ECONOMIC RESEARCH FORUM
منتدى البحوث الاقتصادية

2016

working paper series

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Working Paper No. 1068

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December 2016

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First published in 2016 by
The Economic Research Forum (ERF)
21 Al-Sad Al-Aaly Street
Dokki, Giza
Egypt
www.erf.org.eg

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Abstract

This paper argues that capitalism in Arab low- to mid-income countries is organized in a distinct and recognizable pattern. The key stylized facts are: a stretched, over-committed and interventionist state; deep insider-outsider divides in private sectors and labor markets resulting from lopsided state intervention; and low levels of cooperation and trust between state, business and workers. These features produce an equilibrium of low skills and low productivity that hampers private-driven growth in the region. Some fundamental parts of this story apply to underdeveloped economies in general, notably low government capacity and a segmentation of business and labor into formal and informal markets. Others, however, are regionally specific, including the relative importance and historical ambition of the state in the economy and, closely related, the relative size of the insider coalitions created through government employment and subsidies. Unusually rigid insider-outsider divisions are cemented by a particularly pronounced weakness of universal social security and safety mechanisms. As a result of uneven government intervention and market segmentation, trust and cooperation between state, business and labor are even lower than elsewhere, both on the individual and the organizational levels. Arab cronyism needs to be understood as a key feature of this larger complex of deep state intervention and rigid insider-outsider boundaries. The paper helps explain why cronyism has been so hard to eradicate, but also points to potential structural reforms that could contribute to reducing its incidence.

JEL classification: O57, P51

Keywords: Arab world, Varieties of Capitalism, cronyism, insider-outsider systems, state-business relations, state intervention, trust

ملخص

ترى هذه الورقة أن الرأسمالية في البلدان العربية المنخفضة الدخل إلى البلدان المتوسطة الدخل منظمة حسب نمطا مميزا ويمكن التعرف عليه. الحقائق المجردة الرئيسية هي: دولة تدخليه عميقة متمددة من الداخل والخارج في القطاعين الخاص وأسواق العمل الناتجة عن تدخل الدولة الغير متوازن. وانخفاض مستويات التعاون والثقة بين الدولة ورجال الأعمال والعمال. هذه الميزات تنتج توازنا من المهارات المنخفضة وانخفاض الإنتاجية الذي يعيق النمو المدفوع الخاص في المنطقة. تنطبق بعض أجزاء أساسية من هذه القصة إلى الاقتصادات المتخلفة في والقدرات العامة للحكومة وخاصة المنخفضة وتقسيم العمل والعمالة في الأسواق الرسمية وغير الرسمية. العوامل الأخرى، ومع ذلك، هي على المستوى الإقليمي، بما في ذلك أهمية النسبية والطموح التاريخي للدولة في الاقتصاد، وترتبط ارتباطا وثيقا بالحجم النسبي للتحالفات الداخلية تنشأ من خلال التوظيف الحكومي والإعانات. ويعزز الانقسام من الداخل، على نحو غير عادي من ضعف واضح لا سيما في آليات الضمان الاجتماعي والسلامة العالمية. ونتيجة للتدخل الغير المتكافئ من الحكومة وتجزئة السوق نجد أن الثقة والتعاون بين الدولة ورجال الأعمال والعمال هي أقل حتى من أي مكان آخر، سواء على مستوى الفرد أو المستويات التنظيمية. تحتاج المحسوبية العربية أن تفهم على أنها سمة أساسية من سمات هذا المجتمع وتكون أكبر من تدخل الدولة العميقة. تساعد الورقة على تفسير لماذا كان القضاء على المحسوبية صعب جدا، وتشير أيضا إلى الإصلاحات الهيكلية المحتملة التي يمكن أن تسهم في الحد من حدوثه.

1. Introduction: Arab Capitalism

Capitalism has emerged as the winner of the post-WWII global competition of economic ideologies; yet comparative political economy research over the last two decades has made it clear that the institutions of modern capitalism can differ significantly from one country to the next. This insight was first developed through comparisons of continental European and Anglo-American capitalist systems, but it has increasingly inspired research on how capitalist practices differ across less developed countries.

One region that remains excluded from this debate is the Arab Middle East, an area that has generally become peripheral to current comparative political economy literature. This is although a core set of Arab economies share a set of closely inter-related features that make them distinct from most other developing countries and that arguably explain many of their specific development problems. This paper identifies these core features of this "Arab variety of capitalism", discusses how they are linked, and explains how they have contributed to the region's path of low productivity, limited skills accumulation and uneven growth.

The key stylized facts that low- to mid-income Arab states share are: a stretched, over-committed and interventionist state; deep insider-outsider divides in private sectors and labor markets resulting from lopsided state intervention; and low levels of cooperation and trust between state, business and workers. These features produce an equilibrium of low skills and low productivity that hampers private-driven growth in the region.

Some fundamental parts of this story apply to underdeveloped economies in general, notably low government capacity and a segmentation of business and labor into formal and informal markets. Others, however, are regionally specific, including the relative importance and historical ambition of the state in the economy and, closely related, the relative size of the insider coalitions created through government employment and subsidies. Unusually rigid insider-outsider divisions are cemented by a particularly pronounced weakness of universal social security and safety mechanisms. As a result of uneven government intervention and market segmentation, trust and cooperation between state, business and labor are even lower than elsewhere, both on the individual and the organizational levels.

The formerly "populist" Arab republics Algeria, Egypt, and Syria are closest to this ideal type. Relatively more liberal systems like early republican reformer Tunisia and pro-capitalist monarchies Jordan and Morocco are somewhat less perfect fits, and so is Yemen, which has been too poor historically to develop the same level of state intervention as its republican peers. Yet even the latter cases stand out in international comparison on most of the variables discussed in this paper.

While the focus of this paper goes beyond the mechanisms of cronyism in the Arab world, corruption and favoritism between state and business are a core component of the variety of capitalism identified here: they are a critical part of the lopsided state intervention that creates insider-outsider dynamics in the business sector; they are critical contributing factors to the unusually low trust that Arabs have in their business elites; and the limited competition that crony insiders enjoy allows them to invest little in skills and technology – and in many cases extend cronyism to the rigid local labor market through non-competitive hiring practices. While this paper provides no new empirical insights on the mechanisms of Arab cronyism, it does situate it in a wider institutional landscape, highlighting both some of its structural causes and its wider developmental consequences. The paper helps explain why cronyism has been so hard to eradicate, but also points to potential structural reforms that could contribute to reducing its incidence.

2. Case Selection

This paper deals with seven Arab countries that can be considered "core" members of the region: Algeria, Egypt, Jordan, Morocco, pre-2011 Syria, Tunisia and Yemen. These have been part of a shared regional space of political competition and ideological diffusion in the post-WWII era in a way that more peripheral members of the Arab League like Djibouti, Mauritania, and Sudan have not been – which, with the exception of Djibouti, also are not defined as part of the MENA region by the World Bank.[1]

We exclude high-rent countries – the GCC monarchies and Libya – where hydrocarbons income has created substantially different economic structures, although pre-2011 Libya at least also ticks most of the boxes of the model developed here. We also exclude countries whose economies have been shaped by major, long-term conflicts like Iraq and Lebanon, although pre-1979 authoritarian-populist Iraq also seems to share many of the features of our model.

One might criticize the paper for cherry-picking cases or deliberate selection on the dependent variable(s) (Collier and Mahoney 1996; Geddes 1990). The choice of a limited number of cases that best approach a particular ideal type is, however, standard practice in the "Varieties of Capitalism" (VoC) literature and difficult to avoid given the relative complexity and limited range of the theories it proposes. Perhaps more importantly, the case selection in this paper is theoretically motivated by a particular set of historical circumstances that delimit the applicability of its model: it only includes countries that engaged in an ambitious state-building project that was directly or indirectly affected by the nationalist and statist ideological competition dominating the region from the 1950s to the 1970s. Arab countries that were less affected by this discourse, such as the above-mentioned "peripheral" cases, also do not fit the proposed model well. As we will see, even among our core cases, some fit the model better than others – and it is the ones that pursued the nationalist state-building project the most ardently that evince the best fit.

3. "Varieties of Capitalism" Approaches

What is the idea behind a holistic analysis of a country's capitalist system? The basic premise of VoC literature is that within the capitalist world, firms and workers have different formal and informal ways of coordinating (or failing to coordinate) production, skills formation and innovation. These ways can vary strongly from one system to the next despite similar levels of economic performance. The core components that the original VoC formulation by Hall and Soskice focuses on in their firm-centred approach are corporate governance and finance, inter-company networks, industrial relations, and skills systems (Hall and Soskice 2001). They distinguish "liberal" and "coordinated" market economies. The former are Anglo-American economies that rely on competitive markets to generate and allocate capital, labor, and skills. "Coordinated" systems, by contrast, are continental European economies that rely on non-market mechanisms for coordination between firms, between firms and labor, and between firms and banks. Capital, labor and skills are often developed and deployed through longer-term, often informal links in which coordination is at least as important as competition.

Most variants of VoC assume that different features of a given type of capitalism are complementary and reinforce each other through "increasing returns". In the German coordinated market economy, for example, long-term employment relationships allow workers to acquire highly specialized, non-portable skills, and enable cooperative industrial relations that contribute to incremental innovation and high-quality training; close inter-firm cooperation within the same sector similarly allows cooperation on skills development, reduces labor

[1] These three cases are not much in standard political economy works on the region (Richards and Waterbury 2007; Henry and Springborg 2010).

market competition and prevents "poaching" that would disincentivize within-company training. Cooperation between companies allows banks to better monitor their performance and to provide "patient capital" through long-term loans, which in turn allow firms to guarantee long-term employment relationships and avoid excessive redundancies when profits fluctuate.

While the original VoC formulation has been much criticized (Hancké, Rhodes, and Thatcher 2007; Schmidt 2009; Streeck 2010), it has spawned a search for specific "types" of capitalism not only among advanced countries but also in less developed areas. Nölke and Vliegenthart (2009), for example, describe "dependent market economies" in Eastern Europe, characterized by a dominant role of foreign capital that exploits relatively cheap and high-skilled labor, while giving the countries at hand a subordinate role in international value chains. Nölke and Claar (2013) propose "state-permeated market economies" as model for non-Western countries characterized by close and often informal state-business relations. Schneider (2013) suggests "hierarchical market economies" (HMEs) as a model for Latin America's large and more developed countries, characterized by diversified private conglomerates, a strong role of transnational capital, atomized labor relations and low skills. He argues that these factors and the interactions between them are characterized by non-market, hierarchical relationships, and that there are "negative complementarities" between them, resulting in a low-skills equilibrium that prevents the region from catching up with advanced countries.

Ross Schneider's model is worth discussing in more detail, as he comes closest to developing a full-fledged model of complementarities that could apply in other less developed countries. The following are key causal links in his account: Diversified business groups focus on breadth rather than depth of production and leave hi-tech production to transnational companies; they therefore generate low demand for skilled labor. Transnational companies focus on less technology-intensive sections of the production chain in their Latin American investments, also creating limited demand for skills. Low skill levels in the workforce in turn limit the opportunities for technology investment by either local or international firms – the classical chicken and egg-style "skills trap".

Atomized labor relations with weak unions, high staff turnover and large informal labor markets similarly provide limited incentives and opportunities for skills acquisition. Finally, due to their limited skills needs, diversified groups have little incentive to negotiate with (badly organized) labor collectively, resulting in limited coordination on skills formation, labor standards, and job security (B. R. Schneider 2013, 34). Across the whole system, relationships in the workplace, within and between companies, are often hierarchical rather than based on either transparent and efficient markets or horizontal, cooperative non-market relationships. The groups that have best adjusted to the demands and opportunities of this system tend to be the best politically organized, leading to "political complementarities" that make reform difficult.

