

ECONOMIC  
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2008

# working paper series

AUTHORITARIANISM,  
CREDIBILITY OF REFORMS, AND  
PRIVATE SECTOR DEVELOPMENT IN  
THE MIDDLE EAST AND NORTH AFRICA

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Working Paper No. 443

# **Authoritarianism, Credibility of Reforms, and Private Sector Development in the Middle East and North Africa**

Mustapha K. Nabli, Carlos Silva-Jauregui, and Ahmet Faruk Aysan

**Working Paper 443**

**October 2008**

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We would like to thank Phillip Keefer, Najy Benhassine, Paloma Anos Casero, Jennifer Keller and Farrukh Iqbal for helpful comments and suggestions, and Joey Ghaleb for effective research assistance.

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## **1. Introduction**

Despite recent gains, the development challenges of the Middle East and North Africa (MENA) region remain formidable. Job creation remains the most important one given the magnitude of its demographic transition and the seventy million people that are expected to seek employment opportunities in the next twenty years. Four reports published by the MENA region of the World Bank in 2003-04 spelled out the state of reforms and the fundamental transitions needed in the MENA economies to move to higher and more sustainable sources of growth and job creation.<sup>1</sup> The reports identified three critical realignments or transitions: (i) from public sector-dominated to private sector-led economies; (ii) from closed to more open economies; and (iii) from oil-dominated and volatile economies to more stable and diversified economies.

The reform agenda for MENA remains large. In this paper, we assess and attempt to explain the progress or lack thereof achieved in economic reforms in the MENA region. In order to be more specific and limit the scope of the paper we focus on the dimensions of economic reforms which are related to the first transition mentioned above: the development of a dynamic private sector. The importance of the employment challenges makes the development of a competitive private sector to become the lead engine for more productive growth and employment creation a central concern. In a sense, private sector development can be seen as symptomatic of the process of reforms taking place in MENA. Hence, from this angle, we analyze reforms in the region and their prospects.

The paper is organized as follows. In the next section we assess the progress in economic reforms and their impact on the development of the private sector in the region. Economic reform affects the balance of power between members of society by redistributing rents across economic actors. As such reform is a clearly political issue and sometimes difficult to advance. Trying to understand the progress in economic reforms leads inevitably to the need to consider the political and governance issues which are related. In Section 3 we review a number of critical factors, which shaped the political economy of reform in the region. We review in Section 4 the various arguments and theories which have been used to explain progress in economic reforms and assess the extent to which they help explain the recent experience. In Section 5 we provide some empirical results in support of the arguments made in the previous sections. This analysis is used in Section 6 to draw conclusions and explore future prospects for reform.

## **2. Private Sector Development: Reforms and Performance**

All MENA countries embarked on significant programs of structural reform and made progress to create environments more conducive to private sector development and shifting their economic systems to be more private sector market driven.

Following independence, and in part to rectify social inequity, a social contract between the government and the public developed in countries throughout the MENA region. This social contract was characterized by a paternalistic view with a leading role for the state which included state planning, protection of local markets versus outside competition, and a view of the state in providing welfare, social services, and even employment. Economies became heavily protected and labor markets became highly regulated, with a strong emphasis on employment protection and access to public sector jobs. Businesses developed under the patronage of governments, basically living off the state and benefiting from government contracts and preferential public procurement rules.

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<sup>1</sup> World Bank 2003a, 2003b, 2003c, 2004a. For a summary of these reports see World Bank 2004b.

As early as the 1970s some MENA countries started reforming these economic systems to give more room to private initiative, and a greater role for markets and international trade. But the major thrust for reforms began in the early 1980s. Many countries in the region—facing significant balance of payments crises and slow or negative growth—undertook macroeconomic stabilization and structural reform programs aimed at restoring macroeconomic balances and promoting the private sector as an engine of growth. The first countries to embark on reform were the resource-poor economies, but within a decade most countries had followed suit.

Despite ongoing efforts to spur recovery and accelerate reforms, countries in MENA remained on a slow growth path during the 1990s. Unemployment was growing, and the slow and delayed demographic transition that the region was experiencing—with a heavy supply of young workers to the labor force—was pressuring social and economic infrastructures.

The outlook changed dramatically during the 2000s. Countries continued with their economic reforms, and in parallel with steadily rising oil prices, and a more favorable global environment, MENA's economic performance has improved, with GDP growth averaging in excess of 6 percent a year for the last three years, up from 4.6 percent during 2000-03 and 3.7 percent in the 1990s. The current pace of economic growth has narrowed the gap in per capita income growth between MENA and other developing regions.

The progress with reform has however lagged behind the rest of the world and varied significantly across areas of reform, and across individual countries. It has followed three country groupings: resource-poor and labor-abundant or emerging economies (RPLA), resource-rich and labor-abundant or transition economies (RRLA), and resource-rich and labor importing (RRLI) economies.<sup>2</sup>

Providing a business environment in which a dynamic and competitive private sector can thrive is a multidimensional endeavor. This section reviews MENA's progress with several reforms related to building a good private investment climate, including a stable macroeconomic environment, more open trade regimes, a better business regulatory framework, stronger and deeper financial sector reform, and less government ownership or more privatization of businesses.

The diversity of experience in terms of progress in reforms discussed above is summarized in Table 1 which gives a score ranging from -2 to +2 (based on the data and discussion below) according to where each of the three country groupings stand, on average, in terms of reform in the various areas, as well as highlighting individual countries when they deviate significantly from their country grouping. The scores show that, except for macroeconomic performance, the region remains at or below the median in terms of reforms for the private sector. Among the resource-poor countries, those which achieved more in terms of reforms remain less advanced in their reform programs than the more successful middle-income developing countries.

### ***Macroeconomic Environment***

Businesses depend upon mechanisms that provide for macroeconomic stability, critical for affecting the certainty of investors' decisions. Macroeconomic stabilization achievements were impressive, with better macroeconomic policies and debt renegotiations resulting in

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<sup>2</sup> In this paper we use a categorization of countries in the region into three groups: the *resource-poor, labor-abundant* (RPLA) or *emerging* economies (Egypt, Jordan, Lebanon, Morocco, Tunisia); *resource-rich, labor-abundant* (RRLA) or *transition* economies (Algeria, Iran, Iraq, Syria, Yemen); and *resource-rich, labor-importing* (RRLI) (Gulf Cooperation Council, GCC economies: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates). Libya exhibits features of both resource-rich and transition as well as labor-importing economies, and we generally consider it part of the second group.

reduced debt burdens, contained inflation, reduced fiscal deficits, and strong declines in external debt. Macroeconomic achievements made during the first decade of reform have largely been sustained when one looks at the standard indicators of macroeconomic stability.

### ***Trade Reform***

In addition to a conducive macroeconomic environment, businesses depend on trade and exchange rate policies which do not undermine competitiveness. Most of the MENA economies have undertaken trade liberalization efforts to remove impediments to greater trade, and over the last few years the region has made significant progress in improving the environment for trade. At the start of this decade, only half of the countries in the region, Bahrain, Djibouti, Egypt, Kuwait, Morocco, Qatar, Tunisia, and the United Arab Emirates, were members of the World Trade Organization (WTO). But over the past seven years, Jordan, Oman, and Saudi Arabia have acceded to the WTO. Bilateral and regional trade agreements have proliferated in MENA, dominant among these the Association Agreements with the European Union. Tunisia and the Palestinian Authority, on an interim basis, had agreements in force by 2000. Since then, all of the other resource-poor economies but Djibouti have signed and put into force EU Association Agreements, and both Algeria and Syria have signed agreements which have yet to be put into force. MENA countries have also entered bilateral trade agreements with other major trading partners, including the United States (free trade agreements have been signed between the United States and Jordan, Morocco, Bahrain, and Oman, and others are pursuing such agreements).

Partly as a result, the region has made strong progress in reducing tariffs, just in the last decade from an average 19 percent of import value to 13 percent (Table 2). And while the region continues to suffer from some behind-the-border constraints to trade, the time associated with exporting and importing in MENA is about on par with other developing regions of the world—a significant achievement given the considerably protected regimes from which MENA economies started their trade liberalization efforts.

Trade policy however, varies in the region. Resource-poor countries continue to maintain high tariffs, averaging some 18.4 percent, although behind-the-border constraints to trade are fairly mild. Tariffs also are high among resource-rich and labor-abundant countries, which additionally maintain significantly cumbersome behind-the-border procedures to conduct trade. GCC countries, on the other hand, have almost universally maintained lower tariffs and had fewer behind-the-border constraints to trade.

### ***Business and Regulatory Reform***

A favorable business environment requires a regulatory environment that promotes competition, supports efficient resource allocation, and protects property rights, and a strong legal environment which effectively enforces and administers commercial laws. MENA countries have also taken actions to liberalize the regulatory environment for business, including liberalization of specific services in the economy, across-the-board business and regulatory policy reform, and targeted interventions to promote growth in specific sectors.

MENA's recent liberalization of services has centered primarily on a few key areas, including telecommunications, transport, and banking (discussed further below). In addition to opening key services to competition, the region has taken some steps to reduce the regulatory obstacles to doing business. MENA countries have also utilized interventions targeted to specific sectors in an effort to "launch" private sector growth. In Morocco and Tunisia, these targeted efforts came after the *mise à niveau* programs aimed at upgrading industry in general, which have moved on to upgrade more specific sectors. These targeted reforms are also visible in GCC countries, with most working to develop competitive service centers (for

financial services, tourism, technology, and the like), creating international legal and business infrastructures separate from the rest of the country.

Relative to the rest of the world, however, MENA's regulatory environment for business remains weak overall with significant variation across country groupings. Based on current information of the overall regulatory environment<sup>3</sup>, GCC economies have fairly developed business infrastructure and generally favorable business policies, only behind high-income economies. But MENA's resource-rich, labor-abundant *and* resource-poor countries are among the least business friendly in the world, with burdensome and costly procedures and practices that thwart business development. Only Sub-Saharan Africa maintains a more restrictive regulatory environment than MENA's non-GCC countries (Table 3).

In resource-poor economies, only a few countries such as Jordan and Tunisia have regulatory policies and infrastructure which are fairly conducive to attracting and maintaining investment. The majority of countries have significant impediments to conducting business, especially in the areas of starting a business, protecting investors, and contract enforcement in sales disputes.

Two countries which have especially large challenges in improving the business climate are Egypt and the Islamic Republic of Iran, among the most populated countries of the region. In Egypt, in every sphere of the business climate, the country ranks in the bottom third worldwide. Despite the significant recent improvements in the indicators for 2007, almost all aspects of doing business suffer from major obstacles. However, the problems are especially severe in contract enforcement, where the total time required for dispute settlement can average almost three years, about twice the world average; as well as in dealing with licenses. In the Islamic Republic of Iran, although some features of the business climate are well developed, a few key areas are exceptionally problematic, resulting in a seriously weak overall business climate. One of these areas is in dealing with licenses; where it costs on average almost US\$19,000 for the regulatory procedures to build a warehouse, and where the approval for an electrical connection alone can take a year on average.

