The Middle East Economies in Times of Transition

Edited by

Ishac Diwan and Ahmed Galal

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International Economic Association
Series Standing Order ISBN 978–0–333–71242–9 (Hardback)
978–0–333–80330–1 (Paperback)

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Economic Research Forum (ERF)

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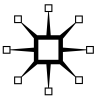

First published 2016 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

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ISBN 978-1-137-58394-9 ISBN 978-1-137-52977-0 (eBook)
DOI 10.1007/978-1-137-52977-0

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
The Middle East economies in times of transition / Ishac Diwan, Ahmed Galal.
pages cm
Includes bibliographical references and index.
ISBN 978–1–137–58394–9 (pbk.)
1. Middle East—Economic conditions—1979– 2. Middle East—Economic policy. I. Diwan, Ishac, editor. II. Galal, Ahmed, 1948– editor.
HC415.15.M525 2016
330.956—dc23 2015027807

Typeset by MPS Limited, Chennai, India.

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Foreword

These essays were presented at the 17th World Congress of the International Economic Association held in Jordan, June 6–10, 2014. It was organized in partnership with the Columbia Global Centres – Middle East (Amman) and with generous support from a range of sponsors. The five-day programme included five plenary sessions, 24 invited sessions, 15 policy session and over 90 contributed sessions, with over 600 people in attendance. The selection of papers in this volume gives a flavour of the range of issues that were discussed in the congress sessions which brought together a group of established and younger scholars from all over the world. The IEA is a fine example of international cooperation in the discipline of economics. The success of the congress owed much to the energy and commitment of the IEA President at the time, Joseph Stiglitz.

Timothy Besley
London, May 2015

Preface

When the International Economic Association (IEA) held its Annual Congress in Jordan in June 2014, the Economic Research Forum (ERF) was invited to join the IEA in the preparation of this conference. Besides mobilizing the participation of researchers from the Middle East in this important event, ERF organized a number of sessions on a variety of topics on the Middle East economies. After the conference, Josef Stiglitz, then President of the IEA, invited ERF to edit a volume on the Middle East economies to accompany other volumes in this series. We were delighted to accept the invitation.

In selecting the topics of the volume and potential authors, we decided early on not to limit its content to the issues presented in the conference. The Middle East was going through a significant political transition, and that by itself merited a serious rethinking of the main challenges facing the region. It was also an opportunity to take stock of existing knowledge, especially as it relates to the interaction between economics and politics, to outline a research agenda for the future.

The topics we opted to focus on in this volume are: economic growth and structural transformation, inequality, natural resources, and political transitions. These topics were addressed by a distinguished group of economists and political scientists with extensive knowledge about the Middle East region. Their contributions we believe will put an end to the notion of "Arab Exceptionalism", which has prevailed for a long time. Surely the region has its own distinguishing characteristics, including the persistence of extractive political institutions and the abundance of natural resources. However, the analysis in this volume indicates that the region shares many of the characteristics of other developing regions of the world. As such, researchers working on the region should not limit themselves to their own "area study", but instead, they can benefit from entering into a closer dialogue with the global debates of the day, and indeed, by contributing to global knowledge more dynamically.

To be sure, the volume does not provide full or final answers to the questions we pose in the introductory chapter, nor do we claim to have provided a full textbook on the political economy of the Middle East. Instead, we here tried to offer new insights on some of the key challenges facing the region at this critical juncture of its history. We realize that the choices made by countries in transition today are likely to have enduring impacts on the lives of Arabs for decades to come. And for this reason alone, we hope that the volume would

contribute toward charting a better course of action for building more prosperous and peaceful Arab societies.

Ishac Diwan
Ahmed Galal
Paris and Cairo, June 24, 2015

Notes on Contributors

Ragui Assaad is Professor of Planning and Public Affairs at the University of Minnesota's Humphrey School of Public Affairs, USA. He is a Research Fellow of the Economic Research Forum in Cairo, Egypt and serves as its thematic director for Labor and Human Resource Development and as a member of its Board of Trustees. His current research focuses on labour markets in the Arab World, with a focus on youth and gender issues as they relate to education, transition from school-to-work, employment and unemployment, informality, migration, and family formation. He holds a PhD in City and Regional Planning from Cornell University.

Robert P. Beschel Jr. is a Lead Public Sector Specialist and Head of the World Bank's Center of Government Practice. He manages the Bank's Governance and Public Sector Team – a unit tasked with providing strategic and policy support to the Bank's new Governance Global Practice. Previously he headed the Governance & Public Accountability Cluster within the Bank's Public Sector Anchor, which was responsible for overseeing the Bank's global practice on issues of governance, anticorruption, political economy analysis, revenue mobilization and expenditure rationalization, and transparency and right to information among other topics. He also headed the Secretariat for the Governance and Anticorruption (GAC) Council – the body that oversees the World Bank's practice on issues of governance, integrity and anticorruption. In 2010, he was recruited by the Office of Tony Blair and the Government of Kuwait to serve as Deputy Director for Policy (and subsequently as Acting Director for Policy) in the newly created Technical and Advisory Office (TAO) of the Prime Minister. Previously Dr. Beschel was Lead Public Sector Specialist for the World Bank's Middle East and North Africa Vice Presidency, where he was responsible for overseeing the Bank's work on governance and public management throughout the region. Dr. Beschel has a Master's degree in Public Administration from Harvard University's John F. Kennedy School of Government and a Master's and PhD in Political Science from Harvard's Government Department. He has worked on public sector reform in over 40 countries and authored a number of books, reports, articles and other publications on issues of governance, public financial management, civil service and administrative reform, and anticorruption.

Melani Cammett is Professor of Government at Harvard University, USA. Recent books include *Compassionate Communalism: Welfare and Sectarianism in Lebanon* (2014), which explores how politics shape the distribution of welfare

goods by ethnic and sectarian organizations, and *A Political Economy of the Middle East* (co-authored with Ishac Diwan, 2015), which analyzes the interplay of economic, political and social factors in economic and social development in the region. Her co-edited book, *The Politics of Non-State Social Welfare in the Global South* (2014), examines the origins, evolution and consequences of non-state welfare provision for state-building and human security in diverse regions. Cammett's current research projects explore governance and the politics of social service provision by public, private and non-state actors in the Middle East and identity politics in the region. She is also beginning a new project on the long-term historical roots of distinct development trajectories in the Middle East. Cammett has published numerous articles in academic and policy journals and consults for development policy organizations.

Ishac Diwan is currently affiliated with Dauphine University and the Paris School of Economics in France as the Paris Sciences et Lettres research chair on the Middle East. Recent books include *A Political Economy of the Middle East* (co-authored with Melani Cammett, 2015), which analyzes the interplay of economic, political and social factors in economic and social development in the region. His edited book, *Understanding the Political Economy of the Arab Uprisings* (2014), reassesses the interests, potential, and constraints of the various socio-economic players and their importance in the building of an environment for democratic progress in the Middle East. His current research interests focus on political economy issues in the Middle East, and include a focus on the study of crony capitalism, and of opinion surveys. Ishac is directing the Economic and Political Transformation programme of the Economic Research Forum, and he is a fellow at Harvard University Middle East Initiative.

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Caroline Freund is a senior fellow at the Peterson Institute for International Economics. Prior to that she was chief economist for the Middle East and North Africa at the World Bank. She has also worked in the research departments of the World Bank, the IMF and the Federal Reserve Board. She works primarily on economic growth and international trade and also writes on economic issues in the Middle East and North Africa. She has published numerous articles in economics journals, including *American Economic Review, Quarterly Journal of Economics, Review of Economics and Statistics, Journal of International Economics,* and has contributed to many edited volumes. She is on the scientific committees of CEPII (Institute for Research of the International Economy, Paris) and the Economic Research Forum (Cairo), and is a member of the US Export-Import Bank Advisory Committee and of the Center for Economic Policy Research.

Ahmed Galal is Managing Director of the Economic Research Forum of Forum Euroméditerranéen des Instituts de Sciences Économiques. Mr. Galal was Egypt's Finance Minister from July 2013 to February 2014. Previously, he worked for the World Bank for 18 years, conducting research and providing policy advice to governments. From 2000 to 2006, he was the Executive Director and Director of Research of the Egyptian Center for Economic Studies. He has authored more than a dozen books and several journal articles. In 2004, he was awarded the regional prize for Economic and Social Sciences by the Kuwait Foundation for the Advancement of Sciences. He holds a PhD in Economics from Boston University, USA.

Caroline Krafft received her Master's in Public Policy from the University of Minnesota's Humphrey School of Public Affairs and is now a PhD candidate in the Department of Applied Economics at the University of Minnesota, USA.

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Mélise Jaud is an economist in the Chief Economist's Office of the World Bank's Middle East and North Africa Region. She works primarily on international trade, including the determinants and impacts of firms' export dynamics and growth, food safety issues in trade, and policy reforms in developing and transition countries. Prior to joining the World Bank she worked as an economic advisor to the Ministry of Agriculture in Mozambique. She holds a PhD in Economics from the Paris School of Economics.

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Mustapha K. Nabli is currently international consultant, President of North Africa Bureau of Economic Studies International, based in Tunis. He was Governor of the Central Bank of Tunisia from January 2011, just after the revolution, until July 2012. Prior to that he was at the World Bank as Senior

Advisor at the Global Prospects Group (1997–1999), then Chief Economist and Director of the Social and Economic Development Department for the Middle East and North Africa Vice-Presidency (1999–2008), then Senior Advisor to the World Bank Chief Economist (2008–2010). Prior to joining the World Bank, he was during the period 1995–1997 an independent consultant and researcher. From 1990 to 1995 he was Minister of Planning and Regional Development, then Minister of Economic Development in the Government of Tunisia. He also held the position of Chairman of the Tunis Stock Exchange (1988–1990). From 1975 to 1988 he was Professor of Economics at the University of Tunis, and visiting professor at various international universities. He holds a Master's and PhD in Economics from the University of California at Los Angeles (1974).

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Tarik M. Yousef served as Chief Executive Officer of Silatech between 2011 and 2015, a Doha-based innovative regional organization that promotes the

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Puzzles and Clues – An Overview

Ishac Diwan and Ahmed Galal

Introduction

After a long gestation period, finally there was an Arab spring in January 2011, which has since turned into other seasons. Along with the spring came an avalanche of new books on the political economy of the Middle East and North Africa (MENA). So, do we need one more book on the subject? The short answer is yes, simply because no topic is ever exhausted, and all the more so for an event of that historical significance. Furthermore, there are at least four observations about the region that raise important questions that remain largely unexplained. This volume contributes to a better understanding of these observations.

The first observation is that new social contracts and political settlements are being rewritten in the Middle East in the wake of the uprisings in 2011. However, it is not clear what kind of new social contracts are likely to emerge in the future. What is commonly believed is that the old authoritarian bargain, in which the rulers made a compact with their citizens to exchange economic benefits for political acquiesce, has collapsed at least in some countries. New social contracts are in the making but their contours still remain highly uncertain. Tunisia may be ahead of Egypt on the democratization front, but Egypt is a bigger ship and its success can have a much larger demonstration effect on other countries in the region. The monarchies in Morocco and Jordan have not endured massive protests, but they have taken steps in the direction of being more inclusive and their regimes appear relatively stable. The GCC countries and Saudi Arabia seem to have been able to delay major political upheavals, thanks to the abundance of rents from natural resources. Much more problematic, however, are the cases of Syria, Iraq, Libya and Yemen, which got mired in internal conflicts, which could lead at best to entirely new political settlements, and at worst to disintegration into failed states and perhaps even the reconfiguration of the post-colonial borders.

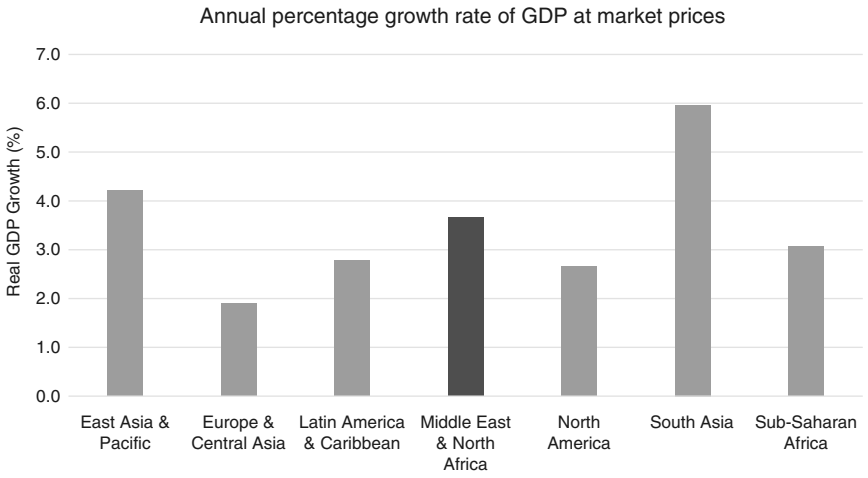

Figure 0.1 Economic growth in the MENA compared with other regions (1980–2013)
Source: World Development Indicators (2015).

The second observation has to do with economic growth. It is true that the region has on average done reasonably well over the past few decades. As shown in Figure 0.1, real economic growth rates in the region averaged 3.7% between 1980 and 2013, which compares favorably to 3.1% in sub-Saharan Africa, 2.8% in Latin America and the Caribbean, and 1.9% in Europe and Central Asia during the same period. However, the rebellions of 2011 were driven in part by economic grievances, as reflected in the main revolutionary slogans (and in particular, "bread, freedom, and social justice"). This prompted some analysts to argue that these revolts were led by middle class elements that defected from authoritarian coalitions and evolved into champions of change, driven by the lack of opportunities for socioeconomic advancement and anger about rising perceived inequalities (Cammett et al., 2014).

What is questionable though is whether regional growth rates were high enough, inclusive enough, or sustainable enough. There was by all accounts limited structural transformation involving the reallocation of resources from low productivity to high productivity sectors. Besides exporting oil, and for the poor countries, labor, it is still unclear if and how the region may fit in more productive ways in the evolving international division of labor. It appears that in the recent decades, economic policies were guided primarily by political rather than economic rationality. Indeed, the private sector that emerged out of the pro-market reforms of the 1980s was not dynamic – it was politically loyal rather than efficient. Moreover, the economy became characterized by an acute form of dualism, between a small modern sector with good jobs, and a large informal and low productivity sector (see Figure 0.2). It is therefore

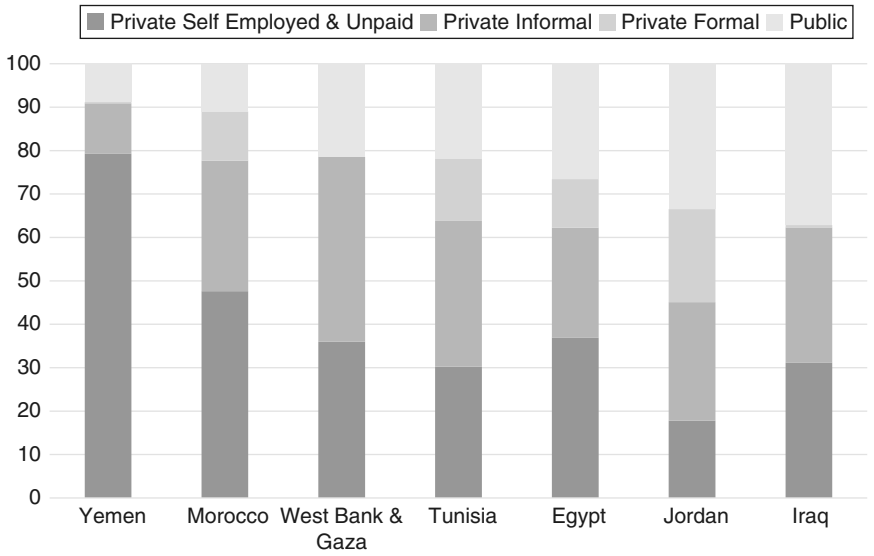

Figure 0.2 Employment distribution by contract type (in %) in different MENA countries
Source: World Bank (2014).

important to go beyond average growth rates and develop a better understanding of the type of growth, and the underlying political economy drivers of policies (such as fiscal, industrial, or trade policy) in order to understand more clearly how the size and quality of economic growth can evolve over time.

The third observation is related to inequality. Here too, the region is generally considered a moderate inequality region on the basis of Gini coefficients derived from household consumption or income surveys (Bibi and Nabli, 2010). However, as noted above, the rebellions of 2011 have also been related to grievances connected with popular perceptions of a lack of social justice. These perceptions may be related to inequalities of opportunity with respect to access to health, education or jobs, which may be stunting social mobility. Or they may be due to rising inequality of income between the top 1% or 10% and the middle class. At this stage however, we know little about both types of inequality. And although there is a broad consensus on the prevalence of gender bias, an integrated account of this bias is not well documented. The role of government in reducing or exacerbating these types of inequalities is not well understood. The complexity of the political economy driver of government policy when it comes to inequality is amply demonstrated by the very high percentage of energy subsidies relative to total government expenditures in the region compared with other regions of the world (Figure 0.3). It is well known that such subsidies are regressive and thus increase consumption inequality.

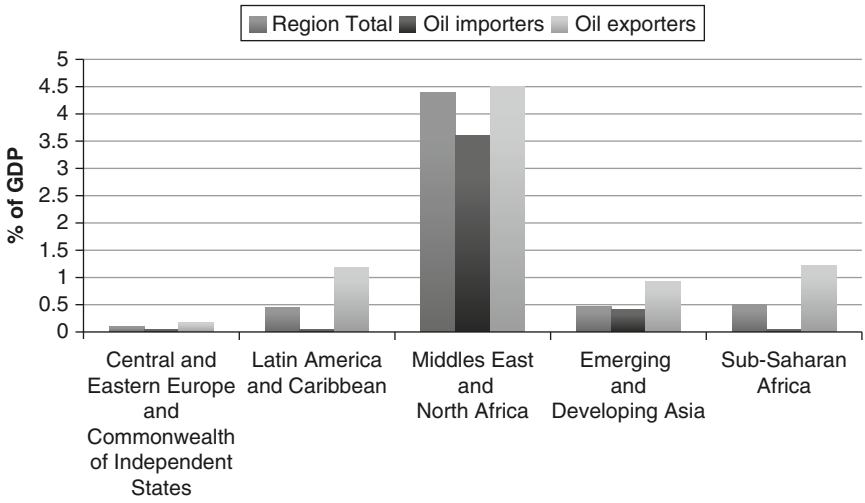

Figure 0.3 Pre-tax petroleum subsidies (% of GDP) in MENA compared with other regions, 2011
Source: International Monetary Fund (2013).

Finally, while the region has a number of distinguishing characteristics, the most glaring is the abundance of natural resources (Figure 0.4). Indeed, the region accounts for close to 60% of world proven oil reserves and about 44% of world proven natural gas reserves (OPEC, 2015). But regarding this observation as well, there is an everlasting question as to whether this natural resource gift has been a blessing or a curse for the region. More usefully perhaps is the question related to the conditions under which natural resources could have positive or negative effects on economic development and whether these conditions are changing in the region for the better or not.

In light of these observations, this volume attempts to contribute to answering the following broad questions:

- Is the region on a path of sustainable economic growth?
- Is it providing equal opportunity to its citizens?
- Is the region blessed or cursed by the abundance of natural resources?
- Finally, are the unfolding transitions in the region likely to be successful?

On the growth question, we focus on the measurement of structural transformation, before turning to an exploration of the political economy reasons for the lack of structural change, and the external conditions that made change more difficult. On inequality, we offer new measures of equality of opportunity in human development and in the job market, decomposing the level

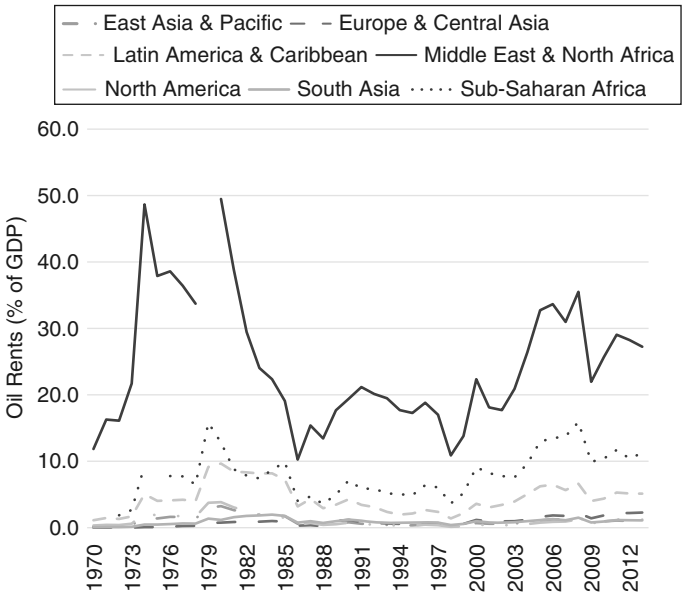

Figure 0.4 Oil rents by region (% of GDP)
Source: World Development Indicators (2015).

of inequality into factors related to effort and others related to circumstances beyond the control of individuals. We also review the complex political economy of subsidy removal. Regarding natural resources, the volume provides: an extension of the concept of "rentier states" to a global setting by one of its creators; evidence that resource curse effects do not rise monotonically with the size of the resource rent; an extension of the concept of rent to the other non-oil rents that are also predominant in the region; and a discussion of the difficulties of implementing technocratic public sector reforms in rentier states. Finally, the volume places the political transition in the region in a global perspective using various methods – theoretical, comparative, and empirical – and it explores the relationship between democracy in its variety of forms and economic development.

In assembling the topics of this volume we were guided by a simple political economy analytical framework, which can be stated as follows: good politics produces good policies, hence good economic outcomes. As in Acemoglu and Robinson (2012), societies that build inclusive political institutions are likely to adopt economic policies that promote innovation, higher economic growth and shared prosperity. We have been especially interested in the interplay between economics and politics. The two economic outcomes we decided to focus on are economic growth and equality. The policies we chose are fiscal

policy, human development, energy subsidy, public sector reforms, and global integration. The political angle we took as a focal point is the transition to democracy, and the nature of possible political settlements after the breakdown of the autocratic order in parts of the region.

In the remainder of this overview, we first summarize the main findings of the volume, followed by a concluding section pointing out the limits of the volume and questions for further research.

Main findings

Beside the overview, the volume is made of four parts and 13 chapters. Some of the chapters are in the form of critical surveys of recent research, while others present new findings. Below is a succinct summary of these chapters, placed in broader perspectives.

Economic growth and structural transformation

Most economists agree that economic growth is a prerequisite for shared prosperity. They also tend to agree on the proximate drivers of economic growth, such as factor accumulation, productivity improvements, and structural transformation, and on the institutional underpinnings such as macroeconomic stability and the protection of property rights. What is less clear however are the political economy determinants of good policies and of good outcomes. Accordingly, the chapters in Part I of this volume start by looking at the extent of structural change and productivity growth in the region, and then attempt to understand the impact of politics on these economic processes by looking at what determined particular policies.

The chapter by Doemeland and Schiffbauer (**Structural Transformation**) analyzes the MENA's growth performance through the prism of structural change. Using a newly developed data set it shows that although per capita growth in MENA has been broadly in line with other regions, the contribution of productivity growth to overall growth has been very weak. MENA's growth has to a large extent been driven by demographic change, contributing nearly 50% to economic growth. High fertility rates combined with rapidly declining mortality contributed to a sharp increase in MENA's working-age population (as a share of total population), which has rapidly increased MENA's potential labor supply.

The chapter then computes the contribution to overall economic growth of productivity growth within sectors, and that due to reallocation of workers across sectors. It shows that the contribution of structural change to growth in value-added per worker in MENA has been at par with the global average, but smaller than in successful regions such as in East Asia. Structural change was not sufficient to reduce significantly the large employment shares in lower productivity sectors, and this has continued to hold back aggregate productivity

growth. At the same time, within sector growth was very low by international standards in MENA. In particular, manufacturing productivity growth remained way below the world average, despite some convergence. The chapter concludes that in all likelihood, firm productivity growth has been held back by relatively low competitive pressure on incumbent firms, which would have forced them to innovate in order to become more cost effective.

The chapter by Cammett and Diwan (**The Roll-back of the State and the Rise of Crony Capitalism**) seeks to understand the political economy reasons for the rise of an inefficient form of crony capitalism in the region. In recounting the transition to a market economy after the market reforms of the 1980s and 90s, the chapter documents the dramatic transformation of fiscal policy over the past 50 years, with state expenditures first growing to very high levels by the 1970s and 80s (to around 50 to 60% of GDP), in the context of state-led import substitution strategies, and then shrinking enormously starting in the late 1980s (to about 25 to 30% of GDP), in the context of an inevitable market liberalization. The authors argue that the impact of the transformation of fiscal policy on the economy, society, and polity has been profound. In particular, the chapter argues that the massive rollback elicited rising political opposition, and led to new political settlements where rulers were on the defensive. They had to liberalize markets in order to boost economic growth, but at the same time, they also managed markets in a political manner to counter the rising opposition forces.

The chapter further summarizes recent research on Egypt that sheds light on the way this regime of crony capitalism worked – the mechanisms used to bestow privilege and exclude potential opponents, and the impact of this regime on economic growth. Mechanisms included preferential access to energy subsidies by connected firms, trade protection using Non-Tariff Barriers, better access to land, better treatment by regulators, and much larger access to credit. They show that while crony firms grew fast, boosted by these privileges, other firms in crony sectors, which were typically sectors with high growth potential, took a back-seat and did not invest, innovate, or create jobs, resulting in lower overall net growth in these sectors compared to potential.

The third chapter, by Diwan and Mouhoud (**Regional and Global Integration**) looks at the effect of regional and global economic forces on the growth performance of the economies of the region. MENA countries' past attempts to integrate in the global system of trade in goods and services have yielded modest results so far. Exports have risen modestly, they have not been a source of growth, and have not become more diversified or technologically more sophisticated over time. While Import Substitutions Strategies can be blamed for these failures in the distant past, the authors argue that the more recent culprits have to be found in local and global conditions. Local conditions were clearly not favorable to competiveness, as the dynamism of the private sector was taxed by the emergence of a crony form of capitalism. But global conditions were

not favorable either, and they must have taxed the incentives for reforming domestic policies.

Like other developing countries, MENA countries had to contend with increased competition from Asia and Eastern Europe, which meant that an export-led strategy was more challenging in the 2000s compared to the 1980s when Asian exports boomed. But more to the point, the authors blame policies in the two neighboring trade blocs that should have naturally pulled up the economies of the MENA region – the EU, and the GCC. Other developing regions have benefitted from growth in their richer neighbors – as did Asia with Japan, Mexico with the US, or the Eastern European countries with the EU. The developing MENA countries however signed unfavorable Free Trade Agreements (FTAs) with the EU that focused on manufacturing products for which the region possessed little advantages, and excluded agriculture, services, and labor movement, which are areas of great interest to the region (Galal and Hoekman, 1997). The GCC, with a market half the size of MENA's overall GDP, should normally be a large market for MENA's production, considering the comparative advantage in human relations and culture. The enormous subsidies accorded to local production in the GCC itself have, so far, neutralized this potential. However, the economic regime in the GCC, characterized by large subsidies to firms, open labor markets, and guaranteed jobs in the public sector at above market wages for nationals is inefficient and unsustainable, in addition to hurting the development prospects of the poorer MENA countries. The chapter argues that a successful strategy for the region must rest on new agreements on trade and investment with the EU and the GCC that can foster FDI focused on activities that generate technological externalities and allow these countries to move up the quality ladder and generate more skilled jobs. The vision would require domestic and regional policies to promote the expansion of an efficient regional service platform. It would also require commensurate complementary actions by Europe and the GCC that are adapted to the historical political window of opportunity in which the MENA region finds itself. The EU should offer more balanced trade agreements that foster horizontal FDI that generates positive knowledge spillover. And the GCC should over time stop subsidizing domestic production and invest instead in more efficient production in the poorer countries of the region.

Inequality

For a long time, the work on inequality in the Middle East has focused on measuring inequality of income and of consumption using household surveys. In the last few years, attention has shifted to measuring inequality of opportunity on the grounds that differences attributed to effort are ethically justified, while those related to circumstances are not (Roemer, 1998), and as such, they

generate social grievances and reduce trust in social and political institutions. In particular, inequality of opportunity in human development reduces social mobility based on education, one of the essential elements of any just social contract. And inequality of opportunities in the labor market denies income convergence for those that have managed to get an education, based not on their effort, but on the likes of class and social networks. The chapters in Part II provide new insights on these dimensions of inequality. They also look the difficulty of constructing politically supported policies to reduce inequality, based on the now classical case of the attempt to remove energy subsidies in Iran.

The chapter by Assaad and Krafft (**Inequality of Opportunity in Human Development**) argues that human development is a neglected issue in the discussion of inequality in the MENA region. The chapter shows that after fast progress on increasing access to health and education in the 1960s and 70s, state services have stopped offering avenues for social mobility, and instead, have increasingly become more regressive, trapping the poorer elements of society in poverty. Inequality of opportunity is particularly pernicious and destructive when it occurs during the early years of life. Early childhood is the most sensitive time for growth along a number of dimensions, including cognitive, physical, and socio-emotional development. Inequality in the early years translates into inequalities in human development that will persist throughout adult life. The chapter synthesizes the recent evidence on inequality of opportunity in human development in MENA, with a particular focus on education, health, and nutrition, areas where basic services, particularly government services, play a crucial role. It finds a troubling pattern of substantial inequalities in human development before young people have any choice or agency over their outcomes. Especially notable is the fact that while MENA countries essentially guarantee the successful human development of the "best-off" members of society, there is substantial inequality and particularly varying outcomes for the most vulnerable members of society, which goes a long way to explaining the social anger and frustrations that have led to the 2011 uprisings.

Here the most vulnerable individual is a child from the poorest 20% of households, with illiterate parents, living typically in a rural, "bad" region of each country. In contrast, the most advantaged individual is a child from the richest 20% of households, with secondary or higher educated parents, typically living in an urban "good" region of a country. In Yemen, the most vulnerable child has an almost one-in-ten chance of dying in the first year of life, compared to a near-zero chance for the most advantaged child. In Libya and Morocco, the difference between the two groups is very high (3.2% versus 0.4% in Libya, and 5.2% compared to 1.1% in Morocco). Even in less unequal Egypt, the most vulnerable child is more than twice as likely to die in the first year of life than the most advantaged (2.8% compared to a 1.1%).

The chapter also documents pervasive inequalities of opportunity in educational attainment as well as in achievement. The relative chances of joining pre-school education range from a low of a most advantaged child being four times more likely (West Bank and Gaza) to a high of 32 times more likely in (pre-conflict) Syria. The most advantaged children have a near zero probability of not entering primary school, but there are wide variations in the probability of not entering for the most vulnerable children. The most vulnerable boys in Iraq and Yemen have a 60% and 62% probability of not entering school, respectively. In all countries except for Iran, the most vulnerable girls fare worse than the most vulnerable boys and in some cases by a wide margin, suggesting that gender gaps in opportunities remain important, even in the most opportunity equal countries. If they manage to reach secondary school, the most disadvantaged continue to be discriminated against. While the most advantaged boys and girls are almost universally able to reach the upper secondary stage, only 8% of boys (and 3% of girls) among the least advantaged are able to enter in Iraq, 17% in Syria, 37% in Iran, 41% in Tunisia, 52% in Jordan, and 54% in Egypt. There is less information available for university, but limited evidence from Egypt suggests a similar story: while the most privileged students have a virtually 100% probability of entering some kind of higher education institution, the most vulnerable male has only a 9% chance of doing so, and the most vulnerable female a mere 2% chance. There is also evidence that the quality of the education (as measured as scores on the TIMSS test) being provided in public institutions has deteriorated in the region, especially for those who are unable to supplement free public education with parental assistance and expenditures on private lessons and other sorts of out-of-school assistance. Disparities in the ability of parents to supplement their children's education will show up in the form of inequality in learning and achievement (Salehi-Isfahani et al., 2014). The highest levels of inequality of opportunity in the quality of education (with family background explaining up to 30% of the lack in quality) are in Turkey, Iran, Lebanon and Egypt.[1]

In a second contribution, Krafft and Assaad (**Inequality of Opportunity in the Labor Market for Higher Education Graduates in Egypt and Jordan**) focus on outcomes in the labor market. Although measured inequality in income in Arab countries is moderate by international standards, the chapter reviews a growing literature that documents substantial inequality of opportunity in MENA labor markets. In Jordan and Egypt wage inequality includes substantial gender differentials, wages are affected by parental education and location in Egypt, and there is also inequality of opportunity in entering

[1] These ranges are similar to those found in Argentina, Belgium, Brazil, Bulgaria, Chile, France, Germany, and Hungary.

various occupations. But while inequality of opportunity in the labor market is clearly an issue, the roles of pre-market and in-market inequality had not been disentangled. Identifying whether in-market problems are contributing to inequality of opportunity is vital for determining whether the education system alone, or both the education system and labor market, need to be reformed in order to provide more equal opportunities.

The chapter offers a new contribution by examining the extent of in-market inequality of opportunity in Egypt and Jordan among higher education graduates, controlling for educational attainments. It uses a survey of higher education graduates in two fields of study – business and information technology. Their results show that some in-market inequality exists in both settings, but more so in Egypt. More to the point, inequality of opportunity explains a good part of these variations – depending on the outcome they focus on (time to first job, wages five years after graduation, current wages, current job quality), inequality of opportunity explains between 10 and 30% of the variations, and more so in Egypt than in Jordan. This is more than what has been computed in other parts of the world – for example, in six countries in Latin America estimates of the inequality of opportunity share fell in the 13% to 34% range, in the United States it is around 18%, and in Italy around 20%.

The last chapter of the part on inequality, by Salehi Esfahani (**Energy Subsidy Reform in Iran**) focuses on the political economy of subsidy reform. In general, energy subsidies have been higher in the MENA region than in any other region in the world, and they tend to favor richer households (Sdralevich et al., 2014). They have been heavily used by most states of the region as part of a panoply of divide and rule instruments that includes privileges to politically connected firms, hiring in the public sector, and repression of the opposition. In the future, the reduction of these subsidies and the redeployment of public finance towards pro-poor services offer an important avenue to improve social justice and reduce inequalities. The case study of Iran however shows the perils of such a transformation when confronted with complicated politics.

In December 2010 Iran implemented an ambitious subsidy reform program for energy and bread. Prices on these products were raised by factors of 2 to 9 and, in compensation, all households were given a monthly cash transfer of about $45 per person (about $90 in Purchasing Power Parity dollars). The compensation scheme was essential to the initial success of the program and allowed the largest energy price reforms in history to go through without the social unrest that usually accompanies, and often derails, much smaller fuel price increases in other countries. However, three years later, the program has stalled, domestic energy prices were once again well below their global levels, and the fiscal deficit had grown larger on account of large transfers *and* large subsidies.

Two factors explain the failure of the program after a successful initiation. First, in its zest to redistribute income to shore up the power of the Ahmadinejad

administration, the government set the level of cash transfers well above new revenues from the price increases, and printed money to pay for the deficit. The resulting inflation pushed parliament to freeze further price adjustments. Second, about a year and a half after the program began, international sanctions targeting Iran's oil exports and the country's access to global trade tightened considerably causing oil exports to fall by half and disrupting industrial production. Iran's currency, the Rial, collapsed and domestic prices spiraled out of control. The resulting economic crisis eroded public support for the administration and put further energy price increases on the back burner. In 2014, the new Rouhani government has resumed price reform, though this time on a much smaller scale and in calmer domestic environment. But distrust with energy price reform now runs deep, and the effort to bring energy prices back to international levels will be more difficult.

Rentier states reconsidered

The work on natural resources in the region has carried negative connotations, starting from the Dutch Disease, down to the impact of oil price volatility on economic growth, and importantly, the impact of large rents accruing to the public sector on governance. Part IV of the volume provides new insights on the notion of oil rents and Rentier states, with important innovations in several dimensions of the politics of rents – a distinction of the differential effects of oil on the political mechanisms of cooptation and patronage on the one hand, and repression on the other; an empirical substantiation of the claim that moderate amounts of oil can lead to a worse curse than large amounts of oil per capita; and a broadening of the notion of rent to include strategic external rents related to geopolitical motives, and domestic regulation rents related to the politics of economic privileges and cronyism.

The chapter by El Beblawi (**The Concept of "Rentier States" Revisited**), who was one of the creators of the term "Rentier Economy or State" in the 1980s, revisits the usefulness of the concept by extending it to the global context. The idea of oil rent finds its root in the paper "The Patterns and Problems of Economic Development in Rentier States" (1970) by Mahdavy, which was developed further by El Beblawi in an article under the title of "The Predicament of the Arab Gulf States: Individual Gains and Collective Losses" (1982). In a Rentier state engaged in the production of oil or of other natural resources, rent production is centered on a small fraction of the society while the rest of society is only engaged in the distribution of this wealth. In such states, citizens become less demanding in terms of political participation.

Rather than focusing on domestic politics in oil exporting countries, El Beblawi emphasizes in his chapter the distributional consequences of natural resource rents at the global level. While the Gulf oil exporters with very narrow domestic absorptive capacities had to accumulate international financial assets, the

parallel surge in the issuance of large quantities of financial assets by rich countries represented a rise in a new type of quasi-rent to the issuers, displacing the issue of rents from oil countries to the West. Thus, there are two types of Rentiers, one derived from the extraction of a natural resource gift and the other derived from the excess issuance of financial assets. The first is characterized by too little effort. The second is associated with too little responsibility, and the possibility of exposing the global economy to unwarranted uncertainty, if not to financial chaos. The combination of using the US Dollar as an international reserve currency and the excessive deregulation of the financial sectors in developed countries exacerbate the problem globally and entail an extra and systematic redistribution of wealth from developing to developed countries. El Bebalwi's analysis has several implications. For natural resource rich countries, they need to reconsider their strategy in terms of the rate of depletion of their natural resources as well as the form, nature, and location of their excess liquidity. In the case of the Arab countries, El Beblawi recommends that oil rich countries should invest in the labor abundant poor neighboring countries, especially where investment opportunities do exist. For developed countries, his analysis emphasizes the need for stronger financial regulation in order to avoid destructive asset bubbles.

Since the introduction of the Rentier state theories, a well-established theoretical and empirical literature has emerged, that shows, based on cross-country comparisons, that there is an oil and mineral resource curse, reflected in lower long-term growth rates in oil producing countries, and which tends to be a long-term phenomenon that operates largely through political governance mechanisms. Yet, 30 years after the rise of the GCC, it is hard to argue that oil has been a curse for these very oil rich countries, even though one sees various manifestation of Rentier mentality such as low individual effort at income generation, or low social pressures to democratize. But while these countries are not considered democratic states, they have solid rule of law and government capacity, and they have grown immensely in the past two decades.

This paradox had been tackled in recent research qualitatively and theoretically by Cammett et al. (2014) and Ali and Elbadawi (2014) in particular, who argue that there very rich oil states are able to ensure political stability through patronage, and are not threatened by the development of the private sector like moderate oil producers. On the other hand, countries with moderate levels of oil per capita cannot afford to enlist large parts of society through patronage, and they are tempted to develop repressive institutions to stay in power, and to distrust the private sector. The chapter by Elbadawi (**Thresholds Matter: Resource Abundance, Development, and Democratic Transition in the Arab World**) is the first paper that empirically verifies this conjecture by showing that economic growth and good governance are related (negatively) to oil wealth through a non-monotonic U-like relation. In particular, economic

growth declines as oil resources rise until a threshold is reached, after which the negative impact of oil on growth comes down. Similar non-monotonic relations are found between oil wealth and the onset of civil wars and for democratic transitions. The empirical discoveries of Elbadawi confirms that the unusually high resource abundance allowed the emergence of a more developmental and sustainable political equilibrium in the GCC as well as in other equally endowed countries. Hence, the GCC regimes were not directly affected by the uprisings of 2011 and they simply reacted by increasing patronage. For these countries, the oil curse is about sustainability – with rising population, oil per capita will only come down over time, a theme that echoes the warning raised in the El Beblawi and the Diwan and Mouhoud chapters that also stress the need for such systems to evolve in order to avoid falling into a curse trap in the future, as well as to create growth opportunities in the poorer MENA countries.

In the following chapter, Malik (**Beyond the Resource Curse: Rents and Development**) further confirms the usefulness of the concept of rents for the understanding MENA societies as he proposes to broaden the concept of rents to rents that arise outside of natural resources. He argues that while MENA's political economy has long been studied through the prism of the resource-curse, many of the region's pathologies are rooted in an economic structure heavily reliant on external windfalls other than oil. The chapter develops the case for a broader conceptualization of rents that includes also rents derived from aid, remittances, and the government manipulation of the economy. Discussions of Arab political economy should therefore be framed as part of a broader enquiry of the relationship between rents and development. This requires, in turn, a deeper understanding of business–state relationship and the role of regional linkages in development.

The characterization of crony relations as "regulatory rent-creation" is particularly illuminating. In Malik's view, such a rent stream is generated from the domestic economy by erecting competitive barriers, administrative controls and burdensome regulation in order to give control of the heights of the economy to insiders. These extractive policies and the rents they generate are seen as a mechanism to sustain an elite coalition whose interests are broadly aligned with those of the regime. It is therefore not without reason that such protective devices are more pervasive in MENA's labor-abundant economies where the distributional commitments are large relative to the available resource envelope. Thus, when rents from hydrocarbons are scarce, other rent streams assume greater significance for regime survival. This large-scale subversion of markets blurs the boundaries between the public and private sectors and creates impermeable barriers for unconnected firms. The pathology of the missing middle, where the firm space is divided between large connected firms at the top and informal firms in the periphery, is partly a result of such exclusive economic policies. For Malik, it is this political economy that explains why Arab

markets are so protected, and why non-tariff barriers, which are well known for their arbitrary, discretionary and non-transparent character, are more pervasive in MENA economies than other developing regions.

The chapter by Beschel and Yousef (**Public Sector Reform**) shows how difficult it is to reform the Rentier state (now taken in the broader sense of Malik), since its logic is driven more by the politics of patronage or clientelism than by economic efficiency. The states of the region tend to be large, overstaffed, and overly bureaucratic. The state has been in various places an instrument for patrons to provide favors to their clients, including public service jobs, privileged access to services, and/or privileged access to business opportunities. In many countries, allegations of corruption, insider dealing and abuse of office were at the heart of the popular uprisings. Perhaps no response was more ubiquitous across the region in the wake of the Arab Spring than that of increasing civil service pay. It does not come as a surprise to find that in the past, public sector reforms were not particularly successful. In developing ten case studies of reforms in public financial management, the civil service, and service delivery, the authors conclude that the main drivers of the few cases of successful reforms have been the presence of political will and of leadership. The close link between reforms and personalities is symptomatic of the lack of norms and mechanisms that can make institutions work.

The authors also review developments on public sector management after the revolutions. Revolutions are inherently complex and messy affairs. But amidst broken economies and increased chaos, they document how a flurry of new legislation and state reforms, from the constitutional level down to service delivery, might be laying the ground for a broad transformation of the state in the future. In particular, in the wake of the uprisings, parliaments are being empowered vis-à-vis the executive, and new institutions have been created to advance transparency, combat corruption, and protect citizen rights. These reforms are reducing the overwhelming power of the executive vis-à-vis the legislative and judicial branches, as well as starting to create, in some countries, more open, inclusive, and contestable political processes. There was also progress in curbing the power and influence of state security agencies, and several countries have focused on strengthening constitutional and legal protections for human rights and individual liberties. In particular, Morocco's constitutional reforms (July 2011) specifically affirmed the Kingdom's commitment to universal human rights, and the new Tunisian constitution (January 2014) upholds many key civil, political, social, economic, and cultural rights. Some countries have started to toy with decentralization, especially states with historically disgruntled regions or constituencies such as Iraq and Libya, but the establishment of viable local governments remains a longer-term agenda. Many Arab countries – such as Jordan, Kuwait, Morocco, and Saudi Arabia – rushed to implement a variety of new anticorruption measures. Finally, while prior to the

revolutions of 2011 transparency was not a very popular issue among governments, there has been a flurry of interest in such legislation since 2011 – most notably with new right to information laws passed in Tunisia and Jordan.

Political transitions

Part IV of the book deals with the historical transformations ongoing in the region and situates the uprisings that started in 2011 in broader theoretical, empirical, and cross-regional comparative perspectives. It draws implications for the factors that enabled or inhibited change during the authoritarian breakdown phase and the ongoing transition period, and that are likely to influence the consolidation of democratic institutions. These chapters pay particular attention to concepts such as elite cooperation, leadership, social trust and social polarization. They also highlight how both "structure" and "agency" matter and interact in shaping outcomes.

Although mass mobilization contributed to regime breakdown, Cammett (**Transition Experiences and Relevant Lessons**) argues that elite defection was more decisive in bringing down authoritarian rulers and in shaping the new rules governing political life. She argues, based on case studies of the Philippines, Malaysia, Indonesia, Spain, and Portugal, that when elites are willing to compromise, even in the face of profound ideological differences, the probability of successful democratic transitions increases. In the Arab transitions, the breakdown of authoritarian rule originates with splits within political and military elites. If the army had opposed the ouster of Mubarak in Egypt or Ben Ali in Tunisia, autocrats might have held onto power, while elite unity, particularly in the ranks of security officers, helps to explain the Assad regime's retention of power in Syria.

A review of the case studies generates however only tentative explanations for the emergence of elite cooperation. These range from contingent factors, such as leadership and the ideological orientations of key stakeholders, to structural conditions, such as politicized ethno-religious cleavages, the robustness of patronage networks sustaining the authoritarian coalition, and the relative power of societal groups that support or oppose incumbent dictators, and particularly the middle class.

Cammett distinguishes between "pacted" and "sharp transitions". The type of transition shapes the quality of democracy, such as the rule of law, accountability, civic and political liberties, economic equality and the responsiveness of government officials to voters. The defection of economic elites from authoritarian bargains does not automatically produce elite consensus behind an alternative system of government. When the transition is pacted between regime incumbents and members of the opposition, as occurred in Indonesia, patronage networks are more likely to remain intact, facilitating a smooth transition but at the price of a less inclusive democracy, both politically and

economically, as has happened in Tunisia, Morocco, or Jordan, and ultimately in Egypt as well. Conversely, when democratization occurs through a sharp break, powerful elites whose interests were tied to the previous authoritarian regime may lose access to patronage and act as spoilers. Furthermore, it is difficult for new rulers to quickly establish their own patronage networks to incorporate disaffected elements from the prior regime. Thus, transitions based on a sharp break from the prior regime can be unstable, as in Egypt under the Muslim Brotherhood, and in Syria, Iraq, or Yemen.

Nabli's chapter (**Democracy and Economic Development**) examines the economic performance of democracies by reviewing the political economy theoretical and empirical literatures and asking how this body of work may apply to the Arab region. He reminds us that democracy is not a recipe for economic development. There is no significant, empirical relationship between democratic development and economic growth (there is though a negative relation between democracy and the *volatility* of economic growth). However, there is good empirical evidence about a significant and positive impact of good governance on economic growth, with causality running from institutions to growth. The implication for the Arab region is that only if better governance can be achieved through democratization, can significant gains be achieved in terms of economic growth.

There are several considerations here. First, democratic institutions come in different forms, which may have different impacts on governance and outcomes. For example, there is a rich literature that compares the economic performance of presidential vs. parliamentary democracy, proportional representation vs. plural-majoritarian systems, or majoritarian vs. consensual democratic systems. These features themselves however will tend to be endogenous to politics. In Egypt a "presidentialist/majoritarian" political regime was adopted which did not allow for compromise and consensus building, enhanced polarization and leading to the collapse of the democratization process. In Tunisia on the other hand, the electoral system selected for the first elections in 2011 was based on proportional representation, with reduced powers for the presidency, and this supported consensus and compromise. The different choices were themselves a result of the strong presence of the military institution in Egypt and the stronger middle class in Tunisia.[2]

Second, the impact of democratic institutions depends on other institutional characteristics prevailing in the country that democratizes, and in particular, state capacity and the rule of law. As such, the impact of democracy on development may be quite different depending on the stage of institution building. Countries experienced different paths and sequencing in developing

[2] The middle class is estimated at only 44% of the population in Egypt, and at 58% in Tunisia (ESCWA, 2014).

democracy and good institutions. Echoing the work of Levy and Fukuyama (2010), Nabli describes two typical cases of sequencing that have occurred historically. First, in many historical experiences, a strong and capable state develops first, often under authoritarian orders, and when subsequent democratic development takes place, it has a strong positive impact on economic development. Examples of such historical experiences include France, Prussia/Germany, Sweden, Denmark, Japan, and Korea. In all these cases economic progress or growth takeoff pre-dated democracy, and the prior development of a modern state and rule of law made the success of democratization easier, which enhanced economic success. The second type of change involves democracy being introduced before the development of a modern, strong, capable and impersonal state. The typical outcome is a clientelistic political system, ripe with corruption. Typical cases include Italy, Greece, the Philippines, India, and most of Latin America and the democratic countries of Africa. In these countries, economic outcomes vary widely, some achieved strong growth even with weak governance, while others got stuck with weak governance systems and weak growth. Developing countries that democratize tend to be of the second type with weak state capacity and weak rule of law when democracy is introduced. As shown in the work of North, Wallis and Weingast (2009), inclusive institutions only emerge in rare occasions historically. This process is enhanced by the emergence of a middle class and of a business elite with an interest in an impersonal and effective state and improved rule of law.

The recent uprisings have raised hopes that the establishment of democratic institutions would enhance development outcomes. But the evidence Nabli and Cammett discuss does not warrant such an optimistic view. In Libya and Yemen, the pre-conditions for a workable democracy were simply not there – as state capacity and rule of law were extremely weak to start with, and the existence of large natural resources fueled conflict. From that perspective, Tunisia and Egypt stand a better chance in view of their limited resource wealth and stronger state capacity. However, in both countries, social polarization remains a major problem. Moreover, the economics have not been supportive of the politics. Arab transitions have been, so far very costly. The unsuccessful transitions in Libya, Yemen and Syria have led to a collapse in law and order, conflicts, and civil war, devastating institutions, infrastructure and societies. Even in Egypt, Tunisia, Jordan, and Morocco the costs have been smaller but still large, which led to losses in terms of poverty reduction, employment, and social indicators. In all cases, the political dynamics of regime change make the task of economic recovery all the more difficult. During political transitions, economic reform is not a priority. Instead, the reform of political institutions is the major issue. This situation imperils the economic future of the Arab uprising countries and, through negative feedback loops, also undermine political reform. Because the public has little appetite for prolonged hardship, the

incentive for politicians to enact populist measures during transitions at the expense of longer-term growth and development rises.

Both Cammett and Nabli highlight the impact of various structural factors, such as inequality, endowments in natural resources, ethnic and cultural diversity, geographical location, and colonial history on the relationship between institutions and politics. The uprisings of 2011 impacted mostly non-resource rich countries like Tunisia, Egypt, Yemen and Syria, while resource-rich countries (with the exception of Libya) were able to contain the spread of contagion using their wealth. The divisions about the role of religion in politics and of identity politics has shaped the post-uprisings developments in all countries, taking in many cases the form of extreme violence undermining the chances of any consensual institution building.

Freund and Jaud (**Transition Experiences: A Statistical Analysis**) attempt to evaluate the structural conditions of success of political transitions by looking empirically at what one could learn from over 100 countries that have changed regimes in the last half-century. Overall, experiences from transitions around the world provide a cautionary tale. An initial move towards democracy does not guarantee a complete transition to democracy. In their sample, only 38% of the countries that initiated a transition experienced a complete and rapid transition to democracy, 29% had a failed transition, 10% moved gradually to democracy, and another 22% went in reverse, from democracy to autocracy.

Several of the findings in this chapter offer valuable lessons for the region. The richer countries of the GCC should reflect on the fact that elsewhere and in the past, richer autocracies have been less likely to attempt democratization, but more likely to succeed when they tried. The findings highlighted in the inequality chapters about the high level of gender inequality in some countries of the MENA region take on a new dimension when we learn that in other regions, high levels of inequality for women has been a predictor of unsuccessful transitions. On the other hand, the finding that a history of military rule and presidential systems had made democracy harder to achieve elsewhere warns us against the attraction of strong-handed populist solutions in the Arab region. The findings suggest that countries that reform into a parliamentary system are on average more likely to transit to a complete democracy more quickly than countries that reform into a presidential system. However, the fact that there is no evidence that countries that select proportional representation have higher chances of rapid and complete democratic change is also valuable. Finally, that there is evidence of a strong neighborhood effect for transition durability suggests that a successful transition in Tunisia or Egypt will have a potentially important demonstration effect in the region. Whether the past helps predicts the future or not, each of these historical regularities teaches us something about the points of tension in the MENA region.

Other, more negative findings, are equally instructive. Experiences from 50 years of transitions suggest no significant association between the size of the youth in the population and the initiation of transition, which helps to debunk the notion that the existence of a youth bulge explains revolution in the Middle East. This is confirmed further by recent opinion polls that fail to show important intergenerational differences in values in the region (Diwan, 2015). And while many authors, including in the present volume, stress that ethnic heterogeneity may negatively affect democratization, the historical record suggests that ethnic fractionalization actually *promotes* democratization, perhaps because democracy is the fairest way of governing rival factions. Finally, the data do not support the claim that Islamic values retard transition.

Future research

Clearly no single volume could address all problems once and for all, nor does the process of knowledge accumulation ever comes to an end. Here, we would like to point out a research agenda for the coming years on issues related to those explored in this volume. Many of the knowledge gaps were made apparent by the insurrections of 2011 themselves, which were largely unexpected. Indeed, much of the political research of the past two decades had focused on the political economy of regime survival, and how long-lasting autocrats have been able to preserve power through cooptation and repression, as well as divide and rule strategies that extended to the economic domain, rather than on the social transformation that ended up shaking the status quo.

On the growth agenda, much is known about the lack of structural transformation towards more productive, diversified, dynamic, and export oriented activities. What is less understood is why. This performance is being attributed by new research to an environment of privileges rather than competition, and/or political instability. While the issue of state– business relationship is now better understood, careful empirical research has only focused so far on the cases of Egypt and Tunisia. More careful work to map out the mechanisms of inclusion/exclusion, and the impact of such policies on growth is needed. Moreover, it is not clear how networks of influence are likely to evolve over time in light of the emerging political settlements. Another important area where little is known relates to the effectiveness of industrial policy and the political conditions under which it can work better. Governments in the region are engaged extensively in selective interventions, but these interventions are rarely evaluated and convincing alternatives offered. For industrial policy to be effective, not only will politics need to be supportive, but in addition, there must be a reasonable vision that outlines the areas in which the region can become competitive given the evolving international division of labor, the spread of global value chains, and the rising importance of services in ensuring

improved competitiveness. All these are areas where more research is crucial in order to figure out how to create skilled and unskilled jobs to accommodate the fast growth of the labor force in the region.

With respect to equality, despite the progress being made on measuring inequality of outcomes and of opportunity in the region using household consumption/income/labor market surveys or other data on human development, more work is needed. The measures of inequality of opportunity in the labor market that exist are limited to two countries, and they only offer a lower bound on true inequality of opportunity due to unobservable circumstances, including social networks, parental values for work and education, or additional family circumstances such as income and wealth. Some observers (e.g. Kanbur and Wagstaff, 2014) have noted that given that the region has less inequality to start with than other regions, the 25% to 30% inequality of opportunity in labor markets is unlikely to be bad enough to generate revolutions. Moreover, there is very limited information in the MENA region on the evolution of inequality of opportunity over time. Limited studies show that nutrition has not shown much improvement, but access to education has exhibited decreasing inequality of opportunity at the primary and secondary levels in Egypt. And while inequality of opportunity in higher education is very high, there are no strong trends on this score. Further work is clearly needed to assess inequality of opportunity trends over time across a variety of dimensions of human development.

The topic of gender inequality in the region has witnessed soaring interest over the past decades, especially in the context of the rise of religious conservatism in the region. The two chapters by Asaad and Kraft suggest that while there are important differences across the gender dimension in access to education and health services, especially among the least advantaged part of the population, the reasons why female labor force participation rates in the region are so much lower than in the rest of the world remains a mystery. The extent to which this phenomena is related to lower access to education, a rising mismatch between jobs women prefer and jobs available, or to patriarchal cultural values and social norms that advantage men, remains an open question.

In addition, we know very little about other types of inequality, which may matter even more politically than inequality of opportunity. In particular, the distribution of income at the top quantile, or how badly assets are distributed within countries, are areas of complete ignorance, so far. These issues have gained prominence after the publication Pikkety's book, *Capital in the Twenty-First Century* (2014). Equally important, there is a dearth of knowledge on the policy and institutional drivers of inequality in the region. While much is known on issues of subsidies and the political rationale for them, much less research is available on evaluating the effects of alternative policies on equality,

and in particular, of different types of taxation, and different types of targeted affirmative action.

Regarding the issue of natural resources, traditional research focused on the impact of the volatility of oil prices on economic growth, saving and investment decisions and economic diversification. Ample attention has also been given to the adverse effects of oil rents on democracy and governance. And new research is now underway on how natural resource rich countries can structure their macroeconomic institutions (both fiscal and monetary) and how to manage sovereign wealth funds better. The next generation of research should delve more into issues related to labor markets, especially in the labor scarce oil rich countries, and issues of economic sustainability, which will remain a challenge as along as nationals have no incentives to work in the private sector.

The most glaring gaps in knowledge concern probably the political economy of transitions. While a growing body of research has focused on the grievances and aspirations leading to the uprisings of early 2011, much less is known about what has happened afterwards and why. In many ways, history is now moving much faster than researchers, who have to rush in order to comprehend the historical transformations taking place in countries such as Iraq, Syria, Yemen, or Libya. The sharp rise in social polarization in the region, whether along the religious/secular dimension, or along ethno-religious or even tribal lines, continues to surprise. At the micro-level, exploring carefully what opinions and values survey data can reveal about the state of society is increasingly a necessary area for deeper investigations. A new line of research using experimental techniques can also be useful and rewarding in that respect. On the macro front, research seems necessary to develop a better understanding of the possible political settlements in the region, especially in the more fractured states. More systematic research is needed to both identify the root causes and consequences of conflicts, as well as what can be proposed on the reconstruction level in order to make the likelihood of conflict resolution more realistic.

Gaining new insights through careful and relevant research about the region is important in its own right. In addition, it may prove to be the most rewarding investment that the region could make to build peaceful societies for the benefit of all citizens.

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Part I
Economic Growth and Structural Transformation

1
Structural Transformation

Doerte Doemeland and Marc Schiffbauer

1.1 Introduction

The Middle East and North Africa (MENA) region is an economically diverse region. It encompasses oil-rich, high-income Gulf countries and resource-scarce, lower-middle-income countries, such as Djibouti, Morocco, West Bank and Gaza and Yemen (Figure 1.1).[1] The countries are also very different in their demographic structure. There are relatively few young people as a share of the population in Qatar and United Arab Emirates, while in Iraq, Yemen and West Bank and Gaza more than 40 percent of the population is younger than 15 years of age (Figure 1.2). Moreover, while the Gulf states are net migrant recipients, all other MENA countries, including natural resource-rich countries such as Algeria, Iraq and Iran, export migrants.

Though per capita growth in MENA has been broadly in line with other regions, the contribution of productivity growth to overall growth has been very weak. MENA's growth has to a large extent been driven by demographic change, here defined as the change in working-age population as a share of the total population and contributed about 50 percent to economic growth. High fertility rates combined with rapidly declining mortality contributed to a sharp increase in MENA's working-age population as a share of the total population and has rapidly increased MENA's potential labor supply.

The objective of this chapter is to analyze MENA's growth performance through the prism of structural change. Using a newly developed data set, it assesses the role of structural change in explaining MENA's growth performance. In particular, it analyzes the contribution of productivity growth at the sector level, within sectors, and due to reallocation of workers across sectors, to overall economic growth. It also provides empirical evidence as to which

[1] Lower middle income countries are defined as countries with a 2012 GNI per capita using the World Bank Atlas method between $1,036 and $4,085.

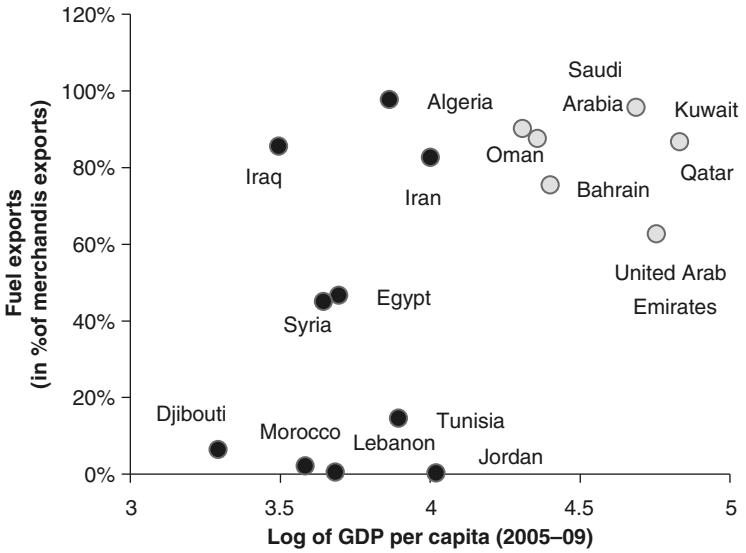

Figure 1.1 GDP per capita and fuel exports

Source: Authors' calculations based on WDI. Daata for Libya, West Bank and Gaza and Yemen are missing. Dark grey circles are developing countries, light grey circles high income countries.

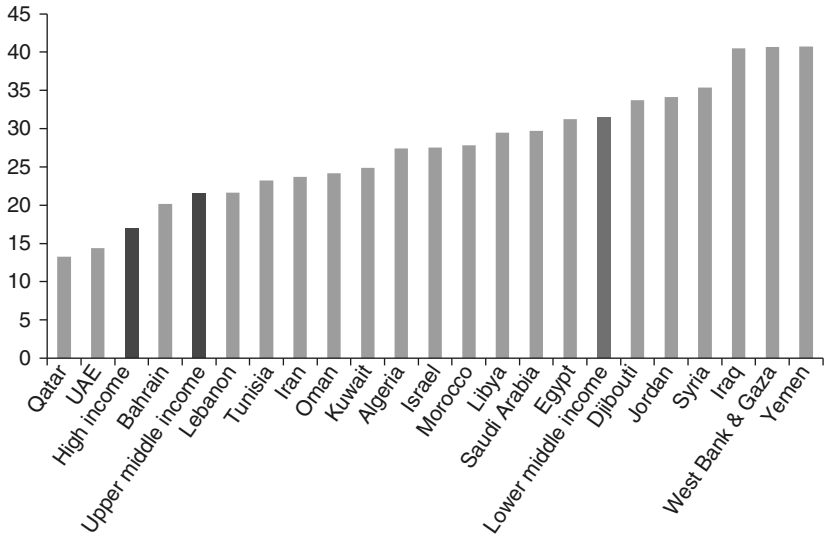

Figure 1.2 Percentage of population younger than 15

Source: Authors' calculations based on WDI. Dark grey bars are country group averages.

factors may have contributed to MENA's slow structural change and discusses unconditional convergence within MENA's manufacturing sector.

The chapter is structured as follows. First, it provides an overview of MENAs growth performance over time and relative to other regions. Then, it present patterns of labor productivity growth in the MENA region, before assessing structural change and its determinants. Next, it provides a discussion of unconditional convergence within manufacturing. The final section concludes.

1.2 MENA's growth performance

With the exception of Asia, MENA's growth in per capita terms has outperformed all other regions during the last two decades. After a prolonged economic stagnation during the 1980s, growth in MENA recovered in the 1990s as governments shifted away from state-led economic models towards more private-sector led economic policies and promoted global integration. Thanks to increased global integration, export growth, even when excluding minerals and fuels, surged above the average of developing countries. Between 1991 and 2012, real GDP growth per capita averaged 2.2 percent in constant terms, outpacing all other regions with the exception of South Asia and East Asia and Pacific. This good growth performance was not driven solely by MENA's oil exporting high-income countries. Real GDP per capita growth was also strong among MENAs developing countries, averaging 2.1 percent between 1991 and 2009 and accelerating to 2.6 percent between 2000 and 2009.

In no other region was growth as strongly associated with demographic change as in MENA. Demographic change, which is the change in working-age population as a share of population, contributed about 50 percent to economic growth (Figure 1.3). The MENA region has the second highest population growth rate in the world. Its population growth rate between 1990 and 2021 averaged 2 percent and was only surpassed by population growth in Sub-Saharan Africa, which averaged 2.7 percent over the same period. High fertility rates combined with rapidly declining mortality contributed to a sharp increase in MENA's working-age population as a share of total population (Figure 1.4), rapidly increasing MENA"s potential labor supply. Though its demographic is often blamed for MENA's economic vows, the relative size of the labor force is a key determinant of country's income level. If the share of working-age population in total population increases, labor supply tends to increase and with it the economy.

Riddled with structural constraints, many MENA economies have not been able to absorb a fast increasing labor force. Formal sector workers as a share of the working-age population in MENA are much lower than in other middle-income regions like Latin America and the Caribbean (LAC) and Eastern Europe and Central Asia (ECA). Unemployment and inactivity, in particular among

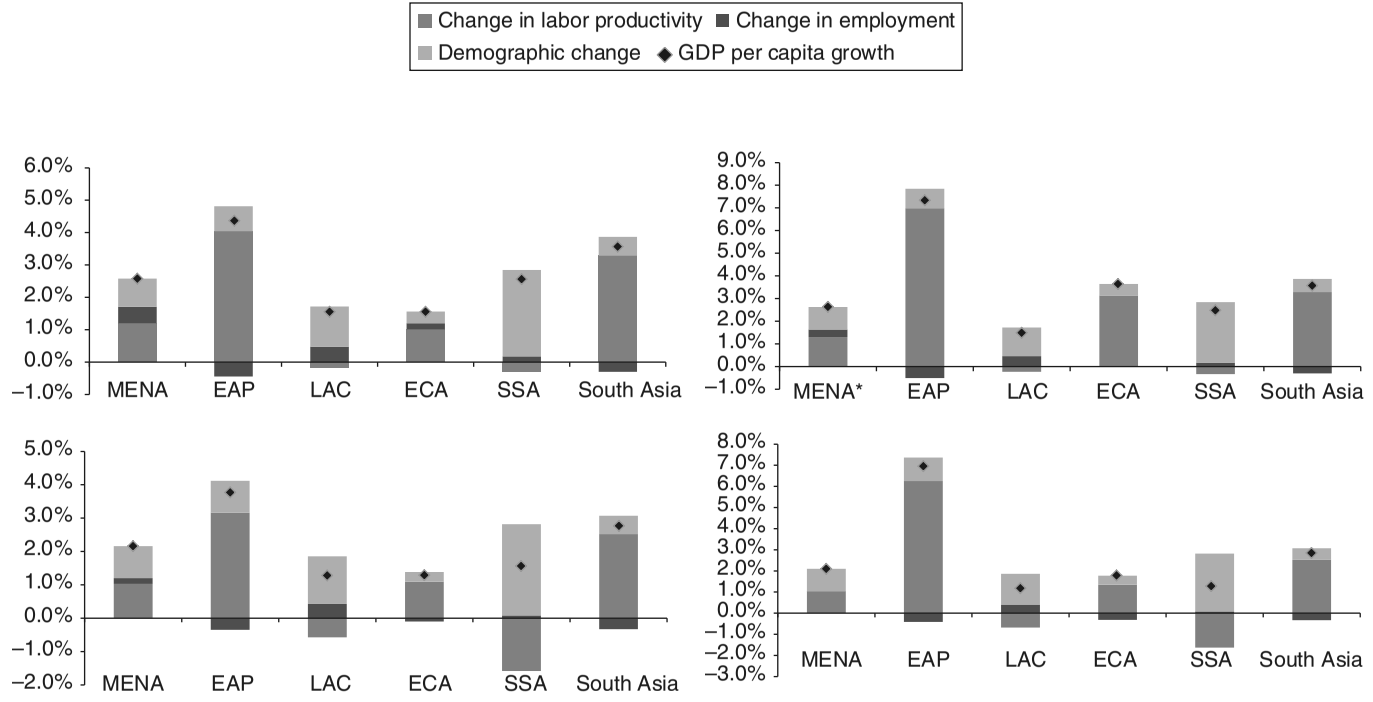

Figure 1.3 MENA's growth performance

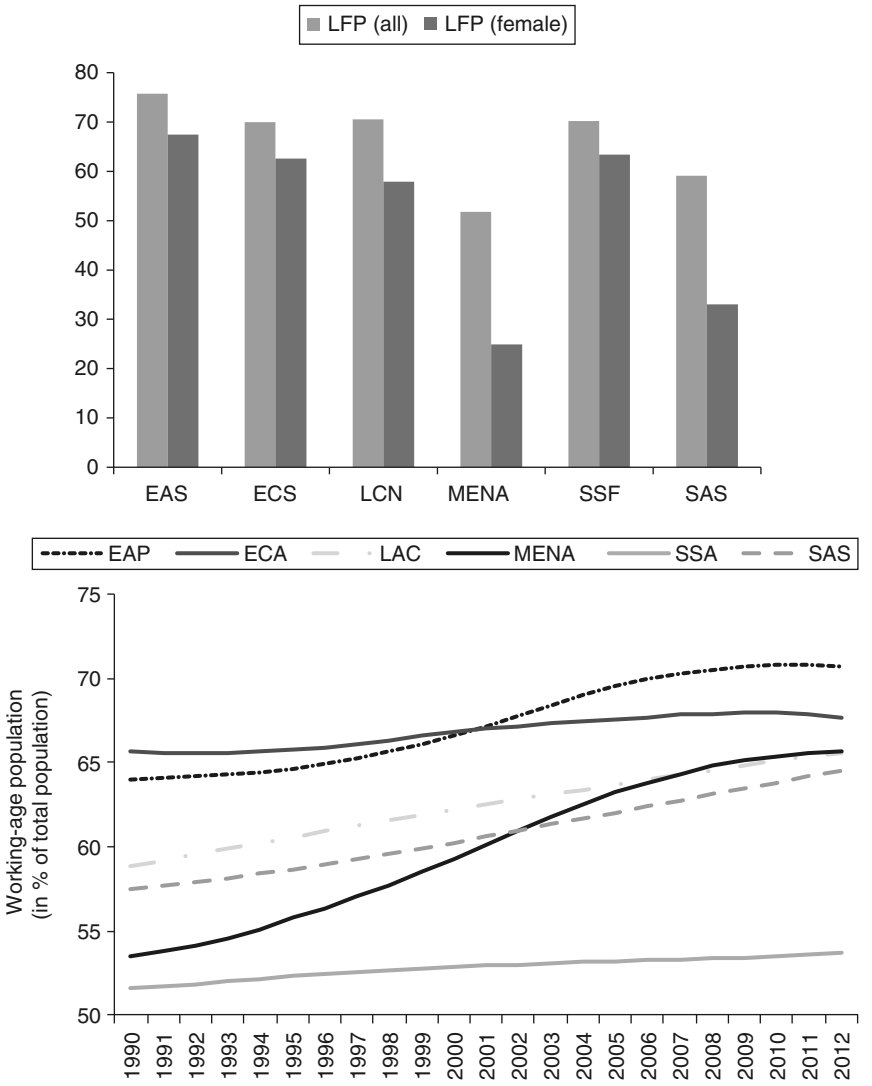

Figure 1.4 Demographic change

women, are also more prevalent. Less than a quarter of all working-age women in the MENA region participated in the labor force in 2012. This compares to over 60 percent in East Asia and Pacific, Eastern Europe and Central Asia and Sub-Saharan Africa (Figure 1.5).

The contribution of productivity growth to GDP growth was low in MENA compared to other countries in the region. Change in labor productivity explains about 49 percent of real GDP growth of MENA's developing countries

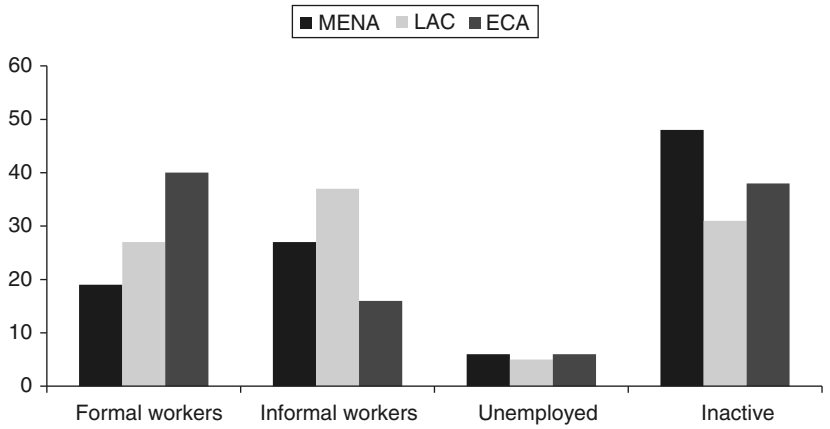

Figure 1.5 Composition of working-age population
Source: Authors' calculations based on WDI. World Bank. 2013. Based on ILO-KILM database.
***Refers to selected countries for ECA, LAC and MENA for 2012.*

over the last two decades which is significantly less than that of any other regional growth with the exception of LAC. For the MENA region as a whole per capita growth accelerated between 1995–2000 and 2000–2005 as demographic change, measured as the growth of the working-age population as a share of the total population, accelerated. In MENA's high-income countries, the change in labor productivity has not been positively associated with economic growth in the last 15 years. Productivity growth, however, was much more strongly associated with growth in MENA's developing countries or non-oil exporting countries, contributing more than 50 percent to real GDP per capita growth between 1995–2000 and 2005–2009 (Figure 1.6).

MENA's weak economic performance is often attributed to the Dutch disease. Inflows in foreign exchange generated from natural resource exports can lead to a downward pressure on the exchange rate and an upward pressure on domestic prices, resulting in real exchange rate appreciation. This can lead to a crowding out of other tradable goods, for example in the manufacturing sector. There are good arguments why diversification into manufacturing or other non-resource tradable goods might be necessary to achieve higher income.[2]

[2] Matsuyama (2002), for example proposes that the manufacturing sector is characterized by learning by doing, while the primary sector (agriculture) is not. Manufacturing and services also tend to be more labor-intensive than natural resource exploitation thus offering better scope for job creation (Rodrik, 2011) Production of natural resources also limited spill-over effects in terms of technology transfer and human capital externalities.

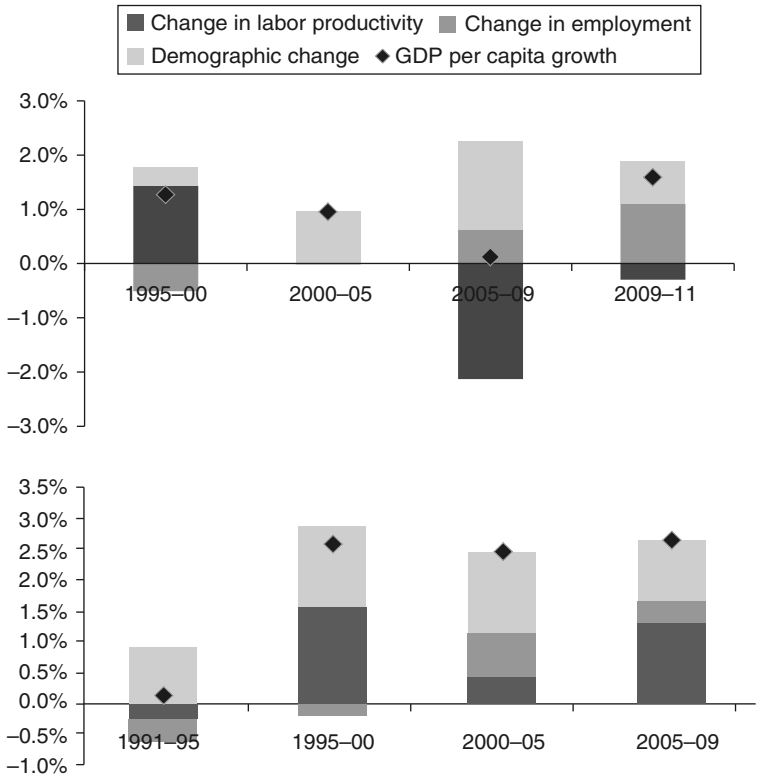

Figure 1.6 Real GDP per capita decomposition of high income and developing MENA countries

a) High income MENA countries b) Developing MENA countries

Source: Authors' calculations based on WDI.

Notes: High income countries do not include Qatar because of lack of data.

In addition, since volatility of commodity prices propagates to revenues, resource richness can complicate fiscal management and if permeated to aggregate spending, increase real exchange rate volatility, which can act as a tax on investment. Even oil-poor countries are sensitive to changes in the oil price because a large part of their economies depends on work remittances, aid and tourism revenues from oil-rich countries (Dahi and Demir 2008). It has also been argued that the adoption of pegged or fixed exchange rate regime to shelter oil-rich economies from oil price volatility lead to a real exchange rate overvaluation and thus losses in competitiveness of the region (Nabli and Veganzones-Varoudakis, 2002; Diop and Marotto, 2013).

But equally often state-led economic policies have been blamed for MENA's weak economic performance. From independence to the late 1980s, the region's economic policies were dominated by state-led import-substitution models. Oil discoveries combined with successive increase of petroleum prices fueled economic growth. Supported by oil revenues, governments implemented a wide range of industrial polices to support the manufacturing sector. In the early 1990s, most MENA countries recognized that the state-led import-substitution models had run out of steam. They introduced reforms aimed at shifting towards a more private sector-led economy, integrating their economies with the rest of the world and reducing the oil dependence of their economic base. Still, the private sector reform agenda fell short of containing distortionary government interventions and creating a level playing field for all business. With the exception of the Maghreb countries, Algeria, Morocco, Tunisia and Libya, MENA countries tend to be less open in 2012 than in 1990. And with the exception of Qatar and Tunisia none was able to significantly reduce fuel exports as a share of total exports.

In this chapter we analyze MENA's structural transformation with a view of identifying opportunities for accelerating productivity growth. In particular, it discusses productivity growth at the sector level and productivity growth driven by a reallocation of workers across sectors. It could be argued that increased productivity growth doesn't only boost growth but also labor demand over time.

1.3 Change in sector productivities and employment shares

One of the key insights of development economics is that growth is driven by a structural shift from agriculture to manufacturing. This sectoral shift tends to be mirrored in the pattern of employment so that over time the labor force in the nonagricultural sector increases while employment in the agricultural sector declines. As labor moves to the industrial sector, overall productivity rises and incomes expand. Reallocation of workers from one sector to another is hence an important aspect of economic development. One of the traditional work-horse models of structural transformation, the surplus labor model (Lewis, 1954) illustrates the indispensability of labor reallocation. It assumes that a traditional (agricultural) and a modern (industry) coexist. Ranis and Fei (1961) divide the development of surplus-labor countries in several stages. In the first stages, surplus labor in the agriculture sector is pulled towards the nascent industrial sector. The economy's wage level and agriculture output remain unchanged. Still, the marginal product of labor is below the wage level. In a next phase, workers who are producing agriculture output but earn less than the wage level move to the industrial sector and agricultural output declines. The nominal wages in the industrial sector rises. In the last stage, farm workers

who produce output equal to their wages move to industry and agriculture productivity increases. The faster the reallocation from agriculture to industry the faster growth materializes.

Over time, economics have moved to a three-sector view of structural change. As incomes continue to rise, people begin to demand more services. In fact, in many countries the share of the service sector in GDP rises almost linearly. Still, labor productivity of services does tend to grow less than of agriculture and industry because many service jobs require manual labor. In fact, labor productivity in the service sector as a share of average labor productivity tends to rise at lower levels, then declines over an intermediate range, before increasing again in the OECD (Eichengreen and Gupta 2014). The second surge is most likely caused by the rise of the modern service sector, which includes business services, telecommunication and finance.[3] In most industrialized countries, the service sector has become the dominant sector

Contrary to all other regions, services did not increase as share of GDP in MENA (Figure 1.7). As expected, agriculture has declined as a share of GDP between 1990 and 2011 in all regions of the world, but so did manufacturing. In fact, services increased as a share of GDP in all regions except for MENA. The decline in MENA's service is particularly striking since public wage bills (which are the key component of public sector value added) have increased significantly during the period and the public sector is subsumed under services. The production of services tends to require relatively less natural capital and more human capital than the production of agricultural or industrial goods. The decline in the share of services is likely to be one reason why unemployment of highly educated workers has been high in some countries, such as the Arab Republic of Egypt, Jordan, Tunisia and Morocco.

More detailed data reveal significant differences in labor productivity growth across sectors between 2000 and 2010. In Jordan and Morocco, for example, labor productivity growth was driven by improvements in agriculture, manufacturing and mining. Tunisia and Morocco also experienced strong labor productivity growth in transport and telecommunication and government services whereas financial and business services were a drive of productivity growth in Jordan.

Contrary to more advanced economies, developing countries tend to be characterized by large differences in productivity across sectors. While the three-sector economic model is only a rough approximation, productivity gaps persist in developing countries across sectors and even across firms (Hsieh and Klenow, 2014). These productivity gaps may be indicative of misallocation of

[3] This pattern may however not be replicated in today's middle countries as technology transfers will make it easier for these countries to adopt new technology in the services sector.

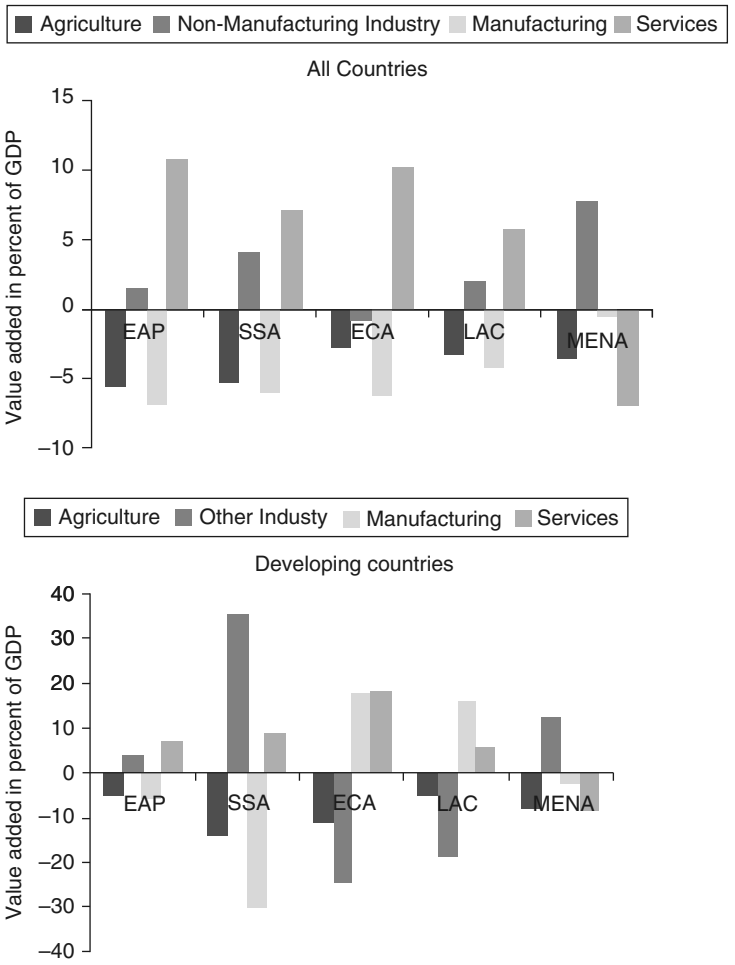

Figure 1.7 Change in sector composition of GDP, 1990–2011
Source: Authors' calculations based on WDI.

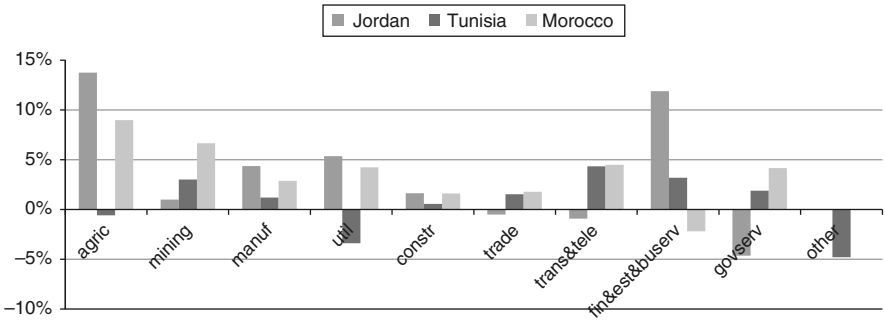

Figure 1.8 Labor productivity growth by sector (annual average), 2000–2010

resources. At the same time, large productivity gaps across sectors suggest that reallocation of workers from low-productivity to high-productivity sectors can be an important driver of economy-wide labor productivity and income growth in developing countries.

There is significant empirical evidence that productivity differences across sectors can explain a significant variation in cross-country income. In fact, more than 60 percent of cross-country income difference might be explained by large differences in TFP (Klenow and Rodriguez-Clare, 1997; Hall and Jones, 1999). Large differences in TFP can be the result of variation in the weights in GDP of sectors with different productivity at the sector level. This is even the case if sector productivities would be identical across countries (Caselli, 2005). More recently, Chanda and Dalgaard (2008) show that as much as 85 percent of the international variation in aggregate TFP can be attributed to differences in the relative efficiency across sectors. In fact, in developing countries, productivity levels of some sectors can reach the level of more advanced countries, while labor productivity in other sectors, such as for example agriculture, is far below the leading sector, driving down overall productivity. In many high-growth countries, in particular in Asia, re-allocation of workers across sectors has contributed positively to growth during the last 20 years, while in many Latin American and Sub-Saharan African countries structural change has depressed economic growth (McMillan and Rodrik, 2012).

Countries with low levels of labor productivity tend to have a high dispersion of productivity across sectors. This implies that the dispersion of productivity across sectors tends to be particularly large in developing countries – and the MENA countries appear to follow this trend. The country with the highest labor productivity and its lowest dispersion are the United States, followed closely by other European high income countries. Figure 1.9 relates the intersectoral productivity gaps, measured by the coefficient of variation, to the (log of) economy-wide labor productivity. The clear negative relationship reveals that countries with low average labor productivity tend to have a high dispersion in sectoral labor productivity, and vice versa.

