

# EXECUTIVE SUMMARY



Economic growth in Asia-Pacific economies, although steady, is modest compared with its recent historical trend amid prolonged weak external demand and its ramifications, such as subdued investment and rising trade protectionism. While robust economic growth is not a sufficient condition for achieving broader development goals, the lack of it could undermine efforts to reduce poverty and expand the availability of decent jobs. At the same time, decades of rapid economic growth, facilitated by globalization and technological advances, came at a cost – rising inequality and environmental degradation. Addressing such economic, social and environment challenges in a coherent and decisive manner will be critical for improving the region's future prospects.

The *Economic and Social Survey of Asia and the Pacific 2017* contains an examination of these policy challenges, especially from the perspective of better governance and effective fiscal management. In particular, in the *Survey for 2017* it is found that the quality of governance affects development outcomes through its impact on the composition and efficiency of public expenditure. At the same time, weak governance partially explains the low levels of tax revenue in several countries in the region. In the *Survey for 2017* it is argued that better governance and effective fiscal management in the Asia-Pacific region can not only improve long-term economic prospects but also facilitate the process of grappling with social and environmental concerns. Indeed, balanced progress on all three fronts is the essence of the 2030 Agenda for Sustainable Development.

Governance quality has been defined in various ways by different organizations and institutions. In the *Survey for 2017* political dimensions, such as democratic accountability, are avoided, and governance is framed in terms of how power is exercised instead of how it is acquired. This approach respects the diversity of cultures, historical experiences and levels of development that countries in the Asia-Pacific region share. A more functional definition of governance enables the focus of the *Survey for 2017* to be on transmission mechanisms – mobilization and allocation of fiscal resources – through which governance affects various aspects of sustainable development. For this purpose, governance is measured by analysing data on government effectiveness, regulatory quality, rule of law and control of corruption – four of the six dimensions of governance covered by the Worldwide Governance Indicators database. In the *Survey for 2017* it is argued that enhancing transparency and accountability in public administration is fundamental to improving governance quality and achieving better fiscal management; several policies that can help on this front are discussed.

The first chapter of the *Survey for 2017* provides a macroeconomic assessment of the region, with a discussion of risks to the economic outlook, and it highlights the importance of improving the quality of economic growth. A case is made for a proactive role for fiscal policy and supporting structural reforms not only to enhance economic potential but also to strengthen social protection and improve resource efficiency. The second chapter provides a more disaggregated analysis of economic issues and indicates that the potential benefits of better governance and effective fiscal management are large and wide-ranging, including: better health outcomes in the Pacific; economic diversification in North and Central Asia; decent jobs in South and South-West Asia; ecological innovations in East and North-East Asia; and narrowing development gaps in South-East Asia. The third chapter contains a study of the relationship between governance and various dimensions of sustainable development; the study delves in detail into analysing the role of governance in improving fiscal management and contains a discussion of a range of policy options to improve the quality of governance in support of better fiscal management.

## Economic growth dynamics and risks to the region's economic outlook

**Economic growth in the Asia-Pacific region has relied more on domestic demand in recent years than in the past, given the prolonged weakness in external demand and global trade.** In particular, in line with the region's growing purchasing power, domestic private consumption has been the major growth driver, supported by low inflation, ease of borrowing at low interest rates and spending by the rich that have benefited from the increased value of their assets. These factors, however, are unlikely to support a sustained expansion of domestic demand; as inflation gradually increases, the capacity to repay borrowing weakens in the wake of slower growth in employment and incomes, and favourable liquidity conditions tighten. A sustained increase in consumption needs to be backed by consistent growth in real wages, which ultimately depends on productivity growth and labour market policies, both of which are areas that require greater policy attention.

**Private investment has not been forthcoming in many countries despite low interest rates.** This phenomenon is explained in part by global factors, such as weak aggregate demand and heightened uncertainty. For instance, global growth forecasts have been constantly revised downward in recent years, lowering the expected returns for business. A related factor is excess capacity and low capacity utilization in certain industrial sectors, as reflected in subdued industrial production. There are also signs of debt overhang and balance sheet pressures in the corporate and banking sectors in some of the major economies. While large public infrastructure outlays in major economies, such as China, have offset to some extent the slowdown in private investment, this is not the case in most countries.

