Quality of institutions and integration in the world economy: Applied study on Egypt

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ABSTRACT: Does better institutional quality of countries have higher integration in the world economy (to trade and FDI)? This paper offers a critical review of the fast-growing comparative research on relationship between institutions, trade and FDI. The paper investigates the role of quality of institutions on FDI and trade in Egypt during the period 1995-2010. The empirical analysis finds that Quality of Institutions has a positive and significant effect on trade flows and FDI and Quality of Institutions have a larger effect on FDI than trade and is statistically significant. These results support the hypothesis that institutional variation is an important determinant of trade and FDI and might help to explain why some countries observe positive welfare effects of an increase in trade openness and FDI, whereas other countries do not benefit from FDI and trade.

Keywords: Quality of Institutions, Governance, corruption, Openness, Foreign Direct Investment (FDI), Trade.

JEL Classification: Q3, Q4

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Introduction

Openness is good for any Country. Countries that are integrated into the world economy benefit from technological linkages, access to ideas and larger markets. But what determines openness and how do countries become integrated in the world economy?. Is trade and FDI enough or does integration into the world economy requires deeper policy changes, such as institutions reforms or better governance? (Berkowitz et.al, 2003).

There has been a growing interest in the determinants of foreign direct investment (FDI) and trade in developing countries, as FDI is considered one of the most stable components of capital flows to developing countries and can also be a tool to transfer of technological progress through the use and diffusion of improved production techniques (Agnes, et.al, 2007). Simultaneously, there is extensive theoretical and empirical literature on the potential gains from trade. Countries that open up to foreign trade can achieve Co-benefits due to gains from the exchange and gains from specialization.

Recent literature has much improved our understanding of the role of institutions in countries' economic performance. The empirical studies of quality of institutions focused on four major sectors: economics, political, social, and environmental. Economically, the studies concerned with the impact of institutions on growth, trade and FDI as a key variable in any economy. Although, these studies show interest in answering this open question-"Does the Institutions matter"?, a lot of empirical evidences suggest that the relationship between institutions, trade and FDI is ambiguous, which may be due to either sampling or measurement issues. One of the possible solution that can help us to overcome these ambiguous results is to rely more on the time-series variation in institutions, trade and FDI, hoping that internal instruments will be less weak than the cross-sectional applications. For this reason, this study is based on the use of time-series analysis in an attempt to overcome some measurement problems.

Compared to the literature on institutions and growth, the literature of the impact of institutions on trade flows and FDI has limiting. Regarding trade, Anderson (2001) suggested that the retreat performance of institutions reduces foreign trade, because it increases the costs and risks of trading abroad. Anderson and Marcouiller (2002) noticed that good institutions increase the trade. Finally, Dollar and Kraay (2002) conclude a positive relation between openness and the quality of institutions with bilateral relations between the two variables. Concerning FDI, a first study by Wheeler and Mody (1992) unsuccessful to find a significant relationship between FDI and institutions. The estimation results of Wei (2000) by using a comprehensive data set of bilateral FDI flows, find that a negative relationship between corruption in the host country and FDI. Also, Henisz (2000)

finds that foreign firms prefer to enter countries with large population and reliable political rules (Sekkat and Meon, 2004).

The main objective of this paper is to provide an assessment of empirical evidence on the effects of institutional quality on FDI and Trade in Egypt. It will focus on two related questions:

(i) What are the factors that appear to help countries obtain the benefits of integration in the world economy (to trade and FDI)?

(ii) To what extent do improvements in institutional quality help attract more FDI and trade flows in Egypt?

Econometric specifications of trade and FDI inflows' determinants are estimated to include both traditional explanatory variables and indicators of the quality of institutions. The result of the paper suggests that Quality of Institutions has a positive and significant effect on trade flows and FDI and Quality of Institutions have a larger effect on FDI than trade and is significant.

The rest of this paper is organized as follows: Section 2 provides a literature review divided into two parts, the first deals with the relation between quality of institutions and trade and the second explores the relation between quality of institutions and FDI. Section 3 provides trends of economic integration with the world economy in Egypt. Section 4 discusses the variables, data set and the empirical model. Concludes of the paper are presented in section 5and section 6 is policy implication.

Literature review

Quality of institutions and trade

What does theory tell us about the impact of institutions on trade? To provide a theoretical perspective, the paper combine lessons from the literature on trade determinants with the literature on institutions and trade.

The study of the relationship between institutions and trade is still in its infancy, which results in the relative scarcity of theoretical arguments linking trade and governance. However, there are reasons to contend that institutions may affect trade both directly and indirectly. A lot of empirical evidence suggests that the relationship between institutions and trade is ambiguous and may be due to the second best theory or sample selection bias.

This section reviews the recent empirical evidence on the impact of institutions on trade. Table 1 provides an overview of the different studies in terms of country

samples, time periods and institutional variables used. It also summarizes the main findings.

