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**UNDERSTANDING REVOLUTION IN THE MIDDLE EAST:  
THE CENTRAL ROLE OF THE MIDDLE CLASS**

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**Working Paper No. 726**

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## Abstract

The paper argues that the changing interests of the middle class can explain the authoritarianism of the past and the more recent shift to democracy in some, but not all the countries of the Middle East. The framework proposed includes the evolving class structure and related class preference for economic and social policies. It compares the possible coalitions between classes that can form either an autocratic bargain or a democratic coalition, and it explores the conditions under which a shift from one sort of equilibrium to the other can occur. It then reviews the evidence in two areas. First, it looks directly at changes in opinion in Egypt, Iran, and Morocco and asks whether these are consistent with the predictions of the theory. Second, it examines the corporate sector in Egypt around the time of the revolution, in order to understand the performance of "crony capitalism" and to evaluate whether it may have affected the incentives of the middle class to defect.

**JEL Classifications:** P16, P26

**Keywords:** Revolution, Middle East, Middle Class, Democratic Coalition

## ملخص

تناقش هذه الورقة المصالح المتغيرة للطبقة الوسطى وكيف يمكن أن تفسر الاستبداد الماضي والتحول إلى الديمقراطية الأكثر حداثة في بعض، ولكن ليس جميع بلدان الشرق الأوسط. الإطار المقترح يشمل البنية الطبقيّة المتطورة وما يتصل بها من تفضيل طبقة معينة لسياسات اقتصادية واجتماعية. تقوم هذه الورقة بمقارنة التحالفات المحتملة بين الطبقات والتي يمكن أن تشكل إما صفقة استبدادية أو ائتلاف ديمقراطي، وتستكشف الظروف والتي من خلالها يمكن أن يحدث تحول نوع من التوازن إلى آخر. ثم تستعرض الأدلة في مجالين. أولاً، تنظر مباشرة في التغييرات في الرأي في مصر، وإيران، والمغرب، وتساءل ما إذا كانت هذه تتفق مع التنبؤات النظرية. ثانياً، فإنها تفحص قطاع الشركات في مصر في وقت قريب من الثورة، من أجل فهم أداء "الرأسمالية المحسوبية"، وتقييم ما إذا كان هذا الأداء قد أثر على الحوافز الطبقة الوسطى.

## 1. Introduction

The Arab world is at a crossroads, facing enormous challenges as well as opportunities that can lead to either a gradually improving democratic path or an authoritarian retrenchment. In the absence of a shared understanding of the social, political, and economic transformations that have led to the recent uprisings sweeping the region, it will be difficult for the multitude of new actors that have become suddenly more influential to navigate the stormy waters of the ongoing transitions.

A shared frame may be emerging intuitively, but it has not yet been brought together into a coherent and logical framework. Many of the characteristics of the recent Arab uprisings are puzzling and do not fit easily with popular intellectual frames. Why did they occur at the end of 2010, when there were no apparent direct triggers such as declines in subsidies or shifts in foreign alliances, rather than in the 1990s when the welfare state started to roll back? Why did the revolutions start in Tunisia and Egypt, the countries with some of the highest economic growth in the region in the preceding few years, rather than in countries such as Syria or Yemen where economic conditions have been more dire and political repression more severe? Why were they initiated by secular middle class (thereafter MC) youth, the supposed beneficiaries of the modernizing republics, rather than by the long-standing Islamic opposition? And by which mechanisms did the uprisings of Tunisia spread so fast to the rest of the Arab world when Arab nationalism had been pronounced dead long ago?

The goal of this paper is to offer the outlines of a theoretical framework that helps answer these questions in ways that can stand up to empirical validation. A useful analytical frame would offer a coherent view about both the persistence of autocracy *and* the genesis of the recent revolts in countries *where* they took place. My main thesis in this paper is that to have traction such a framework needs to include class structure as well as economic and social policies (inequality/redistribution). I also explore a possible role of “Political Islam” (thereafter PI) in the dynamics leading to the ongoing transition. I will then test empirically the implications of the framework in two different yet essential directions: first to explore what opinion polls show about the evolution of opinion among classes in Egypt, Iran, Jordan, and Morocco; and second, to try and ascertain if the type of capitalism that developed in Egypt during the past decade should be seen as a main contributor to low economic performance.

The paper builds on recent literature on this topic, and is to an extent the summary of my recent work in the area. Section 2 critically reviews the theoretical models used to characterize the region in light of the stylized facts and of the global literature on transition, and it outlines a broad framework more adapted to the conditions of the region. It argues that the uprisings should be seen as episodes where the MC shifted its allegiance from the autocratic to the democratic order.<sup>1</sup> Section 3 examines the evidence available from opinion poll surveys on the evolution of the MC opinions relating to economic and social policies. It finds that distributive considerations made democracy more attractive to Egyptians, especially those that belong to the MC, but not to Moroccans and Iranians. Section 4 describes recent work on state-business relations in Egypt and finds considerable support for the thesis that cronyism was prevalent, and some more limited support for the thesis that this was bad for growth. Section 5 concludes by highlighting the main future economic and political challenges.

## 2. Towards a More Useful Theoretical Framework

In this section, I review selectively the recent literature on Middle East (thereafter ME) politics, both contrasting it with the global literature on transition, and confronting it with

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<sup>1</sup> In the text, I will use revolution and uprising interchangeably and somewhat loosely to indicate a forceful takeover of the state following mass protests. The models discussed below will make the terminology more precise.

stylized facts of the recent past. I then present the outlines of a distributional model that can explain the recent transformations—why (and when) transitions to democracy occur, and when they do not. I also argue, using casual empiricism, that the model explains well the onset of the uprisings where they occurred (before turning to more serious empirical investigations in the next sections).

Game theoretic models of governance have been at the heart of the analysis of ME politics for the past two decades. The basic approach has been to study how the interactions between an autocrat and citizens lead to an autocratic, or an elite bargain model (such as in Desai et al. 2009), where citizens surrender their political rights to strong autocrats in exchange for economic security. The intuitive appeal of this long honored tradition of Middle Eastern scholarship—it goes back to Marx and Wittffogel—is that the extractive nature of oriental governance (such as in the Ottoman Empire in the past) did not allow for the development of social classes that would lead to modernization. In its more recent manifestation, this strand of literature has continued the tradition of not looking deeply at social transformations within societies given that it is this presumed immobility that allows and reinforces the Faustian elite bargain. Since the “Presidents for Life” seemed unmovable (Owen 2012), the analytical focus had rightly been placed on the various ways in which they managed to maintain themselves in power, using political tools such as cooptation and repression. These models are more concerned about the sharing of rents rather than about the opportunities of various social classes to improve their well-being if the political regime were to shift from autocracy to other modes that would serve their interests better. This approach has colored analysts’ views about contemporary challenges—for example, a usual prediction has been that the demographic bulge in the region would lead to demands that the autocrats cannot satisfy, leading to revolutionary tensions in the absence of accommodation. However, in a rational forward looking model, they would only switch their allegiance from autocracy to a democracy *if* they thought that in response to the youth bulge, democracies had a better *comparative* ability to create new jobs relative to the autocratic regimes in place. In reality, the possibility of political change was not considered seriously in recent studies because most observers generally discounted the possibility of major change. As a result, the intellectual models used did not contain the tools necessary to study transitions carefully. On the other hand, they tended to explain current developments quite well—in particular, how in reaction to the roll back of the state in the region, opposition arose, and as a result, autocrats managed to maintain control with a mix of repression and cooptation.

A look at key economic performance indicators for developing Arab countries as a group from 1980 to 2008 (depicted in Figure 1) reveals several marked trends. First, it shows that the roll back of the state began 25 years ago. Government expenditure shot up in the 1970s on the back of rising oil wealth in the region, but it fell precipitously in the 1980s, reaching 22% GDP in the early 1990s, a low figure by international standards.<sup>2</sup> The reforms in the Arab world tended to hurt the poor (subsidies to agriculture were deeply cut for example) as well as the MC (especially in lower public sector wages and a stop to hiring). Those actions led to protests and bread riots across the region but fell short of leading to democratization. This period consolidated the alliances between the autocrats and elite capital. By the mid-1990s, the old social contract was already dead (Diwan and Walton 1998).

These trends raise an important question that has saddled academics in the past decade. What has sustained autocracies during the past 20 years and allowed autocrats to survive for so long? In Latin America (of the 1980s) and Africa (in the 1990s), similar structural

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<sup>2</sup> Some have argued that other forms of external rents, for example workers’ remittances, played a role. But remittances declined in importance over time. Moreover, remittances usually travel directly to communities bypassing formal institutions, so it is hard to argue that this source of income was a factor in the autocrats’ survival. Official assistance also remained low.

adjustments have led to a nearly synchronous wave of democratization. To deal with the decline in economic resources and consequent social pressure, the autocratic rulers did not relax political and social policy across the board. Figure 2, which depicts the evolution of an index of political rights (Political Empowerment Index, see Cingranelli and Richards 1999) between 1980 and 2010, suggests that in fact the opposite has been the case. The region was politically less open in 2010 than in the mid-1980s, with the average score for the region falling from about 6 in 1980 to 2 in 2010 on a scale from 0 to 14, with 0 depicting complete dictatorship.

The literature on the ME describes in detail how (and in some cases why) different regimes chose to respond with a different mix of cooptation and repression to maintain their control (in particular, see Beilin 2005, and the articles in Schlumberger 2007, and Posusney and Angrist 2005). The autocrats sought to maximize the use of their dwindling assets through dividing citizens into two groups, one of which benefited from cooperation while the other was subject to repression. Figure 2 also depicts average levels of repression in the region, as measured by the Physical Integrity Index (also from CIRI), on a scale from 0-8 where 0 is maximum repression. Over the period, the average value of the index for the Arab countries fell from 4.5 to 2.5. That repression became an essential tool in the preservation of autocratic regimes in the late 1990s is also proved by the level of spending on security matters. Autocrats also sought to strengthen their coalition by coopting the MC. Cooptation was largely achieved through direct economic benefits in the form of subsidies for goods that are consumed relatively less by the poor, such as petroleum and energy (earlier, subsidies for small scale agriculture and for basic food items that benefit the poor had been reduced or eliminated).<sup>3</sup> At the same time, the fiscal regime became more pro-rich over time: tax rates have been relatively low and generally regressive and universal services have decayed in most countries.