**Leading indicators, such as the Purchasing Managers' Index for assessing the health of the manufacturing sector and the latest export and import data, point to a mild economic recovery in 2017 and 2018.** However, the recovery is unlikely to be a firm rebound given that the factors which held back private investment remain largely unresolved, even as rising trade protectionism effectively offsets potential recovery in external demand. Nevertheless, average economic growth in developing Asia-Pacific economies is projected to rise to 5 and 5.1 per cent in 2017 and 2018 respectively, from an estimated 4.9 per cent in 2016.

**The most significant risk to the broadly positive economic outlook is rising trade protectionism.** At the same time, recent shifts by the United States of America in its policies concerning trade, currency and immigration together with the so-called Brexit have increased global policy uncertainty and could have negative impacts on the region, including for China's goods exports and India's services exports. Any foregone trade and investment in turn could harm employment prospects and act as a drag on productivity growth in the years to come. An alternative economic growth scenario contained in the *Survey for 2017* would suggest that economic growth for the major developing countries in the region in 2017 could be up to 1.2 percentage points slower than the baseline projections if an increase in trade protectionism and global economic uncertainty is steeper than anticipated.

**This increase in uncertainty comes at a time of potential tightening of global financial conditions, which could effectively bring to an end the region's cycle of monetary easing.** Capital outflow pressures, which increased in the wake of United States presidential election in November 2016 before subsiding recently, could re-emerge with the announcement by the United States of fiscal stimulus, and lead to further depreciation of regional currencies. On the upside, regional exports may benefit from relatively stronger external demand and currency-induced competitiveness, but any boost is likely to be limited due to the high number of trade protectionist measures.

**Within the region, China's role as originator and transmitter of shocks has increased in recent years, given its role in global value chains.** Real or perceived economic instability in China could lead to bouts of financial volatility in the region, as witnessed in early 2016. Given that several regional economies are competing with China in global value chains, the depreciation of the renminbi puts pressure on other regional currencies also to depreciate. On the upside, if China's economic performance is stronger than expected, as it was in 2016, there could be positive trade spillovers.

## Economic policy and structural reform considerations

**Boosts to credit and domestic demand from low policy rates have been smaller than expected, indicating limited efficacy of monetary policy under current conditions.** In going forward, the recent uptick in inflation, though mostly due to non-domestic demand factors, such as oil prices and exchange rate depreciation, should also dissuade policymakers from further interest rate reductions. Likely currency depreciation could further limit monetary policy space, not least due to its inflationary impact. Indeed, monetary policy stances in the region have recently shifted

from “accommodative” to “neutral” as upside risks to inflation increased slightly. Average inflation in the developing Asia-Pacific region is projected to rise from 3.6 per cent in 2016 to 3.8 per cent in 2017 and 2018. The region's economies are advised therefore to maintain the status quo in terms of policy interest rates. They should consider strengthening capital flow management and macroprudential measures to mitigate adverse effects of exchange rate depreciation and to ensure financial stability.

**Fiscal policy, on the other hand, could play an active role in boosting domestic demand and supporting development priorities,** such as reducing poverty, mitigating inequalities and supporting social protection measures. Indeed, fiscal policy stances in the region have been broadly countercyclical and expansionary in recent years. Nevertheless, ensuring fiscal sustainability is important and would require comprehensive tax reforms and effective debt management. Tax collection remains relatively low in the Asia-Pacific region, and the scope for boosting revenues through improved compliance and base-broadening is particularly large. Beyond financing, countries need to pursue broader public sector governance reforms to ensure that fiscal spending translates into better development outcomes. In assessing fiscal sustainability, countries should also consider the potential long-term positive spillovers of social and infrastructure investments in the economy. If the spillovers are sufficiently large, for instance due to the “crowding in” of private investment, the public debt-GDP ratio could be stable over the long term. This is an area where more research is needed given the mixed empirical evidence.

