

Development Research Group

Knowledge in Development Note 11

Governance

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Donors have traditionally equated governance with the avoidance of corruption. This has had to do, in part, with their fiduciary responsibilities and, in part, to the belief that by curbing corruption, countries improve their ability to achieve development objectives. Research has viewed governance through a broader lens: the extent to which governments have incentives and the ability to credibly pursue policies in the broad public interest. This has yielded tools to measure and assess governance; assessments of the impact of governance at both macro and micro levels; and greater understanding of the sources of good governance. Based on these contributions, donors have incorporated broad governance assessments into decision making and development strategy.

Research has also reached two important conclusions that are, though more slowly, also being integrated into donor policy: narrow steps designed to counter corruption may have little effect on country characteristics that undermine governance broadly; and policy measures to improve governance broadly may have significant advantages in the specific fight against corruption.

Significant knowledge gaps, now being addressed by research, have hobbled donor efforts to address the broader governance agenda. One challenge is simply measurement: finding indicators of governance that are actionable (under the control of policy makers), but also meaningfully related to the fundamental governance challenges that countries confront. The other research challenges are to analyze the impact of these more specific and objective indicators of governance on development outcomes; and to improve our understanding of both the political and social determinants of good governance in order to design better strategies for improving governance.

What we know so far

Although the vast majority of research on governance never uses the word, it has had direct applications for the donor governance agenda, related both to assessing governance and to developing strategies for addressing governance.

Subjective measures of governance are informative and useful

Nearly all governance data that permit cross-country comparisons and over-time monitoring are necessarily based on subjective evaluations by experts or survey respondents of country risk, the investment climate, or competitiveness. Other indicators that are also taken as measures of governance in policy circles—measures of voice, electoral competitiveness and political checks and balances—are regarded by most researchers as possible *determinants* of governance.

Country-level governance indicators were introduced into the academic literature in the mid-1990s. They have since acquired legitimacy among donors as useful measures

of the broad governance environments in countries and have assumed a central role in donor policy making (e.g., the governance components of the World Bank's CPIA ratings weigh heavily in IDA aid allocations).¹ However, controversy has begun to surround their use. Countries have disagreed with their rankings, both relative to other countries and their evolution over time. Officials have questioned the extent to which the indicators point to particular reform priorities. And countries—and some academics—have disputed the degree to which high scores on these indicators are necessary or sufficient for development to occur.

These criticisms have emerged in large part because donors and affected countries have asked more of these indicators than they can provide. Assessments of broad governance are usually based on expert judgments about the cumulative effects of all government decisions that reveal government incentives and ability to make credible policies in favor of the broad public interest. Direct indicators of governance are also necessarily noisy, since governance phenomena such as the security of property rights or corruption are not easily observed.

Researchers have issued substantial caveats regarding the precision of the broad and more subjective governance indicators now widely used in policy circles. While countries can be reliably located in the top, middle, or bottom thirds of country rankings with regard to most governance indicators, finer distinctions are usually not meaningful. These caveats are often ignored, however. Greater precision is clearly needed and researchers are responding by investigating other strategies for measuring governance, which are reviewed below. These will be useful supplements to the broad, more subjective governance measures that are currently employed, but are unlikely to substitute for them, however.

A second criticism of broad, direct measures of governance is policy-makers' concern about how to respond to diagnoses of poor governance. They are therefore placing new emphasis on developing "actionable" indicators of governance. However, evidence does not yet demonstrate whether changes in such indicators—specific aspects of public sector management, for example—are associated with significant effects on broad governance and development.

Measurement difficulties also explain some of the criticism about the causal relationship between governance and development. In the view of most researchers, the fact that some countries with mediocre governance indicators have grown rapidly does not mean that governance does not matter (as skeptics argue). Instead, it means that governance problems were solved in unusual ways that current governance indicators have not captured.

Even if these criticisms do not entirely undermine the use of existing broad measures of governance, they do point to important areas in which research on governance needs to move. In fact, efforts to respond to these criticisms motivate much of the ongoing and future research on governance.

Good governance has a significant effect on development

Existing research has illuminated numerous ways in which different dimensions of governance matter for development.

- *Good governance accelerates economic growth*

Both policy makers and the research community agree that governance is key to entrepreneurial decisions that underlie growth. Where entrepreneurs believe that future returns to investment and innovation are likely to be expropriated by government policy or by bureaucratic fiat, they adopt less efficient production technologies and invest and innovate less. Broad microeconomic evidence—from land reform and titling, natural resource management, and the management of collectively owned goods—has clearly shown that poor governance drives down investment. However, quantitative evidence of the hypothesis that governance is a systematic determinant of *growth* awaited the construction of the broad governance indicators discussed earlier.

