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Economic Policy, Institutional Development, and Income Growth:

How Arab Countries Compare with Other Developing Countries

by

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Abstract

Similar to most other developing countries, almost all Arab countries failed to catch up economically with advanced industrial countries. This paper discusses three possible explanations of the disappointing growth performance: (i) an insufficient reform-mindedness of developing country governments, (ii) counterproductive policy recipes of the Washington Consensus and (iii) more deeply rooted barriers to growth related to institutional deficiencies prevailing in various developing countries. The empirical evidence for Arab countries and other developing countries provides little support to the first two hypotheses. By contrast, institutional development is shown to have a significant impact on policy-related variables and the growth performance of developing countries. For Arab countries as a group, institutional development is more advanced than for the control group of other developing countries. Yet, serious institutional deficiencies tend to constrain future growth in several Arab countries. These findings have important implications for national policymakers and the international community.

Keywords: Washington Consensus, implementation deficits, effectiveness of reforms, institutional growth determinants

JEL classification: O10, O57

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I. Introduction

Developing countries have performed vastly different in terms of per-capita income growth since 1980. For most of them, hopes that globalisation would render it easier to catch up economically to advanced industrial countries were frustrated. Arab countries are no exception in this regard, as Section II will show. The major objective of this paper is to discuss alternative explanations of divergent growth trends in the past and to derive policy conclusions as to how the growth performance may be improved in the future.

The reasons why only few developing countries narrowed the income gap to industrial countries are highly disputed. The World Bank and the IMF maintain that economic policy prescriptions according to the so-called Washington Consensus (Williamson 1990) were essentially correct and effective. These institutions tend to blame the developing countries for not having followed external advice, or having implemented policy reforms at best partially. In a similar vein, a recent report published by the Study Group on Middle East Trade Options of the Council on Foreign Relations argues that the poor economic performance of many countries in the Middle East and North Africa (MENA) is largely due to domestic economic policy failure (Hoekman and Messerlin 2002).

The major responsibility for the poor growth record would then rest with the developing countries themselves. By contrast, various critics of the World Bank and the IMF argue that the standard recipes utterly failed to deliver what had been promised by their proponents. We will check both claims in Sections III and IV.

We then turn to a third explanation of the divergent growth patterns. According to the hypothesis advanced by prominent development economists in recent years, the Washington Consensus was hardly effective in inducing catching-up processes because it ignored more deeply rooted barriers to growth, notably the institutional deficiencies prevailing in many developing countries (Section V). Section VI summarizes and offers some policy conclusions for national policymakers and the international community.

In order to assess the experience of Arab countries, a large group of developing countries in Africa, Asia, and Latin America serves as the point of reference. The comparison between Arab countries and the control group of other developing countries relates to growth performance, economic policies, and institutional development as well as the links between these three factors. The focus of the subsequent analysis is on Arab countries which are members of the

Arab Planning Institute (API).[1] In addition, some references are made to Algeria (A), Morocco (Mo), and Saudi Arabia (SA).

II. Catching Up and Falling Back

The evidence presented in this section supports the view that the economic performance of many Arab countries during the past decades has been "disappointing" (Hoekman and Messerlin 2002: 1). The economic growth performance of Arab countries and other developing countries is measured in the following by relating their per-capita income (in PPP terms) to the per-capita income of the United States (representing the group of advanced industrial countries) and by comparing this relative income measure between the years 2000 and 1980:

$$GNIUS^i = \frac{GNI00^i}{GNI00^{US}} : \frac{GNI80^i}{GNI80^{US}}$$

with i=sample countries.

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[1] This focus is because this paper was motivated by a conference on "Institutions and Development Performance" organized by the Arab Planning Institute. API members are (abbreviations used below are given in parentheses): Bahrain (B), Egypt (E), Iraq (I), Jordan (J), Kuwait (K), Lebanon (Le), Libya (Li), Mauritania (M), Oman (O), Qatar (Q), Sudan (Su), Syria (Sy), Tunisia (T), United Arab Emirates (U), and Yemen (Y).

According to this formula, GNIUS = 1 represents the dividing line between developing countries which caught up to the United States (GNIUS > 1) and those which fell further back (GNIUS < 1).

Figure 1 shows that less than one quarter of the 88 sample countries achieved a higher growth of per-capita income than the United States. A few impressive cases of catching up contrast sharply with many developing countries which fell back significantly. Among API members for which sufficient income data are available from the World Bank (2002), only Egypt narrowed the income gap, whereas the per-capita income increased by less than in the United States, or even decreased, in eight API member states (as well as in Algeria, Morocco, and Saudi Arabia).[2] The decline in the relative income position was most pronounced for the United Arab Emirates and Kuwait, i.e., two API members which are extremely dependent on oil. This is not surprising considering that oil prices were exceptionally high at the beginning of the observation period.

The negative bias for major oil exporters resulting from the peak in oil prices in 1980 can be reduced, though not eliminated, by calculating GNIUS for a shorter

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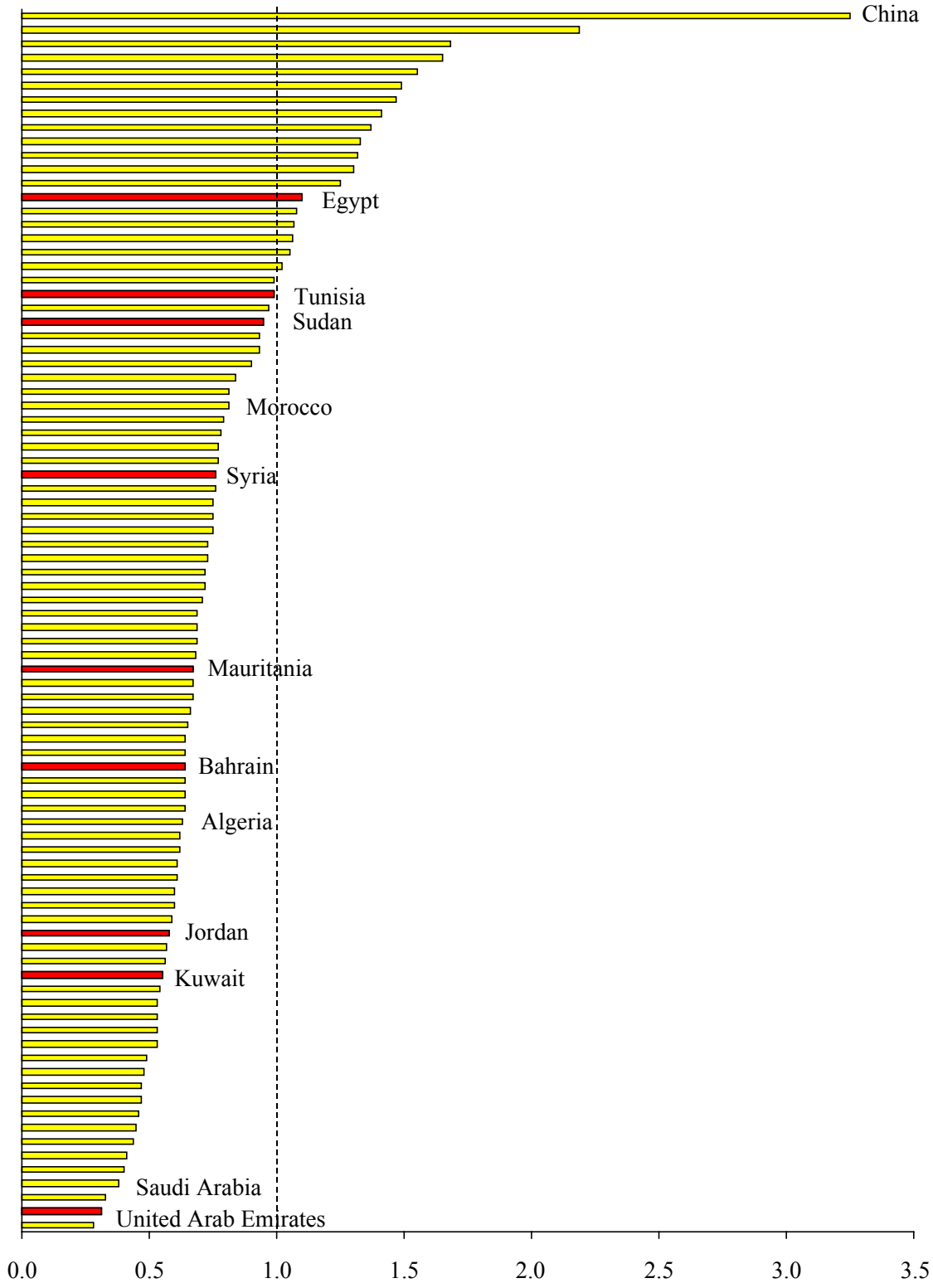
[2] For the development of per-capita income in API member countries with sufficient data, see also Annex Figure 1.