### ***Financial Sector***

A favorable environment for private sector development is often supported by efficient financial institutions, which can mobilize and make available resources for entrepreneurs to start new businesses, and for existing businesses to grow and expand. While progress has been made, MENA has had a mixed record with respect to financial sector developments.

One troubling aspect of MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although many of MENA's banks are flush with liquidity, they play a limited role in financial intermediation and economic development throughout most of the region. Credit remains concentrated among a select minority, and few private businesses can access to finance.

Barring a few exceptions, most countries in MENA enjoy a reasonably high level of financial intermediation, deep bank assets, and seemingly robust onward lending to the private sector. Given the strong observed linkages between finance and development, this would suggest a supportive environment for new investment, economic growth, and employment generation at

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<sup>3</sup> The business environment is evaluated based on current information in eight areas important for doing business: (1) ease of starting a business; (2) ease of closing a business; (3) ease of hiring and firing; (4) ease of enforcing contracts; (5) ease of registering property; (6) ease of paying taxes; (7) degree to which investors are protected; and (8) ease of dealing with licenses. In each of these areas, a variety of available indicators related to that sphere were utilized, often including the time, cost, and number of procedures required for fulfilling a certain business obligation.

the firm level. However, World Bank Investment Climate Assessments (ICAs) undertaken within the region provide evidence to the contrary. A low proportion of firms have access to finance, and many businesses report that one of the major impediments to growth is both access to, and the cost of, finance: firms from Algeria, Morocco, and Saudi Arabia all highlight finance as a major constraint to their operations. Indeed, evidence suggests that firms in the MENA region have less recourse to bank finance than in any other region of the world, with 75 percent of funding for investment being sourced from retained earnings and only 12 percent from the banking sector.

Six critical factors lie at the heart of the structural disconnect between the relatively plentiful financial resources found across the region and the scarcity of external financing for enterprises: (a) high levels of public sector ownership significantly impact the direction of credit, operating efficiency, and the ability of the banking sector to conduct robust risk analysis; (b) regulatory frameworks, with limited market forms of oversight and discipline, have created adverse outcomes for credit allocation; (c) banking access remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority; (d) contractual savings and capital markets remain underdeveloped, removing a source of competition for the banks and an alternate avenue for firm finance; (e) governance structures undermine formal financial relationships across much of MENA; and (f) a host of problems with the business climate further undermine commercial-finance relationships.<sup>4</sup> These factors are fundamentally linked to low levels of competition and poor conditions for enforcing credit contracts.

### ***Weight of the Public Sector in the Economy***

Privatization has also lagged behind in MENA vis-à-vis other developing regions of the world. In MENA the state still holds a significant hand in the production of goods and services of the region. In part this is due to oil and the existence of large national oil companies in resource-rich countries, but also because major sectors of the economy, which were privatized elsewhere a long time ago, remained in the hands of the state in MENA. These include energy, telecommunications, and banking. Even in resource-poor countries there is significant presence of the state in the real sector, despite a recent wave of privatizations.

In banking, for instance, state ownership remains high at over 40 percent of the assets, twice of that in middle-income countries and six times more than high-income countries. Because the banking system is the primary conduit for savings and investment in the MENA region, the ownership of the banking sector is a matter of considerable importance to efficient financial intermediation and the fostering of long-term economic growth. In Algeria, Libya, Syria and the Islamic Republic of Iran, 89-100 percent of banking assets are majority-controlled by the state, while at the other end of the spectrum, Lebanon and the Gulf states of Bahrain and Oman have no direct majority state ownership in any bank. Egypt, Morocco, Qatar, Tunisia, and the UAE stand between these extremes, with state control of 35-65 percent. Yet these figures understate the often substantial (though minority) stakes that MENA governments have in the banking sectors: the Omani government owns 40 percent of the nation's leading bank, and the Saudi Arabian state also has substantial minority positions in five banks. The impact of state ownership appears to have been felt in three key respects: (i) high credit provision to the public sector; (ii) a weak credit culture and endemic inefficiencies; and (iii) low profitability and high nonperforming loans.

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<sup>4</sup> World Bank (2006).

The reforms spanning the last 20-25 years have helped MENA countries achieve some progress in increasing the role of the private sector, but the response to reforms has been weak, and performance has lagged significantly behind the rest of the world.

Economic reforms are essential to generate the levels of sustainable real output and employment growth needed to cope with the demographic transition taking place in MENA.<sup>5</sup> As a result of the reforms initiated since the 1980s, but also in response to the global movement that has affected all developing regions in the world, MENA countries have achieved some progress in giving a greater role to the private sector. This is reflected in several indicators such as higher private sector investment, FDI, manufacturing exports, and employment, although the growth rates of these indicators have been significantly lower in MENA.

Focusing on investment, the emphasis on private business has had significant results across the world. Worldwide, private investment as a share of GDP has risen from an average of 13 percent in 1985 to 19 percent by 2005. The private sector is increasingly becoming the fundamental pillar for investment within countries, especially in regions like East Asia and the Pacific, where private investment has grown in real terms by an average of 13 percent a year, driving real sector growth and exports.<sup>6</sup> The private sector has also become the major engine for job creation, accounting for more than 75 percent of employment today compared with only 57 percent just two decades earlier.

In MENA private investment has grown at a slower pace than almost all developing regions in the world, and slower than expected at the onset of reforms. For the six countries where there is long term data, private investment has averaged only 2.8 percent growth a year between the early 1980s and the mid 2000s,<sup>7</sup> compared with more than 8.6 percent growth a year in South Asia, and 13.1 percent growth a year in East Asia and the Pacific (Figure 1).

For the full set of MENA countries for which data is available, private investment increased slightly during the period, from 11.4 percent of GDP in 1995 to less than 13 percent in 2003. This shows a very weak response to almost two decades of reform. The expansion in private investment started to be noticeable in 2000 but has accelerated since 2003-04 (Figure 2). The current oil boom growth acceleration episode has been accompanied by higher private sector investment in MENA across the board, and most of the new employment in the region—which has been quite strong in the past five years—has been driven by the private sector.<sup>8</sup> But the share of private sector investment to GDP remains low in the MENA region compared to the average for other regions.

In a pattern similar to the progress on reforms, MENA's private sector performance has also varied significantly along the lines of the three regional groupings, based upon the abundance of natural resources and labor in each country. While the increase in private sector investment has been across all sub-regional groupings, the largest gains have taken place across *resource rich labor importing* countries, while *resource-rich labor-abundant* countries—despite the oil boom—have remained at the bottom of the region since 2000.<sup>9</sup>

In parallel to private investment performance, the MENA region has made weak progress in attracting large foreign direct investment (FDI) flows. Despite positive trends over the past

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<sup>5</sup> World Bank (2004).

<sup>6</sup> The sample for EAP covers China, Philippines, Indonesia, and Thailand for the period 1984-06.

<sup>7</sup> The sample for MENA includes Algeria, Egypt, Jordan, Morocco, Oman, and Syria.

<sup>8</sup> World Bank (2007).

<sup>9</sup> Iran has been excluded from this aggregate since it is impossible to differentiate between true private investment and “mixed public-private” investment in the data. Iran, however, maintains investment rates among the highest in the region, but inefficiencies are high and productivity is low.



couple of years,<sup>10</sup> FDI has barely risen as a share of regional GDP over the past 35 years, compared with the tremendous growth in other developing regions of the world like Latin America and the Caribbean, Europe and Central Asia, and East Asia and the Pacific. This weak FDI performance signals both the lack of opportunities for foreigners to invest in MENA countries—either through privatization or greenfield investments—but also the perception of high risk that detract foreign investors, in part driven by a weak business environment.

While MENA's FDI remains low, *resource-poor* countries captured 4 percent of GDP on average during 1996-2006, a significantly larger amount than *resource-rich* countries (Figure 3). The Gulf countries—*resource rich labor importing*—attracted marginally more FDI than *resource rich labor abundant* countries, despite the fact that the former invest significantly abroad.

One entry point for new private sector activity worldwide has been through foreign trade. Many of the countries which have substantially increased the role of the private sector in the economy have done so through trade, and particularly through manufacturing exports. Part of the story behind MENA's anemic private sector growth is reflected in the lackluster performance in manufactured exports, which have increased only marginally over the past forty years (Figure 4). Despite improvements in trade regimes that place MENA on par with the world average regarding indicators of trade policy reform,<sup>11</sup> manufactured exports as a percent of GDP remain far below that of other regions.

In the case of manufacturing exports the performance of country groupings is again in line with the other indicators. While MENA's overall performance has been weak, *resource-rich labor-abundant* countries tend to under perform the other two groups by a significant amount, with levels of manufacturing exports' share of GDP only about one-fourth of the share attained by *resource-poor labor-abundant* and *resource-rich labor-importing* countries.

Manufactured exports of the MENA region are by and large not diversified, with ISIC 23 (manufacturing of petroleum products) capturing, on average, 41 percent of total net manufactured exports and ISIC 24 (manufacturing of chemicals) constituting another 19 percent, both of which are oil-derivate goods. *Resource-poor* countries have been the most diversified, but their export structure has remained concentrated, low-tech, generally unsophisticated, and based on resources and low-skill production. Lebanon is among the most diversified in the RPLA countries, but with a low volume of exports. Although Egypt, Tunisia, and Morocco show signs of diversification, structural changes in their export portfolios have been minimal and Egypt is becoming more dependent on the energy sector with oil-based exports now constituting a significant share (34 percent) of its total manufactured exports in recent years.

Iran and Syria are relatively the most diversified among the *resource-rich labor-abundant* countries with their manufactured exports spread over five or six ISIC groups. Oil-derivative exports constitute, on average, about 20 percent for Syria, but food and apparel are also exported in sizeable proportions. Iran's oil-based exports capture 35 percent of their total manufactured exports. Base metal (ISIC 27) constitutes another 15 percent with textile and food respectively 16 percent and 7 percent. Among *resource-rich labor-importing* countries, Oman is most diversified but its volume of exports is the lowest among Gulf economies.

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<sup>10</sup> FDI surged in 2006 and continue to increase in 2007.

<sup>11</sup> See World Bank 2007 op cit., for an analysis of trade reforms. There are significant differences among countries in the region, with *resource-rich labor-abundant* countries performing at the bottom of the region and *resource-rich labor-importing* countries performing well above the regional average.

Kuwait and Saudi Arabia are dominated by two items (ISIC 23 and 24), with shares of 95 percent and 85 percent respectively.

### **3. Factors Shaping the Political Economy of Reform**

There is no consensus in the region of why the reform progress has been slow or has shown such variability across countries and areas of reform. Instead, there are many views on what has prevented a more intensive reform effort in MENA and a better private sector response to the reforms.