**The important role of fiscal policy management in promoting social development is evident in Pacific island developing economies.** Evidence suggests that the current relatively large amount of health spending in the Pacific subregion could be made more effective when more resources are devoted to preventive care and early treatment by specialized health services. Regarding revenue policy, taxes and tariffs have been introduced to discourage consumption of unhealthful products, although there appears to be room for higher tax rates. Such policies as user-pay health-care services and public-private partnerships are also a possible option, but they require careful implementation and effective governance to ensure people's access to services.

**Structural reforms – measures that are aimed at raising productivity – could complement fiscal policy and help lift potential economic growth.** Structural reforms are not new to the Asia-Pacific region and have been critical to the region's unprecedented structural transformation in recent decades. As seen from the perspective of the region's own experience, different reforms are needed at different stages of economic development. For instance, measured and gradual sectoral shifts from agriculture to manufacturing, particularly in East Asia, led to considerable productivity gains, supported by trade reforms, skills upgrading and infrastructure outlays. Similarly, China is now promoting high-technology industries through road maps, such as “Made in China 2025”, while gradually increasing the share of services in the overall economy. Yet for other developing countries in the region, such as India, expanding the manufacturing base, including to relatively labour-intensive sectors, will be important for making broad-based productivity gains.

**While structural reforms are generally viewed as productivity-enhancing, a careful assessment is needed concerning their distributional and environmental impacts.** As “creative destruction” of jobs takes place, workers will need to be equipped with the necessary skills and protected from disruptive impacts. Moreover, rather than following a “one-size-fits-all” and “big bang” approach, a less ambitious alternative is to follow sequential targeting of binding constraints. A potential advantage of this approach is that early wins create political support for reforms over time, and the sense of ownership increases, which allows time for countries to “learn to reform”. The region's own experience, including that of China, supports the sequential targeting approach. It also highlights the important role of the State in structural reforms. The Government provides an enabling environment in terms of policies, institutions and public services that helps factor and product markets to work efficiently. This situation in turn enables private sector-led growth to take place.

**In many cases, the driving force for implementing domestic structural reforms is new opportunities brought about by external developments.** For example, in the North and Central Asian subregion the Eurasian Economic Union (EAEU) aspires to become a single market with free trade among members, while the Belt and Road Initiative (BRI) of China is aimed at improving trade and infrastructure connectivity between China and European countries through the Eurasian landmass. To capitalize the potential gains from EAEU and BRI, subregional economies need to reduce domestic regulatory burdens to enable firms to benefit from lower cross-border trade costs. As productive capacity increases, more active participation in global supply chains can help widen the subregion's economic base.

## Quality of economic growth

**The benefits of economic expansion have accrued relatively less to the poor as is evident from the rising income inequality in the region.** In the context of slower economic growth, sustained poverty reduction would need to rely more on enhancing income distribution and addressing non-income factors, such as social exclusion. Comprehensive measures are needed to tackle inequality, including fiscal measures, such as progressive taxation and social assistance, and labour market policies, such as minimum wages and training of low-skilled workers.

**To tackle rising inequality and high levels of poverty in South and South-West Asia for instance, the availability of decent and high-productivity jobs will be a crucial factor,** as most households depend entirely on labour income for their living. There is also a need to reduce the prevalence of informal jobs, which typically offer low pay and limited social protection. The economic formalization process would benefit from streamlining paperwork requirements and linking incentive schemes, such as financial support, with business registration and basic compliance with labour regulations. Governments could also provide informal workers with more support, including by delinking social security benefits from employees' contributions.

