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# GROWTH FUNDAMENTALS AND ECONOMIC GROWTH IN THE MENA REGION

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**Abstract**

This paper examines the strategies of Middle Eastern and North African (MENA) countries concerning growth-enhancing institutions and policies. Long-term economic growth depends crucially upon the quality and robustness of a country's institutions. The fundamental institutions are typically perceived as rule of law, impartial courts, representative government, effective bureaucracy, and open markets with minimum necessary regulation. However, building these growth fundamentals takes a long time and a great deal of resources. As a result, for developing countries with weak institutions, a key growth strategy question is whether to focus on building their institutions and to wait for the long-term growth to emerge or to seek short- and medium-term substitutes for the fundamentals, which are not permanent solutions and may violate some principles of good governance, but bring about growth for a while and create opportunities for further development. It is argued that some MENA countries have been investing in the fundamentals with limited returns so far. Some others have found good substitutes and have grown faster. But, most have lacked conscious and effective growth strategies. This bodes poorly for the ability of the latter countries to cope with the waves of future economic shocks.

**ملخص**

تبحث هذه الورقة أساليب دول الشرق الأوسط وشمال أفريقيا بخصوص المؤسسات والسياسات المعززة للنمو. ويعتمد النمو الاقتصادي طويل الأجل بصورة أساسية على جودة مؤسسات الدولة وقوتها. وتتمثل تلك المؤسسات الأساسية نمطياً في سطوة القانون، وحياد القضاء وتمثيل الحكومة وفعالية البيروقراطية وانفتاح الأسواق مع وجود حد أدنى من القيود التنظيمية الضرورية. ومهما يكن من أمر، فإن إقامة أسس النمو هذه، يتطلب وقتاً وطويلاً وقدراً عظيماً من الموارد. ومن ثم يتعين مع الدول النامية ذات المؤسسات الضعيفة أن تجد إجابة على سؤال مهم يتعلق بأساليب النمو وهو أيهما أولى باهتمامها: بناء هذه المؤسسات ثم الانتظار لحين ظهور النمو طويل الأجل؟ أم السعي لإيجاد بدائل قصيرة أو متوسطة الأجل لتلك المؤسسات، لا تشكل حلولاً دائمة، بل قد تعد انتهاكا لمبادئ الحكم الجيد، ولكنها تحدث نمواً إلى حين وتخلق فرصاً للمزيد من التنمية؟

## 1. Introduction

In recent years, the sharp increases in the price of oil seem to have speeded up the pace of economic growth in the Middle East and North African (MENA) region. After many years of slow growth during the oil slump, a key question now for the economies of region is whether the renewed growth will continue to be driven largely by the oil boom and end, sooner or later, with the eventual stagnation or decline of oil prices. What can be done to avoid that fate and bring about higher rates of long-term economic growth to MENA countries? In which ways are MENA countries on track and what factors have prevented faster and broader growth experience in the region?

Over the past couple of decades, there has been increasing recognition that long-term growth crucially depends on governance, that is, the institutional constraints and incentives facing the economy's policymakers, administrators, and other agents. However, the nature of the institutional arrangements that provide appropriate incentives for fast growth remains unclear. Economies are complex phenomena and institutions entail innumerable details, making it difficult to know which arrangement works well in each context. Sometimes, more or less the same outcome is generated by different arrangements, while similar arrangements seem to produce divergent outcomes in different contexts. Of course, the key concern is the functions that institutions provide and, one may argue, the details should not matter as long as the outcome meets the first-order economic principles. Indeed, there is a widespread view among many economists and policy analysts, especially in multilateral institutions, that high growth can be achieved by implementing institutions that yield key principles of good governance, specifically rule of law, impartial courts, representative government, effective bureaucracy, and open markets with minimum necessary regulation. But as Rodrik (2005) points out, these principal requirements do not map into unique institutional arrangements and policy packages. The approach can shed light on the types of policies that might sustain growth, but does not offer any specifics. Some policy analysts, especially in multilateral institutions, have searched for "best practice" policies and institutions to offer a menu of options to policymakers in developing countries. But such prescriptions have rarely worked because the outcomes of growth policies and institutions are highly context-specific.

The view that growth in low-income countries requires focusing on the principles of good governance faces further, perhaps deeper, challenges as well. The range of institutions and policies typically identified as embodying those principles (here called "growth fundamentals") consists of those that have sustained growth as self-correcting processes in developed countries over long periods of time. Building growth fundamentals takes a long time and it is not clear that growth is a rising function of progression towards better fundamentals. In fact, partial progress in some dimensions can slow down growth, as in the case of democratization in the absence of other strong fundamentals, which may exacerbate the common pool problem in policymaking. See also Rodrik (2008) for more micro-level examples. So it is not clear that focusing on growth fundamentals will bear fruit in terms of growth in a politically feasible time frame. Moreover, the fundamentals seem to be as much the outcome of the growth process as its prerequisite. Thus, for low-income countries, the key issue seems to be finding some other means of triggering and sustaining growth for at least a few decades, creating a chance for the fundamentals to develop. Indeed, this is precisely what most successful fast growers among developing countries seem to have done.

The mechanisms that can serve as substitutes for the fundamentals are different from the fundamentals themselves in two important ways:[1] The substitutes have much shorter

[1] The idea of substitute for the fundamentals expounded here is closely related to Rodrik's (2008) concept of "second best" institutions. However, I use the term substitutes to emphasize the non-permanent and instrumental nature of the institutions that may help promote growth in the absence of adequate fundamentals.

expected lives that the fundamentals and may violate some principles of "good governance," as commonly defined. For example, rapid growth in East Asia has generally been managed by single party, dictatorial governments that intervened heavily in the economy and motivated investment and innovation at least partially based on personal trust relations. These features also suggest why such substitutes are not expected to survive in the long run and, eventually, are to be replaced by strong fundamentals if the country's growth is to continue, as has happened in Korea and Taiwan. They seem to work in the short and medium run because they address serious contracting failures in the economy and remove its most important bottlenecks. But once the economy moves beyond those bottlenecks, new problems arise and new arrangements may be needed. Such dependence on the time and constellation of constraints on growth makes the appropriate policy and institutional solutions quite context specific and hard to identify from outside the system. The choice is even more complex when one wants to take into account the fact that the substitutes should sooner or later lead to the development of growth fundamentals and give way to them.

This background enables us to ask our opening questions about economic growth in MENA somewhat differently. In particular, it is important to inquire about the extent to which MENA countries have tried to develop their growth fundamentals as opposed to relying on some form of substitute. How successful has each strategy been? Which types of substitutes have been employed in MENA countries? How successful have those countries been in identifying the right substitutes? The present paper makes an attempt to explore and address these questions. I start in Section 2 with an overview of growth and institutional development in MENA. In Section 3, I examine the impact of economic growth on the fundamentals in a broad cross-country setting. Then, in Section 4, I analyze the role of growth fundamentals and substitutes in MENA. Section 5 sets out my conclusions.

