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The economics of the Arab Spring

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ABSTRACT

This article explores the economic underpinnings of the Arab spring. We locate the roots of the region's long-term economic failure in a statist model of development that is financed through external windfalls and rests on inefficient forms of intervention and redistribution. We argue that the rising cost of repression and redistribution is calling into question the long-term sustainability of this development model. A singular failure of the Arab world is that it has been unable to develop a private sector that is independent, competitive and integrated with global markets. We argue that developing such a private sector is both a political as well as a regional challenge. In so far as the private sector generates incomes that are independent of the rent streams controlled by the state and can pose a direct political challenge, it is viewed as a threat. And, the Arab world's economic fragmentation into isolated geographic units further undermines the prospects for private sector development. We explain this economic fragmentation as a manifestation of centralized and segmented administrative structures. Revisiting the politics and geo-politics of regional trade, we argue that overcoming regional economic barriers constitutes the single most important collective action problem that the region has faced since the fall of the Ottoman Empire.

KEY WORDS: Arab spring, fragmentation, regional trade, protectionism

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I. Introduction

The real struggle for change in the Arab world¹ will only begin when the dust from its youth revolutions has finally settled down. After emergency laws are lifted, constitutions are drafted and elections are held, policymakers in the Middle East will be faced with a tough practical challenge: how to create economic opportunities for its teeming millions? Arab revolutions had a clear economic underpinning; they were fuelled by poverty, unemployment and lack of economic opportunity. Without a concrete economic response, therefore, the hopes generated by these revolutions can easily give way to despair, raising the spectre of future political volatility.

There is a risk that the Arab spring meets the same fate as revolutions elsewhere have in the past. That is, they can often result in a greater continuity than change. The recent literature on political economy offers a convincing reason for such institutional persistence. Revolutionary upheavals can often lead more quickly to *de jure* change in political institutions, without necessarily altering the underlying distribution of economic power. Whether it is the abolition of slavery and apartheid or the granting of voting and property rights, the underlying lesson is usually the same: *de jure* reforms do not automatically result in effective change.² This is because elites have a remarkable ability to endure; they can reverse change or mould it in their favour. Even if old political players are replaced with new ones, this can lead simply to a re-configuration of political power leaving the basic economic structure unaltered. The challenge for the Arab world is no different: offering greater political representation is desirable, but unless coupled with a greater access to economic opportunities, it is unlikely to be a game changer. The current impasse in Egypt best illustrates this institutional dilemma. While Hosni Mubarak has departed, the structure that sustained his authoritarian rule survives. As the civil society is now discovering, the power of entrenched insiders is not easy to dislodge. *De facto* power, whether economic or political, resides with the Egyptian military. It controls vast economic resources, from manufacturing to real estate and services, and its budget enjoys immunity from parliamentary scrutiny. The military's role as a regional peacemaker further entrenches its power. For the Egypt's youth movement, this generates an important commitment problem. The real powers supervising Egypt's political transition are unlikely to commit to their own dismantling.

In thinking about reform, the centrality of the economic question is evident. Over the last few decades, the Middle East has witnessed an unprecedented youth bulge that has dramatically changed its demographic profile. An overwhelming proportion of its population—in many countries about three-quarters—now consists of young people under the age of 30. Together with a greater female participation in the labour force, these demographic trends have greatly enhanced the number of people looking for jobs. During the period, 1996-2006, labour force in Middle East and North Africa has grown three times as much annually as in the rest of the developing world, resulting in one of the largest rates of youth unemployment in the world. In Jordan, for instance, more than 70 percent of the unemployed are under the age of 29 years.³

But, over time, the Arab world has not only grown younger, it has also become more educated. The region might have failed on multiple accounts, but it has had a resounding success in expanding access to education and closing gender gaps in educational attainment. Of the top ten countries that made the most impressive strides in human development during the last forty years, five were from the Arab world.⁴ Starting from one of the lowest levels of educational achievement in the 1960s, adult

education rose faster in the Middle East during the 1980-2000 period than any other region in the World.⁵ Despite reservations about the quality of education imparted, even this quantitative expansion of education has led to a silent revolution of sorts. It is a revolution of aspirations. Even as aspirations have become more mobile with the new gadgets of globalization, the local systems of governance are ossified and offer limited economic mobility to the region's youth. Even physical mobility across borders is restricted. Unlike Western Europe, where class-based struggles have historically driven political change, the Middle East is witnessing a truly *generational* struggle for inclusion.

While coping with these demographic trends is a challenge, they also offer an opportunity for economic advancement. The Middle East is not the only region to have witnessed these demographic changes; other emerging market economies in Asia have successfully harnessed their youth bulges for development. Why should this demographic transition then be feared? The irony in the Middle East is that there is a vivid mismatch between demography and economic structure. While the demography is evolving, the economic structure is unresponsive to the needs of growing populations. Middle Eastern economies are heavily dependent on hydrocarbons, dominated by the public sector, and are failing to keep pace with the growing labour force. The limited economic opportunities that do exist are rationed by connection rather than competition. This leads to tremendous economic injustice for the young who see little hope for economic and social mobility.

Labour markets remain segmented at multiple levels—between the public and private sectors, between formal and informal sectors and between nationals and non-nationals.⁶ For instance, in many resource-rich countries of the Gulf, there is a perverse division of labour between the public and private sectors. The public sector generates well paid jobs for nationals, while the private sector runs a competitive job market relying mainly on migrant workers. In the GCC states close to 70 percent of the labour force consists of foreign migrant workers.⁷ Such contradictions in the labour market are not just restricted to small, resource-rich states. In Jordan 20 percent of the total workforce consists of foreign workers.⁸ This segmentation allows neither citizens nor the state to develop real stakes in private sector development.

In many ways, the unfolding crisis in the Middle East is not just about the Arab state—its failed efforts to redistribute, reform and represent ordinary citizen's interests. It is also about the private sector—or, more appropriately, its absence. A singular failure of the Arab world is that it has been unsuccessful in developing a strong private sector that is connected with global markets, survives without state crutches and generates productive employment for its young. With few exceptions, the private sector is generally weak and dependent on state patronage; success in it is determined more by patronage than entrepreneurship. With the public sector acting as the main avenue for job creation, the region suffers from a precarious employment strategy and is left unprepared to deal with the demographic challenge.

While the need for a vibrant private sector is widely recognized, it is less clear how to develop it. The challenge of private sector development is traditionally viewed through a narrow technocratic and apolitical lens. When it comes to the Middle East, however, the limits of World Bank's recipes are particularly evident. Private sector development is not simply a matter of improving investment climate, reducing the cost of doing business, offering cheap credit, or introducing market friendly economic reforms.⁹ It is

also a *political* problem, since a private sector can create income streams independent of the patronage network of the regime, thereby challenging the ruler's position.

And, the absence of a vibrant private sector is also a *regional* failure, not simply a failure of individual countries. The Arab world remains fragmented in isolated geographic units with limited economic linkages between them. Such fragmentation carries a heavy cost for the region's economy. For a private sector to survive and thrive, the size of the market matters. There is often a competitive threshold to industrialization. Fragmented markets prevent firms from realizing the benefits of producing for a bigger market and locating next to each other.¹⁰ These cost advantages, commonly termed as economies of scale and agglomeration, have fuelled trade and growth in emerging economies, but are simply absent in the Arab world.

Any blueprint for private sector reform must therefore include as one of its central objectives the creation of regional economic commons in the Arab world. While the need for this is clear and urgent, a key argument of this article is that political incentives of Arab elites are not fully aligned with opening regional markets. The physical and policy barriers that divide the region preserve the monopoly power of local elites. The question, therefore, is: Can the Arab spring, fed by latent demographic pressures, break this political deadlock? In our opinion, creating regional economic linkages across the Arab world constitutes the single most important collective action problem that the region has faced since the fall of the Ottoman Empire. The region's future—and that of the rest of the world—crucially depends on solving this.

Before we proceed further, an important clarification is in order. In terms of its geographical focus, this article treats the Middle East as one analytical object, side-stepping, for the time being, differences within the region. This is clearly an oversimplification. The Middle East is a differentiated tapestry, where countries differ on multiple dimensions, such as size, resources, history, policy, ideological orientation, and the like. We do not downplay the significance of these, but simply contend that a big picture view of the region can furnish additional insights and is particularly well-suited to the main objective of this article, which is to: delineate broad economic undercurrents and analyse the challenge of regional collective action. Our analysis also underscores the need to emphasize linkages between various levels of analysis—economic, political and geo-political. We aim to capture spaces within disciplines to paint a rich picture. The adage that the whole is greater than the sum of its parts holds special relevance to scholarship on the Middle East.

This broad characterization is not completely unwarranted given the existence of unifying threads across the region. There are at least five common denominators that cut across commonly recognized conceptual boundaries—for example, whether an Arab state is a monarchy or a republic, labour-scarce or labour abundant, resource-rich or resource-poor. *First*, all across the Arab world both economic and political power is concentrated in the hands of a few. *Second*, the typical Arab state can be characterized as a security state; its coercive apparatus is both fierce and extensive. *Third*, the broad contours of demographic change and the resulting youth bulges are fairly common across the region. *Fourth*, Arab countries are mostly centralized states with a dominant public sector and, with few exceptions, weak private enterprise. *Fifth*, external revenues—whether derived from oil, aid or remittances—profoundly shape the region's political economy.

The remaining article is organized as follows. Section II highlights the vulnerability of the prevailing development model. Section III discusses the region's puzzling economic fragmentation despite its favourable geography. Section IV provides a snapshot of the pervasive trade barriers that underlie the region's economic divide. Section V develops the case for an infrastructure for economic cooperation. The politics and geo-politics of trade are discussed in section VI. Finally, section VII concludes.

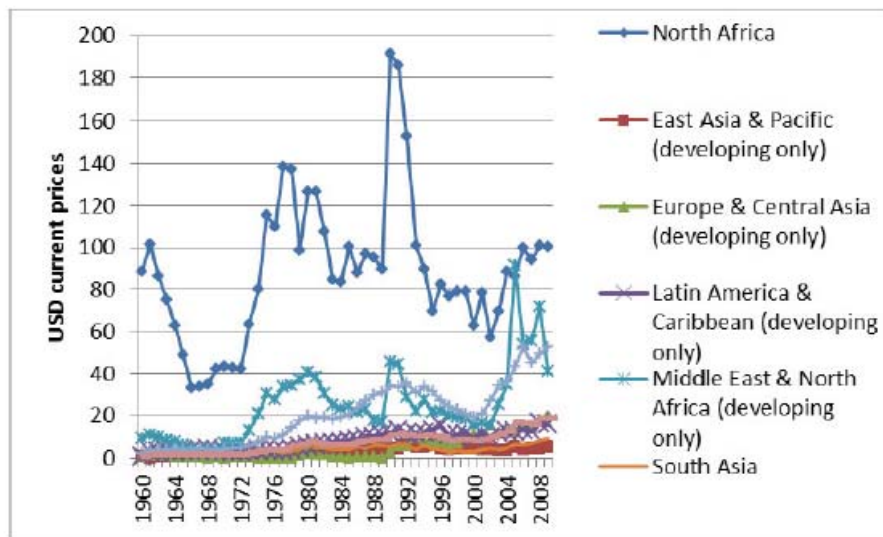
II. The original sin

The state in most Arab economies is the most important economic actor, eclipsing all independent productive sectors. When it comes to essentials of life, such as food, energy, jobs, shelter, and other public services, the state is often the provider of both first and last resort. The functioning of this system rests on a heavy dose of subsidies, economic controls, and a variety of other uncompetitive practices. While a centralized, bureaucratic system has worked well for ruling elites and the narrow clienteles that thrive with their support, it has failed to deliver prosperity and social justice to ordinary citizens. The interests of governing coalitions have proved more enduring than the force of ideology. Neither socialism of the 1960s and 1970s nor the neo-liberal economic reform of the 1990s has been able to dismantle this system of centralized control, discretion, and privilege.

