



Economic Development, Technological Change, and Growth

Institutions and Development in the MENA Region: Between Economic Growth Challenges and Political Instability

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Abstract: The main goal of this paper is to study the effect of governance on economic growth. Our main focus is on the 17 Middle Eastern and North African (MENA) countries during the period 2002-2018. Using a dynamic panel System GMM approach by Blundell and Bond (1998). We found insignificant effect of Governance on economic growth in the MENA countries. The nature of the relationship between growth and governance explains the outbreak of the "Arab Spring" in some countries of the region which revealed pervasive corruption, especially in the political sector, also the region have been vulnerable to global, financial and political crises, negatively impacting its prospects of economic growth.

Keywords: Governance; Economic growth; FDI; GFC; GMM

JEL Classification: C33, F21; O11; O16

1. Introduction

It remains a common belief that improving a country's business climate is key to both stimulating investment and attracting international investors, which would in turn promote economic growth. To this purpose, most investors avoid putting money into corrupt countries, as well as nations that are based on a bureaucratic and

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politically unstable economy. Similarly, investors shy away from territories where government services are not executed in a transparent and efficient way.

Failure regarding the quality of governance has often been cited as the main reason for underdevelopment in countries in general, and as an obstacle in the face of economic and political transition of MENA countries in particular. In fact, since the founding work of Douglass North, a Nobel Laureate in Economics with Robert Fogel in 1993 on the primacy of institutions, international financial institutions have made good governance a priority in their development programs.

According to a report by (World Bank, 2003), the MENA countries are among the least endowed economies in terms of quality of institutional governance compared with countries of similar economic characteristics, including East Asia, Eastern Europe, Latin America, and other developing countries. The study emphasizes that economic, social, and human development in the MENA region is fragile. This fragility can be attributed to the precariousness and weakness of the quality of institutions; in which the region lags behind the rest of the world.

In view of this, the central goal of this paper is to empirically evaluate the link between governance and economic growth. The study will focus on the 17 countries in the MENA region over the years 2002-2018. The paper is organized as follows: The first part provides an overview of related theoretical and empirical literature. Meanwhile, the second part touches on the empirical research methodology, as well as the data used. The final part features a discussion on the results obtained.

2. Literature Review

2.1. Theoretical Background

The economic analysis of institutions emerged in the early 20th century by works generally classified as heterodoxies, notably in Germany and the United States. This includes the German Historical School and American Institutionalism, which respectively developed in the light of the writings of (Schmoller, 1902; Veblen, 1899; Mitchell, 1927; Commons, 1931). Starting from the 1970s, new research in this area has been classified within the New Institutional Economics (NEI), allowing the renewal of institutional economics. Among the works that have been conducted within the NEI are those by (Coase, 1937; Williamson, 1975; North, 1990; Williamson, 2000). The NEI is based on the development of neoclassical instruments to develop a unified theory on the function of institutions in the coordination and implementation of economic activities.

(North, 1990) highlights that productive elements are more productive when country's institutions are robust, especially when it comes to secure property rights, structural regulation and higher quality contract enforcement. Achieving the latter

could foster a suitable environment for technological innovations and capital investments, which would stimulate economic growth.

According to (North, 1991; 1994), Factors of production such as accumulation of physical capital, accumulation of human capital, knowledge and technology are not direct causes of economic growth. This brings into question the contributions of the neoclassical growth theory (Solow, 1956), as well as the part of endogenous growth theory, which respectively explain that economic growth is in support of accumulated human capital, physical capital, and knowledge. The NEI stipulates that these factors provide only a minimal explanation of income inequality between countries in as much as they are themselves directly influenced by the institutions.

Nearly (Rodrik et al.; 2004) have indicated that the quality of the institutions offers an explanation for the differences in terms of economic growth rates among East Asian countries, by placing the institutions higher than geography and integration. Moreover, they postulated that foreign trade does not directly affect the economic growth of the country. As far as the authors are concerned, it going to act first on institutional infrastructure, which in turn would affect economic growth.

To progress, at the inability of the neoclassical growth theory to provide a structural analysis of economic growth, as well as their ignorance of the institutions, was challenged by the neo-institutionalism theory. The latter features the works of a number of scholars, including (Coase, 1937; Williamson, 1975; North, 1990; Williamson, 2000) and other empirical studies to incorporate the quality of governance in order to explain income inequality between countries (Helliwell, 1994; Pritchett, 1997; Jones & Hall, 1999; Acemoglu et al.; 2001; Acemoglu et al.; 2005; Barro, 1996; Knake & Keefer, 1995; Alesina & Perotti, 1996; Rodrik et al.; 2004).

