Discussion Draft
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Rethinking Governance

Empirical Lessons Challenge Orthodoxy

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Abstract: In this discussion draft, linking research findings with concrete operational challenges, we review key issues in worldwide governance, and present recent empirical evidence. Focusing on defining and unbundling key governance components, such as rule of law, voice and accountability, corruption control, and state capture, we then provide evidence which suggests a sobering picture: on average, there appears to be scant progress worldwide in recent times in improving rule of law and governance, in controlling corruption, and in improving institutional quality -- although there is clearly variance across countries. Further, recent empirical research points to the private sector as influencing public governance, thereby challenging traditional notions of the functioning of politicians, public policy and the public sector, and on the conventional determinants of the investment climate. We posit that the interplay between the elite's vested interests and the political dynamics within a country, in turn affecting governance and corruption, has often been under-emphasized in program design. These argue for revisiting conventional approaches to promote institutional reform. In particular, we challenge the notion that passing laws by fiat, creating new public institutions, or embarking on anti-corruption 'campaigns', can be very effective, and question the value of traditional public sector management and conventional legal/judiciary reform approaches for many emerging economies. We argue instead that sharper focus on external accountability is required, focusing on: transparency mechanisms and empirically-based monitoring tools (including e*governance), as well as participatory 'voice' and incentive-driven approaches for prevention. These need to feature more prominently in providing checks and balances on traditional public institutions, in empowering non-traditional stakeholders, and in ameliorating state capture and mitigating the very 'unequal influence' playing field in many countries. In turn, this necessitates probing deeper into the private-public governance nexus, which *inter alia* leads to focusing on concrete measures to address the challenges of political contestability, political financing reform, and transparency in parliaments, the judiciary and the executive. Recommendations on governance strategies for the next phase are suggested, including on the role of the international community.

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[1] The author is the Director of Global Governance and Regional Capacity at the World Bank Institute (WBI). This paper builds on the chapter entitled 'Governance Crossroads' in the 2002/03 Global Competitiveness Report by the World Economic Forum (February, 2003). The responsibility for the errors and views in this paper are the author's, yet credit for the work discussed here is due to many at the World Bank, in academia, at the World Economic Forum, TI, and other partner institutions. The work carried out at the World Bank in this area would not have been possible without the support of its President. I have benefited from feedback at conferences and workshop presentations at Stanford University, Madrid's Judiciary Workshop, Davos World Economic Forum, European Parliament, European Commission, OECD, DfID-UK, ODI, Wilton Park, and at the World Bank. The work draws from collaborative projects within the World Bank with J. Hellman, A. Kraay and F. Recanatini, as well as inputs from J. Turkewitz, M. Gonzalez and S. Pradhan and other governance experts in the Bank's Public Sector Board and WBI. I have benefited from the insights in the collaboration on governance and anti-corruption programs with L. Moreno-Ocampo and colleagues at TI. The excellent assistance of M. Mastruzzi, D. Vasileva, E. Farnand and K. Morgan is acknowledged. The views, data, and research findings aim to further debate and analysis, and do not necessarily reflect official views of the World Bank or its Board of Directors. The margins of error in any governance and institutional quality dataset imply interpretative caution is warranted in general, and in particular argue against inferring seemingly precise country rankings from the data. For details on the governance research and data: http://www.worldbank.org/wbi/governance/.

PREFACE: FAMINES VS. FREE PRESS; DYING CHILDREN VS. GOVERNANCE

The twenty-year old insight that it is not food scarcity *per se* nationwide which explains famines, but instead the absence of a free press and multi-party democracy, contributed to the award of a Nobel Prize in Economics to Amartya Sen. Yet today we also face a less dramatic yet perverse challenge on a subtler variant of a famine – the severe malnutrition and deaths of children. And this in a food-abundant setting, with a vibrant competitive press and multi-party electoral democracy. Consider the case of Maria Rosa Gomez, aged 6, whose skeletal photograph while barely alive appeared in the national and international media in mid-November, 2002, when she weighted 20 pounds, almost 50 below normal. She passed away; while her two brothers were fighting for the lives in a hospital, their limbs described by *El Pais* as 'needles' - severely malnourished child weighing a fraction of normal weight. Unfortunately, these children are not rare exceptions; thousands of children are either severely malnourished and thus ill and at severe risk, or actually dying of hunger in this country.

Where is this taking place?: in the sixth largest world food exporting country, capable of feeding 300 million inhabitants but populated with only 1/10th that number of mouths to feed, in fact long regarded as the world's grainstore, and rated as middle income country worldwide. Indeed, this is happening in Argentina today, which has a free press. Tucuman is its northeast province where little Maria Rosa died of hunger, while every month the authorities received generous food aid. But the province reportedly 'has been devastated by corrupt governments', and has had as its 'chief executive a general accused of human rights violations during the military regime'. Investigations into diversion of aid funds are currently taking place, and at the federal government is now bypassing local authorities. Tucuman is not alone in failing to feed its children. It is estimated that in the Buenos Aires metropolitan area one-third of the children are malnourished, and in poorer provinces the rate approaches one-half.[2]

One can coldly debate points of detail for such tragic turn of events in a country which at the turn of the 20th century was the seventh wealthiest in the world. Analysts may not agree on the precise weight of various potential determinants of the crisis – such as the risky combination of a rigid exchange rate regime with mismanaged public (including provincial) finances; tax evasion; political corruption and patronage (also at the subnational level); a misgoverned judiciary, as well as others. Irrespective of which priority factors the particular analyst will settle on, the cumulative weight of the evidence points to severe misgovernance as a structural problem, associated with extremely unequal access to food, health and related basic needs. This, in turn, has major repercussions for the country's children of the poor. The reaction of the media did elicit a response to this acute episode of misgovernance, hopefully boding well at least for the plight of many other children.

Good governance is obviously a complex and multi-faceted challenge, clearly transcending a free press or any one factor. Indeed, the plight of these children at the dawn of the 21st century, not only in Argentina but elsewhere, who are denied basic needs and access to food, are forced into armies (e.g. in some countries in Africa), or trafficked as a tradable commodity (including into child prostitution, such as in some former socialist countries and others), forces us to rethink conventionally held notions about governance and development.

[2] El Pais, Madrid, November 16th, 2002.

CHALLENGING ORTHODOXY

Less than a decade ago, governance issues did not figure prominently in the agenda of international financial and development institutions. Then there was no road: the absence of institutional and governance reforms was arguably the most glaring omission of the "Washington Consensus" of the past decade on the 10 tenets of sound economic policies and management. In fact, the challenges of governance and corruption were often ignored altogether. It was frequently argued that even though there were ethical concerns, governance and corruption were not central to economic development, and thus outside the mandate of the international financial institutions (IFIs). Some analysts even argued that corruption could at times be beneficial to development—the "grease-of-the-wheels-of-commerce" argument. Yet in terms of starting to face up to the corruption challenge in the international fora, a turning point took place at the time of the International Monetary Fund (IMF)/World Bank Annual Meetings in late 1996, when the President of the World Bank placed the corruption issue center stage as a worldwide challenge for development (Wolfensohn 1996). This was followed by support from the IMF and other such institutions, complementing the work of the nongovernmental organization (NGO) in the anti-corruption arena, Transparency International (TI).

Since those meetings, supporting local initiatives in a number of countries, many IFIs and bilateral donor agencies have significantly scaled up their support of anticorruption and public-sector reform programs. There have been a number of successful initiatives in some countries, for particular institutions, and also at the subnational level, as in the case of localities in Brazil and Venezuela, or a state in India, as well as others, and a number of these initiatives have been supported by the World Bank and other development agencies. And we need to take into consideration that these efforts have taken place against the backdrop of a relatively undeveloped state of the art in the complex and multidisciplinary field of governance and anticorruption—especially compared with well-established areas such as public finance, international trade, and financial sector reforms. It is thus timely to try to distill some lessons from experience and recent research, and also—where warranted—to challenge received wisdom. The increasing availability of data on permits us to address thorny governance issues from an empirical perspective and question some orthodoxies.

In this paper we present an analysis of evidence from various sources, yet at the same time with some particular focus on the most recent survey of firms' executive (thereafter referred to as the 'Survey') carried out by the World Economic Forum for the Global Competitiveness Report. This is complemented with the worldwide aggregate governance research indicators dataset that we have constructed as part of a long term research project, as well as reviewing the results emerging from in-depth country diagnostics on governance.

In taking this empirical route, and distilling the evidence, we implicitly question received conventions, namely that: (1) corruption and misgovernance are virtually synonymous; (2) addressing them requires a similar approach across countries; (3) it is virtually impossible to define and measure key concepts in this field, and thus a "softer" qualitative approach is needed; (4) to attain concrete progress, the focus has to be on traditional public sector management and judicial/legal measures; (5) steady progress, however gradual, has been recently attained in governance worldwide; (6) reduction of administrative bribery within the public sector bureaucracy in emerging economies ought to continue being the focus for corruption control, (7) significant progress is possible taking a technocratic approach to governance and anti-corruption, abstracting from the complex political dynamics within a country, and, (8) the shaping of the investment climate is essentially in the hands of public sector officials and politicians, and the policies that matter most for the investment climate (such as tax incentives and labor regulations) are mostly outside of the core governance realm.

By putting forth alternative tenets, we challenge these views, contending that they may contain myths -- implying little support from the recent evidence -- or that they miss elements within a broader multidisciplinary and cross-sectoral framework. In this context, we make the case for addressing explicitly the links between corporate behavior and public governance, and present empirical evidence on cross-thematic links between capture, corruption, finance, political funding, transparency, and citizen voice. By so doing, we move beyond the confines of narrow notions of governance, *inter alia* making the case that the links with elite corporate strategies and political forces are key. This analytical strategy has practical implications, since the emerging evidence does suggest that we may be at a crossroads in governance worldwide, with scant evidence of significant progress at the country level in many settings (although there are successful initiatives and projects), while the commitment of the international community to address this challenge forcefully is on balance lukewarm.

Indeed, which path the international community and emerging countries embark on in the coming years on governance may prove critical for success or failure in providing for an appropriate climate for renewed investment and private-sector growth in emerging markets, for poverty alleviation and, related, with progress towards the Millennium Development Goals (MDGs). Equally important nowadays is to focus on countries in governance crisis, a good number of which the empirical evidence provided by the governance indicators does suggest that they can be considered ('quasi' or actual) failed states. The concern has ceased to be merely one of an economic nature, or one of altruism: failure to address such acute forms of misgovernance within a broad developmental framework is likely to further increase the likelihood of cross-national security threats in the future.

The analysis of the evidence also enables us to move beyond the challenge to the above listed 'orthodoxies', permitting us to put forth a set of concrete forward-looking propositions. In the coming sections of this paper we address some key tenets implied in the above orthodoxies, suggesting alternative approaches, from both an empirical and practical perspective. Thus, in subsequent sections of the paper we discuss explicit areas of operational focus in future strategies. Our aim is to provide a framework for analysis and to inform, based on recent evidence, in order to generate debate to help move ahead to the next concrete phase in addressing governance and anticorruption challenges around the globe.

GOVERNANCE AND CORRUPTION: BASIC ANALYTICS AND EMPIRICS

GOOD GOVERNANCE: BEYOND CORRUPTION CONTROL—A BROADER FRAMEWORK

Although there are crucial links between both, which necessitate further in-depth analysis, corruption and governance are distinct notions.

Corruption is commonly defined as the abuse of public office for private gain. *Governance* is defined as the exercise of authority through formal and informal traditions and institutions for the common good, thus encompassing: (1) the process of selecting, monitoring, and replacing governments; (2) the capacity to formulate and implement sound policies and deliver public services, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

For measurement and analysis, the three dimensions in this definition of governance can be further unbundled to comprise two measurable concepts per each of the dimensions above, for a total of six components: (1) *voice and external accountability* (i.e., the government's preparedness to be externally accountable through citizen feedback and democratic institutions, and a competitive press); and also (2) *political stability and lack of violence, crime, and terrorism*. Then (3) *government effectiveness* (including quality of policymaking, bureaucracy, and public service delivery); (4) *lack of regulatory burden*; and, finally, (5) *rule of law* (protection of property rights, judiciary independence, and so on); and (6) *control of corruption*. *Governance* is thus a much broader notion than *corruption*, the latter being *one* (albeit admittedly very important) among a number of closely intertwined governance components.

THE POWER OF DATA: GOVERNANCE CAN BE MEASURED, MONITORED, AND RIGOROUSLY ANALYZED.

Not everything that can be counted counts,
and not everything that counts can be counted.

-- *Einstein*

Less than a decade ago, in fact, most dimensions of governance were regarded as not measurable, and often writings were subject to long prose. At times, misplaced efforts to count concepts that in essence "do not count" do in fact take place. Consider, for instance, an attempt to measure the quality of rule of law by focusing on official statistics on the number of jailed citizens as a percentage of the population. At the top of the high end of this indicator stand together Russia and the United States, while on the very low end one finds Japan and Indonesia. Interpretation of this numerical indicator as contrasting excellent versus poor quality of rule of law is futile. Indeed, these types of ill-advised attempts to over-interpret official statistics—which in fact that can be subject to an even larger margin of error than data from surveys and expert polls—are potent illustrations of the first part of Einstein's assertion (counting what does not count); the result of a search for measures when a conceptual framework is lacking.

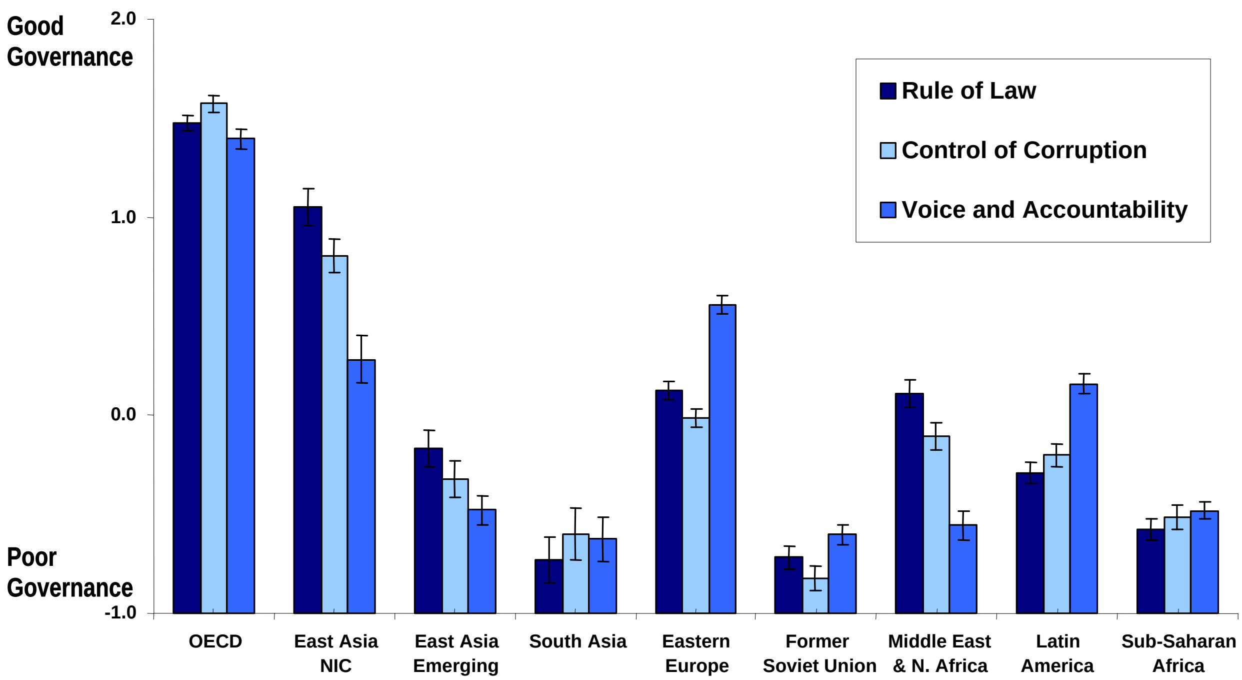
Thus, the real challenge has been to count what used to be considered uncountable, yet that does count—focusing on conceptually rigorous notions of governance. Significant advances in the analysis and measurement of governance allow in-depth and rigorous analysis and monitoring. Applying the definition of governance advanced in the previous subsection, and gathering data from many different sources (including the Executive Opinion Survey [GCR] data of various years in the past), we have analyzed hundreds of cross-country indicators as proxies for various aspects of governance.[3] Imposing structure on these many available variables from diverse sources, the data are mapped to the six subcomponents of governance listed above, are expressed in common units, its margins of errors (which are not small) are measured, and, thanks to a statistical aggregation methodology, aggregated into the six governance indicators—hereby improving the reliability of the resulting composite indicator and the analysis.