This class of models, while suited for analyzing the past, is not useful as a tool to describe the current issues facing the region. Indeed, why did the careful balance of repression and cooptation suddenly collapse in recent years, and in some but not all Arab countries? The youth bulge has actually peaked earlier, around 2000, and subsidies were not being cut, quite the opposite. The uprisings have opened up an intellectual Pandora's box, as new policy and methodological/epistemological questions come up, new actors and agents of change become prominent, and more generally, the analytical frame that is necessary to portray reality needs to focus more centrally on the incentives of actors for political change.

There is an abundance of global literature on transition to democracy which emerged in the shadow of the "third wave" of democratization that engulfed Latin America, Africa, Asia, and Eastern Europe in the past two decades. This strand of literature places distributional concerns at the heart of the analysis, with groups rationally comparing outcomes under autocracy with outcomes under other regimes, including democracy. In these models that started with the seminal work of Ghandi and Przeworski (2006), the poorer segments of the population favor taxation and redistribution, which the rich oppose. As a result, there is an incentive for the rich elite to govern in an autocratic way, and for the poorer segment to attempt to take over and form a democracy where tax policy is determined by the median voter. Starting from a socio-political equilibrium, when inequality rises, the system comes under stress in various ways. The equilibrium can shift to either a more repressive authoritarianism, or to a democratic order to which elites will sign on, or some elements of

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<sup>3</sup> In the last decade these subsidies grew to become about 200 percent the combined budget of health plus education in 2009 in Egypt, and 150 percent in Tunisia. The situation in Syria and Morocco is also similar. These subsidies went predominantly to the MC and the rich – in Egypt, 46% of the benefits for example accrued to the top decile in 2010 (Abouleimen, Al-Laithy, and Kheir-el-Din 2009).

the previous ruling coalition will split to the new democratic coalition (see Acemoglu and Robinson 2006).

In models of democratic transitions, the distributive motive for change is expanded to endogenize the very existence of democratic governments. When elites are confronted with mobilization from below, they can make short-term concessions to diffuse the threat, but they can also be expected to default on these promises when mobilization subsides. Democratic institutions provide therefore a means for the elite to commit credibly to a more equal distribution of income in the future (because reversals are costly) when faced with credible challenges (Acemoglu and Robinson 2006). As a result, when low income groups mobilize in favor of redistribution, they do so by militating for a more democratic order. In a recent wide-ranging empirical review of the past two decades, Haggard and Kaufman (2012) shows that more than one half of recent transitions are explained by distributional concerns—the other half is divided between cases where it was driven by splits within the ruling elites, and cases where elites perceived democracy to serve their own interests.

Several variants of such models allow for the existence of critical constituencies or “selectorates” (de Mesquita et al. 2003), or particular ethnic groups that could be easily mobilized against existing regimes, and rulers will try to target favors in the direction of these groups. In our case, I will focus mostly on the MC as the pivotal player (and explain why below), but in multi-ethnic countries, powerful ethnic groups would also play this role. Thus, groups will be included or not in the ruling coalition depending on a cost benefit calculus. Repression can also be added to these models: while in general violence will not occur within cooperative equilibria which depend on latent violence, non cooperative equilibria as described above would have some level of repression and violence when a dollar spent on repression improves the welfare of the ruler more than a dollar spent on transfers (Ghandi and Przeworski 2006). Finally, another variation that will be relevant to the ME is that of Desai et al. (2009) which introduces preferences over both income and social policy, showing how autocrats could also react to increased pressure for redistribution by relaxing social, rather than economic policies (and especially so when they cannot afford the latter).

Making inequality a core driver to understanding the Arab Spring is tempting, as this stems from the central role of inequality in the history of the region, as it travelled from socialism and populism towards capitalism, and ended with what is commonly described today as a regime of crony and unequal capitalism. This regime is perceived to have generated unacceptable inequalities, directly by supporting the growth of a class of super-rich, and indirectly by being unable to create sufficient good jobs for the newly educated MC.

It is however not straightforward to simply fit the situation of ME countries to such a framework, to hypothesize for example that those among them bearing the larger brunt of income inequality must have undergone transition first. Indeed, in this class of models, the effect of inequality on the possibility of transition is actually not clear-cut, it increases the incentives of citizens to rebel, but it also increases the incentives of the elites to repress since it makes the alternative to autocracy more costly to them in terms of taxation. So more inequality can reinforce or destroy the autocratic bargain. Theoretically, the relation between democratic transition and inequality would be like an inverted U: transitions would be more likely to occur when inequality rises at middle levels of inequality. This intrinsic indeterminacy calls for augmenting the bare-bones model with some of the key specificities of the region/country being studied in order to characterize its evolution.

In looking for these characteristics, several elements can be considered. Repression could have become more costly when, for example for ideological reasons, it makes it harder to keep the governing coalition together. We can also look at the opposition core challenge of coordination—the collective action problem has been taxing under the repression of



autocrats, and only some groups, such as religious groups that had sought the protection of the mosque were allowed to get organized. In societies that have been divided along secular/religious and ethnic lines, this coordination is harder to achieve. But I will argue first that more centrally, to have a sufficiently rich conceptual framework that can explain both the persistence of autocracy and its ultimate demise in some countries, we will need to bring in class structure and its evolution over time into the analysis, with a special emphasis on the role of the MC as the key selectorate. In this view, the uprisings of 2010-11 are seen to be the result of long-term changes in factors that affected the relative incentives of the MC to support the ruling regimes and that encouraged it instead to throw its support to a democratic coalition with the poor. With this coalition with the poor the MC ensures that the new coalition will win the day— as the costs of repressing most of the society will typically be too high for the rich to want to mount a strong defense.

There are several reasons for bringing the MC into the analysis. First, a focus on two players only would suggest for example that Islamic movements, the main political actor that has emerged in post-uprising elections, have finally won their long war against liberalism. The reality is much more nuanced. The “revolutions” were in fact led by MC youth, not hardened Islamists. Second, Arab autocrats have valued keeping the mainly secular MC led parties in the governing “political settlement”, either within the governing coalition, or as part of the legal opposition, due to their important legitimizing role. For the regimes in place, secular and liberal ideology was at the center of their Arab national ideologies of the 1950s, which ushered leaders such as Bourguiba and Nasser, and brought around the Attatuk model of modernization based on secular and nationalist ideologies. For the Arab autocrats, losing their MC anchors is tantamount to losing all legitimacy and turning into naked dictatorships with no operational narrative. In this broader frame, the authoritarian bargain in the Arab world in the past decade can be best characterized as an alliance between elite capital and elements of the MC that delivered economic benefits to the coalition members, including in the form of subsidies (this does not apply to Iran, which I see as an autocracy of the poor). The poor in the meantime were denied economic advantages and their political movements were severely repressed. Third, the MC has changed after the economic liberalizations of the 1990s. Until recently, Middle Eastern scholars did not seem to believe that the MC could play an active role in leading political change. Its effective influence on policies was low as it was mainly made up of civil servants and employees of state owned enterprises, which reduced its ability to play the role of an autonomous actor. Indeed, the interests of this group have not been protected in the past and it became poorer as a result of the rolling back of the state. Low public sector wages also fueled petty corruption in areas such as health and education, generating another important source of discontent.<sup>4</sup> A new market oriented MC rose in late 1990s in response to economic liberalization. The newcomers tended to be small merchants and industrialists that have benefited from the market oriented reforms as well as the small but expanding skilled labor of the formal private sector labor market. This group has been politically more active than the old (see Nasr 2009)—for example, it played an important role in securing the success of the Iranian revolution in 1979, and the rise of the AKP in Turkey.<sup>5</sup>

A rapid exploration of household level data reveals that it is indeed the composition rather than the size of the MC that has changed over time in the region. To provide a sense of magnitude, I have estimated the size of the income classes for the region as a whole, using

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<sup>4</sup> In Egypt, for example, real wages in the public sector declined over time. The minimum wage, which anchors all wages, has declined from 60% of per capita GDP in the early 1980s to a mere 13% in 2007 (Abdelhamid and El Baradei 2009). This can be also seen very sharply at the macro level—by 2009, 30% of the Egyptian labor force worked for the state but earns a total wage bill of less than 9% GDP, implying that average wages were in the neighborhood of one third of GDP per capita, which is extremely low by international standards.

<sup>5</sup> Indeed, it benefitted handsomely from the alliance with the support provided to SMEs and the rise of what became known as the Anatolian tigers, SMEs that drove growth in Turkey in the past decade (Demiralp 2009 and Gumuscu 2009).

World Bank data on income distribution, and utilizing reasonable assumptions on the definition of classes. The results represented in Figure 3 are striking: throughout the period, the size of the MC remains around 30% of the population for the region as a whole, that of the rich at about 10%, and that of the poor (using an expansive definition of having an income of less than \$4 a day) at about 60%. In many countries (with the notable exception of Tunisia, Jordan, Lebanon, Iraq, Iran, and the Gulf), the median voter is poor.

Bringing the MC into the analytical frame requires that we understand its evolving preferences, social and economic, including in relation to the preferred policies of the other main groups, the elite, and the poor. We can speculate here (the next section will conduct more formal tests) that while the MC may have done better than the poor in the newly liberalized market economy, the parallel rise of the very rich may have increased its appetite for taxation. Moreover, high and rising rates of unemployment among the educated youth must have hurt profoundly its modernizing aspirations, the question being whether the autocratic regimes underperformed on job creation and economic growth relative to what could be expected to happen under other feasible political regimes.