Table 1: Selected empirical studies of the impact of institutions on trade

Author(s)	*Sample*	*Main results*
Directly affect of institutions on trade		
Anderson and Marcouiller (1997)	General equilibrium trade model with endogenous the predation.	Insecurity may prevent trade even though it offers the potential mutual gains. For example, the predation reduces trade not only because it is a direct deduction on the flow of traded goods, but also because it diverts resources from their productive allocation towards the defense of property rights.
Anderson and Young (1999)	Simple model of replete with paradoxical comparative statics with paradoxical comparative statics.	Lack of enforcement of contacts may act as a tariff on risk-neutral traders and therefore reduce trade.
Anderson and Marcouiller (2002)	48 developing and developed countries 1996.	Institutional variables are significant determinants of the trade.
Bigsten et al. (2000)	Manufacturing firms in four African countries 1992 - 1995.	Contractual flexibility is pervasive and that it is a rational response to risk.
De Groot et al, (2004)	Set of more than 100 countries 1998.	Institutional quality has a significant, positive and substantial impact on bilateral trade flows. The results support the hypothesis of the study that institutional variation is an important determinant of informal barriers to trade.
Gilbert (2002)	102 countries 1970-2000	Failed policies to trade due to the low institutional quality may be the cause as it was still dependent upon primary exporting products introduced by the European colonization in the 19th century.
Matthias, et al (2007)	The Asia Pacific Economic Cooperation (APEC) member economies.	Improving trade-related transparency in APEC could hold significant benefits by

		raising intra-APEC trade.
*Ambiguous relationship between institutions and trade*	
Lambsdorff (1998)	2 importing developing countries and 6 exporting developed countries.	The degree of corruption in importing countries affects the trade structure of exporting countries. It is concluded that these findings are due to the differentiated inclination of exporters to offer bribes.
Lavallée (2005)	145 countries 1984-2002	Corruption must be analyzed as a Directly Unproductive Profit-seeking activity (DUP)**,** such as tariff evasion or smuggling.
Rodrik et. al (2002),	Model for three different samples: the original 64-country sample used by AJR; an 80-country sample which is the largest sample, we can use while still retaining the AJR instrument and 140-country sample that maximizes the number of countries by replacing the AJR instrument	Once institutions are controlled, the trade is almost insignificant and often enters the income equation with the "wrong" (i.e., negative) sign, although trade too has a positive effect on institutional quality.
*Indirect effect of institutions on trade through economic growth*	
Das, 2010	102 countries (76 developing countries, 22 OECD countries and 29 least developed and small-medium size countries- over 5 time periods.	Economic institutions have a more significant impact on development than social or political institutions. It is possible that countries with better institutional quality are in a better position to reap benefits from trade integration and geography.
Dollar, 2003	102 countries-over 1980 to 2004.	There is minimal evidence to suggest that institutions have a negative impact on development. Our results further indicate that parametric estimates suffer from misspecification bias and the impact of institutional quality on development quality is heterogeneous across countries and time periods.
Olson et al. (2000),	Cross- country on developing	Subset of developing countries is growing very rapidly, taking advantage

	countries.	of opportunities to "catch-up" at the same time that other developing countries are growing slowly. This is due to differences in the quality of governance.
Hall and Jones(1999)	Across 127 developing and developed countries.	The differences in capital accumulation, productivity and therefore output per worker are driven by differences in institutions and government policies.

A theoretical analysis by Anderson and Young (1999) provided a first theoretical illustration of the relationship between institutions and trade. They found that the lack of enforcement of contacts may serve as the customs duties on risk-neutral traders and decrease in trade.

Using gravity models, Anderson and Marcouiller (2002) lend empirical support to the impact of the quality of institutions on trade. They argued that weak institutions acted as significant barriers to trade. Increasing the transparency of the trading environment through greater predictability and simplification can be an important way of reducing trade costs (Matthias, et al 2007) while De Groot et al, 2004 found that both institutional quality and existence of similar institutions in trading partners were positively associated with bilateral trade. Also, Lavallée (2005) uses a gravity model to assess the impact on the trade of the proximity and the quality of institutions. A new index of institutional similarity is proposed, it is computed on the basis of data on national legal traditions.

The trade policy can explain the relation between institutions and trade. Gilbert (2002) explains the importance of 'good governance or quality of institutions in addition to trade openness (policy). Also the effect of institutions on trade may result from their effect on the risks associated with international transactions. Anderson and Marcouiller (1997) found that the lack of security may prevent trafficking even though it offers the potential mutual gains. For example, predation reduces trade not only because it is a direct deduction on the flow of traded goods, but also because it diverts resources from their productive allocation towards the defense of property rights. It follows that good institution that may help bar predation and thus foster trade (Sekkat and Meon, 2004). Bigsten et al. (2000) examine the contractual practices of African manufacturing firms using survey data, I t is shown that contractual flexibility is common due to the risk.

Although, a lot of studies find that institutions quality has a positive and sensitive impact on trade, this conclusion is not shared by Rodrik et. al (2002), the authors concluded that institutions have strong have effects on income while trade shows

weaknesses. Lambsdorff (1998) finds that the corruption in importing countries influences the trade components of exporting countries.

However, this literature neglected "second best theories" which considered corruption as a way to bypass imposed by governments. Bhagwati (1992) suggests that corruption must be explained as a Directly Unproductive Profit-seeking activity (DUP). Regarding of international trade, corruption can be compared to other DUP activities such as tariff prevarication. Although these theories do not explain the relation between the corruption and trade directly, they considered corruption as a tool of promoting trade (Lavallée, 2005).

In addition to their direct effect, institutions may also indirectly affect trade through their impact on other variables that determine trade flow such as investment and productivity. Hall and Jones (1999) observed that bad institutions reduce aggregate productivity. While Olson et al. (2000) found that the lower of productivity is an impediment to competitiveness in the world markets, one may reasonably expect that countries whose institutions result in low productivity will likely have difficulties in exporting and trading abroad. Wacziarg (2001) measures the impact of trade openness on economic growth in the long-run through a range of distinct channels, which include government size and enhanced government policy (institutional quality).

