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Reform Failure and Underdevelopment in Egypt: An Institutional Explanation

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Reform Failure and Underdevelopment in Egypt: An Institutional Explanation

By Marissa Block

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Abstract

The January 25 Revolution in Egypt and the larger wave of demonstrations throughout the Arab World shattered the façade of stability and have brought the region to a critical juncture. The underlying causes of the Arab Spring point to the preponderance of socioeconomic issues, namely unemployment, poverty, and lack of social mobility. Yet, in the late 1990s in Egypt, Mubarak initiated a series of economic reforms designed to sustain economic growth. In light of the 2011 Egyptian uprisings, I seek to understand the failures of economic reform and persistence of underdevelopment in Egypt through the framework of new institutional economics. Ultimately, economic outcomes are determined by economic and political institutions, which are predicated upon the distribution of political power. I model the behavior of development-enhancing institutions as a stable equilibrium, whereas development-stunting institutions are unstable, leading to extreme outcomes. Through the use of historical evidence, my analysis has shown Egyptian society is largely built upon development-stunting institutions. I have identified a number of trends in the trajectory of Egyptian institutions, including the ability of elites to undermine and evade institutions, and the existence of an imbalance between the incentives of political and economic institutions. Institutions are the foundation upon which society is built. As such, the future development of Egyptian institutions should be subjected to inclusive planning, in which all players, not simply the elites, have a voice in the process. In order to tackle the root of underdevelopment and reform failures, political institutions must first be reformed before economic reform measures are introduced.
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I. Introduction

When Egyptians filled Tahrir Square in January 2011 chanting “Bread, freedom, and social justice,” it was a monumental moment that shattered any allusions of stability under a decades-old dictatorship. On the surface, macro-economic indicators seemed to imply that all was well. In the first decade of the twenty first century, economic growth averaged 5 percent, Mubarak successfully signed a deal with the IMF, and in fact, in 2008, the World Bank named Egypt as one of the top reformers in making it easier to do business (Alissa 19). The economic reforms introduced in the 1990s seemed to follow the preferential policy prescriptions of the Washington Consensus, which advocated privatization and liberalization of markets and the rollback of the state in economic affairs. In 2010, Egypt was named one of the CIVETS, six favored emerging markets countries comparable to the BRICs.

Despite these macro-economic improvements, average Egyptians begged to differ on the extent of the success of economic reform. The emphasis on “bread, freedom, and social justice,” highlighted the lack of an institutional framework providing food security and other basic social rights. Unemployment was high, and opportunities of upward social mobility were out of reach for much of the general population. How can these persistent economic hurdles be explained, in light of the liberalization reforms that began during the Sadat era? In Why Nations Fail, Acemoglu and Robinson assert that these hurdles, “stem from the way political power in Egypt is exercised and monopolized by a narrow elite,” concluding that “Egypt is poor precisely because it has been ruled by a narrow elite that have organized society for their own benefit at the expense of the vast mass of people,” (2). Since 2000, Egyptian unemployment has consistently

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1 The statement is based on the Doing Business 2008 report by the World Bank and IFC.
2 The acronym was initially created by Robert Ward from the Economist Intelligence Unit, but was popularized by Michael Geoghegan from HSBC. For a brief description see http://online.wsj.com/news/articles/SB10001424053111904716604576546632573895382.
remained above 9 percent and inflation has remained above 6 percent since 2003. Poverty and food security are also major issues. A UN report on the topic claims between 2009 and 2011, some 15 percent of the population moved into poverty, twice the number who moved out of poverty (“UNited in Egypt” 1). Inflation, poverty, and rising unemployment are all serious concerns. One analyst of the current situation in Egypt writes, “No Egyptian government will be stable unless it successfully addresses the country’s many interrelated economic troubles” (Samhouri, “Egypt’s Economy and the Fall of the Beblawi Government”). Thus, it is clear that economic growth should not be interpreted as the primary indicator of economic wellbeing of a country, especially in developing countries, where growth is not widely shared. Therefore, growth does not necessarily imply development, or the standard of living across socioeconomic realms, if benefits accrue to the few.

In his seminal work *Institutions, Institutional Change and Economic Performance*, Douglass North states, “they [institutions] are the underlying determinant of the long-run performance of economies,” (10). In *Why Nations Fail*, Acemoglu and Robinson seek to explain the differences in development across countries through new institutional economics and conclude extractive institutions lead to ultimate failure. In light of the 2011 Egyptian uprising, this paper seeks to apply a similar institutional framework of analysis to understand the state of development in Egypt and explain the rise of corruption and failure of economic reform to create significant improvements in standards of living from 1952 to the present. In using historical evidence, I argue that Egyptian elites continuously undermined institutions. Furthermore, in the situation of an imbalance between political and economic institutions, meaning the incentive structures do not align, reform measures fail and economic growth is difficult to sustain. Since

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3 The calculation comes from World Bank data and is based on ILO estimates.
the Free Officer’s Movement in 1952, Egyptian institutions have gradually weakened, resulting in a soft state in which laws are not properly enforced. The Egyptian military has played a consistent role in the weakening of institutions, and subsequently strengthened its own position in the economy. Economic growth has failed to lead to development because of the rise of corruption and the failure of economic reform. These, in turn, stem from the nature of Egyptian institutions as development-stunting, meaning extractive and obsolete. Egyptian political elites have undermined institutions, which have allowed corruption to flourish, and thus the underpinnings of economic reform are lacking. The fate of Egypt matters due to its geostrategic importance in the Middle East and the rest of the world. Egypt was historically the leader of the Arab world, but considering the current internal situation, Gulf countries, particularly Saudi Arabia, are jockeying for this position through financial power. The uprising and ongoing turmoil and violence since 2011 are outcomes of bad institutions. In the event of a Sisi presidency, which seems likely, the future president must initiate institutional reform, or the current cycle of upheaval will continue.

I will first present the theoretical framework and provide a brief literature review of new institutional economics and corruption. Building on North’s notion of institutional change, I will provide the beginnings of a model of institutional change of development-stunting institutions and compare it to the ideal situation of development-enhancing institutions. Next, I will proceed in chronological order and analyze the institutional matrices of the Nasser, Sadat, and Mubarak periods through historical evidence. Each section will consider the general state of political and economic institutions, how elites have undermined these institutions, including the role of the military, and the presence of corruption and attempts at economic reform during the reign of
each ruler. Finally, in the last section I will consider the Arab Spring and the future of Egyptian institutions.

II. New Institutional Economics: Theoretical Framework

Just as in neoclassical economics, new institutional economics assumes scarcity and therefore the primacy of competition. However, neoclassical economics also assumes perfect information and rational choice theory of individuals. If information is costless, transaction costs are nonexistent, and institutions don’t matter. Yet, new institutional economics argues institutions do matter. Modeling human behavior as rational is unrealistic. North has argued individual behavior is determined through motivation and perception of the environment. The uncertainties of interaction stem from incomplete information regarding the behavior of other individuals, and the limitations of the individual are based on his or her capacity to process, organize, and utilize information, and the way in which he or she perceives the environment (Institutions, Institutional Change 25). Institutions exist to reduce these uncertainties. Additionally, the neoclassical growth model is restricted in its explanatory power to developed countries, and it assumes institutions are determined endogenously. More importantly, Solow’s model of economic growth predicts convergence. Yet, disparities between developed and developing countries still exist, otherwise there would be little need for the field of development economics. New institutional economics seeks to extend neoclassical theory and address these disparities by offering an interdisciplinary approach of political economy. The framework diverges from past theories of development in that it takes into account political and social factors, and it does not focus on a purely economic framework. Rather, the intention is to analyze the underlying factors that determine the structure of economic activity.
North defines institutions as “the humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights),” (“Institutions” 97). Theoretically, formal institutions can change over night, whereas informal institutions are far less susceptible to rapid change. In employing a sports analogy, North states that institutions are the rules of the game, while organizations, such as political figures, the military, or businessmen, are the players. The causality between the two runs both ways, since institutions determine the opportunities available to organizations, and eventually organizations can induce change of the institutional structure. In considering the first direction of causality, that is institutions effect on organizations, the rules of the game will affect how players interact with each other. North writes that, “together with the standard constraints of economics they [institutions] define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity,” (“Institutions” 97). Institutions construct a framework of incentives for interaction between organizations and transaction costs dictate whether interaction will occur.