There is no direct evidence that inequality had risen in the recent past, or that the MC was hurt by the market reforms and squeezed by the rise of crony capitalism, or that its interests have geared more towards redistributive policies. In particular, there is no direct evidence of increased inequality in income distribution data, but then, assessing changes in inequality—the share of national income commanded by the MC—is tricky. Generally, household surveys reveal that inequality (as measured by Gini coefficients for example) is moderate in the region by global standards (Gini coefficients are between 35 and 45%), and that it has increased marginally during the past decade (Bibi and Nabli 2010), with the income of the rich rising faster than average incomes. But the increase seems small relative to other regions. Household surveys are however notorious for under-counting the rich. There are several signs to suggest that there is now a wealthy Arab “1%” which commands a large share of national income. In evaluating whether the economic interests of the MC have shifted over time, careful country-based analysis will be needed. But we can already note that the conditions for revolution seem good: inequality rising from a low base was predicted in our theory discussion to lead to situations where the incentives to rebel rise faster than the elites’ incentives to resist.

The rise in inequalities and relatively low performance of Arab economies in terms of job creation are now being related to the type of state-business relations that had developed over time in the region. The liberalization of market, especially the credit markets, seems to have led to a concentration of economic power in the hands of the few firms with good connections to the state (see in particular the pioneering work in Heydemann 2004). It may be that such forms of capitalism were not conducive to economic dynamism, and that they also biased politics. The perceived corruption of the economic elites was one of the main drivers of revolutions. But the literature of the economic impact of the type of state-business relations that had grown in the ME is not developed enough to allow one to make such allegation in any convincing way. State-business relation can either support a dynamic capitalism or lead to a low equilibrium of corruption and low investment. What is needed at this stage is to study the performance of Arab capitalism in more depth to understand both its (lack of) performance, and the mechanisms leading to this. We return to this theme in section 4.

The second aspect of the MC preferences that will interest us is its views towards PI. In the past, PI posed a threat to these regimes by organizing the poor, and it was severely repressed (see for example Fattah (2005) on Egypt). The cost of repression was low due to heavy support from the West (Sayyid 2007). But the fear of PI may have also helped autocrats keep

MC in coalition at lower economic costs, especially where divisions along secularism /religious conservative fault lines were deep in the early 1990s. In these countries, socially liberal groups feared a takeover by Islamic parties because of the different views these held on a broad range of social issues such as civil rights, separation of mosque and state, the role of women in society, or foreign policy. This must have drawn the MC to support the autocrats, even where economic benefits fell. But here too, dynamic factors have been at play as more moderate Islamic parties took root within the MC over time.<sup>6</sup> When moderate elements within Islamist parties in several countries tried to reach agreement with liberal and leftist forces on joint political programs, over-repression was used strategically by autocrats to try and radicalize the Islamists and prevent a MC split.<sup>7</sup>

Finally, a last factor that can explain variations that I alluded to earlier is external influence. External actors have had a vital role in keeping the autocrats in power for that long, but much more in the form of political and military support than in the form of direct economic support (Sayyid 2007). Official assistance has been on average between 2% and 5% of GDP in the region, peaking at 5% in the early 1990s at the time of the first Gulf War, and again around 2005 (Figure 2). Given the reliance of the autocrats on repression in a global environment of increased democratization, political support must have been extremely valuable. Unlike the cases of Latin America and Africa where donors have exerted great pressure to democratize, no such pressures were applied to the Arab autocrats. Instead, the terms of the relation were based on the stability of oil production, the containment of the Islamist “threat”—especially after 9/11—and the defense of Israeli interests. While external support has been central in allowing for the continuation of the autocratic bargain for so long, it has also planted seeds for its own destruction because it has supported the adoption of unpopular policies in ME countries which have caused what has been perceived as a “loss of dignity”. In particular, the MC decision to split could have been affected by the increased anti-US sentiment (after the invasion of Iraq), and increased anti-Israel sentiment (after the wars on Gaza and Lebanon), with a negative impact on their client regimes. But not all countries received support from the West. Syria in particular turned to Iran, China, and Russia, and this allowed it to develop a devastating counter-offensive to its own revolution. Similarly in Bahrain, the Saudi intervention was decisive.

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<sup>6</sup> The question of whether PI can be a trusted actor in a democracy has been debated for a long time. The future will tell, but at this stage, it is clear that the voters in Egypt and Tunisia seem to believe that it can. Meanwhile, the intellectual debate on these issues continues. In contrast to the well-known critique of Bernard Lewis (1998), others (for example Platteau 2008) have argued that Islam is not inimical to the separation of Mosque and State. The experience of 18 century Europe demonstrate that in similar conditions Christian movements did end up playing by the democratic rule, albeit Catholics had the advantage of a binding commitment mechanism in the form of Vatican’s dominance, which at least Sunni Islam does not have (Kalyvas 2000). But commitment can also be developed by organized parties with long-term views through mechanisms of organization and transparency, as demonstrated by Schwedler (2006) in her comparative analysis about the participation of Islamic parties in governments in both Jordan and Yemen during the 1990s. The example of Turkey must have played an important role in convincing liberals that the Faustian deal was not the only option. Demiralp (2009) shows how the AKP’s moderation can be explained by a combination of lessons from repression, opportunism, and the growth of a friendly MC. Several Arab Islamic movements have made efforts to moderate their more extreme wings to become credible republican actors. Al-Nahda, committed publicly in 1981 that: “we have no right to interpose between the people and those whom the people choose and elect” (quoted in Osman 2010). In Egypt, it was only in 2004 that the Muslim Brotherhood managed to commit publicly to abide by a constitutional and democratic system, calling for the recognition of “the people as the source of all authority”, and committing itself to the principles of the transfer of power through free elections, the freedom of belief and expression, the freedom to form political parties, and the independence of the judiciary system (Rand 2010).

<sup>7</sup> A much cited example from Egypt is the increase in repression around 2008, after the election gains of PI in the 2005 elections where it started to appear as an increasingly credible alternative to the ruling regime (see for example Osman 2010). In this case, increased repression met increased moderation. State Security jailed hundreds of officials, closed down many companies close to the movement, and prevented it from running for elections after 2007. The pressure created deep divisions within the Muslim Brotherhood over whether it should abandon the political process, and in this atmosphere, the conservatives managed to displace the moderates and elect a new Supreme Guide who supported disengagement (Ottaway 2010; Bubalo et al. 2008).

What would a basic augmented model look like? In another paper (Diwan 2012), I present a formal model in the tradition of Acemoglu and Robinson (2006) that is calibrated to include the essential ME's stylized facts discussed above. In the model, there are 3 core groups: the rich, the MC, and the poor, and let's imagine that in the initial situation, the rich class is in charge as part of a coalition that includes the MC. In this set-up, democracy would emerge if and when the MC switches its support from the rich and autocracy towards the poor and democracy, and this can happen for combinations of the exogenous variables, including inequality, cost of repression, and attitudes towards PI. Conflicts of interest arise in relation to the determination of income redistribution funded by taxes. Our three groups will have varying incentives for progressive policies, with the rich favoring a low tax, the poor favoring a high tax and redistribution, and the MC taking a middle position. Revolutions by the poor can take place, and will, when the cost of revolution is small enough, from the point of view of the poor, relative to the gains (in terms of higher taxation). Autocrats can prevent the occurrence of revolutions in two ways: either by increasing taxes and redistribution, or by using repression. Taxes need to be time consistent, meaning the regime is unable to commit to high taxes if it has incentives to renege once the threat of revolution passes. This type of game affords three types of equilibria: (i) autocracy with or without the MC and with or without repression; or (ii) a winning revolution by the poor, which is a chance event typically in these games; and (iii) a democratic coalition of the MC with the poor.<sup>8</sup> The first is more likely when there are small inequalities between the MC and the rich (and large with the poor), when the cost of repression is not too high, and when the cost of revolutions is high. When some of the underlying variables change, one can shift from one type of equilibrium to another. In particular, a shift from an autocratic equilibrium to a democratic one can theoretically occur when inequality goes up from a relatively low base, and/or when repression becomes more costly. In the same paper, I also introduce preferences over the tenets of PI in the agents' utility functions. The moderation of PI can be modeled by considering that the preferences of the MC over social outcomes become more align over time with those of the poor, and farther away from those of the rich. Another way is to consider that the MC becomes (more) unhappy about repression when PI moderates, since the MC then identifies with its tenets more closely. An MC split will be more likely if its preferences are close to the poor on this dimension too. Indeed, when the poor are more conservative socially, the MC would experience an extra dis-utility in a democratic order if they think that the poor will apply the values of PI if they came to power beyond its own preferred level.

We are now in a position to develop a tentative story-line of what has, and has not happened in the region in the last few years on the basis of the stylized facts of the scarcity of skilled jobs, the moderation of PI, and the unpopularity of foreign policy. Where transitions did not happen or were resisted, these variables must have looked different: inequality was higher and led to increased repression, or foreign allies were less supportive. Two other factors that we did not discuss in detail would also matter: ethnic divisions that shadow over alternative settlements, or the rule of kings, which may offer these regimes the ability to commit to long-term gradual changes in ways that autocratic republican regimes cannot do.

I find it convincing to think of the uprisings as generated by a split of the MC rather than a revolution of the poor. This seems to fit the situation more in Tunisia, Egypt, Libya, and Yemen—but admittedly, careful empirical work would be needed before we can be convinced of this hypothesis (some of it is presented in the next section). Some would balk at

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<sup>8</sup> We can also think of the democratic MC-poor coalition as a democratic bet which needs subsequent consolidation to survive. One of the main challenges in the Arab world is to establish greater cooperation between Islamists and secularists. But by "coalition" I mean a deep national political settlement, and not a governing coalition. The character of this settlement will vary depending on, among other factors, the preferences and bargaining power of the poor vs. the MC.

a description of the “Arab Revolutions” as a switch of the liberal MC. But the uprisings in these countries were driven in large part by secular MC youth who had become disenchanted with the deal their parents had struck with the autocrats and were concerned about economic and social justice and their future. Their action amounts to creating a free space (a “foco”) where supporters of the revolution could demonstrate their opposition, thus facilitating their coordination. We can speculate at this stage about the more fundamental shifts that have produced MC splits in these countries. That Tunisia and Egypt were the countries where the tipping point for the MC was discovered first is not surprising. In both countries, the MC was larger due to the relative success on the economic front, its economic interests were being increasingly squeezed by a crony oligarchy, and liberals and Islamist movements had operated a rapprochement over the years. In both Libya and Yemen the revolutions were met by fierce resistance by the autocrats. But one can argue that in both cases, the stronger resistance put up by the leaders of Yemen and Libya (and the harsher preventive measures developed by the rulers in Sudan), may be due to the larger inequality in these countries which made the incentives of their rulers to cling to power stronger.

