Governance and Growth:
Causality which way? -- Evidence for the World, in brief

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Per capita incomes and the quality of governance are strongly positively correlated across countries. This can be seen in Figures 1A-C, which plot three measures of governance on the horizontal axis (control of corruption, the protection of property rights or rule of law, and voice and accountability) against real per capita GDP adjusted for differences in purchasing power across countries on the vertical axis. These three governance measures are part of a set of six dimensions of governance for which we have constructed composite indicators, drawing on over 190 measures of perceptions of governance compiled by 17 organizations worldwide, and covering up to 170 countries. The other three dimensions of governance covered comprise government effectiveness, regulatory quality, and political stability. We first constructed these six governance measures for 1997/98 and 2000/01. These indicators are interactively available on the internet.[2] Further, we will shortly be releasing updated indicators covering 200 countries with updated data covering the period until end-2002.

One of the main innovations in these measures is that we report statistically-sound margins of error for individual country estimates. These are shown as horizontal bars around the estimates of governance in Figure1A, indicating the likely range of values of governance for selected countries. A qualification to keep in mind when using these or any other measures of governance is that these margins of error can be substantial. As shown for selected countries in Figure 1A, the statistically-likely range of values of governance for many pairs of countries overlap, indicating that one should be cautious in ascribing much significance to differences in the reported estimates of governance for such ('overlapping ranges') countries whose point estimates are not far apart. Even accounting for the margins of error, however, the data can be rather informative, and does reveal interesting patterns. For example, Figure 1B highlights all the countries in the Latin American and Caribbean region. It is striking that 21 out of 26 countries in the region for which we have data fall above the simple line of best fit in Figure 1B. Similar analysis can be conducted for other regions.

But how should we interpret the strong positive relationship between incomes and governance shown in Figures 1A-C, or for that matter the relative positions of any particular group of countries? Logically there are three possible explanations for this strong positive correlation: (1) better governance exerts a powerful effect on per capita incomes; (2) higher incomes lead to improvements in governance; and (3) there are other factors which both make countries richer and also are associated with better governance.

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[1] The authors are at the World Bank. The views expressed here are the authors' research findings, and do not necessarily represent those of the World Bank, its Executive Directors, or the countries they represent.

[2] The governance indicators are available at http://www.worldbank.org/wbi/governance/govdata2001.htm. For a description of the data sources and methodology, see Kaufmann, Kraay and Zoido-Lobatón (1999a, 1999b, and 2002), also available in the above website containing the indicators themselves.

Which of these three possibilities is most important matters crucially not only for how we interpret Latin America's relative performance as per Figure 1B, but more generally, for how we interpret the close link between governance and incomes worldwide. If governance causes higher incomes, then at first glance the fact that countries in Latin America in the mid-nineties exhibited relatively high income levels for their levels of governance could suggest a fragility in these income gains – to the extent that these are not solidly "supported" by good governance. If on the other hand the causality direction runs mostly in the opposite direction, and thus higher incomes tend to raise governance, then it may instead be concluded that countries in the region have surprisingly weak governance given their income levels – and that future growth will eventually lead to better governance in the region. More generally, for the world at large and for other regions and countries, untangling the observed high correlation between incomes and governance is important in order to ascertain whether an automatic 'virtuous cycle' where higher incomes are translated into improved governance is present, or instead very concerted and continuous policy effort to improve governance is needed.

Consequently, we need a good understanding of the effects of governance on incomes, and any feedback mechanisms from incomes to governance that might exist – simply observing a strong correlation between income growth and governance will not suffice. Untangling the directions of causation underlying the strong correlations in Figures 1A-C is the objective of our paper "Growth Without Governance", recently published in the journal *Economia*.[3]

Consider first the effect of governance on per capita incomes. As recently as 200 years ago, per capita incomes were not very different across countries. The wide gaps in per capita incomes across countries that we see today reflect the simple fact that countries that are rich today have grown rapidly over the past two centuries, while those that are poor today did not. A recent strand of research attributes a substantial fraction of these vast differences in very long-run growth performance to deep historical differences in institutional quality. By isolating the part of current differences in institutional performance that can be traced back to countries' colonial origins, these studies have identified a powerful effect of initial institutional quality on growth in the very long run.[4]

