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Article

Segmented market economies in the Arab world: the political economy of insider–outsider divisions

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Abstract

This article argues that the low dynamism of low- to mid-income Arab economies is explained with a set of interconnected factors that constitute a particular variety of capitalism which we call 'segmented market economy'. These include an over-committed and interventionist state; deep insider–outsider divides in private sectors and labor markets that result from and reinforce lopsided state intervention; and an equilibrium of low skills and low productivity that results from and reinforces insider–outsider divides. These mutually reinforcing features undermine encompassing cooperation between state, business and labor. While some of these features are generic to developing countries, others are regionally specific, including the relative importance and historical ambition of the state in the economy and, closely related, the relative size and rigidity of the insider coalitions created through government intervention. Insiders and outsiders exist everywhere, but the divisions are particularly stark, immovable and consequential in the Arab world.

Key words: developing countries, labor markets, regulation, segmentation, trust, varieties of capitalism structure, scope, and performance of government, segmented labor markets, comparative analysis of economic systems

JEL classification: D73, H11, J21, J24, J42, J45, J46, J62, O53, P51

1. Introduction: Arab capitalism

The weak performance of Arab economies has been a key factor contributing to both the revolutionary turmoil of 2011 and the subsequent instability. The region boasts the world's highest unemployment rates, the lowest share of hi-tech goods in manufactured exports, the lowest firm entry rates and the smallest growth in labor productivity (Benhassine, 2009; European Bank for Reconstruction and Development, 2013; Gatti *et al.*, 2013). Most Arab

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countries have comparatively strong state infrastructure, have made great strides in providing basic public goods in health and education and lie in close proximity to European markets—why then this picture of stagnation?

This article will argue that a 'Varieties of Capitalism' (VoC)-inspired approach can help us understand the low dynamism of core Arab economies. Economies outside of the oil-rich Gulf share a set of closely inter-related features that set them apart from many other developing countries and that help to account for many of their specific development problems. The article explains how these features—which revolve around deep insider–outsider divides in labor markets and private business—reinforce each other and how they have contributed to a persistent path of weak diversification, limited skills accumulation and low productivity. Finally, it shows that while all core Arab economies display the core features to some extent, they are particularly pronounced among Arab republics with a history of statist development.

The key stylized facts that characterize core Arab economies share are: a stretched, overcommitted and interventionist state; deep insider–outsider divides in private sectors and labor markets that result from and reinforce lopsided state intervention; and an equilibrium of low skills and low productivity that results from and reinforces these insider–outsider divides. These mutually reinforcing features undermine cooperation and trust between state, business and labor, hence impeding the negotiation of encompassing reforms that could overcome the divides. Exclusion of outsiders and low productivity of insiders contribute to the weak diversification and growth outcomes in the region.

Some fundamental parts of this story apply to underdeveloped economies in general, notably low government capacity and a segmentation of business and labor into formal and informal markets. Others, however, are regionally specific, including the relative importance and historical ambition of the state in the economy and, closely related, the unusual rigidity of insider–outsider divisions. Insiders and outsiders exist everywhere, but the dividing lines are particularly stark, immovable and consequential in the Arab world—hence the term 'segmented market economies' to describe our cases (henceforth [AQ]SEMEs).[1]

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

The ambition of this article, like in much of the VoC literature, is both conceptual and explanatory: it first aims to identify the main features of capitalism in key Arab cases and illustrate how they are interlinked. It also, more tentatively, proposes that these features help explain the generally low dynamism and weak growth outcomes in the region. Theoretically, the article extends the political economy of insider–outsider labor markets to the developing world, where this socially corrosive phenomenon thus far has mostly been analyzed through a purely economic lens.

1 We choose SEME to distinguish the concept from Schmidt's 'state-influenced market economies' or SMEs, advanced capitalist countries with an interventionist state (Schmidt, 2009).

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After an explanation of its case selection and method, the article outlines the 'SEMEs' concept in more conceptual detail, followed by an overview of the historical roots of etatism in the Arab world. The main empirical section investigates the state, labor, firms and the market for skills. The final section concludes and outlines future research needs.

2. Case selection and method

This article deals with seven Arab countries that can be considered 'core' members of the region: Algeria, Egypt, Jordan, Morocco, pre-2011 Syria,[2] Tunisia and Yemen. These have been part of a shared regional space of political competition and ideological diffusion in the post-WWII era in a way that more peripheral members of the Arab League like Djibouti, Mauritania and Sudan have not been (Kerr, 1965; Choueiri, 2000).

We exclude high-rent countries—the Gulf Cooperation Council (GCC) monarchies and Libya—where hydrocarbons income has created substantially different economic structures.[3] We also exclude countries whose economies have been shaped by major, long-term conflicts like Iraq and Lebanon.[4]

One might criticize the article for cherry-picking cases. Investigating a limited number of cases that best approach a particular ideal type is, however, standard practice in the VoC literature and difficult to avoid given the relative complexity and limited range of the theories it proposes. Our omission of more peripheral Arab cases is also in line with definitions of the region among international institutions.[5]

Perhaps more important, the case selection in this article is theoretically motivated by a particular set of historical circumstances that delimit the applicability of its model: it only includes countries that engaged in an ambitious state-building project that was directly or indirectly affected by the nationalist and statist ideological competition dominating the region from the 1950s to the 1970s (aggregate comparative data on the rest of the Middle East and North Africa (MENA) region as well as other world regions are, however, contained in the Online Appendix). As we will see, even among our core cases, some fit the model considerably better than others—and it is the ones that pursued the nationalist state-building project the most ardently that show the best fit.

Like other contributions to the VoC debate, the research process producing the article has combined deductive and inductive elements: it has used Ben Ross Schneider's definition of non-Western 'hierarchical market economies' (HMEs) as point of departure, combined with a prior, based on a reading of secondary literature, that insider–outsider divides for Arab firms and labor market participants are particularly deep. The details of the SEME

2 Data on Syria in this article is from 2010 or just before.

3 GCC countries have notably been able to absorb a majority of the national workforce in the public sector and rely on a migrant workforce for most private-sector jobs. There is little informal employment of citizens, while there is considerable informal employment of foreigners, including in informal foreign-run businesses. Labor markets and private sectors are therefore also segmented, but in very different ways.

4 Although excluded, pre-2011 Libya and pre-1979 authoritarian-populist Iraq share many of the features of our model.

5 https://data.worldbank.org/region/middle-east-and-north-africa; https://www.unescwa.org/about-escwa (last accessed 20 March 2020).

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model were then refined inductively through further investigation of data and case literature.

3. Existing literature on MENA political economy

My motivation for developing a new conceptual framework for Arab political economies is that existing literature does not sufficiently account for key descriptive features of core Arab cases. The focus of some authors on the (neo-)patrimonial nature of Arab capitalism usefully highlights the informal nature of elite-level insider coalitions (Heydemann, 2004; Schlumberger, 2008; King, 2009). I propose, however, that formal rules and institutions can matter at least as much in organizing economic exclusion in the region, and that insider–outsider dynamics also play out on the lower rungs of the labor market, which contains a large and theoretically neglected insider group of formal state employees.

Literature on the decline of corporatist institutions and the inequality brought about by 'neo-liberal' reforms in the region rightly points to the erosion of old social contracts (Ehteshami and Murphy, 1996; Guazzone and Pioppi, 2009; King, 2009). It does, however, not tell us much about the important areas in which insider privileges continue to be defended, which extend beyond capitalist elites to a well-protected minority of formal employees.

More broadly, existing literature does not engage systematically with linkages between different spheres of the economy like the private sector, the labor market and the (seldom discussed) skills system. Most authors also focus primarily on within-region differences rather than situating the region in the global comparative context (Ayubi, 1995; Henry and Springborg, 2010; Cammett *et al.*, 2015). In both these regards, a VoC approach holds particular promise.

4. 'VoC' approaches and the Arab world

The basic premise of VoC is that capitalism is not uniform. Instead, firms and workers in different advanced economies use different formal and informal ways of coordinating economic transactions. The core spheres of coordination in the original, firm-centered VoC formulation by Hall and Soskice are corporate governance and finance, intercompany networks, industrial relations and skills systems (Hall and Soskice, 2001).

Most variants of VoC assume that different features of a given type of capitalism are complementary and reinforce each other through mutually 'increasing returns', hence keeping the system in an equilibrium that privileges certain types of exchange (e.g., short-term, market-based vs. long-term, non-market based). While the original VoC formulation has been much criticized, it has spawned an ongoing search for different types of capitalism not only among advanced countries but also in less developed areas (Nölke and Vliegenthart, 2009; Walter and Zhang, 2012; Schneider, 2013; Nölke *et al.*, 2015).

Although based on a study of Latin American cases, Schneider's account of 'HMEs' comes closest to a full-fledged model of complementary institutions that could apply to developing countries in general. HMEs are characterized by the dominance of diversified, technologically unsophisticated private conglomerates, a strong presence of transnational companies, atomized labor relations and low skills. He argues that these factors and the interactions between them are characterized by non-market, hierarchical relationships that

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undermine horizontal coordination, and that there are 'negative complementarities' between them, resulting in a low-skills equilibrium that prevents Latin America from catching up with advanced countries. The groups that have best adjusted to the demands and opportunities of this system tend to be the best politically organized, leading to 'political complementarities' that make reform of the system's interlocking components even more difficult.

At least descriptively Schneider's model seems to fit the Arab world quite well. In the core Arab cases, large firms tend to be similarly diversified and are, if anything, less technologically sophisticated; skills are even less developed; the workforce is even less organized; and levels of cooperation and coordination among firms and between firms and labor are even lower, as formal and informal relationships between market participants remain largely hierarchical. It is also quite plausible that all these features reinforce each other in a detrimental way. The region differs only with regard to transnational capital, the presence of which in the Arab world is much smaller. It remains, by contemporary standards, relatively isolated, with fairly small, often domestically-owned manufacturing sectors.

That said, there are critical, mutually reinforcing features that distinguish Arab capitalism which the HME model does not capture. The full set of these is outlined in Figure 1 and empirically illustrated in subsequent sections of the article. First, a key player structuring Arab capitalism is the state, an actor that Schneider discusses only in passing. Its deep role as employer, subsidizer and interventionist regulator in the Arab world is central to the model, adding another level of the hierarchy.

Deep intervention by the state is a key cause for the segmentation of both businesses and workers into insiders, who enjoy state support and protection, and outsiders, who do not. Much of Arab business remains dependent on support and protection from the state and vulnerable to state intervention, even more so than in other regions. Informal access to state

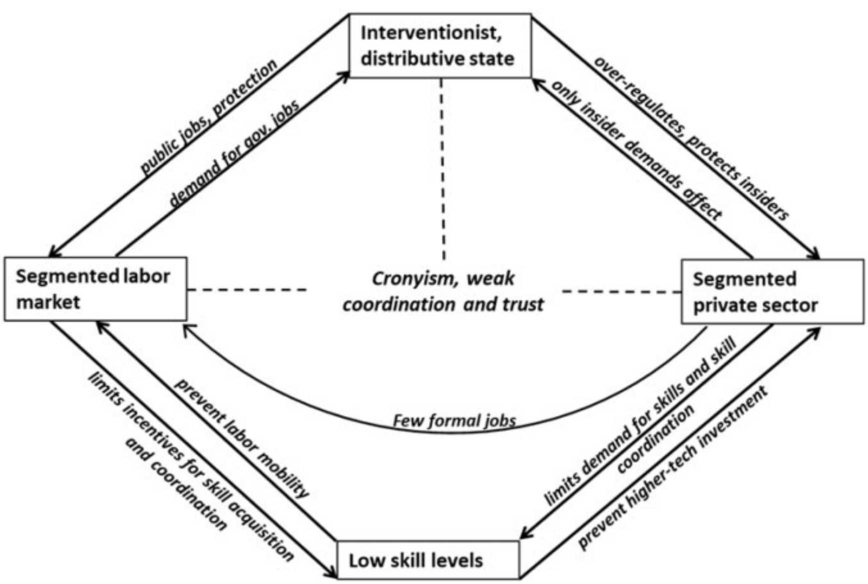

Figure 1. SEME.

