The Dead Hand of Socialism
State Ownership in the Arab World
By Dalibor Rohac

EXECUTIVE SUMMARY

Extensive government ownership in the economy is a source of inefficiency and a barrier to economic development. Although precise measures of government ownership across the Middle East and North Africa (MENA) are hard to come by, the governments of Algeria, Egypt, Libya, Syria, and Yemen all operate sizeable segments of their economies—in some cases accounting for more than two-thirds of the GDP.

International experience suggests that private ownership tends to outperform public ownership. Yet MENA countries have made only modest progress toward reducing the share of government ownership in their economies and are seen as unlikely candidates for wholesale privatization in the near future.

MENA countries need to implement privatization in order to sustain their transitions toward more representative political systems and inclusive economic institutions. Three main lessons emerge from the experience of countries that have undergone large privatization programs in the past. First, the form of privatization matters for its economic outcomes and for popular acceptance of the reform. Transparent privatization, using open and competitive bidding, produces significantly better results than privatization by insiders, without public scrutiny. Second, private ownership and governance of the financial sector is crucial to the success of restructuring. Third, privatization needs to be a part of a broader reform package that would liberalize and open MENA economies to competition.

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INTRODUCTION

The events of the Arab Spring were not fueled only by demands for more political accountability in countries that had been long governed by autocratic regimes. They also arose from the failure of those regimes to provide access to economic opportunity for their people. The countries of the Middle East and North Africa (MENA) have long suffered from low rates of economic growth and high unemployment, especially among young people.

The lack of economic dynamism in the Arab world has many competing explanations. The most prominent ones emphasize the role played by bad policies and institutions, the corrupting nature of unchecked oil and gas revenue, and the legal and political heritage of Arab socialism. The resulting landscape is thus characterized by barriers to competition, protectionism, legal uncertainty, a high incidence of corruption, and a heavy-handed government presence in the economy. One facet of the socialist legacy in the Middle East is the strong component of government ownership in the economy. In various years over the course of the past two decades, government investment accounted for up to 90 percent of the total investment in countries such as Egypt and Libya.

Some of the MENA countries privatized large parts of their economies in the 1990s and 2000s. These include, most notably, Morocco, Tunisia, Jordan, and Egypt. Others, like Lebanon, have not had a significant legacy of large-scale government involvement in the economy at all. Yet at the present time, several Arab countries, including Algeria, Libya, Egypt, Syria, and Yemen, maintain a sizeable government presence in their economies. Governments tend to run the oil and gas sectors, which are important sources of public revenue, but they are also represented across the board in utilities, financial services, and manufacturing. Precise estimates of the size of government ownership are seldom available, but indirect evidence suggests that government ownership is a large burden on economies in the MENA region.

This paper reviews the available evidence about the size of government ownership across MENA countries, its concentration in different segments of their economies, as well as its evolution over time. It also discusses the existing international evidence about the comparative performance of state-owned enterprises (SOEs). With some exceptions, which are mostly of theoretical interest, private ownership systematically outperforms public ownership. Economies that have scaled back public ownership, including the United Kingdom, countries of Latin America, and the post-communist economies of Central and Eastern Europe, have seen dramatic improvements in the performance of privatized companies, as well as lower prices and higher quality for consumers.

However, the devil is in the details. Different forms of privatization lead to different outcomes. This makes a close reading of international evidence particularly relevant for countries like Egypt, where privatization has provoked a popular backlash in which it has been widely associated with corruption and cronyism. In Eastern Europe, privatization by insiders typically produced worse outcomes than other forms of privatization. It therefore seems important that privatization in MENA countries is done through a transparent process open to as many potential bidders as possible, including foreign companies. It is also important that privatization is not just an isolated policy step, transforming publicly owned monopolies into private ones. Instead, it has to be a part of a broader liberalization package that would also remove barriers to competition in the region, improve the business environment, and reduce the regulatory and tax burden facing entrepreneurs.

Given the ongoing political turmoil in the region and the civil war in Syria, this may seem like an awkward time to discuss privatization and market reforms. In most countries of the region, radical reforms do not seem politically realistic at the moment. In Egypt, the privatization undertaken in the final years of the rule of Hosni Mubarak was not received well
because it allowed a small group of politically well-connected individuals to become extremely rich. Because of an overregulated and opaque institutional environment, privatization generated only limited economic benefits for the general public. Some may argue that MENA countries have to address their political woes before pursuing economic reforms. That, however, may be a mistake, as a growing body of literature suggests that there is a link between political and economic institutions and that it is difficult to conceive of inclusive political institutions without inclusive economic ones as well, which empower the general population. The success of political transitions in the Middle East, therefore, is likely to be conditioned by economic liberalization and reforms that foster sustained economic growth. A far-reaching privatization agenda will be a necessary component of any such reforms.

STATE OWNERSHIP IN THE MIDDLE EAST AND NORTH AFRICA

The study of state ownership in the Middle East and North Africa faces two barriers. First, as a general rule, very little comparable data exist on state ownership around the world. In the 1990s, the World Bank developed the “Bureaucrats in Business” database, which provided comprehensive data for 88 countries over the period of 1978–1991. The database contained information about the share of state-run sectors in the economy and about the performance of state-owned enterprises. However, the database has been discontinued, and it cannot be used as a source of up-to-date information about state ownership in the region. After the waves of mass privatization in Central and Eastern Europe and Latin America, the interest of economists in the subject has declined, resulting in a lack of systematic data about state ownership. MENA governments only seldom publish reliable aggregate information about state ownership in the economy, making it difficult to assess the size of state-run sectors over time and across countries or industries. This is certainly related, in part, to the way these countries have been governed—typically by authoritarian rule, without much regard for government accountability or transparency.

