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CONTENTS

Abstract:

New data, new concepts, new results: This working paper offers tools to rethink the role of "good governance" in development strategies. What is "good governance"? Transparency of public action, control of corruption, free operation of markets, democracy and the rule of law. With macroeconomic stabilisation, "good governance" has imposed itself as a universal imperative in development policies since the 1990s.

Yet, with the help of a new database (the 2006 Institutional Profiles database), we show that there is a correlation between "good governance" and the <u>level</u> of development (per capita GDP), but there is no correlation between it and the <u>speed</u> of development (medium-to-long-term growth). Why? Because it does not touch on the driving forces behind institutional, economic, political and social change. We therefore elaborated new concepts to analyse the reality of governance in developing countries, and tested them with the help of the "Institutional Profiles" database.

In this way, we identified the governance capabilities that developing countries truly need: "good governance" does not emerge as a priority for economic take-off. It becomes one later, along with the opening of the social regulation system when, having experienced sustained and lengthy growth, a country seeks to converge with developed countries. In other, non-converging developing countries, the priority is to build capacities for strategic vision and co-ordination among elites. We therefore propose a wider definition of governance ("governance for development") and new indicators to measure it.

Keywords: Institutions, Governance, Corruption, Informal, Development, Growth, Social order

JEL: C8, K0, O10, O17, O4, O57, P0, P1.

Résumé:

Nouvelles données, nouveaux concepts, nouveaux résultats: ce travail offre des outils pour repenser le rôle de la 'bonne gouvernance' dans les stratégies de développement. Qu'est-ce que la 'bonne gouvernance' ? La transparence de l'action publique, le contrôle de la corruption, le libre fonctionnement des marchés, la démocratie et l'Etat de droit. Avec la stabilisation macro-économique, la 'bonne gouvernance' s'est imposée comme impératif universel des politiques de développement depuis les années 1990.

Pourtant, à l'aide d'une nouvelle base de données (Profils Institutionnels 2006), nous montrons que si la 'bonne gouvernance' est corrélée au <u>niveau</u> de développement (le PIB par tête), elle n'est pas corrélée à la <u>vitesse</u> de développement (la croissance de moyen-long terme). Pourquoi ? Parce qu'elle ne touche pas aux ressorts du changement institutionnel, économique, politique et social. Nous élaborons donc de nouveaux concepts pour analyser la réalité de la gouvernance dans les pays en développement, et les testons à l'aide de la base de données « Profils Institutionnels ».

Nous identifions ainsi les capacités de gouvernance dont les pays en développement ont vraiment besoin: la 'bonne gouvernance' ne ressort pas comme une priorité pour le décollage économique. Elle le devient dans un second temps, ainsi que l'ouverture du système de régulation sociale, lorsque, bénéficiant d'une croissance soutenue et prolongée, un pays cherche à converger avec les pays développés. Dans les autres pays en développement (non-convergents), la priorité réside dans la construction de capacités d'anticipation stratégique et de coordination entre élites. Nous proposons alors une définition élargie de la gouvernance (la 'gouvernance pour le développement') et de nouveaux indicateurs pour la mesurer.

Mots clés: Institutions, Gouvernance, Corruption, Informel, Développement, Croissance, Ordre social.

JEL: C8, K0, O10, O17, O4, O57, P0, P1.

Verba volent, scripta manent.[1]
Latin proverb

L'écriture n'est que l'ombre de l'oralité.[2]
Amadou Hampâté Bâ

IS "GOOD GOVERNANCE" A GOOD DEVELOPMENT STRATEGY?

Are "good governance" reforms effective in achieving take-off for developing economies?

What governance capacities do developing countries truly need?

A preliminary response based on the exploitation of the "2006 Institutional Profiles" database and certain theoretical elements.

INTRODUCTION

How an economy achieves long-term growth is still a largely unexplained phenomenon. This is true of the economic take-offs achieved in the past sixty years by a limited number of East Asian countries but also of that of Japan at the end of the 19th century. Going back further in time, we still wonder about the causes that singled out a small part of humanity in the European peninsula from the rest of the world.

As early as the 19th century, economists had identified the role played in growth by the factors of production consisting of capital and labour. The economic models constructed since then partly explain long-term growth by the mobilisation of these factors. But the explanation is only partial: there remains a large unexplained factor, which economists have associated with technological progress and the way in which these factors are combined together.

It is at this point that institutional economics entered the picture, notably during the final quarter of the 20th century, opening up new explanatory paths. If an increase in the quantities of capital and labour has a positive impact on growth, what is it that mobilises (or fails to mobilise) these factors of production? Moreover, mobilising these factors on a massive scale is not sufficient to ensure lasting growth: so, what makes this mobilisation effective over time?

Douglas North has provided an answer to these questions: it is the "rules of the game" in operation in societies, linking all social actors, including the State, that model behaviours and expectations, and contribute (or not) to growth. These rules of the game, this system of incentives, consist of institutions, either formal or informal, and create, in differing degrees and in a wide range of ways, the basic

[1] "Spoken words fly away, written words remain."
[2] "The written word is but the shadow of the spoken word."

framework allowing an actor to conduct (or not) a transaction with another, to initiate (or not) a project for the long term (an investment, spending on children's education), acts that are at the heart of the creation of wealth and its extension, economic growth. This framework provides (or does not provide) the fundamental element in the process of wealth creation, the reduction of uncertainty. This lessening of uncertainty is the **confidence that individuals have in the fact that rules will be followed by all of society.** It is what makes actors' transactions and anticipations more secure.

The questioning then moves to the factors that engender this confidence between agents and make it possible to reduce uncertainty in economic, social and political relationships. What are these factors? How can they be generated?

In the field of development policies, the international financial institutions have provided a *de facto* response by proposing an operational tool modelled on the institutions existing in developed countries. This tool is "**good governance**": individual rights respected, contracts secured, effective administration, democratic political institutions. This "good governance" is presented as a universal solution to ensure that the confidence needed for economic growth is generated. Developing countries are asked to adopt this tool for themselves, formulated as a set of technical measures, in order that the development process may begin.

"Good governance" nevertheless leaves several major questions unanswered

Although included among the development assistance priorities of all the major donors for more than ten years, "good governance" raises serious questions:

- First, can it be transferred to developing countries? In other words, have "good governance" aid policies improved governance in these countries?
- Second, is it effective in terms of growth? In other words, have "good governance" reforms actually led to a significant acceleration in long-term growth rates?
- Finally, is "good governance", which is indeed a powerful factor in the confidence at work in developed countries, the only way to generate confidence in all countries, regardless of their resources, history and growth dynamics?

These questions lead us to widen the field of our reflection to include the very processes of institutional transition that lead to economic take-off. Such processes are marked by major breaks in the ways in which political, economic and social systems are organised, as well as in individual behaviours. We then sketch out certain theoretical paths for rethinking development in terms of **breaks** and **resistance to change**.

To do so, we combine research into new concepts liable to provide a better understanding of the process of development with an empirical approach based on the exploitation of an original database, "Institutional Profiles", which evaluates the institutional characteristics of eighty-five developing and developed countries. A detailed presentation of the database can be found in Working Document No. 47 (Meisel and Ould Aoudia, 2007) available on the AFD's website (www.afd.fr) and the CEPII's website (www.cepii.fr).

Our work is part of a series of critical reflections, notably those of Mushtaq Khan (2004 and 2006) and of North, Wallis, Webb and Weingast (2006 and 2007), concerning the standard analyses applied to developing countries, and proposing a radically different vision of the functioning of societies in general and of developing societies in particular.

At the level of economic theory, all this work, including our own, proceeds from an approach **that indissolubly links the functioning of the economic and political systems**, irrespective of the level of development. When applied to developing countries, this approach opens up new paths for research, at a time when the predominant development paradigm is being called into question by the success of countries that have not applied it.

Definition of the concepts used in this document

Governance institutions cover, according to the international financial institutions, those institutions that safeguard individual rights, and regulate markets and the functioning of public administration and the political system.

Our approach is to test the relevance of the priority given to "governance for development" policies, using long-term growth as the yardstick. It leads us to distinguish economic growth from development. **Development** is, basically, a process of institutional change. It is a result of the combined effects of numerous economic, demographic, political and social factors. It involves, by definition, a far-reaching transformation of human groups' social regulation systems. Institutional change takes place over a timescale that is neither that of the immediate economic situation nor that of long, historical periods. Its scale is that of the **medium-to-long term,** during which the economic and social breaks characteristic of a capitalist transformation occurred in countries that began their economic take-off during the second half of the 20th century.

We try to elucidate the links between institutional change and growth. For **economic growth,** we look at GDP growth per capita over the medium-to-long term. Among institutional growth factors, we concentrate our analysis on the institutional factors that are specific to **economic take-off** (lasting acceleration in the growth of developing countries). This take-off combines productivity gains and improvement in the standard of living over the medium-to-long term. It is during this take-off phase that the most far-reaching institutional breaks are launched (paradigm shift).

We make a distinction between take-off and **economic catch-up**, the latter concerning countries that have already achieved take-off and have entered a sustained phase of convergence between their levels of income per capita and those of the developed countries.

Finally, we also make a distinction between **institutional functions,** which are universal and timeless (such as the production of confidence, the preservation of order and security in society, etc.), and **institutional arrangements** (or institutional forms) that take on different faces depending on the country, its level of development, its history, etc.

Our work leads to the following main conclusions:

(1) "Good governance" is indeed a key factor in the establishment of confidence in developed countries by systemically procuring, via compliance with formal rules, a high degree of transaction security. This security, in its turn, procures **a decisive advantage** in a society's capacity to produce wealth.

(2) As all societies have done for thousands of years, developing societies operate under a mode of confidence production that is based on **personal relationships.** Yet, demographic transition and growing urbanisation inevitably cause these societies to enter **a process by which social relations are <u>depersonalised</u>.** This depersonalisation weakens the traditional factors in the production of confidence in these societies.

(3) Developed societies operate according to a **radically different** mode of confidence production, as it is based on impersonal rules that apply to all regardless of the intrinsic characteristics of each

individual. Thus, institutions are separate from people. This detachment, the fruit of lengthy elaboration of **formal rules,** systemically ensures high confidence **that rules will be followed.**

(4) In developing societies, the rule depersonalisation movement **does not spontaneously bring about** a shift towards the mode of confidence production in effect in developed countries. In this way, there emerges a "grey area" in which the previously predominant confidence production factor no longer functions, whereas that of developed countries is not established.

(5) The recommended "good governance" measures aim to establish the mode of confidence production at work in developed countries. **In fact, they amount to dictating that institutions (rules) be formalised and made universally applicable (separate from people).**

(6) The transposition of this process of impersonal formalisation of rules in low-income countries **does not work.** The resistance to the risk of destabilising social orders that it causes is an insurmountable obstacle in the short-to-medium term. Although desirable in itself, **it is not applicable** in these circumstances. This is why the relationship between "good governance" and growth is so weak and why programmes in support of this "good governance" have so little impact.

(7) Countries in the economic **take-off** phase have introduced **different arrangements for the creation of confidence,** in most cases organised around a strategist State which ensures, in a manner specific to each country, the functions of co-ordination of actors and providing a secure basis for their anticipations. These functions are combined in the concept of a "governance focal monopoly". These countries manage to set off an institutional change involving profound breaks in the modes of regulation of social, economic and political systems.

(8) The countries that have experienced this take-off phase over the medium-to-long term have accumulated sufficient resources and economic experience, including on world markets, to undertake the process of **catching up with standards of living in developed countries**. Their institutional transformations then involve the acquisition, at their own pace, of the institutional characteristics of developed countries (formalisation and opening up of the existing system of social regulation).

(9) From these results, there emerges a **form of institutional progression** that is a function of countries' economic dynamism, with low-growth developing countries moving closer to developing countries that have already begun their economic take-off, and then with these countries moving closer to developed countries (economic catch-up).

(10) In this way, a new and broader concept of governance emerges, namely **"governance for development"**, which covers the various institutional arrangements that produce confidence depending on the income level of the country and dynamic of opening to new actors. This opening up of the regulatory system occurs on the economic level (extending the possibilities of market entry to new actors), on the social level (increased role of merit) and on the political level (democracy). We are therefore in a position to define "good institutions" in non-normative fashion: good institutions are those that ensure lasting confidence among agents, and between agents and organisations (the State, firms, etc.).

(11) From this new definition of governance derived directly from its link to growth, we move to its **measurement**, by proposing a set of **"governance for development" indicators** that cover all the constituent elements in the production of confidence (governance focal monopoly, formalisation of rules) and those that deal with the opening up of the regulatory system.

Outline of the document:

After presenting the “Institutional Profiles” database (Section 1), we conduct a series of empirical analyses using data from the database to situate “good governance” in the institutional field, assess how effective “good governance” is in speeding up the pace of growth in developing countries, and identify the institutional characteristics of countries that have entered a take-off or catch-up process (Section 2).

We then elaborate theoretical elements to account for the results of the previously conducted empirical analyses. Institutional change is a process that involves **profound breaks** with previous modes of regulation of social, economic and political systems. It runs into **fierce resistance**, especially from the elites. On this basis, we analyse various factors producing confidence between actors, as well as the political economy of change in light of the stability of social and political systems, and come up with two concepts: that of the **“governance focal monopoly”** designating the capacity for the coordination of actors and strategic visions, on the one hand, and that of the **“insider system”** designating the interplay of interests among the elites, on the other (Section 3).

Finally, we propose to widen the concept and measurement of governance (“governance for development”) by taking into account the local political economy (Section 4).

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SECTION 1: PRESENTATION OF THE "INSTITUTIONAL PROFILES" DATABASE

1.1. Definitions and principal parameters in the institutional database

A broad definition of institutions. The database is founded on the World Bank's definition of institutions (1998), which is in turn based on that of D. North (1990): institutions are constituted by a set of formal rules (constitutions, laws and regulations, political systems, etc.) and informal rules (value systems, beliefs, mental images, social norms, etc.) that govern the behaviour of individuals and organisations, the latter being groups of individuals pursuing common goals (enterprises, trade unions, NGOs, etc.). In this context, institutions structure the incentives that act on behaviour and provide a framework for economic exchanges.

Geographic coverage. The countries that make up the database cover all zones—developing, in transition and developed countries (see Annex 1 for a complete list), accounting for 90% of world population and GDP, and thus providing a wide range of economic and institutional trajectories. The 85 countries are broken down as follows: East Asia and Pacific (11), Europe and Central Asia excluding OECD (12), Latin America and the Caribbean (11), Middle East and North Africa (11), South Asia (4), sub-Saharan Africa (21), and developed countries (15).

The field of institutions covered in the database is structured into nine subject headings or functions: (1) political institutions, (2) safety, law and order, (3) functioning of administration, (4) markets' operating freedom, (5) co-ordination of actors and anticipation capacities, (6) security of transactions and contracts, (7) regulations and corporate governance, (8) openness to the outside world, and (9) social cohesion. These **nine institutional subject headings** are then in turn broken down across **four sectors:** (A) public institutions, civil society, (B) the market for goods and services, (C) the capital market, and (D) the labour market. The full institutional field is captured in the analytical framework of institutions presented in Annex 2.

Transparency of the database. The database is freely accessible to researchers and development institutions on the websites of the Centre d'Études Prospectives et d'Informations Internationales (CEPII)[3] and the Agence Française de Développement (AFD). It is the subject of detailed descriptive documents available on the site from which it can be downloaded in Excel format (Berthelier *et al.*, 2004; Meisel and Ould Aoudia, 2007). All the elementary variables from which the indicators used in the document were compiled are available and the aggregation methods chosen are clearly explained (other methods are possible, depending on researchers' needs).

Elaboration of the database. The database was elaborated by researchers from the French Ministry of the Economy, Finance and Employment (MINEFE) and the Agence Française de Développement (AFD). The data were obtained notably from a questionnaire filled out by their respective agencies in each of the eighty-five countries covered.

Two surveys have already been carried out, one in 2001 and the second in 2006. The next will take place in 2009.

[3] /www.cepii.fr/

1.2. A database focusing on the role of institutions in growth and development

Most institutional databases focus on a defined objective: to measure the advance of freedom around the world (Freedom House), press freedom (Reporters Without Borders), corruption (Transparency International), etc. The "Institutional Profiles" database focuses on long-term growth and development: it aims to identify the factors that foster or block growth, in the field of institutions.

This emphasis on issues relating to development implies that the subject scope has to go far beyond simple "governance". In other words, governance, whether narrowly defined (market regulation and the functioning of public administrations) or broadly defined (to include the functioning of political institutions) is one of the essential but non-exclusive aspects of the institutional field.

As a result, the database contains a large number of indicators, covering the most complete thematic field possible. The questionnaire on which it is based contains 356 basic variables. After first order aggregation, these variables produce 132 indicators: 110 indicators on the state of institutions ("stock" indicators) and 22 indicators on reforms ("flow" indicators).

Among other things, the attention paid to the links between institutions and economic growth required the questions asked during the surveys to deal more with the effectiveness of institutional arrangements (*de facto* approach) than with their existence or precise legal form (*de jure* approach).

This point is a fundamental characteristic of the database, as it touches on the issue of **enforcement of and compliance with rules,** which establishes the link between institutions and development: adopting rules does not guarantee that they are effectively applied and followed. The *de facto* quality of institutions depends on compliance with rules. And, it is this specific dimension—enforcement of (or not) and compliance with (or not) rules—that the database aims to capture.

1.3. The statistical instruments used in this document

At this stage of our work, we are using the data from the database according to a multi-criteria approach involving no inferential dimension, i.e. we let the data "speak for themselves". The use of exploratory data analysis (EDA)[4] statistical instruments corresponds to this option (Lebart *et al.*, 1997; Robin, 1999).

From these tools, we provide an illustration to show the extent of the institutional field covered by the "Institutional Profiles" (IP) database. Using two principal components analyses (PCAs), we compare this database to the World Bank Institute's six governance indicators, which are themselves the result of aggregating several dozen existing institutional indicators.

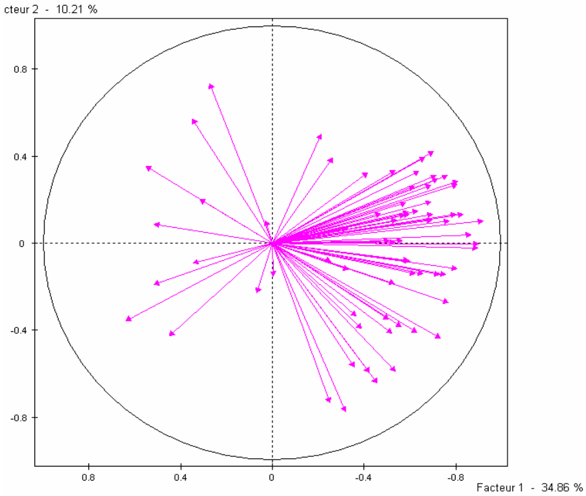
In graph 1, which represents the circles of correlation that capture most of the information contained in the two sets of indicators (see Annex 4 for information on PCA methodology), the extent of the field covered by the IP database can be estimated by the fact that the arrows (each arrow represents one indicator)

[4] Exploratory data analysis (EDA) is a statistical method applied to a group of individuals characterised by a large number of variables. Its aim is to obtain as faithful a description possible of a set of observations that are too numerous and too interdependent to be interpreted at first glance. In addition, this data representation technique necessitates neither statistical hypotheses on the joint distribution of data nor reference to a particular model. It involves neither modelling nor inferential procedures, letting the data "speak for themselves" (Lebart, Morineau and Piron, 1997). In the analyses developed here, this means that we do not take as an *a priori* starting point a model of the link between institutions and development. Among the many EDA instruments, we use here principal component analysis (PCA) and canonical variate analysis (CVA), which does in fact contain a certain degree of inference. We discuss this point in more detail below.

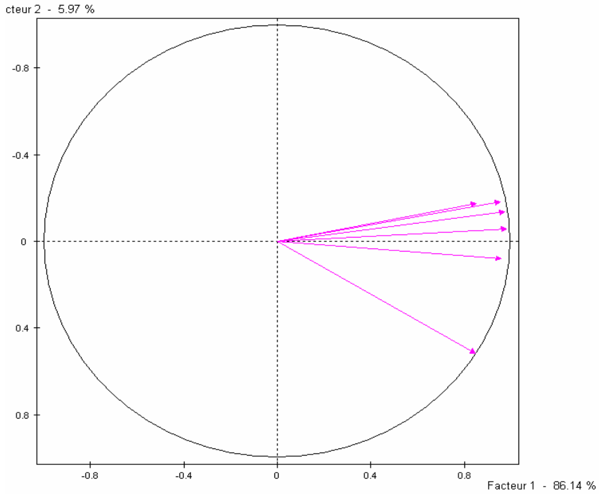
spread in nearly every direction, whereas those from the WBI database are highly concentrated around only one direction: the horizontal axis to the right.

Graph 1: Projection of the Two Sets of Indicators on the Circle of Correlation[5]

IP database indicators



WBI governance indicators



Sources: "Institutional Profiles" and WBI. SPAD software.

Among other things, one notes that five of the WBI's six indicators show a strong correlation to each other (the angle formed by the arrows representing them is very acute). The information provided by these six indicators, and through them by the dozens of indicators used to compose them, is therefore very little diverse.

In all, the "Institutional Profiles" database therefore covers a much vaster institutional field than that of the governance indicators.

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[5] In these two PCAs, we have conducted the analysis on the 85 countries present in the "Institutional Profiles" database. In the IP database, we have reduced the 110 "stock" indicators into 71 aggregated indicators. In the WBI database, we have analysed the 6 governance variables.