## 2. Growth and Institutional Development in MENA

Table 1 summarizes the trends in economic growth of MENA countries since 1970 and compares them with the average trends in high-income OECD countries as well as oil-exporting and other developing countries in the rest of the world. Figures 1a and 1b offer more detailed glimpses of such trends over a longer period, but focus on subsets of MENA countries to make the graphs accessible. In these figures, it is notable that in the 1950s MENA countries generally had incomes well above the average of non-oil-exporting developing countries and close to the incomes of oil exporters at the time. This advantage was maintained until some time around 1980, and most MENA countries did even better than oil exporters in other regions. Then a period of slowdown or decline started across the region, which ended sometime in the mid-1990s. However, growth since then has been relatively slow, especially when compared to the weighted averages in the rest of the developing world. It is true those averages are in part driven by the high performance in two most populous countries in the world, China and India, but it highlights the standards that can be reached, but are not attained in MENA. Even the recent oil-driven boost in growth does not seem too eye-catching, whether one uses the averages for the oil exporters or the non-oil-exporting countries as the standard.

Another important observation in the growth experiences in MENA is that despite the common trends discussed above, there are still large variations in terms of average growth and volatility across countries, whether oil-exporting or otherwise. In particular, oil-exporting countries have generally experienced more volatility and the slower growth rates since 1970. However, some non-oil-exporting countries, especially Jordan, have also been subject to economic fluctuations. As we will see below, these variations seem to be linked more closely to differences in the substitutes for growth fundamentals rather than to the fundamentals themselves.

One may wonder whether the above trends are largely due to the pattern of population growth or the direct role of oil and other natural resources in GDP in MENA countries. However, this does not seem to be the case, as shown in Table 2, where I present the average growth rates for per worker GDP adjusted for energy and mineral depletion.

Is economic performance in MENA countries related to the development of their growth fundamentals? To explore the possible answers to this question, I use the six Governance Indicators developed by Kaufmann, Kraay, and Mastruzzi (2007) that are closely linked to the concept of fundamentals and capture their key elements. The dataset covers 1996-2006 and includes the following indices, which are expressed in terms of standard deviations of country rankings around zero.

> 1. *Voice and Accountability* measures the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
>
> 2. *Political Stability and Absence of Violence* gauges the perceptions of country experts concerning the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism.
>
> 3. *Government Effectiveness* reflects the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
>
> 4. *Regulatory Quality* indicates the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
>
> 5. *Rule of Law* measures the extent to which citizens have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.
>
> 6. *Control of Corruption* is an indicator for the extent to which a country's institutions prevent the exercise of public power for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Table 3 presents the 1996-2006 averages of these indicators for MENA countries and compares them with the weighted averages from oil exporters and other developing countries outside MENA as well as the minimum levels reached among high-income OECD countries during the same period. The table shows that, except for *Voice and Accountability*, on average MENA countries do better than most other developing countries. In that sense they seem to be relatively better endowed with the fundamentals than many other countries. The weakness in *Voice and Accountability* is of course an issue, but this dimension of governance does not seem to be a condition for economic growth. Indeed, despite a major quest to assess whether democracy—the ability of citizens to express their views and hold public officials responsible for their actions—is a fundamental condition for long-term growth (Barro, 1996; Przeworski, 2004; Acemoglu, Johnson, Robinson, and Yared, 2007), there is no evidence that it contributes to growth at lower levels of development, possibly because in the absence of complementary institutions, high coordination costs may counteract the benefits of broad political participation (Olson, 1982; Przeworski, 2004) even though democracy does coincide with high levels of income.

Although the Governance Indicators of Kaufmann *et al*. (2007) are rather comprehensive, they are available only from 1996. To show a glimpse of trends in the development of the growth fundamentals in MENA, in Table 4 I summarize the Rule of Law index available

from Political Risk Services' governance dataset, International Country Risk Guide (ICRG). The picture that emerges from these data for the post-1994 period is similar to the one produced by the Governance Indicators, but it is a generally more positive one for MENA compared to the rest of the developing world. The table further shows that most of this improvement had come about between the mid-1980s and mid-1990s, when MENA countries were experiencing a major economic slowdown. This is a very different picture from the one often depicted of MENA countries as continuing to be held back by "governance deficit" (World Bank, 2003). The problem, as I argue here, is that building growth fundamentals may not pay off for quite some time, and alternative mechanisms are needed in the mean time to move the joint process of economic and institutional development forward.

While MENA countries on average rank higher than other developing countries in terms of growth fundamentals, their growth rates do not rank similarly. This is even more visible in the case of one group of Gulf MENA countries that has done particularly well in building its fundamentals—namely, the Cooperation Council (GCC), excluding Saudi Arabia, that is, Bahrain, Kuwait, Oman, Qatar, and the UAE. These small, oil-rich countries have generally attained levels of growth fundamentals comparable with or above the minimums prevailing in the high-income OECD countries, yet their economic growth has been far below those in most other MENA countries and the rest of the world. It seems that these countries have used their large oil resources to build their growth fundamentals rather successfully. But the payoff from that investment has been slow to come. As the steady rise in GDP per capita since the mid-1990s in the UAE suggests (see Figure 1a), growth may finally be coming to this part of the region. But even that trend is not particularly supportive of the view that building the growth fundamentals in developing countries pays off within a few decades.

To further highlight the complexity of the relationship between the fundamentals and economic growth, I map economic growth during 1970-2006 (Figure 2) against a pivotal indicator of governance, Rule of Law, using the earliest data available from the International Country Risk Guide (ICRG) dataset. The fact that these data refer to the mid-1980s entails some endogeneity problem for interpreting the impact of the fundamentals on long-term growth. But that does not affect a key conclusion one can draw from Figure 2: above some minimal levels, achievements in the fundamentals do not seem to have been associated with economic growth during the past four decades. In fact, the highest growth rates have been reached by countries in the middle ranges of Rule of Law score, though even at low levels of the index, there are countries that have consistently grown fast and have converged on the high-income OECD group. These claims become stronger if we take into account the possible positive effects of growth on the development of the growth fundamentals. That is, high growth countries may have in fact started with lower Rule of Law indices than shown in Figure 2, weakening any support for the view that rapid growth needs to start by building the fundamentals.

The above observations do not mean that growth can continue indefinitely without adequate fundamentals. Rather, they suggest that the growth process can start and continue for some decades without strong fundamentals. This can give a country a chance to develop its growth fundamentals and eventually transit into a state of sustained long-term growth based on institutions that function indefinitely in a self-correcting process. This is, in fact, what the successful developing countries such as Korea and Taiwan seem to have achieved. In the next section, I will present econometric evidence confirming that growth can indeed contribute to the development of the fundamentals. The question that will remain then is the nature of the substitutes that can support growth during the combined institutional and economic development process. I will return to this question and examine it in the context of MENA countries in Section 4.