Based on the results from the updated worldwide composite measures from 2000–2001, in Figure 1 we illustrate three of the six composite governance components: control of corruption, rule of law, and voice and external accountability. The height of each column presents the average governance estimate for a given region, while the thin line atop the column depicts the margin of error—or statistical confidence interval—for the each component's estimated governance level. Since, at the country level, the margins of error generally are not small, it is misleading to have countries "run" in seemingly precise worldwide "horse race" rankings in governance. Instead, grouping countries into a limited number of broad categories (ranging from "green light"/exemplary, to "yellow/orange" vulnerable, to "red light"/governance crisis) for each governance dimension is more appropriate and statistically consistent. Thus, this broad grouping of governance indicators (and transparently presenting the margin of error for each data point) is how we organized the overall governance indicators dataset for 175 countries, available interactively at http://www.worldbank.org/wbi/governance/govdata2001.htm.[4]

[3] For methodological details on the worldwide governance indicators presented here in brief, see Kaufmann and Kraay (2002). The individual indicators used for the composites came from a variety of organizations, including commercial risk rating agencies, multilateral organizations, think tanks, and other NGOs. They are based on surveys of experts, firms, and citizens and cover a wide range of topics: perceptions of political stability and the business climate, views on the efficacy of public service provision, opinions on respect for the rule of law, and perceptions of the incidence of corruption. For a detailed explanation on sources and access to the full governance indicators databank see http://ww.worldbank.org/wbi/governance/govdata2001.htm. Note that for corruption there is also another composite indicator, Transparency International's (TI) CPI index, covering about 90 countries.

[4] A discussion on the methodological challenges in these indicators (and other such similar measures), is also in Kaufmann and Kraay's 'Governance Indicators, Aid Allocation and the Millennium Challenge Account (MCA)', which touches upon methodological points addressing some issues related to the MCA and other related aid allocation approaches (http://www.worldbank.org/wbi/governance/mca.htm)

Figure 1: Rule of law, voice, and accountability, and control of corruption—regional averages, KKZ 2000/01



Source: Worldwide Governance Research Indicators based on Kaufmann and Kraay (2002) data for 175 countries. Details at http://www.worldbank.org/wbi/governance/pubs/growthgov.htm. Units in vertical axis are expressed in terms of standard deviations around zero. Country and regional average estimates are subject to margins of error (illustrated by thin line atop each column), implying caution in interpretation of the estimates and that no precise country rating is warranted. See also regional clarifications in note 6.

Even after fully accounting for its margins of error, the worldwide and broad-based governance indicators research dataset we have developed turn out to be highly informative and yield many insights. Since our focus in this paper is to present results of one particular enterprise survey, we deal with these indicators only in brief here, as many materials, data, and articles are available separately online and discussed elsewhere. As shown in Figure 1, there is a substantial cross-regional variation in the quality rating of governance. Further, although there is a correlation within each region across the various governance components, these variables do not move fully together. Some regions do not rate very poorly in the voice/civil liberties dimension, although they face a very large challenge in rule of law and control of corruption; this is the case of Latin America for instance, and to an extent eastern Europe (although the latter has made strides over the past decade).[5] Yet there is evidence on a contrasting situation in the case of Middle East and developing East Asia (and, in relative terms, for industrialized East Asia), where the voice and external accountability dimension remains as a significant challenge.[6] In the former Soviet Union,

[5] Even comparing the governance indicators with the preceding (yet recent) measure in 1997–98, there is an improvement in most every governance dimension for eastern Europe. To generate the chart on all governance indicators, visit http://info.worldbank.org/governance/kkz/sc_country.asp, and select Eastern Europe region, and then opt for the 1997/98 year comparator.
[6] In terms of country classification in mapping onto regional averages, note that Israel (as well as Turkey) are included in the Middle East regional grouping (also including North Africa), while Japan is part of OECD (and thus

South Asia, and Africa, the challenges in all three governance components are rather substantial.

Yet these are generalizations based on regional averages, which hide significant variation in the quality of governance across countries in the same region. Indeed, a more in-depth review of the country data reveals that there are countries in Latin America, Africa, Asia, eastern Europe, and Asia that rate above some OECD countries on a number of governance dimensions, challenging the notion that being fully industrialized or wealthy is a prerequisite for good governance. Furthermore, these worldwide composite governance indicators, although covering a much larger set of countries than is available under any individual survey or poll, do not permit a detailed unbundling of particular manifestations of misgovernance. Some cross-country enterprise surveys, such as the focus below, as well as in-depth, in-country governance diagnostics through surveys of firms, users of public services, and public officials (discussed only in brief in this paper, in Box 2) do assist in complementing the broad-based comparative approach of the worldwide governance indicators depicted above.

STAGNATING GOVERNANCE AND CORRUPTION CONTROL PERFORMANCE: UNBUNDLING AND ASSESSING TRENDS BASED ON SURVEY

THE SURVEY PERMITS UNBUNDLING

Deepening the analysis with surveys such as the Executive Opinion Survey (GCR) of the World Economic Forum , which this year utilized a comprehensive and specially designed module on governance so as to probe, further complementing the aggregate indicators, is warranted. Figure 2, based on the firm responses, presents an unbundling of selected types of corruption and depicts the regional averages of the extent of bribery in connection to public utilities (as a proxy of administrative corruption), in public procurement, and in the illicit "purchase" of laws and regulations (this illicit purchase is termed *capture*).[7] It is again clear that although types of corruption are correlated with each other within a country or region, there is not necessarily one-to-one mapping: in some regions public procurement corruption is rated as the most prevalent form, while in others it is the extent of illicit purchase (or capture) of laws, policies, and regulations.

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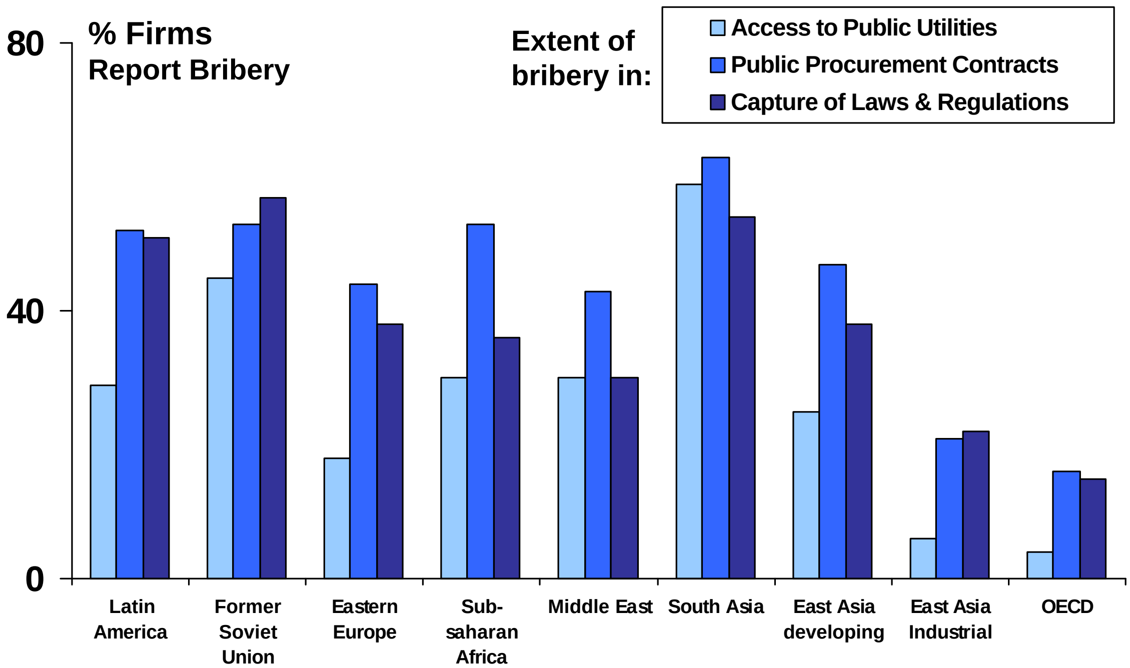
not in East Asia). Given the relatively higher ratings for Israel in all governance indicators, except for political stability/absence of violence & terror, its inclusion implies that in the other five governance indicators the average regional ratings for the Middle East are higher than would be the case if Israel were to be excluded from this region.

[7] The regional Executive Opinion Survey (GCR) results included the following country groupings: **East Asia Industrialized:** Hong Kong SAR, South Korea, Singapore, Taiwan. **East Asia Developing:** China, Indonesia, Malaysia, Philippines, Thailand, Vietnam. **Middle East and North Africa:** Israel, Jordan, Morocco, Tunisia, Turkey. **Africa:** Botswana, Mauritius, Namibia, Nigeria, South Africa, Zimbabwe. **Eastern Europe and the Baltic States:** Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia. **Former Soviet Union:** Russia, Ukraine. **South Asia:** Bangladesh, India, Sri Lanka. **Latin America and Caribbean:** Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay, Venezuela. **OECD:** Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States. Note therefore that in some regions, such as Africa and the Former Soviet Union, most countries are not covered by the Executive Opinion Survey (although the covered countries are particularly large).

Figure 2: Unbundling corruption—
Executive Opinion Survey (GCR) regional averages, 2002



% of firms rate type of corruption as high/very high

The data provided by the enterprises surveyed in this year's Survey suggest, for instance, that in Latin America the challenges of capture and corruption in public procurement and the judiciary (not shown) are particularly acute, in contrast to administrative corruption associated with connections to public utilities, export/imports or taxes. By contrast, in Africa public procurement corruption stands out relative to all other forms, while in South Asia the extent of corruption in all types, except for judiciary bribery, is reported to be very high. Even in OECD countries there are relative differences: the virtual absence of administrative types of bribery compared with the reported existence of procurement corruption and capture.

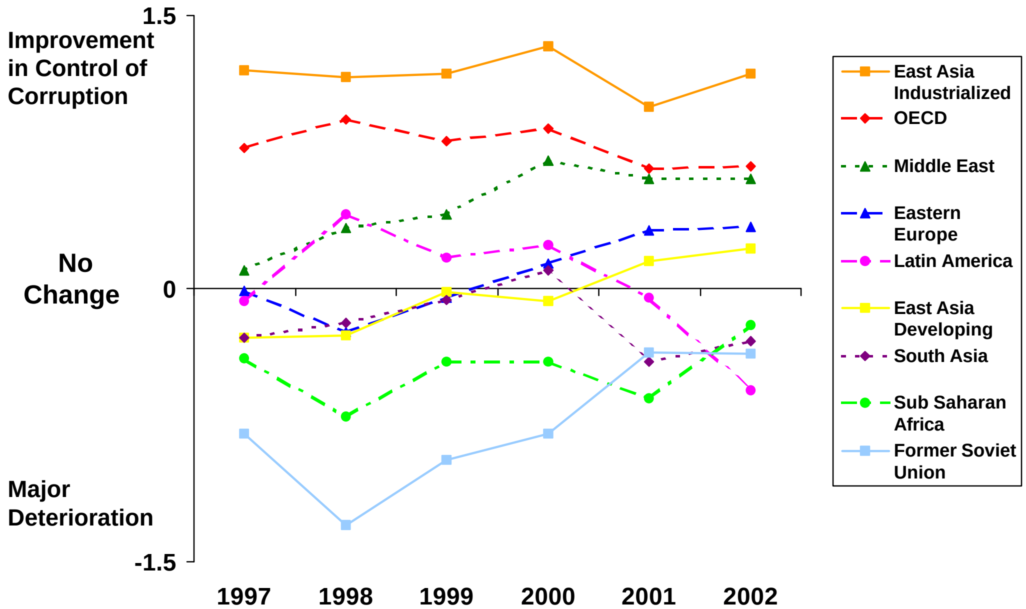
Equally telling, however, is the extent of variance *across* countries within each region. For instance, on the question measuring the extent of provision of transparent and clear information to the enterprise sector by the government, the evidence suggests that some countries in Africa—such as South Africa, Namibia, Mauritius, and Botswana—perform rather well: Botswana, in fact, is well within top quartile in the sample, and rating above 11 OECD countries. Then, more specifically on corruption, these four countries in Africa rate in the top half in most every dimension measured in corruption, and often in the top third and above some OECD countries. For instance, in terms of control of misuse of public funds, Botswana is in the top quartile, above many OECD countries in fact, while in terms of independence of the judiciary, and in control of bribery in the judiciary and for tax evasion, Botswana, Mauritius, and South Africa perform relatively well, above some countries in Europe according to the reports by the firms.

TRENDS IN GOVERNANCE OVER TIME: TIME-SERIES ANALYSIS OF THE GLOBAL COMPETITIVENESS REPORT *(GCR) EXECUTIVE OPINION SURVEYS*

Reviewing trends in recent times can be done thanks to the common questions that have been asked in Surveys for a number of years. A troubling finding from the comparison over the past five to six years is that overall there has been stagnation—or, in some cases, even deterioration—in key dimensions of governance, in apparent contrast with other important areas, where overall an improvement over time is detected. Based on the various Surveys over the period 1997–2002, we see this stagnation in governance in Figures 3a–3f, which depict the trends in six different dimensions—four in governance, and two in other areas. The first four panels (Figures 3a, 3b, 3c, and 3d) depict respectively the firms' reports on corruption trends over the previous three years, the extent of independence in the judiciary, the effectiveness of anti-monopoly policy, and the reported costs to business from organized crime. In none of these governance dimensions has there been an improvement over time on average. This is also the case regarding the extent of corruption in the judiciary (not shown). In fact, there even appears to be deterioration in some governance dimensions, such as judiciary independence, as seen in Figure 3b. Some important differences in regional trends from region to region are also evident: for the Survey country sample in South Asia, Latin America, Africa, and the Former Soviet Union, enterprises report a deteriorating trend in corruption on average, in contrast with the other regions.

These disappointing trends on governance contrast with the improvements in other dimensions outside core governance, such as in the overall quality of infrastructure, and in the effective absorption of new technologies (shown in the last panels, 3e and 3f, respectively), as well as in the quality of math and science education, and in the soundness of the banking—where overall there is also an improvement (not shown in Figure 3). While the focus here is in reviewing the evidence based on one particular survey, given that such approach is bound to be associated with a non-insignificant margin of error, we also reviewed all other evidence from various surveys and expert polls. Such review does suggest that on balance there is no evidence of a significant improvement in governance or control of corruption worldwide, and for the emerging regions in particular. Again, this contrasts with reviewing other variables on macro-economic performance, for instance – average inflation rates as well as budget deficits have come down over the past 15 years or so.

Figure 3: Trends in selected governance and other variables, GCR yearly Survey, various years
Figure 3a: Trend in corruption as reported by firms



Note: Scale in this trend variable is also -4 to 4; where 0 is neutral/no change, lower than 0 signifies a deterioration and higher than 0 an improvement in the control of corruption.