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elites and bureaucracy creates a small group of firms with privileged access to regulation, credit and subsidies and, as a result, unusually high profits. Most other businesses, particularly smaller firms, remain outsiders whose property rights are uncertain and whose interests are not represented in the policy-making process (Heydemann, 2004; Benhassine, 2009).

On labor markets, the state also retains a stronger role both as regulator and, crucially, as direct employer. Heavy labor regulations and weak job generation by formal private businesses create a large informal sector, not unlike other developing countries. But different from most other cases, insiders on the labor market for the most part are formal *public* employees rather than private ones, as formal employment in the weak private sector remains tiny (Gatti *et al.*, 2013). Employment-related ('Bismarckian') social security benefits are unusually generous in the Arab world, yet as they are based on formal employment, they increase divisions with outsiders who are excluded from them (Levin *et al.*, 2012). The divided labor market not only caters to a relatively large insider group but also creates particularly distortive incentives for skills formation and saps state resources that are diverted from more inclusive and growth-oriented policies.

Segmentation in the Arab world is particularly rigid and hard to overcome in both business and labor market. There is less mobility between segments and barriers to entry are higher—both, again, the result of particularly deep formal and informal state intervention that creates especially pronounced and stable privileges for insiders (Benhassine, 2009; Schiffbauer *et al.*, 2015). Arab capitalism provides more widespread distribution of state resources than most other developing country governments, benefiting a relatively broad middle class. Yet the system remains deeply exclusive for those outsides of this coalition.

Rigid insider groups in business and labor market, in turn, create vested political interests that make economic reforms to reduce segmentation difficult. As we will see, insiders in the Arab world have more to lose than elsewhere and hence often resist reforms actively, both in authoritarian and democratic systems. Outsiders similarly demand expansion of insider benefits to them rather than wholesale reform. Encompassing interests that could push for inclusive reforms have weak incentives and opportunities to organize. Political elites are incentivized to privilege insider protection over other policies.

Like other developing countries, the Arab world is trapped in a low-skills equilibrium in which companies do not invest in technology because the required skills are not available, while students or workers do not invest in skills because they are not in demand (Booth and Snower, 1996; World Bank, 2008a). This dynamic is, however, reinforced by segmentation: insider–outsider divisions, ossified privileges and higher barriers to entry in both labor markets and corporate sector mean that productive skills are even less needed and rewarded—and hence not acquired. The perceived availability and preference for public employment in particular undermine the formation of skills relevant to the formal private sector (Assaad, 2014; Schiffbauer *et al.*, 2015). Low skills acquisition, in turn, prevents mobility of labor into better jobs in the limited cases where they are available. Insider–outsider divisions also make collective coordination on skills or labor standards difficult. The result is low-technology, undiversified production structures.

The state's over-stretch and deep meddling, and the attractiveness of increasingly scarce insider status, give rise to cronyism as a key mechanism that shapes and deepens segmentation, not only in state–business relations but also on labor markets (Gatti *et al.*, 2013). Such cronyism reflects rent-seeking by state elites as well as privileged non-state actors, both of whom use and reshape intervention mechanisms to their benefit. It further undermines

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encompassing collective action, weakens formal cooperation between state, business and labor, and results in particularly low trust between the three groups of actors.

As in Schneider's model, the key mode of coordination in this type of capitalism is hierarchical, be it between state elites and business or employers and workers—but it is mostly limited to insiders. Different from Latin America, there is little mobility between formal and informal status on the labor market, making insider–outsider division a durable organizing principle.

The article contributes to the broader VoC debate not only by incorporating new cases and developing (yet) another model but also by outlining more broadly how the interaction of the state with labor markets and firms can be conceptualized in developing country capitalisms. By focusing on insider–outsider dynamics more explicitly, the article captures a core dynamic of modern capitalism that political economists to date have mostly discussed with reference to advanced countries (Rueda, 2007; Palier and Thelen, 2010; Thelen, 2014; Biegert, 2019), but which is even more important in developing countries with high levels of inequality, stretched government resources and unreliable institutions. The full ensemble of these dynamics is unlikely to be the same outside of the Arab world—in many passages, this article does indeed show that it is not. Yet many of the individual mechanisms of segmentation identified here could be usefully investigated in other less developed regions with a view to building up a comparative understanding of labor market and business stratification in the global South.

Table 1 below provides an overview of how the SEME concept differs from other main VoC models, including Schneider's model.

4.1 VoC and the Arab state

The state was not included in the original formulation of VoC, but has been increasingly integrated in more recent contributions (Hancké *et al.*, 2007; Schmidt, 2009; Walter and Zhang, 2012; Schneider, 2013; Nölke *et al.*, 2015). Its role in most Arab countries in terms of shaping markets and distributing resources is central: it critically shapes incentives for firms and labor market participants to seek insider status—while the segmented structures

Table 1. Key features of different VoC models

	Liberal market economy	Coordinated market economy	HME (Schneider)	SEME
Coordination mechanism	Market	Networks	Hierarchies	Insider hierarchies
Labor relations	Market-based, short-term	Collective bargaining, long-term	Atomized hierarchy, short tenures	Atomized hierarchy, long-term insider protection
Skills formation	Based on market signals	Based on long-term informal, collective cooperation	Undermined by atomized labor relations	Undermined by atomized and exclusive labor relations
Role of state	None	Limited	Complementing hierarchies	Complementing and reproducing hierarchies

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of private sector and labor markets, and the lobbying incentives these create, in turn, push state elites and bureaucrats to prioritize policies that benefit insiders.

Returns to lobbying for insider benefits are higher if state apparatus and regulations are geared to providing such benefits, while the political returns to the provision of insider benefits are higher for state elites as outsiders are less organized, more diffuse and insider benefits are often better understood and more easily delivered. The structure and institutions in both spheres increase the returns to insider-oriented strategies in the respective other (without directly forcing such behavior).

In this context, it is not the deep presence of the state *per se* that imperils economic performance. It is, instead, its function as defender of insiders that creates the low dynamism and exclusion that characterize core Arab economies. The resources of Arab states are stretched thin due to their commitments to insiders, preventing investment in more inclusive welfare or broader economic development.

This is a key aspect in which Arab states differ from the 'state capitalism' that has been discussed in recent years with regard to large emerging markets like China or Russia. State capitalism entails the use of productive state assets for purposes of diversification and, in many cases, geo-strategy (Bremmer, 2010; Musacchio and Lazzarini, 2014; Nölke *et al.*, 2015). SEMEs are so caught up in distributional obligations that there is limited scope for long-run economic strategy. They are retrenched, not developmental or strategic.

5. Historical roots

The historical origins of Arab capitalism are not the main focus of this article. Yet some quick historical literature review is required to understand both the origins of the persistently high level of economic statism in the region as a whole and the similarly 'sticky' relative differences in the level of statism among individual cases.

When the Maghreb and Mashreq countries in the core of the Arab region achieved independence in the 1950s and 1960s, they were poor, underdeveloped and had small state apparatuses (Diwan and Akin, 2015, p. 18). Yet they, by and large, embarked on a more ambitious path of state-building than their peers in other developing regions, resulting in a consistently high share of government spending in GDP (Figure 2).

While the reasons for this are beyond the scope of this article, a key part of the story arguably was intense ideological competition across the region during the era of Arab nationalism in the 1950s and 1960s, a family of ideologies that held genuine mass appeal and proposed state-oriented, populist economic programs (Waterbury, 1983; Ayubi, 1995; Heydemann, 1999).

The region's nationalist republics Algeria, Egypt, Iraq, Syria and, to a lesser extent, Tunisia and Yemen were the most ardent proponents of such policies (Ayubi, 1995; Owen, 1998; Henry and Springborg, 2010; Cammett *et al.*, 2015). They nationalized strategic sectors and intervened deeply in the remaining, smaller-scale private economy through restrictive licensing rules, price controls, regulation of labor and production processes, and state-directed credit allocation. They used public sectors as tools of mass employment and introduced heavy subsidies for consumer goods and, from the 1970s onward, energy (Waterbury, 1983; Heydemann, 1999; Henry and Springborg, 2010; Cammett *et al.*, 2015).

The populist-distributional policies of the first nationalist republics—which had mostly emerged from nationalist coups against conservative monarchs (Kerr, 1965) —put pressure

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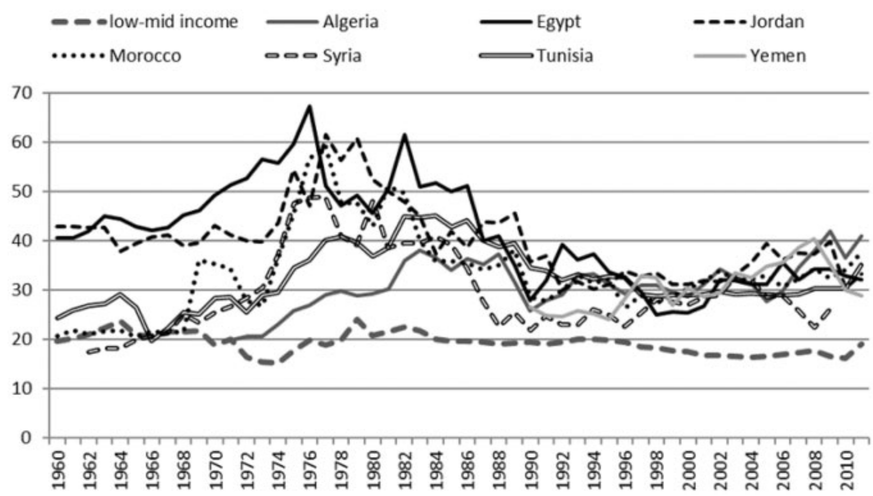

Figure 2. Share of government spending in GDP (in percentage).

Source: Data courtesy of Ishac Diwan and Tarik Akin (based on International Monetary Fundion (IMF) sources).

on other regimes in the region to play catch-up in controlling the national economy and providing public employment. This was visible particularly in Jordan, which was positioned at the fulcrum of regional ideological competition for much of post-WWII Arab history and witnessed several aborted nationalist coup attempts (Peters and Moore, 2009). Morocco, a geo-strategically and culturally more peripheral monarchy with deeper local historical roots, appears to have been under less pressure to follow the trend, which is consistent with its relatively lesser statist and distributive legacy (Waterbury, 1970; Zartman, 1987).

Arab states have had to scale back their ambitions and operations ever since the original statist model faced a fiscal crisis in the 1970s, resulting in partial economic liberalization and a gradual, sometimes conflict-ridden downscaling of distributional commitments (Cammett *et al.*, 2015; Diwan and Akin, 2015). Yet, as shown above, state spending has remained consistently above the international average.

We do not have comparably good historical data on the regulatory presence of the state. The only indicator going back far enough is the Fraser Institute's 'regulation index', which is informed by a libertarian economic philosophy and does little to distinguish necessary from excessive regulations. While acknowledging the potential biases this might create, it is worth noting that with the exception of Jordan, state intervention according to the index has remained persistently deeper in our cases than the global average (Figure 3) as well as the average of all other world regions (Online Appendix, Figure O1). We provide more data below from other, potentially less partial sources to show that regulatory intervention remains deep across the region and that alternative rankings of our cases broadly align with those in the Fraser index. Given that Fraser's potential biases are unlikely to fluctuate strongly over time, this gives us some confidence in its historical data.

