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Governance and Macroeconomic Management

Although references to the importance of "governance" can be found in studies of development from the early 1970s, it has been only over the last decade that donor agencies have emphasized the concept. Much time was spent initially defining what was implied since the literal meaning of governance, namely, "the act, manner, power, or function of government" did not fully reflect what was intended. Subsequent contributions have stretched and molded the idea so that, as currently used, "good governance" reflects a commitment to transparent administration, accountability, respect for human rights, democratic processes, the non-tolerance of corruption, and sensitivity to gender and environment.

There is, however, a more narrow interpretation derived from the literal meanings of "government" and "administration." This policy brief examines how these concepts relate to macroeconomic management. Our intention is to emphasize that prudent (and responsible) economic management is a crucial dimension of "good governance."

As separate issues, macroeconomic management and governance have been widely studied. Much less attention has been given to the connection between the two. We begin by making two distinctions: the role of government, and the performance of government.

The Role of Government:

In any mixed economy, the "proper" role of government can never be fully resolved. Local and foreign circumstances alter, the capabilities and competence

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of government officials vary, and public perceptions of equity, fairness, and "national welfare" change over time. The willingness of different societies to bear the costs of public sector activities changes as well. These considerations continually modify the types of activities and policies that a government can and should pursue. For instance, the conventional justification for government intervention namely market failures stemming from the existence of public goods, externalities, and missing markets has lost much of its appeal over recent years. This has been due to the high (and often) rising costs of bureaucratic (or government) failures. And, even in the absence of large-scale inefficiency, there has been a growing expectation that governments should disengage from activities that can be undertaken commercially. The implication is that contemporary analyses of the role of government tend to focus on the relative benefits and costs of changing the existing pattern of government involvement, particularly in ways that reduce their involvement.

The history of disruption and decline in Africa over the last three decades, as governments became seriously over-extended, has biased the present trend in favor of public sector disengagement. A prominent argument is that governments should confine their efforts to creating an "enabling environment" for the expansion of non-government activity. Although agreement exists on this point in principle, its implementation has been subject to broadly different interpretations. The extent and pace of disengagement is never clearly specified. Moreover, in some areas, such as health, education, and national food security, a strong case can be made for public sector re-engagement. Recent discussions of democracy and governance have stressed the role that government can play in supporting "civil society."

Cross-country experience now provides useful guidelines on the role of government that is consistent with accepted standards of "good governance." Based on this experience, governments should:

- disengage from activities that can be more efficiently undertaken by the private sector;
- reduce subsidies, especially those which have negative social returns; and
- pursue activities for which the risk-adjusted net social benefits are positive.

Government bureaucrats, especially in Africa, have demonstrated their lack of commercial skills in many unfortunate ways. Social waste is already high in most poor countries due to excessive official travel, lavish representation abroad, the under-funding of expenditure for operations and maintenance, and the accelerated deterioration of public sector capital. Commercially inept bureaucrats have simply compounded the problem.

Subsidies might be justified if the special advantages provided to the favored groups made a positive net contribution to the broader national welfare. Governments typically justify expenditures on drought relief and infrastructure development in isolated regions in these terms. What is not justified, however, is the "capture" by special interests of public support that provides them with a private advantage. An obvious example is the continued over-staffing of African civil services. The problem has been that those responsible for implementing economic reform (often civil servants themselves) have been unwilling to begin cutting where the waste and inefficiency is most apparent. If subsidies such as these were evaluated relative to their contribution to national welfare, most would be eliminated. In practice, subsidies are often politically impossible to remove. Yet, if economic reform is to proceed, subsidies that have no redeeming social value — such as support for loss-making national airlines, sub-market interest rates, and an over-valued official exchange rate that boosts urban real incomes — should be removed.

Weighing the benefits and costs of particular activities is fundamental to effective macroeconomic management. Indeed, a standard criterion of public choice is that the prospective (risk-adjusted) benefits of any activity (including the provision of subsidies) should outweigh the opportunity cost of the resources involved. Public actions derived from this criterion are basic to the idea of "transparency," itself a crucial feature of "good governance."

The Performance of Government:

Perceptions of the role of government directly influence judgements about the performance of government. These judgements are never straightforward due largely to the intermittent, non-marginal, changes in the reform agenda. The recent focus on "governance" is an example. It is now one of many items that have been added to the development agenda over the last two decades. When viewed in isolation, such additions can readily be justified for their potential contribution to social welfare. Yet, the cumulative effect has been to clutter the development agenda in ways that deflect governments from the basic task of providing a setting for rapid sustained rates of growth and development. Most African governments long ago over-reached their administrative and financial capacities. Improved performance requires a drastic simplification and scaling back of their agendas.

A government's performance will satisfy standards of improved governance if they are consistent with the principles of prudent fiscal and monetary management. Such principles require governments to finance themselves in non-inflationary ways, allocate public expenditure according to its prospective social returns, maintain sovereign debt at levels that can be serviced on a sustainable basis, and use public assets to foster public welfare rather than serve narrow sectional interests. Guided by these principles, governments will also enforce the tax laws without fear or favor so that all groups in society share the costs of public administration, and actively avoid "over" dependence on foreign assistance. Appropriately implemented, all of these measures would be undertaken pro-actively.

Is this a tall order? Does this simplify the agenda or simply clutter it in other ways? A relatively straightforward way of satisfying these principles would be for African governments to eliminate the public sector deficit. Doing that would sharply reduce the rate of inflation, help stabilize the exchange rate, slow down the growth of public sector debt (internal and external), and achieve the macroeconomic stability needed to encourage financial deepening, raise the level of investment, and stimulate capital inflows. Eliminating the deficit may be politically difficult. But, it is not technically difficult. There is now broad-based experience in the implementation of "cash budgets," zero-based budgeting, revenue reform, contracting out for public sector services, commercializing government operations, and privatization. Any government committed to the elimination of its deficit has sufficient instruments to succeed. Indeed, this is precisely how appropriate macroeconomic management contributes to good governance.

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