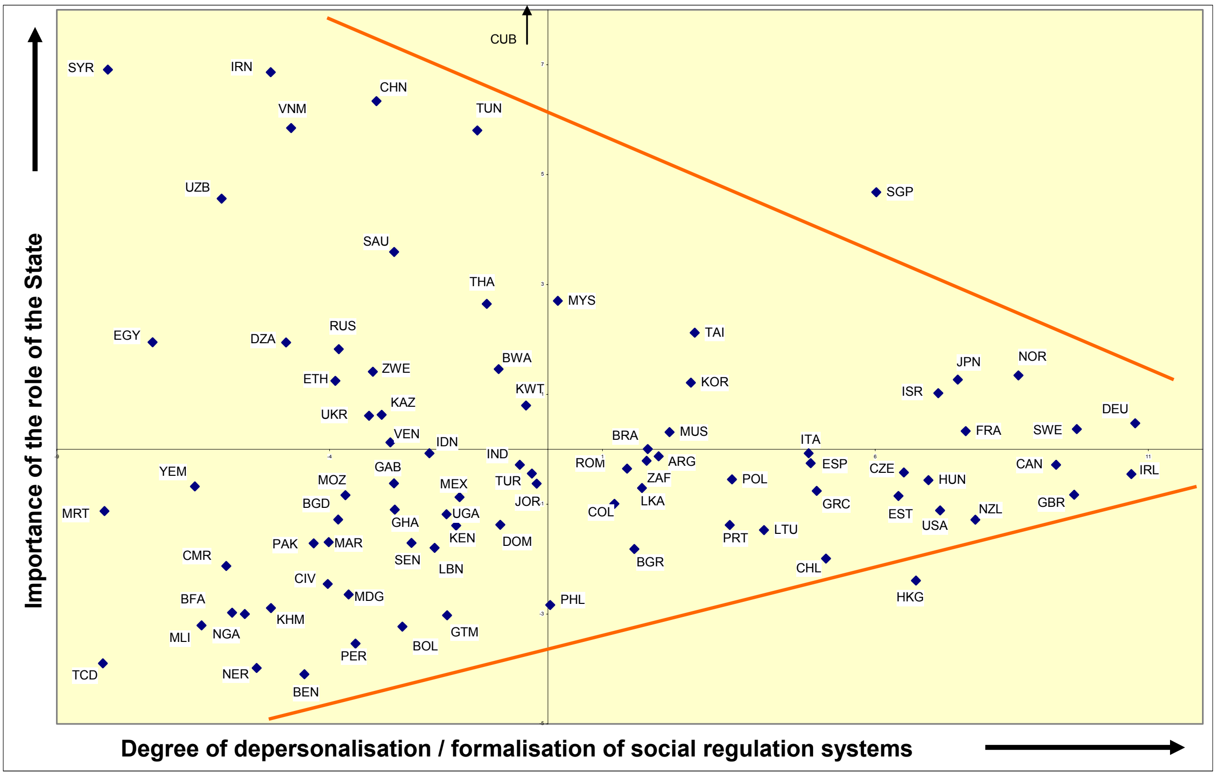
SECTION 2: "GOOD GOVERNANCE" AND ECONOMIC DEVELOPMENT: WHAT DO THE DATA SAY?

In this section, we apply the standard analyses of "good governance" to the results of the exploration of the institutional indicators supplied by the database.

2.1. The degree of formalisation of rules is the first discriminatory factor between institutional profiles

The exploration of the data is carried out, initially, using principal component analysis (PCA) on all the data in the database[6]. This initial analysis determines which institutional characteristics are most meaningful for the countries documented. The first two axes of dispersion of variables revealed by PCA form the first factorial plane on which all the countries are projected (graph 2). These two axes capture 45.1% of total variance, that is to say of the information contained in the entire database. A detailed analysis of this PCA can be found in Annex 4.

Graph 2: Countries projected on the first factorial plane of the PCA (85 countries, 71 active stock variables)



Source: Institutional Profiles database.

[6] Only "stock" indicators have been used in this document. The base formed by these 110 indicators was then reduced by successive aggregations (see the method used in Berthelier *et al.*, 2003), to a set of 71 institutional indicators used for the various exploratory data analyses presented here (see Annex 3 for a list of the indicators used).

● **On the first axis** (34.9% of total variance) the following variables are notably projected: level of security for property rights and transactions, functioning of administration, level of corruption, level of market regulation, operation of solidarity mechanisms (health, unemployment, old age), functioning of political institutions.

This axis compares:

- to the left, the systems **in which these functions are essentially fulfilled informally,** based on **interpersonal** relationships; and
- to the right, the systems **in which these functions are systemically fulfilled according to a formalised**, written and objective mode based on **impersonal** relationships.

Among other things, by choosing the *de facto* approach to gathering information that led to the elaboration of the database (see Section 1), the indicators evaluate the **effective application** of institutional systems (enforcement of and compliance with rules).

In all, axis 1 is a snapshot, at a specific moment of time, of the position of countries according to **the degree of depersonalisation of their social regulation systems**[7] and according to the effectiveness of the response provided by the **formalisation of and compliance with formal rules.**

The first factor that differentiates countries thus concerns two modes of establishing social rules, that is to say two modes of **producing confidence in the application of rules,** either based on informal and interpersonal rules or on formal and impersonal rules (i.e. separate from people). It describes, from left to right, the situation in countries according to the degree to which their systems of economic, political and social regulation have been formalised.

Societies that are currently developed have also followed this long march from social systems in which confidence is built on the basis of interpersonal relations on a limited scale to systems in which confidence is more systemic and governed by impersonal law-based relationships. Thus, the rights and status attached to birth abolished at the time of the French Revolution (during the night of 4 August 1789) are examples of personal links (by birth) and not of formal rules independent of individuals.

This initial empirical result rejoins the classical sociological analyses elaborated at the end of the 19th century (Weber, Durkheim) and taken up by North (1973, 2005), Kuran (2005) and Greif (1993, 2004), among others.

● **The second axis** is, by construction, the one that comes in second place in regard to the quantity of information captured in the database (10.2% of total variance). It compares:

- on top, variables marking the presence of the State in the political, institutional and economic arenas; and
- on the bottom of the axis, variables characterising political and social liberties, and weak involvement of the State in the economy and society.

The second factor therefore differentiates countries according to the relative weight of the State in economic, political and social regulations. The primary orientation of this vertical axis compares societies

[7] However, one must guard against seeing the predominance of interpersonal relations (more in an informal mode) only as a vestige of the past, a residual element that will inevitably be reabsorbed through a linear and controllable process. On the scale of small groups, new forms of informality persist and even develop at all levels of economic development. They do so no only "at the bottom of society" but also in its heart and even at the cutting edge of innovation (Braudel, 1986; Aoki, 2000).

in which the State's influence over society is considerable (and can even take authoritarian forms: Cuba, Syria, Iran) with societies in which economic and civil liberties are more extensive, and in which the State is not very active, or even failing, notably in sub-Saharan Africa.

Two general remarks on this vision of countries:

- Along the horizontal axis, one can see a strong correlation between the degree of formalisation of rules and the level of development: the countries to the right of the graph are developed countries, which have highly formal systems of social regulation, while those to the left are developing countries whose forms of social regulation are little formal. This point will be discussed in greater detail below.
- The point cloud captured on this first plane is funnel-shaped, being broad to the left where informal rules prevail, and narrow to the right where rules are formalised and the level of economic development is high. This suggests that, as the level of wealth rises, there is a relative stabilisation of institutional profiles around formalised and properly-applied systems of rules that are typical of developed countries, rules that are promoted through their manifold relations with the rest of the world. On the other hand, it also shows the extreme diversity of institutional systems in developing and emerging countries (to the left of the graph). The analysis of this institutional diversity should enable us to deepen our understanding of the phenomena that foster (or hinder) economic take-off.

Formalisation of rules and "good governance"

In fact, highly formalised systems of social regulation, in which rules are generally followed (to the right on the horizontal axis of graph 2), present the full set of **characteristics that define "good governance":** effectively functioning formal rules ensuring the respect of property and contracts, effective and little corrupt administrations, efficient regulated markets, respected rules of democracy.

We confirmed this result through a PCA of the two sets of indicators combined: the World Bank Institute's six governance indicators[8] and all of the indicators in the "Institutional Profiles" (IP) database[9]. This analysis makes it possible to verify that the horizontal axis of graph 2 (representing, from left to right, the degree of depersonalisation/formalisation of social regulation systems) **is in fact the exact expression of what the international financial institutions call "good governance"** (graph 3).

Indeed, an examination of the graph on the right shows:

- For the IP database (indicator names in small type): the indicators that contribute the most to the formation of this axis (with high values) are the level of transaction security on markets for goods and services (6secutr) and in the financial system (6Fsecutr), the security of formal property rights (6dprof), control of corruption (3corupt), and the efficiency of administrations (3Adm).

- For the WBI database (indicator names in bold), one finds the six "good governance" indicators (with high values): government efficiency (GovEff), good application of rules (RuLaw), a high

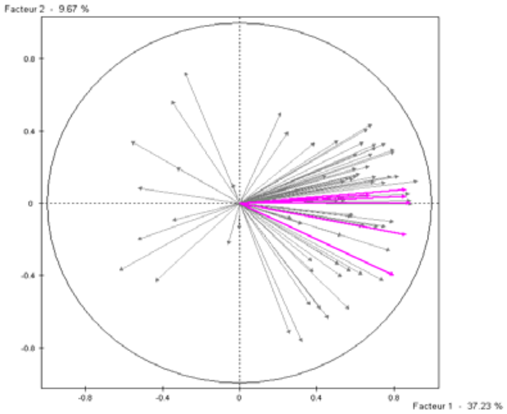
[8] They are: (1) Voice and Accountability (V&A: the level of civil liberty and political institution operation), (2) Political Stability (PolStab: the level of political stability), (3) Government Effectiveness (GovEff: the State's capacity to formulate and enforce its policies), (4) Regulatory Quality (RegQual: free operation of markets), (5) Rule of Law (RuLaw: compliance with laws and regulations by citizens and the State), and (6) Control of Corruption (ContCor).

[9] This PCA was conducted with 77 active variables: the 71 variables from the IP database and the WBI's 6 governance variables.

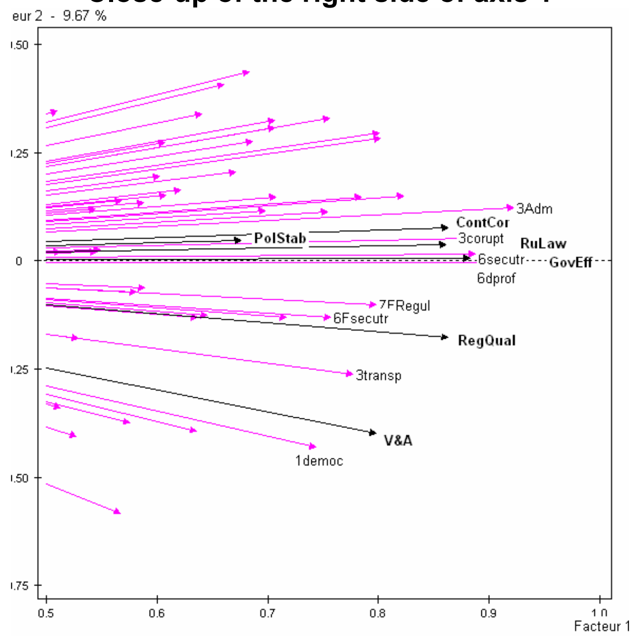
level of control of corruption (ContCor), liberty of operation for markets (RegQual), and democracy (V&A). The political stability indicator (PolStab) is also correlated to the horizontal axis, but to a lesser extent[10].

Graph 3: "Institutional Profiles" and WBI governance indicators projected onto the same circle of correlation

The full circle of correlation



Close-up of the right side of axis 1



Sources: "Institutional Profiles" and World Bank Institute. SPAD software.

In all, this first analysis of the database reveals three important results:

- the degree of depersonalisation of social regulation systems and the effectiveness of the response provided by societies through the formalisation of and compliance with rules make up the decisive fundamentals of countries' institutional profiles;
- these decisive factors are closely linked to countries' levels of development; and
- a high degree of formalisation and effective application of formal rules covers, for the most part, the "good governance" that characterises in fact the social regulation systems of developed countries.

Based on these initial results, we seek to deepen the links between institutional transition processes and development.

[10] One will note that the two indicators corruption (ContCor and 3corupt) and democracy (V&A and 1democ) present in both databases show a high correlation (the angle between them is closed). The four other WBI indicators do not have exact equivalents in the IP database, which is less aggregated for these items.

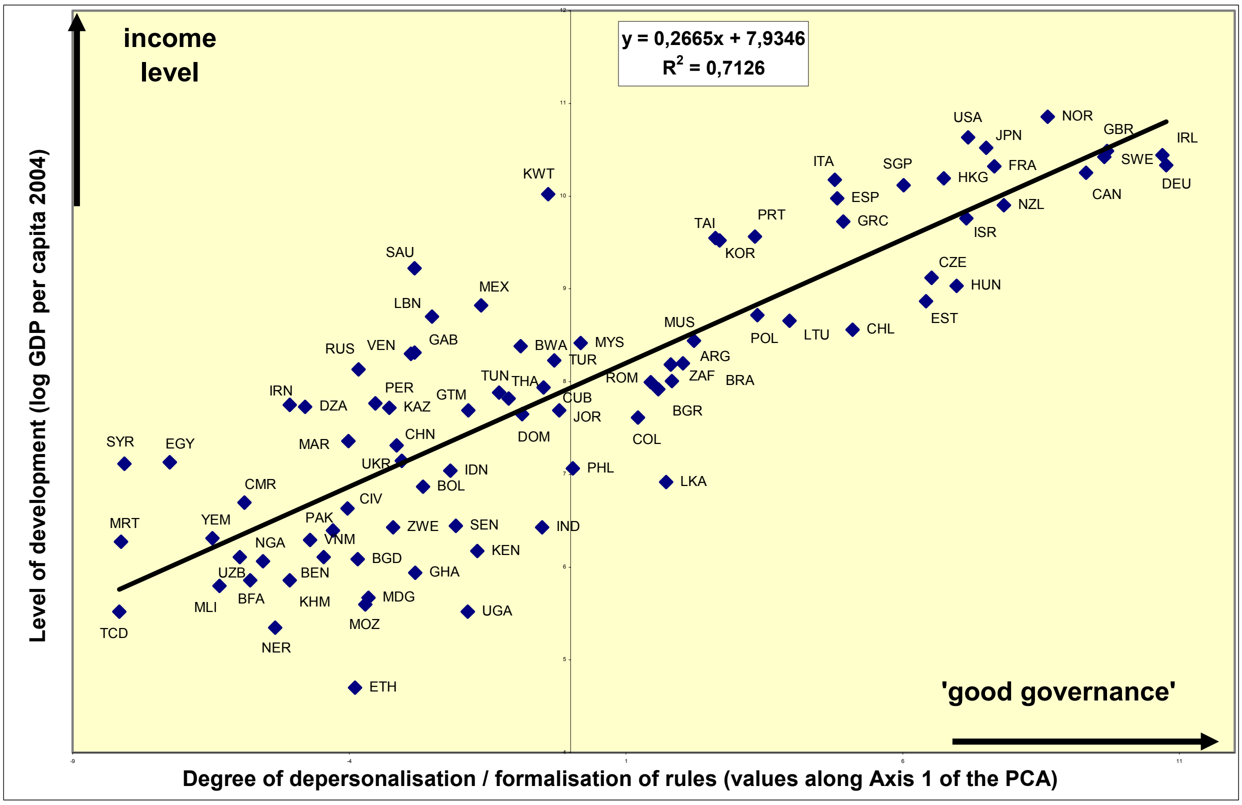
In the rest of this section, we verify the strong relationship between "good governance" and income **levels** (2.2), whereas the relationship between "good governance" and income **growth** does not seem proven: developing countries with the same level of "poor governance" can have opposite economic performances in terms of medium-to-long-term growth (2.3). We then seek to identify which institutional factors differentiate high-growth developing countries from low-growth developing countries (2.4).

2.2. What is "good governance"? Answer: the system of social regulation that prevails in developed countries

We have identified that the PCA's horizontal axis, which differentiates countries the most, is also the axis of development, opposing poor countries to the left and wealthy countries to the right.

We now seek to deepen this observation by examining the relationship between the variables forming this axis (the formalisation of countries' regulation systems) and the level of development, here measured by income. To do so, we use the country coordinates on the horizontal axis of the PCA (as an indicator of the degree of depersonalisation/formalisation of regulation systems) as the abscissa, and the logarithm of GDP per capita as the ordinate.

Graph 4: Canonical relationship between "good governance" and income level



Sources: Institutional Profiles database, World Development Indicators (World Bank).

This analysis confirms the canonical relationship, in accordance with the results of the World Bank Institute (Kaufmann *et al.*, 1999), showing that good governance (the degree of formalisation of rules) is very closely correlated with the level of a country's development[11], in a relationship of circular causality. By creating an environment that is conducive to transactions, the formalisation of rules permits increased production of wealth which in turn makes it possible to finance the institutional arrangements that ensure the security of transactions on a systemic scale.

What the Bretton Woods institutions call "good governance" is, in the end, nothing more than an advanced stage in the formalisation of rules.

Box 1. Governance and income level:
Which is cause and which is effect?

The question of the direction of the causality in the relationship between governance and income levels has been the subject of abundant literature: is governance caused by or does it cause income levels?

Having determined that the direction of the causality was from institutions towards income levels ("*Governance Matters"* - Kaufmann et al., 1999), Kaufmann and Kraay (2002), in a document entitled "*Growth without Governance"*, concluded that there was no circular causality relationship: while better governance tends to promote economic growth, growth, for its part, does not necessarily improve governance.

They arrive at this result at the cost of two strong hypotheses: (1) that the present dispersion of GDP levels per capita is the expression of long-term growth differentials between countries; and (2) that governance evolves very slowly, to the point that the present dispersion in measurements of governance between countries is mainly the expression of governance differentials between countries prior to any differentiation due to growth. In other words, the governance situation forty or more years ago would determine today's level of income.

Arndt and Oman (2006) re-examine Kaufmann's work and come to the conclusion that there is a circular causality relationship between income levels and governance, meaning that it is impossible to determine one single direction for the relationship that is valid at all times and in all countries.

We would make two remarks, however:

(1) The assumption, in the model of Kaufmann *et al.,* that governance is virtually fixed over the long term leaves—paradoxically—little hope for policies that aim to improve governance, policies given priority today by international financial institutions.

(2) In our view, neither Arndt and Oman nor Kaufmann provide a sufficiently clear definition of one of the terms of the relationship: **are we talking about income level or income growth?** Rodrik (2006) also pointed out this ambiguity in most studies on the links between institutions and growth, in particular those conducted by Acemoglu *et al*. (2001). The fact that each country's present income level expresses its long-term growth is trivial: the present level of income is the result of past growth flows. However, this relationship is not linear, as illustrated by the case of countries, such as Argentina during the 20th century, where living standards have fallen at certain periods of time.

While the relationship between growth flows and income levels holds for the very long term, it does not account for medium-to-long-term evolutions (15-20 years), and it is precisely on this scale that the economic take-offs of the past sixty years have taken place (Korea, Taiwan, Malaysia, China, Vietnam, etc), with **very rapid growth accompanied by very low levels of both income and governance.** In our view, the relationship that remains to be analysed is therefore that between medium-to-long-term income growth and level of governance.

For our part, we continue to hold to this circular causality without joining in the debate on its direction. Over the very long term, governance and income levels are indeed related, but this statement regarding the

[11] Here, in order to measure "good governance", we have used the values along axis 1 of the PCA for the entire "Institutional Profiles" database aggregated into 71 variables (see Annex 3 for the list of indicators used). Other measures, covering a more restricted range of variables—those in subject headings 3 (functioning of administration), 5 (co-ordination/strategic vision), 6 (transaction security) and 7 (regulations)—give similar results.

past provides few tools to analyse the economic take-offs seen in the last sixty years. Over the medium term, the level of income and the level of formalisation of rules move in concert, through successive adjustments. One may move ahead of the other at a given moment and then be overtaken again, depending on the particular historic situation unique to each country.

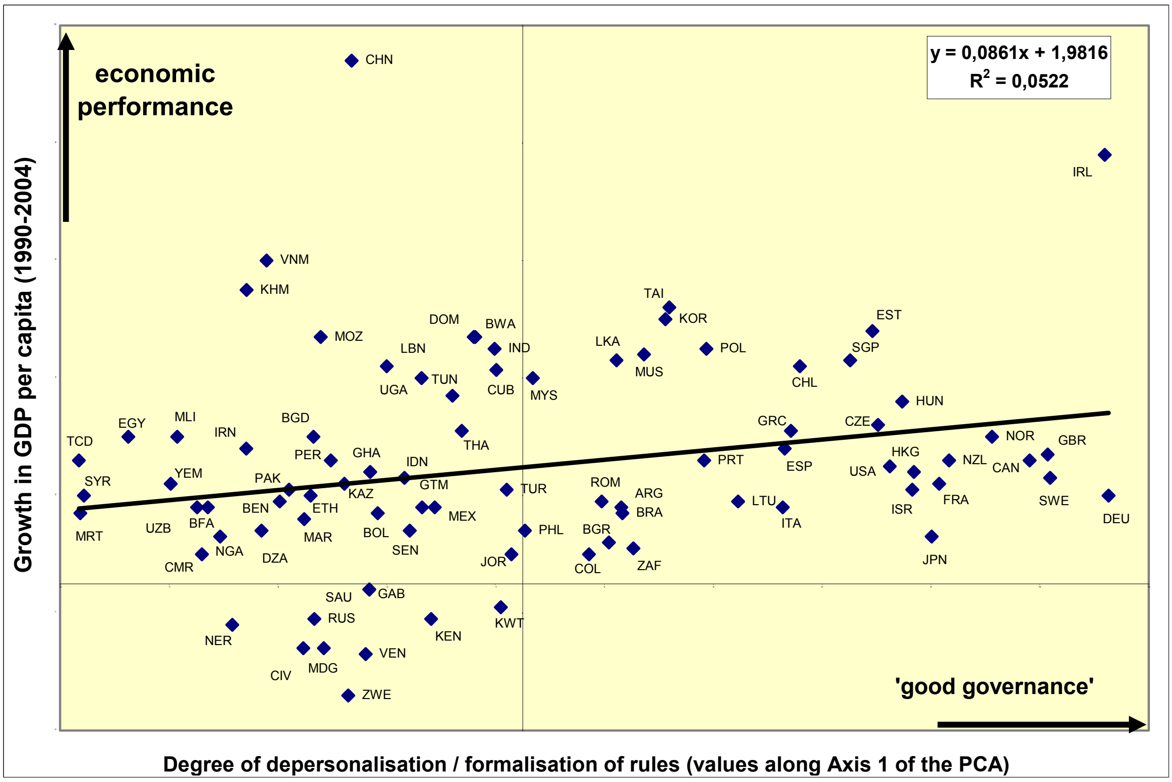
A cross-sectional econometric study covering all countries cannot therefore grasp, or even less explains, this type of phenomenon.

