

Original Paper

The Effects of Governance on Economic Growth

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Received: November 15, 2020 Accepted: December 4, 2020 Online Published: December 24, 2020
doi:10.22158/eprd.v1n2p34 URL: <http://dx.doi.org/10.22158/eprd.v1n2p34>

Abstract

In this article, we are interested in a very topical issue—to what extent and through which channels can governance influence the economic growth of nations? To answer this question, we reviewed the literature in this field before embarking on the empirical analysis. The main results that we obtained from this research work stipulate that economic governance, approximated by “economic freedom”, has a positive effect on economic growth through its effect on investment. As regards political governance, it seems that it has no effect on economic growth. This reinforces the idea that the role of political institutions is limited to the creation of good economic institutions.

Keywords

governance, economic growth, panel data, simultaneous equations

1. Introduction

Traditional economic literature argues that the development of economic determinants is *sine qua non* for economic growth. However, several new economic studies have presented a new view showing that many non-economic determinants play an important role in the economic development of any country. Admittedly, several researchers are convinced that there are non-economic factors that have an impact on production. Two countries with the same level of resource endowment will prosper at different rates, if the non-economic determinants are different. The country with a more business-friendly environment will be expected to grow at a faster pace than the country with a less business-friendly environment. However, the scarcity of funding sources on the one hand and the requirement of economic competitiveness in the context of globalization on the other hand suggest the need to improve the quality of governance, which has become a requirement by the donors. Governance is defined as “the exercise of

economic, political and administrative authority for the purpose of managing the affairs of a country at all levels. This includes the mechanisms, processes and institutions through which citizens and groups express their interests and differences, exercise their rights and fulfill their obligations. Governance includes the State but goes beyond it by also including the private sector and civil society organizations” (Note 1). In the context of economic growth and development, governance refers to the key elements of all institutions. These are particularly important elements of governance, namely the political institutions of society, the capacity of the State and the regulation of economic institutions. Thus, the interactions between governance and growth are intimately linked to the interactions between institutions and economic growth.

The study of the process of economic growth and its classical determinants is based on the neoclassical school, which focuses on the supply of factors and the level of technology. In the past, the role of non-economic determinants and institutional factors of economic growth was not considered of great importance. However, more recently, researchers have shown that non-economic determinants also play an important role in economic growth through the environment in which the factors of production, labor and capital function. As a result, it is now recognized that these non-economic factors play a crucial role in the performance of labor and capital over time in any country.

In the present paper, we seek to answer the following question: **To what extent can institutions influence the economic growth of nations?**

In order to address this question, we follow the following methodology: review the literature related to this topic; define and measure the various concepts used in the paper; and finally try to validate the relationship through empirical analysis.

2. Literature Review

The practical definition of what constitutes good governance has evolved over the years. Schneider (1999) defines good governance as the exercise of authority, or control over the management of the country’s affairs and resources. The United States Agency for International Development (USAID, 2002), on the other hand, defines good governance as a complex system of interaction between structures, traditions, functions and processes characterized by values of accountability, transparency and accountability of participation. UNDP (2002) defines good governance as the search for the rule of law, transparency, equity, effectiveness/efficiency, accountability and the strategic vision in exercising political, economic and administrative authority.

Historically, Owens (1987) and Sen (1999) argued for the need for economic and political freedom as necessary conditions for economic growth and development of nations. However, most studies conducted prior to the 1990s focused on the effects of poor governance (reflected by political instability and corruption) on the sources of growth rather than its direct impact on economic growth in emerging countries. This is usually explained by the fact that these studies were theoretical discourses rather than conditions necessary for growth and development.

In a study focussing on several developing countries, Chauvet and Collier (2004) found that countries with poor governance registered on average 2.3 percentage points less GDP growth per year compared to other developing countries. Similarly, Campos and Nugent (1999) also found that governance institutions improve development performance. Kaufmann et al. (1999a and 1999b) examined the problems associated with the aggregation of good governance measures. They concluded that governance does matter for economic development. However, Keefer et al. (1997) found that institutions such as property rights and contract enforcement have a positive influence on economic growth.

