

ESGnomics





Foreword

Climate change, reduced inequality and better governance are all challenges to making our world more just and sustainable in the future, and Rothschild & Co is committed to this goal.

The Group's economic research is part of this approach, providing analysis on the main risks and opportunities to which economic players are exposed. ESGnomics aims to convey in an educational manner the contributions of economics to the discussion of Environmental, Social and Governance issues.

The benefits of good governance



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When analysing environmental, social, and governance factors, the “G” element is often forgotten amid considerations over climate risk and other “E” and “S” threats. However, understanding governance risks is also important.

The WGI components:

- 1) Corruption control
- 2) Government effectiveness
- 3) The rule of law
- 4) Voice and accountability
- 5) Regulation quality
- 6) Political stability and absence of violence

G’s factor

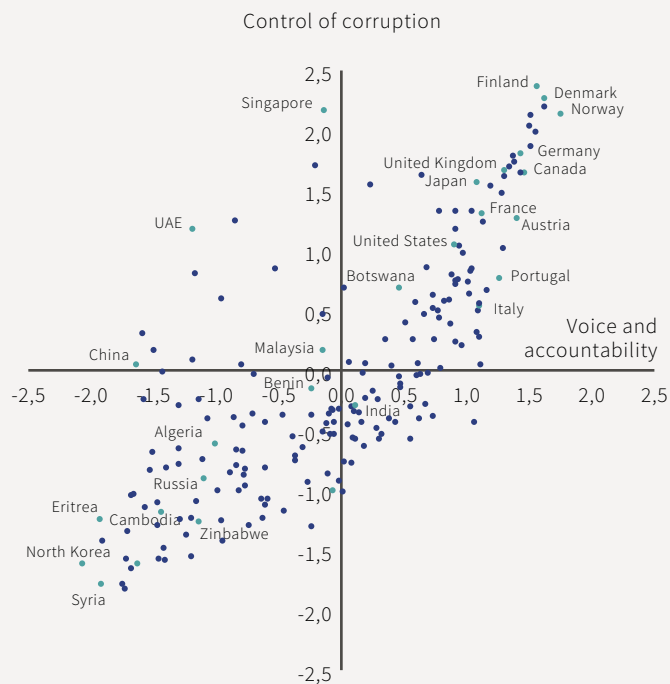
In the private sector, poor corporate governance practices have stood at the core of some of the biggest corporate scandals, with Volkswagen’s emissions tests misconduct coming to mind as an example. That’s why issues such as sustainability and ethical standing now sit alongside traditional measures of financial strength and market position as factors that are indelibly tied into decision-making for investors. In fact, research has shown that businesses that rank well below average on good governance characteristics are particularly prone to mismanagement and risk their ability to capitalize on business opportunities over time⁽¹⁾

In terms of sovereigns’ policymaking, scholars mostly agree that a strong relationship exists between economic growth and national governance. But how can we measure the quality of government and how it affects growth?

“ A strong relationship exists between economic growth and national governance... ”

(1) S&P Global, “What is the “G” in ESG?”, 2020.

World – Development index



Source: World Bank, Rothschild & Co Asset Management Europe, 2023.

What is good national governance...

Although the concept of governance is widely discussed there is no strong consensus around a single definition of governance or institutional quality. Defended by World Bank economists, it refers to how governments are selected, monitored and replaced; the governments' capacity to effectively formulate and implement sound policies and provide public services; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.

But measuring governance is difficult, and all measures of governance are necessarily imprecise, requiring interpretative caution. Still, the World Bank developed the Worldwide Governance Indicators (WGI) composed of six key components, of which corruption control and the rule of law.⁽²⁾

While the WGI indicate that many countries have made progress over the past years, it also reveals that many of them have failed to make such improvements, highlighting serious challenges remain. What's more, good governance is not the exclusive preserve of rich countries. In fact, several emerging countries, including Chile, Botswana or Costa Rica, have governance scores better than those of industrialized countries such as Italy or Greece.