Quality of institutions and investment

There is a lot of literature to explain the impact of institutions on FDI. The importance of the impact the institutional factors on (FDI) has long been understood in the economics literature. The earlier study by Bose (1963) finds that the political instability has an effect on FDI. More recently, the literature on impact of institutions on FDI increased for several reasons; first, it is widely believed that the trend towards integrated production and marketing has the major cause for developing country attractiveness to foreign direct investment (FDI). Second, the growth of FDI flows to developing countries since the early 1990s reflect that multinational enterprises have increased presence in these host countries as competitive investment locations. Together, many specialists confirmed that the determinants of FDI in developing countries have changed in the process of globalization. The investors are becoming more interested in institutional quality compared with traditional determinants of FDI when decide to invest in the country (Bevan et al 2004).

This section reviews the recent empirical evidence on the impact of institutions on FDI. Table 2 provides an overview of the different studies in terms of country samples, time periods and institutional variables used, it also summarizes the main findings**.**

Table 2: selected empirical studies of the impact of institutions on FDI

Author(s)	Sample	Main results
Positive and significant relationship between institutions and FDI		
MacDonald, et.al, 2008	107 countries	Institutions are tools of predictor of FDI and there is a significant relation between Institutions and propriety rights.
Addison & Heshmati 2003	110 countries	There are positive relation between Democracy and FDI.
Asiedu 2005	22 African countries.1984-2000	The countries can attract more FDI by Less corruption, political stability, and a good legal system.
Busse & Hefeker 2005	83 developing countries. 1984-2003	Democratic rights, Government stability and ensuring law and order are highly significant determinants of FDI.
Busse, 2004	69 developing &emerging market countries. 1972-2001	There is a positive relation between democracy and FDI, but this not for 1970's and 1980's.
Campos& Kinoshita, 2003	25 transition economies. 1990-1998.	Both institutional factors are positive and significant.
Drabek &Payne 1999	49 countries 1991-95.	Countries that increase the grade of transparency in its policies and institutions could expect significant increase in FDI inflows.
Darby et.al (2010)	Developing countries	Good public governance has a positive and significant effect on FDI in a given host country.
Daude and Stein (2007)	Developing countries	Institutional factors are significant determinants of the location of FDI. Especially the laws, regulations and policies, excessive regulatory burden, government instability and lack of commitment play an important role in deterring FDI.

Gastanaga et al 1998	22 less-developed countries. 1970-95.	Different institutional characteristics are shown to have significant effects on FDI.
Globerman & Shapiro 2002	144 countries 1995-97	The general Governance Index is more important than Human development index and Infrastructure index
Jensen 2003	114 countries. 1970-97.	Democracy has a positive effect on FDI but other institutional variables have no significant effects on FDI.
Kolstad & Tondel 2002	61 developing countries 1989-2000.	Democracy is a very factor determinant of FDI. On the other side, Government stability and bureaucratic quality not important for FDI, the external conflict and law are not important for Foreign investors.
Li & Resnick 2003	53 developing countries. 1982-95	There are positive relation between Democracy and FDI by improving property rights and negatively by imposing constraints on FDI in host country's government.
Meon & Sekkat 2004	107 countries.	Political risk and corruption have an effect on FDI.
Non-significant effect of institutions and FDI		
Asiedu 2002	71 developing countries. 1988-97	There is no significant relation between Political risk and FDI.
Harms & Ursprung 2002	62 developing & emerging-market countries. 1989-97	Countries has a political freedom can attract FDI and this variables is very important comparison of other institutional variables.
Noorbakhsh et al 2001	36 developing countries 1980-94.	Democracy and political risk have no significant effect on FDI.
Jun & Singh 1996	31 countries. 1970-93.	Institutional determinants have positive effects on FDI but not strong relation.

The literature that specializes in studying the relation between the quality of the institution and investment explain a lot of results. Firstly, the literature provides guidance about the relative importance of institutional factors that effect on attracting FDI. Gastanaga et al. (1998) find that corruption, bureaucracy and incomplete contract application are associated with lower FDI to GDP ratio. Also, Globerman and Shapiro (2002) estimate the effect of component of governance indicators on both inflows and outflows FDI, they find good governance has both positively impact on FDI inflows and outflows and The general governance index is more important than human development index and infrastructure index. Campos et al. (1999) find that the predictability of corruption is important and a significant determinant of the investment ratio. A same result explains by Brunetti et al. (1998).

Lambsdorff (2003) view that the predictability of corruption has an effect on capital inflows that is distinct from the effect of the level of corruption. Darby et.al (2010) investigates whether the high prevalence of south multinational enterprises (MNEs) in risky developing countries may be explained by the experience that they have acquired of poor institutional quality at home. They concluded that the positive impact of good public governance of FDI in the host country is moderated significantly and even in some cases eliminated, when MNEs have been faced with poor institutional quality at home.

Secondly, however, there are a lot of studies argue the effect of the institutions factors on FDI, there are some of the studies find that institutions not matter for FDI. Asiedu (2002) finds that political risk and expropriation risk have no effect on FDI but he explains the relation between institutions and FDI by sector, where political risk which may well be explained by the high profitability of FDI in the oil sector which more than satisfy for political risk. Noorbakhash et. al (2001) finds that no relation between democracy and political risk and FDI. Harms and Ursprung (2002) and June, Singh (1996) find that the effects of institutions on FDI are not strong (MacDonald, et al, 2008). Been attributed a large part of these results to sampling or measurement issues.

Thirdly, some of studies explain the indirect effect of bad institutions on FDI flows through their effect on other index. These studies such as (Mody and Srinivasan, 1998, Noorbakhsh, Paloni and Youssef (2001) and Globerman, Shapiro, 2002), shown that human capital index, health of the workforce and the public infrastructure have an effect on FDI.

