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Institutional quality and economic development in MENA region

Comparative analysis

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Abstract:

This paper examines the role of institutions and the mechanisms by which they influence economic growth and development according to the new institutional approach. To do so, we compare the quality of institutions and their efficiency, economic development and the extent of corruption between Algeria and selected countries in the MENA region.

Key words: Neo-institutional approach, institutional quality, economic development, governance, corruption.

JEL Classification Codes: O1, D86,D02,D73.

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Introduction :

Nowadays, there are still huge disparities in income and living standards between rich and poor countries, as is the case in sub-Saharan Africa, South America and South Asia, which have non-functioning markets and a poorly educated population. Their means of production are obsolete due to their low investment in human and physical capital, unlike the countries of North America, Western Europe and East Asia which have a high standard of living, long life expectancy, strong human capital and innovative technologies, etc.

From the second half of the 20th century to the present, three main approaches have explained economic growth: the neo-Keynesian model of Harrod-Domar, the neoclassical model of Solow-Swan and the endogenous growth model of Romer-Lucas (Snowdon & Vane, 2005). Furthermore, some authors attribute differences in development and economic growth between countries to institutional and geographical differences (Acemoglu, 2003, p. 27). Studies by North (1981), Jones (1987), and Olson (1982) have prompted researchers and policymakers to pay more attention to the role of institutions in economic growth and development.

Based on this work, we attempt to answer the following question: what are the main institutional determinants of these gaps?

We hypothesize that institutional quality positively affects economic performance and that corruption is one of the most important factors hindering economic development. Thus, we aim to examine the role of institutions in explaining disparities in economic growth and development across countries.

To do so, we have adopted the comparative method and statistics to compare the economic performance and the quality of institutions of some countries in the MENA region. These countries were chosen because of their common characteristics, including rent and the beginning of a transition process from central planning to a market economy, their history, and their specific economic situation. Thus, the use of strong and quality institutions was one of the prerequisites for building a market economy and achieving sustained economic growth over the long term. It should be noted that the analysis covers

different time periods depending on data availability. Consequently, the report has three main parts. The first part reviews new institutional theories that highlight the links between institutional quality and economic growth, while the second part discusses the institutions that drive economic growth and the channels through which they influence economic growth and development. Finally, in the third part, we examine the institutional quality in the MENA region using the World Governance Index (WGI) calculated by the World Bank to arrive at the phenomenon of corruption given its consequences on the economy and society in the long run. Indeed, it is considered an obstacle to economic growth and a factor hindering the performance of institutions. Using the Corruption Perception Index (CPI) calculated by Transparency International, we will compare its magnitude in the region in question to finally arrive at recommendations and solutions to address the issue.

1. The role of institutions:

The idea that institutions affect the prosperity and wealth of nations goes back to Adam Smith. Since then, economists have become aware that property rights that protect against expropriation by others or by the state are an important condition for individuals to invest. Currently, the role of institutions in economic development has become one of the most studied areas by economists (Stein, 2008, p. 92). Institutions became the key factor in economic growth and development with the rise of the new institutional economics in the 1980s. In the early 1990s, the World Bank and the International Monetary Fund identified poor institutional quality as a fundamental cause of poor economic performance. In the same vein, North and Thomas (1973) emphasized that factors such as innovation, economies of scale, education, capital accumulation, etc. do not cause growth, they represent it; only accumulation and innovation are the immediate causes of growth. Thus, the difference between institutions is the major explanation for the disparity in levels of development.

Institutions are defined in different ways. North defines them as "the rules of the game in a society or, more formally, as the man-made constraints that shape human interaction. Accordingly, they structure the incentives in human exchanges, whether

political, social or economic (North & al, 1990, p. 3). Thus defined, they are a set of rules for the members of society that determine their behavior. Institutions can be formal (laws, property rights, constitutions) and/or informal (taboos, traditions, sanctions and codes of conduct). In an ideal situation, formal and informal institutions complement each other. "Institutions provide the incentive structure of an economy; as this structure evolves, it determines the direction of economic change toward growth, stagnation or decline" (North, Institutions, 1991, p. 97). By this definition, institutions cannot be treated as an exogenous or benign factor in the development process, contrary to what neoclassical economists thought. The current dominant view is that institutions are the fundamental determinants of economic performance - "institutions maters". Empirical studies by Rodrik, Subramanian and Trebbi 2002, Moers, 1999, March and Olsen, 1998, carried out in different countries confirm the positive effect of institutions on economic growth and development (Drankovska & Antovska-Mitev, 2022, p. 11). Economists such as North emphasize the role of institutional factors such as property rights, corruption and the quality of governance on the development of countries. As a result, these factors influence individuals to invest, thus influencing their tendency to innovate and participate in entrepreneurial activities.

