THE POLITICAL ECONOMY OF GOVERNANCE AND DEVELOPMENT: TOWARDS A NEW WORLDVIEW

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Abstract

This paper focuses on governance from an institutional economic perspective in trying to better understand the complexities of the decision making process and their implications for economic outcomes and growth. The paper is divided into six sections. Section I provides an introduction and background. Section II sketches various governance models within the conventional western paradigm. These are basically the 'market-based' model and the 'relationship-based' model. A recent third paradigm is also gaining momentum in the literature, namely 'family capitalism' or the 'family business'. Together, these three models or frameworks may be construed as the *quantitative* perspective to governance, driven by a rule-based environment. It will be indicated that these models are a necessary but not sufficient condition for effective and qualitative delivery of governance ensuring trust, honesty and integrity. This section also emphases the critical importance of institutions, cultural traditions, value systems, mores and history as crucial ingredients in the development process over and above issues of compliance.

Keywords: Governance, Development, Institutions, Economic policy, and Political economy

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I Introduction

This paper focuses on governance in both the private and public sector from an institutional economic perspective in trying to understand better the complexities and outcomes of the policy decision-making process, having an impact on economic growth and development. In essence, governance has a major indirect effect on the socioeconomic-growth-development nexus of a country because finance and investment decisions impact either positively or negatively on the development process and thus the quality of life of people.

The paper is divided into six sections. Section II sketches various governance models within the conventional western paradigm. These are basically the 'market-based' model and the 'relationship-based' model. A recent third paradigm is also gaining momentum in the literature, namely 'family capitalism' or the 'family business'. Together, these three models or frameworks may be construed as the *quantitative* perspective to governance, which is driven by a rule-based environment dependent on the level and depth of governance, legal institutions, and financial institutions. The paper will indicate that these models are a necessary but not a sufficient condition for effective and qualitative governance, which should ensure trust, honesty, and integrity.

An important but often neglected element in the governance literature is the central importance of the capacity and ability of institutions on economic outcomes. This is covered in Section III where a conceptual framework in presented. It is because of the impact of finance and investment decisions by both the private and public sector that governance has to go beyond the functional framework of the *quantitative* aspects of governance. It was in the presence of this rules-based environment that a number of scandals and corruptions occurred recently. This section also emphases the critical importance of institutions, cultural traditions, value systems, mores, and history as crucial ingredients in the development process over and above issues of compliance. Collectively, these aspects can be interpreted as *qualitative* governance. Section IV provides a review of trust relations and its impact on economic outcomes. Evidence suggests that a moral or ethical deficit is manifesting itself in a number of countries and that the status-quo policy environment is inadequate in addressing these issue at its core.

This exploration of qualitative governance links to Section V of the paper, which investigates the moral flavour of governance and asserts that a self-enforcing governance system allows for less corruption and fraud than is otherwise the case. It is an accepted and disconcerting fact that current governance systems are dysfunctional encouraging fraud and corruption in the world and that they are becoming an extremely important financial and political concern of most western democracies. In

general, this section provides a moral dimension of governance reflecting on its basic tenets, institutional structure, and the present social fabric within which governance systems operate in market economies. The paper argues that the existing socio-economic structure is not a sufficient condition in addressing the moral dimension of governance. What is needed is something in addition to the various conceptual frameworks of governance mentioned in Section II. In other words, successful and effective governance has to move from the conformance mode to the performance mode. The paper presents Islamic Finance which is currently developing across the globe as an example of a mega-policy and as an emerging alternative to status-quo financxing options. Whether this mode of finance is more effective, cost-efficient and conducive to economic growth and development can only be empirically tested in the immediate future. Finally Section VI concludes.

II. Models of Governance

The surge of interest in governance has occurred around the world due to a number of factors: the spread of capitalism and the speed of privatization, the growth of corporations, deregulation, and the integration of capital markets and globalisation, pension fund reform and the growth of private savings, shareholder activism, the 1998 East Asia crisis, and a series of U.S. scandals and corporate failures of late, for example Enron and WorldCom. According to Plender (2002) "Enron has turned into the greatest case study in unethical business practices for a generation". In response to these developments, different models or conceptual frameworks have been put forward concerning the critical importance of providing an effective and efficient system of governance. At the core of all these models of governance is the principal-agent or collective action problem, which arises as a consequence of a conflict of interests between various corporate claimholders and those managing the firm. It is within this situation that infectious greed, fraud, and corruption develops. A similar trend has evolved in public sector democratic governments (discussed later).

Becht, Bolton & Roell (2002) provide a literature review of a number of governance models as possible solutions to solving the collective action problem among dispersed shareholders. These models consist of the takeover model, the block-holder model, delegated monitoring and large creditors, board models; executive compensation models, and multi-constituency models. Collectively, these models can be construed as *quantitative* governance. Without them, firms violate promises and resources that directly impact on potential national economic growth and development because the demand for investment capital is increasing throughout both the developed and developing world. More important is the realisation by policy makers that the *quality* of governance is relevant to capital formation for weak governance systems combined with corruption and cronyism distort the efficient allocation of resources hindering investment opportunities and ultimately economic development. For example, in a cross-section of over 150 countries, Kaufmann, Kray, and Zoido-Lobaton (1999) provide empirical evidence of a strong causal relationship from better governance to better development outcomes.

