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# An Outline Of The Relationship Between Governance And Sustainable Economic Development

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# An Outline Of The Relationship Between Governance And Sustainable Economic Development

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## 1. Introduction

The main objective of this speech is to outline the interconnections and interactions between governance, economic development and sustainable development. We start off by providing the definitions of the concepts of governance, economic and sustainable development, emphasizing their multidimensional character. Having defined the relevant phenomena we go on to investigate the links between them as well as the main factors that shape them.

We must point out right from the beginning that it is a well documented fact that the quality of governance significantly affects the economic and sustainable development of nations. More specifically, governance, whose key elements are the political and economic institutions of a society, affects the level of economic activity mainly through the quality of the political system and the level of corruption, which in turn affect the sustainability of economic development. But also, the economic activity via the same route affects the quality of governance. Generally speaking, governance and economic activity are highly and positively correlated. Good governance is usually associated with economic development, while developed economies are usually associated with good governance. Moreover, in principle, the level of economic development is positively correlated with the extent or the degree of sustainability of development.

Therefore, if a country seeks to ensure the sustainability of its economic development in the long-run, in addition to the factors proposed by the traditional theory of economic growth, such as physical capital accumulation, human capital accumulation, technological innovation and other productivity-augmenting mechanisms, special emphasis should be put on improving the quality of its institutions. In this context governance could be considered as a “quasi” factor of production. We must note that the role of institutions in long-term economic performance of nations is explored by the field of economic literature known as “institutional economics”[1]. Referring to this issue, Acemoglu and Robinson conclude that the deviations regarding economic institutions between individual economies are the single most important factor that determines the differences in their levels of well-being (Acemoglu and Robinson, 2010).

[1] See mainly in North (1990).

## 2. The Notions of Governance, Economic Development And Sustainable Development

### 2.1 Governance

"Governance" is defined as the processes and systems of making and implementing (or not implementing) the decisions of a society or an organization. In other words, it is the processes and systems regulating its operation (UNESCAP, 2006).

We must note that the issue of governance has been examined by numerous scientific disciplines, especially by political science, public administration and economics. It was first included in the agenda of international organizations in the early 1990s, when it became a general consensus that the failure of the development strategies implemented in many countries during the previous two decades was largely due to the system of their governance (Boţa-Avram et al., 2018). In 1992, the World Bank defined governance as "the manner in which authority is exercised over the management of a country's economic and social resources for development" (World Bank, 1992), thus directly combining the concepts of governance and development. In this context, the concept of "good governance" was introduced for the first time by the World Bank in its report in 1989 (World Bank, 1989). In 1994 the concept of good governance was broadened by the same international organization to include, along with good governance practices, a broader approach of accountability, transparency and a strong civil society (World Bank, 1994).

Despite the fact that governance constitutes a particularly important subject of theoretical and empirical analysis, there is no commonly accepted definition of its concept. On the contrary, each international organization, if we limit our attention to them, provides its own definition of the concept. The different definitions are due to the multidimensional nature of the notion of governance, since it can be conceptualized in various ways emphasizing its different perspectives with the main focus on its economic and political aspects (Bevir, 2011).

Differences in definitions, albeit small, raise questions about the exact content of the concept and especially about the characteristics of governance and its metrics. According to the European Union, governance concerns the state's ability to serve its citizens and "refers to the rules, processes, and behavior by which interests are articulated, resources are managed, and power is exercised in society" (Commission of the European Communities, 2003).

According to the United Nations Development Programme (UNDP), governance is "the exercise of political, economic, and administrative authority to manage a nation's affairs", while "good governance" is characterized as "participatory, transparent, accountable, effective, equitable and promoting the rule of law" (UNDP, 1997). The same organization recognizes governance as "the system of values, policies, and institutions by which a society manages its economic, political, and social affairs through interactions within and among the state, civil society and private sector" (UNDP, 2007).

The World Bank Institute (WBI) considers that governance is "the traditions and institutions by which authority in a country is exercised" (Kaufmann, Kraay and Mastruzzi, 2009). This includes:

1. The process of selecting, controlling and replacing those in positions of power.
2. The capacity of governments to effectively formulate and implement sound policies.
3. The respect by citizens and the state of the institutions that govern the economic and social interactions between them.

Moreover, according to the International Monetary Fund (IMF), "governance is a broad concept covering all aspects of how a country is governed, including its economic policies, regulatory framework, and adherence to the rule of law" (IMF, 2002), while the Organization for Economic Co-operation and Development (OECD), linking good or bad governance to participatory development, human rights and democratization, defines governance as "the use of political authority and the exercise of control in a society in relation to the management of its resources for social and economic development" (OECD, 1995).

The simple overview of the above definitions of governance highlights the relationship between governance and the economy. Governance and economic development are interconnected. The quality of governance affects the process of economic development, but also the level of economic development affects the quality of governance. So, the causal relationship between governance and economic development is a two-way process[2].