Figure 1 — Catching Up and Falling Back of Developing Countries[a], 1980–2000



[a]Change in per-capita income (PPP) relative to the United States. The vertical line represents the dividing line between countries that fell back and countries that caught up. For calculation procedure, see the text; Bahrain: 1980-1999; UAE: 1980-1998.

Source: World Bank (2002).

period of observation. If 1983 (instead of 1980) is taken as the base year,[3] the growth performance of the group of nine API members turns out to be more favourable (Table 1). While the average of GNIUS increases slightly if the calculation is restricted to 1983–2000, the rise in the median of GNIUS is fairly pronounced. Nevertheless, it remains true that the relative income position of API members deteriorated until the end of the millennium. The average and the median of GNIUS both remain significantly below one. Moreover, the average of GNIUS, though not the median, continues to be smaller for API members than for other developing countries.

Table 1 — Changes in Per-capita Income, Relative to the United States, for API Members[a] and Other Developing Countries: Alternative Calculations of GNIUS[b]

GNIUS	API		Other
	1980–2000	1983–2000	1980–2000
Average	0.73	0.78	0.83
Median	0.67	0.82	0.69

[a]Nine countries with sufficient data, as listed in Figure 1. – [b]See text for calculation formula. Values below one indicate that the relative income position of the countries under consideration deteriorated.

Source: World Bank (2002).

[3] We choose 1983 as the base year in our modified calculations because two major oil exporters (Bahrain and Kuwait) experienced the low point in per-capita income in the previous year, while the per-capita income of the United Arab Emirates continued to decline until 1986; see Annex Figure 1.

III. How Relevant Are Implementation Deficits?

As mentioned in the Introduction, international financial institutions tend to blame developing countries for an insufficient reform-mindedness and implementation deficits, resulting in their fairly disappointing growth performance. For instance, the World Bank (1997) reported that only about one quarter of African countries which received structural adjustment loans during the period 1980–1996 fulfilled to a sufficient extent the policy conditions attached to these loans. As concerns IMF programmes, Bird (2001: 1855–6) concluded: "The most recent evidence suggests that more than two-thirds of programs are poorly implemented and break down." The disappointing growth performance of countries in the MENA region is attributed to two policy failures in the report by the Study Group on Middle East Trade Options of the Council on Foreign Relations: "One important explanation is the failure to develop links with the global economy through foreign investment and trade in services and goods other than oil. A second reason is that most of the governments in the Middle East and North Africa have made scant headway in reducing the interventionist role of the state in the economy" (Hoekman and Messerlin 2002: 1).

Yet, the proposition of an insufficient reform-mindedness of developing countries rests on weak empirical foundations. We consider several variables in the following that can be shaped by national economic policies. These policy-

related variables reflect the request of international financial institutions for macroeconomic stabilisation, factor accumulation, trade liberalisation and openness to foreign direct investment (FDI).[4] Macroeconomic stabilisation efforts are captured by two variables: (i) annual average rates of inflation and (ii) government consumption expenditure in per cent of GDP. Investment in physical and human capital is proxied by gross fixed capital formation in per cent of GDP and average years of schooling, respectively. Trade-policy-related variables include the share of imports and exports in GDP as well as import tariff revenues in per cent of import value.[5] Finally, openness to FDI is measured by FDI inflows and inward FDI stocks, both related to the host country's GDP.

The question we are interested in is how these variables, which reflect the major thrust of the Washington Consensus, developed over time. If most developing countries had refused to implement the Washington Consensus, economic stability indicators should have deteriorated, investment in physical and human capital should have declined, and countries should not have opened up to trade and FDI.

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[4] For detailed definitions of variables and statistical sources, see the Annex.

[5] We prefer import tariff revenues over mean tariff rates as the World Development Indicators of the World Bank present comprehensive time series data only for the former variable. Data on mean tariff rates from this source are deficient in particular with regard to API members; it is only for Oman and Tunisia that mean tariff rates are given for both the early 1990s and more recent years.

By contrast, the evidence on policy-related variables presented in Table 2 suggests that the economic policies pursued by API members and other developing countries were in accordance with the Washington Consensus in various respects:

- Compared to the median for other developing countries, inflation in API member countries was fairly low in the early 1980s already. Inflation was further reduced to a very low median in recent years.[6]

- Government consumption, as a share of GDP, was slightly higher in API member countries than in other developing countries, but curtailed by about two percentage points in both country groups.

- The evidence on factor accumulation is mixed. The share of gross fixed capital formation in GDP fell in both country groups, though considerably more so for API members.[7] On the other hand, human capital formation, proxied by average years of schooling, improved more pronouncedly for API members (and Algeria).

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[6] Essentially the same applies to Algeria, Morocco, and Saudi Arabia. Significant improvements in macroeconomic policies in the MENA region are stressed by Hoekman and Messerlin (2002: 6).

[7] The share of gross fixed capital formation in GDP declined most dramatically in Bahrain and Jordan (World Bank 2002). Non-member countries, notably Algeria and Saudi Arabia, also reported declining investment ratios.

Table 2 — Policy-related Variables[a]: Median for API Member Countries and Other Developing Countries

	API[b]		Other	
	1980–1983[c]	1997–2000[c]	1980–1983[c]	1997–2000[c]
Inflation	7.8 (B, E, J, K, Q, Su, Sy)	1.6	13.1	6.5
Government consumption	17.4 (B, E, J, K, M, Sy, T)	15.7	14.4	12.5
Gross fixed capital formation	27.7 (B, E, J, K, Su, Sy, T)	20.2	21.6	20.2
Years of schooling[d]	3.3 (B, E, I, J, K, Su, Sy, T)	5.6	3.3	5.1
Imports	43.6 (B, E, J, K, M, Su, Sy, T)	40.9	31.5	35.3
Import tariff revenues	13.6 (B, E, J, K, O, Su, Sy, T)	9.7	12.1	8.8
Exports	38.8 (B, E, J, K, M, Su, Sy, T)	41.5	22.2	28.2
FDI inflows	1.6 (E, J, K, M, O, Su, Sy, T)	0.9	0.4	2.2
Inward FDI stocks[d]	1.7 (all except I, Li, M)	12.3	4.3	24.2

[a]For definition of variables and statistical sources, see Annex. – [b]In parentheses: API members for which data are available in both periods. – [c]Annual averages if not stated otherwise. – [d]1980 and 2000, respectively.