2.3 "Good governance" and medium-to-long-term economic growth

We maintain the same abscissa (level of formalisation of rules) but this time take as ordinates a measure of the speed of economic development (growth in GDP per capita over the 15 years 1990-2004).

While the level of formalisation of rules seems to be strongly correlated with the level of development, the same cannot be said of the speed of development (graph 5)[12].

Graph 5: The elusive relationship between "good governance" and medium-to-long-term growth



Sources: Institutional Profiles database, UNDP.

[12] Economic performance is measured here by growth in GDP per capita over the period 1990-2004 (source: UNDP). A similar exercise carried out using average growth in labour productivity, taken from the Penn World Table for September 2006, gives comparable results.

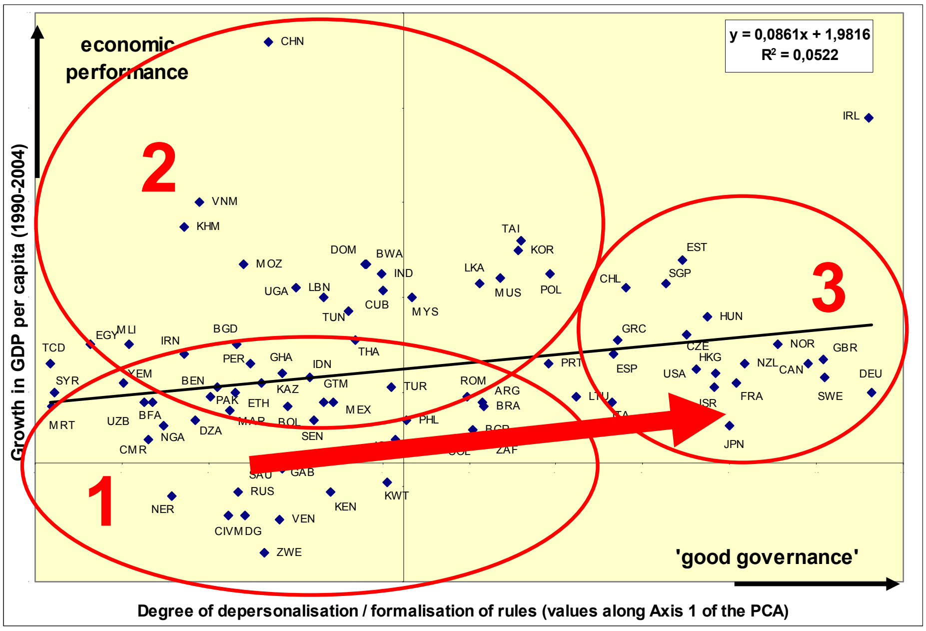
The reputedly self-evident relationship between “good governance” and medium-to-long-term growth seems to be weakened, to say the least. Khan (2004) arrives at a similar result.

However, the most interesting question needing to be addressed is the following: what explanation can be found for the fact that the developing countries with the best economic performances (countries in group 2 of graph 6, below) do not have high performances in terms of governance? Or, formulated differently, why do countries with appreciably equivalent levels of governance have extremely different economic performances? This is the case for China and Vietnam, on the one hand, and Zimbabwe, Madagascar, Côte d’Ivoire and Venezuela on the other.

These results cast doubt on the priority given to progress towards “good governance” that has constituted for the past 15 or so years one of the major prescriptions of official development assistance policies.

Is the adoption of “good governance” rules in line with the standard prescription the appropriate response for raising medium-to-long-term growth rates in countries that have not begun their economic take-offs (graph 6)?

Graph 6: The standard prescription of good governance



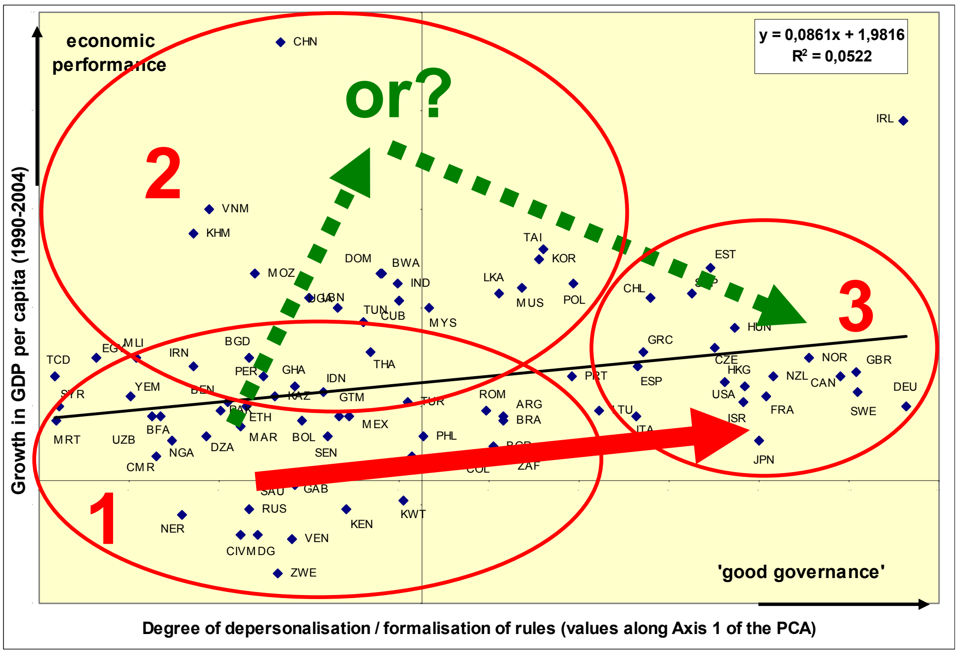
Sources: Institutional Profiles database, UNDP.

Three groups of country emerge in graph 6: group 1 consists of low-growth developing countries; group 2 of high-growth countries; and group 3 of developed countries, whose growth rate turns out to be intermediate. When moving from group 1 to group 2, countries are in the economic **take-off** phase; when moving from group 2 to group 3, countries are in the economic **catch-up** phase.

The standard prescription (shown by the arrow) takes the form of an injunction to developing countries, notably those in group 1, to progress at all costs towards the formalised systems of economic, political and social regulation (formal property rights, market regulation, efficiency and transparency of public action, efficient judiciary and legal systems, democracy, etc.) that prevail in developed countries.

Even leaving aside the question of the appropriateness of this agenda for action, we have doubts about its feasibility. Is the path shown by the arrow in graph 6 even possible? Or would it not be better to envisage that institutional transition can take other paths, more circuitous but also more feasible (dotted arrow in graph 7)?

Graph 7: A more realistic alternative?



Sources: Institutional Profiles database, UNDP.

In the following sub-section, we seek to identify the institutions most conducive to economic take-off (arrow from zone 1 to zone 2), then to economic catch-up (arrow from zone 2 to zone 3).

2.4. What institutional factors explain differences in economic performance between developing countries?

Here, we aim to identify, using the indicators in the "Institutional Profiles" database, the specific factors that can explain why, at equal levels of governance, some countries undergo high and lasting economic growth while others remain trapped in low-growth regimes.

Stated differently, our research will aim to find the key institutional variables to kick start growth (economic take-off) and the key institutional variables to make this growth sustainable over the long term (economic catch-up).

Basing ourselves on the work of Khan (2006), we break the 85 countries in the database down into three groups: developed countries (as defined by the World Bank); converging developing countries and countries in transition (which have growth rates higher than the developed-country average); and diverging developing countries and countries in transition (which have lower growth rates than the developed-country average)[13]. The economic performance indicator used is growth in GDP per capita over the period 1990-2004[14]. From the three groups constituted in this way[15] (see Annex 5, Table A), we try to identify the institutions that are most characteristic of each in relation to the others.

The statistical instrument used is canonical variate analysis (CVA), which makes it possible to identify the variables that differentiate the most between the groups of individuals (countries, in this case) previously constituted on the basis of an exogenous variable (in this case, economic performance), minimising intra-group variance (within each group) and maximising inter-group variance. When interpreting the results, a statistical test makes it possible to verify the discriminatory power of each of the variables and eliminate the variables that are non-discriminatory (see Annex 5 for a detailed explanation of the method and the complete results tables)[16].

The analysis is carried out by comparing the three groups of countries, taken in pairs. It makes it possible to identify the possible institutional trajectory of developing countries, from diverging to converging (economic take-off) and then from converging to developed (economic catch-up). The comparison between the three groups of countries, taken in pairs, yields three analyses[17].

► First comparative analysis: Diverging *versus* converging countries

A comparison of these two groups of countries unequivocally reveals the family of indicators that mark the State's capacity to co-ordinate agents and improve the security of their anticipations as the one that differentiates most significantly between these groups (see Annex 5, Table B for a detailed analysis). These indicators are part of the institutional function no. 5 in the table in Annex 2 presenting all of the indicators in the database (co-ordination of actors and anticipations).

Going into detail, the following indicators single out converging countries in comparison to diverging countries (the number of the institutional function to which the indicator belongs (*cf.* Annex 2) is given in parentheses: the elites' priority for development (5), concertation to bring out common interests (5), authorities' strategic vision (5), society's aptitude for innovation (5), capacity of the political authorities (5), technological environment of non-financial firms (5) and co-ordination between ministries and public authorities (5). In addition, there are two further indicators: quality of public goods (basic education and healthcare) (3), and security of agricultural property rights and contracts (6), the only indicator of the formalisation of rules group to appear in this comparison. No other confidence factor due to this formalisation emerges between these two groups. The formalisation of rules (i.e. "good governance") does not appear to be a factor in economic take-off.

[13] These three groups correspond to those roughly indicated by circles in graphs 6 and 7 above.
[14] Source: UNDP.
[15] There are 15 developed countries, 24 converging developing countries and countries in transition, and 46 diverging developing countries and countries in transition, making 85 countries in all.
[16] Compared with the EDA instrument used earlier (PCA), CVA introduces an initial element of inference since the breakdown of individuals (countries) is done using a criterion that is exogenous to the data (an economic criterion, i.e. country growth rates).
[17] No graphic representation is possible for this analysis. The number of factorial axes generated by CVA is equal to the number of groups of individuals minus one. Only analyses carried out with three groups produce a graph with a two-axis factorial plane. Those carried out with two groups, as here, are projected on a single axis, for which the software used (SAS) produces no visual representation.

In Annex 5 can be found the headings of the elementary questions at the most detailed level corresponding to the principal indicators presented in this analysis[18]. We refer readers to the database on the Internet site for exhaustive details.

Here, we touch on the "governance paradox": countries sharing the same "bad governance" can have totally opposite economic performances, with some experiencing high growth that ensures their economic take-off and others very low growth that keeps them in poverty. This first comparative analysis allowed us to identify the confidence factor that **substitutes itself for** the **formalisation of rules:** the State's capacity to co-ordinate actors and secure anticipations.

The series of indicators identified in this way makes it possible to pinpoint the priority governance capabilities on which diverging developing countries and countries in transition should concentrate their efforts in order to approach, first, the characteristics of converging countries: the capacities of co-ordination of actors and security of anticipations. **The distance to be covered is more reasonable** than it would be in the case of direct acquisition of the confidence factors characteristic of developed countries (highly formalised and depersonalised rules).

► Second comparative analysis: Converging *versus* developed countries

A comparison of converging and developing countries identifies, as major differentiating indicators, totally different institutional functions than those identified in the first analysis of diverging and converging countries (see Annex 5, Table C).

Compared to converging countries, developed countries have the following distinguishing traits (the numbering is given by the table in Annex 2): public rights and freedoms (1), decentralisation (1), trade union freedom (1), efficiency of administrations (3), corruption control (3), transparency of public action (3), security of formal property rights (6), security of transactions (6), regulation of competition (6), observance of labour laws (6), regulation (7) and security (6) of transactions in the financial system, institutional solidarities (9), and social mobility (9).

None of the variables belonging to function 5 (co-ordination/anticipation) figure among these factors that distinguish between converging and developed countries. However, there is a series of indicators of **<u>the formalisation of rules</u>:** an effective, transparent and little corrupt administration (3), property rights and transactions protected by formal rules (6), observance of labour laws (6), and formalised systems of solidarity (9).

The other differentiating variables—political and social democracy (1), decentralisation (1), regulation of competition (6), and social mobility (9)—belong to a field that we can identify as **<u>the openness</u> of social regulation systems in the political, economic and social fields.**

All of these functions, which converging countries would need to acquire to catch up with developed countries, belong to profoundly different fields than those that differentiate between diverging and converging countries. **Here too, the distance to be covered is realistic,** because converging countries,

[18] As an illustration, we show the detail of the "capacity of the political authorities" indicator here (taken from the questionnaire):

<u>Capacity of the political authorities</u>: the <u>5coor9</u> indicator is made up of variable A510, which is itself an aggregate of three basic variables, those that gave rise to answers in the questionnaire: A5100, A5101, and A5102:

A510	**Capacity of the political authorities** (from 1=low levels of capability, consistency, authority, rapidity to 4=high levels …)
A5100	Decision-making capacity of the political authorities in economic matters (responsibility, rapidity, etc) (from 1 to 4)
A5101	Consistency and continuity of government action in economic matters (from 1 to 4)
A5102	Authority of the political powers over the administration (from 1 to 4).

thanks to their capacities for co-ordination among actors and anticipation, have already, over the past 15-20 years, experienced a high growth rate, the beginnings of the formalisation of rules (notably in the field of agricultural property rights), a high level of basic education and healthcare, and the beginnings of technological accumulation. What remains for them to acquire is what still differentiates them from developed countries: continued formalisation of rules and opening of the social regulation system.

► Third comparative analysis: Diverging *versus* developed countries

Naturally, the largest differences are to be found between these two groups. Practically all institutional functions differentiate these two groups: State capacities for co-ordination and strategic vision, openness of social regulation systems, and formalisation of rules (see Annex 5, Table D).

This is a very great leap to take if diverging countries are to accede to the institutional characteristics of developed countries.

In this way, a sequencing of the process of institutional change takes shape

For the countries that are already well launched on economic take-off (converging countries), effort needs to be concentrated on the openness and formalisation of social regulation systems, while the countries with the slowest growth (diverging countries) should concentrate their resources on acquiring the capacity for co-ordination/strategic vision, improving the quality of basic public goods and, in the legal field, on an element of the formalisation of rules that is essential for societies that are mainly rural, namely agricultural property rights.

In this way, a **step-by-step approach to institutional development emerges,** one that is suited to the characteristics of each country according to the vitality of its growth, and in which the State is called to play a major role in the processes of economic take-off and catch-up. This role does not draw on the import-substitution-based models of interventionist States in the 1960s and 1970s. The approach to the role of the State sketched out here effectively finds its context in market economies that are open to economic and financial trade.

States' capacities for co-ordination/strategic vision therefore emerge as a major element in the economic take-off process. This touches on the most political aspects of the way societies operate, and converges with the work of North, Wallis and Weingast (2006) for whom **economic and political dimensions are indissociable** in explaining how societies function and, in particular, develop (or do not develop). The function of co-ordination/strategic vision that the State has been able to organise in high-growth countries, even before the regulation system has been formalised, stems from a narrow and singular articulation between the political and economic spheres, unique to the history of each country. It involves the State's capacity to offer the actors credible forms of co-ordination, management of divergent interests, leading societies in the direction of risk-taking and the achievement of a common good that is greater than the sum of individual interests—in a word, its capacity to reduce uncertainty and spread confidence.

This clarifies the successive roles of the **two major confidence factors**: the function of co-ordination/strategic vision and the formalisation of rules, validating the hypothesis that the confidence of economic agents is a key element in long-term growth and development. This universal function (i.e. systemically reduce uncertainty and deliver confidence) takes different forms in different countries, depending on their histories, economic dynamism and income levels.

These two factors are articulated with the **openness of social regulation systems**, which manifests itself through the increase in the number of economic and political actors, the opening up of social prospects to deserving individuals (regardless of their personal status or of whether they belong to the dominant social groups), the extension of areas of freedom for civil society, and more democratic functioning of political institutions. We will discuss this dynamic of opening social systems later in this document.

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SECTION 3: FRAGMENTS OF THEORETICAL ANALYSIS CONCERNING THE ROLE OF GOVERNANCE IN THE DEVELOPMENT PROCESS

Development as a radical change

We understand development as a long, complex and difficult process because of the profound breaks and the radical changes it implies at all levels of societal functioning for both groups and individuals.

Radical change from a society in which existence is meaningful only through inherited membership to a group (family, clan, village, etc.) to one in which human beings are above all individuals free to choose their own identities. Radical change from societies in which what prevails is submission to higher authority—the father, tradition, beliefs—to one in which the freedom of the individual is based on impersonal rights. Radical change from the solidarity mechanisms for dealing with sickness, unemployment, old age in which solidarity is based on the sharing of risks at family or village level to institutionalised (impersonal) solidarity based on universal rights. Radical change in the attitude to fertility, from one that regards children as immediate resources and security for old age to one in which children are a cost, for whose future parents invest. Radical change from systems where it is each individual's social capital that determines his or her position in society to systems in which individual merit is recognised, regardless of one's origins. Radical change in the approach to economic investment, from a system where diversifying one's activities is the rational survival response to risks of a climatic, economic, political or health nature, to investment aimed at maximising profits in an institutional environment that is secured on a large scale by universal (impersonal) rights. Radical change from societies in which access to the market is blocked by the elites in place to societies where business start-ups, access to credit, security of property rights for all make it possible for a large number of people to become entrepreneurs on a significant scale. Radical change from a system in which organisations (the State, firms, etc) are indissociably linked to the persons leading them to a system in which these organisations have an existence that extends beyond their managers, backed by legal provisions that are independent of persons, formally managing the arrangements for devolution and change of power. Radical change from societies in which the permanent threat of destabilisation of the social order reduces actors' horizons to societies in which political and social conflicts are confined by formal and accepted rules, permitting a widening of the horizon for the taking of individual and collective risks in investments, creation and innovation.

In the final analysis, these breaks with the past amount to a radical transformation of the systems that lay down social, economic and political rules on the basis of personal relations and rules that are in most cases not written down, to systems founded on impersonal law and the written word.

The systems that have progressively been set up on national level in developed countries over several centuries, often at the price of major social and political struggles, are indubitably more economically efficient, socially fairer and more secure, and politically more stable; they deliver more freedom to individuals. They appear to be desirable in themselves.

In that case, why do these more efficient, fairer, more secure, more stable systems that give greater freedom not prevail in all developing countries even though they dangle temptingly before the eyes of populations around the world?

Theoretical tools needed

The empirical analyses presented in section 2 led to results that contradict a certain number of preconceived notions: contrary to today's "common sense", the links between "good governance" and growth are not proven, far from it.

We provide some tentative responses by taking a theoretical detour through, first, institutional change at the level of society as a whole (3.1.), and then on the level of the leading economic and political groups (3.2.). Finally, we explore the original institutional arrangements set in place by countries that have experienced a phase of accelerated growth, namely the governance focal monopoly (3.3.).

3.1. Understanding institutional change: a long process of depersonalisation of social regulation systems

The process by which formal institutions emerged in now-developed countries

As North (1990) and the founders of the New Institutional Economics emphasise, the development process is heavily marked by the tension between economies of scale and specialisation on the one hand, and transaction costs on the other.

In small, closed rural communities, production costs are high because the level of division of labour and innovation is limited by the size of the market. However, interpersonal relations keep transaction costs low. In particular, fixed costs are low because the institutional infrastructure is simple. In order to share information or power, in order to make economic exchanges, in order to enforce rules, social regulation mechanisms are mostly based on largely informal interpersonal relationships and unwritten rules (countries to the left on the horizontal axis in graph 2). This type of regulation of social relationships has predominated in all societies at some point.

As populations and markets grow, as the economy becomes more complex and more open, as the opportunities for trade increase, the cost of observing rules under the previous mode increases with each new transaction. This is because the personal investment required by the predominant regulation system (confidence based on the quality of interpersonal links) is extraordinarily time-consuming. A single individual can only maintain a limited number of relationships (and hence transactions) established in this mode. Transaction costs (related to the search for information, to the specification and verification of the execution of agreements) rise until it becomes less costly to elaborate institutions to back the transactions carried out between people who do not know each other (impersonal exchanges).

Now-developed societies have responded to the depersonalisation of regulation systems by progressively building institutions that are more formal, more complex, depersonalised and based on the written word in order to reduce the uncertainty of social interactions, provide credible rule application mechanisms, share information at a systemic level, detach power from individuals and, all in all, ensure a higher level of observance of rules throughout society (countries to the right on the horizontal axis). This package of institutions ensures high levels of confidence production on a systemic scale as part of their normal operations. The basic social function of legal norms therefore lies in their capacity to channel individuals' behaviours and their expectations regarding the behaviour of others. This long process of institutional change has taken place endogenously, on the basis of a learning process and borrowing from other societies (Chang, 2001).

