

Reviving Arab Reform

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Reviving Arab Reform: Development Challenges and Opportunities

BY

ISLAM ABDELBARY

Arab Academy for Science and Technology



United Kingdom – North America – Japan – India – Malaysia – China

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List of Abbreviations

ACs	Arab Countries
ALO	Arab Labour Organisation
BOP	Balance of Payments
CA	The Current Account
CPI	Consumer Price Index
CPI	Corruption Perceptions Index
CSA	Central & South Asian countries
DPD	Dynamic Panel Data
DER	Distribution of Economic Power
DW	Durbin-Watson
EAS	East Asian Countries
EC	European Commission
ECS	European countries
EFA	Education for All
EIU	Economist Intelligence Unit
EU	European Union
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment
FE	Fixed Effect
FH	Freedom House
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GMM	Generalised Method of moments
GNI	Gross National Income
GNP	Gross National Product
HIPIC	Heavily Indebted Poor Countries
ICRG	International Country Risk Guide
ICT	Information and Communication Technology
ILO	International Labour Organization
IMF	International Monetary Fund
IPS	Im-Pesaran-Shin
IV	Instrumental Variables
LCN	Latin America countries
LDCs	Least developed countries
LICs	Low-Income Countries
LM	Lagrange Multiplier
LSDV	Least Squares Dummy Variables
M & E	Monitoring and Evaluation

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MDG	Millennium Development Goal
NAC	North American Countries
NGOs	Non-Governmental Organisations
NIE	New Institutional Economics Theory
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Square
OPEC	Organisation of Petroleum Exporting Countries
POLS	Pooled OLS
PP	Phillips-Perron
PPP	Purchasing Power Parity
R&D	Research and Development
RE	Random Effect
RPLA	Resource-Poor, Labour-Abundant
RRLA	Resource-Rich, Labour-Abundant
RRLI	Resource-Rich, Labour-Importing
SSF	Sub-Saharan Africa Countries
SUR	Seemingly Unrelated Regression
SWFs	Sovereign Wealth Funds
TFP	Total Factor Productivity
UAE	United Arab Emirates
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organisation
WDI	World Development Indicators
WGI	Worldwide Governance Indicators
WHO	World Health Organization

About the Author

Islam Abdelbary is an Egyptian economist and an assistant professor of Economics at the Arab Academy for Science and Technology. Currently, he is an economic consultant at the United Nations and Alumni research fellow at the University of Plymouth. Abdelbary's research focuses on Institutional Economics, Sustainability and economic development. He has published several research papers on development reform policy in developing countries and particularly in the MENA region. His research has awarded several international prizes, such as the Ibn Khaldun Prize 2019. Abdelbary also works as an independent researcher in several multi-disciplinary research projects for national and international organisations.

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Preface

The Arab region has numerous natural resources and great human capital wealth, perhaps the largest in the world. A long history of civilisation, supported by a geographical location that mediates the whole world, granted it the largest business centre.

Nevertheless, the countries of the region suffer from chronic low-economic growth rates, weak production structures and a decrease in the competitiveness of their products, along with poverty, inequality and corruption rates that are the highest in the world. Despite the success of the development experiences of some countries during the past five decades, they were not sustainable or inclusively planned.

As a result of this situation, many uprisings have taken place in most Arab countries, supported by the middle class, especially youth, asking for a change in the status quo and broad reform that includes the economic, social and political aspects of society.

For the same reason, I have embarked on this study as my doctoral research project for over 4 years to contribute to the ongoing debate on ways to revive Arab reform from a holistic approach. The study proposed development frameworks (based on some key economic, political and social variables, taking into consideration the distinctive features of each region group) that may lead to more comprehensive and integrated development in the region. These frameworks are a vital strategy for enhancing the effectiveness of reform programmes in the region and achieving targeted inclusive growth outcomes.

