ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA (ESCWA)

SHORT- AND MEDIUM-TERM ECONOMIC CHALLENGES OF THE ARAB COUNTRIES IN TRANSITION

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Introduction

Addressing the immediate economic challenges of the Arab Countries in Transition (ACTs) will be a vital component of ensuring the successful outcome of the transition process that many countries in the region are facing.[1] Indeed, at the start of the transition, the public in the Arab region deemed a strong economy to be at least as important as a functioning democracy (PEW, 2011). However, these challenges have not been adequately focused on thus far and are strictly bound to the region's deeply rooted socioeconomic characteristics.

Despite the political and socioeconomic heterogeneity in the Arab region, the economies of the region have all been affected by the impact of the global recession and the recent uprisings, though in various ways and to different degrees.[2]

This incredibly complex region is perhaps best described as one where people live most of their social, political and economic lives in compartmentalized spaces. From very early on in life, Arab men and women are subject to a plethora of conditions that are likely to influence their capability, choice and life perspectives forever. These include whether they come from an urban or rural area; are born to a family whose parents are educated; belong to one of the many confessions or tribes in such countries as Jordan, Lebanon, Libya, the Syrian Arab Republic, or Yemen; have access to functioning education and health services; are able to find a job in the formal or informal sector; are able to emigrate legally; or are simply a normal consumer who can only find one type of product or service on the market because of state or private monopolies.

Despite the fact that all the countries in transition have undertaken structural adjustment programmes, albeit with varying levels of conviction and commitment, they all display the broad characteristics of exclusionary practice in the economic arena and weak service delivery by the state. The interplay between these two deficiencies created a situation in which private investment remained low, job creation sluggish, subsidies remained indispensable and corruption festered. More than two decades of economic reforms and structural adjustments have taught Arab policymakers that in this region economic reforms cannot be disjoined from political ones if they aim to be sustainable, pro-growth, equitable and inclusive.

The uprising of the people of Tunisia had a contagious effect on many other Arab countries. Popular calls for political reform resonated across the region; demands translated across borders, slogans travelled, often verbatim from country to country, and mobilization tactics and strategies were disseminated through social media from Tunisian "veterans" to latter-day protesters in other states. Protesters linked demands for political rights with socioeconomic justice under the common slogan of "bread, dignity and freedom" thus pulling together an amalgam of such heterogeneous groups as educated youths, women, labour activists, civil servants, small businessmen, professional associations, unemployed and underemployed, and the poor under one common cause.

While there may have been some shared ethos in the political demands, presumably resulting from commonalities in the underlying political deficiencies of the pre-uprising regimes, a look at the economic and development profiles of the countries that experienced the regional wave of protests reveals enormous differences and clear heterogeneity in terms of resource endowment, access to capital, technology absorption, development policies and outcomes before the revolutions.

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[1] ACTs analysed in this study are the following: Egypt, Jordan, Libya, the Syrian Arab Republic, Tunisia, and Yemen. However, when it is sensible to do so because of close interlinkages with ACTs, sometimes we expand our analysis to other such countries as Algeria, Bahrain, Lebanon and the countries of the Gulf Cooperation Council (GCC).

[2] Due to the events affecting most of the region, in this report we primarily focus on the Arab region rather than the region of the Economic and Social Commission for Western Asia (ESCWA) so as to keep a more systematic regional approach that allows us to put our analysis in a wider and more interconnected context. We also use Arab region and Middle East and North Africa (MENA) interchangeably.

Yet, stark similarities have been identified on the ground since the uprisings; countries in transition experienced negative growth rates across the board in 2011, and they have all seen investment dwindle and unemployment rise. The temptation to adopt populist policies, particularly in a time of generalized disorientation, is therefore a serious one, and governments have already engaged in quick fixes that try to appease public pressure at great cost to the uncertain and dwindling public budgets.

To complicate the picture further, different social groups have different perspectives on the transition process and the reforms entailed. Regime cronies and beneficiaries, for example, would consider reforms successful if they enabled them retain their benefits despite regime changes; international financial institutions (IFIs) might view reforms as successful if they primarily generate sustained growth and macroeconomic stability; foreign powers might judge them positively if they bring peace and stability to the region and its neighbours along with an uninterrupted provision of mineral resources; while the public might consider them successful depending on the extent to which they result in palpable improvements to their standards of living. The challenge ahead therefore lies in how to address the expectations of as many groups as possible, bearing in mind that Pareto-optimal transitions and reforms do not exist, at least in the short run.

The early phases of most transitions are highly fluid and therefore being prescriptive does not usually help and can even serve to create more problems. At this crucial political and economic juncture, domestic savings are typically scarce, national markets are small and fragmented, and endogenously developed technology is weaker than that of more mature economies in achieving rapid and inclusive growth. Transitions are also heavily affected by time inconsistency and collective action problems. Low inflation, a stable currency, quality service delivery and a healthy business environment are public goods and as such accrue to the whole society, although they are likely to damage such parties as former oligarchs, disenfranchised state bureaucrats and militaries, and subsidized entrepreneurs, to name a few. This dispersion of potential benefits cum concentration of certain losses is at the heart of the political economy of transition for it gives the losers greater incentives to engage in collective action than the winners (Hellman, 1998). In the short term, after regime change, new politicians face the dilemma of how to initiate and sustain economic reforms that demand severe and certain sacrifices for the mere prospect of future gains that are certain to not benefit some specific groups. Politicians are therefore understandably reluctant to undertake radical reforms, the benefits of which will not materialize before the next election cycle, even more so because many of the governments currently in place are transition governments designed to oversee constitutional reforms while keeping the country together and to eventually hand over to the democratically elected governments under the newly approved constitutions, expected in the course of the 2013-2014 biennium.

The medium-term challenge is therefore in how to spread the burden of reforms fairly so that transitions are socially and politically acceptable. The immediate challenge ahead is to identify the low-hanging fruits, i.e. the most acute constraints on development whose relaxation may accelerate equitable growth in the short run, while a consistent and credible long-term strategy, consisting of the cumulative impact of many small reforms over a protracted period or of a small number of bold reforms, depending on the context, is formulated. In the aftermath of a swift regime change, citizens face daunting challenges and the policymakers leading these countries often have only a narrow window of opportunity in which to progress or regress transitions. Hence, the difficult times that ACTs are going through necessitate a time of extraordinary politics during which common citizens, political leaders and the international community must all assume their respective roles in contributing to a swift process that causes the least pain possible and is also irreversible, thereby securing prosperous democracies for the Arab people.

This report is the result of an extensive literature review and consultation process. It attempts to take stock of the economic challenges characterizing countries currently facing this pivotal yet precarious juncture in the history of the region, with a view to understanding the constraints the authorities now face and the resources and tools available to them over the current and next election cycles. We will try to analyse the short- and medium-term economic challenges and opportunities of the nascent transition process and explore methods for designing and adopting economic reforms that could strike a balance between historically misused trade-offs between stability and balance of power, and inclusiveness and accountability. The agenda that stakeholders and the public throughout the region have just started to discuss is therefore one based on contestability, access, participation and accountability. What lies ahead for this region is clearly a governance-based reform agenda.

The paper is divided into three parts. Part I analyses the key structural characteristics of the economies, policies and possible development outcomes of ACTs that need to be borne in mind when starting a transition process of such scale and scope. Part II focuses on the key challenges of the transition process itself. Part III draws conclusions and tries to provide some critical recommendations on how to address the challenges the region is facing.

I. SOCIOECONOMIC BACKGROUND OF THE REGION

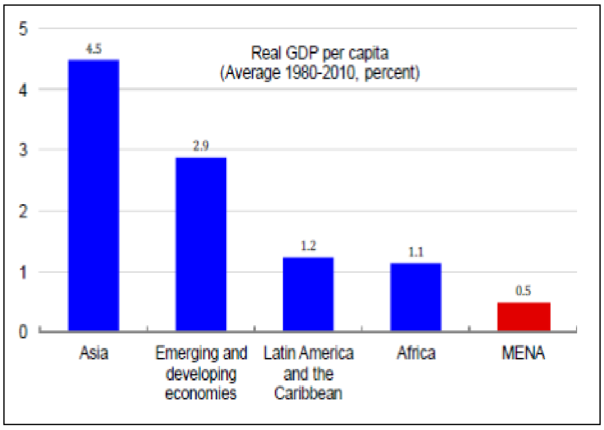
A. OVERVIEW

The Arab region has the most marked intraregional inequalities in the world, where the highest per capita gross domestic product (GDP) level, namely, that of Qatar, is over 40 times that of the poorest countries, which are the Sudan and Yemen; the agricultural sector counts for large shares of GDP and labour force in some countries, Egypt, Morocco, the Sudan, and Yemen, and is non-existent in other such countries as Bahrain, Qatar and the United Arab Emirates; informal sectors constitute almost half of the national economy in some countries, for instance, Yemen, while counting for less than 10 per cent in other such countries as Qatar and the United Arab Emirates; and countries are characterized by completely different production structures, with GCC countries and Libya being oil-based and capital-intensive, while oil-importers are service-based and labour-intensive.

Constraints on political rights and civil liberties have concentrated political and economic power throughout the region. This concentration has been associated with: a highly centralized state capacity that is interventionist and redistributive in nature and provides public goods as a result of patronage; weak public sector management; corruption; and a private sector that has thrived on privileges and symbiotic relationships with the state authorities while ignoring their inefficiencies and monopolistic behaviour towards the collectivity. This social contract contained an implicit trade-off between a widespread subsidy-based welfare system providing basic public goods and services and limited political and economic freedom.

Despite economic reforms, over the last three decades, real GDP growth in the MENA region has been constantly lower, at about two thirds, than that of emerging and developing economies. The gap is even wider when growth is analysed in terms of real per capita GDP, at about one sixth, as shown in figure 1. Population growth above 2 per cent has heavily contributed to such a low performance in per capita terms.

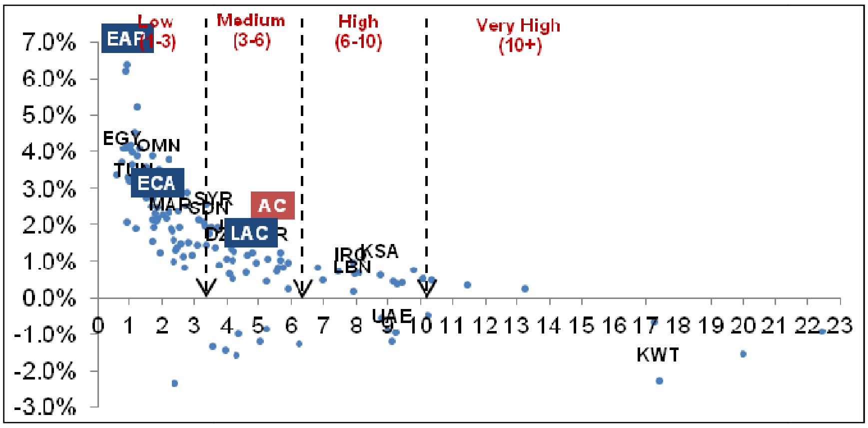
Figure 1. Real GDP per capita growth (1980-2010)



Source: IMF, 2011d.

Growth has been volatile in half of the region, with resource-dependence, probably combined with low governance levels, protracted instability and conflict being the underlying factors. As a result, the Arab region has on average reported higher volatility than other regions. Interestingly, figure 2 shows that the countries that have recorded higher average growth rates are also the ones reporting lower volatility.

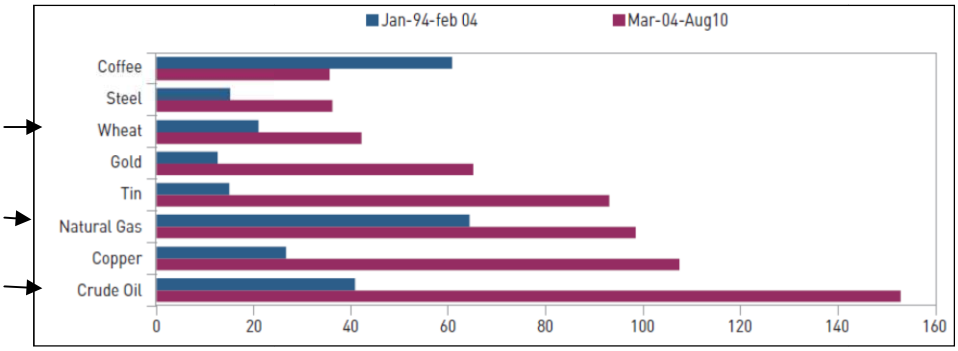
Figure 2. Coefficient of variation and average annual real per capita GDP growth (1970-2009)



Source: Elaboration from UNDP, 2012.

Note: AC refers to Arab countries.

Figure 3. Commodity price volatility
(*Standard deviation of monthly prices*)



Source: World Bank, 2011a.

Countries in the region have made considerable progress in terms of macroeconomic stabilization over the last two decades, which is particularly reflected in the lower inflation rates. However, high deficits and public debt, including implicit and contingent liabilities, and current account deficits remain high for non-oil economies, while inflation spiked in the wake of the fuel and food crisis. Although in various ways and to different extents, many countries in the region face such fiscal issues as dependence in some form or another on donor support, high budgetary exposure to fluctuations in hydrocarbon prices (figure 3), high defence expenditure often associated with a bloated subsidy system and weak tax bases.

Most analysts agree that one of the ways to step up employment growth in the region would be to diversify exports away from raw materials toward high value-added and labour-intensive products. However, the Arab share of non-oil exports has remained relatively flat compared to that of emerging and developing economies, which have more than doubled their export shares. Arab exports have also remained relatively restricted in sector (low value-added) and geographic terms. This trend goes hand in hand with the lack of economic diversification, following a Dutch disease pattern, which has disproportionally focused on such non-tradable service sectors as construction, transport, wholesale and hotels and restaurants (figure 4) at the expense of tradable manufacturing (Richards and Waterbury, 2008). In fact, manufacturing has historically contributed to growth and job creation in other transition economies as was the case for Brazil, Indonesia, Malaysia, and Turkey (Hausmann and others, 2007). In contrast, the Arab region remains the least industrialized middle-income region in the world and displays decreasing trends, as illustrated in figure 5. However, most ACTs, including Egypt, Jordan, Morocco, Tunisia, and the Syrian Arab Republic (before the civil conflict), represent notable exceptions both in terms of manufacturing and in terms of tourism contributions to their economies.

Figure 4. Economic sectors for selected Arab countries (2009)
(*Per cent of GDP*)

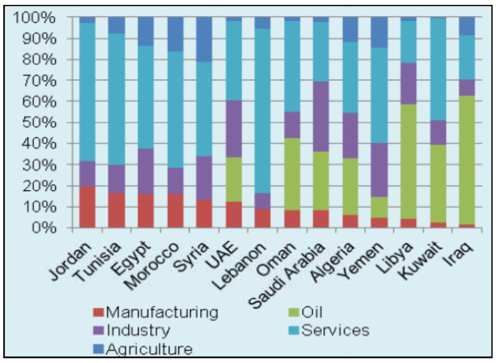
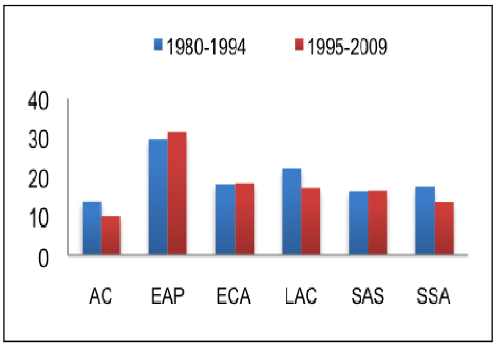


Figure 5. Manufacturing in developing regions (1980-2009)
(*Per cent of GDP*)



Sources: WDI Database and UNDP, 2012, from UNIDO Industrial Statistics Database 2010 at the 2-digit level of ISIC Code (revision 3) and UNSD National Accounts Database.

Note: AC refers to Arab countries.

Although the oil importers have fared better than the oil exporters, the region's manufacturing sector, which is heavily concentrated in the production of chemical and petroleum-related products, has generally stagnated over the last fifteen years. At the same time, the textiles industry in the Maghreb has been in decline.

With the oil sector accounting for almost half of the GDP in GCC countries, with services accounting for around 60 per cent of GDP in the oil importing countries, and with subsidy policies being heavily based on energy, many countries in the region suffer from distorted incentives that tend to favour capital-intensive production. Yet, when looking at labour generation, it is the labour-intensive, low- and semi-skilled service sectors that tend to be the main sources of employment in the region.

With the exception of Saudi Arabia and the United Arab Emirates, the best Arab performers export around 1,500 products, most of which have low technological content, whereas Turkey and Malaysia, for example, export almost 4,000 products. In Algeria, just four products make up more than 85 per cent of the country's total exports. The technological content of exports by non-oil Arab countries is about one third that of countries in Eastern Europe or East Asia (World Bank, 2011a). Economic diversification has become an absolute priority for Algeria, the Syrian Arab Republic and Yemen. The situation is clearly better in Egypt, Jordan, Morocco, and Tunisia, where services hover at around 30 to 50 per cent of total exports. These patterns are reflected in the Herfindahl-Hirschman Index, which has remained quite stable and highly concentrated in Algeria, highly diversified and decreasing in Egypt and Jordan and highly diversified but stable in Tunisia (Dogruel and Tekce, 2011). Based on recent empirical studies, trade liberalization seems to cause two distinct effects on diversification: (a) World Trade Organization (WTO) and Pan-Arab Free Trade Area (PAFTA) integration fosters export diversification; and (b) Association Agreements with the European Union lead to specialization and export concentration (Dogruel and Tekce, 2011).

Finally, in terms of competitiveness, many Arab transition economies lags behind, as listed in table 1. Tunisia, ranked at place 40 in the Global Competitiveness Index (GCI) in 2011 (but was not included in the 2012 round), performed well in a number of areas, including health, education and macroeconomic policy. Jordan, ranked at place 64, lags in labour market efficiency and macroeconomic management. Morocco, ranked number 70, lags in the efficiency of its labour market and education and training sectors. Egypt suffered from a sizable drop in ranking, now at number 107, and faces several competitiveness challenges that include its inefficient labour market and weak educational system as well as its macroeconomic situation. Libya and Yemen suffer from wider and more structural deficiencies.[3]

TABLE 1. 2012-2013 GCI RANKING OF ARAB COUNTRIES

Country/economy	Rank/144	Score (1-7)	Rank among GCI 2011-2012 sample	GCI 2011-2012 rank
Qatar	11	5.38	11	14
Saudi Arabia	18	5.19	18	17
United Arab Emirates	24	5.07	24	27
Oman	32	4.65	32	32
Bahrain	35	4.63	35	37
Kuwait	37	4.56	37	34
Jordan	64	4.23	64	71
Morocco	70	4.15	70	73
Lebanon	91	3.88	90	89
Egypt	107	3.73	105	94
Algeria	110	3.72	108	87
Libya	113	3.68	n/a	n/a
Yemen	140	2.97	136	138

Source: WEF, 2012.

B. POVERTY AND INEQUALITY

Despite remarkable achievements in terms of Millennium Development Goals (MDGs), national poverty in the region has generally declined slowly over the last two decades – although it reportedly increased in Yemen, Syria, and Egypt – (figure 6) and the Human Development Index (HDI) average is still lower than what one would expect given the income levels in the region. The highest Human Poverty Index (HPI) among ACTs is in Yemen, at around 35 per cent, followed by Morocco with almost 32 per cent[4] (UNDP, 2009), presented in figure 7. Poverty as measured by the usual international income level of US$1.00 or 1.25 per day is very limited in the region, but when the threshold is raised to US$2.00 per day, a manyfold increase is seen in all ACTs.

According to the United Nations Development Programme (UNDP), the HPI for Arab countries is significantly higher than would be expected when compared to any other developing region, and within the region, the gap between actual and expected HPI is signifantly larger for the Maghreb countries. The trends in the gap between actual and expected HPI over the period 1997-2007 were not uniform within the Arab region. In fact, the ratio declined significantly for the GCC countries, suggesting that they were able to match the rapid growth in GDP per capita with a more rapid reduction in the HPI. The ratio also declined in the Maghreb and Mashreq countries, though the former still recorded a large gap between their actual and expected HPI in 2007. Egypt and Yemen witnessed an increase in the gap between actual and expected HPI. This retrenchment in human poverty reduction efforts is quite worrying considering the rapid growth in GDP per capita which took place in these countries over most of the 1997-2007 period. In Egypt, for example, average child undernutrition spiked in the period 2003-2008, though GDP per capita contnued to rise (Breisinger and others, 2012b). This trend is also reflected in the increasingly disproportionate levels of dissatisfaction recorded in perception surveys over recent years (part II). The divide seen over the last decade might suggest that monetary poverty measures are not able to fully capture trends in the well-being of the poor.

[3] Syria is not reported on due to the lack of data.

[4] Morocco performs particularly poorly on this index compared to middle-income countries because of is relatively high illiteracy rates.

Figure 6. Variations in incidence of poverty

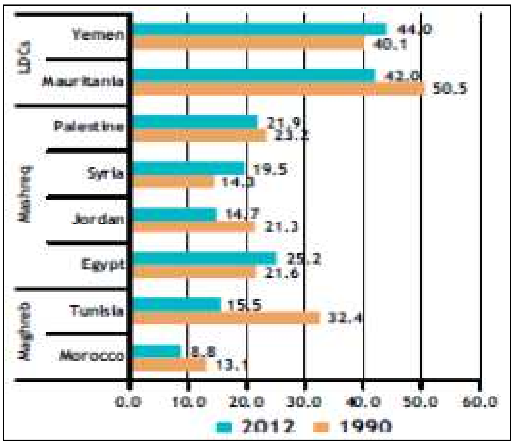
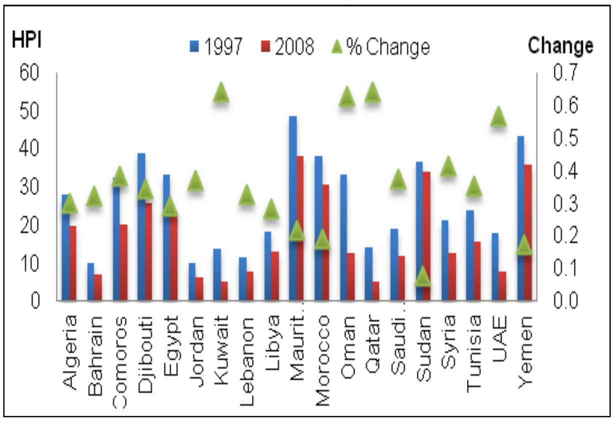


Figure 7. HPI variations by country (1997 and 2008)



Sources: ESCWA, 2013a; and UNDP, 2012.

Vulnerability to shocks makes the impacts of positive and negative shocks on poor households asymmetric. Given the underlying economic and institutional characteristics of the Arab region, as well as the relatively high concentration of the population within the lower income levels, there is a risk that the poor will not benefit from economic prosperity as much as they will suffer from economic recessions. In relative terms, they do not benefit from upturns as much as the richest strata of the society do and they suffer more during downturns. Poor households therefore tend to be risk-averse in their asset-allocation strategy, and this aversion is even more pronounced during political and economic transition, which is often characterized by a combination of political instability, natural shocks and international price shocks (figure 9). This leads to ever-decreasing food-security levels and also more risky, but more profitable, business opportunities being passed up. In this phase, social protection becomes crucial in helping the poor and vulnerable to improve their livelihoods and risk-coping strategies. Arab countries entered the economic crisis with already inadequate social protection systems, despite the fact that a large share of the population in the transition countries is considered vulnerable given that it hovers close to the poverty line. Egypt, the Syrian Arab Republic and Yemen exhibit a share of the population with per capita consumption within US$0.50 per day above the US$2.00 poverty line in the range of 15-17 per cent; in the Syrian Arab Republic and Morocco, this share is estimated at around 13 per cent and 11 per cent, respectively. Child poverty is also endemic, with children living below the national poverty line in Egypt, Jordan, Morocco and Yemen, ranging from 20 per cent in Jordan to 36 per cent in Yemen (World Bank, 2012e).

Figure 8. Poverty rates by poverty levels

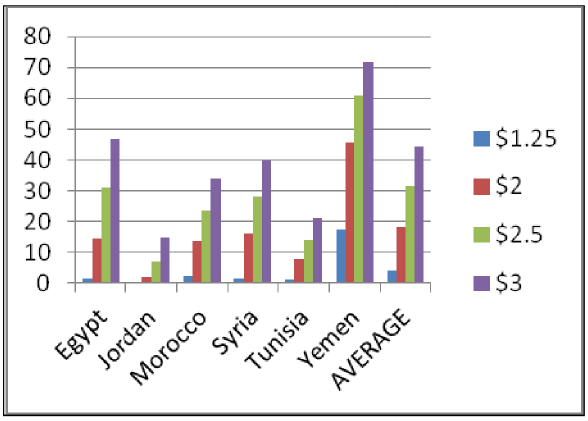
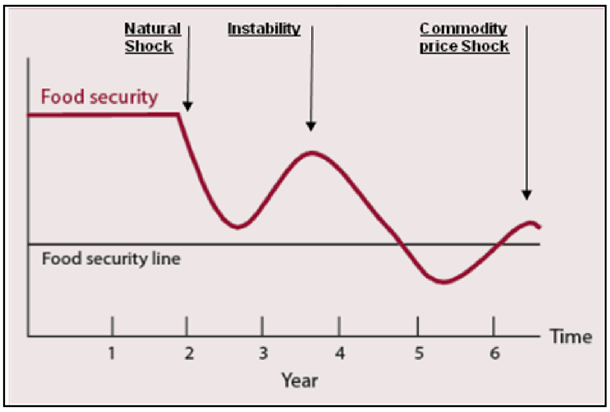


Figure 9. Impact of reinforcing shocks on the vulnerable



Source: 2004-2008 national surveys as reported in PovcalNet. Available from http://iresearch.worldbank.org/PovcalNet/index.htm.

Based on available data, depicted in figure 8, poverty seems to be relatively shallow in most ACTs. In other words, a significant proportion of the population is clustered between the US$1.25 and US$2.00 per day lines. Hence, any small shock to income distribution can produce a significant impact on severe poverty. It is therefore expected that poverty has increased significantly since 2008. UNDP projections for such middle-income countries as Lebanon, Morocco, the Syrian Arab Republic, and Tunisia predict an increase in poverty of approximately 10-15 per cent. However, the sharpest increase is expected to be seen in the least developed countries (LDCs). In Yemen, which is the most vulnerable to rising international food prices, poverty is expected to have risen by 20-30 per cent since 2006 (UNDP, 2012).

Analysing income or expenditure inequality in the region is a challenging endeavour due to data constraints. The available data shows that inequality is not very high compared to other regions and decreased or at least stabilized over the 1980s and 1990s, despite limited growth. Although country-level analyses are contradictory (Bibi and Nabli, 2010), this might imply that in such countries as Egypt, Jordan, the Syrian Arab Republic, and Yemen, poverty seems less growth-elastic and more distribution-elastic, meaning that public subsidies and increased primary education might have played a prominent role in poverty reduction rather than growth. Conversely, this could also imply that, if inequality was actually low, as raw data seems to indicate, higher growth rates might result in high growth elasticity of poverty.

Looking at the difference between household expenditure reported by surveys and national accounts as collected by UNDP, it seems there is a persistent gap between the two sources. This might indicate a consistent pattern of underreporting among the top percentiles of the income distribution. Moreover, while in other such regions as Latin America, most estimates of distribution use income data rather than expenditure data, Arab countries tend to use expenditure data. Typically, Gini coefficients for household income distribution are larger than the Gini coefficients for expenditure distribution because of consumption-smoothing effects. Also, individuals and households with higher incomes tend to underreport and to spend a smaller fraction of their income. Therefore, expenditure distributions are characterized by less variance than income distributions. As a result, inequality distribution in MENA might be much closer to that of Latin America than it would appear.[5] These potentially high inequalities are confirmed in the distribution patterns of education, which show that the Gini coefficients for the region are much higher than those of East Asia or Latin America, with MENA hovering around 0.5 and the latter two regions under 0.4 (World Bank, 2008; Bibi and Nabli, 2010). Finally, the pattern of high inequalities seems to be confirmed by the unequal distribution of land, which is the second highest in the world after Latin America (Majid, 2004).[6] This is shown in figure 10. In Egypt, for example, about 7 per cent of all landowners hold about half of the land (Hanstad, 2004) and in Yemen, 12 per cent of households control 80 per cent of the land with a land Gini coefficient of about 0.7 with further deterioration likely (World Bank, 2010b). If this data is correct, links between education and poverty reduction and also between agriculture/land tenure and poverty reduction are weak.

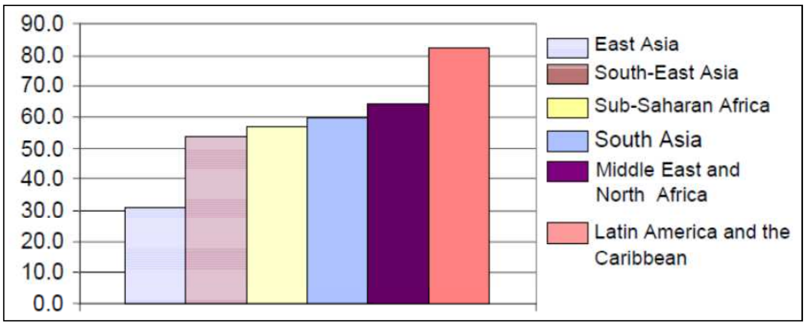
The Arab region is a patchwork consisting of a few high-density areas, where both economies and diseconomies of agglomeration are at play, within vast desert and marginalized areas. Increasing evidence has shown high and perhaps widening disparities between richer and poorer subnational regions, particularly in the middle-income countries in the region. Such metropolitan areas as Cairo, Casablanca, Tunis and Amman and such coastal regions as Alexandria, Aqaba and Tangier have benefited the most from past

[5] Jordan, Morocco, Tunisia and Yemen have a share of expenditure ratio between the highest and the bottom decile amounting to over 10, while only Egypt and the Syrian Arab Republic have a ratio within the range of 7-8 (Bibi and El-Lahga, 2010b). The World Bank estimated that the income distribution Gini coefficient for Tunisia in the period 1990-2003 was around 0.48-0.50, while the expenditure distribution Gini coefficient was 0.39-0.41. This would rank Tunisia at around the middle of Latin American income distributions (World Bank, 2008).

[6] According to Deininger and Olinto (2000), the land Gini coefficient in some of the ACTs is as follows: Egypt (0.55), Jordan (0.68) and Tunisia (0.65).

episodes of growth, while rural and marginal areas host about 70 per cent of the poor. The Tunisian coastal region accounts for about two thirds of public investment and three quarters of non-agricultural jobs (AfDB, 2011a). Data on per capita urban and rural consumption in six countries of the region has allowed an index of disparity between urban and rural populations to be built. Morocco has the highest urban-rural consumption ratio, followed by Egypt, while Jordan has the lowest measured ratio (Mijiyawa and others, 2011). Taking Egypt, which is the most populous Arab country, figure 11 shows how the gaps appear to have worsened income poverty levels, with differences of up to 60 times between the richest and poorest governorates. 80 per cent of the country's extremely poor live in the Rural Upper Egypt (World Bank, 2011f). Child mortality rates for the poorest income quintile are 2.6 times higher than the national average, while infant mortality is three times higher. Regional disparities in poverty rates seem to also be increasing in the Syrian Arab Republic and Yemen, and, to a certain extent, in Tunisia (table 2). Spatial disparities in service provision seem not to be linked to access problems as much as to there being large differences in their quality, as qualified employees and professionals tend to migrate to the largest urban centres to study and then settle down there. This is a reflection of a development process that favours urban elites and consumers concentrated in growth poles, with limited economic linkages amongst the regions. It seems that fiscal policies have not been systematically designed to spatially redistribute resources, as evidenced by the very low levels of fiscal decentralization and centralized public financial management systems that lack transparent formulas for intergovernmental fiscal transfers. Rather, a high degree of discretionality in allocative choices remains.

Figure 10. Regional Gini coefficients of distribution of land
(*Population weighted*)



Source: Majid, 2004.

The neglect of certain regions in some countries is also likely to be politically motivated, linked to their association with specific opposition groups and/or movements, thereby aggravating this pattern of unequal development. It is possible that the agglomeration index in the Arab region has been higher than in comparators because of autocratic political systems and political instability that provide an "urban premium" to the population, unlike democracies that tend to be motivated by the "median voter theorem". These factors tend to accelerate urbanization processes and increase spatial disparities (Mijiyawa and others, 2011).

TABLE 2. DISTRIBUTION OF THE POOR IN SELECTED COUNTRIES

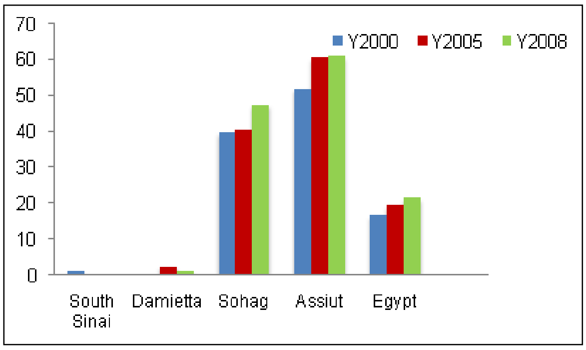
	Percentage rural population[a/]	Percentage agricultural employment[a/]	Percentage urban poor[b/]	Percentage rural poor[b/]	Rural/urban poor ratio[b/]	Percentage of total poor in rural areas[b/]
Egypt	56	31	10	27	2.7	78
Jordan	17	2	12	19	1.6	29
Syrian Arab Republic	43	15	8	15	1.9	62
Morocco	43	41	5	15	3.0	68
Tunisia	34	16	2	8	4.0	75
Yemen	68	23	9.5	32.5	3.4	89

Sources: a/ WDI. Data for Tunisia is from World Bank, 2009d.

b/ World Bank, 2011f. Data for Yemen is from IFPRI, 2010.

Note: National poverty lines used.

Figure 11. Poverty distribution in top and bottom two governorates in Egypt



Source: UNDP, 2012, based on data from Central Agency for Public Mobilization and Statistics, 2009.

A complex trade-off exists between tapping into economies of scale by means of industry spillovers, access to intermediate inputs, including skilled labour, and proximity to large markets, which generate productivity gains and jobs and a balanced regional development, which helps defuse grievances. However, economies of scale and spillover effects are inescapable and business will always tend to concentrate where lower transaction costs and skilled manpower are located. People are locked into low-productivity regions because of such factors as high transport costs, lower levels of education and lack of access to affordable housing in urban areas. The policy focus therefore needs to shift from spreading out industrial location to spreading out access to markets and public services and facilitating factor mobility. Spatially equalizing policies include the regulation of land and housing markets, taxation of land and real estate, fiscal decentralization, infrastructures that facilitate the movement of goods, factors and people, equal access to quality basic services throughout the country, build-up of individual portable assets and targeted social safety nets (SSNs).

Domestic migration movements do not seem to be able to offset such spatial disparities because they are primarily local migrations from rural to urban areas rather than countrywide movements between lagging and leading regions or governorates.[7] This seems to support the idea that migrations are primarily guided by the presence of an informal social network of relatives and friends in the town of destination.

Rural-urban migration may lead to the feminization of agriculture as men leave for urban centres or travel abroad to find work. When women become doubly burdened with raising children and farming, both responsibilities can only be pursued with suboptimal results. This situation is only sustainable if harvests are abundant, no droughts strike and remittances flow. However, in the light of continuing instability, low human security, recent economic turmoil and climate change, such favourable conditions are increasingly less likely. In order to cushion vulnerable pockets of society against social costs, farming communities need efficient instruments in the area of SSNs directly targeting vulnerable households. SSN programmes have been a crucial component of any transition process worldwide because, if well designed and inspired by the concept of building access and assets, they can help vulnerable households cope with stressful events and reverse their loss of assets during shocks, break the cycle of intergenerational poverty and tackle geographical concentration of poverty.

C. Food security and subsidy systems

Food security is particularly linked to poverty in the transition countries due to their high vulnerability to food-related external shocks. Indeed, the Arab region imports over half of the cereal demand worldwide

[7] These short-range movements also result from the fact that over 60 per cent of MENA population live within three hours of a major city (World Bank, 2011f). This makes investment in rural feeder roads as well as urban and peri-urban mass transit systems very important in supporting the diversification of income sources for rural households.

and buys around one third of all traded wheat, and this figure is expected to increase to 40 per cent over the current decade. The region is far more self-sufficient in such food commodities that are more likely to be consumed by the rich as meats, fish and vegetables than in those that are more likely to be consumed by the poor, which are cereals and sugar, among others. Spikes in food commodities particularly hit the poor as 35-65 per cent of their income is typically spent on food.[8] Child malnutrition is particularly high in Egypt, Morocco and the Syrian Arab Republic, and is at alarming levels in Yemen, irreversibly affecting cognitive and intellectual development and lowering labour productivity. In Yemen, due to the oligopolistic structure of cereal importers, wheat prices are on average twice as high as average international prices (IFPRI, 2010). Simulations in Egypt calculated that a 30 per cent increase in food prices would result in a 12 per cent increase in poverty levels (World Bank, FAO, IFAD, 2009). In addition, downward price rigidities have been found in the region, hinting that consumer price inflation goes up more quickly than it goes down (Albers and Peeters, 2011).

Conventional wisdom suggests that economic growth should improve food security and poverty conditions. The International Food Policy Research Institute (IFPRI) has tested this hypothesis by simulating the long-term elasticities between GDP growth and child stunting in the region.[9] According to these estimates, listed in table 3, Tunisia and Jordan appear to have sizable coefficients, with the latter also having sizable elasticities in the agriculture and manufacturing sectors. Unlike other regions in the world, agriculture in the Arab region does not seem to contribute to reducing malnutrition, as measured by child stunting.[10] Reasons for this could be the following: (a) agriculture only constitutes a small share of the total economy, usually less than 15 per cent, and its growth has often been negative over the last two decades; (b) currently, agricultural production is highly inefficient due to underlying structural factors that will be examined later in this study; (c) agriculture is seldom the main source of income for the population, including the rural population; and (d) staple foods are mostly imported, thereby limiting the potential benefits of any increase in domestic agricultural productivity.

TABLE 3. NUTRITION-GROWTH ARC ELASTICITY BY SECTOR

	GDP	AgVA	MaVA
Egypt	-0.20	-0.61	-0.24
Jordan	-1.09	1.33	-0.57
Syrian Arab Republic	-0.79	0.39	0.28
Morocco	-0.77	-0.73	-1.27
Tunisia	-1.35	-1.60	-1.91
Yemen	0.45	-0.49	-0.24
Average ATCs	-0.62	-0.28	-0.66
Arab Region	-0.83	0.63	-0.73

Source: Breisinger and others, 2012b.

Note: AgVA is short for agriculture value added; and MaVA is short for manufacturing value added.

In the wake of the food and financial crisis, many Arab countries, including Egypt, Jordan, Oman, Saudi Arabia, the Syrian Arab Republic, and Yemen, have increased wages for public sector employees.

[8] For instance, food and housing are the largest consumption groups for the poorest quintile in Egypt, with 52 and 17 per cent, respectively. In Yemen, food accounts for more than half of total expenditure of the lowest two quintiles of expenditure distribution of the population.

[9] Stunted growth, mainly explained by malnutrition during childhood, may lead to mental and physical impairments.

[10] This finding seems to be supported by simulations done in Yemen which show that growth in industry and service sectors leads to a higher average annual reduction of food insecurity and child stunting compared to an agriculture-led growth (Ecker and others, 2011). However, these findings seem to contrast with earlier simulations done by a joint assessment on food security in Egypt, according to which growth in the agricultural sector has the highest potential impact on poverty reduction with an elasticity of about three (Arab Republic of Egypt, 2009).

Egypt, Jordan, the Syrian Arab Republic and Yemen have tried to support the poor by increasing bread subsidies, implementing direct cash transfers and lifting tariffs on basic food commodities.[11]

However, some of the food subsidies have proved to have regressive effects, including those in Egypt and Yemen in the 1990s, with the highest quintiles, often living in urban areas, receiving at least as much as the lowest one, mostly resident in rural areas.[12] Food subsidies have gradually become more targeted, albeit with further improvements needed in efficiency. Some have been reduced in scope and are increasingly replaced by targeted cash transfers. Energy subsidies are estimated to amount to on average around 5 per cent of GDP across the region, peaking at about 13 per cent in Yemen, 11 per cent in the Syrian Arab Republic, 8 per cent in Egypt, 5 per cent in Morocco and 4 per cent in Tunisia (World Bank, 2012e). Overall, food and fuel subsidies in the region account for more than four times the respective average in developing countries. These subsidies again tend to be heavily tilted towards the non-poor, as witnessed in Egypt, where gasoline subsidies disproportionally go to the richest quintile of consumers (figure 12). Moreover, the reduction of import tariffs on staples is likely to accrue largely to the non-poor.

The waste entailed, particularly in energy subsidies, is in sharp contrast with other potentially more justifiable SSN instruments, which are very often underresourced, with a regional average of just 0.7 per cent of GDP, and fragmented among many institutions and small programmes that may have gaps or overlaps in their coverage (figure 13).[13] These factors result in non-subsidy SSNs having an imperceptible impact on poverty and inequality, particularly in Egypt and Yemen. The subsidy system throughout the region is therefore in need of a major overhaul not only because of its inherent inefficiencies and fiscal impact but also because the elimination of unnecessary price distortions is likely to result in efficiency gains for the whole economy and therefore to lead to economic growth.

Figure 12. Share of benefits from subsidies by income groups

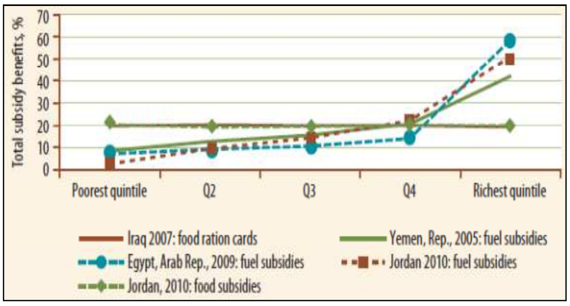
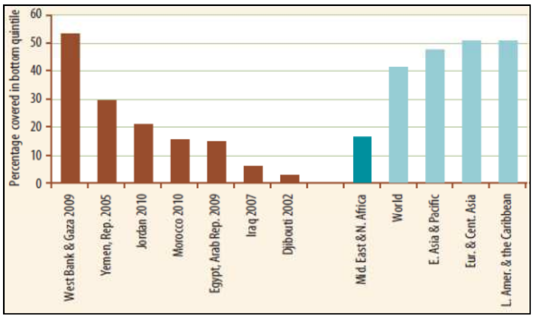


Figure 13. Comparisons of coverage of non-subsidy SSNs



Source: World Bank, 2012e.

A wide variety of SSN programmes have been established in transition countries in a bid to reduce poverty. Such programmes as cash transfers are believed, in principle, to be the most effective in benefiting the poor. These programmes prove particularly useful in the aftermath of an exogenous shock as they help families immediately and also contribute towards breaking the spiral of vulnerability typical in a post-shock setting. However, it is important to bear in mind that even well-designed and implemented SSNs cannot by themselves protect from poverty unless they are accompanied by poverty reduction strategies that increase

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[11] While reducing import taxes is an easily implementable policy, it has caused a controversial debate over the past few years for the following reasons: (a) it can be costly to the budget and can worsen already tight fiscal balances; (b) at least part of the benefit tends to accrue to the non-poor; and (c) unlike value added tax (VAT) cuts, tariff cuts lower importing food prices with the risk of hurting domestic producers, at least in the short run.

[12] World Bank, 2006.

[13] According to the World Bank, 2012e, social safety net programmes in the region do not reach two thirds of people in the poorest quintile and distribute only 23 per cent of their benefits to the bottom quintile of the population, compared to around 59 per cent in Latin America and Eastern Europe.

real incomes of the poor in the medium and long term. Efficient SSNs are generally well targeted and flexible so that they can be cost-effective in reaching the people in need and can be scaled up or down depending on the likelihood of systemic or covariate shocks occurring. Efficient targeting requires reliable and up-to-date data in order to identify and locate the needy, good analysis to link policies and their impacts on poverty, and capable organizations that can learn from experience and modify policies when needed.

However, many programmes in the region do not possess these requisites and, sometimes, when the institutional capacity is limited, duplications occur and resources are wasted. For example, SSNs in aid-recipient countries can be provided through a complex web of programmes supported by the government, international donors, non-governmental organizations (NGOs) and charitable organizations, some of which may have the same target populations. In addition, social protection programme reforms have no chance of success without a thorough assessment of the political economy context. For instance, they heavily depend on the type of inequality specific to a country and the level of tolerance to it. As commodity targeting is more horizontally equalizing than selective socioeconomic targeting (for an application, Bibi and Duclos, 2007), the former tends to be more politically feasible in countries with high horizontal inequalities and therefore more suitable in such countries as Libya, Morocco, the Syrian Arab Republic and Yemen. In fragile political contexts, exclusion error is more politically accepted than inclusion error. In the medium term, with the generally limited state capacity available, it is therefore advisable to investigate options within an approach that mixes subsidies that have been proven to be pro-poor, such as self-targeting food subsidies,[14] with cash transfers so as to combine efficiency requirements with political economy considerations.[15]

Box 1. Poverty and food insecurity in selected countries at the outset of transition

Egypt

- Egypt is one of the largest per capita consumers and importers of wheat in the world;
- Poverty rates have high geographic variance, ranging between close to 0 in Suez and 60 per cent in Assiut;
- One fifth of Egyptians are calorie-deprived, receiving less than 80 per cent of the required daily calorie intake;
- 14 per cent of children under five are severely stunted;
- There are geographic patterns of caloric deprivation (central governorates) and nutrition deficiency (Upper Egypt);
- However, there is a puzzle: under-five stunting is higher in Lower Egypt than in Upper Egypt, whereas poverty is not.

Syrian Arab Republic

- Civil conflict and embargoes have affected the purchasing power of Syrians due to depreciation of the Syrian pound and the increase of import prices;
- 30 per cent of rural population are estimated to be vulnerable to food insecurity;
- The conflict has also affected domestic agricultural production through:

[14] Unlike other subsidies, food subsidies tend to be pro-poor, as shown in Egypt, where their impact on poverty reduction is estimated at about 9 per cent (World Bank, 2010a).

[15] According to the World Bank's MENA SPEAKS survey, which is available from http://www.gallup.com/poll/158906/mena-residents-put-onus-government-help-poor.aspx?version=print, the subsidized goods least preferred by beneficiaries are cooking oil and gasoline in Egypt, bread and diesel in Tunisia and electricity and diesel in Jordan. However, these estimates should be used with caution because: (a) a large share of respondents, ranging between one quarter in the case of Jordan, and one half in the case of Tunisia, were not aware of the existence of fuel subsidies in the first place; and (b) upper income groups in Egypt, Jordan and Tunisia in the survey opposed any subsidy reform.

- Restrictions of movements and increase in transport costs;
- Rise in prices of inputs (fuel, fertilizers, feed) and production factors (labour, capital), resulting in increase of overall production costs;
- Increase in renting costs of equipment;
- Many moneylenders now only lend in US dollars.

Box 1 (*continued*)

Yemen

- About 54 per cent of the population are below the poverty line, 44 per cent are food insecure and 59 per cent of children are stunted;
- The food insecure are concentrated in rural areas, mainly in households headed by agriculture wage labourers, and in the western part of the country;
- The country is almost entirely dependent on food imports and therefore highly vulnerable to commodity price volatility. Combined with currency depreciation and decreasing exchange revenues, this has reduced the ability to purchase the required amounts of food;
- Food price spikes are by far the most reported main shock event for households;
- The number of severely food insecure almost doubled between 2009 and 2011 alone from 12 to 22 per cent;
- Food purchase on credit has increased and now makes up one quarter of total food purchase;
- Despite the increase in malnutrition, households spend about 10 per cent of their budget on qat[*], which is more than expenditure on health and education combined;
- Gender parity in education remains low (0.66 for basic, 0.45 for secondary);
- The Consumer Price Index (CPI) rose from 12.5 per cent in 2010 to 23.2 per cent in 2011;
- Internally displaced persons (IDPs) and refugees from the Horn of Africa remain particularly vulnerable.

Sources: World Food Programme (WFP) country overviews for Egypt, Syrian Arab Republic and Yemen (accessible at www.wfp.org); Breisinger and others, 2012b, for Egypt; and World Bank, United Nations, European Union, and Islamic Development Bank, 2012, for Yemen.

Note: [*] Qat is a mild stimulant and addictive plant native to some areas of the Arab region.

D. LABOUR MARKETS AND POLICIES

1. *Labour markets*

Over the last two decades, official unemployment, particularly youth unemployment, has remained stagnant at higher-than-world-average rates, hovering around 10 to 14 per cent and 20 to 30 per cent, respectively (figure 15). Youth unemployment ranges between two and eight times higher than adult unemployment, according to data by the International Labour Organization (ILO). In 2011, the youth unemployment rate stood at 26.5 per cent in the Middle East and at 27.9 per cent in North Africa (ILO, 2012). Based on some estimates (Chaaban, 2008), the associated economic loss due to youth unemployment for the whole region is thought to exceed US$40-50 billion annually, equivalent to the GDP of countries like Tunisia or Lebanon (IFC, 2011).[16] Employment ratios have remained at lower-than-average levels, resulting in the lowest employment-to-population ratios in the world (figure 14). The low employment rate in the region is a function of both low female participation and youth frustration at job prospects. Youth unemployment makes up around two thirds of total unemployment. Arguably, youth frustration, at least for

[16] If such indirect costs as school dropouts and migration are added, the overall cost could easily increase.

educated first-time job seekers, is likely to derive from unrealistic salary expectations that result from lack of knowledge of the labour market due, among other things, to the poor intermediation role carried out by schools but also by employment centres.[17] Arab female unemployment is on average almost double that of men and more than double among the youth. Considering the informal sector, actual unemployment is probably much higher. First-time job seekers account for most of the unemployed, confirming that unemployment in the region is largely a labour market insertion problem for the youth. This is particularly difficult to tackle for two reasons: (a) youth lack capacity to cope with income shocks since they typically lack assets and are primarily dependent on labour income; and (b) employment trajectories are, and seem to be increasingly, persistent. In other words, those who are in low-quality jobs from the start of their employment history are likely to remain so.[18]

Figure 14. Employment rates in selected countries and regions

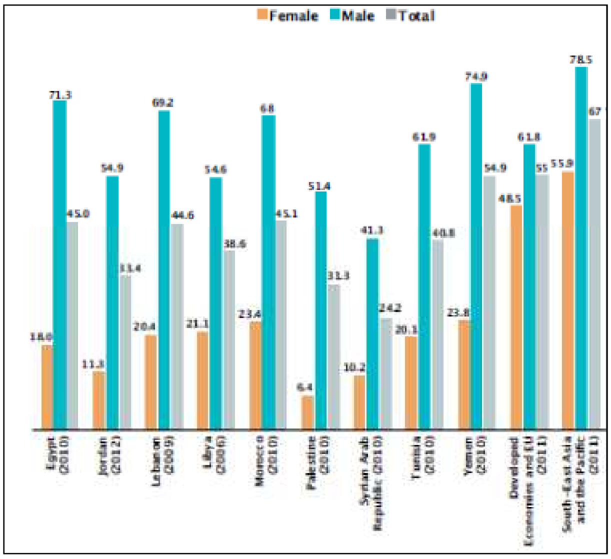
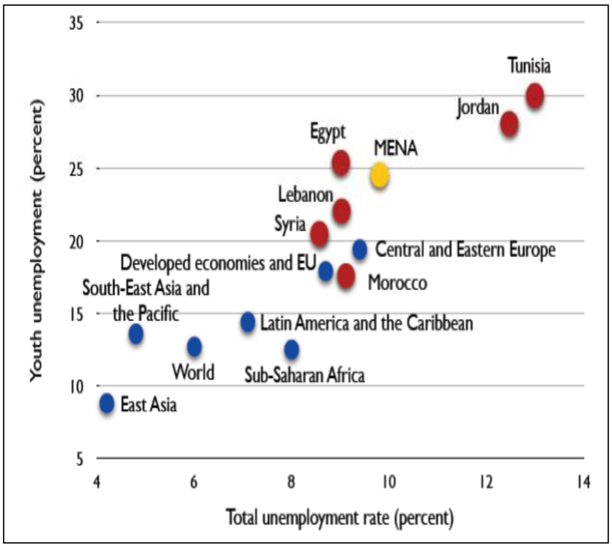


Figure 15. Total and youth unemployment by region



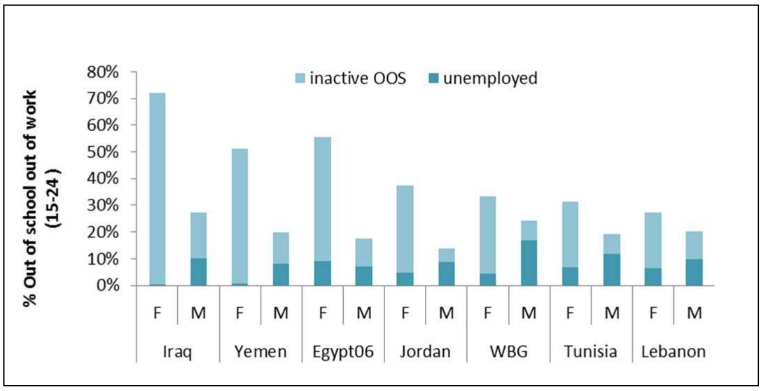
Source: ILOSTAT Database as reported in ESCWA, 2013a; and IMF, 2012b.

Using youth unemployment as an overall indicator of youth access to the labour market is somehow reductive as it disregards the share of young discouraged job seekers. Such data on the joblessness rate as that included in figure 16 on the ratio of youth who are neither in education nor in employment would provide a better picture of the scale of frustration and despair among the Arab youth, including women, so that policy interventions in terms of training and active labour market policies can target this segment of the population. In the region, joblessness seems to be directly related to poverty and inversely related to levels of education.

Figure 16. Youth joblessness and unemployment in selected countries

[17] Surveys conducted in Egypt, Jordan and Morocco show that salary expectations for current students are much higher than those of current employees (IFC, 2011).

[18] A study conducted in Egypt finds that young men have become less socially mobile by means of employment (Binzel, 2011).



Source: Morgandi, 2012.