Dispersion of labor productivity across sectors is higher than their income level suggests in oil-rich Saudi Arabia and Syria but lower in Jordan, Tunisia and West Bank and Gaza. In Saudi Arabia and Syria, labor productivity in the mining sector is more than 180 times higher than productivity in the least productive sector, which is services in Saudi Arabia and construction in Syria. Only Nigeria, Senegal and Malawi have a higher dispersion of productivity across sectors in the sample. Jordan is the MENA with the lowest dispersion of productivity. Nevertheless, labor productivity of its most productive sector (Financial sector and real estate) is roughly 20 times higher than of its least productive sector (other services), compared to a 10-fold increase from the least to the most productive sector in the United States. All MENA countries in the

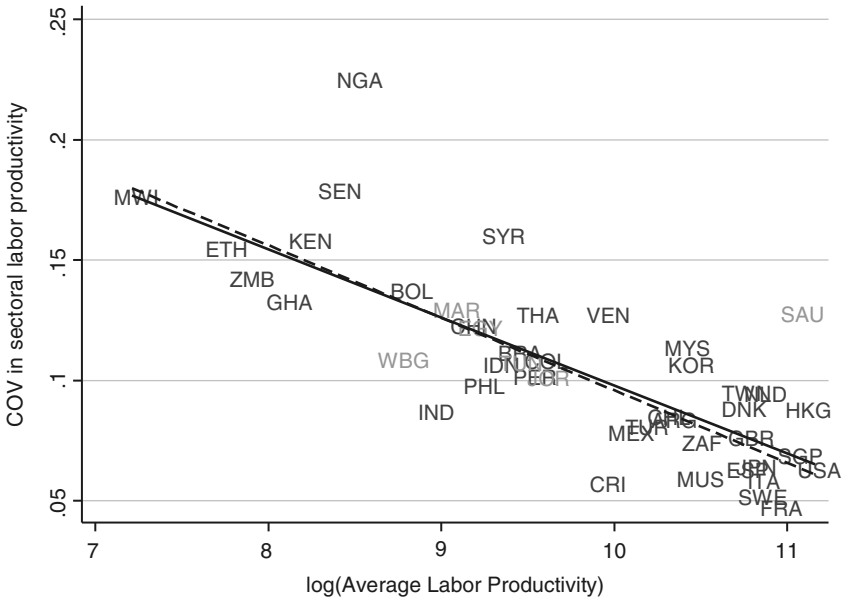

Figure 1.9 Cross-country level and dispersion of labor productivity

Correlation between coefficient of variation in sectoral labor productivity and average labor productivity, 2005. The solid line results from plotting the slope of a linear regression from COV on average LP using all countries, the dashed line excludes the MENA region. For Saudi Arabia, data are for 2006.

sample have a coefficient of variation of the log of sector labor productivity above the sample mean and median.

The potential of structural change as a source for productivity-enhancement depends on the distribution of labor across sectors and sector productivity as a share in overall productivity. Large productivity gaps across sectors suggest that a reallocation of workers from low-productivity to high productivity sectors can be an important driver of economy-wide labor productivity and income growth in developing countries. In fact, in many high-growth countries, in particular in Asia, re-allocation of workers from low-productivity to high productivity sectors has contributed positively to growth during the last twenty years (McMillan and Rodrik, 2012). In Syria and Tunisia, 65 percent and 88 percent, respectively, of total employees are working in sectors with a sectoral labor productivity that is below the economy-wide labor productivity (Figure 1.10). If the share of workers in sectors with above economy-wide labor productivity were to increase, growth would accelerate.

The dispersion of sector labor productivity of all MENA countries is highest in Syria and lowest in Tunisia. In Syria and Tunisia about one-third of the population is employed in the two sectors with the lowest labor productivity, agriculture and social and personal services. What is striking in

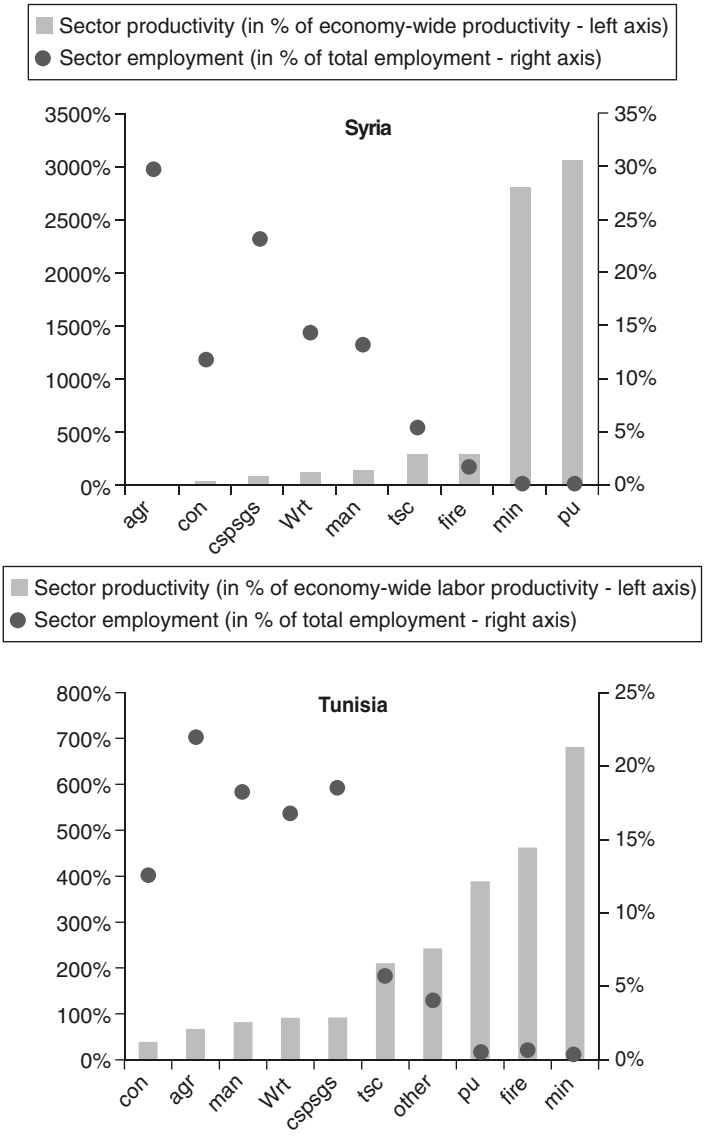

Figure 1.10 Sector productivity and employment share in Syria and Tunisia
Source: WB staff calculations. Data source see Annex I. Syria data for 2001 and Tunisia data for 2000.

Syria is that labor productivity is very low in most sectors compared to the two sectors with the highest labor productivity, mining and public sector, which employ less than 1 percent of the Syrian labor force. Measuring productivity of the public sector is notoriously difficult since it produces non-market outputs whose value cannot be directly observed. As a result, public sector

output is generally calculated by equating it to its inputs, i.e. the amount spent on producing this output, which to large extent consist of wages.[4] This implies that increases in public spending translate automatically into one-to-one increases in output, rendering an analysis of public sector productivity based on national accounts data meaningless. The mining sector and public sector are also high productivity sectors in Tunisia but so is "Financial intermediation and real estate." These three sectors employed 2.2 percent of the Tunisian labor force in 2000.

In Tunisia, the gap between manufacturing and the agriculture sector is strikingly low. In 2005, labor productivity in the manufacturing sector was about 1.2 times higher than in agriculture which compares to an average ratio of manufacturing to agriculture productivity of 2.3 in Africa, 2.8 in Latin America and 3.9 in Asia (McMillan and Rodrik, 2012). The low productivity of Tunisia's manufacturing sector is noteworthy. With some notable exceptions, manufacturing in Tunisia tends to focus on simple assembly activities with low value added and is only to a low degree integrated with the rest of the domestic economy.

Still, MENA has a relatively weak negative correlation between labor productivity and employment shares across sectors. For all regions the correlation between labor productivity and share of employment is negative, implying that comparably few employees are working in relatively productive sectors. In 2005, the negative correlation is strongest in Latin America and the Caribbean. MENA and Africa have the lowest correlation which is driven by the high share of workers in low productivity sectors (Figure 1.11).

Overall, the share of workers in low productivity sectors is higher in MENA than in any other region, except Africa. In 2000, the average share of workers in sectors with below average productivity was 78 percent in MENA, 74 percent in Africa, 70 percent in Asia, 67 percent in LAC and 64 percent in high income countries. In 2005, MENA still had the second highest share with 69 percent. The country with the highest share of labor force employed in low productivity sectors – 92 percent – is West Bank and Gaza. If relatively few employees are working in relatively high productive sectors, a reallocation of labor from low to high productive sectors can potentially be an important source for overall productivity growth. In all MENA countries of the sample, the highest employment shares are observable in agriculture or community, social, personal and government services, which both have a very low productivity, suggesting a large potential for structural change.

[4] The economic rationale behind equating output and input is that "rational" governments would spend up to the point where the marginal benefit from spending was equal its marginal cost.

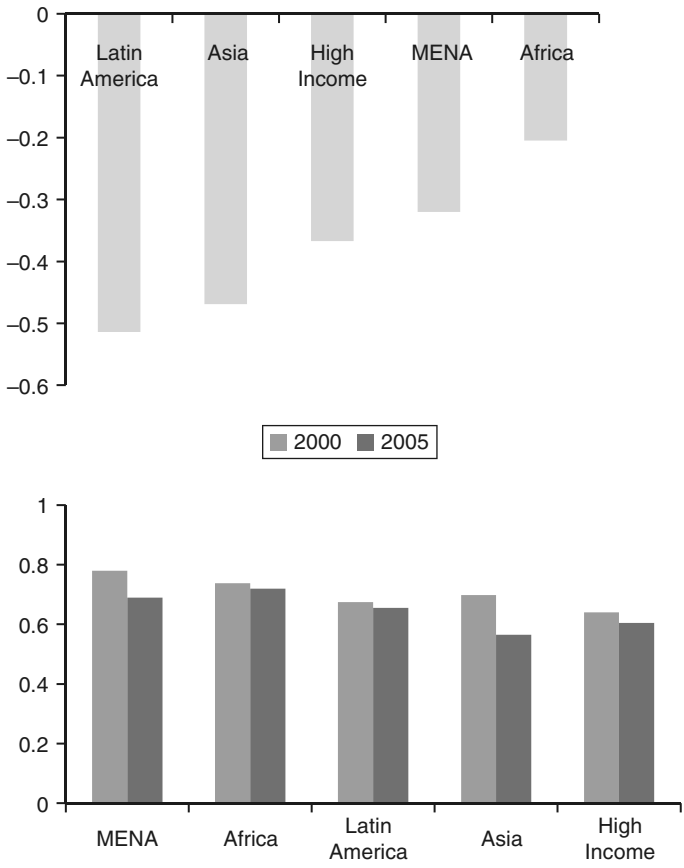

Figure 1.11 Sectoral employment and labor productivity across regions
a) Correlation coefficients in 2005.* b) Employment share of low productivity sectors.
**The correlation between sector employment shares and labor productivity as shares of economy-wide labor productivity.*

1.4 Structural Change in the MENA Countries

Structural change

Only in Morocco, Syria and Jordan was labor productivity growth, measured here as change in output per worker, in 2000 and 2005 above the sample average and median. Productivity growth in Egypt, Saudia Arabia and West Bank and Gaza was negative. During 2000 and 2005, Morocco's, Syria's and Jordan's overall productivity grew by 4.9 percent, 4.1 percent and 3.6 percent per year, respectively, at a rate that is significantly above the average and the median of

the sample. Morocco's labor productivity growth is among the highest in the sample, only surpassed by China, Indonesia, Turkey and Nigeria. In West Bank and Gaza, labor productivity declined over the early 2000s, reaching a level in 2005 which is comparable to Bolivia, Senegal and Nigeria. Also, Saudi Arabia's labor productivity fell steeply between 2000 and 2005, driven by a massive influx of non-Saudi workers. Egypt faced the steepest decline in annual labor productivity during this period of –2.2 percent.

Labor productivity growth in terms of change in output per worker can be decomposed into "within" sector change and changes "across" sectors or structural change. Structural change captures the contribution of reallocation of labor (or change in sector weights) to growth. This can be written as $\Delta y_t = \Sigma_N S_{i,t-k} \Delta y_{it} + \Sigma_N y_{i,t} \Delta S_{it}$ where ΔY_t is the change in aggregate labor productivity between t and $t - k$, θ_{it} is the employment in sector i at time t and y_{it} is the productivity level in sector i at time t. The first term is the "within" component and the second term the "across" component (Figure 1.13). Economy-wide labor productivity is thus decomposed into two parts. The first component measures the change in labor productivity that is due to changes in sectoral labor productivity, and it captures how labor productivity evolved under constant employment shares across sectors. The second component captures the impact of structural change on labor productivity development. It measures the counter-factual productivity level that was reached if sectoral productivity levels remained unchanged and only shifts in labor across sectors change productivity.

Structural change contributed positively to labor productivity growth in MENA but "within" sector growth was very low. In fact, MENA would have had the lowest labor productivity growth among all regions in the world, were it not for positive structural change. In addition, the contribution of structural

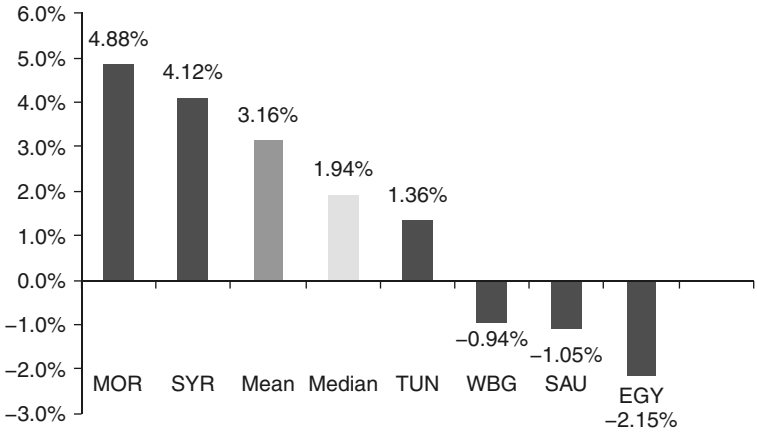

Figure 1.12 Average growth in labor productivity 2000–05

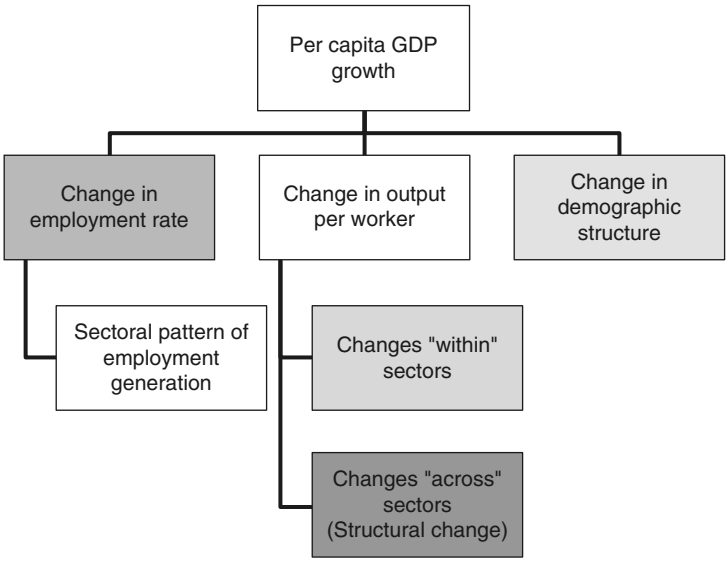

Figure 1.13 GDP decomposition

change to overall growth in MENA was even higher than in Asia. In Asian countries, economy-wide labor productivity was highest in the Asian countries, reaching roughly 3.8 percent (annualized) between 2000 and 2005. This strong performance was due to the fact that high growth in sectoral employment was complemented by productivity-enhancing structural change (see also McMillan and Rodrik, 2012, and McMillan, Rodrik, and Verduzco-Gallo, 2014, for very similar findings). Sub-Saharan Africa also experienced considerable productivity growth between 2000 and 2005. Unlike Asia, however, parts of the benefits from increased sectoral productivity were offset by negative structural change. If Africa would have experienced a positive structural change, its labor productivity growth would have been close to Asia's. "Within" sector productivity growth was, however, the lowest among all regions.

All MENA countries in the sample, with the exception of Saudi Arabia, experienced positive structural change between 2000 and 2005. Structural was highest in Syrian and Egypt. In Syria, the country with the highest structural change term in the MENA region, reallocation of labor accounted for roughly two thirds of overall productivity growth (2.7 percent-points). In Egypt, structural change in Egypt accounted for over 1 percentage points of economy-wide productivity change, and prevented in even sharper decrease of productivity. Only Saudi Arabia experienced a negative structural change, as a result of the influx of non-Saudi workers, many of whom were hired for low value added service activities.

In Egypt, labor productivity growth has been negative since 1982, mainly driven by a steady decline of "within" sector productivity (see Figures 1.15).

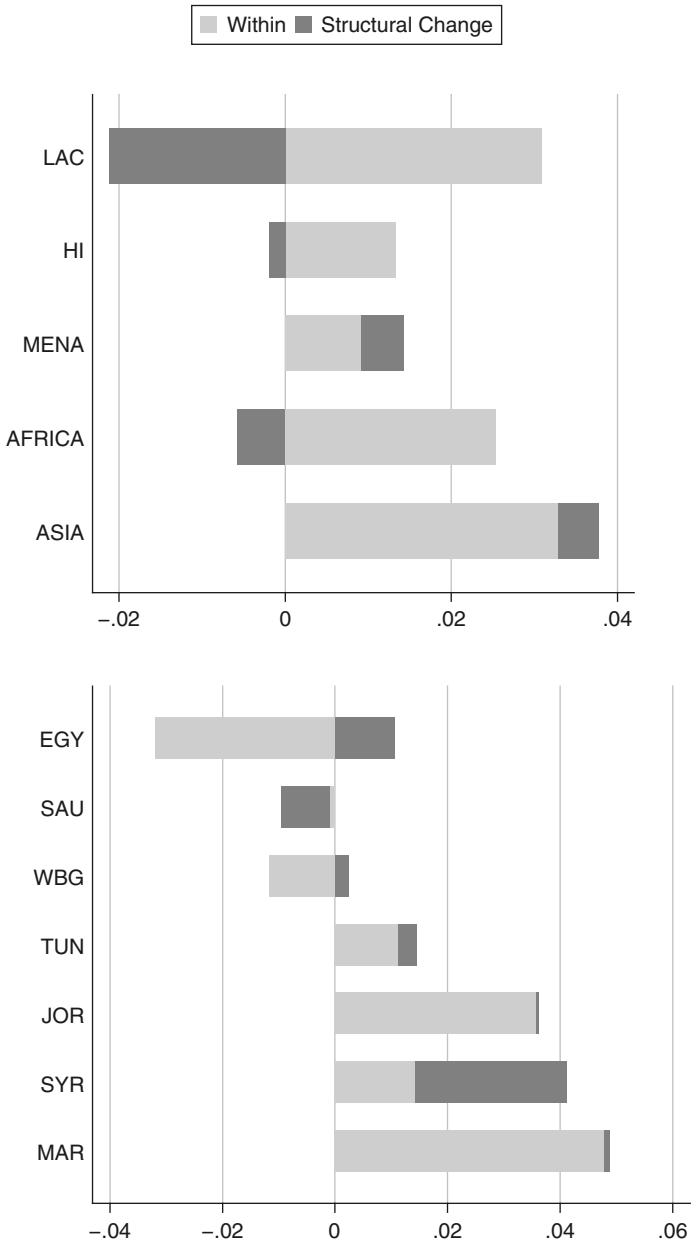

Figure 1.14 Structural change 2000–05
a) Across regions. b) Among MENA countries.

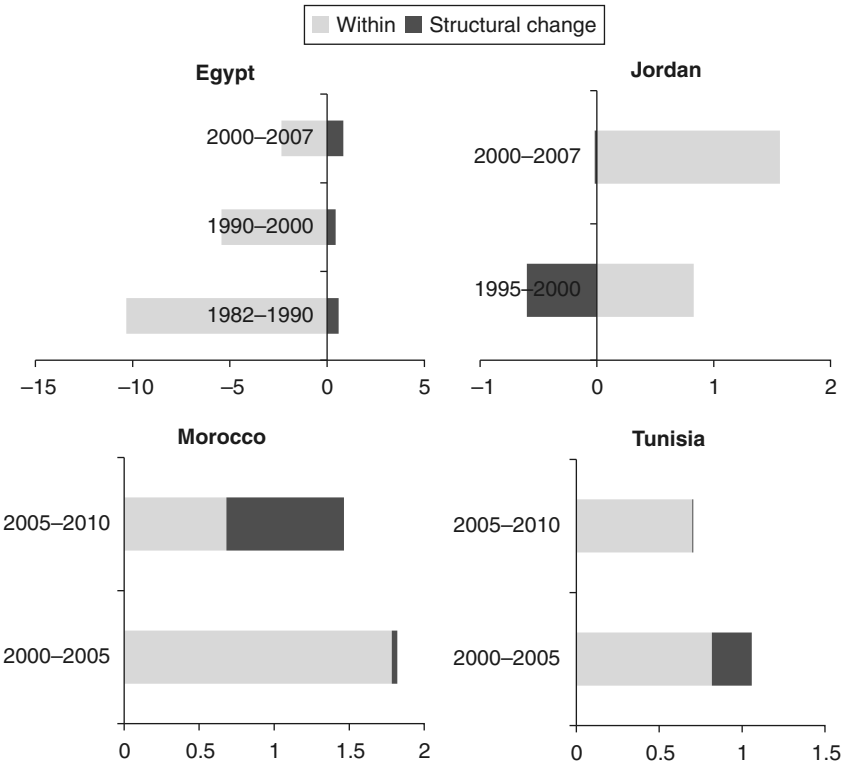

Figure 1.15 Long-term structural change in four MENA countries

Mining, manufacturing and wholesale, retail and trade are the sectors in which labor productivity declined the most (see the first graph in Figure 1.15). Structural change was positive throughout the last three decades, but too small to stem the productivity decline. Structural change was largely driven by employment growth in the mining sector.

Productivity growth was also negative in Saudi Arabia and West Bank and Gaza between 2000 and 2005. Productivity growth declined in Saudi Arabia due to negative structural change and in West Bank and Gaza due a negative "within" sector productivity growth. Negative structural change in Saudi Arabia was the result of a decline in mining jobs and increased employment in manufacturing and agriculture. In West Bank and Gaza, labor productivity fell steeply in agriculture, wholesale and trade and transport and communication. This positive structural change was driven by an increase in employment in community, social, personal and government services, wholesale and retail trade and the transport sector (Figure 1.16).

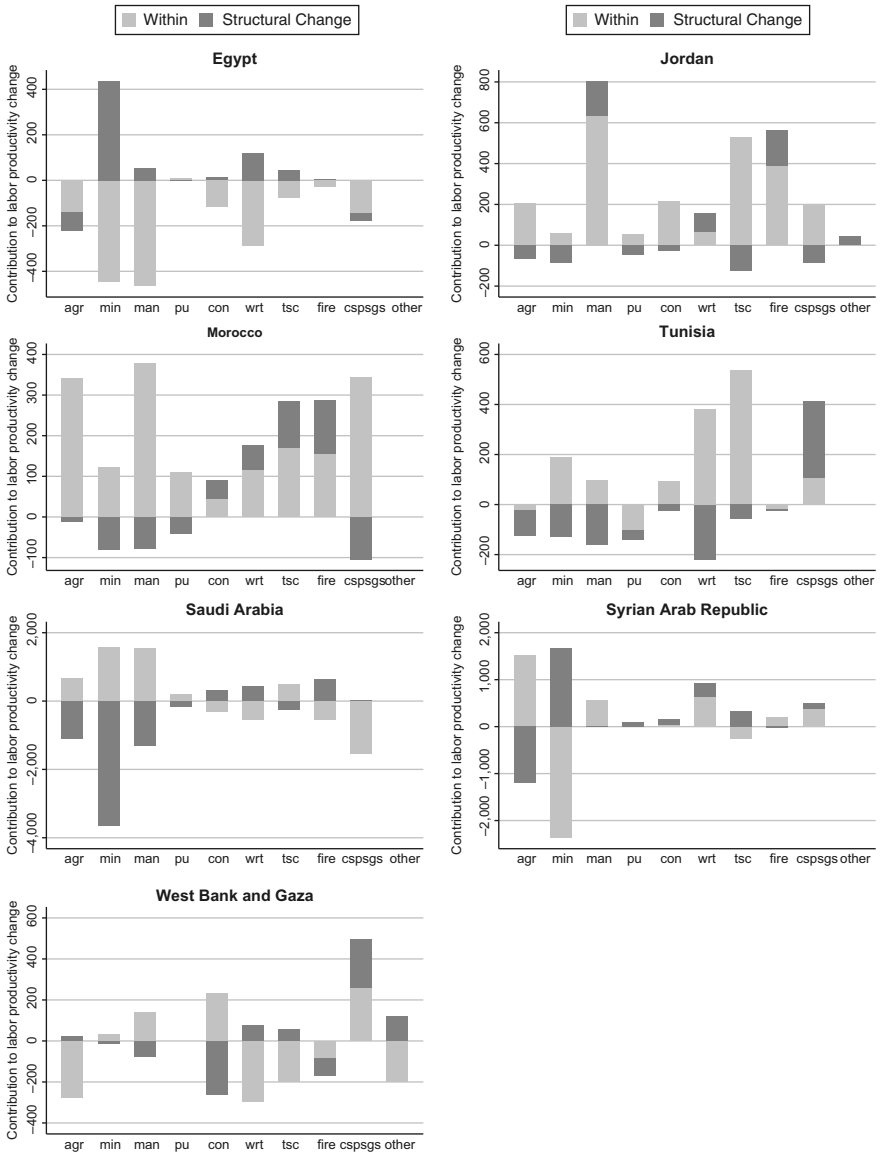

Figure 1.16 Structural change by sector 2000–05

Syria experienced the largest positive structural change in the MENA region between 2000 and 2005. In fact, Syria's structural change contributed more than half to overall productivity growth, i.e –2.7 percentage points of the overall productivity growth of 4.1 percent can be attributed to efficient reallocation

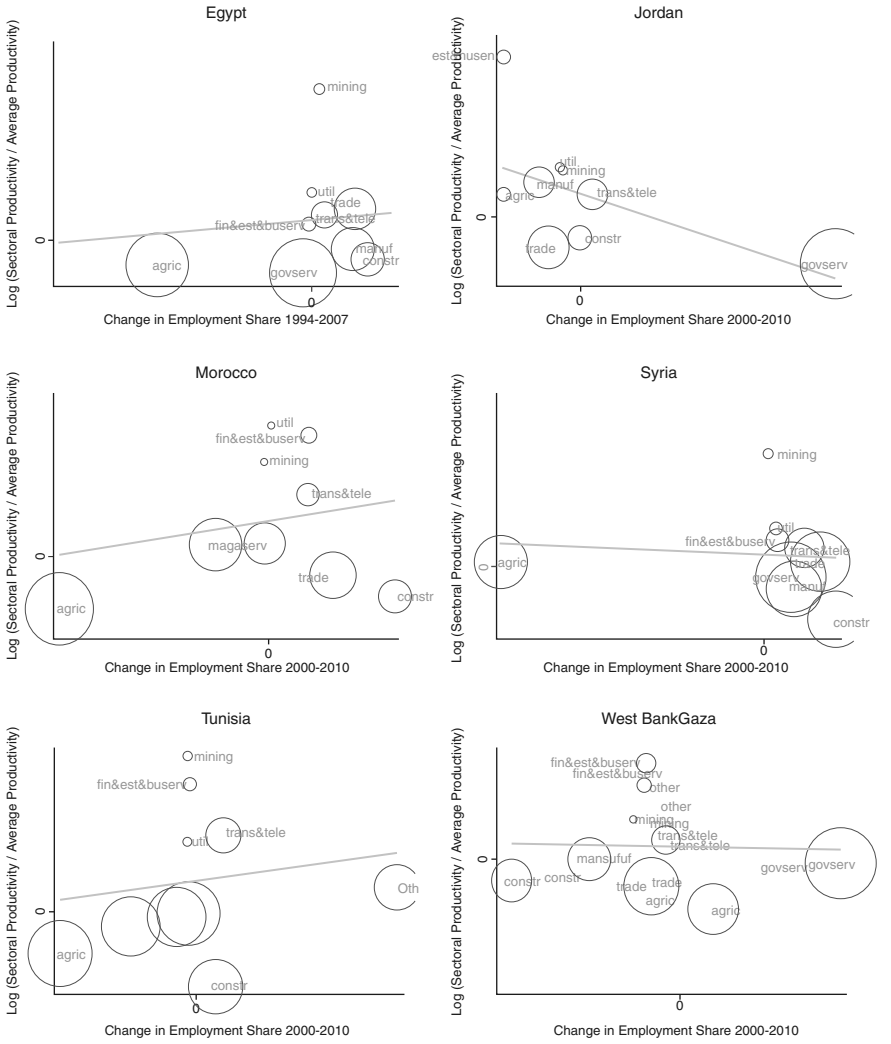

Figure 1.17 Structural change 2000–10

of labor across sectors. Agricultural productivity rose and was accompanied by an employment decline, thus, contributing positively to structural change. In the mining and quarrying sector the reversed pattern was observed.

In Jordan, within-sector productivity growth was high since the mid-1990s but structural change was negative in the second half of the 1990s. Structural change was negative in the second half of the 1990s and became

insignificant in the new millennium. Within-sector productivity growth was driven by the manufacturing sector, transport and communication as well as financial services. Manufacturing (through labor shedding) and financial services (by attracting new workers) also contributed positively, while a steep increase in government employment contributed negatively to structural change (Figure 1.17).

Morocco experienced both strong within-sector productivity growth and structural change, which accelerated between 2005 and 2010. Similar to Jordan, also in Morocco, productivity increased in each sector between 2000 and 2005, most noteworthy in agriculture, mining and community, social, personal and government services. Employment in agriculture, mining, manufacturing, public utilities and community, social, personal and government services declined. Increase in employment shares of utilities, financial and business services, mining, communication and real estate contributed to the positive structural change.

Similar to Morocco, Tunisia experienced positive within-sector productivity growth and structural change in the new millennium. Between 2000 and 2005, almost 25 percent of productivity growth was driven by structural change. Contrary to Morocco, structural change slowed down after 2005 as a wave of privatization came to an end. Likewise, an increase of employment shares in utilities, financial and business services, mining, communication and real estate contributed to the positive structural change.

Controlling for human capital

Measuring labor productivity in units of human capital rather than per worker can provide additional insights about resource allocation. Several countries in the MENA region, have undergone a steep increase in educational attainment during the last decades. To understand better how recent increases in Tunisia's educational attainment have affected the reallocation of human capital across sectors, we replicate the structural change analysis for the years 2005 to 2010 using output per unit of human capital.[5] Using output per unit of human capital instead of output per workers reveals some intriguing differences. For example, while both agriculture and the public sector employed 18 percent of the total working population in 2005, the share of imputed human capital was

[5] For the years 2005 to 2010 we have data on the amount of employees by sector with a primary, secondary or post-secondary degree. We assign 0, 6, 12 and 16 years of education to employees with no degree, primary degree, secondary degree and post-secondary degree, respectively. Using a standard Mincerian technique and assuming a 10 percent return to each year of schooling, we assign each employee a human capital equal to exp(.1 * years).

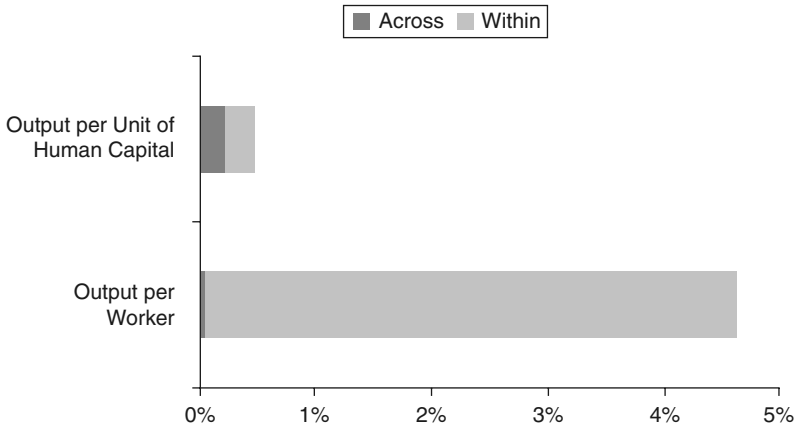

Figure 1.18 Growth in output per worker and output per unit of human capital

12 for agriculture but 27 percent for the public sector. Interestingly human capital productivity growth within the agricultural sector was negative implying that human capital increased faster than value added. Human capital adjusted productivity growth between 2005 and 2010 was about 60 percent of output per worker growth. This implies that human capital per worker significantly exceed employment growth by about 50 percent, accounting for a significant share of labor productivity increase. About 2 percent of human capital adjusted productivity growth was the result of a reallocation of human capital.

Controlling for human capital reveals also significant misallocation of human capital. In 2009, 75 percent of Tunisia's human capital augmented labor was employed in sectors with below average productivity, of which 24 percent in public administration alone, 12 percent in the public works program.

Marginal productivity of labor

The above analysis of structural change has been based on average productivity. To pass judgment on whether this change was welfare improving and growth promoting however would require a more in-depth analysis.[6] One important step in this direction is to look at marginal productivity across sectors. Under perfect competition, marginal labor productivity – not average productivity – should

[6] Not any structural change is good. For example, productivity may be higher in sectors with monopoly power. A reallocation to these sectors would contribute positively to structural change but would not necessarily promote growth or enhance welfare (for a more detailed discussion).

be equalized across sector. Assuming a constant returns production function, since labor share are not necessarily negatively correlated with average productivity, large gaps in average productivity may reflect large gaps in marginal labor productivity. There are some caveats though. For example, high average labor productivity in capital-intensive sectors, such as mining, may simply reflect that fact that the labor share is low.

The marginal productivity of labor can be calculated by estimating the labor's share of income. Using I2D2 data, we calculated the income share of labor using wage date for Tunisia and Egypt, the only two countries where reliable data were available. In a perfectly competitive market, wages equal the marginal product of labor. Labor markets are often not perfectly competitive, for example, in the presence of unionization or indexed contracts. Moreover, in many developing countries some workers, for example, in the agricultural sector or household employees are only paid partially in wages. Finally, using wages to calculate the labor's share of income automatically leads to an exclusion of self-employed. To eliminate biases arising from unobserved heterogeneity, the data is narrowed down to a sub-set of workers. The marginal labor productivities are calculated for single male aged 30–34 years with elementary education. The wage data is adjusted for the rural-urban price differential.

The share of labor force in paid employment is particularly low in agriculture. In Egypt, only 12.1 percent of the agriculture labor force was in paid employment in 2006, declining from 14.3 in 1998 (Table 1.1). In Tunisia, also agriculture is the sector with the lowest share of the labor force in paid employment, though at 28.2 percent in 2001, this share is significantly higher than in Egypt. The sectors with the highest share of the labor force in paid employment are public utilities and mining.

Gaps among average wages are significantly smaller than among productivity per worker, but remain significant. In 1998 in Egypt, the gap between the highest productivity sector (mining) and the lowest productivity sector (community services) was 57, while the raw difference between the minimum (agriculture) and maximum (financial intermediation) wage was only 2.2. The difference becomes even small when controlling for individual characteristics, shrinking to 1.5. However, this gap between wages has increased in Egypt. In 2006, an individual with the same characteristics and education would have earned nearly 2.5 half times more if she would have moved from agriculture (the lowest wage sector) to mining (the highest wages sector). A 30–34 year old, male Tunisian worker with primary education, working in elementary education and living in a six-person household with three working members would have increased its wage 1.6 fold in 2001 by moving from agriculture (the lowest wage sector) to mining (the highest wage sector).

Table 1.1 Estimates of labor's share and marginal productivities using I2D2 data

Country	Year	Sector	Code	Value added per capita		Average wages (raw differences)		Average wages (controlling for individual		Average wages (controlling for individual		% of Labor force in paid employ-ment	Employ-ment Share in I2D2
				In 2005 PPP dollars	Employment in National Accounts Share	In 2005 PPP dollars	Implied Labor Share(pc)	In 2005 PPP dollars	Implied Labor Share (pc)	In 2005 PPP dollars	Implied Labor Share (pc)		
Egypt	1998	Agriculture	agr	6,320	29.7%	1,447	22.9%	1,394	19.3%	1,448	19.4%	14.3%	40.5%
		Mining	min	298,623	0.5%	2,681	0.9%	1,642	0.9%	1,694	0.9%	95.5%	0.2%
		Manufacturing	man	12,642	11.5%	2,281	18.0%	1,837	19.5%	1,899	19.5%	81.3%	11.9%
		Public utilities	pu	21,056	0.8%	2,737	13.0%	1,734	13.7%	1,797	13.7%	100.0%	0.7%
		Construction	con	7,888	6.9%	2,188	27.7%	1,929	29.4%	2,002	29.4%	87.8%	5.3%
		Commerce	wrt	19,262	10.5%	2,032	10.5%	1,835	13.6%	1,898	13.6%	36.0%	11.9%
		Transports and communications	tsc	16,908	4.3%	2,586	15.3%	1,823	16.7%	1,882	16.7%	81.7%	4.5%
		Financial and business-oriented services	fire	14,529	1.4%	3,247	22.4%	1,929	24.3%	2,002	24.3%	84.2%	1.5%
		Community and family-oriented services	cspsgs	5,221	34.5%	1,856	35.6%	1,304	37.8%	1,351	37.8%	95.3%	23.5%
	2006	Agriculture	agr	6,166	27.3%	1,646	26.7%	1,654	22.3%	1,712	22.3%	12.1%	38.4%
		Mining	min	229,672	0.8%	5,623	2.4%	3,935	2.7%	4,083	2.7%	89.6%	0.2%
		Manufacturing	man	8,138	12.7%	2,631	32.3%	2,104	33.6%	2,169	33.6%	73.2%	11.6%
		Public utilities	pu	25,656	0.8%	3,520	13.7%	2,163	14.3%	2,235	14.3%	98.7%	0.7%
		Construction	con	6,287	7.8%	2,667	42.4%	2,294	44.9%	2,366	44.9%	82.0%	6.3%
		Commerce	wrt	18,278	11.6%	2,397	13.1%	2,267	16.9%	2,337	16.9%	45.3%	14.5%
		Transports and communications	tsc	16,420	4.7%	3,379	20.6%	2,592	21.5%	2,675	21.5%	79.2%	5.8%
		Financial and business-oriented services	fire	13,978	1.4%	3,680	26.3%	2,393	29.4%	2,475	29.5%	77.7%	2.2%
		Community and family-oriented services	cspsgs	5,137	33.0%	2,583	50.3%	1,697	53.3%	1,754	53.3%	96.9%	19.6%

(*continued*)

Table 1.1 Continued

Country	Year	Sector	Code	Value added per capita		Average wages (raw differences)		Average wages (controlling for individual		Average wages (controlling for individual		% of Labor force in paid employ-ment	Employ-ment Share in I2D2
				In 2005 PPP dollars	Employment in National Accounts Share	In 2005 PPP dollars	Implied Labor Share(pc)	In 2005 PPP dollars	Implied Labor Share (pc)	In 2005 PPP dollars	Implied Labor Share (pc)		
Tunisia	2001	Agriculture	agr	9,036	21.8%	249	2.8%	249	2.5%	215	2.6%	28.2%	22.0%
		Mining	min	109,239	0.6%	782	0.7%	406	0.8%	353	0.8%	95.6%	0.5%
		Manufacturing	man	12,302	18.2%	380	3.1%	315	3.4%	272	3.4%	80.7%	20.5%
		Public utilities	pu	34,167	0.6%	408	1.2%	310	1.1%	268	1.1%	90.3%	12.8%
		Construction	con	6,158	11.9%	468	7.6%	283	8.3%	245	8.3%	54.6%	3.4%
		Commerce	wrt	12,842	17.3%	417	3.3%	287	3.5%	248	3.5%	50.7%	14.1%
		Transports and communications	tsc	30,666	5.8%	610	2.0%	342	1.9%	296	1.9%	64.6%	5.4%
		Financial and business-oriented services	fire	69,077	0.8%	837	1.2%	365	1.3%	314	1.3%	98.0%	0.8%
		Community and family-oriented services	cspsgs	13,169	18.7%	592	4.5%	308	4.8%	267	4.8%	93.5%	20.3%

* Regression results controlling for urban location, gender, age (6-year intervals), marital status, occupation and education level (no education, primary, secondary and post-secondary).
** Adds household size and number of working members to the previous controls.
Data source: I2D2.

Determinants of structural change in MENA

Some economic policies may slow down structural change. McMillan and Rodrik (2012) argue that Asian economies experienced positive structural change and, thus faster economic growth, since they put policies in place that protected employment in low-productivity sector while supporting employment growth in high productivity sectors. For example, entry barriers, whether due to constraint access to finance or regulations, can slow down the inter-sectoral reallocation within manufacturing industries (Ciccone and Papaioannou 2008). Barriers to capital accumulation (Restuccia 2004), imperfection in factor markets (Vollrath 2006), multiple equilibria (Graham and Temple 2006), frictions in labor mobility (Landon-Lane and Robertos 2004) and weak property rights and contracting institutions can slow-down structural change. Chanda and Dalgaard (2008) show that the relative efficiency level of sectors is strongly affected by the institutional environment of individual economies, geographic conditions and trade.

We find that exports of raw materials, rigidity of employment and the valuation of exchange rates slow down structural change.[7] The rigidity of the labor market is found to be an additional robust determinant of structural change by McMillan, Rodrik, and Verduzco-Gallo (2014). They argue that in labor markets that are perceived as flexible, the obstacles for an effective reallocation of labor are lower and the potential for productivity-enhancing structural change is likely to be higher. In fact, our result confirm that rigidity of employment is the most robust and stable determinants of structural change. Another favorable condition for structural change is a competitive (undervalued) exchange rate (McMillan, Rodrik, and Verduzco-Gallo, 2014). In the spirit of McMillan, Rodrik, and Verduzco-Gallo (2014) we construct an index for the undervaluation of a country's exchange rate and include it in our analysis. Furthermore, McMillan, Rodrik, and Verduzco-Gallo (2014) argue that in a country with a high initial share in of employment in agriculture the potential for an efficient reallocation of labor across sectors is comparably large, and thus the impact of initial agricultural employment would be expected to have a negative impact on structural change. The reduced horizon of five years in this analysis might not allow us to isolate this convergence effect that is usually observed in a long run framework. Competitive advantages in natural resources and primary products tend to limit structural change, as these – usually very productive –sectors are typically not the ones absorbing considerable shares of employment. In order to test this we use the share of raw materials in total merchandise exports, natural resource rents and exports of fuels, ores and metals as possible explanatory variables in the analysis.

[7] The baseline specification (Table 1.2) is same as McMillan, Rodrik, and Verduzco-Gallo (2014).

Table 1.2 Determinants of structural change

	–1	–2	–3	–4	–5	–6
Init. agr. em	–0.118	1.171	0.433	1.538	0.599	0.108
	–1.374	–1.722	–1.758	–2.147	–1.624	–1.672
Rigidity of empl	.	–7.449**		–7.711**	–5.629**	–5.308**
		–2.767		–2.824	–2.049	–1.918
" * Africa			–14.48***			
			–2.19			
" * LAC			–13.30**			
			–5.712			
" * High income			0.479			
			–0.516			
" * MENA			–5.734***			
			–1.984			
" * Asia			–0.932			
			–1.937			
Raw exports				–0.0198		
				–0.0264		
" * Africa					0.0299**	0.0429**
					–0.013	–0.0182
" * LAC					–0.101***	–0.102***
					–0.0353	–0.0339
" * High income					–0.0911	–0.0922
					–0.112	–0.0939
" * MENA					0.00835	0.0236
					–0.0134	–0.022
" * Asia					–0.00788	–0.0285
					–0.0342	–0.0388
Undervaluation						1.153
						–1.13
Africa	–1.145	–1.359*	2.238***	–0.98	–2.368*	–2.856**
	–0.889	–0.751	–0.791	–0.866	–1.209	–1.235
High incom	–0.831*	–0.238	–1.052**	–0.191	0.161	0.748
	–0.431	–0.877	–0.401	–0.942	–1.349	–1.385
LAC	–2.733*	–1.454	2.409	–0.818	2.034	2.07
	–1.403	–0.929	–2.007	–1.034	–1.307	–1.294
MENA	0.447	1.351**	2.321**	1.931	0.709	0.0399
	–0.611	–0.618	–0.935	–1.155	–1.041	–1.202
Constant	0.634	2.078***	0.700*	2.244***	1.903**	1.928**
	–0.462	–0.748	–0.378	–0.816	–0.823	–0.802
Observation	41	40	40	40	40	40
R–squared	0.187	0.436	0.634	0.464	0.692	0.703

Standard errors in parentheses.

Apart from labor market flexibility, no robust medium term determinants of structural change can be detected for the MENA region. Neither the undervaluation of currencies nor a strong natural resource and primary products sector or institutional characteristics are found to causally explain structural change.

The small sample size in addition to the short time period considered complicates a robust and precise estimation of parameters, and the fact that the MENA region is the region with the lowest number of countries represented in the sample makes it difficult to draw informative conclusions that are statistically valid.

1.5 Unconditional convergence

The decline of the employment share in manufacturing of several MENA countries could potentially slow down their rate of convergence. According to Rodrik (2013), labor productivity in manufacturing in poorer countries tends to converge to that in high income countries independent of institutions, education or other growth determinants. Rodrik (2013) argues that unconditional convergence in manufacturing, however, does not imply unconditional aggregate income convergence due to (i) the lack of unconditional convergence in the rest of the (non-manufacturing) economy; and (ii) a declining manufacturing labor share in several developing countries.

Labor productivity in MENA's manufacturing sector grew at a significantly slower rate (1.2 percent) than in the rest of the world and was particularly low among MENA's oil exporters. This data is based on the compound average annual labor productivity growth rate across 23 manufacturing sectors for the latest decade post 1990. The growth rate is measured net of year-industry specific effects and the sample corresponds to the baseline post 1990 specification in Rodrik (2013). In this data, manufacturing labor productivity growth (net of year-industry specific effects) amounted to 4.2 percent across all 104 countries with available data. In contrast average, growth among MENA countries was only 1.2 percent which is close to the Latin American average. The difference in the growth rate is statistically significant. The growth rate among oil-exporters was even negative. In Jordan and Syria manufacturing grew well beyond the average (4.2 percent) while Morocco and Egypt fell only slightly behind.

Manufacturing labor productivity in MENA has been converging with the same convergence rate as the rest of the world, but has slowed down since 1995 relative to the rest of the world due to the lower convergence rate of the manufacturing industries of oil importers. Table 1.3 shows to which extent MENA countries do not catch up with manufacturing productivity with high income countries using the specification from Rodrik (2013). In all cases the dependent variable is the (compound annual) growth rate of labor productivity for two-digit manufacturing industries. Regressors are the log initial labor productivity and industry-year fixed effects. In columns 5–15 we test if the convergence rate is different in MENA, by including a region dummy and its interaction term with log initial labor productivity in the corresponding estimation specifications. The coefficient of the interaction terms measures if the convergence

Table 1.3 Manufacturing labor productivity growth rates

Annual growth rate (in %)				Is the annual growth rate of manufacturing productivity different in MENA?							
	All countries	**countr**	**obs**	**MENA**	**oil-impo**	**oil**	**JOR**	**SYR**	**MOR**	**TUN**	**EGY**
post-1990	4.2	104	1861	1.2*	2.8	–0.4***	8.3***	12.4**	3.0	0.0	4.4
				(–1.67)	(–0.48)	(–2.90)	(4.56)	–1.96	(–1.39)	(–1.54)	(0.09)
1995-2005	2.7	58	955	1.4	0.5	2.7	3.6	–10.3***	3.1		1.7
				(–0.99)	(–1.26)	(0.04)	(1.60)	(–15.20)	(0.78)		(–1.41)

Columns 2–4 replicate the baseline finding of Rodrik (2013). Columns 5–12 show the convergence rate in manufacturing labor productivity in different MENA countries and MENA country groups. Each cell is based on a regression of growth on initial productivity including year-industry dummies and a region dummy as well as the interaction term of the region dummy with initial productivity. The coefficient shows the compound convergence coefficient (baseline-coefficient + interaction term). Standard errors are clustered at the country level in all specifications.

Table 1.4 Convergence rate in manufacturing labor productivity

Rodrik (2013)				Did the speed of convergence differ in manufacturing productivity in MENA?							
	All countries	**countr**	**obs**	**MENA**	**oil-impo**	**oil**	**JOR**	**SYR**	**MOR**	**TUN**	**EGY**
Baseline	–0.029***	118	2,122	–0.041	–0.037	–0.044	–0.033	–0.039	–0.005***	0.195***	–0.064***
	(–6.95)			(–1.51)	(–0.75)	(–1.05)	(–0.57)	(–0.56)	(3.30)	(3.49)	(–3.21)
post-1990	–0.029***	104	1,861	–0.037	–0.039	–0.026	–0.033	–0.144***	–0.005***		–0.064***
	(0.004)			(–1.01)	(–0.95)	(0.21)	(–0.58)	(–8.32)	(3.43)		(–3.33)
1995–2005	–0.024***	58	955	–0.044*	–0.067***	–0.023	–0.032	–0.067***	–0.033*		–0.101***
	(0.004)			(–1.92)	(3.79)	(0.12)	(–1.31)	(–8.16)	(–1.78)		(–14.47)

[1)] The t-statistics tests if convergence coefficient is statistically different from the convergence coefficient in the full sample, i.e. across all counties (e.g., –0.029).

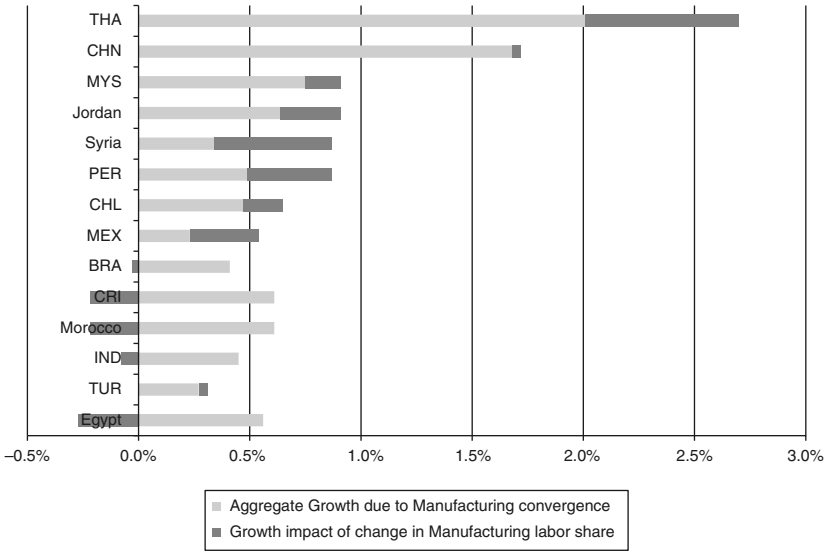

Figure 1.19 Predicted aggregate growth rates decomposed in a manufacturing convergence term and a reallocation term

rate was different from the convergence rate of the entire sample. We find that between 1995 and 2005, the convergence rate in MENA was significant lower. The low convergence rate seems to be driven by the oil-importing MENA countries in the sample.[8]

1.6 Conclusions and Potential Policy Implications

Though per capita growth in MENA has been broadly in line with other regions, the contribution of productivity growth to overall growth has been very weak. MENA's growth has to a large extent been driven by demographic change, here defined as the change in working-age population as a share of population and contributed about 50 percent to economic growth. High fertility rates combined with rapidly declining mortality contributed to a sharp increase in MENA's working-age population as a share of total population and has rapidly increased MENAs potential labor supply.

[8] Unconditional convergence in manufacturing does not necessarily lead to aggregate productivity convergence. Rodrik (2013) shows empirically that the fact that we find little empirical evidence for unconditional productivity convergence is driven by a lack of convergence in non-manufacturing sectors as well as declining manufacturing labor shares.

The contribution of structural change to growth in value-added per worker in MENA has been smaller than in East Asia. More specifically, an increase in the employment shares of lower productivity sectors seems to have held back aggregate productivity growth in some countries such as in recent decades. The results show that faster structural change was limited by the rigidity of the labor market in MENA suggesting that existing labor market regulations prevent a more effective reallocation of labor across economic activities. Still, structural change contributed positively to labor productivity growth in MENA and was stronger than in some other regions.

In contrast, "within" sector growth was very low by international standards in MENA. Manufacturing productivity growth in MENA was below the world average. Despite a convergence in labor productivity in manufacturing with the rest of the world, productivity growth has been relatively slow. Thus, firm productivity growth within sectors has been low.

While MENA countries should reform rigid labor market regulations to enhance the reallocation of labor towards higher productivity sectors, the main growth impetus will come from higher firm productivity growth. Increasing firms' labor productivity growth requires upgrading the skills of the labor force across the board. It also requires more startups that can put competitive pressure on existing incumbent firms forcing them to become more cost effective or innovate. It thus requires a level playing field among all firms within sectors so that the most cost effective and thus productive firm grows fastest.

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Annex I: Data Description

Our analysis is based on data on employment, value added and labor productivity by sector for a panel of 35 countries, of which 7 countries are from the MENA region. Nominal value added is converted to value added in constant PPP terms using the PPP conversation factor from Penn World Tables Revision 7.1. Labor productivity for sector i is calculated as value add in constant PPP terms of sector i divided by employment of sector i. The data set expands data used by Timmer and de Vries (2009) and McMillan and Rodrik (2012), by adding newly compiled statistics for MENA countries.

Our time-series on value added, price deflators, and employment by sector for MENA countries is constructed from available statistical sources. We follow the methodology developed by Timmer and de Vries (2009), also used by McMillan and Rodrik (2011), using national data which tends to harmonized in terms of industry classifications. Gross value added in current and constant prices is taken from the national accounts of the various countries. In recent years, value added series have been compiled according to the 1993 United Nations System of National Accounts (UN SNA). So, international comparability is, in principle, high. We follow Timmer and de Vries (2009) and McMillan and Rodrik (2011) as closely as possible to construct a data set for the main 9 sectors according to the definition of the 2nd revision of the internal standard industrial classification (ISIC, rev. 2). These 9 sectors are 1) Agriculture, Hunting, Forestry and

Fishing; 2) Mining and Quarrying; 3) Manufacturing; 4) Public Utilities (Electricity, Gas and Water); 5) Construction; 6) Wholesale and Retail Trade, Hotels and Restaurants; 7) Transport, Storage and Communications; 8) Finance, Insurance, Real Estate and Business Services and 9) Community, Social, Personal and Government Services. We also use data from population census as well as labor surveys to estimate sector employment, which captures here all persons employed in a particular sector, independent of their formality status or whether they are self-employed.

The additional areas include Egypt, Jordan, Morocco, Syria, Tunisia and West Bank and Gaza, Saudi Arabia.

In order to obtain data for Egypt consistent with ISIC Rev 2 categorization, we split the sector 'Industry & Mining' into two separate ones 'Manufacturing' and 'Mining and Quarrying' respectively using the share in value added of these two sectors based on UN 2 data. Since UN data is only available for the period 1996–2008, we assumed that these shares remained constant for the years 1982–1995. We received employment data from the Central Agency for Public Mobilization and Statistics for Egypt using the ISIC Rev. 3 classification for 1998, 2006 and 2012 and linearly projected employment data for the periods 1999–2005 and 2007–11.

For Jordan, we converted data on value added and employment for 38 sectors from 1994 to 2008 from Unido to the ISIC Rev. 2 classification.

For Morocco, we converted data on value added and employment for 15 sectors from 1998 to 2010 to the ISIC Rev. 2 classification. Employment for Morocco comes from the population census.

For Tunisia, we use data on value added for 20 sectors (NAT96) for 1998–2011.[9] To convert the NAT96 data into ISIC Rev. 2 classification we disaggregate "Energies and mining" into two separate categories using detailed sectoral data from national accounts and assume that "Public Sector" and "Non-Market Services" correspond to the ISIC Rev. 2 sector 'Community, Social, Personal and Government services'. Employment data is available at NAT 1996 classification (20 sectors) for the years 1984, 1987, 1989 and1994–2010 from the National Employment Survey (Enquête Nationale de l'Emploi) and includes public and informal employment.

For West Bank and Gaza, we converted data on value added and employment for 13 sectors from 1994 to 2011 to the ISIC Rev. 2 classification. We used IMF PPP conversation factors because PWT does not provide PPP conversation factors for West Bank/Gaza/Pal Ter. For Syria, we converted data on value added and employment on 8 sectors for 2001–08 into the ISIC Rev 2. Classification assuming a assuming that "Services" correspond to "Community, Social, Personal and Government services" and assuming that value added and employment in "Other sector" equals zero.

Data for Saudi Arabia covers 10 sectors for value added and employment between 1970 and 2011.

We complement this data with information on the level of education of workers by sector for Tunisia, Moroco and Jordan.

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[9] Pre 1998 data is not directly comparable since the INS has changed its methodology for calculating value added by sector in 1997, leading to a significant upward revision of GDP, largely driven by an upward revision in the value added of services. As a result there are two consistent series available. Data on sectoral value-added at NAT 1996 from 1983 to 2002 are based on the old methodology. Data on sectoral value-added from 1987 to 2011 based on the new methodology are available in constant (chained) and current Tunisian Dinar.

Annex II: Labor Productivity in 2005 PPP Terms

Country	Region	Av. LP	COV 1/	Sector	Maximal LP	Sector	Minimal LP	Growth LP 2/
USA	HI	70,235	0.062	pu	391,875	con	39,081	2.19%
HKG	ASIA	66,020	0.087	pu	407,628	agr	14,861	3.32%
SAU 3/	**MENA**	**63,981**	**0.130**	**min**	**2,293,442**	**cspsgs**	**12,645**	**–1.08%**
SGP	ASIA	62,967	0.068	pu	192,755	agr	18,324	2.10%
FRA	HI	56,563	0.047	pu	190,785	cspsgs	37,148	0.95%
NLD	HI	51,516	0.094	min	930,958	cspsgs	33,190	1.00%
ITA	HI	51,457	0.058	pu	212,286	cspsgs	36,359	–0.59%
SWE	HI	50,678	0.051	pu	171,437	cspsgs	24,873	2.50%
JPN	HI	48,954	0.064	pu	173,304	agr	13,758	2.08%
UKM	HI	47,349	0.076	min	287,454	wrt	30,268	1.35%
ESP	HI	46,525	0.062	pu	288,160	con	33,872	–0.25%
TWN	ASIA	46,129	0.094	pu	283,639	agr	12,440	2.25%
DNK	HI	45,423	0.088	min	622,759	cspsgs	31,512	0.92%
ZAF	AFRICA	35,760	0.074	pu	91,210	con	10,558	1.09%
MUS	AFRICA	35,291	0.058	pu	137,203	agr	24,795	1.85%
KOR	ASIA	33,552	0.106	pu	345,055	fire	9,301	3.12%
MYS	ASIA	32,712	0.113	min	469,892	con	9,581	3.49%
ARG	LAC	30,340	0.083	min	239,645	fire	18,290	–0.03%
CHL	LAC	29,435	0.084	min	194,745	wrt	17,357	1.24%
TUR	TURKEY	25,957	0.08	pu	148,179	agr	11,629	6.12%
MEX	LAC	23,594	0.078	Pu	88,706	agr	9,002	2.26%
VEN	LAC	20,799	0.126	Min	297,975	pu	7,392	1.45%
CRI	LAC	20,765	0.056	Tsc	55,744	min	10,575	1.48%
JOR	**MENA**	**14,721**	**0.100**	**fire**	**64,390**	**other**	**3,460**	**3.63%**
COL	LAC	14,488	0.108	Pu	271,582	wrt	7,000	0.38%
THA	ASIA	13,842	0.127	Pu	161,943	agr	3,754	2.29%
PER	LAC	13,568	0.101	pu	117,391	agr	4,052	2.76%
TUN	**MENA**	**12,543**	**0.107**	**Min**	**125,802**	**con**	**6,261**	**1.36%**
BRA	LAC	12,473	0.111	pu	111,923	wrt	4,098	–0.08%
SYR	**MENA**	**11,305**	**0.16**	**min**	**605,826**	**con**	**3,228**	**4.12%**
IDN	ASIA	11,222	0.106	min	85,836	agr	4,307	3.66%
PHL	ASIA	10,146	0.097	pu	90,225	agr	5,498	1.94%
EGY	**MENA**	**9,870**	**0.121**	**min**	**232,517**	**cspsgs**	**5,183**	**–2.15%**
CHN	ASIA	9,518	0.122	fire	105,832	agr	2,594	8.43%
MOR	**MENA**	**8,594**	**0.129**	**fire**	**98,506**	**agr**	**2,832**	**4.88%**
IND	ASIA	7,700	0.087	pu	47,572	agr	2,510	7.05%
BOL	LAC	6,670	0.137	min	121,264	con	2,165	–0.77%
PAL	**MENA**	**6,338**	**0.108**	**fire**	**49,739**	**agr**	**2,549**	**–0.94%**
NGA	AFRICA	4,926	0.224	min	866,646	cspsgs	264	7.51%
SEN	AFRICA	4,401	0.178	fire	297,533	agr	1,271	0.34%
KEN	AFRICA	3,707	0.158	pu	73,936	wrt	1,601	0.46%
GHA	AFRICA	3,285	0.132	pu	47,302	wrt	1,507	2.77%
ZMB	AFRICA	2,643	0.142	fire	47,727	agr	575	3.15%
ETH	AFRICA	2,287	0.154	fire	76,016	agr	1,329	2.22%
MWI	AFRICA	1,355	0.176	min	70,846	agr	521	–1.77%

1/ COV refers to the coefficient of variation for the log of sectoral labor productivity.
2/ Refers to period 2000–2005, with the exception of Saudi Arabia where the period is 2001–2006.
3/ Data for Saudi Arabia is for 2006.

Abbrev. of sectors: [agr] Agriculture, Hunting, Forestry and Fishing; [min] Mining and Quarrying; [man] Manufacturing; [pu] Public Utilities (Electricity, Gas and Water); [con] Construction; [wrt] Wholesale and Retail Trade, Hotels and Rest.; [tsc] Transport, Storage and Communications; [_re] Finance, Insurance, Real Estate and Business Services; [cspsgs] Community, Social, Personal and Government Services; [other] Other.

Annex III: Labor Productivity Growth Decomposition, 2000–05

Country	Region	LP growth	within	structural
JOR	MENA	55.59%	120.67%	–65.08%
CHN	ASIA	8.43%	6.28%	2.15%
NGA	AFRICA	7.51%	5.33%	2.18%
IND	ASIA	7.05%	7.12%	–0.07%
TUR	TURKEY	6.12%	4.46%	1.65%
MAR	MENA	4.88%	4.78%	0.10%
SYR	MENA	4.12%	1.42%	2.70%
IDN	ASIA	3.66%	3.41%	0.25%
MYS	ASIA	3.49%	3.31%	0.18%
HKG	ASIA	3.32%	2.83%	0.49%
ZMB	AFRICA	3.15%	1.89%	1.26%
KOR	ASIA	3.12%	3.62%	–0.50%
GHA	AFRICA	2.77%	1.64%	1.13%
PER	LAC	2.76%	2.52%	0.24%
SWE	HI	2.50%	2.91%	–0.40%
THA	ASIA	2.29%	1.32%	0.97%
MEX	LAC	2.26%	2.27%	–0.01%
TWN	ASIA	2.25%	1.77%	0.48%
ETH	AFRICA	2.22%	3.02%	–0.80%
USA	HI	2.19%	2.84%	–0.64%
SGP	ASIA	2.10%	1.25%	0.85%
JPN	HI	2.08%	2.03%	0.05%
PHL	ASIA	1.94%	1.92%	0.02%
MUS	AFRICA	1.85%	1.54%	0.31%
CRI	LAC	1.48%	1.46%	0.01%
VEN	LAC	1.45%	13.15%	–11.69%
TUN	MENA	1.45%	1.12%	0.33%
GBR	HI	1.35%	1.84%	–0.49%
CHL	LAC	1.24%	1.64%	–0.39%
ZAF	AFRICA	1.09%	1.83%	–0.74%
NLD	HI	1.00%	1.41%	–0.41%
FRA	HI	0.95%	1.03%	–0.08%
DNK	HI	0.92%	0.88%	0.04%
KEN	AFRICA	0.46%	0.08%	0.38%
COL	LAC	0.38%	1.33%	–0.95%
SEN	AFRICA	0.34%	6.53%	–6.18%
ARG	LAC	–0.03%	0.21%	–0.23%
BRA	LAC	–0.08%	–0.28%	0.20%
ESP	HI	–0.25%	–0.30%	0.05%
ITA	HI	–0.59%	–0.67%	0.08%
BOL	LAC	–0.77%	5.50%	–6.27%
WBG	MENA	–0.94%	–1.18%	0.24%
MWI	AFRICA	–1.77%	0.94%	–2.71%
EGY	MENA	–2.15%	–3.21%	1.05%

Compound growth rate of labor productivity in Column 3, ranked in descending order.

2

The Roll-Back of the State and the Rise of Crony Capitalism

Melani Cammett and Ishac Diwan[1]

2.1 Introduction

A fiscal sociology of the state offers a useful lens for tracing the evolution of social contracts and the underlying political settlements[2] that sustain them (Campbell 1993; Goldscheid 1958). In the Middle East, fiscal policy has gone through dramatic changes over the past 50 years, with state expenditures first growing to extraordinary levels, and then shrinking enormously. The nature and sheer size of the rise and the fall of public spending both reflected and in turn shaped the economic and political history of the region. From small post-independence states, in the rising nationalist states, republics and kingdoms alike, state expenditures rose to reach 50 to 60% of GDP in most of the region during the 1960s and 1970s. These spending levels were in line with the high level of state activism and ambition of the time. In the late 1990s however, the size of the state had shrunk, on average to 25 to 30% of GDP. These dramatic changes reflect important shifts in the composition and degree of inclusiveness of the social coalitions underlying the distinct forms of authoritarian rule in the region.

This "fiscal bulge," or the difference between peak and low expenditure levels, resulted from three main factors, in various combinations depending on the country. The first relates to the change in the predominant development model,

[1] We want to thank Adeel Malik and Ahmad Galal for helpful comments and suggestions and Tarik Akin for excellent research assistance. The paper draws on material in our book, *A Political Economy of the Middle East* (Cammett et al. 2015). The data work on fiscal accounts draws on Diwan and Akin (2015).

[2] Political settlements refer to the relative distribution of power among different groups and organizations contesting the distribution of resources (Khan 2009). As Parks and Cole (2010, 5) note, elites are central to the establishment and maintenance of political settlements, which are informal arrangements that arise from conflict and compromise among different factions of political and economic elites.

which was state driven from the 1950s to the 1970s, until this mode of development became unworkable and had to be discontinued, leading to a long period of forced adjustment, which lasted well into the 1990s in many countries. The second important influence reflects the drying up of sources of finance that had allowed and supported the previous rise of the state. In particular, the price of oil, which peaked in the 1970s and hit lows in the 1980s to 1990s, affected oil exporters and importers alike, the latter because of fluctuations in the amount of aid received from oil exporters and in workers' remittances. The third factor is political, with the quasi-socialist regimes of the 1950s gradually replaced by regimes that implemented market liberalization reforms. In countries that adopted liberalization policies, rulers sought the political support of the business elite and of the middle class, which were largely composed of higher echelon public sector employees and some formal sector workers in Middle Eastern countries, instead of their traditional constituencies of farmers, workers, and lower level civil servants.

Changes in fiscal policy have been gradual, with the "bulge" lasting over 20 years, and the rollback period often taking more than a decade. Although the Arab uprisings of 2011 cannot be directly attributable to the rollback of the state, which took place more than 20 years ago, over time, the impact of the transformation of fiscal policy on the economy, society, and polity has been profound. In this chapter, we argue that the rollback elicited rising opposition, which rulers met or preempted with a combination of rising repression of some groups and the cooptation of others in a changing political settlement that advantaged elites. A key feature of the new political regime was the emergence of a system of crony capitalism. After a lost decade due to the macro effects of fiscal adjustment, the supply response came, but it was muted and distorted by the low level of dynamism of a largely monopolistic private sector. As a result, the quality of economic growth deteriorated – it was much less inclusive than in the past, the private sector became increasingly informal, and there was little trickle down to the disadvantaged.

In response to growing social malaise at the loss of a credible development path, and the rollback of the welfare state and its services, which restricted social mobility, regimes increasingly enforced political stability through more repression and more costly economic co-optation, particularly to maintain the crucial support of their middle classes. Supported by the West, this low equilibrium lasted for two decades. But mounting fiscal pressures, driven in large parts by rising subsidies and lower tax revenues, exacerbating the deterioration in social services, further hurting the poor and peripheral regions and leading to increasing identification with the poor rather than middle classes among the population. In this context, the Arab uprisings of 2011 emerged, led by middle class elements that defected from authoritarian coalitions and evolved into champions of change, and were driven by the lack of opportunities for

socioeconomic advancement and anger about rising perceived inequalities (Diwan 2013).

This chapter develops these themes in more detail and is organized in five main parts. After presenting a typology of the countries of the MENA region in the next section, section 2.3, which is the heart of the chapter, looks at the changing composition of state expenditures and revenues. Section 2.4 traces the direct and indirect effects on growth, and section 2.5 details the impact of the rollback of the state, together with less inclusive growth, on a range of development outcomes. The conclusion addresses the implications of this history for the future.

2.2 Three types of Arab countries and oil prices

Rather than discussing each country of the region on a case by case basis, it is more useful, following Cammett et al. (2015), to classify the countries of the region into an analytically useful typology classified by oil and population endowments. There are important differences, both political and economic, between oil and non-oil countries on the one hand, and among oil rich countries between those with large and those with small indigenous populations. The first group has low oil per capita and the other two have medium and high oil per capita. Accordingly, we divide our countries into three groups, depending on their level of oil per capita:

- Resource Rich Labor Poor (RRLP) – the GCC countries, with Saudi Arabia, with $23,000 per capita being the lowest in the group;
- Resource Rich Labor Abundant (RRLA) – Algeria, Libya, Iran, Iraq, Sudan, Syria, and Yemen);[3]
- The Resource Poor Labor Abundant (RPLA) – Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza (WBG).

This taxonomy is meant to be only suggestive; its boundaries are porous. Interestingly, these categories are also sharply differentiated in their governance indicators (Cammett et al. 2015). An array of governance indicators, including the rule of law, government effectiveness, perceived corruption, repression, and empowerment, point to a consistent pattern: the resource-rich, populous

[3] Note that Syria, Yemen, and Sudan are in this group, but not Egypt and Tunisia, although their oil per capita figures are not largely different ($250/330 for the first group vs about $170 for the second). However, these countries are more clearly different when one looks at the relative importance of oil in the economy, as reflected by the oil/GDP ratio for example: the first group has levels of oil/GDP in the range of 20%, while for Egypt and Tunisia, the ratio is well below 10% GDP.

countries (RRLA) exhibit the most inferior outcomes in comparison with the other country groupings in the Middle East. Conversely, the RRLP countries consistently show relatively high values on all governance indicators except empowerment, although there is more internal variation in this category. The RPLA countries are similar to the RRLP on most governance indicators, save their weaker measures of the rule of law and state capacity, and higher levels of repression. These trends hold with respect to economic growth and development trajectories, as we show below. Thus, the alleged oil curse does not seem to apply as a blanket rule across the region. Rather, it afflicts the labor abundant countries far more than their sparsely populated oil-rich counterparts. Algeria, Iran, Iraq, Sudan, Syria, and most recently Yemen are characterized by institutional environments that are least conducive to fast growing development trajectories in comparison with the RPLA and RRLP countries. Virtually all of the RRLA countries adopted populist policies at independence, but when these failed in the 1970s and 80s, autocrats were unable to shift to patronage, unlike the monarchies of the Gulf, for a lack of sufficient resources, and had to resort increasingly to repression in order to survive, hurting the private sector more than in the RPLA countries. In the rest of the chapter, we focus the analysis on the more populous countries, since fiscal policy was less constrained in the RRLP oil rich countries.

Oil prices experienced two main periods of boom: one in 1973–79; and the other more recently, in 1998–2014. Since mid-2014, prices have collapsed, and this may represent a new long-term cycle. The first oil boom had spectacular effects: as oil prices quadrupled between 1972 and 1979, reaching nearly $100 per barrel (in 2010 dollars). As a result, oil revenues in the region jumped from less than $100 billion in 1972 to over 700 billion (2010) dollars in 1979. The second and more recent boom was equally if not more spectacular, bringing the region about $900 billion in direct oil revenues. In between, however, there was a long period where oil prices oscillated between $20 and $40 per barrel (again, in 2010 dollars) and revenues were only around $200 billion a year. These huge variations have equally huge effects on the economies, societies, and polities of the region.

Oil production represents an important share of the gross national product in both RRLP and RRLA countries. While in per capita terms oil revenues grew much faster in the RRLP countries, oil production as a share of GDP grew faster in the RRLA countries. This reflects the fact that the first group increased diversification over time, but in the second, diversification decreased over time. The oil importers benefitted from high oil prices, too, even though they had to pay more for energy imports.[4] Both remittances and aid from oil producers

[4] Some RPLA countries such as Egypt and Tunisia had some oil production.

fluctuated with oil prices, which led to boom and bust cycles in the importers. First, poorer countries, and especially those of the Mashrek region (particularly Lebanon, Jordan, the WBG, and Yemen), benefitted from large remittances from their workers who flocked to the oil producing countries, especially during the 1970s and 1980s. The sheer volume of labor migration sets the region apart. Jordan, Lebanon, and the WBG received between 8% and 13% of GDP from remittances, while Morocco and Egypt received about between 5% and 10% of GDP from this source. Second, overseas development assistance (ODA) rose, in part due to support by the GCC countries and especially during oil booms, with the frontline states of Jordan, the WBG, Egypt (until its peace agreement with Israel in 1979), and Syria being the largest beneficiaries of this type of aid.[5]

2.3 The collapse of the expenditure bulge of the 1970s

The extent of the rollback of the state and the challenges of these economic legacies remain poorly understood. Surprisingly few studies have traced the drivers, trends, and impact of fiscal policy in a region-wide comparative manner. The last 20 years have seen a slow transition, not just from state-led to market-driven growth, but also from a very large to a much smaller (but still large) and much impoverished Middle Eastern state, outside of the RRLP countries. These fiscal developments have directly affected welfare and the growth process via their effects on capital formation, infrastructure, skills, human development, taxation and subsidies, changes in the civil service, and redistribution policies, which are reviewed in this section. In addition, as the next section shows, the fiscal evolution of the state has had indirect political ramifications with the rise in societal opposition and its impact in on the structural adjustment process.

The main empirical contribution of this chapter is an attempt to reconstitute the fiscal accounts of as many Arab countries as possible since the 1960s. Data availability poses a major challenge to this exercise: fiscal accounts, as available from national sources and from the international financial institutions (IFIs), tend to begin in the 1990s, when most of the region turned to these external actors to support their macroeconomic and structural adjustment efforts. Older data exist for some countries, but the classification of various types of

[5] Added to this is Western aid, especially from the US, first to Israel and Egypt, then to Jordan, and more recently to Iraq, the increased involvement of the EU in the region under the guise of the Southern Mediterranean program, and the involvement of the international financial institutions, with the IMF most active during economic crises. As a result, most countries of the RPLA type received generous support to the tune of 5% to 8% of GDP over much of the period, which on a per capita basis represents one of the largest levels of support globally (Malik and Awadallah 2013).

expenditures varies across countries and across time. For countries that have not had close relations with the International Monetary Fund (IMF), little data is available. For example, there is no data for Iraq, little data for Sudan, and very little data for Yemen before its unification. Similarly, there is no data for the WBG prior to the establishment of the Palestine National Authority (PNA) in 1994, and no data for Lebanon before 1990. As a result, the countries that can be documented in some detail are restricted to Morocco, Tunisia, Algeria, Egypt, Jordan, Palestine (only for 2005–11), Lebanon (only 1990–2010), Syria, Iran, Turkey, and Yemen. (See the annex at the end of this chapter for more information on the data collection procedures.)

A look at the level of state expenditures for the region as a whole and the three sub-groups from the 1960s to 2010 shows clearly that the rollback of the state began in the 1980s. (See Figure 2.1.) Government expenditure shot up in the 1970s in the two groups of countries examined in this chapter – the RRLA and RPLA countries – on the back of rising oil wealth in the region, but fell precipitously in the 1980s before stabilizing in the 1990s at much lower levels. Thus, while state spending exceeded that of other global regions during the whole period, unlike all other regions, it exhibited a downward trend in the past two

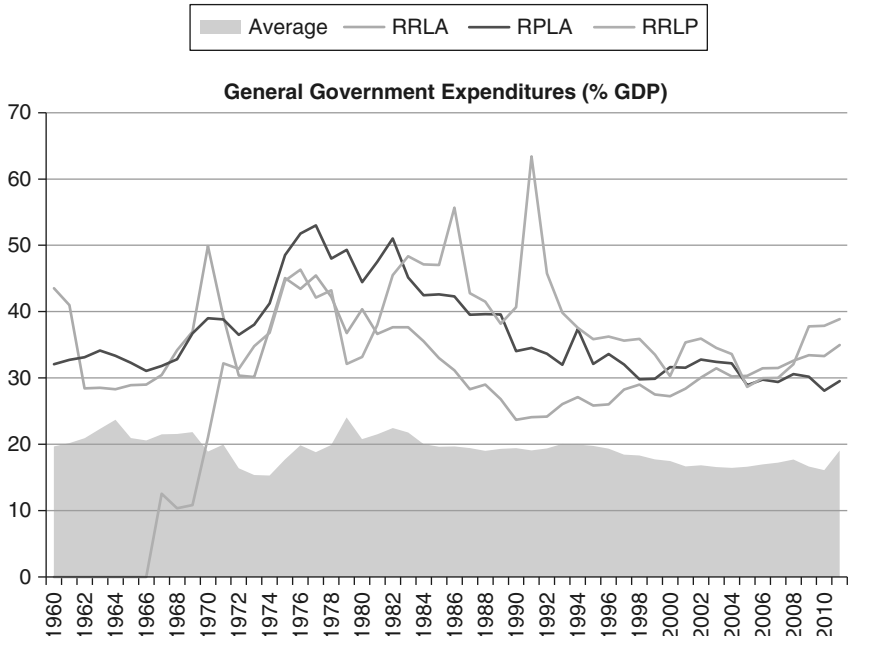

Figure 2.1 The evolution of the size of the state in the MENA political economies
Source: Diwan and Akin, 2015.

decades. It is noteworthy that all countries started to increase expenditures again during the more recent second oil boom, and especially the RRLA countries.

In the RPLA countries, government expenditures decreased most dramatically. On average, state expenditures peaked in the early 1980s at about 50% of GDP, but by the early 1990s, declined to about 30% of GDP. In these countries, adjustment tended to be slow and gradual because it was supported by the IFIs, and it only concluded in the late 1990s. Over time, the rollback of the state had a dramatic impact on some of the main services offered by the state. Since the 1980s, public welfare institutions have declined steadily, affecting all segments of the population but particularly damaging the poor, who rely on government services to meet their needs.

State expenditures exhibit the same pattern in the RRLA countries. The rise of state expenditures came earlier, reflecting the early industrialization push in Iran, Iraq, and Algeria, but the decline also started earlier, partly because of the effects of war in Iran and Iraq and partly because these countries received very little international support to smooth their adjustment. In these countries, the expenditure bulge was as dramatic as in the RPLA countries, reaching a peak of 45% of GDP in the mid-1970s, and falling below 25% of GDP in the early 1990s.

To show how this enormous fiscal adjustment occurred, Table 2.1 depicts the composition of state expenditure at its peak and at its bottom for each country of the region. For example, the table shows that in the case of Egypt, the highest level of expenditure was 61.5% of GDP in 1982 and its lowest was 25.1% of GDP in 1998. As a result, Egypt experienced an enormous fiscal bulge of 36% of GDP. Subsequent tables in this section show the size of some of the main budget items, including public investment (Table 2.2), the civil service wage bill (Table 2.3), expenditure on health and education (Table 2.4), and military

Table 2.1 Peak, low, recent peak total government expenditures as a share of GDP

	Available data	**Peak expenditure (Eh)**	**Date of peak**	**Lowest expenditure (El)**	**Date of low**	**Bulge Eh-El**	**Recent peak**	**Date of recent peak**
RRLA		43.3		22.2		21.1	35.4	
Algeria	1971–2011	38.1	1983	25.7	1990	12.4	41.9	2009
Iran	1960–2009	43.6	1980	19.2	1991	24.4	31.6	2006
Syria	1962–2010	48.2	1980	21.8	1990	26.4	32.9	2003
RPLA		53.2		27.9		25.2	38.1	
Egypt	1960–2011	61.5	1982	25.1	1998	36.4	35.7	2006
Jordan	1960–2011	52.5	1980	29.9	1992	22.6	39.8	2009
Lebanon	1990–2011	55.7	1994	29.6	2011	26.0	42.3	2000
Morocco	1960–2011	51.0	1981	26.2	1996	24.8	37.7	2011
Tunisia	1960–2011	45.1	1984	28.8	1998	16.2	35.0	2011

Source: Diwan and Akin, 2015.

spending and subsidies (Table 2.5) in the same years when expenditures peaked and then hit the bottom of the bulge for each country, as shown in Table 2.1. It is thus possible to compare the extent to which expenditures on each of these budget lines was affected when the bulge disappeared. Below, we address the main budget items in turn, and look at how much they bore the brunt of adjustment as a backdrop for analyzing the impact of adjustment on the economy, society and politics.

Public investment

The fiscal bulge had an especially deleterious impact on public investment, which collapsed in most countries from about 14% to 15% of GDP during the 1980s and early 1990s to an average of 6% to 7% at their lowest levels in the RPLA and RRLA countries, respectively (Table 2.2). Among these countries, the collapse of public investment was most marked in Algeria, Syria, Jordan, and Tunisia. Over time, this lower investment in infrastructure, schools, and other state assets would have an increasingly negative effect on economic growth, especially in the marginalized regions that were allowed to fall behind – and from where some of the 2011 uprisings started (as in Sidi-Bouzid in Tunisia) (Achy 2011, 19–20).

The MENA countries had invested comparable proportions of their national output as other developing countries in the 1960s to 1980s. Between 1970 and 1990, investment rates in the RRLA and RRLP countries were between 25 and 27% of GDP, below East Asian record levels, but more than in any other developing region. Nearly half of this investment was made by the public sectors of the region and much went to public enterprises. Initially, state-owned firms

Table 2.2 Peak, low, recent peak public investment as a share of GDP

	Peak public investment	**Low public investment**	**Recent peak public investment**	**Private investment 1971–90**	**Private investment 1991–2000**	**Private investment 2001–2010**
RRLA	15.6	7.7	19.9	15.24	14.55	13.04
Algeria	18.9	8.2	38.5	22.74	18.38	12.22
Iran	10.4	7.5	10.1	15.14	16.43	17.94
Syria	17.6	7.4	11.2			
RPLA	14.5	6.1	5.0	8.07	10.51	16.85
Egypt	20.7	14.1	8.0	10.27	12.01	10.05
Jordan	17.7	6.1	8.2	3.32	15.44	10.40
Lebanon	9.3	1.7	3.1	13.53	16.10	18.73
Morocco	8.4	3.0	4.5	9.62	5.58	10.30
Tunisia	16.5	5.7	1.4	15.93	17.61	17.04

Source: Diwan and Akin, 2015.

reaped good returns in terms of growth but, typically, these investments were of low return, especially when combined with import substitution policies. Large and inefficient investments were mainly the problem of oil rich countries such as Algeria, Syria, and Iran in the 1970s and 1980s.

By the late 1990s, public investment had collapsed to about 5% of GDP in the RPLA countries. Private investment however only partly filled the gap (Table 2.2). It rose only slightly from its historical levels in RPLA countries such as Morocco, Tunisia, Jordan, and in Lebanon after the end of its civil war.[6] Private investment remained low in Egypt, fluctuating between 10% to 15% of GDP and capital flight remained high, at between 5 and 10% of GDP, reflecting high political risk (Kar and Curcio 2011). Private investment also remained low in the RRLA countries, and declined in Syria and Algeria.[7] Foreign direct investment (FDI) too remains relatively low for most countries in the region outside of the oil rich Gulf states. During 2001–10, most FDI flows went to the RRLP countries, especially to Saudi Arabia and the UAE, which each received more than 20% of total FDI flows to the region. This contrasts to the earlier period, when most funds went to the RPLA countries, a trend that shifted largely due to the growing attractiveness of oil exploration with high oil prices (Cammett et al. 2015, 496–497).

The civil service

Public sector employment is a critical focus in this fiscal analysis of the state given its key role in promoting social mobility and the formation of the new, post-independence middle classes. The civil sector wage bill was squeezed too, but typically much less than public investment. Averaging over country types, the reduction in the wage bill was highest in the RRLA (from 10.7% to 7.5% of GDP) and then by the RPLA group (12.3% to 9.5% of GDP). (See Table 2.3.) Compared to the average developing country, where the wage bill stands at about 10% of GDP, the wage bill in the RRLA and RPLA countries still stands below these global averages in 2010.

New hiring in the public sector was at least reduced and in most cases frozen, dealing a hard blow to educated entrants to the job market who had traditionally joined the public sector in the past. Due to legacies of past hiring trends, public sector employment remains high in the region, but in most of

[6] In several countries, and especially Morocco and Iran, much of what is counted as private sector is investment by public enterprises.

[7] The reforms have led to a situation where the return on investment, in terms of growth was somewhat improved (Noland and Pack 2007). Other factors also improved and contributed to growth, in particular higher skill levels in the workforce. But these efficiency gains were tempered by growing weaknesses in infrastructure caused by government spending.

Table 2.3 Peak, low, recent peak expenditures on wages and public employment as a share of GDP

	Peak wage bill	Low wage bill	Recent peak	Average 1990s	Average 2000s	Average 2010s	Public % total LF 1990s	Public % total LF, 2005–10
RRLA	10.7	7.5	7.3	7.6	6.7	11.0		22.3
Algeria	7.8	9.3	8.8	8.9	7.2	11.0	58	30.0
Iran	16.2	8.0	7.7	9.4	7.8	N/A		16.0
Syria	8.1	5.2	5.5	4.6	5.0	N/A	29	21.0
RPLA	12.3	9.5	10.3	9.9	9.6	9.9		22.3
Egypt	9.7	5.9	6.8	6.1	6.7	6.4	32	27.0
Jordan	20.9	12.8	15.3	14.5	13.8	13.7	49	34.0
Lebanon	9.1	8.3	6.9	8.1	5.8	8.1		17.6
Morocco	12.1	10.4	11.7	10.6	11.4	11.3	26	11.0
Tunisia	9.9	10.2	10.6	10.0	10.1	10.1	32	22.0

Source: Diwan and Akin, 2015.

the RPLA countries the public sector has shrunk in the past two decades. In these countries, the overall wage bill fell faster that public sector employment, resulting in a still large but underpaid civil service, which has fed petty corruption. The large and underpaid state sector poses a huge challenge across the RRLA and RPLA countries, and it has hindered the ability of the state to deliver basic services to the population, as we detail in the next section. Figure 2.2 depicts variation in state capacity across political economy types, as measured by the World Bank's indicator of government effectiveness.[8] State capacity is a sine qua non for successful economic development and taps into a variety of state activities, such as making and enforcing rules and regulations, collecting taxes, and managing the economy. Figure 2.2 shows that "capacity" has been relatively high in the RPLA countries relative to their income levels, albeit declining over the recent period, but was abysmally low in the RRLA countries.

Social services

The first few decades after independence witnessed major gains in quality of life indicators, arguably contributing to popular support for the new regimes. For example, in 1960, the infant mortality rate (IMR) was slightly higher in Arab

[8] The variable Government effectiveness captures "perceptions of 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" (Kaufman, Kraay and Mastruzzi 2010).