As mentioned above, institutions involve costs, such as maintenance/administrative costs and transaction costs. Maintenance costs involve the costs of creating and maintaining institutions, while transaction costs are those that the players bear in interacting once an institutional framework is already established. If maintenance costs are too high, then institutions will have trouble developing and bad institutions are generally costly to maintain, especially in the long-run. Demsetz (357) considers the emergence of property rights as being organically developed when the gains of creating institutions to internalize the externalities outweigh the maintenance costs. In regards to transaction costs, the aim of development-enhancing institutions
is to reduce transaction costs in order to better facilitate interaction by providing a consistent framework. For example, consider the institution of property rights and its provisions that constrain a buyer and a seller of land. What are the transaction costs involved? Assuming imperfect information, the buyer and seller will most likely hire a realtor and lawyer to determine the most appropriate price and contract. Therefore, transaction costs involve the costs of coordination and negotiation, which help to level the playing field, in spite of imperfect information. The contract itself and the deed to the land are physical manifestations of property rights and act as enforcement of the rules. Without private property protection, transaction costs would be high and buyer and seller would have little confidence in their arrangement.

*The Primary Determinant of Institutions*

But how exactly do these rules develop? Acemoglu, Johnson and Robinson argue that the answer lies in the distribution of political power, making political and economic institutions endogenously determined. The authors describe a cycle of persistence in which “political institutions allocate de jure political power, and those who hold political power influence the evolution of political institutions, and they will generally opt to maintain the political institutions that give them political power,” (5). Essentially, the distribution of political power dictates the nature of economic institutions, which ultimately determine economic outcomes. Similarly, Bates writes, “Those in control of the state [political power] may be motivated to employ economic institutions to generate wealth and protect its accumulation. Or those in charge of the state may be motivated to use its power to seize wealth and engage in redistribution, employing the power of economic institutions to engage in predation,” (152). Thus, political institutions, as one might expect, are rather durable, or resistant to significant change, since those in power are likely to create institutions beneficial to themselves (Acemoglu, Johnson, and Robinson, 6). Consequently, a significant shift in political power is required to change political institutions.
Egyptians in Tahrir recognized this notion that the economic reforms will never be entirely successful without a change in political institutions, or rather a redistribution of political power in Egyptian society. Rodrik (10) warns that initial spurts in growth can be achieved with minimal changes in institutional arrangements, such as the so-called liberalization efforts of Sadat and Mubarak. Alissa confirms this in questioning the ability of Egypt’s current institutional environment to sustain growth, and more importantly, to create jobs and alleviate massive poverty (1). Thus, it is imperative to distinguish between the right types of institutions and the distinction between stimulating versus sustaining growth. Sustaining growth leads to development, whereas stimulating does not lead to long-lasting improvements in the standards of living.

Political institutions that entail checks and balances on the limits of political power are more likely to facilitate the emergence of good economic institutions that facilitate development, or an increase in the standard of living. To avoid ambiguity, I will refer to good institutions as development-enhancing institutions. Such institutions encompass the following:

1. Inclusiveness – Good institutions should make opportunities broadly available, and be welfare-enhancing in order to create incentives for organizations to operate towards allocative efficiency. This implies a concern for social benefit over private benefit, or an optimal distribution of goods and services based on society’s preferences. Finally, inclusiveness implies that the rules should be applied with consistency to all organizations.

2. Reduction of transaction costs – These will better facilitate exchange between organizations and remove any uncertainties involved in interaction. Transaction costs should be applied with consistency to all organizations.
3. Centralization – Institutions should be sufficiently centralized to ensure their enforcement. Yet, political power should be broadly based in order to encourage pluralism.

I will refer to bad institutions as development-stunting institutions, which are those that fail to meet the above conditions, and often result in implicit costs such as bribes. Lack of transparency and accountability are regular features of both, creating an environment where corruption is commonplace. Development-stunting institutions can be broadly categorized as obsolete or extractive. Obsolete institutions are inefficient, involve high transactions costs, and thus create incentives for individuals to avoid them, often through bribes. Additionally, maintenance costs are high, especially in terms of the opportunity cost of efficiency and growth. For example, excessive bureaucratic procedures to register a business or property, exhibit high maintenance and transaction costs, and are thus inefficient institutions, which stunt economic activity. On the other end of the spectrum, formal rules may be nonexistent, and so informal rules dictate interactions. The development of informal institutions aligns with Demsetz’s view that institutions develop organically to internalize the externalities of excessive bureaucratic procedures. This phenomenon is common in the slums of developing countries where property rights are lacking and an informal or extralegal sector emerges. The transaction costs are higher than under formal institutions, since the law does not back informal sector activity. However, interaction, or economic activity, does occur. De Soto argues that the extralegal sector consists of dead capital, assets that cannot be used to their full potential. He believes the extralegal sector should be formalized.

Extractive institutions imply unequal distribution of benefits skewed towards those in control of political power. They fail to meet the condition of allocative efficiency. These are welfare
reducing and stem from a concentrated distribution of political power. As a result, these institutions tend to become too centralized. When extractive institutions develop, this creates a soft state, and subsequently soft institutions. The instance of soft institutions exemplifies a fusion between good and bad institutions and the way in which multiple institutions influence society simultaneously. Soft institutions are weak, in that those holding political power can afford to avoid the rules, but the rules themselves are welfare-enhancing and efficient. For example, a tax collection system is necessary to generate government revenue. In the case of soft institutions, political elites can afford tax evasion, yet the institution of the tax system itself is good and welfare-enhancing. In essence, there is a persistent discrepancy between theory and practice. Extractive institutions are inconsistently applied, or exclusive, and ultimately inhibit development.

Characterizing extractive institutions as soft stems from Gunnar Myrdal’s theory of the soft state, which describes a state with grave deficiencies in legislation and the implementation of laws. It also has reverberating effects that soften the rest of the institutional framework. He explains that, “in such a society laxity and licentiousness spread to all social and economic strata. But it is those who have economic, social, and political power who can exploit fully the lack of social discipline in their environment,” (735). As a result, the soft state is an institution, which is highly vulnerable to corruption. Corruption and crony capitalism became increasingly prominent features of the Egyptian economy towards the end of the twentieth century and are thus crucial in explaining the failure of reform measures to enable development to take root.

*Corruption and the Institutional Environment*

Defined as the misuse of public office for private gain, corruption is not just a developing country or Egyptian phenomenon. However, it is a pronounced feature in both. Corruption is an outcome of the soft state, which enables the establishment of patronage networks, or an
extractive institution that distributes benefits to patrons of those in political power. Such a state fails to meet the condition of allocative efficiency. Moreover, corruption arises when the players are able to bend the rules, or organizations are stronger than the institutions that bind them. As such, political elites who wish to consolidate power will strengthen the loyalty of their supporters through the granting of special privileges. Patronage networks emerge to grant political favors, and can ultimately spill over into the economic sphere, resulting in crony capitalism, an economy in which success is driven by close relationships between businessmen and government officials. The informal rules of patronage networks constrain the choices available to the players, and clearly increases transaction costs for the general public. At the same time, they may reduce transaction costs for the government and business elites. The maintenance costs of upholding patronage networks are relatively high due to their inefficiency. The exclusivity, inconsistent application, and high costs involved with patronage networks labels them as development-stunting.