## 3. Economic Growth as a Determinant of Institutional Development

To make the case that growth may be as much the cause of institutional development as its consequence, I regress the average ICRG Rule of Law index during 2004-2006 on economic growth during 1984-2004, while controlling for the initial conditions in 1984 as well as regional effects. The reason for averaging the Rule of Law index over the three years is to reduce the effect of the ranking in individual years. I also repeat the exercise for sub-periods 1984-1996 and 1994-2006. Because the Rule of Law index ranges from 1 to 6, the dependent variable of the regression is a limited one and a TOBIT estimation method is required. In addition, since growth is endogenous, I instrument it with the terms of trade change during the period. This is an appropriate instrument because changes in the terms of trade are unlikely to be directly correlated with the Rule of Law, while they are correlated with growth, though rather weakly (a correlation coefficient of about 0.3).

The initial conditions are measured by the three year averages of the Rule of Law index and openness (share of imports plus exports in GDP) at the start of the period. I experimented with the initial level of GDP per capita in the regressions, but it was never significant. The regional dummies that showed any significance, and were thus retained in the final results, are those for high-income OECD countries, MENA, and East Asia and the Pacific. Transition countries are not included in the regression because their histories with growth and institutions building are too short. The sources of data for the analysis are cited at the bottom of Table 6, which reports the results for both TOBIT and IVTOBIT regressions. Table 5 presents the summary statistics for the observations of variables included in the IV regressions.

It is clear from the results that growth tends to speed up the development of Rule of Law in statistically and quantitatively significant ways. Interestingly, addressing the simultaneous bias by instrumenting for growth raises the magnitude of its estimated coefficient considerably. The results imply that for a typical developing country, an increase of one percentage point in the rate of economic growth during 1985-2005 could raised its Rule of Law index by about 0.7, or by an average of 0.35 per decade. This means that a typical developing country with a Rule of Law score of 4 in 2005 could have ended up with a score of 5 or 6 (developed country range) if it had grown 2 percentage points faster during 1985-2005. This highlights the positive role that substitutes can play in a low-income country by supporting growth in the absence of the fundamentals for a few decades and creating the opportunity for building long-term institutions of good governance.

The 2 percent growth boost over two decades is indeed the kind of experience that would have put MENA countries above the average for the non-oil-exporting developing countries over the past two decades, while helping them to raise their growth fundamentals to high standards. The positive coefficient of the MENA dummy in the regressions confirms our earlier observation that the countries in the region managed to raise their Rule of Law index, especially between the mid-1980s and mid-1990s. The amount was not trivial at all: on average, the index went up by about one level (out of the five available levels) beyond the score predicted by the model based on the experience of other countries. This effect is not due to the investment that the GCC countries made in their fundamentals, because those countries do not have any terms of trade data and are not included in the IV regressions. Thus, it shows that like the GCC, other MENA countries have also tried to focus on building their fundamentals, though not as vigorously.

The regression results in Table 6 offer a few other interesting observations as well. By the 1990s, the history of institution building in high-income OECD countries had put them two levels (in the index range of 1-6) above the developing countries in terms of Rule of Law index. However, that advantage seems to have dwindled to one level in recent years. Many

developing countries are building their institutions and catching up rather fast. As a result, the initial levels of the index have a relatively small effect on its current levels, especially when one examines the trends over two decades. This indicates that existing institutional endowments are not destiny, and the effort to build institutions (or the neglect and institutional failure) plays an important role in final outcome. Openness also helps in a non-trivial way. Moving from a closed economy with a trade ratio of 20 percent to an open one with a trade ratio of 70 percent can raise the Rule of Law index by an average of 0.65 over two decades. Finally, the improvement in the Rule of Law index in East Asia seems to have come about largely through growth and trade processes. In fact, other factors may have had an adverse effect on that development during 1995-2005.

## 4. Growth Fundamentals and Substitutes in MENA

As we have seen in the above two sections, many MENA countries managed to markedly improve their fundamentals in the 1980s and 1990s. Some, especially THE UAE and to some extent Bahrain and Qatar, seem to have started to benefit from investment in their institutions, though that effect is difficult to separate from the role of rising oil prices over the past decade. The growth dividend for the others remains quite ambiguous. The MENA countries that managed to grow relatively fast are typically not the ones with the best growth fundamentals. In fact, they typically violated some key aspects of the fundamentals, particularly the requirement for "open markets with minimum necessary regulation." This point can be seen in Figure 3, which graphs economic growth during 1987-2006 against a measure of overall Policy Restrictiveness derived from the Heritage Foundation's *Index of Economic Freedom*. This variable is available after 1995 and I have used its average for 1995-1997 to reduce possible errors in individual years. Since, like the Rule of Law, market liberalization may be facilitated by economic growth, the mid-period observation for Policy Restrictiveness should strengthen the expected negative correlation between the two variables. But if anything, the observed correlation is positive. At least, one can say that over the past two decades greater restrictiveness has not always been associated with lower growth across the spectrum. Indeed, the fastest growing non-oil-exporters—Tunisia and Turkey—have maintained moderate levels of intervention. It is also notable that during that period, non-MENA developing countries with no oil exports grew faster on average than all MENA countries, while pursuing generally more restrictive policies.

The fact that many MENA fast growers used relatively restrictive policies may offer clues about why building growth fundamentals in the region has not generated broad payoff. It may also shed light on the kinds of substitutes that some countries have employed to grow faster. To gain some insights into the possible factors involved, it is helpful to compare the two non-oil countries of the region that have experienced relatively high growth rates—Tunisia and Turkey—with the rest of the group. Both countries had pursued extensive state-dominated import substitution industrialization (ISI) policies in the 1960s, and started to liberalize some time in the 1970s and early 1980s. However, in neither case was liberalization quick or thorough. Rather, they relied on some type of "dual track" strategy, a mechanism that later became popular due to its successful adoption in China.[2] Under this strategy, a country with extensive market interventions and public ownership of enterprises starts liberalizing at the margin and allows the latter part to expand based on its higher efficiency. The government maintains many of its interventions as a means of managing political and economic risk, and thus making the reform credible. The strategy also enables the government to learn about the requirements for the proper operation of markets and to develop the necessary institutions

[2] Bechri and Naccache (2006) offer an interesting analysis of the dual track strategy in Tunisia. Öniş and Şenses (2007) provide a summary of Turkey's experience with the strategy. For the case of China, see Lau, Qian, and Roland (2000).

and regulations for new markets. However, interventions continue as a means of support for the new markets and entrepreneurs, support which is needed particularly because the markets in the economy initially suffer from a variety of imperfections. Such interventions can, of course, move the economy in the wrong direction both in terms of efficiency and institutional development, unless policies are ultimately guided by some type of measurable performance criteria. This is why dual track strategies work best when they are combined with a policy focus on export earnings. Indeed, both Tunisia and Turkey moved to rely on export promotion in the 1980s and did much better than Egypt, which also initiated a dual track strategy in 1974 but did not combine it with a vigorous export promotion. Egypt was the beneficiary of considerable foreign aid and had far less need to promote exports than Tunisia and Turkey.