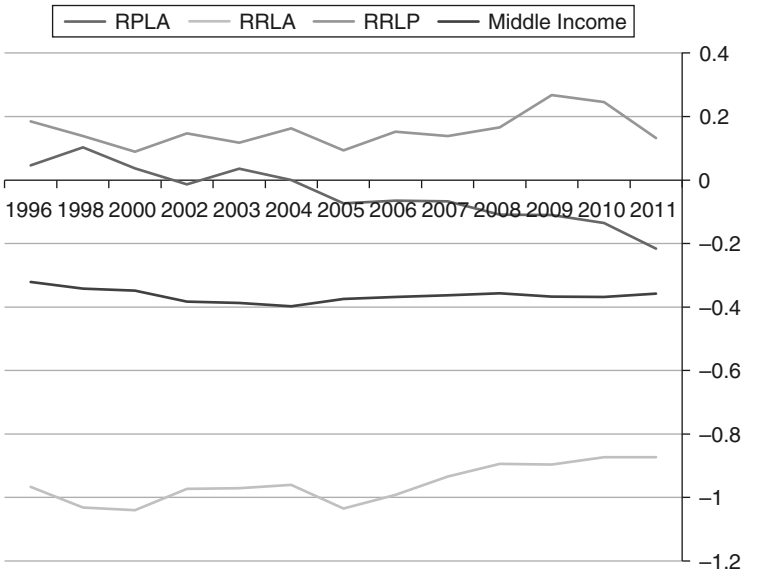

Figure 2.2 Government effectiveness in the various sub-regions (2003–12)
Source: World Bank Governance Indicators.

states (154 deaths per 1,000 births) than in sub-Saharan Africa (151 per 1,000 births). In 2011, the IMR in the Arab world was 30 and in sub-Saharan Africa was 86 per 1,000 births. Thus, over a 45-year period, the Arab states maintained the highest annualized rate of IMR reduction (3.6%), three times faster than in Africa (1.2%), one-third faster than in Asia (2.7%) and slightly faster than in Latin America (3.4%). In addition, poverty rates declined significantly more in the Middle East than other regions in the Global South (Kuhn 2013).

As the fiscal bulge shrank, government spending on health and education has been the least affected in the region as a whole, falling from about 8% to 6% of GDP. In the RRLA countries, however, it fell precipitously from 6.5% to 3.8%, an extraordinarily low level that mainly reflects low levels of spending in this category in Syria. (See Table 2.4.) The freeze in budgets for health and education led to less progress in human development and a decline in the quality of services, especially those going to the poor who could not afford to purchase medical care and schooling in the burgeoning private sector. A recent UNDP study confirms this in dramatic ways. The study traces the evolution of the Human Development Index (HDI) and measures the performance of the health and education systems in all global regions during 1990 to 2010 and compares these measures to the period from 1970 to 2010. All countries experienced a slowdown, but it is particularly marked in the Arab region. After taking off in

Table 2.4 Peak, low, recent peak, and decade average expenditures on health and education as a share of GDP

	Peak H+Eh	**Low H+Ee**	**Recent peak**	**H+E average 1990s**	**H+E average 2000s**	**H+E average 2010s**	**HDI ranking average 80,90,00,10**
RRLA	6.5	3.8	5.6	6.4	5.4	N/A	
Algeria	N/A	N/A	8.3	10.4	6.8	N/A	70, 81, 84, 93
Iran	9.9	5.6	2.9	6.1	3.9	N/A	75, 86, 75, 75
Syria	3.0	2.0	N/A	2.8	N/A	N/A	64, 83, 90, 115
RPLA	6.9	5.7	6.5	6.1	6.4	6.0	
Egypt	6.5	5.5	5.7	5.4	6.0	5.1	81, 92, 91, 111
Jordan	5.3	6.2	7.8	7.5	8.1	6.9	59, 72, 77, 99
Lebanon	N/A	2.7	3.6	3.5	3.4	2.8	137, 151, 163, 74
Morocco	7.8	6.9	8.3	6.7	7.2	8.0	85, 99, 107, 130
Tunisia	7.9	7.1	7.3	7.7	7.3	7.2	72, 85, 80, 92

Source: Diwan and Akin, 2015.

the 1970s, the rate of increase in the HDI in the Arab region slowed markedly. As elsewhere, initial improvements were easier to achieve coming from a low base and were boosted by the high expenditures on socials sectors in the earlier post-independence period, which was characterized by the rise of the state and the first oil boom. Progress has become more constrained in recent years, partly because incremental advancement is harder but also because of serious fiscal constraints.

The evolution of revenues

A classic claim in the literature on Middle Eastern authoritarianisms is that there is no taxation without representation. In the countries with large hydrocarbon reserves, tax rates have been relatively low but, as shown by Waterbury (1997), most MENA countries are taxed at fairly high levels. Efforts to collect revenue would be expected to rise when the fiscal constraint becomes more binding. The evidence in Table 2.5, however, suggests that with the exception of Syria, Jordan, and Lebanon, revenues actually decreased after the reforms of the 1990s were implemented. This surprising development in an indicator of the political re-orientation of the state towards the corporate sector for which taxes were typically cut. For example, in the late 1990s, Egypt instituted a flat corporate tax rate of 20%, which is low by international standards: On average, corporate taxes range from about 35% to 50% of corporate profits. Indeed, an early reform after the uprisings in Egypt raised the corporate tax rate to 35% and instituted a capital gains tax.

Table 2.5 Taxes and revenues as shares of GDP

	Peak tax	**Low tax**	**Recent tax peak**	**Peak grants**	**Low grants**	**Recent peak grants**	**Direct over indirect taxes at peak**	**Direct over indirect taxes at low**
RRLA	8.7	10.5	12.2	7.2	1.2	0.3	39.8	47.3
Algeria	N/A	12.2	9.8	N/A	0.0	0.0	N/A	39.6
Iran	6.9	6.7	8.2	0.0	0.0	0.1	55.2	36.1
Syria	10.5	12.7	18.8	14.5	3.6	0.7	24.4	66.1
RPLA	20.0	19.3	17.9	4.4	1.0	0.6	25.0	28.0
Egypt	28.5	16.0	15.8	0.3	0.6	0.4	36.4	56.9
Jordan	14.0	23.0	17.1	17.2	3.8	2.0	19.2	20.4
Lebanon	10.8	17.5	11.9	3.1	0.1	0.4	16.9	13.0
Morocco	21.2	20.9	23.8	1.4	0.0	0.2	29.8	27.3
Tunisia	25.8	19.2	20.9	0.1	0.4	0.3	22.9	22.2

Source: Diwan and Akin, 2015.

At fiscal regimes seem to have become more pro-rich over time, it is interesting to ascertain whether the role of direct taxes have fallen relative to indirect taxes, which tend to be more regressive. Indirect taxes in the form of VAT system did become a more important component of tax revenue in much of the region after the reforms of the 1990s, and they are inherently regressive because they are applied to consumers across the board, regardless of income levels (Imam and Jacobs 2007). However, at the same time, custom taxes fell as trade was liberalized. On a net basis, our computations in Table 17 suggest that the share of direct taxes in total tax revenues did not fall, and actually rose marginally. However a proper evaluation of the incidence of tax regimes is not available: A more detailed incidence analysis will be needed before concluding on this core.

2.4 The politics of power maintenance: repression and cooptation

One important consequence of the withdrawal of the state is that social grievances rose, and with them, a broad movement of opposition was unleashed from the late 1970s onwards. Food riots and workers actions inflamed the Arab street – 1981 and 1984 in Casablanca, 1977 and 1982 in Cairo, 1982 in Hama, Syria, 1983 in Tunis, 1988 in Algiers, 1989 and 1996 in Jordan, plus countless other incidents. By then, opposition parties were established on the left, and over time Islamist opposition movements had emerged or were consolidated, leading to a civil war in Algeria after the early 1990s and to years of acute instability in Egypt.

In other regions, such as Latin America and sub-Saharan Africa in the 1980s and 1990s, economic crises had helped to provoke regime change during the near synchronous "third wave" of democratization (Huntington 1991). In the Middle East, however, rulers did not open up the political space in order to reduce social pressures stemming from the decline in economic resources. There were three main differences with other reformers around the world. The needed fiscal adjustments were larger than in other countries, including Africa. Mounting opposition by new Islamist and old leftist movements threatened regime change in more radical ways than in Latin America, countries with some market and democratic traditions. And unlike in the Soviet Union and Eastern Europe, foreign donors encouraged authoritarian rulers to battle the forces of political Islam and to consolidate their hold on power instead of pushing for serious political reforms (Levitsky and Way 2010). To the contrary, in 2010, the region was less open politically than it was in 1980, particularly in the two groups of countries examined here.

A large literature has developed to explore how regimes managed to survive by using these sticks and carrots (see, inter alia, Henry and Springborg 2010; King 2009; Lust-Okar 2005; Posusney and Angrist 2005; Schlumberger 2007). Repression is certainly a core component of any account of authoritarian persistence (Bellin 2004), especially in the RRLA countries (i.e., Iraq, Algeria, Sudan), but also increasingly after 9/11 in the RPLA countries (notably Egypt and Tunisia). The threat of harassment, persecution, imprisonment, torture and death are powerful disincentives for anti-regime activism.

Yet repression is never a sufficient or even the most effective tool of political control. The literature on persistent authoritarianism in the Middle East has described in detail how (and, in some cases, why) different regimes chose to respond with distinct mixes of cooptation and repression to maintain their control. Autocrats aimed to maximize their dwindling assets by dividing citizens into groups that benefited from cooperation while others were subject to repression and neglect. In countries that lacked high per capita oil wealth, authoritarian rulers sought to strengthen their coalitions by co-opting the middle classes. External support for authoritarian rule is a distinctive feature of the region and, therefore, is a key component of any explanation for the persistence of authoritarianism in the Middle East in comparison with other regions (El Badawi and Makdisi 2007; Bellin 2004; Levitsky and Way 2010). External support provided rents in the form of aid and military support and helped to fuel the militarization of the region, which in turn facilitated state repression of opposition groups.

The rise in grievances led rulers to tighten their grip over the "street" in order to defend their authority. In Morocco, mounting repression during the 1980s and 1990s – les années de plomb – continued until 1998, when Youssoufi, the leader of the opposition Socialist Union of Popular Forces (USFP, by its French

acronym), was asked to form a government, and the long-serving Minister of Interior Basri (1979–99) was removed after the new king was sworn in and initiated social reconciliation efforts. In Algeria, the 1988 Algiers riots were followed by a short-lived political opening, followed by the elections of 1991, which were won by the Islamists and then robbed by the military, initiating a long civil war that saw various factions in government and opposition dividing up the spoils of war. In Tunisia, the 1987 coup ushered in as president the previous minister of interior and head of security, who established a repressive system of governance. After an initial two years of political liberalization, Ben Ali took advantage of the Gulf war in 1991 to unleash a harsh campaign of repression, imprisoning 30,000 members of the Islamist opposition party, El-Nahda, and neutralizing the left, which was worried about the rise of the Islamic Salvation Front (FIS) in Algeria. Under Ben Ali's control, social control intensified: by the 2000s, the ministry of interior allegedly employed 100,000 persons (1 per 100 Tunisians) and the ruling party had a million members. Repression also rose in Egypt in the 1980s and 1990s, as the regime fought the Islamic opposition. As elsewhere, the fight against political Islam was used as a divide-and-rule tactic to scare elements of the middle class away from supporting the opposition (Lust 2011).

The republican RRLA countries were borne out of more violent political processes that put at the helm groups that espoused radical departures from the past, embodied for example in Baath ideology in Iraq and Syria, Islamism in Iran and Sudan after 1980s, and socialism in Algeria. In these countries, oil supported a more benign form of autocratic rule in a first phase, within a modernist nationalist phase of fast development and industrialization. A second, more violent and repressive phase ensued, especially after the industrialization drives of the 1960s and 1970s ended in failure, while the humiliating defeat of 1967 for the frontline states put into question the core legitimacy of these regimes.

Against this backdrop, the oil shock shook the RRLA regimes to the core and they reacted violently. In some cases, as notoriously illustrated by Iraq's invasion of Kuwait, foreign adventurism was an attempt to replenish "strategic rents." In Algeria, the attempt to reform after the first oil shock led to the civil war that still marks the sociopolitical scene today. With increased repression under the guise of the fight against Islamists, army interests came to dominate stagnating private sectors. In Syria, low oil prices (together with falling reserves) led to a rapid economic adjustment that reduced dramatically state involvement in peripheral regions from which the ongoing revolution emerged. The country's intervention in Lebanon was largely predicated on extracting rents. Emerging from the war with Iran with a huge foreign debt and destroyed infrastructure, Iraq invaded Kuwait as a way to shore up its economy, with dramatic consequences for the Iraqi people. Iraq lost most of its oil revenues during its war with Iran when its export facilities at Shatt-el-Arab were

bombed, and again when it was under sanctions after the first Gulf war. In both cases, the country had to undergo wrenching and socially calamitous adjustment periods. In Sudan and Yemen, the shock was not due to changes in the international price of oil, but to security "shocks". In Sudan, the fight over dwindling resources contributed to the disaster of Darfur, and the pursuit of oil revenues culminated in a deal with the Sudan People's Liberation Movement (SPLM) that led to the division of the country. In Yemen, the fight over newly discovered oil led to a civil war and the forced unification of the country.

Security expenditures and repression

The level of spending on security is much harder to measure due to the opacity of relevant data. (See Table 2.6.) Typically, military expenditures were also cut, but they remained very high. (The global average is less than 2%). In both the RRLA and RPLA countries, spending on defense was cut but rose for internal security and police as repression increased, in large part to quell the rise in protests and social demands. Moreover, in several countries, the military went off budget to protect its interests. In Egypt for example, it is estimated that the military economy ranges between 10% and 30% of GDP, with the army operating its own factories, housing schemes, and consumer goods distribution (Elbadawi and Keefer 2014).

Figure 2.3 depicts country scores on the Cingranelli and Richards (1999) Physical Integrity Rights Index, which measures physical repression of populations at the country level. This additive index is constructed from the Torture, Extrajudicial Killing, Political Imprisonment, and Disappearance indicators ranging from 0 (no government respect for these four rights) to 8 (full government respect for these four rights). It is apparent that repression was much

Table 2.6 Expenditures on security, the military, and subsidies as shares of GDP

	Peak security	**Low security**	**Recent peak security**	**Peak defense**	**Low defense**	**Recent peak defense**	**Peak subsidy**	**Low subsidy**	**Recent peak subsidy**
RRLA	0.0	0.7	1.2	14.5	3.2	4.6	11.4	6.1	7.9
Algeria	N/A	N/A	1.8	2.0	1.5	3.8	7.1	5.2	10.6
Iran	0.0	0.9	1.8	5.7	1.7	3.7	6.9	0.0	2.8
Syria	0.0	0.6	0.0	35.9	6.4	6.2	20.2	13.1	10.4
RPLA	1.6	1.8	2.4	6.4	3.7	2.8	9.7	1.1	4.4
Egypt	1.7	1.4	1.7	7.1	2.8	2.6	22.7	1.5	8.8
Jordan	N/A	2.0	4.1	10.7	6.6	5.89	7.0	2.0	1.5
Lebanon	N/A	1.4	1.3	4.1	3.6	3.6	1.6	4.8	0.4
Morocco	N/A	N/A	N/A	7.2	3.9	3.4	5.6	0.6	6.1
Tunisia	1.5	2.4	2.5	3.0	1.7	1.5	11.4	0.2	5.4

Source: Diwan and Akin, 2015.

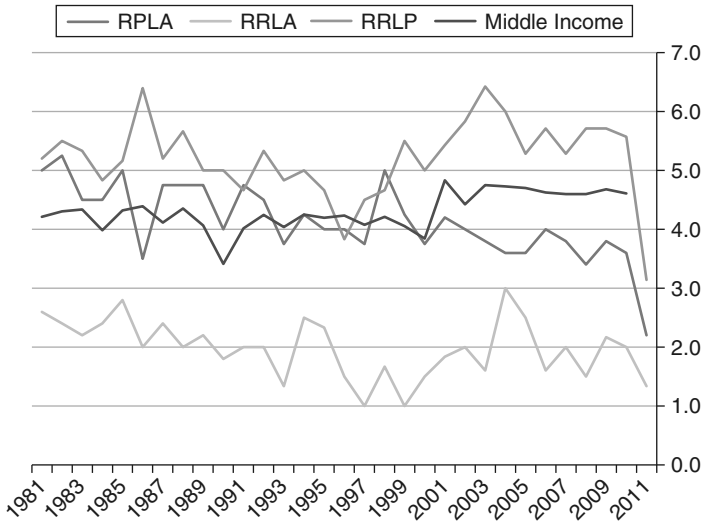

Figure 2.3 Repression in the various sub-regions (1981–2011)
Source: Cingranelli-Richards Physical Integrity Index.

higher in the RRLA countries compared to regional averages, and lower in the RPLA countries. This striking empirical evidence provides some confidence that our country classification has analytical teeth. Repression has important effects on the economy and on society, which helps to explain why the development paths followed by the two sets of countries have differed.

Subsidies

In addition to public investment, the other item slashed most severely during the adjustment period was subsidies for consumer goods. In the 1980s, these were often in the form of food subsidies and went predominantly to the poor. Although this line item is measured imprecisely in fiscal accounts, our figures in Table 2.6 illustrate the magnitude of the decline in subsidies, especially in the RPLA countries, where they were cut from a height of about 9.7% to about 1.1% of GDP. Early attempts to reduce these subsidies had led to food riots from Casablanca to Cairo, and governments had to resort to "stealth" reforms to reduce these subsidies over time (Sadowski 1991).[9] In the RRLA countries, subsidies started at higher levels and, despite some cuts, remained high, as this is one of the main ways in which these regimes transfer some oil income to their citizens.

[9] For example, rather than increase the price of the subsidized *baladi* bread, the authorities in Egypt reduced its size.

With the increase in energy prices in the 2000s and the attempts by many governments to maintain the support of the rich and middle class, blanket subsidies on energy and petroleum products rose in the 2000s, further shrinking an already squeezed fiscal space. Energy subsidies grew over time and, by 2011, were much higher in the Middle East than in any other region of the world. In absolute terms, about 50% of global energy subsidies are disbursed in the MENA region. In 2010, these subsidies represented about 8.5% of regional GDP and 22% of total government revenues, much larger than in other developing regions, while subsides tend to be negligible in the advanced economies. Within the region, levels of subsidies vary, but 12 of the countries in the region have subsidies above 5% of GDP. About half of all subsidies in the Middle East go to petroleum products followed by electricity (IMF 2013).

Government expenditures on these subsidies have gone up even more in recent years together with energy prices. In many countries, they now represent an expense several times higher than total spending on health or on education.[10] This phenomenon is not restricted to oil exporters. For example, in 2011, energy subsidies represented 41% of government revenues in Egypt, 22% in Jordan and 19% in Lebanon. Among oil producers, Algeria and Iran have particularly large energy subsidies – 27% and 50% of their respective government revenues – even *after* the famous Iranian subsidy reforms (Salehi-Isfahani et al. 2013). It is well known that such subsidies are very regressive, as oil products tend to be consumed in much larger quantities by richer people. For example, a study in Egypt shows that in the case of petroleum subsidies, 46% of the benefits accrued to the top quintile in 2008 (Abouleinem et al. 2009). Once in place, it is almost impossible to reduce or eliminate subsidies because of the threat of political backlash by key constituents.

The effects of fiscal retrenchment on economic growth: the lost decade and the rise of crony capitalism

The direct impact of fiscal retrenchment on growth was through a much reduced aggregate demand, and lower public investment, both of which led to a rapid growth deceleration in the 1980s to 1990s, when most MENA countries experienced a "lost decade" (see Table 2.7). This period, which in some cases was shorter and in others longer, coincided in most countries with the height of the youth bulge, when the share of labor entrants to total population was at its maximum. In other regions, and in particular in East Asia, this created a demographic dividend, as the labor force grew faster than the population, thus providing an extra push to GDP per capita. In the Middle East, however,

[10] Spending on energy subsidies exceeded social expenditures by two to three times in Egypt and Tunisia in the mid-2000s.

Table 2.7 Real GDP per capita growth

	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010	SD 1960–2010	Av. 1960–2010
Resource abundant labor rich	3.02	3.88	–6.47	3.98	2.06	4.41	1.30
Algeria	2.08	3.07	–0.21	–0.18	2.22	1.50	1.40
Iran	8.31	0.86	–1.15	1.99	3.79	3.59	2.76
Iraq	3.20	8.00	–30.00	14.92	–1.53	17.27	–1.08
Sudan	–0.77	0.70	–0.11	3.13	4.39	2.20	1.47
Syria	2.29	6.76	–0.87	2.46	2.37	2.72	2.60
Yemen				1.59	1.14	0.32	1.36
Resource poor labor rich	3.03	6.16	0.00	2.44	2.38	2.21	2.80
Egypt	2.82	4.32	3.04	2.50	2.97	0.70	3.13
Jordan		11.74	–1.58	0.99	3.89	5.77	3.76
Lebanon	4.00	7.00	–9.10	4.61	3.93	6.38	2.09
Morocco	2.09	2.65	1.52	1.00	3.80	1.08	2.21
Tunisia	3.21	5.14	1.11	3.10	3.46	1.43	3.20
Palestine		6.10	5.00	2.47	–3.74	4.40	2.46

Source: World Bank WDI.

the coincidence of the youth bulge with rough economic times led to rising social frustrations, setting the backdrop for the 2011 uprisings. Growth fell deeply during the lost decade, which came later but lasted typically longer than in Latin America, but there were significant differences among countries. Viewing the 1980s as a whole, GDP per capita growth was –1.0% a year in the RPLA countries (i.e., Egypt, Jordan, Morocco, and Tunisia), –0.6% a year for the RRLA countries (i.e., Algeria, Iran, Syria, and Yemen), and–-2.0% in the wealthy RRLP countries.

The slowdown in growth was especially jarring coming on the heels of a long period of state building and rapid growth. Economic growth and structural change had proceeded briskly in the region in the 1960s and 1970s, initially because statist policies work for a while before running into contradictions, and later because the first oil boom in 1973 allowed states to continue with such policies after they had run their course. In the early post-independence phase of development, growth in the MENA region was among the highest in the world, a stark contrast to the relatively low levels experienced in the 1950s. This period was the height of a movement that started with the rise of nationalist states and the formation of the new middle class, in part due to investments in human development. Economic growth was rapid at 3% to 4 % a year on a per capita basis, reflecting high rates of investment and accumulation as well as increased productivity linked to the development of human capital.

Oil exporters did particularly well, boosted by the extraordinary rise in oil revenues after 1973. In the 1960s, for example, Iran grew at above 7% per capita. Others, too, benefitted from the regional tide, with Syria, Jordan, Tunisia, Lebanon, and even the WBG growing at rates above 5% a year in the first two post-independence decades.

By the 1980s, in order to jump start growth again, important structural reforms would be required. As elsewhere in the world (in particular, in Latin America), state-led industrialization strategies focused on import substitution faltered after an initial period of fast growth. Shielded from international competition, labor productivity remained low and the region did not take advantage of the fast growth in global trade, as did East Asia. When they were hit by the increase in their petroleum-import bill after 1973, most RPLA countries in the region attempted to delay adjustment by borrowing, only to face the day of reckoning a few years later. These countries resorted to international debt in order to delay adjustment and, by the late 1980s, the average debt to GDP ratio of this group stood at over 100%. In the countries with abundant oil (Algeria, Iran, or Saudi Arabia), oil revenues and external borrowing allowed for delaying adjustment until later in the 1990s.

The collapse of oil prices of the mid-1980s and the rise in global interest rates sounded the death knell of ISI in the region. The first countries to undertake adjustment were Morocco (1985), Tunisia (1986), and soon after Jordan and Algeria (1989), followed by Egypt (1991), all of which adopted IMF programs backed by the World Bank and other Western donors. Other countries adjusted without recourse to an IMF program, such as Saudi Arabia (in the mid-1990s), Iran, Syria, and later, in a different context, Sudan and Lebanon. The timing of stabilization was dictated much more by the availability of finance, than by any ideological decisions to reduce the size of the state, as had happened in the UK and the US with the Reagan and Thatcher revolutions. With the partial exception of Morocco and Tunisia, which took an early calculated decision to develop strategies aimed at boosting exports to European markets, most countries resisted adjustment as long as possible.[11] The content of the programs tended to be similar and is covered extensively elsewhere. Public expenditures were slashed, emasculating the welfare state and reducing social mobility. By the mid-1990s, macroeconomic indicators had largely stabilized and economic growth picked up in most of the region, reaching moderate levels of about 3%

[11] In some cases, countries sought to make good on strategic assets they possessed. For example, Egypt's two major adjustment programs coincided with the Iraq war in 1990 and the Gulf war in 2000. Similarly, Jordan adjustment coincided with its peace agreement with Israel. In both cases, generous financing allowed for a slow and gradual adjustment over time.

between 2000 and 2010. Some countries even exceeded this rate (i.e., Egypt, Iran, Jordan, Lebanon, Morocco, Sudan, and Tunisia).

The central question of why the Arab region underperformed, given what looked on paper to be impeccable market reforms, has been debated for years. Economists have tended to argue that market reforms did not go far enough (Noland and Pack 2007; World Bank 2009). Indeed, in contrast to fiscal stabilization, reforms to promote export-led growth and privatization proceeded in a haphazard fashion. Daunting domestic challenges posed obstacles to these strategies. When the starting position is one of gross inefficiencies in production, as was the case in the Arab World (as well as in Latin America and Eastern Europe, when they started their own reforms), the political difficulties of transitioning from an import-substitution to an export-driven strategy are compounded. In contrast, in the East Asian newly industrialized countries (NICs), import substitution had performed better, laying the ground for a smoother passage to a competitive export economy.

A different interpretation of MENA economic underperformance is that the reforms appeared better on paper than they were in reality. As markets were liberalized, the rules that govern the market were applied in a discretionary manner, benefiting "networks of privilege" (Heydemann 2004), or capital holders with personal and social ties with the political elites rather than promoting truly competitive markets. The effects of fiscal adjustment in most countries of the region had led to the parallel rise of opposition movements. The resultant threat to political stability required that the emerging private sector needed to be managed in order to ensure its political quiescence and to deter it from supporting the opposition. Politics infuse the operation of markets, not only with respect to redistribution but also in terms of organizing private activity, thus preserving the power ruling elites and maintaining political stability (Chaudhry 1993). As long as political instability remained high, economic liberalization required that the rising business elite had to be incorporated into the ruling coalition as a trusted member. As Henry and Springborg (2010, 205), write on Egypt, "political management of capital by all means, including using intimidation and managed predation," was at the center of the "active efforts by political elites to strongly discourage potential manifestations of political behavior by business elites." The state's relationship with the private sector then involved both carrots and sticks. On the one hand, control over the private sector could be achieved by erecting barriers to entry that exclude opponents and provide privileges to a small group of trusted allies (Malik 2013). On the other hand, in this context, "support for the opposition was a red line punishable by closure and expropriation" (Henry and Springborg 2010, 205).

The constitution of networks of privilege varied from country to country, but in all cases, markets became increasingly concentrated. In Egypt, the trend to control the private sector accelerated in the last decade with the "businessmen"

cabinet, which was closely tied to Gamal Mubarak and headed by Prime Minister Ahmad Nazif (2004–11) and took on the large-scale reform of the economy. As they developed new sectors and modernized and expanded old ones, they were backed by state favors and occupied important posts in government, the ruling party, parliament, and various boards and committees (Osman 2010), allowing them to influence economic policy directly. In Tunisia, the government continued to direct the economy by using indirect forms of regulation rather than the direct involvement of the ISI era. Although the state gradually gave up its direct control of productive assets, these new forms of regulation increased state control over the economy (Bellin 2002). All large government contracts had to be approved directly by the president's office, and declining tariffs were replaced by rising nontariff barriers of all sorts. Increasingly, the Ben Ali and Trabelsi families monopolized business opportunities and even expropriated the real estate and business holdings of wealthy elites (Kaboub 2014). Similar stories about favoritism and insiders abound in Syria, Libya, Yemen, Jordan, Lebanon, Morocco, and Algeria, where political cronies came to control large chunks of the private sector; Alley 2010; Haddad 2012; Hibou 2006; Leenders 2012; Tlemcani 1999). When business interests became too autonomous, politically driven efforts to contain them took place, such as anticorruption campaigns in Morocco and Algeria, the closing down of Islamist financial institutions in Egypt, and the tax inspections to drive out successful businessmen with a rising interest in politics in Tunisia. In all the countries, open political support was also encouraged. In several countries, firms were allowed to avoid taxation if they contributed directly to funding projects and supporting constituencies important to political elites (Cammett 2007).

Reforms were designed more to elicit the backing of key constituencies than to create jobs and improve economic efficiency and had to be structured in ways that balanced the gains and losses of economic elites. For example, in Morocco and Tunisia, when import tariffs went down, corporate and income taxes were also reduced to offset the increased cost advantages of international competitors. In Tunisia, some firms from the old elite in the trade or import substitution sector moved into new sectors with high potential, but they were given special access to privileges that would allow them to make the adjustment more easily, such as subsidies, nontariff barriers, or loose application of the regulations, including anti-monopoly laws. Sometimes they made deals with new entrants to slow down the reform so as to create win-win opportunities, as in the Moroccan garment and textile sectors (see Cammett 2007). In many cases, public monopolies were replaced by private monopolies. Other politically meaningful constituencies such as high-level bureaucrats and powerful labor unions also remained protected. Organized labor has long been a force in Morocco, Tunisia, Egypt, and Algeria. Although, labor unions did not represent the vast number of workers employed in the informal sector, they were strong

in larger enterprises and in the public sector. Keeping the social peace required their acquiescence. These political imperatives, then, help to explain why the civil service remained over-bloated, privatization was slow, and rigid labor market structures persisted.

The patterns of growth that emerged after most of the countries of the region undertook structural adjustment programs reflect the low dynamism of MENA private sectors, particularly in the context of intensifying global competition. Manufacturing remained low, and exports only rose moderately, calling into question the sustainability of recent growth, which is mainly driven by non-tradables and entails little movement up the quality ladder. Indeed, while exports increased in most countries, performance was generally mixed. Some countries made some progress, like Morocco, Tunisia, Lebanon, and Jordan, while others did not, notably Egypt, Algeria, and Iraq. In the RRLA countries, manufactured goods account for a very small share of exports. Moreover, the new production structures were not favorable from a fiscal perspective: firms run by regime cronies devour subsidies of various sorts while the remaining large informal sector does not pay taxes.

Economies in the MENA countries tend to be based on deals between political and economic elites rather than on the enforcement of clear and impartial rules. Mechanisms to bestow privileges to allies and exclude potential opponents included practices such as protecting monopoly rights, preferential access to privatization offers and loans or loan guarantees (often implicit), favored access to government procurement opportunities and public land, and better treatment by regulators. These arrangements are reflected in responses to firm-level surveys, which show that in the MENA 35% of surveyed firms regard regulatory policy uncertainty as a severe obstacle (and 50% as a moderate or severe obstacle) to their growth and that regulatory uncertainty is perceived as one of the biggest obstacles to growth. Ample evidence indicates that firm owners are most concerned about discriminatory policy implementation that benefits a few insider firms and creates an uneven playing field.

These political dynamics have played out clearly in privatization initiatives across the region. In virtually all countries, privatization tended to be modest and advantaged insiders. Newly connected entrepreneurs, who benefit disproportionately, include high levels bureaucrats who entered business by benefitting from the new instruments of industrial policy (Waterbury 1991 – "state bureaucracy"). In Egypt, observers note that privatization was politically managed by the government "to allocate patronage to a narrow circle of supporters that it trusted" (Sfakianakis 2004). The lack of transparency was an inherent part of a political process to further the government's goals (Kienle 2001). In Tunisia, high-level bureaucrats and party members bought many privatized firms. Over time, Ben Ali's inner circle came to dominate the privatization process and monopolized government subcontracting deals, ushering in a period of large-scale corruption

(Kaboub 2014). By 2009, when a third telecom network was put out for competitive bids, the two finalists were both sons-in-law of Ben Ali. In Morocco, the course of privatization has likewise been far from smooth. Many observers allege that sales were often made to the politically well-connected, who enhanced their market share and weakened domestic competition (Bergh 2005; Hibou 2006). In Algeria, the process of privatization was even more opaque, with regime insiders allegedly benefiting greatly from the privatization of some banks, import-export companies, and construction firms. Privatization in Algeria was nomenklatura privatization (Boubakeur 2013).

Recent research on Egypt (Diwan et al. 2015) and Tunisia (Rijkers et al 2014) looks in depth at the characteristics of the politically connected firms. These studies were made possible by revelations about elite economic holdings following the Arab uprisings and court cases brought against the cronies. In the case of Egypt, Diwan et al (2015) identify around 500 firms controlled by 32 businessmen closely connected to Gamal Mubarak, most of whom occupied political posts in the mid-2000s. By 2010, these firms earned 60% of overall corporate profits, even though they employed only 11% of the labor force in the formal private sector. Regime support was instrumental in sectors in which they operated: tourist resorts were built on formerly government-owned land; investments in oil and gas required government approval; and new banks or factories in specific manufacturing sectors such as cement required government licenses. Following Ben Ali's ouster, the new government expropriated the assets of Ben Ali, his family, and his closest cronies, valued at an estimated $13 billion, or about one-quarter of Tunisia's 2011 GDP. The confiscation affected 117 individuals—including Ben Ali himself and his relatives and in-laws—and 400 enterprises. These firms, which were accused of illegally profiting from political connections, were predominantly in the real estate, industrial, telecom, air transport, and banking sectors, and all were in the onshore market. Collectively, these firms accounted for a whopping 21% of all net private-sector profits in 2010, although they produced only about 3% of private-sector output and employed 1% of the labor force.

These studies also have started to uncover some of the mechanisms used to provide privileges to the politically connected. Diwan et al. (2015) show how connected firms in Egypt benefited from protection from foreign competition through the growth of nontariff barriers in the sectors where they were active, preferential access to energy subsidies and to land, and preferential regulatory treatment. In Tunisia, the number of sectors requiring licenses expanded under the Ben Ali administration, and connected firms were primarily found in sectors with investment restrictions—those that required licenses to operate or were closed to FDI—since firms were most likely to benefit from government connections in these sectors. Rijkers et al (2014) even find evidence that the Ben Ali clan had a hand in manipulating

investment laws to increase exclusionary regulations in sectors in which they planned to invest.

The banking sector has played an important role in supporting the political regulation of markets. This has been done directly in countries where public banks still dominate, and indirectly elsewhere. In some cases, connected groups developed their own banks, and in others, truly private banks chose to lend to the connected because they were perceived to be backed by government guarantees, which facilitated bank recapitalization where non-performing loans (NPLs) rose rapidly. In Egypt, lending patterns became extremely concentrated as bankers were more interested in lending to the government and to large firms than to small and medium enterprises (SMEs) (World Bank 2010). By 2010, 92% of credit was going to the largest 5,000 private firms lands with 145 firms controlled by 32 connected families. In Tunisia, the Central Bank was often accused of excessive regulatory intervention, with persistent reports of collusive behavior among bankers (Henry 1996). Even after three years of stimulus following the Jasmine Revolution of 2011, one of the main threats to the Tunisian economy is once again the very high number of nonperforming loans carried by the state banks (IMF 2012). In Morocco, big financial groups maintained and even increased control and blocked new entrants, including in new financial markets (Henry 1996).

Competition creates dynamic forces that drive the private sector to innovate and to invest in processes and assets that can help improve efficiency and labor productivity, leading over time to the creation of jobs and the upgrading of existing jobs. However, as Aghion et al. (2001) show, these incentives are attenuated when leading firms, like the politically connected firms of Egypt and Tunisia, have exogenous cost advantages that cannot be overcome by trailing firms. This leads to market structures with a few large and capital-intensive, but inefficient large firms, a missing middle that taxes growth since job creation typically takes place largely in this segment, and an overly large sector of inefficient small firms. In the case of Egypt, cronyism seems to have led to stagnant economic growth and poor job creation through both direct and indirect channels. While their advantages allowed connected firms to increase their profits, they were also run less efficiently than their competitors, partly because they were more capital-intensive and partly because they were shielded from competition. This contributed to the misallocation of scarce national savings, notably bank loans and state subsidies, which starved the rest of the corporate sector of much-needed capital. Equally important, Diwan et al. (2015) find that sectors that were dominated by a few crony firms were less competitive, saw lower firm entry, had a larger "missing middle" of medium-size enterprises, and did not create many jobs compared to more competitive sectors. They estimate that Egypt's growth could have been 1% larger per year, and labor demand 20% larger over the past decade, in the absence of privileges. Similar processes

may be at play in the other countries.[12] A more indirect effect of favoritism on growth is that industrial policy, which could play an important role in fostering growth, becomes ineffective when it is captured by rent-seekers and thus ceases to be driven by job creation concerns.

The social effects of concentrated capitalism have also been highly problematic. Cronyism has made "capitalism" unpopular and led to the emergence of a very rich "1 percent," The slow growth of the formal private sector also exacerbated labor market dualism, increasing the inequality of opportunities faced by young graduates and arguably helped to sustain unpopular regimes in Tunisia and Egypt. For all these reasons, large swaths of the population increasingly came to see cronyism and corruption, both petty and grand, as the hallmark of economic liberalism and the source of many ills, including the job deficit, the rise in inequality, and the lack of progress on democratization. Indeed, perceived "corruption" of the political and business elites was a driving force of popular discontent. Many indicators point to rising popular dissatisfaction with corruption. A Pew survey reveals that in 2010 corruption was the top concern of Egyptians, with 46% listing it as their main concern even ahead of lack of democracy and poor economic conditions (Pew 2011). Changes in the corruption ratings of Arab countries in Transparency International's Corruption Perceptions Index (CPI) confirm this popular perception. In 2005, Egypt ranked 70th, Tunisia ranked 43rd, Libya ranked 117th, and Yemen ranked 103rd out of 158 rankings on the index. Perceived corruption increased markedly in the following three years. In 2008, Egypt dropped to 115th, Tunisia to 62nd, Libya to 126th, and Yemen to 141st out of 180 rankings on the on the index. A recent study of Gallup data during 2009 to 2012 in 18 Arab countries reveals that perceptions about state corruption were highly correlated with perceptions of business corruption (Diwan and Nabli 2013).

2.5 Social development outcomes

The somewhat improved economic growth experienced across the Middle East since the mid-1990s has generated a healthy employment response. The region's labor force grew at the most rapid rate in the world (and so employment "elasticities" were among the highest in the world (see IMF 2013). Thus, growth has not been "jobless," as it is often claimed, but the jobs created were low productivity jobs largely in the informal sector. Moreover, job creation was not sufficient to absorb the youth bulge. By 2010, unemployment rates were large, especially among the educated youth and women, who have traditionally

[12] In the case of Morocco, a recent study finds that the sectors dominated by large firms tend to be less dynamic and experience lower gains in productivity and jobs (Achy and Sekkat 2008).

preferred public sector jobs. Meanwhile, the public sector has shrunk and the formal private sector remained small. As a result, the expanding informal sector has absorbed most of the labor entering and moving from agriculture.

In much of the region, the informal sector is now the biggest component of the labor market. The formal private sector varies in size across the region, but tends to be much smaller than the civil service or the informal sector. In Egypt, employment in the formal private sector barely grew. In 2010, 25% of the labor force worked for the government as compared to 35% a decade earlier, while only 12% worked in the formal private sector, barely more than the proportion a decade earlier. Moreover, real wages in the late 2000s were at the same level as in the late 1980s. The informal sector created only about one in five jobs for new workers in 1970, but by 1998 it was creating six in ten new jobs (Wahba 2009; World Bank 2004). By the 2000s, formal sectors constituted only about 10% to 15% of the labor force in Morocco and Tunisia, a pattern reflected in most of the region. The typical MENA country now produces one third of its GDP and employs 67% of its labor force informally (World Bank 2013). The share of the informal sector in the economy is now estimated at about 44% in Morocco, 33% in Egypt, 30% in Tunisia, and 50% in Algeria. These shares exceed those in many other developing countries. In Indonesia and Vietnam, for example, the informal sector accounts for about 21% and 16% of the economy, respectively. Moreover, informality in the MENA region has continued to expand in the recent past. Despite its relatively small size, the formal private sector receives most of the finance going to the private sector, starving the informal sector of credit and capital.

Unemployment also rose, and especially for skilled youth. Today the employment problem may be the most politically volatile economic issue facing the region. Unemployment mainly affects young, semi-educated people, who are prime participants in political unrest. In some countries, unemployed youth provided fertile ground for the revolutionary fervor that led to the Arab uprisings (Assaad and Salah 2013). Unemployment was highest in recent years in Tunisia and Algeria where over one-third of youth and nearly 50% of women were unemployed. Unemployment rates peaked in the 1990s, and so job creation has had to contend with a large stock of unemployed workers for a fairly lengthy period (Tzanatos 2013).[13]

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[13] There has been much debate on the cause of the high unemployment rates, especially among educated youth. One line of thought holds that much of the problem is due to the unemployed themselves, notably their high reservation wages and their willingness to wait until public sector jobs open up (Assaad et al. 2013). There is certainly some truth to this in the richer GCC countries, but the evidence for such phenomena in the poorer countries is scant. The more convincing argument in the poorer countries is that the lack of good jobs is due to the excess demand for jobs, which is connected to the low dynamism of the private sector (Tzanatos 2014).

During the adjustment period of the 1990s, poverty reduction gains were halted and even reversed in some countries. For Egypt, evidence indicates that poverty fell in the second half of the 1990s, but rose marginally again in the 2000s, and especially after the 2008 global crisis (ESCWA 2013). For Tunisia, available data suggest that poverty fell over time but became concentrated in marginalized regions. The middle class has also become more vulnerable, with large numbers clustering just above the poverty line, especially in Egypt (Prasad 2013). These trends have important political implications: a sizable portion of the population in many countries is unable to progress socially in the ways previous generations did – through hard work and education – and has been left in an inter-generational poverty trap by the rollback of state services.

Apart from the persistence of poverty, a possible rise in inequality has also been cited as a major factor behind the Arab uprisings. Consumption inequality tends to be low in the region compared to more unequal regions of the world (such as Latin America and Africa) as a result of the "socialism" of the past. There is some notable variation, with inequality highest in Morocco and Tunisia (where Gini coefficients are around 40%) and lowest in Egypt (Gini coefficients around 30%). Data for long-term comparisons (covering 30 years) are only available for a few countries. Egypt also exhibited a drop in living standards in rural and marginalized parts of these countries. Inequality figures do not reflect realities well: they are based on consumption rather than income; they generally do not include the rich (who rarely fill out consumption surveys); and they do not account for the geographical distribution of income. While inequality between the poor and the middle class has not varied much, the inequality between the middle class and the rich increased substantially after the 1990s (Diwan 2013; Prasad 2013). Indeed, two groups have profited most from the liberal reforms: the top 10% of the population who have a household member employed in the formal labor markets, and the top 1% who have greatly benefited from their political connections. Another recent line of research focuses on a different concept of inequality that is especially relevant for educated youth in the labor market – the inequality of opportunities (Salehi-Isfahani et al. 2013; Roemer 1998, *inter alia*).

In the RRLA countries, the private sector is extremely weak and dominated by a narrow range of cronies and a few poorly performing public enterprises. As a result, unemployment is high and the economies of these countries have become *less* diversified over time. Despite their large endowments of oil and labor, the economies of the RRLA countries are becoming economies dominated by three things: oil, some public employment for the lucky ones, especially in the security forces, and a huge unproductive informal sector for the rest. Prospects in these countries remain dim. On the one hand, states could use their considerable revenues from oil to promote inclusive growth. However, these revenues underpin a political settlement, which is based on a narrow

authoritarian coalition and requires repression to sustain. When confronted with popular movements, the RRLA governments have generally reacted violently and, when oil prices rose in the 2000s, whatever reforms occurred in the 1980s were undone. More productive fiscal policy in the RRLA countries will have to await a more favorable political settlement.

2.6 Conclusions

Fiscal policy crystallizes the political settlements that sustain distinct forms of rule and social bargains. In the MENA region, then, changes in public finance since the 1980s reflect shifts in ruling coalitions and state-society relations. As regimes across the region defaulted on the post-independence social contract, they entered into coalitions with narrow business elites and increasingly squeezed the middle class while neglecting the poor. As a result, fiscal policy became more regressive. Expenditures on energy subsidies and security shot up, and the tax effort was reduced. Public investment took the brunt of the adjustment and has remained low ever since. Reductions in government expenditures, especially on wages, health, and education reduced aggregate demand and hurt growth during the 1990s. The quality of public services also deteriorated, reducing the speed of progress on human indicators and hurting social mobility.

Since the state shrunk most in the 1980s and 1990s, more than 20 years before the rise of the Arab uprisings of 2011, the decline of the public sector cannot be seen as the direct cause of mass mobilization. But the large-scale rollback of the state had ripple effects and has marked politics and economic change in the region ever since. The indirect effects of the rollback of the state on growth were equally large. In order to stabilize the political situation in the face of mounting opposition, rulers liberalized their economies reluctantly and selectively. The old regimes reinvented themselves as market friendly, and created new rents in the guise of "regulation rents," or rents that accrue as a result of privileges and exclusion mechanisms. As a result, economic growth was far less inclusive than in the past, much of the private sector became informal, monopolies and privileges rather than competitive markets became the rule, little trickle down occurred, and income inequalities rose.

In response to growing social malaise, autocratic regimes increasingly enforced their dominance through divide and rule strategies, based on a combination of blanket subsidies and repression as well as fear mongering about political Islam, leading to an increasingly fragile and narrow governing coalition. Supported by the West, this autocratic, low equilibrium lasted for two decades. Mounting fiscal pressures, driven in large parts by rising subsidies and lower tax revenues, led to deteriorating social services and lower public investment, further hurt the poor and peripheral regions and increasingly led populations to identity with

the poor rather than middle classes. In this context, the Arab uprisings of 2011 were led by middle class elements that defected from authoritarian coalitions and evolved into champions of change (Diwan 2013), driven by the lack of opportunities for socioeconomic advancement and anger about rising perceived inequalities.

Initially, governments reacted to the uprisings of 2011 with expansionary policies to smooth out the downturn, especially in the face of rising social demands and the high expectations generated by the uprisings. Public sector wages, subsidies, and government investment were increased in many countries around the region. By 2013, fiscal deficits in Morocco, Jordan, Tunisia and Lebanon had shot up to between 6 and 7% of GDP. In Egypt, the fiscal deficit ballooned at 12% of GDP and international reserves plummeted. These developments meant that by 2013, governments had no fiscal space to continue with stimulus programs. Expansionary policies were supported mainly by domestic debt levels and, in Egypt, by funding from the GCC. The uprisings occurred in the context of a global economic downturn and the Eurozone crisis, which restricted the availability of external support. As a result, in Egypt, Jordan, and Tunisia, economic indicators are deteriorating, and macroeconomic crises with sharp currency depreciation and banking crises are possible in the future. At present, Jordan, Morocco, and Tunisia have signed onto IMF programs, while other countries, such as Egypt and Lebanon, have continued to resist the adoption of comparable agreements. In many MENA countries, the "street" may not allow the passage of reform programs aimed at containing deficits.

In Tunisia and Egypt, the most immediate challenge of economic stabilization to avoid an economic and financial meltdown has been met successfully. The revolutions in these countries were experienced as a negative economic shock. Tourism took a hit, capital flight accelerated, exports declined, and investment collapsed in Tunisia, Egypt, and Yemen. As a result, economic growth declined sharply in 2011 and only stabilized at lower levels in 2012 and 2013. Output collapsed in Libya given the disruption to its oil production. Across the region, unemployment has increased. Syria has been devastated. The human toll in death and suffering is staggering. Millions have been made refugees, in their country and in neighboring countries. Economic production has taken a big hit, and the destruction of assets is already estimated in the tens of billions of dollars. The economies of Lebanon and Jordan have also been negatively affected by regional instability and the influx of refugees.

As political settlements in the transitional RPLA countries evolve, the interests of the poor and lower middle class will need to be rebalanced against those of the rich and the upper middle class. At the heart of such a settlement, fiscal policy will need to be reconfigured. While the precise role of the state must be re-imagined, the reconstruction of state capacity and the rehabilitation of public services, especially health, education, and social protection, must stand

at the center of new settlements. New governments with broad popular support should be able to redirect expenditures towards social services and away from subsidies that benefit the better-off, and to make tax systems more progressive while enlarging the tax base. Improving service delivery and fighting petty corruption will require increased public sector wages, which will be complicated by the large size of the civil service. The other central focus should be on private sector development. Improving competition and fighting monopolies, reducing politically connected privileges, and democratizing credit are the main instruments needed to reduce informality and make the private sector more dynamic.

The political and economic challenges facing these countries are compounded by high popular expectations and difficult legacies of the past. The main economic challenges will be difficult to resolve. How to build a package of measures that reduces expenditures and raises revenues and that commands some minimum level of popular support is a tricky endeavor in the best of circumstances, and it will be very challenging in the current atmosphere of regional instability.

Annex on Data

One of the main difficulties in putting together a long history of fiscal policy in the region is that the fiscal accounts, as available from national sources and from the IFIs, tend to only start in the 1990s, when most of the region turned to the IFIs to support their macroeconomic and structural adjustments. Such a task is problematic. The key source of information we use is the IMF Government Finance Statistics (GFS) database. The data is spotty, especially before 1990s, and the classification of various types of expenditure varies across countries and time. Little data is available for countries that have not had close relations with the Fund. For example there is no data for Iraq, little data for Sudan, and very little data for Yemen before its unification. Similarly, there is no data for the WBG prior to the formation of the PNA, and no data for Lebanon before the end of the civil war in 1990. The accounts of the oil producers of the GCC are not covered systematically by the Fund. As a result, the countries which we are able to document in some detail are restricted to: Morocco, Tunisia, Algeria, Egypt, Jordan, Palestine (only for 2005–11), Lebanon (only 1990–2010), Syria, Iran, Turkey, Yemen, with some partial coverage for the countries of the GCC.

Another source of complication is the predominant role of the state in production, and especially the operation of public enterprises. The GFS does not cover public enterprises, restricting our coverage to general accounts and neglecting the many ways in which governments exercise influence through off-budget or extra-budgetary spending. Similarly, military expenditures and

off-budget subsidies, such as energy subsidies in oil producing countries, tend to have low or no coverage.

The classification used by the GFS database is complex and our task has been to simplify it into a form that can be readily analyzed around simple analytical concepts and variables. The GFS Database and the GFS-Historic Database are the two main sources that we use. The former database covers the period between 1990 and 2011, while the latter covers 1972 to 1989. These databases differ not only with respect to their years of coverage but also in terms of accounting rules, analytical framework and degree of detail. The GFS is prepared in line with the framework of the Government Finance Statistics Manual, 2001 (GFSM 2001) and is mostly recorded on an accrual basis and includes cash and non-cash data. The database also allows the user to extract detailed revenue, expense, outlay, and acquisition of financial and non-financial asset tables for most of the countries. Moreover, the sectoral decomposition of the data includes detailed information about central government, local governments, extra-budgetary operations and social security funds. As noted above, public corporations are not included in the database.

On the other hand, the GFS-Historic database is comparatively limited in coverage and in detail though this dataset also provides information about revenue, expenditure, lending minus repayments, financing, and debts of central government, social security funds and extra-budgetary operations. The GFS Historical database is prepared in line with the framework of the Government Finance Statistics Manual, 1986 (GFSM 1986) that is mostly recorded on a cash basis. Moreover, it uses a functional definition of public entities rather than an institutional definition as in the GFSM 2001. Although the GFS and the GFS-Historical databases differ in some respects, their coverage (general government) is more or less the same, permitting the creation of a long time series by combining the two datasets. Because of the differences of coverage and possible breaks in the data resulting from the definitional changes after and before 1990, other checks are also employed to see whether the data is consistent across these two database. For example, national sources are used for consistency checks and to "glue" together distinct time series.[14]

Several fiscal policy dimensions have remained under-developed in the chapter for lack of data. Quasi-fiscal activities could not be covered adequately. While we have mentioned the frequent recourse to off-budget expenditures, especially in the context of defense and subsidies expenditure, we do not

[14] We also use other sources to make adjustments to the data, in particular cases. For example, we use energy subsidies information from the IEA. Public investment data from the WDI is used as a comparator, but the differences in definition between the two sources is noted. We supplement the GFS data with Defense expenses data from SIPRI. We take privatization receipts data from the WB Privatization Database.

have sufficient information about the magnitude and frequency of these types of expenditures. There is also limited data on public sector enterprises. Tax analysis has also been restricted given the data available. Research on the incidence, evasion and exemptions of taxes are needed in the future as tax reforms become more attractive. A better understanding of how to improve automatic stabilizers of fiscal policy will also be useful, including further refining our understanding of oil stabilization funds and sovereign wealth funds whose withdrawal rules are either not clearly spelled out or not clearly enforced.

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3
Regional and Global Integration[1]

Ishac Diwan and El Mouhoub Mouhoud

3.1 Introduction

In the past 50 years, the MENA region has been integrated to the world economy through two main channels: the sale of oil, and labor migration. Labor migration, in retrospect, acted as the main way to redistribute oil revenues from the oil exporting to the importing countries, especially those in the Mashrek region, greatly benefitting millions of households. The migration of mostly unskilled workers from the Maghreb to Europe, during its period of fast growth, played a similar role. But migration will almost certainly never again boom as it did in the past.

During the same period, MENA countries' attempts to integrate in the global system of trade in goods and services have yielded modest results. Exports have not been a dynamic source of growth. While Import Substitutions Strategies can be blamed for these failures in the distant past, the more recent culprits have to be found in local and global conditions. Local conditions were clearly not favorable to competiveness, as the dynamism of the private sector was taxed by the emergence of a crony form of capitalism since the market liberalization of the 1980s (see Chapter 2).

In considering its external engagement with the global economy, the challenge of youth and skilled employment must be considered as the absolute priority for the MENA region. We argue in this chapter that a successful strategy for the region must rest on new arrangements on trade and investment with the EU and the GCC in particular that can foster FDI focused on activities that generate technological externalities and allow the developing countries of the MENA region to move up the quality ladder and generate more skilled jobs. The increased competition from Asia and Eastern Europe means that an export-led strategy is more challenging now compared to the 1980s when

[1] The chapter draws in part from Cammett et al, a Political Economy of the Middle East (2015).

Asian exports boomed. Nevertheless, the rise of FDI in the context of the rise of global value chains and the central role played by services offer good opportunities for the MENA countries to benefit from regional and global integration in ways that creates good jobs for skilled youth, including in the manufacturing and agricultural sectors. The vision would require domestic and regional policies to promote the expansion of an efficient regional service platform. But it would also require commensurate complementary actions by Europe and the GCC, the two main trade bloc with large potential for the region, that are adapted to the historical political window in which the region finds itself.

In other parts of the world, regional and global economic integration have been complementary affairs – regional integration supporting global integration, and vice-versa. An important reason for this is the neutralization of hub and spoke biases that reduce the attractiveness of FDI to the region, including from Europe and the GCC. The "flying geese" phenomenon in East Asia, where investment and trade originating first from Japan rolled down the peninsula over time to expand the "Asia Factory", is the quintessential example of this complementarity. Europe too became more competitive globally by expanding its own market and unleashing capital and labor movement, inter-industry trade, and the forces of innovation and competition.

There have also been dreams and visions of an integrated Middle East region in the past, but they have ended up in failure. The constitution of a large regional market in the future depends in large measure on the role of the GCC, whose economy has now become the more dynamic part of the regional economy. The GCC has a large market for goods and services for which the region possesses a cultural advantage. It has access to large amounts of public and private investable capital. And it is the place of residence of a large share of the region's skills. Policies can be devised along all these dimensions that foster economic dynamism in the MENA countries. This should in time include policies that make it more attractive for production for the GCC market to take place in the developing MENA countries rather than in the GCC, which would require lower subsidies to energy, capital, and labor in the GCC countries themselves.

The Euro-Med initiative, started in 1995, was meant to connect the region to European markets but it has essentially failed to make a difference. These agreements were superseded by EU enlargement, which brought Eastern European countries that compete with MENA exports into the heart of Europe. These agreements need to be substantially improved. More balanced Euro-med agreements would be more similar to those signed with Eastern Europe – they would lower effective tariffs and NTBs further, support the MENA countries in meeting quality standards, propose deeper rules that need to be adhered to (eg anti-monopoly, public procurement), and most important, implement pro-active policies to upgrade skills in the MENA countries. The main goal should be to encourage FDI originating in the EU to move beyond the search for low-pay jobs and towards more sophisticated activities, and especially those that can serve the larger Arab market.

The rest of the chapter explores the possibility that a new perspective on MENA's regional and global integration can lead to better economic growth. It analyzes recent developments along each of the dimensions of trade in labor, goods and services, and capital, highlighting the inter-linkages across these dimensions and proposing in each case innovative solutions that together, can form a new architecture of relations with the global economy that would be more promising for MENA's development.

3.2 Labor migration

In retrospect, labor migration has transformed the political economy of the region further, at least so far, than trade in goods or capital flows. Broadly speaking, there were somewhere close to 20 million Arabs working outside their country of origin around 2010 (ESCWA 2013). About half of them worked in Arab countries around 2010, mostly in the GCC. The number of economic migrants in GCC states in 2010 has been estimated at about 12 million (compared to about 4 million national workers). While workers in the Gulf were predominantly from Arab countries in the 1970s, the share of Arabs has fallen to less than 50% currently. Lebanon and Jordan, and a few years ago Libya and Iraq, have also been destination countries. A whole range of skills are utilized, but, in general, unskilled work and domestic service in the Gulf today is largely performed by Asians, while Arabs have increasingly moved into the semi-skilled and skilled tasks. The interaction of people from different parts of the region in the Gulf has shaped a renewed sense of a regional culture and fostered its dynamism, including with the spread of satellite TV.

Equally, the large influx of Maghrebis in Europe also had profound effects on society in the Maghreb. Migrants who arrived to Europe before the 1990s were less-educated migrants seeking economic opportunities, while the more-recent migration waves included a larger share of more educated migrants motivated by more personal and strategic reasons.

International migration to Europe and the GCC creates opportunities for larger remittances, but it can rob countries of their best skills. Brain drain has been exceedingly costly for the region, as their expatriation rates for qualified workforce are abnormally high compared to other countries with similar per capita income (Docquier and Rapoport, 2012).[2] The main flows associated with migration of highly skilled workers come from countries of North Africa, specifically Algeria, Morocco and Tunisia to France and Belgium and more recently to Spain and Italy, but also of Jordanians and Lebanese

[2] For example, 45% of Arab students who study abroad do not return to their home countries, 34% of skilled doctors in Britain are Arabs, and the Arab world has contributed 31% of the skilled migration from developing states to the West, including 50% of doctors, 23% of engineers, and 15% of scientists (Zahlan, 2014).

to the EU and the GCC. In more recent times, there has been massive exit of skilled labor from Syria and Iraq. Highly qualified women are over-represented in international migration in general and from MENA countries in particular, because of the added cultural and social costs to migration, which can more easily be lowered through investment in education (Miotti et al 2012).

North America is increasingly attracting the most qualified. Migration to the US and Canada are recent and self-selected due to both high emigration costs and to immigration policies that favor qualified immigration. As a result, in recent years, there is a relative decrease in the number of migrants to Europe and an increase in migration towards the US (Mouhoud 2015). This notable change also reflects the excessively restrictive immigration policies in the EU. In France for example, migrants with a temporary status move in a Kafkaesque universe where foreigners need to constantly worry about the renewal of their status, with all the administrative overhead that this process entails, thereby placing them in a permanent state of stress and mistrust towards public authorities and negatively affecting their professional and social integration strategies. Furthermore, these migrants often experience a drop in status, at least at the beginning. Compared to the situation in the US, in the EU, the migrants tend to be unemployed at much higher rates than the natives. In Canada and the US, the first residence permit granted to migrants can be a springboard for quick access to citizenship, a natural step after a few years of residence. Among the potential emigration candidates, those who can meet the selection criteria in terms of skill and education levels prefer to emigrate to Canada and to the US, while those who rely on family networks to reduce their costs of emigration continue to go to Europe (Miottiet al 2012).

Remittances

Estimates of the magnitude of remittances are shown in Table 3.1. Remittances remain a crucial source of foreign exchange in the region. Indeed, remittances, estimated at some $13 billion in 2010 just from the GCC and perhaps up to $20 billion from all sources still dwarf both foreign direct investment and official development assistance for the region. For Yemen and Egypt the value of remittances exceeded that of any commodity exports. Remittances often paid for a substantial fraction of imports, especially in Egypt, Jordan, Morocco, and Yemen. Remittances to Tunisia, for example, represented 4.5% of GDP on average during 2003–12, and 7.5% in Morocco.[3] Official figures for remittances

[3] At particular moments in time, remittances played a crucial role. On the eve of the Gulf War of 1990–91, remittances to Egypt were the equivalent of 10% of that country's GDP, and in Yemen, remittances were at near one-third of GDP. Lebanese remaining in their country at the end of the civil war subsisted primarily on remittances, which were the equivalent of two-thirds of Lebanon's GDP.

Table 3.1 Workers' remittances (% of GDP)

Countries	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Labor Abundant Resource Rich	4.34	3.14	7.99	5.54	2.91
Algeria	4.34	2.07	0.72	2.33	0.92
Iran, Islamic Rep.				1.09	0.54
Iraq					0.61
Sudan		1.59	1.96	3.00	4.88
Syrian Arab Republic		5.77	2.78	2.52	2.45
Yemen, Rep.			26.50	18.78	8.05
Labor Abundant Resource Poor		8.63	9.96	11.62	13.65
Egypt, Arab Rep.		10.56	9.89	6.99	4.53
Jordan		14.71	18.75	19.76	19.21
Lebanon					21.88
Morocco		5.72	6.94	6.14	7.71
Tunisia		3.54	4.27	3.57	4.47
West Bank and Gaza				21.62	24.10
Israel	1.34	1.55	1.39	1.04	0.34
Turkey		2.42	2.63	1.90	0.38
Overall MENA	2.84	4.88	6.94	6.36	5.90

Source: World Bank Indicators

represent only the tip of the iceberg. Much money enters labor-exporting countries through unofficial channels.[4]

A number of factors may reverse this trend (Docquier and Rapoport 2012). One reason is the changing composition of the migrant stock. In Algeria, the new migration of the 1990s and 2000s includes young men and women called "Harragas"[5], who are characterized by weak attachments to their country of origin and who declare a lack of desire to return (Mouhoud 2015). Using individual data from a specific survey conducted in France, Miotti et al (2012) have shown that transfers were lower for migrants from the Maghreb and Turkey than for those from sub-Saharan Africa, which suggests particular links between the need to remit and the incentive to emigrate. Migrants from North Africa who arrived before the 1990s were more likely to remit than are those who arrived more recently. The earlier less-educated migrants had stronger ties to their home country, which accounts, after controlling

[4] According to some estimates, informal remittances received in Algeria for example are two to three times higher than official remittances received, because the conversion of remittances at the black market exchange rate increases their purchasing power by up to 50% (Charmes 2010).

[5] The word in Maghreban Arabic could be translated by "who burn" referring to identify papers.

for a number of other explanatory variables, for their greater tendency to remit compared to more-recently arrived migrants whose emigration was linked to aversion towards the home country and/or insecurity-related factors (Mouhoud and Odinet 2010). There is a concern in the Maghreb countries about the risk of a reduction in transfer income in the future (Margolis et al 2015).

In recent years, the movement of people has accelerated as a result of the political instability in the region, and especially in Syria, Iraq, Yemen, and Libya. Over 10 million Syrians have fled their homes since March 2011, with 3.7 million Syrian refugees in neighboring countries (Lebanon and Turkey have nearly 2 million refugees each, and Jordan nearly 1 million), and 6.5 million are internally displaced within Syria. Refugees present massive humanitarian, social, and economic challenges. The catastrophic rush across the Mediterranean of people from the region and from Africa, fueled by wars and poverty, is creating a human disaster, which has so far been remedied in Europe only through security tools, which is insufficient to deal with the unfolding human drama of sunk boats and shattered lives.[6]

Policy challenges

Most migrants do keep a contact with the home country: the large majority comes back at least temporarily for major holidays and for important family events such as weddings; others come back seeking investment opportunities, or opportunities to use their specialized skills for the national interest; and the vast majority of migrants to the GCC want to return home. Beyond important humanitarian concerns, how to better take advantage of diasporas in the West and in the GCC to improve development prospects must be at the centers of regional concerns. These diasporas can be tapped for finance, entrepreneurship, and technical skills. Such an initiative would help speed up the region technological catch-up along three possible tracks.

A first track would be to encourage improved interaction of highly skilled migrants with their home countries. Involving them in specialized functions in their countries of origin, such as in academia, research and innovation, or the financial sector would yield valuable gains. This would not be aimed at a definite return, but rather, at creating a framework of incentives that can tap into their emotional attachment to the home country. There are successful

[6] It must be noted also that as part of their Euro-med agreements, the Maghreb countries had agreed to play a role in the repressive European anti- immigration policy against would-be-migrants from their countries and of those from sub-Saharan Africa transiting through their territories, such as agreeing to re-admit their nationals expelled from Europe.

examples of many countries in Latin America and Asia, which have implemented strategies to tap into the global stock of expatriate skills for their highly specialized development needs.[7]

A second track would aim at promoting the free movement of students and qualified staff within the MENA region. Such a process is already at work in the GCC countries where monetary incentives and better conditions act like pull factors towards the GCC, while geographical and cultural proximity facilitates movement back and forth in a process of accumulation of skills and financial resources that continuously searches for new opportunities between the home and destination countries. This sort of rapid mobility of human capital creates forces for deep regional integration.

A third track can focus on actions that can be undertaken by the receiving (EU, USA, Canada, GCC) areas to encourage exchanges between diaspora communities and their native countries by promoting mobility of individuals. This does not mean completely opening borders to international migration, but ensuring that those who are legally resident have a stable and secure status. This pre-supposes that migrants could return to invest and work in their native countries without losing their entitlements and the right to come and go. Improved security would encourage migrants to take investment risks in both their host and native countries.

3.3 Trade in goods and services

The Arab region focused on producing for its own market in the 1960s and 1970s when it followed state-led, import-substitution growth strategies, and only shifted to private sector and export led growth later in the 1990s and 2000s. The transition has not been wholly successful however, principally because institutions and policies were not adequate to the task. As a result, the region as a whole has not seen its export revenues driving its economic growth, in spite of good endowments of labor (in the labor rich countries), capital (in the oil exporters), and energy, and its closeness to the large European and GCC markets. Global and regional conditions have also not been favorable, especially with the rise in competition from East Asia and from Central and Easter Europe connected to the rise of the WTO and EU enlargement, and the rise of a highly subsidized economy in the GCC.

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[7] Examples include programs such as Red Caldas de Colciencias (Colombia), Talven (Talentos para Venezuela), SANSA (South African Network of Skills Abroad), and Philippines Brain Gain Network. The case of China and India are also considered exemplary in their mobilization of skilled diasporas companies.

Performance in non-oil trade

The region now represents about 4% of the world economy (up from 3% in the 1990s). Its share of global exports of goods and services was about 5% in 2010. But over 80% of this is accounted by oil. The region's share of non-oil global exports of goods and services was only about 1.2%, up from 1% in the 1990s, which much of the improvement coming from service export, including tourism (World Bank 2013b). While these outcomes suggest that the region is not as poorly integrated in the global economy as it is sometimes suggested, it is also clear that it has not been able to take advantage of global markets to grow as East Asia has done.

Exports increased in most countries over time, but performance was unequal and overall modest at best. Petroleum exports still dominate trade, and indeed the economy of much of the region. Compared to East Asia, which exported 41.1% of its GDP during the 2000s, the developing countries in the sub-region do seem to compare too unfavorable, exporting 34.7% of its GDP in goods and services in the 2000s. There are however two reasons why for many countries, this is not a good performance. First, the share of manufacturing goods in total exports remains considerably smaller than in East Asia, with 22.7% GDP in manufactured exports, against 31.8 in East Asia. As important, most of the regional economies are small, and as such, they would be expected to trade more with the outside world. Taking into consideration population size, GDP per capita, and distance to market, Behar and Freund (2011) estimate that the oil importing countries of the region export about 30% less than their potential. By their measure, only Morocco, Tunisia, and Jordan over-perform. Indeed, these countries increased their manufacturing exports most in the last decade (Table 3.2). Others, and especially Egypt, did not however. Among the oil producers, a small share of exports is constituted by manufacturing goods. Nevertheless, one can note the remarkable success of Saudi Arabia's expansion of manufacturing export (and also Bahrain and the UAE), but also, that this was largely dependent on the enormous energy subsidies provided to the industrial sector.

A more detailed analysis of Arab countries' export performance reveals that the main constraint has not been to find new products to export. Indeed, the region seems no less capable than other regions at discovering new market niches where it may have comparative advantages (Chauffour 2011). Instead, and in contrast to East Asian exporters, the main constraint has been to expand the production of these market niches, or to exploit the "intensive margin". Even the more successful exporters such as Morocco and Tunisia have not been able to penetrate large shares of their export markets – for example, their share of the EU's garment sector could not rise above 3–4% of the market, and even went down under pressure from other more competitive exporters in recent years. As a result, exports from the region had been made up largely

Table 3.2 Export performance

	Exports of goods and services (% of GDP)			Manufactures exports (% of GDP)		
	1971–1990	1991–2000	2001–2010	1971–1990	1991–2000	2001–2010
Labor Poor	65.5	48.3	63.3	17.3	7.7	4.7
Resource Rich						
Bahrain	107.3	81.6	89.8	39.8	22.7	8.5
Kuwait	64.5	46.0	58.4	14.7	4.3	2.5
Libya	39.7	28.3	59.6		1.3	2.2
Oman	57.3	46.8	54.6	2.6	6.9	4.2
Qatar		51.4	59.8		7.3	4.6
Saudi Arabia	51.4	37.2	54.8	1.1	3.2	4.8
United Arab Emirates			65.8			2.2
Labor Abundant	18.7	22.0	31.9	1.4	1.0	2.5
Resource Rich						
Algeria	25.9	27.6	39.9	0.4	0.9	0.7
Iran, Islamic Rep.	21.5	20.5	28.7	0.8	1.6	2.6
Iraq						
Sudan	9.4	6.6	17.9	0.0	0.3	0.1
Syrian Arab Republic	18.2	30.5	36.7	3.1	3.1	7.3
Yemen, Rep.	12.2	24.6	36.0		0.1	0.5
Labor Abundant	27.6	28.4	33.3	9.7	18.8	22.7
Resource Poor						
Egypt, Arab Rep.	21.0	21.4	25.6	4.6	7.8	7.9
Jordan	39.9	49.2	50.0	16.4	25.4	35.6
Lebanon	18.2	12.2	20.1		9.8	13.9
Morocco	21.2	26.1	31.9	6.6	14.8	21.2
Tunisia	34.2	40.7	46.0	14.2	31.3	34.8
West Bank and Gaza		16.1	14.9			
Israel	38.3	31.3	38.5	30.8	28.1	32.8
Turkey	9.6	19.0	23.5	4.6	14.2	19.2
Overall MENA	34.7	32.5	42.6	10.0	10.2	10.8

Source: World Bank Indicators

of traditional products, with services making up most of the growth. The evidence, using various measures of the technological sophistication of products exported, suggests that the skills and knowledge content of Arab exports has only increased slowly and moderately since 1990 (Chauffour 2011). The great bulk of MENA country exports concentrate on low value-added products, such as textile and clothing, fuel products, basic chemicals, or agriculture. Low quality products account for about half of total manufacturing products exports, whereas high quality products generally do not exceed 25% of exports.

Although there has been a recent improvement in the technical contents of the products, progress towards upgrading has been slow (Peridy and Roux 2012). The countries of the MENA region did not manage to develop comparative advantages in the specialized high-technology sectors, and more generally, in products high up on the quality ladder that require specialized skills.

Trade in services

Access to efficient services – banking, insurance, telecom, transport, retailing services – is crucial for productivity and global competiveness. Services represent a large share of the value of industrial production – an average of 20%, and much more for the more sophisticated products that tend to be produced in global value chains that combine inputs from many destinations, and thus include large R&D and travel inputs. Services offer other advantages too. They can grow fast through technological catch-up, employ skilled youth and more women than in traditional sectors; and they offer a comparative advantage to Arab speakers given the need to conduct much of the work in Arabic.

As in the rest of the world, there has been a rapid rise in the export of services from the region, and most of it has gone into regional trade – the sector has doubled in size between 1990 and 2010, yet its share in global service trade has remained flat at 2.8%. Some countries of the region did however do better than this: today, 80% of Lebanon's and 40% of Jordan's exports are made of services, and the figure while lower, is also high at 20% for Egypt, Tunisia, and Morocco (World Bank 2013b).

There is large under-exploited potential in many of these areas. Services industries are notorious for depending heavily on effective regulatory regimes in order to balance their growth with their social value (anti-monopoly, banking supervision, telecom rules). However, regulatory agencies have considerable degrees of discretion, and services have been a core area for cronyism in the past (Malik and Awadallah 2013). Compared to other exporting region, MENA thus ranks relatively low in terms of the quality of its service trade restrictiveness index (World Bank 2013b). As a result, the development of a regional services platform, a crucial ingredient for a more dynamic regional investment and trade strategy, has been lacking.

Regional trade

Ideally, the MENA region could count on at least two complementary trade blocs to pull its growth through trade and investment – the GCC and Europe. In practice however, the role that Japan played in Asia, the US for Mexico, or Europe for the Eastern European countries after they moved away from communism has not been filled by these two entities to date. The constitution of a large Mediterranean market, going from Southern Europe to the GCC, would have been ideal to pull up growth, with the Mediterranean Sea acting as the

"Mare Nostra" – the sea that connects – a role steeped in the history of the region, from the Phoenician to the Venitian and Maghrebi traders (Braudel 1966).

Many countries of the region have not been able to export more within the region, despite the comparative advantage provided by culture and individual connections. There are several factors that underlie this relative failure, besides a general lack of competiveness. First, costs associated with administrative red tape and weaknesses in regional transport related infrastructure services are ranked as the most important constraints to intra-regional trade (Hoekman and Zarrouk 2009, Dennis 2006). Second, outside of production meant for the GCC market, countries from the region tend to produce similar products, and they consequently tend to experience more pressure from their domestic producers to impede regional trade (Galal and Hoekman 2003). Finally, the various conflicts between the countries of the region have not helped – for example, disputes between Morocco and Algeria over the Western Sahara have undermined the development of trade within the Maghreb region.

Using exports to the region as a share of total export as a measure of trade integration, MENA trade integration has not improved since the 1970s – from 6.0% of total exports in 1970 to 10.8% in 1990, and 5.2% in 2010. These fluctuations largely represent changes in the value of oil exports (while regional trade is mainly in non-oil goods and services). A more precise estimate of regional trade would thus exclude oil. In 2010, non-oil export of goods to the region was 18% of total non-oil exports of the region (ESCWA 2013). By way of comparison, 25% of Asean trade, 49% of NAFTA's trade, and 65% of European trade is within their region.

Is 18% too little or too much? After all, if trade destination was completely random, the region should only sell 4% of its exports within the region, since the region only represents 4% of the world economy. To evaluate performance, we need to keep in mind that overall trade in non-oil goods and services is small. Moreover, we need to factor into this calculation the drivers that normally foster regional trade. Studies that use a standard "gravity model" of international trade theory to ask whether inter-regional trade flows are lower than what could be expected given levels of GDP, geography, culture, and trade agreements yield ambiguous answers. While earlier studies were somewhat negative (Hoekman and Sekkat 2010), the more recent studies suggest that inter-regional trade is now larger than what standard gravity models would predict (Abedini and Peridy, 2008). Still much more progress could be made if goods and services could flow more easily within the region, and many have argue that the creation of an effective regional free-trade association (or custom union) could raise intraregional trade significantly, perhaps even doubling it (ESCWA 2013).

At only 4.3% of regional to total exports, the Maghreb countries had the lowest share of inter-regional trade as their economies are more turned towards

Europe.[8] The GCC is just a bit more trade-integrated – only 5% of its exports go to the region – but this represents 20% of its non-oil export revenues. Some countries of the Mashrek however, building on historical ties with neighboring countries and with the GCC (see Owen 1999 for a history), have expanded their regional exports significantly. On average 19.1% of Mashrek's exports went to the region in 2010 and regional markets represented more than 50% of the (small) exports of Syria and Yemen, 35–40% of the exports of Lebanon, Bahrain, and Oman, and 25% of the exports of Jordan and Egypt.

Unfavorable Euro-Med trade agreements

The most significant trade treaties are those negotiated with the World Trade Organization, the European Union,[9] and to a lesser extent, the US,[10] and within the region. Thirteen countries in MENA have joined the WTO; seven others are in various stages of application.[11] States in the region have all signed agreements to liberalize trade with the European Union. EU trade policy towards the MENA countries is covered under the general framework of the EU regional trade agreements (RTAs) as well as the EU free trade agreements (FTAs)[12]. The association agreements with the European Union are highly significant for Algeria, Morocco, and Tunisia, while the national project to join the European Union seems to be receding in importance in the political economy of Turkey.

There is a marked contrast between the ex-ante studies, which concluded as to the existence of significant potential gains of the Euro-Med agreements, and the ex-post analyses, which show small gains for the region. Peridy and Roux (2012) compared the results of 24 CGE models, which assess the effects of trade liberalization in the Euro-Med area. Almost all studies highlight important

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[8] According to recent estimates, the Maghreb countries are trading very much below than what their characteristics should allow (Bhattacharya and Wolde 2010).

[9] The Euro-Med association members are, as of 2014: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, and Tunisia.

[10] Various types of FTA signed by the US with Bahrain, Jordan, Israel, Lebanon, Morocco, Oman.

[11] Turkey is a charter member of the WTO. Other MENA members (and date of accession) are Bahrain (1995), Egypt (1995), Israel (1995) Jordan (2000), Kuwait (1995), Morocco (1995), Oman (2000), Qatar (1996), Saudi Arabia (2005), Tunisia (1995), the UAE (1995), and Yemen (2014). Countries in various stages of application are Algeria, Iran, Iraq, Lebanon, Libya, Sudan, Syria, and Yemen.

[12] The European Union's trade policy instruments consist of both bilateral cooperation (e.g. The European Neighborhood Policy (ENP), Association Agreements (AA), Partnership and Cooperation Agreements (PCAs)) and multilateral (e.g. Eastern Partnership (launched in Prague in May 2009), the Union for the Mediterranean (the Euro-Mediterranean Partnership, formerly known as the Barcelona Process, re-launched in Paris in July 2008), and the Black Sea Synergy (launched in Kiev in February 2008). For an overview of ENP policy, see Wesselink and Boschma (2012).

effects on GDP and trade growth in the region, with growth rates of more than 5% in most of the studies.[13] But the ex-post studies of the result of these agreements show very limited impact. While the measured impact is positive on the region's imports, it is insignificant or negative on its exports (Michalek 2007; Cieslik and Hagemejer 2009).

It is now clear that the Euro-Med agreements were not favorable to the MENA countries. Autocratic rulers in the region rushed to sign them as a way to foster their international legitimacy, more than to secure economic gains.[14] These agreements were made in a bilateral and non-cooperative fashion and they neither included agriculture nor trade in services. Instead, they were limited to manufactured goods for which countries of the region had few advantages.[15] The EU protection on agricultural products has remained high, considerably constraining EU market access to MENA products, so much so that the share of its agricultural exports to the EU is below the overall share of agriculture in MENA's total exports. In 2009, the EU received a third of MENA agricultural export, and these represent only 7% of the region's total exports. During 1995–2009, the MENA region had increased the relative share of manufacturing exports in its exports to the EU, but this was largely due to the performance of Turkey and Israel, who exported respectively 42% and 11% of the MENA region's exports to the EU. Within this, the rise of more sophisticated manufacturing remained limited (FEMISE, 2010). As a result, while MENA imports from the EU have increased rapidly since the Barcelona process was begun, exports from MENA to the EU have stagnated. The decline in net trade in manufactured goods, and the maintenance of barriers to the exporting of agricultural products, could only be compensated by tourism, remittances of migrants, and foreign direct investment, which ended up too low to make the difference.

The Euro-Med agreements were built on what seems like a workable vision of an "Arab Factory". Beyond the problems noted above, its failure can also be attributed to an acute hub-and-spoke problem (Puga and Venables 1997). The Euro-med agreements have done little to attract new investments in

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[13] Using the framework of the new trade theory (Helpman and Krugman 1989), and the new theory of regional integration (Pomfret 2003), these studies include traditional gains (factor reallocation an comparative advantages) and gains due to the non-tariff barriers liberalization and the evolution of terms of trade.

[14] In the case of the expansion agreements with the countries of Central Europe (Peco) the advantage was clearly in favor of Peco that held a number of barriers against EU countries while the latter undertook from the outset to fully open their borders to the former.

[15] The liberalization in the low-skills manufacturing sector in which the Mediterranean countries had comparative advantages was not complete until recently because of Voluntary Export Restrictions that remained in place until the middle of the 2000s.

manufacturing exports and to increase intra-regional MENA trade (Ülgen 2011). Decision-makers were aware of the hub-and-spoke problem when the EU-Med agreements were being negotiated, and efforts were deployed to avoid it by broadening the regional space. The agreements foresaw that the creation of a regional market would proceed at the same time as the region would open up to the EU market, in order to foster positive dynamics in the regional economy as a result of the association with Europe.[16] But among other difficulties (see next section), the challenge of negotiating separate agreements with the EU and each MENA nation in parallel turned out to be a huge logistical challenge.[17]

A fragmented Arab market

The main attempt at opening up a region-wide unified market is the 1997 agreement to establish the Greater Arab Free Trade Area (GAFTA), an effort that was initiated by the Arab League as early as 1953. GAFTA has by now been ratified by 18 countries. It focuses on gradually reducing tariffs between Arab countries. Studies have found that the effect of the agreement has so far remained modest, increasing regional trade by about 20% (Abedini and Peridy 2008). There are two main factors that have reduced the effectiveness of the agreement. First, it only concerns goods with a sufficiently large share of Arab origin – i.e. at least 40% of the value of the product needs to be produced by the exporting country to benefit from the lower protection afforded by the agreement. There are however very few goods, besides food or natural resources, that satisfy this requirement – for example, garments typically use imported textile, and the labor content tends to be only about 10% of the value of the final goods. Second, importing countries were allowed to develop a negative list of goods that would be excluded from free trade. Moreover, the negative list grew to be quite long, as local producers feared competition by similar producers in neighboring countries and lobbied for protection (World Bank 2013b).

[16] In addition, these agreements included in most countries support for industrial upgrading to help domestic firms improve their competitiveness and withstand competition by European firms.

[17] Still, many new regional FTAs were signed, but only to complicate further the "spaghetti bowl" of overlapping trade agreements in effect in the region. One important impediment to regional trade was, here too, the "rules of origin" issue. Each (small) country cannot produce alone a large share of the value of exported products. Yet, effective "cumulation" of right of origin is not allowed. Only the "deeper" integration Agadir Agreement, signed between Egypt, Jordan, Morocco, and Tunisia (implemented in 2007), has started to allow these countries to "cumulate" rights of origin. It is too early to tell if this new agreement will manage to advance the cause of intra-regional trade more than its predecessors (Cieślik and Hagemejer 2009). It should be noted that the US rules for FTAs don't allow cumulation and this has hampered US-MENA trade like it had hampered the Euro-Med FTA agreements.

Negotiations on free trade in services was initiated in 2003, but has not been completed, owing to differences in interest again. More recently, a decision was taken to establish an Arab custom union by 2020.[18,19]

The most important constraint to regional integration has increasingly shifted towards the unfair competition by GCC producers for the Arab market. The extraordinary rise of the GCC in recent decades meant that by 2010 its GDP was about equal to that of the rest of the Arab world. Unlike the poorer MENA countries, the GCC has managed to grow its private sector immensely in the last two decades, in areas such as real estate and services, but also in tourism, manufacturing, and energy intensive industries. Manufacturing activities have expanded rapidly and so have exports. In 2011, manufacturing as a share of non-oil GDP stood at 22% in Saudi Arabia and Qatar, 19% in Bahrain, and 13% in UAE, in all cases well above these ratios in the 1990s.[20] While most exports are dominated by oil and gas (which accounts for over 90% of exports in Saudi Arabia, Qatar, and Kuwait, and 75% in Bahrain and Oman), non-oil exports have been growing too. While 50 to 60% of non-oil exports are constituted by petrochemicals and high-energy products, other exports include agro industries, base metals, electrical machinery, and services, especially transport and tourism.

But this performance is unsustainable, and it has been boosted artificially by enormous subsidies for home production. Energy subsidies are huge: in 2011, they stood at $44 billion in Saudi Arabia, $8 billion in Kuwait, $18 billion in the UAE, and $4 billion in Qatar (Espinoza et al 2013).[21] In addition, about 20% of the budgets of Qatar, Bahrain, and Kuwait are now spent subsidizing businesses in other ways. Equally, the GCC region is unique in the world for the scope of its labor import. It is ranked third (after the US and the EU) as an immigration region in 2010. Around 2010, it was estimated that there were about 12 million migrant workers in the GCC, constituting 80% of its

[18] But given that many Arab countries have their own FTA with non-Arab countries, this project will have difficulty progressing. Establishing a custom union between the Arab countries would require that either all FTAs with non-Arab countries be abolished, or that all Arab countries join in the same FTAs.

[19] The GCC countries have already moved to a customs union (meaning they have free trade among themselves and similar tariffs to the rest of the world), with a possible monetary union on the horizon. But the level of the GCC intra-trade has not changed significantly over the recent years and had probably reached its full potential during the first decade of the GCC creation (Boughanmi 2008), with little change in production structure directly connected with the agreement, except possibly for the United Arab Emirates (Insel and Mahmut 2011).

[20] Saudi Arabia is today the largest exporter of industrial products in the region: $20 billion compared to Egypt's $5 billion.

[21] These amounts represent the quantity sold to the private sector, times the difference between international price, and the price energy was sold at to local producers.

workforce (ranging from 62% in Saudi Arabia to over 90% in UAE and Qatar) and about 35% of its population. This dependence had grown over time, and the source of the demand is now much more from the private sector than from governments: the private sector is a sector for expatriates who constitute over 90% of its labor force.

In effect, the GCC is the only region of the word where wages in its private sector are set by a global labor market, ensuring that it gets the cheapest wage for every level of skill in the world. But equally, there is no other region in the world where national labor accepts such competition by foreign labor – normally, labor may feel, and rightly so, to be entitled to benefit from oil booms. This policy benefits mainly rich private entrepreneurs, and is accepted by national labor only because (and as long as) they get their share of the pie in the form of state patronage, free social services, cheap energy and water, subsidized housing, and importantly, by being massively hired by their governments at very high wages.[22] This quid-pro-quo – open labor imports to satisfy the private sector against generous patronage to satisfy naional labor – is at the heart of the social contract in the Gulf between the rulers, the private sector, and the national middle class engaged in the labor market. Private sector development has mostly benefitted entrepreneurs, who have become richer, but it has so far not affected positively the GCC middle class.

