

Creating a Dynamic Legal Environment for Business in the MENA Region: Challenges and Priorities  
Key Requirements to Improve the Legal Environment for Doing Business

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## The Quality of Legal Institutions and Service

Arlette ZAKARIAN <sup>1</sup>

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### INTRODUCTION

Globalization and increasing international flows of goods and capital have created a sense that the importance of individual nation states and the public goods they provide, including law and law enforcement institutions, is in decline. Opting out of domestic legal institutions and into those of a third country or into an “international” architecture have been elevated to important complements, if not substitutes for “good” institutions at home. If traders and investors could indeed effectively opt-out of their home jurisdiction’s legal systems, we should observe empirically that the quality of domestic institutions has little impact on international patterns of trade flows. Yet, empirical studies suggest the opposite, namely that a country’s domestic legal institutions have strong explanatory power for its integration in international markets. In recent years, there has been a resurgence of interest in the development of a legal environment for business development, both in the academy and in policymaking arenas. Not only are legal scholars displaying renewed interest in legal institutions in developing countries, so are scholars in the cognate disciplines of economics, political science and sociology. Moreover, prominent members of institutions such as the World Bank (WB) and the International Monetary Fund (IMF) are proclaiming that quintessentially legal institutions such as contract law and property rights are critical to the development process.

Once again there is a sense in both the academy and the larger policy-making community that rather than being merely epiphenomenal, law plays an independent and significant role in the development of less developed countries.

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<sup>1</sup> Associate Professor of Public International Law at the *Institut d’Etudes Politiques de Paris (Sciences Po)*.

In the last decade, the countries of Middle East and North Africa (MENA) passed through huge macroeconomic and institutional reforms to increase international opening, improve stability and encourage the development of the private sector. In this essay we seek to determine the theoretical and empirical bases for the assertion that legal institutions play a significant and independent role in business development.

We should try to understand what role do legal institutions and services play in economic development in the MENA region. What is the legal impact on the commercial and business development? Why is it that some countries have developed the types of legal institutions that are conducive development while others have not? What steps, if any, can be taken to encourage the emergence of the legal institutions that facilitate development in countries where those institutions have not evolved? Why do domestic legal institutions matter, and why can trading parties - in particular exporters of complex goods - not easily opt-out of their domestic legal institutions? We argue that domestic institutions remain important even in a globalized world. <sup>1</sup>

## DEFINITION

The core conception of modern law was essentially the American formal legal system, named “liberal legalism” by Trubek and Galanter in their <sup>2</sup> article announcing the demise of the law and development movement.

The core components of this model were as follows:

- 1) Society is made up of individuals who consent to the state for their own welfare;**
- 2) the state exercises control over individuals through law, and it is constrained by law;**
- 3) laws are designed to achieve social purposes and do not offer a special advantage to any individuals or groups within the society;**
- 4) laws are applied equally to all citizens;**
- 5) courts are the primary legal institutions with the responsibility for defining and applying the law;**
- 6) adjudication is based upon a comprehensive body of authoritative rules and doctrines, and judicial decisions are not subject to outside influence; and**
- 7) legal actors follow the restraining rules and most of the population has internalized the laws, and where there are violations of the rules of enforcement action will guarantee conformity.**

Modern law was believed to be the “functional prerequisite of an industrial economy.” <sup>3</sup> That means law would provide the necessary elements for the functioning of a modern market system, including contract and private property rights, and universal and uniformly applied rules that allow for predictability and planning. Furthermore, modern law was viewed as essential to political development as it would help create a pluralist, liberal-democratic state, and serve as the primary restraint on arbitrary state action. <sup>4</sup>

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<sup>1</sup> HIRST, Paul. (1997) The Global Economy - Myths and Realities. *International Affairs* 73: 409 (arguing that the world economy has been global already for a long time and that state sovereignty and state institutions are as important as ever).

<sup>2</sup> TRUBEK, David M. (1972) Toward A Social Theory of Law: An Essay on the Study of Law and Development. *Yale Law Journal* 82: 44.

<sup>3</sup> Ibid.