It may be puzzling why countries such as Jordan and Morocco, which had been more market-oriented from the beginning and have better institutional and policy rankings than Tunisia and Turkey, have not grown nearly as fast. After all, it seems they should have had an easier time improving their markets and, therefore, should have done better than those pursuing dual track strategies. In particular, they both started with higher per capita incomes than Egypt and Tunisia in the 1950s (see Figure 1b) and did not go through the highly interventionist phases that the other two countries experienced in the 1960s. But during the following decades neither grew as fast as Egypt, and both fell far behind Tunisia. A possible answer to this puzzle may be the combination of inadequate growth fundamentals with absence of substitutes such as the dual-track-cum-export promotion mechanism. Jordan and Morocco relied on markets, but this did not guarantee that their economies functioned efficiently because their fundamentals were relatively weak and their markets remained imperfect. Policymakers in neither country developed a deeper understanding of how a market economy should work, and solutions to those problems were slow to emerge. Also, they did not develop the administrative machinery to intervene in markets extensively and intensively, as Egypt, Tunisia, and Turkey did. This may seem to have been beneficial because it may have avoided the distortion, waste, and corruption that arise under interventionist regimes. However, the organizational capacity to identify and address the economy's problems did not develop either. Such capacity can help a great deal, especially when the power structure is legitimized based on the government's handling of the economy, and as a result, the policymakers have the incentive to use the administrative experience and capabilities to address the economy's problems and to correct any policy mistakes. Having gained power on the promise of economic prosperity, the ruling politicians in Egypt, Tunisia, and Turkey were under greater pressure to find ways of enhancing growth, subject to their political constraints. Similar political pressures seem to have been weaker in Jordan and Morocco, where the rulers' powers originated from more traditional political structures.

Syria and Sudan are interesting cases that contrast with the other countries discussed so far. Both had dirigist policies until the 1990s when they started to reform. Syria was slow to privatize and tried to rely on "state-led export promotion" in which public enterprises would participate in export markets. However, this has not turned into an effective substitute for its weak growth fundamentals, though it has managed to grow at a moderate rate with help from its limited oil resources and some foreign aid. It is possible that ideological biases may have prevented the policymakers from identifying and implementing more effective policies. The policy choices and the low growth outcome may have also been the result of Syria's geopolitical situation and its high level of defense spending. Sudan, on other hand, has pursued privatization and foreign investment quite vigorously with help from emerging economies such as China, Malaysia, and India, which themselves have relied on various substitutes to grow fast.

Among the oil exporters, as we have seen, the GCC countries clearly focused on building their growth fundamentals by means of their substantial oil rents and engagement of foreign workers and businesses, but the jury is still out on the extent of gains from that strategy. The choice of growth strategy for these countries seems to have been a natural one. They are traditional monarchies built around tribal connections, where the monarchs are expected to look after the welfare of their subjects. When substantial oil reserves were found in those countries after World War II, the monarchs used the export revenues to raise the standard of living of their citizens by subsidizing consumption and providing improved public services. Since domestic labor was scarce and lacked the necessary skills, the monarchies resorted to massive importation of goods and services as well as labor, which required extensive involvement of foreigners in the domestic economy. To ensure that the process remained orderly and delivered sufficient benefits to the nationals, the engagement of the foreigners had to be carefully regulated. Consequently, the governments in the GCC had to focus on establishing clear and effective rules for economic activity and used their substantial wealth to build the necessary mechanisms for backing those rules. Among these countries, the more successful ones—especially Bahrain and the UAE—took pragmatic approaches to economic policy and did not hesitate to recruit foreign expertise to develop their policymaking and administrative capabilities. The result was a quick process of institution building and market orientation that ensured high levels of growth fundamentals and openness. But the other GCC countries have not grown as much, possibly because of their more conservative approaches to the engagement of foreigners in their economies. Foreign workers cannot reside permanently in GCC countries and, at times, have had to depart in large numbers due to regional instability or a drop in oil revenues. The nationals, on the other hand, have enjoyed very high rents with a dampening effect on their incentive to put effort into production or productivity enhancement. The strong fundamentals have played a role in attracting the migrant workforce and ensuring a decent level of productivity, but have not been sufficiently effective in raising productivity continuously and yielding high rates of growth.

Yemen is also an oil-exporting country, but it has hardly managed to develop its fundamentals or find substitutes. In fact, it seems to have gone backward in terms of Rule of Law (Table 4). It has followed advice from multilateral institutions to liberalize its economy, but it lacks the necessary foundations for efficient operation of markets. It also lacks the administrative experience and capacity to identify its own unique problems and formulate policies that address them effectively. As a result, the much hailed economic reforms that it started in 1997 and the resource revenues at its disposal have yielded dismal growth results.

Finally, the case of Iran is an interesting one. It does not score very high on any dimension of the growth fundamentals, and its growth strategy has varied considerably over the years. Yet it has grown faster than most MENA countries over the past two decades. Part of this is due to the rapid recovery that the economy enjoyed in the late 1980s and early 1990s after a decade of turmoil, war, and economic decline under extreme market controls. At that time, the policymakers tried to implement a dual track strategy, but lacked the necessary expertise and approached the reform with an inconsistent set of policies about market liberalization that were in some ways pragmatic, but in other respects rather ideological (Esfahani, 2002). As a result, although Iran's substantial oil revenues helped generate a jump in growth for a couple of years, the liberalization experiment ended in a major financial crisis and growth slowed down sharply for several years. Since then, a mixture of multiple tracks with occasional improvements or regressions in the fundamentals has come to prevail in the economy. The "multiple track" refers to various forms of ownership and control that have emerged under Iran's unique and highly complex political system with its multiple sources of power. The mechanism has given rise to some growth because each "track" can protect its interests and investments under an equilibrium where different political forces balance each other.

However, it also entails major inefficiencies because of lack of adequate coordination. This set- up has enabled the country to use its substantial oil revenues for keeping investment up, which has generated some growth, but the economy's total factor productivity has been virtually stagnant (Esfahani, forthcoming).

## 5. Conclusion

Over the past few decades, many MENA countries have been trying to build good governance as the foundation for sustained long-term growth. Some have tried to do so by promoting the rule of law, efficient courts, effective bureaucracy, and open markets with minimum necessary regulation. These elements, which may be viewed as the main dimensions of growth fundamentals, can support economic development in the long run if they collectively reach certain levels of quality and sophistication. This strategy has gone furthest in the small oil-rich countries of the region (the GCC), but its success has been limited. Those countries have been most suited to adopt the strategy because they have possessed the necessary resources to build their institutions and wait for growth to come while enjoying high standards of consumption. The long-term success of this group crucially depends on their ability to continue their strategy long enough to complete their institutional development and find ways of stimulating growth until it becomes self-sustaining. Other MENA countries that have opted for building the fundaments but lacked large resource rents (such as Jordan and Morocco) have been slow to proceed in that direction or to grow.

