Institutional quality and Economic Performance in the Southern African Development Community (SADC) Region: A Dynamic Panel Analysis

Presented by: Kholiswa Malindini

Email: kholiswa.Malindini@wits.ac.za

2 St Davids Place, Parktown, Johannesburg

University of the Witwatersrand

06 May 2022

Outline

- Introduction and context
- Drivers of economic prosperity in the SADC region
- Meaning and overview of institutional quality
- Problem statement
- Research objective and questions
- Theoretical review
- Methodology and data sources
- Results analysis
- Conclusion and recommendations

Introduction and context

- Economic growth has been the most crucial economic indicator through which macroeconomic objectives can be achieved and a backbone for all economies.
- A powerful tool and a prerequisite for the economic development of countries, job creation, poverty alleviation, and even distribution of wealth and incomes resulting from an increase in the actual gross domestic product of the country.
- Economic models suggest that economic output is driven by physical capital, human resources, and technology (Solow, 1955).
  - According to these models, labour and capital combined with technology warrant an increase in the country's gross domestic product per capita.
  - these models have been criticised for the narrow view of the determinants of economic growth – thus ignoring other possibly crucial factors that may directly affect sustainable growth (Siyakiya, 2017).
- Within this context, the focus recently shifted from the conventional determinants of economic growth as outlined in the theoretical models to consider the role of institutions on countries' economic performance.
- Accordingly, institutional quality has increasingly become a key determinant of economic performance, particularly in developing countries where economic growth is stagnant or moving at a meagre rate.

What drives economic prosperity in the SADC region?

- The SADC's Regional Indicative Strategic Development Plan (RISDP) states that quest for poverty eradication, deeper regional integration and economic prosperity will not be realized in the absence of good governance' (SADC Secretariat, 2001).

- The economic outlook report reveals that since 2016, the region's economic growth has averaged 1.9 percent, and this trend continues, thus, giving rise to the unemployment rate, inequality, poverty, and unsustainable public debt levels.

- In contrast, Asian economies have been growing faster at about 7.5 percent (Tralac, 2019).

- The literature reveals a shift from traditional economic growth determinants (such as market size, export earnings, trade openness and inflation) to institutional quality as the significant growth determinant (Dunning, 2002; Mougani, Rivera, Zhang, Mezui, and Kim, 2013; and Chidede, 2017).

What are institutions?

- The growing awareness of the significance of good governance for developing countries' development agenda has raised interest among scholars, however, the definition of governance is still vague
  - ‘Traditions by which authority in a country is exercised in managing a country’s social and economic resources (World Bank, 1991)
  - Political and administrative authority in managing a country’s complex mechanisms, processes, relationships and institutions - through which citizens and groups communicate their wellbeing, apply their lawful rights, meet their obligations and facilitate their differences (UNDP, 2015)

- These definitions suggest that governance is about stimulating relationships and interactions and promoting consensual decision-making.
- Institutions refers to the ‘*rules of the game*, the ‘humanly devised constraints that structure political, economic and social interactions’ these include formal rules and informal constraints which shape human behaviour (North, 1990)

- These ‘rules of the game’ are endogenously created through the strategic interactions of agents and cannot be imported from other countries.
- According to the literature, formal rules consist of fundamental rules, legal systems, and institutional environment
- It is through an institutional environment that institutional arrangements are created between individuals and organizations to manage activities.

