in allocating functions to various tiers of government, there must be a sense of balance between readiness to respond to local needs and consciousness of the goal of scale economies (Shah 1994).

Figure 37. Local governments in Asia still have difficulty coping with income shortfalls.



Source: IMF Government Finance Statistics.

It goes without saying that defense, foreign affairs, currency banking, international trade, immigration, and domestic market preservation should remain the responsibility of central government, as they are national public goods. On the other hand, subnational bodies should provide local public goods. This "division of labor," common to OECD countries, also finds ground in Southeast Asia. Many services like industry and agriculture, education, health, social welfare, police, environmental management and even public works are increasingly decentralized or assigned as joint responsibility of central and subnational governments. Table 6 shows which government levels in Southeast Asia are responsible for the different expenditure assignments (which mean setting the amount, determining the structure, executing, and supervising) vis-à-vis the provision of certain services.

Many services in sectors like industry and agriculture, health, education, and welfare contain both national and local public goods elements and are now the joint responsibility of many subnational governments, especially those in Malaysia, Indonesia, and the Philippines. However, concurrency raises hard issues on how well each tier's responsibilities are delineated (Das Gaiha 2001). Public works, natural resources and the environment are still central concerns. In the Philippines, local governments are responsible for the execution of social services like health care, and regulatory functions such as agricultural land reclassification. In the case of Vietnam, primary and preschool education is the main responsibility of the local governments. However, universities, hospitals, and interurban highways are completely controlled by the central government.

Table 6. Expenditure assignment in Southeast Asian countries.

Type of Service	Country				
	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Industry/agriculture	C/S	C/S	C/S	C	
Education	C/S	C	C/S	S	C/S
Health	C/S	C/S	C/S	S	C
Social welfare	C/S	C/S	C/S	C	
Police	S	C/S	C/S	S	
Highways	C	C	C	S	C
Natural resources	C	S	C	C	
Environment	C	S	C/S	C	

Sources of basic data: Shah (1994); World Bank Qualitative Decentralization Indicators; Philippine Local Government Code of 1991.

Legend: C = responsibility of federal or central government; S = responsibility of subnational governments, e.g., state, provincial, departmental or local government; C/S = joint responsibility of national and subnational governments.

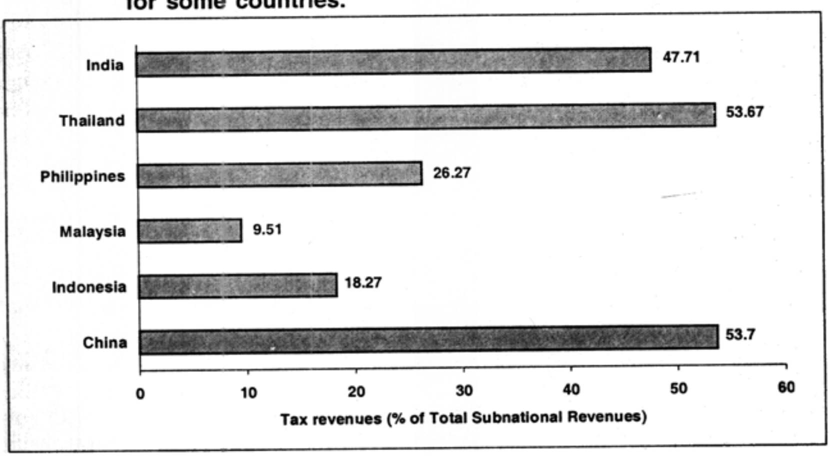
Tax assignment. Decentralization of expenditure must come with a corresponding decentralization in revenue generation (that is, taxation). Otherwise, local governments will depend heavily on transfers and grants from national government to support devolved functions. Likewise, local governments will have little incentive to deliver government services competitively and be innovative.

How much autonomy do subnational governments have in raising revenues? Subnational revenues generally consist of tax and nontax revenue, intergovernmental transfers and grants. Certainly, the greater the fiscal autonomy, the higher the degree of decentralization. Some Asian countries have devolved expenditure without increasing revenues for subnational governments and/or delegating tax collection to subnational governments, thus putting fiscal pressures on local governments and/or making them dependent on intergovernmental fiscal transfers.

Subnational governments in Southeast Asian countries present varying fiscal capacities (see Figure 38). Thailand's local governments have the highest share of tax revenues as a percentage of total subnational expenditures (over 60 percent). This is comparable to China's, demonstrating high local government autonomy relative to other subnational governments in Asia. The lower shares, registered by local units in Malaysia, Indonesia, and the Philippines, are smaller than that of India.

Thailand is on a roll as far as giving its local authorities more taxing power is concerned. The Thai government is currently designing a framework on decentralization based on its National Decentralization Act of 1999,

Figure 38. Tax shares of subnational governments vary, and are quite low for some countries.



Source: IMF Governament Finance Statistics.

and projects local shares to rise to 35 percent of total revenues by 2006. To meet the target for 2006, local governments may need to double their own revenue collection from the present level of 1.5 percent of GDP (Das Gaiha 2001). The Philippine Congress has also broadened the powers of local government units to levy taxes and fees. Yet an increase in central-local fiscal transfers (called the internal revenue allotment) from 11 percent to 40 percent is in many cases a disincentive in expanding local tax bases.

What accounts for the poor showing of subnational governments in most of Southeast Asia in tax generation? In spite of attempts at devolution, central governments in the region retain control of tax determination and administration. Most subnational governments in Asia have limited revenue collection on their own due to limited knowledge of and access to their own tax bases.

Table 7 summarizes the involvement of subnational governments in setting the rate and administering the most common types of taxes that are relevant at the subnational level. It also shows the tax shared (or piggybacked) by central and subnational governments. Most of the taxes listed in the table are still centrally collected and administered. Only property taxes and local fees are within the domain of local governments,[16] except in Indonesia, where property tax remains a central levy. Malaysia's customs duty, ordinarily a central tax in Asian countries, is concurrently administered by its subnational governments.

Excise is the most commonly shared tax by central and subnational governments. Local authorities piggyback on resource taxes. A budget law in Vietnam, enacted in 1997, formalized levy of charges, fees, surcharges, and collection of voluntary contributions by local governments.

Indonesia is an example of a grossly centralized tax assignment. The central government sets the instrument, base, rate, and collection of most taxes (e.g., property, sales, excise, industry and trade, natural resource). It is therefore not surprising that subnational governments in Indonesia depend highly on transfers from the national government. As a consolation, local units share taxes on natural resources and participate in determining tax rates for vehicles (WDR 1999/2000).

[16] In China, the central government shares a number of tax responsibilities with subnational governments especially in administering levy on income/gifts, estates, sales, excises, property, among others. Revenues from value-added tax, resource, and security exchange levies are also shared with the provincial governments (for instance, a 50:50 sharing of VAT proceeds). In India, except for customs, estate and corporate taxes, all other taxes are assigned to/shared with subnational governments. Given the scope of tax assignment, it is not surprising that local governments in China and India collect the highest subnational tax revenues in Asia.

Table 7. Tax assignment in selected Southeast Asian countries.

Type of tax	Country			
	Indonesia	Malaysia	Philippines	Thailand
Customs	C	C/S	C	C
Income and Gifts	C	C	C	C
Estates		C		
Corporate	C	C		C
Resource	C	C/S	C	
Sales	C	C	C	
VAT	C		C	
Excises	C	C/S	S	C/S
Property	C	S	S	S
Fees	S	S	S	

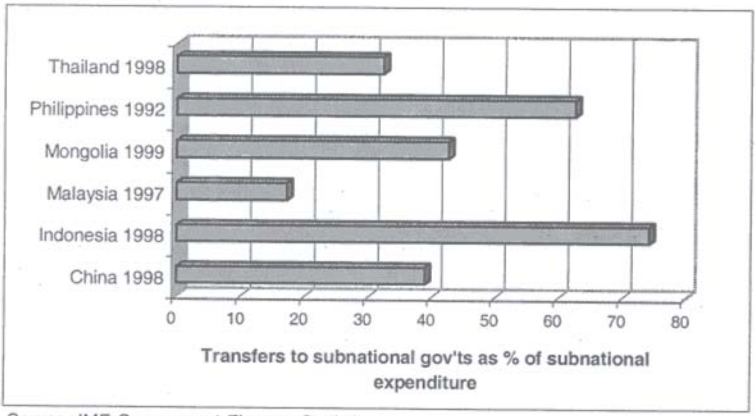
Source of basic data: Shah (1994).
Legend: C = tax base, rate and administration assigned to federal or central government;
S = assigned to state, provincial, departmental or local government;
C/S = shared responsibility or piggybacked.

