Interdependency of Aid Effectiveness and Good Governance

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Abstract

The spirit of this article is to offer a fresh perspective related to the future of aid as a way of informing the ongoing discourse on development assistance to the benefit of policy makers and key stakeholders. It suggests that aid deployment ought to change in such a way as to improve governance and has shown where and how. We explore governance’s focus as well as the World Bank dimensions. Under focus, we concentrate on the transparency of government, the simplicity of procedures, accountability and responsibility, the need to fight against corruption, individual freedom and collective expression, and independence of the legal system. For the World Bank dimensions, the concentration is on: voice and accountability, political stability and the absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. With respect to regulation and corruption, we address whether to use market-based or regulatory measures, possible policy instruments, implementation issues, and difficulties and problems. Under possible policy instruments, mandatory policy instruments, voluntary agreements, compliance instruments, and precautionary measures are explored. Implementation issues include introductory matters, costs, free riding and voluntary agreement and compliance. In addition, we examine difficulties associated with distributional issues, compensation, regulatory capture phenomenon, and the effect on innovation. Regarding corruption, we examine its definition, state capture versus conventional corruption, corrupt acts, forms of corruption, hypothetical causes of corruption, some analytical points, theoretical consequences, unbinding bribery, incidence of corruption, fraud, and control measures.

Keywords: aid, governance, policy, regulation, fraud, corruption
Introduction

As governments and institutions continue to provide development financing, aid deployment should change in such a way as to improve governance. Good governance has proven central to economic development that is specific to a given country or set of countries. Fresh thinking related to the future of aid informs the ongoing discourse on development assistance and should therefore be availed to policy makers and key stakeholders. Such is the spirit of this article as it focuses on governance, particularly in relation to regulation and corruption.

Governance

According to Jha and Zhuang (2014), the concept of governance is broad – but nearly always includes voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Good governance has political, economic, and institutional dimensions; Kaufmann (2005: 41) defines it as the following: “traditions and institutions by which authority in a country is exercised for the common good. This includes the process by which those in authority are selected, monitored, and replaced (the political dimension); the government’s capacity to effectively manage its resources and implement sound policies (the economic dimension); and the respect of citizens and the state for the country’s institutions (the institutional respect dimension)”.

The World Bank offers a narrower definition, describing good governance to be “epitomized by predictable, open, and enlightened policy making (that is, transparent processes); a bureaucracy imbued with professional ethos; an executive arm of government accountable for its actions; and a strong civil society participating in public affairs; and all behaving under the rule of law” (Rajkumar and Swaroop, 2008: 7). Jha and Zhuang (2014) states that good governance requires transparency, accountability, rule of law, and effective and legitimate institutions.

Much emphasis has been recently placed on good governance as a key to development effectiveness and it has been argued, for example, that merely spending money on public goods and services may not lead to desirable outcomes if the country does not have the right governance environment. Indeed, economists have known for some time that there is a highly significant correlation between governance and economic growth over the long run, but the precise nature of this relationship is difficult to pin down because growth is a function of many variables. That said, the World Bank clearly states, “the direction
of causality is clear: it goes from better governance to higher income and not vice versa”.

Governance focuses on the following¹:

1. Transparency of government: Citizens must be kept informed of the decisions of the state and their justification.
2. Simplicity of procedures: Whether in fiscal matters, investment, or other areas, administrative procedures need to be as simple as possible, with the number of participants reduced to a minimum.
3. Accountability/Responsibility: Public officials must be held accountable and, if necessary, penalized for offences.
4. Fight against corruption: Eradicating this scourge is imperative for promoting health competition, eliminating surcharges, and strengthening the efficiency of economic management.
5. Individual freedom and collective expression: A free and responsible press, in particular, is an important pillar of democracy.
6. Independence of the legal system: To be free from pressure and intervention from political forces or other organizations to ensure that its decisions are independent and impartial.