Crony capitalism is an extractive institution, which usually involves corrupt acts. It is clear that a negative stigma is attached to corruption, yet Kang argues that corruption and growth can coexist especially in developing countries with weak institutions (17). If there is a balance of power among a small and stable set of government and business elites, then money politics, what Kang equates to corruption, can reduce transaction costs. His model implies that excessive strength by the government or business sector elites would lead to excess rent seeking, whereas a balance of power limits the discretion of both government and business. Kang writes, “in this mutual hostage situation, both the political and economic elites are powerful enough to harm the other but are deterred from such actions by the damage that the other side can inflict,” (17). If a balance of power situation persists, both groups realize their vulnerability, and prefer to preserve
the status quo, or the secrecy of deals by raising entry barriers, or transaction costs, for outsiders (Bardhan 1326). Bardhan also reviews the effects of corruption on efficiency. He argues that if there are pervasive and cumbersome regulations in developing countries, or obsolete institutions, corruption may actually improve efficiency and help growth. Efficiency could manifest itself in the form of “speed money,” which reduces the delay in moving files through administrative offices or getting ahead in slow moving lines for public services (Bardhan 1323). Here, speed money is a transaction cost resulting from obsolete institutions. Theoretically, if good institutions were in place, speed money would no longer be necessary.

Corruption exists within the government, but also within the public sphere. However, since corruption here is defined as the use of public office for private gain, the primary concern will be with corruption involving government officials. When one considers committing a corrupt act, the individual will consider the expected costs and expected benefits of doing so. The temptation is heightened if the expected cost of a penalty is unlikely. The Egyptian economist Galal Amin argues that, “under certain social conditions, such as those which prevailed in Egypt during the last two decades, both the desire for the reward and the opportunity to get away with it greatly increased,” (21) and corruption became more pronounced beginning with the Infitah under Sadat. During the Mubarak era corruption was a common facet of life and Amin concludes that corruption has itself become the law that cannot be broken, or rather the ‘institutionalization of corruption,’ (43). Corruption was no longer an outcome of weak institutions, but rather an informal institution itself, shaping the interactions of organizations. If corruption has become the rules of the game, then it is fair to claim that certain players were able to modify the rules, or develop their own alternative set of rules. In a soft state, organizations are stronger than the institutions.
Figure 1 provides a visual representation of the theoretical foundations of my argument. The distribution of political power is the primary determinant of the formal institutional framework. Informal institutions are developed exogenously from culture and norms, but also organically to fill in the gaps the formal institutions leave. As institutions develop, maintenance costs are considered, or the costs of upholding the institutions. Both types of institutions limit the choices available to the players, and influence their interactions through transaction costs. External organizations, labeled as external powers, also influence the institutional environment, and can help enable political elites to break the rules. It is important to remember that there are multiple institutions acting on organizations simultaneously, so both good and bad formal and informal institutions exist concurrently, making it hard to isolate and analyze a single institution. The process could be classified as circular causation, in that one change has a domino effect, typically inducing change in the rest of the system.

FIGURE 1
**Institutional Change and Reform**

Since the uprising began in January 2011, countless newspaper articles have indicated that Egypt’s next government must fix the economy that stemmed from the failures of reform during Sadat and Mubarak. In the context of new institutional economics, economic reform is destined to fail if the nature of institutions remains exclusive and/or obsolete. Furthermore, if organizations overpower the institutional framework, then corruption is likely to arise.

Institutional reform requires a more thorough reconstruction of institutions, whereas institutional change is an incremental process. North concludes that institutional change is primarily driven by changes in relative prices (84) and considers this in the context of institutional equilibrium. I will consider a change in relative prices as a change in opportunity costs. Such equilibrium exemplifies a situation in which none of the players would find it advantageous to allocate resources into restructuring agreements, give the bargaining strength of the players and the set of
contractual bargains (86). North notes that this does not imply that both sides are happy with the rules in place, but that the costs of restructuring the rules outweigh the benefits. For example, a change in opportunity costs might be the change in maintenance costs or the expected amount of foreign aid. Sadat perceived that liberalizing the Egyptian economy would derive more benefit in the form of aid from the West, and it was in his advantage to allocate resources into restructuring economic institutions. When formal rules change, disequilibrium ensues, and a new informal equilibrium should gradually evolve after a change in the formal rules (North 88). In other words, informal institutions will gradually match the incentives of formal institutions. As the formal institution of the Egyptian public sector expanded into a large bureaucracy, informal institutions responded through corruption.

Accordingly, how can we account for negative institutional change and a lack of institutional reform in Egypt, exemplified by the persistence of development-stunting institutions? North generalizes the process as follows: Due to increasing returns from an initial set of institutions, there are disincentives for productive activity, which leads to the creation of organizations with a stake in the existing rules and constraints. As the players shape the institutions in their interest, these institutions may provide incentives that encourage military domination of the polity and economy [evident in Egypt], religious fanaticism, or redistributive organizations [evident in the Nasser Era], but there are few incentives from increases in the stock and dissemination of economically useful knowledge and the organizations will develop ideologies that rationalize the institutional framework, and subsequent policies will reinforce the existing incentives and organizations (Institutions, Institutional Change 99). In his article “The New Institutional Economics and Development”, North claims, “if the institutional framework made the highest pay-offs for organizations piracy, then organizational success and survival
dictated that learning would take the form of being better pirates,” (4). The Egyptian institutional framework generally granted the highest pay-offs to elites closest to the regime, so organizations would devote resources to becoming close associates of the regime. It is no wonder that North claims this process as suggesting path-dependency.

Egypt has followed a path dependent process of institutional inadequacy determined by the distribution of political power. However, I have provided insufficient evidence as to what caused this distribution of power in the first place. Concentrated political power leads to extractive institutions, which in turn, ensures the continued concentration of power. It is a self-reinforcing process and a classic example of a causality dilemma. Since the case study is concerned with Egyptian institutions from 1952 to the present, we will begin with the transformation of Egyptian institutions under Nasser and the Free Officers Movement. The 1952 revolution aimed to reconfigure political institutions by overthrowing King Farouk and abolishing the constitutional monarchy. Eliminating the ancien regime meant breaking away from British influence and establishing independence. External European powers, primarily the French and the British, were wary of rising nationalist sentiment in its former territories, and the 1952 Revolution was seen as a threat. In response, Nasser consolidated political power to counter this external threat, but also any internal threats. This was achieved firstly through total control of the military by the regime, and secondly by neutralizing and eliminating other existing centers of power (Vatikiotis 127). Since the 1952 Revolution was a coup d’état and the officers did assume power by force, it was natural for the officers to feel a sense of vulnerability. To abate this fear, the officers sought to control the machinery of the state [institutions] to the exclusion of all the other interested groups in the country. “The elimination of rivals became a precondition of all other measures,” (Vatikiotis 128). Therefore, the distribution of political power reflected the
needs of the Free Officers to secure their position as rulers. The demand for such institutions was high.

Despite little political freedom, Nasser legitimized his position through promoting social welfare. The maintenance cost to supply such institutions was low, because Nasser had the support of the public, which perceived the transformation as desirable. The institutions were also reflective of the time. As a leading proponent of the Non-Aligned Movement during the Cold War, Nasser promoted Arab nationalism to create a region free of foreign power influence in order to promote Egypt’s role as leader of the Arab world (Vatikiotis 225). This helps to partially explain the nationalistic, and inward-looking nature of Nasser era institutions.

The institutions established under Nasser exhibited increasing returns and were self-reinforcing. By increasing returns I mean the more extractive institutions are, the more benefits political elites can derive from the process. Self-reinforcing implies that institutions have developed incentives and complementary institutions, which encourage the preservation of the entire institutional framework. Organizations have a stake in the existing institutions and it is in their interest to ensure perpetuation. Sadat and Mubarak continued to reap benefits from increasing returns to scale by maintaining and extending the network of development-stunting institutions to ensure their continued existence and thus their own power. Additionally, external players, particularly under Sadat and even more so under Mubarak, were largely influential in helping to preserve the existing distribution of political power, and thus development-stunting institutions. In providing foreign aid to maintain stability, external players effectively subsidized the maintenance costs of development-stunting institutions. Despite poor institutions for the general public, the political elites were subject to a far friendlier institutional environment, characterized by artificially reduced maintenance and transaction costs. Consequently, incentives
for institutional reform were also low because at a certain point, the costs of reforming institutions are too great.