The important role of transnational capital aside, at least descriptively Ross Schneider's model seems to fit the Arab world, and arguably much of the wider developing world, quite well. In the core Arab cases, large firms tend to be similarly diversified and are, if anything, less technologically sophisticated; skills are even less developed; the workforce is even less organized; and levels of cooperation and coordination among firms and between firms and labor are even lower, as formal and informal relationships between market participants remain largely hierarchical. It is also quite plausible that all these features reinforce each other in a detrimental way.

That being said, there are critical features which distinguish Arab capitalism that are not captured in the model: Ross Schneider engages with the role of the state only in passing; its deep role as employer, subsidizer, and interventionist regulator in the Arab world is probably the most pronounced difference to Ross Schneider's model of Latin American capitalism.

Ross Schneider does account for market segmentation, describing both dual labor markets and, at least implicitly, the division of the domestic private sector into huge diversified groups on one hand and a residual category of smaller companies on the other. Both are typical for developing countries at large (Feige 1990; Khanna and Yafeh 2007; F. Schneider and Enste 2000). The specifics of segmentation in the Arab World differ significantly from what he describes, however, has to do with the large role of the state and the relative weakness of the private sector.

Much of Arab business remains dependent on support and protection from the state and vulnerable to state intervention, even more so than in other regions. As recent research on Arab cronyism has shown (Chekir and Diwan 2015; Diwan, Keefer, and Schiffbauer 2015; Nucifora, Rijkers, and Freund 2014), access to state elites and bureaucracy creates a small group of privileged firms with regulatory privileges, access to credit and subsidies and, as a result, unusually high profits. Most other businesses, particularly smaller firms, remain outsiders whose property rights are uncertain and whose interests are not represented in the policy-making process.

On labor markets, the state also retains a stronger role both as regulator and, crucially, as direct employer. Labor regulations that are perceived as particularly heavy by local firms create a large informal sector. While this sector also exists in other developing countries, different from most other developing economies, the "insider" group on the labor market mostly consists of public employees, as formal employment in the weak private sector remains tiny. This setup makes for a relatively large insider group, but also creates particularly distortive incentives for skills formation and crowds out state resources for more inclusive and growth-oriented policies.

Segmentation in the Arab world moreover is particularly rigid and hard to overcome in both business and labor market. There is less mobility between segments and barriers to entry are higher – both, again, the result of particularly deep formal and informal state intervention.

Arab capitalism provides more widespread distribution of state resources than most other developing country governments, benefiting a relatively broad middle class. Yet the system remains deeply exclusive for those outside of this coalition, with fewer universal social security and safety mechanisms than in most other regions, including highly unequal Latin America – a skewed structure that again reduces mobility between segments.

Rigid insider groups in business and labor market in turn create vested political interests that make economic reforms to reduce segmentation difficult. This is similar to Ross Schneider's "political complementarities". But while he mostly describes Latin American insiders' indifference to reform, in the Arab world insiders have more to lose and hence can resist reforms actively. At the same time, encompassing interests or marginalized groups that could push for inclusive reforms have even less space to organize. Conversely, at least some of the insider-outsider dynamics are also in the interest of regimes as they allow for divide et impera of business and labor. The politically critical middle class is placated through relative privileges on the labor market and important segments of the business class are politically tied to the regime through favoritism. Business cronyism, moreover, allows regime elite to enrich themselves.

Yet the system satisfies few outside of outside of small elite circles. Given the state's over-stretch, broken promises, meddling and favoritism, and the deep insider-outsider divisions in business and labor, trust and cooperation between the three groups of actors is particularly low in the Arab world. Incentives for investment and skill formation are particularly distorted, resulting in low-technology, undiversified production structures.

This paper argues that the core Arab cases do not only share a descriptive pattern of distorted development, but that the key components of this pattern are also linked causally, reinforcing each other (see Figure 1). It contributes to the broader VoC debate not only by incorporating new cases and developing (yet) another model, but also outlining more broadly how the role of the state can be conceptualized in developing country "capitalisms" – which might be particularly visible in the Arab cases but is difficult to ignore altogether also in many other developing countries where heavy regulation and cronyism are rife. By tracing the origin of Arab capitalism to a history of interventionist state-building and subsequent unequal retrenchment, it also contributes to historicizing the VoC debate in non-Western countries, which has been largely static and silent about the origins of institutions (Nölke and Claar 2013; Nölke and Claar 2013; B. R. Schneider 2013).

Finally, by focusing on insider-outsider dynamics more explicitly, the paper captures a core dynamic of modern capitalism that to date has been discussed mostly with reference to advanced countries (Palier and Thelen 2010), but which is even more important in developing countries with high levels of inequality, stretched resources and unreliable institutions. All of these dynamics are unlikely to play out across the developing world in exactly the same way that they have in the Arab world – the paper indeed argues that the core Arab cases stand out in international comparison in several important regards – yet on a more general level these variables are likely to be important for understanding VoCs also in other less developed regions.

4. Historical Roots

A proper understanding of Arab capitalism's main features requires some historical background on the emergence of modern Arab states and economies after WWII. When the Maghreb and Mashreq countries in the core of Arab region achieved independence in the 1950s and 1960s, they were poor and underdeveloped, with human development outcomes on a par with post-colonial sub-Saharan Africa (Diwan and Akin 2015, 18). Yet they by and large embarked on a more ambitious path of state building than their peers in sub-Saharan Africa, Latin America or South Asia.

While the reasons for this are beyond the scope of this paper, a key part of the story was intense ideological competition across the region during the era of Arab nationalism in the 1950s and 1960s, a family of ideologies that held genuine mass appeal and, in its most prominent incarnations, proposed state-oriented, populist economic programs with a strong element of redistribution (Ayubi 1995; Heydemann 1999).

The region's nationalist republics Algeria, Egypt, Iraq, Syria and, to a lesser extent, Tunisia and Yemen were the most ardent proponents of populist economic policy that were directed against old economic elites and aimed to improve the lot of the impoverished masses. They nationalized strategic sectors, built large public enterprises, and intervened deeply in the remaining, smaller-scale private economy through restrictive licensing rules, price controls, regulation of labor and production processes, state-directed credit allocation etc. Aspiring to the creation of a new middle class, the leaders of the populist republics used public sectors as tools of mass employment and introduced heavy subsidies for consumer goods and energy. Business and labor were both organized through state-controlled corporatist associations with limited autonomy (Bianchi 1989; Henry and Springborg 2010; Heydemann 1999; Richards and Waterbury 2007).

The populist-distributional policies of the first nationalist republics – which had mostly emerged from nationalist coups against conservative monachical rulers – put pressure on other regimes in the region to play catch-up. The ideological competition between Arab nationalism and conservative monarchism from the 1950s on (Kerr 1965) in particular forced monarchies to step up their own distributional efforts. This was visible in the Gulf oil monarchies' expansive employment and subsidy policies, but also similar policies in much poorer Jordan, which was positioned at the fulcrum of regional ideological competition for much of post-

WWII Arab history and witnessed several aborted nationalist coup attempts. Morocco as a geo-strategically and culturally more peripheral monarchy with deeper local historical roots appears to have been under less pressure to follow the trend, which is consistent with its relatively lesser statist and distributive legacy.

The one republic in the core of the Arab world that never quite embarked on a path of nationalist state-building is Lebanon (Henry and Springborg 2010). Despite considerable energy subsidies, it is also the case with the smallest public sector footprint in the region. Its unusually weak statehood, however, contributed to its descent into a civil war in the 1970s that itself was shaped by the ideological and power rivalries of the region. At least in the classical period of ideological rivalry in the region from the 1950s to the 1970s, distributional state-building may have been a condition of regime survival.

The availability of natural resource and strategic rents in the region did help states to engage in rapid state expansion, government over-employment and provision of subsidies. As the experience of other regions shows, however, rents do not automatically generate such structures: Sub-Saharan African or Southeast Asian oil states for example tend to have smaller state apparatuses and much less generous subsidy regimes. Similarly, the involvement of various regimes in intra-Arab conflicts and repeat wars with Israel also likely contributed to tighter state control of economies – but it does not explain the populist-distributional nature of economic policy.

Outside of the communist world, few post-WWII regimes made as heavy social commitments to their populations as the core Arab states: All expanded education, health systems and public employment rapidly, with several of them guaranteeing government jobs for all university graduates; most of them initiated extensive public housing programs; and all provided extensive food subsidies which in some cases reached 10% of GDP (Diwan and Akin 2015, 19). In the view of political economists, this has buttressed an "authoritarian bargain" in which welfare was exchanged against political quiescence (Amin et al. 2012; Desai, Yousef, and Anders 2007; Luciani 1987).

Arab states have had to scale back their ambitions and operations ever since the original statist model faced a fiscal crisis in the 1970s, resulting in partial economic liberalization and a gradual, sometimes conflict-ridden downscaling of distributional commitments (Diwan and Akin 2015; Ehteshami and Murphy 1996; Richards and Waterbury 2007). The share of state operations in GDP in the Arab world nowadays is no larger than the developing world average. Yet, as we will see, the region's statist legacy remains visible in above-average public sector employment, subsidies, as well as the heavy bureaucratic penetration of the life of citizens and businesses. While the private sector today plays a much larger role in economic development, it does so in the shadow of the state.

In some regards, Arab governments' historical commitment to welfare has produced impressive results: Among developing regions outside of East Asia, the Arab world has recorded the fastest improvement in human development indicators, notably regarding reductions in child mortality and malnourishment as well as increases in school enrolment rates. Figure 2 below shows that five of the core Arab countries continue to record higher scores on the human development index than their GDP per capita would let us expect; the two exceptions are the relatively peripheral cases Morocco and Yemen.

Poverty rates have also declined faster in the Arab world than other developing regions (Kuhn 2013). The core Arab states hence are no basket cases or kleptocracies – they have built important infrastructural capacity and have been unusually generous to large parts of their populations.

That being said, their high ambitions of state-led growth and distribution are also at the root of many of their modern problems. Since at least the 1970s, available resources have not kept pace with the commitments of lower-rent Arab countries. This has meant that public services, although in principle wide in coverage, have remained low in quality – often leading to de facto rationing of higher-quality services through corruption as well as backdoor privatization in which better situated citizens buy education or medical services privately (World Bank 2008; World Bank 2013).

Perhaps the most expensive promise, that of government job provision, has also been broken in all cases: public employment, although remaining expansive, has become a scarce good from which younger and less educated job-seekers in particular are excluded, and which also often is allocated in intransparent ways. At the same time, due to the limited capacity of the formal private sector and heavy labor regulation, formal private employment is small, leaving the informal sector as default option for most job-seekers.

The continuing importance of the state in the allocation of goods and services combined with their relative scarcity has led to an unintended segmentation of citizens according to their chances of access, particularly on the labor market. As we will see, this segmentation distorts incentives in the skills acquisition and job search process and negatively affects productivity, in turn weakening the private sector.

At the same time, despite Arab regimes' post-1970s commitment to private-driven growth, private firms remain subject to heavy government intervention as well as dependent on various forms of scarce and discretionary state support, including protected markets, access to subsidies, land, infrastructure and credit. Similar to the workforce, the private sector is deeply segmented into insiders and outsiders and more state-dependent than in most other developing regions.

5. The Core Arab VoC

The following sections outline the roles of state, business and labor that have emerged from this history in more detail, and explain the impact of their interactions on skill formation. It will present data on all core Arab countries as available and provide international comparisons where possible. The paper will put particular emphasis on complementarities between various factors. While the long history of state intervention is the main long-term cause of the current system, it has created path-dependencies in which various features feed on each other – including, but not limited to, political pressures on the state to stay its current course.

5.1 Over-ambitious states

Due to decades of austerity, the share of Arab governments in GDP has strongly declined since the 1970s (Diwan and Akin 2015). Yet, while resources are stretched very thin, the state retains a deep presence through market regulation and particular forms of distribution that crowd out other forms of state spending. Perhaps nowhere else in the developing world is the disconnect between state ambitions and means as deep as in the Arab world.