The World Bank’s database on governance is based on the following six dimensions² which are also covered more briefly than below by Kaufmann (2005: 41-43):

1. Voice and accountability includes indicators that measure various aspects of the political process, including civil liberties, political and human rights, and the extent to which citizens of a country are able to select their governments.
2. Political stability and absence of violence combines several indicators that measure perceptions of the likelihood that government will be destabilized or overthrown by unconventional means, including through domestic violence and terrorism.
3. Government effectiveness combines responses on the quality of public service, the independence of the civil service from political pressure, and the credibility of the government’s commitment to various policies.

¹ Rajkumar and Swaroop (2008) used two indicators of governance in a country, the level of corruption and the quality of bureaucracy, to examine the link between specific budgetary allocations and outcomes and to see how these relationships are affected by improved governance.

4. Regulatory quality focuses on policies that hamper the functioning of an efficient market, such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

5. Rule of Law includes several indicators that measure the extent to which citizens have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the ability to enforce contracts.

6. Control of corruption is a measure of corruption, conventionally defined as the exercise of public power for private gain or, according to Kaufmann (2005: 41) “abuse of public office for private gain”. It is based on scores of variables from polls of experts and surveys.

**Regulation**

We start by addressing whether to use market-based or regulatory measures. Regulatory policies are generally government imposed restrictions or controls, while market-based policies encourage economic principles of supply and demand to determine the course of action. There are several reasons why politicians traditionally take a regulatory approach rather than an economic incentive-based approach. Industry tends to favor direct regulation over incentive mechanisms because if a tax instrument is used, the offender must pay fees in addition to controlling costs, although the acceptance of this approach will be influenced by any revenue recycling while firms may have greater influence over the specifics of uniform standards. The effects of quantity regulation are perceived to be more certain while economic efficiency arguments often rely on a relatively sophisticated understanding of market operation and price effects which are indirect compared with regulation.

In the final analysis, governments are likely to choose a mixture of regulatory and market-based approaches. In economies without well-developed market systems, there may be net efficiency gains from applying regulatory approaches. On the other hand, the adoption of a market-based approach may speed the development of the market system. Net efficiency gains may favor the development of market-based systems at an earlier date than otherwise would be the case.

After looking at the reasons why regulatory or market based policies might be preferred, we now look at the various possible policy instruments in this area:

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3 The broader definition and other aspects are given in the second last section of this article.
Mandatory policy instruments may include imposing quantity limits on the use of particular inputs or outputs. For instance, a company may be required to use so much power or water per day in its production and/or consumption activities. Technology standards can be imposed like a producer being asked to use only a particular or a better technology in the production processes.

Beyond mandatory policy instruments, voluntary agreements can also play an important role. The threat of mandatory government intervention may be enough to encourage voluntary agreements. Forward-looking firms may undertake some control steps if they fear costlier mandatory controls in the absence of voluntary actions.

Compliance instruments may include deposit requirements and/or tax obligations. Deposit refund systems can be compared to tax/subsidy schemes where the deposit acts like a tax, while the refund acts like a subsidy. One of the advantages of deposit refund systems is that ordinary taxes are not required for financing the refund/subsidy incentive.

As precautionary measures, policy instruments should be designed to provide needed information. Ways in which this can be done include government taking actions that directly reduce regulatory uncertainty. At a minimum government or regulatory authorities can avoid creating regulatory barriers that drive up transaction costs and discourage trading.

Implementation Issues

We have looked at some policy instruments that can be used under regulation in order to make aid effective. Below we look at some implementation issues that come into play so as to make regulation effective in directing and assisting aid efforts by aid agencies.

In assessing any of the wide range of instruments as potential devices, it is imperative to give due consideration to the implementation issues that can severely affect real-world outcomes. Such issues need to be considered in the design, whether at the national, multilateral, or global level (Sacasa, 2008).
In terms of costs, a number of factors can adversely affect the performance of actual regulatory programs or policies. These include: administrative and transaction costs; nonprofit-maximizing behavior such as sales or staff maximization; the pre-existing regulatory environment; and the degree of monitoring and enforcement.

