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It's Better Institutions, Middle East!

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The Middle East and North Africa region (MENA) entered the new millennium saddled with a number of intricate challenges. The most thorny of these is how to register high enough economic growth rates in the coming years in order to absorb the nearly 25 million unemployed in the region, as well as generate an additional five million new jobs annually for the new entrants to the labor market. Failing to do so, the region is likely to find itself facing tens of millions of disgruntled workers and the ensuing social and political unrest. In order to avert this unenviable situation, it is imperative that the region encourages investment. Although progress has been made in a number of areas, much more has to be done and at a faster pace. In particular, a major overhaul of the economic and political institutional frameworks of the region is in order.

Building better institutions entails change. MENA countries must work to reduce the size of the public sector, uphold the rule of law, protect property rights, root out corruption, respect human rights, promote freedom of the press, and seek greater integration regionally and globally.

International partnerships, multinational finance organizations, development organizations, and the private sector can all play a role in facilitating those reforms, but the most important impetus for change must come from within the region itself. It is essential that local civil society organizations and NGOs are formed and promoted, thereby putting the needed constraints on the power of the state and supporting private sector economic activity. The human, financial, and natural resources of the region provide MENA countries with the capacity to build truly sound institutional frameworks and attract the investment they need.

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Introduction

The world economic and financial landscape has transformed swiftly in the past two decades. A new era of globalization, intensified by the information technology revolution, and characterized by economic, financial, and trade liberalization, has created mounting challenges, as well as, promising opportunities to developed and developing countries alike. Underdeveloped countries in particular, including those in the Middle East and North Africa region (MENA), have to face the music as the forces of globalization take root.

Not surprisingly, coping with the new paradigm and coming to grips with its complex nature has not been an easy task for many national policymakers throughout the world. The MENA region is no exception, especially since it is likely to find itself in the very unenviable situation of facing an army of disgruntled unemployed young people in the next few years if it fails to absorb the already unemployed and generate additional jobs for the new entrants to the labor market. The figures are alarming indeed.

A case in point is the assertion of the Arab Labor Organization (ALO) that unemployment in the region has approached a dangerous level. The ALO estimates that 25 million people are unemployed, which represents an extremely high 20 percent of the labor force – the highest rate of unemployment in the world. The ALO also asserts that the region has to create five million jobs each year and that 70 billion dollars will be injected in the Arab economies to help achieve this goal.[1] Further, the World Bank estimates that the gross domestic product (GDP) in the region must grow at about six to seven percent annually in real terms to absorb entrants to the labor force. The number of entrants is forecast to increase drastically by 2025, which reflects a relatively high population growth rate.[2] Unfortunately, the region is not even close to these badly needed economic growth rates.

As a matter of fact, real output growth rates in the region have been declining. Data show that the Middle East and North Africa region has experienced increasingly lower rates of growth since the mid-1960s. The region grew at an annual average of almost 8 percent during 1966-1973, compared with a sheer average of 3.4 percent during the 1990s. The performance during the "lost decade" of the 1980s was even lower than that of the 1990s, averaging only about 2.5 percent.[3] Despite the improved performance since the year 2000, growth in the region still falls short of the required levels. This unfavorable pattern of output growth was mirrored by decreasing income per capita. Compared to average growth rates of about five percent in the late 1960s and early 1970s, real income per capita grew at a rate of less than one percent during the 1990s, and it decreased on average during the 1980s.

In addition, poverty still poses a serious problem for the region. The number of people living on less than $2 per day increased from about 50 million people to about 72 million people during the 1990s, which is a growth rate of nearly 44 percent – much higher than those of Latin America, South Asia, and Sub-Saharan Africa.[4] Failure to raise economic growth rates and create enough jobs to absorb the already unemployed and provide employment for the new entrants to the labor market is a sure recipe for aggravating the poverty problem with potentially destabilizing social unrest.

