MANAGING DEVELOPMENT
THROUGH INSTITUTION BUILDING

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Abstract

Governance is closely linked to the performance of public administration and its relationship to civil society. The application of governance criteria must respect the specificities of public administration and society in each country. Numerous examples can be given of how some countries—particularly in East Asia—have achieved significant levels of growth, development management, and private and public sector interaction, even in the absence of some of the institutions that characterize Western democracies. For this reason, the promotion of good governance must not seek to impose specific solutions derived from one country's experience, regardless of how successful, but must identify broad objectives that can guide country-specific solutions by suggesting general criteria or standards.
I. Introduction

The outcomes of broadly similar reform packages have varied significantly across countries. Governance, the capacity of the institutional environment in which citizens interact with each other and with government agencies, is one of the factors underlying these variations. Hence, getting the policies right may not, by itself, be sufficient for successful development. Good governance is required to ensure that governments actually deliver the promises to their citizens.

The experience within Asia does not establish any direct correlation between the type of political regime and rapid economic and social development. Successful development has taken place in countries with different political systems. Within the region, it is the quality of governance, not regime type, that seems to be associated with the differences in economic performance.

Evaluations of project performance in developing countries indicate the importance of the nonpolitical, functional components of governance. Separate evaluations conducted by both the Asian Development Bank and the World Bank reveal that even when projects are narrowly focused, success is often dependent upon the overall capacity of public administration. Well-designed programs are important, but so is the ability to implement them. This ability cannot be predicted from regime type. Implementation capability reflects three fundamentals in the strategic interactions between citizens and government officials. These fundamentals—accountability, transparency, and predictability—determine the performance of economic policy.

II. Essentials of Development Management

A. Accountability

Accountability refers to the imperative for citizens or key broad-based elites to make public officials responsible for government behavior and responsive to the needs of citizens. Accountability at the microlevel implies that government structures are flexible enough to offer beneficiaries the opportunity to improve the design and implementation of projects. Similarly, outcomes of macropolicies affecting the economy as a whole, ultimately,

1 A general definition of governance used by the World Bank is "the manner in which power is exercised in the management of a country's economic and social resources for development". This definition was designed to extend beyond the capacity of public sector management to the rules and institutions that create a predictable and transparent framework for the conduct of public and private business, and to accountability for economic and financial performance" (World Bank 1991).

2 Background papers for the Asian Development Bank (ADB 1994b) Report of the Task Force on Improving Project Quality concluded that a number of projects that were technically sound fell short of their potential because of problems in implementation. These failures indicated that weaknesses spread through the public sector will diminish the impact of even narrowly focused ADB projects, increasing costs for both borrowers and lenders alike.

This project survey confirmed earlier findings of a World Bank study conducted in November 1992, which similarly cited implementation as a critical component of project performance. That study (World Bank 1993a) called for rethinking project design to account for the influence of implementation capability on project outcomes.

The importance of implementation became especially clear to the World Bank in connection with structural adjustment lending, where it was recognized there was a need to create an enabling environment in which the macroreforms could be anchored (World Bank 1992b).

1 For example, most East Asian regimes had a high degree of participation of local leaders in policy making.
depend on the support and cooperation of those groups affected. This may necessitate some degree of citizen representation, ranging from narrowly conceived consultative committees to a broadly elected legislature.

Accountability also means establishing criteria to measure the performance of public officials, as well as oversight mechanisms to ensure that standards are met. The litmus test is whether private actors in the economy have procedurally simple and swift recourse for redress of unfair actions or incompetence of the executive authority. Lack of accountability tends, in time, to reduce the state’s credibility as an economic partner. This can ultimately cause even autocratic regimes to fail, since they are rarely able to sustain the confidence that leads to long-term, growth-enhancing investment from the private sector. In short, accountability can curb sovereign risk.

Accountability must also include the existence of mechanisms to evaluate the economic and financial performance of public institutions. Economic accountability relates to the effectiveness of policy formulation and implementation, and efficiency in resource use. Financial accountability covers accounting systems for expenditure control, as well as internal and external audits.

B. Transparency

Transparency refers to the availability of information to the general public (including rival elites), and clarity about government rules, regulations, and decisions. Thus, it both complements and reinforces predictability. Ensuring transparency is difficult because the generator of information alone may know of its existence, and therefore can limit access to it. Hence, the citizen’s right to information must be supplemented by legal enforceability. Broadly restrictive laws that permit public officials to deny information to citizens, for example, an Official Secrets Act, should provide for an independent review of claims to confirm that such a denial is justified in the greater public interest.

Access to accurate and timely information about the economy and government policies can be vital for economic decision making by the private sector. Such data should be freely and readily available to economic agents on the grounds of efficiency alone. While this is true across all areas of the economy, it is especially relevant to information-intensive sectors, such as finance, in general, and capital markets, in particular.

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The risk of confiscation, favoritism, or capricious enforcement of policies characteristic of autocratic rule will generate uncertainty that can reduce private sector initiative. The irony of autocracy is that the leader’s claim to be above the law reduces the state’s credibility as an economic partner and undermines the willingness of citizens to take risks and engage in wealth-enhancing activities.

A comparison of uniform tariffs and multiple tariffs will illustrate the point. With a uniform tariff, merchants know exactly what payment is required. In contrast, multiple tariff rates offer customs officials discretion over the classification of goods, and thus provide a basis to supplement their private income. Although a good case can be made for multiple tariffs from an economic point of view, a developing country that offers discretionary interventions to underpaid officials has opened a Pandora’s box, regardless of how compelling the argument for multiple rates may seem. When bureaucratic capability is in doubt, the uniformity of tariffs at very low levels would reduce the possibilities for corruption, as well as rationalize economic decision making. Similarly, inconsistent foreign investment laws subject to different interpretations can create uncertainty among potential investors. The successful East Asian regimes combine transparent rules for protecting, registering, and taxing property rights, with effective company laws. As a result, the legal rights to contract and maximize the income or return on assets are guaranteed. Many countries offer variable rates for imported automobile registration. Complex standards for assessing rates allow for personalized negotiations and side payments between importers and officials.
Transparency in government decision making and public policy implementation reduces uncertainty and can help inhibit corruption among public officials. To this end, rules and procedures that are simple, straightforward, and easy to apply may be preferable to those that provide discretionary powers to government officials or are susceptible to different interpretations. However well-intentioned the latter type of rule might be in theory, its purpose can be vitiated in practice through error or otherwise.

Limits on the principle of transparency may sometimes be necessary. Such limits should be mindful of the distinction between information as a commodity, and information as a process. For example, intellectual property rights may need to be protected to encourage innovation and invention; but decisions making on the establishment of intellectual property rights, thereto (that is, to whom they are granted and why) should be transparent.

C. Predictability

Predictability refers to the existence of laws, regulations, and policies to regulate society, and their fair and consistent application. It is dependent upon a rule of law that encompasses both well-defined rights and duties, as well as mechanisms to enforce laws and settle disputes in an impartial manner. The state and its subsidiary agencies must be bound by, and answerable to, the legal system, as must private individuals and enterprises.

Rule-based systems of rights are essential for economic actors to plan investment decisions. A predictable regulatory framework enables firms to calculate the return on their investment. On the other hand, regulatory uncertainty raises the cost of capital by increasing the risk of investment (Price Waterhouse 1994).

Predictability can be enhanced through appropriate institutional arrangements. For example, it has been argued that an autonomous central bank could lead to more predictable monetary and exchange rate policies. Many governments face the challenge of regulating money supply while pursuing expansionary fiscal policies to encourage investment. In such situations if monetary policy is too accommodating, inflationary pressures can put investor confidence at risk, thus defeating the very objective of the fiscal policy. In some countries, managing the fiscal deficit may be made more difficult by compulsions to bail out a politically manipulated banking sector. By granting greater autonomy to the central bank, government can signal to investors that macroeconomic policy will be prudent and sound. Insulating economic ministries from political pressures can have similar benefits.