Source: World Bank (2002); Barro and Lee (2002); UNCTAD (2002).

- Import tariff revenues accounted for less than 10 per cent of the import value in both county groups in recent years. The trend towards import liberalisation is also reflected in the increasing import share in GDP in other developing countries, though not in API member countries. The ambiguous picture for Arab countries is in line with the findings reported in Hoekman and Zarrouk (2000: 2), who conclude: "Virtually all Arab countries ... have undertaken major steps to implement tariff and fiscal reforms and to dismantle quantitative import restrictions. Notwithstanding these efforts, the pace of integration into the world economy achieved by the region has been slow". High transaction costs associated with international trade are attributed to inefficiencies in customs clearance procedures, administrative red tape, and deficient transportation and telecommunication services in many Arab countries.[8]

- The ratio of inward FDI stocks to GDP soared in both country groups, which is consistent with the worldwide trend towards the liberalisation of FDI regulations reported by UNCTAD (2002: 7). However, the median of this ratio for API members remained substantially below the median for other developing countries. This is consistent with Nabli and De Kleine

[8] For recent survey results on barriers to trade and investment in the MENA region, see Zarrouk (2002). According to Hoekman and Messerlin (2002: 8), many countries in the MENA region maintain relatively high trade barriers in the form of tariffs.

(2000), who found FDI flows to Arab countries to be relatively small and concentrated in a limited number of sectors.[9]

All this does not invalidate the claim of international financial institutions that the implementation of policy conditions attached to World Bank and IMF loans was incomplete in various cases. On average, however, Arab countries as well as the large group of other developing countries have clearly moved in the direction suggested by the Washington Consensus. This invites the next question: Are widening income gaps to be attributed to counterproductive policy recipes of the Washington Consensus, rather than the reluctance of policymakers in developing countries to follow the conventional wisdom?

IV. How Effective Are Conventional Policy Reforms?

Globalisation critics have long argued that the Washington Consensus bodes developing countries no good. Furthermore, prominent economists such as Easterly (2001) and Stiglitz (2002) have highlighted the shortcomings of conventional policy recipes recently. Hence, there is sufficient reason to check the effectiveness of policy-related variables in helping developing countries to catch up economically to advanced industrial countries. This is done in the

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[9] Likewise, Hoekman and Messerlin (2002: 8) point to the limited magnitude of FDI flows to the MENA region.

following by correlating the variables introduced in the previous section with our measure of relative growth performance (GNIUS). Based on these cross-country correlations for the overall sample, we assess how API members fit into the general pattern for all developing countries.

Data constraints prevent us from introducing policy measures such as monetary restraint, investment incentives, import liberalisation, and FDI deregulation directly into the correlation analysis. Rather, we capture important transmission mechanisms (macroeconomic stability, factor accumulation, trade intensity, and inward FDI) through which policy measures may impact on economic growth. The policy-related variables are largely defined as before. However, the subsequent cross-country analysis requires some adjustments. Inflation (INF), government consumption (GOV), gross fixed capital formation (GFCF) and FDI inflows (FDIFL) are calculated as annual averages for the whole period of observation (1980–2000). Data on years of schooling (SCHOOL) and inward FDI stocks (FDIST) refer to 1980, in order to contain endogeneity problems and capture the effects of these variables on subsequent growth. Finally, the shares of imports and exports in GDP, which are supposed to reflect developing countries' openness to trade, are corrected for country size. We run a simple regression of these shares on the population of developing countries (not shown)

and take the residuals (RESIDIM and RESIDEX, respectively) as openness indicators, in order to avoid a large-country bias.[10]

Table 3 presents the correlation matrix for the overall sample, including API member countries for which the relevant data are available. It turns out that the claim of globalisation critics, according to which policy reforms along the lines suggested by the Washington Consensus are counterproductive, is grossly exaggerated. None of the correlations between policy-related variables and the growth performance of developing countries (GNIUS) supports the view that conventional economic policy measures which were taken in the context of stabilisation and structural reform programmes, and which have shaped the indicators considered here, were detrimental to growth. The correlation coefficients reported in the first column of Table 3 rather suggest that such measures helped higher growth, notably by encouraging factor accumulation and promoting openness to trade.

First of all, higher investment in physical capital (GFCF) is associated with higher growth. The particularly strong correlation between GFCF and GNIUS may be surprising considering that physical capital accounts for only one-third

[10] Note that larger countries typically report smaller trade shares. For details of calculation, see Annex.

Table 3 — Policy-related Variables and the Growth Performance of Developing Countries[a]: Cross-Country Correlations

	GNIUS	INF	GOV	GFCF	SCHOOL	RESIDIM	RESIDEX	FDIFL
INF	–0.15							
GOV	–0.18	–0.03						
GFCF	0.54***	–0.15	0.25**					
SCHOOL	0.28**	–0.01	0.08	0.38***				
RESIDIM	0.31***	–0.11	0.40***	0.62***	0.23**			
RESIDEX	0.26**	–0.14	0.18*	0.42***	0.35***	0.74***		
FDIFL	0.20*	–0.02	0.29***	0.49***	0.34***	0.60***	0.51***	
FDIST	0.17	–0.05	–0.00	0.15	0.23**	0.44***	0.51***	0.33***

[a]For detailed definitions of variables and statistical sources, see Annex. The number of observations ranges from 67 to more than 100. *** denotes statistical significance at the 1 per cent level; ** 5 per cent level; * 10 per cent level (two-tailed test).

Source: World Bank (2002); Barro and Lee (2002); UNCTAD (2002).

of total production so that strongly diminishing returns to investment are to be expected (Easterly 2001: Chapter 3). However, the positive correlations between GFCF, SCHOOL, RESIDIM and FDIFL indicate that physical capital formation, typically, did not take place in isolation; it went hand in hand with human capital development and productivity-enhancing technology transfers via imports of capital goods and FDI inflows, which counteracted diminishing returns to investment.

Second, the correlation between human capital formation and growth also turns out to be significantly positive, but the correlation coefficient is considerably smaller than in the case of GFCF. The latter finding points to the limitations of average years of schooling as a proxy of human capital formation; SCHOOL captures neither the quality of schooling nor the importance of vocational training. Third, in addition to domestic factor accumulation, openness to trade (reflected in RESIDIM and RESIDEX) appears to have helped developing countries to catch up economically to advanced industrial countries.

All this is not to ignore that the effectiveness of conventional policy reforms was less than hoped for by the proponents of the Washington Consensus. For instance, macroeconomic stabilisation by fighting inflation (INF) and reducing government consumption (GOV) is not significantly correlated with higher growth. This is probably because macroeconomic stabilisation, though often required for sustainable growth, constrained growth in the short run.[11] Furthermore, the relation between FDI and growth remains ambiguous. The finding that FDI inflows (FDIFL), but not previous FDI stocks (FDIST), are associated with higher growth is consistent with the recent academic literature on this issue and puts into question the euphoria currently prevailing among

[11] The insignificant correlation between INF and GNIUS may also indicate that the average level of inflation matters less for growth than the volatility of annual inflation rates.

policymakers about FDI as a stimulus to growth.[12] It should be noted that the positive correlation between FDIFL and GNIUS may be because higher FDI inflows are induced by a favourable growth performance of host countries, rather than higher growth being the result of higher FDI inflows.

The correlations reported in Table 3 have to be qualified in another respect. Elsewhere we have shown that the relation between policy-related variables and economic growth weakens considerably if the calculation is restricted to the subsample of developing countries with a per-capita income of less than 1500 US$ in 1980 (Nunnenkamp 2003b). Several API members belong to this group, including Egypt, Mauritania, Sudan and Yemen. None of the openness indicators (RESIDIM, RESIDEX, FDIFL, and FDIST in Table 3) was associated with higher growth for the subsample of poor developing countries. In other words, openness to trade and FDI appears to have failed in inducing catching-up processes exactly where they were needed most.

