『国際開発研究フォーラム』19 (2001.10)
Forum of International Development Studies, 19 (October 2001)

ECONOMIC GOVERNANCE AND ECONOMIC PERFORMANCE IN DEVELOPING COUNTRIES

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Abstract

The governance issue has been placed greater emphasis in the development fields since the outbreak of the Asian crisis in 1997, as one of the underlying causes of the crisis. Despite the importance of the issue, the definition, purpose and elements of good governance are not well understood, partly because the subject is qualitative rather than quantitative. This paper attempts to find some commonalities and differences of the definition, purpose and elements of good governance based on discussions in international organizations and suggests that the governance issue might have a negative impact unless properly treated.

As far as impacts of governance on economic affairs (Economic Governance) are concerned, economic governance effects the economy through policy decisiveness, policy predictability, transaction costs and competition although the relationship has several debatable points. Furthermore, as previous studies find, this paper finds there is a positive relationship between economic governance and economic performance such as GDP per capita, Investment and FDI. However, it should be noted that the impacts on economic performance depend on each element of economic governance.

I. INTRODUCTION

The purpose of this paper is to analyze the relationships between economic governance and economic development in developing countries. Since the Asian crisis in 1997, the governance issue has been seriously discussed as one of the underlying causes of the crisis. In fact, economic recovery programs of the crisis-hit countries are designed based on this perception.

Despite the importance of the issue, current discussions on governance are unclear and ambiguous. For example, although East Asian countries were assessed to have achieved good economic governance before the Asian crisis, this positive assessment was suddenly reversed. This sudden reversal in perception itself shows the difficulties and ambiguity inherent in the governance issue. Two problems can arise if this ambiguity is not resolved. One is that the real causes of crises cannot be properly comprehended. Accordingly, the governance discussions may not contribute to the prevention of possible future crises. The other is that policies for economic recovery based on misperceptions and misunderstandings of governance may lead to a delay in recovery or even to another crisis.

Although the Asian crisis intensifies discussions on governance, this paper focuses not only on crises in particular but also on economic performance in general. As pointed out in this paper, the relationship between economic governance and economic performance is not so straightforward as current studies generally suggest. Therefore, as a milestone, an analysis of the relationships between economic governance and economic performance should contribute to a better comprehension of the

causes of crises in the further research. The analysis should also benefit discussions of ways to prevent future crises. This paper mainly attempts to answer the following questions.

(1) What is 'governance' and 'good governance'?
(2) What are the drawbacks in the current governance discussions?
(3) What is 'economic governance' and its relationship to economic policies?
(4) What are the theoretical relationships between economic governance and economic performance?
(5) What are the empirical relationships between economic governance and economic performance?

The composition of this paper is as follows. In the second section, a conceptual framework of good governance is clarified. Discussions that have occurred among several international organizations are drawn upon in order to ascertain commonalties and differences of the concepts, use and background of both governance and good governance. Although there are a lot of studies about governance both in private and public organizations, works by international organizations are particularly comprehensive and provide a guide for comparison. This paper does not attempt to set a clear definition of good governance, because good governance includes value judgements and is interchangeable according to changes in perceived purpose of it. In the third section, the relationships between economic governance and economic performance are discussed. Current studies generally find a positive relationship between economic governance and economic performance. The basic logic behind the positive relationship is that good economic governance attracts investment and capital, which eventually lead to good economic performance. This section attempts to verify this assertion theoretically and empirically. Consequently, this paper casts doubt on the general finding of current studies. Although the governance issue has social, political and economic impact, this paper focuses on the economic impact. Finally, the aforementioned questions are summarized and answered. It should be noted that this paper mainly treats governance within the public sector, although of course the governance issue also relates to the private sector, as in the case of corporate governance.

II. GOVERNANCE AND GOOD GOVERNANCE

1. Governance Discussions in International Organizations

Currently, the governance issue is one of the most fashionable in the field of development studies. However, since the early 1990s the governance issue has been dealt with mainly by international organizations. Despite the importance of this issue, however, there is no established consensus on governance even among international organizations, as each organization has its own definition, interpretation and usage. Moreover, the conceptualization and analysis of governance seems to change according to the evolution of development discourse.

Among international organizations, the World Bank (1992) first discussed the governance issue in the early 1990s (Table 1). The World Bank defines governance as *"The manner in which power is exercised in the management of a country's social and economic resources for development"* (ibid, p.1). Good governance is treated as a synonym for sound development management, which is composed of (1) accountability, (2) the legal framework for development, and (3) information and transparency. Although it is not clearly mentioned, the public sector is the target of the discussion. Accordingly, good governance can be interpreted as sound development management by the public sector. Furthermore, the World Bank lists 6 elements of poor development management and five elements of poor governance.

Table 1: Governance Discussion of the World Bank

Definition of governance	The manner in which power is exercised in the management of country's social and economic resources for development
Purpose	Development
Good governance = Sound development management	(1) Accountability (2) The Legal Framework for Development (3) Information and Transparency
Poor development management	(1) Weak Institution (2) Lack of an adequate legal framework (3) Weak financial accounting and auditing systems (4) Damaging discretionary interventions (5) Uncertain and variable policy framework (6) Closed decisionmaking
Poor governance	(1) Failure to make a clear separation between what is public and what is private, hence, a tendency to divert public resources for private gain (2) Failure to establish a predictable framework of law and government behavior conducive to development, or arbitrariness in the application of rules and laws (3) Excessive rules, regulations, licensing, requirements, and so forth, which impede the functioning of markets and encourage rent-seeking (4) Priorities inconsistent with development, resulting in a misallocation of resources (5) Excessive narrowly based or nontransparent decisionmaking

Source: World Bank (1992) "Governance and Development"

The Asian Development Bank (ADB) defines governance exactly in the same way as the World Bank does (ADB, 1999) (Table 2). Although most of the ADB's frameworks of how to treat governance is quite similar to that of the World Bank, the ADB's discussions have three distinguishing features. First, 'participation' is included in the elements of good governance. Second, the ADB develops the ideas of good governance by listing 6 key areas of governance such as decentralization. Third, the private sector is included in so-called "key areas", as 'corporate governance and public / private interface'.

Table 2: Governance Discussion of the Asian Development Bank

Definition of Governance	The manner in which power is exercised in the management of a country's social and economic resources for development (the way those with power use that power)
Economic Governance	Sound Development Management
Purpose of Governance	Development
Four Pillars of Governance	(1) Accountability (2) Transparency (3) Predictability **(4) Participation**
Six Key Areas of Governance	(1) Participation, Civil Society, Social Capital (2) Law and Development (3) Corporate Governance and Public/Private Interface (4) Governance considerations in Sector and Project Work (5) Core Government Functions at the National Level (6) Decentralization
Universality of Good Governance	Each nation's path to good governance is different, depending on culture, geography, political and administrative traditions, economic conditions, and many other factors…The instrumental nature of governance implies that the four governance "pillars" are universally applicable regardless of the economic orientation, strategic priorities, or policy choices of the government in question.

