Governance in an interconnected world

The dynamics of governance do not play out solely within the boundaries of nation-states. Countries today face an interconnected, globalized world characterized by a high velocity and magnitude of flows of capital, trade, ideas, technology, and people. From 1960 to 2011, global trade’s share of the global gross domestic product (GDP) more than doubled, from 25 percent to over 60 percent. The share of foreign direct investment (FDI) increased from less than 10 percent to over 40 percent from 1992 to 2010. Meanwhile, foreign debt’s share of the global GDP grew from only 11 percent in 1970 to 90 percent in 2010. Today, the world is very different from the one in which the current developed countries emerged: cross-border flows were low; they received no aid; and they were not subject to a proliferation of transnational treaties, norms, and regulatory mechanisms. For developing countries, the era of globalization and “global governance” presents both opportunities and challenges.

Globalization can greatly benefit countries in search of sustained and inclusive development. The rapid diffusion of technology and greater access to capital and world markets have enabled annual growth rates of over 7 percent for a subset of developing countries—a previously unfathomable rate of growth that helped lift over 1 billion people out of poverty from 1981 to 2012 (Spence 2011).

Globalization can, however, also present great challenges. By making it possible for domestic actors to send money and resources abroad, transnational flows increase the capacity for them to opt out of local bargains. These flows have also been associated with a marked rise in inequality within countries and with a greater vulnerability of countries to global economic crises, such as the 1997 Asian financial crisis and the 2008–09 global financial crisis. Global interactions can undermine domestic social and economic development by exerting power in ways that prevent the adoption of policies fit for the domestic or local context or by reinforcing preexisting conditions that sustain socially undesirable outcomes. The resurgence today of populist politics and its rejection of trade and migration in several Western countries can be seen as a reaction to these negative effects.

Transnationalism and the domestic policy arena

The policy bargaining framework discussed in this Report provides a lens for discerning how to maximize the positive impacts of transnational flows and international actors to achieve security, growth, and equity. These flows can be critical instruments for enhancing the ability of domestic actors to commit, coordinate, and cooperate to advance development outcomes. But they also can disrupt these functions by confusing expectations, competing with social norms, and undermining citizen-state accountability. Understanding these effects requires in turn understanding how transnational factors shape the incentives of domestic actors, influence their preferences to change outcomes, and affect contestability in the policy arena.

At times, international actors enter directly into the policy arena (figure 9.1, panel a). Foreign states, multinational corporations, development agencies, or transnational nongovernmental organizations (NGOs) can gain a seat at the domestic bargaining table as they pursue specific goals or support domestic efforts that are aligned with their interests.
The proliferation of these forums raises unresolved questions about their functional design, political legitimacy, and accountability. For example, as states increasingly subcontract government functions such as public infrastructure and service delivery, the tools of commercial arbitration may undercut the role of citizens in accountability. This challenge is reflected in Figure 9.1. However, international actors and mechanisms largely affect the policy arena indirectly. In doing so, they may change incentives and preferences toward enabling or constraining institutional functions for development and open or foreclose the possibilities for contestation.

International actors can shape the arena in which policy making and contestation occur by creating alternative spaces in which actors can bargain (figure 9.1, panel b). For example, foreign investors can bring states to the International Centre for Settlement of Investment Disputes (ICSID) for independent arbitration rather than rely on the legal mechanisms of the host state. Citizens of countries party to the European Court of Human Rights can bring claims against their home state. Several international human rights treaties require states to report and answer to an international expert body. And a vast number of international and transnational forums exist for the development of industry-specific rules, monitoring their application and sanctioning violations to various degrees.
in contemporary public concerns about the role of investor-state dispute settlement in bilateral and multilateral investment treaties such as the Trans-Pacific Partnership.

Transnational flows and mechanisms can change the payoff structure and incentives of domestic actors by providing inducements or threats (figure 9.1, panel c). For example, conditions attached to foreign aid (conditionality) can make assistance dependent on specific behavior by domestic actors. Similarly, the desire to attract foreign investment can act as an incentive for positive changes in domestic governance. For example, the pursuit of foreign investment in China and Vietnam spurred institutional improvements in economic management at the provincial level, with greater flows leading to even more institutional reforms (Dang 2013; Long, Yang, and Zhang 2015). International trade agreements, by changing the incentives of domestic actors, can serve as a commitment device. At the same time, the incentives and payoffs may be structured in favor of private goods rather than global or national public goods. A government may sign a trade agreement to tie its hands in the face of domestic vested interests that might induce it to implement suboptimal policies such as high tariffs, or it may use transnational flows as a reason to avoid regulating a costly and challenging issue, such as the environmental damage caused by mines (Maggi and Rodríguez-Clare 1998, 2007; Shemberg 2009).

International actors and transnational interactions also shape preferences by influencing the ideas and beliefs of actors in the domestic policy arena (figure 9.1, panel d). Improvements in technology, by facilitating greater global connectivity, have helped spread international ideas and norms. Transnational networks of technical experts can play an important role in changing preferences and internalizing new norms through the diffusion of evidence and authoritative expertise. In China, the interaction of the National Environmental Protection Agency (NEPA) with experts resulted in new perspectives, peer standards, data, and research findings that NEPA drew on to shape the debate over accession to the Montreal Protocol to protect the ozone layer, shifting the views of other political actors and allowing successful bargaining with more domestically grounded agencies, including the State Meteorological Administration (Economy 2001). Beyond finance and other forms of leverage, development actors can be most influential through the dissemination of knowledge and evidence. But, as Michel Foucault has argued, knowledge and evidence can also reflect particular agendas and reduce the space of public discourse (Lukes 1986). Development indicators, for example, provide certainty and an impression that a clear trajectory exists to changing phenomena that are inherently complex and contested, such as peace or well-being (Davis, Kingsbury, and Merry 2012).