Finally, the results of previous studies suggest that the relationship between institutions and FDI is ambiguous. Although a lot of empirical studies support the positive relation between institutions and FDI but some studies evidence against institutions. The ambiguous relationship between institutions and FDI due to sample selection bias, difference measurement, conceptual, and methodical

problems in the empirical studies. On the other side, the deference between the countries (developing or developed) and the time can explain the variation in the relationship between institutions and FDI. Where FDI is very important, especially for developing countries and there is being increasingly attracted by manufacturing and services (during 1990s) compared by the primary sector Busse (2004), this will need more studies for this relationship, especially in developing countries.

Trends of economic integration with world economy in Egypt

Egypt is a lower middle-income economy in the Middle East and North African region. Although, Egypt retains its key advantages – a large domestic market, an enviable strategic location and a relatively diversified economy, but a decline in institutional quality in Egypt, one of the key drawbacks for their ability to integrate with the world.

FDI trends in Egypt

Table 3 provides an Egypt FDI Inflows (US$ billions) and the ratio of FDI inflow to GDP (%).

Table 3: Egypt FDI Inflows (US$ billions, % GDP)

Years	FDI (US$ billions)	FDI\GDP (%)
1995	598	1
1996	636	1.1
1997	890	1.2
1998	1.076	1.3
1999	1.065	1.2
2000	1.335	1.2
2001	510	1
2002	647	1
2003	247	.2
2004	1.253	2
2005	5.375	6
2006	10.042	9.3
2007	11.578	9
2008	9.494	6
2009	6.711	4.1
2010	6.385	2.9
2011	1.812	.7

Source: World Development Indicators (WOI), Various Year, World Bank.

There was very modest in the foreign direct investment (FDI) inflow in Egypt since 1995 in comparison to many developing countries. During the period 1995-2000 the FDI inflows increase from$ 598 billion to$ 890 billion in 1997 and peaked in 2000 at nearly $1.5 billion, but fell to $510 million in 2001. Starting from 2004 to 2007 the FDI inflow increased gradually to reach to $ 11.578 billion in 2007 (see table3). The declines in FDI in 2008 came mainly from a significant reduction in FDI flows to developed countries, whereas flows to developing countries remained resilient with an expansion of 17%. There are major changes in global FDI patterns in 2008 that preceded the global crisis and that will most likely gain momentum in the short and medium term*(World Investment Report, UNCTAD, 2011).*

Inflow during the last two years averaged $2.8 billion per quarter, much of it from the EU, which invested $1.6 billion (59%), followed by the US with an average quarterly inflow of $445 million (16%). In 2010, Egypt saw it FDI inflow drop to $6.380 billion, but maintained its place as Africa's second largest recipient of investment, receiving 12 per cent of the continent's total (*World Investment Report, UNCTAD, 2011).*

During the period 1995-2004 the average ratio of FDI to GDP was 1%. Beginning of 2005 this ratio rose significantly to reach 6%, then 9.3% in 2006**.** Since 2009 the ratio has declined again to reach the lowest level.7 in the year 2011 to reflect the political changes in Egypt since 2011 and which affected directly on FDI inflows.

The FDI inflows decreased from $6.3 billion at 2.9% as a ratio of GDP in 2010 to $1.81 billion at 7% as a ratio of GDP in 2011. The main explanation for the decline is Egypt's widespread political upheaval during the first quarter of 2011 when a popular uprising led to the ouster of longtime President Hosni Mubarak.

The Government has approved measures to simplify the procedure for approving new industrial projects and to ease the restrictions on setting up franchises. However, the impact of investment incentives might be limited in the current climate of political transition and the return of investor confidence is likely to depend on the overall political settlement and the geopolitical situation surrounding the country.

Trade trends in Egypt

Trade has an important role in economic development in developing countries. On the other side, Trade policy plays an influential role in attracting FDI in these countries. In Egypt, trade has played a significant role in Egypt's economic development. Exports of goods and services have been pushed the economic growth and export-led growth was a key factor in the economic recovery which

took place between 2004 and 2008. However the results of the assessment indicate that Egypt has achieved substantive reforms in almost all areas of trade policy; the country still needs to be facing a number of challenges, especially in the quality of institutions that directly affect on investment and trade in Egypt.

Table 4: Trade (Merchandise and Commerce Services) and Trade openness ratio in Egypt 2000-2011(Billions US$)

	Export			Import			Trade openness ratios
	Merchan-dise Export	Commerce Services Export	Export/ GDP	Merchand-ise Import	Commerce Services Import	Import/ GDP	
2000	5 276	9 687	16	14 578	7 161	23	39
2001	4 825	8 815	17	13 376	6 356	22	40
2002	5 546	9 127	18	12 770	6 013	23	41
2003	7 408	10 837	22	12 950	6 038	24	46
2004	9 661	14 046	28	15 950	7 470	30	58
2005	12 912	14 449	30	22 449	9 507	33	63
2006	16 728	15 834	30	27 300	10 288	32	62
2007	19 224	19 660	30	37 100	13 088	35	65
2008	26 224	24 660	33	48 382	16 335	39	72
2009	23 062	21 302	25	44 946	12 765	32	57
2010	26 428	23 618	21	52 923	13 003	26	47
2011	29 611	19 265	23	58 940	13 546	30	53

Source: World Trade Organization (WTO), Trade Statistics, 2012.
Trade openness ratio = Trade (exports + imports) as a percentage of GDP.

Egypt has more liberalized its economy and opened it up to foreign trade. It has expanded its network of regional and bilateral trade agreements and protocols with its main trading partners, the EU and the US. Openness of trade (exports + imports/GDP) has increased from just over 39% in 2000 to 72% in 2008, with the exception of a small drop during the worst of the financial crisis in 2009 (see table 4).   The signing of regional trade agreements has led to rising trade with neighboring Arab countries in the last decade. Indeed, in 2008-9, Arab countries represented an 11.4% share of Egypt's total trade up from 8.9% in 2003/4 and 5.3% in 2000/1(OECD, 2010).

