

**From ‘Law and Order’ to ‘Rule of Law’:
*Lessons from Governance Empirics
Around the World***

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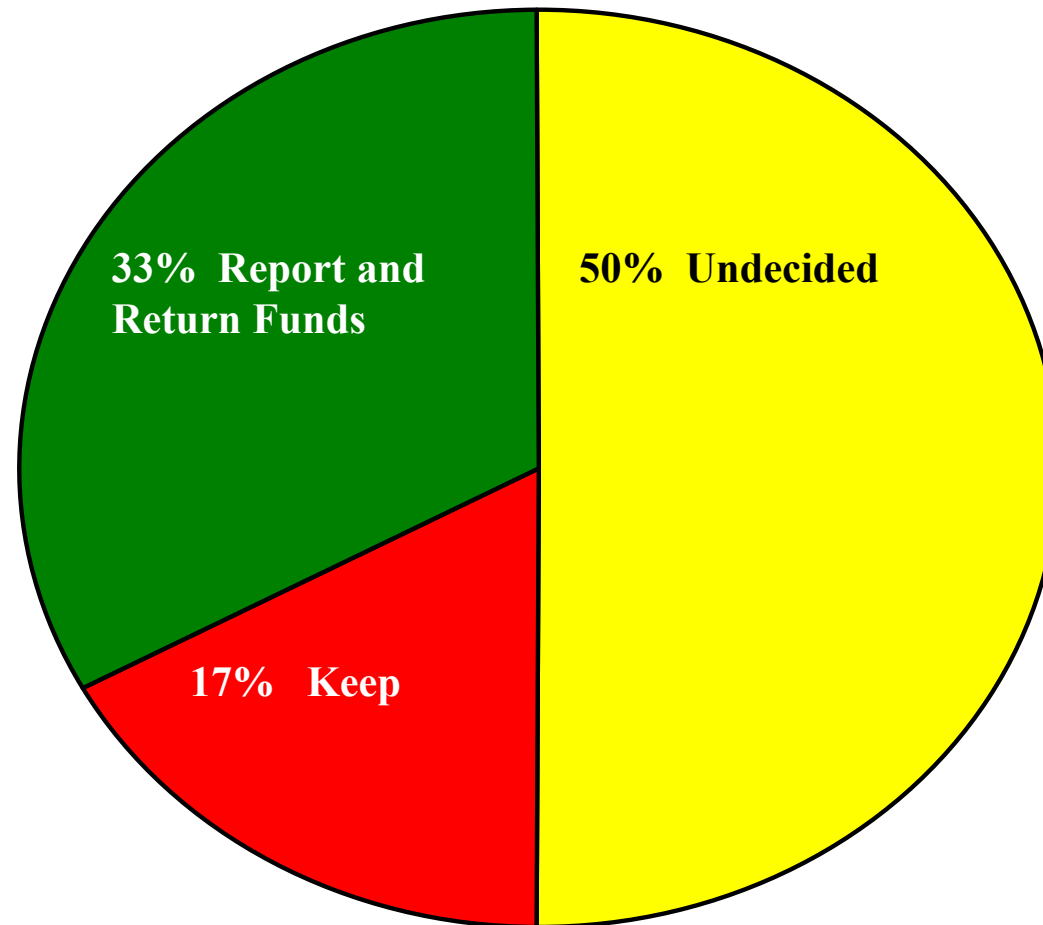
Keynote Presentation at the 2nd Global Confernce on Law & Order Upgrade, organized by the Institute for Industrial Policy Studies, sponsored by the the Ministry of Justice and the Presidential Council on National Competitiveness, at the Korean Chamber of Commerce & Industry, Seoul, Korea, June 24th, 2009

A 'Live' Test: 'Culture', Information and Incentives:

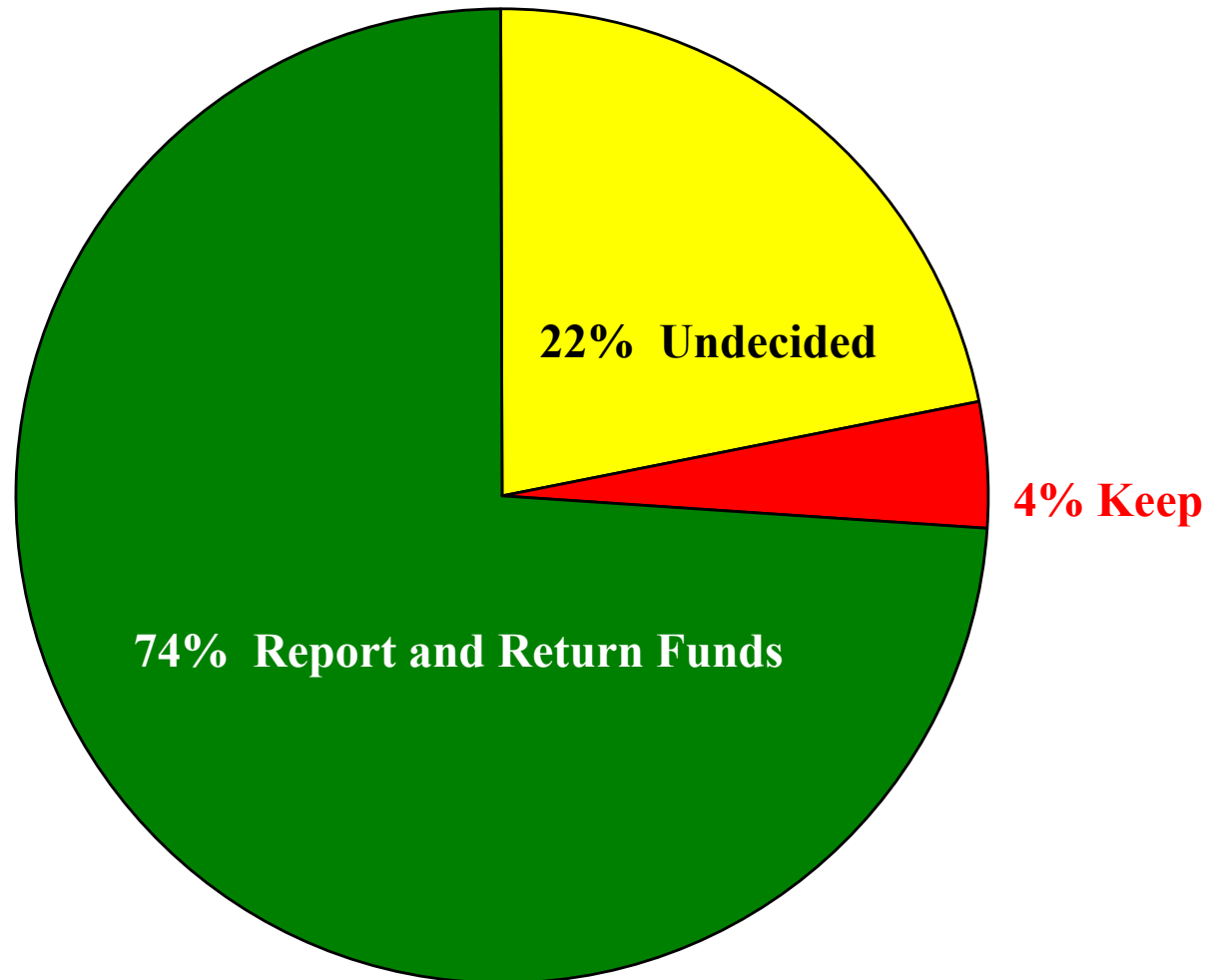
- You are approaching your car in the empty and unattended garage late at night**
- You see an envelope on the floor, and you pick it up**
- It contains 20 bills of US \$100 each.**
- If no possibility that anyone would know: No cameras, no monitoring, no reporting**
- What would you do with such envelope full of cash?**

A. If no possibility that anyone would know:

You are alone, there is no monitoring, cameras, or possibility of reporting



B. If 30% probability that information is shared
(e.g. 30% that camera recording info which may be reviewed)



Challenging Convention on Governance from an Empirical Perspective

- 1. From Law & Order to Rule of Law: ‘Thin’ vs. ‘Thick’ definitions**
- 2. Rule of Law & Governance: Unmeasurable?**
- 3. The Data: The WGI, Aggregate & Disaggregated Databank**
- 4. Do Institutions Change in the Short Term?**
- 5. Does Rule of Law Matter for Development?**
- 6. Other Governance Factors for Growth & Competitiveness**
- 7. Lessons from Firms on Investment Climate & Informality**
- 8. Capture & Undue Influence: forgotten in Rule of Law**
- 9. Some Implications for Debate**

From Law & Order to Rule of Law

- **Law & Order: Narrow component of Rule of law, which focuses on whether enforcement function functions properly, mitigating crime**
- **Rule of Law: Broader than Law an Order, but component of Governance**
- **Rule of Law: What is not ‘Rule of Man’...**
- **Our Rule of Law interpretation : *trust & confidence that all stakeholder in society have in the rules of society, whether they abide to these rules, including the quality of contract enforcement, property rights, the police, and the courts, as well as existence of crime and violence.***

Governance distinct from Rule of Law?

- Rule of Law is broader notion than Law & Order
- But Rule of Law ought not interpreted too broadly
- Governance is broader than Rule of Law
- Our WGI Definition of Governance (1999): *"...the traditions and institutions by which authority in a country is exercised.*
- This includes: *i) process by which governments are selected, monitored and replaced; ii) capacity of the government to effectively formulate and implement sound policies; and ii) respect of citizens and the state for the institutions that govern economic and social interactions*

WGI: Six Dimensions of Governance

Governance as the set of traditions and institutions by which authority in a country is exercised-- specifically:

- **The process by which those in authority are selected and replaced**
 - **VOICE AND ACCOUNTABILITY**
 - **POLITICAL STABILITY & ABSENCE OF VIOLENCE/TERRORISM**
- **The capacity of government to formulate and implement policies**
 - **GOVERNMENT EFFECTIVENESS**
 - **REGULATORY QUALITY**
- **The respect of citizens and state for institutions that govern interactions among them**
 - **RULE OF LAW**
 - **CONTROL OF CORRUPTION**

Empirical Frameworks: from aggregate to disaggregate indicators of governance

- **Macro-Aggregate Level, e.g. WGI, TI, CPIA**
- **The Mezzo Level, e.g. WEF, BEEPS, Doing Business**
- **The Micro, in-country, in depth diagnostic, e.g. WBI GAC diagnostics, scorecards (Bangalore), randomized experimental projects**
- **Complementarities and Hybrids**

Why Measure Governance?

- **Governance matters for:**
 - **Development outcomes**
 - **Effectiveness of foreign aid**
- **WGI are not a “horserace”**
 - **entry point for serious empirical analysis drawing on a wide variety of data sources**
- **Data on governance:**
 - **empowers reformers and civil society to advocate for change**
 - **enables evidence-based policymaking**

Why Aggregate Indicators of Governance?