Delinking taxing from spending responsibilities often leads to accountability problems at subnational levels. If tax and expenditure assignments are not determined simultaneously, so that revenue means harmonize with expenditure needs, local governments may not feel answerable for fiscal deficiencies and the resulting poor service provision. Yet, as tax and expenditure matching is not easily resolved, it may be worth it to examine the role of intergovernmental transfers, as a way of mitigating local accountability shortfalls (Huther and Shah 1998).

Intergovernmental transfers. Since most subnational governments in Asia have limited revenue collection on their own, they depend heavily on transfers from national government. Dependency of subnational governments can be discerned from vertical imbalance. Decentralization in Southeast Asia has a mixed record, based on data in Figure 39. Vertical imbalance, which is measured by intergovernmental transfers as a share of subnational expenditure, indicates the degree to which subnational governments rely on central government revenues to support their spending needs.

Of the seven Asian countries for which data on vertical imbalance are available, Malaysia (17.21 percent) seems to have the least need for central disbursements. Thailand (32.33 percent), along with regional neighbors India (36.11 percent), China (38.9 percent), and Mongolia (42.6 percent), is moderately dependent on central allotments. In Indonesia (at a high of 74.24 percent) and the Philippines (62.66 percent), intergovernmental transfers are the main sources of revenue of subnational units, indicating a very high degree of central depen-

Figure 39. Vertical imbalance: some SE Asian central governments still hold the purse.



Source: IMF Government Finance Statistics.

dence.[17] By comparison, decentralization pacesetters in Latin America, such as Bolivia (47.58 percent), Brazil (34.39 percent) and Mexico (35.41 percent), get less than half of their spending needs from central resources.[18]

In the Philippines, the extent of intergovernmental transfers can be gauged from the internal revenue allotments (IRAs) for local governments, which have increased substantially since the passage of the Local Government Code in 1991. As a proportion of the total Philippine budget, the IRA increased from 6.7 percent in 1992 to 20 percent in the year 2000. In absolute terms, the IRA increased from PhP9.8 billion in 1991 to PhP121.8 billion in 2000, translating to an average growth rate of 32 percent (Diokno 2000).

Vertical imbalance suggests that control of central governments on subnational governments in Southeast Asian countries persists as the latter continue to be hounded by fiscal underperformance. Shah (1994), using the coefficient of vertical imbalance or an index of subnational autonomy to measure the degree of control exercised by the central government over lower levels of government in selected countries, finds that central control is strong in Indonesia, India, Pakistan, and even in Australia, an OECD member. But in Brazil, federal influence over local priorities is quite limited, making its municipal governments the envy of subnational governments in both devel-

[17] Poorer regions in Indonesia depend on subsidies from the central government. Decentralization in the country is proceeding slowly because of fiscal risks, but its more important implication may be to deprive poor areas of resource transfers, thus exacerbating inequities. There are suggestions to increase the weighting given to poverty indicators among the criteria for a region getting "balancing funds" from the central government (International IDEA 2000).

[18] Obtained from the IMF Government Finance Statistics.

oped and developing countries. In Laos, the central government pays about 85 percent of the budget resource of the public sector appropriated to the Public Investment Plan for local governments through each line ministry. Curiously, in this setup, the local governments manage the public expenditure of the line ministries (JBIC 2001).

Intergovernmental transfer initiatives in Vietnam have become important in the light of its need to maintain rapid growth, which in turn depends on infrastructure support and provision of public services along diversified regional requirements. The 1997 budget law attempts to link expenditure responsibilities to the revenue assignment of each level of government with the budgetary process as the means to integrate revenues and expenditures at all levels. A system of assignment and transfers will remain in force for three to five years.

Transfers are often in the form of grants. Local governments obviously want unconditional grants without matching funds, as they provide leeway in spending. Central authorities, on the other hand, may wish to direct grants toward expenditures that pursue national objectives (e.g., public health). In such cases, conditional grants ensure compliance. If matched with local resources, they ensure local ownership of the processes and outcomes arising from the grants. The experience of Indonesia offers important insights in grant design. Indonesia's education and health grants use simple and objectively quantifiable indicators in allocating funds. Conditions for the continued eligibility of these grants stress objective standards of access to these services. Grants for public sector wages on the other hand, represent an example of an inadequately designed scheme, as they introduce incentives for higher public employment at subnational levels (Huther and Shah 1998).

Subnational borrowings. Local borrowing to augment local expenditure remains a major issue in many Southeast Asian countries. Lack of data on subnational loans hampers analysis of the borrowing behavior of local governments, especially if borrowing regulations induce moral hazard problems. Table 8, however, provides useful perspectives on the regulation of subnational borrowings in the region.

Of the three Southeast Asian economies represented in the table, only Indonesia allows subnational borrowings, but with tight administrative guarding from the center. Thailand and Vietnam do not permit lending to subnational units. Local government units in the Philippines are also allowed to borrow in the market by floating bonds. Comparing it to decentralization benchmark countries in Latin America suggests how far behind Southeast Asia is in the development of subnational borrowing instruments and regulations. In Argentina, Bolivia, Mexico, and Brazil, tax sharing can be used as loan guarantee. Subnational governments in Mexico, Argentina, and Brazil own banks,

Table 8. Regulatory framework for subnational borrowing (East Asia and the Pacific).

Allowed?	Subnational Borrowing Controls[1]		Institutional setup for capital market access	Numerical or other contraints on borrowing	Contraints on the the use of loan proceeds?	Can tax sharing be used as a guarantee?	Do local/ provincial governments own banks?	Is borrowing approved by the center?	Other remarks
	Domestic	Foreign							
China Formally, no	Prohibited	Prohibited	Commercial banks or financial institutions set up by local governments to raise money for investments						
Indonesia Yes	Adminis-trative	Adminis-trative	Predominantly from the center					Yes	
Korea Yes	Adminis-trative	Adminis-trative						Yes, by the Ministry of Home Affairs	Approved by the local council
Thailand No	Prohibited	Prohibited	n/a	n/a	n/a	n/a		n/a	
Vietnam No	Prohibited	Prohibited	n/a	n/a	n/a	n/a		n/a	Borrowing not allowed. Local SOEs can borrow with permission from central gov't.

[1] Categories for subnational borrowing controls: market discipline, cooperative control, administrative control, rule-based control, borrowing prohibited.
Source: World Bank Qualitative Decentralization Indicators.

and local debt service arrangements are well developed in these countries.[19]

All things considered, Southeast Asian nations have a long road ahead in fiscal decentralization. As shown in Table 9, which sizes up fiscal decentralization in terms of subnational expenditure and subnational taxes as a proportion of total budget and total taxes, respectively, Indonesia, Malaysia, Thailand, and the Philippines are way off the mark set by China and India in both expenditure and tax departments.

Voice and Participation at Local Levels

Voice depends on the degree to which the public can influence the quality and quantity of a service through some form of articulation of preferences (Manasan et al. 1999). Voice can be in the form of representation arising from election results. In Table 10, subnational interests in the Philippines and Thailand are protected through the election of representatives in intermediate and local bodies. In these countries, the voting power of citizens over local authorities helps exact greater accountability from government.

In the transition economies of Vietnam, Laos, and Cambodia, decentralization has taken place with little citizen power. In Laos, provincial governors are appointed by the central government. Village chiefs whose main responsibilities are law enforcement and implementation of instructions from higher authorities, are the only elected representatives at the local level.

Citizen participation is possible only if political freedom (voice and exit) is allowed and political stability holds sway. Exit considers the ability of the public to explore other options when dissatisfied with public services while

Table 9. Fiscal decentralization in some Asian countries.

Country	Share of subnational government (%)	
	In total public expenditure	In total revenue (%)
China (1997)	55.6	51.4
India (1997)	53.3	36.1
Indonesia (1997)	14.8	2.9
Malaysia (1997)	19.1	2.4
Philippines (1990)	6.5	4.9
Thailand (1997)	9.6	5.5

Source of basic data: *World Development Report 1999/2000.*

[19]Obtained from the World Bank Qualitative Decentralization Indicators.

