

Economic Outlook for Southeast Asia, China and India 2015

STRENGTHENING INSTITUTIONAL CAPACITY

Main Findings and Policy Recommendations







Main findings and policy recommendations

While the growth prospects of the OECD countries continue to moderate, they look favourable overall in the 12 Emerging Asian economies (i.e. ASEAN-10, China and India) for 2015-19, averaging 6.5% per year, according to this Outlook's Medium-term Projection Framework (MPF-2015). Although growth in Emerging Asia will moderate gradually due to the slowdown in China, for the ten ASEAN countries as a whole, growth momentum remains robust and broadly similar to the past ten years, averaging 5.6% in 2015-19. The year 2014 saw major transformations in the region's political landscape, with economies being impacted differently. Indonesia's presidential election brought Joko Widodo to power, while India's general election ushered in Narendra Modi as the new Prime Minister. The electoral processes in both countries were regarded as successful, peaceful changes of government. However, territorial disputes over the sovereignty of the South China Sea affected tourism and exports in some countries, while political unrest in Thailand has had relatively strong economic impacts.

Table 1. Real GDP growth of Southeast Asia, China and India

Annual percentage change								
Country	2013	2019	2003-07	2011-13	2015-19			
ASEAN 10 countries								
ASEAN-5 countries								
Indonesia	5.8	6.3	5.5	6.2	6.0			
Malaysia	4.7	5.6	6.0	5.2	5.6			
Philippines	7.2	6.3	5.7	5.9	6.2			
Thailand	2.9	4.6	5.6	3.2	4.1			
Viet Nam	5.4	5.8	7.2	5.6	5.7			
Brunei Darussalam	-1.8	1.9	1.7	0.9	1.6			
Cambodia	7.5	7.3	10.6	7.3	7.1			
Lao PDR	8.0	7.7	7.1	8.1	7.6			
Myanmar	7.5	7.8	-	6.9	7.8			
Singapore	3.9	3.6	7.9	4.1	3.5			
Two large economies in the region								
China	7.7	6.6	11.7	8.2	6.8			
India	5.0	6.8	8.8	5.5	6.7			
Average of ASEAN 10 countries	5.2	5.8	5.9	5.4	5.6			
Average of Emerging Asia	6.5	6.5	9.5	7.0	6.5			

Notes: The cut-off date of data is 6 October 2014. Emerging Asia denotes ASEAN-10 countries plus China and India. ASEAN-5 includes Indonesia, Malaysia, Thailand, the Philippines and Viet Nam.

Source: OECD Development Centre, MPF-2015 (Medium-term projection framework). For more information on MPF, please see www.oecd.org/dev/asiapacific/mpf.

Individual countries' growth paths point in different directions. The large ASEAN-5 economies – Indonesia, Malaysia, the Philippines, Thailand and Viet Nam – will sustain their growth momentum in the medium term, led by Indonesia and the Philippines (6.0% and 6.2%, respectively). Indonesia's economy will be supported by robust domestic demand and expectations of reform – with the Jokowi administration possibly rationalising the fuel subsidy. Another economy driven by domestic demand, strongly supported by remittances from overseas and political stability is the Philippines, where

growth is expected to be favourable in the medium term. The success of measures to create jobs, reduce unemployment and improve infrastructure will be key to sustained growth.

Malaysia's vigorous domestic demand, supported by the rise of the middle class and the growing export-oriented sector, will remain resilient despite still weak demand in OECD economies. Political unrest in **Thailand** adversely affects growth prospects in the near term, as consumer and investor confidence and the country's trade performance weaken amid uncertainty related to the new economic roadmap. With declining but long-lasting high inflationary pressures, **Viet Nam** could enjoy stable economic growth in the medium term, although risk remains in the banking sector.

Economic growth prospects are stable for **Brunei Darussalam** and **Singapore**. Brunei's growth performance will depend on the energy sector and the volatility of oil and gas prices, however, while smooth economic transformation in healthcare and social services and effective land use will be challenges for the Singaporean economy.

More rapid growth is expected for the **CLM** countries (Cambodia, Lao PDR, and Myanmar) than for the ASEAN-5. Their growth is slated to exceed 7% over the next five years. Improvement in the agriculture sector and the business environment will be engines of the growth of **Cambodia** and **Lao PDR**. As for **Myanmar**, it has seen rapid progress in many areas, which will keep it on a favourable path in the medium term. The performance of the new CLM growth engine in Emerging Asia will also affect the speed of the ASEAN integration initiative.

The region's two largest economies, **China** and **India**, face significant challenges. China's growth is slowing as it seeks to adjust to its changing demographic landscape, switch its hub of growth from investment to consumption, and cope with environmental, agricultural and educational issues. India's growth should be stable over 2015-19, but the prospects could change depending on the implementation of the reforms of the new Modi government. These plans include promoting domestic and foreign investment, creating jobs, improving food security, raising the standards of education and skills development, building new key infrastructure, enhancing water governance and increasing India's overall competitiveness, particularly in the manufacturing sector.

The key points of the medium-term economic outlook are as follows:

- Despite slight moderation in the first quarter of this year, growth in Emerging Asia should remain robust, at 6.5% over 2015-19. The Chinese economy is slowing, but the large ASEAN economies are showing resilience and growth momentum remains broadly similar to the past ten years (5.6% over 2015-19). The CLM countries are expected to become the new centres of growth in ASEAN, with average annual growth in each exceeding 7%.
- Overall, current account imbalances are gradually improving, particularly in the ASEAN-5. The CLM countries will continue to show a deficit in the medium term. There are signs that FDI is slowing in the region. Additional efforts to attract and hold investors will be required.
- Generally speaking, there will be no dramatic changes in fiscal conditions, though trends will differ by country. While Malaysia and the Philippines may improve, Thailand and Viet Nam will worsen in the medium term. Overall, fiscal reforms need to be strengthened further.