Elsewhere, regimes in power have managed so far to resist change. It would be important to explore whether this may have been due to structural factors. In Iran, the Green Revolution was put down in 2009. In Iraq, Bahrain, and Syria, ethnic factors have complicated the political change equation. To the extent that they are important supporters of the regime, minorities fear the “tyranny of the majority” and would not easily switch their support unless they receive guarantees that they will not be discriminated against in the future. Arab monarchies have weathered the storm best. In oil rich countries, government spending has increased, very much along the lines that would be suggested by the classical autocratic model—these are countries that can afford to pay for allegiance. The non-oil monarchies, Morocco and Jordan have initiated change from within in response to popular pressures. Time will tell if these are serious or cosmetic concessions, but it does seem as if monarchies have a larger capacity to pre-commit even when ex-post these commitment would not be incentive compatible due to the long term horizon of their rulers; indeed, kingdoms have been much more stable in the past (Smith 2004; Menaldo 2010).

Does this type of model say something about regional contagion? In other regions where contagion had been observed, transitions to democracy were caused by a common external factor.<sup>9</sup> What are the likely common forces that displaced Ben Ali and Mubarak, and led to uprisings all over the region within a few months? First, there may have been information effects, basically that the West will not come to the rescue of its former allies. Second, it can be plausibly argued that contagion can be explained by a sense of commonality across countries such as shared culture and history which encouraged emulation. But this would not necessarily lead to a regime change if structural variables are not supportive. So third, our model suggests that there are common factors supporting change since the key drivers of change that we considered have evolved in parallel in many countries of the region. Indeed, there is a simultaneous rise in an autonomous MC, borne out of the simultaneous reforms of the mid-1980s (timing is here related to the oil shock that hit all Arab states alike). There is the simultaneous moderation of PI and its success in growing deep roots within the MC, explained by the regional and global nature of theological debates and their engagement with global developments. There is the simultaneous spread of “crony”-capitalism across the region, a phenomenon that must have been encouraged by the coexistence of political

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<sup>9</sup> In Africa, the fall of the Soviet Union and the economic crisis of the 1980s provided a common cause for the fall of dictatorships, which was achieved by popular pressure working hand in hand with changing patterns of international assistance that insist on democratic transitions as pre-conditions for support (Bratton and van de Walle 1997). In Latin America, it has been argued that the debt crisis of the mid-1980s led to the third wave of democratization (Haggard and Kaufman 1995). In Eastern Europe, the fall of the Soviet Union led to the rapid fall of dictators across the whole region.

repression and economic liberalism. And finally, most of the regimes were shored up in the same way (and for similar purposes) by external powers.

To conclude this section, let me stress the limits of the discussion above: the augmented model may well be coherent, but other models will be coherent as well. The model as presented is based on two essential suppositions: that the MC's aspiration for democracy improved over time in some (but not all) countries, driven by both a desire for more redistribution, and perhaps a lessened fear of PI, and that one of the main causes of discontent—the lack of jobs—was indeed connected to the political regime, and can thus be expected to improve following regime change. The goal of the next two sections is to initiate some research in these two areas and report new and promising results.

### **3. Some Evidence from Opinion Polls**

Looking at evidence from opinion polls to understand popular uprisings is an attractive proposition. Uprisings are about change. Popularity should mean that many hold similar opinions about the desirability of change. By looking at micro data, across country, and over time, one should be able not just to observe the rise of revolutionary fervor, but also, to pinpoint who the leading agents of change are, and possibly, what drove them to change.

In this section, I draw heavily on Akin and Diwan (2012) which analyzes the evolution of public opinion in Egypt, Iran, Jordan, and Morocco between 2000 and 2008. The dataset we use comes from the World Value Survey.<sup>10</sup> Four groups of questions are of particular interest for us here: those about opinion on democracy/order; those related to opinions on redistribution (a progressive/ conservative political economy axis); those connected to the role of PI in solving social problems (a progressive/conservative social issues axis); and those related to the importance of the economy in people priorities. We also have information on individual characteristics of respondent such as their (self-declared) social class and age.

What are the testable implications for our conceptual framework? If I can simplify complex realities, I would say that in all the three countries that I will cover here, there were Autocrats in place, representing the elite interests in Egypt and Morocco and those of the poorer segment of the population in Iran. To characterize policies further, I would also venture to say that these autocratic orders were pro-PI in Iran and Morocco (the King being the Commander of the Faithful). Starting from these autocratic equilibria, an uprising that leads to a democratic alliance could theoretically occur if the MC has an interest to shift to an alliance with the poor in the case of Egypt and Morocco, and with the rich in the case of Iran. We can first check directly if it does. We can further look deeper at the reasons why such a shift may or may not be attractive to the MC—the main question being the movement of its positions relative to those of the other classes on both the economic and social dimensions.

Let us look first at the extent of support for democracy (Table 1). Opinions are surprisingly diverse among these countries. There is a very significant shift of opinions in Egypt, with support for democracy jumping from 24% to 52% of the population over the period. In Morocco and Iran, support is initially a sizable minority at 36%, but it only improves marginally over time (to 37% and 40%). If uprisings happen on the basis of big changes in opinions relating to the desirability of democracy in autocratic environments, then these figures would suggest that by 2009, one could say that a revolution could be expected in Egypt, but had limited prospects in Iran and Morocco (there the question would be whether the champions, while a minority, have a will to fight, and if so, why that influence has had no effect in the past).

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<sup>10</sup> These are the only countries from the ME in the WVS dataset that have two polls each. The precise dates are: Egypt 2000 and 2008; Jordan 2001 and 2007; Iran 2000 and 2007; and Morocco 2001 and 2007. A new poll for Egypt will become available at the end of 2012.

The next question to ask is whether these changes in opinion about the desirability of the current autocratic regime compared to a possible democratic one are connected to changes in opinions on the economic and social dimensions of policy that we have discussed earlier. Before dwelling on group/class considerations, let us look at country averages. Figure 4 shows the changes, over the two periods, in average national opinions about social and economic policies. Several facts are striking: in both Egypt and Iran, opinion turns on average a lot to the left on economic policies, and towards a lesser role for PI in solving social problems. In Morocco, there is a very large shift to the left, but no movement on PI. In Jordan, there is no discernible change between the two periods. What can we make of this information, in comparison to Table 1? First, Egypt experiences large changes in all these dimensions—the move to the left and to more moderate PI may have fostered a desire for democracy, leading to the type of revolutionary change experienced at the beginning of 2011. The question however is why similar underlying changes have not led to a similarly successful revolution in Iran (recall however that there was a “green” revolution after the elections of 2009, which contested those elections, but which was repressed successfully by the old guard). Finally, what about Morocco? Why would a large change of opinion on economic policy, but without a change on the PI front, not lead to a serious threat to the autocratic monarchical order? In order to dig deeper into these questions, along the type of frameworks developed above, we need to look at the evolution of class opinions, to both develop a better feel for the identity of the leading social forces (if any), and then see how their economic and social preferences evolve, and whether these changes may have generated incentives for particular classes to shift from one type of political equilibrium to another.

I start by looking at the evolution of the support for democracy in each of our four countries, disaggregated by class (Figure 5) and by age (Figure 6) to identify possible agents of change.

- *Class differentiation.* In the 3 countries, the opinions of social classes are more stratified over time, suggesting that they represented more sharply their preferences than in the past.
- *Is the MC the agent of change?* The answer is yes and clearest in the case of Egypt where the MC (and to a slightly lesser extent the poor) becomes much more pro-democracy over time (from 25% to 60%). In Iran and Morocco where support for democracy was moderately high to start with, support among the poor and the MC rises marginally.
- *Is there an age effect?* Not in Egypt where initially, the youth were more democratically inclined, but this effect fades away to class. A slight age effect can be seen in Morocco but the effect tends to fade away over time. There is however an important age effect in Iran which becomes more marked over time.

### **3.1 Digging deeper into social preferences**

I now investigate the incentives of agents for change to explore whether changing opinions on democracy can be related to these “fundamentals”. Above, we found that the possible agents of change were: in Egypt, the poor and MC democrats, (a majority by 2009); in Iran and Morocco, a MC/youth democratic alliance is possible, but we must ask why it had not formed in the past. In all cases, the central question is whether the MC is feeling less like the richer class and more like the poor population over time on one or both of the policy dimensions, and so, whether it may have been on a path to switch allegiance away from autocracy and to a democratic coalition. I start with the Egyptian and Iranian cases, where we saw large movements on the fundamentals in Figure 4 but with a surge in support for democracy in Egypt only. I then look at Morocco where significant changes in opinion on economic policy (but not on PI) are not translated into a rising support for democracy.

Egypt turns out to be an iconic case, very closely connected to the analytical framework of an equilibrium switch (see Figure 7). Between the two periods, there are major shifts in opinions

among the poor and the MC, both towards the left and to less PI, so much so that in 2009 the MC becomes closer to the poor than to the rich in both dimensions. At the same time, as a group, the size of the democratic MC rises from 25% to 60% of the MC group as a whole. That the MC democrats score higher on PI than the poor suggests that they do not see the poor as a threat from this perspective—actually, the MC becomes in the late 2000s the bastion of a relatively moderate PI. So the shifts of opinions about the underlying factors do suggest that the group of democratic MC has incentives to rise up as indeed it did at the end of 2010. All in all, the claims about the perceived threat of PI to MC interest seems to be exaggerated and not supported by the data—in neither 2000 nor 2008 were Egyptians divided in important ways about the role of PI in politics according to our data (maybe unlike Tunisians, who are unfortunately not covered by the WVS).