What is truly disconcerting is that a simple comparison of the MENA region with other countries or regions shows an incongruously lopsided situation. The MENA region, with a population of nearly five percent of the world population and about 10 percent of the world's size, is endowed with almost 60 percent of world oil reserves, 30 percent of global oil production, and 31 percent of world gas reserves.[5] Yet, its gross domestic product is a mere two percent of total world output, and its exports amount to only four percent of total world exports, including oil exports, which implies that the region's non-oil merchandise exports are almost negligible. The picture has not changed much in the past few years. The World Bank estimates that the annual growth rate of export volumes of the MENA region was the lowest of all other country groupings during the period 1993-2002.[6]

Furthermore, the region has not been able to raise investment to the levels needed to generate the required GDP growth rates and employment opportunities. This is not due to a lack of financial resources but to the inability or refusal to create a business climate hospitable to growth and investment. Financial resources are ample in the region itself, though a large part of it is invested overseas. According to the Secretary General of the Union of Arab Investors, Arab investments abroad amount to the staggering sum of nearly $1 trillion.[7] Part of these investments could be reintroduced into the region should the situation improve.

As for attracting foreign capital inflow, the MENA region exhibits a low level of integration with the world. World Bank estimates show that despite increases over the past two years, the ratio of net foreign direct investment (FDI) to GDP in 2003 averaged only a third of the level achieved worldwide.[8] FDI in the MENA region was less than $5 billion in 2003, representing a mere 0.8 percent of world FDI, according to "World Development Indicators 2005."[9] Thus, the region is not attracting sufficient private capital inflows to promote growth and sustainable development.

FDI is not the only type of investment that the region is not attracting; portfolio investment is also lacking. According to the Institute of International Finance (IIF), of the nearly $37 billion net portfolio investment made in emerging markets in 2003, the share of portfolio investment in the Middle East and Africa was only $500 million – approximately 1.4 percent. The IIF estimates, however, that the figures increased significantly in 2004-2005.[10] It is worth mentioning in this regard that the size of the securities markets altogether in the region amounts to nearly 0.5 percent of world market capitalization. Switzerland, a country whose population is about 2.4 percent and its size is about 0.3 percent of MENA's, enjoys a market capitalization that is two to three times that of MENA countries' markets combined. Further, the combined assets of the 470 banks in Arab countries is about $1 trillion, significantly less than that of one major international bank such as JP Morgan Chase. Given the region's human, financial, and natural resources, it should be performing at a much higher level.

Hence the need for better performance...

Obviously, MENA economies must increase their performance if the countries are to sustain adequate levels of economic growth, combat increasing unemployment, and raise the standard of living. At the very least, the standard of living must not fall further, in order to prevent potentially destabilizing social unrest throughout the region. As things stand today, the record does not augur promising news: economic growth is low, unemployment is high, investment growth is not forthcoming, and poverty is increasing.

It is true that many countries in the region have been implementing structural adjustment programs for years and have managed to carry out many policy reforms in areas such as tax, trade, financial, and investment policy. These reforms cause governments to loosen their grips on economic activities and move away from financial repression, rigid tax and trade laws, and a restricted investment environment. Yet, these efforts have not been bold, adequate, or fast enough to generate the "critical mass" needed to jumpstart the MENA economies and put them on the path of sustainable development.

Why?

The reasons lying behind these halfhearted endeavors are multifaceted, the most important of which is the lack of genuine political commitments towards economic reform and the lack of effective institutional arrangements conducive to reform. The latter is the result of what is called "state capture," whereby the status quo is protected by those in power and who themselves set the laws and regulations and shape formal institutions. Hence, reform measures are, for the most part, adopted and implemented through a piecemeal approach largely to comply with the conditionality of the International Monetary Fund (IMF) and the World Bank adjustment programs or to meet the commitments agreed upon as part of the accession process to the World Trade Organization (WTO). It should be emphasized that the solution for the MENA region's economic woes goes much farther than the realm of economics. The lack of political and institutional reforms casts a heavy shadow on its economic future. Without profound progress on this front, no tangible economic benefits are to be anticipated.