D. Balancing the Extremes

Although the three elements of good governance—accountability, transparency, and predictability—tend to be mutually supportive, in general, accountability must take priority over transparency. The need to balance accountability with the independence of central

For example, a uniform tariff rate (where merchants know exactly what customs duty payment is required) may be preferable, on this ground, to multiple tariff rates that offer customs officials discretion over the classification of goods.

Central banks must be able to signal to investors that macroeconomic policies stabilize fiscal deficits and resist the political clout of vested interests. Independence insulates the bank from pressures to use monetary and exchange rate policy irresponsibly or to endorse loans to regime cronies or uncompetitive parastatals. Hong Kong’s commitment to predictable macroeconomic policies was affirmed by pegging its currency to the American dollar thereby removing any basis for concern that local politics would motivate opportunistic monetary policies. The independence of financial ministries from political opportunism can have the same beneficial effect of an independent central bank.
bank officials illustrates this relationship. The experience of the central banks of both Germany and the United States suggests that to ensure accountability, fixed terms and transparent rules for personnel turnover, as well as rules that will prevent the abuse of power, such as prohibitions against the appointment of relatives, are all essential. A supervisory board, perhaps composed of representatives of private banks from different regions, is one way to establish effective oversight procedures. An adjudication system is important as a final resort in disputes over questionable behavior.

Transparency also requires careful balancing. One can anticipate a number of situations in which parties may choose not to enter a negotiation for fear of exposing their position to public hostility or for fear that rivals will gain advantages from the public exposure of private information. The limits of transparency must respect the need to prevent the disclosure of private information that can compromise the position or key partners to an agreement.

Although conceptually the three elements of governance indicated above tend to be mutually reinforcing, accountability is the ultimate safeguard of transparency and predictability. In general, transparency and predictability cannot be ensured without institutions that impose accountability. As noted, while predictability requires financial decision-making by a politically independent bureaucracy, it must be balanced with agency accountability to the communities targeted by their policies.

Devices to achieve accountability must subject officials to constituent oversight, and they must impose a standard to measure agency performance. Without the requirement to be accountable to affected groups, agencies may become self-interested entities that place agency interests over those of their constituents. Transparency and information openness cannot be ensured without legal frameworks that balance the right to disclosure with the right of confidentiality, and without institutions that accept accountability. Predictability in the functioning of the legal framework is helpful to ensure the accountability of public institutions. At the same time, predictability also requires transparency, because without information about how similarly placed individuals have been treated, it may be difficult to ensure adherence to the rule of equality before the law. Transparency facilitates accountability, participation, and predictability of outcomes.

III. Providing the Institutional Framework

Building an effective public sector that can provide the necessary physical infrastructure and promote equity and social justice requires administrative capacity. Because politics will influence the outcome, the criteria for institutional reform in one country may be different from what works in another.

In diplomacy, it is generally accepted that transparency is temporarily suspended when negotiating concessions from parties to an agreement may require delaying public exposure of the terms under discussion until the reactions of parties directly privy to the agreement are registered. Another trade-off is between transparency and innovation. Transparency between bidders for existing public utilities to supply new capacity requires specifying the type of plant. However, a bidder may resist precise specifications when innovative solutions are being considered. Changes in exchange rates represent another area in which premature exposure could invite behavior that undermines the policy. Students of international relations acknowledge that transparency does not always increase cooperative behavior between political rivals.

For example, the independence of finance ministers from political pressures must be balanced by the need to be consistent with the commitment to constituents on political issues.
Throughout the developing world, a large informal sector has developed in response to the state’s failure to provide basic services. To induce firms to play by the rules, positive incentives must be given to encourage them to become licensed operators in the formal sector, and thereby provide tax revenues. Thus, in turn, will increase government’s ability to perform its functions better. Reform must begin with the elimination of the dangers of arbitrary taxation and discretionary standards for licensing by unaccountable government officials, who often operate in overlapping administrative jurisdictions. Tax rates should be consistent and should not unduly burden economic activity, forcing enterprises into the informal sector.

A government’s ability to implement projects successfully or undertake reforms depends in large part on its institutional capacity to conduct public business. Failure to provide effective public sector management undermines the credibility of reform initiatives. When credibility is lacking, firms will act in the expectation that government will not be able to sustain growth, and will only make short-term investment decisions. When government fails to adequately provide property rights or the necessary infrastructure, industry responds by failing to provide the necessary investment, shrinking tax revenues and reducing growth.

The key to sustaining a growth equilibrium is to convince the parties whose cooperation is necessary that they will gain more by postponing present consumption in order to enjoy greater long-term benefits. Leadership must provide assurances that the benefits will not be eroded by corruption or by the rent-seeking of powerful elites. Thus, microlevel reform of the public sector, including the civil service, is a fundamental component of economic reform. Unless the government’s ability to protect property rights and ensure a level field for all players is established, individuals are unlikely to sacrifice present consumption for increased investment.

B. Improving Accounting and Auditing Procedures and Statistics

Improvements in auditing and accounting procedures are the first line of reforms that governments must undertake to ensure responsible performance of management tasks. Improved financial accountability often requires improved accounting and auditing practices, compliance with financial management standards, and financial accountability assessments.

Audits are fundamental to accountability and are a necessary component of public sector performance. An independent audit system strengthens expenditure control by monitoring and evaluating public expenditure programs for effectiveness and performance. A mechanism to review and act on audit results is critical. So, too, are reliable accounts—their absence has been a major constraint to efficient public sector management. Another issue of great concern is the allocation of budgetary expenditures within and between sectors.

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1. In some Asian countries, for example, India, Philippines, and Sri Lanka, wage employment in the urban informal sector grows faster than in the formal sector. This deprives the government of revenue and the producers of legal protection. "In India, twice as many jobs have been created in the unorganized manufacturing sector as in the organized" (United Nations Development Programme 1993).
2. Financial accountability refers to the duty of anyone who handles public funds or goods to publicly respond to others for the manner in which the duties have been performed. Accountability can be enhanced when an independent auditor examines a paid invoice and counts the money returned. Audits should entail a publicly presented or independently verified report.
3. Development agencies can help by providing funds to train accountants and auditors; upgrade professional standards by imposing a code of ethics and disciplinary procedures; modernize procedures; and finance career development through the support of teaching and research and by making materials more accessible.
The politics of reducing all budgets by 10 percent—macro adjustment—vary significantly from those of moving 10 percent of the budget of one government bureau to another, as in public sector management. Although measures to stabilize the economy through price and trade liberalization require considerable technical capacity, they are not complex administratively. A small circle of nonofficials—technocrats in a few key ministries who have the backing of top leadership—is needed. Most importantly, the political costs of such liberalization can be diffused. Because the initial temporary costs of macrostabilization are spread over much of the population, coordinated opposition focused in a legislature or among powerful interest groups may not be as focused as opposition to changes in public sector management. For example, in many developing countries, civil service reform may require the cooperation of a range of government ministries that may have divergent points of view. The sweeping institutional changes that accompany financial sector reforms, rationalization of state enterprises, or the restructuring of social services may require cooperation of the legislature, courts, and local governments. The costs of such reforms are highly localized, imposing permanent losses on specific, often well-organized interests. The combination of well-organized resistance and the need for broad governmental coordination makes the politics of public sector reform more difficult than adjustment of the monetary system. To avoid a direct confrontation that may weaken the government’s resolve, fiscal reform that affects all sectors of the economy can be an equally good point to begin the process of public sector renewal. An effective fiscal system establishes the foundations of responsive government.