In Iran, the possible agents of change are the poor, the MC, and the youth democrats but they are a large minority across each of these groups! As seen in figure 8, all move left and towards less PI in ways comparable to the Egyptian case. This group did lead a rebellion, albeit an ultimately unsuccessful one, with a relatively muted economic agenda, but the anti-clerical/pro-democracy campaign was not successful. In reality, the Iranian government did veer to the left on economic policies during the period, thus responding to popular demands, and to some extent, deflecting inequality concerns by going populist. What remained then is an opposition by democrats to high PI policies. However, this group cannot count on the poor to support their agenda as the poor are more conservative on matters of PI. Thus, the democratic/revolutionary drive of the MC/youth is not consistent with the type of policy change that they can expect in a democratic alliance. As a result, they are likely to have fewer incentives to mobilize, which would explain why the democratic influence did not grow further among the MC during the events of 2009.

Finally, the Moroccan case also presents a situation where some important (but limited) underlying change does not drive political change (Figure 9). The coalition for change includes the MC and to a lesser extent the youth. However, the MC democrats are on the right of the poor and autocratic supporters—they look economically more like the rich and so they have no serious incentives for going democratic. Interestingly, there is also a rich opposition characterized by a very low level of PI, which probably reflects opposition to the King, and may be related to increased perceptions of corruption. The poor on the other hand move to the left quite a bit, reflecting unhappiness with economic outcomes, but they seem to remain largely for autocracy and do not question religion and autocracy. So overall, the opposition is divided – the poor are unhappy but they are conservative socially and trust the King; the MC and rich are afraid of domination by the poor (on economic policy).

Going deeper in the analysis, one would ask for the reasons behind the shift to the left in Egypt and Iran, but not in Morocco and Jordan. There may be many reasons behind these changes, but one that stands out is how well the economy is doing. In Egypt, only 20% of the population listed the economy as its main concern in 2000 but 70% did so in 2008. Indeed, Egypt was then under the influence of the global financial crisis, with inflation rising to 25% in that year, and real wages collapsing. In Iran too, the shift in opinion on the economy was large, rising from 20% to 40% between the first and second period. However, there was only a marginal change in perception in Morocco and Jordan.

**To conclude this section**, the comparative analysis above seems broadly supportive of the theory of change proposed in the previous section. First, in most case (save Iran), class differentiation is much more marked than age differentiation. This suggests that there is no generational split at work here—the youth may well be unhappy with the lack of economic



opportunities, but their parents are equally unhappy.<sup>11</sup> Second, the agent of change in Egypt, the only country in our sample where democratic sentiments gain support during the period, is the MC. Conversely, divisions within the MC is a clear impediment to change in Iran and Morocco—partly because their economic interests are not aligned with the poor (Morocco), or because their social values differ (Iran). Third, class differentiation increases over time in Egypt and Iran, seemingly as result of harder economic conditions. Forth, both dimensions of economic policy and attitudes to PI seem to matter. In particular, one can argue that in Egypt, the lack of fear of PI by the MC was a key characteristic relative to Iran, and similarly, the close views on economic policy held by the MC and the poor also helped, unlike the case of Morocco.

#### **4. State-Business Relations and Networks of Privilege**

The popular discontent that led to the uprisings can be traced to two main elements of economic policy: the roll back of the state, alluded to above, and the consolidation of close relations between the state and particular elements of the business elites under economic liberalism. The central question of why the Arab region has under-performed in terms of job creation given what looked on paper as impeccable market reforms has been debated for years. Some have argued that the market reforms have not gone far enough; others, that it had become dominated by “networks of privilege” (Heydemann 2004) or even “crony capitalists” (Sadowski 2001) with myopic short-term interests that have stifled competition, innovation, and ultimately job creation. Conceptually, there is nothing intrinsically bad about close state-business relations. Khan in particular describes how industrial policy can foster accumulation and the development of new sectors, as had happened with Korea’s Chaebols for example (Khan 2010). To the extent that they have the right incentives to perform, close state-business relations can form the basis for dynamic capitalism and an effective state. But they can also become sources of influence, corruption and other forms of rent-seeking that distorts economic and political incentives.

Popular perceptions of business elites have become quite negative in the region. Cronyism is now seen as the key characteristic of opening up the economy which started in the 1990s and accelerated in the 2000s, and at the source of many ills including the job deficit, the rise in inequalities, and distortions to politics which has prolonged the life of the autocrats. The perceived “corruption” of the political and business elites was a key driving force of popular discontent. For example, the Pew survey reveals that in 2010, corruption was the top concern for Egyptians with 46% listing it as their main concern, ahead of lack of democracy and poor economic conditions (Pew 2011). This is confirmed by the Transparency International Ratings—for example, Egypt moved from a rank of 70/158 in 2005 to 115/180 in 2008. We now know that this was not just about perceptions. In both Tunisia and Egypt, the ongoing trials of leading businessmen is starting to shed light on the ways in which influence was yielded for private gains—the granting of monopoly rights to close associates of the rulers, the selling of public firms and land at reduced prices, and the manipulation of the financial markets for the benefits of a few insiders. In Egypt, it seems that the trend was accelerated in the last decade with the “market” reforms led by Gamal Mubarak. In Tunisia, the Ben Ali and Trabelsi families monopolized business opportunities. Similar stories about favoritism and insiders abound in Syria, Libya, Yemen, and Algeria, where political cronies seem to control large chunks of the private sector.<sup>12</sup>

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<sup>11</sup> Campante and Chor (2012) show that educated youth get more mobilized than other part of the population in politics and protests.

<sup>12</sup> This similarity in the patterns in which cronyism has spread in all Arab countries begs an important question: how does one explain this coincidence in time and form especially that those countries differ in their historical and social characteristics? One hypothesis relates to the similarity of their deploying neo-liberal policies in an environment characterized by political repression. All countries faced the challenge of opening up the economy including trade and

But despite these perceptions, it may or may not be true that “cronyism” was bad for growth and jobs. In the model I outlined above for example, there is a possibility that the transitions have been caused more by “push factors” (the rejection of repressive policies) than by “pull factors” (the expectations that the economy would be managed better by a democratic regime). If this was the case, the economic challenges of the future would be much harder to overcome.<sup>13</sup>

The big question that needs to be addressed then is that of the economic performance of neo-liberal economies under autocracy, relative to the counter-factual performance imagined by the MC then (and unfolding now under our eyes). This is by no means an easy task. But at a minimum, one should be able to describe more objectively and quantitatively some of the characteristics of the *ancient regime*, and to develop a clearer sense of the impact of “cronyism” in particular on economic performance (and on polity). This suggests three main areas for research. Is there evidence of favoritism? How do the connected operate in an economy that is ostensibly liberalized and thus out of reach of governmental dictates? More ambitiously, are there more objective ways of evaluating the impact of the types of state-business relations that were developed in the 2000s in the region on economic and political performance? As a result, what are the type of measures—legal innovations, strengthening of institutions, political alliances—that would be needed to reform Arab capitalism in ways that enhance development prospects?

The literature on Arab capitalism is still in its infancy. There has been more work on Egypt (e.g., Skafianis 2004; Roll 2010), Morocco (Henry 1997), and the Gulf (Hanieh 2011), and recent work by Steve Heydemann and associates (Heydemann 2004), and from the World Bank (World Bank 2009) but essentially, it has remained difficult to get direct measurements of the extent of favoritism, and there has been no serious attempts to statistically evaluate its socio-economic impact. A recent study of the Egyptian stock market around the momentous events of 2010 (Chekir and Diwan 2012) shed some light on these issues.

The stock market is relatively new in Egypt. The market only really took off in the last decade of Mubarak’s reign, when his son Gamal Mubarak, working closely with a group of young economic experts and ambitious businessmen, took it on himself to define a new vision for Egypt, and by doing so, started to redefine the political program of the aging ruling party. After the socialism of Nasser (1958-68), the timid opening of Sadat in the 1980s, and the State capitalism of the first Mubarak’s period up to the early 2000s, a new effort was underway to modernize Egypt’s private sector—or so the official narrative went. This effort included a push to create an internationally competitive corporate sector in the midst of a renewed effort at stabilization, privatization, trade reforms, and at the center, the liberalization of the financial market, after a costly state financed capitalization. The period saw the emergence of a new class of capitalists backed by state favors. They were the prime beneficiaries of the privatization drive and they spearheaded the development of new sectors and the modernization and expansion of old ones. The rising businessmen were well connected and some occupied important posts in the Government, the ruling party, Parliament, and various influential boards and committees (El-Mahdi 2009; Osman 2010).

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finance in the mid-1980s. But at the same time, the rise of repressive and exclusionary politics must have also compelled them to restrict potential competitors from becoming autonomously rich, since this would have strengthened their opposition. This pushed rulers to find new ways of restricting entry into economic activity by political rivals. These defensive barriers to entry at the same time created rents to insiders which were allowed to control the pinnacles of the economy. An additional corruption factor was the influence of Gulf capital. The tradition of insider deals between royalty and their local merchant entrepreneurs dates back to the 1950s. When these merchants became large financial groups, they exported this way of doing business to the rest of the region (Hanieh 2011).

<sup>13</sup> But equally, if the pull factors were more salient, the main challenge ahead would be making a political settlement between secularists and Islamists work.

#### 4.1 The value and nature of favors

In our paper (Chekir and Diwan 2012), we do three things: first, we evaluate the value of connections through an event study around the time of the revolution; second, we compare the past corporate performance of connected and unconnected firms; and finally, we discuss the broader economic impact of privileges. We use a publicly available database of the corporate performance and stock prices of the 100 largest Egyptian companies that are traded on the Egyptian Stock Exchange. In the study, we rely on extensive market knowledge of the inner working of these firms to identify 22 firms among them as being closely connected to the state. These firms operate in all sectors. In 2002, their size was about the same as other firms on the exchange, but by 2010, their median size had increased to a phenomenal seven times the median of non-connected firms which had barely grown during the period.