Egypt's total merchandise and Commerce Services export have been increasing steadily, with the exception of a small drop during the worst of the financial crisis in 2008 (see table 4). For the years 2007-2009, the ratio of trade to GDP (trade/GDP) in Egypt was 65.2%. In 2009 the country exported US$23.1 billion in merchandise while it imported US$44.9 billion in merchandise, then in 2011 the merchandise export increased to US$ 29,6 billion. For commercial services, Egypt exported US$25.4 billion in 2011 while importing US14.5 billion

in the same year, the export of the commercial services in Egypt concentration in information and communication technology (ICT).

The most important trade partners of Egypt are the United States, Italy, China and United Kingdom. The major exports of Egypt include: agricultural products (citrus fruits, rice and dried onion), chemicals, metals and its products; cotton, textiles and clothes. On the other side, Egypt's imports mostly include: fuels, foodstuff, cereals, chemicals, machinery and electric equipment.

The Asian emerging countries are most important trading partners of Egypt after the EU and the United States (US). Over the past five years, the non-Arab Asian countries accounted for 16.6% of Egypt's total merchandise trade. China led the way with 5.5%, followed by India with 3.4% and South Korea 2.0%.

Quality of institutions in Egypt

Egypt recorded a decline in all indicators of governance (Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Low and Control of Corruption) during the past two decades. The score of Egypt recorded-0.37 in 2000 and -0.65 in 2010 (the scale of indicators is -2.5 - +2.5 – see table 5).

Table 5: Indicators of governance in Egypt (1996-2010)

	Years	*Percentile rank (0-100)*	*Governance Score (-2.5-+2.5)*
Voice and Accountability	2010	13.3	-1.20
	2005	21.6	-0.96
	2000	24.5	-0.82
	1996	25.5	-0.74
Political Stability	2010	17.9	-0.91
	2005	24.0	-0.75
	2000	4.8	-0.70
	1996	25.5	-0.64
Government Effectiveness	2010	40.2	-0.43
	2005	39.0	-0.43
	2000	46.8	-0.21
	1996	50.7	-0.51
Regulatory Quality	2010	46.9	-0.18
	2005	39.2	-0.41
	2000	35.8	-0.35
	1996	52.5	+0.01
Rule of Low	2010	51.7	-0.11
	2005	53.6	+0.03
	2000	52.6	-0.01

	1996	55.0	+0.08
Control of Corruption	2010	34.4	-0.56
	2005	38.0	-0.52
	2000	43.4	-0.39
	1996	56.1	-0.07

Source: World Bank, Governance Indicators, 1996-2010

The Middle East and North Africa, which has long been the region with the lowest levels of democracy in the world, continued its steady decline in 2010. In addition to a reduction in Egypt resulting from the country's sham elections, declines were seen in Bahrain, Kuwait, and Iran. There were no status or ratings improvements in the region (see table 6).

Table 6: Comparison between Middle East& North Africa (MENA) of important indicators of governance in 2010.

	Control of Corruption	*Political Stability*	*Voice and Accountability*
Egypt	34.4	17.9	13.3
Algeria	37.8	11.8	18.5
Israel	72.2	9.4	67.8
Jordan	58.9	34.4	26.5
Lebanon	21.5	8.5	35.5
Morocco	53.1	27.8	28.4
Syria	14.8	21.7	4.7
Tunisia	55.8	50.5	10.4
United Arab Emirates	80.4	75.9	24.2
Kuwait	67.0	60.8	32.2
Bahrain	63.6	33.5	25.1
Qatar	91.4	86.8	91.4
Malta	79.4	90.1	86.7

Source: World Bank, Governance Indicators, 1996-2010

The corruption perceptions index measures the perceived levels of public sector corruption in 183 countries and territories around the world. A country/territory's score indicates the perceived level of public sector corruption on a scale of 0 - 10, where 0 means that a country is perceived as highly corrupt and 10 means that a country is perceived as very clean. The score of corruption perception index CPI declined in Egypt during the last six years, while the rank in 2005 is 70 by scoring 3.4, and the rank in 2011 is112 by scoring 2.9 (see table 7).

Table7: **Corruption perceptions index** in **Egypt (1996-2011)**

	Rank	*Score*
1996	41	2.84
2000	63	3.1
2005	70	3.4
2006	70	3.3
2007	105	2.9
2008	115	2.8
2009	111	2.8
2010	98	3.1
2011	112	2.9

Source: Corruption Perception Index (CPI)

Egypt shifted from Partly Free to Not Free as a result of a crackdown prior to and during the November 2010 parliamentary elections, which included legal harassment, spurious arrests and violations of due process against journalists and bloggers. The pre-election period also saw a satellite television outlets and text-message based news services banned; both are key outlets for disseminating independent views (see table 8).

Table 8: Freedom House Index of political freedom in Egypt (2002-2011)

	2002	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
Status	Not free	Not free	Not free	Partly free	Partly free	Partly free	Not free
Free freedom Score	56	58	62	59	60	60	65
Legal Environment	26	22	22	21	21	21	23
Political Environment	28	21	22	20	21	21	24
Economic Environment	23	18	18	18	18	18	18

Source: Freedom House Index of Political Freedom, 2002-2011.

The institutional framework is an important element in explaining the size of transaction costs that include: the registration costs, the real estate agent fees, the legal fees and the sales & transfer taxes. A low quality of institutions increases the transaction costs that are incurred in exchange. Egypt recorded a rise in the ratio of

transaction cost (11.74%) compared to other countries in the Middle-East (see table 9).