Figure 3b: Extent of independence of the judiciary

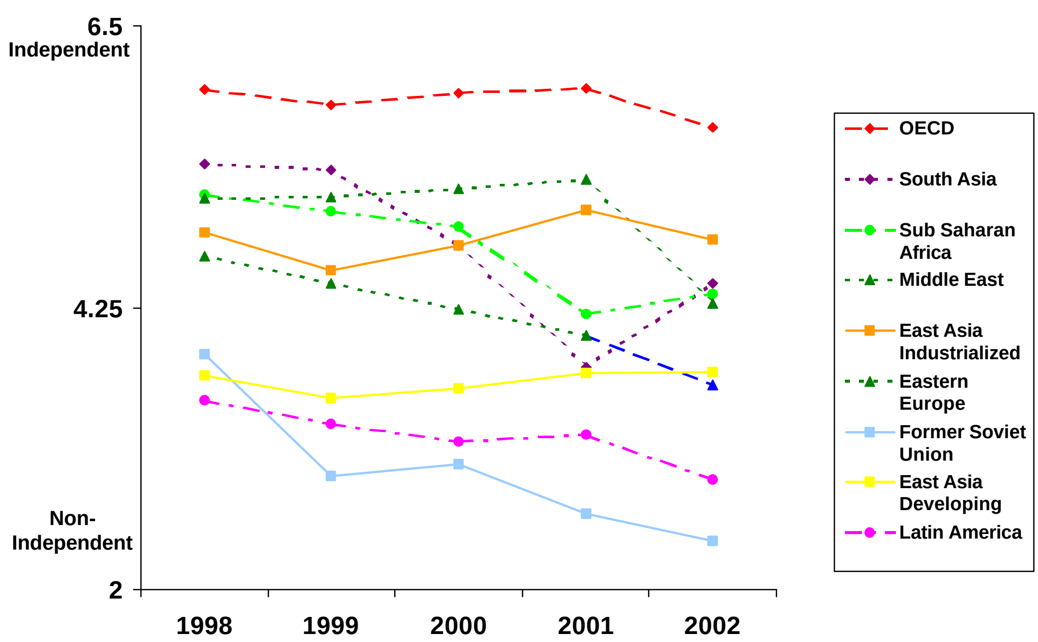


Figure 3: Trends in selected governance and other variables, GCR yearly Survey, various years

Figure 3c: Effectiveness of anti-monopoly policy

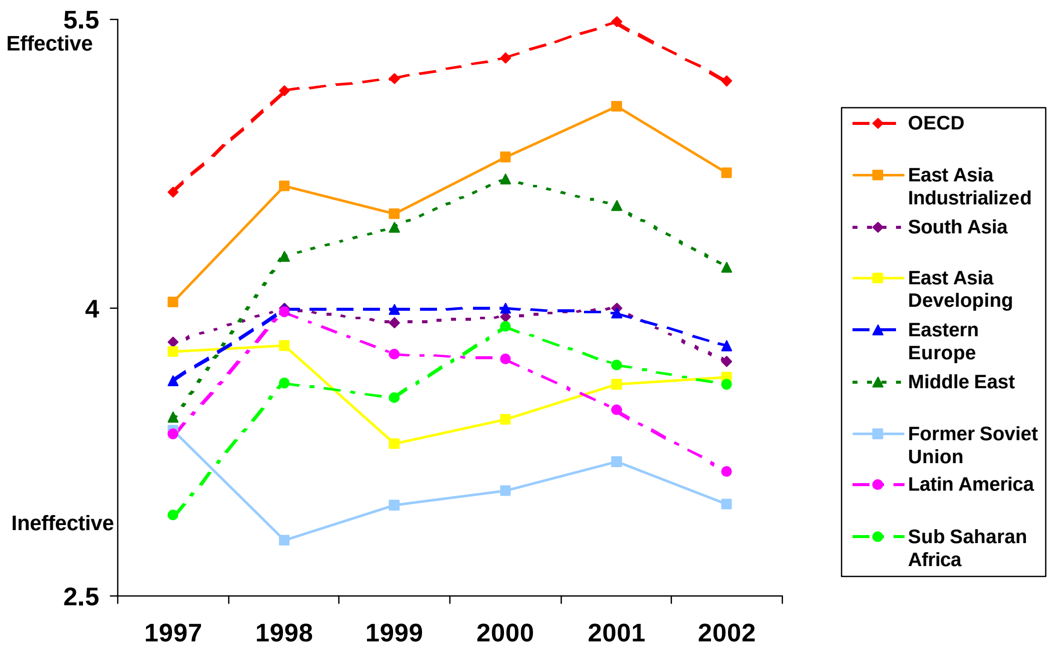


Figure 3d: Extent of control of organized crime

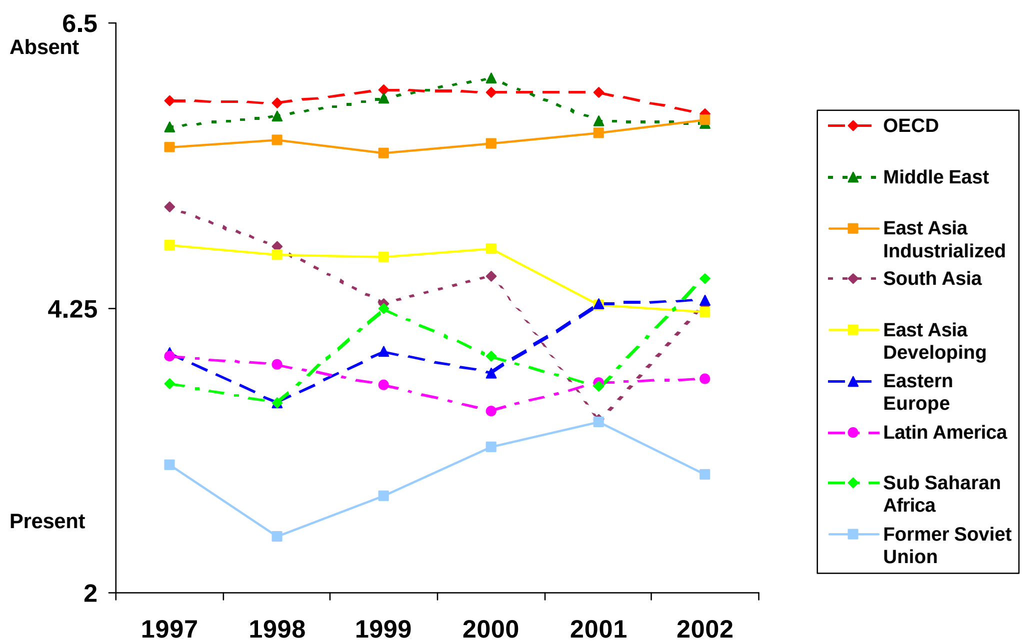


Figure 3: Trends in selected governance and other variables, GCR yearly Survey, various years

Figure 3e: Quality of infrastructure

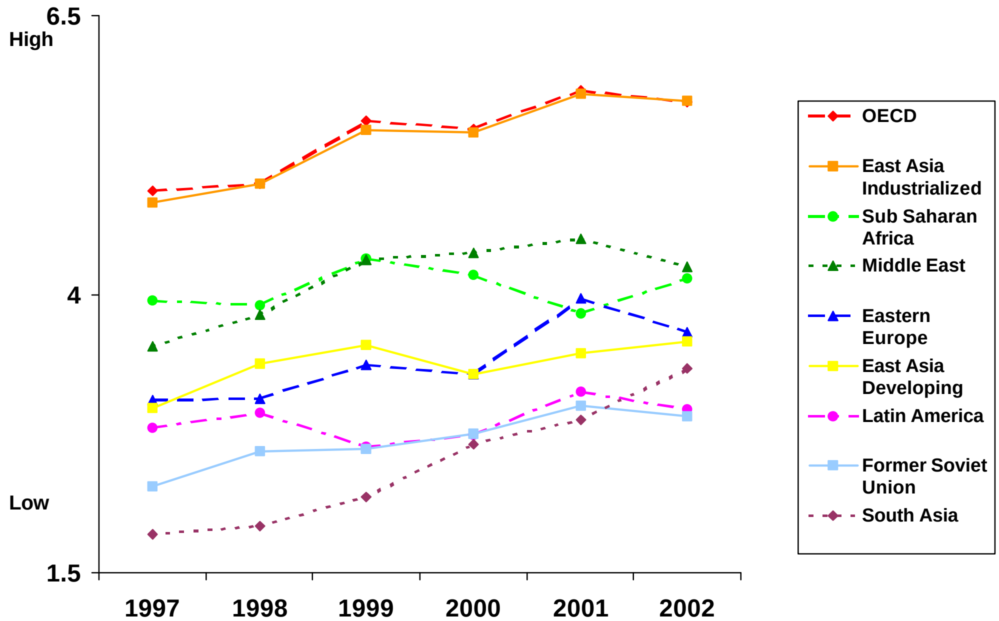
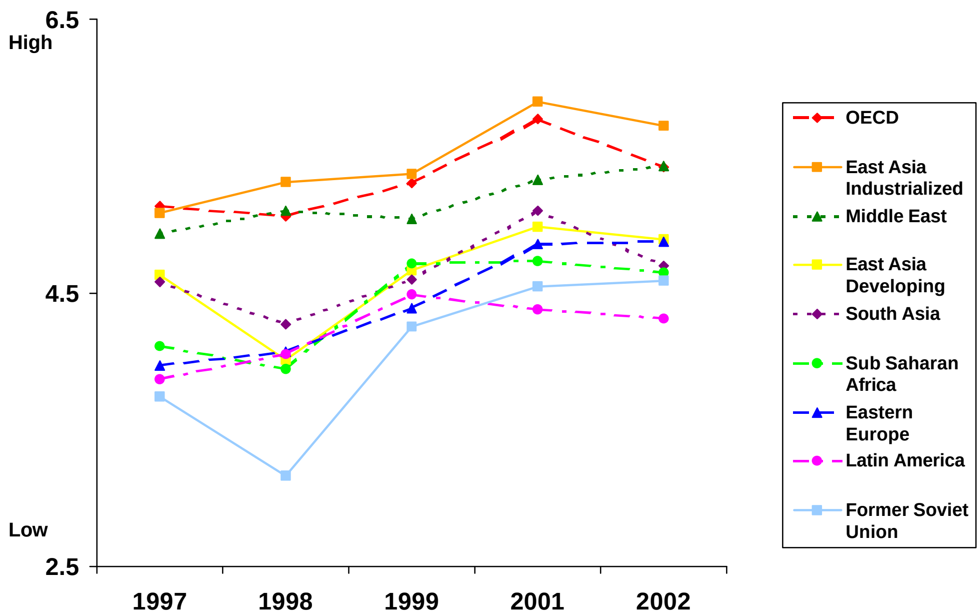


Figure 3f: Effective absorption of new technologies



Note: No data exist for 2000.

In terms of the corruption trend performance *within* regions, there are salient differences again. For instance, in Africa, Mauritius and Botswana exhibit a clearly improving trend in reported control of corruption, in sharp contrast to countries such as Zimbabwe and Nigeria, and also with countries such as Venezuela, Guatemala, Paraguay, Ukraine, Romania, Indonesia, Bangladesh, and Germany in other regions. In each region there are cases of improving as well as clearly deteriorating governance dimensions, pointing to the limits of inferences that can be made based on regional averages alone.

Probing further on the within-regional variance by focusing on a region currently facing enormous socioeconomic and financial challenges—Latin America—provides insights. On average, the firms in the region report a deterioration in corruption control, as seen in Figure 3a. This reported deterioration set in a couple of years ago, following a few years where, on balance, there appeared to be some incipient improvement in the trend. Yet again, these regional averages mask important variation. For instance, Chile in many governance dimensions rates in the top quartile of the Survey country sample, even rating above some OECD countries. Until the year 2000, Chilean entrepreneurs had been reporting an improvement in control of corruption for some years. Yet over the past two years this trend appears to have been reversed, with the majority of respondents reporting a deterioration, even though the *level* of probity in general is still rather high (see Annex 1 on Chile). Brazil, on the other hand, from a lower initial starting point in control of corruption over the past two years has continued to exhibit an improved trend. Countries such as Venezuela and Paraguay exhibit both significantly deteriorating trends in corruption as well as very low current levels of probity, as reported by the firms, while Costa Rica shows relatively high levels of probity, as well as relatively neutral trends over the past few years.

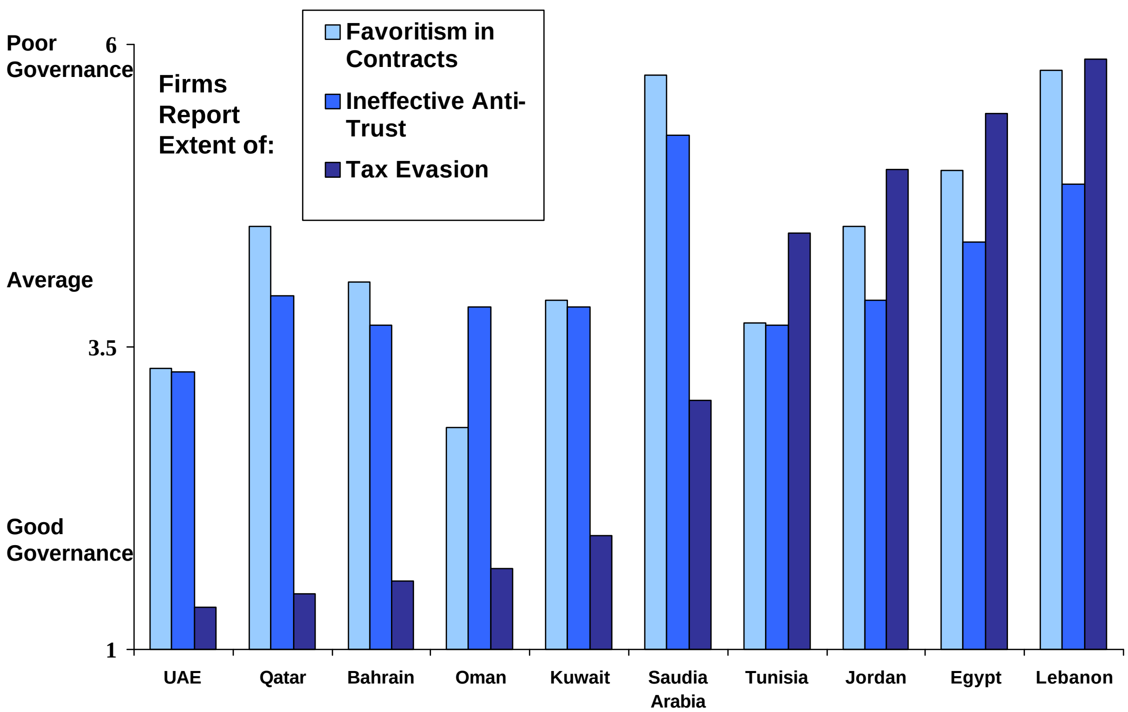
Latin America is not unique in exhibiting significant cross-country variation within a region—that is the case in virtually every region. Furthermore, as we have seen, each country has relative strengths and weaknesses. The variation within a region is also illustrated in the case of the Middle East. This year's Executive Opinion Survey (GCR) included relatively few countries from that region.[8] Yet a few months earlier an enterprise survey dedicated to 10 countries in the Middle East had been carried out by the World Economic Forum, permitting an analysis with a larger country. Selected results on governance-related variables are summarized in Box 1.

[8] And, in the case of Egypt, which was not part of the covered country sample for this year's Survey implementation, the data were not available to the World Economic Forum.

BOX 1: VARIANCE ACROSS COUNTRIES WITHIN A REGION—AND ACROSS GOVERNANCE DIMENSIONS WITHIN A COUNTRY: RESULTS FROM A SURVEY OF 10 ARAB WORLD COUNTRIES

The competitiveness Survey for countries in the Arab World was carried out in late 2001/early 2002, as an input to the *Arab World Competitiveness Report 2002–2003*, for which additional countries are also to be analyzed. The cross-country variance within the region, as well as the within-country variation across different governance dimensions, is illustrated in Box 1 Figures A and B for selected dimensions of governance. In some Gulf countries, such as Oman, there is low reported awarding of public contracts according to favoritism and influential contacts, for instance, in contrast with a number of other countries in the Middle East (see Box 1 Figure A). There is also significant variation in tax evasion, which is related to the tax regime burden. With few exceptions, however, in relative terms there appears to be a common challenge across the surveyed countries in enhancing the effectiveness of anti-monopoly policies (Box 1 Figure A). From an analysis of the worldwide governance indicators database discussed early in this chapter, also worthy of note is the extent of intraregional variation across countries in a dimension where, on average, the region rates low—namely "voice and external accountability." This suggests the importance of focusing on the country specifics and not relying unduly on country averages.