In figure 2 I have modeled development-enhancing institutions through the relationship between economic growth, political stability, and marginal benefits and costs. Though stability has a positive connotation, here I have defined stability as indicating constant, predictability, and inflexibility. It encompasses the distribution of political power and its effects on institutions. In quadrant I, the relationship between growth and political stability is quadratic. Moving from the point of origin, at autarky, there is zero growth and zero stability. As political stability increases, economic growth increases. The increase in stability implies political power is strengthening and institutions are being developed. As long as growth is increasing, then institutions are generally inclusive. However, a tradeoff exists between growth and stability. As stability increases, the power of the elites is increasing to a level of too much centralization. Since elites have little incentive to relinquish their power, the decisions of the elites become predictable, and more importantly, inflexible to change. Growth still occurs, but at a decreasing rate. Institutions tend to be extractive. G is defined as the minimum level of growth required, and it is exogenously determined.

In quadrant IV, Point A is a stable equilibrium, which determines S*, the optimal level of political stability in quadrant I. If political stability shifts to the right of S*, then MC > MB and market forces will push the level of stability back towards its equilibrium because it is more costly to operate at such a level of stability. In essence, the checks and balances of development-enhancing institutions will prevent elites from grabbing too much power. If political stability shifts to the left of S*, then MB > MC and again, market forces will push stability back towards equilibrium, when MB = MC.
In contrast to figure 2, figure 3 attempts to model institutional change and the path dependency of development-stunting institutions. I will assume organizations are subject to bounded rationality, and are limited in their decision-making abilities due to imperfect information. Therefore, the optimal outcome is not necessarily achieved. Additionally, I will assume increasing returns to scale because organizations have a stake in the existing institutions and will ensure their continuance. This assumption can be linked to imperfect information. As institutions are shaped more in the favor of particular organizations, organizations derive increasing benefits from maintaining the institutions. Thus, the MB curve is upward sloping and increases at an increasing rate. The MC curve also increases at an increasing rate, just as in
figure 2. In quadrant I, S* does not correspond with the maximum, or optimal level of political stability, due to the assumption of bounded rationality.

Unlike the situation of development-enhancing institutions, development-stunting institutions exhibit an unstable equilibrium. In quadrant IV, MB=MC at point A. If political stability shifts to the left of S*, MC > MB, and political stability will continue to decrease until an extreme outcome is reached. If political stability shifts to the right of S*, then MB > MC. The benefits of more political stability outweigh the costs, and self-reinforcing effects ensue, pushing stability further to the right. At a certain point, S^R, the level of political stability is equal to G, the subsistence level of growth. At any levels of stability to the right of S^R, growth is below the minimum threshold, and there is a potential for revolution. The market forces in quadrant IV push political elites beyond S^R. The model confirms the path dependent process of development-stunting institutions. However, in predicting the inevitability of revolution in the long-run, there is a potential to disrupt the path dependent process.

FIGURE 3
It is clear that Egyptian institutions are more akin to Figure 3. By 1952, Egypt had reached a point beyond $S^R$ and the Free Officers succeeded in staging a revolution and overthrowing the monarchy. Immediately following the revolution, equilibrium was reestablished and Egypt was at Point A. However, Nasser needed to protect his power and ensure his legitimacy by creating more stability, and $S^*$ shifted to the right. The MB outweighed the MC and self-reinforcing effects of increasing stability ensued. Political stability continued to increase under Sadat and Mubarak. Growth was not strictly negative during these time periods, but the overall trend was a decline. The subsequent sections will provide historical evidence of Nasser, Sadat, and Mubarak continually pushing for more stability because the benefits of more stability, and thus more extractive institutions, were increasing, and outweighed the costs of
maintaining the high levels of stability. I will discuss more in detail the various institutional outcomes associated with too much political stability, such as crony capitalism, or corruption.

What attempts have been made so far to combat the market forces, which lead to increasing stability? Beginning in the 1990s, Mubarak initiated a series of economic reforms. In a report published by the IMF as recent as 2007, IMF staff provided a favorable outlook of Egyptian reform and claimed, “the broad-based economic expansion has created many jobs, public finances have improved, and structural reforms have further liberalized the Egyptian economy,” (4). Despite attempts at economic reform, development-stunting institutions in Egypt have persisted. Good governance, including accountability and transparency, implies that institutions are inclusive, which then act as the foundation for sustainable economic development. In effect, real reform should involve a restructuring of institutions as development-enhancing, which as I have shown, is dependent upon the distribution of political power. Institutional reform will facilitate a more conducive environment for successful economic reform policies. The exclusiveness of institutions in Egypt has created a reform process that lacks consensus on the meaning and ramifications of reform among key national stakeholders, and debate with the state over reform is basically limited to major private sector actors, who are often close to the regime or part of it (Alissa 1).

Since the 1980s and 1990s, economic reform has been dictated by the Washington Consensus and was primarily concerned with liberalization of markets, or reduced interference of the state in economic affairs. This neoliberal paradigm contends that the ultimate aim of development is best achieved through growth, which is better realized through free-market forces than state intervention (Nonneman 4). The Washington Consensus implicitly concludes that economic and political institutions must be stronger than the organizations, and organizations
have limited ability to significantly change the institutional environment in their favor. If implemented correctly, the Washington Consensus should not be conducive to immense corruption. However, the consensus is frequently criticized for being a form of free-market fundamentalism, which lacks complete institutional reform. For example, market liberalization is pushed, but the institutions that underlie such a policy are lacking. The same can be said for privatization. If political institutions are exclusive, then the implementation of privatization will likely be an exclusive process.

In terms of implementing reform, Nonneman concludes, somewhat paradoxically that, “a strong state, whether authoritarian or democratic, are much more likely to carry through economic reform than an undeveloped, truly minimal, or unstable political and state system,” (40). However, if the state in question is soft, then reform is unlikely to be sustainable. Again, successful economic reform is predicated on institutional reform. Since the aim of this paper involves the persistence of Egyptian underdevelopment, then as Amin states, “the ultimate goal of economic policy for a country at Egypt’s stage of development, then, is to guarantee (by means of changing the economic structure) a sustainable rise in material prosperity (growth) for the greatest number of people possible (distribution),” (46). Changing the economic structure indicates institutional reform and material prosperity for the greatest number of people possible describes an inclusive institution. Similarly, Sakamoto describes the concept of inclusive development as including good governance, education reform, strengthening vocational training, labor market reform, and small and medium enterprise development (3). In this model, inclusive development is synonymous with development-enhancing institutions.
III. Institutions During the Nasser Era: Social Welfare-Maximizing

In order to understand the state of corruption and economic reform in Egypt today, one should first consider Egypt following the British colonization era and the subsequent 1952 revolution, which ushered in a new era of modernization and reform, based primarily on socialist principles. The Nasser Era spans from 1952 to 1970, though Nasser did not become president until 1956. During this time period, the Egyptian economy was transformed through state-led industrialization, making the public sector an engine of growth. In the context of my institutional model, the distribution of political power was relatively concentrated among the elites, particularly Nasser. This is evident in his ordering of the house arrest of then President Muhammad Naguib, and his subsequent accession of executive office. Nasser’s presidency, along with the new constitution, was confirmed overwhelmingly in a public referendum in 1956. Nasser and the Free Officers Movement were able to reshape the distribution of political power for several reasons, including their status as the sons of migrant lower middle class clerks, an increasingly illegitimate monarchy, and the nationalist struggle against British colonialism, and as preservers of the nation, the new leaders were able to steer Egyptian affairs in a radically new direction (Harb 276). This radically new direction involved a restructuring of formal institutions, the most prominent of which is the Agrarian Land Reform Law of 1952. Prior to the law, a very large percentage of Egyptian land was owned by a very small percentage of Egyptian elite. Law Number 178 of 1952 attempted to redistribute land and prohibited landowners from possessing more than 200 feddans (Vatikiotis 265). Successive laws decreased the maximum amount of land that could be owned. Private property rights, an imperative development-enhancing institution, were subject to uncertainty.