In Egypt, the share of government investment fell from around 85 percent in the late 1990s to below 40 percent in 2012. The magnitude of government investment is a proxy for the size of the government-run sector in the economy. Obviously, the two are not identical—the share of public ownership is a stock, and government investment is a flow. Yet, other things being equal, the larger the share of government investment over time, the larger the share of state-owned enterprises in the economy. The most significant feature of the graph is the large variation in government investment both over time and across countries. In Egypt, for example, the share of government investment fell from around 85 percent in the late 1990s to below 40 percent in 2012. Over the same period of time, the share of government investment in Algeria doubled, from around 30 percent to above 60 percent. Throughout much of the same period, the average for lower-middle-income countries hovered under 30 percent and the average for upper-middle-income countries was just above 30 percent. In Libya, Egypt, Syria, and Algeria public investment represents more than one-half of the total investment at different points in time. In contrast, in countries such as Tunisia, Morocco, or Jordan, government investment is comparatively small, accounting for less than 20 percent of the total. Internationally, public investment in these countries exceeds the world average for lower-middle and low-income countries, which hovers between 25 and 30 percent.

A complementary source of information about the evolution of the size of state-owned sectors of economies over time can be found in the World Bank’s Privatization Database, which provides data on proceeds from privatization over the period of 1998–2008. Obviously, these data need to be taken with a grain
Algeria, Syria, Libya, Yemen, and Egypt have the largest government-run sectors in the region. Of salt, as they reflect not only the fundamental value of assets that were being privatized but also the choice of different privatization methods, leading to a variation in prices of assets that were transferred to private owners. Still, they provide a potentially valuable source of information about the relative size of the state-owned sector. Countries with large privatization proceeds relative to the size of the economy can be expected to have downsized their government-run holdings, whereas countries with low privatization proceeds can be expected to have either expanded their state-owned sectors or left them unchanged. Among MENA countries, Morocco, Egypt, Tunisia, and Jordan had the largest proceeds from privatization between 1988 and 2008 (Figure 2). Incidentally, with the exception of Morocco these also happen to be the countries that recorded significant decreases in the share of public investment in the economy. (Relative to the region, Morocco never had a terribly high share of public investment in the first place.)

Algeria, Syria, Libya, Yemen, and Egypt have the largest government-run sectors in the region. Elsewhere in the region—most notably in Lebanon, Tunisia, Jordan, and Morocco, state ownership is much more limited. This is either because these countries never had a direct experience with Arab socialism in the form in which it was practiced in Egypt or Syria or because they have already undergone—like Morocco, Tunisia, or Jordan—far-reaching privatization.

Many sectors in Morocco underwent successful restructuring, including telecommunications, agriculture, housing, ports, and

Figure 1
Proportion of Government Investment over Total Investment in Selected MENA Countries

Source: World Bank World Development Indicators.
Tunisia has succeeded over time to turn over the bulk of its manufacturing and service sectors to private owners. In the 1990s and the 2000s, the government has partially privatized Tunisie Télécom, the incumbent telecom operator; large parts of the banking sector; and its large cement companies, such as La Société des Ciments de Djebel Oust and La Société des Ciments d’Enfidha.

Jordan has a lingering state presence in its (small) upstream oil and gas sectors, refineries, mining industry, power generation, and financial industry. The government has privatized Jordan Telecommunications Company as well as state cement, phosphate mining, and potash companies. It has also divested its ownership stakes in the national airliner, the Royal Jordanian; the Central Electricity Generation Company, the Electricity Distribution Company, and Irbid District Electricity Company.

Where is government ownership concentrated? Table 1 provides a tentative list of the large state-owned companies in selected countries of the Middle East and North Africa, based on publicly available information. The list focuses on large, widely known examples in prominent sectors of the economy. Its extensiveness is naturally limited by the opaque nature of state
### Table 1
Selected State-Owned Companies in Algeria, Egypt, Libya, Syria, and Yemen

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<td><strong>Oil and Gas/Mining</strong></td>
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<td>Sonatrach (80 percent of all oil and gas production)</td>
<td>Egyptian General Petroleum Corporation (EGPC)</td>
<td>National Oil Company with its subsidiaries</td>
<td>General Petroleum Company (GPC, upstream)</td>
<td>Yemen Petroleum Company (YPC)</td>
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<td>Naftal (principal domestic seller of petroleum-based fuels)</td>
<td>Egyptian Natural Gas Holding Co. (EGAS)</td>
<td>Zawia Oil Refining</td>
<td>Al Furat Petroleum Company (AFPC)</td>
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<td></td>
<td>Egyptian Mineral Resources Authority (EMRA)</td>
<td>RASCO</td>
<td>Sytrol (selling Syria’s crude oil exports on the international market)</td>
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<td>Ganoub El Wadi Petroleum Holding Co. (Ganope)</td>
<td>Brega</td>
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<td></td>
<td>Egyptian Petrochemicals Holding Co. (Echem)</td>
<td>Agoco</td>
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<td></td>
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<td>Sirte Oil Co.</td>
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<td>Jowef Oil Technology</td>
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<td>National Drilling Co.</td>
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<td>North Africa Geophysical Exploration Company</td>
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<td>National Oil Fields and Catering Company</td>
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<td>Waha Oil Co.</td>
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<td>Tamoil (downstream group based in the EU)</td>
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<td><strong>Banking/Financial Services</strong></td>
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<tr>
<td>Crédit Populaire d’Algerie</td>
<td>Banque du Caire</td>
<td>Agricultural Bank of Libya</td>
<td>Commercial Bank of Syria</td>
<td>Yemen Bank for Reconstruction and Development</td>
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<td>Banque Misr</td>
<td>Libyan Foreign Bank</td>
<td>Agricultural Cooperative Bank</td>
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<td>MisrInsurance Holding Company</td>
<td>Umma Bank</td>
<td>Real Estate Bank</td>
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<td>(controlling 60 percent of the insurance market)</td>
<td>Jamahiriya Bank</td>
<td>Popular Credit Bank</td>
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<td>Wahda Bank</td>
<td>Saving Bank</td>
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<td>Sahara Bank</td>
<td>Industrial Bank</td>
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<td>National Commercial Bank</td>
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<td><strong>Power</strong></td>
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<td>Sonelgaz (national electricity and gas distribution company)</td>
<td>Egyptian Electricity Holding Company</td>
<td>General Electricity Company of Libya (GECOL)</td>
<td>Public Establishment for Electricity Generation and Transmission (generation and transmission)</td>
<td>Public Electricity Corporation (PEC)</td>
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<td></td>
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<td></td>
<td>Public Establishment for Distribution and Exploitation of Electrical Energy (sales and distribution)</td>
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The choice of countries—Algeria, Egypt, Libya, Syria, and Yemen—is informed by their significant legacies of socialism, economic planning, and import substitution. The similarities among these countries are not accidental but rather the direct result of a political and ideological legacy common to a large part of the MENA region. Arab socialism established itself in the region in the 1950s and 1960s, typically in the form of one-party political systems, like Nasserism in Egypt or Ba’athism in Syria. Arab socialism typically combined an emphasis on government control of the economy with the ideology of Pan-Arabism. On the international front, Arab so-

