International Relations and Diplomacy, April 2018, Vol. 6, No. 4, 231-238
doi: 10.17265/2328-2134/2018.04.002

DAVID PUBLISHING

Good Governance and Growth in Emerging Countries: A Critical Review

Rachid Mira
University Paris 13, CEPN laboratory, Paris, France

Numbers of economists of development consider that good governance, defined as the quality management and orientation of development policies has a positive influence on economic performance. The question is what content the literature gives to the concept of governance. According to the World Bank, good governance is evaluated by the implementation capacity of governance principles of a country, providing a framework for market development and economic growth. Empirical studies tested the relationship between good governance in the sense of "market-enhancing governance" (stimulus institutions market) and showed a positive relationship between good governance and economic growth. However, a good governance policy needs for developing countries to achieve minimum economic growth and political reforms in order to reach a level of development similar to that of industrialized countries. We focus on good governance definition made by the World Bank and criticism formulated by Mushtaq Khan, who reconstructed the notion of Governance Capabilities, taking into account the capacity of states to drive structural change in institutional, political, economic, and social fields, in order to ensure long-term economic growth. Our goal is to use a new concept of governance in order to build a new political economy approach more suitable for emerging countries.

Keywords: states failures, good governance, economic growth, development policy

Introduction

Good governance is defined by a set of institutions managed by government in order drive economic policies. Empirical studies made by World Bank (Kaufman, Kraay, & Zoido-Lobaton, 1999; Kaufman, Kraay, & Zoido-Lobaton, 2005) showed that good governance has got a positive effect on economic growth and enhance market development for emerging countries.

Can good governance explain economic performance? Or according to the thesis of Mushtaq Khan (2000; 2004), reforms of economic structures and government capabilities are the first step to improve economic performance of developing countries, and in a second step to allow economic growth to enhance good governance.

The first thesis (market enhancing governance) defended by neo-institutionalist authors (Kaufman et al., 1999; Kaufman et al., 2005; Knack & Keefer, 1995; 1997) considered the state as a sovereign role as welfare state. Economically, the proper functioning of markets is correlated to the proper functioning of institutions through efficient practice of State Governance, what is commonly called "good governance". Therefore, underdevelopment and low economic growth performance of countries could be explained by a "state failure"

Rachid Mira, Ph.D., University Paris 13, CEPN laboratory, Paris, France.

and the components of good governance with the increase in corruption, instability of property rights, market distortions, and lack of democracy.

The second thesis (growth enhancing governance) developed in particular by Mushtaq Khan (1995; 2004; 2005; 2007) and partly by Dany Rodrik (1995; 1998), and Rodrik, Subramanian, and Trebbi (2002), concerned the ability of the state to implement social change and a voluntary policy of economic development: The transition of developing countries towards a capitalist system comparable to that of developed countries, cannot operate without the establishment of efficient institutions in relation with distribution of political power in these countries. Conversely, those countries would face a state failure, as a result of a mismatch between institutions and economic policy for development.

Our research consists first to present some results of an empirical model (Hammadache & Mira, 2013) based on a panel of developing countries chosen by region (MENA, Latin America, and Asia) and due to their natural resource endowment. The aim is to check if growth rate may or may not be correlated with good governance indicators as defined by the World Bank. The goal is to lead in a second time an analysis of criticism made by Mushtaq Khan on the definition of governance, the causes of state failure and barriers to economic development. Our contribution is to discuss the concept of good governance and the failure of states taking into account the level of development and governance capacity, based on a structure and distribution of political power that evolves in time and may or may not be positive for growth. The assumption we make here is that the so-called good governance policies are relevant if countries reach an adequate level of economic and social development that enables institutions of good governance to boost growth.

Good Governance, State Failure, and Economic Growth: The State of the Debate

Approach Neo-institutional Economists' Institutions Called Good Governance Positively Affect Economic Growth

Institutions are all formal rules (legal, economic, and political) and informal rules (social, behavioural norms, and conventions) that structure social life. According to Douglass North (1990), a distinction was made between formal and informal institutions.