As an event study in the spirit of Fisman (2001), the revolution of January 2011 presents a near perfect case—it allows us to use an event period where the probability of a regime’s demise is high to estimate the value of connections by observing the drop in the stock market performance of connected firms. The revolution was largely unexpected, which suggests that the market fully valued the benefit of connections before the event. When the stock market reopened again in February 2011, it was quite clear that these firms’ with high level connections had lost most, if not all, their value. As a result, the securities of all these firms must have been re-priced. While the paper’s focus is the uprising that started on December 15 2010, we also look at three documented events related to rumors about the health of President Mubarak (March 2010, August 2007, and June 2004). In each of these events, the price of connected firms fell by more than the price of non-connected firms. However, such differences in price movements do not necessarily reflect *just* the differences in levels of connections. They also reflect other differences, such as differential leverage to market or to revolution specific risks. We thus made two corrections, one related to the sensitivity of firms to the aggregate shock experienced by the economy, and the other, to their sensitivity to sector specific shocks connected directly to the revolution. The main results are in Table 2. They confirm that connected firms lost more value than others during these events *on account of* their connections. In particular, in the weeks following the Egyptian uprising of Jan 2011, the stocks of the group of connected firms fell on average by 20 percentage points on account of their connections, in addition to sector effects experienced by firms in particular sectors.<sup>14</sup>

We then looked at the corporate performance of connected firms in the five years before the revolution to ascertain directly how they may have benefited from their connections. Given data availability, we were able to investigate empirically (using regression analyses reported in Table 3) the differences in four dimensions: their market shares in the sector where they operated, their debts, the taxes they paid, and their profitability. First, we found that connected firms had a larger market share than their non-connected competitors (an average advantage of 8% of the market). Second, we also found that they were able to borrow much more than their competitors, with an extra leverage of 25 points on average over the period, but with this advantage rising significantly over the period (they end up with an average debt to equity ratio of 1.7 compared to 0.8 for their competitors).<sup>15</sup> Third, and unlike what is often claimed on the basis of anecdotal evidence, we found no evidence that connected firms paid fewer taxes than non-connected firms, which seems to indicate that some institutions were more prone to favoritism than others. And finally, we found that connected firms have lower

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<sup>14</sup> This is a very large figure by international standards. Faccio (2010) looks at the value of connections in an international sample, and find them to be around 5% of value. Moreover, our estimate is likely to be a lower bound of the true value of connections, since after Mubarak was removed there was still a chance that his regime would continue.

<sup>15</sup> On this front too, this benefit is estimated to be much higher in Egypt than in other countries (Faccio 2010), or than in Pakistan for example, which is a country where connections are perceived to have high value (Khwaja and Mian 2005).

profitability than non-connected firms (for example, their return on book assets is only 4% as opposed to 6% for non-connected firms).

#### ***4.2 Implications on economics and politics***

Two possible stories are consistent with the evidence presented. The classical “cronies” story is about connected firms that benefit from state favors by unfairly excluding their competitors—this is a story of corruption as sand in the wheels of the economy. Privileges in this case entail larger market shares (boosted by state contracts for example, or a preferential access to inputs such as land) and their purpose includes denying the pinnacles of the economy to potential regime opponents. The larger market share in turn allows privileged firms to secure a large share of private credit. Their returns are lower than unconnected firms (controlling for size) because they are run inefficiently—their owners and managers are selected because they are trusted rather than skilled, and partly because they bankroll the ruling party. Once their connections die out after the uprising, they lose their ability to dominate the markets in which they operate, but are also freed from political obligations, and so their value falls by the difference between these terms. In this regime, capital flows to inefficient sectors, reducing economic growth directly. Moreover, it is also possible that this unfair competition reduces the dynamism of the economy as a whole, both because energies go to rent seeking rather than to value maximization, and also because innovating does not pay in non-competitive markets.

But there is an alternative narrative, which is more positive, and that cannot be easily dismissed. Egypt’s was in a messy state in the early 2000s, struggling to escape the weight of its past, and its leaders were trying hard to get the country to grow out of its weaknesses. A predatory bureaucracy and high levels of political risk kept investors away—they required high rates of return to invest in Egypt. Thanks to the state protection they enjoyed and the ensuing lower perceptions of risk, a few trusted entrepreneurs were willing to invest in Egypt’s future against lower rates of return. As a result, they put in the equity and were able to attract large loans (the demand for credit by others was low, like for the first story). As a result, their market share grew. In this story, the 20% of their value that was lost by these firms after the revolution reflects the fact that their assets became valued at the higher risky rate of return, given that these firms would now be subject to as much predation as the rest of the market. This is essentially a story of favors oiling the wheels of the economy, and leading to favorable outcomes, compared to the counter-factual with much less investment and growth.

It is hard to tease out of the data clearer indications about the exact nature of these state-business deals. But we can calculate directly the value of connections under each of these two scenarios, and ask how these estimates compare to the market valuation of connections. A rough estimate suggests that the value of an extra market share of 8%, or of being priced at a lower risk adjusted rate of 4% rather than 6%, are each valued at the same amount, around 30% of the firm’s value. This does not help identify the “mechanisms” more precisely, but it does point to the possibility of firms repaying favors to politicians (for an amount valued at 10% of the firm’s value). This suggests that cronyism may have had a large effect on politics by shoring up unpopular leaders. Future research should look more closely at such issues—for example, one could study whether sectors where favored firms did not operate grew more dynamically than those sectors where ordinary firms had to compete with favored ones.

But what matters most, in the end, is whether a dynamic form of capitalism was emerging or whether the economy was stuck in a low investment trap. That private investment in Egypt has struggled to stay above 10% GDP, and that capital flight has been estimated at over \$5 billion/year (Kar and Cursio 2011) weigh for the second interpretation. Part of this stagnation is observed in the behavior of non-connected firms, which essentially have not grown in the

last decade. The connected firms had an advantage of 20%—we can think about it as a subsidy of 1/5<sup>th</sup> of capital—which they derived either by forcefully appropriating larger market shares, or by benefitting from special protection against predation. Either way, the unconnected firms had an implicit tax of 20% of equity, which is huge and speaks loud about the quality of the investment climate in Egypt at its liberal apogee. So both readings suggest that the new regime has some “growth space” of which to take advantage. Similarly, a large and rational “pull factor” may have been operating in the lead to the Egyptian uprisings, with revolutionaries believing that a democratic regime could deliver better economic outcomes.

## **5. Conclusions**

The analysis in this paper suggests that the historical challenges of the moment are to a large extent political, with a central focus on consolidating democracy and avoiding reversions to negative closures. In Egypt and Tunisia, the post-Spring elections have been divisive, and it can be expected that writing constitutions will also sharpen social differences and preferences as many contentious issues will have to be addressed, such as the limits of blasphemy law, the nature of freedom of speech, or the application of shari’a on family law. Liberal/secular forces may be tempted to offset their electoral defeats by attempts to reconstitute an autocratic order with the support of the military. Leaders of the victorious Islamic parties may be tempted to replace the old elites in coalition with armies, rather than to take risks and try to deliver the challenging political and economic reforms that their supporters aspire to. New governments may be tempted by short term populist policies. The post revolutionary Arab world will be shaped by the way in which these two movements evolve and interact. If broad parties cannot establish themselves credibly, a clientelistic patronage system may evolve. To prevent political fragmentation, Islamic parties will need to adjust their ideological tenets in ways that allow for coexistence with secularists, and the Liberal movement will need to reinvent itself and make a credible comeback.

The challenges of the moment are compounded by high popular expectations and the problematic inheritance of the past. Economic policies will be largely determined by how political challenges will be addressed. Unless new surprises arise, the contours of the emerging political settlement will include less favors for elite capital. But there should also be attempts to make peace with it and to convince it to invest in the future, rather than withdraw, as has happened with the socialist revolutions of the 1960s. Another source of political economy uncertainty concerns how the interests of the poor will be balanced with those of the MC.

But there will be technical challenges that will be difficult to resolve in any case, even if politics are supportive. The first challenge is economic stabilization. Right after the revolutions in Egypt and Tunisia, the attitude of the transitional regimes has been to favor expansionary policies in order to offset the negative shocks experienced by the economies which include a loss of tourism revenues and the collapse in investment. There are risks of entering negative vicious cycles. For example, the financial situation in Egypt could deteriorate before a stable government could be formed. This in turn would make the formation of a stable government more difficult.

The second area of focus concerns the modernization of the state and the rehabilitation of public services, especially health, education, and social protection. The new coalition should be able to agree on redirecting expenditures towards social services and away from subsidies that are not pro-poor and make taxation more progressive. Improvements require increased public sector wages, but an extremely complicating factor will be the large size of the civil service.

The third agenda concerns the business environment and job creation. Past experiences, and especially the failures of both socialism and state capitalism limit the choice of an Arab

model. Parts of the agenda are clear but solutions will not be easy when it comes to improving competition, democratizing credit, or reducing the constraints faced by the informal sector.

All these are complicated challenges, technically, politically, and administratively. In the end, what will make a difference is the process by which solutions adapted to the particular environments of each country are found and implemented. The greatest contribution of the “revolutions” to these perennial challenges should be in fostering greater popular participation in the decision-making process. It is the sense of empowerment of new actors such as labor unions, employers’ associations, student groups, and other civil society groups who can cross ideological lines to represent social interests and hold their representatives to account that constitutes the real revolution.