This chapter looks at how international actors can influence domestic governance dynamics through two primary instruments: (1) the introduction and diffusion of transnational rules, norms, and regulations and (2) the distribution of official development assistance or foreign aid. In discussing both instruments, this chapter focuses on the mechanisms through which these instruments act on the incentives and preferences of actors in the policy arena and the contestability of that arena.

Transnational rules and regulations: Enhanced cooperation and focal points for change

As the flows across borders expand, the instruments and mechanisms used to manage them expand as well (figure 9.2). Since the late 20th century, an ever-increasing number of international and transnational efforts have been made to govern the activities, relationships, and behavior that transcend national frontiers. These efforts stem in part from the nature of today’s global challenges—such as climate, finance, and cross-border crime—which require solutions that go beyond the traditional state model of regulation. Unlike traditional international relations, these transnational efforts involve a broad array of actors—nation-states, multilateral organizations, private actors, and advocacy groups—and cover a wide range of issues—business transactions, labor, crime, information management, intellectual property, procurement, utility regulation, human rights, food and safety standards, and environmental sustainability (Hale and Held 2011).

Much of this proliferation of regulation has been in pursuit of further deregulation, as exemplified by the increasing de jure openness of capital accounts (figure 9.2, panel a). Other regulations and treaties are intended to enhance coordination on issues of global importance. For example, more than 1,000 multilateral and 1,300 bilateral environmental agreements are now in place (Green 2014).

The formation and diffusion of this overlapping web of transnational rules mirror this Report’s framework on a transnational level. The nature and content
of each regime are a product of contestation among multiple actors with varying incentives, preferences, and relative power. Transnational rules are institutionalized in some form of instrument, from authoritative/binding legal instruments to nonbinding declarations of norms and voluntary standards and regulatory regimes. These instruments perform the functions of commitment, coordination, or cooperation through various mechanisms, from coercion to socialization (table 9.i). They may directly target state governments, as do the European Union’s (EU’s) fiscal and monetary rules or labor and tax standards aimed at avoiding a race to the bottom. They may bypass state governments to directly regulate private actors, as do voluntary industry regimes such as the Roundtable on Sustainable Palm Oil. Or they may reach out directly to citizens by legitimating local grievances through international rights and norms (Braithwaite and Drahos 2000; Shaffer 2013).

What follows is a closer look at how transnational rules interact with the policy arena—specifically, (i) the rules that seek to achieve international cooperation on global goods by changing incentives; (2) the rules that help induce a credible commitment to domestic reform through trade and regional integration incentives; and (3) the rules that serve as focal points for domestic actors to shift preferences and improve coordination to overcome collective action challenges.

**International cooperation: Changing incentives to prevent races to the bottom**

In the same way that firms in competitive markets lower prices to attract consumers, when goods, services, and capital are freely exchanged and move internationally countries have an incentive to adopt competitive strategies to gain market share or attract investment. To attract productive investments, countries may lower taxes on corporate income for foreign companies. Competition among countries on these forms of taxation has the effect of depleting the domestic tax base and considerably decreasing revenue. It also tends to shift taxation onto less mobile factors such as labor. In turn, lower revenue means that countries have to shrink spending, with detrimental effects on the well-being of the poorest and least powerful in society. Moreover, competition to boost exports may result in lax labor and environmental standards (Chau and Kanbur 2005). These are examples of races to the bottom.

Once competition pushes countries to a low equilibrium, they have no incentive to change policy. An attempt by one country to raise taxes on goods and services, capital, or corporate income would result in...
Governance in an interconnected world

Investment or environmental standards, labor standards, or tax coordination. If all countries coordinate and adopt the same policy, such as international labor standards (Basu and others 2003), they will all be better off. For example, in parallel with the creation of a common market, the EU set up a Code of Conduct to prevent countries from engaging in harmful tax competition and to harmonize value added taxes on goods and services and, less successfully, corporate taxes and capital income taxes.

Such agreements can strengthen the commitment of countries to specific minimum standards that prevent the occurrence or perpetuation of an undesirable equilibrium. However, in the absence of credible sanctions, incentives to defect are very high. Preventing defection requires recognition that achieving a sustainable agreement is a two-level game, involving both an international bargaining process and a domestic bargaining process (box 9.1). Ultimately, the...
Box 9.1 Legitimizing the second-best: Governance options for global public goods and the Paris Agreement on climate change

Climate change is a global public goods problem. Solving it requires universal participation (all countries need to reduce emissions), but there is an incentive to free-ride in any agreement. An obvious solution is a global governance body that ensures the participation of all countries and a fair distribution of efforts. From the United Nations Framework Convention on Climate Change (UNFCCC) in 1992 through the Kyoto Protocol in 1997 and the Copenhagen negotiations in 2009, international negotiations have tried to create such a framework to decide on a global target for temperature change, country-specific emission targets, and a set of processes to ensure flexibility and compliance.

The Kyoto Protocol failed to achieve universal participation. Developing countries were reluctant to take on commitments that could slow their economic growth, and many countries were reluctant to expose themselves to possible sanctions from a supranational body (Stewart and Wiener 2003). As predicted by economic theory, in the absence of a supranational governance body, a credible commitment was impossible to achieve (Carraro and Siniscalco 1992; Barrett 1994). The 2015 Copenhagen conference, however, was a paradigm shift, moving away from the first-best option of sanctions to a system of “pledge-and-review,” by which countries make unilateral commitments that are reviewed and monitored by the international community (Barrett, Carraro, and de Melo 2015).