- Emerging Asian countries may have to contend with external risks. For instance, the normalisation of US monetary policy, the slowdown in the Chinese economy, the implementation of structural policies related to "Abenomics" in Japan and uncertainties concerning the growth prospects of the Euro areas. However, the impact of these factors on the region will be moderate, since markets have already factored these changes in their expectations. Transformations in the political landscape will affect different countries in different ways. There are worries over the current political unrest in Thailand in particular. Overall, effective capital flow management (of both inflows and outflows) will remain a challenge in the region in the medium term.
- Further acceleration of regional integration by 2015, in furtherance of the goal of the ASEAN Economic Community (AEC), will be necessary – particularly to narrow disparities within the region.

Challenges of regional integration

The medium-term outlook for Emerging Asia could be less favourable than the projections imply for a number of reasons concerning not only the success of the countries themselves in their national economic policies, but the success of key regional initiatives towards the goal of the ASEAN Econmoic Community.

- A notable achievement is the reduction of tariffs, which has supported the steady increase in intra- regional trade. The current Common Effective Preferential Tariffs (CEPT) rates are close to 0% for advanced ASEAN economies, though slightly higher rates of 2.6% are applied by Cambodia, Myanmar, Lao PDR and Viet Nam (Figures 1 and 2). Trade facilitation is also being strengthened through the implementation of National Single Windows (NSWs) and their streamlining and integration to develop the ASEAN Single Window as a single platform for electronic trade. Although improvements have been made in trade facilitation initiatives, there is still a wide disparity within ASEAN.
- Institutional arrangements for regional integration have gradually been established
 recently, though there is still room to accelerate this progress overall. On the free
 flow of investment, the ASEAN Comprehensive Investment Agreement (ACIA),
 which came into effect in 2012 and built upon the past two ASEAN investment
 frameworks the ASEAN Investment Area Agreement (AIA) and the Investment
 Guarantee Agreement (IGA) lays out the rules for investment to enhance the
 business environment and to attract more domestic and international investment.
- Financial integration under the Roadmap for the Integration of ASEAN in Finance is crucial to achieve the goal of the AEC. Capital market development has been advanced with the launch of the marketing and branding campaign for the ASEAN Exchanges initiative and the development of an ASEAN Bond Market Development Scorecard. To strengthen the integration of the banking sector, two frameworks for the banking sector integration are in place: the ASEAN Framework Agreement on Services (AFAS) and the ASEAN Banking Integration Framework, which compliments the AFAS. In addition, the multilateral currency swap arrangement among the ASEAN+3 (China, Japan and Korea) countries through the recently amended Chiang Mai Initiative Multilateralisation (CMIM), of which the total size amounted to an enlarged USD 240 billion, with the IMF de-linked portion raised to 30%, will strengthen the region's ability to respond to liquidity problems in times of urgency.
- Progress in the implementation of programmes related to narrowing disparities in the region needs to be accelerated. In particular, greater efforts will be required

on ICT, education and infrastructure. Higher education could improve through the strengthening of the ASEAN University Network (AUN) and, overall, quality of education in ASEAN countries could be emphasised further. There will be room to speed up the implementation of large-scale infrastructure projects, such as the ASEAN Highway Network (AHN) programme. Integration should also continue with a broader range of issues addressed, including topics like environmental protection that have so far been mostly left aside.

96 8 7 6 5 4 3 2 1 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014

Figure 1. Average of the Common Effective Preferential Tariff rates for ASEAN

Source: ASEAN Secretariat.

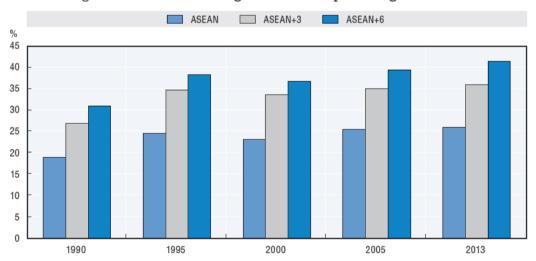


Figure 2. Share of intra-regional trade as percentage of total trade

Note: ASEAN+3 includes ASEAN 10 countries plus China, Japan and Korea. ASEAN+6 includes ASEAN+3 plus Australia, India and New Zealand

 ${\it Source: CEIC, OECD\ Development\ Centre\ calculations.}$

Institutions for effective policy implementation: What are the barriers to achieving medium-term plan targets?

Institutional capacity is needed to design and implement national development plans

Medium-term development plans can be valuable tools for governments looking to guide and co-ordinate their own policies in pursuit of strategic goals and to signal these intentions to the private sector and other domestic and international actors. They can cover a wide range of development goals and policy areas, from growth and macroeconomic stability to inclusiveness, sustainability and well-being. Despite their widespread use in Emerging Asia and around the world and the need for these plans to remain credible, however, targets are sometimes unrealised. This can be the result of contextual and political factors but also of institutional weakness in plan design and implementation, reflecting poor data availability, the lack of skilled staff, barriers to inter-ministry co-operation, and disconnects between planning and budgeting. The achievement of plans' targets therefore offers a useful way of measuring governments' institutional capacities in broad terms.

Capacity is needed throughout the planning process to produce relevant, reasonable and ambitious targets and to ensure their timely implementation (Figure 3). The designing of plans also needs to balance inclusiveness with technical expertise. The leadership and expertise of officials in agencies in charge of producing plans may have to weigh competing costs and benefits against each other when trying to determine what constitutes the public good. Planning requires these agencies to have – or have access to – strong technical capacities. Budgeting strategies may also be needed to manage multiple projects, because successfully implementing development plans is largely dependent on matching programmes of work with appropriate funding. As line ministries tend to be less concerned about their overall budget impacts, budgeting strategies can offset their tendency to propose too many projects and make large expenditure requests, which could otherwise lead to unsustainable deficits, poor resource allocation, and inefficient spending on public goods and services.