Good governance in the definition of the World Bank is the capacity of management and institutional reforms conducted by state policy, that improve coordination and delivery of effective public services, accountability of political actors, and individual citizens in the driving of development policies. Good governance therefore connects adequate political institutions and practices to allow development. Several econometric studies (Kaufman et al., 1999; Kaufman et al., 2005) tested the relationship between good governance in the sense of "market-enhancing governance" (stimulus institutions contract): A positive relationship has been obtained between good governance and economic growth. Then, implementation of good governance policies can promote economic development and ensure convergence towards level of developed economies.

Indicators of good governance according to the World Bank: Presentation and interpretation. The World Bank (Kaufmann et al., 1999; 2005) built composite indicators summarized under six headings:

- "Voice and accountability": which measures tendencies of political process, civil liberties, political rights, and independence of the media. The responsibility is that of citizens who participate in political life through elections, public decisions.
- "Political instability and violence": which measures the perception of a possible destabilization of the

political regime through elections or violence.

- "Government effectiveness": which measures the perception of the quality of public service or public administration. This index assesses the perception of the government's credibility through the trust given to its administration.
- "Rule of law": measures the perception of citizens of the rules that structure society and the degree of compliance with these rules. The indicator measures the perception of the efficiency and fairness of the judicial system and respect for contracts and agreements tied.
- "Quality control": measures perceptions which are favourable or not for market economy, including anti-liberal interventionist policies, such as price controls, imports and exports, and the banking system. This index allows us to appreciate the business climate for foreign investors, for example.
- "Control of corruption": measures perceptions of the use of public power in the pursuit of private gain.

These indicators are rated on a scale as appropriate -2.5 to +2.5 or on a scale from 0 to 100. The lowest indicator is considered as the least favourable and above the most favourable.

The purpose of the construction of these indicators is to measure the evolution of good governance by country and implement a policy to improve these indices in order to ensure that improving good governance could reduce the failure of state. Indeed, in the first argument, the state perceived in its functions as a public services provider, is right but seems to be narrow if it assumes to reflect the ability of the state to carry out economic development policies and policy changes and social. The role of the state is certainly to create a set of institutions that constitute the "rules of the game" (North, 1990), which offer people incentives and opportunities, so that social coordination operates. The institutions included in the indices of the World Bank include security of property rights through the "rule of law" indicator for example. Nevertheless, the improvement of this indicator needs to take into account the notion of "enforcement" (North, 1990) considered as efficiency or a certain degree of enforcement. The state must be equipped with skills so that it has capacity in binding rules it has issued. Hence, the construction of institutional indicators would include measuring the degree of respect, quality, and efficiency of the rules.

Institutions and evolution of institutions developed by North (1990) had influenced the definition of indicators of the World Bank. It is interesting that North diagnosed failure in development of economies of the Third World, because of their institutional weakness, which causes historical stagnation and contemporary underdevelopment in the Third World. Specifically, Douglass North highlighted the arguments of insecure property rights, legal rules ambiguity and uncertainty in the behaviour of agents of the economies of the Third World. From this, institutional diagnosis could have emerged the first thesis which put in relation failure of states and "bad governance" of states that could not provide an institutional framework conducive to growth and economic performance.

Empirical Results of the Work of the World Bank

Daniel Kaufmann et al. (2005) developed a set of six composite indicators covering nearly 190 measures perception of governance and agglomerate the collection of data from 17 institutions, out of 170 countries. The Kaufmann studies have to correlate the quality of governance with the per capita income in all the countries studied. Thus, their econometric studies show a positive relationship between income per capita growth rates and improvement of components each indicator of good governance.

Daniel Kaufmann concluded with the following assumptions:

- Better governance has a significantly positive effect on per capita income.
- An improvement in income leads to better governance.
- Other factors affect the increase in income and wealth of countries and are also associated with better governance.

Considering Daniel Kaufmann as the relationship between governance and income levels and GDP growth, rate operates in an opposite direction, and then, it is surprising that in the short term high income levels produce only weak governance.

In another paper, Daniel Kaufmann and Aart Kraay (2003), entitled “Growth without governance”, analyse the causality between growth in per capita income and governance, leading them to analyse growth of per capita income over the long-term, particularly the last two centuries, and do not reveal big differences between countries. The gap in per capita income that we know today makes industrial and technological revolutions that have allowed the accumulation of physical and human capital and achieve a level of wealth and income per head of the current developed countries that distinguish developing countries that have not experienced the same social transformations.

