Governance Technical Notes

Technical Note 1. Governance and Poverty—Recent Research[1]

THE EVIDENCE

"Good governance" in the form of public institutions and policies that enforce property rights and contracts, while restraining corruption, is now widely viewed to be a *necessary condition* for long-term economic growth. Douglass North[2] and many others have generated a growing body of work that combines rational choice theory, information economics, game theory, law, and organization theory to focus on the incentives that shape decisionmaking by public and private players. The recent empirical work corroborates these theoretical arguments, quantifying the costs of over-regulation, corruption, and other manifestations of bad government in terms of foregone investments and growth.[3] Because increases in per capita income are usually, although not always,, accompanied by reductions in poverty rates,[4] there is a strong presumption that good governance—through its impact on growth—alleviates poverty. Knack and Anderson[5] provide a more direct analysis of the governance-poverty link. Examining growth in incomes for the poorest quintiles of income earners, they find that good governance is progressive in that it is associated with larger growth rates in incomes for the poor than for the population overall. Gupta, Davoodi and Alonso-Terme find a large and statistically significant positive association between corruption and poverty rates.[6]

There is strong presumption linking higher per capita incomes to improved health and education outcomes, for example, reductions in infant mortality and in illiteracy.[7] Because of the demonstrated effects of good governance on income growth, there exists a strong presumption that good governance improves health. Kauffman, Kraay and Zoido-Lobaton[8] provide some evidence of direct links between governance and health and education outcomes. They show that countries scoring higher on their indexes of

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[1] The World Bank research findings on governance can be searched by accessing: **http://wbln0018.worldbank.org/research/workpapers.nsf/SearchForm?OpenForm&F0N=Governance^F0V=^Op1=^**

[2] See North's *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

[3] See Knack and Keefer (1995) and Mauro (1995).

[4] See Michael Bruno, Martin Ravallion and Lyn Squire (1998). "Equity and Growth in Developing Countries: Old and New Perspectives on the Policy Issues." In V. Tanzi and K. Chu, eds., Income Distribution and High-Quality Growth. Cambridge, MA: MIT Press.

[5] See Stephen Knack and Gary Anderson, "Is Good Governance Progressive? Property Rights, Contract Enforceability and Changes in Income Equality." Paper presented at the 1999 Annual Meeting of the American Political Science Association, Atlanta, GA.

[6] Gupta, Sanjeev, Hamid Davoodi and Rosa Alonso-Terme (1998), "Does corruption affect income inequality and poverty?", IMF Working Paper, WP/98/76, May

[7] See Deon Filmer and Lant Pritchett (1998). "Child Mortality and Public Spending on Health: How Much Does Money Matter?" World Bank Policy Research Working Paper No. 1864. Also see Lant Pritchett and Lawrence Summers (1996). "Wealthier is Healthier." Journal of Human Resources, 31(4), 841-68.

[8] See Dani Kaufmann, Aart Kraay, and Pablo Zoido-Lobaton (1998). "Governance Matters." World Bank Policy Research Working Paper No. 2196.

such areas as rule of law, graft, and voice and accountability tend to have lower infant mortality and higher literacy rates, as well as higher per capita incomes. Norton[9] finds that countries scoring higher on indexes that rank the security of property rights also fare better on a human poverty index, constructed from longevity, literacy, child nutrition, and access to health services and safe water.

There is some evidence that democratic institutions have a positive impact on poverty, as measured by infant mortality rates, literacy rates, and other objectively measurable outcome indicators. Amartya Sen argues that democracy can make a positive contribution to development by creating political incentives for rulers to respond positively to the needs and demands of their citizens.[10] There is reason to assume that the architecture of the state, including the relationships between the executive, legislative, and judiciary branches and other institutional arrangements for the transfer of power between governments, including voting arrangements and electoral laws, affect the performance of the public sector in responding to poverty. [11] Dreze and Sen assert that the openness and accountability of democratic societies explain why India but not China has managed to avoid large-scale famines. [12] Kaufmann et al. find that an index of "voice and accountability" is associated with lower infant mortality and illiteracy across countries. [13] There is also some evidence that participating in local and national decisions helps to improve the quality of projects[14] and the welfare of vulnerable groups such as women and their children.[15]

MEASURING GOVERNANCE

In recent years, the number and type of governance indicators has increased dramatically. However, this period has seen little agreement about their use and there are few examples of governance indicators having a substantial impact on the policy

9 Seth W. Norton (1998). "Poverty, Property Rights, and Human Well-Being: A Cross-National Study," *Cato Journal*, 18(2), 233-45.