5.1.1 Public employment

As we have seen, Arab states remain relatively successful at providing basic health and education services, even if their relative HDI ranks have been declining since the 1980s (Diwan and Akin 2015) and service quality is often questionable. A more problematic distributional legacy is their ongoing commitment to large-scale public employment. Several states in the region created a formal government job guarantee for all university graduates during the heyday of state-building (Salehi-Isfahani and Dhillon 2008). Due to fiscal constraints, public employment has been declining – yet it remains high in international comparison, with only Morocco lying below the global trend line in Figure 3. Redundancies are almost unheard of as distributional commitments remain "locked in".

The shares of public in total employment mostly lie between 20 and 40%, far above those in richer Latin America, where they range from 4 to 15% (OECD 2014, 61), sub-Saharan Africa, where they range from 2 to 9% (Monga and Lin 2015, 138), or East Asia and Pacific, where they mostly lie below 5% (Packard and Van Nguyen 2014, 16).[2] Commentators generally agree that there is considerable excess employment (World Bank 2003, 61, 217).

As governments have been unwilling to trim the size of the public sector through anything but natural attrition, the inevitable fiscal adjustment has been happening since the 1970s through declining real salaries (Said 1996), which many authors see as an important cause of petty corruption. Yet, in the cases were we have data, salaries in government typically remain higher than in the private sector, especially compared to the informal sector (Bodor, Robalino, and Rutkowski 2008; Bodor 2010; International Monetary Fund 2012, 44; Yousef 2004).[3] This contrasts with Latin America, where pay on average is lower than in the private sector (Inter-American Development Bank 2004, 171). Even more important, in the public sector benefits tend to be better, working hours are shorter, absence is often tolerated and in many cases workers are able to "double dip" by pursuing private economic activities on the side (Gatti, Morgandi, and Grun 2013, 150).

As a result, the desire for government employment remains high across most of the region, as a recent Gallup poll shows (Figure 4).

On average, only about a fifth of respondents in the poll had a preference for private employment, with figures ranging from 8% in Yemen to 35% in Morocco.

Skills are of limited relevance in surplus government jobs, and as such jobs remain scarce and coveted, recruitment is widely perceived as marred by favoritism (El-Gammal 2013; Gatti, Morgandi, and Grun 2013, 190).[4] This contributes to an informal segmentation of insiders and outsiders and alienation from a system seen as unfair and failing to deliver on its original promises. Over-employment and non-meritocratic recruitment also impair state administrative efficiency, in turn limiting state capacity to implement targeted development policies.

Another key distributional commitment of Arab governments is the provision of subsidies, particularly energy subsidies, which are drastically higher than in other regions (Figure 5). While these are universal in principle, richer households tend benefit far more from them, making their distributional impact regressive (International Monetary Fund 2013; World Bank 2014). Due to increases in international energy prices, increases in local consumption and declines in local hydrocarbons production, their volume dwarfs that of food subsidies. The latter lie between 1% and 3% of GDP, with monarchies Jordan and Morocco being relatively less generous, and have declined strongly since the 1980s (Sdralevich et al. 2014, 12; Diwan and Akin 2015).

As governments have been facing fiscal crises, they have started to gradually reduce energy subsidies in recent years (Sdralevich et al. 2014). This however will at best help to reduce deficits; resources for development-oriented spending remain tight.

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[2] The only exceptions among 16 sub-Saharan African countries for which (Monga and Lin 2015) contains data are mid-income countries Botswana and South Africa, where public employment reaches 16 and 25% respectively. Botswana is a rentier economy and South Africa's GDP per capita lies considerably above that of most Arab cases.

[3] Another piece of evidence comes from the 2010-14 wave of the World Values Survey, which included 12 Arab countries, and which asked respondents both about their income and their employment status. While government employment in this survey appears to be better paid on average all over the world, the average gap in the Arab world in the WVS data is twice as large.

[4] For details on Algeria, Egypt, Morocco, and Syria, see (World Bank 2003).

5.1.2 Low investment in conventional social security and safety

Excessive spending on crypto-welfare policies like public employment and subsidies has made it impossible for Arab countries to invest sufficiently in conventional, more inclusive welfare policies such as social insurance and social safety.

Social insurance in Arab countries in all cases excludes important shares of the population. Contribution-based pensions and health insurance systems have a strong urban bias, and mostly benefit employees in the formal sector (Loewe 2010), leaving the rest of the population without old age income security and rudimentary state-provided health services. They are also internally fragmented, typically dividing (formal) public and private employees and sometimes different categories of public and private workers among themselves. Of 13 countries covered in a 2005 report on MENA pensions, only 3 had an integrated system of public and private pensions (Robalino 2005).

Pensions cover only 33% of the population in the Middle East region, with republics scoring somewhat better than monarchies (Robalino 2005). The overall average is similar to Latin America, but lies considerably above those in South Asia and sub-Saharan Africa (Gatti, Morgandi, and Grun 2013, 23), reflecting a relatively large insider coalition considering the Arab world's low-income status. The depth of insider privilege is further reflected in the unusual generosity of most pensions schemes, which in many cases allow and even encourage early retirement and some instances offer replacement rates above 100%, i.e. provide benefits that exceed pre-pension income (see Figure 6). As a result, and despite the relative youth of Arab populations, Arab pensions systems are incurring unsustainable deficits, potentially crowding out other forms of social spending. Few countries in the Arab world have an unemployment insurance system, and the few that exist are weak (Gatti, Morgandi, and Grun 2013, 30).

Even if benefits were adjusted to reduce current insider privileges, creating contributory social security systems with high coverage might be too ambitious for low- to mid-income countries as our core Arab cases. They do also, however, stand out in the weakness of non-contributory social safety programs such as cash benefits, micro-credit, workfare and training programs etc. – even in comparison with other developing countries (Loewe 1998). Such programs only amount to an average of 0.7% of GDP across the Arab world (Levin, Silva, and Morgandi 2012) and are deeply fragmented. The few programs that do exist moreover are remarkably ineffective: World Bank research shows that they fail to reach two thirds of individuals in the poorest quintile of the population, a coverage rate that is less than half the world average, including in regions not generally associated with generous welfare benefits like Latin America or Central Asia, where rates are 3 times higher.[5]

Arab governments are deeply involved in distributing jobs and benefits, but do so in a costly and exclusive way that creates rigid insider-outsider systems. Universal social safety policies can in principle lessen the segmentation of labor markets into formal and informal through unemployment assistance, cash benefits, micro-credit programs and active labor market policies, all of which can facilitate skills acquisition and ease the transition into formal employment – but Arab governments have very little resources or capacity for these (Gatti, Morgandi, and Grun 2013).

5.1.3 Government intervention in the private sector

Administrative capacity in the Arab world is not particularly low: In international rankings, Arab states generally achieve levels of government effectiveness that are in line with their GDP per capita – albeit states with a stronger history of populist-distributional tend to score worse

[5] "The average nonsubsidy SSN program in the region distributes only 23 percent of its total benefits to the bottom quintile, while the corresponding figure for the average comparator programs in Latin America and the Caribbean and in Eastern Europe and Central Asia is 59 percent." (Levin, Silva, and Morgandi 2012, xxiv)

(Figure 7). They stand out however in stretching their capacity by extensively and deeply intervening in business and labor markets through both distribution and regulation.

Generous if exclusive social insurance systems reflect a general tradition of deep state involvement in the economy, including in the private sector. On the one hand, governments provide a wide range of support to business, including above-mentioned energy subsidies, provision of land and, through state-owned banks, credit (World Bank 2009).

On the other hand, governments tend to get deeply involved in business operations through regulation. Some of the heavier regulations of the 1960s-statist period have been rescinded or reduced: There are fewer currency and price controls and FDI restrictions have been relaxed. Many remain, however: Licensing and inspection regimes, bankruptcy procedures and labor rules are seen as particularly onerous in the Arab world; only Tunisia and Morocco rank in the top half of countries in the IFC's international "Doing Business" comparison of business environments (see Table 1).

Arab countries rank particularly badly in the enforcement of regulations (Gatti, Morgandi, and Grun 2013, 18; World Bank 2009, 79). In most countries, firms polled in World Bank enterprise surveys report above-average impact of corruption on their operations; again, only the two monarchies are close to comparator regions (Figure 8).

Arab countries fare somewhat better on general measures of corruption such as the "control of corruption" index included in the World Bank Governance Indicators, where Sub-Saharan African states tend to do worse. The high impact of corruption reported by Arab businesses in particular likely is a combined outcome of corruption with particularly deep state intervention – an interpretation also supported by international survey work on tax inspections and bribery, which shows a somewhat higher incidence of bribery in sub-Saharan Africa, but a much higher incidence of inspections in MENA, resulting in the highest combined score of bribery and inspection intensity for the region (Gatti et al. 2014, 141). We will discuss more evidence below that Arab interventions on the private labor market are also particularly deep.

5.2 A segmented business sector

State intervention divides business into different segments. Some sectors of production in the Arab world are still dominated by state-owned enterprises, including military ones, narrowing the scope of formal private business (Amico and Hertog 2013). The more important factor of segmentation today however is the state's intervention in private economic activity itself. The state's extensive and often discretionary involvement in terms of both state-granted support and regulatory control is a key factor dividing Arab business into insiders and outsiders.

State resources and intervention creates opportunities for state-business crony networks, which have been documented at some length in recent research and the scale of which in at least some cases is staggering (Heydemann 2004; Nucifora, Rijkers, and Freund 2014): In Egypt, "politically connected" companies under Mubarak accounted for only 11 percent of total employment, but 60 percent of total net profits among listed firms (Diwan, Keefer, and Schiffbauer 2015). In such networks, state actors often continue to be the senior partners as they can use various tools of coercion and threats to withdraw resources to control private firms.

Cronyism and insider business is not unique to the Arab world, and corruption might be worse in other regions – but there is evidence for a particularly deep and rigid division between well-connected and outsider firms in the Arab world. Recent World Bank research for example demonstrates that the variation in waiting times for regulatory services in the Arab world is higher than in most other emerging economies, especially in Egypt, Jordan, Tunisia, Yemen and Morocco (World Bank 2014, 49f.). This shows that some companies are able to deal with the state much more effectively than others. The division of the private sector into some very large firms and numerous small ones also appears to be more pronounced in the Arab cases than in other emerging markets (World Bank 2014, 29).

The original motivation behind bureaucratic intervention in the 1950s and 1960s was for the most part not cronyism but state-led development. But since at least the 1970s, this interventionist legacy has provided tools for favoritism in the course of partial economic liberalizations that regime elites have used for self-enrichment and alliance-building with business elites. Politically connected firms however tend to push the majority of unconnected businesses into unproductive small-scale, often informal activities (World Bank 2014, 82), where they enjoy weak property rights. There is a dearth of productive medium size firms across the region (M. C. Cammett et al. 2015, 17; Diwan, Keefer, and Schiffbauer 2015).

The pressures for informality seem to be stronger and, in particular, more persistent than in other regions: There are more firms in the MENA region that start without a formal registration, and companies remain informal for a particularly long period, indicating very low mobility from the informal to the formal sector (see Figure 9). In Arab economies, economic opportunities seem to depend more on where a firms started and what its connections are than elsewhere – evidence that "market corruption" through which in principle any firm can contest markets if it is willing to pay bribes is not the prevalent mode of influence-peddling. Instead, rigid, long-term networks determine success.

There is more evidence of high barriers to entry and of the fact that once a firm has achieved insider status, it is particularly hard to dislodge. Firms in MENA on average are older, there are fewer firm entries and exits and generally fewer registered firms than in other regions. Creative destruction is limited (World Bank 2009; Gatti, Morgandi, and Grun 2013). The dispersion of value-added within sectors is particularly high, which reflects lack of competition, as we would expect low value-added firms to exit in a competitive market (World Bank 2009, 103). Figure 10 below shows the average annual number of new firms registered per 1000 residents in the 2000-2009 period in different countries and world regions. The core Arab cases, and the MENA region more broadly, rank at the very bottom.