Table 10. Electoral decentralization.

Country	Subnational elections		No. of elected subnational tiers
	Intermediate 1999	Local 1999	1999
Cambodia	No	No	0
Indonesia	No	No	0
Lao, PDR	No	No	0
Malaysia	No+	No	0
Philippines	Yes	Yes	2
Thailand	No	Yes	1
Vietnam	No	No	0

Source of basic data: *World Development Report 1999/2000.*

Notes:

Intermediate means state, province, region, departments, or other elected entity between local and the national government.

Local means municipality or equivalent.

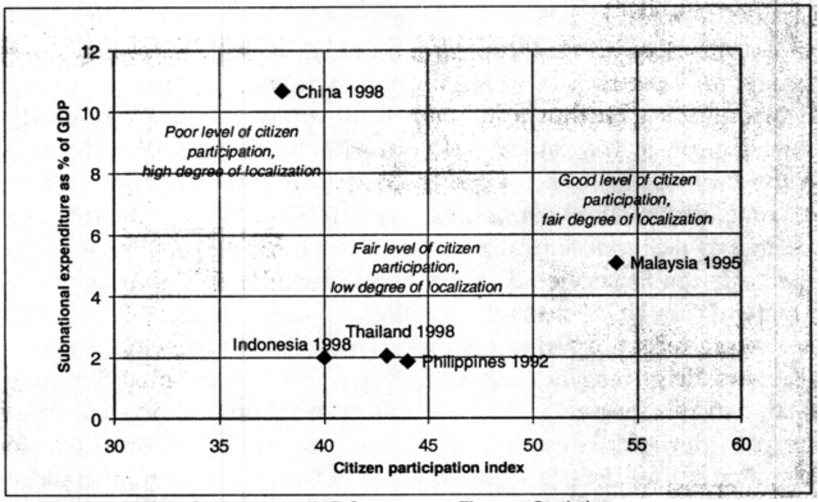
In Cambodia, local elections are planned for late 1999 or early 2000. A law is being drafted to define the powers and responsibilities of elected commune officials.

No+ indicates that although the legislature is elected, a nominated executive head (for example, a mayor or governor) holds significant powers.

voice takes into account the ability of the public to exert pressure on providers to perform well. Huther and Shah (1998) combine the individual rankings of countries on these indicators to develop a composite index of citizen participation. They find that citizen participation and public sector accountability go hand in hand with decentralized public sector decisionmaking. When the citizen participation index is paired with the depth of localization in Asia, localization and participation move together, but only tenuously, with respect to Southeast Asian countries. In Figure 40, Malaysia scores well in both localization and citizen participation. Indonesia, the Philippines and Thailand have poor to fair degrees of participation and low levels of decentralization. Neighboring China may be very good in localization but citizen power is almost nonexistent.

Anecdotal evidence suggests the strong power of citizen participation. Community mobilization in Thailand, despite uneven results, managed to help alleviate economic hardships in rural areas in the aftermath of the Asian crisis. A viable partnership between people's organizations and NGOs in Naga City in the Philippines formalized the participation of local communities in identifying development priorities. The *Kaantabay sa Kauswagan,* a key urban development program, managed to distribute government land to the city's poor population, upgraded slum housing, and engaged in land banking for future housing projects (Das Gaiha 2001).

Figure 40. Localization and voice: no single pattern.



Sources: Huther and Shah (1998); IMF Government Finance Statistics.

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 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).

Fisman and Gatti (2000) find that fiscal decentralization is consistently associated with minimal corruption. Countries with more decentralized expenditure have better corruption ratings. The size of the coefficient implies that one standard deviation increase in decentralization will be associated with an improvement in the country's corruption rating of 40 percent of a standard deviation.

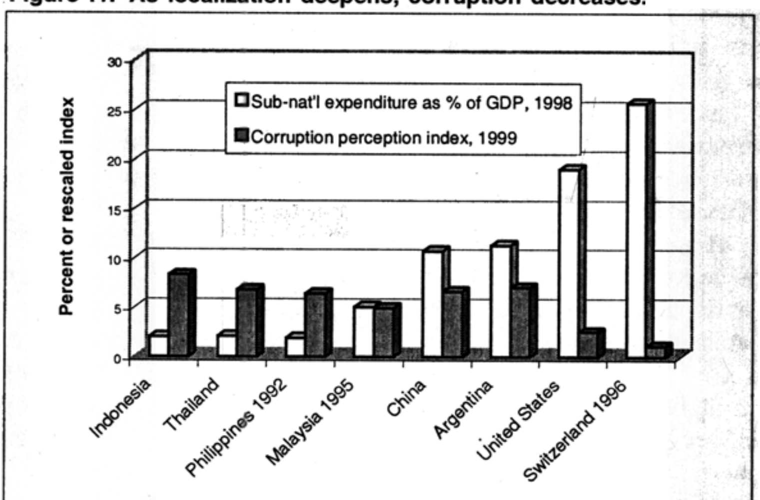
Figure 41 validates this result. When the extent of decentralization is matched with Transparency International's corruption perception index, what becomes apparent is the negative association between them, at least in certain parts of Southeast Asia. Indonesia, which has the worst corruption rating 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 is fairly decentralized. Notice that in highly devolved systems such as Switzerland, corruption is least. The same is true with the US and Argentina, to a lesser extent.

Earlier findings by Huther and Shah (1998) also confirm the negative correlation between fiscal decentralization and corruption. A composite ranking of countries on three indicators, namely, judicial efficiency, bureaucratic efficiency, and the lack of corruption, provides a good measure of government orientation. Huther and Shah then relate the degree of expenditure decentralization to the ranking of countries on individual indicators as well as to the composite rank on government orientation. They find that all of these correlations show a positive, and statistically significant, association. This suggests that a decentralized country is more responsive to citizen needs and preferences in service delivery than centralized countries.

Several case studies corroborate these findings. Blair (1996), citing the Philippines' more recent experience with decentralization, concludes that decentralized democratic governance has a positive impact on the quality of governance, especially in reorienting government from a command-and-control role to a service provider role. Humplick and Moini-Araghi (1996) report that for a large sample of countries decentralization leads to lower unit administration costs for road services. Decentralization also increases productive efficiency in the Philippines by limiting the leakage of funds and other sources (Azfar et al. 2000).

Beyond these evidences, there is still the possibility that decentralization can worsen corruption. Subnational governments can still be captured by the local elite especially in areas where there is inequitable distribution of assets (Das Gaiha 2001). Local elections that create opportunities to get the voice of the citizens heard can be controlled by the elite, since they are usually the candi-

Figure 41. As localization deepens, corruption decreases.



Sources: Transparency International; IMF Government Finance Statistics.

dates themselves or they bankroll the candidacy of chosen subordinates. Potential losses from decentralized procurement can also be staggering. With less oversight, since the cost of monitoring is prohibitive, local governments are more susceptible to capture by or collusion with local contractors.

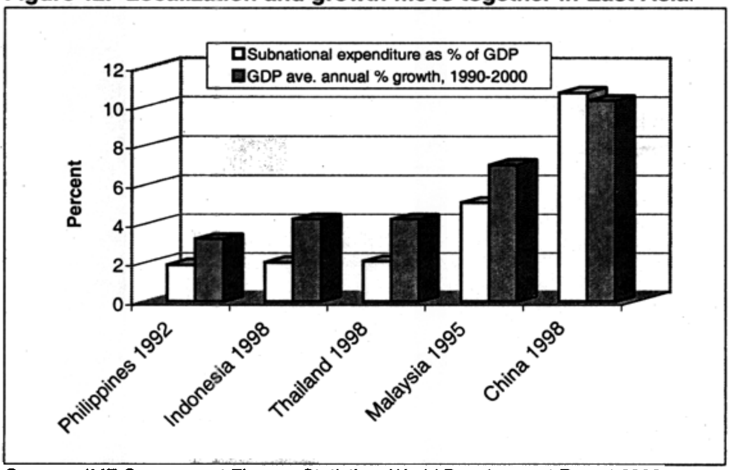
Central to any country strategy to combat corruption is the creation of citizen-led demand for better delivery of services. However, this, too, can be hamstrung by collective action problems as well as information barriers facing the public.