Source: Asian Development Bank (1999) "Annual Report 1998"

United Nations Development Programme (UNDP) defines governance as "*the exercise of political, economic and administrative authority in the management of a country's affairs at all levels"* (1997, p.ix). As shown in Table 3, UNDP recognizes governance more broadly as compared with the World Bank and the ADB in stating that, *"the definition [of governance] is deliberately broad, comprising the complex alloy of mechanisms, processes, relationships and institutions through which citizens and groups articulate their interests, exercise rights and obligations and mediate differences"* (ibid. p.ix). As such, nine elements are listed in good governance.

Table 3: Governance discussion of United Nations Development Programme

Purpose of Governance	Sustainable Human Development (defined as expanding the choices for all people in society)
Definition of Governance	The exercise of political, economic and administrative authority in the management of a country's affairs at all levels
Governance	Governance comprises the complex mechanisms, processes and institutions through which citizens and groups articulate their interests, mediate their differences and exercise their legal rights and obligations
Exerciser	Governance includes the state, but transcends it by taking in the private sector and civil society
Characteristics of Good Governance	**(1) Participation** **(2) Rule of Law** **(3) Transparency** **(4) Responsiveness** **(5) Consensus Orientation** **(6) Equity** **(7) Effectiveness and Efficiency** **(8) Accountability** **(9) Strategic Vision**
Economic Governance	Decision-making processes that affect a country's economic activities and its relationships with other economies

Source: UNDP (1997) "Governance for sustainable human development"

2. Arguments on Good Governance from Discussions of International Organizations

A comparison among three international organizations reveals discrepancies in definition and elemental framework of good governance. The discrepancies can be seen as evidence of ambiguity within the governance discussion.

(1) Definition of Governance and Good Governance

A core part of the definition of governance can be considered as 'exercises of economic, political and administrative power by the public sector' from discussions of three international organizations. It is important to note that no value judgments are included in this definition. Value judgments clearly separate good governance from governance. For example, the World Bank (1992) defines good governance as 'sound development management', although the term 'sound' is as ambiguous as 'good'. The ambiguity of the term 'good governance' is apparent in the defined elements of good governance in each international organization (Table 4). Accountability, the legal framework for development (predictability and rule of law), and transparency are common. What is new for the ADB is 'participation', and for UNDP 'equity', 'effectiveness' and 'efficiency', and 'strategic vision'. The ADB's four elements currently comprise the most commonly utilized elemental framework for good governance.

Table 4: Elements of Good Governance

World Bank	ADB	UNDP
Accountability	Accountability	Accountability
		Responsiveness
The legal framework for development	Predictability	Rule of law
Information and transparency	Transparency	Transparency
	Participation	Participation
		Consensus orientation
		Equity
		Effectiveness and efficiency
		Strategic vision

Source: Summarized from Table 1-3

The differences in the elements of good governance stem mainly from two sources. One stems from the purpose of good governance. The other stems from the evolution of development discourse. Firstly, the elements of good governance reflect the purpose of it, because good governance is generally recognized as a means or an intermediary factor in the achievement of the ultimate purpose. The World Bank and ADB consider good governance as a means for development, while UNDP considers it as a means for sustainable human development. Although conceptual differences between development and sustainable human development are debatable, the latter can be said to be more human oriented. UNDP has then included 'consensus orientation' and 'equity' within the elements of good governance.

Secondly, the evolution of development discourse has had an impact on the definition of the elements of good governance. After World War II the term 'development' was long synonymous with economic growth. However, economic growth itself has not been able to resolve development issues such as poverty. Inability to resolve development issues has forced to an evolution of development discourse. Participatory development and civil society, for example, became key words in development fields in the 1990s. As a result, participation became one of the elements of good governance. The

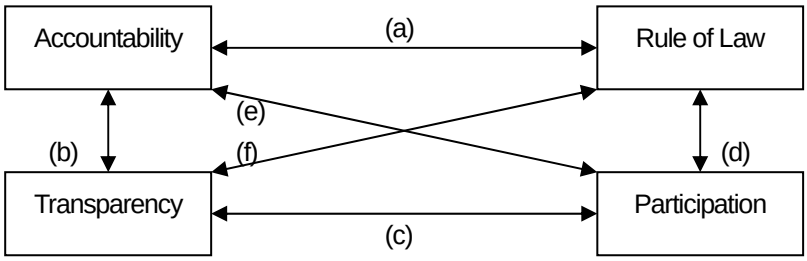
reason that the World Bank (1992) did not include 'participation', while ADB (1999) and UNDP (1997) did include it, is due to this discursive shift.

It should be noted that the definition of good governance is changeable according to changes in perceived purpose of good governance and / or in development discourse. Therefore, setting a concrete definition of good governance seems to be useless, and categorizing common elements of good governance may be more useful in order for 'good governance' to play an active and unambiguous role in the development fields. In this sense, currently, four elements can be defined as core elements of good governance: accountability, rule of law, transparency and participation.

(2) Relationships among Four elements of Good Governance

What are the relationships among these four elements of good governance? As shown in Figure 1, there are six sets of combinations.

Figure 1: Relationships among Four elements of good governance



Source: Author

Each element of good governance can be summarized defined as follows (World Bank, 1992, ADB, 1999, and UNDP, 1997).

(1) Accountability: Public officials are responsible and accountable for their actions.
(2) Rule of law: Legal framework should be fair and enforced impartially, resulting in predictability
(3) Transparency: Access to relevant, reliable and timely information
(4) Participation: All people have a voice in decision-making

UNDP (1997, p.5) states *"core characteristics [of good governance] are mutually reinforcing and cannot stand alone. For example, accessible information means more transparency, broader participation and more effective decision-making* [(b) and (C) in Figure 1]. *Broader participation contributes both to the exchange of information needed for effective decision-making and for the legitimacy of those decisions* [(c) and (d) in Figure 1]. *Legitimacy, in turn, means effective implementation and encourages further participation* [(a) and (d) in Figure 1]. *And responsive institutions must be transparent and function according to the rule of law if they are to be equitable* [(a) and (b) in Figure 1]*".* Also, good governance reduces the incentives for corruption (Broadman and Recanatini, 2000). Transparency enables the public to observe political decisions and improves accountability and reduces corruption ((b) and (c) in Figure 1)(Vishwanath and Kaufmann, 1999).

The governance issue is deemed qualitative rather than quantitative. However, Kaufmann, Kraay and Zoid-Lobaton (1999) constructed the aggregate governance indicators by combining numerous available governance related indicators such as Corruption Perception Index by Transparency

International. The aggregate governance indicators not only cover more than 130 developing countries, but also cover all four core elements of good governance. Kaufmann et al (1999) labels six governance clusters depending on each element of the governance definition (Table 5). Although four elements of good governance and six clusters in Table 5 cannot directly match, each element of good governance is correlated based on Kaufmann's original explanations as follows.