The state-centred development paradigm rests on the uninterrupted flow of external windfalls. In fact, many of the region's pathologies—whether it is a weak private sector, segmented labour markets, or limited regional trade—are ultimately rooted in an economic structure that relies overwhelmingly on rents derived from fuel exports, foreign aid or remittances. Reliance on such unearned income streams is the “original sin” for Arab economies. The region is home to abundant natural resources, with oil and gas exports constituting more than 80 percent of total merchandise exports in many Arab countries. Even where natural resources are less abundant, Syria being one example, fuel exports have dominated the export structure. Up until 2005, around 67 percent of the total exports in Syria consisted of fuels. Similarly in Yemen, which is a fairly insignificant player in oil markets, fuel exports constitute 70 per cent of total exports.¹¹

Where oil is scarce, foreign aid takes over. Like oil, aid revenues can also stifle economic and political incentives, turning economies away from production to patronage. Egypt and Jordan, by virtue of their strategic location, have historically derived significant external rents through foreign aid. In Egypt alone—hardly a typical case of resource curse—two-thirds of foreign exchange revenues are derived from oil, aid and revenues from the Suez Canal.¹² In describing the region's political economy, the influence of aid is underemphasized. On a per capita basis, the Middle East and North Africa received the highest overseas development assistance in 2008 (\$73 compared to \$49 in sub-Saharan Africa).¹³ North Africa has consistently been the biggest recipient of net aid per capita since the 1960s (see Figure 1). These aid flows are largely driven by geo-political considerations.¹⁴ For resource-poor countries of the region, remittances constitute another important source of income. In Jordan, for example, nearly 13 percent of GDP was derived from remittances in 2010. In Lebanon this ratio was 20 percent.¹⁵ Resource windfalls from oil and aid have given rise to an adverse political economy and sustained a social pact that trades welfare distribution for regime security. External rents have expanded the public sector, bolstering its ability to provide employment and subsidized public consumption.

FIGURE 1: NET AID PER CAPITA BY REGION, 1960-2009



Source: Harrigan (2011), based on OECD DAC database

Traditionally, the Arab state has preserved social order through a combination of repression and redistribution. But that strategy might have run its course. The forces unleashed by demography and technology, together with corruption and inequality of access, have raised the cost of both repression and redistribution. With the proliferation of electronic and new social media, traditional modes of repression have become less effective. For decades the Arab state, regardless of whether it is a monarchy or republic, has ruled through the fear of its security services. It has perfected the art of demolishing any commons imaginable—whether civic, political, or economic. Social media has generated new spaces for collective action, however. These are the virtual commons that adroitly evade the long arm of the state.

At the same time, the cost of redistribution has also risen significantly. The region's youth explosion has stretched existing welfare systems beyond capacity.¹⁶ A sharp rise in food prices has further escalated the cost of this social bargain even in countries that are richly endowed with natural resources. The MENA region is one of the most food deficit regions in the world and, in the face of falling agricultural production, it is massively dependent on food imports.¹⁷ Arab governments are now spending a vast proportion of their budgets on providing subsidized food items—a policy that is likely to be even more fiscally unsustainable in the face of recent predictions of a long-term spike in food prices. Saudi Arabia alone is spending over a billion US dollars per month on food imports. In Egypt food subsidies (directed mostly at wheat) consumed US\$3 billion in 2010.¹⁸ The GCC imports 90 percent of its overall food requirements. By 2020 total food imports in GCC are set to rise by 105 percent.¹⁹ Together with the region's demographic changes, growing unemployment, and media penetration, this provides for a combustible mix.

The inherent volatility of oil markets, despite their present buoyancy, also poses a structural risk to Arab economies. Public finance remains vulnerable to the vicissitudes of oil markets. Public expenditures are sticky even when oil prices fall. In fact, when

compared to countries with similar levels of development and resource riches, oil exporters in the Middle East are more vulnerable to external shocks.²⁰ And, through remittances and investment flows, these shocks are rapidly propagated to lesser fortunate neighbours. In 2007 alone US\$ 60 billion were remitted by expatriates to other MENA and Asian countries. With limited natural resources and increasingly young populations, it is precisely these countries where the states' ability to provide essentials is especially strained.

What does this mean for the Arab world? Recent events in the region provide an apt reminder that the prevailing development model has reached its expiry date.²¹ This model built on oil and aid fortunes—and a leviathan state—is fast becoming a political and economic liability. This development model has been politically expedient, but this temporary political bargain is becoming growingly unsustainable. Apart from questions about its fiscal sustainability, this development model has also bred a colossal failure of expectations. New entrants in the labour market come with an ingrained preference for high paid jobs in the public sector, where remuneration is usually de-linked from skills or productivity. This results in high levels of voluntary unemployment but leaves the private sector with a shortage of skills. These labour market contradictions mean that a growing proportion of young people are not only unemployed, they are also *unemployable*. This is clearly a failing both of the education system and the economic structure. The wage structure offered by the public sector directly militates against the development of labour-intensive manufacturing. A generous welfare entitlement also acts as an inducement for larger families, contributing to the region's very demographic change.

When faced with global economic pressures and public revolts Arab governments have tended to reinforce this fragile social contract. They have responded to these emergent challenges by increasing the subsidies on food and fuel (this has been the case in Algeria, Libya, Egypt, Jordan, Morocco, Syria, Tunisia, Kuwait). Oil rich countries have tried to placate their populations by significantly scaling up salaries in the public sector.²² The Arab world needs a fundamental rethinking of the social contract. It needs to imagine a new development paradigm that is based on a competitive, entrepreneurial and inclusive private sector. It is true that the private sector has recently witnessed an impressive growth, especially in the Gulf, there is a question as to how genuinely *private* is this private sector. The boundaries between the public and the private are notoriously blurred, with the result that the private sector sometimes operates as a disguised public sector—or simply as extension of the state.²³ Public investment still remains the central driver of private economic activity, especially when oil prices are high. The profits of the private sector depend more on access to power than on entrepreneurial abilities.

Although, state-business relationship varies tremendously across the region, it is usually a personalized rather than an institutionalized relationship. Businessmen and rulers are often connected through overlapping networks, which usually makes their engagement with the state “informal, exclusive and short-term”.²⁴ Even in Gulf economies, where business is admittedly more dynamic, the boards of listed companies are dominated by a few influential families. With some exceptions, major business fortunes in the region are accumulated through patronage. There are familiar echoes of this in the Arab spring—be it the Trabelsi family of Tunisia, Ahmed Ezz of Egypt or Rami Makhlouf of Syria. Such crony capitalism denies a level playing field to potential aspirants and restricts economic mobility. Exploiting new economic opportunities in

this environment becomes a game of insiders. That is a running theme in the Arab world.

This makes for a poor business environment and adversely affects the performance of firms. The private sector in the MENA region is notable for its limited export presence, few productive spill-overs across firms, and has one of the lowest levels of productivity. This is a profound weakness for a region that has witnessed one of the world's highest rates of youth unemployment and has long aspired for economic diversification. Indeed the challenges of demography and diversification are closely intertwined, as neither the oil sector nor the state can absorb a growing pool of unemployed youth. A long term vision for the region must therefore involve a gradual shift away from natural resources towards a globally competitive private sector. In virtually all countries that succeeded in reducing poverty and unemployment, labour-intensive manufacturing was an essential component of the development strategy. That is where the failure of the Arab world is most visible. The Middle East and North Africa region holds less than one percent of world market share in non-fuel exports—compared to 10 percent in East Asia and 4 percent in Latin America. The region suffers from a dangerous dearth of manufacturing: in 2003 the combined manufactured exports of the entire Middle East were less than those from just one South-East Asian nation, the Philippines.²⁵

The need for diversification is not lost on national policymakers. Government documents frequently cite diversification as a core development objective. But, apart from partial success stories in Oman and Bahrain, diversification has merely remained a paper aspiration. International development institutions have, on their part, advanced globalization as a panacea, insisting on trade liberalization and deregulation of the domestic economy. Despite these reforms, Arab economies still remain insignificant players in export markets, with limited success in entering new markets or introducing new products. This failure is partly rooted in the region's inability to benefit from the forces of gravity—forces that create natural advantages of trading with neighbours. Behind a weak private sector lies a key puzzle: the Arab world's economic fragmentation despite its favourable coastal access and high levels of urbanization.

III. The puzzle: a fragmented region

In the Middle East borders matter—not just politically, but also in economic terms. As the world becomes a more globalized place, bringing together companies, capital and people, the Middle East remains one of the most fragmented regions of the world in terms of production, trade and economic linkages. With a population of 350 million people that share a common language, culture and a rich trading civilization, the Arab world doesn't function as one economic market. Trade linkages between Arab countries are surprisingly weak. Regional markets are cut off from each other and from the rest of the world, playing the role of a bystander rather than an active participant in processes of globalization.

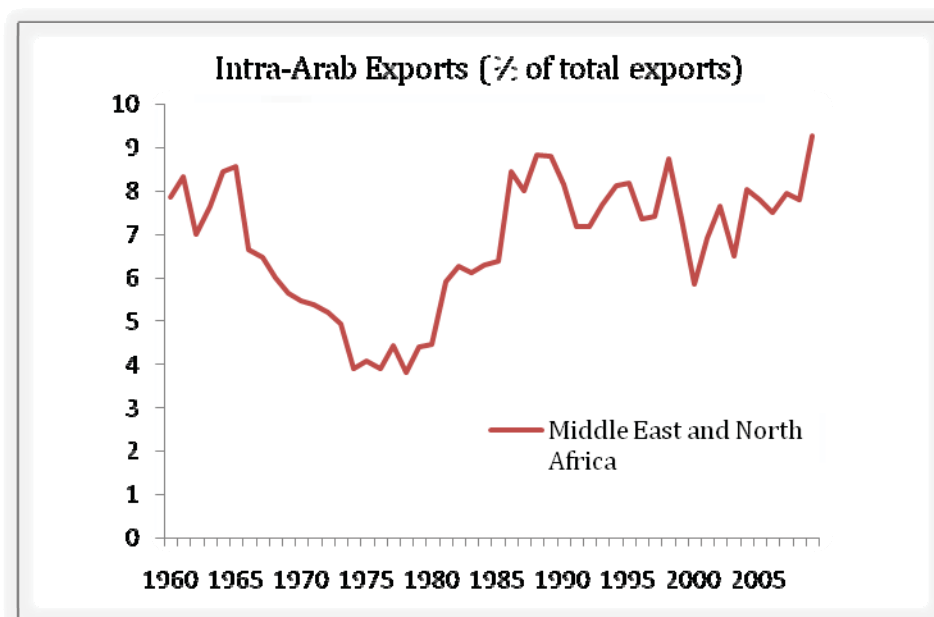
Few Arab countries consider their neighbours as their natural trading partners. Pan-Arab trade is noticeably insignificant. Despite having tripled between 2000 and 2005, the share of intra-Arab trade in total merchandise trade still hovers around ten percent. Figure 2 plots the share of intra-Arab exports as a share of total exports. It shows that the region has made very limited progress in enhancing regional trade. The share of intra-Arab exports, despite having fluctuated widely, is only marginally higher than that in 1960. At the same time, exports from South Asia to the Arab world have increased

from 6 to 18 percent. And Turkey has enhanced its share from 8 to 21 percent.²⁶ Even this limited trade is geographically clustered, with countries in the Gulf and North Africa trading predominantly within their own sub-regions. Nearly 58 percent of the intra-Arab exports of GCC are with other GCC countries. Trade integration remains particularly limited between North Africa and the rest of the Arab world. There is a minimal trade even among members of Agadir agreement and the Arab Maghreb union.