Notwithstanding the rapid growth in governance models in the literature, they do not provide an appropriate answer to the collective action problem. In addition to the various models cited above, two comparative perspectives on governance systems are proposed in the literature. That is, the Anglo-American market-based model and the long-term large investor models of, for example, Germany and Japan. Which of these systems has dominated can be interpreted as a function of the relative success of each country's underlying economy discernible in two broad phases: the 1980s, when the Japanese and German long-term-investor governance perspective was considered a strength compared to the Anglo-American market-based short-term perspective, and the 1990s, when the reduction in shareholder protection and the greater reliance on equity financing in the Anglo-American systems were seen as major advantages (Becht et al 2002).

The Anglo-American capital market-based model emphasizes the maximization of shareholder value. A study undertaken in 2000 by International Patterns of Institutional Investment (see www.conference-board.org) indicates the enormous financial power of U.S. and UK institutional investors. According to the study, institutional investors hold US$24 trillion in financial assets in the world's top five markets; about 76% of these assets are held by US and UK investors; and the 25 largest US pension funds account for two thirds of all foreign equity investment by US investors. These figures indicate the enormous influence the market process has on economic growth and development. However, the market process suffers from a number of shortcomings – known as market failure – which requires some form of government intermediation or intervention. We will refer to this issue later.

The Japan/German model is focused on a relationship-based model that emphasizes the maximization of the interests of a broader group of shareholders. These two comparative corporate perspectives do not constitute a comprehensive theory of governance, but provide convenient paradigms for classifying actual governance systems that exist today. According to Tabalujan (2002) a third paradigm has been gaining momentum. This is based on the prevalence of the family business, which, according to previous studies, indicates that family business or family capitalism has wielded enormous economic power in particular countries. For instance, Table 1 indicates the extent of family capitalism drawn from a study done by Stijn Claessens et al based on 1996 data cited in Tabalujan (2002):

Table 1

Country	Number of top family Groupings	% Listed Assets	% GDP
Indonesia	15	61.7	21.5
Philippines	15	55.1	46.7
Hong Kong	15	34.4	84.2

The evidence indicates that family values appear to have a significant influence on the outcomes of family capitalism and therefore governance. Family values include a set of social, cultural and ethical values which prevail within a particular family or which characterize the families of a particular community. The question is to what extent does family values, as opposed to values or culture in general, influence or impact governance – for the better or worse. For example, the research of Blair and Stout (2001), and Licht (2001) as listed in Tabalujan (2002) focus on trust as a social value and the way in which value dimensions from cross-cultural psychology determine the impact of culture on governance. This is an area of social research to be investigated in greater depth, for the notion intuitively is apparent – family values do have an impact on governance. For instance, the nature of representations that stakeholders can expect from boards of corporations depends crucially on the social background of representatives or family values. These social orientations matter because culture is a powerful force. In fact, "preferences depend on the framing of choices, the context in which choices are made, and the method by which choices are elicited" (Kuran 1998). In this connection, Ayogu (2001) for instance, provides an empirical analysis of quality governance in Africa. The thrust of the study is that moral sentiments, manifested by norms and values and the social background of corporate directors, do play an important role in the boardroom decision-making process. The issue of culture and value systems or worldview will be referred to again in the next section.

III. Institutional Approach to Governance

Other than the three paradigm shifts of governance mentioned above, namely the different model types (micro perspective of the firm), the comparative systems of governance (a macro perspective at country level), and the family capitalism mode, one can also provide an additional perspective to governance from an institutional economics point of view. The new institutional economics perspective focuses on two complementary parts. One part deals predominantly with background conditions (an expansion beyond property rights to include contract laws, norms, customs, conventions, etc) and the other part deals with the mechanisms of governance (Williamson 1996).

Table 2 is a revised version of Williamson's (2000) four levels of social analysis in which he unbundles to some extent the various forces or elements that influences economic outcomes. According to Williamson the levels are interconnected in the sense that "(t)he solid arrows that connect a higher with a lower level signify that the higher level imposes constraints on the level immediately below. The reverse arrows that connect lower with the higher levels are dashed and signal feedback." Much of the governance problems are located at levels 2 and 3. This paper attempts to reinforce this interconnectedness and indicate that the present policy environment dealing with governance is insufficient in coming to terms with the envisaged economic outcomes. Something different has to be done. About this later. Furthermore, Table 2 is linked to Figure 1 in that the latter provides a conceptual framework of governance underpinned by the power relations to be found in different countries.