Kaufmann and Kraay (2003) showed that per capita incomes and the quality of governance are strongly and positively correlated. In their study, they presented six governance indicators, which were political instability and violence, government effectiveness, regulatory burden, control of corruption, rule of law, and voice and responsibility. The first indicator “political instability and violence” is a combination of several indicators that measure the overall fall of government for non-institutional means and/or for violence. The two indicators of “government effectiveness” and “regulatory burden” reform various indicators that measure the degree of government capacity in building reliable political institutions. As for the indicators “control of corruption” and “voice accountability”, they highlight the respect of laws by citizens as well as the regulation of corrupt practices. The indicator “rule of law” allows to measure the degree of trust and obedience to the laws of the society. Then, the authors chose three measures of governance, namely control of corruption, protection of property rights or the rule of law, and the voice and responsibility in relation to real GDP per capita adjusted for differences in purchasing power among the countries for which they have constructed composite indicators, based on 190 governance perception measures compiled by 17 organizations around the world and covering up to 170 countries. They found a strong and positive relationship between income and governance and provided three possible explanations for this, namely that better governance has a powerful effect on per capita incomes; higher incomes lead to improvements in governance; and finally that there are other factors that make countries richer and associated with better governance. The authors conclude that they need to fully understand the effects of governance on revenue and the mechanisms for revenue feedback to governance that may exist.

In their Governance Matters study, Kaufmann, Kraay and Zoido Lobaton (1999) examined the correlation between the six global indicators of governance, “voice and responsibility”, “political stability and violence”, “government efficiency”, “weight regulation”, “rule of law” and “fight against corruption”, and economic outcomes measured in terms of per capita income, infant mortality and literacy rates. They found each indicator to be positively correlated with the log GDP per capita and the literacy rate and negatively correlated with the infant mortality rate. The analysis goes beyond this simple correlation and envisages a study that traces the interrelationships between governance and the rate of income growth through a series of cross-sectional regressions between this rate and each indicator of governance.

Hall and Jones (1999) attributed the difference in the output per worker between countries to the level of “social infrastructure” in each country, which, according to Kaufmann et al., expresses the governance already mentioned. Hall and Jones measured the social infrastructure as the average of several governance indicators from PRS (political risk survey) and a variable that measures the trade openness built by Sachs and Warner. In their study, Kaufmann et al, following the same approach, used several indicators of governance, collected from many sources, to define the nature of the relationship that can exist between governance and economic growth, for a large sample of countries. They run a regression between these three dependent variables: the logarithm of GDP per capita, infant mortality and the literacy rate, and the six indicators of governance. The key finding was that “governance issues are of paramount importance to economic outcomes”. The estimations show that an increase in the standard deviation of one of the governance indicators results in an increase in per capita income ranging from 25 times (for “voice and accountability”) to 4 times (for “political instability and violence”), in a decrease of 2.5 to 4 folds in infant mortality rate, and in a 15- to 25-fold increase in literacy.

The analysis by Kaufmann et al. shows that the improvement of governance has an important effect on growth. For example, on the rule of law, they note that the transition from the low levels noted in Russia to the intermediate levels noted in the Czech Republic, or the decline in corruption from the very high level observed in Indonesia to the lower level recorded in Korea, translates into a 100 to 300 percent increase in per capita income, a comparable decline in infant mortality, and an increase of 15 to 25 percent in the literacy rate.

Ziadi A. (2016) used a panel data model of eight countries to explain the relationship between economic growth and some governance indicators for the period 1985-2009. Political rights, civil liberties, rules of law, political stability and corruption were integrated. The results of the estimates showed that the corruption variable has a negative effect on economic growth and then hampers the optimal allocation of resources. Similarly, political instability and violence were found to negatively affect economic growth. Ahou B., Odoun-Ifa A. and Couao-Zohi G. (2014) used a panel model for 129 countries over the period 1996-2011 to show that good governance improves economic growth. To do this, they regressed the variable economic growth on a set of explanatory variables that can measure governance, namely voice and responsibility, political stability, government efficiency, quality of regulation, rule of law, control of corruption, expenditures on final consumption by the public administration, openness rate, credit to the economy, gross enrollment rate, inflation rate and GDP per capita. The results showed that among Kaufmann’s six governance indicators, only three have a significant impact on economic growth. They prove that the results obtained vary according to the level of per capita income of the country. However, the variables “voice and responsibility” and “government efficiency” were found to positively influence economic growth and the “rule of law” to negatively influences economic growth, while all other variables were insignificant.