As previously mentioned, economic institutions created the most incentives for the public sector, and the state undertook a major role in providing social services through what came to be
known as Arab socialism. Nasser’s National Charter of 1962 established an agenda of nationalization, agrarian reform (like the aforementioned Land Reform Law), and constitutional reform. The charter exemplifies institutional reform, since it introduces new rules for the players to abide by. More specifically, new policies included secure government employment for those with a secondary school diploma and subsidies for basic foodstuffs, utilities, electricity, and water (Alissa 2). The institutions were social-welfare maximizing.

According to North, revolutions are considered a discontinuous change, or a radical change in the formal rules (89). This radical change ushered in an era of great hope for the future and Egyptians enjoyed sizeable benefits from social welfare policies. The economy experienced substantial growth throughout the early 60s, and it is fair to claim that the standard of living of ordinary Egyptians improved. However, growth was unsustainable, partially due to the Egyptian defeat in the Six Day War of 1967, but also because institutions did not exhibit development-enhancing characteristics. The quality of institutions is subject to the Anna Karenina principle, which derives its name from Tolstoy’s novel that begins, “Happy families are all alike; every unhappy family is unhappy in its own way.” Jared Diamond (157) popularized the principle in his book *Guns, Germs and Steel*. In applying the principle to an institutional framework, a deficiency in institutions in any one of a number of factors condemns the institution a failure. In other words, there are a number of ways in which institutions can be characterized as development-stunting. While economic institutions may have produced temporary prosperity, Nasser was able to manipulate and weaken political institutions, initiating the process of negative institutional change. In terms of corruption, Sakamoto concludes, based on studies from Amin (2011) and Nagasawa (2012) that the Nasser era experienced growth in suppression, but little in corruption, due to the modesty of Nasser’s personal character (7). The suppression of political
parties and consolidation of the ruling elite and an extensive security apparatus characterized the period as authoritarian.

In terms of economic policies, the nationalization of the Suez Canal in 1956 was an enormous success for the popularity of Nasser, but this initiated a series of sequestrations of domestic and foreign enterprises, including the confiscation of commercial banks, insurance companies, and foreign trade businesses as stated in Laws 22, 23, and 24 (Waterbury 68). Secure property rights are an imperative development-enhancing institution that embeds confidence in the institutional framework, particularly for investors. As public sector dominance became the rules of the game, Nasser established organizations, which had a significant stake in maintaining the existing rules. For example, the Economic Organization, established in 1957, supervised all existing public enterprises and mixed enterprising in which the public share was 25% or more (Waterbury 71). Additionally, nationalization policies vastly expanded the public sector, which produced inefficiencies through the increase of the bureaucracy. Harb states that the bureaucracy increased by 161% between 1961-62 and 1970-71 and the number of ministries increased from 15 in 1952 to 28 in 1970 (278). The public sector is not a definitively bad thing, but as Vatikiotis claims, “a public sector run largely by a cumbersome bureaucracy and hampered by a miasma of regulations, licensing requirements and other politically determined controls inevitably led to the attempt by many to bypass or escape them,” (221). While the operation and management of the Suez Canal was largely a success, the remainders of Egyptian state enterprises were far less efficient.

Prior to Nasser, Egypt was largely an agrarian society, so a highly productive agricultural sector already existed, and the expansion of an industrial sector was the next step along the path of development. Nasser’s development policies were conceived through Five Year Plans, which
somewhat paradoxically required participation from the private sector. For example, the Five Year Development Plan for 1960-1965 called for private savings to equal 55 percent of all local investment, private interests would be responsible for 64 percent of all industrial investment, and in the first year of the plan, the private sector was supposed to provide 70 percent of all domestic investments, (Mursi qtd. in Waterbury 72). However, the National Planning Committee had no formal interaction with the private sector (Waterbury, 71). The formulation of development plans without the contribution of the private sector renders the plans exclusive. The choices available to private investors were severely constrained and transactions were costly, especially if companies were at risk of being nationalized.

As for the political repression and security apparatus, Nasser initiated the role of the military in political institutions, which was extended through Sadat, Mubarak, and is still evident in the current state of post-revolution Egypt. Military personnel were common facets of the bureaucracy, especially in the upper echelons of the government. Vatikiotis claims “Nasser did not perceive the role of the army in society strictly as a military institution, but as a bureaucratic system that could administer sanctions, and as an old boys’ network that could dispense patronage,” (160). Nasser strengthened his own position and that of the military, particularly security officers, at the expense of weakening the state institutions like the constitution. Similar to North’s description of the persistence of development-stunting institutions, Nasser recognized the increasing returns available from the Free Officers’ Movement, and the potential incentives from consolidating power. Nasser increased the stakes of the military organization in the existing institutional framework and needed to ensure his regime remained coup-proof. As the regime became stronger, and political institutions more repressive, increasing opportunity costs meant the regime would have to give up more and more of its power in order to establish development-
enhancing institutions. Nasser’s political arrangements resembled a pyramidal structure of power with Nasser at the top, and little room for political competition among lesser groups (Vatikiotis, 172). Since the Arab Socialist Union, established in 1962, was Egypt’s sole political party, Nasser and his confidantes were virtually the only players in the very one-sided game.

Though Nasser did much to raise the social welfare of many Egyptians, the overall institutional framework was very much authoritarian. Nasser was able to secure the support of average citizens in return for universal healthcare, education, employment, and subsidies. The employment program is of particular importance, which Waterbury characterizes as giving teeth to the inclusivist rhetoric of the period (91). Yet, diminishing marginal productivity meant overemployment hurt economic efficiency. The expansion of the public sector was an institutional change advantageous to Egypt’s elites, who reaped the economic and political benefits. The new institutional arrangement lacked any incentives to honestly appraise public enterprises. As a result, competition was suppressed in the economic and political spheres, and average Egyptians had little real say. Nasser initiated the softening of the Egyptian state and undermined political institutions through strengthening his own position at the expense of the masses, and economic institutions followed suit as exclusive.

IV. Attempts at Liberalization Under Sadat

In 1974 President Sadat announced the inception of infitah policies in his October Paper, implicitly instigating institutional change, and pushing Egypt further to the right of S* in Figure 3. As mentioned, the institutional arrangement of the Nasser period was an unstable equilibrium, leading Egypt to an extreme outcome. Though Sadat considered it advantageous to allocate resources towards opening the economy, he also moved towards more political control and rigidity. Maintenance costs, or the government expenditures on social welfare, under Nasser
were too large. External pressure from the IMF and the West also influenced Sadat’s decision and he saw a positive change in benefits in moving from Soviet support to Western foreign aid. In the October Paper, Sadat proclaims, “The conditions in the world today caused by the reshaping of international relation, the emergence of several world powers and because of the status acquired by Egypt and the Arabs since the October War, all these factors provide us with the opportunity to benefit from foreign investments,” (64). In 1974, Law 43 for Arab and Foreign Investment in Egypt was passed, providing the institutional underpinnings for the open-door policy (Waterbury 131). Economic liberalization seems to connote a sense of inclusiveness since barriers to entry are generally reduced, as are transaction costs. On the surface, the policies of Sadat appeared development-enhancing, though in reality, Sadat continued to undermine institutions, just as Nasser. Liberalized economic institutions exhibited a façade of inclusiveness, as did political institutions. Political power was less concentrated during Sadat as compared to Nasser, but decisions were still left to the political elites. Sadat saw little incentive to relinquish the benefits of his own power, and so liberalization was limited. In fact, liberalization policies facilitated the strengthening of patronage networks and rise of crony capitalism, an extractive institution. The players could flout the rules, and corruption escalated. Without development-enhancing institutions underpinning the attempts at economic reform, failure was imminent. Finally, the role of the military in undermining Egyptian institutions is also important to consider. The military began disengaging in direct politics as pushed by Sadat.

