OVERVIEW

On the occasion of the Asian Development Bank's 30th Annual Meeting in May 1997 at Fukuoka, Japan, it was deemed appropriate to hold a seminar on a theme pertinent to the Bank's mandate. A decision was therefore taken to invite an elite group of high-level speakers to address the subject *Governance: Promoting Sound Development Management.* This publication is a summary of these eight presentations.

The focus of the seminar was on public administration and legal system reforms. First, Messrs. Shoji Nishimoto and Barry Metzger provided an overview of Bank policy and practice in the area of governance.

In his Opening Remarks, Mr. Nishimoto emphasizes that governance is increasingly recognized as an essential component of sustainable and equitable development. In August 1995, the Bank's Board of Directors approved a major policy paper, *Governance: Sound Development Management.* This paper committed the Bank to assisting its developing member countries to enhance their capabilities in this area. A Governance and Capacity Building Resource Group was recently established under the Office of the President to provide an institutional focal point for these issues within the Bank. Mr. Nishimoto concludes by expressing the view that, given the rapidly changing global economic environment, the Bank will continue to be relevant only if it can help bring about lasting improvements in the institutional capabilities of its developing member countries to manage development.

According to Mr. Metzger, it is generally agreed that the creation of an enabling environment for economic development implies the need for laws that regulate society, as well as the creation of institutions that ensure consistent application and enforcement of those laws. A focus on the legal dimensions of the development process, however, means more than simply creating "modern" laws. It is of crucial importance to communicate the idea that specific legal interventions must be complemented by systemic approaches to law and development. A systemic approach implies a shift of focus to the resources made available to the courts and regulatory agencies, as well as to the efficiency with which such resources are utilized. Mr. Metzger concludes that, as a step towards a systemic approach, the Bank's recent law-related assistance emphasizes continuing legal education for existing professionals, especially in the public sector; and enhancing the capacity of local institutions to provide training in newly enacted laws and regulations for a market economy.

The two Bank presentations were followed by three distinguished speakers from New Zealand, Japan, and Malaysia who advocated different approaches to public administration reform.

The keynote speaker, the Honorable Ruth Richardson, former Finance Minister of New Zealand, is a proponent of the "big bang" approach to governance. Outlining how market-oriented governance reforms had dramatically transformed the economy of New Zealand, she cites the recent experience of her country as proof positive that the quality of development management is a cornerstone of prosperity. New Zealand's governance reforms, which began in 1984, utterly transformed the country's economic performance in only ten years. Its average growth has been number one among members of the Organization for Economic Cooperation and Development (OECD) since 1991, its unemployment rate is low, and the Government's budget now runs a surplus. Recent international surveys place New Zealand at the top in terms of competitiveness and economic freedom. In her presentation, Ms. Richardson explains that the New Zealand reforms were derived from a "rethink" of the entire role of the State. The reformers were tasked with identifying those areas where the State had a legitimate role and how its job could be most effectively fulfilled. The result was the wholesale separation of commercial functions from other Government functions. Ms. Richardson concludes that while there is no panacea for economic woes, global lessons, whether derived from the spectacular emergence of East Asia or the radical reforms of New Zealand, are the same. Nothing is more important than sound development management that combines good governance with sensible economic policy.

Mr. Isao Kubota, Director General of Japan's Ministry of Finance, provides an alternative view on the role of Government in economic development. He cautions against wholesale acceptance of the belief that the East and Southeast Asian economic success stories are the result of good governance. When discussing the role of Government, the approach of the "new orthodoxy" is to assume that the government and the private sector are enemies by nature — that Government is a kind of necessary evil, and the smaller it is, the better. Mr. Kubota argues that this is not the lesson one should derive from the successful Asian economic stories. Rather, the lesson is that the Government and the private sector have basically similar goals and that when they work together to identify the optimal development policy aims for their country, and effect policy measures to achieve these goals, the full potentialities of the country are realized.

Like Mr. Kubota, Dr. Abdullah Sanusi Ahmad, Vice Chancellor of the University of Malaya, stresses the importance of Government-private sector cooperation and endorses a gradual approach to reform. He reflects that the most significant change in public administration in Malaysia started with the establishment of the Malaysian Administrative Modernization and Manpower Planning Unit (MAMPU) in 1977. MAMPU's objectives included providing management consultant services to Government organizations, carrying out administrative reforms, and coordinating activities on human resource planning and development for effective management. During the 1980s a number of innovations and ideas were introduced and implemented. These included Government-private sector cooperation under the concept of "Malaysia Incorporated", replacement of western countries as role models by Japan and South Korea under the "Look East Policy", and programs that resulted in significant changes in the values and productivity of civil servants. Dr. Sanusi concludes that even though administrative reforms and transformation in Malaysia began more than two decades ago, the goal of excellence is ongoing and must be continually nurtured.

The three presentations on approaches to public sector reform were followed by three case studies of Bank-assisted governance and legal system reform. These were presented by key representatives of the Governments of Sri Lanka, Gujarat (India), and Mongolia.

Presenting the first case study, Dr. Lal Jayawardena, Economic Adviser to the President of Sri Lanka, states that the primary economic goal of the Government is the elimination of the overall budget deficit by 2000. This means nothing less than eliminating loss-incurring enterprises, cutting subsidies, and reducing the civilian public service wage bill and the pension burden. The objective of these reforms is to have an efficient, motivated, result-oriented, and vastly slimmed down public administration. Dr. Jayawardena explains that two main instruments of reform will be created: an Administrative Reforms Management Division, charged with designing the reform program and overseeing its implementation; and a Management Council, charged with providing a single, central focus for all strategic policy initiatives and ensuring the overall coordination of policy development. Two additional elements of the reform process explained by Dr. Jayawardena are the assigning of sole authority for public service appointments to an independent and revitalized Public Service Commission, and the identification of redundant departments and institutions as candidates for elimination.

The second case study is presented by Mr. S. K. Shelat, Chief Secretary to the Government of the Indian State of Gujarat. Mr. Shelat tells how a weak and deteriorating fiscal position, a large state-owned enterprise sector that was draining resources, and infrastructure investment requirements far in excess of available public resources obliged the Government of Gujarat to initiate reforms. The process began in 1994, and, with Bank support, a program aimed at reducing the State's role in commerce and enhancing private sector participation in the economy was adopted. As a result of the reforms, the Government will vacate areas that can be successfully operated by the private sector. Mr. Shelat explains how the successful completion of the program will put Gujarat on the road to self reliance and improve the quality of life of its citizens.

Presenting the final case study, Mr. Jigjid Unenbat, Governor of the Bank of Mongolia, explains how the Bank's law and development program assisted with legal training, advice on commercial legislation, translation into English of the Civil Code, and preparation of a compendium of principal commercial and economic laws. Assistance was also provided for reviewing the legal framework for restructuring and liquidating commercial banks, amending the banking law and regulations, enacting the Central Bank Law, and preparing a business plan for the Ministry of Justice. Mr. Unenbat describes the Bank's assistance in establishing a retraining center for teaching legal professionals to apply market economy principles in commercial laws and regulations, and in such lawyering skills as negotiating and drafting legal agreements and regulations.

Taken as a whole, these eight presentations represent an important addition to the literature on the subject of governance. The Bank's careful selection of speakers ensured that the subject would be addressed engagingly by some of the prime movers of reform in the Asian and Pacific Region.

Opening Remarks

The Bank's Governance Policy

Shoji Nishimoto
Chief, Strategy and Policy Office
Asian Development Bank

Governance, defined as "the manner in which power is exercised in the management of a country's social and economic resources for development," is being increasingly recognized as an essential component of sustainable and equitable development. There are many ways in which good governance contributes to economic development. Governments make decisions on macroeconomic and social policy that have a direct impact on the long-term health of the economy. Governments provide critical goods and services, such as infrastructure, health and education, that determine the competitiveness of the economy. Governments foster an enabling environment for private sector growth and regulatory structures that balance objectives of growth and equity. The experience of East Asia shows that good governance is also an essential component of dynamic private sector growth — simply put, markets will not function well without it.

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The presentations in Part I of this seminar by the Honorable Ruth Richardson, Mr. Isao Kubota and Dato Abdullah Sanusi, bring out both the importance of good governance and its multifaceted nature.

In August 1995, the Board of Directors of the Asian Development Bank (ADB) approved a paper, *Governance: Sound Development Management,* that has committed the Bank to assisting its developing member countries in enhancing capabilities in this area. The paper identifies four basic elements of good governance:

(i) accountability, the need for public officials to be held responsible for delivering particular outputs;
(ii) transparency;
(iii) predictability, the need for a stable, open, and widely understood set of "rules of the game"; and
(iv) participation, to ensure ownership and beneficiary support for development initiatives.

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We are now moving forward to implement the key thrusts contained in this paper. A Governance and Capacity Building Resource Group was recently established under the Office of the President to provide an institutional focal point for these issues within the Bank. Some basic information on the Resource Group, including the e-mail address, is available in the first issue of *our News and Notes: Governance and Capacity Building at the ADB*, which is included in the seminar materials provided to you. I urge those who are interested to contact the Resource Group for information on governance issues in general, as well as on specific activities of the ADB.

Since August 1995, we have made three loans amounting to $290 million and over 20 technical assistance grants to help our developing member countries reform their core administrative systems. In addition, about two thirds of our loans and over 80 percent of Technical Assistance grants have some component aimed at strengthening institutional capacity. The presentations in Part II of this seminar represent some of the prominent examples of the Bank's loans and technical assistance in the area of governance.

Our work on governance and capacity-building issues is organized along several dimensions. There is a strong public sector management component that covers the parastatal sector, as well as how governments prepare and implement policies and deliver public services. A second dimension is private sector development and the role of governments in creating and fostering an enabling environment for private sector growth. Another dimension is strengthening civil society, which includes participation of stakeholders and beneficiaries in development policies and projects and a growing role of NGOs in delivering certain services. Keeping these in view, the thrusts of the Resource Group include public administration reforms in South Asia, a greater focus on public sector outputs and their measurement, increased responsibility on the part of executing agencies to design projects, and restructuring and improving municipal management in major cities.

President Sato has stated on many occasions that the relevance of our Bank in the coming years will be measured by much more than just our financial contribution to development. In my view, the Bank will continue to be relevant only if it can help bring about lasting improvement in institutional capabilities of our developing member countries in addressing problems of development.

Finally, I would like to emphasize that good governance is the responsibility of all. There are many here today who have thought extensively about these issues and done work in this area, and we would like to benefit from your ideas and experience. Also it has been demonstrated time and again that involvement of stakeholders is essential for the success of all reform efforts. We therefore hope that this seminar will serve as an important step in building a partnership between our member countries, civil society organizations, and the Bank to promote good governance in the region for sustainable and equitable growth and development.

LAW AND DEVELOPMENT: An Essential Dimension of Governance

Barry Metzger
General Counsel
Asian Development Bank

As the governance debate unfolds, it can be safely said that there is now a general consensus that creation of "an enabling environment" for economic development necessarily implies the need for laws to regulate society and the creation of institutions to ensure consistent application and enforcement of laws. This growing importance of law in the development process is reflected in the increase in the number of law-related projects and the amounts committed for them by both bilateral and multilateral donors in recent years. For example, the latest issue of the *Law and Development Bulletin*, a six-monthly Bank publication that compiles information on law-related development programming in the Asian and Pacific Region, lists 231 law-related technical assistance projects undertaken by the Bank and other multilateral institutions. Yet even this compilation is incomplete because it does not encompass legal components of project, program, and sector loans financed by the Asian Development Bank and the World Bank.

This increased focus on legal dimensions indicates that there is now a far greater realization of the importance of law in the development process than ever before. This can be attributed to a number of factors.

- First, the clarity of the perception that a wholesale revamping of the legal system is necessary to effect the transition from state-planned central economies to liberalized market-oriented economies in such countries as the Cambodia, People's Republic of China (PRC), Lao People's Democratic Republic, Mongolia, and Viet Nam.

- Second, the growing recognition that the private sector and private sector lenders must be encouraged to play a more active role in the development process than was permitted in

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many developing countries during the past thirty years, and that such investors and lenders require a predictable framework of rules in which commercial activity and lending activity can be conducted, including accessible and comprehensive legal rules which are actually applied and the breach of which gives rise to sanctions.

- Third, a realization that the effectiveness of government in implementing development-oriented public policies involves the use of law as an instrument of social change as well as social control, and that inefficiencies in the legal system have been a contributing factor to ineffective development policies.

- Fourth, in some countries the recognition that law and legal process can help protect the citizenry from the excesses of an overreaching state (in the PRC immediately after the Cultural Revolution, in the former Soviet Union under the Gorbachev reforms, and in Eastern Europe, the "rule of laws and not of men" has been a phrase oft-repeated by the leaders of new or reformist governments).

A focus on the legal dimensions of the development process, however, means more than simply the creation of "modern" laws which are accessible, comprehensible, and usable. There is a growing realization that specific legal interventions in the context of the Bank's project, sector, or program lending must be complemented by a more systemic approach to law and development. A systemic approach to law reform involves shifting the focus away from the "black-letter law" of the legal rules toward the institutional capabilities of the legal system, including the judiciary and government administrative and regulatory agencies. It calls for greater attention to the education, skills, and in-service training of the judiciary and government officials staffing legal and regulatory institutions. A systemic approach implies a shift of focus to the resources made available to the courts and regulatory agencies and to the efficiency with which such resources are utilized. The enactment of new legislation and regulations is, in some respect, the easiest part of donor-assisted law reform: it is often relatively short-term work and inexpensive. Institutional reforms and the development of the necessary human resources within such institutions, however, require longer-term commitments and greater resources.

As a step towards a systemic approach, a hallmark of the Bank's recent law-related technical assistance has been an emphasis on (i) continuing legal education for existing professionals, especially in the public sector; and (ii) enhancing the capacity of local institutions to provide training in newly-enacted laws and regulations for a market economy. Two examples of the Bank's approach are

- the Bank's technical assistance in Cambodia, PRC, Mongolia, and Viet Nam, for institutionalizing continuing legal education; and

- the recently approved technical assistance for Mongolia on Restructuring and Capacity Building in the Ministry of Justice.

As the Bank and other donors come to realize the importance of a systemic approach to law reform, an important role they can play is to familiarize developing member countries with "best international practices" in solving common problems often faced by different legal systems. An eclectic approach to law reform which draws upon different international experiences is not altogether uncommon to the region as evident, for example, from the legal systems of South Asia (Bangladesh, India, Pakistan, and Sri Lanka), the PRC, and Japan. Indeed, in the case of Japan, the Meiji Restoration in 1868 saw a remarkable period of 20 years of institutional modernization. Feudal privileges were ended and a market economy was created for land, labor, and capital. And even though there were no foreign donors in the 1860s and 1870s to provide legal technical assistance to the Japanese reformers during the Meiji Restoration, foreign advisers played a significant role. Hermann Roesler, a German, played a significant role in the writing of the Japanese Constitution, which became effective in 1890. Two French advisors, Georges Boussquet and Gustave Boissonade, came to Japan in the 1870s to teach law and became quite active in the drafting of various codes and working with the courts in interpreting various laws. Five major codes were enacted. The enactment of such codes was an ongoing process, as Japanese jurists made efforts to adopt foreign models to Japanese customs and mores. Indeed, the first codes of the Meiji Restoration were generally supplanted within 10 to 20 years by new codes which were viewed as more appropriate to Japanese conditions, though still patterned after European (and particularly German) models.

