USAID Development Information Services

Economic Governance and 'Near Miss' MCA Countries
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Executive Summary

Since the 1980's various indicators of the quality of economic governance, such as corruption and freedom indices, measures of regime stability, openness to trade, and ease of opening a business, have been used as explanatory variables in empirical economic growth literature. The notion that economic governance is closely linked to growth and development evolved both from this work and from the experience of development practitioners. Yet economic governance remains a broad and subjective concept which cannot be easily, consistently, or oftentimes accurately defined or measured. Recent academic and policy literature has shed some light on this topic, particularly regarding 'governance' in general. 'Economic' governance is an extension of this and can be best understood by considering institutions and practices that impact an economy overall and, more specifically, the economic environment in which the private sector functions. It is generally agreed that good economic governance consists of well-functioning institutions, laws and regulations which support the private sector and encourage growth, reasonably transparent macroeconomic regimes with oversight and accountability, and microeconomic policies which provide appropriate incentives to firms and enable them to function efficiently.

Most major development organizations support improvements in economic governance to at least some degree, with the World Bank being most heavily involved in this area. Since the mid-1990's the World Bank has helped clients build the institutions necessary for implementing sound economic policy and has increasingly devoted attention to corruption. Governance and anti-corruption are now focal points of country assistance strategies.

Economic governance in most potential Millennium Challenge Account (MCA) and likely near-miss MCA countries is fragile. Institutions are often inefficient, inappropriate, and/or inadequate, and the economic environment not conducive for sustained growth and private sector development. One result of poor economic governance is that countries lack the capability to construct effective and realistic development plans, set appropriate priorities, consistently implement successful programs, or use funds effectively. USAID may play a role in helping a country improve its capability in these areas. Additionally, since most of the indicators used by the Millennium Challenge Corporation (MCC) to identify eligible countries are related to economic governance, programs focused on economic governance-related issues may help 'near-miss' countries improve their overall performance, increasing their chances of receiving future MCA funding.

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I. Introduction

Since the mid-1980's researchers have used several specific indicators of good economic governance to explain economic growth. Though most of these indicators were indeed positively correlated with per capita growth, due to limited or poor quality data and lack of an adequate explanation of the concept, no known study has successfully used more than two or three such variables at one time and none has used a comprehensive measure of governance. Because economic governance is subjective and qualitative in nature, the concept remains broad, difficult to quantify, and somewhat ill-defined.[1] But an appropriate definition is important and would allow a better understanding of the relationship between the quality of government and development, would improve monitoring of country performance, and may help identify areas of weakness so that assistance strategies may be more focused and, ultimately, more effective.

Recent work suggests that economic governance is not likely to improve simply as a consequence of growth, implying that growth without good economic governance is not usually sustainable (Kaufmann et al. (1999)). One reason is that entrenched political and economic elites often benefit from poor governance and the resulting lack of a meritocratic system, and consequently have a strong incentive to resist change. In addition to academic literature, practical experience supports this hypothesis and supports the proposition that that good (or improved) economic governance is a necessary condition for sustained growth and development. Consequently, an effective development strategy should focus on elements of economic governance and should address growth from this perspective. This is especially true for potential MCA and likely near-miss MCA countries, many of which do not have the capacity required to effectively utilize large amounts of funding and are vulnerable to corruption and mismanagement.

The objective of this paper is to: (1) identify a coherent definition of 'economic governance' based on current research and policy studies; (2) specify elements of good economic governance which could serve as a basis for development assistance and identify areas where USAID can support 'near-miss' MCA countries; and (3) identify which major ODA donors address economic governance.

II. In Search of 'Economic Governance'

a. Governance and the Economy

Over the years the meaning of the term 'governance' has evolved.[2] In the most basic sense governance refers to the relationship between a government and its citizens. When government is efficient, transparent, just, supports political and economic freedom and

[1] Zuvekas (2002), Hydan (1998), and others discuss the difficulty of defining and measuring governance at length.
[2] See appendix 1 for various definitions of the terms 'governance' and 'economic governance'.

productive activity, and clearly defines and enforces property rights, the relationship between a government and its citizens is likely good. Though good government is obviously something favorable, looked at in this way the concept is broad and not analytically useful.

