Democracy and Economic Growth: Evidence in MENA countries

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Abstract

The debate on the effect of democracy on economic growth has been comprehensively growing since 1980s in theoretical and empirical literature. The existing literature provides conflicting views of this relationship. For this reason, the aim of this paper is therefore to empirically investigate this relationship in 17 MENA countries over the period 1983-2012. We explore this relationship by using fixed (FE)/random (RE) effects and generalized method of moments (GMM) system approaches. We show that a priori the sign of the effect is ambiguous. The major empirical is that democracy, measured by Institutionalized Democracy Score, Institutionalized Autocracy Score, Competitiveness of Executive Recruitment, Openness of Executive Recruitment and Executive Constraints have a robust and negative impact on growth in MENA countries.

Keywords: Democracy; Economic Growth; MENA Countries; FE/RE effects; GMM in system.

1. Introduction

The study of the relationship between democracy versus authoritarian regimes and economic growth has known a peak during these last decades. Democracy was seen as the process of demilitarization in emerging countries in the late 1970s and early 1980s, and the concept today is popularly identified with such features like freedom, equality, progress and modernity. Referring to El-Rufa'i (2003), democracy is defined as a political system in which attempts are made to frame rules that maximize the well-being of people. Rivera-Batiz and Rivera-Batiz (2002) defined democracy as follows: “…whether a country has checks and balances on executive powers, constitutional processes...
and guarantees, freedom of the press and the absence of censorship, clear and effective judicial and legal structures, incumbent term limits, and transparency, openness and citizen input in policymaking”. In this paper, we investigate analytically and empirically whether economic growth is ameliorated or no by democracy. Last decencies, there’s a surge of corpus of studies in the relationship between democracy and growth conducted, but conclusions remain mixed (Przeworski and Limongi, 1993; Przeworski et al., 2000; Kriekhaus, 2004; Brown and Mobarak, 2009; Chowdhury, 2012; Aisen and Veiga, 2013). This article challenges this consensus. Since the 17th century, democracy can stimulate economic growth. Economic growth requires what Sklar (1987) calls “developmental democracy” in which legal and electoral limits on arbitrary power give individuals the security to plan for their economic futures. This finding is consistent with the notion that democracy promotes economic growth. Kurzman et al. (2002) point out that democracy affects economic growth through many channels like investment (crucial ingredient for economic growth), State Expenditure and Social Unrest. Rock (2009) and Knutsen (2013) find a robust and positive effect of democracy on economic growth. In contrast, others points of views, like You (2011), concludes that democracy has a negative impact on growth. He shows that democracy increases the level of corruption and consequently affects negatively the rate of economic growth. Aisen and Veiga (2013) confirm this negative effect of democracy on growth. Other studies have found no relationship between democracy and growth. Narayan et al. (2011) find that the increase in democracy has a negative effect on real income. We conclude that there is no consensus on this issue. This study contributes to the exiting literature by determining the relationship between democracy and growth by two aspects: Firstly, few scientific papers treat this relationship only in the theoretical framework. Secondly, no scientific papers treat this relationship in the MENA region. Finally, previous studies had found that the nexus democracy-growth is mixed. The rest of the paper proceeds as follows: Section 2 presents a brief survey of related literature. Section 3 outlines empirical models introduced data, retained variables, econometric approaches and provides results. Concluding remarks are in Section 4.