The alternative to the strategy of growth fundamentals development has been to find substitute mechanisms that may violate the principles of good governance and are unlikely to remain in place in the long run, but can solve the economy’s problems in a second-best fashion and bring about rapid growth. This can give the country a chance to develop its resources and eventually build its fundamentals. Tunisia and Turkey have been most successful at employing such strategies. Other countries, especially Egypt and Syria, that have pursued such alternatives have not arrived at arrangements that could match their specific conditions. Finally, some MENA countries, especially Iran, have developed new alternatives of their own, but mostly as a result of unintended processes and with mixed results.

Based on the analysis in this paper, most MENA countries seem to lack conscious and effective growth strategies. This situation entails institutional uncertainties that do not bode well for the ability of those countries to cope with the waves of economic shocks that are likely to come in the coming decade. The framework for analyzing growth strategies presented in this paper has important advantages that can enrich the policy debates and research agendas for enhancing economic growth. Thinking about growth strategies in terms of fundamentals versus substitute options can make policymakers more conscious of the relevant decisions and can enhance the effectiveness and coordination of policy outcomes. It provides a perspective for examining medium versus long-run institutional issues and for making choices among alternative institutional arrangements with different time horizons.

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**Table 1: Economic Growth in MENA Countries, 1970-2006 (Percent per Year, Period Averages)**

| | Period: | | | |
|---|---|---|---|---|
| **Country** | **1970-2006** | **1970-1985** | **1986-1995** | **1996-2006** |
| **Oil-exporting MENA Countries' Average** | **0.71** | 0.83 | –0.88 | 2.00 |
| Algeria | **1.16** | 2.82 | –2.55 | 2.28 |
| Bahrain | **1.36** | 0.96 | 0.37 | 2.96 |
| Iran | **1.04** | 0.16 | –0.41 | 3.56 |
| Iraq | **n.a.** | 0.83 | –14.26 | n.a. |
| Kuwait | **–2.92** | –8.83 | 4.22 | –1.20 |
| Libya | **–3.39** | –5.57 | –5.32 | 1.35 |
| Oman | **1.96** | 3.63 | 0.90 | 0.51 |
| Qatar | **n.a.** | –7.53 | –5.63 | n.a. |
| Saudi Arabia | **0.20** | 1.14 | –1.12 | 0.11 |
| UAE | **–0.65** | –2.81 | –1.40 | 3.33 |
| Yemen | **2.17** | 4.26 | –0.02 | 1.32 |
| **Non-Oil-exporting MENA Average** | **2.51** | **3.36** | **1.15** | **2.53** |
| Egypt | **2.72** | 4.52 | 0.10 | 2.65 |
| Jordan | **1.94** | 4.57 | –1.33 | 1.34 |
| Lebanon | **0.64** | 0.72 | 0.01 | 1.12 |
| Morocco | **1.97** | 2.57 | 0.29 | 2.68 |
| Syria | **2.35** | 3.83 | 1.32 | 1.27 |
| Tunisia | **3.12** | 3.66 | 1.55 | 3.81 |
| Turkey | **2.69** | 2.55 | 2.58 | 2.96 |
| West Bank and Gaza | **0.77** | 3.27 | 3.29 | –4.91 |
| **Non-MENA Oil Exporters**[**] | **0.01** | **–0.93** | **0.12** | **1.19** |
| **Non-MENA Non oil-Exporters**[**] | **3.17** | **2.42** | **3.28** | **4.09** |
| **High-income OECD Countries**[**] | **2.08** | **2.34** | **1.91** | **1.91** |

[*] Units of all indices are expressed in terms of standard deviations of rankings around zero.

[**] Population is used as weight to form cross-country averages. The developing countries included in the averages are those with available data. Non-MENA Oil exporters are Angola, Azerbaijan, Brunei, Rep. of Congo, Gabon, Nigeria, Trinidad & Tobago, Turkmenistan, and Venezuela.

Sources: Angus Maddison, 2007, World Population, GDP and Per Capita GDP, extended for 2004-2006 with data from The World Bank, *World Development Indicators Website*.

**Table 2: Growth Rates of Per-worker GDP Adjusted for Energy and Mineral Depletion[*] in the Sample of Eight MENA Countries Compared to Non-MENA Developing Countries[**]**

| Country | 1970-1985 | 1986-1995 | 1996-2004 |
|---|---|---|---|
| **Algeria** | 2.92 | –3.16 | 0.00 |
| **Iran** | 2.28 | –0.26 | 0.89 |
| **UAE** | –4.84 | –4.58 | –0.39 |
| **Yemen** | n.a. | 1.90 | 1.80 |
| **Egypt** | 4.66 | 0.78 | 1.42 |
| **Jordan** | 4.88 | –3.13 | –0.72 |
| **Morocco** | 1.74 | 1.60 | 0.36 |
| **Tunisia** | 3.02 | 1.14 | 1.87 |
| **Non-MENA Oil Exporters** | **1.07** | **0.72** | **–2.27** |
| **Non-MENA Developing Countries** | **2.54** | **3.30** | **3.04** |

[*] The adjustment is a deduction for the energy and mineral depletion from national income calculated by the World Bank, *World Development Indicators*. Since those effects are reported as shares of current price GDP, the GDP deflator and energy prices are used for calculating the constant-price share.
[**] The developing countries included in the average are those with data for the entire period. The growth figures in *italics* are more than half a percentage point lower than that of the comparison group during the same period and those in **boldface** are equal to higher than those benchmarks.
Sources: World Bank, *World Development Indicators Website*, *Penn World Tables 6.1*, US Department of Energy Website.