These developments led to universal participation in the Paris Agreement, underpinned by 162 unilateral commitments to contribute to reductions in global emissions. The agreement, which went into effect in November 2016, also includes provisions to facilitate the adaptation to climate change, support to cope with unavoidable loss and damage, financial flows, and financing instruments, and processes for the monitoring and revision of commitments. The pledge-and-review scheme has two obvious limitations. First, there is no reason to expect that the sum of the unilateral commitments will meet the global target of maximum temperature change, and indeed they currently do not meet the goal of the Paris Agreement (limit warming to 2 degrees and try to achieve 1.5 degrees). The hope is that commitment revisions will lead to a gradual increase in ambition (van Asselt 2016). By providing a “ratcheting mechanism” that encourages countries to follow the lead of others in increasing commitments, the Paris Agreement is an important coordination mechanism (Keohane and Victor 2016). The 2015 Copenhagen conference, however, was a paradigm shift, moving away from the first-best option of sanctions to a system of “pledge-and-review,” by which countries make unilateral commitments that are reviewed and monitored by the international community (Barrett, Carraro, and de Melo 2015).

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The second limitation is the lack of a compliance mechanism beyond monitoring that enables “naming and shaming” of countries that do not deliver on their commitment (Aldy 2014). However, climate negotiations are part of a broader network of agreements. Thus, failing to deliver on climate commitments may not lead to direct sanctions, but it could have a cost in other areas such as trade and technological cooperation. Nordhaus (2015) suggests that even a minimum trade-related cost for noncompliance would lead to much greater participation and ambition.

Even though the Paris Agreement is far from an optimal mechanism to govern global public goods (Stiglitz 2015), it is an attractive second-best option, building on countries’ self-interest in implementing climate policy actions at the country level (Busby 2016; Keohane and Victor 2016).

Source: Prepared for WDR 2017 by Stéphane Hallegatte.

Transnational rules that provide incentives for a credible commitment to domestic reform: Trade agreements

The desire to attract investment and expand trade can also provide incentives for improvements in domestic governance. Indeed, international agreements on economic integration can mean that domestic actors will make credible commitments to follow through on economic reforms. The success of the EU integration process, for example, demonstrates the power of inducements. Prospective member countries have to change their domestic rules to abide by the 80,000 pages of regulations in the acquis communautaire. For those countries that have joined the EU, the potential economic benefits of joining outweighed any loss of domestic autonomy in specific areas, and the benefits of accession were used by elites to overcome domestic resistance to the required reforms.
EU membership contributed to the consolidation of democratic institutions in former dictatorships in the European periphery, such as Greece, Portugal, and Spain in the 1980s, and in central and eastern European countries in the former communist bloc in the 1990s and 2000s.

The possibility of accession to the General Agreement on Tariffs and Trade (GATT) and then its successor, the World Trade Organization (WTO), has induced considerable domestic reforms in nations that seek to develop through global trade. WTO accession has had the strongest growth-promoting effects in countries that undertook deeper commitments as part of their accession negotiations, including China and Vietnam. Moreover, this pro-growth effect of accession has been strongest in countries with the weakest domestic governance (Tang and Wei 2009).

In China, the process of WTO accession at the turn of the millennium led to a major restructuring of the economy toward more market- and rules-based mechanisms, with accession acting as a “wrecking ball” for the closed command economy (Woo 2001; Jin 2002). China’s leadership leveraged foreign competition and external commitment to accelerate domestic reforms, including reductions in tariff and nontariff barriers, market access for foreign firms, and protection of intellectual property. China’s commitments to liberalizing its trade in services have been the most radical of any country acceding to the WTO (Mattoo 2004). The accession helped China’s leadership overcome domestic opposition to reforms, and it also signaled to the emerging private sector that reforms were credible. The reforms enhanced the commercial legal environment and forced state-owned enterprises and state-owned banks to restructure and compete on a market basis, facilitating a more modern financial system and rapid private sector growth (Lardy 2002).

Another example of a trade agreement that led to domestic reforms is the Multi Fibre Arrangement (MFA), which went into force in 1974 under GATT. In response to pressure by the United States to protect the U.S. domestic clothing industry, the MFA set quotas for textile exports from developing countries, but it excluded some of the world’s least-developed countries from the quota system. As a result, countries such as Bangladesh, Cambodia, and Tunisia, which could produce more and set prices higher than their competitors, received “quota rents.” In Bangladesh, this positive shock prompted the government to facilitate institutional innovations, including back-to-back letters of credit and the bonded warehouse, which enabled a transformation of the Bangladeshi economy and an evolution of the elite bargain that determined governance dynamics and political reform (Khan 2013).

Trade agreements can help achieve commitment to domestic reforms by empowering new domestic actors. For example, workers at a Nike factory in Mexico succeeded in unionizing by leveraging the corporate codes of conduct and transnational advocacy networks that developed after implementation of the North American Free Trade Agreement (NAFTA)—see Rodriguez Garavito (2005). In Cambodia, a surge in garment exports to the United States following implementation of the MFA led to a bilateral trade agreement in 1999 that used export quotas as a mechanism for improving domestic labor standards, thereby giving greater bargaining power to Cambodian workers. Specifically, the United States agreed to increase garment quotas by 14 percent a year if working conditions complied with international standards, and an International Labour Organization (ILO) project was established to independently monitor workers’ conditions in Cambodian garment factories. This enhanced commitment led to significant improvements in freedom of association following the agreement, with the share of unionized garment workers rising from only 12 percent in 2000 to nearly 50 percent by 2005 (Adler and Woolcock 2009).