(1) Accountability = Government effectiveness
(2) Rule of law = Rule of law
(3) Transparency = Regulation burden
(4) Participation = Voice and accountability

Table 5: The Aggregate Governance Indicators

Elements of Definition	Cluster	Explanation
The process by which those in authority are selected and replaced	Voice and Accountability	Measuring various aspects of the political process, civil liberties, political rights and the independence of media
	Political Instability and Violence	Measuring perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means
The ability of government to formulate and implement sound policies	Government Effectiveness	Measuring perceptions of the quality of public service provision and the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies
	Regulatory Burden	Measuring the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulations
The respect of citizens and the state for the institutions which govern their interactions	Rule of Law	Measuring the extent to which agents have confidence in and abide by the rules of society including perceptions of the effectiveness and predictability of the judiciary, and the enforceability of contracts
	Graft	Measuring the perceptions of corruption

Source: Summarized from Kaufmann, Kraay and Zoid-Lobaton (1999) "Governance Matters" (Washington, World Bank)

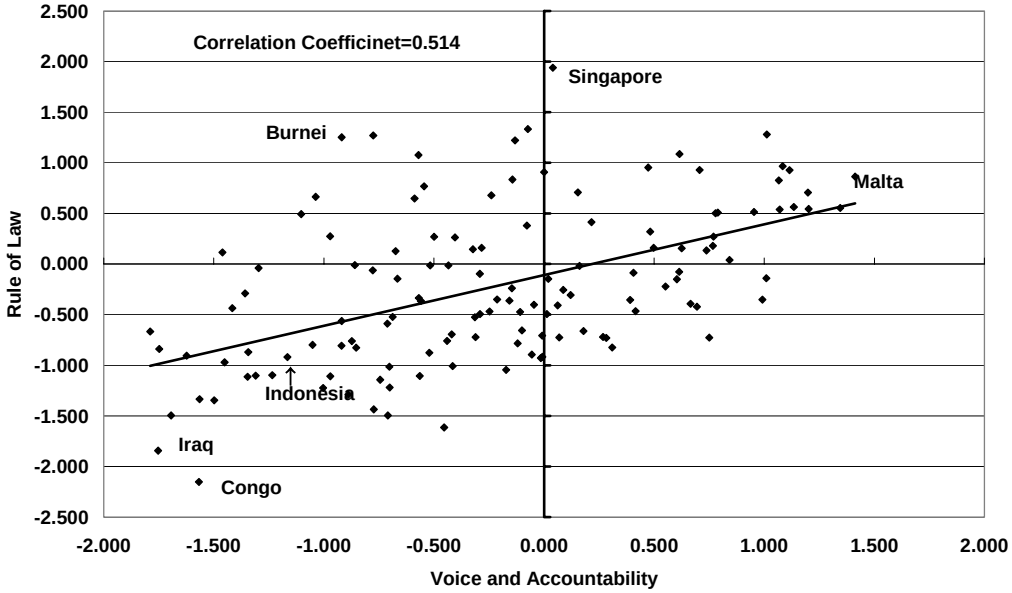
Correlation coefficients among four elements are shown in Table 6. The results reveal that all correlation coefficients are statistically significant. This means that four elements of good governance are closely connected. However, correlation coefficients with 'Voice and accountability' (Participation) are relatively low. In Figure 2, many countries such as Brunei are plotted in the second quadrant. These countries are able to achieve, for example, rule of law without participation or rule of law does not help to improve participation. Although the importance of participation cannot be denied, it can be surmised that participation is rather an independent element of good governance.

Table 6: Correlation coefficients among 4 Elements of Good Governance

	GE	RL	RB	VA
Government effectiveness (GE)(Accountability)	1.00	0.80	0.71	0.60
Rule of law (RL)(Rule of Law)	-	1.00	0.67	**0.51**
Regulatory Burden (RB)(Transparency)	-	-	1.00	0.68
Voice and accountability (VA)(Participation)	-	-	-	1.00

Source: Summarized from Kaufmann, Kraay and Zoid-Lobaton (1999) "Governance Matters" (Washington, World Bank)

Figure 2: Voice and Accountability & Rule of Law



Source: Calculated from Kaufmann, Kraay and Zoid-Lobaton (1999) "Governance Matters" (Washington, World Bank)

(3) Poor Development Management and Poor Governance

Among international organizations, only the World Bank (1992) treats the negative sides of governance enthusiastically. It seems strange that although the World Bank asserts good governance is synonymous with sound development management, the Bank clearly separates poor development management and poor governance.

A comparison between poor development management and poor governance in Table 7 reveals that elements of both categories are quite similar. However, if closely watched, poor development governance is related to 'system', while poor governance is related to 'implementation'. For example, the first element of poor governance is quite similar with the definition of corruption, which is the use of public or private office for private gain.

Table 7: Poor Development Management and Poor Governance in the World Bank Discussion

Poor development management	(1) Weak Institution (2) Lack of an adequate legal framework (3) Weak financial accounting and auditing systems (4) Damaging discretionary interventions (5) Uncertain and variable policy framework (6) Closed decisionmaking
Poor governance	(1) Failure to make a clear separation between what is public and what is private, hence, a tendency to divert public resources for private gain (2) Failure to establish a predictable framework of law and government behavior conductive to development, or arbitrariness in the application of rules and laws (3) Excessive rules, regulations, licensing, requirements, and so forth, which impede the functioning of markets and encourage rent-seeking (4) Priorities inconsistent with development, resulting in a misallocation of resources (5) Excessive narrowly based or nontransparent decisionmaking

Source: World Bank (1992) "Governance and Development"

(4) Universality of Good Governance and Political Intervention

Whether the concepts of good governance are universal and, applicable to all countries, is one of the most important agendas for developing countries with scarce economic and financial resources. International organizations generally advocate the universality of good governance, though they to some extent respect cultural, social, political and economic differences. For example, the ADB (1999, p.18) states *"the instrumental nature of governance implies that the four "pillars"* [accountability, transparency, predictability and participation] *are universally applicable regardless of the economic orientation, strategic priorities, or policy choices of the government in question".*

It may be inevitable that developing countries in general have to deal with assessments from international communities. In other words, characteristics of each developing country tend to be undermined. In this situation, most developing countries have no choice but to deal with the assessments of international communities due to different bargaining power even if there are disagreements about the interpretations of good governance. For example, the IMF's economic reform program towards Indonesia places a lot of attention on the governance issue in the areas of financial sector reform and decentralization. The Indonesian experience reveals that when the governance issue is questioned by the IMF, threats are made not to disburse the IMF funds, which, in turn, lead to the loss of international creditworthiness and cause the depreciation of the currency, stock prices and capital outflows. Therefore, even if there are disagreements between a developing country and international organizations and/or bilateral donor developed countries, it is inevitable that the discussions may converge on international organizations.

Furthermore, although one of the most important principles of international organizations is that they do not intervene and are not affected by political regimes of recipient counties, this principle is challenged by some scholars. For example, Frischtak and Atiyas in Dhonte and Kapur (1996, p.9) asserts that *"the World Bank documents have used the concepts of governance to capture and define the interests of both the World Bank and other international institutions in the political and institutional factors effecting structural adjustment"*. And Clark (1999, p.33) states *"In modern times, the rule of law has also been used either as a synonym for democratic government, or at least linked to it".*

The convergence on the discussions of international organizations and the fear for political intervention may lead to misunderstanding of the governance issue and/or mis-implementation of a policy direction. Moreover, if people and/or governments of developing countries perceive the convergence of the governance discussions as political intervention of international organizations and/or donor countries, the promotion of good governance may have a negative impact on developing countries through, for example, nationalist movements.

