The Future of the Private Sector in an Age of Uncertainty
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The chapter is concerned with the future of state–business relations (SBRs) in the MENA region, and about the potential for private sector growth. Can the new environment of heightened popular demands and lower oil prices encourage the political regimes in place to improve their efforts at boosting economic growth, even at the political risk of tolerating a larger private sector? The chapter outlines four types of relatively successful SBRs models that have taken hold in the MENA region, and asks if particular models can be replicated in the rest of the region. It outlines how the intensity of social movements, and the ways the state reacts to them, influences the formation of SBRs. The main conclusion is that for many regimes, there seem to be only bad options to choose from, ushering an age of dilemma with uncertain choices and prospects.

1. Introduction

This volume has shed new light on the nature, mechanism, and impact of dominant forms of cronyism in the Middle East. We conclude in this chapter with a discussion of what these studies, and further political economy analysis, suggest about the future of state–business relations (SBRs) in the region, and about the potential for private sector growth.

In thinking about the future, one cannot escape the need to reflect on how two major recent shocks will reshape the political economy of the region: the uprisings of 2011–2012 and their aftermath, and the oil shock of 2014–2015. Economically, both have represented negative shocks, unbalancing the economy and lowering growth. While short-term concerns are about stabilization, the prospects of low oil prices in the medium and long terms, and of increased social restlessness, pose fundamental challenges to all countries’ development trajectories. More than ever, a dynamic productive sector is essential for creating the jobs that increasingly educated youth aspire to.

Countries where the uprisings of 2011 remained largely peaceful, such as Egypt, Tunisia, Morocco, and Jordan, are engaged in finding a new political equilibrium—in some cases through an opening up of politics, and in others through a restoration of hard autocracy. At the same time, the region is in the midst of a particularly dangerous period of its history, marked by rising regional polarization and ongoing proxy wars in Syria, Libya, and Yemen, which in addition to the older Palestine–Israel conflict, risk setting the stage for a large regional conflagration. In such an environment, external forces may end up

1 I would like to thank, without incriminating them, Izak Atiyas, Eberhart Kienle, Adeel Malik, Moustapha Nabli, Eric Rougier, and Steffen Hertog for their valuable comments and suggestions, which have led to multiple revisions, and hopefully to improvements of this chapter.
playing a more important role than internal circumstances in shaping economic performance. Nevertheless, the long-term prospects of the region would be greatly enhanced if a few countries start finding their place in the evolving international division of labor, which other countries of the region could emulate over time.

The question then is whether the changing conditions affect the political equation in ways that may allow the private sector to become an agent for change in the future. Can the new environment of heightened popular demands and lower oil prices encourage the regimes in place to improve their efforts at boosting economic growth, at the political risk of tolerating a larger private sector, and even of encouraging it? And if so, what type of political adaptation and change would be required?

In order to gauge the terms of this trade-off in the region, it is necessary to develop a broad analytical framework that connects SBRs with the nature of political power and with the intensity of social movements. In keeping with these broad themes, I follow Kelsall and vom Hau (2017), Khan (2010), and North et al. (1990) by focusing on a political economy framework that highlights how state, business, and civil society relate to and interact with each other to form a political settlement. The broader frame is useful in understanding how SBRs in the region were structured because, as I argue in the chapter, social movements, and how the state reacted to them, influenced their formation in important ways. Moreover, in both of these respects, there were also variations among the countries of the region and over time. It is thus important to reflect how political settlements vary, and how they may evolve over time, in order to be able to project the probable path of the private sector in the various countries. In delineating the different forms that SBRs have taken in the region, I outline four main types of relatively successful models that have taken hold, and compare them with examples of SBR cum political settlements observed in other developing countries around the world.

The characterization of political settlements of the countries of the region is deeply colored by an important distinctive feature underpinning their SBRs compared to the rest of the world. This distinction concerns the particular distrust felt by the regimes of the region for an independent and emancipated private sector, which is related to the fear by governing elites of the emergence of autonomous actors that could threaten regime durability. This is reinforced by the ability of many regimes to use external and natural resource rents for the financing of coercive security systems, and, in some countries, by the inheritance of a state that sees the private sector as a political competitor by excellence.

The chapter thus starts, in section 2, by outlining this specificity. It then explores in section 3 how exclusion has colored SBRs. The analysis is broadened to a political economy approach, with the goal of investigating the ways in which the prevalent phenomenon of exclusion can be linked to the particular forms that state–society relations have taken. Section 4 develops a typology of political settlements cum SBRs, which are applied to the region in section 5. Section 6 explores in some detail regional variations and describes four political economy models that have delivered some growth in the region. Finally, in the section 7, I explore how the twin-macro shock introduced above is
likely to affect the incentives of regimes to open up the polity and to allow for broader forms of economic inclusion. Opening up may challenge the prevailing mode of governance in the short term; but the lack of private sector inclusion means lower growth and higher levels of popular discontent in the long term, illustrating the central thesis of Acemoglu and Robison (2012) that nations fail when they are built on political and economic exclusion. For many regimes, there seem to be only bad options to choose from, ushering an age of dilemma with uncertain choices and prospects.

2. The Private Sector as a Political Actor

When it comes to SBRs, the high sense of distrust that politicians developed toward an autonomous private sector may well be at the heart of the specificity of the MENA region. While private sector development may have been the apparent mantra of development plans in the 1990s, autonomous private firms were in fact largely perceived as a potential political threat by autocrats, if they were not kept under control. As is clear from the various chapters in this volume, private sector development has been deeply affected by political efforts to align economic interests with power structures. Indeed, analysts of the MENA region have come to conceptualize markets as political spaces, with reforms being seen as processes of re-regulation as opposed to one of de-regulation (Heydemann 2004). Political logic infuses markets, not just because of concerns about redistribution, but also through the organization of rent extraction and distribution in ways that preserve regime durability (Chaudhry 1994). In this vein, the political science literature during the liberalization phase makes the political management of the private sector the central mechanism that resolved the contradictions created by the gradual liberalization of the region’s economies while political power remained highly autocratic.

By the late 2000s, “imperfections” in economic policies and SBRs became the central focus of attention, as they provided a way to understand how weakening regimes managed to redefine the rules of the game by building alliances with a supportive business elite to create new sources of patronage, but also to neutralize possible opposition.² Henry and Springborg (2010) argue that in Mubarak’s Egypt, the regime acted to discourage potential manifestations of political behavior by business elites by using intimidation and managed predation when needed. When business interests become too autonomous, politically driven re-adjustment took place, such as anti-corruption campaigns and tighter banking regulations, to weaken successful businessmen with interests in politics and in some cases drive them out of the country.

By 2018, state dominance over the private sector has become more salient, with a recent wave of state expropriation aimed at power consolidation after the Arab Spring, unseen since the large nationalizations of the 1950s and 1960s.

• In Tunisia, more than 220 firms owned by Ben Ali’s associates were expropriated after 2011 (and then partly resold). New networks of connected firms, associated with the new parties, arose and corruption has reportedly risen.

• In Egypt, companies suspected of connections with the banned Muslim Brotherhood (with a reported value of several hundred million dollars) were expropriated between 2014 and 2016 by presidential decree. The Mubarak cronies were largely rehabilitated, but they retain much less influence than in the past, with state favors now supporting a new network of army-associated firms to drive economic growth.

• In Turkey, assets worth billions of dollars of Gulenist-connected firms were expropriated after the failed coup d’état of 2016, under a regime of national emergency with little judicial oversight. The media has come to be dominated by crony interest and now closely toes the regime’s line.

• In Syria, the old bourgeoisie, which had made a comeback during Bashar al-Assad’s short-lived liberalization, was wiped out and replaced by a new elite that fed on the spoils of the war economy. A recently issued law (Law 10 of 2018) allows for the expropriation of large swaths of real-estate property left behind by millions of refugees and internally displaced people (IDPs), in the context of new mega real-estate developments organized by the new cronies under the guise of “reconstruction.”

• In Saudi Arabia, some of the richest businessmen of the kingdom were expropriated in 2018 in what became known as the Ritz-Carleton incident, where, reportedly, assets worth US$100 billion in corruption payoffs were “returned” to the government’s coffers.