On average, the labour force participation rate for the region has stagnated at the lowest levels worldwide, although there are huge disparities within the region, represented by the LDCs and transition countries at the lower end and the GCC countries at the higher end. On the supply side, this stagnation is notably due to the lower rate of participation of women. The gap is even more significant for the female youth labour participation rate, which is about half of the average of other developing regions. More puzzling is the fact that such ACTs as Egypt, Morocco and Yemen have show stagnating or even deteriorating trends of female labour participation over the last two to three decades.

Over the last decade, the region has created jobs at a higher average rate than other comparators, amounting to around 3 million new jobs a year. However, the majority of these are informal jobs primarily in such non-tradable service sectors as construction and agriculture (Nabli and others, 2007), and are still about only two thirds of what would be needed in order to absorb all the new entrants and bring down unemployment. The percentage of young adults aged 15-29 in the working age population has consistently hovered between 45 and 50 per cent over the last three decades and is expected to remain at around 40 to 45 per cent over the next decade. The combination of huge demographic pressure along with a higher average education level and accelerated female participation has more recently resulted in a remarkable surge in the young labour force, averaging around 3 per cent growth a year, while the female rate of growth is around 5 per cent. From this perspective, transition economies will see an increasing divide among themselves with most of the Maghreb countries, namely, Egypt, Morocco and Tunisia, being characterized by a labour force growth of about half of that of the Mashreq transition economies, which are Jordan, the Syrian Arab Republic and Yemen.

The labour force is expected to increase by around 40 million workers during this decade, expanding by an amount similar to its increase over the span of the last 20 or 30 years of the last century, with disproportionally higher growth in urban areas. About half of new entrants are expected to originate from ACTs alone. If the region wanted to bring both unemployment and labour force participation rates up to the world average rates, which are at around 6 and 52 per cent, respectively, this would require the creation of something in the order of 90 million jobs. In creating these jobs, specific issues in terms of geographic distribution, educational skills and gender would have to be taken into account. The need to generate such an immense number of new jobs confronts the region with one of the most difficult developmental challenges in contemporary history that will require greater efforts than those needed for the East Asia miracle. Given the average increase, in ACTs, of working age population of around 2 per cent per annum and a historical average increase in labour productivity of around 3 per cent, as in the case of Egypt, this implies that some of the ACT economies would need to expand by about 5 per cent per year just to keep the unemployment rate stable. Moreover, to absorb the unemployed and new entrants to the labour market over this decade, it is estimated that non-oil economies would need to drastically increase their GDP growth recorded over the last decade to about 7 to 8 per cent in real terms (Gelvin, 2012, table 4).

TABLE 4. RATES OF GROWTH REQUIRED TO CURB UNEMPLOYMENT
(1980-2005 AVERAGES)

Country	Annual rate of growth of employment (*Percentage*)	Real GDP growth (*Percentage*)	Employment elasticity	Required rate of GDP growth (*Percentage*)
Algeria	1.48	3.71	0.40	8.00
Egypt	1.87	6.05	0.45	7.11
Jordan	3.06	4.86	0.63	5.08
Morocco	1.78	4.02	0.44	7.27
Syrian Arab Republic	2.56	5.69	0.45	7.11
Tunisia	1.65	5.15	0.32	10.00
Average	2.06	4.91	0.42	7.62

Source: League of Arab States and UNDP, 2009.

In addition to the large role played by the public and the informal sectors, and in part affected by it, worker productivity growth between 1991 and 2010 has been stagnant (figure 17), with an increase of around only 0.5-0.6 per cent per year – the lowest in the world – with the notable exceptions of Egypt, Jordan, Morocco, and Tunisia, over the last decade. Arab transition economies lag behind most of their direct comparators, namely, Argentina, Malaysia and Turkey, among others, as depicted in figure 18. This, in turn, implies that revenues, competitiveness and private sector demand are likely to have stagnated as well. This also means that, given the structure of the economy, policies cannot contemporarily achieve lower unemployment and higher wages, at least in the short run. Rather, reductions in unemployment in the short term can partly be attained at the expenses of wages.[19] To make a comparison, in the fast-growing emerging economies of Brazil, Turkey and East Asia, trade, transport, tourism and information and communications technology (ICT) sectors were the main engine of both value added and employment.

Figure 17. Annual productivity growth by region (1991-2010)

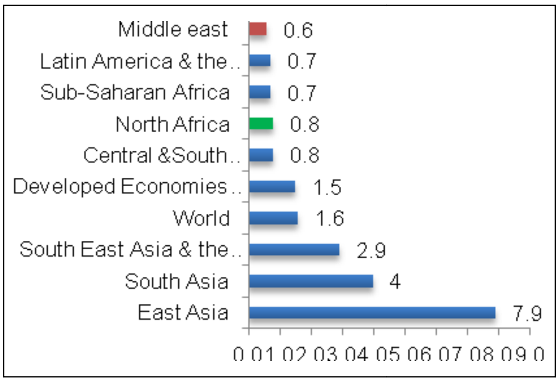
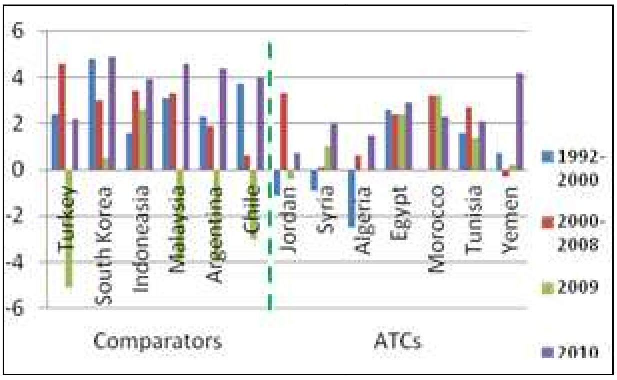


Figure 18. Trends in labour productivity in ATCs and some comparators



Sources: Tzannatos, 2011b; and ILO, KILM, data available from http://kilm.ilo.org/2011/download/kilm17EN.pdf.

The new labour force is increasingly more educated, particularly in Egypt and Jordan, and has higher female participation, although still the lowest in the world with less than 30 per cent, but unemployment and the increase of informality have prevented such advancements from realizing economic returns.[20] These

[19] The available evidence suggests a decline or stagnation in real wages in the 1990s and early 21st century. In Algeria, Egypt and Jordan, real wages registered a decline. In Egypt, in the period 1982-2003, the index of real GDP per person employed went up by 40 per cent, while there was a decline in real wages over the same period. In Algeria and Jordan, the real GDP per person employed declined by 30 per cent between 1980 and 2003. In short, the benefits of growth have not trickled down to large sections of the population and, in particular, to those in the potentially (in terms of productivity gain) most dynamic sector of the economy.

[20] In Egypt, an informal worker with primary education earns wages similar to those of an informal worker with secondary education. In the formal sector, the ratio would range around 1:2 to 1:3 (Angel-Urdinola and Semlali, 2010).

combined phenomena, together with labour market segmentation, contribute to deadweight losses of a large share of public investment in secondary and tertiary education. The discouraging wage prospects once in employment due to low worker productivity are also evidence of poor labour market outcomes. This situation explains the low contribution of human capital to economic growth in the region[21] and is actually allowing huge amounts of human capital to go to waste.

Slow school-to-work transition remains the main reason behind high youth unemployment rates. In Egypt, for instance, about 80 per cent of the unemployed are youths entering the labour market for the first time (Assaad, 2009), and it takes on average about seven years for an unemployed youth to find his or her first stable job (Angel-Urdinola and Semlali, 2010). Most job searches by the Arab educated youth begin within the public sector. But hope for a good job turns quickly into frustration at no or low-paid work. As a result, informality, as measured by per cent of workers without a contract and per cent of workers not contributing to social security, increased from 56 per cent to 63 per cent and from 49 per cent to 58 per cent, respectively, between 1998 and 2006, as described in table 5. As expected, in the rural areas in Egypt, these percentages are above average at both points in time: from about 66 per cent to 73 per cent and from 62 per cent to 70 per cent, respectively (Angel-Urdinola and Semlali, 2010). Among workers with primary or secondary education, almost all employment found in the period of observation was informal and typically in the wholesale, construction and hotels and restaurants sectors. The increase in informality has particularly affected the most educated workers, whose numbers have more than doubled in the same period. Regarding the gender aspect, women have experienced more challenges than men in transitioning from an informal to a formal job (World Bank, 2011g). While the labour force was experiencing these difficulties, the country was being praised on the international scene for its above-average economic growth, labour regulation modernization and apparent drastic progress in reforming the business environment.

TABLE 5. INFORMALITY TRENDS IN EGYPT

	Workers not contributing to social security as percentage of total employment	Workers without a contract as percentage of total employment	Share of workers in firms with less than five employees
1998		**Total**	
2006	49.0	56.0	40.0
percentage	58.3	62.8	52.6
change	19.0	7.6	12.1
1998		**Urban**	
2006	33.6	44.4	32.2
Percentage	42.6	48.8	44.0
change	26.8	12.8	9.9
1998		**Rural**	
2006	62.4	66.1	45.6
percentage	70.0	73.4	56.1
change	12.2	4.1	11.0

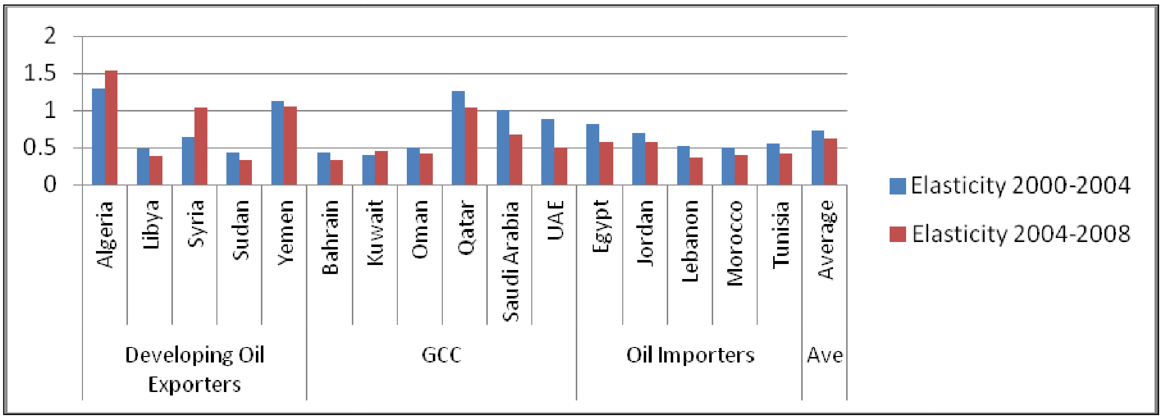
Source: Angel-Urdinola and others, 2010.

Estimates for employment elasticity show that the GCC countries and oil importers have relatively lower values than developing oil exporters (figure 19). These values decreased in the second half of the 1990s and again between 2000-2004 and 2004-2008. Particularly remarkable and worth further analysis are the low elasticities estimated for Egypt, Morocco, the Syrian Arab Republic and Tunisia included in the decreasing trends recorded in the middle-income countries of the region that may be in part due to an increase in labour productivity in some of their economic sectors. This is because, overall, the region historically witnessed a negative relation between productivity growth and employment creation (Nabli and

[21] Abu-Qarn and Abu-Bader, 2007, found that since the early 1990s, MENA growth performance was essentially determined by physical capital accumulation, to a lesser extent by human capital accumulation, and no contribution from total factor productivity (TFP).

others, 2007). However, one needs to look at sectoral differences in order to better explore this relation. Regrettably, very little information is available in this respect. A recent report by the European Commission has calculated that, in the case of Egypt, 1 per cent growth in agriculture or industry would generate around 0.35 per cent growth in employment, which is lower than Egypt's average, whereas in the services sector, the relationship would be more than double that rate, namely 0.85 per cent (European Commission, 2010). These trends seem to be confirmed by sectoral estimates from other countries that show lower, or even negative, elasticities for agriculture and higher elasticities for the construction, services and public sectors. This seems to confirm the procyclical attitude of the state in this region, which will be discussed in more detail in the fiscal policy section.

Figure 19. MENA trends of employment elasticities to growth



Source: ILO/KILM.

2. *Labour policies*

Higher than market equilibrium minimum wages, costly redundancies with high severance payments and cumbersome procedures, and high labour tax wedges[22] have kept formal labour costs artificially high. In Lebanon and the Syrian Arab Republic, more than a third of firms perceive labour regulation as a major constraint, as opposed to the GCC countries. In Egypt, total severance payments equal up to 132 weeks of a worker's most recent salary, in Morocco, 85 weeks and in the Syrian Arab Republic, 80 weeks – averages that are much higher than in such comparator regions as Latin America and the Caribbean (LAC) (53 weeks), East Asia and the Pacific (EAP) (42 weeks) and Eastern and Central Africa (ECA) (28 weeks).

Stringent labour regulations make it costly to hire and fire workers in the formal sector. These regulations are considered a major constraint to business compared to other regions and are considered as particularly high in Egypt, Lebanon and the Syrian Arab Republic (World Bank, 2011g). A survey of manufacturers, service firms and hotels in Egypt reports that they would hire 21 per cent, 9 per cent and 15 per cent more employees, respectively, given more business-friendly labour regulations (Angel-Urdinola and others, 2010).[23] In Lebanon, firms indicate that on average they would hire more than one third of their current workforce with a more flexible regulatory framework. As it stands, young workers have little opportunity to acquire practical skills and capitalize on previously acquired education, resulting in skill

[22] Tax wedges are particularly high in Morocco and Egypt, where they are just below 40 per cent of the total labour cost. Egypt, however, has lately embarked on reforming the labour tax framework.

[23] It is worth mentioning that in Egypt as well as in Jordan, more flexible labour regulations are applied in special economic zones, with mixed results.

degradation and the waste of public financial resources allocated to education. This, in turn, prevents human capital from effectively contributing to economic growth in the region. Continuous entrance of a large new labour force combined with less efficient labour markets is likely to lead to higher unemployment rates, particularly in such countries as Algeria, Egypt, Libya, Morocco, the Syrian Arab Republic, and Yemen.

In the field of social protection, rather than insurance systems linked to the new requirements of the labour market being introduced, resources were increasingly channelled into poverty alleviation schemes through a fragmented institutional setup within the state apparatus and were increasingly implemented by confessional and communal NGOs, whose risk of contributing to social polarization is not yet clear. The coverage of unemployment insurance in the region is probably the lowest among all middle-income countries, as shown in figure 20. In non-GCC countries, low formal employment levels, low female labour force participation and high levels of youth unemployment remain key causes of low coverage rates of formal social security schemes, as most social security systems in the region are contributory rather than universal, are financed from general tax revenues and linked to formal employment. As a result, most working-age people lack any form of social security other than some basic form of social assistance. Nearly all women, except the small proportion with stable employment in the public sector, have little or no social security coverage in their own right. In addition, this lack of security contributes to labour market segmentation and erodes the countercyclical role that automatic stabilizers tend to play in times of downturn.[24] For the situation to be improved, a paradigm shift would be required in the region, moving from the protection of jobs to the protection of workers and the enhancement of the resilience of the unemployed. Currently, a significant proportion of the burden of social protection is placed on employers. While hiring regulations are generally aligned to international standards, with the exception of Algeria, Lebanon and Morocco, workers' protection costs, namely, maternity benefits and firing costs, are usually covered by employers, resulting in widespread evasion of labour legislation and, consequently, informal work.[25] Transition countries have not generally introduced unemployment insurance (Algeria and Tunisia are notable exceptions and Egypt has introduced it with limited results so far), relying instead on severance restrictions and payments. Unemployment insurance has become an increasingly important feature of dynamic labour markets and advanced social security systems.

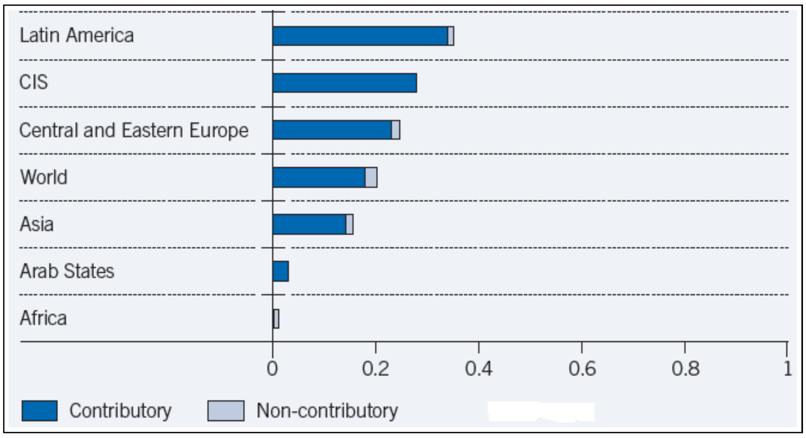
Minimum wages are often not set based on the marginal product of labour of the new entrants, and in Morocco and Yemen, which happen to be two countries with serious unemployment problems, the ratio of minimum wage to average wage is 0.72 and 0.60, respectively, as opposed to Egypt and Oman, where the ratio is 0.11 and 0.13, respectively.[26]

Figure 20. Unemployed with unemployment benefits
(*Share of total unemployed*)

[24] Automatic stabilizers in the budget mainly work via taxes, particularly direct taxes, and transfers related to unemployment and other income support schemes, which are sensitive to cyclical developments. In the face of cyclical fluctuations, the absence of automatic stabilizers leaves countries with two policy options: (a) to resort to discretionary fiscal policies for stabilization purposes; or (b) to assign a more active role to monetary policy, but limited only to countries with flexible exchange rates. Both options have procyclical risks.

[25] Strict labour regulation usually leads to labour market segmentation between insiders, namely, workers with protected jobs, and outsiders, namely, people who are unemployed or with temporary contracts. The literature on market segmentation provides many examples of how this usually works to the detriment of the most vulnerable groups, which are the poor, youth and women.

[26] For the sake of comparison, in LAC, this ratio averages around 0.40 but is even lower in such comparators as Argentina, Brazil and Mexico.



Source: Tzannatos and others, 2011.

The Declaration on Fundamental Principles and Rights at Work issued by the International Labour Organization (ILO) in 1998 lists four core labour standards that should be upheld by all countries, regardless of their level of development. These standards are:

(a) Unconstrained freedom of association and effective recognition of the right of collective bargaining;

(b) Elimination of forced labour;

(c) Elimination of child labour;

(d) Elimination of discrimination in employment.

In most non-GCC countries in the region, collective bargaining is not widespread and therefore labour regulations tend to be quite rigid, as they are a core instrument in protecting the rights of workers. Countries with more flexible labour regulations, however, tend to be characterized by higher levels of collective bargaining. With the exception of Tunisia, trade unions in this region are often state-controlled and, in any case, are rarely influential social actors. In fact, most countries have not ratified the ILO Convention on the Freedom of Association and Protection of the Right to Organise.[27] As most Arab countries have ratified most ILO core conventions which, being international treaties, supersede the national legislation, they are rated with a low score on the trade union right index. In the cases of Libya and the Syrian Arab Republic, the score is zero. In the Syrian Arab Republic, collective bargaining has not been practised despite being legal. In Jordan, strikes cannot take place without government authorization.

TABLE 6. RESTRICTIONS ON TRADE UNIONS IN ESCWA MEMBER COUNTRIES

No trade unions allowed	Trade unions highly restricted	Some level of free unionization

[27] The ILO Convention 87 on Freedom of Association and Protection of the Right to Organise has only been ratified by Egypt, Kuwait, Libya, the Syrian Arab Republic, Tunisia and Yemen but in most of these countries the Convention is not properly implemented as the national laws only allow for one official trade union. ILO Convention 98 on the Right to Organise and Collective Bargaining has been ratified by Egypt, Iraq, Jordan, Kuwait, Lebanon, the Sudan, the Syrian Arab Republic, Tunisia, and Yemen. Several ESCWA member countries, namely, Bahrain, Egypt, Iraq, Kuwait, Lebanon, Oman, Qatar, the Sudan, the Syrian Arab Republic, the United Arab Emirates, and Yemen, have freedom of association enshrined in their constitution, although this does not necessarily extend to trade unions, which are sometimes forbidden and are often severely restricted by regulation or state intervention. Even in the countries where unions are allowed, rates of unionization are low notably because of the huge number of small and medium enterprises (SMEs) that operate informally. Estimates for Jordan for 2004 show a 10-15 per cent unionization rate and workers in the private sector are generally underrepresented in collective bargaining agreements. In Egypt, union membership amounts to about 20-25 per cent of the formal work force. Unions played an important role in negotiating redundancy conditions (social packages) in the framework of Egypt’s privatization programmes but they are less representative of small businesses. Estimates of union membership in Lebanon range around 6-7 per cent.

Saudi Arabia (exception: workers' committees within workplaces with more than 100 employees) United Arab Emirates	Sudan Egypt (currently changing) Yemen Syrian Arab Republic Qatar Jordan Iraq Bahrain	Oman Lebanon Kuwait Palestine

Source: ESCWA, 2012c.

Employment services in the region are limited. They primarily aim to provide job-matching services or to actively reach out to private-sector enterprises and prepare job seekers through training and skills development. Some employment agencies, mainly in the GCC countries, are more prepared to provide integrated services, combining job searching with career guidance and targeted skills enhancement and training. In ACTs, employment services need a major overhaul. An online and industry-based platform could have an immediate impact on facilitating coordinated actions across the three main stakeholders, which are education providers, job seekers and employers. Such a platform could combine three critical components: (a) key information and statistics on employment, graduation and career trends;[28] (b) a repository of education and employment experience-sharing by youths; and (c) matchmaking across the three stakeholders. Labour offices in the region typically have very limited resources, outdated organizational structures and procedures, are inadequately staffed and do not systematically use monitoring and evaluation as an integral part of their programme management. Around the world, job matching and career counselling are increasingly outsourced to the private sector and ICT has proven essential in enhancing job matching through online job banks and databases for curricula vitae that can be directly accessed by job seekers and employers.

The region has a plethora of active labour market and social protection programmes (ALMPs) that constitute a large administrative burden on the institutions that administer them but usually do not have a systemic impact if not complemented with functioning unemployment schemes that support workers during labour transitions. ALMPs aim to: (a) increase employability through productivity and skill enhancement: (b) create employment and maintain jobs through public works programmes (PWPs) and wage subsidies; and (c) decrease frictional unemployment by enhancing labour supply and demand matching processes through employment intermediation services. They have been extensively used during crisis and transition periods in other regions and are potentially suitable instruments in the Arab transition, although they cannot remedy structural labour market problems. Successful ALMPs in terms of aims (a) and (c) usually require effective public-private partnerships, as in Turkey, for example (Betcherman and others, 2010), and the existence of a good coordination mechanism. Unfortunately, in the MENA region, the public and private sectors often show signs of mutual distrust. For this reason, many private ALMP service providers do not coordinate with the central authorities out of fear of getting caught up in red tape, while central authorities point at the low quality of services provided by informal businesses.[29] Most ALMPs focus on such training programmes that are usually supply-driven and of traditional format as in-class training of theoretical technical concepts, with limited practical experience and employment intermediation services.[30] In addition,

[28] Key information and statistics include such data on the annual number of jobs and graduates in each industry as number of annual graduates in each related discipline; number of annual positions hired in the industry; the employability achieved by each education provider, including number of months following graduation until graduates find a job; employer assessment on the quality of graduates broken down by different institutions and degree programmes; and career pathway information that helps youths understand pathways from entry positions upwards in their respective industry.

[29] In some countries, private employment intermediation is actually prohibited. If not properly regulated, private agencies tend to serve the better skilled and better educated as well as privileged metropolitan areas, hence tending to ignore or underserve rural areas.

[30] For example, in Egypt, vocational training is provided by a myriad of ministries, agencies and public enterprises with no coordination of curricula and examination standards. Most of them provide certificates of attendance rather than certificates attesting

accreditation and certification systems are underdeveloped (Angel-Urdinola and others, 2010) and national qualification authorities are either non-existent or inadequate in regulating skill-training programmes. Most youth employment programmes do not provide practical experience and most ALMPs are not targeted and therefore risk being regressive in their scope, thereby favouring urban educated male youth who are the least in need of these types of public interventions, instead of focusing on such disadvantaged groups as women, urban poor and youth from rural areas (World Bank, 2010e). Good practices in this policy area are summarized in table 7.

Recently, PWPs have been employed in the region, and with increasing regularity. Estimates for Egypt and Tunisia suggest that infrastructure investment could generate about 87,000 and 18,000 jobs, respectively, for every 1 per cent of GDP spent (Angel-Urdinola and others, 2010). In Yemen, projects use predominantly locally sourced materials and labour so communities have a strong incentive to ensure their continuation. PWPs can potentially provide transferred benefits together with risk-coping benefits and contribute to the overall improvement of the infrastructure base of an economy. If designed well, they can improve community infrastructure and provide assistance to the poorest households with able-bodied members. In rural areas, they usually combine such labour-intensive infrastructure projects as soil conservation, feeder roads and drainage construction and maintenance with hiring policies to maximize the pro-poor impact. These programmes have had a significant countercyclical function in helping poor farmers to cope with covariate risks associated with systemic shocks in many countries in other regions.

TABLE 7. SUMMARY OF GOOD PRACTICES IN ALMPS

Employment services	Training	Wage subsidies	Public works	Self-employment promotion
Targeting individuals with skills in demand by employers	Coordination with private sector (demand-driven training)	Used to sustaining jobs in crisis	Rural areas, builds community assets	Wide dissemination
Exploit information technologies	Post-training employment guarantees (caution!)	Temporary measure to encourage demand for disadvantaged workers (youth/women)	Temporary measure, think of graduation strategy	Careful selection of beneficiaries/business plans
Maintain close links with employers	Financial incentives for employers	Combine with training, counselling, job search assistance	Combine with training, counselling, job search assistance	Provide management skills/counselling
Decentralize provision	Combination of soft and hard skills		Set wage level appropriate to allow for self-targeting	Labour market information system to monitor successful programmes
Encourage private employment agencies (but regulation)	Institutional capacity (high quality training institutions, competent teachers)			Targeting women (sustainability of programme)
Ensure institutional capacity of PES	Accreditation system			

Source: Angel-Urdinola and others, 2010.

Finally, the Arab youth suffer from multiple dimensions of youth exclusion because, as well as being excluded from the labour market, they are also excluded from participation in public life. On average, they

the actual acquisition of particular skills. Only 27 per cent of the trainees interviewed who participated in the National Youth Employment Programme declared having obtained a job because of the training they received (Semlali and Angel-Urdinola, 2011).

have a very low participation rate in civil society organizations (CSOs) and volunteering activities. Volunteering and community services can be an important means of acquiring such soft skills as relational, time management and team work skills, among others, while also expanding the social space for youths. Social programmes tailored for the Arab youth should therefore give special attention to the support of such youth bodies as student organizations, youth councils, youth representation in trade unions, and more.

E. The informal economy

The size of the informal economy is large even when compared with other emerging economies, with estimates ranging from 26 per cent of GDP in Jordan, 30 per cent in Lebanon and Tunisia, 34 per cent in Egypt and the Syrian Arab Republic, up to 44 per cent in Morocco (figure 22). Even though estimates differ according to the source used, on average they tend to converge around the figure of about one third of the GDP in most ACTs (Schneider and others, 2010; and Buehn and Schneider, 2012)) (figure 21). At the same time, 43 per cent of the labour force in Egypt lack pension coverage, 51 per cent in Tunisia, 62 per cent in Jordan, 67 per cent in Lebanon and over 80 per cent in Morocco, Palestine and the Syrian Arab Republic. In Yemen, informal employment is estimated to account for over 90 per cent of the labour force (see figure 24). On average, two thirds of the labour force in Arab countries are not covered by a mandatory pension (World Bank, 2011g).[31] Self-employment accounts for about 28 per cent of all employment (World Bank, 2012a). These estimates look puzzling given the large share of public sector employment. In the non-GCC countries, the informal labour market is inherently countercyclical, meaning that it expands as economic activity contracts due to the more flexible allocation of labour in the production process compared to the formal labour market, and due to the inability of SMEs to adjust to shocks in the same manner as large enterprises do.

With agriculture shedding workers and no longer absorbing surplus labour,[32] and manufacturing stagnant in most of the region, services are playing the lead role in labour absorption. However, new entrants to the labour market generally find low-productivity and low-quality jobs in such labour-intensive sectors as construction, tourism, trade, and, more recently, logistics and communication services. These trends, combined with declining public-sector job opportunities, limited job creation within the formal private sector and constantly increasingly education levels, result in persistently high levels of informal employment, showing that informality is not just a transient phase that affords new entrants upward mobility towards a formal job (Dhillon and Yousef, 2009). This state of affairs in the education-to-work transition has increasingly resulted in mounting frustration and grievances among the new entrants.[33] As a result of this imbalance, the non-GCC economies are locked in a low productivity equilibrium, where the oversupply of labour feeds into the informal economy, which is relatively less remunerative because of lower value added; the educated workers hope to quickly move out of informal labour into the public sector, which is, in turn, declining, resulting in their being trapped in the informal economy at the long term. Informal employees find themselves caught in a low-productivity-low-return-to-investment-in-education trap[34] whereby the demand for better-quality education services is hampered by the gloomy prospect of getting a decent job. Historical trends in growth of the non-oil sectors, particularly manufacturing, suggest that they will not suffice to provide employment to the current and future tidal wave of the working age population. A structural transformation of the economies and labour markets is needed.

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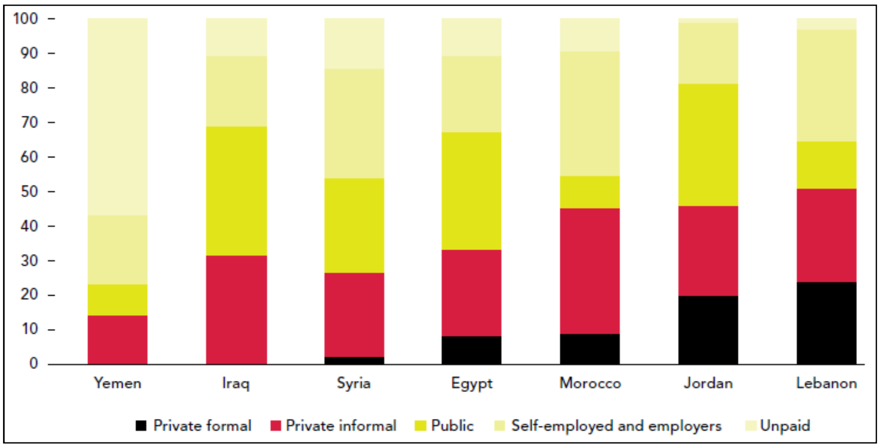
[31] This means that the informal sector has on average half the productivity of the formal economy.

[32] Agriculture, however, still represents an important economic sector, namely, over 15 per cent of GDP and 25 per cent of labour force, in Egypt, Morocco, the Sudan, the Syrian Arab Republic, and Yemen.

[33] This trend, combined with lower public-sector employment opportunities, is also likely to result in increasing discriminatory practices in gender-related labour conditions and wage treatment. MENA also shows persistence in informality with businesses having a longer operating time spent prior to being formalized compared to other regions.

[34] Available estimates for the region on an average rate of return for an additional year of schooling are remarkably lower than comparator regions, with the highest rates for female university students in Morocco, and the lowest for male primary and secondary school students in Tunisia (World Bank, 2008). This is consistent with the stagnation in real wages and TFP reported over most of the 1990s and 2000s.

Figure 21. Types and shares of employment



Source: World Bank, United Nations, European Union, and IDB, 2012.

Figure 22. Size of the informal economy
(*Per cent of GDP*)

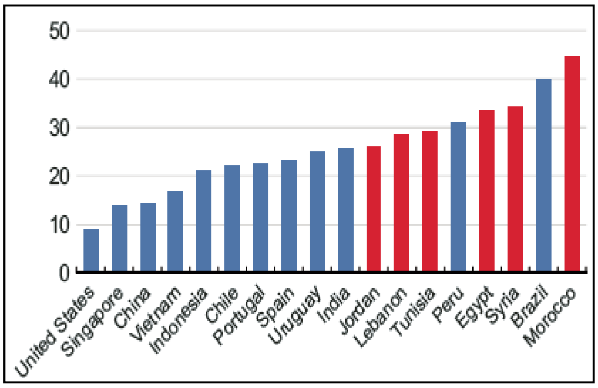
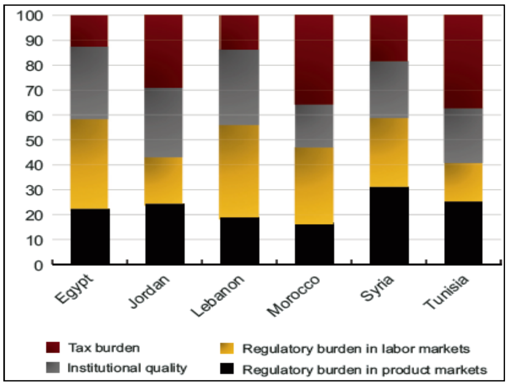
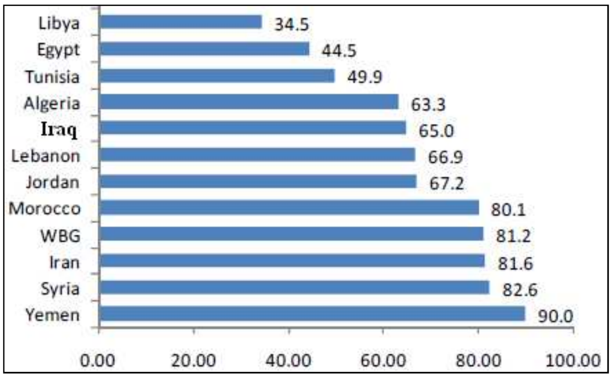


Figure 23. Determinants of the informal economy
(*Per cent share*)



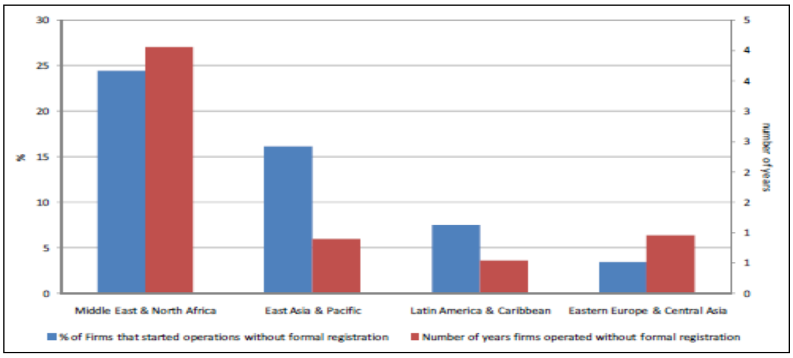
Source: IMF, 2011b.

Figure 24. Non-contributor to social security
(*Per cent of labour force*)



Sources: Loyaza and Wada, 2010; and World Bank 2011g.

Figure 25. Sizes of unregistered firms by region



Source: World Bank. WDI Database.

The high tax burden seems to be particularly relevant in explaining the size of the informal economy in Morocco and Tunisia, as explained in figure 23. In fact, these countries have higher than average corporate tax rates, namely, about 30 per cent vis-à-vis a 20 per cent average in developing countries. Enterprise surveys show that in the Syrian Arab Republic and Yemen, the average revenue reported by a firm for tax purposes is only half of the actual revenue.

Non-wage labour costs still appear to be high in many countries. As we have seen earlier, social security contributions, in particular, are still too high and are of the old generation format whereby they are shared between employers and employees, thereby giving strong incentives to both parties to evade them. As a result, it is plausible that a de facto tacit agreement has emerged throughout the region between the government authorities and private businesses, particularly microenterprises, as these are the most numerous ones operating informally, according to which, while preserving the façade of a firm labour framework, these laws are not in reality strictly enforced for new entrants into the labour market, thereby potentially giving rise to all manners of abuse.

The legal and regulatory framework offers no incentive for these firms to formalize. One way to encourage such entities to join the formal rank is to pursue a gradual approach, starting from the granting of a reasonable medium-term grace period to the already established informal entities within which firms could benefit from credit facilities and some technical assistance through, for example, business incubators.

F. Migration flows and policies

Migration has perhaps been the main form of global and regional integration for the Arab region. The benefits from labour mobility can be more substantial than those from the movement of goods and capital because of the huge differential in the wage rates for similar skills across countries. Cross-country regressions for the Arab region show that a 10 per cent increase in remittances as a share of GDP would reduce poverty by 5.7 per cent (Adams, 2003). Thus, as we will see in a moment, there is room for enhancing the rate of return for education through migration. In the early 2000s, there were more than 9 million migrants from the MENA region residing in Organisation for Economic Co-ordination and Development (OECD) countries and another 3.5 million in GCC countries.[35] Remittances to the region from outside were estimated at around US$13 billion in 2005, and between US$25 and 35 billion when intra-regional remittances are included, (World Bank, 2007a), although they declined as a percentage of GDP over the last decade. In 2010, remittances represented almost 16 per cent of GDP in Jordan, 6.6 per cent in Morocco, 5.3 per cent in Tunisia, and 5.2 per cent in Yemen, followed by Egypt with 4 per cent (World

[35] The share of Arab labour in the Gulf has declined from a peak of 72 per cent of all in-migration in the beginning of the 1970s to an estimated 23 per cent in 2005 (ILO, 2009). As shown in figure 26, Qatar, Saudi Arabia and Kuwait tend to employ the highest number of national Arab workers (between 30 and 40 per cent of the total foreign workforce) among the GCC countries, whereas, in the United Arab Emirates and in Oman, the share of Arabs among non-national workers is below 10 per cent. There are even higher shares of Arab workers in both Jordan and the Syrian Arab Republic, even though in both countries, the vast majority of these workers are Arab migrants. In Jordan, most of the Arab workers come from Egypt; in the Syrian Arab Republic, most are Palestinian refugees.

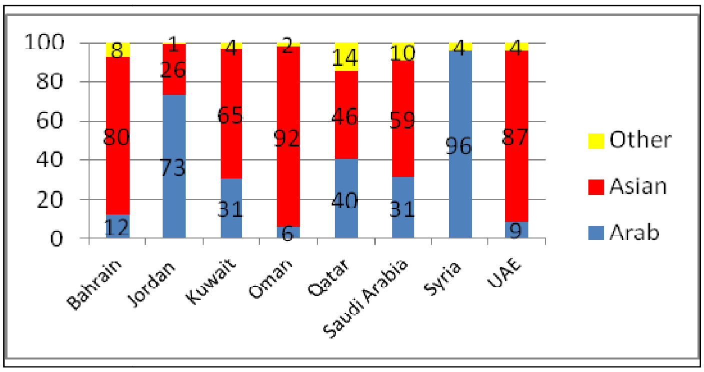
Bank, 2011h). In 2010, remittances to the ACTs alone were estimated at around US$31 billion. The top-ten migration corridors in the region involve ACTs either as origins or destinations of flows and are the following: Palestine-Syrian Arab Republic, Egypt-Saudi Arabia, Algeria-France, Yemen-Saudi Arabia, Palestine-Jordan, Egypt-Jordan, Morocco-France, Morocco-Spain, Morocco-Italy, and Egypt-Libya. Egypt has been the largest exporter of migrants in the region with about 15 per cent of its labour force working abroad (World Bank, 2011h).

While migrants from the Maghreb, mostly with low average education levels, are heavily concentrated in Europe, migrants from the Mashreq and Egypt are more concentrated in Anglo-Saxon, these with higher average education levels, and GCC countries. Immigrants from MENA constitute the second, third and fourth largest groups of immigrants in Continental, Northern and Southern Europe, respectively, accounting for over 10 per cent of total immigrants in all three cases versus less than 3 per cent in the Anglo-Saxon countries.

Although ACTs seem to be particularly affected by a high expatriation rate of highly educated individuals compared to other regions, particularly over the last two decades, defining this phenomenon as a brain drain may be misleading and could negatively impact migration policy. Both in Egypt and Tunisia, skilled migration is likely to send abroad a surplus of human capital that is unlikely to be absorbed by their economies in the medium term. This type of migration can then provide a unique opportunity for the new governments in ACTs to tap into this huge stock of human capital built at lower cost for the originating countries and capitalize on their experience, skills and financial resources. Overall, migration seems to have a positive developmental effect, as evidenced by high wage differentials,[36] reduction of social and political tensions in the labour market of the home country, increase in household income and human capital and additional capital and know-how for investment in home countries. Moreover, migration tends to be relatively stable and to manifest a countercyclical behaviour.[37]

Figure 26. Composition of foreign employment by region of origin in selected Arab countries

(*Percentage*)



Sources: For data on the Syrian Arab Republic, the Syrian Arab Republic Population Census 2004, available from http://www.carim.org; and data on Jordan from 2009, Ministry of Labour, Annual Report, various years, available from http://www.carim.org;. For data on all other countries, see ILO, 2009, based on data from ALO Database 2005.

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[36] Real wages in the Arab Mediterranean countries are about one sixth of net wages in the European Union, calculated in purchasing power parity. Comparative wages studied by the World Bank for a few selected ESCWA member countries suggest that a manufacturing worker from Egypt could earn almost double his monthly wage in Jordan, three times his wage in Qatar and four times the amount in Bahrain. In the real estate sector, Egyptian and Jordanian workers could double their wage if they went to Qatar. In the financial intermediation sector, the monthly wages in Qatar are five times those in Egypt and more than double the rates in Bahrain and Jordan.

[37] In the aftermath of the uprisings, remittances seemed to hold up well in Egypt, Morocco and Tunisia. However, in the short term, remittance flows to Morocco and Tunisia could be affected by the debt crisis in the European Union.

Figure 27. Trade and remittance flows between selected Arab countries and Europe

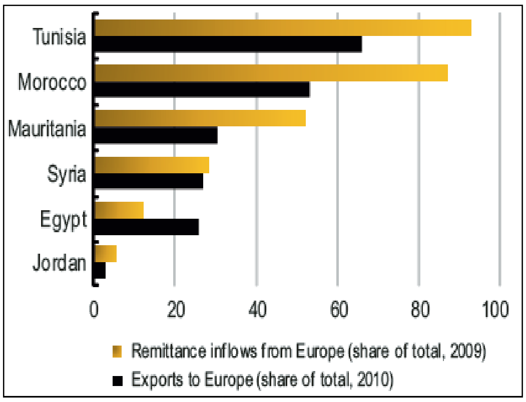
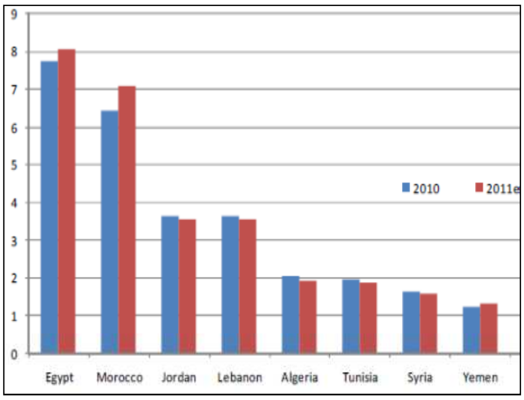


Figure 28. Remittance inflows to selected Arab countries
(*Billion US dollars*)



Sources: IMF, 2011b; and World Bank, 2012a.

The demographic outlook for Europe runs opposite to that of the Arab region. Europe is, therefore, a strong magnet for MENA migrants as it is projected to lose one third of its total labour force by 2050, tilting the worker-retiree ratio to 1:2, and is currently estimated to need as many as ten million low- and mid-skilled migrants yearly, including sales persons, waiters and nurses, just to keep the current dependency ratio. With freer labour mobility between Arab countries and Europe, convergence of incomes would proceed faster than with free trade alone. Migration, therefore, would have complementary effects with trade between these two regional blocks. However, the current restrictive European Union migration policy does not seem to adequately address this gap. The situation is no better in the GCC countries, where, under the *kafeel* system, Arabs who want to emigrate must be sponsored in order to be granted a permit. These countries only attract temporary labour because the GCC does not grant nationality to long-term residents, and ownership rights to housing and business are still restricted.[38]

TABLE 8. TOP DESTINATIONS OF MIGRANTS FROM ACTs

	Egypt		Jordan		Morocco		Tunisia		Total	
Destination	Number (‘000)	Inflows (USD mil)	Number (‘000)	Inflows (USD mil)	Number (‘000)	Inflows (USD mil)	Number (‘000)	Inflows (USD mil)	Number (‘000)	Inflows (USD mil)
France					841	1 804	302	936	1 143	2 740
Italy	90	210		22	476	992	122	369	688	1 593
Germany			16	96	108	240	37	117	161	453
Saudi Arabia	1 006	2 177	172	939	21	39	12	36	1 211	3 191
United States	132	341	72	471	84	199	8	28	296	1 039
United Kingdom	27*		4	25					31	…
Spain					778	1 631			778	1 631
Israel					246	496	15	44	261	540

Source: World Bank, 2011h.

[38] Most of the GCC countries have also introduced quotas for hiring nationals that businesses, because of the higher labour cost of nationals, perceive as extra costs imposed on them.

Notes: * Data taken from UK Office of National Statistics.

(…) means that data is not available.

Europe, the GCC and the labour exporting countries in the region would profit from well-managed migration flows that focus on labour shortages while offering opportunities for both integration in host countries and return migration.[39] However, organized migration programmes that aim to achieve skills matching are practically non-existent in the ACTs. The few programmes in place are either not known about or do not seem to be run effectively (Sabadie and others, 2010). The same applies to return programmes. Evidence from Egypt shows that temporary and circular migration can have beneficial effects on the income of migrants, whereby return migrants earn wage premiums over non-migrants with similar characteristics, and can limit the negative effects of brain drain and stimulate investment in the home country (Özden and Shiff, 2007).[40] Active migration policy also tends to have long-term productivity gains, as returning migrants can contribute significantly to short- and medium-range migration flows, bringing back significant skills, experience and connections with business networks in Europe as well as savings that are more likely to be used for productive investment than domestic savings. As shown by the Eastern Europe experience, such pull factors in home countries as a better investment climate, tend to encourage migrants to return.

Countries of origin of potential migrants, therefore, need to enhance mid-level skills by improving their vocational training and secondary education systems and to establish a responsible body able to provide proper information[41] and guidance about the range of available migration options, including job counselling. In addition, flows between the European Union and the Arab region, and within the latter, could be encouraged and better managed by allowing social security and health insurance portability, as the lack of portability creates incentives for temporary migrants to work informally. Social security coverage may incentivize return by providing a safety net to returning migrants who want to invest back home. Finally, student mobility can be a powerful tool for encouraging flexible forms of mobility with significant potential spillovers in terms of knowledge and technological absorption (IOM, 2011). This could help the youth maximize their returns on their investment in education by enabling them to make more informed decisions, reducing information asymmetries and transaction costs, and helping them to better integrate in the host

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[39] While in North Africa and in non-GCC countries in the region, regular migrant workers are covered by the relevant social security systems, in the GCC, there is no such provision, apart from employment injury protection. Thus, a huge proportion of the population in these countries are left without any social security coverage. On a positive note, Bahrain has included protection of migrant workers in its new unemployment insurance scheme.

[40] Experience around the world shows that recent innovative migration schemes, based on temporary and circular migration, seem to be promising. For instance, every year Canada's Seasonal Agricultural Workers Programme brings about 20,000 workers from Central America and the Caribbean to do seasonal work on Canadian farms for up to eight months, with compulsory return at the end of the work period. The programme offers repeat employment opportunities over the years, provided that both migrants and employers comply with the law and the rules of the programme. Employers provide free housing and cover part of the travel costs. Seasonal workers are offered the same wage and work conditions as Canadian workers doing the same job and enjoy similar social benefits, including health insurance. Sending countries screen and recruit the workers and monitor their living and working conditions in Canada through their consular services. By doing so, the programme has reduced screening and hiring costs over time as well as encouraging migrants to invest in their home countries (World Bank, 2012d). A similar and promising programme is in place in France for Tunisian migrants but its impact seems to be affected by poor job intermediation services and administrative hindrances. A German-Polish workers agreement allows German companies to outsource certain activities to Polish companies whose employees receive German wages but pay Polish social security contributions. The workers thus receive relatively higher wages and the German companies save on social contributions. Spain is piloting a similar scheme with seasonal Moroccan workers in agriculture and tourism. These schemes could potentially be expanded in many other low- and medium-skill sectors. Further analysis is needed to investigate the possibility of transforming these schemes from being merely seasonal or temporary into longer-term migration programmes for those employees that succeed in finding a long-term job.

[41] Several European Union countries have developed systems to assess short-term skill needs. Eurostat has set up a European Union-wide job vacancy survey, which helps monitor unfilled positions and labour demand in the region. In addition, the European Centre for the Development of Vocational Training (CEDEFOP) produces forecasts for skill needs. The latest report for the period 2006-2015 shows large demands for sales and service workers, tourism, transport and communication. These initiatives could also be replicated in the GCC countries and interfaced with an Arab regional office that mirrors them from the supply side.

society.[42] A simplification of the European Union and GCC bureaucratic hurdles involved in applying for a visa or work permit will be a condition *sine qua non* for the advancement of the above reforms.

In the short term, facilitated migration from ACTs towards the GCC countries and Libya would help to partly release the demographic pressure on the labour markets of ACTs and would act as a constructive sign of cooperation and support for these economies that are undergoing challenging economic and political transitions. Overall demand for migrants in Libya and the GCC countries is expected to grow at a much faster pace than in the European Union, as the former will undergo a post-conflict recovery phase with projected average growth rates above 7 per cent in the next five years (IMF, 2012c) with expected high public investment and a resurge of foreign direct investment (FDI), while the GCC countries have fiscal space and long-term investment plans that will fuel demand for imported labour. In the short term, GCC countries could allow an increasing number of ACT citizens to enjoy the rights to work and settle in these countries, as well as to receive social protection, retirement, health, education and social services. Priority could be given to the countries that are the least equipped with economic options in the medium term and that are undergoing the most difficult transition processes.

In the medium term, the European Union could speed up the introduction of the Blue Card, which was inspired by the United States Green Card, to encourage migration to economic sectors that are suffering from skills shortages. Concurrently, progress should be made in mutually recognizing qualifications, both academic and professional, firstly throughout the entire Arab region, including the GCC and Libya and eventually with the European Union.[43] Pilot actions could help harmonize qualifications, starting from such labour-intensive sectors as agriculture, construction and nursing.

Migration policy is by nature multisectoral, and even though it alone cannot solve the region's pressing unemployment problem, due to its links and interactions with other important areas, it is a crucial component of a set of coordinated policy actions that need to be taken in this field. A complementary action to migration is the delocalization of some mid-skilled jobs from the original markets. Development in ICT, together with declining costs, has made it possible for many firms to delocalize some of their activities offshore, namely, to countries that are more attractive in terms of labour cost and quality, the efficiency of the infrastructure system and business environment. Firms increasingly outsource some of their activities to companies that reside offshore. Activities that can usually be conducted offshore are technical support, call centres, software development, accounting and human resources management. According to Datamonitor, the annual growth of outsourcing to MENA was projected to be around 14 per cent in the period 2002-2007 (Datamonitor, 2003). The United Arab Emirates has emerged as a service hub within the region, with Egypt growing rapidly while also hosting services for leading multinationals and the largest call centre in the whole Arab region. Jordan and Morocco also have the potential to emerge as outsourcing centres given their geographical and linguistic proximity to the GCC and the European Union, respectively, two important economic poles.

Another complementary field of activity would be the modernization of the financial sector, particularly regarding: (a) cost of remittance transfers and currency convertibility to facilitate capital movements for migrants from both host countries and home countries; (b) access to financial services for beneficiaries of remittances; and (c) such innovative government financing as Diaspora bonds.[44]

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[42] An interesting experience worth investigating is that of the Philippines Overseas Employment Administration.

[43] There seems to be no recognition in home countries of skills obtained in European Union countries during the migration period. As an example of regional harmonizing of professions, the European Union recognized and harmonized the following professions throughout its territory: midwifery, nursing, medicine, dentistry, pharmacy, and architecture.

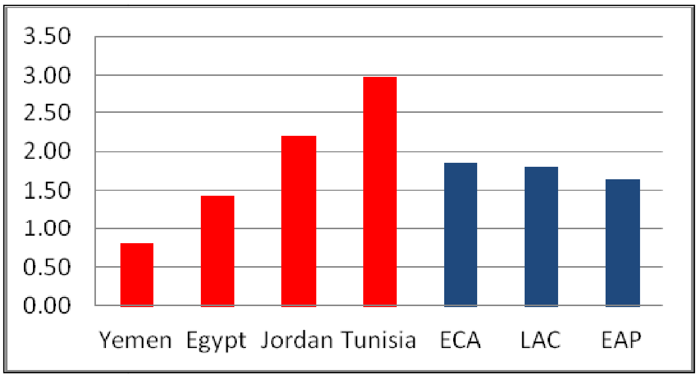
[44] Since savings of migrants are mostly held in cash or in low-yielding bank accounts in the destination countries, offering an interest rate of 4 or 5 per cent per year on Diaspora bonds could look attract to investors. Diaspora bonds can be sold globally to communities abroad through international banks, money transfer companies and post offices.

Finally, higher education and research and development systems in home countries could greatly benefit from tapping into the pool of high-skilled Diaspora professionals, especially in scientific fields, in order to enhance education and research quality at home. A very recent programme implemented by the International University in Morocco might be worth studying more closely.

G. INVESTMENT PATTERNS

Over the last two decades, the Arab region's capital investment pattern recorded a sustained increase, averaging about 23 per cent of GDP annually in the 2000s compared to about 22 per cent in the 1990s. This pattern compared favourably with those of all other regions (except East and South Asia) due to the increased public investment that took place, particularly in Libya and Algeria, that more than offset its halving in Egypt[45] and Lebanon as well as falls in Tunisia and the Syrian Arab Republic. However, despite significant public investment in infrastructure, many countries in the region have been unable to keep pace with the pressing needs that stem from population growth, rapid urbanization and structural changes of economies. With the exception of Yemen, Arab countries tend to fare worse in terms of infrastructure quality than in infrastructure access due to lagging institutional reforms in infrastructure sectors, as evidenced by Agenor and others (2005) and Um and others (2009). Political and institutional factors seem to affect infrastructure conditions in the region a great deal. Though public investment was at record levels, reflecting a policy centralized on capital-accumulation, some of it was inefficient, generating low rates of return and economy-wide inefficiencies that eventually reflected in stagnating total factor productivity (TFP). Limited evidence shows that expansion in public investment plans as a countercyclical measure to tackle the global crisis has had a small impact in the short term but can have a robust one in the medium and long term.[46] This delayed impact is often due to inefficient public expenditure management and lengthy procurement procedures (Diop and Abdallah, 2009), particularly in such countries as Egypt and Yemen, as shown in figure 29.