A. Building Government Capacity

A critical issue for public sector management is the need to endow government with the administrative capability and revenue to offer essential public services. Inevitably, the provision of indispensable public goods and services requires an increase of tax revenue or the transfer of funds from one agency to another. In some cases, expanding the state’s capability necessitates eliminating commitments to parastatals and to large public bureaucracies or, at the least, enhancing the efficiency of the concerned enterprises. Such public sector reform cannot be achieved without opposition from one highly mobilized interest group or another. Initiating measures to enhance the efficiency of the concerned enterprises is often the best way to begin.

To compensate for rampant tax evasion, governments in developing countries devise tax regimes that allow considerable official discretion in assigning rates. But expansive tax powers that are capriciously applied drive private firms into the informal sector. Deprived of these tax revenues, governments cannot provide basic services, such as law enforcement. Failing to collect what citizens owe, governments often depend on parastatals for revenue. The result is that the impoverished government has few benefits to offer firms that cooperate in the disclosure of profits.

The political risks of public sector reforms are greater than those of monetary reforms "... all stabilization measures carry risks, but these risks may be lessened by emphasis on measures which are relatively neutral with respect to income distribution in the short term. Monetary policy is the prime example of a socially neutral policy. When the consequences of tight monetary policy are estimated by means of counterfactual analysis using a macro-micro model, the incomes of all groups are found to fall in roughly equal proportion .... Workers bear the consequences of tight monetary policy, but they find it difficult to draw a clear connection between monetary policy and their situation. There are delays between the monetary measures and firm failures, not all firms face equally poverty (Haggard, Latas, and Morrison 1995).
One area that is often overlooked is the relationship between capital and recurrent expenditures. Appropriate fiscal approaches are needed to ensure that borrowers consider maintenance costs when they contemplate capital investments. Many projects fail when they are funded without reference to a government's ability to ensure project upkeep. In extreme cases, investment will be deterred by the difficulty of evaluating profits when official accounting is inadequate to calculate statistics for inflation.

C. Renewing the Civil Service

Improving the productivity of the civil service is perhaps the most elusive transformation that a reform-minded government must undertake. A professional and accountable bureaucracy that can enforce the rules and ensure standards, competition, and property rights is critical to encouraging private sector confidence that liberalization can succeed. Clear career paths and adequate compensation are vital. Efficiency at lower levels requires mechanisms to evaluate performance so that promotion is based on achievement. Such incentive systems are key to improving staff productivity. Performance improves when compensation is explicitly linked to successful administration of programs. For instance, incentives should include linking the possibility to upgrade skills with successful program implementation.

Rare is the country not concerned with reducing corruption. Indeed, corruption is responsible for reducing the economic prospects of a number of countries in the region. Some strategies for corruption control are more effective than others. Countries must design and adopt national procurement rules that emphasize transparency and open access. Simplifying procedures and reducing the number of unproductive staff will also decrease the scope for corruption, as well creating effective oversight mechanisms. The links between agencies within the bureaucratic structure must be clearly defined.

A number of additional questions should be raised. What are the monitoring criteria within the agency? Does a criterion exist for external oversight? Have political authorities endowed agencies with mechanisms such as hearings, investigations, and policy pronouncements, which serve as guides to regulators? How are the views of constituents transmitted to overseers? How do constituents express dissatisfaction to overseers? Do alternatives exist to the explicit monitoring and evaluation of agency administration? Do mechanisms exist that allow overseers to judge agency success without directly evaluating agency decisions?

The region features many examples of oversight mechanisms that are successfully institutionalized to prevent government agencies from serving their own interests. Singapore and Hong Kong offer outstanding examples of independent agencies that monitor and prosecute abuse, and report directly to the highest executive authority. Japan has developed an independent agency that supervises the various government agencies and sets the criteria for recruitment and salaries. In the Republic of Korea, the fear of executive censorship has motivated departments to set up their own penalty committees to evaluate abuse among members.

Corruption control requires tailor-made solutions that can be designed by policymakers familiar with what has worked elsewhere. Appropriate design of an oversight system depends on a case-by-case evaluation of what is feasible in a particular environment. A body with oversight capability is critical, but where to lodge that body will depend on what institutional patterns are already established.
D. Reforming Public Enterprises

Transitional economies often require the comprehensive restructuring of state enterprises. This can take several forms. The region's successful cases suggest that preceding privatization, the first step to promoting efficiency is the development of a market orientation. Paramilitary reform can involve divestiture and liquidation, as well as measures to improve the governance structures of state enterprises so that production can be coordinated with the market. One way to proceed is to convert state-owned enterprises into joint stock companies with the state as a shareholder. The need for public assessment of its economic prospects will prompt the adoption of more efficient management systems and the disclosure of assets and profits. In general, downsizing the public sector and trimming inefficient parastatals often requires finding additional modes of taxation. Conversely, increasing the tax base will loosen the government's dependence on parastatals.

When privatization is chosen, government must avoid privatization's deadly sins. Creating a competitive environment should take priority over increasing government revenues in the short term. This means public monopolies should not be replaced by private ones. Sales should be transparent, allowing assets to be evaluated by an independent agency or firm. This tactic helps prevent the danger of only regime insiders having accurate assessments of plant capacity and liabilities. Labor should be invited to participate in the process so that false promises do not lead to subsequent organized unrest.

To avoid radical shifts in policies when the government is replaced, a broad consensus on when and what to privatize is best. This consensus can be achieved by starting small so that successful models are established before larger operations are privatized. Staggering the sale of state enterprises is one way to avoid unifying opposition. Political support for privatization can also be encouraged by selling shares to individuals or local financial institutions through an open bid process. The sales can then help to stimulate local capital markets.

Privatization is more politically sustainable when local capitalists participate as partners. Creating a national interest in privatization will prevent opposition against sales that appear to benefit international capitalists. Since international owners cannot vote or become involved in local politics, the creation of domestic political allies is another benefit of involving local groups.

E. Creating a Coalition for Change

Public sector reform is a political process that requires broad coalitional support. This process is made particularly difficult by its dependence on the cooperation of groups that stand to lose the most from the reforms. Firms, politicians, bureaucrats, and, oftentimes, organized labor may combine to block reforms of the public sector to prevent the loss of rents. Meanwhile, those who stand to benefit from the reforms are either unorganized, for example, consumers, or are unwilling to incur present costs that might lead to future benefits. Fearing a loss of support, politicians may hesitate to implement

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1 Collecting taxes is particularly problematic during the transition from socialism. For example, in the People's Republic of China, taxation shortages will ultimately affect the question of participation in policy making. A central government agency has yet to be established, and the decentralized system does not provide adequate taxation for national infrastructure. New direct and indirect taxes are not yet adequately implemented. The government of the Socialist Republic of Viet Nam has yet to learn how to collect taxes to pay for infrastructure.
policies needed to reform the public sector. Even when reform is mandated, government officials at all levels can undermine its implementation.

Good policies by themselves are insufficient if doubts about the quality of public sector management undermine social support for the policies. A reform that cannot be credibly implemented, however well designed, inspires little support and may, in fact, arouse strong opposition from those groups upon whom the regime depends. If groups perceive that the regime cannot credibly commit to the implementation of policies designed to spur growth, they will prefer the status quo of no growth. When uncertainty exists about a regime's ability to implement a policy or about its very survival, it is rational for players to defend present wealth against uncertain future benefits.