As it turns out, even our abbreviated analysis reveals that depending upon which perspective one uses to analyze the concept of development, it becomes more or less plausible that law exercises an independent influence on the process of development. Moreover, to the extent that law does appear to play this sort of independent role in development, different perspectives focus upon different aspects of the legal system and ultimately lead to different prescriptions for the design of legal institutions. <sup>o</sup>

## LEGAL INSTITUTIONS: A TOP-DOWN APPROACH - THE LEGAL EDUCATION

Legal institutions can be defined as a “systems of regulative and constitutive rules that provide frameworks for social action within larger rule-governed setting” <sup>1</sup>. Armed with an instrumental model of the role of law in development, we could adopt a top-down approach. Moreover, we emphasize the reform of legal education and the legal profession and to a lesser extent the reform of formal legal rules. The assumption is the following: lawyers trained to use law as an instrument for change would promote the developmental goals of the state. The reform of the legal education and profession would stimulate other forms of modernization, including the emergence of other institutions in an effective modern legal system such as those responsible for administering and enforcing legal rules.

## HOW INSTITUTIONS AFFECT ECONOMIC DEVELOPMENT

Better governance requires reforming several aspects:

- **notably improving the efficiency and operation of the government apparatus and increasing its accountability;**
- **enhancing the legal framework by improving the efficiency and credibility of the court system;**
- **clarifying property rights;**
- **clearing law texts from incoherence and inconsistency;**
- **enforcing the rule of law;**
- **guaranteeing transparency and the easy dissemination of information; and harnessing participation of civil society.**

Reform strategies – implemented, for instance, in Israel, Egypt, Morocco, Algeria and Jordan, increased the macroeconomic stability of the region. They were able to establish a strong basis for the claim that a successful economy requires appropriate institutions. But, although we can conclude that institutions “matter” in a broad sense, it is still difficult to assess institutional quality in practice. Institutions are by their nature quite complex, and many important aspects of institutional structure are not easily observed. Moreover, the economic impact of a particular set of institutions often depends on context. For example, certain institutions make it difficult for the government to institute policy changes. In some contexts, this is beneficial for economic development, since it makes government commitments more credible <sup>2</sup>. On the other hand, in times of economic crisis or rapid change, these same

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<sup>o</sup> RODRIK, Dan et al. (2002) Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development. National Bureau of Economic Research, Working Paper No. 9200. ANDERSON, James E. and MARCOUILLER, Douglas. (1999) Trade, Insecurity, and Home Bias: An Empirical Investigation. National Bureau of Economic Research, Working Paper No. 7000. See also BERKOWITZ, Daniel et al. (2002) Trade, Law and Product Complexity.

<sup>1</sup> RUITER D.W.P. (1999) A basic classification of legal institutions. *Ratio Juris* 10(2): 207-221.

<sup>2</sup> BRUNETTI and WEDER (1994). HENISZ (2000).

institutions can hinder a government's ability to respond effectively <sup>^</sup>. An independent constitutional court may encourage foreign business transactions by ensuring that the executive does not arbitrarily seize property, but if it were to prevent the rapid adoption of policies needed to counteract a financial crisis, it might also discourage the Closing. The consensus seems to be that, in developing countries, maintaining credibility tends to be more economically important than retaining flexibility, but the example illustrates the complexity involved in assessing the clear economic impact of institutions.

The inherent difficulty in measuring the quality of institutions is being made in investigating the link between "institutional quality" and economic development. Despite all the problems with measuring the quality of institutions, almost all empirical work on the subject has concluded that institutional quality – in one form or another – correlates strongly with economic development. Nonetheless, while there are strong reasons to suppose that good institutions facilitate development, it is also plausible that high levels of economic growth spur the development of better institutions. Indeed, many researchers believe that the causality runs in both directions, thus suggesting "multiple institutional equilibria". <sup>¶</sup>

In other words, there may exist both a vicious circle, in which low growth leads to weak institutions causing continued low growth, etc., and a virtuous circle, in which high growth leads to stronger institutions, which facilitate more growth, etc. If this is indeed the case, it poses a challenge for development planners. Moving from the vicious circle to the virtuous circle requires understanding the strength of the causal relationships between institutional quality and economic growth, and vice versa, something that is still not known with much certainty at all. Indeed, moving out of the vicious circle may require reforming several things at once.

