

## **EXPLORING THE NEXUS BETWEEN GOVERNMENT EFFICIENCY, REGULATORY QUALITY, AND ECONOMIC GROWTH IN TRADE**

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**Abstract:** *The pivotal role of institutions in economic development has been well-established in the literature since the 1990s. Scholars like North (1990), Mauro (1995), Engerman and Sokoloff (2003), and Dollar and Kraay (2003) have underscored the significance of quality institutions in fostering economic growth and enabling effective economic policy measures. While prior research has extensively examined the connections between institutions and trade, their impact on economic growth remains relatively understudied. This study bridges this gap by exploring the relationship between institutions, trade openness, and economic growth, drawing upon the frameworks of endogenous growth theory and the new theory of international trade. It acknowledges that trade openness can be a catalyst for economic growth, offering economies of scale and facilitating technology transfer. However, recent decades have witnessed disparities in economic performance between developed and developing countries, prompting a reassessment of the presumed positive effects of trade openness.*

*This research contends that the quality of national institutions plays a crucial role in shaping a country's economic growth trajectory, potentially acting as a determining factor for its successful integration into global trade networks. By delving into the nuanced interplay of institutions, trade, and economic growth, this study aims to provide valuable insights for policymakers and researchers alike.*

**Keywords:** *Institutions, Trade Openness, Economic Growth, Endogenous Growth Theory, Developing Countries.*

### **1. Introduction**

During the 1990, literature gave institutions a primordial place. It provided a series of analyzes aimed at demonstrating the essential role of quality institutions in the process of economic development and in the effectiveness of economic policy measures. North (1990) was one of the first to demonstrate the importance of institutions in economic development. Mauro (1995) emphasizes the phenomenon of corruption which is harmful to investment and economic growth in developing countries; while Engerman and Sokoloff (2003) postulate that there are economies of scale due to good quality of institutions and trade openness in determining economic development. In the same vein, Dollar and Kraay (2003) formulate that countries which have good institutions tend to trade more. However, most

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of the work examines the links between institutions and trade ignoring their effect on economic growth (Lavallée, 2006; Levchenko, 2013; Avom and Gandjon, 2014; Gandjon, 2017).

According to the theory of endogenous growth and the new theory of international trade, openness to international trade is a catalyst for economic growth insofar that it allows countries to benefit from economies of scale and promotes transfer of technology. However, the differences in economic performance observed between rich and developing countries over the past three decades have put the positive effects of trade openness on economic growth into perspective (Sachs and Warner, 1995). Thus, any poor quality of national institutions could further harm contributed to countries weakness economic growth that could truly miss its integration into world trade.

In this background, using annual data, this paper analyses whether efficiency in terms of policy execution and the quality regulation matters on the relationship between trade and economic growth in Central African countries. Objective of this paper is to provide an overview of the role of regulation quality and government efficiency in the relationship between trade openness and economic growth, the question that could be raised here is why this research remains relevant for the economy of Central African countries.

One reason mentioned, is the choice of the political dimension of institutions that is justified by controversies of the work and the scarcity of our knowledges which analyzed the effect of the quality of political institutions especially the effectiveness of the government efficiency and regulation quality on trade and growth. Indeed, these two indicators seem mixed when compared to the statistics of the World Governance Indicators (WGI, 2017) and in view of other countries with a quality institution appreciate (Transparency, 2010). Moreover, considering these indices, these indicators in terms of political governance have progressed relatively compared to previous years (Transparency, 2016).

The rest of the paper is organized as follows: the second section reviews the existing literature. The third section shows the methodological framework used. The fourth section presents the various results and discussions obtained. The last part concludes this work.

## **2- Literature review**

Trade is a central concern in macroeconomics in view of the controversies existing literature. There is a growing and clear interest on the relationship between trade openness and economic growth. Some work has been devoted to this analysis. The studies are divided into two categories.