Unlike Nasser, Sadat was more welcoming to political diversity, as seen in the eventual demise of the Arab Socialist Union and introduction of a multiparty system. However, Waterbury calls this “controlled liberalization” since a series of laws generally constrained the freedoms of the opposition parties. More specifically, Law 40 required parties to comply with a
specific set of principles, and they could not be similar to existing parties. The Political Parties Committee, dominated by Sadat’s National Democratic Party (NDP), tended to bend the law as they pleased, either purposely expansive or narrowly defined in order to disqualify political opponents from obtaining legal recognition (Cook 69). Sadat undermined political institutions in raising the transaction costs for opposition political parties that strayed too far and while Law 40 was development-enhancing in theory, that is allowing for pluralism, in practice it was applied inconsistently. Since political institutions were soft, Sadat could exploit institutions. Ultimately, the distribution of political power remained concentrated at the upper levels, and did not spread to the general public. In expanding the width of political power at the upper levels, Sadat sought to manipulate political institutions in order to satisfy and gain legitimacy from elites. He also mastered the technique of “divide and rule,” through exploiting intra-elite rivalries and reshuffling elites, to ensure no one elite gained enough support to challenge the president (Hinnebusch 445). The institutions lacked checks and balances. However, somewhat paradoxically, Sadat installed an autonomous Supreme Constitutional Court (SCC) with power of judicial review. Yet, his underlying motive was to attract foreign investment by showing Egypt respected the rule of law. Additionally, the court tended to support Sadat’s economic interests by overturning socialist-oriented legislation from the Nasser Era.

Since economic institutions are intimately linked to political institutions, it is no wonder that economic liberalization policies failed to lead to development, despite Sadat’s adherence to the Washington Consensus prescriptions. The economy grew at an average rate of 8 percent a year between 1974 and 1985, but much of this seemed to stem from windfall rents exogenously determined. Rents, which is income derived from non-productive activity, or with little effort, included petroleum exports, Suez Canal revenues, workers’ remittances, and tourism. With the
exception of petroleum, none of the sources of growth were produced in the industrial sector, despite industrialization being the typical prescription for economic development. Waterbury characterizes the munfatihun, or the “openers” as having direct links to public sector officials and political elite. They traded in influence, inside knowledge, and fixing deals, and were the major beneficiaries of infitah policies (175). Waterbury is describing a system in which the private sector was dependent on public sector patronage, so liberalization was limited in its extent. Sadat also claims in his October Paper, “the public sector will also remain the basic instrument of expressing the national will shaping our national economy,” (58). Clearly, the public sector would continue as an important institution constraining available choices. Furthermore, a large public sector was seen as a useful mechanism to retain the passive loyalty of a large portion of the work force (Waterbury 377). Again, this hints at another attempt of Sadat undermining institutions by raising transaction costs of activities in the public sector through inefficiency.

High-level public sector officials could and did use their office for private gain, signaling corruption. Amin concludes the growth in corruption following the Infitah was closely related to the large increase in state revenues and high rates of economic growth, which increased opportunities for social mobility through corruption (37). Rather than free market capitalism, Egypt succumbed to crony capitalism. The munfatihun were most successful in imports since domestically produced goods were not protected, and thus consumer demand for cheaper imports multiplied. For Sadat, the GDP growth confirmed the success of his economic reforms. However, infitah policies attempted economic reform without institutional reform, and growth based on rents is unsustainable and subject to volatility. On the surface, economic institutions under Sadat projected a development-enhancing appearance. Nonetheless, attempts at liberalization were coupled with extractive political institutions, and the growth from the
liberalization period was difficult to sustain due to the imbalance between political and economic institutions. Political stability in Egypt continued to increase.

Finally, the role of the military in undermining institutions was less extensive under Sadat, and the military was more subordinate to the presidency. Sadat sought to professionalize the military, and limit its role to external defense. Whereas Nasser repressed and often jailed any outspoken critics, Sadat adopted a similar policy but utilized it towards military personnel. He had jailed General Faqzi, arrested General Sadiq, exiled General Shazli, and retired General Gamassi, all high-ranking military officers. Waterbury claims this sidelining of potential alternative power centers allowed for Mubarak’s smooth accession to the presidency, in the sense that there were no entrenched military leaders (376). At the same time, the appointment of Mubarak was a sort of appeasement to the senior military officers. Even if military officers were less visible in the Sadat regime, the emergency law, Law 162 of 1958, has been in effect since 1967 up until May 2012. The law is effectively military rule, which suspends constitutional rights, extends police powers, enacts heavy censorship, and establishes a parallel judicial system. Though it was mentioned that the SCC was relatively independent, the regime could instead rely on the Supreme State Security Court as a result of the emergency laws. This is an unmistakable example of political elites undermining institutions by raising transaction costs for the public.

Though the Egyptian military became more professional under Sadat, it did seek to position itself comfortably in the prevailing *infitah* institutions as *munfatihun*. The beginnings of the economic branch of the military began to emerge. As it tried its hand at direct economic activity, the military portrayed its interests as in alignment with the national interest of economic and social development. However, the softness of institutions meant that the benefits were not truly distributed in the favor of the national interest.
V. Institutional Facades Under Mubarak

The onset of President Mubarak’s rule in 1981 began with his promising decision to release a number of political prisoners. Perhaps Mubarak had realized the maintenance costs of the existing institutions were too great, and thus institutional reform would help secure his popularity and legitimacy. However, his decision brought false hope, and it soon became obvious Mubarak was primarily concerned with maintaining political stability and preserving the status quo of the institutional environment. In the early 80s, annual GDP growth averaged above 5 percent, so “no serious steps were initiated to lay the foundations of an internationally competitive productive apparatus in manufacturing and sophisticated services able to support a rising population,” (Weiss and Wurzel 32). In other words, Mubarak saw little incentive for economic, let alone institutional reform, given the annual growth rates. However, by 1986 the growth rate dropped to 2.65 percent and per capita income fell, the capital account deficit rose, foreign debt increased, and inflation accelerated to more than 20 percent. The drop was a consequence of the 1985-86 oil price collapse, which impacted the economy through rent channels from the Suez Canal, petroleum exports, and remittances from Egyptian workers in the Gulf.4 Macroeconomic indicators seemed to indicate the inevitability of economic reform, and the IMF and World Bank pressured Egypt to adopt its stabilization and structural adjustment programs. Mubarak pursued economic reform measures gradually, leaving the economic and political institutions of the Sadat era largely intact. The military assumed a more extensive role in undermining institutions, primarily as an economic player. Over time, the Egyptian military has tended to increase its engagement with economic institutions at the expense of its engagement with political institutions. However, the military has a stake in maintaining the existing political

4 The World Bank reported Egyptian oil rents from 1981-85 as 32.95, 27.87, 24.52, 24.76, and 21.92 percent of GDP, respectively.
institutions, which allow for its pervasive economic presence. Just as in the eras of Nasser and Sadat, the institutional network of the Mubarak era exhibited imbalances. The incentives of political and economic institutions did not align, and so growth, and ultimately stability, was unsustainable.

Political institutions under Mubarak continued their repression of maneuverability in the political sphere. Mubarak distributed political power as he pleased. Freedom of the press was restricted, and some papers were suppressed, while others became patrons of the government. The government directly appointed editors-in-chief of government newspapers, and other media officials who were willing to implement the directives of power (Amin 143). The dominance of the NDP lay just beneath the surface of the façade of the multiparty system. Elections to the People’s Assembly were consistently subjected to referendums if the government’s desired results were not achieved. Furthermore, the government controlled civil society organizations, and thus mobilized their leadership to support its agendas and programs (Alissa 15). Additionally, Alissa writes much of the Egyptian population had increasingly avoided political activities since political parties and unions were disconnected from the public (15). The lack of political participation is explained by the high transactions costs of interacting in the political sphere. The economic reform measure of privatization did not change the distribution of political power. In fact, Mubarak undermined political institutions through the allocation of economic patronage and restrictive authoritarianism that allowed control of the political opposition and of electoral institutions (Sfakianakis 85). Pratt confirms so-called political liberalization was aimed at maintaining the status quo, not redistributing political power, and multiparty elections distracted observers away from measures taken to strengthen executive control (96). Egypt remained governed by the Emergency Law, and in 2006 Mubarak extended the law, contrary to
his promise to ease restrictions.\textsuperscript{5} In raising transaction costs for those beyond the elite circle, Mubarak stunted the development of inclusive institutions.