## **ECONOMIC DEVELOPMENT AND THE QUALITY OF LEGAL INSTITUTIONS**

One reason the development community is fostering legal and judicial reform is the belief that, beyond their intrinsic worth, such reforms will help improve economic performance.

This belief in the power of legal and judicial reform to spur economic development is supported by a growing body of research showing that economic development is strongly affected by the quality of institutions – including the quality of a nation's legal institutions. It is very hard to measure the quality of legal institutions, harder still to sort out the strength of the causal relationships between their quality and economic development, and virtually impossible to sort out the complex and contingent relationship between the different components of real-world institutions.

## **WHY INSTITUTIONS AFFECT ECONOMIC DEVELOPMENT**

While early work on economic development took for granted the existence of institutions that established clear and enforceable property rights, kept the costs of transacting business to a minimum, and reduced the threat of coercion, more recent work has shown that this is rarely the case. Indeed, current research suggests that the capacity of national institutions to protect property rights, reduce transaction costs, and prevent coercion may be decisive in determining whether economic development takes place.

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<sup>^</sup> TSEBELIS (1995).

<sup>¶</sup> CHONG and CALDERON (2000).

Furthermore, researchers have started to pay more attention to how institutions that affect the governance of a nation affect economic performance. Government officials respond, at least in part, to the incentives created by political and legal institutions. Therefore, the structure and quality of political institutions can affect whether the government facilitates or inhibits economic development. Stated most simply, the incentives institutions create for government decision-makers will determine whether the government uses its power to create a framework for productive economic activity or to redistribute wealth to itself or its supporters.

## **REGULATORY AND LEGAL FRAMEWORKS ARE A MAJOR CONSTRAINT ON GROWTH**

Business and commercial policy relates to a country's laws, regulations and practices that directly enable or discourage investment and that enhance the public benefit from investment. The quality of a country's investment policies directly influences the decisions of investors, be they small or large, domestic or foreign. Transparency, property protection, non-discrimination and dispute settlement practices are core business policy principles that underpin efforts to create a quality commercial environment for all.

Business contractors are also concerned with the way the commercial policy is formulated and changed. They will avoid circumstances where policies are modified at short notice, where governments do not consult with industry on proposed changes and where laws, regulations and procedures are not clear, readily available and predictable.

Five characteristics needed in modern regulatory systems <sup>10</sup>:

- **Security** (legal security, consistent respect for market solutions, predictable enforcement)
- **Transparency** (clear and simple rules, openness through the entire policy process, less corruption) <sup>11</sup>
- **Legitimacy** (must protect safety, health, environment, consumers, public interests)
- **Efficiency** (low-cost rules, orderly and timely decisions, move swiftly to meet market needs)
- **Expertise** (good regulatory skills and understanding of complex markets and technologies)

Well-functioning market economies depend on access to information.

For foreign business contractors this means being easily able to obtain meaningful information on all measures that may materially affect their commercial relations. And to reassure all market participants that business operates on a level playing field, it also means that business laws and regulations and their enforcement should be codified and clear to all.

This requires a consistent, predictable system of laws, policies, regulations and administrative practices, as well as information on rulings and judicial decisions. While the sheer number

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<sup>10</sup> Public sector transparency and the international investor-OECD (2003).

<sup>11</sup> Transparency vis-à-vis international contractors is generally understood to involve:

- a) effective communication to investors of meaningful information on local laws, regulations and practices that may materially affect their investments,
- b) prior notification and consultation of regulatory changes of interest to them and
- c) due process and procedural fairness in obtaining the necessary licensing, permits, registration and other formalities for carrying a business.

and complexity of laws and regulations may not always make it possible to provide comprehensive information on all matters that might influence investor decisions, governments have an interest in providing essential information on how to start a business and inform the parties about ownership and exchange control restrictions, administrative requirements, taxation, investment incentives, monopolies and concessions, intellectual property protection and competition policy, as well as environmental and social requirements as well as corporate responsibilities.

