



## Governance, resources and growth



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### ABSTRACT

Using a large sample of 50 oil exporting countries, we extend the prior literature by examining the role of quality of governance (*QOG*) on economic growth under the condition of heterogeneity and cross-sectional independence in errors. We document that *QOG* is by far the most consistent driver of economic growth both in the long- and short-run. Our result is robust to an alternative and an inverse measure of *QOG*. We also investigate a number of mediating factors contributing the *QOG* and economic growth linkage. We show that the long-run positive effect of *QOG* on economic growth is stronger in countries with higher information communication technology (*ICT*) diffusion; and such effect works only in countries with higher social capital, economic globalization, and financial development (*FD*). We also show that the ‘resource curse’ or ‘resource blessing’ debate in growth literature is sensitive to methodological choices.

### 1. Introduction

The linkage between resources and economic growth is an unresolved empirical puzzle with two major opposing strands: (a) resource abundance impedes economic growth<sup>1</sup>, and (b) resource abundance facilitates economic growth<sup>2</sup>. A different body of literature proposes that governance plays a role in economic growth and explains the persistence of high income disparity among countries as a product of discrepancies in institutions or governance - the rules of the game in society<sup>3</sup>. A recent body of literature, hence, links resources with growth via governance mechanisms and provides mixed results<sup>4</sup>. We contribute to this debate by establishing the most robust resource-governance-growth nexus within a theoretically sound growth model and uncover the reasons contributing to the mixed prior evidence.

A critical review of the prior literature highlights several notable shortcomings. For example, although the interplay of capital and labor in the classical and neo-classical growth process is indisputable, almost all prior studies overlook some key parameters such as labor (Sachs and Warner, 1995, 1999, 2001; Van der Ploeg, 2011; Ebeke et al., 2015; Arezki and van der Ploeg, 2007; Cavalcanti, et al 2011) and financial capital (Smith, 2015) in their models. Moreover, a critical argument for a resource driven growth process lies in the fact that

resource discovery (i.e. oil, gas, etc.) provides significant economic leverage and enables a resource-abundant country to earn foreign currency through trading. Autarkic trade policies in most resource-abundant countries prolong anti-growth policies and hurt economic growth in these countries (Auty, 1994). Trade also facilitates the transfer and diffusion of technologies (Yanikkaya, 2003) to improve the efficiency of the growth process. Thus, trade openness should play a significant role in the growth process. Nevertheless, a large volume of prior literature on the resource-growth nexus (e.g. Bulte, Damania, and Deacon 2005; Morelli and Rohner, 2015; Smith, 2015; Cavalcanti, et al. 2011a; Cavalcanti, et al. 2011b) overlooks trade openness in their modeling.

Apart from the modeling issues, the question of methodological appropriateness is another significant concern for a clear majority of the previous literature. General economic intuition suggests that the discovery of exhaustible natural resources is an economic shock that continues to influence long-run macroeconomic cycles. A static framework fails to consider such intertemporal dynamics of resources in explaining growth. However, a significant number of long panel studies on the resource curse paradox (Bulte, et al., 2005; Brunnschweiler, 2008; Smith, 2015; Morelli and Rohner, 2015; and others) apply a static estimation process. Moreover, a large volume of literature (Sachs

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<sup>1</sup> Sachs and Warner, 1995, 1999, 2001; Gylfason, 2001; Mehlum et al. 2006; Van der Ploeg, 2011.

<sup>2</sup> Alexeev and Conrad, 2009; Arezki and van der Ploeg, 2007; Cavalcanti Mohaddes, and Raissi, 2011; Smith, 2015.

<sup>3</sup> North and Thomas (1973), Knack and Keefer, 1995; Mauro, 1995; Svensson, 1998; Acemoglu and James, 2001; Rodrik, 2002; Dollar and Kraay, 2003.

<sup>4</sup> Bulte, et al. 2005; Brunnschweiler, 2008; Morelli and Rohner, 2015.

and Warner, 1995, 1999, 2001; Van der Ploeg, 2011; Ebeke et al., 2015; Arezki and van der Ploeg, 2007; Cavalcanti, et al., 2011 and others) focusing on cross-country samples remains silent about the possible spatial effect through trade and financial integration, resulting in a compromised empirical understanding<sup>5</sup>. Indeed, the failure to consider cross-sectional dependence due to unobserved common factors or spatial spillover results in spurious estimates (see Andrews, 2005; Pesaran, 2004; Su and Yang, 2015). Overall, we argue that the findings of prior studies should be interpreted with caution.

We draw our empirical motivation from the inadequacies of prior literature in our resource-governance-growth nexus. We address this important empirical puzzle within the appropriate growth equation and estimation process to provide a more robust understanding of the resource-governance-growth relation and reconcile the mixed prior evidence. We also draw our motivation from the anecdote arguing that, had a natural resource such as oil been the primary determinant of a country's prosperity, then oil-rich countries would have been the richest countries in the world. However, contrasting oil-rich countries like Algeria (first oil discovery in 1956), Argentina (first oil discovery in 1907), and Austria (first oil discovery in 1860) with three non-oil countries like Singapore, Hong Kong, and South Korea suggests that the latter countries are much more prosperous than those oil-rich countries<sup>6</sup>. Thus, our view is that at any given level of resource, governance plays a key role in the resource-governance-growth nexus. We, therefore, aim to explore the conditions under which governance can lead to growth in these resource-abundant countries.