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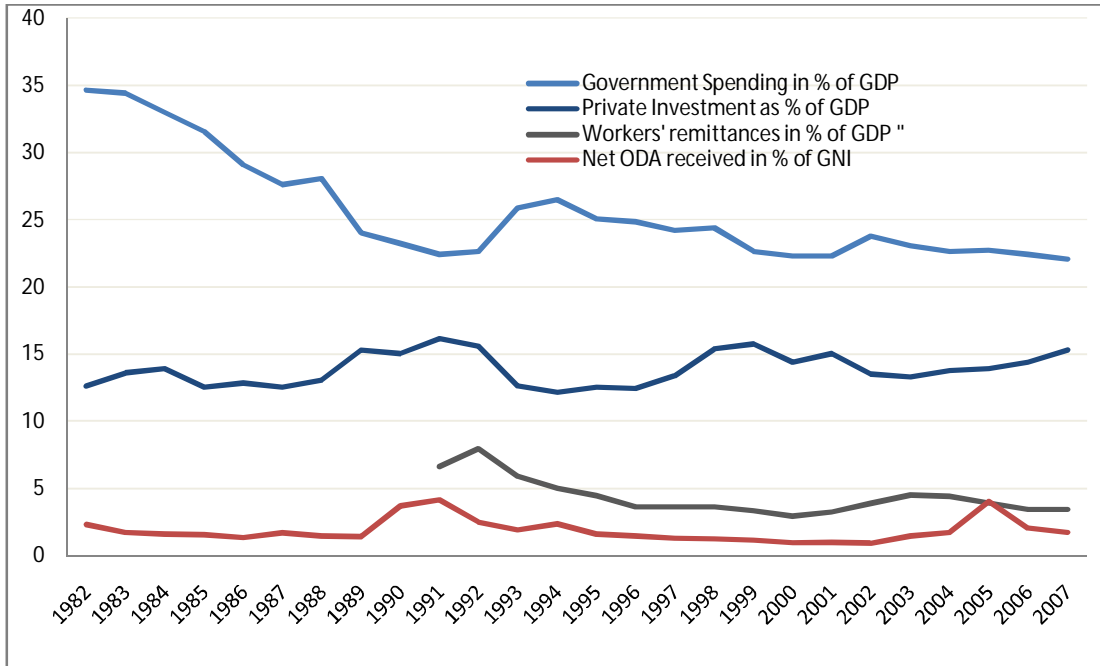
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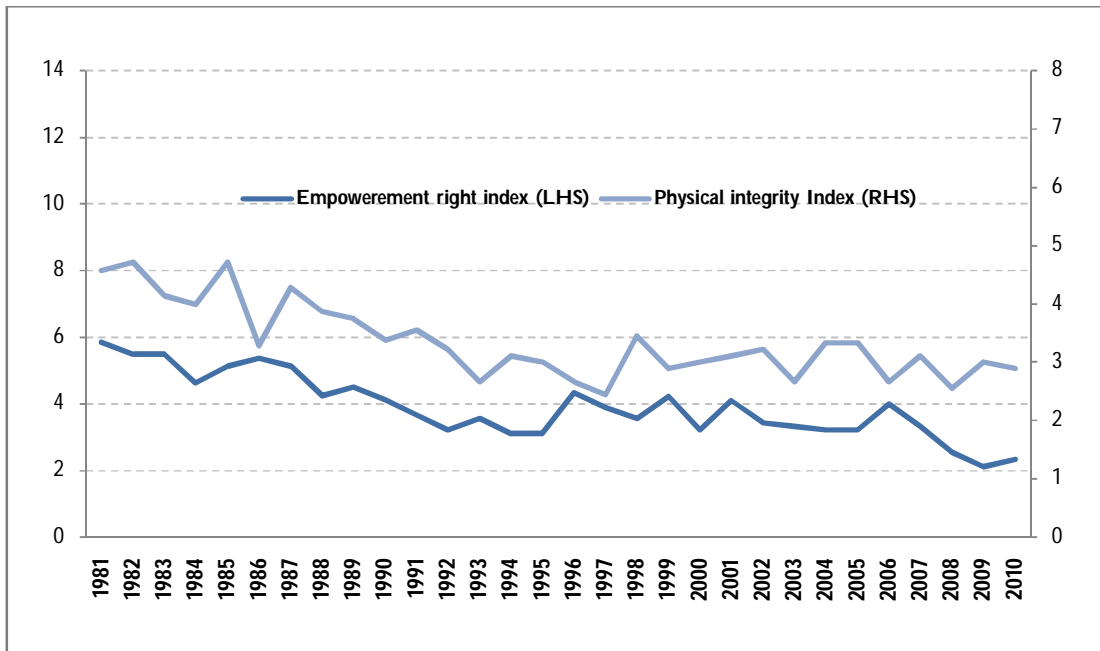
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**Figure 1: Macroeconomic Indicators**



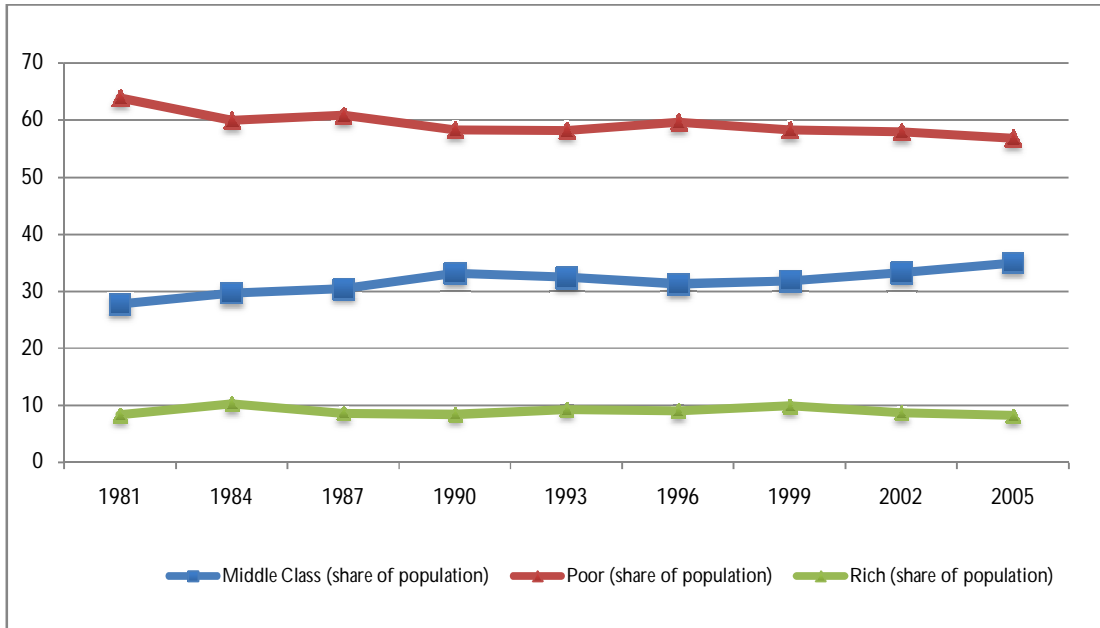
Source: World Bank. Averages over all Arab Developing countries.

**Figure 2: Repression and Freedom Indexes**



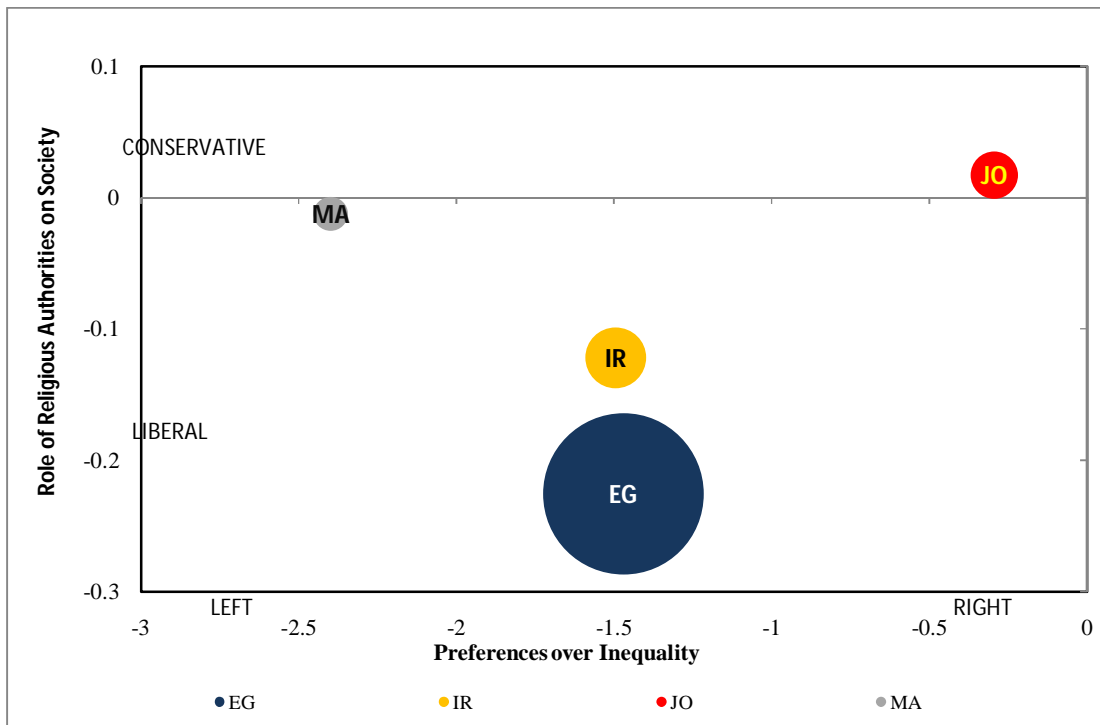
Sources: CIRI, average for all Arab countries.

