GOVERNANCE, FISCAL POLICY AND ECONOMIC GROWTH

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Abstract

Governance is not a controversial and misunderstood concept. Sometimes concepts such as corruption, institutions and democracy are used as governance’s proxy. In general terms, it means how an organization is governed being the science of government performance and behavior and it refers to several processes that must include from historical, cultural, social and political determinants. For this reason it is possible to establish a relationship between governance and institutions.

Communities of persons, firms, institutions are essential ingredients of good governance and its analysis could be developed considering two possibilities. First, considering the factors under which government would more efficient in welfare terms. Second, taking into account the economic results obtained by the government. Precisely, the main goal of this paper is analyse the relationship between governance and economic growth. We will consider the indirect effects of governance on growth through its effects on private investment, public expenditure and income distribution. An empirical analysis is developed considering the case of ten European Union Countries, considering a multiequational model that includes a private investment, public investment, Gini and GDP equations.

JEL Classification: E62, O40.

Key Words: Governance, Economic Growth, fiscal policy, public investment, income distribution.
1. INTRODUCTION

Governance is a term that has a higher priority in certain circles, especially between economists and corporate sector. A wide literature has come out in the last decades considering different relationships and elements connected with governance from theoretical as well as empirical points of view. However, is a concept that remains controversial and misunderstood. There is not a single definition of governance and sometimes is related to concepts such as democracy, corruption, institutions...

Governance means in a broad sense how an organization is governed. Communities of persons, firms, institutions, etc. are essential ingredients of good governance. However it is not a new concept. As Bowles (2004, pp. 474-478) states, different classical thinkers, Aristotle, Aquinas, Burke, Rousseau, among others, recognized communities behavior as government ingredients. Mandeville’s *Fable of the Bees* stressed that governing social interactions could encourage selfish motives that would enhance social welfare. Classical economists in their analysis of the selfish *Homo Economicus*, stressed that the ingredients of governance are the role of competitive markets, property rights and well intentioned states. During the nineteenth and twentieth centuries the economists and political thinkers were interested in the controversy state intervention versus laissez faire.

In this paper we will consider the public governance and the channels through which it affects economic growth. Not only fiscal resources are the only factor to improve economic performance but also the quality of government. Laws, decisions made by policy makers and public officials, institutions, create incentives for economic agents affecting the allocation of investment and public expenditure that have relevant effects on economic growth. From this point of view the analysis of governance can carry out from two perspectives. First, establishing the conditions and factors under which the government activity can be more efficient in terms of welfare. Second, considering the outcomes which are expected from a government. We will mainly consider the latter.

One of the most relevant economic policy goals is economic growth. Nowadays, the effectiveness of economic policy is tested on economic growth results. Countries that show better growth rates are considered as good governed. In the controversy state versus market the economic result obtained is the best way to decide between both. It is relevant to know if governance is growth enhancing.

This is the main objective of this paper. In section 2 we will briefly considered the governance concept. Section 3 the relationship between governance and economic growth is analysed. In section 4 the empirical study is developed. Section 5 contains the main conclusions.

2. GOVERNANCE

Different governance definitions can be considered. In general terms, governance is the science of government performance and behavior and it refers to several processes that must include from historical, cultural, social and political determinants.
In this sense it is possible to establish a relationship between governance and institutions. Good governance can be considered as the existence of an appropriate set of institutions in a country. North (1990) states that these institutions play an important role in the economic performance. Institutions introduce rules that determine the conduct of the economic agents in the different areas of the economic activity.

The nexus between markets and government is one of the most relevant elements in the analysis of the economic performance. Both are interdependent at least in several ways (Dréze and Sen, 1995). First, government facilitates economic growth due to its education policies that improve skill formation in the labor force. Government also generates economies of scale and technological externalities. Second, in many cases market mechanism is dependent on government economic policy. For example, government can play an important role designing measures that modify income distribution and introducing taxation policies that would have relevant effects on market dynamics. Third, markets need legal enforcement to develop their activity. They hardly can work if there are not property rights, for example.

