



Overview

Main message: Arab countries need a new development model

The Arab World is facing a historic moment, propelled by myriad forces demanding transformative change. A resurgent Arab region is seeking an end to a system marked by the political economy of rentier states and demanding developmental states with a commitment to freedom, social justice, and human dignity. From the outset, those in control failed to understand the dynamics driving popular discontent, built up over many years in a system characterised by political repression and economic and social inequality. Repressive tactics were employed to silence or contain dissenting voices, but so deep-seated was the pent-up popular opposition towards ruling elites that, in response to this repression, large and diverse segments of Arab populations joined the youth who stood at the movement's vanguard. Consequently, in one year, four long-standing leaders in Tunisia, Egypt, Libya and Yemen were toppled.

The movement for change that has spread through the socio-political landscape of the Arab region requires new development pathways that give greater prominence to the interlocking issues of democratic governance, social justice, and decent employment. A successful transformation is contingent upon understanding the demands of the Arab street for political, economic and social inclusion. This report takes these demands as its point of departure and strives to offer some options, without being prescriptive, to those driving the current change process.

This report aims to contribute to the present policy debate, particularly in countries in transition, on the region's developmental trajectory. The authors argue for a new Arab development model, where issues of stability are not addressed solely from a security standpoint and, above all, where progress is not simply viewed in terms of the utility of goods and services (such as growth in per capita income), but rather in terms of substantive capabilities to choose a life one has reason to value. The proposed developmental state is capable of transforming the enormous potential of the region into an inclusive growth base that respects human rights, reduces poverty, creates decent work opportunities, and views social expenditure as a real investment in the future. The Arab world is richer than it is developed. Thus, the main mission of the Arab developmental state is to invest in its citizens. To this end, the region requires an overhaul of current social policies, sound national development plans that emphasize industrial, agricultural and trade policies, increasing labour productivity, and prioritization of investment in sectors and projects that guarantee a sustainable economic and environmental base. The implementation of these national development strategies within a broader Arab regional integration framework would also create positive spillover effects at the national and regional levels.

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Rethinking Arab development along these lines requires an in-depth understanding of the historical context that led to the emergence of these waves of popular uprisings. The shift to "free" markets after decades of centrally managed economies, as well as a corresponding social contracts characterized by weak political participation and ill-fated national development projects, shaped this context. Regrettably, corruption tainted political structures, affecting implementation of liberal economic reform programmes and negatively impacting economic structures. Policymaking was marred partially by political interference (internal and external) and rent-seeking behaviour of political and economic elites, and partially by lack of a well-articulated, long-term, inclusive development vision. The poor implementation and mismanagement of free market policies squandered the enormous potential of the Arab region for inclusive economic development by denying the majority of Arab society their right to development.



Growth dividends have become increasingly concentrated in the hands of political and economic elites who had preferential access to the ownership of crucial assets and resources. This accompanied the increasing concern of policymaking with the consumption and distribution of rents from these assets and resources, rather than with promoting higher value-added production that provides decent jobs and equitable delivery of good-quality, basic

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social services. Predominantly, oil became the backbone of the region's trade and production, with its revenues financing luxury goods and services in oil-rich economies.

Oil-led economic growth has led to premature de-industrialization and has reinforced the subordinate position of the Arab region in the global hierarchy of production. Unbalanced development, within and between Arab countries, has marked this process, hindering manufacturing and agricultural sectors

and leading to anaemic growth of outlying areas. Entire segments of Arab societies have been left out of the growth process, as country after country focused attention on growth poles in particular sectors and geographic areas without complementary policies to widen the impact of investments. This aggravated sub-national imbalances and increased the rural-urban divide through rent-based accumulation in activities such as tourism, speculative real estate or high-end retail outlets. At the same time, it accelerated the region's reliance on imports for most of its basic necessities. This economic structure is responsible for the failure of the Arab region to generate decent and productive jobs for its people. The rise in international and domestic food prices since 2007 has also placed an overwhelming burden on the well-being of millions of the poor in rural and peri-urban areas. The accumulation of various socio-economic distortions in a country like Egypt, for example, has intensified rural poverty since 2000 and increased the gap between rural and urban dwellers, further exacerbating an unsustainable pattern of internal rural-urban migration.

The facts and analyses contained in this report and in the background papers document the extent of socio-economic disparities and demonstrate that the demand for transformative change is fundamentally a reaction by a wide segment of Arab societies to systematic exclusion from the benefits of economic growth and from decisions that affect their lives. This is regrettable in a region that holds enormous development potential, where the leaders had plenty of opportunities to adopt alternative policies that could have responded to their people's aspirations. Weak social, political and administrative accountability mechanisms, as well as politically oriented socioeconomic planning models, have further perpetuated structures of neglect and produced ostensible stability for elites oblivious to people's social, economic, political, civic and cultural rights. Lack of respect for human rights and suppression of dissent, combined with social and economic policies that favour quick fixes rather than long-term development solutions, effectively squandered development opportunities.