As concerns FDI, this finding is again in line with much of the relevant literature. In one way or another, recent empirical studies corroborate the proposition that developing countries must have reached a minimum level of economic development before they can capture the growth-enhancing effects of

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[12] For a literature review and new findings on the link between FDI and economic growth in developing countries, see Nunnenkamp and Spatz (2003) and Nunnenkamp (2003a).

FDI (Nunnenkamp and Spatz 2003; Nunnenkamp 2003a). In addition, certain types of FDI are fairly unlikely to deliver significant growth effects. FDI aiming at the exploitation of natural resources, including oil, in the host countries is often concentrated in foreign-dominated enclaves with few linkages to the local markets. Rather than stimulating economic growth though spillovers, resource-seeking FDI in the primary sector might lead the host country into some form of "Dutch Disease" (i.e., real currency appreciation not backed by productivity increases).

In the remainder of this section, we show how Arab countries fit into the picture drawn for all developing countries. The presentation is restricted to those policy-related variables which were shown before to be significantly correlated with growth.[13] Annex Figure 2 reveals the position of Arab countries with sufficient data in four scatter diagrams which plot policy-related variables against growth. In Table 4, we summarize the evidence by ranking Arab countries according to relevant policy-related variables.

The following observations deserve to be mentioned. Among the four policy-related variables, insufficient human capital formation is most likely to hinder economic growth in API member countries. While gross fixed capital formation

[13] Moreover, we focus on RESIDIM as an indicator of openness to trade. Unreported results for RESIDEX are very similar to results for RESIDIM.

Table 4 — Ranking of Arab Countries[a] according to Relevant Policy-related Variables

	Gross fixed capital formation (1980-2000) GFCF		Years of schooling (1980) SCHOOL		Import residual (1980-2000) RESIDIM		FDI inflows (1980-2000) FDIFL	
Above median	*Algeria*	(*28.9*)	Kuwait	(4.5)	Bahrain	(42.3)	Tunisia	(2.1)
	Tunisia	(27.2)	Jordan	(4.3)	Jordan	(32.0)	Egypt	(1.9)
	Jordan	(26.8)	Syria	(3.7)	Lebanon	(21.7)	Jordan	(1.3)
	UAE	(24.9)	Bahrain	(3.6)	Mauritania	(19.3)	Oman	(1.2)
	Egypt	(23.9)			Kuwait	(4.3)		
	Bahrain	(23.4)			Tunisia	(1.8)		
	Syria	(22.7)			UAE	(-1.1)		
	Morocco	(*22.6*)			Qatar	(-5.4)		
	Mauritania	(22.1)			Yemen	(-5.4)		
	Saudi Arabia	(*21.4*)			*Saudi Arabia*	(*-5.7*)		
					Oman	(-5.8)		
Below median	Yemen	(19.9)	Tunisia	(2.9)	Libya	(-9.0)	Mauritania	(0.8)
	Kuwait	(17.9)	*Algeria*	(*2.7*)	Egypt	(-9.6)	Sudan	(0.6)
	Sudan	(13.7)	Iraq	(2.7)	*Morocco*	(*-11.0*)	Lebanon	(0.5)
			Egypt	(2.3)	Syria	(-11.1)	*Morocco*	(*0.5)*
			Sudan	(1.1)	*Algeria*	(*-17.0*)	Syria	(0.5)
			Yemen	(0.3)	Sudan	(-25.1)	Kuwait	(0.1)
							Algeria	(*0.1*)

[a]For Arab countries not listed, the relevant data are not available. The median serving as the dividing line is for the sample of all developing countries.

Source: see Annex Figure 2.

(GFCF) exceeded the median for all developing countries in seven out of ten API member countries,[14] average years of schooling (SCHOOL) were fairly low by developing-country standards in various API member countries with data for this variable. The latter finding is in line with Hoekman and Messerlin (2002:

[14] This was also true for Algeria, Morocco, and Saudi Arabia.

23) who argue: "Although education has improved in the MENA region, it still lags behind the rest of the world". Similar to domestic factor accumulation, Table 4 points to an ambiguous position of API members with regard to openness. On the one hand, most of them were open to trade when the median of country-specific import residuals (RESIDIM) is taken as a yardstick.[15] On the other hand, FDI inflows remained below the median for all developing countries in five out of nine API member countries (in Algeria and Morocco, too). As argued above, however, minor FDI flows might be less damaging to growth than insufficient schooling in poor API members such as Mauritania and Sudan.

At the same time, the ranking of API members presented in Table 4 underscores the elusive relation between policy-related variables and economic growth. For only some API members, the ranking resembles their position with regard to growth as given in Figure 1. Bahrain, Mauritania and Syria, whose growth performance was in the medium range, rank close to the median in Table 4, too, notably with regard to GFCF and SCHOOL. Egypt and Tunisia, the best growth performers among API members, rank favourably in terms of GFCF and FDI inflows. For both countries, however, average years of schooling (SCHOOL) are

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[15] In contrast to the change in the share of imports in GDP reported in Table 2 above, the result for RESIDIM is in some conflict with Hoekman and Zarrouk (2000), who argue that the world-market integration of Arab countries is relatively weak. However, Hoekman and Messerlin (2002: 8) find a similarly ambiguous picture with regard to the *level* and the *change* of openness to trade in the MENA region.

low by developing-country standards. The opposite pattern (low values of GFCF and FDIFL, but the best value of SCHOOL) is observed for Kuwait, whose growth performance heavily depends on the period of observation (see above on oil prices).

The rankings with regard to policy-related variables and growth differ most strikingly in the cases of Sudan and Jordan. Sudan's record is extremely poor in terms of openness to trade and domestic resource mobilisation. Weak incentives for domestic resource mobilisation can be attributed to the civil war in this country. Against this backdrop, it is highly unlikely that Sudan can sustain its relatively favourable growth performance reported in Figure 1. Political developments are crucially important in the case of Jordan, too, which suffered from the embargo against neighbouring Iraq. In the past, Jordan's relative income position deteriorated significantly, even though this country is rated favourably in all four policy dimensions. Jordan thus represented the clearest example among API members suggesting that domestic resource mobilisation as well as openness to trade and FDI are not sufficient conditions for high growth of per-capita income.

V. How Influential Is Institutional Development?

In the previous section, we rejected the view that policy reforms along the lines of the Washington Consensus are counterproductive for economic growth in

developing countries. It turned out, however, that the effectiveness of conventional policy reforms cannot be taken for granted. The experience of API member countries suggests that the relation between policy-related variables and economic growth is loose at best. Ambiguities are partly due to exogenous factors, among which world-market prices for commodities, notably oil, play a crucially important role for some API members (see also Yeats and Ng 2000: 40). Yet, recent research invites an additional explanation for the ambiguous relation between conventional policy reforms and economic growth. Easterly and Levine (2002: 33) argue that "bad policies are only symptoms of longer-run institutional factors, and correcting the policies without correcting the institutions will bring little long-run benefit." Likewise, Acemoglu (2003) stresses the role of institutions as a *fundamental* cause of divergent economic fortunes, whereas policy-related variables such as investments and education are considered only *proximate* causes. According to Rodrik and Subramanian (2003: 34), the primacy of institutions implies that "conditionality on policies [as required by the IMF and the World Bank] is often ineffective."[16]

[16] Factors related to geography, notably infectious diseases, high transport costs and low agricultural productivity in tropical areas, may represent another fundamental cause of divergent growth experiences. The geography hypothesis, the most prominent proponent of which is Sachs (2001), is not discussed here as most API members are not located in the tropics.