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<td><strong>Telecom</strong></td>
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<td>Algérie Télécom</td>
<td>Telecom Egypt</td>
<td>Libya Telecom and Technology</td>
<td>Syrian Telecom is the only provider of fixed-line telephony</td>
<td>Yemen Telecommunications Corporation</td>
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<td>General Posts and Telecommunications Company</td>
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<td>Libyana (mobile provider)</td>
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| **Other Utilities** |              |                                    |                                            |                                            |
| Holding Company for Water and Wastewater | General Company for Water and Wastewater (GCWW) |              |                                    |                                            |

| **Manufacturing**   |              |                                    |                                            |                                            |
| Misr Spinning and Weaving Company | Arabian Cement Co. | General Organization for Textile Industries (running a large part of textile manufacturing industry) | Yemen Economic Corporation (YEC) |                                            |
|                     | Libyan Cement Company (owned partly by the state-run Economic and Social Development Fund) | Libyan Iron and Steel Company (Lisco) |                                          |                                            |
|                     | Libyana      |                                    |                                          |                                            |

| **Transport**       |              |                                    |                                            |                                            |
| Société Nationale des Transports Ferroviaires | Egypt National Railways | General National Maritime Transport Company | Chemins de Fer Syriens | Yemenia (national airliner) |
| Air Algérie         | EgyptAir     |                                    |                                            |                                            |

Source: Author’s research from various sources.
socialism was intimately linked with the idea of international nonalignment, placing Egypt and other Arab countries close to Tito’s Yugoslavia and Nehru’s India on the international scene. Although it rejected Soviet communism, Arab socialism placed a strong emphasis on industrial planning, centralized trade unions, and barriers to trade, which were meant to foster domestic development through import substitution. In the affected countries, although to a varying degree, the rise of Arab socialism typically had four features: (1) nationalization of industry, (2) capture by government of large parts of the banking sector and financial services, (3) introduction of price controls and subsidies, and (4) the use of oil wealth as a source of funds for patronage.

As one would expect, governments in these economies are operating large parts of the oil and gas industry, utilities and telecom, banking, and even manufacturing. The appendix provides detailed overviews of state ownership and privatization attempts in each of these countries. Of these five countries, only Egypt implemented a sustained privatization program in the final years of President Hosni Mubarak’s rule, resulting in a marked decrease in the share of state ownership in the economy. Companies that were being privatized, in whole or in part, included Telecom Egypt, Bank of Alexandrie, and Commercial International Bank, as well as companies providing transport infrastructure, communications, and energy. The process, spearheaded by Mubarak’s son, Gamal, was accompanied by widespread allegations of corruption and cronyism, and has been brought to a halt by the events of the Arab Spring. In contrast, Algeria, Libya, and Syria undertook little or no privatization. Yemen proceeded with a divestiture of shares in Yemen Mobile, a mobile operator, in 2006.

ARE SOES HOLDING BACK MIDDLE EASTERN ECONOMIES?

Before the Second World War, even many pro-market economists, such as Henry Simons or Lionel Robbins, accepted that the government ought to take over industries that could not be run effectively under conditions of open competition. Those included, most prominently, utilities or railways, in which competition was seen as impracticable due to the nature of network externalities. However, today such situations are no longer seen as necessary or sufficient conditions for the desirability of state ownership. Even in cases when the government does want to provide a specific good or service—which may display positive externalities or public-goods characteristics—there are good reasons to contract its provision out to the private sector instead of relying on production by the government. In theory, state ownership and provision of goods and services directly by the public sector seem desirable only under very limited conditions, such as when strong incentives to maximize profit or minimize costs could lead to undesirable outcomes (e.g., national security). Otherwise, private ownership will tend to outperform government-run provision for two main reasons.

First, there is the problem of incentives created by public ownership. The separation of ownership and control in modern corporations creates a problem of asymmetric information and misaligned incentives—the management can choose to shirk or maximize the perks of the office instead of corporate profits. In publicly traded companies, this problem is mitigated by the financial market. Bad economic performance by the firm will lead investors to exit. Such a mechanism is absent in the case of public ownership. At most, the government can threaten to replace the current management unless some pre-specified goals are met. However, this does not create strong incentives to reduce costs or innovate beyond the minimum required by the government. Furthermore, if state-owned companies are expected to meet different, and sometimes conflicting, objectives, such as maximizing revenue, maximizing output, providing employment, and so on, then monitoring their performance becomes even more problematic.