Design
(including target setting and related consultation)

Implementation

Review and evaluation

Figure 3. The planning process comprises design, implementation and evaluation

Source: OECD Development Centre.

Effective planning also relies on broader institutional capacities across government. Reliable statistics are needed where targets are quantified to establish baselines and historical trends and, as the plan is put in place, to monitor on-going and final progress. Additionally, the targets established by medium-term plans may often be unfeasible because they are disconnected from annual budgets which, unlike development plans, are binding on government. Reconciling planning and budgeting over annual and medium-term timeframes may be facilitated through medium-term budgetary frameworks (MTBFs) which use projected expenditure for guidance in preparing annual

budgets. Most Emerging Asian economies use MTBFs – or the related medium-term fiscal frameworks (MTFFs) and medium-term performance frameworks (MTPFs).

After the plan is set and assuming that the government is in fact committed to it, it is responsible for implementing the plan and striving to meet its targets. However, this process is complicated by the multiple actors involved and the limited resources available to them. Public expenditure management (PEM) systems are a useful tool to facilitate the supervision of line ministries. Supervision may be carried out directly by the ministry of finance, either ex ante or ex post. Whatever the approach, mismanagement may be dealt with through internal disciplinary action or, in cases of corruption, through the courts. Co-ordination and management in plan implementation are not only the responsibilities of the ministry of finance and other central agencies; these organisational responsibilities are also needed to direct cross-ministry co-operation and within-ministry operations. There must consequently be effective co-ordination between central agencies and line ministries, between ministries, and within them. Capable and motivated staff and flexible institutions are then needed to implement plans.

The implementation of development plans in Emerging Asia can be improved

This Outlook includes country case studies on medium-term development plan targets and implementation for the large ASEAN-5 countries (Indonesia, Malaysia, Philippines, Thailand and Viet Nam), Myanmar, China and India. Each study summarises the key targets set in the country's current plan, the original status of these indicators and progress made thus far toward the targets. The targets themselves and the patterns in the achievement of these targets are discussed in terms of their implications for the country's development and for where greater attention may need to be paid by governments (Table 2). While countries are paying attention to the areas that should be priorities for their development, actual performance with respect to plan targets has been uneven across countries and across policy areas within countries. The recognition of areas of relative weakness may be used to help identify where targets can be rethought or where greater implementation efforts are needed.

Indonesia is near the end of the period of its 2010-14 National Medium-term Development Plan, which aims to create a prosperous, just and democratic country through reforms in the areas of macroeconomic growth and stability, poverty reduction, education, health, food production, energy production and distribution, infrastructure development and good governance. Overall, the country is making good progress towards its targets, particularly in macroeconomic performance and junior high school enrolment.

A number of important gaps remain, however. Progress toward goals for health outcomes in Indonesia has been particularly weak and has even worsened in some cases. Poverty rates remain high in some areas and inequalities are not being adequately addressed (Figure 4). While continued growth requires the expansion of knowledge-based industries, access to advanced education remains low. Greater investment in and attention to infrastructure development and anti-corruption will also be needed to continue to attract investment and encourage the growth of new businesses.

The Tenth Malaysia Plan (2011-15) focuses on growing to a high-income economy while ensuring inclusiveness and sustainability. It aims to achieve this through the fulfilment of targets in balanced economic growth, efficient fiscal policy, the development of key sectors and SMEs, the reduction of poverty and inequalities, and

reforms of labour markets and education and healthcare systems. Growth rates are strong and investment rates exceed targeted levels, but there is still room for making the productivity improvements that will be needed for Malaysia to become a high-income country. SMEs have a greater role to play in this transition, as do new industries that will need to develop further, such as ICT. At the same time, fiscal stability can be improved through reduced reliance on oil and gas revenue and the introduction of new revenue-raising tools, such as a goods and services tax (GST).

Table 2. Policy challenges in implementing national plans in Emerging Asia

Country	Policy focus
ASEAN coun	tries
Indonesia	The widest gaps are found in the area of health. Improving access to and the quality of health services, especially for mothers and children, is crucial. Coverage of the newly implemented health insurance scheme should also be expanded
	Further efforts are required in order to improve the education system, particularly in access to secondary and tertiary education for students from low-income households.
	The national plan is not addressing growing inequality adequately.
Malaysia	Further improvements in productivity are needed to support sustainable economic growth and transform Malaysia into a high-income, developed nation.
	Further development of ICT, which is particularly important for supporting growth, is required.
	Fiscal stability should also be enhanced and dependence on oil reduced. The successful introduction of GST is important for improved tax performance.
Myanmar	Reliable indicators, quantifiable goals and measurements of government performance are necessary for effective planning and monitoring, particularly in the areas of regulatory reform and public finance.
	Policy planning and budgeting, including appropriate financial support in agriculture and education – should be developed.
	Co-operation with the private sector through PPPs and setting up new businesses and with civil society is an important part of Myanmar's on-going transition.
Philippines	To sustain economic growth, the Philippines needs to step up its competitiveness through quality employment and increase value added through innovation.
	A responsive, inclusive, development-oriented financial system must be built as a platform for the efficient management and mobilisation of resources.
	Social development must be further improved to ensure equal opportunity so that Filipinos may find decent jobs, acquire assets and lift their living standards.
Thailand	To ensure sustainable economic growth and enhance competitiveness, Thailand must accelerate its progress towards meeting certain targets and improve its productivity.
	$The \ country \ should, in particular, make further \ efforts \ in \ environmental \ management \ in \ order \ to \ support \ green \ growth$
	$Improving \ good \ governance-with \ particular \ emphasis \ on \ corruption \ and \ transparency-needs \ more \ effort \ to \ reduce \ obstacles \ to \ growth.$
Viet Nam	Maintaining stability in key economic and social indicators is a priority for implementing socio-economic strategies.
	Addressing implementation gaps in the development of high-tech industries and skills training is essential not only to meeting the goals of the medium-term plan, but also to realising the 2020 vision of a modern, industrialised Viet Nam.
The two larg	e economies in Emerging Asia
China	Environmental degradation remains a major issue despite the country's efforts in reducing pollution. Further efforts are needed to increase consumers' access to clean energy.
	Rural and agriculture development could help promote urban-rural social equality.
	Continued improvements in education are required. Reforms are also needed to support the development of the service sector, which has the potential to help drive future growth.
India	De-industrialisation needs to be addressed. Manufacturing has been slowing down in the last few years and even show negative growth in 2013-14.
	Access to secondary education needs to be widened to achieve the goal of universal secondary education by 2017.
	The public health system needs to be strengthened. Access to both curative and preventive healthcare facilities needs timprove.
	Accelerating the development of infrastructure is crucial, especially in rural areas.