Law, more than most intellectual disciplines, has been much influenced by foreign models.

Law, more than most intellectual disciplines, has been much influenced by foreign models. In the donor community today we may refer to the search for appropriate models and for the adaptation to local conditions as the application of "international best practice". The same process was at play during the Meiji Restoration, as Japanese jurists sought appropriate foreign models, and then sought to adopt them to Japanese conditions, The same process has been at play in other countries over the course of a far longer period of time and the technical assistance provided by the Bank and other donors is consistent with this historical process and has indeed helped to catalyze this process.

As the Bank and its developing member countries continue dialogue on law and development and other governance issues, experience of countries in which similar problems have been solved will enrich this dialog and assist in the search for workable and efficient solutions to governance issues. I am sure that today's seminar with its distinguished speakers and guests from around the globe will demonstrate the usefulness of such an eclectic approach.

Keynote Address

Governance: Promoting Sound Development

Management Lessons from New Zealand

Ruth Richardson
Finance Minister of New Zealand, 1990–1993

The Honorable ***Ruth Richardson*** *was the first Finance Minister in Jim Bolger's National Party Government in New Zealand (1990–1993), in which capacity she was the driving force behind her country's dynamic reform agenda. Ms. Richardson was first elected to Parliament in 1981. As a member of the opposition, she acted as Shadow Minister of Education from 1984 to 1987, and as Shadow Minister of Finance from 1987 until her party assumed power in 1990. Since completing her fifth term in Parliament in 1994, Ms. Richardson has been in demand as a policy consultant to governments around the world on streamlining governance and public sector reforms. She is currently a Director of Wrightson Ltd and the Aoraki Corporation, and Chairman of Dairy Brands Ltd.*

The quality of a country's economic policy and the integrity with which that policy is implemented are crucial factors for its prosperity. Compared to these factors, natural resources are usually of strictly limited value to a country — a fact attested by the existence of many poor but resource-rich countries, and rich but resource-poor countries. Cultural factors such as the capitalist ethic and civic trust are much more important for prosperity than natural endowments, yet a poor policy framework will still prevent even the most promising cultural conditions from being realized in the best economic outcomes.

It is true that a rich country may often be able to "carry" a poor policy framework for a period of time before its underlying contradictions become too pressing and demanding to be addressed, whereas a poor country with an inadequate policy framework more often and more rapidly reaches crisis point. But rich or poor, a country cannot indefinitely blame inferior economic performance on international trading conditions or other such factors.

At the end of the day, prolonged low growth, high unemployment, high inflation, and indebtedness are effectively political choices.

It is the quality of governance that makes the crucial difference; in particular, the quality of the development management and the policies chosen to advance a nation's economic and social ambitions. At the end of the day — and no matter what the characteristics of an economy — prolonged low growth, high unemployment, high inflation, and indebtedness are effectively political choices.

For instance, a country with high unemployment resulting from inflexible labor market practices effectively makes a political choice to retain its unemployment level. That country could choose — as New Zealand has done — to tackle vested interests through liberalizing its labor market, but instead chooses to opt for the sclerotic status quo.

New Zealand was a rich country which was reduced to "poor country status" by first world standards, as a result of poor policy choices. A heavily overregulated and inefficient domestic economy, high protective barriers, and inconsistent and irresponsible monetary and fiscal policies had caused New Zealand to have the worst productivity growth rate, and the worst economic growth per head, of any country in the Organisation for Economic Co-operation and Development (OECD).

By 1984 we were also approaching crisis point, since the rapid buildup in our Government and overseas debt — another OECD record — had become unsustainable. New Zealand's exports, though growing more diversified, were still dominated by bulk unprocessed pastoral products, essentially a developing country's export base. Our poor economic performance could no longer plausibly be blamed on external influences. We had run out of excuses as an economy, and the need for reform was undeniable.

Reforms in Brief

The New Zealand economic reforms took place under two governments, starting in 1984. In the course of 10 years our economic performance was transformed. Few other countries have undertaken reforms of such far-reaching scope or mutual consistency. As the OECD put it in its latest survey of New Zealand: "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework, stressing predictability, transparency and accountability."

The reforms included:

- The internationalization of the economy through the reduction of border protection and abolition of exchange controls.

- Wholesale domestic deregulation in both goods and factor markets, including major liberalization of the labor market.

- The transformation of Government through the corporatization and privatization of state trading activities, and major performance management reforms to the core state sector.

- The focusing of monetary and fiscal policy on sound medium-term objectives rather than short-term and unsustainable objectives. Monetary policy is now dedicated to price stability and fiscal policy to reduce debt and to run balanced budgets over time.

In sum, the reforms greatly increased the role of market forces in creating wealth, while putting in place a sound macroeconomic framework to ensure that poor monetary and fiscal settings would not compromise the benefits from the new microeconomic climate.

There were two major waves of reform. An initial wave of rapid but uneven liberalization was undertaken by the Labour Government elected in 1984. A second wave of reforms, which included the liberalization the labor market and the reining in of Government overspending, removed the final major anomalies in the policy framework and set the scene for economic recovery. This final wave of reforms was undertaken in the first term of the 1990 National Government, in which I served as Minister of Finance.

A crucial component of New Zealand's reforms was the strong commitment from key political players. The most successful periods of reform were characterized by a clear strategy among ministers, and a consistent application of that strategy throughout the public sector. The poor performance of the economy, and the powerful vested interests opposed to change, meant that a sense of urgency was important in maintaining the momentum of reform.

It is important to place high quality people in key public sector positions to ensure that the vision of the reformers is not frustrated by a bureaucracy resisting change.

Just as important was the placing of high quality people in key public sector positions to ensure that the vision of the reformers was not frustrated during the implementation stage by a bureaucracy resisting change. Effective communication of the rationale for the reforms was crucial. Business needed to understand the overall reform strategy so as to be in the best position to realize its benefits. And a sufficient percentage of the public needed to be persuaded to give reform the benefit of the doubt during a testing initial period when the adjustment costs outweighed any tangible benefits.

Securing the support of key private sector groups to the cause of reform was an important factor in securing public acceptance of the liberalization program. So too was the overall resolve of the Government. As the reforms proceeded, sector groups typically gave up demanding to have their privileges restored, and instead began to urge the Government to treat them evenhandedly by moving to reform those sectors that were not yet liberalized.

After coming through the difficult initial period, the New Zealand economy has now performed so robustly that the reforms have been described by the OECD as "remarkably successful." Since economic recovery began in 1991, growth has averaged between 3 and 4 percent per annum, the unemployment rate has fallen to 5.9 percent (one of the lowest in the OECD), and the Government's budget has swung into surplus, allowing taxes to be cut while simultaneously paying off all Government overseas debt. New Zealand's credit rating has been upgraded.

Surveys such as that of the World Economic Forum have placed New Zealand among the leading nations for competitiveness. **The Economist** has called New Zealand's monetary and fiscal policies "the world's best." The 1996 Survey of Economic Freedom of the World ranks New Zealand as one of the top performers, second only to Hong Kong. And German anticorruption organization Transparency International has named New Zealand the least corrupt country of the 41 it surveyed — a reflection both on our culture and on the degree of economic freedom now possessed by New Zealanders.

With all these favorable outcomes, it is no wonder that the **Financial Times**, in an article entitled *Lessons from the Antipodes* (12 March 1996), stated that "New Zealand has demonstrated that orthodox economic reforms, energetically executed, can make a difference to an economy's prospects. For this reason, it offers important lessons." In my view the most important of these lessons are:

- The value of comprehensive reform. The New Zealand reforms were both microeconomic and macroeconomic. They encompassed capital and labor markets, goods markets and the Government sector.

- The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth (namely an inflexible labor market and Government overspending) had been effectively tackled.

- The value of a medium-term focus. All New Zealand's principal reforms had such a focus.

- The value of political commitment, a clear strategy, and high-quality implementation by key people.

- The importance of effective communication and a sense of urgency in reform.

Rethinking the Role of the State

The New Zealand reforms involved a rethink of the entire role of the State.

The New Zealand reforms involved a rethink of the entire role of the State. Over time, Government in New Zealand had become greatly overstretched: it was undertaking many activities where it had no legitimate role, and was generally doing badly those things that *did* constitute its core functions. Objectives were often confused or conflicting, accountability weak, incentives for efficiency minimal, and management hamstrung by centralized decisionmaking and excessive bureaucratic rules.

The task facing our reformers was to identify those areas where the state had a legitimate role, then determine in each instance how that role could be most efficiently and effectively carried out. This inevitably meant a reduced Government presence in the economy, as well as a transformation in how the State undertook its remaining functions.

The State's roles had included regulating private sector activity, producing many goods and services itself, and providing social services. As regulator, the state has now taken on a much less obtrusive role, though its core function of setting the legal framework against which open and competitive markets can operate remains, of course, a quite crucial function of Government. New Zealand now combines generally sound law with an uncorrupted, independent and relatively competent judiciary, and thus scores highly as an economy where the rule of law is upheld.

The Government has also reduced its role as a participant in economic activity, through corporatizing and privatizing many state trading activities. When it comes to the provision of social services, by contrast, the changes have mostly concerned how the Government discharges that function, rather than involving a reduction in the overall Government presence.

A decade of reforms in New Zealand's public sector has resulted in a model of public sector management that has brought world acclaim. The model starts at the strategic level, where cabinet Ministers decide on their key priorities. As the only participants with democratic legitimacy, ultimately it is only Ministers who can set the desired social and economic outcomes resulting from Government action.

Each year a document is produced setting out the Government's vision of the outcomes it wishes to see achieved in the years ahead. Well in advance of the presentation of the budget, the Government also publishes a Budget Policy Statement — another strategic document incorporating the Government's economic and social ambitions. This document binds the whole of the Government to the published strategy.

In line with the strategy, individual Ministers in turn choose the outputs they wish to purchase from their departments and from other State entities in order to help realize the outcomes sought by Government. The chief executive of each department is responsible for providing the relevant Minister with the contracted outputs.

The chief executive is on a fixed-term contract, and has wide discretion to manage departmental inputs — including labor. Labor practices are flexible, with unionism voluntary and a large percentage of state sector workers covered by individual contracts (also the case in the private sector). Pay-by-performance is commonplace. Often tasks are contracted out to private sector organizations that can perform the function more efficiently; there is no presumption that Government is the preferred provider.

Besides purchasing outputs, the Government also has an ownership interest in the assets tied up in Government agencies. In the core state sector, each department must calculate a balance sheet, and a system of capital charging has been introduced. These twin disciplines provide a powerful incentive for departmental chief executives to manage their balance sheet so as to make the most efficient use of their assets.

But it is the area of state trading activities where the Government's ownership interest has been most radically reassessed. Prior to the reforms, most trading activities were contained in governmental departments, facing poor incentives, bureaucratic controls, and often mixed objectives. Service was notoriously poor, and many activities ran permanently at a loss. Under the reforms, these activities were separated into distinct organizations, becoming state-owned enterprises (SOEs).

SOEs are registered under the Companies Act and are required to operate in most respects as private companies. They have a clear profit objective and their boards are largely free from political control. They must borrow on their own account and pay tax and dividends to the Government. Nor are they shielded from facing private sector competition. Day-to-day running of an SOE is in the hands of its board and management.

The shares are held by two ministers. The sole task of the shareholding ministers is to manage taxpayer ownership interest by appointing the board, setting dividend policy, and monitoring overall performance. Under the improved incentives provided by the new regime, there were some huge productivity increases following corporatization, some big real price reductions and some rapid transformations into profitability on the part of SOEs.

While these developments were welcome, in the case of the great majority of SOEs, there were strong economic reasons for taking the further step of transferring the business to the private sector. Only in the private sector would productivity be maximized, and each business be best placed to undertake new investment. Corporatization was a halfway house, and the performance incentives and monitoring mechanisms under Government ownership, while much improved, still did not match those available in the private sector, where shares were freely tradeable and companies subject to takeover.

There was also a genuine risk of policy slippage over time. Political fashions can change, and commercial considerations can easily become subordinated to political considerations once again, given the often short time horizons of the political process. The slow infiltration of politics into SOE policy can be manifested in terms of soft required rates of return, interference in key decisions such as pricing, or excessively political board appointments.

For all of these reasons, a major privatization program was undertaken in New Zealand. Policymakers were insistent that prior to any privatization the market must be deregulated, e.g., telecommunications, banking, and transport. Most of the sales were by open tender and it transpired that all were trade sales. Since the objective of the program was to maximize return to the taxpayer, very few restrictions were placed on who could enter the bidding.

In a highly successful series of sales, around NZ$14 billion in assets were privatized — many to overseas interests. Proceeds from the privatization program were dedicated wholly to the retirement of Government debt.

The wholesale separation of commercial functions from other functions of governmental departments has been one aspect of an overall program of restructuring the public sector so as to make objectives and accountability more unambiguous. Thus the provision of policy advice has typically been separated from

The provision of policy advice has been separated from the operational functions of departments, and the funding of activities has been separated from their provision.

the operational functions of departments, partly to remove any conflict of interest from those involved. For similar reasons, the funding of activities has been separated from their provision.

Regulatory functions have also been isolated into separate agencies. In any given area of policy, a small ministry is likely to be giving policy advice, and other agencies acting as purchaser or provider. Almost the whole of the public sector has been restructured along these lines.

Any government that takes seriously its role as purchaser of outputs and as owner of assets will put in place sound systems to measure performance. After all, if you cannot measure it, how can you manage it? Here, too, the New Zealand public sector performance management model leads the world. Information requirements right through the public sector are substantial. In line with the new stress on outputs, all departmental reporting and financial accounting is on an output basis.

At the aggregate level, the New Zealand Government now calculates an annual operating statement on an accrual basis, as well as a consolidated balance sheet for the whole of the State sector — the only country in the world to do so. Fiscal projections are also open and transparent. By law, the Government must produce and publish twice-yearly economic and fiscal projections, including a set of forecasts just prior to each general election.

The Government has gone further by binding itself to conduct fiscal policy in line with certain specified principles of responsible fiscal management. These principles are contained in the Fiscal Responsibility Act 1994, which I introduced to Parliament as Minister of Finance. The principles include running balanced budgets over the course of the business cycle, reducing debt to prudent levels, and pursuing policies consistent with a reasonable degree of predictability in future tax rates.

Any departure from the principles must be temporary, and must be accompanied by a published strategy for ensuring that fiscal policy soon complies again with the principles of responsible fiscal management. Thus the Fiscal Responsibility Act still allows an elected government to make a full range of expenditure decisions in line with its social priorities, but prevents irresponsible deficit financing which damages economic growth and subordinates long-term to short-term considerations.

Principles of Good Governance

The Asian Development Bank has stressed four key principles of good governance — accountability, transparency, predictability and participation. In the concluding section of this paper I add a fifth: *credibility*. The New Zealand public sector reforms rate highly on all of these principles.

1. Accountability

In New Zealand, accountability has been enhanced at all levels. Departmental chief executives are now directly accountable for their performance in delivering their departments' outputs, and even ordinary employees are more accountable than under the old union-dominated state sector. The outputs of a department are now clearly specified. Both Ministers and the wider public can see what they are buying, how much it costs, and who is responsible.

Privatized SOEs now face the disciplines of the competitive marketplace. SOEs that for various reasons have not yet been privatized still face much increased accountability: shareholding ministers seek an economic rate of return on the taxpayers' assets, and are empowered not to reappoint directors after their terms have expired.