By contrast, the other recent grand corporate scandals around the world do not involve outright expropriation. The three most prominent cases in 2017–2018 involving Odebrecht in Brazil, Samsung in Korea, and 1MDB in Malaysia led to the criminal persecution of corporate officers and even of politicians on charges of corruption, and, in all cases, to a weaker rather than harsher state control over the private sector. 3 To be sure, the Middle East is not unique in the dominance of the state over business. 4 But it remains that, more than in other regions, political regimes in MENA countries are deeply involved in managing the business sector, using all kinds of ways to keep firms in check, and that when they get in trouble, they are willing to go as far as strategic predation and even expropriation in order to prevent firms from playing an active political role that could threaten their rule.

3 In the first case, a construction firm was found to have spent several billion dollars bribing politicians in several Latin American countries (Peru, Venezuela, Mexico, Brazil) to get construction contracts (and many of the bribes were contributions to election funds). In Korea, Samsung’s payments seem to have been initiated by requests from the president. In Malaysia, president Najib Razak and his close circle were accused of having stolen funds from a development bank.

4 In Russia, the Putin regime expropriated many of the oligarchs that came to dominate the economy under the Yeltsin presidency. Similarly, Thaksin Shinawatra’s wealth was partly expropriated in Thailand in the 2000s to weaken him politically.
If the dominance of politics over economics and the private sector is a characteristic of the region, several important questions arise: What is it in the political environment that gave rise to this drive for control? What were the implications for growth? And how is this likely to evolve given the new economic and political developments in the region? Before addressing these questions, it is useful to start by building up a conceptual framework that clarifies the possible political functions of cronyism. Section 15.3 does this and prepares the ground for a broader discussion in subsequent sections on how different types of SBRs get inscribed into the broader political and social structures of these countries.

3. Variety of SBRs

The term “crony capitalism” has come to describe all sorts of SBRs, the same way the term “corruption” has come to describe all sorts of non-institutionalized distribution of benefit, from pure theft, all the way to informal political payoffs that can be at the base of political settlements (Khan 2010; North et al. 2009). Different types of crony capitalism are prevalent across the world and can lead to different types of economic outcomes. This is because relations between state and business can represent different types of “exchanges,” depending on the type of political settlement in which they are inscribed. Thus, to understand MENA specificity and business dynamics in recent years, we need to start by unpacking its SBR “terms of exchange.”

It is useful to focus on the SBR in terms of its patron–client characteristics, where the state is (typically) the patron. The terms of the patron–client relation is bargained between the two sides. These relations tend to be personalized, sometimes through matrimonial relations or institutionalized, for example in the form of an industrial policy that supports state champions. On the business side, privileged firms can get at minimum a commitment from the state to refrain from predation (i.e., to secure the owners’ property rights), which can be especially valuable in environments where state institutions do not function well (Haber 2013). But payoffs can be much larger, especially if corporate political functions grow. As discussed in the Introduction of this volume, privileges can take the form of favored treatment by regulatory authorities, trade protection, and privileged access to public contracts, credit, land, and infrastructure.

What the politically connected firm delivers to the patron in exchange varies, depending on the particulars of the political settlement. Broadly speaking, privileged firms can provide three types of pay-back to politicians.

First, politically connected firms may pay-back the favors they receive by generating jobs. This is especially valuable for long-lived patrons that are willing to invest some of their political capital to increasing the size of the economic pie. This form of SBRs is most prevalent as part of an industrial policy, whose goal is to correct market failures, including by intervening in the credit market (Krueger 2002). Firms participating in this
type of SBR stand to be in sectors that are most likely to have growth potential.\textsuperscript{5} Let us denote this type of SBR by type I.

Second, politically connected firms can provide a financial pay-back to politicians and bureaucrats. This can include bribes to make the wheels of a dysfunctional bureaucracy churn, which can improve overall efficiency. But these informal pay-backs can also play a more political role, such as supporting election finance and/or capturing the media for the benefit of the patron. More ambitiously, rents can be extracted and distributed to the political elite as a way of binding them into the governing coalition, including by setting up clientelistic networks that offer jobs and services to clients lower down the chain (North et al. 1990). In all these cases, privileged firms would typically operate in rent-thick sectors (for example, in the construction and natural resource sectors), where state favors can easily be directed in discretionary ways. To the extent that this type of cronyism is limited to a small range of sectors, it may have a moderately negative overall impact on growth.\textsuperscript{6} Let us denote this genre of SBR, which would be expected to be more prevalent in more competitive polities, by type II.

Third, politically connected firms can play a more active political role, becoming part of a system of policing markets in ways to prevent non-elite owners of capital from jointly and collectively challenging political authorities. Privileged firms are driven in all these cases to occupy market spaces in ways that deny growth opportunities to the unconnected. This type of cronyism would tend to take place more in sectors with high growth potential, since this is where there is new room for autonomous agents that could end up supporting a political opposition to take root and grow. This type of political pay-back is more likely to be costly in terms of economic performance, and it would be valuable only for regimes that care more about short-term survival than about long-term performance (Khan 2010). Let us denote this genre of SBR, which would be expected to be more prevalent in autocratic polities, by type III.

In actual political economies, one would expect SBRs to have some elements of each type described above—but there is likely to be a dominance of one type over others. For example, the relation between President Mubarak and the top 30 connected families must have entailed a commitment to growth and job creation. But the cronies were also expected to finance the regime’s political campaigns, to dominate the “free media” in ways that supports the regime, and to fund the regime’s puppet social projects. But arguably, the most central role of this elite group was to ensure that no autonomous forces would be allowed to grow to occupy space in the heights of the Egyptian economy (see chapter 2). Politics ruled in the specific sense that when politics required it, markets

\textsuperscript{5} The fact that privileges may be needed to boost investment incentives is related to the difficulty of reaching what North et al. (1990) call “an open order,” recognizing instead that in developing countries, the rule of law tends to be imperfectly applied. When political risk is high, and/or when domestic firms are far from the global competitive frontier, the provision of rents becomes more necessary as an incentive for investment.

\textsuperscript{6} In the spirit of North et al. (1990), one can also argue that such rent extraction and distribution has a positive overall impact, at least in the short term, by strengthening the political order and preventing violence.
were distorted even if the economic cost was large. This occurred, for example, in the 1980s when the Islamic finance system was badly hurt by efforts to tighten banking regulations in ways to reduce sources of finance for firms associated with the Islamic political opposition (see chapter 2).

One important issue is the extent to which the determination of the quality of SBRs is a result of a deliberate political project that aligns money with power, or the by-product of more endogenous factors, such as a country’s inheritance in terms of countervailing institutions, or the result of lobbying by economic elites. In reality, both types of processes are likely to move in parallel, as politicians try to extract as much as they can from connected firms, and the firms try to influence power in ways that benefit them. At the end of the day, the relation between elite power and elite money is a matter of bargaining, and one thus expects that as a ruling power’s political position weakens, that of its crony firms rises (i.e., there is a relative move from type I to type III SBR), as they get entitled to demand a higher return on their investments given the prevailing higher political risk.

Thus, “crony” SBRs can have positive or negative effects on growth, depending on the type of pay-back expected from the client firms, itself determined by the broader political economy perspective. The positive and negative feedback loops from SBR to economic performance and growth have been illustrated in several chapters (2, 4, and 5).7 Generally, the question is whether firms—privileged or not—have an incentive to invest in productivity upgrading methods or in rent-extraction efforts. Type I SBRs favor employment and productivity, while type III push toward a rent-seeking economy, with type II in an intermediate position. Those incentives are also influenced by other factors that affect corporate returns on investment. As argued, high political risk pushes firms to require more privileges and higher returns to invest. Weak fiscal accounts, which lead to low investments in infrastructure, reduce competitiveness and can have the same effect. Finally, the farther away domestic firms stand from the global technology frontier, the more they have incentives to invest in political relationships and rent extraction. In general, one can think that more corporate exclusion is detrimental to growth, but with the caveat that a narrow but well-managed economic elite can also generate growth.

Given the prevalence of the exclusionary motive in the MENA region, the presumption is that SBRs have been largely of the third type, leading to a narrow business elite and to poor economic performance.8 Indeed, growth rates have remained modest post

7 As summarized in the Introduction chapter, several chapters of the book focus on analyzing how specific mechanisms of economic exclusion lower economic performance, including by weakening competition and the incentives of both privileged and non-privileged firms to innovate, by leading to higher levels of informality, by fostering inefficient utilization of capital, and by advantaging rent-seeking over productivity growth by the entrepreneurial class.

