Good Governance and Economic Growth: A Contribution to the Institutional Debate about State Failure in Middle East and North Africa

Rachid MIRA & Ahmed HAMMADACHE
(Université Paris 13, CEPN Laboratory, France; IFC, Renmin University, China)

Abstract: Several econometric studies (Kauffman, Knack) tested the relationship between good governance in the sense of “market-enhancing governance” (stimulus institutions market) showing a positive relationship between good governance and economic growth. However, a good governance policy allows developing countries to achieve minimum economic growth and political reforms in order to reach a level of development similar to that of industrialized countries? In this article, we focus on the definition and the development on the concept of good governance by the World Bank and the criticism formulated by Mushtaq Khan, who reconstructed the notion of governance in a broader sense, taking into account the capacity of states to drive structural change in the institutional, political, economic and social fields, in order to ensure long-term economic growth. Our contribution is to examine the concept of good governance and the failure of states taking into account the level of development and governance capacity based on a structure and distribution of political power that evolves over time and may or may not be positive for growth. The assumption we make here is that the so-called good governance policies are relevant only if countries reach an adequate level of economic and social development that enable institutions of good governance to boost growth.

Key Words: States Failure; Good Governance; Economic Growth; Development Policy

I. Introduction

Numerous economists of development consider that good governance, defined as the

---

footnotes:
1 Dr. Rachid MIRA earned his Ph.D. in economics from the University of Paris 13. His published works to date have focused on economies in North Africa and relevant economic issues. Dr. Ahmed HAMMADACHE earned his Ph.D. and master’s degree in economics from the University of Paris 13.
quality management and orientation of development policies has a positive influence on economic performance. The question is to understand what content the literature gives to the concept of governance. According to the World Bank, good governance is evaluated by the implementation capacity of governance principles of a country, providing a framework for market development and economic growth. Several econometric studies tested the relationship between good governance in the sense of "market-enhancing governance" (stimulus institutions market) which showed a positive relationship between good governance and economic growth. However, a good governance policy allows developing countries to achieve minimum economic growth and political reforms in order to reach a level of development similar to that of industrialized countries? We focus on the definition and the work on the concept of good governance made by the World Bank and criticism formulated by Mushtaq Khan, who reconstructed the notion of governance in a broader sense, taking into account the capacity of states to drive structural change in institutional, political, economic and social fields, in order to ensure long-term economic growth.

Can good governance explain economic performance? Or, according to Mushtaq Khan\textsuperscript{5} thesis, are reforms of economic structures and government capabilities the first step to improve economic performance of developing countries, and in a second step to allow economic growth to enhance good governance?

Following several works of neo-institutionalist economists\textsuperscript{5} on the relationship between economic growth and good governance two divergent theories of “state failure” in developing countries have emerged:

The first thesis (market Enhancing governance), defended by neo-institutionalist authors, considers the state as having a sovereign role and being a welfare state. Economically, the proper functioning of markets is correlated to the proper functioning of institutions through efficient practice of state governance, what is commonly called “good governance”. Therefore, underdevelopment and low economic growth performance of countries could be explained by “state failure” due to the increase in corruption, instability of property rights, market distortions, and lack of democracy.

The second thesis (growth Enhancing governance) developed in particular by Mushtaq Khan and partly by Dany Rodrik, concerns the ability of the state to implement social change and pursue a voluntary policy of economic development: The transition of developing countries towards a capitalist system comparable to that of developed countries, cannot operate without the establishment of efficient institutions in relation to distribution of political power in such countries. Conversely, those countries would face state failure as a result of a mismatch between institutions and an economic policy of development.

Our research consists first to present our main results of an empirical study based on a


\textsuperscript{7} Ibid.

number of developing countries chosen by region (MENA, Latin America, and Asia) and their natural resource endowment. The aim is to check if growth rate may or may not be correlated with good governance indicators as defined by the World Bank. The goal is to lead in a second time an analysis of criticism made by Mushtaq Khan on the definition of governance, the causes of state failure and barriers to economic development. Our contribution is to scrutinize the concept of good governance and the failure of states taking into account the level of development and governance capacity based on a structure and distribution of political power that evolves over time which may or may not be positive for growth. The assumption we make here is that the so-called good governance policies are relevant if countries reach an adequate level of economic and social development that enable institutions of good governance to boost growth.