The exceptionally low dynamism of Arab business has led to weak performance on pretty much all available indicators. The Arab world has the world's lowest share of private in total investment and the lowest share of manufacturing exports to GDP, which moreover have very low technology content (World Bank 2009, 50, 59, 61). The contribution of total factor productivity to growth over the last two decades has been dwarfed by those of labor and physical capital (European Bank for Reconstruction and Development 2013, 12).

Large, diversified private groups – which some authors see as a reaction to weak institutions (Khanna and Yafeh 2007) – dominate business in the Arab world. If connections are a company's main comparative advantage, then this advantage presumably can be leveraged in many markets. Most businesses in the region are sole proprietorships, and the region has the lowest share of limited liability companies worldwide. Latin America, by comparison, has a much higher share of publicly listed companies. The market for corporate control in the Arab world is hence largely closed, further separating business insiders from the rest of private sector and society.

5.2.1 Weak interest groups

Deep traditions of state intervention and control have left little space for independent collective action by Arab business: The World Bank describes business associations in the regions as "generally weak, unrepresentative, or nonindependent," with little space for less well-connected businesses to organize (World Bank 2009, 187). Given the prevalence of insider structures and favoritism, businesses often find individual, informal strategies more effective in pursuing their interests and deal with an interventionist state. Recent research on Tunisia shows that politically connected firms under Ben Ali were very effective at making the state raise barriers to entry in the particular markets in which they operated (Nucifora, Rijkers, and Freund 2014).

In line with general structures of segmentation, interests of large and small companies tend to diverge. Business associations usually are controlled by large businesses close to the state. A World Bank survey of Arab business associations' shows that their lobbying typically focuses on the defense of specific insider privileges like regulatory protection and subsidies rather than the broader policy and regulatory reforms demanded by the majority of businesses (World Bank 2009, 188). Policy input from business is limited.

As a result, demand for rule of law and for improvements to government effectiveness are low and business provides limited policy input or policy-relevant information. This takes reform pressure off government and contributes to a trap of low coordination and low trust in which most companies try to avoid the state rather than to cooperate with it (Hertog 2012). In Arab economies, like in coordinated market economies, businesses use non-market, informal coordination mechanisms with the state, but these mechanisms are individualized and often used for favoritism rather than for policy coordination. The low investment in technology and skills across our cases happens not only because individual firms are weak, but also because collective business demands for government support in skills and technology acquisition are weak.

5.3 A segmented labor market

Insider-outsider segmentation is, if anything, even more rigid Arab labor markets, which are divided into formal public employment, formal private employment and informal private jobs. Informal private employment dominates, followed by formal public employment; formal private employment is a residual category.

5.3.1 Labor market structure

A Figure 11 below shows, the informal labor force in the region is large, but not unusually so in international comparison.What is unusual, however, is the ratio within the formal sector of public to private employment. In the cases where data are available, public sector jobs dominate formal employment (Figure 12).

This contrasts with sub-Saharan Africa: While the formal sector in countries on which information is available in general tends to be smaller, within it formal private employment on average is 30% *larger* than government employment (Monga and Lin 2015, 138). In Latin America, according to (Galli and Kucera 2004, 815), formal private employment on average is more than twice the size of public employment.[6]

There is, moreover, strong evidence that within the small formal private sector in Arab countries, hiring is not competitive. High shares of job-seekers find their positions through friends or relatives (Gatti et al. 2014, 187). In interviews with headhunters in Jordan and Lebanon, "all recruiters unanimously said that hiring is not done in a meritocratic way" (Gatti, Morgandi, and Grun 2013, 189). Fewer firms in the region rely on professional management in hiring decisions than in any other region (Gatti, Morgandi, and Grun 2013, 193).

Gatti, Morgandi, and Grun (2013, 167) describe a "meritocracy deficit" that reduces incentives among youth to seek the education relevant for private jobs. The presence of nepotism is in turn facilitated by low levels of skills in the population as well as the limited competitive

[6] The authors' proxy for formal employment (holding a job in a large firm) might somewhat overestimate formality, as large firms can also employ informally (B. R. Schneider 2013). As we have seen, however, public employment generally is much smaller in Latin America than in the Arab world. For public sector employment to dominate private employment as in the Arab world, formal private employment in the (typically richer and more developed) Latin American countries would have to be implausibly tiny.

pressures on Arab firms described above (Gatti et al. 2014, 160). The presence of insider hiring networks very likely reduces trust in business more broadly.

Different from the Latin American cases Schneider describes, there is little mobility between labor market segments. Very few workers leave the public sector with its security and benefits for private employment (Gatti, Morgandi, and Grun 2013, 52) – while in Latin America, patronage employment in the public sector can be is subject to considerable turnover when new governments come in (Schuster 2015). Informality moreover typically lasts longer than in other countries (Gatti et al. 2014, 187; Gatti, Morgandi, and Grun 2013, 153). Labor turnover is generally low in the region, with new entries and job losses generally below 10% of the stock of workers (Gatti, Morgandi, and Grun 2013, 150f.). All this indicates that like for firms, the insider-outsider system in the region's labor market, although generous to a fairly large share of the population, is particularly rigid and inflexible.

5.3.2 Drivers of segmentation

There are two main drivers of segmentation: Generous public sector employment and tight regulation of formal private employment. Generous public sector employment does not only lock a substantial part of the population into an insider position few will ever leave. It also provides a de facto reservation wage (Gatti, Morgandi, and Grun 2013, 22), in particular for young university graduates, whose unemployment levels in the Arab world are unusually large (Gatti, Morgandi, and Grun 2013, 10), and who do not have a strong incentive to seek skills relevant for the private labor market. Literature on Arab labor markets documents the phenomenon of "queuing" in which young job-seekers remain idle, waiting for a government position to become available (Assaad 1997; Gatti, Morgandi, and Grun 2013, 147; Yousef 2004).

As in other regions, the segmentation of the private labor market into formal and informal is to an important extent caused by state regulation, which tends to be particularly intense. Dismissal of formal employees for example remains more difficult in the region than in any other part of the world (Gatti, Morgandi, and Grun 2013, 22). All core Arab countries bar Morocco require the employer to notify government of the dismissal of even just one worker (Gatti, Morgandi, and Grun 2013, 22). The difficulty of making employees redundant is ranked the highest in the world according to „Doing Business" rankings (see Figure 13), and surveys show that labor market regulation is seen as important constraint by more than one-third of employers in the region, the highest share all developing regions (Gatti et al. 2014, 24).[7] According to the World Economic Forum, all countries bar Jordan rank in the bottom fifth of 144 countries on its indicator of "labor market efficiency" (Jordan is 97th).

While formal workers are well-protected (and hence cling to their jobs), the state does little for the outsiders that its protective regulations create. As the region's default welfare mechanisms are exclusive state employment and regressive subsidies, there is little or no welfare coverage for informal employees – who are but an afterthought in systems that have come to cater to a shrinking and economically stagnant, yet privileged middle class constituency under direct protection of the state.

5.3.3 Weak interest representation

As is the case with Arab business, organizations of collective interest representation for labor are weak, state-dependent and cater to insiders. In the region's authoritarian state corporatism, unions have always been under the control of states that discouraged or prohibited strikes and limited collective bargaining (M. Cammett and Posusney 2010). Different from business, unions arguably have been additionally weakened through the partial economic liberalizations

[7] For more similar statistics, see http://www.imf.org/external/pubs/ft/reo/2011/mcd/eng/pdf/mreo1011.pdf

since the 1970s. In some cases like Egypt, informal unions have emerged in parallel to the discredited state-endorsed unions, but they remain weak and fragmented.

Within firms, industrial relations are atomized. Most unions have no shop-floor representation, hence allowing none of the coordination on process innovation and skills formation that is known from coordinated market economies (Hall and Soskice 2001) – while at the same time, the absence of open and transparent markets for skills and labor prevent market-driven productivity upgrades as in liberal market economies. Weakness of unions and employer associations similarly undermines coordination on sectoral or national bases. As in Latin America (B. R. Schneider 2013), states tend to intervene on an ad hoc basis in labor matters, undermining autonomous negotiations between social partners and orienting their lobbying efforts towards government rather than each other.

To the extent that unions play a political role they tend to defend insider interests. The UGTT in Tunisia for example, which has been historically more important than any other union in the region and has emerged as a critical political player after the fall of Ben Ali, has spent much of its political energy on asking for public sector salary hikes.[8] The informal sector in the region remains disorganized and unions have done little to push for more inclusive social security or social safety arrangements.

A significant share of the working population are insiders in the formal sector that have a vested interest in state employment instead of inclusive social safety spending. While not well organized in international comparison, their lobbying power far exceeds that of the atomized and marginalized outsiders. Their political importance is reflected in the reaction of both anciens and new regimes during the regional political unrest in 2011: Across the region, governments increased public sector wages, created new government jobs and increased subsidies rather than strengthening more inclusive welfare mechanisms (Hertog 2011). Even the civil war in Syria seems to only have boosted traditional patterns of distribution: According to recent reports, the number of state employees in Syria has increased to 2.1 million by 2015, constituting half of the country's workforce.[9]

The status quo persists because its benefits are relatively concentrated while the gains of more inclusive welfare are more diffuse (Olson 1965). While this is the case with many policies in many countries, in our Arab cases the boundaries of the insider group are particularly rigid and it has particularly much to lose. Labor market participants barely face the "veil of ignorance" about where they will be in the future that can make more inclusive social security appealing even to the relatively privileged in other countries.

Arab labor markets have been deeply divided by ambitious, interventionist states. There is widespread informality as in other developing regions, but a considerably larger insider group in the public sector. The large size of this insider group helps to explain the region's moderate Gini coefficients, but also why there are so few resources left to support the excluded and facilitate their social and labor market mobility. Outsiders are not well organized while insiders have no interest in, or actively oppose, reform (B. R. Schneider and Karcher 2010).

The segmentation of Arab labor markets reduces both demand for and supply of skills. Static, low-productivity employment in both informal and public sector means that there is little use for high-quality training, and there are few opportunities for skills acquisition. Few manage to break into formal private sector employment. The weakness of the private labor market and the prevailing low level of skills in turn create demand for government jobs. As the next section will explain, public sector employment in particular distorts incentives for skill formation, and

[8] https://www.middleeastmonitor.com/news/africa/21242-tunisian-government-raises-public-sector-salaries

[9] http://www.dailystar.com.lb/News/Middle-East/2015/Nov-04/321623-state-employs-up-to-half-of-syrias-workforce-report.ashx

private firms‘ contribution to skills formation is weak even in comparison to other developing regions.

5.4 Low skills

The segmentation of private sectors and labor markets described above gives incentives against skills formation on several levels. Low skill levels in turn make a move towards more inclusive and productive forms of industrial organization and welfare less viable, further locking Arab economies into a low-productivity equilibrium.

The evidence of low skill levels in the Arab region is strong, even controlling for the region’s fairly low level of economic development. In a bivariate correlation of GDP per capita and average scores on the TIMMS test of pupils’ mathematical abilities, all Arab countries bar Tunisia do worse than their wealth would predict (while Tunisia lies just on the regression line; Gatti, Morgandi, and Grun 2013, 34).

This weakness has to do with the limited resources available per pupil in systems where secondary enrolment by now is almost universal and teaching is a secure but low-status public sector occupation (World Bank 2008). It also has to do, however, with the segmented, inefficient and sometimes corrupt Arab labor markets which create little demand for advanced skills.

While government job creation has shrunk drastically, Arab skill systems continue to be organized around public sector oriented “credentialism” where the formal level of education matters more than the subject studied (Salehi-Isfahani 2012; Amin et al. 2012, 62) The perception of the “public sector as the main client of education and training” (Gatti, Morgandi, and Grun 2013, 25) remains widespread.