**For the region as a whole, expansion of the availability of decent jobs continues to remain a challenge.** In 2016, average employment growth in the Asia-Pacific region was modest but remained steady at 1.1 per cent, while the share of vulnerable employment remained persistently high at about 50 per cent. In 2015 (latest data), real wage growth was relatively robust in South Asia, possibly due to disinflation, and in China, where the share of labour in national income had been recovering. Wage growth in the Asia-Pacific region, however uneven, outperforms that of the rest of the world. Between 2006 and 2015, real wages in the region grew by 44 per cent, at a compound annual growth rate of 4.2 per cent. However, the region's dynamic performance is driven largely by China; wage growth elsewhere has been much more modest. Also, average wages across and within countries in the region still vary considerably.

## Expanding social protection financing and coverage

**As economies go through structural transformations, a robust system of social protection can help in dealing with issues of inequality, poverty and vulnerable employment,** and contribute to strengthening domestic demand in a more equitable and durable manner. In the *Survey for 2017* it is shown that countries with higher social protection spending tend to have a lower incidence of poverty. Key aspects of social protection include: universal access to affordable health care; free primary and secondary education; unemployment benefits for wage earners and income-support measures for those in need; contributory and social pensions; and full access to social benefits for persons with disabilities. Social protection could also improve the functioning of labour markets, by facilitating skills development and employment, which is especially important in economies that are undergoing rapid structural changes.

**The development of social protection floors is a multi-step process that includes a national social dialogue, a financing strategy and delivery mechanisms.** The Asia-Pacific region currently falls behind the rest of the world in terms of social protection financing and coverage, although there are some successful examples in the region. Average total public social protection spending, including health expenditures, as a percentage of GDP, increased from 3.5 per cent in 2000 to 5.3 per cent in 2010/11 (latest year) in the region, but it is still lower than the global average of 8.6 per cent. In terms of social protection coverage, countries such as China, Thailand and Viet Nam have made notable progress since the 2000s, but coverage levels remain weak in most countries in the region. For instance, effective coverage with unemployment benefits (contributory and non-contributory) is limited to 7 per cent of the population in the region compared with the global average of 12 per cent. Financing social protection schemes and improving their delivery rests critically on stable fiscal positions, and effective governance and institutions.

## Internalizing costs of environmental degradation

**Although not captured in the GDP measure, environmental degradation, carbon emissions and air pollution reduce social welfare and undermine the sustainability of economies.** The region's rapid economic growth in the past few decades has been achieved in part on the back of environmental degradation, with concomitant adverse health impacts, and intensive and inefficient use of resources and natural wealth. Furthermore, the region is highly vulnerable to climate change, the adverse effects of which can substantially undermine the economic development gains in the region. Clean air, safe drinking water, sufficient food and secure shelter are also being adversely affected.

**Despite having made gradual improvements, the region falls behind the rest of the world in terms of levels of energy and carbon intensity.** On average, developing Asia-Pacific economies use twice the resources per dollar of GDP as the rest of the world. A clear example of policy effort to achieve more environment-friendly economic growth can be seen in East and North-East Asia. After years of heavy industrialization that led to deteriorating environmental conditions, the subregion is now focusing on green growth and developing energy-efficient and renewable technologies. Together, China and Japan account for nearly half the world's commercial investments in clean technology, while China accounts for most of the world's patent filings in climate change mitigation technologies.

**Experience from East and North-East Asia points to three desirable aspects of public policies to promote clean energy, all of which highlight the role of effective governance.** The first dimension is a well-designed governance structure that features a whole-of-government approach, effective monitoring and evaluation mechanisms and multi-stakeholder partnerships from development to diffusion of technology. The second aspect is a balanced policy framework in which Governments consider a mix of incentives, such as favourable pricing of renewable energy, and regulations, such as setting minimum energy efficiency standards. The third dimension is an enabling financing system, particularly non-traditional green financing instruments, such as carbon trading and green bonds.