- Governance viewed as a much broader notion than ‘formal rules of the game’
- Individual data sources provide a noisy “signal” of broader concept of governance, e.g.:
 - trust in police → RULE OF LAW
 - freedom of press → VOICE & ACCOUNTABILITY
- Benefits of Aggregation--*through U.C. Method*
- aggregate indicators are more informative about broad concepts of governance
- broader country coverage (*than individual indicators*)
- generate explicit margins of error for country scores
- less likelihood of outliers

Worldwide Governance Indicators

- Data on six dimensions of governance covering 212 countries over 1996-2007
- Synthesis of hundreds of underlying indicators taken from 35 different data sources
- WGI capture views of tens of thousands of stakeholders worldwide
 - household and firm survey respondents sharing their successful and failed interactions with the state
 - experts in NGOs, private and public sectors sharing their international perspective on governance successes and failures
- Aggregate and individual indicators available at www.govindicators.org, largest publicly-available governance database in the world
- Result of longstanding research project at World Bank led by D. Kaufmann and A. Kraay, featuring “Governance Matters”

Transparent and Interactive Access to Data

- **WGI are built on 35 underlying data sources**
 - **interactive access to 6 aggregate indicators are virtually all underlying data sources at www.govindicators.org**
- **Full disclosure of limitations of data**
 - **all governance indicators are imprecise**
 - **WGI quantify this imprecision with “margins of error” i.e. likely *range* of governance scores for each country**
 - **when these overlap, differences are not significant**

Individual sources for constructing the WGI

- **Cross-Country Surveys of Firms:** Global Competitiveness Survey, World Competitiveness Yearbook, BEEPS
- **Cross-Country Surveys of Individuals:** Gallup World Poll, Global Corruption Barometer, Latinobarometro, Afrobarometer
- **Expert Assessments from Commercial Risk Rating Agencies:** Global Insight, Political Risk Services, BERI, Economist Intelligence Unit, Merchant International Group, IJET Travel Consultancy, Asia Risk Consultancy
- **Expert Assessments from NGOs, Think Tanks:** Reporters Without Borders, Heritage Foundation, Freedom House, Bertelsmann Foundation, Amnesty International, IREX, Global Integrity, Binghamton University, International Budget Project
- **Expert Assessments from Governments, Multilaterals:** World Bank CPIA, EBRD, AFDB, ADB, State Department, OECD, IFAD

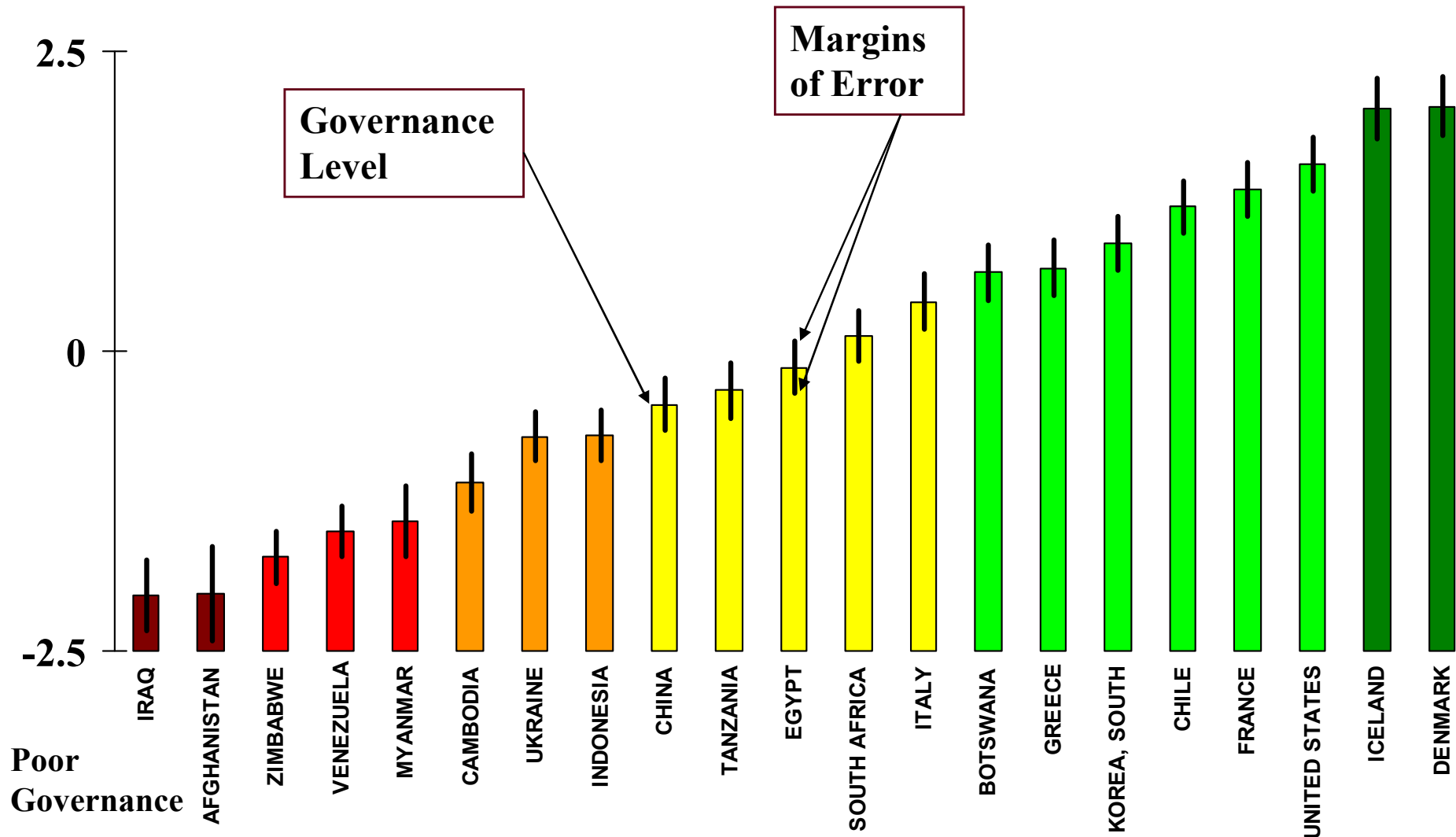
Building Aggregate Governance Indicators

- Use Unobserved Components Model (UCM) to construct composite governance indicators, and margins of error for each country
- Estimate of governance: *weighted average* of observed scores for each country, re-scaled to common units
- Weights are proportional to *precision* of underlying data sources
- Precision depends on how strongly individual sources are correlated with each other
- Margins of error reflect (a) *number of sources* in which a country appears, and (b) the *precision of those sources*

Good
Governance

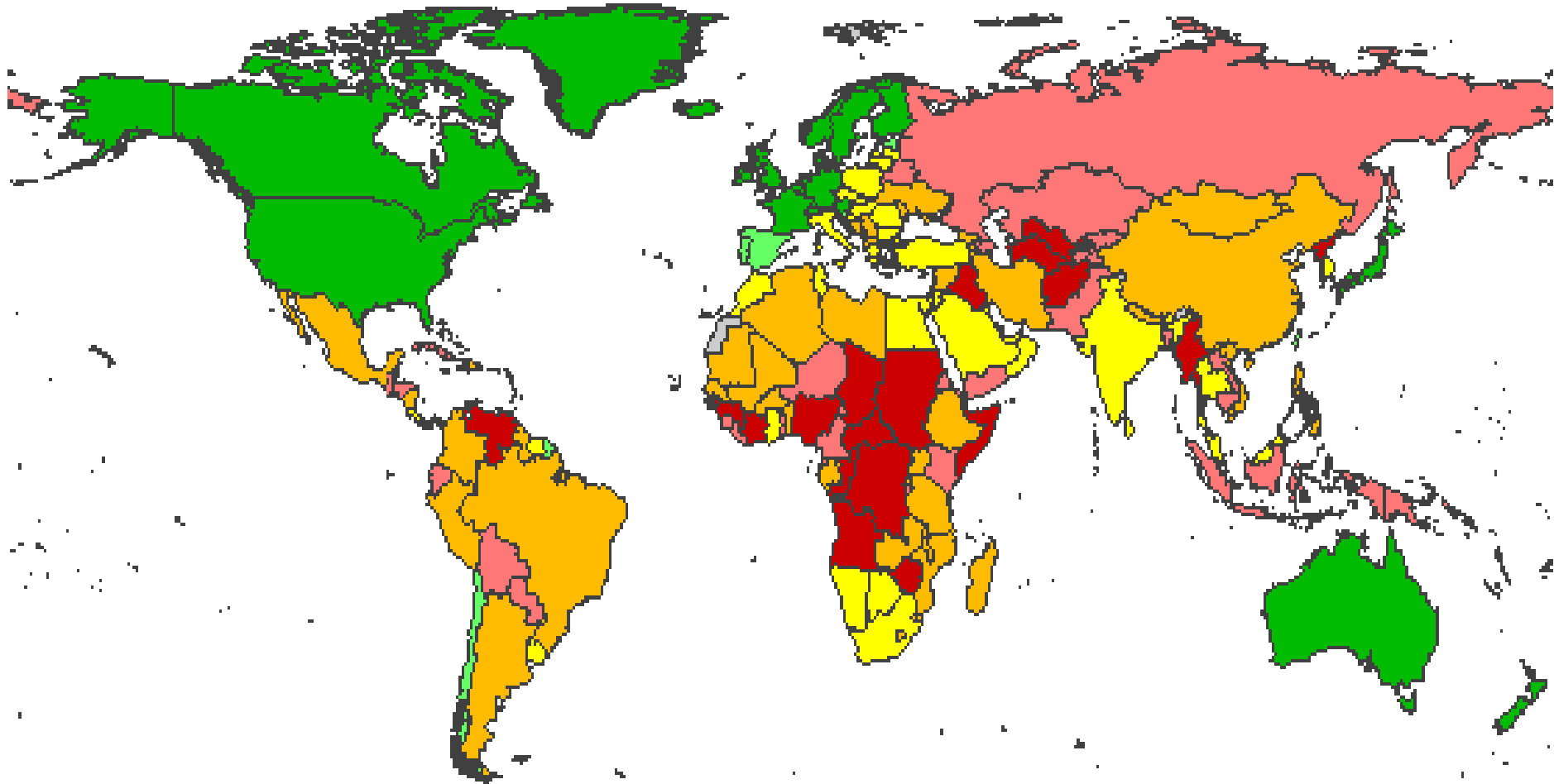
Rule of Law

Selected Countries in 2007



Source for data: 'Governance Matters VII: Governance Indicators for 1996-2007', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2008, www.govindicators.org. Colors are assigned according to the following criteria: Dark Red: country is in the bottom 10th percentile rank ('governance cliffs'); Light Red: between 10th and 25th percentile rank; Orange: between 25th and 50th percentile rank; Yellow, between 50th and 75th; Light Green between 75th and 90th percentile rank; and Dark Green: between 90th and 100th percentile (exemplary governance). Estimates subject to margins of error.

