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# Institutional Reform for Economic Growth in the Arab Countries

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Thank you for that kind introduction.

The importance of institutions to a country's economic growth and development has become almost axiomatic. Indeed, you would be hard-pressed to find a recent research paper on economic growth or development which does not spotlight institutions – the set of rules that govern the relationships between actors in the economy – as fundamental for economic performance, through their influence on the incentives for saving, investment, production and trade.[1] The IMF, for example, has devoted substantial discussion to the importance of institutions to development several of its World Economic Outlook reports.

But juxtaposed to our increasing appreciation for the importance of institutions – be they market systems, legal systems, political systems or civil society – is a sincere dearth of knowledge on how to transfer this to a successful plan for implementing institutional reform at the country level.

The fact is, when we move from the broad axioms or findings established from cross-country research to the individual country, there remains substantial uncertainty about institutional reform. Countries have found success with varied institutional arrangements, so knowing how to design institutions to improve institutional quality is by no means routine. The causality between institutions and growth is far from

[1] North, 1990.

straightforward, and so the prioritization and sequencing of growth-enhancing policy changes versus institutional reforms is not always obvious. Nor is the interdependence of institutional reforms well understood. Perhaps most important, we have little *a priori* appreciation for how difficult or easy it will be to implement sustainable reforms to legal and other institutions. The country context may well determine the ability for a set of institutional reforms to flourish in one setting and fail in another. As Jeffrey Sachs has pointed out, institutions matter, but they are not the only things that matter,[2] and those other factors may have an overriding effect on the success with implementing institutional reform. Thus, I think it would be fair to say that in the vast study of institutions and growth over the last two decades, as much of the vastness comes not from the answers we have reached, but the questions which remain.

It is in the context of these lingering questions that I turn to the Arab region, and the role that institutions play in the region's major development challenges.

I don't think there is any doubt, when you look at the fundamental economic challenges facing this region today, that prevailing institutional structures lie at the very heart of most of these challenges.

Take the challenge of creating a strong and competitive private sector, which is perhaps one of the fundamental development priorities for the Arab region – not only to create jobs for a rapidly growing and increasingly educated labor force, but also to diversify the limited economic base to reduce economic volatility.

As it stands, throughout most of the Arab world, the formal private sector remains substantially underdeveloped. The Middle East and North Africa region of World Bank is in the process of producing its flagship report on private sector development, and according to almost any standard measurement – be it private investment, private sector output, private sector employment, inward FDI, etc – this region has only approached the margins of what the rest of the world has achieved in the last few decades, in terms of attracting and sustaining private business. The Arab private sector is concentrated in a small number of large firms that have benefited from protective policies, along with a

[2] Sachs, 2003.

number of micro-enterprises that account for much of employment but have little access to formal finance, markets, or government support programs.[3] Few private businesses export – and the majority of exports are heavily concentrated among a few export categories. Few exporters outside the hydrocarbons industry demonstrate competitiveness.[4] And as a result, the region's private sector has not prospered and has not generated strong job growth.

I do not intend to dwell too much on the specifics of this issue but I'd like to use this example to make **two main points** about how quality institutions relate to this and other development challenges facing the Arab region. The first is that the **scope for required institutional change is immense**. Businesses depend upon mechanisms that provide for macroeconomic stability, critical for affecting the certainty of investors' decisions. They depend on trade and exchange rate policies which do not undermine competitiveness. They require regulatory institutions that promote competition, support efficient resource allocation, and protect property rights, and which are implemented without unnecessary encumbrances or corruption. A strong legal environment which effectively enforces and administers commercial laws, as well as efficient financial institutions which can mobilize and make available resources for entrepreneurs to start new businesses and for existing businesses to grow and expand are also important for bolstering a good investment climate.

But these might be what we would consider the first-order institutional implications. And then, equally important, private sector development hinges on access to quality laborers with relevant skills. This brings up an entirely new set of potential institutional issues. It involves sufficient access to education, of relevant quality for private sector needs. It involves the persistence of public sector employment, which can affect not only the wage expectations of workers available to the private sector, but also the continuing educational choices of workers who hope for public sector jobs. It involves labor market and migration policies – including for use of expatriate labor –

[3] World Bank, 2005.
[4] World Bank, 2005. This is based upon the share of non-oil exports in the region in which MENA demonstrates above (world) average comparative advantage, as measured by revealed comparative advantage.

which affects whether the private sector is able to access internationally competitive skills at cost-efficient wages.

Businesses also require an enabling infrastructure to operate. This involves institutional issues in the provision of power, communications technology, water, and transport facilities. In short, private sector development has **comprehensive institutional implications**.

And so it will be with **any** of the major development challenges facing this region.

And the second point I'd like to make about institutions is that **piloting through the vastness of potential reforms is daunting**. I don't think we in the development community serve countries well by naively spouting the need for reform without recognizing the considerable difficulty institutional reform entails. Institutional reform is deeply political – it affects the balance of power between actors in society, and challenges the entrenched practices and economic privilege that some have enjoyed for generations. It should be no surprise then that worldwide, successful institutional change has proven difficult.

Moreover, this is ***not*** a well charted path. Successful institutional reform has followed many paths. For many countries, reform has come as the result of political or financial crisis. But other countries have approached reform with gradualism. In some cases, institutional change has come from the bottom up, with greater demand for better institutions. In some cases it has come from the top down.