The standard political economy of reforms approach will be used in the next section to explain the observed reform outcomes and their impact on private investment in the region. Within this framework reforms are undertaken as a result of a process where demand for and supply of reforms interact.

Whether they are inherited, slow to change (weakly endogenous), or exogenous, three features of the political and economic environment in MENA have been critical in shaping the speed and scope of economic reforms through their impact on the nature of the mechanisms and incentives for undertaking economic reforms. In short these factors have played a central role in the political economy of reform and are briefly reviewed in this section. These factors relate to three main characteristics of the region: (i) the authoritarian nature of the political regimes, (ii) the pervasiveness of conflict and violence, and (iii) the importance of rents.

#### ***Authoritarian Political Systems***

It is widely recognized now that economic reforms depend on and are essentially shaped by the nature of the political system and progress on political reforms.<sup>12</sup> All MENA political regimes have been authoritarian with very limited progress in democratic and public accountability institutions. The organizational structure of the state, however, is well developed and stable in most countries with the exception of a few cases where conflict has been recurrent (Lebanon, Iraq, and Yemen).

Figure 5 shows how MENA countries lagged systematically in comparison with the rest of the world in terms of the development of democratic institutions. Despite some limited progress over the last few years they continue to be non-democratic.

Another way to illustrate the same point is to use an index of public sector accountability. Figure 6 again shows that MENA countries rank the lowest on this score, with the resource-rich labor-abundant transition countries showing the weakest indicators.

Political regimes in MENA are mostly either autocratic presidential republics, or absolute monarchies and emirates. As we show below, this has been critical in determining the content and pace of reform as well as the response of the private sector.

#### ***Pervasiveness and Persistence of Conflict and Violence***

Regional security concerns and conflict are frequently used to justify the slow pace of both economic and political reform in MENA and the maintenance of the status quo. Since the wars of independence, conflict has been a characteristic of the MENA region, which has been plagued by civil unrest, and by bilateral and multilateral wars, including the multiple facets of the Arab-Israeli conflict (1948 to the present), the Lebanese civil war (1975-1990), the Iranian revolution (1978-1979), the Iraq-Iran war (1980-1988), the Iraqi invasion of Kuwait and subsequent First Gulf War (1990-1991), and the Second Gulf War and current occupation of Iraq (2003 to the present). In addition there have been tensions between Jordan and Syria

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<sup>12</sup> Acemoglu and Robinson (2008); North, Wallis and Weingast (2006), and Dixit (2007).

in the 1960s-70s, Jordan and the P.L.O. (the Black September of 1970), Egypt and Libya (the 1970s), Iraq and Kuwait before the 1990 invasion, as well as the Western Sahara conflict involving Morocco. Civil unrest has also taken place in many countries of the region, including Algeria, Djibouti, Egypt, Syria, and Yemen, among others. In recent years, acts of terrorism have taken place in practically all countries of the MENA region—including those countries with heavy state control—increasing the perception of risk and insecurity. But MENA is not unique in this respect, as conflict and insecurity are present in many regions and countries of the world (Figure 7).

### ***Large Oil Revenues and Rents***

A large share of MENA countries are oil economies and derive their main income from the exploitation of this non renewable natural resource. This group of *resource-rich* countries represents 62 percent of the total population in MENA. *Resource-poor* countries tend also to benefit from oil, via employment opportunities abroad and remittances—dominant factors in the past—and foreign direct investment flows in the present.

The existence of large natural resource rents may affect reforms indirectly through its impact on the nature of the governance mechanisms, usually producing lack of public sector accountability. But the accrual of large revenues from natural resources or other rents may also influence the process of reforms directly through other channels which generally weaken the incentives to undertake reforms. The rents provide the resources, which can be redistributed to satisfy the supporters of the regime, without searching for improved efficiency and economic performance through reforms. The availability of potential rents creates soft budget constraints, which serve to delay the changes needed even when demands for redistribution cannot be fully met under current levels of rent.

## **4. Explaining Progress on Reforms and Private Sector Response**

The discussion in section 2 shows that while economic reform has been moving forward, neither resource-rich nor resource-poor economies have undergone comprehensive reform of a kind seen in other leading developing regions of the world. Reforms have not gone deep enough, and across the region countries show significant differences, with resource-poor and resource-rich labor-importing economies leading, and resource-rich labor-abundant economies lagging.<sup>13</sup> Neither have reforms generated the response that would make of the private sector the main engine for growth and development.<sup>14</sup>

In this section we provide an explanation of these outcomes in terms of reforms and their impact in the region, using the political economy of reform approach. The main focus is the explanation of the outcomes over the long term—the last twenty to twenty-five years. We start by sketching the broad contours of how the various factors play out in the political economy framework in terms of demand and supply of reforms. In the next step we develop the full argument for each of the three sub-groupings of countries in order to explain the scope, speed and extent of reforms. In a final sub-section we address the issue of why the response of the private sector even to the limited reforms has been weak.

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<sup>13</sup> See World Bank (2007) for an analysis of the pace of reforms in MENA.

<sup>14</sup> Lebanon may be an exception regarding the role of the private sector. In Lebanon the private sector plays a more important role than in other MENA countries. Nonetheless, even in Lebanon, the distinction between the public and private personas of political leaders is blurred, and important sectors like electricity are still in the government's hands.

### ***Weak Demand and Coalitions for Reform***<sup>15</sup>

The standard theory of political economy of reform emphasizes the role of collective action and interest groups in determining economic reforms.<sup>16</sup> The theory of collective action tells us that organized groups apply more pressure on politicians than unorganized groups, even when the former are smaller in size than the latter. Those who benefit from rents and the status quo, and for which rents could be lost, tend to be well organized, and to have access and voice. In contrast, those groups who might benefit from reform are generally more dispersed and have a weaker notion of how economic reform will benefit them. Consumers, for example, are generally the primary beneficiaries of competition and trade reforms, but it is intrinsically difficult for them to come together, organize, and speak for change with a single voice.

The ability of groups to organize effectively is made easier in democratic systems where certain fundamental rights are available. They need access to information to formulate choices; they need the ability to mobilize; and they need the ability to contest policies. But MENA countries are characterized by weak democratic institutions with limited voice for regime outsiders and limited accountability for regime insiders. Those rights that are common in democratic countries are weak or not present at all in the region. Government information is often not accessible to the public. Freedom of the press is limited, carefully monitored, and circumscribed in most countries. There are restrictions on civil society and on freedom of association. Moreover, the ability to contest government policies is weak.

These conditions have implications for the nature, content, and pace of reforms. *First*, they constrain the processes of collective action and the formation of coalitions for change which are not internal to the state structure. The process of political influence often takes place outside of direct political participation, through clientelism and family networks. Under such regimes, collective action and effective influence on policy tend to be limited to the privileged insiders. The broader segments of population are able to influence policy only through violent means such as riots. *Second*, they do not allow effective processes of external or internal accountability and policy corrections, leading to more risk aversion to reform.

Internationally, private businesses are one of the most effective lobbies for policy change. But the private sector in most MENA economies is underdeveloped, with a predominance of small and family businesses. The large scale private sector tends to favor the status quo or pursue its interest by seeking specific beneficial measures (rather than systemic changes). Despite these weaknesses, the private sector has been the group with the most vocal presence for reforms in most countries. The relative strength of this action has varied depending on country-specific conditions related to size, potential benefits or losses from reform and their distribution among business groups, and links to the political regimes.

Trade unions in the world have often proven another instrument in organizing support for comprehensive reform. In MENA independent trade unions are rare. They were banned until recently in several GCC economies and several other MENA countries. Trade union membership is limited to a single national trade union, many times in cahoots with the government. Throughout the MENA region, free union activity is strictly controlled. As a result, trade unions have not been effective in organizing the labor force to press for reform, either because they lack real independence from the political system, or because they are part of the status quo.

In parallel to the strong regime insiders who want to maintain the status quo, the ability of regime outsiders to press for change has been weak and their voices have been muted. In

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<sup>15</sup> This section draws on Nabli (2007).

<sup>16</sup> Olson (1982).

MENA, not all groups have been well represented in the region's social contract. Indeed the region's development paradigm has suffered from weaknesses in inclusiveness. Under-represented groups include the youth who are largely unemployed; women who face limitations on open participation in the public space; small businesses and those entrepreneurs who seek to enter protected markets but have difficulty accessing finance or face entry barriers; consumers who may pay high prices and/or get low-quality public goods and services; small farmers, and so on. But these groups have not been able speak with a strong voice and unite for change.

In a nutshell, it is the presence of entrenched interests by regime insiders combined with lack of information, restrictions, and an inability to mobilize and press for better policies by regime outsiders that produces an uneven playing field and prevents the emergence of stronger demand for deeper reforms.

Reforms have been mainly supply driven to enhance the interests of the ruling regimes. The supply side of reforms has been the main mechanism driving the scope and pace of reforms in MENA countries. The nature of political regimes constrains the set of reforms undertaken to those which strengthen the political power of the ruling groups, and avoids those which would weaken it. This has implications in terms of the nature and content of reforms as well as their credibility.<sup>17</sup>

Leaders of non-democracies have a range of options from which to choose in establishing guarantees for private sector investors, ranging from personal reputation and affinity-based strategies which offer guarantees to only a handful of investors, to institutional arrangements which offer guarantees to a larger set of beneficiaries. But they face a difficult choice in selecting such institutionalized arrangements. On the one hand, *arrangements which are inclusive and provide credible guarantees* place limits on the ruler discretion and those who benefit from these broader arrangements confront lower costs of collective action in attempting to respond, for example, to leader expropriation of members assets; and reduce the costs of replacing the ruler in the event that the ruler reneges. This also allows members to demand a larger share of rents from the leader—particularly, natural resource rents. On the other hand, these arrangements create a more favorable environment for economic growth by making private actors more willing to invest and produce new wealth, thereby providing the leader with a potential source of rents that would not exist under alternative arrangements. The fastest growing non-democracies seem to have chosen institutional arrangements which are more inclusive.

In addition, the magnitude and shape of rent-seeking is a consequence (rather than a cause) of leaders' choices of guarantee mechanisms. Common types of rents are high rates of return in protected markets, which leaders offer to bind supporters to the regime. If the regime changes, these supporters are less likely to receive those rents, and so are willing to support the current regime against challengers. By the same token, they are likely to oppose the regime if their rents are threatened by reform. Leaders can choose to introduce mechanisms that allow them to guarantee both incumbents and newcomers a future flow of rents under the reformed state that exceeds their expected rents in the absence of those guarantees.

### ***Explaining the Weak and Varied Progress in Reforms***

The nature of authoritarian regimes, the pervasiveness and persistence of conflict as well as the large rents discussed above have shaped the supply for reforms, and resulted in different outcomes in the three major country groupings.