2. Review of related literature

The last two decades, many countries introduced many reforms to enhance democracy. Przeworski and Limongi (1993) point out that: “we do not know whether democracy fosters or hinders growth”. Brunetti (1997) examined 17 studies about the relationship between democracy and economic growth and found 9 studies report no relationship, one study a positive, one study a negative, 3 studies a fragile negative relationship and three studies a fragile positive relationship between democracy and economic growth. There is no consensus on this relationship. Democracy is good for investment and has a positive indirect effect on economic growth. Investment will grow in a climate of liberty, free-flowing information, and property rights secure from the arbitrary power of the state. Tavares and Wacziarg (2001), using simultaneous equation framework in a panel of 65 industrial and developing countries over the period 1970-1989, find that democracy fosters growth by improving the accumulation of human capital and, by lowering income inequality. For Papaioannou and Siourounis (2008), democratic transitions are subsequently associated with a higher growth rate of real per capita income. Benhabib et al. (2003) Knutsen (2013) confirm this conclusion. Profeta et al. (2013) conclude that the relation between democracy and growth is somewhat reinforced, at least in the countries under consideration like Latin America and South-East Asia and European Union. Hellmanzik (2013) introduces a new channel to test the impact of democracy on growth: creative production -by using a historic, high-frequency dataset on the value of modern art products. He concludes that democracy has a significant positive impact both on the density of superstar painters and the collective artistic human capital in a country. Jong-A-Pin (2009), using a factor analysis to examine the effect of 25 political instability indicators and their effect on economic growth, points out that higher degrees of instability of the political regime lead to lower economic growth. This conclusion is in total concordance of findings of Alesina and Perotti (1996) that find socio-political instability generates an uncertain politico-economic environment, raising risks and reducing investment. Bjørnskov (2010) has struggled the importance of democratic process in attracting foreign aid that creates economic growth. Knutsen (2011) finds a very robust evidence for a positive, and quite substantial, effect of Proportional Representation electoral rules on economic growth because presidentialism systems promotes broad-interest-, rather than special interest, policies and produces credible economic policies. More recently, on a sample of 169 countries over the period 1960-2004, Aisen and Veiga (2013) find that higher degrees of political instability are associated with lower growth rates of economic growth because instability negatively affects physical and human capital accumulation. Also, they conclude that only economic freedom and ethnic homogeneity are beneficial to economic growth. Another idea of the positive effect of democracy on growth is that democratic regimes spend less on the
military, and thus promote economic growth. However, autocracies regimes spend more on the military, raise taxes to pay for these expenditures, and thereby reduce economic growth. Derived from the liberal tradition and the recent Marxist literature on class compromise, democracy can stimulates economic growth by providing formal channels for the expression of grievances (Kurzman et al., 2002). In contrast, Tavares and Wacziarg (2001), in a panel of 65 industrial and developing countries over the period 1970-1989, conclude that democracy hinders growth by reducing the rate of physical capital accumulation and by raising the ratio of government consumption to GDP. Kurzman et al. (2002) affirm that democracy is an obstacle for promoting investment- the single strongest predictor of economic growth – because Democracies regimes dare not impose unpopular measures to increase investment but only an authoritarian regime will be able to do so. Doucouliagos and Ulubasoglu (2008) conclude that democracy’s net effect on the economy does not seem to be detrimental. Democracy does not have a direct impact on economic growth but positive indirect effects through higher human capital, lower inflation, lower political instability, and higher levels of economic freedom. Tanga and Yung (2008), using ARDL model in eight Asian economies, show that democratization significantly affects growth, but the effect is not consistent and not robust. They, also, find a statistically significant long-run relationship running from democratization to growth, which can be either positive or negative. Yang (2008), based on empirical analysis for a sample of 138 countries over the 1968–2002 period, concludes that in countries with high degrees of ethnic heterogeneity, democracy appears to significantly reduce growth volatility and in countries with low degrees of ethnic diversity such a relationship is not significant. Collier and Hoefler (2009) found, that in developing countries, the combination of resource rents and democracy (measured by Polity IV) has been significantly growth-reducing. Narayan et al. (2011) and Aisen and Veiga (2013) confirm this negative effect of democracy on growth. Among others, Knutsen (2011), conducted an interesting study on a sample of 100 countries over the period 1820-2002, concludes that there is no robust effect of presidentialism or parliamentarism on growth and plural-majoritarian systems produce lower economic growth than both presidentialism and semi-presidentialism systems.

3. Empirical study

The economic growth–democracy correlation is the cornerstone of the “modernization theory”. The empirical association is more robust than the theoretical literature. Several studies support this hypothesis. The model to be tested is the following:

\[
GROWTH_{it} = \beta_1\INF_{it} + \beta_2\TRADE_{it} + \beta_3\GOVTSIZE_{it} + \beta_4\POP_{it} + \beta_5\DEMOCRACY_{it} + \epsilon_{it}
\]  

Where: GROWTH is the GDP per capita growth. INF denotes annual change in consumer price index (CPI). Trade is Import plus export divided to GDP. POP is the Growth rate of total population. GOVTSIZE is the Ratio of Government final consumption to GDP. For democracy, we use 5 measures*: Institutionalized Democracy Score (democ), Institutionalized Autocracy Score (autoc), Competitiveness of Executive Recruitment (xcomp), Openness of Executive Recruitment (xropen) and Executive Constraints (xconst). Data cover the 1983-2012 periods, taken from the World Bank (World Development Indicators) for macroeconomic variables and from Integrated Network for Societal Conflict Research for democracy variables. The empirical study is based on a sample of 17 countries in the MENA countries: Algeria, Bahrain, Egypt Arab Rep, Irak, Iran, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Tunisia, Turkey and United Arab Emirates. Table 1 presents the estimation results of the Fixed/Random effects regressions that include democracy variables after controlling for other growth determinants.