## **PRIOR NOTIFICATION AND CONSULTATION**

Involving investors and other stakeholders in the process of legal and regulatory changes contributes to their legitimacy and effectiveness. It also reflects a commitment to professionalism and contributes to building trust between investors and relevant stakeholders. Moreover, policy is more likely to be sound and not produce unintended side effects if it is formed in a structured and transparent manner that permits input from all interested parties. Prior notification and consultation is a process that begins with public hearings, policy papers outlining the reasons why changes are needed, circulation of draft regulatory changes to all concerned stakeholders, and processes for revision and recirculation based on these public inputs.

## **PUBLIC APPEALS PROCESSES**

Public appeals processes increase procedural transparency, thereby helping to avoid regulations that impose undue burdens and limiting the discretionary power of officials. Procedural transparency can be institutionalized by systematically ensuring that changes in implementing regulations and administrative decisions are subject to an open, prompt and impartial public review and appeals processes.

## **POLICY PRACTICES TO SCRUTINIZE**

A key issue consists in assessing the transparency of a country's commercial and corporate laws and regulations is how information on business laws and regulations and any amendments is provided.

Is information on commercial and business laws, regulations and administrative requirements provided:

- **through a legally stipulated and codified system;**
- **which applies to primary and secondary legislation;**
- **at both national and sub-national levels of government and**
- **with exceptions and qualifications to making information available clearly defined and delimited?**

What means are used to communicate and disseminate information on a country's commercial laws and regulations?

- **systematic use of print (e.g. official gazettes), government websites and other electronic communication technologies (e.g. on-line compendiums and e-gateways);**
- **formal and informal contacts by government departments and regulatory agencies.**

## DISPUTE SETTLEMENT GUARANTEE

This instrument is a necessary requirement for enforcing a claim against a party in the event of a breach of contract. International contracts take place in the shadow of the parties' home institutions. Unless parties can negotiate a settlement, or the losing party voluntarily complies with a foreign court or arbitration ruling, the winning party must seek enforcement against the assets of the losing party - and they tend to be located primarily in that party's home jurisdiction. For reasons further explained below, importers and exporters are not equally exposed to the risk of bad domestic institutions' actions. By implication, exports, and particularly complex goods exports suffer more from bad legal institutions in the exporter's home jurisdiction, than imports.

Contracting parties cannot foresee all future contingencies and therefore cannot possibly write a complete contract that addresses all of them, avoiding disputes and thus eliminating the need to revert to the courts for dispute settlement and enforcement.

We also find that international law, in particular a country's ratification of key international treaties affects trade patterns.<sup>12</sup> The mechanism through which international laws affect trade outcomes is a change in the perception of a country's credibility to commit to impartial contract enforcement. Ratification of such a treaty - even in the absence of tangible institutional change - sends an easily verifiable signal to foreign entrepreneurs.<sup>13</sup> In this part of the paper, the potential of international law to act as a substitute for domestic institutions is further explored. In assessing the reach of international law on private transactions it is important to note that dispute resolution mechanisms under international law typically address sovereign States. Some are designed to resolve disputes between States - such as arbitration at the World Trade Organization (WTO).<sup>14</sup> Others enable private parties to hold States accountable for breach of contract and/or violation of treaty obligations. An example is the International Convention for the Settlement of Investment Disputes (ICSID).<sup>15</sup>

Legal institutions do indeed matter for international trade flows. Countries with higher ratings on institutional quality experience greater trade flows. Our finding that the quality of domestic institutions is important for a country's participation in international trade flows - in particular of complex goods - challenges the proposition that international economic law can substitute for domestic institutions. By contrast, private parties have to employ domestic institutions of a sovereign State to enforce foreign court or arbitration awards. The closest there is to a supranational enforcement mechanism for private parties is the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (New York Convention).<sup>16</sup>

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<sup>12</sup> See U.C.C. Revised Article 9: Letters of Credit prefatory note, at xv. See also Annual Survey of Letter of Credit Law & Practice (BYRNE, James E. and BYRNES Christopher S. 2004).

<sup>13</sup> MILLER, Grady. (1996) The Legal and Economic Basis of International Trade. *The Legal and Economic Basis of International Trade* 169 - 182 (discussing the business origins of trade finance). See BRAUDEL, Fernand. *Sozialgeschichte des 19. - 18. Jahrhunderts*.