All these reasons show the interdependence between markets and government. However the main point is to determine their respective domains and their efficiency to achieve the objectives. Developed countries, especially European Union countries, considered that the main economic objective is to achieve a certain inflation rate, more or less 2%, considering that this inflation target would contribute to obtain adequate economic growth levels. Markets flexibility, especially labor market, fiscal discipline and the interest rate modifications would be the main elements to achieve such objective. In this case, institutions would play a secondary role in the process: they must help to the markets to be more flexible. In the case of the developing countries the story is quite different. Several institutional questions must be considered: the role of corruption, the political and institutional stability, the protection of private property.

The answer to the controversy market versus government will depend on the results obtained. Economic theories emphasize efficiency and it is necessary to test if governance would help to achieve the economic goals. From a theoretical point of view and in the case of economic growth, the literature shows that there is a relationship between both. In a broad sense, economic growth rests on the following key variables: efficiency, the saving rate and the depreciation of capital. And these variables depend, in turn on governance among other variables (Gylfason, 1999, 14). The relationship between economic growth and governance is developed in the next section.

3. GOVERNANCE AND ECONOMIC GROWTH

As it is well known two main economic growth models have been developed since 1950s: exogenous and endogenous growth models¹. Former assumes, among other questions, the existence of appropriate institutions for markets and they don’t introduce any price distortions and there are no resources misallocations. All at all, exogenous growth models assume that the institutions operate in an appropriate way. There are not possibilities to create monopolies and the efficiency of the system prevents the

¹ Demand side growth models have also developed (see e.g., Lavoie, 1992, McCombie and Thirlwall, 1994). However the main economic growth literature has mainly focused on these two approaches.
existence of corruption. Therefore it is not possible the existence of bad governance and for this reason it is not necessary to take it into account in the analysis.

Endogenous growth models on the other way, introduces the factor accumulation from R&D expenditure, the spillovers from introduction of new technology, the development of human capital… that have relevant effects on productivity that enhances economic growth. In this sense, it is possible to incorporate the effects of governance on the capital-augmenting effects as well as on the efforts of individuals.

In this kind of analysis it is also necessary to take into account the role of fiscal policy. The empirical literature doesn’t show a unique conclusion showing different results depending on the data, methodology used and the set of countries.

If we consider the standard Keynesian analysis, fiscal policy through increases public consumption and/or reducing taxes, enhances private investment increasing domestic demand. Higher private investment has positive effect on economic growth. However it doesn’t take into account the negative effects derived from this measure, such as, “crowding-out” effect, inflationary pressures, and modifications on exchange rate… that discourage the investment decisions and reduce economic growth. Other effects can also be considered, such as, wealth effect, wages… To avoid these negative effects on investment the opposite measure is recommended, that is, reduce public deficits. These reductions have also the positive effect on investors’ expectatives because deficit reduction is considered as a signal of political stability (Drazen, 2001)

The previous mechanisms mainly work in the case of high-income countries. In the case of low-income countries there are some restrictions that could reduce their efficiency. For example, the existence of financial repression and not adequately developed financial markets eliminate or reduce the interest rates and wealth effect responses to public deficit. It is also necessary to consider the existence of a restricted economic freedom that discourages the investment process, especially if the property rights are not defended. For all these reasons, the analysis of the relationship between governance, fiscal policy and economic growth is developed considering the investment function.

However, from our point of view we consider that there are also other channels that must be taking into account. Of course private investment is one of them but also public investment and income distribution. Good governance improves the public investment in the case of high-income countries due to the better allocation and use of the resources independently of the negative effects on economic growth derived from its financing. Low-income countries will obtain easily and more resources if they have a good governance. These relationships are showed in figure-1.

Income distribution has also effects on economic growth. Economists have not had a unanimous position on the sign of this relationship. In the literature of the 1950s and 1960s it was accepted that higher inequality would enhance economic growth (e.g. Kaldor, 1956; Kelly and Williamson, 1968; Cook, 1995). They considered the hypothesis that the savings is related to income and play a relevant role in the economic

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2 On the other hand, private investment tends to be insensitive to price stability due to mainly to the fact that in many countries the investment process is mainly undertaken by the public sector that obtains their funds from loans provided by internationally agencies.
growth process. In this case it was necessary to shift the income from consumers to savers. This implied to use a redistribute fiscal policy that shifts income from poorer to richer, who have a higher propensity to save. A higher savings will increase capital accumulation and economic growth.