Referring to the work of Robert Hall and Charles Jones (1999) and Daron Acemoglu, Simon Johnson, and James Robinson (2001), companied that have high income levels today have experienced in the last two centuries of the very rapid rate of economic growth. Their economic performance can be interpreted by deep historical differences in the quality of their institutions. This work has focused on developing countries that had a colonial history and show a strong relationship between initial institutional quality and growth in the long run.

In general, thesis is that Daniel Kaufmann consideration of reverse causality, from income levels of governance, is as plausible as countries with high incomes can financially take the implementation of good policy governance improving government effectiveness, rule of law, and control of corruption.

But is the relationship between growth in per capita income and governance always positive? Daniel Kaufmann and Aart Kraay (2003) indicated that no, the sign of the positive or negative causality depends on the implementation of a proactive policy of states that build a set of efficient institutions and forward improvement the so-called good governance. Daniel Kaufmann’s thesis is that causality could not be positively mechanically without considering the political will and the existence of feedback mechanisms (feedback loops) between per capita income and governance, to create a “virtuous circle” good governance and national wealth.

Thus, the thesis of improving per capita income and waiting a mechanical improvement of governance is challenged by Daniel Kaufmann. He followed in a certain way thesis developed by Mushtaq Khan (since 1995) of the role of political factor in economic growth: In effect, Mushtaq Khan developed the concept of “political settlement” and “patron-client networks” combined with his analysis of the “rent-seeking”, explaining that good governance can only occur if one overcomes the symptoms of “state failure”. The state can improve its governance and makes economic reforms for growth, if the elites forming the coalition have a coincidence of interests between growth strategy and their proper rent seeking. Daniel Kaufmann developed a similar thesis explaining the existence of “feedback” in the negative relationship between per capita income and governance, which are caused by the phenomenon of predation of state, defined as the illegal or improper influence of the state represented by its elites forming interest groups, on the construction of laws, policies, and rules, which can lead to poor governance. Thus, per capita income can increase without improved governance, when the latter does not converge with the interests of the elite.

Mushtaq Khan's Criticism and Theoretical Alternative

As we saw earlier, economists oppose two theses on the role of institutions in the definition and establishment of good governance: the so-called theory of "market enhancing governance" which attributes to the state strictly sovereign functions of justice, police, and compliance with market rules. The state would be the actor who would establish and strengthen the institutional rules, so that the market can operate more efficiently by ensuring the exchange contracts, private property, establishing incentives, and binding rules for the market.

Mushtaq Khan's criticism on relationship between good governance and growth. Several econometric studies of Daniel Kaufmann et al. (1999), Stephen Knack and Philip Keefer (1995; 1997), Robert Barro (1996), Hall and Jones (1999) showed that the variables of good governance, such as control of corruption, stability of property rights or democracy are closely correlated with variables such as GDP growth rate per capita, investment or human capital development. These empirical tests seek to support the first view already cited the relationship between market enhancing governance and economic performance of the countries implementing it. The purpose of these studies is to show that improved indices of "good governance" have positive effects on economic growth and provide long-term convergence with the so-called developed countries.

Among the precautions taken by Mushtaq Khan to interpret the results of this literature, the question of temporality is questioned: Indeed, if we want to test the effect of good governance mechanisms on economic growth, it should be taken a reference period of these institutional indicators, in order to study the effects on economic growth for example a decade or two decades later (data collected by Stephen Knack and IRIS began in 1984 and data collected by Daniel Kaufmann and the World Bank began in 1996). Thus, the authors took the choice to study relationship between good governance at the end of the period of economic growth which began in 1984 for Stephen Knack's data or in 1996 for Daniel Kaufmann's data. In effect, economic growth period studied is the consequence of political and institutional capabilities developed since the 1950's and 1950's in Asian countries for example. Good governance indicators of the 80s and 90s are thus not correlated to economic growth which results in the same period. There is a gap period to take into account when considering effect of good governance on economic growth; otherwise there is a methodological bias. So this means, according to Mushtaq Khan, that the actual relationship studied and not assumed by authors is that of the effect of economic growth on good governance. However, the dependent variable chosen is that of economic growth! The second problem is to take into account a threshold effect in the step reached by countries in their economic growth: Underdeveloped countries could make efficient good governance policies only after a period of learning in state capabilities and after reaching a level of development, so that enhancing good governance indicators could generate better economic growth rates.

