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Opening up and Distribution in the Middle East and North Africa: The Poor, The Unemployed and The Public Sector*

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Abstract

The paper reviews the links between long-run growth patterns, the process of opening up, and the effects on income distribution. Three themes are developed. First, the historical pattern of development brought dividends to all until the end of the oil boom, but is now bankrupt and is a potential disaster for poverty and employment. Second, much of the region is on a knife edge between two options: opening to trade combined with public sector reform and hanging on to the old path and social contract. Risks are attached to both paths, but the first can lead to robust and broad employment growth in the medium term, while hanging on to the old path is likely to lead to sharpened distributional conflicts. Third, sequencing of policy reforms matters: the best sequence is to open first, and undertake employment-reducing public sector reform afterwards.

ملخص

تستعرض الورقة الروابط بين أنماط النمو طويل الأجل، وعملية الانفتاح، والآثار على توزيع الدخل، وتم معالجة ثلاثة مواضيع. أولًا، لقد جاء النمط التاريخي بربح للجميع استمر حتى نهاية الازدهار النفطي، إلا أنه قد أفسد الآن وأصبح بمثابة كارثة على الفقر والتنشيط. ثانياً، أصبح جزء كبير من المنطقة على حد السكين بين خيارين: الانفتاح على التجارة مع اصلاح القطاع العام، أو الشريعة بالمنهج القديم والعقد الاجتماعي، والمخاطر المرتبطة بالمنهجين، غير أن المنهج الأول قد يؤدي إلى نمو متناسب وواسع في التنشيط على المدى المتوسط، في حين أن الشريعة بالمنهج القديم قد يؤدي إلى ازدحام عدة النزاعات المتعلقة بتوزيع الدخل. ثالثًا، إن تسلسل الاصلاحات السياسية أهميته: والنسل الأمثل هو تطبيق الانتفاح أولاً، يليه تخفيف العزلة الناجمة عن إصلاح القطاع العام.
INTRODUCTION

Opening an economy to international trade and capital seems both a desirous and perilous activity. No economy has achieved sustained, rapid growth in wages and employment without making use of international markets. Yet, at the point of opening, fear has too often been the dominant collective emotion, whether of specific groups or the whole populace, fed by anticipation of job loss or wage declines. Nowhere is this apparent paradox more evident—and more relevant—than in the group of Middle Eastern and North African economies. Almost all pursued employment strategies dependent on growth of public sector employment coupled with substantial expansion of education for public sector jobs until the early 1980s—with the boom and bust in employment closely linked to the oil cycle. This strategy is now bankrupt: in most countries public sector wages have stagnated or fallen and unemployment has risen, while in some returns to education have significantly declined. One group has already started to follow the first path (including Morocco, Tunisia and Turkey) while another group (notably Algeria, Egypt, Syria and Yemen) remains stuck on the second. Some, notably Jordan, fall in between, while the West Bank and Gaza has an extreme form of the employment problems because of the political and economic environment in which it has been operating, more than internal policy choices. None has completed the transition. An employment malaise is present everywhere.

In this paper we review the links between long-run growth patterns, the process of opening up of economies and effects on different socio-economic groups. We mainly focus on the middle income Arab countries that have been reviewed more thoroughly by the authors¹, but also refer to Turkey. We discuss overall effects on income distribution and in particular explore stylized effects on three groups: the poor or near-poor, the unemployed and public sector workers.

The paper explores the following three themes:

- the historical pattern of development and implicit social contract brought dividends to all until the end of the oil boom, but is now bankrupt and is a potential disaster for poverty and employment in the long run;

- much of the region is, or has been, on a knife edge between two options: opening to trade combined with public sector reform; and hanging on to the old path and social contract. Political risks are attached to both paths, since both involve losers, but the first can lead to robust employment growth, the maintenance of reasonably equal income distribution and poverty reduction, at least in the medium term. Hanging on to the old path is likely to lead to sharpened distributional conflicts, and further loss of social cohesion.

¹ See World Bank 1995b.
• sequencing of policy reforms matters: probably the best sequence is to open first, and undertake employment-reducing public sector reform afterwards. But interactions are key—some fiscal adjustment is necessary throughout to cushion reform and buy off permanent losers, while failure to follow opening with deep public sector reform can lead to a fragile and unstable position. Restructuring public employment is central to public sector reform.

The paper is organized as follows. The first section outlines the key facts on employment, unemployment and poverty in the region. The second relates this to interactions between growth, openness, and education, and describes the actual historical pattern of development in the region. The third sets the international stage in relation to the domestic plight many countries are in. The fourth discusses the consequences of opening of economies for different groups, and the fifth briefly looks at the questions of sequencing of public sector and trade reform from an employment perspective.

1. UNEMPLOYMENT, POVERTY AND THE PUBLIC SECTOR--SOME STYLIZED FACTS

The Region is struggling with a deep-seated employment problem. This has the following symptoms: high unemployment, stagnant or falling wages, high public sector employment, and (in some) low or falling returns to education, in part linked to wage compression in the public sector. Despite a generally dismal employment situation, poverty is relatively low for the income level, a reflection of relatively equal income distribution. There is, of course, substantial diversity: in general the group of reforming countries (especially Morocco, Tunisia and Turkey) have begun to work their way out of some of these difficulties; while those stuck on the old growth path, whether due to policy or politics, are suffering worsening problems. And there have been large changes over time, reflecting the boom and bust that has mirrored the oil cycle. We will frequently come back both to the diversity and the boom and bust cycle, but it remains useful to start by characterizing the inherited situation in terms of five stylized facts.

High unemployment. Unemployment has risen enormously and is now higher than in any other region of the world (Figure 1). On average 15 percent of the regional labor force is unemployed. In Algeria, Jordan, Tunisia, the West Bank and Gaza and Lebanon, unemployment rates exceed 15 percent; in Egypt, Morocco, Turkey and Yemen unemployment is 12-14 percent of the labor force, and only in Syria is recorded unemployment less than 10 percent.

In most countries, the unemployed are predominantly first-time job seekers, reflecting the fast rise in labor supply as baby-boomers enter the labor market. But the proportion of young workers among the unemployed is especially large in Egypt and Syria (at about 80

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2 The working age population grew at over 3 percent per annum in the past thirty years, the fastest of any region in the world. See World Bank, 1995e.
percent) where first time entrants have to line up in order to get increasingly scarce jobs. In Jordan, Morocco and Tunisia however, reforms have shaken up previously protected industries, and over half of the unemployed have lost a previous job.

Figure 1. Unemployment in MENA and other regions

Note: The regional unemployment rates are weighted averages for a sample of countries within the region where the weights are the shares in the working age population in 1995. For MENA region the sample comprises Jordan, Tunisia, Yemen, Syria, Algeria, Morocco, Iran, and Egypt.