And yet the substance and institutional design of trade agreements can harm poor constituencies. At times, they may prompt a regulatory race to the bottom for low-wage or casual workers, such as those in Mexican maquiladoras or the Bangladeshi garment industry (Carr and Chen 2002; Santos 2012). Policy makers and publics are well aware of this problem, and a body of transnational law and regulations has emerged to complement the domestic efforts just described. These efforts, though, face ongoing institutional design challenges—in particular, how to build participatory legitimacy along with effective enforcement. Meanwhile, as these efforts to foster transnational coordination proliferate, evidence suggests that the coordination effects of regulatory instruments should not be overstated. In WTO jurisprudence, whether a restriction on imports counts as a legitimate regulation or a nontariff barrier is indeterminate—a phenomenon recognized by WTO lawyers and staff themselves. The indeterminacy is part of the strength of the regulatory regime: the concept of the nontariff barrier is flexible and potentially context-specific (Lang 2011). And yet those players who know how to navigate the WTO rulemaking and appeals system will do better than those who do not. Among developing nations, this is often those who have the capacity and staff to be repeat players at the WTO (Santos 2012).
Transnational rules as focal points to shift preferences and induce coordination

The last century has witnessed a “Rights Revolution” in which global treaties and norms have facilitated the spread of the notion of rights (figure 9.3)—see Pinker (2011). International human rights and gender quotas illustrate the ways in which transnational ideas diffuse and the mechanisms through which those ideas affect domestic governance arrangements. Although a range of incentives can lead to the formal adoption of such norms, the norms eventually become effective and internalized according to the extent to which they reshape societal preferences.

Since passage of the Universal Declaration of Human Rights in 1948, human rights have been increasingly specified and embedded in international treaties, institutions, and organizations. Country adoption and participation have been widespread. However, international treaties are not always effective in changing state behavior and practices. Indeed, a persistent implementation gap exists between the de jure pledge to protect human rights—as measured by states’ ratification of major international human rights treaties and conventions—and actual compliance (figure 9.4). Some scholars argue that human rights are nothing more than window dressing or empty promises that are unable to constrain power or change the behavior of domestic actors (Posner 2014).

Explaining why state compliance with human rights treaties and conventions varies requires taking a closer look at the interaction between international norms and the domestic bargaining process. Once signed, international treaties “empower individuals, groups, or parts of the state with different rights preferences that were not empowered to the same extent in the absence of the treaties” (Simmons 2009, 125). By referring to international norms, ordinary citizens and disadvantaged groups can strengthen the legitimacy of their claims and successfully challenge the prevailing norms, pressuring governments to transform state institutions and reform public policies. Elite resistance frequently increases the incentives for domestic actors to build transnational alliances to support their claims. Often referred to as the “boomerang effect,” this dynamic process increases the costs incurred by state actors when resisting change and eventually leads to compliance (Keck and Sikkink 1999). The human rights struggles in Latin American countries during military dictatorships illustrate this point, as well as the mobilization against the apartheid government in South Africa. Indeed, the most transformative social movements of the 20th century—including

Figure 9.3 The “Rights Revolution” has led to a global spread of rights-related norms, facilitated and supported by global treaties and agreements

a. Use of “rights” terms in English-language books, 1945–2008

b. Countries with policies helping ethnic minorities or discriminating against them, 1950–2003


Note: Policies include economic and political policies that discriminate or favor any ethnic group in a given country-year.
their capacity to influence constitutional reforms and lobby for the adoption of gender-sensitive policies. Many countries, however, still face important challenges in closing their implementation gap and achieving the level of political participation for women defined in the quota laws. The gap is larger for legislative quotas. Although these gaps may reflect in part overly ambitious targets, the short time since adoption of the quota, and the weakness of mechanisms to sanction noncompliance, evidence suggests that social norms also play a role. In Spain, for example, a recent study found that political parties nominate female candidates for seats in areas where they have little chance of being elected in order to reduce the risk of losing decision-making power within the party (Esteve-Volart and Bagues 2012). It is yet to be seen how more recent reform efforts by some parties, such as the adoption of “zipper systems” in which male and female candidates are alternated on ballot lists, will influence these dynamics within Spain.

Major shocks—such as conflict—can speed up the process of changing norms and create new windows of opportunity for disadvantaged groups. A process of “policy learning” can also occur; initially ineffective quota laws have been revised to improve their effect on the de facto political representation of women (Norris and Dahlerup 2015).
Foreign aid and governance

Since the end of World War II, foreign aid has been one of the most prominent policy tools used by high-income countries to promote security, growth, and equity in low-income countries. Primarily intended to fill capital shortfalls, official development assistance (ODA) has become a means of meeting a range of development, humanitarian, strategic, and commercial goals. In addition to finance, aid includes the transfer of knowledge, expertise, and ideas intended to influence norms, capacity, and power (box 9.2).

Between 1960 and 2013, member countries of the Organisation for Economic Co-operation and Development actors, especially the international financial institutions, have been among the most influential generators of transnational rules, norms, and ideas, using aid as a diffusion mechanism. Just as economic orthodoxy has evolved over time—from an emphasis on the role of the state in planning and investment in the 1960s and 1970s, to the macroeconomic discipline and market liberalization of the Washington Consensus in the 1980s, to poverty alleviation and market institutions in the 1990s, to achievement of the Millennium Development Goals (MDGs) and improvement of governance institutions in the 2000s—so, too, have aid modalities evolved in search of more effective means of translating these norms into development outcomes.