The people of the Arab region possess two features of social capital in more prominent form than in most other societies: a spirit of economic initiative and a highly sustainable level of social cohesion. The failures in some state-led policies adopted by most Arab countries since the 1960s have crippled that entrepreneurial spirit, while Washington Consensus policies undermined social cohesion. Such has been the impact of public policy choices on these two important social assets.

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Although the authors refrain from detailed policy prescriptions, they provide several policy directions and insights that address longer-term development challenges and issues of democratic transition. The main

conclusion, as in the 2009 ADCR, is that Arab countries need a new development model. Moving from the prevailing rent-based political economy to a developmental state, however, is possible only through the adoption of political, social, and administrative accountability mechanisms that promote inclusive development in both political and economic spheres. Such a shift is contingent upon the design and implementation of a new accountability framework based on the separation of powers that creates a system of checks and balances and admits the right to information.



Most importantly, the move to a developmental state requires extensive efforts for the proper management of four critical resources: energy, water, agricultural land and human resources. Of these resources, two (renewable energy sources, as opposed to finite oil and gas, and human resources) are in great abundance and hold significant potential, and two (water and agricultural land) present tough and limiting constraints. This report asserts that in order to re-position the Arab region on a trajectory of equitable and sustainable long-term development, it is imperative to devise remedial policy actions that address major governance failures in the management and utilisation of these critical resources.

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Human development and poverty in a wealthy region

This report is anchored in UNDP's human development approach. It views human development and the reduction of human poverty as the ultimate goals of socio-economic policy. As such, progress in the region should be primarily measured in terms of human development. Based on the most recent data, the report finds that significant progress on human development has been achieved in all Arab countries. Using 1970 as the base year, the region appears to have done very well in terms of absolute changes in human development, as highlighted in the 2010 Global Human Development Report. This is predictable, given the large investments in social services undertaken by most Arab governments and the extremely low starting values for all three components of human development.

However, if we take a later starting point, the improvement loses much of its glitter, with the increase in human development slowing distinctly after 1990. Furthermore, the Arab region as a whole, and most Arab countries individually, show a lower level of human development than one would expect based on their income levels. As human deprivation is a mirror image of human development, it is not surprising that the Human Poverty Index has declined since the 1990s, particularly in oil-rich GCCs (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates). However, it is still higher than expected compared to other developing regions with similar levels of income per capita. Both improvements in human development and reductions in human poverty are the lowest in Arab LDCs (Comoros, Djibouti, Mauritania, Somalia and Sudan).

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The MDGs are also an appropriate framework to monitor development progress. Many countries of the region, while having scored major achievements in education and gender equality, still lag behind on MDG targets related to maternal mortality and access to safe water. Progress has also been slow in under-five nutrition and mortality, adult illiteracy, and access to sanitation.

Poverty, whether measured in terms of human capabilities or in money-metric terms of income or expenditure, reflects the convergence of social, economic and political exclusion, which is glaring for the majority of the Arab rural population. Indeed, the severity of rural poverty and the large disparities between rural and urban development are indicative of failed rural development policies. Tellingly, 50% of the Arab population is rural, while agriculture, their primary economic activity, accounts for no more than 15% of Arab GDP.

A different narrative of Arab poverty emerges based on the international poverty line (\$1.25 per person per day), which indicates both a very low poverty incidence and a notable decrease since 1990. As argued in the report, this poverty line is too low to allow for any objective comparison of money-metric poverty in Arab countries relative to other developing regions. The report recommends an alternative methodology that allows poverty lines to vary according to the country's level of income.



Given this alternative measurement approach, which applies daily poverty lines that range from \$1.5 to \$3.5 depending on the level of expenditure per capita of the concerned country, the main conclusion is that most Arab countries have a low rate of poverty compared to their level of per capita expenditure. This result is expected, given the high level of social cohesion that characterizes most countries of the region. However, the results also indicate that the Arab region has not been successful in significantly reducing money-metric poverty since 1990. For most Arab countries, per capita consumption expenditure did not rise sufficiently in real terms to allow for any tangible poverty reduction, and income distribution did not show any signs of major improvement. This conflicts with the substantial increases in per capita GDP that occurred over the same period, as reported by national accounts data. In addition, the Arab region is vulnerable to increases in poverty as a result of shocks, such as rising food prices and economic recession.

To make matters worse, despite the accumulation of evidence on the seemingly intractable nature of unemployment, poverty, and inequality in recent years, the governing elite made no serious attempt to address the underlying factors that impeded progress on these fronts. Political institutions failed to understand the need to establish a broad-based and empowered process of development planning with strong monitoring and evaluation of development results and to create a strict system of accountability to effectively address poverty and social injustice. Instead, the dialogue within development circles focused on poverty as a technical problem. The proposed technical solutions did little to address the governance and political economy failures that lie at the heart of the problem. Even at the technical level, poverty alleviation interventions such as cash transfer programmes, which have been successfully applied in many parts of the world, failed to impact poverty because they were conceptualized and implemented in isolation from a broader framework of pro-poor macroeconomic policies. Hence, economic policy continued to impoverish entire population groups despite a myriad of social safety net programmes reaching millions of beneficiaries.

