Why measuring governance matters

Development is all about governance these days. When the Group of Eight (G8) countries announced their decision to double aid to Africa on July 8, a whole section in their communiqué was devoted to "promoting good and responsive governance." And while attaching fewer strings to aid is the new mantra of the development community, governance is one area where recipient countries can expect to face much greater scrutiny. But what exactly is governance, and how is it measured? Aart Kraay, one of the pioneers of the World Bank's governance indicators database—viewed as the state of the art within the development community—gave a tour d'horizon of governance at a June 16 seminar arranged by the IMF Institute.

The World Bank's database includes six dimensions of governance (see box, next page), ranging from "voice and accountability" to "control of corruption." The data cover 209 countries over an eight-year period (1996–2004) and are derived from 37 separate data sources that include cross-country surveys of firms, commercial risk-rating agencies, think tanks, government agencies, and international organizations.

Almost all of this material is perception based. Why? Kraay explained that it makes sense to use subjective data (for instance, asking firms if they think government interferes with investment decisions) as opposed to objective data (for instance, counting the number of police patrolling the streets). Perceptions are what really matter when it comes to governance, because *de jure* rules often are not followed, or are abused. A country can have proportional representation, but if elections are routinely rigged, the election system matters very little. For these reasons, governance indicators that rely on subjective data are actually more informative about certain dimensions of governance than those relying on objective data.

Governance is not a luxury good that only wealthier countries can afford.

—Aart Kraay

An imperfect business

If one accepts this premise, the next question is: Just how precise are the indicators? Is it justifiable to give aid to one country but cut it back for another based on data collected in this manner? Kraay did not address that question directly, but he did discuss the quality of the indicators at length. Many changes in the governance indices are small relative to the margins of error, even over the eight-year period covered by the indicators, and there is a lot of "noise" in the data, he said. The margins of error, which vary from country to country, are normally attributable to two factors: cross-country differences in the number of sources used to assess governance for individual countries, and differences in the reliability of the sources used for each country.

Countries where changes in governance—as measured, for instance, by a change in voice and accountability—were within the margin of error, and therefore insignificant, included Bolivia, Brazil, and the Philippines. But for other countries, including Haiti, Ivory Coast, Nepal, Venezuela, and Zimbabwe, governance deteriorated markedly, whereas it improved in Latvia, Serbia, Sierra Leone, and Tanzania. Kraay said his team estimates that actual changes in governance are about half as large as *observed* changes, so that should be taken into account when using the database. Crucially, however, these margins of error are not unique to subjective or perception-based measures of governance. Rather they are pervasive in any effort to measure governance using any type of data, and it is important for policymakers to take this uncertainty into account.

Governance and growth

Economists have known for some time that there is a highly significant correlation between governance and economic growth over the long run, but the precise nature of this relationship is difficult to pin down. This is because several other factors also matter for growth, including geography, trade, human capital, and different types of institutions. New research has tried to approach the problem by running "horse races," for instance between the effect of trade and governance on growth, but much more work remains to be done, Kraay said, before economists can get a clearer picture of how governance relates to growth.

Even so, the World Bank estimates that a country that improves its quality of governance from a low to an average level can quadruple the income per capita of its population in the long term, and similarly reduce infant mortality and illiteracy. And the direction of causality is clear: it goes from better governance to higher incomes, and not vice versa.

In other words, Kraay said, governance is not a "luxury good" that only wealthier countries can afford. This also implies that the weak governance performance observed in many poor countries should not be "discounted" based on their low incomes—both rich and poor countries can improve their governance regardless of their income levels.

State capture can severely hinder a country's ability to benefit from economic growth: if the fruits of income growth largely accrue to an elite that benefits from misgovernance, then any possible positive impact of income growth on governance could be offset by the elite's negative influence.
—Aart Kraay

Growth without governance

Unfortunately, this also implies that higher incomes do not necessarily lead to better governance. New research by Kraay and his colleagues shows that the absence of a virtuous circle between growth and governance means that the hard work of rooting out corruption must be done regardless of a country's economic performance. In fact, there may even be negative feedback from per capita income to governance—especially in the face of undue and illicit influence of the elite in shaping the laws, policies, and regulations of the state—what Kraay refers to as "state capture."

State capture differs from conventional corruption—the use of bribery to influence the *implementation* of laws and regulations—and has a potentially wider impact. State capture can severely hinder a country's ability to benefit from economic growth: if the fruits of income growth largely accrue to an elite that benefits from misgovernance, then any possible positive impact of income growth on governance could be offset by the elite's negative influence, Kraay argued. Recent research has identified state capture as a fundamental challenge in many transition countries, with evidence suggesting that it is widespread in Latin America as well.

So where does that leave Africa and G8 aid and debt relief? While low-income countries will likely have to contend with tough new demands from donors wanting to make sure that their aid is being put to good use, there is still precious little advice on how exactly to achieve that coveted improvement in institutions and the rule of law. But at least we now have a somewhat clearer picture of what governance looks like, how it is evolving across the world, and how important good governance is for economic development. ■

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Making sense of governance

The World Bank's governance database is based on the following six dimensions:

- ***Voice and accountability*** includes indicators that measure various aspects of the political process, including civil liberties, political and human rights, and the extent to which citizens of a country are able to select their governments.
- ***Political stability and absence of violence*** combines several indicators that measure perceptions of the likelihood that a government will be destabilized or overthrown by unconstitutional means, including through domestic violence and terrorism.
- ***Government effectiveness*** combines responses on the quality of public service, the independence of the civil service from political pressure, and the credibility of the government's commitment to various policies.
- ***Regulatory quality*** focuses on policies that hamper the functioning of an efficient market, such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.
- ***Rule of law*** includes several indicators that measure the extent to which citizens have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the ability to enforce contracts.
- Finally, ***control of corruption*** is a measure of corruption, conventionally defined as the exercise of public power for private gain. It is based on scores of variables from polls of experts and surveys.

For more information about the World Bank's work on governance, please visit *www.worldbank.org/wbi/governance/index.html.* The governance indicators are available at *www.worldbank.org/wbi/governance/govdata.*