Ex ante conditionality. Structural adjustment lending policies in the 1980s marked the high point of ex ante conditionality—that is, aid transfers depended on the recipient’s adoption of preset conditions. Today, however, this approach has been largely regarded as a failure because conditional loans proved ineffective as a commitment device. In theory, the threat of nondisbursement, or reward of disbursement, was an incentive to government actors to overcome obstacles to reform because of either opposing objectives or domestic political economy factors. Although ex ante conditionality could sometimes strengthen the hand of reformist governments that needed to swing domestic opinion behind these changes, it proved ineffective in changing incentives and the preferences of opposing elites (Collier and others 1997). This outcome was due in large part to the lack of a credible threat and the time consistency problem: more often than not, donors submitted to pressures to disburse despite the failure of recipients to meet the prescribed conditions (Killick 1997; Kanbur 2000).

More fundamentally, the prescribed conditions were often politically infeasible because they sought to disable the systems of patronage needed to hold coalitions together (Mbembe 2001). In short, the diffusion of norms through coercion was incapable of changing the much stronger dynamics of the domestic bargaining arena (Temple 2010).

Ex post conditionality. In the 1990s, ex ante conditionality was largely replaced by aid modalities based on principles of partnership and ownership, assuming that aid would be more effective in good policy environments (World Bank 1998; Dollar and Burnside 2000). Many donors adopted a form of ex post conditionality under which aid in the form of budget support (mostly unconditional funds) would be directed to countries that themselves adopted good economic and governance policies. Although aid still served as an incentive, its primary role was to amplify reform efforts and maximize poverty reduction in those places most likely to achieve results. Yet another feature was an emphasis on social participation in the development of policies, as introduced in the Poverty Reduction Strategy Paper (PRSP) process adopted by the International Monetary Fund (IMF) and the World Bank as a means of enhancing the contestability of the policy arena. These developments were also subject to criticism, most notably around the imperfect science of measuring institutional performance for purposes of aid allocation and the questionable concept of “ownership” in view of the power imbalance both between donors and recipients and between government elites and other domestic constituencies (Wilhelm and Krause 2008).

At worst, such an approach can give rise to enhanced legitimacy for governments that go through the motions of “ownership,” while in fact reducing the space for local contestation and innovation. Some observers questioned the extent to which this method was an answer to the flaws of ex ante conditionality.

Outcome-based conditionality. The most recent generation of aid instruments seeks to overcome the difficulty of influencing the bargaining arena to yield “good” policies by focusing instead on outcomes. Donors have introduced a range of results-based approaches, such as the World Bank’s Performance for Results (PforR) instrument, which disburses upon achievement of results according to agreed-on performance indicators. This outcome-based conditionality is particularly suited to social sector outcomes such as those set out in the Poverty Reduction Strategy Paper (PRSP) process adopted by the International Monetary Fund (IMF) and the World Bank as a means of enhancing the contestability of the policy arena. These developments were also subject to criticism, most notably around the imperfect science of measuring institutional performance for purposes of aid allocation and the questionable concept of “ownership” in view of the power imbalance both between donors and recipients and between government elites and other domestic constituencies (Wilhelm and Krause 2008).

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Box 9.2 Aid as a delivery mechanism for transnational rules and ideas (continued)

in the MDGs. In theory, by setting clearly defined objectives, indicators, and verification protocols for programs initiated by a government, this method seeks to enhance government accountability to its own goals (Temple 2010). Another noteworthy development is the New Deal for Engagement in Fragile States, which established a mutual compact between Organisation for Economic Co-operation and Development donors and a group of fragile states known as the g7+ to support country-led strategies based on a set of overarching peace-building and state-building goals.

Source: WDR 2017 team.

Development (OECD) that are also members of the Development Assistance Committee (DAC) provided some US$3.5 trillion (constant 2009 dollars) in aid. Non-OECD economies are an increasingly important source of aid: in 2014 the flow of aid to developing countries from both DAC and non-DAC contributors amounted to over US$161 billion (map 9.1). Although aid has ebbed and flowed over time, its significant increase over the last two decades coincides with the establishment of the Millennium Development Goals, as well as with the surge in flows toward conflict-affected countries in the aftermath of the cold war.10

Map 9.1 Aid flows amounted to over US$161 billion from donor countries (purple) to recipient countries (orange and green) in 2014

Aid flows (US$)

Source: WDR 2017 team, using data from the Organisation for Economic Co-operation and Development.

Note: Data are on a per capita basis as of 2014. Shades of orange denote recipient countries. Shades of purple denote donor countries. The darker the country, the higher is the amount of aid received or transferred. Green countries (China, Indonesia, and Panama) are recipient countries in which the flow of aid received is smaller than the repayment of debts.
Still, few donors have met the ODA target of 0.7 percent of gross national income (GNI), which they first agreed to in 1970.

Although the volume of aid is increasing, its share relative to flows of private capital and other sources of finance is decreasing. In middle-income countries, aid makes up only 1.9 percent of GDP (median), compared with 9.6 percent in low-income countries. Foreign direct investment—largely reflecting new and increased exploitation of natural resources—and remittances have overtaken aid as a percentage of GDP in 21 out of 43 African countries based on the available data. Nevertheless, aid makes up more than 10 percent of GDP for half of all low-income countries and over 30 percent of total revenues for 26 developing countries (figure 9.6).