III. ECONOMIC GOVERNANCE AND ECONOMIC PERFORMANCE

1. DEFINITION OF ECONOMIC GOVERNANCE AND IMF PERSPECTIVES

Although the governance issue has social, political and economic dimensions and they are interlinked, the main concern of this paper is how the governance issue effects economic performance. UNDP (1997) defines economic governance as decisionmaking processes effecting economic activities and relations with other economies, while Dhonte and Kapur (1996, p.1) define economic governance as "*capability of government to achieve stable economic conditions".* Here, economic governance generally means that it is a subset of governance which effects economic affairs. As with the definition of governance, economic governance itself does not have value judgments. Accordingly, elements of good

economic governance can be the same as the four elements of good governance discussed above: accountability, rule of law, transparency and participation.

Among international organizations, the International Monetary Fund (IMF) treats good governance from economic perspectives. The IMF's points are summarized in Table 8. The purpose of good governance for IMF is economic efficiency, macroeconomic stability and sustainable growth. As such, the IMF's good governance in related to surveillance to macroeconomic policies.

Table 8: Good Governance Discussions in the IMF

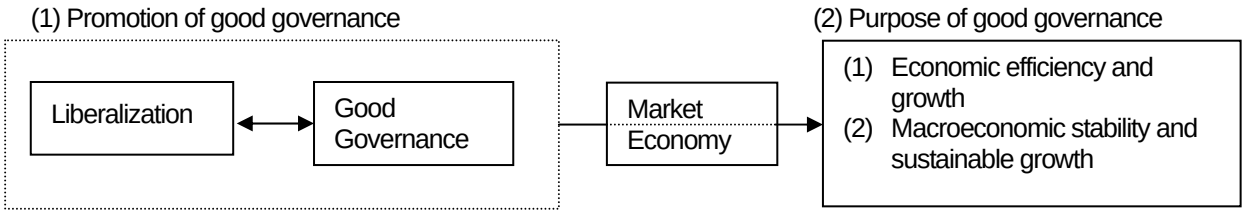
Subject	Points
Purpose of good governance	Economic efficiency and growth Macroeconomic stability and sustainable growth
Universality of good governance	Governance issues are relevant to all member countries, although the problems differ depending on economic systems, institutions, and the economic situation.
Good governance	Relating to surveillance over macroeconomic policies (1) The **transparency** of government accounts; (2) The **effectiveness** of public resource management; (3) The stability and **transparency** of the economic and **regulatory environment** for private sector activity.
Promotion of good governance	(1) Limit the scope for ad hoc decision making, for rent seeking, and for undesirable preferential treatment of individuals or organizations (Measures: liberalization of the exchange, trade, and price systems, and the elimination of direct credit allocation) (2) Enhance their (member countries) capacity to design and implement economic policies, in building effective policymaking institutions, and in improving public sector accountability (3) Promote transparency in financial transaction sin the government budget, central bank, and the public sector more generally, and has provided assistance to improve accounting, auditing, and statistical systems
Political intervention and good governance	The IMF's adjustment should not be influenced by the nature of a political regime of a country, nor should it interfere in domestic or foreign politics of any members…Nevertheless, the IMF needs to take a view on whether the member is able to formulate and implement appropriate policies…As such, it is legitimate for management to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation.
Economic impacts of good governance	The potential risk that poor governance could adversely affect private capital inflows and investment- even in countries enjoying relatively strong growth and private capital inflows- should also be brought to the attention of the authorities.

Source: IMF (1997) "Good Governance: The IMF's Role" (Washington, IMF)

One of the most important aspects of the IMF discussion is its ideological bias towards liberalization. The IMF's logic of good economic governance and economic performance is shown in Figure 3. Liberalization economic policies are measures to promote good economic governance. They are interrelated and, in turn, enable the achievement of economic efficiency, macroeconomic stability and sustainable growth through the forces of market economy.

As far as the universality of good economic governance is concerned, the IMF is of the position that *"governance issues are relevant to all member countries, although the problems differ depending on economic systems, institutions, and economic situation"* (IMF, 1997, p.6). Therefore, developing countries, especially those under the IMF's financial supports such as the crisis-hit Asian countries, have no choice but to follow liberalization economic policies to promote good governance as shown in Figure 3.

Figure 3: IMF's Logic of Good Governance and Economic Performance

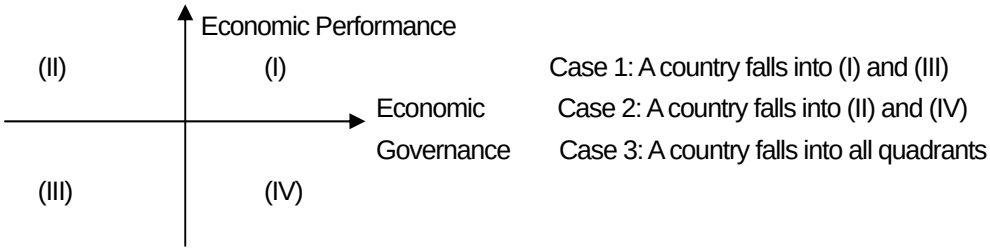


Source: Adapted by the Author from IMF (1997)

2. THEORETICAL REVIEWS OF THE RELATIONSHIPS BETWEEN ECONOMIC GOVERNANCE AND ECONOMIC PERFORMANCE

There are three sets of relationships between economic governance and economic performance: (1) a positive correlation, (2) a negative correlation, and (3) no significant correlation. In Figure 4, the farther right on the horizontal axis, the better the economic governance. This higher the vertical axis, the better the economic performance. If there is a positive correlation between economic governance and economic performance, countries tend to fall into the (I) and (III) quadrants, while if there is a negative correlation countries tend to fall into the (II) and (IV) quadrants. In the case of no significant correlation, countries scatter into all quadrants randomly.

Figure 4: Economic governance and performance



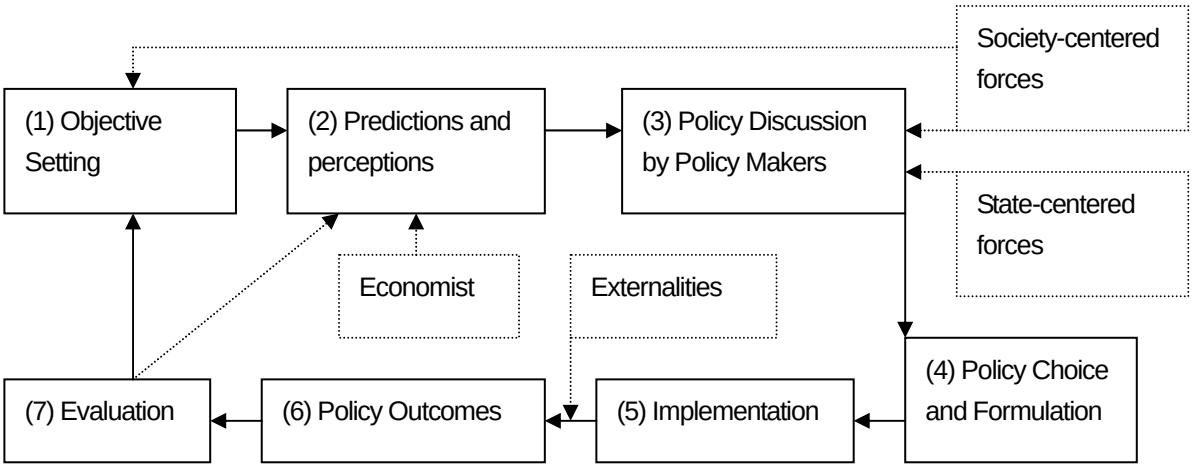
(1) How does economic governance determine economic performance? (Literature Review)

Current studies generally conclude that there is a positive correlation between economic governance and economic performance in two ways. Good economic governance has a positive impact on economic performance, while poor economic governance has a negative impact on economic performance. Investments and capital flows are two main sources that influence a country's economic performance - implying that larger investment and capital flow lead to better economic performance. There are four key factors that connect economic governance with, investments and capital flows. They are (1) policy decisiveness, (2) policy predictability, (3) transaction costs and (4) competition.