Available fiscal and regulatory data suggest that structural adjustment has affected the region like other parts of the developing world, yet relatively speaking, it has retained its distinctly statist profile. As we will see below, the region's statist legacy remains visible in

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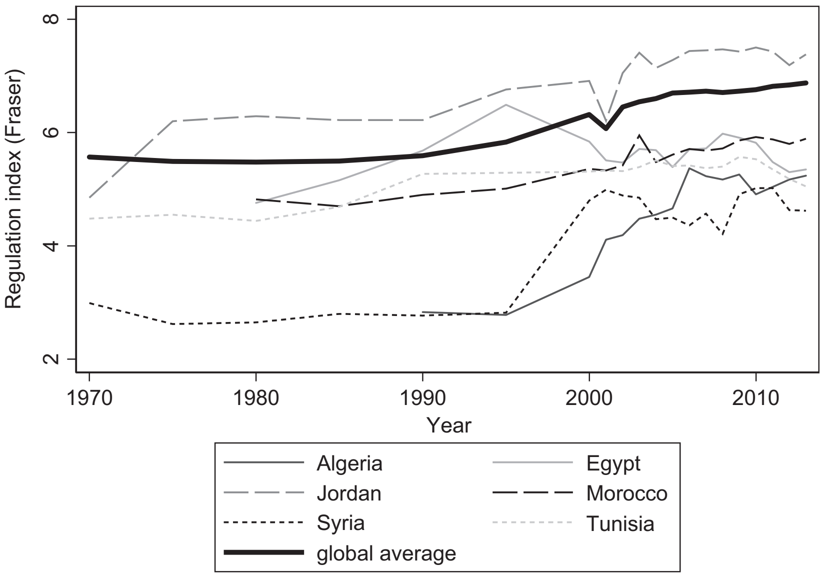

Figure 3. Arab scores on the Fraser 'regulation index'.
Note: Higher scores indicate lighter regulation.
Source: Fraser Institute.

unusually high levels of public sector employment and the heavy bureaucratic penetration of labor markets and business activities. The relative scarcity of state resources and the discretionary nature of state intervention have, however, produced deep divisions between privileged insiders and outsiders in these spheres. While the statist histories of Arab regimes and their economies are well documented, this article probes their less well-understood, divisive consequences in the present day, exploring the equilibria that keep divisions in place and retard more inclusive development for workers and firms.

6. SEMEs in the Arab world

The following sections outline the roles of state, business, labor and skills markets that have emerged from the region's interventionist history in more detail, focusing particularly on complementarities between these spheres. It will present data on all core Arab countries as available and provide international comparisons where possible. We will see that the *populist republics (Algeria, Egypt and Syria) are consistently in line with the ideal type on all measures*, while the other core cases fit it more often than not (see Online Appendix, Section O7, for average comparisons with other world regions).

6.1 Over-ambitious states

The Arab state retains a deep presence in the economy through both extensive distribution and deep bureaucratic penetration of markets. Understanding these is critical for understanding the structure of Arab labor markets, corporate sectors and skills systems, and the ways these interventions benefit insiders.

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State involvement in labor markets

Arab states' distributive and welfare ambitions remain strong. These have produced faster post-WWII increases in schooling years and life expectancy than in any other developing region (Diwan and Akin, 2015). A more problematic distributive legacy is their ongoing commitment to large-scale public employment. Due to fiscal constraints, the share of public employment has been gradually declining—yet it remains high in international comparison, with only Morocco lying below the global trend line in Figure 4.

The shares of public employment mostly lie between 20% and 40%, far above those in richer Latin America, where they range from 4% to 15% (OECD, 2014, p. 61), sub-Saharan Africa, where they range from 2% to 9% (Monga and Lin, 2015, p. 138) or East Asia and Pacific, where they mostly lie below 5% (Packard and Van Nguyen, 2014, p. 16).

While public salaries are by no means high, in the cases where we have data, they typically remain higher than in the private sector, especially compared to the informal sector (Assaad, 2014; Gatti *et al.*, 2014, p. 255).

At the same time, Arab government extensively regulates formal private labor markets, providing fairly high protection for the minority able to land a formal job there. Labor regulations that restrict hiring and firing, while not exceptional, are relatively intense, particularly in the region's republics (Figure 5), and formal benefits are particularly generous. The consequences of the private labor market will be further discussed below.

State intervention in the private sector

Arab governments also distribute goods to private business. A key channel are energy subsidies which go to both households and industry and which mostly lie above international averages (Figure 6).

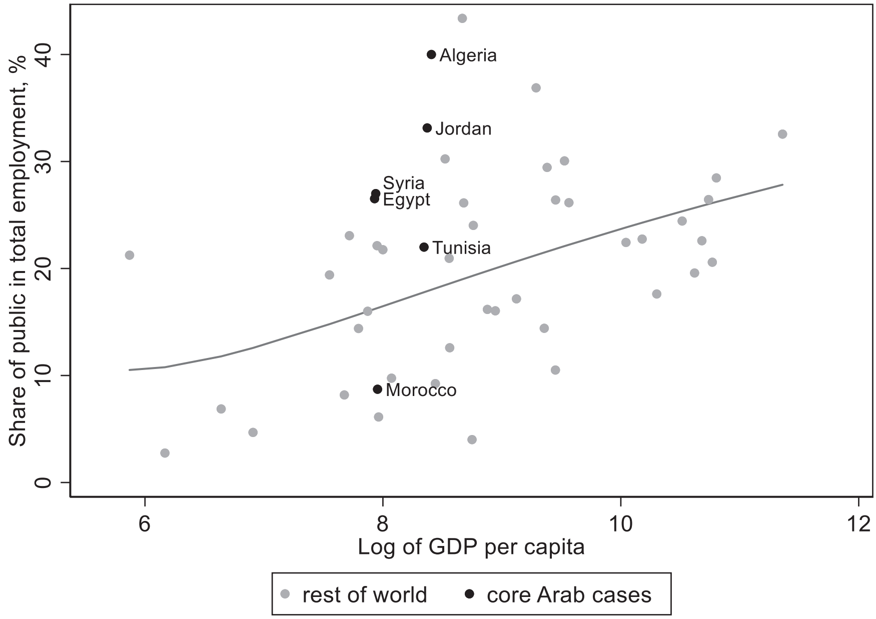

Figure 4. Share of public in total employment (in percentage).
Source: ILO, national sources.

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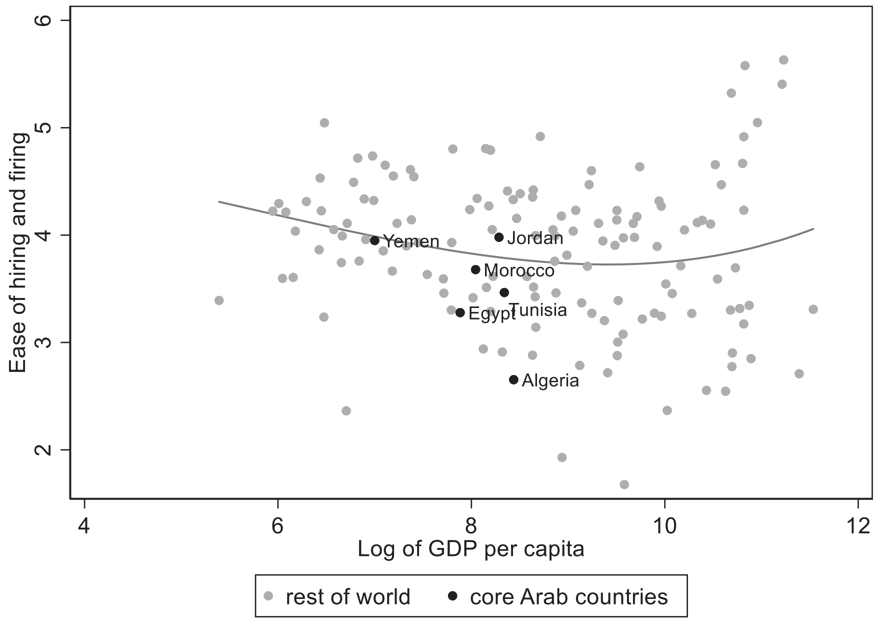

Figure 5. Ease of hiring and firing (World Economic Forum; WEF).

Note: Higher values indicate greater ease.

Source: WEF Executive Opinion Survey.

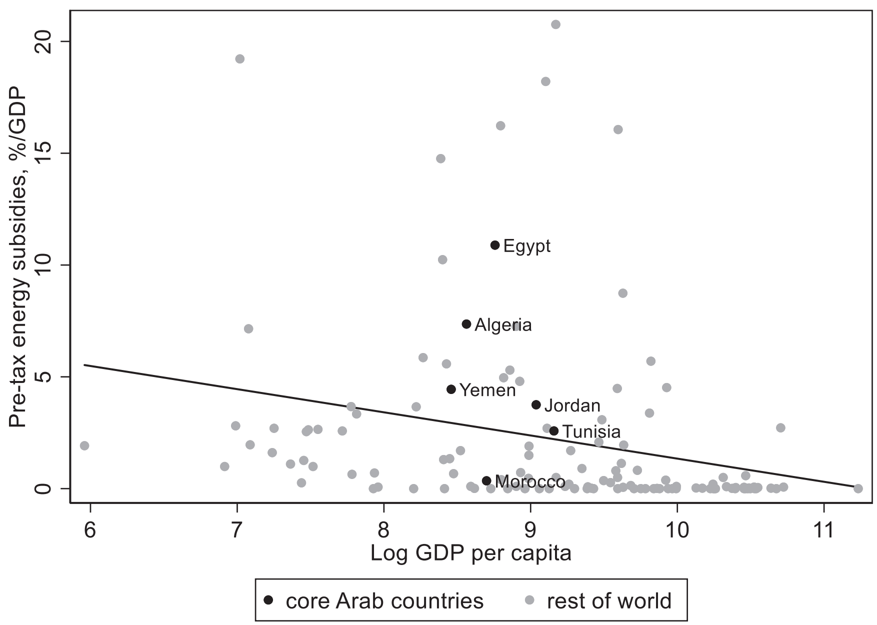

Figure 6. Pre-tax energy subsidies (percentage of GDP, 2013).

Source: IMF.

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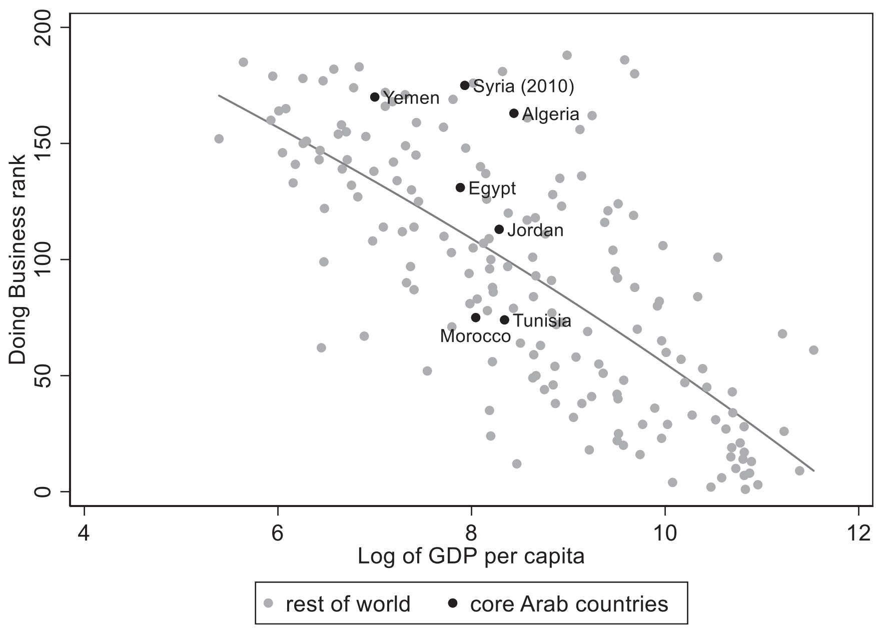

Figure 7. World Bank global 'Doing Business' rankings (2013).
Note: Smaller means better rank.
Source: IFC.

Similarly, the state remains deeply involved in the allocation of land as well as credit, as Arab countries, by and large, retain higher state ownership in banks than is the case in other regions (Benhassine, 2009, p. 119).