**Table 3: Governance Indicators in MENA Countries, 1996-2006 Averages***

| Country | Voice and Accountability | Political Stability | Government Effectiveness | Regulatory Quality | Rule of Law | Control of Corruption |
|---|---|---|---|---|---|---|
| **Oil-exporting MENA Average** | **–1.24** | **–1.17** | **–0.68** | **–1.06** | **–0.70** | **–0.50** |
| Algeria | –1.05 | –1.74 | –0.60 | –0.72 | –0.87 | –0.59 |
| Bahrain | –0.80 | –0.16 | 0.55 | 0.77 | 0.63 | 0.63 |
| Iran | –1.17 | –0.85 | –0.60 | –1.44 | –0.64 | –0.51 |
| Iraq | –1.79 | –2.51 | –1.73 | –2.07 | –1.69 | –1.39 |
| Kuwait | –0.37 | 0.17 | 0.24 | 0.24 | 0.74 | 0.89 |
| Libya | –1.72 | –0.48 | –0.97 | –1.69 | –0.83 | –0.85 |
| Oman | –0.76 | 0.74 | 0.56 | 0.48 | 0.79 | 0.69 |
| Qatar | –0.64 | 0.81 | 0.59 | 0.29 | 0.64 | 0.68 |
| Saudi Arabia | –1.50 | –0.49 | –0.28 | –0.07 | 0.27 | 0.25 |
| UAE | –0.70 | 0.72 | 0.75 | 0.74 | 0.83 | 0.96 |
| Yemen | –0.95 | –1.44 | –0.78 | –0.77 | –1.12 | –0.62 |
| **Non-Oil-Exporting MENA Average** | **–0.70** | **–0.71** | **–0.17** | **–0.11** | **–0.03** | **–0.21** |
| Egypt | –0.98 | –0.77 | –0.31 | –0.30 | –0.02 | –0.32 |
| Jordan | –0.51 | –0.22 | 0.16 | 0.32 | 0.38 | 0.19 |
| Lebanon | –0.49 | –0.90 | –0.23 | –0.15 | –0.27 | –0.38 |
| Morocco | –0.49 | –0.32 | –0.06 | –0.07 | 0.03 | 0.00 |
| Syria | –1.58 | –0.60 | –0.90 | –1.03 | –0.40 | –0.57 |
| Tunisia | –0.85 | 0.16 | 0.53 | 0.13 | 0.10 | 0.20 |
| Turkey | –0.28 | –0.94 | 0.02 | 0.27 | –0.01 | –0.16 |
| West Bank and Gaza | –0.95 | –1.78 | –1.12 | –1.04 | –0.32 | –0.91 |
| **Non-MENA Oil Exporters**[**] | **–0.92** | **–1.43** | **–0.99** | **–1.00** | **–1.32** | **–1.17** |
| **Non-MENA Non oil-Exporters**[**] | **–0.54** | **–0.64** | **–0.22** | **–0.28** | **–0.39** | **–0.49** |
| **Minimum for High-income OECD Countries During 1996-2006** | **0.73** | **0.27** | **0.60** | **0.68** | **0.53** | **0.31** |

[*] Units of all indices are expressed in terms of standard deviations of rankings around zero.
[**] The developing countries included in the average are those with available data. Population is used as weight to form cross-country averages. Non-MENA oil exporters are Angola, Azerbaijan, Brunei, Rep. of Congo, Gabon, Nigeria, Trinidad & Tobago, Turkmenistan, and Venezuela.
Source: D. Kaufmann, A. Kraay, and M. Mastruzzi. 2007. "Governance Matters VI: Governance Indicators for 1996-2006," World Bank Website, http://www.worldbank.org/wbi/governance/govdata/.

**Table 4: ICRG Measure of Rule of Law in MENA Countries, 1984-2006 (Percent per Year, Period Averages)**

| | Averages for the Years: | | |
|---|---|---|---|
| **Country** | **1984-1986** | **1994-1996** | **2004-2006** |
| **Oil-exporting MENA Countries' Average** | 1.87 | 3.73 | 3.18 |
| Algeria | 2.0 | 3.0 | 2.8 |
| Bahrain | 4.0 | 5.3 | 5.0 |
| Iran | 1.9 | 5.0 | 4.0 |
| Iraq | 1.0 | 2.0 | 1.5 |
| Kuwait | 2.9 | 5.4 | 5.0 |
| Libya | 1.0 | 4.6 | 4.0 |
| Oman | 3.0 | 4.9 | 5.0 |
| Qatar | 3.0 | 5.8 | 5.0 |
| Saudi Arabia | 3.9 | 5.2 | 5.0 |
| UAE | 2.9 | 4.0 | 4.0 |
| Yemen | n.a. | 3.4 | 2.0 |
| **Non-Oil-Exporting MENA Countries' Average** | 2.59 | 4.37 | 4.38 |
| Egypt | 2.9 | 4.0 | 4.0 |
| Jordan | 2.0 | 4.9 | 4.0 |
| Lebanon | 1.0 | 4.0 | 4.0 |
| Morocco | 2.0 | 5.6 | 5.0 |
| Syria | 1.9 | 4.5 | 5.0 |
| Tunisia | 2.0 | 4.5 | 5.0 |
| Turkey | 3.0 | 4.3 | 4.5 |
| West Bank and Gaza | | | |
| **Non-MENA Oil Exporters**** | **1.46** | **2.83** | **1.85** |
| **Non-MENA Non-Oil-Exporters**** | **2.32** | **3.77** | **3.31** |
| **High-income OECD Countries**** | **5.35** | **5.95** | **5.07** |
| **Minimum for High-income OECD Countries**** | **3.00** | **5.47** | **3.86** |

** Population is used as weight to form cross-country averages. The developing countries included in the averages are those with available data. Non-MENA oil exporters are Angola, Brunei, Rep. of Congo, Gabon, Nigeria, Trinidad & Tobago, and Venezuela.
Source: Political Risk Services, Inc. (2008), *International Country Risk Guide Data, 1982-2007*.

**Table 5: Summary Statistics for the Rule of Law Regressions**

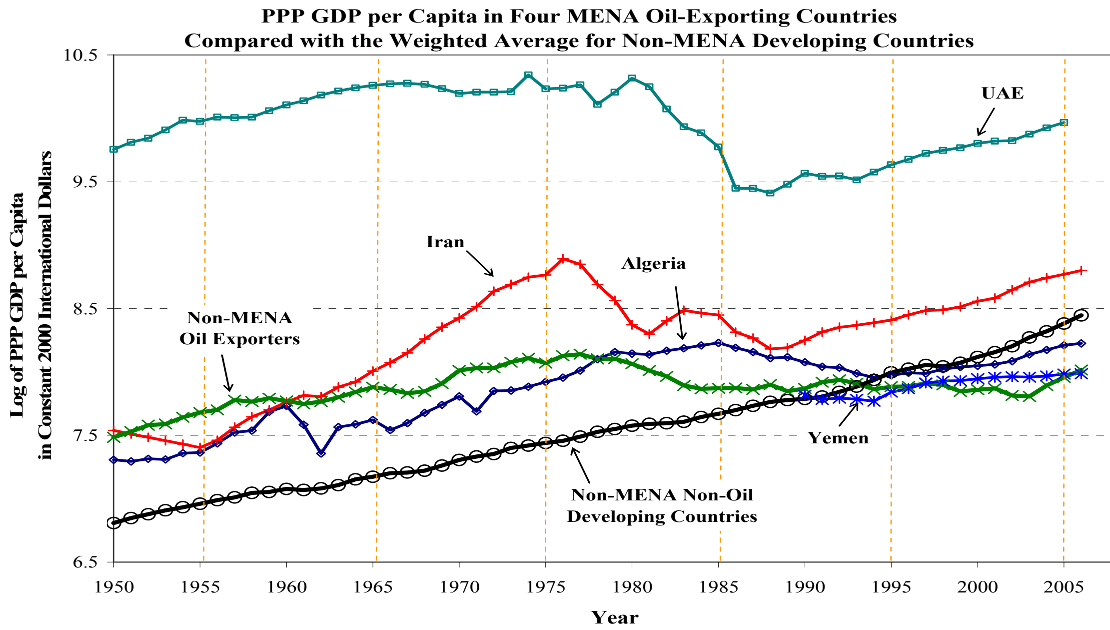
| Variables | Observations Used in IV Regressions | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| **Rule of Law, 1984-1986** | 80 | 3.047 | 1.580 | 1.000 | 6.000 |
| **Rule of Law, 1994-1996** | 80 | 4.125 | 1.289 | 1.000 | 6.000 |
| **Growth Rate during 1984-1995** | 80 | 0.746 | 2.611 | -5.525 | 7.149 |
| **Growth Rate during 1995-2006** | 80 | 1.918 | 1.864 | -4.106 | 7.861 |
| **Growth Rate during 1984-2006** | 80 | 1.211 | 2.010 | -4.956 | 6.699 |
| **Openness in 1984** | 80 | 55.260 | 32.262 | 11.545 | 191.889 |
| **Openness in 1994** | 80 | 61.266 | 39.772 | 3.995 | 267.022 |