Quality of Rule of Law, 2006

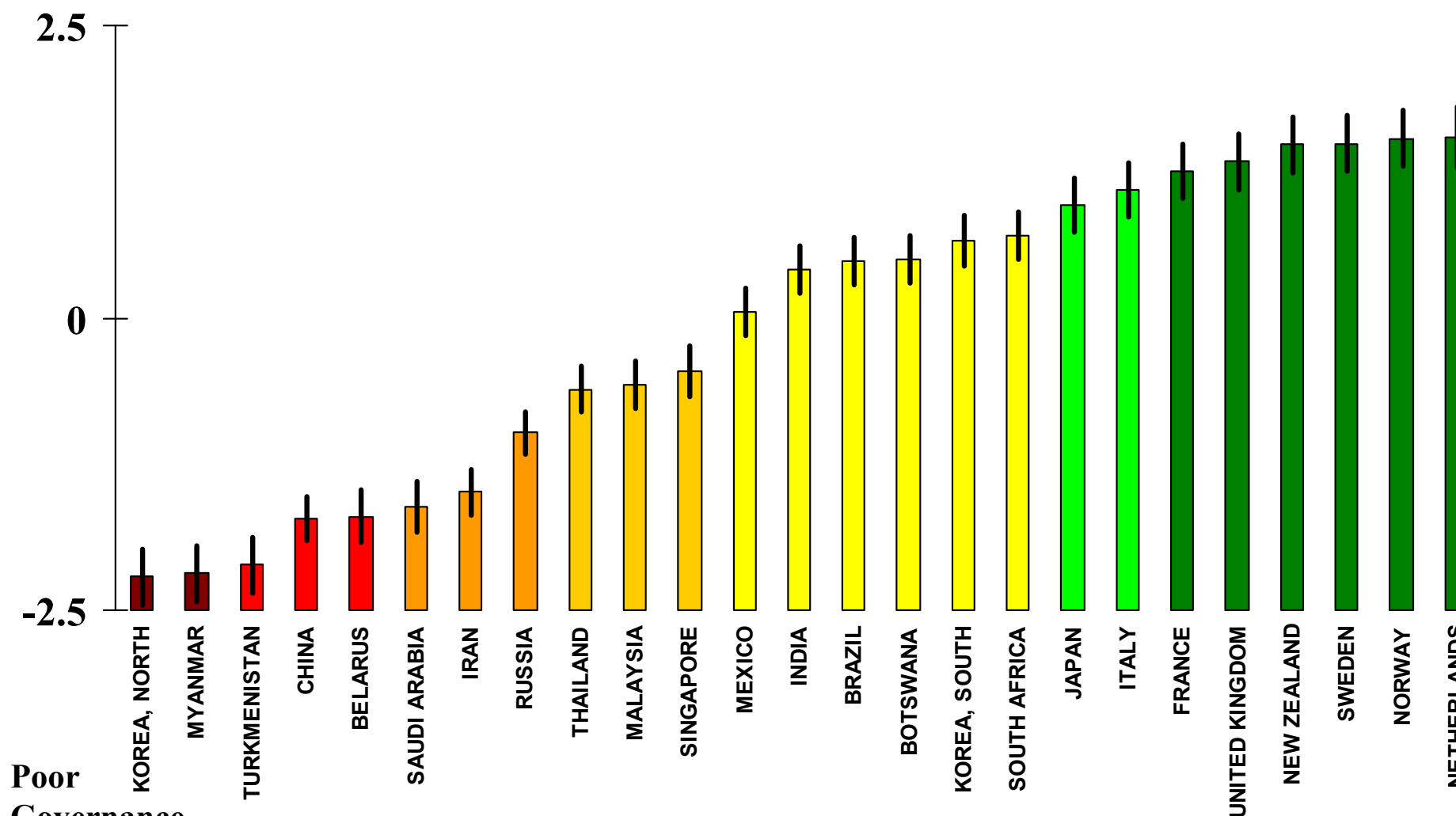


Source for map: 'Governance Matters VI: Governance Indicators for 1996-2006', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2007 - www.govindicators.org. Colors are assigned according to the following criteria: Dark Red: country is in the bottom 10th percentile rank ('governance crisis'); Light Red: between 10th and 25th percentile rank; Orange: between 25th and 50th percentile rank; Yellow, between 50th and 75th; Light Green between 75th and 90th percentile rank; and Dark Green: between 90th and 100th percentile (exemplary governance). Estimates subject to margins of error.

Voice and Accountability

Selected Countries in 2007

Good
Governance



Poor
Governance

Source for data: 'Governance Matters VII: Governance Indicators for 1996-2007', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2008,

www.govindicators.org. Colors are assigned according to the following criteria: Dark Red: country is in the bottom 10th percentile rank ('governance crisis');

Light Red: between 10th and 25th percentile rank; Orange: between 25th and 50th percentile rank; Yellow, between 50th and 75th; Light Green between 75th and 90th percentile rank; and Dark Green: between 90th and 100th percentile (exemplary governance). Estimates subject to margins of error.

Application 1: Good Governance a 'Luxury Good' that only the rich country can 'afford', and does governance change very little in the short term?

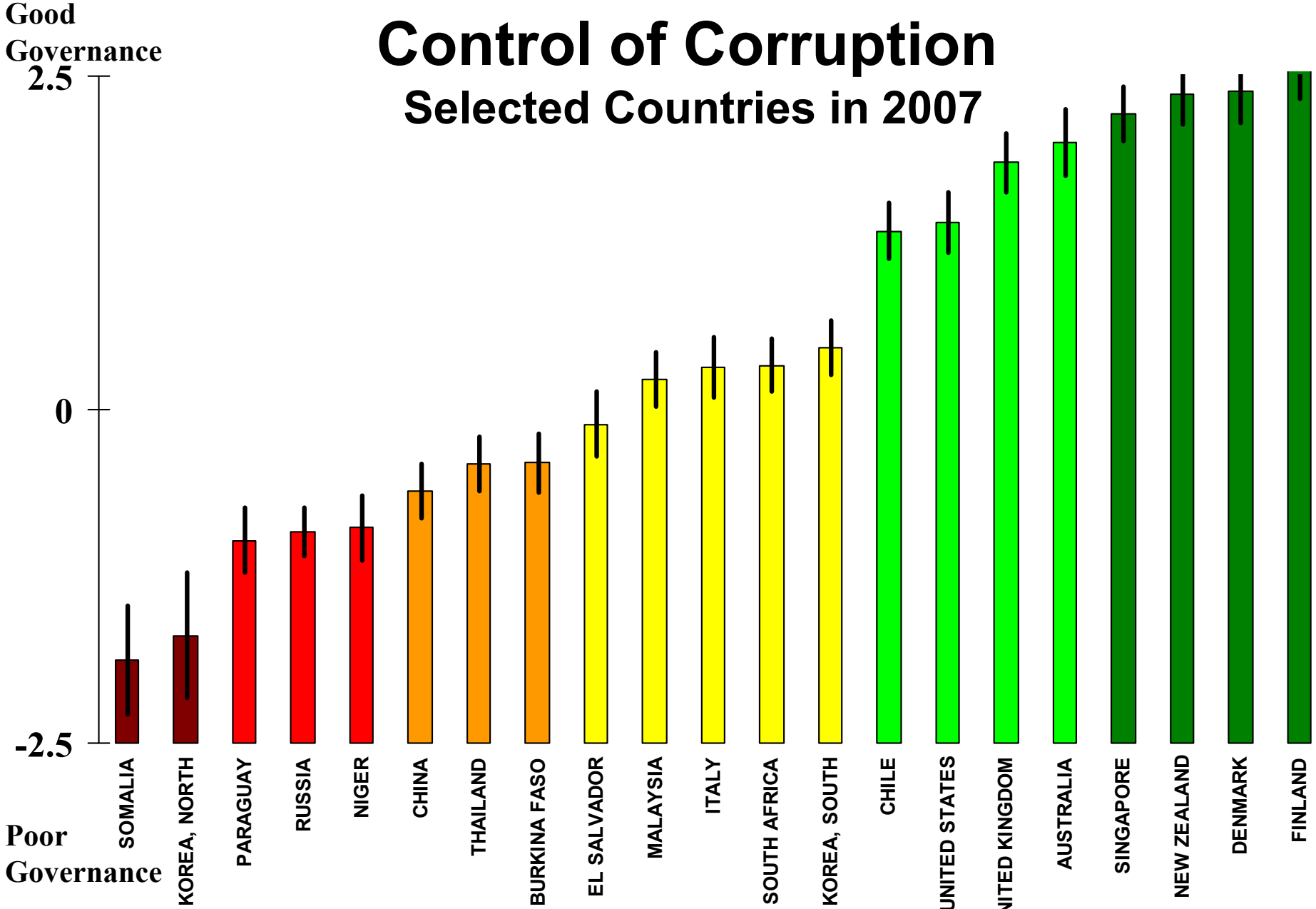
- **A few insights from empirics...**

Good Governance Can Be Found At All Income Levels

- **Over a dozen developing countries rank better than industrialized countries like Greece or Italy in various dimensions of governance**
- **Examples include Slovenia, Chile, Botswana, Estonia, Uruguay, Czech Republic, Hungary, Latvia, Lithuania, Mauritius, and Costa Rica**

Control of Corruption

Selected Countries in 2007

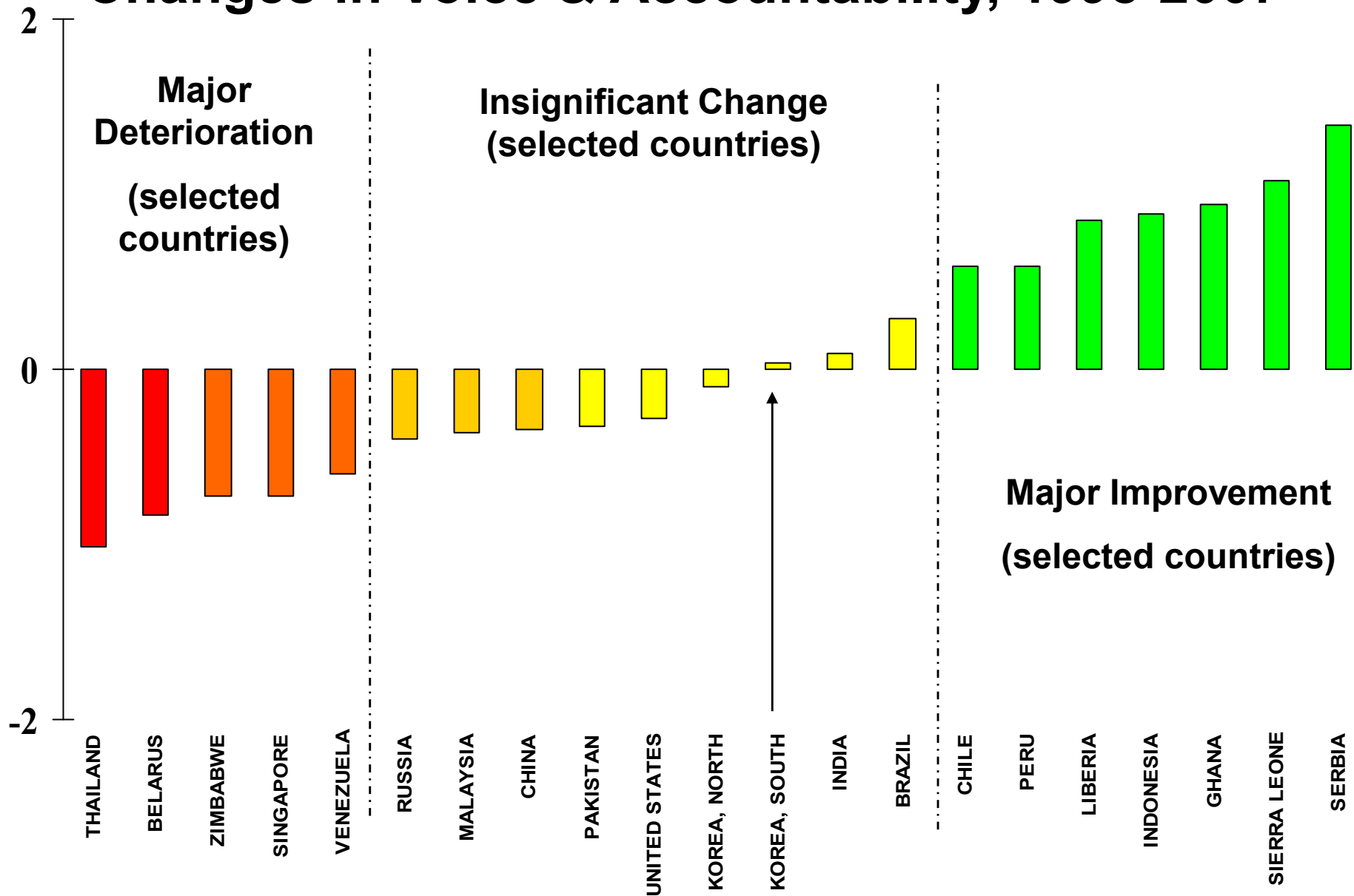


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Governance Success Stories in Short Term