Is MENA condemned to poor economic growth and rising social problems, and is it too late to catch up with the world? No! Despite these challenges and impediments, the region has the potential to attain the needed levels of economic growth provided that MENA's ample human, natural, and financial resources are allocated efficiently and that the right policies are adopted and carried out. The most salient ingredient of these policies is introducing real – not cosmetic – public sector reforms and promoting private sector development. This requires better governance and strong institutional capacity based on the rule of law, property rights protection, combating corruption, and broader participation of civil society organizations, thereby going beyond the economic paradigm that simply states that growth is a function of capital, labor, and total factor productivity.

Thus, the traditional arguments that resource endowments such as capital and financial resources, labor, geography, and the like are the sources of growth is no longer fully convincing. Such variables are necessary conditions of economic development, but they are not sufficient conditions; they alone cannot be considered determinants of growth. Hence, the growth and development equations and models in the region should include other variables, namely the institutions that create a conducive environment for effective resource allocation. Many researchers have recently made strong arguments in this regard.[11]

This subject has recently assumed greater importance, and it has been argued by many that improving resource allocation and, thereby, overall economic performance in a world of continuous change necessitates going beyond the static analysis of economic theory. This would require a better understanding of the factors that affect economic development, such as political economy, transaction costs, and institutions.[12]

Why would better institutions promote growth in the MENA region, and where does the region stand comparatively with respect to institutional quality?

Institutions can be defined as the rules of the game; that is the formal rules and informal norms and their enforcement, which altogether define the way the game is played.[13] According to IMF Managing Director Rodrigo de Rato, good institutions mean the adoption of policy frameworks where (a) the private sector is the main actor on the economic stage, (b) property rights are protected, (c) the rule of law prevails, and (d) that there is a stable macroeconomic environment.[14]

Research has shown that good institutions ensure two desirable outcomes. The first is equal access to economic opportunity – a level-playing field for all economic agents – and the second is that providers of labor and capital are appropriately rewarded and their property rights are protected.[15] The MENA region can do better on both counts.

As for the impact on growth and income, a great deal of research has presented evidence that good institutions represent a potent ingredient in the policy mix of economic reform efforts. Kaufmann, Kraay, and Mastruzzi (2005), using combined aggregates and micro-data sets covering 209 countries and territories and several hundred variables measuring perceptions of governance, showed high correlations between governance and per capita incomes and that the causal direction is from governance to income.[16] The study concluded that the findings point to the importance of implementing reforms, including (a) promoting transparency (i.e. natural resource revenue, assets of politicians, fiscal accounts, etc.), (b) altering incentives to promote prevention and deterrence as opposed to prosecutions, and (c) strengthening the role of the private sector.

Thus, the study actually confirmed previous IMF findings that high-income countries tend to have relatively strong institutions and, conversely, institutions tend to be consistently weaker in low-income countries. In addition, the study showed that across the board, per capita income and institutional quality generally rise in tandem. The IMF empirical research found that institutional measures have a statistically significant impact on GDP growth and GDP per capita, and that poor institutions may lead to growth volatility.[17]

In addition to purely academic studies, revealing though they are, experience demonstrates that aid donors have come to the conclusion that the aid they provide has a stronger positive impact on development in countries with good institutions.[18] Due to the recognition of the important role of institutions in economic performance, both bilateral and multilateral aid donors have become increasingly more assertive in demanding that recipient countries take tangible steps to improve their institutions. A number of initiatives have evolved in that regard in the past few years, such as the Partnership Forum on Improving Donor Effectiveness in Combating Corruption that took place in December 2004 and the GOVNET's draft "Anti-Corruption Principles for Donors," whose basic aim is to encourage aid efforts and improve the quality of aid given by OECD member countries to developing countries.[19]

In March 2005, the Paris Declaration was endorsed by representatives of 93 countries and approximately 40 regional and international organizations. The Declaration promotes a model of partnership that increases transparency and accountability regarding the use of development resources through the creation of a stronger mechanism through which donors and recipients of aid are held mutually accountable. Eight Arab countries adhere to the Paris Declaration, namely Egypt, Jordan, Kuwait, Mauritania, Morocco, Saudi Arabia, Tunisia, and Yemen.[20]