MENA: Middle East and North Africa
ECA: Europe and Central Asia
SSA: Sub-Saharan Africa
LAC: Latin America and the Caribbean
SA: South Asia
EAP: East Asia and the Pacific

In the countries where public employment is large, unemployment is high among the kind of workers that are over-represented in public service. In Egypt, Jordan, and Syria, the share of young workers with secondary education among the unemployed is abnormally large at between 40 and 60 percent (Table 1). In Egypt, workers with more than secondary education represent 26 percent of the labor force but they hold 60 percent of public sector jobs and make up about 60 percent of the unemployed; in contrast, they constitute only about 20 percent of private non-agricultural sector employment. This pattern is also marked among women where they were disproportionately employed in the public sector, as in Egypt, Jordan, and Tunisia. In Egypt 71 percent of women with university degrees work for the state, and their chances of being unemployed are about 5 times larger than for men. This kind of unemployment tends to have long duration, young workers lining up until jobs in the public sector open up.
Table 1. Unemployment structure in the Middle East and North Africa

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Unemployment Rate (%)</th>
<th>First time job seekers as percent of total unemployed</th>
<th>Young entrants (25 yrs and less) as percent of total unemployed</th>
<th>Those with at least secondary education as % of unemployed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2) (3) (4) (5) (6) (7) (8) (9) (10)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Algeria</td>
<td>1991</td>
<td>21.0 22.0 17.0 .. .. .. 40.0 31.3</td>
<td></td>
<td></td>
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<tr>
<td>Egypt</td>
<td>1991</td>
<td>10.6 6.3 27.8 8.8 13.1 76.6 78.4 57.0</td>
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<tr>
<td>Iran</td>
<td>1991</td>
<td>9.1 11.1 9.5 24.4 12.4 10.2 .. 33.3</td>
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<td></td>
</tr>
<tr>
<td>Jordan</td>
<td>1991</td>
<td>18.8 .. .. .. .. 37.2 58.0 53.0</td>
<td></td>
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</tr>
<tr>
<td>Morocco</td>
<td>1991</td>
<td>12.1 11.6 13.0 5.6 20.6 45.6 41.0 24.9</td>
<td></td>
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<tr>
<td>Syria</td>
<td>1991</td>
<td>5.7 .. .. .. .. 78.0 68.0 45.0</td>
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<tr>
<td>Tunisia</td>
<td>1993</td>
<td>16.1 14.7 21.9 14.8 15.6 42.7 54.5 31.0</td>
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<tr>
<td>WBG</td>
<td>1993</td>
<td>15.3 8.4 2.7 .. .. .. ..</td>
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<tr>
<td>Yemen</td>
<td>1992</td>
<td>12.3 14.0 6.0 11.4 16.3 32.0 .. 18.0</td>
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</tbody>
</table>

.. Not available.

* In some cases the definition of unemployment is not consistent with ILO definition.


Falling wages. Formal sector wages declined in most countries in the mid to late 1980s and have stagnated since. In manufacturing, for which data exist for most countries (from UNIDO), wage growth during the 1970s was comparable to that of East Asia, Latin America, and Eastern Europe. But while wage growth continued in East Asia in the 1980s, they fell in other regions, with particularly sharp declines in the Arab countries, by some 30 percent on average. This reflects the tail end of the oil-based boom and bust cycle and the failure to achieve sustainable growth in labor demand for other sources.

There is again significant diversity in experiences. The sharpest recent declines have been in those countries that have felt the full brunt of the international oil cycle and its spillovers, and have not yet undertaken, or completed, reforms, such as Egypt and Jordan. Morocco had more moderate decline in wages. Turkey experienced falling wages during much of the 1980s as part of its stabilization and restructuring strategy, but then experienced a sharp real wage in the early 1990s.

3 World Bank, 1995f.
High public sector employment. The public sector is a big employer in the Region, probably employing a higher fraction of the workforce in any Region outside the centrally planned states. The share of the labor force employed in the public sector is commonly between 30-40 percent (Figure 2). Central government employment varies between nearly 20 percent in Morocco and Tunisia to 40 percent in Jordan. In all countries, central governments are larger than the average for middle income countries⁴; indeed, they are larger than in rich OECD countries (18 percent). Public enterprise employment is also high in several countries. It is highest in socialist Algeria (31 percent of the labor force), followed at a distance by Egypt and Tunisia (around 10 percent). In the OECD and Latin America, the comparable figure is only 5 percent.

Figure 2. Workers in the public sector as a share of total employment

![Diagram of Figure 2]

Note: Morocco: Urban areas only. Bahrain & Kuwait: Nationals only.


While the public sector has been large in the numbers of employees, it has been increasingly poor in the wages offered. In the post oil bust, post-stabilization period the characteristic response of public sectors has been to keep expanding employment but to squeeze wages.⁵ The syndrome of the large, but poor state is now widespread, but again particularly severe amongst those hard-hit by shocks and stuck in the old path. In Egypt

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⁴ For example, Turkey and Greece: 10 percent; Spain and Portugal: 15 percent.
government wages fell 50 percent between 1980 and 1992, but government employment rose 80 percent, almost entirely by 1990.\(^6\)

**Figure 3. Government wages and employment**

\[\text{Index of Real Wages in the Government (1980=100)}\]

\[\text{Index of Government Employment (1980=100)}\]


*Low returns to education.* Low and falling returns to education is a feature of some economies—though here there is relatively sharp contrast between those stuck, for various reasons, and the early-reforming group. Returns to education are low in Jordan and Egypt, and barely exist in the West Bank and Gaza, but are much higher in Morocco and Turkey—comparable to an East Asian economy such as Thailand.