Decentralization, Growth, and Poverty

The quality of local governance, according to Manasan et al. (1999), is determined by the overall capacity of subnational governments to mobilize and utilize resources, deliver public services in an efficient and effective manner, and ensure accountability—all of which are prerequisites of good socioeconomic performance and growth. Asia's experience shows that decentralization and growth go together (Figure 42). China, the frontrunner, has the deepest local base and the highest GDP per capita average annual growth rate in the period 1990-1999. Malaysia is not far behind. In Indonesia, Thailand, and the Philippines, weaker decentralized structures also translate into weaker growth rates.

Decentralization is also correlated with human development. Huther and Shah (1998) find that fiscal decentralization is positively correlated with two indices of social development: human development and income inequality. The

Figure 42. Localization and growth move together in East Asia.



Sources: IMF Government Finance Statistics; *World Development Report 2002*.

human development index (HDI) incorporates life expectancy, adult literacy, educational enrollments, and per capita GDP in purchasing power parity terms.

But has decentralization helped the poor in Southeast Asia?

The outcome of decentralization in Asia depends on whether influential groups are being "coopted" or challenged in the process of devolving power and resources to subnational governments. In a recent survey of decentralization and poverty alleviation in Asia, Das Gaiha (2001) claims that although greater local economy and expanded resource base of local governments are likely to lead to some efficiency gains and benefits to the poor, it is doubtful whether these are widely shared. Decentralization has generally not benefited the poor in Asia.

Box 1. Have the poor in Southeast Asia gained from decentralization?

Drawing on case studies, Das Gaiha brings up the following country-specific points:

- The decentralized system in Cambodia is in its early stages, and it is difficult to say if it has contributed to poverty reduction. A decentralization initiative, the SEILA program, has been cramped by lack of community participation—the poorest members of the village and cannot attend to commune development activities because their daily struggle for survival takes up most of their time. In any case, the committees are dominated by the locally powerful. Moreover, plans and public investments reflect the concerns of line ministries with little consequence on provincial priorities.

- Poverty reduction in Vietnam is primarily attributed to economic liberalization and only to a lesser extent on decentralization. One of the notable achievements of Vietnam in rural development is the transformation of the country from a food-shortage country to an exporting one. According to Vietnam's Department of Agriculture and Rural Development, the success of Vietnam's food production industry is partly due to a shift from a centrally planned to a market-oriented economy and the subsequent transfer of central government functions to local governments. Yet the poorer provinces are at a disadvantage and income inequalities are likely to rise.

- The use of grassroots organizations as part of decentralization strategy in Thailand (that is, when the Tambon Administrative Organizations were authorized in 1999 to disburse the Miyazawa Fund to help address economic concerns at the community level) produced mixed results. The TAOs were held back by funding constraints, poor capacity building, and coordination shortfalls. Because of these, the campaign for community mobilization suffered setbacks and proved to be ineffective in reducing economic hardship in rural areas.

- In the Philippines, a decade of decentralization since the Local Government Code was approved by the legislature has not provided any indication of how the poor fared. Congressional interference in intergovernmental transfers has also somewhat gotten in the way of the local governments' effort to be more responsive to local needs.

- The reconsolidation of subdistricts into larger districts in Laos means that poorer villages in far-flung and inaccessible regions will become underserved, with adverse implications for poverty reduction.

VIII

Policy Recommendations

Weak governance and poorly functioning public institutions have held back growth in Southeast Asian countries. The economic downturn uncovered high levels of corruption and poor fiscal management, and provoked political instability. The transition economies were somewhat spared from the crisis. But "distortions" in their economies also restrained growth.

To accelerate broad-based and equitable growth and prevent another economic shock, the region needs major reforms in governance and public institutions. Southeast Asia's hope of recovering and accelerating its 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.

Transparency and Accountability

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

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 pursuing 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 can 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, is recommending to reform 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, central government cannot immediately relinquish its responsibility. Concurrency is necessary when 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 any 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.

Indonesia, the Philippines, and the transition economies in Southeast Asia are facing tough challenges to raise revenues through better tax administration and fiscal management. Laos, according to the World Bank, requires specific policy measures to improve transparency and efficiency in public budgeting and execution and revenue collection and control. Tax reforms are needed to increase the share of domestic direct and indirect taxes, reduce reliance on trade taxes and royalties, and broaden the income tax base.

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.

In Laos, the main challenge for the government is to provide equitable access to a basic minimum standard of education services. 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 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. All countries are currently getting World Bank support and encouragement for these efforts.

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 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 which cannot be held accountable for their action or non-action 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 Anti-Corruption 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 in some Southeast Asian countries like Thailand and Singapore, stricter regulations (e.g., higher cost of registration and complex procedures for registering a business) in the rest of the region discourage 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 microenterprises, 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 costs 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 simplification of rules (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, however, 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 in ensuring fair governance. What is urgent and easily doable is to reform litigation procedures to fast-track the 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. Government is known to impede the development of markets through the 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. Building new institutions in some Southeast Asian countries is not easy and would take time. Political conflicts or changeovers can cause reversals of newly installed institutions.

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, development of management cadre, and 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, have many effective checks and balances on the actions of political leaders (e.g., separation of powers, and the presence of veto points). Elections exist as another veto point, but in Southeast Asian economies under a command-and-control governance framework, the extent of the electorate's participation in elections is perceived as not truly representative of the citizens' voice. Voice mechanisms that could be strengthened include representation in subnational bodies, using civil society as pressure point, and allowing users to determine/influence the delivery structure of government services. Mechanisms must also equip various sectors, especially ethnic groups, with veto powers.

Strengthening the rule of law in Southeast Asia is critical to ensuring orderly, coherent, and predictable governance processes. Corollary to this is the need for more effective and forceful instruments for redress. Southeast Asian countries need to strengthen their legal framework including anticorruption institutions such as the Ombudsman.

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 firms can participate in the provision of public goods. Civil society organizations can also serve as government substitute in providing services (e.g., in 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 provision of basic services like basic education and health to subnational governments. Gradual takeover of functions must be done to prevent severe disruption of existing mechanisms. Abrupt changes 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. Nonetheless, if the capacity of local governments can be improved, then decentralization is a promising route toward a more effective delivery of social services. If they must do what central government did in the past, then improvements in the capacity of subnational governments would be at par with central government.

Subnational governments need additional instruments to discharge the functions devolved to them such as a mechanism for subnational borrowings. 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 urgent in areas where ethnic groups are generally disadvantaged due to poor living conditions, poor infrastructure, less access to 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.

IX

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 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 reforms in civil service. Career executives are instrumental in improving the quality of public management. Frontline service personnel can guarantee quality, consistency, and 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 decentralization. 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.

X

Principles to Consider

Improving governance in Southeast Asia requires a reform agenda that is aimed toward broad-based development and is 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 makeup 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. Many Southeast Asian economies are already suffering from "reform fatigue," and newer and more urgent interventions may face stronger resistance, not because they constitute radical changes but because the countries involved may have inadequate institutional capacity to absorb the treatment. Phasing also means that the more crucial interventions to reduce poverty (such as widening the poor's access to basic services) and to resolve internal conflict must be high on the reform agenda. 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 IMF 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—are 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 a strong political will.

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Appendix

Official Development Assistance

A.1 Aid Effectiveness

Aid flows in Southeast Asia. Aid is usually associated with official development assistance (ODA) from developed countries and is customarily targeted to the poorest countries. ODA is a subset of official development finance[1] and comprises grants, plus concessional loans with at least a 25 percent grant component. Aid can be bilateral or multilateral. Some bilateral aid is tied, that is, it must be used to produce goods and services from the donor country[2] (World Bank 1998).

During the last few decades, poverty has emerged as the central issue in the allocation of international aid. Following the calls for global effort to reduce poverty, donors attempted to channel more official aid to poorer countries. The change is characterized by the adoption of poverty reduction strategies of international institutions such as the United Nations Development Programme, the World Bank, and the Asian Development Bank to guide development assistance to low income countries.