II. Good Governance, State Failure and Economic Growth: The Level of the Debate

2.1. The approach to institutions neo-institutional economists called good governance positively affect economic growth.

Institutions are all formal rules (legal, economic, political) and informal rules (social, behavioral norms, conventions) that structure social life. According to Douglass North\(^\text{1}\), a distinction should be made between formal and informal institutions.

Good governance in the definition of the World Bank is the capacity of management and institutional reforms conducted by state policy that improve coordination and delivery of effective public services, accountability of political actors and individual citizens in the driving of development policies. Good governance, therefore, connects adequate political institutions and practices to allow development. Several econometric studies\(^\text{2}\) tested the relationship between good governance in the sense of "market-enhancing governance" (stimulus institutions contract): a positive relationship has been obtained between good governance and economic growth. Then implementation of good governance policies can promote economic development and ensure convergence towards level of developed economies.

2.1.1 Indicators of Good Governance according to the World Bank: Presentation and interpretation according to Douglass North thesis\(^\text{3}\)

The World Bank\(^\text{4}\) built composite indicators summarized under six headings:

-“Voice and accountability”: measures tendencies of political process, civil liberties, political rights and independence of the media. The responsibility is that of citizens who participate in political life through elections, public decisions.

-“Political instability and violence”: measures the perception of a possible


\(^{3}\) Ibid.

could not provide an institutional framework conducive to growth and economic behavior of agents of the economies of the Third World. From this institutional diagnosis the arguments of insecure property rights, legal rules ambiguity and uncertainty in the historical stagnation and contemporary underdevelopment. Specifically, North highlights economies of the Third World as due to their institutional weakness, which causes definition of indicators of the World Bank. North diagnosed failure in development of the measuring the degree of respect, quality and efficiency of the rules.

The state must be equipped with skills so that it has capacity in the binding enforcement. The state must be equipped with skills so that it has capacity in the binding agreements.

-“Quality control”: measures perceptions which are favorable or unfavorable to a market economy, including anti-liberal interventionist policies, such as price controls, imports and exports, and the banking system. This index allows for the appraisal of the business climate for foreign investors, for example.

-“Control of corruption”: measures perceptions of the use of public power in the pursuit of private gain.

These indicators are rated on a scale as appropriate -2.5 to +2.5 or on a scale from 0 to 100. The lowest indicator is considered as the least favorable and above that figure the most favorable.

The purpose of the construction of these indicators is to measure the evolution of good governance by country and implement a policy to improve these indices in order to ensure that improving good governance could reduce the failure of the state. Indeed, in the first argument, the state, seen in its functions as a public services provider, is right but seems to be narrow if it assumes to reflect the ability of the state to carry out economic development policies and policy and social changes. The role of the state is certainly to create a set of institutions that constitute the “rules of the game” which offer people incentives, opportunities, so that social coordination operates. The institutions included in the indices of the World Bank include security of property rights through, for instance, the “rule of law” indicator. Nevertheless, the improvement of this indicator needs to take into account the notion of “enforcement” considered as efficiency or a certain degree of enforcement. The state must be equipped with skills so that it has capacity in the binding rules it has issued. Hence, the construction of institutional indicators would include measuring the degree of respect, quality and efficiency of the rules.

Institutions and evolution of institutions developed by North have influenced the definition of indicators of the World Bank. North diagnosed failure in development of the economies of the Third World as due to their institutional weakness, which causes historical stagnation and contemporary underdevelopment. Specifically, North highlights the arguments of insecure property rights, legal rules ambiguity and uncertainty in the behavior of agents of the economies of the Third World. From this institutional diagnosis the first thesis, which puts in relation failure of states and “bad governance” of states that could not provide an institutional framework conducive to growth and economic

---

2 Ibid.
performance, could have emerged.

2.1.2 Indicators of Good Governance from IRIS (University of Maryland, USA)

Stephen Knack\(^1\), constructed indicators of good governance with his team of IRIS (Maryland University), in reference to North’s institutional concepts\(^2\) in order to support the thesis of initial conditions for economic development: only improved good governance can lead to secure property rights, improved equity and legal credibility secure contracts assumed by the government whose bureaucratic quality and low corruption exist. Thus, the government can promote entrepreneurship, orient investment and production in productive sectors and not in other unproductive sectors which are sources of rents far from the optimum of social income in the sense of economic theory. Stephen Knack believes that there is a consensus among economists about the sources of growth which cannot be explained solely by natural resources, climate or foreign aid, but by the institutional conditions that encourage economic sources of wealth activities by reducing transaction costs due to the security of contracts, the institutional framework that promotes investment, production, specialization, and building of human capital.