At the country level, governance is accepted to have three main dimensions (Kaufmann, 2005):

1. The political dimension, which refers to the process of selection, evaluation and replacement of those in authority.
2. The economic dimension, which refers to the government's capacity to effectively manage its resources and implement sound policies.
3. The institutional dimension, which refers to the respect by the state and citizens of the country's institutions.

The quality of governance is measured via various indicators. The most recognized governance indicators in terms of empirical research are estimated by the World Bank and in particular by the World Bank Institute, within the framework of the "Worldwide Governance Indicators" project. Since 1996 (and annually since 2002), six Worldwide Governance Indicators have been compiled, according to the definition of governance by the World Bank cited above. The governance indicators that have been developed in this context try to capture six key aspects of institutional quality or governance, and measure, the political, economic and institutional dimensions of governance. The six broad indicators of governance that correspond to its three dimensions are the following (Kaufmann, Kraay and Mastruzzi, 2010):

[2] For an extended analysis of the notion of governance, see among others in Rontos et al. (2015).

1. **Voice and Accountability**, that expresses perceptions of the extent to which citizens of a country are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media.
2. **Political Stability and Absence of Violence/Terrorism**, that expresses perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.
3. **Government Effectiveness**, that expresses perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
4. **Regulatory Quality**, that expresses perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
5. **Rule of Law**, that expresses perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
6. **Control of Corruption**, that expresses perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as capture of the state by elites and private interests.

The first two indicators try to capture the political dimension of governance, the second two the economic dimension and the last two refer to the institutional dimension of governance. It should be pointed out, however, that these indicators do not constitute a first best measure of governance, and strong criticism has been made regarding their construction methodology (Arndt and Oman, 2006). Despite such criticisms, they are generally recognized to this day to be the most satisfactory measures of the quality governance at the country level.

## 2.2 Economic Development

The second concept on which this speech is focused is "economic development". We must note that economic development is among the most important long-run or structural economic policy objectives, especially for developing countries. Incorrectly, the concept of economic development is often identified with that of economic growth. This identification was especially true until the late 60s. So, the question arises as to what is the content of economic development and how it differs from the simple expansion of production, i.e., economic growth.

The term "economic growth" is defined as the long-term expansion of production or the long-term increase in the total or per capita real output of an economy. Since real gross domestic product (GDP) is the measure of total output, the term economic growth can be defined as the rate of increase in total or per capita real GDP. The term "economic development" has a broader meaning. It does not just involve the simple expansion of production. This expansion is a prerequisite for development but it must be combined with significant changes in terms of the structure of the economy and the distribution of the real product, i.e., changes in the institutional and technological framework in which the real product of the economy is produced and distributed. Thus, while economic growth means reproduction or expansion of total output, economic development means economic and social transformation.

So, in contrast to economic growth which is a one-dimensional process, in the sense that it is investigated only on the basis of one criterion, namely the increase of the real GDP, economic development is a multi-dimensional process, which is associated with significant changes in the structure of the economy, in the social structure, in the quality of the factors of production, in the institutions and in the distribution of income. It should be mentioned that economic development is basically a problem for countries that are characterized as low- and middle-income countries, that is, those that are more widely known as “developing” countries. On the contrary, economic growth is a problem of economically developed countries.

**2.3 Sustainable Development**

Particular emphasis has been placed during the last decades on the concept of “sustainable development”. Various definitions of this concept have been given. The most prevalent one is that of the United Nations Conference on Environment and Development that was held in Rio de Janeiro in 1992 and adopted the “Rio Declaration on Environment and Development”. The Rio Conference defined sustainable development as that development that meets the needs of the present generation without compromising or limiting the ability of future generations to meet their own needs and recognizes that the concept of sustainable development incorporates three basic components. A social, an economic and an environmental (World Commission on Environment and Development, 1987).

However, the need for a more general shift in environmental protection was recognized much earlier at the United Nations World Conference held in Stockholm, Sweden in 1972, in which a framework of a declaration of principles for the environment and an action plan for the environment were adopted and is considered as the beginning of the formation of the concept of sustainable development (Shi et al., 2019). The Stockholm Conference, however, only urged countries to strengthen environmental protection and did not adopt any binding framework of rules.

An important global milestone in terms of sustainable development was the Johannesburg Summit of 2002 or the World Summit on Sustainable Development, where a decade after Rio (and for that reason therefore unofficially named “Rio+10”), the three fundamental components of sustainable development were reaffirmed: economic, environmental and social (United Nations, Department of Economic and Social Affairs, 2002).