Despite some notable progress, the region has generally failed to transform its massive oil wealth into commensurate improvements in human well-being and a decrease in human deprivation. Furthermore, the absence of effective social protection mechanisms exacerbates the risk of falling into poverty, as the poor are at the receiving end of economic systems that favour patterns of consumption for the rich, such as investment in luxury and speculative real estate projects, while those sectors that can create decent and more stable employment opportunities languish. Failing to institute mechanisms of participation and accountability, Arab regimes missed many opportunities for course correction and failed to understand people's aspirations, creating the conditions that led to popular uprisings.

Rent-based governance relations

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The prevailing form of the Arab social contract was one where the population exchanged political freedom in return for the provision of certain services, such as state employment, access to public healthcare and education, and exemption from or low taxation. This social contract came under pressure starting in the 1970s due to the increasing inability of the state to co-opt the educated youth into the civil service, which was previously a well-paid sector that acted as a mechanism for upward social mobility. In country after country since 1980, the public sector has not been able to absorb the ever-increasing numbers of graduates produced by the educational system. Furthermore, structural adjustment measures resulted in a decline in the real income of government employees and in government expenditure on

social services, coupled with the increasing privatization of such services without guarantees of quantity or quality. This prevailing social contract, understandable in a rent-based political economy, has allowed many Arab states to continue to follow a non-developmental path.



Several Arab countries have appeared stable in terms of the longevity of ruling systems and rulers. That stability rested on the suppression of human rights and citizens' aspirations, often with the support of external powers with vested geo-strategic interests. These interests also kept the region's economies dependent on the sale of primary commodities while importing critical life-sustaining inputs like food and intermediate goods. Stability built on patronage and oppression, as opposed to a healthy social contract between the state and citizens, reinforces the drive for quick returns on private sector investments (e.g. real estate) rather than the longer-term and job-creating investments required to absorb a more educated labour force. The business sector's acute awareness of the potentially explosive social context of inequality and unemployment created a sense of insecurity that led to capital flight or to investments in quick return markets that do not produce decent jobs. The high share of ill-gotten wealth in many Arab countries aggravates capital flight, as evidenced by recent reports about huge assets owned by former rulers, mostly held outside the region.

The prevailing governance structures in the Arab region have led to two mutually reinforcing processes: no public accountability of the state and an ever increasing concentration of political and economic power in the hands of a few. Furthermore, the power structure reflects the interlocked interests that concentrate authority within a small circle and prevents rotation of power.

In fact, regardless of whether one agrees or disagrees with neoliberal reforms, they could have been more palatable to Arab citizens had they been accompanied by well-targeted social protection programmes and participation of representative institutions in a transparent dialogue between winners and losers of these reform processes. The absence of these institutions further reinforced the rentier character of the state. Concurrently, the deterioration in productive sectors and the proliferation of low value-added services caused an expansion of informal activities and vulnerable employment. Representative institutions and remedial interventions to alleviate the unintended negative consequences of liberal economic reforms were absent. Tax systems were developed without popular representation in the decision-making bodies that manage public expenditure. Meanwhile, bilateral and global trade agreements severely limited the policy space available to Arab governments and further compounded the structural deficiencies of Arab economies during the reform process. They lacked the flexibility necessary to develop sound trade and industrial policies to encourage the establishment of a modern industrial base and grant more market access to small and medium enterprises.

Growth without decent employment

Arab economies have weak structural foundations, due to the pursuit of oil-led growth. The growth process has been highly volatile, particularly for oil-rich countries, with periods of growth followed by years of stagnation. This volatility, combined with a lack of long-term vision to mitigate its impact, has adversely affected long-term productive investment.

These structural features had a significant impact on employment. Over the past two decades, the Arab region had the fastest rate of employment growth among developing regions. The region managed to reduce the overall unemployment rate from a level of 12% in 1990 to 9.3% by 2010. However, the Arab region still holds the highest unemployment rate of any developing region. Moreover, the substantial decline in unemployment registered in Algeria and Morocco largely explains the regional decline. The improvement in these two countries does not reflect dynamic economic productivity with the ability to produce sustainable jobs. Rather, government-subsidized employment opportunities are a primary source of the increase in employment in Algeria; the

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sustainability of these gains rests on the government maintaining subsidies. In addition, many of the new jobs in Algeria are in the service and informal sectors. In Morocco, the reduction in unemployment is due to the dramatic increase of illegal migration to Spain and Italy during the first decade of this century, which itself was due to the large reduction in job opportunities produced by the various economic sectors during that same time period.¹

In fact, during this period, unemployment rates increased in LDCs (from 8% to 11%) and in the MICs of the Mashreq (Egypt, Jordan, Lebanon, Occupied Palestinian Territory, and Syria) (from 9.3% to 9.8%). Furthermore, although declining from 30% in the 1990s, youth unemployment remained high, at 24% in 2009. This is more than double the global average of 11.9%. The share of youth among unemployed populations was over 50% for most Arab countries.