Stephen Knack and Philip Keefer\(^3\) used similar indicators as those of the World Bank, which took into account the impact of risk issues - Country: there are five indicators: “corruption in the government”, “state right”, “the risk of expropriation”, “repudiation of contracts by the government”, “the quality of the bureaucracy”. They have found that an increase in the composite index of 12 points on a scale of 50, allows annual growth rate of income per capita to increase by 1.2% on average. They developed a synthetic indicator, the "ICRG Index", which represented an explanatory variable of per capita income growth: The model includes other explanatory variables:

- the level of education (between 1980 and 1998)
- the log of inflation (between 1980 and 1998)
- the coefficient of variation of inflation (same period)
- Monetary mass M2 / GDP and Exports / GDP

All these variables were chosen because of their significance in the literature of good governance and explanation of growth of GDP per capita.

2.2 Empirical results of the work of the World Bank

Daniel Kaufmann\(^4\) developed a set of six composite indicators covering nearly 190 measures perception of governance and agglomerate the collection of data from 17 institutions, out of 170 countries. Kaufmann’s studies correlate the quality of governance with the per capita income in all the countries studied. Thus, their econometric studies show a positive relationship between income per capita growth rates and improvement in the components of each indicator of good governance.

Daniel Kaufmann concludes with the following assumptions:
- Better governance has a significantly positive effect on per capita income
- An improvement in income leads to better governance

\(^2\) Ibid.
\(^3\) Ibid.
\(^4\) Ibid.
- Other factors affect the increase in income and wealth of countries and are also associated with better governance.

Considering Daniel Kaufmann’s the relationship between governance and income levels and GDP growth rate operates in an opposite direction, and then it is surprising that in the short term high income levels produce only weak governance.

In another article, entitled “Growth without Governance”, Daniel Kaufmann and Aart Kraay\(^\text{\textsuperscript{d}}\) analyze the causality between growth in per capita income and governance, leading them to analyze growth of per capita income over the long term, particularly the last two centuries, and did not reveal big differences between countries. The gap in per capita income we know today makes industrial and technological revolutions which have allowed the accumulation of physical and human capital and achieved a level of wealth and income per head of the current developed countries that distinguish developing countries have not experienced the same social transformations.

Referring to the work of Robert Hall, Charles Jones\(^\text{\textsuperscript{c}}\) and Daron Acemoglu, Simon Johnson, James Robinson\(^\text{\textsuperscript{c}}\), companies that enjoy high income levels today have experienced in the last two centuries a very rapid rate of economic growth. Their economic performance can be interpreted by deep historical differences in the quality of their institutions. This work has focused on developing countries that had a colonial history and show a strong relationship between initial institutional quality and growth in the long run.

In general, Daniel Kaufmann’s consideration of reverse causality, from income levels of governance, is as plausible as countries with high incomes can financially take the implementation of good policy governance improving government effectiveness, rule of law and control of corruption.

But is the relationship between growth in per capita income and governance always positive? Daniel Kaufmann and Aart Kraay\(^\text{\textsuperscript{d}}\) indicate that it is not; the sign of the positive or negative causality depends on the implementation of a proactive policy of States that build a set of efficient institutions and forward improvement the so-called good governance. Daniel Kaufmann's thesis is that causality could not be automatically positive without considering the political will and the existence of feedback mechanisms (feedback loops) between per capita income and governance, to create a “virtuous circle” of good governance and national wealth.

Thus, the thesis of improving per capita income and waiting for mechanical improvement of governance is challenged by Daniel Kaufmann. He followed in a certain way the thesis developed by Mushtaq Khan since 1995 on the role of the political factor in economic growth: in effect, Mushtaq Khan developed the concept of "political settlement" and “patron-client networks” combined with his analysis of “rent-seeking”, explaining that good governance can only occur if one overcomes the symptoms of “state failure”. The


\(^{d}\) Ibid.
state can improve its governance and makes economic reforms for growth, if the elites forming the coalition have an overlap of interests between growth strategy and their proper rent seeking. Daniel Kaufmann develops a similar thesis explaining the existence of “feedback” in the negative relationship between per capita income and governance, which are caused by the phenomenon of predator State, defined as the illegal or improper influence of the state represented by its elites forming interest groups, on the construction of laws, policies and rules, which can lead to poor governance. Thus per capita income can increase without improved governance, when the latter does not converge with the interests of the elite.