Table 2. Economics of Institutions

LEVEL		PURPOSE
Level 1: Social theory	Embeddedness: informal institutions, customs, traditions, norms, religion	Often noncalculative; spontaneous
Level 2: Economics of property rights/ positive political economy	Institutional environment: formal rules of the game – especially property (polity, judiciary, bureaucracy)	Get the institutional environment right. 1st order economizing
Level 3: Transaction cost economics	Governance: play of the game – especially contract (aligning governance structures with transactions)	Get the governance structures right. 2nd order economizing
Level 4: Neoclassical economics/agency theory	Resource allocation and employment (prices and quantities; incentive alignment)	Get the marginal conditions right. 3rd order economizing

Source: Adapted from Williamson 2000 - "The New Institutional Economics: Taking Stick, Looking Ahead"

Figure 1 is an extension of the three-level schema provided by Williamson (1996) by including both corporate governance and state governance. Governance of whatever type does not operate in a vacuum. It is underpinned and influenced by social institutions on the one hand, and the attributes of economic actors on the other. Together these forces drive governance into a particular direction with certain explicit or implicit goals. By state governance is meant the capacity and ability of a government managing, controlling and evaluating all aspects of the public sector as opposed to corporate governance, which refers to similar activities relative to the private sector. The diagram above depicts a causal model of the institutional environment. The individual and the type of governance indicate that the efficacy of the different modes of governance, referred to earlier, varies with the institutional environment on the one hand and the attributes of economic actors on the other.

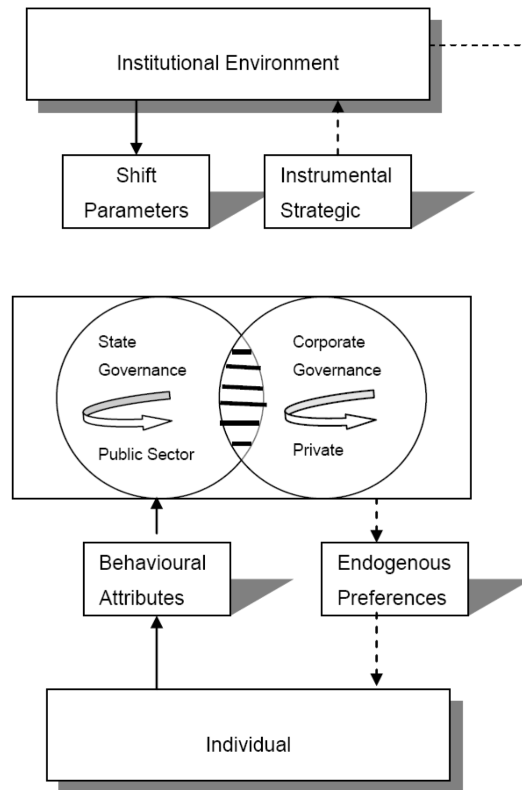

Figure 1. Conceptual framework of Corporate Governance

More important, is the overlap between state governance and corporate governance which collectively determines the depth, type and form of economic growth and development in a particular country – this is presented in the striped area. The bigger this area, the better the quality of life underpinned by better living standards and the like. This interpretation is confirmed by recent studies of the importance of institutions on growth and development (see *Finance & Development*, June 2003).

In fact, the quality and quantity of the striped area depends on the extent to which the sphere of governance dominates the political economy of a particular country. Put differently, economic growth and development are determined fundamentally by the interplay of the forces of both the public and private sector. It is also important to note that each institutional fabric (public or private) comes with its shortcomings. For instance, when state governance is weak a country suffers from government failure to the extent that it does not deliver public goods according to its promises because of a combination of factors such as public budgetary constraints or lack of institutional capacity or blatant pervasive corruption of government officials. Similarly, the private sector may fail because of the prevalence of market failure due to the presence of asymmetric information, monopoly power, and externalities. Corrective action is usually sought in some form of institutional mechanism when the one or other type of governance fails. For instance, if there is government failure then privatization is normally sought. If market failure exists in whatever form, then government intermediation or intervention in the market process is sought. Conceptually, there is thus a perpetual tension (if you wish) between government/market institutions in trying to resolve the basic economic problem of what to produce, how to produce and for whom to produce. However, it is important to recognise that history records that no country developed without a strong devlopmental government in place.

The above discussion underpins the conceptual framework illustrated in Figure 1 above. As illustrated, there are three main effects shown by solid arrows: the environment, governance and the individual, each with a different emphasis and intention influencing economic outcomes. Secondary effects are drawn as dashed arrows. As discussed below, the institutional environment defines the rules of the game. However, a more important question to ask from a political economy perspective is: who makes the rules and how were they determined in the first place? To view governance from this perspective allows the framework of analysis beyond conventional criteria of homo economicus using rational choice theory, which according to Basu (2003) can yield revealing insights. "If changes in property rights, contract laws, norms, customs, and the like induce changes in the comparative costs of governance, then a reconfiguration of economic organization is usually implied" (Williamson 1996). The solid arrow from the individual to governance carries the behavioural assumptions, within which transaction-cost economics, concerned with the governance of contractual relations, operates. . The circular arrow within the governance sector reflects the nature, composition and characteristics of the type of organization.