As a result of the informal institution of patronage, political and business elites were intimately linked in a symbiotic relationship. In fact, many of the business elites tended to be a part of the regime. Thus, while several political elites recognized the need for reform, it was possible that their position of power would be compromised. At the same time, business elites tended to support reform efforts, particularly the institutions governing privatization. Privatization worked in tandem with patronage networks, and public sector enterprises were typically privatized and distributed through patronage channels to cronies of the regime. As such, benefits were allocated not based on efficiency or innovation, but rather based on the quality of the businessman’s relationship to the state (Sfakianakis 84). The most prominent example of pseudo-privatization is the sale of Coca-Cola in 1993 to Mohamed Nosseir. As a close associate to the regime, Nosseir purchased, with little competition, the El Naser Bottling Company, which had the monopoly rights to bottle and sell Coca-Cola in Egypt. Nosseir resold the factory two years later, at a price reportedly more than triple his cost.\textsuperscript{6} Privatization, as a means of economic reform, occurred in the absence of institutional reform. As such, the political and economic institutions remained largely intact, and so did the distribution of political power. Power was narrowly distributed to the elites, political institutions were exclusive, and so economic institutions were inevitably exclusive in nature too.

In theory, privatization should help promote growth through competition and innovation, but in practice, Egyptian privatization was a soft institution, in which elites could bend the rules

\textsuperscript{5} See news article here announcing extension: http://www.washingtonpost.com/wp-dyn/content/article/2006/04/30/AR2006043001039.html.

\textsuperscript{6} Acemoglu and Robinson relate the story of Nosseir and other Egyptian whales 395-398 and Sfakianakis 88-89.
and manipulate the imbalance between political and economic institutions. Elites undermined reform by redirecting its benefits to advance their own interest (Alissa 9). Additionally, Weiss and Wurzel write of the deficiencies in the legal system, or rather the presence of obsolete institutions. “Many outdated laws and regulations are still enforced without full awareness of their effects, or are retained to protect vested interests of powerful supports of the regime.” (171). The maintenance cost of repressive political institutions is high, but in manipulating economic institutions to assume an inclusive appearance, the regime could offset the high costs of maintaining the status quo. In distributing power among business elites, the regime could also distribute the burden of high maintenance costs. As I mentioned earlier, Kang argues corruption and growth can coexist if a balance of power among political and business elites exists. Under Mubarak, the symbiotic relationship between regime and business elites exhibited a balance of power situation, which was predicated on corruption. If the government’s main constituency is the state bureaucracy and business elites, it is highly unlikely the government will initiate reforms, which would undermine its own constituency.

Finally, the role of the Egyptian military as an economic player significantly intensified under Mubarak. Its disengagement from politics was partial and the political system under Mubarak may have been demilitarized on the surface in the formal sphere, yet the military was still the most important backer of the regime. Cook concludes, “it is the military’s crucial and intimate association with the presidency that ensures the continuity of Egypt’s political system,” (73). The symbiotic relationship reduces transaction costs for military officers. As an economic force, the military produces not only military hardware, but also typical household goods (washing machines, clothes, etc.) and infrastructure. The military reportedly owns factories,
restaurants, and even child care centers. It portrays itself as an engine for growth and development, in hopes of legitimizing its extensive role. The estimates of the military’s stake in the economy vary, but since much of their activity is off budget, a true estimate is hard to determine. Off budget activity was enshrined back in 1979 under Law 32, which “gave the military the financial and institutional independence from the government’s budget and allowed it to open special accounts in commercial banks,” (Harb 285). Law 32 highlights the ability of elites to extract the surplus from society and hamper efficiency. It also enables the institutionalization of corruption. Military elites could legally use their position as a public figure for private gain. In discussing the prevalence of authoritarianism throughout the Middle East, Bellin postulates that, “the low level of institutionalization in the region’s coercive apparatuses constitutes one more factor explaining the robust will of so many to thwart political reform,” (150).

The economic role of the Egyptian military also helped reduce the high maintenance costs associated with development-stunting institutions. If a significant portion of the economy is under the wing of the military industrial complex, then maintenance costs are internalized. In a report by a U.S. Army officer entitled, “The Role of the Egyptian Military in Domestic Society” the author emphasizes the military’s economic role and argues it is an engine for growth and development due to its comparative advantage (Gotowicki 4). The benefits of military production are not necessarily efficient or socially optimal, but rather reduce the maintenance costs associated with development-stunting institutions. Furthermore, the Mubarak regime also sought to lessen the burden of high maintenance costs through its alliances with external players.

primarily the United States. The U.S. supported Mubarak by providing massive amounts of foreign aid, mostly to the military, and in return Mubarak offered the preservation of the status quo, including peace with Israel. Gotowicki asserts the overall role of the Egyptian military has been positive and even states, “the military is also no longer the dominant interest group in the country,” (10). However, his claim is somewhat contradictory since a significant portion of U.S. aid goes to the military, in effect making them the dominant interest group. Egypt has received an estimated $1.3 billion a year in military aid since 1987. Military aid distorts the process of institutional reform and Egypt can extract a geopolitical rent with ease, not only from the U.S. but Arab Gulf states too. The donors tend to avoid vehement support of reform because it is in their interest to avoid the risks of political destabilization (Weiss and Wurzel 204). In a soft state, the bending of the rules by internal players makes it easier for external players to distort and exploit the rules of the game. External players can manipulate the incentives of the institutions in their favor, rather than having incentives that serve the interests of the general public.

VI. The Arab Spring

Thus far, I have adopted a political economy approach of understanding new institutional economics in order to explain Egyptian underdevelopment and failed economic reforms. In light of the revolution in 2011 and the subsequent series of tumultuous events, how can one understand the connection between the institutional environment and the revolution? I have argued that Egyptian elites undermined institutions by increasing transaction costs for ordinary Egyptians. With high transaction costs comes high maintenance costs, and elites had to find the means to cover the costs of maintaining development-stunting institutions. The easiest method

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8 A detailed analysis of U.S. foreign assistance to Egypt is beyond the scope is beyond the scope of this study, though more details can be found in a Congressional Research Service report entitled, “Egypt: Background and U.S. Relations”.

was receiving foreign aid, essentially subsidies for the maintenance of development-stunting institutions. However, elites also very gradually diffused political power. Whereas under Nasser, elites were very narrowly defined, elites under Sadat and Mubarak come to include those in the military, political, and business realms. Admittedly, many elites were part of all three, but *Infitah* policies did expand the width of the elite circle. The burden of high maintenance costs could then be spread among more players.

It has also been shown that an imbalance between political and economic institutions has existed more or less since the Nasser era. If these two types of institutions do not align, then economic reform is doomed to fail. More importantly, economic growth is unsustainable in the long run, which leads us to the Arab Spring. Many of the development-stunting institutions described here (crony capitalism, patronage networks, the Emergency Laws) are obvious triggers of discontent. The cries of “bread, freedom, and social justice” refer to these development-stunting institutions and their outcomes of high unemployment, food price inflation, and political censorship, to name a few. As Amin argues, corruption did become institutionalized under Mubarak (43), and many Egyptians felt there was a lack of opportunities. Amin goes so far as to claim, “as examples of violations of the law increased and people heard of one example of corruption after another in various spheres of life, they grew accustomed to it and stopped expecting anything different,” (43). His claim implies the norms of acceptable behavior, or informal institutions, have changed. However, the Arab Spring is a testament against his claim because Egyptians became fed up with the level of corruption and lack of opportunity. The uprising proves the unsustainable nature of imbalance between political and economic institutions. From figure 3, political stability exceeded $S^R$ and growth dropped below $G$. 
Has Egypt reached a critical juncture with the Arab Spring? Is it an opportunity for Egypt to diverge from its path dependent process? Can significant institutional reform be achieved?