During these years, five working papers from the thesis have been presented in several international conferences; three of them published as book chapters in the book entitled *Impacts of political instability on economics in the MENA region*. The outcomes also have awarded several international prizes, such as the Ibn Khaldun Prize, during the ASSA meeting in Atlanta, 2019.

In many conferences and meetings, I have received frequent suggestions from experts and discussants to turn the study into a monograph book in order to disseminate the results of the study on a larger scale to target not only academic researchers but also policy-makers, especially in the Arab region. I became eager about the idea to deliver my message to all stakeholders. Thanks to Emerald, this transformation has become possible.

Finally, I hope this book represents a good contribution to sustainable development research in the Arab world and inspires the leaders and decision-makers in the region towards achieving the expectations and aspirations of their people.

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Foreword

Jeffrey B. Nugent*

This is a rare and much-needed book on the challenges of development, but with special reference to the Arab countries of the Middle East. Despite the remarkable success of a number of these countries historically and, thanks to the oil resources of some of them even in recent decades, Professor Abdelbary correctly detects a general lack of sustainable economic development in the region. Along with that, he finds decreasing competitiveness and weak institutions throughout the Arab region at the present time. He is quite convincing in demonstrating that major economic reforms are needed and that these reforms need to be appropriately designed so as to be more inclusive, carefully coordinated and administered, and complemented by vastly improved institutions including good governance.

Rather than either a historical account or a descriptive one as is typical of other books on the region, his analysis is founded on a comprehensive analysis of Development Theory, including not only classical and neoclassical development theory but also the New Institutional Economics and distributional considerations. Unlike textbooks on the Arab region or more generally on Development Economics, it focuses on how the economies of the region have responded to shocks like the global financial crisis and the Arab Spring crisis, and features a careful econometric analysis of 17 Arab countries and 61 other countries from all over the world. In his empirical analysis, he goes to great lengths, both (1) to make use of variables deemed especially relevant to the Arab countries and to their problems, such as export concentration, the relative importance of oil rents, and a number of different governance indexes, and (2) to utilize estimation techniques designed to overcome the usual problems of (a) the relatively short time series of some of the key variables relevant to the analysis, and (b) potential endogeneity of many of the explanatory variables.

His straight-forward growth comparisons across regions early in the book shows clearly that Arab countries have fallen far behind the growth of all other regions, especially since 2009, i.e., a period including both the financial and Arab

* Nugent is Professor of Economics at the University of Southern California since 1976. He is also a senior researcher in this field he has worked on a wide variety of issues, problems and analytical techniques and in and on a variety of countries from Latin America, Africa, South and East Asia and especially the Middle East and North Africa. He has written over one hundred articles in refereed journals, numerous chapters in edited volumes and edited or co-edited four books. He serves on the Board of Directors of several economic associations, and editorial boards of several journals.

Spring crises. He traces this back to the general failure of Arab economies to maintain internal economic stability, but in this respect pointing to the greater success of some of the Gulf countries in using Sovereign Wealth Funds to smooth out some of these instabilities. The economic instabilities have in some cases contributed to extremely high-income inequality, armed conflict, violence, civil war and refugee problems. While Abdelbary points to a number of areas in which a number of countries have made significant policy reforms, such as in moving away from the rigidities of central planning, encouraging the development of private banks and credit, and in improving health and education, there have been major shortcomings in all of these respects. For example, the private sectors of these economies have remained weak, without sufficient competitiveness and distorted with inefficient regulations and all too much corruption. Similarly, although education has expanded, it has been of low quality, especially at high levels. Moreover, the constraints put on so many of the favorable developments by the failure of some of these same economies to balance their fiscal budgets and their balance of payments, have greatly limited the full extension of these services and the realization of their benefits.

From his very impressive panel regressions for overall economic growth across three different regions (developed, developing and Arab economies) within his 78 country sample, Abdelbary draws some interesting contrasts. For example, he shows especially large positive effects on growth of improvements in technology in Arab countries, suggesting that through improvements in the quality of education (especially at high levels), and improved governance, it could be possible for Arab countries to raise their growth rates significantly through the technology mechanism, in part by inducing more FDI. Similarly, from the especially large coefficient of the freedom from corruption component of governance for the Arab region, and the extremely low values of this index in most Arab countries (which indeed were responsible for the costs to development Arab Spring instabilities), he points to the potential for boosting growth in Arab countries by improving control of corruption.