Governments have become increasingly cash-strapped and have cut subsidies during the fiscal crisis of the 2010s. They might well disappear in the coming years. Regulatory intervention and protection remains at least as important for Arab business, however, and has proven stickier.

Some of the heavier regulations of the 1960s statist period have been rescinded or reduced: there are fewer currency and price controls while FDI restrictions have been relaxed. Many remain, however: licensing and inspection regimes, bankruptcy procedures and labor rules are seen as particularly onerous in the Arab world. Only Tunisia and Morocco rank in the top half of countries in the International Finance Corporation's international 'Doing Business' comparison of business environments (Figure 7). Similarly, all countries bar Jordan score lower than the international trend line for the Fraser Institute's 'regulation index', which attempts to measure the heaviness of regulation across credit markets, labor markets and business regulations (Figure 8).

Finally, Arab states also remain heavily involved in regulating cross-border trade. All known core Arab cases bar Yemen show an above-average score on the Overall Trade Restrictiveness Index, a compound measure of tariff and non-tariff barriers (Figure 9).

Due to their large share in GDP, states remain key drivers of economic demand in the region.

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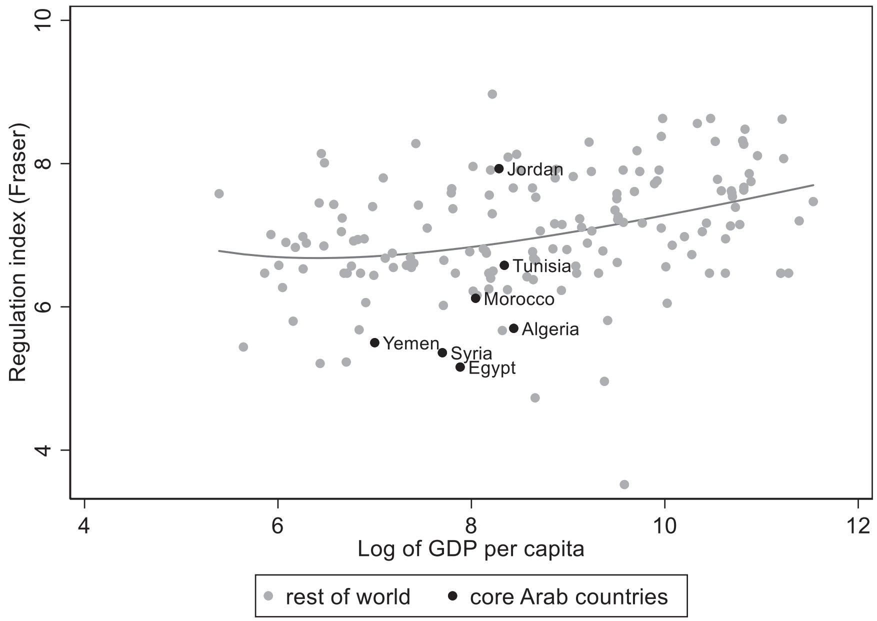

Figure 8. Fraser Institute 'regulation index' scores (2013).

Note: Higher values imply less regulatory intervention.

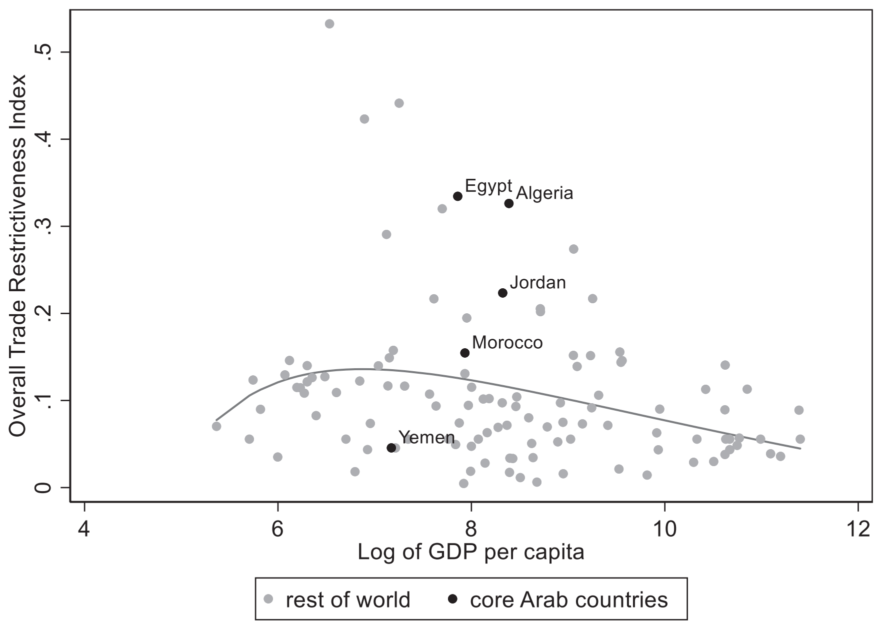

Figure 9. Overall Trade Restrictiveness Index (2009).

Source: Kee *et al.* (2009).

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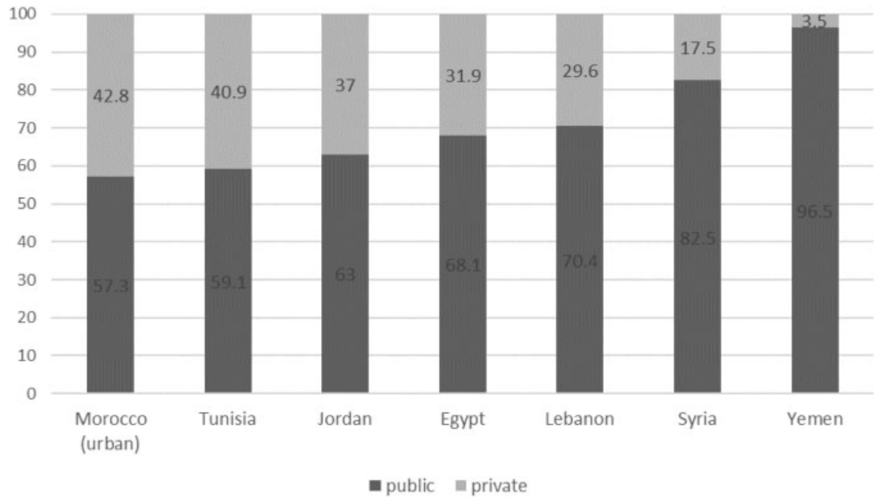

Figure 10. Distribution of formal employment (in percentage).
Sources: Gatti *et al.* (2013, p. 148) and Gatti *et al.* (2014, p. 90).

There is limited privately driven consumer demand because such a large share of better-paid employment is public and outsiders are relatively poor. The weakness of non-commodity exports further deepens firms' dependency on state spending. The need to stimulate economies and support insiders through public consumption has led to high public debt levels and limited investment: all our cases bar (oil-dependent) Algeria have been operating on higher debt levels than the average country in their income groups, and all but Algeria and Morocco have recorded lower gross fixed capital formation.[6]

6.2 A segmented labor market

State intervention deeply shapes economic incentives and outcomes. In particular, deep state involvement in Arab labor markets has created rigid insider–outsider divisions which, in turn, are reinforced by political feedback loops.

Arab labor markets are divided into formal public employment, formal private employment and informal private jobs. The informal labor force—defined as workers not contributing to social security—averages 65% across the Arab world outside of the Gulf monarchies. This is high, but not higher than in other developing countries (Gatti *et al.*, 2014, p. 52).

What is unusual, however, is the very high ratio within the formal sector of public to private employment (Figure 10).

6 Average debt/GDP from 2000 to 2017 range from 52% to 85% for all countries bar oil-rich Algeria (which recorded 24%), while the emerging and developing market average was 43%. Gross Fixed Capital Formation clustered from 17% to 24% with only Algeria and Morocco reaching 38% and 32%, respectively, compared to the lower middle income average of 28%. Data from World Development Indicators.

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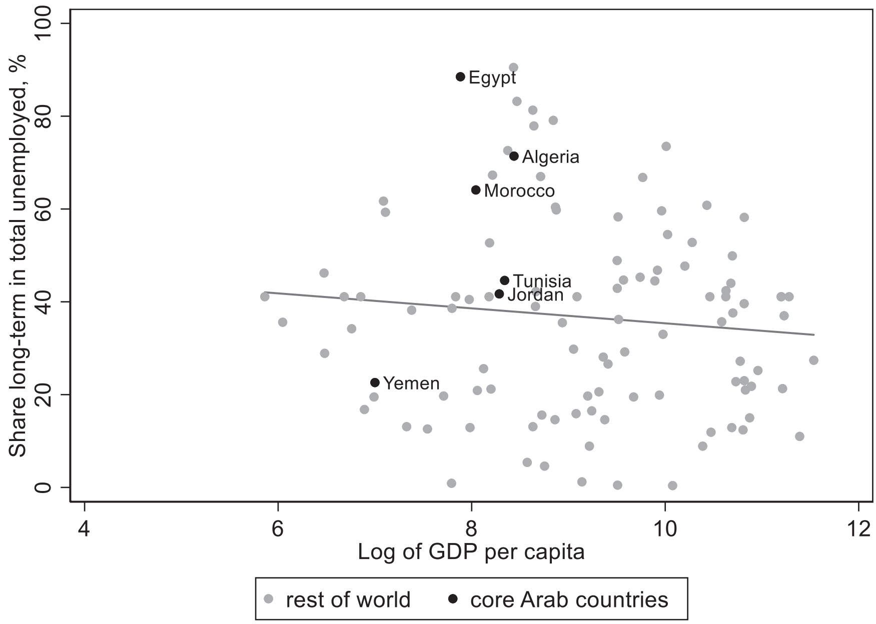

Figure 11. Share of long-term unemployed among all unemployed (in percentage).
Source: World Bank Development Indicators.

This contrasts with both sub-Saharan Africa and Latin America, where formal private employment is significantly larger than government employment (Galli and Kucera, 2004, p. 815; Monga and Lin, 2015, p. 138).

As important, and different from the Latin American cases Schneider describes, there is little mobility between labor market segments. Very few workers leave the public sector with its security and benefits for private employment (Gatti *et al.*, 2013, p. 52; Angel-Urdinola *et al.*, 2015, p. 11)—while in Latin America, patronage employment in the public sector typically is subject to considerable political turnover (Schuster, 2020).

In Arab countries, informality moreover typically lasts longer than in other regions before individuals move into another labor market status (Gatti *et al.*, 2013, p. 153; Gatti *et al.*, 2014, p. 187). Similarly, long-term unemployment accounts for a disproportionate share of all unemployment (Figure 11), reflecting durable exclusion particularly in the republics Algeria and Egypt. Labor turnover is generally low (Gatti *et al.*, 2013, p. 150f; Angel-Urdinola *et al.*, 2015, p. 85). All this indicates that the insider–outsider system in the region's labor market, although generous to a fairly large share of the population, is particularly rigid and inflexible: outsiders stay outsiders for longer and insiders very rarely lose their insider status.