This growth model is clearly unsustainable, in addition to it indirectly harming the private sector in the rest of the region where production for the GCC market, or at least for its culture specific goods, could be undertaken on a more efficient and sustainable manner. The sustainability problem of the Gulf States is not (yet) how to live in a world without oil, but rather, how to employ effectively a fast growing national labor force. The current strategy of public sector employment will reach its limits sooner or later, given the high rate of growth of its national labor force, now at about 4%. Already 40 to 60% of state budgets are going into wages and social programs. At the same time, the current rates of national employment in the private sector in the various GCC countries range are miniscule, ranging from 1% to 4% (in Qatar Kuwait, and the UAE), to about 10 to 15% (in Saudi Arabia, Bahrain, and Oman). In effect, unless the gap between private and public compensation narrows dramatically, nationals are simply not employable in the private sector. Reversing this situation entails reducing labor migration as well as subsidies to the private sector, and accepting to live with a smaller and more efficient private sector, supplemented by more efficient and smaller transfers per capita to the population.

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[22] Most Gulf state nationals not only work for the state, but the wages they earn tend to be multiples of what is offered in the unregulated private sector labor market: 2 to 4 times in Saudi Arabia (4 for lowest skills), and about 2 times in Bahrain for example (Espinoza et al 2013).

The political problem with this transition is that it pits the interests of labor (the rising middle class) and those of the elite in the private sector, which explains why the policies to constrain foreign labor migration, which have been implemented since the early 2000s, have been unsuccessful. The political dilemma is all the more important given the rising income and education levels of the population, which makes it more demanding of freedoms and autonomy. As such, such a transformation will in the best of cases be slow and gradual, although it is bound to happen.

In recent years, the GCC regimes have reacted to the Arab Spring with a dramatic rise in patronage commitments and a reversal of economic reforms.[23] They have also become the main international financiers of the transition countries, and especially of Egypt (see further below).

The effect of domestic policies

Trade policy has been an active area for reforms, in both its regional and global aspects, but there remains however a lot of unfinished business, much of it related to the agenda of "behind-the-border" trade facilitation. Investment risk and cronyism have continued to tax the economies of the region up to the present. As a result, domestic jobs were lost in the face of increased foreign competition, the supposed gains from trade liberalization tended to have difficulty materializing (except in the more attractive GCC market). For example, after they entered the WTO, the influx of cheap Asian textiles in Tunisia and Egypt hurt domestic manufacturers (in both cases public sector enterprises), who lost out to Asian manufacturers in local markets and could not compete in the global market (Henry and Springborg 2010, 48). The high tax and regulatory barriers affecting the trade of services, such as in the heavily regulated airline, transportation, and communication industries impeded competiveness in both countries. Still, Tunisia's supply response was more dynamic than Egypt's as many firms, especially those in the off-shore sector, took advantage of new market opportunities abroad to expand production in new sectors such as electrical goods and food processing. Overall, some studies have calculated that trade liberation resulted in small net gain of jobs in Tunisia, while Egypt, which was more "structurally impeded" from expanding new exports, ended up losing jobs on a net basis (Konan and Kim 2004).

In spite of trade agreements, the region remains more protected than other regions, especially in services, which taxes its competitiveness. While tariffs were

[23] In Saudi Arabia, the cost of the package announced in February and March 2011 to mollify popular grievances – which included public employment, housing, and welfare measures – was costed at $130 billion. In 2012, nearly 300,000 young Saudis were hired in the public sector – as much as during the previous decade. Similarly, public sector salaries were raised by 70% in the UAE.

reduced everywhere, over time, other type of impediments, Non-Tariff-Measures (NTBs), rose in parallel. Examples range from slow clearance and inspection processes, to complex signatures needed to process trade, to license or registration requirements for importers, packaging requirements, regulations on production or distribution processes, traceability, sanitary restrictions, and product-quality requirements. Such regulations can be useful when their goal is to protect the national interest, but they can also be pushed by local producers to defend their interests, as often happens in Europe, for example in the case of agricultural imports. The recent studies of cronyism in Tunisia (Rijkers et al 2014) and Egypt (Diwan et al 2014) show that restrictions were driven by lobbying activities of politically connected large firms, trying to defend their domestic market interests in the face of rising global competition. For example, tariff rates were reduced in Egypt by the end of the 1990s (from an average tariff rate of 16.5% in 1995 to 8.7% in 2009) but Egypt responded by increasing the use of non-tariff technical import barriers. By 2009, there were 53 different types of regulations that could be construed as instruments of protection. Of the NTBs in place in Egypt in 2009, almost half (24) were introduced or amended around 2000. Diwan et al (2014) find that the politically connected firms were much more likely to be in sectors protected by NTBs than other firms. In particular, they find that 82% of connected firms but only 27% of all firms sell products that are protected by at least two types of NTBs, while 71% of politically connected firms but only 4% of all firms are in sectors that have at least three types of NTBs.

New perspective on global integration

Past choices to promote outsourced assembly activities in sectors that are intensive in labor (textile, leather, clothing, electrical equipment, toys) were failures. They did not encourage a move up the chain towards industrial segments with more added value, and the incentives to increase the level of training and qualification remained low. In recent years however, imitating the last generation of products has become more difficult because of the widespread use of intellectual property rights, and thus for high technology products, barriers to entry have become extremely high. As a result, new strategies are needed to improve the technological content of MENA exports.

At the end, the main question confronting the region remains that of the way in which it would participate in the emerging global distribution of labor. So far, a private sector that lacks dynamism and poor regional arrangements have prevented it from becoming the "big factory" that it could have become. The countries of the MENA region should take advantage of recent transformations in global production to achieve a better integration into global value chains, as well as increase its export to GCC markets.

The rise in transport costs and rising labor costs in emerging countries have led to a reconfiguration of the location of the different segments of the

productive process on a regional basis, particularly in Europe. Global production is expanding not only in industry but also in services via global value chains (GVC) with countries and firms specializing in certain segments or activities rather than in whole sectors. While it has been increasingly harder to decentralize industrial activities out of industrial countries due to the acceleration of production automation and the higher transportation costs, which affect the bulkier industrial goods, in contrast the service sectors has become easier to outsource. Indeed, there is close to zero outsourcing cost in the provision of intangible services given the widespread use of new information and communication technologies (ICT). In high-income countries, manufacturing production actually has a significant share of its added value coming from services and the competitiveness of industrial production of formerly industrialized countries depends increasingly on the competitiveness of their business service sector. In Interacting with GVCs, firms have developed global innovation networks that organize their R&D activities, and services have become key elements of an efficient GCV strategy. The countries that manage to specialize in these segments will experience faster catching up.

New strategies need to take account of these recent global developments. An opportunity exists for the MENA countries to participate in this regional reconfiguration, principally by attracting FDI and outsourcing operations in business service activities both upstream (fundamental research and development, consulting, design) and downstream (logistics, brands, personalization, publicity). Services can create jobs for qualified personnel, and catch-up with industrialized countries is possible given the relatively low fixed investment costs needed in intangible activities. Moreover, services influence the capacity of adaptation and innovation of industrial and tertiary/service firms. Indeed, recent studies show that the preferred environment for innovation is now in services, albeit still in response to demand coming from industry (Gallouj and Djellal 2010). Innovations in many other sectors, such as health and education, the environment, tourism, and the financial sector also find their origins in services. But while service activities can promote technological catch-up and a more extensive employment of graduates, not all service activities are equal in this respect. It is thus important to figure out which activities are most conducive to the development of an economy of knowledge and the extensive use of graduates. Priorities are likely to include services related to knowledge and intangible investments such as basic research and development, higher education, consulting, and marketing, followed by intermediation services (logistics, postal sorting, railways triage center, and transport). Collective services with high economies of scale, public or private (health, hospital, legal services) are geographically anchored activities and they are complementary to specializations in other sectors (Gaugris and Mouhoud 2013).

3.4 Capital movement

FDI inflows can supplement domestic investment by bringing in much needed finance to the struggling private sector of the region. But more important, it has the potential to expand the manufacturing sector, which can be a major source of new jobs, by bringing in much needed transfer of technology and management know-how to boost productivity and allow countries to catch up with the technology frontier. Foreign manufacturing MNCs tend to have better access to external markets than domestic firms, and so, by developing linkages with domestic firms as producers of intermediary products and services, they can create spillover benefits to the whole economy, beyond their sector of activity.

As discussed above, an important impediment for a good performance of the Euro-Med agreements is the fragmentation of the regional market. Indeed, one important goal of regional trade integration is to increase the region's attractiveness to global FDI – foreign companies moving their production to the region in order to lower their costs of serving regional as well as neighboring markets more effectively. Indeed, the vision of an Arab factory, that would grow initially by selling to the large Arab market, before expanding over time to integrate globally into profitable global supply chains, relies centrally on the development of a large internal market (Chauffour 2011, ESCWA 2013). In a fragmented regional market, the development of free trade with Europe or the US can actually *hurt* the cause of the regional market further by encouraging investment (and especially FDI) to move out of the region and locate instead in the EU (or Eastern Europe), or in the US, the so-called *hub-and-spoke* problem. Indeed, it is now accepted that FDI can boost growth only under favorable circumstances. Not only is a minimum level of capital stock necessary to benefit from FDI spillover effects, but in addition, the market for the output must be large enough to justify the type of FDI that can upgrade the receiving country's skill level. Bouoiyour et al. (2009) have looked at the relation between FDI, human capital, and productivity in 63 developing countries over the period 1960–2004. While in general, FDI was found to improve growth globally, in the MENA region, FDI had no impact on productivity and had little spillover effects. Instead, FDI has tended to build islands of quality that increase growth directly but with little indirect effects on the rest of the economy.

FDI flows to developing countries rose substantially in the 2000s, more than quadrupling relative to their level during the 1990s. By 2012, FDI flows to developing countries were as large as those going to rich countries (at about $800 billion), a historical premiere, which was connected to rising commodity prices, increased global liquidity, and excess production capacity in much of the developed world. This wave of rising FDI flows did not bypass the Middle East. Starting from a relatively low base in the 1990s, they rose dramatically in

many parts of the region. From less than 0.5% of total FDI flows in the 1990s, flows to the region rose to nearly 6% of total flows by 2010. Given that Arab economies oscillate between 3 and 4% of global GDP, this seems then to be a solid performance, the region getting "more than its share" of global FDI. In some countries, FDI supplemented domestic private investment in important ways, especially in the smaller economies of Lebanon, Jordan, and Bahrain. Indeed, they became in many countries a major source of foreign exchange competing with remittances and exports.

During 2001–10, most of the FDI flows went to the GCC, and especially to Saudi Arabia and the UAE, which received more than 20% of total FDI flows to the region each. This is in contrast to the earlier period where most of the funds went to the non-oil producing MENA countries, and it can be explained by the rising oil prices, which made oil exploration more attractive. The GCC received on average about 3.4% of its GDP in FDI flows. The non-oil countries received about 30% of total FDI flowing to the region, constituting on average 4.9% their GDP. Flows were especially large in Lebanon and Jordan (12% and 10.1% GDP respectively), followed by Tunisia and Palestine (5%), and then Egypt (4%) and Morocco (about 2.5% GDP). Finally, the third category of medium oil countries started the decade with low flows but by the end of the decade, these rose. For the decade as a whole, they received on average, 1.5% of GDP annually. This went predominantly to Algeria, Iraq, and Syria, and to the natural resource sectors.

FDI global flows collapsed during the global financial crisis of 2008, but they quickly recovered by the early 2010s. However, they continued to retreat in the MENA region, with the most marked retreat in the developing countries of the region, many of which were most affected by political instability after the uprisings of 2011. Using a unique data-set for new greenfield investment from the FDI Markets database, several important characteristics of these investments can be noted – see Table 3.3.[24]

First, FDI inflows were concentrated in non-tradables (mostly real estate) and mining, each receiving about one third of total FDI. Services (mainly transport and tourism) received a bit less – so registering a solid performance, but manufacturing got much less (16% of total FDI). In the GCC, real estate, mining, and manufacturing attracted about one fourth of FDI each. In the poorer oil exporting countries, more than half of FDI moved into mining, and the rest mainly into real estate. In the LARP countries, non-tradables and services received about a third of the inflows each, but manufacturing only got 13%. In many Arab capitals, from Cairo to Beirut, Amman, and Casablanca, GCC companies now dominate the high-end real estate market.

[24] The data are from the World Bank and it is collected on the basis of formal announcements. The data cover FDI in 17 Arab countries between January 2003 and December 2012. Overall, this represents 7,426 projects by over 4,500 multinationals corporations.

Table 3.3 FDI into the Arab countries, 1991 to 2012, share of GDP

Into	1991–2000	2001–10	2011–12
LPRR	0.3	3.4	2.9
LARP	1.8	4.9	2.1
LARR	0.2	1.5	1.0

Source: UNTAD data, aggregated from data presented in World Bank 2013. See Chapter 2 for a definition of the three country groups.

Second, the largest share of these investments, more than 50%, came from MNCs from the rich West (first panel of the table). MNCs tend to have high research and development capacity and could have done much to support the development of manufacturing in MENA countries. However, more than 60% of their investments went into oil and non-tradables – such as real estate and construction (third panel).

Third, the rest of Western FDI went into labor-intensive sectors seeking low wage labor to re-export to the MNC local market. Thus, there was a large missed opportunity here to grow the type of sectors than can create a large number of skilled jobs. Indeed, the majority of investment was of the vertical type with very weak spillover effects instead of dynamic horizontal FDI of the *market* seeking type, motivated by access to markets and decentralization. Horizontal FDI tends to lock in receiving countries into specialization in low value-added activities, compared to horizontal FDI that creates new comparative advantage in upscale activities with higher level of technological sophistication. The hub-and-spoke problem has thus been fully operational here.

Fourth, GCC investment was large and more than a third of it was directed at the poorer non-oil countries. The share of FDI provided by the GCC was 60% in Egypt, 70% in Tunisia and Jordan, and 50% in Libya. Indeed, in these countries, this was the largest source of FDI. But here too, the main sectors of investment did not include manufacturing – instead, real estate and tourism projects, and investments in services, came first (Hertog 2008, Baaboub 2009).[25]

Fifth, because of their concentration in mining and construction, FDI inflows have not generated many jobs – close to a trillion dollars of investment generated "only" about 1 million jobs – implying that it took nearly $1 million to generate one job! The smaller FDI in manufacturing (16% of total FDI), by way of contrast, created 55% of total jobs. The sectors that benefited include food-processing, consumer products, textile industries, and petro-chemicals. The countries that gained most of the jobs were Saudi Arabia and the UAE, countries that rely largely on migrant workers. Among the investors, Arab investment was highest in terms of its labor intensity (as a larger part went into construction activity).

[25] The GCC countries were not just a major investor, but also the largest destination of FDI to the region, principally by western MNCs seeking to develop oil reserves.

Table 3.4 Characteristics of FDI in MENA: cumulative FDI, 2003–12. In US$ billion.

	1. FDI, from:				Jobs created (1000s jobs)
FDI to:	DCs	Arab	LDCs	Total	
LPRR	293	89	64	446	
LARP	100	128	12	240	
LARR	109	99	41	249	
Total	502	316	117	937	
	2. Sector destination of FDI				
FDI to:	Oil	Manufacturing	Services	Non-tradables	
LPRR	137	87	115	106	582
LARP	50	31	74	88	482
LARR	97	35	52	66	278
	3. Sector destination of FDI				
FDI from:	Oil	Manufacturing	Services	Non-tradables	
DCs	200	90	102	109	716
Mena	23	29	125	139	452
LDCs	59	33	13	12	136
Total	283	153	241	260	1340
% of total FDI in sector	30%	16%	26%	28%	
% of total jobs created	7%	55%	19%	19%	

Source: computed from data in WB 2013. DCs stands for developed countries, LDCs for less developed countries. LPRR, LARP, LARR as defined in chapter 2.

The FDI recent surge is surprising given the high degree of political instability, and of cronyism and corruption, which have characterized the region and impeded the growth of its private sector. What then explains the high level of (pre-2011) FDI to the region? There are two types of explanations. First, GCC investors seem to be "over-investing" in the region, from a profitability and diversification perspective. This suggests that their cultural affinity gives them special incentives to work in the region, and that they are for example perhaps less affected by corruption or political instability as their inside knowledge allows them to navigate the regional waters better than western MNCs (Sekkat 2012, World Bank 2013a). A second finding is that political instability and corruption affect mainly investment in the manufacturing sector. However, political instability or high levels of corruption do not affect investment levels in the oil sector, which tends to operate as an enclave. In effect, MNCs in manufacturing have a choice of location and tend to select sites with stability and high levels of skills, while those in oil tend to have less choice (Burger et al 2013). As a consequence the region receives more vertical FDI than horizontal FDI (Bouoiyour et al 2009).

In addition to greater investment by and greater market access to the GCC, the promotion of market expanding FDI requires public action by the EU to prevent the current system of race-to-the-bottom that characterizes contracts between MNCs and regional sub-contractors. The form taken by the types of contracts offered by European companies to businesses in the Maghreb countries involves short-term profit maximization, and thus, specifications that are unfavorable to the South, as they encourage competitive bidding by subcontractors that do not internalize growth prospects brought about by investments in skill and quality upgrading.[26]

Other capital flows

Outside of FDI, the region continued to receive more than its fair share of external official assistance – GCC, EU, and US bilateral aid, and IFIs' regional and multilateral support, but these flows became more concentrated over time (see Table 3.5). Countries undergoing post-war reconstruction received the largest share – during the 2000s, official assistance went mainly to Palestine (30.2% of its GDP a year on average during the decade), Iraq (16% of GDP per year), and to a lesser extent to Sudan (4% of GDP per year, mostly to South Sudan). Among the other countries of the region, and until the Uprisings of 2011, levels remained relatively large only in Jordan at 5.5% GDP per year during the 2000s – a level largely below what the county received in the 1970s (22.7% of GDP a year) and the 1980s (13.4% GDP). ODA has remained low and flat in Morocco, Tunisia, and Lebanon (at between 1 and 2% of GDP per year) in the last decade. And it went down dramatically in Syria – it stood at 0.6% GDP in the 2000s, compared to 9.9% in 1970s and 4.9% in 1980s), and in Yemen (1.5% in recent years, down from 6.9% in the 1980s). So on the eve of the uprisings of 2011, MENA was largely getting weeded out of official assistance, after being the most assisted region historically (Malik and Awadallah 2013), a reflection of the fall in strategic rents in the region between the second Gulf war and the 2011 uprisings.

The region did not take advantage of the huge expansion of the international credit markets, which took off in the 1990s and 2000s, until the global crisis in 2008 put a stop to that expansion. While Lebanon continued with heavy borrowings (which has resulted in one of the largest external debt ratios in the world), most other countries now have comfortably low external debts, after the large deleveraging of the 1990s. All countries have external debt to GDP ratios below the 50% dangerous limit, with only Tunisia in addition to Lebanon approaching the red-zone. Jordan and Tunisia continued to retain

[26] Such practices are damaging both for the subcontractor countries and for the outsourcing countries in the long run, and need to be corrected by policies that set standards in ways that promote industrial upgrading.

a small access, borrowing moderately about 2–3% of GDP per year (on a net basis) during the 2000s – for Jordan this was a very large change compared to its heavy borrowings in the past (6% of GDP per year in the 1990s). Egypt and Morocco too did not borrow any substantial amounts, and relied instead on domestic debt to finance government deficits.

The major oil-exporting countries increased their support to oil-importing countries after the first oil shock of 1973 —direct, bilateral, and contributions to regional and multilateral agencies all rose.[27] Moreover, a notable attempt to use capital as an instrument of economic integration has been the region's various development funds.[28] More recently, the surge in oil prices during the 2000s have transformed the countries of the GCC into major players on the world financial stage, with the rapid growth of Sovereign Funds invested in OECD financial markets (De Boer et al 2008). The recent slump in oil prices will reduce these reserves, but they remain very large. As the economies of countries that experienced political upheaval after 2011 weakened, GCC countries (except Bahrain) have mobilized to provide financing. Egypt, Jordan, Morocco, Tunisia, and Yemen have been so far the principal beneficiaries of this increased support. Given the reduced access of these countries to capital markets, and the relatively low level of support from the West under the umbrella of the Deauville agreements, such support has allowed transition countries to continue providing economic stimulus longer than they could have otherwise. By the end of 2014, total pledges by GCC countries amounted to about $100 billion, mainly in the form of soft loans and commodity aid. Much of the financing is for budget and balance of payment support. A large share of these pledges is for Egypt, followed by Jordan, Morocco, and Lebanon, and Saudi Arabia accounts for more than half of the pledges. It remains to be seen if these massive investments will end up financing consumption and delaying reforms, or at the opposite end, encourage reforms and investing in a better future.

3.5 Conclusions: new perspectives for integrating MENA countries in the global economy

The low diversification of the MENA countries is partly explained by the lack of commitment to building a truly regional market, including through active policy by the GCC, despite the implementation of the free trade agreement between

[27] Saudi largesse continued even during the long period of low oil prices. In 2003, the Saudis gave away about 1% of their GNI compared with a rich country average of only 0.25%.

[28] Among these funds, the Arab Fund has had the most self-consciously political agenda, focusing on expanding regional infrastructure in ways that enhance regional cooperation.

Table 3.5 International capital flows

Countries	Net flows on external debt (% of GDP)					Grants, including technical cooperation (% of GDP)				
	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Labor Abundant Resource Rich	0.0	3.8	3.3	0.7	–0.1	0.7	2.7	2.9	1.5	3.7
Algeria	0.0	8.0	0.8	–0.2	–2.5	2.0	0.8	0.2	0.4	0.3
Iran, Islamic Rep.	0.0	0.0	0.0	–0.3	0.7	0.1	0.1	0.1	0.2	0.1
Iraq	0.0	0.0	0.0	0.0	3.1	0.3	0.1	0.1	1.0	16.0
Sudan	0.0	7.2	3.4	0.7	0.7	0.4	2.5	5.1	3.1	4.0
Syrian Arab Republic	0.0	3.6	8.8	2.7	–2.7	0.9	9.9	4.9	1.1	0.6
Yemen, Rep.	0.0		6.8	1.1	0.2			6.9	3.1	1.5
Labor Abundant Resource Poor	–0.1	7.0	7.2	2.9	2.2	4.9	8.1	5.4	4.9	6.8
Egypt, Arab Rep.	–0.1	9.7	5.9	–0.1	–0.3	2.2	6.3	4.1	4.1	1.2
Jordan	0.0	6.5	11.1	6.3	2.0	11.3	22.7	13.4	5.6	5.5
Lebanon	0.0		9.2	5.4	6.8			6.0	1.5	1.7
Morocco	0.0	7.0	6.1	0.2	0.0	1.3	1.3	1.8	1.7	1.2
Tunisia	–0.2	5.0	3.6	2.4	2.7	4.8	2.1	1.4	1.1	0.8
West Bank and Gaza									15.5	30.6
Israel						0.1	2.6	4.3	1.6	0.5
Turkey	–0.2	1.6	–0.4	0.0	1.8	0.3	0.1	0.3	0.3	0.1
MENA w/o LPRR	0.0	4.9	4.6	1.5	1.0	2.2	4.4	3.7	2.9	4.6

Source: World Bank Indicators.

Arab countries. We have pointed out the potential detrimental effects of such a vertical "hub-and-spoke" trade liberalization between the EU and the MENA countries if not completed by genuine horizontal trade liberalization within the region. A renewed drive towards regional integration between the developing countries in MENA should also be the basis for a reassessment of the association agreements with the EU in the framework of the European neighborhood policy.

The MENA countries should renegotiate with the EU the content of their free trade agreement on a multilateral and not on a bilateral basis. Indeed they must complete their tariff removal with regard to EU products. Besides Israel and Turkey, the other MENA countries still exhibit significant average tariffs which need to be reduced ideally through a multilateral negotiation against new and more favorable arrangements such as the free movement of skills, liberalization of trade in services and the inclusion of agriculture. The adoption of a more favorable system for rules of origin should also be a priority as a means of reducing trade costs between the EU and its partners. This should also include provisions for the participation of countries of the the MENA region in European research and innovation programs and tenders.

The regional opportunity is to meld the labor and capital present in the region in a successful partnership. Both capital (in the Gulf) and skilled labor (in the LA countries) are in excess supply in the region. The second oil boom has transformed the GCC into the main growth center of the region and a large market for the region's goods, services, and skills. While this will not lead to new growth in migration, there has been a steep rise in capital flows from the GCC into the labor-intensive countries, both in the form of direct investments, and aid to transition governments. It is imperative that these massive flows of funds be shifted in the future towards sectors that create good jobs in a more sustainable manner. The challenge then is to improve the effectiveness of the emerging partnership between Arab capital and labor. The countries of the Gulf have become in recent years the main financiers of the countries in transition. For the first time, the GCC and transition countries sit at a same table and discuss macro plans for the future. The current creditor-debtor relation should shift into a broader win-win opportunity for mutual gains. The GCC could encourage investment and trade, and thus help itself as a creditor, by opening wider its own market. Part of the bargain could include preferential treatment for regional FDI in the region, or partnerships with western MNCs to invest in more skill intensive sectors, or even granting special favors to regional exports in the GCC. The new geopolitical space opened up by the "crowding out" of Turkey, an economy of more than half of the size of the GCC, from the prospect of integration into the EU also presents opportunities.

At the end however, while the external environment can make it easier for the region to integrate into valuable global interactions, the political will to allow for the development of a more dynamic private sector will remain central.

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Part II
Inequality and Social Justice

4

Inequality of Opportunity in Human Development

Ragui Assaad and Caroline Krafft

4.1 Introduction

A strong concern with social justice has permeated the politics of the Middle East and North Africa (MENA) region in recent years and has undoubtedly served as a strong impetus for the tumultuous events that have come to be broadly known as "the Arab Spring" (Diwan, 2013; Richards et al., 2014; Verme et al., 2014). Yet by conventional measures of inequality, such as the Gini indices for household consumption, the MENA region does not stand out as particularly unequal (Bibi & Nabli, 2009; Hassine, 2015).[1] One reason that people in MENA may perceive existing levels of social injustice as unacceptable may have to do with the nature of inequality in the region, especially the perception that there is a lack of a "level playing field," in terms of the life chances and the opportunities individuals face. There appears to be a widespread perception that people's life chances are determined by factors outside of their control, such as social class, ethnicity, or where they live.

One issue that has received insufficient attention in the discussion of inequality and social justice in MENA is the role of human development, particularly children and young people's unequal chances for healthy growth and education. This chapter demonstrates that unequal opportunities begin very early in life, in terms of unequal human development, driven in part by unequal access to basic services that determine investments in human capital, including health and education. To show the unequal chances that begin so early, this chapter synthesizes the evidence on inequality of opportunity in human development in MENA, with a particular focus on education, health, and nutrition. These are areas where basic services, particularly government services, play a crucial role in the course of human development. Thus this chapter highlights how countries perform in providing the services and support to ensure young people

[1]Measures of inequality of income are generally unavailable in the MENA region.

face equal opportunities for healthy human development. We find a troubling pattern of substantial inequalities in human development before young people have any choice or agency over their outcomes. Especially notable is the fact that while MENA countries essentially guarantee the successful human development of the "best-off" members of society, there is substantial inequality and particularly varying outcomes for the most vulnerable members of society.

To assess inequality of opportunity in human development, the chapter begins in section 4.2 with a discussion of the concept of inequality of opportunity and how it can be measured. Section 4.3 assesses inequality of opportunity in education across the stages of early childhood care and education, school entry, basic, secondary, and higher education, as well as examining achievement (learning) in school. Section 4.4 examines inequality of opportunity in early health and nutrition, including early health care services, infant mortality, malnutrition, and access to micronutrients. A brief discussion of trends in inequality of opportunity occurs in section 4.5. Section 4.6 concludes with important points for understanding inequality of opportunity and human development in the MENA region, as well as key insights for addressing inequality of opportunity moving forward.

4.2 Conceptual framework

Inequality of opportunity

One of the challenges in discussing inequality is that the moral implications and economic consequences of inequality vary greatly depending on the type of inequality. An important distinction in terms of the nature of inequality is made by deploying the concept of inequality of opportunity (IOp), which partitions inequality into two elements: the share due to circumstances, which is morally unjustifiable and economically harmful, and the share due to individuals' efforts, which is economically desirable and morally justifiable (Roemer, 1998). Circumstances are those things outside of an individual's control – gender, place of birth, or parents' education – while efforts are things within an individual's control. Paying individuals different wages based on their efforts will generate inequality in wages, but such inequality is both justifiable and economically desirable, as it rewards and incentivizes effort and productivity. Paying individuals different wages based on their gender or ethnicity is economically inefficient, as it separates efforts and incentives; this sort of inequality is also morally unjustifiable and constitutes inequality of opportunity. Besides being economically inefficient and morally unjustifiable, this type of inequality violates people's sense of fairness, thereby resulting in frustration and unhappiness on the part of those being treated unfairly. This sort of inequality can undermine social cohesion, damage the legitimacy of public institutions, and contribute to social instability and political strife.

The extent of equality or inequality of opportunity within a society can be considered a key measure of economic development, namely whether society both justly and efficiently allocates resources (Roemer, 2014). Treating as "types" unique combinations of circumstances (for instance, a female child in rural Upper Egypt, with uneducated parents), inequality of opportunity can be assessed along two dimensions. The share of inequality due to circumstances (differences across types) in total inequality of an outcome (referred to as the IOp share) can be used as one measure of inequality of opportunity throughout society. How the worst-off type does in society, in comparison to the rest of society or the best-off type, is another crucial dimension of inequality of opportunity (Roemer, 2014).

Inequality of opportunity is particularly pernicious and destructive when it occurs during the early years of life. Sometimes inequality occurs even before children are born. This type of inequality of opportunity is especially concerning for three reasons. First, inequality at early stages of development is entirely inequality of opportunity. Whether children receive prenatal care or attend early childhood care and education (ECCE) is entirely outside of their control. Thus, all inequality at this stage can be considered inequality of opportunity (Roemer, 2014). Secondly, inequality of opportunity early in life, particularly during early childhood, is especially harmful. Early childhood is the most sensitive time for growth along a number of dimensions, including cognitive, physical, and socio-emotional development (Shonkoff & Phillips, 2000). The first years of life are particularly important for brain development (Grantham-McGregor et al., 2007). Inequality in the early years, for instance when some children experience poverty and others do not, translates into child developmental inequalities that will have long-lasting consequences (Walker et al., 2011). Lastly, inequality in the early years translates into inequalities in human development that will persist throughout adult life (Helmers & Patnam, 2011). Thus, addressing inequalities in adult outcomes requires addressing inequalities in access to services and human development during the early years of life.

Quantifying inequality of opportunity

A variety of different methods can be used to quantify inequality in general and inequality of opportunity in particular. The method used also depends on the type of outcome being measured, as different measures are required for continuous and discrete outcomes. In the case of continuous outcomes, the general entropy (GE) class of indices has the most desirable properties for decomposing inequality into the share due to circumstances (the IOp share) and that due to efforts (Duclos & Araar, 2006; Ferreira & Gignoux, 2011). In the case of binary outcomes, the dissimilarity index performs a similar function, quantifying the share of opportunities that would have to have been distributed differently for inequality of opportunity to have prevailed

(de Barros et al., 2009; de Barros et al., 2008). Another important quantification of inequality of opportunity is assessing how those who are worst-off in society (the bottom type) fare, in comparison to the rest of society and those who are best-off (the top type) (Roemer, 2014). This can be quantified by simulating the outcomes of the "most vulnerable" and comparing them to the "most advantaged" within a society and for an outcome. In this chapter we summarize results from studies using all of these different approaches.

4.3 Inequality of opportunity in education

In this section we examine inequality of opportunity in education at three different levels: (i) early childhood care and education, (ii) basic and secondary education, and (iii) university education. While we focus primarily on access to education and educational attainment, we also examine inequality in educational achievement by analyzing inequality in mathematics and science test scores as provided by the internationally comparable TIMSS test for eighth graders. Since it is arguable that children should not be held responsible for their accomplishments before an "age of consent" is reached, for most of the children we consider in this section, their educational attainment and achievement could be seen as the result of nature and nurture, and therefore all attributable to the circumstances in which the child was raised or luck. Thus the decompositions we carry out serve to distinguish between the contribution of observable circumstances to educational attainment, on the one hand, and that of unobservable circumstances and luck, on the other. Although we only provide a lower bound estimate of the role of circumstances in the inequality of educational outcomes, our approach serves to highlight which circumstances are most important in explaining variations in outcomes across children and how much of this variation can be attributed to the circumstances that we observe.

Inequality in early childhood care and education

There is enormous inequality of opportunity in whether children access early childhood care and education (ECCE) throughout MENA. Although there is heterogeneity in ECCE program impacts by program quality, programs generally improve cognitive and educational outcomes and lead to higher wages later in life (Berlinski et al., 2009; Berlinski et al., 2008; Bernal & Fernández, 2013; Engle et al., 2011; Mwaura et al., 2008). Inequality of opportunity in access to ECCE is in fact the dimension of early childhood development (ECD) with the greatest inequality of opportunity in studies examining multiple indicators and dimensions of development (El-Kogali & Krafft, 2015; Krafft & El-Kogali, 2014). Dissimilarity indices (also known as D-indices) ranged from 12.1 (West Bank and Gaza) to 43.5 (Iraq), meaning that between 12% and 44% of the opportunities

to attend ECCE would have to have been redistributed from those more likely to attend to those less likely to attend for equality of opportunity to have prevailed. As a contrasting reference, in Brazil the D-index for daycare at age 3 was estimated to be 15.1 and the D-index for preschool for ages 4–6 was 9.0 (Foguel & Veloso, 2014). Inequality in ECCE in MENA also tends to be higher than global inequality in primary schooling. Inequality of opportunity in completing primary education on time had a D-index of 6.3 in Egypt (World Bank, 2012) and ranged from 3 to 27 in Latin America, with an average of 11 (de Barros et al., 2009). Inequality of opportunity in ECCE is therefore quite high in MENA.

The very different chances the most advantaged and most vulnerable children in MENA face in experiencing this important preparatory step for success in school and later life are stark (Figure 4.1). Here the most vulnerable individual is a child from the poorest 20% of households, with illiterate parents, living typically in a rural, "bad" region of each country. In contrast, the most advantaged individual is a child from the richest 20% of households, with secondary or higher educated parents, typically living in an urban "good" region of a country.[2] The chances that the most vulnerable child attends ECCE range from less than 1% in Iraq to a high of 13% in West Bank and Gaza, while the

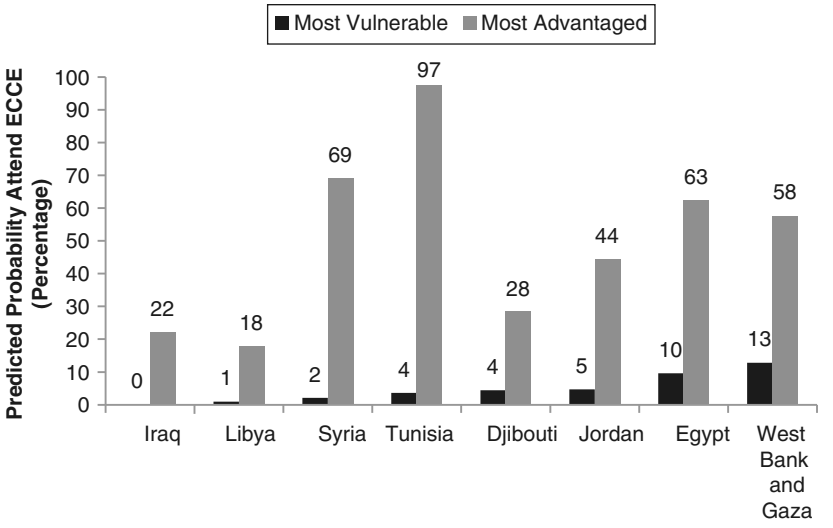

Figure 4.1 Probability of attending ECCE, most vulnerable and most advantaged simulations

Source: Figure 2.28 of El-Kogali and Krafft (2015).

[2]For more detailed information on the profiles of the most advantaged and most vulnerable in each country, including specific regions for each country, see El-Kogali and Krafft (2015).

most advantaged child has a chance of accessing ECCE between 18% (Libya) and 97% (Tunisia). The relative chances range from a low of a most advantaged child being four times more likely (West Bank and Gaza) to a high of 32 times more likely in (pre-conflict) Syria. These are enormous differences in early development and preparedness for school that will place children on unequal footing throughout their lives.

These differences in early experiences are due not just to wealthier parents making greater investments, but also inequality in accessing public services. We illustrate this for the case of Egypt, showing in Figure 4.2 the different chances children have of attending a public kindergarten or a private kindergarten. The chances of attending a public kindergarten increase with wealth and it is only among the richest quintile that private kindergartens are common. Thus, public kindergartens play a key role in ECCE access for wealthier families, but are not equally available across wealth levels, or in terms of geographic and other dimensions of access (El-Kogali & Krafft, 2015; Janssens et al., 2001). Addressing inequality in ECCE could play a crucial role in equalizing later outcomes. A study in Indonesia demonstrated that an ECCE program reduced the achievement gap between rich and poor children (Jung & Hasan, 2014). A study examining a variety of different education policies identified expanding pre-primary as the education policy that has the largest impact in terms of reducing earnings inequality (Checchi & van de Werfhorst, 2014).

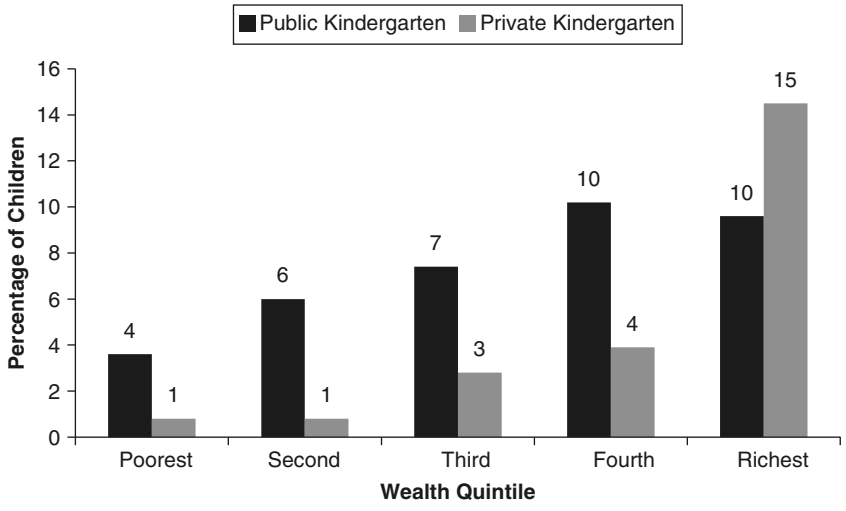

Figure 4.2 Percentage of children aged 3–5 who attended public and private kindergartens, by wealth quintile in Egypt
Source: Figure 6.8 of El-Kogali and Krafft.

Inequality in access to primary and secondary education

Assaad et al. (2014b) used data from Household Income, Expenditure and Consumption Surveys from eight MENA countries to examine the role of family circumstances in determining the educational attainment of children aged 12–17.[3] Because parental information in these surveys is only available if children are still living with their parents, they used 17 as the upper age cutoff to reduce the potential selectivity resulting from individuals leaving their parental home. The four levels of attainment they examine are (i) entering primary school, (ii) completing the primary stage, (iii) completing the preparatory (or lower secondary) stage, and (iv) entering the upper secondary stage. Because of the relatively low upper age cutoff, they are unable to observe whether children complete the upper secondary stage. The circumstances they use as explanatory variables are gender, father's education and mother's education (four categories each), household wealth (five quintiles), urban/rural residence and its interaction with wealth. They conduct their estimates of the probability of reaching each of the four levels using censored ordered probit models that take into account that some children in the age range will still be in school and therefore have censored observations on their ultimate level of attainment.

Using these models, Assaad et al. (2014b) predict the probability of not entering primary school for a most vulnerable and most advantaged boy and girl in each of the eight countries. The most vulnerable child has illiterate parents, lives in a rural area and comes from a household in the lowest wealth quintile. The most advantaged child comes from a household where both parents have more than secondary education and are in the top wealth quintile in an urban area. As shown in Figure 4.3, the most advantaged children in all eight countries always have a near zero probability of not entering school. However, there are wide variations in the probability of not entering for the most vulnerable children. In Tunisia, where schooling is almost universal, the most vulnerable boy has a zero probability of not entering and the most vulnerable girl a 5% probability. The results in Jordan are similar with a 1% probability for boys and an 11% probability for girls. Thus both of these countries have achieved a high degree of equality of opportunity in school entry, although some differences along gender lines remain. At the other extreme we have Iraq and Yemen, with the biggest gap in opportunities. The most vulnerable boys in Iraq and Yemen have a 60% and 62% probability of not entering school, respectively. The most vulnerable girls fare even worse with a 76% probability of not entering in Iraq and a whopping 94% probability of not entering in Yemen. In all countries

[3]The years of the surveys are as follows: Syria 2004, Tunisia 2005, Yemen 2006, Iraq 2007, Egypt and Palestine 2009, Jordan 2010, and Iran 2011–12. The Iranian results have been added since the working paper version.

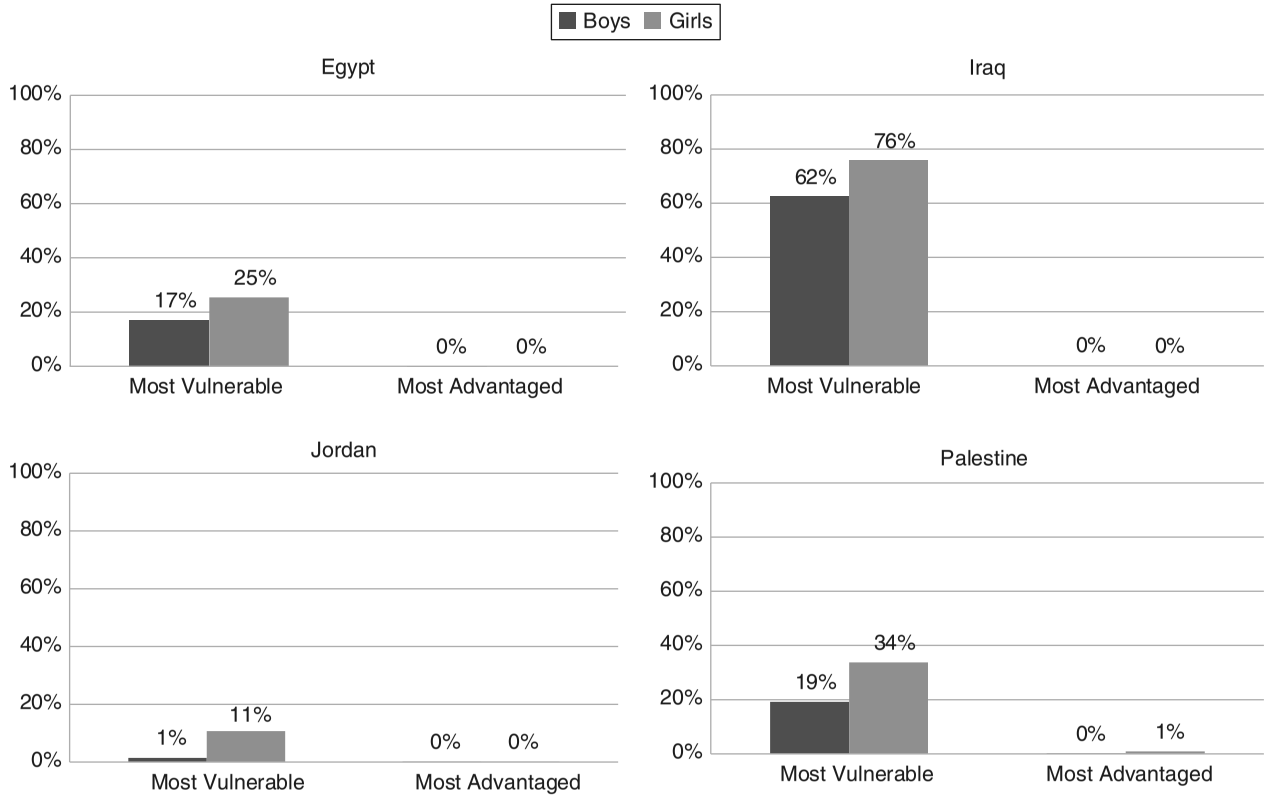

Figure 4.3 Probability of not entering school for most vulnerable and most advantaged child, by sex
Source: Based on Figure 2 in Assaad et al. (2014b).

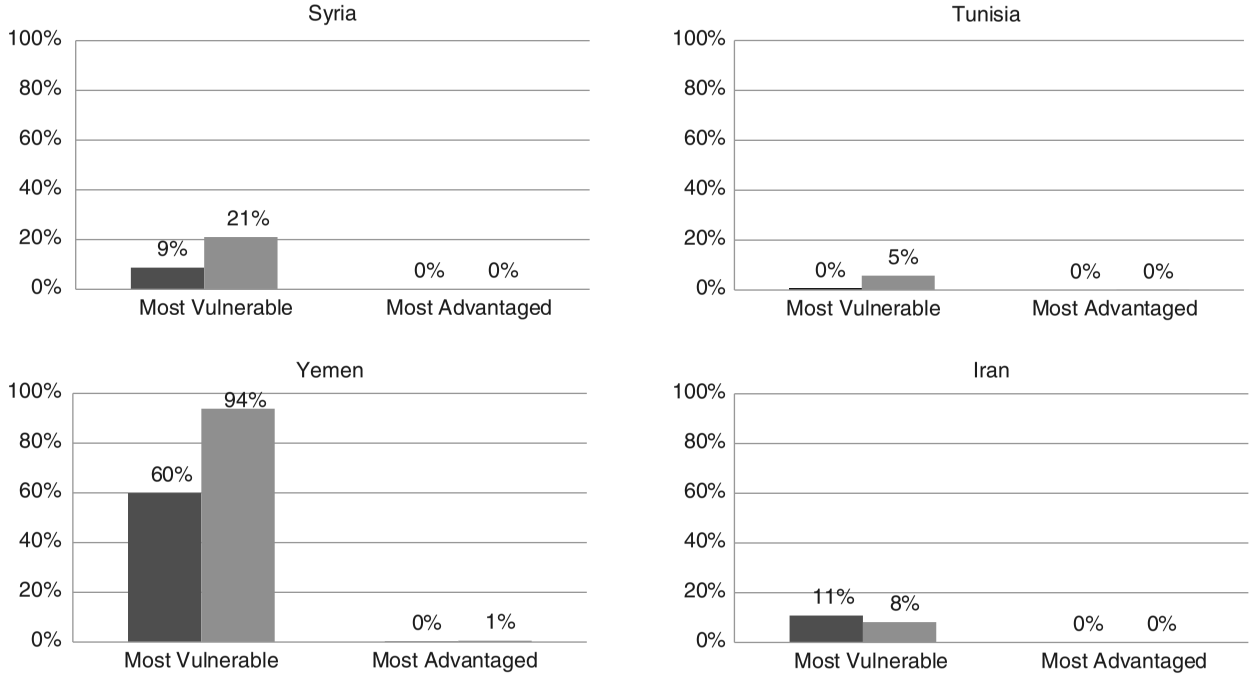

Figure 4.3 Continued

except for Iran, the most vulnerable girls fare worse than the most vulnerable boys and in some cases by a wide margin, suggesting that gender gaps in opportunities remain important, even in the most opportunity equal countries.

Assaad et al. (2014b) also report probabilities of reaching the upper secondary stage for the most vulnerable and most advantaged children. As shown in Figure 4.4, the most advantaged boys and girls are almost universally able to reach the upper secondary stage. Only Iraq, Jordan, Palestine, and Syria have probabilities of reaching secondary stage for the most advantaged children that are more than 5 percentage points below 100% and invariably these probabilities are lower for boys than they are for girls. This suggests that the lure of the labor market rather than access to secondary schooling is the main factor at work there. The situation is quite different for the most vulnerable children in each of these settings. Iraq is again the country where the most vulnerable are least able to reach the upper secondary stage, with only 8% of boys and 3% of girls in this category being able to enter. Although Yemen comes in second place in terms of lack of access to secondary school for the most vulnerable girls, it is Syria that occupies second place for boys. Despite the fact that Egypt fared much worse than Iran, Jordan and Tunisia, and even a bit worse than Syria in terms of its most vulnerable children being able to access school at all, it appears to have the highest probability for its most vulnerable children to reach the upper secondary stage. The probability of a most vulnerable boy reaching upper secondary in Egypt is 54% compared to 52% in Jordan, 41% in Tunisia, 37% in Iran, and 17% in Syria. The probability of the most vulnerable girl in Egypt reaching upper secondary is a bit lower than for boys (43%), but is still the highest among all countries of the region (Figure 4.4).

We conclude from this analysis that in terms of both access to primary school and upper secondary school, the disparities among the most vulnerable and most advantaged children are most extreme in Iraq and Yemen, and especially so for girls. The most vulnerable in Palestine and Egypt fare relatively poorly in terms of access to primary school, but they fare relatively well in Egypt when it comes to access to upper secondary school. Thus, conditional on making it into school, the most vulnerable Egyptian children have the best chance in the region of making it to the upper secondary stage. This is probably because of the relative ease of entry into the technical secondary stream in Egypt, which is widely considered inferior to the general secondary stream and which, by all measures, provides a very low quality education (Krafft, 2012, 2013; OECD/The World Bank, 2010; Salehi-Isfahani et al., 2009; UNDP & Institute of National Planning, 2010).

Inequality in access to higher education

There remains a need for comparative work on access to higher education in the MENA region, but work specifically on Egypt is illustrative of some key issues.

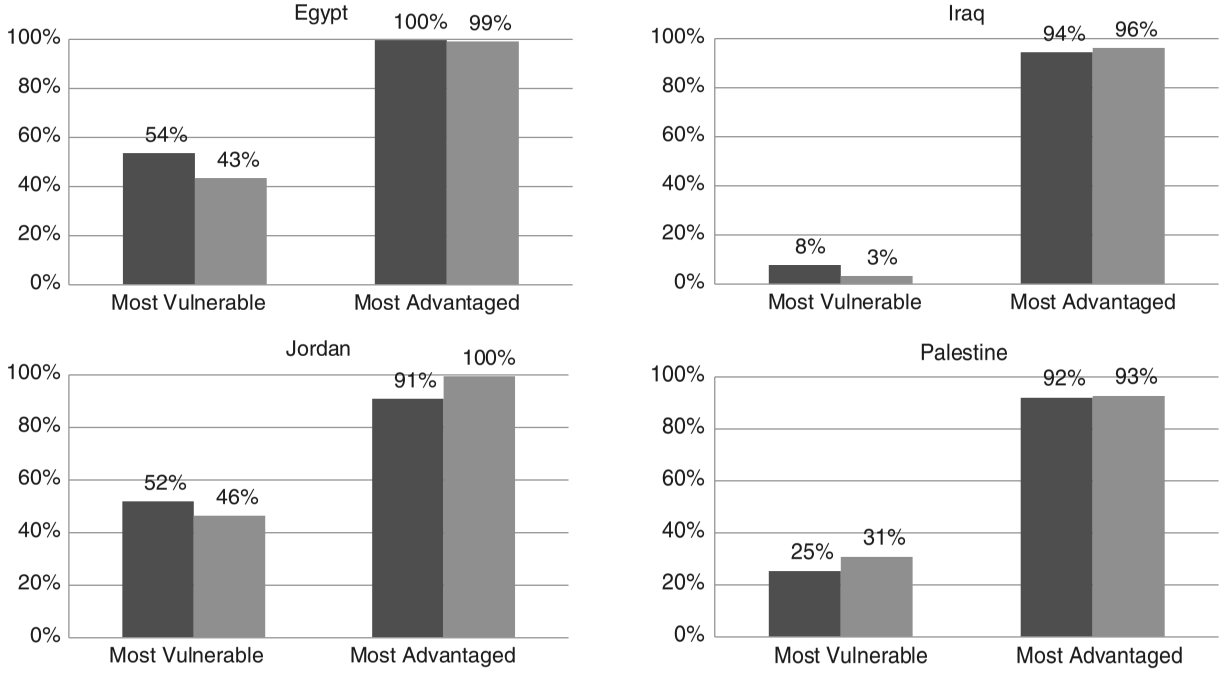

Figure 4.4 Probability of reaching secondary for most vulnerable and most advantaged child, by sex
Source: Based on Figure 3 in Assaad et al. (2014b).

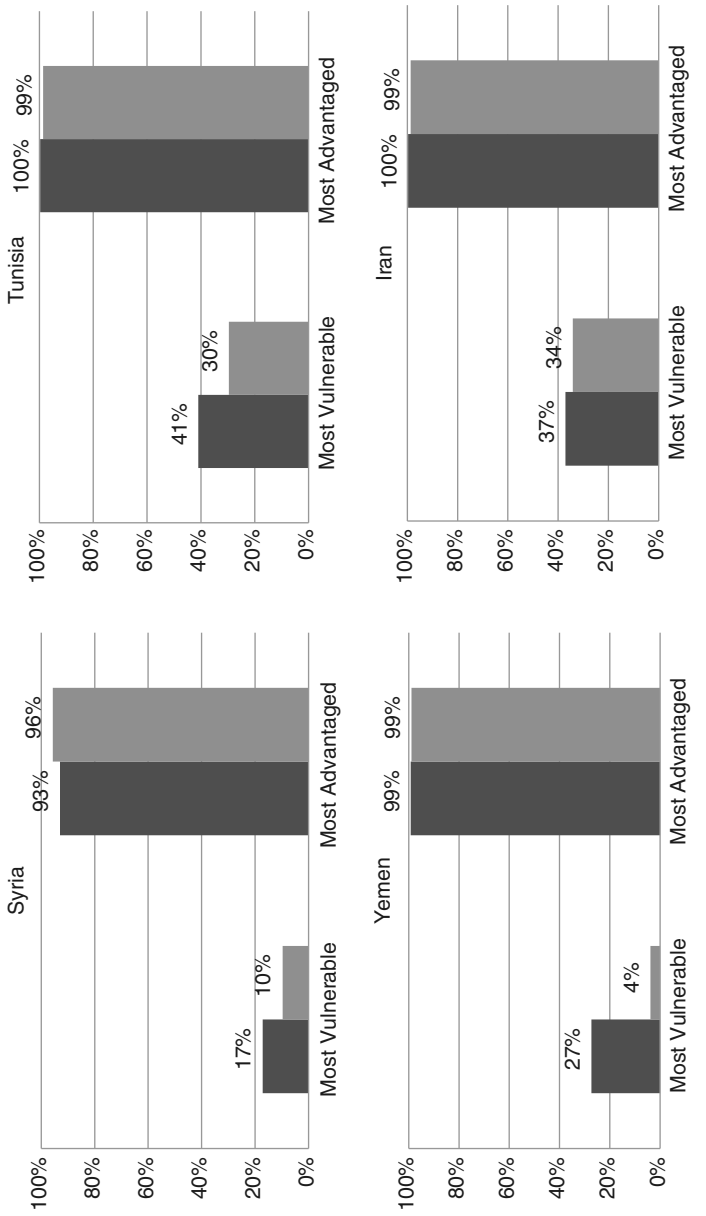

Figure 4.4 Continued

Assaad (2013) estimated the probability of the highest educational attainment for young people 20 to 29 in Egypt using the Survey of Young People in Egypt (SYPE 2009). The circumstances that were included in the analysis were father's and mother's education (seven categories each), parental wealth (five quintiles), urban/rural/urban slum residence, and region of residence. The most vulnerable males or females are ones whose parents are illiterate, belong to the lowest household wealth quintile and live in rural Upper Egypt. The most privileged males or females are ones whose parents have university education, are in the upper quintile of wealth and live in one of the Metropolitan governorates outside an urban slum area.

As shown in Figure 4.5, the most privileged male or female each have a virtually 100% probability of entering some kind of higher education institution, but the most vulnerable male has only a 9% chance of doing so, and the most vulnerable female a mere 2% chance. As we have seen above, the probabilities that these most vulnerable male and female youth have of reaching secondary school are a respectable 47% and 24%, respectively. This confirms that the big social divide in terms of accessing education in Egypt is between secondary and

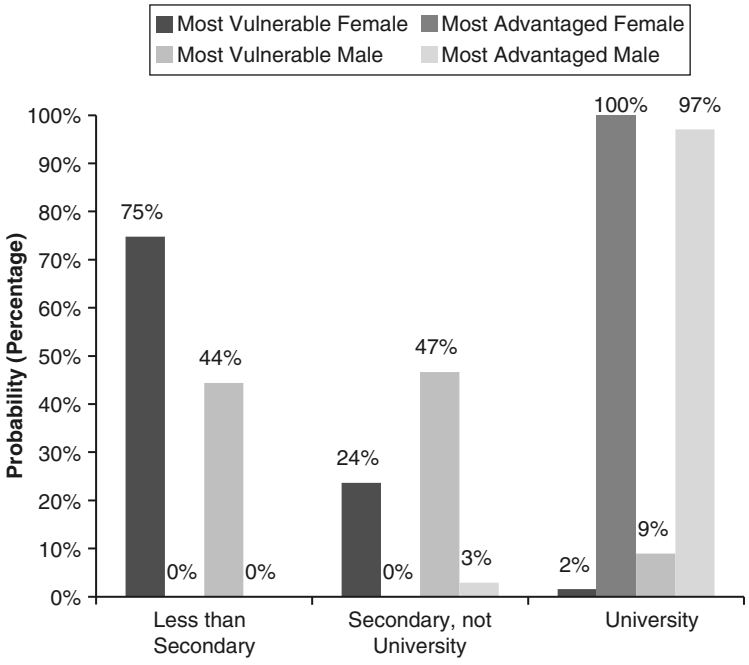

Figure 4.5 Probability of attaining less than secondary, secondary and university education for most vulnerable and most privileged by sex
Source: Figure 2 in Assaad (2013).

higher education. In fact, it turns out that access to general secondary education, which is virtually the only way to make it to higher education, is highly stratified by social class in Egypt. Assaad (2013) shows that the most privileged youth have a nearly 100% probability of entering the general secondary track in Egypt, whereas the most vulnerable have about a 20% probability of doing so, conditional on reaching secondary at all.

Inequality of opportunity in educational achievement

Access to education has expanded substantially in the MENA region in recent years. Out of the top 20 countries with the largest increases in the mean years of schooling in the 1980 to 2010 period, eight were Arab countries and Iran was a ninth (Campante & Chor, 2012). This expanding access is bound to improve equality of opportunity in terms of access and eventually attainment, particularly at lower levels of schooling. However, there are serious doubts about the quality of the education being provided in public institutions in the region, especially for those who are unable to supplement free public education with parental assistance and expenditures on private lessons and other sorts of out-of-school assistance. Disparities in the ability of parents to supplement their children's education will show up in the form of inequality in learning and achievement. In this section we draw on the results of Salehi-Isfahani et al. (2014) to illustrate the extent of inequality of opportunity in educational achievement in 16 MENA countries.

Salehi-Isfahani et al. (2014) analyze the test scores of a random sample of eighth graders from MENA countries who sat for the Trends in Mathematics and Science Study (TIMSS) tests in 1999, 2003 and 2007. We focus here on the 2007 results, which cover the largest number of MENA countries (16). Salehi-Isfahani et al. (2014) conduct parametric and non-parametric decompositions of the inequality of math and science scores to determine the IOp share. The circumstances they considered in their analysis were gender, family background (including parents' education, the presence of a computer and the number of books at home), ethnicity (based on language used at home) and community characteristics.

The IOp shares in math and science scores are shown in Figure 4.6 in all 16 MENA countries that administered the test in 2007. Based on these results countries can be usefully classified into three groups on the basis of their IOp share in educational achievement: (i) high inequality of opportunity, with an IOp share in the 30% range (Turkey, Iran, Lebanon, and Egypt)[4], (ii) intermediate inequality of opportunity, with an IOp share in the 15–25% range (Dubai, Saudi Arabia, Oman, Kuwait, Bahrain, Tunisia, Jordan, Palestine, and Syria),

[4]Qatar also falls in this category if scores in science are taken into account.

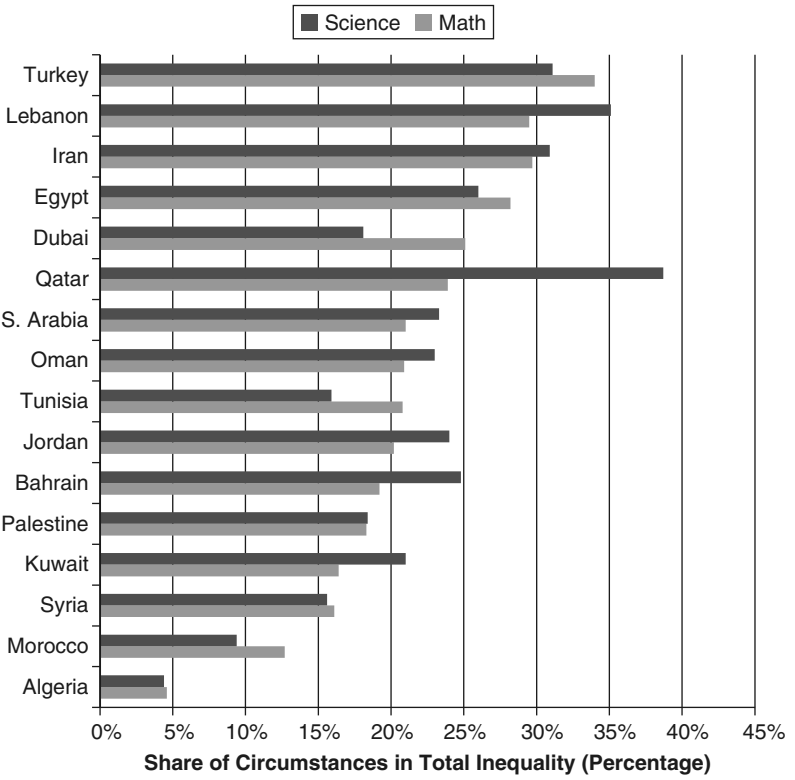

Figure 4.6 Share of circumstances in total inequality of math and science scores of eighth graders, 2007 (percentage)
Source: Based on Table 3 in Salehi-Isfahani et al. (2014).
Notes: Parametric estimates.

(iii) low inequality of opportunity, with IOp shares in the 5%-15% range (Morocco and Algeria).

Although methodologies and data sources differ somewhat, these results can be compared to IOp shares of educational achievement obtained by Ferreira and Gignoux (2013) for the 57 countries that administered the PISA survey in 2006.[5] The only four countries in common between those covered by PISA in 2006 and those shown in Figure 4.6 are Jordan, Qatar, Tunisia, and Turkey.[6] Ferreira and Gignoux (2013) also find that the highest IOp shares in their

[5] The PISA survey, carried out by the OECD, is similar to the TIMSS survey used by Salehi-Isfahani et al. (2014).
[6]The IOp shares obtained by Ferreira and Gignoux (2013) (FG) are comparable to those obtained by Salehi-Isfahani et al. (2014) (SI) but not identical. For Jordan, FG report an

sample are in the 30–35% range and include countries such as Argentina, Belgium, Brazil, Bulgaria, Chile, France, Germany, and Hungary. Countries with IOp shares below 20% include Hong Kong and Macao in Asia and the Nordic countries of Finland, Iceland, and Norway, but also Australia, Italy, and Russia.

To further understand the origins of inequality of opportunity and inform efforts to combat it, Salehi-Isfahani et al. (2014) decomposed the inequality explained by circumstances into the shares that are due to family background (parent's characteristics and home environment) and community characteristics (community size, community type, average class size, average teacher characteristics and the percentage of students coming from economically disadvantaged homes). These decompositions are shown in Figure 4.7 for the case of mathematics scores.[7] It is clear from the figures that in most countries, family background contributes more to inequality of opportunity than community characteristics. The exceptions are Lebanon, Syria and Dubai. In a few additional countries, like Iran, Morocco, Syria, and Qatar, the contribution of community characteristics is fairly sizable at more than 40% of total inequality of opportunity.

A large contribution of community characteristics to inequality of opportunity suggests that there are community-level disparities in school quality, something that can be more readily addressed through policy than inequalities emanating from differences in family background. To illustrate the link between inequality of opportunity in educational achievement and public expenditures in education, Salehi-Isfahani et al. (2014) examined this relationship through the cross-country scatter diagram shown in Figure 4.8. The distinct negative relationship is suggestive that increased public expenditure per student relative to the size of GDP per capita reduces inequality of opportunity in educational achievement. They go on to examine the relationship between per pupil expenditure and the share of community characteristics in total inequality of opportunity and also find a strong negative relationship.

IOp share of 0.27 for both math and science, as compared to 0.20 and 0.24, respectively in SI. For Qatar, FG report IOp shares of 0.25 in math and 0.26 in science, as compared to 0.24 and 0.39 in SI. For Tunisia, FG report IOp shares of 0.27 in math and 0.19 in science, as compared to 0.21 and 0.16 in SI. For Turkey FG report an IOp share of 0.24 in math and 0.25 in science, as compared to 0.31 and 0.34 in SI. After correction for selection into school, the FG estimates for Turkey rise to 0.32 in science and 0.33 in math. The differences in the point estimates between the two papers could be attributable to the precisions of the estimates, differences in the methodologies of analysis, in the coverage of the two surveys (8th graders in TIMSS versus 15-year olds in PISA), and in other aspects of the data collection methodologies of the two surveys.

[7] We should note that the sum of the partial contributions does not always add up to the share attributed to all circumstances shown in Figure 4.7.

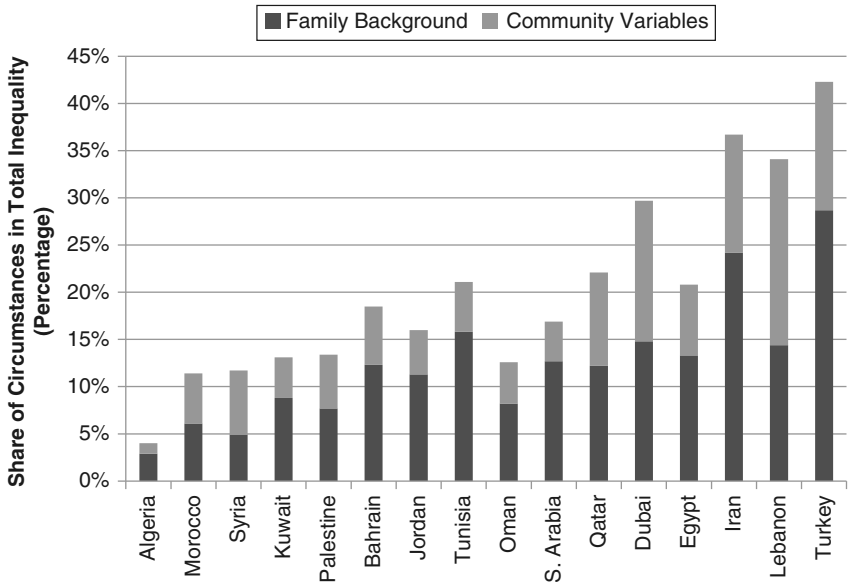

Figure 4.7 Decomposition of inequality of opportunity into the contribution of family background and community characteristics, mathematics scores, 2007
Source: Based on Table 4 in (Salehi-Isfahani et al., 2014).
Notes: Parametric estimates.

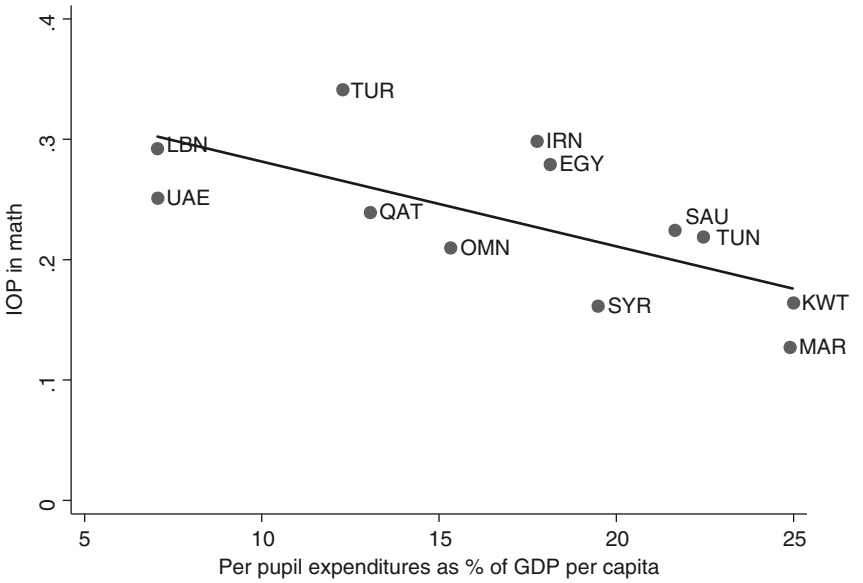

Figure 4.8 Public expenditures per pupil and inequality of opportunity share in mathematics scores, 2007
Source: Based on Figure 5 Salehi-Isfahani et al. (2014).
Notes: Parametric estimates.

These results suggest that when the education system is starved of public resources, more well-to-do parents invest in family help, private schooling and private tutoring to improve the performance of their children, driving a wedge between their performance and other children who have to rely exclusively on public inputs. It is these more privileged students who are then able to perform well in the highly competitive centralized exams needed for entrance to university. It is therefore not surprising to find that access to higher education is highly unequal, as we have shown above for the case of Egypt.

4.4 Inequality in early health and nutrition

Early nutrition and health are crucial formative experiences with lifelong impacts on human development and economic outcomes. In this section, we investigate inequality in early health and nutrition. For early health, we examine prenatal and delivery care services, immunizations, and infant mortality. Prenatal and delivery care are crucial for ensuring mother and child health (UNICEF, 2008; World Health Organization, 2004). Immunizations are a highly cost-effective way to prevent illnesses that can impair the development of children or even lead to their deaths (Lomborg, 2009). Infant mortality, dying before age 1, is the ultimate loss of human potential and should not be determined by children's circumstances.

We examine nutrition in terms of anthropometric measures of (mal)nutrition such as height and weight. In regards to physical growth and malnutrition, height-for-age relative to a healthy reference population is the best indicator of accumulated malnutrition and healthy growth. Children are considered stunted when their height-for-age falls two standard deviations below that of a healthy reference population. Height-for-age when a child is two is the best predictor of adult human capital and productivity (Victora et al., 2008). Malnutrition also impacts school performance (Glewwe & Miguel, 2008) and adult income and productivity, with children receiving nutritional supplementation earning much more as adults (Hoddinott et al., 2008).

We also reflect on children's access to micronutrients, specifically examining the case of adequately iodized salt. Iodine deficiency is the most common cause of mental retardation, leading to a drop in IQ of approximately 10 points (Molina, 2012). Iodine deficiency can be easily prevented by adding iodine to salt, an effort which raises salt costs by approximately 5% and has a benefit-cost ratio between 15 and 520 (Behrman et al., 2004). No child in MENA should face unequal opportunities for healthy brain development due to inequality of opportunity in salt iodization.

Inequality of opportunity in early health

Inequality of opportunity in early health varies substantially by country. Inequality of opportunity in early health is measured with the dissimilarity

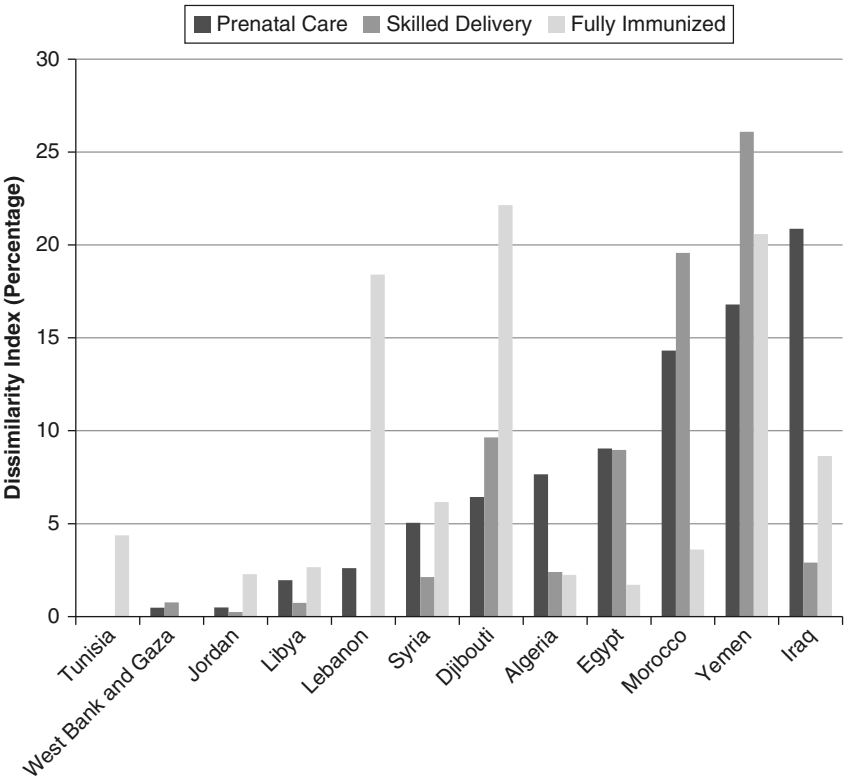

Figure 4.9 Dissimilarity indices for prenatal care, skilled delivery, and immunizations (percentages)

Source: Table 2.1 in El-Kogali and Krafft (2015).

Notes: Because of universally high rates, dissimilarity indices could not be estimated for delivery care in Lebanon or prenatal or delivery care in Tunisia. Data was not available on immunizations in West Bank and Gaza.

index, showing the percentage of opportunities that would have to be redistributed for equality of opportunity to prevail. A number of countries have fairly low inequality of opportunity in prenatal and delivery care (largely due to coverage that is quite high), including Algeria, Jordan, Lebanon, Libya, Syria, and West Bank and Gaza (El-Kogali & Krafft, 2015). Djibouti, Egypt, Iraq (for prenatal care), Morocco, and Yemen all have substantial inequality of opportunity in prenatal and delivery care, with a D-index of 20.9% for prenatal care (in Iraq) and 26.1% for delivery care (in Yemen). Inequality in immunizations tends to be low, but the D-index for it is as high as 22.2% in Djibouti, 18.4% in Lebanon, and 20.6% in Yemen. Notably, Egypt and Morocco – which do poorly on prenatal and delivery care equality of opportunity – do better at delivering immunizations regardless of circumstances.

Differences in early health services can translate into very different health outcomes, including differential patterns of infant mortality between the most vulnerable and most advantaged children (Figure 4.10). Children coming from the most vulnerable background are always more likely to die before their first birthday, but the differences vary substantially by country. Jordan has less than a 1% chance of infant mortality for both types of children, and in Iraq mortality is fairly high (3.9% or 3.0%) for both the most vulnerable and most advantaged. However, in a number of countries the differences are substantial. In Egypt, the most vulnerable child is more than twice as likely to die, 2.8%, compared to a 1.1% chance for the most advantaged child. In Libya the difference is even higher; 3.2% for the most vulnerable versus 0.4% for the most advantaged. Large gaps exist in Algeria and Tunisia as well, and particularly Morocco, where the most vulnerable child has a 5.2% chance of infant mortality, compared to 1.1% for the most advantaged. In Yemen, the most vulnerable child has an almost one-in-ten chance of dying in the first year of life, compared to a near-zero chance for the most advantaged child. Overall, there are systematically different patterns of infant mortality, meaning the families into which children are born affect their chances of surviving their first year of life.

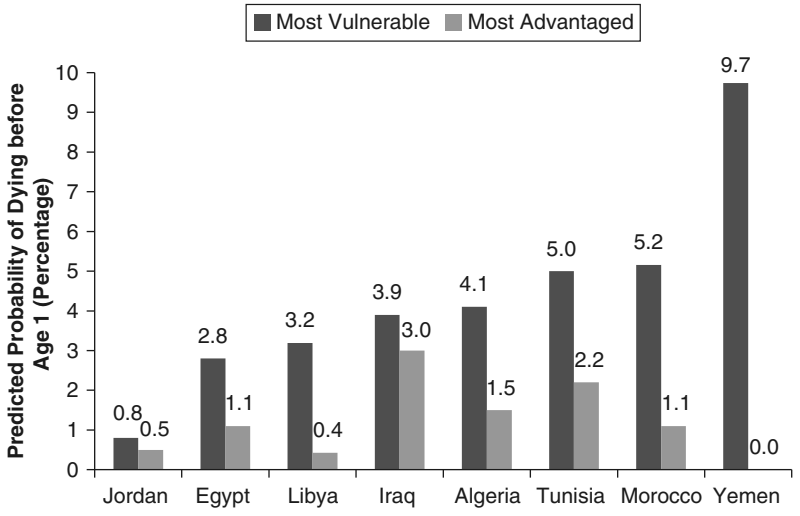

Figure 4.10 Infant mortality, most advantaged and most vulnerable simulations
Source: Figure 2.23 in El-Kogali and Krafft (2015).
Notes: Outcome was too infrequent to model inequality in Lebanon. In Djibouti, pre-conflict Syria, and West Bank and Gaza, the underlying model was not statistically significant so simulations were not undertaken.

Inequality in nutrition

Malnutrition and anthropometrics

There is substantial inequality of opportunity in children's physical growth and nutrition in MENA, which will in turn limit children's adult opportunities. A study examining inequality of opportunity in height-for-age and weight-for-height over time in the Arab World and Turkey (Assaad et al., 2012), estimates that the IOp share in height-for age was between 5% to 20% in these countries. Slightly lower IOp shares were found for weight-for-height, which measures temporary episodes of illness, whereas height shows accumulated malnutrition. A variety of different individual circumstances, including region, parents' education and occupation, family wealth, demographics (including gender), and infrastructure all contributed to inequality of opportunity, but to varying degrees across countries (Assaad et al., 2012).

The inequality of opportunity translates into substantially different heights and weights for the most vulnerable and most advantaged children (Figure 4.11). Here, the most vulnerable child is generally third-born, lives in a rural area, is from the poorest 20% of households, and has uneducated parents. The most advantaged child is first-born, lives in an urban area, is from the richest 20% of households, and has university-educated parents. These different circumstances translate into very different nutritional outcomes. For a 24-month old female child, the gaps range from 5 cm to 12 cm in height and 1 kg to 4 kg of weight – large differences at an early age. The best and worst off children in Yemen are the furthest apart on both measures, but other countries show large gaps as well. These differences in health will have lasting consequences. For instance, estimates indicate that a 1 cm increase in adult height translates into 1.4–2.4% higher wages (Haddad & Bouis, 1991; Thomas & Strauss, 1997) and in MENA large differences are evident even at only 24 months.

Further work specifically focusing on stunting as a binary outcome and using dissimilarity indices for recent surveys found statistically significant inequality in stunting in Egypt, Iraq, Jordan, Morocco, Syria, West Bank and Gaza, and Yemen (El-Kogali & Krafft, 2015). The country with the highest inequality (dissimilarity index of 24.1%, Jordan) actually had the lowest stunting rate, 7.6%, while the country with the lowest inequality (dissimilarity index of 4.9%, Yemen) actually had the highest stunting rate, 53.1%. This suggests that as overall nutrition levels improve, socio-economic disparities in malnutrition may persist. One paper on Jordan also tries to unpack the mechanisms through which circumstances may impact nutrition (Krafft, 2015). Jordan generally has low levels of malnutrition, but strong socio-economic gradients, with 16.7% of children from the poorest wealth quintile stunted, compared to 0.7% of children from the richest quintile. The study finds that it is primarily prenatal factors, including birth weight and mother's height, that drive inequality of

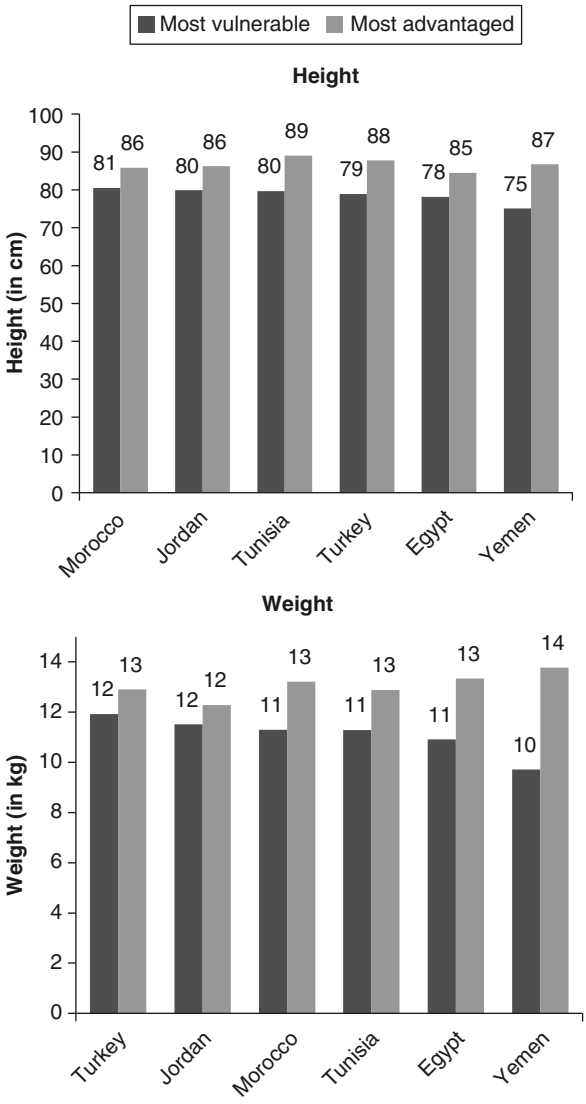

Figure 4.11 Height and weight, most advantaged and most vulnerable simulations for a 24-month old female

Source: Figure 10 of Assaad et al. (2012).

opportunity, suggesting that, at least in Jordan, reducing inequality of opportunity in malnutrition has to occur during pregnancy and across generations.

Micronutrients

As well as facing unequal chances to have healthy physical growth, children in MENA face unequal opportunities for healthy brain development, in terms of access to adequately iodized salt. Although data are not available in many countries, among the five countries with data available, only in West Bank in Gaza is there not statistically significant inequality of opportunity as measured by the dissimilarity index (El-Kogali & Krafft, 2015). In Egypt, 7% of the chances to access adequately iodized salt would have to be redistributed from the better off to the worse off for equality of opportunity to prevail. In Libya this figure is 16.9%, in Iraq 20.3%, and in (pre-conflict) Syria the dissimilarity index was 32.3%. Thus, while their brains are developing and before they even enter school, children face very different chances of accessing iodized salt or being potentially iodine deficient and losing 10 IQ points.

4.5 Trends in inequality of opportunity

Ideally, we would see inequality of opportunity in health, education, and other basic services declining over time. There is very limited information on which to base comparisons over time, as the limited literature on inequality of opportunity in such services and outcomes tends to focus on a point in time and not comparisons over time. One study examines patterns of inequality over time and across countries in the Arab World and Turkey for children's anthropometrics (Assaad et al., 2012). Countries do not exhibit strong time trends in terms of inequality of opportunity in height-for-age, largely fluctuating over time. While Egypt and Jordan show fluctuations or increases in weight-for-height IOp shares, Morocco and Turkey show some decreases in IOp shares over time.

Two studies on inequality of opportunity for Egyptian children provide some insight into what the potential dynamics might be across a range of outcomes in that country (Ersado & Aran, 2014; Velez et al., 2012). Access to healthcare, including dimensions of healthcare before and during pregnancy and utilization, has become more equal over time, but this appears to be driven by large increases in coverage, rather than redistributive effects. Nutrition has not shown much improvement, but access to education has exhibited decreasing inequality of opportunity at the primary and secondary levels in Egypt (Ersado & Aran, 2014; Velez et al., 2012). However, social mobility through education has not necessarily improved as a result; inequality of opportunity in higher education is very high (Assaad, 2013; Krafft et al., 2013) and there are no strong trends in IOp of educational achievement in Egypt or the rest of the region (Salehi-Isfahani et al., 2014). The case of Egypt demonstrates how looking at

trends in inequality of opportunity using a single indicator, such as access to primary schooling, can be misleading. Further work is clearly needed to assess inequality of opportunity trends over time across a variety of dimensions of human development.

4.6 Conclusions

Redressing inequality of opportunity in MENA countries will require tackling inequality of opportunity in human development for being in and of itself morally repugnant, and also for its role as a mediator for unequal opportunities later in life in social participation and economic success. Governments have an important role to play in this regard. The current landscape suggests that, if anything, government programs and policies are exacerbating inequality – for instance, there are more public kindergarten slots for rich children in Egypt than for poor children (El-Kogali & Krafft, 2015). Greater public investments in human development are needed to equalize opportunities, as demonstrated by the countries with higher rates of public investment in education facing lower inequality of opportunity (Figure 4.8). The right programs and policies can actually be equalizing forces; for instance in Europe universal pre-primary education was identified as the education policy that had the greatest impact on reducing income inequality (Checchi & van de Werfhorst, 2014). In Indonesia, early childhood development programs helped close the achievement gaps between poor and rich children when they entered school (Jung & Hasan, 2014). Although more work is needed to identify the most effective programs and policies for MENA countries, redressing inequality of opportunity in human development provides an opportunity to simultaneously promote economic efficiency and social justice.

Equalizing opportunities for human development, "leveling the playing field" in MENA will require not only political will and effective policies, but also better and more up-to-date information. The landscape of both data and studies on inequality of opportunity in human development in MENA is sparse. For instance, the only country with an assessment of inequality of opportunity in higher education is Egypt (Assaad, 2013; Krafft et al., 2013). Assessing the state and especially the trends in inequality of opportunity in human development is going to require more frequent and more readily accessible data. Notably, the studies assessing inequality in early childhood development use the most recent available information for each country, which is data spanning an entire decade (El-Kogali & Krafft, 2015; Krafft & El-Kogali, 2014). Most countries in the region have at least annual and often quarterly assessments of the labor market, in the form of labor force surveys, with the latest unemployment rate receiving much, perhaps undue (see Krafft & Assaad, 2014) attention. Equally frequent assessments of the state of human development and inequality in

human development are merited and would help spur public attention and action. Data quality also needs to be improved; it is difficult to assess inequality of opportunity without information on circumstances, but there are model surveys in the region for assessing circumstances such as parental education or the early home environment (Assaad et al., 2014a; Assaad & Krafft, 2013). The papers discussed here tended to find that the exact circumstances contributing to inequality of opportunity varied from country to country as well as across outcomes, making ongoing assessment across a variety of dimensions crucial for each country.

Government services and early opportunities for human development should be equally available to all citizens of MENA countries, if not explicitly targeted toward the poor and disadvantaged. MENA is currently far from attaining such a goal, with substantial inequality of opportunity across early health, nutrition, and education. It is important to note that the inequality of opportunity in human development – already high – is a lower bound on true inequality of opportunity, as only a few circumstances are observed and included in these studies. Unequal opportunities across the different dimensions of human development are sure to only be further compounded by the ongoing effects of circumstances in adult life as well. Particularly notable across the different studies discussed here is the fact that those born into the best circumstances do well in all the countries studied. These young people attend ECCE, go to school, attend secondary, and go on for higher education. They had prenatal care, delivery care, and all their immunizations. They are rarely malnourished and had good access to micronutrients. In contrast, those from the worst circumstances struggle in education, health, and nutrition – but to varying degrees. Some countries do substantially better by their most vulnerable young citizens than others, suggesting that there is, importantly, scope for improvement and success throughout the region. Building on these successes will be an important part of ensuring social justice – a clear priority in the MENA region, in light of the Arab Spring.

