Worldwide Governance Indicators and key Findings: *Implications for Credit, Investment and Policies in Emerging Markets*

Daniel Kaufmann
The World Bank Institute

or, [www.govindicators.org](http://www.govindicators.org)

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Evidence-based Approach, through empirics

1. Data Matters—on Governance & Institutions: data can be gathered, analyzed, and used judiciously
2. Institutions, Governance and Corruption Matters
3. On average stagnation on Governance – yet high variance --some countries improve in short term
4. Behavior of the Firm and Investor also Matters
5. Global collective responsibility
6. Governance matters for a country’s: growth, competitiveness, investments & financial markets
7. Implications for Political Risk Analysis & Sectoral Policy
The ‘Power of Data’: progress in measurement

1. The ‘Macro’/Aggregate Level of Measurement:
   *Worldwide Aggregate Governance Indicators*: 200 countries, 6 components, periodic.

2. ‘Mezzo’: *Cross-Country Surveys of Enterprises*

3. ‘Micro’: Specialized, in-depth, in-country Governance and Institutional Capacity Diagnostics: Includes surveys of: i) user of public services (citizens); ii) firms, and, iii) public officials

*On ‘Aggregate/Macro’ Level first…*
Six Dimensions of Governance Measured

Governance as the set of traditions and institutions by which authority in a country is exercised -- specifically:

- The process by which those in authority are selected and replaced [Political Governance]:
  1. VOICE AND ACCOUNTABILITY
  2. POLITICAL STABILITY & ABSENCE OF VIOLENCE/TERRORISM

- The capacity of government to formulate & implement policies, and deliver services [Economic Governance]:
  3. GOVERNMENT EFFECTIVENESS
  4. REGULATORY QUALITY

- Respect of citizens and state for institutions that govern interactions among them [Institutional Governance]:
  5. RULE OF LAW
  6. CONTROL OF CORRUPTION
2006 Worldwide Governance Indicators: *Key Features after a decade of Governance Data*

- Widely used by policymakers and researchers to study causes and consequences of good governance
  - biannual data since 1996, now *annual* data
- Based on 31 data sources from 25 organizations, capturing views of thousands of informed stakeholders
- Covering over 213 countries & territories, estimate of 6 dimensions of governance and of margins of error
- Now also: access to individual data underlying the construction of the aggregate indicators
  - hundreds of individual indicators over past decade
  - very large on-line governance data resources, at [www.govindicators.org](http://www.govindicators.org)
Sources of Governance Data

- **Cross-Country Surveys of Firms:** Global Competitiveness Survey, World Business Environment Survey, World Competitiveness Yearbook, BEEPS
- **Cross-Country Surveys of Individuals:** Gallup International Voice of the People, Latinobarometro, Afrobarometer
- **Expert Assessments from Commercial Risk Rating Agencies:** DRI, PRS, EIU, World Markets Online, Merchant International Group, IJET Travel Consultancy, PERC
- **Expert Assessments from NGOs, Think Tanks:** Reporters Without Borders, Heritage Foundation, Freedom House, Amnesty International, Bertelsmann Foundation, Columbia University, International Research and Exchanges Board
- **Expert Assessments from Governments, Multilaterals:** World Bank CPIA, EBRD, AFDB, ADB, State Dept. Human Rights Report, Trafficking in Persons Report
Building Aggregate Governance Indicators

- Benefits from Aggregation
- Use Unobserved Components Model (UCM) to construct composite governance indicators, and margins of error for each country
- Estimate of governance: \textit{weighted average} of individual scores for each country, re-scaled
- Weights are proportional to \textit{precision} of underlying data sources, and \textit{precision} based on extent of ‘consensus’ among sources
- Margins of error reflect (a) \textit{number of sources} in which a country appears, and (b) the \textit{precision of those sources}
Control of Corruption
Selected Countries, 2005


Note: Colors are assigned according to the following criteria: Dark Red, below 10th percentile rank among all countries in the world; Light Red between 10th and 25th; Orange, between 25th and 50th; Yellow, between 50th and 75th; Light Green between 75th and 90th; Dark Green above 90th.
Are Countries Stagnating in Governance?

• The world on average has not improved on governance, though it has on the macro-economic policies, infrastructure, etc: there is a ‘governance gap’

• But large or small variation across countries?

• New method: for each country, we can identify whether there are significant changes over time

• It is found that changes can take place in the short-term: in 6-to-8 years, some deteriorations as well as some significant improvements as well
Significant Decline in Inflation Rates Worldwide

High Inflation

Low

(\textit{avg. in logs})


Source: ‘Rethinking Governance’, based on calculations from WDI. Y-axis measures the log value of the average inflation for each region across each period
Quality of Infrastructure also improved...