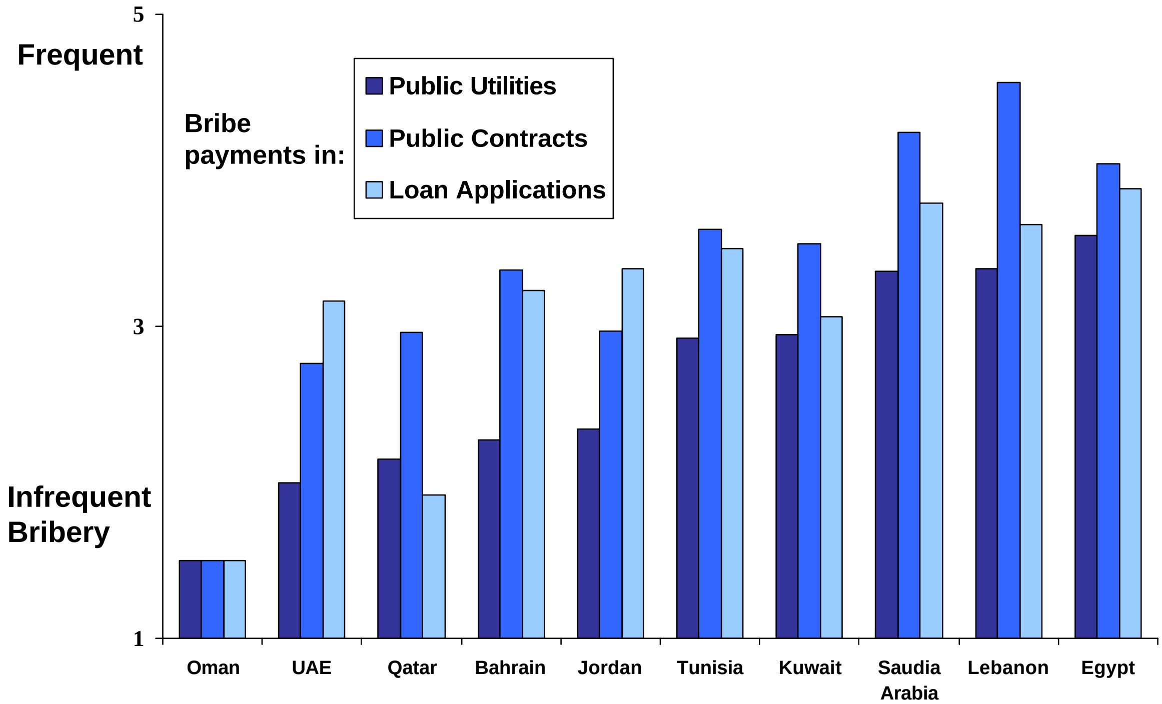
Box 1 Figure A: Governance as reported by firms, selected variables (Arab World Competitiveness Report 2001–2002, 10 countries)



(continued)

There are also significant differences across countries in the frequency of illegal payments, as illustrated in Box 1 Figure B, based on the reports by the firms, respectively, for the cases of bribery to attain public utilities connections, for public procurement contracts, and for obtaining banking loans.

Box 1 Figure B: Frequency of bribery as reported by firms (Arab World Competitiveness Report 2001–2002, 10 countries)



DOES GOVERNANCE ACTUALLY MATTER?

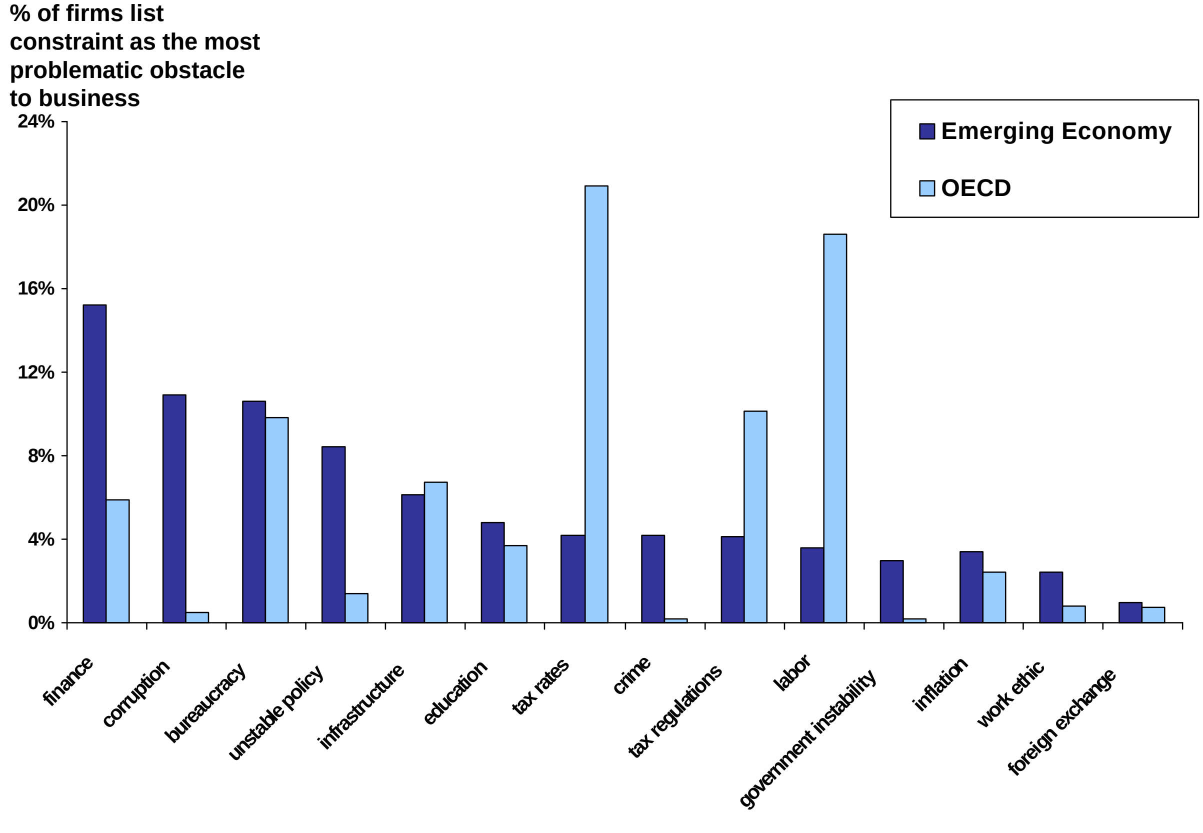
Through the data emerging from worldwide governance indicators, and from enterprise surveys, systematic assessments of the benefits of good governance worldwide have been performed by a number of researchers. Recent empirical studies confirm the importance of institutions and governance for development outcomes. One study (Knack and Keefer 1997) performed cross-national tests of institutions using various indicators of institutional quality; they found that the institutional environment for economic activity determines, in large part, the ability of emerging economies to catch up to industrialized country standards. Further work has been carried out by La Porta et al. (1999); Acemoglu, Johnson, and Robinson (2001); Engelman and Sokoloff (2002); Mauro (1995) Easterly and Levine (2002); and Rodrik et al. (2002); among others, showing the importance of governance for growth and development.

The set of six worldwide governance research indicators that we have developed over the past few years allows systematic assessment of the benefits of good governance in a large sample of countries. At the most basic level, the data at first reveal a very high correlation between good governance and key development outcomes across countries. Yet this is a "weak" finding in terms of policy application, since such correlations do not shed light on the direction of causality or on whether an omitted ("third") correlated variable is the fundamental cause accounting for the effects on developmental outcomes (see Annex 2 for details).

In recent research we find, in fact, little evidence of a significant positive effect going from higher incomes to better governance, challenging the notion of governance simply being a luxury good (Kaufmann and Kraay 2002). By contrast, focusing on the rule of law variables, the analysis suggests a *large direct causal effect* from better governance to better development outcomes (see Annex 2). Indeed, *an improvement in the rule of law (or, say, control of corruption) from relatively poor to merely average performance would result in the long run in an estimated fourfold increase in per capita incomes, a reduction in infant mortality of a similar magnitude, and significant gains in literacy*. And since at the same time we find no support for income growth guaranteeing improved governance, we thus challenge the notion that governance is a "luxury good" that automatically accrues with wealth accumulation—an assertion often used as a justification for complacency or to explain away misgovernance in a country. Instead, concerted efforts to improve governance and address corruption are required even during periods of robust growth (Annex 2).

A number of studies at the firm level also point to the paramount importance of governance variables for growth in private-sector development. In-depth research of this type with the new Survey data set is in the agenda for the future, yet an initial exploration of the evidence suggests support for this link as well. At a very basic level, it is illustrative to perform a simple analysis of the last question of the Executive Opinion Survey (GCR) instrument, which—instead of asking for a severity rating in the firm response—requested from the firms a list of the top constraints to business development faced by them. Firms were asked to list a maximum of five key constraints in descending order of importance, from a list of fourteen options, thereby prodding the enterprises to choose among the most important obstacles for their development.

Figure 4: Most problematic constraint to business in your country (Executive Opinion Survey [GCR] 2002)



As depicted in Figure 4, showing the responses in terms of the most constraining obstacle, in emerging economies after the common concern (in every type of enterprise survey) about finance, the enterprise sector faces on balance its most severe constraint from corruption and an ineffective government bureaucracy. Again, there are important regional differences, however (not depicted): in South Asia, for instance, infrastructure constraints are listed as an even higher priority than control of corruption, while infrastructure is less of a constraint in other regions. Within OECD countries there is less variation, and there is a more dichotomous choice of what constitutes an obstacle (relative to the other obstacles): tax rates, labor and tax regulations, and the government bureaucracy.

VOICE, OVERSIGHT AND TRANSPARENCY ARE KEY—AND NOT ONLY IN THE PUBLIC SECTOR

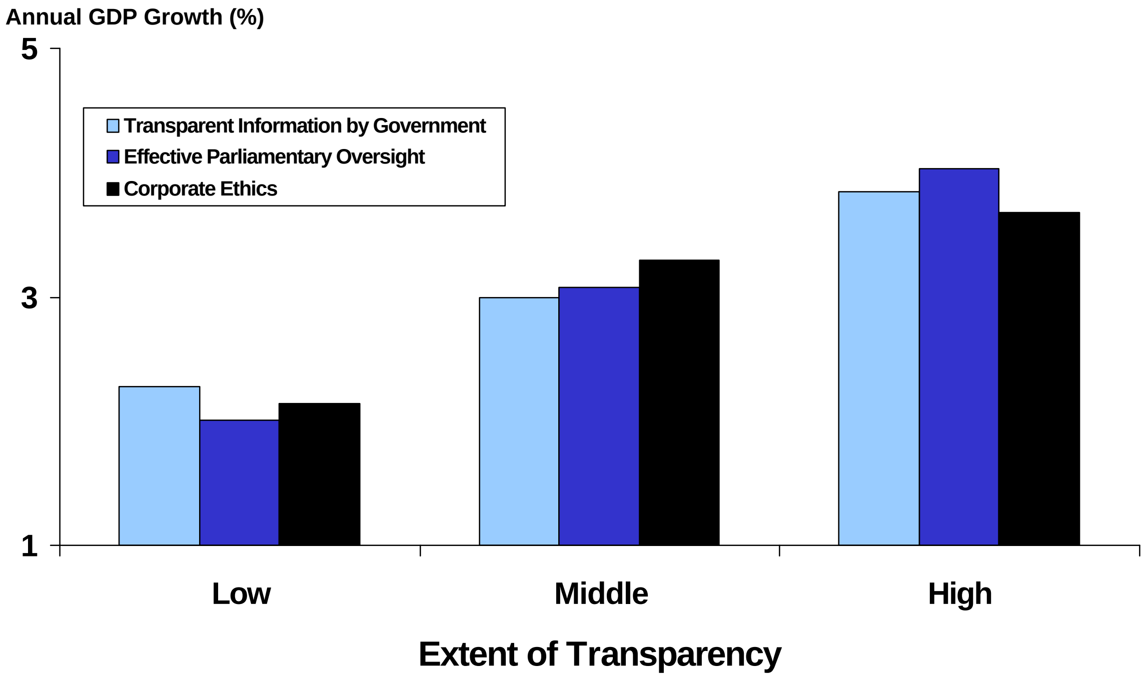
TRANSPARENCY MATTERS, AND OUTSIDE OF THE PUBLIC SECTOR AS WELL

Governance within the public sector matters significantly, and within it, in many complex ways not merely viewed from the point of view of the extent of corruption, but also from the point of view of broader dimensions of governance such as transparency. Transparency challenges, however, afflict both the public and private sectors. Often the inclination has been to place the full onus of the governance challenge on the public sector, and the approaches to data collection and analysis tended to magnify such bias at times. Thus, it is important to recognize explicitly that many measures of misgovernance, such as bribery, tend to involve agents on both the public and private sector (in some cases, such as bribery for bank loans, it may in fact be a transaction between two private-sector agents). Further, probing the uniqueness of each setting and type of misgovernance is warranted in order to determine whether it is the public-sector official (or politician) who holds most of the power in the transaction (hence the transaction is akin to extortion) or the private-sector agent (in this case, the transaction is closer to "capture," as described in more detail below). And, finally, it is timely to go beyond traditional measures of bribery in the public sector, also measuring the firm's own assessment of the corporate ethics within their industry. This has in fact been done in this year's Survey, via a dedicated question on corporate ethics.

Not surprisingly, the average country ratings based on the enterprise responses to the Survey vary significantly from country to country, and are very highly correlated with measures of public-sector governance and corruption. Clearly, the challenge of corporate ethics cannot be divorced from public-sector governance. The link is either through perverse, and often illicit, forms of influence on public policy or law-making by private interests (such as capture) or, conversely, through legal and competitive forms of influence (such as lobbies).

The importance of institutions outside of government for good national governance is also exemplified by the key legal institution, the parliament, not only because of their law-making role but also because of their oversight duties over the executive. In this year's Survey, firms have also provided an assessment of the parliament in their country. Furthermore, they have also given an assessment of the extent of a transparent and effective information flow from government related to the policies affecting them, another important mechanism of accountability. As depicted in Figure 5, in those settings with high levels of transparency, effective parliamentary oversight, and high standards of corporate ethics, there was a higher rate of GDP growth over the previous three years than in countries with lower standards of transparency, of parliamentary oversight, and corporate ethics.

Figure 5: Transparency and GDP growth



Sources: Annual GDP growth for 1999–2001 is taken from WDI 2002; GDP is computed in PPP terms. The various transparency and governance variables are drawn from the Executive Opinion Survey (GCR) 2002.

Transparency is nonetheless an area where public policy has a key responsibility as well—alongside the role of the private sector. In fact transparency and governance, while distinct concepts, are linked. It is apt in this context to define the often-vague notion of transparency, which refers to the key characteristics of an effective flow of information—namely access; timeliness; relevance; and quality of economic, social, and political information—accessible to all relevant stakeholders. It is thus about private investors' use of loans and the creditworthiness of borrowers; about properly audited accounts of key governmental, private, and multinational institutions; about the budgetary process and data from the government; about monetary and real economy statistics from the central bank and government service provision; about political and campaign finance disclosure and the voting records of parliamentarians; and about the effective oversight role of parliament, the media, and the citizenry in the public budgetary accounts—as well as about the activities of international institutions and foreign investors. Conversely, a lack of transparency occurs when an agent—whether a government minister, a public institution, a corporation, or a bank—deliberately withholds access to or misrepresents information or fails to ensure that the information provided is timely, relevant, or of adequate quality.

Hence, *access* (including timeliness and nondiscrimination), *comprehensiveness* (ensuring inclusion of key items, such as off-line financial and budgetary items), *relevance* (avoiding superfluous information overload)*,quality*, and *reliability* are key attributes, which together help policymaking and provide market confidence to investors. Yet markets on their own rarely induce socially desirable levels of transparency, partly because there can be payoffs from non-disclosure. Further, some key information related to transparency—such as economy-wide economic and financial statistics—can emanate only from government institutions. Thus, the government has a role in promoting a transparent flow of relevant information from its institutions, and, as suggested by the results illustrated in Figure 5, the transparency and effectiveness of such information flows do matter.

Similarly—and potently illustrated by the recent corporate scandals afflicting a few large conglomerates in the United States—in the context of measures enhancing corporate ethics and transparency, it is important to address in depth the challenges of corporate governance and corporate responsibility in general, and the problems of effective audit and accounting in particular. A new variable measuring the effectiveness of audit and accounting standards was thus also included in this year's Survey, alongside questions on corporate governance, permitting further research on these issues (see discussion below). The data suggest a relatively high correlation between the country's audit standard effectiveness and economic performance as well (not shown in Figure 5). In a broader context of transparency, the evidence also suggests that in many countries in the OECD (including the United States) and elsewhere face a challenge in how political financing by enterprises directly affects policy outcomes, a topic deserving separate in-depth analysis in the near future.