Figure 29. Comparisons in public investment management indices



Source: Calculations based on Dabla-Norris and others, 2011.

Notes: The public investment project implementation index evaluates the degree of competition for contracts, the procurement complaints mechanism, payment processes and effectiveness of internal controls. Ratings are from 0 to 4, with a higher score reflecting better project implementation.

ECA stands for Economic Commission for Africa, LAC stands for Latin America and the Caribbean, and EAP stands for East Asia and the Pacific.

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[45] Simulations done by the World Bank estimate that an increase of public investment of 2-4 per cent of GDP would lift GDP growth by 1 per cent in the short and medium term (World Bank, 2009).

[46] Nabli and Veganzones-Varoudakis (2007) find that the contribution of infrastructure to growth in MENA over the 1980s and 1990s was on average over 1 per cent. Hymel (2009) finds that employment elasticity to congestion ranges around 0.25-0.47. This means that a 10 per cent reduction in travel time will increase employment by 2.5-4.7 per cent. The estimated average cost of congestion in Greater Cairo alone is estimated at 1.2 per cent of national GDP (World Bank, 2012c).

TABLE 9. INDICATORS OF INFRASTRUCTURE QUALITY GAPS FOR FIRMS

Region	Electricity connection delay (Days)	Value lost to power outages (Per cent of sales)	Water connection delay (Days)	Mainline telephone connection delay (Days)
East Asia and the Pacific	21	2.6	18	16
Europe and Central Asia	15	3.0	9	16
Latin America and the Caribbean	34	4.1	35	36
Middle East and North Africa	62	4.3	44	49
South Asia	49	7.4	29	50
Sub-Saharan Africa	38	5.9	42	54
OECD	10	2.3	--	9

Source: Data is derived from World Bank Investment Climate Assessments, and reported at www.enterprisesurveys.org.

In many ACTs, a significant percentage of large business profits were not reinvested at home. Increased private profits seem to have fuelled capital flight rather than domestic investment. Estimates of capital flight out of Egypt, the Syrian Arab Republic and Tunisia vary according to sources. Egypt and the Syrian Arab Republic averaged around US$3 billion per year during the last decade (Global Financial Integrity, 2012). Tunisia's outflows are estimated to have multiplied by five in 2010 (Ndikumana and Boyce, 2012).

Although, at times, public investment may have crowded out private investment, if properly designed and carried out, it can provide public goods and an important countercyclical tool as well as play a critical pro-growth and pro-poor role in the presence of market failures.[47] Moreover, infrastructural investment influences growth, particularly when combined with human capital and innovation; otherwise infrastructure alone has little impact. When properly managed, public investment can increase the marginal productivity of factors of production, thereby lowering marginal production costs, which, in turn, may lead to higher private investment.[48] The issue then is not whether public investment has a role in the development strategy of the region, but rather how to improve complementarities between public and private investment and how to increase their social returns.[49] Given the limited budget available to transition countries, public investment projects should be prioritized based on a combination of such criteria as highest net present value, highest pro-poor impact and contribution to economic integration.[50] The impact of an investment stimulus plan is

[47] To avoid a sharp adjustment of fiscal policy once oil reserves are exhausted and to secure the participation of future generations in this source of national wealth, oil-producing countries accumulate financial assets during the period in which they produce oil, particularly when prices are high. In principle, capital expenditure and the accumulation of real assets could represent an alternative to the accumulation of financial assets, thereby reducing the need for persistent fiscal surpluses. However, the uncertainties surrounding the effects of public capital expenditure on productivity, future output and government revenues, and the difficulties in distinguishing between capital expenditure and current expenditure, warrant caution in this regard. Due to governance and institutional deficiencies, which can be observed in some oil-producing countries, the ex-post real return of public investment may be lower than the return on financial assets offered by mature economies.

[48] The majority of studies in this field find that public infrastructure investment has a positive impact on private investment. However, the real exchange rate would tend to appreciate in an oil-based economy due to the combined effects of current account surplus and multiplier effects on the aggregate demand resulting from public investment. The net effect on output may be negative or positive depending on the inter-temporal elasticity of substitution between domestic and imported goods. Dynamic general equilibrium models may help study and measure the relationship between public and private investment.

[49] Incentives for private investment are also provided by the effective regulation of infrastructure service providers. This type of institutional reform also tends to maximize the overall impact of infrastructure investment on growth through higher TFP. Based on growth regressions, MENA reports lower-than-average returns on electricity and ICT investment, possibly because of the poor institutional framework (Noumba Um and others, 2008). Rossotto and others, 2005, show that, in MENA, full market openness in ICT would increase internet penetration by up to 18 hosts per 10,000 people, from an average of only two hosts in service. Qiang, 2009, reaches the conclusion that a 10 per cent increase in broadband uptake would generate a 1.3 per cent increase in economic growth in emerging economies. Currently, the average internet speed in the region is about 2.73 Mbps, less than a third of the global average, which is 8.69 Mbps (available from http://www3.weforum.org/docs/WEF_YGL_AcceleratingEntrepreneurshipArabWorld_Report_2011.pdf).

[50] In, Egypt, for instance, the Cairo ring road will rank highly if such criteria are to be used to ascertain priorities.

typically robust in the medium term but negligible in the short term because of the limited absorption capacity of public institutions due to lengthy procurement procedures and scarce capacity of government institutions in implementing investment projects. This, combined with the fact that private investment during political transitions typically takes longer to resume than, for instance, income growth, clearly demonstrates that, in the short term, governments should focus on ensuring political and macroeconomic stability while addressing institutional constraints.

FDI tends to reinforce imbalances in the regional economy. Unlike other such transition economies in the past as Chile, the Czech Republic, Rwanda and Slovakia, which gave FDI great prominence in their economic strategy, most Arab transition countries do not seem to have had an organic and consistent approach in this respect in the recent past, with public enterprises, including the military in Egypt, still playing a prominent role in various service sectors including banking and finance, utilities, transportation, telecommunications and tourism.[51] In fact, the majority of FDI directed to the region, which was about US$28 billion in 2010 down from almost US$35 billion in 2008, flows into the real estate and hydrocarbon sectors, while the majority of FDI-related jobs are usually in the agriculture and manufacturing sectors. In the last decade, the latter only received around one fifth of all regional FDI but is estimated to have created more than half of all FDI-related jobs (World Bank, 2011a).[52] This pattern of FDI has generated Dutch disease concerns that it might raise inflation by pushing up the price of such non-tradables as housing, thereby contributing to exchange rate appreciation and lower competitiveness of tradable sectors on international markets. FDI inflow is relatively higher in Jordan and Lebanon, where it has increased by approximately five and seven times, respectively, over the last two decades. However, FDI has been concentrated over the last decade compared to the 1990s, with the only countries benefiting from sizable shares within the region being Egypt, Saudi Arabia and the United Arab Emirates, which together account for almost 60 per cent of the total.[53]

This new pattern has resulted primarily from more profitable investment in the oil sector due to higher oil prices and the launch of privatization programmes in these countries. In fact, a clear co-movement of the growth rates of the two variables has been recorded since the mid-1980s (see figure 30).

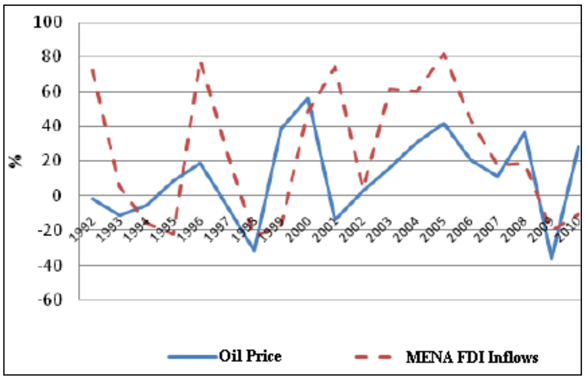
Figure 30. Trends in oil prices and FDI inflows

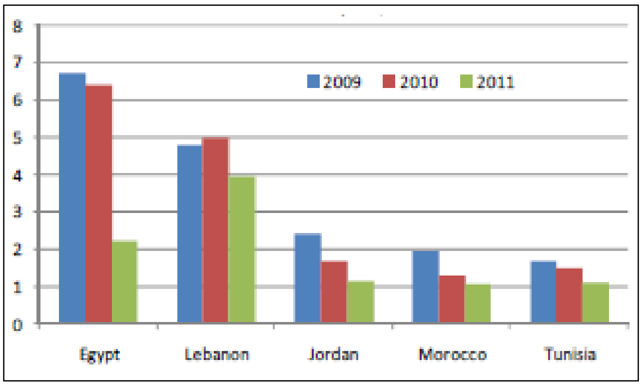
Figure 31. Recent trends in FDI inflows
(US$ billion)

[51] According to the World Bank's Investing Across Borders (IAB) Index, Egypt, Morocco and Tunisia scored below the world averages in a number of critical sectors, including banking (Egypt), electricity (Morocco and Tunisia) and transport (Morocco). It is generally thought that Libya has an even more restrictive regime.

[52] FDI in food processing, textiles and consumer products created the largest share of manufacturing-related jobs in the region.

[53] A 2002 international investor survey on priorities influencing investment decisions carried out by the Multilateral Investment Guarantee Agency (MIGA) found that market size and access were the leading priorities for foreign investors in their site selection (77 per cent of respondents), followed by a stable political environment (64 per cent), ease of doing business (54 per cent), and reliability and quality of infrastructure and utilities (50 per cent). Other significant factors included availability of technical professionals and managers and the level of corruption (MIGA 2002). The top priority, namely, market access, gives a strong motivation for further regional integration. All other priorities listed above are areas where many of the transition countries lag behind, and this study has tried to address them. They need to be included at the top of policy priorities in the ATCs in the short and medium term.





Sources: elaborated from World Bank, 2011i; MIGA, 2011; and World Bank, 2012d.

Note: Oil price refers to simple average of crude oil quotations of Brent, Dubai and WTI oil.

In the non-oil sector, FDI has become a major share of private investment in Jordan, which is a transition country with strong GCC links that has put in place a massive privatization and public-private partnership programme, as well as in Egypt and Tunisia. Libya, Morocco, the Syrian Arab Republic, and Yemen, however, have performed below the regional average. GCC economies, particularly Bahrain, Qatar and the United Arab Emirates, are increasing their FDI flows and now make up more than half of the FDI in Egypt, Jordan and Libya, while just one quarter in Morocco. The real estate sector has been the top recipient in most of these countries, particularly in Egypt, Jordan and Libya, manifesting their high sectoral concentration. However, in the transition economies, tourism and manufacturing FDIs have shown a sizable share of labour generation, at 30-40 per cent, despite their relatively limited share in the economy, namely, 10-15 per cent)[54] Attracting manufacturing FDI is clearly a priority during transition as it would contribute to higher job generation and economic diversification in the medium term.

H. Housing and land markets and policies

Housing is the second largest expense after food for the poorest segments of the population in ACTs. In Egypt, for instance, 17 per cent of the income of the lowest quintile is spent on housing (World Bank, 2012e). According to Beidas-Strom and others (2009), almost two thirds of the population in MENA live in self-owned houses, ranging from as low as 38 per cent in Egypt to over 80 per cent in the Syrian Arab Republic and Tunisia. However, there is a shortage of housing stock for low- and middle-income households due to risk-averse bank mortgage lending, which particularly affects low-income households, and land supply constraints caused by land structure and titling issues.[55] The housing and rental market in MENA is affected by oil boom and bust cycles as well as remittance flows, resulting in a decoupling between housing prices and the underlying structure of an economy. Moreover, the increasing demographic pressure on housing demand is reflected in stark price increases in urban areas. The house-price-to-income ratio appears to be higher in Algeria, but also in Morocco, Lebanon and Yemen (World Bank, 2005), as listed in table 10. Informal settlements are a growing concern in Algeria, Morocco and Yemen. In Egypt, more than two thirds of the population of Greater Cairo live in informal housing that every year absorbs three quarters of the new migrants moving to the city. The Commission on Legal Empowerment of the Poor estimates that the value of informal housing there is worth around US$240 billion, which is more than the national GDP of Egypt. In Tunisia, informal settlements constitute one fourth of the overall housing stock (World Bank, 2005).

Box 2. Land titling and economic development in the Arab region

[54] The shares of manufacturing and tourism FDIs in Tunisia are relatively higher and hover around 35 per cent.

[55] In Egypt and Morocco, only one forth of land is titled (Beidas-Strom and others, 2009). However, the former has an underdeveloped mortgage market, while the latter has one of the most advanced markets in the region, together with Jordan.

Insecure or weakly enforced property rights in the region display the following characteristics:

- They increase the risk of expropriation, which diminishes incentives to invest and decreases productivity;
- They do not allow productive assets to be transferred to those whose livelihoods require them (subsistence farmers) or who could use them most productively (commercial farmers);
- They hinder access to financing;
- They exacerbate overurbanization and socioeconomic disparities in the aftermath of a conflict;
- They can cause both grievances and greed.

Due to the lack of well-designed and enforced property rights, the following issues have arisen:

- Property disputes constitute the single largest cause of backlog cases in the judicial systems of many Arab countries. Therefore, land titling would be a great starting point for reforming the judiciary);
- In the region, the state and other public entities own vast areas of land (more than 90 per cent of all the land in Egypt), including *waqf* and communal land, but lack a coherent land management strategy, resulting in outdated land information systems, fragmented institutional frame (45 laws in Egypt) and discretional allocation to elites. This has created segmented land markets;
- Property tax collection is untapped (main local revenue source in most developing countries). The estimated tax potential for Baghdad is approximately US$300 million per year;
- The land rights that should be an important driver of food security and, therefore, of social stability, given that food price shocks hit the landless the hardest, are not fulfilling their function.

Social housing policies are varied in the region with state subsidies showing signs of being regressive[56] in Algeria, Egypt and Morocco. Egypt introduced rent control in the 1960s, which resulted in the skyrocketing of the informal housing market. In Egypt, the stock of vacant housing units in urban areas is estimated at over 3.5 million, a far higher share than in comparator countries, and unlocking it would entail reforming the property tax system and strengthening rental market regulations, including the reform of rent control. Turkey can provide an example of successful reform in this sector.[57]

Housing finance is underdeveloped, estimated at around 10 per cent of total credit in Tunisia and 7 per cent in Egypt and Algeria (Salehi-Isfahani and Dhillon, 2008). A more developed mortgage finance market would allow households to smooth consumption, and easier access to housing finance could increase the demand for housing. However, legal and administrative obstacles in property registration and collateral foreclosure procedures stand in the way.

TABLE 10. CHARACTERISTICS OF THE HOUSING MARKET IN THE MENA REGION

	Home-ownership	Rental and leasehold	Informal and social (subsidized) housing	Land market problems	House price/income ratio	Supply gaps
Algeria	0.45	0.30	0.25	Yes	12	Yes

[56] Interest rate subsidies and land subsidies to developers tend to be regressive. Targeted upfront subsidies to poor households are usually a transparent and non-regressive way to implement housing policies.

[57] The Turkish experience can provide a reference for the overhauling of housing policies reliant on public-private partnerships as a means to quickly overcome the shortage of decent housing for low-income groups. The Mass Housing Authority (MHA), which was backed by government finance and allowed access to state-owned land, was able to carry out the construction of half a million residential units between 2003 and 2010 without burdening the public budget. According to its business model, the MHA delivers the land, auctions the construction projects to private developers and monitors the construction and marketing of the projects. It also provides housing loans to low-income earners. The success of the MHA led Algeria, Egypt, Jordan, the Syrian Arab Republic, and Yemen to ask the MHA to carry out or assist in housing projects in their countries (Ülgen and others, 2012).

Bahrain	0.68	0.20	0.12	Yes	12	No
Egypt	0.38	0.33	0.29	Yes	7	Yes
Jordan	0.71	0.17	0.12	No	3	No
Kuwait	0.68	0.27	0.05	Yes	…	Moderate
Morocco	0.65	0.22	0.15	Yes	9	Future
Qatar	0.72	0.28	...	…	…	Moderate
Saudi Arabia	0.56	0.44	…	No	…	Future
Syrian Arab Republic	0.85	0.07	0.08	…	…	Moderate
Tunisia	0.77	0.08	0.15	…	5	No
United Arab Emirates	0.55	0.45	0.05	…	>12	No

Source: Beidas-Strom and others, 2009.

Notes: (…) means that data is not available.

The 2009 issue of the Global Corruption Barometer (GCB), a survey issued by Transparency International, summarized in table 11, presents the main findings of a public opinion survey that assessed the extent to which key institutions and public services are perceived to be corrupt and includes questions about the level of bribery and political corruption in the land sector (Transparency International, 2009b). Four countries from the region were included in the survey, and the answers provided depict a discouraging picture for Kuwait, Lebanon and Morocco, where for more than three quarters of the respondents, corruption in land matters is serious or very serious. According to the survey, in MENA, the most bribe-prone institutions are reported to be those handling procedures related to buying, selling, inheriting, or renting land.

TABLE 11. HOW SERIOUS DO YOU THINK THE PROBLEM OF GRAND OR POLITICAL CORRUPTION IS IN LAND MATTERS IN THE MIDDLE EAST AND NORTH AFRICA?
(*Percentage*)

	Total sample	Middle East and North Africa			
Answers	69 countries	Iraq	Kuwait	Lebanon	Morocco
1 Not a problem at all	2	3	1	1	0
2	6	11	7	1	0
3	18	17	10	4	2
4	23	22	18	14	17
5 Very serious problem	36	21	56	79	77

Source: Transparency International, 2009b.

Note: Grand or political corruption refers to corruption in the privatization of state-owned land, zoning or construction plans assigned without technical support, and/or land being expropriated (compulsory purchase) without appropriate grounds or even any compensation for actual land value.

According to the Investing Across Borders (IAB) index of the World Bank, Egypt and Tunisia are below global average on access to land information, and Egypt has below average availability of land information. In Morocco, it takes substantially longer than the global average to lease either private or public land. Access to land has been an impediment to investment in most ACTs. Indeed, one reason for the establishment of special zones in the region is to bring a temporary solution to this problem for both national and foreign industrial investors.

Throughout the region, the state owns vast areas of land and usually lacks a coherent land management strategy. This results in outdated land information systems, fragmented governance systems and preferential land allocation in favour of large and well-connected firms, with the final outcome of highly inelastic land supply. This prevents a precious asset from fulfilling its huge developmental potential. For example, of all the investment projects approved in Aden, Yemen, over the last two decades, half did not materialize because of land-related problems (World Bank, 2009a). About 37 per cent of manufacturing firms in the region identify access to land as a major constraint to doing business, which is more than double the percentages reported in South Asia and Latin America, and even more than those in East Asia and the ECA region. As a result of these rigidities and bottlenecks, the mortgage finance market does not develop, and a lot of land transactions are informal or governed by customary rights. Despite land speculations, vacant land is not systematically taxed in Algeria, Egypt, Lebanon, and Morocco. A single unified national authority should be responsible for managing all public land.

I. WHAT TYPE OF INDUSTRIAL POLICY?

Historically, the region has actively used such traditional industrial policy instruments as sweeping nationalizations of industry, trade and agriculture in the 1950s and 1960s, followed by import substitution in favour of its infant industry.[58] Such industrial policy was based on the socialist concept of growth that centred around heavy public spending oriented towards the accumulation of both physical and human capital. The exchange rate appreciation that derived from increasing oil revenues and inflow of remittances supported the view that industrial policy was crucial for long-term economic diversification and growth. However, evidence that such policies led to corruption and weaknesses in the financial system and did not improve the total factor productivity of the economy has lately changed the consensus on them. The advent of the Washington Consensus and the fall of the Iron Curtain further accelerated the dismantling of such policies. However, the region today still retains many characteristics of the old times with high levels of public involvement in the production of strategic goods and services and a complex web of price controls and subsidies that are implemented and monitored by a plethora of ad hoc offices and agencies.[59]

One of the most tangible results of these structural adjustments has been the creation of large private businesses that are unable to compete but are able to thrive because they operate in an uncompetitive environment and can extract rents from the protectionist policies built around them and from privileged access to such subsidized inputs as land, fuel and credit. Looking at this landscape, it seems as if governments have become victims of their own designs and have locked themselves in preserving the structures, elites and dependency logic that they had previously created. Past industrial policies have prevented new and more innovative pressure groups from emerging. Governments have failed to diversify their industry and have deterred innovation and product development and hindered domestic production from integrating into global chain values. As a consequence, the industrial sector is dominated by SMEs and large, inefficient firms serving local markets and functioning with little competition and low competitiveness and faces a complex structure of administrative controls and a rigid labour market (Amin and others, 2012).

In Egypt and Tunisia, state-owned enterprises (SOEs) represent an important share of the manufacturing sector. Sekkat (2008) found that productivity is negatively affected by lack of competition and noted that the intensity of entry and exit in Jordan, Morocco and Tunisia is much lower than in other emerging economies. Egypt, Jordan, Morocco, and Tunisia all have competition laws in place but their enforcement and the independence of the competition authority remain poor. In Egypt and Morocco, only a few cases involving competition issues have been dealt with so far.

Box 3. Privatizations in Arab countries in transition

According to the World Bank database on privatizations, in the period 2000-2008, total privatization proceeds in the Arab Countries in Transition (ACTs) amounted to US$26.9 billion, with Egypt leading with about 43 per cent of the total, followed by Morocco, with 29 per cent, and Tunisia, with 13 per cent. Industry and

[58] The infant industry argument is based on the dynamic-comparative-advantage concept that newly established production activities will typically have higher fixed costs and production costs than those of well-established competitors from other countries. In the presence of market failures and without initial protection and provision of essential services and infrastructure granted by the state, private investors will never kick in.

[59] Administered prices create arbitrage opportunities within a country or at the border with neighbouring countries between fixed-price and market-price sectors that can generate enormous gains. The region provides plenty of evidence in the fuel and food sectors.

services are the sectors that have most widely undergone privatization, followed by infrastructure, mainly telecommunications, and finance. Privatization programmes in the ACTs have provided mixed results because they are often conducted in an environment prone to state capture, corruption and oligopolistic pressures. Successful privatization programmes in the region show that performance gains, reduction in tariffs and improvement in access appear stronger in countries where there are: (a) equitable and modern regulations enforced by an independent and functioning regulatory authority; (b) strong commitment by the state to ensure a credible privatization process; and (c) proper sequencing of the process, including a restructuring phase prior to the divesture (Kauffmann and Wegner, 2007). If privatization is implemented within a strong governance framework and is inspired by the principle of the universal right of access to basic services, it can be conducive to equitable growth through allowing a rationalization of the bloated role of the state in which opaque subsidy mechanisms are replaced by more transparent allocations of public expenditure. Privatization of such natural monopolies as water and power generation and distribution is more controversial from a welfare point of view because of the risk that private businesses might capture monopoly rents.[a/] In addition, privatization can only be a catalyst for the development of the private sector if combined with reforms of the business climate and the financial market. A regional study aiming to assess the impact of privatization on employment and on the overall welfare effect on consumers would be highly advisable at this crucial juncture.[b/]

a/ Utilities can be properly managed by the state. According to Kauffmann and Wegner (2007), Tunisia is a good example of a well-managed state water provider with sizable welfare effects since water accounts for only 0.9 per cent of the household budget compared to the internationally accepted benchmark of 3 per cent. Experience from other transitions shows that management and concession contracts, rather than full-fledged privatization, can in part offset some of the above-mentioned shortcomings.

b/ Many countries in transition have particularly focused on these aspects. In Turkey, for instance, the government introduced a series of safety net measures, including a supplementary unemployment indemnity and retirement benefits, which helped ease the burden on employees.

Industrial policy has traditionally been vertical, or selective, rather than horizontal.[60] The former approach is typically susceptible to the risk of state capture and involves the dilemma of identifying the winners or the losers, depending on whether the goal is to promote or protect, because of information asymmetries, as the amount of information generated in the market will be dominated by the so-called incumbents or insiders, in other words, the most vocal and best-organized already established sectors. Selective policies will have a limited impact if the overall business environment is poor. This seems to have been the case in Algeria, Libya and the Syrian Arab Republic (World Bank, 2009e). Worldwide evidence on industrial policy results is mixed while that derived from the Arab region tends to show the failure of vertical industrial policies due to their complexity, discriminatory practices and the excessive red tape and rent seeking involved (Nabli, 2007). Also, administered prices throughout the region cancel important market signals linking prices to production costs.

A new generation of industrial policy has increasingly been focusing on intrastate or regional disparities following the European Union experience. Priority development areas have been identified throughout the Arab region. Such preferential treatment as grants or tax exemptions, is given to companies that decide to locate themselves in these specific areas, which are chosen for social, economic or political reasons. At the same time, additional efforts are exerted to provide these regions with infrastructure systems and quality services. However, as we have already seen in the section on poverty and inequality, economies of scale and spillover effects are inescapable and business will always tend to concentrate where lower transaction costs and skilled manpower are located. The policy focus, therefore, needs to shift from spreading out industrial locations to spreading out access to markets and public services, as well as facilitating factor mobility.

[60] Vertical industrial policy targets inputs, outputs and prices of selected industries, firms or regions, while horizontal policy targets underlying inputs, services and prices that would benefit all firms; this includes skill formation, building public infrastructure, encouraging research and development, and others. Selective vertical policies in specific production activities have often produced disincentives in upstream or downstream industries as prices are often distorted and so deprive these industries of the opportunity to take full advantage of competitive market prices of factors of production.

The new industrial policies required in the region will need to be highly context-specific as countries with an economic typology like those of Algeria and Libya, where there is a great need for their economies to be diversified, require strategies different from countries with such a typology as Egypt and Morocco, which need to find industries that would allow them to break into global markets, or that of Tunisia, which needs to move up the value chain. Above all, a new generation of industrial policy in the region will have to focus more on the provision of public goods, efficiency gains and on the ability to acquire and adapt technical innovations. In brief, it needs to focus on governance in the immediate future.

J. A GOVERNANCE-BASED AGENDA

Two universal criteria characterize good governance (GG): inclusiveness and accountability. Inclusiveness means that everyone must be treated equally by the authorities, can equally enjoy public services and can participate equally in governance processes. There are typically two types of accountability: external, to the citizens, and internal, between different institutions based on checks and balances, and it means that those who act on behalf of the people are answerable for what they do. Accountability requires transparency, allowing everyone to be fully informed, subsidiarity, providing essential services at the point closest to citizens, and contestability, enabling everyone to participate in the choice of alternative leaders, policies, service providers and goods. These underpinning values aim to reduce the information asymmetries between citizens, businesses, service providers and governments, and thus reduce transaction costs as well as uncertainties and unpredictability in the application of government rules and regulations. This, in turn, is likely to translate into more viable productive investment by the private sector which ultimately means more and better quality jobs.

Increasing empirical evidence suggests that improvements in governance may have sizable positive economic returns while more burdensome regulatory systems lead to more corruption and lower income levels (Acemoglu and others, 2010; Djankov and others, 2002). Better governance is normally associated with higher private investment and FDI and with fewer political stress events (IMF, 2011b).[61] Therefore, governance reforms are crucial in countries with limited fiscal space that are increasingly relying on private investment and FDI to enhance their prospects of growth. Studies have found that measures of governance have a positive impact on economic growth, but only indirectly through their impact on the improvement of market-enabling institutional reforms and on better designed, implemented and transmitted instruments of economic policy (Ahrens and Meurers, 2002; Staehr, 2003). In 2003, the World Bank estimated that the governance gap in the MENA region annually costs on average 1-1.5 per cent of GDP. Enders (2007) and López-Cálix (2005) in their respective growth diagnostics for Egypt and Morocco found that poor institutional capacity is a key constraint to growth in both cases. De Wulf and others (2010) estimated that shifting public expenditure from unproductive to productive categories while at the same time improving governance would have substantial growth effects in the Arab countries.[62] It is possible that the governance gap in the region has a negative influence on growth through its effects on the business environment due to higher transaction costs and information asymmetries between businesses and governments and through unsatisfactory provision of key public goods. Countries affected by elite capture, which is the shaping of state institutions and policies for the benefit of a few cronies, also tend to have lower investment and growth rates in the private sector (Kaufmann, 2012b). With an effective governance system, public investments draw in private investment by providing public services, energy, roads, logistics and communications, which

[61] Empirical evidence shows that differences in the quality of institutions are an important explanation for differences in wealth across countries (Acemoglu and others, 2010). Similarly, excessive regulatory burden is more likely to lead to more corruption and lower income levels (Djankov and others, 2002).

[62] It is estimated that a 1 per cent GDP shift combined with an improvement of governance scores in Algeria, Egypt and the Syrian Arab Republic would increase their per capita GDP in excess of 1 per cent, while Jordan, Morocco and Tunisia would grow by an extra 3-6 per cent. Also, the impact of a 1 per cent of GDP increase in secondary education expenditure on net enrolment is higher (between 2 and 8 per cent depending on the country) for countries with higher governance scores; while the impact of a shift of 1 per cent of GDP on the health sector may substantially increase life expectancy and decrease child mortality (De Wulf and others, 2010).

are all necessary for firms to be more productive and competitive on international markets. According to Aysan and others (2006), improving the quality of public administration and accountability in the region by one standard deviation would increase private investment by about 3.5 per cent of the GDP. One important lesson learned from drastic unemployment reductions in past transitions is that good governance and an environment conducive to business can be even more important than labour regulations in creating jobs.[63]

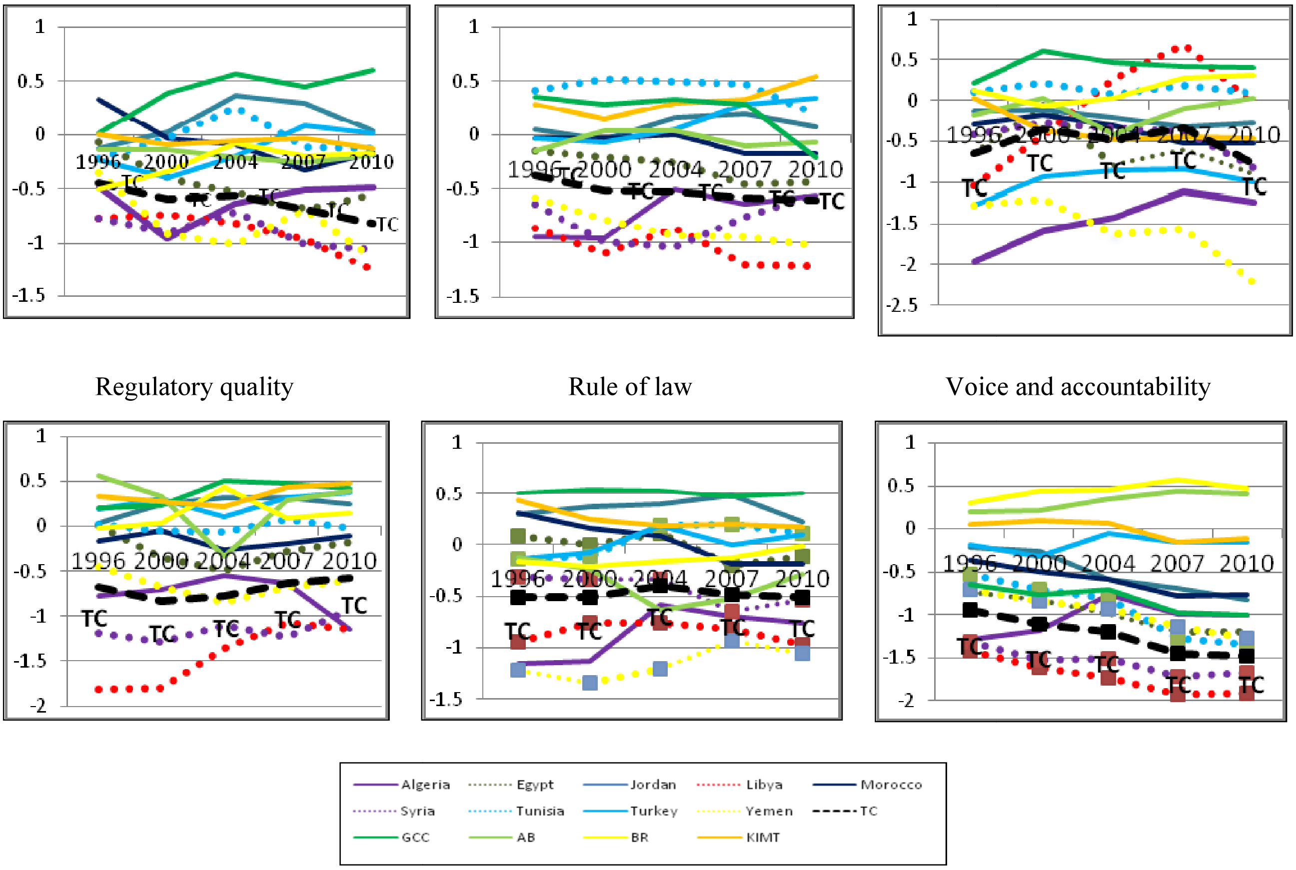
The Arab region performs poorly in all GG underlying pillars. Governance quality is lower than expected for their income levels. Political power tends to be highly concentrated in the executive with close control of the legislative and judiciary powers, as well as of domestic media. Association laws impose cumbersome restrictions on CSOs in many countries. Governments have made selective use of civil society, particularly in the field of development projects and service provision, and have arbitrarily screened and filtered them, attracting individuals from CSOs and absorbing them into their structures, but have been reluctant to involve CSOs in institutional and legal reforms and, therefore, in a wider GG reform process. In addition, CSOs themselves suffer from many similar challenges and shortcomings including politicization, favouritism, dependency, and patronage.

Over the last decade, the region has persistently been in the bottom half of key governance indicator rankings, with improvements recorded mainly in regulatory quality. The Worldwide Governance Indicators for the region show stagnating or even deteriorating trends over the last 15 years (see figure 32). This becomes apparent when such trends are disaggregated specifically into the countries in transition, namely, Egypt, Libya, the Syrian Arab Republic, Tunisia, and Yemen, and compared to other countries in the region and other comparator regions. In the countries in transition, there are clear patterns of deterioration in the fields of corruption, government effectiveness and voice and accountability. The 2011 Freedom House rankings rated no Arab countries as free, with three being partly free and the rest being not free. This trend manifests a deterioration compared to two years before when seven countries in the region were rated partly free. Aside from these global rankings, whose validity may be questionable, everywhere in the region, family or clan members and close friends or allies of those in power hold prominent positions in ministries and publicly owned enterprises. Others use their networks to acquire monopolies, enter an oligopoly or acquire privileged information and use it as an insider advantage for strategic business decisions or simple speculations. Corruption and rent distribution are often used to buy loyalty to the status quo from both regime associates and opponents, with the aim of making them stakeholders. At the same time, formal institutions are kept weak and such status apparatuses as military and security forces are used as tools for controlling the population and opposition while, at the same time, they are divided and pit against one another so as to reduce any risk of a coup.

Figure 32. World Governance Indicators (1996-2010)

Corruption | Government effectiveness | Political stability

[63] It is estimated that an improvement of one standard deviation in the Index of Economic Freedom issued by the Heritage Foundation would lead to a 0.9 per cent reduction in unemployment. A one-point improvement in the index increases the probability of a drastic drop in unemployment, by at least one quarter within four years, of 3.6 to 5 per cent. Further estimates show that corruption delays service delivery in the region by approximately 41 per cent when applying for an operating license, 61 per cent when applying for a construction permit, and 24 per cent and 31 per cent when exporting and importing, respectively (World Bank, 2012a).

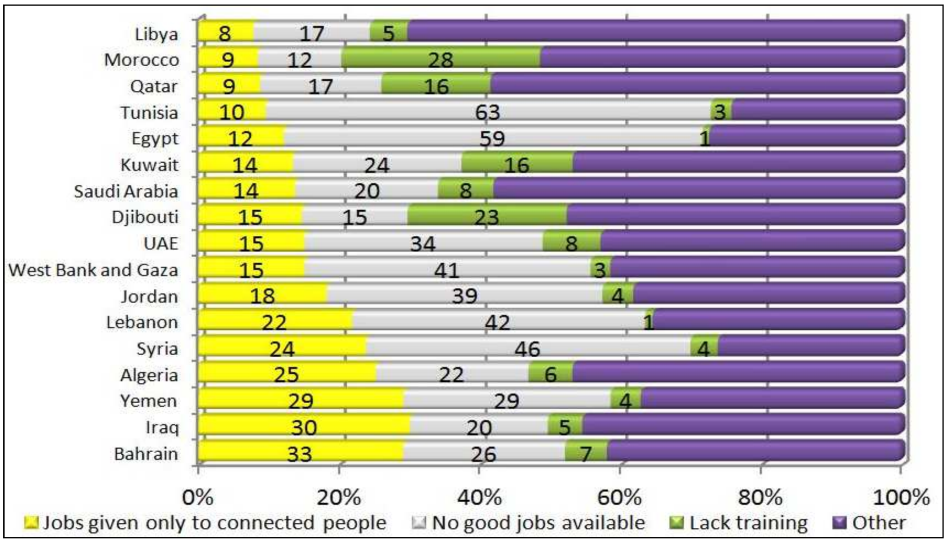


Source: ESCWA calculations based on World Bank, World Governance Indicators, 2011.

Note: AB: Argentina and Brazil; BR: Bulgaria and Romania; KIMT: Korea, Indonesia, Malaysia, Thailand; and TC: transition countries (Egypt, Libya, Syrian Arab Republic, Tunisia, and Yemen).

As confirmed by various opinion surveys (see figure 33), public administrations in the region suffer from a meritocracy deficit which undermines the whole process of building up human capital, and more importantly, hope, or venturing in business endeavours because people think that without the right social status and connections everything else becomes irrelevant in terms of finding a decent job and creating opportunities for themselves. The youth in the region are, therefore, affected by a double transition from education to employment, where the first stage is to acquire the right skills and diplomas, and the second stage is to find a way into the labour market in which meritocracy is not the overarching value and primary selection criteria. The second transition is likely to leave large segments of the population frustrated and angry.

Figure 33. Perception of constraints to getting a job among Arab youth



Source: Gallup and Silatech, 2009.

Many judiciaries in the region suffer from a lack of independence and credibility despite the fact that some constitutions enshrine the principle of independence. The executive generally controls appointments and promotions of judges as well as the, often insufficient, budget and administration of the judiciary. Civilian judiciaries have further been constrained by the expansion of the jurisdiction of military courts in the aftermath of September 11. The result is large numbers of caseloads and very slow and inefficient services (Salem, 2010). Empirical evidence shows that Egypt and Tunisia would be able to raise their ratio of FDI inflows to GDP by more than 1 per cent point if they were to enforce laws and regulations to the level of Switzerland (World Bank, 2012d). Corruption in the courts and customs offices is also significant because of opportunities created by poor and paper-based case management systems. Jordan and Morocco have undertaken reforms that have automated court systems, while Egypt and Tunisia seem to lag behind in this respect. Egypt, Jordan, Morocco, and Tunisia have been upgrading their customs systems through the introduction of the United Nations Automated System for Customs Data (ASYCUDA) systems, computerization and risk management. However, they still perform poorly in the customs indicators. Moreover, most transition countries do not have such oversight institutions as effective anticorruption and antitrust agencies, and when they do have them, they are typically weak in investigative and enforcement capacities (Transparency International, 2009). Tunisia has adopted freedom of information acts and Morocco has guaranteed it as a constitutional right. However, all the transition countries are at the very initial stages in this crucial endeavour.[64]

Quite interestingly, until the uprisings, most ACTs had governments led by a current or former military. Military and security personnel in Egypt represent a large proportion of public employees and are estimated at over 900,000 and approximately 1.4 million staff, respectively. In 2012, the combined budget allocated to defence and interior affairs was estimated at around US$8 billion, on top of which an estimated US$1.3 billion of military assistance was provided by the United States (Sayigh, 2012). Currently, in Egypt, on-duty or retired personnel control large shares of the state apparatus, SOEs, and an unknown part of the Egyptian economy. According to Sayigh (2012) and Gelvin (2012), the military controls sizable manufacturing sectors, from construction to consumer durables, from defence to chemicals and from pasta to dairy production, thereby risking of crowding out the private sector through cheap labour, economies of scale, vertically integrated processes and privileged access to heavily subsidized inputs and financing. Arguably, this state of affairs has escalated since the intensification of neoliberal economic reforms that took place over the last decade or so. The experience of China might be relevant in this regard. After securing the

[64] Studies have recently shown that greater access to public information generates important economic benefits. For instance, Vickery (2011) finds that in the European Union, such access is quantified at 1.7 per cent of GDP.

military's support during the cultural revolution, and during the first phase of its open-door policy, China undertook an aggressive demilitarization of its economy including a shift of military production to civilian companies, large-scale transfer of manpower and industrial facilities to the latter, and downsizing together with more professionalization of the armed forces. Cheung (2001) argues that without this extensive and rapid demilitarization of the Chinese economy in the midst of the economic transition, China would not have enjoyed the benefits of economic liberalization to the extent it did.[65] Many of these productive activities could gradually and carefully be privatized while precautions are taken to ensure that their privatization does not entail raised concerns regarding transparency, market distortions and fair treatment. So far, there has not been any civilian oversight of the military, including its budget, and the drafting of the new constitution will represent a litmus test of the parliamentary role in this respect.

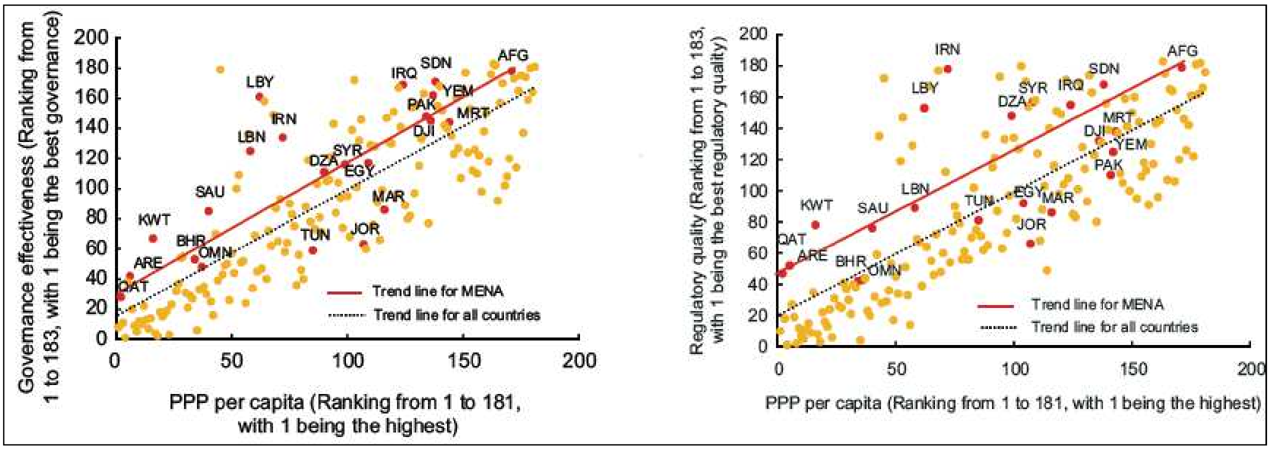
Absenteeism in service provider facilities is also an issue in ACTs. In Egypt, for example, a recent survey found that one quarter of employees in public health facilities are absent on an average day (Grun and others, 2010).

Discretional implementation of regulations coupled with barriers to markets and competition creates an uneven playing field and encourages the pursuit of privileged access, resulting in political capture and private-sector stagnation, and serves to discourage investment. Private-sector stagnation tends to prevent the reforming strata of civil society, the so-called middle class, from growing and gaining voice. Such circumstances have forced citizens to meet their own needs through patronage networks or other private means. Those who are able to provide for themselves do so, increasing the gap between those who can afford private services and those who depend on the government for essential services, leaving poor populations even more vulnerable. Indeed, most Arab countries appear to have lower scores on governance indicators than their GDP per capita predict.[66]

Figure 34. Governance indicators and income

[65] In the words of Cheung, "by getting the People's Liberation Army involved in business, Deng was able to ensure that the military's interests became closely intertwined with his own policy goals" (Cheung, 2011, p.171). However, by the 1990s, Chinese "military chiefs had come to the decision that the advantages of commercialism were now outweighed by negative consequences, some of which included the erosion of central military values, such as centralized command, hierarchy, discipline, intercommunication,and esprit de corps" (Cheung, 2001, p. 58).

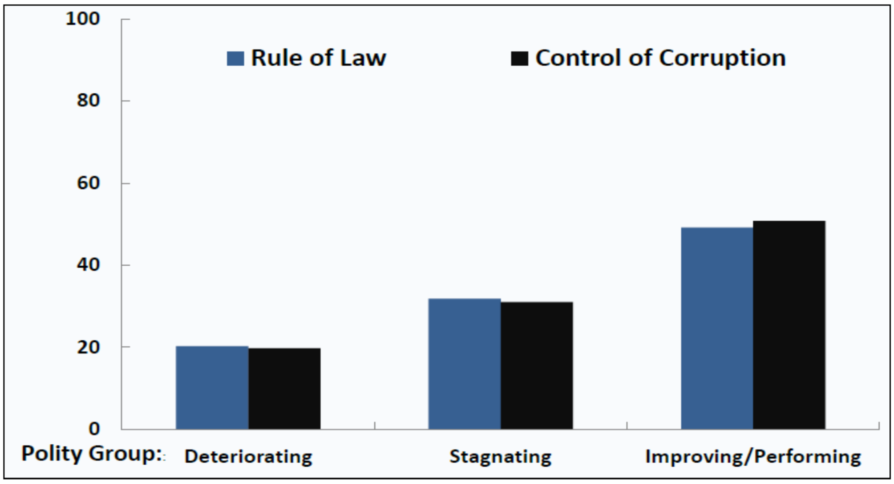
[66] Douglass North, in his historical analysis of the transition from natural states, which are typically rent-based, to open societies, which use economic competition and political institutions to regulate social, political and economic relations (North and others, 2009), can offer an illuminating political economy framework in which to analyse state capture, cronyism and power struggle experienced in many Arab countries. Therefore, it can be quite helpful in providing a key to understanding the challenges of the Arab transition process. As a first step in the transition from natural states to a more open society, the Arab uprisings have reclaimed their citizenship rights and demanded more equal access to economic, social and political opportunities. The next step, according to this reading, would consist of creating more accountable and transparent political and economic institutions. Examples in which countries have achieved higher growth and improved welfare after modernizing their institutions can be found in the cases of Botswana, Chile and Korea (Acemoglu and others, 2010). Some of these transformations took place in democracies, others in more autocratic regimes, while others in a mix of the two.



Source: World Bank, WGI and IMF, 2011b.

Transitions around the world have provided a unique window of opportunity for improving national governance systems, particularly concerning voice and accountability and regulatory quality in the first few years of transition, though improving rule of law, corruption control and government effectiveness has proven difficult (World Bank, 2011a). Improving governance indicators is not only good for growth but also increases the chance of success in the transition process itself. According to Kaufmann's estimates (Kaufmann, 2012a) presented in figure 35, countries with low ratings regarding corruption and rule of law have deteriorating levels of democratization, unlike those with high levels of these governance indicators.

Figure 35. The relationship between governance and democratization



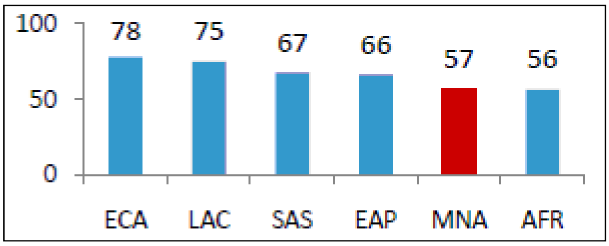
Source: Kaufmann, 2012a.

The good news is that, from a short-term fiscal point of view, many such governance-related reforms as the systematic use of open tenders in public procurement, the systematic publication of information and data by the state administration, and strengthening competition regulators and judicial enquiries into corruption have the advantage of being almost costless and would bring about significant benefits to the whole population in a relatively short period of time.

A governance-based reform agenda at this initial stage of transition also needs to start a new typology of research work, which maps and monitors interest groups and undertakes a more general, evidence-based risk analysis of cronyism, corruption and state capture that, in turn, can inform policies and programmes. The role of the international community and civil society will be instrumental in this regard.

Finally, it is worth stressing that there is a positive association between the statistical capacity and commonly used governance indicators in a country, although the causality is probably bidirectional. In other words, better production and dissemination of data is likely to contribute to public transparency and better governance in the same way that better governance is likely to foster data production and dissemination. Also here, the region scores very low (see figure 36).

Figure 36. Statistical capacity by region



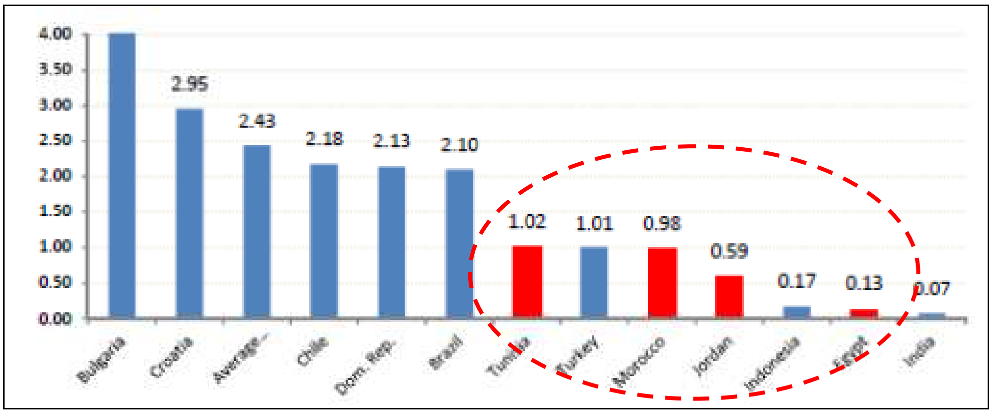
Source: World Bank. Bulletin Board on Statistical Capacity (data for 2010).

Note: ECA stands for Economic Commission for Africa, LAC for Latin America and the Caribbean, SAS for South Asia, EAP for East Asia and Pacific, MNA for Middle East and North Africa, and AFR for Africa.

K. THE BUSINESS ENVIRONMENT

Microenterprises and SMEs make up over 90 per cent of all enterprises in Egypt, Jordan, Morocco, Tunisia, and Yemen (98 per cent in Tunisia and 97 per cent in Yemen),[67] and provide between one fifth and one third of the total employment in those countries. They are usually family-owned microenterprises and mostly operate informally. According to the International Finance Corporation (IFC) and World Bank, the region has the highest SME density among all developing regions but one of the lowest in terms of formally newly registered businesses (World Bank, 2012d). As shown in figure 37, Egypt, Jordan and Morocco have higher densities while Libya, the Syrian Arab Republic, Tunisia, and Yemen have lower densities as to the former indicator. However, Egypt and Tunisia swap positions when entry density of formal businesses is considered.

Figure 37. Firm entry density in selected economies (2004-2009 average)



Source: Klapper and Love, 2010.

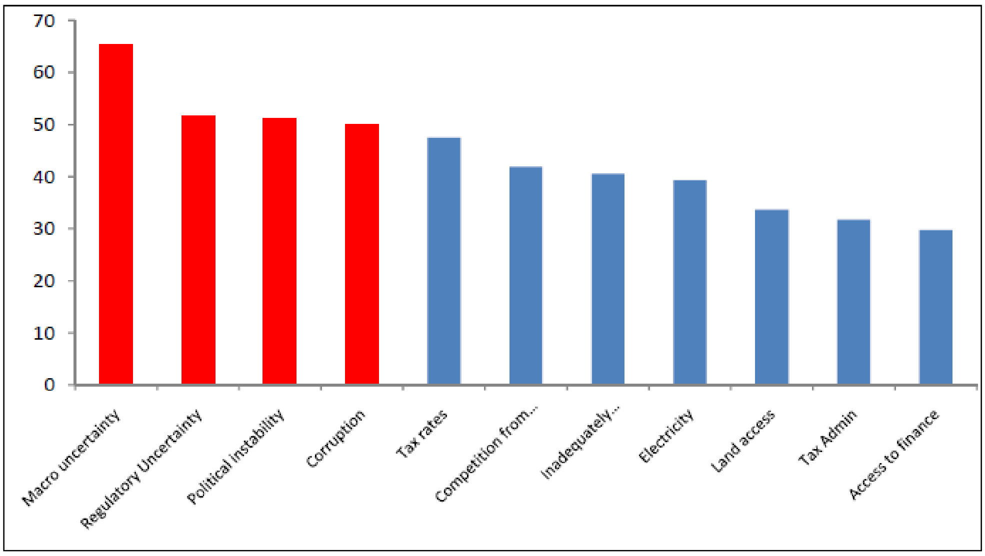
Note: Entry density measures the number of newly registered limited liability firms per 1,000 people of working age (15-64).

[67] World Bank, 2009e.

Turning more specifically to the business environment, the Doing Business indicators, as part of the Global Competitiveness indicators, show that, while most of the GCC countries rank quite high, most of the transition countries in the region rank low, particularly, Libya, the Syrian Arab Republic and Yemen. More generally, although these kinds of global ranking should be taken into consideration with caution because of a number of methodological and underlying policy constraints, region-wide the real constraint does not seem to be the legal framework but rather its implementation that, according to enterprise surveys, seems to be based on red tape, arbitrariness and unequal treatment. These findings are presented in figure 38.

Recent surveys capture investor constraints in the region. Business managers in Egypt confirm that the priority problems are political instability and policy uncertainty, but also emphasize inefficient bureaucracy and corruption, worker training and labour regulations, access to finance and informal competition. Respondents in Jordan highlight taxation, bureaucracy and corruption and access to finance. Moroccan firms highlight bureaucracy and corruption, access to finance, infrastructure supply, including electricity, informal competition and taxation. Tunisian firms emphasize government bureaucracy, access to finance, political and policy instability, and restrictive labour markets. Libyan respondents stress on access to land, regulatory policy uncertainty, access to finance, macroeconomic uncertainty, and tax rates. Corruption seems to be a major concern for about two thirds of firms in Egypt, the Syrian Arab Republic and Yemen. In Egypt, about 36,000 regulations are thought to affect the private sector, giving rise to potentially pervasive administrative discretion and corruption (Amin and others, 2012, p. 23) and 43 per cent of surveyed firms and more than half of the surveyed hotels report having made informal payments in order to gain a construction permit and an import card, respectively (World Bank, 2009e).