There have been repeated attempts to forge greater economic cooperation between Arab neighbours, taking the form of numerous regional initiatives such as the Arab Common Market, the United Arab Republic, Federation of Arab Republics, Arab Cooperation Council, Arab Maghreb Union, the Greater Arab Free Trade Agreement, the Agadir Agreement (Egypt, Jordan, Morocco and Tunisia) and the Gulf Cooperation Council. These have turned out to be a litany of failures. Evidence suggests that the sub-regional trade arrangements have especially failed to expand regional trade.²⁷ Attempts at economic integration have been frustrated by internal rivalries, dependence on external powers and the absence of a strong domestic constituency for integration.

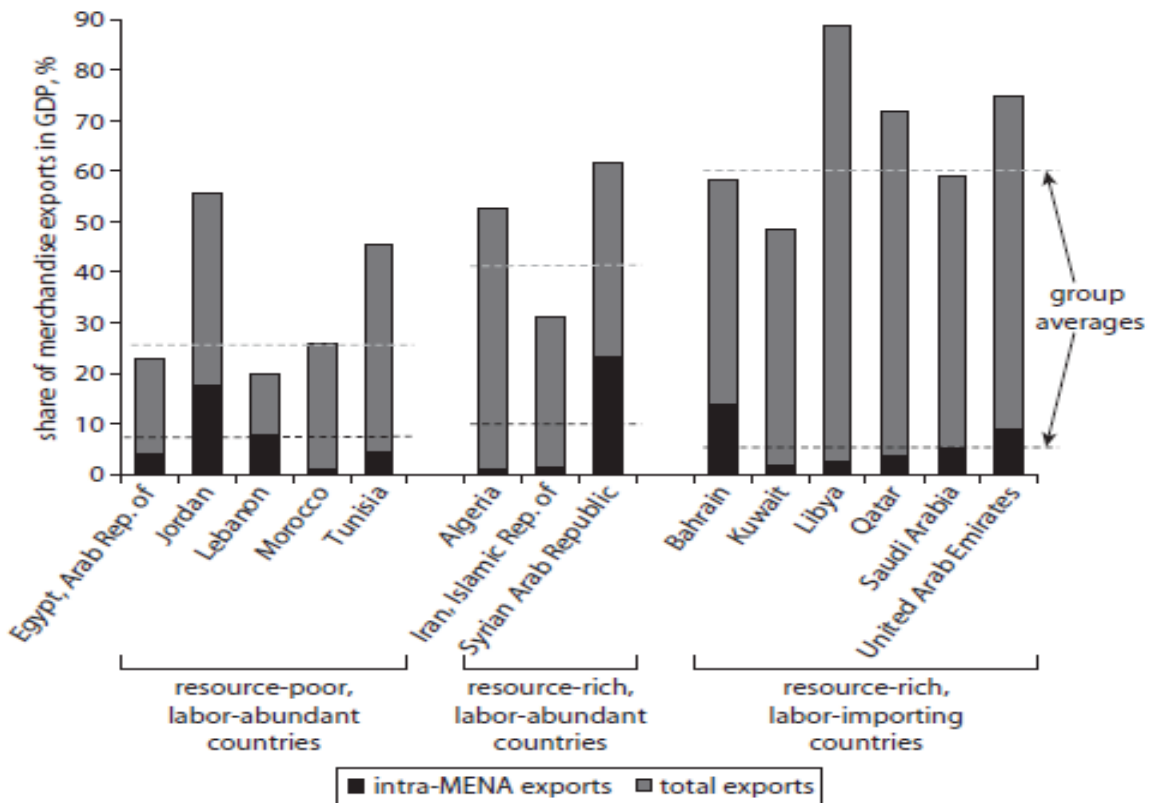
Many analysts have written off the prospect for regional trade, simply because the basic economics to support mutual trade is missing. A frequent lament is that Arab countries produce similar goods, specializing mostly in hydrocarbons, and lack the

FIGURE 2: LIMITED MUTUAL EXPORTS



Source: World Development Indicators 2010.

FIGURE 3: INTRA-ARAB EXPORTS, BY COUNTRIES



Source: Shui and Walkenhorst (2010).²⁸

complementary production structures that serve as the basis for trade. But evidence suggests that there is actually greater complementarity when it comes to non-fuel trade, services and investment. When non-oil exports are taken into account, roughly one-quarter of exports are destined for the Arab world.²⁹ Moreover, trade patterns are not uniform, as some countries trade more with their neighbours than others. As Figure 3 demonstrates, Jordan, Lebanon, Syria, Bahrain and UAE have deeper trade engagements within the region. Taken together, even if limited trade complementarity is an irritant it is not an insurmountable barrier. At least, it has not prevented other emerging economies from forging mutually advantageous trading relations.

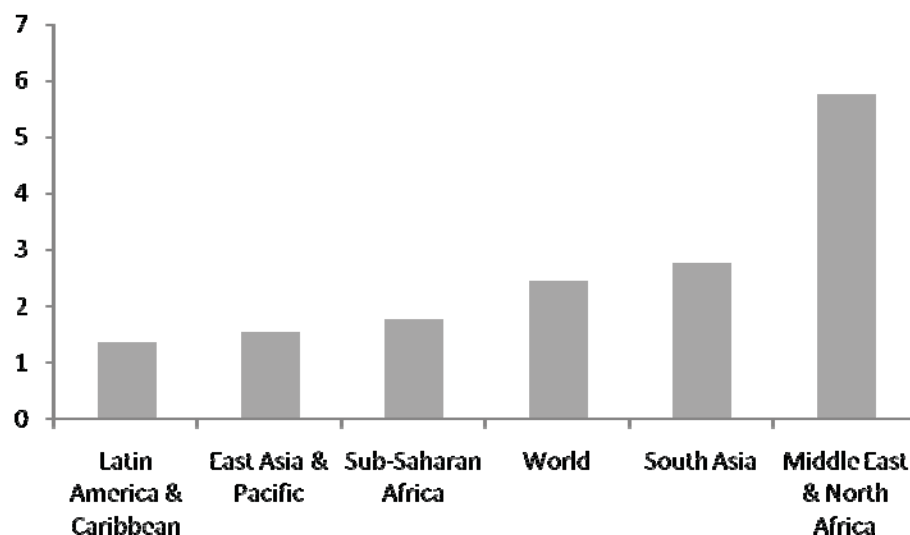
III. A. The costs of fragmentation

Fragmentation imposes a wide range of costs on the region. These are not simply restricted to the absence of scale economies. Thick borders preserve the sanctity of rent streams for insiders and prevent the emergence of competitive markets, entrenching the monopoly power of insiders. This increases the returns to predation relative to the returns to production, and reinforces existing inequalities. Fragmentation also adversely influences the investment climate by increasing the relative price of capital goods, which serves as a critical input for the productivity of investment.³⁰ This higher price of investment goods (relative to the price of GDP) stems in part from the greater import content of investment goods and the smaller market available to suppliers of these goods. This makes business environment particularly risky. While contemplating new investments, firms face the classic threat of “hold-up”: in the absence of a larger market for second hand capital goods, they run the risk of being stuck with bad

investments.³¹

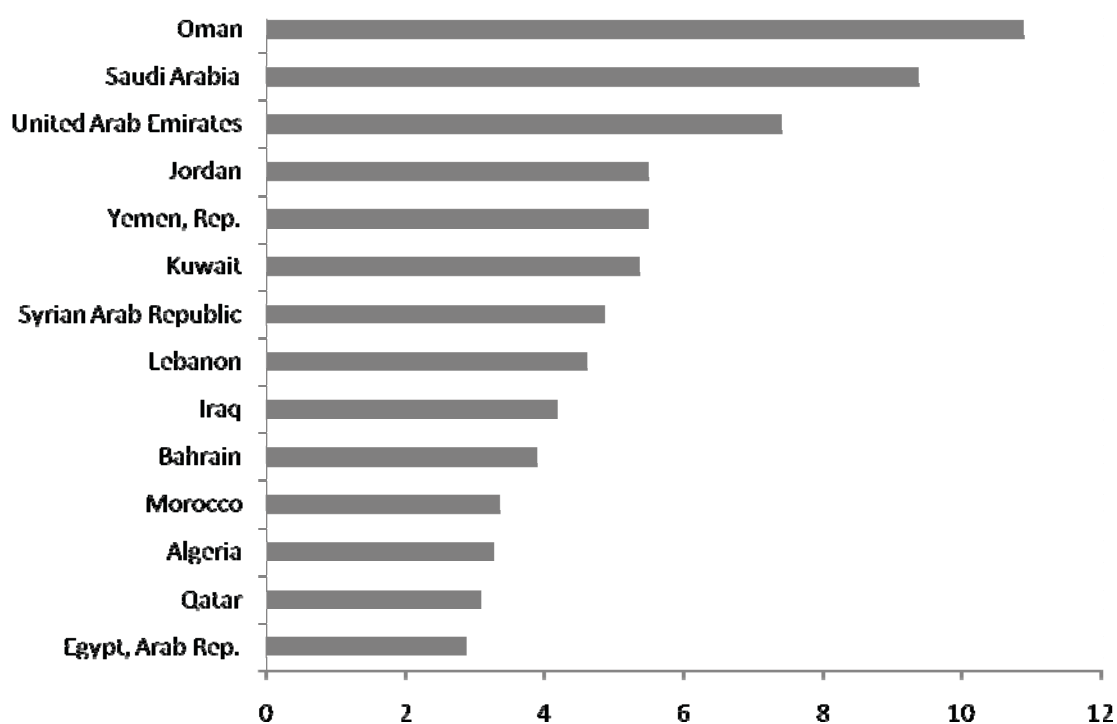
Another adverse consequence of fragmentation is that regional public goods are undersupplied, preventing fruitful cooperation between countries and resulting in a loss of productive spill-overs. This will be explored more systematically in section V. Another aspect of fragmentation that is largely ignored in the MENA literature is the wasteful duplication of defence expenditures. The segmentation of Arab countries into separate geographic units scales up the cost of securing borders. Even smaller Arab nations are allocating vast sums of money on defence and security. As Figure 4 shows, during the last decade average spending on defence in the MENA region has surpassed that of any other region in the world. Overall, the region spent twice as much on defence as South Asia; the Gulf oil exporters, especially Oman, Saudi Arabia, and UAE, are globally one of the highest spenders on defence (as a percentage of GDP) (see Figure 5). This spending pattern is not restricted to the rich Gulf States alone: in fact, a typical MENA country spends more on defence than an average country globally (2.43%). In comparative terms defence spending is high even in countries that are otherwise resource-scarce—such as Morocco, Jordan, Syria and Lebanon—and even after accounting for the large outlay on internal security. The Middle East also remains one the largest market for global arms purchases.

FIGURE 4: DEFENCE SPENDING, % OF GDP
(AVERAGE 2000-09)



Source: SIPRI Database, World Development Indicators 2010.

FIGURE 5: VARIATION IN DEFENCE SPENDING, MENA COUNTRIES, % OF GDP



Source: SIPRI Database, World Development Indicators 2010.

III. B. Defying the forces of gravity

This economic fragmentation is puzzling given the region's favourable geography. The Arab world is well-positioned to be a global trade and production hub. Geographically, it lies at the cross-roads of major sea and trading routes with easy access to Europe, Africa and the near East. Egypt alone has a strategic location that any other emerging economy will be eager to trade places. Strictly speaking, there is not even a *single* landlocked country in the Arab world, even if Iraq and Jordan have narrow coastal strips. Some, like Algeria, are blessed with a thousand kilometres of coastline and an enviable proximity to European markets. Yet, this favourable geography fails to translate into the economics of trade and agglomeration. It is ironical that a region that connects Asian merchants with European markets is itself stuck in primary production. Everywhere in the world proximity to coasts tends to be associated with lower transport costs and better access to global markets. The Arab world defies these forces of gravity, however. It has coastal proximity without market access, in part because both borders and sea are difficult to navigate in the region.