Transaction costs, among others, are potentially important in the performance of a regulation. Potential sources of transaction costs include search and information, bargaining and decision, and monitoring and enforcement. The magnitude of these transaction costs will depend on the structure of the market and the extent to which individual transactions require regulatory approval. Implementation costs may be least where incentives to comply are self-enforcing. Monitoring, for instance, could rely partly on self-reporting, supplemented by access to inventories. An effective enforcement system makes ultimate sanctions credible, so that penalties would rarely need to be imposed. Monitoring and enforcement can be significant but these costs are typically borne by the respective government authority.

Although technology-based standards may seem to be the least cost-effective of the policy instruments, if monitoring costs are high in some particular circumstances they may have an advantage because they are relatively easy to monitor and enforce. An inspector can simply check whether a particular piece of equipment has been installed, rather than continuously monitor information.

The direct cost of regulation is the reduction in profits and consumer welfare due to regulatory constraint on choice. The distribution of this cost is often hidden, but that does not make it unimportant (Fisher et al. 1996: 415).

As long as participation is voluntary, participants will have incentives to free ride, sharing the benefits without sharing the costs. This is a distortion. Free-rider deterrence is concerned with securing broad participation in an agreement. A stable coalition of co-operators may exist in spite of free-rider incentives. The size of this coalition will depend on the ability of the co-operators to punish that might withdraw from the coalition and reward that who might accede. However, to be effective, such punishments and rewards must be substantial and credible, but these requirements often clash. As a result, the size of the stable coalition may be quite small.

There is also a compliance concern, or the incentive that participants have to fulfill their pledges under an agreement. Some agreements contain explicit compliance measures. However, it is more usual for agreements to seek alternative means for securing compliance.
Sheng (2009) is of the view that regulatory circles must include constant reviews of outcomes against objectives. These reviews must examine how the strategy, priorities, incentives, standards, structures, processes, and execution have been done; and whether in the right dimensions and contexts. Further, regulators should focus on making and implementing rules, not making market choices. However, they should improve the trading system, monitor special interest groups, ensure adequate information disclosure, penalize offenders, and educate investors.

**Difficulties and Challenges**

Adoption of any instruments will have some impact on the distribution of wealth between and within countries. Negotiations about distributional issues are likely to be crucial in determining the final policy mix that is chosen. For instance, some of the government revenues from taxes may be returned to the affected parties. Although the precise nature of the distribution will be the subject of vigorous political discussions, participants are unlikely to accept an agreement that substantially shifts the distribution of wealth or political power.

All instruments probably will have to, and also can, be connected with compensatory measures. Where the costs of regulation are regressive, compensatory transfers may be used, funded from a specific tax or general government finances, or the regulation might be modified, exempting some individuals or firms from the regulatory net.

Regulatory capture phenomenon is a difficulty with a regulatory approach where the regulatory agency may, over time, develop such a close working relationship with the regulated industry, for example, that it relaxes its enforcement standards in the interest of the industry itself (Fisher *et al.* 1996: 413). The state regulatory agency created to act in the public interest instead acts in favor of the commercial or special interests that dominate in the industry or sector it is charged with regulating.

Another regulatory problem is that once a performance standard has been satisfied, there is little benefit to the individual firm from developing and/or adopting even cleaner or better technology. In addition, regulated firms may fear that if they do develop a cleaner or better technology, the performance standard will be tightened. In this way innovation is affected negatively.

Technology standards are even worse than performance standards in inhibiting innovation, since, by their nature, they constrain the technological choices available, and may therefore remove all incentives to develop new technologies. In this way regulation may inhibit innovation or remove incentives to develop new technologies. It is therefore very important while considering
regulation to consider its likely effect on innovation. Aid agencies would therefore try to strike an optimal balance so as not to prevent innovation while at the same time they are effective with their regulation. Specific policy suggestions would include setting standards, instituting bans, unifying technology and performance, and using incentives.