Where the public sector is large it has an important influence on overall wage structures. While public sector wages have fallen across the region they have tended to remain higher than in the private sector for the average public servant. In Morocco and Tunisia, wages are higher in the public sector at all skill levels.\(^7\) In Egypt and Jordan, cash wages are now lower in public sector, but recent studies show that once the value of all benefits are taken into account, the wage differential between the public and private sectors are about 20-40 for the average public servant.\(^8\) Civil service pay tends to be more sensitive to seniority than the private sector, less sensitive to performance, and less dispersed across skill levels than private wages. As a result, women, older workers, and workers with medium levels of education tend to earn higher wages compared to what they would command in the private sector. The general effect is to distort the structure of wages and

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the returns to education. The one exception is that for women lower differences in public employment may reflect the benefits of a public sector working against norms of discrimination in many societies.9

Figure 4. Returns to education for men

(Wage with schooling/wage with no schooling)

<table>
<thead>
<tr>
<th>Country</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Bank &amp; Gaza</td>
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<tr>
<td>Egypt</td>
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<tr>
<td>Jordan</td>
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<td>Tunisia</td>
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<tr>
<td>Morocco</td>
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<tr>
<td>Turkey</td>
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<tr>
<td>Thailand</td>
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</tbody>
</table>


In Egypt, there is evidence of public sector wage compression over time. For other countries there is evidence of compression not over time, but by comparing wage differentials among private and public sectors. In the public sector, the ratio of skilled/unskilled is smaller than in the private sector, while the difference for unskilled is smaller.10

Relatively low poverty and equal income distribution. Poverty levels, unlike unemployment, are low by international standards. Using a conservative poverty line of $30 per person per month11, the estimated average poverty for six countries in the region with information (Algeria, Egypt, Iran, Jordan, Morocco and Tunisia) was 6 percent in 1990 compared with 28 percent in Latin America, despite only slightly lower average

9 See also World Bank, 1995b for the case of Jordan.


11 More precisely, this is a cutoff of $30 for average monthly per capita consumption in terms of 1985 purchasing power parity dollars. While a figure of $30 per month is a useful yardstick for international comparisons, most observers of the region would probably use a higher cutoff for absolute poverty. Using a cutoff of $50 per month for per capita consumption raises the headcount ratio for poverty to 18 percent for the six countries in 1990, ranging from 7 percent in Algeria, to 24 percent in Egypt and 36 percent in Jordan.
This reflects the relatively low degree of inequality in the Region—much less than Latin America or the more unequal East Asian societies, such as Malaysia, but still more unequal than formerly centrally planned countries, such as Hungary. This relative equality of income and spending probably reflects a combination of relatively equal asset distribution and substantial private transfers between households, that survey evidence (for example from Jordan) finds to be well-targeted on the poor.

In most countries, the key poverty group is rural households with little or no land. Jordan is an exception, with private employees in urban areas accounting for a high fraction of the poor. Elsewhere, urban poverty, while relatively low, is highest amongst low-skilled workers in the informal sector. In all countries poverty is strongly correlated with lack of education, and with large households with few bread-earners. Although some of the unemployed are poor, most of the poor cannot afford to remain unemployed.

Changes in poverty have generally reflected the overall economic cycle. Where average incomes rose between 1985 and 1990, as in Algeria, Morocco and Tunisia, poverty fell; where incomes fell, as in Iran and Jordan, poverty rose. In Egypt poverty rose despite a small rise in average incomes. This reflected worsening in inequality. There has also been a change in inequality in Morocco, Tunisia and Jordan. As measured by the Gini coefficient it has risen slightly in Morocco (39.1 in 1985 up to 39.6 in 1991), fallen in Tunisia (from 43.5 in 1975-85 to 40.2 in 1990), but has risen in Jordan (36.2 in 1986 to 43.3 in 1992). Thus, a lot of the reduction in poverty in Morocco and Tunisia was due to growth rather than redistribution effects (which were small and positive for Tunisia and small and negative for Morocco). At the same time, a measure of income dispersion (household income ratio of the top to bottom quintile) has risen in the three countries and especially in Jordan and Morocco.13

2. OPENNESS, LABOR DEMAND AND EDUCATION: ALTERNATIVE GROWTH DYNAMICS

We have five stylized facts: high unemployment, falling or stagnant wages, high public employment, low returns to education (for some), and relatively modest but rising poverty incidence. In this section we seek to relate these to patterns of development. Some may see pressures on employment as a characteristic feature of a market-oriented growth path and an increasingly integrated world—this is after all a hot item in industrial countries. We first sketch a scenario of a virtuous long-run cycle in which openness can lead to highly favorable employment outcomes. We then describe the key features of the very different actual pattern of growth pursued in much of the region that help to explain the stylized facts. We come in a subsequent section to issues of transition.

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A Virtuous Long Run Cycle

The fast growing East Asian economies exemplify a pattern of growth in which educational expansion, investment and openness interacted to produce huge, sustained increases in labor incomes, large reductions in poverty and generally some reduction in income differentials (though country differences vary). The gains have been astonishing: as a group they enjoyed industrial wage growth of 170 percent and employment growth of 400 percent between 1970 and 1990. Three things can be learned from the pattern of growth that are of relevance here.

First, growth in labor incomes are essentially driven by increases in labor productivity. In this the East Asian stars excelled. Rising labor productivity can be thought of as being determined by three things: capital accumulation (that raises the ratio of physical capital to labor), expansion in skills (that raises the ratio of human capital to workers) and the effectiveness with which these factors are combined (including gains from structural shifts, better use of resources and from technological change). There is some debate about what proportion of the better performance of East Asia is attributable to each of the three determinants. All observers agree that capital deepening was key and that skills mattered. Some think that's the end of the story, others that in East Asian economies the residual, or total factor productivity growth, also grew significantly faster.14 We don't need to take a strong position on this--since what matters is that workers were able to reap the gains from accumulation and technological change in the conditions prevailing in fast-growing East Asian countries.

Second, openness was important in sustaining both labor demand and labor productivity growth by releasing growth in production of non-food tradeables, especially in manufactures, from the constraints of domestic demand, and encouraging productivity-increasing structural change, both has workers moved from lower to higher productivity activities (at a broad level, agriculture to manufacturing and services) and through the induced productivity growth within subsectors encouraged by international trade. There were large movements of labor out of agriculture into secondary and tertiary activities, complemented by rising labor productivity in agriculture. The balance of distribution between the two latter sectors largely depending on the countries comparative advantage in trade. In resource-poor countries such as Korea a high fraction of workers went into manufacturing, while in resource-rich ones, such as Indonesia and Malaysia, more went into services, though labor-intensive manufactures have still been an important source of employment growth.

Third, there was a changing but happy equilibrium between growth in demand for skills and expansion in education systems, that contributed to rising average productivity and underpinned the steady structural shift in production and trade. All the successful East

14 Compare, for example, World Bank, The East Asia Miracle (1993), with Alwyn Young 1993.
Asian countries invested heavily in basic education—often in the decade or so prior to rapid growth, so that when growth took off, it did so in parallel with quite fast rises in the skills of the workforce. This supported the initial shift into labor-intensive manufactures, for which basic education is usually a prerequisite, and then the steady move into more skill-intensive activities, that countries such as Korea, Hong Kong, and Malaysia have passed through.