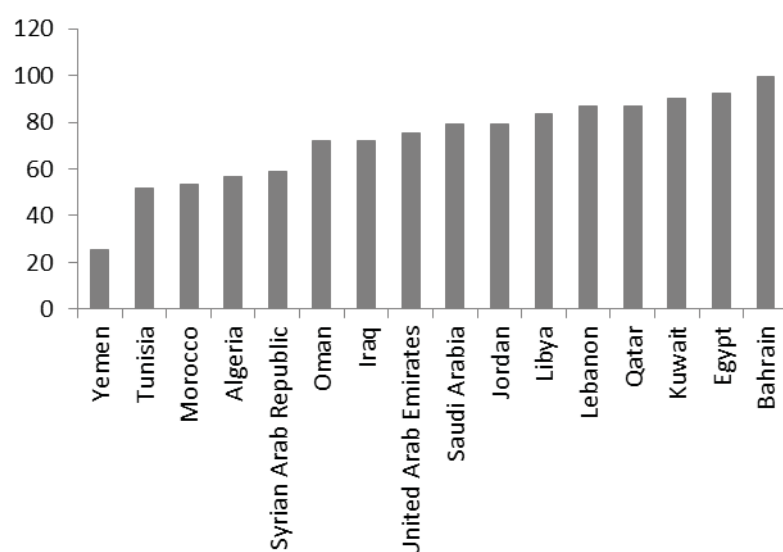
An associated puzzle is that the growing levels of urbanization in the region are not translating into material benefits for Arab firms. Cities generate economic prosperity for its people and firms. A growing body of empirical evidence indicates that firms can save on their costs by locating in mega cities and urban clusters. A firm that operates in a city

of 10 million people, for instance, can reduce its cost by 40 per cent compared to a firm operating in a city of 100,000 people.³² This is because cities offer a range of mutually supportive activities. Bringing together machinery, skills, suppliers and resources together in a single location can be tremendously advantageous for firms. Such agglomeration economies are missing in the Middle East, even if it is more urbanized today than several developing regions: 58 percent of the region's population lives in urban areas, compared to 30-37 percent in sub-Saharan Africa and South Asia.³³ In some countries, such as Egypt, three quarters of the population lives in urban areas.³⁴

Levels of urbanization are even higher when more sophisticated measures of urban concentration are considered. The recently constructed agglomeration index, which combines three dimensions of urban concentration—population density, the population of a large urban centre and travel time to that large urban centre—places the Middle East ahead of all other developing regions, including Latin America that has typically been described as the most heavily urbanized.³⁵ As Figure 6 shows, with the notable exception of Yemen, most MENA countries have significantly high levels of urban concentration. Yet, Arab firms are failing to reap the cost advantages that growing urbanization confers on them. In fact, the region's geographic advantage has consistently failed to translate into a trading advantage.³⁶ Observed levels of intra-Arab trade are at least 10-15 per cent lower than the predictions of the gravity model, which stipulates that size and distance are important determinants of bilateral trade flows.³⁷ However viewed, the region's actual performance defies its potential; existing trade can easily double from its current level.

In the face of these puzzles, Africa provides a striking contrast. Like the Middle East, it is both rich in natural resources and a severely fragmented region. But Africa is divided by ethnicity and geography. Its ethnic fractionalization and adverse geography, through landlocked regions and sparsely distributed populations, limits the possibilities for trade. About 40 percent of Africa's population lives in landlocked countries. Its resource riches have fuelled internecine civil wars. Ethnic divisions, rooted in the history of slave trade, have weakened trust among communities and led to the under-provision of public goods.³⁸ Even if the Arab world is not as structurally disadvantaged as parts of Africa, it still lies on the periphery of global trade.

FIGURE 6: AGGLOMERATION INDEX FOR MENA COUNTRIES, %



Source: Uchida and Nelson (2008).³⁹

What has then gone wrong in the Middle East? If sub-Saharan Africa is divided by ethnicity and geography, the Middle East is divided by history and policy. The Arab world has inherited an unfavourable and divisive legacy. The roots of a weak private sector run deep in history. Merchants were politically weak even under the Ottomans, whose centralized bureaucratic rule worked hard to prevent the emergence of autonomous social groups.⁴⁰ A robust private sector was more feared than favoured. When business thrived, it remained effectively in the hands of foreign merchants and local minorities. This was politically expedient: foreign merchants benefited from the economic privileges granted by rulers, but seldom challenged their authority. The break-up of the Ottoman Empire into a multitude of independent states created new political boundaries, but, over time, these became permanent economic boundaries.⁴¹ The new borders, which were largely an imperial creation, severed historic trade connections. For example, trade routes linking Aleppo to Mosul and Istanbul became largely dysfunctional; the trade corridor stretching from Damascus to Jerusalem and Nablus was met with a similar fate.

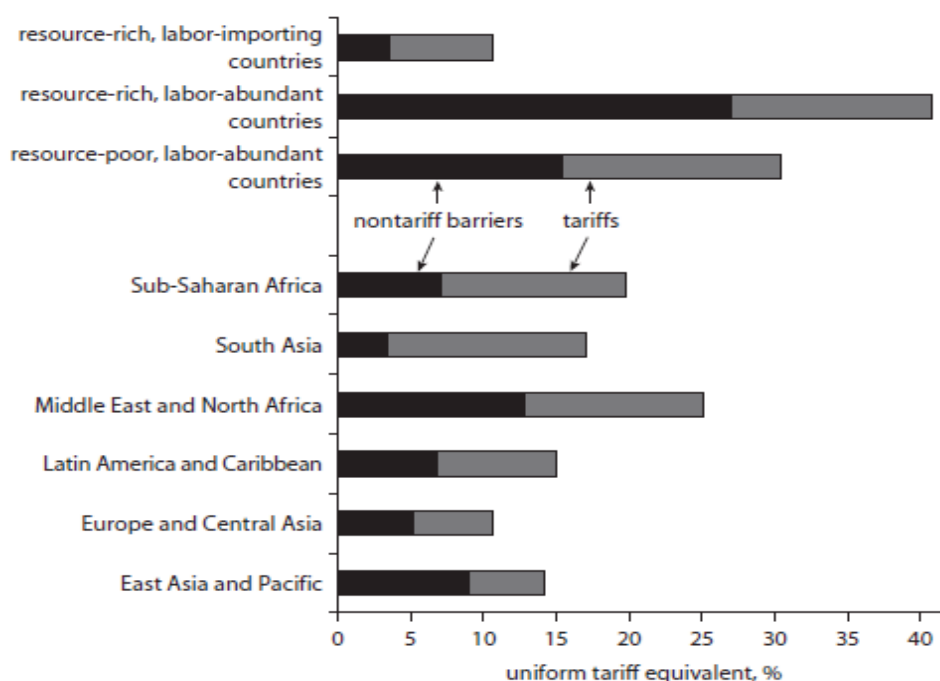
To make matters worse, national independence was sometimes accompanied with an exodus of European merchants, leaving behind a vacuum that never got properly filled.⁴² When independent Arab states emerged from the ashes of the Second World War, many of them lacked a solid constituency for private sector development.⁴³ Even a weak indigenous bourgeoisie enjoyed little continuity after independence. Nationalist governments were often hostile to business. Syrian businesses were punished through border closures with Jordan, Saudi Arabia and Iraq.⁴⁴ A wave of mass nationalizations swept through the region. They were based on socialist rhetoric, but effectively strengthened the hands of ruling elites who were all too eager, like the Ottoman Empire, to ensure their autonomy from society. Morocco was one of the rare exceptions, where the Monarchy sided with merchants to stave off the threat of nationalization. In Lebanon, where a critical mass of merchants did exist at the time of independence, sectarian divisions and the ensuing civil war emaciated private enterprise.

By and large, however, the nationalist moment in the Arab world strengthened the state at the expense of the bourgeoisie, crowding out an important constituency for pro-business policies and regional economic integration. A key failure of the project for Arab nationalism was that it had weak economic underpinnings and remained largely a linguistic and cultural bond. The discovery of oil and the birth of political conflict in Palestine generated new economic rents that froze these patterns and further reinforced economic divisions.⁴⁵ As the state's fiscal reliance on oil and aid revenues increased it became less dependent on merchants. In the Gulf Monarchies, for example, oil revenues shifted the balance of power from merchants to rulers, making the private sector more dependent on state patronage.⁴⁶

As centralized authoritarian rule took root, policy distortions came to play a more divisive role in the Arab world, eroding its natural geographic advantage. While Africa is trapped in adverse geography, the Middle East has erected man-made barriers through one of the most elaborate and enduring *license raj*. The Arab state has a shadowy presence that dominates all spheres of economic activity, making it one of the most protective trade regimes in the world. Although average tariff barriers—the taxes levied on imports and exports—have fallen in the wake of economic reform, many states in the region such as Algeria, Libya and Iran remain heavily protected. Levels of trade protection are comparatively high even in countries with sizeable export presence (Tunisia, Morocco and Egypt). Although there has been a partial success in slashing tariffs, neo-liberal reforms have failed to dismantle the more cumbersome non-tariff barriers. These are usually discretionary, non-transparent and have a more damaging effect on trade. As a result, the Middle East has today the most restrictive non-tariff barriers in the world. It lies at the bottom of the pack on the World Bank's overall trade restrictiveness index, scoring even worse than sub-Saharan Africa (see Figure 7).⁴⁷

The bureaucratic hand has long stifled entrepreneurship in the region, and has kept markets localized, segmented and cut off from each other. By distorting competition these barriers act as road blockers, privileging insiders by assigning them control over access points to the economy. Many of these administrative controls are ultimately a reflection of the absence of an institutionalized framework for decision-making. Even when they exist, rules are subjectively and inconsistently applied.⁴⁸ Results from business surveys indicate a weak enforcement environment with a noted disjunction between the *de jure* and *de facto*. Nearly 60 percent of business managers expressed the view that rules and regulations, as they appear “on paper”, are not applied consistently and predictably. In Egypt, Lebanon and Syria, firms experience a wide variation in the time required to obtain an operating license.⁴⁹ Such inconsistencies originate from centralized administrative structures with limited inter-ministerial coordination. This reduces bureaucracy to clienteles that are vertically integrated but segmented from each other.⁵⁰ This results in massive coordination failures and reduced profitability of both public and private investment.

FIGURE 7: NON-TARIFF BARRIERS IN THE MIDDLE EAST



Source: Shui and Walkenhorst (2010).⁵¹

By closing off markets to ordinary investors, these trade frictions distort the level playing field and restrict the entry of new firms. The number of registered businesses per 1,000 people in the Middle East is less than a third of that in Eastern Europe and Central Asia. Markets in the MENA region are dominated by older, more well-established firms. The average age of firms in MENA is almost ten years older than those in East Asia or Eastern Europe.⁵² The sort of entry and exit of firms that raises economic efficiency is largely absent. Access to credit can be particularly difficult for younger, less connected firms. A recent study shows that bank loans to SMEs in the MENA region do not exceed 8 percent of total lending operations.⁵³ The bulk of bank lending goes to larger and more connected borrowers. One evidence for such “connected lending” is that “the ratio of exposure to top 20 loans to bank equity is nearly four times higher” in the MENA region than in North America.⁵⁴

Evidence from the World Bank’s Enterprise Surveys suggests that a typical manufacturing firm in Algeria, Morocco, Syria, Egypt, Yemen and Jordan finances at least 75 percent of its investment requirements from internally generated funds. Few firms have an established line of credit from a banking institution; in Yemen only 8 percent of firms have a bank loan. Collateral requirements can be cumbersome, with at least 80 percent of loans based on some form of collateral.⁵⁵ Even in a resource-rich country like Algeria, which sits atop US\$180 billion of cash reserves, 50 percent of firms viewed access to credit as a major constraint. These credit constraints can be particularly cumbersome in a business environment with discouragingly high start-up costs. In Syria and Yemen, for example, “capital required for starting a business is more than 2,000% of income per capita” (the comparable global ratio is 115 percent). With such high initial thresholds for investment and limited access to credit, Arab firms are ill-prepared for the world of manufactured exports. The next section unpacks one aspect of this distorted trade regime: trade logistics.