Second, state ownership often goes hand in hand-in-hand with an absence of competition.
It is no coincidence that state-owned enterprises typically operate in noncompetitive environments. For example, governments have often invested a large amount in the fixed costs of establishing utility businesses in sectors with large network externalities. The vertical integration of such businesses makes competitive entry difficult, even in the absence of formal restrictions on competition. Worse yet, after starting such a business, the government faces incentives to erect barriers to competition that could threaten to drive the state-owned incumbent out of business—much in the same way as private entrepreneurs would like (if they could) to keep their competitors out of the business through statutory barriers. As a result, government ownership will tend to be associated with noncompetitive market structures, to the detriment of consumers.

The experience of many countries around the world, particularly in the developing world, vindicates the idea that private ownership outperforms public ownership. A study of SOE performance in 12 West African countries in the 1980s found that 62 percent of the companies under consideration reported net losses and 36 percent were operating at negative net worth. These results are not specific to Africa. For example, a 1994 study of 61 companies from 18 countries and 32 industries between 1961 and 1990 showed that SOEs that were transferred into private hands “increase[d] real sales, [be- came] more profitable, increase[d] their capital investment spending, improve[d] their operating efficiency, and increase[d] their work forces.” Moreover, the effect of privatization on firm performance is remarkably consistent—providing strong evidence for the superiority of private ownership. “This consistency is perhaps the most telling result we report—privatization appears to improve performance measured in many different ways, in many different countries,” wrote economists William L. Megginson and Jeffry M. Netter in their survey of empirical studies on privatization around the world.

Countries that have had extensive experience with state and private ownership include the formerly planned economies of Eastern Europe, but also many countries of the West. The United Kingdom, for instance, underwent a far-reaching privatization program during the Thatcher era, and was followed by Germany, Italy, and Spain—and Latin America. In all these regions of the world, the basic results were the same—private ownership generated substantial efficiency gains and resulted in better-functioning industries.

**Experience From Transitional Economies**

Focusing on transitional countries of Central and Eastern Europe, numerous studies have found that, broadly speaking, privatization improved the performance of enterprises. According to Megginson and Netter, private ownership is associated with better firm-level performance than is continued state ownership.

In turbulent transitional environments, a mere formal transfer of property did not guarantee the creation of a vibrant private sector, especially if the newly created property rights could be challenged or if governments could renege on the decision to privatize. The economists Clifford Zinnes, Yair Eilat, and Jeffrey Sachs found that when privatization occurred in good institutional environments, it had an unambiguously positive effect on corporate performance. The examples from Central and Eastern Europe were numerous. Some privatized companies developed global brands following their privatization, including Škoda Auto in the Czech Republic or the Żywiec Brewery in Poland. The privatization of others, like the oil and gas company MOL in Hungary, gave an impetus to the development of local financial markets.

However, such strong positive effects were missing when privatization occurred in bad or dysfunctional institutional environments. In some countries, including Russia and the post-Soviet republics, privatization was followed by stagnation and decapitalization of companies, instead of better financial results and increased efficiency. But even under bad institutions, privatization did not produce outcomes
Privatization in the UK was associated with higher rates of profitability, higher productivity growth, and overall efficiency.\(^\text{17}\)

Privatization in the UK

The United Kingdom is the most prominent example of a large-scale privatization undertaken in an advanced industrial economy. Following the election of Margaret Thatcher, the government first privatized British Aerospace and Cable and Wireless in 1981, Amersham (a pharmaceutical company) in 1982, followed by British Shipbuilders, the National Freight Corporation, British Telecom, and British Gas, among other enterprises. Later, in the 1990s, British Railways and the National Express—the inter-urban coach transport provider—were privatized as well.

Overall, privatization in the UK was associated with higher rates of profitability,\(^\text{18}\) higher productivity growth,\(^\text{19}\) and overall efficiency.\(^\text{20}\)

Obviously, there were exceptions—especially in sectors with little competition, such as telecommunications or utilities, where privatization did not always lead to unambiguous and clearly measurable improvements. Its success was thus related to the presence of genuine market competition. As David Parker, the UK Government’s Official Historian of Privatization, noted “[m]anagement in monopolies may seek an ‘easy life’ whether in the private or public sectors; while in private-sector monopolies management can meet investors’ expectations of profits by simply raising prices.”\(^\text{21}\)

Privatization in Latin America has been controversial in part because of corruption allegations surrounding large privatization tenders, such as the sale of Aerolíneas Argentinas, or the Argentinian national telephone company ENTel.\(^\text{25}\) In contrast to some of the criticisms raised against privatization, very little evidence exists that would indicate market-power abuses, exploitation of workers, or an erosion of fiscal revenue. In their review of evidence on Latin American privatizations, economists John Nellis, Rachel Menezes, and Sarah Lucas argue that even in countries where the unemployment rate rose in the aftermath of large privatization programs, those were caused by “external shocks, labor market rigidities, and financial indiscipline—not just privatization. It has even been argued that privatization may have mitigated unemployment—that, absent privatization, unemployment levels would be higher.”\(^\text{26}\)

Privatization in Latin America received a lot of flak because of its often ambitious nature, covering areas that had traditionally been under government control, such as public utilities. But even in those areas, compelling evidence suggests that privatization produced good outcomes. A famous study of water privatization in Argentina, for example, shows that it led to a dramatic reduction of infectious and parasitic diseases among children, and to a fall of 5–7 percent in child mortality in municipalities that privatized their water provision.\(^\text{27}\)

Effects of State Ownership in MENA

True, in contrast to the transitional countries of Central and Eastern Europe, Western Europe, or Latin America, systematic evidence about the comparative performance of state-owned enterprises in the Middle East and North Africa is still lacking. But one area
The Middle East and North Africa have fewer non-oil exports than Finland or Hungary, but more than 20 times the population of both those countries combined.

