# The role of cronyism in Arab capitalism

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## Introduction: Arab capitalism

This volume contains many innovative and empirically rich chapters on the extent and mechanisms of different forms of state-business cronyism in the Arab world. The purpose of this chapter is different: it is to locate Arab cronyism in the broader political economy of Arab capitalist systems. It does not provide a detailed empirical investigation of particular instances of cronyism but rather develops a conceptual argument that cronyism is a key component of a broader system of insider-outsider divisions that also extend to labor markets and other spheres of Arab economies.

I will argue that although economic dualism and insider privileges exist all over the developing world, the division is particularly deep and rigid in Arab countries. This is to an important extent explained with a legacy of deep state involvement in the Arab economies under which state ambition has increasingly outstripped state resources. Scarce resources have led to a de facto restriction of material privileges to insider groups, abetted by a legacy of deep bureaucratic intervention that lends itself to the creation of regulatory rents. Insider protection results in low levels of cooperation and trust between state, business and workers, and creates an equilibrium of low skills and low productivity that hampers private-driven growth in the region. This argument is developed mostly on the basis of descriptive, cross-country data.

The chapter is inspired by the “Varieties of Capitalism” literature (Hall & Soskice 2001). VoC theories argue that capitalism in different countries is organized in recognizably different ways. Specifically, transactions in core spheres of capitalism such as the firm, labor markets, and financial markets tend to be based predominantly on market transactions in some countries, while in other countries non-market forms of coordination are more important. VoC, originally developed to describe advanced Western economies, posits that specific forms of interaction in different spheres are complementary to each other and reinforce each other.

I argue that similar mechanisms explain the reproduction of insider-outsider divisions in Arab economies, which exist in different spheres and reinforce each other. The state’s creation of long-term, non-market, insider privileges for firms allows these firms, for example, to provide similar privileges for their (small) formal workforce which is often hired through uncompetitive channels. Banks are able to provide preferential credit to insider firms because such firms enjoy implicit political guarantees, producing insider-outsider divisions in financial markets while also helping to reproduce such divisions in the private sector more generally. Insider-outsider divisions create political feedback mechanisms through which insiders defend their privileges, both because insiders have better access and because outsider status is particularly unattractive and hard to escape in Arab economies.

The focus of this paper goes beyond the mechanisms of cronyism in the Arab world: some of the insider protection described here is legally formalized and extends to large numbers of actors, e.g. when it comes to certain types of subsidies or public employment. Yet corruption and micro-level favoritism between state and business are a core component of the variety of capitalism identified here. Cronyism is abetted by high levels of state intervention which provides opportunities for widespread insider dealing and for the survival of inefficient, crony businesses. As recent research on subsidies and non-tariff trade barriers in the Arab world has shown, cronyism also is a cause for creating and maintaining bureaucratic interventions in the first place. 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.

The advantage of VoC-type approaches is that they allow us to analyze economic behavior in a broader institutional context, taking account of feedback loops that exist between different spheres of economic activity. The disadvantage is relative complexity and difficulty in proving causal links conclusively. The chapter does not claim to evidence all of the hypothesized causal links conclusively; much further research will be needed for this. It does however assert a descriptive claim that insider-outsider divisions and cronyism extend beyond immediate state-business interactions, and that these are often particularly rigid in the Arab world.

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. Although to different degrees, all seven cases have pursued a nationalist, statist development project after independence and during the heyday of Arab nationalism. 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 fits the model developed here rather well. 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.

Given their history of particularly deep state intervention, the formerly “populist” Arab republics Algeria, Egypt, and Syria are closest to the ideal type of state-dominated insider-outsider systems. Relatively more liberal systems like early republican reformer Tunisia and pro-capitalist monarchies Jordan and Morocco are somewhat less perfect fits, as is Yemen, which lacked the historical resources to develop the same level of state intervention as its republican peers. The variation across cases for the most part confirms our hypothesis that statism creates insider-outsider dynamics.

The rest of this chapter outlines the key conceptual features of Arab capitalism, briefly discusses its historical roots and then analyzes its empirical features in sections on the state, the labor market, and the business sector. It concludes with a discussion of the role of cronyism in these spheres and the low levels of trust and cooperation characterizing them throughout.

## An Arab “Variety of Capitalism”

The Arab variety of capitalism proposed here deviates a fair amount from orthodox VoC, notably by according the state a prominent role. Yet it shares the assumptions that forms coordination are similar across different spheres of capitalist activity and that they reinforce each other across spheres.