A look at the impact of more than five decades of development aid on security, growth, and equity reveals the great variation across regions and countries (figure 9.7). As this Report explores, aid has to be understood in terms of how it interacts with the existing domestic power imbalances and how it affects the decision-making processes and the allocation of resources. Some groups and actors are better positioned to channel foreign aid flows to their benefit or to that of their constituencies, whether in or outside government, and thus strengthen their position of

**Figure 9.6** Aid makes up a large share of GDP and revenue in many developing countries

Sources: WDR 2017 team. Official development assistance (ODA) data: Organisation for Economic Co-operation and Development; government revenue data: IMF, World Economic Outlook, various years.

Note: The graphs show ODA from all donors to all recipients in low- and middle-income countries with a population of at least 1 million. Figures for ODA (percent of GDP) are capped at 20 percent of GDP for the sake of visualization. The underlying uncapped data are Afghanistan, 24.1 percent; Central African Republic, 35.4 percent; Liberia, 37.0 percent; and Malawi, 21.8 percent. Figures for ODA (percent of government revenue) are capped at 100 percent for the sake of visualization. The underlying uncapped data are Afghanistan, 105.2 percent; Central African Republic, 260.6 percent; Liberia, 126.0 percent; and Sierra Leone, 143.2 percent.

**Figure 9.7** Low- and lower-middle-income countries vary greatly in the amount of aid received and improvement in GDP per capita

Source: WDR 2017 team, using data from the World Bank, World Development Indicators (database).

Note: GDP = gross domestic product; ODA = official development assistance.
influence. In this way, aid, like other resources, can reinforce or offset existing power imbalances, resulting in heterogeneous outcomes when it comes to growth and equity, depending on the specific context.

Understanding the impact of aggregate aid flows on governance

Two decades ago, an influential study concluded that the link between aid and growth is much stronger in countries with sound policy and institutions, leading to calls for donors to direct assistance to those states that could demonstrate good governance (Burnside and Dollar 2000). But what effect can aid have on governance? This question has been the subject of considerable debate among leading scholars, spawning an array of attempts to measure empirically whether aid in the aggregate promotes or undermines the quality of institutions in recipient countries. Some of the pessimists, including Deaton (2013) and Easterly (2006), claim that large amounts of aid can deepen pathologies in countries with poor governance. Conversely, the optimists argue that aid can help overcome resistance to good policies and support the development of political institutions, including democracy. Unfortunately, the evidence belies clear answers, in large part because of the inherent methodological flaws, including the fact that aid aggregations lump together different sources (bilateral and multilateral); different modalities (budget support, project finance, technical assistance); different desired outcomes (development, democracy, humanitarian relief); and different local contexts. Ultimately, aid is neither inherently good nor bad for governance. What matters is how aid interacts with the prevailing domestic context and which groups or actors see their influence enhanced.

Although empirically inconclusive, the literature converges on a set of analytical arguments that sheds light on the conditions under which aid can have a positive or a negative impact on governance. Studies of aid in the aggregate include large amounts of bilateral aid, which historically has been used to project a dynamic mix of the donor’s strategic, commercial, and programmatic priorities. Significant correlations have been documented between the allocation of aid and a range of donor interests, including former colonial ties, voting record in the United Nations, business opportunities, and supply-side factors such as a food surplus (Alesina and Dollar 2000; Qian 2015). According to one argument, in inherently unstable or institutionally fragile environments, the multiple purposes often projected through ODA—stability, security, humanitarian assistance, state building—frequently have contradictory and—most often—unintended effects (Paris and Sisk 2007). When aid is granted without making the development objective of the recipient country the priority, it is more likely to have negative effects on governance.

Another argument focuses on the great potential for aid funds to be misused by those in power, whether through outright embezzlement (perhaps best illustrated by the case of Mobutu Sese Seko, former dictator of the Democratic Republic of Congo, who reportedly appropriated $12 billion in aid money) or through the diversion of aid money—or government funds freed up by the injection of aid money—to nondevelopment aims that reinforce extractive, patrimonial, and exclusionary power structures (Ahmed 2012; Deaton 2013). Several econometric studies have found a negative correlation between high levels of aid and the accountability of political institutions. This risk is even greater where aid is unconditional and where political elites do not face organized opposition (Acemoglu, Robinson, and Verdier 2004). Some investigators have argued that large amounts of aid may encourage political instability and coup attempts as individuals and groups vie for the opportunity to control aid-financed assets (Grossman 1992).

Underlying these arguments is the claim that aid can undermine the relationship between the state and its citizens by making the state less responsive to their demands. The more a state relies on revenues from the international community, the fewer incentives it has to build the public institutions necessary to mobilize domestic revenues through taxation. And the less a state relies on its domestic tax base, the more its state-citizen accountability erodes (Moore 2004). Aid has thus been likened to the natural resource curse: a windfall of unearned income that enables irresponsible government spending and behavior, unconstrained by the kind of state-citizen social contract thought to lie at the heart of modern democracies. However, the empirical evidence linking aid flows to domestic taxation is mixed (box 9.3).

Aid and the policy arena: Incentives, preferences, and contestability

A growing theoretical and empirical literature is examining how development projects interact with the policy arena to produce three possible outcomes for governance: no effects, negative effects, or positive (generative) effects. The first category includes projects that, intentionally or not, miss opportunities to reshape elite incentives and preferences. Projects that deliver goods directly, and thus circumvent government
Box 9.3 The impact of aid on domestic resource mobilization: What does the evidence say?