It might be clearer to explain the four key factors with Figure 5 which shows the relationship between economic policies and the economy. There are seven main components: (1) objective setting, (2) predictions and perceptions, (3) policy discussions by policy makers, (4) policy choice and formulation, (5) implementation, (6) policy outcomes, and (7) evaluation. As described in Figure 5, the relationships between economic policy formulation and the economy is a circular process rather than a linear one. Objectives are set and predictions and prescriptions are made with the help of economists. Based on policy predictions and prescriptions, policy makers' discussions are carried out. In this process,

society-centered forces such as interest groups and voters and state-centered forces such as state interest have influence (Meier, 1995). Policies are chosen and formulated. Although certain economic policies lead to policy outcomes, the outcomes are also products of externalities. Finally, an evaluation of outcomes affects the next round of objective setting.

Figure 5: The Relationships between Economic Policy Formulation and The Economy



Source: Modified from Meier (1995, p.581)

In order for the relationships between economic policy formulation and the economy to function successfully (in other words whether the process contributes to economic development), good economic governance is essential. One of the keys to objective-setting is understanding how opinions of society-centered forces such as public interests can be reflected. This is related with 'participation'. And predictions and perceptions are inseparable from 'transparency', because without transparency and necessary information it is impossible to make predictions and define perceptions properly. During the policy choice and formulation phase, accountability is vital and successful implementation cannot be expected without rule of law, as institutions and individuals cannot react to policies.

The four factors (policy decisiveness, predictability, transaction costs, and competition) are essential to attract investors. MacIntyre (1999, p.145) asserts ""*Policy decisiveness is concerned with the extent to which political institutions promote qualities, such as efficiency in policy making and implementation or the ability to make and carry out difficult but necessary policy decisions in a timely fashion*". Broadly, policy decisiveness covers (1) to (5) elements in Figure 5, though in a narrow sense policy decisiveness is limited to objective setting ((1) in Figure 5). In that policy decisiveness can be labeled 'specificity'. Specificity is composed of specifying objectives, methods, and controlling achievement, and foreseeing impacts on participants (Israel, 1989). How does policy decisiveness effect investors? It depends on whether certain economic policies have a positive impact on the interests of the investors. Generally, if an economic policy is perceived to have a positive impact on economic development, investors are attracted because overall rates of return on the economy are increased.

Policy predictability is synonymous with an investor's confidence in the ability of a government to adhere to its commitments (MacIntyre, 1999) and with a key factor of predictability (Dhonte and Kapur, 1996). In relation to elements of good economic governance, policy predictability is closely connected with 'rule of law'. A system based on rule of law is defined, *"government in all actions is bound by rules*

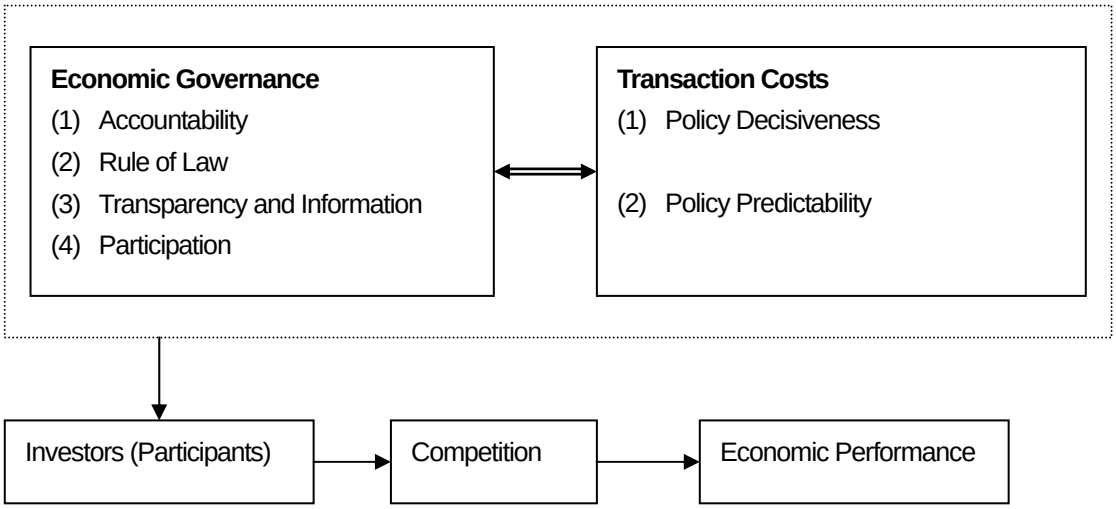
fixed and announced beforehand- rules which make it possible to foresee with fair certainly how the authority will use its coercive powers in giving circumstances and to plan one's individual affairs on the basis of this knowledge" (Hayek, 1994 in Dhonte and Kapur, 1999). Why is a system based on rule of law essential to attract investors? Investor's decision-making, especially the private investors, generally depends on costs and benefits evaluation following the principle of profit maximization and cost minimization'. Calculation and evaluation of benefits and costs cannot be done without policy predictability. If a government is not committed to its economic policies, uncertainty prevails regardless of attractiveness of economic policies. The World Bank (1992, p.28) mentions "*some elements of the rule of raw are needed to create a sufficient stable setting for economic actors…to assess economic opportunities and risks to make investments".*

Transaction costs are the most commonly utilized gauge of how economic governance effects economic performance (e.g. World Bank (1997), North (1990)). For example, North (1990) asserts *"institutions affect the performance of the economy by their effect on the costs of exchange and production"* (1989, p.5) and *"the costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchange and the cost of protecting rights and policing and enforcing agreements"* (ibid, p.27). The latter part of North's assertion focuses on the importance of information costs, in other words transparency, which is also one of the core elements of good economic governance. Also, protecting rights, policing and enforcing agreements are aspects of rule of law. Regarding the relationships between policy decisiveness, policy predictability and transaction costs, policy decisiveness and predictability can be considered as subsets of transaction costs as decisiveness and predictability determine transaction costs.