An ambitious and deeply interventionist state is a core feature of Arab VoC. It creates protection and privilege for some, while marginalizing others. Insider protection for business includes trade-related tariffs and measures, regulatory and licensing privileges as well as access to state-provided credit, subsidies, and land. But the majority of businesses, particularly smaller firms, remain outsiders whose property rights are uncertain and whose interests are not represented in the policy-making process. On the labor market, insider privilege is provided through relatively strong employment protection for the small private formal workforce but also, more importantly, through large-scale, relatively privileged and highly stable state employment. Yet the largest group of workers are outsiders, employed in the insecure informal market, typically for much longer periods than in other developing countries.

The small size of formal employment created by low-productivity private businesses limits labor market participants’ incentives to seek advanced skills, which in turn depresses skills supply and firms’ incentives to invest in productivity improvements (a particularly acute version of what is known as the “low skills trap”(Booth & Snower 1996)). The limited competition that insider businesses enjoy further decreases incentives to invest little in skills, technology and productivity – and in many cases allows firms to extend cronyism to the rigid local labor market through non-competitive hiring practices, making it even less accessible to most job seekers. The limited extent of formal employment also weakens and fragments the structural links between labor and business. Together with a strong popular distaste for cronyism, this creates distrust between workers and capitalists and undermines the potential for class compromise (Przeworski 1986).

Market dualism or segmentation is mentioned in some VoC literature, notably Ben Ross Schneider’s work on “hierarchical” capitalism in Latin American mid-income countries (B. R. Schneider 2013). Schneider points to 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 & Yafeh 2007; F. Schneider & Enste 2000). Yet these features are less central in existing models and, as we will see, dualism in the Arab world is more rigid, with both insider and outsider status being “stickier”.

The VoC model propose here also focuses more explicitly on the role of the state in creating duality for both businesses and labor market participants. 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 that, in many cases, is shaped through long-term crony networks.

Rigid insider groups in business and labor market in turn create vested political interests that make economic reforms that could reduce segmentation difficult, including the necessary move from excessive state employment as a welfare tool to a modern social security system or a reduction of barriers to entry in the private sector. This is similar to Ross Schneider’s account of “political complementarities” in large Latin American economies. But while he mostly describes insiders’ indifference to reform, in the Arab world insiders have more to lose and hence resist reforms actively – in the case of business often drawing on informal networks to stymie policy change. At the same time, encompassing interests or marginalized groups that could push for inclusive reforms have even less space to organize than in other regions.

At least some of the insider-outsider dynamics are also in the interest of regimes as they allow for political divide et impera of business and labor. Important parts of the politically critical middle class are placated through relative privileges on the labor market and important segments of the business class are politically tied to the regime through favoritism. Outsiders such as informal businesses and workers are sometimes controlled through government coercion and otherwise neglected, as informality provides an economic safety valve for over-stretched Arab states (B. R. Schneider & Karcher 2010).

In sum, 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. The core elements and links as described above are summarized in Figure 1. Rigid segmentation of Arab markets into insiders and outsiders is a key factor that hampers private-driven growth and productivity improvements in the region – and cronyism is a key mechanism shaping this segmentation.

Figure 1: An Arab Variety of Capitalism



## Historical roots

This chapter can only give a very brief account of the historical origins of the Arab world’s capitalist systems. Most Arab states started into independence with little by way of state infrastructure and very low levels of social and economic development. They nonetheless embarked on some of the most ambitious projects of state-building anywhere in the developing world, with a deeper presence of the state in the economy than in any other region outside of the Communist sphere.

In the age of Arab nationalism, Arab republics in particular pursued state-led, populist economic programs with a strong element of redistribution (Ayubi 1995; Heydemann 1999). These involved mass state employment, extensive nationalizations, price controls, and subsidy regimes (Diwan & Akin 2015 p. 19). While Arab monarchies did not formally subscribe to the socialist development tenets of Arab nationalism, the ideological competition of the 1950s and 1960s (Kerr 1965) forced them to similarly step up their statist development projects – although less in Morocco than in Jordan, which was much more exposed to Arab nationalists ideologies and threats. Among the republics, Algeria, Egypt, and Syria pursued the route of populist-nationalist state-building the most vigorously.

Arab state-building has led to impressive improvements in human development since the 1950s. But legacies of state-led growth and mass patronage are also at the root of many of their modern problems. Due to slow economic growth, Arab states outside of the oil-rich Gulf have a limited revenue basis and public services that are generous on paper are often rationed in practice and de facto privatized (World Bank 2008, 2013). State employment, at times formally promised to all university graduates, is similarly rationed.