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<sup>17</sup> This section draws on notes by Phil Keefer on the politics of private sector development in MENA for the forthcoming World Bank flagship report on Private Sector Development in the MENA region.

*Resource-poor labor-abundant/emerging economies.*

As early as the 1970s, countries in MENA such as Tunisia and Egypt initiated some degree of liberalization in response to the emergence of macroeconomic imbalances.<sup>18</sup> This process intensified and became generalized in all countries of this group (Egypt, Jordan, Morocco, and Tunisia)<sup>19</sup> as they experienced macroeconomic crises in the 1980s and early 1990s, often as a direct result of the surge in oil prices (or its collapse for those countries which had at the time some significant exports of oil, such as Tunisia) and collapse in economic performance. Serious macroeconomic crises emerged in Morocco in the early 1980s, in Tunisia in the mid-1980s, in Egypt in the late 1980s, and in Jordan in the early 1990s.

After the initial surge in reforms in the 1980s and early 1990s, resistance to reform has deepened among those groups whom the prevailing social contract protects. The success of stabilization programs and return of stable macroeconomic conditions were followed in most cases by slow progress in structural reforms. While macroeconomic crises prompted in all cases the onset of reforms, none of the crises experienced by MENA countries was serious enough to lead to a major collapse or the emergence of a new political equilibrium along the lines of Olson (1982).<sup>20</sup> This meant that progress on reforms was to depend less on a weak effective demand for reforms and more on the role played by the ruling authoritarian regimes to shape the reform agenda according to their interests.

On the *demand side* there was a diffuse pressure to reform as unemployment started to increase and standards of living to decline or at best stagnate. By the mid-1980s these countries were undergoing a remarkable demographic transition.<sup>21</sup> The old mechanisms to distribute rents started to break down when countries in the region were unable to fund the extensive social welfare systems and generate enough jobs to cope with the growing employment demands of their youth. Governments were no longer able to deliver the rents they have been used to redistribute. With limited and declining rents from oil and other sources, the regimes in place saw the need for the economies to generate more wealth through private sector development. This diffuse pressure was progressively but slowly reinforced by the only interest group which had any significant organized power, the private sector. As the economies started to transform, some parts of the private sector, which are more export-oriented and less dependent on the old import-substitution, state-dominated economy, started to become vocal in favor of reform. However, this pressure for reform was countered by pressure which is often stronger in favor of the status quo by the private sector “insiders” as well as other groups such as labor in the public sector or the bureaucracy.

The weak demand for reform meant that the extent and scope of reforms in these countries has been determined essentially on the *supply side*. Reforms would be shaped by the extent to which they are consistent with maintaining or “upgrading” the authoritarian nature of the regimes while enhancing its ability to capture more rents.<sup>22</sup>

It was clear from the outset that the complete lack of natural resource rents (Jordan, Morocco) or their limited and declining importance (Egypt, Tunisia) meant that the ruling regimes were

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<sup>18</sup> Starting in 1971 in Tunisia, following the failure of the socialist experiment in the 1960s; and in Egypt following the Arab-Israeli war in 1973.

<sup>19</sup> Lebanon, which belongs to this group, had a very specific conditions, being more democratic but with predominance of sectarian politics, and a long civil war.

<sup>20</sup> See Olson (1982). The case which came closest to such a major transformation is the case of Algeria at the end of the 1980s where the collapse of oil prices led to a major economic crisis as well as a domestic civil conflict.

<sup>21</sup> See World Bank (2004).

<sup>22</sup> See Heydemann (2007),

facing severe budget constraints and were dependent on the extraction of rents from the private sector, which needed to grow. On balance the need for reform was more pressing than in resource-rich countries. Being in a conflict prone neighborhood seems to have had an ambiguous impact on reforms. But it helped sustain the existing regimes and indirectly, the nature of the reforms undertaken. The regimes have used security concerns to justify large military and securities spending, maintaining control on economic activity and delaying reforms.

These considerations had significant implications in terms of the speed and content of reforms. The political regimes saw the benefits from reforms. Their ability to deliver rents and benefits to insiders and supporters of the regime through the old system of state-owned enterprises, public employment, public sector banks, and other rents from controls and restrictions (including import substitution) was much reduced. Reforms would help achieve higher growth and private sector development, creating also opportunities to capture rents and sustain the regime. On the other hand the threat of resistance and revolt by the public at large was real as became apparent with a number of episodes of civil unrest following the reduction of some subsidies. At the same time there is the risk of the private sector becoming too “powerful and threatening” or autonomous vis-à-vis the regime. The reforms would need to allow the state to retain its ability to capture rents and redistribute them to its base.

This was achieved by maintaining some significant ownership of the financial system, and a large measure of controls on trade and investment. Accordingly the reform programs have tended to exhibit the following characteristics:

1. They are dominated by “top down” measures which are easily implemented through changes in the regulations, but do not require dealing with deeper governance issues (such as stronger property rights, more independent judicial systems, availability of information).
2. They maintain a large degree of government discretion and ownership of financial and productive assets, and limited privatization.
3. Progress is not steady but mostly “stop and go,” depending on the perceived need to create more wealth and jobs.
4. The progress in reforms had to be slow as the regimes tried to manage both the need to cater to existing interests while allowing the emergence of new activities. This was clear in trade and competition policy, where progress was very slow in all cases.

In addition failing to supply institutional arrangements that provide a large spectrum of private investors, often with a focus on foreign investors, with more guarantees regarding their investments (i.e. leveling the playing field for private investors, abolishing the differentiation between insiders and outsiders) there is a pervasive use of alternative institutions. These include the creation of Special Economic Zones, with dedicated, sometimes preferential, regulatory oversight and provision of better services. Another mechanism is for governments to invest substantial amounts in growth-oriented infrastructure. Even if infrastructure is not the main obstacle to private investment, governments have more to lose by renegeing on commitments to private investors if the political payoffs to large infrastructure investments are zero in the absence of a private investor response. Infrastructure thus has a double payoff: it directly lowers costs of doing business, and it raises government costs of renegeing on commitments not to expropriate.

*Resource-rich labor-abundant/transition countries.*

This group includes a set of countries (Algeria, Iran, Iraq, Libya, Syria, and Yemen) which share a number of very special characteristics: (i) they have sizeable oil wealth (though quickly depleting in the case of Syria and Yemen); (ii) they have large populations (except in the case of Libya, which has a smaller population and is labor-importing ); (iii) they have

experienced the most advanced forms of socialist/command economies; (iv) they have all been involved in external conflict, experienced some domestic violence or unrest, or have been subject to international sanctions; and (v) the political regimes (with the exception of Iran) have their origin and main base in the military.

As in the case of the resource-poor countries, reform in this group was triggered in most cases by a macroeconomic crisis: as was the case in Algeria towards the end of the 1980s, in Iran and Syria in the early 1990s, and in Yemen after a civil war and crisis in the mid-1990s. In Libya the reforms started much later, in the 2000s, but were not triggered by a macroeconomic crisis. Compared to the non-oil-exporting countries this group tended to lag behind in terms of reforms and development of the private sector. The state remains more dominant and the transition to market- and private sector-driven economies is still very much work in progress.

On the demand side pressure for reforms was weaker. The role of the state remained large and the prevailing interests remained strong, which meant that the constituency for reform was weaker. The private sector remained small and dominated by the “insiders’ and beneficiaries of the old system.

On the *supply side* the three specific characteristics of the authoritarian nature of the regimes, the importance of the oil rents and the prevalence of conflict and violence played an important role in the political economy of reform. The insiders and beneficiaries of the system were mainly dominated by the “military and security” establishments. These characteristics had a number of implications in terms of the incentives to reform and to develop the private sector. First, the ruling regimes have readily available rents, which they can distribute to their constituencies, and the need to tax a larger private sector to sustain the regime is weaker. Second, it is cheaper to distribute these rents than to develop better institutional arrangements, which support a larger private sector, and better governance, which may mean giving up more rents and running the risks of collective action against the rulers. Third, the softer budget constraints allow them to delay reforms even in the presence of crisis and when oil revenues decline, as happened in the 1980s and 1990s.

The implication is that while reform programs in these countries exhibited all the characteristics found in the resource-poor group, they lagged significantly behind and were much slower and more hesitant. The dominance of the state in ownership was both larger at the beginning and tended to change at a slower pace.

#### *Resource-rich labor-importing countries (GCC).*

The political economy dynamics in the Gulf Cooperation Council countries differs significantly from the other oil exporting countries. Two main contextual factors were apparently similar: the non-democratic nature of the political systems and the importance of oil wealth. But in fact they played out very differently.

On the *demand side* the private sector, which included the ruling families, was supportive of reforms favoring the private sector. The private sector continued to thrive throughout in these countries and was intrinsically linked to the regimes in place. Governments did recycle some of the oil rent into government-run economic activities in infrastructure as well as other productive sectors. The state-owned enterprise sector expanded significantly. But it was not meant to substitute for the private sector; it was rather a practical response to the need to recycle the oil revenues into wealth-creating activities. There were no opposing interest groups, which would in any case have been unable to organize.

On the *supply side* the ruling regimes did not face a credibility problem. The oil wealth is much larger in per capita terms and the budget constraints are much softer, which meant that the regimes were much less dependent on extracting private sector wealth. On the other hand,



the political regimes were long established with the existing monarchies and emirates. They did not undergo regime changes like all of the other oil countries. While non-democratic, the regimes were not military/security based and did include significant checks and balances and some measure of accountabilities. At the same time they were less directly impacted by the conflicts in the region. This made any perceived incentive for the regimes to renege on promises to provide a favorable environment to the private sector very weak. The regimes did not even need any specific political institutional arrangements to ensure their credibility. The relative wealth of the rulers and the readily available rents at the governments' disposal to sustain the regimes were enough to ensure against expropriation.

These factors meant that these countries maintained, from the beginning, predominantly market-based, private sector-driven economies. Therefore progress on reforms was possible and easily achieved, since there was not much opposition and, with the continued surge in revenues, there was no need for the rulers to expropriate. Reforms became broader and deeper as the requirements for better integration into the world economy and management of the accumulated wealth became even more urgent. The reforms were credible allowing for a stronger private investment response.

One interesting feature of reforms in the GCC is the large discrepancy between the strong progress of reforms related to the development of the private sector while progress on other reforms lagged. The surge in oil revenues since the early 1970s allowed the regimes to distribute large rents both to their supporters and the population at large. The mechanisms used for the latter included public sector employment and an extensive system of subsidies to consumers. The reform of this domestic price system and the civil service which create huge price distortions in both goods and labor markets, has lagged considerably. This feature is fully consistent with the arguments above.