There are other means by which accountability in government can be strengthened. Free and open financial markets are an important ally of good government. They sit on daily judgement over a country's economic policy, and bring home to a government visibly, and rapidly, the medium-term consequences of poor policy. Where asset prices appear misaligned, they usually reflect underlying imbalances in economic policy. By so doing, they put pressure on policymakers to address those imbalances.

In New Zealand, the liberalization of exchange controls and interest rate controls in the mid-1980s, along with the clean float of the New Zealand dollar, played an important role in encouraging governments to adopt prudent policies — especially in the area of fiscal and monetary policy.

2. Transparency

Clear operating rules and a free flow of information assist economic decisionmaking, reduce uncertainty, and increase confidence in the legitimacy of a government.

The New Zealand model rates equally highly in terms of transparency. Clear operating rules and a free flow of information assist economic decisionmaking, reduce uncertainty, and increase confidence in the legitimacy of a government (whether democratic or not). New Zealand has an Official Information Act [1982] policed by an independent Ombudsman. That legislation sets down the general principle that information should be made available in the absence of compelling reasons otherwise.

Crown-owned entities report regularly to Parliament, while New Zealand's fiscal reporting is the fullest in the world. The Government's overall fiscal strategy must be disclosed in accordance with the requirements of the Fiscal Responsibility Act.

Other important arms of economic policy typically operate also under substantial transparency requirements. For instance, the Reserve Bank Act 1989 unambiguously sets down "stability in the general level of prices" as the principal goal of New Zealand's central bank. A public Policy Targets Agreement between the Minister of Finance and the Reserve Bank Governor details how the Bank will perform its function of maintaining price stability.

The Bank has day-to-day operating autonomy. However, twice-yearly it must produce a detailed monetary policy statement, which is tabled in Parliament and examined by a parliamentary select committee. A government can temporarily direct the Reserve Bank Governor to conduct monetary policy in accordance with an aim other than price stability, but such an action (which is most unlikely to occur) must again be transparent: any such "override" would need to be tabled in Parliament.

3. Predictability

Where policies are transparent and accountable they are also likely to be predictable in their impact. Thus it is in New Zealand. Monetary policy furnishes a good example: the operational autonomy of the Reserve Bank, its single and explicit objective, and the transparent contracting between Government and Bank lends policy a high degree of predictability. This predictability came about through explicit design: the more credible the Government's commitment to price stability, the lower the inflation risk premium in interest rates, and the more confidently will business be able to invest in the expectation of a low inflation environment.

Similarly, the transparency and medium-term focus of New Zealand's public sector management model lends fiscal policy increased predictability.

The requirement in the Fiscal Responsibility Act to run a balanced budget over the course of the business cycle, along with the high level of information disclosure required by the Act, is an explicit mechanism for entrenching sound fiscal outcomes over time. Governments are under constant short-term pressure to run fiscal deficits.

But so long as the Fiscal Responsibility Act remains in place — and it is supported by all but one minor party in parliament — business can be confident that fiscal policy will be conducted in a responsible manner. Already the Act has helped change the nature of political dynamics and the wider policy debate: the current coalition government wishes to be seen as "fiscally responsible" in terms of the legislation, while the private sector regards compliance with the Act a key aspect of responsible economic management.

4. Participation

Participation is a principle rightly stressed by the Asian Development Bank. One of the features of a market economy is that it is a vast network of participation on a voluntary basis. Every consumer is a voluntary participator, as is every producer, every investor, and every worker who uses the opportunity provided by a free labor market to gain employment. Clearly the quality of those participations will be greatly improved where there is strong civic society.

Government cannot itself create civic society, but the quality of its own participation can make a big difference to the success of an economy.

Government cannot itself create civic society, but the quality of its own participation can make a big difference to the success of an economy. In New Zealand prior to the economic reforms, participation by Government was far too obtrusive and largely of the wrong sort. Government did everything from running financial institutions to participating in tripartite wage-setting decisions (employers, unions, and Government) that were the proper preserve of the relevant private sector players. The predictable outcome was poor economic performance.

The Government now participates in the economy to a much reduced extent, but with greater effectiveness. All governments have a crucial role in assisting private sector participation by upholding the rule of law, allowing the free flow of information in both public and private sectors, and making the rules of the economic game as transparent as possible. As we have seen, the New Zealand model performs well on these criteria.

Shortcomings of the New Zealand Reforms

Not all of the New Zealand reforms have been of the same quality. In two sectors in particular — health and education — policies have so far lacked the coherence and boldness of most other elements of the reform program.

Health and education are politically sensitive sectors where powerful vested interests make progress particularly difficult. In reforming these services, there has been some limited progress in putting in place better supply side structures, but hardly any in introducing greater choice on the demand side. As a result, improved outcomes have been limited, and widespread public dissatisfaction with these services persists.

In restructuring New Zealand's publicly-funded hospital sector, moves were at least made towards greater accountability and transparency by (i) separating the funding of hospital services from their provision, (ii) by setting up hospitals on a more businesslike basis, and (iii) by explicitly contracting for hospital services. But for political reasons, the Government has been relatively weak in demanding high-quality performance from the hospital sector. Moreover, there is still relatively little competition in the health system, either between public health care providers or between the private and public sectors.

The Government shelved a plan to let individual New Zealanders effectively take their share of public health funding and use it to purchase their own private health care plans. Thus an initiative that would have broken up the uncompetitive and monolithic public health service by allowing individuals greater choice and participation did not in the end proceed.

In the field of education, a similar unwillingness to adequately think through the Government's role from first principles has been experienced. While there are good reasons for the Government to fund schooling, there is no reason why the State should itself provide schooling directly.

Such a task can be most effectively left to private sector incentives and disciplines through a voucher system or similar scheme. Unfortunately, in New Zealand we are still at the stage of attempting to make Government-run schools work better. That is inevitably a difficult task in a sector noted for its inflexibility, unresponsiveness, and dominance by teacher unions. While some limited improvements have been introduced, genuine parental choice and the ability to participate as a consumer of education remains largely unrealized.

The lesson from New Zealand regarding health and education is that deviation from sound first principles will result in unsatisfactory outcomes. As in other areas of policy, halfhearted reform sells the public short. Only by bringing about maximum choice on the demand side, so that control passes from producer to consumer, will we make progress of similar quality to that elsewhere.

Conclusion

We possess a considerable body of theory and international evidence concerning the role of government, and the type of policy regime that most encourages economic development. Too often, however, political considerations and the demands of vested interests prevent a government from acting in a manner consistent with sound outcomes.

Too often, political considerations and the demands of vested interests prevent a government from acting in a manner consistent with sound outcomes.

We know that open and competitive markets are the most effective generators of wealth over any reasonable period of time. The role of Government is to support markets by maintaining a consistent and predictable legal framework, involving few restrictions on contracting and maximum transparency in the conduct of economic policy. While this may sound a comparatively minor task for government, it is a crucial role which is performed well by few countries anywhere. One of these countries is New Zealand.

Credibility

Much that is important in governance ultimately comes down to the issue of credibility. Does the government adhere to a consistent set of principles, and pursue policies that are not in contradiction with each other? Can private sector participants make decisions in the confidence that the government will act predictably in given circumstances? And at the level of implementation, will policies be carried through in a manner consistent with maintaining and strengthening the entire culture of a market economy?

New Zealand's reform program largely meets these tests of credibility. For instance, by making fiscal policy more predictable, transparent, and accountable, the Fiscal Responsibility Act has improved the credibility of Government, transformed the nature of the political debate on fiscal policy, and assisted materially in generating better private sector performance.

Institutional Design

These outcomes from the Fiscal Responsibility Act illustrate how improved institutional design has a positive impact on the behavior of participants in the economy, both in the public and private sector. Many other New Zealand institutional reforms also demonstrate this principle. For example, the discipline provided by the Reserve Bank Act has led successive governments to pursue price stability in preference to policies that favor the short term at the expense of the medium term. That Act has also changed private sector behavior by reducing inflation expectations and business uncertainty.

The new institutional framework under the State Sector Act 1988 and the Public Finance Act 1989 promoting a performance management regime involving accountability and transparency throughout the public sector — such as the requirement to produce a departmental balance sheet — has improved performance at all levels.

And in the labor market, the change in framework under the Employment Contracts Act 1991 from centralized bargaining to free contracting has led to big cultural changes at the level of the firm, in the form of greater cooperation between employers and employees, increased flexibility, and reduced industrial conflict. Correct design of the institutional framework clearly makes a big difference to economic performance.

Good governance is epitomized by a framework of policies that are consistent, transparent, predictable, and credible.

Good governance is epitomized by a framework of policies that are consistent, transparent, predictable, and credible. The State should not attempt to perform tasks that are the proper province of the private sector, but should rather provide the overall climate within which markets can flourish.

Private sector participants, for their part, must be prepared to take the lead in investment decisions, and look to their own skill and resources in the search for higher productivity, rather than seek to be rescued by government rules that confer privilege on them while raising costs on others. And private sector participants must observe the legitimate rules of competitive markets and stay within the law.

A policy regime that realized this partnership with a high degree of effectiveness would look like this:

- A monetary policy aimed at price stability, and an institutional mechanism — such as New Zealand's Reserve Bank Act — that effectively locks price stability into the economic framework.

- Fiscal policy that does not attempt to be actively counter-cyclical, but which aims to run balanced budgets over the course of the business cycle — preferably with an institutional mechanism such as New Zealand's Fiscal Responsibility Act as a means of cementing in good fiscal behavior.

- A government sector that is only performing those functions that could not more efficiently be performed by the private sector, and is undertaking those tasks in as efficient, transparent, and accountable a manner as possible. Commercial businesses belong in the private sector.

- A tax system where low rates of tax are conferred over broad tax bases.

- Open and competitive markets without price controls or monopoly powers conferred by statute.

- No trade barriers. If import protection is deemed necessary, tariffs are generally preferable to quantitative controls. Rates of tariff should be as even as possible to minimize distortions.

- Open, competitive, and lightly regulated capital markets, including an inward investment regime that welcomes foreign capital.

- A labor market where there is complete freedom to contract between employer and employee (and freedom to form associations voluntarily).

- Most important of all, clear and consistent laws that participants in the economy can be confident will be upheld in the courts. Strong property rights and an independent judiciary free of corruption are two vital elements of the machinery that is necessary to support markets.

There is no easy recipe for economic success. But the global lessons — whether from the spectacular emergence of East Asia or the radical reform of New Zealand — are the same. More important to sound development management than anything else is the successful combination of good governance and sound economic fundamentals — stable macroeconomic management, investment in people, open markets, and allowing prices to reflect economic scarcity. For most countries, realizing such a template of policies would require a substantial adjustment in how the government sees itself —

from government-as-controller to government-as-setter of the framework within which markets can operate. But the lesson from New Zealand and other countries is that such a transition is possible, and that the economic and social benefits abundantly repay any transition costs. All that is required is the political will.

The lesson from New Zealand is that such a transition is possible, and that the economic and social benefits abundantly repay any transition costs. All that is required is the political will.

The Role of the Government in Dynamic Economic Development Process

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Behind the Asian Miracle

For a very long time, a successful economic development of Asian countries was considered to be an extremely difficult, if not impossible, task. The efforts required to change Asia's social, economic, and possibly psychological structures seemed so daunting that, about 30 years ago, no sensible scholar expected the remarkable progress in the region which was to come. Thus, when an eminent economist and sociologist of Sweden, Professor Gunnar Myrdal, predicted an extremely bleak outlook for Asia in his book **Asian Drama** (1968), nobody questioned his proposition. He mainly focused on Burma (now Myanmar), Ceylon (now Sri Lanka), India, Indonesia, Malaya (now Malaysia and Singapore), Pakistan, the Philippines, and Thailand.

A quarter of a century later, however, the World Bank, the leading multilateral development bank, published a book, **The East Asian Miracle: Economic Growth and Public Policy**, in which it detailed the extraordinary economic development of East Asian countries. In the book, the World Bank told the world the story of how eight countries and economies in East Asia — Hong Kong, China; Indonesia; Japan; Republic of Korea; Malaysia; Singapore; Taipei,China; and Thailand — had succeeded in attaining rapid per capita income growth. From 1965 to 1990, the per capita income in these countries grew at an average annual rate of 5.5 percent. These eight economies grew roughly three times as fast as Latin America and 25 times faster than Sub-Saharan Africa. The World Bank also found that income distribution in these countries improved during the period. In recent years, other Asian countries such as People's Republic of China, India, Lao People's Democratic Republic, Sri Lanka, and Viet Nam have also been recording high growth rates.

Various factors have been conducive to the Asian Miracle, among them the strenuous efforts of the people and well-chosen governmental policies. One can look at these success stories both as the results of sound development management and as examples of good governance.

The Role of the Government as a Center of Governance

Though there are many aspects to what we call governance, I think the role of the government in development process is at the center of the issues. If Asian success stories are partly the result of successful governmental policies, as they are certainly are, there should be right answers, or at least clues to right answers, pertaining to the proper role of the government for successful economic development in the experiences in the region.

Thus, in spite of the fact that the role of the government has become a popular subject, a subject that many eminent scholars and officials have recently addressed, I am much tempted to focus on the role of the government when we discuss the issue of governance.

Traditional Dichotomy in the Analysis

I believe that the traditional dichotomy in which the role of the government has been studied is thus far insufficient. It seems that, in discussing the role of the government in the literature of economics, people tend to put forward their argument, explicitly or implicitly, based on dichotomy in many ways.

For example, many economists argue that governmental measures are discretionary and oppose market forces. The assumption is that the government always acts against market forces and that the government and the private sector are each other's enemy by nature. The popular expression "market-friendly government" is only possible if you assume that the government and the private sector are opponents by nature.

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However, as I take up in detail later, the government and the private sector have common goals in many areas. For example, they have common interest in realizing a high growth with low inflation. Realization of safe and comfortable life for people should also be one of their common aims. Indeed, as the government is chosen, directly or indirectly, by the people, it is wrong to assume that the goals of the two are different, let alone that they are opponents.

Many economists argue that government policy measures are by nature against market forces and that its discretionary intervention in the markets is to be avoided as much as possible. Not necessarily. Markets fail for various reasons. Contrary to assumptions made by many economists, information is not equally shared, market participants are not always rational, and they are not always experts on the subject. Sometimes, market forces point to short-term interests, which may not coincide with long-term, hence ultimate, interests. Furthermore, the existence of externalities and the infant industry argument are also used to verify the insufficiency of market forces. In such cases, interventions by the government are called in for the benefit of the society.

Based on the experience in Asia, or indeed in any region where success has been achieved in economic development, policy recommendations and specific policy measures based on such dichotomy are essentially mistaken.

The government and the nongovernment sectors have basically common goals. As I argue later, they have to work together to identify optimum development policy aims for their country and policy measures to attain these goals.

In sum, so long as we base our analysis on false assumptions — that the government is a necessary evil, that the government and the private sector are enemies by nature, and that the smaller the government, the better — we may not be able to realize the full potentialities of the country.

Government Industrial Policy

Next, let me touch on the often undue criticism of, or prejudice against, government industrial policies. There are many cases in the region where governments have taken proactive roles in introducing strategically important industries to their countries. Also, one may encounter occasions when governments have helped those sectors with potential comparative advantage in the economy. Some of these policies were successful and some were not.