Source: EOS 1997-2003 (Quasi-balanced panel). Question 6.01: General infrastructure in your country is among the best in the world?
But by contrast, governance has stagnated…

Judiciary Independence (EOS survey results 1998-2004)
No Significant Trend in Control of Corruption
Worldwide Averages

PRS country coverage in 1996: 129, all other periods 140; QLM and EIU country coverage: 115 for all periods.

% countries in 1995

% countries in 2004

Source: Freedom House. Y axis measures percentage of countries in the region with free press (rating of 30 or below), partly free (ratings between 30 and 60) and not free (rating above 60).
Changes in Control of Corruption, 1996-05

Changes were calculated on the basis of the differences in country estimates from 1996 and 2005. Classification for major deteriorations and improvements were based on 75% confidence interval. Source for data: ‘Governance Matters V: Governance Indicators for 1996-2005’, by D. Kaufmann, A.Kraay and M. Mastruzzi, September 2006 - www.govindicators.org
Development Dividend From Good Governance

- **Control of Corruption**

Data Source for calculations: KK 2004. Y-axis measures predicted GDP per capita on the basis of Instrumental Variable (IV) results for each of the 3 categories. Estimations based on various authors’ studies, including Kaufmann and Kraay.
Good Governance associated Country’s Competitiveness

Constraints to Business vary across regions & countries  
(responses from the Firm in EOS 2005)

% firms reporting constraint among top 3:

- Infrastructure
- Bureaucracy
- Corruption
- Tax Regulations
- Inflation

Source: EOS 2005. The question posed to the firm was: Select among the above 14 constraints the five most problematic factors for doing business in your country. Note that the overall EOS sample covers 120 [CHECK] countries, and in some regions –particularly in the Middle East, Africa and the FSU, many countries are not surveyed. Thus, regional averages need to be interpreted with caution, since typically countries not surveyed tend to rate lower in governance than those surveyed.
Unbundling Corruption: Different types of Bribery (responses by firms 2005)

% Firm Report High Bribery (1-3)

Multinationals Bribe Abroad?

% Firms Reporting Frequent Procurement Bribery, EOS 2005

Source: EOS, preliminary. Question: In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with the following: permits, public utilities, tax payments, loan applications, awarding of public contracts, influencing of laws, policies, regulations and decrees to favor selected business interest, and judicial decisions. Any firms reporting answers 1 through 3 were considered to be reporting at least high frequency of bribery, while answers 4 through 7 were not.
Governance Matters for Assessing Emerging Financial Markets Prospects

Indicators Matter, and Some Empirical Lessons
Stock Market Volatility vs. Control of Corruption

\[ r = -0.56 \]

Opacity (or misgovernance) affects Herding (investors mimic each other’s behavior)

Gelos and Wei, 2005

Opacity (Misgovernance)
Misgovernance → Higher Fragility of Financial Sector
Soundness of Banks vs. Control of Corruption
(View of the firm, GCS 2001)

Source: Global Competitiveness Survey, 2001, KK Governance Indicators
2006 Bond Spreads vs. Corruption Control

$r = -0.57$

Sources: Bloomberg Financial Services & WBI. Bond spreads are drawn from the Global Emerging Market Bond Index (EMBIG) produced by JP Morgan on 33 emerging economies.
Summary and Implications

1. Governance measurement skepticism challenged
2. Misgovernance as one binding constraint nowadays
3. Beyond corruption: governance more broadly
4. Beyond administrative corruption -- influence peddling and state capture by firms is also key
5. Governance Matters for country growth prospects, for Investments, and for financial markets
6. Misgovernance affects: fragility of financial markets & banks, volatility of equity markets; investor herding behavior (& lower I); bond market spreads
7. Capital Market Development: Disciplining for GG
8. Assessing & Measuring Governance key for Political Risk assessment
9. Good Governance & Transparency at Sectoral Level
10. Global Challenges and Responsibility
Governance Has Improved in Some Groups: e.g. “Pull Effect” of EU Accession

Governance Indicators: Chile, 2004 vs. 1996

Source for data: [http://www.worldbank.org/wbi/governance/govdata2002](http://www.worldbank.org/wbi/governance/govdata2002); Colors are assigned according to the following criteria: Dark Red, bottom 10th percentile rank; Light Red between 10th and 25th; Orange, between 25th and 50th; Yellow, between 50th and 75th; Light Green between 75th and 90th; Dark Green above 90th.