This is confirmed by available research on labor market transition matrices which measure the incidence of transfers between different labor market states, including inactive, unemployed, formal private, formal public and informal employment. Transfer rates are systematically lower for Arab countries on which we have data—Algeria, Egypt, Jordan and

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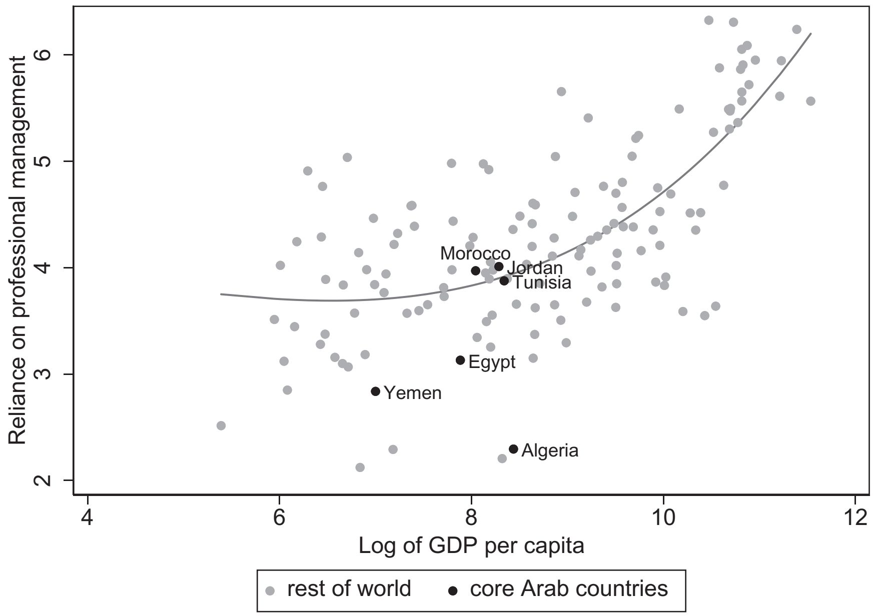

Figure 12. WEF scores for reliance on professional management.
Note: Higher score implies more reliance on professional management.
Source: WEF executive opinion survey.

Tunisia—than for sub-Saharan African and Latin American countries analyzed in the literature (see Online Appendix, Table O1).

Drivers of segmentation

There are several drivers for the deeper segmentation of labor markets: tight regulation of formal private employment that disincentivizes hiring and firing, the prevalence of rigid and exclusive informal networks on labor markets, the relative generosity and rigidity of public sector employment, and contribution-based social security systems that privilege insiders.

As in other regions, the segmentation of the private labor market into formal and informal is to some extent caused by state regulation of the formal sector. As seen above, hiring and firing is perceived as difficult. Similar to some European labor markets with high levels of job security for permanent contracts (Palier and Thelen, 2010), employers are reluctant to hire because workers can be hard to dismiss.

Insider–outsider divisions are bolstered by weak human resource management and nepotism in Arab private companies. Unusually high shares of job-seekers find their positions through friends or relatives (Gatti *et al.*, 2014, p. 187). The World Economic Forum finds that in the majority of Arab countries, including all republics, senior management positions are unusually often held by friends and relatives rather than by professionals chosen for merit (Figure 12).

Gatti *et al.* (2013, p. 167) describe a 'meritocracy deficit' that reduces incentives among youth to seek the education and skills relevant for private jobs. Low skills in the population,

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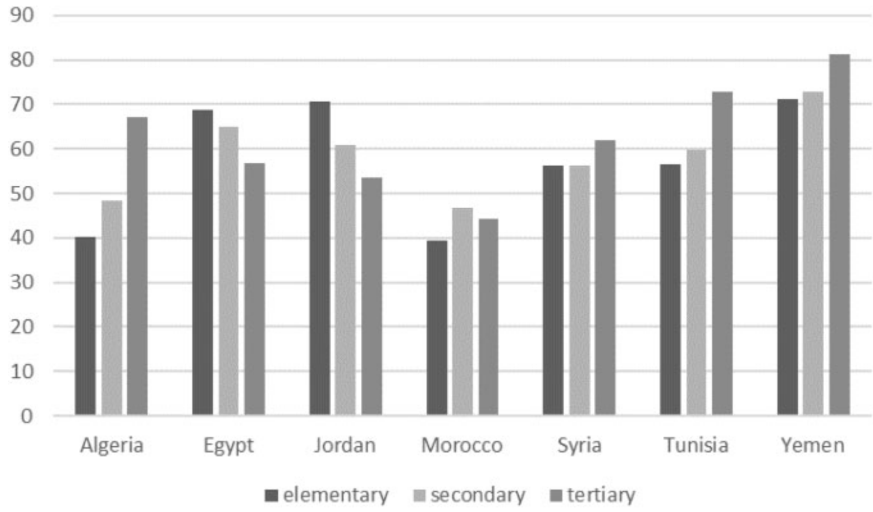

Figure 13. Share of respondents preferring a government job, by education level (in percentage, 2010).
Source: Gallup polls (analysis provided by Ishac Diwan).

in turn, abet nepotism, which is further buttressed by limited competitive pressures on Arab firms (Gatti *et al.*, 2014, p. 160; see also below).

A further key factor that reduces fluidity and efficiency of the private labor market is the indirect impact of state employment. As we have seen, public employment across the region is not only large but also on average better paid than private employment (the opposite is the case in Latin America; Inter-American Development Bank, 2004, p. 171). Public sector benefits also tend to be better and working hours shorter (Gatti *et al.*, 2013, p. 150). Government employment, hence, is more attractive for the typical, non-elite job-seeker. As a 2010 Gallup poll shows, the desire for government employment remains high across most of the region, especially among graduates (Figure 13).

On average, only about a fifth of respondents preferred private employment (the remaining respondents voiced no preference). Analyzing Mexican data, Maloney (2004) has found limited evidence that informal workers would prefer a formal job and documents high mobility between informal and formal employment. The Arab world evinces the opposite pattern: formal, particularly, government employment is coveted but mobility between different forms of employment is low.

Generous public sector employment not only provides rigid insider privilege. Expectations of public employment increase general reservation wages across the economy (Gatti *et al.*, 2013, p. 22; Assaad, 2014) and lead to unproductive and stagnant 'queuing' behavior during which job-seekers remain idle until a government job becomes available (World Bank, 2008b, p. 48f; Gatti *et al.*, 2013, p. 147; Gatti *et al.*, 2014, p. 256). Public employment also distorts incentives for skills acquisition: not only because the formal education required for government jobs is often irrelevant for private employment but also because government recruitment, just like private recruitment, is widely perceived as nepotistic (Gatti *et al.*, 2013, p. 190).

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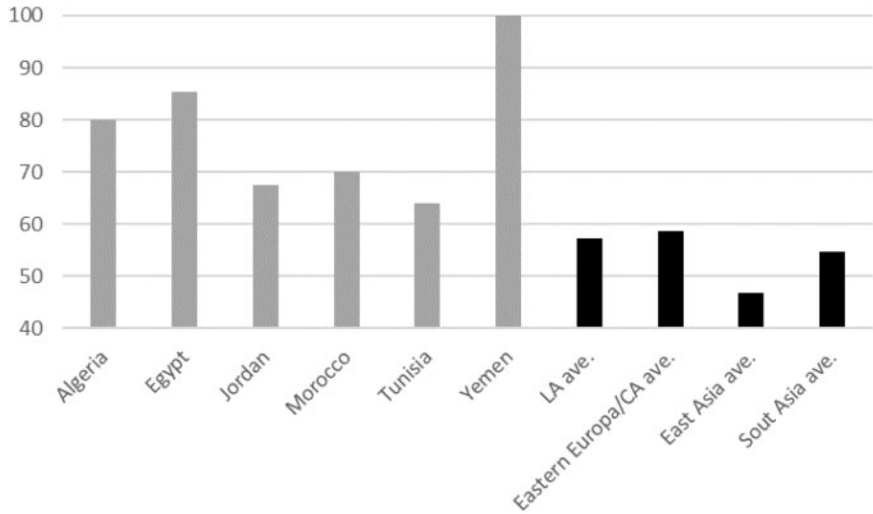

Figure 14. Gross replacement rates, by level of earnings and region (percentage of individual earnings).
Source: Based on Whitehouse (2007).

Governments further deepen labor market segmentation through welfare policies built around generous social security mechanisms that are contingent on formal employment. While imperfect welfare coverage is typical for the developing world, the difference between insider privileges and what is available for outsiders is again particularly steep in the Arab cases. It is reflected in the unusual generosity of most formal pension schemes, which different from other regions still operate on a defined benefit basis. In many cases, these allow or even encourage early retirement and in some instances offer replacement rates above 100%, that is, provide benefits that exceed pre-pension income (Figure 14). As a result, despite the relative youth of Arab populations, Arab pensions systems are incurring unsustainable deficits, potentially crowding out other, more inclusive forms of social spending (Jawad, 2015).

Even in comparison with other developing countries, Arab states stand out in the limited provision and lopsided nature of non-contributory social safety net programs such as cash benefits, microcredit, workfare and training initiatives. Such programs only amount to an average of 1% of GDP across the Arab world (World Bank, 2018, pp. 19 and 20) are deeply fragmented and have coverage rates far below those in other developing regions (Levin *et al.*, 2012, p. xxiv; Angel-Urdinola *et al.*, 2015, pp. 7 and 118). There is variation across the region: Egyptian social assistance is particularly meager, while Tunisia and Morocco provide more. Yet, the MENA region as a whole has the lowest mean ratio of social safety spending to GDP of all world regions bar South Asia, and the ratio for all core Arab countries apart from Morocco lies below that regional mean (Morocco barely exceeds the mean; World Bank, 2018, pp. 19 and 20).

Outside of Palestine, social assistance program has little effect on poverty rates, indicating that they often benefit insiders (Ghaith and Abu Shama, 2015; Jawad, 2015). There has been experimentation with new social assistance mechanisms in the course of partial subsidy

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reforms in recent years, but more timidly than in most other regions, and coverage of the poor remains bad (Jawad, 2015; ESCWA, 2016; Osorio and Soares, 2017).

Universal social safety policies could in principle lessen the segmentation of labor markets into formal and informal through unemployment assistance, cash benefits, microcredit programs and active labor market policies, all of which can facilitate skills acquisition and ease the transition into formal employment—but Arab governments have limited resources or capacity for these. They instead, by and large, prioritize insiders.

To sum up, Arab governments are deeply involved in providing labor protection, jobs and social security, but do so in a costly and exclusive way that creates rigid insider–outsider divisions. These are reinforced by unmeritocratic recruitment practices among badly managed but sheltered private businesses. The region's main *de facto* and *de jure* welfare mechanisms are exclusive state employment and contribution-based social security, respectively, while there is little welfare coverage for informal employees. Informal workers are often an afterthought in systems that have come to cater to a shrinking and economically stagnant, yet privileged middle-class constituency under direct protection of the state—a constituency that, in turn, has little interest in encompassing social safety provision.

Weak and segmented organization of labor interests

The structural segmentation of labor markets is reproduced in the field of labor organization. Not only are formally recognized unions historically weak and state-dependent in most Arab countries (Cammett and Posusney, 2010), but they also invariably cater to insiders. In

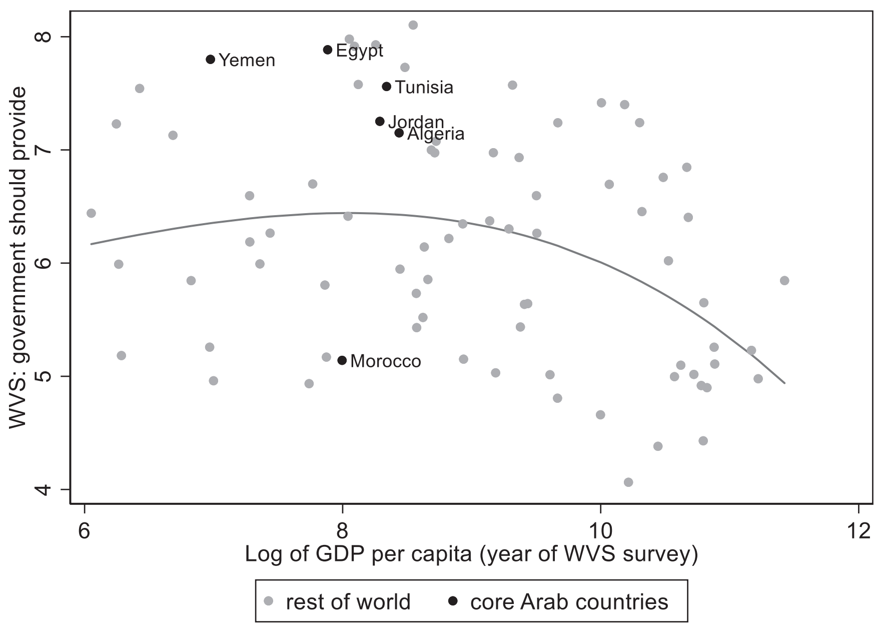

Figure 15. Average agreement to statement that government should make sure that everyone is provided for (1–10 scale).