Figure 38. Main constraints to firms in selected Arab countries



Source: World Bank, 2012a.

As a consequence of limited competition, red tape and higher barriers to entry and exit, the productivity dispersion reported in the garment industry is higher in the region than in most comparator countries. In Algeria, Egypt, the Syrian Arab Republic, and Yemen, the value added per worker of an average firm in the eightieth percentile of the distribution is over six times higher than a firm in the twentieth percentile, compared to only 3.8 times in Turkey.

Investigating limited competition and crony capitalism, Chekir and Diwan (2012) looked at the corporate performance of connected Egyptian firms in the five years before the revolution to analyse how they may have benefited from their connections. They found that: (a) connected firms had a larger market share than their non-connected competitors, namely, an average advantage of 8 per cent of the market; (b) they were able to borrow much more than their competitors, with an average extra leverage of 25 per cent and with an average debt to equity ratio of 1.7 compared to 0.8 for their competitors; and (c) connected firms have lower profitability than non-connected firms. For instance, their return on book assets is only 4 per cent as opposed to 6 per cent for non-connected firms.

The region is still affected by bottlenecks in such sectors as retail and real estate, which are protected from foreign investors in most of the GCC countries, Egypt, the Syrian Arab Republic and Tunisia. After two decades of reforms, there are still barriers to the entry of firms, namely, the need for prior ministry approvals, restrictions to foreign ownership and minimum capital requirements, and to foreign ownership in certain sectors in Algeria, Egypt, Libya, the Syrian Arab Republic, and Tunisia. The World Bank (2009e) estimates that, in response to previous reforms, private investment in the region increased by only 2 per cent of GDP, compared to between 5 per cent and 10 per cent in Asia, Eastern Europe and Latin America. The same report estimates that, with less entry and exits of firms, the average business in the region is much older than in East Asia or Eastern Europe (World Bank, 2009e). These factors seem to point to an endogenous relation between a distorted business environment and a rentier-oriented business sector as evidenced by the prominent role that large incumbent, very often government-affiliated, firms have in these economies.

Countries have yet to establish a unified interagency business identification system aiming at streamlining interactions of enterprises with such critical public administration services as customs, business registry and tax authority. An improved business environment is crucial in order to benefit from trade openness (Freund and Bolaky, 2008) and attract more efficient private investment in such labour-intensive formal sectors as manufacturing and services, particularly, tourism, logistics and ICT.

Lately, however, some transition countries have undertaken partial reforms. Morocco has stood out in the region for its commitment to reforming the business environment. In Tunisia, the government has started a regulatory guillotine that cut down hundreds of obsolete regulations. In Egypt, the government simplified foreign company registration, removed the requirement for media companies to be registered with the security apparatus and extended the validity of many certificates to three years rather than one. However, such reforms are easily exposed to obstacles and reversals. The recent experience of Jordan seems to be a case in point.

L. THE FINANCIAL SECTOR

The financial sector often undergoes a particularly complex and delicate phase during transition, posing systemic risks and huge costs to small businesses and the most vulnerable segments of societies. Financial crises have been witnessed in transition countries in Eastern Europe, Latin America and Eastern Asia due, in some cases, to increased volatility through sudden liberalization and exposure to international markets, often combined with protracted political instability and deterioration of financial asset quality. At the same time, past transitions have shown that productivity gains and growth are more likely to come from a generation of new investors than the expansion of existing businesses and also that access to finance becomes a crucial factor in letting this new generation of businesses take off. Aysan and others (2006) shows that one standard deviation increase in private credit would increase private investment by 1.2-1.7 per cent of GDP in the Arab region. It, therefore, becomes of primary importance to assess and properly reform the sector from the very start of the transition in order to better facilitate its crucial role as a lubricant for the economic gears.

The financial sector in the Arab region is heavily based on the banking system, accounting for approximately 120 per cent of GDP in the non-GCC region,[68] which has historically relied on large state-owned and family-owned businesses, resulting in relatively higher loan concentration, particularly in the real

[68] Bank assets amount to, on average, about 140 per cent of GDP in transition economies dominated by private banks, namely, Egypt, Jordan, Morocco, Tunisia and Yemen, but are less than half that in economies dominated by state banks, which is the case for Algeria, Libya and the Syrian Arab Republic (World Bank, 2011b).

estate and construction sector, and connected lending. The ratio of top 20 exposures to total loans is nearly three times higher in the Arab region than in Latin America (see figure 41). Egypt has the highest concentration with more than half of top 20 exposures out of total loans, followed by Tunisia and Jordan with almost one third (World Bank, 2011b). The weak corporate governance and financial disclosure practices in the region make it hard to track ultimate beneficiaries of loans. The frequent presence of family and industrial groups in the financial sector raises a number of governance concerns. In Egypt, Jordan, Lebanon and Morocco, domestic banks own most of the public debt, and this contributes to a symbiotic relationship between governments and banks and a risk of crowding out private credit. Egypt, Jordan, Morocco, and Tunisia have a large deposit base compared to other regions, reflecting large workers' remittances and capital inflows.

As shown in the figures below, the banking system enjoys its position of primacy due to the lack of competition from capital markets and non-bank financial institutions (NBFIs). The latter, such as insurance companies and mutual and pension funds, are particularly underdeveloped in most ACTs. Only Morocco stands out as an exception with NBFIs, including mutual funds, accounting for about 90 per cent of GDP, although the largest ones are state-owned, compared with a range of 10-15 per cent in the rest of the region (Garcia-Kilroy and Caputo-Silva, 2011). Equity markets are highly concentrated in a few sectors, being dominated by financial and infrastructure companies, to the detriment of equity market capitalization in industry and other service sectors. Corporate and mortgage-backed bonds and housing finance are still in a nascent stage and, hence, there are no investment alternatives to bank finance. In addition, the region, with the exception of Jordan and Morocco, also ranks very poorly in access to microcredit, with the share of borrowers at around half of that in other regions. All this clearly hampers the access of SMEs to finance, young households looking for affordable housing and the overall regional competitiveness, as depicted in figures 43-45.

Figure 39. Bank deposits
(*Predicted and actual values*)

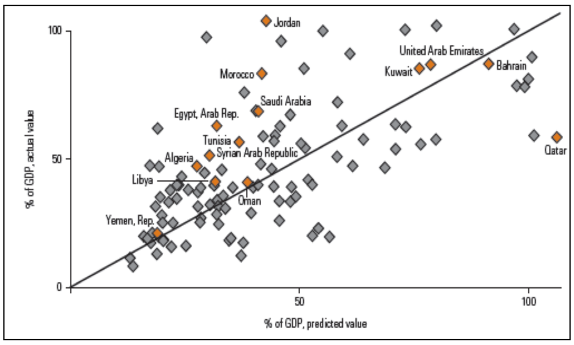
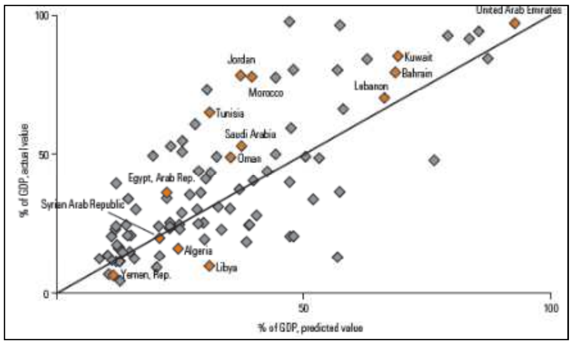


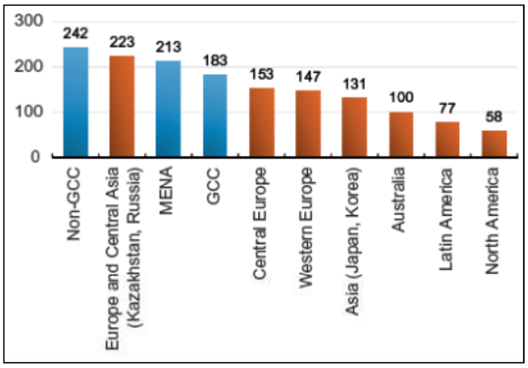
Figure 40. Private credit
(*Predicted and actual values*)

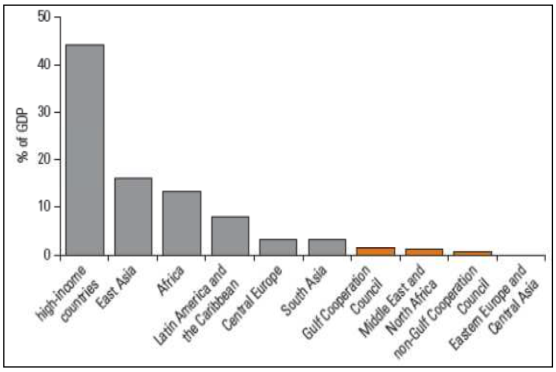


Source: World Bank, 2011b.

Figure 41. Top 20 bank credit exposures
(*As per cent of total bank equity*)

Figure 42. Domestic private bonds
(*Per cent of GDP*)





Sources: Standard and Poor's; and World Bank, 2011b.

Stock markets tend to be too volatile to attract sizable domestic savings. This also explains the urgent need to establish a sound banking system at the outset of a transition. Private credit in ACTs accounts for over 60 per cent of GDP, which is high by international standards (see figure 40), in countries where private banks are dominant but only accounts for about 12 per cent where there is extensive financing of state enterprises (World Bank, 2011b). If private credit is disaggregated by business size, it is clear that SMEs are particularly penalized. Indeed, only 20 per cent of the SMEs in the region have a loan or line of credit and even fewer have access to such alternative instruments as equity, leasing and factoring. The average share of SME loans of total loans in transition economies is only 13 per cent (see figure 44), while mortgage loans amount to around merely 10 per cent. Morocco and Tunisia are the top lenders among transition economies, while Egypt and the Syrian Arab Republic perform relatively the worst with SME loans only accounting for up to 5 per cent of total loans.

Several countries have set up special programmes to encourage SME lending, including bank exemptions on reserve requirements in central banks and credit subsidies. They usually generate limited impact because underlying governance and business environment problems are still in place. Until these are addressed, SME financing programmes will continue to have little impact, particularly regarding start-ups.

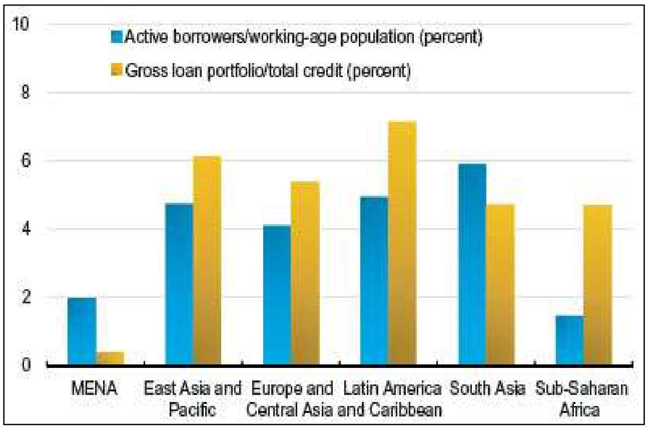
Worldwide, there is evidence that Partial Credit Guarantee Schemes (PCGS) are a less costly means of expanding access to finance than directed lending, and they are market friendly as the lending decision generally remains with the lending institution. PCGSs are already in place in most of the ACTs and, based on the experience in these countries, can provide an important contribution to SME lending, particularly in contexts with weak credit information and creditor rights. However, available data seems to suggest that guarantees are concentrated in the upper segment of SMEs and do not reach out to smaller businesses because of their limited funds and overall risk-averse strategies. Guarantee funds, although state-funded, should be managed independently, for instance, by a company or a non-for-profit institution, and be self-sustaining over the medium term. Adequate capitalization of schemes during their initial phases of development would provide an indication that the government has serious intentions to both borrowers and lenders. In summary, governments should play a catalytic role rather than being involved in the management of SME funds.[69]

Transition economies should tap into successful cases of SME and investment finance within the region, particularly from the GCC countries, given their sizable financial resources, so as to facilitate closer

[69] SICAR, a Tunisian investment company, offers an innovative model of equity investment that could be further explored, perhaps with the addition of a guarantee element. This model involves minority equity investment for a fixed duration, usually two to five years, with the majority shareholder able to buy out the minority equity at the end of the period (OECD, 2011b). Going beyond this scheme, if one also applies an equity guarantee to this type of fixed-term equity investment, one might create incentives for these investments to be sold to third parties and, therefore, might attract additional equity investment.

linkages between the wealth of the latter and the significant investment needs of the former.[70] According to the Emerging Markets Private Equity survey conducted in 2011, the slowdown in most developed economies has increased interest in emerging economies (EMPEA and Coller Capital (2011). This means that the Arab transition economies could potentially take a larger share of private equity if their structural shortcomings were swiftly addressed. Development funds from the GCC countries could play a pivotal role in promoting entrepreneurship in ACTs by offering seed capital guarantee funds, loan and equity finance, and offering technical and marketing assistance to investors. For instance, the Inter-Arab Investment Guarantee Corporation could be strengthened and serve to provide credit guarantees and insurance coverage for inter-Arab investments and export credits. Concerning credit guarantees and venture capitals provided to start-ups, the tax authorities could offer private investors tax exemptions for any investments and loans and offset any potential investment losses against their tax liabilities.

Figure 43. Microfinance indicators by region



Source: Pearce, 2011.

Figure 44. SME loans
(*Per cent of total loans*)

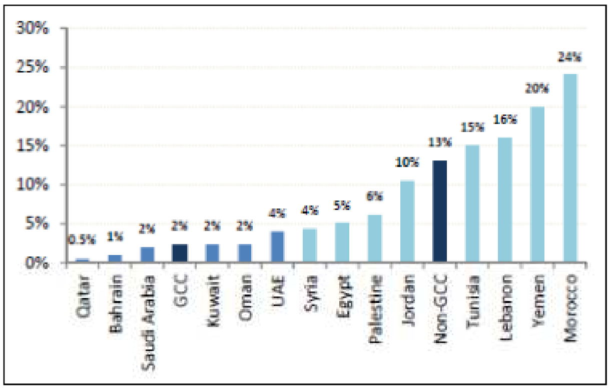
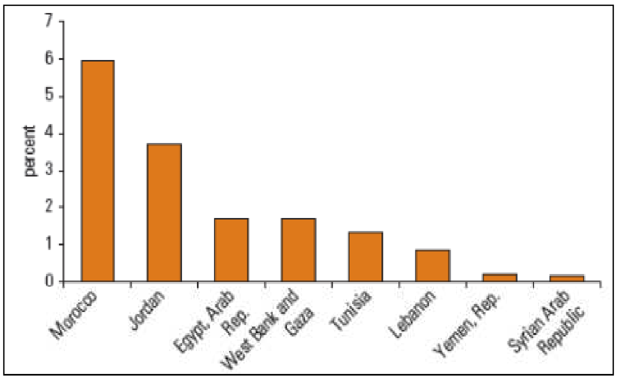


Figure 45. Microcredit borrowers
(*Per cent of working-age population*)



Sources: Rocha and others, 2011; and World Bank, 2011b.

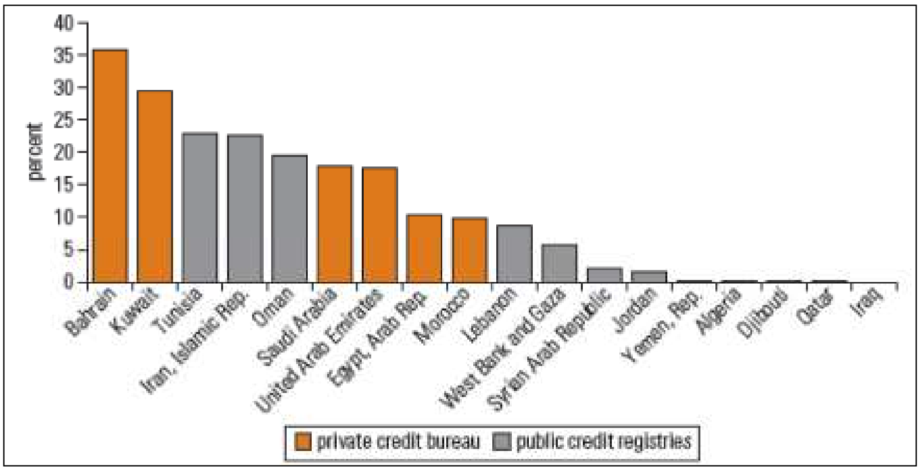
The lack of adequate housing finance is a particular reason for concern, given the high growth rates of urban population in the region due to the youth bulge and sustained rural-urban migration flows. In this field, Morocco and Tunisia are ahead of other transition peers, while Egypt is lagging far behind.

[70] For instance, the Saudi Industrial Development Fund is a well-managed state institution providing long-term finance to manufacturing companies, including SMEs.

Arab countries need to strengthen credit information systems, creditor rights and collateral infrastructure, which are precisely the areas identified as major constraints to firms, particularly SMEs, in the region. Credit information systems are crucial in screening potential borrowers and monitoring their performance, and without them lenders become more risk-averse, requiring more collateral to be frozen, which then becomes idle. This increases interest rates and rationing credit, thereby disproportionally hitting SMEs. In the region, credit registries are often fragmented among different types of collateral and financial industries, giving rise to multiple borrowings, lack of transparency, market segmentation and all types of inefficiencies. They need, instead, to be consolidated and ICT-based so as to give wider and more complete access to any type of institutional creditor. Tunisia has the best coverage among transition countries, while Jordan, the Syrian Arab Republic and Yemen lag far behind, though Egypt, Jordan, Libya, Morocco, and the Syrian Arab Republic have recently upgraded their credit information systems (see figure 46). The region ranks lowest compared to other regions in the Strength of Legal Rights Index by the World Bank, with all transition countries ranked in the bottom half as a result of outdated practices in the use of movable collateral, protection of secured creditors in case of borrower's default, collateral registration systems and access to their information, and seizure of collateral and in other enforcement of the rights of secured creditors.[71] The range of assets that can be used as collateral is limited primarily to immovable property and vehicles, excluding bank accounts, inventories, accounts receivable, and other movable assets. These constraints have also limited the growth of other such important financial instruments for SMEs as leasing.

Figure 46. Coverage of credit information systems

(*Per cent of borrowers*)



Source: World Bank, 2011b.

In Algeria, Egypt, Libya, and the Syrian Arab Republic, many insurance companies are still state-owned. Egypt, Libya, Morocco, the Syrian Arab Republic, and Tunisia restrict the share of insurance companies that can be owned by foreign investors. Such compulsory insurance as third-party motor liability, is still not effectively enforced in many countries; as a result, the sector has not been allowed to grow and to expand its good public nature. The GCC countries could expand the sector further by introducing health insurance for expatriates. Unlike the banking sector, the insurance industry is not regulated and supervised by a strong and independent authority, as could be the central bank.

Similar to other such exchange powerhouses as NYSE-EURONEXT/Deutsche Borse, the Chicago Mercantile Exchange/Chicago Board of Trade, Singapore Exchange/Sydney, NASDAQ/OMX Scandinavia, and others that provide one-stop-shop trading platforms, the Arab exchanges could enter the fray, providing

[71] Slow seizure or sale of collateral contributes to its fast devaluation and, therefore, waste, defeating the very purpose of its existence. In Tunisia, a fast-track process to recover credits has been established in courts and seems to be effective.

for much needed investment activity lacking in the region. Similar to other successful strategies employed by such Arab service companies as airlines, an exchange powerhouse located in the Gulf would provide a link between Asia and Europe, and another exchange located in North Africa would be the gateway to the rest of Africa.

Consequently, such mergers are expected to open the gateway to trading multiple asset classes across national borders and regulatory frameworks on a single, regional cash, debt, equity, and derivatives trading platform. The expected benefits are twofold: (a) they would provide much-needed financing for Arab firms, a need which is not satisfied by debt markets and bank lending; and (b) in the case of GCC countries, a regional powerhouse would provide ample opportunities for Asian firms to get closer to Europe, and, vice versa, Europe closer to Africa, consequently fostering economic development in the region hosting the exchange.

Our analysis indicates that Arab exchanges are minute in size to garner interest individually, hence, a consolidation could provide economies of scale. Moreover, we find that the stock market correlation is low among GCC and African exchanges, which, if increased, would promote cross-investment and diversification benefits flowing from Africa to the GCC and vice versa. But more importantly, we find that the Arab exchanges have low correlations with other exchanges worldwide; hence, providing a strong case that such regional exchanges would necessarily command the attention of other regional powerhouses. For example, the Paris Bourse is correlated with the London Stock Exchange with a factor of 0.9, while the same co-movement with Arab exchanges is 0.3. Hence, diversification benefits the OECD cash-rich investors who would want to invest in the GCC and Africa for the expected diversification benefits.

Finally, microfinance programmes can be a useful instrument for reaching out to microenterprises and marginalized communities in both urban and rural areas. Successful programmes in the region do exist and could be scaled up. The Community Development Programme Microcredit Scheme could be one such enterprise. It lends to individuals, 40 per cent of whom are women, through selected NGOs, charging relatively lower-than-market interest rates, and its overall repayment rates remain high (Semlali and Angel-Urdinola, 2011). In Yemen, the Al-Amal Microfinance Bank has recently become one of the largest microfinance banks in the region, offering its services to young people and the poor.

M. Trade and logistics

Despite increasing trade openness, trade complementarities with such economic poles as the European Union and United States and a gradual increase in export diversification, Arab countries find it difficult to make non-oil trade a driver of employment creation and growth. This is partly due to the fact that the exports from the region are still concentrated in low value-added activities with slow-growing markets, and partly because of its poor links to global production processes, which have increasingly become a driver of growth in global trade, and to non-oil and non-real-estate FDI flows. Although the non-oil exports coming from the region have progressively shifted towards new fast-growing markets instead of concentrating on slow-growing Europe, as Jordan, Morocco and Tunisia have, its capacity to penetrate foreign markets with new and more value-added products is low when compared with other such middle-income countries as Turkey, not to mention East Asia. Jordan, Morocco, Tunisia, and, more recently, Egypt, have displayed some diversification (see the Herfindahl-Hirschman Index of trade concentration in table 12), although they mainly rely on such low value-added activities as garments and textile, mineral and agricultural products. A slow shift towards more sophisticated products seems to be taking place in the chemical, pharmaceutical and mechanical sectors. The region faces intensified competition in world markets in both skilled and unskilled labour coming from Eastern European countries and East Asia, and South and East Asia, respectively. The longer the region delays the implementation of policies that will enhance its competitiveness, the more disadvantaged businesses will be in facing such competitive pressures in both areas.

The massive revenues from commodity sales in hydrocarbon-exporting countries and remittances in other economies have allowed a pegged exchange rate that serves as a disincentive for sustaining the production of other tradable products. This Dutch disease situation can only be reverted by an active, non-protectionist industrial policy for the development of key industries and an exchange rate policy that allows the alignment of the real exchange rate with its long-term fundamentals.

Figure 47. Export destinations of selected countries in 2009

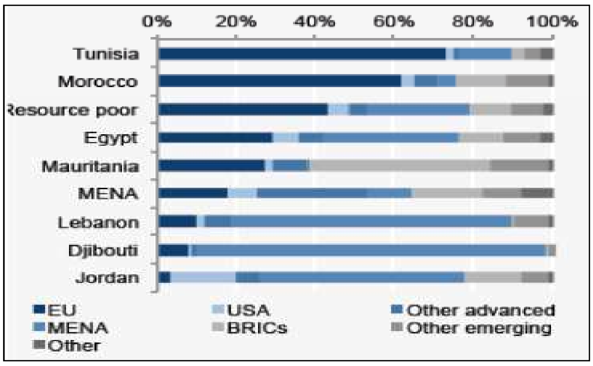


TABLE 12. TRADE CONCENTRATION AS MEASURED BY THE HERFINDAHL-HIRSCHMAN INDEX

	Algeria	Egypt	Jordan	Morocco	Tunisia
1991	0.3399	0.2264	0.1048	0.0482	0.0629
1992	0.2988	0.1620	0.0869	0.0459	0.0673
1993	0.3077	0.1951	0.0698	0.0503	0.0663
1994	0.3136	0.0979	0.0683	0.0509	0.0682
1995	0.3128	0.0860	0.0690	0.0528	0.0698
1996	0.3156	0.1187	...	0.0536	0.0760
1997	0.3002	0.1041	0.0695	0.0548	0.0699
1998	0.3092	0.0756	0.0979	0.0578	0.0723
1999	0.2997	0.0981	0.0563	0.0559	0.0689
2000	0.3010	0.1291	0.0274	0.0539	0.0467
2001	0.2900	0.1110	0.0444	0.0518	0.0648
2002	0.3061	0.0896	0.0529	0.0490	0.0629
2003	0.3293	0.1344	0.0459	0.0506	0.0622
2004	0.3798	0.1306	0.0394	0.0472	0.0593
2005	0.3823	0.1309	0.0411	0.0431	0.0543
2006	0.3969	0.1357	0.0392	0.0447	0.0497
2007	0.3920	0.1267	0.0485	0.0419	0.0513
2008	0.3720	0.0692	0.0580	0.0598	0.0513
2009	0.3427	...	0.0478	0.0414	0.0446

Sources: COMTRADE data, 2011; and IMF, Direction of Trade Statistics database, 2011.

Note: (...) means that data is not available.

With intraregional merchandise exports accounting for 10-11 per cent of total merchandise exports and intraregional non-oil exports constituting about one quarter of the total, gravity models consistently find that regional trade is still below its potential[72] and intra-industry trade, a key driver of regional trade integration in other such regions as Europe and East Asia, driven by regional production chains, is close to non-existent. Many ACTs have lower costs in trading with the European Union than in trading between themselves. This potential for intraregional trade could possibly be developed through industrial complementarities and efficiency gains that could be reached through a regional distribution of agriculture production, economies of

[72] Oil accounts for about half of the GCC's GDP and 80 per cent of its fiscal and export revenues, while intra-GCC trade is almost 10 per cent of total GCC trade. The trade patterns of Jordan, Lebanon and the Syrian Arab Republic are notably more regionally integrated. For more information, see Miniesy and others (2004), Peridy (2005), Achy (2006), and Behar and Freund (2011).

scale in manufacturing and the promotion of the region as a trade hub. To tap into this potential, harmonized regional customs regulations would have to be in place, and a significant reduction of non-tariff barriers, a reduction of tariff rates and an improvement in trade logistics would be required. Trade in the services sector is hampered by a lack of mutual recognition of professional qualifications and education diplomas as well as restrictive regimes in the transportation, telecommunications and financial sectors, particularly in the GCC countries, Egypt and Tunisia (World Bank, 2012d). Hence, export potential and further intraregional trade have not been fully explored, and integration in global value chains has been hindered.[73] PAFTA remains restrictive on trade in the agriculture and service sectors[74] and weak in clearly regulating rules of origin. The GCC formed a common market in 2008 and has been able to coordinate industrial policies among its countries but imposes serious restrictions in the service sector, resulting in strong disincentives for such service-related FDI as banking, insurance, ICT, and transport.

With Morocco and Tunisia maintaining the highest most favoured nation (MFN) tariffs in the region, hovering around 25-30 per cent vis-à-vis non-European Union and non-PAFTA countries, there are risks of trade-diversion effects for these two countries that might benefit the European Union more than the region. Non-tariff barriers (NTBs) to trade are substantial in the region, covering about 40 per cent of the goods imported into the region and 50 per cent of import value (Augier and others, 2012), and can significantly reduce regional trade preferences.[75] For example, some PAFTA members have asked exporters from partner countries to obtain special import permits that have to be presented to the border agencies so that they can benefit from the preferences (Filali, 2007). Apparently, if an import-competing industry could be harmed by the imports, these permits were often not granted so that importers had to pay the full MFN tariffs. NTBs create wedges between domestic and world prices that often generate highly concentrated rents for a very few winners, such as licensed distributors. Standards are not harmonized across the Arab region, resulting in market fragmentation and limited economies of scale. Moreover, differences in the cumulation of rules of origin of the various intraregional agreements, which are PAFTA, the Arab Maghreb Union and the Agadir Agreement, can also generate additional compliance costs. Moreover, the intraregional rules of origin are different from those implemented according to the Euro-Mediterranean agreements, adding another procurement and operational burden to companies that are serving both MENA and European markets.

For the Maghreb countries, preferential trade agreements with the European Union have not yet yielded the expected benefits. In fact, Cieslik and Hagemejer (2009) found that trade agreements with the European Union increased MENA imports from the European Union but not its exports. Agriculture has been excluded from association agreements and, therefore, the European Union keeps imposing high average tariffs for agricultural products, namely, 15.2 per cent on average, compared to 4.1 per cent for non-agricultural products (Anderson, 2009). Agriculture, services and textiles sectors in the European Union are still shielded from MENA competition through a web of NTBs. Reinvigorating negotiations to open these sectors to MENA exporters should be a priority action. Dismantling European Union tariffs and NTBs on imports of fruits, vegetables, olive oil, and sugar would be immediately beneficial to the transition countries. Moreover, transition countries find it difficult to take advantage of their preferential trade agreements with the European Union because of overly complex rules of origin adopted by the latter (World Bank, 2012d).

[73] This also applies to the promotion of regional electricity and gas infrastructure integration, which is still very limited. A number of grid-strengthening projects are being studied in the region, including 400 kV interconnections between Morocco and Algeria, Algeria and Tunisia, and Tunisia and Libya. Consideration has also been given to establishing new interconnections between the Maghreb region and Europe.

[74] Morocco and Tunisia are among the most restrictive countries in banking and insurance; in the telecom sector, Egypt and Tunisia still lag behind; in maritime transport, major restrictions exist in Morocco; and in air transport, Egypt imposes high restriction levels (World Bank, 2011a). Agricultural trade is hampered by tariff and non-tariff barriers, particularly by sanitary and phytosanitary standards. PAFTA and other bilateral agreements either exclude trade in agricultural products or tend to be fairly flexible, allowing numerous exceptions for sensitive goods.

[75] These figures pale in comparison to the NTMs in the European Union amounting to 83 per cent and 89 per cent, respectively (Augier and others, 2012). In the region, only Egypt has similar levels. Hoekman and Nicita (2008) calculate an elasticity of trade to NTMs of around one-half and a cut of 10 per cent in NTMs would boost trade by 5 per cent.

This results in duty being unduly paid on a significant share of duty free exports to the European Union.[76] Currently, there are about 60 bilateral protocols on rules of origin in the Euro-Mediterranean area that could be replaced by the 2011 Convention on Pan-Euro-Mediterranean Rules of Origin if adopted and implemented. In addition, the European Union adopts non-tariff measures (NTMs) on most of its imports, particularly, sanitary and phytosanitary measures (SPS) on agricultural products. None of the transition countries have yet reached an Agreement on Conformity Assessment and Acceptance (ACAA) for industrial products with the European Union. Technical assistance on SPS and ACAA certification systems would also facilitate exports in the medium term.

Trade openness can have more rapid dividends on growth and job quality and creation than education or research and development policies. However, one important lesson to bear in mind from transitions in Latin America and Africa is that reforming trade openness can cause output and employment losses and can increase inequality and informality when specific sectors are not able to bear the competition coming from foreign markets. In the Arab region, this could be the case for low such value added agriculture and manufacturing as apparel and footwear. This seems to typically occur where weak economic governance is in place. Even when industries are competitive, opening up markets can lead to job destruction in the short run before new ones are created so that, again in the short run, unemployment rates may rise. Therefore, in labour abundant countries in the region, some trade reforms should be implemented with their immediate employment implications having been carefully considered. Simulations based on Egypt show that trade reforms are likely to expose formal domestic firms to fiercer foreign competition, and they try to adapt by reducing labour costs through cutting workers benefits, replacing permanent workers with part-time labour and not providing workers with formal contracts or social security (Zaki and Selwaness, 2012). In addition, multilateral trade liberalization brings welfare gains primarily to consumers and skilled workers, with wage inequalities generally decreasing in urban areas and increasing in rural areas through unskilled men and skilled women (Hendy and Zaki, 2010). Further trade liberalization initiatives will need to carefully take into account the potential effects on these areas and groups.[77]

A number of such impediments to intraregional trade as incorrect policy implementation and inefficiency of customs clearance processes are not structural but rather policy-induced and could be easily reversed in the short run, provided there is political will. The increased trade openness observed over the last two decades coincided with a gradual deterioration of national institutions, resulting in unsuccessful attempts at both regional integration and bilateral partnerships with the European Union, United States and other countries outside the region for generating jobs and export diversification. It is widely felt that the benefits of the openness have been captured by national elites or politically connected cronies who are another key impediment to further regional integration and private sector development.

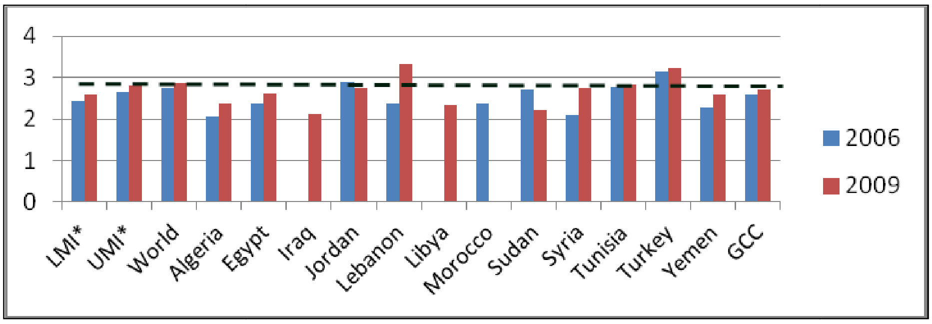
The region has steadily advanced in terms of logistics performance, as suggested by figure 48. However, Algeria, Libya and Morocco are still lagging behind. The most marked logistics challenges are observed in infrastructure, logistics service competition and cargo tracking and tracing. Significant medium-term gains could be reaped by overhauling the regulatory regime for the trucking sector, increasing competition in port and air freight services, reorienting customs authorities towards trade facilitation and

[76] It has been estimated that in the period 1996-2006, Jordan unduly paid duties to the European Union on 18 per cent of its exports (Ayadi and others, 2009).

[77] Services liberalization tends to carry fewer risks of income losses than liberalized merchandise trade because lifting common services restrictions does not cost the government revenues. However, services liberalization tends to be more complicated than tariff reform since it requires the establishment of a carefully designed regulatory system and appropriate safeguard mechanisms. The regional agreements existing in MENA do not cover the services trade sector. Intraregional differences in regulations and restrictions on currency convertibility and labour mobility are currently discouraging any development in this critical field that has huge welfare-enhancing potential. The highest barriers to trade in services in the region appear in such professional services as audit and legal services, financial services and transport services (Chaffour, 2011).

enhancing cross-border transit procedures based on the Transport International Routière (TIR) carnets model.[78]

Figure 48. Comparative logistics performances



Source: World Bank. Logistics Performance Index.

Note: * LMI is short for low- and middle-income countries; and UMI is short for upper-middle-income countries.

In addition to immediate efficiency gains, the growth of the transport and logistics sector can provide substantial potential for employment growth in the medium term.[79] Being a service industry with relatively limited investment requirements compared to other industries, transport and logistics is a labour-intensive economic sector with a strong focus on a less skilled workforce, which is a source of comparative advantage for the Arab countries. In addition, growth in this field would enable countries in the region to enter into global and regional manufacturing value chains which heavily rely on just-in-time and highly integrated manufacturing models.

The Arab region has a particularly strong regional trade integration deficit. In order to illustrate this deficit, table 13 compares various trade-related indicators, namely: (a) the World Economic Forum Enabling Trade Index;[80] (b) the World Bank Logistics Performance Index (LPI);[81] (c) the World Bank Ease of Doing Business Index;[82] and (d) export shares of manufactures and services. The table shows that the GCC region outperforms the more diversified economies in all categories, with the exception of the export share of manufacturing and services. As a whole, the region tends to perform worse in many trade development indicators than other middle-income regions and, in some cases, even below the world average. These indicators are heavily affected by the following: (a) the lack of overall responsibility for trade facilitation; (b) no integration of border services and inspections; (c) the lack of simplified procedures for transit freight; and (d) the poor state of railways and road infrastructure in the conflict-affected countries, as typified by the conditions of the roads and border crossings between Palestine and Jordan, and between Iraq and the Syrian Arab Republic and Jordan.

TABLE 13. TRADE DEVELOPMENT INDICATORS IN THE ESCWA REGION

Country/territory	Enabling Trade Index	Logistics Performance Index	Ease of Doing Business Index (ranking)	Export share of manufacturing and services

[78] Dennis (2006a) estimated that the welfare benefits from intraregional trade facilitation would be more than three times as high as those from intraregional tariff elimination.

[79] On average, a one-day delay in export shipment means a reduction in trade of agricultural products of about 7 per cent (Djankov and others, 2006).

[80] Available from www.weforum.org/en/initiatives/gcp/GlobalEnablingTradeReport/index.htm.

[81] The Logistics Performance Index (LPI) ranking is available from http://info.worldbank.org/lpi.

[82] Available from http://www.doingbusiness.org/EconomyRankings.

			Business Rank	
Bahrain	4.8	3.4	18	26.2
Egypt	3.7	2.6	114	16.4
Iraq	Na	2.1	152	...
Jordan	4.4	2.7	101	38.8
Kuwait	4.0	3.3	52	7.8
Lebanon	...	3.3	99	27.5
Oman	4.5	2.8	57	7.4
Palestine	...	...	131	8.0
Qatar	4.5	3.0	37	6.4
Saudi Arabia	4.4	3.2	16	5.9
Sudan	...	2.2	147	0.8
Syrian Arab Republic	3.3	2.7	137	12.8
United Arab Emirates	5.0	3.6	46	5.3
Yemen.	...	2.6	98	2.9
More diversified economies	3.7	2.5	125.5	11.6
GCC sub-region	4.4	3.2	25.6	6.1
World	4.0	3.1	91.0	16.5

Sources: WEF and World Bank databases (2010).

Note: (...) means that data is not available.

To conclude, trade reforms are more complex nowadays as they go well beyond import-tariff reforms and include behind-the-border regulatory reforms. Hence, trade reforms have become increasingly difficult to implement from a political economy point of view, and transition governments are in need of clear incentives that can be seen by the public in order to garner their support *vis-à-vis* potential opposition from the elites in favour of the status quo. This was the clear advantage that Eastern European countries had in preparation for accession to the European Union, as the Union served as an external anchor with a clear road map and sequencing of reforms that, as well as granting the countries access to external markets, contributed towards the more efficient functioning of their internal markets. To some extent, this also applies to the Turkish reform process during its transition (Togan, 2012). The Deauville Partnership Report (World Bank, 2012d) has put forward the realization of a symmetric common Mediterranean economic space as an incentive for such reforms in the Arab region. In light of what has been discussed above, this should perhaps be implemented asymmetrically in the medium term with a more gradual openness of borders to the European Union products that compete with the agricultural and manufacturing sectors that have a strategic relevance for the countries in transition but that are still uncompetitive on global markets. This would balance the short- and medium-term bitterness of such difficult policy reforms. A similar arrangement could also be put in place with Turkey.[83] It would be crucial, however, that: (a) investment and such services sectors as banking, insurance, health, and education benefit from a symmetric openness by virtue of their increasingly crucial role in the economy and society of emerging economies; and (b) such an asymmetric and gradual openness has clear benchmarks and deadlines and that it be considered irreversible so as to discourage old and emerging interest groups likely to arise during any reform process in the region from derailing it for their own entrenched interests.

Finally, studies of trade liberalization in Morocco and Tunisia show that, when factor markets are flexible, the benefits of trade liberalization are three to five times greater than when factor markets are rigid (Dennis, 2006b). The agriculture sector in transition countries would, therefore, benefit from reforms to modernize land titling systems, simpler requirements for starting a new business and easier access to credit.

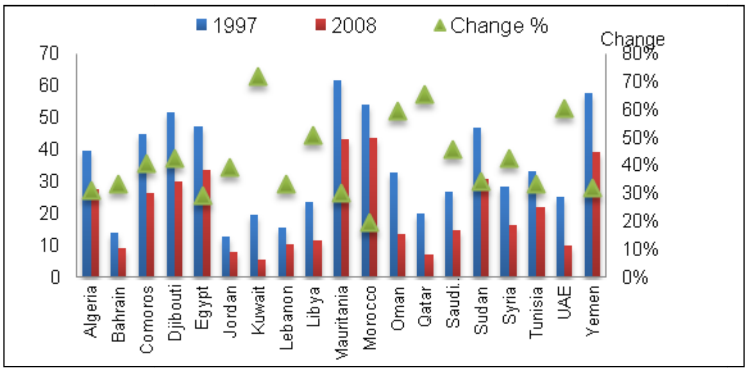
N. Education

Worldwide, there is a strong positive relation between the formation of human capital and economic growth. In the Arab region, this relation is weaker. In contrast to most developing countries, lower education

[83] Turkey has recently signed a Memorandum of Understanding (MoU) of preferential trade agreement with Tunisia and is discussing one with Libya.

tends to offer lower private returns than higher education, although it tends to generate higher social returns (Bardak, 2005). Arguably, unproductive public sector jobs are driving higher private returns in higher education without reflecting productivity patterns. Moreover, education levels and poverty are strongly correlated, as the poor seldom manage to complete secondary education. This would mean that focusing government spending on primary and secondary education would entail gains in social equity and obvious human capital accumulation. Between 1970 and 2008, MENA countries spent, on average, around 5 per cent of their GDP on education, with Tunisia allocating the most, namely, around 7 per cent, in the last decade, compared to a range of 3-4 per cent in East Asia and Latin America. As a result, the average number of years of schooling has doubled over the 1980s and 1990s, drastically reducing the gap between girls and boys[84] and reducing population inequality (Gini) in schooling by half over the period 1970-2000. Although at the start of the period identified, the region had relatively low levels of gender parity, equality has now almost been reached for basic education and the parity indices for secondary and higher education are not significantly different from those of Latin America and East Asia. The area where more progress is still needed is in relation to illiteracy, which remains significant among the female adult population in Algeria, Egypt, Morocco, and Yemen (see figure 49). Considering the fast rate of population growth, these achievements are even more remarkable.[85] However, while education has been one of the success stories in the region due to its huge advances over the last four decades, it has historically been characterized by overly centralized management, promotion based on seniority rather than qualifications and performance, and a lack of monitoring and evaluation. Outdated curricula still tend to focus on passive and notional knowledge, and there has not been a significant shift towards competency-based curricula that focus on technical but also soft skills that have become increasingly necessary in the knowledge economy. These include problem-solving, creative and critical thinking, and developing the capacity to adapt to new situations[86] as well as life-long learning.

Figure 49. Illiteracy rates (1997 and 2008)



Source: UNDP, 2012.

Labour supply is the most rigid factor because it typically takes 15-20 years to provide a potential worker with adequate skills. Hence, the quality of tomorrow's labour force, and therefore its economic prospects, will depend on today's education system. Today's Arab youth tend to be overqualified in terms of the level of diploma they hold, but under-skilled for the labour market in the region. Scores of international mathematics and science tests carried out by the Trends in International Mathematics and Science Study

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[84] Significant gender gaps remain only in secondary education in Iraq, Morocco, the Sudan and Yemen. Female adult illiteracy remains high in Algeria, Egypt, Morocco, the Sudan and Yemen. The average years of schooling of a girl from a rural area in Egypt are four, whereas the national average is ten. Survey data for Egypt also confirms that, despite improvements, among the poorest 40 per cent of 15-19 year olds, only 43 per cent reached grade 9, compared to 84 per cent for the richest 20 per cent.

[85] Since the vast majority of school age youth are in school, it becomes all the more crucial to use schools for such behavioural and civic value components in the curricula as providing correct health-related information.

[86] The potential shift from secularist-type curricula to increasingly religious ones should not happen at the expenses of critical thinking, civic values as well as such core subjects as mathematics and natural sciences.

(TIMSS) and the Programme for International Student Assessment (PISA), suggest that the outcomes of the Arab education system are worse than those of its comparators, namely, ECA, Latin America and East Asia, and mask large disparities across the region, with Jordan and Lebanon performing better than Morocco, Tunisia and the GCC countries. The best performer among ACTs scored around 14 per cent and 19 per cent below the 2007 TIMSS in mathematics and the OECD average for PISA, 2009, respectively. As a further evidence of inefficiency within the educational system, there are also significant rates of repeaters. Although the median percentage of repeaters in the Arab region has consistently narrowed, in 2007, the percentage in the primary cycle for the ESCWA region stood at 5.6 per cent, well above the middle income rate of 3.3 per cent. The aggregate cost of premature secondary school dropout in the region hovers around 3-4 per cent of GDP and reaches 10 per cent in Morocco and Yemen.

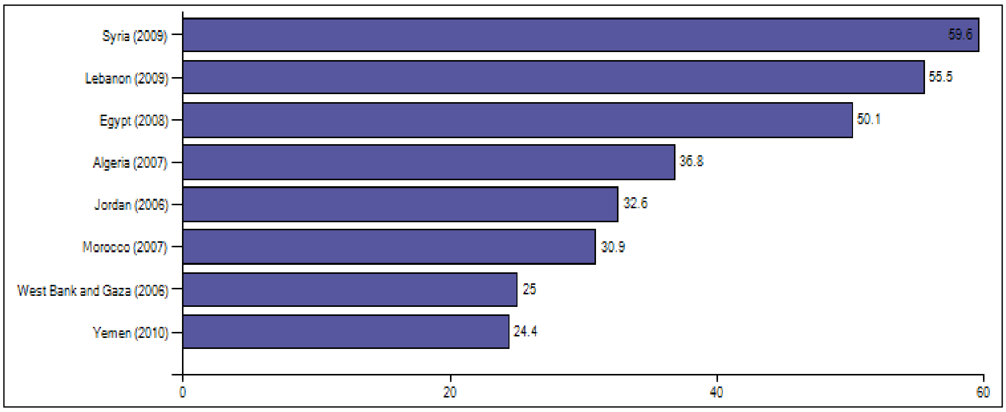
So far, the schooling system seems to have failed to adapt itself to the signals sent from the private sector about the type of education needed. The vast majority of tertiary education students, which are increasingly women, join overcrowded humanities and social science faculties in the hope of acceding to a public sector job[87] but with little prospect of finding employment in the manufacturing and high-skill services. In contrast with practices in Latin America, internship programmes are not offered directly through universities and are not considered part of the academic curricula. The general culture within schools and universities seems to be biased toward knowledge of facts and concepts which can be tested via exams rather than the ability to actually apply those concepts in a real context. This seems to be merely based on the requirements needed in order to enter the public administration, which are centred on holding diplomas rather than real skills. For example, the Egyptian military uses the educational attainment of the applicant, but also of his parents, as a filter to enter military colleges.[88]

This failure is confirmed by enterprise surveys conducted throughout the region over the last decade, summarized in figure 50, reporting that about 40 per cent of enterprises interviewed feel that the skills of the labour force do not meet the private sector demand. This is the highest regional average in the world and is particularly considered as an emergency in Egypt, Lebanon and the Syrian Arab Republic from among all the countries where surveys are available. A survey conducted in Egypt in 2007 indicated that about two thirds of all employers interviewed experienced unsatisfactory performances of first-time job seekers due to inadequate knowledge and communication skills (Angel-Urdinola and others, 2010). Surveyed private employers in Egypt, Jordan, Morocco and Yemen report that not even one third of new university graduate employees are ready for the workplace, a much lower rate than in other regions (IFC, 2011). The number of those satisfied with the skills of vocational graduates was even lower, at 10-25 per cent, with Egypt and Jordan at the lower end. Consequently, many employers feel obliged to provide substantial training to their new hirees to ensure work readiness that they think should have been provided by the education system. Only one third of surveyed youth believe that their education prepared them adequately to be competitive in the labour market.

Figure 50. Share of firms indicating labour skills as a major constraint to business

[87] The scale of civil service recruitment in the region has distorted incentives over time by artificially raising returns to education in non-technical disciplines that are not requested by the labour market. As a result, students in humanities and social sciences account for more than 70 per cent in Egypt, Morocco, Oman, Palestine, Saudi Arabia, and the United Arab Emirates compared to an average of around 32 per cent in China, 44 per cent in the Republic of Korea, 45 per cent in Argentina, and 55 per cent in Chile (World Bank, 2008).

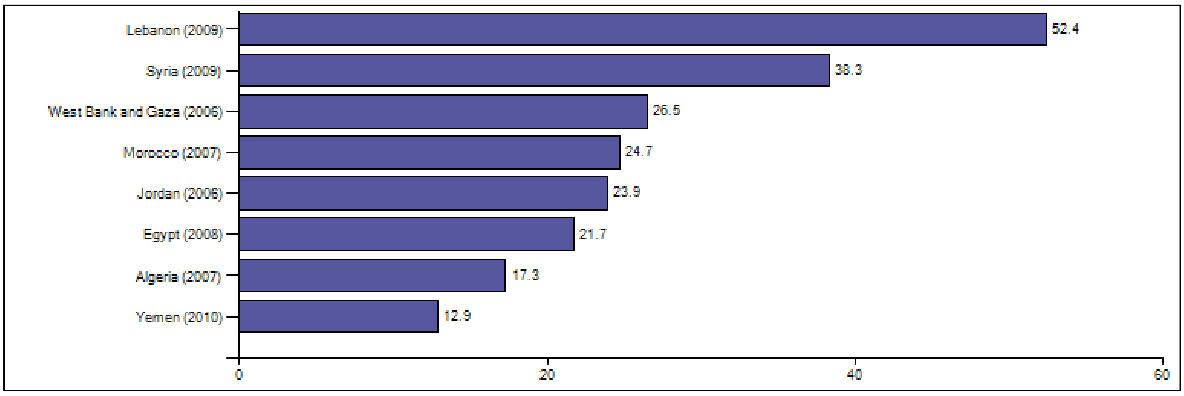
[88] Increasing spending on private tutoring has also become an important tool to increase the chance of entering public offices. This has resulted in more and more discriminatory selection processes based on mere socioeconomic background.



Source: IFC and World Bank, Enterprise Surveys.

However, firms in the region generally seem less willing than those in comparators to provide training to their existing employees, as indicated in figure 51. Lebanon, as the best performer in this regard, barely reaches the average of East Asia or LAC and the overall MENA average amounts to about half that of these two regions.

Figure 51. Firms providing training to employees
(Percentage)



Source: IFC and World Bank, Enterprise Surveys.

The demand for vocation skills in such areas as ICT, tourism and health care is growing throughout the region and globally. The current negative perception of the Technical and Vocational Education and Training (TVET) system being a second-class education system needs to be overcome, and it should become a crucial pillar of the whole education system in ACTs so that the dynamic regional and global labour demand can be tapped into. In order for TVET to fulfil its role, three conditions need to be met: (a) close involvement of the industry in curriculum content, training and internship opportunities, to ensure that modern curricula are in line with market requirements; (b) wide recognition of TVET diplomas within a national, and potentially regional, qualifications framework; and (c) attractive wage levels. TVET in ACTs is in urgent need of reorganization given its tremendous potential for impacting the youth bulge and the state of neglect that it has suffered from for decades due to: (a) the inadequate national qualification frameworks; (b) the fragmented governance structure that results in the perpetual duplication of training programmes and a lack of coordination between different public institutions; in Egypt, for instance, training schools are affiliated to 27 different and independent authorities; (c) non-existent monitoring and evaluation of training programmes; (d) the distribution of public funds according to bureaucratic criteria rather than performance criteria; (e) outdated curricula; (f) the lack of constant monitoring of skills needed in the labour market; (g) outdated teaching methods, namely, typically, lack of balance between theory and practice, and equipment; and (h) the lack of involvement of the private sector (ETF and World Bank, 2006). As evidence of its potential, in Tunisia, the insertion rate of TVET graduates is higher than that of university graduates (World Bank, 2011e). However, given the issues listed above, the average rate of return of TVET in the region tends to be lower than ordinary secondary education. A more market-oriented approach to TVET that caters to the needs of the private sector could involve training vouchers that can be used in accredited training centres.[89] It would also be strategic to link TVET to the diaspora working in the GCC countries, Europe, the United States, and elsewhere in order to tap into high-quality professionals living abroad for training, advice and internship and job opportunities.

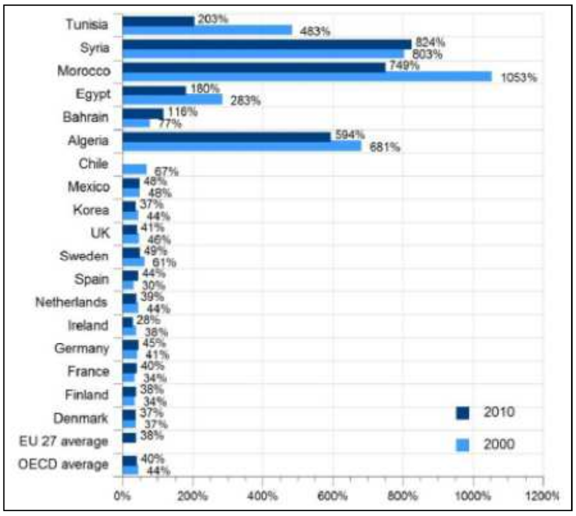
Fiscal space is also very limited in the ACT countries, and, therefore, reallocation and efficiency improvement in education spending has become an absolute priority. Egypt carries a particular burden in this respect because, historically, almost half of all enrolments in tertiary education in the region are from this country. The costs of a graduate as a percentage of per capita GDP, shown in figures 52 and 53, imply that graduation in the Arab region tends to cost much more than in other comparators, with the Arab countries consistently above the 100 per cent threshold and with Algeria, Morocco and the Syrian Arab Republic above 500 per cent, and the comparator countries all below it, with OECD hovering around 40 per cent (Kosaraju and Zaafrane, 2011). Expenditure on higher education is generally quite high, as it constitutes about one quarter of total education expenditure (Millot, 2011) although its growth recently has been lagging behind tertiary enrolment growth rates. Despite the disproportional allocation of resources to tertiary education, international university rankings place very few Arab universities in the top 500 list, namely, 0-6 universities depending on the methodology. Some equity-driven considerations may induce the countries with the least low rankings that have limited fiscal space to consider alternative funding options, including public-private partnerships, for this level of education while primarily focusing their spending on primary, secondary and TVET education[90] as well as efficiency and equity gains across all levels.[91] Waste of limited fiscal resources also occurs in higher education. For example, about one third of the tertiary education budget in Yemen is being used for granting scholarships to study abroad, benefiting about 6,000 students, while only half of this amount is going to the operational budget of public universities, hosting about 250,000 students, which are, in turn, being subject to a reduction in their budgets and have serious quality issues. Another example is the Skills Development Fund (SDF), which is sitting on substantial resources but lacks strategy and capacity (World Bank, United Nations, European Union, and Islamic Development Bank, 2012).