The decline in unemployment is also somewhat deceptive in that it mainly reflects an increasing willingness to accept any job or simply abandon a futile job search. A systematic expansion of informal employment in Arab countries is also a powerful sign of increased vulnerability and exclusion from decent work. If one takes into account the declining quality of jobs on offer, it becomes clear that the region has not managed to win the struggle for decent jobs.

To address the employment challenge, Arab countries need to adopt more accommodating macroeconomic and sectoral policies.

Arab women in particular are exposed to unemployment and vulnerable employment. The share of women in the workforce is extremely low. Less than 20% of women work in non-agricultural jobs, the lowest of all developing regions. Even Tunisia, which has the highest percentage in the region of women's participation in non-agricultural work, lags behind the average for developing regions. Even more concerning, this indicator has remained relatively constant since the 1990s.

The region's incapacity to create decent employment is sometimes attributed to the low quality of education and the mismatch between educational outcomes and market demand. The report argues against this hypothesis by showing that the limited labour demand for educated workers and skills is fundamentally a demand-side problem that is closely associated with the structure of output growth and investment. Unsatisfactory labour market outcomes are primarily due to unfavourable macroeconomic conditions that inhibit investment in fixed capital and productivity growth, accompanied by inadequate growth of labour income. Indeed, the relatively low investment ratio of the region—on average 20% of GDP, compared to 35% in East Asia—is indicative of this structural deficit.

The Arab region faces a major job creation challenge. Non-GCC Arab countries have to create ninety two million jobs by 2030 in order to reach full employment and raise women's labour force participation rate to 35% (which is still 15 percentage points below the average for developing regions) at an estimated bill of \$4.4 trillion (in constant 2005 prices). This would require an average annual investment of \$220 billion, which is approximately 50% of the GDP of these countries in 2009. The required rate of investment is substantially higher for LDCs, around 100% of GDP, clearly requiring substantial external support for its realization.

To address the employment challenge, Arab countries need to adopt more accommodating macroeconomic and sectoral policies. This report argues that despite the global recession, domestic fiscal space is available in most countries for financing the required development transformation. The focus of Arab macroeconomic policy therefore need not be on fiscal prudence or adequacy but on making sure the fiscal space is used to expand economic activities. The first priority is to use public investment to facilitate economic activity in those formal sectors with high potential for decent work. This would contribute to the competitiveness of Arab economies and encourage more investment in the productive sectors so that the demographic opportunity, currently present in the high share of working-age population, is translated into real growth.



Natural resources: a serious threat or an opportunity for development?

The sustainable use of environmental resources is perhaps the most serious long-term development challenge facing the Arab region, which, according to the most recent ILO and FAO data, employs one-third of its labour force in agriculture and imports a major share of its food needs. In all Arab countries, with the exception of Iraq, Sudan and Lebanon, the per capita share of renewable water resources falls below the international water poverty line (one thousand cubic metres annually). In Yemen, the per capita share of water has reached 100 cubic metres annually, a tenth of the international water poverty line. Sadly, the bulk of increasingly scarce water resources in Yemen were directed to the production of 'qat', a popular narcotic plant.

Various studies have shown that the region is one of the most severely affected by global climate change, as increasing episodes of drought will almost certainly have a direct negative impact on poverty and internal migration. A good case in point is Syria from 2004 to 2009. In addition to the poverty impact, successive droughts resulted in waves of internal migration that added significant pressure on the already deteriorating public services in Damascus and its outskirts². Global food price hikes also have a major impact on poverty in Arab countries. The Arab LDCs are undoubtedly the most vulnerable to food price hikes, given the higher share of food in their consumption basket and the weak coverage of social safety nets and food subsidies. When rising food prices are combined with climate change, systemic environmental degradation and conflict, the result is certain to be catastrophic, as the recent chapter in the history of Somalia's famine has proven.

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The oil curse is at the origin of the Arab rentier state's autocracy, technological backwardness, economic fragility, and social injustice. The Arab region has managed to squander its considerable oil wealth with unsustainable patterns of production, pricing, and consumption that have created some of the highest levels of energy intensity per dollar of GDP in the world. It has also hindered any serious scientific research endeavour in renewable energy, and in some countries, like Yemen, it has led to rapid depletion of underground water resources. The mismanagement of natural resources in Arab countries provides the strongest example of compounded failures in governance and economic policy.

Despite the enormity of food security and water scarcity challenges, and a strong nexus between poverty and poor management of natural resources, Arab governments have shown indifference to the environmental challenge and the deterioration of natural resources in the region. The region is marked by limited investment in the management of water resources and improvement of irrigation and agricultural productivity.

A more effective mix of policies that develops incentives for investment in renewable energy and achieves a gradual transformation in pricing of oil and fresh water resources is a prerequisite for improvements in efficiency of resource use. This policy shift should be undertaken under the umbrella of a new social contract based on a dialogue between the state and representative institutions. The Arab developmental state can become a leading global pole for research, development, and production of renewable energy. The adoption of new irrigation technologies, for example, is necessary for structural change in the pattern and efficiency of agricultural production that could fill a large part of the Arab food insufficiency problem and contribute significantly to alleviating the severity of rural poverty. Only a new developmental state that upholds good governance of natural resources, and invests in rural areas, agricultural production, and in scientific research, can transform the enormous environmental challenge into a historic opportunity.