BEYOND BUREAUCRATIC CORRUPTION: CONFRONTING THE CHALLENGE OF STATE CAPTURE

In the anti-corruption arena, the focus on "pettier" forms of administrative bribery is giving way to the need to address explicitly the enormously costly challenges of "grander" forms of corruption, such as the tendency by some elite firms and conglomerates to shape illicitly the formation of the state laws, policies, and regulations, which we refer to as *state capture*.[9] Until recently, however, these more political and "grander" forms of corruption were not regarded as subject to measurement. We have challenged this tenet through recent surveys, which led to empirical research pointing to the extent of state capture by some elite firms (including some with foreign interests) in selected countries in transition and in Latin America, and to their substantial socioeconomic costs and consequences. For the first time, this year's Survey also included measures of state capture, which was illustrated in the unbundling of various types of corruption in Figure 2. From the evidence in this Survey which covers all regions, it is clear that there are many countries in most parts of the world where the challenge of state capture is present -- while other countries where is less so. Such variance suggests the need to probe further into the determinants and consequences of state capture in the next stage of research, based on this dataset for 80 countries.

The prevalence of state capture by powerful conglomerates (including some transnationals) brings out four corollaries challenging orthodox views about how we have tended to view governance and investment climate. First, the extent of capture by private agents backstops the importance of rethinking the traditional approach to assessing the business environment and investment climate. Such approach has been predicated on the notion that the government provides such a "climate" to the passive enterprise sector. The public sector has been thought of as the business climate "maker," while the private sector is the climate "taker." The reality turns out to be more complex, with powerful elites and conglomerates (including some multinationals) playing an important role in shaping the rules of the game for the business environment. Second, the existence of state capture constitutes an extreme manifestation (yet a realistic one in many settings) of the importance of understanding the private-public sector governance nexus, and as a result requires rethinking the traditional advice of controlling corruption as if it was solely a problem within the bureaucracy.

[9] See Hellman, Jones, and Kaufmann, http://www.worldbank.org/wbi/governance/pubs/seizestate.htm.

Third, in terms of focusing on the causes of misgovernance, state capture implies that corruption is not always merely a symptom of more fundamental factors; instead, the very political and economic forces associated with capture play a pivotal role in shaping policies and political economy outcomes. Fourth, the prevalence of state capture in many settings implies that further emphasis will be needed to understand and empirically assess the key institution of "influence," which exists everywhere and challenges the simplistic interpretation of Adam Smith's invisible hand (in fact, while it is largely unrecognized, he did understand rather well the key role that influence and monopolistic tendencies by some enterprises do play in the market economy).

IMPLICATIONS OF THE PRIVATE-PUBLIC GOVERNANCE NEXUS

Indeed, where capture is prevalent, we need to rethink the strategies to address misgovernance. Instead of focusing on changes in the internal bureaucratic structures and on organizational rules and regulations, the implication of this work points again to the need to focus on broader external accountability measures, prominently featuring voice and transparency mechanisms—including disclosure of parliamentary votes, asset declaration, transparent surveys, and higher standards for the media (including investigative journalism and media independence). Furthermore, it is important to have an improved understanding of the institution of 'influence': the political and economic incentives shaping the legal, regulatory, and policymaking process. Bureaucracies, senior public officials, and the political leadership do not operate in a vacuum but rather are influenced by diverse forces outside of the public sector. And more focus is required in working with the competitive segments of the private sector (business associations for traders/exporters or medium-sized enterprises, for instance).

The need to focus increasingly on these issues is partly due to the growing evidence that outright transplants of OECD "templates" of *internal* accountability of government to emerging economies has not met with the best results. Similarly, creating new public agencies to address governance challenges (such as new anti-corruption agencies or commissions) have often failed. Thus, the challenge is to encourage the pendulum to shift toward *external* accountability mechanisms, with new participatory approaches, providing voice and feedback mechanisms to stakeholders outside the executive—complementing the key priority areas of institutional strengthening within government (see also Box 2 below).

Evidence from governance country diagnostics points to how important the feedback mechanisms from public-service users are, alongside transparency tools, in contrast with traditional internal rule-making measures (see Box 2). In this context, focusing more on parliamentary, NGO, and citizen oversight is crucial, as is the transparent use of new tools such as citizen scorecards; diagnostics based on survey reports from public officials, public-service users, and firms; and tools to track public expenditures in detail. In a number of settings, such as in Latin America, these have been backstopped by innovative web-based applications—as in procurement, tax collection, and the budget, as well as in disseminating comparative data on governance indicators. A full-fledged embracing of the role of the youth (and leaders of the future) in these collective-action approaches is also needed. Finally, where it has not been captured by the monopolistic state's or elite's vested interests, the media can play a key role in pro-transparency governance reforms.

BOX 2: COUNTRY GOVERNANCE DIAGNOSTICS FOR TRANSPARENCY AND ACTION PROGRAMS

The collection, analysis, and dissemination of multi-country data on governance and corruption—as well as the in-depth, in-country Governance and Anti-Corruption (GAC) diagnostics supported in many countries by the World Bank (in partnership with bilateral agencies and NGOs)—are altering the policy dialogue on governance and corruption and empowering reformists in government and civil society as well as the competitive segments of the private sector through collective action. These in-depth self-diagnostic tools are tailored to the needs of each country that opts to subject itself to such transparent governance review, and implemented by local institutions. The first set of in-depth governance and corruption diagnostic surveys of public officials, firms, and citizens at the country level were carried out in Eastern Europe. More recently such surveys have been conducted in countries in the other emerging regions. The analysis of the links between various institutional variables has significantly expanded the understanding of corruption and its causes, particularly its governance and political roots.

These country surveys ask *citizens* (service-delivery users), *enterprises*, and *public officials* detailed questions about types, manifestations, extent, costs, and private returns of misgovernance and corruption. Survey respondents report on budget transparency and embezzlement of public funds; theft of state property; bribery to shorten processing time; bribery in procurement, banking, and state capture, as well as many other dimensions of governance such as the functioning of merit-based systems in the public sector and the access and quality to public services by the enterprise sector and citizenry. Detailed statistics collected on the access and quality of public services and on the various dimensions of governance and corruption, can be used to prioritize reforms in the country.* The reform priorities that are identified by utilizing such diagnostic inputs tend to vary significantly from country to country, reinforcing the importance of localized knowledge. Increasing focus on external accountability factors in these in-depth diagnostic surveys covering multiple institutions within a country permit exploration of the relative importance of many different factors for improving governance within a country—such as transparency, feedback mechanisms, and incentive reforms to enhance prevention. (see Kaufmann, Mehrez, and Gurgur 2002).

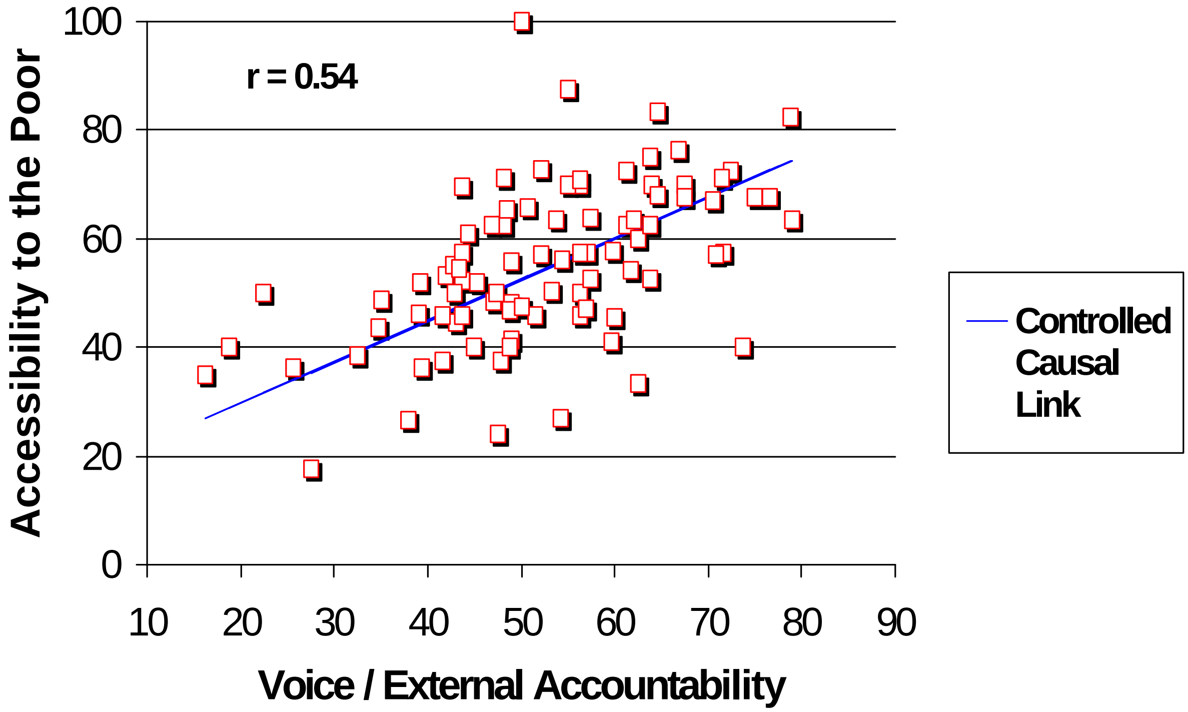
Indeed, a number of such country diagnostics show the importance of voice, external accountability, and feedback mechanisms given to the citizenry in providing oversight of the public institutions, as illustrated in Box 2 Figure A, which is based on an in-depth survey of public officials in Bolivia. Similar results were found, in fact, in terms of the importance of transparency mechanisms and in the depoliticization of agencies as a determinant of good governance performance for their public institutions, in contrast with enacting rules, autonomy by fiat, or, often, mere focus on salary levels alone.**

* When empirical results from surveys such as the Survey or GAC diagnostics are presented in workshops to policymakers, members of the business community, and civil society, the debate changes from vague or personalized accusations to one focused on empirical evidence and systemic weaknesses.

** For details on these Governance diagnostic instruments, visit http://www.worldbank.org/wbi/governance/tools.htm

(continued)

Box 2 Figure A: External accountability/feedback improve access of the poor to public services (Bolivia GAC diagnostic)



Source: Based on Kaufmann, Mehrez and Gurgur (2002). The sample of institutions includes 44 national, departmental, and municipal agencies that provide services to the poor. Each point depicts an institution.

THE CHALLENGE TO TRADITIONAL LEGAL AND JUDICIARY REFORMS

In the context of moving beyond the traditional approach to public-sector and bureaucratic corruption, it will also be important to rethink orthodoxy on legal and judiciary reforms. Although donor programs supporting the traditional and largely unsuccessful legal and judiciary technical assistance projects of the past is yet to be fully abandoned, a salutary move away from narrow support for hardware, study tours, traditional training, focus on marginal improvement in narrow organizational issues such as caseload management, and the like is beginning to take place—even if slowly. In the next phase it will be important to face up to the enormous difference in the nature, performance, and vulnerability of legal and judiciary institutions across emerging countries. These vast differences have major strategic and practical implications.

Consider two countries at similar stages of development, rating similarly in governance on the aggregate: in one country the parliament may be relatively effective compared with other institutions, and the judiciary may be corrupt; in the second country it may be the reverse. The main reason for dysfunction may also vary: in one country, dysfunction can be the result of capture from private elite economic forces; in another, the culprit would be the absence of political independence from the executive. Depending on the diagnosis of the country specifics, traditional legal or judiciary reform programs may not work. Funding traditional judiciary projects that provide training, hardware, organizational advice, convenes an international conference, and provides technical assistance for superficial issues such as caseload management within the existing structure, is likely to backfire by entrenching the existing misgoverned regime and vested interests (or related corrupt networks) in cases where judges are appointed on basis removed from merit-based considerations and/or subject to economic capture.

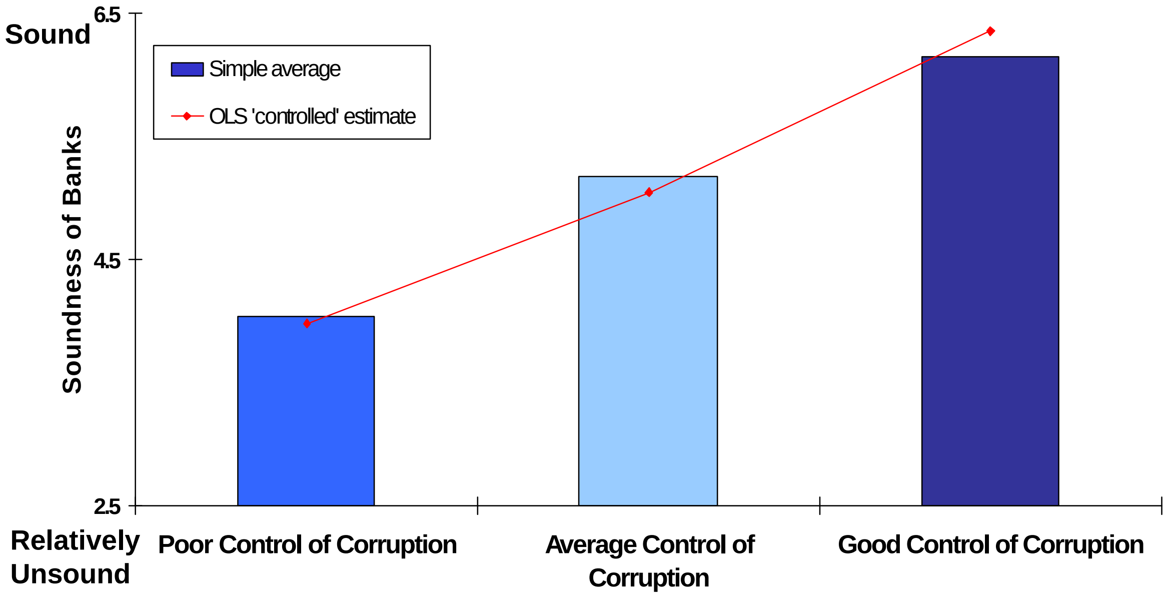
Starkly, in a number of countries, a poorly performing judicial and/or legal institution is likely to be misgoverned in ways that would also often include the purchase of the appointed positions (in either the legislative or judiciary). Those payoffs can subsequently be reflected in the "privatization" of law-making and judiciary ruling. Where that prevails, the legal and judiciary institutions become a large part of the broader governance problem rather than a potential entry point for its solution, at least in the near term. Thus, bolder approaches to find venues for concrete progress will be required—including the choice of reform entry points in institutions outside of the judiciary or legal arena. This could include budgetary institutions, regulation within the administration (in some settings), competitive enterprise and financial sector (including capital market) development, international courts, and specialized NGOs. These may be expected to apply pressure for a revamp of dysfunctional legal or judiciary institutions. Similarly, adaptation to the reality of emerging countries of Alternative Dispute Resolution (ADR) mechanisms is worth much further consideration. Importantly in this context, as well as more broadly as a key incentive for improved governance and rule of law institutional framework, is also the effective pro-governance use of EU accession framework to potential expansion candidates, as well as other such cross-national or regional cooperation membership criteria (WTO, NAFTA, etc.).

GOVERNANCE IN FINANCE MATTERS FOR PUBLIC GOVERNANCE, AND VICE VERSA

The recognition that misgovernance and corruption were major challenges for the financial sector came belatedly, in the aftermath of the financial crises, in Asia, Russia, and Latin America. From the research in transition settings discussed above, we learn that the financial sector has in fact also been significantly engaged in state capture, with dire consequences for overall national governance. Conversely, where there is poor public governance, the soundness of the financial sector is impaired. Based on the evidence of this year's Survey as well as the worldwide governance indicators, we explored the relationship between different forms of public misgovernance, on the one hand, and the health of the financial sector, on the other. Figure 6 shows the clear link between the extent of nationwide corruption and the soundness of the banking system. A very significant link applies even after controlling for other factors. Further, the evidence suggests that certain forms of high-level corruption, such as state capture, may have an additional adverse effect on the health of the financial sector. Thus, the involvement of the key financial institutions in a country (with the leadership of the country's central bank and largest commercial banks) in overall governance improvement and anticorruption programs is an imperative in countries that are vulnerable in this context.

The importance of probing into misgovernance in finance within a broader framework (than would be appropriate if focusing narrowly within the finance sector) is illustrated by the challenge of money laundering, which has tended to be viewed in rather narrow terms. Indeed, over the past year there has been increasing focus on the problem of money laundering, yet the focus has been on laundering through the banking sector and on specific guidelines and regulations within that sector.