Economic policy has seen considerably liberalization since the 1970s (Diwan & Akin 2015; Ehteshami & Murphy 1996; Richards & Waterbury 2007). Yet state spending as a share of GDP remains considerably above global averages and, as we will see, the region’s statist legacy remains visible in unusually large public sector employment, subsidies, as well as the heavy bureaucratic penetration of the life of citizens and businesses.

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. Partial liberalization has often created opportunities for exclusive access and continued de jure or de facto protection for privileged businesses, condemning other firms to the (often informal) margins.

## The core Arab VoC

The following sections outline the roles of state, business and labor that have emerged from the above history in more detail. It will present data on all core Arab countries as available and provide select international comparisons. 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

While Arab state resources are stretched thin, the state retains a deep presence through a) extensive resource distribution to insiders which crowds out developmental and inclusive forms of state spending and b) extensive regulation of labor markets and business activities.

#### Public employment and subsidies

As mentioned, 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 & Akin 2015) and service quality is often questionable. A more distortive distributional legacy is their ongoing commitment to large-scale public employment. Due to repeat fiscal crises, public employment has been declining – yet it remains high in international comparison.

The shares of public in total employment mostly lie between 20 and 40%, far above those in Latin America (OECD 2014 p. 61), sub-Saharan Africa (Monga & Lin 2015 p. 138), or East Asia and Pacific(Packard & Van Nguyen 2014 p. 16). Redundancies are almost unheard of. While fiscal adjustment has happened through declining real salaries (Said 1996), pay typically remains above private sector levels, especially compared to the informal sector (Bodor 2010; Bodor et al. 2008; International Monetary Fund 2012 p. 44; Yousef 2004).

As a result, the desire for government employment remains high across most of the region, as reflected in a 2014 Gallup poll in which on average only about a fifth of respondents had a preference for private employment while a majority preferred government jobs.[[1]](#footnote-1)

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 et al. 2013 p. 190).[[2]](#footnote-2) 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 employment promises.

Another key distributional commitment of Arab governments is the provision of subsidies, particularly energy subsidies, which are drastically higher than in other regions (Figure 2) and which benefit both households and the private sector. Not only is their distributional impact regressive for households (International Monetary Fund 2013; World Bank 2014a). As access to cheap industrial energy is often rationed in practice, only insider firms tend to benefit from it.

Figure 2: Pre-tax energy subsidies as % of GDP in 2011

Source: (International Monetary Fund 2013)

As governments have been facing fiscal crises, they have started to gradually reduce energy subsidies in recent years (Sdralevich et al. 2014); yet they by and large remain higher than in other developing countries.

#### 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 republics with a stronger history of statist development tend to score worse (Figure 3). Arab states stand out, however, in how they stretch their capacity thin by extensively and deeply intervening in business and labor markets through both distribution and regulation.

Figure 3: Arab government effectiveness in comparison (2012)



Source: World Bank Governance Indicators

Arab governments provide a wide range of support to business, including above-mentioned energy subsidies, but also provision of land and, through state-owned banks, credit (World Bank 2009). At the same time, governments tend to get deeply involved in business operations through administrative intervention. While some of the regulations of the earlier statist period have been loosened or dismantled, many remain: Trade protection, licensing and inspection regimes, bankruptcy procedures and labor rules are seen as particularly onerous in the Arab world. Only Tunisia and Morocco are in the top half of the IFC’s international “Doing Business” ranking of business environments (see Table 1).

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

Trade restrictions similarly remain high: In the World Economic Forum’s global competitiveness index for 2014, all cases bar Yemen rank in the lowest quarter of countries ranked for the prevalence of trade tariffs (Yemen sits at 50%). Available (older) rankings for non-tariff trade barriers look similar (Kee et al. 2009)

Arab countries rank particularly badly in the enforcement of regulations (Gatti et al. 2013 p. 18; World Bank 2009 p. 79). In most core Arab countries, firms polled in World Bank Enterprise Surveys report above-average impact of corruption on their operations; only the two monarchies are close to comparator regions (Figure 4).

Figure 4: Percentage of firms identifying corruption as a major constraint

Source: World Bank enterprise surveys, various years

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 an outcome of corruption combined 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 p. 141). We will now discuss more evidence below that Arab interventions on the private labor market are also particularly deep.

### 5.2 A segmented labor market

Deep intervention through both resource distribution and regulation also characterizes Arab labor markets, resulting in deep insider-outsider segmentation.