Approaching the topic systematically, Kaufmann et al. (1999, 2000, 2002, and 2003) have identified an acceptable definition and have quantified specific elements of good governance. According to this research, governance is most accurately defined as “the traditions and institutions that determine how authority is exercised in a particular country”, where the most important aspects of this authority are: (1) the process by which governments are selected, held accountable, monitored and replaced; (2) the capacity of governments to manage resources efficiently and formulate, implement, and enforce sound policies and regulations; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them. In their work Kaufmann et al. attempt to measure governance by considering several hundred separate measures from twenty-five sources, a large number of which are based on surveys of country residents, entrepreneurs, foreign investors, and civil society at large. Using this approach, the opinion of virtually all stakeholder groups is taken into account. Though unavoidably subjective in nature, this data is comprehensive and useful, offering a good indication of governance quality. Kaufmann et al. contend that it is important to be aware of the subjective nature of these indicators, but that subjectivity should not be of great concern. They argue that since a country’s residents must have confidence in institutions if they are to contribute to good governance, the perception of quality may be as important as are objective differences in institutions across countries.

In order to construct practical and comprehensive measures, Kaufmann et al. form “clusters of indicators corresponding to six basic and tractable dimensions of governance” which embody the three components listed above. These dimensions are: (a) voice and accountability; (b) political instability and violence; (c) government effectiveness; (d) regulatory burden; (e) rule of law; and (f) control of corruption. When broken down into these clusters, it is clear that governance has both political and economic aspects and that each of these six dimensions of governance affect economic activity to at least some degree, with regulatory burden, rule of law, and control of corruption arguably being most important. Looked at in this way, political and economic governance are unavoidably interrelated.

B. ‘Economic’ Governance

‘Economic governance’ has emerged as a closely related yet more specific concept than governance per se, and is best approached from a slightly different viewpoint. Typically, economic governance focuses on institutions and practices that affect the economy as a whole and the private sector in particular, and can be loosely divided into two parts, the microeconomic environment, which includes but is not limited to policies, laws and regulations affecting economic activity and competitiveness, and the quality of macroeconomic practices and regimes (i.e. monetary, fiscal, and regulatory).

Micro-level economic governance is best understood by specifically considering the private sector. The work of Dixit (2003), De Soto (1989, 2000), and North (1990) argues that virtually all economic transactions need governance because of the incentive for buyers and sellers to cheat for their own gain, and the potential for unintentional misunderstanding and disagreement due to ill-defined, non-existent, or unenforced rules of transaction and/or property rights. When economic governance is insufficient the fear of suffering a loss for these reasons can make prospective buyers and sellers either unwilling to enter a transaction that would benefit both parties or unwilling to commit themselves to the desired extent.

Excessive or inappropriate regulations and processes can have similar results. De Soto (1989, 2000) offers examples from several countries where legally starting a small business or purchasing property requires obtaining approval from dozens of government offices, paying large fees (and usually bribes), and waiting many months for documents to be processed and approval granted.

Whether economic governance is insufficient, excessive, or inappropriate, the results are the same: fewer transactions, less incentive for entrepreneurship and innovation, and less commerce. In such an environment the firms that do exist tend to have short time horizons, little fixed capital, little or no access to financing, and will tend to be small in scale and confined to local activity (North (1990, p. 67)). The wider-reaching effects of such an environment include a smaller tax base, more corruption, lower growth levels, and less development. Many of these problems may be addressed by providing appropriate, clear and enforced rules of transaction, clearly defined property rights, and policies that encourage competitiveness, such as the removal of unnecessary legal and regulatory constraints and trade restrictions so that the private sector can respond to market-driven signals and can function efficiently.

From a macroeconomic perspective, economic governance includes the institutions through which economic policy is made and implemented and 'rules of the game' enforced. The quality of such institutions will have a significant impact on investment and growth where 'good' institutions are those which are reasonably transparent, have predictable rules and regulations that encourage competition, offer equitable access to public services, and have a competent and accountable economic bureaucracy which includes an independent central bank, responsible budget preparation, sound financial management, a liberal trade policy, and a tax system which is not overly complicated or burdensome.

III. <u>How Can USAID Support 'Near Miss' Countries?</u>

According to Kaufmann et al., countries that successfully improve rule of law, control corruption, and promote accountability, can expect about a four-fold increase in per capita income over the long term, as well as dramatic improvements in literacy and child mortality. Clearly, the quality of economic governance determines whether a country has the capability to sustain growth and in most cases should be the focal point of development strategy.

USAID can support likely near-miss MCA countries either directly or indirectly by: (1) helping countries improve their performance on specific indicators which the MCC considers when determining whether a country is eligible for MCA funding; and/or (2) helping near-miss countries construct and implement an appropriate, high quality development plan focused on issues related to economic governance in order to secure and effectively utilize MCA funds once they are disbursed. Such a plan would serve to complement rather than take the place of other initiatives which may be in place. Either approach would contribute to improving economic governance and increase the chances of future MCA funding.