2.3 Critique of good governance by Mushtaq Khan and the theoretical alternative to the relationship between institutions and growth in developing countries.

As seen earlier, economists oppose two theses on the role of institutions in the definition and establishment of good governance: the so-called theory of “market enhancing governance” which attributes to the State strictly sovereign functions of justice, police and compliance with market rules. The state would be the actor that establishes and strengthens the institutional rules, so that the market can operate more efficiently by ensuring the exchange contracts, private property, establishing incentives and binding rules for the market.

2.3.1 Discussion of Mushtaq Khan’s thesis about relationship between good governance and economic growth.

Several econometric studies by Daniel Kaufmann and Aart Kraay\(^1\), Stephen Knack and Philip Keefer\(^2\), Robert Barro\(^3\), Hall and Jones\(^4\) showed that the variables of good governance, such as control of corruption, stability of property rights or democracy are closely correlated with variables, such as GDP growth rate per capita, investment or human capital development. These empirical tests seek to support the first view already cited about the relationship between market enhancing governance and economic performance of the countries implementing it. The purpose of these studies is to show that improved indices of “good governance” have positive effects on economic growth and provide long-term convergence with the so called developed countries.

Among the precautions taken by Mushtaq Khan to interpret the results of this literature, the question of temporality is questioned: indeed, if we want to test the effect of good governance mechanisms on economic growth, a reference period of these institutional indicators should be measured in order to study the effects on economic growth, for example a decade or two decades later (data collected by Stephen Knack and IRIS began in 1984 and data collected by Daniel Kaufmann and the World Bank began in 1996). Thus, the authors took the choice to study the relationship between good governance at the end of the period of economic growth which began in 1984 for Stephen Knack’s data or in 1996 for Daniel Kaufmann’s data. In effect, the economic growth period

---

\(^1\) Ibid.
\(^2\) Ibid.
\(^4\) Ibid.
studied is the consequence of political and institutional capabilities developed since the 1950s and 1960s in Asian countries, for example. Good governance indicators of the eighties and nineties are thus not correlated with economic growth which results in the same period. There is a gap period to take into account when considering the effect of good governance on economic growth; otherwise there is a methodological bias. So this means, according to Mushtaq Khan, that the actual relationship studied and not assumed by authors is that of the effect of economic growth on good governance. However, the dependent variable chosen is that of economic growth! The second problem is to take into account a threshold effect in the step reached by countries in their economic growth: underdeveloped countries could make efficient good governance policies only after a period of learning in state capabilities and after reaching a level of development, so that enhancing good governance indicators could generate better economic growth rates.

2.3.2 Other theoretical difficulties highlighted by Mushtaq Khan (2007)

The series selected low and high economic growth to allow detection of the possible correlation between good governance and growth. However, most so-called emerging Asian countries which have successfully developed their economies have experienced strong growth rates from the 1960s through 1980. However, statistical series of good governance indicators start for Stephen Knack in 1984 (the best) and for Daniel Kaufmann in 1996 (the worst). If we assume a strong relationship between good governance and economic growth for these rapidly developing countries, we have a lack of institutional indicators in their early historic period of economic takeoff. The significance of the correlation cannot be shown posteriori with indicators of “good governance” for a more recent period of economic growth.

Furthermore, the number of years observed in order to make a robust econometric test is not sufficient to explain the performance in terms of economic growth for emerging countries of the Asian region in particular and enable better understanding of the institutional mechanisms for their economic success.

Another major obstacle is that the levels of the indicators of good governance, although available over the recent period only, do not show a significant difference between fast-growing countries and countries with slow growth. In other words, good governance of fast developing countries does not differ significantly from that of low developing countries. Although we can establish a significant correlation between good governance and economic growth, the level of fast-growing countries indicators does not converge with those of the developed countries.