8 Pritchett et al. (2017) classify state–business relations (which he terms deals) in ways that can be more directly related to good versus bad corporate dynamics. He focuses on two characteristics of such deals: how open versus closed they are, and whether they are ordered or not. The best firms dynamics are generated when deals are open and ordered—that is, rules are predictable, and there is little exclusion. Lower but possibly nevertheless positive performance is associated with closed and ordered deals—here rules are restricted to a narrower elite, but their property rights are protected in a predictable manner.
liberalization, at between 2 and 4 percent per capita during the 2000s. From a long-term perspective, even this modest performance was not sustainable because it generated large social discontent. For market-led growth to be sustainable, it must allow for structural change, which requires a socially acceptable management of urban migration, education upgrading, and sufficient social provisioning to protect labor from market shocks. Moreover, the type of growth needs to be sufficiently labor intensive to reduce unemployment rates, particularly among the growing cohorts of young graduates. As apparent with the eruption of social discontent in 2011–2012, these conditions were not satisfied in much of the MENA region two decades or so after the market reform process was initiated. In the chaos that followed the uprisings, growth collapsed in much of the region.

4. A Typology of Political Settlements (and SBRs)

It is necessary to expand the discussion to the broader realm of evolving political settlements in order to better understand both the genesis and the implication of the narrow form of crony capitalism that developed in the MENA region post market liberalization. For our purposes, it will be useful to think of a political settlement as a three-way arrangement between the state, the business sector, and other parts of society, which ensures some coherence between the interest of the regime in power and society in ways that can be sustained for a period without generating forces of self-destruction. In the context of a study of the MENA region, we are particularly interested in variations in political settlements according to two dimensions: the extent of social demands and contestation, and the reaction of regimes to such demands. In what follows, we adopt a

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9 While this performance was better than during the adjustment phase of the 1980s and 1990s, it did not keep up with the average of developing countries during this period (5 percent), nor did it approach the 6 percent and more observed in the fast-growing economies of East Asia.

10 Indeed, and for these reasons, throughout the world, growth tends to be episodic—easier to initiate than to sustain over long periods (Hausman et al. 2005; Sen 2013). The main characteristic of growth that is of interest from a long-term development perspective is its ability to be sustained over a long period without generating political instability that directly threatens the end of the episode, due to rising social grievances, or indirectly, through generating unsustainable macro-imbalances.

11 According to North et al.’s (2009) most general definition, a ruling coalition that monopolizes violence potential remains in power by restricting organizations in ways that generate rents to finance itself and to keep other groups from developing violence potential. The political economy sustainability depends on two conditions. The first condition relates to political sustainability: The rents extracted must be large enough to support the viability of the coalition, including keeping society from contesting the political order. The second condition is economic: The restrictions on organizations must not be so large as to unduly hurt the economy, which would threaten the long-term stability of the regime.
variant of a model developed by Tim Kelsall and Mathias vom Hau, because it focuses on these two features as the main factors differentiating diverse settlements.

In such a political economy frame, economic growth requires that labor be healthy, equipped with marketable skills, and protected from market shocks in ways that foster the type of flexibility that allows migration to cities and to rising sectors. But the provision of social services should be financeable in ways that do not crowd out important investment in competitiveness, such as the provision of adequate infrastructure. Thus, social demands should not lead to the type of contestation that increases political risk unduly (since this depresses investment incentives), or that creates unsustainable pressures for fiscal expenditures to pacify society. Our main interest is to explore the role of social and political developments in shaping SBRs, addressing such question as: How do social forces by powerful groups such as the old statist middle class or the emerging new market-oriented middle class affect SBRs? How did the region’s “autocratic bargains” evolve in the face of these pressures? And did social discontent play a role in fostering a narrow form of cronyism?

The choice between political stability and economic performance presents a central trade-off, and, as a result, different settlements will have different characteristics in terms of growth and stability (Khan 2010). In particular, when social demands rise because of low economic growth, regimes come under threat, and they can try to re-establish regime durability in one of the two ways. A repressive strategy entails more restrictions on the entry of new organizations, which may stabilize politics in the short term, but at the risk of hurting long-term growth by reducing competition and innovation. An inclusive strategy, on the other hand, tries to enlarge the size of the governing coalition by reducing restrictions on entry and increasing social expenditures, which may result in more stability and growth in the short term, but which can become politically unsustainable if growth is not sufficiently increased.

The choice between these two different strategies depends on a multitude of factors, some historical and inherited, some structural, and some subject to agency (particularly during critical junctures). During these policy adjustments, elite cohesion is tested, especially if reforms reduce rent extraction, creating a political dilemma whose resolution depends on country circumstances. If the political adjustment selected entails concessions by existing elites, there will be a broadening of the governing coalition through the social and economic inclusion of particularly vociferous groups. On the contrary, existing elites may split and become narrower by relying more heavily on the stick of repression and exclusion, political and economic.

Thus, whether the political management of the growth process has positive or negative effects on SBRs depends largely on the scale of social demands, and on whether regime

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12 In this regard, it should be noted that both low and high growth can unleash new social demands and lead to a rise in political contestation. When growth is high, aspirations connected to modernizing forces are raised, which can generate pressures on the state for better state services and better economic performance. Conversely, when growth is low or unequalizing, grievances among particular groups, such as the poor or the educated unemployed youth, can rise.
survival strategies advantage more accommodation and inclusion or whether they settle for repression and exclusion. In a highly heuristic set-up, one can represent the possible outcomes of the interactions between social demands and political responses in a $2 \times 2$ matrix, as in Table 15.1, where the x-axis represents the intensity of social demands (relative to economic growth) and the y-axis represents the regime’s political survival response in its choice of exclusion/repression versus inclusion/accommodation of these forces.\(^{13}\) We get four ideal types of political economies, which I term the development state, repressive populism, clientelistic competition, and inclusive growth.\(^{14}\) Each ideal case embodies a particular form of SBR. Economic performance is expected to be stronger along the diagonal than in the off-diagonal cases.

### Table 1. A global typology of political settlements cum SBR types

<table>
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<tr>
<th>Power relations</th>
<th>Social pressures (given growth performance)</th>
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<tbody>
<tr>
<td>Low inclusion/high exclusion</td>
<td>SBRs: closer to type I Development state e.g., South Korea</td>
</tr>
<tr>
<td>High inclusion/low exclusion</td>
<td>SBRs: mostly type II Clientelistic competition e.g., Ghana</td>
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*Source:* Adapted from Kelsall and vom Hau (2017).

Broadly speaking, the MENA countries belong to the high social demand/low inclusion case, but there are regional variations around this archetype. Before describing in more detail how the MENA countries fit on this map, it is useful to illustrate the varieties of crony types of capitalism worldwide, in order to better appreciate the ways in which societal demands and regime responses form different political economy “equilibria” at least for a period. To do so, it will be useful to focus the discussion on four examples: the Korean, Russian, Ghanaian, and Brazilian iconic cases.

The *Korean model (circa 1970–1990)* is that of a classic development state. It emphasizes tight monitoring by the patron for performance—the main chaebols obtained many economic advantages, but those that did not deliver rising exports risked having their owners go to jail (Kang 2002). Khan (1998) notes that the small size of the middle class in Korea (an inheritance from Japanese colonialism) allowed the Park regime to easily suppress demands for redistribution and, as a result, to be able to sustain high investment rates (including in infrastructure) for a long period. In this model, the state supported select businesses, which created jobs, thus ushering a long virtuous circle of

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\(^{13}\) The economic, social, and political domains interact in complex ways, and there are many possible political settlement resolutions, connected to particular internal and external circumstances and historical legacies. In what follows, I simplify this complex system by presuming that the main causal forces run from social grievances to political conditions in the medium term, which determine a country's capacity to resolve its economic challenges over the long term.

\(^{14}\) For more detail on the character of each type see Kelsall and von Hau (2017).
growth and relative political stability. The particularity of the Korean case is that social demands arose quite late in the development process, allowing rulers to have a strong bargaining position relative to protected businesses, and to thus extract from them a high level of performance. The resulting SBRs thus closely resemble type I—in effect, power is itself infused with an economic logic. In its ideal form, this type of political economy is immune from political and social pressures, and, in effect, it lowers the transaction costs imposed by the political realm.