Capital-deepening is obviously good for labor productivity, when the capital is combined effectively with labor and skills put to good use. But behind these developments were also a set of relationships between growth, openness and skills. Growth itself characteristically leads to rising demand for skills—induced by the structural transformation of production from agriculture to industry and services. The effects of openness are more complex. We return to this below, but it is worth thinking broadly in terms of two factors, both of which can be observed in the East Asian context. First, there are effects of trade on the international division of labor and consequently the internal structure of demand for labor of different skills type. Broadly a Heckscher-Ohlin view of the world, in which countries trade in line with their factor endowments holds. This is reflected in the strong correlation that exists between the structure or trade and the ratio of skills to land in a country—the higher the ratio the more a country exports manufactures. As skills-to-land ratios rise, countries increase their exports of manufactures—the characteristic trajectory of a most East Asian countries, though how much manufactures are exported at a point of time also depends on how resource intensive they are. Second, however, opening can itself induce demand for skills upgrading. Analysis of firm behavior in Taiwan, China and Malaysia finds that export-oriented firms, especially in the more technologically advanced sectors, also train their workers much more—providing evidence of higher demand for skills. We return to these relations below when we discuss the process of opening up.

Finally, the fast-growing East Asian countries have low open unemployment rates. This is for two reasons. First, steadily rising labor demand and growing wages absorbed a growing labor force, and meant that new cohorts didn’t enter work with expectations of jobs that weren’t met. Second, labor market dualism was relatively low by international standards—wages of those in “good” jobs, primarily in formal sector manufacturing and services, did earn more than other workers (even after adjusting for skill differentials) but the gaps were kept relatively low, most importantly by the market test of openness and relatively small public sectors.

16 See Bhatra and Tan, 1995.
17 See World Bank, 1995g.
The Arab Path--From Boom to Bust

As the stylized facts vividly show, the countries of the Middle East and North Africa did not sustain the happy paths for labor of most East Asian economies. We now turn to the relationship between their development paths and the adverse labor conditions of the 1980s and 1990s. However, we postpone looking at the initial effects of reform for those countries--especially Morocco, Tunisia and Turkey--until later.

During the 1960s and 1970s, the Arab economies were among the fastest growing in the world. The young states advocated modernity and "the big push," invested heavily in large infrastructure projects, built state industries and erected protective walls to nurture them during infancy, and sought shared growth and social mobility by encouraging education and initiating nationalization and land reforms. Fueled by the regional oil boom, average growth per worker was about 3 percent a year during 1965-80 -- not far below that of East Asia. As in East Asia, rising urbanization was a common feature of this growth path.

For the working population, this growth path brought large benefits. These flowed from two aspects of the development pattern, for both of which the public sector was key: policies that promoted the modern sector, especially through expansion of millions of jobs in government services and protected public enterprises; and vigorous expansion in publicly-funded education, at all levels. This was to large extent financed by oil. And since oil was concentrated in only some of the states, it had an important international dimension, with economies with high ratios of labor to oil reserves--notably Jordan, Egypt, the West Bank and Gaza, and Yemen--getting access to the jobs and resources to underwrite this strategy through a mixture of migrants flowing out to the oil centers, and oil money flowing in (in grants and remittances). The labor surplus economies exported workers directly rather than moving into labor-intensive manufactures. In a comparable fashion, large numbers of Turkish workers went to Germany.

The old social contract kept labor demand, especially for educated workers, high though policies that protected and promoted the modern sector. Food and consumption subsidies were also broad, bringing benefits to the middle classes and the poor. Unskilled workers reaped gains from domestic and international construction booms. And there was the promise of social mobility through education and public employment.18

When oil prices collapsed in the mid-1980s, the old sources of employment growth collapsed too. The combination of declining public sector revenues, fast-rising labor supply, rapid urbanization, and large gains in education have rendered the old social contract unaffordable. Since the second part of the 1980s, growth performance has been dismal (Figure 5). Labor productivity has stagnated in the non-oil producing countries and has fallen by more than 4 percent a year in the oil producing countries. The slow-

18 Richards, 1995.
down in the demand for labor in Europe, and later in the Gulf has depressed labor markets in the sending countries. At the peak in the mid-1980s, there were over 5 million Arab workers in the Gulf, and perhaps half as many migrants from the Maghreb working in Europe. This exodus accounted for 10 percent of the sending countries' labor force on average (much more for Jordan, Lebanon, the West Bank and Gaza, and Yemen), boosted wages at home, and generated large remittances.19

Regional and European labor markets stopped growing in the mid-1980s. Work in the oil-rich economies took a plunge with the Gulf war in 1991, hitting Jordanian, Palestinian, and Yemeni workers hard. In Jordan, returnees (about 10 percent of the labor force) crowded out young entrants to the labor market.20 They also invested parts of their savings, increased labor demand and reducing the effect of the shock, but this effect was only temporary. In the West Bank and Gaza, the return of highly educated Palestinians from the Gulf led to a crash in skilled wages, sending returns to education nearly to zero.21 More recently, many Palestinian workers were hit by the reduced access to the Israeli labor market. In 1992, about a third of the labor force (mostly unskilled workers) worked in Israel. In 1995, less than 10 percent received work permits. In Yemen, returnees represent about 13 percent of the labor force; unemployment soared and remained high as civil war broke out.22 In Lebanon, unemployment among the population displaced by the war has been estimated to be twice the national average.23

At the same time, the public sector, which was the main employer of skilled workers in many of the countries of the region is now under pressure. The limits of state-led growth were recognized in the region as early as the 1970s. But the massive external assistance received during the 1970s and early 1980s allowed the system to continue for an extra decade or so. With the oil bust, private labor demand slumped, and public sectors increased their hiring initially, financing their rising deficits with financial repression and external borrowing. In Algeria, hiring grew at 10 percent a year after 1985 when private demand stumbled.24 Half the new jobs created in Tunisia between 1982 and 1989 were in the public sector.25 The experiences of Egypt and Jordan were similar. Public hiring

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19 Up to 10 percent of GNP in Morocco, 12 percent in Egypt, 18 percent in Jordan, 22 percent in Yemen, and 30 percent in the West Bank and Gaza.


23 Issa, 1993.


accelerated and then stalled with the fiscal crisis and stabilization programs of the late 1980s.

**Figure 5. Annual growth in GDP per worker in MENA and elsewhere.**

![Graph showing annual growth in GDP per worker in MENA and elsewhere.](image1)


The private sector generated new jobs until the mid-1980s as rising incomes led to increased demand for labor in the service sector. The construction industry alone employed more than 10 percent of the labor force in most countries of the region, and up
to 20 percent in the Gulf.\textsuperscript{26} Protected private industries became large employers in Jordan, Morocco, and Tunisia. More recently, the rising scarcity of capital inflows, coupled with some measure of financial liberalization wreaked havoc on firms accustomed to two decades of cheap foreign exchange. Old firms in import-substitution sectors are now struggling and are a weak source of employment growth.