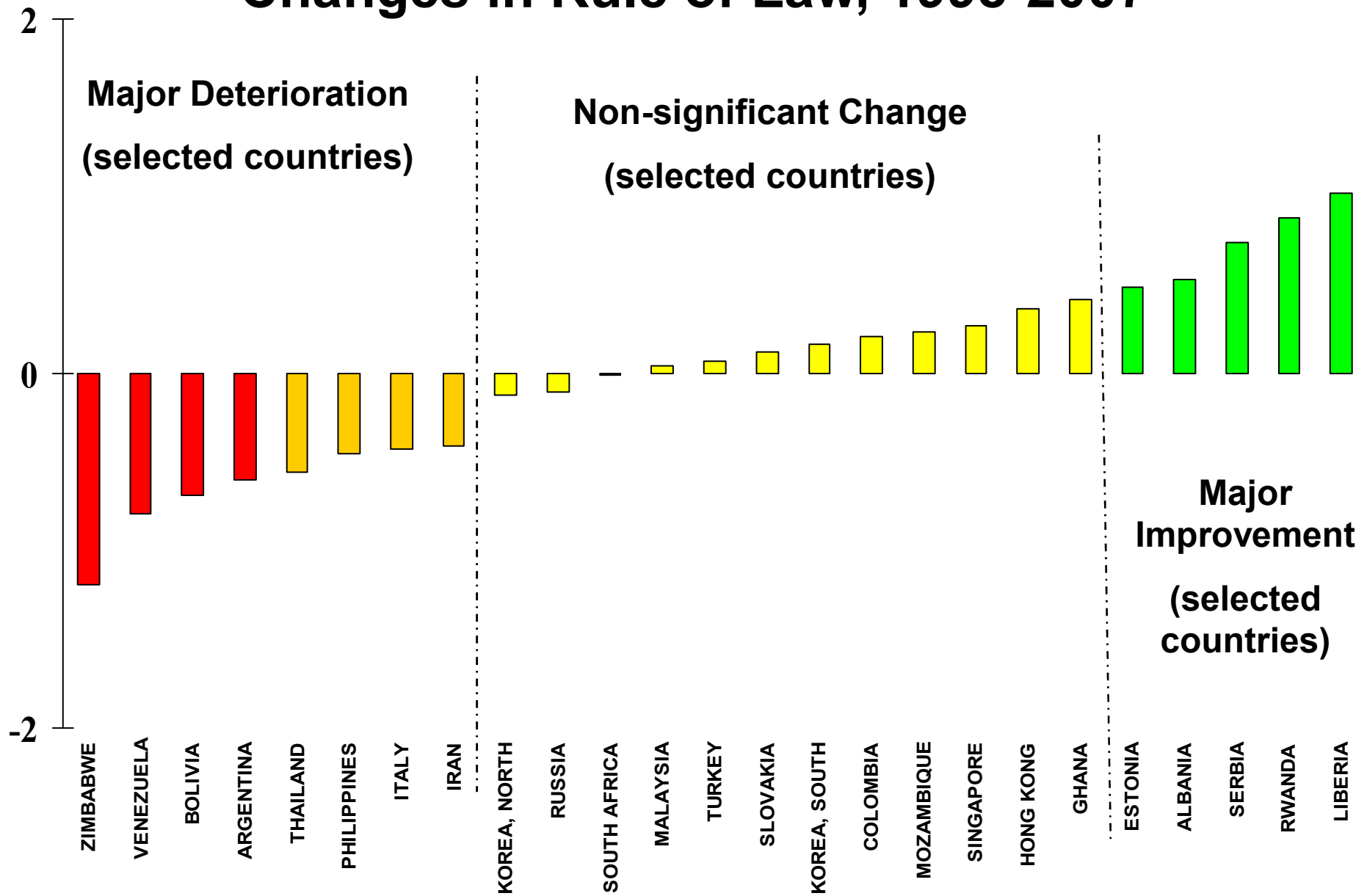
- For instance, between 1998 and 2007 significant improvements in:
 - Voice and Accountability in Ghana, Indonesia, Liberia, and Peru
 - Political Stability/Absence of Violence in Algeria, Angola, and Rwanda
 - Control of Corruption in Serbia and Liberia
- But declines in other countries too (e.g. Venezuela, Cote d'Ivoire and Zimbabwe)
 - No evidence of global trends in governance

Changes in Voice & Accountability, 1998-2007



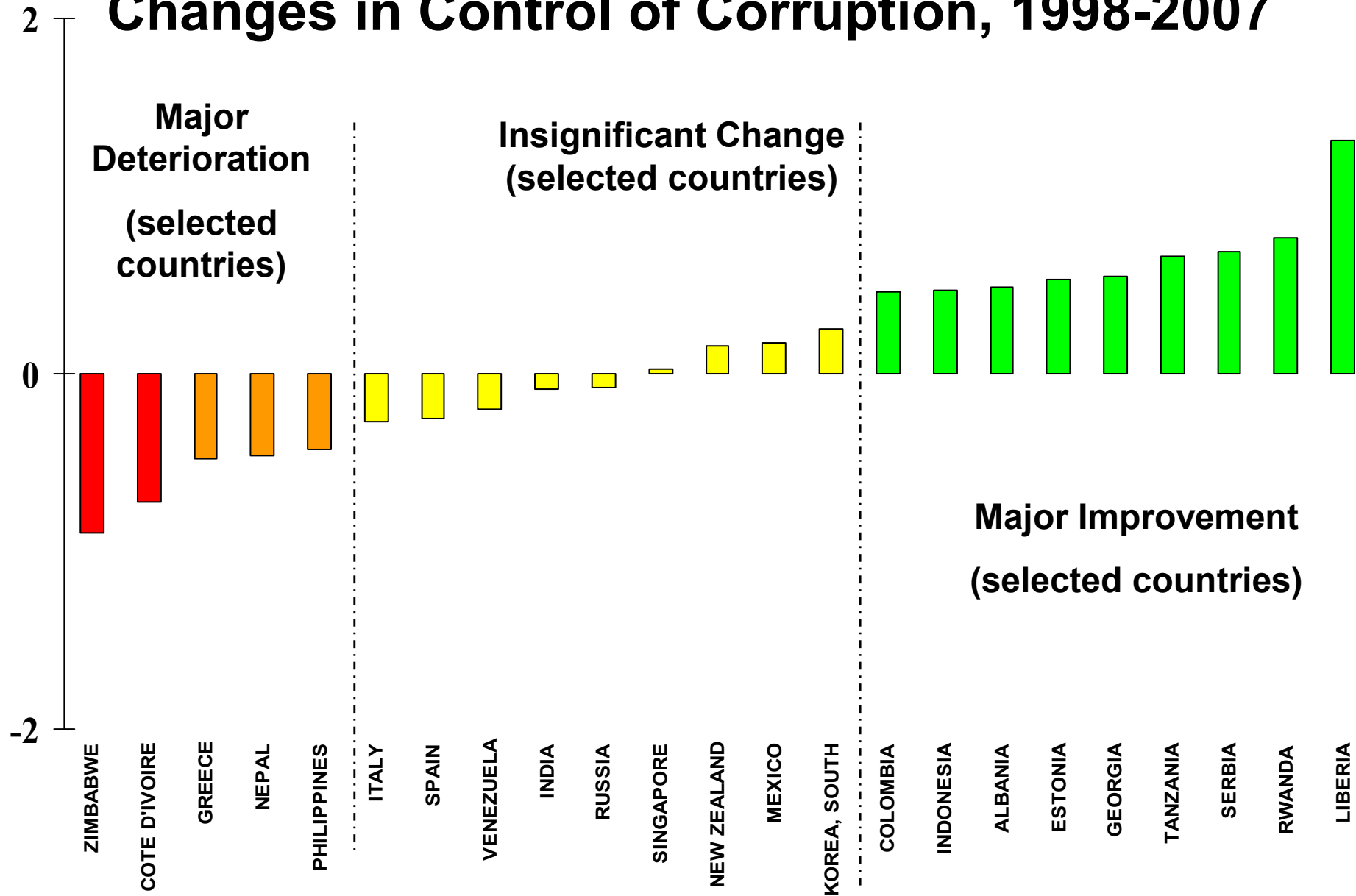
Changes were calculated on the basis of the differences in country estimates from 1998 and 2007. Classification for major deteriorations and improvements were based on 75% confidence interval. Source for data: 'Governance Matters VII: Governance Indicators for 1996-2007', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2008 - www.govindicators.org

Changes in Rule of Law, 1998-2007



Changes were calculated on the basis of the differences in country estimates from 1998 and 2007. Classification for major deteriorations and improvements were based on 75% confidence interval. Source for data: 'Governance Matters VII: Governance Indicators for 1996-2007', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2008 - www.govindicators.org

Changes in Control of Corruption, 1998-2007



Changes were calculated on the basis of the differences in country estimates from 1998 and 2007. Classification for major deteriorations and improvements were based on 75% confidence interval. Source for data: 'Governance Matters VII: Governance Indicators for 1996-2007', by D. Kaufmann, A. Kraay and M. Mastruzzi, June 2008 - www.govindicators.org

Application 2: Governance Matters for Development?

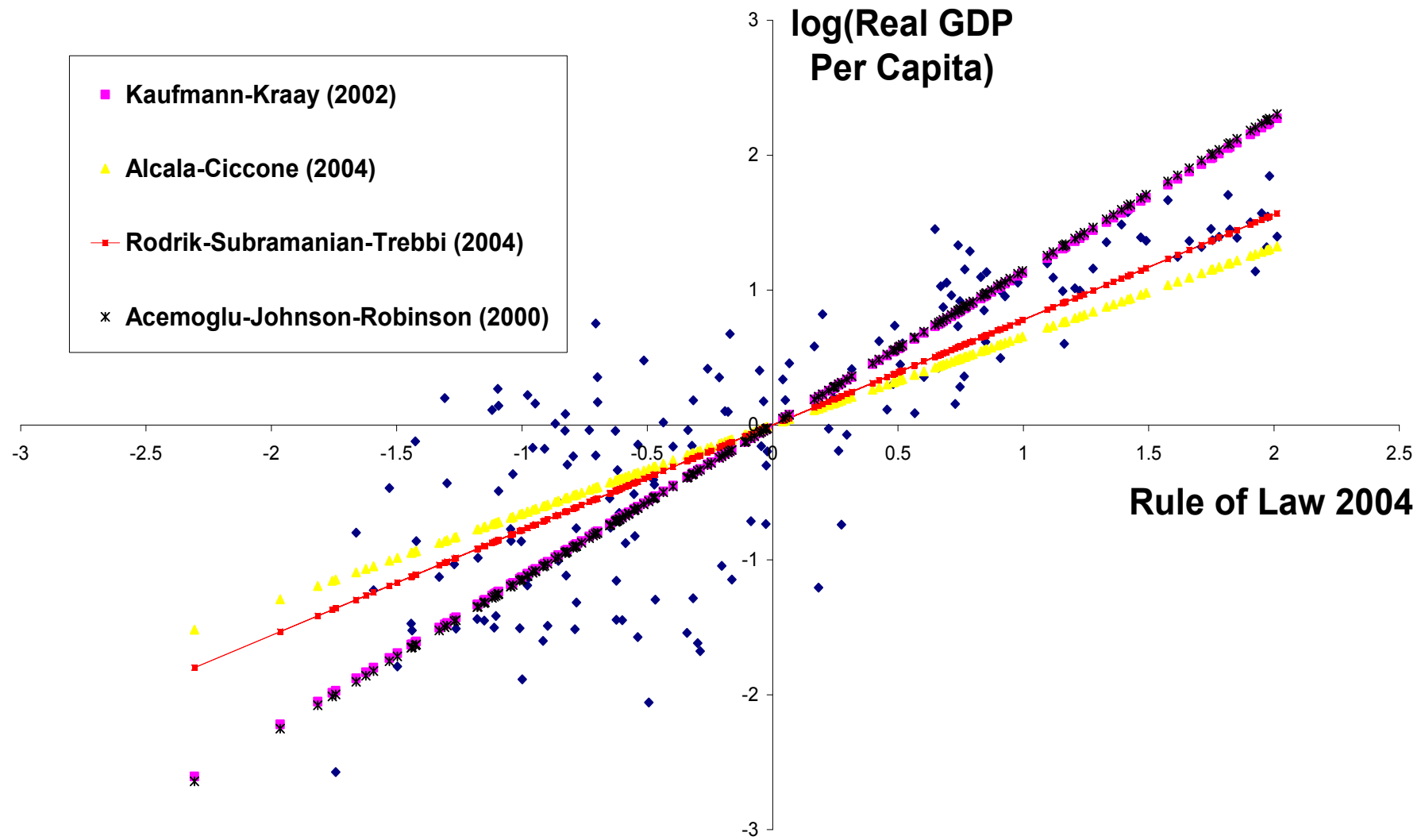
- **Governance Matters for Development?**
- **Taking seriously the challenge of Causality Direction**