Table 1: Relation between Property Right Indicator (from 0 to 50) and Growth Rate, 1980-1990

<table>
<thead>
<tr>
<th></th>
<th>Developed countries</th>
<th>Weak Developing countries</th>
<th>Strong Developing countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of countries</td>
<td>21</td>
<td>52</td>
<td>12</td>
</tr>
<tr>
<td>Median of property right index</td>
<td>45.1</td>
<td>22.5</td>
<td>27.8</td>
</tr>
</tbody>
</table>
Good Governance and Economic Growth: A Contribution to the Institutional Debate about State Failure in Middle East and North Africa

1.2.1 The Relationship between Good Governance Indicators and Economic Growth

The relationship between good governance indicators and economic growth is not straightforward. Studies have shown that good governance indicators from the 1980s and 1990s are not correlated with economic growth of the same period. This suggests a gap period that needs to be taken into account when considering the effect of good governance on economic growth. According to Mushtaq Khan, the actual relationship studied and not assumed by authors is that of the effect of economic growth on good governance. However, the dependent variable chosen is that of economic growth. The second problem is to consider a threshold effect in the step reached by countries in their economic growth: underdeveloped countries could make efficient good governance policies only after a period of learning in state capabilities and after reaching a certain level of development.

2.3.2 Other Theoretical Difficulties Highlighted by Mushtaq Khan (2007)

The series selected low and high economic growth to allow detection of the possible correlation between good governance and growth. However, most so-called emerging Asian countries which have successfully developed their economies have experienced strong growth rates from the 1960s through 1980. Statistical series of good governance indicators start for Stephen Knack in 1984 (the best) and for Daniel Kaufmann in 1996 (the worst). If we assume a strong relationship between good governance and economic growth for these rapidly developing countries, we have a lack of institutional indicators in their early historic period of economic takeoff. The significance of the correlation cannot be shown posteriori with indicators of "good governance" for a more recent period of economic growth.

Furthermore, the number of years observed in order to make a robust econometric test is not sufficient to explain the performance in terms of economic growth for emerging countries of the Asian region in particular and enable better understanding of the institutional mechanisms for their economic success.

Another major obstacle is that the levels of the indicators of good governance, although available over the recent period only, do not show a significant difference between fast-growing countries and countries with slow growth. In other words, good governance of fast developing countries does not differ significantly from that of low developing countries. Although we can establish a significant correlation between good governance and economic growth, the level of fast-growing countries indicators does not converge with those of the developed countries.

| Table 1: Relation between Property Right Indicator (from 0 to 50) and Growth Rate, 1980-1990 |
|---------------------------------|-----------------|-----------------|-----------------|
| Developed countries             | Weak developing countries | Strong developing countries |
| Number of countries             | 21               | 52              | 12              |
| Median of property right index  | 45.1             | 22.5            | 27.8            |
| Difference observed from property right index | 25.1-49.6        | 9.4-39.2        | 16.4-37.0       |
| Median growth rate per capita, 1980-1990 | 2.2            | -1.0            | 3.5             |


| Table 2: Relation between Property Right Index and Growth Rate (from 0 to 50), 1990-2003 |
|---------------------------------|-----------------|-----------------|-----------------|
| Developed countries             | Weak developing countries | Strong developing countries |
| Number of countries             | 24               | 53              | 35              |
| Median of property right index  | 47.0             | 25.0            | 23.7            |
| Difference observed from property right index | 32.3-50.0        | 10.0-38.3       | 9.5-40.0        |
| Median growth rate per capita, 1980-1990 | 2.1            | 0.4             | 3.0             |


| Table 3: Relation between Voice and Accountability Index (between 0 and 1) and Growth Rate, 1990-2003 |
|---------------------------------|-----------------|-----------------|-----------------|
| Developed countries             | Weak developing countries | Strong developing countries |
| Number of countries             | 24               | 53              | 35              |
| Median of Voice and accountability index | 1.5            | -0.4            | -0.3            |
| Difference observed from Voice and accountability index | 0.4-1.8         | -1.5-1.1        | -1.7-1.4        |
| Median of growth rate per capita, 1980-1990 | 2.1            | 0.4             | 3.0             |


| Table 4: Relation between Political Stability and Violence (from 0 to 1) and Growth Rate, 1990-2003 |
|---------------------------------|-----------------|-----------------|-----------------|
| Developed countries             | Weak developing countries | Strong developing countries |
| Number of countries             | 24               | 53              | 35              |
| Median of Political stability and violence | 1.2            | -0.4            | 0.0             |
| Difference observed from Political stability and violence | -0.5-1.6        | -2.8-1.1        | -2.7-1.0        |
We note that the median of property rights, voice and accountability, political stability and the violence index compared for weak and strong developing countries, do not differ significantly. However, the median indices of “good governance” of both countries having slow and fast development groups significantly detached from developed countries. Thus, developing countries, with high per capita GDP growth, converge on economic growth but differ in terms of “good governance” from developed countries.