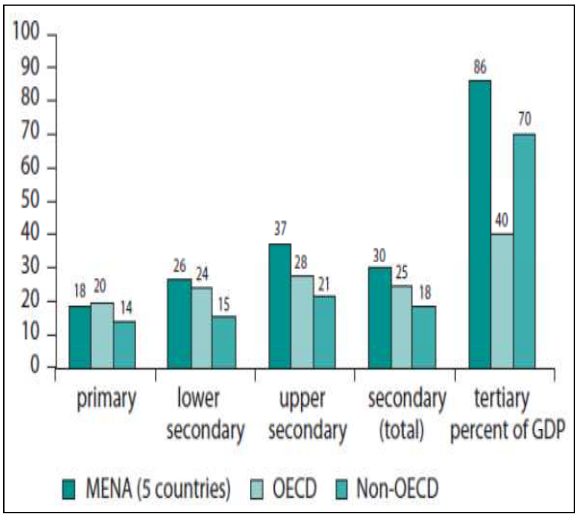
Figures 52 and 53. Comparison of average costs of a graduate and spending per student
(*Per cent of per capita GDP*)

[89] A review of such successful programmes and institutes from other transition economies as Chile Joven, Argentina's Proyecto Joven and Malaysia's Penang Skills Development Center, might prove useful in reforming the TVET system in the region. Malaysia, in particular, could provide relevant lessons learned in the adoption of training vouchers.

[90] East Asia has essentially privatized higher levels of schooling and left primary education almost entirely in public hands. A similar pattern holds for Latin America, although with lower public commitment to primary education than in East Asia. Many countries in Eastern Europe have historically employed a relatively solid public TVET system.

[91] Efficiency and equity could be improved through both supply-side and demand-side actions. On the demand side, recent innovative actions have been focusing on vouchers schemes in the form of coupons that can be spent in any education institution of a given education level, which aim to create competition between service providers. Tunisia has introduced such a scheme in its private TVET system.





Sources: Kosaraju and Zaafrane, 2011; and World Bank, 2008.

Note: The five MENA countries are Algeria, Egypt, Jordan, Morocco, and Tunisia.

National quality assurance systems tend to be focused on such inputs as the student/teacher ratio, rather than output, an approach that needs to be addressed. Harmonized quality standards and curricula in higher education would be instrumental in promoting greater mobility of skilled labour. This should have a two-track approach with a harmonization process within the Arab region and another one with the European Union. For instance, a Bologna process was proposed for the Euro-Mediterranean region, as many ACTs have higher education systems modelled on the French or British systems. This could be combined with a specific student mobility programme, similar to the famous Erasmus programme of the European Union, within the Arab region but also with the European Union, United States and such emerging economies as Brazil, Russia, India, China and South Africa (BRICS). A similar logic could be applicable to TVET through the Copenhagen Process initiated by the European Commission. In addition, affiliation to recognized distance-learning programmes could be useful, particularly for those in employment.[92]

Finally, complimentarily to university and TVET education, work readiness programmes can help with the school-to-work transition. These programmes provide job seekers with specific additional skills training, including language training and computer skills, and are delivered primarily through private sector institutions, either for-profit or not-for-profit. The duration of most work readiness programmes ranges from a few weeks to a few months. A voucher scheme could be utilized in accredited training centres.

O. Health

Private expenditure on health in Middle Eastern countries exceeds that in comparators, whereas levels of government expenditure on health in the region are much less than that of the global average aggregate spending. This trend may be, inter alia, indicative of governance constraints. Government expenditure on health as a percentage of total expenditure in the Syrian Arab Republic, Yemen and the Sudan stood at 1.6 per cent, 1.5 per cent and 1.3 per cent, respectively, in 2009. Social security expenditure on health is absent in Iraq, Libya, Qatar, Saudi Arabia, the United Arab Emirates and Yemen; while out-of-pocket spending is 100 per cent in Iraq and Libya. Social security expenditure does not seem to contribute to reducing out-of-pocket expenditure.

Table 14. Expenditures on health

[92] For instance, Anhanguera is the largest for-profit education provider in Brazil, with 500,000 vocational education and training (VET) students and 300,000 university students. It has hundreds of distance-learning centres spread throughout the country (IFC, 2011). However, it manages to keep costs relatively low, namely, in the range of US$200-300 per month.

Countries	Social security expenditures on health (as percentage of government exp. on health)		Out of pocket expenditures on health (as percentage of private exp. on health)	
	2000	2008	2000	2008
Algeria	35.5	31.0	96.7	94.7
Bahrain	0.4	1.4	68.7	57.2
Djibouti	11.3	8.8	98.4	98.6
Egypt	24.3	21.6	97.4	97.7
Iran	57.8	66.6	96.2	96.6
Iraq	0	0	100	100
Libya	0	0	100	100
Qatar	0	0	84.5	72.7
Saudi Arabia	0	0	66.7	53.4
Sudan	8.1	11.6	91.9	95.8
United Arab Emirates	0	0	69.4	66.0
Yemen	0	0	94.5	98.8

Source: WHO, 2011.

As shown in table 15, total expenditure on health, including private spending, as a share of GDP shows that for most Arab countries, spending on health is, and has been for the past decade, around 4 per cent, with the exception of Jordan, where health spending constitutes close to 9 per cent of GDP.

TABLE 15. TOTAL HEALTH EXPENDITURE
(*Per cent of GDP*)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Bahrain	3.95	4.26	4.39	4.25	3.95	3.71	3.55	3.63	3.66	4.54
Egypt	5.43	5.78	6.13	5.82	5.47	5.25	5.28	4.93	4.81	5.02
Jordan	9.71	9.99	9.86	9.47	9.46	8.93	8.43	8.64	9.40	9.26
Libya	3.28	3.96	4.85	3.66	3.12	2.53	2.37	2.79	3.02	3.89
Syrian Arab Republic	4.92	4.88	4.97	5.15	4.49	4.14	3.90	3.21	3.06	2.93
Tunisia	5.95	5.83	5.85	5.91	6.20	6.17	6.24	6.16	6.16	6.23
Yemen	4.46	4.78	4.67	5.74	5.33	4.88	5.26	5.31	5.31	5.63

Source: World Bank, WDI.

The share of private expenditure on health that is out-of-pocket, as listed in table 16, is staggeringly high in the region: in Libya and the Syrian Arab Republic, out-of-pocket expenditure is the only form of private spending on health.

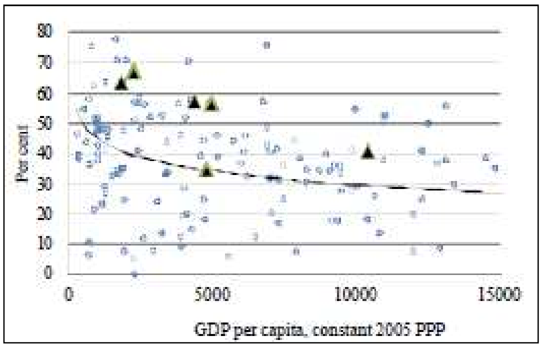
TABLE 16. RATIO OF OUT-OF-POCKET/PRIVATE EXPENDITURE ON HEALTH

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Bahrain	68.65	68.90	67.74	67.40	69.29	70.79	70.30	65.41	57.14	57.90
Egypt	97.42	97.97	98.39	98.44	98.43	98.37	98.24	98.03	97.70	97.72
Jordan	74.94	74.31	77.74	80.66	83.02	85.15	87.37	88.32	82.48	83.46
Libya	100	100	100	100	100	100	100	100	100	100
Syrian Arab Republic	100	100	100	100	100	100	100	100	100	100
Tunisia	80.27	80.27	80.31	80.33	83.64	84.31	85.69	86.94	87.02	87.04
Yemen	94.52	94.77	94.83	96.18	97.28	97.95	92.48	98.44	98.53	98.57

Source: World Bank, WDI.

When coupled with figures on the relative size of private expenditure on health, the results for the Syrian Arab Republic are even more alarming: private expenditure on health constitutes more than half of total expenditure on health and is all out-of-pocket. Out-of-pocket payments also constitute the practical totality of all private spending on health in Egypt and Yemen. The long-term trend shows a substantial increase in the share of private spending that is out-of-pocket in Jordan and Tunisia. If out-of-pocket payments are an indication of the inadequacy of the public sector in providing sufficient health-care services and the absence of a developed private health insurance market, then the figures and trends for each of the countries included, with the possible exception of Bahrain, are alarming and call for reforms that address the problems in availability and quality in publicly provided health care and access and provision in private health insurance markets.

Figure 54. Out-of-pocket expenditure on health worldwide and in non-GCC countries



Source: ESCWA, 2012a.

In some countries of the region, there is a lack of gender balance in key health services. For example, in Yemen, there are only five nurses per every 10,000 people and two midwives per 10,000. Given the local culture, there is an urgent need for more female personnel in hospital and primary health-care facilities.

P. Fiscal policy

Macroeconomic shocks in the region often originate from or are transmitted by the fiscal sector. The fact that substantial deficits persist despite past robust growth points to underlying fiscal problems that do not seem to merely be a symptom of weaknesses in economic growth but rather of lax fiscal discipline, redistributive-type economic policy and weak institutional capacity. Since sustained structural deficits are a major source of macroeconomic instability, it is important to take steps to bring the fiscal dynamics to a more sustainable path in order to maintain medium- and long-term growth prospects.

Over the last few years, public revenue has hovered at around 35-40 per cent of GDP in oil-exporting countries and at around 24-28 per cent in non-oil economies, with Lebanon standing out with the lowest public revenue in the region. Tax revenue as a percentage of total public revenue is highest in Morocco and Tunisia at around 80-90 per cent and lowest in Jordan and Egypt at less than half, countries that have both historically relied heavily on foreign aid. Compared with other regions, the percentage of direct taxation out of total revenue is relatively low, with the highest level in Morocco and Tunisia at around one quarter and the lowest in Jordan and Lebanon at 10-11 per cent. Among non-oil exporters, tax revenue as a percentage of total revenue is highest in Morocco and Tunisia and lowest in Jordan and the Syrian Arab Republic at less than 50 per cent. The contribution of direct taxes to budgetary income is relatively low, reflecting weaknesses in tax administration, as levying direct taxes tends to require more administrative capacity than raising indirect taxes (Crandall and Bodin, 2005). The contribution of indirect taxation, namely, VAT and excise duties, to total revenues is higher than in oil-producing countries. VAT, which has been introduced in all Arab Mediterranean countries except Libya and the Syrian Arab Republic, even though plans were prepared in the Syrian Arab Republic for VAT introduction and in Yemen for the introduction of goods and services tax (GST), over the past two decades, has become a relatively efficient revenue-raising instrument and a stable source of budgetary income. Revenue productivity, which can be measured by relating the standard VAT rate to revenue, tends to be higher in such countries as Jordan, in which VAT is relatively broad-based with as few exemptions and reduced rates as possible (Sturm and Gurtner, 2007). This is, in general, also good practice in direct taxation.[93]

TABLE 17. ESTIMATED TAX REVENUES
(Per cent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
Algeria	-	9.4	10.6	10.0	9.5	8.5	8.5	8.1	8.7	11.2	11.4	9.6
Egypt	-	13.4	13.4	13.9	14.0	15.8	15.4	15.4	15.7	12.4	14.9	14.4
Lebanon	-	-	14.4	15.1	15.7	14.5	14.6	14.8	16.5	17.4	18.4	15.7
Libya	11.6	11.4	4.6	2.4	3.7	2.6	2.5	2.9	3.1	5.6	5.0	5.0
Morocco	24.1	22.8	22.9	19.7	19.9	21.4	22.2	24.8	25.5	25.9	26.1	23.2
Sudan	-	5.6	5.3	5.8	7.4	7.0	6.3	6.9	6.2	-	-	6.3
Syrian Arab Republic	9.8	9.1	10.2	10.6	11.6	10.8	11.6	10.9	8.4	12.2	11.6	10.6
Tunisia	-	21.6	21.5	20.6	20.7	21.0	20.5	20.8	-	-	-	21.0
Yemen	-	-	-	7.1	7.3	7.4	7.2	7.3	7.1	7.4	7.8	7.3
Average	16.7	14.2	13.8	12.6	13.0	12.9	12.9	13.2	12.2	13.8	14.3	13.3

Source: Roy and others, 2011, based on data from World Economic Outlook database.

Following the work of Henry George and Milton Friedman, international research converges on the point that property taxes are a growth-friendly instrument for raising revenues and improving efficiency. In many past transitions, rapid increases in housing and land demand, together with their typically inelastic supply, led to large increases in equilibrium prices, so that economic growth made rich landowners even richer. Because of poor land and housing markets in most ACTs, supply is inelastic and tax on land tends not to alter the market allocation. There is relatively lower deadweight loss compared to other types of taxes, and consequently the tax revenue for the government equals the loss mostly of the rich landowners.

TABLE 18. ACTUAL TAXATION, ESTIMATED TAX CAPACITY AND TAX EFFORT BY COUNTRY
(2002-2009)

	Tax/GDP	Estimated Tax Capacity	Tax Effort
Egypt	14.6	16.7	0.88
Jordan	20.4	21.5	0.95
Morocco	26.6	18.5	1.4
Syrian Arab Republic	17.1	16.6	1.0
Tunisia	26.5	19.3	1.4
Yemen	10.1	16.6	0.6
Average	19.2	18.2	1.0
Argentina	15.0	15.85	0.95
Brazil	21.5	16.1	1.3
Malaysia	15.5	19.4	0.8
Ukraine	27.8	27.1	1.0

Source: Le and others (2012).

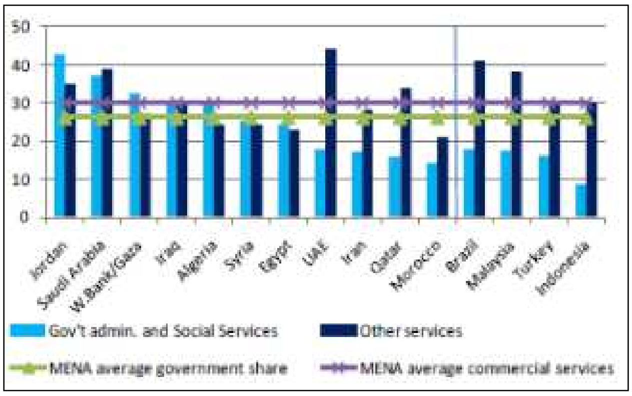
Note: Estimated Tax Capacity refers to the predicted tax/GDP ratio estimated through econometric regression, taking into account a country's specific macroeconomic, demographic and institutional features. Tax Effort is the ratio between column one and column two in the table.

Estimated expenditure composition for the period 2007-2010 has varied a lot across countries, according to the data presented in table 18. In particular, the ratio of primary current expenditure, or net interest rates, to capital expenditure ranged from less than 1:1 in Libya up to about 8:1 in Egypt and

[93] A simplified taxation system for small enterprises along with VAT exemption up to a predetermined threshold and introducing capital depreciation could be ways to induce small firms to become formal and to promote investment and higher productivity.

Lebanon. Regarding the average of the nine countries for which data is available, it appears that regional public expenditure on wages and salaries is comparable to capital expenditure. Services that could be outsourced to the private sector are still provided by the public sector. This is the case with food, cleaning, engineering and information technology (IT) services in ministries, the military and hospitals. Outsourcing can have a dual benefit: (a) better value for money for the service; and (b) private sector development. Although employment in public administration has been decreasing over the last decade, it still represents a significant percentage of overall employment in Algeria, Egypt, Jordan and the GCC countries[94] and even more so when employees in SOEs are included. As shown in figure 55, the bulk of civil service employment is not concentrated in health and education services, but rather in government administration, including security apparatuses that amount to approximately double the share in other developing regions (Nabli, 2007). In this region, real wages in the public sector have historically and quite uniquely, when compared to other regions, been higher than real wages in the private sector. Public sector employment has generated rigidities in the labour market, for example with the introduction of large non-wage benefits. With government employment concentrated among the more educated sections of the population, public sector jobs cannot be considered as a safety net instrument, given that they tend to be disproportionally concentrated in the highest income quintile of the population (World Bank, 2004). Additionally, government and public enterprises have not been able to sufficiently keep up with employment growth to absorb the new entrants to the labour market, while productivity has decreased and wage expenditure became more and more unsustainable in public finances. All in all, this tends to subtract potential resources from the private sector and represents a drain on the economies in the region.

Figure 55. Employment shares of public and commercial services



Source: ILO, as reported in World Bank (2011i).

This composition clearly risks crowding out expenditure in infrastructure, education, innovations, and health care, some of the essential determinants of economic growth. In fact, expenditure on wages and salaries in Yemen, Egypt, Libya, Algeria, Tunisia, and Morocco ranges between 25 per cent and 40 per cent

[94] In Algeria, Egypt, Iraq, Jordan, Palestine, Saudi Arabia, and the Syrian Arab Republic on average more than a quarter of the labour force is employed in the government service sector. In the 1960s, Egypt guaranteed employment to all university graduates, but was forced to abandon the policy in the 1990s when public sector employment as a share of total employment reached almost 40 per cent. However, currently half of the wage earning population is still employed in the public sector. In the GCC countries, the number of public sector employees is usually over 50 per cent, with Kuwait reaching around 90 per cent. Public sector wage bills have historically been overinflated in many Arab countries, particularly in the unstable ones, as a result of strong political pressures to incorporate militias, opposition groups and clan members, making civil services more an instrument of patronage that uses the public sector as a social safety net more than an effective deliverer of public services. For instance, Palestine has a wage bill amounting to over half of the budget and one-fifth of GDP. In Iraq, the wage bill is estimated to have reached 17 per cent of GDP and in Yemen, the wage bill is thought to be at least 10 per cent. By comparison, international benchmarks commonly set the ceiling within 6-8 per cent of GDP. Average expenditure on government wages in the region as a share of GDP was the highest in the world, amounting to about 10 per cent and reaching almost 20 per cent in most of the GCC countries. As a result, the public sector in these countries has been characterized by absenteeism, rent seeking and very low capacity and productivity; it contributes to higher reservation wages in the labour markets; and it tends to crowd out pro-growth productive spending.

of total government expenditure, among the highest rates worldwide.[95] Reducing wage bill expenditure is, therefore, necessary in the medium term. But dismissal of employees is not the right policy tool. While an outright reduction in wages is not feasible, benefits and allowances that accrue to the wages of public employees account for a sizable share, normally in the 30-50 per cent range,[96] of the overall payslip and could be revised, starting from the most blatant cases and privileges.

Subsidies and transfers are on average high throughout the region,[97] but are relatively low in Lebanon and Morocco despite the incidence of poverty, at least in the latter. In general, the relative weight of expenditure is heavily tilted towards current expenditure in non-oil economies. Expenditure on wages and salaries and transfers and subsidies are the two single largest items in Algeria, Egypt, Libya, and Yemen. Interest payments represent an arduous constraint in Egypt and Lebanon, with about one-fifth and over one-third of the overall expenditure, respectively, absorbed by it. The vulnerability resulting from high debt in Egypt is partly mitigated by the fact that a large part of debt is domestic,[98] while a large proportion of the debt in both countries is short-maturity debt.[99]

TABLE 19. ECONOMIC CLASSIFICATION OF ESTIMATED EXPENDITURES
(*Per cent of GDP*)

	Algeria				Yemen				Egypt			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total expenditure	33.1	38.0	41.4	42.6	38.6	41.7	29.6	28.4	31.5	33.8	27.4	28.8
Current expenditure	17.8	20.1	22.5	25.9	31.4	34.6	23.6	22.4	27.7	29.6	24.3	26.1
Wages and salaries	6.7	7.5	8.6	11.4	10.9	10.4	9.7	8.9	7.0	7.3	7.4	7.1
Interest payment	0.9	0.6	0.4	0.3	2.2	2.2	2.6	2.6	5.6	5.1	6.0	5.9
Goods and services	1.0	1.0	1.1	1.4	3.9	3.0	2.8	2.9	2.1	2.4	2.3	2.4
Subsidies and transfers	8.1	10.1	11.1	11.5	12.3	18.1	7.6	7.0	10.3	12.2	6.2	8.3
Others	1.1	0.9	1.3	1.3	2.0	1.0	1.0	1.0	2.7	2.6	2.4	2.4
Capital expenditure	15.3	17.9	18.9	16.7	7.2	7.1	6.0	6.0	3.8	4.2	3.1	2.7
	Libya				Jordan				Lebanon			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total expenditure	35.3	39.3	55.9	49.1	37.2	33.2	33.2	29.2	35.2	34.7	37.5	34.1
Current expenditure	14.1	15.4	28.2	25.3	31.0	27.8	25.7	24.3	32.8	33.0	34.6	31.4
Wages and salaries	8.4	6.8	11.3	10.2	4.8	4.5	4.3	4.3	9.5	9.2	11.3	11.3
Interest payment	0.0	0.0	0.0	0.0	3.0	2.3	2.2	2.3	12.5	11.4	12.7	13.1
Goods and services	0.0	0.0	0.0	0.0	2.9	3.7	3.7	1.8	0.5	0.6	0.6	0.5
Subsidies and transfers	2.4	6.1	12.4	11.2	10.7	7.9	6.2	7.0	2.2	1.5	1.8	1.6
Others	3.4	2.5	4.4	4.0	9.5	9.4	9.2	8.8	8.0	10.2	8.2	4.9
Capital expenditure	21.1	23.9	27.7	23.8	6.2	5.4	7.5	4.9	2.4	1.7	2.9	2.7
	Tunisia				Syrian Arab Republic				Morocco			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Total expenditure	26.0	24.7	24.7	24.6	26.6	23.8	27.4	26.0	28.4	31.3	31.1	30.7
Current expenditure	20.1	19.0	18.1	18.0	17.0	16.6	17.1	16.4	23.9	26.4	26.1	25.4
Wages and salaries	11.6	10.4	10.7	10.5	4.9	4.6	6.1	5.7	10.6	10.6	10.6	10.5
Interest payment	2.6	2.1	2.0	1.9	0.8	0.7	0.6	0.4	3.1	3.0	2.6	2.9

[95] The Egyptian security apparatus alone is estimated to have between one and two million people on its payroll out of a total five million public sector employees (Gelvin, 2012).

[96] Among transition economies, Libya is believed to have historically been beyond this range with massive overemployment in education and health sectors and in the huge web of state-owned enterprises (AfDB, 2011d).

[97] For the sake of comparison, in Eastern Europe, most expenses covered under this item are transfers and not subsidies, reflecting the features of the social system that are common to European countries. In MENA, explicit and implicit subsidies are prevalent as a key instrument of social policies, in particular for petroleum products and food items.

[98] This does not mean that the consequences of debt default would be less dramatic than foreign debt. Historically, the rise in consumer prices under domestic default is on average far higher than that under an external debt default.

[99] A high share of short-term liabilities increases vulnerability as a large proportion of debt needs to be rolled over in a short period of time and is, thus, sensitive to increases in interest rates as well as external shocks or domestic development that increase risk aversion. As for external debt, short-term liabilities are more limited.

Goods and services	1.7	1.6	1.7	1.7	1.2	1.2	1.1	1.1	0.0	0.0	0.0	0.0
Subsidies and transfers	4.2	5.0	3.7	3.6	4.0	4.9	5.8	5.9	2.6	5.0	4.2	3.2
Others	0.0	0.0	0.0	0.3	6.1	5.2	3.5	3.3	7.6	7.8	8.7	8.8
Capital expenditure	5.9	5.8	6.6	6.6	9.6	7.2	10.3	9.6	4.5	4.9	5.0	5.3

Regional average	2007	2008	2009	2010
Total expenditure	30.8	30.9	30.2	30.1
Current expenditure	22.9	23.3	22.6	22.1
Wages and salaries	7.4	7.6	7.3	7.4
Interest payment	2.7	2.9	2.9	2.7
Goods and services	2.4	1.9	1.7	1.7
Subsidies and transfers	6.0	6.5	6.0	5.6
Others	4.3	4.4	4.6	4.8
Capital expenditure	7.9	7.6	7.6	8.0

Source: Roy and others, 2011, based on data from IMF, Countries' Article IV.

Note: Boxes in orange report potential fiscal vulnerabilities.

In the medium term, Egypt, Morocco and the Syrian Arab Republic suffer from a structural fiscal challenge given their macroeconomic fundamentals and the fact that their economies are too large to rely on aid, while they are also too poor to rely on such traditional measures as expenditure switching.

Fiscal consolidation needs to be one of the top priorities for ACTs in the short and medium term. In order to achieve it, there are two obvious options: either increasing government revenues, or cutting expenditure. The IMF position leans toward the former option since short-term fiscal multipliers are higher for expenditure measures than for revenue measures (IMF, 2012b, p. 49). This should not be a trade-off. In ACTs, public expenditure is highly inefficient because it is primarily driven by a redistributive and basic needs logic rather than one inspired by capability, efficiency and productivity. Therefore, any efforts towards fiscal consolidation should include measures to reequilibrate public expenditure and make it more efficient, while expanding tax revenues. Tax revenues can be expanded through broadening the tax base. This can be achieved in two ways: (a) broadening of property and sales taxes; and (b) application of income tax. This may constitute an equity-efficiency dilemma in the medium term. If it is true that ACTs are skewed towards indirect taxation which entails the indirect risk of having a regressive impact on income groups, it is also true that direct taxation, even if strongly progressive, tends to bring about distortionary effects that are even more sizable when the institutional capacity of tax authorities is low and governance-related risks are high. Allowing for individual specificities in a country, what is needed is a gradual shift from labour taxation to consumption and wealth taxation so as to increase equity and competitiveness at the same time, both of which need to be urgently addressed in all ACTs.

When we examine the relation between public spending and economic outcomes in the Arab region, it seems to differ considerably from that in the rest of the world (see table 19). Taking the IFPRI dataset and running macroeconometric regressions for the region, it appears that in the Arab region, unlike in the rest of the world, increasing public spending has a statistically non-significant effect on per capita GDP. Clearly, this raises important questions about the efficiency of public spending. When we disaggregate total government expenditure into social-sector expenditure, namely, education, health and social protection combined, and productive-sector expenditure, agriculture and infrastructure combined, and then into the individual sectors, results show that in both the Arab region and the rest of the world, social-sector spending can be a driver of growth in the short term, as indicated by the reported coefficients. Interestingly, an examination of social spending by sector reveals that the economic effects are different for the two groups. For the rest of the world, the effect seems to be driven by health and education, while in the Arab region, it seems to only be driven by social spending. Therefore, the results of the regressions raise serious concerns about the quality of both education and health systems and the effectiveness of public service delivery more broadly. Productive-expenditure sectors, on the other hand, seem to have a positive effect in the Arab region, but not in the rest of the world, although their impact in terms of per capita GDP is half that of social expenditure.[100]

TABLE 20. SHORT-TERM ELASTICITIES OF PUBLIC SPENDING ON PER CAPITA GDP

	Total				Main sector aggregates				Main sector breakdown			
	Arab		ROW		Arab		ROW		Arab		ROW	
Lagged GDP per capita	1.023	***	0.876	***	0.858	***	0.901	***	0.889	***	0.959	***
Public spending (per capita)												
Total expenditures	-0.007		0.091	*								
Social sectors					0.048	***	0.061	***				
Health									0.002		0.018	**
Education									0.027		0.020	***
Social protection									0.006	***	-0.006	
Productive sectors					0.024	***	0.012					
Agriculture									0.021		0.011	
Infrastructure									0.005	*	-0.011	**
Other expenditures					5E-04		0.001		-0.005		0.024	**
Constant	-0.121		0.508	**	0.828	***	0.544	***	0.730	***	0.142	
Arellano-Bond test for AR(1), p-value	0.073		0.006		0.074		0.007		0.068		0.002	
Arellano-Bond test for AR(2), p-value	0.896		0.096		0.721		0.028		0.715		0.024	
Sargan test of overidentifying restrictions	0.216		0.000		0.131		0.000		0.023		0.000	

[100] However, one has to notice that regressions are run based on a population-adjusted dataset. When regressions are run on an unweighted dataset, results are mostly statistically insignificant.

TABLE 20 (*continued*)

	Total		Main sector aggregates		Main sector breakdown	
	Arab	ROW	Arab	ROW	Arab	ROW
Hansen test of overidentifying restrictions	1.000	0.970	1.000	1.000	1.000	1.000
Observations	278	1289	278	1289	278	1289
Instruments	82	82	138	138	222	222
Countries	12	55	12	55	12	55

Source: IFPRI, based on data from World Bank, 2011 and UNSTAT, 2011.

Notes: The dependent variable is GDP per capita in 2005 US dollars. All models control for country-specific trend effects. Long-run elasticities of public spending, which measure the effect of current spending on per capita GDP in subsequent years, can be derived by dividing the coefficients through the coefficient of the lagged growth variable.

Arab = member countries of the League of Arab States; ROW = rest of world.

$^{*}p \leq .10$; $^{**}p \leq .05$; $^{***}p \leq .01$.

Table 21 below shows the possible crowding out effect that military expenditure can have on social expenditure in the region, particularly in countries with a limited budget. In fact, average military expenditure in the Arab region has constantly been more than double that of the world average and more than triple that of emerging economies from such comparator regions as EAP and LAC. At the same time, public health expenditure has been remarkably lower than in EAP and LAC. In 2007, seven out of the ten countries with the highest military spending as percentage of GDP worldwide were from the Arab region.

TABLE 21. MILITARY EXPENDITURE VERSUS SOCIAL EXPENDITURE, AVERAGE
(*Per cent of GDP*)

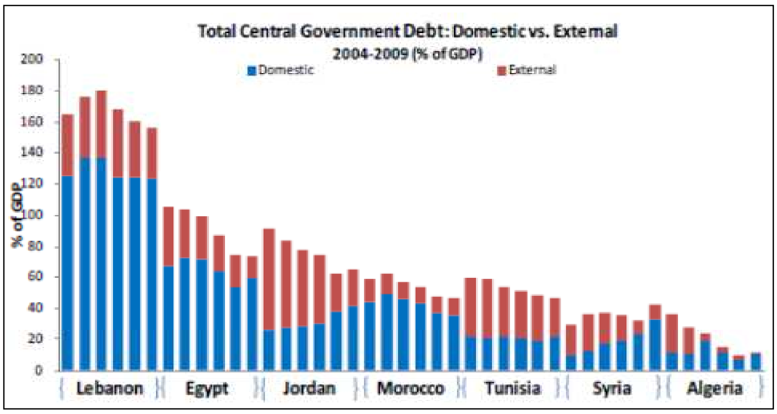
	Military expenditure average		Public education expenditure average		Public health expenditure average	
Country/territory	2000-2004	2005-2009	2001-2004	2005-2008	2000-2004	2005-2009
Bahrain	4.40	3.36	-	3.10	2.79	2.66
Egypt	3.24	2.50	4.80	4.06	2.32	2.12
Iraq	2.38	4.54	-	-	1.01	2.58
Jordan	5.74	5.22	-	-	4.86	5.30
Kuwait	6.92	3.79	6.30	4.24	2.49	1.92
Lebanon	4.91	4.29	2.64	2.46	3.44	3.93
Oman	11.89	9.86	4.05	3.72	2.56	1.99
Palestine	-	-	-	-	-	-
Qatar	3.88	2.25	2.14	-	2.37	2.07
Saudi Arabia	9.80	8.93	7.27	5.97	2.99	2.78
Sudan	3.77	4.24	-	-	1.07	1.88
Syrian Arab Republic	5.49	4.22	-	5.09	2.21	1.45
United Arab Emirates	8.40	5.73	1.84	1.09	2.44	1.81
Yemen	6.16	4.62	9.63	5.15	2.42	1.62
ESCWA average	**5.92**	**4.89**	**4.83**	**3.88**	**2.71**	**2.67**
Arab Region	**6.40**	**5.28**	**5.07**	**3.95**	**2.57**	**2.44**
EAP	**1.49**	**1.58**	**3.98**	**3.79**	**4.69**	**4.28**
LAC	**1.35**	**1.36**	**4.18**	**3.96**	**3.19**	**3.51**
World average	**2.39**	**2.48**	**4.33**	**4.45**	**5.64**	**5.76**

Source: World Bank. WDI database, 2011.

Note: (-) indicates that data is not available.

Public debt in the region is mostly domestic, as shown in figure 56. Since 2005, Egypt, Jordan, Lebanon, Morocco, and Tunisia have tried to reduce their public debt-to-GDP ratio, primarily in light of higher economic growth rates. Egypt has a short-term maturity structure with an annual rollover of about a quarter of GDP. Debt reduction may be difficult to sustain in the current environment of lower global and regional growth, expenditure rigidities[101] and the upward fiscal pressure resulting from the uprisings.[102] Marketable debt is more negligible in Libya, the Syrian Arab Republic and Yemen.[103] A more comprehensive strategy for the implementation of a fiscal policy based on structural public sector accounts, grounded in the non-cyclical component of fiscal revenues and expenditure, including long-term rather than market prices of commodities exported, would yield beneficial results in terms of supporting long-term growth while attenuating short-term volatility through countercyclical fiscal policy during both recessions and periods of growth, as the experience of countries like Chile during the recent global crisis has demonstrated.

Figure 56. Government debt breakdown in the period 2004-2009
(*Per cent of GDP*)



Source: Garcia-Kilroy and Caputo Silva, 2011.

Historically, in addition to economic downturn, and partly as a consequence of it, many countries undergoing transition have faced contingent liabilities from SOEs and the banking sector. Transition countries cannot afford to let fiscal deficit increase uncontrollably because, besides the macroeconomic stability implications of such a policy, they have to cushion against potential fiscal losses deriving from these two sectors.

Most oil exporters in the region have set up stabilization, or sovereign wealth, funds to deal with both the long-term and short-term challenges of fiscal policy.[104] However, such funds pose a number of problems

[101] In the region, expenditure rigidities together with weak institutions tend to make a prompt fiscal response to shocks more difficult while debt financing is relatively easier compared to other emerging economies, thereby creating a bias towards the latter.

[102] Vulnerability is potentially high in countries, such as Lebanon and Jordan, which are characterized by a combination of high debt level, high share of foreign currency-denominated debt, open capital accounts, and an exchange rate peg. The systematic holding of government securities by domestic banks adds, in principle, to this vulnerability. The prospect of challenging debt dynamics makes the need for reforms on domestic public debt markets even more pressing.

[103] The case of the 2000-2001 financial crisis in Turkey provides interesting lessons for the interaction of fiscal and monetary policy in emerging market economies with high public debt as follows: (a) undisciplined fiscal policy was a key factor affecting the chronically high inflation rate in Turkey; (b) such fiscal variables as the primary surplus and the debt burden and expectations regarding fiscal policy were key to forming inflation expectations; (c) enhanced fiscal discipline was the major anchor of the disinflation process; and (d) rapid disinflation and tight fiscal policies are very effective when accompanied by buoyant economic growth. Actually, in the Turkish case, fiscal discipline was a precondition for growth, given that any relaxation of fiscal policy would have translated into higher interest rates (Sturm and Gurtner, 2007).

[104] The long-term challenge of intergenerational equity and fiscal sustainability through accumulating assets is addressed by the savings function of such funds, while the short-term challenge of fiscal planning and macroeconomic stability through absorbing and injecting revenue from and into the budget is addressed by the stabilization function of such funds. Norway and Chile provide two examples of adequately managed sovereign funds that, with an overall long-term savings objective, have helped in the short-term stabilization of the economic cycle.

as to how they should be managed, as their contribution to sound fiscal policies depends on the general quality of institutions and the governance of public finance. Oil-producing countries could also deal with the unpredictability of oil revenues by using market instruments to hedge oil market risks.[105] However, their role in the region so far seems to have been limited due to underdeveloped markets for such products and institutional constraints. Botswana and Chile can provide examples of prudent and sustainable approaches to resource-based fiscal revenues. Since independence, Botswana has used the wealth deriving primarily from diamond mining to finance the goals set in its national development plans, which place particular emphasis on education and health. Chile is using the growing revenues from its copper mining sector to expand its stabilization fund and foreign currency reserves, and, recently, in response to the global crisis, was able to use these reserves to finance its anti-cyclical stimulus programmes.

Q. PUBLIC FINANCE MANAGEMENT

In most countries, there is room to improve public finance management (PFM) in order to achieve better fiscal outcomes. The PFM systems of many ACTs suffer from the following shortfalls: (a) such unreported government expenditures as SOEs and contingent liabilities;[106] (b) weak procurement systems; (c) limited use of medium-term expenditure framework for both project and recurrent expenditure, cyclically adjusted budget balance and revenue forecasting; (d) budget fragmentation and splits in budget processes with separate arrangements and ministries for operating and capital expenditures, typically with the ministry of finance and the ministry of planning being responsible for the two respective categories of expenditure; (e) weak expenditure control and internal auditing systems; (f) inconsistent adaptation of international accounting and reporting standards; (g) weak external auditing procedures; (h) secondary role of parliaments in the budget preparation and oversight; (i) multiple treasury accounts or limited coverage of single accounts; (j) data limitations that hamper policy formulation; (k) high rates of tax evasion; and (l) high incidence of quasi-fiscal operations by SOEs and public banks.

The above constraints are reflected in the constantly poor performance reported by the Open Budget Index in most ACTs (see table 22). Weak participation and accountability in the budget process, at both national and local levels, contribute to inequalities in service delivery.

TABLE 22. OPEN BUDGET INDEX OF SELECTED ARAB COUNTRIES

	2006	2008	2010	2012
Algeria	-	2	1	13
Egypt	19	43	49	13
Jordan	50	53	50	57
Lebanon	-	32	32	33
Morocco	19	28	28	38
Tunisia	-	-	-	11
Yemen	-	10	25	11

Source: International Budget Partnership. Open Budget Survey.

Notes: Open Budget Index scores: 81-100 = extensive information; 61-80 = significant; 41-60 = some; 21-40 = minimal; 0-20 = scant or no information. All scores are rounded to the nearest whole number.

(-) means that no data is available.

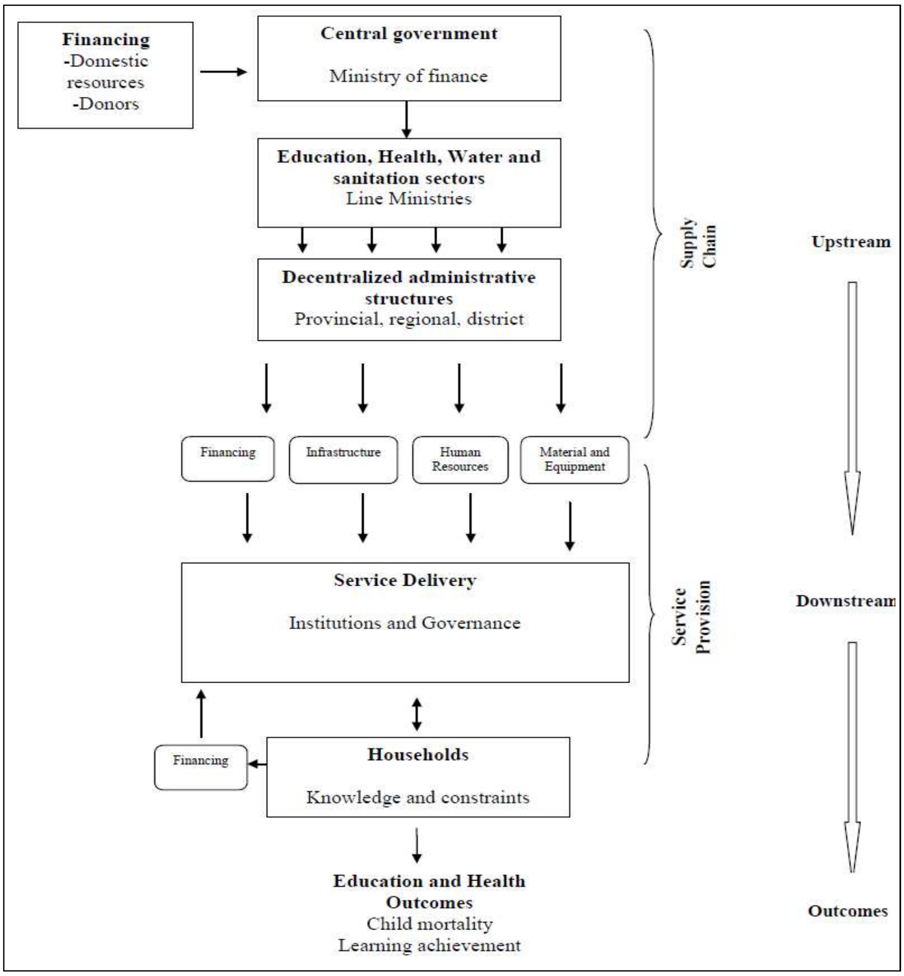
[105] A good example of such hedging is the experience of Mexico, a country that, since 2009, has hedged its crude oil production using options. The oil hedging programme of Mexico has become the biggest single annual deal in the commodities markets worldwide. This strategy paid off when oil prices dropped in 2009. It has given more stability to the revenues of the public sector and has facilitated the budgeting process. Qatar followed this strategy for some of its 2012 oil production.

[106] Typical contingent liabilities in the region are non-performing loans of state-owned banks. As a result, the region's countries face limited ability to absorb shocks.

In ACTs, a single responsible agency needs to be established for managing and implementing the procurement of basic infrastructure services at subnational levels, thus moving away from the current fragmented practice whereby each branch office of a line ministry or central agency does its own procurement, contracting, construction, supervision, maintenance, and operational management.

Resource leakages can be sizable throughout the budget transfer chain when in a context of governance deficit (see figure 57). In about 30 surveyed developing countries, leakages are usually in the range of 30-80 per cent. In Yemen, auditors estimate that about 30 per cent of revenues are lost and do not reach the national treasury (Gelvin, 2012). This is in addition to delays in resource transfers that can take many months and to the absenteeism of 20-40 per cent of health-care providers and 10-30 per cent of teachers. Leakages and delays in resource transfers tend to penalize rural areas. In a governance deficit environment, service funding and delivery are often regressive. All these indicators are likely to exist in most ACTs. However, very limited diagnostics surveys, as the Public Expenditure and Financial Assessments (see figure 58), Public Expenditure Tracking Surveys and Quantitative Service Delivery Surveys (see figure 59), among others, have been conducted in the region.

Figure 57. Potential vulnerabilities of resource allocation and transfers



Source: Information compiled by ESCWA.

Figure 58. Regions covered by PEFA assessments
(Percentage)

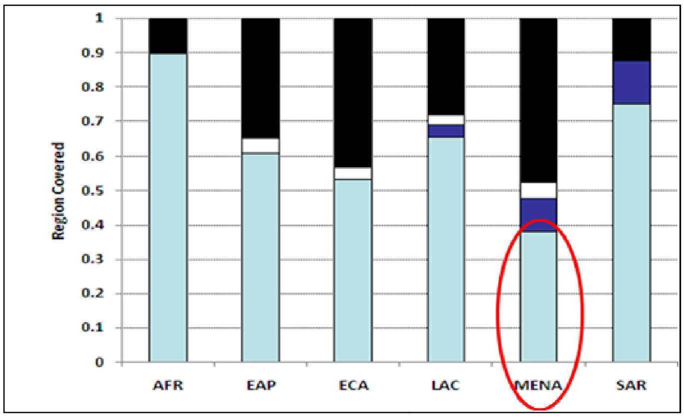
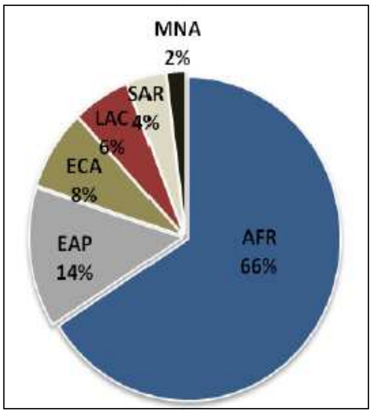


Figure 59. PETS/QSDS conducted by region
(Percentage)



Sources: Actionable governance indicators (AGI) data, available from https://agidata.org/site/CoursePresentations.aspx; and Gauthier and Ahmed, 2012.

Note: PEFA is short for Public Expenditure and Financial Accountability; PETS is short for Public Expenditure Tracking Survey; and QSDS is short for Quantitative Service Delivery Survey.

A large number of government budgets are not subject to any type of formal and open oversight. This is particularly true for military and security allocations and expenditures. In Egypt, around US$8 billion is allocated to this sector, with an additional US$1.3 billion of assistance from the United States, and there are no publicly available audit reports on how this money is spent. Military involvement in large segments of the national economy further confuses the PFM system. Such social welfare and development services as construction of infrastructure systems, water treatment plants and free distribution of food are often provided by the military on a discretional basis and are not included in any annual budget documents. There is a risk of blurring the mandates of different state entities, confusing favours with entitlements, establishing a climate of lack of transparency and accountability in state services, and ultimately allocating the limited state budget inefficiently to the detriment of projects that may have higher anti-poverty impacts.

Given the breadth and scope of PFM reforms, the creation of inter-agency task forces usually facilitates coordination in the overall reform process (World Bank, 2010d). Based on the results of public expenditures and financial accountability assessments conducted at the country level, Libya and the Syrian Arab Republic are the countries where reforms are particularly urgent.

R. Fiscal decentralization

A carefully designed decentralization process could improve public accountability and efficiency of service delivery if it is paired with representation of citizens in local councils. Very often, local development issues are most relevant to the living standards of communities, and the local level is where concrete results can be more easily achieved. The 2004 World Development Report on ensuring that services in Uganda reach the poor made information available about the resources allocated to schools and how much actually reached them (World Bank, 2003b). It caused a strong reaction from citizens and led to a shift in the education governance system. Otherwise, decentralization, or in this case, deconcentration, could have the opposite effect as it can further reduce the consistency of service delivery across subnational regions. The Arab region has historically been the least decentralized of all, but more and more countries are increasingly adopting programmes decentralizing decision-making to subnational governments (evaluation summarized in table 23). The delegation of responsibilities covers many areas of service delivery, including primary health care and education. Customer surveys and community scorecards should become a regular diagnostic and monitoring tool of the quality of service delivery in both urban and rural areas. The experience of Indonesia shows that they send to the public a strong signal of a political will to improve services and can also serve as a vehicle for the participation of citizens in reform programmes. In addition, an assessment of the effectiveness of the decentralization that has occurred in the region, and in other such transition countries as Indonesia, over the last decade would be very useful.

While the state or provincial governments are not locally elected in the majority of Arab countries, municipal governments are mostly locally elected, except in Egypt and Morocco. Despite the expanding practice of local elections, the region still features power sharing between the central and local levels of government that is still skewed towards the former. Many countries have an often confusing plethora of laws regulating the division of roles and responsibilities, but essentially they have more often implemented a deconcentration process rather than outright decentralization. Deconcentration of line ministry functions may, in turn, result in a lack of clear accountability to local governments and, therefore, some blurred lines as to who is ultimately responsible for what. In a few countries, the municipal chief executive is still appointed by the central government rather than being elected; this may also be the case for some civil servants. This is obviously a disincentive for more accountability.

When looking at intergovernmental fiscal relations, it is clear that the region tends to be overly centralized in terms of revenues and expenditure.[107] Governorates or provinces do not have authority over taxing, spending or legislating. This is a major constraint to local decision-making in the region. Egypt, Jordan, Tunisia, and Yemen are particularly centralized in social service functions. Egypt and Jordan have significantly centralized fire protection, heating, irrigation, and police services compared to other Arab countries. With the exception of Jordan, revenue allocations are not based on clear transfer rules and are, therefore, inherently unstable due to business cycles and government revenue volatility. There is also the risk of this resulting in extensive bargaining and favouritism based on political considerations or mere discretionary reasons. Worryingly, local government expenditure data is not available for most countries. All this, together with limited statistical capacity, in turn, negatively affects the ability of local governments to support poverty reduction programmes in their constituencies despite the fact that their position would make them very useful channels of assistance. Social funds and safety nets that are administered by central governments or through charities are the only instruments available for addressing poverty. The Turkish experience in this respect could provide useful lessons.

This is an area with potential for development, as some studies have argued that fiscal decentralization results in improved efficiency in the allocation of resources and in the delivery of public services. This would require subnational governments to be granted more autonomy and to be assigned revenue sources as well as increased responsibilities and accountability requirements. Development of technical capacities at the local level and institutional strengthening are needed in order to minimize adverse incentives and promote transparency and accountability.

Public service provision has not supported subnational regional integration because there is usually no clear relation between resource allocation and results. The allocation of resources from the central government to the local level is merely based on the population distribution, when it is not discretionary and politicized. For instance, although half of the Egyptian population resides in Upper Egypt, in fiscal year 2009, it received only 18.2 per cent of the health expenditure, 19.5 per cent of water expenditure and 29.4 per cent of education expenditure. In order to provide all local governments with at least the minimum level of public services, regardless of their economic standing and ability to raise local taxes, many transition countries in other regions have used an equalization transfer from the central government that is needs-based, allocating relatively more resources to the relatively poorer regions.

[107] In Egypt, the central government collects 98 per cent of total government revenues, and it is responsible for 86 per cent of total government expenditure, whereas local governments, or governorates, disburse almost 14 per cent of total expenditure but collect only 2 per cent of total revenues. Transfers from the central government to governorates finance nearly 90 per cent of local spending, and local revenues cover the difference (Abdellatif, 2012).

Figure 60. Local government per capita investment
(*US dollars*)

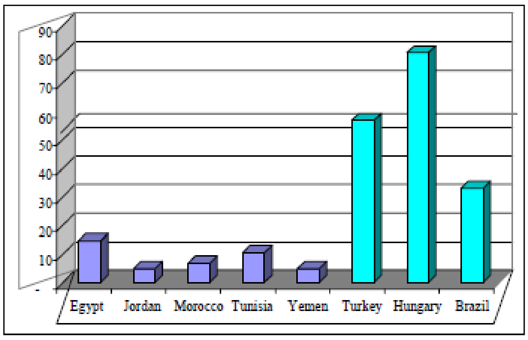
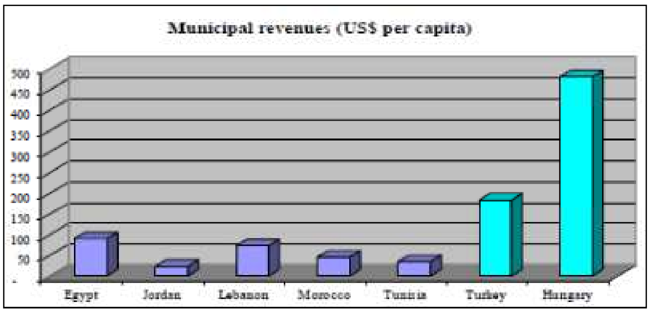


Figure 61. Local government per capita revenues
(*US dollars*)



Source: World Bank, 2007c.

TABLE 23. EXPENDITURE RESPONSIBILITIES BY FINANCING AND PROVISION

	Financing							Provision						
Function	Egypt	Jordan	Lebanon	Syria	Tunisia	Palestine	Yemen	Egypt	Jordan	Lebanon	Syria	Tunisia	Palestine	Yemen
Social welfare	C	C	C	P	C	C	C	C	C	C	P	C	C	C
Hospitals	C	C	C	P	C	C	C	C	C	C	P	P	C	C,P
Public health	C	C	C	P	C	C	C	C	C	C	P	C	C	C,P
Universities	C	C	C	P	C	C	C	C	C	C	P	P	C	C
Secondary education	C	C	C	P	C	C	C	C	C	C	P	P	C	C
Primary education	C	C	C	P	C	C	C	C	C	C	P	P	C	C
Housing	C	C	C		C	C	C	C	C	C		C	C	C
Urban transport.	C,P,M	C	C	C,P	C,P	C,P,M	C,P	C,P	C,P	C	C,P	C,P	C,P,M	C,P,M
Railroads	C	C	C	P	C	N/A	C	C	C	C	P	C	N/A	C
Airports	C	C	C	P	C	C	C	C	C	C	P	C	C	C
Ports and navigable waterways	C	C	C	P	C	C	C	C	C	C	P	C	C	C
Urban highways	C,P,M	M	C	P,M	C,P	C,P,M	C,P	C,P	M	C	P,M	C,P	C,P,M	C,P,M
Interurban highways	C,P	C	C	C,P	C,P	C,P,M	C,P	C,P	C	C	C,P	C,P	C,P,M	C,P,M
Electricity	C	C	C	P	C	M	C	C	C	C	P	C	C	C
Waste collection	M	M	C	P	M	M	P	M	M	C	P	M	M	P
Water and sewerage	P,M	C	C	P	C,P	M	C,P	P,M	C	C	P	C,P	M	C,P
Fire protection	C	M	C	M	C	C,P,M	C,P	M	C	C	M	C	C,P,M	C,P
Heating	C	N/A	C	C	N/A	M	N/A	N/A	C	C	C	N/A	M	N/A
Irrigation	C	C,P	C	C	C,P	C,P	C,P	C,P	C	C	C	C,P	C,P	C,P
Police	C	C	C,M	P	C	C	C	C	C	C,M	P	C	C	C

Source: ESCWA calculation.

Note: C: Central government; P: Provincial Government; M: Municipal government; N/A: Not applicable.