Arab labor markets are divided into formal public employment, formal private employment and informal private jobs. Informal private employment dominates numerically, followed by formal public employment; formal private employment is a residual category. As Figure 5 below shows, the informal labor force in the region is large, but not unusually so in international comparison.

Figure 5: Percentage of the labor force not contributing to social security

Source: (Gatti et al. 2014 p. 52)

The Arab region really stands out, however, in the ratio *within* the formal sector of public to private employment. In all of our cases, there are more formal public sector than private sector jobs ((Gatti et al. 2013 p. 148, 2014 p. 90)). This is different from both Latin sub-Saharan Africa (Monga & Lin 2015 p. 138) and Latin America (Galli & Kucera 2004 p. 815).

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 p. 187). In interviews with headhunters in Jordan and Lebanon, “all recruiters unanimously said that hiring is not done in a meritocratic way” (Gatti et al. 2013 p. 189). Fewer firms in the region rely on professional management in hiring decisions than in any other region (Gatti et al. 2013 p. 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 cost of nepotism is in turn lowered by the generally low levels of skills in the population as well as the limited competitive pressures on Arab firms described below (Gatti et al. 2014 p. 160). The presence of insider hiring networks very likely also reduces trust in business.

The detachment of labor market from productive skills is also reflected in unusually low provision of formal training by Arab companies. All countries bar Jordan rank in the bottom third for the “extent of staff training” in the WEF’s Global Competitiveness Index (Jordan is in the 60th percentile). Higher education systems are focused on subjects of no relevance to private labor market (Adams and Winthrop 2015; World Bank 2008b).

Different from the cases Ross Schneider describes in his account of VoC in Latin American mid-income countries, there is little mobility between labor market segments. Very few Arab workers leave the public sector with its security and benefits for private employment (Gatti et al. 2013 p. 52), informality lasts unusually long (Gatti et al. 2013 p. 153, 2014 p. 187) and labor turnover is generally low in the region (Gatti et al. 2013 p. 150f.). All this shows that like for firms, the insider-outsider system in the region’s labor market is particularly rigid.

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 a stable, long-term insider position. It also provides a de facto reservation wage (Gatti et al. 2013 p. 22), in particular for young university graduates, whose unemployment levels in the Arab world are unusually large (Gatti et al. 2013 p. 10), and who have only weak incentives to seek skills relevant for the formal private labor market.

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 remains more difficult in the region than in any other part of the world (Gatti et al. 2013 p. 22). All core Arab countries bar Morocco require the employer to notify government of the dismissal of even just one worker (Gatti et al. 2013 p. 22). The difficulty of making employees redundant is ranked the highest in the world according to „Doing Business” rankings (see Figure 6), 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 p. 24).[[3]](#footnote-3) 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).

Figure 6: Difficulty of Redundancy Index (0-100)

Source: (Gatti et al. 2014 p. 139)

While formal workers are well-protected (and hence cling to their jobs), the state does little for the outsiders that its protective regulations create. Social security is for the most part based on a “Bismarckian” contributory model that provides fairly generous benefits – but only to formal employees (Levin et al. 2012). There is little or no welfare coverage for informal employees and very little experimentation with modern social safety mechanisms like conditional cash grants.

#### Weak and segmented 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 (Cammett & Posusney 2010). Different from business, unions have been additionally weakened through the partial economic liberalizations since the 1970s.

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.[[4]](#footnote-4) The informal sector in the region remains disorganized and unions have done little to push for more inclusive social security or social safety arrangements.

While not well organized in international comparison, the political influence of labor market insiders far exceeds that of the atomized and marginalized outsiders. Their political importance is reflected in the reaction of both existing and new regimes during the regional unrest of 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).

Arab labor markets have been deeply divided by ambitious, interventionist states. Insider status is particularly rigid and outsiders find it particularly hard to break in. The structural link between the formal private sector and the citizenry is tenuous as businesses provide so few good jobs. The weakness of the private labor market decreases incentives to acquire productive skills and increases demand for government jobs and insiders’ incentives to defend their privileges. Coveted formal jobs in public and private sector are sometimes allocated through crony networks, further reducing the efficiency of labor markets, depressing incentives for outsiders to seek relevant skills, and increasing alienation from the system. Labor cannot act as coherent political player as its interests are fragmented by type of employment.

### 5.3 A segmented business sector

Like in the labor market, state intervention divides Arab 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 & 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.

