



Institutional infrastructure and economic growth in member countries of the Organization of Islamic Cooperation (OIC)



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ABSTRACT

This paper examines the relationship between the quality of different dimensions of institutional infrastructure and economic growth in a panel of 39 member countries of the Organization of Islamic Cooperation (OIC). The empirical results confirm that better-quality political and economic institutions can have positive effects on economic growth. All in all, the evidence from nonlinear model reveals that the quality of political institutions that ensure stable government, less expropriation, and low external conflict are the core dimensions of an institutional matrix because they influence the growth effects of economic institutions, confirming the “hierarchy of institutions hypothesis.” The study also finds that when political and economic institutions are accounted for, institutions that prevent internal conflict and tensions arising from ethnic and religious conflicts do not have significant (positive) impacts on growth. Thus, institutional reforms to upgrade the quality of *both* political and economic institutions are crucial for development in OIC countries.

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1. Introduction

A general consensus holds that weak institutional infrastructure is the fundamental constraint on countries' ability to accumulate productive factors (e.g., physical and human capital) and to innovate and adopt new technology (North, 1981, 1990). Weak institutions inadequately support private economic activities because they lead to expropriation activities as a result of low constraints on executive power, judicial manipulation, entry barriers to new entrepreneurs and technologies, corruption, and inefficient bureaucracy (Asoni, 2008). The bulk of the literature shows that having well-functioning of broad institutions is fundamental to achieving economic growth (see, *inter alia*, Acemoglu et al., 2001; Banerjee and Iyer, 2005; Carlsson and Lundstrom, 2002; Dawson, 1998, 2003; De Haan et al., 2006; Doucouliagos and Ulubasoglu, 2006; Fedderke, 2001; Gwartney et al., 2006; Hall and Ahmad, 2012; Hall and Jones, 1999; Heckelman and Stroup, 2000; Knack and Keefer, 1995; Rodrik et al., 2004).¹

Despite important advancement on the topic in the literature, the question remains as to the *relative* importance of different dimensions of broad institutions in the growth process, because institutions are multidimensional and thus may have differential effects on economic growth. Although several studies have emerged that focus on specific effects of different dimensions of the institutional matrix on growth—for example, democracy (Narayan et al., 2011a), market-supporting institutions (Bhattacharyya, 2009; Rodrik, 2005), and other institutional risks (e.g., Nawaz, 2015)—only a few look at the relative importance of political and economic institutions (Acemoglu and Johnson, 2005; Aidt et al., 2008; Flachaire et al., 2014; Siddiqui and Ahmed, 2013). Moreover, the focus has been on global samples with different country characteristics. In addition, institutional indices are highly correlated (Langbein and Knack, 2010), which may have prevented the analysis on the relative influence of different institutional dimensions on growth in a single empirical framework.² Recent studies (Narayan et al., 2014, 2015) have successfully dealt with this issue using principal component analysis to extract a single institutional indicator from three or four correlated institutional indices (as measured in the *International Country Risk Guide* [ICRG]) in order to study its effects on stock market

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¹ Huang's (2010) studies show that political institutions can affect the level of financial development and hence economic growth through the investment channels, suggesting that the extent of benefits from financial development depends on governance (see also Anwar and Cooray, 2012).

² It is well known that institutions are a broad concept and that existing indicators are highly correlated, thus they do not provide a clear distinction between different sets of institutions. Our study deals with this issue and tries to provide a clear distinction between different sets of institutions and their impact on economic progress.

returns. In this paper, we follow and extend these studies by extracting different unique dimensions of institutions from all twelve ICRG institutional indices in our attempt to shed additional light on the importance of the relative effects of different dimensions of the broad institutional matrix on economic growth in both the developed and developing economies.

The relative importance of different sets of institutions can be drawn from a recent theoretical view suggesting that political institutions are the most important dimension in the aggregate institutional matrix, the “hierarchy of institutions hypothesis” (see Acemoglu and Robinson, 2000, 2008; Acemoglu et al., 2005). This hypothesis argues that “political institutions ‘set the stage’ in which economic institutions can be devised” (Flachaire et al., 2014, p. 213). It conjectures that the emergence and persistence of equilibrium economic institutions—for example, institutions that protect private property rights and enforce contracts—depend on political institutions. Political institutions determine the allocation of political power and set the constraints on its usage among competing individuals or groups. Because economic institutional arrangements differ in their distribution of resources, these individuals or groups, using their relative political power allocated by political institutions, seek to shape equilibrium economic institutional arrangements (i.e., the rules of the game) that align with their preferred distribution of resources.³ Thus, political institutions determine the distribution of political power,⁴ which in turn shapes equilibrium economic institutions. Examples of political institutions include forms of government (e.g., democracy vs. dictatorship) and the extent of constraints it places on political power holders (e.g., politician and political elites); see Acemoglu et al., 2005. In this sense, economic institutional arrangements that promote growth may not be chosen when political institutions are weak (i.e., a high concentration of political powers is in the hands of a single or a few individuals, and these power holders are subject to weak constraints).⁵