In contrast, the Russian model of Vladimir Putin, which is also autocratic, emphasizes extreme business exclusion as a survival strategy, based much more on preventing any opposition from taking root in the country than on buying consent by delivering economic performance. In this model, only firms closely affiliated with the regime have secure property rights and are allowed to operate at the heights of the economy. The crony firms also cooperate with the regime’s political endeavors (Lansky et al. 2018). This model was shaped by Putin’s instrumentalization of a popular yearning for the restoration of national sovereignty in the face of a perceived collapse in Russia’s global standing, and as a substitute to the Yeltsin model where oligarchs came to dominate not just large swathes of the economy but also polity itself (not unlike the Latin American situation of hierarchical capitalism). Social aspirations are in effect deflected through nationalistic appeal and, when needed, through repression. Thus, Russian SBRs resemble closely type III—markets are completely infused in the political realm and their access is tightly guarded. In this type of political settlement, the “agency costs” of politics can be quite large in terms of their implications for economic efficiency.

More competitive systems offer a range of possible outcomes. The Brazilian model under the presidency of Luiz Inacio Lula Da Silva (2003–2011) departed from the low-growth Latin form of hierarchical capitalism (dominated by large corporations) by cultivating social provisioning for the poor, supporting SME growth and improved competition, and boosting aggregate demand by supporting household investments. This was achieved by tax reforms, better access to finance, and a more expansive safety net. The model has delivered growth as long as high commodity prices allowed for expansionist policies, but came under pressure under the presidency of Dilma Rousseff, when the commodity boom ended (Bresser-Pereira 2015). While capitalism expanded by becoming more inclusive, the Odebrecht scandal reveals that in rent-thick sectors (especially construction) politically connected firms had remained dominant, repaying the favors by bribing politicians and financing their political campaigns. The type of SBRs that emerged were thus a combination of types I and II, with growth boosted by inclusion but taxed by the relatively high “agency costs” related to political competition. The specificity of Lula’s center-left policies is that they managed to stabilize the macro economy, after years of mounting debts and deficits. The political “agency costs” were likely to be limited in magnitude, although they could rise in competitive systems heavily reliant on clientelism.¹⁵

¹⁵ In the spirit of North et al. (1990), one can also argue that such rent extraction and distribution have a positive overall impact, at least in the short term, by strengthening the political order and preventing violence.
Finally, the Ghana model (post 1992) is one of a society divided by ethnic affiliation and susceptible to a very competitive form of clientelism. In this model, the corporate sector dominates politics, possibly even becoming the patron in its relation with politicians, but excessive political competition has led to steep electoral budget cycles and to repeated and prolonged periods of macro instability. At the same time, political competition and the resulting political turnover have generated a system of competing cronyism with frequent changes in the identity of the networks of privilege (Abdulai 2017). This has increased the cost of doing business and political risk, and, together with macro instability, has led to reduced incentives for private investment. The resulting SBR here closely resembles type II, where the “agency costs” created by an overly competitive and low cooperation political system stymied growth. But some growth “on the edge of chaos” does take place, as political competition creates incentives for politicians to deliver on some reforms, especially before elections (Levy and Fukuyama 2010).

Several implications that will be of interest for the analysis of SBR cum political settlements in the MENA region can be drawn from these iconic examples. First, cronyism, in the sense of the politically motivated and strategic articulation of exclusion (repression) and inclusion (privilege), characterizes SBRs in all these cases, with privileged firms, close to politicians, standing at the height of the economy. Cronyism is at play in all our iconic cases, but with varying intensities and forms. The countries also vary in terms of the intensity of social demands and how regimes respond to these demands. In all cases, regimes would benefit if privileged firms were more efficient, creating more jobs and driving growth higher, but this could not be attained because of political constraints.

Second, economic growth can come from either an effective management of elites or from the increased inclusion of entrepreneurs (and of labor, as in some European countries). When the patron can afford to have foresight and a long horizon and is able of build up bureaucratic capacity, as in the Korean case, industrial policy is more likely to be successful, because the bargaining power of patrons is high, allowing for an effective management of elites. Overall, the “agency costs” of politics are avoided here altogether, but this comes with the long-term risk of mismanaging social demands. On the other hand, a strategy of growth through inclusion, as in Brazil’s competitive system, delivers growth through expansionist macro policies and improved competition (as in type I SBRs), but it can also be constrained by the potentially high agency costs of politics, when cronyism of type II starts weighing on the economy. On the other side of the coin, weak growth can be due to two diverse genres of political conditions: (1) Growth can be taxed by the narrowness of the elite coalition, as in the case of Russia. Here, the state tends to have a weak bargaining position vis-à-vis privileged firms, and is unable to persuade them to invest in productivity-enhancing projects, as opposed to in ameliorating their rent-seeking postures; or (2) growth can be depressed by political fragmentation and excessive competition among political elites, which fosters state predation of political opponents, thus weakening the investment climate.
Third, the dynamics of such systems tend to determine the growth episode’s longevity. While South Korea’s rising cycle ultimately led to a rich and open society, Lula’s growth episode turned out to be not very resilient and collapsed when commodity prices fell, Ghana’s performance continues to cycle around political contests, and the Russian current path seems to manage to survive so far only through external adventures. More generally, a vicious circle arises if high levels of political risk strengthen the bargaining power of clients, who demand a higher return for their political support, leading to lower job creation, more political instability, and, over time, a narrowing of the business elite. On the other hand, a rising virtuous path involves a lowering of political risk, leading to a shift in bargaining power away from clients, a broadening of economic inclusion, and improved economic performance.

We are now ready to discuss how the various countries of the region fit this typology, as a basis for exploring the future of the private sector in the region.

5. Political Settlements in MENA

I will now argue that political settlements prevalent in the MENA region after the partial reforms of the 1980s and 1990s have given rise to a narrow form of capitalism because of a preference by autocratic regimes for a politically controlled private sector (as opposed to economically regulated or incentivized), together with a system of managing social tensions built around mechanisms of clientelism, cooptation, and redistribution. This system has led to large fiscal deficits, economic instability, and slow structural change and growth. While strengthening the cronies’ power to capture the state, social and political instability were exacerbated, creating a vicious cycle, as in the Russian case.

The two questions that concern us in this section are: (1) what are the main causes behind the prevalence of business exclusion in the political settlements of the MENA region? And (2) what are the contours of the typical political settlement in the economic domain, which following Hertog (chapter 1), we term a “segmented form of capitalism”? Below, after drawing on the lessons from the four iconic examples, we look more carefully at variations of these typical political settlements that we observe in the region, and at how SBRs vary as a result.

What Is Behind the Prevalence of Exclusion?

One needs to come back to the political environment in which the reforms of the 1980s took place to appreciate the role that social discontent played in shaping the resulting SBRs. During the move from a state-run economy to one where the market played a bigger role in the mid-1980s, the massive rollback of the state reduced access to social services and to civil service jobs and, as a result, reversed the past dynamics of social mobility. This represented a clear break with the previous modernist social contract anchored around a growing middle class connected to state employment. The changing private–public balance entailed social discontent and contestation at the same time that autocratic governments were losing the traditional tools through which they established authority, including the levers of not only nationalist and in many cases populist
ideology, but also ownership of state-owned enterprises, large investment budgets, large civil services, and large military and security spending. This was especially the case among the republican regimes erected by leaders that arose in opposition to preceding regimes and that distrusted the old economic and political elites.

At the same time, regimes in place were unable to draw the social forces that might benefit from market liberalization into their ruling coalition. Unlike other regions of the world, a specificity of the MENA region is that the regimes in power chose to selectively liberalize their economy, but not their polity. This has been related to several factors specific to the region: (1) the presence of oil rents, which allowed weakened regimes to build-up their repressive apparatus (Bellin 2004); (2) support from important international actors for autocrats that could protect their interests, whether related to oil, the fight against extremism, or the Israeli–Palestinian issue (Bellin 2004); and (3) the institutional inheritance of the past, where a legacy of state intervention facilitated the creation and distribution of regulatory rents, and in states with populist regimes, where the bureaucracy had an anti-business attitude inherited from the socialist past that facilitated market repression (see chapter 1).