The feedback effects from both the state and corporate forms of governance to the environment can be either instrumental or strategic. An example of the former would be the reform in company law for a more effective and efficient governance system in a country. The King Commission on Governance for South Africa (2002) is a case in point as is the Sabarnes-Oxley Act of 2002 in the U.S. Strategic changes could take the form of protectionist trade barriers against foreign competition, as, for example, the enormous subsidies to farmers in the agricultural sector in the European Union which prevent access to their markets by the developing world, especially those of Southern Africa.

According to Williamson (2002) the "feedback effects from governance to the level of the individual can be interpreted as 'endogenous preference' formation (Bowles and Gintis, 1993), due to advertising or other forms of education". Moreover, the environment influences the individual because endogenous preferences are the product of social engineering. Moreover, it is in this context that the moral dimension of corporate governance is rooted because "bolstering the restraints on bad behaviour is to acknowledge the importance of the ethical dimension in economic activity" (Plender 2002). Thus human behaviour is the fundamental explanatory variable in explaining socio-economic outcomes underpinned by family values, culture, and belief systems.

The discussion thus far indicates that the institutional economics discourse provides powerful insights leading to a better understanding of governance issues for it uses an inclusive approach as opposed to a minimalist approach which focuses exclusively on the rules-based environment. To take the institutional economics' paradigm debate further, Grindle and Thomas (1991) also illustrate numerous African case studies highlighting the profound impact institutions have on economic outcomes and performance as reflected through the policy-making environment. In addition, the success or failure of the policy implementation process is heavily dependent on the cultural and political institutions in place. Furthermore, Williamson (1994) and Putnam (1994) argue for the importance of social institutions based on trust over the outcome of economic relations performance. Once social institutions are disrupted, the possibility of successful public policy implementation to restore 'social capital' is a tedious and time-consuming task. According to a study by Putnam (1993), the best explanation for contributing to economic development is not so much the soundness of macroeconomic fundamentals, wealth or education, demographic stability or party politics, but rather the nature, structure, and composition of social capital. "In a world of multiple social equilibriums and path dependence, societies blessed with high levels of social capital are able to sustain a more productive equilibrium in political, administrative, and even economic terms. Social capital affects economic performance both directly, by fostering better government performance, and directly, by reducing transaction costs and facilitating incomplete contracting" (Putnam 1993).

Rodrik and Subramanian (2003) argue that the need is to find the right institutional preconditions rather than to micromanage outcomes: "…if institutions are indeed the deep determinants of development, then we cannot evaluate traditional policies – fiscal, monetary, exchange rates, structural reforms – simply by looking at the intended effects...the exclusive focus in conditionality on getting prices right needs to be rethought."

This is precisely what institutional economists have been arguing for sometime (see Williamson 2000). Moreover, economists and other social scientist have long realised the importance of "policies". In fact, the political economy of governance and institutions 'requires a framework for thinkng about why policies differ across countries'. In this connection, Acemoglu's (2005) review of the book *The Economic Effects of Institutions* by Persson and Tabellini makes a meaningful contribution. In terms of social choice literature (e.g. Kenneth Arrow's (im)possibility theorem 1963; Anthony Downs's median voter result 1957) the aggregation of society preferences into a good social choice rule is hard to come by, if at all. This is what much of political economy does. Acemoglu's (2005) puts it in this way: "The central working hypothesis has been that agents – as voters, lobbyists, revolutionaries, politicians – have *induced* preferences over policies. This means that they understand that different policies will map into different outcomes, and consequently

their preferences over policies are shaped by their preferences over the outcomes that will be induced by the policies." That "institutions matter" is a unanimous view, but the unbundling thereof requires new research initiatives as reflected by Acemoglu (2005). It is therefore not surprising that the theme of the *World Developemnr Report 2002* is Building Institutions for Markets, where issues about how institutions support markets, growth and poverty reduction as well as how to build effective institutions.

IV. Trust and economic outcomes

To extend the above theme further, Amartya Sen (1997) puts it in this way: "The expansion of human capabilities, thus, have both "direct" and "indirect" importance in the achievement of development. The indirect role works through the contribution of capability expansion in enhancing productivity, raising economic growth, broadening developing priorities, and bringing demographic changes more within reasoned control. The direct importance of human capability expansion lies in its intrinsic value and its constitutive role in human freedom, well-being and quality of life."

In this context, the issue of trust becomes paramount because a decline in business ethics has important economic consequences. First, corporate wrongdoing erodes legitimate wealth creation and therefore dampens the level of economic development. Second, and more fundamental, ethics affects economic activity because ethical conduct creates the quality of trust. Trust, in turn, reduces monitoring and transaction costs in companies and the wider economy. This does not mean that ethics is a low-cost substitute for internal and external regulation. In fact, ethical behaviour reinforces and is the root cause for successful performance standards. Regarding the relationship between trust and growth, Zak and Knack (2001) using a general equilibrium heterogeneous growth model, show that trust depends on the social, economic and institutional environment in which transactions occur. This means that low trust environments reduce the rate of investment. "Because trust reduces the cost of transactions (i.e. less time is spent investigating one's broker), high trust societies produce more output than low trust societies. A *fortiori*, a sufficient amount of trust may be crucial to successful development."