Governance Matters around the world: The 300% 'Dividend'

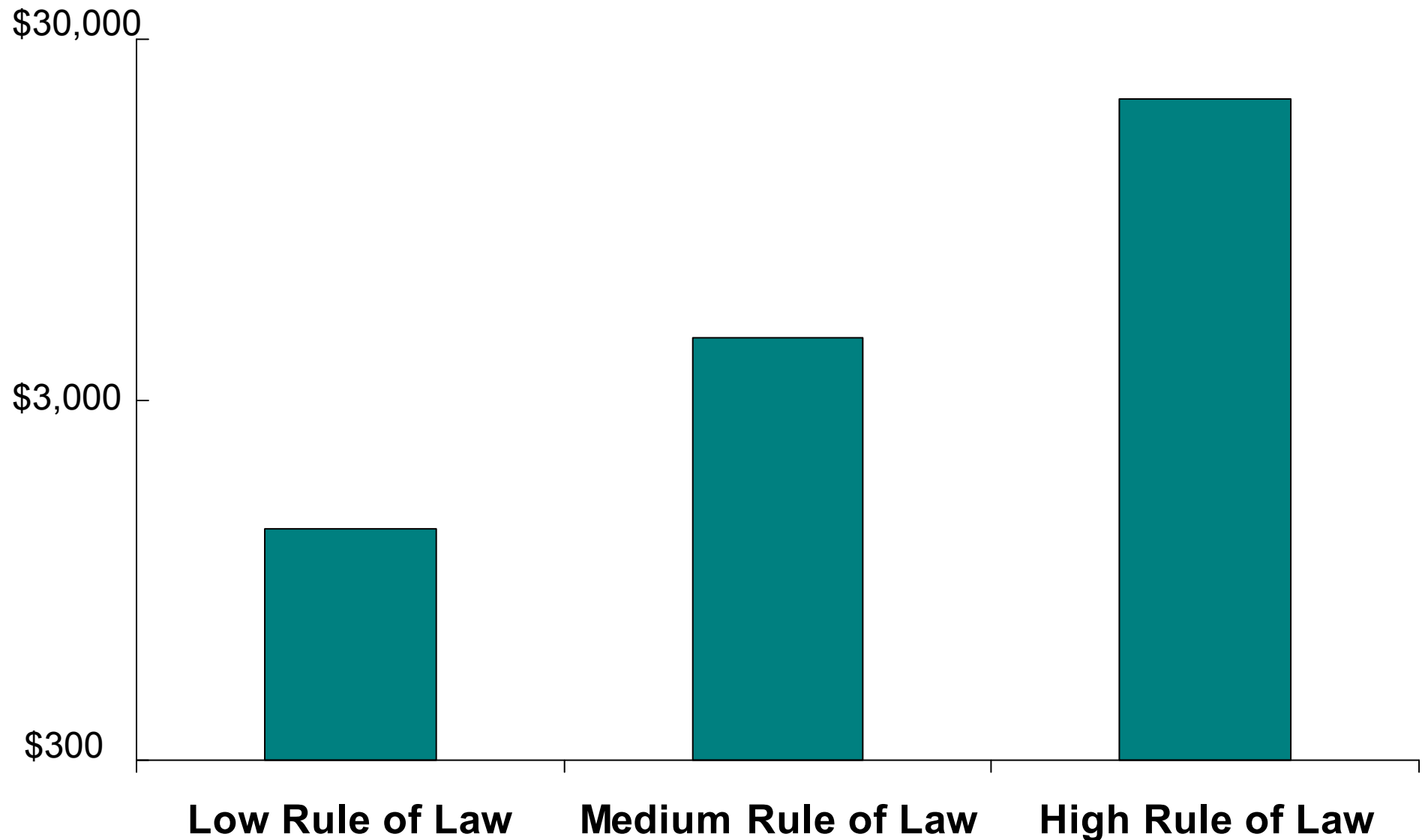
- **Large Development Dividend of Good Governance: a *one-standard-deviation improvement in governance (say, in rule of law or in corruption control) raise incomes per capita in a country by about 300% in long-run***
- **But is such a decline in corruption unrealistically large?: NO -- *One S.D. is the difference from: Somalia → Togo or Guinea-Bissau → Namibia or Rwanda → Botswana or Portugal → Netherlands or Sweden***
- **The impact is from governance to incomes, and not viceversa -- *higher incomes alone will not automatically do***

Governance Matters -- The 'Development Dividend'

Isolating Causality: From governance to income



Development Dividend From Good Rule of Law



Data Source for calculations: KK 2004. Y-axis measures predicted GDP per capita on the basis of Instrumental Variable (IV) results for each of the 3 categories. Estimations based on various authors' studies, including Kaufmann and Kraay.

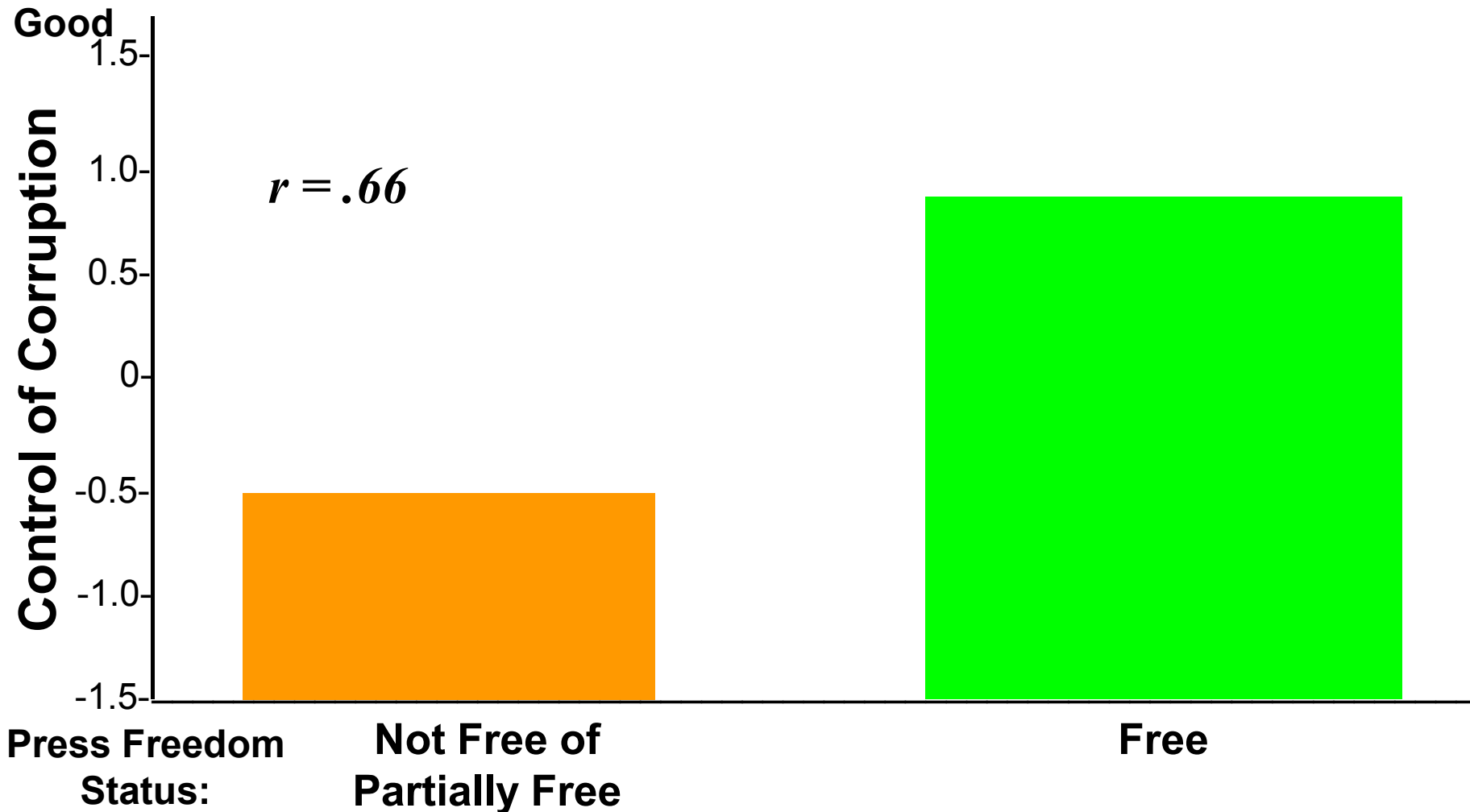
Rule of Law is Associated with Lower Infant Mortality for the Population, 2006



Application 3: Media Freedoms and Transparency Matter for Corruption Control and for Competitiveness

Freedom of the Press is associated with better Control of Corruption

(*& civil liberties more generally is associated with better performance of World Bank-funded projects – see WBER article 1997*)



Source for control of corruption: : 'Governance Matters V: Governance Indicators for 1996-2005', D. Kaufmann, A. Kraay and M. Mastruzzi, September 2006 (<http://www.govindicators.org/>). Source for Press Freedom: 2006 Freedom House's Press Freedom Report. Terciles divided according to Press Freedom ratings (190 countries total). Free: 0-30 (69); Partly Free: 31-60 (54); Not Free: 61-100 (67).

Application 4: What does the 'micro' data tell us about Firms and Managers?