Arab integration: a need for all, not a favour from some

Arab countries, whether rich or poor, can all benefit from regional integration, given their de facto cultural amalgamation and complementary resource endowments. The region wasted innumerable opportunities to improve development outcomes because of a lack of economic and political integration. One example is the loss of US\$300 billion of Arab wealth³ during the global financial crisis of 2008, an amount equivalent to one and a half times the annual investment required to address Arab unemployment from 2010 to 2030. Yet advocating for Arab integration based on obsolete, dogmatic, and often politicized slogans that resort to emotional rather than evidence-based arguments does more harm than good to the cause of Arab unity. In all areas, social, political or economic, a national developmental state that is regionally integrated will preserve its national security

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more effectively than a rentier state that is economically and politically dependent on the interplay of geopolitical forces controlled by countries outside the region.

Not surprisingly, the ability of Arab countries to defend their national interests against contending foreign interests has dwindled as Arab governments have become increasingly constrained in exercising sovereignty over many economic and political decisions. If a country surrenders any of its autonomy, it should be to a supranational entity

that represents the common interests of a unified group, such as in the case of the European Union, instead of relinquishing it to foreign powers whose interests are often radically opposed to its own national interests.

The road ahead: what should be done now and how?

The relationship between circles of political, economic, social, and environmental exclusion and regional marginalization has created a complex and explosive reality. Radical changes can remedy the situation by building a critical number of regionally integrated developmental states that put people at the core of the development process. Such structural transformations do not and cannot take place overnight. Time is needed for stable, constitutional and popular governments to emerge and for policy objectives to be properly designed and planned. Due to the institutional constraints and political realities facing Arab governments in transition, design of long-term socio-economic plans will require substantial preparations to ensure that people's aspirations are translated into socially and environmentally feasible development interventions, with negotiated agreement on trade-offs between winners and losers of particular policies and programmes.

Arab governments and their partners must move swiftly towards addressing a number of critical challenges, particularly creation of decent work opportunities for youth and genuine improvement in democratic governance.

Arab revolutions produced high expectations that make it imperative for governments, civil society and international partners to move swiftly towards addressing a number of critical challenges, notably creation of decent work opportunities for youth and genuine improvement in democratic governance. Sustainable, longer-term development and successful democratic transitions require pragmatic measures to reach the minimum acceptable level of employment and growth and provide a stable

economic environment. Failure to take these actions risks causing significant economic losses that might erode much of what has been gained in the political arena.

Therefore, the priority in responding to the demands of the Arab people should be attaining a package of measures that are feasible within the current regulatory and public administration systems. A successful transformation toward



the developmental state is more likely if the focus in the immediate term is on a limited number of key institutions that affect the relationship between the state and society. Economic issues, which have been central to the Arab uprisings, are trailing behind political issues in the post-revolution public discourse between the state, civil society, and the international community. This potentially risks erosion of popular support for democratic transition if these economic issues are not properly addressed. Of principal concern during the transition is to address the immediate fiscal and monetary policy challenges that inevitably arise in periods of instability. In particular, there is need for a careful and imaginative assessment of available fiscal space to finance the rising claims on current expenditure, such as demands for raising wages and salaries and innovative schemes for creating youth employment.

Economic policy

Public finances based on taxation without representation, as exist in most Arab countries, are no longer tenable. Efforts to revamp fiscal space by examining issues such as sustainability of public debt and investment should be complemented by strong monitoring and evaluation of the impact of fiscal policy on development results (including the thorny issue of food and fuel subsidies) and wider representation in formulation of fiscal policy.

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Similar to fiscal policy, monetary and exchange rate policies occupied a pivotal role in the functioning of the Arab rentier political economy. Sometimes exchange rates were undervalued to benefit large exporters, who were often connected to the ruling elites, without concern about the detrimental impact of the resultant higher prices of imported foods on poor and low-income families. Other times, often in line with restrictive prescriptions to target inflation handed down by the IMF, exchange rates were overvalued to suit the interests of importers, who also had close ties to elites, with utter disregard of the impact on investment in the productive sector and on competitiveness of local producers in global markets. Monetary policy and financial sector operations were also slanted towards providing cheap credit to the politically well connected while small and medium enterprises—those responsible for most job creation—are deprived of access to formal credit.

Thorough analysis of monetary policy and financial mechanisms is necessary, including analysis of norms for credit operations of banks that aim to support productive sectors and firms, especially small and medium enterprises. This will mandate a number of measures that include raising the velocity of circulation by targeting higher credit-to-GDP ratios and applying monetary and exchange rate policy frameworks that are friendly toward employment and human development.