**Table 9: The transaction cost as a percentage of property value (%)
in the Middle- East (2011)**

Jordan	Morocco	Egypt	Lebanon	Iran	Israel	Tunisia	UAE	Bahr -ain	Oman	Qatar
15.24	12.3	**11.74**	11.57	9.93	9.57	7.10	5.05	5	3.01	0.00

Source: Global Property Guide Research.

The policy instability, inefficient government bureaucracy and corruption represented 13.6%, 9.2%, 7.5% respectively, of the problematic factors for doing business in Egypt. Also, irregular payments and business costs of terrorism have a negative effect on the business sector and record low score at 3.6, 3.8 respectively [1 = very low; 7 = very high], relatively with the most of developing countries (The Global Competitiveness Report, 2011-2012).

The rule of law has the highest value among governance indicators in Egypt (see table 5). The efficiency of the legal framework for private businesses recorded score at 4 and the rank 50 from 142 countries (The Global Competitiveness Report, 2011-2012). Also, the business environment has had many challenges since the nineties of last century, which did not show an improvement only in the last five years, for example: the number of days required to obtain an operating license decreased from 150 days in 2000 to 113 days in 2004 and then 43 in 2009. Also, the time required to start business decline from 45 days in 2000 to 7 days in 2010[16] (World Development Indicators, World Bank). Such institutional challenges affected the business environment and more particularly foreign direct investment inflows in Egypt during the past decades

The Empirical Model

The key question is the extent to which the empirical strategy of the papers discussed in the previous section is an appropriate one to evaluate the effects of institutions on trade and FDI and so, the institutions quality impact on Egypt's integration in the world economy**.** A two-step analysis is used in this paper. The

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[16]-The institutional variables such as: cost of transactions, complexity of administrative systems, uncertainty over rules of the game and allocation of cost/risk as the key variables that reflect the degree of institutional quality affecting the business activity, but due to the non-availability a time series of these data in Egypt and the lack of any data on some of these variables, it has adopted the model applied in this study on the governance and corruption variables, which used by allot of the studies in this area.

first step identifies the impact of institutions quality on trade. The second assesses the influence of institutions quality on foreign direct investment.

Regression Analysis of Influencing Institutions Quality on Trade

The dependent trade variable is defined by the degree of openness, measured through time series (1995-2010): Openness in trade = (Exports + Imports) /GDP.

Four explanatory variables are used, two of them are being related to the quality of institutions.

-GDP of partners: Relative size of partner's countries also directly affects bilateral trades between two countries. In particular, it predicts that countries with high incomes or GDPs tend to trade more with each other. Historical works, especially those of Tinbergen, Nobel Laureates in Economics, supported these predictions. The coefficient of GDP of Egypt's partners expected should be positive. The paper measure the average of the main partners of trade in Egypt, European Union (EU) and the United States (USA).

-Foreign direct investment variable: This is measured as the ratio of foreign direct investment to GDP. The paper takes the lag of this variable. This is based on the assumption that investment must be raise the capacity, resulting in a greater supply of goods and increasing the imports of intermediate goods for increasing the production. The importance of technology and inflow physical capital for economic growth provides an important link between FDI inflows and host country economic growth (Hermes& Lensink 2003 and Andreas 2006). Therefore a positive relationship between openness and FDI is expected.

Although the overall importance of institutions has been emphasized in the literature, there is less agreement on how to measure the quality of institutions. The paper uses the two time varying indices: the index published in the Governance Indicators of the World Bank and freedom house's index of political freedom. The paper expects to see a positive effect of the quality of institutions on trade.

A better quality of the institutional framework reduces uncertainty about contract enforcement and general economic governance. This reduces transaction costs directly by increasing the security of property, as well as indirectly by increasing the level of trust in the process of economic transactions. Homogeneity in the perceived quality of institutions may give rise to similar norms of behavior (conventions, business practices) and similar levels of trust in doing business. Institutional homogeneity leads to familiarity with each other's formal procedure and with the informal conventions and habits developed to deal with the

governance situation. Countries with good quality of institutions will be likely to facilitate economic activities and other factors that could positively affect trade.

- Governance Indicators: the paper used the most recent and comprehensive data-set on the quality of governance available. This database was constructed for the World Bank by Kaufmann et al. (2002). Indicators from 17 different sources, constructed by 15 organizations have been combined. We discuss these indicators in turn.

- Accountability, State power must be accountable before other countervailing, monitoring institutions in the state and civil society. Accountability is capturing perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

- Rule of law, indicates the quality of the legal system. It indicates society's perceived success in upholding fair and predictable rules for social and economic interaction. Essentially, it focuses on the quality of the legal system and the enforceability of contracts.

- Control of Corruption, indicates the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

 - Government Effectiveness, indicates the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

- Political Stability, indicates the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

- Regulatory Quality, indicates the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. ,

These variables are subjective measures of the Quality of Institutions. All indicator scores have been scaled from –2.5 to +2.5 (see Kaufmann et al. 2002).

- Political freedom: The paper chose freedom house's index of political freedom to use the political rights and civil liberties based on a 1 to 7 scale, They averaged two scores to create the freedom variable. Hence, each of our dependent variables range from 1 (the highest level of political rights, civil liberties and freedom) to 7 (the lowest level of political rights, civil liberties an overall freedom).