This view has been criticised and changed during the last decades. The introduction of endogenous growth models implied to consider again that relationship but introducing new factors and variables. The empirical literature showed from this new position that could be a negative relationship between inequality and economic growth. Different channels could explain this new view (Perotti, 1996, pp. 150-154; Aghion, Caroli and García-Peñalosa, 1999, pp. 1621-1630):

1.- Fiscal channel. In an unequal society, poor voter will vote for those fiscal programs that promise a better income distribution through taxation or public expenditure. That implies the fiscal redistribution must be financed by distortionary taxation that distorts economic decisions, and discourages investment and finally economic growth (Alesina and Rodrick, 1994; Bertola, 1993. On the public capital effects, see Alfranca and Galindo, 2002, 2003).

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The possibility that inequality is growth-enhancing is also supported by the stage of economic development. Countries in early stage of economic development need physical capital accumulation to improve the economic growth process. In this case, inequality is growth-enhancing, because higher savings is necessary to finance such capital accumulation. In later stages of economic development, on the contrary, equality is growth-enhancing. If inequality is maintained, with credit market imperfections, there would be lower human capital accumulation that leads to a lower economic growth. This later channel could explain why empirical evidence with a wide range of countries, shows a positive effect of inequality on growth.
2.- Socio-political problem. Some literature (Alesina and Perotti, 1996; Benabou, 1996a, b) has stressed the impact of income inequality on political instability and social tensions. These problems will increase uncertainty that leads to a lower investment and economic growth.

3.- Education. As it is well known, the empirical evidence shows that there is a positive effect of education on economic growth. In the case of income inequality, there are different mechanisms in the relationship between both variables. On the one hand, higher inequality implies higher underinvestment in the education when credit markets are imperfect. In the developing countries poor households are constraint for cash and unable to borrow, so they have many difficulties to keep their children in school. This situation leads to a vicious circle where initial poverty leads to underinvestment in education among poor which further will increase inequality. On the other hand, with the introduction of new technologies in the production process, demand for technologically skilled workers will increase. The demand for unskilled workers will contract. The gap between poor and rich will be widening, and it will be reduced when poor keep their children in school and increase the supply of new graduates.

4.- There are also other channels that consider the relationship between income distribution and growth, including democratization (Bourguignon and Verdier, 2000), property rights (Svensson, 1998; Keefer and Knack, 2000), economic volatility (Alesina and Perotti, 1996; Aghion, Banerjee and Piketty, 1997), among others.

If we accepted the modern relationship between equality and economic growth, it is necessary to introduce adequate policies that reduce inequality. In this case good governance would improve the efficacy of these measures. Therefore, a positive relationship between governance and equality is expected and indirectly on economic growth.

Governance is expected that have some influence on these factors and through them, indirectly, on economic growth. We have seen that governance would be related with fiscal policy through it effects on public investment. Also, an adequate fiscal policy designed by good institutions that are connected with good governance will also have relevant effects on private investment and income distribution. We will consider both possibilities in our empirical analysis.

4. EMPIRICAL ANALYSIS

To carry out our analysis we are going to consider a multiequational model, three equations, using panel data for 1996-2003 period for the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Portugal and Spain. The econometric estimation method that we are going to use is fix effects panel data for the countries chosen and for the period 1996-2003.

The general specification of fixed effects panel data, to include the differences among countries, through variations in the constant term in a typical OLS model is as follows:
\[ Y_{it} = \alpha_i + X_{it}' \beta + \epsilon_{it} \]

being \( \alpha_i \) a scalar that includes the specific effects of i-sm region. It is constant during the period. \( \beta \) is a vector kx1 of parameters that includes the effects of the k explicative variables. \( X_{it} \) is the matrix of the k exogenous variables that vary for each region and period.