He concludes this highly analytical book with a brief outline of a comprehensive set of political, institutional, economic and social reforms designed to mitigate the existing problems detected in his econometric and other analyses and to promote more inclusive growth in the years ahead. Hopefully, the proposed reforms will be given serious consideration by the people and their leaders throughout the Arab region, so that we may see a brighter path to the development being realized in the coming decades.

Foreword

Mahmoud Mohieldin*

The Arab region is in trouble. Some of the world's worst humanitarian crises have devastated societies, destroyed economies, and displaced millions of people, turning many of them into refugees. The continued marginalization of women and girls and inadequate investment in education and health services hold back social and human development. Water is scarcer than anywhere else in the world, jeopardizing food security and threatening urban and rural development, and climate change have ominous implications for the region, today and in the future. The Arab region is also the only region in the world in which extreme poverty has increased; inequality has also widened. It requires massive efforts and a paradigm shift to be put in track for achieving the Sustainable Development Goals (SDGs).

To address these challenges, this rich and ambitious study argues that a bold new approach—based on comprehensive institutional, economic, and social reforms in the region—is needed that dismantles the barriers to good governance and leads to dynamic transformation. Transformative change requires more than just resources, according to the author; it requires a shift in orientation toward a new developmental policy framework in which institutional, political, social, and economic reforms are crafted and implemented simultaneously.

Abdelbary's book is using advanced technical methods in assessing development opportunities and challenges in the Arab region, these tools outcomes were fascinating, especially the recommended framework that has been adequately analyzed in detail across the book. Moreover, the book has very strong policy implications useful for decision makers, which will make it a very useful tool for the assessment and monitoring of reforms.

This book fills a critical knowledge gap by presenting a new framework and examining the effects of three exogenous factors resource abundance, conflicts, and demographic change on development. It provokes thinking about alternative scenarios of reforms in the Arab world and raises fundamental questions about

** Dr. Mohieldin, is an economist with more than 30 years of experience in international finance and development. He is the United Nations Special Envoy on Financing the 2030 Agenda. He was the former Minister of Investment of Egypt, and most recently, served as the World Bank Group Senior Vice President for the 2030 Development Agenda. He is also Professor of Economics at Cairo University and a Visiting Professor at several renowned Universities worldwide. He holds leading positions in international research centers and economic associations.*

the region's prospects. The framework developed in this book could be used to analyze other endogenous and exogenous factors and their impact on the Arab region such as climate change, pandemics, technological change, and the shifts in the center of the global economic gravity towards the east.

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First and foremost, all praises be to Allah for His blessings for giving me the courage, strength and enthusiasm to complete this work.

Sincere thanks and gratitude to those who provided constructive intellect and continued assistance, especially Dr James Benhin for his sincere support and tremendous guidance, I was fortunate to work and learn from him.

Thanks to all readers, discussants, fellow panellists and audience members at all conferences and workshops to whom I have presented my work for their insight, comments and suggestions as this project has been reconstructed over the last few years.

I owe my deepest gratitude to my wife, who has been steadfastly by my side. My little kids Ahmed and Farida, for being a source of happiness and unconditional love. My great mum and supportive sister; most of what I have achieved in my life is because of their prayers and endless support.

Deep thanks to Nick Wolterman and Emerald Publishing team for being enthusiastic to the book idea. Without their support, the project could not have been satisfactorily completed.

Finally, I hope this book will bring a lasting impact providing a vision for making our region as we dream.

Islam Abdelbary
July 2020

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Chapter 1

Introduction

Background and Rationale

The story of development in the Arab region is very old, and perhaps it started with the earliest human settlements. The great location of the region, mediating the three ancient continents, made it a destination for different commercial movements since ancient times. However, this geographic gift had been coveted by all the grand empires throughout history.