Since technology-based (or design) standards typically require the use of specified equipment, processes, or procedures, aid agencies would spell them out. Uniform standards can also take the form of outright bans of certain products or processes. Aid agencies could set up uniform technology and performance-based standards which may be effective in achieving particular goals and standards. Use of conventional technology can also be encouraged. As with virtually all policy instruments, the administration of uniform standards typically includes programs for compliance monitoring and enforcement.

All forms of intervention have the potential for inducing or forcing some amount of technological change because, by their nature, they induce or require firms to do things they would not otherwise do. The specific combination of methods that might best achieve the goals and the value of the used methods to the various nations would depend on the intervention approaches used. In the literature there are the general equilibrium, the policy (socialism and development), and the social market economy.

The general equilibrium approach is based on the assumption of independent decision making of economic units (households and firms) interacting in such a way as to maximize efficiency and social welfare in terms of the pareto optimality conditions and the Abba Lerner welfare conditions. For the policy approach we start with the social objective function (SOF) specifying goals and priorities. It is a macroeconomic function exogenously given by the state in a socialist setting but under perfect competition we assume it is there and originates from each household. Under the socialist approach, the SOF defines equality of opportunities as an ultimate social objective derived from collective ownership and central planning of the means of production. In this case state intervention abolishes the market mechanism. The development approach contains a development function, like fair distribution of opportunities and social-economic transformation of resources. Here intervention requires achieving these goals within a market mechanism environment. It may imply dealing with both the limitations and improvements of the efficiency of the market mechanism but the criterion for intervention is the SOF. The value system under the social market economy approach or model is based on market efficiency that rests on equal opportunity.
Corruption

Corruption can be broadly defined as the use and/or abuse of public office or exercise of public power for personal private unlawful gain. It is the misuse of office for unofficial ends. Within this broad definition of corruption, we now distinguish between state capture/influence peddling and the conventional or traditional corruption. According to Shah and Schacter (2004: 41), state capture/influence peddling is a collusion by private actors with public officials or politicians for their mutual, private benefit. The private sector “captures” the state legislative, executive, and judicial apparatus for its own purposes. State capture coexists with the conventional (and opposite) view of corruption in which public officials extort or otherwise exploit the private sector for private ends.

State capture, according to Anderson (2005), is the undue and illicit influence of the elite in shaping the laws, policies, and regulations of the state. It differs from the conventional corruption, the use of bribery to influence the implementation of laws and regulations. State capture has potentially wider impact and can severely hinder a country’s ability to benefit from economic growth if the fruits of income growth largely accrue to an elite that benefits from improper governance.

We need to look specifically at corrupt acts before we delve further in the subject of corruption. Corrupt acts include bribery and extortion which involve two parties who often both benefit. Fraud and embezzlement are carried out alone. As seen above, state capture and/or influence peddling are/is also a corrupt act so is nepotism.

“Speed money”, money paid to government officials to speed up their consideration of a business matter falling within their jurisdiction is a corrupt act. Practices of insider lending and use of inside information and/or knowledge for private gain are also corrupt acts. Appropriation of public assets for private use, appropriation of rents and excessive profits, and misuse of aid and public funds are also corrupt acts.