Other theoretical difficulties highlighted by Mushtaq Khan. The series must select low and high economic growth to allow detection of the possible correlation between good governance and growth. However, most so-called emerging Asian countries which have successfully developed their economy have experienced strong growth rates from the 1960s through 1980s. However, statistical series of good governance indicators start at best for Stephen Knack in 1984 and the worst for Daniel Kaufmann in 1996. If we assume a strong relationship between good governance and economic growth for these rapidly developing countries, we have a lack of institutional indicators in their early historic period of economic takeoff. The significance of the

correlation cannot be shown as posteriori with indicators of "good governance" for a more recent period of economic growth.

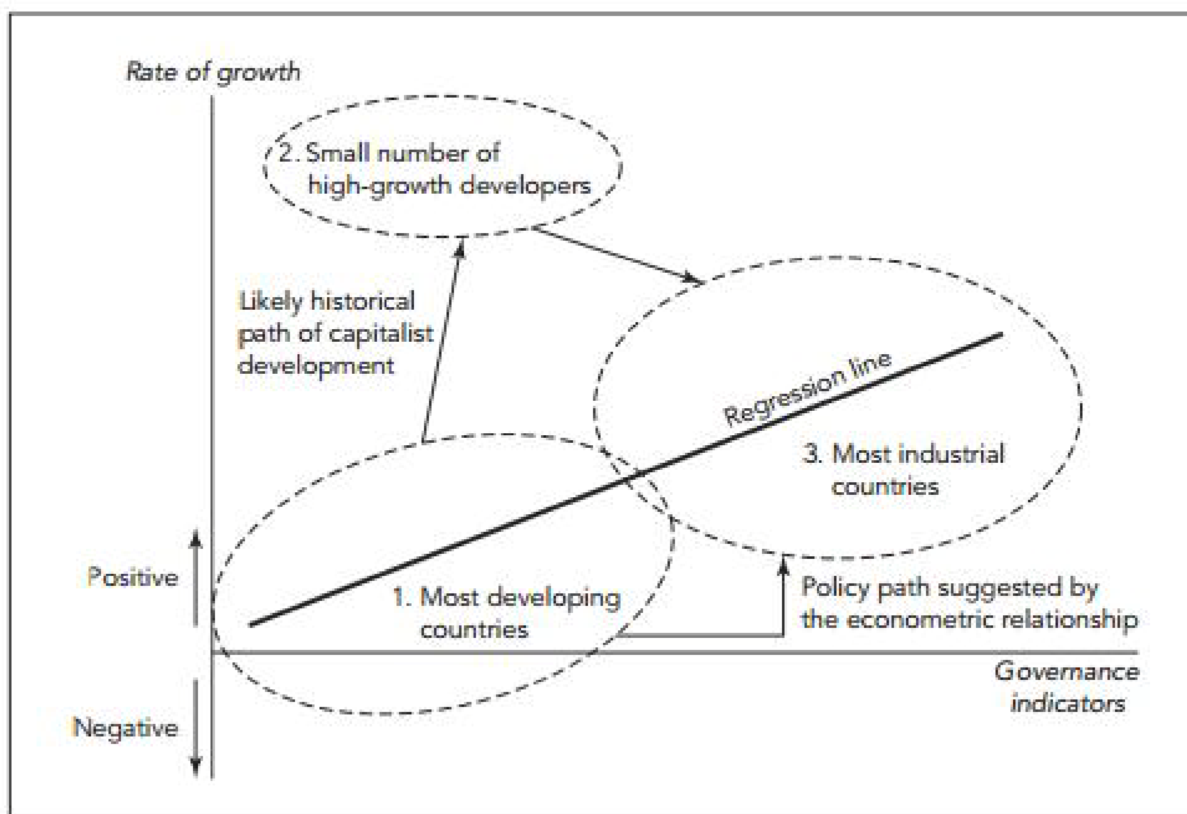

Figure 1. Interpreting the evidence on governance and development (Source: M. Khan, State failure in developing countries and strategies of institutional Reforms, SOAS, 2004).