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5

Inequality of Opportunity in the Labor Market for Higher Education Graduates in Egypt and Jordan

Caroline Krafft and Ragui Assaad

5.1 Introduction

In a well-functioning labor market, outcomes differ across individuals because of the quality of their human capital and level of skill, as well as the work effort they expend. Likewise, when the education system is functioning well, the human capital and skills individuals accumulate should reflect differences in their effort in school. Therefore, in a country with both a well-functioning education system *and* a well-functioning labor market, labor market outcomes will reflect individual effort, some of which is embodied in human capital and skills. However, the labor market could fail to properly allocate or reward human capital and skills, but instead allocate human capital and rewards on the basis of individuals' circumstances, such as their social class, their gender or where they live. While unequal outcomes related to effort are morally justifiable, unequal allocations on the basis of circumstances outside of individuals' control are morally unjustifiable, and can be termed inequality of opportunity (Roemer 1998). Inequality of opportunity also offends people's sense of fairness, leading to anger and frustration among those who are aggrieved, thus threatening social cohesion, reducing trust in public institutions and undermining political stability.

Access to high quality human capital and skills could very well be determined by a person's circumstances, like social class background and parental education, and thus may embody a great deal of inequality of opportunity. Education affected by circumstances represents pre-labor market inequality of opportunity. It could still be the case that, once human capital is accounted for, rewards in the labor market are otherwise unrelated to individuals' circumstances. However, if after correcting for the quantity and quality of human capital, an individual's circumstances still play a substantial role in his or her labor market outcomes, that could be evidence of imperfectly competitive labor markets in which family connections, social networks, and personal ties

make a difference in access to jobs. This would be a case where there is in-labor market inequality of opportunity.

In the Middle East and North Africa (MENA), there are unequal opportunities to accumulate human capital. Inequality of opportunity is pervasive throughout the education system. There are pervasive inequalities of opportunity in educational attainment (Assaad, Salehi-Isfahani, and Hendy 2014) as well as in achievement, measured as scores on the TIMSS test (Salehi-Isfahani, Hassine, and Assaad 2014). Egypt provides an example of the systematic patterns of unequal access to opportunities to accumulate human capital throughout the education system. Inequality of opportunity is substantial beginning even in pre-primary education (El-Kogali and Krafft 2015; Krafft and El-Kogali 2014) and at school entry (Elbadawy 2015; Krafft 2012). There is inequality of opportunity throughout basic and secondary education, and especially in accessing higher education (Assaad 2013). There is even substantial inequality of opportunity *within* the higher education system in Egypt (Krafft, Elbadawy, and Assaad 2013). These unequal chances to accumulate human capital will be pre-market factors contributing to inequality of opportunity within the labor market.

Although measured inequality in income in Arab countries is moderate by international standards (Bibi and Nabli 2009), there is evidence of inequality of opportunity in MENA labor markets. In Jordan and Egypt wage inequality includes substantial gender differentials (Said 2014, 2015). Wages are known to be affected by parental education and location in Egypt (World Bank 2012). Around a fifth of inequality in wages in Egypt is inequality of opportunity, with father's background, geographic origins, and mother's education making substantial contributions (Hassine 2011). There is also inequality of opportunity in entering various occupations. Youth from lower socio-economic backgrounds have unequal access to high-level occupations (Binzel 2011). Although inequality of opportunity in the labor market is clearly an issue, the roles of pre-market and in-market inequality have not been disentangled. Identifying whether in-market problems are contributing to inequality of opportunity is vital for determining whether the education system alone, or both the education system and labor market need to be reformed in order to provide more equal opportunities.

By focusing on inequality in labor market outcomes while accounting for human capital, we can isolate if and how circumstances directly affect inequality in the labor market, i.e., whether there is in-market inequality of opportunity. Past research suggests that inequality of opportunity persists beyond human capital. For instance, parents' education has been shown to affect children's earnings even after controlling for children's own education in Egypt (Nugent and Saleh 2009). Work on youth in Egypt, Jordan and Morocco distinguished between the contributions of education and age compared to circumstances beyond an individuals' control and found that more than half

of the explained inequality in employment, formal employment, public sector employment, permanent jobs, and high-wage jobs was due to circumstances (World Bank 2013). Unequal access to occupations is related to personal networks (Binzel 2011). Personal, kinship, and social networks play a particularly important role in accessing employment in the MENA region (Assaad, Krafft, and Salehi-Isfahani 2014; Assaad 1997). Labor markets are strongly segmented by kinship and socio-economic class, as well as along gender lines (Assaad and El-Hamidi 2009; Assaad and Krafft 2014; Assaad 1997; Barsoum 2004).

We make use of two unique data sets from Egypt and Jordan to test whether labor market outcomes are systematically affected by a person's circumstances after carefully controlling for the type and quality of human capital an individual possesses. The data sets come from surveys of higher education graduates in two fields of study – business and information technology – who were between the ages of 25 and 40. Limiting the fields to these two areas allows us to keep the type and quantity of human capital fairly constant. We also control for any remaining differences in human capital by having a wealth of information on the educational experiences of the respondents both before entering higher education as well as during their studies.

These detailed data on the educational trajectory of individuals allow us to control to a great extent for the quality of human capital investments and thus focus on the direct role of circumstances in determining labor market outcomes. By excluding and then including the additional educational variables from our models we can also examine the full impact of family circumstances on labor market outcomes and estimate the share of the effect that is transmitted indirectly through the human capital variables and the share that directly affects labor market outcomes. The labor market outcomes we examine are time to first job, wages in the first job, growth in wages over time, wages five years after graduation, current wages, and current job quality.

5.2 Methods

Inequality of opportunity (IOp)

To understand and decompose inequality, we turn to the substantial and growing body of literature discussing and applying the concept of inequality of opportunity. The work of Roemer (1998) is the cornerstone of this literature. Roemer divided inequality in outcomes into inequality due to effort (factors within an individual's control) and inequality due to circumstances (factors outside an individual's control). While inequality due to effort is morally justifiable, and indeed, economically desirable to incentivize effort, the inequality due to circumstances is not morally justified. The inequality due to circumstances is termed inequality of opportunity. Circumstances can include factors

such as gender, place of birth, parents' socio-economic status, and other characteristics over which individuals have no control. When, for instance, females and males receive different wages for the same effort, this is a case of inequality of opportunity in the labor market.

Inequality of opportunity is important to consider not only as morally or ethically undesirable, but also because the lack of fairness can have harmful consequences for individuals, economies, and societies. If individuals' circumstances determine their labor market outcomes, this is likely to generate substantial inefficiencies in the labor market, with human resources not being allocated optimally. Additionally, when circumstances affect outcomes this may disincentivize individuals' efforts in school and in the labor market. The unfairness inherent in inequality of opportunity can have particularly corrosive effects on social cohesion and trust in institutions. For instance, the need for greater "social justice" was articulated as a key demand of protest movements in Egypt's January 2011 Uprising and throughout the Arab Spring (Bayat 2013; Diwan 2013; Malik and Awadallah 2013; Richards et al. 2014). Thus, inequality of opportunity is of concern not only as an ethical matter but also as an obstacle to the functioning of the economy, political institutions, and society.

Measuring inequality

A variety of different labor market outcomes are considered in this paper. To measure inequality of opportunity for a given outcome y, such as income, we must first assess total inequality. Denote as $F(y)$ the cumulative distribution function. Then $F(y)=p$ is the proportion of the population with outcomes y or lower. Denote $Q(p)$ as a quantile function, the outcome level below which we can find p of the population. The quantile function, $Q(p)$, can also be interpreted as the outcome of an individual whose percentile in the population is p. Additionally, the mean is μ. Measuring inequality is essentially the task of quantifying the shape of the distribution $Q(p)$ (Duclos and Araar 2006).

General entropy measures of inequality

Our goal is to assess inequality of opportunity in labor market outcomes, and the shares (partial effects) attributable to different circumstances, such as family background. Quantifying the partial effects requires a decomposable inequality index. In this paper we use a general entropy (GE) index, the most common type of decomposable inequality measures (Ferreira and Gignoux 2008).

For a continuous outcome variable, we primarily use the GE(0) index, which draws on the quantile function $Q(p)$ and can be described as (Duclos and Araar 2006):

$$GE(0) = \int_0^1 ln\left(\frac{Q(p)}{\mu}\right) dp$$

The GE(0) index is more sensitive to values at the lower end of the distribution.

In one case, because one of the outcomes we examine, wage growth, can be zero or negative, this rules out the GE(0) index. For this outcome we use the GE(2) index (Duclos and Araar 2006):

$$GE(2) = \frac{1}{2}\left(\int_0^1 \left(\frac{Q(p)-\mu}{\mu}\right)^2 dp\right)$$

This functional form puts emphasis on inequality at the higher ends of the distribution.

Decomposing inequality

In decomposing inequality, we wish to identify inequality of opportunity. If there are *k* groups, where a group is a unique combination of circumstances, we can divide inequality into between-group inequality, which is inequality of opportunity, and within-group inequality, which we attribute to effort.

The GE class of inequality indices can thus be partitioned into within and between-group inequality as:

$$GE(\alpha) = \underbrace{\sum_{k=1}^{K} \phi(k)\left(\frac{\mu_k}{\mu}\right)^{\alpha} GE(k;\alpha)}_{Within} + \underbrace{\overline{GE}(\alpha)}_{Between}$$

denoting by $\phi(k)$ the proportion of the population in group *k*, μ_k as the mean outcome of group *k*, and $GE(k;\alpha)$ as the $GE(\alpha)$ index of group *k*. Since $GE(k;\alpha)$ measures inequality for individuals with the same set of circumstances, it captures the within-group inequality, and once groups are population weighted, captures within-group inequality on the population level. Between-group inequality is then measured by $\overline{GE}(\alpha)$, which is the general entropy index of the population if each member of group *k* experienced labor market outcome μ_k, their group's mean (Duclos and Araar 2006).

Quantifying between-group inequality

Between-group inequality, $\overline{GE}(\alpha)$ can be quantified residually, relying on a standardized distribution. A standardized distribution is denoted $\{v_i^k\}$ and is the distribution that results from replacing the outcome value for individual *i* in group *k*, y_i^k, with $v_i^k = y_i^k \frac{\mu}{\mu^k}$, that is adjusting each group's distribution to have the same mean as the population mean. Then all between-group differences are neutralized and only within-group differences remain. Between-group inequality can then be calculated residually using the $GE(\alpha)$ inequality index as:

$$GE\left(\{y_i^k\}\right) - GE\left(\{v_i^k\}\right)$$

It can be transformed into a residual measure of the IOp share, the share due to circumstances in total inequality, as follows:

$$\theta_r = 1 - \frac{GE\left(\left\{v_i^k\right\}\right)}{GE\left(\left\{y_i^k\right\}\right)}$$

It is important to keep in mind throughout this discussion the multitude of forces that contribute to the IOp share. Total inequality is composed of both the between-group (inequality of opportunity) and within-group (inequality due to effort and luck) components. Total inequality can thus be high because inequality of effort is high, or inequality of opportunity is high. At the same time, it is entirely possible for total inequality to be middling (as analyses of economic inequality comparing MENA to elsewhere have suggested (Bibi and Nabli 2009)), while inequality of opportunity is high, if inequality in efforts is low. An important – and unanswered – question in the inequality of opportunity literature is how inequality of opportunity and inequality of efforts are inter-related. In contexts with high inequality of opportunity, individuals may scale back their efforts since they perceive limited rewards to such efforts, generating middling total inequality. This possibility is particularly concerning and relevant in the context of MENA, and should be kept in mind throughout the discussion.

Additionally, in the context of this paper we are limiting our analyses to a very specific group: higher education graduates in commerce and IT. This restriction makes for an excellent context in which to assess whether there is inequality of opportunity in the labor market itself, after controlling for human capital. However, it makes comparisons with other inequality of opportunity statistics, using entire populations, quite challenging. Circumstances may determine labor market outcomes to a greater or lesser extent for these higher education graduates than for other groups. Additionally, since there is substantial inequality of opportunity in accessing the higher education system itself and different specializations within it (Assaad 2013; Krafft, Elbadawy, and Assaad 2013), inequality of opportunity on the population level will also be driven by the contribution of circumstances to the probability of accessing higher education. Although we make comparisons with inequality of opportunity statistics from other studies, it must be kept in mind that we are examining a relatively restricted universe.

Parametric methods for estimation

Both parametric and non-parametric methods can be used for estimating inequality of opportunity. Ideally, we would partition the population into *k* different unique combinations of circumstances, or types. However, even

accounting for a modest number of circumstances non-parametrically can rapidly become problematic in terms of having too many cells and an insufficient sample size to populate those cells. Parametric methods are therefore preferable when sample sizes are limited. We make parametric assumptions that outcome y depends on circumstances C as follows:

$$y_i = C_i\psi + \varepsilon_i$$

With continuous outcomes, we can estimate this equation with ordinary least squares (OLS).

Following Ferreira and Gignoux (2008), the parametrically standardized distribution, $\left\{\hat{\tilde{y}}_i\right\}$ can then be generated by applying the estimated coefficients, $\hat{\psi}$, to mean circumstances $\bar{C}$ and adding the estimated residuals from OLS regression as follows:

$$\hat{\tilde{y}}_\iota = \bar{C}_i\hat{\psi} + \hat{\varepsilon}_i$$

After differences in circumstances have been neutralized, the inequality of the distribution $\left\{\hat{\tilde{y}}_i\right\}$ is entirely within-group inequality and can be subtracted from total inequality to get between-group inequality, as a residual, essentially replacing y_i^k with $\left\{\hat{\tilde{y}}_i\right\}$:

$$GE\left(\left\{y_i^k\right\}\right) - GE\left(\left\{\hat{\tilde{y}}_\iota\right\}\right)$$

This can provide a parametric estimate of the IOp share as:

$$\theta_r = 1 - \frac{GE\left(\left\{\hat{\tilde{y}}_i\right\}\right)}{GE\left(\left\{y_i^k\right\}\right)}$$

Partial effects for different circumstances or sets of circumstances

We are particularly interested in the roles of different circumstances, such as family background, in contributing to inequality. It is possible to isolate the effect of a particular circumstance, or set of circumstances, *J*, by estimating the counterfactual standardized distribution (Ferreira and Gignoux 2008):

$$\hat{\tilde{y}}_i^J = \bar{C}^J\hat{\psi}^J + C_i^{j\neq J}\psi^{j\neq J} + \hat{u}_i$$

where $\hat{u}_i$ is again the estimated residual from the regression.

Then inequality attributable to circumstance *J* is (Ferreira and Gignoux 2008):

$$GE\left(\left\{y_i^k\right\}\right) - GE\left(\left\{\hat{\tilde{y}}_i^J\right\}\right)$$

As is the case for overall between-group inequality, the relative contribution of circumstance *J* to total inequality, or the partial effect of *J*, can be expressed residually as:

$$\theta_r^J = 1 - \frac{GE\left(\left\{\hat{\bar{y}}_i^J\right\}\right)}{GE\left(\left\{y_i^k\right\}\right)}$$

Direct and indirect effects

An additional complication arises in disentangling effort from circumstances in empirical data. Schooling is often treated as an effort variable (World Bank 2013), or as "effort" that may be influenced by circumstances (Bourguignon, Ferreira, and Menendez 2007). Denote measured "effort" as *E*. Then if measured effort is influenced in part by circumstances, the relationship we wish to estimate becomes (Bourguignon, Ferreira, and Menendez 2007):

$$y_i = C_i\alpha + E_i\beta + \lambda_i$$
$$E_i = CH_i + \eta_i$$

Where α and β are vectors of coefficients and *H* a matrix of coefficients capturing the relationship between the different effort variables and circumstances. For the purposes of estimating inequality of opportunity, these models do not have to be estimated in full, but can be estimated in a reduced form as:

$$y_i = C_i(\alpha + \beta H) + \eta_i\beta + \lambda_i$$

which can be estimated as the earlier:

$$y_i = C_i\psi + \varepsilon_i$$

This reduced-form approach to estimating inequality of opportunity captures both the direct and indirect effects of circumstances on the outcome *y*.

5.3 Data

Sample

Our data are designed to test whether labor market outcomes are significantly affected by a person's circumstances after carefully controlling for the type and quality of human capital an individual possesses. We examine and compare higher education graduates in two countries – Egypt and Jordan. The data sets come from surveys of higher education graduates in two fields of study – commerce (business) and information technology.[1] Limiting the fields to these two

[1] The datasets are publicly available through the Economic Research Forum (ERF) Open Access Microdata Initiative (OAMDI) dataportal (OAMDI 2014a; b).

areas allows us to keep the type and quantity of human capital fairly constant. We also control for any remaining differences in human capital by exploiting a wealth of information on the educational experience of individuals both before entering university as well as during their studies. The surveys sampled only individuals who were higher education graduates, between the ages of 25 and 40, in urban areas, and who had ever worked.

The surveys were fielded in 2012. The sample sizes of the surveys were 1,710 in Egypt and 1,539 in Jordan. However, we exclude some individuals from our analyses. In Egypt, we exclude those who went on to post-graduate education (as this is additional human capital that might affect labor market outcomes). In Jordan we exclude individuals who attended higher education outside of Jordan or who were not Jordanian citizens, to account for the substantial presence of migrant workers in the Jordanian labor market. This yields a final sample of 1,616 for Egypt and 1,418 for Jordan.

Outcomes

We examine seven different outcomes: time to first job, wages in first job, wage growth, wages five years after graduation, current wages, current job quality, and a combination of current wages and current job quality. These outcomes together track the key experiences of graduates as they enter and progress through the labor market, and also allow us to account for possible tradeoffs between different outcomes. For instance, individuals may accept a job with slightly lower wages in exchange for better job quality.

Time to first job is measured in months from graduation until first employment. Individuals who immediately transition to work are treated as having a one-month transition. In the regressions, we use the natural log of time to first job. Wages in the first job are based on real wages in local currency terms, specifically Egyptian Pounds (LE) and Jordanian Dinars (JD). Wages are adjusted into real terms using each country's CPI, and are expressed as monthly earnings. For the regressions, we use the natural logarithm of wages. Annual wage growth is the annual percentage change in wages from the start of the first wage job until the current or last wage job. The annual rate of change is calculated as the natural logarithm of the ratio of the ending and starting wage divided by the time from starting wage work until the end of wage work (or current date if the individual was currently working). This is calculated only for individuals who spent at least one year in wage work. Wages five years after graduation are, like first job wages, expressed in real terms as a monthly salary. These are only available for individuals working for wages five years after graduation, regardless of whether the individual spent all that time in the labor market. If individuals were in the middle of a position five years after graduation, we use linear interpolation to calculate wages based on reported starting and final (or current) wages in the job.

Three different measures of current work are used as labor market outcomes. We look at current wages for those currently working at the time of the survey. As with the other wage outcomes, current wages are in real terms and expressed as monthly earnings. We also examine current job quality. To measure job quality, we create an index using rich information on job characteristics, benefits, responsibilities, and perceived satisfaction. The job quality variable is calculated based on a factor analysis.[2] Additionally, we consider tradeoffs between current wages and job quality. Higher education graduates are likely to engage in public sector work, which may have lower pay but substantially better job conditions and benefits. Since nonwage benefits may be traded off with wage benefits, we also create a standardized variable for current wages and combine them with the standardized current job quality index.

Characteristics: circumstances and effort

In assessing inequality, it is important to distinguish between inequality of opportunity, that is inequality related to circumstances outside of an individual's control, and inequality due to differences in the efforts individuals expend. It is, however, quite difficult to disentangle the contribution of circumstances from that of effort. We therefore distinguish between characteristics that are pure circumstances, such as parents' education, and characteristics that are likely to be a mix of circumstances and effort, such as test scores.

We consider family background, place of residence, and gender to be pure circumstance variables. Table 5.1 presents the variables we consider and their categories. The data include a rich set of pre-labor market characteristics in regards to family background. In estimating the extent of inequality of opportunity, we first model inequality under a "reduced form" specification, which includes only these pure circumstance variables, namely family background, place of residence (geography) and gender. This specification also controls for years of work experience (and its square) for current work outcomes. As others have done (Abras et al. 2013; World Bank 2013), we do not consider the contribution of work experience to inequality to be inequality of opportunity.

We also consider, in a fuller specification, a number of covariates that are likely to be a mix of circumstances and effort. We consider the characteristics of the individual's basic schooling, his or her secondary school characteristics and performance, the type of higher education and performance in it, and the educational processes the individual experienced during higher education.

[2] Details of factor analysis are available from the authors upon request.

Table 5.1 Variable categories

Category	Variables	Circumstances or Effort
Family Background	Father's Education, Mother's Education, Computer, Internet, or Magazines and Books in Home at Age 15, Father's Age at Birth (and Square) or DK, Mother's Age at Birth (and Square) or DK, Father's Employment Status	Circumstances
Gender	Female	Circumstances
Geography	Governorates (Country-specific)	Circumstances
Experience	Years of Work Experience (and Square)	Effort
Basic Schooling	Kindergarten Attendance, Primary Private and Preparatory Private (Egypt), Basic Private (Jordan)	Both Circumstances and Effort
Secondary Schooling and Performance	Secondary Private, Secondary Specialization, Frequency of Computer Use in Secondary, Age Graduated Secondary, Secondary Grade and Square, Secondary Grade DK (Egypt), and interactions between grade and specialization.	Both Circumstances and Effort
Higher Education (HE) and Performance	Private, Selective, and IT and interactions; University Grade and Square; Interactions between University Grade, Square, IT and Private; Language of Instruction	Both Circumstances and Effort
HE Process Factors	Factors[1] for Pedagogy, Accountability, and Perception of Quality	Both Circumstances and Effort

Note: [1] see Assaad, Badawy, and Krafft, 2014 for a detailed discussion of the creation of the pedagogy, accountability, and perception of quality factors.

5.4 Results

Labor market outcomes in Egypt in Jordan

Despite the homogeneity of education level and specialization in our study, we see substantial variation in the labor market outcomes of the graduates (Table 5.2). The average time to first job is seven months in Egypt (standard deviation of 14) and nine months in Jordan (standard deviation of 16).[3] In Egypt, mean wages in the first job were 1,059 LE, and annual wage growth was 7.6%, but large standard deviations are observed around both of these outcomes, as with wage after five years (mean 1,774 LE) and the current wage (mean 1,377 LE).

[3] Because this statistic includes both those who found work immediately as well as those who searched from some time, and because we focus on two specific fields of study, it varies from estimates of unemployment duration in other studies (cf. Kherfi 2015).

Table 5.2 Summary statistics for labor market outcomes in Egypt and Jordan

	Time to First Job	**Wage in First Job**	**Annual % Ch. in Wage**	**Wage after 5 years**	**Current Wage**	**Current Job Quality**	**Current Job Wage & Quality**
Egypt							
Mean	7.27	1059	7.57	1774	1377	5.43	6.92
Standard Deviation	14.34	923	20.93	1608	1017	0.99	1.54
N (Observations)	1605	1443	1175	751	1069	1135	1069
Jordan							
Mean	9.17	342	6.32	561	466	5.97	8.29
Standard Deviation	15.81	212	9.97	827	278	0.96	1.49
N (Observations)	1411	1389	1305	913	1264	1271	1264

Source: Authors' calculations based on the surveys of higher education graduates in Egypt (OAMDI 2014a) and Jordan (OAMDI 2014b).

In Jordan, where the mean wage in first job is 342 JD and wage growth is 6.3%, the standard deviations around first wages and wage growth are relatively smaller. However, the standard deviation for wage after five years (mean 561 JD) is relatively larger than in Egypt, although current wages (mean 465 JD) have less dispersion.

Overall inequality and explained inequality

An important initial dimension of assessing inequality of opportunity is estimating the extent of overall inequality in different outcomes. Table 5.3 shows the measures of inequality and their bootstrapped standard errors for each of the outcomes in Egypt and Jordan. It is important to keep in mind that, while comparisons across countries for the same outcome are valid, comparisons across different types of outcomes cannot be readily made. For instance, current job quality is a standardized factor variable and will thus have a very different distribution than time to first job, which has a large mass among those who immediately find a job and then a long right tail. Inequality in the different measures of wages (first, five year, and current) can be compared, although different age distributions and differential selection over time must be kept in mind.

Egypt tends to have more inequality overall than Jordan, with the exception of inequality in time to first job, which is quite similar in Egypt and Jordan. Overall inequality in first job wages is more than twice as large in Egypt as in Jordan, and a similar pattern is observed for current wages. Inequality in wage growth is also higher in Egypt than in Jordan. Wages after five years have more inequality in Egypt than in Jordan, a greater level of wage inequality than in the first job, although the inequality gap between Egypt and Jordan has decreased somewhat after five years. Additionally, Egypt has greater inequality in job quality than Jordan, and likewise in the combined current job wages and quality. The fact that overall inequality is higher in Egypt must be kept in mind when interpreting the IOp shares discussed below. Similar IOp shares will mean greater absolute inequality is due to IOp in Egypt than in Jordan.

Even for individuals with considerable similarities in their level and type of education, we find that there is substantial inequality of opportunity in labor market outcomes, particularly in the long run. Keeping in mind the restricted universe of our analysis may yield different results, as benchmarks we note that previous estimates of the IOp share for wages in Egypt have fallen in the 15–22% range (Hassine 2011). In six countries in Latin America estimates of the IOp share fell in the 13–34% range across countries (Ferreira and Gignoux 2011). A recent estimate of the IOp share in earnings in the United States is around 18% (Pistolesi 2009) and that for income in Italy is around 20% (Checchi and Peragine 2010).

Table 5.3 Overall inequality in labor market outcomes in Egypt and Jordan

	Time to First Job	Wage in First Job	Annual % Ch. in Wage	Wage after 5 years	Current Wage	Current Job Quality	Current Job Wage & Quality
Egypt	1.147	0.246	3.815	0.346	0.230	0.0182	0.0239
	(0.0279)	(0.0135)	(0.876)	(0.0187)	(0.0118)	(0.000903)	(0.00126)
Jordan	1.158	0.0974	1.251	0.255	0.0987	0.0138	0.0150
	(0.0247)	(0.00952)	(0.0908)	(0.0404)	(0.00857)	(0.000619)	(0.00101)

Source: Authors' calculations based on the surveys of higher education graduates in Egypt (OAMDI 2014a) and Jordan (OAMDI 2014b).
Notes: Bootstrapped standard errors in parentheses.

Figure 5.1 presents explained or between-group inequality as a share of total inequality for Egypt and Jordan and for both the reduced form specification and the full specification.[4] The reduced form specification can be interpreted as providing a measure inequality of opportunity, the IOp share, while the full specification incorporates variables that are a mix of circumstances and efforts. Experience is controlled for in the current job outcomes in both specifications, but is not considered part of explained inequality.

The IOp share is moderate for time to first job, from 11–15%. Explained inequality increases somewhat from the reduced to full specification, i.e. with the inclusion of basic, secondary, and higher education variables, including test scores. Looking at wages in the first job, in Egypt under the reduced form specification, 16.1% of inequality in wages in the first job is inequality of opportunity, while in Jordan it is lower at 12.1%. The full specification produces somewhat higher shares, 21.7% of all inequality explained in Egypt and 19.2% in Jordan.

There is very limited explicable inequality in annual wage growth, either with the reduced form or full specifications. Explained inequality is in fact statistically insignificant for both specifications in Egypt, and is the only outcome for which this is the case. Explained inequality in wage growth is statistically significant, although small in Jordan, at 6.2% in the reduced specification and 9.8% in the full specification. Although the explained inequality in wage growth is modest, if the advantages conferred by circumstances in the first job are similar to the advantages in wage growth, this will compound inequality as individuals spend more time in the labor market.

Explained inequality is quite high for wages five years after graduation, substantially more so than for wages in the first job. This means that the contribution of circumstances to inequality increases rather than decreases over time. In Egypt under the reduced form specification, circumstances explain 29.2% of inequality in wages five years after graduation. Almost a third of inequality in wages five years after graduation is inequality of opportunity in Egypt. In Jordan, the IOp share is lower at 17.9%. The shares of explained inequality rise somewhat, 4–6 percentage points, with the full specification, which includes measured efforts that potentially mediate some of the effect of circumstances as well. The contributions of (measured) effort pale in comparison to those of circumstances.

Inequality of opportunity in current wages is fairly similar in Egypt and Jordan. Explained inequality is 15–17% under the reduced specification and 23–26% under the full specification for both countries. That current wages have similar IOp shares in these countries while wages in the first job and

[4] The exact quantities underlying this information are available from the authors upon request.

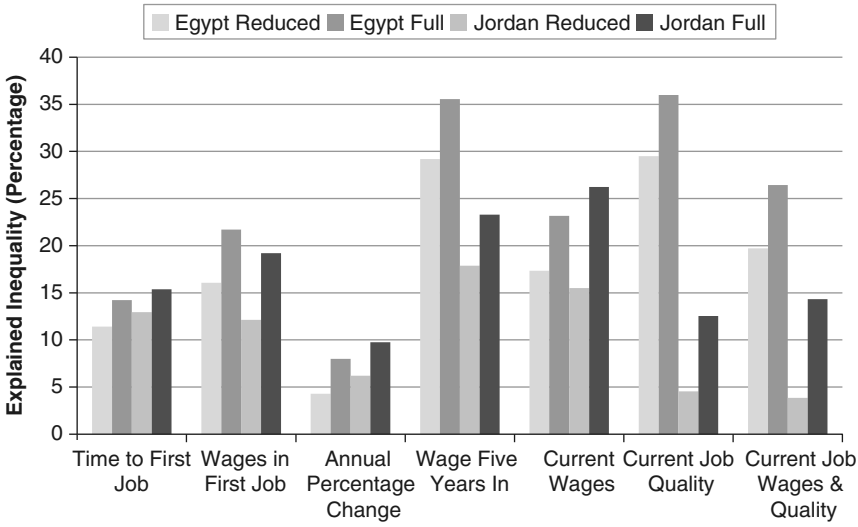

Figure 5.1 Explained inequality as a share of total inequality (percentage)
Source: Authors' calculations based on the surveys of higher education graduates in Egypt (OAMDI 2014a) and Jordan (OAMDI 2014b).

wages after five years exhibit higher IOp shares in Egypt is due to the fact that, on average, the sample in Egypt has been in the labor market for a shorter time than the sample in Jordan, so current wages represent different points along individuals' long-term labor market trajectories.

IOp shares of current job quality are relatively large in Egypt, but not in Jordan. In Egypt, 29.5% of the inequality in job quality is inequality of opportunity under the reduced form specification, while in Jordan it is just 4.5%. Explained inequality shares rise to 36.0% (Egypt) and 12.5% (Jordan) with the addition of the variables in the full specification. In Egypt, job quality is substantially determined by circumstances, but in Jordan, circumstances matter only a little. Similarly, the variable that combines standardized current job wages and current job quality in equal shares shows a substantially higher share of explained inequality in Egypt (19.7%) than in Jordan (3.8%) under the reduced form specification, rising to 26.4% (Egypt) and 14.3% (Jordan) under the full specification.

One important finding about explained inequality is the fact that inequality of opportunity (explained inequality in the reduced specification) dominates explained inequality as measured in the full specification. This means that inequality related to (measured) effort, as well as the indirect contributions of additional, unobserved circumstances through educational experiences, play only a small role in unequal rewards in the labor market. Overall, the inclusion

of effort, such as test scores, educational experiences and remaining differences in human capital usually explains only a small share of inequality for most outcomes, in comparison to that explained by circumstances alone.

What specific circumstances contribute to inequality?

In this section we examine the contribution of specific sets of circumstances to total inequality. Figure 5.2 and Figure 5.3 show the shares attributable to different sets of circumstances for the seven labor market outcomes.[5] The figures specifically examine the shares of inequality attributable to family background, gender, and geographic differences in the reduced and full specifications. Although we know that adding measurable effort and controls for any remaining differences in human capital tends to only slightly increase explained inequality, it could be the case that effort and additional human capital play a substantial mediating role in inequality of opportunity. If this were the case, we would expect to see the shares of explained inequality related to circumstances drop substantially once measured efforts and differences in human capital were included. This is not the case; circumstances continue to make large, direct contributions to explained inequality in the full specification.

Looking first at time to first job, the contribution of circumstances remains essentially constant comparing the reduced and full specifications, meaning that circumstances directly affect time to first job. Gender makes the largest contributions to inequality in the time to first job (explaining around 7% of total inequality) in both Egypt and Jordan, in both the reduced and full specifications. This is consistent with educated females experiencing higher rates and longer durations of unemployment in both countries (Assaad and Krafft 2015a; Mryyan 2014). Geographic differences and family background also contribute to overall inequality in time to first job, although geographic differences are statistically insignificant in Egypt. The contributions of family background are similar in both countries, but geographic differences contribute to a greater extent in Jordan. In Egypt in the full specification, secondary characteristics and performance make a small contribution, which is statistically significant (not shown in the figure).

Looking at the decomposition results for wages in the first job in the reduced specification in Egypt, we can see that gender contributes the largest share (8.3% of all inequality), followed by family circumstances (4.6% of all inequality) and geographic differences (3.6% of inequality). All are statistically significant and remain of similar magnitude in the full specification. In Jordan family circumstances make the greatest contribution to inequality in first job wages, 5.5% of all inequality, in the reduced form specification, but this contribution is not statistically significant. Only the contribution of gender

[5] The exact quantities underlying these figures are available from the authors upon request.

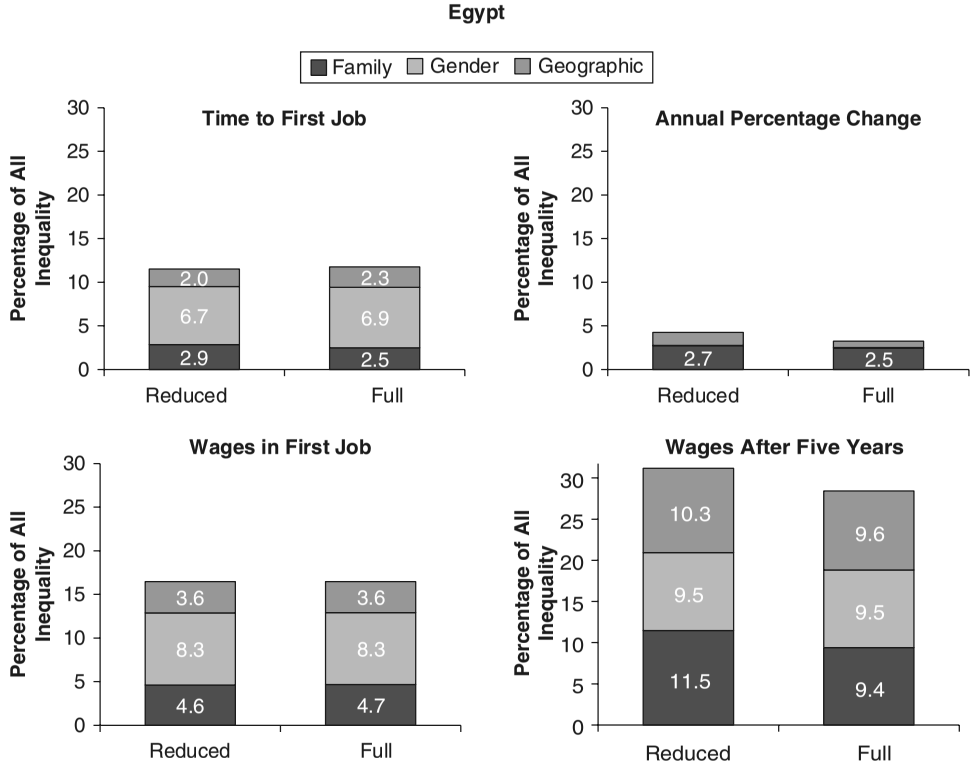

Figure 5.2 Shares of inequality attributable to different characteristics, by labor market outcome and characteristic, Egypt and Jordan

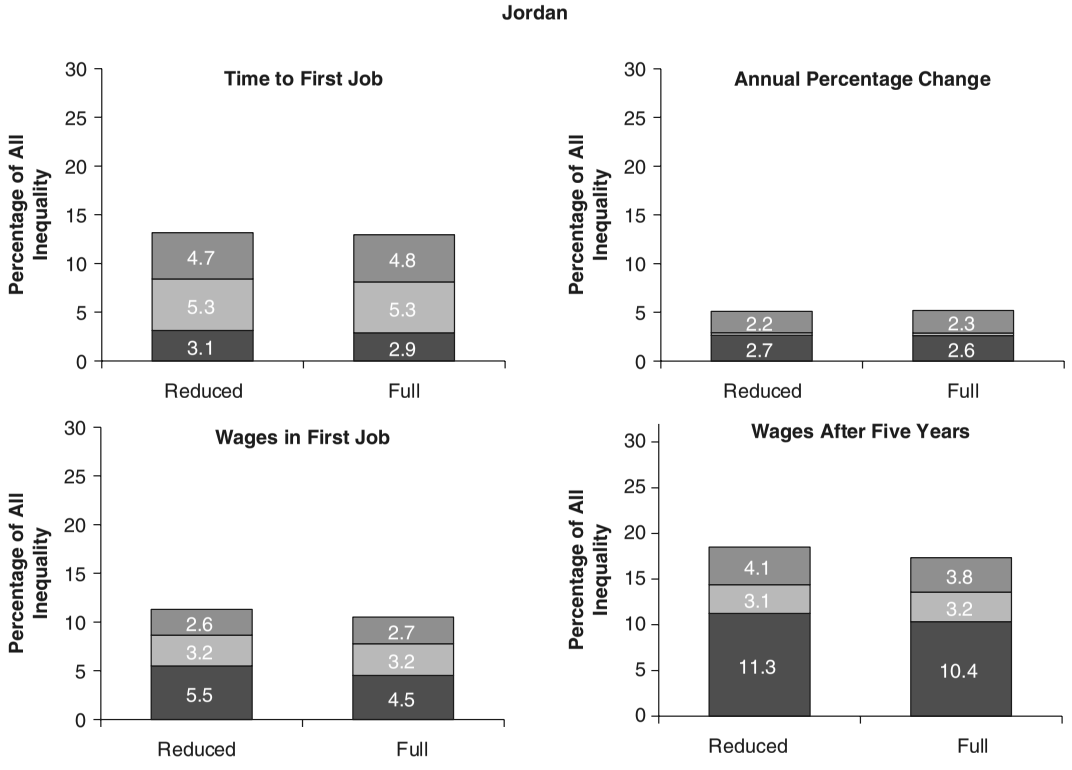

Figure 5.2 Continued

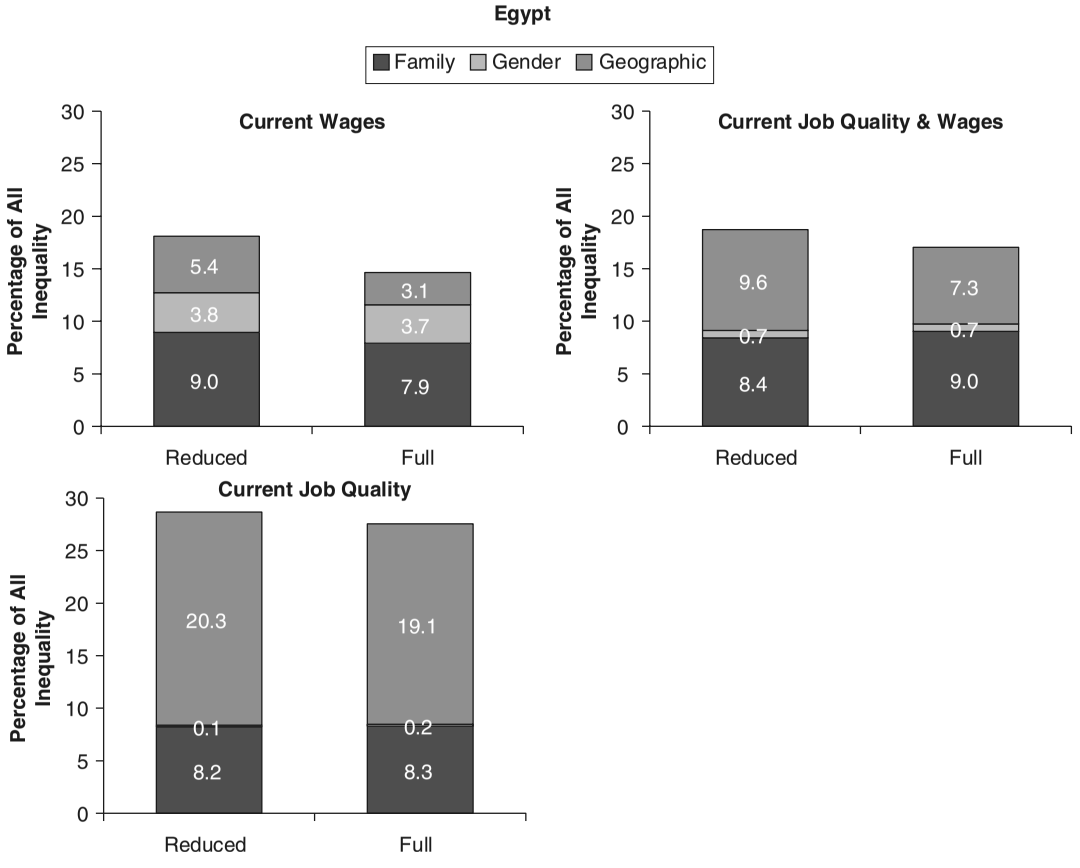

Figure 5.3 Shares of inequality attributable to different characteristics, by current labor market outcome and characteristic, Egypt and Jordan

Source: Authors' calculations based on the surveys of higher education graduates in Egypt (OAMDI 2014a) and Jordan (OAMDI 2014b)

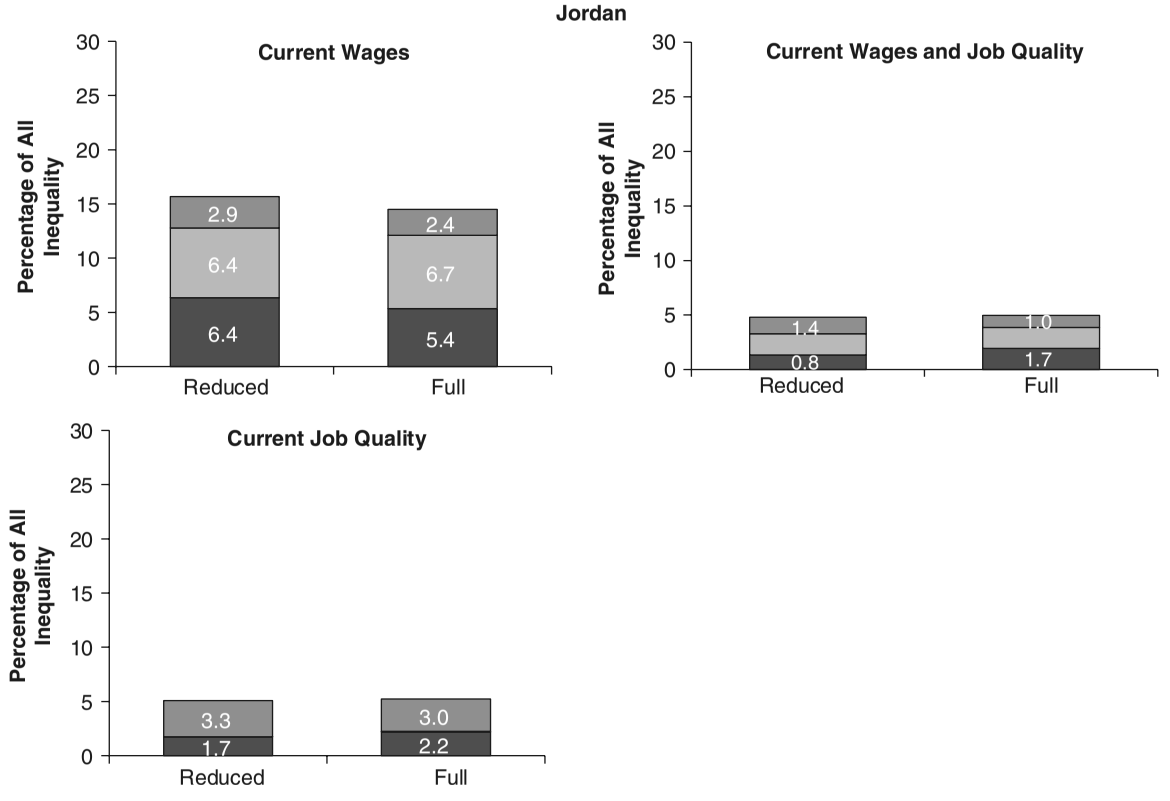

Figure 5.3 Continued

(3.2% of all inequality) is statistically significant in the reduced form specification for Jordan. Shares remain similar, although the contribution of family background is slightly reduced, in the full specification for Jordan. In Jordan in the full specification, the greatest contributor to explained inequality in first job wages is secondary school characteristics and performance, contributing a significant 6.6% to total inequality (not shown in the figure). In Egypt the equivalent share for the contributions of secondary characteristics and performance is 3.7%. The comparison between the contributions of secondary school experience and performance in Egypt and Jordan is telling; (measured) effort contributes nearly twice as much to first job wage inequality in Jordan than in Egypt.

In Egypt, no specific set of circumstances contributes in a statistically significant manner to the inequality in the annual percentage change in wages, although family background has a share of around 3%. For this particular outcome, the effects of all the circumstances (and measured effort variables) are not jointly statistically significant in Egypt in either the reduced form or full specifications. In Jordan, family background and geographic differences contribute significantly to inequality in wage growth, but not gender. Secondary school characteristics and performance also contribute significantly to wage growth in the full specification, explaining around 3% of inequality in wage growth, a similar share to the contribution of family circumstances.

Inequality of wages after five years is strongly explained by family background. In Egypt under the reduced form specification, 11.5% of that inequality is attributable to family background. This drops to 9.6% in the full specification, suggesting that a moderate share of the effect of family background is mediated through schooling variables. In Jordan, 11.3% of inequality in wages after five years is attributable to family background in the reduced form specification, dropping to 10.4% in the full specification. In Egypt, gender also contributes substantially (9.5%) to wage inequality after five years, as do geographic differences (10%). The contributions of gender and geography are smaller in Jordan (3% for gender, 4% for geography). In the full specification, none of the added categories of variables significantly contribute to wage inequality after five years in Jordan, although 5.0% of the inequality is explained by secondary school performance and experiences. In Egypt, the type of higher education and higher education performance contribute a significant 5.1% share of the inequality in wages after five years. All the circumstance variables are significant in both Egypt and Jordan. Comparing the contributions of family background to those of measured effort and considering their relative statistical significance, we can conclude that circumstances continue to have a much larger effect on the dispersion of wages after five years than does measured effort.

Moving to current wages, we see that family circumstances make the greatest contribution to inequality in Egypt, 9.0% in the reduced form specification and

7.9% on the full specification. Gender contributes around 4% in both specifications, and geographic differences 5.4% in the reduced form specification, falling to 3.1% in the full specification. In Jordan, family circumstances contribute 6.4% to inequality of current wages, falling to 5.4% in the full specification. Gender contributes 6–7%, and geographic differences 2–3%. In both countries all circumstances are statistically significant in the reduced form specification, although geography is not in the full specification for Egypt. Only for Jordan is secondary school performance and experience significant, contributing 8.5% to current wage inequality, along with a statistically insignificant 4.6% attributable to higher education experiences and performance. For current wages, the comparison between Egypt and Jordan is particularly notable; while both have substantial contributions from family background, in Jordan there are also contributions from secondary and higher education experiences and performance, which may partially represent effort.

The contribution of circumstances to current job quality shows very different patterns in Egypt and Jordan. In Egypt, family background contributes around 8% of the inequality in current job quality and geographic differences contribute around 20%. Both are statistically significant, but gender is not. In Jordan, only geographic differences are significant, explaining 3% of differences in job quality. In the full specification, in Jordan, secondary school experience and performance and higher education experience and performance are also statistically significant contributors to inequality in current job quality, explaining 3.0% (secondary) and 4.3% (higher education) of total inequality. In Egypt secondary school experience and performance is not a significant contributor, but basic education is. Higher education experiences and performance are significant contributors to job quality as well in Egypt, contributing 6.2% of inequality. Higher education factors (pedagogy, accountability, and perceptions of quality) also contribute significantly (5.9%) to inequality of job quality in Egypt.

In the combined current wages and current job quality outcome, in Egypt, both geographic differences and family background contribute substantially and significantly to inequality (8–9%). In Jordan, in the reduced specification, only gender contributes significantly (1.7%) to inequality. In the full specification in Jordan, secondary and higher education characteristics and performance are also significant contributors, accounting for 6.4% (secondary) and 4.5% (higher education) of the inequality of combined wages and job quality. In Egypt, basic and secondary education characteristics, and both measures of higher education, are also significant contributors to the inequality of this combined measure. Basic education contributes 3.2% of inequality, secondary education 3.5%, higher education type and performance 5.2%, and higher education processes 4.5%.

Over all the outcomes, the common pattern that persists is that the direct contributions of circumstances dominate, the indirect contributions are small, and measured effort matters more for Jordan than for Egypt.

5.5 Discussion and conclusions

There is substantial inequality of opportunity in the labor markets in Egypt and Jordan. This is the case even after accounting for pre-market inequality, by comparing individuals with the same level and type of education. The direct effects of circumstances outside of an individual's control are large, and their indirect effects, mediated through mixed circumstance/effort variables, are small. The labor market itself is therefore a substantial source of inequality of opportunity, over and above the inequality of opportunity caused by access to different levels and kinds of education. Family background, gender, and geographic differences all contributed significantly and substantially to labor market outcomes in both Egypt and Jordan, after accounting for level, type and performance at various levels of education.

Institutional features of the labor market, especially segmentation on socio-economic, kinship and gender lines (Assaad and Krafft 2015b, 2014; Assaad 1997, 2014a; Barsoum 2004), are likely to be contributing to the substantial inequality of opportunity. A legacy of dualism in Arab labor markets (Assaad 2014b), with the formal public sector offering substantially better overall benefits than the largely informal private sector may also play an important role in inequality of opportunity. Circumstances may play an important role in individuals' access to public sector jobs, and especially to good jobs within the private sector, particularly in Egypt (Assaad and Krafft 2015b, 2014; Assaad 2014a). That Jordan has had greater success in generating formal private sector jobs than Egypt (Assaad and Krafft 2015b; Assaad 2014a) may have contributed to the lower degree of inequality of opportunity observed in Jordan, particularly for job quality. Although we cannot test trends over time directly with our data, the policy shift from state-led to private sector-led growth appears, in other work (Assaad and Krafft 2014), to have exacerbated inequality of opportunity in the labor market in Egypt and this has likely contributed to the social frustrations behind the uprisings in 2011.

Overall, Egypt is found to have more inequality as well as greater inequality of opportunity in the labor market than Jordan. The stronger role of social networks and connections in the job search processes of graduates in Egypt may contribute to this pattern (Assaad, Krafft, and Salehi-Isfahani 2014). Additionally, in Jordan, measured effort, as captured by type of education and educational performance, contributes more to the inequality of labor market outcomes than in Egypt. It could be the case that exams in Jordan better measure efforts, underlying ability or future productivity than exams in Egypt. Alternatively, if the countries' examination systems provide equivalent measures of effort, underlying ability and future productivity, it may be the case that the Jordanian labor market rewards these features more than the Egyptian labor market.

It is important to note that despite having a rich set of background characteristics, the inequality of opportunity that we measure is still likely to be a lower bound on true inequality of opportunity, due to additional unobserved or unobservable circumstances, including social networks, parental values for work and education, or additional family circumstances such as income and wealth. In Egypt, we observe that almost a third of inequality in long-run wages can be explained by circumstances. If this is a lower bound on inequality of opportunity, perhaps half of the observed inequality in wages is in fact attributable to inequality of opportunity.

These high levels of inequality of opportunity are concerning for a number of reasons. We have shown that there is inequality of opportunity not just premarket, but in-market, which represents discrimination, segmentation, and unequal rewards to the same human capital. These problems represent a serious deviation from social justice in the labor market. Although the restriction of our sample makes exact comparisons challenging, our estimates of inequality of opportunity show moderate to high inequality of opportunity relative to past estimates and other countries (Checchi and Peragine 2010; Ferreira and Gignoux 2011; Hassine 2011; Pistolesi 2009) particularly for long-run outcomes and in Egypt. They also represent a substantial dysfunction in the key purpose of the labor market – efficiently allocating and rewarding human capital, effort, and abilities. The incentives to accumulate skills and exert effort are substantially reduced in the face of such unequal rewards, creating economy-wide losses due to inequality of opportunity. Substantial reforms of the labor market will be required to improve its functioning so as to reduce the influence of nepotism, imperfect information, and segmentation, and promote rewards based on human capital and effort.

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6
Energy Subsidy Reform in Iran

Djavad Salehi-Isfahani[1]

6.1 Introduction

On December 19, 2010, Iran embarked on an ambitious reform of its extensive subsidies. Energy prices that had been kept well below international levels for decades were raised by a factor of 3 to 9 and bread prices were doubled. Energy price reform had been discussed for at least a decade, and the specific plan for this particular reform program was announced by president Ahmadinejad in 2008 and enacted into law in January 2010. This attempt at reform ended a huge government subsidy, estimated at upwards of $70 billion per year, or nearly $1000 per person per year. It was distributed highly unequally and caused Iran's productive sectors to become the least efficient in the world (Guillaume et al 2011, IEA 2010, Salehi-Isfahani et al 2012).

Unlike reforms in other countries, Iran's massive price reform went smoothly, without the type of social unrest that had plagued such reforms in other developing countries. However the initial success of the reform in getting underway and being able to maintain the initial price increases proved temporary. In the last three years since the reform, energy prices have remained fixed, declining in real terms by over 60%. Iran's experiment in energy price reform has important lessons for other MENA countries that currently subsidize energy and are contemplating price reform. This chapter explains the essential features of Iran's reform, offers an evaluation of its performance, and suggests reasons why it has faltered.

[1] The research for this policy brief was supported by a grant from the ERF RIAD initiative. I am grateful to the Statistical Center of Iran for the survey data. This paper first appeared as ERF Policy Perspective No. 13, 2014.

6.2 Why the reform?

At the outset, it is important to understand that Iran's energy subsidy reform was not prompted by dire budgetary needs, as is the case with most developing countries. Governments in these countries undertake politically difficult subsidy reform because they are not able to pay for them.

In Iran, the bulk of the subsidy for energy products is foregone government earnings because the government is the main producer and supplier of energy. As a result, reform is postponed and subsidies accumulate until their sheer inefficiency and inequity prompt the government to take action. Energy subsidies pollute; they encourage energy and capital-intensive technologies, and most of their benefits go to the rich.

The government of Iran delivers more than 4 million oil-equivalent barrels of energy (gasoline, natural gas, and electricity) each day to consumers inside the country. The total value of this energy in the global market is more than $100 billion, but even after the price increases of 2011 the government reports less than $10 billion in profits. Given the great need for public investment and expenditures on social programs the budgetary pressures to end energy subsidies are considerable, even for a net energy-exporting country like Iran. But these pressures are nothing like having to borrow internationally, to tax, or to print money to pay for the subsidy. So as a result energy subsidies are larger and last longer in countries that are net energy exporters than in net importing countries.

Neither budgetary pressures nor economic efficiency was high on president Ahmadinejad's mind when he started his push for energy subsidy reform. Significantly, the discussion to end energy subsidies started in earnest in Iran around 2007 when oil revenues were at their height. The fact that cheap energy had rendered the air in Iran's major cities unbreathable, or that during the past two decades Iran had doubled the amount of energy it used per $1 of GDP while the rest of the world was cutting theirs, were not the reasons why the government decided to act (Salehi-Isfahani et al. 2012). President Ahmadinejad was looking for ways to redistribute income and replacing energy subsidies with cash transfers seemed the most effective way to do it.

6.3 Political economy

Given that energy subsidies are hugely inefficient, in principle, their elimination should garner wide social support. Furthermore, because they disproportionately benefit higher income groups who use more energy, one would expect the poor to be more supportive of energy price reforms. But, because the poor spend a larger proportion of their incomes on energy than the rich, and have less room to maneuver when energy prices go up, they are more apprehensive

and therefore more likely to resist them. As a result, peaceful implementation of energy subsidy reform depends heavily on a credible compensation mechanism that assures the poor that they will not lose in the bargain.

In Figure 6.1, data from the Household Expenditure and Income Survey (HEIS) for 2009/2010 (March 20, 2009 to March 20, 2010) show the inequality of benefits from energy subsidies as well as the higher share of energy in poor people's consumption. The shaded areas are expenditures per person per year on various energy products and bread by decile of per capita expenditures, measured in Purchasing Power Parity (PPP) dollars (left axis). Assuming that the subsidies that directly accrue to households (as distinct from the indirect benefits from, say, lower transportation costs) are proportional to expenditures the shaded areas are proportional to the subsidies received. (Since some energy prices are non-linear they may be less than proportional.) These curves show that the individuals in the top decile, who spent on average $350 per year on these subsidized products, received in total subsidies 2.5 times as much as a person in the bottom decile, who spent less than $150 on average. Gasoline was the most regressive subsidy, with the richest benefitting about 15 times as much as the poor, while the bread subsidy was virtually uniformly distributed.

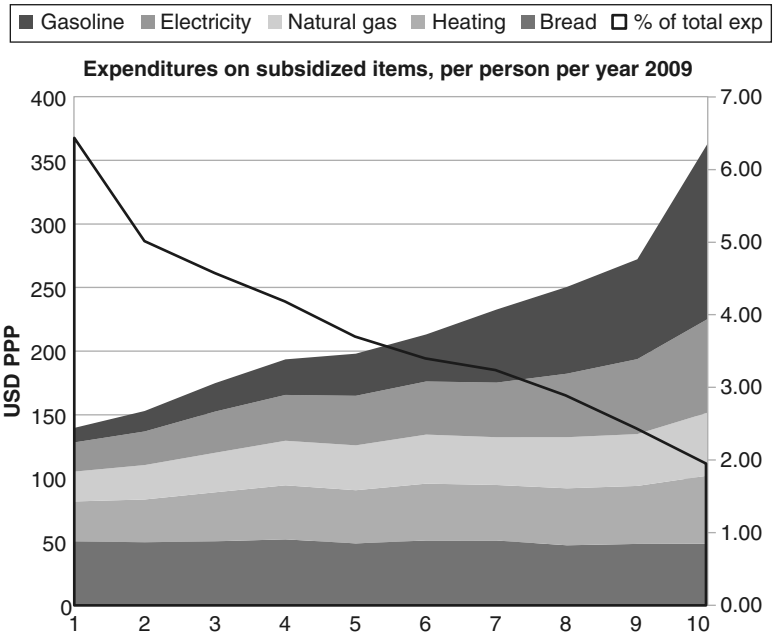

Figure 6.1 Expenditures per person per year on subsidized goods and their share in total expenditures (by decile of per capita expenditures, 2009/2010)

Source: Author's calculation using data from the Household Expenditure and Income Survey (HEIS) (2009/2010, Iranian year 1388), Statistical Center of Iran.

The right axis shows that expenditures on these products accounted for more than 6% of the budget of a person in the bottom decile compared to 2% for a person in the top decile. Assuming linear prices, subsidies were three times as important for the poor than the rich. Given the poor's greater reliance on energy subsidies and their much lower ability to cut other expenditures, a three-fold increase in prices without compensation would have throws millions into deep poverty. Peaceful implementation of the reform thus called for a scheme that compensated them for the price increases.

Iran's subsidy reform program both benefitted from and was harmed by the fact that its champion was a populist president, Mahmoud Ahmadinejad, who had considerable credibility among the poor but was also more keen on redistribution than price reform (Salehi-Isfahani 2009). Trust in his desire to redistribute helped calm the poor regarding the consequences of the program for their wallets. Such fears were further allayed by allowing cash transfers to sit in people's accounts for weeks before simultaneously raising energy prices and allowing them to withdraw the money.

The downside of Ahmadinejad's redistributive view of the reform was that the cash payments were set too high and exceeded by about one-third what the government was able to recoup from higher prices. To make matters worse, the program's deficit was financed by printing money, which fueled inflation and alienated large sections of the population, in particular the salaried middle class. In an attempt to maximize its redistributive impact, Mr. Ahmadinejad had undermined his own signature reform.

Another controversial decision was to increase prices in one step instead of gradually. Gradual increases soften the shock and are usually preferred, but only if they can be maintained over several years so prices can catch up with their intended targets. In Iran, the experience with gradual increases had not been encouraging as the government and the parliament had not seemed capable of committing to increases beyond one year. Small increases in one year were rarely followed by increases the next year as the powerful lobbies of energy-using industries (such as petrochemicals and the auto industry) found ways to push to postpone further increases. This experience, in addition to Mr. Ahmadinejad's eagerness to generate revenue for redistribution, provided the impetus for shock therapy.

6.4 The program

Except for gasoline, the actual size of the energy price increases are difficult to estimate because for natural gas, electricity, and water the rates increase with usage. There were also price variations to allow for differences in climate across the country. Gasoline had a two-tier price to begin with, 1000 rials per liter for rationed and 4000 rials per liter for free market gasoline; these were increased

to 4000 and 7000 rials respectively. At the time, in 2010, the adjusted free market price was about $0.70 per liter, close to its border price. In 2014, with the rial worth about one-third of its previous value, gasoline was being sold at about $0.25 per liter, far below its border price. The price of gasoil, which had the highest subsidy, was set to increase by 22 times, but protests from truckers forced the government to keep the increase to nine-fold.

Initially, the government had a more ambitious redistributive goal, to pay cash transfers to the lower deciles only. Failing to come up with a dependable method to identify the poor, the government decided to pay everyone the same amount – 455,000 rials per month. Several months before the program was to take effect, households were asked to open a bank account for the household head and document the number of household members. Funds were electronically deposited into these accounts but could not be withdrawn. On December 19, 2010, when prices were increased, the funds became simultaneously available. In the political environment of Iran in which people do not trust the government to keep its words, the early deposits helped assure most households of compensation.

According to the government, during the first four months of the program, about 62 million people (about 82% of the total population) started to receive cash transfers. This number increased quickly to cover about 95% of the population. Survey data indicates that coverage in rural areas where banks are less accessible was actually higher than in urban areas (Salehi-Isfahani et al. 2012).

6.5 Impact

Iran's subsidy reform program has come under criticism for a number of subsequent economic ills, many of which may have had other causes. A rigorous analysis of the causal impact of the reform package on any number of outcomes, such as inflation and unemployment, requires the construction of good counterfactuals that can help distinguish the impact of the subsidy program from other causes, in particular international sanctions. Sanctions tightened considerably in the months following the subsidy reform, culminating with the US decision in December 2011 to restrict Iran's oil exports and cut it off from the international financial markets.

A quick review of the evidence on inflation shows that not all the subsequent inflation can be attributed to the subsidy reform program, and survey data suggests that poverty and inequality improved in the two years after the reform,.

Inflation

Iran experienced unprecedented levels of inflation during 2011–2013, only part of which was due to the subsidy reform. There were two sources of inflation both entailing the growth of money supply. One source is change

in relative prices caused by energy price increases and currency devaluation, both of which were accommodated by growth in money supply. The second source is government deficit arising from a general lack of fiscal discipline of the Ahmadinejad administration. The deficits in the subsidy reform program and a low-income housing program (*Maskan Mehr*) were financed by printing money.[2]

Figure 6.2, which plots the path of inflation over the last four years by month, demonstrates that the spurts of high inflation due to relative price shocks, each lasting a few months, were followed by a drop in the rate of inflation. The first spurt is caused by the sharp increase in energy prices, which in three months elevated the rate of inflation to 40% per annum. The timing of the next two surges in prices is clearly related to sanctions that restricted Iran's

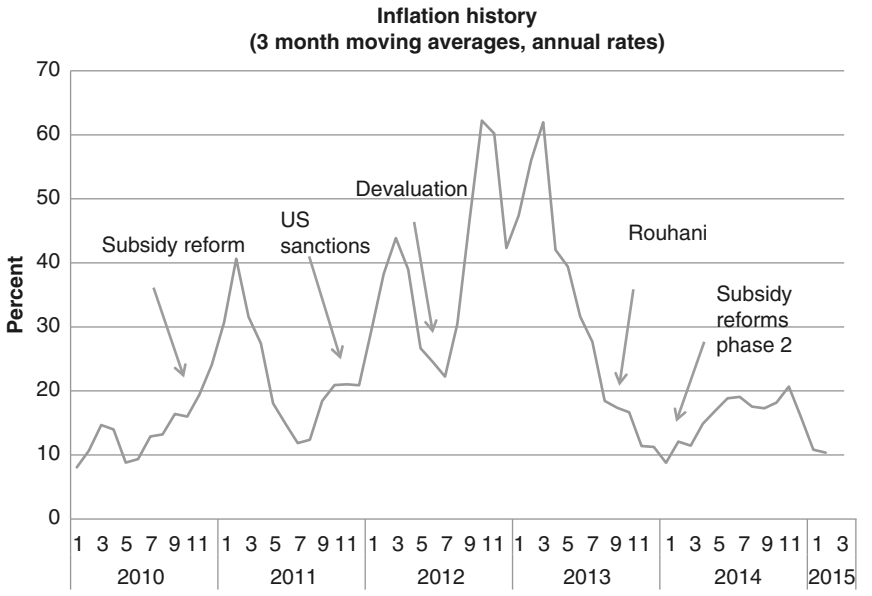

Figure 6.2 Inflation rate, 2009–13 (percentage increase by month)
Source: Author's calculations based on monthly CPI reports of the Central Bank of Iran, http://www.cbi.ir.

[2] The deficit due to the subsidy reform program has been around 1–2% of GDP. In 1391 (2012/2013), the program earned 302.8 trillion rials and spent 413.2 trillion on cash transfers, leaving it with a deficit of 111.6, which is about 1.1% of GDP (Farzin 2014). According to the Minister of Housing, Maskan Mehr has cost the government 500 trillion rials, which is nearly twice the deficit of the subsidy reform in the last three years (http://www.donya-e-eqtesad.com/news/785310/).

oil supply and reduced government revenues by one-third, and to the collapse of Iran's currency, the rial, in late September 2012. Inflation picked up in pace each time before declining. From this graph it appears that once the relative price shocks were absorbed, inflation settled down to its chronic rate of about 15–20 percent, which was the average for the last two decades.

The election of the moderate president Rouhani on June 2013 raised hopes that inflation will continue its recent downward trend, as shown in Figure 6.2. With fears of high inflation abating, the government is paving the way for resuming energy price reforms in 2014/2015, though at a gradual pace and without additional compensation.

Poverty and inequality

In 2011, before inflation and devaluation had eroded the value of cash transfers, they were significant sums for poor households, especially those with many members. The average family of four could count on 1,820,000 rials per month ($364 PPP), which was about 60% of the minimum wage, 28% of the median per capita expenditures, and greater than the monthly expenditure of 2.8 million Iranians. Poor families' energy expenditure increased by less than the value of the cash transfers, so the program as a whole reduced poverty and improved inequality.

Table 6.1 provides evidence about the change in poverty from surveys taken after the reform. According to both the Headcount Ratio and the Poverty Gap Index, during 2009–12 poverty declined significantly. For the purpose of

Table 6.1 Poverty rates [by year and region (percent)]

Year	Headcount ratio				Poverty gap			
	Rural	Urban	Tehran	Total	Rural	Urban	Tehran	Total
2009	13.4	9.8	6.2	10.2	4	2.6	1.3	2.8
2010	10.3	7.2	5.6	7.8	2.9	1.8	1.1	2
2011	6.3	5.2	2.8	5.2	1.5	1.1	0.7	1.2
2012	5	5.4	4.4	5.1	1	1.1	0.8	1

Source: Author's calculations using data files from Household Expenditures and Incomes Surveys, the Statistical Center of Iran, various years.
Note: Headcount ratios are the percentage of individuals below the poverty line and the Poverty Gap Index is the average of poverty gaps as a percentage of the poverty line. The poverty line is set at 36,520 rials per person per day ($5 at the PPP exchange rate of 7,403 rials per dollar in 2012); to adjust for differences in the cost of living, it is lowered by one-third for rural areas and raised by one-third for Tehran. Incomes and expenditures are in constant 2012 rials using the Consumer Price Index of the Central Bank of Iran.

illustration, I set the poverty line at $5 per person per day in 2012 international dollars (see also the note for Table 6.1). The program registers a more significant decline in poverty when measured by the Poverty Gap Index, because this index is sensitive to the extent of the shortfall of the income of the poor compared to the poverty line, and not just the number of individuals whose income falls short. This index captures the fact that Iran's cash transfer program was able to reach the poorest individuals on whom the transfers had the greatest impact.

The Gap Index was four times lower in rural areas where poverty incidence is higher. Such a sharp decline in poverty at a time when Iran's economy was contracting under the weight of international sanctions and domestic economic mismanagement is difficult to explain without resort to the cash transfer program. In the absence of the subsidy reform and cash transfers, poverty would have surely increased as the economic crisis deepened after 2009.

The impact of cash transfers on the poor is also evident from a comparison of the growth of real per capita expenditure (PCE) between the poor and the rich during 2009–12,when the economy stagnated,. In 2012, the median PCE was about the same as in 2009, while PCE for the 10th percentile was 30% higher, while it was 7% lower for the 90th percentile.

Evidence on improvement in inequality is equally strong. Table 6.2 shows three indicators of inequity of expenditure and income all falling significantly, starting in 2011, the full year of the implementation of the reform. The decline in the General Entropy Index GE(–1), which is more sensitive to inequality in the lower part of the distribution, shows the largest decline for both income and expenditure, indicating the importance of the cash transfer for lower income individuals.

Table 6.2 Inequality of per capita expenditures and incomes, 2009–12

Year	Per capita expenditures			Per capita income		
	GE(–1)	GE(1)	Gini	GE(–1)	GE(1)	Gini
2009	0.432	0.313	0.421	0.47	0.306	0.414
2010	0.404	0.312	0.415	0.443	0.31	0.414
2011	0.309	0.262	0.382	0.284	0.239	0.367
2012	0.281	0.254	0.375	0.272	0.262	0.367

Source: Author's calculations using Household Expenditures and Incomes Surveys, Statistical Center of Iran.
Note: Inequality measures are based on the distributions of expenditures and incomes of individuals, calculated by dividing household net incomes and gross expenditures by household size.

6.6 The reform stalled

Although initially the law had goals to raise energy prices to their border levels, once the economy went into the tailspin with inflation and devaluation, the parliament and popular sentiment prevented further price increases. So, in practice, prices remained fixed at their values of December 19, 2010. As other prices rose, energy prices declined in relative terms and once again energy was the least expensive item in the households' basket.

In the years since the start of the reform, the Ahmadinejad administration proved to be its worst enemy. Instead of finding a way to plug the hole in the finances of this program and its other populist programs, the government continued with its reckless policy of inflationary finance. Instead of seeking parliament's approval for further prices that would bring revenues from the subsidy reform program closer to its outlays, President Ahmadinejad promised to increase cash transfers "five times". His evident lack of understanding of basic macroeconomics convinced many of his own supporters in the parliament that it would not be wise to allow further price increases. The populist president's desire for quick redistribution, which was the initial power behind the ambitious price reform, caused its undoing.

Iran's subsidy reform program is not dead by any means. After months of hesitation, the new government of president Rouhani has implemented another round of energy price increases, this time raising prices by a fraction of the increase that would have brought them to opportunity cost. Gasoline prices were raised to 7000 rials per liter for the rationed gasoline and 10,000 rials per liter for demand in excess of 60 liters per month per car. Even at the higher price, about $0.30 per liter, gasoline in Iran is still priced at less than half its fob value and one-sixth of its price in neighboring Turkey. Other energy prices were raised by 20–30%, which is far below the 120% increase in the general price level since the reform went into effect in December 2010.

The Rouhani government's strong pro-market stance suggests that it is serious about making sure that Iranians use energy at market prices, while it is unwilling to increase the cash transfer at the same time. Its recent experiment with an alternative scheme to distribute a free basket of food to needy families – which oddly included the armed forces, journalists, and other non-poor groups – was a fiasco (Salehi-Isfahani 2014).

6.7 Conclusions

Iran's subsidy reform program was unique in several ways: (a) the government did not pay for much of the cheap energy it distributed so budgetary pressures were not as strong as in countries without abundant energy, (b) the price increases to eliminate the subsidies were very large, and (c) all consumers

were compensated by universal cash transfers, and the poor over-compensated. Despite its uniqueness, it does offer a few lessons for energy price reform in other countries.

The first lesson is that the longer the reform is postponed the more painful it will become. Had Iran's energy prices not been as low as they were, the price shock would have been more moderate and the adjustment less painful. The large size of the price increase necessitated a large cash transfer scheme, which proved too costly. Second, energy price reforms can reduce poverty and inequality provided that an appropriate mechanism is devised to use the savings from the reform to compensate the poor. Iran's cash transfer program had several advantages in this regard: it was simple to implement, had a wide reach, and avoided corruption. It also has one fatal flaw: it was too large relative to the price increases, fueling inflation and undermining the reform.

Third, the main benefit of energy price reform is to increase efficiency in the use of energy. To encourage investment by firms and households in energy-saving equipment, the government must be able to commit to preventing the erosion of energy prices in the long run. In Iran, the initial heroic increase in energy prices did not continue, so energy prices declined in relative terms by 30–40% per year, and with it the incentive to conserve energy.

As for Iran itself, mistakes in implementation have sharply reduced the appetite of the politicians and the public for further energy price reform, but the need to limit waste of energy is as strong as ever. The most important lesson for them is that the direct transfer of a small fraction of the nation's oil wealth in the form of cash transfers can significantly improve poverty and equity.

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Part III
Rentier States Reconsidered

7
The Concept of "Rentier States" Revisited

Hazem El Beblawi

7.1 Introduction

The term "rent" is well established in the economic literature since the time of the fathers of Political Economy. For Adam Smith "rent", though a source of income, is nonetheless different from other sources, in that it is not the cause of prices but, rather, the effect of them. For Ricardo, the concept of rent plays a central role in his statement of the diminishing returns. Malthus had to use it to complete his population theory. And for Marshall, rent is "the income derived from the gift of nature".

In the last quarter of the twentieth century, the concept of a "rentier state or economy" reemerged to describe new realities of economic growth based on the exploitation of natural resources. The oil price increase in 1973–74 was looked upon as a turning point in recent international relations. The oil shock marks a milestone in the history of the Gulf States, thus promoting them from relative remoteness to the forefront of international finance and politics. Suddenly, peripheral countries are called upon to assume a world central role to maintain the world economic and financial health.

Since the concept of a "rentier economy and/or state" is intimately related to income generated from the use of natural resources, the so-called "Dutch Disease Syndrome" cannot be dissociated from the concept of a rentier economy. This model was, first, presented by Max Corden and Peter Neary in 1982.[1] The basic idea of a Dutch Disease is that the revenues generated from the exploitation of natural resources disrupt the comparative advantages of the economy in other sectors, thus disfavoring manufacturing and agriculture and benefitting the extraction of natural resources.

[1] W. Max Corden and J. Peter Neary, "Booming Sector and De-Industrialization in a Small Open Economy" *The Economic Journal*, 92 (December 1982).

It was, perhaps, Mahdavy's article[2] that brought attention to the concept in a new context, not only as a source of income, but also as a feature of a new *type of economies*. In spite of its title, Mahdavy's article did little to discuss the genesis or to define the theoretical meaning of the concept of a "rentier economy or state". The article limited itself to the description and analysis of the Iranian economy, as it was *implicitly* understood to be an example of a rentier state. Perhaps the greatest merit of the article was to draw the attention to the connection between the concept of "rent" and oil money. Also, the article emphasized the importance, in the Iranian context, of the notion of an *"external rent"*.

Mahdavy's remarks of the importance of the notion of "external rent" shed light on the disrupted relations between "surplus" and "deficit" economies.

The oil shocks implied two major changes, a change in relative prices, and a change in world income distribution. By and large the *price effect*, because it was more apparent and immediate, drew most of the attention to the neglect of the more important *distribution of income effect*. Though both are operating and mutually reinforcing, it is always analytically useful to distinguish the two effects. While it is usually the price effect that dominates the rest, in the OPEC case, it is probably the redistribution of income and the subsequent impact on macro categories that have had far-reaching ramifications.[3] From its pre-oil shock level of about 1 percent of gross domestic product (GDP), oil cost absorbed about 5 percent of GDP.[4] The oil import bill rose from $28 billion in 1970 to $535 billion in 1980, an increase of almost 20-fold over the decade. In 1970, the oil trade represented 7 percent of world trade and reached 21 percent 10 years later.[5]

Beblawi wrote a paper at the time, under a title inspired by the *fable of the bees* of Mandeville, "The Predicament of the Arab Gulf States: Individual Gains and Collective Losses".[6] The paper emphasized the fact that the Gulf states, with enormous resources of oil and gas, while constrained by narrow national economies and limited domestic absorptive capacities, had to accumulate huge *"foreign financial assets"* in return for the depletion of their stock of *"real assets"* (energy sources underground). The paper showed that the global explosion in producing "financial assets", at the time, without parallel growth in "real assets", resulted in an increase in world inflation and consequently lead to the

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[2] Hossein Mahdavy, "The Patterns and Problems of Economic Development in Rentier States: the case of Iran", in *Studies in the Economic History of the Middle East*, ed. M. A. Cook, Oxford University Press, 1970.

[3] Hazem Beblawi, "The Oil Decade: An Appraisal in Perspective". The IBK Papers, No. 10, September 1983. The Industrial Bank of Kuwait.

[4] Maurice Laure, *Reconquérir l'Espoir*, Julliard, Paris, 1982, p. 20.

[5] IBRD, *World Development Report*, Washington, D.C. 1981.

[6] Beblawi H. "The Predicament of the Arab Gulf Oil States: Individual gains and collective losses", in M. Kerr and E.S. Yassin (eds). *Rich and Poor States in the Arab World*, Westview Press, Boulder 1982.

erosion of the real value of the accumulated financial assets of the oil producing countries.

This analysis was based on the fact that the oil price increases at the time (the 1970s), amounted, in the last analysis, to a *redistribution of world income* in favor of the oil producing countries. Since most of these countries, particularly in the Gulf region, have already reasonably high per capita income, and limited domestic absorptive capacity, they accordingly increased their national saving in the form of foreign investment.

Keynesian economics is not always welcome. However, its contribution to macroeconomics remains valid in many areas. I refer here to Keynes' technique of the accounting identity of *ex post* saving and investment. If the equality of saving and investment must hold *ex post* in all cases, then the increase in OPEC's countries saving, particularly in Gulf States, must be matched by a parallel increase in investment, *real* and/or *nominal*. Beblawi's paper envisaged three possible scenarios as a result of the emergence of the Gulf States, new savings:

i. There could be a parallel increase of *real investment* worldwide to match the increase in OPEC savings.
ii. There could be *dis-savings* elsewhere in the world to offset the increase in OPEC savings.
iii. There could be neither an increase in world real investments nor dis-savings, but only an *increase in financial assets*, with real investment remaining roughly unchanged.

The paper proposed to call the first scenario "the investment case", the second "the distribution of wealth case", and the third scenario "the placement case". These labels need some explanation. In particular for the third scenario we used the French term *"placement"* which differs from "investment". By that term, I mean the purchase of titles to debts (including money) or shares, that is, financial assets which are ultimately *claims* on real assets. The paper showed that it was this third scenario that prevailed in reality.

The sharp rise in oil prices was thus financed by a corresponding surge of international financing, mostly by commercial banks.[7] The paper also referred to the fact that empirical investigation has shown a remarkable historical constancy in the capital/output ratio of advanced industrial countries.[8] It follows from this, and given the relative constancy of the capital output ratio, that the

[7] Robert Triffin, "Gold and The Dollar Crisis: Yesterday and Tomorrow", International Finance Section, Essays in International Finance No. 132, December 1978, Princeton University p. 11.

[8] N. Kaldor, "A model of Economic Growth", *Economic Journal*, 1957 and also Luigi L. Pasinetti "Growth and Income Distribution" in his *Essays in Economic Theory*, Cambridge University Press, 1974.

nominal increase in the value of capital (with the growth of financial assets), would lead to a corresponding increase in the *nominal* value of world output. Thus, the increase in OPEC savings placed in various financial assets should also increase the nominal value of capital assets, and a general movement of price increase would be triggered off. Thus, *nominal investment* would accordingly be increased and the identity of investment-savings could be maintained, and hence Keynes' sacred identity between the two (*investment* and *saving*) would be rescued.

In fact, the economic dynamics of the market always favor the developed countries in redressing their external accounts imbalances. In a classic article,[9] Hla Myint distinguished between two kinds of external vulnerabilities. The first stems from what he called "the productivity theory of trade" where a country "has adapted and shaped its productive structure to meet the requirement of the export market through a genuine process of specialization". The second kind of vulnerability, is related to his theory of "the vent for surplus" where a country "happens to possess a sizeable surplus productive capacity which it cannot use for domestic production" and which implies "an inelastic domestic demand for the exportable commodities and/or a considerable degree of international immobility and specificness of resources". In general, developed countries exhibit the first kind of vulnerability, while developing countries suffer from the second. The increased productivity in the first case and the high rigidity in the second explain, to a great extent, the ability of OECD countries to adjust their external accounts in due course to the oil shock, and the failure of the LDC's to cope with it. One way of measuring economic development is the ability of the economy to adjust. The more the economy is developed, the easier for it to readjust to new and unforeseen situations, and vice versa. Developed countries' ability to adjust is not only confined to restructuring their internal economies to cope with, and, eventually absorb imbalances, but they have a wider scope to shape the external environment to their advantage. The latter aspect is usually known as the *dominance effect* of the more developed economies on the rest of the economic system.

The advanced economies (OECD countries) had to incur balance of payments deficit of the order of $27.5 billion in 1974, compared to a surplus of about $9.5 billion in the previous year, succeeded to balance their external balances four years later, while the deficit of the rest of the developing countries continued to deteriorate.[10]

The discrepancy in the growth rates between *real* and *financial* assets continued its course due to the dynamics of the market economy. We are, thus, faced with the emergence of a new type of quasi-rent in the form of *seigniorage*

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[9] Hla Myint, The Classical Settlement, Annual Report, No. 50, 1980.
[10] *The Economist*, March 17–23, 1979.

rights. Thus, the excess of financial assets, which exploded during the *oil shocks'* time, as a means to counter and limit the emerging *oil rents*, became themselves a source of a new form of rent accruing to the issuing countries of excess in financial assets in the last two decades. Thus, we witness, over the last four decades the appearance of *natural resources rent* (oil shocks) to be followed by a new form of rent or quasi-rent based on the *privileged positions* at the head of the financial system (seigniorage rights).

Of course, these are not the only types of rentier states. There are various forms of rentier economies, such as location rent, monopolistic rent, trade mark rent, and even blackmail rent (mafia type), and the list is quite long. The reason we emphasize the natural resource and financial rents is because both have a global impact on the world economy. The other forms of rents remain, to a large extent, local phenomena.

Let us deal with them one by one.

7.2 Natural resources rentier economies

Perhaps the first systematic discussion of the concept of a rentier state came during the preparation for a study proposed by Giacomo Luciani of the Istituto Affari Internazionali, Rome, on "Nation, State, and Integration in the Arab World".

I remember that, at the time – in the mid-eighties – a group of researchers gathered at Malcolm Kerr's office at the American University of Beirut, to discuss the content of the project and to select the potential authors for the diverse topics of the study. In that meeting, I suggested that we cannot produce a study on the Arab economy without discussing the concept of a "rentier economy", which characterized the oil producing countries and others in the region. All present agreed that the project should include a volume on the "Rentier State"[11] to be edited by Giacomo and myself. The volume appeared with 10 contributions by different authors from within and outside the region. I will refer here to two or three of these contributions.

The first essay in the volume, by Thomas Stauffer, entitled "Income Measurement in Arab States", emphasized that the so-called *oil revenues* are, in fact, more in the nature of depleting natural resources than producing real income. Stauffer showed that "the present system of national accounts (SNA) involves accounting conventions, which are not well suited to certain third world economies". He referred to the fact that many – if not most of the economies of the Middle East – are characterized by an unusual degree of dependence upon non-renewable assets. Though Stauffer did not explicitly use the notion of *financial* versus *real* assets, he affirmed that since the production

[11] *The Rentier State*, edited by Hazem Beblawi and Giacomo Luciani, Croom Helm, 1987.

of oil is a liquidation of a "*finite* asset", oil income must be interpreted much more carefully. In fact, oil revenue is more of the nature of *wealth* than a recurrent *income*.

The importance of Stauffer's paper resides in the fact that he gave an early warning of the consequences of the misinterpretation of the *nature* of oil proceeds. If it is in the nature of an income, it would follow that these proceeds could be equally used for consumption and/or investment. If, on the other hand, these proceeds are considered wealth, they must be *invested* by adding to the national productive capacity in the future. Otherwise the country would be depleting its net worth.

Unfortunately the conventional definitions of national accounts prevailed, and the oil money was looked upon, in all oil producing countries, as another source of government revenues. In contrast, when Norway started its exploitation of oil, it did not include the proceeds of its oil sales in the budget as income to be added to GDP, instead it has been looked at as *sovereign wealth*, since 1990. This conclusion came after long discussions starting in 1974, and reflected an early realization that most oil proceeds are no more than an exchange between *real* and *financial* assets. The whole point was how to preserve the value of the new form of assets.

In his contribution to the volume, Giacomo dealt with the subject from a different angle, i.e. the source of the government's revenues and its impact on its economic behavior. Not too far from the German historian Wittfogel's theory of "hydraulic civilizations" and his "oriental despotisms", Giacomo, though with much more nuance, proposed a parallel new category of a "hydrocarbon society". In his essay on "Allocation vs. Production" States, Giacomo drew attention to the fact that in oil-producing countries, it is the state revenue from oil exports which determines the GDP of the country. "If oil is mostly exported, and the income of the state is mostly linked to exportation of oil, then that state is freed from its domestic economic base", and is "sustained by the economic base of the countries which are importing its oil". Therefore, it follows that a "rentier or exoteric state will inevitably end up performing the role of allocating the income that it receives from the rest of the world". In a "*production state*", on the contrary, "the largest part of the population derives its income from sources different from the state itself". In this case, economic growth becomes the primary goal of economic policy. None of this, Giacomo said, is "to be found in an allocation state", and "the only relevant problem to an *allocation state* is extracting the maximum potential revenue from the rest of the world". "The essential impact of oil production and exports is that they free the state from the need of raising income domestically." While economic growth, is the primary goal of the "production states", an "allocation state priority is given to other goals including welfare, prestige, etc.". Also, Giacomo, does not overlook the historical relation between democracy and taxation. For

him "democracy is not a problem for allocation states" (no taxation without representation). Probably, we should also add to the local scenery, the fact that most of the Gulf States had thin populations before the oil era, and thus had to rely heavily on imported labor after the discovery of oil. This population mix, with expatriate majorities in many of the Gulf countries, added to the peculiarity of the situation. And some states (Kuwait for example) started its parliamentary political system with only a small minority of the population benefitting from the new democracy.