There is a growing consensus that increasing the mobilization of domestic resources can enhance accountability, particularly if such efforts are explicitly linked to the provision of public goods. If policy makers need to depend on broad-based taxation—or indebtedness, which implies more taxation in the future—they are more likely to include citizens and elites in policy discussions. The need for revenue to finance wars led European states to bargain with subject populations for greater taxation (Tilly 1990). Once taxed, citizens demand a greater say in state affairs. As 18th-century American colonists claimed, “Taxation without representation is tyranny.” More recently, in Sub-Saharan Africa paying taxes has been shown to increase political interest (Broms 2015).

Projects that aim to directly improve governance arrangements, such as public sector reform or demand-side initiatives, may end up creating negative dynamics by providing incentives that reinforce the preexisting power imbalances. The tendency of donors to introduce reforms based on best-practice solutions that worked elsewhere (with the expectation that tight monitoring of top-down implementation will yield similar results) has been called an example of isomorphic mimicry, a term drawn from organizational sociology (DiMaggio and Powell 1983). These reforms focus on forms—such as laws, systems, and procedures—without paying attention to how they change the nature of the policy arena. This practice can create “capability traps” when recipient governments adopt these forms to ensure flows of donor financing and to reap legitimacy gains, while evading more fundamental reforms to make the functioning of institutions more effective. Not only does this approach leave recipients with unsustainable and dysfunctional institutions, but it also may reduce the space for local innovation and collective action (Pritchett, Woolcock, and Andrews 2010; Andrews, Pritchett, and Woolcock 2013).

The effects of domestic resource mobilization also depend on the nature of taxation. Some taxes do not enhance accountability (resource taxation) or have distortionary effects (trade taxes). International corporate tax competition has diminished states’ capacity for domestic resource mobilization (see earlier discussion on races to the bottom). In environments with low savings rates or the potential for capital flight and tax evasion, consumption taxes are most likely to be effective, but also likely to be regressive. In 9 out of 25 countries with household survey data available for circa 2010, the net effect of all government taxing and spending was to leave the poor worse off in terms of actual consumption of private goods and services (Lustig 2016).

Source: WDR 2017 team.

a. Clist and Morrissey (2011) invalidate the contemporaneous negative correlation found in Gupta and others (2004) by introducing a lagged effect of aid on taxation, concluding that the relationship is negligible.
and social norms is not new. Hirschman documented this observation most eloquently using World Bank projects in his 1967 classic, *Development Projects Observed*. Building on the literature and knowledge base that have emerged over the last few decades, the framework explored in this Report points to the following four principles to guide efforts to use aid outcomes points to a common set of principles, which are discussed in the next section.

**Using aid to foster positive governance dynamics for development**

Recognition that development is an inherently contentious process that implicates power imbalances and social norms is not new. Hirschman documented this observation most eloquently using World Bank projects in his 1967 classic, *Development Projects Observed*. Building on the literature and knowledge base that have emerged over the last few decades, the framework explored in this Report points to the following four principles to guide efforts to use aid...
in ways that foster positive governance dynamics for development outcomes.

*Diagnose the underlying functional problem.* As discussed in chapter 2, diagnoses of development problems—and proposed prescriptions—often focus on proximate causes. The *World Development Report 2015: Mind, Society, and Behavior* (World Bank 2015) called for expanding diagnostic methods to identify the individual psychological, behavioral, and social obstacles underlying development problems. This Report has emphasized the need to understand the underlying governance challenges that hinder the adoption and implementation of policies that can improve security, growth, and equity outcomes. Diagnostic approaches should home in on the specific commitment and collective action problems that stand in the way of achieving outcomes and on the ways in which power asymmetries in the policy arena constrain these functions.

*Target development cooperation in ways that overcome obstacles in the policy arena.* At times, it is most appropriate for aid to steer clear of the policy arena in order to deliver direct benefits to populations in need. Emergency and disaster responses, humanitarian aid, and, in some cases, direct service delivery may warrant aid approaches that work in parallel with domestic governance. However, where aid is intended to support sustained improvements in development outcomes, the most important role it can play is to facilitate changes in the policy arena that will alleviate existing constraints to the adoption and implementation of development-oriented policies. As emphasized in this Report, this means focusing on three key levers of change: incentives, preferences and beliefs, and contestability.

The use of financial forms of aid as an incentive to influence the policy arena is discussed in box 9.2. Beyond providing monetary support, aid in the form of technical assistance, analytical expertise, and knowledge sharing can be a powerful means of changing preferences, especially where it enables internal debate and adaptation. Supporting the generation of evidence about the effectiveness of policies and making such evidence publicly available in transparent ways will enhance an informed public debate about policy (Banerjee 2007; Devarajan and Khemani 2016).

Understanding the role of aid in promoting contestability is at an earlier stage. The last decade has seen the proliferation of demand-side, participatory, and multistakeholder donor-funded aid initiatives under the rubrics of social accountability, legal empowerment, open governance and transparency, and citizen engagement. Evaluations of such programs have pointed to the need to strengthen the dissemination of information and bottom-up approaches, but also to focus on creating enabling environments that activate collective action and promote a commitment to respond (Fox 2015; Khemani and others 2016).

Time frames are critical. Ultimately, aid can only nudge or accelerate a development trajectory that is determined by a complex set of intricately connected, self-reinforcing factors. Indeed, it may be ill-advised for those pursuing development aims that confront deep-vested interests or threaten a delicate stability to use aid in ways that disrupt the existing agreements in the policy arena. Although interventions may have little impact within the life span of a project, they can aim to set in motion a collective dynamic that, over time, will reduce power asymmetries, effectively change incentives, and reshape preferences. Attention to the dynamics of elite bargains, as discussed in chapter 7, can help identify strategic opportunities to invest in ways that align with the interest of influential groups and also bring other actors into the policy arena, enhancing the adaptive capacity of societies in more inclusive ways.