This is reflected in the excessive focus in tertiary education on subjects of limited relevance for the private economy (Adams and Winthrop 2015; World Bank 2008). Figure 14 below shows that according to UNESCO statistics, a disproportionate share of Arab students study arts and humanities subjects.

The lack of skills relevant for the private labor market is felt by firms. Enterprise survey data show the highest average rates of dissatisfaction with the state of education among the local workforce among all world regions (Gatti, Morgandi, and Grun 2013, 25).

Despite these complaints, however, firms in the region for the most part provide little in-house training (see Figure 15). World Bank research shows that the incidence of training is lower than predicted by GDP per capita levels in all core Arab countries (Gatti, Morgandi, and Grun 2013, 180).

It appears that many Arab firms, sheltered from competition and often subsidized, have made their peace with the low available skills levels, focusing on low-tech production and making no attempts to upgrade the skill levels of their workforce.

The core Arab world seems to face a particularly bad case of a “low-skill trap“ in which limited supply of and demand for skilled labor feed on each other (Booth and Snower 1996). The small size of the formal private labor market and limited competition among private firms seem to depress demand for advanced skills even more than is the case in Latin America, giving labor market participants even fewer reasons to acquire them. The resulting weak supply of skills in turn disincentivizes investment into skills-intensive production processes.

Public spending on insider benefits moreover contributes to crowding out government spending on training relevant to the labor market; vocational training systems are weak and considered a dead end by many job seekers in the region (Gatti, Morgandi, and Grun 2013, 24, 178–184). Weak social safety nets moreover make it difficult for job seekers and informally employed to invest in skills acquisition.

Segmentation and weak organization of business and labor means that there is little coordination between government, firms and workers on skills formation; existing attempts to take private sector input on board in designing vocational training or university programs have been desultory, with government delegating little authority to stakeholders (Gatti, Morgandi, and Grun 2013, 177). Existing programs hence often miss market needs.

As mentioned above, low prevailing skill levels themselves result in stronger demand for both informal and government jobs, thereby reinforcing labor market segmentation. At least workers in government jobs in turn have little interest in upgrading the national skills system. Low skill levels also make it harder for workers to join the formal private sector.

5.5 An equilibrium of low cooperation and trust

After independence, Arab states made expansive promises of job creation, growth and welfare to their citizens on which for the most part they have failed to deliver. Commanding scarce resources, states have become stretched thin, and have to de facto ration many of the goods they provide, most notably government employment. At the same time, deep regulatory intervention intended to protect workers and local business combines with limited administrative capacity to produce bureaucratic uncertainty, influence-peddling and an uneven implementation of rules.

The result is a static and unfair insider-outsider system that undermines the formation of encompassing interest groups and prevents inclusive coordination between firms, labor and government. Exclusion and low coordination come with low levels of trust between all actors. In core Arab cases, public trust in government institutions tends to be lower than in other countries on comparable levels of development (Figure 16; results are similar regarding trust in courts and civil service). The republics, where state ambitions and intervention have historically been the most wide-ranging, record the lowest levels of trust.

Citizens are similarly wary of a formal private sector that provides few good jobs and is tarred by cronyism: About twice as many World Values Survey respondents have no trust at all in large companies in the region than elsewhere (Figure 17).

It seems to be large insiders in business in particular that are not trusted, as general attitudes to entrepreneurship and markets in the Arab region are positive according to Ishac Diwan's analysis of Gallup data (albeit relatively speaking youth, uneducated and poor – all outsiders – tend to take a dimmer view of entrepreneurs). Gallup poll data show that perceptions of corruption in business and government go together, highlighting the crony nexus that undermines public trust (Ishac Diwan). While we do not have poll data on business leaders' trust in government, it is clear from the above enterprise survey data that expectations of inconsistent implementation of rules and corruption are prevalent (World Bank 2009, 87, 89).

Favoritism, exclusion and the resulting low trust undermine micro-level cooperation among firms, between firms and government, and between labor and firms. They also undermine the formation of credible meso- and macro-level institutions that could facilitate the collective search for policy solutions. The absence of such institutions in turn weakens trust and makes agents resort to informal workarounds. Low levels of trust have been shown to negatively impact economic development, reducing both growth and investment (Dincer and Uslaner 2009; Zak and Knack 2001; Algan and Cahuc 2013; Algan and Cahuc 2010).

6. Conclusions

In the core Arab countries, inter-firm and business-labor relationships are less market-based than in liberal market economies. Instead, like in coordinated market economies, non-market relations and informal networks play an important role – but different from European CMEs, these are not embedded in strong meso-level institutions such as unions, employers' associations, or industrial banks.

Instead, heavy state intervention rigidly divides firms and workers into insiders and outsiders, both formally and informally. This division undermines trust and the formation of encompassing interest groups, thereby stymieing coordination and reform. Interests are pursued individually and often through informal means. The insider/ outsider distinction in this system is particularly resilient, contributes to a low skill trap by creating strong incentives against skill formation, and allows insiders to persist with low productivity (firms) and low skills (workers), hence giving them a strong vested interest in maintaining the system. The maintenance of insider privileges is costly, crowding out inclusive social policies that could facilitate skills acquisition and increase mobility into formal employment. Prevailing low skills and a weak private sector in turn create demand for more insider employment in government.

The above patterns are particularly pronounced in the Arab republics with a deep history of statism. But even in relatively liberal regimes in the core Arab region like Tunisia and Jordan, insider coalitions are larger and the resulting divisions more pronounced than in other developing countries.

Cronyism is critical in determining insider/outsider boundaries. This is obviously the case for firms but, in subtler ways, also on the labor market, where recruitment both in government and private sector is often not meritocratic and shaped by informal networks. Cronyism produces a particularly strong interest in maintaining the status quo as crony players often would not be competitive on a functioning market – and perhaps not even in a more efficient system of "market corruption" in which the kinds of long-term networks that seem to prevail in the Arab world are less important than the ability to pay bribes.

State-business and labor market cronyism also potentially reinforce each other as less productive crony entrepreneurs are likely (and able) to prize worker loyalty over performance while less productive crony employees have an interest in maintaining their firm's non-market advantages. Cronyism also creates an obvious "political complementarity": a mutual interest of state elites and crony capitalists in maintaining high barriers to entry and discriminatory state support. The policy tools used to this end often go back to the statist era of the 1960s and by and large did not come into being for corrupt purposes, but have been politically appropriated in the course of partial liberalization.

The same is true for segmented labor markets: exclusion emerged by default rather by design as state employment guarantees frayed in the wake of fiscal crisis in the 1970s and 1980s. And yet today's exclusive labor market structures protect a politically important insider group. This middle class coalition has become much worse for wear and few of its members are happy with the status quo. Yet protecting it remains politically imperative, even if this is at the expense of the lower classes and the informal sector – even a case like Tunisia which has jettisoned its old authoritarian leadership.

The various negative equilibria outlined above mean that cronyism will be hard to combat through individual policy interventions that only affect one sector or factor at a time, as other factors will continue to bolster insider-outsider structures (cf. Schneider and Karcher 2010 for a similar point). A wider VoC approach to Arab capitalism helps us explain not only the persistence of low productivity and skill levels in the Arab world, but also the continued nepotism after the fall of several Arab dictators in 2011.

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Figure 1: An Arab Variety of Capitalism

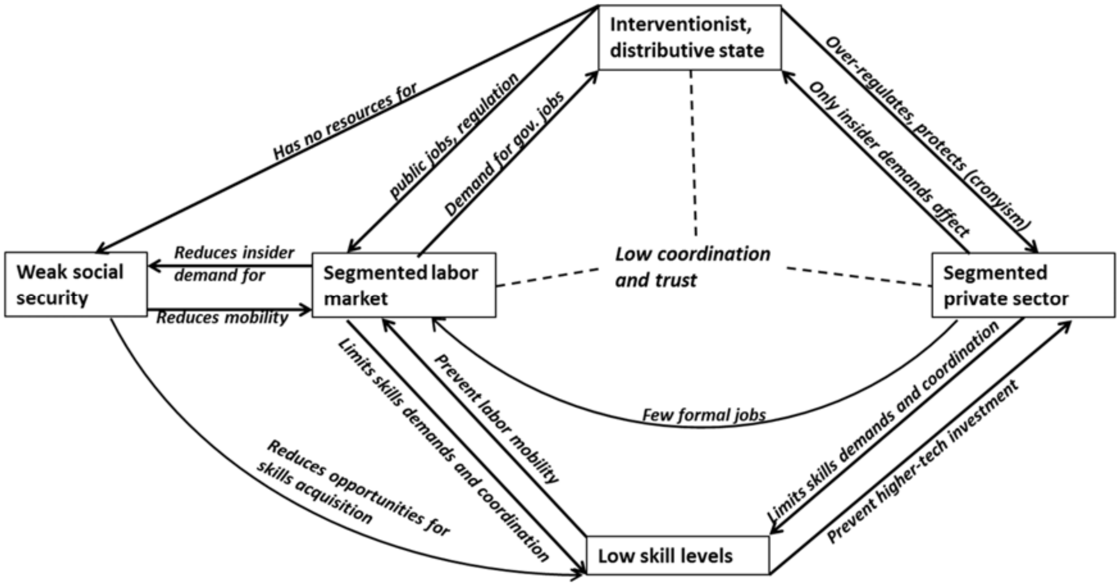
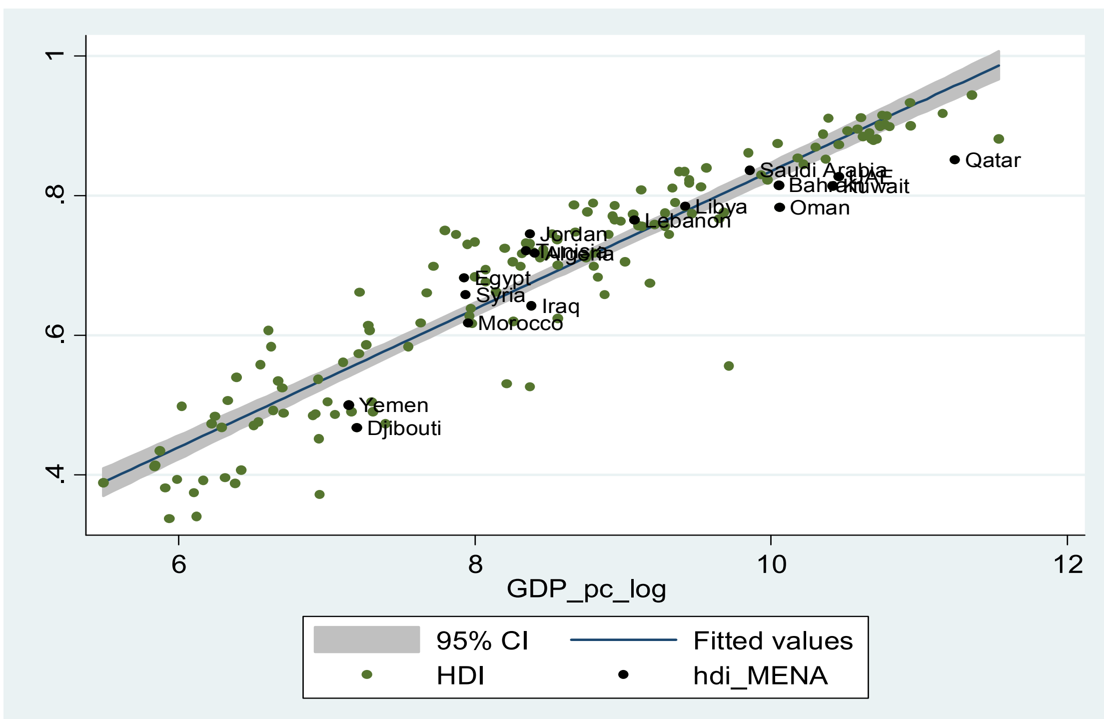
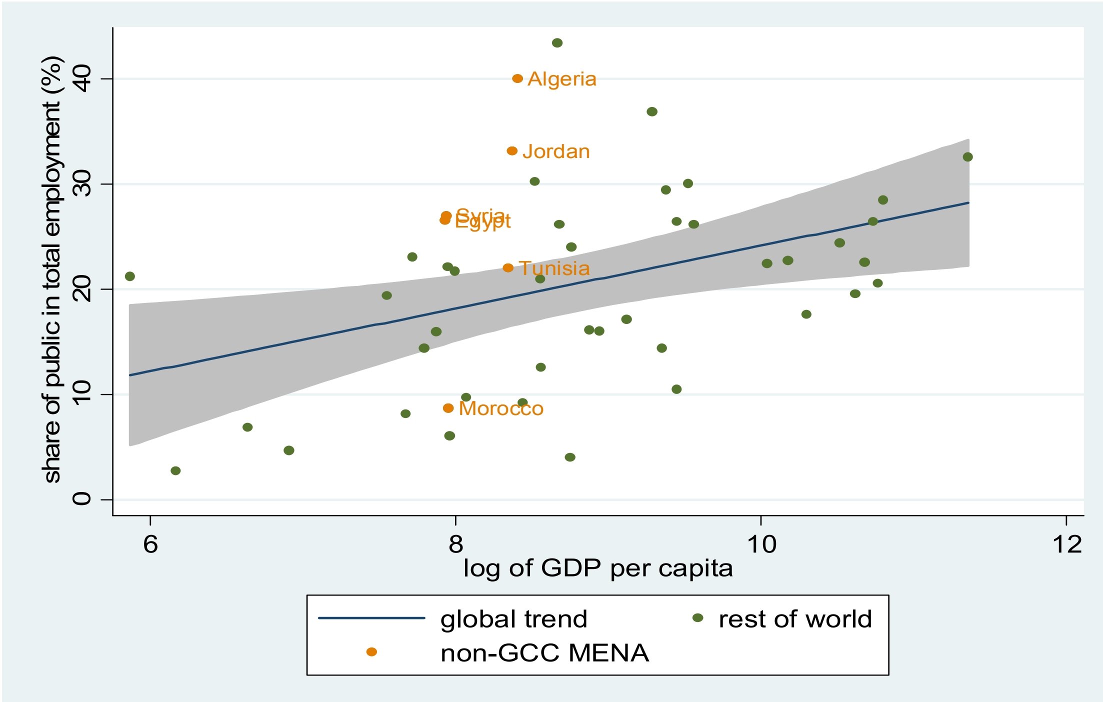