Indeed, it is not an easy task to support specific industries with both comparative advantage and strategic importance for the development of the country. It is important to avoid making mistakes in the following three processes.

- **Policy aims or policy targets.** The target of the industrial policy should be correctly chosen. One must examine which industries are worth supporting under the circumstances surrounding the country. That specific industry should have comparative advantage in the country. Also, one should estimate whether, by the time the specific industry matures, its competitors in the rest of the world would have become more competitive or not. The choice of the industry must also reflect the present. A strategically important industry in 1950s may not be the same in 1960s. Even if your neighbor was successful in choosing the shipbuilding industry for a strategically important sector in the 1960s, you may be unsuccessful choosing the same industry in the 1970s. The correct choice of policy targets is not easy.

- **Optimal policy measures.** Realization of the specific policy targets under specific circumstances should be optimal. Again, the choice is not easy. Countries are different in endowment. Demographic structures are different. Educational systems are different. Social structures are different. Indeed, the cultures themselves are different. You must find optimal sets of policy measures that best fit the country at the time. There is no guarantee that measures adopted in other countries are suited for your country.

- **Timely implementation.** Even if policy aims are correctly chosen and the measures best suited for the country, failure to implement the measures in a timely fashion cannot ensure the expected results. Factors such as political complications, social disturbances, and social unrest can prevent timely implementation of the measures.

In sum, industrial policies may fail should any of these three processes fail.

The important point is that cases of failure should not be quoted as evidence of the ineffectiveness of industrial policies. Such cases only exemplify the difficulty of satisfying all three conditions at the same time. We should not confuse the case of failure of a specific industrial policy with ineffectiveness of the policy per se in economic development.

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Unfortunately, however, many arguments are found in the literature of development economics where these two are not distinguished. By quoting failure examples of specific policies of specific countries, the argument is often made that because industrial policy per se is ineffective, a case can be made for a smaller role for the government.

The Time Factor

A need exists to incorporate the time factor fully in policy for successful economic development. The role of the government can be more positively evaluated if the time factor is taken into consideration.

In other words, development policy should be formulated based on dynamic terms so that consideration of time is considered in various aspects. So far, dominant development policy has been based unsatisfactorily on comparative statics, which is extremely insufficient, because economic development policy aims at growth over a period of time.

Traditional theory assumes that in developing countries, the existing circumstances are fitted to economic development as in developed countries. In fact they are not.

The traditional theory of economic development does not assume change over time. And yet the aim of economic development policy is to realize changes (i.e., to attain faster growth with more equitable income distribution).

It assumes that a country's citizens have a constant set of indifference curves, or tastes, that ensure growth, and that the purpose of economic policy is to realize successful development based on that set of indifference curves.

They may be wrong. For successful development, the indifference curves must be addressed. Tastes must be changed. For that purpose, the government has a role to play.

For example, for a sustainable economic development, you have to agree that savings are important and that a higher savings rate is desirable. To attain a higher savings rate, people have to reduce their consumption patterns. In order to do that, the government can offer a forum through which people understand the need for change in consumption patterns. The government has to create environments which help people save more. A countrywide network of savings institutions would help, as would incentives for savings.

The traditional theory of economic development argument also assumes that conditions are the same in different countries. It implicitly assumes that in developing countries the existing circumstances are fitted to economic development as in developed countries. In fact they are not. Underdevelopment is partly the result of the existing environment. For economic development, the surrounding circumstances must be changed, and the government has an active role to play, either as a prime mover or as a mediator.

Another shortcoming of traditional economic theory is that it does not take into consideration the time required for successful economic development. Because the attainment of high growth from an undeveloped starting point requires considerable time, the coverage of development policy should be long enough to realize it. The time required for attaining success varies depending on the specific policy aim. If it is desirable to reduce demand in order to cope with external imbalances, i.e., deficits in balance of payments, government expenditure must be reduced, taxes increased, and monetary policy tightened. The effects of these policies will become visible after about six months.

If the economic structure itself is changed, e.g., deregulation of markets, the positive effects will reveal themselves after two or three years.

It takes many years to change people's behavior. Sometimes it is necessary to wait a long time for demographic changes to occur.

These considerations underscore the importance of incorporating a time factor in the establishment of a successful economic development policy, which in turn highlights the importance of the role of the government.

The Role of the Government in Dynamic Development Process

The government has a very important role to play in the dynamic development process.

First, in choosing policy aims, the people, and indeed the government itself, might not fully know which policy aims are best suited to the attainment of long-term growth. The government is in a position to show people alternative policy aims based either on their own analysis or following the advice of such multilateral development banks as the ADB. People in the private sector may well have different ideas. The government then can offer opportunities to exchange views on policy aims through establishment of a board. Through discussions on the board, which are open to the public, both the government and the people can deepen the analysis for desirable policy aims. The general public will understand what is at stake and offer comments on the issues taken up on the board. Public participation is popular and makes people conducive to selecting choices likely to be successful, and ultimately, to supporting the implementation of measures that will realize the policy aims.

Second, a similar role is expected for the government in choosing policy measures. The government may propose specific measures or offer opportunities to find the best measures to realize the policy aims. Because policy measures largely hinge on cultural, economic, and social structures of the country, successfully reflecting the will of the people is important, and the government can play a vital role.

Third, for timely and successful implementation of these policy measures, the role of the government along the lines described above is expected. If the people have good understanding of the legitimacy of policy aims and the need for the policy measures to realize them, these measures will be timely implemented, and a successful development policy will then be assured.

Observed from a slightly different angle, the government has also important roles to play in the dynamic development process.

Governments must ensure economic, social, and political stability. Only in a stable country can people establish the medium- and long-term plans essential for sustainable growth, and hence for the economic development of the country.

Thus, in the dynamic economic development process, the government is expected to play a more important and positive role than that preached by traditional theory.

It is noteworthy that in order for the government to play these expected roles sufficiently in the dynamic development process, the participation of the people, the predictability of the system, and the transparency of information — all important ingredients of good governance — are essential.

In the dynamic development process, the participation of the people, the predictability of the system, and the transparency of information — all important ingredients of good governance — are essential.

Public Administration Reforms in Malaysia: A Developing Country Perspective

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Since attaining its independence in 1957, Malaysia has seen a remarkable change in its public service organization. The reforms that the Malaysian civil service has undergone as part of the country's national transformation are nothing less than phenomenal. Through a series of innovative changes and a perceptive reorganization, Malaysia's civil service has been transformed from being a caste apart from the public into an organization dedicated to serving and meeting the needs of the public. This paper explores the circumstances that led to the metamorphosis of the Malaysian civil service and the values that brought it about. It also examines the policies and practices underpinning the political and economic framework of the country since independence, and how these led to an administrative reformation.

Background

A brief description of the Malaysian bureaucracy since independence is necessary in order to appreciate the administrative reforms and changes that have since transformed the Malaysian civil service to its current dynamic position. When Malaya achieved her independence from the British on 31 August 1957, the country inherited a new independent Government based on parliamentary democracy similar to that of its previous colonial rulers.

Tunku Abdul Rahman, the country's first Prime Minister, began to lay the foundation for the systematic administration of the new nation. The Federation of Malaysia was formally established on 16 September 1963. It consists of the Federation of Malaya in Peninsular Malaysia and the states of Sabah and Sarawak on the island of Borneo in East Malaysia. Demographically, the population of Malaysia is composed of three major ethnic groups: Malays

(12 million), Chinese (5.3 million), and Indians (1.5 million).

In the initial stages of its economic development, the country was dependent largely on its exports of raw materials such as rubber, tin, timber, palm oil, and pepper. Today the country is moving fast toward an industrialized economy.

The supreme head of Malaysia is the Yang di-Pertuan Agong (the nearest western equivalent is "king" or "sovereign"), who serves a five-year term as both the Head of State and the religious head of the official religion, Islam. According to the Constitution, every act of Government flows from his authority, although he acts on the advice of the Cabinet.

Malayanizing the Bureaucracy

Like all developing countries in Southeast Asia that obtained independence from colonial rule, Malaya adopted an "ization" policy in the civil service. The Malayanization program was carried out in stages with generous compensatory terms, thus preventing an exodus of expatriates. In many cases, an expatriate was requested to retire only when there was an understudy to replace him/her. This process of replacing the expatriates while enlarging the bureaucracy made for smooth transition, and the Malayanization process was less painful than the experience of other former colonies where no such preparations were made.

In 1957, expatriate officers staffed 67 percent of all Malayan Civil Service posts (about 1,564 officers). By early 1963, only 9.2 percent of the expatriates (24 officers) remained.[1] In the technical and professional fields, the Malayanization process was

[1] Tilman, R.O. 1964. *Bureaucratic Transition in Malaya.* Durham, N.C.: Duke University Press.

extended over a much longer period, as there were limited numbers of local officers to replace the expatriates, and training first had to be expanded. By 1980, there was almost a 900 percent increase in the size of the bureaucracy.

The Need for Administrative Reforms

After independence, the role of the civil service remained relatively unchanged. In the late 1960s, however, strong pressure was exerted upon the civil service to increase its performance and play a more developmental role.

Fresh from the triumphant general election of 1964, the Alliance Government sought to fulfill its promises of increasing the welfare of the citizens and raising the standard of living of the masses. It appeared, however, that the burdens the bureaucracy had been asked to shoulder since Independence had increased more rapidly than their capabilities. So, in 1965, the Government of Malaysia obtained the services of a team of consultants to undertake a review of the public administration. This was the first time in the history of the public service that a deliberate attempt was made to study the administrative systems of the country with a view to suggesting reforms and innovations. The main objective of the study was, "to improve the administrative system and achieve efficiency and administrative leadership in the public service to meet the needs of a dynamic and rapidly developing country."[2]

This was the first time in the history of the public service that a deliberate attempt was made to study the administrative systems of the country with a view to suggesting reforms and innovations.

The Report recommended improving administrative systems by speeding government action, reducing costs, and improving the quality of service.

[2] Montgomery, John D., and Esman, Milton J. 1966. *Development Administration in Malaysia.* Kuala Lumpur: The Government Printer.

Proposal for Government Action on Administrative Reforms

As a result of the study undertaken by the consultants under the Ford Foundation, a proposal for reformation of the Malaysian public service was recommended. The most important proposals drew attention to the need for three major governmental actions.

- Creation of a Development Administration Unit in the Prime Minister's Department, staffed by professional management analysts. This Unit would plan and guide the major problems of administrative improvement. It was intended that the Unit would focus on Government-wide systems, such as those involving personnel and career development, budgeting and expenditure control, procurement and contracting. It would also help the various Government departments and statutory bodies plan and implement their own management improvement activities.

- Improvement of the Government's education and training programs for all levels of the civil service. One such program was the creation of a graduate study program in development administration at the University of Malaya. Also, it suggested that mid-career university-level education should be provided to professional officers. Finally, it envisaged that expanded in-service training facilities should be made available to technical and clerical staff, and that periodic seminars be held for senior officials.

- Strengthening of professional competence of the civil service so that it could provide the

> necessary administrative leadership for the rapidly developing country. This called for a post entry university course in development administration for all newly selected officers.

The Report was accepted by the Government, the Development Administration Unit (DAU) was set up, and began functioning in November 1966. Training programs for all levels of the civil service were introduced and the professional capabilities of the administrative officers were strengthened.

During the 1960s, the bureaucracy faced many problems while implementing rural development programs. The then Prime Minister, Tun Razak, was prompted to equate them as the "seven deadly sins" of bureaucracy. These were:

1. interdepartmental jealousy in the course of day-to-day execution of governmental functions and conflicting departmental policies;
2. a lack of coordination between departments in what they were trying to do in the rural areas;
3. a complete lack of cooperation between officers on the ground, mostly due to a lack of understanding of each other's tasks;
4. every department thinking its actions were the most important;
5. a lack of proper planning in various departments resulting in an unfit master plan for the rural areas;
6. a lack of a master plan at all levels for the purpose of achieving the maximum development of rural areas; and
7. a lack of sufficient directive control at the top to ensure that Government in the rural areas functions as an efficient machine manned.[3]

[3] Fisk, E.K. 1963. *Features of the Rural Economy*, in T.H. Silcock and E.K. Fisk (eds.). *The Political Economy of Independent Malaya*. Canberra: Eastern Universities Press.

The Operations Room Technique

The "seven deadly sins" created bottlenecks in the Government administrative machinery and slowed down economic development.

These "deadly sins" created bottlenecks in the Government administrative machinery and slowed down economic development. It was imperative that administrative reforms of the entire civil service should also impact positively upon administration of the rural sector and enhance improvements of the whole economy. It was then that the Operation Room (OR) technique was mooted as an administrative effort to foster rural development. OR comprised several mechanisms such as the Committee System, the Operations Room, the Red Book Plans, the Briefing Method and Field Inspections, as well as the Adult Education and Community Development.

The OR technique was a successful mechanism for improving communication and coordination within the planning organization. It operated especially well at district levels. For minor rural projects, the system circumvented the authority of the state, and gave direct supervisory and responsibility to district committees, though it also allowed for accountability at the state level. For minor rural projects, the system facilitated both funding and spending for the development projects.

The technique also boosted team spirit and cooperation between generalists and technical personnel. Both served as one team and as a result, they perceived rural development as a common objective. The system also helped foster relations between civil servants and politicians. By mobilizing their close cooperation towards a common goal, it promoted greater understanding of the roles of different sectors in rural developments. In this way, the conflict between bureaucrats and politicians that had previously existed at the state and local levels was minimized.

There were several factors contributing to the considerable success of the OR technique. The single most important factor was the top level directional control exercised by Tun Razak, who exerted control both at the ministerial level and at the local and state levels. In 1976, changes were made in the OR Technique, including new monitoring techniques and more provision for feedback from less developed states.

The Process of Administrative Change — The First Phase

While the OR technique concentrated on speedy rural development, DAU concentrated on the major systems of the whole Government administration. After having operated for a few years in its original form, in 1972 DAU and its functions were incorporated into a new body, the Implementation, Coordination and Development Administration Unit (ICDAU). ICDAU was responsible for coordinating the government's policies in all departments and agencies and improving administrative methods.

The role and mandate of DAU in instituting administrative reform, however, was not clearly spelled out in the new body. Moreover, DAU was eclipsed by emerging needs and the urgent task of expediting and coordinating the implementation of development policies.

Important changes were therefore made in 1976. The development administration part of the ICDAU was transferred to the National Institute of Public Administration. The objective of the new institute was to develop its capacity for management auditing and to offer management consultancy services to public corporations for closer coordination of their operations. The remaining functions of the ICDAU were to be performed by the Implementation Coordination Unit (ICU).

Second Phase of Malaysian Administrative Reforms — The Establishment of MAMPU

While the establishment of DAU and ICDAU provided the first phase of administrative reforms and their foundation, they outlived their roles in meeting the urgent requirements of expediting and coordinating the implementation of development policies. The administrative machinery faced increasing demand on its capacity with greater complexity and a multifold increase of administrative functions.

By 1977, the urgent demands for improving the effectiveness of the civil service resulted in the establishment of the Malaysian Administrative Modernization and Manpower Planning Unit (MAMPU). The background to the setting up of MAMPU can be traced to Dr. Mahathir Mohamad, then Deputy Prime Minister. Dr. Mahathir was responsible for initiating the establishment of MAMPU, while the writer of this paper was given the onerous responsibility of conceptualizing the structure, functions, and role of this new organization.[4] The concept paper of this dynamic organization was accepted when presented to Dr. Mahathir, and soon MAMPU was established and supported by the political leadership as the unit for modern administrative reforms in the Malaysian civil service. MAMPU was established after cabinet approval through Cabinet Paper no. 207/1079/97.