Source: World Values Survey (WVS), sixth wave.

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some cases like Egypt, informal unions have emerged in parallel to the discredited state-endorsed unions, but they remain weak and fragmented (De Smet and Malfait, 2015).

As Figure 15 shows, Arab citizens do retain high expectations *vis-à-vis* their governments, with less statist Morocco the only exception. These high expectations are usually not articulated through demands for wholesale welfare reform, however, but demands to expand insider privileges.

The inability to build a coalition that would overcome current insider cartels is quite likely also explained with the persistent authoritarianism in the region, which gives outsiders and rival political elites that could mobilize them less space to organize (Schmitter, 1974; Ayubi, 1995). Yet at least in the short run, political openings in the region have not led to substantial changes in the insider–outsider systems.

Egypt and Tunisia are the two core cases that have undergone at least a temporary political opening since 2011 and have, hence, experienced by far the highest levels of political mobilization and, at times at least, freedom of organization and hopes for a new 'social contract'. We hence briefly look at these two 'most likely' cases for socio-economic change to illustrate that even when political constraints are relaxed, organized labor most of all defends insider interests.

The Tunisian General Labour Union (UGTT), the historically more important union in the region which has emerged as a critical political player after the fall of Ben Ali, has spent much of its political energy on asking for public sector salary hikes (MEMO, 2015), and fighting increases in the formal pensions age (the latter has also been the key trigger for mobilizing Algerian and Moroccan unions; El Yaakoubi, 2016; Reuters, 2016). The UGTT mostly represents middle-aged, middle-income insiders in formal employment (Hartshorn, 2016). In Egypt, the only presidential law that the tame new parliament under President Sisi challenged was an attempt to reform the bloated civil service (Mazen, 2016). In 2016, a key reason for the Egyptian government's attempts to avoid an inevitable currency devaluation was that it would have affected the real income of state employees on nominally rigid wages (Walsh, 2016). Once the devaluation happened, the bulk of the May 2017 social adjustment package went into pension increases and civil service bonuses (Wahba, 2017).

Even when outsiders mobilize, they tend to simply ask for insider status to be extended to them: in Tunisia, protests often focus on demands for government employment, with protesters in early 2016 asking for one guaranteed government job per family (Gall, 2016). Similarly, the first public protest in Egypt after the July 2013 military coup focused not on politics but was organized by graduates demanding government jobs (Mansour and Aboelgheit, 2016).

Tunisia has expanded some social assistance tools like the 'Programme national d'aide aux familles nécéssiteuses' cash transfer program in recent years. Yet targeting remains weak, with estimates that 60% of benefits go to non-poor households (ESCWA, 2016). Public wage spending, under pressure from insiders and those aspiring to join their ranks, has risen from 10.7% to about 15.5% of GDP, one of the highest ratios in the world (Amara, 2018). The increase alone corresponds to more than five times the country's total social safety net spending.

After the re-establishment of military authoritarianism under President Sisi, Egypt has introduced the non-contributory cash grant programs *Karama* and *Takaful* with World Bank assistance as compensation for IMF-imposed fiscal reforms. Yet the programs remain small:

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in 2015, they covered only 5.5 million out of more than 90 million Egyptians (Jawad *et al.*, 2018).

A significant share of the working population are insiders in the formal sector who have a vested interest in state employment instead of inclusive social safety spending. Even in authoritarian contexts, their lobbying power far exceeds that of the atomized and marginalized outsiders. Their political importance is reflected in the reaction of both anciens and new regimes during the regional political unrest in 2011: across the region, governments in the first instance increased public sector wages, created new government jobs and increased subsidies rather than strengthening more inclusive welfare mechanisms (Hertog, 2011). Even the civil war in Syria seems to only have boosted traditional patterns of distribution: according to recent reports, the number of state employees in Syria has increased to 2.1 million by 2015, constituting half of the country's workforce (AFP, 2015).

The *status quo* persists because its benefits are relatively concentrated while the gains of more inclusive welfare are diffuse (Olson, 1965). While this is the case with many policies in many countries, in our Arab cases the dynamic is reinforced as (i) the boundaries of insider groups are particularly rigid and (ii) they have particularly much to lose. Labor market participants barely face the 'veil of ignorance' about their future employment situation that can make more inclusive social security appealing even to the relatively privileged in other countries. The weak organization of outsiders—at least in parts an authoritarian legacy—further weakens their ability to demand a new distributional regime. State elites are incentivized to privilege relatively better mobilized insiders, perpetuating a shrinking, state-dependent middle-class coalition.[7]

In sum, Arab labor markets have been deeply divided by ambitious, interventionist states, which cater to a large and sheltered insider group in the public sector. Supporting this group leaves few resources to support the excluded and facilitate their social and labor market mobility. Outsiders are not well organized while insiders have no interest in, or actively oppose, reform. Rigidity and exclusion undermine labor market dynamism and thereby hinder productivity growth, which during recent decades has been below global averages throughout the region.

A further factor undermining labor market dynamism is the weakness of the private sector, the topic of the next section. Like in the labor market, deep state intervention divides business into static camps of insiders and outsiders. Sheltered insiders, who provide most formal jobs, lack incentives and capabilities to create high-quality jobs or recruit meritocratically and have particularly strong political incentives to defend their privileges.

6.3 A segmented business sector

Similar to the labor market, there is also a significant segment of direct state activity in economic production: important sectors of production in the Arab world are still dominated by state-owned enterprises, including military ones, narrowing the scope of formal private business (Amico and Hertog, 2013). More important, however, is the division of private enterprises into insiders and outsiders, related to but not identical with the distinction of formal and informal businesses.[8] Such a distinction is not unusual in the developing world, but

7 See Iversen and Soskice (2012) on how employers and workers in the export sector of European CMEs can anchor a similar (though more productive) political coalition.

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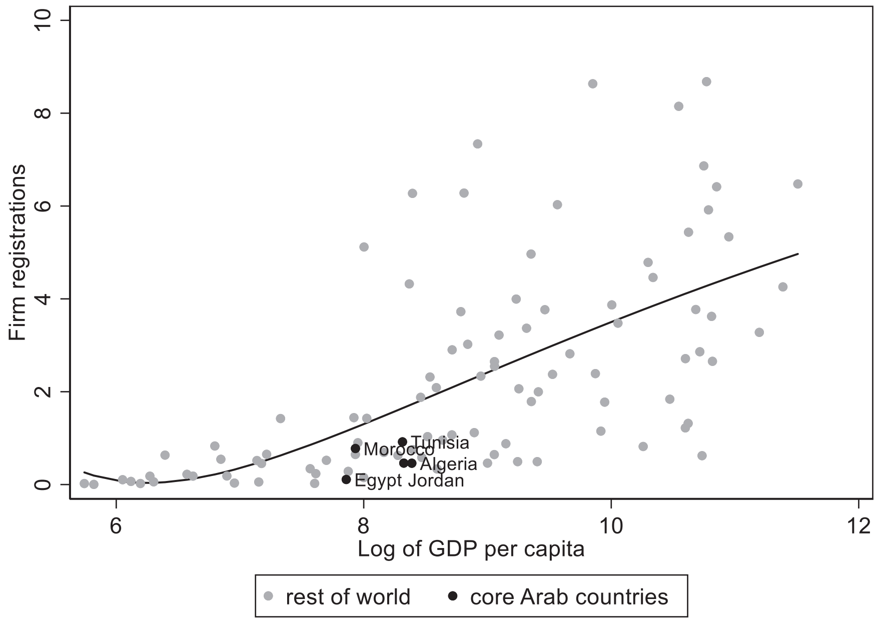

Figure 16. Number of new limited liability companies registered per 1000 inhabitants (2000–2009 average).

Source: Data provided courtesy of Leora Klapper (Klapper and Love, 2011).

once again the depth of insider privilege for larger formal players in the Arab world is particularly deep and mobility between segments particularly low.

One sign of deeper divisions in the business sector is that Arab private sectors are typically divided into some very large firms and numerous small ones, more clearly so than in most other emerging markets (World Bank, 2014, p. 59; Cammett *et al.*, 2015, p. 17; Diwan *et al.*, 2015; Schiffbauer *et al.*, 2015, p. 29). High barriers to entry into formal operations are, moreover, reflected in the very low entry rates for new limited liability companies—the main internationally recognized form of modern formal business—in the five cases where data are available (Figure 16).

Companies in the region also remain informal for particularly long periods, again suggesting low mobility from the informal to the formal sector (Gatti *et al.*, 2014, p. 17). Finally, transitions to larger firm sizes are also relatively rare (EBRD, 2016, p. 69).

There is, conversely, evidence that once a firm has achieved insider status, it is particularly hard to dislodge. Firms in the Arab region on average are older and there are fewer firm exits than in other regions; creative destruction is limited (Benhassine, 2009; Gatti *et al.*, 2013). Most companies in the region are privately held, closing the market for corporate control to outsiders.

8 Not all formal businesses enjoy particular privileges. We can, however, assume that practically all informal businesses are outsiders.

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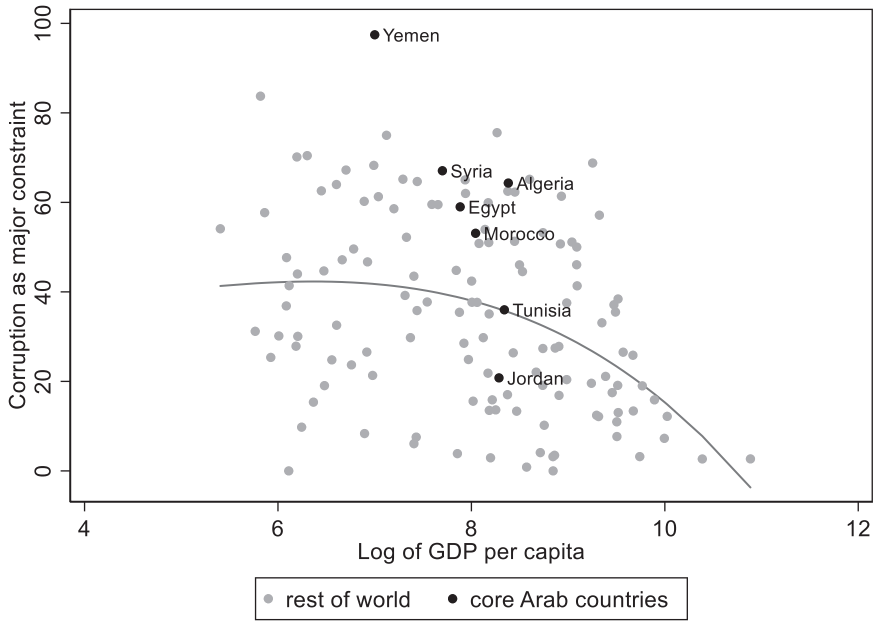

Figure 17. Percentage of firms identifying corruption as a major constraint.
Source: World Bank enterprise surveys (most recent years available).

Drivers of segmentation

All the above is evidence of insider–outsider segmentation and low mobility between the segments. The most important reason for this is the state's extensive and often discretionary involvement in the private economy through both material support and regulatory intervention.

We have already mentioned the extensive range of tools—subsidies, credit and provision of land—through which Arab states can support private businesses. All these resources are rationed in practice. Like in the case of state employment, this makes privilege for some and exclusion for others inevitable. As important, we have also seen evidence of deep regulatory intervention in the private sector. There is strong international evidence that heavy regulation both reduces firm entry and increases informality (Enste and Schneider, 2000; Klapper *et al.*, 2006).

There are good reasons to believe that both material support and regulation have asymmetric effects across Arab firms and, moreover, benefit the best-connected rather than the most efficient businesses. Arab countries rank particularly badly in the enforcement of regulations (Benhassine, 2009, p. 79; Gatti *et al.*, 2013, p. 18). In all countries bar Jordan, firms polled in World Bank enterprise surveys report the above-average impact of corruption on their operations (Figure 17).