It is as a result of these divergent experiences worldwide with changing institutions, as well as divergent experiences with managing to sustain reforms, that economists have sought to find commonalities behind success stories. What are the mechanisms that countries have found to successfully implement and sustain institutional reform? It is these mechanisms I would like to highlight today. Because ultimately, whatever the development priorities, the Arab region needs to be able to utilize these levers for change to support successful, sustainable institutional reform.

The international experience with implementing and sustaining institutional reform points to **VIRTUOUS CIRCLES**: building those coalitions within the economy which need quality institutions, thus building the demand on institutions to respond. Successful institutional reforms are characterized by demand for change across the board, not just change instituted at the top.

And the international experience has pointed to a few key levers which can create these coalitions:

- One of these levers is **GREATER TRADE OPENNESS**

There is an overwhelming amount of evidence that trade openness and competition spurs further institutional reform. But the pathways by which trade openness creates momentum for institutional reform are both varied and inter-connected. At its core, opening economies to greater trade and competition improves institutions by expanding the role of non-rent dependent export sectors. And these more productive and efficient segments of the economy demand better institutions across the board, providing the feedback mechanisms for other areas of reform. For example, Mexico's trade liberalization through NAFTA induced business associations to lobby the government for reductions in the regulatory burden to help them compete.[5] Trade doesn't just raise the demand for other reforms, it also raises the *marginal product* of other reforms, in that better infrastructure, telephones, roads, and ports translate into better performance of the export sector[6]. And greater openness and trade also expose the work force to the need for new skills and knowledge, creating another effective coalition for reform, with this workforce demanding the skills and services needed to compete in this economic setting.

On the trade front, the Arab region has taken many positive steps over the last several years to strengthen exports and expand trade, with bilateral and regional trade accords, and notable progress in tariff reform, particularly in Egypt, Algeria, Jordan, Lebanon, Saudi Arabia, and Yemen[7]. But this is clearly an unfinished agenda, with the

[5] Kikiri, Kenyon, and Palmade, 2006.
[6] Berg and Krueger, 2002.
[7] According to tariff reform progress as noted in World Bank, 2006.

Arab region continuing to be one of the most trade-restrictive in the world. The World Bank's annual report on the region[8] notes that the Middle East and North Africa region on average ranks in the bottom 46th percentile worldwide with regard to trade regime openness (as measured by tariffs and behind the border constraints to trade). In the area of tariffs alone, the region on average ranks in the bottom 38th percentile. So this is clearly an area in which the Arab region needs to continue to move. Improving institutions is substantially easier with a strong and effective export coalition.

- Another lever for change is **GREATER OPENNESS IN INFORMATION**

Information is the first step to formulate choice. Greater information exposes the sources of economic rents in the economy, increasing the pressure to dismantle them. It helps to identify institutional weaknesses and provides alternatives to the status quo, and thus creates demand for change.

The Arab world has much to do to create openness in terms of information. Little government information is accessible by the public (a few countries have recently began to publish some government statistics). Freedom of the press is carefully monitored and circumscribed in most countries. Use of the internet is often controlled.

There are, of course, a multitude of restrictions on citizens from mobilizing for change, in terms of restrictions on civil society and the like. These are symptomatic of the institutional challenges facing the region. But without the information, few demands can be mobilized for change. Information is the first step in creating the groups interested in better institutions.

- Finally, **EXTERNAL ANCHORS** can be an effective lever for reform

External agreements on trade and investment and other measures to fix policy can be effective anchors for institutional transition, allowing countries to leapfrog some of the domestic resistance to and thus political inertia in advancing policy reform. The EU Association Agreements between the EU and the Arab Southern Mediterranean countries

[8] World Bank, 2006.

are just one type of anchor, designed to promote trade and the expansion of economic and social relations between the EU and Mediterranean region and to encourage regional integration within the Southern Mediterranean zone.

But these agreements must provide enough tangible benefits for undertaking reform. When you look some of the outcome indicators which we would have expected to strengthen with a regional trade partnership, I think it would be fair to say that EU-MED agreements, signed between 10-15 years ago, have not generated the strength of outcomes of achieved in other countries following the implementation of their regional trade partnerships, such as in Mexico following NAFTA or in Hungary, the Czech Republic and Poland following the EU Accession agreements. FDI, non-oil exports, and the market share of Arab non-oil exports in Europe have increased, but not anywhere close to the levels witnessed in the Accession countries or Mexico following implementation.

One reason for the weaker trade outcomes has been the structure of the agreements themselves, which do not provide strong enough incentives for undertaking reforms. The EU Association agreements typically exclude agriculture and services. They make no provisions for labor or capital. Nor do they contain precise commitments on the part of Arab countries relating to domestic policy and institutional reform.

This brings up my final point about these levers for change. The mechanisms I have mentioned: trade liberalization, greater information, and external anchoring are in the end policy reforms – the policy reforms which internationally have been found most effective in ***spurring*** sustainable institutional changes.

But to get there – to go from the very specific policy reforms to institutional improvements – there need to be mechanisms of accountability. Policy reform can help to build coalitions who expect and demand good institutions. But there needs to be some feedback mechanisms in place for these expectations and demands to be heard and met. Accountability is, of course, one of the key elements of good institutions. Creating accountable institutions is indeed an institutional reform itself. However, developing accountability, as with all institutional improvements, is an iterative process. There are policy reforms that can take place which can *initiate* greater accountability. And with this window, the levers for change I mentioned today can create virtuous circles of policy and institutional reform.

Throughout the next two days, as we reflect on the institutional challenges in this region, let us make sure that these levers for successfully implementing these reforms figure high in our thinking.

Thank you.

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