The outcome of this evolution towards the formal taking charge of confidence production by impersonal institutions is reflected in the high ratio of public spending to GDP in developed countries compared to in developing countries. This ratio is generally on the order of 35% to 50% in wealthy countries, compared to 15% to 25% in less developed countries that, furthermore, have much lower GDP levels. This spending enables the community to take on a large proportion of the transaction costs and risks related to the regulation of human exchanges. These transaction costs and risks are, in this way, mostly converted into fixed costs. The pooling of these costs via public institutions (or private ones, such as banks, that provide services that have the nature of public goods) makes it possible to reduce the marginal cost of each individual transaction considerably.

Profit-maximisation reasoning versus risk-diversification reasoning

In the shelter of these institutionalised protections and security, at a systemic level, profit maximisation is free to operate. It is thanks to this complex and depersonalised set of market and public institutions that individual actors can reap the benefits of the productivity gains stemming from economies of scale and technical progress.

Conversely, in the absence of a generalised system of confidence and security production, each producer has to cope on his own with a number of high risks on personal level (corruption, arbitrary administrative decisions, sickness, etc) and the collective level (climatic events, social and political instability, etc). Any additional threat to this unstable equilibrium involves a threat to his survival as an active member of the population and to his family. His rational response is to diversify his activities to minimise the risks incurred, since no public institution shoulders them for him, as is the case in developed countries (another rational response in order to radically reduce the risks incurred at individual level is to become a civil servant). As a consequence, he is unable to achieve a high degree of specialisation in his activity and his time horizon remains short. Economies of scale and productivity increases on investments that are scattered and short-term are small or non-existent[19]. The vicious spiral of poverty is complete: low returns erode investment, and low investment in turn provides low returns.

In developing countries, the shift to the formalisation of regulation systems has not occurred

The system of regulation that continues to dominate the social sphere remains based on personal links and relationships, observance of unwritten and strict norms (submission to authority, to tradition, etc). Observance of agreements between persons is difficult to verify by a third party in a neutral position, since this third party would not have the information needed for impartial arbitration, not being party to the relationship. Confidence (in the relation to authority, the circulation of information, and the observance of rules) is produced and shared on an idiosyncratic basis, in other words in the light of the intrinsic characteristics of individuals or their membership to a group that is, by definition, small (family, tribe, etc).

In these circumstances, recourse to incentives that are based simply on legal and financial norms is largely illusory because of the opaqueness of the rules, the very low level of available information, and restricted devolution of power. The fact that these norms do not emerge from a process of construction internal to societies is a key factor in explaining hindrances to development.

[19] Polanyi (1944) interprets the change-over from the motive of **subsistence** to the motive of **gain** as a major characteristic of the industrial revolutions in Europe in the 19th century.

A depersonalisation movement that is exogenous to institutions

However, a series of evolutions that are entirely exogenous to institutions takes place in developing countries: population growth that multiplies the number of actors, increasing urbanisation, and the extension of the geographic space for economic relations which loosen the relations based on personal links to the point that they become economically unsustainable. Everything else remaining equal, confidence dwindles as the size of the market increases.

These evolutions in combination generate an ineluctable process of **depersonalisation** of systems of social, economic and political regulation, a process that powerfully erodes the traditional systems for the production of confidence.

Two radically different systems for the production of confidence

We therefore find ourselves faced with two modes of "confidence production", confidence that is the very foundation of social order and economic activity. There is the mode that predominates in developing societies, based largely on informal rules anchored in interpersonal relations; and there is the mode that is widespread in the more advanced economies, based on law and on written impersonal conventions. And these two systems for the production of confidence show **two asymmetric movements**, one ineluctable (depersonalisation), and the other not spontaneously initiated (formalisation of rules). A large share of development difficulties stems from this asymmetry between the major trends affecting societies in the South.

Do institutional transitions take place progressively or rather in a series of lurches?

The institutional transition associated with the change in the regulation system does not take place uniformly within society but manifests itself rather as a series of breaks with the past cutting across the entire social field.

This process of depersonalisation of social relationships affects societies unevenly: at any given moment, certain sectors adopt formal rules while others remain at a more informal level of interpersonal relationships. A single actor may have to operate on both levels simultaneously (for example, formal relationships with customers and informal relationships with suppliers). This means the possible juxtaposition at the same time and in the same place of actors who are at different stages in response to this depersonalisation of rules[20].

The process of depersonalisation of informally-based regulation systems is marked by a decline in respect for the given word, even though the force of the written word (which implies widespread literacy, standardisation of procedures, accessible and efficient courts of appeals, etc.) has often not yet been established (Aoki, 1995).

[20] Moreover, informality may be preferred as the rational option for small entrepreneurs and even for employees, especially when the benefits of formal status are slim in terms of remuneration and social welfare. On the basis of research carried out in Latin America, Maloney (2004) has shown that a significant number of workers voluntarily switch between formality and informality based on a very wide range of criteria (being subject or not to tax, freedom of action in work, accumulation in the formal sector in order to invest in an informal autonomous activity, social advantages, access to formal credit, etc.).

Several legal systems may also be obliged to coexist, for example, in the field of property law: traditional systems (often based on individual testimony), collective ownership systems (at village level), religious systems (*habbous* property in Morocco, for example), property rights systems inherited from colonial periods, and modern cadastral systems. Their superposition creates complexity and legal instability, hampering transactions and investment because the outcome of a transaction is unpredictable and its security is not assured. The formalisation of rules (for example by means of a single cadastral system) runs up against strong resistance, backed by established traditions and interests.

Social welfare mechanisms for dealing with sickness, unemployment and ageing are also at the heart of this major transformation. The prevalence of traditional solidarity systems (founded on links on the scale of the family, clan, district, village, etc.) in developing countries is in opposition to that of institutional nation-wide systems (anonymous, founded on rights) in developed countries. But, in many countries of the South, the erosion of the interpersonal solidarity systems resulting from rural exodus, reduction in family size, and the dissemination of the Western model of individualised behaviour takes place in most cases without institutional forms of solidarity having been put in place. This means that the erosion of the traditional forms of solidarity associated with the depersonalisation of regulation systems leads to the informal security being lost without any equivalent gain in the field of formal (institutional) security.

This in turn means that the move from an informal institutional state to a more formalised institutional state requires a passage through phases of increased uncertainty in which the old rules (loyalty, observance of the given word, traditional forms of solidarity) no longer operate and yet the new rules based on legality and the primacy of the written word have not been established at the heart of societies. This **"slump"** can therefore bring about a period of reduced confidence between agents, increased complexity due to the superposition of multiple reference systems, legal uncertainty, and social instability.

To deal with this problem, formal rules that are simply transplanted have very little chance of being applied. On the contrary, this can provoke an expansion of grey zones conducive to arbitrariness (for example, a rule is invoked by a public official without the capacity to refer to a written document). In the end, the public institutions responsible for the rule formalisation process can engender more mistrust than confidence. Worse still, the resulting grey zone between the formal and informal registers tends to blur the dividing line between public and private, and between legal and illegal. Corruption then has wide room to flourish and, with it, illicit activities.

The "modernisation" of societies can therefore lead to an increase in personal insecurity, a rise in uncertainty, and a decline in confidence.

All in all, these transformations institute new rules throughout society, define new and radically different relationships between individuals and, in so doing, design new institutions.

"Development" can be interpreted as a process of institutional transformation, in which several different forces combine together:

- those resulting from the inevitable trend towards **the depersonalisation of regulation systems**, under the impact of population growth and the expansion of market size;
- and those relating to internal and external pressures **in favour of the formalisation of rules** that are based on predominant standards disseminated equally by economic and cultural exchanges and by the participation of developing countries in multilateral arenas and development assistance schemes.

Each developing society combines these forces in the light of its own cultural, political and social resources. How do they respond to the challenge of this depersonalisation of social relationships? How does resistance build up within the previous regulation systems? How do the local “advocates of modernity”, when they exist, translate these pressures into the local language (Panikkar, 1953)?

The resultant of the two major forces described above is not self-evident. The formalisation of rules is long and complex. It is the subject of fierce resistance and can only become established through a process involving the whole of society. Countries can fail to advance down this road and can remain blocked at the threshold of institutional transition.

Having discussed the reasons for the complexity of the process of institutional change at the level of society as a whole, we now turn our attention to the question of what is at stake for the political and economic elites. In the following sub-sections, we successively present two analyses of the factors that transform or block regulation systems in developing countries. The first hypothesis relates to the political economy of developing countries (3.2.), the second to the institutional factors driving the take-offs observed in a number of developing countries (3.3.).

3.2. In developing countries, social regulation systems are hijacked by the activities of narrow interest groups among the elites: “insider systems”

In this sub-section, we develop the analysis under which a fundamental cause of resistance to change in developing countries is linked to the predominance of specific interest groups acting across the social, economic and political spheres and at all levels of governance (from local to international). Any transformation of the social order that might call into question their privileged access to economic and political resources generates strong resistance on their part: they notably resist the introduction of impersonal institutions that would guarantee, in the economic, social and political fields, **open access for all** and **regulated competition**.

The balance of power, power plays and unending struggles between these interest groups centred on a small elite constitute what we call an “insider system”. The term “insiders” designates the economic and political elites that share access to the principal resources (power, information, wealth, etc.) at all levels (from national to local). At each level, several specific interest groups generally exist and compete for access to resources. The insider group generally associates factions or coalitions of factions that would have the capacity to destabilise the balance of power in place, either by mobilising their access to certain resources or by making use of violence. Minor interest groups, which pose less of a threat to the dominant coalition, do not therefore necessarily have access to the insider group.

Although potentially present in all societies at all levels of development, the activities of these insider systems explain and dominate the functioning of the economic, political and social spheres in developing countries.

Analysis of insider systems in developing countries

Most developing countries have systems that regulate the relationships between economic and political elites that are based predominantly on interpersonal and informal arrangements. These systems are given various names in the literature[21]: “distributional coalitions” or “predatory cartels” (Olson, 1982), “patrimonial and neo-patrimonial State” (Bayart, 1989; Medard, 1998), “embedded autonomy” (Evans, 1995), “crony capitalism” (Haber, 2002), “patron-client relations”, “insider systems” (Meisel, 2004),

[21] The bibliographic references are given here for purposes of illustration.

“limited access social order” (North et al., 2006 and 2007), “hand-in-hand arrangements” (Moore and Schmitz, 2007), etc.

We shall not discuss each of these concepts in detail, and refer readers to the authors cited. We shall retain, in order to deal with our subject, the concept of “insider system”, which has several advantages for the analysis: it does not exclude *a priori* any country from the scope of analysis (unlike the limited access social order, which does not concern developed countries); it specifically focuses on the elites (unlike “patrimonial” relations, cronyism or nepotism, which affect all of society); finally it does not carry from the start too negative a connotation (unlike crony capitalism or Olson-style cartels) or too positive a connotation (embedded autonomy).

Insider systems can be more or less productive. They can ensure economic growth and productivity gains by limiting access to resources to a small number of insiders, by “[guaranteeing] a subset of asset holders that their property rights will be protected […] As long as their assets are protected, these asset holders will continue to invest as if there were universal protection of property rights. Thus economic growth can occur” (Haber, 2002). However, since these arrangements are usually unwritten and informal, the promise is not spontaneously credible: the dominant coalition within the insider system could always change the rules of the game and confiscate the wealth created once asset holders have made the investment. The solution generally consists of including members of the coalition in power, or those close to them, with the gains generated by the asset holders in the exploitation of these resources. Examples of such mechanisms can be found in all countries through all the forms of arrangement that make it possible to align interests within the elites, such as the involvement of those close to managers in public and private firms or the moving back and forth of elites between the public and private sectors. In this way, the political and administrative elites acquire a more or less all-encompassing interest in the resources generated by the economy.

Insider systems are therefore not necessarily antagonistic to a certain level of economic growth. However, they have serious limitations.

- First, they pose a problem of **economic efficiency**. Resources have to be permanently created and distributed to the insider asset holders in order to give them an incentive to invest. The most usual resources are, for example, facilitated access to bank finance (often without any requirement of reimbursement in practice), or market shares (granted either directly or through fixing public tenders, or by protecting them from competition through the creation of entry barriers against foreign or domestic competitors). In these circumstances, oligopolies, monopolies or even entire industries are created, extended or maintained when they should not have been, while other opportunities are left unexplored, even when they would be socially useful, internationally competitive and when there are entrepreneurs with the skills required to develop them.

- Second, arrangements among insiders are an incentive for **short-termism**. It is difficult for a coalition exercising power in an insider system to commit itself over the long term, as the commitments made will probably last only as long as it remains in power. This is why those who hold power of control over economic assets, out of fear that they would not have the necessary political connections in the event of a change in the dominant coalition, will also tend to reason in terms of short time-horizons by requiring short payoff periods and high rates of return.

- Third, insider systems pose a problem of **social justice**. The resources distributed to the insiders have a cost. This cost is generally borne by society as a whole (through higher prices, squandering of tax revenues, inappropriate allocation of public spending, lower quality of public services, etc). Similarly, power struggles between factions can mobilise and waste considerable resources. While the benefits of the insider system are concentrated in just a few hands (the gains are "privatised"), the risks and the losses are spread throughout society (the costs are "socialised"). In short, this type of system tends to be socially predatory, and therefore deepens inequality.

- Fourth, because of the scale of their resources (accumulated rents, economic and political connections, capacity for self-financing, etc), especially compared with those of their potential competitors, insiders can end up being so powerful that one can no longer imagine seeing them give up the exercise of power within the dominant coalition. The inequalities in the distribution of power and resources can reach levels such that they block the rearrangement of institutions, even when new configurations would have permitted general "pareto-superior" development. The resistance of insiders is therefore seen as a factor blocking institutions, producing increased rigidity of society, and also as **harbouring risks of violent destabilisation**, since the tensions built up through social structures and between the insider coalitions themselves have no predictable institutional outlet.

On top of these destabilising factors that are internal to insider systems, there are other factors linked to historical evolutions that modify relationships between insider systems and the rest of society: population growth, urbanisation, the raising of the general education level, and the dissemination of information at world level, etc. make it more difficult to keep these insider systems closed, as had been possible for centuries. The massive cohorts of educated urban youths linked to other parts of the world through information networks are knocking at the doors of this closed social order to demand their place in society. Faced with this influx of young people of working age, of whom only an infinitesimal proportion manage to find a solution in emigration to the countries of the North, this closed social order is increasingly difficult to maintain.

Insider system and social order: two distinct concepts

Recent work by North *et al.* (2006, 2007) analyses the interplay of interests within elites on the basis of concepts close to our own[22]. They distinguish between "limited access social orders" characteristic of developing countries and "open social orders" characteristic of developed countries. What they call limited access social order has characteristics very close to what we have just described in relation to insider systems.

In our view, the social regulation systems in developing countries are in fact most of the time dominated by (conflictual) interplay between insider groups, thus blocking the countries' development trajectories.

[22] In their most recent work, North *et al.* (2006 and 2007) propose a theoretical corpus on the historical functioning of societies, primarily developing societies. Indissociably linking the political and economic fields, they notably create the concept of "limited access social order" as a fundamental characteristic of the functioning of societies for 10,000 years, characteristics from which European countries started to move away 400 years ago. This limited access social order is controlled by a coalition organised around the political leader who has succeeded in ensuring a certain degree of security, both internally and externally. The coalition brings together the economic actors who will benefit from the rents allocated by the political leader. The cement binding this coalition is therefore the security it provides for the governing elites: security of persons and goods, rights, access to rents. Its survival as an elite depends directly on its capacity to close off access to this social order in the face of new actors: the coalition therefore keeps firmly in its hands the monopoly on the creation of organisations (economic, political, social, religious, etc) and, by this very fact, limits the possibilities of economic and political development. According to the authors, countries' development is linked to the opening up of this social order.

But insider systems are equally present in developed countries. The difference is that their activities are constrained and their effects counterbalanced by the powerful impersonal regulation institutions, private and public, formal and informal, that these societies have developed and refined over centuries with the aim of guaranteeing the population wide access to resources in the economic, social and political fields. This control over the activities of insiders, with the help of sophisticated and impersonal regulation systems in these three fields, has turned out to be a decisive factor in political stability and economic development.

Our insider system concept is therefore operative for all "social orders" as defined by North *et al.*, regardless of their degree of openness. At all levels of development, insider systems can bring the interest groups present in society more or less closely together.

Nevertheless, from the contribution of North *et al.,* we retain the idea of **opening of social regulation systems** (illustrated in the transition from converging to developed country in the comparative analyses presented in sub-section 2.4) and the key role that such opening has in institutional change processes in developing countries.

A widespread illusion: the acquisition of formal rules should be self-evident

Most of the recommendations addressed to developing countries insist on the importance of having governance institutions that are robust, transparent and accountable, based on the observance of formal legal rules (legal and judicial infrastructure, supervisory and regulatory bodies, etc).

For the past 50 years in developing countries, decolonisation, the virtual disappearance of socialist regimes, and participation in international organisations and development assistance programmes have diffused a set of formal rules and institutions in the political field (constitution, parliament, etc), the economic field (trade code, investment code, banking code), and the social field (labour law, civil and family law, etc). Therefore, the vast majority of these countries today have a body of written rules that has been perfected—on paper.

However, the recommendations from developed countries suffer from three problems that explain the **resistance** they provoke to their practical application.

- First, these recommendations made to developing countries miscalculate the time that was needed for now-developed countries to achieve these institutional advances (several centuries) (Chang, 2001). Admittedly, the present stage reached by this process in developed countries forms a relatively stable, attractive and consistent landscape, but the process itself, the path really followed, still remains poorly understood. The statutory corpus of laws often followed a long path made up of multi-secular influences (Roman law, religious law, etc), a learning process, and political and social struggles that punctuated their discovery and application. For example, the right to vote was initially given only to men who were of a certain age, wealthy and educated. Women, young people, the poor and the illiterate were excluded. Progressively, and at speeds that varied from country to country, the right to vote was opened up to those previously excluded, often at the price of intense political struggles (in France, for example, women were not granted the right to vote until 1945)[23].

[23] In the villages of the Moroccan Atlas, a region that was long left beyond the scope central government control because of its poverty, there is a local power system, the *Jmaa*, that has for centuries settled questions relating to the collective life of the village: upkeep of the mosque, justice, regulation of access to irrigation, public works, local festivals, etc. This institution brings together the village notables, i.e. old, wealthy men. Since the mid-1980s, an NGO set up in France by migrants from this region investing in their villages of origin ("*Migrations & Développement*") has worked for the creation of village associations open to the young and to migrants from the

- Next, and despite its advantages, a mode of governance based on formal, depersonalised rules implies very high fixed costs for society. And the formal institutions set up must themselves have functioned for sufficiently long periods to generate enough confidence in them and transform attitudes towards them. Given the situation in most developing countries and the constraints they face in terms of financial and human resources and time, they do not generally have the means to make this investment in the short or medium term. In the end, many of the prescriptions handed down by the aid agencies to developing countries are tantamount to asking them to be already developed, which explains why they are difficult to implement!

- Last but not least, the requirement of rule formalisation pushes for the introduction of systemic arrangements granting rights to all (and especially property rights) on the basis of written texts and capable of being defended in the courts[24]. Because of its formalised and universal nature, this requirement carries within it **seeds of the destabilisation of social systems**: this extension of rights to all citizens on an egalitarian basis poses a direct threat to the privileges held by those in charge of the social order (insiders) whose power is derived precisely from their exclusive access to the security of rights and to resources.

In this way, the trend towards the formalisation of rules is the object of **fierce resistance by elites (the insiders).** It is also the object of fierce resistance by **society** because, by threatening the distribution of rents on which the equilibrium of the system if based, it brings about a risk of destabilising not only the coalitions of insiders but also, through them, society as a whole. Even those who do not belong directly to the insider group, benefit only marginally from the exploitation of rents, and might see advantages in change are aware of this threat of systemic destabilisation. The asymmetry between the known losses and uncertain gains to be expected from the change, the fear of the unknown and, in particular, of the introduction of violence can also help to spread resistance to change throughout society.

Behind the ostensible consent to the institutional transformations being advocated and the superficial adoption of numerous imported formal rules, the resistance of the elites and of societies takes the form of the bypassing of these written rules and institutions: bypassing of democratic processes (for example, the role of parliaments and audit bodies in sub-Saharan Africa); bypassing of the rules of good governance (for example, adopting anti-corruption schemes that are not applied); bypassing of trade liberalisation measures; privatisations; etc.

The principle is always the same: reputed to erode the rents acquired by insiders, these measures are formally adopted if the insiders have an interest in this taking place (for example, in order to maintain good relations with countries of the North or to appropriate development assistance) but are implemented in such a way that the elites preserve their rents or reconstitute them in different form. Opening up of trade and privatisation are models of how those in charge of the social order maintain their rents, which often takes the form of transfers, within the same insider system, of monopoly rents from the public to the private sector.

In practice, the systems of social regulation that prevailed before the surface adoption of these written rules continue, therefore, to function, for the deep-seated structural reasons that we have just analysed.

village and including, often in conflictual fashion, the members of the *Jmaa*. In this way, the migrants have, at local level, played a definite role in opening up the social order that had previously prevailed. However, women are still not admitted, with the exception of the chairwomen of women's associations and co-operatives who participate in village-level decisions under the protection of their status.

[24] Exclusion of a section of the inhabitants from rights is rarely codified. This was the case in South Africa under apartheid, it is the case in colonial situations and, finally, it is the case for refugees and immigrant populations. Apart from these cases, the formalisation of rules is normally part and parcel of the status of citizen, granting rights on an egalitarian basis.

What is at stake is the stability of the entire system, of the coalition of interests in power and of the social order as a whole.

The question of **the enforcement of rules** is indeed the central point in the relationship between institutions and development (Khan, 2006). In numerous developing countries, the forced march to the adoption of formal rules, generally financed with development aid funds, takes place without any significant effect on reality. It contributes to increasing the complexity of the system of economic, political and social regulation, but does not increase its effectiveness.

