

Referee Report

For MS 2520-1:

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

by

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General Assessment

The revision of the paper makes the paper much more readable and eases accessibility to the interesting analysis. However, the main concern of Report 1, regarding the interpretation of the results, is still not addressed. If it would be, the paper could be an important contribution to the literature on the (short term) growth effects of democracy in an interesting setting.

Major comment

The main concern with the analysis (and/or the interpretation of its results) is that it postulates to establish an overall link between democracy and growth. Finding a non-significant effect of democracy in the estimation of (1), the authors claim that this shows no effect of democracy on growth overall, the reason being that the positive effect of FDI and public consumption expenditure found by estimating (3) and (4), respectively, cancel out. This is, however, *not* what the estimation shows. Since in (1), both, democracy, and the mediating factors FDI and GOVSP are included, the insignificant effect of democracy on growth captures only a non-existing *direct* effect, *given* the levels of FDI and GOVSP. These do, however, as the authors stress rightly, affect growth, and are, as Columns (3) and (4) of Table 1 show, themselves affected by democracy. Therefore, the overall (direct plus mediated) effect of democracy on growth could well be significantly different from zero.

Other authors cited, such as Helliwell (1994), and Tavares & Wacziarg (2001) take a different approach to analyze the overall effect in similar settings, which seems more appropriate. They first analyze the direct effect of the mediating factors (which would be FDI and GOVSP here) on growth (Helliwell, 1994, while controlling for the direct effect, see Table 2, column (2); Tavares & Wacziarg, 2001, while not controlling for the direct effect, see Table 12, first column). They then multiply them with the effect of democracy on the respective mediating factors (p 243, last paragraph in Helliwell; Table 3 in Tavares & Wacziarg; standard errors on the multiplied coefficients are obtained by Tavares & Wacziarg, and can also be bootstrapped) to obtain the overall effect. The approach by Helliwell seems of course preferable here, as it allows to weigh the direct and the indirect effects.

Doing so, one might well end up with a different conclusion on the overall effect of democracy on growth. From a first glance, it seems that the overall effect in this region and time tends rather to be positive, as the positive effect of FDI and the negative effect of GOVSP on growth are more or less equal in magnitude in estimation (1), but the effect of democracy on FDI (3) is larger than that on GOVSP (4) (while each individual relationship can of course not be compared due to different scaling

of the variables, the fact that the product of the two, i.e. the mediated effect of democracy on growth via the respective channel, seems to be different in magnitude, is relevant here).

Another first step could also well be to simply leave the mediating factors out in a first regression of growth on democracy, to establish an overall link, *including* that which operates via FDI and GOVSP. The positive coefficient in the regression of democracy on growth in column (2), Table 1, of the authors gives an indication that this relationship would indeed be positive. (Neither of the indications for the overall positive relationship is visible in the robustness check in Table A4, however.)

Minor comments

- Since equation (2) in a one-by-one estimation does little to contribute to answering the main question of the effect of democracy on growth (and the direct effect of democracy on growth is insignificant anyway, so its determinants play no role here), but only explains the reverse causation, it could well be left out here or be presented as an additional analysis.
- It would still be nice to have a discussion of the economic significance of the effects identified (e.g. by how much does a typical change in the level of democracy in this period in this region, 1 sd or different, increase FDI flows, and by how much does this increase growth, etc.) in the text for accessibility.