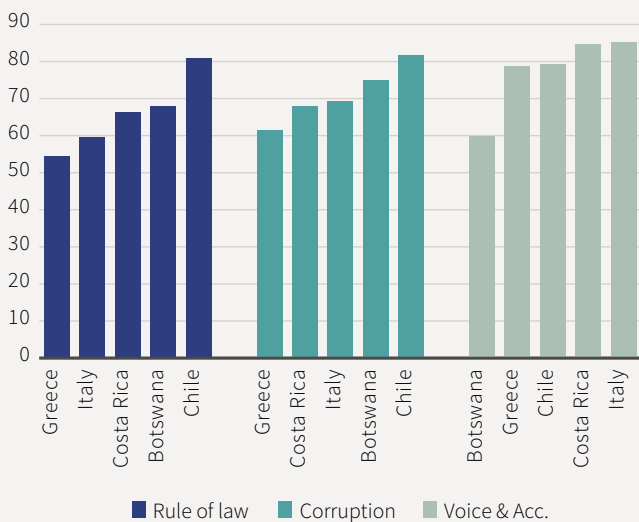
... and how it affects the economy?

There is a close relationship between growth and governance as economic development is an inherently political process that challenges vested interests.

Corruption – the first component of the WGI defined as the abuse of power for private benefit – is not a new phenomenon and exists both in the private and public sectors. In the latter, it is generally connected with the activities of the state, especially with its discretionary power.

In recent decades, the role of the government in the economy has grown with large increases in the level of public spending, in regulations and controls on economic activities. As such, the scope for corruption has widened. For instance, economic operations requiring various kinds of authorizations have grown through the years, giving the bureaucrats charged with delivering the permits the opportunity to accept offered bribes. Furthermore, because in some countries entrepreneurs have to devote their scarce time to bribing officials, the benefit of small and medium-sized enterprises is not fully realized and this misuse of resources weakens economic growth and has serious implications in terms of public finances⁽³⁾.

World – Governance indicators



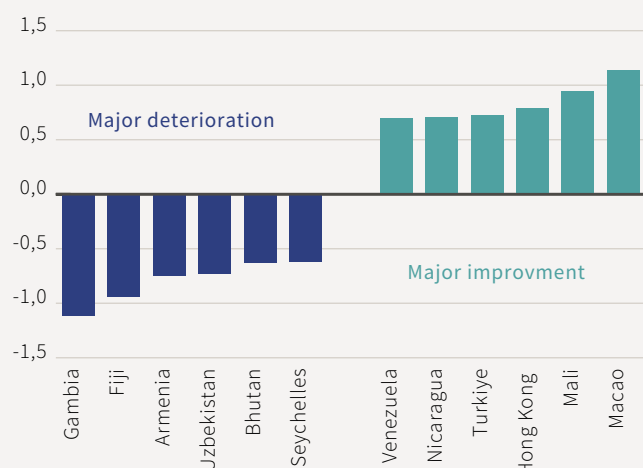
Source: World Bank, Rothschild & Co Asset Management Europe, 2023.

(2) The WGI are based on the aggregation of perceptions of governance from 31 different data sources provided by 25 different organizations, and so provide a synthesis of the views of a very large and diverse group of stakeholders regarding the quality of governance across countries.

(3) Vito Tanzi and Hamid R. Davoodi, "Corruption, Growth, and Public Finances", IMF, 2022.

World - Changes in voice & accountability

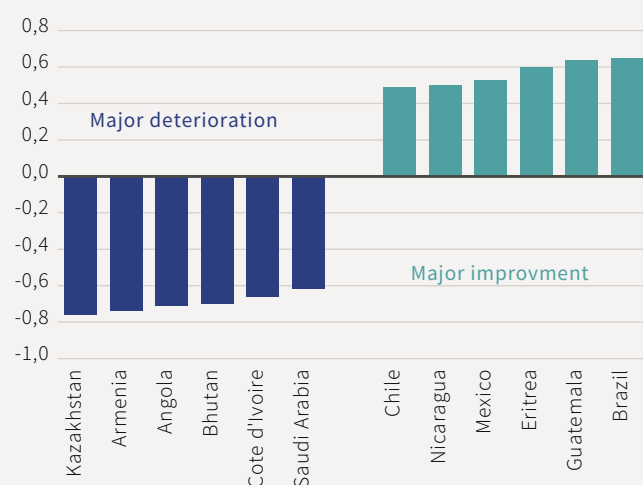
index, 2011-2021



Source World Bank, Rothschild & Co Asset Management Europe, 2023.