In the following, we proceed as in the previous section: First, we present cross-country correlation results based on the overall sample, in order to assess the general relevance of institutional factors. Second, we check how institutional development in Arab countries compares with that in the control group of other developing countries. As concerns institutional development, we refer to the widely used data presented by Kaufmann et al. (2002). This source comprises six indicators, all of which range from –2.5 to 2.5 (with higher values indicating better institutions): voice and accountability (VOICE), political stability (POLSTAB), government effectiveness (GOVEFF), regulatory quality (REG), rule of law (LAW), and control of corruption (COR). These factors are supposed to shape the incentive structure of economic agents. Hence, they are likely to affect policymaking, factor accumulation and, eventually, economic growth.[17]

And indeed, according to the correlations reported in Table 5, it would be unreasonable to assume that policy-related variables are truly exogenous growth determinants. All four policy-related variables that turned out to be relevant for growth in the previous section are correlated with institutional factors. Measuring institutional development by the average of the six indicators (INST),

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[17] Studies on the determinants of international differences in the *level* of per-capita income use instrumental variables for institutional development. This is because institutional development, typically, is more advanced in higher-income countries. However, endogeneity problems are less relevant in the present context of analysing medium-term growth trends.

better institutions are associated with higher domestic factor accumulation (GFCF, SCHOOL) as well as more open trade and FDI policies (reflected in RESIDIM and FDIFL). The rule of law, i.e., the protection of persons and property, the availability of independent judges and effective contract enforcement, appears to be most important for physical capital formation. Average years of schooling are correlated most strongly with effective control of corruption and the rule of law. If corruption is pervasive, opening up to trade and attracting FDI inflows seem less likely.

Table 5 — Institutional Factors, Policy-related Variables and Economic Growth in Developing Countries[a]: Cross-Country Correlations

	GFCF	SCHOOL	RESIDIM	FDIFL	GNIUS
INST	0.35***	0.64***	0.41***	0.34***	0.35***
VOICE	0.16	0.45***	0.14	0.01	0.08
POLSTAB	0.24**	0.48***	0.28***	0.23**	0.31***
GOVEFF	0.27**	0.57***	0.44***	0.30***	0.34***
REG	0.22**	0.52***	0.22**	0.04	0.25**
LAW	0.38***	0.60***	0.42***	0.10	0.40***
COR	0.30***	0.61***	0.52***	0.40***	0.34***

[a]For detailed definitions of variables and statistical sources, see Annex. The number of observations ranges from 74 to more than 100. *** denotes statistical significance at the 1 per cent level; ** 5 per cent level; * 10 per cent level (two-tailed test).

Source: World Bank (2002); Barro and Lee (2002); Kaufmann et al. (2002).

Against this backdrop, it is no longer surprising that institutional development appears to be crucially important for developing countries to catch up economically to advanced industrial countries. The correlation analysis suggests that the relative growth performance of developing countries, measured by GNIUS, improves most significantly when developing countries adhere to the rule of law. Other institutional factors that turn out to be relevant for growth include the control of corruption and government effectiveness.

From an institutional perspective, the prospects for sustainable growth of per-capita income appear to be slightly better for the group of API members than for the control group of other developing countries. Table 6 reveals that the median of INST (representing the average of all six institutional indicators) is less negative, i.e., more favourable, for API members than for other developing countries. A similar picture emerges for all individual indicators, except VOICE which, according to the evidence presented in the last column of Table 5, is the least important institutional growth determinant. API members compare most favourably with other developing countries with respect to LAW, i.e., the most important institutional growth determinant identified above. By contrast, the median of COR, which represents another important institutional factor, is only slightly better for API members than for other developing countries.

Table 6 — Institutional Development:[a] API Member Countries and Other Developing Countries, 1997/98

	API members			Other developing countries
	Median	Top3[b]	Bottom 3[b]	(median)
Voice and accountability	-0.67	J, K, Le (-0.08)	Sy, Su, I (-1.54)	-0.26
Political stability	-0.06[c]	Q, O, U (1.04)	Y, Su, I (-1.82)	-0.33
Government effectiveness	0.04[c]	O, T, J (0.72)	Li, Su, I (-1.63)	-0.29
Regulatory quality	0.10	B, T, J (0.53)	Sy, Li, I (-2.14)	-0.04
Rule of law	0.26	Q, O, K (1.08)	Li, Su, I (-1.43)	-0.40
Control of corruption	-0.24[c]	K, Q, O (0.56)	Li, Su, I (-1.05)	-0.32
Average of six indicators	-0.02[c]	Q, O, K (0.47)	Su, Li, I (-1.58)	-0.26

[a]Indicator values range from –2.5 to 2.5, with higher values corresponding to better institutional development. – [b]In descending order; average indicator value in parentheses. – [c]Excluding Mauritania for lack of data.

Source: Kaufmann et al. (2002).

However, the comparison between API members and the control group of other developing countries obscures that institutional development varies tremendously among the former. The average indicator value for the three countries which rank most unfavourably among API members (bottom 3 in Table 6), typically, is –1.5 or worse, whereas the average indicator value for the three best-rated API members (top 3) is 0.5 or better (except VOICE). In other

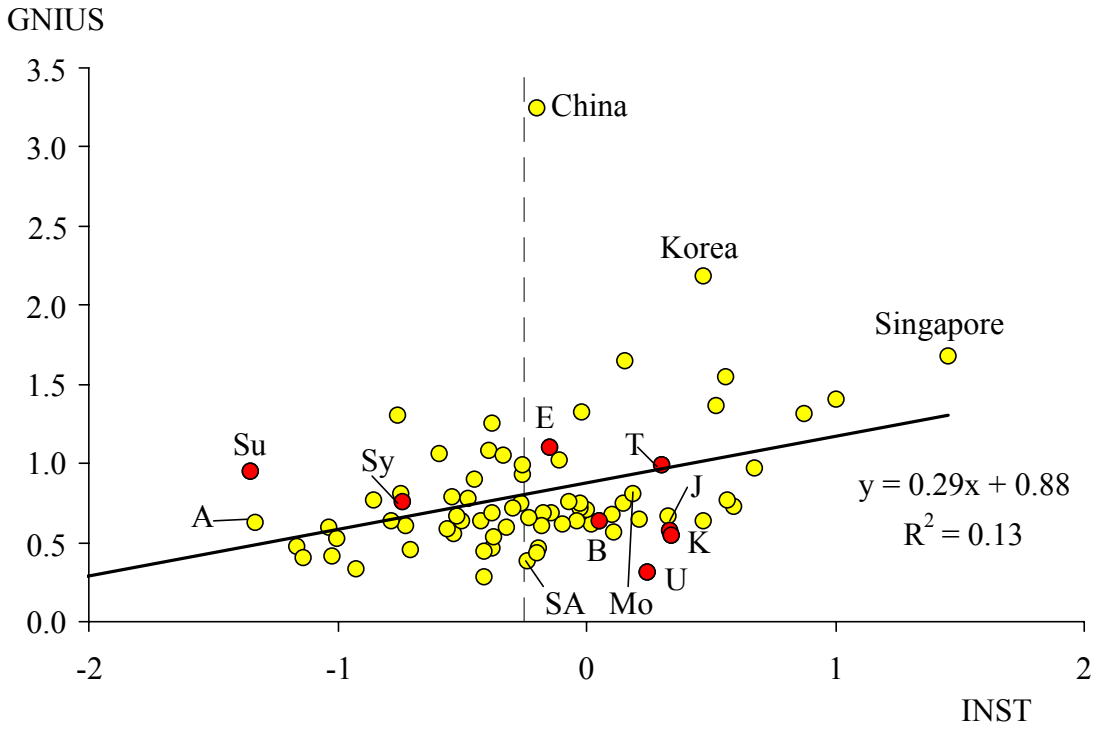
words, institutional development in the API group ranges over much of the spectrum of the index of Kaufmann et al. (2002). The same is true for other Arab countries (detailed results not shown): Institutional development according to INST is fairly advanced in Morocco (0.19), close to the median for other developing countries in Saudi Arabia (–0.24), and highly deficient in Algeria (–1.33).