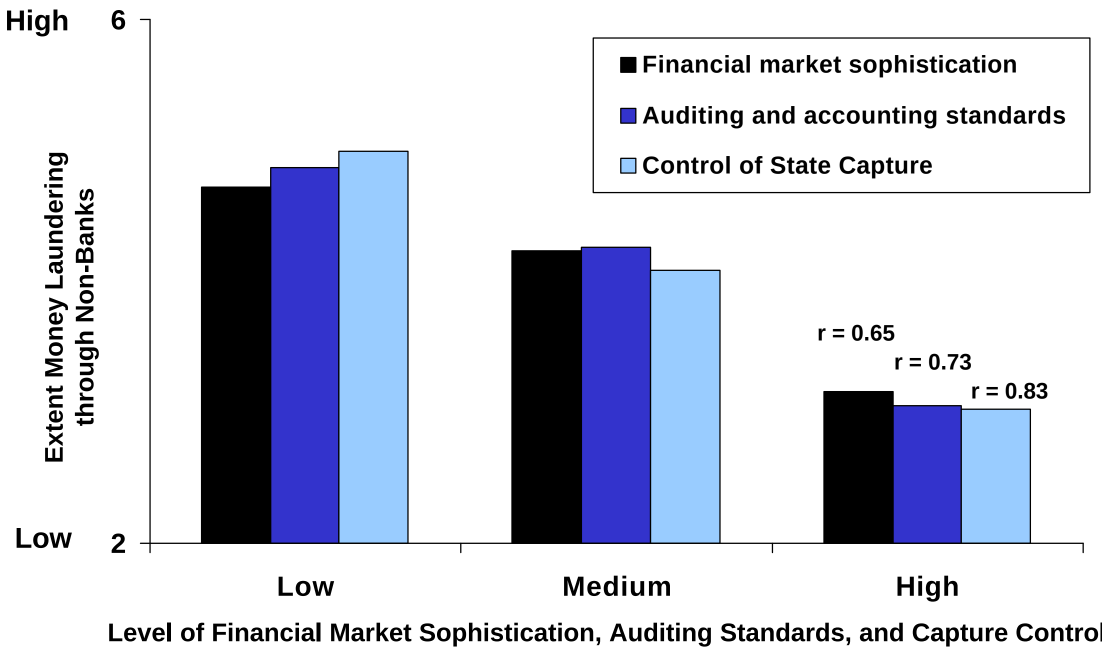
Figure 6: Soundness of banks versus control of corruption



Sources: Executive Opinion Survey [GCR] (2002); Worldwide Governance Research Indicators, http://www.worldbank.org/wbi/governance/govdata2001.htm. The sample of 80 countries has been divided into three terciles according to their rating in Control of Corruption. The three columns therefore represent the average ratings for Soundness of Banks within each tercile. The fitted line instead represents the predicted value of Bank Soundness controlling for the effects of GDP per capita and Regulatory Quality through an ordinary least squares (OLS) regression estimation procedure. Each fitted value is computed as the sum of the estimated constant plus the value of Control of Corruption within each tercile, times the estimated coefficient plus the mean values of Regulatory Quality and GDP per capita, times their respective estimated coefficients.

This year's Survey provides measures of money laundering based on the reported enterprise estimates of the extent of the problem in their country. This first empirical assessment, based on Survey data, also challenges convention, as in many countries and most regions it is reported that the extent of money laundering is very significant through the nonbanking system (formal and informal)—yet it is the banking sector that has been subject to almost exclusive scrutiny. Furthermore, strategies to combat money laundering need to encompass a broader and more integrated framework than merely adopting special laws and regulations. Depending on the setting, the main source of ill-gotten proceeds from money laundering stems from public-sector corruption, tax evasion, arms or drug trades, or other related sources. Depending on the extent to which the regulatory framework has been captured by corrupt interests, the ease by which money laundering will occur is also likely to vary. The evidence in Figure 7 suggests, in fact, that although internal factors to the financial sector may be significantly associated with the extent of money laundering, other determinants may be at least as important, as illustrated by the extent of state capture by private interests, a form of grand corruption.

Figure 7: Extent of money laundering versus financial market sophistication, audit/accounting standards, and control of state capture (Executive Opinion Survey [GCR] 2002)



Note: *r* is the correlation coefficient for each variable for the full sample.

POLITICS MATTERS

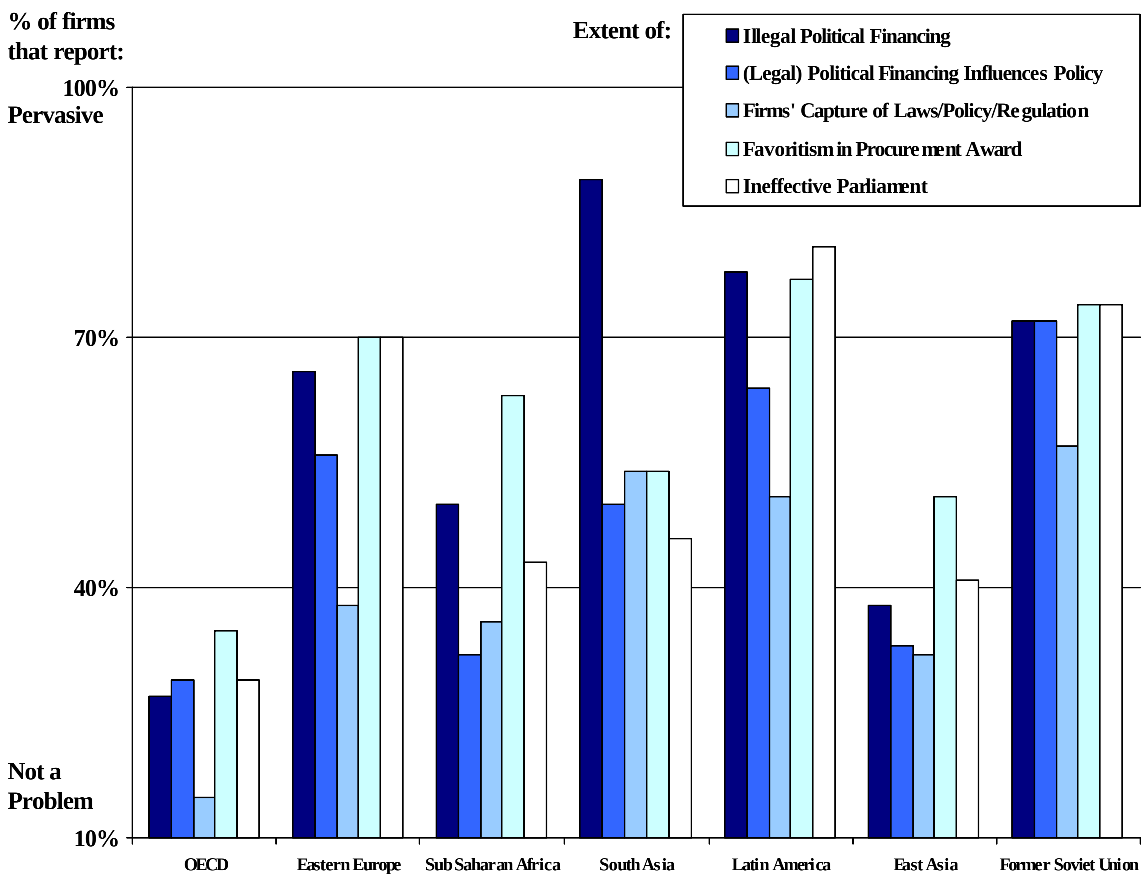
One of the most difficult issues in the field of governance is the imperfect understanding of how politics shape governance and developmental outcomes. In part this stems from the multitude of possible factors and high variance across countries in terms of which factors may matter most. Another reason is the insulated approaches taken by different academic fields (e.g. economics vs. political science), as well as the general reticence (with notable exceptions, however) to gather empirical evidence and provide quantifiable analysis in these thorny areas. An initial empirical exploration of the links between some political, governance and corruption variables has been possible through the worldwide governance research indicators discussed in the early sections of this paper.

Furthermore, while in this broad piece we do not attempt to do full justice to the importance of this topic, the need for furthering an in-depth empirical exploration taking a more multi- (and across-) disciplinary perspective is also suggested by the enterprise Survey evidence, as suggested in Figure 8 below. We observe that according to the reports by the surveyed firms, while there are differences across regions in terms of the prevalence of major challenges in political funding (and the extent to which they influence policy), there is overall a major governance issue; similarly with respect to the reported effectiveness of parliaments, the illicit purchase (capture) by elite enterprises of regulations, policies or laws, and the favoritism by which public procurement contracts are awarded to influential interests (vs. level playing field) in many settings.

This, in turn, suggests that misgovernance and corruption cannot always be viewed as a *symptom* of more fundamental political forces, but instead it may not be uncommon in some settings to find that certain forms of corruption and misgovernance do in turn shape political forces and outcomes – such as in the case of capture and illicit political funding. Under these circumstances, any analysis about the static notion of 'political will' in a country needs to probe much further into the complex forces that shape and can affect such political will – rather than being a mechanistic assessment whether the political leadership is committed to change. The political leadership in many circumstances is influenced strongly (or further) by very powerful outside interests. Further operational research in the future into the issues of influence institutions, capture, and the nature of political funding, and their links with governance, is warranted, and within it, there is a need to build on the work initiated over thirty years ago by Scott (1970) on the typologies of the interface between politics and corruption (also extended by Johnston, 1996, and others).

Indeed, there is a particular need to move beyond blanket treatment of 'politics-as-an-obstacle' (to implementation of governance reforms), and instead have a more rigorous (and realistic) typology, where the particular characteristics of the country will receive particular attention at an early diagnostic and program design stage. Questions that need to be addressed include: i) how mature and competitive are political institutions?; ii) what is the relative prevalence and dominance of state capture and undue elite influence, or of patronage, nepotism, and 'clientelism'?; iii) what is the link between the level and process of democratization and the relative importance in the country under study of systemic corruption at the top (including the extreme case of kleptocracies), versus more democratic settings where political financing reform may be a key challenge?; and, iv) what is the role of more accountable and transparent parliaments -- and in the country under study, is parliament in the early phases of a program part of the problem or the solution? With the increasing sophistication of empirical diagnostic measurement tools, it is now feasible to address the challenge of integrating rigorous political analysis at the country level, with a supportive role for data in unbundling different forms of political dimensions for assessing obstacles to good governance and control of corruption.

Figure 8: Politics Matters for Governance (source: EOS 2002)



A FRAMEWORK OF INTERNATIONAL RESPONSIBILITY FOR COLLECTIVE ACTION

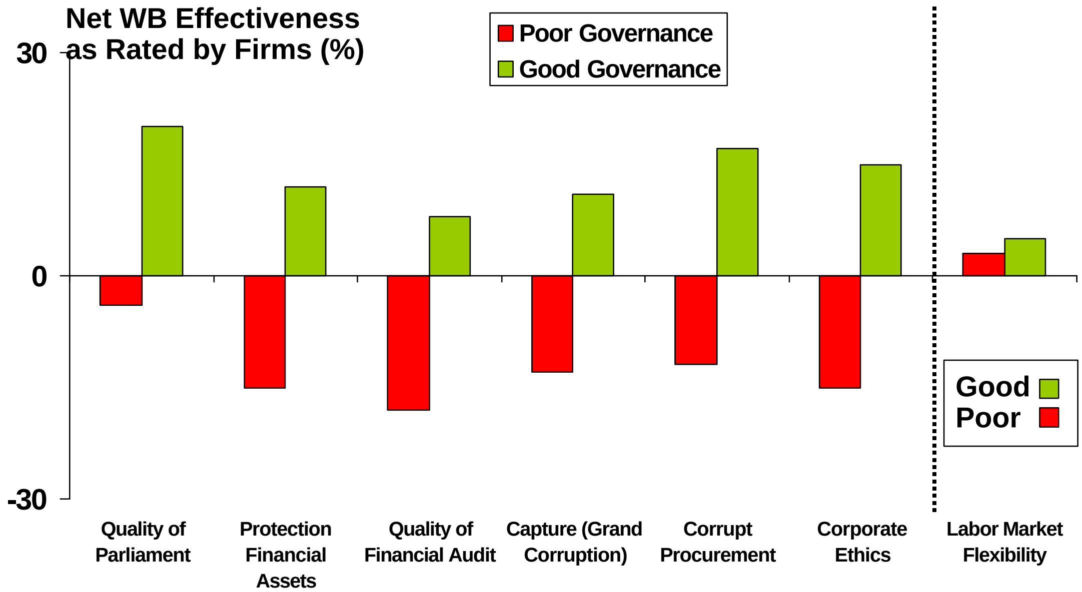
The results from the research on state capture and related forms of undue influence highlight the fact that focusing narrowly on misgovernance within the domestic public sector does not suffice. Instead, understanding the complex interface between private and public sector governance and, within it, the "institution" of influence and capture by elite interests, is increasingly important. And it is clear that scrutinizing only the strategies of powerful *domestic* conglomerates will not suffice either. The evidence suggests that many foreign direct investors (FDI) and multinational corporations (MNCs) still engage in transnational bribery nowadays, in spite of the recent adoption of the transnational OECD anti-bribery convention, and in spite of the United States having enacted legislation during the 1970s (under the U.S. Foreign Corrupt Practices Act [FCPA]). Further incentives for improved MNC performance in their corporate strategies so to promote good governance in emerging economies are needed, as is working with those MNCs that currently are instituting exemplary codes of corporate ethics.

In this context, it is also paramount to face up to the challenges within OECD and EU regarding improved governance and anti-corruption practices (witness for instance the recent EU court of auditors report inter alia on the EU's fraudulent subsidies), and also to address the relatively low priority given by most in the G-7 to globally address governance issues. And we ought not sidestep our own responsibilities within the IFI community, which include continued implementation of a zero tolerance policy on corruption within international organizations, further implementation of strategies and practices to reduce to a minimum corruption in donor-funded projects (e.g. the World Bank now publicly bars from bidding firms found to engage in corruption), supporting emerging economies to improve governance and address corruption, and learning from the lessons of experience and being well informed on the different vulnerabilities facing different countries. This means that drawing lessons from mistakes, failures, and successes—as well as challenging orthodoxy when the evidence so warrants—is to be encouraged. We have learnt, for instance, that the capacity-building approaches of the past supported by the bilateral and multilateral international community have not worked well, in large measure due to the narrow emphasis on organizational, “hardware,” and internal rules-based approaches, without proper focus on key governance dimensions.

Further emphasis is also needed on the link between governance and business-sector development. The private sector surveyed in this year’s Survey provides a clear message on the importance of governance in general: as we have seen in the evidence presented so far, for enterprise governance is an integral component of the investment climate. More specifically, the enterprise sector appears to place responsibility on IFIs for the quality of the governance environment. The Survey asked the firms to evaluate the effectiveness of IFIs in promoting private-sector development (and poverty alleviation), through dedicated questions. On average, the firms in emerging economies did not evaluate highly the performance of the IFIs in their countries on private-sector development support (or poverty alleviation). The enterprise sector in emerging markets on average does not evaluate the effectiveness of IFIs any higher than they evaluate their domestic institutions—and in some cases lower.