<sup>14</sup> The rules for dispute settlement under the WTO are set forth in the Dispute Settlement Understanding (DSU) the "Understanding on Rules and Procedures Governing Disputes" which were adopted as part of the Uruguay trade negotiations.

<sup>15</sup> Similarly, under the North American Free Trade Agreement (NAFTA), private parties can invoke arbitration to resolve disputes with one of the Member States. Moreover, European Union law enables private parties to seek judicial review of State actions.

<sup>16</sup> JAN VAN DEN BERG, Albert. (1981) The New York Arbitration Convention of 1958: Towards a Uniform Judicial Interpretation (providing a detailed review of the history of the convention and its implications).

## **EFFECT OF INTERNATIONAL INSTITUTIONS ON THE PERCEIVED QUALITY OF DOMESTIC INSTITUTIONS**

Since globalization, multilateral and regional trade agreements have become one of the most important factors shaping the future of national economies, it becomes very relevant to understand their institutional implications for the different sectors and facets of the MENA economies whether on corporate organization, public-private relations, role of the state, etc. There are various ways in which a country may try to signal a friendly business environment. It may, for example, unilaterally declare that it will from now on play by the rules. A unilateral declaration may not be very compelling, however, especially in countries with a weak track record of property rights protection and contract enforcement. A more credible signaling strategy is to enter into a legally binding commitment, by, for example, becoming a party to an international convention.

The signing or even ratification of an international convention, however, does not guarantee that a country will implement and enforce the rules specified therein. Since the international community cannot easily police and enforce compliance, ratifying a convention creates a commitment, but on its own does not imply institutional change. Still, ratifying an international convention is a more credible signal than a unilateral declaration, because deviations will be noticed not only as domestic aberrations, but as violations of the international legal order as well. Indeed, we find strong evidence that for instance, the ratification of the NY Convention affects the perception of a country's institutional quality even after controlling for openness to trade, GDP per capita, or for ratifying the United Nations Convention on Contracts for the International Sale of Goods (CISG), which harmonizes important aspects of contract law.

## **CORRUPTION AND THE RULE OF LAW <sup>11</sup>**

Within an idealized "rule of law" system, equitable legal and regulatory institutions operate as safeguards against abuses of state and non-state power while well-functioning regulatory frameworks are crucial for the effective delivery of public services. A "rule of law" system is generally characterized by multiple arms of government - the executive, legislature and judiciary - with each branch holding the others accountable through differing "checks and balances". The separation of powers principle aims to combat the dangers of investing state power in one person or group. The judicial branch, in particular, exists to protect citizens against the arbitrary or inequitable use of political or economic power. Further, predictable and fair "rules of the game" and secure legal rights are seen as the basis for an effectively functioning society. Arguably, the *raison d'être* of these institutions is to further the common good by exercising power based on a sound balance between collective and individual interests.

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<sup>11</sup> The definitions of corruption are as diverse as the forms corruption can take. For the purposes of this paper, we will understand corruption as the abuse of public power or public office for private gain, taken from YOU and KHAGRAM (2005). So what is abuse of public power? The term "public power" relates to the exercise of government functions. Their abuse can be imputable to two different perpetrators. The first one is the person who holds public office and exercises government functions. The abuse can be the deed of this public official without anybody else's participation. The other perpetrator can be a person who seeks to influence by inappropriate means the exercise of government functions that he himself does not have. In this case, corruption is collusive behavior. As a consequence, the abuse of public power comprises both configurations. Private gain in this context is the change of the sound balance between public and private interests (common good) during the decision making process in favor of particular interests. As a consequence, neither the processes nor the outcomes are equitable.



Unfortunately, this ideal bears little resemblance to reality in many countries around the world. In some countries, justice sector institutions by their very design perpetuate elite interests at the expense of the majority of the population. In many other countries, formal rules which seemingly protect the interests of the broader community are undermined by institutional practices and informal strategies. Whether understood as elite capture or corruption, these systems and practices serve to increase the power and wealth of a few at the expense of the majority of the community, leaving the poor suffering the harshest consequences. In practice, inequalities in power and the effectiveness of legal institutions have a two way casual relationship. Political and economic elite may establish, maintain, subvert or ignore weak institutions to protect their power base - either by excluding other groups or actively discriminating against them. In turn, weak institutions are open to corruption or elite capture. Weak institutions are open to two contrasting forms of elite capture - by political elites across different arms of government, or capture by economic elites, typically called “state capture”.