**Table 6: Determinant of Change in the Rule of Law Index* (*p*-values are given in parentheses)**

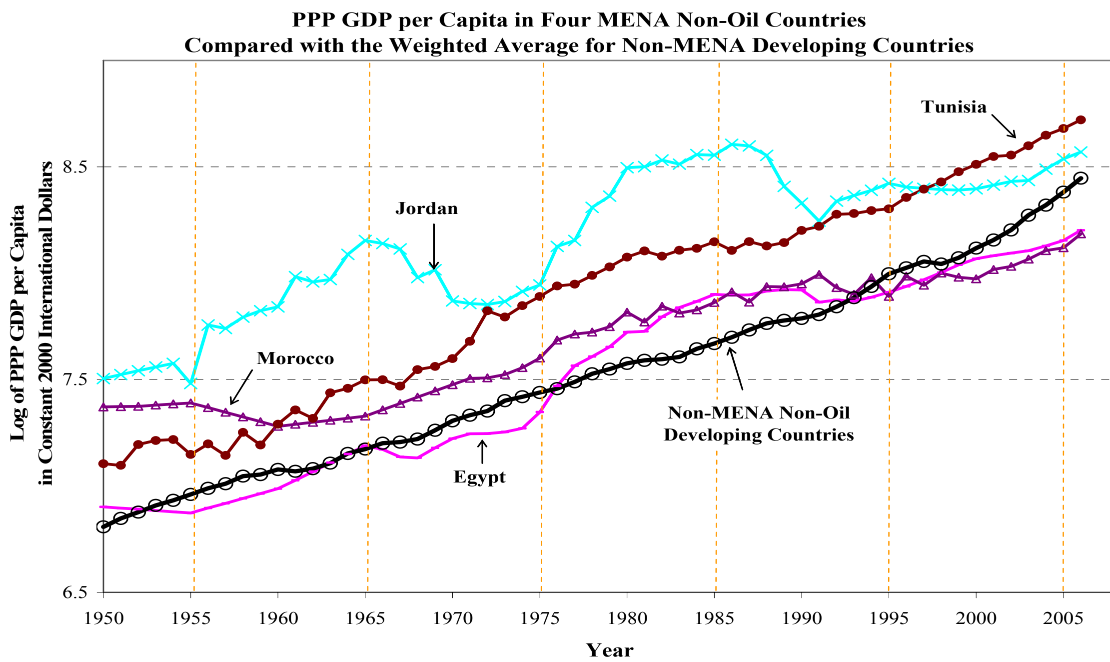
| **Dependent Variable: Rule of Law Index at the End of the Period …** | **1985-1995** | **1995-2005** | **1985-2005** | **1985-1995** | **1995-2005** | **1985-2005** |
|---|---|---|---|---|---|---|
| **Estimation Method** | TOBIT | TOBIT | TOBIT | IVTOBIT† | IVTOBIT† | IVTOBIT† |
| **Growth Rate During the Period** (Instrumented in IV regressions) | 0.165*** | 0.0549 | 0.217*** | 0.251** | 0.416** | 0.699** |
| | *(0.000)* | *(0.211)* | *(0.000)* | *(0.026)* | *(0.028)* | *(0.014)* |
| **Rule of Law at the Start of the Period** | 0.182*** | 0.700*** | 0.179** | 0.173** | 0.529*** | 0.0374 |
| | *(0.009)* | *(0.000)* | *(0.025)* | *(0.037)* | *(0.001)* | *(0.811)* |
| **Openness at the Start of the Period** | 0.00434** | 0.00165 | 0.0071*** | 0.00421* | 0.0083*** | 0.0131*** |
| | *(0.044)* | *(0.337)* | *(0.002)* | *(0.065)* | *(0.005)* | *(0.002)* |
| **High-Income OECD Dummy** | 2.196*** | 0.930*** | 1.944*** | 1.966*** | 1.040*** | 1.905*** |
| | *0.000* | *(0.006)* | *(0.000)* | *0.000* | *(0.004)* | *(0.000)* |
| **MENA** | 1.260*** | 0.488** | 1.423*** | 0.953*** | 0.383 | 0.883*** |
| | *(0.000)* | *(0.024)* | *(0.000)* | *(0.001)* | *(0.114)* | *(0.007)* |
| **East Asia and Pacific Dummy** | 0.474* | –0.333 | –0.0706 | 0.305 | -0.812*** | -1.253 |
| | *(0.064)* | *(0.120)* | *(0.780)* | *(0.468)* | *(0.010)* | *(0.101)* |
| **Constant** | 2.644*** | 0.381 | 1.877*** | 2.691*** | 0.0657 | 1.542*** |
| | *0.000* | *(0.294)* | *0.000* | *0.000* | *(0.846)* | *(0.000)* |
| **Observations** | **105** | **109** | **104** | **77** | **80** | **75** |

† Average terms of trade change during each period is used as an instrument for average growth during that period.
* Significant at the 10 percent level. ** Significant at the 5 percent level. *** Significant at the 1 percent level.
Sources: Political Risk Services, Inc. (2008), *International Country Risk Guide Data, 1982-2007*, Excel Workbook, Syracuse, NY; Angus Maddison, 2007, World Population, GDP and Per Capita GDP; *World Development Indicators 2008*.

