

# Annex H

## Governance: Technical Notes

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### Technical Note H.1 Recent Research<sup>1</sup>

“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 (1990) 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 overregulation, corruption, and other manifestations of bad government in terms of forgone investments and growth (Mauro 1995; Knack and Keefer 1995). Because increases in per capita income are usually, although not always, accompanied by reductions in poverty rates (Bruno, Ravallon, and Squire 1998), there is a strong presumption that good governance—through its impact on growth—alleviates poverty. Knack and Anderson (1999) 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 (1998) find a large and statistically significant positive association between corruption and poverty rates.

Higher per capita incomes seem to be linked to improved health and education outcomes, for example, reductions in infant mortality and in illiteracy (Filmer and Pritchett 1998; Pritchett and Summers 1996). Because of the demonstrated effects of good governance on income growth, there exists a strong presumption that good governance improves health. Kaufmann, Kraay, and Zoido-Lobaton (1999) provide some evidence of direct links between governance and health and education outcomes. They show that countries scoring higher on their indexes of 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 (1998) 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 effect on poverty, as measured by infant mortality rates, literacy rates, and other objectively measurable outcome indicators. Amartya Sen (1999) 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. 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.<sup>2</sup> Dreze and Sen (1982) assert that the openness and accountability of democratic societies explain why India, but not China, has managed to avoid large-scale famines. Kaufmann, Kraay, and Zoido-Lobaton (1999) find that an index of “voice and accountability” is associated with lower infant mortality and illiteracy across countries. There is also some evidence that participating in local and national decisions helps to improve the quality of projects (Isham, Kaufmann, and Pritchett 1997) and the welfare of vulnerable groups such as women and their children (Narayan 1999).

## Technical Note H.2 Measuring Governance

In recent years, the number and type of governance indicators has increased dramatically (see table H.1). However, there is little agreement about their use and there are few examples of governance indicators having a substantial impact on the policy actions of governments or on specific reforms proposed by donors and international financial institutions.<sup>3</sup> Most governance indicators have 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<sup>4</sup>—but it does not necessarily follow that they reliably point to where development will occur in the future.<sup>5</sup> 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 finding has dramatically altered perspectives on the process of development, but it does not offer any firm prescriptions about what should be done. There are no firm grounds on which to assert, for example, that decentralization or improved budgetary arrangements will improve some particular aspect of public sector performance.

This illustrative list, of course, could 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 (1998) 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.

**Table H.1. Selected Sources of Governance Indicators**

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

<b>I. Indicators of institutional arrangements</b>		
<b>Sources</b>	<b>Datasets</b>	<b>Concept measured</b>
<b>Policy and public spending management</b>		
World Bank (as calculated from IMF, Government Finance 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
<b>Public employment</b>		
World Bank (Schiavo-Campo, de Tommaso, and Mukherjee 1997)	Aggregate wage bill totals and employment totals of civil and public servants (multiple) Civil service pay relative to private sector pay	Public officials are categorized to allow for cross-country comparability Average salary for civil service divided by average worker income
<b>II. Indicators of government performance.</b>		
<b>Sources</b>	<b>Datasets</b>	<b>Concept measured</b>
Business Environment Risk Intelligence	Political Risk Index (multiple) Operation Risk Index (multiple)	Sociopolitical conditions Bottlenecks for business development
<i>Wall Street Journal</i>	Annual survey of business analysts (multiple)	Attractiveness of the business environment
Standard & Poor’s	Country Risk Review (multiple)	Risk to the profitability of investments
European Bank for Reconstruction and Development	Transition indicators (multiple) Legal reform survey (multiple)	Progress toward a market economy Effectiveness of the legal framework
Economist Intelligence Unit	Country Risk Service (multiple) Country forecasts (multiple)	Risk ratings for investors Attractiveness of the business environment
Freedom House	Freedom in the World (multiple) Nations in Transit (multiple)	Political rights and civil liberties 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	<i>International Country Risk Guide</i> (multiple)	Political, economic, and financial risks for investors

**Table H.1. Selected Sources of Governance Indicators (continued)**

<i>Sources</i>	<i>Datasets</i>	<i>Concept measured</i>
Political and Economic Risk Consultancy	<i>Corruption in Asia</i> (multiple) Transparency in Asia (multiple) Quality of the media (multiple)	Quality of the legal system Business environment Censorship and access to foreign media
Institute for Management Development	<i>World Competitiveness Yearbook</i> (multiple)	Business environment
World Bank	1997 <i>World Development Report</i> 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)	Waiting for key service generally provided through government
Contract-intensive money (as calculated from International Financial Statistics)	Contract-intensive money: noncash share of the money, from IMF, International Financial Statistics	Proxy for contract enforceability/trust in government
Private-sector credit (from IFS data)	Private sector credit/GDP, from IMF, International Financial Statistics	Financial sector development

Note: This table draws from, among others, Kaufmann, Kraay and Zoido-Lobaton (1999).

## Notes

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. Some argue that the empirical evidence that democracy reduces corruption is weak. In studies by Paldam (1999) and Treisman (2000) that investigate this relationship while controlling for the level of development as depicted by GDP per capita, 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 to be 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 although the current degree of democracy is not significant, a long period of exposure to democracy is associated with less corruption. Lijphart (1998) provides further evidence from a 36-country study.
3. One exception is the use of indicators to identify countries where a governance discount in International Development Association allocations should apply.
4. See the list of research studies demonstrating that measurements of governance do indeed correlate with measurements of development provided in Burki and Perry (1998).
5. Exceptions are the Business International, Business Environmental Risk Intelligence, and International Country Risk Guide indicators, which became available in the early 1970s (BI and BERI) and early 1980s (ICRG). The BI indicators were used by Mauro (1995). The BERI and ICRG indicators were used by Knack and Keefer (1995). Several researchers have tried to resolve the causality problem using two-stage least-squares methods. See Mauro (1995); Hall and Jones (1999), and Kaufmann, Kraay, and Zoido-Lobaton (1999). For an investigation of causality exploiting time-series variation in the BERI and ICRG data, see Chong and Calderon (2000).