MAMPU was located in the Prime Minister's Department to give it sufficient political leverage to carry out directed programs of reform. There were two main tasks of MAMPU in carrying out administrative modernization and human resource development. The objectives were (i) to provide management consultancy services to Government organizations;

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[4] Abdullah Sanusi Ahmad, 1994. *Perkembangan Pentadbiran Awam dan Pengurusan* (Development of Public Administration and Management), Kuala Lumpur: Dewan Bahasa dan Pustaka.

(ii) to carry out administrative reforms, update public administration, and strengthen administrative capacity for implementing national economic plans effectively; and (iii) to coordinate activities on human resource planning and human resource development and deployment. MAMPU successfully initiated and instituted changes in the area of field administration, and dedicated itself to the creation of a model district office to improve the delivery of services to the people at the grassroots level. At the same time, MAMPU mooted the master plan for human resource planning and budgeting at the national level. These actions were in line with its establishment objectives of spearheading administrative modernization and reforms at the Federal, State and Local/District levels.

When Dr. Mahathir became Prime Minister in 1981, MAMPU continued and expanded its role, reinforcing administrative changes and seeking to further modernize the civil service. This period of administrative reforms marked the beginning of the third phase of Malaysia's administrative reforms, which highlight the leadership dynamism and visionary perception of Dr. Mahathir.

Political Leadership and Administrative Reforms — The Third Phase

Dr. Mahathir's tenure as Malaysia's fourth Prime Minister since 1981 signaled dynamic change in Government administration. Under Dr. Mahathir, a series of policies and actions started a new dimension in Malaysia's political and socioeconomic development. It also highlighted the necessity of a civil service that works closely and in tune with the political leadership in every aspect of Government operations. To achieve success, the dynamism of leadership has to be transmitted to the bureaucracy.

To achieve success, the dynamism of leadership has to be transmitted to the bureaucracy.

Given the opportunity and the right political support, the public sector can accept the challenges of change and reform. The administrative reform movements of the 1980s and the present economic and business management era have shown that administrative reform and political leadership priorities are intersupportive and complementary.

During this phase of administrative reforms, major innovations and ideas were introduced and encouraged by the present top leadership. For instance, the Government began to liaise with the private sector under the concept of Malaysia Incorporated. This means that Malaysia under Mahathir should be viewed as a company in which the Government and the private sector are both owners and workers. Mahathir also believes firmly in "leadership by example" which became the slogan of his administration. Another drastic change in his administration is the Look East Policy. Under the policy, the people of Malaysia were encouraged to change their traditional views of Western countries as role models and to look instead towards Japan and South Korea as the Asian blueprint for economic success.

A clean, efficient, and trustworthy concept of Government emerged from the Look East Policy. New systems, techniques, and procedures of administration were introduced in search of increasing efficiency and effectiveness in public service. Matters of reexamination included diligence and discipline at work, loyalty to the nation and to the enterprise, emphasis on quality, productivity, and management systems that concentrate on long-term achievement rather than short-term increases in dividend.

The management of the nation was geared toward more efficiency so as to achieve political stability and development. Work manuals and filing systems were introduced. Civil servants were encouraged to be more punctual and efficient. Name tags were worn by all civil servants to make them more personally accountable to the general public. Time clocks were installed at every Government office to ensure that the stated working hours were strictly adhered to. The shift in attitude towards the East was accompanied by a greater emphasis in Islamic values within the administration itself. A fresh move against corruption and mismanagement was launched, and steps were taken to weed out corrupt officials. Some civil servants resigned immediately on hearing that the new Prime Minister was planning to remove them from office.[5]

In each of the areas of reform efforts, Mahathir has shown his interest and commitment in achieving the expressed goals of his policies. Administrative reform is a continuing process, and political leadership is vital in determining the fate of any reform at any given time. In the absence of strong leadership traits, reforms are often doomed to failure. Mahathir's emergence in the midst of bureaucratic inertia had a profound effect on policy reforms.

Reforms Towards Improvements In the Malaysian Civil Service

The civil service in any country is the backbone of its Government. The continuous succession of innovative programs and policies of Malaysia's civil service have culminated in an economy of high growth and achievement. Importantly, this symbiotic partnership between political leaders and civil administrators must be perpetuated; otherwise the progression will simply halt. In any developing country, the implementation of policies and action plans of the nation as a whole is carried out mainly through the civil service. It is the strongest agent of the Government.

The civil service in any country is the backbone of its Government.

5 Tilman, Robert and Tilman, Jo H. 1977. *Malaysia and Singapore 1976; A Year of Challenge, A Year of Change*, in **Asian Survey,** February 1997, Vol. Xvii, No. 2.

Hence, in perpetuating economic growth and national development, administrative reform in the civil service and the building of a positive partnership with the political leadership are basic fundamentals to a developing nation's growth and success. The Malaysian civil service, through the various stages of administrative reform, has emerged a highly improved and versatile organization, spearheading the country's course into the twenty-first century. As Dr. Mahathir said: "We should be grateful because we have an administrative machinery which we can be proud of. It is not only efficient, disciplined and productive, but also provides quality service and is comparable to the administrative machinery found in more developed nations. This has enabled our nation to implement the development process in a smooth and effective manner."[6] It is imperative at this juncture to summarize the achievements and improvements made by the Malaysian civil service.

Administrative Programs for Improvements

The Malaysian civil service has undergone major changes in its adaptation to the transformational agenda for national development encapsulated in the nation's Vision 2020 policy (the year in which Malaysia will achieve the status of a developed nation). The process of transforming the Malaysian civil service into a culture of excellence involved making incremental but significant changes — changes that encompassed not only structural and system adjustments but shifts in the values and the mindset of civil servants. The core values inculcated through a paradigm shift included quality, productivity,

[6] Government of Malaysia 1994. *The Civil Service of Malaysia: A Paradigm Shift*, Kuala Lumpur: Government Printers.

innovation, integrity, discipline, accountability, and professionalism. To enable the implementation and coordination of administrative improvement programs in the civil service, a permanent committee called the Panel on Administrative improvements to the Civil Service was established and chaired by the Chief Secretary to the Government. The Panel has the role of ensuring that administrative improvement efforts are undertaken throughout the civil service on an ongoing basis. The overall objectives of the Panel are to

(i) to generate ideas and programs to further improve the system of public administration, and
(ii) to identify concrete measures to bring about improvements in public administration.

Quality and Productivity Management

Quality management is an important area of emphasis in the civil service, where it provides the foundation for the inculcation of quality in all public organizations and service. Since 1991 the civil service issued a number of guidelines to assist Government agencies in implementing quality management programs through the Total Quality Management concept.

The involvement of supporting staff was actively encouraged through Quality Control Circles (QCCs). Through this process supporting staff were provided the opportunity to utilize their skills and talents in initiating innovative ideas to increase the quality of services provided. In 1994, MAMPU was given the responsibility of promoting and monitoring the progress in the implementation of QCCs at all levels, while the National Institute of Public Administration concentrated on the training aspect. The policy of setting standards according to ISO 9000 and ISO 14000 is seen as a serious attempt to improve standards and quality, not only in service but in products of international acceptance.

Client Charter

The concept of a client charter was introduced by the civil service in June 1993 and has since been implemented by 318 Government agencies and departments.

The client charter is basically an assurance on the part of the department concerned as to the quality, features, and standards of the products or service produced for its customers. This represents a major new initiative on the part of the civil service to be more efficient and customer-focused. The concept of a client charter was introduced by the civil service in June 1993 and has since been implemented by 318 Government agencies and departments. This charter has improved the quality of Government services, especially in speeding up the delivery process. The client charter operates in tandem with QCCs, where the continuous monitoring and work improvements form the basic principles of civil servants.

Counter Services

In the past, the general consensus concerning counter services operated by Government agencies and departments was that these services were slow, indifferent, and cumbersome. Bearing in mind that counter services are actually the front line service (since the public's first contact with the department is with the counter staff), effective and efficient counter services cannot but enhance the image of any organization. Towards this end, the civil service devised a strategy to reform the culture of counter service staff to become more perceptive to the needs of the public, who are now termed customers and/or clients. Counter service improvements which were initiated in 1991 can be used as a barometer for evaluating Government services.

The measures undertaken to improve counter service include reducing waiting time; establishing different types of counters such as one-stop counters or drive-in counters; and enhancing the level of comfort of waiting customers by providing more comfortable chairs, airconditioning, piped music, and television. The initial response from the public was one of skepticism, but when the effects of the improved counter services began to be realized, especially in the critical departments (immigration, land office, transport department, local authorities), the public was delighted at the reduction in red tape, and the improvements of counter staff services.

Malaysia Incorporated

The Malaysian Incorporated Policy was launched in 1983 in an effort to realize greater national economic development goals through close cooperation and collaboration between the public and private sectors. As partners under this concept, each sector adheres to the perception of the nation as a corporate or business entity jointly owned by both sectors. Malaysia Incorporated is based on the precept that the public sector is the facilitator, fulfilling the needs of the private sector; and the private sector, having secured the cooperation of the public sector, becomes the engine of growth for the nation as a whole.

The public sector is the facilitator fulfilling the needs of the private sector; and the private sector is the engine of growth for the nation as a whole.

Privatization

The Privatization Policy was introduced in Malaysia in 1983. It complements the Malaysia Incorporated Policy and encourages private sector participation in Government. Through this policy, activities of the public sector can be transferred to the private sector. Privatization is two-prong strategy in Malaysia. Firstly, it reduces the Government's presence in the economy, thereby decreasing public spending; secondly, through privatization, market forces are allowed to determine economic activities. Since the implementation of the Privatization Policy, 116 projects have been privatized (of which 88 are existing projects involving the taking over of Government functions by the private sector, and 28 new projects involving the construction of infrastructure and utility projects that have been privatized). Indeed, privatization has reduced the size of the public sector and succeeded in relieving the financial burden of the Government though savings made in terms of operating expenditure and development. On the whole, the benefits to the public have been immense. The creation of new companies provides a significant source of new listings in the stock exchange. Efficiency and innovation have improved because of the need to compete in the open market; and the transfer of technology an upgrading of skills of the staff involved have opened up more opportunities and avenues for them.

Performance Appraisal at the Individual Level

While quality performance can be measured by perceiving the organization as a whole, however, the contribution of each individual to the enhancement of the organization should not be overlooked. In this regard, the civil service implemented a new system of performance appraisal to measure and evaluate the annual performance of civil servants individually. The purpose is to eventually reward an individual who has been recognized as an excellent worker with promotion and salary progressions. Evaluations are based on achievements of annual work targets and other criteria by the superior officer. The concept of performance appraisal for the individual is in line with the civil service's overall notion of managing for results. By rewarding individuals who have performed well, other workers will be influenced and encouraged to improve themselves. Ultimately, the organization as a whole benefits through increased efficiency and productivity.

Moving Into Information Technology

With the emphasis on increasing quality, efficiency, and productivity in the public sector, the development of sophisticated machinery and equipment is inevitable. The public and private sectors need to develop information technology (IT) infrastructure that can support and sustain Malaysia's Vision 2020. Within the public sector IT can no longer be viewed solely in the context of transaction processing or management information systems, but in terms of the capability of improving performance of individuals in organizations.

As Malaysia gears up for a culture of a paperless administration in the civil service, all Government departments will be computerized. A strategic investment in IT was introduced with this goal in mind. Under the auspices of the Government, MAMPU set up an IT Division which comprised the IT Department and the Civil Service Link in 1994. The main task of the IT department is to oversee the computerization of government ministries and agencies, while the Civil Service Link is a one-stop resource center that serves as repository or database where users, particularly the private sector, can be linked up to obtain information on the public sector.

The Government's seriousness of purpose in pursuing the IT agenda was strengthened recently when Dr. Mahathir launched the National Information Technology Agenda, which will transform the nation into a center of excellence for multimedia technology. The most important tasks of the agenda are the creation of the Multimedia Super Corridor and utilizing IT to create a balanced development for the country in the areas of people, infrastructure, and applications. Positive actions have also been undertaken on the ground with the establishment of a Multimedia University, the setting up of "smart schools," and a futuristic administrative center for the Government at Putra Jaya along the Multimedia Super Corridor. In propelling the nation towards a paperless administration, both the political leadership and the civil service need to nurture a culture of IT literacy and usage in Malaysian society.

Conclusion

This paper has outlined some of the successful programs that have been launched and practiced by the Malaysian civil administration. Even though administrative reform and transformation in Malaysia began more than a quarter of a century ago, it remains an ongoing process, for it is our belief that the path to excellence is fluid and has no end.

In developing nations, the civil service plays a crucial role and must be both efficient and effective.

Within the Malaysian context, administrative reforms that have been undertaken successfully are even more significant in view of the fact the ours is a multiracial society. Although there are other variables that determine the success of administrative reform, at least in a developing country like Malaysia, political stability is one key variable that can ensure progress and achievement in civil service transformation.

In developing nations, the civil service plays a crucial role and must be both efficient and effective. Hence, a successful transformation of the civil service will serve to enhance the country's vision, its mission, and its plan. In this respect, the experience of administrative reform in Malaysia has illuminated the fact that a well-planned civil service reformation can culminate in greater national and economic growth to the benefit of its citizens.

As aptly stated by the Malaysian Premier, "Malaysia should be proud of its success and its efficient administrative system. Because of our success in the administrative system we have earned the respect of the others and are able to stand tall even amongst the developed countries."

Sri Lanka: Reforming Public Administration

Lal Jayawardena
Economic Adviser to the President of Sri Lanka

Lal Jayawardena *currently serves as Economic Adviser to the President of Sri Lanka. Previously, he has also served as Secretary to the Treasury and Economic Adviser to the Prime Minister. At the age of 41, Dr Jayawardena became Sri Lanka's youngest Secretary of Finance and Planning. He is a seasoned diplomat, having served as Ambassador to Belgium, the Netherlands, and Luxembourg, and to the European Community. Dr Jayawardena's international record also includes serving as Assistant Secretary General of the United Nations, in which capacity he became the first Director of the United Nations University's World Institute for Development Economics Research (UNU/WIDER) in Helsinki, Finland (1985–1993). He is an Honorary Fellow of King's College, Cambridge, where he took his PhD in Economics in 1963.*

The Sri Lankan Government is firmly committed to the pursuit of "market friendly policies where the private sector becomes the principal engine of growth."[7] However, as indicated in the Asian Development Bank's Board Paper on Governance, governments have a vital supporting role to play in performing certain key functions, namely: (i) maintaining macroeconomic stability, (ii) developing infrastructure, (iii) providing public goods, (iv) preventing market failures, and (v) promoting equity.[8]

An essential element in discharging these functions — indeed possibly the most important public good governments can provide is an efficient, motivated, results-oriented, and in Sri Lanka's case, a vastly slimmed down public administration. This is the goal that the Government is presently pursuing with support from the ADB, the World Bank, and the international donor community.

The most important public good governments can provide is an efficient, motivated, results-oriented, and in Sri Lanka's case, a vastly slimmed down public administration.

This paper focuses on three issues:

- the linkage between the Government's medium-term economic reform agenda and the reform of the public sector, especially public administration;
- the nature of the administrative reform envisaged; and
- the longer-term development challenge that this reform seeks to meet.