When determining which countries are eligible to receive funding, the MCC considers only those that have had some success in three broad areas: ruling justly, encouraging economic freedom and investing in people.[3] Though all three are related to economic governance, ruling justly and economic freedom are of more central concern. Under each of these two categories the MCC considers six specific indicators. Of these twelve indicators, ten are very closely, if not directly, related to economic governance. If improving economic governance with the hope of securing future MCA funding is a country's primary objective, it may be useful for USAID to consider supporting projects which address these specific areas.

However, several points need to be stressed. First, depending on the indicator concerned, previous experience suggests that it may take several years before positive results are generated. Given that the timeline is short, this approach may not prove successful with most indicators. Second, because the criteria for eligibility changes from year to year, improving some indicators in no way guarantees MCA funding in future rounds. Ironically, one indication of MCA's success would be a gradual increase in the numeric value of eligibility indicators. Such a result would suggest that MCA countries are utilizing funds effectively and responding to positive incentives. Third, if USAID rather than the country in question takes the lead in improving performance in a specific area, this may allow the country to absolve itself of responsibility for its own performance, which both is counterproductive and discourages good economic governance.

The degree to which potential MCA and likely near-miss countries have the capability to formulate realistic, high quality proposals, set priorities, consult with stakeholders, formulate growth plans, or manage projects is uncertain. Nevertheless, USAID can help countries improve their chances of securing MCA funding by assisting in the development of well conceived plans which focus on economic governance and which could help countries better manage development resources. As part of the process, stakeholders such as business associations and the private sector could be consulted. By stressing economic governance and encouraging consultation, private sector development can be brought to the forefront. By bringing the private sector to the table competitiveness can be promoted and growth-oriented strategies, anti-corruption

[3] See appendix 2.

measures, and regulatory reform encouraged. Since most potentially eligible MCA countries do not have many business associations, USAID may serve a useful function by providing strategic technical assistance to the private sector, in this way facilitating public-private dialog.

IV. Do Other Major ODA Donors Support Economic Governance?

The World Bank is the only major development organization which is heavily involved in economic governance. It is especially focused on helping clients build institutions which will allow them to make and implement good policy and deliver public services. The Bank is also focused on controlling corruption. Though it does not deal with economic governance per se, rather with governance in general, the areas it tries to influence are primarily related to economic issues.

Over the past four years the World Bank has shifted focus and has devoted more attention to governance and anticorruption in Country Assistance Strategies (CAS) than it has to individual policy changes or to the provision of public services. All CAS's now address governance and corruption and the majority also address issues such as accountability, transparency, and participation. As part of the overall effort, the World Bank has pursued three initiatives, which are especially important for Africa: (1) the Poverty Reduction Strategy Paper process; (2) community-driven development; and (3) expenditure accountability in the HIPC program.

Appendix 1

Definitions of Governance:

Frischtak (1994, p. 28): "[T]he uncoupled dynamic quality of government, [where government is] understood as the norms, processes, instruments, and institutions that comprise the state apparatus. Governance is also the steering quality manifested in the state's conduct of policy But most importantly, governance is about power."

ADB (1998): "[T]he manner in which power is exercised in the management of a country's social and economic resources for development."

Kaufmann et al. (2000): "[T]he traditions and institutions that determine how authority is exercised in a particular country."

Definitions of Economic Governance:

North (1990): "Economic rules of the game (with enforcement) that induce sustained economic growth."

ADB (1998): "[S]ound development management."

Ekpo (2002): "Economic governance centres around sound economic management and performance of an economy over time [which] must result in sustainable economic growth and development [and] includes the provision of sound macroeconomic policies that create a stable environment for economic activity. It implies the creation, protection, and enforcement of property rights…, the provision of an efficient regulatory regime, the absence of corruption, consistent policies to eradicate poverty, [and] the provision of appropriate institutions."

Fischer (2003): "[Good economic governance means] efficient judicial systems, civil service, and tax system, and other elements in the enabling environment for private sector activity."

Appendix 2

<u>Eligibility Criteria for the MCA</u> (from: Radlet (2003))

I. Ruling Justly

1. Control of Corruption
2. Rule of Law
3. Voice and Accountability
4. Government Effectiveness
5. Civil Liberties
6. Political Rights.

II. Investing in People

7. Immunization Rate: DPT and Measles
8. Primary Education Completion Rate
9. Public Primary Education Spending/GDP
10. Public Expenditure on Health/GDP

III. Economic Freedom

11. Country Credit Rating
12. Inflation
13. Regulatory Quality
14. Budget Deficit/GDP
15. Trade Policy
16. Days to Start a Business

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