After World War II, most of the Arab countries (ACs) got their independence from colonial countries and started mobilising their own resources and utilising them in establishing a new economic, social and political structure. The development process aims to satisfy the basic needs of the people, such as food, clothing, housing, education and treatment and then seeks to steadily raise the level of the well-being of people.

ACs have diversity in size, income levels, natural resources, economic structure, human capital, social institutions and economic practices. The overall Arab land area is 44% greater than China, this is 3.8 times the size of the European Union and has half the world's estimated oil reserves. Therefore, the oil sector has been the dominant driver of economic growth and social development in the region for oil and non-oil exporting.

After independence, the ACs' development paradigm was concentrated on strong governments, centralised planning for social and economic goals and restrictive policies for wealth redistribution. During the 1970s oil boom, the ACs, in particular the Gulf countries, initiated massive public investment in infrastructure and construction sectors. However, this progress encountered real challenges in the mid-1980s because of the collapsed oil prices. Thus, many of the ACs began economic reform programmes in the 1990s and 2000s guided by the International Monetary Fund and the World Bank. These reforms were principally treated with macroeconomic stabilisation and structural adjustment policies.

Nevertheless, these reforms were not able to boost the standard living of Arab people and failed to overcome the main barriers of development such as strong dependence on oil, the poor manufacturing base, high unemployment and population growth rates, low levels of returns on investment, low level of integration in the global economy and ineffective of market regulations.

Besides the fragile economic circumstances, there is a poor institutional structure. According to Freedom House annual reports, the region as a whole had the lowest civil liberty scores, and most of its countries were categorised as partly free or not free. ACs rank among the worst in the global Corruption Perceptions Index estimates. They also noted that corruption is the region's main threat, as three countries from the region among the bottom ten countries in 2017.

In light of the above, politics in the Arab states are characterised by high power concentrated, top-down structural and pure personalised, while economically, the distribution of wealth and income was highly skewed. Under this bleak image of living conditions, a massive wave of demonstrations erupted across most of the Arab world, popularly referred to as the 'Arab Spring'. The Arab street appeared to have made it clear that it is no longer able to trust these models of development. The central aims of the protesters were easy to capture from their mottoes. The first was 'the people want to overthrow the regime' and the second was 'bread, freedom and social justice'. These slogans reflected what the Arab people looking for. They want more participatory and democratic political structures, a fairer economic structure and an independent judiciary.

The first slogan accomplished in Tunisia, Egypt, Libya and Yemen by ousting old rulers, whereas the second, which emphasises the interdependent political, economic and social integration, still require more time to identify alternative solutions and a range of policy options.

However, Arab governments have been doing little to address those goals. Almost all governments have failed to implement the deep reforms that were needed to transfer Arab economies from rentier economies into modern and productive ones based on innovation and competition. Many ACs have fallen into the trap of internal and regional conflicts and have turned into struggles between revolutionary forces and old regimes that even if their heads are removed, their followers' control most of all the state's joints. They made the post-Arab spring policies just an extension of the same one that led to the revolutions.

Therefore, Arab streets have witnessed other several waves of protesting; people have taken to the streets once again in Algeria and Sudan, and they succeeded to remove the autocratic regimes of presidents Bouteflika and Al-Bashir, driven by the conviction that the old system is totally underqualified to address the current moment challenges. Although the triggering demonstrations vary from country to country, the major reason is a pervasive distrust of government performance.

People all over the region ask for new developmental approaches that offer considerable priorities to the interlinked matters of political governance, decent employment and social justice. During this critical era for the region, the need for a new strategy of Arab development has become necessary. Under this plan, an economy can transform the available resources into an inclusive growth base that generates suitable job opportunities, reduces poverty, recognises human rights and sees social expenditure as a real investment for the future.