Furthermore, a World Economic Forum (2002)[6] global public opinion research survey unveiled that trust in many key institutions has fallen to critical proportions. Table 3 discloses a dramatic lack of trust in democratic institutions, and global and large national companies; trust is even low when it comes to NGOs, trade unions, and media organizations across the world. Table 4 indicates a most troubling finding, namely that the principal democratic institution in each country (i.e. parliament, congress. etc) is the least trusted of the 17 institutions tested, including global companies. This is particularly true in the Middle East (Turkey and Israel), Latin America (Argentina, Bolivia and Panama), some Eastern and Central European states (especially Georgia), and some countries in the Asia Pacific region (especially Japan and South Korea). Elected legislatures are trusted most strongly in North America, some European countries (Denmark, Norway, Sweden and Switzerland), and other countries in the Asia Pacific region (especially, Malaysia, Hong Kong, India and Indonesia).

However, the research further provides evidence of distrust in the democratic process: fully two-thirds of those surveyed disagree that their country is "governed by the will of the people" (see Table 5). Majorities in only four countries of the 46 said that their country was governed by the will of the people – the Dominican Republic, Israel, Luxembourg and Malaysia. Even in established democracies like the United States and the United Kingdom, less than half agree that democracy is in place in their country. Indications are that global companies and large domestic companies are equally distrusted to operate in the best interest of society.

These results confirm the view that an ethical deficit is gaining momentum at the heart of modern capitalism. Another example revealing infectious greed is the startling growth in income inequality between directors and employees because of stock options initiatives. "In September 2002 a *Business Week* survey showed that, in 2000, CEOs of quoted companies made 531 times the amount earned by the average worker, compared to just 42 times in 1980" (cited by Plender 2002).

What is the appropriate response? More rules or values-based regulation? This is addressed in Section V. As indicated earlier, it is almost impossible to legislate moral values, but it is important to acknowledge the strong impact the ethical dimension has on economic activity.

The above issues are very important in the corporate/state governance context because the institutional economic perspective deviates from a purely economistic analysis based on targets as policy drivers (e.g. earnings per share, company valuations, deficit as % of GDP, inflation targeting) without fully understanding the forces behind such processes.

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[6] The *Voice of the People* survey of 36,000 people across 47 countries on 6 continents conducted by Gallup International and Environics International reveals that Trust will be one of the major issues. The sample statistically represents the views of 1.4 billion citizens. Respondents were asked to rate their level of trust in 17 different institutions "to operate in the best interest of society."