Figure 2: Human Development Indicators for the Arab World (2012)



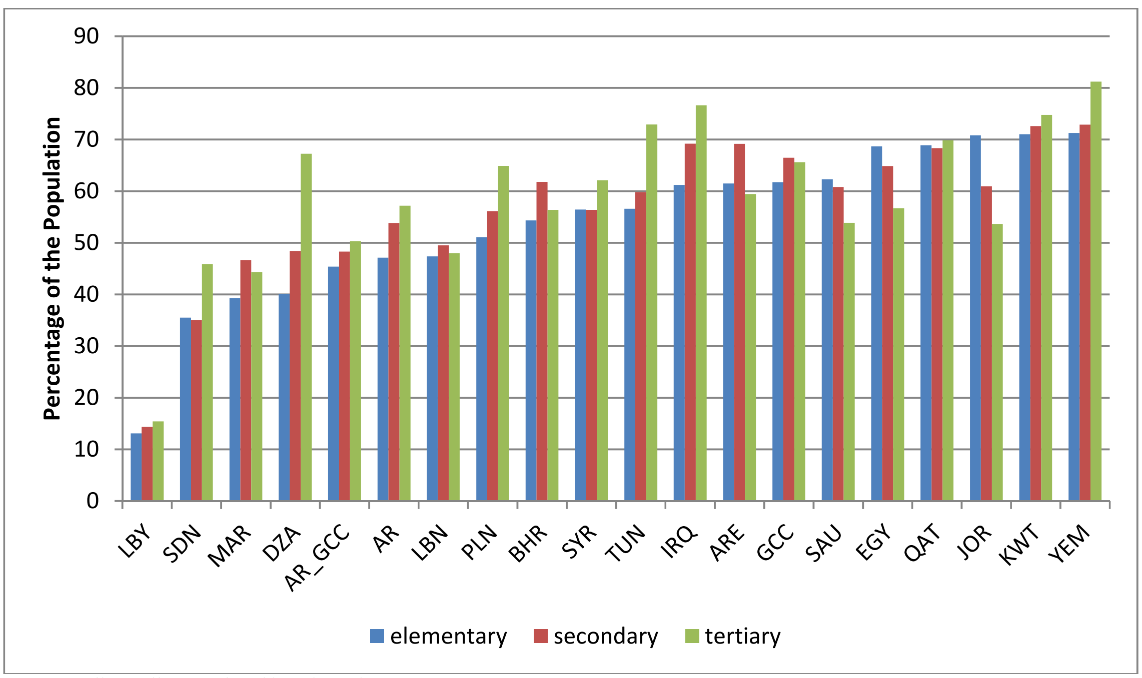
Source: WDI and UNDP data

Figure 3: Public Employment Shares in International Comparison (Early 2010s, Various Years)



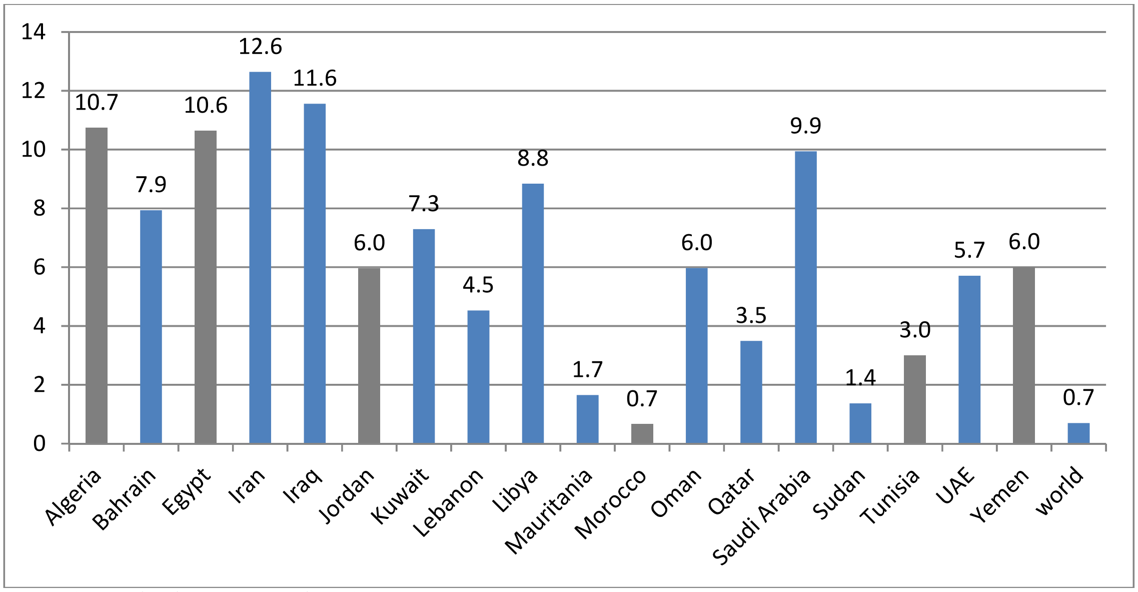
Source: ILO, national sources

Figure 4: Preference for A Government Job, by Education Level-2010



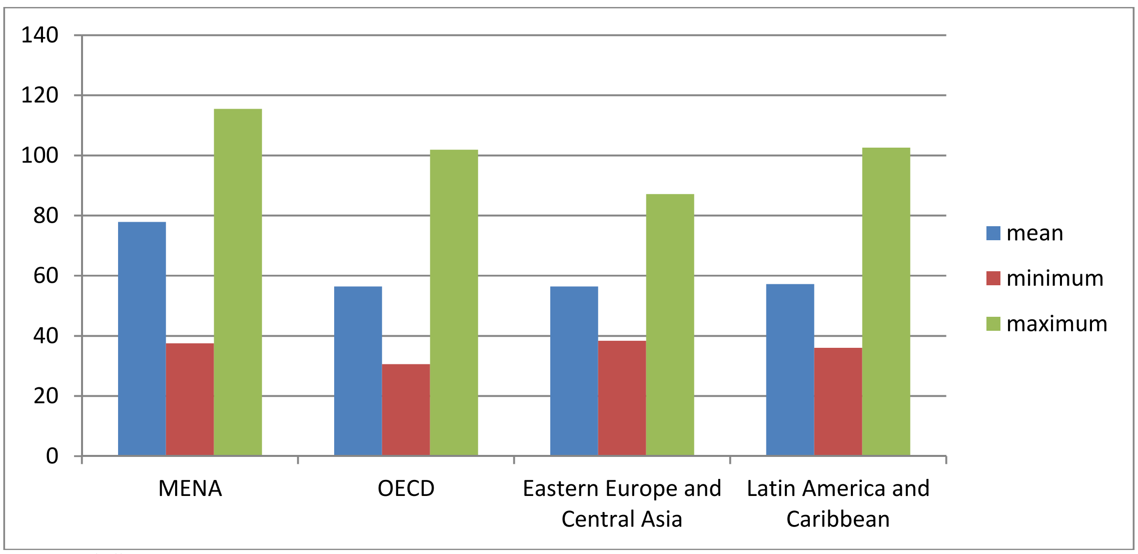
Source: Gallup polls as analysed by Ishac Diwan

Figure 5: Pre-Tax Energy Subsidies as % of GDP in 2011



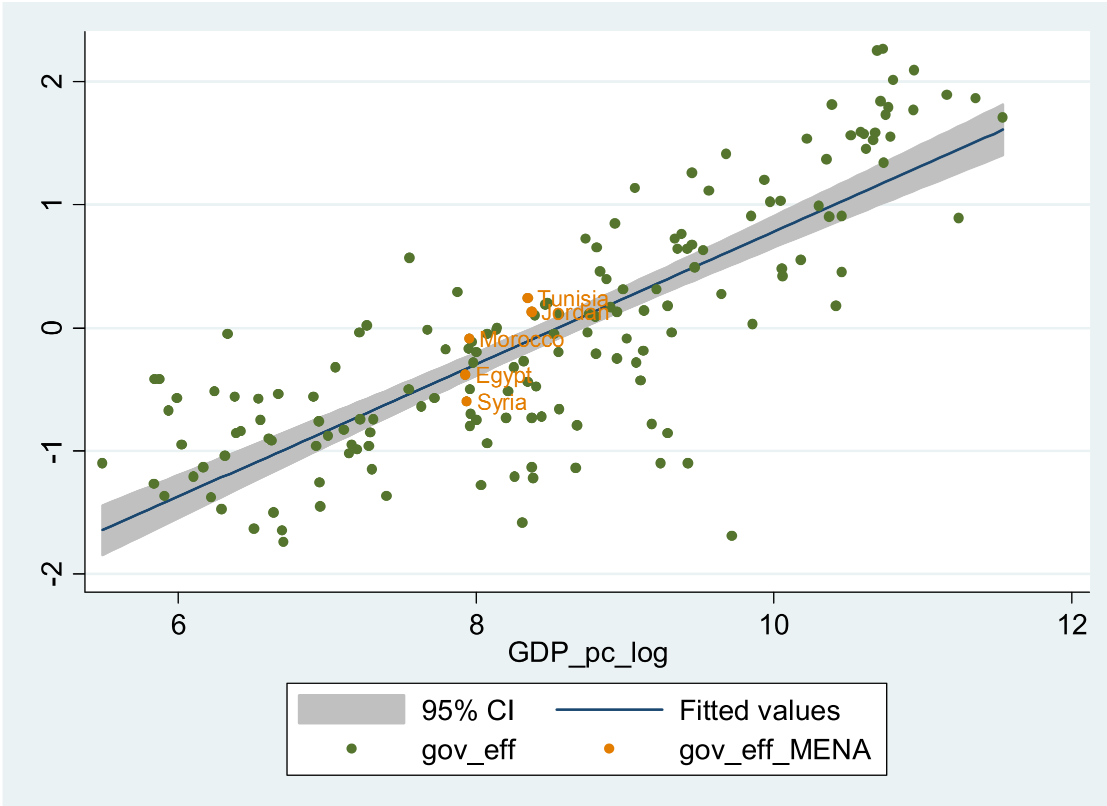
Source: (International Monetary Fund 2013)