Insider-outsider dynamics are not unique to the Arab world – 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 2014a p. 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 (and typically well-supported) firms and numerous small ones also appears to be more pronounced in the Arab cases than in other emerging markets (World Bank 2014a p. 29). All cases bar Jordan and Morocco rank in the bottom half of the distribution in the WEF’s “extent of market dominance” indicator, which measures business leaders’ perception of the extent to which the private sector is dominated by a few big players. There is a dearth of productive medium size firms across the region (Cammett et al. 2015 p. 17; Diwan et al. 2015).

The link between insider-outsider divisions and cronyism is particularly strong when it comes to business. The original motivation behind bureaucratic intervention in the 1950s and 1960s was for the most part not favoritism but a state-led development ideology. 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.

As recent research has shown (Chekir & Diwan 2015; Diwan et al. 2015; Nucifora et al. 2014), access to state elites and bureaucracy creates a small group of privileged firms. In Egypt, “politically connected” companies under Mubarak provided 11 percent of total employment, but received 60 percent of total net profits among listed firms (Diwan et al. 2015). Politically connected firms in turn push the majority of unconnected businesses into unproductive small‐scale, often informal activities (World Bank 2014a p. 82), where they enjoy weak property rights. In sectors of the Egyptian economy witnessing entry of crony businesses, the distribution of employment has become skewed towards smaller, less productive firms, showing that the presence of crony businesses reduces dynamism and growth opportunities of the rest of the economy (Diwan et al. 2015).

Given both relative scarce resources and continuing bureaucratic intervention, the potential for favoritism in our cases is large. Tools include selective trade protection, access to land, and favourable regulatory enforcement (Diwan et al. 2015). They also include energy subsidies, which we have shown above to be widespread in the Arab world. In Egypt and Tunisia, politically connected businesses are indeed much more likely to be present in sectors that depend on energy subsidies (Eibl 2017).

Similarly, the share of state-controlled banks in the region remains unusually high. Such banks typically have much higher shares of non-performing loans, reflecting potential insider deals (Farazi 2011; World Bank 2009 p. 119). Politically connected firms in Egypt also receive better credit from private banks due to implicit or explicit bailout guarantees in Egypt, effectively locking others out of credit markets (Diwan & Schiffbauer 2016). The WEF’s ranking of the “trustworthiness and confidence” of financial and banking systems in our cases is particularly low, arguably reflecting the prevalence of relationship-based transactions (see Figure 7).

Figure 7: Percentile ranking on the WEF’s financial trustworthiness and confidence indicator

Regulations are not only used but also in many cases created to protect insiders, hence increasing barriers for outsiders. In Tunisia, regulatory restrictions have been shown to be much higher for firms linked to the Ben Ali family (World Bank 2014b p. 112). In Egypt, non-tariff trade barriers have risen disproportionately in sectors in which politically connected businesses are active (see Eibl and Malik in this volume).

In crony networks, state actors often continue to be the senior partners as they can use various tools of coercion and threats to withdraw resources in order to control private firms. At the same time, political elites either neglect or repress outsiders, especially in the informal sector (Singerman 1995).

While corruption is widespread in other developing regions, insider status seems to be “stickier” in the Arab region. 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 8).

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” (Scott 1972), 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. This is also suggested by case accounts of cronyism in specific countries which point to long-term links between ruling and business elites (Heydemann 2004; Roll 2010).

Figure 8: Informality by region

Source: (Gatti et al. 2014 p. 17)

There is further quantitative 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 (Gatti et al. 2013; World Bank 2009). 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 p. 103).

The Tunisian case has been particularly closely investigated after the regime change in 2011. Research has shown that few Tunisian firms manage to grow, there is little churn among businesses and exit rates are low (World Bank 2014b). Resources like capital and labor are not reallocated over time to more efficient firms and firm growth is only weakly correlated with profitability – all of which are signs of insider privilege and the cost it exacts in terms of the low overall dynamism and efficiency of the private sector (Angel-Urdinola et al. 2015 pp. 29–31). The patterns are “at odds with the up-or-out dynamic often observed in developed countries, in which entrants tend either to survive and grow or to exit” (Angel-Urdinola et al. 2015 p. 29).

Low dynamism is not limited to Tunisia. Figure 9 below shows the average annual number of new limited liability companies registered per 1000 residents in the 2000-2009 period in different countries and world regions. The core Arab cases for which we have data, and the MENA region more broadly, rank at the very bottom, even below the Tunisian number.