For the first category, trade openness has a positive effect on economic growth. It highlights the important role of trade openness as a factor that promotes long-term growth in improving well-being through increased productivity (Frankel and Romer, 1999; Abessolo, 2005; Busse and Koniger, 2012). Regarding the second category, trade openness has no significant effect on economic growth if it is separated from quality institution (Constantinos and al, 2014; Vitola and Senfelde, 2015; Votsoma et al, 2020). Drawing on studies by Dollar and Kraay (2003), Balogoun (2016) assesses the effect of trade openness on poverty in developing countries. It shows that to a large extent trade openness reduces income inequalities. However, the growth channel, relayed by the theoretical literature, remains insignificant. He concludes that the analysis of the transmission channel, through nonlinear regressions suggests that the impact of trade openness on poverty does not come from the effects of the redistribution income on economic growth, but rather from other institutional variable.

Conversely, Mathew and al (2014) separately analyze trade openness and the quality institution on economic growth in Sub-Saharan Africa using the Least Square Dummy Variables (LSDV) and the Generalized Moments Method (GMM) on the period 1985-2012. The study is significant considering the fact that trade openness and institutions exert to some extent a positive influence on the economic growth of African countries. The results indicate that the institutions had a positive and significant impact on economic growth but trade openness was not very significant on the economic growth of African countries.

In Africa, Dinkneh and Yushi (2016) find that Africa-China trade openness has a positive and robust effect on the real GDP growth of African countries. This trade of Africa-China interacts with the political institutional and human capital of Africa. Its effect is positive and significant. Therefore, it needs Africa strong domestic absorption capacity in order to reap the technology improving effect of trade with China. These results therefore provide evidence that trade openness and the quality of institutions are an important to economic growth for Africa. Hence, Niyongabo (2007) hypothesizes that openness policies can be more effective if they benefit from good quality political institution in developing countries. Using the Ordinary Least Squares (OLS), he concludes that good governance and the adoption of open trade policies act interactively and are positively associated with increasing income, reducing inequalities and the cushioning of trade shocks.

Meanwhile, Krenz (2016) studies the two-way relationship between political institution and trade. To this end, it works covers 87 countries and spans the period 1990-2007. Using the Co-integration method, the results conclude that the political institutional framework has a positive long-term effect on trade. This report is robust to different evaluation methods. The estimators report unbiased evaluations for cointegrating variable, even under the presence of endogenous repressors. In addition, the results confirmed a long-term causality from institutions to trade. He concludes that an improved political institutional framework is a cause of increased trade exchange.

However, Mina and Ndikumana (2007) explore that one of the causes limiting the growth in the degree of trade in Africa may be weak institution. Their results of Arellano Bond method (GMM) assessments on panel data from African countries show that institutions play an important role.

They find that the common effect of institutions and trade has a U shape, suggesting that while trade has the high levels of expansion institution play an important role in harnessing the trade engine that drives economic growth

Whereas, Linh Bun (2009) uses a regression by the Least Squares Method (OLS) in panel. He examines the effect of openness on the growth of the ten countries of the Association of South-east Asian Nations. He also combines the quality institution and trade. Its results suggest that trade and the quality of political institutions positively affect economic growth and find that the good quality of institutions has a greater effect on economic growth.

In contrast, using the GMM method, Kilishi and al (2013) first assess the quality of institutions and economic growth in Africa, addressing two questions: Do institutions matter in Africa? If so, what are the interaction effects of institutions on growth? To this end, it shows that political institution is important in promoting growth. This improvement in the quality of institutions affects the growth rate through the quality of standardization, the legal framework and political stability. Thus, according to him, improving the standardization quality of trade agreements may have more of an effect on growth

than in isolating them. Finally, they find that institutional factors become much more important associated with trade openness on economic growth.

### 3. Methodology

This paragraph successively sets out the economic growth model to be estimated, the data and their sources as well as the model estimation strategy.