The 2030 Agenda for Sustainable Development, adopted at the United Nations Summit in New York in 2015, specified 17 sustainable development goals (SDGs) with their associated 169 targets, which are considered an integrated and indivisible framework that balances the above three fundamental dimensions of sustainable development (UN, 2015). These goals and targets consist an evolution of the Millennium Development Goals (MDGs) adopted by the United Nations Millennium Declaration at the United Nations Millennium Summit held in September 2000 in New York and constituted a global action plan for sustainable development. For the implementation of the 17 goals of sustainable development, 230 indicators have been specified till now, in an effort to integrate all three fundamental dimensions of sustainability. The European Union is committed to fully implementing the 2030 Agenda through its internal and external policies (EC, 2019).

The definition of sustainable development adopted since 1992 is obviously very general and therefore vague. Right from the start, however, the multidimensional character of sustainability was recognized and so was the fact that it cannot be measured using a simple index. The Commission for Sustainable Development of the United Nations formulated a large number of indicators of sustainable development divided in four groups: economic, social, environmental and institutional (United Nations, Department of Economic and Social Affairs, 2001). However, it should be pointed out that the sustainable development indicators are associated with many problems and weaknesses. Due to their limitations, but also due to the lack of a wider agreement as to the exact content of the notion of sustainable development, the assessment of the sustainability of development still presents many inadequacies.

## 3. The Interactions between Governance Quality, Economic Development and Sustainable Development

Since the beginning of the 1990s, international organizations, such as the World Bank and the OECD, started to point out the high importance of governance in economic development. Moreover, several empirical studies have shown that there is a high correlation between governance quality and economic growth (Kaufmann and Kraay, 2002). In particular, it seems that there is a strong causal relationship between them directed mainly from the quality of governance to economic growth (the quality of governance significantly affects economic growth), but also a weak one in the opposite direction (economic growth affects the quality of governance). Of course, there are studies that question this relationship (Rodrik, 2008). Regarding the relations between governance and sustainable development, it is noted that good governance is considered as a basic precondition for ensuring sustainability (Kemp, Parto and Gibson, 2005).

The interactions between governance and the economy can be examined more systematically mainly through the effects that exert on them two key factors, namely the political system and corruption. The notion of political system is widely known and therefore there is no need to define it here in detail. The investigation of the political system refers mainly to the degree of democracy with which a country is associated. The basic components or characteristics of democracy are the right to vote, the existence of political parties, the freedom of every citizen to form a political party or organization, the holding of free and fair elections and the right of free expression (Dahl, 1971).

On the other hand, corruption can be defined in various ways. The most widely used definition of the phenomenon is the one provided by the non-profit international organization Transparency International. It defines corruption as "the abuse of entrusted power for private gain" (Transparency International, 2020). The phenomenon can take various forms. It includes a wide range of behavioral characteristics such as public servants demanding or taking money or even favors in exchange for some services, politicians misusing public money or granting public jobs or contracts to their voters, sponsors, friends or families, as well as corporations bribing state officials to promote their interests, etc.

The determining factors of corruption are numerous. The most important ones are the level of economic development, the type of political authority, the quality of governance, the quality of the institutional framework, the effectiveness of the judicial system, the degree of globalization, the level of competition, the structure and the size of public sector, as well as cultural qualities, the geographic location and history. Widespread corruption largely unveils the existence of institutional and political weaknesses as well as economic and social underdevelopment (Manolopoulos, Vavoura and Vavouras, 2022). Corruption might be the single most significant barrier to both democratization and economic development of countries. However, the general attitude towards corruption is also determined by the level of individual morality, that is by the system of individual behavioral and moral attributes (Rontos, Salvati and Vavouras, 2013).

Before investigating the interactions between governance and the economy, it is useful to briefly examine the relationship between the political system and corruption that has been the subject of extensive research. In general, corruption is considered both a symptom and a cause of the dysfunctioning of democratic institutions. According to the prevailing view, political development and in particular democracy reduces corruption, through the increased competition for political office. It is accepted that the political system determines the motives of politicians and high-ranking state officials and the actions – reactions of these factors determine the behavior of the state bureaucracy according to the "principal – agent" model. Empirical research shows that democracy reduces the extent of corruption, but without immediate results. However, it seems that it is the long period of democracy a factor that reduces corruption (Treisman, 2000). It is therefore the democratic tradition rather than the simple adoption of a democratic constitution that appears to be a critical factor in curbing corruption.

Most researchers agree that corruption has a significant negative impact on the level of economic development, through its effects on the various components that determine the total output. In particular, corruption has negative effects on investment due to the higher costs it imposes and to the uncertainty it creates. Empirical analysis has shown that corruption negatively affects investment and in particular foreign direct investment. Very often, the decline in investment is due to higher costs and the uncertainty caused by corruption. The prevailing view is that corruption operates as a "tax" negatively affecting foreign investors. The effects of corruption on public investment have also been a subject of empirical investigation. It has been argued that corruption actually increases public investment. This result is explained by the fact that public sector creates conditions for corruption in the people who have decisive roles on investment programs in the country.