Competition is regarded as a broad framework of incentives (Israel, 1989). It is defined: *"it entails a large number of participants who are well informed and act independently from each other, without any power to influence the price of inputs and outputs, who have easy entry to or exit from the market, and who have homogenous products"* (Israel, 1989, p.89). Advantage of competition has been widely discussed especially among neo-liberals, as competition is prerequisite for functioning of markets, which in turn allocate resources efficiently.

The relationships between economic governance, transaction costs, competition and economic performance are summarized in Figure 6. Although competition is one factor effecting economic performance, it is regarded as an intermediate factor between economic governance and economic performance rather than a synonym for economic governance. Elements of good economic governance are closely related to transaction costs (policy decisiveness and policy predictability). Lower transaction costs definitely attract investors. As stated in Israel's definition of competition, a large number of participants is needed for competition to function so as to achieve economic efficiency. It should be noted that competition itself does not necessary attract investors. While as the economy flourishes the overall rates of return become greater, with more severe competition the less expected rates of return shrink.

Figure 6: Economic Governance, Transaction Costs, Competition and Economic Performance



Source: Author

(2) How does economic governance determine economic performance? (Arguments)

Existing studies generally find a positive relationship between economic governance and economic performance through the logic in Figure 6. However, the relationship has several debatable points. These are (1) evaluation of economic governance, (2) theoretical relationships between economic governance, transaction costs, competition and economic performance, and (3) prioritizing how to improve economic governance.

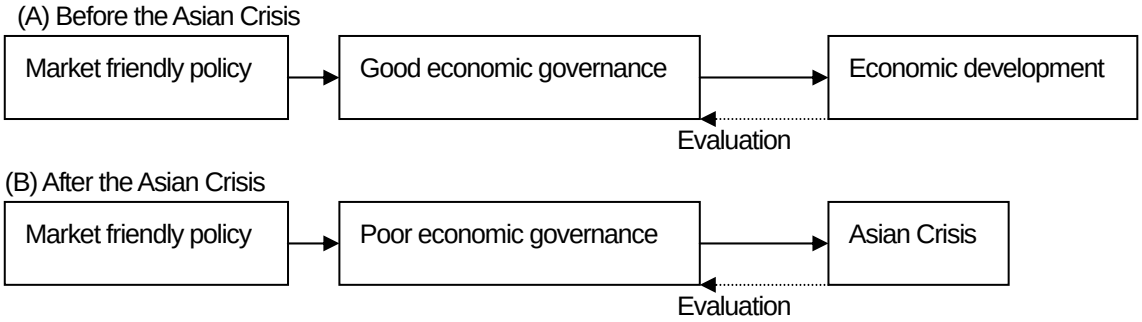
An evaluation of economic governance is difficult given its qualitative nature. As such, good economic governance tends to be evaluated inductively. For example, Dhonte and Kapur (1996, p.9) states *"the capacity to ensure credible economic security provides an important and relevant, though by no means exclusive, benchmark against which economic governance can be evaluated"*. It is further mentioned that 'a secure economic environment' consists of efficient law and order, reasonable macroeconomic stability, political stability and credibility of a government (ibid, 1996). These statements imply that, for example, reasonable macroeconomic stability can be a measure of economic governance. It is understandable that conventional wisdom holds that sustainable economic development cannot be achieved without good governance and poor economic governance eventually leads to poor economic performance and crises. For example, OECD (1998, p.2) notes *"there is also a growing recognition that the current world financial crisis stems from weakness in the institutions of governance, and that durable solutions to this crisis need to address these governance problems"*.

However an inductive evaluation of economic governance may ignore several analytical points. For example, even if macroeconomic indicators are utilized for measuring economic governance, inconsistency among macroeconomic indicators should be taken into account. In other words, an arbitrary choice of indicators may distort an evaluation of economic governance. Thirlwall (1999) asserts that a country can achieve higher economic growth rates as long as the country's net debt inflows are positive. If growth rates are taken as a measure for economic governance, a country can be assessed to achieve good economic governance as in 'East Asian Miracle' in the World Bank (1993) even with mounting foreign debts. Furthermore, although conventional wisdom finds a positive relationship between good economic governance and investments, there is no evidence that investors are capable of

assessing economic governance properly.

The Asian crisis is a typical example of a failure in evaluating economic governance. East Asian governments were perceived to have good economic governance in order to maintain prosperous market economy for economic development (e.g. World Bank (1993, 1997)). However, after the crisis the same economic governance of those countries were suddenly accused as one of the causes of the crisis. The change in perception in Figure 7 shows that economic outcomes (economic development or crisis) are basic for evaluating good or poor economic governance. Before the crisis (A in Figure 7), East Asian governments had adopted a market friendly approach and the roles of the governments for economic development were positively perceived. However, after the crisis (B in Figure 7), the combination of this market friendly approach and the crisis labeled the economic governance of those countries as 'poor'.

Figure 7: Evaluation of Economic Governance before and after the Asian crisis



Source: Author

Current studies conclude that policy decisiveness, policy predictability and transaction costs attract investors, which, in turn, generate an efficient economy through competition. However, this logic can be challenged. Policy decisiveness and policy predictability cannot be achieved without elements of good economic governance. For example, even if poor economic governance, such as a lack of accountability and an existence of corruption, is persistent, strong leadership can substitute for good economic governance and investors may believe the country has achieved policy decisiveness and policy predictability. Bribes for corrupted officials are calculable and investors can perceive bribes as costs, although we do not argue that poor economic governance is better than good economic governance. On the other hand, if a country is in a transition period, for example, from an authoritarian regime to a democratic regime, investors may recognize that the period is fragile and unsuitable for investment. To make matters worse and complicated, once the relationship between poor economic governance and attraction of investors becomes pervasive, the relationship tends to be self-enforcing. The self-enforcing relationship is able to contribute to economic performance at least for a certain period, although it is not sustainable. The improved economic performance may mask and distort the economic governance issue. Moreover, competition does not always function to achieve efficiency. Citing the above definition of competition by Israel (1989), investors do not necessary act independently, which lead to 'contagion' or 'a domino effect' in crises.

Although good economic governance is important, it is almost impossible, especially for developing countries, to improve all elements of economic governance at the same time or in a short period of time. In this sense, prioritizing the achieving of good economic governance might be one of the

