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Economic Diversification and Its Main Determinants

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***Abstract*—**This study aims to highlight the importance of economic diversification for countries, considering it a strategic option for bringing about radical changes in the structure of economies, achieving development, and mitigating external shocks. This is achieved by highlighting its importance in the history of economic thought in attaining various economic objectives for countries that rely on a single resource, with the aim of reducing risks, preserving natural resources, safeguarding the rights of future generations, and diversifying sources of revenue. To identify the extent of economic diversification in a country, various indicators are used to measure the degree of diversification. The study also identifies the different determinants of successful economic diversification.

***Keywords*—**Economic Diversification – Diversification Measurement Indicators – Determinants of Diversification.

Introduction

The reliance of a country on a single sector for the creation of added value increases its vulnerability and exposure to external shocks, thereby making the economy less stable. This situation has prompted the search for other strategic sectors capable of increasing production and promoting economic diversification. Economic diversification is a fundamental issue for countries with mono-sectoral economies, or for those whose economies are dominated by a single raw material or commodity in production and exports. Therefore, countries with mono-sectoral economies, particularly those that rely heavily on oil revenues, have been compelled to bring about fundamental transformations and changes in the structure of their economies at all economic, social, and cultural levels, as well as at the national, regional, and local levels, by adopting an integrated and interconnected development path based on economic diversification.

On this basis, the research problem can be formulated through the following question:

To what extent is economic diversification affected by economic variables?

In order to answer the research problem, the following hypotheses are formulated:

- Investment is one of the most important factors ensuring significant economic diversification.
- Good governance is one of the most important factors influencing economic diversification.

Significance of the Study:

The significance of this study lies in the importance and sensitivity of the topic itself, namely economic diversification and its role in reducing external shocks, in addition to its contribution to achieving economic growth and sustainable development.

Objectives of the Study:

This study seeks to achieve the following objectives:

- Presenting the theoretical framework of economic diversification.
- Identifying the various determinants of economic diversification.

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Structure of the Study:

In order to provide a comprehensive overview of the various theoretical aspects of the study, it is divided into the following sections:

Section One: The Concept of Economic Diversification.

Section Two: Determinants of Economic Diversification.

Section One: The Concept of Economic Diversification

First: The Concept of Economic Diversification

There are various definitions of economic diversification, reflecting the different perspectives from which it is viewed. Some scholars associate diversification with production and sources of income, while others relate it to exports. The following presents some of the most important definitions:

- Economic diversification is defined as reducing dependence on a single resource and moving toward strengthening the industrial and agricultural base and creating a productive base. This entails building a sound national economy that moves toward self-sufficiency across more than one sector.[1]
- Economic diversification can also be defined as "the desire to achieve a greater number of basic sources of income in the country, which would enhance its real capabilities within the framework of global competitiveness, through efforts to increase productive capacities across diverse sectors, without necessarily requiring these sectors to possess a high comparative advantage.[2]
- It may also adopt a diversification strategy to accelerate the pace of growth through exports, as in the East Asian countries, such as Singapore, Malaysia, Taiwan, South Korea, Japan, and others.

From the foregoing, economic diversification can be defined as the transition from dependence on a single source of income to reliance on multiple sources, that is, avoiding putting all the eggs in one basket and mitigating the risks associated with dependence on a single source of income, since a single source is vulnerable to frequent fluctuations.

Second: Motives for Economic Diversification

The main motive for economic diversification lies in protecting the economy from shocks resulting from specialization in the production and export of a single commodity, particularly when that commodity is a raw material. Osakwe (2007) states: "Policymakers in resource-rich countries should be more concerned with diversifying their exports in order to reduce external shocks". [3]

Perhaps the strongest argument for the importance of economic diversification is the one put forward by Singer and Prebisch (1950), through what is known as the Prebisch-Singer Hypothesis (PSH). The hypothesis suggests that a country's economic growth cannot rely on the production and export of raw materials, as the prices of raw material exports tend to decline over time relative to the prices of manufactured goods exports. Consequently, the terms of trade of these countries deteriorate, which is unfavorable to countries that export raw materials and import manufactured goods.[4]

In general, the main reasons and motives for economic diversification can be summarized as follows:

- **Risk reduction:** More diversified countries are considered less sensitive to economic fluctuations, as the risks affecting different sectors are not positively correlated. This hypothesis was confirmed by Massell (1970) through a study conducted on 55 developed and developing countries.[5]
- **Achieving and sustaining economic growth:** The discussion on economic diversification emerged at an early stage in growth theories through the Romer model, which focused on the impact of input diversification on economic growth. Accordingly, product diversification, which may also be used as inputs, is important for achieving economic growth. In this case, an economy that is capable of producing a wide variety of goods can generate higher returns, thereby contributing to economic development and growth. Indeed, various empirical studies have shown that growth and productivity are strongly and positively associated with economic diversification. [6]

Other economists have considered economic diversification a strategic option for achieving sustainable growth, as demonstrated by the study of Thad Dunning (2005). The study showed that there is a negative relationship between the abundance of natural resources and the sustainability of growth. Dependence on natural resources in these countries has led to weak economic diversification, making their economies vulnerable to fluctuations in the prices of these resources and, consequently, unable to achieve economic sustainability.[7]

- **Depletion of natural resources:** The depletion of natural resources, particularly oil, on which many developing countries' economies depend, raises the issue of economic sustainability. Economic logic requires replacing these resources with other forms of capital in order to preserve the rights of future generations as the reserves of these resources decline.

Third: The Importance of Economic Diversification

Its importance lies in avoiding the problems to which rentier economies are vulnerable, given their heavy dependence on the revenues generated by a single resource derived from the possession of natural resources, such as oil and gas. This leads to a weak contribution of productive sectors to production and to the formation of gross domestic product (GDP), causing these economies to focus on distribution rather than production.

Given that natural resources are exhaustible and non-renewable, oil-producing countries are inevitably required, sooner or later, to diversify their economies in order to distribute risk and avoid any problems resulting from fluctuations in oil prices in international markets. This can be achieved by examining the previous experiences of countries, whether successful or unsuccessful: the former can provide lessons for achieving success, while the latter can help avoid the strategies that contributed to their failure.[8]

Accordingly, the importance of economic diversification can be highlighted as follows [9]:

- The issues of economic growth and diversification have occupied an important place in the history of economic thought, as most interpretations have revolved around growth and the diversification of economic activities. Studies have concluded that economic growth and diversification are crucial to achieving sustainable development in countries, particularly oil-producing countries, for two reasons:
  - **First**, the concentration of exports in a single sector makes these countries vulnerable to fluctuations in oil prices.
  - **Second**, dependence on the oil sector does not generate sufficient employment opportunities, which leads to weak productive sectors that could otherwise create jobs and contribute to gross domestic product (GDP).
- The stability of public budgets in rentier economies is closely linked to oil prices. Therefore, the importance of economic diversification lies in achieving public budget stability by activating other productive sectors so that they can make contributions to GDP or exports comparable to that of the oil sector. This, in turn, encourages the implementation of future development plans by providing the necessary human capital, technology, administrative institutions, and a competitive social environment. Given that oil is an exhaustible resource, it is necessary to establish an alternative productive base focused on production in non-oil sectors, such as manufacturing, agriculture, and services.
- On this basis, every rentier state, regardless of the sector on which it depends, needs to diversify its sources of revenue by focusing on other sectors, such as agriculture, manufacturing, and services.

Fourth: Indicators for Measuring Economic Diversification

To determine whether an economy is undergoing economic diversification, several indicators can be used, including [10]:

- **Rate and degree of structural change:** These indicate the percentage contribution of different sectors to gross domestic product (GDP), whether increasing or decreasing over time. It is also advisable to measure the real GDP growth rates by sector.
- **Oil price instability and its impact on fluctuations in GDP growth rates.**
- **The share of oil and gas revenues in total government revenues:** The lower this share, the greater the degree of economic diversification.
- **The share of non-oil exports in total exports:** An increase in this share indicates the existence of economic diversification beyond the hydrocarbons sector.
- **The evolution of total employment across all sectors:** This measure reflects changes in the sectoral composition of GDP.
- **Changes in the contributions of the private and public sectors to GDP:** This indicator reflects economic diversification, as diversification implicitly entails greater private-sector participation in overall economic activity.

The indicators presented above provide an indication of the extent of economic diversification in a country. However, they do not accurately measure the **degree of economic diversification**. To determine the latter, several statistical indicators can be used, which vary in their effectiveness and suitability depending on the purpose of measurement.

