7
Strengthening Governance

There is a growing consensus that good governance is essential if higher aid flows are to be effective in promoting growth and reducing poverty.[25] Major donors have made this point, most recently at the July 2005 summit of the Group of Eight countries in Gleneagles, Scotland (Group of Eight, 2005). Strengthening governance therefore will likely increase the probability that donors will actually disburse the higher aid flows promised in the new scaling-up programs.[26]

7.1. Reducing Corruption

Rent-seeking behavior, which is found in all countries, is more pervasive in some than in others. Pervasive corruption tends to be associated with poorly enforced property rights, a weak rule of law, and weak incentives for productive investment, all of which are damaging to economic growth on their own.

Reducing corruption can enhance growth and improve aid absorption.

A considerable amount of research in recent years has focused on the negative correlation between the level of corruption in a country and its social and economic performance. Corruption has received particular attention because the availability of corruption measures helps to "quantify" its extent and allows for international comparisons. Many studies rely on corruption indices developed by Business International, International Country Risk Guide, and Transparency International. But two sets of World Bank indicators have gained prominence in recent years: the Country Policy and Institutional Assessment

[25]See, for example, Commission for Africa (2005).

[26]The link between aid and governance is a central feature of the U.S. Millennium Challenge Account (MCA), which channels aid directly to specific country priorities. Country eligibility for aid is determined by a set of indicators, including one for corruption. For 2005, seven SSA countries are eligible: Benin, Ghana, Lesotho, Madagascar, Mali, Mozambique, and Senegal. Seven additional SSA countries have "threshold" status, meaning that they are close to meeting the eligibility criteria and can access some aid flows to make additional progress. These countries are Burkina Faso, Kenya, Malawi, São Tomé and Príncipe, Tanzania, Uganda, and Zambia. See *http://www.mca.gov/*.

(CIPA) scores (which became public information beginning in 2005), and the World Bank Institute's indicators on six components of governance (which cover nearly all countries and have been available biannually since 1996).

7.1.1. The Impact of Corruption on Economic Performance

Empirical research highlights the negative impact of corruption on growth, public finances, poverty, income inequality, and the provision of social services. Appendix Table A.2.9 summarizes some of the results.[27] Corruption is shown to lower growth by reducing private investment, attracting talented individuals into unproductive activities, and encouraging poor management of natural resources. Experience in the former Soviet Union and Eastern Europe suggests that structural reforms designed to rationalize the role of the state, increase reliance on market-based pricing, and create a sound regulatory environment contribute to growth directly and indirectly by lowering the incidence of corruption (Abed and Davoodi, 2002).

Corruption also distorts the composition of public expenditures in favor of sectors in which bribes are easier to collect. Corruption typically shifts spending away from routine maintenance and repair, education, and health to excessive and inefficient public investments and higher military spending.[28] Human capital and investment are similarly impeded by poor governance, which limits the growth impact of social sector spending. Corruption in the form of abuse of public funds not only results in weak social indicators, but also weakens revenues because it contributes to tax evasion, improper tax exemptions, and weak tax administration (Ghura, 2002).

7.1.2. Successful Anticorruption Strategies

Successful anticorruption strategies depend on the presence of a credible deterrent to the abuse of public offices.

In a country with weak governance, effective anticorruption measures should strengthen the growth impact of a scaling up of aid. Successful anticorruption strategies are typically predicated on the presence of a real and effective deterrent to curb individuals' instincts to abuse their public office for personal gain. Public officials need to believe that if they abuse their offices, they run a substantial risk of being caught, convicted, and punished.

Moreover, prosecuting serious high-profile corrupt actors is "an essential element of an anticorruption strategy so that a cynical citizenry believes that an anticorruption drive is more than just words" (Klitgaard, Maclean-Abaroa, and Parris, 1999). Independent anticorruption bodies may have a role to play

[27]A number of studies explicitly examine the negative impact of corruption on economic growth. Mauro (1995) finds that increasing corruption by one unit (on a scale of 1 to 10) lowers real per capita GDP growth by 0.3 to 1.8 percentage points; Leite and Weidman (2002) and Abed and Davoodi (2002) report a somewhat narrower range centered on about 1 percent.

[28]Gupta, Davoodi, and Tiongson (2002) find that higher corruption has adverse consequences for social indicators such as child mortality rates and student dropout rates. Baldacci and others (2004) identify a key role for governance in influencing the effectiveness of education and health interventions. In particular, they find that health spending has no impact on social indicators in countries suffering from poor governance.

in this context. Their work should be supplemented by an ongoing public information program to educate the public about the negative effects of corruption and by a system that allows the public to report acts of corruption without fear of retaliation.

It is also critically important to liberalize and reform institutions and practices to reduce the opportunities for rent-seeking and corruption and to strengthen public audit functions. These reforms also strengthen domestic revenue mobilization by signaling the ability and commitment of the government to account for how revenue is spent.

7.1.3. Breaking the Cycle of Poor Governance

Beyond the negative impact on growth, there is a self-reinforcing cycle of poor governance. Citizens demand less and less from their government as their demands go unmet and their expectations diminish. Breaking this cycle is an important element of the scaling-up agenda, although its contribution to improved governance is difficult to quantify.

7.2. Improving Public Expenditure Management Systems

Well-functioning PEM systems are essential if higher aid flows are to be absorbed effectively. They provide assurance to donors that their resources are being used for the intended purposes, while reducing the transaction costs of meeting donor-specified reporting requirements. They also improve governance by making public expenditures more efficient and transparent (including to citizens). Finally, they help governments implement the scaling-up scenarios by tilting expenditures toward priority areas.

Most African countries' PEM systems need considerable upgrading, and donors have identified this as a priority. The World Bank and IMF assessed the PEM systems in Highly Indebted Poor Countries (HIPCs) and found that the systems in 16 African countries required substantial upgrading, those in 4 countries required some upgrading, and only 2 required little upgrading. This suggests that scaling-up scenarios will have to include resources for strengthening PEM systems.

Instituting well-functioning PEM systems is only one part of the larger effort to consolidate fiscal institutions.

Over 50 donor agencies, in addition to the World Bank and IMF, are active in this area and could be called upon for assistance. Instituting well-functioning PEM systems is only one part of the larger effort to consolidate fiscal institutions that many donors are promoting. Policies to introduce greater transparency, strengthen rules governing budget procedures and reporting, and prepare MTEFs are all part of this effort and can provide additional assurance to donors that scaled-up aid will be used effectively (Diamond, 2006). For example, in the Republic of Congo, the recent publication of fiscal data, audited reports on oil activities, and reports on external verification of government revenues, oil contracts, and data has been a strong signal to the country's development partners that a concerted change in the policy regime is under way (World Bank and IMF, 2005).