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# Governance and development outcomes: chicken and egg

*Development trajectories of countries within the Asia-Pacific region vary significantly across countries. While some countries have experienced tremendous advancements in terms of economic and social indicators, others have not been quite as successful. Historical and cultural differences may explain part of the different development experiences of countries in the region. Yet, there is no doubt that the quality of governance and the effectiveness of public institutions are critical factors that contribute positively to the process of development.*

*Indeed, it is universally accepted and incorporated into the 2030 Agenda that more effective, accountable and inclusive institutions (SDG 16), and gender equality and the empowerment of women and girls (SDG 5) are important for development.*

## Governance and development: a two-way relationship

While the empirical and theoretical literature emphasizes mostly the importance of governance for development, it is worth noting that the relationship between governance and development is a two-way relationship.[1,2,3] For instance, better governance can also be the result of economic growth through the emergence of a middle class which seeks better institutions to safeguard their assets and interests. A better educated population would desire accountable and transparent institutions. As a result, governance and development are improved concomitantly, and a long period of time may be required to observe significant changes in governance; particularly in the level of development is low. This policy brief aims at explaining mechanisms through which governance is affected by the socioeconomic conditions, and vice-versa. Finally, it stresses the existence of a virtuous cycle between governance and development. This policy brief aims at providing only an overview of literature on the governance-development nexus.

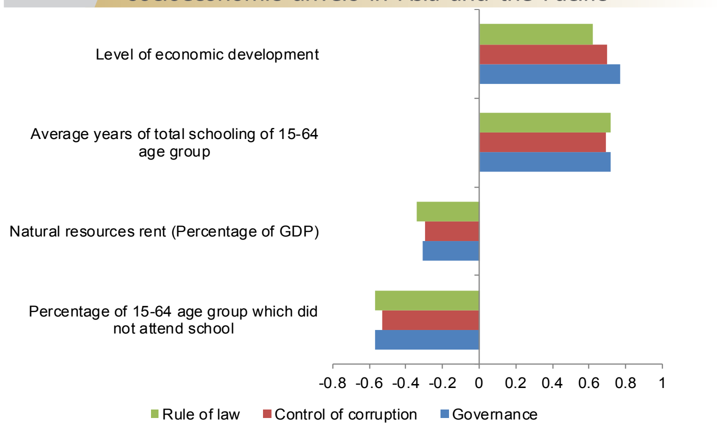
## Explaining governance by socioeconomic factors

Differences in levels of institutional quality and changes over time can be explained by a host of economic, social and political factors. Some theories suggest that cultural factors are also relevant.[4,5,6,7]

Regarding economic factors, it has been suggested that economic development, associated with higher income and education levels, goes hand in hand with greater demand for effective governance and better institutions. As incomes increase or people accumulate more assets, they expect better protection of their property and expect their Government to be more efficient in the delivery of public services or goods.[4,5] An educated population is more likely to notice government abuses and to identify government inefficiencies.[8] Similarly, higher levels of education among civil servants could, for instance, contribute to a reduction in corruption.[9] In figure 1, it is confirmed that in Asia-Pacific countries, better governance is associated with higher levels of development, at least in terms of income and education.

Similarly, the existence of natural resource rents can erode the overall institutional quality of a country by contributing to higher levels of corruption.[10,11] The adverse relationship of natural resource rents with corruption is related to the fact that the market structure of natural resources is often oligopolistic and the high degree of "regulatory discretion" provides grounds for the implementation of policies, which favour private interests at the cost of public welfare. Researchers have also highlighted that the origin of public revenues (tax versus non-tax revenues) shapes government institutions and the "professionalization" of the administration. This is because a high level of tax revenues, relative to non-tax

Figure 1. Correlation between governance and potential socioeconomic drivers in Asia and the Pacific




*Source:* Author, based on data from the World Development Indicators (WDI) database; the Worldwide Governance Indicators (WGI) are from Kaufmann, Kraay and Mastruzzi, "The worldwide governance indicators: methodology and analytical issues", Policy Research Working Paper, No. 5430 (Washington, D.C.: World Bank, 2010).

revenues, calls for greater accountability of Government in the management of fiscal policy. In the Asia-Pacific region, the availability of natural resources, measured as natural resource rent as a percentage of GDP, is negatively correlated with governance indicators (figure 1).[12]