#### 3.1. Econometric specification

The specification of the neoclassical growth model developed by Mankiw and al (1992) considers human capital and physical capital. The model can be expressed as follows:

$$Y(t) = A(t)K(t)^{\alpha}L(t)^{1-\alpha} \quad (1)$$

The Cobb-Douglas production function (Y) depends on physical capital (K), labor force (L) and the level of technology (A). Inspired by this previous function, the neoclassical model of Mankiw and al (1992) is formulated as follows: The global functional form allows us to establish the following relation

$$\text{Direct relation: } \ln PIB_{it} = \beta_0 + \beta_1 \ln PIB_{it-1} + \beta_2 \ln OUV_{it} + \beta_3 \ln X_{it} + \beta_4 \ln IP_{it} + \beta_5 \ln B_{it} + \epsilon_{it} \quad (2)$$

$$\text{Indirect relation: } \ln PIB_{it} = \beta_0 + \beta_1 \ln PIB_{it-1} + \beta_2 \ln OUV_{it} + \beta_3 \ln IP_{it} + \beta_4 \ln B_{it} + \beta_5 \ln X_{it} + \beta_6 \ln B_{it} + \epsilon_{it} \quad (3)$$

Or  $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$  are parameters of the model variable. X is the control variable;  $\beta_2 * \beta_3$  is the interactive variable between trade and the quality of political institutions (government efficiency and regulation quality), OUV is trade openness,  $\beta_4$  is the country specific,  $\epsilon_{it}$  is the error term.

#### 3.2. Variables

*The real economic growth rate* is a percentage to take into account purchasing power parity to allow comparison between countries (Greenaway and al, 2012). *Trade openness* measures the proportion of a country total income that is linked to international trade. *Government efficiency* measures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from policy, the quality of policy development and execution, and the credibility of government policies (Kaufmann and al, 2004). *Regulatory Quality* captures perceptions of government capacities to formulate and enforce sound policies and regulation that enable and encourage the promotion of private sector development (Kaufmann et al, 2004; Koeniger, and Silberberger, 2015). *Public expenditure* measured by final public consumption as a percentage of GDP, this variable allows us to take into account the effect of fiscal policy in our analyses by virtue of Keynesian teachings (Levine and Renelt, 1992, Sachs and Warner, 1995; Edwards, 1998). *The rate of inflation* measures the annual growth rate of the consumer price index (CPI), the CPI is one of the best measures of inflation for economies heavily dependent on import prices. This variable takes into account macroeconomic stability.

In the economic literature, we talk about the rate of inflation when the index is not specified (Romer, 1991). *Gross Fixed Capital Formation* is the aggregate that measures, in national accounts, the investment (acquisition of production goods) in fixed capital of the various resident economic agents. Formerly called gross domestic investment, it consists of expenditures for additions to the tangible fixed assets of the economy plus the net changes in inventories (Yanikkaya, 2003, Wacziarg and Welch, 2008). *Natural resource* measures natural rent by the difference between the selling price of natural resources and their operating costs (Devarajan and Wolfgang, 2013; Mondjeli and Tsopmo, 2017). *The active population* measures the rate of increase of the active population. This variable takes into

account the role of the labor factor in economic activity. Indeed, a demographic expansion increase the proportion of the population considered as non-productive, mainly those of children and seniors. The table 1 shows summary variables.

**Table 1:** variables

Variable	Concept	Component	Measurement indicator	Sign	Source
		Investment			
		Natural resource			
	Control variable	Population			
		Public			
Dependent variable	Economic activity	Economic growth annual%	Real GDP rate in		WDI
Gross fixed capital	(+)	WDI formation as%	of GDP		
Total natural resource	(+)	WDI as%	of GDP		
Annual population growth rate in%	(-)	WDI			
Public expenditure rate	(+/-)	expenditure	as% of		WDI
Inflation rate in % annual	(+ /-)	WDI	Inflation		
		Trade	Sum of exports and imports of goods and services(%GDP)	(+)	WDI
		Government Efficiency	Government Efficiency Index	(+)	WGI
		Quality regulation	Regulation index	(+)	WGI

Source: the author

### 3.3. Data and Study Area

Data was acquired from several sources including: (i) the World Governance Indicator (WGI, 2018), (ii) World Bank Development Indicators (WDI, 2018); and (iii) data from the International Monetary Fund (WEO, 2018). The sample covers a few countries in Central Africa (Cameroon, Congo, Gabon, Guinea and Chad). The incorporation of these five countries in the same sample can be justified by their strong historical and cultural roots, in addition to the economicities of being part of the customs and monetary union.