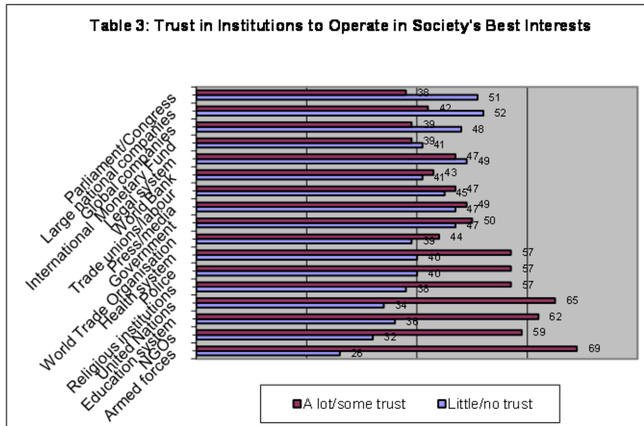

Table 3: Trust in Institutions to Operate in Society's Best Interests

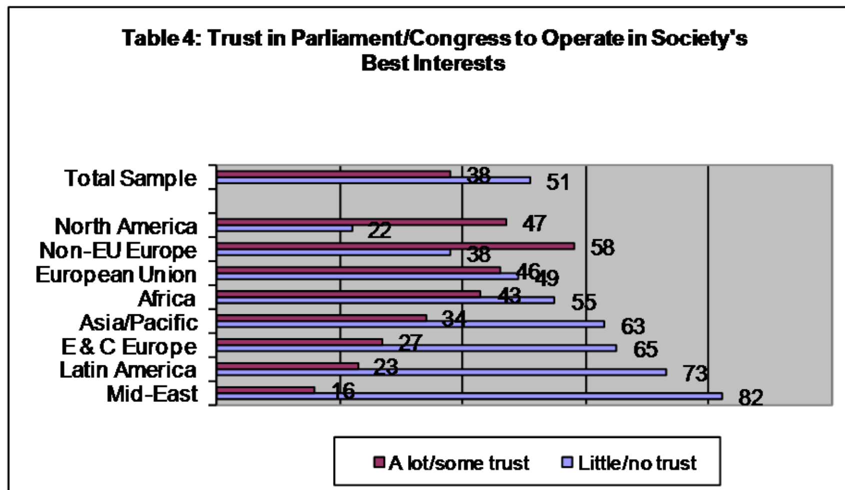

Table 4: Trust in Parliament/Congress to Operate in Society's Best Interests

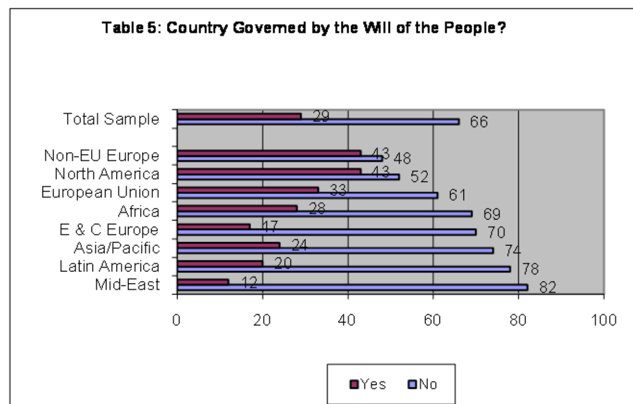

Table 5: Country Governed by the Will of the People?

Gills and Philip (1996) put it in this way:

"We tend to reject the notion that economic policy and national institutions are dis-embedded from the historical society in which they function. On the contrary, we want to insist on re-examining the extent to which social, political, cultural and economic institutions, underpinning economic policy, are deeply embedded both socially and historically, though this certainly does not mean that they are unchangeable or merely static the historicity and deep

embeddedness of socio-economic institutions, run a directly counter to a historicist abstractions about the transferability of democracy and economic prosperity via economic policy and the concomitant prevailing assumption of homogenization of societies pursuing ostensibly the same economic policy trajectory. However, the most remarkable aspect of the current post Cold War international environment has been the emergence of an ultimate consensus [the so-called 'Washington consensus'] about development and, by implication, all the institutions that go with it."

In summary, governance models can be grouped into two strands: those dealing with the rules of the game (micro perspective), and those focusing on country comparative views (macro perspective). Although both are important, they are presented from a minimalist view, which fundamentally interprets governance from a quantitative point of view. Put differently, more rules and regulations do not ensure more honesty, for one cannot legislate against dishonesty. That is why we need to develop a culture of qualitative governance. But qualitative governance – state or corporate – is underpinned by institutional or cultural norms and value systems, which have an enormous indirect influence on economic outcomes and development. In fact, governance in any context reflects the value system of the society within which it operates. Thus the basic argument put forward is to view governance from a political economy perspective, which attempts to view governance at its roots rather than by its mere symptoms. This does not mean such a perspective does not have its shortcomings.

V. A moral dimension of governance, worldview and strategy

The apparent increase in corporate scandals and corrupt governments in the world begs a very fundamental and pertinent question: why in the presence of apparent affluence, conspicuous consumption and within a 'first-world' ruled-based environment, do people, in positions of trust and power, commit fraud and corruption with a mentality of infectious greed? There is obviously no simple answer to this perplexing question. We are of the opinion that no western secular policy will succeed in confronting head-on the core problem of the morality of governance because the filter mechanism, through which western economies operate, is not only insufficient in addressing ethical issues, but in most cases, value judgments and ethics do not enjoy a priority in mainstream economics as well as in governance literature. This aspect has been alluded to earlier.

The filtering device in the market economy is determined and driven by the price mechanism through supply-demand equilibrium where consumers are utility maximisers, and producers profit maximisers. However, the underlying socio-economic conditions giving rise to these rent-seeking outcomes are not addressed and frustrate socio-economic conditions. Thus the filtering device of the market based on decentralised decision making, driven by price alone, is inappropriate in trying to resolve the major challenges facing the world. The price mechanism needs to be complemented by another device to at least minimise unnecessary claims on resources. That is the introduction of a moral filter, discussed later.

The governance models cited in Section II overlap as individuals seek to maximise financial self-interests. The models hinges on the psychological and social determinants of governance compliance which are very important because they challenge the normative assumptions about individual behaviour, and are also central to governance reform, design, and implementation. It is against this context that the pursuit of the morality of governance has to be interpreted as it entails a perspective, which goes beyond pure economic efficiency and equity criteria[7]. This allows one to focus on what is generally known as "good governance". The King Commission on Governance for South Africa (2002) provides seven characteristics of good governance as discipline, transparency, independence, accountability, responsibility, fairness, and social responsibility.

The key question then to ask is: to who are human beings accountable? The answer undoubtedly is to be found in what is known as the role of a worldview and its concomitant strategy in policy design and implementation.