What about causation in the opposite direction, from per capita incomes to the quality of governance? Conventional wisdom holds that richer countries are better able to afford the costs associated with providing a competent government bureaucracy, sound rule of law, and environment in which corruption is not condoned. This suggests that there is positive feedback from incomes to governance as well. Yet to date, this conventional wisdom has not been subject to in-depth empirical scrutiny. In our paper we call this conventional wisdom into question. We propose a novel methodology which allows us to separate out the effects of per capita incomes on governance, and we find evidence that this effect is if anything negative.[5]

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[3] Kaufmann and Kraay (2002).
[4] See for example Hall and Jones (1999) and Acemoglu, Johnson and Robinson (2001).
[5] This of course does not mean that the simple correlation between governance and per capita incomes is negative, since this is dominated by the strong positive effects of governance on income.

This finding of negative feedback from per capita incomes to governance (which is the reason for the original paper title 'Growth without Governance'), has two important implications. First, a strategy of waiting for improvements to come automatically as countries become richer is unlikely to succeed. Second, in the absence of positive feedback from incomes to governance, we are unlikely to observe "virtuous circles" of when better governance improves incomes this in turn will lead to further automatic improvements in governance. Together, these two implications point to the fundamental importance of positive and sustained interventions to improve governance in countries where it is lacking. Indeed, the fact that good governance is not a 'luxury good' to which a country automatically graduates into when it becomes wealthier means in practical terms that leaders, policy-makers and civil society need to work hard and continuously at improving governance within their countries.

It is important to understand the reasons for the absence of positive feedback from per capita incomes to governance when designing strategies to improve governance. Based on empirical evidence, we advance a plausible explanation for this negative feedback: the phenomenon of "state capture", defined as the undue and illicit influence of the elite in *shaping* the laws, policies and regulations of the state.[6] When the institutions of the state are "captured" by vested interests in this way, entrenched elites in a country can benefit from a worsening status quo of misgovernance and can successfully resist demands for change even as incomes rise.

Based on in-depth governance and anti-corruption country diagnostics carried out at the World Bank in a number of countries in Latin America, as well as enterprise surveys in economies in transition, we have found significant empirical evidence on the challenge of State Capture (and, related, 'crony bias' or unequally distributed influence) in many countries. In countries with such a "captured" environment, the focus of efforts to combat corruption and improve governance needs to shift from a narrow emphasis on passing laws and rules, and on procedures within the public administration, to a much broader agenda of greater political accountability, transparency, independence of the media, monitoring and diagnostic surveys (as checks and balances from civil society), as well as the establishment of effective mechanisms through which the voices of citizens and users of public services can be heard (including through the use of innovative e*governance tools). Indeed, empirical evidence from country diagnostic surveys also support the notion that transparency and 'voice' mechanisms play an important role in improving governance of institutions within countries, as exemplified in Figures 2A and 2B, based on research on Bolivia. Growing evidence, for other countries as well, do point to the need to emphasize in particular transparency and participatory voice mechanisms in the next phase of good governance programs.

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[6] Hellman, Jones and Kaufmann (2001). See also more recent evidence in some Latin American countries, emerging from the governance and anticorruption diagnostics (GAC) of the World Bank Institute (WBI) at (http://www.worldbank.org/wbi/governance/tools.htm)