Some of these indicators are based on measuring the phenomenon of **dispersion**, such as the coefficient of variation; others measure the property of **concentration**, such as the Gini index; while others are based on the concept of **diversification**, such as the Herfindahl-Hirschman Index (HHI), which is the most commonly used.[11]

These indicators provide relatively similar measures in terms of their trends and changes when used to quantitatively estimate the phenomenon of economic diversification. Some of these indicators are presented below:

Diversification Index:[12]

This index measures the deviation of the share of a country's major commodity exports in its total exports from the share of exports of those major commodities in total world exports. The index ranges between **0 and 1**. The closer the index is to **1**, the higher the degree of export diversification. When the index reaches **zero**, the structure of national exports coincides with the structure of world exports. It is calculated as follows:

$Sij= (\sum_{i=1}(hij-hi))/2$

Where:

- hij : represents the share of commodity iii in the total exports of country j.
- hi : represents the share of commodity iii in total world exports.

Gini Index (Concentration Index)

This coefficient is used to measure the extent to which the phenomenon under study is concentrated rather than evenly or equally distributed, such as measuring the degree of concentration of major commodity exports in total national exports.

The **Gini Index** is considered one of the best and simplest measures of concentration. This index is based on the **Lorenz curve** and is measured by the area between the Lorenz curve and the line of perfect equality, relative to the total area of the triangle.[13]

There are several formulas for calculating the **Gini Index**:

$$G=1-\sum nK=1(XK-XK-1)(yK+yK-1)$$

Where:

- XK : the ascending cumulative relative frequency of the total variable (the sectoral share of GDP), represented on the horizontal axis.
- Yk : the ascending cumulative relative frequency of the number of sectors.
- n: the number of sectors.

The value of the **Gini Index** ranges from **zero**, which represents perfect equality in the distribution of the phenomenon, to **one**, which represents complete concentration.

Herfindahl-Hirschman Index (HHI):

The HHI was used by U.S. courts in 1982 because of its ease of use and simplicity in measuring the degree of concentration among firms that produce and market the same product or export it to the same market area, or target the same group of consumers. In 1985, the U.S. Department of Justice proposed somewhat revised guidelines for mergers in the banking industry and published the revised guidelines. In 1992, these numerical guidelines were used by the Federal Reserve as a first step in analyzing the competitive effects of bank mergers. [14]

The Herfindahl-Hirschman Index (HHI) is based on measuring the composition and structure of a variable and the extent of its diversification. It is used to measure diversification in the structure of a given phenomenon and to highlight the structural changes that have occurred in its components. This index is widely applied to measure economic diversification. It was originally designed to measure the degree of concentration in an industry or a particular sector.[15]

Formula for Calculating the Herfindahl-Hirschman Index (HHI)[16]:

$H.H=(\sqrt{(\sum_{i=1}^{n}(xi/X)^2)})/(1-\sqrt{(1/N)})$

Where:

- N: the number of activities.
- X: Gross Domestic Product (GDP).
- Xi: the value of output in a particular sector i.

The value of the Herfindahl-Hirschman Index ranges from **zero to one**, i.e., 0≤H≤1.

- If H=0, this indicates **complete diversification** in the economy.
- If H=1, this means that **diversification is absent**.

*Diversification indices can be applied to several variables, including Gross Domestic Product (GDP), exports, imports, actual government revenues, gross fixed capital formation, and the labor force. There are several variables to which economic diversification indices can be applied.

Axis Two: Determinants of Economic Diversification

Economic diversification is associated with a set of important determinants that play a significant role in the success or failure of the diversification process. These determinants include [17]:

First: Investment Volume

Investment plays an important role in developing infrastructure and improving the structural base of the national economy. In this regard:

- Economically, investment is defined as "the use of savings to form new investments or productive capacities necessary for the production of goods and services, and to maintain or renew existing productive capacities". [18]
- From a financial perspective, investment is defined as "a set of expenditures that will generate, over time, revenues enabling the coverage of the initial expenditure required by the investment project". [19]
- In administrative and accounting thought, the term **investment** refers to "the allocation of funds to various assets, including current assets, fixed assets, and other assets". [20]

From the foregoing definitions, investment can be defined as the allocation of surplus funds to various investment instruments and fields with the aim of creating new production, expanding existing production, increasing capital formation at the level of the economy and society, or achieving an actual increase in wealth.