A. The Relationship between the Economic Reform Agenda and Public Sector Reform

Sri Lanka's economic reform agenda can be simply stated. It is the need to reduce, and eliminate as

7 Hon. Chandrika Bandaranaike Kumaratunga, *Policy Statement of the Government of Sri Lanka, Colombo,* 6 January 1995.

8 Asian Development Bank, *Governance: Sound Development Management*, 1995.

rapidly as possible, overall budget deficits which since 1993 have ranged between 9 and 10 percent of gross domestic product (GDP). These deficits were financed by substantial net domestic borrowing averaging 5-7 percent of GDP, principally from captive Employees Provident Fund sources. Since national savings have been about 19-20 percent of GDP, the Government has been preempting between one quarter and one third of these savings for its budget, and denying them to the private sector. This phenomenon, which economists term "crowding out" the private sector, has led to the high cost of finance identified by the World Bank on the basis of firm level surveys as the principal obstacle to the expansion of private investment in Sri Lanka. During the early 1990s, nominal prime interest rates reached 20 percent, and real prime rates have fluctuated since 1985 between 5 and 8 percent, a relatively high figure by international standards.

The more recent macroeconomic situation, it should be noted, is a distinct improvement over that of the preceding decade. Over the period 1978-1993, the overall budget deficit averaged as much as 14 percent of GDP, financed by a combination of money printing, concessional foreign borrowing for development projects, and net domestic borrowing. The latter averaged 7 percent of GDP, swallowing up half the national savings which averaged around 14 percent of GDP. Large budget deficits, in turn, meant substantial inflationary pressures on the economy. The budget deficits were the inevitable result of Sri Lanka's unique combination of high human development and high unemployment, averaging 12-16 percent of the labor force over three decades. In the absence of rapid private sector growth, these circumstances created enormous pressure on the State to become the employer of first resort, resulting in a swollen public service; and to embark on grandiose megaprojects, the costs of which have a habit of ballooning out of control. The inevitable failure to meet popular expectations in this way was punished by periodic bursts of youth unrest which, in turn, slowed down the growth process itself. While growth was 6 percent over the 1978-1982 period, the average for the period 1978-1993 fell to 4 percent as a result of the unrest during the late 1980s.

The principal short-term goal of the Government's economic reform agenda is the elimination, no later than 2000, of net domestic borrowing altogether, so that the crowding-out phenomenon is ended, and the budget is financed solely by a sustainable level of concessional finance. The five percentage points or so in relation to GDP that the Government will cease to preempt for the budget can then be added to private investment, enabling the private sector to truly become the engine of growth. This will raise total gross investment in the economy from last year's level of 25 percent of GDP to at least 30 percent. Gross investment needs to rise by at least another five percentage points to 35 percent of GDP — to realize GDP growth of at least 8 percent in the next decade. The additional steps needed are explored in the concluding section of this paper.

The linkage between public sector reform and the elimination of both crowding out and the overall budget deficit is straightforward and easily stated. If net domestic borrowing is to be eliminated and the amount saved added to private investment, a corresponding reduction in the Government's budgetary expenditures will be required. Government capital expenditure, at around 7 percent of GDP compared with 15 percent in the mid-1980s, has already been cut to the bone, and Government revenues at around 20 percent of GDP are in line with countries of a similar per capita income and can be expanded only with rapid economic growth. The cuts needed to eliminate domestic borrowing must therefore fall on current expenditure.

The linkage between public sector reform and the elimination of the overall budget deficit is straightforward.

Three categories of current expenditure commitments are fixed and immutable in the short term, and swallow up 70-80 percent of our revenue, equivalent in recent years to around 15 percent of GDP. These are, first, military expenditure; second, the interest cost of domestic debt incurred as the legacy of financing the large deficits of the past through borrowing; and third, transfers to households representing the irreducible minimum commitments on targeted poverty alleviation, welfare programs, and pensions. Each of these categories accounts for roughly 25 percent of revenue and 5 percent of GDP.

The balance of revenue available for meeting the remaining current expenditure has therefore been 20-30 percent of revenue, equivalent to 4-6 percent of GDP. This has consistently fallen short of the residual current expenditure needing to be financed, equivalent to 36-38 percent of revenue, and 7-8 percent of GDP. This shortfall represents the Government's current account fiscal deficit or dissavings, ranging between 1 and 3 percent of GDP, and has had to be financed by recourse to nonrevenue sources, i.e., net domestic borrowing. This also means that the capital budget too has been entirely dependent on foreign loans and grants and domestic borrowing for its financing.

In the short term, therefore, with revenue being inflexible upwards and capital expenditure inflexible downwards, the burden of fiscal adjustment must necessarily fall on the residual current expenditure, running in recent years, as mentioned, at 7-8 percent of GDP. Since it is nonbank net domestic borrowing which has in effect been financing much of this expenditure in recent years to the tune of 5-6 percent of GDP, (and 5 percent of GDP in 1996) the room for manoeuvering in an effort to end crowding out overnight is small. This initiative must therefore occur in a phased fashion. This means eliminating loss-making enterprises through corporatization and/or privatization, reducing other subsidies, and reducing the civilian public service wage bill in the aggregate, (it presently amounts to more than 5 percent of GDP). The pension burden, (more than 2 percent of GDP), while inflexible in the short term, is amenable to medium-term reform. The latter two areas, through appropriate public service and pension reforms, involve slimming down the public service and introducing contributory pensions. The privatization of public enterprises can provide additional fiscal space on an enduring basis only to the extent to which it is used to retire outstanding public debt, and reduce its domestic interest cost, rather than to finance the current budget.

This underlines the importance of public sector and pension reform in establishing a stable macroeconomic framework conducive to private sector growth in Sri Lanka's constrained fiscal situation. It also explains why there is no free lunch when it comes to reducing — and eventually eliminating — net domestic borrowing; and in due course the budget deficit, in order to enable the private sector to become a truly effective engine of growth. There is simply no alternative to slashing current budgetary expenditures.

There is no free lunch when it comes to reducing — and eventually eliminating — net domestic borrowing.

Sri Lanka's 1997 budget made a credible move in this direction by seeking progressively to reduce the overall budget deficit within a three-year framework to 7.3 percent of GDP in 1997, 5.2 percent in 1998, and 4.5 percent in 1999. Significant consequential reductions in net domestic borrowing were projected, falling in easy stages from 4.5 percent of GDP in 1997 to 2.5 percent in 1998 and 1.7 percent in 1999. Crucial to reaching these targets is a reduction in current expenditure by nearly 2.5 percentage points in relation to GDP, from nearly 20 percent in 1997 to 17.5 percent in 1999.

In the context of the tough fiscal decisions taken in 1996 to contain the overall deficit for the year at 9 percent of GDP by, for example, eliminating a subsidy on flour, the 1997 budget has been widely acclaimed as involving a renewed and irreversible Government commitment to economic reform. The key elements that have elicited this acclaim are threefold.

- The investment incentive package contained in the 1997 budget.
- The announcement of an intention to reduce both corporate tax rates and maximum personal income tax rates from 35 to 25 percent by 1999.
- The budget's targets for reducing both the overall deficit and net domestic borrowing.

The budget has unambiguously signaled that the Government is serious about implementing its announced intention to make the private sector the principal engine of economic growth by ending crowding out once and for all.

One indication of the positive impact of the budget is that the usually conservative Economist Intelligence Unit, in its country forecast for Sri Lanka for the first quarter of 1997,[9] has revised its estimate of economic growth for the 1997-2001 period upwards by nearly one percentage point, i.e., to 5.5 percent per year compared with its previous estimate of 4.6 percent. The survey concludes that "by 2001 the stage will be set for a period of sustained growth and annual GDP growth rates of 7-7.5 percent will be well within reach. Growth will still be led by exports but the export base will have shifted into non traditional high value added

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9 The Economist Intelligence Unit, *Sri Lanka Country Forecast, 1st Quarter 1997 Main Report*, London 1997.

industrial exports." This is clear international recognition that the growth momentum set by the 1997 budget is irreversible. We nevertheless need to do significantly better than 7-7.5 percent growth, as explained in the concluding section of this paper.

B. The Nature of Sri Lanka's Administrative Reform

As explained, public sector reform, including pension reform, has become crucial in Sri Lanka's constrained fiscal situation for releasing the resources needed to eliminate the dependence of the budget on net domestic borrowing for its financing, and the resulting crowding out of the private sector. It therefore constitutes the necessary conditions for expansion in private investment, enabling the private sector to become the true engine of economic growth. No less important is the nature of the public sector reform itself, with its overriding objective of creating an administrative framework for sound development management, such as the discharging of the several supporting functions identified in the ADB Board Paper on Governance.

The nature of the public administration reform being envisaged is outlined in the Summary Report on the topic presented to Her Excellency Chandrika Bandaranaike Kumaratunga, President of Sri Lanka, by an ADB Team (which included consultants from New Zealand and Malaysia) toward the end of last year. The summary has been adopted by Sri Lanka's Cabinet, and steps to implement it are now under way. The ADB report represents, in my view, the first cautious step toward adapting *New Zealand's Remarkable Reforms*, the title of last year's Fifth Hayek Memorial Lecture by New Zealand's Central Bank Governor, *The goal which the Government intends to pursue is that of creating a results-oriented public service aimed at ensuring that public sector organizations behave like those in the private sector.*

Dr. Donald T. Brash.[10] He cites a description of New Zealand "as a country reformed by Hayekians, run by pragmatists, and populated by socialists." As one of the principal architects of the reforms, he confesses to having been totally innocent of Hayekian influences "having like many of [his] peers been brought up on an undiluted diet of Keynesian economics and an almost undiluted diet of Fabian socialist politics." This description of New Zealand, together with Dr. Brash's qualification, is applicable to much of South Asia, and certainly to Sri Lanka and to my generation of economic reformers.

Its reforms have caused New Zealand to be ranked first for its quality of Government in 1993 by the World Competitiveness Report of the Geneva-based World Economic Forum. Since that time, Singapore has looked to New Zealand as a model for its public sector reforms. In mid-April, Singapore announced the implementation of its adaptation of the New Zealand model. Sri Lanka is therefore in very good company indeed, in seeking as its eventual goal to travel along the same road with the support of the ADB. To summarize it in a phrase, the goal which the Government intends to pursue is that of creating a results-oriented public service aimed at ensuring that public sector organizations behave like those in the private sector, and the ADB report represents the first step in this direction.

The administrative reform currently under way has six key components:

- Adaptation of strategic policy formulation and policy coordination to more effectively achieve policy outcomes.
- Adoption of a result-oriented philosophy as the guiding management principle.

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[10] Donald T Brash, *New Zealand's Remarkable Reforms, Fifth IEA Annual Hayek Memorial Lecture, given in London on Tuesday, 4 June 1996,* published by The Institute of Economic Affairs, 1996.

- Separation of policymaking, service delivery, and regulatory functions of government.
- Realignment of responsibilities to more effectively support the goals of government.
- Training staff to more effectively respond to the new environment and thereby realize their potential.
- Redeployment of surplus staff, if any, to new functions within Government or to new opportunities in the private sector.

There are two main instruments of reform. These are an Administrative Reforms Management Division (ARMD) within the Presidential Secretariat, charged with designing the detail of the reform program and overseeing effective implementation of all its elements; and a Management Council, chaired by the President of Sri Lanka, which provides the critical component in a mechanism to ensure development and implementation of strategic policy.

Of the two instruments of reform, ARMD is a totally new entity charged with, as mentioned, the oversight of the reform process. Its supervision is vested in an Advisory Board on Administrative Reform, which, in addition to an existing *ex officio* Committee of Secretaries of Government, includes three nonofficial members to provide intellectual and professional diversity. One of them is drawn from Sri Lanka's private sector, the second has professional experience in the process of reform, and the third has respected professional credentials.

The second instrument of reform, the Management Council, represents a rationalization of processes already in train to help with strategic policy formulation. The institutional mechanisms already in place prior to the ADB mission included the National Development Council (NDC) and the Department of National Planning within the Ministry of Finance. Operational authority on fiscal policy was vested in the Ministry of Finance, while authority on monetary policy was vested in the Central Bank. The principal objective of NDC was to initiate a dialog with the private sector on policy formulation of the kind pioneered and developed in East Asia, but by and large conspicuously absent (except perhaps in a ritualistic sense) in much of South Asia. NDC currently comprises 14 members under the chairmanship of the President. It includes 4 Cabinet Ministers, 3 persons representative of the two key private sector chambers of commerce and industry, the Governor of the Central Bank, and the Secretary of Finance (as *ex officio* members), two academic representatives, a Deputy Chairperson, and an Executive Secretary who is concurrently Director General of the National Planning Department on whose staff the NDC is expected to draw. The NDC itself has a small nucleus of professional staff directly reporting to the Deputy Chairman, currently comprising three persons.

This structure has so far engaged in several *ad hoc* policy exercises through the medium of Inter-Ministerial Task Forces/Working Groups, all with private sector representation. A Presidential Task Force on Employment Policies and Strategies has reported to the President on a revised labor relations regime which is being considered by a Cabinet Sub-Committee. A Working Group on Agricultural Policy has reported to the President, and its recommendations are in process of implementation. NDC Working Groups on Health Policy and on Information Technology have been the workhorses of Presidential Task Forces on these subjects. A Working Group on Fiscal Policy involving the private sector, the Ministry of Finance, and the Department of Inland Revenue was instrumental in providing an input into the 1997 budget, which culminated in the introduction of a Malaysian style investment tax allowance.

The crucial contribution of the ADB team in coming up with the Management Council concept was to rationalize and make more coherent what was previously an ad hoc policy formulation mechanism. The ADB team identified the need to group the functions of Government Ministries into three sector areas dealing with the economic sector, the infrastructure sector, and the social sector. It is suggested that a fourth sector area dealing with cross-sectoral issues be added. Ministers could be assigned to chair sector committees covering each of these four areas. The Management Council, accordingly, is made up of the Ministers chairing these sector committees, plus the Ministerial members of the NDC. The officials who attend the meetings of the Management Council comprise the official membership of the NDC along with others. They would include the Deputy Chairperson of the National Development Council, the Head of the Management Council Secretariat, the Governor of the Central Bank, the Secretary of Finance, the Secretary to the President, the Secretary of Plan Implementation, the Secretary of Public Administration, the Director General of National Planning, and other relevant officials.

The role of the Management Council is to provide the single, central focus for drawing together all strategic policy initiatives, and to ensure overall coordination of policy development.

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The Council's responsibilities include:

- preparing strategic policies for presentation to the Cabinet,
- reaching agreement on key sector imperatives,
- ensuring that sector committees pursue imperatives and subsequently review progress,
- proposing outputs to be included in the budget to the Cabinet, and
- consulting regularly with the private sector through the NDC.

An urgent task for the Management is to prepare a concise strategic policy position for discussion and adoption by Cabinet, which in turn must delineate the rest of the policy process and the administrative reforms. This process builds on and clarifies existing statements.

Specific decisions and priorities recommended by the Council to Cabinet determine the allocation of operational and capital resources in the budget.

Ministers attend on Council where their portfolio issues were under consideration.

The Management Council is thus conceived of as the Governmental subset, as it were, of the NDC, reinforced by additional Ministerial and official representation. The ADB team has recommended that the Management Council, in order to benefit from private sector viewpoints, should combine with the NDC on at least a bimonthly basis. In the interests of avoiding "multilateral monologue" it would be wise for the membership of these joint meetings not to exceed 20 persons.