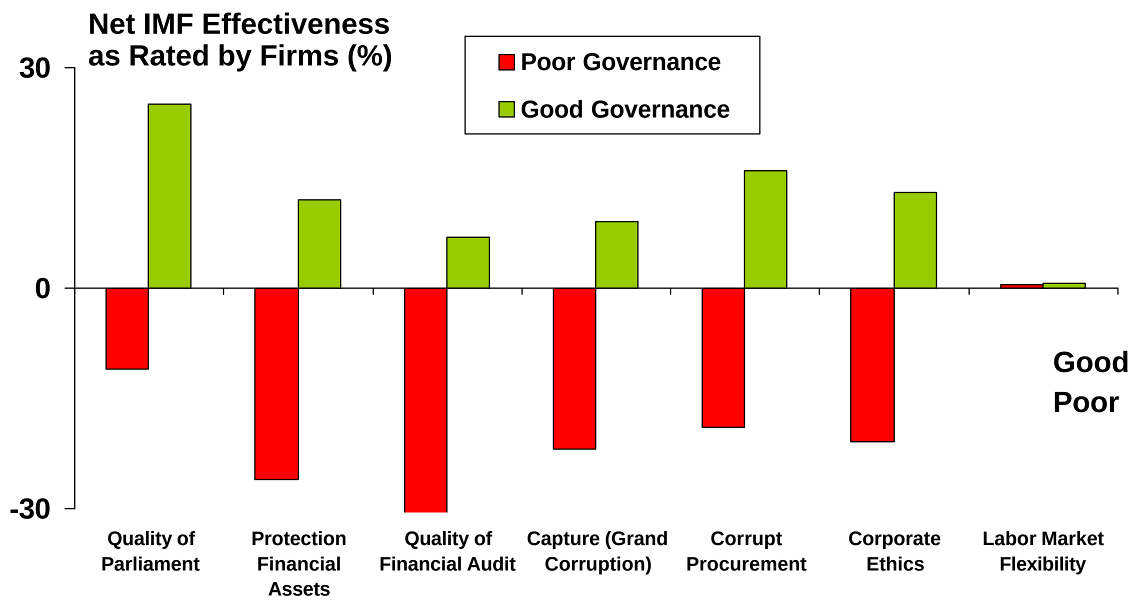
Importantly, firms appear to suggest that governance matters significantly in this context. An analysis of the substantial variance in the results of the firms’ assessment of IFI performance suggests that the quality of domestic governance plays a determining role in how effective the IFI performance is reported to be by the firm. In emerging economies, where the quality of public- and private-sector governance are rated low, the IFI is not seen as fulfilling its role in promoting an environment conducive to private-sector development; the converse is the case where there is better governance. This is depicted in Figures 9a (for the World Bank) and 9b (for the IMF), and is not shown for the Regional Development Banks, for which similar findings on the link between the quality of governance in the country and the firms’ assessment of the effectiveness of the Banks in promoting private-sector development (and addressing poverty) were obtained as well. We observe in Figures 9a and 9b that, depending on the quality of various governance variables—such as capture, corruption, protection of assets, corporate ethics, audit, and quality of the parliament—there is a very large difference in the net effectiveness rating by firms (calculated as the percentage difference between firms in a country rating IFI as effective minus those rating it as ineffective). This is contrasted with an illustrative “nongovernance” variable, namely labor market flexibility: whether policies in such dimensions are rated highly or not are not associated with how well they rate the effectiveness of IFIs. Further, the evidence also suggests that whether IFIs are lending to the country or not and the volume of such lending is much less important in the firm’s evaluation of IFI than the quality of the governance environment in their country (not shown in Figures 9a and 9b).

Figure 9a: Firms evaluate World Bank's effectiveness in PSD: Governance does matter (Survey, Emerging Economy sample)



Note: The vertical axis depicts the firms' net effectiveness evaluation of World Bank's performance in supporting private-sector development (PSD) in their country. Net effectiveness is calculated as the difference between the percent of respondents reporting the institution to be effective minus the percent of respondents reporting it to be ineffective. Each set of two columns displays the net effectiveness ratings provided by countries with a good record in given constraint (in blue) versus those provided by countries with a poor performance in such constraint (in black). Calculations are based on country averages.
Source: Executive Opinion Survey (GCR) 2002.

Figure 9b: Firms evaluate the International Monetary Fund's performance in PSD: Governance does matter (Survey, Emerging Economy sample)



Note: The vertical axis depicts the firms' net effectiveness evaluation of the IMF's performance in supporting private-sector development (PSD) in their country. Net effectiveness is calculated as the difference between the percent of respondents reporting the institution to be effective minus the percent of respondents reporting it to be ineffective. Each set of two columns displays the net effectiveness ratings provided by countries with a good record in given constraint (in blue) versus those provided by countries with a poor performance in such constraint (in black). Calculations are based on country averages.
Source: Executive Opinion Survey (GCR) 2002.

CONCLUSIONS AND IMPLICATIONS

Implicitly, in this paper we have challenged nine tenets put forth as conventions in the introductory section. We have suggested instead that: (1) corruption and misgovernance are rather distinct notions, even if related, and the required governance approach is much broader; (2) addressing misgovernance requires different approaches in different settings; (3) the key concepts in this field are nowadays subject to improved definitions and measurement, permitting a more rigorous analysis; (4) to attain concrete progress, it may be important to move away from excessive focus on traditional public sector management and orthodox judicial/legal measures; (5) overall, the evidence does not suggest steady progress in governance in recent times; (6) for addressing corruption, much more focus is needed on the challenge of state capture and related forms of illicit influence and political funding; (7) corruption and misgovernance, rather than merely a symptom of more fundamental political forces, play an important role in shaping the political forces; (8) the shaping of the investment climate is not only in the hands of the public sector, and the policies that matter most for the investment climate are within the governance realm, and, (9) it is fundamental integrate corruption and governance as within a broad multi-sectoral approach, understanding the complex links between governance and outcomes in the various sectors (rather than viewing it as a 'silo' theme.

While we set out to challenge some received wisdoms as suggested above, the work here also attempts to go further. The richness of surveys such as the Executive Opinion Survey (GCR), coupled with the preliminary nature of the analysis of a broad number of dimensions presented in this chapter drawing on such recent surveys, argues for further in-depth research on topics presented in this chapter. Indeed, some of what we have presented here ought to be seen as research-in-progress, and these results ought not to be over-interpreted. Nonetheless, drawing on the analysis of the Survey dataset, complemented by other worldwide empirical indicators, we challenged orthodoxy in governance. This is particularly the case for the received wisdom pertaining to conventional public-sector management and legal-judiciary approaches, which have largely ignored the importance of the key private-public sector interface in shaping the business environment, governance and political economy.

The implication of this new approach is that much more focus is needed on strategies encompassing effective external accountability mechanisms, transparency, incentives, and prevention for improving governance. In particular, special emphasis in the next stage is warranted in the following areas:

- *Transparent information and knowledge* is needed—including rigorous data, diagnostic and empirical analysis and monitoring, and improved disclosure and access standards for financial, budgetary, and related data—as well as scaling up in the adoption of e*governance tools (web-based applications to improve governance and enhance transparency, such as e*procurement and e*data), transparent disclosure of parliamentary votes and public officials' assets, and so on.
- A proper understanding of the *political* forces affecting policymaking and, related, the set of required institutional *incentives* for progress. This should include better political analysis at the country level, so to distill the type of political obstacles that prevail. This is critical for realistic program design (see previous section on 'politics matter' and diagnostic questions raised). Further, complementing such analysis of political dimensions, review is also warranted of the prevalence of meritocracy within institutions, as well as transparent monitoring and disclosure, and much enhanced external accountability mechanisms—with a focus on improved prevention.
- *Collective action* should be taken, through a systematic participatory and consensus-building approach, involving all key stakeholders in society—the executive branch, the legislative branch, civil society, and the competitive private sector.
- *Political leadership* should be strengthened through mechanisms designed to instill and reward integrity, *inter alia* through voice and external checks and balances, pro-transparency incentives, and measures adopted to address the perverse links and networks between some conglomerates and some corrupt politicians.
- *Influence and capture* should be addressed—integrating into the analysis and recommendations the political economy of misgovernance and corruption, with a deeper understanding of the forces of elite influence, undue political financing mechanisms, the roles of multinationals and of the domestic elite, and the main agents of capture, and designing concrete approaches to move toward a more level 'influence-peddling' playing field.
- *Misgovernance in finance* should be addressed, with further focus on governance, regulatory capture, and corruption challenges in sectors where until recently these issues were not acknowledged, such as the financial sector. In this context, a broader governance context to analyze and act on money laundering may also be required,

moving away from any 'one-size-fits-all' recipes, instead taking into consideration the varied sources, determinants and manifestations of these activities in different settings.

- *The challenge of localization* lies in recognizing the complex, multidisciplinary, and cross-sectoral nature of the field of governance, which *inter alia* implies the need for "localization" of know-how and the institutionalizing of in-depth country diagnostics carried out by local institutions—rather than relying on any uniform template that ignores the specificity of the challenges in each setting.
- Explicit recognition and integration into strategies of the fact that an effective *investment climate* as well as corporate responsibility *is about improving governance broadly*—the narrow notions of the business climate and corporate governance of the past have been challenged by the weight of recent evidence. Explicit integration of incentives and measures towards broader implementation of corporate strategies aiming at improved ethical standards (in the private-public interface) and thus better national governance overall, is also important in the next phase.
- The international community's responsibility to support national efforts in the area of *international compact* is more urgent than ever. The responses from the enterprise sector in this year's Survey, in fact, do suggest that a sharper IFI focus on supporting improved governance in their countries is called for. Similarly, further incentives and mechanisms to ensure improved corporate ethics by many foreign investors operating in countries already afflicted by corruption ought to be put in place, through initiatives that the corporate sector itself can undertake, backstopped by further measures by OECD countries, other regional initiatives, a pro-active stance on global governance in important international private-public for a such as the World Economic Forum, peer (country-to-country) review mechanisms, and continued self-assessment and monitoring through publicly disclosed (and acted upon) stakeholder diagnostic surveys. The international aid community would also need to consider a more rigorous allocation of aid, which follows stricter criteria related to the (trend and level) of the governance climate within the recipient country. As illustrated in this chapter, in fact the capacity to generate yearly worldwide governance indicators exists already (the main restriction in their wider utilization, other than the interpretive care due to the margin of error, lies with the politics of facing up to the evidence suggested by such indicators). Finally, giving more prominence to the effective review of compliance with governance parameters in accession rules to international legal, political, finance, and trade groupings (WTO, EU, NAFTA, etc.) is likely to be ultimately beneficial to the candidate country and to the overall group of countries.

A CALL FOR BOLDER ACTION

Indeed, beyond the natural leadership role that national governments need to play forcefully to substantially improve governance, the role and responsibilities of the financial and corporate sector are also important, both in their domestic and international dimensions. In our research we have documented that depending on the particular corporate responsibility and ethic strategies that powerful enterprises (including foreign investors) choose to carry out can further improve or undermine national governance within the country. The corporate sector, both internationally and domestically, has a role in improving overall governance and in shaping the very investment climate for the rest of the business and financial sector – national governance is not the exclusive domain of the public sector. The role and responsibility of multinational corporations is paramount in a number of settings, with their power often exceeding those of some states.

Citizen and enterprise participation and voice are vital in increasing transparency, providing for the necessary external accountability mechanisms and thus for the checks and balances that even the best internal accountability rules and systems within government cannot fulfill completely. Transparency-enhancing mechanisms involving a multitude of stakeholders throughout society can be thought as creating millions of "auditors." Indeed, such external accountability mechanisms, which often also include very activist media involvement as well as the new set of data-driven diagnostic and Internet-based tools, can be powerful factors supporting a change in the incentive structure of institutions that are monitored.

Nowadays in the enterprise sector in the United States, the public is increasingly applying pro-transparency pressure to publicly listed firms and demanding better information on the true state of the financial accounts of enterprises in the wake of the costly recent financial scandals. Shareholders are quickly divesting from institutions with uncertain or nontransparent accounts, increasingly applying market pressures. The media, shareholders, and the public are also questioning the (political financing) links between certain influential segments of the corporate sector and the political-legislative arena. These recent episodes provide lessons that can be constructively applied in many countries. Institutionalizing the gathering and dissemination of information that would provide further scrutiny and continually monitor the links between the private sector and public policy would constitute a major step toward providing further transparency.[10]

Given the link between governance and development worldwide, the responsibility of the international community cannot be overstated at this juncture. In this sense, governance is at a crossroads. There is still a soft and wavering commitment to improving governance in many quarters today, including members within the OECD and the G-8, and as stated, there are challenges within the EU itself. Admittedly, the crucial requirement for political will in this area, where powerful vested interests conspire against the concrete progress which is essential for development, cannot be ignored. Yet it is clear that without a much bolder approach to attain concrete progress globally in this area in general, and more assertive and concrete integration of governance objectives into specific initiatives such as principles of corporate responsibility, as well as into the Millennium Development Goals implementation, progress toward an improved investment and business climate, poverty alleviation, socioeconomic development, and growth is unlikely to take place in countries that need it the most.

The evidence from the data analyzed here is also clear in pointing to disappointing average progress, if any, on governance in recent years—contrasting some other dimensions (although there are obviously countries where there has been progress on governance). Logic, as well as mere observation of the consequences of failed states as well as the misgovernance-induced financial crises in some countries, argue even substantial political difficulties in forging ahead on a worldwide initiative to improve governance and control corruption would be dwarfed by the cost of inaction. This would require transcending narrow

[10] Recent writings on the needed reforms for Wall Street and to the world of executives are telling in this context of the need for governance reforms by the corporate and financial sector in the US, and go beyond it. See Arthur Levitt's (former chairman of the US Security and Exchange Commission) new book (co-authored with Paula Dwyer) , as well as the new book containing ambitious list of detailed recommendations and admonitions to American executives by the dean of the Yale School of Management, Jeffrey Garten.

vested interests, and a focus on concrete action, moving away from the emphasis on countless unfocused conferences and adoption of international conventions and declarations that are not monitored or enforced. Instead, a renewed global commitment to make improved governance a paramount objective—a compact grounded in concrete political commitment by the domestic leadership and actions from international and national stakeholders, supported by appropriate strategies and decision making informed by the continuing gathering, analysis, and dissemination of detailed evidence and the monitoring of progress (from transparent surveys and governance indicators)—is likely to yield a very large development dividend.

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ANNEX 1: CHILE AT A CROSSROADS: WILL THE "STAR" PERFORM BRILLIANTLY THIS DECADE?

The number of Chile's firms participating in the Executive Opinion Survey [GCR] (at 135) in early 2002 was significantly above the average country sample for the Survey (particularly relative to its population). On this basis, and by comparing with the rest of the Survey countries, it is of interest to evaluate Chile's reported performance based on the enterprise responses. Given that the Survey is but one input to any comprehensive assessment, no conclusive inferences can be made until they are complemented by other evidence and further in-depth analysis. Rather, the focus on one country is intended to illustrate the early detection of strengths as well as vulnerability "warning flags" that the enterprise sector may signal through these surveys.

A puzzle emerges through the review of the Survey data for this Chile country case study illustration. Chile was a "star" performer among emerging economies through most of the 1990s. Over the past five years however there has been a significant slowdown in growth and productivity. And while the Executive Opinion Survey (GCR) responses this year still support the view of Chile's institutions being rather strong in many areas, it is also the case that the Survey data points to a more complex, and at times mixed, evidence when a broad view is taken. Some core areas of strength in governance, which are well known, are supported by the evidence from this year's Survey. Notable is the relative success in maintaining relatively low levels of corruption, in contrast with much of the rest of the region—and with many other countries as well. For instance, in terms of extent of bribery related to external trade, Chile rates in the top 6 among the sample of 80 countries, implying that the country enjoys nowadays a better rating than most of the OECD countries. Similarly, there is a low reported extent of bribery for access to public utilities and for evading taxes (see Annex 1 Figure A), very low illicit diversion of public funds, and far more public trust in the financial honesty of politicians than the vast majority of the rest of the countries. There is also a high regard for some key institutions such as the police, excellent rating for the protection of financial assets and wealth, and there is a rather small estimated unofficial economy—in itself a sign of relatively good governance. And there are also good ratings for the auditing and accounting standards in the corporate sector. Other commendable dimensions of the Chilean success story during the past decade are very well known—such as the quality of macroeconomic management—so these are not detailed further here.