Arab countries fare somewhat better on general measures of corruption such as the 'control of corruption' index included in the World Bank Governance Indicators. The high impact of corruption reported by Arab businesses, in particular, is probably the *combined* outcome of general propensity to corruption with particularly deep state intervention. This

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is supported by international survey data on tax inspections and bribery, which shows a somewhat higher incidence of bribery *per inspection* in sub-Saharan Africa, but a much higher *frequency* of inspections in Arab countries, resulting in the highest combination of bribery and inspection intensity among all world regions (Gatti *et al.*, 2014, p. 141).

Unsurprisingly, some firms can navigate this environment better than others. Recent World Bank research demonstrates that the variation in waiting times for regulatory services in the Arab world is higher than in most other emerging economies (Schiffbauer *et al.*, 2015, p. 49f).

The important role of state resources and deep intervention in markets create vast opportunities for state-business crony networks, which have been documented at some length in recent research (Heydemann, 2004; Nucifora *et al.*, 2014). In Egypt, ‘politically connected’ companies under Mubarak accounted for only 11% of total employment, but 60% of total net profits among listed firms (Diwan *et al.*, 2015). In Tunisia, firms linked to the ruling Ben Ali family accounted for 0.8% of employment but 21.3% of total private-sector profits (World Bank, 2014, p. 112). Mechanisms for capturing such rents include discretionary access to subsidies, trade protection, credit, land and favorable regulatory enforcement (Chekir and Diwan, 2015; Diwan *et al.*, 2015; Eibl and Malik, 2016)—for all of which there are unusually ample opportunities in Arab countries.

Politically connected firms tend to push the majority of unconnected businesses into unproductive small-scale, often informal activities (Schiffbauer *et al.*, 2015, p. 82), where they enjoy weak property rights. In Tunisia, historical firm growth has been shown to be only very weakly correlated with profitability and productivity, reflecting high barriers to entry and discretionary protection (World Bank, 2014, p. 65). The dispersion of value-added within sectors across the region is particularly high. This also reflects protection, as we would expect low value-added firms to exit in a competitive market (Benhassine, 2009, p. 103).

In sum, in core Arab economies, state intervention remains deep and economic opportunities seem to depend more on where a firm started and what its connections are than elsewhere, reducing firm growth and mobility into formality, and cementing insider advantages. Firm entry and growth, in turn, are important determinants of economic growth and productivity (Klapper *et al.*, 2006). The exceptionally low dynamism of Arab business has arguably contributed to weak performance on pretty much all available indicators of economic performance. The Arab world has the world’s lowest share of private in total investment and the lowest ratio of manufacturing exports to GDP, which moreover have very low technology content (Benhassine, 2009, pp. 50, 59 and 61). Expenses on research and development are mostly below international levels (see Online Appendix, Figure O2) and World Bank enterprise surveys show an unusually low use of international quality certification mechanisms by Arab firms (Online Appendix, Figure O3). The contribution of total factor productivity to growth over the last two decades has been dwarfed by those of labor and physical capital (European Bank for Reconstruction and Development, 2013, p. 12). Productivity trends since 1990 have mostly been below those in all other world regions (Online Appendix, Figure O4).

Weak and segmented organization of business interests

Deep traditions of state intervention and control have left little space for independent collective action by Arab business: The World Bank describes business associations in the regions

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as 'generally weak, unrepresentative, or nonindependent', with little opportunity for less well-connected businesses to organize (Benhassine, 2009, p. 187; Malik and Awadallah, 2013). Given the prevalence of insider structures and favoritism, businesses often find individual, informal strategies more effective in pursuing their specific interests and dealing with an interventionist state (Heydemann, 2004; Hertog, 2012). Recent research on Egypt and Tunisia shows, for example, that politically connected firms under Mubarak and Ben Ali were very effective at making the state raise barriers to entry in the particular markets in which they operated (Nucifora *et al.*, 2014; Eibl and Malik, 2016).

Following the segmentation of the private sector, interests of large and small companies tend to diverge. Business associations are usually controlled by large businesses close to the state. A World Bank survey of Arab business associations shows that their lobbying typically focuses on the defense of specific insider privileges like regulatory protection and subsidies rather than the broader policy and regulatory reforms demanded by the majority of businesses according to enterprise surveys (Benhassine, 2009, p. 188).

As a result, demands for rule of law and for improvements to government effectiveness are weak. This takes reform pressure off government and contributes to a trap of low coordination and low trust in which most companies try to avoid the state rather than cooperate with it (Hertog, 2012). In Arab economies, like in coordinated market economies, businesses use non-market, informal coordination mechanisms. But these mechanisms are individualized and typically used for favoritism and individualized bargains rather than for collective policy coordination. The low investment in technology and skills across our cases arguably

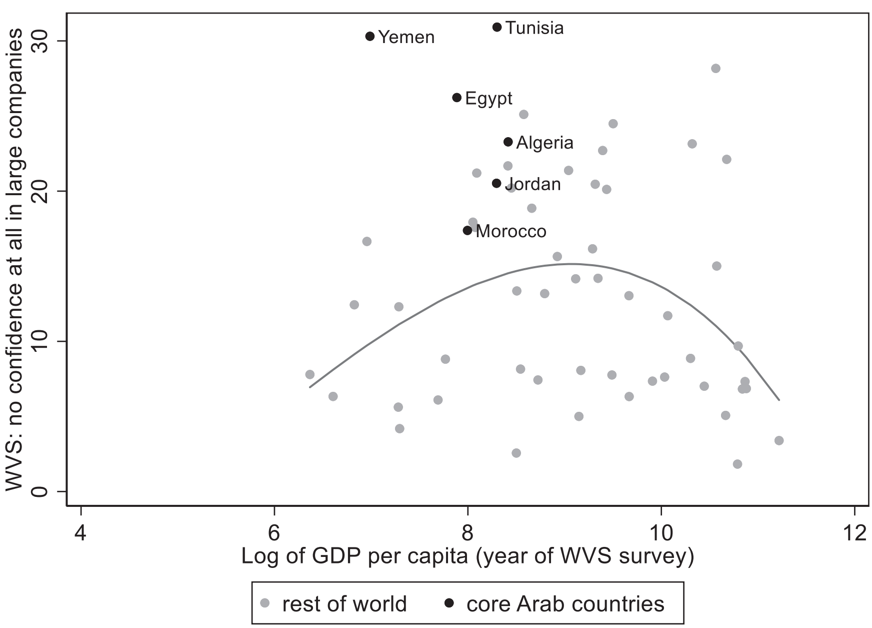

Figure 18. Percentage of respondents with 'no confidence at all' in large companies (WVS).
Source: World Values Survey, sixth wave.

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happens not only because individual firms are weak but also because collective business demands for government support in skills and technology acquisition are weak.

To sum up, deep state intervention provides immediate rent-seeking opportunities for both regime and connected private players, which, in turn, incentivizes these players to defend intervention mechanisms, often through individual interventions. Insider status and benefits are remarkably stable. The building of a broader social coalition for inclusive growth, by contrast, is difficult and uncertain.

Cronyism, insider privilege and limited employment creation contribute to low public trust in business. About twice as many World Values Survey respondents have no trust at all in large companies in the region than elsewhere (Figure 18). Scores in the republics again are particularly bad.

Arab citizens seem to specifically distrust large insiders in business, as general attitudes to entrepreneurship and markets in the region are positive (Diwan, 2014). While trust in business can be influenced by many factors, the differentiation of popular views between large businesses and entrepreneurs suggests that high-level insider cronyism is an important part of the story. Low trust in business, in turn, does little to help encompassing policy coordination between government, business and labor.

6.4 Skills

The last key component of the SEME is its skewed skills system, which helps to lock Arab economies onto a path of low productivity. Segmentation of labor markets and businesses

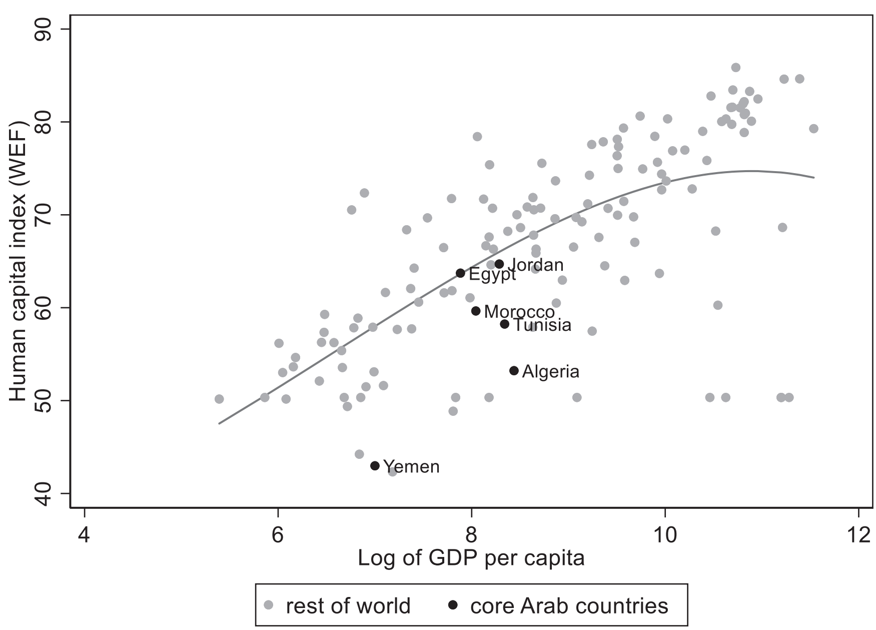

Figure 19. Human Capital Index scores (WEF).

Note: Higher score indicates a better human capital system.

Source: WEF 2016 Human Capital Report.

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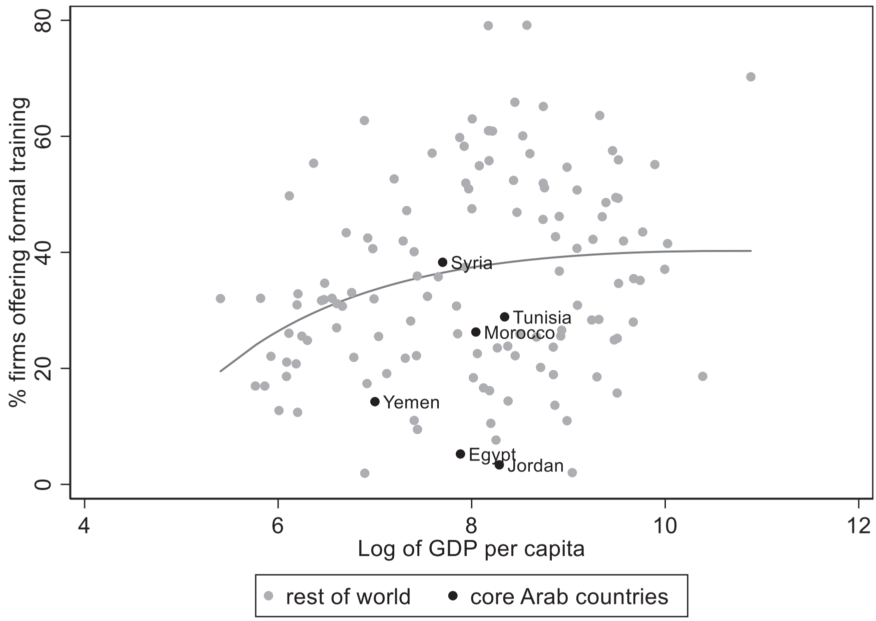

Figure 20. Percentage of firms offering formal training.
Source: World Bank enterprise surveys, most recent years.

depresses both demand for and supply of skills that would be relevant for a diversified private sector. A weak skills basis, in turn, undermines the mobility of individuals into the formal private sector and pushes them to seek state jobs; it also prevents firms from technological upgrades and diversification.