Corruption can be of different forms like high-level or grand, for example kickbacks to Ministers. It can be low-level, like petty bribes to juniors. It can also be well-organized and well-known or chaotic, surrounded with uncertainty. High-level and low-level tend to coexist and reinforce each other. The chaotic form has worse effects (more deleterious) than the well-organized and well-known. This is because it creates a lot of uncertainties, among other things.
Theory is also useful in explaining corruption. We therefore turn to some very simple hypothetical causes of corruption. Namely, corruption is most likely where government regulation gives public officials discreional powers. Indeed, Rajan (2005: 56-57) argues that “…discretion is problematic in the hands of the corrupt.” Hypothetically, corruption is likely where there are institutional inefficiencies, though it can be argued that corruption can bring about institutional inefficiencies. The causal relationship is not obvious but can be established empirically. Other hypothetical causes are the restrictions and government intervention that lead to the presence of excessive profits. Also, when very low wages are paid to workers/employees corruption may result. However, it can be argued that reasonable wages are necessary but not sufficient to avoid corruption.

Analytically we can state that:

\[ C = M + D - A \]

where \( C = \text{Corruption}; \ M = \text{Monopoly}; \ D = \text{Discretion}; \ A = \text{Accountability (transparency)}. \)

\[ C = f(Bribe \ \text{size}, \ Chances \ of \ being \ caught, \ Penalties \ when \ caught \ – \ giver \ and \ taker) \]

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Combating corruption would work on the above variables given political will. Basu, et al. (2013) argue that the way to root out corruption in society is to ensure that corrupt behavior is not worthwhile for amoral individuals by, for instance, enacting policies of punishment that make it not worthwhile for officers to accept bribes.

Some negative consequences that may arise from the hypothetical causes discussed above include the reduction of economic growth as a result of lower incentives to investment thereby reducing private investment. This reduction of growth may push firms underground and acts as a regressive tax in addition to contributing to the misallocation of talents to rent-seeking activities. Corruption also reduces growth through the public investment channel by lowering the quality of public investment thereby distorting the composition of public expenditure. Thus, government ability to raise revenue is undercut, raise tax rates to the few that are taxed, undermines state’s legitimacy, and increases income inequality and poverty.

Nevertheless, corruption has some positive contributions sometimes referred to as counterarguments. It can be argued that corrupt officials work harder because they are often in their offices in order to exploit corruption opportunities. Another counter argument is the grease argument: corruption helps entrepreneurs get around bureaucratic impediments, burdensome regulations, and

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\(^4\) A granger causality test to test for the causal direction and all that surrounds the exercise would do this.
ineffective legal systems. However, the direction of this causal relationship is ambiguous as it may be subject to reverse causality whereby corruption itself helps establish these bureaucratic impediments. Related to the grease argument is the notion of unbinding bribery, through which private parties can “purchase” certain benefits from a politician or bureaucrat. These include government benefits like allocations, both monetary and in kind; government contracts like allocations; public revenues like reducing it; time savings and regulatory avoidance; influencing outcomes of legal and regulatory processes like illegal activities and/or outcomes; and monopoly rights to markets like energy.

**Fraud**

Returning to an examination of fraud, it can be defined as the intentional false representation or concealment of a material fact for the purpose of inducing another to act upon it to his or her injury, or it is dishonesty in the form of intentional deception or a willful misrepresentation of material facts in order to induce another to part with something of value or surrender a legal right. Terms used in reference other than those already mentioned are: conflict of interest, fraudulent financial/non-financial statements, kickbacks, lapping especially in the banking sector when money has been banked but can still be used fraudulently, larceny, and skimming.

Red flags or signs of danger that fraud might be taking place include the gift taker; odd couple, - two people in a company that is difficult to rationalize; excuse maker; rule breaker; the gift bearer; the too successful bidder; poor quality high prices; and the one-person operation, also known as briefcase business person. Some popular schemes in fraud include money laundering counterfeit currency, intellectual property, cyber cash, black dollars, document forgery, cheques, and credit cards.

Negative effects of fraud on business other than those covered under the theoretical consequences of corruption earlier include staff anxiety, compromising confidentiality, bad press, seminar cost to combat the practice, and increased costs of its investigation.

Measures of fraud control include whistle-blower protection, filing, promoting transparency in the operations, using committee systems, duties being segregated, registering assets, clarity about debtors and creditors, and streamlining cheques and cash use.