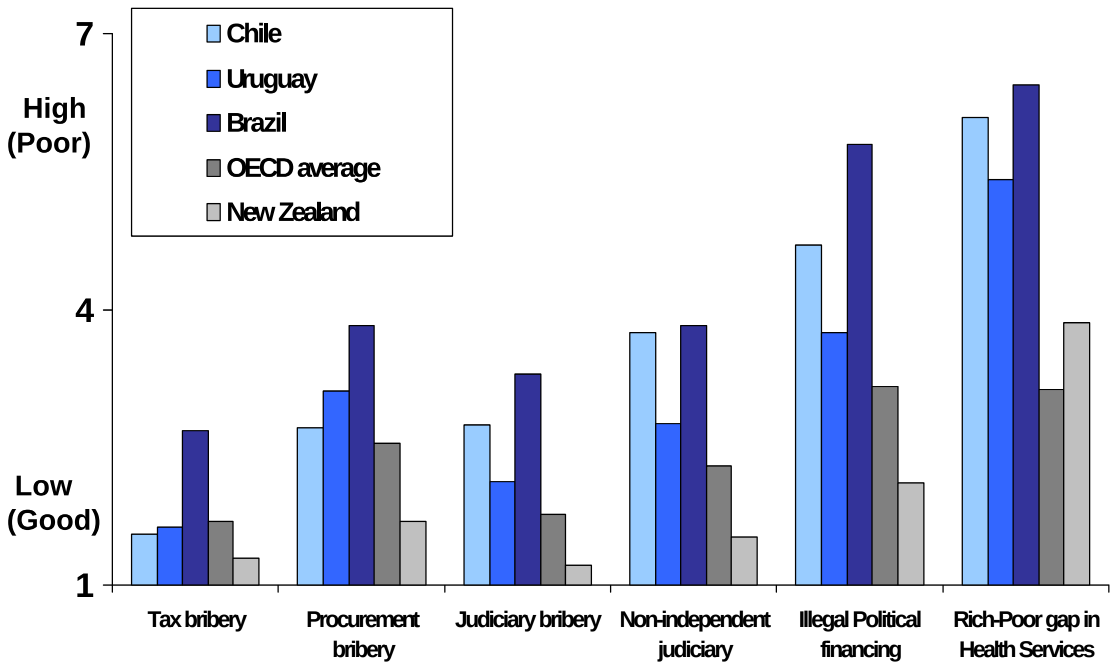
However, not all good things automatically go hand in hand. The unbundling through the GCR Survey also points to a number of areas of relative vulnerability. This matters given the significant slow down in Chile's growth in recent years, and the internal debate about possible areas of improvement and policy intervention needed to restart vigorous productivity growth and attain higher levels of competitiveness. Specifically, in the well below the excellent standards attained in other dimensions (discussed above), and also significantly below OECD averages:

- Ease of entry for new firms and removal of remaining administrative barriers to business (including in the labor regulation area).
- Common crime is seen as rather costly to business.
- Competence of public sector personnel, relative to the private sector, and (related) the efficiency of the government bureaucracy, are seen as a constraint to business.
- The quality of parliament, the independence of the judiciary, and also to some extent judiciary-related corruption (relative to the extremely low incidence of some other forms of

corruption), are identified as vulnerable areas (see Annex 1 Figure A). As stated, in general Chile rates relatively well on various corruption dimensions, yet not only are there some (relative) vulnerability dimensions such as in the judiciary, but firms this year also report an apparent recent deterioration in the (admittedly low) incidence of corruption.

- Elite influence is another area of vulnerability: to the question of "when deciding upon policies and contracts, government officials usually favor well-connected firms and individual," the reported evidence for Chile is very mixed. Similarly, Chile does not rate well in relative terms on the reported extent of illegal donations to political parties, and in the very substantial gap between the rich and the poor in access to quality health care (Annex 1 Figure A). This suggests the need to probe deeper into the complex political economy of inequality and influence.

Annex 1 Figure A: Chile in perspective:
Selected governance dimensions, GCR 2002



In tandem with these potential governance vulnerabilities, among areas of weakness outside the conventional realm of governance, the following dimensions are also candidates for further scrutiny: (1) low levels of reported quality of public schools, and, consistent with this, firms consider an inadequately educated labor force to be a major obstacle; (2) low labor market flexibility; (3) the quality of infrastructure; (4) intellectual property protection; and, importantly, (5) the remaining challenges of the "new economy"/ICT area, where the results are distinctly mixed and the potential for substantial improvement is large.

In sum, by flagging potential areas of relative strength and vulnerabilities for a country based on Survey results (properly qualified and complemented by further analysis; see, for instance, Engel and Velasco (2002) and others), it is possible to suggest focus areas to enhance competitiveness and productivity growth in the future in a country.

ANNEX 2: GOVERNANCE AND GROWTH IN THE LONG RUN: EVIDENCE FOR LATIN AMERICA AND THE WORLD[11]

Per capita incomes and the quality of governance are strongly positively correlated across countries. This can be seen in Annex 2 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.[12] 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 Annex 2 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 Annex 2 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, Annex 2 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 Annex 2 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 Annex 2 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.

Which of these three possibilities is most important matters crucially not only for how we interpret Latin America's relative performance as per Annex 2 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

[11] Synthesis of the research paper 'Growth without Governance', by Kaufmann and Kraay. 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.
[12] 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.

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 Annex 2 Figures 1A-C is the objective of our paper "Growth Without Governance", recently published in the journal *Economia*.[13]

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.[14]

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.[15]

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,

[13] Kaufmann and Kraay (2002).
[14] See for example Hall and Jones (1999) and Acemoglu, Johnson and Robinson (2001).
[15] 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.

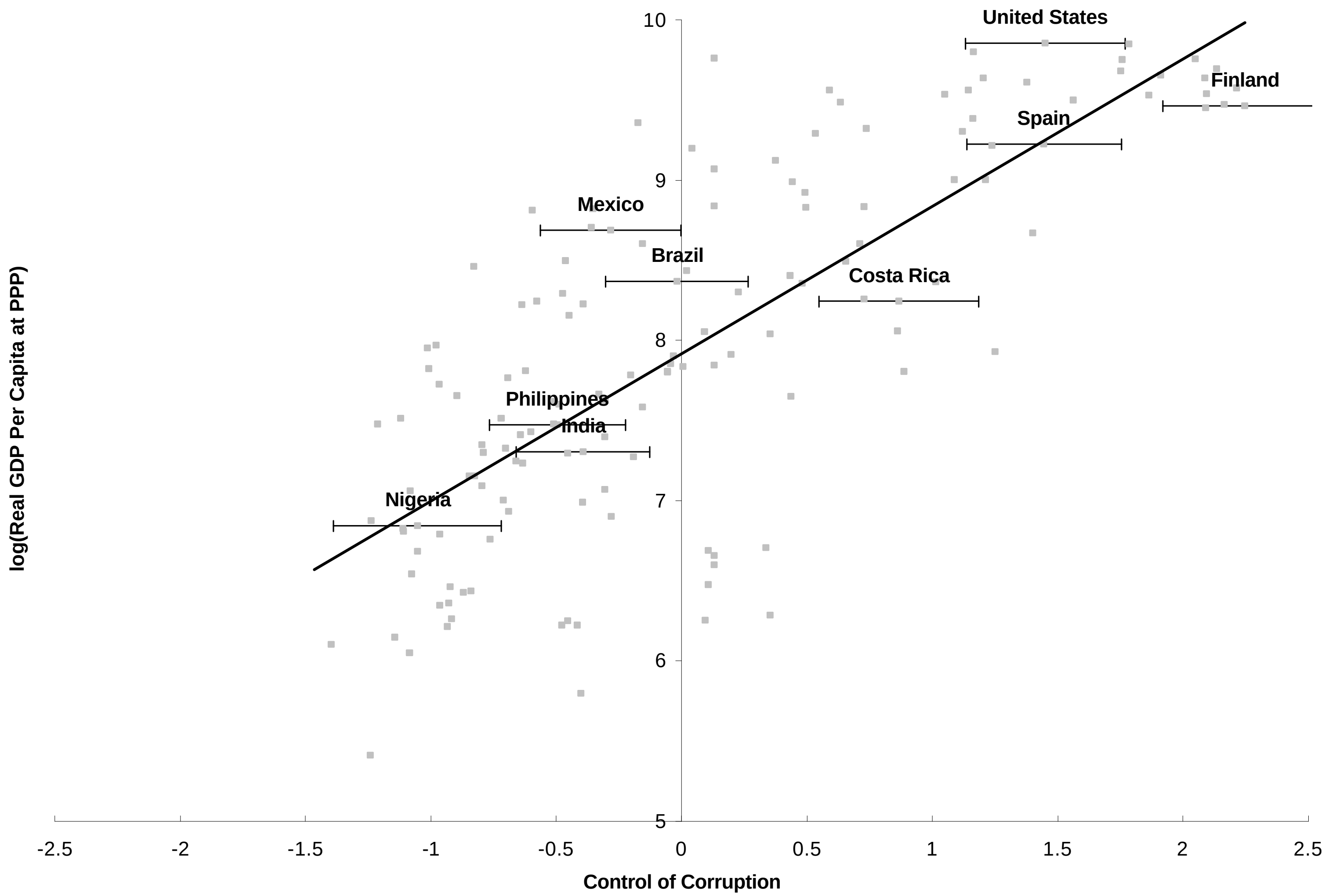
the fact that good governance is not a ‘luxury good’ to which a country automatically graduates into when it becomes wealthier means in practical terms that leaders, policy-makers and civil society need to work hard and continuously at improving governance within their countries.

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.[16] 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.

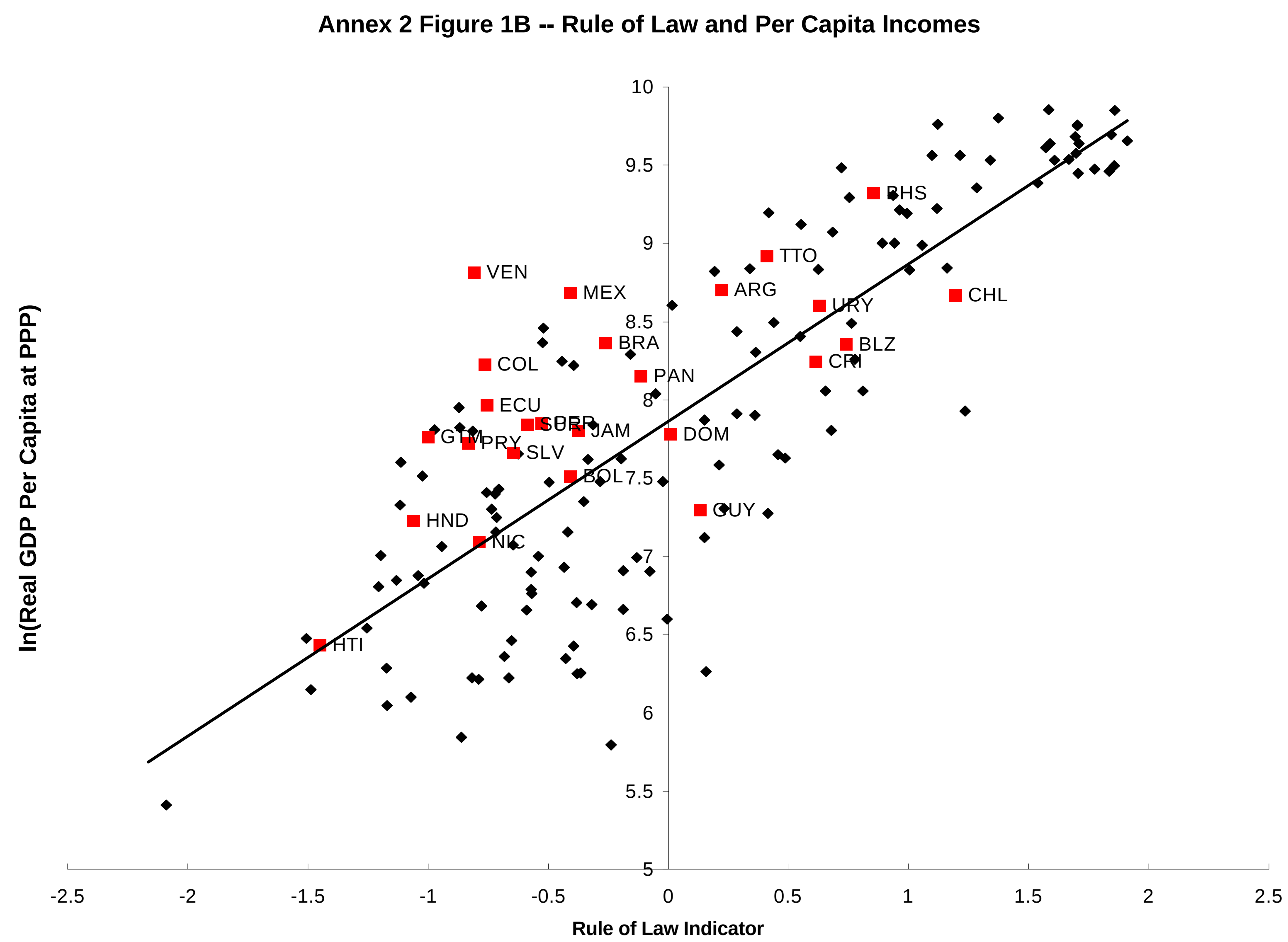
Based on in-depth governance and anti-corruption country diagnostics carried out at the World Bank in a number of countries in Latin America, as well as enterprise surveys in economies in transition, we have found significant empirical evidence on the challenge of State Capture (and, related, ‘crony bias’ or unequally distributed influence) in many countries–for which evidence was provided in the body of the paper. 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, as reviewed in the text of the paper and in Box 2, the 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. 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.

[16] 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).

Annex 2 Figure 1A -- Control of Corruption and Per Capita Incomes

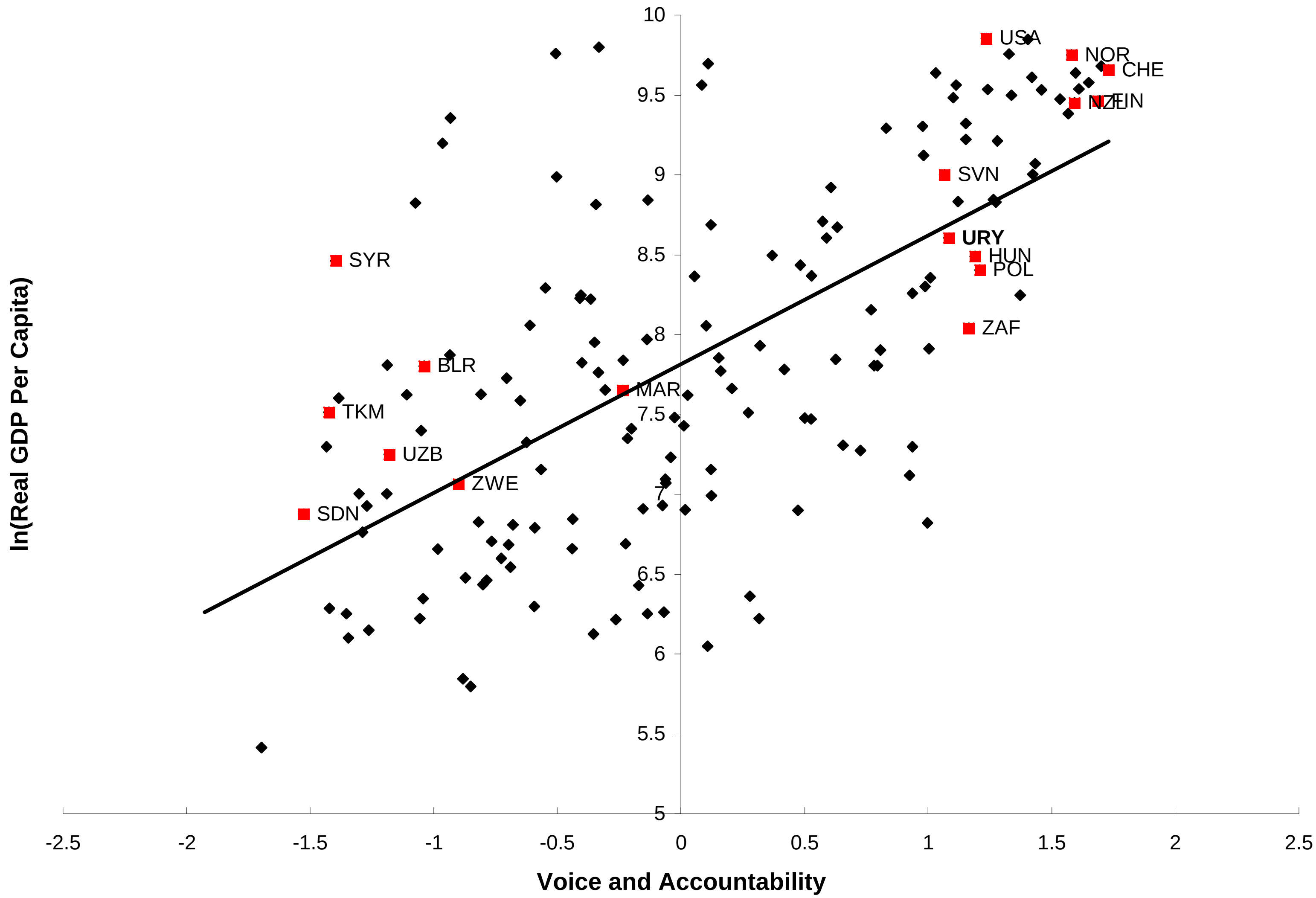


Notes: This figure plots a measure of control of corruption in 2000/01 (on the horizontal axis) against real per capita GDP in 1995 (on the vertical axis). The horizontal bars for selected countries indicate the statistically-likely range of values for the rule of law index for those countries. The governance 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.



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.

Annex 2 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.