### ***Investment Response and Credibility of Commitments***

The previous discussion focused on the relatively limited progress in reforms in MENA countries. But there were reforms, which advanced significantly in many areas and countries. Despite this, private sector response has been limited, and the share of private sector investment in GDP, FDI, manufacturing exports, and other indicators of the overall dynamism of the private sector has remained somewhat muted (Table 1). How to explain this result?

One explanation may be related to conflict, which acts as a deterrent to private sector development because it increases risk and uncertainty. Assets and transactions are put at risk by conflict. As a result, sectors that are more vulnerable and/or visible tend to be more affected. Given the irreversibility of (fixed capital) investment, a higher degree of risk tends to reduce private sector investment response, including foreign direct investment, and to increase capital flight, generating a vicious cycle that negatively affects reform efforts. Conflict can also disturb the level playing field and generate unusually high profits from some parts of the private sector. But in addition to the fact that there is limited empirical evidence about the impact of conflict on private investment, this factor does not explain why this weak response is found not only in countries which are strongly affected by conflict, but also in others which are much less affected (such as Morocco or Tunisia).

Another possible explanation of the muted response may be the lack of credibility of the reforms.<sup>23</sup> In developing countries a key obstacle to private investment is the fear of direct or indirect expropriation of assets by governments or those close to the government. If rulers can provide guarantees to a large number of private investors that they will not be subject to

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<sup>23</sup> This section draws on notes by Phil Keefer on the politics of private sector development in MENA for the forthcoming World Bank flagship report on Private Sector Development in the MENA region.

discretionary adverse decisions, private sector initiative could accelerate. But to be effective, these guarantees must be credible. How can rulers provide credible guarantees? As discussed above, this is achieved by setting institutional arrangements that offer guarantees to a larger set of beneficiaries, which in turn has two effects. First, the guarantee (if credible) acts as an insurance mechanism, changing the perverse incentives that prevail today and expanding investment and private sector participation. Second, the broadening of the investment base—the larger set of beneficiaries—increases the pool of investors and as a result expands the size of the private sector as well. If the institutional arrangements make it easier for these actors to exchange information and organize, this makes collective action against and challenge to the rulers cheaper in case they renege on their commitments.

In MENA countries the non-democratic regimes did not, by and large, provide credible institutional arrangements which would allow broad-based private sector activity. While indicators of the business environment have progressed, indicators of public sector accountability are lagging behind all other regions of the world.<sup>24</sup> Expropriation scenarios can occur even in regulatory environments that seem to encourage private sector investment, when leaders face low penalties for arbitrary departures from the regulatory standard. This signals that the business environment operates differently for insiders than for outsiders, and that guarantees provided by governments are not fully credible. Interviews and detailed firm surveys in countries across the region reveal the significant influence of regime insiders on the economic prospects of outsiders, either through outright expropriatory activity, or through arbitrary contract dispute resolutions, or through regulatory barriers to entry, including those related to access to land.

The foregoing discussion helps to explain why the private sector seems to be reluctant to invest more in MENA, even when there is an overall investment climate that is apparently not significantly different from that of fast-growing comparator countries. The legal environment confronting the median citizen may be no worse, or may even be better than that in comparator countries in the developing world. However, the fraction of MENA societies that benefit from the strong protections of institutionalized restraints on the executive is much smaller. And it is this fraction that drives investment and growth. So it is the distribution of citizens who benefit from investment guarantees, and not only the median level of protection, which seems to matter. Fast-growing comparator countries that offer institutionalized constraints on leader discretion usually do so for well under half the population. For this fraction, the security of property rights and the reliability of regulatory and contract dispute resolutions are both very high.

To the extent that governance measures capture the position of the average citizen, they would not distinguish between MENA and fast-growing developing countries, which differ largely on the size of the upper tail of the distribution, not the average citizen. Other indicators, which are objective measures of the policy environment may be also vulnerable to such distributional issues. The Doing Business indicators, for example, describe *de jure* obstacles to doing business. Under this metric, the MENA region falls in the middle of the road of all developing regions in the world regarding ease of doing business, with an average rank of 87 (out of 178 countries), above Sub-Sahara Africa (at 136) and South Asia (at 107), but below ECA (at 76) and EAP (at 77). The MENA position is, however, a long way from high-income countries (at 22). Other reform indicators<sup>25</sup> also seem to show that MENA ranks in the middle vis-à-vis developing regions, for instance on trade reform and quality of public administration, but falls short on public sector accountability. Nonetheless, these indicators may not map to *de facto* obstacles in the same way across countries: in democracies and non-

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<sup>24</sup> See World Bank (2007).

<sup>25</sup> See World Bank (2007).

democracies with more institutionalized constraints on rulers, *de facto* situations get closer to *de jure* as a larger proportion of citizens can rely on *de jure* interpretations than in those without institutionalized constraints.

The “credibility of commitment” argument seems consistent with the observed variation in the observed private sector response across countries. As we argued above, the credibility issue is much less serious and relevant in those GCC countries where the private investment response to more reforms and better economic prospects has been strongest over the last few years. For non-GCC countries the private sector response has been stronger in resource-poor countries than in oil exporting countries, again consistent with the credibility of commitment argument. Within the resource-poor countries, two—Egypt and Morocco—witnessed the strongest private sector responses; this may be due to the changes in the political context, where signals were given through government changes, and a closer association of the private sector with decision-making enhanced the credibility of the reforms.

### ***Foreign Direct Investment and Credibility***

When they lead to good governance, democratic and open political institutions ensure credible commitments against expropriation and the respect of property rights in an impersonal way. These benefits accrue to domestic as well as foreign investors.

In the context of authoritarian regimes, as is the case of most MENA countries, the institutionalization mechanisms would seem useful to domestic investors. Foreign investors do not participate directly in the domestic political processes. Other mechanisms, such as bilateral and multilateral trade and investment agreements, are used to protect the property rights of foreign investors. Another institutional mechanism is that of special activity zones where investors are not subject to the normal country legislation. One of the most important features of such preferential treatment is that of full tax exemptions, which significantly reduce the risk of expropriation. In the face of lack of credible institutions for protection of investments, one response by foreign investors was to invest mostly in light manufacturing or services, which do not require large fixed non-mobile capital.

The recent emergence of large financial surpluses in many oil-exporting countries has led to a surge in intra-regional capital flows. One of the striking features of these flows has been the predominance of investments in very large projects, mostly related to real estate and tourism. A puzzling question is how investors and autocrats solve the commitment problem in the presence of authoritarian regimes and a weak investment climate. A hint can be found in the fact that by undertaking very large projects, investors can negotiate the terms of the contracts and “agree ex-ante” on the sharing of the benefits from these projects. The magnitude and long term gestation period of such projects would constitute in itself a credible threat by investors to any temptation to expropriate ex-post projects.

## **5. Some Empirical Evidence**

The experience of the MENA countries discussed in the previous sections shows that the nature of political regimes should impact the investment performance of the private sector through two channels. Firstly, better institutions of public accountability, with more openness and less authoritarian regimes, should be associated with more and deeper structural reforms, which in turn should have a positive impact on private investment. Secondly, better institutions of public accountability should enhance the credibility of structural reforms and strengthen the private investment response to them. In this section we provide some empirical evidence for these effects, thereby supporting the qualitative analysis of the previous sections.

In the empirical analysis we use the recently developed disseminated data set on private investment by Aysan, Nabli and Végonzons-Varoudakis (2007). This work uses various

sources to produce a high quality private investment data set, which for example, consistently excludes investment by state-owned enterprises. In order to capture the effects of political regimes, openness, and accountability we employ the public accountability data set from Freedom House in this paper. This data set emphasizes a number of critical aspects of political regimes, which are important for economic reforms and private investment: civil liberties and political rights. Since both of these aspects are crucial for public accountability, following the Freedom House data set, we use the average of these variables to depict public accountability<sup>26</sup>.

We first test for the impact of public accountability on structural reforms using the following specification of fixed effect panel regression model for a sample of forty-one developing countries covering the last three decades of observations:

$$SR_{it} = \alpha_0 + \alpha_1 PA_{it} + \alpha_2 X_{it} + \varepsilon_{it} \quad (1)$$

where  $SR_{it}$  is an indicator of structural reform (SR),  $PA_{it}$  is the public accountability variable,  $X_{it}$  is a vector of other control variables, and  $\varepsilon_{it}$  is the error term ( $i$  indicates the country and  $t$  represents time). The sample includes five MENA countries (Tunisia, Morocco, Egypt, Jordan, and Syria). While the empirical results do not reflect the overall MENA experience, they do provide findings which through their general validity would be relevant to interpret that experience.

The structural reform variable used in this paper is an imperfect one, as it captures only two dimensions of reform for which data exist for a sufficiently long period of time, i.e. the trade and financial sector reforms. The measure of trade reform used is based on the standard export and import ratio to GDP from which we deduct the natural openness parameter developed by Frankel and Romer (1999), and the oil and mining exports ratio. This indicator captures more directly the deliberate policy choices of countries. Financial development is captured by the private credit by banks and other depository institutions. This is a typical proxy widely used to measure financial development (see for example Nabli and Végonzonès-Varoudakis, 2007). To avoid collinearity issues, we aggregate these two dimensions of structural reforms by principal component analysis<sup>27</sup>.

Other variables included are: oil exports as a percentage of total merchandise export, GDP growth rate of the previous year, human capital, and GDP per capita. In addition to these variables, fixed effect panel data regressions employ country-specific dummy variables. As argued in the previous sections on MENA, larger oil rents are expected to have a negative effect on the progress of structural reforms. The expected effect of the lagged value of GDP growth on structural reforms is ambiguous as better periods may weaken the incentives for reforms but may also make them easier to undertake.

The human capital variable used is an aggregate, using principal component methods, of life expectancy at birth, and average years of primary, secondary, and tertiary education. More human capital would be expected to enhance the structural reforms through the demand side, since more reforms would increase the returns to human capital. Lastly, GDP per capita is introduced as an additional control variable. The data on these variables come from the various sources of the World Bank data series like WDI and LDB.

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<sup>26</sup> In the original data set, lower values indicate more of civil liberties and political rights. To be consistent with the other variables, however,

we rescaled the data such that higher values indicate more public accountability.

<sup>27</sup> The results of the principal component analysis are not given here to save space. However, they are available upon request.

The results of this fixed effect model are given in the first column of Table 4. Public accountability is highly significant in explaining the structural reforms. This result is consistent with the qualitative analysis of the deficient structural reforms observed in MENA countries. Given the deficit in terms of public accountability, improving public accountability in MENA countries offers a great deal of opportunities to realize more structural reforms in the region.

The coefficients of the other variables are mainly as expected. The impact of the oil rents variable on reforms is significantly negative, which supports and is consistent with our MENA findings as they relate to the non-GCC countries. We discussed above the special features of the GCC countries which compensate for this negative impact. Lagged GDP growth has a negative impact on reforms, supporting the hypothesis that better episodes reduce the incentives to engage in more reforms. Human capital exerts a positive influence on structural reforms. Finally, higher GDP per capita is strongly associated with higher indicators of structural reforms.