IV. Trapped in trade logistics

Observers of the Middle East have long bemoaned its political repression. Few have appreciated, however, the scale and intensity of its perpetual state of economic repression. The region's fragmentation is partly rooted in arbitrary restrictions and complicated trade logistics that make economic exchange both unpredictable and unprofitable. These behind the border barriers can take several forms: cumbersome procedures, regulations and administrative controls that create costly frictions in transport, communication and services. The movement of goods, capital and people is governed by various restrictions that often defy any economic logic.⁵⁶ Firms that wish to move goods across borders have to incur a range of transaction costs associated with internal transportation, customs, port handling, warehousing, shipments and distribution of goods. On average, Arab countries underperform on various dimensions of trade facilitation⁵⁷, although performance is variable with some in the region—notably, Jordan, Tunisia and the Gulf countries, faring better than others.⁵⁸ But, even the Gulf countries underperform, on average, relative to countries with comparable levels of income.⁵⁹

Regional connections are a particular weakness, even if some countries possess world class infrastructure that connects them with global markets. For example: there is limited coordination among Arab countries on border procedures; compliance with these alone can be an excruciating experience for firms. Internal transportation is particularly costly, thanks to a fragmented trucking industry that is controlled mainly by cartels and subject to a plethora of procedures. Truck drivers have to meet complicated requirements for permits, visas and even restrictions to drive foreign trucks over the weekends. Foreign trucks can be required to return to the country of origin without cargo. Even the movement of labour—otherwise an area of success—is governed by a discretionary and heavily regulated regime.

This translates into a higher cost of production and reduced competitiveness of firms. By one estimate, the cost of such trade logistics exceeds 10 per cent of the total value of goods shipped.⁶⁰ Companies can incur around 95 person-days a year while dealing with such trade transactions.⁶¹ Terminal handling can be significantly delayed; and absence of cool storage facilities at ports limits the potential for agricultural exports. Despite a favourable coastal access, the region is only a transit point for major shipping routes. Limited business forces shipping companies to offer costly and infrequent services with long and indirect sailing times. For example, the voyage from Jordan to New York can take up to 42 days, and sailing times to Hamburg and Tokyo are 30 and 45 days, respectively.⁶² Empirical evidence suggests that trade logistics can cost dearly to exporters in the region. The associated costs can be as high as 55 percent of the product price of Yemeni Tuna, 45 percent for Jordanian okra, 26 percent for Jordanian potatoes and 15 percent for Egyptian garments.⁶³ This can leave exporters significantly disadvantaged, especially in markets where producers compete on narrow profit margins.

Weak trade logistics prevent the integration of product and factor markets, and undermine the region's long-term growth prospect. Importantly, they prevent the region from taking advantage of trade in intermediate goods, which has grown at a faster pace than other forms of trade and offer a feasible route to export diversification. The importance of trade logistics has heightened in a world where production has

become growingly footloose, allowing firms to specialize in different stages of the value chain. Firms are finding it less profitable to run an integrated production process, where all tasks are performed in the confines of a factory. With the option to outsource specific tasks, trade in parts and components has expanded significantly. This unbundling of the production process and the resulting growth of trade in intermediate goods is the new facet of globalization. This has fuelled mutual trade in Asia, with the result that regional trade in Asia Pacific is growing faster today than its trade with the rest of the world.

This dramatic shift in trade from products to tasks has also opened new opportunities for countries that have previously missed the boat of industrialization. For late entrants specialization in individual components of the production process is less daunting than specializing in the entire product.⁶⁴ But the ability of the Arab world to take advantage of these trade possibilities is constrained by weak trade logistics. The arbitrary barriers that Arab governments have built over time have reinforced their economic isolation and prevented the emergence of a regional network of suppliers. This hampers investment from multinationals who are increasingly interested in sourcing cheap inputs and quickly moving them across borders. As a result, its excellent location notwithstanding, the region is a net loser on the global supply chain.⁶⁵

This is a significant loss for a region that desperately needs to broaden its production base and expand jobs for its young. Ironically, these trade frictions are more pervasive and stringent in labour-abundant countries of the Middle East—precisely the countries that urgently need a vigorous private sector. The resource-rich, labour abundant economies of the region have also made the slowest progress on economic reform and lie at the bottom third of economies worldwide in terms of success in economic reform.⁶⁶

The Middle East is truly caught in a vicious cycle. It has small and thin markets that increase business uncertainty, deter investment and deprive private firms from realizing economies of scale. Given that scale economies are more crucial for exports of manufactures, economic divisions prevent firms from branching out into high value added activities in the export sector. A weak private sector, in turn, lacks the political strength to meaningfully influence public policies. And, with production structures that look more similar than different, possibilities for regional trade remain limited. Taken together, this reinforces the region's dependence on primary commodities and a growing reliance on the state for job creation. One way of breaking this development trap is to foster trade synergies across countries by creating an infrastructure of cooperation—an infrastructure that connects regional markets and facilitates trade.

V. An infrastructure for cooperation

One reason why economic fragmentation hinders prosperity is that it leads to the under-provision of regional public goods. An infrastructure that facilitates the movement of goods and people across the Middle East is one such public good. A connective infrastructure is likely to benefit every one in the region, but the costs of putting it in place are exorbitantly high for any single country to bear. This is the classic problem of coordination failure that needs to be solved through a regional collective action of sorts. Without such collective action, the region will fail to benefit from the powerful externalities that an integrated transport network can generate.

A deficient infrastructure provides one reason behind the region's botched attempts at

regional integration. For example: if the Gulf Cooperation Council (GCC) has failed to live up to its dream it is partly the result of ignoring the infrastructure needs.⁶⁷ It is a failure, in other words, of putting the nuts and bolts of cooperation in place. Neither trade complementarity across Arab countries nor integration with global markets can be effectively pursued without connecting the region through ports, roads and rail networks. Even if, individually, some Arab countries have world class infrastructure, access to the region can sometimes be indirect, requiring travellers to make a journey first to Paris or London before reaching another Arab capital. Those wishing to travel from Doha to Dubai, or vice-versa, have to transit through Saudi Arabia.

Even for Arabs the visa requirements for travelling within the region can sometimes be as cumbersome as the journey itself. And, for a Jordanian firm importing goods from neighbouring Lebanon can sometimes be costlier than importing them from Britain. There is no direct transport link between Qatar and Bahrain. A causeway linking the two countries was announced in 2008 but has been delayed by regional politics. Border disputes between Morocco and Algeria—a legacy of French imperial rule—have led to prolonged and costly border closures. The absence of effective regional transport connections has tangible implications for prosperity. Many firms depend on transit facilities in neighbouring countries for accessing global markets. This generates important externalities. If trade logistics improve in Jordan, for example, they will benefit not just Jordanian exporters but also firms in the Arab hinterland. If there is a rail link connecting Basra in Iraq to Latakya in Syria, potential Iraqi exporters can have a better access to European markets, saving them considerable sailing distance. These are just few of many illustrations that make a simple point: without better regional access, Arab firms have little hope of competing in global markets.

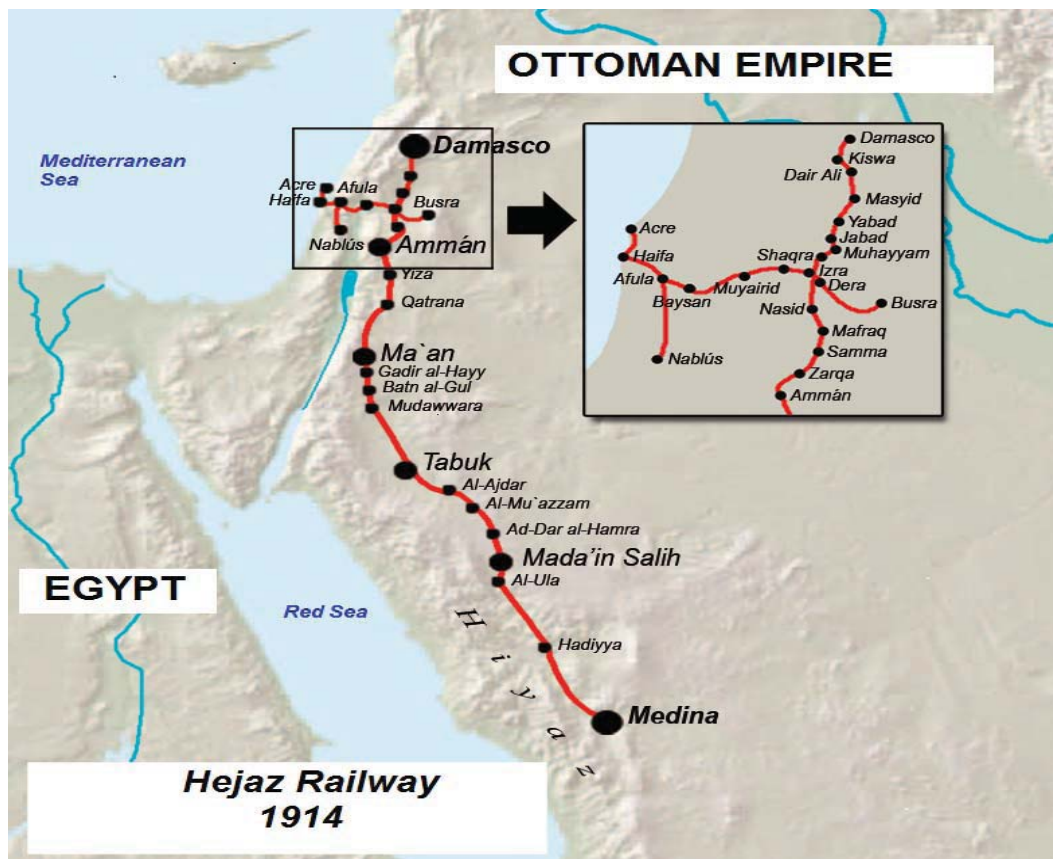
Governments have been slow to respond to this challenge. This is ironical given that resource-rich governments never dither from spending on infrastructure. In fact, it is their pet item on the fiscal balance sheet. Even if the recent oil boom has afforded massive investments on infrastructure, they are mostly inward looking, and centred around prestige projects that are more often based on political rather than economic rates of return. There is also an obsession with roads and highways, neglecting critical investments in rail infrastructure and other trade logistics. Rail infrastructure is a particularly weak aspect of trade logistics in the region; here, the Middle East has been consistently ranked below other regions of the world.⁶⁸

As a result of this neglect, old trade routes and railway systems have fallen into disuse. Hejaz Railway, the famous Ottoman project that connected Damascus to Medina, provides a pertinent example. Originally scheduled to terminate in Mecca, the project has been in-operational since the First World War, despite repeated attempts to revive it (see Figure 8). Today, railway coverage in the region is both limited and uneven, reflecting the strategic needs of a bygone era rather than its current cultural and economic requirements. Rail connectivity presents an important instance of coordination failure. Specification differences in rail infrastructure across Arab countries means that developing rail links across borders entails a significant fixed cost, requiring cooperation from all countries.⁶⁹

Despite these operational difficulties, there is significant potential for cooperation. A state of the art rail network can connect not just Arab economies, but also open a new trade and investment corridor linking these economies to West Asia, Africa and Europe. There is a belated official realization of this, which has led to a renewed push for better

rail connectivity. The agreement in 2003 to establish the Arab Mashreq International Railway project, recent proposals to build a rail network inside Saudi Arabia and efforts to revive train links with Turkey are promising steps. But progress on these projects is slow.