Overall the old path, and the associated social contract, quite effectively delivered expanding employment and reduced poverty for while. Public employment and protected industrialization can be a source of economic and employment growth for a while (compare the rapid growth of many Latin American economies in the 1960s and 1970s). When there is a massive positive resource shock it can be sustained for much longer. In particular oil could bankroll the cycle of public employment growth and provision of education for entry into public sector jobs. But the oil boom basically hid the underlying problems of an unsustainable growth and employment strategy. When boom turned to bust, not only did past sources of employment growth--both national and international--disappear, but the unproductive nature of many of the jobs created became an unhappy and problematic heritage for the future.

Why has unemployment stayed so high? As in Europe, only more so, large scale unemployment emerged because of the adverse shock of the bust--the dynamic of falling labor demand and continued rapid growth in supply. It has persisted because of the deep-seated expectations of the young--especially the educated young now in abundant rather than scarce supply, that a secondary certificate was the pathway to a “good”, modern sector job, and the capacity and willingness of families (especially non-poor ones) to support the unemployed. The old social contract is still present, if increasingly fragile, and within this contract it is the state that is expected to deliver jobs, especially to the educated.\textsuperscript{27}

With rising unemployment many governments responded, as noted above, with continued \textit{expansion} of public employment--most dramatically in Algeria since the late 1980s. But since macroeconomic difficulties put a lid on spending expansion, this was characteristically at stagnant of declining wages, further contributing to the phenomenon of a large pool of unproductive labor in the public sector, with little output contribution and a negative influence on public savings. Unlike some SubSaharan African countries (such as Tanzania) the process of wage decline has not been so steep as to put public sector wages below private sector wages in most cases--especially when non-cash benefits and greater security are accounted for (in Egypt for instance\textsuperscript{28}) But this

\textsuperscript{26} Al-Qudsi et al, 1994.
\textsuperscript{27} Richards, 1995
\textsuperscript{28} See Assaad, 1995.
employment strategy tends to perpetuate dualism and add to the future adjustment problems created by a large, poor state sector.

All three groups--public sector workers, the unemployed and the poor--suffered when boom turned to bust and the lack of viability of the old growth path and contract became exposed. With declining resources the specter of distributional conflict is now rising. Old forms of largesse--notably food subsidies--have often been cut drastically, in direct competition with the public sector wage bill. Food subsidies were typically cut more than salaries to labor elite.29 In Egypt, food subsidies fell by 5 percent of GDP between 1989 and 1993. The public sector wage bill fell by only 0.4 percent of GDP over the same period. They were virtually abolished in Jordan between 1990 and 1992, but the public sector wage bill kept rising, reaching 7 percent of GDP in 1993 (excluding military and public enterprises), an all time high. In Morocco, food subsidies were cut from 5.5 to 0.5 percent of GDP between 81 and 93. The wage bill rose from 11.1 to 14.3 percent of GDP over the same period. Only in Tunisia were food subsidies (and other social sectors) protected and made better targeted, falling from 3 to 2 percent of GDP in recent years (public sector wage bill constant since 1986).

Sooner or later some kind of change is unavoidable. But countries such as Egypt and Syria appear to be in a fragile state of paralysis. Meanwhile rising international integration is both creating opportunities and sharpening competition.

3. A WORLD OF RISING COMPETITION

The world is becoming increasingly integrated, as more and more countries open their borders to trade, as the capital market becomes increasingly international, and as costs of transport and communication have fallen sharply.30 The Middle Eastern and North African economies were traditionally highly integrated with the rest of the world via the oil market, and with each other via the labor market. With respect to capital there was quite a high degree of official capital movement from oil-rich to oil-poor countries, but probably the deepest form of integration for most was via capital flight to Zurich, London and elsewhere.

However, with the partial exceptions of first, Turkey and then Morocco and Tunisia, deep integration via open trading has been limited within the Region. In the international environment of the 1990s failure to effectively integrate production structures via trade will have high long-run costs. This means lost opportunities now, but more importantly countries that fail to integrate risk getting increasingly left behind. Much of the Arab world and SubSaharan Africa are the main parts of the world facing this risk. We quickly

30 See WDR 1995e, chapter 7.
survey the three channels of integration for the Region--via international migration, capital and trade--to provide the context for the opening faced by the regional economies.

International migration, as we have seen, was an integral part of the de facto growth and employment strategy of the past few decades, from countries with large populations relative to their oil reserves to oil-rich economies, to Europe and, for Palestinians, to Israel. It was a powerful source of labor demand, with important second round effects via the spending of foreign-earned income, that had a powerful effect on the bottom half of the income distribution.\(^\text{31}\)

This source of employment creation has now largely gone, and is negative linkage effects that are now usually more important. Palestinians lost jobs in the Gulf, exacerbating labor problems in Jordan, West Bank and Gaza, though these were hidden for while (apart from the collapse of skill differentials note above) by the spending from the repatriates savings of return migrants. When Israel cut migrant Palestinian employment labor difficulties turned into something closer to a labor crisis in the West Bank and Gaza. Yemen has also suffered a severe return migration shock. Labor market problems in Egypt and Syria are spilling over into Lebanon and Jordan.

Capital flows matter as much, or more than, migration flows for employment outcomes. Workers need productive capital to raise their productivity, while movements of financial capital have a powerful immediate effect on macroeconomic activity, and so on wages and employment. When capital flew out of the Region in the 1980s, workers were left to pick up the bill. As with Latin America--only more so--capital controls proved feeble in preventing private outward capital flight when the going got rough. It is now estimated that privately owned foreign assets is equivalent to some 90 percent of GDP, more than any other region in the world. This represents a large tax on past growth, but also an opportunity for the future, since it represents a pool of resources that could be attracted back if the conditions were right internally. Some of the potential has already been seen in the significant reflows of capital that occurred to Egypt in the early 1990s seduced by a combination of opening of the capital account, and the euphoria that flowed from the dual impulses of optimism over peace and the new-found international delight in "emerging" markets.\(^\text{32}\)

Capital flows into Egypt in the earlier 1990s did benefit workers--overall economic activity was higher than it would have been in their absence and this helped the national labor market. But capital is fickle and, to first degree, cannot be controlled, as the experience with capital flight in the 1980s only too vividly revealed. The only way to

\(^{31}\) Although the poor tend to be under-represented amongst migrants, who generally have some education and resources to move, the indirect effects via tightening the labor market, private transfers and second-round spending impacts, undoubtedly contributed to poverty reduction

\(^{32}\) Diwan and Squire, 1995.
permanently attract the capital that will help create sustainable jobs and raise productivity is through putting in place a sound political and economic environment for domestic investment. What happens to the progress toward Arab-Israeli peace will be a contributing factor to the willingness of both domestic and foreign capital to commit to the region and thus to job creation—that is more important the closer you are to Israel (i.e. mildly important for Morocco, but obviously vitally so for the West Bank and Gaza). Economic policy has little or no influence over peace. But it has strong influences over the expectations over profits and the perceived policy risks of investing. Workers, far from being in conflict with capital, have an interest in pushing for economic reforms that provide the macroeconomic conditions and the economic environment that provides a secure place for capital, but eschews special favors (whether via tax deals, special protection or kickbacks) that essentially are taxes on the local populace.