1.1 Institutions for economic growth and development:

Several facts have confirmed that economic incentives in the presence of an adequate institutional framework influence the productivity of individuals through the development of new ideas or new technologies. The relevance of institutions to economic growth and development is reflected in four types of institutions (Rodrik & Subramanian, 2003, p. 32):

- Market-creating institutions: these embody institutions that protect property rights and ensure the enforcement of contracts. They are linked to investment incentives and entrepreneurship. They include judicial institutions, namely the court system.

- Market regulatory institutions: These institutions regulate market imperfections, such as disruptions, monopolies related to economies of scale and asymmetric information.
- Market stabilizing institutions: They maintain macroeconomic stability by stabilizing prices, mitigating cyclical movements and warding off financial crises.
- Market legitimizing institutions: These institutions are responsible for social protection, income redistribution and the resolution of social conflicts.

Recognizing that institutions contribute to economic growth and development, many countries undertook institutional reforms in the early 1990s under the guidance and support of the IMF and the World Bank to create "better" institutions and improve "governance" (Kapur, Webb, & al, 2000, p. 2).

1.2 The quality of institutions and economic development:

Good institutions combined with better incentive procedures are a prerequisite for long term economic reform and transition (Islam, 2002, p. 30). There is no single definition of governance or institutional quality. Some definitions are broad and define governance as roles, enforcement mechanisms, and organizations (Islam, 2002, p. 98), others focus solely on the public sector and define it as a way in which power is exercised in the management of economic or social resources in a country. The Worldwide Governance Indicator (WGI) measures the quality of institutions that view governance as the traditions and institutions through which authority is exercised. The WGI reports six dimensions (Kaufmann, Kraay, & Mastruzzi, 2011, p. 223):

- Voice and accountability: Measure the degree to which citizens participate in choosing their government, the degree of freedom of expression, freedom of association, and freedom of the media.
- Political Stability and Freedom from Violence: This indicator captures the likelihood that the government will be destabilized or overthrown in unconstitutional or violent ways.
- Government Effectiveness: Measures the quality of public services, the quality of the civil service, and its degree of independence from political pressures. It also

measures the ability to formulate and implement policies and the credibility of the government's commitment to them.

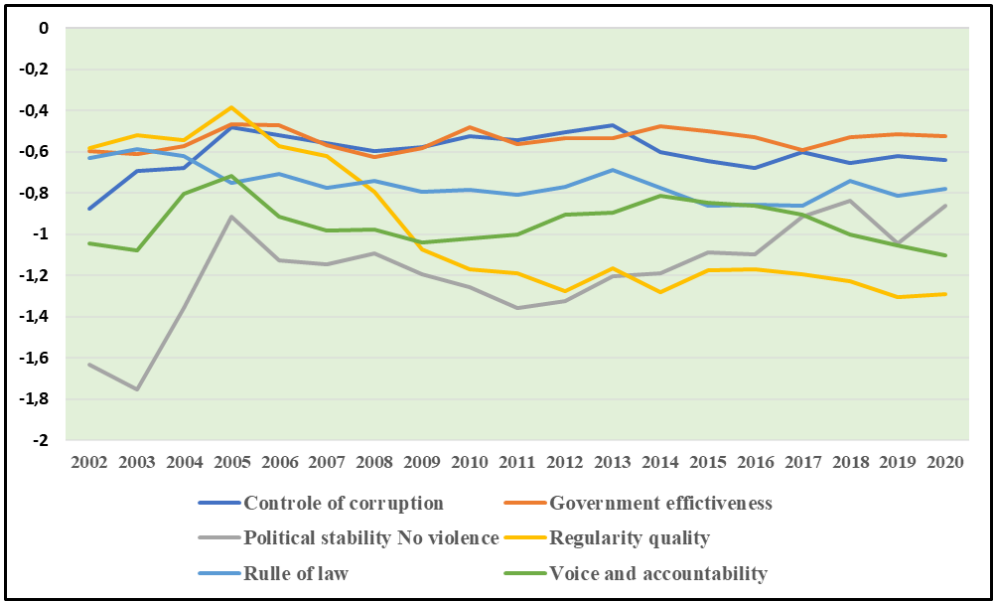
- Regulatory Quality: An indicator of the government's ability to formulate and implement policies and regulations that enable and encourage private sector development.
- Rule of Law: This indicator assesses the degree to which individuals trust and abide by the rules of society, particularly the enforcement of contracts and the protection of property rights.
- Control of corruption: Measures the degree to which public power is exploited for private gain and the confiscation of the state by elites and private interests.