In terms of social factors, there is clear evidence that inequality affects governance and vice-versa.[13,14] Theoretical models and empirical analyses show that the quality of institutions can affect inequality, but that the reverse is also possible: "[…] income inequality and poor institutional quality may reinforce each other […]".[13] For example, well-connected and rich people who benefit from poor governance and weak institutions are typically not willing to support institutional change and improve governance in order to safeguard their own interests. At the same time, poor people are left with little choice but to change their social norms to survive within actual institutional settings and governance frameworks. This type of situation results in entrenchment of existing arrangements, making it more difficult to bring about positive change.[14]

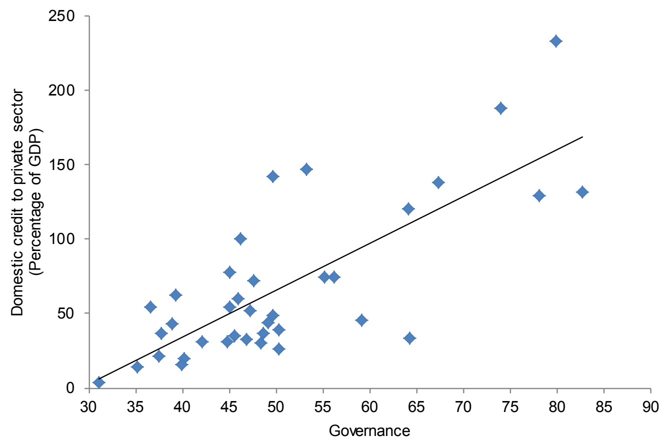
## Impact of governance on development outcomes

Better governance and effective institutions have direct and indirect effects on the achievement of inclusive economic expansion and the transformation of an economy – Sustainable Development Goals 8 (Promote inclusive and sustainable economic growth, full and productive employment and decent jobs for all) and 9 (Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation). Specifically, governance affects the capacities of an economy to improve investment prospects, to innovate and thus increase levels of productivity, and to develop and to have access to a skilled labour force. All three aspects contribute to prospects of sustained economic expansion and thus effective pursuit of the 2030 Agenda. Weak institutions can also reduce the pace of poverty reduction, and contribute to greater inequality (income and opportunities).

Weak institutions and poor governance adversely affect the level of investment by creating operational inefficiencies and encouraging risk-averse behaviour. For instance, corruption is perceived as an additional cost and an unpredictable tax by investors, both domestic and foreign, which does not automatically lead to desired results.[15] Furthermore, large differences between corruption levels in host and home countries can be an impediment to attracting investment[16,17,18] by defining the entry mode of foreign investors and thus reducing their participation. As a result, positive spillover effects from foreign investment inflows are less likely to occur, and it becomes more difficult for countries to transform their economies, to industrialize and to foster innovation by using FDI inflows as an instrument.

In addition to corruption, the rule of law, property rights protection and regulatory quality also affect investors' decisions through, for instance, cases of expropriation without compensation and unfair practices in the application of laws, among others. As weak governance reduce investment and adversely affects development prospects. These elements are particularly important for access to credit, which is a major issue for small and medium-sized enterprises in the Asia-Pacific region.[19] Investment is reduced because of such credit-market imperfections. Credit-market imperfections, such as asymmetry of credit information and limitations of legal systems, negatively affect the capacity to collect defaulted loans or protect debtors' assets.[20] Furthermore, corruption biases the application of rules towards "well-connected" people and thus increases the risk premium faced by "less-connected" people, especially poor people. As a result, potential investments cannot be realized and the productivity of firms is reduced. Figure 2 shows the importance of better governance for the access of firms to loans in Asia and the Pacific.

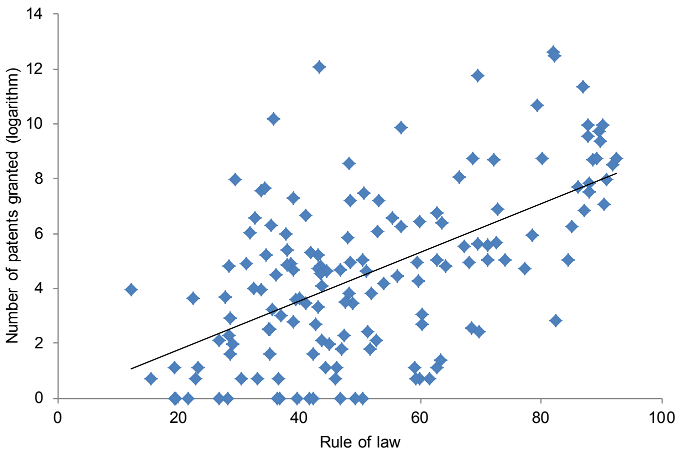
Figure 2. Domestic credit extended to the private sector and institutional quality in the Asia-Pacific region, 2014