7

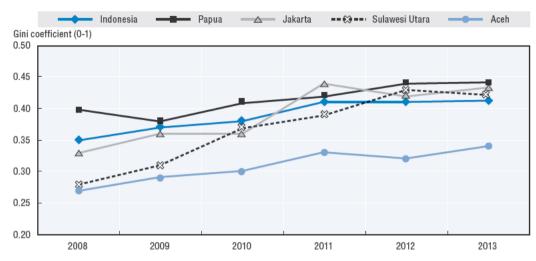


Figure 4. Inequality in Indonesia and selected provinces, 2008-13
Gini coefficient

Source: Statistics Indonesia, Badan Pusat Statistik (BPS).

Myanmar's Framework for Social and Economic Reforms outlines transitional priorities for 2012-15 to help act as a bridge for the new government from the previous five-year plan. It prioritises necessary and achievable reforms in economic development, regulation and governance, the provision of public services and infrastructure development. These targets are less clearly defined than in other countries and more challenging to track, as reliable indicators are often not available in Myanmar. However, progress is being made in economic reforms to open space for the private sector and developing infrastructure. Progress is also being made in implementing programmes to assist agriculture and improve access to education, though it is unclear whether these projects target the areas of greatest need. The regulation of the financial sector and transparency of public finances are in particular need of more attention, as is the development of better government relationships with the private sector and civil society.

The *Philippine Development Plan*, 2011-2016 aims to foster inclusive and sustainable growth through progress toward targets on macroeconomic stability, sectoral competitiveness, financial system resiliency and inclusiveness, social development (i.e. improved health, education, housing and social programmes and outcomes), crime reduction, and environmental protection. Overall, economic performance during the plan's period has been strong, though the same progress has not been made in improving inclusiveness.

Increased competitiveness is critical for the Philippines' continued growth and job creation, but more effort is needed to bring about change in the key sectors for this transformation. Tourism and SMEs hold great potential for driving future growth, but appear to be under-performing. A resilient and accessible financial system is also critical, but has been slow to improve its inclusiveness. While the services sector is expanding, further innovation here and in manufacturing will lay the basis for a high-tech economy. Serious barriers in access to education and health hinder human capital development and fail to address the root causes of inequality (Figure 5).

2008-09 to 2012-13
Students and annual growth rates

Elementary Secondary Growth in elementary and secondary enrolment (RHS)

25 000 000

20 000 000

2.5

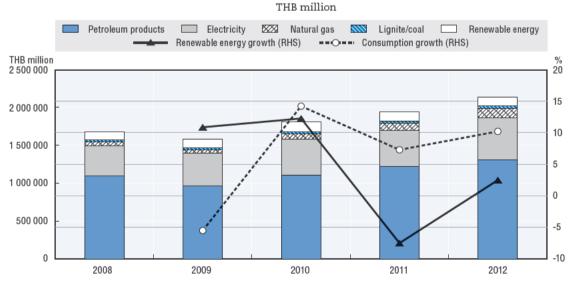
Figure 5. Elementary and secondary enrolment rates in the Philippines,

15 000 000 10 000 000 5 000 000 SY2008-09 SY2009-10 SY2010-11 SY2011-12 SY2012-13

Source: National Statistics Office, Department of Education, Philippines.

Thailand's Eleventh National Economic and Social Development Plan (2012-16) is intended to support inclusiveness and innovation-led growth in the country. The plan's targets focus on inclusive and broad-based growth, education and other areas of human development, food and energy security, increased innovation and growth, trade and investment, and environmental protections. Thailand is on track to meet or exceed macroeconomic targets for growth and inflation, even if other economic performance targets are set to be unmet. While alternative and renewable energy production is increasing, fast-rising energy demand has left the country's dependence on fossil fuels unchanged or worse than before the plan began (Figure 6). New strategies are needed to meet these challenges and to foster creative and research-based industries and reduce corruption to facilitate innovation-led growth in Thailand.

Figure 6. Final energy consumption expenditure by energy source in Thailand, 2008-12

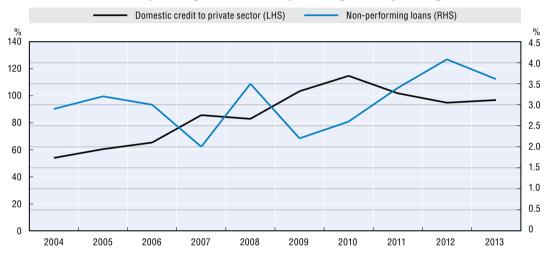


Source: PTT, EGAT, DOEB and DEDE, compiled by Energy Policy and Planning Office (EPPO).