“...has attracted significant attention: the banking sector. Particularly in Egypt, banking was in large part privatized and opened to foreign competition. Even at the early stages of the privatization process, banking privatization prompted an inflow of capital and stimulated stock market activity. Moreover, state-owned banks lagged behind their private competitors—not just in terms of profitability or competitiveness, but also in terms of their capital adequacy, asset quality, earnings, and profitability, which can be partly explained by their heavy holdings of government securities. State banks also had higher costs due to inefficiently large staffing.

It may be difficult to disentangle the effect of state ownership from the broader context of heavy-handed industrial policies, which have been part of the economic landscape of MENA countries for decades. It is safe to say that the economic outcomes in these countries do not easily lend support to the view that governments are well equipped to pick economic winners and foster their success. Instead, as a study published by the Egyptian Center for Economic Studies finds, “[t]he continued strategies of import protection and inward orientation in MENA have resulted in significantly weakened trade, with trade-to-GDP growth at about half of the world’s pace since the 1980s. The region’s exports are dominated by oil, with only the small number of resource-poor and labor-abundant economies developing fairly well-established non-oil export sectors. The entire MENA, with a population close to 320 million, has fewer non-oil exports than Finland or Hungary, with populations of 5 and 10 million, respectively.”

Why do state ownership and industrial policy exist, and why do they seem so entrenched in some parts of the MENA region? Clearly, the pursuit of economic efficiency by governments cannot provide us with an adequate understanding of the persistence of these institutional arrangements. Instead, it is sensible to think that state ownership is one of the tools used by political elites for the pursuit of other, potentially self-seeking, ends. Policymakers can use state-owned enterprises to create networks of patronage and to create excessive employment and investment in areas that generate political payoffs. Obviously, such payoffs are not aligned with the long-term interests of the enterprises and are shielded from the feedback mechanisms of the marketplace because state-owned enterprises face only soft budget constraints and their shares are typically not publicly traded. A study of Algeria found four factors that impeded the privatization process: (1) the constant struggles over rents between different interest groups, which prevent the emergence of coherent reform strategies; (2) interest groups in the form of military and bureaucratic “clans,” which derive rents from the status quo; (3) the role of SOEs in providing clientelist social assistance and patronage to specific parts of the population; and (4) the prevalence of “nationalist, étatist, socialist, and collectivist ideology.” It is evident that all of these factors are at play throughout the MENA region.

**Toward Successful Privatization**

There appears to be only one lasting solution to the problem of large state-owned sectors: privatization. The existing efforts to improve the corporate governance of state-owned enterprises—spearheaded in part by the Organization for Economic Co-operation and Development (OECD)—are unlikely to produce anything but minimal improvements. Plausibly, they will have no effect on the operation of SOEs in the region. These initiatives focus on a clearer control and streamlining of governance in SOEs. They stress coordination among different bodies of government as well as transparency. The ultimate aim is to create a level legal playing field in which SOEs will be treated by the law in the same way as private enterprises—something that cannot be considered the norm in the region.

It would be farfetched to think that the perverse effects of state ownership on economic efficiency could be mitigated by a new set of rules about how the SOEs are managed.
If that were the case, it would be difficult to explain why state ownership produced bad outcomes in advanced Western economies like the United Kingdom or Sweden that decided to pursue radical privatization agendas. If “corporate governance” reforms were not enough in countries with a high quality of governance and low rates of corruption, how can one expect them to address the problems of SOEs in countries that are plagued by government mismanagement, corruption, and weak legal norms?

If better guidelines on corporate governance were implemented as intended, the corporate governance guidelines might limit the extent of outright corruption, embezzlement, or patronage, which without any doubt affect the SOEs. However, for their proper functioning, companies need more than a tighter governance structure. The managers need to face correct incentives to react to market demand and even to restructure the company when necessary. That is difficult without real accountability to private shareholders, and without hard budget constraints. It is equally unclear how managers of SOEs can gather the knowledge needed to restructure the companies in the appropriate way unless subjected to the feedback mechanism of profit and loss. To be sure, “stronger monitoring” from the center is often advocated as a solution to this problem. But unless the government can credibly threaten to close down the business in question—which is easier said than done—such monitoring remains more a wish than a real policy option. This is not to speak of the fact that the government will not know any better than company managers what the desirable forms of restructuring are, or how to react to shifts in consumer demand, underlying technology, and so forth. As a result, SOEs can be expected to be less responsive to shifts in consumer demand and technology. Because their existence depends on government fiat instead of passing the market test, they are shielded from the creative destruction that characterizes competitive markets and, over time, can become a large liability for the whole economy.

It is true that governments can botch the process of privatization, but at the very least, under security of private property, the irreversible transfer of control to private hands prevents further government intrusion into the management of the former SOEs. Three main lessons emerge from the experience of large-scale privatizations around the world.

**How to Privatize**

Not all forms of privatization produce equally good outcomes. In theory, if the costs of transacting are low, then the initial assignment of private property rights does not matter very much. Through the functioning of financial markets, the resources of privatized SOEs will be quickly directed toward the most valuable uses. Inefficient plants will quickly be closed, promising operations will be expanded, and capital will quickly be deployed to its most valued uses.

In reality, however, there are important transaction costs, particularly in environments with imperfect capital markets and imperfect legal norms. In such cases, it does matter who is assigned the initial property title and how. That explains the one regularity about privatization in post-communist countries—namely that privatization by insiders led to worse economic outcomes than other forms of privatization. Studying the performance data of companies in Moldova and Georgia, economist Simeon Djankov finds that the degree of restructuring in state-owned companies and in companies that were privatized by their managers were similar—and lower than in cases when the company was purchased by an outside investor. Similarly, a literature review by Megginson and Netter singles out privatization by insiders as problematic. For a number of reasons, insiders, such as entrenched factory managers, can be tempted to use their position to strip the company of its assets. Unlike outside investors, insiders might also lack the knowledge and acumen necessary for the needed restructuring, particularly if they only became insiders in the first place thanks to their political connections.
Most studies of privatization in transitional economies suggest that investors who are outsiders and have experience with the relevant market are instrumental to the restructuring of formerly state-owned companies and to helping them become financially viable.