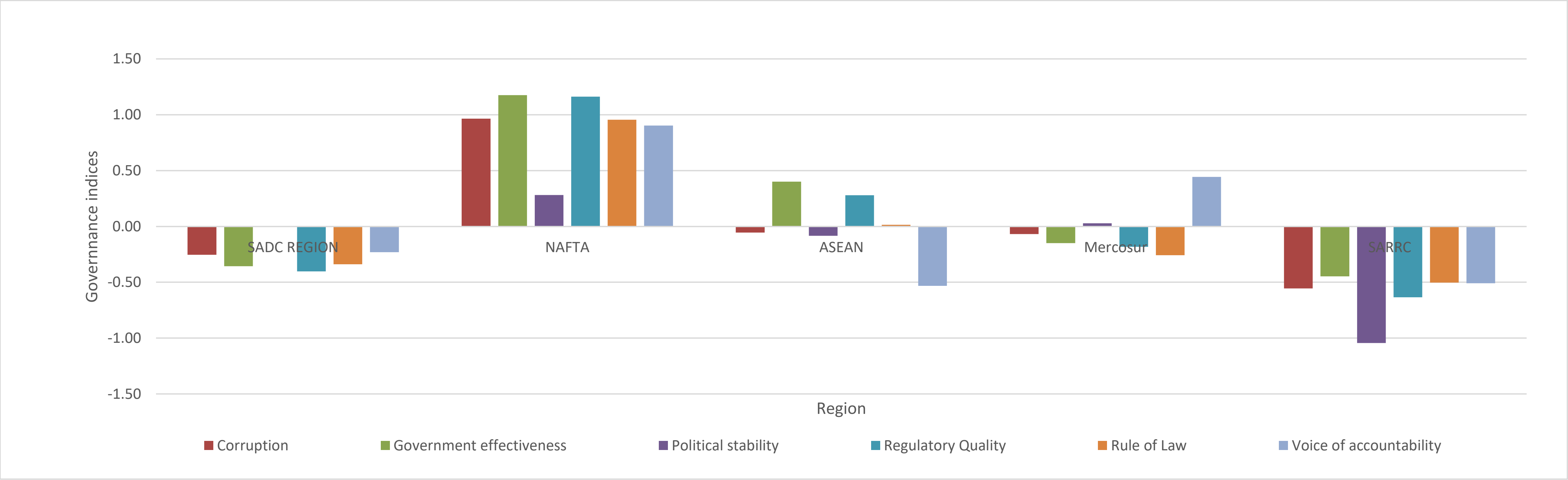
Meaning of institutional quality

- ‘*Rules of the game, which define the respective roles of the participants;*
- *They affect the performance of the economy by their effects on the exchange and production costs and the transaction costs, and the costs of protecting rights and policing and enforcing agreements’* (North 1990: 5).

- Good institutional quality reduces uncertainty and creates an enabling environment

- Foreign investors seek to maximize their profits by investing in countries that promote ease of doing business, and this is possible only if markets are integrated at the national and regional or international level where institutions play a crucial role

Overview of institutional quality in the SADC region



Source: Authors' calculations from the Worldwide Governance Indicators database 2019.

Figure 3: Governance indicators by region: averages from 2003 - 2019

The estimates for governance indicators range from -2.5 to +2.5, with higher values corresponding to better governance while lower values indicate poor institutional quality

Could poor governance be the reason why the SADC region attracts less than expected FDI inflows?

Research Problem

- The SADC region's economic growth has been deteriorating, and this trend continues giving rise to the unemployment rate, inequality, poverty, and unsustainable public debt levels.

- Thus, lower growth rates may be a consequence of institutional weaknesses such as inadequate formulation of laws, regulations and policies, or lack of enforcement of the rules.

- The African Economic Research Consortium (AERC), (2006) echoes the same sentiments outlining that institutional quality explains variation in the growth of African economies.

- This paper sought to examine the effect of institutional quality on economic performance in the SADC region, which has been struggling for growth.

- This paper is premised on the notion that 'institutions matter' for realizing socio-economic outcomes as they create incentives or constraints that shape human behaviour

Research question and objective

- Research objective
  - To examine the extent to which institutional quality influences foreign direct investment inflows into the SADC region.
- Research question
  - To what extent does institutional quality influence foreign direct investment inflows into the SADC region?

Economic performance and Institutions: A Theoretical Review

- **Channels through which institutions influence economic growth and its effects**
- Weak institutions tend to directly reduce the efficiency of investments, thus creating an environment of uncertainty where advanced technology use and property rights protection are not enforced, and growth declines.
- Secondly, institutional frameworks can indirectly affect economic growth through rising transaction costs resulting from corruption and rent-seeking behaviour which ultimately impedes investments.

- The structure of the state and the political decision-making process create political institutions whose role is to create a conducive environment.
  - These shape the political process and legal environment and influence the behaviour of politicians, parties, and other interest groups.

- Inclusive political and economic institutions *(incentivize citizens, leading to technological innovations and human development)* are prerequisites for sustained economic prosperity instead of extractive institutions, which only benefit the ruling elite, and have no incentives for citizens to participate in the economy actively.

- Economic institutions refer to property and contract laws and transaction costs that orchestrate economic interactions.

Empirical analysis

- There exists three strands of literature regarding the effect of institutional quality on economic growth.
- In the first strand, some scholars support the view that institutional quality enhances economic growth through creating an enabling environment for both domestic and foreign investments (Acemoglu and Robinson, 2012a; Acemoglu et al., 2005; Mbulawa, 2015; and Bruinshoofd, 2016).
    - Imperfect/weak institutions adversely affect economic growth by giving rise to rent-seeking behaviour and may inhibit potential growth resources such as the provision of public goods, and
    - Distorts resource allocation, which can lead to unproductive investments and ultimately impede growth (Farole, Rodrí-guez-Pose, and Storper, 2011).
    - Sondermann (2016) reveals that countries with strong institutions develop flexibility towards economic shocks – not only do they bring about resilience but also promote product diversification.

- The second strand of literature finds different results
    - Rodrik (2000) and Williamson (2009 and Siyakiya (2017) find no evidence of a causal relationship, and thus, conclude that institutional quality does not matter for economic growth.

- The third strand
    - The literature also reveals that economic growth and institutional development are mutually reinforcing in the long run (Henisz, 2000; Glaeser, La Porta, Lopez-de-Silanes, and Shleifer, 2004). That is, a bi-directional relationship exists between the two variables.