The equitable distribution of future benefits resulting from growth depends on the quality of economic management. Entrenched administrative corruption, or fears that the sacrifices and benefits will not be broadly shared, will cast doubts on successful implementation—which in turn undermines citizen support for reform. These doubts focus on the fear that the old regime's insiders will benefit most from the reforms. It is therefore critical for public sector reform to precede liberalization. Without an efficient public sector, liberalization is in doubt from the outset. Such doubts will shift the investment horizons among the private sector away from long-term capital-intensive commitments toward short-term projects with immediate payoffs.

IV. A Legal and Regulatory Framework for Development

Legal reform has two dimensions: revising the laws and restructuring the court system. Revising the laws involves upgrading the legal capacity to sustain the level of contract writing required by modern business practices. Restructuring the court system involves protecting the independence of the judiciary and offering commercial litigants a forum for the efficient resolution of disputes.

An appropriate legal framework is one of the institutional characteristics necessary for the effective operation of a market economy. The legal system must protect private property, regulate its exchange, and register titles to facilitate transfers, thus ensuring that property can be used as collateral. This results in the enhancement of credit and liquidity in the economy. The efficiency of the legal system is one of the important determinants of the depth and liquidity of capital markets.

In addition, a legal framework is needed to enforce contracts, reduce the costs of bankruptcies, and set competition policy, including the rules for entry and exit of sectors. The law must also establish the accountability of public authority. Laws must be effectively communicated to all citizens, and mechanisms must exist to change rules that are no longer adequate.

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* Independence of the judiciary includes: (i) independence, impartiality, and freedom from outside pressure, influence, and corruption; (ii) an open process for selecting judges based on competence and integrity and involving opinions outside the executive; (iii) security of tenure for judges; (iv) implementation of judicial rulings; and (v) public credibility of the courts.

* Bankers and lawyers in one ADB developing member country noted that the high court lacks personnel with commercial training. The level of judicial competence is reported to be much higher in civil and criminal, rather than commercial law. The training of high court judges in commercial matters is widely called for. Another solution suggested by interviewees was the establishment of private adjudication in commercial matters supported entirely by the private sector.
Political opponents of the regime must be entitled to equal protection under the law for their rights and property. Accordingly, the rule of law must not apply simply to commercial law. When citizens are not defended from the abuse of state power they will be unable to defend their property rights. Private firms must be able to protect themselves from opportunistic behavior of government-run operations.

The ability of lenders to cope with the inevitable information asymmetry implicit in all credit relations is influenced directly by the efficiency of the legal system. A dysfunctional legal apparatus undermines the confidence of economic actors in the enforceability of agreements, thereby increasing economic uncertainty. The interest rates needed to compensate for risk partly reflect the confidence of both parties in the level of recourse provided by the legal system. By determining the ease with which lenders can attach the borrowers' assets in the case of default, the perceived efficiency of the legal system will determine the willingness of lenders to provide loans. The legal system also influences the ability of firms to finance themselves by offering equity.

Explicit legal liabilities and responsibilities must bind political and administrative authority to follow rules that are transparent to economic decision makers. Uncertainty with regard to contract enforcement impedes investment and trade. The importance of rules that are objectively applied is that property rights will become more liquid as their protection becomes more universal. Uncertainty about the future enforcement of rights and contracts undermines the ability of firms to assess risks. The optimal amount of trade and investment will not occur when property rights are not clearly defined and explicitly enforced.

A forum to reach honest and efficient judgment is necessary for contracts to be enforceable. Especially important is whether the legal system is distinct from the political system. The absence of judicial independence limits exchange to personalized networks. It makes political favoritism in the distribution of resources inevitable and difficult to reverse while preventing the expansion of anonymous trade between third parties.

In countries that do not distinguish between the political and judicial functions of government, the rights of privileged insiders can be maintained because rulers both allocate and enforce rights. If the legal system is not distinct from the political system, contracts may not be enforced so that there is little incentive for more efficient producers to attempt to outbid the ruler's cronies. Loyalty to regime leadership becomes the basis of property enforcement. A good with a value dependent on the strength or weakness of ties to regime insiders is difficult to price and trade. Blocked entry and exit ultimately results, reducing the economic value of loyalty goods.

Productivity is impaired when a nation's economic resources are not open to competitive bidding. The limitations of loyalty rights become especially salient during periods of abrupt economic change. The absence of public information, in turn, reduces credit opportunities and restricts the market for loyalty-based rights. When uncertainty arises because the property rights of all citizens are not equally enforced, adjustment to economic change will be impaired; trade among owners of goods and services will be

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1. The rule of law must include: (i) the fair and public hearing of all criminal charges; (ii) due process, including the concept of innocence until proven guilty, no arbitrary searches or seizures, the right to make a full defense, and the right to review of conviction; (iii) competence, integrity, and impartiality of lawyers; (iv) prosecution of government officials, particularly for violations of others' rights; and (v) public access to legal and juridical services (free legal assistance where necessary).

2. In the same way, the privileges held by members of the Nomenklatura in the Soviet Union created rents that could not be bid out because the rights could only be used by another member of the party.
restricted. In the absence of clearly defined property rights that can be defended by a third party referee, markets may not allocate resources to the users with the highest returns. Rights based on clientelism are not tradable since the rights clients hold are based on their relations with a member of the regime. Potential users of such rights or privileges cannot signal, either by purchase or bribe, the value such rights represent. To get access to rents produced by loyalty rights, excluded groups must focus on gaining political favor. Thus, the absence of a rule-bound system of property rights invites the use of lawless means to gain economic advantage. The politically excluded might divert resources toward overthrowing the regime to gain economic opportunity. Both stability and growth will be impaired.

In sum, markets in countries that do not distinguish the political from the judicial system will not allocate resources to the users with the highest returns. Exchanges will be limited to bidders who possess political connections to defend their property rights. Transparent and rule-bound criteria for business licensing must ensure that firms will be protected from harassment by regime insiders seeking competitive advantages for their own enterprises. When the legal system works only for friends of the regime there are few incentives for businesses to seek formal registration. An informal sector will result that can add to lawlessness.

Because informal producers function in the shadow of the law, they generally cannot register their property, and they do not have access to formal grievance-settling mechanisms. As a result, they often resort to extralegal methods, including force, to resolve disputes. Inevitably they must break some law in order to operate, providing authorities with justification to confiscate or impound their property. Lacking formal titles to property, informal producers have no collateral when seeking credit, so they depend on narrow familial circles for finance.

Creating a transparent regulatory environment, which in turn makes formal registration an advantage rather than a burden, should increase the willingness of firms to operate formally, increasing the state's revenue base. Once dependent on collecting taxes from a functioning and formally registered private sector, government should become more accountable and willing to satisfy a constituency other than itself. Thus, reforming the legal environment will make liberalization more sustainable by increasing the size of the formal sector. Building a broad tax base will enable government to provide equitable and accountable policy enforcement mechanisms, a virtuous circle that will reduce the political causes of economic conflict.

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* American banks will not give a good interest rate to a firm without seeing the books. Organizations like the Securities Exchange Commission were created to make information widely available so a thick liquid market could exist.

* This lack of liquidity due to enforcement problems was one of the reasons the Philippines failed to respond as well to the oil shocks of the 1970s as did neighboring countries. Since the profits of the cronies of Marcos were hidden, contemporaries knew who held a right, but not how much rent could be extracted. Thus efficiency-enhancing deals, like those made in neighboring nations to reduce economic inefficiencies, were not made in the Philippines. When shifts in wealth among individuals occur after the original allocation of the right, those who benefit from the shift, but who are not politically connected to the regime, cannot signal their newly acquired ability.