Furthermore, the number of years' observed in order to make a robust econometric test is not sufficient to explain the performance in terms of economic growth for emerging countries of the Asian region in particular and enable better understanding of the institutional mechanisms for their economic success.

Another major obstacle is that the levels of the indicators of good governance, although available over the recent period only, do not show a significant difference between fast-growing countries and countries with slow growth. In other words, good governance of fast developing countries does not differ significantly from that of low developing countries. Although we can establish a significant correlation between good governance and economic growth, the level of fast-growing countries indicators do not converge to the so-called developed countries.

Here is an illustration of non-disparity in the results of good governance among countries in slow and rapid development indices obtained during the panel econometric studies of IRIS and the World Bank:

The empirical results of Stephen Knack and Daniel Kaufmann reveal a strong correlation between good governance and GDP growth rate per capita, without convincing that the level of institutional indicators of fast developing countries can converge with that of developed countries. We can therefore conclude that the enhancing of good governance cannot be a guarantee of GDP per capita growth and vice versa; the GDP per capita growth can allow improving governance without guaranteeing that its level may converge with that of

developed countries. So, it must be inferred that other factors may explain at once the growth of GDP per capita and the improvement of good governance indicators.

Conclusion

The analysis above is a contribution to the debate on institutional conditions for economic take off in developing countries. The argument of the neo-institutional economists is that improving indicators of good governance is a necessary condition for creating the institutional conditions of lowering transaction costs and thus a competitive market is conducive to increasing the efficiency in the allocation of resources and the pace of economic growth. However, this thesis supported by econometric work of Daniel Kaufmann and Stephen Knack was criticized by Mushtaq Khan especially since the good governance of fast-growing developing countries indicators are not significantly different from those of low-growth countries. The thesis of economic catch-up in developing countries by improving good governance index is weakened by this.

The thesis is more efficient when it comes to carry out economic reforms and improve governance indices and to improve the operation of an existing market economy as in the specific case of developed countries. Nevertheless, this occults in developing countries, structural and institutional conditions in creation of a market economy and a capitalist economic system which implies a major social transformation and the emerging of formal and informal institutional framework. In this issue, the role of the state is crucial in order to drive economic development: State must acquire skills to orient capital into economic sectors with high added value and increase productivity. Khan developed for this purpose the concept of "political settlement" that is stable and consistent relationship between the distribution of political power, an institutional framework and economic growth in a country. Instead of "good governance" as a condition for economic growth, Khan replaces it by the notion of governance seen as redistribution of power to a stable political coalition whose interests coincide with those of the reform and restructuring of the economy, sources of growth and economic and human development.

So, economic growth and takeoff in developing countries can not only be explained by good governance indicators as given by institutional authors. Taking into account the complexity of the issues, including search and economic rent seeking in the relations between political power and coalitions functioning of the economy requires to develop a broader analysis of the concept of good governance to better understand the role of political and institutional factor in economic development.

References

Acemoglu, D., Johnson, S., & Robinson, J. A. (2001). The colonial origins of comparative development: An empirical investigation. *American Economic Review, 91*(5), 1369-1401.

Barro, R. J. (1991). Economic growth in a cross section of countries. *Quarterly Journal of Economics, 106*, 407-433.

Barro, R. (1996). Democracy and growth. *Journal of Economic Growth, 1*(1), 1-27.

Bardhan, P. (1997). Corruption and development: A review of issues. *Journal of Economic Literature, 35*(3), 1320-1346, 26.

Clague, C., Keefer, P., Knack, S., & Olson, M. (1997). Institutions and economic performance: Property rights and contract enforcements. In Clague (Ed.), *Institutions and economic development* (pp. 67-90). Baltimore: John Hopkins Press.

Edison, H. (2003, June). Qualité des institutions et résultats économiques: Un lien vraiment étroit? In *Finances et développement* (pp. 35-37). Washington DC: International Monetary Fund.