Beblawi's essay in the same volume "The Rentier State in the Arab world," should be discussed in conjunction with a previous essay of his, to which we referred earlier, "The Predicament of the Arab Gulf States". These two essays complement each other. In the earlier essay, the emphasis was put on the distinction between *financial* and *real* assets and the implication of the excess issuing of financial assets. The second essay drew attention to the impact of difference in mentalities, i.e. a *rentier* mentality and a *productive* one. These two approaches – financial/real assets, and productive/rentier mentalities – find their genesis in Mahdavy's remark on the importance of the *external* rent. Had the rent been confined to the domestic economy, its implications would have been limited to the income and wealth distribution within the domestic economy. The fact that the major oil producers in the Gulf had limited absorptive capacities, led to the realization of substantial foreign surpluses, and, accordingly to a counter deficit for importing countries. The importing economies settled their deficits through the issuance of new financial assets. Here, we witnessed the encounter between the force of nature (natural resources), and the power of institutional response (issuance of financial assets). Thus, if the possession of natural resources leads to realizing rent, the institutional privileges to issue financial assets would also confer to its holder a counter right to reap a new kind of "rent", as we shall see later.

Let us now return to Beblawi's definition of the concept of a "rentier state". The first point is to remember that there is no such thing as a pure rentier economy. Each and every economy has some element of rent. Second, and this is very important, a rentier economy is an economy which relies on substantial *external rent*. Third, in a rentier *state* – as a special case of a rentier economy – only few are engaged in the generation of this rent, while the majority benefit from the distribution of it. And here, Beblawi joins Giacomo Luciani in his definition of the "productive" and "allocation" states. A "*rentier state*" is thus an economy where the creation of wealth (rent) is centered around a small fraction of the society; the rest is only engaged in the distribution of this wealth. The respective roles of the few and the many can hardly be overlooked. Fourth, a corollary of the role of the few is that the government is the principal recipient of the external rent and the arbiter of its distribution.

The state or government, being the principal rentier in the economy, plays the crucial role as the prime mover of the economic activity. Citizenship

becomes a source of economic benefit. The whole economy is arranged as a hierarchy of rentiers with the state or government at the top of the pyramid. Public goods and private favors have thus gone together in defining the role of the state. With virtually no taxes, citizens are far less demanding in terms of political participation. Thus, the distinction between public service and private interest is often blurred. Compare this with Schumpeter's entrepreneur, hard worker, risk-taker, innovative, and creative economic agent. The contrast is also flagrant with Max Weber's definition of the "spirit of capitalism". The contrast is thus glaring between two different mentalities, a *productive mentality* and a *rentier mentality*.

The Arab non-oil states are by no means rentier states in the sense previously outlined. The predominance of the oil phenomenon on the whole region is, however, such that many non-oil Arab states are showing increasing signs not dissimilar to those witnessed in the oil states. Rhetoric aside, inter-Arab aid was related, to some extent, to its effects on the stability and tranquility of the oil rent in oil-states. External location rent is also evident in the so-called transit countries. Suez Canal revenue and oil pipeline royalties are major revenue sources for some countries, e.g. Egypt and Syria. Workers' remittances are becoming one of the major foreign exchange sources in some non-oil Arab States. Yemen is a well-known example. In Egypt, workers' remittances are the biggest single source of foreign exchange.[12]

The point that Beblawi's essay tried to emphasize is that such a rentier state produces a certain *mentality* or a type of social behavior. The basic assumption here is that this behavior represents a break with the work-reward relation. Reward is now divorced from work, risk, and/or creativeness.

7.3 Financial seigniorage rights

The emergence of money and other financial assets is a manifestation of man's ability to deal with the surrounding environments through symbols. In fact, money and other financial assets are no different from language, writing, mathematics, etc., which are all symbols to deal more effectively with the outside environment.

From an economic perspective, goods and services *(real assets)* are the ultimate source of satisfying human needs. Money and other financial assets are no more than symbols, i.e. claims on those real assets. Their function is to widen their circulation in space, as well as to link the present with the future in time. A major difference between *real* and *financial* assets is related to their mode of production. While the production of *real assets* is, usually, constrained

[12] H. Beblawi, "The Rentier State in the Arab World", *Arab Studies Quarterly*, Vol. 9, No. 4, Fall 1987.

by physical limitations, i.e. the availability of natural resources, the level of productivity and know-how, and the material and human infrastructure, the issuance of *financial assets* is only restricted by institutional arrangements.

Money, the queen of financial assets, went through a very interesting history regarding its issuance. From commodity money, to gold and silver money, to paper money and finally to credit and almost virtual money. During the feudal epoch, the nobility used to debase the weight of the metal (usually gold and silver), while maintaining the money's nominal value intact, thus realizing a profit. By *seigniorage rights* we mean the difference between the cost of producing money and its value; these rights are normally acquired by governments and central banks.

Not all seigniorage rights are, necessarily, in the nature of underserved "rent". Providing the society with an efficient monetary and financial system is, in fact, assuming a vital responsibility of the *state* as the main provider of *public goods*. Historically, the concept of public goods was usually confined to defense, justice, and order. It was realized that the concept should transcend this narrow definition to include such areas as education, health, environmental protection, etc. Maintaining a healthy monetary and financial environment is recognized as a fundamental prerequisite for stability and growth. Thus, earning a return on issuing financial assets is justified, in as far as they respond to a social need. The problem arises only with the *excess* production of these assets. As has been mentioned before, financial assets are not constrained by physical limitations, and therefore there is always a risk of over production of these assets. In fact, with financial assets, there is always a temptation for *excess* issuance, to realize a sort of *financial rent*. The cost of over-issuance is usually born by society as a whole.

We can see an analogy between this situation of *excess* of financial assets issuance and the rent seeker from natural resources. The parallel between the two cases is, however, not perfect. In a way, the financial rentier is more of an adventurer rather than a fatalist who is dependent on nature's gifts. He is, contrary to the natural resource rentier, aggressive and more often than not, over confident if not an outright adventurer. However, in both cases, we are faced with two people; one realizing high revenue without much effort, and another who is highly rewarded while behaving in an adventurous way that might hurt society at large(moral hazard). In a way, we are facing two different situations where income is not related to productive and responsible work.

Let us now move to the real world to see what happened with *global financial assets*. The starting point should naturally be to review the international monetary system, to be followed by what happened in major financial centers.

The story of the international monetary system is simple and straight forward. It is the story of the dollar as the principal international reserve currency.

It was the Bretton Woods agreement in 1944 that laid the foundation for a new international monetary system. In the background there were two

different conceptions for the forthcoming arrangement, i.e. Keynes' – the British representative – and White's, his American counterpart. "White's scheme had member nations putting capital into the Fund, whereas, Keynes' scheme had the new institution creating the capital *de novo*, in the form of 'bancors'."[13] The difference between the two approaches is much more profound than it appears. With Keynes' approach, we would have been promoted to a truly new international system with a new international money as a credit issued by the newly established institutions (eventually the IMF). In that case, the *seigniorage rights* associated with the issuance of new money would have accrued to the international community at large. White's approach finally prevailed and ended up with the American dollar being the internationally accepted reserve money.

The agreement establishing the IMF adopted a *fixed exchange* system, where currencies should be defined in terms of gold and/or a currency convertible to gold at a fixed rate, i.e. the dollar. This led, practically, to making the dollar the international reserve currency. This result came as a reflection of the world's economic realities, where most of the world nations came out of the war totally or partially devastated, while the American economy remained almost intact. The US was about the only country where the war effort did not damage its civil production; on the contrary, it helped by adding a new war economy to its productive capacity. No wonder then that the US stood at the time as the major supplier of the world for agricultural and industrial goods. This was the epoch of the "dollar shortage", where everyone was seeking to get the dollar, and accordingly the dollar enjoyed a kind of world "general acceptability".

The new role of the dollar as the international "reserve currency" affected both the world at large and the US. For the rest of the world, it was what the American Belgium economist, Robert Triffin, called the "dollar shortage", while for the US economy it came to be known as "the Triffin Dilemma". If the US acquiesces to the pressure of the rest of the world and makes the dollar available, then it has to allow for its balance of payment to incur a deficit. Triffin observed that "if the United States corrected its persistent balance-of-payments deficits, the growth of world reserves could not be fed adequately by gold production at $35.00 an ounce. But if the United States continue to run deficits, its foreign liabilities would inevitably come to exceed by far its ability to convert dollars into gold upon demand and would bring about a 'gold and dollar crisis'."[14]

In the two decades after the end of the second world war the US, by and large, maintained a trade surplus balance, while incurring a balance of payments

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[13] Benn Steil, *The Battle of Bretton Woods*, Princeton University Press, 2013, p.162.
[14] R. Triffin, op.cit.

deficit because of large American *overseas investments* during this period. Thus, we can say that the American "Triffin Dilemma" was solved by increasing US overseas investments, and hence, the increase in the US's *financial liabilities* was accompanied by a parallel increase in its overseas *real investments*. Thus, the matching between financial and real assets was maintained to a great extent. The situation changed drastically in the 1980s.

The US current account deficits are a relatively recent phenomenon. The US started running a large current deficit in the 1990s, which reached some $800 billion in 2006. In the meantime, the budget deficit exploded after the financial crisis, averaging $1.4 trillion annually during 2009–12. From 2000 to 2012, the rest of the world transferred about $7 trillion dollars to the US over the same period. The total global accumulation of foreign exchange reserves was about $9 trillion, with $ 6.5 trillion accounted for by emerging and developing economies.[15] The US had about $1.18 trillion of currency in circulation as of March 2013. It is estimated that about two thirds of dollar bank notes worth about $750 billion are held outside the US. With inflation at 2 percent, this implies an inflation tax of about $25 billion per year paid by the rest of the world to the US.[16]

If we look at *private* financial assets, the picture becomes even more alarming. We have mentioned before that the emergence and development of all forms of private financial assets helped enlarge and diversify national economies and thus brought them to a more globalized and efficient economic condition. But this is one thing, and the *excess* of unrestrained financial issuance is another thing.

When we discuss the growth of private financial assets, we have to keep in mind that we usually refer to *claims* issued by financial institutions. Financial institutions are, generally speaking, *intermediaries* between savers and investors, i.e. between those who have more than what they need to spend and, those who need to invest more than what they own. Financial institutions are more of an *agent,* working on behalf of a *principal*. And though, in theory, an agent should act to protect the interests of the principal, this is not always the case, since the agent could in some cases realize a short run benefit, which might harm the principal in the long run. And of course, "in the long run", as Keynes said, "we are all dead". So, there is always the temptation for these institutions to make "a quick buck", and eventually sell their assets to a third party.

It follows from the above that financial institutions' decisions normally affect a large number of individuals who have no voice in the decisions taken by these institutions. From this we can understand that although most financial institutions are privately owned, their decisions exhibit some *externalities*

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[15] E.S. Prasad, *The Dollar Trap*, Princeton University Press, 2014, p. 90.
[16] Op.cit p. 264.

affecting society at large. Thus, financial stability is, to a great extent, a sort of *public good* that needs to be properly regulated and put under strict surveillance. Against this theoretical background, the reality of the major financial markets was totally different.

Regulations were relaxed, the number of new financial institutions mushroomed and exotic forms of new financial instruments appeared. In the absence of strict regulation, the financial system was exposed to serious shocks and failures. It is thus agreed that without such measures the financial system would face serious risks not common to other markets. In such an environment it is not surprising that financial institutions would be induced to embark on *"moral hazard"*, i.e. situations which encourage these institutions to assume high risks, because they believe that someone else will bear the burden of those risks. In the case of large financial institutions, this view was supported by the belief that they are "too big to fail," until they discovered that the reality was that they were, in fact, "too big to bail".

The situation of the financial systems is aggravated by the special nature of financial transactions. In particular, these systems are more exposed to the tendency of amplifying the impact of adverse aggregate shocks and, more often than not, they are characterized by macro-financial feedback mechanisms, which increase vulnerability given the linkages within the financial system itself. Thus, advanced economies' financial systems which look more sophisticated are not necessarily more robust and stable than those of other economies.

In the words of the "Financial Crisis Inquiry Commission" report, "more than thirty years of deregulations and reliance on self regulation, pushed by the powerful financial industry, at every turn, had stripped away safeguards. From 1999 to 2008, the financial sector spent $2.7 billion in reported federal lobbying expenses. Leverage was often hidden in derivatives, in off-balance sheets and through 'window dressing' of financial reports".[17]

From the above, it is no wonder that we witness the emergence of a new form of a rentier type, not the one that received *unearned* compensation without effort, but one who is lavishly rewarded for his activity, which exposes the community to *high risk* in financial stability. Thus we have two types of rentiers. One is accused of too much relaxation, if not idleness, while reaping high revenues, and the other type, who in contrast, while also grabbing unheard of fortunes, exposes society to high risk, if not chaos. One is a kind of Lord Seigneur of natural resources, the other is a kind of Lord of Finance.

In both cases, the general feeling is something of uneasiness, if not outright rejection. It seems that deep human culture requires some relationship between reward on the one hand and effort with responsibility for society on the other. Whenever the reward is divorced from either effort or responsibility

[17] *The Financial Crisis Inquiry Report*, Public Affairs, New York, 2011.

it is considered, somehow, immoral. One has to *earn* a living through honest effort with full responsibility to others. The question is: why this value judgment? Is it only a moral question inherited over long human history, or is there something deeper in the laws of nature?

7.4 Rent and the laws of nature

The British scientist and novelist C.P. Snow gave a famous lecture under the title "The Two Cultures".[18] The message of the lecture is that, contrary to the past, where a "savant" was supposed to be equally knowledgeable in both sciences and humanities, now the situation is becoming completely different, separating the two different worlds of natural sciences on one side, and social and human sciences on the other. They have different languages and are almost strangers to each other. And, to support his thesis, Snow gave the example of the Second Law of Thermodynamics, which is considered as one of the major foundations of physical sciences. Snow claimed that it is almost totally unknown to social studies.

It is not my intention here to agree or disagree with Snow on whether this famous law of physics is known or not to social scientists. What I am interested in here is to show that there is a kind of relationship between the Second Law of Thermodynamics, as I understand it, and the concept of rent in economics in general.

But first, I should give my own understanding of this famous law. The basic idea is that, in a closed system, available energy is constant and cannot be increased, and thus its opposite *entropy* can never decrease. By entropy we mean *disorder* or disorganization. In a way, the Second Law's message is that we cannot create "order" without spending energy, i.e. work (effort). Thus, "order" is not realized without a cost, it needs energy (*work*), and without this work, "order" will disintegrate and, *chaos* will prevail. "Chaos" is the opposite of "order", i.e. no shape, no features, no characters; that is a situation where everything is like everything else. Therefore, we create "order" by organizing the shapeless "chaos" into meaningful order, and all this cannot be achieved without spending energy, i.e. work. This is the message of the Second Law of Thermodynamics, or as Schrodinger calls it, the principle of "order-from-disorder".

If this understanding of the Second Law of Thermodynamics is correct, it follows that the teaching of economics is no more than confirming this law by insisting that production, which brings "order" to chaos, cannot be achieved without effort, and thus economics is consistent with the basic laws of nature, and carry the same message. The message is to *work* (spend energy) to create

[18] C.P.Snow, *The Two Cultures*, University of Cambridge, May 1959.

"order" (production), and to keep away from *chaos* (irresponsible moral hazard). Thus, the feeling of discomfort about *rent* in both cases (natural resources and financial rents) is simply a reflection of the laws of nature. This message is, in fact, no more than restating the physical laws and applying them to the economic field. *Rent*, in all forms, is of bad taste, not only from an economist's perspective but also because it is an aberration from the laws of nature.

8

Thresholds Matter: Resource Abundance, Development and Democratic Transition in the Arab World

*Ibrahim Ahmed Elbadawi**

8.1 Introduction

The empirical cross-country growth literature suggests that the oil and mineral resource curse is a long-term phenomenon and is conditional on bad political governance. This important discovery seems to adequately explain the successes and failures of the exceeding majority of resource-rich economies (e.g. Collier and Goderis, 2009; Elbadawi and Soto, 2012). Indeed, development experiences corroborate the view that without a high enough standard of democracy, to ensure political inclusiveness, and robust political checks and balances to enforce the rules for sharing rents, the median resource endowed country will likely experience the resource curse in the long-run.

However, despite the strong predictive power of this empirical finding and its strong theoretical underpinnings, it has failed to account for the notable successes of a small group of mostly sparsely populated and high oil resource abundant countries, which translate into exorbitantly high rents per capita (hereafter HRPC). These countries defy the fundamental tenets of this strand of the growth literature because they are neither democratic nor governed by explicit systems of political checks and balances. This group is dominated by, but is not confined to, the six countries of the Gulf Co-operation Council (GCC).

This chapter argues that a better understanding of the oil curse requires accounting for threshold effects of the resource rents and how rents per capita above a given threshold might influence the political equilibrium in a way that promotes long-term growth and, hence, allow those few "lucky" countries

*Prepared for the International Economic Association Volume on "Middle East Economies: Before and After the Revolutions" (editors: Ahmed Galal and Ishac Diwan). I would like to acknowledge the research grant from the ERF and the research support by Hosam Ibrahim and Chong Wang.

to escape the oil curse, despite their being ruled by non-democratic regimes.[1] In this context, this chapter makes three novel contributions to the literature. Firstly, we empirically derive the threshold of rents per capita, beyond which countries are likely to be able to harness their resource rents for promoting long-term growth. Secondly, we show that the threshold effect of resource rents matters for explaining the capacity of these countries to maintain a monopoly on the use of organized violence and, hence, the relatively low risk of civil wars they faced. Thirdly, we show that, unlike autocratic regimes in low or moderately resource endowed societies, incumbent regimes in control of very high rents per capita were able to develop a credible "authoritarian bargain" and successfully pre-empt political revolts.

Moreover, very importantly, the evidence provided by this chapter also sheds light on the pivotal question as to why the six GCC countries are different from the rest of the relatively populous and moderately resource endowed countries in the Arab region in terms of growth, human development, civil peace and political stability. The threshold effect, we would argue, seems to be at play in shaping a political equilibrium in the GCC that allows a more developmental as well as more inclusive allocation of rents among the national population. The long-reigning monarchies of these countries are, therefore, able to more effectively fend off potential revolts. Instead, with much lower rents per capita at their disposal, incumbent autocrats in the populous Arab countries relied more on the, arguably, less effective instrument of political repression, which perhaps explains their vulnerability to the popular uprisings associated with the Arab Spring and the numerous episodes of coups, civil wars as well as other forms of violence that characterized the post-independence political history of these societies.

Section 8.2 analyzes the heterogeneity of resource abundance across countries and compares country groupings according to the size of their rents per capita. In particular, we identify a group of 12 highly endowed resource countries (HRPC), six of which are member countries of the GCC, and assess the extent to which the development discourse of this group has differed from other resource-rich countries, where we focus on three fundamental development indicators: growth, civil peace, and political stability. The next two sections (8.3 and 8.4) constitute the hallmark of this chapter. Section 8.3 reviews the received literature on the causal links from rents per capita to growth and

[1] See also Cammett et al (2015), who provides an extensive analysis of the relatively superior development performance of the GCC relative to other resource rich, labor abundant countries in the MENA region; and Ali and Elbadawi (2012), who formally modeled the political economy considerations behind the more developmental approach to rents management in the former group of countries.

civil wars, and provides new evidence on the existence of non-monotonic or threshold growth and civil war effects. Section 8.4 reviews the literature on the role of resource rents as a hindrance to democratic transition in the Arab world, and assesses the significance of threshold effects in explaining the contrasts between the GCC monarchies and the incumbent regimes in other populous oil Arab countries, and discusses the link between the prevailing political equilibrium in both groups of Arab countries and the recent popular uprisings. Section 8.5 concludes and offers some reflections about the limits to the long-term development impact of high resource abundance and possible lessons for the GCC and other countries in the highly resource endowed group.

8.2 A typology of oil and mineral economies

As discussed above, a better understanding of whether oil and mineral resources can be a boon or, instead, a precious bane for resource endowed countries requires accounting for the heterogeneity of these countries in terms of the extent of resource abundance, as measured by rents per capita. In fact there are stark cross-country differences (Table 8.1). The distribution of average rents per capita during 2000–13 suggests that the median annual rent per

Table 8.1 Typology of resource rents per capita (average: 2000–02)

Resource Rents per capita	Median	Min	Max	Number of countries
Rents Pc < 20 USD	9	Iceland (0.06 USD/capita)	Cambodia (20 USD/capita)	**46**
20 < Rents Pc < 200	47	Switzerland (20.01 USD/capita)	Bhutan (189 USD/capita)	**88**
200 < Rents Pc < 400	294	Brazil (200 USD/capita)	United Kingdom (398.5 USD/capita)	**16**
400 < Rents Pc < 2000	616	United States (409 USD/capita)	Venezuela, RB (1424.3 USD/capita)	**15**
Rents Pc > 2000 USD	5322	Gabon (2326 USD/capita)	Qatar (70,537 USD/capita)	**12**

Notes:
1. Source: Appendix Table A.1 of Elbadawi (2015).
2. Total natural resources rents are the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents.
3. For the GCC, resource rents per capita were computed as a ratio of total rents to national population, where the latter was calculated using 49% of total population in Bahrain, 68% for Saudi Arabia, 61% for Oman, 16% for the UAE, 32% for Kuwait, and 16% for Qatar.

capita for a group of 46 countries at the tail of the distribution is equal to only $9.0 (in constant 2000-US dollars). On the other extreme end, the median per capita rent for the 12 countries of the HRPC group stood at more than $5300. In addition to the six GCC countries, this group includes Brunei Darussalam, Norway, Libya, Trinidad and Tobago, and Gabon. In between, the median rent per capita equals $47 for 88 countries; $294 for 16 countries; and $616 for the remaining 15 countries.

Zooming in to country-specific comparisons an even starker picture emerges (Figure 8.1). For example, Qatar collects a staggering rent per capita of more than $70,000, while Iceland only received $0.1 as rent for every citizen. And, focusing on the MENA region, a comparison between rents per capita in Bahrain (at $2428), though by far the lowest in the GCC, and some of the populous oil producing countries in the region is very illuminating. It accounts for more than four times the resource rents per capita for Algeria and Iran, two of the major oil producers in the world. And, for the smaller oil producers, the rent per capita for Bahrain was more than seven times that of Syria and 14 times that of Yemen.

Next, a natural question to ask would be how the heterogeneity in resource endowment coheres with development performance across the country groupings. Specifically, we assess how the GCC and the other six countries in the highest rents per capita group fared compared to other resource endowed countries. During the last decade and a half we found the highest resource

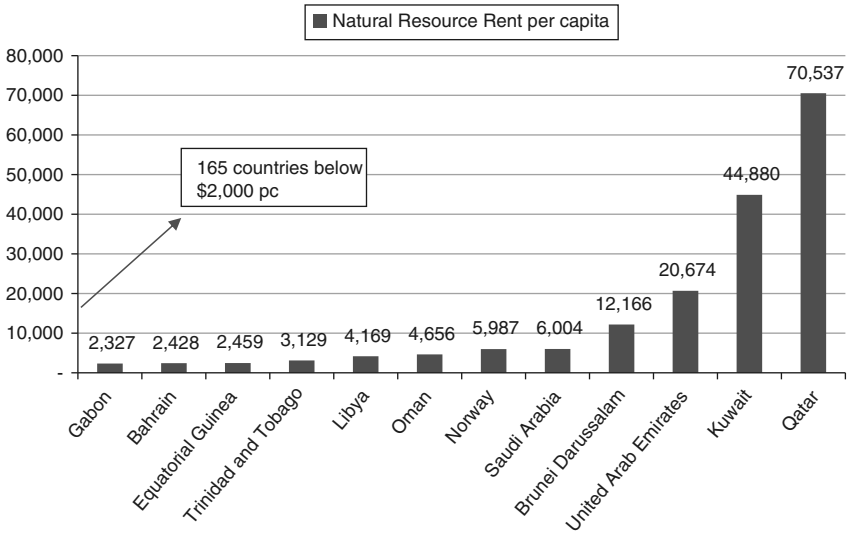

Figure 8.1 Resource rents per capita across countries (average 2000–13)

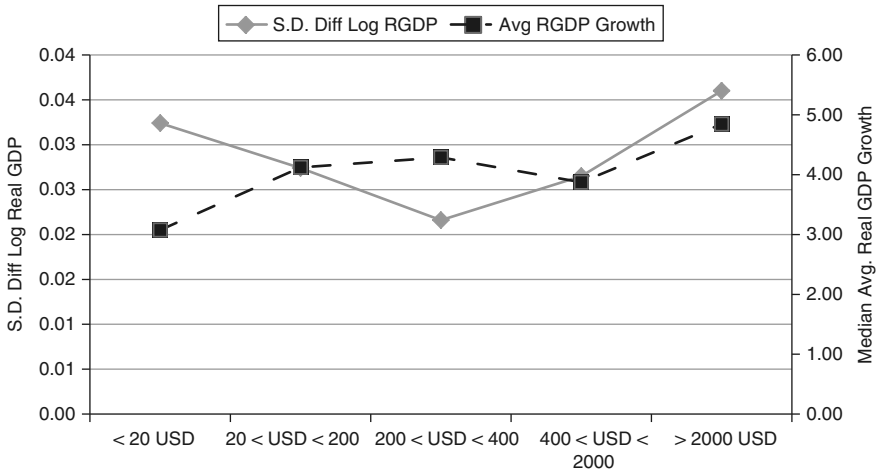

Figure 8.2 Median average standard deviation of differenced log real GDP and real GDP growth in resource-rich economies

abundant group members outperforming their comparators in all of the three fundamental development indicators: growth, civil peace, and political stability. For example, average growth of the median country in the top resource group is higher by about 1.5% than the rate achieved by the second most resource endowed group, which includes major oil but populous countries, such as Algeria, Angola, Iran, and Russia (Figure 8.2). Over the course of the last 14 years (2000–13), such modest but steady growth deferential would scale up to 14%, which is not unrelated to the rising dominance of the GCC economies in the region. For example the GDP in 2013 for Saudi Arabia, with a population size of less than 28 million, and the UAE, with a population of just over 9 million, reached $748 and $402 billion, respectively. Instead the much more populous Algeria, with a population of more than 39 million, and Yemen, with a population of about 25 million, only managed to, respectively, produce $210.2 and $36 billion worth of GDP.[2]

However, the top group was much more distinguished in terms of its capacity to maintain civil peace and political stability. Table 8.2[3] presents the episodes of internal armed conflicts that result in at least 25 battle-related deaths, which we regard as constituting a challenge to the state's ability to exercise a

[2] See World Bank data base (http://data.worldbank.org/country).

[3] In Appendix Table A.2 of a companion paper (Elbadawi, 2015) the full set of country-specific conflict episodes for the entire sample is provided.

Table 8.2 Armed civil conflicts, 1970–2010

Resource rents per capita	Number of countries	Longest war duration
Rents Pc < 20 USD	10	41 years
20 < Rents Pc < 200	36	41 years
200 < Rents Pc < 400	4	41 years
400 < Rents Pc < 2000	7	26 years
Rents Pc > 2000 USD	2	1 year

Source: Appendix Table A.2 of Elbadawi (2015).

monopoly on the use of organized violence.[4] We abstract from other types of organized violence that do not directly involve the state, such as ethnic violence or clashes among rural-based groups or crimes related to the drug trade, etc. The table makes clear that most resource-rich countries are also conflict-affected countries, with most having experienced very long-duration conflicts. The notable exception was the HRPC group, which, unlike all other groups, has been very successful in avoiding costly and long-drawn-out civil wars. Similarly, except for the cases of Libya and Equatorial Guinea, political regimes in the other 10 highly endowed resource countries were able to remained in power ever since independence or the formation of the country (see Table 8.3). While it is not surprising for full democracies, such as Norway and Trinidad and Tobago, not to experience major changes as a political regime type, it is rather remarkable that the monarchies of the GCC were able to weather the winds of change for such long time. Instead, this has been an elusive goal for most other personalized or military autocracies in the other not so well resource endowed countries (Elbadawi, 2015).

At this juncture, now that we have shown that there exists an association, not necessarily causation, between resource threshold and long-term development, we ask about the role of institutions on this phenomenon; and, if there is such a role, what types of institutions are likely to be acting as a catalyst for the threshold effect?

We first consider two measures of political institutions, both considered critical institutional measures for economic development: Polity2, the widely

[4] The data were obtained from Table 1 of Elbadawi and Soto (2015), which was based on data extracted from the UCDP/PRIO Armed Conflict Dataset (2012). See Gleditsch et al. (2002) and Themnér and Wallensteen (2012). The intensity of armed civil conflicts is coded in the UCDP/PRIO Armed Conflict Dataset in two categories: Minor (between 25 and 999 battle-related deaths in a given year) and Civil War (at least 1,000 battle-related deaths in a given year). The type of conflict is "*Internal armed conflict between the government of a state and one or more internal opposition group(s) without intervention from other states*".

Table 8.3 Political regimes types and years in power

Country	Duration and regime type		
	Rents per capita >$2000		
Kuwait	1962	present	monarchy
Saudi Arabia	1928	present	monarchy
Oman	1742	present	monarchy
UAE	1972	present	monarchy
Bahrain	1971	present	constitutional monarchy
Qatar	1971	present	monarchy
Brunei	1984	present	constitutional monarchy
Norway	1886	present	democracy
Trinidad and Tobago	1962	present	democracy
Gabon	1961	present	Party-personal
Equatorial Guinea	1968	present	personal-military
Equatorial Guinea	1979	1978	personal-military
Libya	1952	1969	monarchy
Libya	1970	2010	personal

Source: Appendix Table A.3 of Elbadawi (2015).

accepted measure of political inclusiveness; and Polcon, a new index of the effectiveness of political constraints on the executive and legislative branches of government. The Polity2 is a global data base developed by the "Polity IV: Regime Authority Characteristics and Transitions Datasets" project; and the Political Constraint Index (POLCON-V) is also a global index (Henisz and Zelner, 2010).

Not surprisingly, most country groups, especially the HRPC, received low scores on both indexes (Figure 8.3). According to the Polity2 index (rescaled so that 1 stands for full democracy and 0 stands for extreme autocracy) the median political regime in the three country groups with rents less than $400 is likely to be "partial democracy". Instead, for the group with rents less than 2000 but higher than $400, which includes the populous oil economies of Algeria and Iran, this is likely to be an "autocracy"; and except for Norway and Trinidad and Tobago, the rest of the countries in the highest resource abundance group are all judged to be extreme autocracies. Furthermore, the resource-rich countries tend to fare much worse according to the Polcon, with the median index below 0.4 for all groups, which suggests weak systems of political checks and balances. Again, except for the two democracies of Norway and Trinidad and Tobago, the Polcon index for the HRPC group is close to zero, suggesting that a system of "formal" checks and balances does not even exist in these countries.

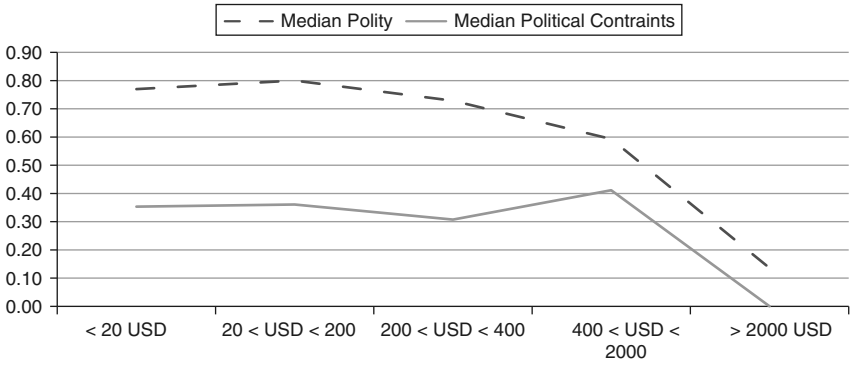

Figure 8.3 Median average resource polity and political constraints in resource-rich economies

However, a cautionary note is in order before we prematurely conclude that political institutions are not relevant for the development of the HRPC group. First of all, evidence from the more recent panel data econometric growth literature finds checks and balances to be almost sufficient for accounting for the impact of political institutions on long-term growth, while the positive impact of democracy was found to be relatively marginal and not as robust as that of the former (e.g. Elbadawi and Soto, 2012). This evidence seems consistent with the critique that the Polity score is likely to be reflecting more the "electoral competition" aspects of democracy than conveying the more relevant feature of "political inclusiveness" (Collier and Hoeffler, 2009). Instead, rules are primarily the manifestation of an implicit contract with the electorate, a public signal of the commitment to maintain mutually agreed standards for managing the economy and achieving the development goals. Therefore, Polcon, as a measure of political checks and balances, seems to account for this institutional aspect. To the extent that political constraint is the more relevant aspect of political institutions for development, it could be argued that the Polcon measure might have under-estimated the strength of the system of checks and balances in the GCC, which of course does not manifest itself in terms of formal political institutions but is implicit and is shaped by repeated interactions between the ruling families and traditional communities. Moreover, the stability and long history of these informal norms and traditions perhaps has been a major factor in sustaining the system of rent sharing in these societies (e.g. Cammett et al, 2015 ; Hertog, 2006).

In view of the above, it is clear that both indexes of political institutions are not likely to be appropriate as possible institutional channels of the resource threshold effect on development. Instead, we consider two World Bank's economic governance indicators of "government effectiveness" and "voice and

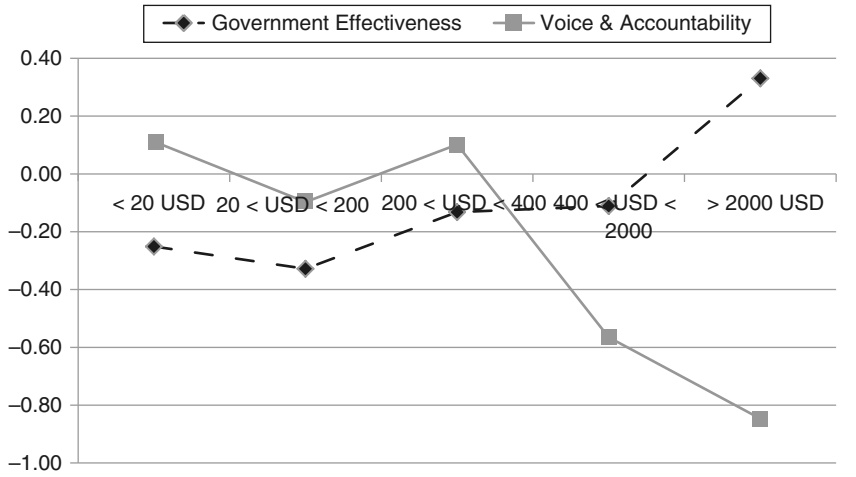

Figure 8.4 Median average government effectiveness and accountability

accountability". These two measures, especially the first, are perhaps better proxies for the type of political equilibrium that is likely to be present in the HRPC group outside of the two full democracies of Norway and Trinidad and Tobago or the failed state of Libya under Col. Gaddafi. This group has done much better than the rest in promoting effective economic management capacity, while it fared badly in terms of voice and accountability (Figure 8.4).

To recapitulate, we have so far provided broad evidence on the association between some major development indicators and resource abundance, where it appears that the HRPC group of countries has on average been able to grow faster, to better maintain civil peace and political stability. Moreover, economic governance, rather than political institutions are likely to be the institutional channel for explaining any potential "causal" development impact of the resource threshold (or non-monotonic) effect. Formal analysis of whether or not such a causal effect exists will be discussed in the next two sections.

8.3 Resource abundance, threshold effects and development

Despite its potential for generating substantial financial wealth, oil and other point-source rents have long been associated with an economic development "curse". The literature has identified multiple manifestations of this curse, including lackluster growth performance in the long-run and proneness of resource-dependent societies to conflicts and political instability. Starting with growth, the major debates and main finding of the development impact of resource abundance could be summarized in three or four fundamental conclusions. This

is made possible by the recent methodological advances in the analysis of panel cross-country growth regressions and the availability of global data on resource rents and other correlates, most notably the global quantitative measures that allowed accounting for heterogeneity of political regimes and economic governance institutions across countries and over time. The modern empirical growth literature suggests that the resource curse does exist, but is a long-run phenomenon and is conditional on the presence of "dysfunctional" political regimes, characterized by lack of political inclusion and absence of meaningful systems of political checks and balances (e.g. Elbadawi and Soto, 2012).

Regarding civil wars, the other major development peril of the resource curse, there is also a good understanding of the causal links from the resource rents to civil conflicts. For example, in a widely cited paper, Ross (2004) reviews a large body of literature on cross-national econometric and qualitative studies on the subject and synthesizes four underlying regularities: first, oil resources are likely to be associated with conflicts, particularly separatist conflicts; second, there is no evidence of a direct link between legal agricultural commodities and civil war; third, there is no evidence of a robust association between primary commodities – broadly defined to include oil, mineral and agricultural goods – and the civil war; and, finally, "lootable" commodities like gemstones and drugs do not make conflict more likely to begin, but they tend to lengthen existing conflicts.

We further discuss the issues and evidence on the ramifications of the resource curse on the two pivotal development indicators – growth and civil peace – and present new evidence on the potential non-monotonic or threshold effects that might lead to more nuanced conclusions on the development impact of resource rents.

Resource rents and non-monotonic growth effects

The recent empirical growth models that allow estimation of the long- as well as the short-run growth impact of the resource rent, find robust evidence that, in countries with low political checks and balances and low standards of democracy, the *change* in net oil and mineral rents/GDP is positively associated with economic growth but the *level* effect of the resource rents has a strong negative effect. However, no evidence of robust long-run association was found between resource rents (or commodity prices) and growth in the global samples that includes countries with all types of political regimes (e.g. Elbadawi and Soto, 2012)[5]. This suggests that, in countries with adverse

[5] See also Collier and Goderis (2009), who estimate a panel co-integration model to analyze the short-run and long-run growth impact of non-agricultural commodity prices. Building on Collier and Goderis model, Elbadawi and Soto (2012) estimate a second generation panel data econometric growth model that accounts as well for cross-country dependency and, instead of commodity prices, uses the recently constructed World Bank's global data base on net resource rents.

political regimes, resource booms have positive short-term effects on output but are negatively associated with the latter in the long-run. Therefore, according to these findings, the curse operates in the long-run and is conditional on "bad" political regimes. Moreover, they also find that, conditional on bad political governance, controlling for the real exchange rate overvaluation and excessive private and public consumption, as measured by external debt and current account deficit, the resource rents (or commodity prices) no longer have a negative long-run effect. The empirical significance of these channels in explaining the negative long-term association between the resource rents and growth in countries with adverse political regimes suggests that economic factors are only relevant as *channels* for explaining the resource curse, but they are not independent *causal* factors.

These new findings constitute a major point of departure from the earlier empirical resource curse literature, which was dominated by the "economistic" approaches to explaining the resource curse, such as the Dutch disease (e.g. Corden, 1982; Corden and Neary, 1984; Neary and van Wijnbergen, 1986; Sachs, 2007) and the more recent volatility view (e.g. Gelb and Grasmann, 2008). However, both have been questioned as an adequate framework for explaining the curse. For example, it has been argued that despite that the real currency appreciation associated with resource booms will likely lead to a squeeze on the non-resource tradable sectors, the pure Dutch disease effect cannot explain the overall collapse of the economy, as evidenced in the collapse of the non-oil GDP associated with the "oil curse" phenomenon (Elbadawi and Gelb, 2010). This is because, at the theoretical level, it is not clear as to why the declining share of the non-resource tradable sectors could not be compensated for by the rising share of the non-traded goods.[6] In the same vein the volatility approach is not likely to offer a plausible explanation for the curse independent of political institutions. The volatility view of the curse argues that because oil prices (and hence revenues) tend to be very volatile, oil-dependent economies tend to experience frequent and oftentimes extreme volatility in economic activity. However, as argued by Hausmann and Rigobon (2003), for a resource curse to happen the non-resource tradable sector must be substantially squeezed beyond a critical size or almost disappear and that the economy must be characterized by financial imperfections.

Instead, the above findings of the recent growth literature strongly corroborate the recent political economy perspective, in that the traditional "economistic" approaches to explaining the resource curse phenomenon,

[6] Assuming that the ensuing real exchange rate overvaluation was very high, still for the resource curse to happen the exporting activities in general must entail some dynamic properties, such as learning by exporting, and that manufacturing in particular generates increasing returns to scale (e.g., Matsuyama, 1992; Rodrik, 2007).

most notably the Dutch Disease and the volatility views, are in fact manifestations of the underlying institutional factors. Along this line, it has been argued, that permanent resource booms when government accountability is lacking allows politicians to expand public sector employment or to directly boost private consumption to enhance their popularity (e.g. Robinson and Torvik, 2005; Robinson et al, 2006). In addition to these distributional aspects in resource economies, another strand of the institutional literature suggests that bad governance also discourage overall savings and promotes excessive spending, which is reflected in appreciated real exchange rates (e.g. Matsen and Torvik, 2005). Moreover, the significance of the real exchange rate channel also coheres with the recent literature on its role as an instrument in the development strategy for economic diversification, sophistication and growth (e.g. Elbadawi and Gelb, 2010).

However, despite the important findings of the recent growth literature and its contribution to our understanding of the resource curse, it has failed to account for the important empirical regularity regarding the different and much better development performance of the HRPC group of countries, especially the GCC. Moreover, this literature is also subject to criticism because the growth model is based on the inherently endogenous concept of resource dependency (rents/GDP). Though the second generation of panel data econometric methodologies allowed addressing several well-known identification problems as well as the econometric challenges associated with cross-country correlated effects, they are still likely to fail in fully addressing the strong reverse causation from growth to the resource dependency measure.[7]

To account for the growth impact of resource abundance in the HRPC group, Elbadawi (2015) estimate a growth model that controls for resource abundance (rents per capita), instead of resource dependency (rents/GDP), as well as allows for the possible non-monotonic growth effect of resource abundance. Table 8.4 reports a subset of the results pertaining to the resource rent effects, political regimes and economic governance institutions. The results suggest that there exists a statistically significant but non-monotonic resource abundance effect on growth (regression 1), with the tipping level of the resource rents per capita equal to $1808. Accordingly resource abundance undermines growth for those countries with resource rents per capita below $1808, while those on the higher side of the tipping level should be able to turn the resource rents into positive growth. The tipping level is much lower than the average rents per capita for Gabon (at $2326) and substantially higher than the average rents per capita for Venezuela (at $1424).

[7] There is clearly a direct causative relationship going from growth to GDP; hence, to the rents/GDP ratio.

Table 8.4 Economic growth and resource rents

Variable	(1)	(2)	(3)	(4)	(5)
Standard growth controls	Yes	Yes	Yes	Yes	Yes
Resource Rents					
Resource rents (per capita)	–0.003	–0.002	–0.002	–0.002	NS
Resource rents SQ (per capita)	0.0002	0.0002	0.0002	0.0002	NS
Political Regimes					
Polcon	–	0.007	–	0.007	–
Polity	–	–	0.0003	NS	–
Economic Governance					
Gov. effectiveness	–	–	–	–	0.02
Tipping Level of Rents Per Capita					
Rents per capita (in constant 2000 dollars)	1806	148	148	148 –	

Notes:
1. Source: Elbadawi (2015): based on GMM dynamic panel data growth regression, estimated using a data field spanning the period 1975–2013.
2. Standard growth controls includes a host of structural factors, policy variables, external variables and catch up effects.
3. All estimated coefficients are attained at least 5% significance level.
4. NS means the estimated effect is statistically insignificant.

Therefore these findings imply that only the HRPC group, especially the GCC, should be able to *unconditionally* turn their resource endowment of oil and mineral rents into positive growth. However, how could we reconcile such a finding with the institutional interpretation of the growth impact of resource rents? After all, societies cannot turn their resource endowment into a boon for development without properly allocating it to the building of human capital and infrastructure and the provision of research and innovation and other necessary public goods for sustained growth and civil peace. This in turn would require at least the coordination of two elements. First, a mechanism capable of aggregating individual preferences in society and channeling them through the political structure so that the population has an adequate representation in policy-decision making. Second, a structure of checks and balances capable of ensuring that those preferences are respected and that those responsible for enacting economic policies actually perform their duty (Elbadawi and Soto, 2012). First, I proxy these two interrelated mechanisms by the indexes of Polity and Polcon, which, respectively, account for political inclusion and political checks and balances. Secondly, the above mechanisms might be delivered by some aspects of economic governance that may not necessarily be

compatible with democracy or even explicit systems of political checks and balances. We use the World Bank's composite "Government Effectiveness" index as our primary proxy.

When the political variables are included (regressions 2–4) the non-monotonic effects still remain significant but the orders of magnitudes changed dramatically. Now the implied threshold level required for the resource to promote growth has substantially declined. When we control for Polity or Polcon, or both, the tipping level for rents per capita becomes $148, which is about the average mineral rents per capita for South Africa. And, under the counterfactual of good regimes that provide political inclusion and accountability, about 51 high and moderate resource endowed countries should be able to use the resource for promoting growth. However, this would leave a majority of more than 120 resource endowed countries on the wrong side of the rents per capita growth curve. Admittedly, for a few of these countries, such as the 20 countries with the lowest rents per capita, the resource rents are inconsequential, as most are developed countries. However, the significance of the finding is that political regimes do not explain the threshold effect.

Instead, government effectiveness seems to provide the answer. When included in the econometric model it enters positively and highly significantly, while both the linear and quadratic effects of the resource rent disappear (regression 5).

Resource rents, threshold effects and civil wars

Like growth collapse, civil wars have been prominently analyzed in the economic and political science literature as a major manifestation of the resource curse. For example, in a path-breaking paper that popularized panel data cross-country econometric analysis of the determinants of civil war onset, Collier and Hoeffler (2004)[8] argue that the existence of a "lootable" resource base is both a motive for rebellion and a facilitating factor. Because they need to purchase arms and recruit fighters, rebel organizations cannot survive without access to natural resource rents or other sources of easy financing, such as financial and military aid from sympathetic diaspora or friendly governments. In this primarily economic model of civil war, the opportunity cost of rebellion is also important and the authors model the supply of rebel labor as a function of the level of poverty (higher poverty reduces the opportunity cost of foregoing productive economic activity in favor of participating in an armed rebellion). The equilibrium level of risk of onset of civil war is given by equating the marginal product of rebel labor and government strength (measured by

[8] See also Fearon and Laitin (2005), Miguel and Sergenti (2004), Sambanis (2004), and Bodea and Elbadawi (2007), as representative examples of natural resource and conflicts.

the economic strength and the size of the military) to their respective marginal costs for a given level of natural resources. This model leads the two authors to argue that the risk of civil war initiation increases with the natural resource endowment and decreases with the opportunity cost of rebellion.

In addition to the "loot" factor, Collier and Hoeffler also consider "grievance" as a second motivation for rebellion. They account for grievance by the indicators of ethnic and religious fractionalization and the level of democracy or autocracy (Polity). It has long been argued in the political science literature that civil wars are largely caused by the "explosive" combination of high social cleavages and exclusive polity (Bodea and Elbadawi, 2007). However, Collier and Hoeffler argue that grievance-driven rebellions are harder to realize as they are more susceptible to collective action problems than are greed-driven rebellions. To resolve these collective action problems, one needs significant social capital or a vanguard of committed rebel sympathizers, whose decision to join the rebel movement encourages others to participate in rebellion. In addition, variables such as the level of ethnolinguistic fractionalization may increase the demand for justice while making the coordination of a rebellion harder. Thus, the net effect of some of these factors on the probability of civil war onset is *ex ante* ambiguous. The two authors test their theory by estimating a probability model of civil war onset[9] and find that educational attainment significantly reduces the risk of war onset as it raises the opportunity costs of political violence; natural resource-dependence (proxied by primary commodity exports as percent of GDP) is significantly and non-monotonically associated with the probability of war onset; ethnic and religious fractionalization do not increase the risk of war onset and may reduce that risk; and democracy has no significant impact on civil war risk. The authors interpret these results as lending more support to the "greed" model of rebellion.

The second generation of this strand of the conflict literature has focused on developing theoretical models that could better account for grievance factors, including by analyzing the extent to which political institutions might ameliorate the role of resource rents as a risk factor. Moreover, these papers employ the recently developed data on oil and mineral resource rents and more sophisticated panel data econometrics[10] to test their theory. For example, Hodler (2006) attributes low growth in resource endowed but fractionalized societies

[9] They estimate the model for the period 1960–99 (five-year panels), using civil war data from the UCDP/PRIO (2012) *Armed Conflict Dataset v.4-, 1946–2011*. Their dependent variable (war onset) is coded 1 if a war is initiated in any five-year period and 0 if there is no war.

[10] Unlike the econometric analysis of the earlier papers (e.g. Collier and Hoeffler 2004; Fearon and Laitin, 2005), which was largely based on pooled probit and logit panel data model, the more recent literature controls for country heterogeneity by using random-effects probit.

to the high susceptibility of these societies to conflicts.[11] Also Fearon (2005) argues that natural resources can foster conflict due to its corrosive effects on institutions and state capacity. And, Besley and Persson (2009) developed a model that predicts greater risk of armed conflicts due to weak institutions, low income and large natural resources. In their model the minority mounts an insurgency by using its army to seize power. Then, the government decides whether to use its army, which it can do whether or not there is an insurgency. These choices and the insurrection technology probabilistically determine who is in power. Finally, the winner determines the allocation of the natural resource. Bodea and Elbadawi (2007) build a game-theoretic model highlighting the role of political institutions and "latent" social conflict for explaining why socially heterogeneous societies that lack functioning democratic institutions are likely to be exposed to violent conflict.

More recently, Elbadawi and Soto (2015) develop a theoretical model describing the interplay between institutions (both political and economic) and natural resource rents. Unlike, Besley and Persson, in this model the majority social group in power mounts an opportunistic grab of the share of the natural resource accrued to the minority population thus potentially leading to a conflict (if the minority chooses to fight). However, whether or not conflict turns out to be the dominant strategy by both groups depends not only on the relative importance of the resource rents, compared to non-resource income, but also to the strength of the prevailing institutions. Their empirical results corroborate the predictions of the theoretical model. First, they find robust and positive association between resource rents per capita and the occurrence of civil conflict. Second, good economic and political institutions do reduce the hazard of conflict. Third, moreover, strong political institutions for checks and balances appear to weaken the impact of resource rents on conflicts. However, they found no significant association between the squared rents per capita and the hazard of civil wars. Hence, like other work in the second generation of this literature, they fail to reproduce the earlier finding of Collier and Hoeffler (2004), who estimate a non-monotonic effect for natural resource dependency as measured by natural resource export/GDP.

Though the linear effect does suggest that too small rents per capita will not be consequential, it does not, however, cohere with theory or the evidence from the HRPC group, especially the GCC. Very high resource rents might in fact be a deterrent to conflict, either through the "Hobbesian" effect of providing the state with substantial resources to crush potential insurgency

[11] See also Caselli and Coleman (2013), Reuveny and Maxwell (2001) and Grossman and Mendoza (2003) as other relevant examples from this strand of the literature.

or through strengthening the "authoritarian bargain", which proved to be effective in preempting incipient conflicts in highly resource endowed societies. Subscribing to this rather compelling argument, and in view of the insignificance of the non-monotonic effect, I hypothesized that perhaps the scale effect might be manifest in terms of a "threshold" rather than "non-monotonic" relationship. To test for this Elbadawi (2015) replicated Elbadawi and Soto's regression with an interactive term between rents per capita and the dummy for the HRPC group. This variable accounts for the potential effect of rents per capita for the country years belonging to the 12 HRPC countries. A subset of the results is reproduced in Table 8.5. Though, as in the original model, the overall linear rent effect remains positive and highly significant, the threshold effect was negative and highly significant as well. This suggests that the HRPC group were able to substantially ameliorate the risk of civil war associated with resource rents. Moreover, marginally expanding the threshold to include the 15 countries in the following group (with rents per capita higher than $400 but lower than $2000: Table 8.1) renders the threshold effect insignificant. As for the two political institutions, political checks and balances was found to be robustly and negatively associated with the hazard of civil war. Moreover, checks and balances appear to have weakened the linear rent effect, which was reduced in terms of order of magnitude and degree of significance when the former is included in the regression. Instead, and contrary to the model's prediction, democracy was not found to exert any significant influence.

Table 8.5 Resource rents and civil wars

Variable	**(1)**	**(2)**	**(3)**	**(4)**
Standard controls	Yes	Yes	Yes	Yes
	Resource Rents			
Resource rents (per capita)	0.327	0.316	0.324	0.315
Resource rents PC for HRPC group (equal 0 for other countries)	–0.250	–0.262	–0.255	–0.265
	Political Regimes			
Polcon	–	–0.692	–	–0.667
Polity	–	–	NS	NS

Notes:
1. Source: Elbadawi (2015): based on a random-effects probit regression model, estimated using a data field spanning the period 1975–2013.
2. Standard civil war onset GDP per capita and population density.
3. All estimated coefficients are attained at least 5% significance level.
4. NS means the estimated effect is statistically insignificant.

8.4 Resource abundance, threshold effects and democratic transitions

Until late in 2010 when the Tunisian revolution ushered the Arab world into a mini wave of popular uprisings, the region has not been affected by past democratic waves that transformed the political landscape in most countries in the developing world. Since the 1960s extreme autocracy reigns supreme, with the regional standard of democracy assessed at –7 in the Polity scale and only marginally improved to –4 by the time of the outbreak of the Tunisian revolution in 2010. The last major democracy wave started in mid-1970s in the Latin American region, which steadily democratized thereafter reaching a "full" democracy status (at a score of 8) in the 2000 decade. A similar but weaker trend was also experienced by East Asia, then Sub-Saharan Africa as part of a worldwide democratic consolidation following the collapse of the former Soviet Union. By mid-2000 both regions were assessed as "partial" democracies with a median Polity score of 4 for East Asia and 2.5 for Sub-Saharan Africa.

The lackluster performance of the Arab world triggered an active debate about the Arab "democracy deficit", with some scholars claiming that Arab societies are culturally different, the so called "neo-patriarchy" thesis. However, the whole cultural-societal approach has been widely criticized in the vast polemical social science and historical literature as irrelevant (e.g. see El-Affendi, 2011, for an extensive review). Also the arrival of the Arab spring should put to rest the couture talk about Arab "exceptionalism". Moreover, there is now ample evidence from various rounds of the "value survey" indicating that the Arab population, like most citizens of the world, do value freedom and democracy (Diwan, 2012). An alternative thesis for explaining the limited democratization in the Arab world is provided by Elbadawi and Makdisi (2011, 2013) and Elbadawi et al (2011), who argue that the dominance of the hydrocarbon resource on Arab economy and politics appears to be the main culprit, because it allowed incumbent autocrats to build a much more durable "authoritarian bargain" than has been possible in less resource-dependent regions. Moreover, the two authors also hypothesized that the frequency and intensity of conflicts, including the long-standing Arab-Israeli conflict, has provided a potent argument for authoritarian regimes to preempt political dissent, historically in the name of the Palestinian cause and more recently in order to contain Islamic extremism and terrorism.

Public sector employment has been used as a vehicle by incumbent autocrats for distributing rents in the Arab world as the key instrument for "greasing" the authoritarian bargain. For example, according to Ali and Elbadawi (2012), the average net oil rents per capita for the top 15 oil exporting countries, mostly from MENA, reached a hefty (real ppp) $ 20,000 during 2007, allowing them to

spend an equivalent of (real PPP) dollars 3,655 per citizen in the form of public sector wage bill per year. This is more than six times the per capita public sector wage bill for other non-resource developing countries, which averaged 586 real PPP dollars. Alesina et al (2000) provide a theoretical model as well as empirical support for why politicians use disguised redistributive policies as opposed to blatant transfers.[12] Therefore, it could be argued that incumbents in the Arab world consider public sector employment as a means to redistribute resources to their citizens, thereby "buying" their political allegiance. Moreover, expenditure on social welfare and infrastructure has also been an important element of the social contract in the GCC (e.g. Cammett et al., 2015).

However, while several incumbent regimes in the oil rich but populous Arab countries have experienced repeated revolts, coups and more recently mass protests, the GCC monarchies remain fairly safe. This points to the limits of the effectiveness of the authoritarian bargain for the former; hence, suggesting that the role of resource rents as a hindrance to democratic transition might be subject to scale effects, akin to the cases of growth and civil peace.

To explain the different political economy of rent distribution in the GCC and other populous oil Arab countries that might be shaped by the scale effect, Ali and Elbadawi (2012) develop a game theoretic political economy model that accounts for two strategies that might be adopted by an incumbent autocrat to avoid or prevent a revolt by the citizenry. One strategy would be to use the rent to expand public employment, where they use the size of the public sector as a "metaphor for the extent of redistribution from state to citizen that takes place". Instead, the other strategy hinges on spending the rents on the army and security apparatus in order to deter potential revolt.[13] Under fairly flexible assumptions, such as that a political repression strategy does not necessarily make the incumbent completely safe, but, instead, it makes the size of the rents (or public sector) needed to avoid a revolt smaller, their model predicts that a monotonic relationship between the size of the public sector workforce and natural resources per capita only exists for some parameter values. For low levels of natural resources per capita, the government sets up a state security organ and public sector employment is kept low. Beyond a threshold level, the optimal policy for the elite becomes to rely less on political repression and set up a large public sector work force; which essentially means, widely share the rents, beyond public employment, through spending on social welfare, infrastructure and other forms of public goods.

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[12] See also Desai, Olofsgård and Yousef (2009).

[13] Many economists have modeled dictatorships' use of repression for this purpose (see Wintrobe (1990), Ali (2009) and Nurmikko (2008)).

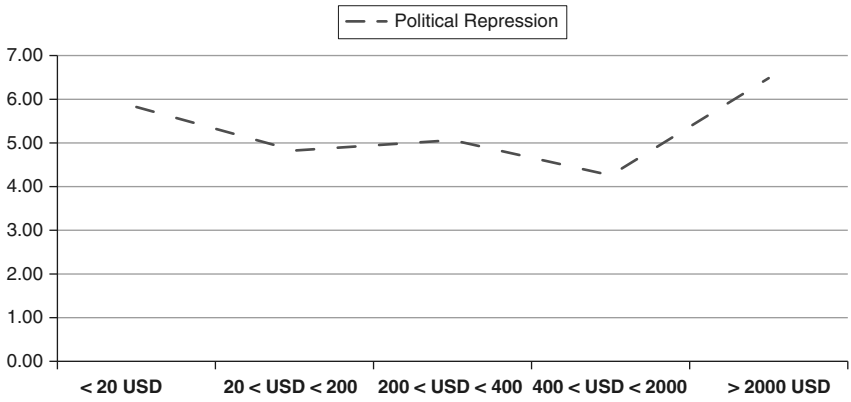

Figure 8.5 Median political repression in resource countries

The predictions of this model are strongly corroborated by the evidence. There is ample evidence of the large share of the budgets in authoritarian oil and other resource-rich countries devoted to military and security spending. However, such spending might also reflect other considerations, such as external threats. To avoid this ambiguity we follow Ross (2009) by using a direct measure of government repression that is available in the recently developed Cingranelli-Richards dataset (2008). This measure, called *Physical Integrity Rights*, constructs an annual variable that ranges from 0 (worst repression) to 8 (repression free) and accounts for the incidence of torture, extrajudicial killing, political imprisonment, and disappearances that are attributable to the government. The HRPC group seems to rely much less on political repression than does the median country in the rest of the resource countries (Figure 8.5). Also, the former, especially the GCC countries, spends much more (on a per capita basis) on education and health (Table 8.6) as well as manages to build a vastly superior infrastructure (Table 8.7).

To assess the effectiveness of the two alternative strategies in preventing a revolt, Elbadawi and Makdisi (2013)[14] estimate an extended version of the modernization democratic transition model that accounts for the potential role of resource rents per capita and political repression as a hindrance to democratic transition. In addition to the standard modernization controls, such as income per capita and economic growth, their model also accounts for the effects of home wars, unemployment and the legacy of previous political instability, given by the number of times a country experienced a transition

[14] This part of the section draws heavily from Elbadawi and Makdisi (2013).

from democracy to autocracy. They estimate the model using a panel data set of 449 half-decadal country periods between 1960 and 2009 and covering 118 countries, including 55 that generated annual average per capita (net) revenues of at least $50 (real PPP) from oil and other point-source minerals during the period; of which 14 are from the Arab world. I reproduce their results in the Appendix (Table A.1). However, to focus the discussion on the main issue under consideration in this chapter, I will only describe the results pertaining to the resource rents, political repression and the associated findings on the unemployment effect.

Effectiveness of the authoritarian bargain: the employment channel

The two authors ask whether resource rents are less effective in halting transition to democracy in economies with high unemployment. To address this question they formally test for this potential unemployment effect in the regression model, where they control for both the linear and quadratic unemployment effects. Their estimation results could be summarized in three main findings. First, the resource rent effect was no longer significant for those countries with resource rents below the top quartile (i.e. the bottom 75% resource countries in terms of rents per capita). Second, instead, for the top 25% group of countries, the resource rent effect remains highly negative and significant, despite controlling for unemployment. Third, unemployment enters with highly significant and non-monotonic effect. According to these estimates, unemployment rates higher than the threshold of about 10%[15] promote democratic transition.

It is pertinent to note that the unemployment story in the Arab world perfectly reflects the dichotomy between the highly resource endowed GCC and other populous oil Arab countries. While it remained well below 10% in the GCC it was much higher than the threshold in the latter group (Elbadawi and Makdisi, 2013). Moreover, the finding that even after controlling for unemployment the resource rent effect remains highly significantly and negatively associated with the probability of democratic transitions for the top resource per capita group, most notably the GCC, suggests that unemployment does not fully account for the resource rent effect for the GCC. This perhaps could be explained by the fact that the ruling monarchies in the GCC also use the rents to finance social programs, infrastructure or to extend direct cash transfers, etc. to their national population (Tables 8.6 and 8.7).

[15] This is given by the U-shaped coefficients of the linear and quadratic terms of unemployment of Table A.1 regression: approximately equal to {(–82.6/2 × 427.5)100 %}.

Table 8.6 Expenditure on human capital and knowledge in resource abundant countries (average: 2000–13 in constant 2011 international $)

	Government expenditure on education per capita	Health expenditure per capita, PPP	GDP per capita, PPP	Research and development expenditure per capita	Natural resource Rents per capita
Gabon	657	1,183	17,175	88	8,314
Equatorial Guinea	230	1,780	31,276		9,477
Norway	4,289	11,602	61,813	1,001	10,034
Trinidad and Tobago	815	2,661	26,051	21	10,914
Bahrain	2,301	3,455	86,619		11,894
Libya		1,729	24,189		13,376
Saudi Arabia	3,990	3,369	62,261	33	30,333
Oman	2,794	2,461	72,081	95	31,703
United Arab Emirates		4,203	466,410	2,281	116,755
Kuwait	14,240	4,620	253,480	300	135,013
Qatar	17,914	6,548	780,187		363,792
Median average of populous Arab countries	423	1,001	9,362	55	183

Notes:
1. Data is obtained from the World Development Indicator (June 2015) and authors' own elaboration.
2. GDP per capita based on purchasing power parity (PPP). PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates (in constant 2011 international dollars).
3. Total health expenditure is the sum of public and private health expenditures as a ratio of total population. It covers the provision of health services (preventive and curative), family planning activities, nutrition activities, and emergency aid designated for health but does not include provision of water and sanitation. Data are in international dollars converted using 2011 purchasing power parity (PPP) rates.
4. Expenditures for research and development are current and capital expenditures (both public and private) on creative work undertaken systematically to increase knowledge, including knowledge of humanity, culture, and society, and the use of knowledge for new applications. R&D covers basic research, applied research, and experimental development.
5. Populous Arab-Resource-Rich Countries include Algeria, Sudan, Syria, and Yemen.

The political repression effect

As argued by Ali and Elbadawi (2012), the incumbent autocratic elites in resource-rich countries would use the resource rents to expand employment and general social welfare of their citizens in their attempt to remain in power in lieu of extending the franchise. However, the elites are not likely to adopt a pure public sector employment strategy, as they might also find it necessary to use their resource rents to build an apparatus of political repression for pre-empting or quelling incipient or unfolding revolts.

Table 8.7 Infrastructure in resource abundant countries (average: 2000–13)

Resource-rich countries	Air transport, registered carrier departures worldwide	Fixed (wired) broadband subscriptions (per 100 people)	Internet users (per 100 people)	Rail lines (total route-km)	Fixed telephone subscriptions (per 100 people)	Logistics performance index: quality of trade and transport-related infrastructure (1=low to 5=high)
Gabon	6,388	0.2	5.2	791	2.3	2.2
Equatorial Guinea	4,371	0.1	4.1	-	–	–
Norway	279,951	22.9	82.5	4,108	41.3	4.0
Trinidad and Tobago	22,973	6.0	35.4	–	23.7	–
Bahrain	43,283	5.9	41.4	–	22.0	3.3
Libya	14,472	1.1	6.6	–	15.0	2.0
Saudi Arabia	146,223	3.0	26.5	1,329	15.7	3.1
Oman	30,873	1.1	22.8	–	10.3	3.0
United Arab Emirates	166,406	5.4	52.6	–	26.7	3.8
Kuwait	22,403	1.1	37.6	-	20.3	3.0

(*continued*)

Table 8.7 Continued

Resource-rich countries	Air transport, registered carrier departures worldwide	Fixed (wired) broadband subscriptions (per 100 people)	Internet users (per 100 people)	Rail lines (total route-km)	Fixed telephone subscriptions (per 100 people)	Logistics performance index: quality of trade and transport-related infrastructure (1=low to 5=high)
Qatar	66,283	5.8	38.7	-	22.4	2.9
Median average of all countries	17,173	2.7	20.1	2,812	15.7	2.4
Median average of populous Arab-resource-rich countries	15,474	0.4	8.1	3,927	4.0	2.2

Notes:

1. Data is obtained from the World Development Indicator (June, 2015) and authors' own elaboration.
2. Registered carrier departures worldwide are domestic takeoffs and takeoffs abroad of air carriers registered in the country.
3. Internet users are individuals who have used the Internet (from any location) in the last 12 months. Internet can be used via a computer, mobile phone, personal digital assistant, games machine, digital TV etc.
4. Fixed telephone subscriptions refers to the sum of active number of analogue fixed telephone lines, voice-over-IP (VoIP) subscriptions, fixed wireless local loop (WLL) subscriptions, ISDN voice-channel equivalents and fixed public payphones.
5. Fixed (wired) broadband subscriptions refers to subscriptions to high-speed access to the public Internet (a TCP/IP connection), at downstream speeds equal to, or greater than, 256 kbit/s. This includes cable modem, DSL, fiber-to-the-home/building and other fixed (wired)-broadband subscriptions. This total is measured irrespective of the method of payment. It excludes subscriptions that have access to data communications (including the Internet) via mobile-cellular networks. It excludes technologies listed under the wireless broadband category.
6. Rail lines are the length of railway route available for train service, irrespective of the number of parallel tracks.
7. Data are from Logistics Performance Index surveys conducted by the World Bank in partnership with academic and international institutions and private companies and individuals engaged in international logistics.
8. Populous Arab-Resource-Rich Countries include Algeria, Sudan, Syria, and Yemen.

Elbadawi and Makdisi (2011) formally test for the political repression effect in regressions by including the index of political repression in the threshold-based rentier model (of Table A.1), where they distinguish between three degrees of political repression, constructed as three quartile-based sub-indexes: low, moderate, and high degree of political repression. They find that both moderate and, especially, high political repression are negatively and significantly associated with democratic transitions. Moreover, they also find that the resource rent effect is no longer significant for the cases of the low and middle quartile per capita resource abundant groups. Instead, as for the case of unemployment, the resource rent effect for the high per capita resource abundant group, most notably the GCC, remains highly negative and significant.

Therefore, the above findings suggest that political repression, like unemployment, seems to fully explain the resource rent effect as a hindrance to democracy in the low or moderate rents per capita group, such as the populous oil Arab economies. Instead, it does not fully account for the resource effect for the highly endowed group, most notably the GCC. Drawing on the implication of these findings, the two authors interpret their findings as corroborating the predictions of Ali and Elbadawi's model, in that in high resource but population scarce countries the elites are likely to rely more on expanding public employment and less on political repression. Instead, the opposite is likely to happen in moderately endowed but populous countries.

The Gulf Cooperation Council (GCC) member countries provide the most notable example of the former, while the other oil-rich but populous Arab economies epitomize the latter. We already reviewed the evidence to this effect on public sector employment. In the same vein the cross-country data on the "physical integrity rights" reveals that the resource-rich countries constitute one of the leading repressive groups. However, again as in the case of unemployment, there is a significant difference between the highly endowed and the other lower resource-dependent countries. For example, during 2000–13 the HRPC group, which includes the GCC, had a median score of 6.0, which is only second to the developed country scores. On the other hand, the median for the group of resource abundant countries with rents per capita lower than $2000 but higher than $400, which includes populous oil economies, such as Algeria and Iran, scored about 3.5, the worst degree of political repression among the country groupings (Figure 8.5).

4.5 Conclusions

This chapter reviewed the received literature on the causal links from rents per capita to growth and civil wars, and provides new evidence of the existence of non-monotonic or threshold growth and civil war effects.

Relatedly, the chapter also analyzes the role of resource rents as a hindrance to democratic transition, and discusses the significance of scale effects in explaining the contrasts between the strategies of the GCC monarchies and the incumbent regimes in other populous oil Arab countries in terms of their use of the resource rents for promoting development and avoiding potential revolts.

There is now a broad consensus in the recent empirical growth literature that the resource curse does exist but it is a long-run phenomenon and is conditional on the presence of "adverse" political regimes, characterized by lack of political inclusion and weak systems of political checks and balances. The latter was found to be particularly critical for enabling resource endowed societies to turn the rents into a boon for growth and development. The empirical literature on the determinants of the hazard of civil wars also suggests parallel conclusions, where the risk of civil wars was found to be increasing with oil and mineral resource rents, but its effects tends to be partially mitigated in the presence of a strong system of political checks and balances. It is notable, however, that democracy turns out to be inconsequential in reducing the risk of conflicts, which reinforces the suspicion that the Polity score, though remains the most widely used quantitative measure of democracy, might be largely reflecting the "electoral competition" aspects of democracy than the other more relevant "inclusiveness" aspect of the political system.

However, this chapter argues that, despite the above important findings of the recent empirical strands of the growth and civil war literature and their contribution to our understanding of the resource curse, nonetheless, they failed to account for the important empirical regularity aspect regarding the different and much better development performance of a few unusually high rents per capita group of countries, most notably the six GCC countries. Against this backdrop the chapter presents new results from the growth and civil war models that account for potential scale effects. According to these findings only the high resource per capita (HRPC) group, especially the GCC, should be able to *unconditionally* turn their resource endowment into positive growth. Moreover, these countries are also less likely to be affected by the high risks of civil wars associated with resource rents, which tend to raise the risk of civil wars for low or moderately endowed resource societies. The very high rents per capita seem to have allowed incumbent regimes in some HRPC countries, especially the GCC group, to use the rents to buy loyalties within their societies , build external alliances as well as strengthen state capacity. These initiatives do not only explain the relatively strong government effectiveness in managing the economies but also in maintaining civil peace among their relatively small and homogeneous populations.

Finally, the chapter assesses the role of resource rents as a hindrance to democratic transition in the Arab world, and discusses the significance of threshold effects in explaining the contrasts between the GCC monarchies and the incumbent regimes in other populous oil Arab countries. We show that the high rents per capita underpinned a more developmental and sustainable political equilibrium that allowed the GCC monarchies to remain largely unaffected by the recent popular uprisings.

This chapter's findings suggest that the resource rents can only be an effective hindrance to democratic transition in a *functioning* authoritarian bargain, when they are used to create employment opportunities in undemocratic societies. Unlike the GCC monarchies, we argue that autocratic elites in lower resource-endowed societies are no longer able to continue expanding public employment, and that they seem to have a higher preference for political repression, as an alternative strategy to sharing rents, for remaining in power. Moreover, the new findings also suggest that the authoritarian bargain would continue to hold in high resource-rich societies even under high unemployment. This finding could be explained by the fact that incumbent elites in highly endowed societies possess enough resources to further promote social welfare through other means, such as direct cash transfers, generous pension programs, subsidized mortgage loans, etc.

Therefore, the unemployment channel, we would argue, is particularly relevant to explaining recent Arab uprisings in the low to medium resource-endowed countries, and the subsequent eruption of violence in most. Whereas, the relatively low unemployment, in addition to various social welfare programs, is relevant for explaining why the Arab Spring is yet to reach the GCC, and may not do so in the foreseeable future.

Our findings on employment and political repression in the context of the contrast between the GCC and the other moderately endowed oil-dependent Arab countries suggest two fundamental conclusions. First, it is clear that ruling autocratic elites in resource-rich societies might rely upon political repression only as a supplementary means of forestalling democratic transitions. Second, political repression is also likely to be a less efficient strategy for fending off democratic transitions than policies promoting public employment. In this context, it is pertinent to stress the fact that, while the populous Arab oil group has been susceptible to regime change, especially in the context of the ongoing political upheavals unleashed by the Arab democracy wave, the GCC countries seem to be relatively unaffected so far.

To conclude, and in view of the fact that the HRPC group, most notably the GCC, appear to have relatively effective economic governance, our results, therefore, suggest that they have been successful in using their massive hydrocarbon rents to promote growth and avert civil wars, because they were able

to put in place relatively effective institutions of economic governance. In turn, the latter was made possible in the first place by a political equilibrium underpinned by the very high rents per capita. However, thinking ahead there are, in my view, some pertinent questions to ask at this juncture: what are the likely long-term prospects for these countries and could they sustain this "good" political equilibrium? Obviously we could only speculate, but here are some cautionary notes.

Firstly, the simple answer is that there is a high risk of the unraveling of the model should major technology or price shocks significantly reduce the per capita resource rents and, hence, change, the political equilibrium faced by the incumbent monarchies

Secondly, the GCC politico-economic institutional set-up might be described in the jargon of the political economy literature as a relatively advanced form of "limited access order" (LAO), where projection of organized violence is firmly under the incumbent authorities and rents distribution is governed by inter-personal networks but adjudication and settlement of disputes among the elites are becoming increasingly formalized through courts and other formal arrangements. However, such an advanced system of LAO might take time to develop into an impersonal "open access order" (OAO), whereby the society graduates to stable institutional equilibrium. Moreover, in their analysis of the recent economic histories of Iran and Turkey, Esfahani and Gurakar (2014) draw implications for the Arab world and argue that the transition from LAO is likely to be uncertain and countries might very well experience a relapse to a fragile state of LAO or, instead, manage to graduate to an OAO.

Finally, and related to the above, the lessons of history regarding development of nations suggest that societies that mange to achieve inclusive political, but not economic, institutions or vice versa, are not likely to mature into economically prosperous and stable democracies (Acemoglu and Robinson, 2012).

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Appendix

Table 8A.1 How resource rent hinders democratic transitions: the employment and political repression channels

Variable	Random Effect Probit [19]		Random Effect Probit [20]		Random Effect Probit [21]	
	Coefficient	Z	Coefficient	Z	Coefficient	Z
Log Real GDP per capita	0.86	0.55	3.08***	3.04	–0.07	–0.20
Real GDP pc Growth	–29.51	–1.44	–32.52*	–1.84	–8.66*	–1.65
Dum_25*Log Rentpc	0.62	0.47	–	–	–0.27	–0.67
Dum_25-75*Log Rentpc	0.12	0.16	–	–	–0.30	–1.31
Dum_75*Log Rentpc	–1.42***	–2.71	–1.09***	–2.63	–0.39**	–2.55
STRA	4.93***	3.11	5.55***	4.25	0.76**	2.16
Non-Oil Arab	–39.93	–0.00	–	–	–10.79	–0.00
SSA	–8.04	–1.44	–	–	–2.18**	–2.41
LAC	–2.52	–1.04	–	–	–0.16	–0.25
SCA	–6.29	–1.47	–	–	–0.27	–0.23
EA	–6.20	–1.50	–	–	–0.55	–0.71
Partial Democracy	–	–	–	–	1.01	1.95
Home War	–	–	–	–	–1.00*	–1.70
Unemployment rate	–79.18	–1.59	–82.62**	–2.10	–	–
Unemployment rate _sq	419.17**	2.06	427.48**	2.56	–	–
Political Repress_25	–	–	–	–	–4.27	–1.64
Political Repress_25_75	–	–	–	–	–1.88*	–1.80
Political Repression_75	–	–	–	–	–2.13**	–2.40
Constant	–0.84	–0.06	–20.82	–2.76	3.23	1.11
Observations	122	–	122	–	216	–
LR statistic	17.86	–	25.94	–	3.16	–

(*Continued*)

Table 8A.1 Continued

Variable	Random Effect Probit [19]		Random Effect Probit [20]		Random Effect Probit [21]	
	Coefficient	Z	Coefficient	Z	Coefficient	Z
Value	0.000	–	0.000	–	0.038	–
Log Likelihood	–34.13	–	–36.86	–	–72.05	–

Notes:

1. From Table 8 of Elbadawi and Makdisi (2013).
2. *: for 0.05 < p-value ≤ 0.10; **: for 0.01 < p-value ≤ 0.05; ***: for p-value ≤ 0.01
3. Definition of dependent variable (***Democratic transition***): a country is coded as having witnessed a democratic transition during the period (t_0, t_0+N), provided that it experienced a jump of 'three' points in the Polity scale at time t_0 and that the average log change in this index is non-negative during the period between t_0 and t_0+N. The length of the transition period (N) is equal to 5v years.
4. Definition of Regressors:
   - Log Real GDP pc: natural logarithm of initial GDP per capita in each period
   - Real GDP_pc Growth Rate: Real GDP pc growth rate in each period
   - Ln Rentpc: Natural logarithm of resource rents per capita
   - Dum_25*Log Rentpc: interaction between Rent pc and a dummy variable for the lowest quartile of the same variable
   - Dum_25-75*Log Rentpc: interaction between Rent pc and a dummy variable for the two middle quartiles of the same variable
   - Dum_75*Log Rentpc: interaction between Rent pc and a dummy variable for the top quartile of the same variable
   - STRA: sum of transitions from democratic to authoritarian regimes during the period
   - Log Real GDP pc: natural logarithm of initial GDP per capita in each period
   - Real GDP_pc Growth Rate: Real GDP pc growth rate in each period
   - Arab: Dummy variable = 1 if country is in the Arab region, 0 otherwise
   - GCC: Dummy variable = 1 if country is a member of the Gulf Cooperation Council of the Arab region, 0 otherwise
   - Other Oil-dependent Arab: Dummy variable = 1 for non-GCC oil-producing Arab countries, 0 otherwise
   - Non-oil Arab: Dummy variable = 1 for non-oil Arab countries, 0 otherwise
   - SSA: Dummy variable = 1 if country is in Sub-Saharan Africa, 0 otherwise
   - LAC: Dummy variable = 1 if country is in Latin America and the Caribbean, 0 otherwise
   - SCA: Dummy variable = 1 if country is in Southern Central Asia , 0 otherwise
   - EA: Dummy variable = 1 if country is in East Asia, 0 otherwise
   - Partial Democracy: Polity multiplied by a dummy for Partial Democracy, where the latter = 1 if Polity falls in the closed interval [1,8]
   - Home war: dummy that equals 1 if a country experiences civil or external wars during the period; 0 elsewhere
   - Unemployment rate (source ILO): the number of unemployed divided by the labor force (employment + unemployment)
   - Political Repress_25: Political Repression index multiplied by a dummy for countries in the lowest quartile of political repression distribution (where the index of Political Repression is increasing in terms of the degree of repression and ranges between 0 (repression free) to 1 (most repressive))
   - Political Repress_25-75: Political Repression index multiplied by a dummy for countries in the two middle quartiles of political repression distribution
   - Political Repress_75: Political Repression index multiplied by a dummy for countries in the top quartile of political repression distribution.

9

Beyond the Resource Curse: Rents and Development

Adeel Malik

9.1 Introduction

This chapter offers a brief critical reflection on the Middle East's resource curse. The region has typically been described as performing in the middling range, growing neither as well as East Asia nor as badly as sub-Saharan Africa. Arab economies have experienced a modest growth performance with substantial volatility of macroeconomic outcomes. The symptoms appear all too familiar: a weak private sector, unproductive investment in white elephant projects, pervasive rent seeking, and a large and oversized public sector. Government spending (especially on subsidies and public employment) has remained surprisingly resilient in the face of fluctuating oil prices. The relationship between oil and development in the Middle East and North Africa (MENA) is well-documented (Yousef 2004; El Badawi 2005; Nugent and Pesaran 2005). Most of the region's development challenges have been traced to the pathologies associated with natural resource abundance.

The underlying theoretical frame to support the region's adverse development record was the well-known approach of the Rentier State Theory (henceforth, RST), which argues that unearned revenue streams, external to a country and accruing mainly to the government, distort economic and political incentives. The concept of a rentier state was originally formulated in the area studies literature to describe Iran's economic stagnation in the face of its growing oil revenues (Mahdavy 1970). Its first systematic typology, developed by Beblawi and Luciani (1987), was also inspired by the experience of Middle Eastern oil exporters. The main implication of RST was political: direct access to resource revenues also allows state elites to buy political consent through repression and (re-)distribution.

Development in a rentier state often descends from above, with the state acting as the principal actor in the economy. The prime function of the rentier state is the allocation or distribution of rents. This turns incentives away from

production to predation, stifling competitive structural change that could have produced a social structure more favourable to democratization – independent classes and horizontal civic alignments in society (Beblawi and Luciani (1987); Ross 2001). As long as the state is able to effectively distribute its rents it remains largely autonomous from society, and, therefore, relatively insulated from independent political action. In terms of economic structure, rentier states are ill-equipped to support (private) production, especially a strong manufacturing capability. After dominating the field for nearly three decades, the RST has come under growing criticism. Although the general claims of the theory fit the actual experience of the Middle East rather well, it has been criticized for: lacking context, especially the role of historical legacy; neglecting dynamics; and offering a limited window into the mechanisms through which oil wealth undermines development.

This chapter develops the case for re-imagining the study of Middle Eastern political economy through a broader conceptualization of rents that goes beyond an exclusive focus on hydrocarbon rents. I argue that the region's political economy is best understood by considering the totality of the rentier experience of which oil rents are only one, albeit dominant, component. Other important non-oil rent streams to consider in this regard are derived from foreign aid, remittances and rents from government manipulation of the economy. Together with oil, these rents play a hugely significant role in explaining the region's perverse political economy characterized by authoritarian resilience and dependent economic structures. Importantly, considering these rents in totality allow us to consider, as part of the same framework, the problem of development in resource-scarce economies of North Africa and Levant together with the resource-rich economies of the Gulf Cooperation Council (GCC).

While it is time to retrieve the MENA political economy from its predilection with oil and its aftereffects, this note recognizes the centrality of the unearned revenue streams from oil for the region. Rarely any facet of MENA political economy can be studied without a deep understanding of the ways in which oil shapes the state-society relationship. Many of the region's pathologies, whether it is unemployment, a bloated state, weak private sector or limited political evolution, are ultimately rooted in an economic structure heavily reliant on external windfalls. In this chapter, I only advocate a broadening of the types of rents and their deployment. Considering the non-oil rent streams from aid and remittances only allows us to drop the over-emphasized distinctions between resource-rich and resource-scarce countries. An important macroeconomic regularity of the region is that growth in all MENA countries – whether oil-rich or oil-scarce – is driven by movements in oil prices. The relative abundance or scarcity of hydrocarbon wealth only defines the degree or extent of economic malaise, but an exclusive focus on oil understates the importance of linkages between oil exporters and oil importers.

An additional difficulty with resource-curse explanations is that they ignore the important contribution of domestically derived rents from economic policy distortions. These rents from protection that favour regime insiders are crucial to sustaining authoritarian stability in countries where revenues from oil are either non-existent or insufficient to meet distributional commitments. These economic rents, which are largely derived by posing barriers to competition, serve an important political function. Among other things, they allow rulers to build elite coalitions whose interests are aligned with regime continuity. Their economic implication is equally significant. Such distortions produce a bipolar economic system, defined by an interventionist state and a large informal sector. Together with revenues from oil, aid and remittances, these regulatory rents shape the region's political economy in a most profound manner. By extending the nature and types of rents, it is easy to argue that the Middle East suffers from a wider *rent curse*, not just an oil-driven resource-curse. The scale and significance of this rent curse has not been adequately appreciated by scholars of MENA political economy.

The rest of this chapter is organized as follows. Section 9.2 provides a broader conceptualization of rent streams. Section 9.3 proposes some distinguishing characteristics of MENA political economy. Finally, section 9.4 offers some concluding remarks on the subject.

9.2 Toward a broader conceptualization of rent streams

The Middle East is a resource-rich region par excellence. Proven crude oil reserves in the Middle East are at least three times higher than other regions. The region is also known to possess one of the largest proven gas reserves in the world. The Middle East's exceptional resource riches are confirmed by several measures of natural resource abundance. Recent estimates for the natural wealth of nations suggest that, on a per capita basis, MENA possesses the highest oil wealth in the world. As a percentage of GDP, natural resource rents in MENA are, on average, three to four times higher than sub-Saharan Africa and Latin America (World Bank 2014). But the Middle East is exceptional, not just on account of its resource riches, but also when judged on the basis of non-oil rent flows. To elaborate on this, consider three rent streams: aid, remittances, and rents from protection.

As a region, MENA is one of the largest aid recipients in the world, leaving behind sub-Saharan Africa and South Asia – the two regions that are home to the largest number of poor in the world. The average MENA state receives more aid rents per capita than the average low-income country or sub-Saharan African state. During the last 40 years MENA countries received roughly two to three times more foreign aid per capita than other developing regions. Regional comparison reveals the scale of difference. While South Asia received only

$6 per capita in net foreign assistance during the last decade, the MENA region received $43 per capita. As global evidence suggests, need is not the only driver of aid. Foreign aid inflows are closely linked with the strategic objectives of donor countries. This is best reflected in MENA, where foreign aid can be best characterized as a geo-political rent. Apart from being endowed with considerable natural resource wealth, the Middle East has also remained a perpetual zone of conflict. The geo-political vision of stability, enforced by global powers and regional patrons, rests on buying peace in the neighbourhood of the Palestinian-Israeli conflict. As a result, the two countries with the largest net aid per capita ($128) are Lebanon and Jordan, both neighbours of Israel. Even the middle-income countries of North Africa – the likes of Egypt, Morocco and Tunisia – receive more aid on a per capita basis than a typical Latin American country.

While the numbers in Table 9.1 correspond to the decade beginning in 2000, aid flows have significantly increased since the Arab uprisings in 2011. In Tunisia, the home of the Arab spring, net aid per capita has risen up to $86; the corresponding figure for Egypt is $158. Egypt's case is truly emblematic. Since the Arab spring, Egypt's fiscal balances are ever more dependent on regular cash injections from rich Gulf neighbours. There are few places in the world that can match the scale of such resource flows. Billions of dollars in aid are needed to keep Egypt's fiscal machine running from one year to the next. Importantly, the region's aid flows are practically free of any explicit aid conditionality that typically accompanies aid in developing countries. Such free cash windfalls exacerbate the moral hazard dilemma and weaken the incentives for reform. The soft budget constraint induced by foreign aid creates weak incentives for economic reform, which, in Egypt's case includes the politically sensitive issue of subsidy reform. Through adverse political economy incentives, aid can replicate the pathologies associated with a resource curse (Djankov, Montalvo, & Reynal-Querol 2008). There is some disagreement on whether this reflects Dutch disease effects (Rajan and Subramanian 2011), rent seeking (Boone 1996) or political instability (Islam 2005).