Figure 6: Gross Replacement Rate Around the World, by Level of Earnings and Region *(percent of individual earnings)*



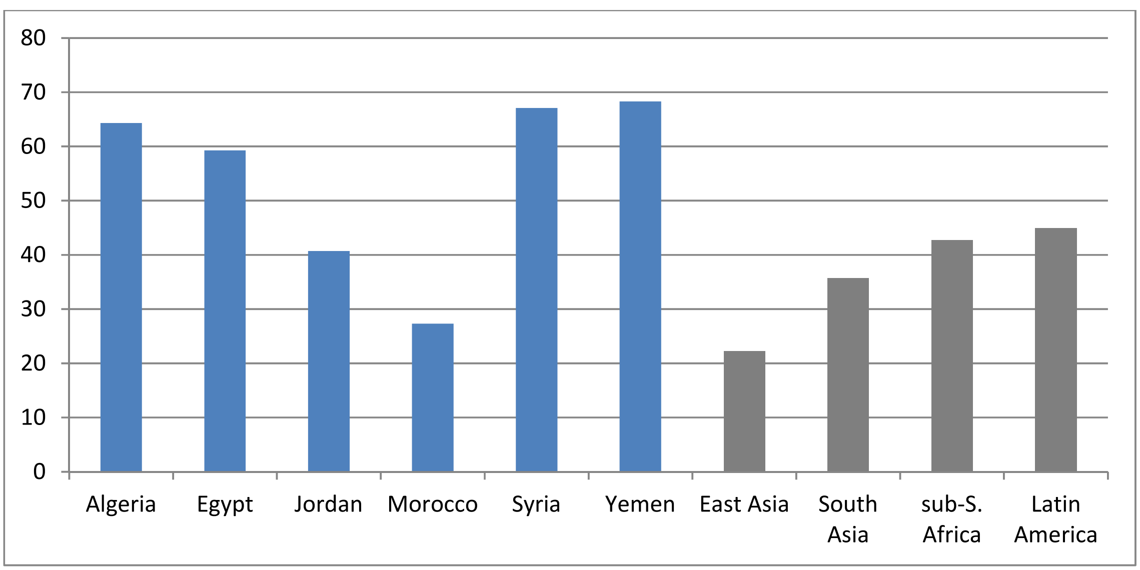
Source: Robalino 2005, 68

Figure 7: Arab government Effectiveness in Comparison (2012)



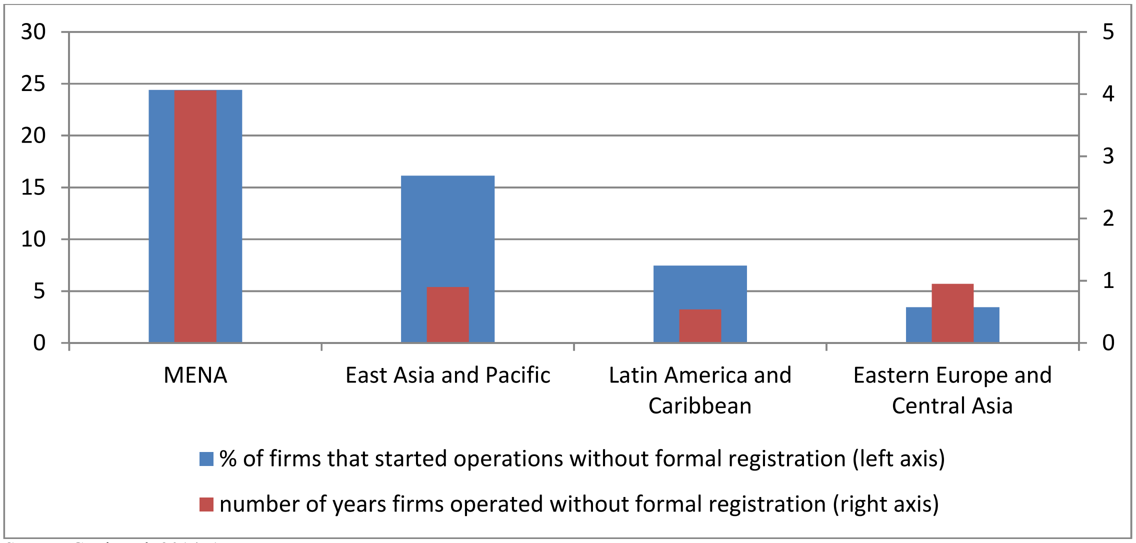
Source: World Bank Governance Indicators

Figure 8: Percentage of Firms Identifying Corruption as A Major Constraint



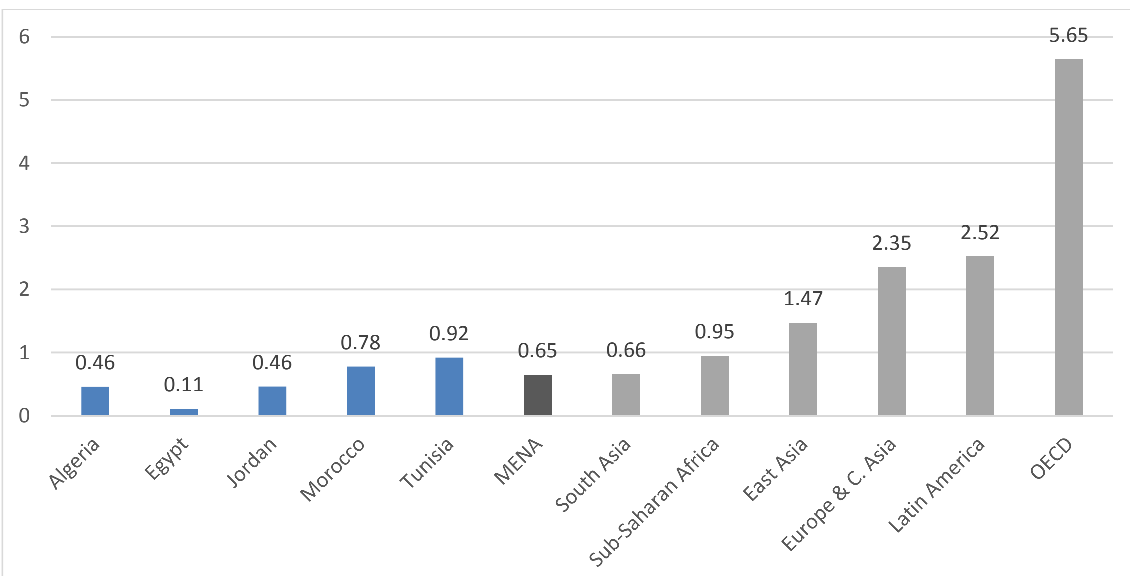
Source: World Bank enterprise surveys, various years

Figure 9: Informality by Region



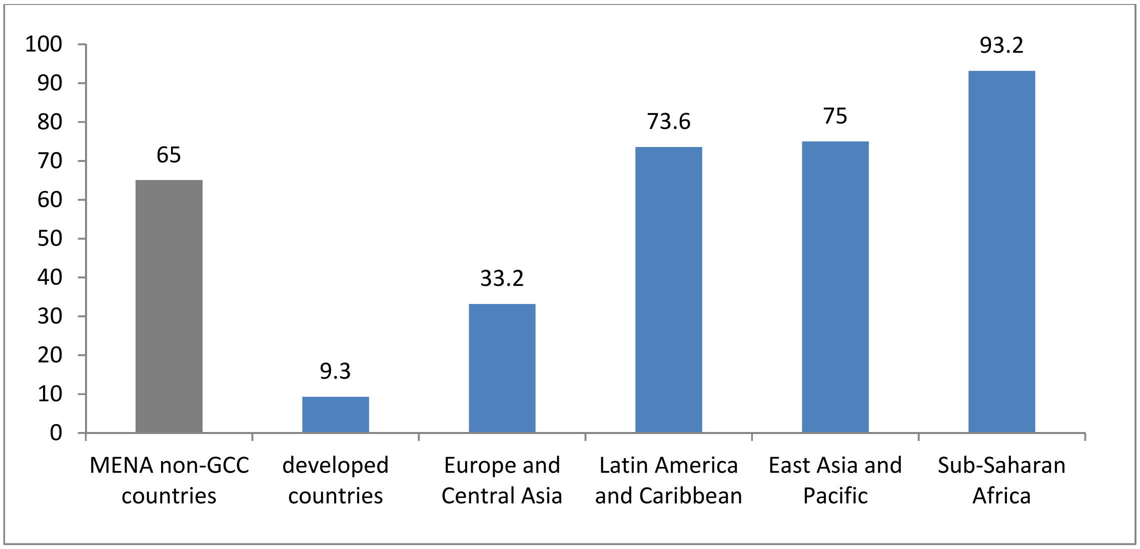
Source: Gatti et al. 2014, 17

Figure 10: Annual Number Of Newly Registered Companies Per 1000 Inhabitants (2000s average)



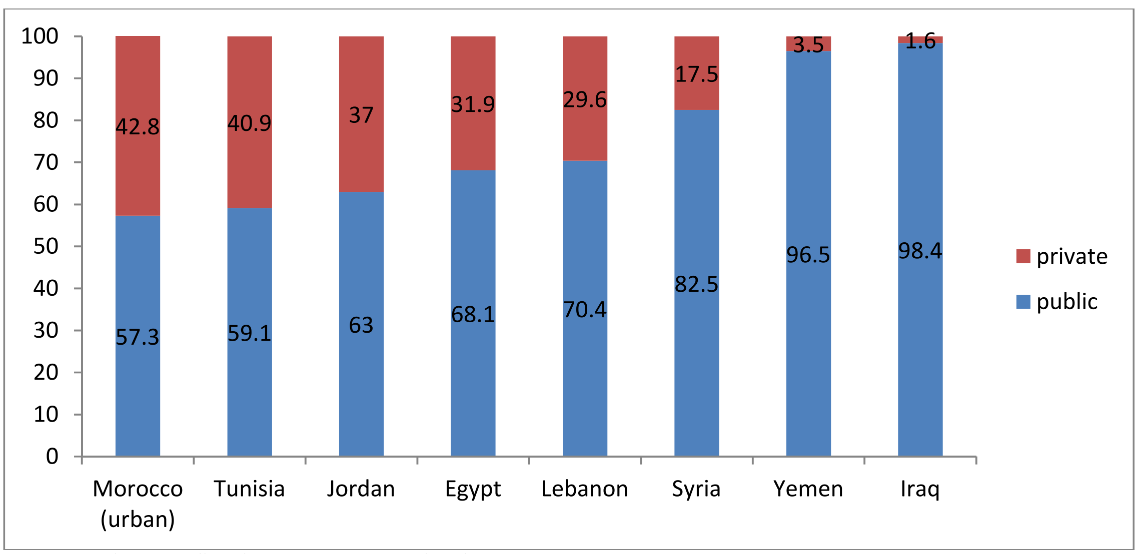
Source: Klapper and Love (2011)

