

Referee Report

For MS 2520:

"The democracy and economic growth nexus: Do FDI and government spending matter? Evidence from the Arab world"

by

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Summary

The paper seeks to estimate the effect of democracy on growth in a sample of 16 Arab countries for the period 2002-2013, which is the period of the so-called "Arab Spring". The authors particularly try to elucidate the effect of democracy on growth which is mediated by FDI inflows and public consumption expenditure (PCE). The findings claim that democracy has no direct effect on growth, but it does affect FDI inflows positively, which in turn positively influences growth. On the other hand, they indicate that democracy also increases PCE, which negatively affects growth. The overall effect of democracy on growth in the sample thus remains unclear.

General Assessment

Given the democratic movements in this part of the world during the time of the analysis, the question of their economic effect is surely interesting. The choice of analysed channels (FDI and PCE) makes sense, given the rather short period of time under study. However, I have some major concerns with both the methodology (which may be due to its presentation) and regarding the interpretation of the results.

Major Comments

Disentangling the direct and indirect relationship between democracy and growth

The paper identifies two channels in particular through which democracy can affect growth, namely that it potentially stimulates FDI inflows and that it potentially raises public consumption expenditure. The first is expected to have positive effects on growth, the latter negative ones. In the analysis, all other effects fall under a 'direct' effect. The choice of channels studied is sensible, since in the short time period, other effects that the literature brings forward (such as increased access to schooling in democracies) are likely to need more time to materialize, such that they would not be found in the data at hand.

Now, as far as the reader can tell, the equations given in Section 3 are estimated independently (see below). When controlling for FDI and PCE, there is no direct effect of democracy on growth. This is interpreted as support for the "skeptical" view. The authors find, however an effect of FDI and PCE on

growth, which are influenced by democracy (as from estimating equations 3 & 4). Since these are influenced by democracy, the overall effect of democracy on growth (which is the aim of the paper), including that mediated by FDI and PCE, remains unidentified. It would have been interesting to see this general relationship and some type of clearly defined mediation analysis for the channels under study.

Methodology

As noted above, there are at least major questions on the correct specification of the model. They authors claim to apply a simultaneous equation model, but do not comment on the methods used, such that I got the impression that each equation is simply estimated on its own. Within each equation, the authors apply an Arellano-Bond estimator. For this, however, the equations given beforehand seem misspecified. Equations 2-4 contain the lagged variables of the dependent variable, while the central equation 1 does not. In order to trust the results, it would be indispensable to see the equations which are finally estimated, and to learn about how the simultaneous equation structure is exploited. Without this, the interpretation of the results cannot be evaluated.

Minor Comments

- In line with the comment on the mediated effects, it would have been nice to have the economic significance of the effects of at least democracy on FDI/PCE on growth discussed.
- In the discussion of the literature, some findings mentioned are contrary to each other (e.g. on the effect of democracy on physical capital accumulation, p. 3). A short discussion where these differences might come from would help to put the findings in perspective. This equally holds for the discussion of the own results where they do not coincide with previous findings.
- Some formulations put forward facts or interpretations that are likely to not be uncontested, such as the interpretation of the background of the Arab Spring in Footnote 1 or the claim that the US invasion in Iraq was motivated by the desire to establish democracy in the Middle East. These should either be substantiated by literature or formulated more cautiously.
- Abbreviations, such as GCC (Gulf Cooperation Council), should be introduced.
- It would be better to stick to one language, even if lines in tables are also understood in French (“Nombre de Pays”)
- It would have been interesting to see descriptive statistics along different dimensions, rather than only the summary statistics of the pooled sample, most notably the *within* variation in the democracy variable (or a graph with the development of the democracy variable by country), or how far average growth rates differ between the countries in the period under study. This also relates to that while the paper is motivated by wanting to analyze the economic effect of the Arab Spring, the Arab Spring can be dated back only to 2010 the earliest, so that the sample, ending in 2013, could capture only very short term effects of the alleged democratization movements.
- Since the robustness tests section consists of replacing one measure of democracy by another, where most qualitative results stay the same, a footnote with reference to the appendix, replacing the entire section, would be sufficient.