Complementing WGI: Country-specific, in-depth Governance & Anti-Corruption diagnostic surveys

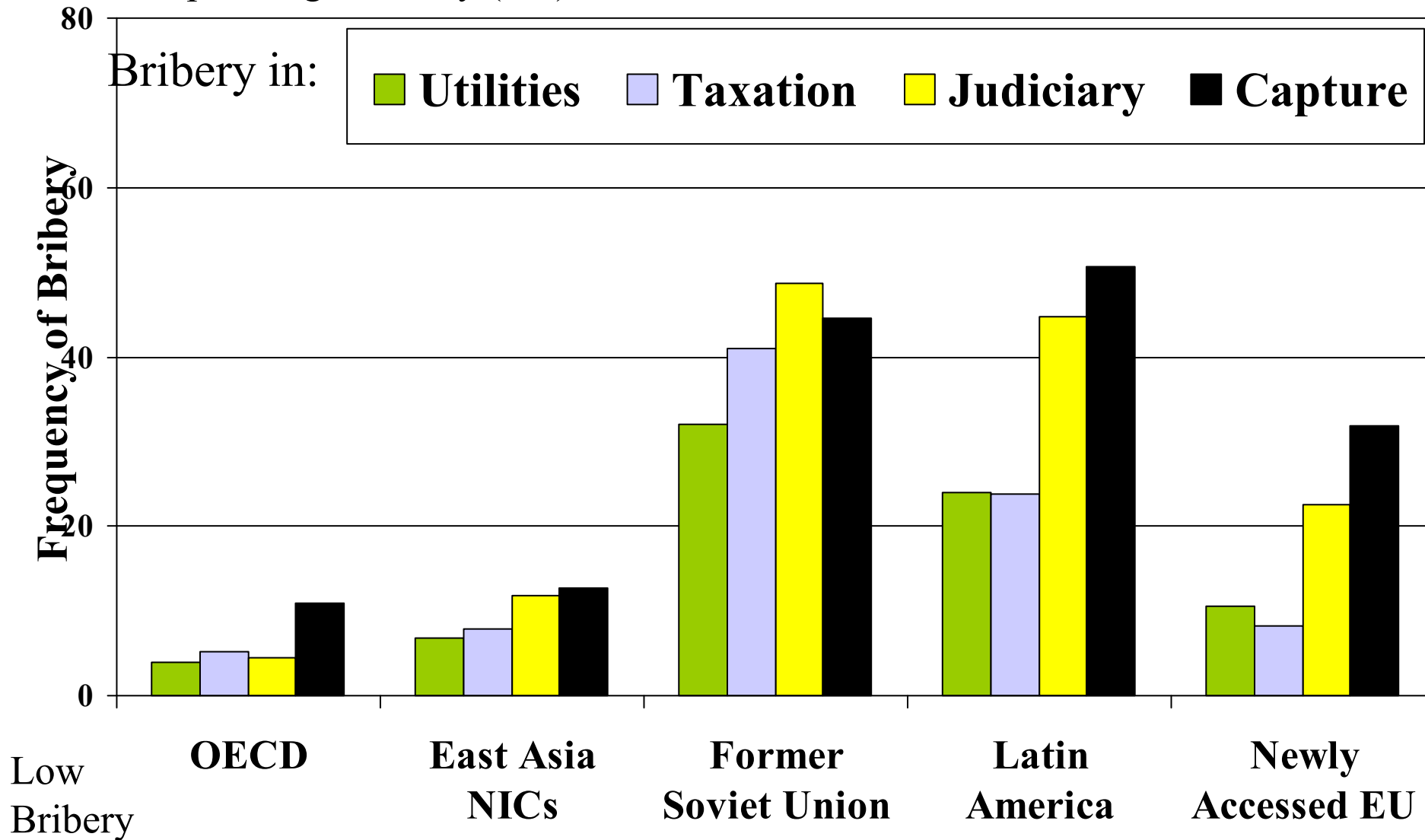
- **A demand-driven, participatory action-oriented process to improve governance**
- **Key features:**
 - ***Three surveys:* households, firms, and public officials**
 - **Questions focus both on *experience* and *perceptions***
 - **Questions are tested and adapted to local realities**
 - **Rigorous technical requirements in *implementation***
 - ***Local institution* implements, with advise from outside**
- **Outcomes: enhanced local capacity, baseline governance data, and action plan for policy reform**
- **In Africa, examples of such diagnostics in Ghana, Zambia, Mozambique, Sierra Leone, Madagascar, Guinea, Nigeria, Malawi, Benin, and Burundi.**

The power of diagnostic data and key dimensions for analysis

- 1. Participatory and Transparency Tool, for all stakeholders within the country to be involved**
- 2. ‘Unpackage’ corruption – administrative, state capture, bidding, theft of public resources, purchase of licenses**
- 3. Identify weak and strong institutions**
- 4. Assess the costs of corruption on different stakeholders**
- 5. Identify key determinants of good governance**
- 6. Input to develop concrete policy recommendations**

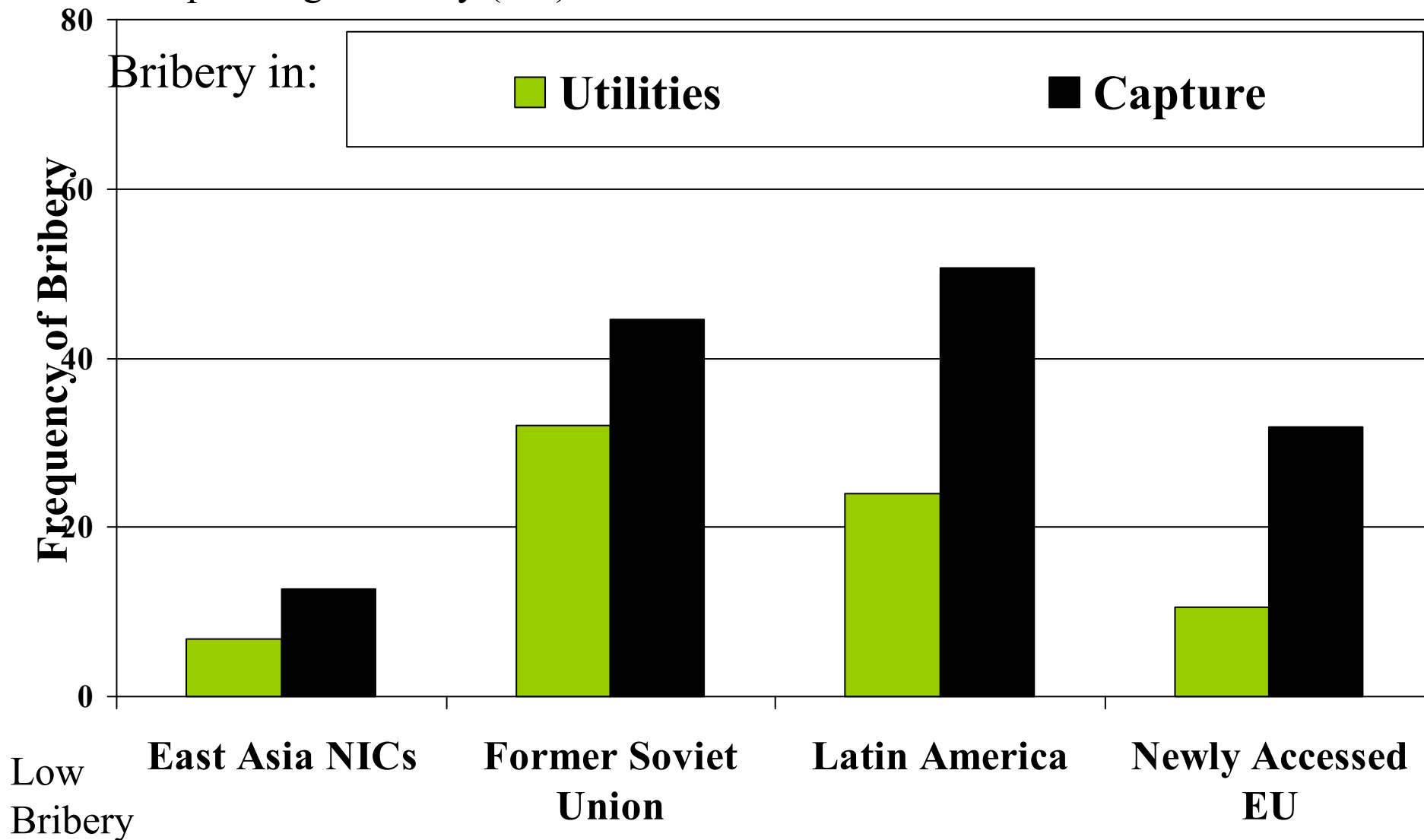
Unbundling Different Manifestations of Bribery, EOS 2006

% Firm Report High Bribery (1-3)



Unbundling Different Manifestations of Bribery, EOS 2006

% Firm Report High Bribery (1-3)



Source: EOS firm survey, WEF2006. Questions: In your industry, how commonly firms make undocumented extra payments or bribes connected with permits / utilities / taxation / awarding of public contracts / influence laws and regulations / judiciary? (common...never occurs).

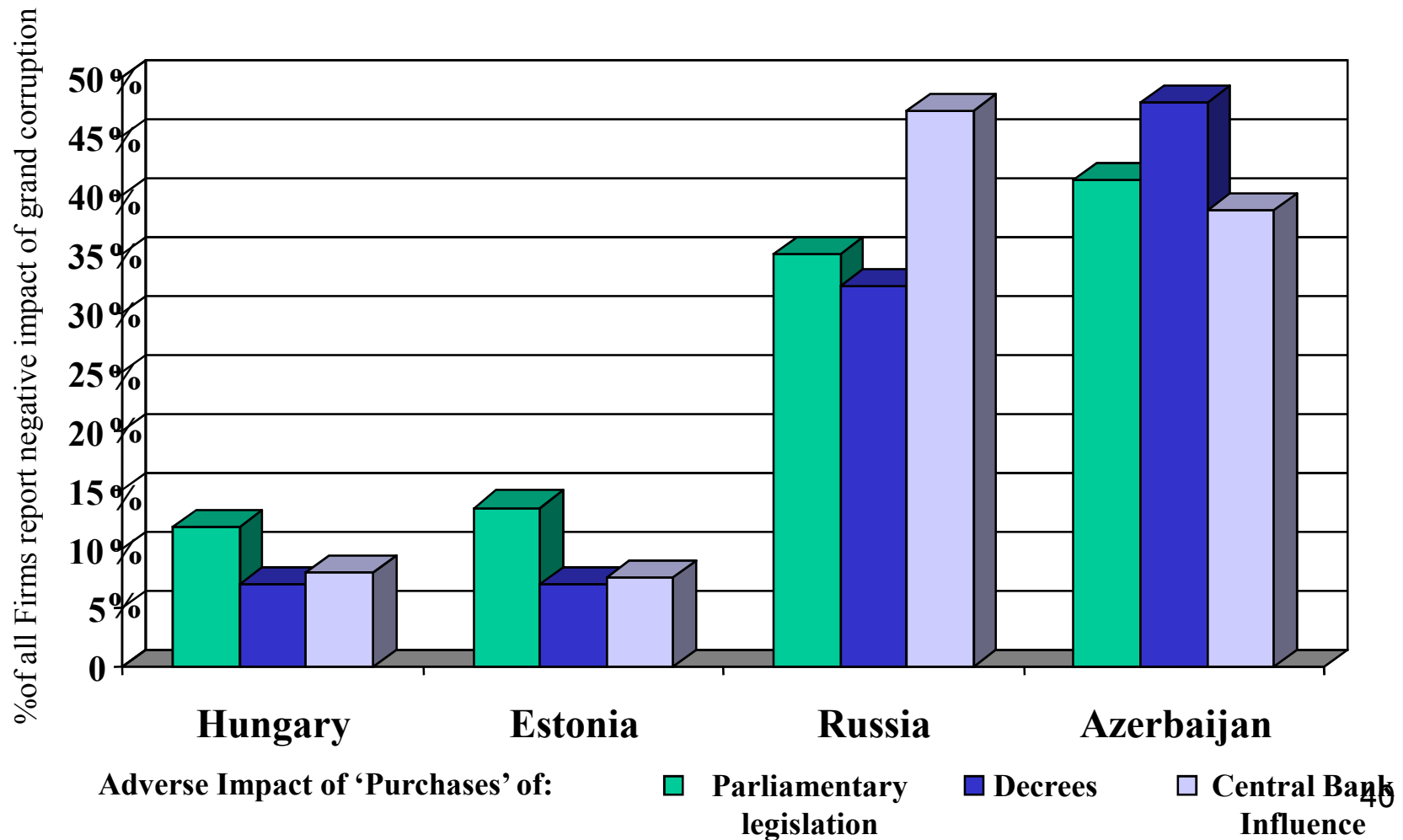
'Seize the State, Seize the Day'
Hellman, Jones and Kaufmann 2000