This development is evident in Southeast Asia, where a higher proportion of aid goes to lower-income and transition economies such as Laos, Vietnam, and Cambodia (Figure A1). Middle-income countries are getting less development assistance. For the Southeast Asia 5, the average ODA disbursement is less than 1.6 percent of GDP.

With increased income resulting from economic growth, countries become less dependent on ODA. Figure A2 shows that as incomes rise, ODA first rises, then falls. In Southeast Asian countries with low income, net ODA disbursement increases as income increases but only up to a certain point, that is, when GDP per capita is below US$3,000. For Southeast Asian countries with GDP per capita of US$6,000 and more, net ODA disbursement decreases as income improves. However, the terms of official loans for middle-income countries are less concessional.

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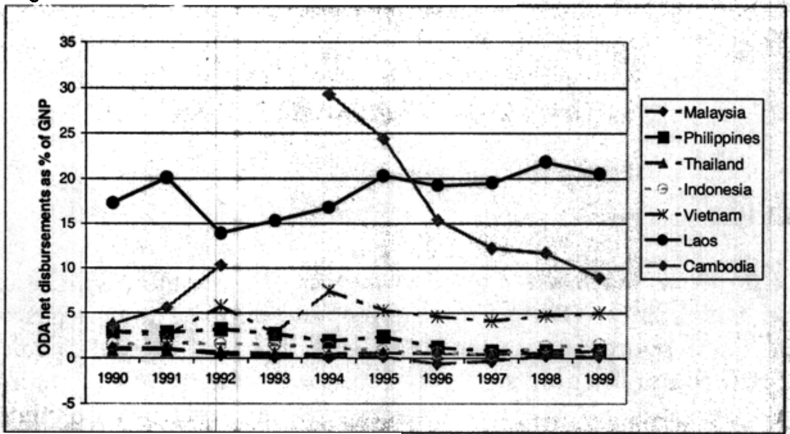
[1] All financing that flows from developed country governments and multilateral agencies to the developing world is called *official development finance* (World Bank 1998).

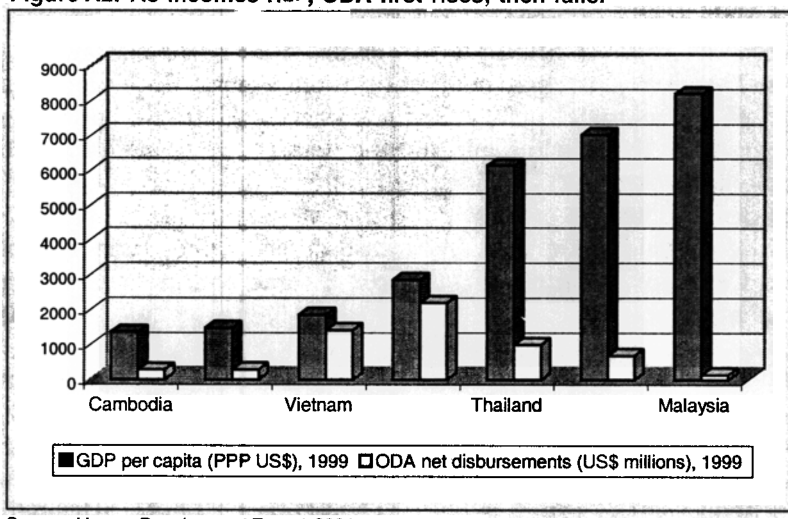
[2] Studies such as those of the World Bank have shown that tied aid reduces the value of that assistance by about 25 percent. Thus untying bilateral aid would make it more effective.

Figure A1. A decade of ODA in Southeast Asia.



Sources: *Human Development Report 1993-2001.*

Figure A2. As incomes rise, ODA first rises, then falls.



Source: *Human Development Report 2001.*

Spending patterns. In 2001, the World Bank reported that concessional aid flows had maintained an upward movement since 1998 and exhibited further increase in 2000.

This level of support, however, is haunted by the dwindling amount of global aid. As such, several donors are making adjustments on which country and on what activities to fund. For instance, the World Bank is already making modifications to remove its bias for infrastructure projects (World Bank 2001a).

Aid spending is also shifting to social and human development concerns. The core and complementary aid allocated to health (including complementary expenditures to improve water, sanitation, and waste management) has grown the fastest. Donor spending on family planning and reproductive health has also increased. Another good news is that allocation on environment, boosted mainly by stronger support for biodiversity preservation and for upgrading environmental administration, has also grown rapidly through country-based aid (World Bank 2001a).

Expenditure for reconstruction and post-conflict peacebuilding grew in the late 1990s in consonance with the regional promotion of peace. Spending for peacebuilding peaked in 1999, displacing part of concessional assistance to health. However, the outlay on knowledge generation and diffusion has been sluggish, with complementary spending on educational facilities and training severely curtailed.

In recent years, development assistance also shifted from financing investment to promoting policy reforms. This reorientation arose from a growing awareness that developing countries were hamstrung more by poor governance than by a lack of finance to invest in roads or dams.[3]

Aid and growth. Did aid matter in promoting growth and reducing poverty in low-income countries? Despite the vast amount of resources poured by donors to address human deprivation, poverty persists as a global problem, casting doubt on the effectiveness of aid.

Theoretically, aid can help reduce poverty. There is evidence that 1 percent of GDP in development assistance translates to a 1 percent decline in poverty and a similar decline in infant mortality. Some cross-country studies made by the World Bank have found that with sound economic management, 1 percent of GDP in development assistance translates to a sustained growth of 0.5 percentage points of GDP (World Bank 1998).

Indonesia in the 1970s, Malaysia and Thailand in the late 1980s, and Vietnam in the 1990s are examples of countries that experienced rapid development under a so-called "sound" economic management. While foreign aid might have played a role in the transformation of these economies, it is difficult to make a direct attribution on the effects of aid on the growth of these countries. Besides, Indonesia's and Thailand's growth was significantly reversed in the 1997 with the onset of the Asian financial crisis.

Generally, the contention is that more aid is associated with more investment. But what aid often does is to encourage domestic investment. A

[3] In their studies of aid and growth, Burnside and Dollar (1997) find that development efforts of poor countries have been held back, not by a financing gap but by an "institutional gap" and a "policy gap."

large part of domestic investment, however, comes from government. Using panel regressions for 56 developing countries, Burnside and Dollar (1997) have found out that bilateral aid has strong positive impact on government consumption. This is consistent with the widely held view that aid is fungible and tends to increase government spending proportionately, not just in the sectors that donors think they are financing. However, the results also suggest that increased government spending has no positive effect on growth.

Contrary to expectations, aid does not necessarily facilitate foreign investment, as Figure A3 suggests. Since aid is directed to poor countries, it is not surprising that higher levels of aid are not associated with increased access to international flows of private capital. In the figure, it is evident that the more stable and robust economies (Malaysia, Philippines, and Thailand) are getting more private flows. The low-income countries (e.g., Cambodia and Laos), characterized by weaker economies and maybe weaker institutional environments, remain unattractive to foreign investors.

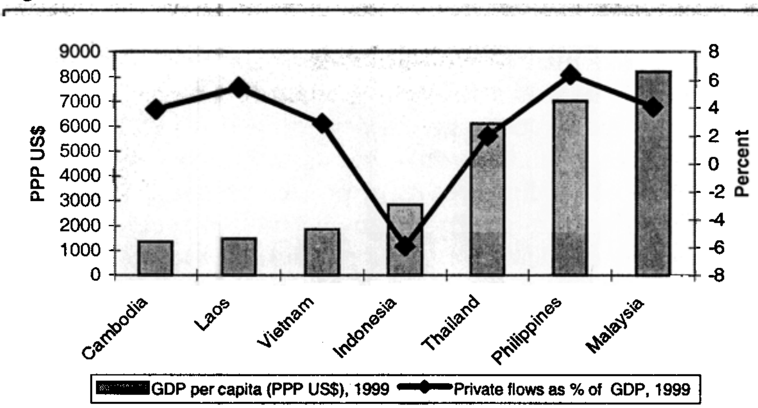
Nonetheless, effective aid can work positively with private investment. In this case, official flows can be used to facilitate more private flows. Studies by the World Bank claim that aid "crowds in" private investment by a ratio of almost 2 to 1 (i.e., every 1 percent of GDP in aid brings in another 1.9 percent of GDP in private investment in well-managed and reform-oriented countries). Under a good policy environment, it is said that aid increases the confidence of the private sector. In an unstable environment, however, aid tends to "crowd out" private investment.