Figure 11: Percentage of the Labor Force Not Contributing to Social Security



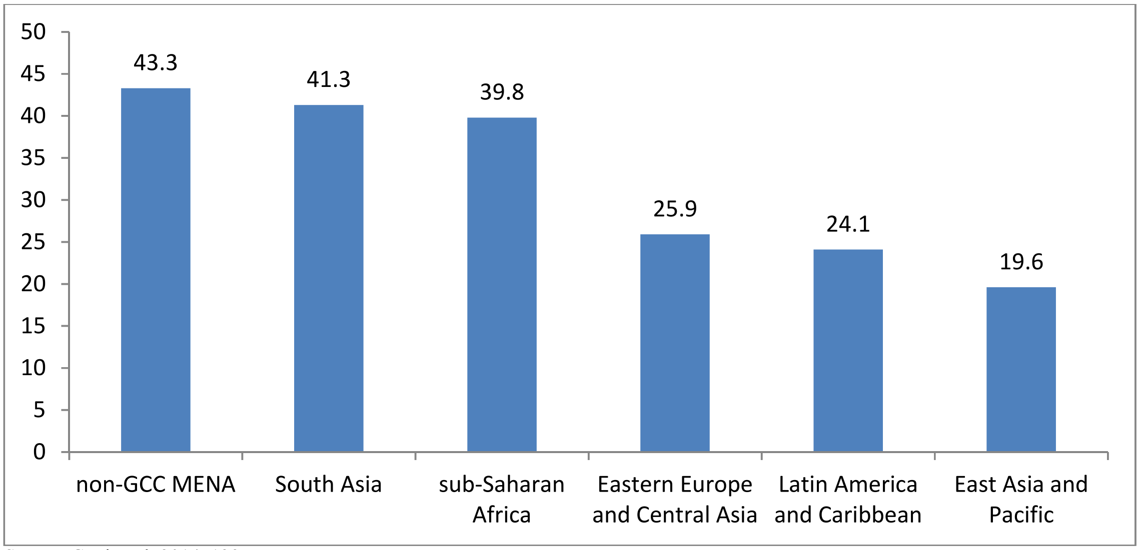
Source: Gatti et al. 2014, 52

Figure 12: Distribution of Formal Employment (%)



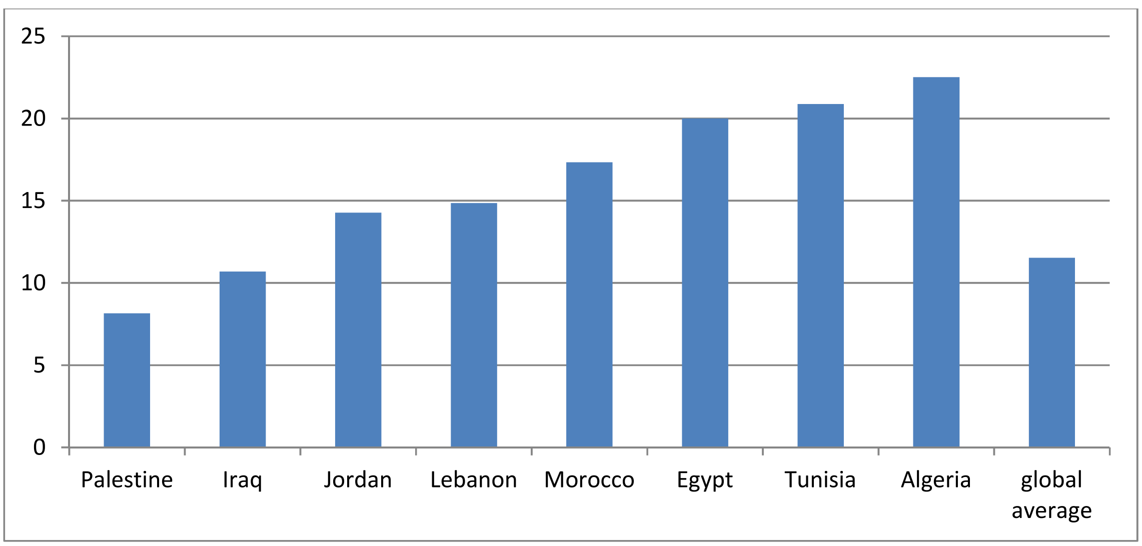
Sources: Gatti, Morgandi, and Grun 2013, 148; Gatti et al. 2014, 90

Figure 13: Difficulty of Redundancy Index (0-100)



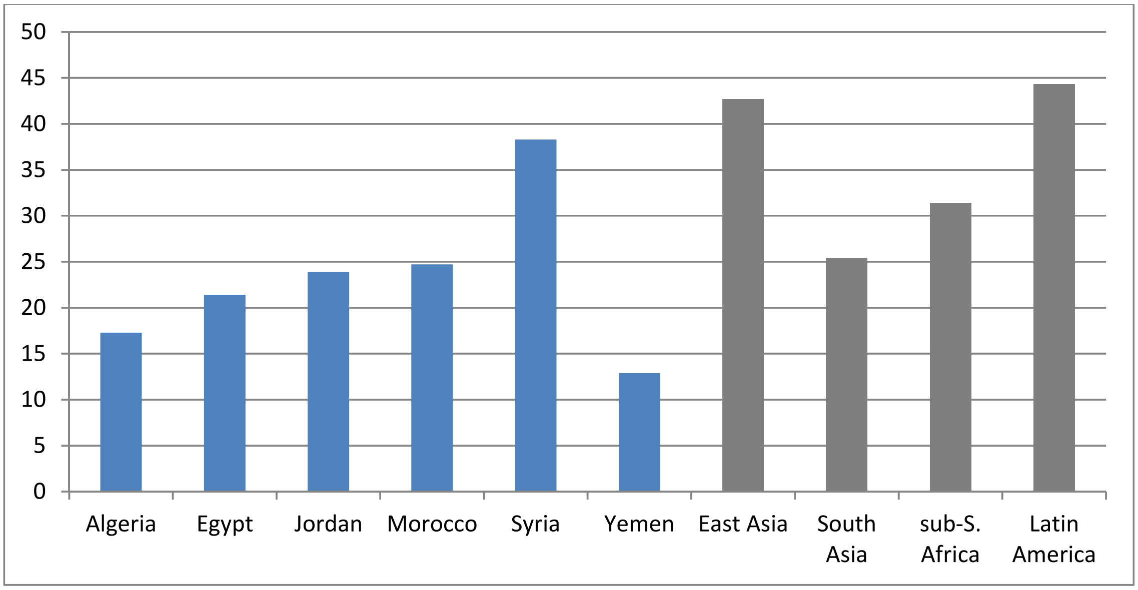
Source: Gatti et al. 2014, 139

Figure 14: Share of Students in Arts and Humanities in Select Arab Countries



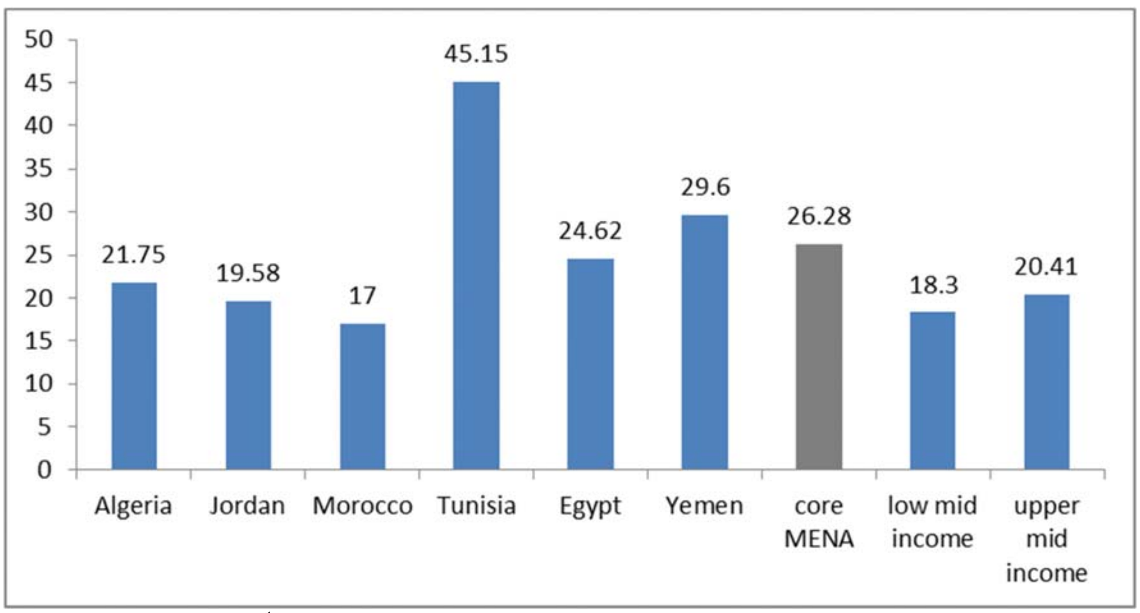
Source: UNESCO

Figure 15: Percentage of Workers Offered Formal Training in Companies



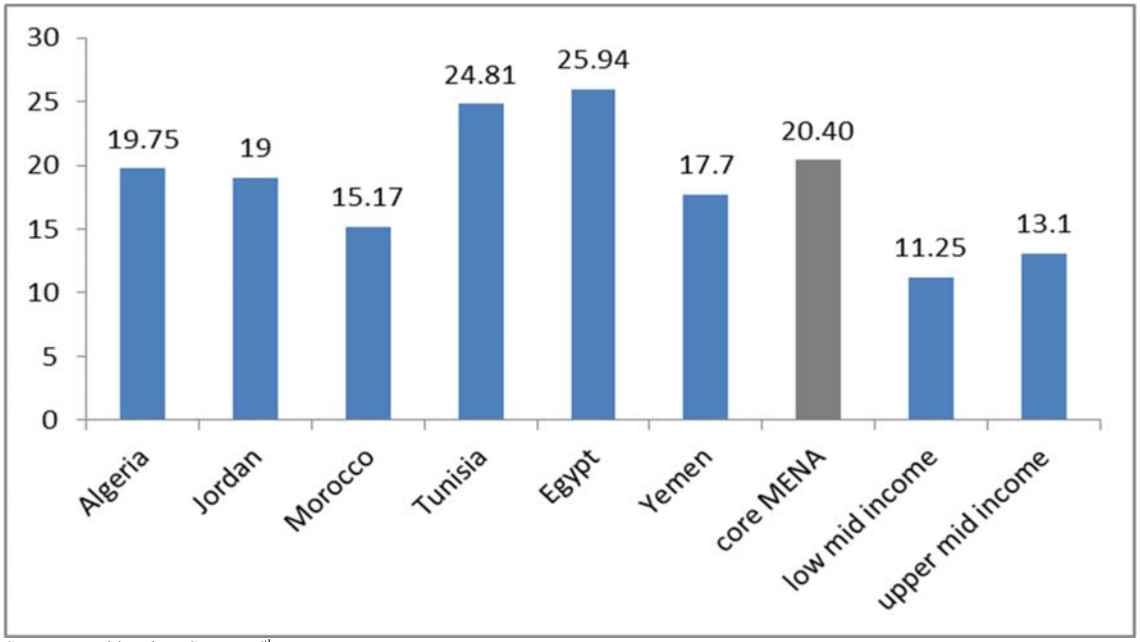
Source: World Bank enterprise surveys, various years

Figure 16: Respondents With "No Trust at All" in Government (WVS)



Source: World Values Survey, 6th wave

Figure 17: Respondents With "No Trust at All" in Large Companies (WVS)



Source: World Values Survey, 6th wave

Table 1: 2015 "Doing Business" Rankings of Core Arab Countries (188 cases)

Tunisia	60
Morocco	71
Egypt	112
Jordan	117
Yemen	137
Algeria	154
Syria	175

Source: IFC Doing Business survey