State Capture: *firms shaping and affecting formulation of the rules of the game through private payments to public officials and politicians*

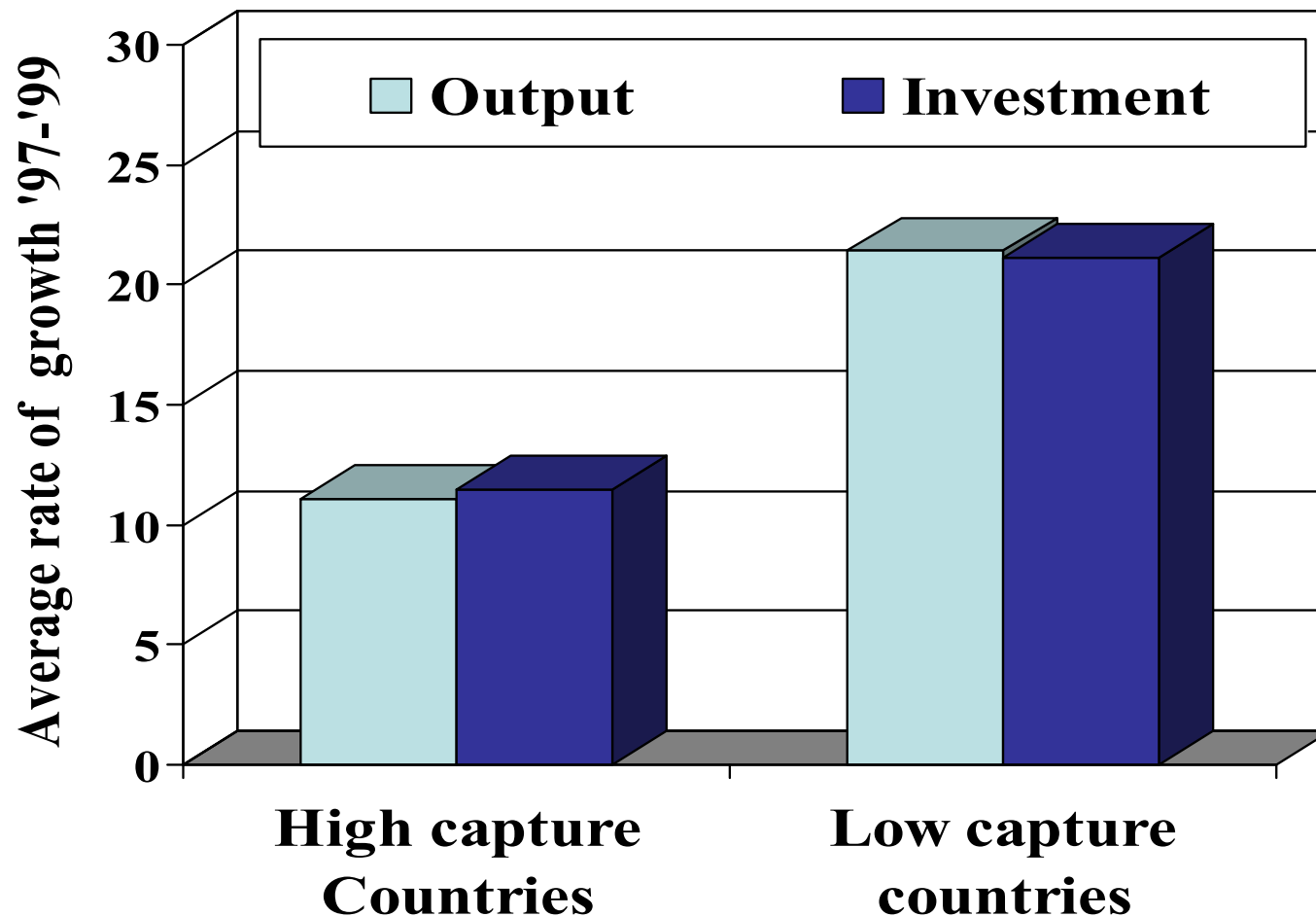
Empirical Research with survey of firms (BEEPS) in transition economies, *where we found that:*

- **Large share of firms reported significant impact on them by capture in many countries in the FSU (e.g. Azerbaijan, Moldova, Russia, and Ukraine).**
- **Captor firms exhibited much higher output and investment growth than non-captors (w/ controls)**
- **In contrast, coerced firms into paying bribes for administrative corruption did not derive benefits**
- **Captor firms benefited in terms output and investment, while the national rule of law and protection of property rights was weakened**

'Seize the State, Seize the Day' (Hellman, Kaufmann, Jones 2000): Differences in Transition Countries on the Extent of State Capture



'Seize the State, Seize the Day' (Hellman, Kaufmann, Jones 2000): Costs of State Capture in Transition – *Private Sector grows and invests less (& more insecure property rights)*



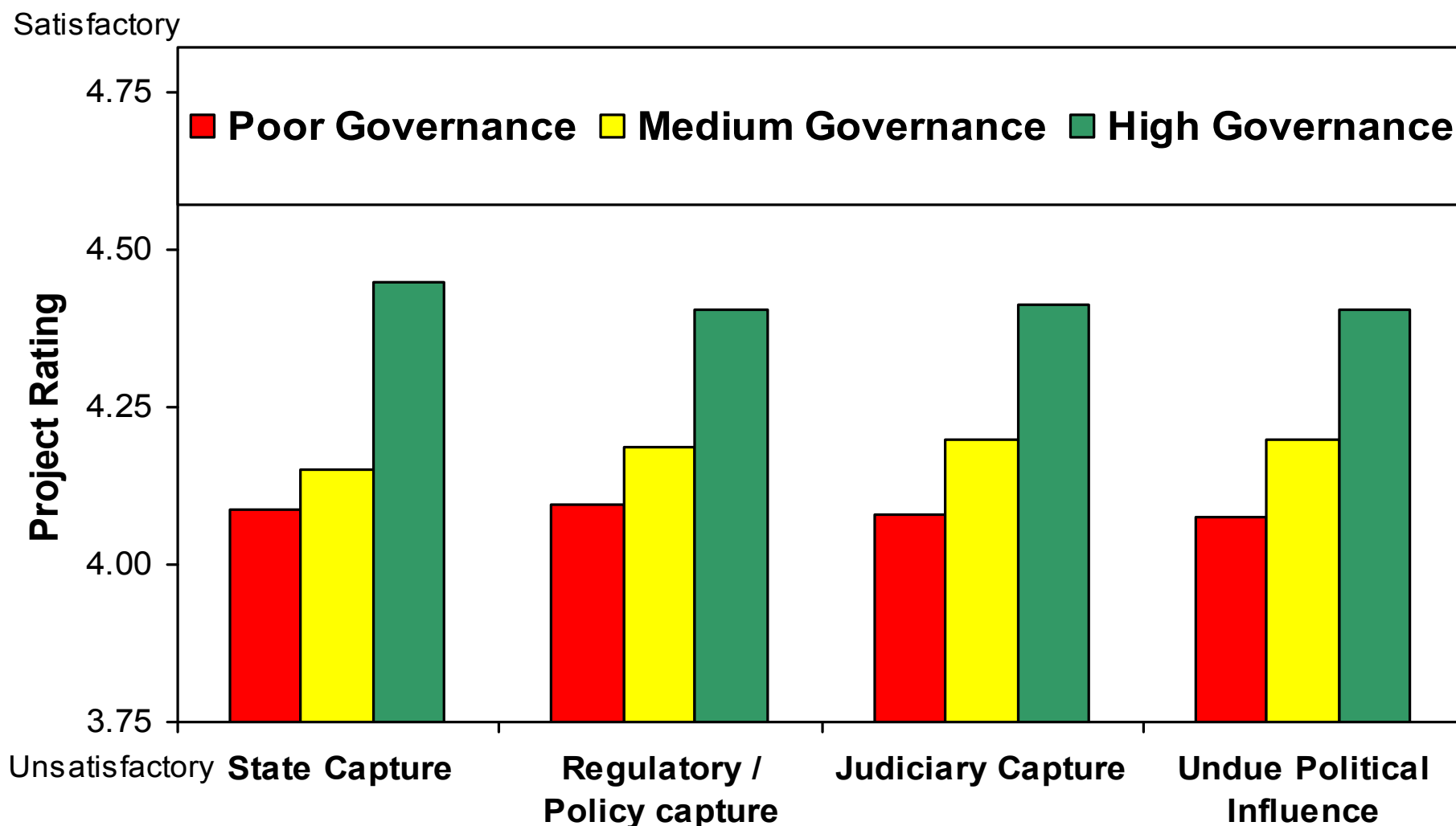
Inequality of Influence, 'Crony Bias'

- In Hellman et al (2002), "*The Inequality of Influence*", we developed proxy measure of the inequality of influence ('crony bias' in political system) from survey evidence from 2002 Business Environment and Enterprise Performance Survey (BEEPS) conducted among 6,500 firms in 27 transition countries.
- We found that inequality of influence has a strongly negative impact on the firm's assessments of public institutions, which in turn affects the behavior of firms towards those institutions.
- Crony bias: associated w/ negative assessment of fairness and impartiality of courts, enforceability of court decisions, and firms reporting prevalence of crony bias are use courts less to resolve business disputes.
- Firms affected by crony bias have less secure property rights than influential firms. Crony bias is also associated with lower levels of tax compliance and significantly higher levels of bribery.
- Inequality of influence not only damages the credibility of institutions among weak firms, but affects the likelihood that they will use and provide tax resources to support such institutions. By withholding tax revenues, paying bribes, and avoiding courts, these firms perpetuate the weakness of such state institutions, making the subject to capture by the more influential.
- The inequality of influence thus appears to generate a self-reinforcing dynamic in which institutions are subverted further strengthening the underlying political and economic inequalities

Does Capture & Undue Influence matter for success of investment projects in emerging economies?