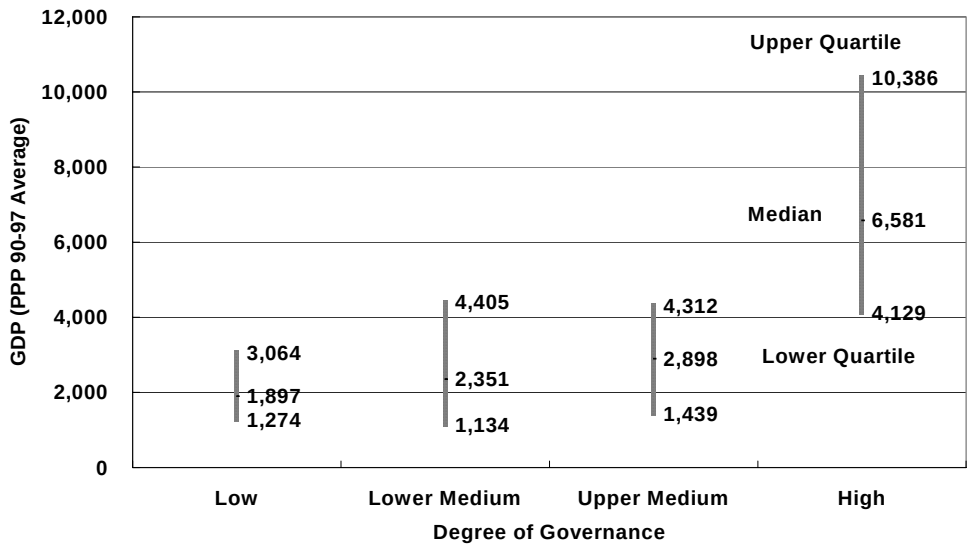
solutions. In comparing policy decisiveness and policy predictability, policy predictability should be tackled before policy decisiveness. This is because even if economic policies are formulated based on good policy decisiveness, potential investors are still reluctant to determine investments without policy predictability. The Indonesian experience reveals this. After the crisis in 1997, Indonesia asked the IMF for financial supports. As the IMF's traditional reform process, the Indonesian government regularly issues the letter of intent (LoI) with consultation with the IMF. The LoI contains the economic policy direction and it is expected to restore investors' confidence. Although Indonesia clearly shows the policy direction in the LoI, it does not work as expected to restore the investors' confidence for two reasons. One is that the Indonesian government is not able to achieve objectives set in the LoI. As a result, enforceability of economic policies and capability of objective setting are questioned. Second, the rule of law, or policy predictability, is considered as one of the most serious problems by investors.

(3) Empirical Relationship between Economic Governance and Economic Performance

Based on the aggregate governance indicators of Kaufmann, Kraay and Zoid-Lobaton (1999), the relationships between aggregate governance indictors and GDP per capita, investments, foreign direct investment (FDI), and debt crises are clarified.

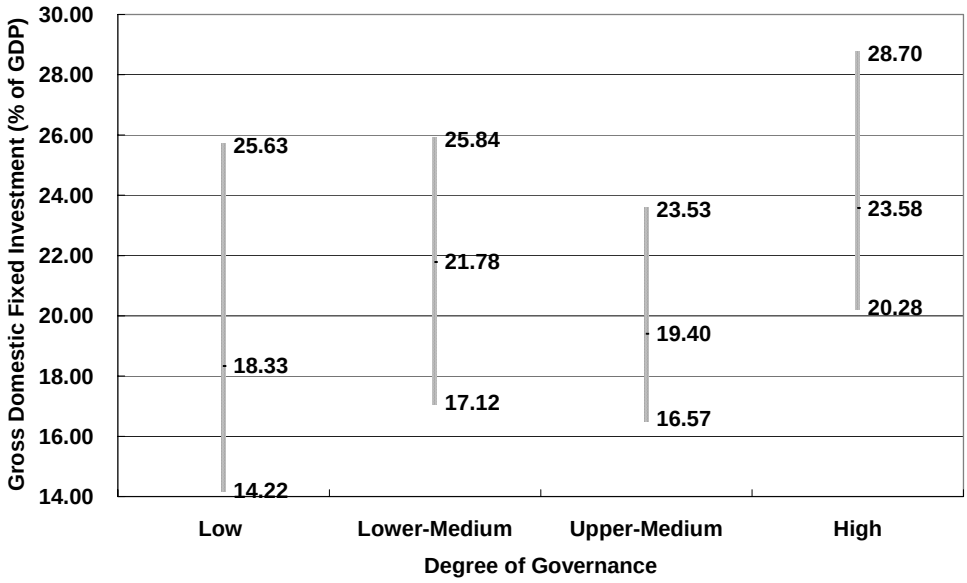
GDP per capita is one of the most commonly utilized economic indicators to measure the degree of economic development. 136 developing countries where data is available are divided into four groups based on the degree of governance, high, upper-medium, lower-medium and low governance countries. GDP per capita is measured by the purchasing power parity basis and an average from 1990 to 1997. Figure 8 illustrates the relationship between economic governance and GDP per capita. It is clear from the Figure that with a better degree of governance comes a higher GDP per capita, although causation is not clear. Here, high GDP per capita is apparent in high governance countries. However, the differences between low, lower-medium and upper-medium governance counties are not very large. This may mean that an improvement of economic governance cannot lead to an improvement of GDP per capita before a certain level of economic governance is attained.

Figure 8: Median GDP per capita and Economic Governance



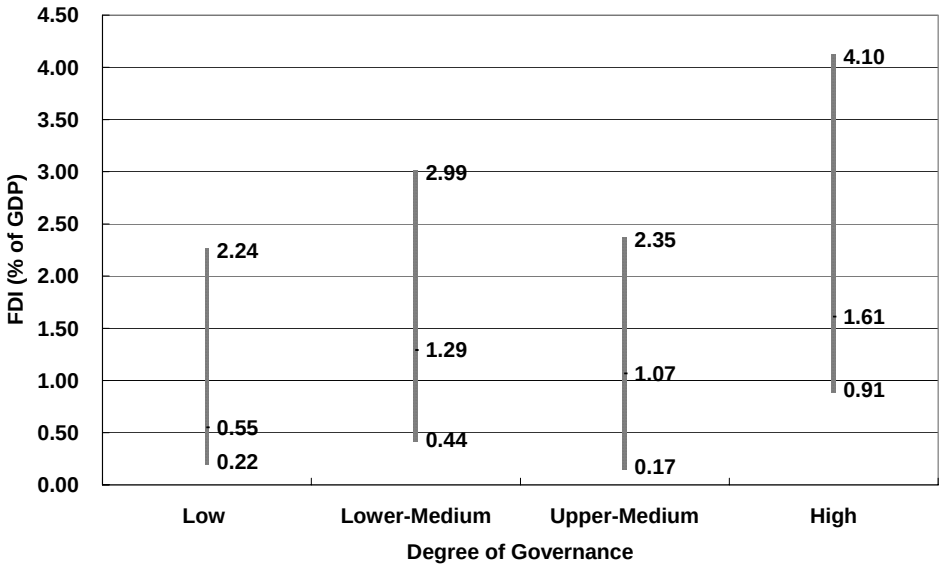
A positive relationship between economic governance and the level of investments measured as a percentage of GDP is utilized in several studies (e.g. World Bank (2000a), Mauro (1997)). Figure 9 illustrates that the better the degree of economic governance becomes the higher gross domestic fixed investment (% of GDP) becomes. Although the relationship is statistically supported, the relationship is more apparent if private and public investments are analyzed separately. Correlation coefficients between economic governance and gross domestic fixed investment are lower than those between economic governance and private investment (% of gross domestic fixed investment). It may be true that public investment tends to be determined regardless of the degree of economic governance. Or as Tanzi and Davoodi (1997) assert, higher corruption is associated with higher public investment.