Moreover, the objective of investment policy is not to choose between domestic and foreign investment, but rather to establish linkages between them through value chains at the local, regional, and global levels. This means that the focus of regulatory reform should not be limited to domestic laws; it should also seek to establish linkages between these laws and international investment agreements, which increasingly govern production at both the domestic and international levels.

- **Investment is not a transaction, but rather a relationship:** Investment policy strategies need to go beyond the issue of attracting initial investments, as this represents only a small part of the overall process. The real benefits to the host country arise at a later stage of the relationship, when the country succeeds in retaining investment and building strong linkages with local business activities.
- **Not all types of investment are identical:** Different types of investment have different effects on socioeconomic development and therefore require different policies.

Economic diversification is also motivated by the need to reduce risks and achieve and sustain economic growth. Investment is likewise among the means of promoting development in specific sectors.[21]

A country's capacity to diversify its economy can also be measured by the volume of investment and the rate of capital formation in the country. A decline in the diversification index encourages the country to increase the volume of investment and, consequently, the degree of economic diversification. This requires countries to develop strategies aimed at improving infrastructure in order to attract investment into new sectors, given the importance of investment in promoting research and development and increasing incentives for innovation, in addition to facilitating the transfer of technology and knowledge and improving productive capacities in the host country.

Therefore, investment is an important element in achieving economic diversification. Accordingly, investment and its basic requirements must be provided in order to develop it and influence its volume.

Second: Economic Growth Rates

Economic growth is a broad concept and has been defined as follows:

It is the occurrence of an increase in average real per capita income over time, that is, the long-term increase in the output of a country. As an increase in production occurs, economic growth is reflected in:

- **An increase in real national output between the two periods.**
- **An increase in the average per capita income.** [22]
- **Economic growth:** It is a complex and interconnected process aimed at bringing about a fundamental change in the economic structure, resulting in an increase in the productivity rate through the utilization of national and global resources and the available level of technology.[23]
- Simon Kuznets defined economic growth as **"a long-term increase in the capacity of a national economy to supply its population with an increasingly diverse range of goods, based on advancing technology and the institutional, structural, and ideological adjustments required by the growth process".[24]**

The Relationship Between Economic Diversification and Economic Growth: Many argue that diversification leads to economic growth for the following reasons:[25]

- **Reducing investment risks and risks to the productive structure:** The productive structure is exposed to risks in sectors characterized by high volatility. A decline in demand for a product, and consequently a decrease in its price due to internal or external factors, inevitably exposes the sector to risks.
- **Reducing the risks leading to a decline in exports:** Countries that depend on exporting a single product or a limited number of products are vulnerable to declines in export revenues when the prices of these products fall.
- **Increasing value added and generating employment opportunities:** Vertical diversification strengthens forward and backward linkages within the economy, as the output of one sector constitutes productive inputs for another sector. It also contributes to generating employment opportunities, thereby increasing the value added generated at both the sectoral and local levels.
- **Increasing human capital:** Economic diversification contributes to increasing labor productivity and human capital, thereby leading to higher rates of economic growth.
- **Promoting sustainable development:** Three main factors have contributed to fluctuations in growth rates and prevented many developing countries from achieving sustainable development:
  - Specialization in the production and export of a limited number of products.
  - The severe and recurrent exposure of these countries to macroeconomic shocks.
  - The high volatility of macroeconomic conditions resulting from the impact of shocks on specialized sectors. This means that an increase in the degree of economic diversification contributes to stabilizing growth rates over time and, consequently, to achieving sustainable development. [26]

Therefore, accelerating economic growth rates, as measured by per capita GDP, contributes to increasing the degree of diversification as a result of increased purchasing power and, consequently, greater opportunities for product diversification.

Third: Applied Foreign Trade Policies

The application of free trade policies in any country leads to an increased level of specialization in goods in which the country has a comparative advantage. However, over time, the economic diversification index may increase as countries seek to protect themselves against external shocks.

Therefore, reducing risks requires **economic diversification**.

Fourth: The Degree of Stability of Applied Macroeconomic Policies

There are several definitions of economic policy, but they generally convey the same meaning. It is commonly defined as "a set of rules, methods, procedures, and measures adopted by the state to guide its decisions toward achieving the economic objectives of the national economy over a specific period of time."