### 3.4. Estimation Methods

The conclusions of Chang and al (2005) has marked the literature that examines how trade openness and institutions interact, seeking a possible role for policy complementarities. Although, they did not give the specific application, he asserts that the essence of the analyses can be extended for the analyzer

of complementarity between trade and other reforms. To achieve our objective of analyzing the effect of government efficiency and the quality of regulation in the relationship between trade and economic growth, this research uses an empirical methodology based on the method of instrumental variables (IV - GMM) over the period 1995-2017. The decision to use this method is justified by correcting for heteroscedasticity in order to best compensate for the endogeneity of certain improvement variables (Arellano and Bond, 1991; Arellano and Bover, 1995; Blundell and Blond, 1998; Roodman, 2009).

**4. Empirical results**

Table 2 below shows the result. Overall, the instrumental variable used in our regression are valid since the Hansen / Sargan test does not allow rejecting the null hypothesis of validity of the instrument in level and in difference (p-value > 0.05). In addition, we find that there is no second order autocorrelation of the errors of the difference equation AR (2), because Arellano and Bond second order autocorrelation test accepts the hypothesis no lack of second-order autocorrelation (p-value > 0.05). The arbitrage is done by comparing the value provided automatically by the conversion associated with the evaluated Wald value, which facilitates the analyses. It will therefore suffice to compare the discussion associated with the Wald-statistic with the 5% threshold used.

If the conversation associated with W-Statistics was selected at 5%, then the Ho hypothesis will be rejected in favor of the alternative hypothesis according to which the regression is globally significant. In this case, the Wald statistic is less than 5%, so the null hypothesis is rejected and the model is globally significant.

**Table 2:** Estimation of interaction term the components of political institution and trade on economic growth

Dependent variable	Real annual economic growth			
	System dynamic panel-data estimation (GMM-type)			
	Model (1)	Model (2)	Model (3)	Model (4)
Lagged growth (-1)	0.007* (0.34)	0.290** (2.10)	0.322*** (2.82)	0.267** (1.69)
Trade	0.154*** (9.74)	0.135*** (7.68)	0.148*** (9.85)	0.139*** (7.32)
Population	-1.973 (-0.32)	6.464 (1.52)	8.389** (1.91)	9.027* (1.72)
Public expenditure	-0.136*** (3.89)	(- 0.601*** (-3.87)	-0.603*** (7.05)	(- 0.429*** (-3.84)
Inflation	-0.298*** (3.37)	(- 0.197*** (-4.57)	-0.188*** (3.53)	(- 0.222*** (-4.16)
Natural resource	-0.653 (-0.89)	0.191*** (2.66)	0.163 (1.51)	0.252** (2.04)
Private investment	-3.456 (-0.98)	2.800 (1.09)	2.974 (1.98)	0.861 (0.30)

Government efficiency	0.069 (0.86)	0.066* (1.61)	0.058 (1.49)	0.169* (1.56)
Regulation	0.022 (0.66)	0.014 (0.42)	-0.011 (0.34)	0.149* (0.65)
Government efficiency *Trade	///	0.103*** (3.81)	//	1.559 (0.23)
Regulation* Trade	//	//	0.098*** (4.84)	0.101 (2.92)
Constant	4.161 (0.09)	-44.263 (-1.40)	-53.190** (2.33)	(-57.011 (-3.92))
<i>Interaction terms</i>	(No)	(Yes)	(Yes)	(Yes)
Observations	95	90	90	90
AR(1) p-value	0.3296	0.4531	0.3488	0.0982
AR(2) p-value	0.4096	0.3244	0.4927	0.574
Wald p_value	0.0000	0.000	0.000	0.000
Countries	5	5	5	5

Note: \*\*\*: significant at the 1% level; \*\*: significant at the 5% level; \*: significant at the level of 10% In Table 2, column 1, 2, 3, 4, there are a positive relationship between trade openness and economic growth.