FIGURE 8: MAP OF THE HEJAZ RAILWAY, 1914

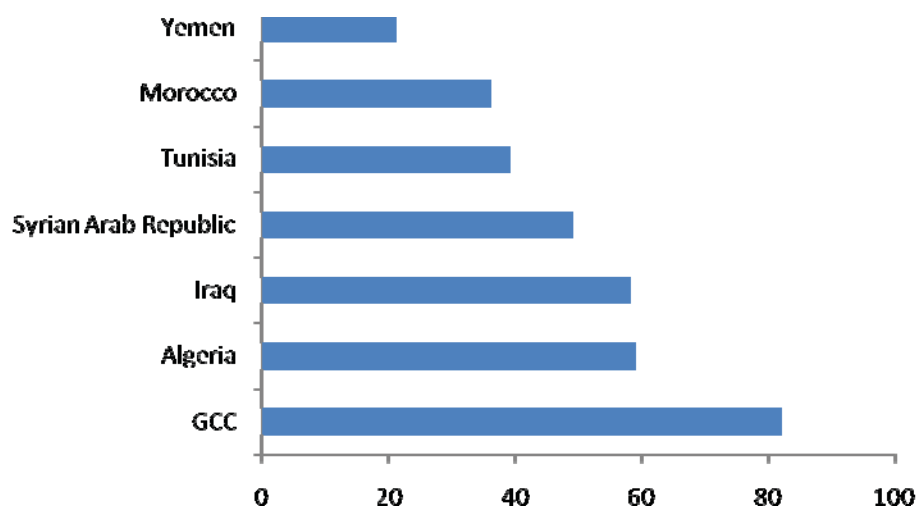


Source: <http://en.wikipedia.org/>

An integrated infrastructure can deliver other un-intended benefits too. It can help arrest food inflation, for example, which fires public protests and consumes a growing share of public subsidies. Arab countries, especially in the Gulf, depend heavily on food imports from neighbouring areas. A better infrastructure, by connecting the region's agricultural markets, can mitigate fluctuations in food prices, since transport costs can make up as much as 40 percent of the overall food price in the region. There is considerable variation within the region in terms of access of rural areas to transport. In several countries outside the GCC, considerable proportions of rural populace have limited transport mobility. Figure 7 plots the Rural Access Index for selected countries in the region. The Index uses household survey data to estimate the number of people who live within 2 kilometers (or about 25 minutes walking time) of the nearest all-weather road. As Figure 9 shows, in Yemen, Morocco and Tunisia relatively smaller percentage of rural populations have access to transport. Rural access to transport in Yemen is lower than sub-Saharan Africa (34%). This keeps rural markets fragmented

and lead to the persistence of poverty and inequality.

FIGURE 9: RURAL ACCESS INDEX, %



Source: Roberts et al. (2006).⁷⁰

Removing frictions in the movement of goods and people, both within and across countries, is essential for fostering trade complementarities and enhancing regional trade. Existing commitment to improving physical infrastructure are dominated by grandiose projects, neglecting small reforms based on specific constraints faced by firms. There is too much emphasis on modernizing the infrastructure, too little on harmonizing border procedures and coordinating trucking standards, for instance. The latter might play a more critical role in bringing down internal transport costs and developing a regional trade corridor. The region urgently needs a new institution that coordinates regional transport initiatives.

In the modern history of the Middle East the year 2011 will be remembered as a critical juncture that created a new opening for change. In confronting these infrastructural challenges, we are struck by a great historic symbolism. In 1917 the British intelligence officer, T. E. Lawrence, led Arab tribes to destroy the tracks of Hejaz railway that connected Arabia to Ottoman cities. Then, it was a strategic military imperative to cut off the enemy supply routes. About a century later, it is now a strategic *economic* imperative to revive these communication links.

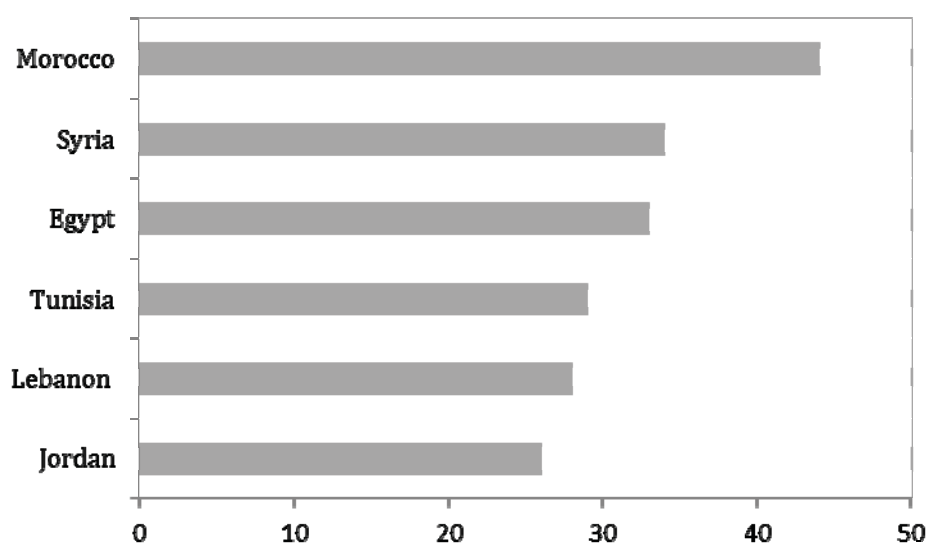
VI. Can demography change the political calculus?

It is clear from the preceding discussion that these relatively invisible trade barriers are divisive and impose a heavy cost on Arab economies. Dismantling these barriers can entail significant benefits. Evidence suggests that the welfare gains from eliminating non-tariff barriers is at least triple the benefits from conventional trade reforms that exclude trade facilitation.⁷¹ Why have these economic divisions endured for so long, then, and why have reforms been so painfully slow? The answer, it seems, lies in the nature of political incentives. If the Middle East has collectively failed to tackle these

constraints, it is not due to the shortage of resources but a dearth of political will. The extensive trade restrictions that the region has built up over time are not simply procedural barriers, but also political barriers. This interplay between economics and politics is central to understanding why these trade frictions have been both pervasive and persistent.

The region's arbitrary trade regime serves a vital political function: by allocating monopoly rights to insiders and by channelling rents to favoured groups, it cements the power of rulers. These institutional rigidities push workers and firms into the domain of the informal sector, which is now both widespread and sizeable in several Arab states. Some of the region's relatively resource-scarce countries have a sizeable black economy, which ranges from 26 percent of GDP in Jordan to 44 percent in Morocco (see Figure 10).⁷² Even fuel endowed economies like Algeria (not shown in the graph) have a thriving parallel market. In many countries, links between the black economy and state institutions, such as the military and security forces, can be murky. Decades of centralized control has restricted economic advantage to those well-entrenched in the system, closing off markets to ordinary investors who are willing to compete on equal terms but are denied a level playing field. All across the Arab world a thin layer of the population dominates the economy, controlling everything from banks, businesses to telecom. This has erected a pyramid of privilege, built around a small number of large firms at the top and a large number of small and informal firms at the bottom. The result is greater economic polarization and limited economic mobility.

FIGURE 10: SIZE OF THE INFORMAL ECONOMY, % OF GDP
SELECTED MENA COUNTRIES



Source: IMF (2011).

It is partly for this politics of policy that shaking off the bureaucratic stranglehold has proven so difficult, despite an era of neo-liberal economic reform. Economic reforms have been “uneven, hesitant and incomplete”.⁷³ Although economic reforms have not been a uniform failure, they have failed to dismantle the state's heavy-handed regulation.⁷⁴ Reforms have not been accompanied with a qualitative shift in decision-

making: policy is still guided by discretion rather than rules. As a result, the investment response to reforms has been weaker: a mere two percentage points of GDP, compared with 5 to 10 percentage points of GDP in Asia, Eastern Europe and Latin America. Neo-liberal reforms have neither levelled the playing field nor dramatically tilted the balance of economic power in the favour of those systematically excluded from the system. As a result, rather than creating a “legitimate constituency” for the private sector, reforms have simply strengthened businesses that are “embedded with those in power”. Viewed in this light, policy reforms have simply been a vehicle for a “re-configuration of political power”—a means for “shoring up regime power rather than dispersing it among social groups”.⁷⁵ The failure of reforms is thus ultimately rooted in the failure to remove the real constraints to growth, which are mainly institutional in nature.

The Arab world is faced with not just a vicious development cycle. It is also trapped in an adverse political equilibrium, sustained by ruling elites who might view a private sector operating outside their sphere of influence as a possible threat. This is easy to understand. When the private sector competes for profits through manufacturing and trade, it is likely to generate middle class incomes that can ultimately pose a challenge to centralized authoritarian rule. Regional trade is thus feared because it can displace the incumbent advantage of insiders who have long monopolized economic opportunity. Therein lay the difficulty of change: even as regional cooperation is welfare enhancing there are few stakeholders for it; by contrast, the status-quo is fiercely defended by a small, cohesive and well-organized elite. That is why man-made barriers are sometimes as difficult to dismantle as geographic barriers to trade.

The primacy of politics is underscored by contrasting the limited progress on trade integration with that of flourishing regional linkages in finance. While trade opening has been resisted, Arab countries have become more financially connected through growing cross-border investment flows. The region’s oil exporters have become an important source of foreign capital for their relatively poorer neighbours. Inward FDI in several resource-scarce and labour-abundant countries of the region has crossed 70 percent of GDP. In 2006 this ratio exceeded 118 percent of GDP in Jordan.⁷⁶ These inward investments were primarily driven by the growth of the services sector, principally telecommunications, tourism, medical and financial services. Apart from the greater complementarity in the services sector, these growing financial linkages also stem from the fact that the politics of financial integration has proven to be relatively less complicated than the politics of trade.⁷⁷ Regional financial opening has been politically more palatable, since the liberalization of banking and telecommunications—that has been the mainstay of economic reforms—has conveniently served as a source for lucrative contracts and licenses for insiders.

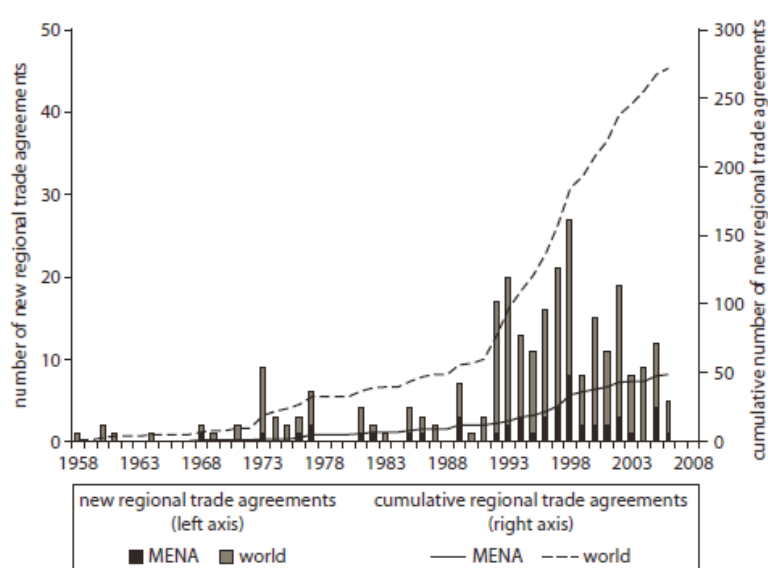
One reason why this political economy of protectionism has endured for so long in the Middle East has to do with the absence of a strong constituency championing for greater economic access. Business associations are weak, stratified and politically embedded, serving primarily as a means to secure narrow interests than to win concessions for the wider business community. They have rarely acted as effective modes of articulating the concerns of smaller and under-privileged firms. The manufacturing sector, as a whole, has limited lobbying power and the key beneficiaries of reform—unemployed youth and young firms—are not collectively organized to push for meaningful reforms. In other parts of the world, trade integration is often a matter of necessity—a strategy for

economic survival, not just growth. In the Arab world, however, rents from oil and aid have engendered a sense of autonomy from integration.