Apart from Iraq representing the taillight among API members in all institutional dimensions, it is for Sudan and Libya that institutional deficiencies are shown to be most severe in Table 6. The composition of the top 3 varies more across institutional dimensions than the composition of the bottom 3. On average, institutional development is reported to be most advanced in Qatar, Oman and Kuwait; the same countries are in the lead with regard to LAW.

Finally, Figure 2 may offer some clues as to the sustainability of growth by plotting institutional development, as given by INST, against the relative growth performance of developing countries in 1980-2000 (GNIUS). Even though data on INST and GNIUS are available for only eight API members, Figure 2 underscores the wide variation of institutional development within this small group of countries. Given their more advanced institutional development, four API countries performed poorly in terms of GNIUS: Bahrain, Jordan, Kuwait and the United Arab Emirates. As noted before, this is largely due to oil price developments (and the Iraq embargo in the case of Jordan). On a positive note,

growth prospects of these countries appear to be relatively favourable in the absence of major external shocks. On the other hand, institutional development renders it rather unlikely that the three API members with the best growth performance in 1980-2000 (Egypt, Tunisia and Sudan; see also Figure 1 above) will remain in this position in the future. It is only for Tunisia that relatively advanced institutions tend to support sustainable growth. In sharp contrast, future growth appears to be constrained most seriously by institutional deficiencies in the case of Sudan, even if civil unrest were overcome.

Figure 2 — Institutional Development and Economic Growth[a]: The Position of Arab Countries among All Developing Countries[b]



[a]For definition of variables and statistical sources, see Annex. The dotted vertical line represents the median of the sample of all developing countries.— [b]For the abbreviations used for Arab countries, see footnote 1 on page 3.

Source: World Bank (2002); Kaufmann et al. (2002).

VI. Summary and Conclusions

In this paper, we have discussed three possible explanations for the failure of most developing countries, including almost all Arab countries, to catch up economically to advanced industrial countries in the era of globalisation: (i) an insufficient reform-mindedness of developing country governments, (ii) counterproductive policy recipes of the Washington Consensus and (iii) more deeply rooted barriers to growth related to institutional deficiencies. The empirical evidence for Arab countries and other developing countries provides little support to the first two hypotheses. However, the effectiveness of conventional policy reforms seems to depend on country conditions. Furthermore, institutional factors are shown to have a significant impact on policy-related variables and the growth performance of developing countries.

These findings have important implications for national policymakers and external advisers alike. Rather than applying standard recipes to all developing countries, country-specific conditions deserve closer attention when designing economic policy reforms. In developing countries with low per-capita income, domestic resource mobilisation appears to be more important than opening up to FDI. Some members of the Arab Planning Institute such as Sudan, Mauritania, and Yemen provide cases in point. However, even in more advanced API

member countries such as Egypt and Tunisia, human capital formation seems key to sustainable growth.

Furthermore, it must be taken into account that the link between economic policy reforms and growth is loose at best. This is especially so for Arab countries, many of which are extremely dependent on oil price developments. At the same time, the case of Jordan demonstrates clearly that domestic resource mobilisation and openness to trade and FDI do not guarantee high growth.

The lesson for international financial institutions is that pressing for economic policy reforms according to the Washington Consensus is not sufficient to improve the growth performance of developing countries. Policy conditionality along traditional lines has little effect unless the institutional underpinnings of "bad" policies are tackled. Moreover, reform programmes have to be based on realistic time horizons, as it takes considerable time to overcome deeply rooted institutional bottlenecks to sustainable growth.

Redefining the Washington Consensus in this way might provide national policymakers with stronger incentives to initiate institutional change by enforcing the rule of law, fighting corruption, easing administrative interference in private business and improving the quality of public services. In all these respects, institutional development is more advanced for API members as a group than for the control group of other developing countries. Yet, institutional

deficiencies tend to constrain future growth in several member states. Effective control of corruption appears to be the greatest institutional challenge of API governments, notably in Iraq, Sudan, Libya, Yemen and Syria. But even API countries in which institutional development is fairly advanced by developing-country standards (notably Qatar and Oman, but also Kuwait, Jordan, and Tunisia) may further improve the institutional basis for sustainable growth. In terms of government effectiveness, control of corruption as well as political rights and civil liberties, the top 3-institutional performers among API countries continue to lag considerably behind institutional development in industrial countries.

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Annex

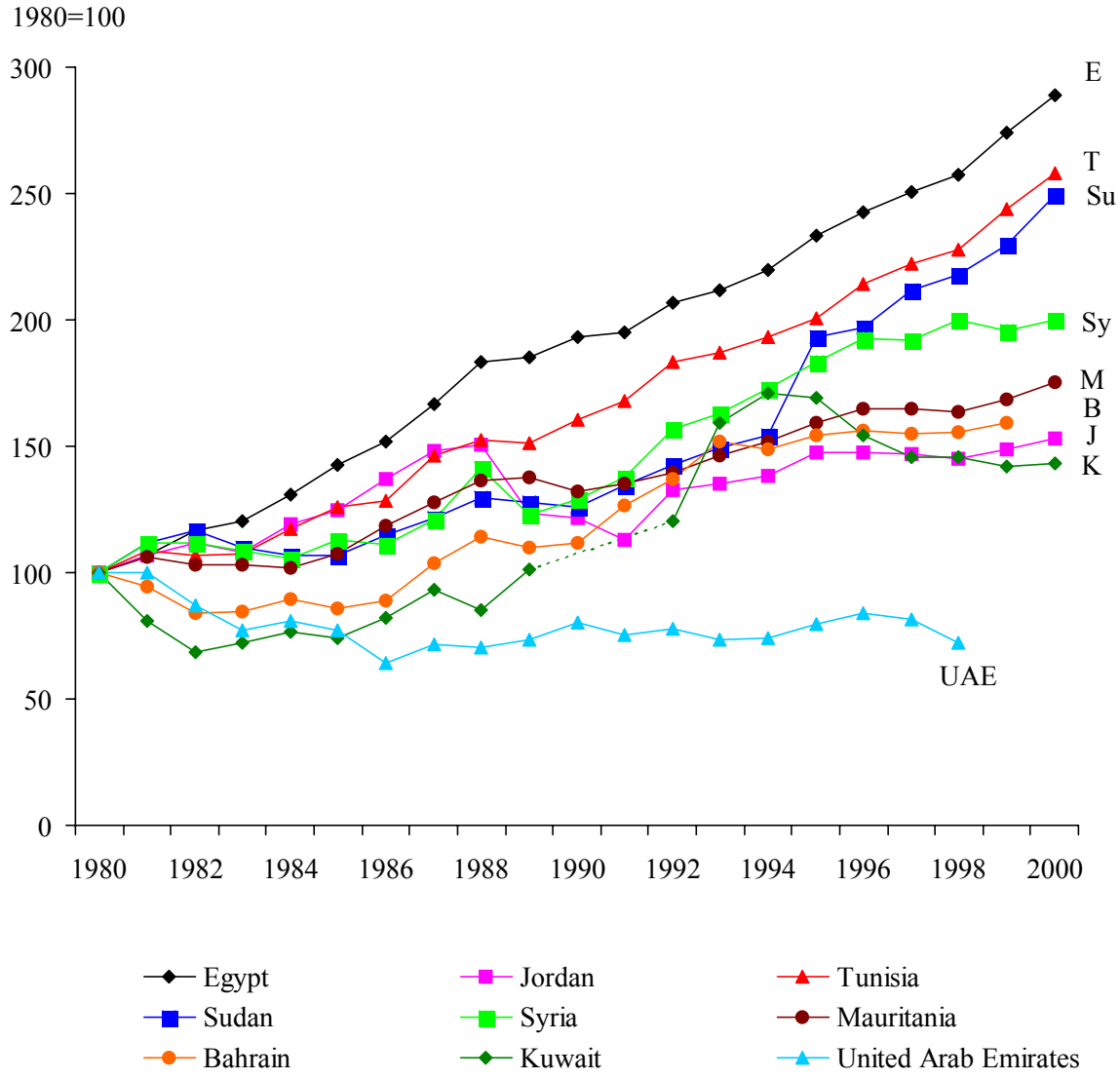
Definition of Variables and Data Sources

