2
The Roll-Back of the State and the Rise of Crony Capitalism

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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.

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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

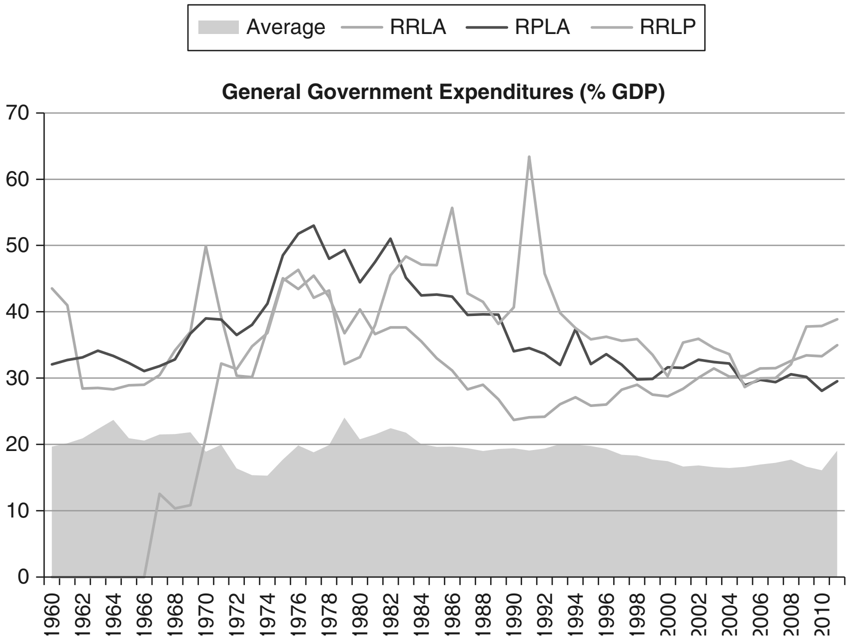

Figure 2.1 The evolution of the size of the state in the MENA political economies
Source: Diwan and Akin, 2015.

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

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[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).

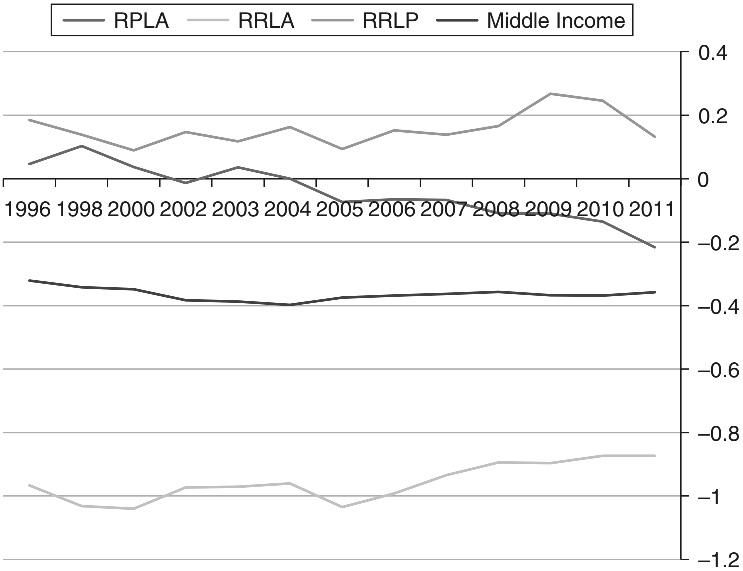

Figure 2.2 Government effectiveness in the various sub-regions (2003–12)
Source: World Bank Governance Indicators.

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.

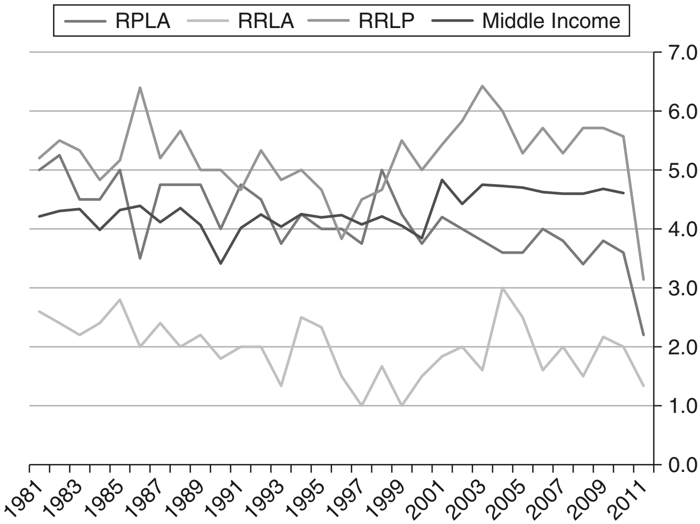

Figure 2.3 Repression in the various sub-regions (1981–2011)
Source: Cingranelli-Richards Physical Integrity Index.

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,

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[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%

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[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]

[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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