Table 1: Democracy and Growth: Random effect (RE)/ Fixed effect (FE) approaches Fixed effect (FE)

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<th>democ</th>
<th>autoc</th>
<th>xcomp</th>
<th>xropen</th>
<th>xconst</th>
</tr>
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<tbody>
<tr>
<td>GOVTSIZE</td>
<td>-0.199</td>
<td>-0.202</td>
<td>-0.201</td>
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<tr>
<td>INF</td>
<td>-0.422</td>
<td>-0.427</td>
<td>-0.425</td>
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* For more details see Marshall et al. (2013)
The empirical investigation includes five regressions with five different proxies for democracy in order to trace any impact of democracy on growth. For all models, the Hausman test also confirms the appropriateness of the fixed-based effects estimation procedure used in this study (P-value of Hausman statistics are lower than 5%). The coefficient on democracy is negative and statistically significant for all measures of democracy except for Openness of Executive Recruitment (xropen). Our findings point to clear evidence that democracy have a negative impact on economic growth in MENA countries. Our result is consistent with previous literature (Tavares and Wacziang 2001; Kurzman et al. 2002; Doucouliagos and Ulubasoglu 2008; Tanga and Yung 2008; Yang 2008; Collier and Hoeffler 2009; Narayan et al. 2011; Aisen and Veiga 2013). The negative impact of democracy on growth can be explained...
by the very low level of democracy. Lebanon, Morocco and Turkey have the highest level of democracy in MENA region. Tunisia and Egypt are partly democratic. The remaining countries are categorized as authoritarian regimes. Freedom House categorizes MENA countries as “Not Free” except for Lebanon, Kuwait, Morocco, Turkey and Israel. In some Presidential republics, like Tunisia and Algeria, there is elections but there are many critics. For Absolute Monarchy, like Saudi Arabia, Morocco, Kuwait, Bahrain, Jordan and United Arab Emirates, the level of democracy is lower but the growth rate is higher. In Islamic governments, like Turkey that has the highest rate of growth last decency, the political party Justice and Development is a moderate democratic party. Also, the political instability, after events of the Arab Spring such as Tunisia, Libya and Egypt, in many countries in MENA region negatively impacts investment and consequently the growth rate. For example, Libya’s economy contracted by more than 60% in 2011, but it’s expected to recoup some of those losses in 2012 with an astonishing annual growth rate of nearly 70%. In the short-run, the growth rate for new democracies (Tunisia; Egypt) is lower than the period before democratic election in 2011 because there were no viable institutions that governed business people before the Revolution of 2011. There is now a dynamic move of democracy in Tunisia and Egypt. Those new democracies are working on policy reform and reforming institutions to support the democratic transition. For robustness test and to extract consistent estimates, we use the GMM in system approach. This methodology takes into account the endogeneity, the GMM in system uses as instruments lagged values of the variable. Table 2 presents the estimation results of the GMM in system regressions. For the 5 models, the Hansen and serial-correlation tests do not reject the null hypothesis of correct specification (P-values of Hansen test and AR (2) test of Arellano and Bond are larger than 5%), lending support to our estimation results. The low p-values for the Wald tests suggest that all models are well specified and fit the data. The reported coefficients estimates are similar to the results issued from fixed effect approach.

4. Conclusion

This paper attempts to answer the question of whether democracy can stimulate economic growth. Using a panel of 17 MENA countries for the period 1983-2012, this paper highlights the impact of democracy on economic growth. Our main results can be summed up as follows. First, within RE/FE, we find that the effect of democracy on economic growth is negative and statistically significant for four measures of democracy. Second, within GMM in system, we find the same conclusion. All MENA countries must strengthen institutions. Many countries are working to upgrade democratic accountability and reduce corruption and external conflicts because a well-functioning political system can positively contribute to higher rate of economic growth. Economic growth requires a long-term protection of civil and political freedoms. To enhance academic understanding of this subject, this research can be extended by introducing other determinants of democracy and other econometric frameworks (Panel data Cointegration, PSTR) because a sound well-functioning democracy regime can positively leads to provide sustained economic growth after the series of revolution in some countries.

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