The equations to be estimated are:

\[
\begin{align*}
\ln(y)_{it} &= \beta_0 + \beta_1 \ln(IP)_{it} + \beta_2 \ln(I)_{it} + \beta_3 \ln(Gini)_{it} + \beta_4 \ln(SC)_{it} + \beta_5 \ln(KHU)_{it} + \epsilon_{it} \quad (1) \\
\ln(I)_{it} &= \beta_6 + \beta_7 \ln(u)_{it} + \beta_8 \ln(\tau)_{it} + \beta_9 \ln(GOV)_{it} + \beta_{10} \ln(GOV \cdot \tau)_{it} + \epsilon_{it} \quad (2) \\
\ln(GOV)_{it} &= \beta_{11} + \beta_{12} \ln(GOV)_{it} + \epsilon_{it} \quad (3) \\
\ln(Gini)_{it} &= \beta_{13} + \beta_{14} \ln(\tau)_{it} + \beta_{15} \ln(GOV)_{it} + \epsilon_{it} \quad (4)
\end{align*}
\]

Equation (1) is GDP equation, where, \( y \) is Gross Domestic Product, IP is Public Investment, I is Private Investment, Gini is Gini index measuring income distribution and KHU is Human Capital.

The sign of public investment is ambiguous. Some authors state that fiscal policy has negative on private investment, thanks to crowding-out effect, and finally on economic growth (e.g. Bertola, 1993, Perotti, 1993, Alesina and Rodrik, 1994 and Persson and Tabellini, 1994, among others). However, the opposite studies (Bénabou, 1996a, 1996b and Bourguignon and Verdier, 2000), conclude that a redistributive policy will have positive effects on investment by different ways: increasing public investment (Saint-Paul and Verdier, 1993) or reducing credit markets imperfections or liquidity restrictions that affects negatively on investment in physical and human capitals (Galor and Zeira, 1993, Perotti, 1993, Banerjee and Newman, 1991, Piketty, 1997 and Aghion and Bolton, 1998).

Gini expected sign is also ambiguous. There are studies that state a negative relationship between income inequality and economic growth, using cross-section (Persson and Tabellini, 1994, Alesina and Rodrik, 1994, among others) or Less Ordinary Square (Clarke, 1995, for instance). Perotti (1996) reaches the same conclusion taking into account structural aspects and Alesina and Perotti (1996) and Alesina and Rodrik (1994) considering the role of socio political instability. Barro (1999) states that there is a scarce relation between income distribution and economic growth and investment, considering that inequality slow down economic growth in poor countries and accelerate it in the richer ones. Deininger and Squire (1998) consider that initial inequality is not a robust determinant of future economic growth. There are also some empirical works that show a positive relationship between inequality and growth, for example, Zou and Li (1998), in the case of the United States. In the case of education, Sylwester (2000) shows that a higher income inequality is associated to a higher public consumption in education that at short-term has a negative effect on economic growth and positive at long-term.
In the case of private investment and human capital expected sign is positive.

Equation (2) is the private investment equation where, \( t_i \) is interest rate, \( \tau \) is tax rate and GOV is governance index. In this case the expected signs of interest rate and tax rate are negatives. The latter is a “proxy” variable of fiscal policy and shows the negative effect of an expansionary fiscal policy on investment decisions although there are several literature that states the opposite. The expected sign of GOV is positive. The last term GOV*\( \tau \) indicates if governance and fiscal policy interact on investment.

Equation (3) is the public investment equation. The expected sign of governance is positive because it is expected that the government will increase public investment in those moments that it is considered, although they can have a negative effect on economic growth at short-term that could be compensated at long-term thanks to externalities. It is also possible to consider that in developed countries public investment is not so necessary, so good governance could control and reduce this kind of expenditure.

Equation (4) is income distribution equation. The expected sign in all the variables included in the equation is negative.

Therefore, the relationship between governance and economic growth is undirected, mainly through its effects on public capital, private capital, social capital and income distribution. It is also expected that there would be an interaction between governance and fiscal policy that would affect income distribution and private investment.

To obtain the Stock of private investment series we have followed the Mankiw, Romer and Weil (1992) and Martin and Velazquez (2001) considering a depreciation rate of 5%, using a geometric depreciation function.

To obtain the initial capital we have assumed that the considered economies are removed from their stationary state. This assumption is included in the neoclassical model to obtain the capital stock growth rate \( \gamma_K \), as follows:

\[
\gamma_K = \frac{I_t}{SK_t} - \delta \quad (4)
\]

being \( I_t \) the private investment in moment \( t \), \( \delta \) is the depreciation rate and \( SK_t \) is the private capital stock in moment \( t \).