Economic policy is therefore implemented by public authorities with the aim of achieving a set of objectives through the use of a range of appropriate instruments. The outcomes of applying these instruments should not conflict with the prevailing economic conditions or with the objectives that public authorities seek to achieve. This takes place over a specific period of time, whether short or long.[27]

Objectives of Economic Policy

Economic policy is designed to achieve one or more objectives. These objectives were summarized by Kaldor into four main goals, known as **Kaldor's Magic Square**, as illustrated in the following figure:

- **Pursuing Economic Growth:** According to Kaldor, the economic growth rate should reach 6%. Pursuing economic growth is considered the most general objective, represented by an increase in national income over time. This objective implies achieving a growth rate higher than the population growth rate. It also relates to the objective of preserving the environment from pollution, which poses a challenge for economic policymakers in achieving a high rate of economic growth while maintaining environmental quality.
- **Achieving Full Employment:** According to Kaldor, the unemployment rate should reach 0%. Full employment means increasing the size of the labor force employed, achieving the highest possible level of employment, and working to minimize unemployment. The concept of full employment also refers to the full utilization of the productive capacities available in society.
- **Achieving External Balance:** Kaldor expresses this objective in terms of imports and exports as a percentage of GDP. An imbalance in the balance of payments, which generally manifests itself as a deficit, leads to increased indebtedness of the economy, negatively affecting its internal economic balances and economic transactions. Therefore, it is preferable for the balance to record a surplus of around 2%.
- **Controlling Inflation:** Inflation refers to a continuous and sustained increase in prices. Kaldor considers it preferable to achieve a zero inflation rate (0%). Failure to control inflation leads to distortions in the economic indicators used to make economic decisions and consequently undermines the confidence of economic agents in economic policy.

The stability of economic policies contributes to increasing the degree of economic diversification. For example, lower inflation rates can promote diversification and, consequently, the growth of new productive sectors to meet the requirements and needs of domestic and foreign markets. Exchange rate policies also affect the degree of economic diversification.

Fifth: Good Government Administration

According to **Al-Mawrid Dictionary by Munir Baalbaki (2014)**, the term *Governance* is translated as "governing," and it is derived from the verb *Govern*, meaning to control, manage, govern, or regulate.

In management science, the concept of **good governance** is synonymous with sound administration, good government, or good management.

There are several available definitions of the term governance, including the following[28]:

1. **Definition by Sarker (2005):** Good governance is a system for structuring, operating, and monitoring an organization, with a focus on achieving long-term strategic objectives to satisfy shareholders, creditors, employees, customers, and depositors, while complying with regulatory requirements as part of environmental and societal needs.
2. **Definition by Abdel Halim Reda Abdel Aal (2005):** Governance is the art of managing government affairs and conducting them smoothly and effectively, while achieving its social objectives in a manner that ensures citizens' satisfaction.
3. **Definition by Asmaa Saeed Mohamed (2011):** Governance is good government that emphasizes participation, transparency, accountability, efficiency, the achievement of justice, and the application of the law. These principles are practiced by the state, the private sector, and civil society to achieve sustainable development.

Objectives of Good Governance

Good governance aims to achieve the highest possible level of ethical standards in the conduct of business and to uphold the principles of integrity, transparency, and the right to accountability. It grants society, whether individuals or their representatives, the right to hold public administration bodies accountable and provides appropriate opportunities for development, ensuring that individuals in society can exercise their rights and improve their quality of life within a democratic society that embraces respect for human rights.

Governance rules also aim to achieve transparency and fairness and to grant individuals the right to hold governmental and non-governmental institutions accountable. Accordingly, they provide protection for individuals while taking into consideration the interests of all stakeholders and limiting the misuse of authority for purposes other than the public interest. This contributes to the development of investment, encourages investment flows, promotes savings, maximizes profitability, and creates new employment opportunities. These rules also emphasize the importance of compliance with the law, ensuring the review of financial performance, and establishing administrative structures that enable management to be held accountable to individuals.