The WGI is generally used by international organizations to diagnose governance problems in countries, to allocate aid to remedy them and to improve their institutional quality.

2. The Worldwide Governance Indicator in Algeria:

Figure 1 below presents Algeria's WGI by its six components, covering almost two decades: 2002 - 2020.

Figure (1): Evolution of the six dimensions of the WGI Algeria, 2002-202

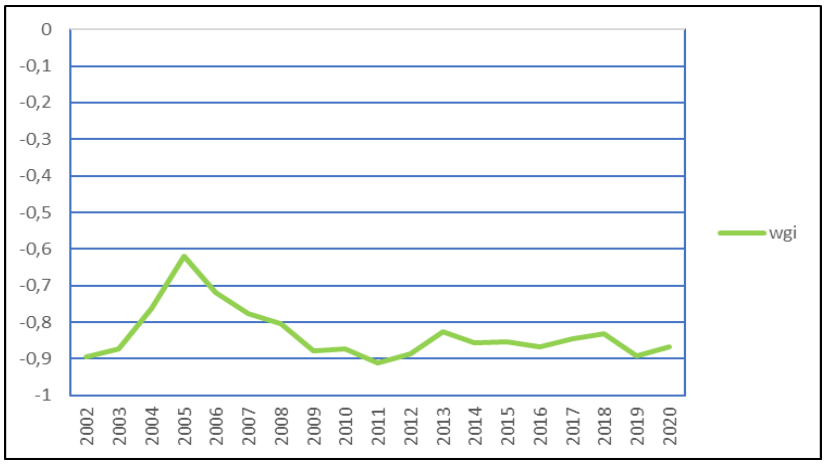


Source World Bank 2021 database

Concerning the first component: voice and accountability, its low level was recorded in 2020 (-1.102) 18.36 percentiles ranking Algeria in 212th place out of 230 countries while the highest value was recorded in 2005 (-0.72) or 25.48 percentiles. It is noted that throughout this period of analysis, this dimension has remained relatively unstable. As for the political stability index, the worst score was achieved in 2003, placing Algeria in 225th place. Thus, over the entire period, the scores have been below average except for 2005 (-0.91) and 2018 (-0.84). Regarding the dimension of government effectiveness, in 2002 recorded its lowest level (-0.59) reaching its highest value in 2005 (-0.46) dropping significantly in 2017, and this, despite efforts to modernize the public administration. Regarding the regularity quality, its scores vary from (-0.38) in 2005 and (-1.30) in 2019 showing an average of (-0.97) reflecting the efforts and willingness to raise the quality of institutions in the country. For the rule of law index, it shows negative results over the entire period. Thus, scores ranged from (-0.63) in 2002 to (-0.78) in 2020. As for the control of corruption dimension, the situation remained as it was in the initial phase of the analysis and scored (-0.64) for the year 2020. The average value of this dimension is (-0.60) which is far from normal.

The average WGI in Algeria for the period 2002-2020 is (-0.83). The negative value of this estimate, in fact, reflects only the poor quality of governance. The best performance was achieved in 2005 (-0.62), followed by an accumulation of poor scores until 2020 with an estimate of (-0.87), (Figure 2).

Figure (2): Evolution of the WGI -Algeria, 2002-2020



Source World Bank 2021 database

Among the recommendations of the IMF (2020) is the need to fight against corruption, the informal sector and to work on political stability, so the quality of institutions remains one of the main challenges for Algeria.

The results of IMF assessments confirm the positive impact of institutional quality, as measured by the World Governance Index (WGI), on economic development, as interpreted by GDP per capita. Analysis by dimension shows that controlling corruption and promoting the rule of law have the strongest impact on economic growth and development. Although major macroeconomic reforms have been taken since independence to build strong market institutions, indicators of institutional quality still reflect weaknesses.