In spite of its apparent virtues, there are limitations to the extent to which privatization by strategic investors can be implemented, especially if the government is seeking to privatize on a large scale. This is because finding the right strategic investor takes time, and it is not obvious that there is always a good match for any given state-owned company. Furthermore, sales of public property to foreign corporations can become a contentious political issue. Such privatizations can potentially lead to reversals, especially if they are perceived as unfair or if they involve large losses of employment.

More importantly, Arab governments should avoid turning privatization into a gradual process of picking politically desirable prospective owners. Because governments do change after elections and because privatization is often a contentious matter, prolonging the privatization process creates a risk that it will be left unfinished or reversed.

One of the methods used in some transition economies to quickly privatize at massive scale in a way that was perceived as fair was voucher privatization. It was implemented with varying degrees of success in the former Czechoslovakia (and the Czech Republic) and in Poland, and—to a smaller extent—in Russia. As Box 1 explains, voucher privatization came under a lot of criticism, yet it proved to be a very effective tool for large-scale privatization.

The large scale of the newly created private sector and the mass character of privatization in those countries, which often involved the population at large as potential shareholders, were seen as a greater constraint for potential renationalization. It is most likely harder electorally to go against the interests of many citizen-shareholders than to go against those of a few capitalists, particularly if they are foreign. A feared side effect of mass privatization through vouchers was that it would result in a dispersed structure of ownership—a fear that did not materialize.

The role of the Eastern European experience for the Arab countries is not to slavishly copy the example of voucher privatization. However, in countries where a large stock of government property is to be transferred into private hands in a short period, governments would be well advised to follow some method of mass privatization, potentially including vouchers. More important than the somewhat technical choice of the specific privatization method is the transparency of rules guiding privatization and the openness of the sale process to a wide section of potential buyers, thus mitigating the danger of allowing incumbent managers or government cronies to simply gain control of privatized firms.

The Role of Banks and the Financial Sector

The financial sector is important because financial intermediation is a crucial factor affecting corporate restructuring and firm growth. A widely recognized pitfall of the privatization in Czechoslovakia—and later in the Czech Republic—was the emergence of the so-called “banking socialism.” During the mass voucher privatization, state-owned banks became major owners throughout the newly privatized Czech companies. This happened because banks’ mutual funds bought vouchers from the general population and quickly established large ownership shares throughout the economy. Simultaneously, banks remained practically the only source of capital to privatized enterprises. However, the banking sector remained dominated by large state-owned banks. This hampered the much-needed restructuring of privatized companies. As the Czech economist Eva Kreuzbergová noted, “the overall dependence of the economy on banks coupled with their imprudent credit practices led in particular to the prevalence of soft budget constraints and incidence of various forms of moral hazard. These iniquities emerged above all due to the omnipresence of the state (specific encouragement to extend credit or general expectations
In the Czech Republic the voucher program accomplished its role of transferring property into private hands in a durable way and over a short period.

Box 1

Voucher Privatization

Voucher Privatization was a method of mass privatization deployed in transitional economies including Czechoslovakia, Poland, and Russia in the 1990s. It relied on a distribution of vouchers to the general population, available for a small fee. These could be exchanged for shares in state-owned enterprises. These exchanges occurred in the form of simple auctions that only used vouchers, typically denominated in “points,” for the bidding. The Czech privatization scheme used a centralized bidding process to set the “prices” for the shares on the basis of the difference between existing demand and the available number of shares. In Russia, such a process proved to be too complex, given the amount of state-owned property that was being privatized, and instead decentralized auctions were used to sell of government-owned assets.

The governments in Czechoslovakia and Poland decided to only include larger enterprises in the voucher programs, while selling small business like shops or restaurants directly for cash. There were two main reasons for using vouchers instead of direct sales for cash for larger companies, and both of them were political in nature. First, in the formerly centrally planned economies the distribution of wealth typically reflected individuals' status within the former regime. It was thus feared that direct sales would lead to a concentration of assets in the hands of former communist elite and/or individuals involved in organized crime, making privatization even more contentious. Second, it was expected that mass participation in privatization would create a strong constituency that would prevent reform reversals in the future.

The voucher privatization was surrounded by controversy. A 1998 OECD country report, for example, claimed that the rapid voucher privatization “impeded efficient corporate governance and restructuring.” However, there is evidence that in spite of its possible pitfalls, Czech privatization did result in superior performance of privatized firms relative to those that remained in the hands of the government.

However that may be, in the Czech Republic the voucher program accomplished its role of transferring property into private hands in a durable way and over a short period. By the end of 1994, the Czech Republic had advanced the furthest in terms of the share of its private sector, with some 75 to 80 percent of its enterprises privatized. This compares to roughly 55 percent in other Central European countries, and much less in countries of the former USSR.

that the state would bail out the banks in case of trouble), mixing of ownership and credit relationships within the banks also due to the deficient legal and institutional framework.”

State ownership of the banking sector and a lack of properly functioning capital markets were a barrier to restructuring in other transitional economies—most notably in Slovakia—although the methods of privatization used there were different. In contrast, similar troubles were largely avoided in Hungary, Poland, and Slovenia, which privatized their banking sectors early on. This suggests that unhampered capital markets are an important prerequisite for successful restructuring after privatization. State ownership of the banks, particularly in countries with weak institutions, can easily damage the privatization process, particularly in cases when the elected politicians have an interest in postponing unpopular restructuring. Bank privatization should therefore be high on the agenda for the countries under consideration—particularly because they all have a sizeable government presence in the banking sector.