S. MONETARY AND EXCHANGE RATE POLICY

Unlike many past transitions, most ACT economies have not as of yet gone through severe and disorderly currency devaluations. Many non-oil economies in the region have pegged their exchange rates to a basket of strong currencies in an attempt to keep their exchange rates stable while keeping some room for manoeuvre in their monetary policies (see table 24). At the same time, most Arab oil-exporting countries have been keeping their exchange rates pegged to the US dollar.[108] This arrangement has helped to keep domestic proceeds of oil exports more stable, give a general certainty to the macroeconomic and policy environment by helping anchor inflation expectations, and reduce exchange rate risks associated with international borrowing. Conversely, these pegs are implemented in small-size economies where the prices of important commodities are imported and, in addition, they make it difficult for central banks not to follow the interest rate decisions of the Federal Reserve so as to avoid potential speculative manoeuvres on their currencies.[109] Particularly relevant to the region, the peg allows the pass-through of international food prices into domestic prices and, obviously, hinders competitive devaluation.[110] Central banks and governments, therefore, face an inherent and often contradictory dilemma.[111] Evidence shows that the impact of external shocks tends to be smaller in developing countries that have a more flexible exchange rate regime (Gallego and Tessada, 2008). Over the last three years, with United States interest rates at historically low levels and with excess liquidity and relatively higher inflation in the Arab oil-exporting countries prompting higher rates in the region, monetary policy has become more challenging. Despite these challenges, Egypt, Morocco and Tunisia have successfully retained price stability as the overriding objective of their monetary policy.

One of the lessons learned from other transitions is that it is unlikely that the exchange regime makes a significant difference by itself. The debate on the right regime may have been overblown as floaters had to tightly manage their exchange rates while the fixers had to devaluate repeatedly and often ended up floating. In general, some form of monetary targeting was needed but, as a first approximation, it matters little which target is chosen as long as it is adhered to. Two aspects seem to be important here. Firstly, when there is a limited degree of capital mobility,[112] an exchange rate commitment, whether explicit or implicit, leads to market-based discipline being imposed on the central bank. In countries where central banks are not independent, or lack public and political support for non-expansionary monetary policy, this is particularly desirable. Secondly, the introduction of some degree of exchange rate flexibility is then needed once capital movements increase in size and become a potential threat.

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[108] Dollar pegs are in place in Bahrain, Iraq, Jordan, Lebanon, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen. Algeria, Kuwait, Libya, Morocco, the Syrian Arab Republic, and Tunisia are pegged to a composite currency basket. Egypt and the Sudan instead adopt a managed floating regime.

[109] This is a consequence of the trilemma according to which a country with a fixed exchange rate and free capital movement loses monetary-policy autonomy, at least to a certain degree.

[110] Some studies indicate that real exchange rate devaluations fail to raise exports because they tend to be rigid in the short term while imports hike more quickly in terms of value and the external balance deteriorates (Cobham and Dibeh, 2009). Moreover, it is usually difficult to predict the fiscal impact of devaluation, particularly in this region, given the heterogeneity of economic structures. The demand for exports from a country may be inelastic due to changes in the relative price induced by a nominal exchange rate devaluation because of market access and product specificities, among other factors. However, in cases where subsidies on imported food and fuel are large and the economy is not oil-based, as is the case in Egypt, Jordan, Morocco, and Tunisia, depreciation is likely to increase the fiscal deficit in the short term.

[111] The literature does not provide unanimous evidence that exchange rate pegs are relatively more effective in reducing inflation in emerging economies (for a review, see Cobham and Dibeh, 2009).

[112] One lesson from the Latin American and Asian crises is that full capital mobility is undesirable during periods of rapid structural changes. While most transition countries have retained various restrictions on capital mobility, international market pressure still leads transition countries to aim for rapid liberalization.

TABLE 24. EXCHANGE RATE ARRANGEMENTS BEFORE AND AFTER THE UPRISINGS

Country	Exchange rate arrangements		
	2006	2008	2012-2013
Egypt	Other conventional fixed peg arrangements	Managed floating with no predetermined path for the exchange rate	Stabilized arrangement
Jordan	Other conventional fixed peg arrangements	Other conventional fixed peg arrangement	Conventional peg
Libya	Other conventional fixed peg arrangements (against a composite)	Other conventional fixed peg arrangement (composite)	Conventional peg (composite)
Morocco	Other conventional fixed peg arrangements (against a composite)	Other conventional fixed peg arrangement (composite)	Conventional peg (composite)
Syrian Arab Republic	Other conventional fixed peg arrangements	Pegged exchange rate within horizontal bands (composite)	Other managed arrangement (composite)
Tunisia	Managed floating with no predetermined path for the exchange rate	Other conventional fixed peg arrangement (composite)	Crawl-like arrangement
Yemen	Managed floating with no predetermined path for the exchange rate	Other conventional fixed peg arrangement (US dollars)	Other managed arrangement

Source: IMF. De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks.

Arab economies have several common institutional features underlying their respective monetary policies:

(a) Low financial deepening and the predominant role of banks vis-à-vis other financial institutions, with underdeveloped local currency government security markets;[113]

(b) The banking sector is often oligopolistic and not open to foreign banks;

(c) Financial intermediation is weak, with most credit directed to a few large enterprises and little financial access granted to SMEs;

(d) Public banking plays an important role in the financial system;

(e) Interbank markets are thin;

(f) Money supply shocks usually occur through an external channel, with shocks deriving from the volatility in current accounts, particularly due to oil, remittances and tourism revenues.

Shortcomings in financial intermediation and the underdevelopment of the financial system limit the range of policies that central banks can implement and may attenuate or distort the transmission of monetary policy.

[113] Egypt, Jordan, Lebanon, Morocco, and Tunisia have government bond markets of limited size and potential for development. These countries have sizable debt-to-GDP ratios and domestic tradable debt and are all middle-income, oil-importing countries with diversified exports. These macroeconomic characteristics help to explain their greater need to issue debt and rely on domestic debt markets. The only MENA countries included in global emerging markets local currency bond indices are Egypt, which appears in the J.P. Morgan's GBI-EM index and the Markit iBoxx Global Emerging Market Index (GEMX), and Morocco, which is included only in GEMX. GEMX takes into account capital controls, taxes, secondary market liquidity, size of the investor base, quality of regulations, and market infrastructure. These criteria were applied to 33 emerging economies, including Egypt, Morocco, Tunisia and Lebanon, which received low scores, ranking between 21st and 33rd. Lebanon and Tunisia did not even reach the minimum scores required for inclusion in the GEMX.

Foreign ownership has been highly beneficial in other transitions, as is the case in Latin America. It allowed for recapitalization and the transfer of technology. It reduced the pressure on national budgets and also strengthened the quality of banking oversight and regulation. In addition, it provided an external lender of last resort (Wyplosz, 2000).

The underdevelopment of MENA security markets is due to common features in the key building blocks that sustain deep and liquid public debt markets:[114]

(a) Money markets are shallow as a result of inadequate governance framework and structural excess liquidity that is ineffectively sterilized; [115]

(b) Primary markets provide an imbalanced choice of maturities skewed towards longer-term and illiquid securities instead of adopting a systematic approach to gradually lengthening the yield curve through a balanced maturity structure of debt from short-term to long-term;

(c) There is a low degree of competition in auctions due to concentration of demand by state-owned institutions, creating low portfolio diversification and potential uncertainty over the pricing of securities;[116]

(d) Secondary markets are shallow as a result of excess liquidity and bottlenecks in the institutional organization of the market. This, combined with the lack of alternative investment options, promotes highly concentrated buy-and-hold investment strategies;

(e) The investor base is not well diversified as a result of the dominance of banks and state-owned institutions. Mutual funds play a limited role and foreign investors, except for Egypt, are almost non-existent, as they are discouraged either by preferential treatments towards local players, poor governance or overall weak market infrastructure;[117]

(f) The clearing and settlement infrastructure needs significant upgrades in order to support more liquid and investable markets.

The table 25 summarizes the key challenges facing the security markets of the region.

In the past, governments have resorted to central banks for deficit financing rather than borrowing on capital markets. This has historically imposed a severe constraint on the independence of central banks, which had to combine monetary policy concerns with fiscal ones up to the point of the so-called fiscal dominance of macroeconomic policies.

Importers of oil and cereals should pay heed to imported inflation and its fluctuations. High inflation reduces domestic savings through negative real interest rates and real appreciation of the exchange rate.[118] In these countries, due to inflation inertia, disinflation cannot be achieved in the short and medium term without increasing unemployment above the natural level. Therefore, measuring inflation inertia and developing inflation forecasting capabilities are key in designing appropriate disinflation policies. Inflation persistency

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[114] For an extensive treatment of the topic, please refer to Garcia-Kilroy and Caputo-Silva (2011).

[115] High reserve requirements are the main instrument used to absorb excess liquidity in the region, resulting in high operational and opportunity costs to the banks. A wider set of instruments would be useful for making liquidity management more effective and reducing these costs. Brazil and Mexico provide some successful examples in this respect.

[116] Egypt, Jordan and Lebanon have the most concentrated investor bases, with banks and the public sector holding more than 80 per cent of issued debt (Garcia-Kilroy and Caputo-Silva, 2011).

[117] Particular attention should be paid to GCC-based investors, including sovereign wealth funds (SWFs), that might have huge investment potential in the ACT security markets.

[118] Empirical evidence indicates that the link between interest rates and inflation in emerging economies weakens with high debt/GDP ratios (Baig and others, 2006).

may be caused by a lack of countercyclical macroeconomic policy and high fiscal deficit.[119] Procyclical macroeconomic policy may result in shocks to the output side, leading, in turn, to higher inflation persistency through the Phillips curve. A narrow focus on inflation targeting, despite its positive effects in terms of policy predictability and credibility, may generate a bias towards a strong exchange rate and macroeconomic stabilisation vis-à-vis employment and growth objectives. As the Asian transition shows, balancing monetary, as well as fiscal, rules and flexibility can be useful to muddle through crises. Thus, keeping long-term fiscal deficit under control and implementing timely macroeconomic policy responses are key in reducing inflation inertia and, thus, the cost of disinflation.

TABLE 25. SUMMARY OF CHALLENGES AND REFORM OPTIONS FOR MENA SECURITY MARKETS

Structural constraints	High depth in buy-and-hold portfolios	Excess liquidity	Concentrated demand and dominance of banks
Stumbling blocks	• Legacy issues: illiquid and uncertain valuation	• Fixed exchange regime • Lack of predictability of government cash flow	• Legacy of state-owned banks • Inefficient credit markets • Captive demand
Consequences	*Shallow money markets*		
	Lack of competition in primary markets		
	Opaque and thin secondary markets		
	Dysfunctional mutual funds		
Actions directed at structural constraints	• Predictable and regular issuance • Consolidation of maturities in benchmarks • Balanced debt structure	• Enhanced liquidity forecasting • Market-friendly operations (effective, accurate and timely) • CB and MoF coordination	• Competition in auctions • Revised framework for mutual funds • Foster foreign investor participation
Actions on the microstructure	• Liability management tools • Repo framework • Price collection and disseminatin (fixing) • Hedging tools for interest rate and FX risks • Upgrade the clearing and settlement infrastructure		

Source: Garcia-Kilroy and Caputo-Silva, 2011.

Note: CB is short for Central Bank; MoF is short for ministry of finance; and FX is short for foreign exchange.

[119] Inflation persistency may result in a reduction in the quality and efficiency of spending due to constraints in the administrative capacity or the realization of projects with little marginal value added during periods of high oil prices, but with future high recurrent costs attached to them, and difficulties in containing expenditure following such an expansion. It is usually due to rigidity in the expenditure structure derived from the high share of pre-committed spending outlays. It is usually more difficult to reduce the share of wages and salaries, as seen in Morocco and Tunisia , and of interest payments, as seen in Lebanon, than to freeze some capital outlays.

II. RECENT EVENTS AND RELATED ECONOMIC CHALLENGES

A. THE CURRENT CHALLENGES ACCORDING TO PUBLIC OPINION

While it is too early to predict the outcome of the Arab uprisings, two transition models appear to be emerging: one, where transition was initiated with a relatively low level of violence, and one with a high level of violence and protracted instability. Each country in transition has its own unique social and political context, with some being more fragmented in terms of tribes and ethnic groups, while others are relatively homogeneous. These factors will all play a part in determining the path the country takes after regime change has taken place.

The uprisings of 2011 clearly indicated that citizens in the Arab world were unwilling to bear the political and economic status quo in their countries. However, their reasons for protesting, as well as their demands for change, were diverse and varied from one country to the other. The Arab Opinion Index provides some valuable insights into the main drivers of discontent in the region, having polled more than 16,000 respondents in twelve countries. The Index reports that the main motivating factors for the Tunisian revolution given by respondents were as follows in ranking order: (1) deteriorating economic conditions, including increasing unemployment and poverty; (2) a rise in consumer prices and deteriorating standards of living; (3) regime corruption and nepotism; and (4) the unjustness of the regime, oppression and the unfair and unequal treatment of its citizens (ACRPS, 2012). The same factors were also identified by respondents as the main drivers of the Egyptian revolution, with deteriorating economic conditions ranking first, regime corruption and nepotism ranking second and regime unfairness, injustice, oppression, and tyranny ranking third (ACRPS, 2012). The Arab Youth Survey reveals that, in 2011, the issue of primary importance to youth was having access to reliable health care, at 70 per cent, followed closely by the desire to live in a democratic country, at 68 per cent, and a desire to live in a safe neighbourhood, at 64 per cent. The attitudes of respondents, polled one year after the onset of the revolutions had already changed and economic priorities had taken precedence: being paid a fair wage, with 82 per cent, and owning a home, with 65 per cent, ranked above the desire to live in a democratic country and to live free from the fear of terrorism, which both polled at 58 per cent. Respondents identified the rising cost of living, at 54 per cent as opposed to 46 per cent in 2011, and corruption in government and public life, at 42 per cent as opposed to only 16 per cent in 2011, followed by concerns about the economy, at 33 per cent in 2012 as opposed to 24 per cent in 2011, as the three biggest challenges the region is facing (ASDA'A Burson-Marsteller, 2012, p.12). Government corruption has become a hot button issue in many Arab countries, with citizens taking a keen interest in following the topic.[120] This clearly indicates that Arab youth are looking forward and are concerned about their economic future. It also highlights the urgency of harnessing enthusiasm and support for democratic and participatory processes before the people of the region become mired once again in the daily occupation of economic survival (ASDA'A Burson-Marsteller, 2012, p.7).

Opinion polls also suggest that levels of satisfaction among the population had been deteriorating over the recent pre-transition past in most of the countries that are now undergoing transition. In many of them, while macroeconomic indicators were rising, more and more people became dissatisfied. The data, therefore, underscores how traditional GDP metrics can paint an incomplete picture of economic welfare in a country. The cases of Egypt and Morocco are illustrated in figure 62.

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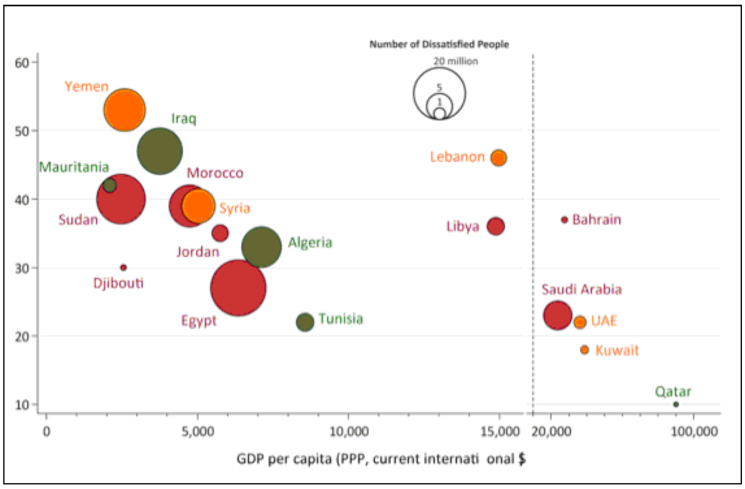
[120] In answer to another question posed by the survey, namely, What do you believe is the biggest challenge the Middle East is facing?, the answers civil unrest and a lack of democracy tied in first place, both polling at 55 per cent. Interestingly, respondents from the GCC countries polled at higher rates on both of these issues than non-GCC countries, at 44 per cent for civil unrest, as opposed to 37 per cent; and 43 per cent for lack of democracy, compared to 40 per cent for non-GCC countries, respectively. Although this poll gauged the opinion of a tiny fraction of the Arab youth, it indicates that a desire for greater political participation is not confined to transition countries alone and that youth in the more economically prosperous countries of the region also demonstrate a desire for greater political engagement.

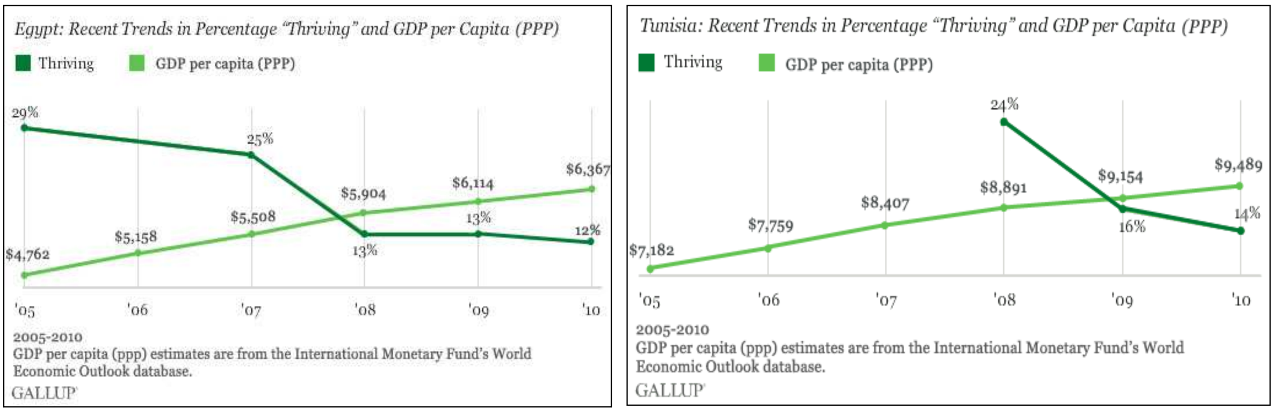
Figure 62. Arab economies and dissatisfied people



Source: Breisinger and others, 2011.

Note: The size of the bubbles proportionally reflects the number of dissatisfied people. The colour scale of a bubble indicates the change of the dissatisfied population from the first to the last survey; green indicates that the change was negative, orange that the shares remained stationary; and red that the change was positive.

Figure 63. Pre-transition trends in percentage of people thriving and GDP in Egypt and Tunisia



Source: Clifton and Morales, 2011.

According to the surveys, while new political leaders risk being dragged into a tug of war over government powers, economic issues are increasingly at the centre of people's concerns. For instance, the PEW Research Center Global Attitudes Project released a survey on Egypt in May 2012 (PEW, 2012a) that showed that despite very positive attitudes towards democracy, with 67 per cent of those surveyed in 2012 believing that democracy is preferable to any other kind of government, and 61 per cent of the same people believing that democracy is more important than a strong leader, Egyptians are equally divided when it comes to national priorities: 48 per cent said that a good democracy is most important whilst 49 per cent felt that a strong economy should be the priority (PEW, 2012b). Solid majorities in Jordan and Tunisia say that democracy is the best form of government, according to other recent surveys by the Pew Research Center. At least seven in ten respondents from these countries say that their national economy is performing poorly.

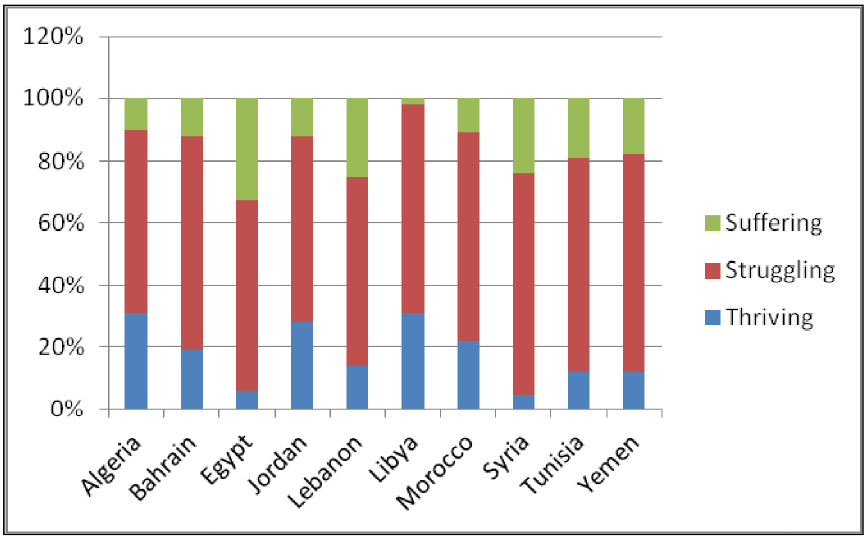
TABLE 26. TOP CONCERNS OF THE EGYPTIAN PUBLIC IN APRIL 2012
(*Percentage*)

What is the mose important issue or challenge that the government of Egypt should address? (open-ended)				What is the second most important issue or challenge that the government of Egypt should address? (open-ended)			
	Unemployment/ job creation	Eonomic situation/increase wages	Security		Unemployment/ job creation	Eonomic situation/increase wages	Security
General public	39	23	20	General public	25	31	20
Freedom and Justice Party	41	24	18	Freedom and Justice Party	22	31	22
Nour Party	36	23	22	Nour Party	23	31	22
Free Egyptians Party	37	21	21	Free Egyptians Party	27	31	16
Question asked in an open-ended format, with interviewer placing response in one of the following categories: Unemployment/job creation; economic situation/increase wages and pension; security; other/do not know/refused				Question asked in an open-ended format, with interviewer placing response in one of the following categories: Unemployment/job creation; economic situation/increase wages and pension; security; other/do not know/refused			
GALLUP				GALLUP			

Source: Younis, 2012.

The global context is contributing to this discouraging picture, with the weak European economy and high commodity prices that are a primary cause of export decrease and import increase, respectively. However, growth prospect is forecast to relapse to long-term trends as long as social and political stability are guaranteed, although it is expected that it will be led more by government consumption through social transfers and less by investment and exports. Conversely, delays in attaining political stability and advancements in governance reforms will adversely impact inclusive growth while raising public debt. The most recent Gallup data, presented in figure 64, underscores how difficult the current phase is for most people in Algeria, Bahrain, Egypt, Jordan, Lebanon, Libya, Morocco, the Syrian Arab Republic, Tunisia, and Yemen.

Figure 64. People suffering, struggling and thriving in selected countries
(Percentage)



Source: Gallup, 2012 surveys.

B. CHALLENGES OF POLITICAL TRANSITION

A wide consensus exists on the need for political transition to a multiparty democracy. However, the road of political transition is fraught with daunting political and economic challenges. Throughout history, autocratic regimes have used different methods to try to control political power. Even when there have been regime changes, regime elites tried to prolong their hold on power through two methods that represent the extremes of a continuum: namely, military repression in order to deter any threat of revolution, and populism in form of welfare transfer to the population without aiming at increasing the capability of people in order to dissuade them from attempting a revolution. [121] The particular combination of these two methods used is highly context-specific and depends on historical, political, economic, and geopolitical connotations, the relative organizational capacity of both elites and masses and the opportunity cost of one method vis-à-vis the other. The amalgamation of these variables can lead to three different political outcomes depending on the level of control held by the elites: (a) the permanence of the status quo; (b) partial reform equilibrium; or (c) full-fledged transition to democracy. The political outcome is hence based on the incentive of the elite to defend its power vis-à-vis the incentives of the masses to challenge it, including their capacity to do it. Arguably, from an economic perspective, we can define a populist equilibrium as inherently inefficiently pro-poor, while an oligarchic equilibrium tends to be inefficiently pro-rich. Historically, however, the distinction between oligarchy and democracy has often been blurry, particularly in times of transition.[122] Indeed, according to Machiavelli and Schumpeter, democracy is the political arena in which different elites contend for votes from the masses. Since World War II, populism has played a major role in the disputes between pro-oligarchic and pro-democratic segments of societies during transition in many countries all over the world. And as Latin America has shown, populism thrives in contexts characterized by high socioeconomic inequality (Mejia and Posada, 2005). Inequality has, therefore, become a crucial characterizing factor in many transition processes and is expected to also be so in the Arab transitions.

Using this framework, we could hypothesize that the recent political history of the Arab region can be divided into three main stages:[123] (a) the first stage, in the half a century following World War II, during which the new post-colonial regimes used primarily populist redistribution to legitimize the regime change; (b) the second stage, coinciding with the final quarter of the last century and the post-9/11 era, when regimes underwent structural adjustment programmes that rolled back the redistributive role of the state while using such military repression as state of emergency and martial laws to deter any revolutionary attempts, driving Islamist movements underground and contributing to radicalizing them;[124] and (c) the new stage, which has just started, where pro-oligarchic and pro-democratic forces, regardless of whether they have a religious or a secularist approach, dispute for political power. The background to these transitions has to do with a protracted political and economic rentier system, an increase in economic inequality, a deterioration of the institutional capacity of regimes, a gradual opening up to international markets, an increase in the relative importance of the role of human capital in the production process, and better organized political representation of the masses.

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[121] From this perspective, an increase in educational levels as merely measured by years of education, without addressing the demand side of labour markets, has not caused a parallel increase in returns to education and, therefore, has not played a pacifying effect on the masses. Conversely, it can be speculated that it has increased their grievances and incentive to organize and challenge regimes.

[122] In the Philippines, for instance, the parliament has long been a stronghold of oligarchic dominance in the political dynamics of the country (Croissant, 2004).

[123] This characterization is to keep the argument schematic. In fact, most Arab regimes were pragmatic enough to craft ever-changing mixes of political space and repression to deflect some international criticism and diffuse internal tensions, without actually changing the power structure and real decision-making.

[124] This is arguably the stage where Arab countries diverged from the Turkish path towards democratization, where the elite, supported by a growing middle class, were able to manage a gradual opening up of the political space in their country and encouraged Islamist parties to become more moderate, while pushing the military out of political life.

Considerable literature has examined the impact of political instability during transition on the most common macroeconomic variables. Panel data econometric analyses by Burke and Leigh (2010) and Alesina and others (1996) have documented a bidirectional relationship between economic growth and instability. Aisen and Veiga (2006 and 2011) find that instability causes higher inflation and lower productivity and discourages physical and human capital accumulation. However, a word of caution is due at this point. Most of the literature finds no evidence to suggest that democracy brings about higher economic growth than other political systems (Durlauf and others, 2005).[125] The relation between good governance and growth seems to transcend any particular political, system as long as political representation is institutionalized and allows for the contestability of the agents, namely, the representatives, and the smooth transition of leadership (Gehlbach and Keefer, 2011). Political institutionalization of this nature tends to reduce the risk of corruption and discretion and fosters greater transparency, voice and accountability. Using the median voter theorem in a transition process could mean that the process itself risks being characterized by a larger demand for redistributive policies and higher government propensity to consume, often initially justified by market failures, rather than to produce investment. In fact, some studies observe that younger democracies tend to be prone to corruption, less rule of law, lower bureaucratic quality, underprovision of public goods, rent seeking and less credible commitments (Keefer, 2005).[126] Moreover, the different political and institutional arrangements of a democracy may affect economic performance. For example, Persson (2004) shows that economic gains following democratization are higher in the context of a proportional (versus majoritarian) representation and in a parliamentary (versus presidential) system. In developing countries, such imperfections in political markets as lack of voter information,[127] campaign financing more prone to capture and the easy strumentalization of social cleavages, tend to make democracies, or at least partial and consociative democracies, less effective, as elected governments are more likely to adopt policies in favour of their own constituencies or narrow segments of the population rather than the collectivity, generating long-term distortions in the provision of public goods. Arguably, this could be even more likely in transitional democracies endowed with sizable rentier economies that run the risk of being locked in high redistributive spending patterns or worse, in kleptocratic regimes with short-term horizons, perpetuating social cleavages and unable to catalyse a consensus around a common vision.

In addition, sectarian and extremist groups, when politically organized, tend to set forth an unambiguous and uncompromising agenda that looks appealing to a confused electorate in a disorienting period of transition.

Last but not least, for many organized groups the transformation from being an outsider, an oft-oppressed opposition force, to being a party in power will present a serious political challenge, given all the responsibilities that this entails, particularly in policymaking. In the end, there is no one-size-fits-all solution to different constitutional arrangements and what really matters is that any arrangement that is agreed-upon

[125] One of the exceptions is Acemoglu, according to whom oligarchies generate stagnation in the long run because they isolate elites from economic competition, while democracy induces competition, fostering a more efficient allocation of resources (Acemoglu, 2003). Przeworski (2004) found that, despite the non-existence of a causality such as this, democracies have lower fertility rates and, therefore, higher per capita income. In general, international literature tends to converge and finds it more plausible that, while the relation between democracy and income level, or growth, is elusive, in the long term, democracies are better equipped to prevent conflicts, respond to exogenous shocks, prevent famine, deal more pacifically with changes in leadership, and deal with ethnic and social fragmentation, but not polarization. Moreover, Keefer (2005) finds that the time of exposure to democratic institutions is a key element, with more years of democracy being correlated with better government performance. However, literature has focused on realized democracies and not so much on partial democracies that would typically characterize any ongoing transition process. Other authors found that, in the specific context of economies in transition, democratization does not entail a cost in terms of economic growth (Rodrik and Wacziarg, 2005).

[126] The experience of Indonesia is quite telling in this respect. In 2003, the Indonesian NGO Indonesia Corruption Watch concluded that systematic corruption in courts had not improved under the democratization, but rather had been consolidated (Croissant, 2004).

[127] In the literature, voter information is commonly informed by newspaper circulation which shows, *ceteris paribus*, that higher newspaper circulation is on average associated with lower corruption, better rule of law and bureaucratic quality, and higher secondary school enrolment (Keefer and Khemani, 2005).

is able to address security, stability and an adequate provision of public goods. Unfortunately, recent events in Egypt and the Syrian Arab Republic show the high scope of the risk of exclusionary practices and lack of shared democratic principles during transition processes.

Regardless of the particular political arrangements chosen after transition, the new system should place great value on the legal and judicial capacities of the state, the private sector, civil society organizations, and the participation of all groups, including the youth, in the development of national and local policies. Restoration of political rights, transparency, accountability, control of corruption, open participation, and greater representation will all help to mitigate the governance deficit that sparked the recent discontent experienced by ACTs.

Recent analyses have demonstrated the long-term beneficial effects of civic activism on successful democratization. Out of 67 countries that underwent democratic transition during the period 1972-2005, 75 per cent of the transitions driven by civic coalitions successfully democratized, while only 18 per cent of those that lacked the active involvement of civic coalitions succeeded in the transition. Reversion to non-democratic regimes is also more likely in countries with weak civil society (Karatnycky and Ackerman, 2005). However, we witness a circular logic here. Arab societies in transition countries are likely to continue to wrestle with an undersupply of bridging social capital and an oversupply of bonding social capital that is built around close-circle interpersonal ties. This in turn inhibits the growth of a vibrant civil society. A circuit breaker is, therefore, needed.

C. CHALLENGES OF ECONOMIC TRANSITION

Historically, many deep and broad economic reforms resulted from such fundamental political changes as regime changes or from dramatic economic shocks. Transitions in Eastern Europe and Latin America are clear evidences of this. Although the Arab uprisings may have increased unpredictability in the political dynamics in the region and left analysts feeling uncertain as to the possible outcomes, this is the same historical moment that other regions seized within their own different contexts. Like in any other transition, better security, rule of law and a viable transition strategy would help to build the confidence of economic agents in the transition, which would lead to production, job hiring and domestic and foreign investment being resumed. However, the far-reaching reform agenda that the region is embarking on is beginning in the wake of the worst global recession since 1929, exactly at a time when the costs are less manageable and the resources needed to mitigate its associated adjustment costs have been depleted, at least in the non-GCC countries.

Consequently, the 2011 and 2012 estimates for real GDP growth for countries in turmoil have been revised down due to the combined effects of: (a) a prolonged global crisis affecting the main trading partners of the region, namely, the European Union and United States[128] that is impacting the region through such real sector channels as trade, FDI and remittances[129] rather than the financial sector;[130] (b) sustained commodity prices, with oil prices currently around one third higher than in 2010, particularly impacting Jordan, Lebanon and Morocco, the most oil-import-dependent countries;[131] (c) region-wide instability causing double-digit declines in tourism revenues[132] and FDI, particularly, in Egypt, Jordan, Lebanon, Morocco, the Syrian Arab

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[128] This particularly applies to Maghreb-Europe real and financial sector linkages as Europe is the destination for about 60 per cent of the exports originating from the Maghreb region, the source of 80-90 per cent of tourism revenues and about 80 per cent of FDI. European banks also have a large presence in the subregion through local subsidiaries and cross-border lending.

[129] The remittance channel particularly affects Morocco and Tunisia, given the massive presence of nationals from these countries in Europe whose remittance flows account for 9.5 per cent and 5 per cent of GDP, respectively (World Bank, 2011k).

[130] Here, research shows that contagion effects are higher and more prolonged in countries with weak economic fundamentals and bad governance (Bekaert and others, 2011).

[131] This higher import bill for Jordan and Morocco, however, is mitigated by the increased value of their phosphate exports.

[132] In Egypt, tourism is estimated to have contracted by one third in the first half of 2011 compared to the same period in 2010, while in Tunisia, estimates range around a 40 per cent decrease for the same time span. In the Syrian Arab Republic, estimates are expected to be even bleaker.

Republic, and Tunisia, and volatility in the real and financial markets, although remittances have generally remained robust, except those originating from Libya going to Egypt and Tunisia; and (d) country-specific prolonged strife, particularly, in Libya, the Syrian Arab Republic and Yemen. The difference between 2011 forecasts and the latest ones clearly shows the scale of the impact of the transition, which, in most ACTs, is usually above 4 per cent of GDP. The Syrian Arab Republic has been paying the highest toll with double-digit estimated GDP contractions in 2012 and 2013. However, tables 27 and 28 show how different institutions give different estimates and forecasts in terms of GDP and CPI. Table 28 also shows the difference in IMF estimates (the most widely used) as reported in 2011 and 2013 for the years 2011 and 2012.

In other transitioning countries, gaining political stability and public confidence and demonstrating commitment to accountability and transparency during the reform process has usually sped up the recovery from downturn, putting countries on a path to higher and more equitable growth. Limiting economic contraction, avoiding its persistence and resuming growth as soon as possible, but in a more equitable manner, will require comprehensive political and economic reforms in selected priority areas.

The debate around economic transition is expected to become very contentious, starting from the overarching vision that is going to dominate the transition itself, either opening up space for the private sector and international markets to curtail rentier economic systems and corruption, with the state being a mere facilitator of development, or demanding more state intervention through a social and distributive role while it tackles unemployment, poverty and inequality. Both approaches have virtues but also sizable shortcomings when applied to this part of the world as the former has historically been associated with cronyism and monopolistic rents, while the latter has been associated with oppression mixed with populism and basic distributional policies that do not provide opportunities but only inefficiency and low quality services. Serious governance deficits and blatant corruption have pervaded both approaches. There is also a debate concerning the speed of transition, with some advocating a rapid, broad-based reform approach to insure irreversibility, while others support a gradual approach that allows private and public institutions to adjust and develop in order to foster a competitive environment. Although examples from transition countries seem to support one approach or the other, the latter seems to have been reinforced by the experience of more countries (for example, Roland, 2002).

As the experience of privatization in the region has shown, problems lie more in corruption, inefficiency and mismanagement than in a private-versus-public-sector ownership dichotomy. Egypt experienced disappointment both with the state-dominated economic development approach under former Egyptian President Gamal Abdel Nasser and with subsequent experiences of liberalization. Polarization, however, does not necessarily need to be the case. A more pragmatic approach shows that the two options are complimentary and various amalgamations may be possible according to a specific context and phase of transition, provided that their common motive, namely, resolving the governance deficit, is given centre stage from the very beginning. Current ways of thinking about the economy need to move on from the Cold War-era dichotomy between the private and public sectors and reach a new dimension of participatory and evidence-based policymaking. The last thing transition countries need at this moment in time is an ideological debate on economic reforms that could easily be utilized for partial benefits, to the detriment of the wider collectivity.

Economic and political transitions are bound to affect one another as their multiple and intertwined dynamics may contribute to public grievance, discontent and potential protracted instability, if not addressed from the outset. From an economic perspective, experiences from previous transitions show three possible outcomes: (a) an incomplete transition with unsatisfied economic and political needs leading to a recurrence and deepening of conflict; (b) a partial transition which leaves the country in a protracted state of low economic development; and (c) a successful transition where the foundations for medium-term stability and long-term growth are established and the population gains in terms of political and economic rights.

TABLE 27. ECONOMIC GROWTH OUTLOOK FOR THE PERIOD 2009-2012

	World Bank (September 2011)				UN-DESA LINK (June 2011)				IMF (October 2011)				ESCWA (November 2011)				EIU (September 2011)				ΔEst (2010-2011)[a/]	ΔEst (2011-2012)[b/]
Country	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2011	2012
Bahrain	3.1	4.5	0.7	2.5	3.1	4.3	3.7	4.7	3.1	4.1	1.5	3.6	3.1	4.5	2.5	3.5	3.1	4.5	2.2	3.3	-2.8	-1.6
Egypt	4.7	5.2	1.8	3.5	5.0	5.1	4.1	4.6	4.7	5.1	1.2	1.8	5.1	1.9	3.0	0.5	4.7	5.1	1.2	3.5	-4.2	0.2
Jordan	5.5	2.3	2.5	3.5	2.3	3.2	3.5	3.7	5.5	2.3	2.5	2.9	2.3	3.1	3.0	4.0	2.3	3.1	3.3	4.3	-0.2	-0.4
Lebanon	8.5	7.0	4.0	5.0	8.0	7.3	3.1	5.1	8.5	7.5	1.5	3.5	8.5	7.0	2.5	4.5	8.5	7.2	1.3	3.6	...	-1.5
Libya	-2.3	4.2	<-50	…	1.7	3.3	-16.0	10.2	-2.3	4.2	…	…	n.a.	n.a.	n.a.	n.a.	-0.7	3.3	-28.2	13.6	-28.2	...
Syrian Arab Republic	6.0	3.2	0.0	-1.0	4.0	5.6	6.0	5.3	6.0	3.2	-2.0	1.5	5.9	5.5	-1.0	5.0	6.0	3.2	0.2	2.0	-4.5	...
Tunisia	3.1	3.0	1.1	3.4	2.1	3.4	2.3	3.5	3.1	3.1	0.0	3.9	n.a.	n.a.	n.a.	n.a.	3.1	3.4	0.8	3.3	-5.2	-6.6
Yemen	3.8	7.8	-5.0	2.5	3.9	6.0	2.9	2.8	3.9	8.0	-2.5	-0.5	4.7	3.5	-2.5	3.5	3.8	6.2	-5.5	4.0	-6.3	-1.4

Sources: Compiled by ESCWA, based on information taken from World Bank, UN-DESA LINK, Economist Intelligence Unit (EIU), ESCWA, and IMF.

Notes: a/ Differences between 2011 forecasts produced in 2010 and October 2011.

b/ Differences between 2012 forecasts produced in 2011 and October 2012.

N.a. means not applicable.

(...) means that data is not available.

TABLE 28. CONSUMER PRICE INDEX (CPI) INFLATION RATE IN SELECTED COUNTRIES 2009-2013

	IMF (Oct 2011 and May 2013)							ESCWA (Nov 2011 and Nov 2013)				
Country	2009	2010	2011	ΔEst (2011-2013)	2012	ΔEst (2012-2013)	2013	2009	2010	2011	2012	2013
Algeria	5.9	3.9	11.1	6.6	7.7	-1.2	5.0	…	…	…	…	
Egypt	11.7	11.4	11.2	1.3	11.0	2.6	10.9	11.8	11.3	11.5	11.0	11.0
Jordan	-0.7	5.0	5.4	1	5.6	0.8	5.9	-0.7	5.0	5.4	5.5	5.0
Lebanon	1.2	4.5	5.9	0.9	5.0	-1.6	6.7	1.2	4.5	6.0	6.0	5.2
Libya	2.4	2.5	6.8	-9.1	5.2	-0.9	2.0	2.8	2.5	15.0	5.0	3.5
Morocco	1.0	1.0	1.5	0.6	2.7	1.4	2.5	…	1.0	0.9	1.3	1.8
Sudan	11.3	13.0	20.0	1.9	17.5	-18	28.4	11.2	13.0	14.0	11.0	12.0
Syrian Arab Republic	2.8	4.4	6.0	...	5.0	...	...	2.8	4.4	6.0	4.5	12.0
Tunisia	3.9	4.4	2.2	-1.3	2.1	-3.5	6.0	3.5	4.4	3.5	4	4.2
Yemen	3.7	11.2	19.0	-0.5	18.0	7	7.5	5.4	8.5	17.0	12.0	8.0

Sources: Compiled by ESCWA, based on data taken from IMF and ESCWA .

Notes: ΔEst measures the difference of IMF estimates between CPI rates related to 2011 and 2012 as forecasted in 2011 and estimates of the rates for 2011 and 2012 as reported in 2013. Negative signs mean that CPI forecasts in 2011 were lower than the actual estimates as reported in 2013.

(...) means that data is not available.

The main challenges of economic transition likely to affect trajectories of ACTs and determine the outcomes will be analysed below:

(a) In a context of lower global growth rates, particularly in the Southern countries of the European Union, and high oil and food prices, economic recovery is likely to be lower than potential, particularly in the Maghreb,[133] with unemployment remaining at high levels.[134] It is, therefore, of the utmost importance that social cohesion and macroeconomic stability are balanced, despite the fact that there could be a trade-off between the two in the short term due to higher and even populist pressure on social spending, potentially resulting in rising public deficits.[135] One of the most challenging aspects of transition will then be to ensure fiscal sustainability while managing the diverse social demands of the population. Fiscal space in transition economies has already deteriorated as a result of the economic downturn associated with increased spending on universal subsidies and public-sector wage bills, tax revenue decrease and the scale-up of automatic stabilizers.[136] Despite the shrinking fiscal space available, a generalized and persistent demand for wage rises has already emerged in various countries in transition, while the economy and economic policy are unchanged and suffer from all the constraints highlighted previously in this study.[137] Some of the ACTs, and

[133] The close links between European Union and Maghreb are evidenced by the following four channels: (a) exports to the European Union are over 15 per cent of GDP; (b) the European Union accounts for over 70 per cent of FDI; (c) remittances from the European Union amount to over 3 per cent of GDP; and (d) the European Union is a major source of tourist arrivals.

[134] These constraints are going to be particularly binding for Jordan and Morocco, given their economic structures.

[135] In Egypt, for instance, the Supreme Council, which was guarding the initial phase of the transition, after waves of strikes were started by different professional categories, ceded to meet the populist demand for increases in the public sector wages and the creation of 450,000 jobs in the public administration. However, requests for specific categories are still pressing.

[136] Jordan, Libya, the Syrian Arab Republic, and Tunisia have increased allocations for social welfare through more subsidies and transfers; Egypt, Jordan, Libya, the Syrian Arab Republic, and Yemen have raised government salaries and benefits; and most ACTs have introduced tax breaks.

[137] Giavazzi and Tabellini (2005) find evidence that countries experience economic gains when they liberalize the economy first, and then the polity. Here, there are lessons from other regions that have already undergone transition. For instance, the Argentinian financial and economic crisis in the 1990s occurred in the aftermath of its democratization process when policymakers addressed structural weaknesses and rigidities of the Argentinian economy in an inconsistent manner because of fear of unpopular sentiments. This resulted in loosened fiscal stance and general lack of credibility.

economies affected by social cleavages in general, are likely to have partisan disagreements about spending priorities in terms of items and geographic areas: for example, one party may prefer to invest in schools while another would prefer to invest in roads or in their own respective constituencies. More broadly, social expenditure is likely to be affected, and there is a potential risk of further perpetuating the kind of redistributive logic that has often been witnessed so far. Should this be the case, there could be a bias toward government consumption to the detriment of public investment, since the former is easily adjustable and fungible while the latter tends to be more rigid and imply longer-term commitment.

In response to social unrest, higher commodity prices and the global economic downturn, fiscal and current account deficits have been widening since 2009. The governments of Bahrain, Egypt, Jordan, Morocco, the Syrian Arab Republic, and Tunisia have implemented a countercyclical fiscal stance with a sharp increase in public-sector wage bills, universal subsidies and transfers, and tax breaks, often, at least in non-oil economies, at the expenses of capital expenditures,[138] thereby tilting the balance towards redistributive and consumption-oriented policies rather than pro-growth ones. Given that increases in wage bills tend to become entrenched over time, contributing to higher reservation wages and negatively impacting labour cost in the formal private sector, this policy shift may have long-term implications on growth and competitiveness, particularly for the oil-importing countries characterized by limited and deteriorating fiscal space, if it persists beyond its emergency purpose. The GCC countries have implemented similar policies resulting in huge net spending increases of at least 50 per cent on average for Bahrain, Qatar, Saudi Arabia, and the United Arab Emirates over the period 2008-2011. However, their spending will be more than offset by increasing oil revenues, and will thereby continue to be a source of positive spillovers within the Arab region, primarily through sustained remittance and import flows.[139] The IMF estimated the fiscal financing needs of the middle-income oil importers in the region, namely, Egypt, Jordan, Lebanon, Morocco, and Tunisia, to be around US$50-55 billion a year, with Egypt accounting for almost half of this amount. As a result, fiscal deficits are expected to stabilize at current levels or even widen for such countries affected by unrest as Egypt, the Syrian Arab Republic, Tunisia, and Yemen. The balances of Jordan and Morocco are also expected to remain in the current deficit zone (see table 29). These fiscal deficits have increasingly been financed through domestic banks, with the exception of Tunisia. However, this rise in nominal debt has been counterbalanced, in some cases, by moderate inflationary trends and close-to-zero real interest rates, resulting in stable overall public debt levels.

Adherence to a sustainable fiscal balance in terms of medium-term stability and long-term debt dynamics sends markets a strong signal of the commitment and credibility of a government and helps to anchor expectations and attract capital inflows, a task that is all the more arduous in the wake of the global downturn. Low budgetary flexibility, resulting from difficulties in both raising revenues and cutting expenditure, leaves relatively little room for fiscal policy to react to external shocks or to address new spending priorities that may result from the transition phase.

However, this does not mean that fiscal balance should drive the overall economic policy but rather that it should be used dynamically in favour of pro-growth policies while keeping fiscal discipline in the medium term. The experience with the deficit bias driven by distortions in political economy dynamics during transition processes has drawn attention to the potential usefulness of clear and binding fiscal rules, which are still lacking in many countries. Two types of rules can be distinguished: (a) quantitative rules, which provide numerical benchmarks for one or more key parameters of fiscal policy; and (b) procedural or institutional fiscal rules aimed at improving budgetary institutions and management: for instance, enhancing control of the Treasury over the budgetary process, strengthening the role of the finance minister within the government or establishing independent fiscal councils. As to the former type, there are different such options as: (a) non-oil

[138] The GCC countries have undertaken massive public investment projects in housing, property development, new power plants, new urban areas, airport, port and industrial zone expansions, oil refineries, and more.

[139] The GCC contributes around 10 per cent of global remittances despite their total GDP being less than 3 per cent of the world GDP.

budget balance/non-oil GDP ratio;[140] (b) targeting a medium-term level of public debt-to-GDP ratio[141] and using the primary balance as a fiscal tool, thereby allowing some flexibility in the short term while maintaining the confidence of investors; and (c) setting a cyclically adjusted annual budget balance, as did Chile. Clear measures should be implemented to secure focused spending programmes for education, innovation, health care, and productive infrastructure and to ensure that programmes that sustainably stimulate aggregate demand are prioritized in the budget allocation. In terms of revenue, steps must be taken to strengthen the tax revenue base, including indirect taxation[142] and reducing distortionary tax exemptions, improve tax collection through a simple and administratively easy collection system and reduce tax evasion.

TABLE 29. GENERAL GOVERNMENT FISCAL POSITIONS OF SELECTED ARAB COUNTRIES

	Fiscal balance				Gross government debt			
	2010	2011	2012p	2013p	2010	2011	2012p	2013p
Egypt	-7.8	-9.9	-11.1	-9.8	73.2	76.4	79.7	81.1
Jordan	-5.6	-5.7	-6.5	-5.5	67.1	70.7	79.2	83.0
Lebanon	-7.7	-6.1	-7.9	-8.3	141.7	137.4	135.2	135.6
Morocco	-4.4	-6.9	-6.1	-5.3	51.3	54.3	58.1	58.9
Tunisia	-1.2	-4.1	-4.3	-4.3	40.4	41.7	48	48
Algeria	-2.3	-0.2	-3.9	-1.3	10.9	9.5	8.6	7.9
Iraq	-8.8	7.6	-1.9	-3.1	116.7	88.7	77.7	25.5
Libya	16.7	-27.7	19.4	7.7	...	...	...	...
Syrian Arab Republic	-4.8	-11	-9.1	-	29.4	...	...	...
Tunisia	-0.9	-3.1	-6.4	-5.3	40.5	44.4	46.3	51.5
Yemen	-4	-4.3	-5.7	-6.0	40.9	42.3	44.9	45.1
Bahrain	-7.0	-2.4	-3.9	-3.6	35.6	36.8	36.1	37.1
GCC	4.5	12.7	14.6	11.2	15.9	12.1	11.8	11.4
ACTs (excl. Libya)	-6.0	-8.0	-9.1	-8.0	62.7	66.2	69.6	71.3

Source: IMF, 2012c.

Notes: Cells in yellow highlight potential fiscal strains.

(...) means that data are not available.

In addition, clear legal provisions need to be in place to rule out central bank lending to the government, as the existence of fiscal vulnerabilities in most of the countries in transition implies that, if faced with fiscal stress, governments may put pressure on the central bank to finance public deficits, to the detriment of monetary policy objectives. This may be the case even more so nowadays with access to international financial markets being difficult, the underdevelopment of some domestic financial markets and fiscal rigidities complicating budgetary adjustments. If necessary, while taking into consideration long-term debt sustainability and financial soundness, governments should seek grants or soft loans to relax the short-term deficit financing constraints and improve the macroeconomic situation.

[140] The specific fiscal challenges in oil economies have to be taken into account when formulating fiscal rules. For instance, the deficit-to-GDP ratio cannot be considered a reliable indicator because, in a period of rising oil prices, the deficit-to-GDP ratio may decline in spite of expansionary fiscal policies. Conversely, in a period of falling oil prices, the deficit-to-GDP ratio may rise in spite of budgetary consolidation. A fiscal rule based on an unqualified deficit-to-GDP ratio could even exacerbate procyclical behaviour. Thus, other such indicators as the non-oil budget balance/non-oil GDP ratio isolating the budget balance from oil price developments appear more appropriate as a basis for numerical fiscal rules in oil-producing countries. This is all the more needed if the depletion of oil reserves is no longer a distant prospect, as is the case in the Syrian Arab Republic and Yemen.

[141] Panel studies on debt of developing countries show that sovereign spread is a function of debt ratio with an average coefficient of 0.4. In other words, a 1 per cent increase of debt/GDP ratio would raise the cost of government funding by 40 basis points (Herrera and Salman, 2009; and Caselli and Freyer, 2006).

[142] In comparison to direct taxation, indirect taxation makes it easier to raise revenues, a factor particularly important in the complex years at the beginning of transition, improves the efficiency of the overall tax system and could raise the propensity to save.

(b) There is a strong possibility of lack of political cohesion around a development programme. Economic policy choices are likely to be contested by different stakeholders in case of the following: (i) the business community emphasizing the importance of stability to reassure investors; (ii) labour movements focusing on working conditions and wealth redistribution; (iii) youth movements lobbying for better education, anti-corruption mechanisms and more labour opportunity; and (iv) segments of secularist movements contrasting with components of the Islamist groups that are concentrating on religious and moral issues while drafting the constitution. These lobbies are even divided within themselves, as the post-Mubarak labour movement in Egypt shows (Beinin, 2012).[143] Differing agendas combined with identity politics and shallow but catchy slogans will be difficult to consolidate into one consistent programme, and pragmatic compromises on all sides will be necessary. However, compromises are less likely during periods of political confusion when enthusiasm and expectations are very high. The result is typically either an inconsistent economic programme and opportunistic but misplaced alliances formed around some of its parts, as the repeated U-turns over an IMF loan to Egypt has shown,[144] or the dangerous exclusion of some groups from the policy debate.[145] This provides a fertile ground for radical movements to develop because, in times of confusion, their unambiguous and uncompromising agendas give them a strong appeal among the electorate.

(c) High short-term socioeconomic expectations of the public are unlikely to be fulfilled because many economic reforms, if properly implemented, will only show results in the longer run. With regime shifts as radical as those currently taking place in the Arab region, the expectations of people tend to be unrealistically high and impatient as a perfectly understandable reaction to decades of individual and collective frustrations. More importantly, enthusiasm for democratic transition may wane quickly, as it did in just a decade in such former communist countries as Russia and Ukraine (Bell, 2011). The key driver of such a drastic rise in the discontent of people leading up to transition has usually been the combined effect of unequal economic reforms together with an increase in corruption. Where transition is taking place, the state is being asked to do more precisely at the moment it is least able to do so. The real risk is that policymakers may be tempted to address immediate but less consequential issues of the day in a disorderly fashion while losing sight of the broader strategic visions. As a result, there is a danger of decisions being taken and implemented in haste and with some improvisation, which may, in turn, stir up further discontent. Policymakers and the wider public need to be mindful of the fact that, even though the region has historically been affected by a double, namely, democratic and development, deficit, democratization does not necessarily entail economic development, at least in the medium term. Lane (2003) argues that countries with higher output volatility and dispersed political power are likely to run procyclical policies. This, combined with relatively thin financial markets, high and increasing fiscal deficits, poor economic governance, exposure to commodity price fluctuations, high defence expenditure, and a weak tax base, ends up widening procyclicality in many countries of the region even further.[146] Empirical studies show that procyclical fiscal policies harm the poor relatively more that other groups because of the weak safety net system in the region (Erbil, 2011).

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[143] Divisions are also likely to emerge within current government parties since they come from a long period of opposition and some components will not easily compromise on some important issues just because their new role entails more responsibility and political maturity in the management of the economy.

[144] In the case of the IMF loan, the Supreme Council of the Armed Forces (SCAF) formed quite an unusual coalition of interests with various leftist groups, while they opposed each other on all other issues, that also wanted to stop the loan, clearly for completely different reasons.

[145] Many Egyptian youth leaders do not participate in political parties. This has prompted fears that many of them will be left out of the transition and remain focused on street protests. Yet, there is still a role for such movements to help shape the future policy debate.

[146] MENA countries typically have few such automatic stabilizers as income tax and unemployment insurance built into their fiscal systems that would support procyclical patterns.