World - Changes in control of corruption

index, 2011-2021



Source: OECD Employment Outlook 2012.

“Governance is seen as stimulate investment by reducing uncertainty...”

However, the way the state operates and carries out its functions is at least as important than the size of public sector to determine the risk of poor governance as some of the least corrupt countries in the world, such as Canada, Finland and the Netherlands, have some of the largest public sectors.

More broadly, there are multiple mechanisms through which good governance, such as an independent judiciary, property rights protection and press freedoms, results in sustained long-run development. For instance, governance is seen as stimulate investment by reducing uncertainty and creating an attractive investment environment. It can also benefit economic growth by improving resource utilization or budget management.

Better governance also helps in the fight against poverty and improves living standards. In that regard, research indicates that when governance is improved by one standard deviation, infant mortality declines by two-thirds and incomes rise about three-fold in the long run⁽⁴⁾.

What's more, social mobility, which is the extent to which socio-economic circumstances at birth influence a person's future status and prosperity, is improved in countries where governance enable to create opportunities for their people to rise on the basis of their creativity and work ethic. As discussed in another issue of ESGnomics, social mobility tends to reduce income inequality, and correspondingly its negative effects on economic growth⁽⁵⁾.

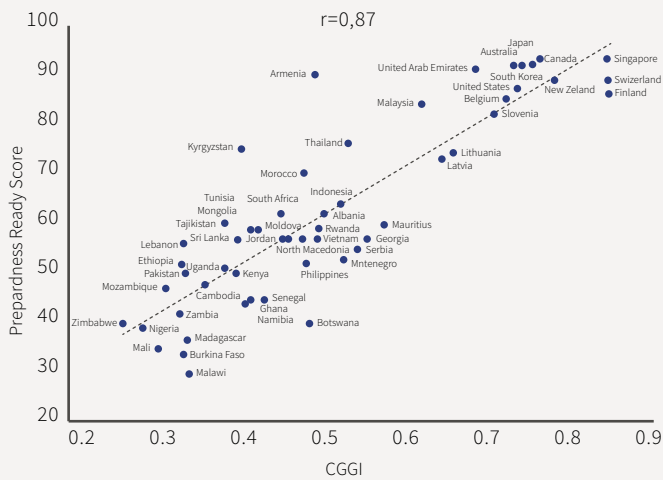
Furthermore, a country's governance quality is a better predictor of whether it is prepared for pandemics than its income level. In other words, a well-governed country is more likely to be prepared for a pandemic than one which is simply wealthy⁽⁶⁾.

(4) Kaufmann, D., Kraay, A. and Mastruzzi, M., "Governance matters 2009: Learning From Over a Decade of the Worldwide Governance Indicators", 2009.

(5) Corak, M., "Income Inequality, Equality of Opportunity, and Intergenerational Mobility." Journal of Economic Perspectives 27 (3), 2013.

(6) Chandler Good Government Index, 2022.

Good Governments are Better Prepared for Pandemics



Sources: CGGI 2022; Preparedness Ready Score, Prevent Epidemics.

How to improve governance?

It is an impossible task to summarize in a few lines how governance can be enhanced. Still, effective judicial systems play a crucial role in upholding the rule of law, which is an important structural element for an investment and business friendly environment. Reducing the length of court proceedings and improving procedures for the appointment, promotion and evaluation of judges are examples of measures to support the independence of judicial systems and thus enhance the rule of law.

Corruption is a complex phenomenon that is almost never explained by a single cause, hence the fight to reduce it must be pursued on many fronts. But any realistic strategy must start with an explicit recognition that demand and supply are relevant. On the former, the briber wants something from the public official and is willing to pay a bribe for it. On the latter, the official wants to be compensated for the risk and the effort involved. And as is the case with all demands and supplies, the price plays a major role, and to a large extent it is the State that, through its many policies and action, will influence this interaction.

Yet, beyond its effect on economic growth, governance – or the lack of it – can also have an important impact on climate change. That's a topic we will address in a forthcoming issue of ESGnomics.

“The rule of law is an important structural element for an investment and business friendly environment...”

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