The true model can be specified in a single equation model as can be seen in the following (Eq 1):

$$OPE_t = \alpha_0 + \alpha_1 GDP_{tp} + \alpha_2 FDI_{t-1} + \alpha_3 GOV_t + \alpha_4 PFI_t + + \mu_t$$

Where OPE for openness of trade, GDP stands for gross domestic product of main trading partners, FDI for the ratio of foreign direct investment to GDP, GOV for governance indicators and PFI for freedom house's index of political freedom and $\alpha_1, \alpha_2, \alpha_3, \alpha_4$ are slops coefficients with respect to the variables GDP, FDI,

GOV, and PFI respectively, α_0 is the intercept term and μ is the disturbance (error) term. The linear form was chosen and OLS is the method of estimation.

Regression Analysis of Influencing Institutions Quality on FDI

As mentioned above, the dependent variable can be measured by FDI through time series 1995-2010. FDI variable represented as the ratio of foreign direct investment to GDP.

There are four explanatory variables should be used here to explain the expected changes in the dependent variable. They will be specified in the following:

Traditional Variables:

GDP Per capita: The foreign investor's goal is profit, so it will be more attracted towards fast-growing economies to ensure access to benefits and future opportunities resulting from increased growth. It may also be an indicator of growth rate of market expansion, which makes the investor expected to sustain the continuity of its activity and the flow returns (Jun, et.al, 1996). Therefore a positive relationship between GDP per capita and FDI is expected.

Inflation Rate: Countries that have a low rate of inflation and low level of budget deficit is expected to be more attractive to foreign direct investment, with low risk and expense transactions of the foreign investor. Particularly, the rate of inflation is the more indicators which reflect instability, the distortions and imbalances fiscal and monetary policies in the country, which adversely affect the level of profitability and then the decision of FDI. Therefore the negative relationship between inflation rate and FDI is expected.

Industrial Wages: Industrial Wages is considered a magnet or the expulsion of the foreign investor. The higher of the wage reflect in higher of cost and

then decreased the expected return of the foreign investor. The multinational companies prefer direct investment in developing countries which have low labor costs.

Institutional indicators

The paper uses the same two indexes (Governance Indicators and freedom house's index of political freedom) used before. A positive effect of the quality of institutions on FDI is expected. A low quality of governance increases the transaction costs that are incurred in exchange. The impact of institutions on investment is argued to be at least as important in international exchange as in domestic transactions. Moreover, the quality of formal rules affects the informal norms and procedures of doing business that is devised to cope with transnational uncertainty. Countries with good quality of institutions will be likely to facilitate economic activities and other factors that could positively affect FDI.

The true model can be specified in a single equation model as can be seen in the following (Eq 2):

$$FDI_t = \alpha_0 + \alpha_1 GDP_{tp} + \alpha_2 INF_{t-1} + \alpha_3 IWL_t + \alpha_4 GOV_t + \alpha_5 PFI_t + + \mu_t$$

Where FDI for the ratio of foreign direct investment to GDP, GDP stands for gross domestic product per capita (growth rate), INF for the inflation rate, IWL for Industrial wages, GOV for governance indicators, PFI for freedom house's index of political freedom and $\alpha_1, \alpha_2, \alpha_3, \alpha_4, \alpha_5$, are slops coefficients with respect to the variables GDP, INF, IWL, GOV, and PEI respectively, α_0 is the intercept term, and μ is the disturbance (error) term. The linear form was chosen and OLS is the method of estimation.

Results

Table 10 presents the results of estimation Influencing Institutions Quality on Trade in Egypt (1995-2010). The results for the openness of trade using the governance index explain a significant positive relationship (0.76) between the trade and governance. Also, there is a significant positive relationship (0.62) between political freedom and trade, confirming that higher political risk disables a country's participation in world trade. On the side traditional variables, foreign direct investment is associated with higher trade- there is a significant positive

relationship (0.41) between FDI and trade, but there is a non-significant positive relationship (0.05) between the GDP of main partners and trade.

We focus on the degree of governance index and political freedom index. Our estimation reveals that the elasticity of the trade to the index 0.76, 0.62. This means that if Egypt increased its good governance and political freedom by 1 per cent, during any year, its trade ratio would be expected to rise by 0.76 and 0.62 per cent respectively. In the regression, all coefficients of the control variables except GDP of partners are significant and have the expected sign, but stronger effect on trade of Institutions Quality variables compared with traditional variable. The whole model seems to be significantly accepted based on the value of R^2 (0.66). In addition to the reasonable value of D.W coefficient about 1.9 which means no autocorrelation or serial correlation.

Table 10: Results of Estimation (Eq, 1)
The dependent variable is the trade during (1995-2010)

Variable	GDP	FDI-1	GOV	PEI	
Coefficient	(0.05)	(0.41)***	(0.76)***	(0.62)**	
T- Statistic	1.06	4.72	3.92	2.65	
R^2	0.66				
D.W	1.9				

Note: t-statistics are in parentheses, and *, **, *** denotes significance at 10%, 5%, and 1%, respectively.

The estimation results in table 11 reveal that there is a significant positive relationship between good governance (GOV) and FDI by (1.17), it means that increase good governance has opened up new opportunities for Egypt to attract more foreign direct investment and rise of competitiveness. As expected, the political freedom variable has a positive at (1.58) and is a significant effect on FDI.

Accordingly, we cannot ignore other traditional determinants of FDI. INF variable significantly explains the changes in FDI in the negative direction (-0.09) as the economic theory said. As expected, the variable GDP has a significant and positive (0.44) effect on FDI. Industrial wages IWL may play a key role to support these traditional determinants, has a positive (-0.86) and significant (-3.15) effect on FDI. The importance of IWL variable refers to most of the countries with poor levels of governance are developing countries and poor, then moving most of the foreign direct investment to the labor-intensive industries

and endemism because of the presence features that make it more profitable for the company To produce or provide the service in the host country, rather than locally or export production (such as the abundance of cheap raw materials and low labor costs). The whole model seems to be significantly accepted based on the value of R^2 (0.95). In addition to the reasonable value of D.W coefficient about 2 which means no autocorrelation or serial correlation.