A high risk that institutional change will be blocked

The risk is therefore that, faced with a trend towards the depersonalisation of social regulations, a society will be unable to overcome these resistances in order to draw up and implement its own endogenous system of formal rules. The balance of forces within the dominant coalition can block any evolution towards the opening up of the insider system or towards the opening up of the social regulation system.

In that case, the society may find itself caught in a "governance trap": institutional transition is blocked, traditional functioning continues to prevail massively, and society operates in a grey zone (the persistence of gradually eroding interpersonal rules, and a lack of formalised rules that are sufficiently established and accepted in depth by society).

Relevance of the insider system analysis grid

We can illustrate the contribution of analysis in terms of insider systems with two examples: the question of the factors that attract foreign direct investment (FDI) to countries, and the issue of corruption.

1st example: "Good governance" is not a factor in attracting foreign direct investment.

A common assumption is that a low inflow of FDI to a country is the result of non-compliance with legal rules, the fragility of property rights, the opacity of decision-making mechanisms, bureaucracy, the scale of corruption, etc. Indeed, all these phenomena are seen as discouraging foreign investors from the start. In short, the attractiveness of a country for FDI is associated with "good governance".

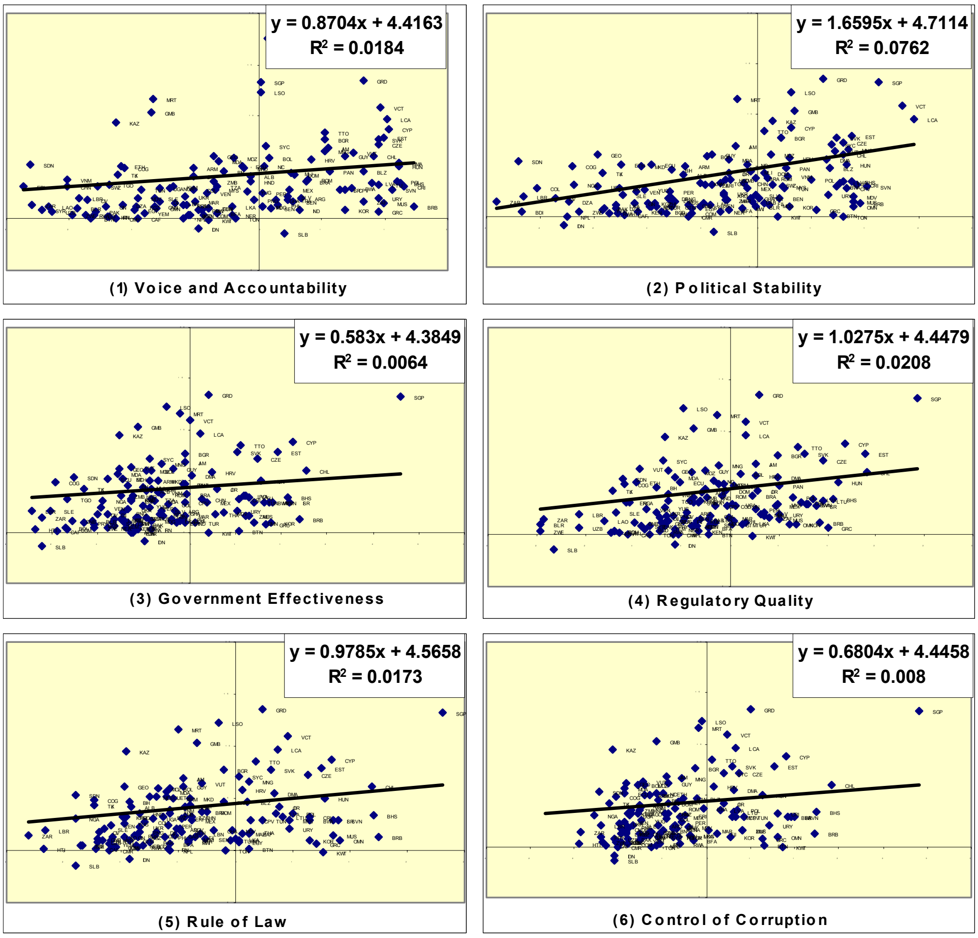
To evaluate the robustness of the idea that "good governance" is a decisive factor in individual investors' decisions, we attempt to measure the link between governance indicators and FDI inflows. For this, we use the WBI's governance indicators, which cover broad geographic area (140 developing countries)[25].

The relationships between each of the six components of governance[26] and FDI presented in graph 8 show that there is no significant correlation between these two sets of data.

[25] We have successively compared the 6 World Bank Institute indicators (2000-2004 average) with the FDI/GDP ratio (2000-2004 average, source: WDI) for the 140 countries documented in both databases. Analysis of the 70 developing countries in the "Institutional Profiles" database yields comparable results.

[26] Voice and accountability (1), political stability (2), government effectiveness (3), regulatory quality (4), rule of law (5), and control of corruption (6).

Graph 8: Is "Good governance" a factor in attracting foreign direct investment?
(FDI/GDP compared to each of the WBI's 6 governance indicators)



Sources: World Bank Institute, WDI.

Neither the democratic operation of political institutions (1), nor the efficiency of administration (3), nor compliance with laws (5), nor political stability (2), nor markets' operating freedom (4), nor even corruption (6) emerge as being significantly correlated to FDI inflows. Contrary to "common sense", "good governance" does not appear to be a major criterion for international investors when deciding where to make their FDIs.[27]

Why is it that countries with very low scores on governance indicators nevertheless receive high inflows of investment? Or, symmetrically, why do countries who perform well in the field of governance receive little FDI?

On the basis of our analysis of how insider systems function, we can postulate that the main factor attracting FDI, apart from basic variables such as the size and vitality of the market, is due much more to the willingness of insiders in the host country (public and private elites alike) to allow or not to allow a new actor to enter the market. The decisive question is then as follows: do those operating the insider

[27] Here, we examine the factors that make a country attractive to FDI in the field of institutions. Of course, other factors such as the size and vitality of markets play a large role in FDI localisation decisions. More generally, simple regressions cannot satisfactorily answer the question of the impact of governance on FDI due to risks of functional misspecification, omitted variable and simultaneity biases. For more detailed work, we refer readers to Globerman and Shapiro (2002).

system have an interest (personal or collective, short- or medium-term) in the inflow of FDI or do they perceive the inflow of FDI as a threat to their rentier positions?

When the latter is the case, the insiders resist the entry of new actors onto the market. For the foreign investor, this resistance takes the form of an accumulation of difficulties related to the non-observance of property rights, the multiplication of administrative obstacles, etc. despite the frequent existence of investment codes that are, on paper, very welcoming.

Conversely, it may be that another country with comparable or even inferior performances in terms of governance attracts greater amounts of FDI. The same difficulties that investors faced in the previous case are smoothed over because local actors find an interest in welcoming these foreign investments. Facilities are granted to the FDI, more or less formally, in order to surmount all the obstacles (cumbersome administrative procedures, instability and opaqueness of regulations, slowness and partiality of the justice system, etc). These facilities can be part of a policy of welcoming foreign investors drawn up in function of the country's long-term development objectives (for example, Korea's filtering of FDI in the 1980s and 1990s); they can also respond to political criteria (for example, the nationality of the investor or the zones of influence of major world political powers); finally, they can also be dictated by the insiders' desire to have access to sectoral rents that they are incapable of exploiting on their own (investment in the extraction of natural resources, for example).

Thus, analysis of the political economy within developing countries can help one understand why "good governance" in a country is not the relevant criterion to analyse the location of FDI.

2nd example: Corruption versus growth?

In the "Institutional Profiles" database, breaking down the indicator of the level of corruption into **petty corruption** (involving relations between citizens and administrations) and **grand corruption** (between enterprises and the State) shows that petty corruption is more highly correlated to the level of income per capita than is grand corruption[28]. In other words, both aspects of corruption are indeed linked to the level of development, but "petty corruption", the component affecting everyday relations between populations and administrations, is more closely linked. There is little petty corruption in the developed countries. Grand corruption, which is by definition less perceptible by the population as a whole, affects all countries, developed and developing alike.

When it comes to medium-to-long-term growth, analysis of the relationship between corruption and economic performance shows only a very weak correlation between these two phenomena[29]. Although a substantial number of countries have low economic performance levels and high corruption levels (Côte d'Ivoire, Yemen, Cameroon, Zimbabwe, Gabon, Kenya, Peru, Chad, the Philippines, etc.), all the other combinations also exist: there are countries where both economic performance and corruption are low (e.g., France, Japan, etc.), countries with high performances and low corruption (Ireland, Chile, Singapore, Norway, etc.), and, more surprising at first glance, countries with both high levels of corruption and strong economic performances, such as Vietnam, Malaysia, Thailand, Mauritius, the Dominican Republic, India and China.

Such a diversity of situations shows that there is no simple relationship between corruption and growth. The existence of countries where economic performance and corruption are both high challenges the standard analyses and prescriptions.

[28] The correlation coefficient between the level of petty corruption and GDP per capita is -0.66, compared to -0.53 for that between the level of grand corruption and GDP per capita.

[29] The correlation coefficient between petty corruption and growth (measured here by average growth of GDP per capita, source: UNDP) is 0.02, compared to 0.04 between grand corruption and growth (source: "Institutional Profiles").

Reinterpreting corruption

How can one explain why developing countries with different economic performances cannot be differentiated based on their corruption scores?

We rely on Khan (2006) and on our previous analyses to shed light on the structural factors at work behind corruption in developing countries. In the first place, the economic and political elites (insiders) base their domination over the rest of society precisely on the fact that they are the only ones to enjoy durably protected rights, notably with regard to property. Indeed, the institutions needed to define, transfer and protect property rights on the universal scale are extremely costly to set up and operate. The low levels of tax revenues and productivity of assets (which is, by definition, the rule in developing countries), means that asset holders generally have neither the incentive nor sufficient resources to finance an adequate level of protection of their assets. Only developed countries have the means to provide all economic agents with this type of protection at the systemic level. The consequences of this structural legal uncertainty have to be dealt with, at individual level, by informal or illicit means that then take on the aspect of corruption.

This protection, obtained through one's proximity to the political or administrative powers-that-be, is usually informal. It ensures insiders privileged access to a certain number of resources. Power and wealth are, therefore, intimately linked. Maintaining political and social stability implies unceasing transfers of resources for the benefit of the various interest groups outside or alongside official, formal channels of public spending. It is more a vital functional requirement of these societies than a pathology. One only has to see the amounts redistributed through official public spending per inhabitant in developed countries to measure the functional importance of this type of transfer (e.g., tax loopholes, advantages for particular corporations, etc.).

Khan (2006) also points to the scarcity of tax revenues (which is itself a consequence of the low level of development), which leads to a limited offer of basic public services by the formal public institutions. The multitude of informal arrangements allowing the population access to these services already explains the bulk of "petty corruption" in developing countries (Olivier de Sardan, 1999) (e.g., access to water, to hospital services, etc.).

Finally, States pursuing growth objectives can choose interest groups in the public or private sectors and give them incentives to achieve productivity gains or reach certain performance targets. This was the case in numerous European and Asian countries during their periods of economic take-off in the 20th century. The introduction of these public policies implies the creation of transfers that have to be properly managed for them to act as incentives (tax deductions, subsidies, subsidised interest rates, etc.). The risk is that the incentive operates for a time but that the accumulation of rents by specific interest groups ultimately enables them to "capture" segments of the public sector (politicians, civil servants, the judiciary), in order to secure automatic access to these resources independently of their performance. This "entrenchment" phenomenon has in fact taken place in more or less pronounced form in all developing and developed countries that have implemented growth policies that involved the stimulation of specific groups to bring them to contribute actively to the attainment of national development objectives. The close association between insider groups from the public and private spheres in the attainment of common objectives, or even their confusion (encouraged by back-and-forth movements of resources and individuals between the public and private sectors), has turned out to be a powerful factor in corruption.

As Kaufmann (2005) points out, most of these mechanisms for "State capture" by private interest groups have not disappeared in developed countries. They have merely been formalised and legalised. They allow large firms to exert legal pressure on the drafting of laws and regulations (for example through pressure brought by lobbies or through the private financing of political parties). The fact that these pressures and these transfers are made legally, "in due form", does nothing to alter their (collusive) nature and their purpose (the purchase of privileges).

All in all, this analysis calls for an understanding of corruption phenomena that goes beyond an approach based on strict legality. In fact, the institutional change associated with economic development is not necessarily accompanied by a diminution in the appropriation of public goods or in embezzlement. The relationship between corruption and economic performance is much more complex than most anti-corruption recommendations suppose. Indiscriminately lumping under the single term "corruption" phenomena as heterogeneous as informal public transfers ensuring a minimum of security of rights, social stability and public services, and transfers targeting growth sectors explains nothing.

Most of the standard analyses simply stigmatise, in a moralising tone, the capture of public resources by public and private elites in developing countries but, in so doing, ignore the structural determinants of corruption (the exchange of stability of the social order for privileged access to rents, scarcity of tax revenues, and low productivity of assets), minimise the question of developed countries' responsibility in grand corruption and divert attention from the question relevant for economic development: rather than seeking to abolish these arrangements between interest groups, how can one see to it that they are made as productive as possible?

3.3. The hypothesis of a governance focal monopoly as a trigger for economic take-off[30]

We seek to deepen our understanding of the links between development and institutional change by basing our work on earlier research according to which the capacity of institutions to **produce confidence through the system of economic, political and social regulation**, constitutes the key factor in economies' long-term growth (Meisel, 2004).

According to North (1994), the causes of long-term growth are to be sought first in the existence of incentives for efficient organisation. The structure of incentives for economic agents (individuals and organisations) is provided by institutions (the rules of the game). It is the efficiency of these incentive systems that enables a State and a functional market to establish themselves and generate both the possibility of taking and the desire to take the risk of investing, producing, and creating wealth. In his view, the traditional explanatory variables of long-term growth evoked by economists (capital accumulation, technology, economies of scale) are much more manifestations of than factors in growth.

The relationship between confidence and growth essentially moves through two channels: transaction costs and anticipations.

- According to North and Wallis (1986), **transaction costs** can account for up to half the GDP of a developed country. Acting on these costs is therefore a powerful way of acting on growth. The greater the capital of confidence between contracting partners is, the lower the costs of information, specification and monitoring the execution of contracts are and, hence, the more the co-operative relationships are facilitated. The value of this collective asset—confidence—can be estimated by the sum of the reductions in risk premiums demanded by the partners compared to a situation in which there is total absence of confidence (Breton and Wintrobe, 1982).
- The other channel taken by the relationship between confidence and growth is that of **anticipations**: a decision to invest (in physical or human capital for an enterprise; in the children's education or in financial assets for a household) requires a reasonable reduction in uncertainty, in other words a minimum of visibility and confidence in the future.

[30] This innovation is based on a programme of research into corporate governance, public governance and governance indicators carried out at the OECD Development Centre (Oman 2003, Oman *et al.* 2003, Meisel 2004, Arndt and Oman 2006)

In countries dominated by the interplay of insider factions but where formal rules and institutions have not been accepted as a factor for the systemic creation of confidence, (interpersonal) confidence remains extremely limited by the size of the insider group and by the degree of credibility they manage to give to their commitments. This raises a question: how and why have certain developing countries that show all these characteristics managed, in the space of a few decades, to generate lastingly high growth rates on the basis of what was at the start a relatively informal institutional base and at the same time carry out the transformation from one regulatory mode (informal and personalised) to another (formal and depersonalised) while relying only on the resources of the previous social order?

Our analysis, which until now examined institutional development in light of three dimensions (depersonalisation, formalisation of rules and openness of social regulation systems), therefore needs to be supplemented by a new tool to account for the institutional transformations that occurred during the episodes of economic take-off in the second half of the 20th century.

The Governance Focal Monopoly

The results obtained in the empirical section of our analysis (Section 2) showed that the countries that had strong and lasting acceleration in growth (notably in Asia, but also in continental Europe in the post-war period) developed **systems of co-ordination among actors and securisation of anticipations that increased many times over the production of confidence in society**. These modes of organisation, that we baptise with the generic name of **governance focal monopoly** (Meisel, 2004), have, to different degrees, made it possible to regulate the interplay of individual interests in the economic and social field with the aim of actualising "the most shared possible" interest. Such a regulation turned out to be particularly profitable in countries where market incentives do not function on the systemic scale, that is to say where domestic and international market signals are not enough to co-ordinate economic agents in a productive equilibrium.

The governance focal monopoly has historically taken concrete form through one or more key organisations that co-ordinate—that "focus"—all relations between predominant interest groups at the various levels of society (international, national, local). The existence of a governance focal monopoly makes it possible to bypass the oligopolistic struggles between these groups for access to rents. These struggles between interest groups or insider coalitions are very costly for society. The institution in a governance focal monopoly position has precisely the capacity, first, to bring together the specific interests that count most in the definition of a "common" interest and, second, to incite them to achieve this desirable common interest. It makes it possible to see to it that the focused and regulated operation of interactions between rival forces continually enables a common interest to emerge and be attained. It allows the **convergence** of interests between factions to prevail over divergences. A governance focal monopoly therefore modifies the structure of incentives and information in the interplay of specific interests so that they serve an interest that is much wider in scope than their own.

It is possible to model the benefits of a governance focal monopoly with the help of game theory (Meisel, 2004). The governance focal monopoly's strength depends on its capacity to draw into its sphere negotiations between interest groups, so that the parties involved are not solely interested in what the other is thinking or is about to do (pure strategic rivalry) but in finding the basis on which a stable, single solution can be established. If the governance focal monopoly is sufficiently powerful, it can ensure that the collective level is taken into account from the onset by each of the interest groups when drawing up their own strategies because the negotiation has every chance of taking place, at one time or another, mediated by the institution in a position of focal monopoly. Being a powerful reducer of uncertainty, the governance focal monopoly therefore operates directly on growth by reducing **transaction costs** and by providing security for agents' **anticipations**.

The governance focal monopoly concept goes beyond the notions of interventionism or *dirigisme*, in that it is based on simultaneous understanding of the reasoning applied by private and public organisations. It also goes beyond mere opposition between public and private interests, in order to address the inclusion of a maximum number of **specific**-interest groups in the definition and attainment of their **common** interest.

Several historical experiences illustrate the functioning of the governance focal monopoly

Several countries have, in the recent past, set up institutions that incarnate the governance focal monopoly concept on local, regional, sectoral or national levels: France in the 30 post-war boom years, Taiwan from 1949 on, Singapore under Lee Kuan Yew from 1959 on, South Korea under Park Chong Hee from 1961 on and China starting in 1949[31]. The acquisition by certain public governance institutions in these countries of the capacity for co-ordinating private interests by positioning themselves as the unavoidable focal point of governance relations is a distinctive feature shared by these countries.

The governance focal monopoly has often taken the form of original institutional creations that foster dialogue and co-ordination among public and private elites in which confidence is inextricably created on a basis that is *simultaneously* interpersonal, process-based and institutionalised[32]: the French Planning Office, the Economic Planning Board in Korea, the Economic Development Board and the National Wage Council in Singapore, the Industrial Development Commission and numerous associations set up under the Kuomintang in Taiwan and, more generally, notably in the best-performing East and Southeast Asian countries, a large number of structures institutionalising the regular exchange of information and opinions between administrative, political, economic and even trade union leaders (Amsden, 1997; Lee Kuan Yew, 2000; Rodrik, 1994; Root, 1996; Woo-Cumings, 1999).

A phrase by Jean Monnet (1976), father of Europe and founder, in 1946, of the Commissariat Général au Plan (the French planning office), summarises the fundamental characteristic shared by all these approaches: ensuring that “private initiative subordinates itself to the general interest” by aligning private yields with social yields, that is to say by **causing private interests to take an interest in the accomplishment of socially desirable objectives.**

Yet, nothing indicates that the governance focal monopoly causes the processes by which specific-interest groups spread their roots to cease. On the contrary, public transfers and political stability are generally conducive to the consolidation of their positions. Simply, in order to conserve or increase their advantages at the lowest cost, they have every interest—at least for a time—in accepting the functional imperatives of the governance focal monopoly.

Following similar processes, consultations between organisations representing the private sector, trade unions and the government have made a decisive contribution to the success of certain stabilisation plans, for example in Israel (the 1986 “heterodox” Stabilisation Plan) and in Mexico (the Economic Solidarity Pact, 1987).

In certain countries, arrangements between insiders have only managed to produce a governance focal monopoly at sectoral level. This was the case in Brazil (automobiles and aviation), in the coffee sector in Colombia, and in several sectors in Chile (Schneider, 1997; Silva, 1997).

Post-war Italy is an interesting case in that it was impossible to set up a governance focal monopoly at national level because of the strong implantation of Mafia-type interests and relatively weaker implantation of the Nation-State in the South. It was at decentralised and sectoral level, mainly in the northern half of the country, that arrangements of the governance focal monopoly type imposed

[31] There are, obviously, major differences between the regimes mentioned, from authoritarian regimes in the strict sense of the term (China, Taiwan, South Korea) to those that were democratically elected (Singapore, France).
[32] For a precise definition of these three modes of confidence production, see Zucker (1986).

themselves as a mode for co-ordination of actors (industrial districts) and under the auspices of local political leaders.

Argentina, throughout the 20th century, displayed, on the contrary, all the symptoms of the elites' inability to establish this type of arrangement. The country was characterised by incessant power struggles between antagonistic interest groups unable to form a governance focal monopoly.

South Korea from the 1960s to the end of the 1990s achieved its economic take-off with a State that had a strong capacity for co-ordination and strategic vision. The State's intervention in the economy took the form more of price-distorting incentive policies (notably the "filtering" of imports and FDI and sector-by-sector support for exports) than of public spending, public ownership of firms, or social policies. The degree of formalisation of rules was embryonic, and corruption was rife. The transaction security that was not provided by the general institutional environment was reconstituted within large conglomerates (the *chaebols*) through the internalisation of the various complementary strategic functions (industrial, financial, commercial, dispute settlement) needed for the achievement of the industrial objectives set. These objectives were themselves co-ordinated by the State through the provision of substantial tax and financial incentives, while obliging these groups to submit to competition on world markets. Indeed, access to rents (subsidised loans, export subsidies, etc.) was conditional upon the attainment of profitability and international competitiveness objectives. There was a credible threat of withdrawal of these rents. The strategy combined the "carrot" of public support and the "stick" of international competition (Rodrik, 2004).