2.1 Comparison (WGI) in MENA

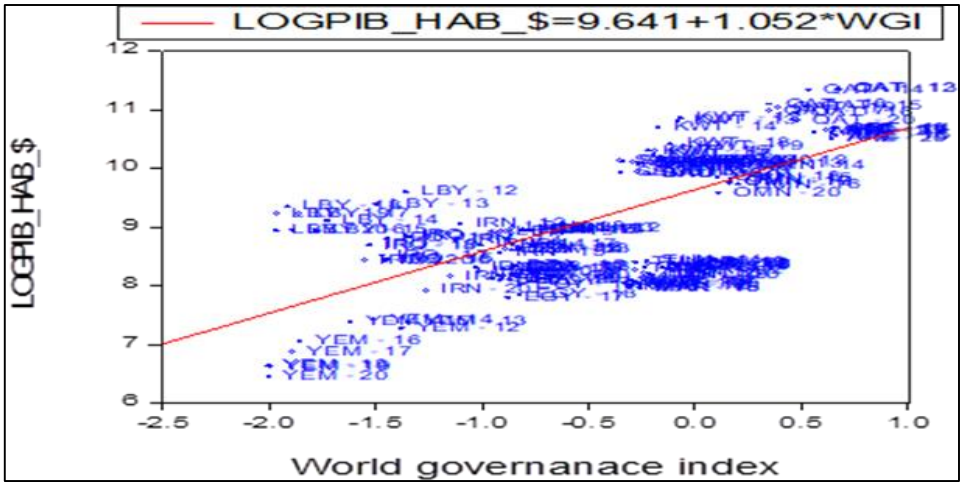
Table 1 above represents the WGI of the MENA countries for 2020 (Algeria, Egypt, Jordan, Tunisia, Libya, and Qatar). The focus on these countries was made because they have approximately started transition processes. The data presented in Table 1 shows that Qatar is the country with the highest institutional quality among the analyzed countries with the best performance on the six dimensions of the WGI, having one of the highest standards of living with a GDP per capita of USD 50124.39 in 2020. Libya, on the other hand, has the lowest performance in institutional quality (World Bank, 2021). As for Algeria, it is positioned in 5th place in 2020 in terms of institutional quality, thanks to the strengthening of the country's political stability, while the constraining factors are regulatory quality, voice and accountability, and above all the control of corruption.

Table (1): WGI MENA, (estimates and percentile rank) 2020

	Algérie	Egypte	Jordanie	Tunisie	Libye	Qatar
Controle of corruption. Estimation	-0,64	-0,81	0,07	-0,07	-1,62	0,78
Controle of corruption. Rank	28,36	22,59	59,61	52,40	2,88	77,88
Government effictiveness. Estimation	-0,53	-0,54	0,11	-0,20	-2,01	0,91
Government effictiveness. Rank	33,65	32,21	57,21	43,75	1,92	78,36
Political stability no violence. Estimation	-0,86	-1,21	-0,32	-0,63	-2,48	0,67
Political stability no violence. Rank	17,45	11,32	35,85	24,06	2,36	68,39
Regularity quality. Estimation	-1,29	-0,69	0,22	-0,36	-2,32	0,85
Regularity quality . Rang	9,13	25,48	60,10	39,42	0,96	75,96
Rulle of law. Estimation	-0,78	-0,36	0,21	0,14	-1,97	1
Rulle of law. Rank	21,63	39,90	59,13	58,17	1,44	82,69
Voice & accountability. Estimation	-0,64	-0,81	0,07	-0,07	-1,62	0,78
Voice & accountability. Rank	28,36	22,59	59,61	52,40	2,88	77,88