Table 11: Results of Estimation (Eq, 2)
The dependent variable is FDI during (1995-2010)

Variable	GDP	INF-1	IWL	GOV	PEI
Coefficient	0.44	(-0.09)**	(-0.86)***	(1.71)***	(1.58)***
T- Statistic	1.23	-2.95	-3.15	4.16	3.51
R^2	0.95				
D.W	2				

Note: t-statistics are in parentheses, and *, **, *** denotes significance at 10%, 5%, and 1%, respectively.

The econometric analysis confirmed the role of good governance and political freedom in fostering trade and is compatible with the results of empirical studies that supported the significant, positive and directly impacting of the institutions quality on trade (Anderson and Marcouiller (1997, 2002), Anderson and Young (1999), Bigsten et al. (2000), De Groot et al, (2004), Gilbert (2002), Matthias, et al (2007)). Similarly, estimation showed that a better quality of institutions and political freedom increase the attractiveness of countries with respect to FDI and has confirmed the results of empirical studies that supported the significant, positive and directly impacting of the institution's quality on FDI, such as, Addison & Heshmati (2003), Asiedu (2005), Busse & Hefeker (2005), Daude and Stein (2007), Meon & Sekkat (2004), Jensen (2003), Darby et.al (2010). Overall, the results explain strong support to the hypothesis that the performance of their institutions may disrupt the participation of Egypt in the global economy. From an econometric point of view, the results for FDI are, however, stronger than for trade. It is found that deterioration of the quality of institutions is, in general, associated with low performance in terms of trade and FDI attractiveness.

Conclusion

Recent research draws attention to the importance of unofficial barriers to international trade and FDI, caused by intangible factors. Theoretically, a low quality of governance increases the transaction costs that are afforded in exchange and the international commerce, financial integration induces countries to have efficient and less bad governance to increase the trade and attract foreign investors. The empirical analysis performed in this paper investigates the question whether the institutions affect significantly on the trade and inflows of FDI in Egypt as the main indicators of the Egypt's integration with the world economy. The ideas emphasized here are an addition to the recent growing literature that shows that weak institutions have relatively greater power in explaining a poor economic outcome (in particular in this paper, low trade and less inflows of FDI).

The empirical analysis finds that institutional quality measured by the various indexes taken from Kaufmann et al. (2004) and La Porta et al. (1999), has a significant, positive and substantial impact on trade flows, FDI and Quality of Institutions have a larger effect on FDI than trade and is statistically significant. These results suggest: (i) the hypothesis that institutional quality is an important determinant of trade and FDI, (ii) institutional quality is an important pre-requisite for successful trade liberalization and attracts FDI policies, (iii) explain why some countries observe positive welfare effects of an increase in trade openness and FDI, whereas other countries do not benefit from FDI and trade.

The results of the model support the notion that in general "Institutions Rule" and has confirmed the previous results of empirical studies that supported the significant, positive and directly impacting of the institutions quality on trade and FDI. The empirical evidences for a lot of studies suggest that the relationship between institutions, trade and FDI is ambiguous, which may be due to either sampling or measurement issues. Overall, the results in the paper indicate that in addition to the significance of institutions, the role of economic determinants which involves financial incentives and economic development based on the mechanisms of the free market have limited influence on attracting foreign direct investment and increase the trade compared with nontraditional determinants (institutions quality) which play the main effect on trade and FDI. These results encourage the efforts to increase the quality of institutions which may help Egypt and a lot of developing countries to increase their trade and receive more FDI, independently of the indirect impact of higher GDP per capita.

Policy implications

The results have the following policy implications. First, for a country that tries to attract FDI and increase the trade, improving the quality of institutions as a non-traditional determinant of FDI and trade**.** Second, Willingness to depart from traditional ideologies and attention to local institutions also makes the case for "rethinking governance" and "challenging orthodoxy", at least because empirical research shows that most developing countries have made scant progress in controlling corruption and improving institutional quality since the rise of the institutions quality agenda. On the other hand, a capacity-building and training tool on the impact of quality of institutions on trade and FDI for easy understanding by policymakers may value considering. Third, the importance of the impact of institutional quality on development quality has enormous policy implications for international organizations concerning for aid to developing countries known as "institutional conditionality", that threaten to cut off this assistance by these institutions, which must be brought to the attention of these countries.

Finally, the bad institutions in Egypt during the past two decades, not only the effect on widespread political and lead to the revolution in January 2011, but also effect on Egypt's ability to integrate with world Economy over the past decades. The results clearly show that Egypt is currently less likely to harness the gains from trade and FDI and that a reform of the institutional framework is clearly a highly important topic on the agenda. Supporters of institutional reform argue that it is precisely what Egypt needs, but that previous efforts did not go far enough, as the lack of institutional reform hampered efforts at economic reform and in the long term, institutional reform should result in better governance and thus lead to a more sustainable growth of economic activities, including trade and FDI.

The detailed analysis is beyond the scope of the present paper, but it would be useful to undertake new studies that can give policy directions on the ways and means through which Egypt can make a positive contribution to improving institutional quality that aid in attract foreign direct investment and increase the trade. Also, the analysis may be confirmed with new institutions variables from alternate sources. Efforts should also be made to collect reprehensive institutions indicators, which contain better information. Furthermore, future studies should be undertaken in order to understand the relationship between governance indicators and trade at a much disaggregated level.

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