Breaking the cycle of economic and social exclusion is contingent on putting in place mechanisms for financing growth in employment-intensive industrial, agricultural, and service sectors. A number of tools can achieve this, including providing preferential interest rates to strategic sectors, establishing public and private loan guarantee facilities, and lowering the required reserve ratio for banks that target small and medium enterprises, particularly in rural areas. Furthermore, to strengthen the developmental role of the financial system and to reduce the cost of borrowing, better management of liquidity and money supply will be necessary, in such a way that increases the banking sectors' return on equity. These changes should parallel attempts to reduce systemic risks, while taking all necessary steps to deal with the large-scale defaults that are expected in the current post-revolutionary economic recession.

Most Arab countries also suffer from weak and politicized business environments that impede long-term private investment. Improvements in this area, however, will require much time and effort at the macro, institutional, and sectoral levels. A key priority is the evaluation of competitiveness indicators and the implementation of measures that can be easily executed by existing institutions, such as the cancellation of all decisions that impede the immediate



establishment of new businesses or expansion of existing ones, particularly in labour absorbing, competitive sectors. Likewise, revisiting the minimum capital required to form a company and streamlining registration procedures would tremendously improve the business climate. An immediate improvement in trade and support services (customs, borders, transportation, finance, etc.) can be easily achieved by cancelling all unnecessary procedures and obstacles that often provide a breeding ground for corruption and friction between the people and public administration.

The economic and social exclusion of youth, exemplified in their lack of access to decent jobs, in addition to their marginalization from the political sphere, is the source of much of the tension witnessed in the region. Indeed, though the unemployment rate is declining, the bulk of the jobs generated are in low-productivity activities in the informal sector.

Unemployment is a serious problem in the Arab region, which reports the lowest labour force participation rate in the world. Interventions that contribute to reducing unemployment by increasing decent job opportunities in the formal sector are urgently needed for a successful democratic transition. The report suggests two immediate interventions: one, it proposes a more in-depth understanding of labour market dynamics with a view to reducing supply- and demand-side bottlenecks that impede attempts to create and access jobs. Secondly, it recommends imaginative use of public procurement processes to increase demand for locally produced goods. This could include insisting on the use of equipment and supplies that are produced by local firms at competitive prices and offering public sector salary increases in the form of vouchers for certain locally produced goods with high labour content. These interventions will make a significant contribution to reducing frictional unemployment, and also boost demand for local producers who are adversely affected by post-revolutionary recessions.

In addition to working on macroeconomic policies to increase the demand for labour by increasing the investment-to-GDP ratio and other demand-side interventions, a series of measures on the supply side can be taken to improve the efficiency of the labour market. They include revising labour laws to ensure worker's rights, encouraging formal and regulating informal employment, creating demand-oriented training programmes, and extending social protection to all workers.

These steps should counter the expansion of informal and unprotected work, which plays a huge role in the formation of circles of social exclusion and poverty in Arab countries. As the majority of workers excluded from social security are self-employed in agriculture and in informal small and medium enterprises, extending coverage to these two groups would be an appropriate intervention. Given the analysis of fiscal space in this report, the cost of extending such coverage is not beyond the reach of the majority of middle- and low-income countries in the region.

Income redistribution and social justice

In order to prevent further deterioration of income distribution, there is urgent need for interventions such as effective application of progressive taxation, especially income, property and capital gains taxes.

The region is characterized by income and wealth inequalities that are not reflected in Gini coefficients. In order to prevent further deterioration of income distribution, there is urgent need for interventions such as effective application of progressive taxation, especially income, property and capital gains taxes. The state can also set minimum wages and employ social security stabilizers in social protection systems and public expenditure policies. However, the majority of Arab countries for which detailed functional budget breakdowns are available already spend upwards of 5% of their GDP on social protection, inclusive of

energy and food subsidies. This means that the region faces a stark choice between either continuing with the current trend of rising, inefficient, and poorly targeted subsidies, or creating the required space to fully respond to popular demands for public investment in social capital, productive sectors and physical infrastructure. The issue is imperative, particularly for countries facing major infrastructure deficits. This increases the urgency of revisiting the question of fiscal space, particularly in middle-income countries in transition, such as Egypt and Tunisia.



Infrastructure

The weak infrastructure in Arab countries imposes high transaction costs on economic activity, lowers the return on investment, and blocks access of the poor and rural dwellers to basic, modern amenities. For example, power cuts in rural areas prevent children from studying at night and clinics from servicing patients. Because investment in infrastructure is the most important determinant of successful transformative change, Arab governments should focus in the next two years on enlarging the fiscal space available for investment in infrastructure, with a focus on improving the access to economic opportunities for poor rural dwellers.

In middle- and low-income countries, limited financial resources and institutional capacity might prevent rapid implementation of infrastructure projects in an efficient and transparent manner. These countries should institute a plan to increase fiscal space and expand institutional capacity in the medium term. In the immediate term, these countries need an assessment of the social and economic benefits of infrastructure projects, before beginning an open and transparent debate to decide on the most beneficial and viable projects. While building up the capacity of public institutions for effective management of development projects, policymakers should explore innovative project implementation, including community management of some smaller projects and public-private partnerships for projects with quick financial payback.