Governance is a dynamic learning process. The mechanisms through which governance affects economic outcomes are fast-changing. While information communication and technology (ICT) itself has had a tremendous effect on economic growth, it has also enabled a space for social media, which makes citizens' voices louder and transparency and accountability easier. Hence, government today cannot control the entirety of public opinion as it could in the past and thus cannot completely guide people to accept a view aligned with the government's political agenda. For example, Statista<sup>7</sup> reports that 27% of the Saudi people today use *WhatsApp* while 25% of the population use *Facebook*. These developments have far-reaching consequences on the way Saudi Arabia will be governed in the future. The same applies to any country in the world. Thus, information diffusion is a mediating factor that can affect the governance-growth nexus, controlling for any level of resource stock. Prior literature is silent about such a mediating factor. We extend the governance-growth literature by explaining the role of the diffusion of information communication technologies in the growth process of resource-abundant countries.

We live in an era of economic globalization. Economic globalization reduces the incentive for authoritarian leaders to cling to power and pushes authoritarian states to decentralize and promote institutional quality, especially by standardizing regulations for financial market interactions. Moreover, economic globalization promotes an open, enlightened, and mature society. Given that most oil-exporting countries are run by authoritarian regimes, economic globalization should

<sup>5</sup> We are aware of a study by Brunnschweiler (2008) that is slightly close to our research question. Brunnschweiler (2008) shows that possession of natural resources positively determines economic growth, while institutional quality does not. However, given the governance-economic growth literature, we believe that institutional quality does matter. We find that Brunnschweiler (2008) conclusion is attributable to the choice of estimation framework (cross country OLS and 2SLS approaches) and incomplete growth model i.e. disregarding key growth variables - trade openness, labor, and financial development. Using a robust cross-section dependence estimator and including key variables in the economic growth model changes the predictions of Brunnschweiler (2008).

<sup>6</sup> Interestingly, Singapore came into existence 100 years, 58 years, and 9 years after the first oil discovery in Austria, Argentina, and Algeria, respectively.

<sup>7</sup> <http://www.statista.com/statistics/284451/saudi-arabia-social-network-penetration/>

play a significant role in the governance-growth nexus. A separate set of literature shows that the concentration of natural resources and civil conflict are highly correlated<sup>8</sup>. The balance of strength and control of resources (Morelli and Rohner, 2015) fuels civil wars. In this regard, building social capital by encouraging social bonding, cohesion, and trust among the various factions of a country can deter internal conflict, which in turn can increase the benefits of natural resources and hasten economic growth. Therefore, in the context of the governance-growth nexus, the level of social capital should matter for resource-abundant countries. Prior studies are silent on this topic. Hence, we extend the governance-growth literature by explaining the role of economic globalization and social capital in the growth process of resource-abundant countries.

Using a sample of 50 oil-exporting countries over the period of 1980–2012, we show that the effect of resources and governance on economic growth is sensitive to methodological choice. Thus, we use the most appropriate panel method that takes into account cross-sectional dependence and heterogeneity bias. Our results show that quality of governance is a key driver of economic growth for oil resource countries in the long-run. We also show that resources have a positive but insignificant impact on the economic growth of those countries in the long-run. Most interestingly, we show that controlling for resource level, governance presents a positive effect on economic growth in the long-run. In line with our empirical prediction, we also find that the positive role of governance on economic growth is more pronounced in countries with higher levels of ICT diffusion, social capital, economic globalization, and financial development. Overall, our results suggest that governments of oil-exporting countries should try to enact financial reform and improve the information diffusion process to enjoy a far more positive and significant effect of governance in attaining higher economic growth.

We contribute to the development economics and governance literature in a number of ways. *First*, we overcome the limitations of prior literature by considering the possibility of the existence of spatial spillover and cross-sectional dependence in the link between governance and growth. We find that controlling for oil resources, governance imparts a positive effect on economic growth both in the short-run and in the long-run. Moreover, we find that the positive effect of governance on economic growth in the long-run is significantly higher than the positive effect of governance on economic growth in the short-run. We also show that controlling for resource level, institutional vulnerability hurts the economic growth process. *Second*, prior literature also overlooks the fact that in a modern state, a 'strong civic role of the public' is a desirable characteristic that can bring greater accountability to government and influence the effect of quality of governance on growth. Using ICT diffusion as a proxy for the empowered role of social media vis-a-vis increased civic activism, we show that the role of governance in economic growth is stronger in countries with higher ICT diffusion. To the best of our knowledge, this finding is new evidence in the literature. *Third*, prior literature on governance and growth in oil-rich countries also ignores the mediating role of social capital, economic globalization, and financial development. We provide empirical support that social capital, economic globalization, and financial development matter in the governance and growth nexus.

The rest of the paper is structured as follows: Section 2 presents the literature review and hypothesis development. In Section 3 we present our data, methodology and descriptive statistics, which is consistent with the cross-sectional and heterogeneous properties of our data. Section 4 presents our main results on the governance-economic growth nexus in oil-rich countries under various scenarios. Section 6 presents a series of robustness checks. Section 6 presents the catalyst driving the governance-growth nexus. Section 7 concludes.

<sup>8</sup> Collier and Hoeffler, 1998; Le Billon, 2001; Lujala, 2009; Van der Ploeg, 2011.

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