### Governance and development outcomes

**The Survey for 2017 shows that better governance and effective institutions affect all three aspects of sustainable development.** For instance, governance affects the capacity of an economy to gain access to a skilled labour force, improve investment prospects and sustain innovation. These factors in turn help enhance the level and pace of productivity, thus improving the long-term economic prospects of an economy. Similarly, in the Survey for 2017 it is argued that, when institutions are weak, inequalities tend to increase and the pace of poverty reduction declines. Weak institutions also partially explain inequality in access to social services, particularly for females as well as the poorest and most vulnerable segments of the society. The quality of governance also affects environmental outcomes, as reflected for instance in varying capacities to make and apply environmental rules and safeguards, and initiate ecological innovation and technological transfer.

**Effective governance can also help close development gaps across countries by contributing to reforms that enable poorer countries to benefit more from regional economic integration initiatives.** For instance, in South-East Asia, the average income per capita in the subregion's emerging economies is more than 10 times that of Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam, the so-called CLMV countries. Development gaps in terms of education and health outcomes are also notable. Narrowing such gaps through structural reforms is critical for CLMV to fully realize potential gains from the ASEAN Economic Community. For this purpose, various governance issues could be strengthened in CLMV, such as improving law enforcement, ensuring property rights and increasing judicial independence. Similarly, promoting greater use of the criminal justice system in addressing corruption, enhancing cross-ministerial coordination to avoid duplication of work and introducing more transparent business regulatory frameworks can go a long way in improving development outcomes in CLMV.

### Governance, tax revenues and public expenditure management

**In the Survey for 2017 it is shown that weak governance partially explains the low level of tax revenues in several countries in the region,** as the quality of governance affects the tax morale of taxpayers, the incentives to operate in the formal sector and the level of compliance of tax officials with relevant laws. Factors that contribute to or encourage fiscal corruption include: complicated tax laws; excessive discretionary power vested in tax administrators and the necessity for frequent interactions between taxpayers and tax officials; weak legal and judicial systems; lack of accountability and transparency in tax administration; and low salaries in the public sector.

**Governance also has impacts on the way public revenues are raised, by affecting tax morale, as the willingness to pay taxes is affected by perceptions of how well tax revenues are used.** Thus, while taxpayers generally are willing to pay taxes if they perceive that the level of public services offered is commensurate with their tax bills, they will shirk their tax responsibilities if they see a mismatch between tax liabilities and services. Low tax morale may also be linked to the perception that evasion of taxes is widespread, especially among those with higher incomes. For instance, in the Survey for 2017 it is estimated that low governance indicator scores explain up to 8 and 21 per cent of the level of tax revenues in Pakistan and Bhutan respectively from 2005 to 2014.



**The quality of governance also affects the achievement of development goals through its impact on the composition and efficiency of public expenditure.** For instance, corruption is shown to distort the structure of public spending by reducing the portion of social expenditure that goes to education, health and social protection. In contrast, it is shown in the *Survey for 2017* that better governance increases the beneficial impact of public-health spending on child mortality rates, makes public spending on primary education more effective and leads to higher attainment in primary education. Moreover, it is also shown that less social expenditure also usually goes hand in hand with greater expenditure on such matters as law and order, fuel and energy subsidies and defence. In the *Survey for 2017* it is estimated that, between 2005 and 2014, the impact of better governance and effective implementation of policies on public sector efficiency ranged from 0.34 per cent in the Russian Federation to 57 per cent in Georgia in the health sector and from 0.15 per cent in Timor-Leste to 32 per cent in Indonesia in the education sector.

### **Policies to improve governance for better fiscal management**

**In the *Survey for 2017* it is argued that enhancing transparency and accountability in public administration is fundamental to improving governance quality and achieving better fiscal management.** For this purpose, it is necessary to improve and strengthen the production of and access to meaningful fiscal information and to develop public administration capacities to monitor, evaluate and audit policies and actions. Inclusive institutions, where public service beneficiaries can exchange views with the Government, could also be instrumental for raising tax revenues and making expenditures more efficient. Also highlighted in the *Survey* are the roles of e-government, information and communications technology (ICT) and decentralization for improving governance in the context of fiscal management.