Of the three channels of international integration, trade is the one that is probably the most important in the long run, but the least exploited in the region (with the partial exceptions noted already). Meanwhile the world is in the midst of a profound opening. Economic reform is leading to the entry of huge pools of labor in South and East Asia, the former COMECON bloc and Latin America into world product markets. The Uruguay Round will both lead to some further opening, especially with respect to labor-intensive manufactures and agriculture (albeit modest), and, perhaps more importantly, helping to lock-in the ongoing process of opening.

The direct effects of the Uruguay Round on the Arab world are modest and negative, with a net loss of $3 billion. The two channels of influence lie via the liberalization of the Multifiber Arrangement, that will lead to lower prices of textiles, and partial liberalization of agriculture, that will lead to higher prices of foods. Since the Region exports textiles and imports food it suffers negative terms of trade effects overall, but farmers would enjoy gains in their terms of trade (assuming international price increases were passed on to them). In the long run, once effects via migration are worked through, the consequences are negligible for agricultural and unskilled workers, and slightly negative for skilled workers. If there is closer association with the European Union, however, there are much larger gains for farmers and, in the long run—after allowing for effects on rural-urban migration—small increases in agricultural and unskilled wages of some 3 percent, but still a small loss for skilled workers, owing to the effects of integration.

These estimates of the effects of integration miss out, however, on the more important consequences of opening. As noted in the brief review of the East Asian experience, it was not terms of trade effects that brought extraordinary long run growth, but the consequences of engagement in international markets—in association with sound domestic economic policies—for the growth of labor-using activities on the back of international markets, for structural shifts in employment and for productivity growth.

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33 This is based on the analysis in Diwan, Yang and Wang, 1995, that uses an aggregation for the Arab countries, and does not include Turkey.
The key lies in the inter-relationship between openness and the internal growth dynamic. Here even Morocco and Tunisia have lagged behind East Asian competitors, especially in productivity growth. It is noteworthy, however, that Turkey with the longest and deepest period of engagement in international markets, plus greater progress in policy aspects of integration with Europe, has a performance in productivity growth that rivals Indonesia and Malaysia.

An integrating world increases opportunities, but raises the stakes. Weak domestic conditions, in terms of politics, macroeconomics or the microeconomic and business environment, will lead to paltry capital investment and vulnerability to destabilizing international capital flows. Many countries within the region risk being left out of the global process of integration. And while there will always be some place in the international division of labor, the real benefits come from getting on to a path of rapid productivity growth and effective use of national skills. The next decade may even represent an opportunity for the region to open, especially with respect to Europe, before the full force of competition from Asia comes to bear on them with the removal of the Multi-Fiber Arrangement early in the next century.

4. THE PROCESS OF OPENING AND LABOR

We have argued that the employment strategy that lay within the old path of public sector expansion and education for public sector jobs is now bankrupt while the need to open into a more integrated world becomes ever more urgent. Some countries--notably Algeria, Egypt and Syria--are in a fragile state of paralysis, needing new economic opportunities to tackle persistent poverty and unemployment but fearful of the adverse effects of opening on inefficient and unproductive current employment structures, especially in the government and public enterprise sectors. Others--Morocco, Tunisia and Turkey--are beginning to break out of this vicious cycle and have used opening as a means to do so. But they remain in the midst of the transition and fears over unemployment remain, as does large public sector employment.

While the gains for workers from East Asian style use of international markets may provide compelling support for such an approach in the long run, most politicians are more concerned with getting from here to there. For this question, it is the transitional effects of opening that are likely to be of dominant concern. Opening involves changes in the pattern of demand for different products, with indirect effects on the pattern of demand for different categories of labor. It also involves an acceleration of the normal process of creation and destruction of jobs. It is useful to divide the effects into two:

- on public sector employment--for which the question of destruction of unviable jobs is key;
- on the overall structure of labor demand for skilled and unskilled workers.

34 World Bank, 1995f.
Effects on public employment are analytically easy and practically tough. Protected state enterprises in tradable activities, subject to the harsh winds of international competition, are likely to close or contract, in any case shedding labor. Both government employment and enterprise employment in services (utilities, for example) are shielded from the direct effects of competition, but there will be heightened pressure from the need for fiscal probity and higher quality services to raise productivity, layoff surplus labor and bring wage scales in line with the private sector. We saw above that the stylized facts on public employment is that it is too large (i.e. there is surplus, unproductive labor), that wages are generally not significantly out of line with the private sector on average, but that wage differentials are sometimes out of line.

So the impact effects on public employment are likely to be negative. In designing a strategy the key question then concerns the implications of opening for the level and structure of private sector labor demand. We discuss this here, including the relationship between medium effects and the timing of job losses. In the next section we briefly turn to the implications for managing the joint process of opening and public sector reform.

The dominant popular view in rich countries is that opening leads to job losses, especially amongst unskilled workers, and is a cause of rising inequality in the United States and persistent unemployment in Europe. While few observers would deny that trade with low-wage countries is a source of some job losses, the weight of the evidence in fact suggests that such trade contributes only part, and probably a small part, of the employment problem in rich countries. Technological change, slow supply responses in the creation of skills, and the functioning of labor markets in Europe, plays a larger role.\(^35\)

In low and middle income countries fears of job losses are also common. But it is important to distinguish between two processes: the effect on opening on the level and structure of labor demand once changes have worked their way through the system; and the likely acceleration of the process of creation and destruction that a change in incentives will bring. For the Arab countries--and to some extent Turkey--in the accelerated destruction of unproductive jobs is essentially the same as the public sector employment issue, while we are, for now, trying to focus on the lasting effects on the structure of labor demand.

The traditional view of economists is that opening in poorer countries would be unambiguously good for unskilled labor.\(^36\) This was based on both theory and evidence. Poorer countries that opened up would be expected to trade and produce more in activities that intensively used their more abundant factors of production. Natural

\(^{35}\) Wood, 1994; Lawrence and Slaughter, 1993.