Earlier reference was made to the effect that western policy initiatives regarding morality are insufficient because of the lack of an appropriate filter mechanism and worldview. Basic economic principles inform us that in order to allocate resources efficiently and to distribute them equitably, every economic system must answer the three well-known fundamental economic questions of what, how, and for whom to produce. The answer to these questions determines not only the allocation of resources in an economy but also their distribution between individuals and between the present (consumption) and the future (saving and investment). All three questions are value-laden and cannot be answered in isolation. It is therefore necessary to have a worldview that is based on a set of implicit or explicit assumptions about the nature of human life. Differences in views about human nature lead to differences in conclusions about the relationship of human beings towards each other and their environment and the criteria for efficiency and equity. Thus a system's strategy is a logical outcome of this worldview Chapra (1992). We will therefore explore this relationship to the moral dimension of governance.

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[7] The aim of this paper is not to address issues of efficiency and equity in the context of mainstream economics or the utilitarian or Benthamite or Rawlsian frameworks.

Furthermore, for any system to realize its goals and objectives, the strategy must consist of a number of indispensable elements. For example, in order to achieve certain macroeconomic objectives such as full employment, economic growth or balance of payments equilibrium, it is necessary to coordinate and monitor particular macroeconomic policy instruments or elements which include fiscal policy, monetary policy or trade policy. According to Chapra (1992), for any system to strive towards certain goals and objectives it must at least subscribe to the following three elements: First, any system must have a filter mechanism through which all claims may be passed by either the `invisible' or the `visible' hand to maintain a balance between resources and the claims on them and to realize optimum efficiency and equity. We know that the filter mechanism responsible for allocating scarce economic resources in market economies in the most efficient manner is the price mechanism. Second, the system must also put in place mechanisms to motivate individuals to deliver their best performance in their own interest and in the interest of society. Third, it must also have an effective way of bringing about socio-economic restructuring in the most efficient and equitable allocation and distribution of resources.

To labour this thesis further, Chapra (1992) puts it as follows: "Unless the worldview and the strategy of a system are in harmony with its professed goals, the goals cannot be actualised (Greenberg: 1974; Keane 1984). To grow a mango tree, you need a mango seed; a lemon seed, no matter how good, will not do. Systems, which reflect an inherent inconsistency between their goals and their worldview and strategy, are unable to bring about the fundamental adjustments in the life-styles and the structure and organisation of their economies. They are therefore crisis-prone. People living in such systems cannot but be the victims of false promises - promises that cannot be fulfilled, no matter how many minor adjustments are made. Such minor adjustments do not penetrate to the root of the problem. They address merely the symptoms of the inconsistency but fail to achieve consistency between the worldview and strategy and the goals. The problems therefore reappear in a different form, more serious, and more aggravated each time."

How then does a worldview and strategy embrace the concept of the morality of governance? This can be viewed at two levels. At one level, we find that too much emphasis is being placed on the rules of law concerning how to reduce potential risk without really addressing the root cause of such corporate delinquent behaviour. Any discipline committed to value neutrality cannot succeed in evaluating policies and recommendations for public choice. Such an evaluation necessarily involves an ethical judgment. According to Amartya Sen [1987] "the distancing of economics from ethics has impoverished welfare economics and also weakened the basis of a good deal of descriptive and predictive economics". His conclusion is that economics "can be made more productive by paying greater and more explicit attention to ethical considerations that shaped human behaviour and judgment". Accordingly, it is therefore necessary to focus on human beings themselves rather than on the market or the state as the latter are but parameters within which economic agents interact with one another.

Human beings constitute the living and indispensable element of an economic system. They are the ends as well as the means, and unless they are reformed and motivated to pursue their self-interest within the constraints of social well-being, nothing can succeed. We thus end up in a situation, within secularist strategies of western economies, that results in a paradox of wealth, where rich countries are not typically happier than poor countries.

The other more important level of striving towards a self-enforcing governance system lies within the realm of creating appropriate strategies, which has not been implemented before. Is it not the case that the Pacific Rim economies have outperformed both North America and Europe in economic growth the past decade? The result of such phenomenal economic growth is to a large measure to be explained in terms of those societies doing things differently to others, that is they have embarked upon economic reform initiatives and implemented economic policies, which others have not attempted before. What is asserted here is that governance reform cannot merely be solved by better criteria or guidelines? In other words, passing more legislation does not ensure corporate scandals from happening, for, in the final analysis, governance rules and a company's compliance with legislation do not guarantee intellectual trust and honesty. As indicated earlier, one cannot legislate against dishonesty. That is why boards of directors need to develop a culture of qualitative governance.