Privatization as Part of a Broader Reform Package

In Eastern Europe, privatization was one of the most contentious aspects of economic transition. Some critics argued that “rapid mass privatisation [...] was a crucial determinant of differences in adult mortality trends in post-communist countries.” Although that claim is difficult to sustain, the experience of transitional economies and also Western Europe suggests that, in and of itself, privatization is not a guarantee of the emergence of competitive private markets and the socially beneficial outcomes they produce.

An obvious risk in privatization involves turning a public monopoly into a private one. This risk is particularly salient in the case of utilities with high fixed costs of entry or industries that enjoy legal barriers to competition in the form of licensing or regulation meant to protect state-owned incumbents. In the MENA region, the barriers to business activity and competition are considerable, as is their potential for capture by special interests. In the World Bank’s Doing Business report, measuring the administrative ease of conducting business activities, Egypt ranks 190th in the world, Yemen 118th, Syria 144th, and Algeria 152nd. These are indicative of the barriers to competitive entry, which take the form of cumbersome legal rules surrounding registration of new business, obtaining various permits, paying taxes, and so on. In Yemen, for example, it takes 6 procedures, 40 days, and costs 66 percent of annual per capita income to register a new company. In Algeria, the process takes less time and is less expensive but it requires going through 14 different steps. In MENA, obtaining a construction permit takes, on average, 146 days and costs 283 percent of annual income per capita. The effects of such an unfavorable environment for business are obvious—it stifles economic activity and drives it underground, instead of promoting competitive markets and employment in the legal economy. The Peruvian economist Hernando de Soto, an expert on the economics of property rights, found that back in 2004 “Egypt’s underground economy was the nation’s biggest employer. The legal private sector employed 6.8 million people and the public sector employed 5.9 million, while 9.6 million people worked in the extralegal sector.”

Existing consumer subsidies to fuels, food, and other consumer products are also a problem as the disbursement of price subsidies requires government control of the supply chain to curb the emergence of black markets. In food and energy markets, subsidies have thus favored incumbent firms. They have come hand-in-hand with other distortions, including protectionist measures. Although Egypt faces severe resource limitations, especially when it comes to land and water, the government is encouraging the production of cereal crops, with per hectare yields that are a fraction of the average of those in developing countries. Such policies are counterproductive, given the country’s natural resource constraints, which make Egypt unlikely to become self-sufficient in
Privatization in the Middle East and North Africa should not be considered in isolation but rather as a part of a broader package of liberalizing reforms. Food production. Because robust private markets and international trade are effective cures for food insecurity, the government should allow the agricultural and industrial sectors to expand their exports by simply removing barriers to competition and trade.48

The energy sector in Egypt—where the bulk of the subsidy spending is directed—has been marked by heavy-handed government involvement as well. The combination of subsidized prices and government-controlled refining and distribution of petroleum products deters entry and leads to persistent shortages. The government-operated Egyptian General Petroleum Corporation controls a large part of oil production and upstream activities, including imports of crude oil and refining. Similarly, the Egyptian Natural Gas Holding Company, run by the government, manages not only the exploration of natural gas, but also other aspects of the natural gas industry, including the use of liquefied natural gas. The government is involved heavily in downstream activities as well. In terms of sales of gasoline, the government-run Misr Petroleum controls 33.5 percent of the Egyptian market, and another 30 percent is controlled by Petroleum Cooperative Society, an arm of the Egyptian General Petroleum Corporation.49

Although some progress has been made in reducing trade barriers in the region, fully integrated markets do not yet exist in the Middle East and North Africa. On its own, the Egyptian government can nonetheless facilitate trade integration by removing the most direct barriers. For instance, because of its complicated border clearance procedures, the country ranks poorly on the World Bank’s Logistics Performance Index (92nd in the world), a survey-based assessment of trade logistics around the world. On the same survey, Algeria ranks 130th, Libya 132nd, Syria 80th, and Yemen 101st.

These examples are mere illustrations of the institutional and regulatory features that hamper competition, thus favoring government-owned incumbent companies over new entrants. As a result, privatization in the Middle East and North Africa should not be considered in isolation but rather as a part of a broader package of liberalizing reforms that will enhance competition by cutting red tape and unnecessary regulation and opening the economies to foreign trade and investment.

CONCLUSION

It is a mistake to think that economic reforms can wait until Middle Eastern countries address their internal political and economic problems. There are not many examples of countries that have transitioned successfully to a representative constitutional government while maintaining economic rules that deny opportunity to large segments of the population. State ownership, accompanied by regulations that favor existing state-owned incumbents, are a critical part of the problem facing countries in the MENA region, most notably Egypt, Libya, Algeria, Syria, and Yemen.

In order to address this problem, privatization has to cease being a dirty word, and policymakers in the region have to start envisaging ways in which the ownership of the public sector could be transferred to private hands. The choice of privatization methods will be crucial not only for the economic success of privatization in producing superior economic outcomes, but also for its popularity among the general population. In order to avoid the backlash seen in Egypt, privatization needs to be—and be perceived as—fair, transparent, and open to a large spectrum of potential bidders, and not as a process that enables government cronies to become rich. The privatization process also ought to be open to foreign investors, in part because of the large potential gains in terms of transfers of know-how, technology, and access to overseas markets. In countries with very large public sectors facing potential reform reversals, policymakers ought also to consider options for mass privatization, which emulate and improve upon the best practice by Central and Eastern European countries in the 1990s. If governments in the region are serious about creating mass prosperity, reducing the role of public ownership should be one of their priorities.
APPENDIX: STATE OWNERSHIP IN SELECTED COUNTRIES OF MIDDLE EAST AND NORTH AFRICA

Algeria

According to some estimates, roughly two-thirds of the Algerian economy is state-owned. The country’s sizeable oil and gas sector is dominated by the state-run, vertically integrated oil and gas company Sonatrach, which controls a dominant part of oil and gas production. Sonatrach owns the leading distribution company, Naftal, with some 10,000 gas stations in the country. Algeria’s financial sector, telecom, and air transport are dominated by the state, and prospects for privatization seem uncertain. Throughout the 1990s and the 2000s, Algeria undertook only very minimal privatization efforts.