Figure 9: Annual number of newly registered companies per 1000 inhabitants (2000s average)

Source: (Klapper & Love 2011)

Insider-outsider divisions of business seems to lead to different perceptions of the business environment: As shown above, World Bank Enterprise Surveys, which are mostly conducted with small to medium size businesses, show a high prevalence of corruption. The World Economic Forum’s elite-oriented Executive Opinion Survey by contrast is more generous, placing three of our seven cases (Egypt, Jordan and Morocco) below the global average in its indicator for irregular payments and bribes. If we assume that the executives of the leading companies surveyed by the WEF are indeed insiders, it would be no surprise if they complained less about bribery.

Insider-outsider dynamics might also affect corporate organization in the Arab world. Large, diversified private groups – which some authors see as a reaction to weak institutions (Khanna & Yafeh 2007) – dominate business in the region. If connections are a company’s main comparative advantage, then this advantage can presumably be leveraged in many markets, which would explain the prevalence of far-flung conglomerates. The prevalence of family businesses in the region might similarly have to do with the types of long-term, informal networks of trust and favoritism that can be built around kinship structures.

Modern corporate forms in general are not widespread in the region: Most businesses in the Arab world are sole proprietorships and few companies are publicly traded. 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.

The exceptionally low dynamism of the closed world of Arab business has led to weak performance on 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 pp. 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 p. 12).

#### 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 p. 187). Given the prevalence of insider structures and favoritism, businesses often find individual, informal strategies more effective in pursuing their interests and dealing with an interventionist state (Hertog 2012).

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 et al. 2014). Eibl and Malik (this volume) have documented the same for non-tariff trade barriers in Egypt.

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 p. 188). The informal sector is particularly marginalized in the policy process.

As a result, effective demands for rule of law and for improvements to government effectiveness are weak 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 while others only seek individual advantages (Hertog 2012). In Arab economies, like in the “coordinated market economies” (CMEs) of the original Varieties of Capitalism theory, businesses often rely on non-market, informal coordination mechanisms, including in their dealings with the state. But different from CMEs, in the Arab world these mechanisms are individualized and often used for favoritism rather than for policy coordination.

### 5.4 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. 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 high barriers to entry.

The result is a static and unfair insider-outsider system that incentivizes cronyism, undermines the formation of encompassing interest groups and prevents inclusive coordination of production, skills and economic policy 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 10; 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.

Figure 10: Respondents with “no trust at all” in government (WVS)

Source: World Values Survey, 6th wave

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 11).

Figure 11: Respondents with “no trust at all” in large companies (WVS)

Source: World Values Survey, 6th wave

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 data also show that perceptions of corruption in business and government go together, highlighting the crony nexus that undermines public trust. 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 there too (World Bank 2009 pp. 87, 89).

Levels of trust in society are influenced by many variables. Yet the variation between Arab cases and the distinction between views of large and entrepreneurs suggest that cronyism explains some of the low levels of trust across the region. Distrust in established large businesses was on vivid display during the demonstrations of the Arab uprisings in 2011, when frustration with cronyism was one of the key factors motivating citizens to mobilize.

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 & Uslaner 2009)(Zak & Knack 2001)(Algan & Cahuc 2013)(Algan & Cahuc 2010).

## Conclusions

Heavy state intervention divides individual firms and workers in the Arab world into insiders and outsiders. This enduring division enables crony networks and in turn is shaped and deepened by them. It undermines skill formation, efficient allocation of resources, private-driven growth, and the formation of encompassing interest groups. Prevailing low skills and a weak private sector in turn create demand for more protection and support from 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 appear 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 but 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 defending 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 appropriated for private ends in the course of partial liberalization.

The same is true for segmented labor markets: exclusion emerged by default rather than 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 in a case like Tunisia which has jettisoned its old authoritarian leader.

A wider VoC approach to Arab capitalism helps us explain not only the persistence of low productivity and business dynamism in the Arab world, but also the resilient nepotism following the fall of several Arab dictators in 2011. 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). Successful reforms will have to address exclusion, barriers to entry and vested interests in several spheres at once.

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1. Aggregate data made available by Ishac Diwan. [↑](#footnote-ref-1)
2. For details on Algeria, Egypt, Morocco, and Syria, see (World Bank 2003). [↑](#footnote-ref-2)
3. For more similar statistics, see <http://www.imf.org/external/pubs/ft/reo/2011/mcd/eng/pdf/mreo1011.pdf> [↑](#footnote-ref-3)
4. <https://www.middleeastmonitor.com/news/africa/21242-tunisian-government-raises-public-sector-salaries> [↑](#footnote-ref-4)