If the domestic constituency for reforms is lacking, so is the external agency for changing the status-quo. Even when globalization was unavoidable, Arab economies have integrated vertically with global structures of trade and finance, while keeping horizontal linkages between regional economies weak and underdeveloped (see Figure 11). The US, EU and other emerging economies have preferred to forge bilateral trade pacts with individual MENA countries. Washington has actively pursued bilateral trade agreements with Jordan, Lebanon and Morocco and individual GCC States.⁷⁸ There is a plethora of similar trade initiatives between the EU and North African countries. The bilateral trade pacts are often negotiated in a top-down fashion without effective input from local industries or business associations. All of this has happened while horizontal linkages between Arab economies have remained minimal. Economies of the Middle East are essentially organized in a honeycomb structure, where individual cells are insulated from each other but connected to the outside world.

Attempts at global and regional trade integration need not be mutually exclusive, especially if regional trade does not discriminate against trade with countries outside the region. Both can be simultaneously pursued to the region's benefit. Evidence suggests that trade with the EU brings welfare gains,⁷⁹ while, at the same time, there is also considerable untapped potential for regional trade between MENA countries.⁸⁰ However, the region's vertical trade engagement with the US and EU should not neutralize attempts at regional integration.⁸¹ Preferring to insist on bilateral relations, foreign powers have sometimes viewed regional pacts with indifference or, at worst, with suspicion.⁸² In fact, regional integration in MENA is curiously omitted from the emerging foreign policy discourse of major powers. This is a notable omission and

FIGURE 11: REGIONAL TRADE AGREEMENTS



Source: World Bank (2011).

contrasts sharply with recent American efforts to mainstream regional trade in South Asia through a revival of the old Silk Road in the Af-Pak region. While connecting regional markets is fast becoming a cornerstone of US foreign policy in South Asia, a similar development vision for the Middle East is noticeably absent from the policy horizon.

Regional integration has not been forcefully pushed by international financial institutions either. While research conducted under the auspices of the IMF and the World Bank has documented inadequate patterns of regional trade and identified underlying barriers, it has stopped short of turning regional trade into a major plank of its policy advice. This reluctance is illustrated by extracts from two reports published, respectively, by the Fund and the Bank. Both advocate a questionable precedence of global integration over regional trade:

“Rather than set as their first economic policy priority the goal of regional integration, MENA countries should focus on domestic policy reforms and the associated process of greater integration into the world economy”⁸³ (El-Erian and Fischer, 1996).

A recent World Bank report emphasizes a similar sequence:

“It seems advisable for MENA policy makers to focus first on how to maintain and strengthen their countries’ competitiveness in the global market and only then ask what contribution regional integration can make toward achieving this end” (Shui and Walkenhorst, 2010).

This emphasis on globalization as a priority policy objective can be misplaced for several reasons. Assuming that trade barriers serve political constituencies, dismantling them for global trade are no more politically expedient than regional liberalization. In fact, the opposite might be argued: if market opening is a concession then it may be easier to accord this selectively and gradually at the regional level. For globalization to succeed it is important that countries make a full use of the scale economies, reduce their dependence on primary commodities and ensure greater market competition. Regional trade integration can facilitate all these. In fact, without actively contested regional markets, trade liberalization will not be complete.

Regional trade integration can also generate more powerful economies of scale. These scale economies are not just restricted to firms but accrue more widely to industries and, ultimately, the economy as a whole. One example of these broader scale economies is in the provision of regional public goods—in transport and communication infrastructure, for instance. Regionalization of trade will also facilitate deeper trade integration that goes beyond a mere reduction of tariff barriers and helps to dismantle the more cumbersome non-tariff barriers. By permitting better coordination and harmonization of policies, regional trade facilitation can significantly improve the investment climate. More importantly, regional trade is integral to efforts towards economic diversification. The region has little hope of diversifying when firms face high transaction costs to exporting. Fragmented markets also deny scale economies to firms. To the extent that scale economies are more important for manufactured exports, a mere insistence on global integration without comprehensive trade liberalization at the regional level can keep the Middle East locked in primary export structures.

Thick economic borders can also disadvantage Arab countries in intra-industry trade which, given the region's similar factor endowments and production structures, offers a promising avenue for economic diversification. With its educated population, high levels of urbanization and favourable access to coasts, the Middle East is particularly suited for trade in tasks. But the trade in intermediate goods relies more heavily on soft economic borders and the presence of regional production linkages, industrial clusters and efficient trade logistics. Putting in place these "soft technologies" of industrialization requires a well-coordinated regional development policy. A regional collective action is also necessary for designing an effective industrial policy that fosters trade complementarity across the region. To summarize, stronger linkages between Arab economies can generate dynamic gains that can, in turn, serve as the springboard for a more productive engagement with the forces of globalization. Rather than treating them as separate policy objectives, there is a strong case for emphasizing the mutually reinforcing character of globalization and regional trade facilitation.

The politics and geo-politics of trade integration are complicated. The Arab world's lopsided patterns of integration have worked well for both regional elites and international stakeholders. A fragmented region cements the power of insiders and prevents the emergence of autonomous social groups. In geo-political terms, it fosters the region's dependence on external powers. The Arab revolutions offer an opportunity to re-think this status-quo. A critical question is whether these youth uprisings can alter the incentives and preferences of decision-makers, both at home and abroad? In other words, can the Arab spring change the political calculus that has prevented economic cooperation thus far? The region is often united when it comes to dealing with security challenges. The unanimous response by the Arab League on enforcing a no-fly zone in Libya is a prime example. But can the region act collectively to save the economic future of its people. The question of regional integration is not just a fancy European ideal to emulate; it is also a matter of human security—of providing opportunities for economic and social mobility.

The Middle East is passing through a defining moment, containing in it the seeds for much creative destruction. Repeatedly in history, when faced with an existential threat, elites have surrendered their privileges and extended rights to commoners. The Arab revolts of 2011 offer precisely such opportunity to spur change. If there is one key strategic concession that the region's elites can collectively offer to the Arab world, it is by creating regional economic commons for its people. By integrating regional markets, Arab rulers can offer the best form of redistribution to poorer neighbours and the most potent economic hand-out to their people—better than doling out billions of dollars in subsidies that keep economies and aspirations artificially alive.

In confronting the region's development challenges, geography will play a pivotal role. It presents opportunities for both change as well as status-quo. The region is massively favoured by its geography of trade and investment. Given its superior access to coasts, markets and resources, the Middle East is naturally predisposed towards trade and competitive production. This can be an agent for change. At the same time, the geography of resources and conflict can be a retrogressive influence, since it generates rents that establish the primacy of patronage over production. The future of the region hinges on how policymakers grapple with this clash of geographies. Can they harness their natural geographic strengths to build a future based on trade and production, or

do they fall back on the geography of rents and patronage?

VII. Conclusion: an “open access order”

The Arab world lies at the cusp of a new era. It is witnessing an unprecedented demographic transition resulting in one of the “largest youth cohorts” in its history. This is, to quote Tarek Youssef’s prophetic expression, the “generation in waiting”—a generation waiting for jobs and justice. The future of the Middle East crucially depends on whether it can convert this youthful transition into a productive transition. This requires Arab rulers to concede not just political space, but also greater economic access. Unless accompanied with a distribution of economic power, political reform alone will not be sufficient. Borrowing the conceptual formulation of Douglass North, what the Arab world needs today is an “open access order”.⁸⁴ The Arab state has typically created rents by restricting access to economic opportunities to a dominant coalition, and used these rents to sustain order.

Through centralized economic control and restrictive economic barriers, Arab governments have erected a system of economic apartheid that systematically excludes people and firms at the margins. Although, the Middle East has modest levels of measured inequality by global comparisons, its central challenge is the inequality of access. Everywhere in the region there are strong advantages of incumbency. To create an “open access order”, a new governance paradigm needs to be imagined that brings people from the margins to the mainstream, offering them ladders for economic mobility—ladders that are defined by merit and competition, rather than *wasita* or connections. This requires that economic rewards are distributed through achievement rather than ascription, and that elite privileges are transformed into universal rights.

Much of this hinges on whether private economic activity can take root and lead to the proliferation of new social groups that ultimately result in a greater dispersion of power. Arab economies have long been greased through revenues from oil, aid and remittances. There is now a need to generate alternative revenue streams through trade and private sector development that can replace patronage with production. But it is inauspicious to talk about the necessity of economic reform at a time when the region’s political climate is decidedly anti-business. The private sector is at once the most *despised* as well as the most *desirable* aspect of reform. Business in the Arab world is often comfortably embedded within the state, with the result that it invokes images of crony capitalism. At the same time, an estimated 100 million jobs need to be created in the MENA region over the next decade or so.⁸⁵ This employment challenge cannot be addressed without a strong private sector. And, without a strong private sector the human capital gains that the Arab world has achieved over time cannot be translated into solid productivity gains.

An independent business sector will also serve a vital political function: it can generate a middle class that can serve as a powerful constituency for political reform. A robust private sector is thus both an economic and political imperative. But this requires a radically different business life. It requires a private sector that is open, competitive and can operate outside the royal circle. This can be achieved through a genuine *infitah* (economic opening) that dismantles entry barriers, replaces privilege with competition and ensures a decentralized and rules-based framework for decision-making. Viewed in this light, the struggle for a new Middle East will be won or lost in the private sector.

The region's deep economic divisions act as a key hindrance to private sector development. Fragmentation increases the returns to predation, preserves the unequal distribution of economic opportunity and enriches elites at the expense of ordinary firms and citizens. Opening economic access is therefore resisted because it can dissipate the rents that sustain the stability of ruling coalitions. While the region lacks a solid constituency for private commerce, the demographic and political upheavals across the Arab world have created a new opening for change. Demography poses a common challenge to Arab governments; it also deserves a common response through an opening of regional markets. Regional economic cooperation, which has long received rhetorical support, assumes a new urgency in this context.⁸⁶ The region urgently needs a new logic of economic integration, based on a broader discourse on security that transcends beyond narrow, short-term concerns of regime security and attends to the long-term challenges of human security.⁸⁷ Connecting regional markets is also an essential step towards effectively competing in global markets.

But, the region's economic fragmentation is partly a manifestation of internally segmented administrative structures. Governance systems in the Middle East are highly centralized that often function through vertical clienteles that are unconnected from each other. This brings us to a fundamental irony that has profound consequences for development: as the Middle East has become more centralized, it has also become more fragmented. The region's centralized and segmented administrative structures have restricted economic access and prevented the diffusion of economic rents through entrepreneurship and trade. Importantly, a segmented state apparatus has prevented the emergence of a business class that has direct stakes in more open regional markets. This has given rise to massive coordination failures, with the result that Arab governments and firms today are particularly deficient in capturing positive externalities and productive spill-overs. In this milieu, public effort and resources are duplicated and complimentary activities are ignored. And the patrimonial ties between firms and the state become stronger than their productive linkages with other firms.⁸⁸ This creates an inhospitable environment for trade, specialization and competitive production.