In the end, economic liberalization was accomplished with a political hardening in most countries, where new business elites were brought into the ruling coalition and old allies, such as unions and farmers, were pushed out—as in Egypt, Syria, and Iraq in particular. As stressed by the political science literature of the period, the resilience of autocracy in the region was connected to the construction of a system of organized cooptation and repression (Bellin 2002; Posusney 2004). The combination of sticks and carrots resulted in a deeply segmented society. While much of the attention has focused on the repression of political opposition, initially from the left, and then increasingly from parties connected with political Islam, the attempt to also control markets was part of the same repressive drive.

In most countries, the survival strategies adopted by regimes resulted therefore in an economic liberalization that rested on a narrow form of capitalism. In addition to a preference for a controlled private sector, other characters of the settlement had implications for the type of SBRs that developed. The strategy of social cooptation generated at times large fiscal deficits, which crowded out public investment in infrastructure, with direct implications for private sector competitiveness. As public sector wages fell in real terms, state capacity declined, and regulatory authority became easier to capture (Cammett et al. 2015). Moreover, one can hypothesize that the rise in social discontent must have increased political risk, inhibiting private investment, and strengthening the bargaining power of crony firms, which demanded increased levels of rents to keep their side of the bargain.

The Character of Segmented Capitalism

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16 In particular, consumption subsidies rose in the late 2000s on the back of the oil boom to extraordinary levels. This reflected a desire by regimes to pacify parts of society with handouts, but without having to open up new opportunities for growth.
The typical genre of political economy equilibrium that arose in much of the MENA countries is well described by Steffen Hertog (chapter 1). Hertog sees a striking similarity between all the countries of the region, after the economic liberalizations of the 1980s, in the deep segmentation of their economies between a small formal private sector, with protected workers and privileged firms, and a large informal economy. He argues that the forces of segmentation have led to a low-level political economy equilibrium. On the one hand, limited competition creates a disincentive for innovation and accumulation, of both capital and skills. On the other hand, segmentation deprives firms and labor of the legitimacy to demand productivity-enhancing change. Hertog sees this deep segmentation as the main characteristic of an “Arab variety of capitalism.” In relation to the varieties of capitalism debate, he compares this version of capitalism vis-à-vis the varieties defined by Hall and Soskice. Unlike Anglo-Saxon capitalism, defined by its high level of innovation and risk or European coordinated capitalism (Hall 2001), and unlike the hierarchical capitalism of Latin America dominated by large economic groups with low incentives to improve efficiency (Schneider 2009), he sees the economies of the MENA region being dominated by defensive states that rule over weak economies and societies riven by division and fragmentation. It is as if a failure to develop successfully along the Korean model has pushed many regimes to pursue survival strategy akin to the Russian model, given the regimes’ unwillingness to open up their polities and thus move toward the Brazilian or Ghanaian models.

Political changes introduced by a reformist elite have been rare in the region, and when they took place, they were hesitant in terms of their ambition. The temptation to delay political reforms through repressive means has created tensions within governing elites, pitting reformist moderates against repressive hard-liners, and generating additional political risk. With the exception of a few countries (such as Morocco and Jordan), rising political instability has empowered the hardliners, backed by a narrow economic elite, possibly because of the presence of external rents that could be tunneled toward supporting repression and clientelism (Bellin 2004). The unwillingness of regimes to open up the political space has precluded the possibility of building up a coalition for change with the rising market-oriented middle class of more educated youth—losers from reforms had a lot to lose and supported the hardliners, while those that stood to gain were fragmented and had low voice, weakening the moderates. It may also be argued (as in Cox et al. 2013) that commitments by the political opposition to allow current elites to benefit from future growth were not credible, a situation especially salient in countries where regimes had “blood on their hands,” leading autocratic regimes on the defensive to deliberately choose policies of exclusion as their preferred strategy, preferring a large share of a small pie to an uncertain future in a more open and prosperous economy.

Instead, the push for change came in 2011 from the proverbial Arab street. Arab capitalism in its pre-2011 form suffered from an important contradiction, in that it generated social discontent, and especially so among youth from middle-class backgrounds, whose parents were the main beneficiaries of public sector-oriented economic arrangements, and the central supporters of nationalist regimes. The uprisings of 2011 were largely driven by popular discontent over cronyism, low economic performance, and the lack of social justice. The driving source of discontent can be
related directly to rising market segmentation, which divided increasingly new and more educated cohorts between a minority that got high-paying jobs in the small formal private sector and a large group that had to accept low wages in the informal market (Assaad et al. 2018; Gatti et al. 2014). For several observers, it is the rise in this particular type of inequality among the educated youth, which is due to the narrowness of the formal private sector, that has pushed the “new” middle class to seek to leave the autocratic bargain and join forces with poorer segments of the population to fuel the mass protests that led to the explosion of the uprisings of 2011 in Egypt and Tunisia (Diwan 2013).

But, as was clear during the events of 2011, there have been great variations among the countries of the region, both in terms of the intensity of popular movements and in the reactions of authorities to increased contestation, which were due in part to differences in these countries’ political settlements. Section 6 focuses on explicating these variations.

6. Regional Variations

While most of the MENA regimes have remained autocratic in the aftermath of the economic reforms of the 1980s, there is more variation in these political settlements than typically acknowledged.

First, there is a great variation in the countries’ level of incomes and access to natural resources and external rents, going from very poor Yemen to very rich Qatar. The regimes ruling the GCC countries could afford to feel more secure than their poorer neighbors, and, consequently, to have a longer planning horizon. On the other hand, countries with moderate levels of oil per capita could afford to build a large security apparatus, but not to heavily subsidize their population (Cammett and Diwan 2018).

A second variation concerns the populist versus conservative tradition of regimes. Populist regimes in Iraq, Syria, Egypt, Algeria, Yemen, and Libya had expropriated their traditional business notables post independence, and had replaced them with a narrower group of trusted businessmen, at the cost of losing economic dynamism over time. In contrast, conservative regimes such as in Saudi Arabia have avoided expropriation, and found gradual ways to strengthen their supporters among the business elite (Chaudhry 1997; Hertog 2010). The narrow regime–business relationship of the populist regimes must have been in part deliberately designed by political elites. Moreover, political and economic elites worked within institutional, sociological, and cognitive constraints and legacies going back to regime formation and decades of statist economic policy (see chapter 1 on this). In countries with a statist past, there was, besides an inherited political attitude of distrust of the private sector, an anti-private sector culture within the bureaucracy, with this type of distrust higher in post-populist republics with a history of class struggle and nationalizations. Looking deeper, the emergence of populist regimes in the 1960s and 1970s has been related itself to historical legacies.

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17 This is a theme explored early on by Chaudhry (1994) in her comparison of Iraq and Saudi Arabia’s liberalization policies in the 1980s.
These differences have affected the decisions of different regimes to use carrots and accommodation versus sticks and repression to manage various social groups. The use of repression in the 1990s to control new opposition groups has been typically aimed at the poorer part of the population and marginalized regions, even among regimes where such constituencies were an important component of the ruling coalition, especially in the bunker states, as in Baathist Syria and Iraq. Henry and Springborg (2010) take the extent to which regimes use sticks more than carrots to define “bunker” states, as opposed to the softer “bully” regimes. The bunker states—Algeria, Iraq, and Syria—have typically relied on relatively modest external rents relative to the size of their population (oil, Arab aid) to finance a repressive system closely allied with the regime, including through matrimonial links. 18

Carrots, on the other hand, have been typically used to coopt groups that can play an important role in ensuring regime durability, because their desertion would be politically costly. As discussed, the middle class have played such a role in most countries, as the central actors of the modernizing programs of the young republics, especially in the context of powerful public sectors. Pre-2001, they benefited, for example, from large consumer subsidies whose cost exceeded that of the education and health sectors combined in several countries of the region (Diwan and Akin 2015). The populist regimes have used their close connection with labor unions as an important political tool, protecting a small privileged category of workers in exchange for their political mobilization when needed. In a few countries, support from particular ethnic groups has also played an important role in strengthening regimes (e.g., Jordan, and more generally in the countries of the Levant).