Tests using these indicators find strong evidence of the long-term growth effects of corruption, the rule of law, and the security of property rights.² Very few disagree with these conclusions, but despite numerous technical efforts to solve the problem, there is debate whether governance drives growth or whether some underlying, unidentified factor drives both governance and growth. Skeptics argue that this uncertainty undermines the rationale for improving governance to accelerate development. It is more likely, however, that these issues indicate that we still need to learn more about the underlying determinants of governance. These are likely to influence not only governance, but also myriad other government policies that researchers are unable to capture effectively. This generic issue affects all efforts to identify the government-determined sources of growth, including trade, financial policy, and education.

- *Good governance improves the quality of public spending*

Research has also looked at the effects of governance on the efficacy of government policies.³ Some survey evidence has indicated that corruption disproportionately denies the poor access to education and health services. Broad governance also affects public investment. On the one hand, public investment as a fraction of national income is substantially larger in countries with poor governance, reflecting the ability of less accountable governments to use public investment to divert resources to themselves or to substitute for private investment in weak governance environments. On the other hand, governance failures are also associated with the mis-targeting of public investment: public investment has significantly lower growth effects in countries with weak governance.

Governments that spend resources more effectively generally should also use aid more effectively. There is some evidence that aid accelerates growth significantly more among recipients with good governance, but several confounding factors make this difficult to establish with complete confidence: the small share of aid in the budgets of many recipient countries; the fact that donors often use governance as a consideration in aid decisions; and the possibility that donors might give aid to countries that are predisposed both to exhibit good governance and higher growth.

Still, taken altogether, the results on governance and government spending reinforce the importance of taking governance into account in decision making about aid. Consistent with this, donors have tentatively begun to take governance reforms beyond a focus on public sector management to link them directly with improved performance across sectors ranging from education and health to infrastructure. Knowledge gaps are

obstacles to these efforts: we are still not sure what specific governance attributes drive sectoral outcomes, and it is still not clear whether within-sector governance reforms can change sector outcomes if the broader governance environment remains unchanged.

How to get good governance

What reforms can strengthen government incentives and capacity to credibly implement policies in the broad public interest? Lacking conclusive guidance on this question, donors have largely relied on existing toolkits, focused particularly on public sector management, including specific anti-corruption activities. To these they have begun to add, though not mainstream, such approaches as increased information, community-driven development, decentralization, and support to civil society organizations. Research has provided some support for these strategies, but with often ambivalent results. At the same time, research has also pointed to a wide range of political and sociocultural determinants of governance that have not yet influenced policy responses to poor governance. These suggest that effective and sustainable governance reforms, including anti-corruption efforts, are likely to extend beyond traditional public sector interventions.

- *Competitive elections and political checks and balances are only weakly associated with good governance*

The experience of rich countries tells us that competitive elections and political checks and balances are associated with limits on the arbitrary exercise of power by government officials. However, it turns out that any causal relationship between these institutions and governance and growth is weak. In simple correlations, democratic institutions are strongly associated with good governance, but the correlation drops dramatically after controlling for income per capita. More directly: poor democracies and poor non-democracies differ little with respect to governance. Most research on the determinants of governance therefore focus, implicitly or explicitly, on various dimensions along which democracies and non-democracies differ among themselves and which could explain the weak relationship between democracy and governance.

- *Decentralization and community-driven development can, but do not necessarily, improve governance*

One of the ways in which countries differ is the extent of decentralization. Decentralization, it is argued, makes governments more accountable by bringing them “closer” to citizens; by bringing decision making down to smaller groups of citizens who are more alike in their views of what issues matter and what politicians should achieve; and by increasing citizen information about what governments are doing. In fact, cross-country evidence suggests that decentralization, particularly of *both* revenue-raising and expenditure responsibilities, is associated with lower corruption, though it has been difficult to control for the fact that countries able to decentralize successfully are likely to have unobserved characteristics that also improve governance.⁴

Micro studies of community-driven development yield much more ambiguous results. CDD programs operate under the assumption that the phenomena that generate political dysfunction and poor governance at the national government level are moderated at the village level. In contrast, researchers often find that local politics can be as or more

dysfunctional—for example, captured by local elites—than national politics.⁵ It is likely that successful decentralization requires upper- and lower-level governments to impose checks on each other: when all levels are dysfunctional, these checks are, as well.