Egypt

Similarly, Egypt has a long tradition of government ownership. Between 1952 and 1956, most of Egypt’s industry, manufacturing, trade, and services was nationalized. State control of foreign trade and progressive taxation were introduced and the property of the six hundred wealthiest families was seized. In 1952, a land reform was introduced, which expropriated large land owners and introduced collectivized organization of agriculture. Government ownership of the industry and active industrial policy persisted until the early 1990s, when a series of liberalizing reforms were undertaken—although many of the features of the traditional, state-heavy model have persisted until the present.

In the oil and gas sector, the Egyptian General Petroleum Corporation (EGPC) controls upstream oil exploration and production, which accounts for 20 percent of Egypt’s oil output and 86 percent of refining capacity—as well as a large part of the downstream oil sector, dominated by EGPC’s subsidiaries. Similarly, the state-run Egyptian Electricity Holding Company (EEHC) controls the electricity market and the largely state-owned Telecom Egypt the fixed-line telephony market. Financial services are dominated by large state-owned banks: BNE, Banque Misr, Banque du Caire, and by two state-run insurance companies. Besides utilities, such as water management, the government is also involved in transportation, owning both the national railway company and the national airliner, Egypt Air.

Furthermore, the government is also involved in manufacturing—prominent examples include the Misr Spinning and Weaving Company, established in 1927 as the first mechanized textile company owned by Muslim Egyptians. Anecdotal evidence suggests that the Egyptian military controls a large network of manufacturing and service companies, but specific estimates of the magnitude of military ownership in the economy are wildly divergent, ranging from 5 to 40 percent of the country’s GDP.

Although a large part of the Egyptian economy is state-run, the government in the 1990s and 2000s pursued a substantial privatization agenda. The initial privatization process in the second half of the 1990s pertained mostly to smaller manufacturing enterprises. In the 2000s, several large privatization deals were made, including the privatization of large cement companies, 20 percent of the shares of Telecom Egypt, a partial privatization of Bank of Alexandria and of Commercial International Bank, as well as numerous manufacturing enterprises. Orascom, the largest private company in Egypt, controlled by the entrepreneur Naguib Sawiris, gained control of parts of Egypt’s transportation infrastructure, communications, and energy. The company, started as a family business, has been called “undoubtedly the largest and most impressive of MENA’s success stories,” with a presence across the region and with stocks of its communications subsidiary traded on the London Stock Exchange. The privatization process in the late 2000s, promoted by President Hosni Mubarak’s son, Gamal, proved to be unpopular, particularly due to allegations of corruption and cronymism, through which people close to the regime gained control of assets worth much more than their sales prices. According to Magda Kandil, the head
Libya’s private economy is dwarfed by its enormous oil and gas sector, which accounts for roughly 80 percent of the country’s GDP.

Libya

Libya’s private economy is dwarfed by its enormous oil and gas sector, which is run by the government and accounts for roughly 80 percent of the country’s GDP and 95 percent of its export earnings. Other than oil and gas, Libya has an extremely underdeveloped private sector, with most of the investment in the economy coming from the government and heavily dependent on oil revenue. The manufacturing industry and services have seen negative rates of productivity growth since the 1990s. Unsurprisingly, the country’s banking sector is dominated by state banks, in spite of dilutions of state ownership in some of the state-owned banks in the final years of Qaddafi’s rule.

Syria

Since the ascent of the Ba’ath Party and the wave of nationalization in the 1960s, Syria has had a long-standing tradition of government involvement in the economy. Syria has long been a planned economy that followed the strategy of import substitution. For practical purposes, that meant industrial planning and tariff and regulatory protection against foreign competition. According to some estimates, prior to the civil war the public sector accounted for 30 percent of Syrian GDP but employed 75 percent of the labor force. State-run companies include those in Syria’s oil and gas sector, which has been state-run since 1964 and remains an important source of government revenue. This is dominated by the General Petroleum Company (GPC) and the Al Furat Petroleum Company (AFPC) in the upstream sector; GPC owns 50 percent of AFPC, with the remainder controlled by foreign investors, including Royal Dutch Shell. Also, Sytrol, another government-run company, is responsible for selling Syria’s crude oil exports on the international market.

The only large privatization was the partial divestiture of the government share in Yemen Mobile, a mobile phone operator, in 2006.

NOTES


2. As an example, see Daron Acemoglu and James A. Robinson, Why Nations Fail: The Origins of Pow-


4. Economists Aldo Musacchio and Sergio Lazzarini note a broader problem, namely that “whether we regard them as benign or pernicious, we know very little about those new forms of government intervention: the various institutional mechanisms by which states exercise control, why state capitalism reemerged and in which form, and its effects on both firm performance and state governance.” See Aldo Musacchio and Sergio G. Lazzarini, “Leviathan in Business: Varieties of State Capitalism and their Implications for Economic Performance,” Harvard Business School Working Paper 12-108 (June 2012), http://www.hbs.edu/faculty/Publication%20Files/12-108.pdf.

5. The causal relationship goes both ways: larger government-owned capital stocks will also require more government investment in order to be sustained.


18. Gladstone Hutchinson, “Efficiency Gains


23. Ibid.


33. Ibid.


52. U.S. Department of State, *Investment Climate Statement–Algeria*.


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