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The Institutional Reforms Debate and FDI Flows to the MENA Region: The "Best" Ensemble

WASSEEM MICHEL MINA *
United Arab Emirates University, United Arab Emirates

Summary. — This paper empirically examines the theoretical debate on the adoption of a best approach to reforming institutions identified by Rodrik (2008) in the context of property rights protection and FDI flows to eight MENA countries. The first best approach comprises strengthening domestic institutional functions only, while the second best comprises in addition entering into force bilateral investment treaties and the interaction between functions and treaties. Empirically both approaches to reducing investment expropriation risk encourage FDI flows. The positive effect of the second best approach depends on the success of the first best approach, suggesting the two approaches are complementary.
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Key words — institutional reforms, property rights protection, FDI, MENA, first best, second best

1. INTRODUCTION

Institutions are defined as the set of rules governing human behavior (North, 1991). They include both formal and informal rules. Formal rules are legal in nature and include constitutions, laws, and regulations created and enforced by the government in response to individuals' needs to organize interactions in society. Informal rules are social in nature and include traditions and customs influenced by cultures and beliefs.

Institutions play an important role in supporting markets and transactions by protecting property rights, enforcing contracts, and facilitating collective action to provide physical and organizational infrastructure (Dixit, 2009). They create order, reduce uncertainty in the exchange of goods and capital, and help to determine transaction and production costs; thus, institutions determine the feasibility and profitability of engaging in economic activity (North, 1991).

Among the positive effects of good institutions is the promotion of a country's integration into the world economy (Rodrik, 2008). The flow of capital constitutes one important integration channel. As other studies have shown, Property Rights Protection (PRP) encourages capital flows and provides incentives for investment and capital exchange.

In the examination of the influence of domestic institutions on capital flows, empirical studies have focused mostly on domestic PRP institutional functions.[1,2] These studies have used indicators of the quality of institutional functions, which assess a country's actual performance against industrialized countries' first best performance.

This assessment approach has been adopted despite diverging social and political norms between developing and emerging market economies and developed economies. This approach implies that institutional reforms should bring the performance of domestic institutional functions in developing and emerging market economies in line with that of developed countries. It may also imply that developing and emerging market economies should adopt an orthodox approach to reforming domestic institutions that is believed to achieve the first best, a point that is discussed further below.

The comparison of a country's institutional performance against industrialized countries' first best is understandable given the globalization that has occurred in the past quarter-century and the growing importance of markets in resource allocation and the conduct of economic activity. The intensification of globalization and development of markets have necessitated the adoption of common institutional functions and standards, similar to the adoption of a common language in communications, which facilitate trade and capital mobility.

However, the adoption of an orthodox approach for institutional reform does not take into account a country's unique circumstances and the interaction of institutions within the country. This view is supported by Rodrik (2008) who argues that institutional reforms promoted by the World Bank, the IMF or the WTO, to name three examples, presume the existence of a unique set of appropriate institutional arrangements to which it is "inherently desirable" that countries conform. He also warns that the convergence to a first best practice does not "consider potential interactions with institutional features elsewhere in the system" and advocates instead for institutional reforms based on the theory of the second best.[3]

Acting along the lines of the theory of the second best, many governments have strengthened PRP through bilateral investment treaties that act as complements or substitutes to their domestic institutional functions. A bilateral investment treaty is an international legal instrument between two contracting

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countries that establishes clear, simple, enforceable, and reciprocal rules for foreign investment protection from government expropriation. A treaty identifies the circumstances under which expropriation can take place and the associated compensation standards, and it establishes dispute settlement mechanisms that facilitate foreign investment in the presence of imperfect domestic PRP institutional functions.

This paper explores the policy debate underlying institutional reforms that is reflected implicitly in the assessment of institutional functions quality and explicitly in Rodrik's (2008) views on second best institutions and explores that debate in the context of the Middle East and North Africa (MENA) region. In particular, this paper empirically examines the influence on Foreign Direct Investment (FDI) flows to MENA countries of the second best approach for PRP, which is *comprised of bilateral investment treaties, domestic institutional functions,* and *the interaction between them*. The paper uses treaties entered into force with high-income OECD countries, which constitute about one-third of the treaties entered into force by eight high- and middle-income MENA countries, comprising Algeria, Egypt, Jordan, Lebanon, Libya, Morocco, Syria, and Tunisia.