Viet Nam's Socio-economic Development Plan (2011-15) emphasises development through upgrading and improvements in efficiency and competitiveness through targets for overall and sectoral economic performance, social targets (e.g. regarding job creation and poverty reduction) and the implementation of environmental protections. GDP growth has been lower than targeted, but other economic targets, such as those regarding unemployment and social investment, are near or above target levels. Insufficient progress is being made by current approaches to a wide range of social challenges, such as alleviating rural poverty and expanding access to technical training and education. The need for improved banking governance amid rising levels of bad debt is another serious challenge that needs to be addressed to support continued development (Figure 7)

Figure 7. Domestic credit to the private sector and non-performing loans in Viet Nam, 2004-13

Domestic credit as percentage of GDP and non-performing loans as percentages of total loans



Note: Domestic credit figures represent annual averages, while NPL ratios represent monthly averages from December in the respective year.

Sources: World Bank (2014), World Development Indicators, World Bank, Washington, DC; State Bank of Vietnam (2014), Statistics on the Performance of Credit Institutions, State Bank of Vietnam, Hanoi, www.sbv.gov.vn.

The Chinese Twelfth Five-Year Plan (2011-15) addresses a range of issues related to rebalancing and promoting continued growth while ensuring inclusiveness and sustainability. It therefore targets progress in macroeconomic performance, economic restructuring, innovation, protecting the environment and reducing pollution, agriculture, and livelihoods and well-being. GDP growth is still above the target set in the plan, which is lower than that seen in China's recent past. In this context of anticipated slower growth, greater effort is needed to address the quality of growth by improving environmental and social outcomes and fostering broad-based growth. While pollution is declining, it remains a major issue to address and more could be done on energy efficiency. The urban-rural divide comprises a large component of Chinese inequalities, necessitating improved rural and agricultural development. Generally, the services sector also has the potential to expand to improve the stability of growth and potential for continued innovation and productivity growth. The continued improvement of education systems will play an important role in supporting this expansion.

India's Twelfth Five-Year Plan (2012-17) sets out targets with the intention of improving sustainability and inclusiveness and quality of life in the country. Included targets focus on growth, poverty reduction and job creation, education, health, infrastructure

development, and reduced emissions and improved environmental protection. Currently, well-being and the improvement in human capital are restrained by low levels of access to education and healthcare. Access to financial services is also low, particularly in rural areas. Infrastructure development and the expansion of renewable energy production are gradually progressing, suggesting that greater and alternative means of investment may be needed.

Lessons from experiences with public sector reforms in Emerging Asia

Emerging Asian countries have been actively engaged for several decades in reforms to improve the quality of their public sectors. These public sector reforms (PSRs) encompass public financial management reforms (PFM) to improve budgeting, expenditure implementation, and tax administration; and administrative reforms to streamline the organisation of government activities, decentralise functions to sub-national governments, strengthen the civil service and combat corruption.

Public sector reforms are motivated by the recognition that the effectiveness and efficiency of the public sector in managing its finances, implementing government programmes and delivering public services are critical to the success of overall development and the achievement of key development objectives. The rapid growth and profound transformation that Emerging Asia has undergone have made PSR of special importance to the region. Public sector reforms can contribute to economic and social development in a number of ways, including by:

- improving the capacity of governments to effectively and efficiently carry out their policies;
- reducing costs and improving the overall efficiency of the business sector;
- · improving the business climate through greater certainty about government policies and greater macroeconomic stability;
- increasing international competitiveness, particularly for FDI;
- strengthening the effectiveness of policies to reduce poverty and to achieve inclusive and green growth; and
- improving the credibility of the government and political processes and overall social cohesion.

Public sector reform has made significant progress in the region but much remains to be done

The experiences of developing countries, including those in Emerging Asia, underscore that public sector reforms are complex, long-term, processes whose ultimate success is determined by broader institutional capacities and political economy factors. A recent study of PSR in developing countries found that civil service reforms and anticorruption reforms improved performance in less than half and barely more than half, respectively, of World Bank-supported programmes in these areas. Outcomes were somewhat better for public financial management reforms but even in these cases major improvements occurred in only one-third of the programmes. These mixed outcomes demonstrate that PSRs are difficult processes and raise the question: what makes them more or less successful?

PSRs have made substantial progress in Southeast Asia, China, and India, but a range of indicators of public sector performance highlight the need for further efforts. These countries rank noticeably below OECD countries on the Government Effectiveness Index produced by the World Bank - a composite measure of public perceptions from a wide

range of sources of the quality of public services and the civil service, the effectiveness of policy formulation and implementation, and the credibility of the government in carrying out its policies (Figure 8). Higher-income countries in the region usually, although not always, outperform their lower-income neighbours. This pattern reflects a broader tendency for the overall quality of public governance to be positively correlated with countries' level of development.

Percentile-rank 2012 100 80 60 40 20 n SouthAfrica United States Jackor VietNam Migeria Philippines Indonesia Thailand Brazil Mexico Malaysia 18Dall Germany EDADY China Chile

Figure 8. Indicators of overall governance quality in 2012
Government Effectiveness Index percentile rankings

Notes: Figure shows percentile rank among all countries (ranging from 0 [lowest] to 100 [highest] ranks). Countries are arranged from lowest to highest per capita income at purchasing power parities. It reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Source: World Bank (2014), World Governance Indicators (database), World Bank, Washington, DC.

Indicators for specific aspects of public sector performance show a similar pattern. Public expenditure management systems and tax administrations are more advanced in middle-income countries like China and India than in the lower-income countries in ASEAN, but still less advanced than in OECD countries. Except for Malaysia, results-based budgeting has either not yet been instituted or is in a very early stage. Tax administrations in the majority of countries are at least partially organised along functional lines but only about half have instituted separate units for large taxpayers. The cost to businesses and time required to comply with tax obligations is significantly higher in the region compared to more advanced countries in OECD economies.