It is useful to group the countries of the region that have achieved some measure of economic success—those studied in the book, but also those that have received less attention in this volume, such as the GCC countries—into four groups, which resemble the four iconic categories described in section 15.4, but which I organize around regional specificities (see Table 2). Each of these groups offers a different way in which the influences of power, money, and society have aligned to produce, for a while at least, moderately successful economic outcomes. These growth episodes have developed endogenously in the region post liberalization, and the goal in the last section of this chapter will be to investigate the extent to which these models are sustainable, given the two shocks discussed in the introduction, and also the extent to which the most successful models can be replicable in countries where political circumstances have changed.

In Table 2, the most promising case is that of Turkey, which experienced a long episode of growth since 2002, built around a rising political party (which became dominant over time). The economic privileges provided by the APK to its SME base (“the Anatolian Tigers”—see chapters 3 and 8) fostered inclusion and growth. In turn, the success of the Tigers fostered regime durability as they continued to support the ruling AKP. The

\[\text{See also Bellin (2004), who describes the conditions under which such praetorian states emerge and how they function.}\]
positive feedback loops linking economics, politics, and society generated a long virtuous circle. The Turkey model resembles that of Lula’s Brazil, and like in Brazil, its rise was made possible by the proximity of Turkish firms to the global technology frontier (thanks to earlier reforms by the Ozal government in the 1980s). Moreover, as in Brazil, political stability was supported by a populist appeal to the poor (in Turkey through Islamism, and in Brazil through progressivism), while the middle class was offered new business opportunities (as opposed to consumption, as in other models discussed below).

Table 2. A typology of political settlements cum SBR types in MENA countries

<table>
<thead>
<tr>
<th>Power relations</th>
<th>Social pressures (given growth performance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard repression and exclusion</td>
<td>SBRs: closer to type I</td>
</tr>
<tr>
<td>(&quot;bunkers&quot;)</td>
<td>Proto-development state</td>
</tr>
<tr>
<td></td>
<td>Morocco, Jordan, Egypt, and Tunisia</td>
</tr>
<tr>
<td></td>
<td>pre 2011, GCC</td>
</tr>
<tr>
<td></td>
<td>SBRs: closer to type III</td>
</tr>
<tr>
<td></td>
<td>Repressive/populist regime</td>
</tr>
<tr>
<td></td>
<td>Algeria, Iran, Syria, Iraq under Baath</td>
</tr>
<tr>
<td>Some accommodation and inclusion</td>
<td>SBRs: mostly type II</td>
</tr>
<tr>
<td>(&quot;bullies&quot;)</td>
<td>Clientelistic competition</td>
</tr>
<tr>
<td></td>
<td>Lebanon, Iraq today</td>
</tr>
<tr>
<td></td>
<td>SBRs: both types I and II</td>
</tr>
<tr>
<td></td>
<td>Inclusive growth</td>
</tr>
<tr>
<td></td>
<td>Turkey 2001–2016</td>
</tr>
</tbody>
</table>

This virtuous phase seems to have come to an end, a victim of the loss of its EU anchor, elite division around 2016, and unsustainable macro policies more recently. In the process, the AKP transformed from economically inclusive to populist, alongside a similar transformation of politics in other countries in Eastern Europe and elsewhere. But the episode illustrates both the power of private sector inclusion and the possibility of the political economy constellation aligning, during a particular historical moment. One cannot disassociate contemporary Turkey from its historical developments. Nevertheless, one can still ask whether such an alignment may be in the cards elsewhere in the region.

The second model is one of closely managed elite capitalism. Egypt, Tunisia, Morocco, and Jordan (“the bully states” in Henry and Springborg’s (2010) terminology) have been characterized by a relatively narrow base of capitalistic development. These are countries that aspire to become a successful Korean-style development state, but that have not managed to produce dynamic economies, principally because their ruling regimes have not been able to find politically acceptable ways to broaden the private sector sufficiently. In the historically conservative monarchies, the business elites are relatively better managed, possibly because of more established historical relations (Menaldo 2012).

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19 The Turkish innovation is how it managed to construct a new political base of pious bourgeoisie (Demiralp 2009). This innovation contradicts the notion that political Islam is inimical to economic growth, and supports instead the thesis that moderation of Islamic parties can occur through participation (Schwedler 2011). While there are the structural and historical features that allowed the AKP to act as it did, its mix of social conservatism and economic liberalism has started to shape the political programs that other Islamic parties in the region (such as Nahda in Tunisia, and the Justice and Development Party in Morocco) have modeled themselves around. The experience also defined the nature of the opposition to such moderate Islamic regimes: socially liberal, and economically left leaning, as with Tunisia’s Nidaa Tunis political alliance.
In Morocco, the narrowness of the middle class has helped keep social demands in check, while in Jordan, the ethnic composition of the middle class has allowed for a relatively successful strategy of divide-and-rule (see chapter 9). As a result, the two monarchies have been able to give rise to a more stable social order (although this is contested in both countries by occasional protest movements). Morocco has also been able to push some sectors closer to the global frontier than Jordan, where political risk stemming from regional instability has kept a lid on investment incentives. In both countries, however, the business base of the formal private sector remains narrow. Egypt and Tunisia point to the risks ahead, as the inability of a narrow-based private sector to generate a sufficient number of good jobs for a growing middle class was at the basis of the 2011 uprisings.

The third relatively successful model is one dominated by state capitalism, and followed by the high oil rent-per-capita GCC. This model is quite unique to the MENA region, as few other countries in the world are both as autocratic and as rich as those of the GCC (except perhaps Singapore). It is a model dominated by state ownership not only of state-owned-enterprises, but also of large parts of the private sector (see chapter 13). In these rentier countries, political stability has rested on supporting a large middle class through public service and consumption subsidies. Rather than repress the private sector, rulers have tended to nurture it by providing incentives for economic elites to develop “teeth in the economy.” This was done by building on the close historical relations that royals had developed since pre-independence with trading families (Cammett and Diwan 2018; Mazaheri 2013). The private sector has grown, becoming larger and more sophisticated over time, but it has remained an enclave sector, creating little positive externalities for the population at large, relying on unimpeded access to labor import, and remaining dependent on state contracts and subsidies.

In spite of its dependent nature, the relative positive outlook for the private sector in the GCC can be contrasted with that of a group of “middle oil” and populist regimes, such as the military-security pouvoir that has dominated Algeria since independence, Iraq under Saddam Hussein, and Baathist Syria, all of which exhibited a high level of repression of private sector activity and relied for survival on a powerful security apparatus. In these countries, the only firms that have been allowed to grow are those owned by very close allies of the rulers (Boubakeur 2013; Haddad 2012; Lowi 2009). The Iranian economy is larger and more complex than that of other middle oil countries and it represents an intermediate case, with the “private sector” not very private, being largely owned by a fragmented collection of competing state agencies (see chapter 14). In all these countries, the liberalization of markets, when reforms were undertaken, were short-lived at best, as in Algeria during the early 1990s, Iraq in the 1980s, and Syria in the early 2000s. As a result, most private activity tends to take place in either the tightly controlled formal sector or the unregulated informal economy. Efficient and competitive sectors are unable to take root in such environments.

Finally, Lebanon offers a model where powerful parts of society are in opposition to a strong state because they fear that other groups would dominate it and use it against their own interests (El-Khazen 2003). It is a model of interest because other countries marked by sectarianism, such as Syria, Iraq, and Yemen, may emulate it in the future. The two
chapters that focused on Lebanon (chapters 4 and 12) describe a political system built on competitive clientelism, but with a small range of politically connected sectors, owing to the low penetration of the state in the economy. In such circumstances, the private sector has found some space in the interstice of state influence, but it is periodically threatened by political and macroeconomic instability. In some ways, the Lebanese model resembles that of the “messy competition” experienced in Ghana, but political competition takes place more within communities, rather than among them.

Thus, the region’s regimes have embarked on a variety of political paths since the 2000s. They have also been subjected to different economic shocks in the past few years. In thinking about the future, the dimensions of this heterogeneity must therefore be put at the center of the analysis.

7. Thinking about the Future

In order to preserve some generality in the analysis, we will think about the future alongside two important factors that vary in intensity among the various countries of the region: How they have been affected by the 2011 uprisings, and the extent to which they are vulnerable to a fall in oil prices. Thus, the first important variation today is among countries with different political dynamics—democratizing versus undergoing an autocratic restoration. The second dimension of variability is the extent to which the massive decline in oil revenue may play out differently in different countries (and compared to the previous oil bust of the 1990s). I will discuss both dimensions in turn. The main question is whether these new factors will push governments to be more open to private sector development, or, on the contrary, more defensive and repressive.