2.2. Empirical Literature

Available literature in this regard gives evidence that institutional quality plays an important role in the economic performance of nations. Among the first researchers who showed interest in tackling this subject were (Kormendi & Meguira, 1985; Scully, 1988; Grier & Tullock, 1989; Helliwell, 1994; Barro, 1996; Isham et al.; 1997). These researchers have found a positive correlation between the impact of civil and political liberties on economic development and growth in a notable number of countries.

Along the same lines (Mauro, 1995) is focusing on the link around corruption and economic growth by using data from Business International (BI) including Corruption, Bureaucratic efficiency and Political stability for a sample of 67 countries during the period 1960-1985. The study first demonstrates a strong correlation between Bureaucratic effectiveness and political stability in terms of

economic performance, and then a weak correlation among corruption and economic growth in so far as pervasive corruption lowers the private investment rate. Similar conclusions are achieved in the works of (levine & Renelt, 1992; Knack & Keefer, 1995; Wei, 2000; Meon & Sekkat, 2005) who revealed that corruption deters economic growth.

One of the most influential studies in the literature on institution is the paper by (Kaufmann et al.; 1999) which employs a new empirical approach. The authors of the paper shed light on the link between governance and economic progress across more than 150 different nations, using six variables to describe each country's governance. Frequently referred to as "Worldwide Governance Indicators" produced by the World Bank, the variables include Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Control of Corruption, Regulatory Quality and Rule of Law. Their result highlighted the centrality of governance in achieving economic development.

Another highly influential research in the literature on institution, the paper by (Acemoglu, et al.; 2001) which shows that differences in economic performance across different countries can be belonging to the variation in institutions. The study proves that different colonization strategies have given rise to diverse types of institutions that have survive until today. In fact, colonies with low mortality rates had higher European settlements and inevitably stronger institutions were constructed which conclusively explains differences between countries in terms of current performance. Moreover, the work of (Acemoglu et al.; 2005) showed that the inequality of growth between rich and poor countries is principally attributed to the difference in the guarantee of the property rights within said countries. Along these lines, (Acemoglu et al.; 2010) show an exceptional example by illustrating the case of some Asian countries with modest economic and institutional freedom have experienced remarkable economic growth.

More recently, a study by (Shchegolev & Hayat, 2018) seeks to provide the relationship between quality of institutions and economic growth for five former Soviet Union countries. They adopted the Worldwide Governance Indicators (WGI), provided by the World Bank and initiated by (Kaufmann et al.; 1999) for the period 1996-2015, and implementing the Fully Modified Ordinary Least Squares method. The study findings unveiled a positive and significant effect that governance indices have on economic growth in all the studied nations, with the exception for voice and accountability, and political stability.

One wave of the growing empirical literature has attempted to examine latterly the link between governance and economic growth in the MENA region, by using certain factors, including, corruption, and political stability, security of property rights, political rights and civil liberties.

For instance, between the years 2000 and 2009, (Hadhek, 2012) examined the effects of institutional variables on investment and economic growth in a set of 11 MENA nations. Employing the World Bank's Worldwide Governance Indicators (WGI) and Freedom House databases. In addition, the study used a model of dynamic panel data by recruiting the method GMM of (Arellano & Bond, 1991). As a result the paper revealed the negative impact that political instability has on the country's investment opportunities and economic growth.

To take a closer, (Arayssi et al.; 2019) studied the issue of governance and economic growth in a total of 16 nations belonging to the MENA region, using the Arellano-Bond dynamic panel estimation during period 2005-2016 and the database WGI. The author convincingly argues that the uprisings of the "the Arab Spring" have slowed down the region's economic growth which may have worsened the macroeconomic equilibrium in some countries into the region.

Newley, (Emara & El Said, 2021) used the (Arellano & Bover, 1995) and (Blundell-Bond, 1998) Dynamic Panel System GMM technique to evaluate the effects of household and business access to finance on economic growth by focusing on different countries respectively, 44 emerging markets (EMs) and 21 countries from the MENA region durant the period 1990-2018. The study found that the entire sample's economic growth has been favourably benefited by access to financing. While the paper revealed also that the influence only has statistical significance when strong institutions are present, but it loses its impact when weak institutions exist, such those in the MENA area.