\(^{36}\) In addition to the dynamic effects of getting on to a productivity and investment enhancing growth path emphasized above.
resources and land matter here—and we gave evidence above on the role of relative land availability in influencing trade patterns. There are then two reasons why unskilled labor would be expected to benefit from opening in labor-abundant poorer countries: across labor categories unskilled labor is abundant relative to richer countries; and for land-rich countries, expansion in agriculture involves higher demand for unskilled labor, that is complementary to land. For oil-rich countries the situation is different, since oil production is capital and skill-intensive, and most labor is in services—these are unlikely to export labor-intensive agricultural or manufactured goods.

Evidence for the view that opening increases the relative demand for unskilled labor comes from data on the higher unskilled-labor content of exports compared with (protected) import substitutes in many countries, and from observed narrowing of wage differentials over time in export-oriented economies—especially the four “tigers” of Hong Kong, Korea, Singapore and Taiwan, China.37 Evidence of actual changes over time is probably more compelling for a government contemplating opening. Unfortunately past work on these countries has generally failed to take account of shifts in relative supply of different categories of labor—and, as noted above, all of the economies were enjoying the fruits of previous educational expansion—nor of changes in labor market institutions. Moreover, more recent evidence, especially from studies of Latin American countries, more commonly finds evidence of widening differentials—notably in Chile and Mexico, also in Costa Rica and Colombia—that were broadly coincident in timing with opening.38 Attempts in some of these studies to control for effects of changes in relative supply of skills (in all cases there was an increase in the relative supply of skilled workers), confirm a shift in relative demand away from unskilled toward skilled workers.

How might opening lead to shifts in demand against the unskilled, when on the face of it, these are the abundant factor? The theory and evidence is still being disentangled—since most of the empirical work finding widening differentials is recent.39 There are three broad categories of explanation that appear promising:

First, widening differentials is a phenomenon that applies to middle income countries that are intermediate in relative factor shares between rich and poor countries and are experiencing the effects of the substantial increase in the international relative supply of unskilled-labor intensive goods due to the opening of Asian labor-intensive countries such as China, Indonesia and Bangladesh and India to trade. China’s exports to the European Union have risen from 2.3 percent of the EU’s total imports in 1985 to 4.9 percent in 1991. By one measure the relative price of labor intensive manufactures has fallen by 20 percent between the mid-1980s and early 1990s.

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37 See especially Krueger et al for the first category of evidence, and Wood for a survey of the latter.

38 See Robbins, Gindling and Robbins, Revenga and Montenegro, Hanson and Harrison

39 See Wood 1995 for a survey and discussion.
Second, openness releases the market for skills from essentially domestic factors. Closed economies that invest heavily in education might run into significant relative price changes due to the expansion of the supply of educated workers. Compressed wage differentials in Arab countries that remained closed and suffered stagnant modern sector job growth is consistent with this. For open economies the price of educated labor is going to be more strongly influenced by international trade, while unskilled wages may continue to be held down by large supplies of labor in low-productivity agriculture.40

Third, some categories of export—or features of exporting—may demand more skilled workers. It has often been argued that modern sector manufacturing requires at least basic education, in contrast to agriculture and informal sector services. This could be important for exports in which high quality is of importance. The same may apply to high-value agricultural production for rich country markets.41

What does this mean for the regional economies? There is little evidence on time series on skill differentials, but it is striking that the three economies that have initiated the process of opening—Morocco, Tunisia and Turkey—have higher returns to skills, but still not unusually high differentials by international standards. Those that are stuck have unusually compressed differentials, that raise questions on whether the return to education is going to be high enough to justify household investment in schooling. Opening may restore differentials in countries that have suffered significant compression. Beyond this, since most of the oil-poor economies fall around the middle of the international income and wage levels, effects of opening are going to be ambiguous on relative demand for skilled and unskilled labor. Much will depend on agriculture, to the extent these are potential exporters of agricultural goods (that tend to be more unskilled intensive). This is, of course, of particular importance to the poor who mainly rely on income from unskilled labor on farms. Finally, we should re-emphasize that net effects during the transition will also depend on the dynamics of creation and destruction of jobs, especially the timing of destruction of old protected jobs.

The experiences of Morocco and Tunisia, the early trade reformers of the region, illustrate well both the opportunities and difficulties ahead. Both countries started to liberalize their trade regime in the early 1980s. Quantitative restrictions were virtually eliminated in Morocco and their coverage reduced in Tunisia; maximum tariffs were reduced from 165 to 45 percent in Morocco and 235 to 45 percent in Tunisia. Since then, foreign investment has boomed, reaching $975 million in Morocco in 1993, and $600 million in Tunisia in 1994, with subcontracting business for European firms (especially in textiles and clothing) taking off.

41 See Robbins 1995 for this argument.
In these sectors, exports increased at a rate of 15 percent a year in Morocco and 12 percent in Tunisia between 1985 and 1991. Labor demand rose fast: in Morocco, total employment rose by about 5 percent a year in urban areas during 1984-1994; manufacturing employment rose at 10 percent; employment in the manufacturing export sector rose at a rate of 20 percent.42 But while employment expanded fast, measured average wages and productivity did not rise. The most plausible interpretation is that this was due to compositional effects with the relative expansion of lower-wage jobs. The manufacturing sector was small and protected in the past, it used capital intensively and employed skilled workers at high wages—these subsectors have been stagnant. The new jobs created in manufacturing exports were instead labor intensive and lower-wage. It is precisely this adjustment that allowed employment to grow so fast in these sectors. In contrast both wages and employment expanded slowly in firms producing for the internal market, although recently, the demand for skilled workers has started to rise.

The experience of Tunisia further illustrates structural change.43 An analysis of employment change between 1984 and 1993, that decomposes job creation into within-sector productivity growth, structural shifts in employment and growth, finds that almost all sectors (except "other services") enjoyed productivity increases, but there was net employment expansion as a consequence of growth in output and structural shifts. Rising within-sector productivity was particularly important in agriculture—the major low-productivity sector—and likely to be a major source of labor income growth for the poor. These changes accommodated, at rising average productivity, a large increase in female labor force participation between the ages of 20 and 44 (there is an offsetting effect for the youth with increased time spent on education).

In reforming Morocco and Tunisia, the net effects on inequality have been small. The demand for skills has fallen in the protected industries, but has started to rise in the export industries as a result of attempts to increase competitiveness with better technologies and management. In other words, what pushed inequality down may have been the effects of trade reform, but this was pushed up and neutralized by rising demand for skills and surplus labor.

Let's return to the three groups in the population that we started with.