3. Methodology

3.1 Definitions and Measures of Variables

According to the above literature review, the variables listed below can be integrated into the equation to estimate our model:

- 1- **Investment (X1)**: the ratio of gross capital formation to GDP.
- 2- **Public expenditure (X2)**: the ratio of government consumption to GDP.
- 3- **Political instability and violence (X3)**: includes the following elements: political tensions, civil wars, social unrest, ethnic tensions, political violence, unpredictable changes in institutions and rules.
- 4- **Voice and responsibility (X4)**: includes the following elements: legal system, transparency, civil liberties (freedom of expression and assembly, equality of chance, etc.), political rights (free elections, free vote, political parties respect for minorities, legislative representation), free press, democratic accountability and independent media.
- 5- **Effectiveness of public authorities (X5)**: includes the following elements: government policies, quality of administration, effective public servants, government credibility, bureaucratic delays, public services, and waste in government expenditure.
- 6- **Weight of the regulation (X6)**: includes the following elements: government intervention in the economy, price controls, trade policies, price liberalization, effectiveness of the antitrust policy, the taxation system, participation of the private sector in infrastructure projects, regulation of financial institutions and protectionist measures.
- 7- **Primacy of the rule of law (X7)**: includes the following elements: costs of the crimes, respect in the execution of the contracts by the government, rights of property, confidence in the political authority as for the security of the goods, intellectual property protection and independence of the legal system.
- 8- **The fight against corruption (X8)**: includes the following elements: irregular payment to civil servants and the judiciary, practices unfit in the public sphere, corruption in the political system as a threat to foreign investment, frequency of cases of corruption in public administrations.
- 9- **Economic Freedom (X9)**: a composite index determined by five major factors: size of administration, legal structure and security of property rights, access to sound money, freedom of trade at the international level and the regulations of credit, labor and business. This indicator is rated on a scale of 1 to 10, with 1 being the lowest degree of economic freedom and 10 the highest.

All the variables cover the period 2000-2015 and are taken from the World Development Report (2005), the six governance variables are taken from the World Bank's governance database, while the variable "economic freedom" is extracted from the website of the Cato institute (Note 2).

3.2 The Model

Our empirical validation test consists in estimating two simultaneous equations. We have opted for this type of model, namely simultaneous equation model, to cover the interdependent relationship between economic growth, investment and institutional variables. According to the literature review, institutions influence economic growth through their effect on investment. There are even those who claim that the effect of institutions on economic growth is an indirect effect. An effect that involves investment on the one hand and by economic institutions on the other. Political institutions are important only to the extent that they are necessary to build healthy economic institutions that can positively influence economic growth; hence, our system of simultaneous equations is specified as follows:

$$\begin{cases} grow_{i,t} = \alpha_i invest_{i,t} + \beta_i gov_{i,t} \\ invest_{i,t} = \alpha_i grow_{i,t} + \beta_i gov_{i,t} \end{cases}$$

3.3 Autocorrelation Matrix

Table 1. Autocorrelation Matrix

	X1	X2	X3	X4	X5	X6	X7	X8	X9
X1	1,000								
X2	-0,0648	1,000							
X3	-0,0107	0,3929	1,000						
X4	-0,0552	0,4205	0,7577	1,000					
X5	0,0556	0,4207	0,8558	0,7675	1,000				
X6	0,0997	0,3863	0,8234	0,7828	0,9375	1,000			
X7	0,0869	0,4744	0,8476	0,7906	0,9680	0,9471	1,000		
X8	0,0176	0,4582	0,8614	0,7839	0,9571	0,9075	0,9615	1,000	
X9	0,1636	0,1528	0,6972	0,6595	0,7728	0,8742	0,7974	0,7554	1,000

According to this autocorrelation matrix, we note that several variables cannot be integrated into the same equations at the same time (i.e., X5 with X6, X7, X8, X9; X6 with X7, X8, X9...). The estimation results of our equations are presented in Tables 2 and 3.