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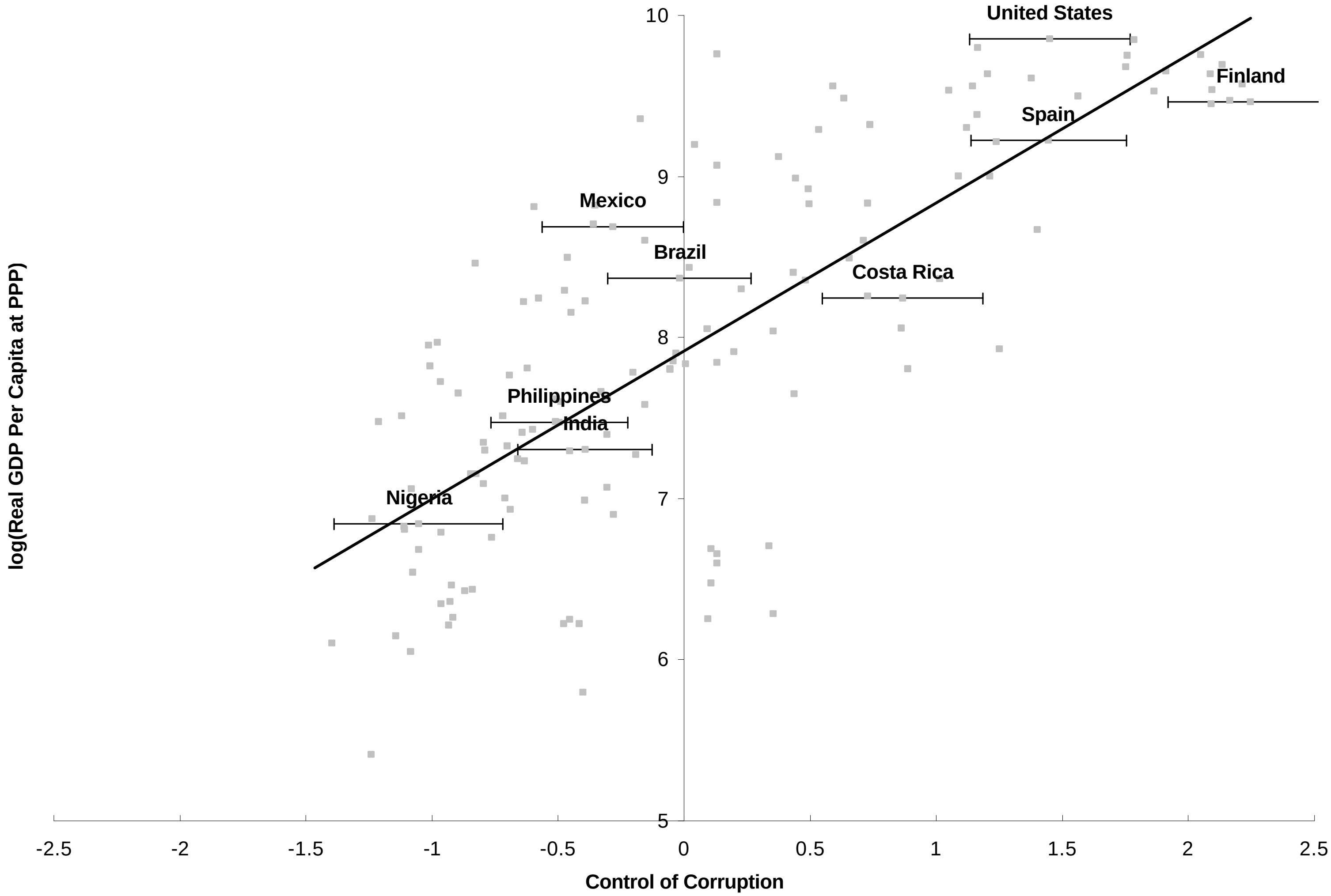
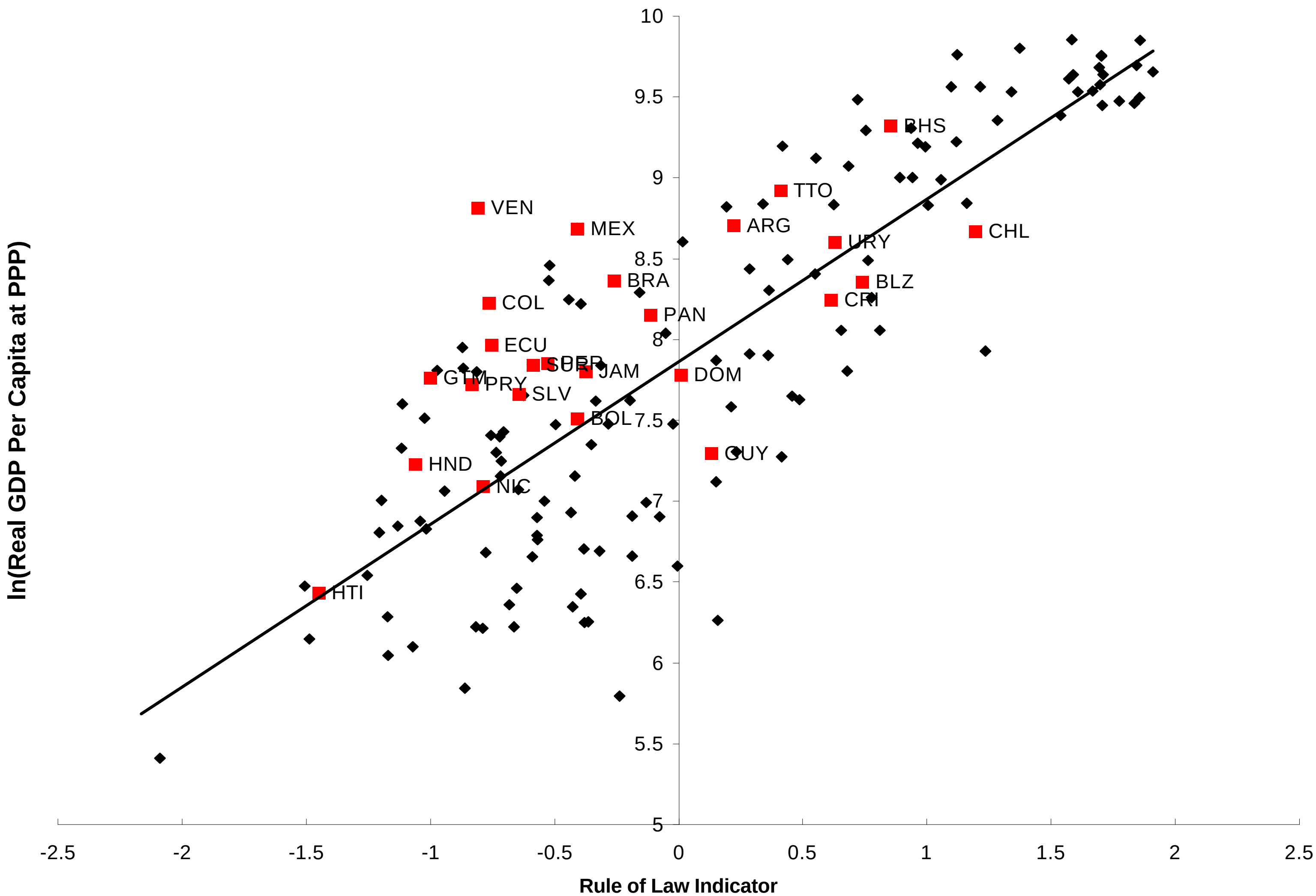
World Bank Institute 'Governance and Anticorruption (GAC) Diagnostics', various countries and years. http://www.worldbank.org/wbi/governance/tools.htm.