*Source:* Author, based on data from the World Development Indicators (WDI) database; the Worldwide Governance Indicators (WGI) are from Kaufmann, Kraay and Mastruzzi, "The worldwide governance indicators: methodology and analytical issues", Policy Research Working Paper, No. 5430 (Washington, D.C.: World Bank, 2010).
*Note:* WGIs have been rebased to 100. High values of the indices represent a good perception of institutional quality. The index "governance" is the average of the four WGIs.

The quality of governance and of institutions also influences the innovative capacities of a country by creating an enabling environment that equips different stakeholders from academia, research institutes, industry and government to collaborate and coordinate their actions. Effective institutions, transparent and enforceable rules and associated administrative infrastructure are required to facilitate

Figure 3. Patents granted (by country of origin) and the rule of law, 2014

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*Note:* WGIs have been rebased to 100. High values of the indices represent a good perception of institutional quality. The index "governance" is the average of the four WGIs.

the interactions of these stakeholders. Rule of law, which governs the management of property rights, protection of intellectual property, settlement of disputes, clarification of existing regulations and usage of public funds, should be concise, transparent and enforceable. In this context, protection of property rights and the existence of an efficient bureaucracy have been found to be important determinants of a higher number of patents in most technologically advanced economies. In the Asia-Pacific region, Malaysia and Singapore are examples of countries that have appropriate regulatory frameworks and a high number of patents per capita. Figure 3 shows that a strong rule of law is positively correlated with the number of patents granted and with innovation capacity.[21] Thus, long-run economic perspectives are better in countries with better institutions.

The impact of governance and the quality of institutions on poverty is partly a result of misallocation of public resources and market inefficiencies. With poor governance and weak institutions, a Government's decision to invest or to hire is more likely to be based on favouritism than public welfare considerations.[22] The same tends to be the case when allocating public resources. In addition, as investment prospects are constrained due to these inefficiencies, sustained expansion of the economy to accommodate a rising population remains below potential. Consequently, there is less investment or misdirected investment in the economy and fewer jobs for poor people. Weak governance is a factor which can contribute to an increase of poverty.

Furthermore, ineffective governance and weak institutions can exacerbate income inequality by making it more difficult for poor and less-well-connected people to easily borrow and invest. Weak enforcement of rules and high asset ownership inequality also contribute to higher risk premiums and lower value of collateral.[23] However, some researchers have also argued that there is an inverted-U shape relationship between governance and inequality: the political Kuznets curve.[24] Initially, an improvement in institutional quality in developing economies results in higher inequality due to the size of the informal sector. Thus, as institutional quality improves, new entrants into labour markets tend to benefit, which in turn translates into a reduction of the relative income of people working in the informal sector.[25]

Empirical analysis also confirms the role of governance in the efficiency and effectiveness of public spending on health and education. For instance, Rajkumar and Swaroop[26] found that higher public health spending is reflected in lower mortality rates while higher public educational expenditure is linked with increases in primary attendance rates in countries with good governance, whereas public spending on health and education has virtually no impact in countries with weak governance. In addition, Sen[27] found that efficient and well-functioning governmental systems in the region positively influence social development outcomes relative to poorly governed ones by increasing the mobilization of domestic resources, such as taxes and increasing the effectiveness of social spending. For instance, in China 40 per cent of respondents to a survey question claimed that corruption was the main source of poor-quality public services.[28]

To conclude, the impact of governance on the level of development can be as important as the impact of the level of development on governance, even though the size and magnitude of those impacts have not been defined and measured simultaneously in the Asia-Pacific region. This situation raises the question of where to start reforms, and how can the general welfare of a society can be increased.

## Governance and development: a policy dilemma?

Governance and Development: A Policy Dilemma?
Answers to the last questions are not evident but there is a single assertion which is clear and universal: the Government has a role to play in moving the development agenda forward. The emphasis of the impact of governance on development can thus be explained in this framework, and it can set the stage for future actions (at the national level) which

can aim at both improving governance and achieving sustainable development. Future analyses will attempt to provide answers to these questions.

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