The evidence of low skill levels in the Arab region is strong. In the WEF's Human Capital Index, which measures enrollment, the perceived quality of the education system and skills levels, all cases are within the bottom 40% (Figure 19).

This weakness stems from the limited resources available per student and the status of teaching as a secure but low-status public sector occupation (World Bank, 2008a). It also has to do, however, with the segmented, inefficient and sometimes corrupt Arab labor markets, which create little demand for advanced cognitive or practical skills.

While government job creation has shrunk significantly, Arab skill systems continue to be organized around public sector-oriented 'credentialism' where the formal level of education matters more than the subject studied, as it determines access to government jobs (Salehi-Isfahani, 2012; Assaad, 2014). The perception of the 'public sector as the main client of education and training' (Gatti *et al.*, 2013, p. 25) remains widespread. This is reflected in the excessive focus in tertiary education on subjects of limited relevance for the private economy (World Bank, 2008b; see also Online Appendix, Figure O5).

Despite the scarcity of relevant specializations in the government education system, however, firms in the region for the most part provide little in-house training to compensate for skills deficits (Figure 20).

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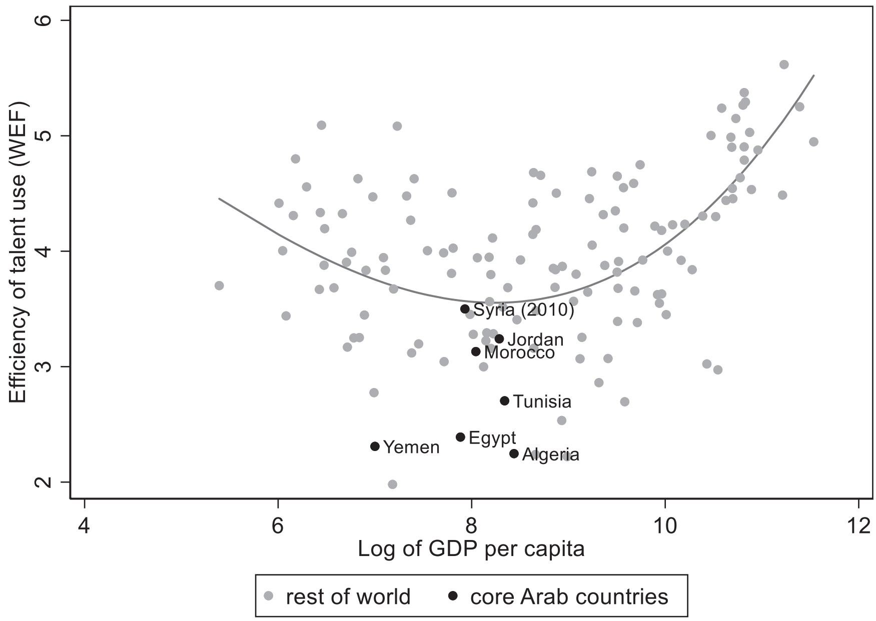

Figure 21. Efficiency of talent use (WEF).
Note: Higher value means higher efficiency.
Source: WEF.

Enterprise surveys show that Arab firms have a particularly low share of skilled workers in their permanent workforce, a result not only of weak skills supply but likely also of nepotistic hiring (see Online Appendix, Figure O6). The World Economic Forum's compound measure for the efficiency of talent used in Arab economies puts all core Arab cases below the international trend line (Figure 21).

It appears that many Arab firms, sheltered from competition and relying on non-meritocratc recruitment, have made their peace with the low available skills levels, focusing on low-tech production instead of upgrading their workforce.

The core Arab world seems to face a particularly bad case of a 'low-skill trap' in which limited supply of and demand for skilled labor feed on each other (Booth and Snower, 1996; Schneider, 2013). Small and rigid formal private labor markets and limited competition among private firms depress demand for advanced skills even more than is the case in Schneider's account of Latin America, giving labor market participants even fewer reasons to acquire them. The resulting weak supply of skills, in turn, disincentivizes investment into technology-intensive production processes.

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

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Segmentation and weak organization of business and labor mean that there is little coordination between government, firms and workers on skills formation; existing attempts to integrate business in designing vocational training or university programs have been desultory (Ashmawi, 2011; Gatti *et al.*, 2013, p. 177). Vocational programs hence often miss market needs.

Low prevailing skill levels themselves contribute to the strong demand for government jobs evidenced above, and in practice often leave only informal employment as a realistic option, thereby reinforcing labor market segmentation. Workers in permanent government jobs have particularly weak personal interest in upgrading the national skills system. Skill deficits make a move toward more inclusive and productive forms of industrial organization and welfare less viable, depressing productivity growth and innovation and further locking Arab economies into a low-productivity equilibrium.

Like other spheres of the SEME, the skills system is kept in an unproductive equilibrium organized around insider interests: rigidly segmented labor markets limit incentives to acquire productive skills, while low skill levels make it harder to use the few mobility opportunities that local labor markets offer. Low skill levels undermine the technological upgrading of firms, while a weak and sheltered private sector provides little training and has limited interest in upgrading the skills system.

7. Individual country outcomes and alternative explanations

This article has presented a wide range of evidence to corroborate our theoretical account of segmented political economies in the Arab world. As expected, the core Arab cases stand out in the degree of state involvement in the economy, the resulting segmentation of labor markets and private business, and a weak skills system that reinforces segmentation. A comparison with averages of nine other world regions in the Online Appendix shows that of the 15 indicators used in the above scatterplots, the core Arab cases do indeed have the most extreme average score on 11, and the second most extreme on 4, all in the expected direction.[9]

Where individual country scores deviate from the ideal type, this is consistent with their historical legacies, as it is almost invariably the relatively less historically statist and populist Arab countries that fit the template less well while populist republics have the most extreme scores. The within-region variation is further evidence for the theory: in the 16 indicators used in the article to measure the four key components of the SEME, statist republics Algeria and Egypt have ‘perfect scores’, with their measures lying on the expected side of the global regression line every single time. Statist Syria is on the ‘right’ side 7 out of 8 times, Jordan 13 out of 15, Yemen 12 out of 14, Tunisia 11 out of 14 and Morocco, the most peripheral of the cases, 10 out of 15 times. Similar patterns obtain for additional indicators included in the Online Appendix.

The broad pattern of variation with the region also shows that factors like natural resource rents and conflict (Beblawi and Luciani, 1987; Heydemann, 2000; Cammett *et al.*, 2015), while undoubtedly affecting Arab development, provide relatively limited leverage in explaining who is more or less SEME-like: not only are there many resource-rich and conflict-ridden countries in regions like sub-Saharan Africa or central Asia that have developed very differently from the statist Arab political economies, with less distribution and

9 The core Arab cases also score worse than other MENA cases for 12 of 15 indicators.

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less intervention, if sometimes more blatant corruption among a small elite. Also, conflict and rents do not seem to make countries within the Arab world systematically more SEME-like. Within the Arab region, cases' proximity to the ideal type also is not linked to rent levels or histories of conflict: Egypt has been at peace with Israel since 1979 while Algeria has not fought a war since independence, yet both remain the closest to our ideal type. Yemen has experienced more conflict yet fits the ideal type less well.

And while statism in Algeria certainly is bolstered by hydrocarbons rents, Egypt is similarly resource-poor as Morocco and Jordan yet a more consistent fit for the SEME type. Finally, the level of authoritarianism, a distinct marker of the whole region, does not seem to make much of a difference, at least not in the short run: insiders on the labor market have, if anything, become more entrenched with Tunisia's transition to democracy in 2011. Going forward, this might change: the creation of broader, non-contributory social protection systems in Latin America has coincided with democratization on that continent (Haggard and Kaufman, 2008; Brooks, 2015). Electoral competition could help political entrepreneurs to mobilize outsiders around a less exclusive labor and welfare regime. For the time being, however, the limited political competition in the region seems to have revolved more around (not always credible) promises to enlarge the insider coalition.

8. Summary and discussion

Core Arab economies stand out in their deep segmentation and low dynamism. To sum up, heavy state intervention, both formal and informal, durably divides firms and workers into insiders and outsiders. This static segmentation allows insiders to persist with low productivity (firms) and low skills (workers), giving them a strong vested interest in maintaining a system that allows them to be uncompetitive. Due to high barriers of entry, labor market outsiders similarly have limited incentives to invest in skills. The state's maintenance of insider privileges is costly, crowding out inclusive social policies and other investments that could improve human capital and increase outsiders' mobility into formal employment. Prevailing low skills and a weak private sector, in turn, push even outsiders—who are in any case politically marginal—to demand more access to government privilege rather than labor market reforms or a reallocation of state resources toward a modern, inclusive welfare system.

In the core Arab countries, economic transactions are less market-based than in liberal market economies. Instead, like in coordinated market economies, non-market relations and informal networks play an important role—but different from European CMEs, these are not embedded in strong meso-level institutions such as unions, employers' associations or industrial banks. Instead, exclusion, segmentation and favoritism divide economic actors, undermine trust and stymie the formation of encompassing interest groups. Agents are left to pursue their interests individually and often through informal means, thereby reinforcing existing divisions.

This article's objective was conceptual but also aimed at explaining the low economic performance of core Arab economies. While many other variables likely bear on regional economic outcomes, the interlinked factors of low firm entry, limited formal employment and low skill formation are bound to exert a drag on economic development via lower productivity. A range of economic studies has indeed linked the each of these three factors to low economic growth (Mincer, 1984; Djankov *et al.*, 2002; Klapper *et al.*, 2006; Chong

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et al., 2007; Loayza and Rigolini, 2011; Hanushek and Woessmann, 2012). Identifying the links between SEME features and growth and diversification with more precision remains for future work.

State failure and inability to deliver basic public goods are worse in some other regions of the world. Yet it seems to be exactly the relatively stronger but skewed presence of Arab states that creates the unique depth and rigidity of insider–outsider divisions in Arab political economies. Similar to Kathleen Thelen's account of continental European economies, the Arab world's core distributional institutions have been rather successfully defended through decades of liberalization—but, as in Europe, the social and distributional consequences of these institutions have changed dramatically and negatively (Thelen, 2014).

The 'institutional drift' (Hacker *et al.*, 2015) of core Arab economies has led to the exclusion of important parts not only of the rural periphery but also younger, educated urban job-seekers over time. As in Bruno Amable's account of advanced capitalist systems, a dominant social coalition of insiders maintains the institutional configuration of the SEME (Amable, 2003), but with particularly strong negative economic externalities.

The system described above has proven resilient even in the face of deep upheaval and political revolutions in the Arab world. As its parts are interlinked and reinforce each other, changing just one aspect is difficult. This is not to say that change is impossible. The answer to the Arab world's economic challenges, however, is not more protection and privilege, but a form of egalitarian liberalization in which insiders will have to simultaneously give up some of their privileges to provide not only more opportunities and mobility but also more social safety and material support for outsiders. This means redistributing resources rather than just cutting.

The region has seen some discussion about a 'new social contract', but the debate has remained rather unspecific (Loewe and Jawad, 2018). Judging by the Latin American experience, Tunisia should have a better chance to create a new distributional regime than most other Arab countries as its more open political system provides more opportunities to organize outsiders around a new, more inclusive economic governance model. Yet even in Tunisia, the political leadership that could provide such a vision has yet to emerge.

An alternative, less fortunate path might be a continued erosion of distribution to insiders due to a continuing fiscal crisis with no substantive improvement for outsiders. This is Egypt's current path, at least for its labor market: while the public sector remains very large and the nominal wage bill continues to grow, real government wages have declined since the forced devaluation of the Egyptian pound in late 2016, insider-oriented compensation policies notwithstanding (International Monetary Fund, 2019). Such crisis-driven adjustment might somewhat level the playing field—and has indeed resulted in higher GDP growth rates since 2016—but it does so through general pauperization rather than inclusion.

Supplementary material

Supplementary material is available at *Socio-Economic Review* online.

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