France in the 30 post-war boom years was also under a State that had a strong capacity for co-ordination and strategic vision, with the decisive role played by the Treasury within the Ministry of Finance, the sectoral committees led by the French Planning Office from 1946 on, and the importance of the "national champions" starting in the 1960s (Meisel, 2004). This constellation of actors under the tight co-ordination of the public sphere ensured very high levels of economic performance from the end of the Second World War to the early 1970s. Public intervention in France had a wider range than in Korea or Taiwan, relying on a high level of public expenditure, strong state involvement in the country's principal banks and major companies, and highly redistributive social policies. The degree of formalisation of rules was also much higher than in the rapidly developing Asian countries.

These States in a position of functional focal monopoly (in other words, in a position to influence the private reasoning of coalitions of specific interests in the general long-term interest) took steps, over sufficiently long periods, to make mutually compatible the interests of the economic, social, administrative and political elites (the insiders), and thereby promote to the maximum their collective interest by avoiding conflictual, negative-sum games.

Underlying this priority there was also the question of how to make the interests of the insiders themselves compatible with relatively equitable growth, in other words growth whose benefits were disseminated throughout the population. In fact, discontent among the poorer classes is always liable to be exploited by one faction of the national elite in order to destabilise, in its favour, the balance of forces previously established among elites. Proactive policies were therefore conducted to ensure that "no one was left by the wayside", even at the cost of making substantial transfers to the most disadvantaged segments of the population. For example, this was the role played by France's social security system from 1945 on, of the support for rural populations in Korea following land reform (Root, 1996), or the social housing policy carried out in Singapore starting in the 1960s (Lee Kuan Yew, 2000).

Qian (2001) shows that, while most of the reforms in China produced good results from 1978 on, this was notably because leaders paid constant attention to the interests of the various social actors concerned by the reform process and, above all, to the interests of various factions of insiders themselves. They did not hesitate to take unconventional paths *at first glance* surprising for foreign observers such as, for instance, the federalist system since 1978 and the success of Township-Village Enterprises (Qian, 2001). There is, therefore, an institutional explanation to the formidable gap in performances between the Chinese and Russian economies in the 1990s, although neither of the two countries had institutions universally recommended by the international financial institutions, whether they were secure financial markets and transparent business governance institutions accountable before shareholders, or more generally good governance institutions ensuring the respect of property rights, control of corruption and the supremacy of the rule of law and democracy.

In all, the formation of a governance focal monopoly makes it possible to trigger, within an insider system, the creation of confidence process on a sufficiently wide basis to speed up the pace of growth sustainably (economic take-off) even though the social body does not yet have the ability to provide itself with formalised impersonal rules on a systemic level.

Since this production of confidence takes place within the traditional social order, it uses modes of social regulation that are anchored in interpersonal relationships. The episodes of growth acceleration seen in Asian countries for forty years show us that, to significantly and lastingly increase growth, the institutions that form the focal monopoly have generated **specific governance capacities in three areas:**

(1) the capacity to elaborate a **strategic vision of development** and cause it to be shared outside the circle of insiders;

(2) the capacity to elaborate **incentive schemes that target** priority productive commodity chains by securing their institutional environment, R&D and the absorption of key technologies (the carrot), but without seeking to establish systemic "good governance", which would be unattainable at this stage; and

(3) the capacity to **discipline** the beneficiaries of such targeted incentive schemes by linking them to the attainment of binding performance objectives (gains in productivity and international market shares) and to a credible threat of their suppression (the stick).

These governance capacities go well beyond the field of "good governance". In the following section, we elaborate tools to measure this wider concept of governance, that we call "governance for development".

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SECTION 4: A WIDER CONCEPT: "GOVERNANCE FOR DEVELOPMENT"

From all the empirical and theoretical analyses conducted until this point, we have derived a new, broader definition of governance: "governance for development".

Meisel (2004) suggests, without referring to any specific institutional model, that "good institutions" are those capable of lastingly preserving public confidence, in other words anticipating factors that could potentially destroy confidence.

From this definition and the results of our analysis, we put forward the concept of "governance for development", which has been elaborated from the link it establishes between specific governance capacities and medium-to-long-term growth in developing countries.

"**Governance for development**" thus covers:

(1) all the institutions that generate confidence between agents and organisations through arrangements appropriate to the level of development of each country (governance focal monopoly, formalisation of rules); and

(2) the political economy of social regulation systems (openness of the insider system).

Based on this definition, we use the variables in the "Institutional Profiles" database to form **three families of indicators** corresponding to (I) the functions of co-ordination/strategic vision, (II) the opening up of the social regulation system, and (III) the formalisation of rules. In the rest of the analysis and in the tables in the annex, these three families of indicators are identified by their respective Roman numerals.

These families are made up respectively of the following variables (detailed in Annex 5):

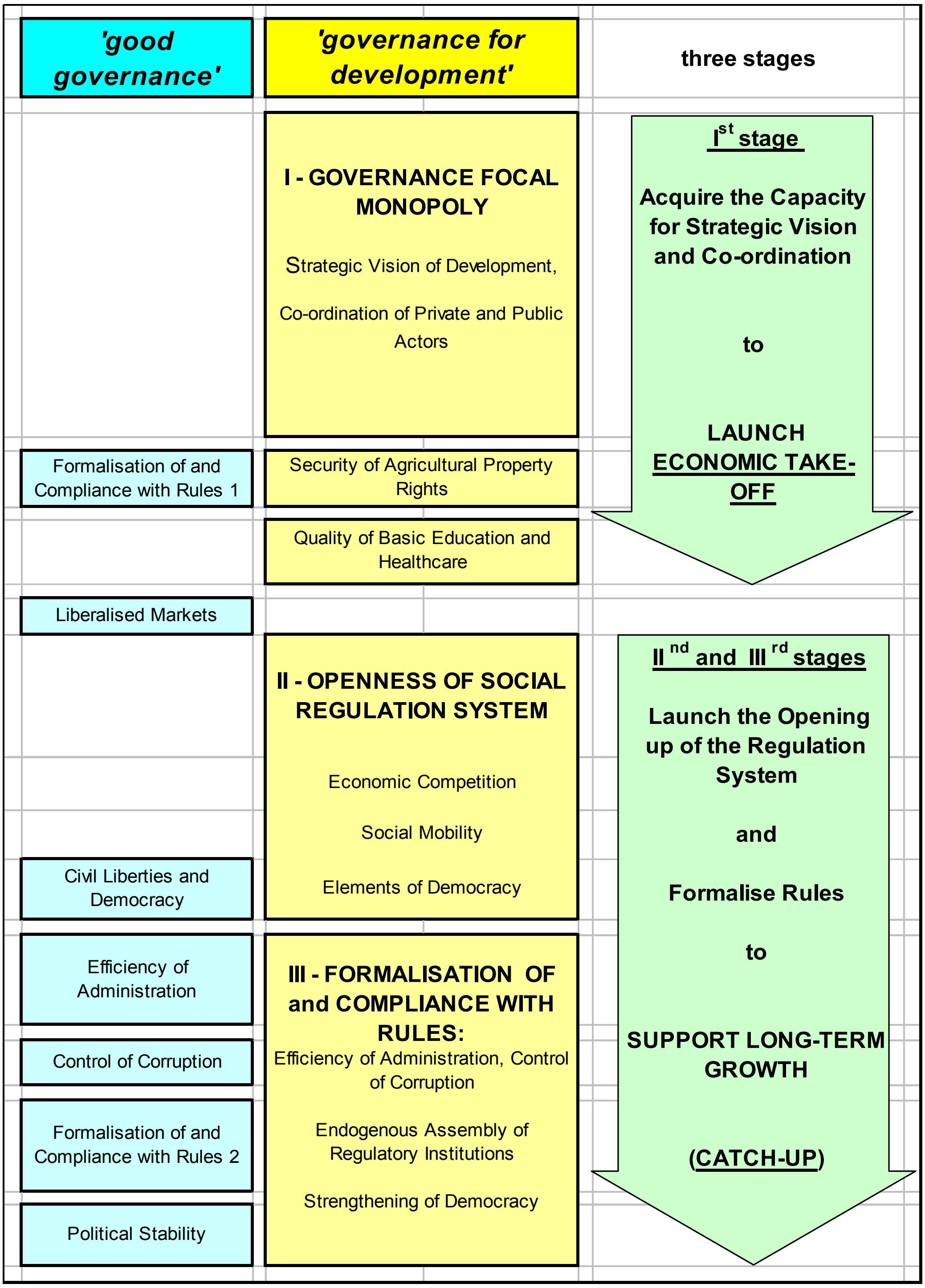
(I) Indicators of co-ordination and strategic anticipation: the capacity of the State to co-ordinate forms of consultation in order to bring out common interests, the State's capacity for autonomous decision-making, the elites' priorities for development, co-ordination within and between administrations, capacity of the political authorities, authorities' strategic vision, society's aptitude for innovation, technological environment of enterprises, investment in the population's future, and venture capital.

(II) Indicators of the openness of the social regulation system, themselves broken down into three subgroups: economic, social and political openness. For economic openness, the following indicators are included: regulation of competition, ease of enterprise creation, ease of market access, dispersion of share-ownership, information on firms' share-ownership. For social openness: social mobility, non-segmentation of the labour market and equality of treatment (i.e. non-discrimination based on ethnic, religious or gender criteria), training of elites, trade union freedom. For political openness: political rights and civil liberties, media pluralism, decentralisation, and transparency of the consultation process.

(III) Indicators of the formalisation of the social regulation system: efficiency of public administration, control of corruption, security of formal property rights, security of transactions on the markets for goods and services and on financial markets, security of property rights and contracts, institutional forms of solidarity, regulation of the financial system, and observance of labour law.

Graph 9 below compares these indicators with those of the World Bank Institute. The indicators aim to evaluate "governance for development" (middle column), which covers a much wider field than the WBI's six "good governance" indicators (right-hand column). Suited to the various phases of development (take-off then catch-up), they do not come from the same groupings. They bring together a large number—but not all—of the "Institutional Profiles" database's indicators.

Graph 9: From "good governance" to "governance for development"



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Conclusion

No explicit economic theories support the “good governance” that most donors have determined to be the top priority for development aid policies. Implicitly, “good governance” assumes a homogenous world in which poor countries have the same institutional characteristics as wealthy countries but are affected by pathologies that prevent them from catching up to wealthy countries (corruption, lack of democracy, State failures, market failures, etc.). To attenuate these pathologies (i.e. applying “good governance”) is to foster their catch-up. This vision of the world is founded on the absolute independence of the political and economic spheres when it comes to their effects on societies. As a result, it is assumed that in the economic sphere the same incentives (via prices, for example) will have the same effects everywhere (produce, invest, etc.) irregardless of the level of development.

This vision has led to a universal prescription of “good governance” whose effects on growth, as we have seen, are small or even inexistent. This vision is not even shared by international investors for whom “good governance” does not seem to be a critical criterion in their decisions as to where to invest. We can therefore state, in response to the question raised by the title, that “good governance” has not proven its relevance as a development strategy.

Developing countries are not countries that would be “wealthy if they were not ill”. They are structurally different in how their social regulation systems operate. The characteristics that still predominate today are not “pathologies” but the mode of regulation that has structured societies for thousands of years from which European countries emerged a few centuries ago to invent new modes of regulation. These new modes of regulation turned out to be extraordinarily effective when it came to wealth creation, technological innovation and the development of individual liberties.

This “good governance” is, of course, a key factor in the establishment of confidence in developed countries precisely because it systemically procures, via compliance with formal rules, a high degree of transaction security. In turn, this security procures a decisive advantage in a society’s capacity to produce wealth.

As all societies have done for thousands of years, developing societies operate under a mode of confidence production that is based on personal relationships. Yet, demographic transition and growing urbanisation inevitably cause these societies to enter a process by which social relations are depersonalised. This depersonalisation weakens the traditional factors in the production of confidence in these societies.

Developed societies operate according to a radically different mode of confidence production, as it is based on impersonal rules that apply to all regardless of the intrinsic characteristics of each individual. Thus, institutions are separate from people. This detachment, the fruit of lengthy elaboration of formal rules, systemically ensures high confidence that rules will be followed.

In developing societies, the rule depersonalisation movement does not spontaneously bring about a shift towards the mode of confidence production in effect in developed countries. In this way, there emerges a “grey area” in which the previously predominant confidence production factor no longer functions, whereas that of developed countries is not established.

The recommended “good governance” measures aim to establish the mode of confidence production at work in developed countries. In fact, they amount to nothing more than dictating that institutions (rules) be formalised and made universally applicable (separate from people).

The transposition of this process of impersonal formalisation of rules in low-income countries does not work. The resistance to the risk of destabilising social orders that it causes is an insurmountable obstacle in the short-to-medium term. Although desirable in itself, it is not applicable in these circumstances. This is why the relationship between "good governance" and growth is so weak and why programmes in support of this "good governance" have so little impact.

This deep-reaching difference in operation implies that the transition from poor to wealthy country requires radical changes, profound breaks, which generate strong resistance, the outcome of which are uncertain.

Countries in the economic take-off phase have introduced different arrangements for the creation of confidence, in most cases organised around a strategist State which ensures, in a manner specific to each country, the functions of co-ordination of actors and providing a secure basis for their anticipations. These functions are combined in the concept of a "governance focal monopoly". These countries manage to set off an institutional change involving profound breaks in the modes of regulation of social, economic and political systems.

The countries that have experienced this take-off phase over the medium-to-long term have accumulated sufficient resources and economic experience, including on world markets, to undertake the process of catching up with standards of living in developed countries. Their institutional transformations then involve the acquisition, at their own pace, of the institutional characteristics of developed countries (formalisation and opening up of the existing system of social regulation).

The slow emergence of modernity in now-developed countries, its laborious learning curve, its social and political struggles, and its deep setbacks (American and European civil wars) provide us with a vision of the challenges that developing countries face today.

But, the path a developing country must follow is not the path forged by today's developed countries. First, developing countries are not entering uncharted territory: they do not have to invent, *ex nihilo*, double entry accounting, limited liability for business entrepreneurs, land registries, the right to vote, etc. Second, they are confronted with the slow but inevitable destruction of their millennium-old modes of operation for the production of confidence even though this destruction is not spontaneously offset by the establishment of the formalised regulations that developed countries have invented and continuously adjusted over several hundred years. Finally, the anteriority and pre-eminence of developed countries' mode of development mean that the exporting of this "model" is experienced as being normative, which limits its appropriation.

A new and broader concept of governance has emerged from our work, namely "governance for development", which covers the various institutional arrangements that produce confidence depending on the income level of the country and dynamic of opening to new actors. This opening up of the regulatory system occurs on the economic level (extending the possibilities of market entry to new actors), on the social level (increased role of merit) and on the political level (democracy). We are therefore in a position to define "good institutions" in non-normative fashion: good institutions are those that ensure lasting confidence among agents, and between agents and organisations (the State, firms, etc.).

This new definition of governance derives directly from its link to growth and requires a new set of **"**governance for development**" indicators** that cover all the constituent elements in the production of confidence (governance focal monopoly, formalisation of rules) and those that deal with the opening up of the regulatory system.

This wider concept of "governance for development" opens new horizons for research and policy more fully at the service of growth and development.

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Annex 1: The 85 countries in the Institutional Profiles database

"2006 Institutional Profiles": List of countries by zone

1	CHN	China	46	BGD	Bangladesh
2	HKG	Hong Kong	47	IND	India
3	IDN	Indonesia	48	LKA	Sri Lanka
4	KHM	Cambodia	49	PAK	Pakistan
5	KOR	Korea, Republic of	50	BEN	Benin
6	MYS	Malaysia	51	BFA	Burkina Faso
7	PHL	Philippines	52	BWA	Botswana
8	SGP	Singapore	53	CIV	Côte d'Ivoire
9	TAI	Taiwan	54	CMR	Cameroon
10	THA	Thailand	55	ETH	Ethiopia
11	VNM	Vietnam	56	GAB	Gabon
12	BGR	Bulgaria	57	GHA	Ghana
13	CZE	Czech Republic	58	KEN	Kenya
14	EST	Estonia	59	MDG	Madagascar
15	HUN	Hungary	60	MLI	Mali
16	KAZ	Kazakhstan	61	MOZ	Mozambique
17	LTU	Lithuania	62	MRT	Mauritania
18	POL	Poland	63	MUS	Mauritius
19	ROM	Romania	64	NER	Niger
20	RUS	Russia, Federation of	65	NGA	Nigeria
21	TUR	Turkey	66	SEN	Senegal
22	UKR	Ukraine	67	TCD	Chad
23	UZB	Uzbekistan	68	UGA	Uganda
24	ARG	Argentina	69	ZAF	South Africa
25	BOL	Bolivia	70	ZWE	Zimbabwe
26	BRA	Brazil	71	CAN	Canada
27	CHL	Chile	72	DEU	Germany
28	COL	Colombia	73	ESP	Spain
29	CUB	Cuba	74	FRA	France
30	DOM	Dominican Republic	75	GBR	United Kingdom
31	GTM	Guatemala	76	GRC	Greece
32	MEX	Mexico	77	IRL	Ireland
33	PER	Peru	78	ISR	Israel
34	VEN	Venezuela	79	ITA	Italy
35	DZA	Algeria	80	JPN	Japan
36	EGY	Egypt	81	NOR	Norway
37	IRN	Iran	82	NZL	New Zealand
38	JOR	Jordan	83	PRT	Portugal
39	KWT	Kuwait	84	SWE	Sweden
40	LBN	Lebanon	85	USA	United States
41	MAR	Morocco			
42	SAU	Saudi Arabia			
43	SYR	Syria			
44	TUN	Tunisia			
45	YEM	Yemen			

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Annex 2: Analytical framework of institutions in the database

		INSTITUTIONAL SECTORS			
		Institutional environment	Markets		
		-A- Public institutions, Civil society	-B- Market for goods and services	-C- Capital market	-D- Labour market
INSTITUTIONAL FUNCTIONS	1- Political institutions	public rights and freedoms			trade union freedom and pluralism
	2- Safety, law and order	safety of persons and goods			
	3-Functioning of administration	transparency, corruption control, efficiency of administration, independence of the justice system	business start-ups		
	4- Markets' operating freedom		share of the private sector, privatisation, price distortions due to the government	share of the private sector, freedom of interest rates, independence of the central bank	share of public-sector employment, flexibility of the formal labour market
	5- Co-ordination of actors and anticipations (consideration of the future)	Government capacity for autonomous decision-making, co-ordination between public institutions, dialogue between actors, innovation and authorities' strategic vision	businesses' technological environment	venture capital	vocational training
	6- Security of transactions and contracts	security of property rights and contracts, commercial justice, bankruptcy laws	information on the quality of goods, the situation of firms, intellectual property	guarantee systems, disclosure requirements	observance of labour laws
	7- Regulations and corporate governance		regulation of competition, corporate governance	regulation of competition, prudential rules, supervision	social dialogue
	8- Openness to the outside world	circulation of persons and information	trade openness	financial openness	circulation of workers
	9- Social cohesion and mobility	social equilibrium, equality of treatment, social mobility, solidarity		micro-lending	market segmentation and social mobility

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Annex 3: Presentation of the variables in the database after reduction

The database presents the 356 elementary variables, as well as a first-order aggregation of these variables leading to 110 indicators of the state of institutions ("stock" indicators). For the analyses conducted here, these indicators were aggregated a second time to lessen the complexity of the database, leading to 71 indicators (see Berthelier *et al.*, 2004, for a description of the database reduction method).

List of the 71 variables used in the data analysis (PCA and CVA)			
1decent	Decentralisation	6faill	Application of bankruptcy laws
1democ	Political rights and civil liberties	6Fcrt	Traditional credit
1media	Media pluralism	6Fsecutr	Security of transactions in the financial system
1Wsynd	Trade union freedom	6secagri	Security of agricultural property rights and contracts
2secext	External security	6secutr	Security of transactions on markets for goods & nfs
2secint	Internal security	6Wdw	Labour law
3Adm	Efficiency of public administration	6Winform	Informal labour
3corupt	Control of corruption	7Eacdisp	Dispersed share-ownership
3creaE	Formalities for enterprise creation	7Eacetat	State share-ownership
3Qbpub	Quality of public goods: basic education and healthcare	7Eccdis	Competition in distribution
3transp	Transparency of public action	7Eentre	Ease of market access
4Epriv6	Share of the private sector (firms) in 2006	7Einfo	Information regarding firms' share-ownership
4Flibcr	Operating freedom for banking system	7Emultis	Multi-sectoral groups
4Fpriv6	Share of private banks in 2006	7ERegcc	Public regulation of competition on the market for goods & nfs
4libpx	Price freedom	7Fccbq	Competitive functioning of the banking system
4Wflex	Labour market flexibility	7FRegul	Regulation of the financial system
4Wpub	Share of non-public employment	7Wdialos	Social dialogue
5ant1	Society's aptitude for innovation	8Fouv	Financial openness
5ant2	Authorities' strategic vision	8ouvcom	Trade openness
5ant3	Elites' priorities for development	8ouvert	Circulation of persons and ideas
5ant4	Investment in the future of the population	8Wouv	Openness to foreign workers
5coor3	Representative organisations	8Wsoldmig	Migration balance
5coor4	Concertation to bring out common interests	9abpub	Access to basic public goods
5coor5	Gov capacity for autonomous decision-making	9egal	Equality of treatment
5coor6	Transparency of the concertation process	9elites	Training of elites
5coor7	Co-ordination among ministries and administrations	9Fmicroc	Micro-lending
5coor9	Capacity of the political authorities	9solidf	Institutional forms of solidarity
5Eant5	Technological environment of non-financial firms	9solidt	Traditional forms of solidarity
5Fant6	Competence of bank executives	9subv	Subsidies for basic products
5Fant7	Venture capital	9Wenfant	Child labour
5Fant8	Insurance companies, pension funds	9Wmobsoc	Social mobility
5Want9	Vocational training	9Wsegm	Segmentation of the labour market

6agrip	Share of public agricultural property	5007	Importance of the administration
6agrit	Share of traditional agricultural property	5015	Importance (de facto) of the single political party
6dprof	Security of formal property rights	5018	Importance of bilateral and multilateral donors
6dprot	Traditional property rights		

Here is an example of indicator aggregation:

The indicator "1democ" is the result of the aggregation of variables A100 (political rights) and A101 (civil liberties), which are themselves the result of the aggregation of:

- for A100, three elementary variables: election freedom and legality (A1000), acceptance or contestation by the population of the last change of head of state (A1001), and participation of military personnel in political life, by law or in fact (A1002); and

- for A101, five elementary variables: press freedom (A1010), freedom of association (A1011), freedom of assembly and protest (A1012), respect of the law in relations between citizens and administrations (A1013), and respect of ethnic, religious, linguistic, etc. minorities (A1014).