Source World Bank 2021 database

Figure (3): Correlation between WGI and GDP per capita 2002 – 2020



Source: Eviews 10 results

3. Corruption as an impediment to growth:

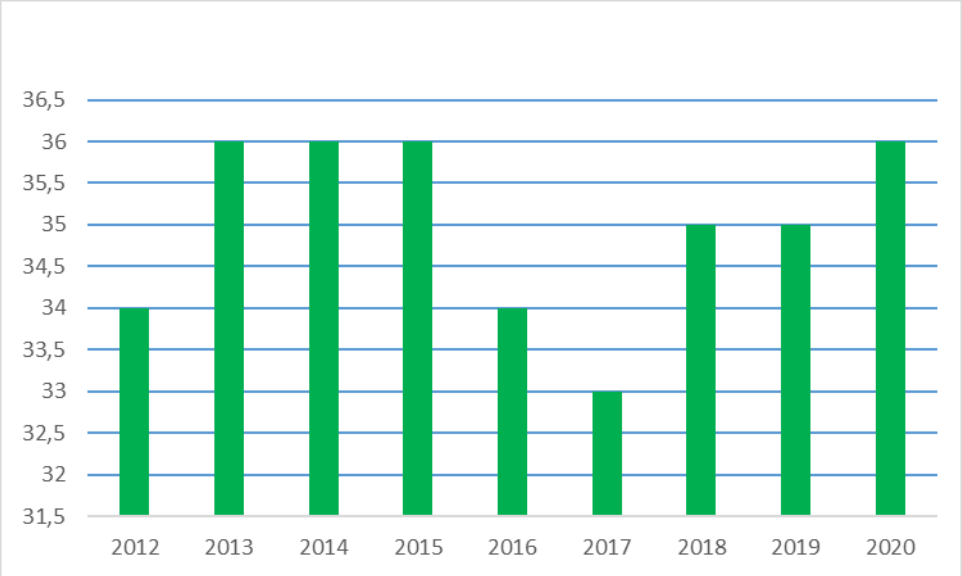
In recent decades, corruption has figured prominently in the economic literature. Mauro (1995); Kaufmann and Kraay, (2002) present it as a major obstacle to development with dramatic consequences for growth and countries with corrupt bureaucracies engage in rent-seeking activities to divert resources away from productive activities (Drankovska & Antovska-Mitev, 2022, p. 20). Empirical evidence indicates that corruption drastically reduces economic growth, especially in countries with weak governance (Mauro, 1995, p. 682). Corruption takes many forms. Academically, it is defined as "using one's position as a public official for personal gain" (Bank, 1997, p. 8). According to Tanzi, corruption is "... the intentional violation of the arm's length principle" (Tanzi, 2003, p. 24). Corruption defined in this way indicates that for the market economy to function effectively, personal or family relationships should not be involved in economic decisions made by government officials or economic agents. Corruption undermines long-term economic growth by affecting investment, taxation, human development and public spending. Corruption affects economic development through different channels (Tanzi, 2003, p. 26):

- It reduces the ability and effectiveness of government to carry out regulatory controls and inspections to correct market failures.
- Distortion of incentives and detour of individual wills in the economy to corrupt practices and not to productive and innovative activities.
- Decrease in investments reducing the threshold of the growth rate at which it is determined by the accumulation of physical capital.
- Increase in public spending causing large budget deficits.
- Reduction or imbalance of the primary role of government (enforcement of contracts, protection of property rights).
- Creation of social problems: poverty and income inequality.
- Reduction of the return on international aid by reallocating funds to unproductive projects or by their irrational use.

3.1 Comparison (CPI) in MENA:

The Corruption Perceptions Index (CPI) is a measurement tool calculated by Transparency International. It is a composite index that ranks countries according to the degree of corruption perceived by a country's business leaders and public officials. The CPI ranks countries on a scale of 0 to 100, where 0 indicates that the country is very corrupt while 100 indicates that the country is very clean.

Figure (4): Evolution (CPI) Algeria 2012-2020



Source Transparency International 2021database

Since the mid-1980s, Algeria has faced a high level of corruption present in all spheres of social life (Talahit , 2000, p. 49). Corruption represents one of the main reasons for the slow development dynamics in the country (Becherair , 2016, p. 443).

Figure (4) represents the evolution of Algeria's CPI from 2012 to 2020. The perceived corruption score has increased from (34) in 2012 to (36) in 2020, and has risen one place in the ranking, i.e., from 105th place in 2012 to 104th in 2020, a result that remains far from a boon. According to Transparency International, the high level of corruption in Algeria is due to the "captive" nature of the state, a highly corrupt public sector, its lack of transparency and the ineffectiveness of institutions responsible for fighting corruption. Thus, this undermines confidence in institutions and their efficiencies. This high level of corruption was one of the most important weaknesses of Algeria's institutions.

3.2 Comparison (WGI) in MENA:

Table 2 shows the Corruption Perceptions Index (CPI) for our sample of countries for the period 2016 to 2020. As was the case in the previous analysis, Qatar leads the ranking, achieving a ranking of 30th out of 180 countries for two years in a row, 2019 and 2020, with scores of (62) and (63) respectively. Comparatively Algeria ranked 104th out of 180 countries, recording a score of (36). The previous analysis of the World Governance Index (WGI) revealed that the control of corruption is the weakest dimension of institutional quality in the following countries: Algeria, Egypt and Libya. This result is also confirmed by the analysis of the Corruption Perceptions Index (CPI).