Corruption remains a significant concern. International surveys indicate that corruption in the region is both rampant and extensive. Both the Transparency International Corruption Perceptions Index, based on extensive surveys of members of the public in the individual countries, and the corruption components of the World Economic Forum's Global Competiveness Indicators, drawn from surveys of business executives, place most Emerging Asian countries in the bottom half of their rankings. Corruption is overall most severe in the CLM countries but still bad in the other countries, although somewhat less so in China and Malaysia. Moreover, there has been at best limited improvement in corruption perceptions since the mid-1990s, although somewhat more in China and Indonesia. Corruption in most Emerging Asian countries extends beyond the core government actors of civil service and politicians (Table 3).

Table 3. Corruption perceptions by sector in Emerging Asia Percentage of survey respondents who think of national institutions as "corrupt" or "extremely corrupt", 2013

Percentage of those surveyed believing sector is corrupt or highly corrupt	Political parties	Parliament/legislature	Judiciary	Police	Public officials/ civil servants
Cambodia	28	16	60	37	30
Indonesia	86	89	86	91	79
Malaysia	69	44	35	76	46
Philippines	58	52	56	69	64
Thailand	68	45	18	71	58
Viet Nam	27	28	53	72	55
India	86	65	45	75	65

Source: Transparency International (2013), Global Corruption Barometer 2013, Transparency International, Berlin, http://www.transparency.org/research/gcb/overview.

Country experiences reveal that public sector reform is a complex and long-term evolutionary process

Emerging Asia has undertaken numerous public sector reforms since the 1970s in all major areas. The reforms have been driven and shaped by both domestic and external factors: globalisation and international agreements on trade and investment, the Asian financial crisis, and major political shifts have been particularly important drivers of the reforms. Overall, PSRs in Emerging Asia can be said to have made significant but uneven progress, with more success in some areas of reform and in some aspects of specific reforms than in others.

The experiences show that PSRs are best viewed as long-term evolutionary processes whose payoffs are usually limited in the near term. PSRs are complex undertakings whose design needs to be carefully tailored to and sequenced in line with institutional capacities in the government, the economy and society. Design matters greatly, although it is not sufficient for success by itself. Sustaining reforms until their main objectives have been achieved has proved to be much more difficult than initiating them. The benefits of PSR generally take a long time to be fully manifest and reforms need to be adapted as institutional capacities develop. Thus, reforms are best viewed as a series of measures over a longer period rather than as measures that are done once and then left alone.

A review of the experiences with PSR in Southeast Asia, China and India leads to a number of observations that provide insights into the circumstances under which they are likely to be most successful.

- First, sustained commitment by high-level political authorities and senior civil servants is very important, indeed often critical, to the success of PSRs. Sustained commitment is critical to gain the support of the public and stakeholders who may perceive threats to their interests and to ensure that the government bureaucracy effectively implements the reforms. This commitment is particularly essential for civil service and anti-corruption reforms to overcome the opposition of stakeholders within and outside the government who perceive threats to their interests.
- Second, PSRs seem to have been most successful and durable when they have become embedded in an institutional culture of reform where the long-term objectives are accepted among the political elite and the public and early stage reforms provide lessons and impetus for further action. In Malaysia, the on-going commitment to developing and refining results-oriented public sector management since the 1970s has helped to ensure continuity and focus in overall PSR efforts across successive

government administrations. Conversely, although economic and political upheavals in the region have often triggered PSRs by galvanising government, the public and outside actors to address the need for fundamental change, the window of opportunity they have created does not guarantee that reforms are sustained. In the Philippines, for example, successive attempts to reform the tax administration from the 1970s through the 1990s had very limited long-term benefits in large part because high level political support was uneven and not sustained.

- Third, strong constituencies for PSR outside the government have been a major force for the initiation of PSRs and, even more importantly, in ensuring that PSR is sustained. Foreign-invested businesses have been a major driver of PSRs throughout the region, especially of reforms to improve tax administration and to reduce corruption. Civil society and the general public can and often have been important in sustaining PSR initiatives. However, they are most likely to be actively engaged in supporting PSR when government policies are reasonably transparent and the legal/regulatory framework promotes strong accountability of the government to its citizens.
- · Fourth, there are both advantages and disadvantages to incremental or partial reform as opposed to comprehensive change. Incremental reforms often gain acceptance more easily and do not have the high costs of failure associated with more comprehensive reforms, as they can also be adapted to unexpected changes in circumstances. However, incremental reforms do run the risk of being overtaken by rapid economic and social change. In China, the incremental approach has proven beneficial in some areas but it has led to recurring problems in fiscal decentralisation reform. Although consensus on the need for comprehensive reform may be harder to achieve and its implementation more challenging, it can bring longer-lasting and ultimately more effective solutions, at least in some areas.
- Finally, reforms that address the root causes of the problems are more likely to be effective and have durable benefits than those that do not. For example, opaque and excessive regulations, inadequate pay for civil servants, and poorly defined rules governing relations between government agencies and businesses create numerous opportunities and incentives for corrupt behaviour and have been an important factor behind the pervasive corruption in many developing countries. Anti-corruption reforms that focus only on legal and administrative enforcement are likely to meet with incomplete success until these root causes are addressed. Similarly, tax administration reforms to improve tax collection need to address not only outright evasion and avoidance but also the inadequate knowledge of tax obligations that is often rife in developing countries.

A number of guidelines would help to improve the effectiveness of public sector reform

Experiences in Emerging Asia do not provide any magic bullets for ensuring that public sector reforms are effective but they do suggest some guidelines for designing and implementing reforms that should help to increase the prospects of their success.

 PSR measures need to be carefully adapted to existing institutional capacities. While there are useful models and best practices for PSR in some areas, these need to be adapted to local circumstances and to evolve as those circumstances change. For example, there are several kinds of medium-term budget frameworks, ranging from frameworks emphasising definition of and imposition of aggregate resource constraints in budgeting that are most suitable for countries in an early stage of development to more sophisticated frameworks, including results-oriented budgeting techniques.