Most recently, Albaity et al. (2023) examined the effect of country-risk factors on bank stock returns in the MENA countries. By using the 2S-GMM method, data from 137 banks between 2011 and 2019. The outcome demonstrated that low risk was positively correlated with returns. Except for financial risk and democratic accountability, Islamic banks outperformed conventional banks in terms of returns, and the relationship between risk and returns was reliant on oil. The findings recommended that MENA nations must improve socioeconomic conditions and work toward achieving greater political and economic stability.

Above empirical analyses many researchers have been justified a positive association among Governance and economic growth (Helliwell, 1994; Mauro, 1995; Kaufmann et al.; 1999; Acemoglu, et al.; 2001). While unfavourable relationships have emerged in some countries, looking closely into the MENA region when the nature of the interaction explains the outbreak of the "Arab Spring", especially in the political sector, which destabilizes economic growth, according to (Hadhek, 2012; Labidi & Oueslati, 2015; Arayssi et al.; 2019; Emara & El Said, 2021; Albaity et al, 2023).

3. Data and Methodology

In order to investigate the presence of relation between MENA countries economic growth and Governance, we used a dynamic panel System GMM approach by (Blundell & Bond, 1998). Our focus is on the 17 countries from the MENA region¹ during the period 2002-2018. It must be noted that countries such as, Syria, Yemen, Djibouti, and West Bank & Gaza are excluded from this study due to missing Worldwide Governance Indicators (WGI) data. The following panel data model is inspired from (Shchegolev & Hayat, 2018) equation:

$$\begin{aligned} [\text{GROWTH}]_{it} &= \beta_0 + \beta_1 \text{CORR}_{it} + \beta_2 \text{GOV EF}_{it} + \beta_3 \text{POLIT}_{it} \\ &+ \beta_4 \text{REG QUALITY}_{it} + \beta_5 \text{RULE}_{it} \\ &+ \beta_6 \text{VOICE AND ACC}_{it} + \beta_7 \text{FDI}_{it} + \beta_8 \text{OPEN}_{it} + \varepsilon_{it} \end{aligned}$$

where GROWTH_{it} represents GDP per capita growth rate for country i during time t . The variables describing a country's governance are Corruption (CORR_{it}), Government Effectiveness (GOV EF_{it}), Political Stability and Absence of Violence (POLIT_{it}), Regulatory Quality (REG QUALITY_{it}), Rule of Law (RULE_{it}), Voice and accountability ($\text{VOICE AND ACC}_{it}$).

The data on these variables are collected from Worldwide Governance Indicators (WGI) provided by the World Bank, compiled by (Kaufmann *et al.*; 1999)². In order to unify among Governance indices, we created an index for each theme using principal component analysis (PCA) in Stata, statistical software. Moreover, WGI provides an estimate results of a country's governance performance ranging from -2.5 (weak) to 2.5 (strong). Our study uses the following variables of interest and regrouped into six dimensions of governance:

Voice and accountability: measures the degree of freedom of expression, association, and the free press, as well as how much a citizen may choose their government.

Political Stability and Absence of Violence: determines the possibility that the government will be toppled or destabilized by violent or illegal means, such as terrorism and acts of political violence.

Government Effectiveness: measures the nation's level of political independence, civil service excellence, and dedication to effective policymaking.

¹ The sample used: Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malte, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, United Arab Emirates.

² WGI indicators database and methodology can be accessed from <http://info.worldbank.org/governance/wgi/#home>.

Regulatory Quality: represents how the public views the government's capacity to create and carry out laws and regulations that encourage and permit the growth of the private sector.

Rule of Law: reflects opinions on how much trust agents have in, and adherence to, social norms, the effectiveness of contract enforcement, property rights, the police, the courts, and the frequency of crime and violence.

Control of Corruption: shows how much authority is used for personal benefit, including both small-scale and large-scale corruption, as well as the "capture" of the state by elites and private interests.

For control variables, FDI_{it} appear as foreign direct investment, net inflows (% of GDP), $OPEN_{it}$ serve as Opening rate (In % per year) Measures Exports + Imports as a share of GDP, the data collected from World Development Indicators (WDI).

The GMM method's approach avoids the endogeneity issue that develops when the lag of the dependent variable within explanatory variable is raised. The addition of lags of independent variables serves as an instrument in the system GMM, Obviously a methodology developed respectively by (Arellano & Bover, 1995; Blundell & Bond, 1998; Blundell et al.; 2000). It is well known in the literature that economic growth models are better estimated by using the dynamic panel system GMM, what guides to achieve efficient coefficients (Caselli et al.; 1996; Bond et al.; 2001; Hauk & Wacziarg, 2004).