More Openness Versus Autocratic Restoration

The governments that emerged from the uprisings of 2011–2012 inherited an economic system that had failed to deliver strong growth, but where at least a few politically connected firms could flourish. The uprisings have initially made the situation worse, disturbing and in some cases eliminating existing privileged relations. In the countries affected by the uprisings, such as Tunisia and Egypt, and to a lesser extent Morocco and Jordan, one could not be certain that the property rights of the elites that were protected in the past will continue to be protected in the future from state predation. In the set-up of Pritchett et al. (2017), ordered deals, even when they are “closed” to a narrow set of firms, remain better from a business climate perspective than “disordered deals”—that is, unpredictable SBRs where petty and grand state-predation create uncertainty for all firms. Once established privileged relations collapse, there are two ways forward that can strengthen again economic incentives: One is to move toward fair and well-enforced rules for all firms, a road that is difficult to travel in the shadow of the corrupting influence of an underpaid bureaucracy, an unhelpful institutional tradition, and a polarized political environment. The other route is for the new regime in place to rehabilitate the old system of privileges, possibly around a new circle of loyal cronies.
Both routes are challenging, as illustrated by the cases of Egypt and Tunisia. In Egypt, President Abdel Fatah Sisi is, like his predecessor, wary of the political clout of an autonomous private sector, in ways that increasingly resemble the situation in Russia. He has built up friendly cronies that he can trust—the innovation relative to the Mubarak regime is that he has put the army in charge of managing them (Adly 2014). But the lack of social and political dialogues keeps the government in fear of the street. Since there can be no debates or compromises with an amorphous street, macro adjustment is delayed until it becomes unavoidable, as happened with the sudden and massive devaluation of the Egyptian pound in 2016, which was a major economic and social shock. This situation is economically inefficient and politically risky, resting on populist appeals to nationalism and identity as a way of hiding economic failures.

In contrast, political change in Tunisia has allowed an increased autonomy for business groups, which bodes well for the future as this is leading to more competitive pressures on both the economic and political fronts. Family groups became more powerful, with networks from Sfax and Djerba acquiring some of the privatized assets of the Ben Ali group (Oubenal and Ben-Hamouda 2018). At the same time, political polarization has created pressures on businesses to take sides. Several businessmen entered politics, financing the new political parties’ campaigns and providing them with economic expertise and networks. UTICA, the main business association, started to play a more central role in national politics. But at the same time, informality and corruption rose, because of a breakdown in bureaucratic discipline and the high financial demands of an overly competitive political system—Ghana style (Bellin 2013). The situation is complicated by the high social demands of a burgeoning middle class, represented in part by a historically powerful labor union, and which has engaged in a chicken game with the state and the corporate sector in its attempt to push the burden of adjustment to other groups. This has continued to weaken state finances as well as corporate profitability, hindering the revival of growth and complicating the creation of a stable political order.

Neither country has so far made a serious dent at improving competitiveness. In both countries, there is growing public dissatisfaction with economic performance. But, over time, this is likely to help the political process in Tunisia to find new cooperative solutions, and to hurt it in Egypt by fostering distributional fights and myopic policies. In Tunisia, while the set-up costs of a new political system continue to weigh on the economy, greater inclusion has fostered dialogue, and one can hope that this will end up supporting win–win bargains between groups with political power. Ex-union leaders and businessmen now sit in the cabinet, and the social debate now focuses on how labor and business can share fairly the burden of a necessary adjustment. Recent local elections have empowered new independent groups that are more invested in economic performance and less in identity politics. Recently, the Tunisian government has

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20 And receiving the Nobel prize for peace along with their “quartet” partners the UGTT (the national trade union), the human rights league, and the bar association, for their “contribution to the building of a pluralistic democracy in Tunisia.”
mustered the courage to put the fight against corruption at the center of its agenda, ushering a divisive social debate on whether to punish or grant amnesty for past crimes.21

While in both countries, public debt is on the rise and will soon reach unsustainable levels, Tunisia’s progress toward democratic consolidation appears to be starting to pay dividends. The economy is slowly recovering; private investment rose to nearly 20 percent of GDP in 2017, from a low of 17 percent in 2015 (it is flat at 11–12 percent in Egypt). On the other hand, Egypt’s economic stabilization efforts may lead to short-term gains, but its strategy of autocratic restoration does not offer a sustainable political path, keeping the private sector narrow and political risk high.

Nevertheless, for the time being, Tunisia remains mired in a state of “messy democracy.” While this may continue for a while, two more sustainable paths are possible in the future, both of which entail a reduction in the agency costs imposed by the political system. The first path is based on a continuation of neck-to-neck competition by two long-lived parties. In its early phases, a competitive system is likely to continue to generate electoral fiscal cycles and macro-economic instability, as in the Ghana model. This system can only improve over time if institutional arrangements are reached between the main political parties to lower the level of competition and commit to policies that are essential for growth, such as macro stability and, more ambitiously, the protection of property rights.22 For a while at least, Lula’s Brazil seemed to have reached such a political pact between the main political forces. The second path is predicated on the rise of a dominant party, as may happen if Al-Nahda ends up becoming more dominant. This case would end up resembling the Turkish model of growth by inclusion, and may be ushered, like in Turkey, by a financial crisis that shakes the confidence of the electorate in the current lead ruling party.

Jordan and Morocco, countries with a conservative past and well-established relations between political and economic elites, have chosen intermediate strategies, combining improvements in rules governing the private sector with selective interventions to promote connected firms. In all likelihood, employment growth will remain constrained as long as political hesitation inhibits gains on the economic front. Other countries could also end in one or the other model. In Iran and Algeria in particular, a broad range of outcomes seems possible in the future, given the weaknesses of regimes in place. In these cases, the current dominant elite coalition may end up fracturing, but it is unclear whether this would usher increased political participation, a meltdown as in Syria and Yemen, or an attempt at autocratic restoration as in Egypt. The situation in Iraq resembles that of Tunisia, with no dominant party at this time, and a fair amount of clientelistic competition and political instability.

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21 Concerns about corruption have also fueled social unrest in Iran, Iraq, Morocco, and Jordan in recent months, but these pressures have not (yet) resulted in tangible political or institutional change.

22 This is the type of development one hopes would occur in Ghana, but this has not happened yet, despite several successful democratic elections held since the instauration of political competition in the 1990s.
Lower Oil Prices

The oil-producing countries of the region now face the twin challenge of having to stabilize their internal and external balances in the face of a large macro shock, and to reform their economic structure in order to fire up new sources of growth to complement their still overly dominant oil sectors.\(^\text{23}\) In some of the oil-rich countries with high and growing populations or shrinking reserves (Saudi Arabia, Bahrain, Oman), such tensions can only rise over time even if oil prices remain relatively high.

The specificities of the current shock are its extraordinary size (a 50 percent fall in oil prices between 2014 and 2017, but with a recent spike in 2018), the fact that it comes on the heels of a long period of high prices (2000–2014), and the high probability that it will be permanent rather than transitory. In Saudi Arabia (and also Bahrain and Oman), the fiscal deficit has been already deeply cut, primarily by slashing public investment, but it remains large at over 10 percent of non-oil GDP. The remaining expenditures are harder to compress. As a result, the non-oil economy will have to be taxed to balance the books. But the implied tax rates are very high because of the narrowness of the non-oil economy and its dependence on the oil economy. Thus, unless the tax base grows over time, deep cuts in domestic consumption will be envisaged (Diwan 2018).\(^\text{24}\)

In Saudi Arabia, the Ritz-Carlton episode, where the detained princes and heads of industries are said to have “paid-back” about US$100 billion of their wealth, illustrates well the policy dilemma ahead. The expropriation of a group that was politically favored in the past can be interpreted as a positive signal of fair burden sharing, and indeed, it is reported to have eased the social opposition to the introduction of a new VAT. But, at the same time, it can be read as a signal of the weakening of the property rights regime (by reducing the orderness of “deals”), at a time when improvements in the business climate to increase the dynamism of the private sector are badly needed. In the past, the wealthy ruling elites of the GCC have secured themselves and consolidated power by avoiding resorting to high levels of market repression found in middle oil countries. The question now is whether the current oil shock will push Saudi Arabia in particular toward more economic inclusion, or toward the more exclusionary type of political settlement that has characterized the “middle oil” populist countries in the past.