Egger, E., & Winner, H. (2005). Evidence on corruption as an incentive for foreign direct investment. *European Journal of Political Economy, 21*, 932-952.

Hall, R., & Jones, C. (1999). Why do some countries produce so much more output per worker than others? *Quarterly Journal of Economics, 114*(1), 83-116.

Hammadache, A., & Mira, R. (2013). Relationship between good governance and economic growth in emerging countries. A descriptive and empirical studies. In *Workshop in CREAD* (p. 73). Algiers, Algeria: ALgier's University.

Khan, M. (1995). State failure in weak states: A critique of new institutionalist explanation. In J. Harris and C. Lewis (Eds.), *The new institutional economics and the Third World development* (pp. 71-86). London: Routledge.

Khan, M., & Jomo, K. S. (dir.) (2000). *Rents, rent-seeking and economic development, theory and evidence*. Cambridge: Cambridge University Press.

Khan, M. (2004a). State failure in developing countries and strategies of institutional reform. In B. Tungodden, N. Stern, and I. Kolstad (Eds.), *Toward pro-poor policies. Aids institutions and globalization* (pp. 165-195). Oxford University Press and World Bank.

Khan, M. (2004b). Strategies for state-led social transformation: Rent management, technology acquisition and long-term growth. In *Hanoi, ADB Workshop on Making markets work better for the poor* (pp. 8-13). Philippines: Asian Development Bank.

Khan, M. (2005). The capitalist transformation. In K. S. Jomo and E. S. Reinert (Eds.), *The origins of development economics: How schools of economic thought have addressed development* (pp. 1-17). London: Zed Press.

Khan, M. (2007). Governance, economic growth and development since the 1960s. *DESA Working Paper, No. 54*. London: London University SOAS.

Khan, M. (2009a). Political settlements and the governance of growth-enhancing institutions (draft paper, London University SOAS).

Khan, M. (2009b, July). Governance capabilities and the property rights transition in developing countries. In *Working Paper* (p. 105). London: London University SOAS

Khan, M. (2009c). Bangladesh: Partitions, nationalisms and legacies for state—building. *Research Paris AFD—London University SOAS, agreement No. 181*. London: London University SOAS

Kaufmann, D., Kraay, A., & Zoido-Lobaton, P. (1999). Aggregating governance indicators. *World Bank Policy Research, Working Paper, 2196*. Washington DC: World Bank Institute.

Kaufmann, D., Kraay, A., & Zoido-Lobaton, P. (2000, June). Governance matters, from measurement to action. *Finance & Development, IMF, 37*(2), 4.

Kaufmann, D., Kraay, A., & Zoido-Lobaton, P. (2002). Governance matters II-updated indicators for 2000/01. *World Bank Policy Research Department, Working Paper, no. 2772.* Washington DC: World Bank Institute.

Kaufmann D., & Kraay, A. (2003, February). Governance and growth: Causality which way? Evidence for the world. *World Bank, Working Paper.* Washington DC: World Bank Institute.

Kaufmann, D., Kraay, A., & Mastruzzi, M. (2005). Governance matters IV: Governance Indicators for 1996-2004. *Policy Research Working Paper Report No. 3630.* Washington DC: World Bank Institute.

Knack, S., & Keefer, P. (1995). Institutions and economic performance: Cross-country tests using alternative institutional measures. *Economics and Politics, 7*, 207-227.

Knack, S., & Keefer, P. (July 1997). Why don't poor countries catch up? A cross-national test of an institutional explanation. *Economic Inquiry, 35*(3), 590-602.

North, D. (1990). *Institutions, institutional change and economic performance.* Cambridge: Cambridge University Press.

Rodrik, D. (1995). Getting interventions right: How South Korea and Taiwan grew rich. *Economic Policy, 10*(20), 53-107.

Rodrik, D. (1998, January). Democracy and economic performance. In *Conference on Democratization and Economic Reform in South Africa, Cap Town* (p. 17). Harvard University, December 1997.

Rodrik, D., Subramanian, A., & Trebbi, F. (2002, October). Institutions rules: The primary of institutions over geography and integration in economic development. In *Harvard Development Seminar and MIT Econometrics Workshop* (p. 4). Harvard: Harvard University.