Chapter 6
The Role of Institutional Quality on Total Factor Productivity:
A Comparative Analysis on the CEE and MENA Economies

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ABSTRACT

Within the settings of the economic growth literature, this study aims at analyzing the determinants of total factor productivity in the Central and Eastern Europe (CEE) and the Middle East and North Africa (MENA) regions, with a special emphasis on institutional quality. Beside descriptive analyses, several fixed-effect panel data regressions are estimated, which enables both cross-country and cross-regional analyses. Estimation results provide strong statistical evidence of institutional influences on total factor productivity in the CEE and MENA economies.

INTRODUCTION

Cross-country differences in economic performances have been discussed both theoretically and empirically with a broad perspective in the literature for years. A vast literature focuses on East Asian countries because of their successful – miracle – development and growth experiences and on Sub-Saharan Africa due to its very poor growth performance. However, the economies of the Central and Eastern Europe (CEE) and the Middle East and North Africa (MENA) draw more attention nowadays in the world's economic development process. The former group of economies, which were ruled by communism in the past, are now charming as they are either the new members of or the candidates for the European Union enlargement process. On the other hand, the MENA countries, which are characterized by unindustrialized state-oriented economies and by the Islamic structure (except for Israel), have high potential for growth and development owing to

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the abundance of natural resources, unless their economic and social reforms are disrupted by the unstable political environment of the region. Although these two groups of countries have almost similar scopes of economic development and growth, the degree of vulnerability to internal and external shocks is considerably different due to their distinct sociocultural environments and geographical locations, which, in fact, shape their institutional structure. Hence, one expects both cross-country and cross-regional income disparities to exist between the CEE and MENA regions, driven by various qualitative factors beside their physical- and human-capital endowments, and thus, reflected in their total factor productivity levels.

Along with the development of the endogenous growth theory by the mid-1980s, a wide variety of factors are considered to be the competing determinants of economic performance, beside the conventional factors of production, i.e., capital and labor. Particularly, the institutional aspects of the economic performance have become one of the recent concerns of the researches in the literature with the emphasis that institutions are the essential determinant of the growth potential of the economies, which set the rules of the economic exchange and the market mechanism. In this respect, in many studies, sources of growth that cannot be explained by the capital- and labor-accumulation are attributed to changes in the structural factors involving the institutions, geographies and the cultures. Thus, the total factor productivity growth, which is known to be the residual component of economic growth in the Cobb-Douglas type output models, stands as the most relevant growth element through which the structural factors can influence the growth performance of the economies. In the relevant literature, the structural factors that reflect the quality of institutions in a society are basically (i) the level of democracy, reflected by the extent of the civil liberties and political rights, (ii) the goodness of government services, resulting from fine bureaucracy, low corruption and sound legal system, (iii) the risks for entrepreneurs, due to government instability, poor socioeconomic conditions, and low investment profile. Weakness in any one of these factors is expected to slow down total factor productivity growth in an economy, possibly due to the increased transaction costs, which propagate inefficiency in resource allocation and curb economic growth accordingly. Institutional deficiencies constitute obstacles against entrepreneurship and innovative incentives, by discouraging the flow and the mobility of resources in the economy. Therefore, in the recent analyses of the institutional influences on growth performance in the literature, changes in the total factor productivity component of economic growth are argued to be a more relevant aggregate than the factor accumulation component.

The objective of this chapter is to provide a comparative analysis of the growth dynamics in the CEE and MENA countries in the last two decades, particularly, based on their total factor productivity differentials, with the following research questions in the mind: (i) In what respects do the sources of growth in these two regions diverge from those in other regions of the world? (ii) What is the share of the contribution of the total factor productivity growth to economic growth rate in these two regions? (iii) What are the demographic, economic and political particularities that are expected to shape the institutional quality of the two regions? (iv) Can prevailing institutional quality differences in these regions explain their total factor productivity differentials? (v) Which of the institutional factors appear as the major driving forces of the total factor productivity changes in these regions? The sample period of the study is limited to the 1990-2011 period due to the unavailability of a long-span comparable data. The period in question coincides with structural reforms in most of the MENA countries, and with reforms of transition to a post-communist era in CEE. Hence, economic