Purpose of the Book

The book provides a good opportunity for the interested audience as the findings of the study can be viewed as significant contributions to the ongoing debate

about reform, economic growth and development. It extends current knowledge and takes an important step towards explaining why some developing countries successfully reform their economies while others fail, as well as identifying the major challenges facing the economic development of the Arab world.

This book investigates the effect of reform programmes in the Arab region on development over the past three decades. Following the analyses, the book proposes a new development framework that could be adopted by ACs to help achieving sustainable development and raise the standard of living for Arab citizens.

Only a few studies have addressed the Arab region, and often the analysis is conducted within a larger sample of countries with no emphasis on the case of the Arab economies. Therefore, the book has been written specifically for researchers and policy-makers interested in the field of development and growth in developing countries in general and the Arab region in particular. Also, those interested in institutional economics will find much enjoyment in the book, which clearly highlights the role of governance in development and considers it the central pillar in any targeted reforms.

Structure of the Book

We start the book with Chapter 2 *The Theoretical Basis*. This chapter is considered as the theoretical foundation of the book, where we describe the key ideas, components and theories of economic development, starting with the classical school and closing with the 'New Institutional Economics'.

The basis of the book extends to Chapter 3 *Methodology*, where we present the methodological issues related to the investigation carried out in this research and discuss the methods that underpin the analysis. We also show the econometric techniques, including any modelling issues and problems and provide techniques for solving these problems.

The analytical investigation begins with Chapter 4 *Insight of Arab Economies: A Reforming Outlook*. This chapter explains the origins and drivers of Arab economies' evolution, determines the pattern of economic growth of the Arab region and compares it to other regions in the world in order to understand the possible explanation of why the growth performance of the region has been disappointing. We also highlight the types of reform programmes implemented in the Arab region during the three decades.

The economic features of the reform are evaluated in Chapters 5 and 6. In Chapter 5 *Economic Stabilisation and Arab Reform*, we explore and assess the factors of the economic stability of ACs in detail during the last 30 years. The macroeconomic stability involves inflation, unemployment, public finance and the exchange rate, whereas external stability includes the current-account balance, foreign debt and international reserves. Chapter 6 *Business and Structural Reform* completes the discussion of the economic aspect through explaining the structural reform efforts that have been made since the 1990s, which include policies that increase the role of market forces, the liberalisation of the market and bank system, tax reforms, financial sector deregulation and diversity of economic activities.

4 Reviving Arab Reform

The social perspective of reform and the social impact of economic reforms are presented in Chapter 7 *Social Aspects of Arab Reform*. It shows the situation of poverty and inequality in the region and then examines the development of the different aspects of human capital reform in the areas of education, health and scientific research. Additionally, it assesses the provision of public goods such as physical infrastructure and technology needed for sustainable development.

In order to complete a comprehensive picture of reform, Chapter 8 *Institutions and Political Aspects of Arab Reform* explains institutional reform based on the six Indicators of Worldwide Governance. This chapter goes beyond explaining the trends of these factors to cover the root causes of current failure in the Arab governance system.

Based on previous explanations, Chapter 9 *Winners and Losers of Arab Reforms* attempts to classify the ACs based on progress in the structural reform and macroeconomic stability. We also reached an important conclusion to determine that major factors have played the leading role in delaying and undermining reform efforts in the region.

The empirical analysis is covered in Chapter 10 *The Impact of Reform Programmes on Economic Growth: An Econometric Analysis*. The model examines empirically the effectiveness of economic, social and institutional reform programmes in achieving sustained growth through using conditional convergence equation for ACs compared to advanced economies and developing countries.

The book recommendations are presented in Chapter 11 *Towards an Inclusive Development Framework for Arab Reform*. This chapter proposes new frameworks for a comprehensive and integrated development based on the economic, political and social growth for the Arab world, taking into consideration the distinctive features of each Arab group. These frameworks recommend public policies' practices through a set of transitions that make up the contours of a new development model and outline the fundamental changes needed for making this transition from different perspectives.