A second significant rent stream is generated by remittances from expatriate workers, which have quadrupled over the last two decades, reaching up to around half a trillion dollars (about three times the amount of total foreign aid globally). The Middle East is again exceptional on this account. As the second panel of Table 9.1 shows, during the period, 1980–2011, the MENA region enjoyed the highest ratio of remittances to GDP in comparison to other major regional groupings of developing countries (4% compared to 1–1.5% in LAC and SSA). Within the MENA region, Jordan and Lebanon stand out in terms of these remittance flows; in both countries remittances comprise around 20% of GDP. Few observers would dispute the profound impact of remittances on the Lebanese political economy. With its dependence on remittances, Lebanon

Table 9.1 Aid and remittances in MENA

Net ODA per capita, current US$

	1960–69	1970–79	1980–89	1990–99	2000–09
Egypt, Arab Rep.	3.993	35.235	31.405	50.839	17.412
Jordan	68.264	219.396	323.901	138.418	128.928
Lebanon	4.909	28.669	62.569	70.969	127.977
Morocco	6.383	14.425	30.462	30.693	26.591
Syrian Arab Republic	2.186	86.681	90.018	27.669	6.235
Sudan	1.771	13.148	37.232	14.824	32.205
Tunisia	17.809	32.361	32.231	26.240	34.407
Yemen, Rep.	3.610	32.602	50.324	21.647	16.133
Memo Items:					
Middle East & North Africa	6.543	24.778	28.097	28.637	43.964
Latin America & Caribbean	2.944	3.763	8.374	12.031	12.530
South Asia	2.301	3.121	4.960	4.634	5.786
Sub-Saharan Africa	3.918	9.031	23.041	29.695	38.113
Low income	2.190	7.515	18.825	23.089	31.111
Selected oil exporters:					
Iraq	0.572	3.175	2.958	11.519	214.734
Bahrain	7.767	173.107	308.432	207.568	103.493
Oman	1.454	124.110	79.221	60.144	33.993

Personal remittances received, % of GDP

	1980–89	1990–99	2000–09	1980–2011
Egypt, Arab Rep.	10.078	7.693	4.248	7.248
Jordan	19.519	18.817	20.001	19.035
Lebanon	–	–	22.123	21.514
Morocco	6.717	6.333	7.588	6.899
Syrian Arab Republic	3.055	2.741	2.265	2.689
Sudan	2.258	2.522	5.183	3.251
Tunisia	4.183	3.644	4.372	4.092
Yemen, Rep.	–	20.097	8.915	13.606
Memo Items:				
Middle East & North Africa	–	4.897	3.497	4.037
Latin America & Caribbean	0.391	0.733	1.688	0.951
South Asia	1.947	2.055	3.615	2.638
Sub-Saharan Africa	0.641	1.035	2.463	1.460

Source: World Development Indicators, 2014.

shares many of the features that are characteristic of rentier states. Unlike the rent streams from oil and aid that are largely concentrated in the government, remittances are well-dispersed among recipients. This can lead to more ambiguous effects. While remittances are shown to have favourable effects on financial sector development, they can also produce the familiar Dutch disease effects that adversely affect the manufacturing sector and economic growth in

the long-run (Rajan & Subramanian 2008, 2011). Remittances are also shown to have favourable effects on health and education outcomes.

Although remittance flows tend to be stable and diffusely distributed their net impact is disputed (Rajan & Subramanian 2011). This is especially true when it comes to mapping the political economy effects of remittances. By cushioning foreign exchange reserves, remittances can artificially insulate countries from economic crises. Since crises often spur economic reform, remittances not only postpone crises they can also weaken the incentives for economic reform. Together with foreign aid, dependence on remittances can weaken efforts for domestic resource mobilization. A weak tax effort, in turn, is associated with lower state capacity, weakening a crucial link between the state and its citizens. At the same time, remittances can have positive localized political effects. In a milieu where voters are tied in patron-client relationships, remittances can extricate their recipients from a disempowering dependence on politicians for public goods provision. As independent sources of income, remittances can also set into motion favourable political dynamics associated with the emergence of a vibrant middle class. The aggregate political economy effects are thus *apriori* unclear. The cross-country empirical evidence casts a negative light on the relationship between remittances and politics. Recent research demonstrates that a greater share of remittances in national income is associated with authoritarian stability (Ahmed 2012). Although the underlying mechanisms are still unclear, the stylized empirical regularity tends to fit the Middle Eastern pattern.

The third rent stream is generated from the domestic economy by erecting competitive barriers, administrative controls and burdensome regulation. Rents generated through such manipulation of economic policy are used to protect the privilege of insiders. MENA economies suffer from large-scale subversion of markets that blurs the boundaries between the public and private sectors and create impermeable barriers for unconnected firms. The pathology of the missing middle, where the firm space is divided between large connected firms at the top and informal firms in the periphery, is partly a result of such exclusive economic policies. All across MENA – but particularly in labour-abundant economies – firms can only grow up to a certain threshold. To cross this barrier of mobility, firms must enter into partnership with ruling elites.

Arab markets are one of the most protected in the world, suffering from a prolonged legacy of exclusive monopoly concessions and a variety of arbitrary barriers to domestic and foreign trade. Although such protection is commonplace across many resource-rich and low-income societies, the MENA region is exceptional in many respects. Non-tariff barriers, which are well-known for their arbitrary, discretionary and non-transparent character, are more pervasive in MENA economies than other developing regions. Even sub-Saharan Africa, which suffers from high levels of protection, trails behind on measures

of trade protection. Such protection is often driven by the need to divide the economy for insiders who are given control of various parts of the economy. These extractive policies and the rents they generate carry a larger significance in political economy terms. They are used to sustain an elite coalition whose interests are broadly aligned with those of the regime. It is not without reason that such protective devices are more pervasive in MENA's labour-abundant economies where the distributional commitments are large relative to the available resource envelope. Thus, when rents from hydrocarbons are scarce, other rent streams assume greater significance for regime survival.

Given the scale and significance of these rent streams, it is clear that MENA's political economy cannot be completely explained away by oil rents alone. The region suffers from a larger rent curse, of which hydrocarbon rents form an important part. It is also difficult to explain the adverse performance of relatively resource-scarce Arab countries (the likes of Syria, Jordan, and Egypt). Despite the absence of vast quantities of oil, many of these societies share the resource-curse symptoms of their oil-rich neighbours. In these contexts, non-oil rent streams from aid, remittances and economic controls sustain the adverse political economy equilibrium.

9.3 How does the MENA political economy differ from other regions?

Having argued that the MENA region suffers from a particularly acute rent curse, it is useful to pose a more general question: What are the distinguishing characteristics of the Middle Eastern political economy? Throwing greater light on this can enrich the discourse on natural resources and development more generally. In this section I propose five salient characteristics that distinguish the MENA political economy from its resource-rich counterparts globally.

Scale of rents and channels of distribution

A first obvious feature, much emphasized in the preceding pages, is the scale and volatility of oil rents. As a share of GDP, natural resource rents in the Middle East are, on average, three to four times higher than Latin America and Sub-Saharan Africa. These rent streams are also considerably more volatile in MENA (standard deviation of the resource rents ratio is 12% compared to 3% in LAC and 5.5% in SSA). Importantly, the significance of resource rents in MENA is demonstrated by the fact that the export structure of even relatively oil-scarce countries is dominated by fuel. The ratio of fuel exports to total exports, averaged over the period 1962–2008, is 63% in Syria, 34% in Egypt, and 21% in Tunisia. The MENA region also stands out for the multi-faceted linkages that bind the fate of oil and non-oil economies of the region. Whether a country in question is resource-rich or resource-poor, hydrocarbons are a

powerful driver of the Middle Eastern political economy. The significance of such spatial effects – operating through aid, remittances, and a variety of other channels – is arguably more profound in the Middle East when compared with other resource-rich regions.

This exceptional scale of resource rents also translates into specific patterns of deployment. While most resource-rich states tend to distribute their wealth through salaries and subsidies, the scale, coverage, and variety of these distributional channels sets MENA apart from other regions. The rent-funded welfare regimes in the Middle East cover a more extensive spectrum of social services, ranging from employment and education to housing and food. The average Middle Eastern country, regardless of whether it is a net exporter or importer of oil, also spends a staggering proportion of its revenues on energy subsidies. About one-half of global energy subsidies are disbursed in MENA, which amounts to nearly a third of the region's oil surplus and 8.5% of its GDP.[1]

Energy subsidies are pervasive even in relatively oil-scarce countries: Egypt spends nearly 11% of its GDP on fuel subsidies; the corresponding ratio in Yemen is 6%. Energy subsidies are even more costly if implicit subsidies (for electricity production and state-owned enterprises) are taken into account. The opportunity cost in terms of foregone spending on health and education is similarly high. In Egypt the total subsidy bill is three times the combined spending on health and education.[2] Food subsidies, though less burdensome in fiscal terms, remain equally pervasive in a region known for its astonishingly high levels of dependence on food imports.[3] Despite its notorious scarcity in the region, water is provided virtually free of charge.[4]

Apart from salaries and subsidies, which dominate the distribution regime, MENA states rely on a variety of other channels for sharing resource wealth. One important channel for rent distribution is the financial sector. Favoured groups benefit from subsidized credit in the form of interest free loans.[5] By early 2013 personal loans granted to the GCC citizens exceeded $355.3 billion.[6] While universal subsidies buy broader public support, other means are

[1] This is equivalent, according to IMF estimates, of 22% of government revenue.

[2] Energy subsidies are also badly targeted, since their benefits disproportionately accrue to urban areas and the rich.

[3] Food subsidies constitute 0.7% of GDP in MENA, while there is considerable variation across individual countries.

[4] Even when charges are in place these are normally very nominal and do not reflect the actual cost of provision.

[5] Many MENA states extend credit for homes and businesses. The financial channel is particularly important in Iran which has suffered through a state of financial repression, and where cheap credit to favoured constituencies has helped to consolidate support for the regime.

[6] Citizens of the UAE and Saudi Arabia were the largest beneficiaries of this favoured credit.

used to purchase elite consent. Oil-funded public investment generates plentiful opportunities for taming political and business elites through construction contracts, import licenses, and land acquisition deals. The construction sector – a key beneficiary of resource-windfalls – depends, in turn, on the import of foreign labour that is organized through a sponsorship system (*kafala*) that generates additional rents for local sponsors, without whose permission migrants can neither enter (or leave) the country nor change jobs. While a comprehensive description of these channels is beyond this chapter's remit, the preceding discussion highlights the scale and variety of distributive rents that set MENA apart from its resource-rich counterparts.

Organization of labour markets

Another distinguishing aspect of the MENA political economy is the structure and performance of its labour markets. Arab labour markets are defined by segmentation along different lines: between nationals and migrants, public and private sector, formal and informal sector, and males and females. Such dualism is particularly evident in the GCC where universal public employment is offered to nationals and the private sector is dependent on migrant workers. Across the region, some 60% of formal employment is provided by the government. Higher wages in government jobs create an ingrained preference for state employment.[7] New entrants to the labour market prefer to queue for public employment than to accept a job in the private sector. This is a feature not just of oil-rich countries alone: in a recent Gallup poll only 5–8% of respondents in resource-scarce North Africa (Tunisia, Egypt, and Morocco) expressed a preference for private sector jobs. As the fiscal cost of maintaining high levels of public employment becomes growingly unsustainable in resource-scarce countries, the adjustment costs are passed on to the "outsiders" of the system: educated youth and the informal sector (Assad 2014).[8] Apart from this inter-generational inequity, dualistic labour markets reinforce multiple distortions in education, finance, and private sector development.[9]

Structurally, however, this labour market segmentation is grounded in a political equilibrium supported by a social contract that uses public employment as

[7] There are several other non-wage benefits associated with government jobs as well.

[8] As Assad (2014) shows falling government employment in Egypt is being compensated for by a growing share of the labour force employed by the informal sector.

[9] This peculiar structure of labour markets comes at a significant development cost. It traps the educated labour force in unproductive public jobs and distorts the educational incentive structure by emphasizing credentials over skills. Access to state employment is also rationed through connections, which means that the labour market system works to the advantage of insiders (especially prime-age workers). It is also associated with low rates of female labour force participation, high rates of youth unemployment, and limited geographic mobility. See Assad (2014) for a detailed review.

a key mechanism for rent distribution to citizens. In fact, the operation of Arab labour markets underscores all three factors in Weber's analysis: class, status, and power. Traditionally, public employment has been used to tie the fortunes of middle classes and members of important sects, tribes, and clans with the fate of the ruling coalition. Keeping middle classes dependent and immobilized, dualistic labour markets have preserved a political division of labour that forecloses all avenues for class-based politics. This dualism is maintained through unhindered access to rent streams, of which oil rents are only one component.

Progress in human development

In the large-N literature, natural resource dependence is associated with higher levels of income inequality and lower education and health outcomes (Gylfason 2001; Gylfason and Zoega 2003). The Middle East defies this trend. Over the last five decades, the MENA region has made impressive progress in human development, especially in universalizing primary education. The region has experienced one of the fastest growth in educational attainments (Youssef 2004). Of the top 20 high achieving countries in terms of increasing mean years of schooling between 1980 and 2010, nine belonged to MENA (Campante and Chor 2012).[10] Despite lingering quality issues, even this quantitative access to education and health services is no mean achievement, especially in a global milieu where many developing countries are still struggling to put all their children in school.[11]

The average Arab state spends a greater proportion of its GDP on education than developing countries. The region also compares favourably on commonly used measures of poverty and inequality. For example: the incidence of extreme poverty is lower (the headcount estimate for 2008 is only 2.70 compared with 6.70 in Latin America and 35.97 in Latin America). The region has also made a remarkable advance on composite measures of human development. In 1990 low-income Arab countries did not fare much better on the HDI than sub-Saharan Africa; in 2007 they surpassed the levels achieved by most developing countries (Malik 2012). This is another instance where MENA's rentier experience produces radically different patterns of human development – patterns that are ultimately rooted in a rent-funded social contract that trades welfare distribution for political acquiescence. The Arab model of the human development model is ultimately self-undermining, since it is primed to produce greater youth unemployment and unfulfilled aspirations. Generous welfare provision also comes at the expense of a long-term advance in human capabilities, since it compromises political agency.

These distinct shades of the MENA political economy are an outcome not just of the region's resource riches but also its history. The impact of natural

[10] Eight Arab countries plus the Islamic Republic of Iran.
[11] Similar achievements have been made in improving life expectancy.

resources on development is mediated through a different set of initial conditions. On the eve of independence, many Arab societies inherited a weak business class and centralized bureaucratic structures. The Ottoman political economy, the strength of prior social formations, and the rentier structures in place before independence left a deep imprint on subsequent paths of development. Importantly, an exclusive focus on oil, without mapping the totality of the rentier experience, cannot adequately encapsulate the Arab political economy.

Anatomy of business-state relationship

The organization of business life in the Middle East and its relationship with the state offers another arena for comparison. Although the private sector in resource-rich countries is typically influenced by a dominant natural resource sector, the fragility of MENA's private sector is legendary. The boundaries between the public and the private are blurred to the extent that business is permitted to thrive only under the shadow of the state. Even in the Gulf, which has a long tradition of accommodating business elites into the ruling circle, businesses lack both "political clout" and an "autonomous organizational space" (Hertog et al. 2013). Throughout the region there is a preponderance of older, more connected firms that monopolize economic advantage. Such crony capitalism, frequently termed as "networks of privilege", was particularly rife in Arab spring countries. By one estimate, about 58% of manufacturing firms in Egypt can be characterized as politically connected. These firms had preferential access to credit: in a sample of ORBIS firm 92% of loans were allocated to the politically connected firms (Diwan and Schiffbauer 2013).[12]

Arguably, such crony capitalism is not unique to MENA. Similar crony capitalist structures have been witnessed in other oil exporting nations, ranging from Angola to Kazakhstan and Nigeria to Venezuela. An important question – and one that still needs to be answered – is whether the Middle East is home to a different variety of cronyism. This remains a fertile area for research. Prima facie, several tentative explanations can be put forward, rooted in factors such as the small size of the non-tradable sector, reliance on specific modes of protection (e.g., monopoly licenses and non-tariff measures), weak initial conditions manifested through a historically weak business class and the legacy of centralized rule. Evaluating the comparative strength of such explanations should be an important task of future research.

Neighbourhood effects

Another striking feature of the MENA political economy is its prolonged exposure to conflict and geo-political instability. While obvious to the lay observer,

[12] ORBIS is a global company database, produced by Bureau van Dijk.

dominant narratives of regional political economy have tended to ignore the pernicious role of negative spatial influences. The Middle East remains an active site of regional and global conflict. This has produced powerful neighbourhood effects from which, effectively, no individual Middle Eastern state is insulated. Given the central role played by this region in global power politics, the external environment profoundly shapes the domestic political economy. Regional spill-overs from conflict take multiple forms, including such diverse factors as migration, capital flight, disruption of supply chains, entrenched uncertainty, absence of connective regional infrastructure and the like. A canonical example of the primacy of the external is provided by Lebanon whose political economy is intimately shaped by regional developments. Similarly, it is impossible to evaluate any aspect of the Jordanian political economy without taking account of the several waves of conflict-induced migrations into Jordan.

In the region's high rent per capita economies, the importance of the external environment can be gauged from the fact that the domestic political arena is co-constituted with the geo-political order. Historically, the GCC states have remained dependent on foreign powers for their income and protection, which binds them in a relationship of mutual interdependence with western powers. But the external dimension is not simply equal to western influence. GCC states have increasingly played the role of regional brokers in conflict management. As recent events have shown, oil-rich states play a direct role in coordinating the war and post-war efforts in the region (their engagement in Syria and Libya is just one example). Enjoying greater financial leverage over neighbouring Arab states, rich Gulf countries have been effectively subsidizing the social contract of Yemen, Jordan, Egypt, and Bahrain. The subsidy regime in these countries will be unsustainable without regular cash injections from their rich neighbours. All of this underscores the important role played by neighbourhood effects and regional spill-overs. With few exceptions, they have largely remained under-studied.

9.4 Concluding remarks

This chapter has developed the case for broadening the scope of rentier analysis beyond its predilection with oil, and by accounting for a variety of non-oil rent streams generated by aid, remittances, and economic protection. The Middle East is exceptional not just in the scale of its natural resource endowments but also in the availability of other rent streams that, together with oil, shape the region's political economy. I have argued that the interaction of these various rent streams provides a richer description of the MENA political economy. In fact, juxtaposing these different rent streams in the analysis can allow us to re-orient existing analysis away from its focus on the resource-curse to the wider – and arguably more significant – rent curse that has trapped the region in an

inferior equilibrium. It is clear that the oil and non-oil streams are inter-linked, since oil prices are a fundamental driver of aid and remittance flows. Given the recycling of oil wealth in the region, the traditional distinction between resource-rich and resource-scarce economies is somewhat redundant in political economy terms. It can only explain the intensity of outcomes and their underlying mechanisms but is not a true marker of their political economy. The boundaries between the oil-rich and oil-poor countries of the Middle East are more fluid than is commonly understood.

In short, a comprehensive political economy mapping of MENA requires a more fine-grained understanding of the different types of rents, their interlinkages, deployment, and effects on the performance characteristics of economy and polity. This is a central exercise for any serious political economy analysis, since MENA's concentrated economic and political structures are fundamentally rooted in the creation, distribution, and sustenance of these rents. The scale, volatility, and degree of concentration of rents matter decisively in shaping elite incentives (Auty 2010). Such a shift of emphasis from oil rents to rents more generally can bring the discourse on MENA's political economy closer to the field of New Institutional Economics (NIE) that studies the origin, development, and impact of institutions. By embedding MENA experience in the emerging political economy paradigms will also enrich the wider field of political economy, since it has only paid passing attention to Middle Eastern experiences. With such a rich potential for a two-way engagement, an exciting turn in the analysis of the Middle Eastern political economy is waiting to be explored.

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10
Public Sector Reform*

Robert P. Beschel Jr. and Tarik M. Yousef

10.1 Introduction

In the brief period since the "Arab Spring" captured the world's attention in 2011, the political landscape throughout the Middle East and North Africa (MENA) has become the topic of intense hope, concern, and uncertainty. Four years into the transition, it is impossible to predict where the scope and trajectory of change will ultimately head. While the bloodiest of the civil conflicts in Syria has run unabated, other conflicts are back in full force in Libya and Yemen after an intermittent period of relative calm. The renewed threat of extremist militants in Iraq has led the US and its allies to reengage militarily in Iraq and Syria against the so-called Islamic State. And while Egypt is stable by comparison, the regime of President Al-Sissi has begun to resemble if not exceed the authoritarian tendencies of ousted Hosni Mubarak. The only qualified success at present is the nascent democracy of Tunisia, which continues to show promise.

Yet through the haze and confusion of the transition engulfing the region, a number of issues are clear. First, the MENA region currently faces daunting economic, social and developmental challenges. Demographically, the population of the Arab world is expected to grow by 40 percent of the next two decades, adding approximately 150 million additional people – or roughly two countries the size of Egypt. This young, growing and increasingly educated population will require jobs, yet the region as a whole has one of the highest unemployment and youth unemployment rates in the world (Sayre and Yousef 2016).

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* This chapter draws heavily on material and analysis in a forthcoming edited volume by the two authors: Beschel, Robert and Tarik Yousef, eds. (2015a). *Public Sector Reform in the Middle East and North Africa: The Lessons of Experience*. The World Bank: Washington, DC. The authors acknowledge excellent research assistance by Tom Chidiac.

Furthermore, MENA has historically been far less adept than other regions in attracting private investment to spur growth and generate employment. Demographic pressures will, in turn, also create major challenges to provide adequate housing, infrastructure, education, health care, and water.

More importantly, there has been a broad consensus among officials, academics, corporate leaders, NGOs, donors, and the wider MENA public that issues of governance and public management will form an essential part of any solution to these problems. Indeed, the impetus towards governance reform is at least two decades old (World Bank 2003; UNDP 2002). Governments have been struggling to implement a variety of improvements in how they organize themselves, make critical policies and decisions, improve the quality of services, and spur private sector growth and development. The majority of these struggles played out, with minimal success, well before the tumultuous events of 2011, and many will continue far into the future. They will be on the agenda of new governments seeking to respond to the demands of an engaged and demanding public. And they will be on the agenda of traditional regimes seeking to modernize so as to meet the rising expectations of their citizenry.

This chapter reviews recent trends in public sector reform in MENA on the eve of the Arab Spring along a number of well-known global dimensions including democratization, the size of the state, decentralization, and transparency. Drawing on some of the most important cases of public sector reforms attempted in the region in last decade, the chapter synthesizes the lessons learned from this experience, both good and bad, that will be highly instructive for future reformers both in MENA and beyond.

10.2 Public sector reform in MENA: where the region stands

The Arab Spring revolutions of 2011 did not occur in a vacuum. Popular protests were grounded in the unique grievances and circumstances of individual groups and countries. They had different dynamics but shared a common assessment in governance failings (Nabli and Ben Hamouda 2015; Mazarei and Mirzoev 2015). A "democratic deficit" existed, and political and economic power was overly concentrated in the hands of a narrow ruling elite. Public sectors were ponderous and generally non-responsive to their citizenry. The rule of law was selectively enforced; corruption was a serious problem; and political liberties and freedoms were not respected (World Bank 2009). Such sentiments were felt profoundly and motivated thousands of ordinary citizens to undertake acts of extraordinary courage and defiance.

While this assessment captures important facets, even prior to the Arab Spring, the governance issues and challenges in MENA were more complex and nuanced (Beschel and Yousef 2009). In some areas, such as e-governance, the region has kept pace and is even ahead of global norms. When it came to the

quality of public administration, the region does not diverge markedly from what we see elsewhere, in that the quality of administration is generally correlated with increases in per capita GDP (Figure 10.1). In other areas, the region lagged significantly behind global trends. Democracy and public participation clearly stood out as the most prominent (Figure 10.2). The core leadership, whether comprised of hereditary monarchies or presidents for life, remained intact. Parliaments and the judiciary were seldom in a position to challenge the executive. Access to information was limited, and civil societies were typically weak and underdeveloped. The net result is that public accountability in MENA did not track developments seen elsewhere in the globe. We discuss each of these dimensions below, including both where the region fared historically prior to the Arab Spring and where many of the recent dynamics post-2011 have been trending.

Political stability and continuity

Political instability has multiple gradations. At the highest level is inter-state conflict and warfare, although in recent decades intra-state conflict and civil war have become much more common. Below this level, there are terrorist activities, strikes and protests, or chronic political turmoil and/or paralysis. The MENA region has been home to a number of international conflicts in Palestine, Lebanon, Iraq and Kuwait, as well as to bloody civil wars in Algeria,

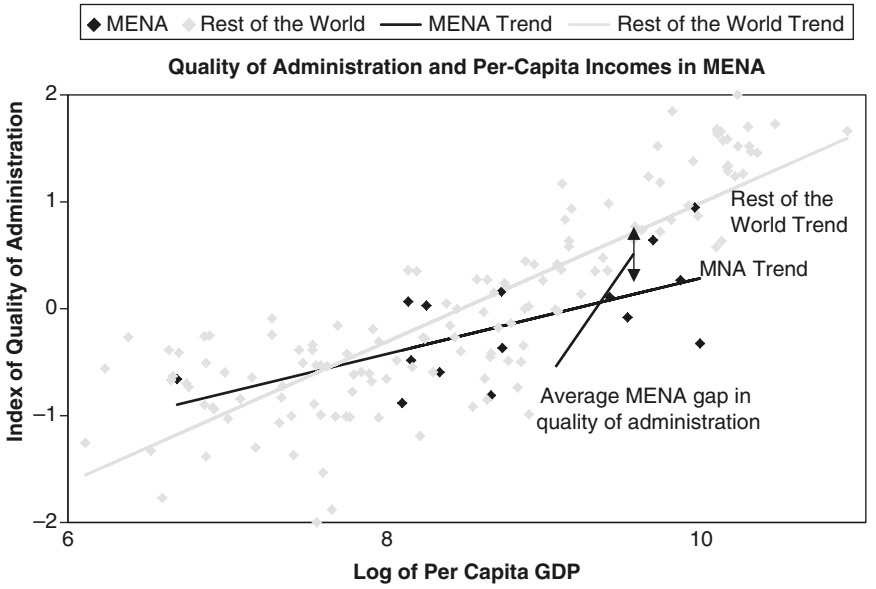

Figure 10.1 Quality of public administration and income

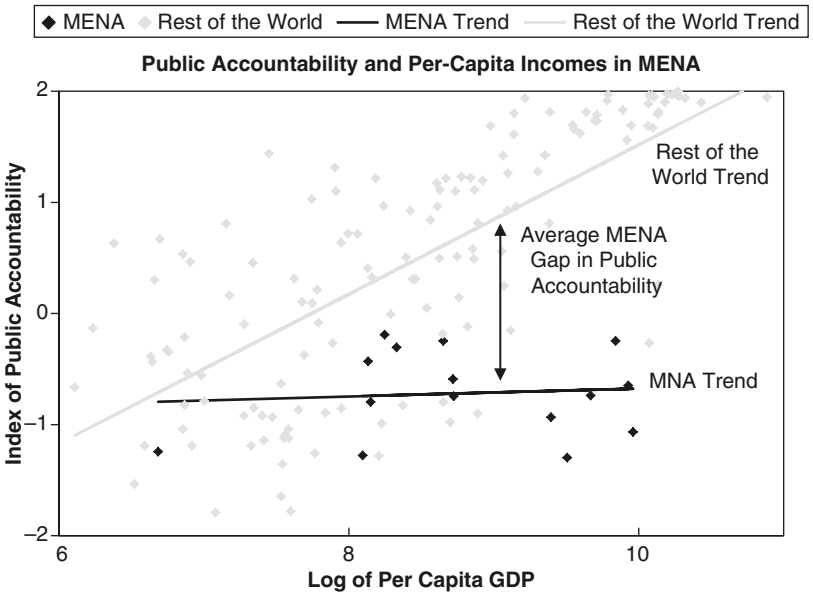

Figure 10.2 Public accountability and income
Source: World Bank (2003); Beschel and Yousef (2009).

Syria, Libya and Yemen. Recently, civil strife in Syria, Libya, Yemen and Iraq have become international in nature. Attacks by Islamic extremists have claimed hundreds of lives in a number of countries throughout the region. Yet in spite of its reputation for political instability, a more accurate rendering – at least until recently – was that the region consisted of islands of instability juxtaposed against oceans of extraordinary stability and continuity.

In the wake of the Arab Spring, the situation has become much more unstable. In its 2013 list of the top 20 countries with the highest political instability, the political risk consultancy group Marsh identified six MENA countries with "extreme" or "high" risk.[1] The region as a whole was second only to Sub-Saharan Africa in terms of dynamic political risk. Data from the Economist Intelligence Unit now places MENA in the highest category of average regional political stability risk. MENA has witnessed deterioration in a variety of sub-categories reviewed by the EIU, including international tensions, the stance of the opposition, orderly transfers, and social unrest.[2] Even relatively stable countries

[1] Marsh, Political Risk Map 2013. http://usa.marsh.com/Portals/9/Documents/Political%20Risk%20Map%202013.pdf
[2] This data reflects World Bank calculations based upon Economist Intelligence Unit data on Security and Political Stability indictors dating from 2010 through 2014.

such as Jordan are dealing with the consequences of conflict, including a large influx of refugees.

Islands of stability and continuity still remain, largely within the GCC. But the overall picture regionally and within many important countries in the region has become much more clouded and uncertain. Even the historical durability of national boundaries may now be under threat especially in the Levant countries but also in Libya and Yemen that have recently descended into full-blown civil wars on the back of strong secessionist movements. Indeed, the creation of the Islamic State of Iraq and the Levant (ISIS) in June 2014 has been heralded by a number of commentators as marking the demise of the Sykes-Picot treaty and. Although such arguments may be over-stated and a general revision of the boundaries established in the wake of World War I is unlikely, the possibility of some additional border adjustments cannot be ruled out (Simon 2014).

Democratization and the rule of law

A second major global trend over the past three decades has been a significant shift away from authoritarianism towards democracy. This transition is characterized by a general increase in the number of democratic regimes (traditionally characterized by constitutionalism, independent parliaments and the prospect of genuine contestability and change in elections). Prior to the revolutions of 2011, relatively little of this "third wave" had lapped upon MENA's shores (Heydemann 2008). As of 2009, Freedom House's assessment of political and civil liberties classified only one country in the region, Israel, as "Free". Seven countries were classified as "Partly Free" (Bahrain, Djibouti, Jordan, Kuwait, Lebanon, Morocco and Yemen), and the remainder were classified as "Not Free". The next year, Bahrain, Jordan, and Yemen were downgraded to "Not Free" even prior to the unrest of the Arab Spring.

After the Arab Spring, the regional picture has become even more complex and nuanced. Governments differed regarding the extent to which they are willing to embrace political reform, with a few willing to go quite far and others making only minimal concessions or engaging in fierce repression. The initial direction of reforms ran towards reducing the overwhelming power of the executive vis-à-vis the legislative and judicial branches, as well as toward creating more open, inclusive, and contestable political processes. Similarly, reforms to curb the power and influence of state security agencies have proceeded along several dimensions. Several countries have focused upon strengthening constitutional and legal protections for human rights and individual liberties. Morocco's constitutional reforms approved in July 2011 included a preamble that specifically affirmed the Kingdom's commitment to universal human rights. In January 2014, Tunisia's National Constituent Assembly voted for a constitution that upholds many key civil, political, social, economic, and cultural rights.

The role and size of the state

Prior to the Arab Spring, a common feature throughout most of the MENA region was the overall size of the public sector. Whether measured in terms of civil service staffing per capita or looking at central civilian government wages as a percentage of GDP, the MENA region is home to the largest public sectors in the world. Perhaps no response was more ubiquitous across the region in the wake of the Arab Spring than that of increasing civil service pay. The amount of the increases varied depending largely upon whether states were oil producers or not. Qatar announced pay increases of between 50 and 120 percent in September 2011. The UAE announced increases in public sector salaries of up to 100 percent. Egypt raised civil service salaries by 15 percent in the waning days of the Mubarak regime, and the Muslim Brotherhood raised them again. Morocco increased civil service salaries by around $75 per month. Jordan provided a one-time cash transfer to public sector employees in August 2011 totaling $112 million.

Another consequence of the Arab Spring has been the populist backlash against privatization and economic liberalization (International Crisis Group 2012). In the wake of the Arab Spring, the backlash against privatization has been prominent in Tunisia and has proceeded furthest in Egypt, who in the latter years of the Mubarak era had been at the forefront of efforts to reduce the overall size of the state and embrace a new private sector oriented approach to development. Yet privatization remained deeply unpopular with both the general public as well as leading members of the regime. Both leftists and Islamists resented efforts to align the economy more closely with the global capitalist order. Darker suggestions were uttered that privatization was foisted upon Egypt by Western countries and institutions, pushed forward by those who had a vested interest in the sales.

Decentralization

In addition to a general retreat or pulling back of state functions, the period from 1989 onward has witnessed the decentralization, devolution, and deconcentration of power and authority away from central governments towards regional and local governments. There were many dynamics behind this movement. Sometimes, the motives were fiscal (World Bank 2003) as overstretched central governments looked for ways to save money by offloading mandates and responsibilities upon subordinate levels. Other times, such moves were political, as restive provinces demanded greater say over how state resources were being collected and utilized. There are technical reasons for devolving responsibility, since it is often easier to raise revenues when there is a more direct connection between taxes and services provided, and local politicians

and administrators are often better positioned to understand the unique needs and preferences of their constituents than senior officials in a distant capital.

Even before 2011, discussions were underway about devolving greater autonomy and control over resources to local governments. Since then, such conversations have accelerated and many MENA countries have embraced the decentralization agenda in the wake of the Arab Spring. Not surprisingly, such issues have garnered the most traction in states with historically disgruntled regions or constituencies. Iraq's struggles to achieve the optimal constitutional balance between the Kurds in the north, the Shia'a in the south and the Sunnis in the center are well known. Post-Qaddafi Libya is also grappling with similar issues, as his transfer of power away from its historical seat in Benghazi and the concentration of administration in Tripoli was one of the many grievances that fueled instability (DRI 2013). In light of the historic cleavages in Yemen, issues of regional autonomy were one of the key demands of the protests against President Saleh. The establishment of viable local governments will be a long-term agenda that will take a decade or more to resolve.

Transparency and anticorruption

In many countries, allegations of corruption, insider dealing and abuse of office were at the heart of the popular uprisings. In the wake of such revelations, many Arab countries rushed to implement a variety of anticorruption measures in the immediate aftermath of the Arab Spring. Jordan made several high-profile arrests on corruption charges. Kuwait's parliament passed new anticorruption legislation. Morocco has created a new Supreme Security Council to monitor corruption, and in March 2012 its Minister of Justice pledged to clamp down on graft and protect witnesses in corruption cases. In 2011, Saudi Arabia set up the National Commission for Combating Corruption that had been initially proposed back in 2007. Even Syria has announced its intention to reduce corruption.

Since the late 1980s, there has been a rapid expansion in government transparency, as many countries in Africa, Asia, Europe, and Latin America have made progress in passing access-to-information legislation and implementing procedures for facilitating citizen requests and supporting the proactive disclosure of government information. Unfortunately, the MENA region has lagged well behind this global trend. Prior to the revolutions of 2011, only a few countries had made halting steps towards increased transparency. In the wake of the Arab Spring, there has been a flurry of interest in such legislation. In May 2011, Tunisia adopted a Decree on Access to Administrative Documents, becoming the second country in the region after Jordan to have a dedicated right to information law. These countries have also taken a variety of additional steps to advance transparency, such as revising press laws, closing down ministries of

information, and embedding freedom of information protections within their draft constitutions.

E-governance

Perhaps one of the most far-reaching developments within the past two decades has been the rapid expansion of "e-governance", or more accurately the application of technical advances in information and communications technology (ICT) to a range of government tasks and problems. Prior to the Arab Spring, MENA was just above the global mean when it comes to e-governance, with wide variation between countries. Not surprisingly, the countries of the Gulf Cooperation Council or GCC have been at the forefront of the ICT movement and score relatively well on the UN index. These countries have extensive resources to invest in ICT. Some initiatives, such as the Dubai's Electronic Visa Registering Process, are cutting edge even among OECD countries. Bahrain topped the region with an impressive program that earned it a global ranking of 13th and placed it in the company of countries such as Singapore, Sweden and New Zealand. Other GCC countries, along with Jordan and Tunisia, were well above global averages. Egypt and Lebanon, which are ranked at 86th and 93rd respectively, were near the global mean.

MENA countries have embraced the e-governance agenda for a variety of reasons. For some, such as Bahrain and Dubai, it offers an opportunity to achieve significant gains in the speed with which services are delivered and to strengthen their comparative advantage as a "business friendly" destination for investment. Others, drawing a page from East Asia's handbook, hoped prior to the revolutions of 2011 that they will be able to use such technology to make technocratic improvements that would ultimately be less controversial than those involving the fundamental devolution of political power. Still others, such as Jordan, envisioned a role for themselves as repositories of IT expertise throughout the MENA region and view e-government as an essential component of that broader vision.

After the Spring

Throughout the region, governments have been struggling to keep pace with the popular dynamics that have been unleashed. Some, such as King Mohammed VI of Morocco, have sought to get out in front of the discontent and use it as an opportunity to push for a variety of political and legal reforms. Others, such as Jordan's King Abdullah, have sought to strike a balance between the demands of different constituencies, some of which are widely shared and others that diverge. A number of presidents and monarchies within the GCC have sought to deflect political demands by a combination of modest political reforms and massive employment and spending programs. More than

a few countries, have also relied heavily upon the instruments of state coercion to keep dissent at bay.

10.3 The experience of public sector reform: case studies

To broaden our understanding and gain insight into the challenges of public sector reform in MENA, we turn to the lessons of experience from some of the most interesting and important reforms attempted in the region within the last decade. Beschel and Yousef (2015a) presented ten case studies covering a range of countries, issues and reform approaches. Five look at reforms in core systems and procedures within government, including the Jordan case on restructuring cabinet reforms; the reforms in public financial management (PFM) in the West Bank & Gaza; the Morocco Voluntary Retirement Program, which sought to reduce the overall cost of Morocco's wage bill; and reforms in human resource management in Lebanon, which sought to strengthen meritocracy across government.

The remaining set of five reforms looks at various efforts to improve the performance of line departments. One case examines Egypt's reforms to improve its business climate and attract foreign investment by streamlining procedures for opening a business. Another looks at Egypt's efforts to enhance revenue collection and improve the business environment by reforming its tax policy and administration. A third case reviews Saudi Arabia's efforts to improve service delivery and bill collection by setting up an automated payments system. A final two cases looks at highly successful efforts to improve document processing within Jordan.

Table 10.1 lists the ten cases (along with two additional examples of earlier reforms in Egypt and Morocco that initially failed but subsequently succeeded) along a five-point spectrum that ranges from a "clear success" to "unsuccessful" (Al Yahya and Beschel 2015). Four cases were unequivocal success stories, including advancing e-Governance in Dubai; the One Stop Shop reforms in Egypt; the SADAD payment reforms in Saudi Arabia; and the second document processing case in Jordan. At the other end of the spectrum, the first attempt at civil service rationalization in Morocco, the Lebanon HR reforms case and the first Egypt One Stop Shop cases were clear failures. Three cases were deemed to be mostly successful, including the WBG PFM reforms, overhauling tax administration in Egypt and the first document processing case in Jordan, and one was viewed as a mixed success (Morocco's second VRP effort). The Jordan cabinet reforms were viewed as moderately unsuccessful.

These reform cases can be classified into three general categories: (1) public financial management (including reforms in both revenue collection and expenditure); (2) administrative and civil service reforms (including reforms in civil service pay and employment and human resource management); and

Table 10.1 Ten public sector reforms in MENA

Clear Success (5)	Mostly Successful (4)	Mixed Success (3)	Moderately Unsuccessful (2)	Unsuccessful (1)
Advancing e-Governance in Dubai The e-Government initiative transformed public sector culture and operations. Significant productivity gains occurred in many services. UAE ranks highly on various global indices of e-Governance. **One Stop Shops in Cairo (Second Attempt)** The second attempt was a clear success. GAFI became a true one-stop shop; the number of procedures was cut from 19 to 3; and processing times were reduced from 34 days or more to only 3 days. There was also a significant increase in businesses registered. **Bill Payment in Saudi Arabia** The SADAD case was a success. The traditional use of banks for bill payments decreased from 73% in 2003 to 6% in 2010. In 2010 SADAD processed more than 9 million transactions in a month. These transactions are fully processed within two seconds, resulting in increased efficiency. **Document Processing in Jordan (1996–2005)** The time required for issuing passports and IDs dropped from 2 hours to 15–45 minutes. Errors in data entry decreased substantially. Service delivery and customer satisfaction increased.	**Reforms in Public Financial Management in the West Bank & Gaza** The PA managed to centralize the flow of revenues; improve expenditure controls; inject greater transparency in the management of public enterprises; and reduce corruption in the payment of salaries to security services. Challenges remained in the lack of alignment of the budget with policy priorities. **Overhauling Tax Policy & Administration in Egypt** The successful implementation of a new tax law which made the process more easy and straightforward. It resulted in higher rates of tax filing which witnessed an annual increase of 10%. Both income and sale tax revenues increased substantially. However, implementation was slow and significant overstaffing remains. **Document Processing in Jordan (1991–2006)** Processing time for passports decreased from two years to two hours. Corruption decreased and the quality of service delivery improved. However, the process still suffered from inefficiencies and high rates of data inaccuracy.	**Civil Service Rightsizing in Morocco (Second Attempt)** The second Voluntary Retirement Program (VRP) resulted in significant financial and economic gains. Approximately 38,600 public servants retired, and the wage bill was reduced from an average of 11.8% in 2005 to 10.2 per cent in 2010. However, problems of adverse selection resulted in a loss of the most talented civil servants, which negatively affected the public sector's capacity and performance.	**Reforming Cabinet Structures in Jordan** The reform of Cabinet decision procedures was not fully achieved. The process generated a White Paper (which was embedded within the broader National Agenda), some excellent analytic work, a revised Cabinet manual, modest improvements in by-laws that reduced the administrative burden upon Cabinet, and some changes in organizational structures. However, a sustained restructuring that addressed many of the fundamental challenges flagged in the case was not forthcoming. Furthermore, some of the major institutional reforms that were implemented initially – such as upgrading the status of the Ministry of Administrative Development and placing it under the Prime Minister's Office – were later reversed.	**Civil Service Rightsizing in Morocco (First Attempt)** The first attempt was a failure since only 696 public employees left instead of the 20,000 target. There was no noticeable reduction in the wage bill. **Strengthening Human Resource Management in Lebanon** The newly proposed hiring system was challenged from the beginning since it was lengthy, complex and directly challenged entrenched political interests. **One Stop Shops in Cairo (First Attempt)** The first attempt was a failure due to the lack of clarity in procedures and investors needed to go to various places to get their approvals. No significant change was made in the procedures for establishing a business in Egypt.

Source: Beschel and Yousef (2015a), Chapter 11.

(3) reforms in service delivery, including business process reengineering and other efforts to improve the quality of services provided to the public. Of the cases we explore in this volume, PFM cases were clearly the most successful. Administrative and civil service reform cases were the least successful, with most being either totally unsuccessful or achieving very modest success. Service delivery reforms fell somewhere in the middle but, overall, were more successful than unsuccessful.

Public financial management

There are several reasons for the relative success of PFM reforms vis-à-vis those in other areas (Beschel and Ahern 2012). Such reforms tend to be more technocratic in nature and fall primarily under the domain of the Ministry of Finance or the Ministry of Planning, who tend on average to be more powerful than Ministries of Administrative Development throughout the Arab world. A body of practice exists that is better developed and more integrated, along with an increasingly well-established set of indices in the Public Expenditure and Financial Accountability (or PEFA) indicators. But perhaps the main reason is that civil service reforms typically touch directly upon the welfare of tens or hundreds of thousands of employees, and as such are subject to tremendous scrutiny and resistance, whereas PFM reforms are viewed as more instrumental in nature and thus inherently less threatening. It is one thing to try to introduce greater efficiency and accountability into the budget process; it is quite another to try to reduce a bloated civil service or to prune back opportunities that have historically flowed to certain groups or communities.

Service delivery and business process re-engineering

There are a number of reasons why these reforms were also successful. The first is that the bar was often set low. Although a number of nations have witnessed improvements in recent years in areas such as business licensing, MENA countries have traditionally been among the most bureaucratic in the world. Prior to the reforms, Jordan document processing required 12 manual steps performed by 10 different employees. It took an average of 25 visits to obtain a business license in Egypt. Processes were labor-intensive, and implementation was erratic. Delays were common at every step of the process. Under such circumstances, reform efforts were able to contribute to massive increases in productivity. Second, it is relatively easy politically to eliminate unnecessary steps. Such efforts may encounter bureaucratic resistance from employees who are uncomfortable with the new procedures or, more perniciously, view them as a threat to their power or livelihood. But they are popular with the public, and administrative friction can be overcome through determined efforts at implementation.

Organizational restructuring

Efforts to restructure government as a whole have not worked in MENA. The layout of government is shaped more by political than technical considerations, and few emirs, presidents or prime ministers are willing to take on many powerful vested interests at once in pursuit of the more ephemeral goals of greater efficiency, crisper organizational charts and a more sensible division of tasks. The reorganization of individual ministries, agencies and departments is a more promising task. Such cases were almost always an adjunct to a broader set of reforms rather than an end in themselves. In Jordan, it was necessary to end a relatively meaningless division and reduce redundancies between two sets of functions that had resulted from an earlier imperfect merger. In Egypt, the merger of the Income and Sales Tax Units was an essential component of the broader effort to rationalize and overhaul tax administration and realign it along the size of the taxpayer rather than the type of tax.

Pay and employment

While MENA is home to some of the largest public sectors in the developing world, pay and employment reforms have seldom been high on the agenda. Morocco deserves credit for being one of the few countries to tackle this problem directly. Its VRP program displayed many of the strengths and weaknesses common to exercises of this type. It was effective in containing wage bill costs, at least for a time. The program may have had positive economic returns, in that a number of those who participated may have gone on to start businesses and engage in pursuits that brought higher value added to the Moroccan economy as a whole. However, the best and the brightest also left the public sector, resulting in skills gaps and some short-term problems with service delivery. The program also illustrates the difficulty inherent in coordinating large public sector reform efforts, as ideally it would have taken place after a series of planned exercises to review the organization and staffing of individual line departments and not before.

Human resource management

If reforms in pay and employment were difficult, those involving human resource management were almost impossible. HRM problems are chronic throughout the region and go to the core of weak performance in many ministries and departments. They include antiquated civil service rules and regulations; recruitment that is formally based on merit but actually rife with waste or "connections"; and massive overstaffing alongside gaps in required skills and competencies. In spite of the need for far-reaching reforms in this area, relatively little progress has been made. The Lebanese effort to tackle these issues directly was at one level commendable, yet it failed miserably when set

against traditional networks of patronage and sinecure. Egypt's Ministry of Administrative Development tried for years without success to implement far more modest reforms to expand contract employment and strengthen administrative disciplinary procedures. Other states, including Bahrain, Morocco and Tunisia have adopted HRM reforms with more success, although the process is slow and many of these efforts remain very much a work in progress.

The lessons of experience

Shifting to a more qualitative analysis regarding the how these reforms were implemented, the cases reviewed provide a variety of lessons for many countries seeking to reform their public sectors. The most prominent of these lessons including the role of political will; how reformers coped with resistance; the use of evidence based management; benchmarking and stretch targets; the importance of generating credibility early in the process; the effective use of oversight bodies; and the importance of leadership.

Most treatises on public sector reform begin or end with the importance of **political will** (Bery 1990). Its existence is inveighed to explain how successful reforms came to fruition; its absence is rolled out as a justification for lack of progress. The cases examined underscore the dangers of tackling the prevailing political culture head on with agendas that are too broad or threatening such as the Lebanon HR reforms, or in trying to take forward a far-reaching reform program during a period when political agendas are rapidly shifting, such as the Jordan Cabinet reforms. Conversely, it is clear that several sets of reforms benefited from backing at the most senior levels, such as the Dubai e-governance reforms or the Morocco VRP program. Most line department reforms were consistent with broader national goals and objectives, and as such enjoyed what could be called the "detached blessing" of national leaders. Those that require extensive coordination across multiple ministries are likely to be hostage to broader political developments.

All of the profiled reforms encountered **opposition** from a variety of sources. Reformers in MENA employed a variety of strategies for dealing with opposition. A fortunate few who received strong backing and support at the highest levels were able to bully, push, convince and cajole their way forward. They had the mandate and often the resources necessary to compel recalcitrant units to fall in line. Staff who refused to "play ball" could find themselves sidelined or even removed. Those who were not so blessed needed to find other ways to accomplish their objectives. Under these circumstances, successful reformers moved in ways that were more analogous to streams than to high pressure hoses. They sought to flow around opposition and minimize its interference rather than taking it on directly and blasting it out of the way. This approach could be characterized as one of "strategic opportunism" or seizing the chances that present themselves in the context of a broader vision (Schick 2002).

A common theme among many of the more successful reforms is a strong reliance upon what could be called **evidence** based management. This should not be confused with how the term is used in the OECD countries – where it frequently refers to the application of rigorous quantitative techniques for management decision-making. Such tools played virtually no role in any of the major reforms in MENA, as they were too costly, time consuming and technically demanding for governments to implement. The reforms that did best often utilized techniques that were more low-tech and user friendly, but still marked a serious effort by reformers to know their organizations and to measure where progress was being made and where it was not. Conversely, approaches that failed often made limited attempts to seriously analyze the problems they were trying to solve.

Another management principle that was used to good advantage was the use of **benchmarking** and setting stretch targets. In Jordan, the goal was set that citizens should receive newly issued documents on the same day they submit their applications and receive document renewals within two hours. Salam Fayyad challenged his staff at the Ministry of Finance in the West Bank and Gaza to implement his public pledge that the ministry would never again issue a bad check. The process of issuing such challenges was typically a consultative one, in that such benchmarks were established only after senior managers first probed their achievability. Perhaps no country went further towards the use of such targets and benchmarking than Dubai. The quantitative targets set for e-enablement – 18 months until roll-out, 70 percent of services online by the end of 2005 and 90 percent by the end of 2007 – were rigorous and placed a huge burden upon government departments, which provide around 2,500+ public goods and services (Geray and Salem 2015).

Reformers face a host of different challenges with regard to garnering **support** and building **credibility** for their efforts. In areas with a clear production function, such as passports and documents, progress would be relatively easy for both officials and the general public to measure. In other areas, such as PFM, the challenges were more difficult. Ease of implementation is often a critical concern in generating these early wins. Some reforms can be done with the stroke of a pen; others require major legal changes or convincing or coercing thousands of employees to perform their duties differently (World Bank 2004). Not surprisingly, many successful reformers started with the "stroke of a pen" reforms first and tackled more difficult and/or serious problems downstream. Salam Fayyad's consolidation of PA accounts into a Single Treasury Account typifies this trend. It is also interesting to note that, as was the case with Fayyad, some of these initial moves required quick "end runs" to be effective. Otherwise, they are likely to have become mired in bureaucratic resistance and the prospects for a quick win would have been lost.

A number of reformers created **oversight bodies**, typically in the form of committees involving other senior government officials or distinguished private sector representatives, who were supposed to help coordinate initiatives that crossed organizational boundaries, provide advice and inputs into the reform process and lend their credibility and support for the reforms. Many but not all of the reforms relied heavily upon external advice and assistance. The IMF and U.S.AID, for example, played an important role in Egypt's tax reforms. The core governance structure was carefully designed to foster a collaborative working relationship between domestic actors and international experts. While consultants provided invaluable expertise and access to international experience, there were inevitable tensions that needed to be worked through. As the SADAD case illustrates, consultants brought with them a predilection for utilizing standard approaches and off-the-shelf systems, which a number of reformers felt were not well-adapted to their unique circumstances and conditions. The most successful reforms avoided superficial, off the cuff assessments in both directions.

Finally, the cases both offer important insights and raise provocative questions on the oft-studied but frequently intangible role of **leadership** (Stoker 2006). At a minimum, the three Jordan cases show the importance of a sustained hand at the tiller. Two enjoyed lengthy tenures at the helm of the Civil Status and Passport Department of five and nine years respectively, whereas the Ministry of Administrative Development witnessed no fewer than eight ministers at the helm between 1999 and 2006. In any public organization, such short tenures make it virtually impossible to implement lasting change, as employees know that they merely have to "wait it out" for a few months or a year until a given minister's time in office is over. Successful leaders in MENA often embody identical talents and techniques used by effective leaders elsewhere. They led through example and modeled the types of behaviors that they expected their staff to follow. In Egypt, reformers in tax administration put an end to nepotism and granting special favors to employees. They worked hard to send consistent signals and to ensure alignment between the "formal" and "informal" rules.

It is difficult to envision any of these reforms being successful without the dynamic leadership of those who championed them. Yet the close linking of reforms to personalities is symptomatic of a broader problem that plagues public sectors throughout the region – the lack of effective institutions, norms and mechanisms that can guarantee the continuity and sustainability of reform and ensure its long-term impact (Yousef 2004). There is a tendency to associate reform with individuals and thus progress is contingent upon whether those officials and their networks remain in their posts. In many cases, reforms slowed down or stopped once their champions left.

10.4 Conclusions

The reforms of the Arab Spring have yet to fully deliver on their promise of greater democratization and citizen empowerment much less their long-term potential for transforming the economies of the region through better governance. But they have unleashed dynamics that have degraded the functioning of Arab public sectors especially in countries in transition. They have also resulted in greater political instability, which is reducing the flow of foreign investment, compounding socioeconomic problems and making it more difficult to reform the state security apparatus (Devarajan and Mottaghi 2014). Yet such an assessment may also be too sweeping and premature. Revolutions are inherently complex and messy affairs, and it may be that our present point of historical departure is wrong.

The public sector reform cases from the past decade provide a body of knowledge about how successful reforms were implemented. The lessons from these cases are instructive but not definitive. For better or worse, the experience captured within these cases reflects the conventional wisdom about what to do – and not to do – with regard to public sector reform more generally. It may not align perfectly with global knowledge and practice, but neither is it wholly alien. To the extent that MENA countries differ, it is only in certain areas and often more by degree than in kind.

The revolutionary changes that swept through the region in 2011 have opened new possibilities, exacerbated old problems, and unleashed political dynamics that are paradoxically both making some badly needed reforms easier while working against others. The ability of Arab reformers to successfully navigate these obstacles and achieve enduring results will determine whether the expectations of their fellow citizens for effective, accountable and responsive institutions will ultimately be met. The cases that we have cited above offer hope that, even within difficult contexts, talented reformers can learn from these examples and achieve indelible progress for their people.

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Part IV
Political Transitions

11
Transition Experiences and Relevant Lessons

Melani Cammett

11.1 Introduction

The Arab uprisings marked a new, large-scale phase of contentious politics in the Middle East and North Africa (MENA). Entrenched authoritarian rulers were ousted from power in Tunisia, Egypt, Libya and Yemen, and citizens across the region discovered the power of mass mobilization and became increasingly vocal in demanding their rights. The period of flux that ensued appeared to be a "critical juncture" (Collier and Collier 1991, Capoccia and Keleman 2007, Mahoney 2000) in which the potential for regime change was heightened. Watching the uprisings and subsequent struggles over institution-building unfold in real time raises questions about the conditions under which democratic reform can emerge in the region.

This chapter situates the Arab uprisings in broader theoretical and cross-regional comparative perspective. Questions about the role of "structure" versus "agency" have long dominated debates about regime change. It is increasingly apparent, however, that this juxtaposition is misplaced given the importance of both factors in democratization processes. Furthermore, the relative importance of structural conditions and contingent behavior may be more or less prominent in distinct phases or dimensions of regime change (Capoccia and Ziblatt 2010, Collier 1999), such as authoritarian breakdown, transition dynamics and the establishment of democratic institutions. Drawing on theoretical approaches and on analyses of regime transitions in other developing and post-communist regions with similar characteristics, I argue that strategic interactions and, where relevant, deals among political elites played a decisive role in the aftermath of the uprisings, shaping the direction of regime change. When elites are willing to compromise, even in the face of profound ideological differences, the probability of successful democratic transitions increases. This claim, however, begs the question of how constructive inter-elite dynamics arise in the first place. To understand why cooperation

and compromise occur, we need to turn to more structural factors. Elite resources and strategies are themselves shaped by structural conditions such as the relative weight of societal groups prior to the overthrow of incumbent dictators (Haggard and Kaufman 1995, Collier 1999, Rueschemeyer, Stephens, and Stephen 1992). Social science theories of democratization thus far do not offer a satisfactory account of inter-elite compromise, in part because some of its determinants are context-specific or contingent. Although elite bargaining is the focus of much research on democratization in the voluntarist tradition, a solid account of democratization must integrate both structure and agency: the economic and political contexts – that is, the factors that constitute "structure" – shape the interests and goals of elites and, hence, their propensity to make concessions to political rivals and to work together constructively.

The chapter is structured as follows. First, I provide an overview of theoretical approaches to democratization, highlighting the interplay of structure and agency in some accounts (section 11.2). Second, the chapter introduces selected country cases of successful and failed democratic transitions beyond the Arab region to identify the factors that enabled or inhibited regime change in other countries with similar characteristics (section 11.3). Finally, the chapter summarizes the lessons from theories of democratization and empirical evidence from the country case studies to developments in the countries that experienced uprisings in the Arab region (section 11.4).

11.2 The sources and dynamics of regime change

Most research on democratization adopts a minimal procedural understanding of democracy. A common starting point is Schumpeter's (1942 [2006]) definition of democracy as "that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote."[1] This definition emphasizes the regular occurrence of free and fair elections to choose officials who manage public policies and in which opposition candidates and parties face a real chance of attaining public office. Even a minimal definition of democracy, however, must emphasize accountability because non-elected representatives, such as government agencies and bureaucracies, are also vital to the work of democracy. Unelected officials should not hold influence that subverts or overrides the power of elected officials and rules must remain binding, regardless of how individual or group interests are affected by policies and decisions (Schmitter and Karl 1991). This chapter, like much of the scholarly literature on democratization, therefore adopts a procedural definition of democracy

[1] See also Dahl (1971) and Huntington (1991).

that emphasizes participation through voting and elections, competition between groups such as political parties, and liberties such as the freedom of speech and assembly, which are necessary for democracy to remain accountable to citizens.

A large body of political science scholarship addresses the causes and dynamics of democratic transitions. For many years, this literature has been aptly categorized into "structural" and "agency-based" or "voluntarist" approaches. Structural explanations prioritize factors that are relatively fixed and are not amenable to manipulation by individuals or even groups of people. These may include economic factors, such as the sectoral foundations of an economy (i.e., agricultural or mineral-based) or levels of economic development and inequality; social factors such as the interests and organization of class-based social groups (i.e., peasants, workers, the middle class, or landed elites) or the presence of indigenous civil society groups and networks; or international influences such as Western democracy promotion efforts. Voluntarist approaches, on the other hand, point to the role of human agency – particularly that of elite representatives of different political factions – in producing democratic transitions. Analyses in the voluntarist tradition emphasize the contingent ways in which the actions and interactions of agents wittingly and unwittingly bring about democratization.

Classic structuralist explanations for democratization emphasize class interests as the foundation of pro- and anti-democratic attitudes and actions across social groups (Moore 1993 [1966], Rueschemeyer, Stephens, and Stephen 1992). More recent studies of democratization point to linkages between levels of inequality and regime transitions. A core insight of this literature holds that democracy emerges when inequality reaches a level where redistributive demands cease to be adverse to the wealthy (Acemoglu and Robinson 2006, Boix 2003). At first blush, absolute inequality levels do not provide a convincing explanation for the initiation of the Arab uprisings as inequality was not particularly high in the Arab region vis-à-vis other global regions and, according to official data, did not experience marked shifts in the years leading up to the revolutions in Egypt, Tunisia and elsewhere (Bibi and Nabli 2011). That said, available data are based on Gini coefficients of household consumption or income, which are unreliable and generally do not capture households in the top income percentiles. Furthermore, recent research on inequality of opportunity in the Arab region suggests that this dimension of inequality is substantial (Assaad, Salehi-Isfahani, and Hendy 2014) and systematic research has yet to occur on patterns of asset ownership, which is where inequality is likely to be most marked. Regardless of the findings of ongoing empirical research in the Arab countries, it remains an open question whether and how inequality shaped the demand for regime change among Arab populations. Indeed, the evolving research program on democratization research suggests

that the role of inequality in driving democratization at best has limited scope conditions (Haggard and Kaufman 2012), a point that Acemoglu and his collaborators accept (Acemoglu, et al. 2013), and may be more associated with democratic consolidation rather than transitions to this regime type (Houle 2009).

A more sociological understanding of inequality may be all the more useful for understanding the roots of popular dissatisfaction in the Arab countries. In particular, the composition of inequality, particularly the nature of differences between established and rising elites, may be more consequential for democratization. As Ansell and Samuels (2015) argue, when the rising middle classes feel excluded by incumbent elites, then the former may begin to favor democracy as a means of securing their position vis-à-vis the latter. An adapted version of this argument resonates for at least some Arab countries, where reduced government spending undercut the position of post-independence middle classes and economic liberalization programs created non-competitive markets that privileged regime cronies (Cammett and Diwan 2013, Diwan 2013, Heydemann 2004). Stagnant prospects for social mobility beginning in the 1980s following very real socioeconomic gains in the 1960s and 1970s was arguably most frustrating for members of this social group, who became more and more dissatisfied with authoritarian rulers in the 2000s (see Chapter 2 in this volume).

A distinct variant of structuralist explanations for democratization – or the absence thereof – centers on the negative ramifications of oil wealth for democratization (Karl 1997, Ross 2001, Ross 2012), and has figured prominently in the literature on persistent authoritarianism in the Middle East (Beblawi and Luciani 1987, Chaudhry 1997). The primary mechanism can be summarized as "no representation without taxation," or the use of low tax rates and extensive state patronage to relieve societal pressures for greater state accountability. A lack of oil wealth cannot explain why some Arab countries have taken steps towards democracy, but the presence of oil wealth is necessary to explain variation in the nature and extent of uprisings within the Arab world.

A third type of structuralist approach focuses on the configuration of state and societal actors and their relative capacities to sustain or oppose authoritarian rule. For example, in analyses of opposition to and the breakdown of communist rule in Eastern Europe, some point to the bankruptcy of officially coopted interest groups and the role of civil society groups and movements in mobilizing opposition, as in the Polish Solidarity movement (Ash 2002, Ekiert 1991, 303–304). Prior to the uprisings, specialists on the Middle East tended to emphasized the weakness of civil society (Langohr 2004) and its vulnerability to state control (Bellin 2002), suggesting that pro-democratic mobilization was unlikely to emerge from civil society groups such

as business, labor or non-governmental organizations.[2] Conversely, the power of the coercive apparatus of the state, propped up by external support and oil rents, further restricted the possibility of regime breakdown and mass unrest (Bellin 2004).

Critics charge that structuralist approaches, particularly the socioeconomic variants, do not reflect empirical realities (Smith 2008), overemphasize material interests (Bermeo 2010, Capoccia and Ziblatt 2010), downplay the role of agency (Rustow 1970), and neglect the international dimensions of democratization, which have become increasingly prominent in recent decades (Levitsky and Way 2010). By identifying factors that increase popular support for regime change, which increase the probability of democratization, structural accounts remain an important component of political science scholarship on democratization and shed light on the role of grievances in the Arab uprisings.

Voluntarist approaches are more useful than structural explanations for understanding how and why the political struggles that play out during transitional periods do or do not facilitate the institutionalization of democratic rule (O'Donnell and Schmitter 1986). A key lesson of the transitions approach points to the importance of elite cooperation, if not consensus, in facilitating democratization. Intense ideological polarization, instability, and sharp divisions among political and military elites, as witnessed in Egypt and Tunisia, are major obstacles to democratization.

The experiences of democratization in Spain and Portugal form the basis of much theorizing on democratization in the voluntarist tradition and highlight the ways in which elite interactions and ideological cleavages shape democratic transitions. The dynamics of transition varied markedly in these two countries, with greater ideological polarization in the case of Portugal. In addition, while Spain represents a classic case of a pacted transition, Portugal is a case of *ruptura*, or democratization initiated with a sharp break from the previous regime. In both cases, however, leadership and inter-elite interactions during key moments of institutional flux and elite compromises were crucial to the two countries' democratization processes. Intense ideological polarization, instability and sharp divisions among political and military elites suggest that the Portuguese experience is more analogous than that of Spain to developments in the Arab countries, notably Tunisia and Egypt. At the same time, distinct structural factors than in the MENA region, which are by definition less susceptible to human agency, shaped the democratization experiences of both Portugal and Spain. For example, the prospect of EU accession, an option not available to the MENA countries, provided a powerful external inducement for

[2] As Chomiak (2011) argues, however, the excessive emphasis on formal institutions and organized interest groups led scholars to overlook less visible and more informal forms of resistance to authoritarian rule in the Middle East.

Southern European democratization, arguably smoothing over serious domestic challenges to political change.

Studies of democratization in Eastern European explicitly point to the interplay of structure and agency in shaping democratization. For example McFaul (2002) highlights two crucial variables that shape inter-elite interactions in democratization processes, including normative commitments to democracy and the distribution of power among relevant actors. The latter point highlights the ways in which the resources of societal groups, a structural variable, link to inter-elite relations, which are emphasized in voluntarist accounts of democratization. Both normative commitments and power differentials among elites resonate in the Arab uprising countries, where elite divisions and divergent interpretations of democracy have stymied political transitions and where the relative power of civil society actors have affected the bargaining dynamics among elites from opposing factions.

A satisfactory account must consider both the constraints on action and the choices of key individuals and groups (Collier 1999, Slater 2010, Rueschemeyer, Stephens, and Stephen 1992, Haggard and Kaufman 1995). For example, in the Arab transitions, the choices of key leaders in the military have shaped the prospects for regime change. If the army had opposed the ouster of Mubarak in Egypt or Ben Ali in Tunisia, autocrats might have held onto power while elite unity, particularly in the ranks of security officers, helps to explain the Assad regime's retention of power in Syria. An explanation for regime change must therefore specify the foundations of elite participation in and defection from authoritarian bargains. The breakdown of authoritarian rule almost always originates with splits within political and military elites. To understand why such divisions emerge in the first place requires attention to the structure of patronage and perceived threats to elite interests (Pepinsky 2009). Ultimately, structuralist and voluntarist approaches must be integrated because the former highlight the factors that raise the probability of authoritarian breakdown and the onset of democratization while the latter more adequately capture the dynamics of regime change in moments of uncertainty, affecting the likelihood that transitions will be complete and sustainable.

Recent analyses of the Arab uprisings collectively point to the ways in which both structural and voluntarist factors have shaped authoritarian breakdown and regime transitions – at least thus far. For example, in their analysis of the ouster of incumbent rulers, Brownlee, Masoud and Reynolds (2015) emphasize the role of oil rents, a core structural explanation for authoritarian persistence in the region as noted above. Although resource wealth does not determine regime outcomes (Okruhlik 1999), countries with sufficient per capita oil rents can preempt or weaken opposition through benefits. Bellin's (2012) post-uprising reappraisal of her prior claims about authoritarian persistence (Bellin 2004) also point to the enduring value of structuralist accounts by underscoring the

relationship between rulers and the coercive apparatus as a critical determinant of distinct trajectories in the uprisings. At the same time, in seeking to account for Tunisia's relatively successful democratic transition, Bellin (2013, 2–3) points to more contingent, actor-centered factors such as elite commitment, ideological moderation, pragmatism, and willingness to compromise. These variables, which correspond to the more voluntarist school of democratization, must be situated within a political context in which civil society groups, notably the peak-level labor union, played a vital watchdog role, thereby increasing the likelihood of inter-elite compromise (Bellin 2013, 4).[3]

What insights can be gained from recent experiences of actual and attempted transitions to democratic rule in other comparable regions? In the next section, I briefly review cases of successful and failed democratization outside of the Middle East in order to identify relevant lessons for the Arab uprisings countries.

11.3 Regime transitions in non-MENA developing and post-Communist regions

Case studies are an appropriate methodological approach for studying the dynamics of political change because they home in on the causal mechanisms associated with diverse regime outcomes in the actual transition period (George and Bennett 2005). This analysis includes case studies of non-Arab countries in the region, notably Turkey and Iran, as well as analyses of transition experiences in Southeast Asia and the Former Soviet Union (FSU).

The logic of case selection

The choice of regions and countries is guided by specific criteria, which are present to varying degrees in the selected cases. These include:

- Variation in the outcomes of attempted democratic transitions;
- Levels of economic, political and social development comparable to the Arab transitioning countries;
- Weak state capacity and legitimacy;
- The presence of political, social and economic problems such as widespread cronyism, regional development disparities, and high youth unemployment;
- The absence of a democratic culture or prior democratic experience;
- The politicization of ideological and/or religious cleavages similar to the divisions between Islamists and secular liberals that have characterized

[3] However, in describing politics during the authoritarian period, however, Bellin (2002) emphasized the weakness of civil society groups in Tunisia, including the national labor union.

transitions in Tunisia and Egypt, or ethnic/tribal tensions that characterize transition in countries such as Libya and Yemen; and/or
- The nature of the transition, notably whether it occurred, at least initially, through a rupture with the previous regime (as found in Egypt, Tunisia and Libya) or a mix of rupture and negotiated transition (as in Yemen).

Each case study provides a brief account of the factors shaping the success or failure of the attempted democratic transition, identifies the most contentious issues during the transitional period, and describes efforts to address economic and political challenges. Table 11.1 summarizes the main findings.

Although no two countries are perfect matches for comparison, each of the selected countries generates insights for the Arab transitioning countries because they exhibit relevant similarities. Southeast Asia presents an appropriate region for comparison to the Arab world. First, like virtually all Arab countries, most Southeast Asian countries experienced protracted colonial occupation, which left institutional legacies that shaped post-independence political and economic development (Acemoglu, Johnson, and Robinson 2007, Mahoney 2010, Owen 1992). Second, in many Southeast Asian countries, Islam is the dominant religion and many countries feature Islamic parties and movements with widespread grassroots support. Third, both Southeast Asia and the Arab world experienced similar developmental trajectories, underwent destabilizing economic crises and, in some countries, have enjoyed large natural resource endowments, which are associated with authoritarianism. Finally, neither region benefited from the prospect of accession to a political and economic union such as the European Union, which has provided direct incentives for democratization in West and East European countries alike. The cases of Indonesia and the Philippines are examples of successful democratization while the third, Malaysia, represents a case of persistent authoritarian rule. Indonesia's "pacted" democratic transition, in which formal institutions established under authoritarian rule remained in place during the transition, was largely orchestrated by negotiations between pro-reform elites.

Since former President Suharto's resignation and the end of his authoritarian regime in 1998, Indonesia has transitioned into a democratic, multi-party system. National elections were held in 1999, 2004 and 2009, all which have been deemed free and fair by international observers. Reforms that extricated the formal presence of the military in political affairs and increased freedoms of the press also contributed to the relative success of Indonesian democratization.

Mass mobilization helped to precipitate Suharto's downfall, but the more immediate cause was the withdrawal of a key component of his elite support base, Chinese capitalists, in the context of economic crisis. Suharto's "authoritarian coalition" consisted of elites with opposing economic interests, including ethnic Chinese capital holders with mobile assets and *pribumi* or

Table 11.1 Non-MENA Cases of successful and failed democratization

Country	Timing	Regime outcome	Ideological polarization?	Politicized identity-based cleavages?	Type of Transition	Economic reforms during transition
Spain	1975/1982	Successful	Low	Yes	Pacted	No major reforms; expansive fiscal redistributive policies; declining economic conditions
Portugal	1974/1982	Successful after turbulent transition	Yes	No	Ruptura	Initially, major reforms (i.e., agrarian reform, nationalizations, freezing foreign capital), worsening economic conditions; major reforms only after transition (1983).

Country	Timing	Regime outcome	Ideological polarization?	Politicized identity-based cleavages?	Type of Transition
Indonesia	1998/1999	Low, main differences over economic reform	Yes, regional secessionism, anti-Chinese tensions	Pacted	Partial IMF-led reforms (i.e., banking, trade, subsidies, competition, decentralization, fiscal policy)
Philippines	1986/1992	Low	No	Ruptura, with instability	Some reforms, but limited success (i.e., decentralization, fiscal policy, infrastructure, land reform)
Malaysia	1998/1999	Low, initial factional conflict within UMNO and debates about economic reform	Yes, ethnic Malay v. Chinese	n.a.	During Asian Financial Crisis, resisted reform (i.e., capital controls, expansionary spending)
Georgia	2003/2004	No	Some regionalism	Electoral transition	After transition, significant reforms (i.e., privatization, fiscal policy, anti-corruption)
Kyrgystan	2005/2010+	No, personality-based parties; patronage networks	Ethnic and regional tensions (i.e., North-South; anti-Uzbek violence)	Electoral transition	1990–1994: reforms (i.e., dissolved collective farms, private sector promotion, decentralization); later, stalled reform, growing corruption; post-2010, new attempts at reform.
Azerbaijan	2003/2005	No, patronage networks	Regionalism, local strongmen (integrated in state patronage networks)	n.a. (attempted electoral revolution)	Oil-based economy; no major reforms enacted; patronage networks intact

"indigenous" entrepreneurs, whose fixed assets made them more rooted in the domestic economy and more opposed to economic liberalization measures. When Suharto's regime failed to protect the interests and holdings of Chinese capital during the Asian Financial Crisis, many ethnic Chinese fled the country, destabilizing the system and opening the way for the incumbent ruler's resignation (Pepinsky 2009, 172–184).

Indonesia's "pacted" democratic transition, in which formal institutions established under authoritarian rule remained in place during the transition, was largely orchestrated by negotiations between pro-reform elites. The role of civil society organizations was not as critical as in other Southeast Asian states, and Islamists have not played a prominent role in Indonesian politics, despite the importance of religion in social and cultural life. Furthermore, Indonesian student groups, which were instrumental in the demonstrations that led to Suharto's resignation, became marginal during the transition period (Abdulbaki 2008, 157). As in the Arab transitions, then, the initial youth and other groups that instigated the revolutionary uprisings were marginalized in the democratic transition process. Furthermore, military leaders and elite capital retained key positions and privileges in the new order, as has occurred thus far in the cases of Egypt, Yemen and, to a lesser degree, in Tunisia and Libya. This is a chief reason for the poor quality of democracy in post-Suharto Indonesia (Heryanto and Hadiz 2005, 255, ICG 2003). Paradoxically, then, the price of Indonesia's relatively smooth transition was the perpetuation of the influence and privileges of key elites in the military and private sector.

During the actual democratic transition when the country was in the throes of the Asian Financial Crisis, economic concerns dominated the Indonesian policy agenda. With the breakdown of the authoritarian coalition, Habibie was able to introduce more substantial economic change than his predecessor, including the reform of trade policy, the institutionalization of anti-monopoly and consumer protection laws, and greater decentralization of fiscal and regulatory authority as well as macroeconomic stabilization (Marks 2009). However, the record of reform shows that the administration more consistently enacted policies such as subsidy cuts, which were more harmful to the popular sector, than those that threatened elite interests (Pepinsky 2009). Economic problems also became intertwined with ethnic politics. The ethnic strife that erupted in the last years of the Suharto regime had economic foundations as Chinese capitalists, whose assets were more mobile than those of the ethnic Malay business community, favored liberalization (Pepinsky 2009). During and after the transition, the Habibie administration implemented a variety of policies to try to appease the Chinese Indonesian community.

The Indonesian case underscores several points of relevance to the Arab transition. First, transitions to formal democracy do not necessarily bring about substantive improvements in economic and social life. The country's

smooth democratization process enabled patronage networks established under Suharto's rule to remain entrenched, limiting political and economic inclusion. At this juncture, this lesson is of great relevance for the transitioning Arab countries, especially Egypt, where the economic interests of the military remain off limits and many big capitalists who benefited under authoritarian rule have maintained their holdings. Despite similarities with Arab countries such as Egypt, however, Indonesia largely escaped the kind of polarization between Islamists and liberals that has stymied the Arab transitions.

Similarly, the experience of the Philippines underscores the importance of elite cooperation in ushering through major political and economic reforms. The Philippines transitioned to democracy after the ouster of Marcos in 1986 in the People Power Revolution. Mass protests played a key role in ending authoritarian rule, but cooperation among elites across the political spectrum and from distinct parts of society was vital in facilitating the transition. The alienation of much of the population, including business elites and key military figures, facilitated elite consensus around the democratic transition while religious leaders, notably Cardinal Sin, helped to galvanize mass support for Marcos' overthrow. In the Philippines, therefore, democratization occurred through the interplay of mass protests and elite cooperation. In the first few years after the People Power Revolution, external actors, notably the U.S., were also instrumental in protecting the new civilian government of Corazon Aquino from coup attempts.

Constitutional reform and decentralization efforts dominated the first years of the Aquino presidency. In 1991, the new government passed the Local Government Code (LGC), a decentralization initiative aimed at encouraging greater local democratic participation. Given the long history of corruption and elite domination of politics, however, decentralization actually consolidated local pockets of authoritarian rule in some areas. The economic and political dominance of a small group of families and resistance to decentralization remained key obstacles to reform, leading to broad disillusionment with the Aquino government (Dohner and Ponciano 1989, 562, Hutchcroft and Rocamora 2003, 279, Timberman 1990, 168). Aquino was more successful in implementing economic policy changes, despite the high debt levels inherited from the Marcos era as well as high unemployment and a stagnant economy (Dohner and Ponciano 1989). After negotiations with the IMF in 1986, the Philippines gained new lines of credit, the national debt was restructured and the country received over $1.5 billion in foreign aid. Aquino also implemented an extensive tax reform program aimed at raising revenue while easing the fiscal burden on the poor and achieved modest improvements in the provision of basic services. Her government, however, was unable to enact major land reform, which was a longstanding source of disaffection under Marcos. Again, the persistent power of local elites, who were not fully subject to the rule of

law, endemic poverty and corruption blocked efforts to reform local governance (Rogers 2004, Thompson 1996).

Like other cases of successful democratization, the Filipino case underscores the importance of elite compromise in facilitating regime transitions. As in Indonesia, however, the quality of democracy remains poor, in large part due to the entrenched influence of local elites, inhibiting greater political and economic inclusion.

Malaysia represents a case of a failed democratization initiative. Despite the emergence of a strong reform movement during and after the Asian Financial Crisis in the late 1990s, Malaysia remains a prime example of an electoral authoritarian regime. The dominant ruling party as well as opposition parties contest elections, which are marred by high levels of a repression and irregularities, while patronage, corruption and restrictions on civic and political liberties continue to characterize Malaysian politics. The Malaysian case also suggests that the politicization of identity politics, notably between Islamists and non-Islamist Malays and Chinese, undercuts the unity of the opposition.

The Reformasi Movement of the late 1990s and early 2000s constituted the most serious threat to the ruling UMNO party in Malaysia's post-independence history. This period witnessed mass popular demonstrations, the formation of new political parties and the articulation of pro-reform political discourses. During this period, splits within UMNO emerged. Opposition within the party coalesced around Anwar Ibrahim, the Deputy Prime Minister and Minister of Finance. Anwar had strong national appeal, particularly among Malay youth and Islamic groups, facilitated by his past leadership of the Malaysian Youth Movement. While Anwar supported IMF proposals during the economic crisis, Mahathir Mohamed, the head of UMNO, opposed IMF conditions, which would have undercut the party's patronage system (Funston 1999, Nair 2007, Pepinsky 2009, Slater 2003). In September 1998, Mahathir fired and imprisoned Ibrahim, who suffered extensive abuse and was charged with the widely the publicized crimes of adultery, sodomy and corruption (Slater 2012).

After the 1999 elections, when the Reformasi Movement was at its height, the opposition alliance quickly fragmented. Although the PAS, the major Islamist party, had downplayed its support for an Islamic state during the campaign, the party quickly changed its rhetoric after receiving the largest vote share of the opposition coalition. In the provinces it controlled, the party passed a law calling for the enactment of *Sharia* and *hudud* codes of punishment. In response, the DAP, a majority Chinese political party, withdrew from the opposition BA alliance, damaging the coalition's image of multiethnic cooperation. Fragmentation also occurred within political parties, which displayed growing factionalism between more hardline Islamists and pragmatists. The PAS' vitriolic reactions to the American invasion of Afghanistan, including calls for Malay men to join in a holy war against the United States, alienated many supporters (Case 2004).

During the attempted democratic transition in Malaysia, both political and economic issues were major points of contention. Splits within UMNO and the opposition, personified in the rivalry between Mahathir and Anwar, were a focus of political conflict. Factions of the ruling party associated with Anwar as well as vocal segments of the broader opposition and public were outraged by Mahathir's treatment of his opponent. The economic downturn stemming from the Asian Financial Crisis also dominated the transitional period. During the crisis, Mahathir strongly opposed the policy recommendations of international financial institutions, which urged greater financial liberalization, and advanced conspiracy theories about Western attempts to control Malaysia. While neighboring countries such as Indonesia implemented the recommendations of the IFIs, albeit partially and in fits and starts, Mahathir rejected the policy prescriptions of the IMF and other international actors. Instead, he embarked on expansionary spending programs and implemented capital controls, which pegged the *riggit* to the U.S. dollar, arguably shielding Malaysia from the worst effects of the financial crisis. Mahathir's policy choices reflected the nature of the coalition undergirding his rule. UMNO's support base of domestic Malay elites and the general Malay population were aligned in their support for protectionist economic policies and expansionary spending measures, preventing the breakdown of the authoritarian rule (Pepinsky 2009, ch. 5).

In the end, the Reformasi Movement failed to launch a real, long-term challenge to the ruling regime. UMNO's continued strength, the fragmented state of the opposition, and the divisiveness of identity politics contributed to the downfall of the opposition. Furthermore, officials and elites continued to back Mahathir due to the system of patronage that had enriched them for years. UMNO's coalition of Malay elites and masses was vested in the domestic economy and benefited from the dominant party's system of patronage. As a result, none of Mahathir's support base had an incentive to defect from the authoritarian coalition (Case 2004, Pepinsky 2009).

The Malaysia case – a case of a failed democratic transition – highlights the importance of working agreements among political and economic elites both for facilitating democratization, as the experiences of other Southeast countries demonstrate, and for sustaining authoritarianism, as in Malaysia. In addition, the Malaysian case also shows that the politicization of identity politics is a major obstacle to political effectiveness, as in the Arab uprisings countries where divisions between Islamists and their opponents have been far more intense, blocking cooperation on political reforms.

The Former Soviet Union

In different respects, countries in the Former Soviet Union (FSU) also provide an appropriate set of comparisons for the Arab transitioning countries. First, the FSU countries did not face the prospect of EU accession, which has provided

strong external incentives for democratization in other post-communist countries in East and Central Europe and, as noted above, played a part in the earlier Spanish and Portuguese democratic transitions. Thus, as in the MENA, external actors had less immediate leverage over political reform processes. Second, countries in both the FSU and Arab region experienced severe economic crises at the time of transition. To be sure, MENA governments do not feature the same legacies of communist rule, which brought their own challenges to political and economic reform process. As Richards and Waterbury (2008) argue, however, the MENA region exhibits similar economic legacies as the former communist countries because of high levels of state interventionism. Third, in some FSU countries, clans and other ascriptive groupings are central to politics. In this respect, they are comparable to Arab transitioning countries such as Libya and Yemen, where tribes constitute important actors in the political system. Finally, Islamists are a growing force in parts of the FSU, although they are not as organized and lack the broad popular appeal that they enjoy in many Arab countries.

This section focuses on the cases of Georgia, Kyrgyzstan and Azerbaijan, which vary according to the degree of success of their respective pro-democracy movements. Recent elections in Georgia, in which the incumbent ruler peacefully ceded power to the opposing party, mark the consolidation of democracy in this country. In Kyrgyzstan, democratization has been less successful, although recent events suggest that the country may now be pursuing more serious democratic reforms. Finally, in Azerbaijan, authoritarian rule remains firmly entrenched.

In the FSU, pro-democracy movements attained varied success in Georgia, Kyrgyzstan and Azerbaijan. Recent elections in Georgia mark the consolidation of democracy in this country. In Kyrgyzstan, democratization has been less successful, although recent events suggest that the country is now pursuing more serious democratic reforms. Finally, in Azerbaijan, authoritarian rule remains firmly entrenched. These countries in the Former Soviet Union (FSU) provide an appropriate set of comparisons because, like the Arab countries, they did not face the prospect of EU accession, experienced severe economic crises at the time of transition, share economic legacies of state interventionism, and feature political systems in which clans and other ascriptive groupings are important actors.[4] In addition, Islamists are a growing force in parts of the FSU, although they are not as organized and lack the broad popular appeal that they enjoy in many Arab countries.

Georgia represents a case of democratization via electoral breakthrough, or an "electoral revolution" (Bunce and Wolchik 2011). Events in Georgia

[4] In this respect, they are especially comparable to Libya and Yemen, where tribes constitute important actors in the political system.

followed a pattern similar to political transitions in other post-communist, where popular protests in reaction to flawed elections led to the overthrow of authoritarian or semi-authoritarian leaders and the empowerment of more democratic political leaders and parties.

Compared with other post-communist rulers, Shevardnadze, who took power in Georgia in 1993, allowed for political pluralism and a relatively open civil society, however, his regime was not democratic (Bunce and Wolchik 2011, 154, Jones 2006, 40). Furthermore, under Shevardnadze's rule, the economic situation was fragile and economic reforms initiated in the late 1990s were limited by widespread corruption (Papava 2006, 659–661). From 1999 onwards, Georgia was unable to obtain loans or grants from international financial institutions due to escalating deficits and, in 2002, the IMF suspended assistance, citing high levels of external debt.

The Rose Revolution that overthrew Shevardnadze was a "revolution without ideology" (Mitchell 2004). The demands of the protesters and the opposition in November 2003 included a rejection of the failed policies of the previous regime, the end of corruption and the ouster of Shevardnadze, but the leaders of the Revolution were not ideologues (Mitchell 2004, 2). Instead, the personal appeal of Mikhail Saakashvili helped to mobilize protests, which ultimately led to the ousting of Shevardnadze (Bunce and Wolchik 2011, 165). The decision of other opposition leaders to ally with Saakashvili, as well as agitation by civil society youth groups, were also vital to the transition process.

The new democratic government engaged in a series of successful economic and administrative reforms. The government achieved some major victories in combating corruption by carrying out measures such as the abolition of the unpopular and corrupt traffic police and the reform of the university exam system. In addition, Saakashvili initiated an ambitious plan for privatization immediately after he came to power. In late 2004, the government changed the tax code and renewed the IMF program (Papava 2006, 661–662), leading to rising foreign direct investment and increased revenue collection (ICG 2007, 1). During this time, the government also actively pursued membership in the EU and NATO. In addition, Saakashvili implemented a series of governance reforms. Free and fair elections were held and the separatist Ajara region was brought under the full control of Tbilisi although other policies, such as the modification of the constitution and the strengthening of presidential power in 2004, raised concerns about the democratic credentials of the new government (ICG 2004; Tudoroiu 2007, 324). In 2007, a crackdown on civil society and opposition protesters was particularly worrisome (ICG 2007). Constitutional amendments initiated in 2009 and slated to come into force in 2013, however, will weaken the power of the presidency and return some power to the parliament and prime minister (ICG 2010). After the 2012 elections, however, Saakasvhili's

quick acceptance of the peaceful transfer of power to Ivanishvili's Georgian Dream (GD) coalition drew international praise and confirmed democratic consolidation in Georgia (ICG 2012).