Here is a graphic illustration of non-disparity in the results of good governance among countries in slow and rapid development indices obtained during the panel econometric studies of IRIS and the World Bank:

The empirical results of Stephen Knack and Daniel Kaufmann reveal a strong correlation between good governance and GDP growth rate per capita, without convincing that the level of institutional indicators of fast developing countries can converge with that of developed countries. We can therefore conclude that the enhancing of good governance cannot be a guarantee of GDP per capita growth and vice versa, the GDP per capita growth...
can allow improving governance without guaranteeing that its level may converge with that of developed countries. So, it must be inferred that other factors may explain at once the growth of GDP per capita and the improvement of good governance indicators.

III. Empirical Study and Main Results

3.1 Content of our model

In this article, we will provide only the results of our previous empirical study\(^1\) which aims to offer answers to the questions of the relationship between economic performance and quality of institutions in 45 developing countries. Several models are estimated, first a panel with fixed effects on GDP growth and GDP per head and finally the growth rate of deviation from the global average over the period 1996-2011. We tried to explain the role of institutions in economic performance of different regions studied (MENA, MENA oil, non-oil MENA, Latin America, East Asia and South). The model chosen for the study combines the determinants of economic performance (GDP growth rate and the GDP per capita), Internal (institutional quality), and external (commodity prices, index of risk perception of global finance and rates Growth in the developed world)

3.2 Main results

We find that the explanatory variables growth rate of developed countries and commodity prices are positive and highly significant with a t-stat and the probability of rejecting H0 is less than 5% of error. Similarly, finance variable is highly significant but with negative sign in the model of GDP growth rate as the dependent variable.

If the variable is of decomposed institutions, we observe that the same non-institutional variables are highly significant, but in the institutional variables, only two variables, namely “government effectiveness” and “political stability and reducing violence” are very significant. These very significant variables are the same as those of the model with growth rate of GDP as an explanatory variable. For the MENA region as a whole, non-institutional variables are highly significant with negative sign for finance. If we break down the INSTIT variable, we also get a significance of non-institutional variables, but for institutions, we retain only the variable “political stability” as very significant.

We find for the other a negative sign and a lack of significance for “voice and accountability”, “control of corruption”, “government effectiveness” and “rule of law”.

For the non-oil MENA, only the variable growth rate in developed countries is very significant. The price of raw materials is less significant. The analysis of institutional variables shows that only “political stability” is significant for non-oil countries. “Voice and Accountability”, “control of corruption” and “government effectiveness” are not significant and even have a negative sign.

For the oil MENA, we find that the growth rate of developed countries is very significant, unlike all other variables. If we analyze effects of institutions, we find that “political stability” is the most significant. This finding is the same as that of the non-oil

MENA, about the role of institutions on GDP per head.

In Latin America, the decomposition of institutions variable does not change the significance of non-institutional variables and highlights only the variable “political stability” as very significant. We note that the variable “voice and accountability” is positive and weakly significant and the variable “rule of law” and not meaningful with negative sign.

In Asia, only the variables growth in the developed countries and commodities are very significant. We find that non-institutional variables, as growth in developed countries, finance and commodities, are not significant. On the other hand, we see that three institutional variables are very significant: “voice and accountability”, “government effectiveness” that are a positive sign and “control of corruption” that has a negative sign.

3.3 Interpretation of the negative sign of the variable good governance

The presence of institutional variables negative sign leads us to ask ourselves the inverse relationship between governance and economic growth: it is in fact admitted in the studies done on “good governance” that improved indices are positively correlated with the growth of GDP per capita. But how could we explain the positive effect of these negative institutional indicators on economic growth?