4. Empirical Result

Data analysis is made using the above described dynamic panel System GMM approach by (Blundell & Bond, 1998). Over the period 2002-2018. Considering that GDP growth as the dependent variable while WGI indices (Voice and accountability, Political stability and absence of violence, Government effectiveness, Control of corruption, Regulatory quality and Rule of Law) and economic development indices (FDI, Trade) are independent variables. Table (1) below depicts the results of the estimating equation:

Table 1. Institutional Quality and Economic Growth: Estimation Results

Dependent variable: Economic Growth

Estimation Method: Dynamic Panel System GMM by (Blundell & Bond, 1998).

Dependent variable: Growth		
	Coef.	P> z
L1.	-0.3823469	0.000***
INDICECOR	2.00156	0.784
INDICEGOV	0.5814909	0.796
INDICEPOL	-3.649183	0.356
INDICEREG	-11.0543	0.055**
INDICERUL	4.084596	0.234
INDICEVOI	-7.098347	0.360
FDI	0.0246454	0.024*
TRADE	0.0511282	0.050**
Number of instruments	143	
Wald chi2(9)	129759.18	
Prob > chi2	0.0000***	
Number of obs	271	
Number of groups	17	
Arellano-Bond test ordre 1	1.1611 0.2456	
Arellano-Bond test ordre 2	-1.1735 0.2406	
Hansen test	8.110314 (1.0000)	

Notes: *, **, *** denotes statistical significance at the 5%, 10%, 1% levels respectively (Student test).

Source: Author's Computation from STATA outputs.

Upon observing table 1, it is apparent that Governance Indices, such as Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Control of Corruption, and Rule of Law, have a negative and insignificant effect (10%) on economic growth, except for the Regulatory Quality index. The latter has a significant effect but with a negative sign. Meanwhile, FDI (Foreign direct investment, net inflows (% of GDP)) and Trade (Exports + Imports/GDP) are positively and significantly (10%) affecting the MENA region's economic growth.

Moreover, no significant relationship is observed between WGI indices and economic growth in the MENA countries. On one hand, this finding does not go hand in hand with some researchers' work, who have argued, in the above-mentioned literature, that nations with a better institutional framework tend to have a better

economic performance (Kaufmann et al.; 1999; Rodrik et al.; 2004; Acemoglu et al.; 2005). On the other hand, the findings of this paper align with the view of particular scholars, who have carried out research on the issue of governance and economic growth in the MENA countries by highlighting the harmful impact of the economic repercussions, due to the recent political issues in the region (Labidi & Oueslati, 2015; Arayssi et al.; 2019; Emara & El Said, 2021; Msann & Viswanthan, 2023; Albaity et al.; 2021; Mallek et al.; 2022; Albaity et al.; 2023).

Since 2011, multiple revolutions and political transformations have occurred in many Arab countries, which revealed pervasive corruption, especially in the political sector. However, uprisings that took place in the MENA area beginning 2010 and 2011, created a wave of protests in Tunisia, Egypt, Yemen and Libya. But the rebellion that some protesters demonstrated have turned into a civil war in several countries, including Syria, Iraq, Libya and Yemen. Underlying all uprisings was a general dissatisfaction with economic conditions, including not only poverty but also growing income disparities in several Arab countries. Along these lines, a notable number of academic literature incorporate issues of income disparities as one of the main reasons that fueled the Egyptian revolution (Hlasny & Verme, 2013; Ncube et al.; 2014). A famous notion suggests that income inequality is strongly associated with political violence and popular revolutions, as in the case of the economic ramifications caused by the political instability that the region has witnessed, widely known as the Arab Spring.

In a similar vein, (Acemoglu et al.; 2018) postulates that the Arab Spring events resulted in marginally less efficient financial markets, which in turn caused a decline in regional economic development. Compared to oil-producing countries, non-oil producing nations experienced more difficulties as a result of the Global Financial Crisis (GFC), which had a more detrimental impact on growth than the Arab Spring (International Monetary Fund, 2014).