Column (1) shows a positive impact of trade openness on economic growth. The coefficient associated with trade is

0.154, which suggests that an increase of 1 unit in the trade openness rate leads to an increase economic growth of 0.154 unit. This result, which at first glance seems to join the conclusion of Frankel and Romer (1999) and Ho and Iyke (2018). Indeed, they highlight the important role of trade openness as a factor that promotes long-term growth. Among the effects favoring economic growth, several authors support the preponderant place that the process of trade openness plays in improving well-being by boosting productivity.

We tested the validity of the interactive effect between trade and government efficiency on the one hand, and the quality of regulation on the other. The results show that the coefficients of the main interactive variable specified have positive sign. Column (2) shows a positive effect of the interactive variable between trade openness and government efficiency on economic growth. The coefficient associated with the interactive variable is 0.103, which suggests that a unit increase in trade openness and government efficiency results in economic growth of 0.103 unit. Therefore, trade and government efficiency are complementary. In other words, perceptions of the quality of public services, the quality of the civil service, the degree of its political independence, the quality of policy formulation and execution, and the credibility of government policies reinforce the positive effect of trade openness on economic growth. This result is consistent with the conclusions of Zaouli and Zaouli (2015) and Bonnal (2015). Column (3) shows a positive effect of the interactive variable between trade openness and regulation on economic growth. The coefficient associated with the interactive variable is 0.098, which suggests that a 1 unit increase in trade openness and regulation leads to economic growth of 0.098 unit. Consequently, trade openness and the quality of regulation are complementary. In other words, the

quality of perceptions of the government capacities to formulate and implement sound policies and regulations to encourage the promotion of private sector development enhances the positive effect of trade openness on the market. This result matches the work of Koeniger and Silberberger (2015) and Mina and Ndikumana (2007).

Regarding the control variable, a unit increase in the population growth rate leads to 8,389 units of economic growth in column (3). This result is consistent with the work of Hanushek and Kimko (2000). However, the coefficient associated with public expenditure is negative. A unit increase in the public expenditure ratio leads to a decrease in growth respectively of 0.136 unit in column (1); 0.601 unit in column (2); 0.603 unit in column (3). These results corroborate with the conclusions of Levine and Renelt (1992) and Edwards (1998). Likewise, the coefficient associated with inflation is negative. A unit increase in the public expenditure ratio leads to a decrease in growth by 0.238 unit respectively in column (1); 0.197 unit in column (2); 0.188 unit in column (3). These results corroborate with the conclusions of Romer (1991). On the other hand, the coefficient associated with the natural resource is positive. An increase of 1 unit of natural resource rent results in an increase of 0.191 unit of economic growth in column (2). These results corroborate with the conclusion of Mondjeli and Tsopmo (2017).

## 5. Conclusion

This article examined whether the quality of political institution, especially government efficiency and the regulation quality, are likely to strengthen the effect of trade on the economic growth of five Central African countries, over the period from 1995 to 2017. To establish this result, we used the econometric model of Mankiw and al (1992). Using the dynamic panel GMM method. Firstly, trade openness positively affects economic growth. Secondly, government efficiency and the quality of regulation reinforce the positive effect of trade openness on economic growth. In order to benefit from growth driven by trade openness, government efficiency and the quality of regulation matter.