This centralized bureaucratic rule has a long historical lineage, dating back to the Ottoman rule. The Ottoman Empire and its successor Arab states have been particularly efficient at promoting and guarding their autonomy from society. But, in this quest for absolutist control, bureaucracy has been turned into an irritant for the growth of bourgeoisie and regional economic integration.⁸⁹ Monolithic systems are designed to preserve harmony than to induce change. This generates a fundamental contradiction with the growth of private enterprise, which demands open economic access, flexibility and an ability to adapt and innovate. A centralized system is therefore anathema to entrepreneurship and innovation. At key moments of history, the Arab state has attempted to institute reforms in various guises, but these have mostly ended up centralizing power, rather than dispersing it. Whether it is the *Tanzimat* reforms under Ottoman rule, nationalization of the 1960s or neo-liberal economic reforms of the 1980s, they have all served as vehicles for refurbishing the state's power. The key question in this regard is whether reforms will once again be a centripetal or a centrifugal force? This is the true crucible of the Arab Spring.

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¹ The "Arab world" is broadly defined to include the Arab nations of the Middle East and North Africa.

² Daron Acemoglu and James Robinson, 2008, "The persistence and change of institutions in the Americas", *Southern Economic Journal*, 282-299. Also see: James Robinson, 2010, "Elites and institutional Persistence", WIDER Working Paper 2010/85, Helsinki.

³ Al Manar, 2010, *Employment and Unemployment Survey: Number of Employed Jordanians 2000-09*. Amman, Jordan.

⁴ Francisco R. Rodriguez and E. Samman, 2010, "The North African Miracle", <http://hdr.undp.org/en/humandev/lets-talk-hd/2010-11b/> (Also, see, the Human Development Report 2010, Oxford University Press).

⁵ Tarek M. Yousef, 2004, "Development, growth and policy reform in the Middle East and North Africa since 1950", *Journal of Economic Perspectives*, 18(3), 91-116.

⁶ The World Bank, 2004, "Unlocking the Employment Potential in the Middle East and North Africa: Toward a New Social Contract", Washington, D.C.

⁷ A. Kapiszewski, 2006, "Arab Versus Asian Migrant Workers in the GCC Countries", UN/POP/EGM/2006/02.

⁸ Sahar Taghdisi Rad, 2011, "Jordan's paradox of growth without employment", *Development Viewpoint* 65, SOAS, University of London.

⁹ The World Bank, 2005, *World Development Report: A Better Investment Climate For Everyone*, New York: Oxford University Press.

¹⁰ United Nations Industrial Development Organization, 2009, *Industrial Development Report 2009*, Vienna.

¹¹ World Development Indicators (available at: <http://data.worldbank.org/data-catalog>).

¹² The importance of Suez Canal can be gauged from the fact that around 8 percent of the global sea-borne trade passes through it. It generated US\$ 4.8 billion in revenues in 2010 alone.

¹³ World Development Indicators (available at: <http://data.worldbank.org/data-catalog>).

¹⁴ Jane Harrigan, 2011, "The political economy of aid flows to North Africa", WIDER Working Paper 2011/72, World Institute of Development Economics Research, Helsinki, Finland.

¹⁵ The World Bank, 2011, *World Development Indicators 2011*, Washington D.C.

¹⁶ There may also be a feedback from the state's redistributive system to demographics, as generous state provision may act as an incentive for a larger family size.

¹⁷ The region imports 50 percent of its food calorie consumption.

¹⁸ Annia Ciezadlo, 2011, "Let them eat bread: How food subsidies prevent (and provoke revolutions in the Middle East?" *Foreign Affairs*, March 23 2011.

¹⁹ http://gitm.kcorp.net/index.php?id=579569&news_type=Economy&lang=en

²⁰ Silvana Tenreyro and Miklos Koren, 2010, "Volatility, diversification and development in the Gulf Cooperation Countries", Kuwait Programme Working Paper, London School of Economics and Political Science.

²¹ For key features of this development model, see, Tarek M. Yousef, 2004, "Development, growth and policy reform in the Middle East and North Africa since 1950", *Journal of Economic Perspectives*, 18(3), 91-116.

²² Clemens Breisinger, Olivier Ecker and Perrihan Al-Riffai, 2011, "Economics of the Arab awakening: From revolution to transformation and food security". IFPRI Note, Washington, D.C.

²³ This is evident in Saudi Arabia, for example, where there are considerable government shares in large business conglomerates.

²⁴ Giacomo Luciani and Steffen Hertog, 2010, "Has Arab business ever been, or will it be, a player for reform?", Arab Reform Initiative Policy Paper 1.

²⁵ Marcus Noland and Howard Pack, 2009, *The Arab Economies in a Changing World*, Washington: Peterson Institute for International Economics.

²⁶ World Development Indicators 2010.

²⁷ Nugent and Yousef (2005).

- ²⁸ *Ibid*, chapter 10 (Lulu Shui and Peter Walkenhorst: "Regional integration: Status, developments and challenges") .
- ²⁹ José R. López-Cálix, Peter Walkenhorst, and Ndiamé Diop, (eds.), 2010, *Trade Competitiveness in Middle East and North Africa: Policies for Export Diversification*. World Bank, Washington, D.C. (chapter 10)
- ³⁰ Francisco Caselli and James Feyrer, 2007, "The marginal product of capital", *Quarterly Journal of Economics*, May Issue, 535-568.
- ³¹ Paul Collier and Anthony Venables, 2010, "Trade and economic performance: Does Africa's fragmentation matter?", In Justin Yifu Lin and Boris Pleskovic, (eds.), 2010, *People, Politics and Globalization – Annual World Bank Conference on Development Economics*, The World Bank, Washington, D.C.
- ³² United Nations Industrial Development Organization, 2009, *Industrial Development Report 2009*, Vienna.
- ³³ World Development Indicators, 2010.
- ³⁴ The Economist, 2010, "Special Report on Egypt", July 17-23 Issues, London.
- ³⁵ The agglomeration index for the MENA region is 67.5% compared to 62% in Latin America and Caribbean. For more details please see, Hirotugu Uchida and Andrew Nelson, 2008, "Agglomeration Index: Towards a new measure of urban concentration", Background paper for the *World Development Report 2009*, The World Bank, Washington, D.C.
- ³⁶ Jeffrey B. Nugent and Tarik Yousef, 2005, "Does MENA defy gravity? How MENA has performed in its intraregional, EU and other trade?", EUI Working Paper 2005/26, European University Institute, Florence.
- ³⁷ Hassan Al-Atrash and Tarik Yousef, 2000, "Intra-Arab trade: Is it too little?" IMF Working Paper 10, International Monetary Fund, Washington, D.C.
- ³⁸ Nathan Nunn, 2008, "The long term effects of Africa's slave trades," *Quarterly Journal of Economics*, 123 (1), 139-176.
- ³⁹ Hirotugu Uchida and Andrew Nelson, 2008, "Agglomeration Index: Towards a new measure of urban concentration", Background paper for the *World Development Report 2009*, The World Bank, Washington, D.C.
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- ⁴¹ The region's fragmentation, together with the intensity of conflict, also increases military spending by individual states.
- ⁴² Malik (2011); Clement Moore Henry and Robert Springborg, 2010, *Globalization and the Politics of Development in the Middle East*, Cambridge, Cambridge University Press.
- ⁴³ The important exceptions in this regard are Morocco, Syria and Lebanon, which had sizeable merchant communities.
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- ⁴⁵ Adeel Malik, 2011, "Explaining Middle East's political economy: Why history matters?", *forthcoming* as QEHS Working Paper, University of Oxford.
- ⁴⁶ Jill Chrystal, 1990, *Oil and Politics: Rulers and Merchants in Kuwait and Qatar*. Cambridge: Cambridge University Press.
- ⁴⁷ "This index corresponds to the uniform tariff that if imposed on all imports from partner countries would leave overall imports unchanged", see Jose et al. (2010).
- ⁴⁸ The World Bank, 1999, *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa*, Washington, D.C.
- ⁴⁹ International Monetary Fund, 2011, *Regional Economic Outlook: Middle East and Central Asia*. Washington, D.C.: IMF.
- ⁵⁰ Steffen Hertog, 2010, *Oil and the State in Saudi Arabia*, Princeton: Princeton University Press.
- ⁵¹ *Ibid*, chapter 10 (Lulu Shui and Peter Walkenhorst: "Regional integration: Status, developments and challenges") .
- ⁵² The World Bank, 1999, *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa*, Washington, D.C.
- ⁵³ Roberto Rocha, Subika Farazi, Rania Khouri, and Douglas Pearce, 2010, "The status of bank lending to SMEs in Middle East and North Africa", World Bank Report, The World Bank, Washington, D.C.
- ⁵⁴ International Monetary Fund, 2011, *Regional Economic Outlook: Middle East and Central Asia*. Washington, D.C.: IMF.
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- ⁶⁵ Tunisia is a partial exception, since its exports of parts and components have significantly expanded in recent years.
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- ⁷³ Tarek M. Yousef, 2004, "Development, growth and policy reform in the Middle East and North Africa since 1950", *Journal of Economic Perspectives*, 18(3), 91-116.
- ⁷⁴ The record of economic reform is mixed in the MENA region. Morocco, Tunisia, Jordan and Egypt were some of the early reformers in the region. Reform was partially successful in Egypt; in Tunisia and Morocco it led to a revival of FDI.
- ⁷⁵ http://www.mcgill.ca/files/icames/Boom_Bust-2.pdf
- ⁷⁶ Jordan, Tunisia, Morocco, Lebanon and Egypt have been the prime beneficiaries of these foreign capital flows. For further details, see Lulu and Peter Walkenhorst, 2010, "Regional Integration: Status, Developments, and Challenges", In ShuiJosé R. López-Cálix, Peter Walkenhorst, and Ndiamé Diop, (eds.), *Trade Competitiveness in Middle East and North Africa: Policies for Export Diversification*. World Bank, Washington, D.C. (chapter 10).
- ⁷⁷ Changing geo-political circumstances in the wake of 9/11 attacks, liberalization of the financial sector and the recent oil boom have all played a helpful part.
- ⁷⁸ Recently, the United States, when faced with the difficulty of negotiating an FTA, has pushed instead for a Trade and Investment Cooperation Agreement with the GCC.
- ⁷⁹ For evidence on welfare gains from trade with the EU, see, Allen Dennis, 2006, "The impact of regional trade agreements and trade facilitation in the Middle East and North Africa region", *World Bank Policy Research Working Paper 3837*, World Bank, Washington, D.C.
- ⁸⁰ In particular, trade between MENA countries can generate significant dynamic gains.
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⁸³ "Rather than set as their first economic policy priority the goal of regional integration, MENA countries should focus on domestic policy reforms and the associated process of greater integration into the world economy". In Mohammad A. El-Erian and Stanley Fischer, 1996, "Is MENA a region? The scope for regional integration", IMF Working Paper 30, International Monetary Fund, Washington, D.C.

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<http://blogs.worldbank.org/governance/the-arab-spring-a-limited-access-orders-perspective>

⁸⁵ The World Bank, 2003, *Unlocking the Employment Potential of the Middle East and North Africa: Toward a New Social Contract*. Washington, D.C.

⁸⁶ In this regard, the proposed accession of Jordan and Morocco to the GCC is a welcome step, but the driving incentive for this should be the integration of markets rather than monarchies.

⁸⁷ Kristian Coates Ulrichsen, 2010, "Internal and External Security in the Arab Gulf States", *Middle East Policy*, available at: <http://www.mepc.org/journal/middle-east-policy-archives/internal-and-external-security-arab-gulf-states>

⁸⁸ Mustafa K. Nabli et al., 2006, "The political economy of Industrial policy in the Middle East and North Africa", The World Bank, Washington, D.C.

⁸⁹ For a further illustration of this point, see the discussion in chapter 4, Nazih N. Ayubi, 2001, *Overstating the Arab State: Politics and Society in the Middle East*, London, I. B. Tauris.