* The economists' assumption that trades will not be consummated until all gains are exhausted will not operate when the legal system is inept. This theory assumes that property rights of all citizens are protected by the legal system. The consummation of all feasible trades depends on the protection of property rights. Thus, in the absence of a legal system to protect property rights, not all economic assets and rights are liquid, and therefore cannot be freely traded as commodities.
Technical assistance is needed to teach informal operators how to access formal sector services, and to prepare documentation that would facilitate gaining access to credit. The goal is not to suppress the initiatives of the informal sector, but rather to assist informal producers to join the mainstream of development. The approach for providing capital to microlevel enterprises must be combined with attention to the legal foundations of microenterprises. Unless the property rights of microfirms are clearly established in a functioning legal system, these firms may fall prey to protection rackets. Their operations will need either extralegal protection or patronage from regime insiders in order to prosper.2

Careful attention to local circumstances and institutions is critical for work on legal reform. For particular interventions or laws to be effective, studies must be conducted to determine whether the legal system is operational and whether laws will be implemented. Approach legal reform from the perspective of economic reform can be more effective than seeking to reform a ministry of justice or the court system directly. One can often find advocates of legal reform in ministries concerned with economic performance.

Among the reform options to be explored are the rationalization of obsolete rules, and where the legal system is bottlenecked, commercial arbitration, and alternative private dispute settlement mechanisms.4 Judges in business law and basic economic analysis of economic and business fields require training.

Transitional economies present special set of issues; rules that originated under socialism allow conviction for crimes that are normal business practice in a competitive economy. Such rules promote arbitrary enforcement. Also, transitional economies present the challenge of enterprises in which the rights and responsibilities of management are ambiguous, making the transfer of ownership particularly problematic.

Sam Rainsy, the finance and economics minister of Cambodia, put the case for legal reform bluntly at the 1994 meeting of Asian Development Bank’s Board of Governors, “We want a market economy, but we need to put laws in place. Without laws, we will have just a jungle economy … The international donor community should help us, advise us, push us to establish a transparent and enforceable legal system” (Reuters Daily News Digest 1994).

A. Participatory Development

A broad consensus exists among practitioners that accountable governance and economic performance depend on mechanisms that allow constituents to participate in the policy making process. The nature of these connections may vary significantly from country to country, and any attempt to link economic progress and political development

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2 The Asia Foundation reports that small and medium-sized enterprises in Indonesia sometimes fall due to their weak legal foundations. The effectiveness and efficiency of the judiciary in commercial litigation is important to the development of small and medium-sized enterprises, which generally lack political connections. Without more access to justice, small and medium-sized firms will be limited to transactions with firms or individuals whose reputations they can verify through personal channels. Moreover, without judicial recourse, they can be exploited by larger firms with political connections.” (Conversation with Steve Parker, Chief Economist of the Asia Foundation, with reference to the Foundation’s project in Indonesia. Participation, Policy and Micro-Enterprise Development, 1993.)

3 The International Herald Tribune quoted the claims of a Japanese manufacturer that ill-defined labor laws caused both disputes and corruption among Chinese government officials. The major problem is that while the basic laws concerning workers have been set, implementation is up to the judgment of regional authorities” (Quint 1994). The implication of this inconsistency is that tribunals were sometimes necessary to prompt officials to either overlook or enforce the laws. The firms had no recourse to the courts to settle these disputes.

4 The former British colonies, such as India, offer access to arbitration, but not private adjudication.
must be mindful of the vast divergence of political terms that have flourished in the region. The coexistence of significant economic development alongside vast political diversity sets Asia apart from other developing areas. A definition of participation that respects the region’s uniqueness and considerable achievements must be appropriately broad. Participation is necessary for government to make informed choices while allowing social groups to protect their rights. The memo of the Organisation for Economic Co-operation and Development (OECD) on participatory development stresses five components (OECD 1995).

1) Consent. In democratic theory, consent is viewed as the foundation of government legitimacy. A mature democracy is one in which the governed can withdraw their consent and participate in a peaceful replacement of one government by another. However, the history of democratic transitions does not offer a sure or direct route to this level of participation, and there is no consensus on the appropriate sequencing of steps toward mature democracy. Most argue that nations must find their own way.

2) Accountability. Participation is a way to ensure the accountability of government. Mechanisms must be in place to ensure that government actors serve the public rather than their own interests. Accountability requires information openness, transparency of decision making, and oversight mechanisms sustained by independent judiciaries. Participatory development contributes to accountability by empowering groups, communities, and organizations to negotiate with and influence state officials and institutions. A strong civil society can monitor and reduce unaccountable behavior by government.

3) Representation. Representative government, which implies parliamentary procedures and multiparty elections, is often defended on the terms of accountability. However, skeptics question whether it can credibly guarantee accountability without a host of supporting mechanisms that are rarely found in developing nations. Moreover, the choice of mechanisms for representation, and the universal merit of multiparty elections raise issues considered outside of the purview of most donors, because they involve the choice of political regime.

4) Appropriate Policies. Participation can assist a government to formulate appropriate policies, and can thereby enhance the efficiency and sustainability of programs. The region features a wide variety of successful participatory mechanisms.

5) Human Rights. Participation can contribute to the protection of individual and group rights. The relationship between participation and human rights, however, is complex. Human rights violations may originate in participatory forums in which majorities can dominate minorities.

While acknowledging that regime-specific linkages between economic performance and participation arouse considerable controversy, the experience of the region indicates that participation is critical for reducing information asymmetry between the private and public sectors (Campos and Root forthcoming). In fact, East Asia stands out among all
developing regions for its successful use of participatory forums to reduce information asymmetry in the economic policy dialogue. As part of a commitment to economic development, participatory development can be promoted as a means of creating avenues for the efficient exchange of information between the state and public sector.

The transparency of government decision making is critical for the private sector to make sound decisions and investments. Freedom of the press contributes to information symmetry or openness, but, alone, does not ensure the exchange of relevant information between the state and civil society.

The publication of reliable audited accounts is critical for the development of capital markets. There is a distinct advantage for firms to conform to standard auditing and accounting procedures. However, if firms fear that disclosure of assets could invite confiscation or extortionary levels of taxation, such information will be withheld. The actions of government are part of the risk calculation that influences private sector decisions; therefore, a competitive private sector requires accurate information about government regulation. Firms will not take risks when information about the regulatory environment is opaque or when the actions of officials are unpredictable. Governments that play by preannounced rules will foster trust upon which conditions of information openness depend.

Capital markets depend on information openness. The existence of publicly available information reduces information asymmetry, thereby reducing interest rates (North and Weingast 1989). Since the government is often a debtor, the existence of effective capital markets can reduce the costs of supplying basic public services. When the government borrows less, the private sector is not crowded out of credit markets. However, when the information environment is uncertain, the public may refuse to part with their savings or may choose not to save.

Corruption or cronyism will impinge upon the development of capital markets by intensifying information asymmetry. Corrupt or arbitrary action by government officials enters the calculus of business by inducing the need for secrecy. Firms will hide assets when profits are the result of special arrangements or behind-the-scenes deals.

Government too must have access to accurate information from the private sector to make effective economic decisions and draft effective policies. The principal barrier to such information flows from the private sector is the danger of a government behaving opportunistically. The solution lies in the design of institutions to reduce the likelihood of opportunistic behavior by government officials. Institutions must be designed to increase the opportunity costs of predatory behavior to government.

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3 Arbitrary relations between banks and clients are a consequence of financial markets that lack transparency. The famous "behest" loans under Marcos or "memo" lending in Indonesia are examples. When disclosure and accounting standards are poor, the lender lacks the means to adequately evaluate the risks or creditworthiness of clients. Instead, reputation or government guarantees become the criteria for borrowing. The guarantees by the state of nonperforming assets in effect socialize private losses, passing the costs along to the population at large. Thus, the lack of transparency in the banking system inevitably reinforces privilege and reduces equity by redistributing the responsibility for private risk to society.