Although aid can stimulate investment, studies revealed that there is no direct link between aid and growth through enhanced factor productivity (World Bank 2001a). It seems foreign capital only affects productivity in countries with superior human capital and developed financial structures. Since the poor countries are weak in both, aid does not work that way. Apparently, the only instance when aid enhances productivity in poor countries is when it is used directly to increase efficiency in government and its agencies.

Aid and governance. Donors generally aspire to direct their aid to countries with good governance structures.[4] For instance, development assistance to Myanmar had declined due to its so-called "distorted" environment. Vietnam, with its relatively good policy environment because of *doi moi,* is a beneficiary in the process. Yet aid does not necessarily reward good

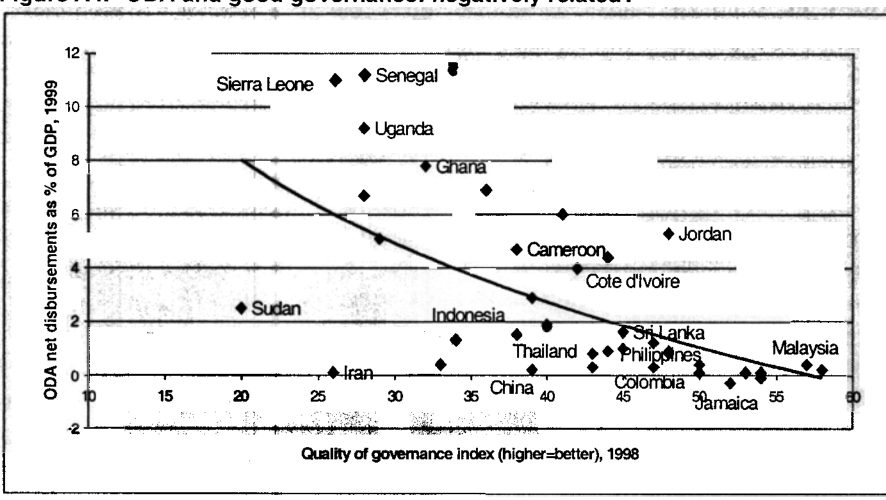
[4] While there are recommendations that aid be allocated on the basis of poverty and economic management, actual allocation has often been influenced by the strategic interests of donors. Accordingly, total bilateral aid has favored former colonies and political allies more than open economies or democracies. But the trend is changing (World Bank 1998).

Figure A3. Private flows behave in reverse fashion as ODA.



Source: *Human Development Report 2001.*

Figure A4. ODA and good governance: negatively related?



Sources: Huther and Shah (1998); *Human Development Report 2001.*

policies or even good governance. Since the philosophy of aid is humanitarian, good governance is not a requisite in the decision of donors on which country to assist.

Figure A4 shows net ODA disbursements as a percentage of GDP versus the quality of governance index, constructed by Huther and Shah (1998). It is noted that ODA disbursements of countries with better governance rating, as in the case of the Southeast Asia 5, are lower. Aid generally goes to countries where the economy is very weak and where poverty is worst—characteristic of poor governance—with the hope that it can help improve the quality of public management in the process.

Nevertheless, there is a strong argument for making good policy environment a key consideration in giving development assistance, since increased aid levels seldom stimulate improvements in policies and institutions. The success or failure of public investment projects (especially those financed by donors) depends on the quality of governance of recipient countries. According to studies, financial aid to poor countries with good policy environments have high rates of success.[5] The findings also highlight the fact that the most critical contribution of donor-assisted projects is not in increasing funding but in strengthening institutions.

In principle, aid could foster growth and reduce poverty by influencing domestic policies and institutions. Specifically, aid can be used by recipient governments to implement difficult reform measures that entail short-term costs but have long-term payoffs. But studies show that economic policies and governance structures rarely respond to increases in aid flows. In some countries, increased aid had encouraged greater dependence on donors or even predatory behavior, with adverse effects on policy and governance (World Bank 2001a).

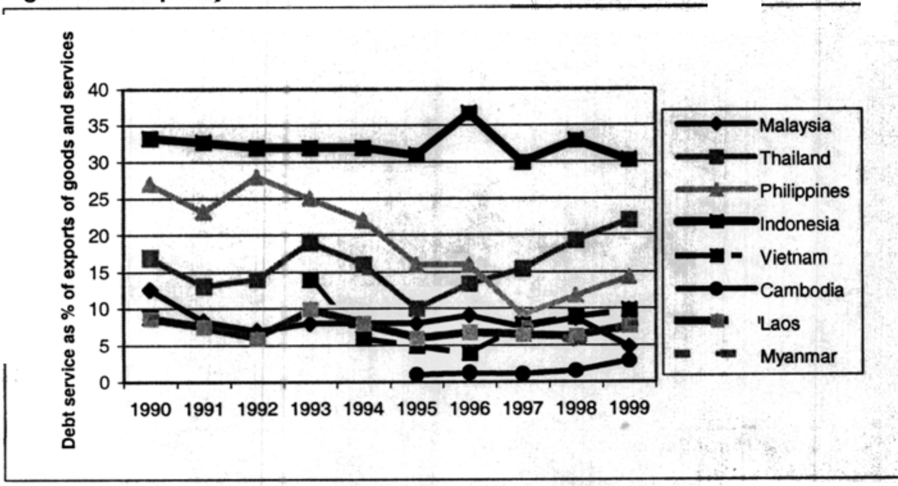
A.2 Aid Management

The persistence of poverty and seeming dependence of some countries on development aid elevate concerns about the efficiency by which development assistance is being managed. Dependency on aid is evident in many countries in Southeast Asia.[6] For some, ODA is a significant source of government revenues. This type of financing, however, carries the burden of debt repayment. The situation is not bad for some Southeast Asian countries whose economies can manage debt servicing. The others, however, have limited capacity to pay (Figure A5). Significant decrease in ODA disbursement and debt servicing can be observed of Malaysia and the Philippines. In the

[5] An analysis of the success and failure of public investment projects financed by the World Bank in roads, power, and education revealed that in countries with good macroeconomic environment and efficient public institutions, projects were 86 percent successful, with much higher rates of return. In countries with weak policies and institutions, the corresponding figure is a measly 48 percent (World Bank 1998).

[6] For instance, Cambodia had to rely heavily on aid for financing basic goods and services, owing to its poor domestic revenue mobilization and questionable expenditure allocation decisions. Donors financed about 60 percent of public expenditure in 1997, including 53 percent of expenditure on social sectors and 83 percent of expenditure on economic services, including rural development and infrastructure. Aid now constitutes 9 percent of its GDP (World Bank 2000a).

Figure A5. Capacity to service debt varies.



Sources: *Human Development Report 1993-2001*; World Bank for 1996 figures.

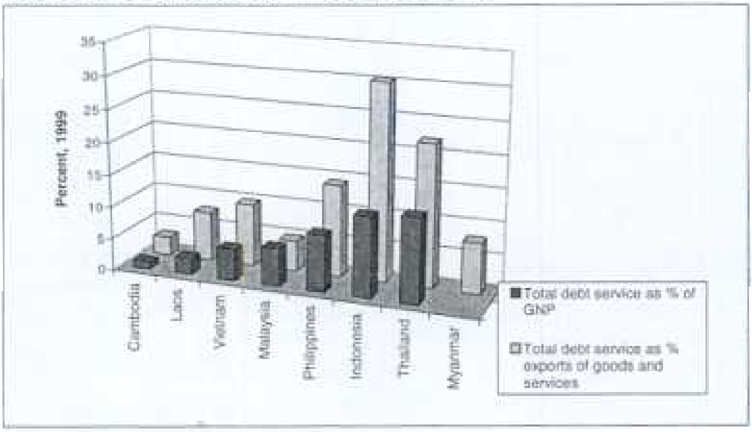
case of Thailand, both ODA disbursement and debt servicing increased. The transition economies, except Lao, PDR, are also marked by increased ODA disbursements and corresponding increase in debt servicing.