- *Political market imperfections—lack of citizen information, lack of political credibility, or social polarization—have a significant negative impact on governance*

The same imperfections that interfere with economic markets, impeding investment and exchange, afflict political markets to an even greater degree. These include the inability of citizens to monitor government actions and their impact on citizens; the inability of citizens to impose a sufficiently high cost on politicians who renege on their promises; and polarization among citizens that leads them to value the identity of politicians more than their performance. This literature suggests, in other words, that the dynamics of political markets have a significant effect on governance.⁶

Research on incomplete information is most advanced. Significant empirical evidence reveals that greater media access is associated with less corruption and a greater likelihood of receiving different government transfers. Evidence from a famous intervention in Uganda showed that one unique type of government spending—capitation grants to schools—was far less likely to be siphoned off by government officials when newspapers publicized exactly how much money each school was expected to receive. Theory and observation, though no rigorous evidence, also suggests that when citizens are poorly informed, politicians bias their policies towards easily observed transfers rather than more cost-effective but also more complex public goods (e.g., high quality education).⁷

Research on information does not demonstrate, however, what people need to know to hold governments accountable nor whether they receive this information through the media channels examined in the literature. More importantly, neither theory nor evidence tells us whether public good provision should rise when citizens are better informed. Little evidence links school quality and information, for example.⁸ There is similarly no evidence that Freedom of Information Acts, a frequent target of donors, have an effect on governance in otherwise low-information societies.

The second political market imperfection is lack of politician credibility. Where politicians suffer a small or no penalty for reneging on their promises to citizens, research shows that they will pursue policies counter to the broad public interest, offering large transfers to narrow groups of the population (those to whom they *can* make credible promises), underprovide public goods, and engage in more corruption. This research explains why young democracies are far less likely to pursue development-oriented policies than older democracies, and points to the importance of a new type of political institution—the programmatic political party—as being of key importance for governance. But research on the origins of political credibility and its effects on policy is still in its infancy.

Finally, a large literature has pointed to the difficulties that social polarization poses for governance. Polarization could exist because of historic animosity or outright racism; because fragmented societies find it more difficult to work collectively; or because of political efforts to use social identity for political advantage. In fact, the inability of politicians to make credible promises to voters is one motivation to rely on

ethnic or religious appeals to voters—as a shortcut to credibility. In either case, persuasive evidence associates social polarization with lower public good provision and greater corruption.⁹

- *Historical, cultural, and social forces have a significant impact on governance*

A growing literature points to other, even deeper roots of good governance. Historical legacies, such as colonial institutions, are one such factor. These seem to have a significant impact on contemporary institutions and governance outcomes. Geography often underlies these legacies: settlement of countries in which natural resource rents were abundant developed temporary institutions adapted to rapid extraction, in contrast to resource-poor countries in which institutions conducive to investment and exchange were developed. The specific channels through which these historical legacies maintained their influence through to the present day remain underexamined, however.

One possible channel of influence is that of elite capture and inequality. In highly unequal societies—such as those where a few early settlers controlled access to vast natural resource rents—governance may be worse for two reasons. First, elites resist the adoption of institutions (such as, but not only, elections) that would offer non-elites security from elite expropriation. Second, even when these institutions are put into place, elites use their resources to manipulate them to their advantage.¹⁰

More immediately relevant to donor work is a growing body of research that demonstrates the potential importance of cultural and social beliefs on governance. For example, individual corruption appears to have substantial spillover effects, encouraging corruption by others, creating a vicious circle.¹¹ Cultural beliefs also affect general incentives to demand accountability. In a series of experiments, researchers have found that when high and low caste Indian children competed with each other in a game, the performance of *both* declined when each knew that they were competing against each other compared to when they did not.¹² Such studies provide rigorous validation for frequent observations that social legacies such as a caste system can create intrinsic barriers to accountability and good governance. These may be amenable to educational and similar interventions.

- *Natural resources undermine governance; foreign aid has a mixed impact*

The literature on historical legacies points to a resource curse: countries with many natural resource rents exhibit poor governance. This finding has been made more directly: governments with large natural resources have fewer incentives to accept institutions that limit their discretion and force them to be more accountable. As a consequence, governance fails. The dangers of a resource curse have been examined in the context of foreign aid. Given the widely known weaknesses of conditionality, it is easy to conceive of foreign aid as an inflow of rents to governments that might affect their incentives regarding governance. In fact, the evidence provides some indication that foreign aid is associated with lower levels of governance.¹³

This result may be more strongly associated with development transfers of the 1970s, 1980s and early 1990s, however, since other research has shown that donors have become more selective in the countries they target for aid. Put differently, just as in natural resources, Norway and Alaska have not seen a collapse in governance due to oil

rents, donors may be sending their money to countries that already have better-established institutions of government accountability, above the threshold at which rents cause governance to decline.