Since the ADB recommendation is essentially a rationalization of existing arrangements, a dedicated Secretariat to service the Management Council is essential. Thought is currently being given as to how best this Secretariat can be put together, drawing on staff involved in sector policy development, both within the Department of National Planning and elsewhere, and in the NDC.

Two additional elements of the reform process need to be mentioned to round out the picture. These are, first, the vesting of public service appointments under the authority of an independent and revitalized Public Service Commission. This harks back to a long-standing tradition Sri Lanka inherited when it attained independence, but which has since been allowed to lapse. The second element is the identification of redundant departments and institutions as candidates for euthanasia as a vital part of the process of slimming down the public service in the interests both of efficiency and of prudent fiscal management.

C. Sri Lanka's Longer-term Development Challenge, 1997–2011

To recapitulate, administrative reform focused on slimming down the public sector is a necessary condition for creating the fiscal space needed for eliminating net domestic borrowing and ending the crowding out of the private sector. Given Sri Lanka's constrained fiscal situation, the adjustment needs to occur in a phased fashion, but no later than 2000, in view of the enormous development challenge the country faces. Public sector reform is also necessary to enable the Government to provide the supporting functions needed for sound development administration, and its nature has been briefly summarized. Both these exercises — the medium-term economic reform agenda and gearing the public service for development — complement each other in enabling Sri Lanka to meet the development challenge that lies ahead in the first decade of the 21st century. This challenge has two principal components.

Slimming down the public sector is a necessary condition for creating the fiscal space needed for eliminating net domestic borrowing and ending the crowding out of the private sector.

First, the large budget deficits of the 1980s could only have been accommodated by heavy cutbacks in expenditures on the social sector — education, health, and basic nutrition — and on infrastructure that was not foreign financed. Social sector expenditures fell by nearly one half, in relation both to GDP and the budget, to 6 percent of GDP and to 17 percent of budgetary expenditure, compared with the 1960s and 1970s. Expenditures during the 1960s and 1970s had averaged annually around 9-10 percent of GDP, and accounted for between 30 and 35 percent of budgetary expenditure. In particular, a food subsidy and related services accounted for as much as 4 percent of GDP and 14 percent of budgetary expenditure. Expenditure on core infrastructure — energy, water (excluding irrigation), transport and communications — much of it foreign financed, averaged barely over 4 percent of GDP during the 1980s, falling to 3.4 percent in the 1990s in contrast to several East Asian countries — Indonesia, Malaysia, the Philippines, and Thailand — whose infrastructure expenditures were in the range of 6-8 percent of GDP. The World Bank's firm level surveys in fact rank inadequate infrastructure in the areas of telecommunications, road capacity, and electric power, as third in the hierarchy of obstacles to expanded private sector investment in Sri Lanka (after the high cost of finance and the tax level).

Second, Sri Lanka's high level of human resource development has enabled it to make the demographic transition relatively rapidly. The combination of high female literacy and low infant mortality means that there is no need for parents to produce children as insurance for their old age. The resulting fall in fertility means that Sri Lanka's population will stabilize at 23 million by 2025 as against today's 18 million. This has four implications.

- Our labor force growth will dwindle rapidly after 2010 and stabilize by 2016 at 14 million. We will by then be short of labor like Malaysia and Singapore are today.

- Sri Lanka's population will be growing older faster than any other country in recorded history. It took France 130 years for the population over the age of 65 to double from 7 to 14 percent, the US 70 years, and Japan 25 years. In Sri Lanka's case this will happen in the next 20 years — between now and 2016.

- Most countries have achieved this transition in the past at per capita incomes in excess of US$20,000, by and large adequate for those at work to support those in retirement. If Sri Lanka were to grow at 7 percent per capita, so that overall GDP grows at 8 percent (allowing for 1 percent population growth), income per capita would double every 10 years. Since our starting point is US$700 per capita in 1996, this means that we will still be somewhat short of Malaysia's 1993 per capita income of US$3000 by 2016. Even if per capita income grows at 10 percent so that it doubles every seven years, with overall GDP growing at 11 percent, it will still fall short of Malaysia's 1993 per capita income by 2011. It will not at this rate exceed US$20,000 until the year 2030. Double digit growth rates have never been sustained (except for relatively short periods and only in a few countries, notably China in the last decade, and Japan and Singapore between 1966 and 1973).

- By 2025, 20 percent of Sri Lanka's population will be over 60 years old, and one third of the population will be pensioners, assuming the current pension age limits hold.

The challenge Sri Lanka faces in the future is nothing less than compressing the kind of development achieved by East Asia over a 30-35 year period into a 15-20 years. It should be borne in mind that in 1960 Sri Lanka's per capita income was US$150 — the same as Korea's and Taipei,China's — admittedly less than Singapore's and Malaysia's, but significantly higher than Indonesia's or Thailand's. By now of course all these countries have forged ahead. Sri Lanka has only grown 4 percent in terms of GDP between 1960 and 1995, while East Asia has averaged

The challenge Sri Lanka faces is nothing less than compressing the kind of development achieved by East Asia over a 30-35 year period into a 15-20 years.

about 8 percent. This means that Sri Lanka must aim for the maximum feasible rate of overall GDP growth in the range of 8-11 percent by 2011 when our labor force growth drops off sharply, and certainly by 2016 when it ceases to grow at all. Such a high growth strategy has several implications for development policy, even if crowding out has been eliminated in the medium term, (i.e., by 2000), and if the public sector reform is fully completed by then.

Rapid growth requires the elimination of the twin constraints of inadequate skills and inadequate infrastructure which East Asia has so successfully dealt with.

Rapid growth requires the elimination of the twin constraints of inadequate skills and inadequate infrastructure which East Asia has so successfully dealt with. The expanded investment in education and skill development, and in ensuring literacy in English, that Sri Lanka needs to equip itself for the information technology age can only be undertaken by the public sector. There will be a similar need to expand the health budget of the country to cope with the needs of an aging population, in addition to various kinds of insurance arrangements. Both will require a reallocation of resources in the Government budget in favor of the social sectors, especially in the context of the cutbacks of the 1980s. Both health and education expenditures, are public goods *par excellence*, typically involving areas of market failure which could be adequately addressed only by public provisioning, and requiring a public service geared to sound development administration. This leaves little choice consistent with reducing and eliminating the overall budget deficit, ending crowding out, thus unshackling the private sector, other than to entrust the infrastructure investment effort, wherever possible, to the private sector. In order to facilitate this process, and to provide 20-year loan financing for private sector projects, a Private Sector Infrastructure Development Company with support from the World Bank and the Kreditanstalt für Wiederaufbau was formally launched in early April.

Rapid GDP growth of at least 8 percent overall in the next decade calls for increasing, by at least 10 percentage points, today's investment rate of 25 percent of GDP to the 35 percent average characteristic of East Asia in 1990. Half this amount, or 5 percentage points, can be realized by eliminating domestic borrowing altogether (also about 5 percent of GDP), and ending crowding out as soon as possible, but no later than 2000. The amounts saved will then be added to private investment. This leaves another 5 percentage points in relation to GDP to be added to investment. At least 2 percentage points of this could be realized much sooner by savings resulting from the negotiated cessation of hostilities in Sri Lanka in relation to the 5 percent of GDP currently spent on the defence budget. The bipartisan agreement between the Leaders of the Government and the Opposition announced in April on the *modus operandi* governing such a negotiation constitutes an important breakthrough and provides ground for optimism. Coming on top of the 1997 budget, the news sparked off a bull run on Sri Lanka's stock exchange.

This leaves an additional foreign investment effort of about 3 percent of GDP needed to raise investment rates to the critical threshold of the 35 percent required for an East Asian style economic take-off. Last year's net foreign direct investment in Sri Lanka was nearly 0.5 percent of GDP, peaking at around 2 percent in 1993. The largest recipient of foreign investment in relation to GDP among developing countries in 1993 was Malaysia at 7 percent. Against that background, Sri Lanka should have little difficulty (assuming a climate of internal peace and harmony) in attracting the additional required foreign investment equivalent to 3 percent of GDP. It goes without saying that a substantial proportion of that foreign investment will have to be in infrastructure development if this key constraint to rapid economic growth is to be overcome in Sri Lanka.

Sri Lanka has quite distinct advantages as a venue for foreign investment.

First, it was foreign investment which transformed our economy from one dependent on primary product exports (principally tea, rubber, and coconut) to the tune of 85 percent of total exports in the 1970s, to the structure we have today where manufactures account for no less than 73 percent of total exports, and garments and textiles for 50 percent. Foreign firms accounted for a large part of this diversification effort — 74 percent of Sri Lanka's manufactured exports in 1992. Sri Lanka is now the largest exporter of manufactures per capita among the low-income countries.

Second, the primary motive for foreign investors to locate in Sri Lanka is the quality and productivity of our labor force. As far back as 1980, a study by the European Commission found that Sri Lankan labor, then costing a dollar a day in our free trade zone, was as productive as German labor after six months training. Surveys conducted by Japan's External Trade Organisation a decade or so later, in 1993, and by the Embassy of Japan in 1995, concluded that almost 85 percent of Japanese investors were satisfied with their investments in Sri Lanka. Around two thirds of the companies surveyed indicated the availability of high quality labor at a very competitive cost, and of liberal fiscal incentives, as the primary reasons for investing in Sri Lanka. With a monthly wage for a worker averaging still around US$1 per day at the current exchange rate, many Japanese and other investors have expressed the view that Sri Lanka labor demonstrates levels of manual dexterity and hand-eye coordination as the best available anywhere at this wage level. These attributes are ideally suited for precision production techniques required for industries such as electronics. For example, a leading Japanese investor in Sri

Lanka, the FDK Corporation, which manufactures magnetic heads for floppy disks, claims that its plants in Sri Lanka have achieved levels of output per worker productivity equal to the Company's factories in Japan and Taipei,China.

Third, Sri Lanka is geographically an ideal position to serve as a hub for accessing the South Asian market in much the same way as Hong Kong serves the People's Republic of China and Singapore serves East Asia. What has come to be known as the Gujral Doctrine, articulated by India's former Foreign Minister and current Prime Minister, whereby neighboring countries are granted access to the Indian market on a nonreciprocal basis, carries with it considerable promise for foreign investors today in Sri Lanka.

Meeting Sri Lanka's development challenge in the first decade of the 21st century requires the coordination of policies on a broad front. It demands political and administrative leadership of the highest caliber, for the task is nothing less than the compression of East Asia's development achievements into about half the time it took East Asia to realize them. A public service geared to rapid development, and a policy formulation mechanism that can harness its talents to the best advantage, are the essential prerequisites. The reforms initiated by the ADB team are vital first steps towards reaching these goals.

Gujarat Public Sector Resource Management

S.K. Shelat
Chief Secretary, Government of Gujarat

S. K. Shelat *has served as Chief Secretary to the Government of Gujarat State, India, since 1995. Prior appointments in his civil service career, which began in 1961, include three posts at the Principal Secretary rank: Finance (1993–1995), Agriculture and Rural Development Department (1993), and General Administration (Planning) (1992–1993). In addition, Mr. Shelat has held numerous other senior management positions, ranging from Secretary of Industries, Mines, and Energy to Commissioner of Training and Director, Sardar Patel Institute of Public Administration.*

Gujarat is one of the 26 States of India, occupying 196,024 sq. km. and having a population of 41.3 million.

Since its formation in 1960, Gujarat has achieved remarkable progress in economic development, and especially in industrialization. Following the economic liberalization policy initiated by the Government of India in 1991, Gujarat has been the number one State in attracting investment, and has projects worth US$31 billion in the pipeline. However, despite all this, Gujarat's public sector is characterized by a structurally weak fiscal position, a large and inefficient State enterprise sector, and inadequate provision of basic infrastructure services such as ports, roads, and power.

The state's fiscal position weakened because of the lack of fiscal discipline and stagnation in tax revenues. State finances were also squeezed by slow growth in Central transfers, because of fiscal consolidation at the Central Government level, and restrictions on overdraft facility from the Central Bank, which forced the State to borrow increasingly at market-determined rates. Since 1991 the Government of Gujarat has adopted a cautious fiscal policy and was initially successful in curtailing the overall budget deficit from over 7 percent of the state's domestic product (SDP) in the early 1990s to 2.6 percent in 1993/94. But the Government was unable to sustain this fiscal adjustment, and the overall budget deficit rose again, reaching 4 percent of SDP in 1995/96. The reversal in fiscal consolidation in Gujarat is attributable to factors such as (i) stagnation in public revenues, (ii) inadequate control over public expenditures, and (iii) generally poor management of public resources.

The Government of Gujarat owns 54 State-owned Enterprises (SOEs), of which 37 are registered as companies and 17 as statutory corporations set up by State or Central legislation. SOEs are active in most sectors of the economy, having a virtual monopoly in the mining, power, transport, and water sectors, and a dominant position in housing, finance, and social sectors. SOEs have been used to achieve a number of objectives, including employment creation, provision of subsidized services (such as power and transport), development of backward regions, and welfare of the weaker sections of the population. SOEs are vulnerable to political interference and suffer from the lack of commercial orientation, nonmerit-based managerial appointments, and inadequate reporting, accounting, and financial control systems.

The Government has opened up all key infrastructure sectors to the private sector and is in the process of evolving an enabling policy environment.

Infrastructure in Gujarat is overextended and cannot meet the growing demand of industrialization. The Government has estimated infrastructure investment requirements at over $23 billion, which far exceeds the availability of public resources. The growing demand for infrastructure, the sharpening resource and implementation constraints, and the poor efficiency in delivery of services by the public sector have changed the Government's approach to infrastructure development. The Government has opened up all key infrastructure sectors to the private sector and is in the process of evolving an enabling policy environment that is transparent and provides adequate incentives to attract the required private investment.

Public Sector Resource Management Program

The Gujarat Government set up a State Finance Commission in October 1992 to look at some of these issues, and the Commission submitted its report in May 1994. Also in 1994, the Asian Development Bank (ADB) initiated a process of dialogue with the Government of Gujarat which resulted in the approval of a loan of US$250 million for the Gujarat

Public Sector Resource Management Program in 1996. The Government initiated a review of recommendations of the Finance Commission in 1994. Drawing on the recommendations of the Commission Report, the ADB simultaneously initiated a policy dialog in order to support implementation of the policy and institutional changes. Thus the Public Sector Resource Management Program is the continuation of a process of reform begun in 1994, in which the Gujarat Government and ADB have been partners from the very beginning.

The Resource Management Program is aimed at augmenting domestic resource mobilization, improving allocation and efficiency of the public sector, reducing the State's role in commercial activities, and promoting market-oriented policies to enhance private sector participation in the economy, particularly in the infrastructure sector. These objective are to be achieved by three initiatives:

- improving the management of the State's public finances;
- privatizing, divesting, or restructuring the SOEs; and
- strengthening the policy, regulatory, and institutional frameworks for the infrastructure sector.

The Program supports the creation of an enabling policy, regulatory, and institutional environment for private sector participation in the power, ports, and roads subsectors.