This hierarchy of institutions hypothesis (HIH) has received little attention in the empirical growth literature. We attempt to provide empirical evidence for this hypothesis, using both linear and nonlinear empirical frameworks, with respect to the relative role that political, economic, and conflict-preventing institutions play in the growth process in member countries of the Organization of Islamic Cooperation (OIC). We focus on these countries because they share the same religion and have similar cultures and, especially in the Middle East and Africa, have wide variations in institutional quality and growth experience.⁶ Poverty levels in these countries are substantially lower than those countries with similar levels of income. One reason why the situation prevails is that the dual Islamic practice of *zakat* (Islamic obligatory charity) and *sadaqa* (voluntary charity) encourages the rich member of the society to donate a percentage of their income and wealth to the poor. These are large sums of money and explain why poverty rate in the Arab world are low relative to income levels. However, these countries frequently experience internal, ethnic, and

religious as well as external conflict, which impedes economic progress.⁷ Such environments are not conducive for productive investment to flourish. Furthermore, reports published by the World Bank and the International Monetary Fund (IMF) indicate that youth unemployment (15–25 years old) in these countries is among the highest in the world. Thus, this set of countries provides a unique sample for assessing the relative influence of different institutional dimensions on economic growth. In this study, we focus on a panel of 39 OIC countries over the period 1983–2009, to exclude the period of uncertainty associated with the post-Arab Spring regime,⁸ which started in late 2010. This was a historic movement in the politics of the Middle East and North Africa (MENA), but its long-term impact remains unpredictable. Many of these countries are still undergoing complex political, social, and economic transitions. In addition, because there seem to be no systematic studies focusing on OIC countries in the context of developing countries in general and in comparison to non-OIC countries, for our robustness check, we also compare the evidence on this issue in OIC countries to that of global and other developing countries.⁹

Our study makes at least three important contributions to the literature. First, this study provides new empirical evidence on the relative importance of political, economic, and conflict-preventing institutions for economic growth in OIC countries, employing (newly constructed) uncorrelated institutional indicators. In doing so, we extract three different unique dimensions of institutions from existing highly correlated indicators, using the principal component analysis (PCA) method. To provide a comparative analysis, we construct three additional panels—a sample consisting of 112 global countries, a sample of 88 developing countries, and a sample of 50 non-OIC developing countries. We look at these subpanels separately to see whether any clear pattern emerges from the empirical analysis.

Second, based on the newly constructed institutional indicators, we provide empirical scrutiny for the HIH for OIC countries based on both linear and nonlinear dynamic panel growth frameworks. This empirical strategy allows us to investigate the threshold effects in the link between institutions and growth. A striking feature of our results is that economic institutions have an enhancing effect on economic growth only after political institutions cross a certain threshold level, below which they have no effect on growth. Specifically, our results suggest that the positive effect of economic institutions on growth is observed when political institutions exceed the 1.99–3.45 range (on scale of 0–10).

Our study provides empirical evidence as to whether political institutions are a “deep determinant” in the growth process in the sense that they influence economic institutions (and policies), as suggested by the HIH. Recently, Flachaire et al. (2014), using a finite mixture regression model on a global sample of 79 countries, show that two growth regimes emerge from political institutions, which in turn condition the differential growth effects of economic institutions. Our study differs from this important study in its focus (39 OIC in the context of

³ Since there is conflict of interests (over the choice of economic institutions), the prevailing choice of economic institutional arrangements would emerge in accordance with the preference of those having more/predominant political power.

⁴ There are two types of political power *de jure* (institutional) and *de facto* (economic affluence) political power.

⁵ The hierarchy of institutions hypothesis argues that earlier models rely on entrenched vested interests to erect barriers to technological innovation and development using economic affluence (i.e. *de facto* political power) (Krusell and Rio-Rull, 1996; Parente and Prescott, 1999) are inadequate, because only those having *de jure* (institutional) political power will be able to erect those barriers (Acemoglu and Robinson, 2000).

⁶ North institutional framework includes both formal and informal institutions (North, 1981, 1990). Informal institutions include, for example, culture, religions, trust, or social capital. By focusing on OIC with relatively homogenous informal institutions, we are most likely isolating independent role play by formal institutions (e.g. political, economic and conflict-preventing institutions) in their growth process.

⁷ A glance at the data on International Country Risk Guide (ICRG) and its components reveals that the 39-OIC developing countries score relatively lower on overall institution risks (ICRG average score of 5.5 on 0–10 scale, with higher score indicating lower institutional risk or higher institution quality) compared to 50-non-OIC developing countries (average score of 6). Compared with non-OIC developing countries, OIC tends to have higher corruption (4 vs. 5 for non-OIC), higher degree of incompetent bureaucracy (4 vs. 4.8), experience higher conflicts (ethnic conflicts, 5.8 vs. 6.5, internal conflict, 6.2 vs. 6.8), lower observance of rule of law and order (5.3 vs. 5.8).

⁸ Arab Spring denotes a revolution wave of demonstrations and protests (both non-violent and violent), riots, and civil wars in the Arab world that first started in Tunisia at the end of 2010. Events in Tunisia were soon spread to Egypt, Yemen, Syria, Libya and other countries in the region. Sakbani (2011) provides a historical perspective on the Arab Spring.

⁹ Most of the studies on the issue have pooled all the countries in one panel. Apart from the global sample (112 countries) we divide the developing country subsamples into developing countries, non-OIC developing countries and OIC countries to highlight the differences, if any, on the role of economic, political and conflict-preventing institutions on economic progress. We thank an anonymous referee for this suggestion.

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