Variables	Abbreviation	Definition/Source
Change in per-capita income	GNIUS	Per-capita income (PPP) of country i (relative to per-capita income of the United States) in 2000, divided by per-capita income (PPP) of country i (relative to per-capita income of the United States) in 1980; World Bank (2002);
Exports	EXSH	Exports of country i in per cent of its GDP; World Bank (2002);
Export residual	RESIDEX	Exports (EXSH) corrected for country size; country-specific residuals from the cross-country regression: EXSH = a + b · POP, with: • annual average of EXSH in 1980-2000 • POP = population of country i in 1990 own calculation on the basis of World Bank (2002);
FDI inflows	FDIFL	Inflow of FDI in per cent of the host country's GDP; World Bank (2002);
Government consumption	GOV	Government consumption expenditure in per cent of the country's GDP; World Bank (2002);
Gross fixed capital formation	GFCF	Gross fixed capital formation in per cent of the country's GDP; World Bank (2002);
Imports	IMSH	Imports of country i in per cent of its GDP; World Bank (2002);
Import residual	RESIDIM	Imports (IMSH) corrected for country size; country-specific residuals from the cross-country regression: IMSH = a + b · POP, with: • annual average of IMSH in 1980-2000 • POP = population of country i in 1990 own calculation on the basis of World Bank (2002);
Import tariff revenues	TAR	Import tariff revenues in per cent of import value; World Bank (2002);

Annex continued

Variables	Abbreviation	Definition/Source
Inflation	INF	Annual average change in consumer prices in per cent; World Bank (2002);
Institutional development	INST	Average of six indicators on institutional development in 1997/98: • voice and accountability (VOICE) • political stability and absence of violence (POLSTAB) • government effectiveness (GOVEFF) • regulatory quality (REG) • rule of law (LAW) • control of corruption (COR); indicators range from –2.5 to 2.5, with higher values indicating better institutional development; Kaufmann et al. (2002);
Inward FDI stocks	FDIST	Stock of inward FDI in per cent of the host country's GDP; UNCTAD (2002);
Per-capita income	GNI00 and GNI80	Gross national income per capita in PPP terms in 2000 (GNI00) and 1980 (GNI80), in current international US$; World Bank (2002);
Years of schooling	SCHOOL	Average years of schooling of the population aged 15 and over; Barro and Lee (2002).

Annex Figure 1 — Per-capita Income (PPP) in API Member Countries[a], 1980–2000 (1980=100)

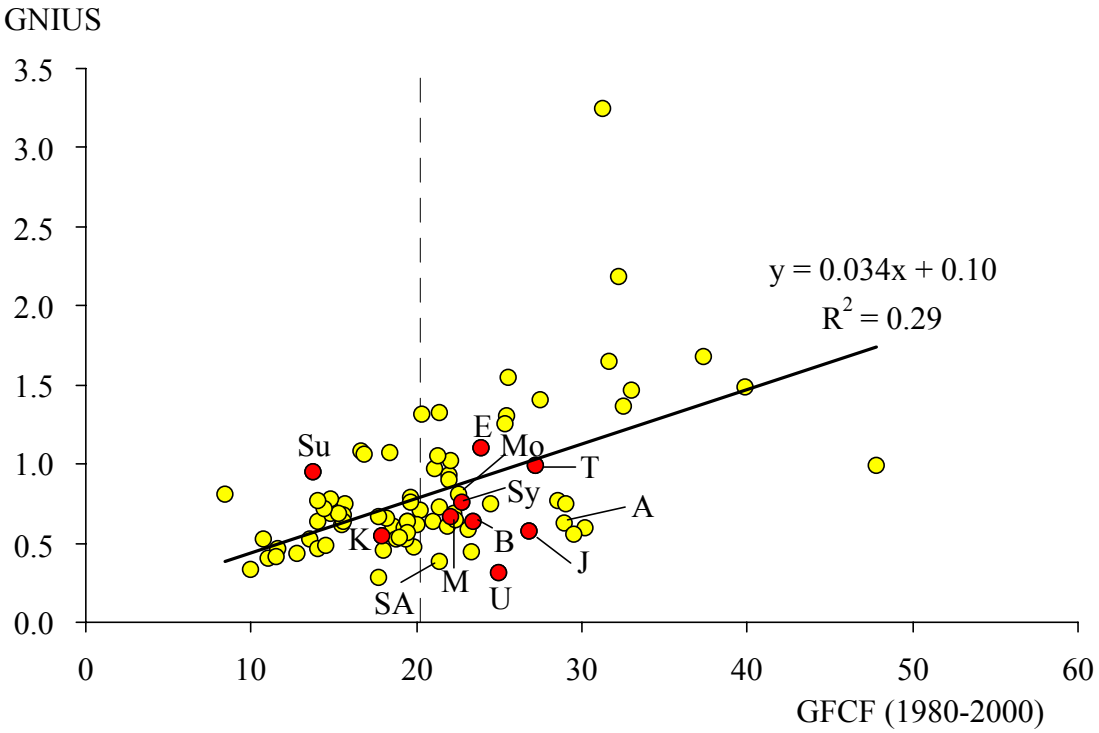


[a]Several countries not shown because of lacking data.