3.4 Results and Interpretations

Table 2. Institutions, Investment and Economic Growth

	Coefficient	P-value	Coefficient	P-value	Coefficient	P-value
Y						
X1	0.2389328	0.000	0.2389328	0.000	0.2681965	0.000
X2	-0.1361343	0.000	-0.1361343	0.000	-0.1857799	0.000
X4	-0.7481231	0.000	-0.7481231	0.000	-0.0947324	0.149
X1						
Y	1.918296	0.000	1.918296	0.000	3.651649	0.000
X6	1.77002	0.00				
X2	0.3034057	0.000	0.3034057	0.000	0.7088521	0.000
			1.77002	0.000		
X9					0.0986805	0.412
X8						

From these results, we can draw the following inferences: investment positively influences the economic growth of countries. This reinforces the idea that investment is an essential driver of economic growth. Public spending is found to have a negative effect on the economic growth of countries, a result in concordance with the literature. This is because public spending is intended for the functioning and not for productive investment, which seems to counteract the efforts deployed by countries to achieve a sustainable economic growth.

The voice and responsibility variable has a negative effect on the growth of countries. This can be explained by the fact that an institutional environment characterized by a weak legal system, a lack of transparency and civil liberty, a lack of respect for political rights, as well as a non-free and independent press, represents obstacles to economic growth.

As for investment, it is found to be positively influenced by economic growth, public spending and regulation, which is an expected result.

The results show that economic freedom has a positive effect on investment, which influences economic growth indirectly. This result can be explained by the fact that an economic institutional framework characterized in particular by a perfect protection of property rights is able to stimulate investment.

The fight against corruption does not seem to influence investment, and the integration of this variable has made the effect of the voice and liability variable insignificant. The result confirms the idea that institutions are multidimensional. Thus, to have the desired effects of institutions, an entire institutional framework must be developed and not only one of the components.

Table 3. Institutions, Investment and Economic Growth (continued)

		Coefficient	P-value	Coefficient	P-value	Coefficient	P-value
Y							
X1		0.2629795	0.000	0.263151	0.000	0.2715314	0.000
X2		-0.1791855	0.000	-0.1796226	0.000	-0.1902227	0.000
X4		-0.0916587	0.118	-0.0800823	0.163	-0.0846454	0.235
X1							
Y		3.715384	0.000	3.720753	0.000	3.623763	0.000
X7		0.0439053	0.710				
X2		0.7004216	0.000	0.6996333	0.000	0.7148615	0.000
X5				0.0311248	0.806		
X3						0.1407806	0.390

Based on the obtained results, the primacy of the rule of law does not seem to have an effect on investment. The same applies to the effectiveness of public authorities and political instability. This finding confirms the idea that political institutions are important only to the extent that they allow the creation of good economic institutions. It is therefore an indirect effect on the economic performance exercised by political institutions via economic institutions. Indeed, in all the estimates of our model, only economic freedom seems to have a positive effect on investment, and subsequently on economic growth.

Economic freedom is found to have a preponderant effect on economic growth. Indeed, the coefficient of this variable is always positive and statistically significant. This indicates that the protection of property rights and contractual rights, as well as a sound legal structure, is likely to foster economic growth by stimulating investments.

As for the political institutions, according to the different estimates of our model, it seems to have effects on investment and economic growth. This result is comparable to that of Borner, Bodmer and Kobler (2004), who found almost the same coefficients and the same degree of significance and robustness for a variable comparable to ours, called “quality of economic institutions”, and closely related to security and property rights as is the case for the variable we used in our model.

4. Conclusion

In this study, our objective was to analyze to what extent institutions influence the economic growth of nations.

To do this, and following a review of relevant literature, we specified a model according to the relations between the key variables. Then, an empirical investigation test using a simultaneous equation model was conducted on a sample of 33 countries over the period 2000-2015.

The main findings of our work, based on the obtained estimation results, stipulate that:

- Economic institutions, approximated by economic freedom, have a positive effect on investment and subsequently on economic growth.
- Political institutions do not seem to have a direct effect on investment.

This finding confirms the idea that the importance of political institutions lies in their effect on the preparation of good economic institutions. Thus, political institutions indirectly influence economic performance.

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Notes

Note 1. Staplen-Hurst F. & Kpundc (1998); ‘Public Sector Participation and the Fight Against Corruption’, p.25

Note 2. <http://www.freethworld.com/download.html>.