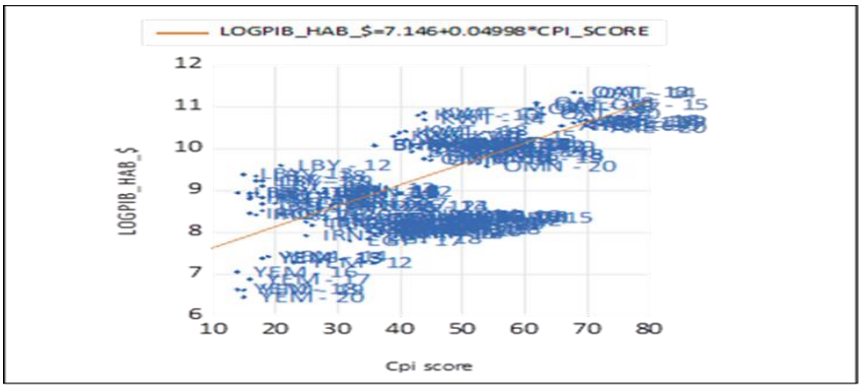
Table (2): CPI evolution -MENA

	2016		2017		2018		2019		2020	
	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank
Algérie	34	108	33	112	35	105	35	106	36	104
Qatar	61	31	63	29	62	33	62	30	63	30
Tunisie	41	57	42	74	43	73	43	74	44	69
Libye	14	170	17	171	17	170	18	168	17	173
Egypte	34	108	63	117	35	105	35	106	33	117
Jordanie	48	58	48	59	49	58	48	60	40	60

Source Transparency International 2021database

Figure 5 shows the correlation between corruption as measured by the Corruption Perceptions Index (CPI) and economic growth as measured by GDP per capita expressed in logarithmic form over the period 2012 to 2020.

Figure (5): Correlation between WGI and GDP per capita 2002 - 2020



Source: Eviews 10 results

The regression analysis includes additional countries to our study sample for reliability. The graphical presentation confirms the negative correlation between corruption and economic growth. Countries with low levels of corruption have high economic growth rates and high living standards. The calculated correlation coefficient is equal to 0.68.

Conclusion:

The analysis has assessed the impact of institutions on economic growth and development, which have been ignored or taken for granted in the standard theory of economic growth, but the rise of the new institutional economics has highlighted their importance. Recent studies have shown that in all countries, regardless of geography, history and stage of development, only the protection of property rights, contract enforcement and the rule of law, and competition, influence the structure of incentives. All of these factors encourage innovation, investment in new technologies, and participation in entrepreneurial activities, thereby promoting long-term economic growth. Regression studies have shown that institutions are strong determinants of economic development. The institutions that generate economic growth in the short run are market-creating institutions. However, for long-term economic development, three other types of institutions emerge: market-regulating institutions, market-stabilizing institutions, and market-legitimizing institutions. The WGI analysis of selected countries showed that countries with high standards of living generally have high quality institutions. Examination of the correlation between the WGI and GDP per capita revealed a positive correlation between institutional quality and long-term economic growth. Corruption is seen as a factor that undermines the quality of institutions and therefore hinders economic growth and development. Corruption hinders economic growth. Because of its sensitivity, corruption is difficult to measure objectively, but the CPI is the gold standard of measurement. The comparative analysis in this paper shows that developing countries have highly corrupt institutions.

The correlation analysis confirms the negative correlation between corruption and economic growth as well as a positive and significant relationship between institutional

quality and economic growth in the long run. Therefore, any economy that ensures effective law and order conditions gains economic wealth and development while, conversely, economies with inefficient and unfavorable environments for economic agents are exposed to lower levels of development. Furthermore, it is widely accepted that institutional reforms are a key factor for development, but the choice of the most effective institutional reform is still a matter of controversy. In our view, successful institutional reforms in less developed countries require, first and foremost, major changes in certain segments that are considered important, namely:

- Strengthening the rule of law, through the implementation of measures to ensure compliance with the principles of supremacy of the law, equality before the law, accountability before the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, prevention of arbitrariness and procedural and legal transparency, etc.;
- Democratization of political parties, to raise the general political culture.
- Strengthen the quality, efficiency and credibility of institutions, mainly by improving the quality of the education system at all levels, as their quality and efficiency are directly linked to the quality of the personnel employed, and in particular to the competence of the leaders
- Fight against corruption through the prevention and repression of malpractice.

In the current context, it is important, especially in the MENA region, to emphasize that institutional reforms are necessary, whether in a growth phase or in a crisis phase.

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