In all, the "1democ" indicator is formed by the aggregation of 8 elementary variables in the database.

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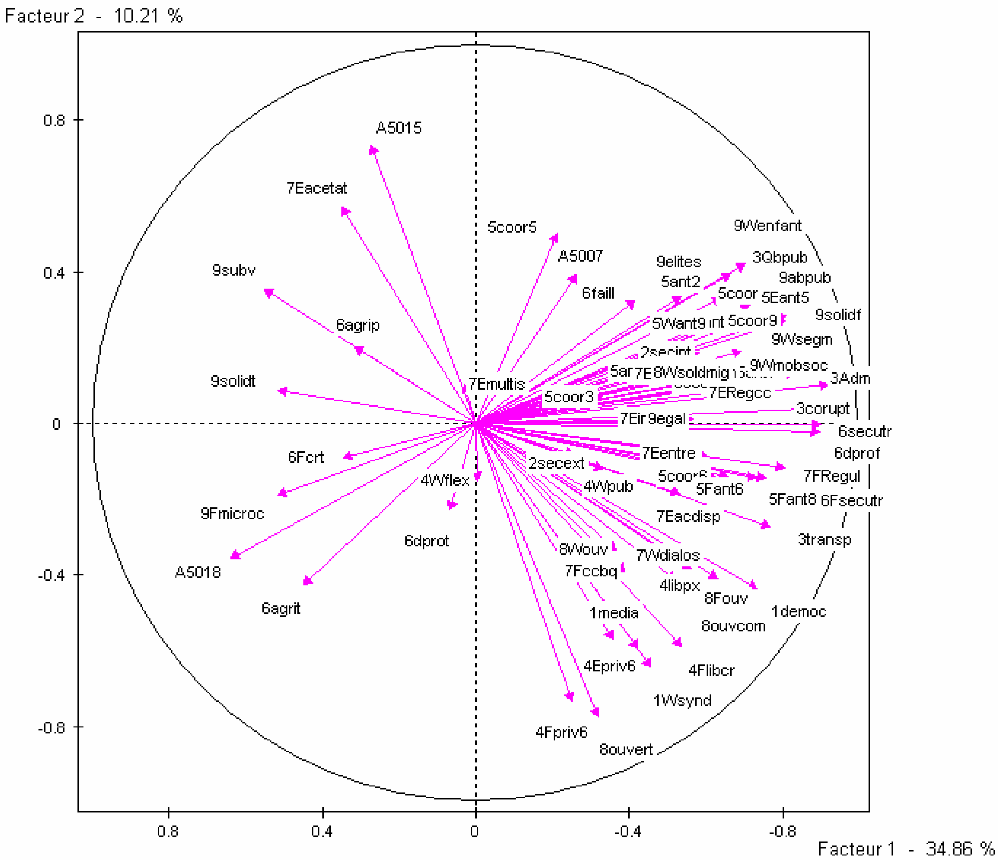
Annex 4: Principal components analysis (PCA) of indicators in the "Institutional Profiles" database

Principal components analysis (PCA) is a statistical tool that allows one to extract the information contained in a database made up of an ensemble of **individuals** (here, the 85 countries) characterised by a large number of **variables** more or less strongly correlated to each other (here, the 71 indicators chosen).

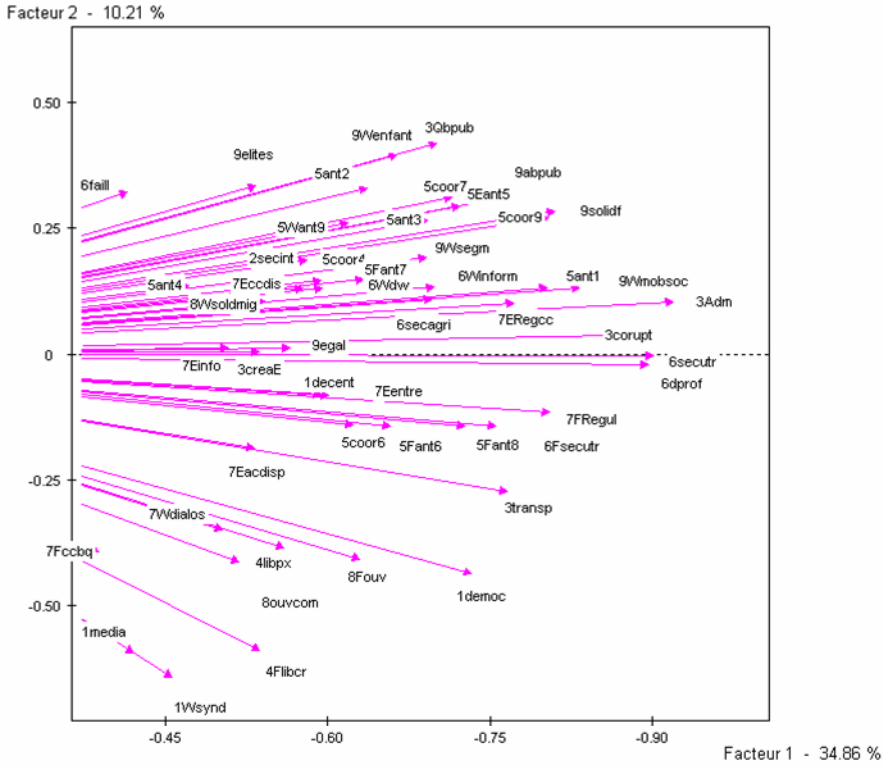
It provides a representation of the individuals on two-dimensional factorial planes (the only ones that can be represented). Graph 2 in the text thus represents the projection of 85 countries on the plane formed by the first two axes, which are by definition those that capture the most information contained in the entire database. In addition to representing individuals, PCA also allows variables to be represented.

Indeed, the axes are formed by the linear combination of variables, and are therefore a **result** of PCA. There are as many axes as there are variables in the database. The meaning of an axis is given by the combination of variables that project themselves heavily on this axis. The first axis is the axis that captures the most variance in the point cloud formed by all the variables, followed by the second, etc. The variables that contribute the most to the formation of the first axis are, therefore, those that most characterise all of the data in the database. With this method, we seek to identify, out of all the database's variables, which ones provide the largest share of the information contained in the database.

Graph A: Projection of variables on the PCA's first factorial plane: the Circle of correlation (85 countries, 71 active stock variables)



A close-up on the right-hand side allows one to better see the variables “close” to axis 1 (horizontal).



Source: “Institutional Profiles 2006” – Software: SPAD.

Variables are represented on the circle of correlation (graph A). A variable’s weight in the formation of an axis is positively linked to the coordinate at which it is projected onto this axis. On the graph, we can say that a variable weighs all the more heavily in the formation of an axis when the arrow that represents it is large within the circle and when the angle it forms with the axis in question is narrow. Two variables whose arrows cover each other are perfectly correlated to each other (R^2=1), two variables whose arrows are perpendicular to each other are totally independent (R^2=0), and two variables whose arrows go in opposite directions are perfectly anticorrelated (R^2=-1).

In the circle of correlation formed by the first two axes, one can see that the variables 3Adm, 3corrupt, 6secutr, and 6dprof are, among all the variables in the database, those that have the greatest weight in the formation of axis 1. It should be noted that a variable can be interpreted independently in one direction or the opposite direction. Thus, “control of corruption” (3corupt), which is projected very closely along axis 1 to the right, corresponds “negatively” to “corruption” (which would be projected very closely along axis 1 to the left).

In addition to these graphic representations, the following tables provide an examination of the principal variables that contribute to the formation of the first two axes:

- The first axis is, by construction, the one that captures the most information contained in the entire database (here, axis 1 captures 34.9% of the information). The variables that form it through linear combination are arranged on both sides of the horizontal axis in graph A according to the scope of their contribution to the formation of the axis (scope identified by the absolute value of the coordinate of the variable projected onto the axis) (in Table A, the variables that contribute the most to the formation of the axis are in bold[33]).

[33] In the “central zone”, the variables that do not significantly project onto the axis studied are not indicated.

Table A: Description of Axis 1 by the active variables in the PCA

Variable name		Formalisation of rules or "good governance"	Coordinate on axis 1
A5018	**Importance of bilateral and multilateral donors**		**-0.64**
9subv	**Subsidies for basic products**		**-0.55**
9Fmicroc	**Micro-lending**		**-0.52**
9solidt	**Traditional forms of solidarity**	X	**-0.52**
6agrit	**Share of traditional agricultural property**	X	**-0.45**
7Eacetat	**State share-ownership**		**-0.35**
6Fcrt	**Traditional credit**	X	**-0.35**
6agrip	**Share of public agricultural property**		**-0.32**
A5015	Importance (de facto) of the single political party		-0.27
6dprot	Traditional property rights		-0.07
7Emultis	Multi-sectoral groups		-0.03
CENTRAL ZONE			
5coor7	**Co-ordination between ministries and public authorities**		**0.71**
5Eant5	**Technological environment of non-financial firms**		**0.72**
5Fant8	**Insurance companies, pension funds**		**0.73**
1democ	**Political rights and civil liberties**	X	**0.73**
6Fsecutr	**Security of transactions in the financial system**	X	**0.75**
9abpub	**Access to basic public goods**		**0.76**
3transp	**Transparency of public action**	X	**0.77**
7ERegcc	**Public regulation of competition on the market for g and nfs**		**0.77**
5ant1	**Society's aptitude for innovation**		**0.80**
5coor9	**Capacity of the political authorities**	X	**0.80**
7FRegul	**Regulation of the financial system**	X	**0.81**
9solidf	**Institutional forms of solidarity**	X	**0.81**
9Wmobsoc	**Social mobility**		**0.83**
3corupt	**Control of corruption**	X	**0.87**
6dprof	**Formal property rights**	X	**0.90**
6secutr	**Security of transactions on the market for g and nfs**	X	**0.90**
3Adm	**Efficiency of public administration**	X	**0.92**

Source: "Institutional Profiles 2006" – Software: SPAD.

To the left of axis 1 (negative coordinates[34], at the top of table A), one finds high values for the following principal indicators (in decreasing order of importance): importance of donors; subsidies for basic products; micro-lending; traditional (non-formal) forms of solidarity; share of traditional agricultural property; state share-ownership; traditional credit; share of public agricultural property. These characteristics designate countries with traditional, little formalised institutions, typical of developing countries (see the countries furthest to the left on graph 2 in section 2, such as Chad, Mauritania, Syria, etc.).

[34] The coordinates' algebraic signs have no particular significance.

To the right of axis 1 (positive coordinates, at the bottom of table A), one finds high values for the following principal indicators (in decreasing order of importance): efficiency of public administration; security of transactions on the market for goods and non-financial services; formal property rights; control of corruption; social mobility; institutional forms of solidarity; regulation of the financial system; capacity of the political authorities; society's aptitude for innovation; public regulation of competition on the market for goods and non-financial services; transparency of public action; access to basic public goods (healthcare, education); security of transactions in the financial system; political rights and civil liberties; etc.

These characteristics designate countries that operate according to highly formalised, written and binding rules and that have systems that ensure a high degree of rule application: an effective, transparent and little corrupt administration, transaction security and property rights, democratic operation of political institutions and a high level of civil liberties, institutional solidarity mechanisms, and other indicators specific to developed countries (social mobility, innovation, regulation of competition, etc.). The countries furthest to the right in graph 2 in section 2 are Ireland, Germany and Sweden.

An examination of the variables that form this axis 1 leads us to remark that most of the variables that express a high degree of formalisation of rules in fact form the components of "good governance" and have high values in developed countries. The same holds true (in the opposite direction) for the variables that express opposing characteristics (informal regulations), which have high values in developing countries.

- The second axis (vertical) is, by construction, the one that comes in second in regard to the quantity of information captured in the database (10.2% of total variance).

Towards the top (positive coordinates), one finds variables that mark the presence of the State in the political and institutional arenas (importance of the single political party and the administration, government capacity for autonomous decision-making, quality of basic public goods, authorities' strategic vision, co-ordination between ministries and public authorities, control of child labour), and in the economic arena (state share-ownership, subsidies for basic products).

Towards the bottom of the axis (negative coordinates), one mainly finds the variables that characterise political and social liberties (political rights and civil liberties, media pluralism, free circulation of persons and ideas, trade union freedom) and low economic involvement by the State (importance of private enterprises and banks, price freedom and operating freedom for lending, trade openness, and financial openness).

The principal orientation of this axis 2 opposes, therefore, societies in which the State's influence on society is strong (which can take authoritarian forms: Cuba, Syria, Iran) to societies in which economic and civil liberties are more extensive, in which the State is not very active, or even failing (as in certain sub-Saharan African countries).

Table B: Description of Axis 2 by the active variables in the PCA

Variable name		Weight of the State (X), Civil and economic liberties (Y)	Coordinates on axis 2
A5015	**Importance (de facto) of the single political party**	**X**	**0.73**
_7Eacetat	**State share-ownership**	**X**	**0.57**
_5coor5	**Government capacity for autonomous decision-making**	**X**	**0.50**
_3Qbpub	**Quality of public goods: basic education and healthcare**		**0.42**
_9Wenfant	**Child labour**		**0.40**
A5007	**Importance of the administration**	**X**	**0.39**
_9subv	**Subsidies for basic products**	**X**	**0.35**
_9elites	**Training of elites**		**0.34**
_5ant2	**Authorities' strategic vision**	**X**	**0.33**
_6faill	**Application of bankruptcy laws**		**0.32**
_9abpub	**Access to basic public goods**		**0.31**
_5coor7	**Co-ordination between Ministries and public authorities**	**X**	**0.31**
_5Eant5	Technological environment of non-financial firms		0.29
_9solidf	Institutional forms of solidarity		0.28
_5coor9	Capacity of the political authorities		0.27
_5ant3	Elites' priorities for development		0.27
_5Want9	Vocational training		0.26
Central Zone			
_6dprot	Traditional property rights		-0.23
_3transp	Transparency of action by the authorities		-0.27
_8Wouv	**Openness to foreign workers**		**-0.34**
_7Wdialos	**Social dialogue**		**-0.35**
A5018	**Importance of bilateral and multilateral donors**		**-0.36**
_4libpx	**Price freedom**	**Y**	**-0.38**
_7Fccbq	**Competitive functioning of the banking system**		**-0.39**
_8Fouv	**Financial openness**	**Y**	**-0.41**
_8ouvcom	**Trade openness**	**Y**	**-0.41**
_6agrit	**Share of traditional agricultural property**		**-0.42**
_1democ	**Political rights and civil liberties**	**Y**	**-0.43**
_4Epriv6	**Share of the private sector (firms) in 2006**	**Y**	**-0.57**
_4Flibcr	**Operating freedom for banking system**	**Y**	**-0.59**
_1media	**Media pluralism**	**Y**	**-0.59**
_1Wsynd	**Trade union freedom**	**Y**	**-0.64**
_4Fpriv6	**Share of private banks in 2006**	**Y**	**-0.73**
_8ouvert	**Circulation of persons and ideas**	**Y**	**-0.77**

Source: "Institutional Profiles 2006" – Software: SPAD.

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Annex 5: Canonical variate analysis (CVA) of the 85 countries split into 3 groups

The formation of three groups of countries

Canonical variate analysis (CVA) aims to identify the institutions that best define each group of countries formed using a medium-to-long-term economic performance indicator. Three groups of countries were created according to two criteria; membership in the developed country group (World Bank classification) and situation in relation to the average of the indicator for developed countries.

The performance indicator chosen is growth in GDP per capita over the period 1990-2004 (source: UNDP). The threshold chosen is the developed-country growth average, which was 2.3% in the period in question. The three resulting groups are then: developed countries, converging developing countries and countries in transition (growth rate above the threshold) and diverging countries (see Table A below)[35].

CVA introduces the beginnings of economic inference into the analysis

CVA minimises variance, in other words, the spread of the point cloud within the groups, and maximises it between the groups. The difference with hierarchical classification lies in the fact that, in CVA, the groups are constituted exogenously (in this case using the performance indicator) while in hierarchical classification, the breakdown of the groups stems from the analysis itself.

The tests of significance of the variables forming each of the axes.

The correlations of the original variables with the factorial axes make it possible to define the set of institutional indicators that contribute most to the formation of each axis. Moreover, the statistical software used (SAS) provides an analysis of variance that tests the significance of the differences between the averages for each group for each of the variables.

The only variables that will be retained as significant are those whose averages are different with a P-value of below 0.1% in the Fisher test of equality of averages on the Univariate Test Statistics in SAS.

The variables found to be significant on the basis of these criteria are identified in the following tables by an asterisk (*) in the last column.

Detailed content of the indicators used in these analyses

Below we provide the detailed content of a few indicators, that is to say the questionnaire headings. For more complete information on all the indicators used in this document, readers should refer to the database itself.

[35] After some hesitation, three countries that were on or very slightly above the threshold (Bangladesh, Iran and Mali) were placed in the diverging countries group.

Table A: Breakdown of the 85 countries into 3 groups, according to their medium-to-long-term growth

:	Developed countries	ΔGDP/capita (1990-2004)
1	**CAN**	2.1
2	**DEU**	1.5
3	**ESP**	2.3
4	**FRA**	1.7
5	**GBR**	2.2
6	**GRC**	2.6
7	**IRL**	7.3
8	**ISR**	1.6
9	**ITA**	1.3
10	**JPN**	0.8
11	**NOR**	2.5
12	**NZL**	2.1
13	**PRT**	2.1
14	**SWE**	1.8
15	**USA**	1.9
	Group 1 average	2.3

	Converging countries	ΔGDP/capita (1990-2004)
1	**BWA**	4.2
2	**CHL**	3.7
3	**CHN**	8.9
4	**CUB**	3.64
5	**CZE**	2.7
6	**DOM**	4.2
7	**EGY**	2.5
8	**EST**	4.3
9	**HUN**	3.1
10	**IND**	4.0
11	**KHM**	5.0
12	**KOR**	4.5
13	**LBN**	3.7
14	**LKA**	3.8
15	**MOZ**	4.2
16	**MUS**	3.9
17	**MYS**	3.5
18	**POL**	4.0
19	**SGP**	3.8
20	**TAI**	4.7
21	**THA**	2.6
22	**TUN**	3.2
23	**UGA**	3.5
24	**VNM**	5.5

15+24+46=85

:	Diverging countries	ΔGDP/capita (1990-2004)
1	**ARG**	1.3
2	**BEN**	1.4
3	**BFA**	1.3
4	**BGD**	2.5
5	**BGR**	0.7
6	**BOL**	1.2
7	**BRA**	1.2
8	**CIV**	-1.1
9	**CMR**	0.5
10	**COL**	0.5
11	**DZA**	0.9
12	**ETH**	1.5
13	**GAB**	-0.1
14	**GHA**	1.9
15	**GTM**	1.3
16	**HKG**	2.0
17	**IDN**	1.8
18	**IRN**	2.3
19	**JOR**	0.5
20	**KAZ**	1.7
21	**KEN**	-0.6
22	**KWT**	-0.4
23	**LTU**	1.4
24	**MAR**	1.1
25	**MDG**	-1.1
26	**MEX**	1.3
27	**MLI**	2.5
28	**MRT**	1.2
29	**NER**	-0.7
30	**NGA**	0.8
31	**PAK**	1.6
32	**PER**	2.1
33	**PHL**	0.9
34	**ROM**	1.4
35	**RUS**	-0.6
36	**SAU**	-0.1
37	**SEN**	0.9
38	**SYR**	1.5
39	**TCD**	2.1
40	**TUR**	1.6
41	**UKR**	-3.2
42	**UZB**	1.3
43	**VEN**	-1.2
44	**YEM**	1.7
45	**ZAF**	0.6
46	**ZWE**	-1.9

Identification of three major functions in the tables

The three major institutional functions identified in the analysis to which the indicators belong are indicated in the first column (only the significant variables):

(I): Governance focal monopoly: co-ordination/strategic vision function of the strategist State;

(II): Process of opening up the social regulation system;

(III): Progress towards the formalisation of rules.