- Where feasible, beginning a PSR programme with a few relatively easy to implement measures with high short-term payoffs can help to improve the credibility of the overall programme and provide lessons for implementation of subsequent and often more difficult steps. For example, the Indonesian tax administration reforms beginning in 1971 were divided into short-term and long-term phases, with the short-term phase focused on using existing capacities to improve tax collection and compliance in order to provide a near-term boost in revenues. The successes of these initial steps provided a foundation for subsequent reforms.
- · On-going commitment to PSR from the highest level of political leadership is essential. Top leaders need to lead not only in instituting reforms but also to maintain pressure for their effective implementation. Unlike Indonesia's tax administration reforms, which benefitted from sustained political support, this was weaker for reforms in the Philippines, which contributed to a series of disappointing results.
- PSR implementation is likely to make more rapid and ultimately greater progress when the concerns of key stakeholders are taken into account. Active efforts by senior political leaders and civil servants to inform government staff about the need for and content of reforms can go a long way toward overcoming bureaucratic inertia and obstruction.

Strong and effective public support can make it much easier to initiate PSR measures and increase the likelihood for their success. Government transparency and accountability and a legal and regulatory environment allowing active participation by civil society are, however, likely to be necessary for such support.

Institutions and informality in Emerging Asia

Informal economic activity tends to be very important in the Emerging Asian economies

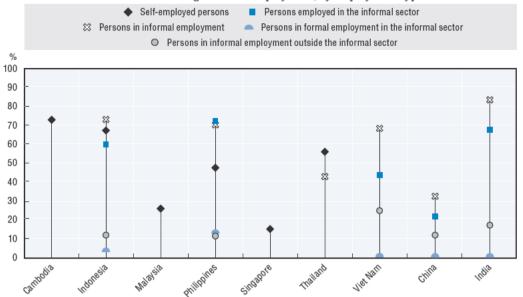
Informal firms and workers are found in all economies. The sheer extent of informality makes it a critical issue for policy makers to understand and address - particularly in economies like those found in Emerging Asia that are undergoing significant structural transformation. Informal activities are more likely to develop in such countries, with serious effects on growth and inclusiveness.

Institutions and institutional capacity are central to understanding the causes and consequences of informality and to developing formal alternatives. While informality may be difficult to define and has multiple overlapping causes, institutional factors are fundamental determinants of how prevalent informal output and employment are. Weak institutional capacity may, in turn, also be exacerbated by informality, as hidden activity lowers government revenue, its regulatory reach and its credibility. And although informality ensures the livelihoods of many, it harms growth and development when it replaces dynamic formal activities. Policies to address informality - which include strengthening institutional and enforcement capacities - are therefore needed to support resilient and inclusive growth.

Informal employment and output by informal firms are relatively common in a number of Emerging Asian economies, particularly the region's lower-income countries and those where institutional capacities are most seriously underdeveloped (Figures 9 and 10). Conversely, more developed Singapore and Malaysia tend to have much lower levels of informality. Indirect measures of informal employment and output over time also suggest that the shares of each in total economic activity are gradually declining across the region as these economies continue to grow and develop and as governance and institutional capacities are improved upon.

Figure 9. Much of employment is informal across Emerging Asia

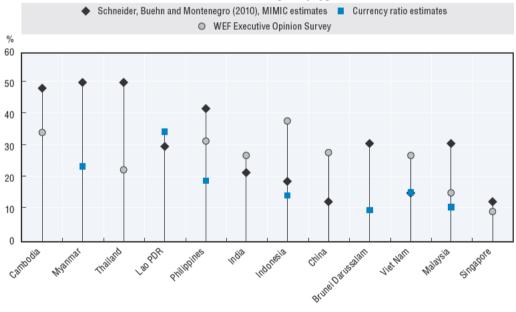
Shares of total non-agricultural employment, by employment type



Note: All data from various years in 2008-10.

Sources: International Labour Organization (2010a), LABORSTA (database), ILO, Geneva, http://laborsta.ilo.org/.

Figure 10. Estimates of informal output show some similar patterns
Informal sectors' shares of total output, by type of estimation



Note: Averages of 2000-07 values from MIMIC and currency ratio estimations and 2006 survey results. Sources: Schneider, F., A. Buehn and C.E. Montenegro (2010), "Shadow economies all over the world: New estimates for 162 countries from 1999 to 2007", World Bank Policy Research Working Paper, No. 5356, World Bank, Washington, DC; World Economic Forum (2006), The Global Competitiveness Report 2006-2007, World Economic Forum, New York; OECD Development Centre calculations.

The region's experiences regarding informality have multiple interconnected proximate and deep-lying causes. High levels of informality are often blamed on excessive tax and regulatory burdens on firms, though these are not always significantly more restrictive where higher rates of informality are found. Factors beyond governments' market interventions also affect informality, as it tends to be higher in underdeveloped and industrialising economies and where social and cultural pressures to comply with laws are weaker. Government capacities remain relevant here as well, however, as social norms in Emerging Asia supporting tax compliance appear to be stronger where opinions on governments' effective use of the collected revenue in providing public goods and services are higher.

At a more fundamental level, institutions are responsible for determining levels of informality over the long term. Effective institutions encourage formality both through push factors – tax and regulatory enforcement and penalties for non-compliance – and pull factors – access to market-supporting public goods and institutions such as the rule of law, the protection of property rights and contract enforcement, as well as closer interaction with formal sector financers, suppliers and customers. Informality tends to be less prevalent in Emerging Asian economies with strong, effective and impartial legal systems, for example (Figure 11).

Estimated informal output share (%) 40 35 Indonesia 30 Philippines Viet Nam 25 Thailand India 20 China 15 Malaysia 10 Singapore 5 0 0 0.1 0.2 0.3 0.4 0.6 0.7 0.8 PRS International Country Risk Guide Rule of Law Index

Figure 11. Weaker rule of law is associated with higher informality Rule of law and estimated informal share of total output in selected countries, 2011

Notes: The PRS Rule of Law Index, which varies from 0 to 1, gives higher scores to countries where the legal system is strong and impartial and the law is popularly observed. Informal output shares estimated using WEF Executive Opinion Survey values for 2006, extended with growth rates estimated using the electricity consumption method.