Figure 1A -- Control of Corruption and Per Capita Incomes



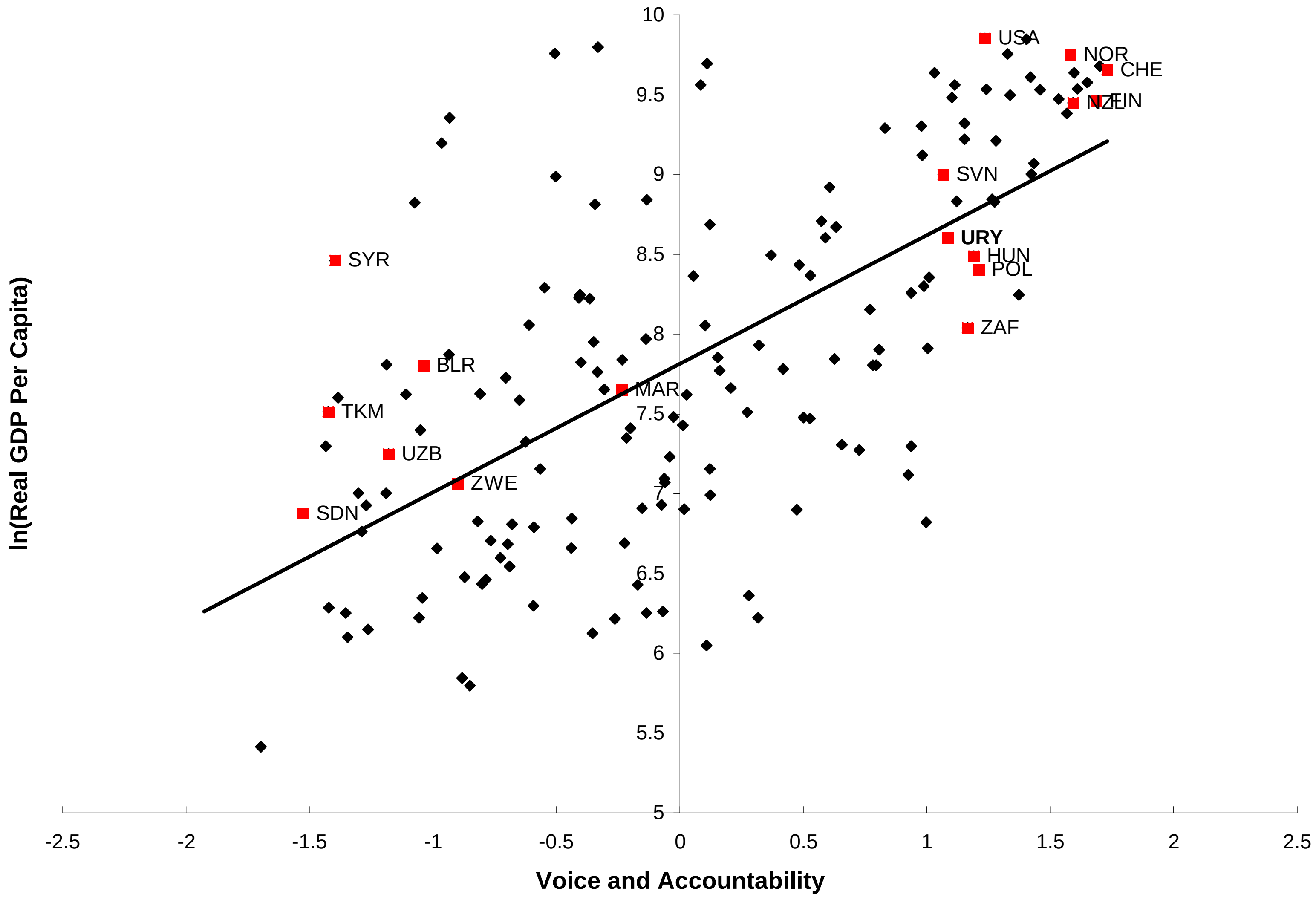
Notes: This figure plots a measure of control of corruption in 2000/01 (on the horizontal axis) against real per capita GDP in 1995 (on the vertical axis). The horizontal bars for selected countries indicate the statistically-likely range of values for the rule of law index for those countries. The governance ratings on the vertical axis are based on subjective assessments from a variety of sources, are subject to substantial margins of error, and in no way reflect the official view of the World Bank, its Executive Directors, or the countries they represent.