Modifying equation (4) we obtain other equation to estimate the initial capital stock, \( SK_0 \), using investment data, assuming that investment growth rate is a nice proxy to private stock capital growth rate (\( \gamma_K \equiv \gamma_I \)):

\[
SK_0 = \frac{I_0}{\gamma_K + \delta} = \frac{I_0}{\gamma_I + \delta} \quad (5)
\]

being \( \gamma_I \) = investment average growth rate during the period.
However, due to investment high volatility, its growth rate could present a great difference from the correspondent capital stock growth rate that shows smooth variation during the period. For this reason we have filtered private investment series using Hodrick and Prescott filter, using a smoothing parameter $\lambda=100$. Therefore, the final equation to estimate the initial stock is:

$$SK_t = \frac{I_{t\text{hp}}}{\gamma_{t\text{hp}} + \delta}$$

(5)

being $I_{t\text{hp}}$ the initial data of the investment trend calculated using Hodrick and Prescott filter, and $\gamma_{t\text{hp}}$ is its average growth rate in full period.

Public capital is determined as the same way as private capital describe above. After the Barro and Lee (1993) research on this variable, several methodologies have been proposed: First, population education levels using average schooling years; second, mixing information on number of enrollment and quality differences considering the expenditure per students; third, public expenditure on education. We will follow the last one and we have use the permanent inventory method considering a 5 % depreciation rate as Mankiw, Romer and Weil (1992) recommends.

Governance index is calculated using principal components method considering the following four key dimensions of institutional quality supplied by the World Bank (Kaufman, Kraay and Mastruzzi, 2005):

1.- Voice and accountability, that measures political, civil and human rights.
2.- Government effectiveness, measuring the competence of bureaucracy.
3.- Rule of law, measuring the quality of contract enforcement, the police and the courts.
4.- Control of corruption, measuring the exercise of public power for private gain.

Finally, Gini index is own estimation following the data supplied by the World Bank.

The results of the estimations are showed in tables 1-4. Table -1 shows the GDP equation estimation results. The signs are the expected and the variables are significant. Public investment shows a negative sign that could indicate that the countries have reached a high level of development and therefore it is not necessary to increase such capital because the positive effects derived from it don’t compensates the negative effects of its financing.
### Table-1
Dependent Variable: y  
Method: Pooled EGLS (Cross-section weights)  
Sample (adjusted): 1996 2003  
Included observations: 8 after adjustments  
Cross-sections included: 10  
Total pool (balanced) observations: 80  
Iterate weights to convergence  
Convergence achieved after 19 weight iterations

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-0.006371</td>
<td>0.147590</td>
<td>-0.043166</td>
<td>0.9657</td>
</tr>
<tr>
<td>KH</td>
<td>0.018505</td>
<td>0.008482</td>
<td>2.181814</td>
<td>0.0327</td>
</tr>
<tr>
<td>I</td>
<td>0.906575</td>
<td>0.050187</td>
<td>18.06411</td>
<td>0.0000</td>
</tr>
<tr>
<td>IP</td>
<td>-0.177092</td>
<td>0.032171</td>
<td>-5.504661</td>
<td>0.0000</td>
</tr>
<tr>
<td>GINI</td>
<td>-0.002861</td>
<td>0.000483</td>
<td>-5.918625</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

R-squared: 0.956440  
Mean dependent var: 3.094292

Sum squared resid: 0.087448  
Durbin-Watson stat: 0.280876


### Table-2

Dependent Variable: I  
Method: Pooled EGLS (Cross-section weights)  
Sample (adjusted): 1996 2003  
Included observations: 8 after adjustments  
Cross-sections included: 10  
Total pool (balanced) observations: 80  
Linear estimation after one-step weighting matrix  
White cross-section standard errors & covariance (d.f. corrected)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C (-1)</td>
<td>0.048047</td>
<td>0.004119</td>
<td>11.66335</td>
<td>0.0000</td>
</tr>
<tr>
<td>ti (-1)</td>
<td>-0.000560</td>
<td>0.000161</td>
<td>-3.471259</td>
<td>0.0009</td>
</tr>
<tr>
<td>*IGOVERN?</td>
<td>-1.85E-08</td>
<td>6.81E-09</td>
<td>-2.72989</td>
<td>0.0083</td>
</tr>
<tr>
<td>GOVERN?</td>
<td>-1.96E-07</td>
<td>2.69E-08</td>
<td>-7.265090</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

R-squared: 0.945390  
Mean dependent var: 0.020341

Sum squared resid: 0.001015  
Durbin-Watson stat: 0.630876

Source: The World Bank
Table-2 shows the private investment estimation. In this case too the signs are the expected and all the variables are significant. Governance has a positive effect on private investment and the interaction factor, that mixes governance and fiscal policy is negative. The crowding out effect due to fiscal policy compensates the governance’s positive effect on investment.