Good governance is an essential prerequisite for creating an enabling environment for economic diversification. This can be achieved through the design and implementation of policies aimed at promoting and developing emerging sectors, allowing them to prosper and make a greater contribution to the national economy. The government also plays an important role in establishing an appropriate regulatory framework to support economic activity and provide a favorable business environment by improving regulatory procedures related to foreign trade, thereby facilitating import and export operations.

Sixth: The Role of the Private Sector

The private sector plays a major role in economic diversification by encouraging innovation in underutilized sectors and promoting research and development activities in new fields and areas that contribute to economic diversification. This requires the government to improve industrial policies, remove bureaucratic obstacles facing the business environment, and encourage partnerships between the government and the private sector.

Seventh: The Degree of Exploitation of Natural Resources

The exploitation of the natural resources available in a country contributes to increasing the volume of production, achieving economic diversification, and increasing exports. For example, oil-producing countries should utilize their available oil wealth to develop manufacturing and service industries, thereby achieving economic diversification.

Eighth: Economic Integration

Arab economic integration has different concepts that vary according to schools of thought and objective circumstances. In general, however, it refers to linking certain parts together. This linkage results from procedures and arrangements adopted by the governments of integrating countries through agreements concluded among them. Economic integration takes place between at least two countries that share common characteristics that encourage them to pursue the process of integration. These characteristics include cultural and linguistic proximity, geographical proximity, strategic and common interests, as well as other shared characteristics that promote economic integration. Through establishing economic integration, countries seek to develop their resources, improve their economic conditions, and achieve political objectives, such as making economic integration a pathway toward political unity or achieving security objectives.[29]

Economic integration agreements contribute to simplifying and harmonizing customs procedures across borders, which, in turn, supports the development of **Spatial Development Initiatives (SDIs)**, thereby stimulating cross-border economic activity and achieving economic diversification.

Conclusion:

Through this study, it has been shown that economic diversification represents a strategic option for countries that rely heavily on a single resource, particularly oil-producing countries, as it provides an opportunity to reduce the risks associated with dependence on a single source of income, production, and exports, and to mitigate the effects of external shocks and fluctuations in the prices of natural resources. The study also showed that economic diversification is not limited to increasing the number of economic sectors; rather, it is associated with structural changes in the production structure and the diversification of sources of income, government revenues, and exports, thereby contributing to enhancing economic stability and achieving growth and sustainable development.

The study also highlighted the existence of several indicators for measuring economic diversification. These include indicators based on structural changes and the contribution of different sectors to GDP, the ratio of oil and gas revenues to total government revenues, the share of non-oil exports in total exports, changes in employment, and the contribution of the public and private sectors. The study also addressed several statistical indicators that allow the degree of diversification to be determined, most notably the Diversification Index, the Gini Index, and the Herfindahl–Hirschman Index.

The study concluded that achieving economic diversification is associated with a set of interrelated determinants, foremost among them the volume of investment, given its role in developing infrastructure and the productive base, attracting technology and knowledge, and promoting innovation. Diversification is also associated with economic growth rates, the trade policies implemented, and the degree of stability of macroeconomic policies, including inflation control and the achievement of economic balances.

The study also highlighted the importance of good governance in providing an appropriate institutional and regulatory environment for economic diversification through promoting transparency and accountability,

enforcing the rule of law, and improving the business environment. It further emphasized the role of the private sector in promoting innovation, research and development, and the development of new activities and sectors, in addition to the importance of properly utilizing natural resources and directing their revenues toward developing other productive sectors. Furthermore, economic integration contributes to supporting economic activity and developing resources.

Accordingly, the success of economic diversification requires the adoption of an integrated approach that does not rely on a single factor, but rather is based on creating an appropriate investment and institutional environment, activating the role of the private sector, promoting innovation and technological development, and developing productive sectors, while making effective use of available resources in a manner that reduces dependence on a single resource and diversifies sources of revenues and exports, thereby contributing to an economy that is more capable of withstanding shocks and achieving growth and sustainable development.

Recommendations:

- Improve the foreign and domestic investment climate by creating a favorable environment for investment.
- Deepen economic integration while stimulating cross-border economic activity.
- Support economic diversification and enhance capacities to encourage new investors.
- Strengthen competitiveness in the labor market.
- Encourage scientific research and innovation in new fields that contribute to economic diversification.
- Strengthen regulatory procedures to facilitate import and export activities.
- Implement economic policies aimed at promoting economic diversification.

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