Figure 1B -- Rule of Law and Per Capita Incomes



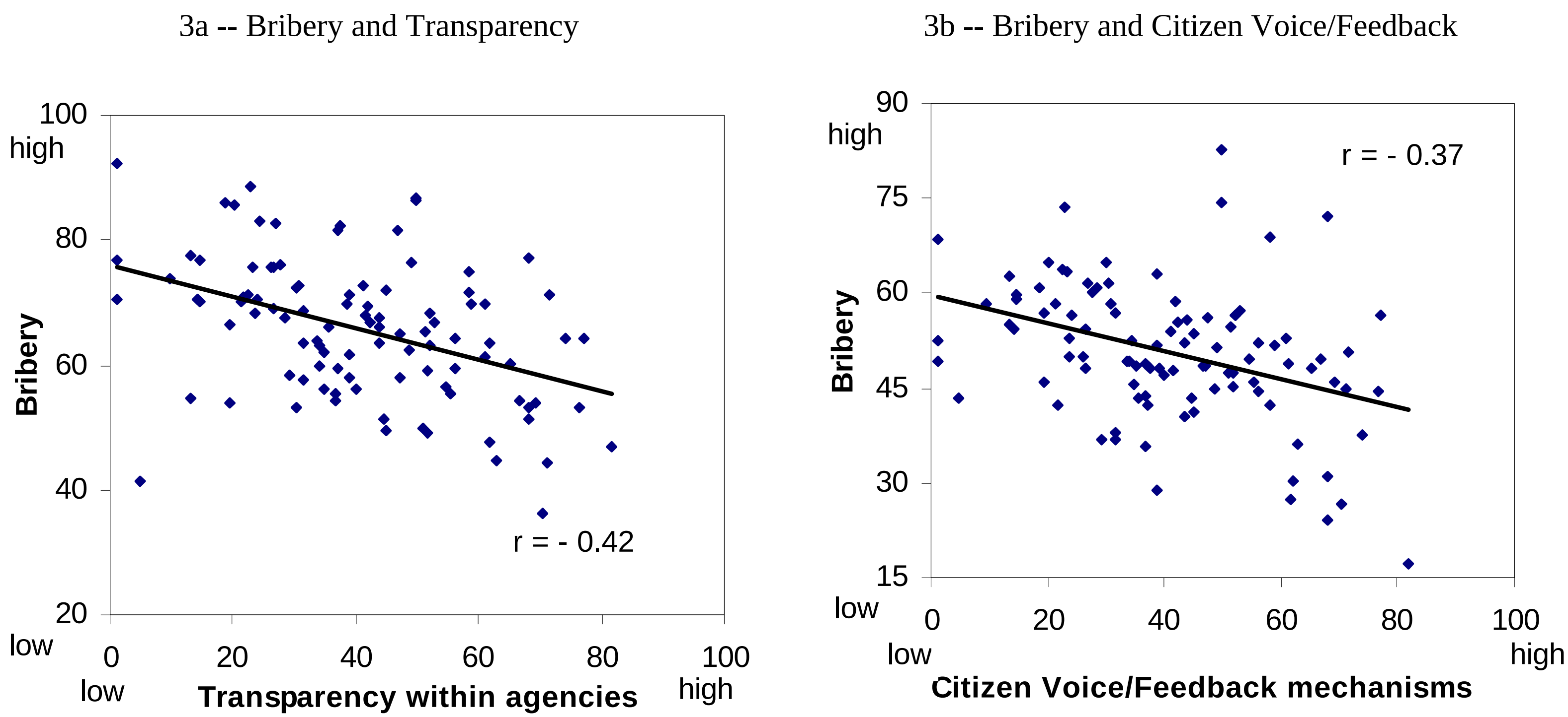
Notes: This figure plots a measure of the rule of law in 2000/01 (on the horizontal axis) against real per capita GDP in 1995 (on the vertical axis). The governance ratings on the vertical axis are based on subjective assessments from a variety of sources, are subject to substantial margins of error, and in no way reflect the official view of the World Bank, its Executive Directors, or the countries they represent.

Figure 1C -- Voice and Accountability and Per Capita Incomes



Notes: This figure plots a measure of voice and accountability in 2000/01 (on the horizontal axis) against real per capita GDP in 1995 (on the vertical axis). The governance ratings on the vertical axis are based on subjective assessments from a variety of sources, are subject to substantial margins of error, and in no way reflect the official view of the World Bank, its Executive Directors, or the countries they represent.

Figure 2 – Agencies exhibiting Transparency and Citizen Voice have lower Bribery – Bolivia Diagnostic of Public Officials, 1999



Note: This graph depicts the extent of corruption across Bolivia's public agencies, as reported by a survey of public officials (on the vertical axis) and the indicated agency attribute (whether transparency or voice -- on the horizontal axis). "Transparency" is based on an average of six questions on the openness of decision making procedures in each agency. "Citizen Voice/Feedback" is an average of four questions on the presence of formal feedback mechanisms available to users.
Source: "Voice or Public Sector Management? An Empirical Investigation of the Determinants of Public Sector Performance Based on a Survey of Public Officials in Bolivia." D. Kaufmann, G. Mehrez and T. Gurgur. 2002. World Bank Institute. (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=316865)