Although the initial optimism about Georgia's potential for democratic institutionalization was followed by more measured assessments, Georgia's peaceful transfer of power after the October 2012 parliamentary elections marked the consolidation of democracy. To explain successful democratization in Georgia, specialists point to elite defections from the authoritarian coalition, in part derived from the drying up of the regime's patronage resources, the construction of a unified opposition and splits within the security forces, which made them unwilling to use violence. Thus, elite cooperation in the ouster of Sheverdnadze as well as the virtual absence of ideological divisions among members of the oppositions greatly facilitated the democratization process.

Like Georgia's "Rose Revolution," Kyrgyzstan's "Tulip Revolution" of 2005 represents an example of an electoral removal of a leader of a post-communist mixed regime (Bunce and Wolchik 2011). As in Georgia, protests following a flawed parliamentary election eventually led to the ouster of the authoritarian president, Askar Akayev. Unlike in Georgia, however, mass mobilization did not grow out of well-established parties or civil society groups but rather as a result of regionally based, local mobilization. Local notables, who were far more entrenched in domestic politics than political parties, played a key role in the protests leading to the president's ouster. During Akayev's regime, local notables had come to rely on patronage networks with MPs and individuals close to the president. As a result, most electoral candidates drew support from close acquaintances, neighbors and extended kin and through patronage networks, relying on interpersonal ties to mobilize protests, particularly in the South. Initial protests launched by unsuccessful candidates arose more from obligations to clients, who feared their loss of access to patronage, than by discontent with authoritarianism (Radnitz 2006, 137). The perception that Akayev favored the North further motivated protests in the South, where most of the president's allies were ethnic Uzbeks who preferred him over nationalist leaders (Ó Beacháin 2009, 22).

The initial phase of democratization in Kyrgyzstan took place around the parliamentary elections of February 2005. Citing widespread allegations of electoral fraud, many unsuccessful candidates challenged the results, which reinstated Akayev's party. Organized by losing candidates and their local supporters, protests erupted, particularly in the South, and opposition leaders and candidates began to coordinate their protest actions around an opposition coalition. On March 24, tens of thousands of protesters stormed the main government building in the capital, Bishkek, and Akayev fled to Russia, submitting

his official resignation ten days later.[5] Bakiyev, the best known Southern politician from the opposition, was named acting president by the outgoing parliament and new elections were scheduled for July. In the presidential elections of 2005, Bakiyev and Felix Kulov, another prominent opposition figure who had strong support in the North, decided not to compete against each other in order to balance regional interests. Instead, they agreed that Bakiyev would run for president while Kulov would serve as prime minister on the condition that the constitution would be amended to transfer greater power to the office of the prime minister. With support from both the southern and northern regions thanks to Kulov's endorsement, Bakiyev won 89 percent of the votes.

The 2005 transition brought about only limited change and Bakiyev's government quickly began to resemble that of his predecessor (Radnitz 2006; Tudoroiu 2007). Furthermore, the political system became increasingly unstable while regional and ethnic cleavages heightened (ICG 2012). In fall 2007, a new constitution was passed by a national referendum and Bakiyev's party gained full control of the parliament (Juraev 2010, 2). The president then appointed relatives to key government posts and increased harassment and repression of opposition figures and media outlets.

In 2009 to 2010, a second phase of democratization was initiated. Bakiyev's reelection as president in 2009 was marred by allegations of fraud and he was ousted by a wave of violent protests after the government raised utility prices in 2010. Roza Otunbayeva, the interim president, quickly adopted a new constitution that significantly diminished the power of the president. Free and fair parliamentary elections were held on October 10, 2010 and presidential elections were held in the following year, leading to the victory of Atambyev and the SPDK. Although the last two elections were deemed largely free and fair, both ethnic and regional tensions persist and periodically erupt in violence (ICG 2012). Since 2010, new governments have attempted to introduce economic reforms, including a relatively successful land reform initiative. Nonetheless, corruption remains entrenched and the decline of the mining sector, which accounts for 50 percent of export earnings and 26 percent of tax revenues, has taken a serious toll on the economy (Bunce and Wolchik 2011, 169, 171; World Bank n.d.).

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[5] The motivations for Akayev's decision not to suppress the protests with force are uncertain but some analyses suggest that the he did not entirely trust the security forces to comply with his orders. By this time, state institutions were weak and the government did not fully control all parts of the country, particularly in the South. Furthermore, military officials were not convinced that force would stop the protestors and were concerned that Akayev would try to use them as a scapegoat if repression backfired (ICG 2005; Matveeva 2010).

The case of Kyrgyzstan shows that not all democratic transitions proceed smoothly and quickly. The fragmentation of political life, which is largely structured along ethnic and regional lines and interpersonal networks, has inhibited the rise of coherent political blocs and programs. Declining economic conditions have also contributed to political instability.

An entrenched authoritarian regime, Azerbaijan witnessed a failed democratic transition in 2003, sparked by the transfer of power from the incumbent ruler, Heydar Aliyev, to his son, Ilham Aliyev. The senior Aliyev, a former communist party first secretary, took power in 1993 in a negotiated takeover from an unpopular nationalist government, which took office soon after the fall of the Soviet Union. Ilham Aliyev's accession triggered a struggle between incumbent authoritarian rulers and opposition groups, which tried to democratize the system through an "electoral transition" model, or the use of elections as a vehicle for political change, during elections held in 2003 and 2005 (Bunce and Wolchik 2011). Opposition efforts to promote democratization have thus far failed due to a lack of unity and government repression.

Under Aliyev family rule, the political scene has consisted of two blocs: the authoritarian incumbent ruler and his supporting party and the opposition bloc, which includes several parties. Attempts to set in motion an electoral transition model have met with little success. Personal rivalries ensure that opposition leaders remain divided, undercutting their ability to mobilize voters and monitor elections effectively (Bunce and Wolchik 2011). Although the number of political parties in Azerbaijan spiked after independence, the regime is largely organized around patronage networks whose primary loyalty is to the president rather than formal political groups. As in Libya and Yemen, these networks are largely based on regional tribal allegiances and personal ties to the ruler. As a result, Azerbaijan's recent political history is characterized less by ideological cleavages than kinship and personal networks. In the early years of Haydar Aliyev's rule, he relied primarily on actors from his native region, Nakhichevan, and on the Yerazi clan (Bolukbasi 2011, 216). His son and successor decreased the importance of these regional ties in favor of networks based on personal loyalty, relying more on clients cultivated in Baku, the capital. A separatist war in the Nagorno-Karabakh Region also raised the importance of military officers and local warlords in national and local politics, in contrast to other countries in the FSU, where the military is generally subordinated to civilian rulers.

The case of enduring authoritarianism in Azerbaijan with its vast hydrocarbon reserves seems to support the classic resource curse hypothesis, notably that resource wealth undercuts pressures for democratization. The Aliyev family has maintained support by controlling oil revenues, distributing wealth through patronage networks, undertaking large-scale populist spending measures and either repressing or coopting the opposition (Bunce and Wolchik

2009, 103, Cornell 2001, 119). Numerous foreign oil companies have signed contracts with the government, tempering Western support for substantive political change in the country. At best, external influence from the EU, the Organization for Security and Co-operation in Europe (OSCE) and the US supports pockets of opposition but does not threaten Azerbaijan's authoritarian system (Alieva 2006, 154–155). Islamist and Islamic groups have become increasingly vocal in recent years in Azerbaijan, however, the regime has exaggerated the Islamist threat in order to justify continued authoritarian rule (Karagiannis 2010), a practice used by autocrats in the Arab region (Lust 2011).

To maintain power, the Aliyev family has built a hybrid regime that serves the interests of key domestic and international audiences. Regime change will require a split in the authoritarian coalition, which is unlikely as long as the Aliyev family fuels patronage networks with oil wealth and the opposition remains fractionalized.

In the next section, I summarize the main lessons from these diverse experiences of initiated or attempted democratic transitions, emphasizing the interplay between contingent and more fixed, structural factors.

11.4 The lessons of successful and failed regime transitions

Insights from relevant social science literature and case studies of successful and failed democratization outside of the Arab region point to several factors that either facilitate or hinder democratic transitions. Here I review an array of factors, both contingent and more structural, that affect the course of democratic transitions.

Inclusive processes of institutional creation and agreement among key actors on the basic rules guiding the construction of new political institutions are vital for the success of democratic transitions. Absent this minimal degree of consent among key political and economic elites, both the persistence of authoritarian rule and democratization are virtually doomed. Although mass mobilization contributes to regime breakdown, elite defection is more decisive in bringing down authoritarian rulers and, in particular, for the institutionalization of new rules governing political life. For example, in the failed democratic openings of Malaysia in the late 1990s and in Azerbaijan in the early to mid-2000s, incumbents maintained robust patronage networks, undercutting the incentives for elite supporters to exit from the authoritarian coalition. In more successful transitions, such as those in the Philippines or Georgia, however, economic and political elites were increasingly alienated from rulers, who relied on narrowing patronage networks.

The need for elite cooperation for successful democratic transitions leads to the question of how constructive inter-elite dynamics arise in the first place. Social science theories of democratization have thus far failed to generate a satisfactory

and broadly applicable answer to this crucial question, in part because some of the determinants of elite cooperation are context-specific or contingent. Although elite bargaining is the focus of much research on democratization in the voluntarist tradition, accounts of democratization must integrate both structure and agency: Structural features of the economic and political contexts shape the interests and goals of elites. A review of the case studies generates some tentative explanations for the emergence of elite cooperation, ranging from more contingent factors, such as leadership and the ideological orientations of key stakeholders, to more structural conditions, such as politicized ethnoreligious cleavages, the robustness of patronage networks sustaining the authoritarian coalition, and the relative power of societal groups that support or oppose incumbent dictators. This section briefly reviews how each of these factors shapes the prospects for elite cooperation in democratic transitions.

Leadership

Virtually all of the case studies reviewed in this chapter point to the critical role of leadership in guiding smooth transition process. This may come in the form of a single leader who has broad credibility, enabling the construction of coalitions across the political spectrum. For example, leaders such as Aquino and Cardinal Sin in the Philippines and Saakashvili in Georgia are widely credited with constructing broad coalitions in support of democratic transitions.[6] In some cases, an initial period of instability facilitated support for moderate leaders because the population was fed up with extremists whose struggles only prolonged disorder and uncertainty. In the Arab uprising countries, no clear leader emerged to usher in smooth democratic processes, although in Tunisia pragmatic bargains among leaders such as Rachid Ghannouchi, head of the Islamist al-Nahdha party, and Beji Caid Essebi, head of the Nidaa Tunis party and current President of the country, successfully struck a deal that enabled competing factions to overcome ideological stalemate, facilitating the institutionalization of democratic institutions and practices.

Ideological moderation

Individual leaders cannot singlehandedly produce harmony in the political arena. Their capacity to form bridging coalitions among key stakeholders is contingent on the preexisting (and evolving) political terrain. Many of the country cases examined in this chapter as well as events unfolding in the Arab uprising countries indicate that extreme ideological polarization inhibits elite cooperation. If not ideological compatibility, then at least a common set of

[6] In the transitions paradigm, which was inspired in part by the Spanish and Portuguese democratization experiences, the roles of Suárez in Spain and Soares in Portugal are emphasized (O'Donnell and Schmitter 1986).

institutional goals is essential for democratization to take root. It is particularly vital that potential spoilers agree to abide by a core set of principles, embodied in formal and informal institutional rules.

Ideological polarization does not necessarily doom democratic transitions. In Portugal, deep ideological divisions between communists and their opponents threatened to undermine the democratic transition but eventually gave way to a centrist coalition. The Portuguese experience, however, underscores the importance of leadership in convincing diverse groups across the political spectrum to cooperate. Without a proponent of an ideological middle ground who can gain broad trust, extremists may continue to dominate the political arena. In the aftermath of the Arab uprisings, this negative dynamic played out in Egypt, where President el-Sisi ultimately took power and crushed the Muslim Brotherhood, and Tunisia, where ideological polarization seriously threatened to undermine the institutionalization of democratic rule.

The role of ideological polarization in hindering elite consensus and, hence, democratization is obviously most applicable to political contexts where ideological commitments are central to the interests of key actors. Ideology clearly shaped the positions of political elites in earlier transitions in Portugal and Spain and, to a lesser degree, in the Southeast Asian countries such as Indonesia and the Philippines. In the Arab transitioning countries, the role of Islamic principles in political life is a key source of contention and poses a serious obstacle to cross-ideological compromise. At the same time, the relative absence of ideological divisions can also inhibit coalition building by enabling rulers to more easily buy off elites who might otherwise cooperate on shared principles.

Politicized ethnoreligious cleavages

A substantial literature in the social sciences shows that politicized identity cleavages reduce the likelihood of cooperation, whether among elites or the general population, complicating democratic rule, civic peace, and development prospects alike (Alesina, Baqir, and Easterly 1999, Easterly and Levine 1997, Horowitz 1985, Lijphart 1977). Among the cases reviewed here, Malaysia and Kyrgyzstan show how ethnic, religious and/or regional identities hindered democratic transitions by preventing inter-elite cooperation and undercutting the quality of governance.

If politicized identity cleavages make democratic transitions more difficult, the cases of Spain and Indonesia are puzzling. In both countries, democratization prevailed in spite of deep identity-based cleavages. In Spain, the incentives provided by EU integration as well as institutional rules granting regional autonomy helped to convince the leaders of separatist movements not to stymie the democratization process. In Indonesia, the historically moderate stance of Islamic movements, which generally did not call for the imposition of *Sharia* in public life and did not enjoy the same level of popular appeal as

in Arab countries, as well as state efforts to appease the interests of Chinese capitalists, who own significant holdings in the country, help to explain why identity-based cleavages did not undercut democratization. This relatively successful management of identity-based cleavages facilitated political and institutional continuity and, hence, reasonably smooth democratic transitions in both countries. This suggests that external incentives and support as well as overriding economic interests can promote democratic transitions, even in the face of politicized ethnoreligious cleavages.

Patronage networks

The nature and durability of incumbent patronage networks affect both the probability of elite defection (and, hence, the likelihood of authoritarian breakdown in the first place) as well as the quality of democracy (and, hence, potentially the stability of democracy in the longer term). Where such networks remain intact, political and economic elites may opt not to throw in their lot with the opposition, which may have relatively limited societal support depending on the distributive breadth of the spoils among the population. For example, in Malaysia, UMNO's coalition of Malay elites and masses benefited from the dominant party's system of patronage, undercutting incentives for Mahathir's support base to defect. In Azerbaijan, the Aliyev family's patronage networks, funded with oil wealth, in part explains why the opposition has had trouble gaining traction. In the Philippines, however, Marcos had sidelined many business leaders, making them ripe for cooperation with the opposition, particularly after Cardinal Sin worked to bring them into the anti-Marcos coalition. Similarly, in Egypt, the military and other domestically oriented business groups, who were threatened by the privatization policies associated with Gamal Mubarak and his allies, did not block the ouster of Mubarak. In Tunisia, the Ben Ali and Trabelsi families increasingly monopolized the most lucrative economic opportunities, alienating much of the business community, which did not defend Ben Ali during the revolution and even welcomed his departure. Furthermore, the Tunisian army was not integrated into Ben Ali's patronage networks, making it relatively easy for the military to defect from the authoritarian regime. The breakdown of patronage networks and subsequent decisions to support democratization, however, does not guarantee continued unity among opposition factions, as the Egyptian and Tunisian experiences attest.

Once a successful transition occurs, the type of transition – and its implications for the continuity of patronage networks – shape the quality of democracy.[7] The defection of economic elites from authoritarian bargains does not

[7] Democratic quality encompasses multiple dimensions, including the rule of law, accountability, civic and political liberties, economic equality and the responsiveness of government officials to voters (Diamond and Morlino 2005).

automatically produce elite consensus behind an alternative ruler or system of government. This depends in part on whether elites remain incorporated in patronage networks during and after the transition. When the transition is pacted between regime incumbents and members of the opposition, as occurred in Indonesia, patronage networks are more likely to remain intact, facilitating a smooth transition but at the price of poor democratic quality. When pacted transitions permit political and economic elites to maintain their privileges, democracy will be less inclusive, both politically and economically. The poor and marginalized components of society may not experience tangible improvements in their lives and will not have equal access to opportunities for social advancement. Poor democratic quality can undermine citizen trust in government and open the way for disenchantment with the transition.

Conversely, when democratization occurs through a sharp break (*ruptura*), powerful elites whose interests were tied to the previous authoritarian regime may lose access to patronage and act as spoilers. Furthermore, it is difficult for new rulers to quickly establish their own patronage networks to incorporate disaffected elements from the prior regime. Thus, transitions based on a sharp break from the prior regime can be more unstable, threatening the consolidation of democracy. Even when key stakeholders from the authoritarian period remain in the new system, ideological polarization, among other factors, may still complicate the transition. In Egypt, the military appears initially to have had tacit agreements with the ruling Muslim Brotherhood, enabling army officers to maintain their economic privileges in post-Mubarak Egypt. Polarizing ideological debates, however, hindered a smooth transition to democracy.

Ultimately, patronage networks require sufficient resources to be sustained. When authoritarian incumbents have access to resources, they can undercut the appeal of pro-democracy movements in the first place. Countries with natural resource endowments are more able to use patronage in order to ensure the loyalty – or at least the consent – of their key constituents and even the broader public, as the cases of Azerbaijan and the Arab Gulf monarchies attest. Even in less wealthy countries, rulers can use cooptation effectively, especially when elites are dependent on state patronage for their survival and enrichment. In Malaysia, for example, Mahathir was able to hold the authoritarian coalition together in the face of a major economic crisis because his core constituents were rooted in the domestic economy and dependent on state subsidies and benefits.

The relative power and interests of state and societal groups

Beyond the durability of patronage networks, the relative power and interests of key state and societal groups shape the nature of inter-elite bargaining during periods of institutional flux. By relative power, I mean the capacity of groups to garner and mobilize popular support and to behave as a cohesive

unit. The Tunisian and Egyptian experiences, and those of other country cases explored in this chapter, clearly underscore this point. For example, in Tunisia, the UGTT, the national labor union, much of which was not entirely coopted under Ben Ali's rule, helped to keep the democratic process on track even when intense ideological polarization between al-Nahdha and its opponents threatened to undermine it (Bishara 2014, Langohr 2014). The role of the military was also decisive in the two countries, and more generally is vital to authoritarian regime survival. As Bellin (2013, 2) argues, the Tunisian "military developed into an apolitical and professional entity not invested in the survival of Ben Ali's regime." These qualities, in addition to the fact that it did not have a hefty corporate stake in the economy, help to explain why the military did not side with Ben Ali in the face of mass protests. In Egypt, the military occupied a distinct position in domestic politics and the economy. Although it effectively permitted the overthrow of Mubarak, the army maintained a vested interested in the system itself, in part due to an interest in preserving its privileged holdings in the economy. Variation in the strength and degree of pluralism of civil society may also help to explain why the Tunisian transition was more inclusive and entailed greater compromise and deal-making across ideological lines than has been witnessed thus far in Egypt (Brownlee, Masoud, and Reynolds 2015).

Policy reform during periods of institutional flux

The nature of democratic transitions arguably shapes the *quality* of democracy, which is vital for understanding how citizens actually experience the fruits of transitions (Munck 2007, 35). In higher quality democracies and, more broadly, in regimes with better systems of governance, citizens are more likely to view their political institutions and representatives as trustworthy and legitimate (Rothstein 2011). Elections and basic democratic institutions do not create a full democracy if many are excluded from the political process, whether by poverty, entrenched corruption and clientelism, or other factors (Dahl 1971, Kitschelt and Wilkinson 2007, Rose-Ackerman 1999, Sen 1999). Arguably, citizen dissatisfaction with democratic institutions can undermine regime stability in the medium to long term.

Difficult economic conditions also pose an ongoing challenge. Political transitions are often accompanied by a decline in macroeconomic outcomes, particularly in the context of political unrest and instability. Economic recovery can be slow, exacerbating unemployment, while protracted uncertainty dampens investment. In the Arab transitioning countries, notably Egypt, Tunisia and Yemen, output has declined, unemployment and fiscal deficits have increased, and international reserves are low. The poor external environment with a global recession and rising food prices has complicated economic recovery in the Arab countries (Khandelwal and Roitman 2013).

The political dynamics of regime change make the task of economic recovery all the more difficult. In many political transitions, economic reform is not a priority, as many of the case studies suggest. Instead, the reform of political institutions is the major issue of contention in most countries. Current developments in the MENA region exhibit a similar pattern: in the Arab transitioning countries, the most vociferous public debates have concerned constitutional reform and, particularly, the substance and extent of individual rights, while pressing economic challenges are pushed to the back burner. Thus, ideological concerns at least initially largely trumped economic reform in Tunisia and Egypt, while in other countries war and violent conflict undercut the construction of new political institutions while exacerbating economic downturns and policy attention to address them. This situation imperils the economic future of the Arab uprising countries and, through negative feedback loops, may also undermine political reform.

With an uncertain political climate and the mobilization of new groups, it is challenging for transitional governments to undertake economic and political reforms simultaneously. Politicians in newly minted democracies are loath to implement policies that generate widespread popular opposition, leading to instability and threatening their prospects for reelection. After a protracted revolutionary struggle, the public has little appetite for prolonged hardship, increasing the incentives for politicians to enact populist measures during transitions at the expense of longer-term growth and development (Przeworski 1991, 161, see also Haggard and Kaufman 1995). Yet the most vociferous opponents of economic liberalization may not be the marginalized mass publics but rather elites who benefited under authoritarian rule. Based on analyses of the post-communist countries of Eastern Europe, Hellman (1998) contends that economic and political elites profited from "partial opening," or privatization and other economic reforms enacted in the context of restricted competition. As a result, they face major losses if democratic reform leads to increased market competition. Both perspectives on the politics of economic reform during and after regime transitions suggest that the prospects of substantive economic restructuring are slim until political institutions become reasonably consolidated. Future research in the Arab region should investigate whether and how differential treatment of former regime cronies and their holdings affects the design and implementation of economic reform policies in distinct ways.

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12
Democracy and Economic Development

*Mustapha Kamel Nabli**

12.1 Introduction

The linkages between democracy or democratization and economic development, mostly as captured by economic growth, continue to be a subject of controversy with very few well established facts and relationships. From a review of evidence three main findings can be mentioned.[1]

First, there is empirically no significant, stable, predictable and causal relationship between democratic development or democratic accountability and economic growth.[2] Some studies show positive direct effects, or rather association, between democracy and growth while others show either insignificant and even negative effects. Work on the Arab region shows similar results.

Second, these controversial and inconclusive results led to a focus on whether and how democratic institutions can produce better economic outcomes through improved governance. There is good empirical evidence about a significant and positive impact of good governance/good quality of government on economic growth, with causality running from institutions to growth.[3] The implication for the Arab region is that if better governance can be achieved, through democratization, significant gains can be achieved in terms of economic growth. The main channels for such an indirect impact are

* I am grateful to Ahmed Galal and Ishac Diwan for useful comments and suggestions.

[1] Nabli and Ben Hammouda (2015a) provide a review of evidence.

[2] A recent statistical meta-analysis by Doucouliagos and Ulubasoglu (2008) confirms the lack of evidence of a direct relationship between democracy and economic growth. But they find evidence of indirect effects of democracy on economic growth through higher human capital accumulation, lower inflation, lower political instability and higher economic freedom. Knutsen (2013) finds a strong effect of democracy on growth in Sub-Saharan Africa even in the presence of weak states.

[3] See Knack and Keefer (1995, 1997), Mauro (1995), Clague *et al.* (1997), Johnson *et al.* (1998), Hall and Jones (1999), Kauffman *et al.* (1999) and Lambsdorff (2005).

through faster capital accumulation, better provision of public goods and more equity and equality of opportunity.

Third, while the links between democracy and the level of economic growth remains controversial, there is strong empirical support for a significant impact of democracy and better political institutions on the volatility of economic growth. Democracy helps resolve better conflicts and tensions which result from shocks, and by achieving better equity and equality it supports social stability and reduces conflict and violence.[4]

One main implication of these findings is that democracy and good governance are not the same thing. And the expectation that democracy would produce automatically good governance and promote successful development is not warranted. Another implication is that "democracy" is neither a necessary nor a sufficient condition for good economic and social outcomes. Beyond these general implications the findings are not very helpful for political actors and international institutions interested in the actual design of institutions and development policies.

These findings suggest the need to go beyond broad statistical analysis and explore the complexity of the factors which determine how democracy affects development outcomes. These considerations about types of democracy, interactions with other complementary institutions and the lessons learned from historical experiences are the main focus of the paper, and are the subject of section 12.2. In section 12.3 we discuss how these findings can help us understand the outcomes and impact of current democratization experiences, and draw some lessons in the Arab region. Concluding remarks are made in section 12.4.

12.2 Going beyond statistical analysis and exploring types of democracy and complementarities with other institutions

The empirical findings, and the difficulties discussed above in sorting out the linkages between democracy and development outcomes, are not surprising for three reasons.

The first reason is the fact that democratic institutions come in different forms and shapes, and empirical analyses do not always differentiate between various forms of democracy, which may have different impacts on governance and outcomes.

The second reason is that the impact of democratic institutions depends on other institutional characteristics and features prevailing in the country which democratizes. This can easily be seen from the observation that in any

[4] See for instance Pzeworsky et. al. (2000), Elbadawi, Makdisi and Milante (2011) and Pritchett and Werker (2012).

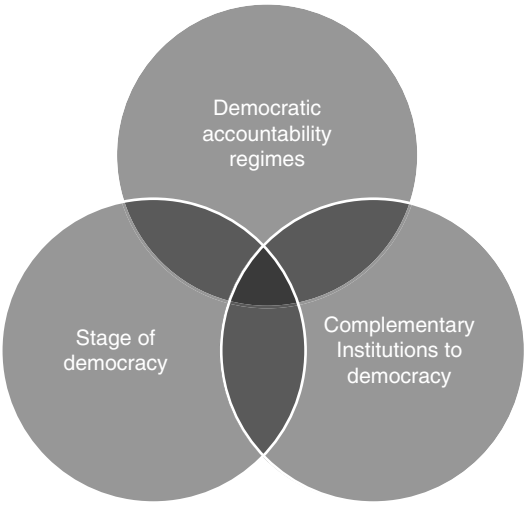

Figure 12.1 Dimensions of the impact of democratic accountability on development

successful well established democracy there is, in addition to the usual democratic accountability institutions, a large set of other political and governance institutions which tend to exist together. But an important part of the debate about democracy has been the lack of consensus on which of these other institutions should be considered essential for a system of good governance.

The third reason is that the impact of democracy on development may be quite different depending on the stage of democratization. It is quite plausible that such impacts would vary depending on whether a country is at the stage of transition towards democracy, is an emerging democracy or a mature and well established one.

These considerations lead us to suggest the following graphical representation (Figure 12.1) which is helpful for understanding the impact of democracy on development. It shows that the impact of "democracy" on development needs to account for three dimensions: (i) the democratic accountability institutions or regime; (ii) the type of other political institutions which are complementary with those of democracy and which are present or lacking; and (iii) the stage of democracy of a given country.

The study of the relationship between democratic institutions and development is even more complex if we take into consideration the role of structural factors. A body of research in this area has suggested that a number of structural factors in developing countries are relevant in affecting how democracy affects economic development, such as inequality, endowments in natural resources, ethnic and cultural diversity, level of income, geographical location, colonial

history, and so on.[5] For instance, it has been widely discussed that countries, especially those of the Middle East, which are rich in oil resources tend to have less success in adopting democratic institutions and experience worse economic outcomes, as there is less scope for accountability and more conflicts about rent sharing.[6] Similar arguments can be advanced about the effect of high inequality in countries or greater degree of fragmentation.[7] We will not pursue the implications of such structural factors in section 12.2 of this chapter, and focus mainly on the three mentioned factors. But we will need to bring these structural factors in our discussion of the Arab region in section 12.3.

We explore the significance and implications of the three factors shown in the figure above on the relationship between democracy and economic and social development by asking three questions which deal mainly with the issues of types of democracy and complementary institutions. The issue of stage of democratization is referred to when relevant.

1. Which democratic institutions or forms of democracy are more supportive of inclusive development?

Democracy comes in many different forms and shapes. And over the last few decades quite a lot of empirical research has addressed the issue of whether there is any evidence that different types of democratic accountability institutions or regimes have different impacts on social and economic outcomes. This research has been mostly based on developed countries experience,[8] and explored the differential impact of a number of stylized forms of democracy. Three major distinctions have been made: *presidential vs. parliamentarian systems*; *proportional representation (PR) vs. plural-majoritarian electoral systems; and majoritarian vs. consensual democratic systems.*

Forms of government: presidential vs parliamentary democracy

In presidential systems there is a division of power between two bodies: the legislature and the president. It has been argued that such separation of power enhances credibility of commitments and strengthens checks and balances. These effects are supposed to be growth enhancing. There is also some empirical evidence showing that presidential systems tend to result in lower public spending and taxation compared to parliamentary systems. The latter have a tendency to redistribute more (Persson and Tabellini, 2004). But it is unclear whether these effects promote higher growth.

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[5] See for instance Rueschemeyer, Stephens and Stephen (1992).
[6] See Ross (2001), Chaudhry (1997) or Beblawi and Luciani (1987).
[7] Acemoglu and Robinson (2006, 2012).
[8] It should be noted, however, that Lijphart (1999) includes 11 developing countries in the group of 36 democracies he studies.

Presidential systems can also produce gridlock if the elected president and legislature are from different political orientations. At the other extreme, presidential systems have often transformed into "presidentialist" systems where the executive branch dominates the legislature, undermining the positive effects of the systems in terms of checks and balances, opening the way for the dominance of narrow special interest politics and groups and even the perversion of democracy.

On the other hand, parliamentary systems are associated with better bureaucratic quality, more protection of property rights, more public spending towards universal programs and less interest-specific ones, more trade openness, and less stop and go policies. These factors promote economic growth.

From this discussion it appears that no government system is clearly superior from a theoretical point of view in terms of its impact on economic performance. However, according to the more standard and significant empirical findings, parliamentary systems tend to outperform presidential systems in terms of economic growth and life expectancy (Gerring et.al, 2009). Persson and Tabellini (2003) find that in low-quality democracies presidential systems are associated with lower quality institutions such as bureaucracy and protection of property rights and reduce productivity growth. But other findings by Knutsen (2011) show that "presidentialism" does not seem to reduce economic growth

Electoral systems: proportional representation vs. plural-majoritarian

The most common presumption is that plural-majoritarian systems tend to induce more effective accountability mechanisms which may motivate adoption of better policies. Majoritarian rules tend to produce clear majorities and better defined choices for the electorate. With such high accountability less performing candidates and parties are quickly voted out of office. Under such systems electoral districts tend to be smaller and monitoring of candidates easier improving accountability. But plural-majoritarian systems can have less desirable effects if they produce large majorities which become less sensitive to voter pressure, and elected officials who are less concerned with nationwide broad interests and focus on narrow district levels interests.

On the other hand, PR systems should induce the adoption of more broad based and universal policies, like the supply of education to the masses, better property rights protection, more open trade policies, better investment climate and less abrupt changes in policies. The need to form coalitions and lack of strong majorities lead to more broad-based policies which try to respond to the needs of larger segments of society, and are less responsive to narrow interests. More redistribution is expected also in order to meet these broader needs. These policies are more conducive to growth than narrow interest policies. PR systems tend also to produce less abrupt changes and shifts in the ruling groups and more stable policies, enhancing predictability and stability.

Empirically most findings show evidence of better performance of PR systems in terms of economic growth. These findings are not robust in Persson and Tabellini (2003) and Persson (2005), and they show small effects in Lijphart (1999). However, strong effects are found by Knutsen (2011), with a 1 percentage point of growth advantage for PR systems.

Majoritarian vs. consensual democracy

A distinction closely related to the previous one has been put forward and emphasized by Lijphart (1999) between two major models of democratic government: majoritarian vs. consensual democracy. In a similar vein, Norris (2008) distinguishes between power-sharing and power-concentrating institutional arrangements.

Majoritarian democracy, or a majoritarian electoral system, tends to be associated with concentration of power with bare majorities, more dominance of the executive, and two-party systems. The typical case is the parliamentarian system in Britain.

Consensual democracy is more inclusive, favors bargaining and compromise. It is associated with more proportional representation, a stronger role for parliaments, multi-party systems, federalism and decentralization.

It has been traditionally claimed that majoritarian systems should produce more effective government, as clear majorities can reach policy decisions more easily and quickly, leading to better policy outcomes. But Lijphart (1999) argues that there is no supportive empirical evidence for this claim. In fact there is weak evidence that consensual democracy is superior and is associated with better performance in terms of control of inflation, and most other macroeconomic variables.

At the same time consensual democracy is associated with better quality of governance in terms of representation and inclusiveness, as well as with "gentler" socio-economic outcomes in terms of welfare, equity or protection of the environment.

The practical recommendation is to favor political systems which include: proportional representation, parliamentarian, bicameralism, more decentralization of power, multi-parties, judicial review, and central bank independence.

2. Are there preconditions for democratization, when it takes place, to lead to good governance and better economic outcomes?

It was suggested above that democratic accountability institutions are complementary or tend to exist jointly with a large set of other political/administrative/legal institutions which condition how democracy impacts development.

For instance the Huntington/Fukuyama approach puts forward two additional sets of institutions.[9] The first is a modern and capable state: relative autonomy

[9] See Huntington (2006), and Fukuyama (2011, 2014).

with respect to political masters; impersonal, meritocratic and competent bureaucracy, which has an eye on the common good and long term interests. The second set of institutions is the rule of law as a constraint on political power: the law applies to all including the most powerful, especially the rulers.

In another approach, Norris (2012) emphasizes the importance of state capacity, mainly the bureaucratic capability dimension. Other types of institutions deemed important complements to democracy include: strong national identity, or strong media.

If by some miracle a given country could create an institutional political framework which has all the requisite components, which are commonly found in well established democracies, it is highly likely that it can achieve very strong economic and social outcomes. But to the best of our knowledge, there is not one historical experience where a country succeeded in implementing simultaneously a set of institutional reforms which deal with all dimensions at the same time and thereby engineering dramatic economic progress outcomes. This implies that empirically the presence of such an all encompassing "good governance" set of institutions is not a necessary condition for successful development!

Countries experienced different paths and sequencing in developing such institutions. The really important question becomes whether there are pre-conditions which ensure that democratization produces good outcomes? Alternatively or conversely are there pre-conditions which when not present prior to a democratization process tend to make it fail in producing good outcomes?

One can seek an answer to such questions by looking into historical experiences. Based on a historical review, Fukuyama (2014) argues that the order and sequencing of how the three sets of institutions mentioned above come about and develop is critical on how democracy works. Two typical cases of sequencing illustrate these relationships.

Case 1

In many historical experiences, a strong and capable state develops first, often under authoritarian and even militaristic political orders, and when subsequent democratic development takes place it has a strong positive impact on the quality of the political order and on economic development. Examples of such historical experiences include: France, Prussia/Germany, Sweden, Denmark, Japan, or Korea.

A review of these cases reveals a number of findings:

- In all these cases economic progress or growth take-off pre-dated democracy.
- The prior development of a modern state and rule of law made the success of democratization easier, which enhanced economic success.
- The relative role of a strong and capable state was critical in all these cases, whereas the role of prevalence of rule of law varied significantly.

The presence of strong state capacity with democratization is what Pippa Norris calls "bureaucratic democracy", and she shows it to be typically successful in delivering good outcomes. However, in a contrarian finding by Knutsen (2013) state capacity is not found to be an important factor in determining the effect of democracy on economic growth in recent African experience.

Case 2

In most other experiences democracy is introduced before the development of a modern, strong, capable and impersonal state. The typical outcome is a clientelistic political system/bureaucracy, ripe with corruption. Typical cases include: the Unites States of America, Italy, Greece, the Philippines, India, or most of Latin America in the 19th century.

These experiences show that:

- Economic outcomes vary widely: some achieved strong growth even with weak governance, while others were not successful.
- Many countries get stuck in such weak governance systems and could not move to better governance.

This is a case of "*patronage democracies*" (Norris 2012) which are not consistent in terms of outcomes, and produce mixed results depending on a variety of other factors.

One can draw a number of critical points from these observations and cases. First, the way democracy impacts development depends on and interacts with other sets of institutions such as state capability and prevalence of rule of law. Second, the presence prior to democratization of a strong state capacity provides a solid basis which supports the success of democratization. Third, the absence of prior strong state capacity makes the outcomes of democratization uncertain, but does not preclude its success. Fourth, democracy with weak state capacity but strong rule of law can generate under some conditions good economic outcomes. However, democracy with no prior development of good state capacity or strong rule of law is likely to lead to clientelistic political systems and bad economic outcomes.

3. Under which conditions can democracy succeed in spurring the development of better state institutions and rule of law, i.e. better governance?

As the previous discussion shows, for many if not most developing countries the most common situation is the pre-existence of weak state capacity, and weak rule of law, when democracy is introduced.

Under these conditions, the most common popular expectation is that democratization by itself would drive change in other institutions in order to improve governance and improve outcomes.

But historical experience shows that such results are not guaranteed and in many cases democratization continues for long periods with weak state capacity institutions and weak outcomes. These cases abound: among the developed countries the cases of Italy and Greece have long been noted; the many cases in Latin America which experienced democratization by the late 19th and early 20th centuries, but did not develop modern states for a long period; the many cases in Africa during the recent wave including Nigeria; or the case of the Philippines in Asia.

The *interesting question* becomes: what are the conditions under which democratic accountability can spur improvements in state capacity and enforcement of rule of law, resulting in better governance overall? According to Fukuyama (2014), there were cases when state capacity was weak prior to democratization and a patronage or clientelistic political system emerged. But these countries were able to fix the state and reform the patronage, and their clientelistic political system. They were able to develop, within a democratic system, a capable state. The most notable examples are: Britain during the 1850s, and the United States from the 1880s to 1930s.These experiences provide some lessons about the conditions which helped overcome the handicap of weak and clientelistic states in democratic countries.

The first lesson is that reform of the state can be achieved rapidly, and the case of Britain is illustrative of major reforms being completed within a decade. But it may take much longer as in the case of the case of the US where it took a few decades. The critical factor was the role of political leadership.

The second lesson is that the process of economic modernization played a critical role in the emergence of an urban middle class which had a strong interest in an impersonal and effective state driven by meritocracy. This created the political context and pressures for reform of the state and its success. The critical lesson is that the coalitions pushing for reform do not have a stake in the existing system, and have most to gain from a new meritocratic system.

The third lesson is that the existence of a strong national identity is very supportive of the development of state capacity, as it increases the level of trust in state institutions and the sense of loyalty which makes support for such institutions stronger.

12.3 What does it all mean for Arab democracy?

It has been widely recognized that the Arab region, and more broadly the Middle East and North Africa region, has lagged in terms of democratization, and where authoritarianism has long dominated (Nabli and Ben Hammouda 2015b). And it has been argued also that the lack of democracy and the prevalence of authoritarianism have been costly to the Arab region in terms of growth and development (Nabli and Ben Hammouda, 2015a).

The attempts at democratization with the recent uprisings in many countries have raised hopes that success and the establishment of democratic institutions could help improve economic performance and enhance development outcomes. But the evidence we discussed above does not warrant such unconditional optimistic view, and provides a number of useful lessons for the Arab region.

In this section we discuss how the considerations we presented above can help us shed light on recent and prospective democratic developments in the Arab region. We illustrate how the three factors we highlighted do interact in various ways to shape the democratization process and its impact of development outcomes in Arab countries.

But before proceeding further it is important to make one observation. We mentioned earlier that structural factors play an important role in shaping the impact democratization and its implications, but that we would not explore them in this paper. But there are two major structural factors in the context of the Arab region which cannot be ignored as they have played a central role in the way democratization attempts and their success played out. The first is natural resource wealth which has, as expected, been a central factor in the way democratization played out in many countries. The uprisings of end 2010 and early 2011 impacted mostly non-resource rich countries like Tunisia, Egypt, Yemen and Syria. Most resource-rich countries were able to contain the spread of contagion using their wealth and the favorable terms of trade at the time in order to sustain the existing regimes. Contagion affected only one major resource-rich country, Libya. The Libyan experience illustrated the limits of democratization in such a resource rich country as it descended quickly into civil war driven to a large extent by the fighting over the control of the oil rents.

The second factor played out in Libya as well. The divisions about the role of religion in politics and of identity politics have shaped the democratization and the post-uprisings developments in all countries. Deep divisions took center stage in societies, taking in many cases the form of extreme violence undermining the chances of any consensual institution building. We will bring these two factors into our following discussion of Arab democracy.

The success of democratization attempts depends crucially on the pre-existing quality of state capacity

The recent Arab uprisings led to a collapse of the existing regimes and a change in the political order in four countries: Tunisia, Egypt, Yemen and Libya. In Syria the political regime did not fall but the country went quickly into civil war. From the outset it would appear that for two countries, Libya and Yemen, the pre-conditions were utterly unfavorable. In both of them state capacity, by any measure, and rule of law, were extremely weak (see Figure 12.2). The prospects for democratization to lead to good outcomes were very dim. In the

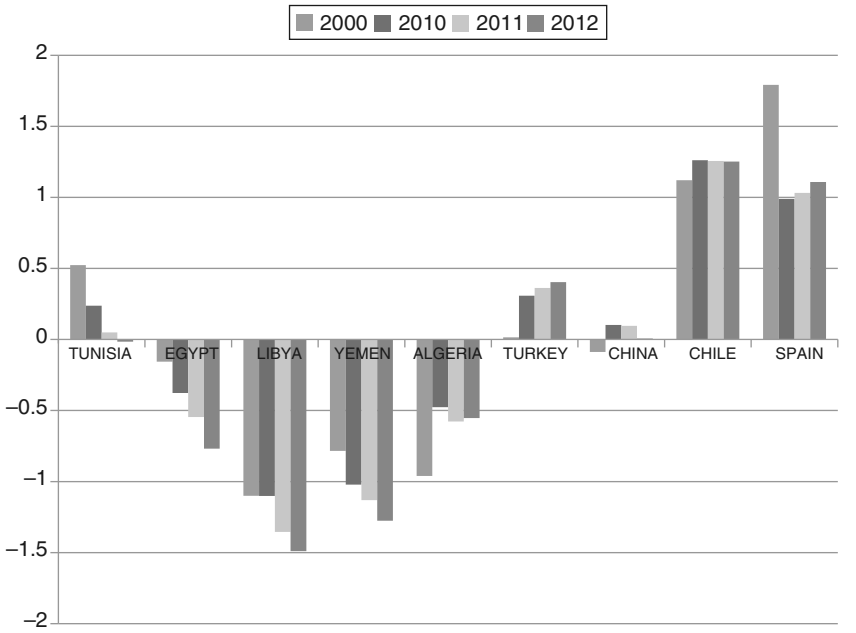

Figure 12.2 Government effectiveness in selected countries
Source: World Bank Worldwide Governance Indicators.
Definition of Government Effectiveness: Index captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately –2.5 to 2.5.

case of Libya the high level of resource wealth meant also that the prospects for success were much weaker from the outset. The fight for control over these resources as well as deep social divisions led quickly to violence and civil war. In both cases the democratization process itself collapsed leading to violence and conflict.

Tunisia and Egypt stood a better chance in view of some favorable conditions: limited resource wealth and stronger state capacity. And the process of democratization advanced much more in these two countries. However, in both countries, polarization driven by ideological considerations about the role of religion and identity politics, emerged quickly as a major problem. And this led to divergent paths.

The literature on democratic transitions has strongly emphasized the role of consensus for their success. In countries where elite cooperation prevails and consensual approaches are pursued democratic transitions are much more

likely to be successful. This is to be compared to situations where political and ideological polarization becomes a major obstacle to successful transitions. This would suggest that "consensual democratic" systems may be conducive to success (World Bank, 2013).

The choice of electoral systems played a significant role here. In Egypt a "presidentialist/majoritarian" political regime was adopted which did not allow for compromise and consensus building, enhanced this polarization, leading to the collapse of the democratization process.

Tunisia has gone the farthest in establishing democratic institutions. The country has a long history in state building and modernization, starting since the middle of the 19th century. There was a strong impulse after independence in building state capacity and better governance. The country has fared well in international comparisons as to state capacity to ensure security, to deliver public services, and protect property rights (see Figure 12.2). It ranks highest among the Arab countries most affected by the uprisings, but the quality of state capacity remains weak when compared to other well performing developing countries such as Chile.

However, there were setbacks more recently, with a weakening of state capacity, and the development of corruption and patronage/clientelistic behaviors. These setbacks contributed to the uprisings and the revolution itself.

The electoral system, selected for the first elections in 2011, was based more on PR and the political regime reduced the powers of the presidency. This contributed to the pressure for consensus and compromise. Polarization and identity politics were as strong as in Egypt with the widespread use of political violence, including political assassinations. But the electoral institutions contributed to the containment of these tendencies and to consensus building whether in terms of the content of the constitution or in the power sharing arrangements.

The institutional pre-conditions, as well as institutional choices, implied that the prospects for democracy to produce good outcomes were much better in Tunisia. But they are not very solid in view of the weakened state capacity during the transition period itself and the political divisions. It is a mixed picture, and in the terminology of financial markets, the prospects remain positive, but with large downside risks.

Of course one can argue that the selection of the electoral system itself was endogenous and was the result of some other structural factors. Such differentiating factors include: (i) the traditional and strong presence of the military institution in Egypt and its involvement in the political process, and (ii) the stronger middle class in Tunisia which resulted in more vibrant and vocal civil society groups. For instance data show a significant difference between the two countries in terms of size of the middle class estimated at 44 percent of the population in Egypt and 58 percent in Tunisia (ESCWA, 2014). Nevertheless, the nature of the electoral system and its outcome with the election of a president

with strong powers in Egypt did exacerbate the polarization of the country and led to a collapse of the process.

The costs of Arab democratic transitions have been very high

As discussed in the previous section, the impact of democracy on development and economic outcomes depends on the stage of democratization. While most studies on the impact of democracy deal with democratic consolidation or mature democracies, the recent experience of Arab countries concerns mostly the first stage, called democratic transition.

Whether they are successful or not, democratic transitions have been very costly in Arab countries. The unsuccessful transitions in Libya, Yemen and Syria countries have led to a collapse in law and order, conflicts and civil war. They have been extremely costly economically and devastating for institutions, infrastructure and societies. Their consequences are likely to affect negatively the development prospects of these countries for a long time.

In Egypt and Tunisia the costs have been large as well, but much smaller than in the other most impacted countries. During the transition period from 2011 to 2014 economic growth has declined in both countries by an average of almost 3 percentage points compared to the pre-democratization period.[10] These translate into major losses in terms of poverty reduction, employment and other social indicators.

The choice or electoral system may also have implications in this context. Contrary to the findings for established democracies, Persson and Tabellini (2006) find that new democracies which are parliamentarian perform more poorly than new democracies which are presidential in terms of economic growth. They grow a full 1.5 percentage points less. This would mean that Tunisia which chose a quasi-parliamentarian system may have to bear a significant cost during its early democratization phase in terms of economic growth. Most recent economic outcomes show a better recovery in Egypt where economic growth is expected to exceed 4 percent in 2015, than in Tunisia where economic growth remains weak. Return of confidence and clarity of policy directions remain a problem under the quasi-parliamentarian system put in place with the new constitution adopted in 2014.

Longer term implications for Arab democracy and development

Tunisia comes closest to the Case 1 of democratization discussed in the previous section. After more than four years of transition the country has gone the farthest towards establishing a democratic system of political governance.

[10] The average total GDP growth was 5 percent per year in Egypt and 4.4 percent in Tunisia during the period 2000–2010 prior to the uprisings, and declined to an average of 2.1 percent and 1.6 percent respectively during 2011–2014.

The pre-existence of relatively stronger state capacity makes success of the democratic transition more likely. While the process remains fragile the selected political institutions which create incentives for compromise and consensus will support the continuation of the process.

The lessons from historical experiences discussed provide an indication on the reform priorities which should accompany such democratization in order to enhance its positive impact. They point towards a critical priority for strengthening state institutions which are not clientelistic, and responsive to the needs of the middle class. Needed reforms can be achieved relatively rapidly if the political will is present. During this process a particular attention should be given to the preservation and strengthening of the middle class as well as national identity and to fight strongly any attempts to weaken such identity.

The consolidation of democracy and the resulting improved governance and credible political system should help the country reach a higher level of economic growth and more equitable development outcomes in the long run, even though it may have to bear larger costs economically in the short to medium run.

For other Arab countries with weaker state capacity institutions the possible paths to democracy are likely to be of the Case 2 type discussed above. This means that the outcomes of the transition to democracy will be uncertain, leading in some cases to failure as we have already observed. But even in the cases where transition may succeed the resulting political systems would likely be characterized by weaker governance institutions with clinentelism, weak rule of law and corrupt bureaucracy. And again the lessons about the importance of strengthening state institutions and the middle class are valid for these countries. Reforming such state institutions, including the bureaucracy, the judicial system and security systems in order to create favorable pre-conditions or to improve governance should be high on the agenda.

12.4 Concluding remarks

When democratic accountability institutions develop in a context which ensures better governance and broad-based policies they support inclusive growth and more equitable development. But the experience of democratization in developing countries most often takes place in an environment when adequate complementary institutions such as strong state capabilities, quality bureaucracy and rule of law are not present. And nothing in principle or in historical experience ensures that democracy would generate such quality institutions. The implication is that establishing democratic accountability institutions does not in itself guarantee good development outcomes. Countries have to strive to develop the needed complementary institutions, with good state capacity being central to that process. Selecting the appropriate governance institutions which support inclusiveness and consensus contributes also to the success of democracy.

The lessons and implications suggest that the prospects for democracy in Arab countries remain uncertain and fraught with difficulties. Most countries do not have the pre-conditions which contribute to success of democratization, such as strong state capability. In addition for many countries the large natural-resource wealth is a constraint on democratic development. Democratization attempts are bound to face major problems which have been made more difficult with the emergence of polarization along ideological/religious/cultural lines and visions. The economic dividends expected from democratization are neither certain nor easy to obtain. Countries have to strive and work hard on the various institutional dimensions whether before democratization or after, in order to create the best possible conditions for its success and to enhance the development prospects of the region.

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13
Transition Experiences: A Statistical Analysis

Caroline Freund and Melise Jaud

13.1 Introduction

In 2011, the people of Tunisia, Egypt, Libya and Yemen toppled autocratic regimes that had governed these nations for decades. The revolutions brought hope for democracy and prosperity in these countries, with more voice for the citizens, accountability of the government, and more opportunities for the youth. Completing the transition to democratic rule has proven more difficult than initially envisioned, as the elections in Egypt and Tunisia resulted in only short-lived governments. Meanwhile unrest has spread rapidly in Libya and Yemen, while Syria descended into civil war as the opposition failed to remove the long-term dictator. In contrast, the Kingdoms of Jordan and Morocco responded to demands for change with partial reform, resulting in less unrest and more consistent economic growth.

In order to understand how comparable the region's experience is to other countries that have undergone similar changes and what to expect going forward, transition experiences from around the world over the last 50 years are taken as a guide.

Over one hundred countries have changed regimes in the last half century. Of these, 38 percent experienced a complete and rapid transition to democracy, 29 percent had an incomplete transition, 10 percent moved gradually to democracy, and another 22 percent went in reverse, from democracy to autocracy. Examining economic outcomes before, during and after these transitions provides some indication of how conditions may evolve in MENA. One important message from these diverse experiences is that transition presents economic challenges, but recovery comes relatively rapidly when regime change is swift. Countries that transit within three years experience a temporary shortfall in growth, followed by a significant long-run growth acceleration of about one percentage point. In contrast, gradual transition is typically associated with a

sharper downturn and a longer period of weakness. There are some exceptions to this rule, when gradual transition is associated with clear and predictable economic policies, countries tend to perform better. In general, governments that are able to move swiftly to demonstrate a clear direction of change while reducing uncertainty bring confidence to potential investors who can drive recovery.

While the time and to a lesser extent the type of transition is difficult to predict, analysis of these episodes enables the identification of some of the key factors associated with rapid transition. In particular, economic development and female literacy tend to be associated with quick and complete transition. Resource-rich countries tend to face additional challenges in moving to more democratic institutions. Importantly, there is a neighborhood effect and one rapid and complete transition can have a big impact in terms of leading to similar outcomes in other countries in the region.

The first section (13.2) identifies four types of transitions, democratic (rapid and gradual), partial, and autocratic before examining the incidence of democratic transitions in the World and MENA. Section 13.3 then looks into the determinants of democratic transitions and their durability. Section 13.4 examines how economic institutional and social development indicators during political transitions. Finally, section 13.5 offers some lessons relevant for MENA.

13.2 Identifying democratic transitions: democratic, gradual and failed[1]

The Middle East and North Africa (MENA) region has historically been less democratic than other regions. Figure 13.1 shows the evolution of the level of democracy (Polity index) between 1960 and 2010. The MENA region remained mostly untouched by the wave of democratization that was initiated in Latin America in the late 70s, spread to Asia and Southern and Eastern Europe in the 90s and finally to some parts of sub Saharan Africa. The Arab Spring ignited some change in the region, but there is uncertainty regarding the scope, the pace, and the durability of the political transitions.

What do democratic transitions look like?

Many countries have moved rapidly from autocracy to democracy, others have gone gradually, while some have tried but change has been limited or the level of voice and accountability has increased only temporarily. Still others have

[1] For a complete description of the data methodology and econometric results please refer to the background paper upon which the analysis presented here draws (Freund and Jaud, 2013).

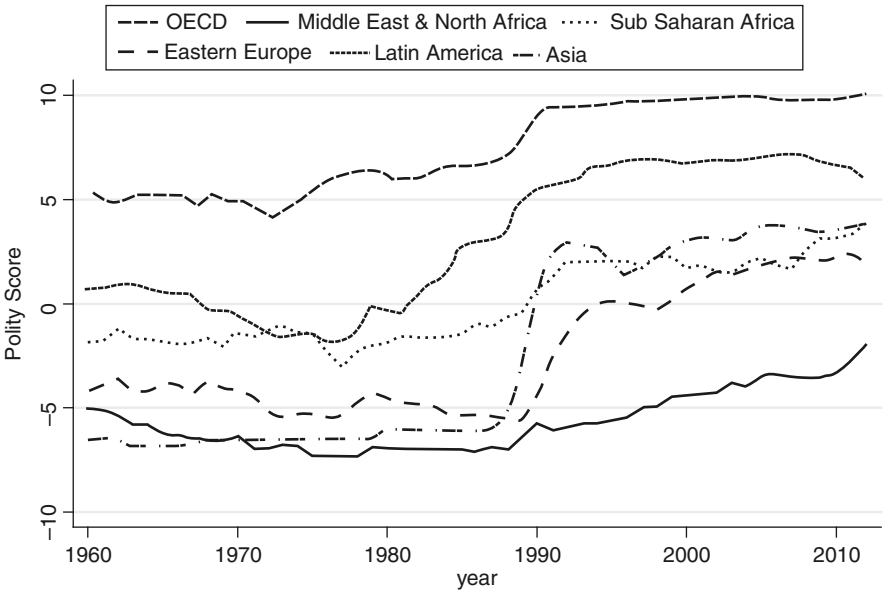

Figure 13.1 Democratic transitions
Source: Polity IV, 2010; Statistics are computed as simple averages of the Polity score at the country level.

gone from democracy to autocracy. This section defines the types of transition we explore.

The Polity score of the Polity IV data base (Marshall, Gurr, and Jaggers, 2010) is employed to measure democracy and construct a new data set of political transitions from autocracy to democracy.[2] Three types of democratic transitions are defined – democratic rapid, democratic gradual and failed – based on

[2] The Polity IV index reflects key characteristics of the executive recruitment, the constitutional constraints on the executive authority and the degree of fairness and competitiveness in political participation. The index attempts to capture not only outcomes but also procedural rules. In addition, the Polity index is a composite index, computed as the difference between a democracy and an autocracy score. While autocratic and democratic authorities are not defined as exact alternatives or opposite one to the other, the composite index does conveniently provide a unified spectrum of political freedom. The index ranges from –10 to +10 with higher values indicating higher level of political freedom. Finally, it is one of the most widely used democracy indicator in the literature and it offers the broadest coverage. The index has however several limitations see Gleditsch and Ward (1997) for a detailed analysis and critique of the POLITY measure. The main one is that the index by construction does not aim to classify political regimes. That is, it is not a continuous measure of democracy; nor is it a cardinal measure or ordinal ranking and scores can be arrived at through different combination of the components that compose the index. In addition, the index is not available for some small countries.

the intensity, the speed and the sustainability of the political reform process.[3] The sample includes 160 countries between 1960 and 2010.[4]

A rapid democratic transition is defined as a swift, substantial and sustained regime change from autocracy to democracy. The transition must have seen a jump of 6 points in the Polity score within three years. In addition the country must have been autocratic in the five-year period before the transition and remain democratic, with a Polity score at or above 6, after the transition.

A gradual democratic transition is defined the same as above with the exception that the transition took longer than three years.

An failed transition is defined as either a move to democracy without completion, not a 6 point jump in the index, or without sustaining a high level of democracy (at 6 or above).

Figure 13.2 shows the transitions by type and how long they are sustained. It also shows an example of each type.

How frequent are democratic transitions?

The identification conditions yield 91 democratic transitions, including: 45 complete rapid, 12 complete gradual, 34 partial, initiated between 1965 and 2005.[5] Seventy-nine of the 160 countries in the sample, more than 50 percent, initiated a democratic transition, with 10 countries experiencing more than one transition. Figure 13.3 shows that a typical autocratic country has about a 3 percent chance of experiencing a transition at some point in any given year.

Importantly, initiating the transition process does not guarantee completion. More than one third of countries that moved toward greater voice and accountability in the last 50 years (37 percent) have not completed the transition. In 50 percent, democracy was consolidated swiftly, while in 13 percent, evolution towards democracy was gradual.

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[3] Several empirical studies construct binary indicators of political transitions from autocracy to democracy, however they incorporate limited information on the transition process itself see for example Przeworski et al. (1996); Mainwaring et al. (2001); Papaioannou and Siourounis (2008). In particular, unlike our classification, previous classifications do not explicitly account for the speed and intensity of the transition on the one hand and its permanency on the other hand.

[4] The dataset dates back to 1800. The data is used starting from 1960 to match the growth data. The data is not rectangular, as some countries were created during the time period (e.g. the former soviet bloc countries), or changed names (e.g. Tchecoslovakia that split into the Czech Republic and the Slovak Republic in 1992). New states and states that changed names are treated as new countries in the analysis. In addition, countries with less than nine years of consecutive Polity data are excluded to allow for identification of transitions.

[5] A list detailing transitions by category country and year is available from Freund and Jaud (2012b). Given the data start in 1960 and go to 2010, episodes in the early and late years cannot be identified because the sustainability conditions are not satisfied.

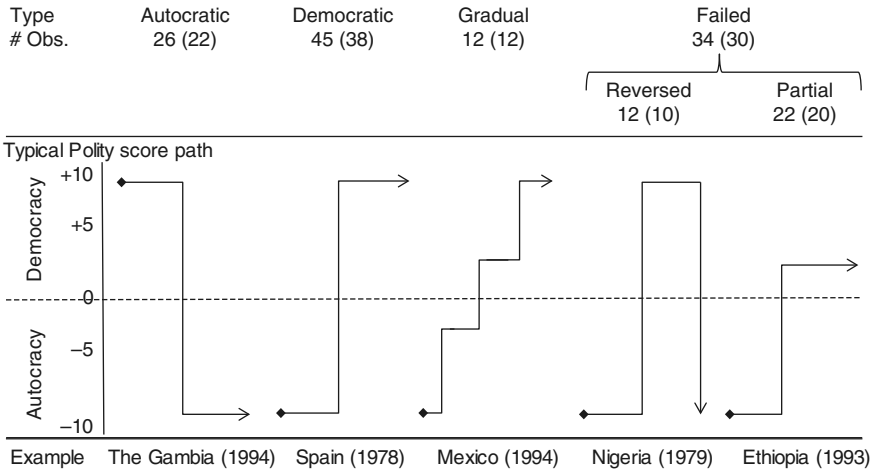

Figure 13.2 Classification of transitions, 1960–2010
Note: The number of transitions with growth data before and after the transition are in parenthesis.

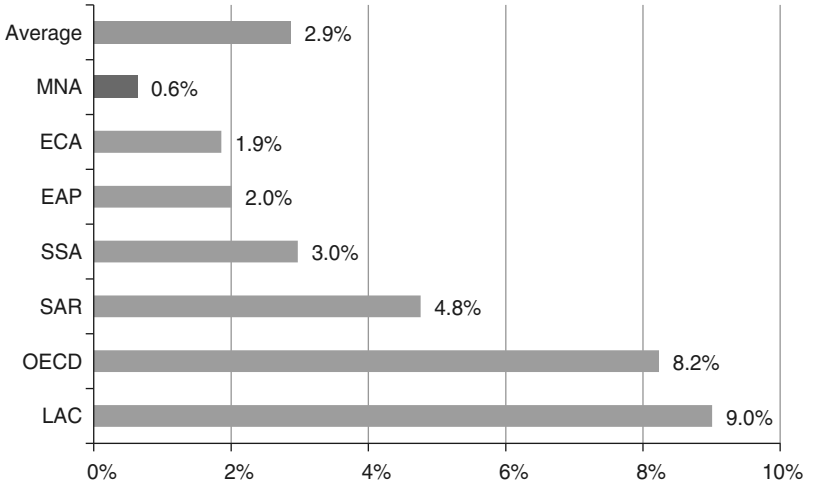

Figure 13.3 Likelihood of a democratic transition
Note: The average (regional) rate of incidence is computed as the ratio of the total (regional) number of transitions to the total (regional) number of potential candidates to transition. The number of potential candidates to transition is the number of country-year pairs that are under autocratic ruling and in which a transition could have occurred.

The world average also masks important regional differences. Geographical and cultural proximity are important factors in the way transition spreads across countries, and countries in a region tend to change (or remain unchanged) together. As shown in Figure 13.3, the MENA region has recorded the lowest share of democratic transitions. The strong regional dynamic toward

democratic change was demonstrated in Eastern Europe following the fall of the Berlin wall and more recently during the Arab spring where the upheaval in Tunisia spread to neighboring countries.

13.3 Factors affecting democratic transitions and their rapid completion

Identifying the conditions that promote democratic change is a difficult exercise. Using the classification of democratic transitions described above and building on a rich theoretical and empirical literature, a host of structural, political and societal factors are considered to estimate the likelihood of transition and the likelihood of completing the process. [6]

Why do transitions happen?

Examining the 91 episodes of transition toward democracy offers some indication of under which conditions transition happen. Overall, it is difficult to predict ex ante when countries will initiate democratic transition.[7] Countries that underwent democratic transitions are on average similar to countries that did not on a number of socio-economic conditions. Nonetheless, the analysis suggests several important factors that trigger or inhibit democratic transitions.

Figure 13.4 summarizes the results graphically.[8] It shows the association between various socio-economic factors and the probability of democratic transition.[9] The coefficients reported are the predicted percentage change of

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[6] In line with Lipset's (1959) modernization theory, a number of empirical studies have positively related improvements in various aspects of economic development, industrialization, urbanization, wealth, and education to democratization (Barro, 1999; Glaeser et al., 2007; Acemoglu, Johnson, and Robinson, 2001). Economic openness is also a critical factor, democracy is more likely to occur and consolidate in open to international trade countries (Friedman, 1962; Acemoglu, Johnson, and Robinson, 2005). Empirical evidence on the role of the ethnic and religious diversity on democratization is ambiguous. However most studies find that democratization is less likely in countries where close links between the clergy and the state exist, in particular Muslim and Confucianism countries. For MENA countries, the real impediment to democratization may have to do more with their oil-rich soil than their religion. A vast literature has emphasized the negative impact of natural resources on democracy (e.g. Acemoglu, Robinson and Verdier, 2004; Ross, 2001). Finally, the likelihood of a country's democratization is partly dependent on external factors. In particular, there is evidence that democratizations occur in waves, with democratization in one country being favored by political changes in neighbor countries (Huntington, 1991).

[7] The different probit models run for the analysis explain between 10 and 24 percent of the variance in the likelihood of transition.

[8] For definitions and sources of variables used, please see Appendix 1.

[9] Results from probit estimations are available in Freund and Jaud (2012b). These results are robust to using alternative specifications and estimation methods.

the likelihood of democratic transition following a standard deviation change of the explanatory variable at the sample mean, so that the effect of each independent variable is comparable. A country's wealth has the strongest correlation with the likelihood of transition. Rich authoritarian countries are less likely to attempt transition to democracy, perhaps because populations are more satisfied with their standard of living. A country's level of urbanization is a significant factor in the demand for democratization. A population that is better connected and able to organize and engage in collective actions is more likely to attempt to overthrow an authoritarian regime. The literacy gap, defined as the ratio of the share of women that are educated to the share of men that are educated, has a positive and significant effect on transition. Specifically, the gap between male and female education discourages transition and the bigger the gap the less likely you are to swiftly reach democracy. In the Middle East and North Africa, the gap between male and female education has declined rapidly over the last two decades, consistent with this notion that broader education is important to stimulate change. Natural resource richness stands out as an important obstacle to democratic transition. This is consistent with the literature on natural resources and accountability, which argues that less accountability is demanded from governments that do not tax the population (Ross, 2001).[10] Countries that experience democratic transitions do not on average differ from countries that do not in terms macroeconomic conditions, economic growth, trade openness, FDI or inflation.[11] The type of regime in place and other external factors may also be important initial conditions for transition. Indeed, results suggest that the modes of regime in place at the time of the transition and the actors empowered have a substantial impact on the likelihood of transition. Military rule encourages transition. An attempt at transition is also more likely to emerge in the aftermath of minor conflicts while large scale wars do not trigger changes in the political structure. Several countries have repeatedly tried to transition. The results suggest that countries that have tried in the past are more likely to transition.[12] In addition, there is

[10] Natural resource rich countries are identified applying the IMF definition (IMF, 2007). Countries are considered rich in hydrocarbons and/or mineral resources on the basis of the following criteria: (i) an average share of hydrocarbon and/or mineral fiscal revenues in total fiscal revenue of at least 25 percent during the period 2000–05 or (ii) an average share of hydrocarbon and/or mineral export proceeds in total export proceeds of at least 25 percent during the period 2000–05.

[11] In econometric specifications controlling for macroeconomic indicators, notably GDP growth, trade openness, FDI and banking crisis, the coefficient s on those variables are never significant. Results are available in Freund and Jaud (2012b).

[12] The coefficients on our main variable of interests remain significant and qualitatively the same after controlling for past attempts at transition, suggesting that the inclusion of this variable does not bias our results.

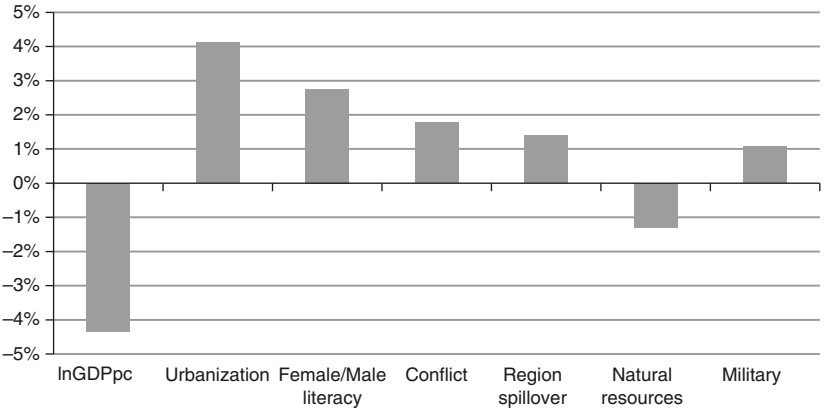

Figure 13.4 Determinants of democratic transitions
Note: Coefficients based on probit regressions including country and year fixed effects. They give the predicted percentage change of the likelihood of democratic transition following a standard deviation change of the explanatory variable at the sample mean.

a neighborhood effect, such that an attempt at transition in the region in the last two years makes all countries more likely to attempt transition.

Finally, the role of several societal factors particularly relevant to the MENA region on the likelihood of transition is considered. The uprisings in MENA were initiated by the young population. Experiences from 50 years of transitions however suggest no significant association between the size of the youth in the population and the initiation of transition. The heterogeneity in the population with respect to ethnicity may negatively affect democratization, as establishing a working democracy may be more difficult if different interest groups are fighting over power. Rather, the data suggest that ethnic fractionalization promotes democratization, perhaps because democracy is the fairest way of governing rival factions.[13] Further research on the mechanism involved is needed. Considering the role of religion on political structure, previous work has suggested that countries with a large Muslim population tend to be less

[13] Existing empirical evidence on the effect of ethnic fractionalization on democracy is ambiguous. One prominent paper from Alesina et al. (2003) finds that democracy is inversely related to ethnic fractionalization. However their study differs from ours in that they examine the impact of fractionalization on the level of democracy rather than the onset of transition. The pathway between fractionalization and democracy may run through conflict. However by and large, most of the literature fails to find any significant evidence of ethnic fractionalization as a determinant of conflict. Rather than the diversity of ethnic groups, ethnic polarization, that is the contested dominance of one large group by another group, increases the probability of civil conflict (Montalvo and Reynal-Querol, 2005; Collier and Hoeffler, 2004).

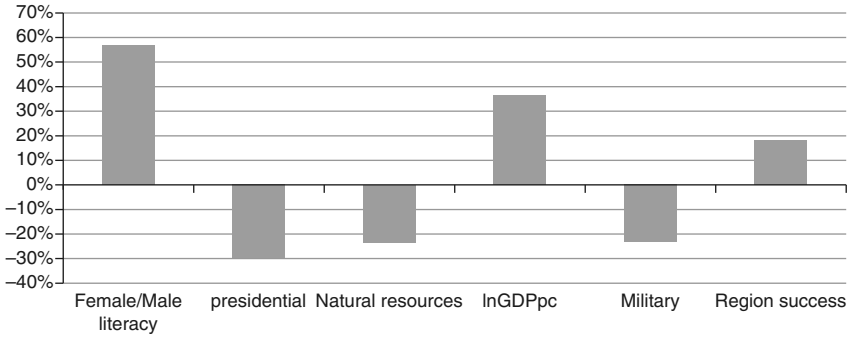

Figure 13.5 Determinants of successful democratic transitions

Note: Coefficients based on multinomial logit regressions including country and year fixed effects. They give the predicted percentage change of the likelihood of successful democratic transition following a standard deviation change of the explanatory variable at the sample mean.

democratic than non-Muslim countries.[14] The data do not support a significant role for Islamic values in either promoting or retarding transition.

What makes transitions rapid and complete?

The factors that make democratic transition more likely to occur are not necessarily the factors that make such transitions, once initiated, more likely to consolidate rapidly into full democracies. With less than half of countries transiting swiftly to democracy, looking into what makes a democratic transition complete, rapid and enduring is fundamental. Empirically, the outcome of transitions is somewhat easier to predict than the likelihood of transition itself. This is reflected by the substantial explanatory power of the models analyzing the likelihood of a swift and complete resolution for countries that initiated transition.[15]

Figure 13.5 summarizes graphically the results.[16] Among the factors that affect the likelihood of transition, income, gender equality and natural resources endowment also matter for completion of the transition. Affluence makes transition more likely to consolidate into democracies in the aftermath of transitions.[17] Natural resources are an important factor of both attempted transition and consolidation of democracy after transition. Countries with abundant natural resources are less likely to democratize, and when they do

[14] See for example Midlarsky (1998), Barro (1999) and Ross (2001).

[15] The sample is a cross section of transition countries only the year of transition that is 90 observations at most. The different models run explain between 25 and 55 percent of the variance in the likelihood to transit completely.

[16] Results from econometric estimations and additional robustness tests are available in Freund and Jaud (2012b).

[17] Przeworski et al., 2000.

they are also less likely to complete the process than resource poor countries. One of the most robust findings is that gender equality in education also matters for a complete democratization. There is little previous work on the relationship between gender equality and democratization. These results suggest this is an important factor and that more research on the mechanism through which it affects the political reform process is needed. One possible explanation for this effect is that democracy is about citizen's rights, and societies with education equality are effectively valuing all citizens both more highly and more equally. Alternatively, greater female involvement in revolutions and their aftermath may produce a less violent revolution and more cooperation in its aftermath.

The effect of conflict and military involvement on the resolution of transitions is ambiguous. One may expect that the challenge of rebuilding the state may be arduous in countries where change involved conflict. This does not seem to be the case. Domestic conflict has no impact on completion of the democratic transition. As seen previously, military rule makes a transition more likely to occur; however, a complete transition is less likely when a military regime is present and the military's prolonged involvement in the aftermath of transitions reduces the likelihood of complete transition further. Importantly, there is evidence of a neighborhood effect for transition durability too. A rapid and complete transition in neighbor countries in the region makes other countries in transition more likely to rapidly consolidate democracy.

The form of democracy, notably the constitutional arrangements put in place in the aftermath of transitions, also has important consequences for the sustainability of such transitions. Countries that reform into a parliamentary system, where the legislature elects the chief executive, are on average more likely to transit to a complete democracy quickly than countries that reform into a presidential system. The results show no evidence that countries where legislators are elected on a proportional representation basis have higher chances of rapid and complete democratic change.[18] Lastly, the outcome of past transitions is not associated with the ethnic or religious composition of the population.

Overall, experiences from transitions around the world provide a cautionary tale. An initial move towards democracy does not guarantee a complete transition to democracy; yet nearly half of the countries that have tried have done so rapidly. However, more than one third of countries that tried in the last 50 years managed only partial transition. Countries with relatively high income and more education equality tend to complete transition more rapidly, while resource rich countries tend to face more challenges. Importantly, rapid change

[18] The electoral system is a proportional representation if candidates are elected based on the percent of votes received by their party.

in one country helps other countries democratize swiftly. The next section examines what happens to growth, governance, and human development following democratic transition.

13.4 Economic, institutional and human development during and after transition

Four years post transition economic conditions are improving in Egypt and Tunisia. However, given current uncertainty, it is impossible to make credible forecast of the medium and long run.[19] One way to get around this issue is to look at what typically happens in other transitions. This section describes the trends and fluctuations in the levels of growth, investment, governance and human development before, during and following transition for the three types of democratic transitions previously identified.

What happens to growth and investment during transitions?

All transitions, even rapid ones, are associated with a rise in uncertainty and cost of capital, and thus a contraction growth. In addition, business disruptions, often quite severe, occur when transition involves revolution or conflict. Figure 13.6 records the level of real per capita income growth relative to time around the transition of lowest growth, where on the horizontal axis negative values mark years before and positive values years after the date the transition is initiated. We use the trough instead of averages relative to transition year because the averaged data may obscure the sharp drop in growth that typically occurs just before or during the transition, but not necessarily in the same year relative to transition in all countries, as some transitions are in January and some in December. To account for this, the data is calibrated by the year of slowest growth around the transition – which in some cases occurs a year before transition in others the year of transition and so forth – rather than by the year of transition. There tends to be a decline around the time of transition, which is much sharper in gradual transitions, and a recovery within the two to three years following. The right panel shows the same pattern, excluding the socialist countries, which all transited at roughly the same time, and the pattern is similar. Figure 13.7 shows growth in Egypt, Libya, and Tunisia in recent years and a similar pattern emerges.

Importantly, the results in Figure 13.6 are simple averages, they do not account for other factors that may affect growth in addition to the democratic transition. After controlling for country-specific characteristics and global

[19] The evolution of unemployment during and after transitions is not examined due to data availability issues. The sample of transition countries for which unemployment data is available prior and following transition is not large enough.

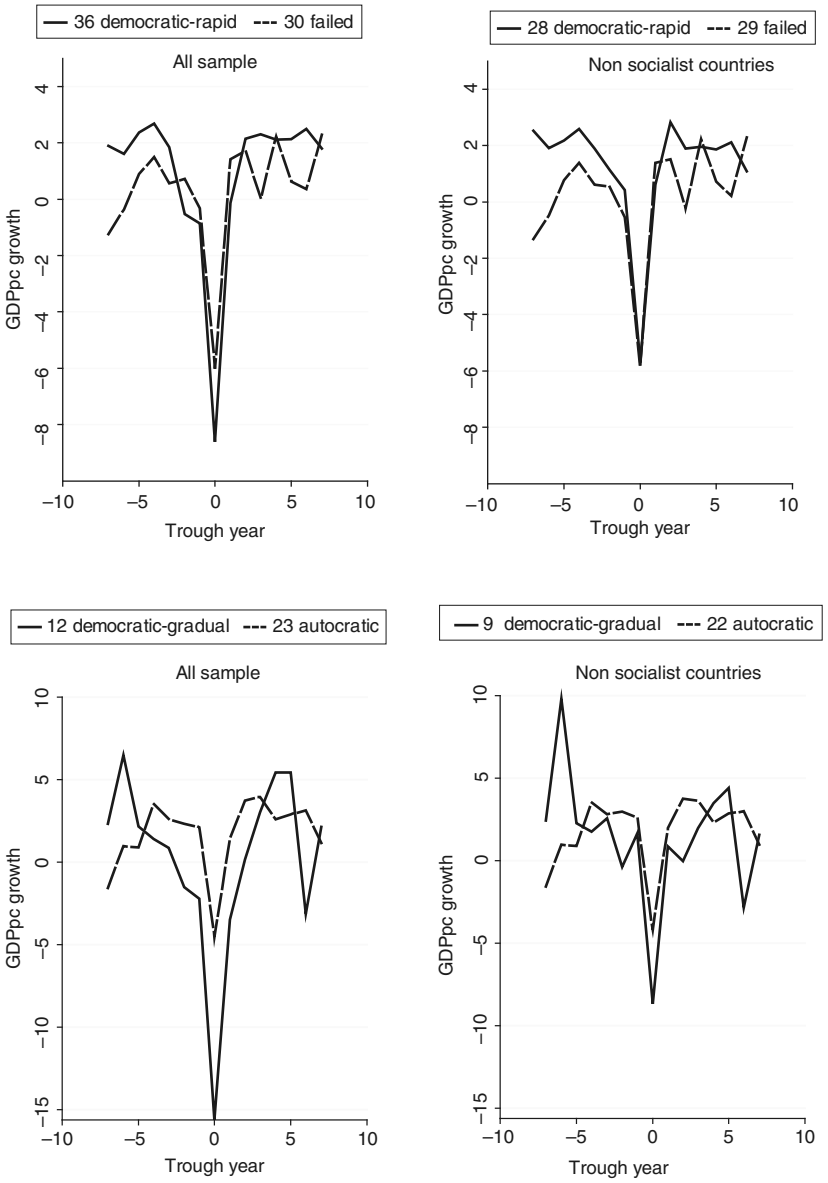

Figure 13.6 Average growth performance during transitions

Panel a: Democratic-rapid and failed transitions

Panel b: Democratic-gradual and autocratic transitions

Note: Panels a and b show the evolution of log per capita real income growth in a 20 year interval around the transition dates for democratic-rapid, failed, gradual and autocratic transitions. In panel b the data are re-scaled taking as year zero the year with lowest growth rate within a four year interval before and after the date of transition.

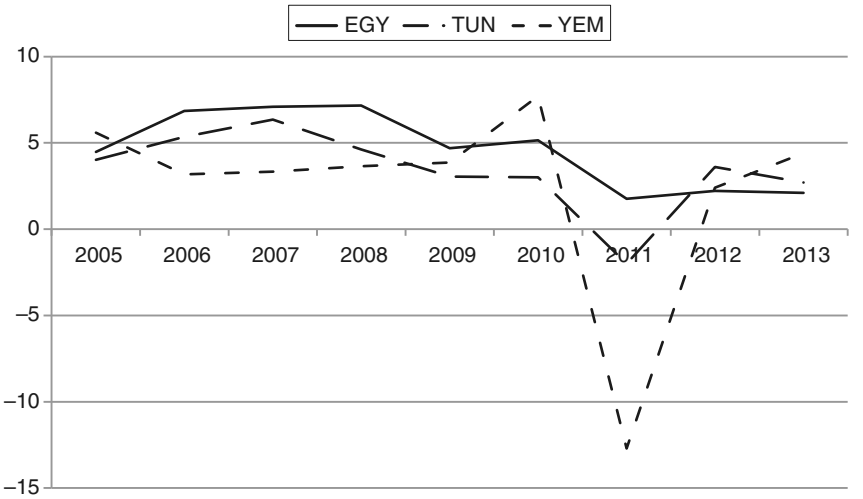

Figure 13.7 Growth in Egypt, Tunisia, and Libya
Source: IMF WEO.

time trends, a swift regime transition is found to be associated with a growth premium of about one percentage point in the long run. This is the case irrespective of direction, towards autocracy or democracy (Figure 13.8), or whether transition is complete or partial (Figure 13.9). Specifically, countries that transit swiftly experience growth acceleration by 0.8 percentage points following transition against no acceleration for countries that transit gradually.[20]

13.5 Conclusion

In conclusion, while each transition is unique, the above analysis offers some insights into what MENA countries can expect politically and economically as they go forward. Three key lessons are drawn:

(i) Economic development and recent gains in female literacy offer reasons for optimism for democratic transition in Tunisia. The significantly greater challenges facing resource rich countries, such as Libya and Syria, are not dissimilar to previous experiences with transition.

[20] These results are obtained using a difference-in-difference framework, with country and time fixed effects, and are robust to controlling for additional standard growth covariates, regional dynamics, and the timing of the economic effect of democratic transitions. All results and robustness checks are available in Freund and Jaud (2012a).

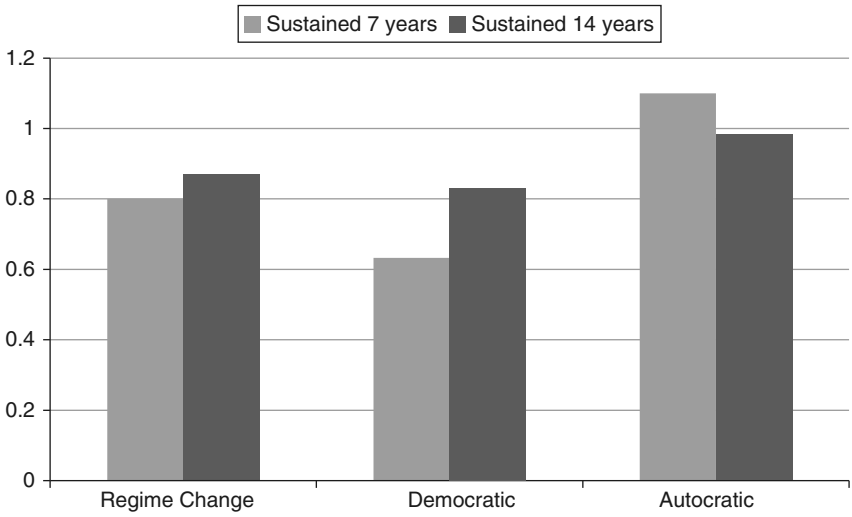

Figure 13.8 Growth dividend during transition
Note: Coefficients based on regressions including country and year fixed effects.

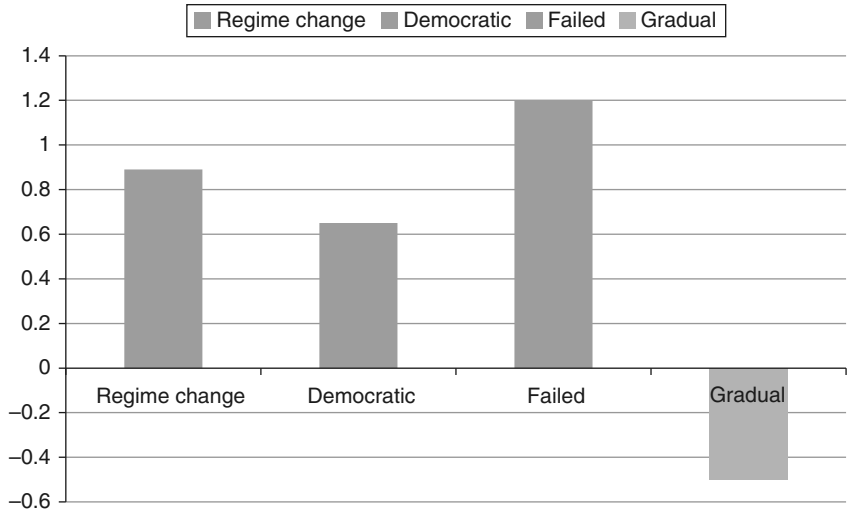

Figure 13.9 Growth dividend from different types of democratic transition
Note: Coefficients based on regressions including country and year fixed effects.

(ii) One success can have a big impact on others. Tunisia started the revolution and fits well many of the favorable categories. The neighborhood effect from attempting transition has already been realized. More importantly now, if democracy is durable in Tunisia (or any of the other countries), it will have implications that extend well outside its borders.

(iii) The pace of the transition is crucial. Assuming uncertainty is resolved swiftly, growth will return to or above pre-transition levels. When transition is gradual, economies are on average hit harder and for a longer period, especially if there is a protracted period of high uncertainty.

Appendix

Table 13B.1 Definition of variables and sources

Variable	Description	Source
I. Democracy data		
Polity2	The combined Polity score is the difference between the democracy and autocracy indicator. This is an additive twenty-one-point scale (–10;10).	POLITY IV
II. Determinants of democratic transitions and their success		
GDPpc (log)	Natural logarithm of real GDP per capita based on purchasing power parity (PPP). Data are in constant 2005 international dollars.	WDI 2010
urbanization rate	Share of the country total population living in urban agglomerations of more than 1 million.	WDI 2010
natural resource	Indicator variable taking value 1 for countries classified according to the IMF as resource-rich countries.	IMF 2007
gender equality in education	The ratio of female to male literacy rate in the adult population (15-64). The literacy ratio is calculated using interpolated data. Data are interpolated using Stata's ipolate function.	WDI 2010
military regime	Indicator variable taking value 1 if the regime type of the country in question was military in any of the previous two years.	Hadenius and Teorell 2007
military regime post transition	Indicator variable taking value 1 if the regime type of the country in question was military the year of the transition or any of the following two years.	Hadenius and Teorell 2007
multiple transition	Indicator variable taking value 1 in years where the country has experienced more than one transition. By construction of the gradual and successful transitions, the previous experiences can only be failed transitions.	Authors' calculations
regional transition	Number of transitions of any type (as defined by the authors) that occurred in the region the country in question is nested in, in the year or any of the previous two years.	Authors' calculations
regional success	Indicator variable taking value 1 if the region the country in question is nested in, experienced at least a successful transition (as defined by the authors), in the year or any of the previous two years.	Authors' calculations

(*continued*)

Table 13B.1 Continued

Variable	Description	Source
presidential system	Indicator variable taking value 1 if the electoral system in place in the country in any of the two years following the transition, is presidential.	DPI 2010
proportional system	Indicator variable taking value 1 if the electoral system is proportional, that is if candidates are elected based on the percent of votes received by their party.	DPI 2010

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