The tables showing the results of the three analyses of the groups of countries compared in pairs are presented below:

Table B: Diverging *vs.* converging countries

Variables classified according to their level of correlation with the axis				
	_6agrit	Share of traditional agricultural property	-0.34	
	_4Fpriv6	Share of private banks in 2006	-0.29	
	_6Fcrt	Traditional credit	-0.23	
	A5018	Importance of bilateral and multilateral donors	-0.22	
	A5015	Importance (de facto) of the single political party	0.27	
	_5ant4	Investment in the future of the population	0.27	
	_9abpub	Access to basic public goods	0.28	
	_9Wsegm	Segmentation of the labour market	0.29	
	_5Fant7	Venture capital	0.32	
	_2secint	Internal security	0.32	
	_3Adm	Efficiency of public administration	0.33	
	_5Want9	Insurance companies, pension funds	0.35	
	_9Wenfant	Child labour	0.37	
	_9solidf	Institutional forms of solidarity	0.38	
I	**_5coor7**	**Co-ordination between Ministries and public authorities**	**0.39**	*
III	**_6secagri**	**Security of agricultural property rights and contracts**	**0.40**	*
I	**_5Eant5**	**Technological environment of non-financial firms**	**0.40**	*
I	**_5coor9**	**Capacity of the political authorities**	**0.42**	*
I	**_5ant1**	**Society's aptitude for innovation**	**0.42**	*
	_3Qbpub	**Quality of public goods: basic education and healthcare**	**0.44**	*
I	**_5ant2**	**Authorities' strategic vision**	**0.46**	*
I	**_5coor4**	**Concertation to bring out common interests**	**0.50**	*
I	**_5ant3**	**Elites' priorities for development**	**0.51**	*

Illustration of the content of the principal indicators in the analysis:

Below we present the survey question headings on the elementary variable level in the database for the indicators that play a significant role in this analysis (marked by an asterisk). The numbers designate the variables as they are named in the database. They are 4-digit variables (e.g. A5140) that received a notation during the survey. The 3-digit variables (e.g. A514) form the first order aggregation in the database.

For more detailed information on the method used to form variables, aggregation tools, etc., readers are invited to refer to the document presenting the database (Meisel and Ould Aoudia, 2007, Working Document no. 46, AFD).

Elites' priorities for development: indicator 5ant3 is formed by the variable A514 for which we give, here, the details as they appear in the database (taken from the questionnaire):

A514 - The priorities of the local elites – (from 1=very low priority to 4=very high priority)

A5140 - Are development and economic growth a priority for the political authority, over and above the declarations? (from 1 to 4)

A5141 - Are development and economic growth a priority for the local public elites (senior civil servants, academics, etc)? (from 1 to 4)

Concertation to bring out common interests: indicator 5coor4 is formed by the variable A505:

A505 - Dialogue structures headed by the political authority to find a common interest among stakeholders (from 0 to 4)

A5050 - Does the political authority organise dialogue structures among the main stakeholders? (0 if no structures - if dialogue structures, mark 1 = very small role to 4 = substantial co-operation role)

Authorities' strategic vision: indicator 5ant2 is formed by the variable A512:

A512 - Long-term strategic vision of the authorities (from 1=poor long-term vision to 4=strong long-term vision)

A5120 - Do the authorities act on the basis of a strategic vision? (from 1 to 4)

Quality of public goods (basic education and healthcare): indicator 3Qbpub is formed by the variable A308:

A308 - Quality of the supply of public goods: education and basic health (from 1 = very low quality to 4 = very high quality)

A3080 - State primary and secondary education system (from 1 to 4)

A3081 - State basic health system (from 1 to 4)

Society's aptitude for innovation: indicator 5ant1 is formed by the variable A511:

A511 - Society's aptitude for adaptation and innovation (from 1=low aptitude to 4=high aptitude)

A5110 - Society's aptitude for technological adaptation and innovation (from 1 to 4)

A5111- Society's aptitude for managerial adaptation and innovation (from 1 to 4)

A5112 - Society's aptitude for legal and institutional adaptation and innovation (from 1 to 4)

Capacity of the political authorities: indicator 5coor9 is formed by the variable A510:

A510 - Capacity of the political authorities (from 1=low levels of capability, consistency, authority, rapidity, to 4=high levels …)

A5100 - Decision-making capacity of the political authorities in economic matters (responsibility, rapidity, etc) (from 1 to 4)

A5101 - Consistency and continuity of government action in economic matters (from 1 to 4)

A5102 - Authority of the political powers over the administration (from 1 to 4)

Technological environment of non-financial firms: indicator 5Eant5 is formed by the variable B500:

B500 - Technological environment, dissemination of technology (from 1 to 4)

B5000 - Proportion of technical staff (engineers, technicians) in SMEs/SMIs (from 1=low to 4=high)

B5001 - Proportion of technical staff (engineers, technicians) in large firms (from 1=low to 4=high)

B5002 - Density and "continuity" of corporate fabric (locally-available maintenance and subcontracting, etc (from 1=low density, continuity to 4=high)

Security of agricultural property rights and contracts: indicator 6secagri is formed by the variable B607:

B607 - Agricultural sector: security of rights and property transactions (from 1 or 0 to 4)

B6070 - Are agricultural land property rights mainly traditional (informal or quasi-informal) or are they formal? (from 1=mainly traditional to 4=mainly or totally formal)

B6071 - Is the security of TRADITIONAL property rights and transactions assured? (0 if no traditional rights - if traditional rights, grade from 1 = minimum security to 4 = maximum security)

B6072 - Is the security of FORMAL property rights and transactions assured? (from 1 = minimum security to 4 = maximum security)

Co-ordination between ministries and public authorities: indicator 5corr7 is formed by the variable A508:

A508 - Co-ordination between ministries and within the administrations (from 1 to 4)

A5080 - Co-ordination and co-operation between ministries (from 1 = low level of co-ordination and co-operation to 4 = high level of co-ordination and co-operation)

A5081 - Co-ordination and co-operation within the administrations (from 1 = low level of co-ordination and co-operation to 4 = high level of co-ordination and co-operation)

Table C: Converging *vs.* developed countries

Variables classified according to their level of correlation with the axis				
	A5018	**Importance of bilateral and multilateral donors**	**-0.64**	*
	_9solidt	**Traditional forms of solidarity**	**-0.55**	*
	_9subv	**Subsidies for basic products**	**-0.53**	*
	_9Fmicroc	Micro-lending	-0.49	
	_6agrip	Share of public agricultural property	-0.43	
	_7Eacetat	State share-ownership	-0.42	
	A5015	Importance (de facto) of the single political party	-0.34	
	_3creaE	Formalities for enterprise creation	0.44	
	_5Fant7	Venture capital	0.45	
	_5coor9	Capacity of the political authorities	0.46	
	_5ant1	Society's aptitude for innovation	0.46	
	_9elites	Training of elites	0.46	
	_5Fant6	Competence of bank executives	0.47	
	_8ouvcom	Trade openness	0.47	
	_8Wouv	Openness to foreign workers	0.49	
	_4libpx	Price freedom	0.50	
	_6Winform	Informal labour	0.50	
III	**_6Wdw**	**Labour law**	**0.53**	*
	_9abpub	**Access to basic public goods**	**0.53**	*
	_5Fant8	**Insurance companies, pension funds**	**0.53**	*
	_4Flibcr	**Operating freedom for banking system**	**0.54**	*
III	**_6Fsecutr**	**Security of transactions in the financial system**	**0.56**	*
III	**_7FRegul**	**Regulation of the financial system**	**0.57**	*
II	**_1Wsynd**	**Trade union freedom**	**0.57**	*
II	**_1democ**	**Political rights and civil liberties**	**0.59**	*
II	**_1decent**	**Decentralisation**	**0.59**	*
III	**_9solidf**	**Institutional forms of solidarity**	**0.60**	*

	_8Fouv	Financial openness	0.60	*
II	_9Wmobsoc	Social mobility	0.61	*
II	_7ERegcc	Public regulation of competition	0.62	*
III	_6dprof	Formal property rights	0.66	*
	_8Wsoldmig	Migration balance	0.66	*
II	_3transp	Transparency of action by the authorities	0.68	*
III	_3Adm	Efficiency of public administration	0.70	*
III	_3corupt	Control of corruption	0.72	*
III	_6secutr	Security of transactions	0.76	*

Illustration of the content of the principal indicators in the analysis

We shall first examine the detailed content of three significant indicators from the top of the table in decreasing order of their coordinates (from the top of the table down), and then the first significant indicators at the bottom of the table in decreasing order of their coordinates (from the bottom up).

Variables at the top of the table (characteristics of converging countries compared to developed countries):

Importance of bilateral and multilateral donors: indicator A5018 is taken from the A500 set of variables (which cannot, by nature, be aggregated):

A500 - Stakeholders: weight and influence of each stakeholder in the country's political affairs (0 if the stakeholder has no weight and no influence - if the stakeholder has an influence, mark 1 = very little influence, very low weight to 4 = a huge amount of influence and weight)

…/…

A5018 - Bilateral and multilateral donors (from 0 to 4 - 0 if the country receives no official assistance)

Traditional forms of solidarity: indicator 9solidt is formed by the variable A903:

A903 - Traditional forms of solidarity (from 1=low level of family support in the case of sickness, unemployment, old age to 4=high-level of family support

A9030 - Traditional solidarity in urban areas (from 1 to 4)

A9031 - Traditional solidarity in rural areas (from 1 to 4)

A9032 - Traditional solidarity between urban and rural areas (in both directions) (from 1 to 4)

Subsidies for basic products: indicator 9subv is formed by the variable A902. One will note that variable A902 is itself formed by the inversed ratings of two other variables in the database:

A902 - Subsidies for primary products (social safety net) = B4030 & B4031 aggregated and inversed (from 1 to 4)

A9020 - Proportion of administered prices (inversed score) (from 1 to 4)

A9021 - Direct subsidies on primary product prices for the benefit of the consumer (inversed score) (from 1 to 4)

Variables at the bottom of the table (characteristics of developed countries compared to converging countries):

Security of transactions: indicator 6secutr is formed by aggregating the following variables: B600, B601, B602, B603, B604, the details of which are given below:

B600 - Information on the situation of firms (0 if no arrangements - where arrangements exist, (from 1=low degree of implementation to 4=satisfactory implementation)

B6000 - Standard accounting system (SMEs) (from 0 to 4)

B6001 - Standard accounting system (large firms) (from 0 to 4)

B6002 - Certification of company accounts (SMEs) (from 0 to 4)

B6003 - Certification of company accounts (large firms) (from 0 to 4)

B6004 - Intervention of international auditing firms (from 0=no intervention; where there is intervention, grade from 1=very rare to 4=frequent)

B601 - Information on the quality of the goods: national norms and standards (0 if no arrangements - where arrangements exist, grade from 1=low degree of implementation to 4=satisfactory implementation)

B6010 - National norms and standards (from 0 to 4)

B602 - Information on the quality of the goods: international norms and standards (0 if no arrangements - where arrangements exist, grade from 1=low degree of implementation to 4=satisfactory implementation)

B6020 - International norms and standards (ISO, Codex, etc) (from 0 to 4)

B603 - Intellectual property (from 1=low level of respect to 4=very high level of respect)

B6030 - Respect for intellectual property as regards manufacturing secrets, patents, etc (from 1 to 4)

B6031 - Respect for intellectual property as regards counterfeit goods (from 1 to 4)

B604 - Arrangements for the protection of intellectual property (0 if no such arrangements - where such arrangements exist, grade from 1=low level of application to 4=very good level of application)

B6040 - Local arrangements for protection of intellectual property (from 0 to 4)

B6041 - International arrangements: TRIPS agreement (from 0 to 4)

Control of corruption: indicator 3corupt is formed by the variable A302:

A302 - Corruption (from 1= widespread to 4= low level)

A3020 - Level of "petty" corruption (between citizens and the administration) (from 1 to 4)

A3021 - Level of "large-scale" corruption (between the administration and firms) (from 1 to 4)

Efficiency of public administration: indicator 3Adm is formed by aggregating the following variables: A303, A304, A305, A306 and A307:

A303 - Government-citizen relations (from 0 to 4)

A3030 - Rapidity and efficiency of citizens' dealings with the administration (from 1 to 4)

A3031 - Public confidence in the administration (from 1 to 4)

A304 - Effectiveness of public action: tax system (from 1 = large informal economy, widespread tax and customs evasion to 4 = small informal economy, little tax and customs evasion)

A3040 - Importance of the informal economy (from 1 to 4)

A3041 - Importance of tax evasion in the formal sector (from 1 to 4)

A3042 - Importance of customs evasion (smuggling, under-declaration, etc) (from 1 to 4)

A3043 - Capacity of the tax administration to implement measures decided on (from 1= low to 4= high)

A305 - Running of the customs administration (from 1 = low capability, low level of co-operation to 4=high capability, very high level of co-operation)

A3050 - Capability of the customs administration to implement its customs commitments (rules of origin, rules of valuation for customs purposes) (from 1 to 4)

A3051 - Capability of the customs administration to take advantage of the trade advantages (preferences, regional agreements, etc) (from 1 to 4)

A3052 - Level of co-operation of the local customs administration with the customs administrations of other countries (rules of origin, detection of fraud, etc) (from 1 to 4)

A306Award of public procurement contracts and delegation of public service (from 1 = very little transparency or public notification to 4 = high level of transparency and public notification)

A3060 - Award of public procurement contracts and public service delegation to local firms (from 1 to 4)

A3061 - Award of public procurement contracts and public service delegation to foreign firms (from 1 to 4)

A307 - Running of the justice system (from 1= low degree of independence, application, rapidity to 4= high degree of independence, satisfactory application...)

A3070 - Independence of the justice system from Government (from 1 to 4)

A3071 - De facto equality of treatment for foreigners (from 1 to 4)

A3072 - Degree of application and speed of rulings (from 1 to 4)

Transparency of action by the authorities: indicator 3transp is formed by aggregating the following variables: A300 and A301:

A300 - Transparency of public action in the economic field (0 if no publications - if publications exist, grade them from 1 = unreliable to 4= totally reliable)

A3000 - Government budget (from 0 to 4)

A3001 - Extra-budgetary funds (if none exist, put 4)

A3002 - Accounts of state-owned enterprises (from 0 to 4)

A3003 - Accounts of public banks (from 0 to 4)

A3004 - Basic economic and financial statistics (national accounts, price indices, foreign trade, currency and credit, etc) (from 0 to 4)

A3005 - Is the IMF consultation under Article IV published? (no =0, partially =2, totally =4)

A301 Transparency of economic policy (fiscal, taxation, monetary, exchange-rate, etc) (from 1 to 4)

A3010 - Is economic policy the subject of an official communication (from 1=thin and opaque to 4= substantial and transparent)

A3011 - Is economic policy the subject of public debate (from 1= little debate to 4= substantial and structured debate)

Migration balance: indicator 8Wsoldmig is formed by aggregating the following variables: D8001 and D802:

D801 - Balance of migration for movements of UNSKILLED individuals (from 0 to 4)

D8010 - Balance of migration for unskilled men (0 if no migratory inflows or outflows - if migration, grade from 1=high deficit (net emigration) to 4=high surplus (net immigration)

D8011 - Balance of migration for unskilled women (0 if no migratory inflows or outflows - if migration, grade from 1 = high deficit (net emigration) to 4 = high surplus (net immigration)

D802 Balance of migration for movements of SKILLED individuals (from 0 to 4)

D8020 - Balance of migration for skilled men (0 if no migratory inflows or outflows - if migration, grade from 1 = high deficit (net emigration) to 4 = high surplus (net immigration)

D8021 - Balance of migration for skilled women (0 if no migratory inflows or outflows - if migration, grade from 1 = high deficit (net emigration) to 4 = high surplus (net immigration)

Formal property rights: indicator 6dprof is formed by aggregating the following variables: A601, A602, A603, A604, A605 and A606:

A600 - Security of traditional property rights (if there is no system of traditional property rights or only very marginal, put 0 - if traditional property rights exist, grade these from 1 to 4)

A6000 - Existence and importance of a traditional system of property rights (0 or grade from 1=weak to 4=widespread)

A6001 - If a traditional system exists, does it ensure security of property rights? (from 1=low security to 4=high security)

A601 - Security of property rights: formal property rights (from 1 to 4)

A6010 - Effectiveness of legal measures to defend property rights between private agents (from 1 = weak to 4 = highly effective)

A6011 - Compensation in the event of de jure or de facto expropriation (by the Government) of real property (from 1 = no compensation to 4 = "reasonable" compensation)

A6012 - Compensation in the event of de jure or de facto expropriation (by the Government) of instruments of production? (from 1 = no compensation to 4 = "reasonable" compensation)

A6013 - Generally speaking, does the government exert arbitrary pressure on private property (red tape, etc)? (from 1 = very frequent arbitrary pressure to 4 = no arbitrary pressure)

A602 - Form of contracts between private agents (from 1 to 4)

A6020 - Do contracts between private agents tend to be oral or written (from 1 = majority oral to 4 = majority written)

A6021 -In the case of the written contracts, are these drafted without mediation or with private mediation (lawyers)? Written contracts drafted without mediation (= 1 or 2) or with private mediation (lawyers) (= 3 or 4)?)

A603 - Security of contracts between private agents (from 1 = little respect to 4 = high respect)

A6030 - Respect for oral contracts (from 1 to 4)

A6031 - Respect for written contracts without mediation (from 1 to 4)

A6032 - Respect for contracts with private mediation (lawyers) (from 1 to 4)

A6033 - Respect for contracts between local private agents and foreigners (from 1 to 4)

A604 - Government respect for contracts (from 1=very frequent and important terminations to 4=very rare or none at all)

A6040 - Have there in the past 5 years been terminations of contracts by the Government vis-à-vis local agents (without "reasonable" compensation)? (from 1 to 4)

A6041 - Have there in the past five years been terminations of contracts by the Government vis-à-vis foreigners (without "reasonable" compensation)? (from 1 to 4)

A605 - Settlement of economic disputes: justice in commercial matters (from 1=low degree of independence, equality of treatment, application and rapidity to 4=high degree of independence …)

A6050 - Independence of the justice system vis-à-vis the Government as regards commercial disputes (from 1 to 4)

A6051 - Independence of the justice system vis-à-vis litigants (local) as regards commercial disputes (from 1 to 4)

A6052 - Equality of treatment between nationals and foreigners as regards commercial disputes (from 1 to 4)

A6053 - Degree of application and rapidity of legal rulings on commercial matters (from 1 to 4)

A606 - Law on bankruptcies (0 if there is no law on bankruptcies - if bankruptcy laws exist, grade from 1=deficient application to 4=swift and efficient application)

A6060 - Law on bankruptcies (from 0 to 4)

A6061 - More precisely, independence of courts ruling on bankruptcies (from 1=low degree of independence to 4=high degree of autonomy)

A6062 - Existence of simplified legal procedures to restructure rather than put into liquidation? (from 1 to 4)

Readers should refer to the database itself for a detailed list of the other indicators.

Table D: Diverging *vs*. developed countries

Variables classified according to their level of correlation with the axis				
	A5018	**Importance of bilateral and multilateral donors**	**-0.64**	*
	9subv	**Subsidies for basic products**	**-0.57**	*
	9solidt	**Traditional forms of solidarity**	**-0.55**	*
	9Fmicroc	**Micro-lending**	**-0.49**	*
	6agrit	Share of traditional agricultural property	-0.34	
	6Fcrt	Traditional credit	-0.33	
	6agrip	Share of public agricultural property	-0.31	
	8Wouv	Openness to foreign workers	0.33	
	8ouvcom	Trade openness	0.33	
	1media	Media pluralism	0.35	
	5ant4	Investment in the future of the population	0.36	
	5coor5	Government capacity for autonomous decision-making	0.39	
	7Eentre	Ease of market access	0.40	
	6faill	Application of bankruptcy laws	0.40	
II	**9egal**	**Equality of treatment**	**0.41**	*
II	**7Eacdisp**	**Dispersed share-ownership**	**0.42**	*
II	**7Eccdis**	**Competition in distribution**	**0.43**	*
	7Wdialos	**Social dialogue**	**0.43**	*
II	**1Wsynd**	**Trade union freedom**	**0.46**	*
II	**3creaE**	**Formalities for enterprise creation**	**0.47**	*
II	**9elites**	**Training of elites**	**0.49**	*
	_4Flibcr	**Operating freedom for banking system**	**0.50**	*

II	5coor6	Transparency of the concertation process	0.50	*
II	7Einfo	Information regarding firms' share-ownership	0.51	*
	4libpx	Price freedom	0.52	*
II	9Wsegm	Segmentation of the labour market	0.53	*
	5Fant8	Insurance companies, pension funds	0.55	*
	9Wenfant	Child labour	0.55	*
	5Fant6	Competence of bank executives	0.56	*
	2secint	Internal security	0.57	*
III	6Fsecutr	Security of transactions in the financial system	0.58	*
III	1decent	Decentralisation	0.58	*
	6Winform	Informal labour	0.58	*
I	5coor4	Concertation to bring out common interests	0.58	*
	8Fouv	Financial openness	0.59	*
I	5ant3	Elites' priorities for development	0.60	*
	3Qbpub	Quality of public goods: basic education and healthcare	0.61	*
	5Want9	Insurance companies, pension funds	0.62	*
I	5ant2	Authorities' strategic vision	0.62	*
II	3transp	Transparency of public action	0.62	*
III	6secagri	Security of agricultural property rights and contracts	0.63	*
	8Wsoldmig	Migration balance	0.63	*
II	1democ	Political rights and civil liberties	0.63	*
III	6Wdw	Labour law	0.64	*
	5Fant7	Venture capital	0.64	*
I	5coor7	Co-ordination between Ministries and public authorities	0.64	*
III	7FRegul	Regulation of the financial system	0.64	*
II	9abpub	Access to basic public goods	0.66	*
I	5ant1	Society's aptitude for innovation	0.66	*
I	5Eant5	Technological environment of non-financial firms	0.66	*
II	9Wmobsoc	Social mobility	0.67	*
I	5coor9	Capacity of the political authorities	0.69	*
II	7ERegcc	Public regulation of competition on the market for goods and non-financial services	0.73	*
III	6secutr	Security of transactions on markets for goods and non-financial services	0.76	*
III	9solidf	Institutional forms of solidarity	0.76	*
III	6dprof	Formal property rights	0.77	*
III	3Adm	Efficiency of public administration	0.80	*
III	_3corupt	Control of corruption	0.82	*

Readers should refer to the database itself for an exhaustive list of the content of the indicators.

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