- Utilizing recent data on evaluation of completed projects funded by the World Bank, implemented by countries (IEG project performance data): 3,340 projects during 1995-2007, in 92 countries. Variables: Project Performance; Institutional development Impact
- For capture and undue influence, data from the annual EOS firm survey by the World Economic Forum. Main Variables:
 - State Capture: Do illegal payments to influence government policies, laws or regulations impose costs or otherwise negatively affect your company?
 - Regulatory / Policy Capture: In your country, how frequently would you estimate that firms like yours make undocumented extra payments or bribes connected with import and export permits?
 - Judiciary Capture: In your country, how frequently would you estimate that firms like yours make undocumented extra payments or bribes connected with obtaining favorable judicial decisions?
 - Undue Political Influence: How much influence do you think individuals or firms with close personal ties to political leaders actually had on recently enacted national laws and regulation that have a substantial impact on your business?
- Basic statistics, and firm-level OLS with of controls

Investment Project Performance & Capture, by Terciles



Note: Top tercile refers to good governance ratings; bottom tercile refers to poor governance ratings. Sources: World Economic Forum's Global Competitiveness Survey, 1996-2007 and World Bank Business Warehouse for World Bank-funded projects. Number of projects evaluated: 3,340 during 1995-2007 for 92 countries. **State Capture:** Do illegal payments to influence government policies, laws or regulations impose costs or otherwise negatively affect your company? **Regulatory / Policy Capture:** In your country, how frequently would you estimate that firms like yours make undocumented extra payments or bribes connected with import and export permits? **Judiciary Capture:** In your country, how frequently would you estimate that firms like yours make undocumented extra payments or bribes connected with obtaining favorable judicial decisions? **Undue Political Influence:** How much influence do you think individuals or firms with close personal ties to political leaders actually had on recently enacted national laws and regulation that have a substantial impact on your business? **Share of Successful Projects** measures the percentage of projects with a rating of 5 or 6 (out of 6 possible ratings). **Share of Failed Projects** measures the percentage of projects with a rating of 1, 2 or 3 (out of 6 possible ratings). **Share of Low institutional development impact Projects** measures the percentage of projects with a development impact rating of 1 or 2 (out of 4 possible ratings)

Table 2a: Project Performance and Capture –Results for Regulatory / Policy Capture Corruption Regression

Independent Variables	Dependent variable: Project Rating (1-6)					
	1	2	3	4	5	6
Regulatory / Policy Capture	0.19	0.15	0.18	0.19	0.17	0.28
	<i>6.31***</i>	<i>4.42***</i>	<i>2.62***</i>	<i>3.31***</i>	<i>3.09***</i>	<i>4.06***</i>
Procurement Bribery			-0.03			
			0.49			
Bribery for Permits				-0.03	-0.03	-0.04
				0.66	0.56	0.63
Inflation Rate (log)		-0.13	-0.13	-0.13	-0.13	-0.15
		<i>4.95***</i>	<i>5.15***</i>	<i>5.19***</i>	<i>4.95***</i>	<i>3.83***</i>
GDP per capita (PPP, log)		0.07	0.06	0.07	0.07	-0.28
		0.62	0.54	0.62	0.66	1.57
Growth Rate (past 3 years)		0.01			0.01	0.00
		1.01			0.95	0.13
Latitude						0.40
						1.21
Dummies	Y	Y	Y	Y	Y	Y
Observations	3241	3092	3098	3098	3092	1830
Adjusted R-squared	0.07	0.08	0.08	0.08	0.08	0.08

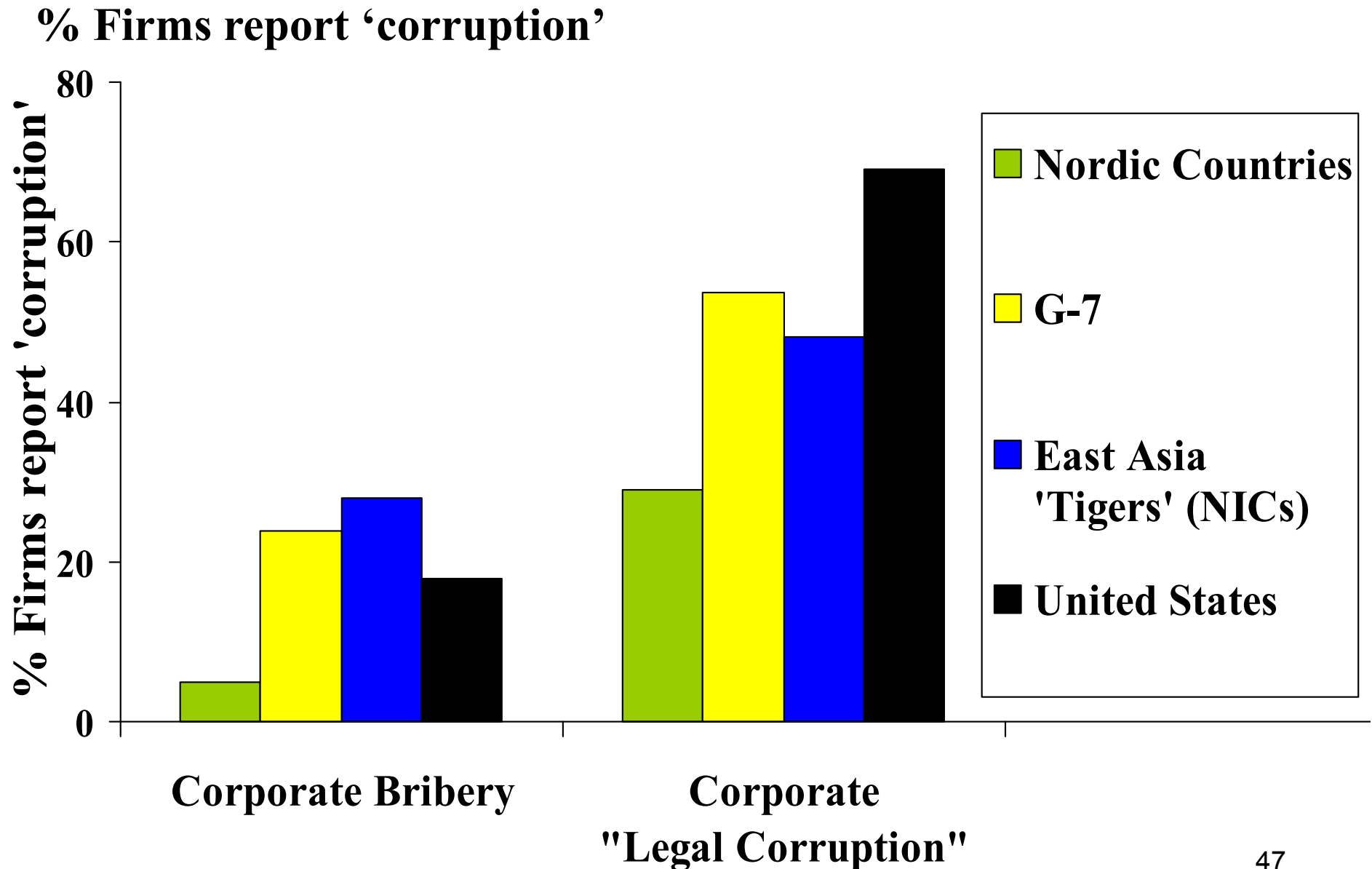
Sources: World Economic Forum's Global Competitiveness Survey, 1996-2007 and World Bank Business Warehouse for World Bank-funded projects. Each specification included regional, project type, project sector and year dummies.

*T-stats in italics; * significant at 10% level; ** significant at 5% level; *** significant at 1% level*

Application 6: Governance and Rule of Law Problems in Rich Countries...

- **The Case of the United States**
- **Governance, Capture and the Financial Crisis**

Bribery vs. 'Legal Corruption' (& soft Capture), 2004



Source: Author's calculations based on EOS 2004.

How has the Governance Matters Research Project Evolved Since the 1990s

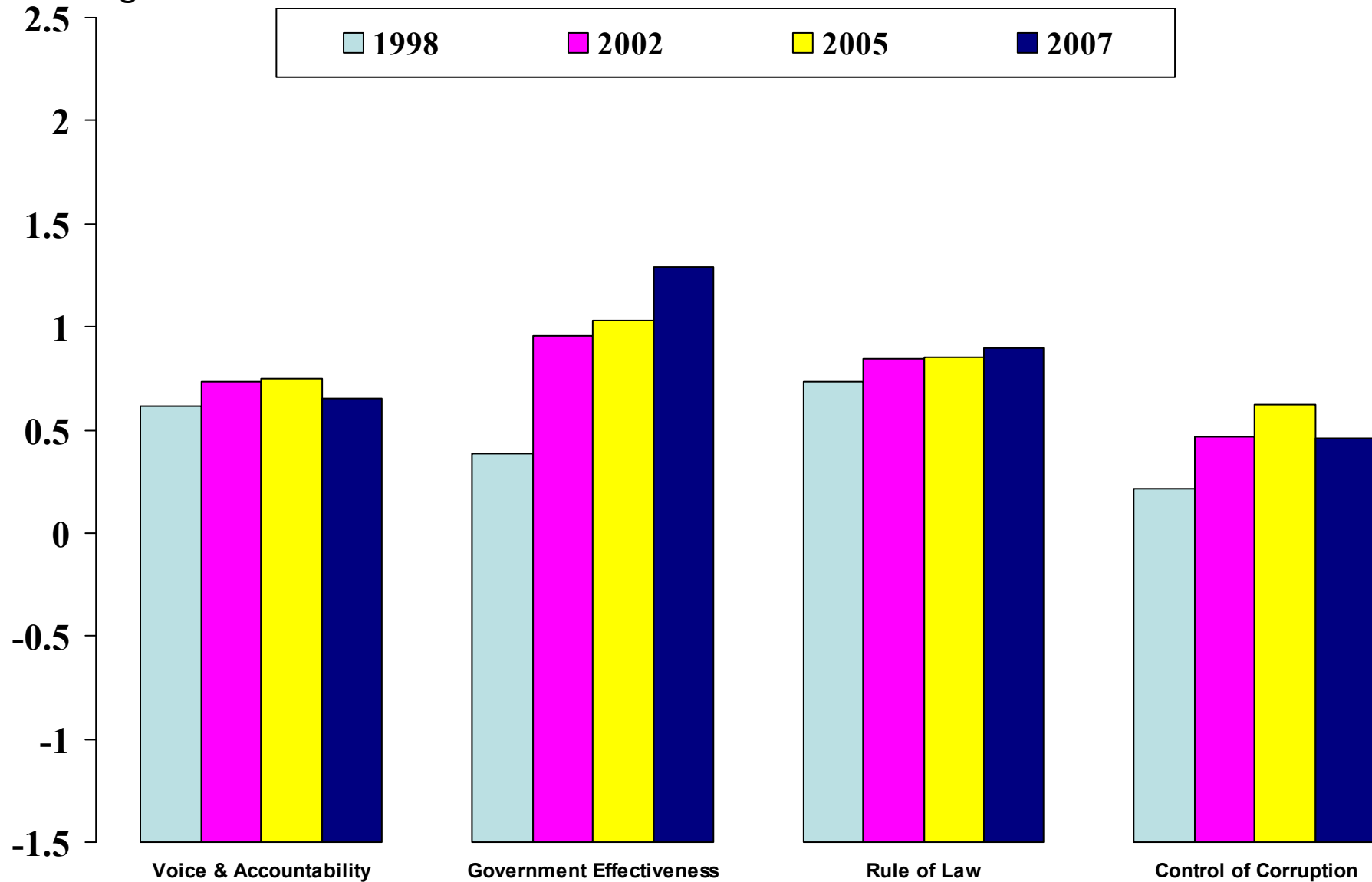
- **greatly expanded set of data sources (13 in 1996, 35 in 2007)– improved precision of aggregate indicators**
- **extensive analytic work on governance measurement – rejecting perception biases, halo effects, correlated perception errors**
- **WGI robust to alternative methodologies**
- **taking margins of error seriously**
 - **most governance and other data sources don't even report margins of error**
 - **no 'horse races' or superficial 'top ten' lists**

From Law & Order to Rule of Law: Concluding

- **Rule of Law interpreted broadly, but not very...**
- **Governance can be measured, and key for evidence-based analysis, research, and policy advise...but with caution, & transparency regarding margins of error, sources, methodology**
- **Variance across countries in Governance & Rule of Law challenges, and changes over time**
- **Rule of Law Matters for sustained growth**
- **Informality important in Rule of Law: Capture & Undue Influence**
- **Each country has specific challenges: tailoring⁴⁹**

Some Governance Indicators for South Korea, 1998-2007

Good governance



Data Power

‘If it cannot be measured, it cannot be controlled’

Lord Kelvin

**‘Not everything that counts, can be counted,
and
not everything that can be counted, counts’**

Einstein