Based on the models of development-enhancing and development-stunting institutions in figures 2 and 3, the marginal benefit curve would need to become downward sloping. The events are still unfolding before our eyes, so it is difficult to postulate the ultimate outcome. Despite criticism of the Morsi government, his election was deemed fair and legitimate. However, there is no denying the massive popular demonstrations that facilitated Morsi’s ouster. Of course, his removal was led by the military, which many are amounting to a coup and it seems that Egypt is back where it began. Mubarak is gone as the face of the regime, and in his place is General El-Sisi. If history provides any clues, then the most recent military coup might revert to repressive political institutions to counter internal threats and secure legitimacy, just as during the Nasser era. Furthermore, external players, primarily Saudi Arabia and the UAE, have been quick to support the coup through offering financial assistance to subsidize the maintenance costs of ensuring the coup’s continuance. In an article entitled “General Sisi’s Greatest Enemy: The Egyptian Economy”, Heineman writes Egypt’s generals have secured $7 billion from the UAE, $5 billion from Saudi Arabia, and $4 billion from Kuwait, none of which are conditioned on any economic reform. Egypt continues to extract geopolitical rent.

The argument exists that Egyptians are tired of the violence and volatility that has encompassed Egypt since January 2011, and Sisi and the military offer a return to stability. But stability under Sisi is likely to be very similar to stability under Mubarak. Heineman states, “but the violent, heavy-handed way in which it [restoring order and stability] has done so has created

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9 Morsi was criticized for granting himself “sweeping new powers” as detailed here: http://www.washingtonpost.com/world/egypts-president-morsi-takes-sweeping-new-powers/2012/11/22/8d87d716-34cb-11e2-92f0-496af208bf23_story.html?wp_login_redirect=0
its own instability, fueling terrorism by underground Islamic groups and anger among some of those who went to Tahrir Square to protest these very police-state methods.” On a more optimistic note, the massive demonstrations against Morsi, in spite of his elected legitimacy, are indicative of inclusive institutions, in that Egypt’s next government must be accountable to the people. If tens of thousands of people can come out into the streets to oppose Morsi, then who’s to say tens of thousands of people won’t protest Sisi if his government isn’t satisfactory? The will of the people through popular demonstrations should not be discredited.

VII. Conclusions
The preface to Why Nations Fail begins with the subtitle “Why Egyptians filled Tahrir Square to bring down Hosni Mubarak and what it means for our understanding of the causes of prosperity and poverty.” This subtitle is a more specific approach in considering the big picture, that is, why are some countries more developed than others? Neoclassical economics predicts convergence. New institutional economics asks why does convergence not occur, and why does underdevelopment persist? In employing an NIE framework, the unit of analysis is institutions, defined by North as the rules of the game. My research is primarily a qualitative analysis, given the limitations in measuring institutions quantitatively. I have focused on how organizations, or the players, interact with and within the institutional framework. As Acemoglu and Robinson claim, the distribution of political power determines the nature of political institutions, which in turn, determines economic institutions. Institutions are not static, but change is gradual, and driven by changes in relative prices, or opportunity costs. Since institutions exhibit characteristics of increasing returns to scale, organizations have a stake in the existing institutions and will continue to solidify the existence of such institutions. In taking the 1952 Revolution as a starting point, Nasser established development-stunting institutions, which
produced self-reinforcing effects, setting Egyptian institutions on a path dependent process. There seems to be little incentive for institutional reform.

The NIE literature places high importance on transaction costs, or those costs associated with interaction between organizations. If transaction costs are low, then the feasibility of economic activity and exchange is high, but as transaction costs increase, it becomes more difficult for organizations to interact. Development-enhancing institutions should reduce transaction costs, thus spurring economic activity and long-run growth and development. However, little is discussed regarding the maintenance costs of institutions. Development-enhancing institutions should also reduce maintenance costs, and create the same effects and incentives as reduced transaction costs. Development-stunting institutions are costly to maintain. Political institutions that extract surplus and inhibit growth require insurance against discontent among the public or alternative power centers. As elites derive increasing benefits from extractive institutions these benefits stem the tide of high maintenance costs. Elites can also look to subsidize maintenance costs from external players, or internalize maintenance costs by diffusing political power among a larger number of elites. In Egypt the sphere of elites gradually increased from Nasser to Mubarak and the military, as a major economic force, could bear the weight of high maintenance costs.

Beginning in the 1990s, Egypt witnessed a series of economic reforms to achieve the objectives of stabilizing the economy and generating sustainable economic growth (Alissa 4). Yet, reforms were largely unsuccessful, ultimately culminating in the January 25 revolution. The chants of “bread, freedom, and social justice” make it clear that reform measures failed. Through a NIE framework, I have sought to uncover the reasons of why economic reforms were inadequate and underdevelopment prevailed. In beginning to develop models of institutional
change through the relationship between growth, political stability, and marginal costs and benefits, I have shown in figure 2 that development-enhancing institutions exhibit a stable equilibrium, whereas the equilibrium of development-stunting institutions (figure 3) is unstable and leads to extreme outcomes. Through historical evidence, my analysis has shown Egyptian society is largely built upon development-stunting institutions. I have identified three important trends in the trajectory of Egyptian institutions that help explain its underdevelopment.

1. Egypt is a soft state, and elites have circumvented and thus undermined institutions from Nasser to Mubarak. In essence, the players are stronger than the rules, which encourages corruption. The military has played an especially prominent role in undermining institutions.

2. A pattern of imbalance between economic and political institutions existed throughout the time period under study. Under Nasser, economic institutions were praised as inclusive and welfare promoting, but political institutions remained highly repressive. Under Sadat and Mubarak, economic reform measures of privatization and liberalization were pushed, but the political institutions were extractive. Rather than capitalism, Egypt experienced crony capitalism. In the long-run, an institutional imbalance is unsustainable and costly.

3. To diminish the maintenance costs of development-stunting institutions, Egyptian elites looked to extract a geopolitical rent by turning to external players for financial assistance to subsidize the regime. In return, Egypt offered stability and peace with Israel. Additionally, the distribution of political power was gradually expanded from 1952 to the present to encompass a larger circle of elites. This effectively spread the high maintenance costs among more players enabling the regime to extend its time in power.
At the same time, it has led to an extreme outcome in which elites are pushed to $S^R$, the point at which revolution can occur, and beyond.

Why does all of this matter for Egypt? Egypt is of geostrategic importance to the Middle East and the rest of the world. It is the most populous Arab country and its policies resonate throughout the region. The momentous events of the Arab Spring are an opportunity for Egypt to alter its institutional path. Rather than gradual institutional change, Egypt can enact institutional reform and properly rise to the leader of the Arab world, as Nasser envisioned. Though authoritarianism manifested itself in different hues under Nasser, Sadat, and Mubarak, the fact remains much of Egypt’s institutional framework has been development-stunting, both extractive and obsolete. The Egyptian military has largely been responsible for the outcome of Egyptian institutions. Thus, for further research, I suggest a detailed comparative analysis exploring the growth of Turkish institutions versus Egyptian institutions. Turkish society is also characterized by a large military presence, and it has witnessed a series of military coups in the mid-twentieth century. Although imperfect, Turkey has been identified as a model for the Arab world of the coexistence between Islam and democracy. An evaluation of Turkish institutions could shed light on recommendations for building development-enhancing Egyptian institutions.

Additionally, it is clear that much research still needs to be done in modeling institutional change and the point at which revolution occurs. If we can understand better what leads institutions down a path dependent process of development-stunting institutions, then better recommendations can be suggested. As for now, the development of Egyptian institutions should be subjected to inclusive planning, in which *all* players, not simply the elites, have a voice in the process. Ordinary Egyptians would be empowered to hold government officials accountable, which would increase the feasibility of achieving social justice. At present, a large portion of the
Egyptian private sector holds close links to the government, curbing the expansion of small and medium-enterprises (SMEs). Ghanem states that nearly half of Egyptians live on between $2.00 and $4.00 per day, much of which is derived from SMEs in the informal sector. Thus, expanding and modernizing the SME sector, or updating obsolete institutions, could provide more and better-paying higher productivity jobs, which helps achieve inclusive growth (30). External to the Egyptian institutional network, Western powers can use foreign aid as a means to realign the incentive of institutions as growth promoting and inclusive. In order to tackle the root of underdevelopment and reform failures, political institutions must first be reformed before economic reform measures are introduced. Only then will economic growth be sustainable.
WORKS CITED