## Figure 1a

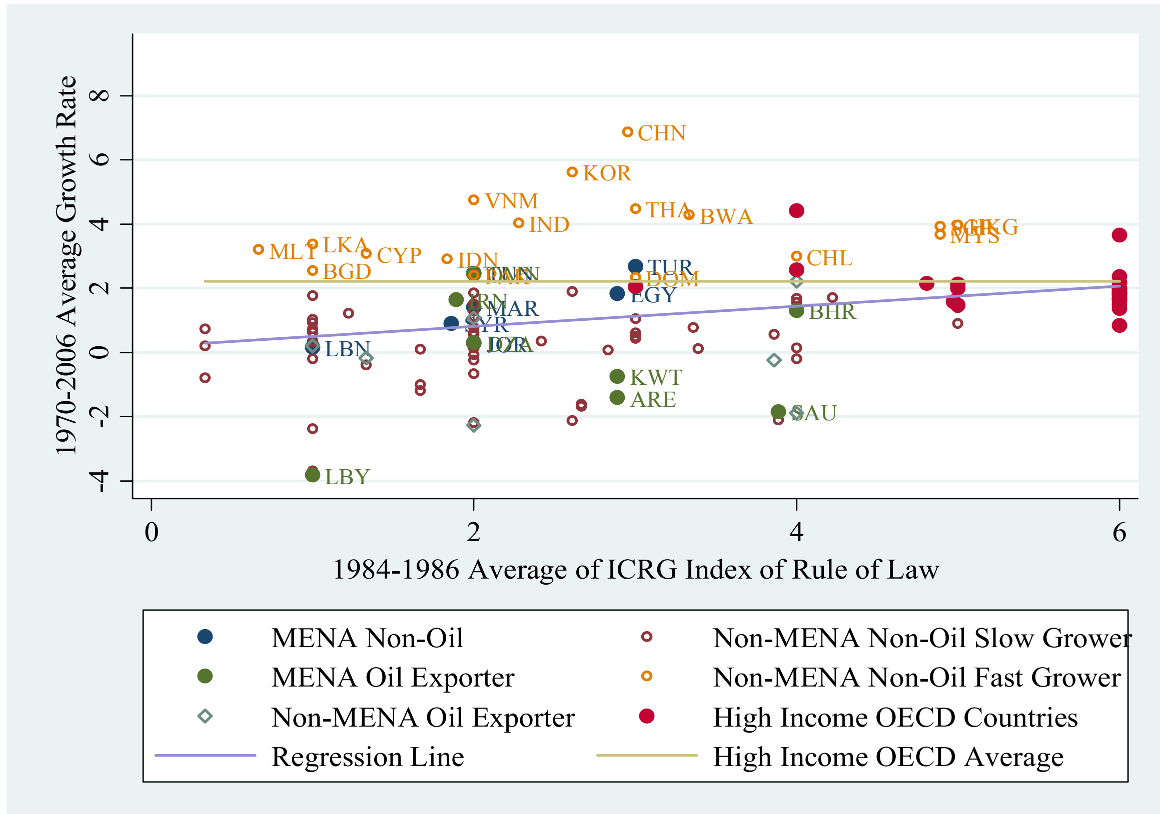



## Figure 1b



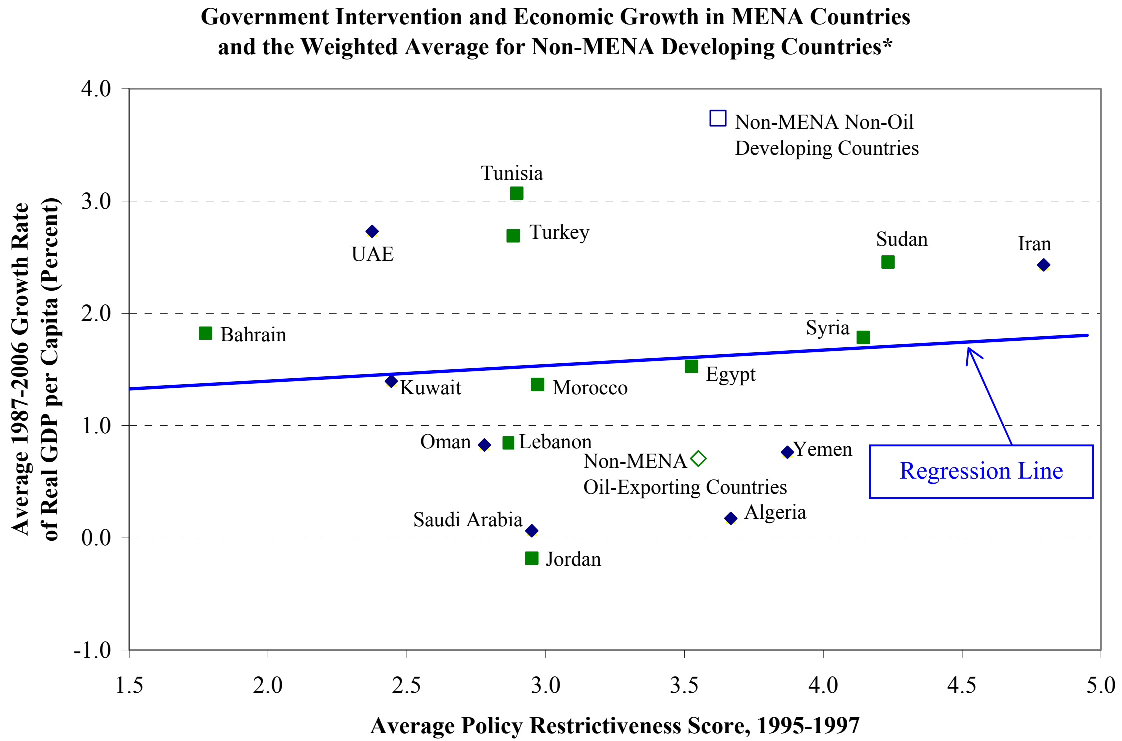

Notes: Population is used as weight for cross-country averages. The developing countries included in the averages are those with data for the entire period.
Sources: Angus Maddison, 2007, World Population, GDP and Per Capita GDP, extended for 2004-2006 with data from The World Bank, *World Development Indicators Website*.

**Figure 2**




[*] Growth rates are the averages for the years during the period 1970-2006 when data are available, augmenting Maddison's data with recent data from World Development Indicators. For non-MENA countries, averages are calculated using populations as weights.
Sources: Political Risk Services, Inc. (2008), *International Country Risk Guide Data, 1982-2007*, Excel Workbook, Syracuse, NY; Angus Maddison, 2007, World Population, GDP and Per Capita GDP; *World Development Indicators 2008* (for 2004-2006 growth rates).

## Figure 3




■ MENA Oil Exporters.
♦ MENA Non-Oil-Exporters.
* Growth rates are the averages for the years during the period 1987-2006 when data are available, augmenting Maddison's data with recent data from World Development Indicators. The Policy Restrictiveness score is the average of Economic Freedom indices developed by the Heritage Foundation for various policies during 1995-1997. For non-MENA countries, averages are calculated using populations as weights.
Sources: Heritage Foundation website, *Index of Economic Freedom*, 2008; Angus Maddison, 2007, World Population, GDP and Per Capita GDP; *World Development Indicators 2008* (for 2004-2006 growth rates).