Next, we focus on the determinants of private investment using the following specification and a fixed effects panel data regression:

$$PI_{it} = \beta_0 + \beta_1 SR_{it} + \beta_2 PA_{it} + \beta_3 X_{2it} + \varepsilon_{2it} \quad (2)$$

where  $PI_{it}$  is private investment to GDP ratio,  $SR_{it}$  the structural reforms indicator (SR),  $PA_{it}$  is the public accountability variable,  $X_{2it}$  is a vector of other control variables,  $\varepsilon_{2it}$  is the error term.

We expect that structural reforms would exert a positive impact on private investment. However, the role of public accountability on private investment is an unresolved issue. Aysan et al. (2007) found a positive but insignificant effect of public accountability on private investment. Concerning the other control variables, fuel exports are usually expected to impact private investment negatively due to Dutch disease effects. Based on an accelerator model, lagged GDP growth rate is expected to have positive coefficient in affecting private investment. However, volatility of growth rates increases uncertainty in the economy and induces the private sector to be more reluctant and cautious about enhancing private investment. Finally we introduce GDP per capita as another control variable, which may capture other effects with respect to the level of development.

Column 2 of Table 4 shows the results of the fixed effect regression. Structural reform, as expected, exerts a significantly positive influence in enhancing private investment. On the other hand public accountability does not appear to be significant in affecting private investment. Consistent with the accelerator model, GDP growth has a strong positive effect on private investment. Oil export and volatility of growth rates also play a negative role on private investment. Finally, while the coefficient for human capital is insignificant, GDP per capita is strongly and positively associated with private investment.

Following the existing literature, we test the sensitivity of results to the estimation method and apply the instrumental variable fixed effect regression model. The main endogeneity problem is with respect to GDP growth. We instrument GDP growth with Gap10. Gap10 is defined as growth rate in that year minus the moving average of growth rate in ten years. As expected, this instrument is highly significant with its positive coefficient in the first stage regressions of columns 3 and 4.

The estimation results in column 3 are very similar to the previous ones, with a significant impact of structural reform on private investment but no direct effect of public accountability (not included). However our discussion of MENA countries suggested that the effect of public accountability may be through the credibility of reforms and therefore the response of

investment to reforms. This suggests the introduction of PA in an interaction term with structural reform. The results are shown in the last column of Table 4. The previous results are robust and mostly remain unchanged, and we find that the impact of the interaction term is similar to that of structural reform separately. While the evidence is not strong, it is consistent with the suggestion that in countries with better public accountability the response of private investment to structural reforms is even stronger, while in countries where credibility is weaker the same reforms would produce a weaker investment response.

While the variables used to measure structural reforms and political institutions, and the empirical model is very simplified to account for the richness of actual experiences, still the quantitative empirical findings provide strong support for the qualitative analysis developed in the previous two sections to explain the MENA experience in reforms. The findings show that structural reforms are shaped significantly by the availability of rents as well as by the nature of political regimes. In addition, the nature of political accountability seems to affect private investment response both indirectly, through its impact on structural reforms, and directly through its multiplicative effect with structural reforms and the enhancement of credibility of the reforms enacted.

## **6. Concluding Remarks and Prospects for Reforms**

The analysis in this paper helps understand the progress in reforms and development of the private sector. It shows the critical role played by the state-private sector relations in determining the progress of reforms, and their impact on private sector development. The authoritarian nature of the political regimes and the existence of large oil and other rents, and of conflict (though to a much lesser extent), have been the major factors shaping the nature, extent, and speed of reforms.

From a positive point of view the analysis implies that the prospects for the reform agenda and private sector development will be determined by the prospects for the various factors which shape the political economy of reform. Given the multiplicity of factors and diversity of conditions of MENA countries, the prospects for reform are likely to vary widely between individual countries and groups of countries. It is clear that a number of countries are likely to remain afflicted by conflict for some time because of domestic sectarian factors or other challenges to the authority of the state. In addition to the Palestinian territories, this is the case in Iraq, Lebanon, and to some extent Yemen. In addition, Syria and Iran remain subject to international sanctions and potential conflicts. As shown by past experience, this is likely to slow down reforms.

We noted above that macroeconomic crises were important in the initiation of the reform programs in non-GCC countries. The budget and balance of payments imbalances and the inability of governments to honor their obligations of the prevailing social contract, led them to seek ways to increase wealth through private sector development. By and large, most MENA countries have achieved stable macroeconomic conditions and it is unlikely that future crises will play a major role in prompting more and deeper reforms. This is obviously the case for the major oil exporting countries. There are, however, three countries where possible future crises may play an important role. The prospect of declining oil production and revenues, within the next decade, in the case of Syria and Yemen poses critical challenges for the adjustment of their fiscal balances. This is likely to lead them to undertake significant reforms, as has already started to happen. The macroeconomic situation in Lebanon is also difficult, with unsustainable public debt and low economic growth. As already recognized by the government, this calls for major reforms, including improving the business environment where the country lags significantly behind.

The recent surge in oil prices has increased oil revenues in MENA by over 300 percent in the last decade, reaching an estimated US\$547.7 billion in 2006—up from an average of US\$126 billion in 1996-99. This high volume of revenues represents 38 percent of the 2006 regional GDP. Global energy demand is expected to remain high, particularly because of the increasing energy requirements of China and India. This energy demand, in conjunction with a limited growth capacity of the supply side in the medium term, is likely to keep oil prices high and the oil rents strong in the near future. Are oil rents likely to slow the pace and delay fundamental reforms needed for sustainable higher growth and employment creation? Recent evidence suggests that this is unlikely to be the case in the GCC countries. However, there is evidence that this has been the case for the resource-rich transition economies and is likely to continue to be the case in the future.

Our analysis shows that for non-GCC countries the prospects for reform are very much linked to the prospects for political reform. The growth of the private sector is essentially determined by the credibility of the policies and institutions which protect investors from expropriation. From the analysis above and a review of the literature, coupled with experience, such credibility can be obtained through two major institutional arrangements. The first is the development of democratic political institutions which constrain the power of the state. The second is the establishment of other mechanisms (such as ruling party institutionalization within a non-democratic context) which have been used by autocrats to make credible commitments. In the approach developed by Gehlbach and Keefer (2007) autocrats can use institutionalized ruling parties as a way to make credible commitments to investors. The ruling parties in such cases can provide checks on the power of the rulers and facilitate collective action by broader, more encompassing elites (and investors).

From a normative perspective one can argue that progress in democracy is probably the most critical factor at this stage of the MENA's history for achieving the required transformation which would ensure better governance, more accountability, a better investment climate, and credible policies for increased private sector investment, employment, and growth. Addressing lags in accountability and inclusiveness in governance through the development of democratic institutions, will help to improve the likelihood of reform as well as to enhance credibility and promote a stronger private sector response to the reform agenda. One can also argue that while democracy can lead to better governance and, therefore, better economic policies and credible reforms, the design of such economic reforms may in itself enhance democratic development. Producing a virtuous circle where democratic development enhances governance and economic growth will itself support the consolidation of democratic development.

MENA countries should strive for more democratic regimes which are likely to produce good governance. This means that democratic development requires going beyond an electoral process that guarantees free, open and competitive elections. A large body of work has shown that democratic regimes which respect the formal democratic processes such as elections may be captured by elites or some coalitions and become unfavorable to broad-based investment and growth. These formal democratic processes have to be complemented by a number of reforms which aim at: (i) minimizing imperfections in the political market, with more freedom of information, a free press, adequate mechanisms to contain clientelism, and increased credibility of political promises; (ii) introducing safeguards and effective checks and balances; and (iii) increasing the legitimacy of the democratic transformation.<sup>28</sup>

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<sup>28</sup> See Nabli and Silva-Jauregui (2007).

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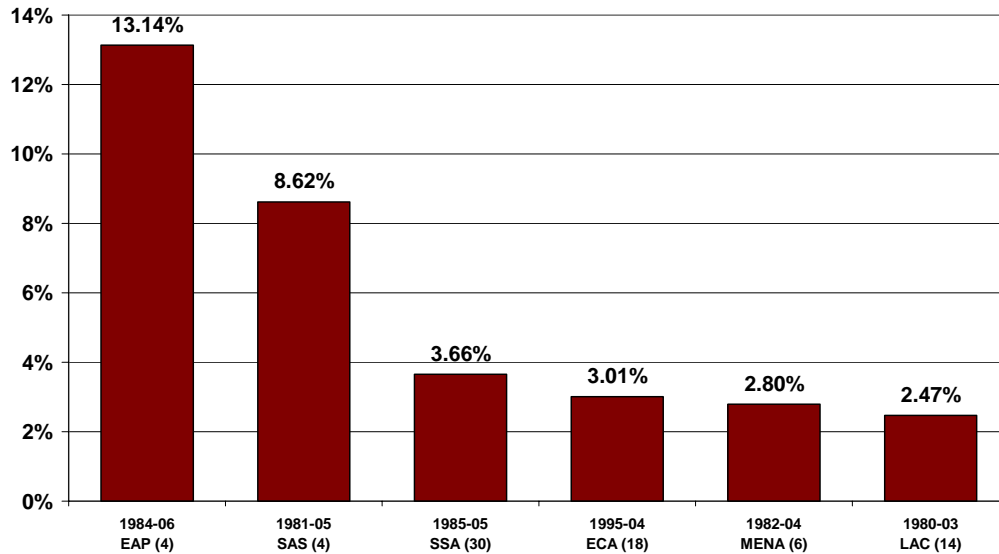
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**Figure 1. Private Investment Growth**

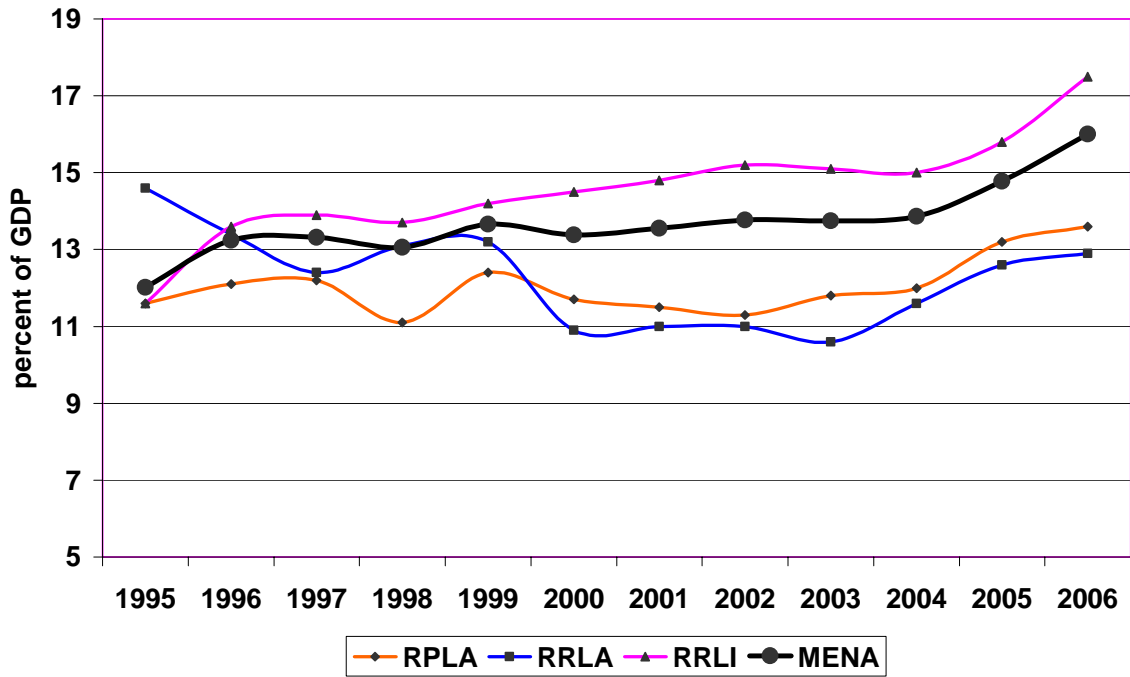
(per annum - weighted average)



Source: Estimates based on World Development Indicators (WDI) database.