Table-3

Dependent Variable: IP
Method: Pooled EGLS (Cross-section weights)
Sample (adjusted): 1996 2003
Included observations: 8 after adjustments
Cross-sections included: 10
Total pool (balanced) observations: 80
Iterate weights to convergence
Convergence achieved after 5 weight iterations

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>1.983297</td>
<td>0.000472</td>
<td>4201.550</td>
<td>0.0000</td>
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<tr>
<td>GOVERN</td>
<td>0.012922</td>
<td>0.003073</td>
<td>4.204500</td>
<td>0.0001</td>
</tr>
</tbody>
</table>

R-squared 0.978164 Mean dependent var 1.983297
Sum squared resid 0.223929 Durbin-Watson stat 0.192237

Source: The World Bank

Table-4

Dependent Variable: GINI
Method: Pooled EGLS (Cross-section weights)
Sample (adjusted): 1997 2003
Included observations: 7 after adjustments
Cross-sections included: 10
Total pool (balanced) observations: 70
Linear estimation after one-step weighting matrix

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>2.089534</td>
<td>0.483616</td>
<td>4.320644</td>
<td>0.0001</td>
</tr>
<tr>
<td>( \tau )</td>
<td>-20.88164</td>
<td>8.632377</td>
<td>-2.418991</td>
<td>0.0187</td>
</tr>
<tr>
<td>GOVERN</td>
<td>-6.177000</td>
<td>1.241254</td>
<td>-4.976420</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

Unweighted Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>R-squared</td>
<td>0.279521</td>
<td>Mean dependent var</td>
<td>1.233934</td>
<td></td>
</tr>
<tr>
<td>Sum squared resid</td>
<td>342.3903</td>
<td>Durbin-Watson stat</td>
<td>1.255875</td>
<td></td>
</tr>
</tbody>
</table>

Source: The World Bank and own estimations
Table-3 includes the public investment estimation and again the sign of the variables is the expected and significant. Governance has a positive effect on public investment. So, government has to control this kind of expenditure to avoid its negative effects on economic growth.

Finally, table- 4 includes the Gini estimation. The signs are the expected and are significant. Governance has a positive effect on income distribution as well as fiscal policy and indirectly to economic growth.

The results show that governance has a positive indirect effect on economic growth. Good governance has a positive effect on private investment, public investment and Gini. Through these variables would have a positive effect on economic growth.

5. CONCLUSIONS

Governance is a concept that has been included in the economic analysis during the last decades. However, is a concept that remains controversial and misunderstood. There is not a single definition of governance and sometimes is related to concepts such as democracy, corruption, institutions… There is also some literature that analyse the controversy market versus government. The election between both will depend on the efficiency terms and their possibility to achieve economic goals.

The main goal of the European Union Countries is to achieve price stability and due to this stability it is possible to enhance economic growth. This inflation target could be obtained through market labor flexibility and modifying interest rates, among other possibilities. Fiscal policy and institutions play a secondary role.

However, the empirical analysis developed in the previous section for the case of ten European Union Countries show that governance would have a significant indirect effect on economic growth. There is a positive relationship between governance and private investment and inequality reduction. Both factors are economic growth enhancing. There is also a positive relationship between governance and public investment, but the latter has a negative impact on economic growth. For this reason good institutions would have to reconsider their public investment policies and try to avoid the negative effects on economic growth. Fiscal policy would have an ambiguous effect on economic growth: positive in terms of inequality reduction and negative in the case of the public investment and in the interaction with governance in the case of private investment.

This analysis could be improved considering other factors in the equations. One of them could be social capital that in the modern literature plays a relevant role from the socioeconomic point of view. There would also be interesting to analyse the factors that would have some effects on governance.
References