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**Appendix**

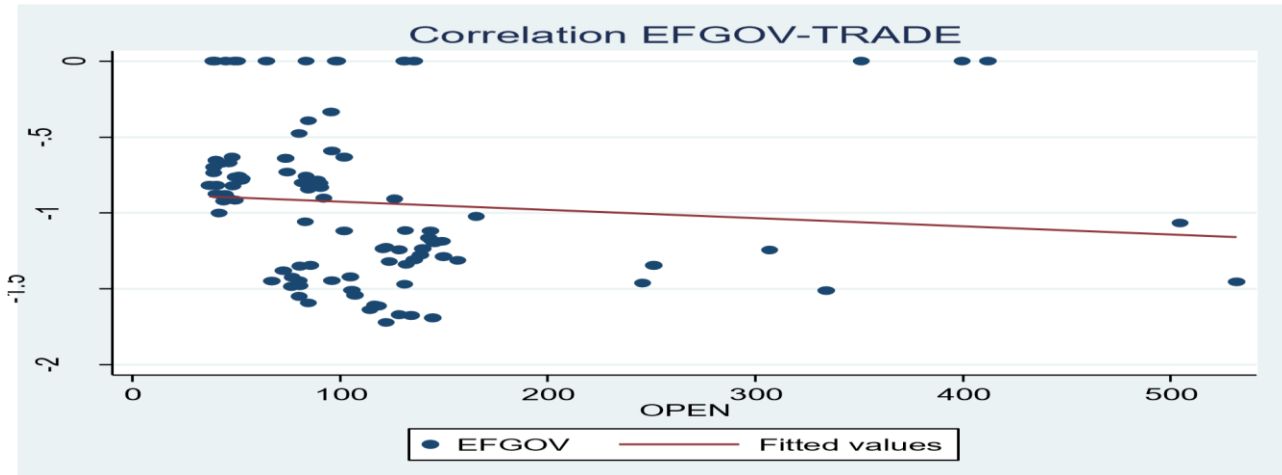
**Appendix 1: Statistics**

Variable	Mean	Std. Dev.	Min	Max
Growth Economic	5.742603	7.495651	37.99873	
Gov efficiency	70	-1.136766	.3386584	-8.724875 - .394153
Regulation	70	-.9982445	.3280813	-1.490816 - .1646162
Trade openness	70	101.5553	49.73676	37.06518 307.0159
Population	70	2.794799	.4569652	2.204565 3.832788
Public expenditure	70	11.11555	3.963983	2.736065 20.58012
Natural resource	70	46.81607	20.87731	4.51427 80.69243

Inflation	70	3.523465	5.948757	-18.07454	20.47896
Investment	70	29.41983	11.74087	14.298	64.852

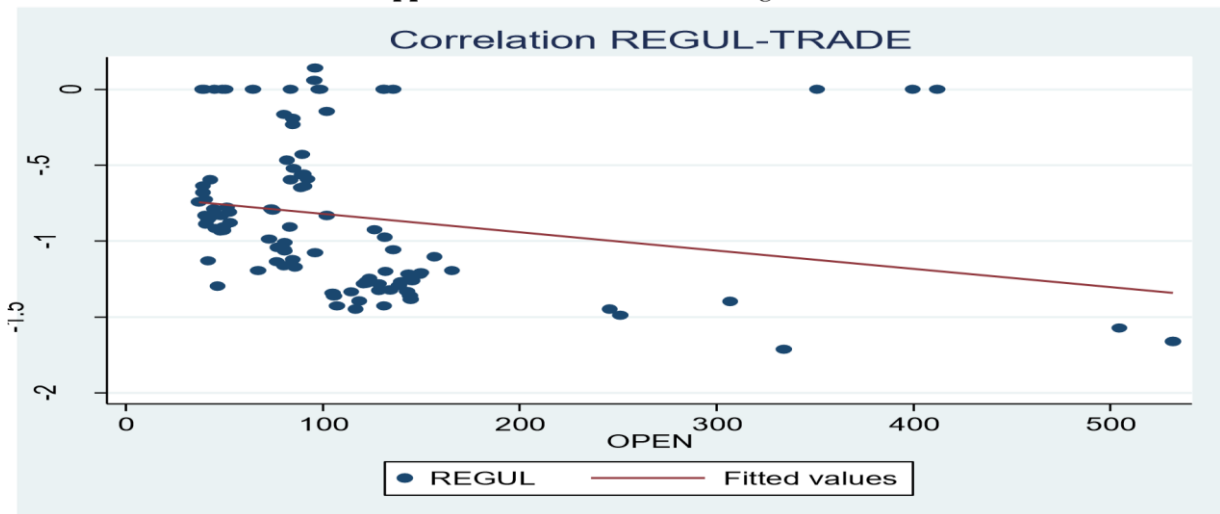
Source: Author by WDI and WGI data (2017)

**Appendix 2:** Fitted Values and government efficiency



Source: the author

**Appendix 3:** Fitted Values and regulation



Source: the author