**In terms of accountability, a regional assessment suggests that several Asia-Pacific countries require public officials at different levels to declare their financial assets in order to help increase the integrity of civil servants as well as public trust in them.** This action has improved the efficiency of government expenditures and the overall quality of governance, although further improvements are needed in terms of public access and the coverage of pertinent information, and the monitoring and oversight of the implementation of such policies.

**Ensuring access to meaningful fiscal information, such as the resources received by various government units responsible for the delivery of public services, can contribute to greater transparency.** However, the availability of and public access to such information remains difficult in several countries in the region, even though these policies have yielded positive results in the case of Georgia, the Republic of Korea, Samoa and Singapore. Furthermore, when information is published, the quality and utility of the published government financial data sometimes seems to be low, particularly in North and Central Asia. In addition to producing and disseminating information, government officials will also need to better manage operational risks associated with the execution of the budget, whether related to tax revenues or expenditures, through internal controls and audits and external audits.

**An assessment of public financial management in selected Asia-Pacific countries shows that there is considerable room to strengthen internal control and audit (external and internal) functions.** For instance, there are issues related to the comprehensiveness, relevance and understanding of internal control rules and procedures. The degree of compliance with rules for processing and recording transactions is also weak. Similarly, with regard to internal audits, there are concerns related to the frequency and the distribution of reports and the extent to which management follows recommendations from an internal audit. Such issues as the scope of an external audit, adherence to international standards and timely submission of reports also require policy attention. Collecting and integrating views and concerns from citizens can also help check the effectiveness of fiscal policies and thus contribute to raising tax morale and revenues. In this vein, there is a need to establish effective feedback systems through which users are informed of the existence of such tools and are able to report wrongdoing by officials or assess the quality of public services.

**The implementation of the above-mentioned policies can be optimized through information and communications technology and wider use of financial services by beneficiaries of public services and by taxpayers.** Tax revenues can be substantially increased on the back of deployment of an e-system for making tax returns and filing taxes. Public expenditure efficiency can also increase due to e-systems because government programmes can be better coordinated, such as in Malaysia with the eKaish system, or funds can be tracked up to their receipt by the final beneficiary as is done in India with the payment of social benefits or wages through bank accounts. While

e-government systems present opportunities for public financial management, and progress has been made during the last decade, Asia-Pacific countries could take greater advantage of the opportunities offered in this regard. Overall, countries with special needs (in particular, least developed countries and landlocked developing countries) do not predominantly use e-government platforms even though they could benefit greatly from their usage.

**Efforts are needed to improve information flows across relevant government departments.** For instance, the tax enforcement function depends on a central database and flow of information from different sources, particularly in the case of value-added tax (VAT) and income tax. However, a typical approach in the organization of tax administrations in developing countries has been to establish separate revenue departments overseeing different tax bases. This situation results in little sharing of information among them, along with difficulties in reconciling data and information on taxpayers. Some countries, such as Maldives and the Philippines, have addressed this problem through reorganizing the tax administration along functional lines.

**Furthermore, through greater ownership of local revenues, fiscal decentralization can strengthen accountability and improve public expenditure efficiency.** However, at the subnational level, gap-filling transfers and shared revenues are preferred to own-source revenues in several Asia-Pacific economies. Measures such as the control over rate structures at the local level could be more effective in generating accountability, even if all or some elements of tax administration are managed at different levels. Given their more limited capacities, subnational administrations could also consider adopting “piggy-back” taxation, wherein tax revenues would be collected by using the tax base, which has been identified by the central Government, and adding a surcharge to the tax rate. Accountability could also be improved by using a property tax system which accounts for the size and location of the property and the cost of the public services delivered.

### Concluding remarks

How societies invest, innovate and ensure that no one is left behind largely depends on the quality of governance and on how much trust and confidence people have in government institutions. As countries in Asia and the Pacific continue to undergo large structural transformations, as reflected in the ongoing rebalancing in China and reforms in India, the role of governance will only increase. The issue of governance is examined in the *Survey for 2017* in the specific context of fiscal management, given the growing demands on fiscal policy to support the economy and address diverse social and environmental challenges.