10 Sen, Amartya (1999). Development as Freedom. New York: Alfred Knopf

11 Dr. Johann Graf Lambsdorff (senior research adviser to Transparency International and assistant professor at Göttingen University) notes that the empirical evidence that democracy reduces corruption is weak. He cites two unpublished studies by M. Paldam ("The Big Pattern of Corruption: Economics, Culture and the Seesaw Dynamics", Aarhus University, Denmark, June.1999) and D. Treisman ("The Causes of Corruption: A Cross-National Study," University of California, Los Angeles, June.1999) that investigate this relationship while controlling for the level of development as depicted by GDP per capita. In such multivariate regressions, democracy does not significantly affect levels of corruption (as measured by the Transparency International index). The two authors therefore argue that the effect of democracy is ambiguous. There appears only a small but significant influence when testing for countries that have been democracies without interruption since 1950. The only tentative conclusion possible is that while the current degree of democracy is not significant, a long period of exposure to democracy is associated with less corruption. Lijphart provides further evidence from a 36-country study in *Patterns of Democracy: Government Forms and Performance in Thirty-six Countries.* New Haven: Yale University Press, 1998.

12 J. Dreze and A. Sen (1982). *Hunger and Public Action*. Oxford: Oxford University Press.

13 Kaufmann, Kraay, and Zoido-Lobaton, "Governance Matters."

14 Isham, Jonathan, Daniel Kaufmann and Lant Pritchett (1997), "Civil Liberties, Democracy and the Performance of Government Projects," *World Bank Economic Review*, vol. 11(2), p.219-42

15 Narayan, Deepa (1999). "Social Capital and the State: Complementarity and Substitution," The World Bank, Policy Research Working Paper No. 2167, Washington, DC.

actions of governments or on specific reforms proposed by donors and IFIs.[16] Most of the growing array of governance indicators has become available only in the last few years, and the limited coverage over time makes it more difficult to convincingly demonstrate causal relationships between governance and measures of well-being. Studies using these indicators confirm that development has occurred where there is now good governance—but it does not necessarily follow that they reliably point to where development will occur in the future.[17]

Governance indicators have been widely used in research, testing links between good governance and economic outcomes. The range of governance indicators now available is impressive (see Table 1), and the literature associated with them demonstrating their linkages to development outcomes is extensive.[18] However, the only conclusions arising from most of this research is that the "black box" of governance in some way affects public-sector performance, which in turn affects poverty or other outcomes. This is an important achievement that has helped to dramatically alter our perspectives on the process of development, but it does not offer us any firm prescriptions about what should be done. We have no firm grounds on which to assert, for example, that decentralization or improved budgetary arrangements will improve some particular aspect of public-sector performance.

[16] One exception is the use of indicators to identify countries where a governance discount in International Development Association allocations should apply.

[17] Exceptions are the BI, BERI, and ICRG indicators which became available in the early 1970s (BI and BERI) and early 1980s (ICRG). The BI indicators were used by Paulo Mauro, "Corruption and Growth," *Quarterly Journal of Economics*, v. 110, 1995. The BERI and ICRG indicators were used by Stephen Knack and Philip Keefer, "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures," *Economics and Politics*, v. 7, 1995. Several researchers have tried to resolve the causality problem using two-stage least squares methods. See Mauro (1995); Robert Hall and Charles Jones, "Why Do Some Countries Produce So Much More Output Per Worker Than Others?" *Quarterly Journal of Economics*, 114(1): 83-116; and Daniel Kaufman, Aart Kraay and Pablo Zoido-Lobaton, "Governance Matters," World Bank Policy Research Working Paper No. 2196, 1999. For an investigation of causality exploiting time-series variation in the BERI and ICRG data, see Alberto Chong and Cesar Calderon, "On the Causality and Feedback Between Institutional Measures and Economic Growth," *Economics and Politics*, forthcoming.