The paper uses panel data for the period of 1992–2008 and adopts two estimation methodologies to ensure robustness. The first is the Random and Fixed-Effects (RE/FE) dynamic panel regression model, which takes into account nonstationarity, endogeneity, heteroskedasticity, autocorrelation, and cross-panel correlation. The second is the dynamic panel Generalized Method of Moments (GMM) model, along the lines of Arellano and Bond (1991), which accounts for potential endogeneity. Both methodologies support the first and second best approaches to reducing the risk of investment expropriation to encourage FDI flows. The GMM methodology supports the second best approach of enhancing government stability to encourage FDI flows.

The paper contributes to the literature of development economics and economic policy literature in two respects. First, in examining the debate on institutional reform to strengthen PRP, the paper stresses that the issue is not whether but how to undertake institutional reform. Second, to the best of our knowledge, this paper is the first in the empirical literature to model first and second best approaches to institutional reforms and to apply the results in the context of international capital flows.

The paper proceeds as follows: Section 2 summarizes the findings of the empirical literature; Section 3 discusses the performance of domestic institutional functions, the proliferation of bilateral investment treaties, and FDI development in the MENA region; Section 4 discusses the empirical model and the testable hypotheses; Section 5 discusses the data challenges and the resulting modeling approach; Section 6 discusses the empirical issues and estimation methodology; Section 7 discusses the empirical results; and, Section 8 provides the conclusion.

2. EMPIRICAL LITERATURE: WHAT ARE THE FINDINGS?

In previous work I survey three strands in the empirical capital flows literature that are relevant to this paper.[4] In the first strand, the influence of domestic institutional functions on capital flows,[5] I find that: (a) the quality of domestic institutional functions positively influences capital flows; (b) better institutional function quality tilts a country's capital structure toward equity and away from debt; (c) a country's portfolio investment is more sensitive to institutional function quality than FDI; and (d) the influence of domestic institutional functions on FDI has been examined in different regions from a geographical perspective with the exception of the MENA region. The first and fourth findings are of special importance and relevance to this paper; the first finding lends major support to the first best approach to institutional reforms typically heralded by international organizations, such as the World Bank and the IMF, and the fourth finding identifies geographical gap in literature coverage, which this paper attempts to fill.

In the second strand in the literature, the influence of bilateral investment treaties on FDI,[6] I find: (a) the influence of bilateral investment treaties depends on the degree of government commitment to PRP and is surprisingly not always positive; (b) domestic institutional functions can complement or substitute for bilateral investment treaties in attracting FDI; and, (c) the impact of bilateral investment treaties tends to diminish as the number of contracted treaties increases globally. Although some of these studies have explored the nature of the relationship between bilateral investment treaties and domestic institutional functions, whether as complements or substitutes,[7] the perspective of institutional reforms is explicitly lacking, with the exception of Hallward-Driemeier (2003).[8] Two policy questions motivate and underlie the hypotheses examined in this paper: should countries strengthen PRP by reforming domestic PRP institutional functions alone—a first best approach—or, should they both reform domestic institutional functions and contract bilateral investment treaties—a second best approach?

In the third strand, on the determinants of FDI in the MENA region,[9] I find that natural resources and human capital discourage FDI flows in GCC countries while institutional quality, trade openness, and infrastructure development encourage FDI flows. In MENA countries I find more generally that (a) market potential encourages FDI, (b) evidence on economic growth is inconclusive, and (c) the level and stability of institutional quality positively influence FDI. The concept that institutional quality influences FDI in the MENA region is of particular importance to this research and supports the first best approach.

3. FDI, BILATERAL INVESTMENT TREATIES AND INSTITUTIONAL FUNCTIONS IN THE MENA REGION

FDI flows have varied across the MENA region as Table 1 shows.[10] Egypt has attracted the highest average level of FDI flows during the period of 1990–2008, amounting to about $2.6 billion and has also accumulated the highest average level of FDI stocks, amounting to $22.6 billion. In contrast, Syria has attracted the lowest average level of less than half a billion dollars.

With FDI expressed in per capita terms or relative to GDP, different countries appear to be the primary FDI recipients during that period. Lebanon had the highest per capita averages with flows and stocks amounting to about $323 and $1720 per capita, respectively. Lebanon had the highest average FDI flow relative to GDP (6%), and Tunisia had the highest FDI stock (62%).

The eight MENA countries have entered into force approximately 230 treaties as Table 1 shows, about one-third of which are with high-income OECD countries. Egypt entered into force the largest number of treaties (64), followed by Lebanon (36), and Morocco (35). Libya entered into force

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