Particularly important at this point is the issue of fiscal transparency, one of the essential conditions for fiscal sustainability and good governance. This covers, among others, budgetary and extrabudgetary operations, accounting and data quality, relations between the different levels of governments and SOEs. Clear, accountable and transparent implementation of all aspects of fiscal policy can help to maintain public support for reforms.

(d) An increase in instability, weakened rule of law, confusing reform initiatives and a power vacuum, combined with the weak capacity of new governments, may leave new room for corruption, criminal activities,[147] exclusionary practices, and predatory behaviour during the transition phase. In such contexts, judicial investigations and anti-corruption campaigns are exploited as political tools to eliminate contenders. The heightened risk of expropriation and uncertainty ends up discouraging investment. Past transitions have seen improvements in voice and accountability and some progress in regulatory quality during the first few years of transition, while rule of law, corruption and government effectiveness have proven more difficult to improve (Freund and Mottaghi, 2011). Confusing and rushed reforms may also complicate the legislative and institutional framework in which citizens and businesses operate, resulting in the further weakening of public institutions, a higher administrative burden, and opportunities for discretional use of power and corruption.

(e) Negative impact on investment is a possibility. In many ACTs, with the notable exception of Morocco, an unhealthy trade-off between current and capital expenditure has emerged that will prove detrimental to the latter because of the following two factors: (i) high levels of political uncertainty that make potential businesses more risk averse; and (ii) the potential crowding-out effect of government borrowing from the domestic market, potentially at higher rates than from IFIs, in economies that have still to recover from the global recession and are, therefore, characterized by limited access to financial resources. Private investment tends to be more risk averse and opportunistic and, therefore, more volatile than public investment, since private investment generally dries up but can also recover more quickly during transition. It is, therefore, crucial that public investment complements private endeavours and facilitates their rebound rather than being a substitute. In countries with weak rule of law, public investment tends not to stimulate private investment and job creation, and if it does, it generally achieves suboptimal levels of allocative efficiency. If this is true of the Arab region, then the top priority of the reform agenda should be to swiftly address gaps in property rights protection, rule of law, competition, and regulatory framework.

A foreign investor survey done jointly by MIGA and EIU in 2011 found that the turmoil in the region had a significant impact on the investment propensity of foreign investors.[148] Almost 60 per cent of those surveyed had put their investment plans on hold, or were reconsidering or withdrawing existing investments. Political violence, especially civil disturbance and, to a lesser extent, war and terrorism, ranked as the highest risk for foreign investors. Investors were also concerned about rising sovereign credit default risks and foreign currency sovereign debt rating downgrades. Just over half of the firms surveyed appeared ready to invest in the region on the condition that there be at least a year of stability under new democratic regimes. As of today, FDI inflows have remained subdued and private investments are projected to remain stagnant for 2013. Morocco is a notable exception thanks to its stable political and macroeconomic environment. Also, in Egypt, Libya and Tunisia, the families of the former leaders had acquired stakes in many sectors of these economies, presenting quandaries that require a legal solution. These stakes, once regained, could be temporarily nationalized, reserving the right, in the case of operational businesses, to be commercialized under state oversight, in preparation for their sale to strategic stakeholders, while bearing in mind the interest of, mainly foreign, businesses that had formed joint ventures with companies run by the former ruling families.

[147] A poll conducted in Egypt and published by Gallup in 2011 showed a significant increase in people's perception of crime incidents since the uprisings although the actual experience of criminal events does not seem to have changed (Gallup, 2011).

[148] In parallel, the Global Competitiveness Indicator ranking dropped considerably, by 13 places for Egypt and 8 for Tunisia, due to higher uncertainty in both countries during the early transition process, as well as, although methodologically controversial, a sudden deterioration in how people assess public and private institutions (WEF, 2011).

After the initial efforts to reach short-term stability, governments should focus on improving the investment climate through the regulatory and institutional reforms described in Part I of this report, as well as through programmes that develop capabilities, incentivize exports and improve financing. Special attention must be placed on supporting SMEs, investing in education and innovation, clear rules to attract FDI, public-private investment partnerships, and other factors that raise marginal productivity of private capital.

(f) The combined effects of the consequences of the global recession and regime changes may increase short-term unemployment, the informal economy and poverty rates, particularly for the youth and women who are concentrated around the poverty lines and in marginal areas. In Egypt and Tunisia, partly due to the negative trends in the tourism sector, which reportedly suffered a revenue contraction, in 2011, of one forth in Egypt and one half in Tunisia, and the repatriation of Tunisians working in Libya, unemployment increased by about 4 per cent from before the Arab Spring (WEF, 2011; IMF, 2012b; and World Bank, 2012f) with the transition disproportionally affecting such labour-intensive sectors as manufacturing, construction and tourism. Many self-employed workers suffered a reduction in earnings, while formal employees witnessed a reduction in working hours. Reduced spending levels in OECD economies will also subdue demand for goods and services from the Maghreb and Mashreq. Estimates by ILO KILM for the ACTs show an average medium-run unemployment elasticity to negative growth of about 0.7 per cent. In other words, a drop in GDP growth of 3 per cent could translate to an increase in unemployment of about half a per cent.[149] Higher unemployment rates are likely to add to social pressures on the newly formed governments in the short term. Moreover, these dynamics might have further increased subnational regional disparities and tensions between such relatively developed and business-oriented areas as Aleppo before the civil conflict) and such cities representing the central authority with a bloated state apparatus as Damascus A further increase in the concentration of urban poverty might be seen, as people migrate from rural areas without finding decent employment opportunities, and this trend may have an impact on the social fabric and stability. For the reasons detailed above, aggregate labour demand may shift from tradable to such urban non-tradable sectors as construction and retail trade, generating less value added per worker. This outcome would imply lower capital-labour ratios and, hence, lower labour productivity. Moreover, protracted instability in the short term might distract financial resources from potentially more volatile, but possibly more productive, forms of investment, namely, securities and equities, and increase cash holdings or channel them into the real estate market, which is usually considered the investment safe haven in the region. The latter would contribute to further inflating housing prices in countries that already have housing affordability problems, which would further erode the purchasing power of large strata of the society.

(g) With the decrease in FDI inflows and drop in tourism revenues, both being still far below their pre-transition levels (see figure 66), amid capital outflows[150] and higher dollarization, or euroization, in the countries experiencing unrest, international reserves have been affected, and downward pressure has been exerted on exchange rates, particularly in Egypt, Libya, the Syrian Arab Republic, and Tunisia. The Syrian pound was traded at 190 Syrian pounds per 1 US dollar on the black market in August 2013, compared to 47 Syrian pounds per 1 US dollar before the start of the civil conflict in March 2012. The tourist sector, which accounted for around 12 per cent of GDP, has now collapsed. In 2012, Egyptian, Jordanian, Tunisian, and Moroccan international reserves were estimated at 40 per cent, 53 per cent, 64 per cent, and 71 per cent of their respective values at the beginning of the protests (IMF, 2012c). More recent data are depicted in figure 65. Foreign-exchange reserves in terms of months of import coverage are close to the IMF-recommended minimum of just three months in Egypt, Jordan and Tunisia. The external debt of Egypt, thanks to its managed floating exchange rate, might potentially benefit from depreciated hard currencies. However, countries heavily

[149] This would mean that a drop of GDP growth of 4.2 per cent, which is the difference between growth in Egypt estimated by IMF in October 2010 and September 2011, could translate to an increase in short-term unemployment of about 3 per cent. Assuming a similar elasticity for Tunisia and based on a drop in growth of 5.2 per cent, short-term unemployment would rise by over 3.5 per cent. For the Syrian Arab Republic, the increase would be even higher.

[150] In the first quarter of 2011, right at the outset of the Egyptian revolution, estimated outflows of foreign holdings of treasury bills amounted to US$6 billion (Galal, 2011).

dependent on imported food and other primary commodities may face more difficulties as hard currency exchange rates might deteriorate. Even under a sound set of macroeconomic policies, external shocks can have a detrimental effect on fiscal accounts, debt dynamics, inflation, investment, and, ultimately, on economic growth. Careful attention should be paid to alert such signals as the current account balance, the capital account outflows, the level of international reserves, and the fiscal deficit. Moreover, a risk of disorderly devaluation, experienced in many other countries in transition, remains if political instability goes on in some of the ACTs. To counter such a risk and avoid a balance of payments crisis in 2013, Egypt has received sizable financial assistance by the Gulf states and has tightened capital controls. However, capital controls, which were heavily adopted by the Syrian regime as well, can be an effective measure in the short run while the political situation can stabilize and viable macroprudential measures are introduced, but beyond that, they may lead to restrictions on imports of such staple goods as wheat and pose a further burden on the private sector through limited hard currency availability and more expensive purchase on the black market.

Figure 65. Changes in reserves during transition

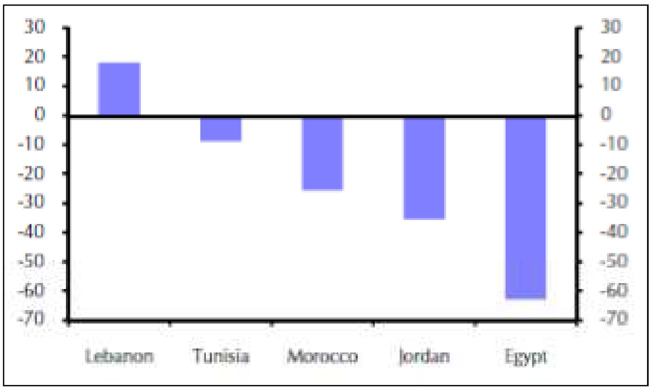
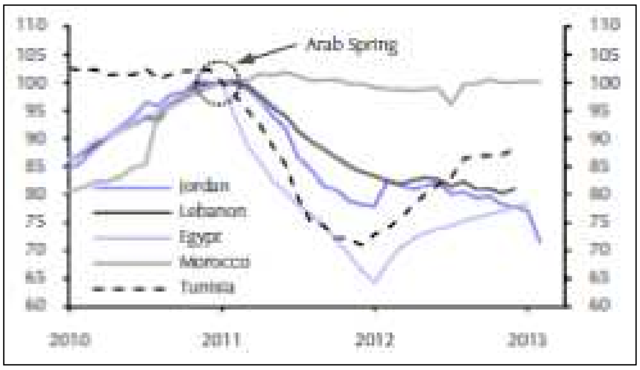


Figure 66. Tourist arrivals
(*January 2011 = 100*)



Sources: Thomson Reuters Datastream and Capital Economics, February and May 2013.

(h) Instability in the security and equity markets in the region, with the latter retreating in 2011 after a recovery started in the second half of 2010 (see figure 70); the higher risk of financial operations and consequently higher levels of non-performing loans; higher risk premiums and sovereign borrowing costs; and the wider spread in credit default swaps (CDS) and debt markets (see figure 69) all make public and private borrowing more costly, thereby negatively affecting investment decisions. The resulting increasing reliance on domestic banks to finance government borrowing associated with a low-growth environment is likely to crowd out credit to the private sector and put pressure on domestic interest rates, as has already happened in Egypt and Jordan (see figure 68), and risks slowing down the recovery even further. To date, no sovereign risk has reverted to pre-recession levels. Therefore, the fast-changing regional political scene might hit demand for the sovereign debt of some of the countries. Bahrain and Tunisia, for instance, have postponed a bond issue planned for 2011. The Syrian crisis is also putting upward pressure on sovereign bond spreads in Lebanon. In Egypt, increasing government debt coupled with rising interest rates due to higher risk premiums has led to an increase in debt interest payments that now account for almost one quarter of total government expenditure. However, the Qatari support to purchase Egyptian government bonds has helped to ease short-term pressures on the fiscal stance in the country and the devaluation of the Egyptian pound. The Middle East Emerging Markets Bond Index (EMBI) of bonds denominated in US dollars has shown underperformance compared to the performance of emerging market bonds throughout last year driven by instability in Egypt, where the spread of the JP Morgan Index over US Treasuries has risen to around 700bp in March 2013, and in Syrian neighbouring countries. Meanwhile, the most recent data show that equity markets in many ACTs have underperformed relative to other emerging markets and the benchmark Egyptian equity index (EGX 30) has fallen back against the backdrop of further civil unrest.

Figure 67. Trade-offs of commercial credit in ACTs

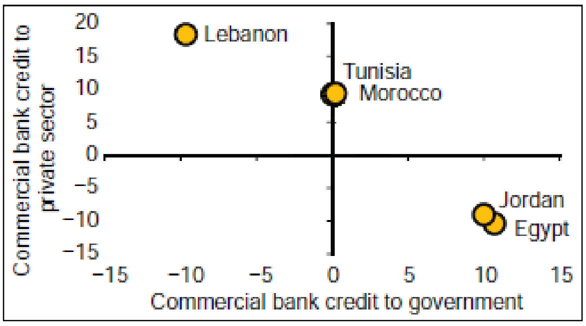
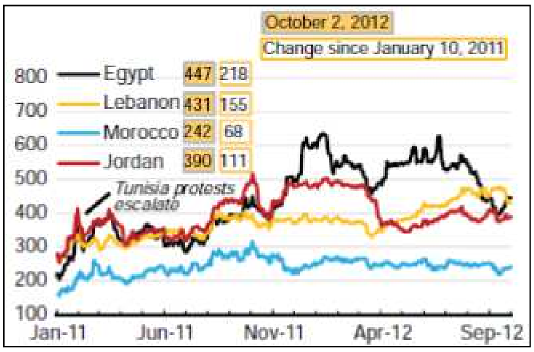


Figure 68. Government bond spreads (over US treasuries) since the uprisings



Source: IMF, 2012c, with data from Markit and Bloomberg.

Figure 69. Changes in five-year CDS spreads between July and September 2011

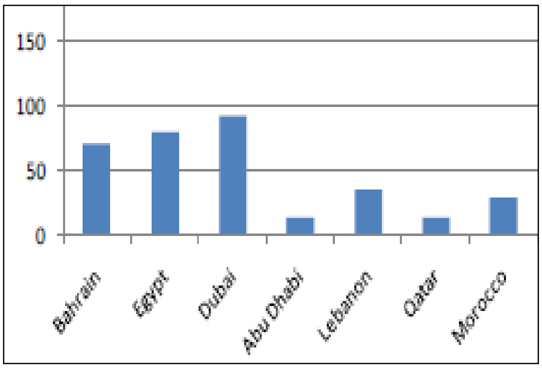
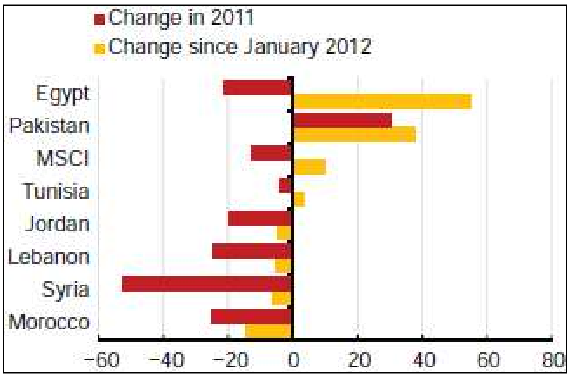


Figure 70. Stock market indices
(*Per cent changes in 2011 and 2012*)



Sources: World Bank, 2011i; and IMF, 2012c, with data from Bloomberg.

The rise in uncertainty due to transition tends to translate to higher risk premiums and higher cost of capital in such ACTs as Egypt, Libya, the Syrian Arab Republic, and Yemen. Typically, procyclical downgrades in sovereign credit by rating agencies, together with negative outlooks, are likely to continue to drive borrowing costs up (see table 30). Yields on nine-month Egyptian Treasury bills were almost 16 per cent by August 2012, signifying an upward move from 11 per cent in 2010, a rate that cannot be easily matched by private companies. Therefore, private investment in these countries may decline in the short and medium term unless a credible political and economic reform agenda is launched soon within a context of social and political stability. Here, as shown in the case of Egypt, IMF negotiations risk to be stuck and caught up in the following vicious circle: instability – deteriorating fiscal stance – tougher and more unpopular measures requested by the IMF – further risk of instability.[151]

Instability in the financial markets is particularly critical in a transition process. Experiences from East Asia, the Commonwealth of Independent States (CIS) and Latin America show that, when transition moves quickly towards a deregulation of the financial system without adequate governance mechanisms, the risk of financial crisis is far higher.

[151] It is worth mentioning that, in order for Egypt to qualify for debt relief from the Paris Club worth about US$15 billion, the government must have an IMF programme in place.

TABLE 30. SOVEREIGN CREDIT RATINGS AND IMF DEALS

	Fitch	Moody's	S&P	IMF deals
Bahrain	BBB↑	Baa1↓	BBB	X
Egypt	B-↓	Caa1↓	CCC+↓	X
Jordan	n.a.	B1↓	BB-	√
Libya	Ratings for Libya withdrawn because of insufficient information	n.a.	n.a.	X
Morocco	BBB-	Ba1	BBB-	√
Tunisia	BB+ ↓	Ba2↓	B ↓	√
Yemen	n.a.	n.a.	n.a.	√

Sources: Fitch, Moody's and Standard and Poor, as taken from their individual websites (May 2013).

Notes: List of countries by credit rating, showing most recent long-term foreign currency credit ratings for sovereign bonds as reported by the three major credit rating agencies. Upwards and downwards arrows indicate trends in outlook. Countries downgraded since January 2011 are highlighted in blue. For Fitch and Standard and Poor's (S&P), bonds rated BB+ and below are considered to be speculative grade. For Moody's, bonds rated Ba1 and below are considered to be speculative grade.

N.a. means not applicable.

Although the financial sector in the non-GCC countries of the region was shielded from the international financial crisis as it tends to be less integrated in the global financial markets, all countries implemented stabilization measures in the banking sector by increasing their capital adequacy ratios while reducing non-performing loan ratios. Monetary authorities have also tended to keep interest rates low due to the synchronization with the accommodative United States monetary policy given their pegged exchange rates, but also with the intent of discouraging speculative capital inflows at a time of very volatile global capital flows while searching for remunerative and safe portfolios. However, growing strains in the balance of payments prevent any easing of monetary policy, thereby keeping interest rates high or even hiking them.

(i) Although inflationary pressure has been modest in the last year (see table 27), there is a risk of consequent higher inflation at around or above 10 per cent projected for Egypt and Yemen, resulting from currency devaluation and the second-round effects of high imported food and, given the protracted regional instability, fuel prices, which typically negatively affect the poor by eroding their purchasing power and by negatively affecting the fiscal stance through higher subsidies. In addition, sustained expansionary fiscal policies are likely to have inflationary effects in economies with limited absorption capacity, and, combined with the dollar peg in many economies of the region, this may result in higher import flows and, consequently, imported inflation. The largest inflation increases are expected to take place in such transition countries that are also undergoing enduring political crises as Egypt, the Syrian Arab Republic and Yemen. According to BMI , CPI in the Syrian Arab Republic reached 40 per cent in May 2013 and is on an upward trend, reaching a projected average of 60 per cent this year (BMI, 2013)]. Inflation in this country is likely to have a scattered pattern due to the uneven access to goods, intensity of the conflict and the different groups controlling specific areas throughout the national territory. Inflation hikes are also expected in such countries as Egypt, Jordan, Morocco, and Tunisia, where reforms of the subsidy system have been planned or where the IMF has a programme in place that relies on subsidy cuts. Monetary policy must respond swiftly to attempt to maintain price stability, and fiscal policy should be supportive if these inflationary pressures are to be contained.

(j) The region is the largest importer of cereals worldwide. Higher and volatile commodity prices have resulted from global market trends, higher oil prices, frozen agricultural investment and low productivity, in addition to increasing natural shocks throughout the region. Morocco is a case in point. This evolution can be seen in figure 71. The price of wheat almost doubled in one year, resulting in further pressure on the household budget of the poor whose food demand elasticity is more rigid and on the fiscal space and/or current account balances of Egypt, Jordan, the Syrian Arab Republic, Tunisia, and Yemen, through their subsidy system, estimated on average at about 2-4 per cent of GDP. Jordan, Tunisia and Yemen are particularly vulnerable due to their almost total reliance on cereal imports and the limited capacity of their grain reserve storage (see figure 72). Transmission from international to domestic food price levels has been significant in Egypt and Yemen, with a food price inflation of over 20 per cent in 2011, and the Syrian Arab Republic, with over 13 per cent in 2010 and a currently even higher percentage due to the protracted civil conflict. Due to capital controls aiming to stabilize the pound in Egypt, wheat imports and national stocks have plummeted in the first half of 2013. Given their dependency on food imports, these countries risk suffering from inflation persistence caused by supply-side inflationary pushes that might cause second-round inflation effects. As a consequence, current account balances of oil-importing Arab economies have been deteriorating. Empirical analysis actually found a negative relation between shocks to world wheat prices and output in Egypt, Jordan, the Syrian Arab Republic and Tunisia (IMF, 2012c). International food commodity prices are likely to exhibit a rising and more volatile medium-term trend, which will remain of particular concern for ACTs because of their rapidly growing populations, limited water and arable land resources and significant dependence on international food commodity markets. In the midst of the transition, all of these factors are likely to reinvigorate populist agendas aimed at national food self-sufficiency. Such approaches have already been proved to be unsustainable (World Bank, FAO and IFAD, 2009; and ESCWA, 2010) and political leaders will have to make an extra effort to restrain themselves from going down this path and using such arguments for mere propaganda purposes.

Figure 71. Trends of international food and energy prices

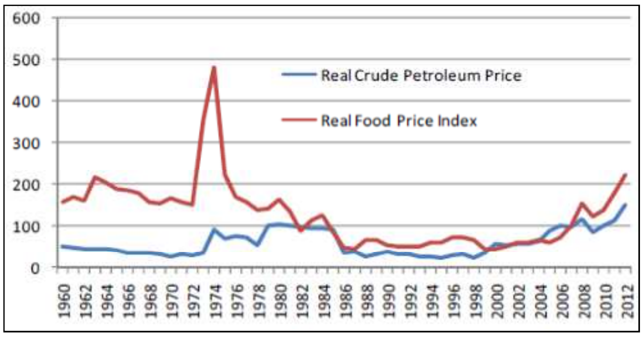
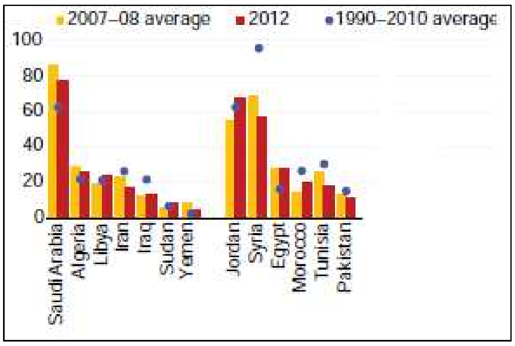


Figure 72. Stock-to-use ratio of wheat



Sources: World Bank, 2012a; and IMF, 2012c.

(k) It is likely that assets illegally held abroad by regime cronies were increased in size at the outset of the uprisings so that they could be secured in foreign jurisdictions and offshore financial centres. Sometimes groundless estimates on the value of such assets abound (see table 31) but it is likely to be in the range of billions of US dollars. Therefore, the impact in terms of opportunity cost of foregone development is huge. Every US$100 million recovered could fund, for example, full immunizations for four million children or provide water connections to 250,000 households. The true cost of corruption far exceeds the value of stolen assets and includes degradation of public administration, deterioration of the investment climate and disruption of the delivery of such essential services as education and health. All this entails a disproportionately adverse impact on the poor. Since the immediate goal of any leader that is voted into power after regime change is to gain the trust of the citizens, the return of misappropriated assets could help to prove integrity and build trust with citizens and the international community. However, preliminary signals from ongoing cases show that recovering such assets is a highly complex and sensitive process, and investigative and judicial cooperation between requesting countries and requested countries can be very difficult.[152] Lessons learned from past cases of ousted dictators in other regions suggest that strong political

[152] Anecdotal evidence from the Arab region indicates that the tightening of financial regulations in some financial centres, for instance, Switzerland, may have increased asset flows to other such centres as London. However, historical ties of former regimes with certain countries and their financial systems are supposed to have played a prominent role in decisions on asset allocation.

will, international cooperation, a flexible legal framework, a clear strategy, and access to sufficient capacity and resources are crucial in order to act quickly and reduce the time and cost of recovery.

Table 31 lists estimates provided by the media and independent experts on the amount of assets involved and the current judiciary processes as reported in the Stolen Assets Recovery Initiative (StAR) database.

TABLE 31. ESTIMATES ON ASSETS HELD ABROAD

Country	Media estimations on total amount	Media estimations on frozen amounts	Stolen Assets Recovery (StAR) Initiative data on frozen assets
Libya	Exceeds US$160 billion	US$15 million Saadi El Gaddafi house in London	*Assets frozen in the Netherlands*: • The Netherlands agreed to unfreeze US$2 billion in Libyan assets that had previously been blocked by the Dutch Government (12 September 2011). • In August 2011, the United Kingdom Telegraph reported that the Netherlands had frozen some EUR3.1 billion in Libyan assets. • The Netherlands gave 87 million British pounds (GBP) of frozen assets to WHO (16 August 2011, The Telegraph). *Assets frozen in the United Kingdom*: • On 26 August 2011, the Guardian reported that the United Kingdom was seeking to unfreeze some of the GBP12 billion frozen in the country. • In 2009 and 2011, MailOnline and BBC News reported on United Kingdom assets held by the Qaddafi family including a GBP10 million Hampstead mansion. *Assets frozen in the United States*: • US$37 billion in Libyan assets have been frozen under United States jurisdiction, and at the request of the Libyan Transitional National Council (TNC), the Treasury has released US$700 million to the TNC to help cover fuel and civilian operating costs and pay salaries.
Egypt	Exceeds US$130 billion	US$1 billion*	*Assets frozen in Switzerland*: • Switzerland has identified US$474 million in Swiss banks that is linked to Mr. Mubarak (2 May 2011). * Only one article mentioned that the Deputy General Attorney revealed that US$1.8 billion in appropriated funds and lands have been recovered, with another US$9 billion on the horizon (Ahram Online, 11 November 2012).
Yemen	US$70 billion*	Ranges between US$10 and 15 billion*	Not Provided
Tunisia	US$23 billion	US$13 billion confiscated (stated by Tunisian Minister of State Property and Land Affairs)	*Assets frozen in Switzerland*: • Switzerland became the first country in the world to freeze the assets of persons associated with the Tunisian regime. These total some 60 million Swiss

			francs (CHF).

Source: Compiled by ESCWA.

(l) Last but not least, experiences from other regions show that countries in transition are at high risk of political instability and conflict (Hegre and others, 2001; and Collier and Rohner, 2008).[153] The economic repercussions of violent transition can be sizable as they can go beyond the temporary disruption of ordinary economic activity, as has been witnessed in Egypt, Libya, the Syrian Arab Republic, and Yemen. In Libya and the Syrian Arab Republic, internationally sanctioned restrictive economic measures, namely, asset freezes and embargoes, were authorized. At the time of writing this report, the Syrian Arab Republic is the only country currently enduring a prolonged embargo, maintained since the start of the uprisings. Economic activities and public services in Jordan and Lebanon are being hurt and overly stretched by the prolonged crisis in the Syrian Arab Republic and its resulting massive flows of refugees, and the two countries are increasingly at risk over potential political spillovers. Moreover, economic deterioration along ethnic and confessional cleavages risks creating unstable relations between state and ethnic and confessional institutions that may distract policymakers from long-term reforms and create a hybrid and inconsistent state apparatus. This would provide fertile ground for protracted instability and reform reversal, as the past Pakistani and Algerian transitions may show. At the economic level, political instability and risks of conflicts in the region are causing a rise of international oil prices. Rough estimates show that a rise of US$10 in the oil price is likely to translate into a US$4 billion increase in the import bill of the resource-poor ACTs.

D. Political economy of transition

In recent history, when low-income groups have mobilized in favour of redistribution, they have tended to do so by pressing for a more democratic order. In a wide-ranging empirical review of the past two decades, Haggard and Kaufman (2012) show that more than one half of recent transitions can be explained by distributional concerns. The other half is divided between cases driven by antagonism within the ruling elite and cases where elites perceived democracy to serve their own interests. In light of our earlier analysis, it seems that the ACTs are firmly placed in the first category, resulting from a progressive weakening of the middle class and a proportional expansion of the more vulnerable groups and hence polarization in society (Diwan, 2012).

Whatever the causes are, the early phases of most transitions are highly fluid, and being prescriptive usually does not help and can even serve to create more problems. Transitions are affected by time inconsistency and collective action problems. Low inflation, a stable currency, quality service delivery and a healthy business environment are public goods and, as such, are accrued to the whole society although they are likely to damage some parties, for instance, former oligarchies, disenfranchised state bureaucrats and military persons, subsidized entrepreneurs, and others. This dispersion of potential benefits cum concentration of certain losses is at the heart of the political economy of transition for it gives the losers greater incentives to engage in collective action than the winners (Hellman, 1998). In the short term, after regime change, new politicians face the dilemma of how to initiate and sustain economic reforms that demand severe and certain sacrifices for the mere prospects of future gains that are certain to not benefit some specific groups. Politicians are, therefore, understandably reluctant to undertake radical reforms whose benefits will not materialize before the next election cycle. The short-term priority in the theoretical debate around the political economy of transition has, therefore, been twofold: (a) how to undertake moderate and

[153] The most commonly cited causes of conflict are related to motivation (poverty, unemployment and underemployment of young men) (Collier and Hoeffler, 2004; De Soysa and others, 1999; and Taeb, 2004); opportunity (inequality in income, land and natural resources) (Auvinen and Nafziger, 1999; Macours, 2011; and Stewart, 2000); polity (poor governance and repression) (Collier and Hoeffler, 2004; and Fearon, 2010); geography (Collier and Hoeffler, 2004); and population pressures (Ostby and others, 2011). Brinkman and Hendrix (2011) and Pinstrup-Andersen and Shimokawa (2008) also cite food insecurity as a cause for conflict. Sørli and others (2005) find that the key drivers of conflict in the Arab world can be narrowed down to: economic growth, or rather, the lack thereof, past frequency of conflict episodes, ethnic dominance, and regime type, with authoritarian and democratic regimes being less prone to conflict than regimes that are somewhere in the middle. Recently, Maystadt and others (2012) found that food insecurity is a major determinant of conflict in the region.

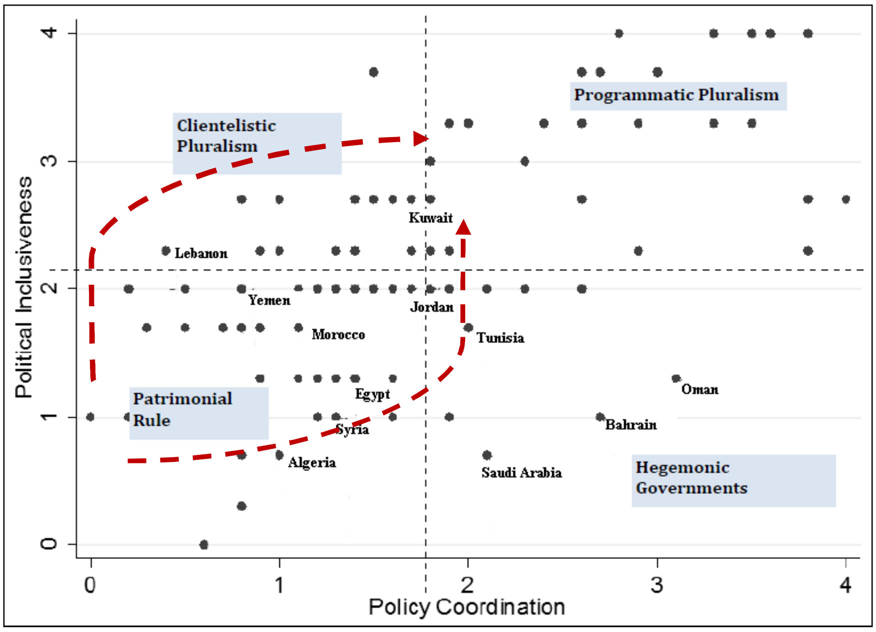
gradual reforms that are time consistent in the long run; and (b) how to insulate state institutions from the pressure of short-term losers until a constituency of winners arises that is solid enough to support reforms.

Regarding the prospective transition challenges ahead for Arab resource- or rent-dependent countries in terms of development policies, Barma and others (2010) argue that political economy contexts and corresponding operational implications can be grouped according to two dimensions, namely, development and diversification policies, which, in turn, are based on the credibility of intertemporal commitment and overall political inclusiveness. For instance, in non-inclusive settings where the intertemporal credibility of commitment is low, rent allocation will be biased towards consumption by politico-economic elites and away from savings and investment for the wider society. Lack of inclusiveness means that societies that lack networks of civil society organizations bridging economic, social and political cleavages are also more likely to experience conflict when a political system collapses or undergoes a significant transition (Varshney, 2002). Economic reforms that expand private-sector activity based on competition rather than privilege can strengthen civil society in ways that may contribute to averting conflict.

The above categories produce four possible typologies of transition (see figure 73). Ross and others (2011) build on this framework to situate Arab countries in the related typologies. Most ACTs are found in the paternalistic and authoritarian lower quadrant of the chart. Therefore, the possible paths towards pluralistic societies are through either economy-enhancing autocracies or through pluralistic systems with limited policy coordination capacity. Each ACT is likely to take its own path.

Lessons learned from other transitions show that initial conditions, macroeconomic stability and a sustained reform process are three critical factors for a successful outcome. In many transitions, poverty and democracy, combined with limited state capacity, have provided opportunities for the empowerment of so-called election brokers, who can be clan bosses, owners of informally organized business conglomerates or even mafia bosses, among others, and who contributed to turning elections into personal feuds for territorial control and rent distribution among powerful clans or families (Griffith and Munroe, 1995). If economic dislocation is twinned with a decline in state capacity, often the result is more corruption and the development of a subculture of illegality.

Figure 73. Prospective typologies of transition



Source: Ross and others, 2011.

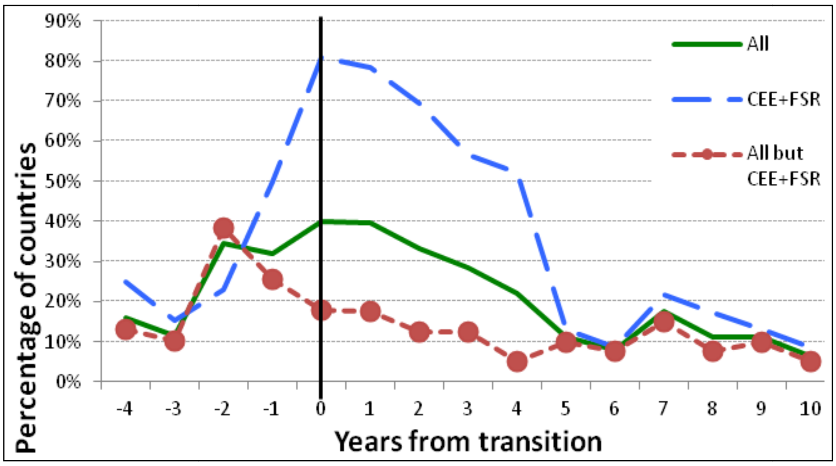
The analysis of other transition processes has revealed a J-shaped growth pattern, whereby growth drops during the initial stages of a democratic transition but then reaches higher rates during its advanced stages, corroborating the view of Friedrich Hayek that the merits of democracy come in the long run (Hayek, 1960; and Miller, 2010). Therefore, the dynamic view of potential short-term pain for long-term gain needs to be extensively discussed and addressed among all stakeholders and the public. Despite certain evidence on the close relationship between fiscal adjustment and growth in transition economies on average (Segura-Ubiergo and others, 2010, among others), the new governments in ACTs have to establish an agenda that balances such short-term needs as macroeconomic stabilization, fulfilment of social demands, and others with, sometimes painful, structural and institutional reforms that will only bring benefits in the medium and long run. In order to achieve this, it is imperative to also find some readily implementable measures that will bring about short-term benefits to the population and also to use any window of opportunity, including, widespread support immediately after elections, to implement unpopular measures, while finding ways to shield the disadvantaged segments of the population from the initial adverse effects of adjustment.

Box 4. J-curve growth in transition economies

An analysis of past transition experiences shows that many countries underwent an economic downturn at the outset. Almost half of over one hundred democratic transitions recorded worldwide over the last half century underwent an economic contraction, and around 40 per cent experienced a persistent contraction typically lasting at least five years (Amin and others, 2012). In the successful transitions, investment and economic growth follow a J-curve pattern, with a drop during the early stages of transition and a rebound after the initial lag (Freund and Mottaghi, 2011). In most cases, the gains after the rebound quickly outweighed the initial loss. Trends in unemployment rates seem to reinforce this pattern. Inflation, on the other hand, typically follows an inverted J-curve process.

Out of 75 transitions for which further data is available, around 40 per cent experienced negative economic growth in the starting year of the transition that was protracted over the following year, then declined over the next three years (see figure 74). Interestingly, another grouping of countries is recorded as having experienced an output decline of around 35 per cent two years before the onset of transition. These two groupings appear to have different geographical patterns. The first grouping consists of the former communist countries, while the second seems to be composed of countries with varied backgrounds. Arguably, the explanation lies in the manner in which transitions occurred in these two groups. In the former communist bloc, transition was abrupt and was more characterized by a so-called big bang approach due to the sudden shifts to new political systems and market economies; while in other transitions, an earlier economic downturn might have contributed to starting the process that was then characterized by a more gradual institutional and policy shift. A final curiosity is that the first group tends to converge suddenly towards the second group around five years into the transition.

Figure 74. Incidence of economic recession among countries in transition



Source: ESCWA calculations based on data from World Bank, WDI.

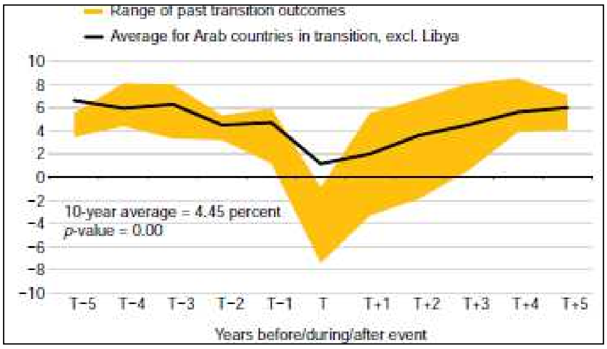
Note: CEE is short for Central and Eastern Europe, and FSR is short for Former Soviet Republics.

Box 4 (*continued*)

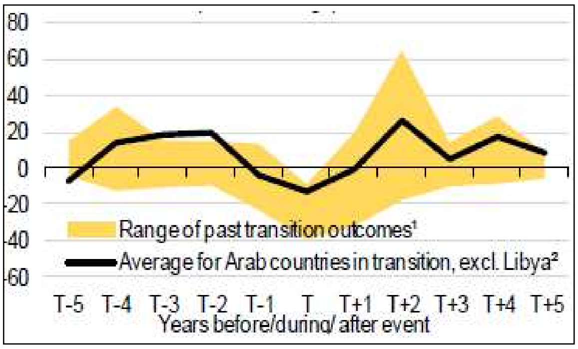
In a recent IMF analysis of transitions that may be comparable to the specificities of ACTs (see figure 75), it emerged that they typically experience an economic contraction of, on average, more than 4 per cent, in the starting year of the transition and growth remains below trend for the following four to five years, as do public and private investment. Unemployment increases by a moderate 1-1.5 per cent in the first two years. Also, fiscal and current account balances deteriorate in this period due to lower revenues and higher spending. ACTs are particularly worse off in terms of fiscal deficit compared to other countries previously in transition.

Figure 75. Comparison of selected macroeconomic trends in countries in transition

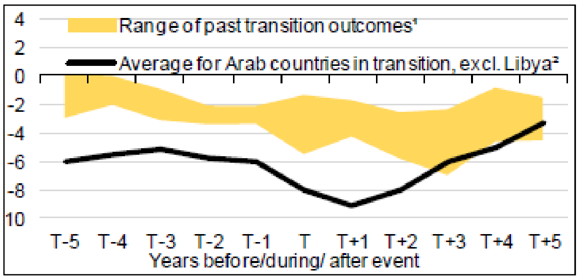
Real GDP growth



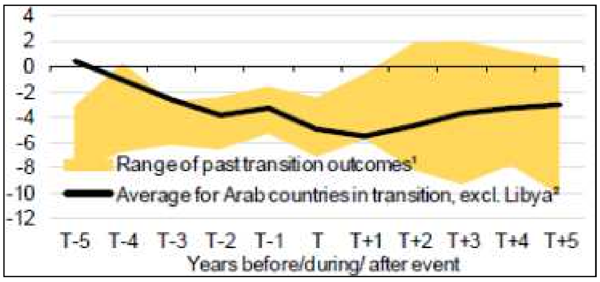
Gross fixed public capital formation



Fiscal balance



Current account balance



Sources: IMF, 2012; and Khandelwal and Roitman, 2013.

In light of past transitions and the patterns observed so far in the current Arab transitions, real GDP growth in ACTs is expected to return to its long-term trend over the medium term, which is four to five years. However, this depends on the typology of transition that takes place during this period: if the transition process is going to be relatively smooth, the catch-up process might be faster, but if transition is characterized by instability and policy reversals, as has been the case in Egypt, not to mention the Syrian Arab Republic, convergence might take longer.

Transition governments should not make hesitant, incomplete or easily reversible reforms, as political tactics matter more the less stable an economy is. Creating irreversible reforms early on allows for governments to change without seriously affecting the transition itself. A shaky economic basis, however, paves the way for policy reversals and uncertainty. From a politico-economic perspective, it is important to bear in mind that the institutions themselves are a product of the transition process and, consequently, an endogenous outcome, which makes the process highly unpredictable. This is further complicated by the fact that oil revenues and geopolitically motivated foreign aid lead rulers to rely on redistribution rather than investment and growth to ensure political stability, thereby keeping incentives to institutionalize low because natural resource rents are high and maintaining control over them is key to preserving support and allegiance. Furthermore, returns to private investment are likely to be low in such sectors as manufacturing because the resource rents reduce their competitiveness through higher real exchange rates.

Lessons learned from the theory of collective action originating from other transitions show that a key factor in explaining why reforms in exclusionary policies have, at best, stagnated or even degenerated has often been the lack of organized constituencies that would benefit from change emerging and putting pressure on weak transitional institutions. Meanwhile, resistance to reforms from the insiders of the status quo arrangements is very high. This is because organized groups that thrived in the old regimes are able to apply more pressure on governments than new and less organized groups. Pre-reform elites are resilient and often able to keep their positions in the post-reform phase. In this region, this unbalance is further complicated by exclusionary governance systems that discourage potential beneficiaries from organizing themselves and actively and effectively lobbying for change. For example, the lobbying power of the manufacturing sector has historically been weaker in ACTs than in other regions. Unlike in Eastern Europe and Latin America, Arab trade unions have also been weak or just another arm of the executive power and have only played a minor role in discussing and catalysing consensus around economic policies.

Underrepresented pro-reform groups are usually heterogeneous and stretch from the young and educated unemployed to small and young businesses, from consumers to small farmers. However, another risk can appear when two or more organized groups or factions emerge from the regime change. This may be the case in Egypt, where the military and majority party have, at times, taken confrontational positions, letting the transition increasingly adopt a winner-takes-all character. In order to successfully overcome the first stage of the transition, it will be crucial to consult broadly and seriously with representatives from the entire political class and reach agreements on the key parameters of a future political system, setting the country on a clear path that gradually leads to full civilian rule, allowing the democratically elected majority to govern while the short-term needs of both sides are addressed.

In order to effectively organize their actions, these groups first need a legal framework that recognizes the right to have access to information provided by an independent and highly competitive media system. The groups must have the ability to contest bad policy choices and to mobilize freely, and should be consulted at certain crucial stages of policymaking. These conditions have been almost non-existent in the region, and enacting legal and regulatory reforms in this direction will have to be the first step taken by any incumbent in power. The importance of this cannot be overstated, since previous experiences in transition countries suggest that anything that harms the competition environment or that leads to a captured economy has an enormously negative influence on the final outcome of the transition process. This includes, for instance, liberalization without clear rules to regulate market mechanisms, privatization without the institutions that create a competitive environment, or the widespread use of quasi-fiscal operations that generate distortions and hinder accountability.

From a microeconomic perspective, these factors are reflected in two policy actions. First, new enterprises in transition economies tend to be more productive than old enterprises (World Bank, 2002). Therefore, it is of primary importance that transition encourages the entry and growth of new firms, particularly SMEs, as they are increasingly going to play a critical role in all ACTs.[154] Second, it is essential

[154] In many transition economies, SMEs in the formal sector have reached higher average value added per employee and, consequently, higher wages, than the rest of the economy. As a result, there will be incentives for factors of production to move to the SME sector, thus increasing its share of the overall economy. Such an increase will, in turn, tend to increase the economic growth rate. Transition in the former Soviet bloc shows two different stories in this regard: (a) the Eastern European experience with new firms accounting for more than half of value added and total employment after a decade; and (b) the CIS, many members of

to impose discipline over the previous business elite.[155] In past regimes, soft budgets allowed these enterprises not to pay taxes or bank debts, and they enjoyed all manners of preferences and support. So far, the personalization of business interests and the preference for privacy has weakened the role of business associations, undermining their capacity for collective action and discouraging them from articulating clear economic agendas or engaging in an open and transparent policy reform debate. In transition, uneven privileges would create inequitable burdens on new firms, as they will have to offset the fiscal losses originated by the business elite. Experience from other transitions also shows that these well-connected businesses may represent a potential systemic financial and fiscal threat if not timely addressed. A resolution would first and foremost entail the overhaul of the legal and regulatory institutions that characterize the national business environment,[156] with rule of law and secure property rights placed at the forefront as preconditions to the launch of any transition process.[157] It would also entail a paradigm shift in the approach to development, from asset stripping and rent seeking to competition and innovation. Discipline and competition force old cronies to restructure themselves and to finally be exposed to the Schumpeterian creative destruction process. This restructuring will help reallocate the assets of old firms in a more efficient way, releasing new economic energies and creating new job opportunities in the markets.

A potential risk for many transitions that is particularly likely in certain Arab countries due to their socioeconomic and political dynamics is a partial-reform-equilibrium trap that in the Arab context could, when combined with inefficient redistributive policies, help to maintain the status quo and prevent any advancement in the process. Too often in the past, Arab rulers have turned, in times of distress, to partial political and economic liberalization while increasing government salaries and a variety of generalized subsidies with the result of guaranteeing political and economic control for a small elite while the vast majority of the population lives on assistance and the informal economy.

Another important lesson from other transitions is that policymakers need to pay attention not only to old elites but also to the early winners benefiting from reforms. The former Soviet countries provide plenty of evidence of how well-connected beneficiaries from the early stages of liberalization and privatization can become an obstacle to further reform advances if these are likely to reduce their initial gains. Examples of such early beneficiaries are criminal organizations which thrive in an environment characterized by increasing economic opportunities, high corruption and weak rule of law; state enterprise insiders who become new private owners with the aim of stripping the assets of firms while benefiting from state subsidies and protectionist measures; managers and owners of privatized commercial banks who benefit from enormous arbitrage opportunities under macroeconomic instability and operate in inefficient domestic financial markets that open up to international markets; other entrepreneurs who benefit from arbitrage opportunities arising from price differentials between liberalized sectors of the economy and those still subsidized and protected; and ministry and regulatory officials who prevent market entry to protect their share of monopoly rents. Economies that suffer from this problem risk being locked in the partial reform paradox that generates concentrated rents while imposing high costs on the rest of society (Hellman, 1998). In such cases, there will be mirror-image J-curves reflecting the two transitional categories: a traditional one for society, representing the short-term losers, and an inverse one for the winners. In the initial stages of

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which are resource-based economies which have seen modest growth of new enterprises with their average share of value added and employment below one quarter of the total.

[155] Reflecting on the role of societal forces during transitions in Europe and South America in the 1980s and 1990s, Schmitter reports that negotiated elite pacts outnumbered revolutionary transitions. Thus, if societal mass mobilization is important in triggering transitions, it often seems to be less influential in shaping the institutional framework. The consolidation of institutions is frequently influenced by negotiated elite pacts that determine the nature of institutions and the rules of the game (Schmitter, 2010).

[156] Here, we refer, in particular, to adopting a solid framework of competition and antitrust laws, adequate accounting and auditing standards, protecting minority shareholders and creditors and regulating conflicts of interest, insolvency and bankruptcy procedures.

[157] Other transition experiences show that high initial levels of inequality in wealth and power can lead to long-lasting insecurity of property rights (Roland, 2002, p. 36).

transition, when institutions are still weak and susceptible to policy reversal, these winners will have room to manoeuvre and the opportunity to oppose the entrance of new, including foreign, competitors to prolong transfers from the state, benefit from tax exemptions, and more. This will be attempted under a spectrum of justifications ranging from such populist arguments as the modern forms of colonization imposed on Arab economies by foreign companies, the need for state assistance during the hard time of transition, and so on. This risk is obviously all the bigger in the oil-exporting economies or those with strong linkages to the former where rent-seeking opportunities and entrenched interests are even larger. The challenge then lies in how to reduce the gap between these two curves as much as possible, which in both, political and economic, terms means how to be as inclusive as possible in policy formulation. Following the experience of such partial reformers as Russia and Central Asia, one could easily imagine the scenario of partial reform in the Arab region: pretty much similar to the current general state of affairs of rentierism, crony capitalism and informality from an economic point of view, with competing elites confronting each other or forming opportunistic alliances for political power.

Firmly steering the fiscal policy by redirecting state support away from a web of individual cronies towards more effective social security and effective ALMPs becomes crucial here. The role of the government should not be focused on providing all kinds of firm-level support but rather on protecting workers and other social categories from unnecessary individual and collective damage. The first mistake in managing the political economy of transition is to cede to the temptation of standardized formulas without paying heed to the contexts in which they are implemented. For instance, in environments affected by high state capture, privatization will further deteriorate rule of law and result in private monopolies and, consequently, lower macroeconomic gains. The first negative consequence of any transition is typically a rise in inequality. However, this rise has different causes that need to be disentangled, as understanding these dynamics will help policymakers take the most appropriate policy actions.

Other transitions show that, very often, the causes of sudden hikes in inequality lie in the following:

(a) Widespread corruption and rent seeking: Corruption is a tax that tends to negatively affect the poor disproportionally;

(b) State capture by narrow interests that disregard the public ones. Here again, state capture tends to disproportionally negatively affect the poor;

(c) The poor being locked in low-skill informal jobs and experiencing an impossible transition from old informal work to new formal jobs if left unaided; (d)A J-shaped growth pattern that reduces income opportunities for the poor.[158]

More equitable growth during transition, therefore, depends on two key factors: the initial conditions determined by geography, history, levels of institutional and policy distortions, and exposure to external shock of a given country; and the interplay of government policies between old and new entrenched interests and civil society, which will also contribute to determining the speed of recovery.

The outcome of reforms will be heavily influenced by the pattern of winners and losers, as each constituency will prefer a different combination of reforms. Based on other experiences, it is likely that state-sector workers and old insiders would prefer the status quo, the new elite would prefer partial reforms that protect them from competition, while potential new firms and the broader category of consumers might be willing to experience initial sacrifices for the promise of later gains. The challenge, therefore, lies in how to put an economy on the track of long-term Pareto optimal reform, which cannot be achieved in the short run, if, in the medium term, the amalgamation of winners and losers is not conducive to such a long-term

[158] For example, in the 1990s, the transition caused real GDP to dip by about 15 per cent in Eastern Europe, and by more than 40 per cent in the CIS. In the same period, the Gini coefficient of income per capita increased from 0.23 to 0.33 in the former, and from 0.28 to 0.46 in the latter (World Bank, 2002).

outcome. This is where politics embraces economics and reinforce one another. However, there are two schools of thought in this respect. One argues that political reforms should precede economic reforms, as the dismantling of authoritarian governments is a *conditio sine qua non* for really inclusive growth. In this case, the transitions of Eastern Europe and CIS countries are used as empirical evidence.[159] The other argues that authoritarian regimes, or technocratic ones, according to a less polarized approach, are better equipped than nascent democracies to carry out large-scale economic reforms. Here, the experience from East Asia and Latin America is often used for empirical support. This debate becomes particularly complex in the Arab transition as the boundaries between the public and private sectors are vague and rentier systems tend towards a high concentration of both political and economic power (Alissa, 2007).

Experiences from other regions have shown that democratization and reforms in the political institutions are crucial for creating a wider and early social consensus on the main direction of economic reforms. Empirical evidence seems to support the simultaneity of economic and political reforms under conditions of stress (Desai and others, 2003). However, in a context affected by low institutional capacity and large political divisions, a certain degree of prioritization and sequencing is necessary. The position advocated in this report is, therefore, one of politico-economic sequencing, whereby political and governance reforms, which are inherently the most popular ones, should lead and facilitate the implementation of structural economic reforms before the honeymoon period between policymakers and the population ends. Reforms by decree reproduce paternalistic patterns of state-society relations and reveal themselves to be unsustainable in the long term.

Box 5. Lessons learned from other transitions

Countries in transition around the world can usually be categorized into two groups: (a) those undergoing single, usually economic, transitions, as, for example, China, Singapore and Vietnam; and (b) those undergoing double, namely, political and economic, transitions, as is the case, for instance, in Eastern Europe and Latin America. Processes and outcomes between the two categories are remarkably different as in the former case transition can be managed by a relatively authoritarian ruler in an orderly and gradual manner over a long period of time.

Transitions have never been homogeneous processes as different countries have taken different courses. Moreover, they were never linear and went through ups and downs and even major political and economic crises. However, according to the Commission on Growth and Development (2008), successful transitions observed since World War II had five core points in common, though they were highly context-specific and were, hence, combined in different ways according to each national transition process: (a) committed and capable governments; (b) macroeconomic stability so that low inflation levels did not tax the poor in a period of high uncertainty; (c) integration in world markets so that the elastic global demand could be tapped into through trade, FDI, technology absorption, and migration; (d) market-based allocations of resources; and (e) high rates of savings and investment, to the detriment of today's consumption.