[18] A particularly comprehensive list of recent research evidence demonstrating that measurements of governance do indeed correlate with measurements of development is provided in Burki, Shahid Javed, and Guillermo Perry, 1998. *Beyond the Washington Consensus: Institutions Matter*. World Bank, Washington, DC, and other sources.

Table 1. An Incomplete List of Sources of Governance Indicators

("Single" means that the dataset contains just one indicator, "multiple" that the dataset includes many individual variables)

I. Indicators of institutional arrangements		
Sources	**Data Sets**	**Concept Measured**
Policy and public spending management		
World Bank (as calculated from Government Financial Statistics)	Policy volatility (single)	Calculated as the median percentage difference from year to year in government spending, by functional classification, over the last four years
U.S. State Department	Compliance with auditing standards for military spending	Compliance with new U.S. legislation on transparency in budgeting
Public employment		
World Bank (1997 Schiavo-Campo, de Tommaso and Mukherjee)	Aggregate wage bill totals and employment totals of civil and public servants (multiple)	Public officials are categorized to allow for cross-country comparability
"	Civil service pay relative to private-sector pay	Average salary for civil service divided by average worker income
II. Indicators of government performance.		
Sources	**Datasets**	**concept measured**
Business Environment Risk Intelligence	Political Risk Index (multiple)	Socio-political conditions
"	Operation Risk Index (multiple)	Bottlenecks for business development
Wall Street Journal	Annual survey of business analysts (multiple)	Attractiveness of the business environment
Standard and Poor	Country Risk Review (multiple)	Risk to the profitability of investments
European Bank for Reconstruction and Development	Transition indicators (multiple)	Progress toward a market economy
"	Legal reform survey (multiple)	Effectiveness of the legal framework
Economist Intelligence Unit	Country Risk Service (multiple)	Risk ratings for investors
"	Country forecasts (multiple)	Attractiveness of the business environment
Freedom House	Freedom in the World (multiple)	Political rights and civil liberties
"	Nations in Transit (multiple)	Progress toward democracy and a market economy

World Economic Forum	Global Competitiveness Survey (multiple)	Business environment
Heritage Foundation	Index of Economic Freedom	Prospects for growth
Political Risk Services	International Country Risk Guide (multiple)	Political, economic and financial risks for investors
Political and Economic Risk Consultancy	Corruption in Asia (multiple)	quality of the legal system
"	Transparency in Asia (multiple)	Business environment
"	Quality of the media (multiple)	Censorship and access to foreign media
Institute for Management Development	World Competitiveness Yearbook (multiple)	Business environment`
World Bank	1997 World Development Report survey (multiple)	Business environment
Transparency International	Corruption Perceptions Index, aggregation of many indicators (single)	Corruption perceptions
World Bank (Kaufmann, Kraay and Zoido-Lobaton 1999)	Aggregating governance indicators (multiple)	'Government effectiveness', rule of law, voice and accountability, and graft
International Telecommunications Union	Waiting time for telephone line (single)	Wait for key service generally provided through government
Contract-Intensive Money (as calculated from International Financial Statistics)	Contract-intensive money: non-cash share of the money, from International Financial Statistics	Proxy for contract enforceability/trust in government
Private-sector credit (from IFS data)	Private-sector credit/GDP, from International Financial Statistics	Financial sector development

Note: This list draws, among others, from Kaufmann, Kraay and Zobato-Lobaton 1999.

This illustrative list could, of course, have been considerably larger. It is not clear where to draw the line between governance indicators and the growing number of political economy indicators that illuminate aspects of the checks and balances on government. Lijphart's recent work in developing measures of the degree to which power is tightly held by the executive branch, and the degree to which power is dispersed among different levels and organizations of government, is a case in point. [42]