Methodology

- This study estimates a micro panel, that is, large N (15) and small T (10)
- This paper uses data generated from the World Development Indicators (WDI) database, International Monetary Fund (IMF) financial development index database, and the Worldwide Governance Indicators (WGI) database.
-
- Model specification
- *GDP per capita growth = f(institutional quality, financial development, gross fixed capital formation, foreign direct investment inflows, natural resource availability, inflation, trade openness, human capital)*

Estimation Technique

- This paper employs the system GMM panel data technique developed by Arrelano, Blundell and Bond (1998) and Roodman (2009).
- The application of this technique follows the Monte Carlo evidence which suggests that when the time dimension is short and the dependent variable is persistent, the more significant number of moment conditions leads to precision while also reducing sample bias.

- the model employed in this paper is specified as follows:
- $Yit = \emptyset Yit-1+\beta X'it+yZ'it+dt+ \varepsilon it$
- Where $Yit-1$ is the lag of the dependent variable, $X'it$ is the vector of strictly exogenous variables, while $Z'it$ is the vector of predetermined covariates and endogenous covariates, dt is the unobserved group-level effect, and εit is the error term.

Regression Results – System GMM

FDI, trade openness, financial development, gross fixed capital formation, and human capital have positive coefficients, implying that these variables stimulate economic growth in the region.

Despite being positively correlated to growth and consistent with the expectation, not all these variables are statistically significant; for instance, FDI and human capital have insignificant coefficients.

On the other hand, the governance index, inflation, and natural resource availability have negative and statistically significant coefficients.

	(1)	(2)	(3)	(4)
VARIABLES	**FE**	**FE – Drisk/Kraay**	**Diff GMM**	**2-stepGMM**
FDI	0.0900**	-0.0900*	0.147	0.222
	(0.0404)	(0.0464)	(0.145)	(0.198)
Trade openness	0.00244	0.00244	0.348***	0.0895**
	(0.0184)	(0.00767)	(0.0955)	(0.472)
Financial Development	-0.88	-0.69*	0.315	0.151***
	(1.920)	(1.625)	(1.13)	(3.13)
Governance index	-3.363**	-3.363***	-2.817	-0.713***
	(1.400)	(0.747)	(3.247)	(2.003)
GFCF	0.0772	0.00772	0.4226	0.1850
	(0.0798)	(0.00969)	(0.3106)	(0.082) **
Inflation	-0.0388	0.00388	-0.0338	-0.0413
	(0.00579)	(0.00246)	(0.0314)	(0.0712)**
Natural resource	-0.0489	-0.00489	-0.008	-0.174
	(0.00965)	(0.00605)	(0.0153)	(0.230)**
Human capital	0.00426	-0.00426	0.0949	0.2367
	(0.0107)	(0.00357)	(0.529)	(0.7393)
2010.	2.075**	2.075***		
	(0.851)	(0.0361)		
2011.	3.538***	3.538***		
	(0.863)	(0.171)		
2012.	2.736***	2.736***		
	(0.894)	(0.340)		
2013.	2.602***	2.602***		
	(0.875)	(0.188)		
2014.	2.221**	2.221***		
	(0.888)	(0.258)		
2015.	0.983	0.983**		
	(0.930)	(0.337)		
2016.	0.313	0.313		
	(0.972)	(0.424)		
2017.	0.289	0.289		
	(0.906)	(0.279)		
2018.	0.341	0.341		
	(0.939)	(0.491)		
2019.	0.0552	0.0552		
	(0.958)	(0.391)		
L.GDPpercapitagrowth			0.230**	0.326***
			(0.256)	(0.133)
Constant	3.258	6.1712***		7.537**
	(3.765)	(1.5598)		(3.070)
Observations	**110**	**110**	**115**	**128**
R-squared	0.380	0.38		
AR1			0.473	0.033
AR2			0.216	0.601
Hansen/Sargan			0.821	0.542
Number of instruments			10	11
Number of panel	10	10	13	13

Robust standard errors in parenthesis *** p<0.01, ** p<0.05, * p<0.1

Conclusion and recommendations

the study concludes that weak governance impedes economic performance in the region. Thus, the poor institutional quality is also linked to the adverse effects of natural resources availability and macroeconomic instability and ultimately stifles growth through limiting inflows to resource-seeking and market-seeking investments.

To expedite the region's developmental agenda and improve complementarity among member states, these states must arrive at a suitable institutional framework that promotes collaboration in the region and ensures effective and efficient implementation of the potential protocols.

Intra-SADC trade and investment is still lacking as the region is dominated by bilateral trade agreements between member states and with countries outside the region, and this is linked to weak institutional quality.

Therefore, to avoid deflecting and diverting trade and to ensure ease of administration, there is a need for convergent bilateral and multilateral arrangements in the region.

The region needs to raise its export competitiveness by attracting domestic and foreign investments, and stimulate global value chains.

The end

Thank you