Figure 9: Median Gross Domestic Fixed Investment (% of GDP) and Economic Governance



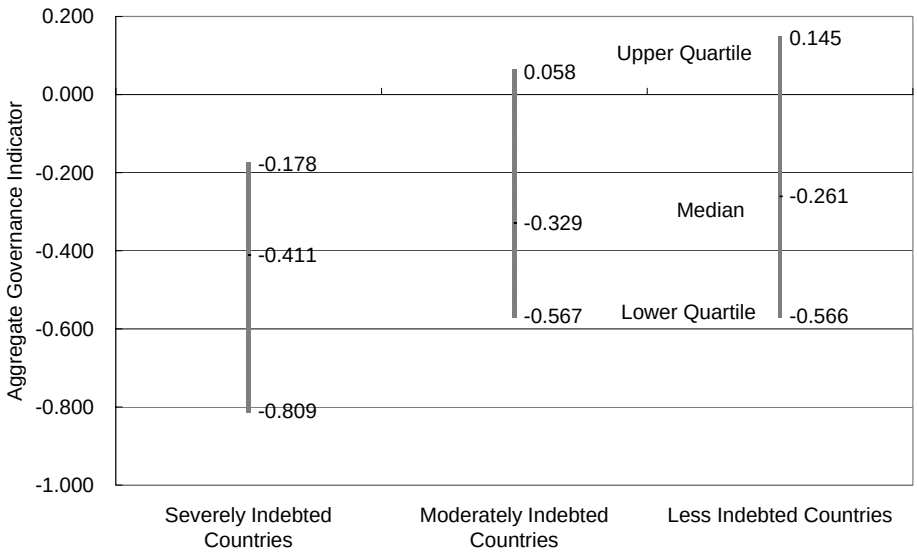
As shown in Figure 10, evidence from 140 developing countries reveals that there is a positive relationship between economic governance and FDI (% of GDP). Although the difference between lower-medium and upper-medium governance countries is not significant, low and high governance countries show a clear picture. Although domestic investments are generally dominant in total investment, a clear difference between low and high governance implies that FDI is more sensitive to the degree of economic governance.

Figure 10: Median FDI and Economic Governance



Aziz, Caramazza and Salgado (2000) state "*financial crises may be grouped into three broad categories: currency crises, banking crises, and foreign debt crises".* They further define foreign debt crises as *"a situation in which a country cannot service its foreign debt, whether sovereign or private"* (ibid, p.6). Although it is not difficult to comprehend the definition of foreign debt crises, it is difficult in reality to judge whether a country is in a situation of foreign debt crisis. As such, in this paper, severely indebted developing countries classified by the World Bank (2000b) are substituted for foreign debt crisis countries. The World Bank (2000b) classifies 45 developing countries as severely indebted, 44 countries as moderately indebted and 49 countries as less indebted. Figure 11 illustrates the aggregate governance indicators based on the classification of foreign debt. The figure shows that the more severe the debt situation becomes, the worse the aggregate governance indicators become.

Figure 11: Median Economic Governance and Debt Classification



The relationships between economic governance and economic performance are different depending on each element of economic governance as shown in Table 9. For example, FDI (% of GDP) is more related to 'regulatory burden', which shows the degree of market-friendly policies, than other elements of economic governance. This may mean that the more a government adopts market-friendly policies, the more foreign investors are attracted to it. On the other hand, 'voice and accountability' that measures the degree of participation has little to do with FDI. This suggests that although economic governance effects economic performance, each element of economic governance has a different impact on the different types of economic indictors.

Table 9: Correlation Coefficients with Elements of Economic Governance

	VA	PL	GF	RB	RL	CC	Average
GDP per capita (PPP, 90-97Ave)	0.21**	0.42**	0.50**	0.36**	0.59**	0.57**	0.52**
Investment (% of GDP)	0.06	0.04	0.08	0.17	0.12	0.15	0.12
Private Investment (% of Investment)	0.23*	0.22*	0.22*	0.27**	0.28**	0.26**	0.30**
FDI (% of GDP)	0.04	0.05	0.07	0.22*	0.08	0.12	0.11

VA=Voice and accountability, PL=Political stability/ Lack of violence, GF=Government effectiveness, RF=Regulatory burden, RL=Rule of law, CC=Control of corruption

Coefficients significance at the 1% and 5% level of significance are indicated with a **, and *

Empirical analysis in this paper suggests that the relationship between economic governance and economic performance is not so straightforward as current studies generally find. There are mainly the following three possibilities behind: (1) The degree of economic governance is not a dominant determinant of economic performance, (2) Causation between economic governance and economic performance is not clear, and (3) Each element of economic governance has a different impact on the different types of economic indicators.

IV. CONCLUSION

Good governance is currently one of the most important words in development discourse and current studies increasingly place more emphasis on the governance issue for development. Although the governance issue effects society, politics and the economy, economic impacts are of importance due to the prevalence of financial crises in Asian countries. In the introduction, this paper presented 5 governance related questions and the findings are as follows:

(1) What is 'governance' and 'good governance'?

A core part of the definition of governance is 'exercises of economic, political and administrative power by the public sector'. The point is that governance itself does not include any value judgments. On the other hand, good governance has principally four elements: accountability, rule of law, transparency and participation. It should be noted good governance is a means for a certain purpose such as development. In addition, the concept of good governance may change according to development discourse and have ideological biases. Therefore, setting a clear definition of good governance is not necessary relevant on this issue.

(2) What are the drawbacks in the current governance discussions?

Currently, universality of the idea of good governance is widely supported by international organizations. Even if there is a disagreement of perceptions between international organizations

and developing countries, developing countries especially under the assistance of international organizations have no choice but to follow the other side due to different bargaining power. However, this disagreement may have a negative impact such as fueling nationalist movements, rather than positive one.

(3) *What is 'economic governance' and its relationships to economic policies?*
Economic governance is a subset of governance which effects economic affairs. As such economic governance makes no value judgments and core elements of good economic governance such as accountability, rule of law, transparency and participation can be the same as those of good governance. As shown in Figure 5, good economic governance is necessary for economic policy formulation to function as expected. For example, 'objective setting' may be meaningless without participation and accountability

(4) *What are the theoretical relationships between economic governance and economic performance?*
Current studies find a positive relationship between good economic governance and better economic performance through policy decisiveness, policy predictability, transaction costs and competition. Although the importance of good economic governance should not be denied, not only good economic governance can lead to policy predictability and policy decisiveness. Furthermore, if economic governance is evaluated inductively, it may mask the real picture of economic governance as shown in the Asian crisis.

(5) *What are the empirical relationships between economic governance and economic performance?*
As with previous studies, this paper generally finds a positive relationship between good economic governance and economic performance such as GDP per capita, investment, FDI and financial crises. However, the relationship is not so significant before a certain level of economic governance is attained. Furthermore, the relationships between economic governance and economic performance differ depending on elements of economic governance.

The governance issue is not new in the development field. However, despite the importance of the issue current discussion is unclear and the governance issue may have a negative impact on development. Although this paper has no space to discuss causality between economic governance and economic performance, such an analysis may shed additional light on the discussion.

While this paper mainly focuses on economic performance in general, some findings of this paper contributes to clarify the relationship between economic governance and crises. For example, a disagreement on the concept of good governance between international organizations such as IMF and developing countries may have a negative impact on the effectiveness of economic policies. In the future study, the relationship between crises in different types and regions, and economic performance will be discussed to analyze whether economic governance is a determinant of crises themselves or of length and deepness of crises.

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