*Anticipate opposition, shifting interests, and unintended consequences.* Over the last few years, development practitioners have seized on a principle long established in the organizational change literature: complex problems require solutions based on incremental and adaptive efforts supported by strong learning feedback loops (see box 9.4). This principle is particularly important because efforts to change the policy arena will often trigger opposition and backsliding, and they may yield unanticipated consequences—both positive and negative. It should be assumed that the progress of reform will not be linear, that adaptations will be necessary, and that domestic coalitions for reform must be supported to reduce the risk of reversal.

Applying such measures will require not only particular skill sets and methodologies, but, most important, an enabling environment within development institutions. Several multilateral and bilateral organizations are exploring ways in which the development community can implement internal reforms as they seek more agile, more flexible, and more adaptive projects. Partnerships such as the Global Delivery Initiative also look at the methodologies and approaches available for development practitioners to work more adaptively through citizen engagement tools and feedback mechanisms, information and communication technologies, and real-time practitioner exchanges in order to overcome complex problems, such as those faced during governance projects.
Look beyond the traditional aid modalities. The declining role of official development assistance relative to other forms of capital and the inherent limitations of the traditional foreign aid model in dealing with many of today’s challenges call for a broader approach to achieving the United Nations’ Sustainable Development Goals. As discussed in this chapter, the increasingly complex and interconnected realm of transnational rules, agreements, and regulations driven by the public and private actors has a significant influence on domestic governance and the achievement of development outcomes. In many cases, the domestic policy space for tackling development challenges is significantly constrained by actions and decisions made elsewhere. Control of corruption, crime, and security at the country level, for example, may depend on how the flows of goods, capital, and migrants are regulated at the transnational level or in the domestic policy arenas of other states (see spotlight 13 on illicit financial flows). The impact of foreign direct investment on local outcomes may be largely determined by how multinational corporations are regulated by their home states as well as through transnational rules that encourage races to the top rather than the bottom. The growing role of private actors and finance in a wide range of development activities—from utilities to education to infrastructure—also highlights the importance of upstream policy arenas that aim to ensure accountability for the public good.

International actors should enhance efforts to engage in the two-level game, using transnational coordination and commitment devices backed by the promotion of incentives, preferences, and contestability in the domestic policy arena to help achieve security, growth, and equity goals. They also might look inward to the ways in which their own policy arenas have increasingly significant impacts on development outcomes across the globe.

Notes
1. World Bank, World Development Indicators (database), various years, sum of exports and imports of goods and services worldwide.
2. Updated and extended version of data set constructed by Lane and Milesi-Ferretti (2007).
3. Updated and extended version of data set constructed by Lane and Milesi-Ferretti (2007).
4. Bourguignon (2015) and Milanovic (2016) have shown that inequality among nations has decreased substantially, whereas inequality within countries has soared, with the exception of Latin American countries, where income inequality has decreased slightly over the last 15 years.
5. Haas (1992, 3) describes an epistemic community as “a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area.”
6. Transnational rules are similar to the so-called international regimes in the international relations and international political economy literature. See, for example, Ruggie (1975) and Krasner (1983).
7. Legislated gender quotas and reserved seats are typically introduced through changes in electoral laws or constitutions, whereas voluntary party quotas are adopted by individual parties that commit to a specific share of female candidates.
8. About 40 percent of the world’s countries have some form of gender quota, according to the World Bank’s 2016 Women, Business, and the Law database: 73 countries have quotas at the national level, and 65 countries have quotas at the local government level. Some countries have quotas at both the national and local levels; others have one but not both. For example, India adopted a quota at the local level but not at the national level.
9. Foreign aid refers to official development assistance as defined by the Organisation for Economic Co-operation and Development.
10. This increase in foreign aid accompanied the steep rise in peacekeeping operations in the 1990s and the post—9/11 interventions in Iraq and Afghanistan.
11. WDR 2017 team, based on data from OECD (ODA); World Bank, Africa Development Indicators, various years (FDI/GDP); and World Bank, World Development Indicators (database, GDP and remittances/GDP). FDI and remittances refer to the latest available data point.
12. See also World Bank (1998). The findings of Burnside and Dollar (2000) have been called into question by Easterly, Levine, and Roodman (2003).
13. This leads to the unsettling view that “when the ‘conditions for development’ are present, aid is not required. When local conditions are hostile to development, aid is not useful, and it will do harm if it perpetuates those conditions” (Deaton 2013, 273). See also Easterly (2006).
14. See, for example, Goldsmith (2001); Dunning (2004); Wright (2009); and Dietrich and Wright (2013).
15. Among the cross-country studies that find a negative correlation between aid and governance quality are Brautigam and Knack (2004); Moss, Pettersson, and van de Walle (2006); Djankov, Montalvo, and Reynal-Querol (2008); Bueno de Mesquita and Smith (2009); Busse and Gröning (2009); and Rajan and Subramanian (2011).
16. But also see Tavares (2003).
17. The “aid curse” argument is made by Moss, Pettersson, and van de Walle (2006); Collier (2007); and Djankov, Montalvo, and Reynal-Querol (2008).
18. See Casey, Glennerster, and Miguel (2012); Wong (2012); King (2013); Mansuri and Rao (2013); and Humphreys, Sanchez de la Sierra, and Van der Windt (2015).

19. But even these interventions can have significant indirect impacts on governance in both negative and positive ways.

References