It is widely accepted that the economic shocks or financial crisis could have serious obstacle for investors. Therefore, this topic has attracted many researchers to investigate the Latin American crisis of 1994-1995 (Fratzscher 1998), Asian crises of 1997 (Fratzscher, 1998; Berg & Pattillo, 1999; McKenzie, 2007), Russian crisis 1998 (Pinto & Ulatov, 2010), technology bubble collapse of 2000 (Perez, 2009). On the sidelines of these crises, recently many studies have questioned the relationship of the global financial crisis (GFC) 2008-2009 with economic growth (Tabata, 2009; Schoenbaum, 2012; Ahmad et al.; 2016; Dao, 2017; Raza & Abd Karim, 2017; Wang et al.; 2017).

In light of this, (Abdelsalam, 2020) study focused on the MENA region countries over the period 1970–2018. The study found that an increase in oil prices positively impacted oil exporting countries, but negatively impacted oil-importing countries. Overall, the MENA region has shown extreme vulnerability to global, financial, and

political crises, which negatively impacted its opportunities of achieving economic growth.

Our estimation results also provide that trade has a positive and significant impact on economic growth in MENA countries. This result has been found in the work of (Dollar, 1992; Edwards, 1998; Harrison, 1996; Lee, 1993; Sachs & Warner, 1995; Wacziarg, 1998; Busse & Königer, 2012), revealing that fight against trade barriers induces higher and more inclusive economic growth. Indeed, on the commercial level, the opening of the region to the rest of the world has contributed to economic development. Similarly, the signing of free trade agreements, such as the Euro-Mediterranean Partnership, has allowed the MENA region to reduce trade and commercial barriers.

As for the foreign direct investment, net inflows (% of GDP), the results showed a positive and significant effect on economic growth in the MENA countries. Which is in line with the studies by (Borensztein et al.; 1998; Bengoa & Sanchez, 2002; Campos & Kinoshita, 2002; De Gregorio & Lee, 1995). Moreover, it seems that the institutional environment is a decisive element in regard to the location choices of foreign investors. Local business framework and institutional conditions, including control of corruption, Bureaucratic efficiency, and political stability are determining factors in the location of FDI (Globerman & Shapiro, 2002; Bénassy-Quéré et al.; 2007; Wang et al.; 2013). Furthermore, MENA countries are invited to enhance their institutional environments in order to foster an investment climate that will attract foreign investments.

5. Conclusion

The objective of this paper was to empirically examine the relationship between economic growth and governance in the MENA countries over the period 2002-2018. The study used Governance Indicators (WGI) provided by the World Bank, compiled by (Kaufmann et al.; 1999) and a dynamic panel System GMM approach by (Blundell & Bond, 1998).

The results shows that Governance Indices, such as Voice and accountability, Political stability and absence of violence, Government effectiveness, Control of corruption, Rule of Law, and Regulatory quality has an insignificant effect on Economic growth. This is due to the different crises that the MENA region witnessed on the financial level (GFC), as well as the recent political reconfigurations as it is commonly known by the Arab Spring. The latter has made the region vulnerable to global, financial and political crises, negatively impacting its prospects of economic growth.

As for Trade (Exports + Imports/GDP) and the foreign direct investment, net inflows (% of GDP), the results showed a positive and significant effect on economic growth in MENA countries. In fact, on the commercial level, the opening of the region has contributed to economic development. Likewise, the signing of free trade agreements, particularly, the Euro-Mediterranean Partnership, has allowed the region to reduce the effects of trade and commercial barriers. Thus, it appears that FDI is as a key factor of economic growth, whereas the institutional environment significantly promotes the direction of FDI localization in the host economy (Acemoglu et al.; 2002; Cantwell et al.; 2010). However, the region would still suffer from long term implications of corruption that has hit a number of countries. This would make said nations unfavourable to capital inflows, which would bring about a harmful effects on economic growth.

In this perspective, the countries of the MENA region are being asked to implement a well-established institutional framework, including fighting corruption, in order to attract more foreign investments and capitals. In turn, policymakers must improve economic, security, and social conditions in the MENA countries to reach a democracy that is adequate for stimulating economic growth, as well as attracting capital inflows and outflows.

This paper can be further extended by research through the application of different estimation techniques, particularly a threshold approach focusing on how institutions' quality affects the FDI-growth nexus in the region. Further studies might shed light on the representation of the new MENA countries entering the oil export category, such as Lebanon. From another perspective, this study can be applied for a comparison between MENA oil exporters and other oil exporters outside the region, such as Canada, Norway, and Malaysia, to draw a picture on the role of the institutional environment in the process of economic diversification.

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