4 One aspect of this problem is fair contract conditions in public procurement. But this is probably the most difficult type of contracting to control by oversight. Nevertheless, the Bank can help to establish procurement guidelines and procedures that can be assessed from the perspective of competition and transparency.

5 This does not mean that officials should be barred from making decisions on the basis of new information, but rather that the criteria upon which those decisions are based is predictable.

6 Recurrent services should be provided from taxation. Only capital assets should be financed out of loans. External current account deficits in finance investment are regarded as healthy compared to those that fund consumption.
The successful East Asian regimes developed structures that reduced information asymmetry between government and the private sector by binding the government to rule-bound decision making. Japan, the Republic of Korea, Malaysia, Singapore, and Thailand all developed an effective government/private sector interface consisting of consultative committees with real input into the policy process.

These committees, or deliberation councils, induce private sector cooperation with the regime while making it more difficult for the government to renge on agreements or rules once they are agreed upon. The business councils were highly valued by the government because they opened lines of information sharing between the private and public sectors. By including the relevant parties in the discussion, the councils increased the capacity of government to achieve consensus on policy directives. The possession of accurate sources of information about private sector needs allowed government to help business coordinate activities.

The gains from cooperation contributed to a bargaining surplus that could be shared among all firms in an industry. The institution was stable because it served a fundamental requirement of regime legitimacy. The councils were politically valued by the leadership, which depended upon private sector support to make the regime's commitment to growth credible. Thus the private sector had self-enforcing assurances that the government would not deviate from the consultative process when formulating economic policy.

The same institutions that facilitate dialogue between the regulators and the regulated also serve as safeguards against corruption. The most effective oversight is derived from open participation in rule making. In East Asia, the actions of bureaucrats were open to the scrutiny of the entire council, making it difficult for officials to secretly arrange behind-the-scenes, sweetheart deals for preferred clients in the private sector.

Thus, the East Asian example suggests that, if properly designed, councils will increase the level of accountability, transparency, and predictability in policy formation, while insulating the bureaucracy from pressures of individual firms or powerful individuals. The benefits of mobilizing cooperation and coordinating investment—which is made possible by effective information flows between the private and public sectors—cut across sectors and firms and are independent of regime type.

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"Councils allowed government to assist industry to achieve collectively desired goals that firms on their own might not otherwise attain. An export drive is an example of how a council can reduce the costs to individual business of undertaking the necessary investment in information. At the outset, knowledge about international markets may be too costly for individual firms to acquire, but when that knowledge is pooled an entire industry can benefit."

This is where the standard confusion over industrial policy arises. By coordinating private sector investment, Japan's Ministry of International Trade and Industry (MITI) created a bargaining surplus for the firms that participated in the process. Getting the firms that benefited most to share the bargaining surplus with those firms that faced the highest costs of adjustment added value to council membership. When MITI tried to direct industry where it should go, i.e., pick winners, it often failed. Success occurred when industry capacity was expanded by planning that involved synchronizing contracts. The harmonization allowed independent producers to provide the increased capacity without government's direct involvement in the costs of the expansion. Standardization of new products was also facilitated by council deliberation (see Campos and Root forthcoming).

"The importance of information in development is emphasized in Asian Development Outlook 1994 (Asian Development Bank 1994a, 46-7)."

"Severe penalties for corruption cannot substitute for an open and transparent information environment. Transparency is a necessary condition in the fight against corruption."
B. Strengthening Civil Society

A strong civil society is necessary to nurture and support an open, competitive economy. An active civil society offers the best hope of finding solutions for social problems. Bringing government closer to the people by expanding the capability of municipal and local government is the first step.

C. Decentralizing and Empowering Local Government

Decentralization is usually discussed in its purely political context, with the questions: How will political power be divided? What will be the political consequences for already constituted interests? Rarely do politicians consider the economic consequences of decentralization. Even where decentralized units of government have registered outstanding economic performance, that performance was often an unwitting consequence of the political struggle for control over resources, not of conscious design.

Research is needed to help identify the characteristics of decentralization that are market-preserving and can enhance economic performance so that political decision makers will be alerted to the economic consequences of their choices.

A sound legal formulation for decentralization that stabilizes intergovernmental revenue flows while allowing comparative advantage to determine regional economic choices is the key to capturing the maximum economic benefits from decentralization. It may also be a key to political stability in a number of countries. During decentralization, a critical issue is whether financial accountability of different components of government can be accurately assessed so that regions can benefit from policies that produce a tax surplus.

Permitting opportunities for local governments to raise funds, through taxation or borrowing, renders local governments more accountable for the fiscal and financial consequences of local policies. When localities are constrained to compete between themselves, they will experience the costs of inefficient policies directly and will not, for example, want to bail out failing industries endlessly.

For the full market-preserving qualities of decentralization to be realized, central authority must be able to prevent local governments from using their regulatory authority to erect local trade barriers. Prohibiting trade barriers among regions will prevent jurisdictions from off-loading the costs of unsound policies on their neighbors.

In some economies, including the People's Republic of China, a legal framework to sustain fiscal federalism is critical to long-term political stability. Formulating firm legal foundations for fiscal federalism may be a crucial step toward expanding the participation of regions in the national policymaking process. A formal process of representation in which tax revenues are exchanged for representation might increase tax yields and economic performance at the same time.

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3 This seems to have been the case for American federalism and for the more recent Chinese decentralization (Rost 1995).

4 Devising a systematic division of total public resources is critical to successful decentralization. In the absence of a coherent constitutional structure, individual local governments will opt to maximize their own receipts to the detriment of the whole. Designing a revenue responsibility trade-off, while the capacity of local government is dramatically increased, are the twin challenges of decentralization. Regional governments must not receive responsibilities without the resources or authority to execute them. To prevent this danger, the managerial capacity of the provinces must be built while the coordinating capacity of the center is expanded.
Decentralization also has important consequences for regional economic cooperation. Regions may find themselves part of trading networks that transcend national jurisdictions, as in the case of Northern Thailand's relationship with Myanmar, Lao People's Democratic Republic, and southern sections of the People's Republic of China.

Decentralization has another advantage, in that it allows for pilot procedures or experiments. The cost of experimentation and the ease of getting a consensus can depend on shared social understandings or norms. Social experiments can more easily be undertaken locally and success can then be copied by neighbors. Although models do not ensure followers, they do help. The best argument that can be made in favor of good governance is the economic success of those countries that practice it.

Concentrating on a sample region that can produce a demonstration effect may help overcome the lack of confidence that goes with economic failure. Special economic zones that generate demonstration effects can counteract the typical excuses for failure. Demonstration effects can also counterbalance the power of vested interests who, to protect rents, will often argue a given reform cannot work here. However, even powerful interests have difficulty arguing with success.

For decentralization to work, the active involvement and widespread participation of the local community is indispensable. Nongovernment organizations can help to foster patterns of social cooperation while being a focal point for the generation of norms of active citizen participation (see Putman 1993).

D. Working with Community or Nongovernment Organizations

The proliferation of nongovernment organizations (NGOs) in many countries offers both borrowers and lenders an added capability to engage civil society in program formulation and implementation. The range of issues in which NGOs can be particularly helpful include tackling poverty, reaching the poor, empowering marginal groups, challenging gender discrimination, and delivering emergency relief. Some of the responsibilities for the micromanagement of projects can be shifted to NGOs—they can operate as consultants, shareholders, and as the eyes and ears for project managers. In addition, their involvement will enrich the policy dialogue.