Chapter 2

The Theoretical Basis*

Introduction

Development is one of the most controversial issues in recent history. The experience of development research of the past 50 years has proved that development is possible but not inevitable. While few countries have succeeded in rapid growth, squeezing the gap between themselves and the more advanced nations and bringing millions of their people out of poverty, many more economies have seen the development gap grow and poverty increase.

The objective of this chapter is to critically demonstrate the theoretical interpretation of development, reform and growth. This chapter will outline the concepts, elements and theories of economic development, starting with Adam Smith and his classical school and ending with the recent theory on development that focusses on institutions, laws and regulations in the area of 'New Institutional Economics (NIE)'.

What is Development?

Economic development, in its simplest form, aims to create the prosperity of a nation. Mainly before the 1970s, rapid economic growth and the size of gross domestic product (GDP) were considered a good proxy for development and its other attributes (Todaro & Smith, 2011).

However, improvements in welfare such as better health, education and more housing for poor people are not appropriately captured by the GDP indicator. The experience of the post-World War II found out that many developing nations did reach their economic growth targets. Still, the levels of living of the masses of people remained unchanged, which was a signal that something was quite mistaken in this conventional understanding of development. Several developing countries have experienced high growth rates in terms of per capita income but a limited change in the living conditions of the majority of the population. In other

*This chapter is based on Abdelbary and Benhin (2019d), which explains in detail this theoretical debate.

words, while per capita income increased, poverty, inequality and unemployment were getting worse.

In the 1990s, the term ‘quality of life’ seemed to be used extensively to determine the degree of development of countries. Diseases, malnourishment and death that happen in the everyday lives of those in the developing countries dramatically changed the view of development goals. By then, many researchers around the world contributed in shifting the development goals set by governments in developing countries to broader objectives.

Therefore, there was an urgent need to a more comprehensive perspective of development goals as reflected in the World Bank’s Development Report

to improve the quality of life it encompasses as ends in themselves such as better education, higher standards of health and nutrition, less poverty, a cleaner environment, more equality of opportunity, greater individual freedom, and richer cultural life. (World Bank, 1991, p. 4)

These changes in development goals highlighted the need to construct alternative composite indices to reflect the quality of life. These directories should take into account not only financial indicators but also non-financial indicators to reflect the development levels achieved. For these reasons, the United Nations Development Programme has published the Human Development Index annually since 1990 in an attempt to provide an aggregate measure of life expectancy, education and income.

Over time, the interpretation of development has expanded again to include removing barriers to liberty, such as hunger and tyranny, that leave people with limited choice and opportunity. This humanistic approach to development leads one to explore what constitutes satisfactory minimum living conditions. For example, an acceptable minimum economic standard could include a person’s ability to consume sufficient nutrients to avoid being malnourished and to live in a dwelling with specific essential characteristics (in terms of size, access to improved drinking water, electricity, etc.). By costing this standard of living, the minimum income needed to achieve this standard can be determined.

The World Bank currently defines economic development as ‘qualitative change and restructuring in a country’s economy in connection with technological and social progress’ (Soubotina & Sheram, 2000, p. 96), while the most inclusive definition is given by Todaro and Smith (2011, p. 5) as ‘an increase in living standards, improvement in self-esteem needs and freedom from oppression as well as a greater choice’.

Is It Development or Growth?

This study believes that economic growth is only one aspect of any real development and reform process. Growth is a necessary but not a sufficient condition for development because GDP per capita might be rising; at the same time, most people do not see any actual improvements in living standards because poverty

might be increasing, inequality rising and massive environmental damage might be occurring.

Economic growth and development have a mutual relationship towards creating a suitable environment, where individuals can strive to enhance welfare, make use of available technology and acquire new knowledge in a secure environment. Economic growth supplies the resources to drive a rise in development and enhancements in human development that guarantees economic progress by the increase in the quality of the labour force.