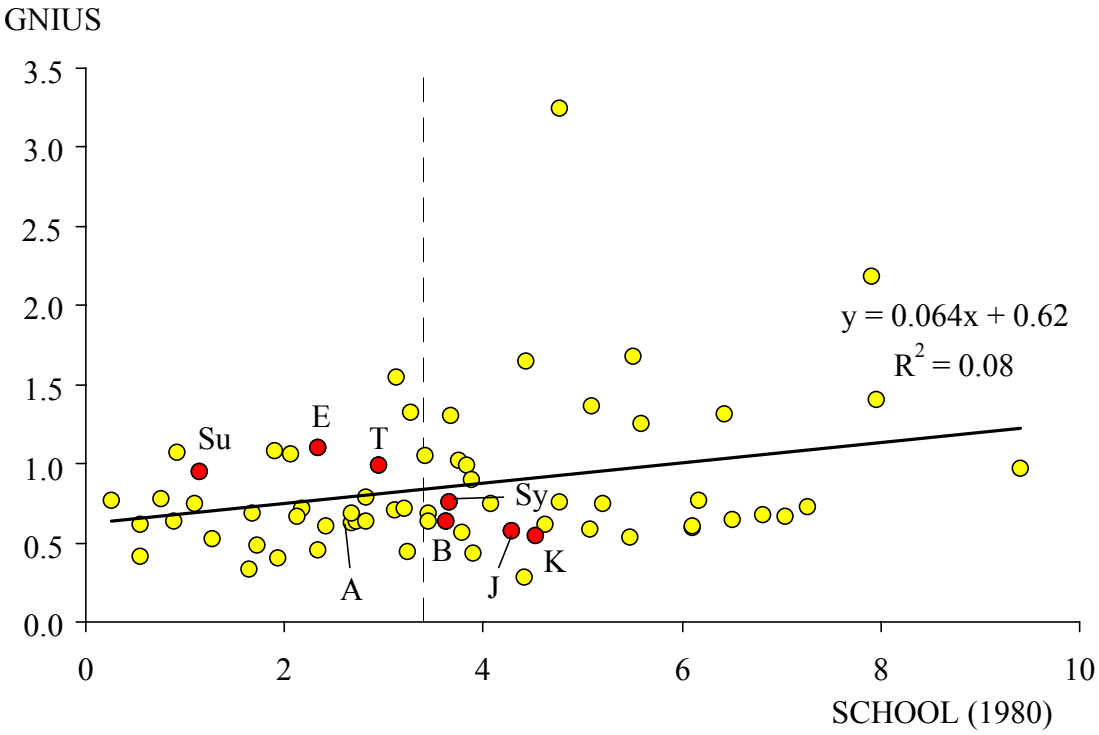
Source: World Bank (2002).

Annex Figure 2 — Policy-related Variables and Growth Performance[a]: The Position of Arab Countries among All Developing Countries[b]

a) Gross fixed capital formation and growth

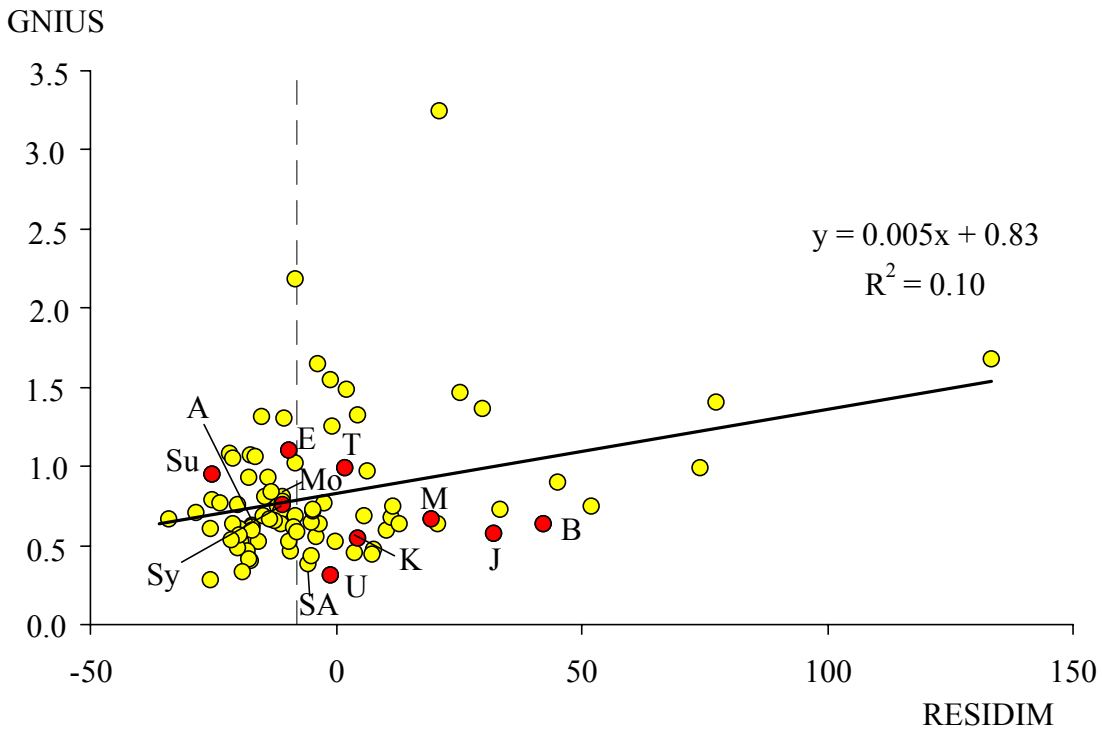


b) Years of schooling and growth

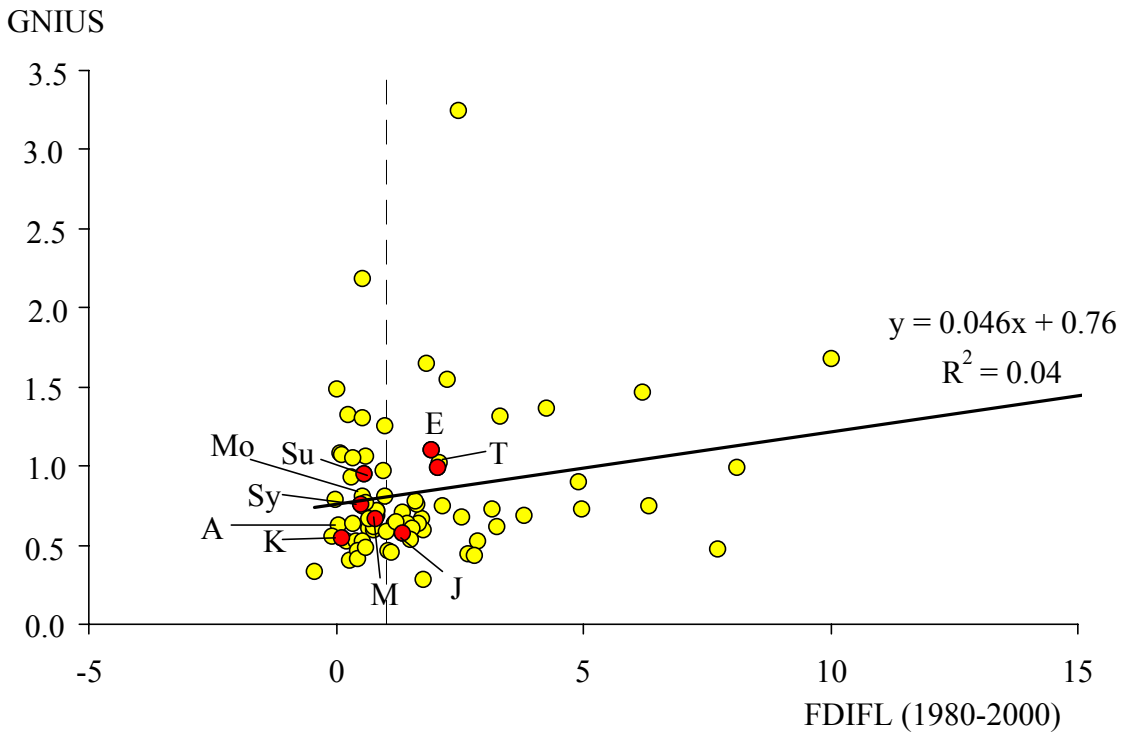


Annex Figure 2 continued

c) Import residuals and growth



d) FDI inflows and growth



[a]For definition of variables and statistical sources, see Annex. In all four figures, the dotted vertical line represents the median of the sample of all developing countries.—[b]For the abbreviations used for Arab countries, see footnote 1 on page 3.

Source: World Bank (2002); Barro and Lee (2002).