E. Expanding Project Level Participation

There are merits to moving beyond poverty alleviation defined strictly in terms of social and economic rights, to an expanded definition that includes empowerment and participation. Participatory development must not be limited to the support of elites who

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3 Although development in East Asia was centrally administered, the region itself was a decentralized system of competing jurisdictions. These multiple and competing polities had a common defense administered largely by an outside power.
4 The NGOs help to increase the access of project managers to information known by the poor (knowledge of local customs or ecology) that is needed for project success; to mobilize and structure the collective action of targeted groups; and to channel the resources of the poor or of local groups into the project (for example, using credit pooling). NGOs must avoid being absorbed by the functions and authority of the professional elites of international donor organizations. They may be vehicles of decentralization but not necessarily of democratization, as their decision making structures may be elitist and hierarchical. They may represent the participation of interested minorities within regions rather than the general, broadly defined concerns of the local population.
dominate the production of goods and services. Rather, the focus should be on supporting local tendencies that contribute to greater participation and good governance. This requires a deeper policy dialogue with partners, both within the government and society.

Participation can and should be brought into the program design process, regardless of the recipient’s regime type. Opportunities for participation should include all aspects of the development process, including project planning and evaluation, as well as strategy formulation. Participation must not be viewed as a substitute for a rational policy environment, but rather as a vital complementary element. While a focus on participation will increase the workload of project managers, the gains can be considerable. A number of development organizations have reported that by reaching out to diverse elements they gain respect and increase legitimacy. Fostering participation reduces suspicion and increases credibility. 

Program managers must recognize opportunities to promote local participation that arise from their special country circumstances. The experience of a number of practitioners on expanding participation suggests that the variations across countries are enormous. There is no paradigm. Rather, approaches to participation must be compatible with local customs and behavior. Practitioners must be encouraged to use what works. Although efforts at defining regional best practices are valuable, it is second-best solutions tailored to the environment that may work best.

The NGOs offer opportunities to expand local involvement. Focus groups managed by NGOs are sometimes the best ways to reach the poorest segments of the population. The extensive use of workshops and forums can help. Forums provide opportunities for groups that do not usually get together to meet. The membership of these groups should include a cross section of the population that includes women, youth, and the elderly. Human rights abuses may be disclosed once a forum for discussion is established, although the abuses were never discussed before. In this sense the economic development process can contribute to political openness by forming a network of relationships in which controversial information can be conveyed.

Local participation should occur early in the strategy-making agenda, ideally even before sector-level interventions are considered. Projects should be designed so that those targeted to benefit will be able to participate in all stages of program design, implementation, and evaluation. Collegial discussion over how a program can be designed will facilitate implementation without detracting from the program budget. First, the scope of work should be done in collaboration with the borrowers. After initial discussion with targeted groups, program managers should be prepared to go back to the drawing board to assess the project’s final design. Participation makes it necessary to respond to issues that may not have been anticipated at the outset, and thus suggests the desirability of phased programs, rolling designs, and flexibility.

Promotion of participatory approaches should begin in avenues that are not likely to seem political and that are not of immediate concern to entrenched powers. Usually a wide range of policy issues are possible. Looking for an entry is preferable to imposing an agenda from the outside. For example, a representative of one country refused to discuss civil service reform on the grounds that it constituted political interference. But when the question of poor implementation of projects was raised, the official replied that help to

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7 This point is consistently made at the monthly ‘Participation Forum’ conducted by the United States Agency for International Development. A summary of the monthly meetings are disseminated by e-mail and INTERNET.
reduce delays would be welcome, and conceded that delays often resulted from internal disagreement between ministries and between local and central authorities over who had responsibility for what. In effect, while conceding that poor linkages within the bureaucracy cause poor program implementation, he was offering an entry point to discuss civil service reform.

Increasing the capacity of civil society to articulate problems that require public assistance will enhance the development process. One of the long-term objectives of participatory approaches is to assist local communities to define problems, assess alternatives, and design viable programs, as well as manage, implement, and evaluate their own needs. Making communities collectively responsible for benefits and losses is a critical component of participatory development, and involves innovative mechanisms to allow localities to participate in the fiscal benefits of programs.

A point of access is needed to initiate engagements at the community level; i.e., a local NGO or political leader, is important. Inevitably, reform means the focus must be on strengthening local alliances and networks. This includes building alliances with senior policy makers and bureaucrats who can benefit by promoting the reform agenda. Identifying promising local officials is helpful because they are often in office for a longer period than their central bureaucratic counterparts and, because they live in the area, have a higher level of commitment. These alliances must evolve into networks that extend beyond government into private interest groups.

F. Equity or Poverty Reduction

Despite the region’s exceptional economic performance, Asia contains the world’s largest population of poor people. The incidence of poverty remains as high as 45 percent in some of the slower growing economies, and, in general, the number of poor has been increasing. This increase poses environmental, health, and, ultimately, political hazards to the region’s overall economic prospects. Poverty strains health, nutritional, and educational services, as well as intensifies gender discrimination and environmental degradation. It is also one of the root causes of political instability and regime failure.

A commitment to equity gives government the latitude in the policy dialogue to resist pressures from narrow interest groups and to concentrate on strategies that provide broadly dispersed, long-term benefits. Unlike those in South America and Africa, East Asian regimes established their legitimacy by promising shared growth. The promise of shared growth made it possible to resist the demands of narrowly constituted interest groups, which would have resulted in long-term, deleterious consequences for economic expansion.

When equity is established, less behind-the-scenes lobbying will occur and government can focus on policy reforms that will make everyone better off. Equity lowers the returns of lobbying. For example, broad-based social support allowed the governments of the Republic of Korea and Japan to ignore radical labor union demands without the risk of regime failure. By appealing to a broad constituency, the goal of growth enhancement dominated the selection of economic policies. As long as the benefits of that growth were perceived to be widely distributed, the government could resist buying the support of organized labor with privileges that could restrain overall productivity. It is for this reason that East Asia’s high performers ranked among the least indebted of all developing
countries during the oil-crisis years. East Asian leaders did not have to buy the support of powerful urban interest groups by subsidizing urban consumption through foreign loans.

The recent experiences of growth in East Asia suggest a high positive correlation between growth and income equality. The fastest growing economies also registered the most equitable distribution of wealth. Thus Asian development diverges from standard economic observations that link the early stages of growth with expanding income inequality. Unfortunately, not all countries grew as quickly or as equitably. Much of the success in Asia can be related to efforts by government to encourage rural prosperity.

G. Fostering Rural Development

Poverty tends to be diffused through the rural sectors in much of Asia, for example, in the Philippines, 70 percent of all poor families live in rural areas (Asian Development Bank 1991). Markets often work poorly in these areas because equity and information are closely correlated. The groups most lacking in information about market opportunities are generally the poorest. To help villages overcome their remoteness from national marketing channels, governments can foster programs to reduce the imperfect and asymmetric information available to the poorer sectors of the population living far from capital cities.

The East Asian high performers all made special efforts to reach farmers by developing mechanisms to increase the access of the rural population to product, land, and credit markets. Rural operators were introduced to alternative technologies, information about prices, national and international markets, and new varieties of seed. Government helped by certifying market information, promoting competition, enforcing contracts, and designing and enforcing quality standards. Producer and consumer groups were organized to benefit from collective credit, while purchasing and selling under name brands.

East Asian leadership recognized that rural programs are not useful unless farmers do well. Bureaucrats who administer farm projects were given incentives to be concerned with the performance of farmers. Compensation was linked to the successful administration of programs.

Special attention must be given to rural credit. Co-guarantees and other forms of group credit help by reducing the costs to bankers of screening loan recipients and enforcing repayment. Groups are organized that will then select members as good risks, screening recipients on the premise that the membership will be responsible for each other’s payments. Because transaction costs to donors are reduced, loans will be larger when granted to an entire group.