Scholars such as Paul Bardhan\(^5\) and Bibel Ben Nahia\(^6\) show the possibility of a positive effect on FDI in the degradation of institutional variables as the “quality control” and “control of corruption”. Indeed, the arguments show that corruption can be favorable to companies wishing to finance investment projects but come up against bureaucratic obstacles due to excessive government regulations. These companies are willing to pay a bribe to speed up administrative procedures. Paul Bardhan\(^5\) believes that corruption in this form generates a time saver since it plays the role of facilitator in administrative proceedings. According Bibel Ben Nahia\(^5\) corruption can have a paradoxical effect since it can be beneficial to foreign direct investment (FDI). Kaufmann also discusses this ambiguous effect of corruption which “lubricates the mechanism” or “greases the wheels”.

Other empirical works, such as Peter Egger and Hannes Winner’s\(^7\) support the view of a positive effect of corruption on direct investments flows: their panel includes 73 developed and developing countries which capture 90% of direct investments flows worldwide over the period 1995-1999, using the data on corruption from Transparency International and the World Bank. The study shows that corruption can have a short-term positive effect on the entry of direct investment flows. Overall, this literature can help to provide explanatory elements of the negative signs of institutional variables such as corruption.

The negative sign was notably found in our estimates for Asia: the experience of Asia in terms of foreign investment showed that foreign direct investment flows have been enhanced by high levels of corruption.

---


\(^7\) Ibid.

\(^7\) Ibid.

IV. Conclusion

The work of descriptive and econometric analysis above is a contribution to the debate on institutional conditions for economic takeoff in developing countries. The results of our studies based on a sample of 45 developing countries do not permit us to conclude as Kauffman and Knack do on the high significance in the relationship between “good governance” and economic growth: in fact, on the one hand, all countries from all regions do not know the significance even on the same indicators: Asia and Latin America regions converge regardless of the model tested for the huge significance of the “voice and accountability” indicator. Nevertheless, the two regions diverge for all models tested on other indicators. Latin America has a very strong significance of the “political stability and reducing violence” indicator (all models) and the “Rule of Law” indicator (for GDP per capital model). In the MENA region, only non-oil MENA countries converge with Latin America for indicators of “political stability” in all models, and for the “rule of law” indicator only in GDP growth per capita model. The oil MENA region differs in the sense that most of the institutional indicators are not significant. Otherwise, non-oil MENA and Latin America have a very significant result for the “political stability” indicator for all models. Asian countries display a singular way with a very strong significance of three indicators: “voice and accountability”, “control of corruption” and “government effectiveness”.

The indicator that emerges in our estimates for its strong significance and this for all models and virtually all regions (excluding Asia) is the “political stability and reducing violence”: the transversal application of this indicator leads to the conclusion that improved political stability is a major institutional factor of growth and economic catch in developing countries.

The argument of the neo-institutional economists is that improving indicators of “good governance” is a necessary condition for creating the institutional conditions of lowering transaction costs and thus a competitive market is conducive to increasing the efficiency in the allocation of resources and the pace of economic growth. However, this thesis supported by econometric work of Kaufmann and Knack was criticized by Khan, especially since the good governance of fast-growing developing countries indicators are not significantly different from those of low-growth countries. The thesis of economic catch-up in developing countries by improving good governance index is weakened by this.

The thesis is more efficient when it comes to carry out economic reforms and improve governance indices and to improve the operation of an existing market economy as in the specific case of developed countries. Nevertheless, this obscures in developing countries, structural and institutional conditions in the creation of a market economy and a capitalist economic system which implies a major social transformation and the emerging of formal and informal institutional framework. In this issue, the role of the state is crucial in order to drive economic development: the state must acquire skills to orient capital onto economic sectors with high added value and increase productivity. Khan developed for this purpose
the concept of “political settlement” that is stable and consistent relationship between the
distribution of political power, an institutional framework and economic growth in a
country. Instead of “good governance” as a precondition for economic growth, Khan
replaces it by the notion of governance seen as redistribution of power to a stable political
coalition whose interests coincide with those of the reform and restructuring of the
economy, sources of growth and economic and human development.

Our work allows supporting the criticism of Khan on the correlation between good
governance and economic growth to the extent that our empirical results do not support the
huge significance of the correlation nor its generalization to all developing country regions.
So, economic growth and takeoff in developing countries cannot be explained only by
good governance indicators as argued by institutional authors. Taking into account the
complexity of the issues, including economic rent seeking in the relations between political
power and coalitions functioning of the economy requires to develop a broader analysis of
the concept of good governance to better understand the role of political and institutional
factors in economic development.