This message was echoed in early April 2006 when the European Parliament called for the creation of an EU blacklist of countries where corruption is rife, in order to help the European Union make decisions on granting development aid. The Parliament also called for an international system of blacklisting to prevent banks from lending to corrupt regimes.[21]

The World Bank has toughened its stance on misuse of its funds by corrupt public officials in developing countries. In an unprecedented move, the Bank has postponed funding for construction, procurement, and other types of projects in many countries as a result of embezzlement and diversion of money from its intended purpose. The Bank recently withheld about $800 million in loans in response to allegations of corruption in countries such as India, Kenya, Vietnam, Chad, Bangladesh, Uzbekistan, and Yemen. In addition, the IMF has been more vocal in recent years about corruption and graft in some member countries.

Naturally, these developments will eventually have adverse repercussions on countries in the region that do not live up to these standards, especially since many international surveys paint a bleak portrait of the region with respect to institutional quality. These surveys reveal that the MENA region lags behind in comparison with other countries, though the region can certainly, and should, do considerably better on this front.

For instance, the findings of the Transparency International "Corruption Perceptions Index 2005" show that on a scale from 1 to 10 (10 being the least corrupt), the scores of the MENA countries ranged between 6.3 (Oman) and 2.1 (Sudan), with most of the scores below 5.[22] Further, the World Bank's "Doing Business 2006" report argues that the costs of starting a business in MENA countries as percent of income per capita is significantly higher than equivalent costs in other countries.[23] The report also shows that the region does not rank well with regard to a number of other issues, namely, the cost of enforcing a contract, the number of procedures required to enforce a contract, and the number of days needed to enforce a contract.

Thus, based on academic findings, lessons learned from experience, and the increasing demands of donors and lenders for more transparency and accountability on the part of recipient countries, it is quite obvious that MENA countries can benefit handsomely from enhancing the quality of their political, economic, and legal institutions. These benefits potentially include higher economic growth, increased income per capita, decreased growth volatility, easier access to official developmental aid and private capital markets, and more portfolio and foreign direct investment inflows.

What needs to be done to improve institutional quality in the MENA region?

First and foremost, what is urgently needed is the development of modern investment laws and investment protection regulations in order to encourage the flow of trade and investment aimed at growth and job creation. The public sector is obviously incapable of offering the needed job opportunities and the growth levels required to absorb the unemployed and new entrants to the work force. The logical alternative is to turn to the private sector and create an environment that facilitates its growth. This requires action and not hollow commitments made during seminars, conferences, and public appearances by government officials. While it is true that there has been some progress, this effort should be expedited and not halted when the economic tides are high. Experience has shown that the cost of introducing reforms in periods of recession is much higher than in periods of growth.

In order to encourage repatriation of capital invested overseas and attract foreign investment, the institutional framework has to improve in the region. As such, improvements must be made, in particular with respect to eliminating red tape and bureaucratic hurdles, weeding out corruption, enhancing the legal and judicial systems, and upholding the rule of law. Sustainable growth requires better resource allocation and improved policy formulation and implementation, which is a task that cannot be accomplished without transparency as well as the accountability of public servants, administrators, and politicians alike.

As stated earlier, the region has a long way to go towards improving the institutional structure, and a number of factors impede progress in this area. In Lebanon, for instance, religious sectarianism plays a major role in protecting corrupt officials, hindering public sector rehabilitation, and stifling economic and political reform. Despite freedom of the press and ample information on corrupt politicians and public officials, the judicial system is not strong and independent enough to effectively deal with this plague. In addition, political institutions have greatly hampered efforts to reform the economy, and it is quite clear that there is intense infighting among various factions trying to rewrite the country's formal institutional framework.