Economic development is the improvement in the standard of living with sustained growth from a deprived economy to an advanced, high-income economy. When the quality of life betters this, it generates development, which includes processes and policies that raise the economic, political and social well-being of the society. The purpose of development policies is to accumulate several productive factors to begin sufficient economic growth that causes improvements in the standard of living, reduces inequalities and increases the welfare of the population.

Accordingly, this study defines economic development as the promotion of economic growth in such countries, which results in improving the standard of living factors such as health, education, working conditions, poverty reduction, improved functioning of markets and, in particular, reform of public institutions, which is the core of this study.

A Brief Review of Modern Economic Development Theories

Comprehending the main forces behind long-term economic growth has spurred a large body of theoretical as well as empirical research. Identifying the sources of growth and thus, development is critical for the design of economic policies that would lead to sustained growth and thus higher standards of living.

On the scene of contemporary economic thought, there are three fundamental theories competing in this regard: neoclassical theory, endogenous theory and institutional theory. The scholars of these three schools argue that their beliefs are more appropriate to explain economic growth and the disparity of wealth among nations. Each group of affiliates recommends specific economic policies that reflect the thoughts of their theories. The following paragraphs introduce a comparison of these theories by highlighting the main characteristics and criticism to each of them.

Neoclassical Theory

The neoclassical theory can be divided into three component approaches: the free-market approach, the new political economy approach (Public-choice theory) and the market-friendly approach. These concepts mean that markets alone are efficient, where commodities' prices are freely determined by supply and demand powers and achieve their equilibrium without government intervention.

The neoliberal theory proposes that social justice can be achieved through 'trickle-down' effect. The idea is that providing economic benefits to those with

upper-level incomes will ultimately benefit society as a whole through the new wealth being invested into the economy and therefore providing wealth for lower-income earners (Aghion & Bolton, 1997). Another strand of neoclassical free-market thoughts, called the traditional neoclassical growth theory originated from the Harrod–Domar, is the Solow and Swan models. Expanding upon the Harrod–Domar formulation, Solow (1956) and Swan (1956) neoclassical growth models emphasised the role of three elements of output growth: increases in the quantity and quality of labour, increases in the capital (through savings and investments) and improvements in technology.

Technological change in Solow's model is incorporated exogenously. Thus, with the same rate of technological progress, the economic growth rate would be projected to converge through countries. Developing countries will attract additional domestic and foreign investment by opening up national markets, thus raising the rate of capital accumulation and return on investment. The developing countries will eventually tend to converge to higher per capita incomes.

The Neoclassical School argued that policies of liberalisation, privatisation, foreign trade, private international investments and foreign aid flowing into developing countries could be expected to accelerate the economic efficiency and economic growth of these countries. Empirically, the models failed to produce the predicted performance. Pro capita growth rates have diverged across countries, with the weak and inadequate regulatory framework. Regardless of the different institutional, cultural and historical context of the developing countries, a free market in these countries does not boost economic development.

New Growth Theory (Endogenous Growth Theory)

In the early 1990s, the endogenous growth theory has explained the lacklustre performance of several developing countries, which implemented recommended neoclassical policies. Unlike the Solow model, the new growth model claims that technological gain has not been equal in most countries, nor has it been exogenously transmitted.

The theory linked the technological change to the production of knowledge. The new growth theory emphasises that economic growth results from increasing returns to the use of knowledge rather than labour and capital. Lucas (1988) argues that the higher rate of returns as predicted within the Solow model is significantly disintegrated by lower levels of complementary investments in human capital (education), research and development (R&D) and infrastructure. Meanwhile, knowledge is different from other economic products as it could grow boundlessly. Knowledge and innovation can be reused at zero extra cost. Therefore, investments in knowledge-building can lead to sustained growth.

Moreover, knowledge could create spillover benefits to other firms once they have acquired knowledge. Markets, however, fail to develop sufficient knowledge, so people cannot absorb all the benefits associated with generating new knowledge from their investments. Therefore, policy intervention is deemed necessary to influence growth in the long term (Aghion & Howitt, 1992). The new growth models believed in the development process through promoting the role of public