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Priorities for poverty reduction and inclusive development

The process of poverty reduction during the transition period must focus on reducing sub-national disparities through geographically targeted programmes. Existing poverty mapping exercises can help guide these interventions. Governments and their civil society and international partners should collaborate to design and implement such programmes, with components for public works, micro finance, small business support, training, and expansion of social services networks, especially those that target women, including the provision of health services and school feeding.

Slums have been the scenes of social and political tensions that preceded the Arab Spring. In fact, the deteriorating conditions of Arab cities were potentially catalysts of political activism pushing for greater social justice. Improving the conditions of neglected and decaying urban and peri-urban areas provides a tremendous opportunity for employment and social inclusion. Therefore, one possible immediate relief measure for countries in democratic transition is to design public works employment programmes that improve living conditions in areas of informal housing and urban decay. Such programmes may include affordable social housing and improved basic services, including pre-schooling and community care for the elderly and the handicapped. The development of health, education, and vocational training service centres can create new employment opportunities for university and high school graduates.

To ensure the success of these programmes, additional financial resources would be required to fund individual and collective small projects that service decaying areas. It is further necessary to empower elected local governments by giving them human power, financial resources, training, and the capacity to build and expand the domain of local decision-making.

In addition, small- and medium-sized towns are pivotal areas in regional development networks, and can be bases for integrating agricultural, commercial, industrial, tourist, and service activities. This requires understanding the socioeconomic and demographic dynamics and characteristics of these cities, so that elected local councils, in cooperation with civil society, can identify and implement pressing interventions. Furthermore, rural development is dependent on links between small and medium cities, and should lay the foundation for regionally balanced development.



For a social justice agenda, national development policy priorities should focus on expanding opportunities to engage in viable agricultural and non-agricultural economic activities as a means of confronting soil and water degradation and rising rates of unemployment and poverty. The current conditions in rural areas of the Arab region require broad structural changes to achieve comprehensive rural development based on a more diversified set of economic activities. Consequently, it is critical to immediately identify the causes of persistently high rates of poverty in the most deprived areas of the countryside. It is also necessary to make available the required financial and technical resources to support the diversification of the rural economy by increasing productivity of small farms and improving access to markets and credit on reasonable terms. These interventions should increase employment opportunities in the agricultural and non-agricultural base of the rural economy and slow down the process of rural-to-urban migration, laying the foundations for more geographically balanced development.

Given the limited scope for increasing agricultural production by expanding the area under cultivation in most Arab countries, public investments should aim to increase productivity of the limited stock of arable land through better diffusion of existing knowledge on improved production methods and rendering the appropriate inputs more accessible. Policymakers must revisit current food subsidy programmes to make them more effective in promoting production and generating greater, more stable incomes for rural populations, rather than subsidizing foreign producers and urban consumers.

Diversifying economic activities in rural areas and slowing down rural emigration also requires improving social services. This must be based on the principle of regarding these services as a right, a matter that necessitates the provision of decent education and health services to the poorest geographic regions. This will not only have a direct impact on employment in these areas but will also grant access to essential services to the poorest of the poor among rural populations, especially smallholder peasants.

The above noted measures cannot possibly be successful in the absence of an accountable and capable state. Past attempts at socially inclusive development show the importance of improving the capacity of public institutions by providing the requisite human and physical resources. The timely and cost effective implementation of publicly funded infrastructure and service development projects also requires, as highlighted earlier, an efficient and transparent system of management of public funds and public investments.

Given the critical nature of water scarcity, most Arab countries need state interventions and state-backed public projects to improve water management with a focus on promoting efficient irrigation technology, establishing water user associations and joint use of underground resources, and enacting more rational water pricing policies. Beyond simply creating jobs, the programme of public works advocated in this report can be more beneficial if the interventions respond to critical impediments to sustainable development in the region.

Institution building and democratic governance

Despite the fact that poverty and unemployment are among the most important factors underlying the popular uprisings, such poor outcomes on the economic front are largely the result of governance failures. One underlying cause of poor development outcomes has been the lack of effective mechanisms for the people to hold those in power accountable for their actions and demand course correction when policies have adverse impacts. Critically, all countries going through processes of democratic transition must ensure that citizens can hold their representatives to account through freely participating in setting policy and overseeing the implementation of agreed measures. This is only possible through the adoption of irreversible measures that expand the scope of popular participation in how public assets are used, changing existing Arab power relations. These measures must include reforms to enshrine a prime role for civil society and local governments as active and indispensable partners in the developmental state.



Above all, reforms must safeguard the independence, integrity and efficiency of the judiciary, not only for the intrinsic value of a just system, but also as a critical factor for promoting long-term productive investment. This can be done by guaranteeing impartial enforcement of contracts and offering redress in cases of arbitrary action by the state or politically well-connected elites.

As the political transition in country after country gets under way, the uncertainty surrounding the role of the state limits the use of traditional mechanisms to implement needed public interventions. Elected local authorities, as well as civil society actors, must carry an added responsibility in managing, implementing, and monitoring critical development interventions such as public works programmes. This requires urgent measures (such as reviewing laws regarding the functioning of civil society organizations [CSOs]) to reinforce their developmental role without circumventing their traditional social functions, enabling them to implement and oversee public projects, including the management of small-scale ventures in rural and urban areas.

