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Governance Indicators for Development

by Charles Oman and Christiane Arndt

- Governance indicators are increasingly relied upon by aid agencies and private investors.
- Such indicators are widely misused.
- More transparency will better serve the needs of users and developing countries alike.

The use of governance "indicators" is booming. These indicators are supposed to quantify the quality of a country's governance institutions by considering, for example, the extent of corruption in the economy, the quality of public and private regulatory systems, the prevalence of "rule of law", the level of political stability, and the effectiveness of government.

The Demand for Indicators

OECD-based international investors and official national and multilateral aid agencies, along with journalists and academics, are the main customers for these indicators. Investors are interested because of the growth of their assets in developing and "emerging market" economies (multiplied by a factor of ten from 1990 to over $4 trillion today). They also want back-up to traditional macroeconomic-based country-risk indicators that have failed to predict costly financial crises. International investors are basing their investment-location decisions on their perceptions of governance and these perceptions are increasingly shaped by governance indicators.

In 1996 the World Bank reversed its long-standing policy of ignoring problems of corruption and bad governance in borrowing countries. Some OECD countries' aid agencies want to identify and reward developing countries that are improving their governance – and punish those that aren't. Many of these agencies also claim to use governance indicators to increase the transparency and consistency of their criteria for determining recipients' aid eligibility. The US Millennium Challenge Corporation, for example, relies heavily on governance indicators, while the World Bank has shifted its priorities from lending for economic reforms (which fell by 14 per cent annually between 2000 and 2004) to improving governance (which rose by 11 per cent).

The Suppliers

Though there are some 140 user-accessible sets of indicators, among the most carefully constructed and widely used are those produced since 1996 by Daniel Kaufmann and his team at the World Bank Institute. Also widely used (and incorporated into WBI's composite indicators) are the International Country Risk Guide, Transparency International's "Corruption Perceptions Index" and Freedom House's "Political Rights" and "Civil Liberties" indicators.

The field is, thus, quite full. It is also quite diverse in terms of suppliers' motives and interests. Governance indicators nevertheless have many common problems.

Problems

Users of the indicators typically want to use them to compare scores of individual countries over time, or to measure countries against each other. The problem is, the techniques used to distil a mixture of governance features into a single number make it unreliable to do that, with the possible exception of scores that are *significantly* different from one another.

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Most compilers produce composite indicators that lack transparency in themselves. The scoring criteria are opaque because of the diversity and large number of underlying indicators they embody. The underlying conceptual framework – the meaning of governance – remains unclear, so there is lack of clarity about how the scores are finally arrived at.

These shortcomings mean that the indicators are of little use to developing countries' own governments, business associations, NGOs and other such "internal stakeholders" who wish to bring about improvement in local governance. For that, they would need indicators that identify specific governance problems and monitor progress in reform with much greater precision. Besides, developing countries often resent being pressured to raise their standards of governance by foreign suppliers of funds – especially using such non-transparent means. Indicators can thus become counter-productive. As a result of these shortcomings, then, governance indicators tend to be used more by "external stakeholders" and non-national business interests.

Among the former are the aid agencies that, perhaps unwittingly, use non-transparent means to determine aid eligibility in the name of enhancing transparency – something of a paradox. It is thus important that they understand the limitations of the tools they are using.

International investors are also easily misled by these indicators. The results may even be perverse, since they may interpret the indicators in the same way that they would macroeconomic-based country-risk data. That reliance can lead to herd behaviour and deprive both sides of viable, development-enhancing investment.

Raising the standards of transparency for the governance indicators that we use, and produce, will not only help clarify the kinds of institutions developing countries need for better governance, it will help to achieve them.

Futher reading: Christiane Arndt and Charles Oman (2006), *Uses and Abuses of Governance Indicators,* OECD Development Centre Study, Paris. www.oecd.org/dev/publications/governanceindicators

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OECD Development Centre
2, rue André-Pascal,
75775 Paris Cedex 16, France
Tel.: +33-(0)1 45.24.82.00
Fax: +33-(0)1 44 30 61 49

E-mail: dev.contact@oecd.org

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