Note: Private investment data are deflated by each country's GDP deflator. Regional averages are weighted by GDP. The timeframe varies according to region in order to capture the largest pool of countries. Regions are: EAP: East Asia and the Pacific; SAS: South Asia; SSA: Sub-Saharan Africa, ECA: Europe and Central Asia; MENA: Middle East and North Africa; LAC: Latin America and the Caribbean. The number of countries included is in parentheses.

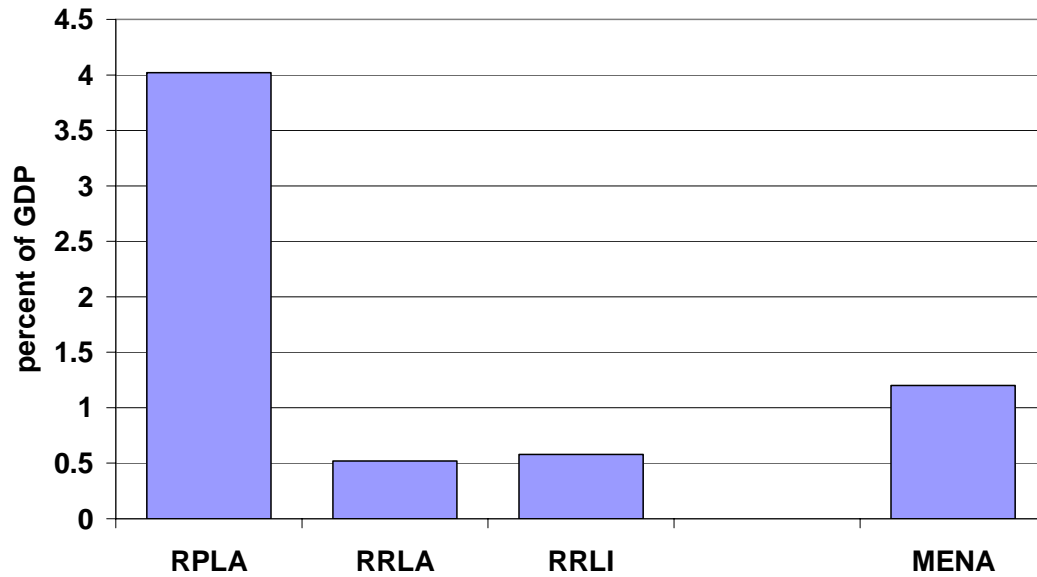
**Figure 2. Private Investment in MENA**



Source: Estimates based on WDI and LDB databases.

Note: Regional averages weighted by GDP. Data for Iran is excluded because of the inability to separate public and private investment in official data sources. Sub-regional groupings are: RPLA: resource-poor labor-abundant; RRLA: resource-rich labor-abundant; RRLI: resource-rich labor-importing.

**Figure 3. Net Foreign Direct Investment in MENA  
(Average 1996-2006)**

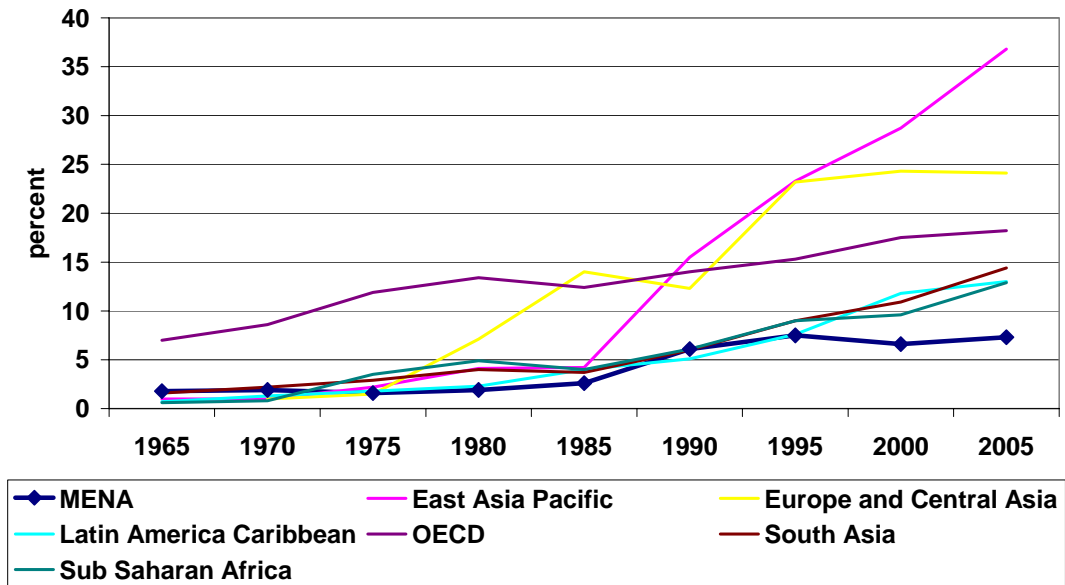


Source: Estimates based on WDI database.

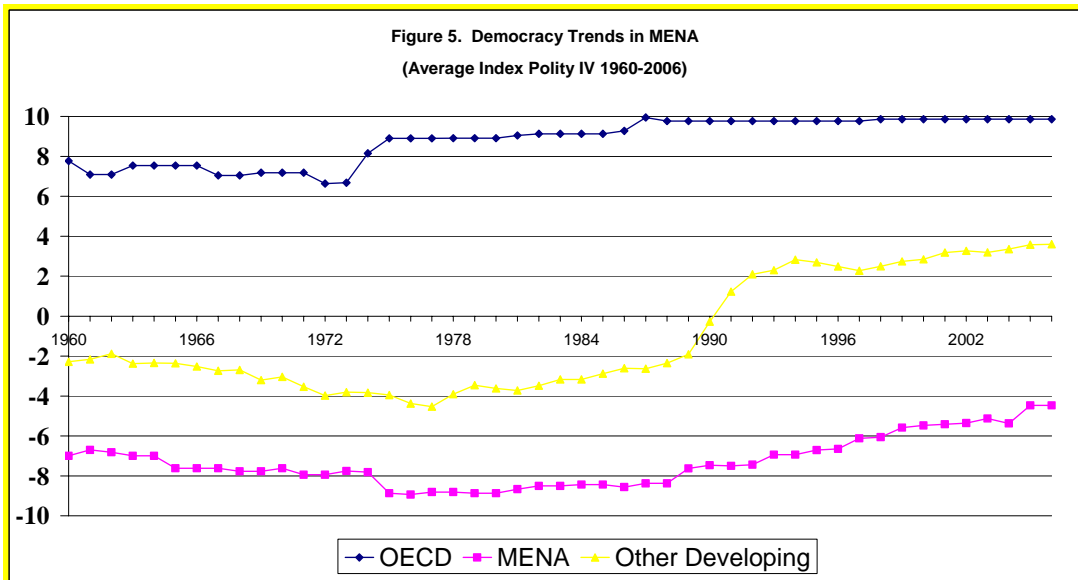
Note: Net FDI flows (inflows minus outflows). Regional averages are un-weighted.

Sub-regional groupings are: RPLA: resource-poor labor-abundant; RRLA: resource-rich labor-abundant; RRLI: resource-rich labor-importing.

**Figure 4. Manufactured Exports  
(Percent of to GDP)**

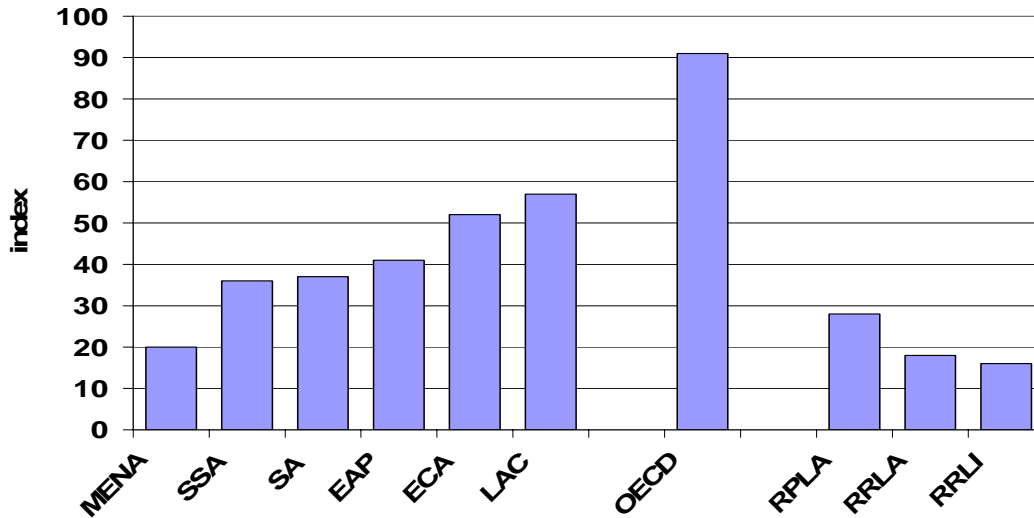


Source: Estimates based on WDI database.  
Note: Regional averages are weighted by GDP.



Note: The Polity IV index is produced by the Integrated Network for Societal Conflict Research Program of the University of Maryland's Center for International Development and Conflict Management (CIDCM). Polity IV contains coded annual information on regime and authority characteristics for all independent states (with total populations greater than 500,000) in the global state system, and covers the years 1800-2006.