1. Improving the Management of the State's Public Finances

The Program supports the formulation, adoption, and implementation of the Medium-term Fiscal Policy Framework for the period 1997/98 to 1999/2000, under which the overall fiscal deficit will be reduced from 4 per cent of SDP in 1996/97 to about 2 percent in 1999/2000. The reduction in the fiscal deficit will take place despite the substantive cost of structural reforms included in the Program, such as the rationalization of taxes and restructuring of SOEs. The key elements of tax reforms envisaged include the simplification and rationalization of the sales tax structure to improve its transparency and efficiency. The reforms of the sales tax have been designed to facilitate eventual introduction of a value added tax in line with the adoption of VAT by neighboring states. The Program supports rationalization of the rate structure of stamp duty, entertainment tax, and motor vehicle tax. An important element of the expenditure reform is the introduction of the Core Investment Program at aggregate and sector level.

2. Privatizing, Divesting or Restructuring the SOEs

The Program focuses on privatization, divestment and restructuring of 23 of the 54 SOEs. The subset of SOEs targeted under the Program includes a mix of strategic enterprises, key state financial intermediaries, and SOEs that perform overlapping developmental and social functions. The SOEs include a combination of both profit-making and loss-incurring enterprises.

The SOE reform program in Gujarat is the first comprehensive attempt towards privatization. In designing this Program appropriate institutional framework and policies have been put in place in advance to insulate the reforms from political disruption. The Government, for example, set up a high-level subcommittee headed by the Chief Minister to approve proposals of SOE reform. The technical work of privatization and restructuring is being handled by a Technical Secretariat and the Price Waterhouse International Group supported through a Bank technical assistance.

To facilitate privatization/restructuring, the Government set up a State Renewal Fund to finance the debt and labor liabilities of the SOEs.

3. Strengthening the Policy, Regulatory, and Institutional Frameworks for the Infrastructure Sector

The Program supports the creation of an enabling policy, regulatory, and institutional environment for private sector participation in the power, ports, and roads subsectors. The key objective of infrastructure reform is to evolve greater transparency and stability in the policy environment. This involves (i) introducing guidelines for transparent competitive bidding procedures and internationally accepted terms for financing of infrastructure projects, (ii) restructuring of public sector agencies that handle the infrastructure sector with a view to promoting commercial orientation and an effective partnership for public and private sector development, and (iii) a sound regulatory mechanism in the post-privatization era that serves both efficiency and equity goals.

The Program loan from the Bank will assist the Government in carrying out the structural reforms as it will enable the State to

- bear the cost of restructuring the Public Enterprise Sector which would involve the closure of nonviable units, such as the Gujarat State Textile Corporation, and the sale, merger, or downsizing of others;
- absorb the impact of the initial decline in Government revenues likely to result from the tax reforms and rationalization;
- protect a core investment program from ad hoc budget cuts; and
- enable the release of funds for social sectors by transferring some areas from public to private sector funding.

Institutional Strengthening

As part of the Program, the Government will set up the Gujarat Infrastructure Development Body which will be responsible for the following functions:

- rationalization of sector development/master plans into a single intersectoral development plan;
- prioritization of specific projects within sectors and between sectors;
- assistance to private sector project proponents regarding project financial packaging; and
- administration of a project development assistance fund.

In this regard the Bank has provided a technical assistance to build capacity of the Gujarat Infrastructure Development Body to advise on policy, legal, and regulatory frameworks of key infrastructure sectors, as well as in the area of assessing, financing, and promoting infrastructure projects, including build-own-operate and build-own-transfer projects.

Additionally, institutional strengthening of the various Government departments for the effective implementation of reforms is planned under the Program. This includes the strengthening of the Finance Department, for which a Bank technical assistance will support the development of skills in

- budget policy formulation and projections,
- expenditure management and control,
- formulation of tax reforms, and
- treasury and debt management operations.

The Finance Department will be assisted by a State Public Finance Reform committee and working groups on tax reforms, expenditure management and control, and computerization and training. The computerization of tax, expenditure, and debt records will upgrade the overall budgetary management and control systems. The Program will also support the reorganization, streamlining, and strengthening of the State tax administration with the establishment of a Directorate of Taxation.

Finally, the Bank is providing a technical assistance to train and advise policymakers and heads of SOEs in the modalities and techniques of privatization. To start off, some key officials closely involved in the process of privatization have attended courses on privatization and restructuring, and a workshop is scheduled to be held later in the year to provide greater exposure to officials on the privatization program and its techniques.

Future Developments

Once the Program is completed, it is expected that Gujarat will be on the road to self-reliance in terms of resource mobilization, coupled with improvement in the quality of life resulting from the increased investment in social infrastructure.

In the Power sector, the most crucial for the State, the present capacity will be raised from 6000 MW to 15000 MW in five years, of which 8330 MW will be through private sector initiative. Also, for the first time, it is proposed to invite the private sector into power distribution. This initiative should instill further confidence among the independent power producers. Privatization of distribution should also help free the Government from the subsidy culture in the agriculture sector and reduce current excessive line losses.

In future, it is expected that private sector investment will grow not only in the ports, power, and roads sectors, but also in the social sectors. For instance, it is expected that secondary and tertiary education, on which the State spends nearly US$20 million per annum, could be gradually privatized by eliminating controls over fees. The public funds so released could then be used for the improvement of primary education. Similarly, in the health field it is proposed to involve private donors and institutions to supplement the infrastructure of Government Hospitals, thereby augmenting and improving the services for the poorest sections of the society. Also, private doctors will be allowed to use the facilities at Government Hospitals and Dispensaries, thus reducing their costs and fees.

A separate State Finance Commission for Local and Municipal Bodies has been set up and its report is expected by June 1997, covering a wide range of reforms and devolution of resources from the State to the local authorities, that will link reward to performance.

State Government would vacate areas that can be successfully operated by the private sector and would become more lean and clean, to perform its basic task of maintaining law and order and providing basic social services and thus making poverty alleviation easier.

Gujarat is now on the threshold of both economic resurgence and social upliftment. In five years it will be able to compete with some of the Asian tigers.

To conclude, Gujarat is now on the threshold of both economic resurgence and social upliftment. In five years it will be able to compete with some of the Asian tigers, such as Indonesia; Malaysia; Singapore; and Taipei,China. In this transformation the Bank's assistance will have played a significant role.

MONGOLIA: Legal Reforms for a Market Economy

J. Unenbat
Governor, Bank of Mongolia

Jigjid Unenbat*, Governor of the Bank of Mongolia, received his first degree from the University of Economics and Statistics in Moscow in 1986, and took his Master of International Affairs degree from Columbia University in 1995. Mr. Unenbat has served the Bank of Mongolia in various posts since 1986.*

This paper is a description of the Asian Development Bank's contribution to good governance in Mongolia through its assistance in the development of the Mongolian legal system.

Since the pro-democracy demonstrations in 1990 and the 1991 breakdown of the Council for Mutual Economic Assistance, whose member states were our main trading partners, Mongolia has moved rapidly to establish the legal framework necessary for a market economy. The basic elements — laws on property, the creation and winding-up of business entities, and a fair marketplace — are in place, as well as laws governing the complex areas of banking, securities, tax, bankruptcy, and accounting. Many of these laws, however, need to be reinforced by detailed regulations. Equally important, capacity building and training are necessary so that these laws and regulations can be implemented and enforced.

Mongolia has moved rapidly to establish the legal framework necessary for a market economy.

The ADB's Law and Development Activities

In this regard, we have been grateful for the ADB's leadership and assistance in (i) reviewing the Mongolian legal system and formulating an action plan for the coordination of foreign assistance in law and development, (ii) drafting and preparing certain key laws and regulations required for a market economy, and (iii) providing training for the implementation and enforcement of these laws and regulations.

1. Industrial Sector Program Loan

The ADB's first substantial law and development activities in Mongolia began in August 1993 in connection with a US$30 million loan for an industry sector program. One of the conditions for the release of the second tranche of the loan was a condition requiring the Government to undertake a review of existing and pending laws affecting the industry sector, including laws relating to business entities, contracts, secured transactions, bankruptcy, and foreign investment. It was clear that market-friendly economic reform had to be matched with laws suited to the purpose.

2. Technical Assistance for Developing Mongolia's Legal Framework

In order to assist the Government with this review, the ADB provided a technical assistance grant of US$500,000 for developing Mongolia's legal framework. The major accomplishments of the assistance were fourfold.

- First, the publication in October 1995 of a needs analysis report on the Mongolian legal sector and a two-day conference to discuss the report's findings with members of the Mongolian legal community and representatives of interested donor institutions. The Legal Needs Analysis Report was the first comprehensive assessment of Mongolian laws with an action plan identifying areas where assistance was required. The conference was the first organized meeting of donors to discuss assistance in the legal sector to Mongolia.

- Second, legal training. Lawyers were trained in three provinces in Mongolia; seven Mongolian lawyers received training overseas at Duke Law School's Asia-America Institute in Transnational Law in Hong Kong; and a senior Ministry of Justice official participated in a three-month internship program at a private law firm in New Zealand.

- Third, four United Nations Volunteer legal advisors and a commercial law expert provided legal advice on commercial legislation and assisted with the translation of Mongolia's Civil Code into English.

- Fourth, a compendium of authorized English translations of the principal commercial and economic laws enacted since 1990 was prepared. This compendium is expected to be published later this month.

3. Technical Assistance for Institutional Strengthening of the Financial Sector

From 1993 to the end of 1996, the ADB provided six technical assistance grants totaling approximately US$2.3 million for Mongolia's financial sector. This technical assistance was primarily in support of institutional strengthening of agricultural banking services, the commercial banking system, and financial intermediaries. Two of these six technical assistance projects included legal components.

The first was a technical assistance grant in 1993 for institutional strengthening of the financial sector. Under this grant, the ADB assisted our Government in the drafting and implementation of a Securities Law which came into effect on 1 January 1995. Prior to enactment of the Securities Law, only procedural rules covering trading operations of the Mongolian Stock Exchange, which was established in February 1992, existed. The grant also assisted in (i) the establishment of the Securities Commission as an independent body to supervise the operations of the Stock Exchange, and (ii) the drafting of rules and procedures for the Commission.

4. Technical Assistance for Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks

The second technical assistance project was a grant approved last year for the development of procedures for the reconstruction and liquidation of insolvent banks. This assistance could not have been more timely in light of the banking sector crisis and closure of the Central Asia Bank, the Ardyn Bank, and the Insurance Bank last year. Although monetary targets were achieved during 1995 and the first half of 1996, most banks violated credit ceilings and minimum reserve requirements, and the Bank of Mongolia was unable to enforce regulatory discipline due to weaknesses in legal authority.

Under the technical assistance, a legal advisor (i) reviewed the legal framework for restructuring and liquidating commercial banks, including the bankruptcy law, contract law provisions under the civil code, and the banking law and regulations; (ii) reviewed amendments to the banking law and statutes of the Bank of Mongolia and recommended appropriate changes; and (iii) advised the Bank of Mongolia on legal aspects pertaining to the revision of its regulations and procedures for dealing with the liquidation of insolvent commercial banks.

The Bank of Mongolia now has the clear power to issue regulations to carry out its functions as supervisor of banks.

Thanks to the combined efforts and recommendations of the ADB, the World Bank, and the International Monetary Fund, the legal framework covering the commercial banking sector was strengthened in September last year with the separation of provisions on central and commercial banking through the enactment of two laws — the Banking Law and the Central Bank Law. Under the Central Bank Law, the Bank of Mongolia now has the clear power to issue regulations to carry out its functions as supervisor of banks.

Provisions on the restructuring and liquidation of commercial banks are included in the new Banking Law. We expect that the stronger legal framework will help increase confidence in the banking system.

5. Financial Sector Program Loan

The ADB's assistance to Mongolia's financial sector culminated in the Financial Sector Program Loan approved in 1996. To support further legal reforms in the financial sector, approval by the ADB's Board of Directors of the Program Loan was conditional on a number of actions, including the enactment of the new Banking Law and Central Bank Law.

Release of the second tranche of the Program Loan is subject to satisfaction of a number of law-related conditions, including (i) submission of a draft Law on Secured Transactions (for movables) to Parliament; and (ii) strengthening bankruptcy legislation to facilitate debt recovery — in particular, giving preferred status to secured creditors.

In order to assist the Bank of Mongolia in fulfilling several of the other conditions specified for the release of the second tranche, the ADB is providing a technical assistance grant of US$1 million for strengthening the supervisory and restructuring capacity of the Bank of Mongolia. This technical assistance includes the services of a legal advisor to (i) advise the Bank of Mongolia on legal issues pertaining to the conservatorship and receivership of commercial banks; (ii) assist the Bank of Mongolia in the liquidation of banks; and (iii) assist the Bank of Mongolia in the preparation of regulations on banking supervision, bank licensing, and conservatorship.

I would now like to move to a critical area of good governance where the ADB has provided invaluable assistance: public sector management and capacity building through training.

6. Technical Assistance for Restructuring and Capacity Building in the Ministry of Justice

Early this year, the ADB's law and development activities included a technical assistance to the Ministry of Justice for restructuring and capacity building. The primary focus of the assistance was to help the Ministry prepare its business plan in accordance with the Government's policy on reforming government processes and the general system of structure. The purpose of the policy is to "redefine directions of Government processes, streamline its general system of structure through re-engineering, introduce management methods suited to market economy relations in a democratic society, reduce budget costs of public entities and raise their efficiency by enhancing the leadership role of the Government."

The Ministry of Justice's Business Plan contains three key recommendations: (i) to enhance the policy and planning capacity of the Ministry; (ii) to strengthen the legal drafting capability of the Ministry by creating a specialized legal drafting department; and (iii) to transfer implementing responsibilities to the Ministry's agencies, while having the Ministry retain the appropriate policy development and coordination functions.

7. Technical Assistance for Legal Training

Finally, I would like to turn to capacity building through training. One of the major conclusions of the Legal Needs Analysis Report was the need to establish a training program for Mongolia's legal professionals. The ADB's assistance commenced with training in skills required for international sales contracts. A second technical assistance project was designed to address the ad hoc nature of the many training programs that had been offered for Mongolian legal professionals by supporting a working group to prepare a program to institutionalize legal training.

8. Proposed TA for the Retraining of Legal Professionals for Market Economy

As a result of the recommendations of the working group, which consists of representatives of the major legal institutions in Mongolia, including the Ministry of Justice, the Judiciary, the General Prosecutor's Office, and the Institute of Law, and at the request of the Mongolian Government, the ADB is currently preparing a technical assistance project to establish a retraining center for legal professionals in Mongolia. The proposed project will be provided on a grant basis over three years, and will be executed by the Ministry of Justice.

The objective of the technical assistance is to establish a retraining center where Mongolian lawyers will be taught how to apply market economy-based legal principles in recently enacted commercial laws and regulations such as the Banking Law, Civil Code and Bankruptcy Law. The Retraining Center will also provide training in lawyering skills such as negotiating and drafting legal agreements and regulations.

The Retraining Center will offer training for about 200 lawyers each year through six three-month programs, and will be located within the Institute of Administration and Management Development, Mongolia's central organization for retraining and upgrading the skills of public administrators and business managers in public and business administration.

The Center will be twinned with an international legal training institution throughout the duration of the technical assistance. This long-term relationship will start even before the Retraining

Center opens when the Center's instructors receive training at the international institution in commercial legal principles, lawyering skills, and effective teaching techniques. It is expected that the Retraining Center will open early next year.

Conclusion

It has been an honor to participate in this conference and to learn more about the experiences and successes achieved in promoting sound development management. On behalf of the Government of Mongolia, I would like to express our sincere appreciation to the ADB for the assistance it has provided in developing Mongolia's legal system, and our hearty congratulations on the ADB's achievements during the past 30 years.

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