Complementary to the fraud control measures above, corruption control measures, in general, would involve the use of international organizations and donor groups, such as the IMF Code of Good Practice on Fiscal Transparency. The Code is based
on four principles: clarity of role and responsibilities, public availability of information, open budget processes, and assurances of integrity. Other guidance could come from the World Bank Country Assistance Strategy and the Poverty Reduction Strategy Paper approach that give priority to cross-cutting governance issues. In addition, high-level/profile government watchdogs can be used. The government can establish such to keep an eye on corruption activities and report to it when anything is detected so that action can be taken. In Uganda, for instance, are the Auditor General, Public Accounts Committee, and Inspector General of Government (Mubazi, 2012).

The influence of the civil society or non-government organizations is critical to controlling corruption. Transparency International that compiles the corruption index is one of the examples of civil societies that help to expose levels of corruption. The media plays a large role in exposing corruption, as can be seen in the Prime Minister’s office in Uganda resulting in top accountants being prosecuted. While the media promotes accountability through the disincentive of negative publicity, transparency of government activities and costs is crucial to restricting corruption in its initial instance. Examples include “expenditure tracking surveys” that publish data on government expenditures in delivering services such as education in Uganda and the Extractive Industries Transparency Initiative, which aims to publish revenues accrued from oil, gas, and mining sectors in many LDCs.

“Freedom of Information” laws have been passed by a number of countries in order to help fight or control corruption and, indeed, have done a commendable job. Economic policy reforms have also been used. They include trade and financial liberalization that can reduce opportunities for corruption by limiting the situations where officials might exercise unaccountable discretionary powers, introducing transparency and limiting public sector monopoly power.

Another potentially effective countermeasure against corruption is decentralization as it increases the accountability of public authorities to citizens. However, this can create new public authorities, each having powers to tax, spend, and regulate that are liable to abuse. Hence it may multiply, rather than limit, opportunities for corruption, and this problem has been observed in many developing countries that have implemented this reform.

Raising salaries and reducing wage compression - the ratio between the highest and lowest pay - can help. However, with weak governance wage-based strategies are not likely to succeed. In fact, reducing wage compression may even encourage corruption if positions are viewed as a lucrative career option.
Raising wages would simply raise the purchase price and subsequent corruption efforts to repay loans.

In controlling corruption, institutional arrangements and enforcements are important. Basu, et al. (2013) argues that corruption may be significantly less pervasive in the developed world than in the developing world because institutional arrangements and enforcement make it less possible or less attractive. In these countries, traditional state activities are relatively efficient, civil societies are relatively effective, and the private sector work well.

Some societies may establish self-enforcement norms whereby bad behavior, like corruption, is collectively punished by all and people punish bad behavior because not to punish bad behavior is itself bad behavior. It has been argued in some developing countries that this is not happening and by so being it breeds corruption.

Conclusion

By way of conclusion, the article has addressed the ways aid deployment ought to improve governance since good governance is central to economic development based on an understanding of a given country or countries. The article has highlighted the areas where and how aid should change such that it improves governance. An intuitive principle is that good governance accompanies development and empirical evidence shows that, on the whole, better governance is positively correlated with higher growth and better development outcomes. Indeed, Jha and Zhuang (2014), among others, take governance as one of the biggest hurdles of growth and development but argue that its reform priorities need to take into account cultural and institutional realities, by focusing on areas that address the biggest hurdles to a country’s growth and development.

The nitty-gritty of governance and its major constituent parts (regulation and corruption in this article) have been analyzed or explored and in some cases very briefly discussed. The rationale has been to show exactly where work, through aid, ought to focus and how. After all, according to Martins (2014) “all successful developing countries have undergone a fundamental and potent process of structural change”. With such in place, development assistance availed to policy makers and key stake-holders would produce better fruits or results for all of us to enjoy.
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