**Figure 3: Income Groups, Share of the Total Population**



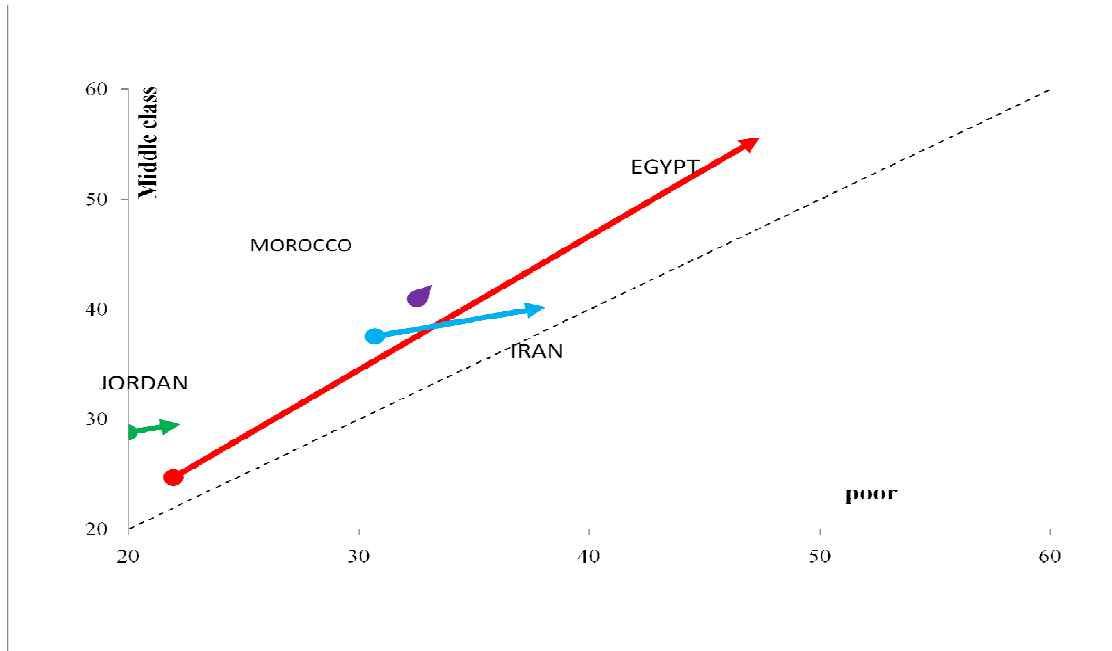
Source: World Bank Povcal

**Figure 4: Change in Opinions 2000-08**

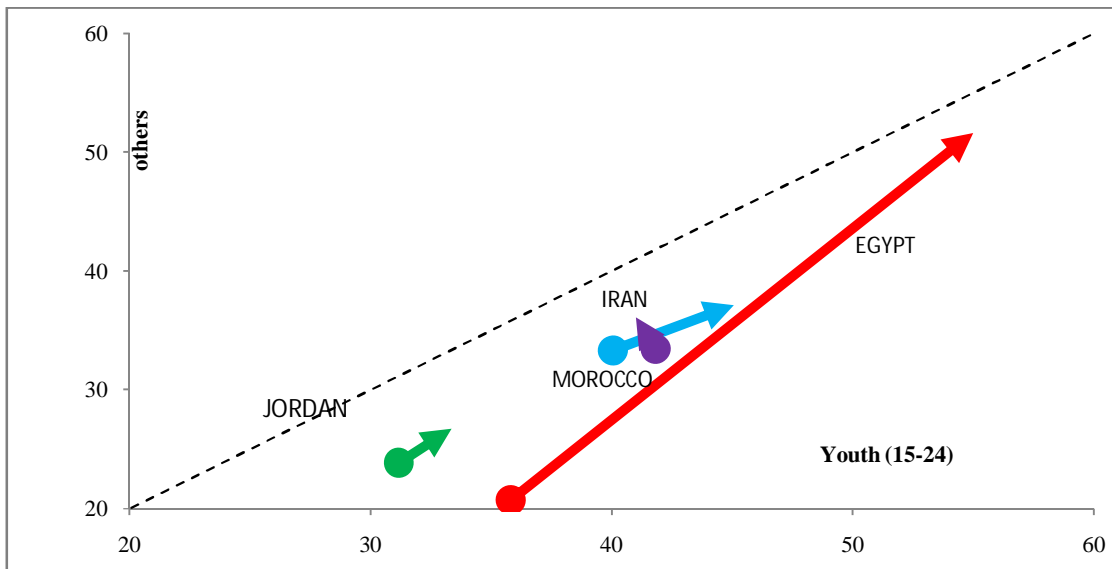


Notes: Radius of bubbles proportional to the size of the change support for democracy between the two periods.

**Figure 5: Support for Democracy 2000-2008 (% of class)**



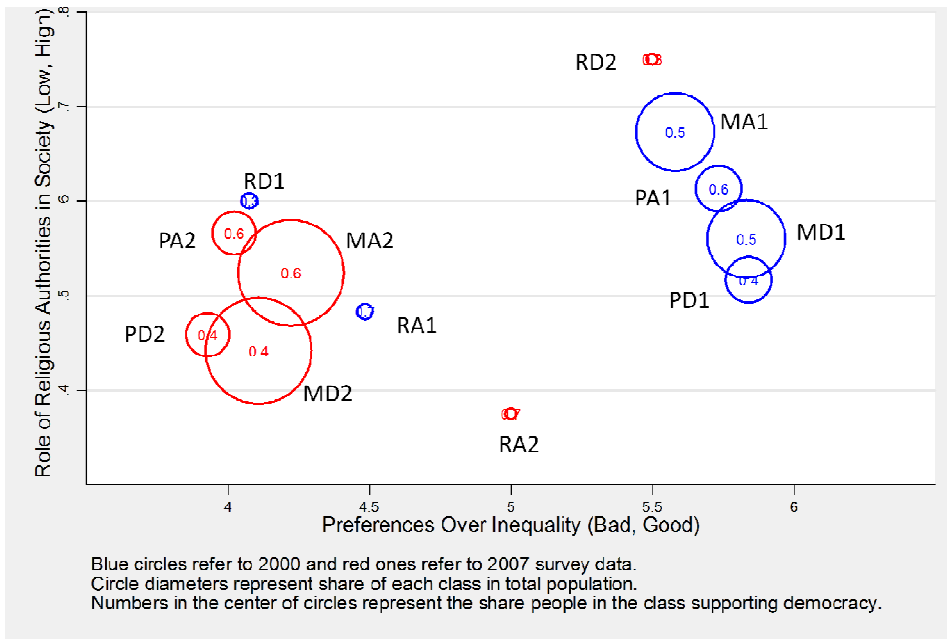
**Figure 6: Support for Democracy 2000-2008 (% of age group)**



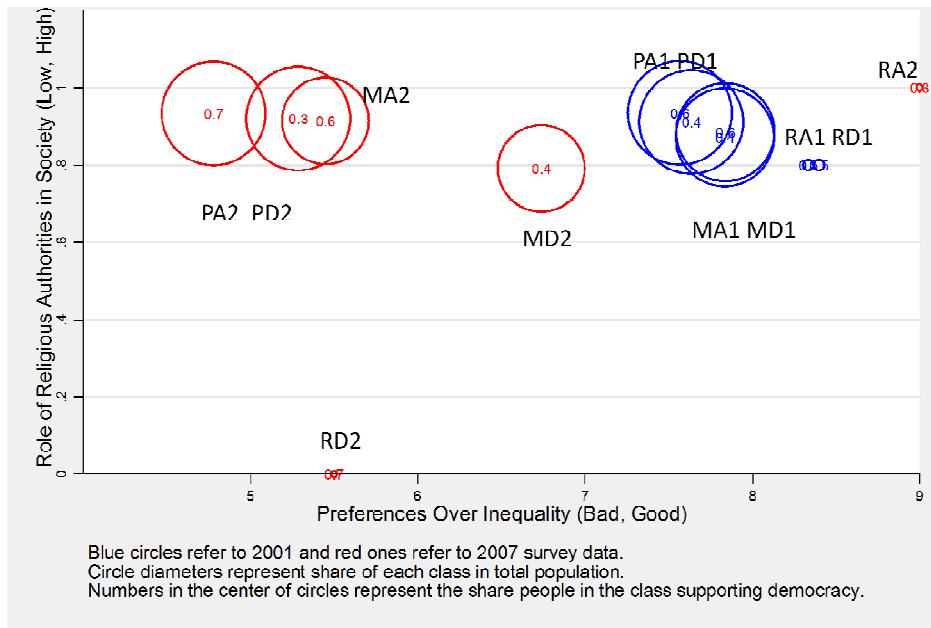
**Figure 7: Egypt Average Opinions on Inequality and Political Islam (by Class)**



**Figure 8: Iran Average Opinions on Inequality and Political Islam (by Class)**



**Figure 9: Morocco Average Opinions on Inequality and Political Islam (by Class)**



**Table 1: Share of Population Supporting Democracy (Over Autocracy)**

	2000	2009
Egypt	24	52
Iran	36	40
Jordan	26	28
Morocco	36	37

Source: World Value Survey

**Table 2: Event Analysis 4 Events (Cumulative Abnormal Returns with fixed effects)**

Variables	Dec 2011	March 2011	2007	2004
Connected	-0.241*** (0.0666)	-0.0232* (0.0136)	-0.0818* -0.0464	-0.0336 (0.0250)
Land	-0.0899* (0.0491)	0.0100 (0.0100)	-0.00219 -0.0327	0.000427 (0.0185)
Constant	0.188*** (0.0276)	-0.0190*** (0.00557)	0.000236 -0.0191	-0.0182* (0.0107)
Observations	111	106	89	81
R-squared	0.173	0.036	0.042	0.028
Nbr sectors	15	15	15	15

Source: Chekir and Diwan (2012)

**Table 3: Panel Regression for Corporate Characteristics (OLS with Fixed Effects: Sectors and Years)**

Variables	D/E	Tax ratio	Market share	RoA
Connected	0.209*** (0.0571)	0.00800 (0.00988)	0.0874*** (0.0193)	-2.103** (0.888)
case30	-0.0784 (0.0532)	0.0232** (0.00985)	0.0504*** (0.0195)	2.024** (0.914)
Constant	0.681*** (0.0572)	-0.155*** (0.0105)	0.117*** (0.0262)	4.116*** (0.927)
Observations	445	428	988	566
R-squared	0.117	0.108	0.378	0.069

Notes: \*\*\* p<.01, \*\* p<.05, \* p<.1. D/E is Shareholder equity (book) minus intangible assets over total liabilities; market power is share of total assets of a firm over the total assets of all firms in the industry; div yield is the dividend per share over the price per share; annual growth of long-term fixed assets; Tax ratio is tax over net income

Source: Chekir and Diwan (2012)