In a number of neighboring countries, the lack of genuine broad participation in political life through political parties does not engender accountability or foster better economic and social policies. While a number of countries in the region have achieved noticeable economic progress, it has not been coupled with much change in political institutions. Freedom of speech and active civil society and non-governmental organizations (NGOs) are essential in this regard. A truly free press is needed, not camouflaged official propaganda. Transparency, accountability, and true representation can not be promoted by a state-controlled press.

Moreover, the region should strive to maximize the benefits of globalization. Openness plays an important role in promoting growth and prosperity. Trade and finance are indispensable ingredients that are provided mainly by greater integration in the world economy. Yet, it is important to note that each country's experience with trade liberalization is different with respect to the impact it has on institutional quality. In some cases, international trade led to the emergence of a small elite group of producers and the installation of institutions that maximized their profits.[24]

How can MENA build better institutions?

Building better institutions entails change – altering the status quo and introducing different rules and modes of interaction among various political and economic actors in a country. This process alters the distribution of power and affects the existing balance among differing interest groups, some of which are likely to lose influence and/or control. Naturally, change will be resisted by those whose interests are likely to suffer from it. Hence, the importance of setting up appropriate incentive structures to facilitate the transition and make it sustainable cannot be underemphasized.

It is crucial to see the MENA region as diverse, not as a homogenous entity, which is a misconception held by many researchers. The region comprises many countries that, in addition to spanning two continents, have been influenced by diverse external factors throughout their histories, have adopted varying economic and political systems, and are at different stages of economic development. In offering ways to build better institutions in the region, one has to fully recognize the considerable differences among the Gulf Cooperation Council (GCC) countries[25], the Maghreb countries[26], *Bilad Alsham* countries[27], and others such as Egypt, Libya, Mauritania, Somalia, and Comoros.

Thus, it is important that a realistic approach be adopted when proposing institutional change packages.

All too often, reforms are presented in a narrow dogmatic manner in which the same set of institutional changes are prescribed as a panacea for different countries, without an understanding of the social and political context of each individual country. Otherwise, these reforms are unlikely to confer the benefits attributed to them. To this effect, Francis Fukuyama (2006) holds that while a body of knowledge has been accumulated about how institutions relate to outcomes, "the full specification of a good set of institutions will be highly context-dependent, will change over time, and will interact with the informal norms, values, and traditions of the society in which they are embedded."[28]

This claim is supported by many examples throughout the world. It has been shown that if new institutions diverge dramatically from community values, no one abides by them and, therefore, "to be effective, institutions need to complement existing conditions in a country."[29] This is particularly true in the MENA region, where informal institutions are very powerful.

Nevertheless, there are general themes that can serve as guidelines for all countries in the region to follow in their endeavor to attain better institutional arrangements. These major themes include reducing the size of the public sector, upholding the rule of law, protecting property rights, rooting out corruption, respecting human rights, promoting freedom of the press, and seeking greater integration regionally and globally.

The latter factor is essential in a region where the internal driving forces for institutional change are ineffectual and the process of change is likely to be stalled by local elites. Greater openness and integration provides an external impetus to guarantee persistent progress in revising institutional structures and, most importantly, complying with the commitments made to regional and international partners. In this regard, strengthening the Mediterranean countries' ties with the neighboring countries in Europe is a good step forward.

Accordingly, it is imperative to take seriously current negotiations and partnerships with the European Union and the Organisation for Economic Co-operation and Development (OECD) and develop mutually beneficial relationships. For instance, the region can benefit handsomely from accelerating the MENA-OECD Investment Programme, which is part of a two-pronged initiative on "Governance and Investment for Development," and the "Good Governance for Development" initiative, both aimed at strengthening ties and improving the investment environment of the Middle East and North Africa in cooperation with the OECD countries.