What is needed is thinking through the process and approaching it in a different manner by generating new innovations, encapsulated in really effective policies, which lead to better living conditions and improvements in the quality of life. This is what Professor John Montgomery of Harvard University refers to as "mega-policies",[8] creative policy innovations that arise outside conventional policy frameworks. Mega policies applied in the governance arena are not only concerned with patchwork or cosmetic changes in policy design. However, such

[8]Megapolicies share four characteristics: (1) they transcend traditional sectoral and intellectual boundaries, (i.e. they are intersectoral because they emerge from challenges that cannot be addressed by existing public or private institutions; (2) they require new organisational or procedural devices for their implementation; (3) they generate new expectations and extraordinary claims on government, and (4) they initiate new paradigms of policy analysis that initially create confusion and uncertainty for conventional policymakers and implementation.

policies are rare but important, and when they 'succeed' they can change their world. Even if they fail they can bring about change. A classic example of a megapolicy is the "Marshall Plan" implemented after World War II in the reconstruction and development of Europe.

Thus the remedy to the demoralization of governance (both state and corporate) lies in the re-moralization of human behaviour and society. The remedy, in fact, lies in reorganizing society and an economic system in such a way that, on the one hand, there is a transformation of the individual from the economic man (homo-economicus) to a morally conscious human being who is willing to live up to the demands of brotherhood and socio-economic justice. On the other hand, there is also a restructuring of the entire economy in such a way that needs are fulfilled without generating imbalances, and inequalities of income and wealth are not only not generated but also subsequently reduced. This is obviously much easier said than done. To overcome the real dilemma of governance failures manifested by infectious greed, corruption and fraud requires a worldview and strategy that embrace a moral dimension to governance.

What is the appropriate response? It was argued earlier that promulgating more rules of the game does not necessarily have a major impact on deterring infectious greed and distrust because the strategy and worldview of the dominant market economy are at variance with each other. Chapra (2002) convincingly argues that the Islamic Economic System provides the answer for Muslim countries because its worldview and strategy are in harmony with the *maqasid al-Shariah*[9], provided there is the necessary political will to adopt its teachings and to implement its reforms. It is not the intention of this paper to explore this proposition in great detail. More importantly, is the critical challenge of striving towards a mega-policy in conformity with these principles based on a strategy consisting of the three elements referred to earlier: a socially-agreed moral filter mechanism; a motivating system to induce individuals to use resources in conformity with the dictates of such a filter mechanism; and a socio-economic restructuring that would reinforce the above two elements.

One area where there has been growing evidence to a changing worldview in terms of building new institutions is the proliferation of economic activity under *Shariah* law in terms of Islamic banking principles. A recent report by Standard Poor found that the growth rate of Islamic banking services outpaced that of conventional banking during the past decade. "Total assets now managed by Islamic Financial Institutions are close to $300 billion – roughly the equivalent of Russia's gross domestic product". (Bachmann 2002). Furthermore, the recent establishment of the Islamic Financial Services Board facilitated by the Internal Monetary Fund addresses the need to provide an enabling operational environment for Islamic finance within the enclave of globalization. Recently, a number of large financial institutions in South Afric and the United Kingdom have opened up new departments specifically administering clients funds under these principles. Moreover, Sundararajan and Errico (2002) provide useful insights into the provision and use of financial services and products that conform to Islamic religious principles.

In essence, therefore, we put forward the idea that the existing western socio-economic structure and its related strategies is a necessary but not sufficient condition in addressing the moral dimension of governance. The challenge ahead is to generate a mega policy of governance morality which coincides with a worldview and strategy that harmonize and reinforce each other in such a manner that a *self-enforcing* system evolves. In this process, the demoralized society becomes demoralized. This is not to suggest utopianism; on the contrary, it forces us to think more seriously in terms of the interdependency between the social sciences. What remains particularly problematic is the question of the connection between attitudes and human behaviour and its implications for economic growth and sustainable development.

VI. Conclusion

This paper has attempted, in a modest way, to highlight the complexities surrounding the deeper issues and forces underpinning the morality of governance rather than providing answers to these complex questions. However, we are of the opinion that the root cause of governance failure lies not in the rules of the game, but with the behaviour and attitudes of members of society, especially those appointed to positions of trust, power and authority. This aspect tends to have been ignored by mainstream governance experts, for it would appear that the academic literature generated by these experts has become increasingly irrelevant to private and public policymaking initiatives. Furthermore, the economics discipline in general is increasingly becoming victim to this assertion, for the preconditions for fighting world poverty is inappropriate given the current global forum and policy environment.

What is required is to step back and ponder over the interrelationship and connection between a system's worldview and strategy to realise its goal of economic growth and development by, for example, using the instrument of governance as a policy lever. In essence, the remedy to the demoralisation of governance delinquency lies in the remoralisation of

[9] Goals of the *Shariah* which refer to the divine guidance as given by the *Qur'an* (Holy Book of the Muslims) and the *Sunnah* which embodies all aspects of the Islamic faith, including beliefs and practices. After the *Qu'ran*, the *Sunnah* is the most important source of the Islamic faith and refers to Prophet Mohammad's (peace and blessings of God be on him) example as recorded in the *aHadith*...

human behaviour and society. The way in which this can be achieved is through the creation of a mega-policy of governance reform design and implementation. The need for creativity and innovative ideas is fundamental for any positive change in societal behaviour and its reward system.

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