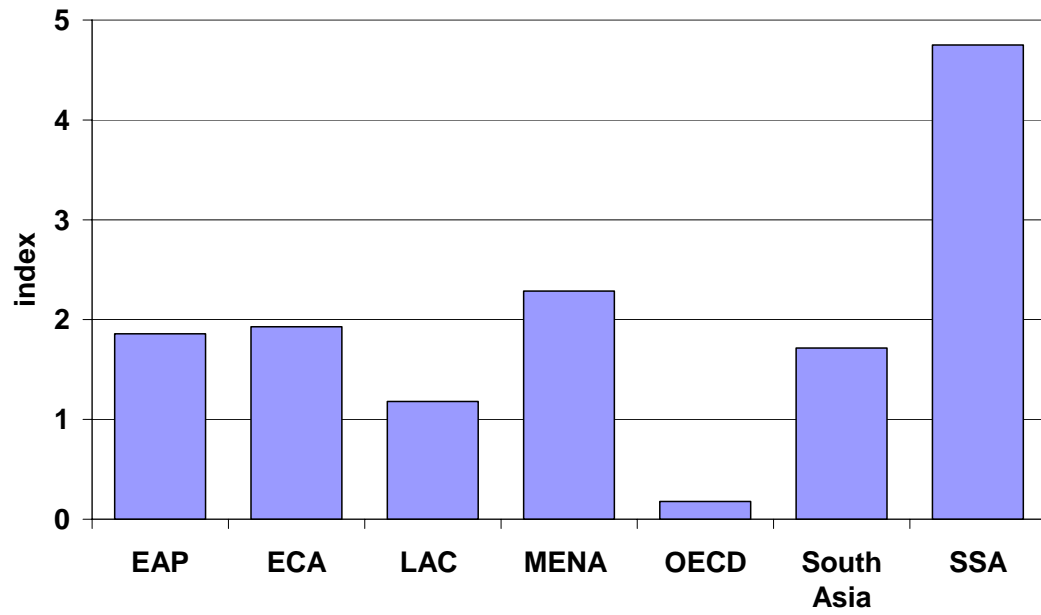
**Figure 6: Public Sector Accountability in MENA and Other Regions  
(Rank ordering)**



Source: World Bank (2007).

Note: The index reflects each country's current placement in a worldwide ordering of countries, based on a variety of indicators of public sector accountability, expressed as a point in the worldwide cumulative frequency distribution, with 100 reflecting the country (countries) with the best/most accountable governance structures worldwide and 0 reflecting the country (countries) with the weakest/least accountable governance structures worldwide. Regions are: EAP: East Asia and the Pacific; SAS: South Asia; SSA: Sub-Saharan Africa, ECA: Europe and Central Asia; MENA: Middle East and North Africa; LAC: Latin America and the Caribbean. Sub-regional groupings are: RPLA: resource-poor labor-abundant; RRLA: resource-rich labor-abundant; RRLL: resource-rich labor-importing.

**Figure 7. Conflict Frequency, 1975-2007**



**Table 1: Summary of Progress on Reforms and Private Sector Development**

<b>Reform area</b>	<b>Resource-poor</b>	<b>Resource-rich</b>	<b>Resource-rich</b>
	<b>Labor-abundant</b>	<b>Labor-abundant</b>	<b>Labor-importing</b>
<b>Macroeconomic Environment</b>	0 (Lebanon: -2)	+1	+2
<b>Trade Policies</b>	0	-1 (Algeria: +1)	+1
<b>Regulatory Environment</b>	0 (Jordan: +1, Egypt: -2)	-1	+2
<b>Financial Sector</b>	+1 (Lebanon: +2)	-2	+2
<b>Weight of public sector</b>	0	-2	-2
<b>Quality of public administration</b>	+1 (Egypt: -1)	-2	+1
<b>Private Investment % of GDP, 2006</b>	14	13	17.5
<b>Change in Private Investment % of GDP, 1996-2006</b>	+1.5 points	-0.5 points	+4 points

Source: Authors' own calculations based on World Bank (2007), WDI and LDB databases.

Notes: Scores indicate average ranking (rounded to the nearest digit) of country grouping by quintile (-2 is lowest quintile and +2 the highest). For each group we compute the average score of the countries in the group for 2006 or the latest year. The various indicators are compiled as follows: (i) macroeconomic environment: an average index for inflation over the last three years, budget deficit and public debt as percent of GDP; (ii) trade policies: an index which combines tariff and non-tariff measures is used; (iii) regulatory environment: this uses principal components from the World Bank "Doing Business" scores, and the Heritage Foundation indicators; (iv) financial sector: we construct an index which takes into account banking sector efficiency, stability, bank concentration ratio, and credit to private sector as percent of GDP; (v) weight of the public sector: based on sources of fiscal revenues by State-owned enterprises. Countries included in country groupings for this table are: (i) resource-poor labor-abundant: Lebanon, Morocco, Egypt, Tunisia, Jordan; (ii) resource-rich labor-abundant: Algeria, Yemen, Iran; and (ii) GCC: Bahrain, Kuwait, Qatar, United Arab Emirates, Saudi Arabia. In parentheses we show scores for some individual countries which deviate significantly from the average.



**Table 2: Trade Policy Reform**

Country/region	Average tariff	Non ad valorem duties (percent of tariff lines)	Time required for importing (days)	Time required for exporting (days)	Trade policy index (0-100)
Algeria	18.7	0.0	22	15	68
Bahrain	5.1	1.0	..	..	..
Djibouti	31.0	2.7	26	25	17
Egypt, Arab Republic of	9.1	0.2	25	20	60
Iran, Islamic Republic of	22.1	0.5	38	26	16
Jordan	11.8	0.3	22	24	44
Kuwait	3.6	1.3	27	18	69
Lebanon	5.4	0.5	34	22	50
Libya	17.0	2.2	..	..	..
Morocco	26.2	0.0	30	18	52
Oman	5.0	1.0	27	23	51
Qatar	5.0	1.0	..	..	..
Saudi Arabia	4.8	1.3	34	13	64
Syrian Arab Rep.	19.6	0.5	49	40	2
Tunisia	26.9	0.0	29	18	53
United Arab Emirates	4.8	0.5	16	18	75
Yemen, Republic of	7.0	0.0	31	33	63
<i>Regional averages (unweighted)</i>					
<b>MENA</b>	<b>13.1</b>	<b>0.8</b>	<b>37</b>	<b>28</b>	<b>49</b>
Resource-poor	18.4	0.6	30	22	46
Resource-rich, labor-abundant	16.9	0.3	55	44	37
Resource-rich, labor-importing	6.5	1.2	26	18	65
East Asia and Pacific	7.3	0.5	25	24	53
Europe and Central Asia	6.8	3.4	37	29	50
Latin America and Caribbean	9.5	0.3	28	22	64
High-income OECD	4.2	5.6	13	11	84
South Asia	15.0	0.4	41	34	28
Sub-Saharan Africa	13.7	0.7	52	40	26
World	9.8	1.8	34	28	50

Source: World Bank (2007). Average tariffs and *ad valorem* duties are from WTO International Trade Statistics.

Note: The trade policy index reflects each country's placement in a worldwide ordering of countries, based on four major categories of trade policy indicators available in 2006. The index is expressed as a cumulative frequency distribution, with 100 reflecting the country (countries) with the most open trade policies and 0 reflecting the country (countries) with the most closed trade policies.

**Table 3: Business and Regulatory Environment**

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<b>Country/region</b>	<b>Current business policy index (0-100)</b>
Algeria	27
Djibouti	11
Egypt, Arab Republic of	20
Iran, Islamic Republic of	25
Iraq	38
Jordan	46
Kuwait	78
Lebanon	44
Morocco	27
Oman	76
Saudi Arabia	84
Syrian Arab Rep.	17
Tunisia	49
United Arab Emirates	53
West Bank and Gaza	35
Yemen, Republic of	69
<b>Regional averages (unweighted)</b>	
<b>MENA</b>	<b>44</b>
Resource-poor	31
Resource-rich, labor-abundant	35
Resource-rich, labor-importing	73
East Asia and the Pacific	63
Europe and Central Asia	56
Latin America and the Caribbean	47
High-income OECD	82
South Asia	49
Sub-Saharan Africa	26
World	50

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Source: Estimates based on Doing Business 2008 database.

Note: Current business policy index reflects a country's placement in a worldwide ordering of countries, based on eight major categories of business environment indicators available in 2007. The index is expressed as a cumulative frequency distribution, with 100 reflecting the country (countries) with the most friendly business policies worldwide and 0 representing the country (countries) with the most unfriendly business policies worldwide.

**Table 4: Governance, Structural Reforms and Private Investment**

<b>Econometric Model</b>	<b>Fixed Effects GLS</b>	<b>Fixed Effects GLS</b>	<b>G2SLS Fixed Effects IV</b>	<b>G2SLS Fixed Effects IV</b>
<b>Independent Variable</b>	<b>Structural Reform</b>	<b>Private Investment</b>	<b>Private Investment</b>	<b>Private Investment</b>
<b>Public accountability (PA)</b>	0.160 (2.96)***	-0.256 (-0.71)		
<b>Structural reforms (SR)</b>		0.976 (3.35)***	0.888 (3.06)*	
<b>SR*PA</b>				0.139 (2.18)**
<b>Oil exports (FE)</b>	-0.015 (-4.96)***	-0.060 (-2.91)***	-0.062 (-3.03)***	-0.067 (-3.24)**
<b>GDP growth</b>	-0.023 (-4.68)***	0.174 (5.23)***	0.141 (4.02)***	0.137 (3.86)***
<b>Volatility of GDP growth</b>		-0.024 (-2.10)**	-0.022 (-2.09)**	-0.021 (-1.98)**
<b>Human capital</b>	0.199 (4.03)***			
<b>GDP per capita</b>	0.001 (12.18)***	0.0014 (3.09)***	0.001 (3.31)***	0.001 (3.89)***
<b>Constant</b>	-2.452 (-7.06)***	11.544 (4.97)***	10.226 (7.43)***	9.811 (6.99)***
<b>Prob &gt; chi2</b>	0	0	0	0
<b>Number of Observations</b>	547	547	547	547

Notes: (\*) indicates significance at 10 %; (\*\*) indicates significance at 5 %; (\*\*\*) indicates significance at 1 %.  
For sources of data, see footnote<sup>29</sup>

<sup>29</sup> Sources of data are as follows: the private investment series have been processed from various national and international sources (International Finance Corporation (*IFC*), World Development Indicators (*WDI*), Life Data Base (*LDB*)). The components of the “Public Accountability” indicator come from Freedom House (2002). The “Structural Reforms” index uses data from WDI, but the oil export series entering the trade policy indicator comes from the United Nations. In the “Human Capital” indicator and the life expectancy series are from WDI. All aggregated indicators have been generated after implementing the PCA methodology. All other data are from WDI.