Courts controlled by political interests tend to serve - rather than curb - abuses of state power. Elite capture can influence both the laws themselves and the processes of adjudication or enforcement. In many cases these different types of elite capture operate simultaneously through partnerships or the combined interests of particular groups in the community. The poor, as well as small businesses, suffer most from paying the extra costs for having access to public services, which are associated with bribery, fraud, and the misappropriation of economic privileges.

This is why corruption is sometimes compared to a regressive tax, which disproportionately affects small businesses and the poor. However, corruption reduces the effectiveness of public administration and distorts public expenditure decisions, channeling urgently needed resources away from sectors such as health and education to corrupted sectors or personal enrichment.

## **THE SITUATION IN THE MENA REGION**

Institutions and institutional reforms are of paramount importance for the Middle East and North Africa (MENA) region on several grounds. The process of its integration in the world economy is slow in comparison with high performing developing countries <sup>18</sup>. Without appropriate institutional changes, notably the development of market institutions and the protection of property rights, the region will forego the windows of opportunities offered by globalization. Moreover, the past weak growth performance of many MENA countries is largely attributed to its low level of productivity, lack of international competitiveness and its reliance on traditional factor-based sources of competitive advantage. The region is also characterized by a high level of social and political instability that can be detrimental to the functioning of market economies.

There has been an obvious effort made by developing countries toward undertaking substantial institutional reform notably through improving their governance structure. <sup>19</sup> The record of the MENA countries on institutional quality as proxied by their scores on country risk indicators published by credit ranking institutions, have improved over the last decade. However, much remains to be done. Several institutional aspects are still lagging behind even by developing countries standards. Individual studies show, for instance, that many countries

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<sup>18</sup> NABLI and DE KLEINE (1998).

<sup>19</sup> Arab Planning Institute-Kuwait; Imed Limam. *Institutional Reform and Development in the MENA Region*.

in the region provide the weakest institutional support for investment and private sector development. This creates the need for analyzing the institutional setup and pinpointing the institutional impediments for the development of the MENA region from both the theoretical and practical perspectives.

Several authors assert that poor assignment of property rights is exacerbated by excessive political control, outright involvement of the state in ownership, and the discretionary bureaucratic allocation of resources. This results in corruption and misallocation of resources that can be detrimental to development. The importance of property rights institutions in reducing transaction costs and misuse of assets. Although this represents a major step toward appropriate institutional reform, the impact of coupling the creation of property rights institutions with the elimination of inefficiencies resulting from political control and non-enforceability of contracts must be addressed. This involves improving the functioning of legal institutions, downsizing bureaucracy, reducing the control rights of bureaucrats, and privatizing.

The institutional and regulatory frameworks in the region are generally polarized between excessive regulation and red tape on the one hand, and vague and inadequate rules and regulations on the other. Good governance practices are lacking and also challenging to achieve in the context of the difficult and sometimes reversible political and economic transition in the region. Furthermore, authoritarian regimes and the lack of genuine democratic practices in the region have made it difficult for strong institutions to emerge. In particular, the region needs a more efficient public sector, a more active private sector, involved civil society, reformed legal systems, and judicial systems that uphold the rule of law.

Therefore, the difference between the poorest and the richest countries can be – at least partially – attributed to the quality of the institutions they have. Countries with good institutions that are conducive to desirable economic behavior tend to perform better than those with pervasive restraints on rule systems. The latter find themselves in a trap where weak institutions and poor economic performance continue to reinforce each other.

Consensus is needed on which state model would best help MENA countries meet economic and social challenges. A social contract which is the outcome of a society wide collective decision mediated through a political process is needed. Stakeholders would be providing finance and investments to fulfill social contract.