To understand the extent of the political challenge ahead, it is good to start from the current political settlement. Besides the much-heralded deal between the royal family and the clergy, political stability in the kingdom has rested on two other separate deals: between the royal family and the kingdom’s traditional elites; and between the state and the population. The deal among traditional elites is rooted in the kingdom’s genesis. Privileged access to government contracts, subsidies, and capital, and the extraordinary

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\(^{23}\) While the short-term evolution of oil prices is as uncertain as ever, the threat of climate change will hopefully push prices down over the long term.

\(^{24}\) In the big regional picture, reduced oil rents may reduce the fierceness of the regional competition between Saudi Arabia and Iran by reducing their willingness to engage in proxy-wars where power vacuums exist (Syria, Yemen, Iraq, and Libya in particular. But the reverse argument can also be made—it has been argued that the lack of income pushed Iraq to occupy Kuwait in 1990.
“right” to import labor freely, have allowed private firms to prosper and grow. The private sector now represents about 50 percent of Saudi GDP. The population, meanwhile, was offered economic security in exchange for loyalty—an arrangement institutionalized through a patronage network of high-paying public sector jobs and a broad array of generous welfare benefits.

The current challenge is to find a more productive form of social organization that can enlarge the economic pie. The much-heralded Vision 2030 proposes to do this through financial diversification (including the partial sale of Aramco, on which there are major question marks now), privatization, a reduction of energy subsidies, and an improved business climate to boost the creation of SMEs. While all these policies can be helpful, the main efficiency gain available to the Saudi economy is to improve its labor force participation and efficiency. Huge gains could be made on this front because the national labor is grossly underemployed and increasingly well educated. Currently, only 35 percent of the working-age population works (and when they do, it is largely in low-productivity government jobs). This compares to employment rates of about 60 percent in the OECD. Low national participation rates are largely due to very low participation by women, but men’s participation is not high by international standards either. Projections suggest that with participation rates growing to 60 percent, non-oil national income could more than double. Improvements in labor productivity would add to this growth rate further. Together, the addition to national wealth is comparable in magnitude to the kingdom’s oil wealth (Diwan 2018).

What would it take to achieve this? About 70 percent of nationals now work for the public sector, while expatriates fill 80 percent of private sector jobs. The wage ratio between Saudi men that work in the public sector over that of the few that work in the private sector is about 2. This means that the Saudi reservation wage is around half the public sector wage. Unemployment benefits, close family ties and support, and the hope to get a “wasta” to join some part of the public sector will keep reservation wages from falling rapidly, even as the prospect of a public sector job fades away. In the private sector, Saudi men earn on average twice more than expats (and higher multiples for those with low levels of education). Saudi unemployment thus reflects both demand and supply constraints—Saudis with reservation wages too high given prevailing private sector wages, and firms finding it more profitable to hire cheaper expats. Thus, to improve labor force participation, expat wages need to go up (to improve the demand for national workers) and national reservation wages need to go down (to expand labor supply). In this scenario, national labor will largely replace foreign labor over time, turning Saudi Arabia into a normal oil economy, with a productive private sector of nationals servicing a large public sector.25

The main challenge of a successful reform is to elicit cooperation between all players and avoid distributional fights. There are two main risks: doing nothing, and doing harm.

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25 In the tradable sector, most firms may not be able to survive this costlier production cost structure, which includes besides higher labor cost, the elimination of energy and water subsidies, and possibly higher interest rates down the line.
Doing nothing and kicking the can down the road by borrowing to avoid reform is a real possibility given the large fiscal space enjoyed by the kingdom. But mismanaged reforms may end up harmful as well. A populist reform program that advantages labor over firms will have a hard time generating a supply response. Similarly, a program that puts firms ahead of labor will only attract more migrants rather than employ more Saudis. Finally, pushing firms to wean-out foreign labor without incentivizing them to invest in the creation of more productive jobs will not convince Saudis to work harder. All these paths would lead to slow decay and the need for harsher adjustment down the road.

The low oil price new normal, if it continues, will be even harder to digest for the autocratic regimes in Algeria, Iraq, and Iran, who have used the previous boom to stabilize their fragile hold on power through a populist consumption drive. In these countries, regimes have few options for survival short of increasing their repression of populations and markets. In Algeria and Syria, for example, the response to an earlier challenge of the same type was a degree of authoritarian upgrading. One clearly cannot underestimate how far regimes can go in defending themselves against change. Nevertheless, it remains to be seen, on a case by case basis, whether lower oil revenues may, in some countries, boost the “moderates,” who can still gain by placing themselves, or their children, at the heart of a more open form of capitalism, as opposed to seeking refuge in a myopic strategy of autocratic hardening.

8. Conclusions

For decades, political settlements in the MENA regions looked surprisingly robust, generating a large literature on the resilience of autocracy. The events of 2011 were both unexpected and surprisingly synchronized across countries, revealing a convergence in popular dissatisfaction across the region.

The chapter argues that the modes of governance and the variety of capitalism that have taken hold in the region have so far prevented the emergence of broad-based reformist coalitions. As crony capitalism got entrenched, the formal private sector gave up its role of militating for the upgrading of the institutions that govern markets, preferring to protect its short-term interests through personalized relations. Elite labor as well remained protective of its short-term interests, giving up its national role as a champion for long-term progress. Moreover, the limited extent of formal employment weakens and fragments the structural links between labor and business. Together with a strong popular distaste for cronyism, this has created distrust between workers and capitalists and undermined the potential for class compromise.

As the dualism between formality and informality in business and labor relations grew, the countries of the region became stuck in a low equilibrium trap. Segmented capitalism led to divided societies, which are unable to form the broad-based political coalitions needed to upgrade institutions in ways that would allow them to move toward higher income status. The central societal challenges of improving the quality of education and of fostering successful technological upgrading are qualitatively different from
developmental challenges at lower levels of development, and it requires the political ability to bring together large parts of society for a sustained effort to improve the quality of institutions. This requires interactions between many social groups—unions, bureaucrats, communities, associations, universities, and research centers—which requires leadership and strong national coalitions, and can hardly happen in a divided society (Doner and Schneider 2016). 

More recently, internal and external pressures have become more challenging. All MENA countries are now faced with the challenge of macro-economic stabilization, and, rhetorically at least, private sector-led growth is seen as the main engine for growth everywhere. But considerations of stability and security are pushing these countries to increasingly diverge in the form of their political settlement and of their economic arrangements. To survive in the long term, regimes will need to deliver economic growth and good-quality jobs. To do so, they would have to stabilize their relations with both the private sector and society at large, in ways that reduce political risk, favor inclusion, and encourage businesses to invest in productivity-enhancements rather than in rent seeking. In the end, some regimes will possibly manage to renew themselves, while others will fail. Meanwhile, the predicament of the private sectors in these countries is that they will have to survive, and try to thrive, in an age of heightened political uncertainty.

While many other countries all over the world have been stuck in this type of political-economy-driven middle income trap, positive change, where it happened, was driven by two types of “upgrading coalitions”: elite deals or social movements typically driven by the middle class. Elite deals are exemplified by the path followed by East Asia and Korea, led by a state-entrepreneurs elite coalition. The second approach, driven by the middle class, was the main driving force for the cross-class workers–firms grand coalition of post-WWII Europe, and more recently of Eastern Europe. If elite deals cannot be constructed by moderate reformists, change will have to come instead from broader middle-class alliances with poorer classes that could construct, over time, a bottom-up coalition for change, which would have a long-term interest in upgrading institutions to improve economic and social performances. Whether this can happen in a gradual and peaceful way remains to be seen. SME-led or FDI-led growth could provide one strategy to gradually strengthen the private sector without deeply affecting the political equation, and slowly change the terms of the policymakers’ dilemma by strengthening moderate elements within regimes. The alternative is stark. While the experience of the first phase of the Arab Spring ended up in disappointment, a failure to change from above will leave little choice for the street but to attempt again, at some point, to foster change from below, costly as it may be.
References