It is encouraging in this respect that representatives of 16 Arab countries at the MENA-OECD Ministerial meeting in Jordan in February 2006 adopted a 19-point "Declaration of Common Principles and Good Practices," in which they expressed their intention to pursue policy reforms to enhance the investment climate and facilitate doing business in the region. Participants acknowledged, among other things, the importance of (a) the protection of property rights and contractual rights; (b) transparency and predictability of national policies, laws, regulations, and administrative practices; (c) investor protection; (d) strengthening anti-bribery legislation; (e) recognition of internationally accepted principles of corporate social responsibility; and (f) a more active role played by the business community and civil society organizations.[30]

With regard to cooperation with the European Union, the region has to strive diligently to benefit from the opportunities offered by the Barcelona Process. The Barcelona Process was launched at the Euro-Mediterranean Conference in 1995 and marked a starting point in the Euro-Mediterranean Partnership. Of particular importance are the objectives embodied in the "Barcelona Declaration" with regard to the economic and financial partnership and the establishment of Euro-Mediterranean Free Trade Area (EMFTA) by 2010. In this context, it would be expedient to note that regional economic integration constitutes a necessity for enhancing the level of competitiveness and real sustainable growth. Arab economies should complement rather than compete with one another.

Another external element that has a strong influence on changing incentive structures is the role that the multinational development and financial organizations can play. The IMF and the World Bank are called upon to continue their recent push towards combating corruption, both internally and in member countries. For decades, some IMF and World Bank funds have been misused and diverted, through inadequate procurement practices or even outright embezzlement. This helped, though indirectly and unintentionally, to shore up corrupt and oppressive regimes.

Of course, it must not be ignored that some multinational corporations operating in the region have a major role to play. They should operate under intense scrutiny to prevent them from engaging in and, in many cases, instigating and inviting corruption. The commitments of MENA countries as part of their accession to the WTO are also helpful in facilitating institutional change in the region. It is beneficial that these organizations take a strict and unwavering stance to nudge member countries in the region to adopt sound institutional frameworks.

As for the internal drive to overhaul the institutional arrangements in the region, it is essential that civil society organizations and NGOs are formed and promoted, thereby putting the needed constraints on the power of the state and supporting private sector economic activity. Shifting power from a number of public bureaucrats to a broader constituency helps markedly to improve political institutions and foster accountability in public life. Whistleblowers should be protected, rewarded, and encouraged to contact organizations set up to advise them on their legal recourse and the most effective ways to serve their communities.

The region has been witnessing a transformation, but the drive towards more reform can no longer be postponed by the same weak excuses used for decades. Trite phrases such as "the region is currently going through a very sensitive period" or "there is a conspiracy and the region is being targeted" are no longer convincing. These pretexts have been used – for far too long – to justify inaction and the desire to forestall transition.

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[3]World Bank, "Global Economic Prospects 2005," p. 280.
[4]Percentages are calculated by author based on poverty data from the "Global Economic Prospects 2005" report published by the World Bank.
[5]Arab Monetary Fund, "Unified Arab Economic Report 2004," UAE.
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[8]World Bank, "Economic Developments and Prospects 2005: Oil Booms and Revenue Management," pp. 41-42.
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[19]For details, see OECD website http://www.oecd.org/dataoecd/8/54/35901020.pdf
[20]http://www.oecd.org/document/18/0,2340,en_2649_201185_35401554_1_1_1_1,00.html
[21]See EU Business website http://www.eubusiness.com/Institutions/060406125742.06mbai9i/view?searchterm=van%20den%20berg
[22]http://www.transparency.org/cpi/2005/cpi2005_infocus.html
[23]http://www.doingbusiness.org/Default.aspx
[24]Quy-Toan Do and Andrei A. Levchenko, "Trade, Inequality, and the Political Economy of Institutions" Policy Research Working Paper No. 3836, World Bank, 2005, p. 29.
[25]Saudi Arabia, Kuwait, United Arab Emirates, Oman, Qatar, and Bahrain
[26]Algeria, Morocco, Tunisia, and Libya
[27]Such as Lebanon, Syria, and Jordan
[28]Francis Fukuyama, "Development and the Limits of Institutional Design," 2005, http://ctool.gdnet.org/conf_docs/Fukuyama_paper_plenary1.doc
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