Decentralization can help improve service delivery. However, overcoming institutional weaknesses through legislative reforms, power delegation, fiscal empowerment and dismantling informal networks is needed. Improving transparency and accountability can create an environment for successful economic and social development. This is essential for providing right checks and balances and countering state capture.

Labor market reforms that involve improving the quality of education and training; reducing restriction to allocation and devising unemployment insurance schemes that minimize negative impact of labor adjustment is strongly needed. Furthermore, the influence of a new actor - civil society - comes into play. Evidence shows that in the MENA region, local governments and civil society organizations play a more proactive role in conflicts ridden countries such as in the West Bank, Gaza Strip, Lebanon and more recently Iraq.

## CONCLUSION

Our analysis shows as institutions play an important role in the relative performances of countries in attracting important business and commercial transaction. It is now widely accepted that the “rule of law” is key to sustainable development.<sup>10</sup> The different legal or rule-based systems in any given society underpin the institutions that govern both market and non-market interactions; they determine the distribution of economic, social and political rights and obligations affecting both economic and non-economic relationships. They shape the regulation of market practices and the delivery of public services, and hence the opportunities people have to take part in economic activity and generate fair returns. Legal institutions also provide mechanisms to mediate conflict resolve disputes and sustain peace and order. Our findings suggest that the perceived quality of domestic institutions matters for a country’s participation in international trade. Domestic institutions reduce international transaction costs. High quality institutions indicate that foreign investors are reasonably assured that they can enforce a contract by using legal institutions in that country, if needed. Given that complex goods are more prone to disputes for reasons related to incompleteness of contracts, higher scores on institutional quality increase a country’s propensity to export complex goods. By contrast, countries that fail to improve institutional quality may wind up in a low equilibrium trap of exporting primarily simple rather than complex goods with relatively limited prospects of diversifying into more lucrative complex goods markets. In addition, high quality institutions reduce transaction costs at home, which again benefits complex goods more than simple goods. We also found that international institutions matter. Countries that have ratified the NY Convention, for example, are able to improve their position in international trade flows, even when domestic institutional quality has not caught up. In particular, ratifying the NY Convention enhances a country’s trade in complex goods. This suggests that to the extent countries can credibly commit to complying with international norms, international law may substitute for weak legal institutions. The channel through which international institutions affect trade flows, however, is indirect. Ratifying an international legal instrument signals a country’s willingness to play by the rules set forth therein. This influences the perception of firms from that country as reliable trading partners. Indeed, our results indicate that ratifying the NY Convention changes both the perception of institutional quality and trade flows. These changes occur even in the absence of real reform. Sustaining these effects requires a certain level of compliance, however. We revealed that while ratifying the NY Convention may send a strong signal, failure to comply with its rules can undermine a country’s credibility as a trading partner. Regaining credibility may require more than just signaling. Instead, it might call for tangible reforms on a national scale and a track record of implementing them. This interpretation of our results is consistent with the notion of institutions as “sustainable systems of shared beliefs.”

Recent changes in the world economy brought about by globalization that has made very apparent the cost of non-reform. The pace of the changes entailed by globalization compels national governments to react by changing the rules of the game, i.e., reforming their institutions. The fight for survival and against the risk of marginalization in an increasingly competitive and integrated world, requires the creation of market-friendly institutions; a stable economic environment; a higher degree of preparedness to adjust to external shocks; proper regulations that influence market outcomes that are not socially optimal; the provision of

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<sup>10</sup> For different discussions on the link between weak institutions and economic development see the World Bank’s website on anti-corruption and public sector management at <http://www1.worldbank.org/publicsector/anticorrupt/index.cfm>; GLAESER, SCHEINKMAN and SHLEIFER (2002). HABER (2001).

public goods such as property rights and basic social services; and the protection of the vulnerable and the environment.

In light of the challenges facing the countries of the MENA region in reforming their institutions, authors have been very insightful in showing in various ways and the various contexts in which institutions affect growth and development. However, it is only natural that research on institutions in the MENA region should go beyond proving that they matter. Research should be directed to the question of how institutions evolve over time and under what circumstances they can become an obstacle to development. Moreover, a more normative and prescriptive stance in research is needed in order to increase its policy relevance for the policy makers in the region.

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