The impact of corruption on international trade has been empirically estimated to be rather limited. On the contrary, exposure to international trade has been found to be an important factor in curbing corruption. Although lifting restrictions on international trade may not have a direct effect on reducing corruption, it has been observed that in the long-run economies that are more open to international trade are exposed to greater international competition and as a result they invest more in improving their institutional framework. Therefore, they enjoy a lower level of corruption (Bonaglia, de Macedo and Bussolo, 2001).

Finally, corruption affects the development of a country through its relations with the informal or underground economy. It is accepted that countries with high levels of corruption are also associated with a large informal economy. First, illegal economic activities lead to corruption and corruption drives many businesses to the informal sector. In addition, it has been shown empirically that countries with high levels of corruption tend to have lower tax revenues as a percentage of their total output (Tanzi and Davoodi, 2000).

Another consequence of the close relationship between governance and economy is the hypothesis that the quality of governance and more specifically the quality of institutions affects the duration of economic crises in various countries, if and when they occur. Strong institutions shorten the period of economic recovery while weak institutions prolong it (Bluhm, De Crombrugghe and Szirmai, 2013). Rapanos and Kaplanoglou (2014), accepting that institutions and governance affect the long-term performance of the economy and its international competitiveness, investigate this hypothesis in the cases of Greece and Cyprus up to the recent economic crises these countries faced. Examining why the recession in the case of Greece was deeper and more extensive than in Cyprus, they argue that a basic explanation is that institutions in Greece are relatively weaker and governance mechanisms are poorer, and point out with particular emphasis that Greece "must improve its institutional framework, and set up new governance mechanisms that will help the government to effectively implement macroeconomic and structural policies" (Rapanos and Kaplanoglou, 2014).

The main direction of causality between governance, democracy, corruption and economy, as it has been discussed above, could be summarized as follows. Good governance affects the level of democracy and the degree of corruption, which in turn affect the level of economic development of the country under consideration. At the same time, of course, there is "feedback" (or an inverse causality) between economy and governance that cannot be ignored. The economy, and more specifically the level of economic development, affects the level of democracy and the degree of corruption, which in turn affect the quality of governance. We should not ignore of course the direct links between democracy and corruption. As noted, political development, and in particular democracy, reduces both forms of corruption, that is political and bureaucratic, and the development of clientelist relationships, mainly through increased competition for holding political office. At the same time, corruption affects the quality of democracy, as it affects the way the government operates, the political culture of the specific country and the status of individual freedoms and rights enjoyed by its citizens.

Of particular interest is also the in-depth investigation of the relationships between governance and sustainable development. In the sustainable development context, ensuring sustainable consumption and production patterns is a key objective, since ensuring sustainability requires responsible management of the planet's limited natural resources. In fact, one of the 17 sustainable development goals we mentioned above, and specifically the 12th, refers to "Responsible Consumption and Production", which is estimated to be achieved mainly through ensuring sustainable consumption and production standards. The United Nations, recognizing that more and more resources are used worldwide to support economic activities, considers that the degree of efficiency with which natural resources are used is of particular importance in ensuring the sustainability of development.

It is therefore established that the concepts of governance and sustainable development are inextricably linked. Good governance positively influences sustainable development, which in turn contributes to improved governance. So, there can be a "virtuous circle" between governance and sustainable development, where improvements in one contribute to improvements in the other. On the contrary, of course, bad governance negatively affects sustainable development, which in turn contributes to the deterioration of governance. So, there can be a "vicious circle" between governance and sustainable development, where the deteriorations of one contribute to the deteriorations of the other. The effects of governance on sustainable development are considered so important that the term "governance for sustainable development" has been proposed, which refers to the socio-political governance processes aimed at achieving sustainable development (Meadowcroft, 2007).

## 4. Conclusions

The goal of this speech was to outline the relationships between governance and the economy. More specifically, following the definition of governance provided by the United Nations (UNDP) and cited above, our aim was to explore the links between the prevailing system of values, policies and institutions by which a society manages its economic, political and social affairs and the level of economic development associated with the specific country. We have shown that between the two notions there is a strong link. The quality of governance and the level of economic development are positively correlated. That is a country with a high quality of governance, that we usually call "good governance", is generally associated with a high level of economic development. On the contrary, a country with a low quality of governance, that we usually call "bad governance", is generally associated with a low level of economic development.

The most important factors that regulate the relations between governance and the economy are the political system and the extent of corruption. We have examined these interactions in some detail. So, we are led to the conclusion that, the goal of economic development cannot be achieved without the improvement of the quality of a country's institutions. Finally, we have looked into the links between governance and sustainable development and we conclude that these phenomena are positively correlated. Consequently, they are joined through "virtuous" or "vicious" cycles.

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