In addition, staff members of financial institutions must be given a stake in the success of programs. Indonesia provides an excellent example: rural banking flourished once local banking units were given authority over loans. Village-level accounting procedures were reformed when the village-level staff was encouraged by a cash incentive system. Volume tripled and 82 percent of village units were profitable after three years.

* In India, where 70 percent of the population live in rural areas, rural development is critical to reducing income inequality. The poor make up 23 percent of the rural population, down from 34 percent in the 1980s. Several years of good monsoons and improved irrigation and agricultural projects, debt relief, and better procurement prices account for the improvements. Nevertheless, few consumer goods penetrate rural areas due to inefficient distribution, weak logistics, and a fragmented transportation infrastructure. The expansion of distribution networks to create markets will help to bring the peasant household into the national economy. However, the costs of developing such networks may be prohibitively expensive for private firms.
Ultimately, rural credit must be based on secure property rights. This requires government involvement in land registration, which in turn will increase the rural sector's access to credit. The political and economic weakness of the agricultural sector has significant implications for the ability of leadership to develop coalitions for growth. Bringing the peasant to the market is especially important in the move toward openness because the rural sector offers the strongest potential support for an open economy.

Samuel Huntington was among the first to observe that power based in the countryside will produce more stable political structures and more export-oriented policies. The People's Republic of China offers an excellent example of this logic. During the transition to open trade, the agricultural sector is less likely to oppose liberalization and monetary convertibility. Less capable of disturbing civil peace, rural populations will have difficulty contesting adjustment programs to gain tax relief or subsidies.

The importance of rural reform was squarely stated by the Cambodian finance minister. "The Khmer Rouge are more afraid of peace than war. The only way to win the battle is rural development." He added that in a country that is 85 percent rural, land ownership laws are crucial, and farmers should be given incentives to stay on the land rather than join an exodus to urban shanty towns or be driven by poverty into the arms of the Khmer Rouge. The program to keep people on the land should include flexible exchange rate policies and rural infrastructure development. Making Cambodians self-sufficient in food was vital (Reuters Daily News Digest 1994).

In fact, the finance minister was repeating a lesson known to all of the region's high performers. The People's Republic of China, Indonesia, Japan, and Republic of Korea, all focused on eliminating rural poverty at the early stages of their development programs. The success of the communist insurgency depends on the willingness of the peasantry to harbor guerrilla soldiers in their midst. This menace can be reduced by bringing the countryside into the growth economy.

H. Upholding Standards in the Marketplace

Markets for certain products will not exist without the establishment and maintenance of standards by an outside authority. For example, providing information about increments of quality may be difficult for a seller. Consider certifying the purity or cream content of milk, or the certification of an animal's health before slaughter. An independent agency that can reduce the costs of manifesting quality will increase the market for that product. The agent rewards the attention to quality by reducing the incentives for buyers and sellers to mislead each other. Reducing the variation in quality across sellers should be expected to increase the demand for the product.

As more products, people, and capital enter the market, there is a need for expanded information systems and devices to ensure the quality of goods and the integrity of contracts. Thus, as markets become more complex (with the addition of new activities and products over wider geographical areas) the costs of management increase. These costs are

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* An interest in reducing poverty is not unique to the high performers. India's development strategy has emphasized concern for human resource development, poverty reduction, and equity; however, progress toward improving social indicators has been slow. The ADB's analysis of India's poverty reduction efforts reports misallocations and poor targeting, including an overemphasis on indirect subsidies (Asian Development Bank 1994a, 141).
* Market institutions evolve more slowly than demand for products and services. For a discussion of the role third parties play in reducing information asymmetry see Kliiggaard 1991.
a basic component of market governance and their elimination is not necessarily automatic since the costs of maintaining the market may surpass the benefits that can be captured by any one seller or producer. A framework for collective action must be established so that the functions are properly performed. When such a framework is costly for independent private firms to establish, then government alternatives should be explored.

V. The Region as a Model

Leaders of East Asia's high-performing economies were institution builders who encouraged economic growth by:

- establishing channels of representation for business to induce the latter to make long-term investments;
- introducing wealth-sharing schemes to elicit the support of the wider population for development, thus making shared growth the foundation for regime legitimacy; and
- developing a competent bureaucracy making possible credible government commitment to long-run, growth-enhancing policies.

The significant improvements in income distribution that accompanied sustained economic growth in the high-performing East Asian economies resulted from effective use of public and private sector institutions and organizations. This institutional development and its effective exploitation for growth with equity was an explicit policy choice by government. While each country determined its own specific pattern of institutional mechanisms and the purposes to which they were put, their experience shows that progress toward sustained, more equitable, and self-reliant development depends, in part, on the strength and quality of a country's institutional and organizational capacity.

A range of institutional innovations designed ultimately to make credible the regime's promise to shared wealth and growth enabled leadership to gain the cooperation of the citizenry. Business invested more and the wider population sacrificed (high savings rates), while making investments in human capital to initiate and sustain growth.

The channels of representation, deliberation councils, offer input into the policy process and have veto power over the outcome. Although representation was limited to select sectors, the councils provided:

- assurances to select sectors that policies governing the sector will not be capriciously altered, i.e., greater predictability;
- a venue for information about the production and implementation of policy that is available to all players, i.e., improved transparency; and
- procedural guidelines and precedents for the exchange of views between leadership and the private sector.

All three augment accountability. Leadership generally avoided undertaking major policy directives without consultation with the major players targeted by the regulation. The councils made information about who gets what from government a matter of record.
thereby limiting the opportunities for preferred firms to engage in behind-the-scenes favor-seeking or private appropriation of gains from insider information.

Sharp contrasts between the successful and less successful bureaucracies in Asia are instructive. In Japan, the Republic of Korea, Singapore, Taipei, China, and some bureaus in Malaysia and Thailand, a merit-based recruitment and promotion system, well-defined career paths, competitive salaries (relative to the private sector), a pension, plus the possibility of retirement to a board seat in a large private or public enterprise upon retirement, along with harsh penalties for corruption (Thailand and Indonesia are exceptions), generated (relative) competence and integrity among bureaucrats. Explicit limits on spending and a binding commitment to monetary stability limited the discretion of less competent bureaucracies in Indonesia and Thailand.

Although direct political participation was lacking, non-elites in all of the high performers (Indonesia; Republic of Korea; Malaysia; Singapore; Taipei, China; and Thailand; with the exception of Japan) shared the fruits of growth as evidenced by declining poverty and a reduction in income disparity. In fact, the countries that grew fastest had the most income equality. Wealth-sharing mechanisms created opportunities for the non-elites to pursue productive rather than politically destabilizing activities. Moreover, growth-promoting policies contribute to regime legitimacy, helping to encourage broad social support for the regime.

The creation and utilization of mechanisms and procedures distinguishes effective development leadership. The difference between development based on political will and that based on institution building is essentially that the latter is sustainable, while the former is not.

The most successful East Asian rulers endowed their governments with a core of neutral competency. They designed organizations to function on a universalistic, rather than particularistic criteria that utilized rule-bound, rather than discretionary, methods for conducting government business. Precedents and rules were introduced that replaced favoritism with merit and supplanted personal preferences with impersonal codes as a prescription for behavior. In essence, they designed institutions to substitute merit and neutrality for patronage and dependency, so that government would be more responsive to general interests.

VI. Governance is a Dynamic Process

Policy reform can rarely begin from a clean slate. Therefore, reformers must consider the existing environment and propose adjustments. The match between national circumstances and choice of regulatory regime requires constant renewal. The balance between objectives and methods fluctuates continually. External circumstances change, technologies are outdated, and administrative systems age. Even the best solutions in one environment may fail in another. Success, ultimately, depends on evolution and learning over time. Through constant fine tuning, in an environment enlightened by institutions that reinforce mutual learning, citizens can help craft the building blocks of an open society.
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