To service their debts, Thailand, Indonesia, and the Philippines had to allocate a substantial portion of their income for loan repayment. Those of Malaysia and Vietnam seem manageable at about 5 to 6 percent of GNP (Figure A6). Laos and Cambodia seem to get more concessional aid and good repayment terms for loans. Since ODA loans are foreign currency- denominated, repayment would have to be sourced mainly from the export earnings of these countries.[7] Of the countries where data are available, Indonesia had to use the biggest proportion of foreign exchange earnings for debt payment (30.3 percent of exports of goods and services). Malaysia manages well its debt servicing at less than 5 percent of exports.

While the transition economies in Southeast Asia seem to be getting favorable ODA terms with lower annual repayments, a different picture emerges in Figure A7. Here, the debt burden of transition economies, including Indonesia is quite high when the present value of debt service is taken into account. Indeed, the more indebted countries are those with weaker

[7]A related issue on repayment is the weakening of the domestic currency of recipient countries. For instance, in the case of the Philippines, a depreciation of one peso against the US dollar results in an increase in interest payments on foreign debt by PhP1.15 billion annually (*Philippine Daily Inquirer*, 16 July 2001). A similar case would not be surprising in other Southeast Asian countries.

Figure A6. Servicing debt in Southeast Asia.



Source: *Human Development Report 2001*

economic management (Table A1). The World Bank indebtedness classification[8] confirms the bigger liabilities of the lower-income economies in Southeast Asia. Those severely indebted are Indonesia,[9] Laos, and Myanmar. Vietnam and Cambodia are moderately indebted. Malaysia, the Philippines and Thailand, which are middle-income, are better off.

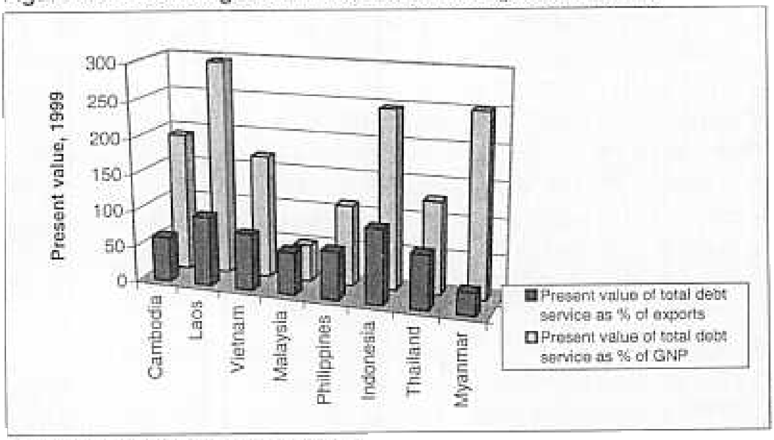
How is aid managed to spur development in poor countries and not pose the burden of debt service?

Fungibility of aid. A key issue in managing aid is fungibility. Development aid is often fungible, which means that a government can use increased resources as it chooses. On a positive note, fungibility allows

[8] The World Bank classifies indebtedness based on two ratios: the ratio of the present value of total debt service to GNP and the ratio of the present value of total debt service to exports. These ratios indicate potential capacity to service debts in terms of (a) exports, because they are the source of foreign exchange; and (b) GNP, the broadest measure of income generation in an economy. If either ratio exceeds a critical value (i.e., 80 percent for debt service to GNP ratio, or 220 percent for debt service to exports ratio), a country is considered severely indebted. If the critical value is not exceeded but either ratio is 3/5 or more of the critical value, i.e., 48 percent for the present value of debt service to GNP and 132 percent for the present value of debt service to exports, the country is classified as moderately indebted. If both ratios are less than 3/5 of the critical value, a country is classified as less indebted. (World Bank 2001a).

[9] The Asian crisis left Indonesia deeply in debt. The World Bank estimates that after Indonesia completes the task of bank recapitalization, government debt will add up to a towering 100 percent of GDP, up from 23 percent of GDP before the crisis. Debt service will take up more than four-fifths of government revenues, along with politically sensitive fuel subsidies and the wage bill, putting unbearable pressure on the budget and threatening to crowd out development spending (World Bank 2001).

Figure A7. Servicing debt in Southeast Asia (present value).



Sources: *Human Development Report 2001*

Table A1. Indebtedness classification of Southeast Asian countries, 1999

Income classification	PV/XGS higher than 220% or PV/GNP higher than 80%			PV/XGS less than 220% or PV/GNP less than 80% but higher than 48%		
Low income: GNP per capita less than $755	Severely indebted Low income			Moderately indebted Low income		
		PV/XGS	PV/GNP		PV/XGS	PV/GNP
	Indonesia	246	103	Cambodia	191	62
	Laos	295	96	Vietnam[a]	169	77
	Myanmar	251	31			
Middle-income: GNP per capita between $756 and $9,265				Moderately indebted Middle income		
					PV/XGS	PV/GNP
				Malaysia	50	59
				Philippines	111	66

Note: PV/XGS is the present value of debt service to exports of goods and services. PV/GNP is the present value of debt service to GNP.
[a] Indebtedness classification has improved
Source: World Bank 2001a.

flexibility and provides more elbow room to recipient governments in the allocation of resources. Yet it makes monitoring difficult.

Fungibility can overshadow the value of aid from the donor point of view and diminish its effects on investments. For instance, an aid dollar used to finance projects in education tends to increase government spending in all sectors to the same extent as a dollar of government revenue form any source (World Bank 1998). Sectoral fungibility is another issue. For instance, aid for education can lead to a reduction in what the government would otherwise have spent on school programs. Conversely, aid for other sectors can cause the government to spend more on education.

Based on these findings, it would seem that development aid simply expands the government's budget. On the bright side, Devarajan and Swaroop (1998) note that even if local spending is diverted, aid may still have an added value, since it comes with technical assistance and the expert management skills of donor agencies. This in turn may increase the project's rate of return and lead to changes in policy, institutions, and project design.

Coordination of aid. Another issue in aid management is donor competition. The proliferation of donors and lack of coordination among them contribute to the inefficient use of limited global aid resources and exacerbate the adverse effects of aid allocation based on donor interests[10]. Some well-managed countries (e.g., Malaysia) are able to force coordination on donors. But in weaker countries, donors can have their own way of choosing projects to promote their own strategic interests.

Donor preference for tangible and high-visibility projects (e.g., infrastructure) is not uncommon, since donors have to justify their spending to their taxpayers. Donor-driven projects, however, often suffer from sustainability problems. Many infrastructure projects turn out to be white elephants due to lack of capacity or diminished interest of recipients to maintain them. Moreover, the piecemeal approach in project execution limits the potential of development aid to effect significant transformations in low-income countries. Poor coordination also leads to "crowding in" of donors in built-up and more accessible areas, leaving out other poorer regions and localities that need assistance most.

[10] The traditional approach to aid management has also reduced the participation of local communities in the design and implementation of development projects. More so, donor responses to weak institutions have been ineffective. Faced with low absorptive capacity and pressures to "move the money," many aid agencies "cocoon" their projects rather than improve the institutional environment for service provision (World Bank 1998).

Cambodia is a case in point. The multiple activities of donors place an unsustainable management burden on the government and its limited institutional capacity. Each donor has a different administrative procedure for procurement and disbursement in Cambodia. Without coordination, large amounts of technical assistance are unable to build real institutional capacity. The Cambodian government claims to have insufficient ownership of many projects and programs, and large amounts of ODA flow outside the government budgetary system. The lack of accountability on projects and programs, including evaluations and audits of the impact of projects, is also a problem (World Bank 2000a).

A.3 Making Aid Better Managed and More Effective

Aid must be effectively managed to make sure that it can stimulate growth and strengthen the institutions of recipient countries. Donors can make aid work more effectively in recipient countries through partnership rather than through competition. They can also enhance the value of aid by increasingly providing ideas not just goods, untying aid and allowing recipients to take "ownership" of and greater flexibility in the use of aid.

Partnering and having a common basket. Donors should bear in mind that the more successful development assistance packages are those focusing on larger transformations, not on individual projects. This fact calls for strong partnership among donors. A "common pool" approach to assistance for each country can create greater impact and ease aid management.

To be effective, donors must also be willing to observe the principle of subsidiarity—or allowing the most knowledgeable organization in any given initiative to take the lead. It is by operating in a decentralized, network-based system of governance that donors will influence political decisionmaking to advance national and regional interests (World Bank 2001a).