Ongoing and future research

The foregoing hints at a broad range of issues on which research is ongoing or planned. These are reviewed here.

- *Measurement*

Measurement research is pointed toward three new types of governance measures that are more objective indicators (more easily verifiable by third parties). The first measures narrow areas of government decision making (budget procedures, statistical capacity) that may be associated with specific governance outcomes (corruption, bureaucratic capacity). The second is an indirect measure of broad governance, which capture the consequences of broad governance failures but does not measure them directly; an early examples of this is contract-intensive money (essentially, the fraction of the money supply that is in the banking system rather than in cash).¹⁴ A third class of indicator is based on survey evidence of actual household or firm experiences with government.

All of these are in early stages and progress is likely to be incremental rather than lead to a sea change in the way that governance is measured by donors.¹⁵ In particular, it is unlikely that these will displace the more subjective, broad measures of governance. Measures of budget procedures, for example, cover only one area of government decision making and do not capture governance outcomes. The validity of indirect measures of broad governance cannot be tested and depends on theoretical arguments. And surveys are expensive and also usually involve only slices of government decision making (for example, bribes in some government offices, but not all). They are also prone to survivor bias (firms that cannot manage a poor governance environment simply do not enter and are not surveyed). Nevertheless, more refined indicators will allow us to look at more “actionable” areas of governance reform and ask whether they are necessary or sufficient for governance to improve. If they are, both country monitoring and policy dialogue will benefit.

- *The effects of good governance*

Research is continuing to bring the latest tools to bear to sort out issues of causality in governance and development. It will rely on existing governance indicators, as well as new indicators that seek to identify both specific governance “inputs” that bear upon the policy-making process (such as those related to budget procedures) and governance “outcomes” (such as survey-based data on firm or household experiences with poor governance). This work will continue to have important implications for policy makers, since studies of new measures of “inputs” and “outputs” will shed new light on the relationship between particular institutions of decision making and particular types of governance outcomes—a first step in the design of policy. This work will also allow new comparators against which existing tools for governance monitoring and diagnosis can be validated.

- *How to get good governance*

Researchers are dedicating considerable effort to this question. They continue to evaluate conditions under which decentralization and alternative civil service reforms (rotation of personnel, inclusion of more women, etc.) improve governance; the role of political market imperfections (citizen information, political credibility, social polarization) on governance; the role and origins of social and cultural factors that undermine government accountability, including the extent to which inequality drives governance failures; and the effects of historical factors, especially civil conflict, on governance.

Research on information is most likely to have the quickest impact on policy: ongoing and planned experiments have been examining the types of information that citizens lack that are relevant for governance; the effects of providing this information on the behavior of citizens and public agents, and ultimately on development outcomes themselves.

Results on civil service reforms, decentralization, and information will have immediate application to the programs of all donors. Work on social and cultural factors will require subsequent rounds of research to identify how these obstacles to good governance can be changed. Work on some political market imperfections, like the sources of political credibility, will be more immediately useful to bilateral than to multilateral donors (for example, the former work directly with political parties). However, even this work will provide guidance to multilateral efforts to boost the credibility of government promises, for example in creating support for economic reform.

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Endnotes

Most Bank documents cited in this summary are available through the documents and reports portal of the World Bank <http://www-wds.worldbank.org/>. The word “processed” describes informally reproduced works that may not be commonly available through library systems.

¹ The first published uses were in Knack and Keefer (1995) and Mauro (1995) (see footnote 3). For the latest developments in cross-country governance measurement, see D. Kaufmann, A. Kraay, and M. Mastruzzi. 2004. “Governance Matters III: Governance Indicators for 1996, 1998, 2000, and 2002.” *World Bank Economic Review* 18:253-287; D. Kaufmann, A. Kraay, and M. Mastruzzi. 2006. “Measuring Governance Using Perceptions Data.” In *Handbook of Economic Corruption*, ed., Susan Rose-Ackerman. Edward Elgar.

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- ⁹ E. Miguel and M. Kay Gugerty. 2005. "Ethnic Diversity, Social Sanctions, and Public Goods in Kenya." *Journal of Public Economics* 90(11-12, December): 2325-68.
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