In addition, the following common aspects emerged in the medium term: (a) a legal framework proactively and effectively promoting free and fair elections as well as human rights, including unrestricted and non-discriminatory freedom of information, expression and association; (b) government outreach to a broadened range of stakeholders and the wider public; (c) focus on better basic service delivery, with the help of community

[159] Quite counter-intuitively, the evidence from the post-communist transitions suggest that countries that had more frequent elections and shorter executive tenures, signifying a higher susceptibility to political contestability and challenges from short-term losers, have been more likely to embark on a comprehensive reform programme than countries that managed to be more insulated from electoral pressures. This seems to contradict the view of many authors (for instance, Haggard and Kaufman, 1995), which argues that insecurity of tenure increases the discount rate of future payoffs from reforms. Politicians who face competitive and regular election tests may be constrained from pursuing policies that benefit a narrow segment of voters while generating high social costs. This has been confirmed by Hellman (1998), who found a strong positive correlation linking political rights indicators and number of coalition governments to economic reform indicators. Particularly relevant is also the fact that in Eastern Europe, thanks to the steadiness of the accession policies of the European Union, changes of governments did not imply policy reversals but only a change of implementation speed.

satisfaction surveys and scorecards, across the country and at the local level; and (d) the development of a realistic timeframe in which benefits might be expected with measurable milestones that the public can use for evaluating progress.

Box 5 (*continued*)

Since the fall of the Iron Curtain, transition processes have usually started from political and/or economic crises and, in some cases, gave way to new opportunities for democratization and a new pattern of economic development. Each country chose its own path and sequencing of reforms starting from different points, such constraints as security and the role of the military in Turkey, terrorism and centrifugal forces in Indonesia and corruption in the Philippines, but also relative strengths, namely, government cohesion and stability in Turkey and lively communities and CSOs in Indonesia as well as the Philippines.

Transition economies heavily reliant on rents or natural resources constitute a special category of transition. Around the world, resources have either been a hindrance to or a facilitator of transitions. Typical cases of the first scenario can be found in the Central Asia republics, whose economies rely heavily on oil, gas and minerals; cases of the second scenario include Botswana, Chile, Malaysia, and Thailand. In both cases, a significant diversification of production was not a realistic aim in the medium term because returns to resource exploitation were very high. However, in the case of Central Asia, natural resources were wasted and/or captured by the ruling elites who managed to remain in power, thereby shutting out reformers and reducing, and even reverting, the speed and scope of transition. In these countries, much of the resource rents were dissipated in energy subsidies rather than used to accelerate reforms through redistribution to potential losers. The real difference between the two groups arguably arose from the establishment of strong budgetary institutions, an independent and well-managed stabilization fund which accumulated resource windfalls, high investment rates within responsible fiscal policies, and a well-regulated financial sector that could effectively intermediate between domestic savings and capital markets (Esanov and others, 2001).

Such countries in transition as Egypt, Jordan, Morocco, and Tunisia have been drafting a new set of laws on freedom of information, transparency and anti-corruption, as well as improving local service delivery, but it is too early to judge their real effects as they were either only recently approved or are still in drafting committees.

The problem then becomes how to align the political incentives of new policymakers with a thriving civil society and a competitive private sector instead of perpetuating old patterns of centralized political and economic control. Economic reforms that create new economic actors, most probably SMEs, and strengthen the constituency of these new actors are, in turn, likely to build support for further political reforms.[160] This process would also promote (and benefit from) a multi-party system, broad-based social movements, including trade unions and SME and professional associations, as opposed to already-established business organizations and structures that, in the early stages of development and when the economic structure is not diversified, may control the state-business relation from the outset so as to give themselves the opportunity to get organized and be an active part of the reform agenda.[161] In addition, the pull effect of such supportive external factors as the Arab-European Union Corporation or integration process may help, as was the case for Eastern Europe accessing the European Union or Latin American countries entering Mercosur.

[160] However, this is not necessarily the case. In the Arab region, the merchant class, which, in other regions, has historically been a prominent advocate of liberalization reforms since the industrial revolution, has preferred to enter opportunistic alliances to extract their share of economic benefits from the central ruler (Amin and others, 2012, p. 43).

[161] This is one of the greatest differences identified between transition in CIS countries and transition in Eastern Europe as well as Latin America. In the latter, for instance, the Catholic Church and trade unions might have helped to limit the rise and power of oligarchs and insiders while keeping the social fabric in the country together. The expansion of civil society is also considered one of the primary causes of East Asia democratizations. In South Korea, for instance, religious institutions played a prominent role in promoting human rights and civil liberties; and in Taiwan and Thailand, civil rights movements and environmentalist groups from the urban middle class demanded democratic reforms (Shin, 2009). Over the last decade, trade unions in Tunisia and religious groups and the private sector in Egypt, Jordan and Morocco have grown more diverse, vocal and organized, and could, therefore, play a vital role in promoting dialogue.

Finally, state capacity matters. Pre-transition institutions can be destroyed more quickly than post-transition ones can be built. The most successful transitions capitalized on already existing key state institutions. Policies enacted during transition, as innovative as they may be, rely on pre-transition institutions that have a character of persistency and slow change, if not of conservation. From an institutional perspective, therefore, transition is a continuum that tends to build on the structures that existed prior to the transition. Hence, it becomes crucial to decide on the speed of implementation and sequencing of reforms that should go in parallel with bureaucracy strengthening, namely, the isolation from daily and undue political influence, and improved professionalism and integrity. Prices and interest rates can be liberalized far more easily than monopolies and market distortions can be broken up; current account liberalization and privatization can be realized more quickly than a healthy domestic business environment can be established; and similarly, at the political level, it is far easier to conduct elections than to painstakingly achieve the empowerment of the population, including marginalized groups. As we have seen in Part I of this report, indicators of government effectiveness in many ACTs have been deteriorating over the last 15 years and, therefore, an extra effort in supporting the development of state bureaucracies will be needed urgently. From this perspective, following the rentier economy reasoning, such states that rely more heavily on taxation as Morocco and Tunisia, are likely to start off the transition process relatively better equipped than those that rely on external rents, as is the case for Egypt, Jordan, the Syrian Arab Republic, and Yemen.

When it comes to modalities of reform implementation, two opposite approaches form the extremes of the spectrum within which reforms are generally implemented. A gradualist approach spreads the costs of reform over time, allowing for the creation of adequate capacity and learning from lessons, and builds support for reforms among the potential beneficiaries.[162] The second approach is the so-called big bang approach, according to which heavy-handed and swift reform implementation reduces uncertainties and opportunities for capture by the conservative elites while benefiting from complementarities between different sectors being reformed. The advantages of one approach are the shortfalls of the other and, therefore, an opportunistic mix of the two approaches is usually advisable. Each country in transition should adopt the right balance based on its socioeconomic, political and institutional attributes and nuances. For instance, the role of tribes will be crucial in the political economy of the Libyan and Yemeni transitions since the tribal groups have long performed some of the functions of state institutions due to the weaknesses of the latter and are, therefore, as much a part of political and social life as political parties and trade unions. At times, tribal boundaries can be associated with geographic socioeconomic disparities, as is the case in these two countries, with the North-South split in Yemen and the East-West split in Libya, embedding tribal issues with a wider equity and justice agenda. To complicate matters even further, tribal leaders do not usually represent the entirety of their tribe, and tribal members retain multiple identities besides their tribe of origin.

In light of the analysis above, in the short and medium term, governments should prepare and catalyse the widest possible segments of the population around a shared development strategy, similarly to the Brazilian approach in the last decade, that clearly outlines what kinds of reforms will be required in order to achieve the set development outcomes and focus on smoothing the curve of winners and losers resulting from the early stages of reforms. The most appropriate and effective policies to this effect are the ones that are based on three fundamental drivers of a transition: (a) social protection; (b) market competition; and (c) budget discipline. In the region, the majority of parties that have taken office after regime changes have come up with either very broad and shallow development visions centred around the two generic thrusts of good governance and social justice, or with detailed sector-specific strategies. To date, no government or majority coalition has prepared a participatory, broad-based, comprehensive, and clearly prioritized development strategy that sets forth the planned actions needed to: realistically attain a disciplined fiscal policy; fight poverty, unemployment and corruption; develop the private sector; improve the efficiency of the public administration; and make the economy more competitive and better linked to international markets.

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[162] In China, for instance, the success of decollectivization supposedly built support for further reforms at a later stage (Roland, 2002).

In light of the discussion above, the following is recommended:

(a) Initial conditions matter. In countries with less advanced political, governance-based and economic reforms, it is likely that resistance to economic reforms will be greater. Therefore, a detailed socioeconomic and political assessment of a society embarking on a transition is crucial;

(b) Mobilizing all stakeholders around a clear long-term reform strategy from its inception and regularly communicating about its implementation and progress should be an integral part of any economic reform effort;[163]

(c) Political economy suggests that faster reforms may involve higher compensation costs. For instance, the big bang approach, which was employed in East Germany, would not have been possible without massive, up to three quarters of the East German GDP, financial transfers from West Germany. Therefore, a faster rate of economic reforms is typically associated with a deterioration of the fiscal stance. Countries with a limited fiscal envelope need to be aware of this relationship;

(d) Interaction between different elements and policies of reforms needs to be continuously monitored so that their potential complementarities can be capitalized on and potentially antagonistic effects eliminated. Socioeconomic repercussions of reforms carried out in the financial sector need to be carefully weighed up before reforms are adopted;

(e) A staggered approach in the transition process would entail two phases in the medium term: first, an urgent phase, lasting approximately one to two years, during which security and stability-related concerns are addressed as a matter of priority but not to the detriment of longer-term development needs. This phase applies particularly to Libya, Yemen and the countries that might experience a difficult and lengthy toppling of the previous regime; and, second, a transitional phase, lasting approximately two to five years, during which the most pressing reforms should be launched. Afterwards, a convergence phase would put the countries on track towards regional best practices in terms of governance and economic policy;

(f) Countries with limited fiscal space have one more reason to focus on anti-corruption and governance-based reforms as many of their components entail zero or very limited budget implications;

(g) Media investigations and internet-based reports on the privileges that elite insiders enjoy at the expense of the collective welfare should be promoted;

(h) Methods need to be improved for identifying poor households and a programme of means-tested cash transfers should be perfected together with conditional transfers for such specific social objectives as primary and secondary education and maternal health care, among others;

(i) Such experiences as the Malaysian unity-in-diversity platform in managing social cleavages during transition should be learned from and drawn upon;

(j) Similar to the widely employed community development funds but larger in scale, regional cohesion funds could be created to provide grants to small infrastructure works benefiting communities that might potentially be affected by the downsizing of economic activities before the effects manifest themselves. Fund allocation should be presided over by boards composed of civil society and chaired by local governments;

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[163] An example of how to incorporate social and civil society groups into political decision-making processes in a meaningful manner is provided by the Economic and Social Development Council established by the Government of President Lula in Brazil. It includes civil society organizations from all areas: unions, women's organizations, the landless movement, environmental groups, consumer protection organizations, and entrepreneurs' associations. Its national Development Agenda is a pact for sustainable growth coupled with social inclusion and employment. The Council also monitors the progress that is being made.

(k) Strengthening the provision of such basic public goods as property rights and the judicial system should be a priority from the outset of the transition;

(l) Rapid privatization sell-offs to insiders are best avoided. The most successful privatization programmes followed a policy of gradual sales. Alternatively, the costs and benefits of mass privatization should be carefully weighed up and, if needed, sales should take place once the institutions that are in charge and the governance framework around them are ready for such an endeavour and a new competitive private sector has already established itself;

(m) Stringent governance frameworks regulating the privatization process must entail, *inter alia*, strict public disclosure rules, independent boards of directors and clear antitrust laws;

(n) Attention needs to be paid to natural monopolies, where average production costs decline as scale increases. Where they exist, policymakers should weigh up welfare gains against losses of privatization so as to avoid inefficient public monopolies being transformed into dangerous private monopolies;

(o) Corporate governance and public financial management must be improved in enterprises that remain under state control;

(p) Solvency and foreclosure rules need to be modernized before any loss-making SOEs left unsold after the privatization process are foreclosed;

(q) Subsidies, tax and duty exemption regimes must be modernized and rationalized while the tax base is broadened;

(r) A progressive system for individual taxpayers could be adopted, whereby the lower quintile of the population is taxed primarily through indirect taxation and the upper quintile is taxed primarily through real estate properties, direct taxation and capital gains, the former with highly progressive taxation and the latter with a simple and reasonable taxation that does not encourage capital flight;

(s) A low and simplified taxation system should be set up for micro- and small enterprises and managed by local governments, together with property taxes;

(t) Different tax policies should be adopted for micro-, small and large agricultural businesses, focusing on just a simple tax regime on land in the case of microbusinesses.

E. THE ROLE OF THE INTERNATIONAL COMMUNITY

ACTs are likely to need two-step financial assistance. In the immediate term, most of them are exposed to significant external and fiscal vulnerabilities associated with anaemic growth prospects, not to mention risks of political instability. Immediate external financing and standby arrangements are required so as to safeguard macroeconomic stability and prevent any downward spiraling of key macroeconomic indicators. In the short and medium term, the newly elected governments will also need financial and technical assistance for equitable macroeconomic and microeconomic adjustments in order to safely shuttle these economies through the transition.

The role that international development assistance has had in influencing the political economy of the region has not been properly investigated. With some 50 per cent more than the amount going to Sub-Saharan Africa, the region receives the highest assistance in per capita terms worldwide. The international community has historically had a primary role in pushing Arab countries towards reforms, although sometimes in a schizophrenic manner. Reforms toward economic liberalization have been attempted in the Arab region over the last three decades. Under IFI monitoring, these reforms focused mainly on the following four areas: (a) cutting government spending; (b) privatization of SOEs; (c) trade openness;

and (d) liberalization of interest and exchange rates. However, reforms are not implemented in a vacuum and, too often, the political and institutional environment in which the reforms took place was not taken into account. The result was that these liberalization programmes were at best half implemented, resulting in a few cronies and members of close elites benefiting from them while leaving the vast majority of the population unaffected or even worse off. In countries where commodity subsidies were cut, which was the case in Egypt in 1977, in Morocco in 1983, in Tunisia in 1984, in Algeria in 1988, and in Jordan in both 1989 and 1996, the so-called IMF riots took place. At the political level, the logic of the international community of sacrificing democratization on the altar of security for the region that has endured throughout the last few decades has become untenable.

As we have seen, reforms tend to easily collapse because of resistance from potential losers. Here, the international community can still play an important role, as it can help overcome internal opposition forces arising from partial benefits, anchor complex reforms and enhance the credibility of a country in this respect. This was the case for the reform programme in Mexico being tied to joining the North American Free Trade Agreement (NAFTA) and for Eastern European countries accessing the European Union. So far, Arab countries have not been able to find a powerful driver that could push reforms as was originally intended, for instance, with the Euro-Mediterranean Partnership. These agreements were designed and implemented in a hub-and-spoke manner and, de facto, have only produced the result of exporting more European Union manufacturing products into the Arab Mediterranean countries. Unlike in other interregional integration agreements, a complementary agenda of wider institutional and democratization reform and convergence was missing in the Euro-Mediterranean Partnership of 1995, the European Neighbourhood Policy (ENP) of 2003-2004 and, more recently, in the Union for the Mediterranean created in 2008, which centred around trade, security, migration, and assistance, although with limited results.[164] It is vital that the European Union and Arab countries redesign this style of agreement by shifting from a piecemeal approach to an overall strategy and by providing enough incentives and rewards for these countries to launch deeper economic reforms, as was the case in the past with the preparation for the accession of Eastern Europe to the European Union, and currently is the case with the negotiations of the Deep and Comprehensive Free Trade Agreements (DCFTA) with Armenia, Georgia, Moldova, and Ukraine. This would mean not only focusing on aid incentives but rather on those centred on trade and migration policies that reduce protection for the European Union agriculture markets, liberalize access to the European Union services markets, simplify rules of origin, implement a more dynamic migration policy ranging from students exchange and scholarship programmes to quotas for specific undersupplied jobs, and implement bilateral and regional agreements on the portability of social contributions.[165] A new European Union neighbourhood policy should provide more effective incentives and rewards by linking the above-mentioned benefits to clear benchmarks that would signify the different stages of institutional and regulatory reforms implemented by Arab countries. The approach would be similar to the one adopted for the accession of Eastern European countries to the European Union, based on a combination of country-tailored policy conditionality and technical assistance provided by twinning arrangements, although possibly with a stronger and more nuanced emphasis on governance-based reform agendas. Complete liberalization of the European Union agriculture and services markets for Arab businesses and the establishment of a Euro-Mediterranean Economic Area as well as the enlargement of the European Energy Community Treaty[166] to the Southern Mediterranean countries could then be the final stage of reward for those countries that have been virtuous reformers throughout the process agreed upon. Meanwhile, a

[164] The Moroccan ENP has been relatively more successful. It has been granted advanced status, which has allowed the country to accelerate political and economic relations with the European Union by gradually adopting its *Acquis Communautaire*.

[165] An actively managed migration scheme that responds to the needs of both the Arab region and European Union would need to: (a) focus on mid-skill workers and vocational training programmes coordinated between relevant institutions from both regions; (b) encourage return migration through tax exemptions, fast track measures and the creation of an Arab- European Union fund for co-financing investment in the Arab countries from Arab entrepreneurs residing in the European Union; and (c) provide more effective services for job and skills matching in preparation for migration.

[166] Such enlargement would allow power exchange across the Mediterranean Sea with potentially huge economic and environmental benefits for both parties given the considerable potential of solar energy in the Southern shore.

renewed Union for the Mediterranean that includes Turkey and is organized by social, economic and political working groups should take place. A specific working group on civil society and human rights that includes the main religious associations in ACTs should also be created. Financial and technical support from the European Union should come according to the advancement towards clear benchmarks established for these working groups as well as negotiations at country level.

Meanwhile, many think that a new Marshall Plan is needed. If a new plan is to be implemented, it needs to be properly managed because it may give rise to rent seeking, inefficiency and inflationary dynamics. Here, some lessons learned from the Marshall Plan could be useful.

Box 6. Lessons learned from the Marshall Plan

The Marshall Plan supported European recovery in the difficult aftermath of World War II and is considered to be the most successful large-scale foreign aid programme of modern times. But what made the Marshall Plan a success? Close scrutiny suggests several elements played a decisive role, many, but not all, of which would be difficult to replicate:

- Recipient input: The allocation of aid under the Marshall Plan relied extensively on recipient input. From the outset, the Economic Cooperation Administration (ECA), operating through the Organisation for European Economic Co-operation (OEEC), invited each participating country to submit a plan of action describing how it would use donated resources so as to reach a position where aid could be terminated in 1952-1953. Consultations between ECA and OEEC and participating governments were ongoing and continuous, and the composition of United States aid was modified in light of the information and requests it received from the recipients;

- Decentralization: Disbursement and administration of aid was extensively decentralized. Administrators encouraged the flow of information from the field to headquarters and adapted programme guidelines in response;

- Public-private partnerships: The European Recovery Programme (ERP) relied on private channels rather than governments for procuring resources. It operated with the participation of business representatives and private advisory committees, in which industry and labour representatives collaborated with senior civil servants;

- Encouragement of competition: A basic tenet of the Marshall Plan was the encouragement of competition as a device for boosting the economy and productivity. United States administrators believed in encouraging free competition and discouraging monopolies and market power, even more so abroad than at home. However, they pursued their objective in pragmatic rather than doctrinaire ways. Where the recipients cited strong social or other traditional arguments for limits on competition, the donor was prepared to bend;

- Regional coordination: The United States insisted on a collective and unified approach to the allocation of aid that encouraged the recipients to think about the spillover effects, both positive and negative, of their use of donated money, and in order to minimize overall dollar demand on the United States. The United States emphasized the institutionalization of regional cooperation, specifically, the creation of standing organizations through which cooperative initiatives could be carried out. One such organization was the United Nations Economic Commission for Europe (ECE). The provision of Marshall Aid to seed the European Payments Union as a vehicle for containing the balance-of-payments problems that arose in the course of current-account liberalization was also critically important in this regard;

- Auto-extinguishment: The Marshall Plan was self-extinguishing. It was set up as a four-year programme and implemented by a temporary government agency rather than as a programme of the United States State Department. The fact that the programme had a clear ending date encouraged the recipients to ponder life after aid and limited the danger of aid dependence;

- Strong institutional capacity: Above all, the European recipients had relatively well-trained and educated labour forces. There had been extensive wartime destruction of industrial capital stock and other productive capacity, but there had also been extensive wartime investment. Property rights and rule of law were well established. All this was of particular advantage as Europe was well positioned to make the most of donated resources;

Box 6 (*continued*)

- Implications: United States conditionality focused on balancing budgets, stabilizing exchange rates and liberalizing prices where these remained under government control, but it did not require precipitous or blanket liberalization. United States conditionality encouraged liberalization and competition but did not require laissez-faire policies. United States policymakers permitted and sometimes even encouraged European governments to remain involved in aspects of economic management. The recipient governments continued to formulate indicative plans, as done by France, and operate state holding companies, in the case of Italy, in order to coordinate complementary investments and solve other coordination problems that decentralized markets, left to their own devices, could not. They developed tax and transfer policies and wage guidelines to maintain what Europeans regarded as a socially acceptable distribution of income and to foster social cohesion;

- Unusually for this kind of foreign aid programme, the Marshall Plan actively encouraged, indeed required, collaboration and steps in the direction of economic and financial integration on the part of the recipients. It helped to set Europe on the road to regional integration, thereby illustrating how foreign aid can reduce the risk of interstate violence.

Source: Eichengreen, 2011.

Given the projected financing needs for the countries in transition and the drying up and increased cost of international capital markets, careful external financing could be an option, particularly in light of the recent commitments made at the Deauville Partnership launched by the Group of Eight (G8) in May 2011,[167] where US$38 billion was pledged to Egypt, Jordan, Libya, Morocco, and Tunisia over the 2011-2013 period, that could support country-led reform agendas through debt relief, technical assistance and lending. Qatar, Saudi Arabia and the United Arab Emirates alone have made large pledges, totalling nearly US$18 billion of grants, soft loans, private sector support, and capital investments. The European Union allocated an additional US$1.75 billion in aid to expand its Neighbourhood Policy in the Mediterranean. However, the IMF estimated external financing needs for ACTs, excluding Libya because of its abundant oil revenues and the Syrian Arab Republic because of the current civil conflict, to be in the range of US$40 billion for 2012 alone and US$33 billion in 2013 (IMF, 2012b).

Despite generalized fiscal constraints in OECD economies, a number of bilateral donors will also offer development assistance that, due to its grant form, is usually welcomed by the beneficiary authorities but is too often poorly prioritized, designed, implemented, and monitored.[168] For instance, there have been indications that the enormous amounts of assistance that the military sector in Egypt has been receiving over the last four decades will be diverted to development-conducive sectors given the trade-off required between the two sectors in times of fiscal restraint. In the aftermath of the G8 meetings, financial flows to ATCs have not yet materialized[169] and a clear aid governance structure involving main donors, comprised of those from the GCC countries, and beneficiary governments has not yet been established (see figure 76).

[167] The Deauville Partnership economic framework is based on the following five pillars: (1) governance, transparency and accountability of economic activities; (2) social and economic inclusion; (3) economic modernization and job creation; (4) private sector led economic growth; and (5) regional and global integration. It currently includes a number of regional and global IFIs and the following beneficiaries: Egypt, Jordan, Morocco and Tunisia; but aims to extend further.

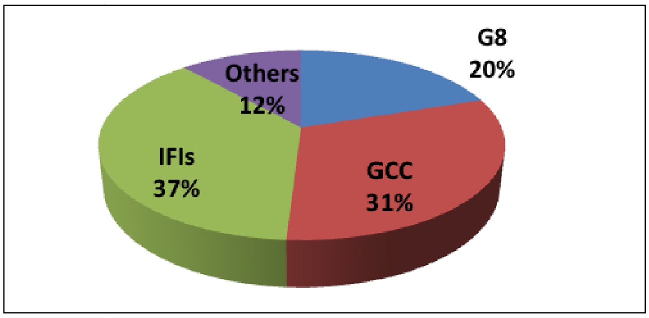
[168] For example, technical assistance has been instrumental in the successful transition in Eastern Europe, from the European Union, and Indonesia, from the United States.

[169] In the case of Egypt, financial support has apparently been on standby because it is conditional on the IMF loan that has undergone repeated U-turns.

In addition, an array of ad hoc and sector-based trust funds and initiatives have mushroomed among IFIs, regional development banks, think tanks and bilateral donors.[170] The lack of an efficient aid governance structure needs to be remedied in order to avoid creating unsustainable and instrumental relationships between donors and beneficiaries. The mistrust between donors, including IFIs, and recipient countries, including the public opinion, that has accumulated over the last two decades has hindered economic reforms and risks being another tool in the hands of partial interests and national elites as well as being used as political propaganda by populist political leaders. Better donor coordination and aid effectiveness is crucial for setting such a relationship straight and on an equal footing.[171]

In the current phase of transition, ACTs cannot afford market-based lending, even at the current low rates. The use of such concessional loans as those offered by the International Development Association (IDA) could help in this respect as the limited fiscal space available and the mounting demands from the population cannot withstand the further deterioration of government accounts during a delicate and uncertain initial transition phase. In October 2012, the members of the Deauville Partnership established a new grant-based Transition Fund. While this is a step in the right direction, its total envelope of US$250 million might be insufficient given its wide mandate that includes economic governance reforms, trade, investment, and social welfare, including job creation, and seemingly does not wield leverage powerful enough to push ACTs to advance reforms.

Figure 76. International official financing disbursed to ACTs in 2011 and (latest available date of) 2012



Source: IMF, 2012c.

Note: Most of these disbursements are from operations and funds that were in place before the transitions.

Donor support could play a crucial role in enhancing human development in this region. However, given the considerable number of stakeholders in the area and the width of the sector, interventions are often either fragmented into various small-scale projects or fall between the cracks both in governments and in development assistance agencies. The amount actually received by transition countries from the G8 and the GCC countries so far is negligible compared to the official promised amounts. Scant government management capacity can sometimes be wasted in administering many small-scale activities that demand different donor preferences, procedures and reporting requirements being catered to. This fragmentation also hinders the ability of civil society to build commitment to a national effort to tackle specific issues while bearing in mind the broader picture of inclusive growth, rather than building loyalties to specific projects. While external aid can be instrumental in ensuring reforms in a transition context, it can also have the detrimental impact of diluting the accountability of the state and the overall governance framework if managed outside an institutional context and without the long-term implications being considered. Finally,

[170] The World Bank alone, under the umbrella of the Arab World Initiative, has developed more than 15 different programmes.

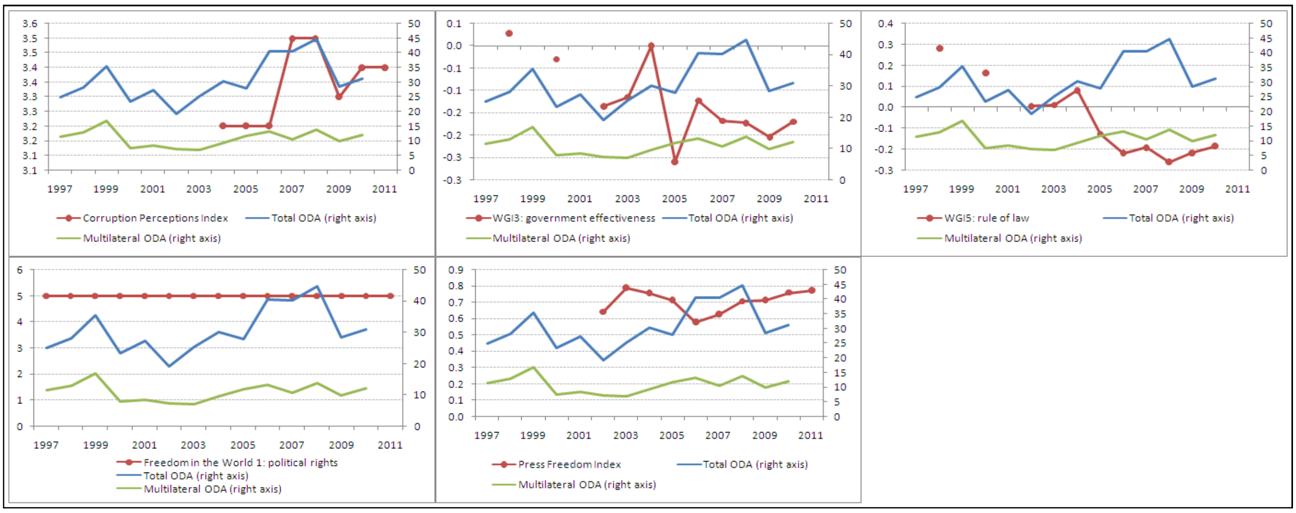
[171] On this point, the rotation mechanism established for the Secretariat of the Deauville Coordination Platform provides an interesting coordination arrangement worth assessing in the near future.

mainstreaming economic, social and human development programmes into Poverty Reduction Strategy Papers (PRSPs) and sector-wide approaches (SWAPs) that incorporate clear and easily measurable progress indicators is a useful way to make government policies more accountable in this area and induce regular financing channels to tackle these issues, rather than ad hoc and volatile funds. Development partners need to help governments to build their commitment and capacity along this process through a proper communication strategy aimed at gaining the interest and commitment of the wider public.

In the past, economic liberalization recipes have not worked in countries characterized by serious governance deficit. Still, aid assistance has historically been provided regardless of advancements, or lack thereof, in the governance system (see figure 77). Economic liberalization is needed in order to transition from a policy of privileged economic elites and crony capitalism to a level playing field that could unleash the potential of the private sector. Any future assistance has to address this conundrum and put a governance reform agenda at the centre of any aid assistance programme. For this purpose, governance diagnostics tools that strengthen country-level analysis and monitoring and evaluation toolkits for donors need to be developed.

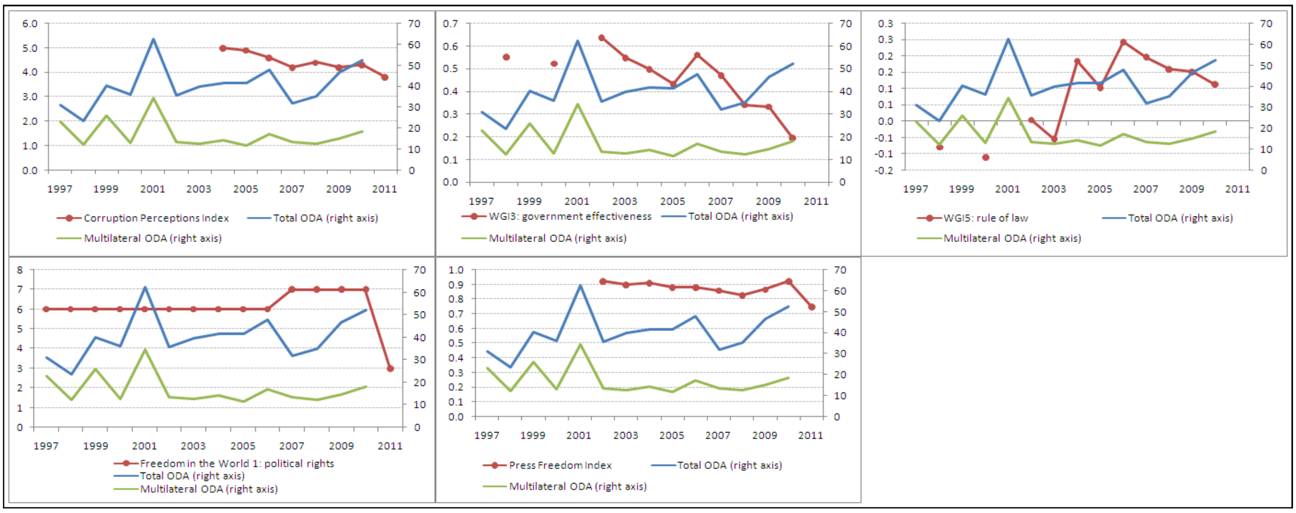
Figure 77. Trends in international aid inflows and governance indicators for selected ACTs

Morocco

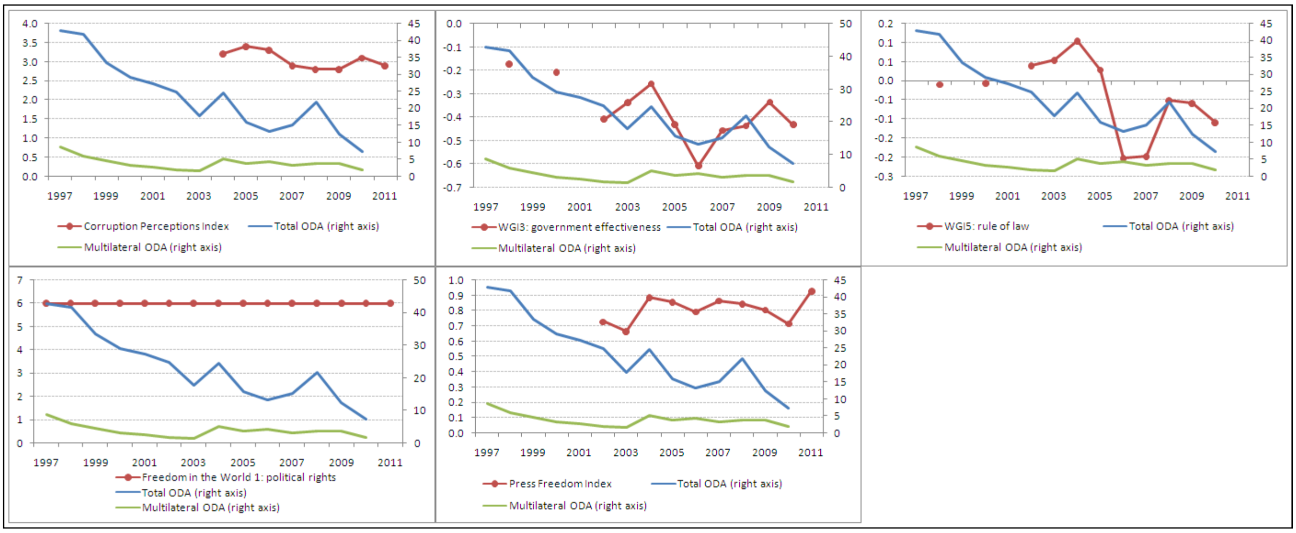


Jordan

Tunisia



Egypt



Source: Compiled by ESCWA, based on data from Transparency International, WGI and Freedom House.

Note: ODA is short for Official Development Assistance.

Egypt, Jordan, Morocco, and Tunisia have submitted national action plans as part of the Deauville Partnership. Although different and context-specific, these plans all cite inclusive growth, investment and productivity and fighting corruption as core development objectives. There are some areas of apparent consensus, but there may be more variances in the details. Virtually all plans pay lip service to the need for greater social justice, but this is a relatively vague notion. The first transition governments seemed to agree that there should be a more progressive tax system, a minimum wage, subsidy reform and more investment in health care and education. Since then, new governments have taken office and new economic development plans have been drafted, but they have confirmed somehow the above objectives. However, no plan has yet been developed in a participatory manner or containing clear development benchmarks.

One of the short-term actions that the Deauville Partnership and the international community could undertake is the establishment of a well-endowed good governance trust fund that would provide financial and technical assistance to ATCs for the implementation of necessary reforms upon the condition of clear and measurable benchmarks to be met. Benchmarks could include the approval of a constitution with a division of powers based, among others, on check-and-balance principles, the establishment of independent media, regular publication of annual budgets, and military retrenchment in civilian affairs. The trust fund should be endowed with several billion US dollars in order to make a significant impact. Given the range of expertise required, it could be jointly managed by institutions that are leaders in such specific governance-related fields as the International Institute for Democracy and Electoral Assistance for election reform support, the World Bank and IMF for PFM reform, the IFC and OECD for business environment reform, and such regional institutions that have experience in democratic transitions as the European Bank for Reconstruction and Development (EBRD), the Council of Europe and the Organization for Security and Cooperation in Europe (OSCE).

Finally, large bilateral development funds and agencies in the ACTs neither enhance development nor improve bilateral relationships between donor countries and beneficiaries. Despite large amounts of funding, offices and projects of the United Stated Agency for International Development (USAID) and European Union in many countries in the region have had very limited impact and did not serve to quell anti-Western popular sentiment. What is needed is a regionalized institution in charge of supporting development. An Arab regional development bank could be instrumental in facilitating the assistance coming from within and outside the region in conjunction with strong technical and evidence-based programme formulation. An Arab bank would be capable of addressing aid governance concerns and managing the current fragmentation of trust funds. Such a bank would need to be authoritative so as to also help distance the geopolitical pressures from the imperative to provide technically sound development assistance. Its focus could be similar, though expanded, to the role carried out by the EBRD in the 1990s in Eastern Europe, focusing primarily on such transition-related issues as trade reform, infrastructural investment, private-sector development, judicial reform, utility sector reform, and more. Its primary shareholders should be both countries in transition and the GCC countries. Such relevant donors and development partners as China, the European Union and the United States could also become shareholders. In the medium term, however, it would be advisable for the EBRD to take on the role of such a bank given its invaluable knowledge accumulated through more than two decades of programmes and policy dialogue conducted in transition countries and its recently expanded mandate and involvement in many of the ACTs. The EBRD could start by establishing a strong geographic Arab or MENA division enriched with technical cross-fertilization from the technical sectors within the bank. By channelling the funds from the Deauville Partnership and the GCC countries that should be in the form of grants and loans similar to those provided by the IDA and with the increase in its capacity, the local division would increasingly become autonomous to the point of getting unbundled from the original bank and becoming a totally independent Arab regional development bank (ARDB). EBRD and ARDB should closely coordinate their activities with those of the above-proposed good governance trust fund.

III. CONCLUDING REMARKS AND SELECTED RECOMMENDATIONS

As seen in other regions, transition to democratic and accountable governance can provide a significant window of opportunity for long-term pro-poor reforms and sustainable development. Studies have found that GDP growth tends to reach higher rates after a post-transition downturn following a J-shaped curve. In the Arab region, it is crucial that, given the highly volatile context, the down phase be as short as possible and higher rates be achieved through economic and trade diversification, a regional labour market, a better investment climate, financial deepening, broadening of the tax base, more efficient public service delivery, and better targeted social policy. Critically, the results will simultaneously depend on how swiftly and credibly governments can commit to reforms, and on the ability of national societies to prevent social and political polarization and maintain a solid, though evolving, national unity and identity.

Transition to democracy is good in itself. Literature reviews show that casual links between democracy and economic growth are weak at best. The Arab public should not expect democratic transition to automatically bring about quick economic gains. The need for patience should inform all public debate.

Reformers will need to be opportunistic in looking for ways of locking in reforms while bearing in mind their snowball effects. Reforms are not implemented in a vacuum and tend to collapse easily because of resistance from potential losers. Therefore, while sequencing is important, in the real economic policy world, reforms are usually implemented partially and stepwise whenever the opportunity presents itself, either because there is a champion leading the process, be it a person or an institution, or because policymakers are obliged to reform due to some form of external pressure. However, experience from other regions shows that a successful reform agenda requires a moderate degree of success in several areas simultaneously. A Big Bang approach to reform is as desirable as it is impractical, particularly in contexts of low institutional capacity. If, however, gradualism is employed, it needs to be as upfront and compressed as possible so as to capitalize on synergies of various reforms.

Regardless of the underlying approach, governance reform is key in any transition, while inflation stabilization and market institution reforms, which include more effective competition policies, emerge as key support for a sustainable economic transition.

Some selected recommendations resulting from this analysis follow, aiming to distinguish between short- and medium-term challenges.

Short-term recommendations (1-2 years)

- Mind the political economy of the transition process that is highly context-specific;
- Governments must define inclusive growth strategies through a broad consultative process that signals the first step toward a new social contract;
- The budget formulation remains fragmented in many ACTs, starting from the split between competencies of the ministry of planning and the ministry of finance. The authorities should focus on the following key priorities: (a) ensuring a unified budget process, including full integration of recurrent and capital budgets; (b) introducing a medium-term perspective to inform the annual budget; (c) presenting a comprehensive and clear budget; and (d) strengthening the links between policy and budgeting. Introducing a budget strategy paper at the start of the budget calendar could strengthen the linkage between policy priorities and budgetary allocations;
- The fiscal balance should be used dynamically in favour of pro-growth policies while fiscal discipline is adhered to in the medium term. To this end, the creation of a macrofiscal policy unit in the government in charge of elaborating medium-term fiscal projections and analyses will

enhance fiscal policy formulation and help make the budget a strategic policy tool linking national policy objectives to macroeconomic performance;

- International agreements can play an important role, as was the case with the reform programme of Mexico being tied to joining NAFTA and with Eastern European countries accessing the European Union. So far, Arab countries have not been able to find a powerful driver that could push reforms, as was originally intended with the Euro-Mediterranean partnership;

- It is important that PAFTA and other regional bilateral agreements insist on a greater level of discipline on tariffs and non-tariff barriers. One approach might be to gradually reduce the maximum level of tariff protection first;

- Conspiracy theories discrediting CSOs as being the long arm of foreign interference in domestic politics should be stopped and CSOs should be allowed to apply for and receive financial and technical support from foreign donors;

- There is an urgent need for growth-employment diagnostic studies to carefully evaluate the policies affecting the sectors that have been providing the bulk of jobs and their prospects for continuing to contribute to employment creation in the future. ESCWA, as part of the United Nations system,) and the League of Arab States could help the region to dig deeper and more broadly into demographic and economic scenarios by using a dynamic general equilibrium framework to capture socioeconomic changes in the region that could inform medium-term policies;

- Fiscal and monetary policies should be adjusted as the economy recovers in order to prevent inflation transmission effects originating from the recent wage and commodity price rises. In countries where pegged exchange rates and international reserves are under pressure, orderly devaluation might need to take place or interest rates might need to be gradually raised;

- International, regional and GCC-based financial institutions could scale up their efforts to provide non-sovereign guarantees for cross-border investment in transition countries. Investments that have a high impact on growth and employment generation should be prioritized. As an example, MIGA has developed a US$1 billion MENA initiative to mitigate the costs associated with heightened risks for investors in the region;

- Trade agreements with the European Union need to be revised so that the region can obtain greater market access in the agriculture, textile and service sectors in order to boost sustained economic diversification;

- Temporary migration schemes inspired by the German-Polish scheme should be tested, with the aim of transforming them into transitional migration programmes;

- Egypt, Libya and Tunisia will need technical and legal assistance in recovering assets held abroad by former regime figures that could be used to finance solutions to some of the medium-term socioeconomic challenges of transition;

- Such regional organizations as the Organization of American States, the European Union and the African Union have adopted formal agreements that commit their members to democratic principles and even to responding collectively in the event of unconstitutional regime changes. ACTs could promote a similar subregional agreement;

- Some room for exchange rate flexibility is advisable for such commodity-importing economies as Egypt, the Syrian Arab Republic and Yemen in order to give more leverage to monetary policy with exchange rates capable of adjusting to external shocks while helping to maintain competitiveness.

Medium-term recommendations (2-5 years)

- The independence of the judiciary must be ensured, antitrust laws enforced and independent regulator legal frameworks strengthened;

- PFM reform strategies need to be adopted in countries where they have not as yet been established and notable gaps exposed by Public Expenditure and Financial Accountability (PEFA) assessments must be addressed;

- Stronger regional integration should be promoted in order to widen small national markets and the scope for economies of scale, as well as to attract more foreign and regional investment;

- Non-tariff and service-sector trade barriers pose the biggest constraints to regional integration. In the medium term, the free movement of goods within PAFTA could be achieved by eliminating unnecessary non-tariff barriers, and a major regional initiative could be launched to liberalize trade in such relevant services as financial services, transport and logistics, ICT, and key professional services;

- A new set of basic principles for the governance of PAFTA must be agreed upon, including the strict but simple regulation of non-tariff measures, and a permanent and independent dispute settlement mechanism to oversee enforcement should be created, including measures to ensure compliance;

- Social security systems should be designed in such a way as to allow for the portability of benefits during employment transitions and also for bridging spells of unemployment. This means that systems of unemployment insurance need to be integrated with pension and health-care systems, ensuring that benefit entitlements and coverage are not lost;

- An open consultation process could be set up with the business community, and inter-agency coordination should be improved for more effective planning and policymaking;

- The unfinished agenda of banking restructuring needs to be finalized through stringent and prudential regulatory and corporate governance frameworks being imposed, hard budget constraints and reputable foreign strategic investors being accepted;

- High tax rates raise labour costs, shift incentives towards informal labour and undermine job creation. Tax wedges on labour must be kept low and tax policy shifted from labour to other such sources of income as immovable property;

- A gradual shift from product-based subsidies to targeted social safety nets is advisable;

- Policy options for social security reforms that benefit youth and women need to be investigated, drawing on the experience of other such transition economies as Turkey, which has recently approved a labour reform package subsidizing social security contributions for these groups within a phasing-out period during which the labour entrant would have acquired the skills needed on the market. The possibility of cross-subsidizing similar programmes from such universal subsidy programmes as fuel subsidies should also be explored;

- In the longer term, subsidies should be phased out and replaced with family allowances. This would assist the poor and also help put an end to the plethora of relatively ineffective and uncoordinated safety nets currently in place. Family allowances for low-income families will be particularly effective if linked to active labour market policies;

- Lessons can be learned from successful reforms in TVET systems and dedicated training programmes and internships for the unemployed. A positive example are those systems established in Latin America initially inspired by the Chile Joven programme;

- Limited efforts have so far been made to promote regional cooperation in agriculture and food security, but options include: (a) establishing a guarantee regional fund for agricultural sector investment; (b) creating a regional fund to hedge against high food prices and to finance short-term food relief; (c) promoting a multilateral research agenda and a regional agricultural research and development fund; and (d) establishing a regional food security monitoring and early warning system;

- Cadastres of all countries need to be enhanced and digitalized. Immovable private properties valued above a pre-determined threshold should be taxed;

- Pension policies need to be fine-tuned to fit the underlying economic and institutional characteristics of a country: middle-income countries should implement regulatory steps towards administering multipillar pension schemes composed of mandatory and contributory pillars, while low-income countries should keep a flat benefit structure to protect the poorest elderly;

- Specific minimum wage and non-wage benefits, particularly pension remunerations and family allowances, could be introduced for young new entrants to the labour market;

- Regional support initiatives could strengthen governance mechanisms, particularly in natural-resource-based economies. Such initiatives as the Extractive Industries Transparency Initiative (EITI) and Publish What You Pay (PWYP) could help the regional public and policymakers advocate greater revenue and expenditure transparency;

- A reasonable maximum ceiling on the number of dependents, often set around three or four, for family allowances should perhaps be set, in line with the national strategy for accelerating the demographic transition;

- Wage bargaining needs to be linked to labour productivity rather than just to inflation. Opportunities should be explored for region-based collective bargaining in countries where labour mobility is very low and there are wide unemployment disparities between a country’s regions, for instance, in Egypt;

- Competitive funding mechanisms for public and private education service providers could be established, particularly in TVET and higher education, including voucher schemes, as well as research and development;

- A Bologna process of harmonizing tertiary education systems for the Euro-Mediterranean region should be put in place. This could be combined with a specific student mobility programme, similar to the Erasmus Programme of the European Union, within the Arab region but also with the European Union, United States and such emerging economies as BRICS;

- Governments could introduce incentives to encourage companies to place initial public offerings on the stock market;

- The development of the non-banking financial sector to support SMEs through innovative financial instruments, including, among others, factoring and leasing, and venture capital, should be a priority;

- Public works programmes in water management are considered to be doubly advantageous as they create jobs while building useful infrastructure systems. Priority should be given to water infrastructure systems that could prove critical, particularly in rural areas, in the conservation, reuse and recycling of water;

- Intraregional migration as well as migration between MENA and the European Union should be promoted and regulated through social security systems, primarily pensions, unemployment and health insurance, to support mobility and portability, while providing adequate protection to workers;

- Macroprudential instruments must be strengthened by adjusting minimum liquidity and capital requirements according to macroeconomic and aggregate financial indicators as well as to results of regular stress testing of the national financial systems. The development of early warning systems will enhance stability in the financial sector;

- Statistical offices and analytical capacity need to be expanded in order to provide more in-depth economic analysis. A number of core indicators, particularly those concerning work conditions and informality, are not available, and this data gap needs to be addressed;

- Spending should be smoothed out, making it more predictable. It should also be delinked from volatile revenues through firmly designed and rooted government budgets within a medium-term expenditure framework (MTEF), which will also help in the design and implementation of a consistent and sustainable countercyclical stance over three to four years;

- It is important to strengthen the capacity of macrofiscal units within ministries of finance or to establish them where they are still lacking;

- Horizontal industrial policies should be favoured over vertical policies as they tend to adjust more easily to changing economic conditions. The playing field must be levelled across industries, transparency increased, backroom politics discouraged, and steps taken to avoid the creation of privileged cronies that will lobby to maintain acquired privileges. It should be borne in mind that horizontal policies suffer from collective action problems and are long term in nature;

- Such enhanced governance efforts in the financial sector as increased bank competition as well as allowing foreign banks to enter domestic markets, stricter disclosure rules, a legal framework that guarantees the independence of central banks and stronger supervision powers will all help to deepen and stabilize the financial system;

- Spreading government debt over a wide range of maturities can help make fiscal and monetary policy instruments more effective;

- Fiscal balance should be used dynamically in favour of pro-growth policies while maintaining fiscal discipline in the medium term. Different options should be explored, namely: (a) targeting a medium-term level of public debt to GDP ratio and using the primary balance as a fiscal tool, thereby allowing some flexibility in the short run while maintaining the confidence of the investors; and (b) setting a cyclically adjusted annual budget balance, as is done in Chile;

- Shifting the financing of government budget deficit from bank borrowing to issuing treasury bills would free up opportunities for banks to focus on lending to the private sector;

- Labour regulations should be relaxed and real collective bargaining promoted, supported by an effective tripartite system based on independent trade unions which may also include the unemployed in their constituencies and employers associations, including SME representatives. Such effective social protection systems as unemployment insurance must also be strengthened so as to make labour allocation more flexible and efficient, thereby reducing the frictional costs of employment transitions. This would require a policy shift from placing the burden of protecting workers at the level of the employer to general protection schemes that draw resources from the general budget;

- Given that private investment tends to be more risk averse and, therefore, more volatile than public investment, which generally dries up and recovers more quickly during transition, it is crucial that public investment complements it and facilitates its rebound rather than acting as a substitute;

- Frameworks need to be developed for land policy, including public consultation. The normative framework, including human rights and gender issues, law enforcement, access to justice, and recognition of customary land rights, and the institutional infrastructure for land administration both need to be reformed;

- ACTs should pursue the following strategies to reduce the impact of volatility and high international prices of food commodities, depending on the national context: (a) build up strategic grain reserves, including at the sub-regional level; (b) develop strategic partnerships while maintaining a diversified portfolio of suppliers; (c) hedge price volatility by utilizing such financial tools as options and futures; and (d) invest in infrastructure and import supply chains to preserve the base cost of food imports, while reducing loss;

- A new title-based property registry and associated property tax should be legislated and then applied to locations of high development interest, namely, areas with particular commercial and business potential. Other such areas as rural areas could be added to the system over time, once both smooth property registration and taxation systems are already up and running;

- The national cultural heritage ought to be tapped into in order to gradually shift from beach-type tourism to a more culture-based sector that has higher multiplier effects on local economies;

- Social assistance targeting needs to be improved in low-income countries through geographical and community-based targeting, as well as self-targeting methods;

- Universal fuel subsidies should be replaced with better targeted subsidies and a more effective social security net framework needs to be established, a process that will entail: (a) consolidating fragmented SSN programmes; (b) starting reforms by addressing the such issues as fuel subsidies, which are the least politically sensitive and, hence, more viable from a political economy perspective and which are incidentally also highly regressive; (c) reaching out to the public regularly so as to build their interest and commitment to reforms; (d) prioritizing such programmes that help build the assets of beneficiaries, particularly human capital, as cash transfers and workfare programmes conditional on building human capital that can help to alleviate poverty as well as limit damage from shocks; (e) strengthening data collection and monitoring and evaluation of SSN programmes for a better evidence-based evaluation of their impact; and (f) using such ICT tools in programme management as a unified electronic registry of beneficiaries, or different registries that can be linked to one another, and smart cards. Egypt is ahead of other peers on this;

- Unemployment insurance should be introduced in middle-income countries;

- The Maghreb integration process should be reinvigorated;

- Support for donors needs to shift from tiny ad hoc projects with no impact to budget support programmes around priority areas set by the government. Implementing the principles of the Paris Declaration on Aid Effectiveness in this critical phase is a priority for effective and sustainable ODA;

- Credit concentration needs to be gradually reduced. Banks exposed to high credit concentration risk should ultimately be subject to additional capital requirements. State-owned banks should be regulated and supervised like private-sector banks;

- It is important to strengthen financial supervision and macroprudential assessment capacities of supervising authorities in the banking and non-banking financial sector. Cooperation and the exchange of information among different sectors or national supervisors need to be built;

- Financial institutions specialized in financing SMEs should be established. They could also be entrusted with managing government equity holdings so as to provide a one-stop-shop offering a complete range of financial services to SMEs, including guarantees, leasing and loans for working capital;

- There is a need for such operational measures in security market regulations that aim to increase competition as establishing caps on the size of allocated bids and opening non-competitive auctions to large public-sector funds to enhance control of debt among different types of investors;

- The region should explore innovative methods for encouraging the financial sector to expand its lending operations to rural areas;

- The infrastructure systems in need of support in rural areas are mostly feeder roads, small rural clinics and rural water supply networks. Support can be implemented through activating community-based mechanisms to design and monitor the systems, thus overcoming weaknesses in official monitoring and evaluation mechanisms;

- Tourism has great medium-term potential. So far, the countries that have benefited the most from tourism are Egypt, Jordan, Lebanon, Morocco, and Tunisia. Libya, the Syrian Arab Republic, and Yemen also have great potential and should develop their international tourism industry further, given their touristic assets and geographical proximity to the European and GCC markets. Political stability is a crucial prerequisite to tapping into this industry, the economic and employment potentials of which are comfortably in the zone of around and even beyond 10 per cent of GDP and employment for ACTs;

- Well-elaborated public works programmes can create jobs for a critical mass of unemployed persons and impact the unemployment problem, though not sufficiently to deal with the overall problem. Also, such programmes will be of very limited use in dealing with the thorny issue of graduate job seekers;

- Allowing dual citizenship and granting voting rights to the diaspora can encourage migrants to maintain ties with their countries of origin. Avoiding the constraints foreigners face on certain such transactions as temporary work and land ownership, and allowing them access to public services and social benefits would likely promote investment in their countries of origin.

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