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The traditional top-down approach of governments in the region has deprived Arab citizens of effective and accountable local administrations that can act as important channels of popular vigilance. Therefore, it is imperative to reconsider legislation governing local administration, particularly relating to the formation of local councils in free elections and to the building of administrative, executive and financial capacities of local authorities to implement developmental interventions. This implies some degree of decentralization that would enable local authorities to mobilize resources and improve their managerial, planning, and monitoring and evaluation capabilities.

Institutional weakness is one of the most important causes of socioeconomic and political exclusion in the Arab region. The weakness of institutions that are responsible for providing essential public services such as social security, health and education is a major cause of larger cumulative development failures, in terms of equitable access to opportunities for socioeconomic development. However, institutional reform is an inherently long-term process that requires, first and foremost, executive authorities to be selected based on merit rather than loyalty. Therefore, there is a dire need for actions that signal permanent reform in the governance of public institutions. In this respect, key institutions should be given priority in the immediate term. The extent of these institutions' impact on development results at the national level must guide their selection. Typically, these institutions would include taxation and customs authorities, central and public banks, and development funds, in addition to audit authorities and anti-corruption and human rights protection agencies. Furthermore, revision of legal codes governing the civil service is necessary to ensure their professionalism and responsiveness to the demands of the public.

Institutional weakness is one of the most important causes of socio-economic and political exclusion in the Arab region.

A successful transition is predicated on the effective role of the judiciary in public life. In the short run, certain measures can be undertaken to reform the judicial system, especially its capacity to adjudicate economic disputes and litigate for collective public interest of the poor and marginalized. Measures of immediate urgency in this respect include abandoning any overlap between executive and judicial authorities, securing the independence and integrity of the judiciary, and the establishment of centres for dispute settlement, arbitration, and specialized courts. Long litigation is an important source of corruption of the judiciary in many Arab countries. Therefore, it is necessary to increase the number of judges and administrators and to automate court work. One issue undermining law and the judiciary in Arab countries is the contradiction between laws and legal codes, which creates many ambiguities that open opportunities for arbitrary action by law enforcement agencies.



Conclusion

The developmental state requires hard choices that only a legitimately elected, responsive, and accountable government can make. No policy pleases everyone all the time. Managing social conflict around hard choices is important for the credibility and sustainability of the developmental state. Inclusive participation in social and political institutions that

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mobilize and articulate collective interests—including political parties, labour unions, and professional associations, or civil society advocacy groups—ultimately enhances the ability of states to manage social conflict.

The transformation process of Arab states is contingent upon uprooting the political economy of exclusion and its oppressive security and stability model. Five key, interrelated governance deficits provide some lessons on what to do and what to avoid to ensure a successful transformation. 1) The state must aim for real reform, not just a façade, to build a basis for legitimacy, effectiveness and stability. 2) A strong constituency is necessary for social justice and accountable governance. 3) Combating corruption, which is a serious symptom of governance deficit and a catalyst of popular anger, requires the combined efforts of judicial, administrative, political and social institutions. 4) Freedom of information, especially budget openness, will strengthen the new democratic process and guarantee that civilians will monitor and oversee security and police services and judicial independence. 5) Transformative efforts have to begin with reforming local governance in order to guarantee equitable development, accountability, and responsiveness of authority to popular demands. The ongoing Arab resurgence has demonstrated that curtailing participation in the name of security or stability has not made oppressive regimes resilient. The only guarantee of increased stability and inclusion in the future is sustained popular engagement in the political process throughout the political cycle as opposed to interludes of political enthusiasm during elections.⁴

Following the approach of the first Arab Development Challenges Report, which was jointly produced with the League of Arab States and endorsed by Arab leaders, the proposals of this report are not meant as a comprehensive solution to the economic, social, and institutional challenges in Arab countries. This report merely intends to provide a flexible menu of policy options that take into account the specific needs, capabilities, and available resources of the region. At the same time, this report can become an effective tool for engaging in policy debates at the national level that deal with necessary measures to ensure that development and economic activities continue at an acceptable pace in the period of transition, and to enact reforms that would pave the way for long-term development planning.

It is also important to note that this is only the tip of the iceberg of what is required by Arab leaders in this difficult transitional stage. Their efforts will determine if the region will regress, as some forces desire, to rent and dependency, or progress towards a developmental state that breaks the destructive convergence between the vicious cycles of political marginalization, economic and social exclusion, environmental degradation, and regional disintegration.

Finally, while this seeming tidal wave of youth-led popular uprisings affects every country in the Arab region, whether directly or indirectly, at the margins or at the core, it is essential to bear in mind that the extent and impact of the development failures underlying this rising tide, as well as the means and measures either taken or to be taken to address them, will differ from country to country. It is also crucial to note that the course, dynamics, and outcomes of transformative change processes will vary, sometimes considerably. Our regional generalizations need to be validated by and appropriately tailored and calibrated to the specificities, fluidities, and dynamics of each country context. In this light, this report should be regarded as a “living document.”