Sources: Political Risk Services (2014), International Country Risk Guide (database), PRS, Syracuse; OECD Development Centre calculations.

Despite some benefits, informality often impedes growth

The consequences of informality can be for the good in emerging economies where they facilitate economic flexibility. Informal firms create jobs for workers excluded from the formal economy, particularly during downturns, which has a buffering effect. Estimates of informal shares of total output, for example, rose considerably in 1998 in in Indonesia, Malaysia, the Philippines, Singapore and Thailand, which were among the Emerging Asian economies worst affected by the 1997 Asian Financial Crisis. Informality also creates employment for poor, marginalised and excluded workers. However, these

benefits are outweighed by downsides if better formal jobs could have instead been created in their place.

In addition, there are numerous negative consequences of informality. Most directly, it stunts government capacity by lowering tax revenues and limiting the reach of its influence on the private sector through product and labour market regulation. Informality also typically constrains growth, as it lowers productivity. Operating informally limits the productivity potential of firms, as they cannot easily access the efficiency-raising institutions available to the formal sector. Because they lack collateral and do not enjoy a legal status, informal firms tend not to borrow through the formal financial system. Instead, they use alternatives that increase costs or provide lower funding, which limits their ability to invest in productivity-enhancing machinery, equipment and technology.

The informal sector constrains productivity not only directly, but indirectly, too. In part, indirect effects are manifest in the greater relative tax burden on compliant formal firms, as noted above, while a related impact is to be found where formal firms share markets with informal producers. They may well find themselves at a disadvantage – even when they are more productive – because of the lower production costs of informal firms who avoid taxes and compliance with other laws and regulations.

Comprehensive strategies are needed to address informality

As a result, strategies are needed to further discourage informal employment and output. Economic growth and industrialisation alone cannot be relied upon to reduce informality, particularly as informality itself already slows growth. Apart from low income levels, institutional and other factors are conducive to the rise of informality. What is needed are comprehensive policy responses that deter disruptive informality without affecting the livelihoods of the poor and marginalised workers who depend on informal income sources. These may include elements of reform that address four policy areas: judicial institutional capacities, investment in formal sector productivity and assistance for SMEs, the tax and regulatory environment, and targeted enforcement and concessions.

Reforming legal and judicial institutions

Informal activities can be curbed if formality is a more attractive proposition. To that end, policy makers should improve governance and administration, particularly with respect to the rule of law and the judicial system as a whole, contract enforcement, and the protection of property rights. These fundamental institutions are relatively underdeveloped among a number of countries in Emerging Asia that rank poorly in international comparisons of the ease of dispute settlement and of property registration, among other issues. Even countries that perform fairly well overall in the World Bank report, Doing Business 2014, are ranked low in areas of critical importance when it comes to addressing informality. Brunei Darussalam, for instance, is ranked 59th overall out of 189 countries, but 161st on enforcing contracts. Cambodia, India and Myanmar also perform poorly on contract enforcement, coming 162nd, 186th and 188th, respectively.

The strengthening of fundamental institutions may, in turn, require legislative and organisational change. Broad-based reforms may also help to boost tax morale, as an improved image of effective, credible government is more likely to coax individuals and firms into paying their taxes. Addressing corruption at all levels through strengthened government oversight bodies and civil service reforms is also important to ensuring the rule of law and improving the public image of government.

Supporting SMEs

At the same time, governments can help more dynamic formal sectors to emerge. Since informal firms often tend to be small and SMEs offer considerable potential for growth in Emerging Asia, policies encouraging formalisation and supporting productivity growth among SMEs should also help to reduce informality. Expanded access to training and finance is particularly important for SMEs. Broadly speaking, they thrive where there are strong financial and education systems, though they may also benefit from additional SME specific schemes like targeted programmes and indirect financial support such as loan guarantees. At the same time, efforts to increase SME awareness of the costs of informality and opportunities to formalise through public information campaigns complement broader policy reforms.

Rethinking tax regulation and administration

As part of efforts to discourage informality, some countries should give thought to the direct costs, levels of taxation, and regulations that weigh on the private sector. They may well have to reform the nature and administration of companies' legal obligations in order to encourage the growth of the formal sector. For the same average tax rate, changes in the structure of taxation and reforms benefitting smaller firms – such as tax exemptions on reinvested earnings or tax credits for investment and job creation - could be part of a comprehensive strategy to reduce informality.

Regulatory and administrative barriers – including those related to tax administration – are high in several Emerging Asian economies. Administrative barriers in starting new firms - a very important factor behind informality - are often relatively high in the region and in need of reform. The problem of low-level corruption among public officials is related to and often a result of complex administrative barriers. This is a particularly large challenge in the CLM countries; in Myanmar in 2014, for example, 35% of formal firms reported being asked for a bribe by tax inspectors.

Additional measures targeting informality

In addition to these broad policy reforms, targeted enforcement of and, possibly, concessions for non-compliant firms and industries prone to informality may be useful. Informality in the region tends to be concentrated in smaller firms operating away from the modern, international sectors of the economy - sectors that may be useful targets of anti-informality policy reforms. Targeted strategies should also seek to simultaneously formalise firms, their competitors, suppliers, customers and even lenders from the informal financial sector. Such a broad approach would help to alleviate concerns over lost cost competitiveness and offer opportunities to formalise business-to-business and financial relationships. In many cases, stepped-up enforcement and legal deterrents will still be needed alongside these targeted approaches. Recent investments in Indonesia in expanding the number of tax office employees and reforms in Viet Nam to amend the statute of limitations on firms' and individuals' tax procedure violations and increase the size of maximum fines, for example, should help to encourage greater compliance.