The donors' "common basket" must increasingly provide more for human development, especially basic education and health. The Sachs commission argues that there would be large collateral benefits from improved health care in the world's poorest nations. Disease, it argues, is a major obstacle to economic growth, which in turn would make the developing countries a richer and safer place to be (Krugman 2001). Investments in these basic services have large externalities that even developed countries can benefit from. Accordingly, the price tag of a program to provide very basic items that many poor nations simply cannot afford (such as antibiotics to treat tuberculosis, insecticide-treated nets to control malaria) would be about 0.1 percent of advanced countries' income. The payoff would be at least eight million lives saved each year (Krugman 2001).

Enhancing flexibility of aid. Without discounting the difficulties in monitoring, donors ought to consider shifting development aid from project to budget support to give recipient countries more flexibility in allocating such resources in the context of their long-term sustainable development goals (Lamberte 2002).

Fungibility of aid is not a bad idea, especially if recipient governments have efficient public expenditure management. Some developing countries believe that they "own" the ODA, especially loans which they will have to repay anyway in the future.

Therefore, they, not the donors, must have control over the disbursement of these resources. But in cases where public sector management is weak and where inefficiencies in allocation exist, fungible aid may not be used productively. Nevertheless, donors must be on the lookout for the overall quality of public spending by recipient countries in choosing the level of financial support and the type of assistance to provide.

Similarly, donors may need to simplify operational policies and procedures and remove burdensome restrictions such as aid tying. They must allow recipient countries to choose the best inputs they see fit for their programs and projects (Lamberte 2002).

Ideas aid vs. money aid. Aid can support effective public institutions and good governance by helping with experimentation on service provision, dissemination of development ideas, and stimulating policy discussion. In governance areas where there is demand for reform, aid can make a big contribution by supporting pilot projects. Thus, donors can leverage through "idea aid" by supporting institutional and policy reforms (World Bank 2001a).

Right timing. Timing of aid is also critical. If donors were good at anticipating "turning points," they could deploy aid just before reforms are started. In such case, an increase in aid flowing to "poor policy regimes" would be followed by reforms. For instance, while it is fair to characterize Myanmar as "poorly managed," chances are there are reform-minded elements in the government. Aid can make a big difference if donors can find and support these reformers (World Bank 1998).

Increasing absorptive capacity for aid. Additionally, a supportive environment that enables countries to absorb and use aid effectively is also needed. Where there is limited absorptive capacity, aid management can also be facilitated by actively involving nongovernment organizations. NGOs can be used as implementing agencies for donor-financed projects. In many cases, NGOs reach local and target groups more effectively than can a typical government agency. While NGOs can be an alternative delivery structure, they cannot replace government and be a permanent substitute for public sector capacity.

Leveraging aid with private resources. Official funds can be deployed to mobilize or "pull in" private finance for activities that offer possibilities for a commercial business (e.g., developing and distributing new drugs and vaccine, bridging the gap between rich and poor in information technology, and increasing agricultural productivity) (World Bank 2001a). Aid resources, by "crowding in" private funds, actually leverage additional money to support developmental activities.

Regional integration of aid. Many environmental, natural resource management, and health issues are regional in nature. Without coordinated efforts, they lead to free riding. Regional approaches can spawn efficiency; regional harmonization of policy can help small countries such as Laos overcome their size disadvantage, which often discourages investment. Differential pricing—lower interest charges for some investment loans—could be applied to the financing of activities with regional or cross-country benefits (World Bank 2001a).

A.4 Japanese ODA

Is Japanese ODA more effectively deployed to poverty reduction?

Japan is the world's largest donor (although its contribution still falls short of the annual equivalent of 0.7 percent of GNP target for industrialized countries). The Japanese ODA has been characterized by a smaller share of grants and a much larger share of loans relative to the DAC average. Of the total Japanese development assistance, 89 percent consists of loans while 11 percent comprises grants. The reverse applies to the United States, with development assistance consisting of 86 percent grants and 14 percent loans (Tadem 2001). Accordingly, the high proportion of loans in Japan's ODA reflects the country's aid philosophy of self-help[11] and the government's desire to leverage ODA resources. But this should not deter the Japanese government to increase the concessionality of Japanese ODA.

A large share of Japanese ODA goes to Asia, up to about 90 percent. In 1999, Japan registered the most significant increase in aid among major donors. The increase was intended for countries affected by the 1997 financial crisis. The main beneficiary of this increase was Indonesia, although Thailand and Vietnam also experienced a rise in aid inflows from the Japanese government.

[11] Recipients of Japanese ODA need to develop their economies as they are faced with the requirement to pay, and forced to allocate more resources more effectively (Kawai and Takagi 2001).

Table A2. Japan ODA loan commitments by sector, as of March 31, 2000 (in percent).

	Indonesia	Malaysia	Myanmar	Philippines	Vietnam
Commodity loans	27.9	-	34.3	21.5	17
Transportation	21.9	14.4	12.8	30.6	34
Electric power & gas	17.5	51.7	10.4	16.1	33.9
Irrigation and flood control	10.3	-	2.9	9.5	-
Social services	8.3	20	-	7.6	8.4
Mining & manufacturing	6.7	11.8	34	7.9	0.7
Telecommunications	4.2	0.7	1.4	2.6	6.2
Agriculture, forestry & fisheries	1.9	1.3	4.2	4.1	-
Others	1.4	-	-	0.1	-
Total	100	100	100	100	100

Source: JBIC.

Despite being the biggest contributor to global aid, Japanese ODA is being criticized for its overemphasis on infrastructure-related projects (Table A2) and for its "restrained willingness" to participate in multilateral partnerships (Kawai and Takagi 2001).

The bulk of Japanese ODA, outside of commodity loans, goes to the transportation sector, electric power and gas, mining and manufacturing which are infrastructure related. Except for Malaysia, which was able to draw a significant amount of development loan for social services, the social application of Japanese ODA is significantly small for the rest of Southeast Asia.

There are also contentions that Japanese ODA is tied to purchases of goods or services from Japanese firms although, according to Kawai and Takegi (2001), the share of contracts given to Japanese outfits in ODA loan projects had already significantly declined from nearly 70 percent in the 1980s to 24 percent in 2000.[12] For instance, Japan is said to earn 75 cents to 95 cents for every dollar of aid it gives in the form of goods and services purchased by the recipient countries (Tadem 2001). A study of Tsuda and Yokoyama

[12] Internally, the Japanese government is faced with public perception that ODA does serve the economic interests of Japan (Kawai and Takegi 2001).

(1986) also revealed that 90 percent of Japanese commodity loans were used to purchase Japanese goods.

Likewise, there are instances when Japanese aid has also been tied to conditionalities. Examples include the Asian Development Bank loan and the use of the Miyazawa Fund for the power sector restructuring plan in the Philippines which was conditioned on the passage of a controversial Omnibus Power Bill (Tadem 2001).

Japan's ODA system is required to make major changes in order to switch from a framework of lending support to a single project by a single entity such as a government, especially a central government, to a system and framework that can provide detailed support to various activities by many different entities (Kidokoro, 2000). Accordingly, the conventional ODA framework based on the notion of government institutions providing services to recipients needs to be changed. Ownership by recipients and flexibility in choosing the improvement measures are important key factors in enhancing the effectiveness of Japanese aid.

To improve the effectiveness and quality of Japanese ODA, Kawai and Takagi (2001) have put forward several proposals. Firstly, there is a need for Japanese aid agencies to adopt a strategic approach to assisting economic development and poverty reduction in low-income countries, in greater coordination with other stakeholders in the international development community, instead of independently undertaking projects. In designing and implementing development projects, Japanese aid agencies must work closely with the community particularly nongovernment organizations and other civil society elements.

Japanese aid must likewise explicitly focus on poverty reduction and human development. Japan's development assistance can also extend its concessional window to middle income countries in Southeast Asia to accelerate antipoverty programs.

Japanese aid agencies should continue to untie aid and allow recipient governments to decide the inputs that best fit their programs and projects. Japan can also do well in providing "ideas aid" based on the Japanese experience. Japanese ODA can also have higher leverage if side by side with hard infrastructure projects, part of the aid will be used on institution building and economic reform.