The poor. The poor are likely to gain from opening, especially from the twin process of accelerated transfer of labor from agriculture to labor-intensive manufacturing and productivity increase within agriculture. Where there are terms of trade gains to farmers this will also be poverty-reducing. The process of growth expansion of labor demand for unskilled work was a key aspect in the dramatic fall in poverty experienced in both Morocco and Tunisia. It both accommodated the rise in female labor participation in

42 World Bank, 1994d.
both societies and it allowed rural workers and workers in construction to get more productive higher wage jobs. While average wages in manufacturing were stagnant or falling in Morocco, the new jobs that were being created in activities that tended to tighten the labor market for poorer workers—those who got these jobs experienced significant rises in their wages.

**Public sector workers.** The effects on public sector employment are likely to be negative, so those that are laid-off will almost certainly suffer at least temporary losses. As the shifts in private sector demand emerge, there is potential for restoration of public sector wage differentials, benefiting the more productive public sector workers.

**The unemployed.** Net effects on the unemployed will reflect different phenomena. Some will gain from more dynamic job creation in new activities, but there will also be a temporary rise in new entrants to unemployment, to the extent inefficient activities are disporsted and governmental employment reform occurs. Both overall and educated youth unemployment is still high in Morocco and Tunisia, in part because of labor market rigidities in the modern sector, but also because of the persistence of expectations and support mechanisms referred to in the section above. However, they both have a much higher fraction of those laid off in the pool of unemployed. In 1991 Morocco had an unemployment rate of 12 percent, of which 55 percent had previously worked and 25 percent had secondary education. By contrast Egypt had only slightly lower unemployment rate of 11 percent, but of the unemployed only 23 percent had ever worked and 57 percent had secondary education.

The international and regional evidence suggest that opening can solve two long-run problems, it can *both* be good for unskilled labor demand *and* restore excessively compressed education differentials. However, the demand will be for productive, not unproductive skills, and during the transition it is highly likely to be also associated with job losses for some of the educated now in "bad" jobs, problems of dealing with the relatively old who do not have productive or flexible skills, and the educated young who have grown up with now incorrect expectations of public sector job opportunities. Expectations can change—especially if governments undertake credible reforms on both opening up and on public hiring policies. But there is likely to be a case for transfers to dealing with permanent and temporary losers.

5. **SEQUENCING AND THE PROBLEM OF LARGE, BUT POOR, STATES.**

There are two reasons for being concerned with the design and sequencing of public sector reform in the context of opening. *First*, there is a large pool of public sector employees who correctly feel vulnerable: opening will destroy many public sector jobs and some incumbents may not have the kind of education or the flexibility to benefit from future rises in demand for productive skilled workers. These workers are likely to suffer permanent welfare losses (and even those with "good", flexible skills, may suffer temporary welfare losses) and are unlikely to vote for opening. *Second*, at both a
macroeconomic and microeconomic level, public sector reform is a prerequisite to achieving the potential gains from opening—and especially the dramatic gains from getting on dynamic paths of development exemplified by East Asian economies. Macroeconomics matters even more after opening, because fiscal imprudence is swiftly punished in a world of mobile capital. Micro reforms matter because they in the end determine the macroeconomic public sector position, via the effects of wage and public enterprise policy, and because of supply side effects on efficiency of production, most of all in the education sector.

In the past the preponderance of the state as an employer has distracted it from focusing enough attention on the core issues of macroeconomic stability, infrastructure, fiscal justice, or education. What is less recognized is that it has also reduced the ability of reformers to pursue trade liberalization. From a distributional point of view, opening can lead to increased fiscal pressures on the state. Old forms of public employment in inefficient public enterprise activities are turned into open losses and while aggregate fiscal imbalances become much less tolerable in an open economy. It is true that most of the region’s economies have undertaken major fiscal adjustments prior or parallel to trade reforms, but the structural public sector reforms have been relatively neglected: privatization or closure of inefficient public enterprises, restructuring of state education systems, laying off of surplus government workers, development of rational pay scales have not been at the core of the fiscal changes, even in the leading reformers.

With large numbers of public employees who have suffered real wage declines, macroeconomic stability is at the constant mercy of wage increases. The public sector wage bill (excluding public enterprises) ranges from 10 percent of GDP in Egypt to 15 percent in Morocco. In most countries, the fiscal deficit would rise by 2 to 5 percentage points of GDP if public sector employees manage to regain the losses they have sustained in the second part of the 1980s. This is precisely what initiated a financial crisis in Lebanon in 1991, and in Turkey in 1994, ending in both cases with large devaluations and a huge losses for workers. The credibility of the reform program is undermined by this fiscal fragility.

The fear of fiscal instability is also taxing the reform agenda. In the countries with large public enterprises, Algeria, Egypt, Syria, and Tunisia, measures to increase competition, such as the liberalization of prices, investments, or trade will increase the losses of the public enterprises and ultimately enlarge fiscal deficits. Financial market reforms also hurt the public enterprises with traditionally large capital to labor ratios and high debts to the banking system. Morocco and Tunisia have, like most countries in Latin America, promoted import substitution by protecting private industry. Trade liberalization has hurt the financial sector. In contrast, many countries of the Mashrek, Egypt, Jordan, Yemen, and Syria's have instead built state industries; for these countries, trade reforms hurt both the financial sector and the fiscal accounts.

The most advanced country in terms of trade success, Turkey, vividly illustrates the fragility of opening without deep public sector reform. In Turkey, inequality deteriorated
with the reform that started in the early 1980s: the state cut price support for agriculture; with the parallel financial liberalization; profits became a much larger share of income; labor was repressed. By 1989 and with political liberalization and the resumption of competitive politics, labor became more active and wages rose tremendously under union pressures. But because the problems of a large public sector were not resolved during the reform period, wage pressures led to larger fiscal deficits, inflation, and a foreign exchange crisis in 1993 that ended up eroding away most of labor's previous gains. Turkey exemplifies how distributional conflicts, centered on public sector involvement in the economy, can jeopardize an opening that is potentially a source of rapid employment and productivity growth.

Is the answer to reform public sectors first? Did the early reformers, who (largely) opened first and then faced the public sector problems second, get it wrong? Probably not. A scenario of public sector reform first (or even simultaneously) implies public employment declines, and welfare losses amongst a key base of political support, prior to reaping any of the gains from opening. As noted in a number of places, this is likely to heighten distributional conflicts—and thus increase credibility-killing uncertainty. It also increases the probability that public sector employees might lose and unemployment rises in the critical early period of reform. There would be some hope that the poor would be gaining from opening, but they tend to be a weak base of support. Of course, while general employment reducing public sector reform may be inadvisable early, other categories of reform do make sense and are desirable as soon as possible: removal of job guarantees for graduates (explicit or implicit) to try and break the expectation of “good” (but actually “bad”) public sector jobs; and deep educational reform to create the preconditions for flexible and market-oriented educational institutions.

The following sequence would seem to make sense for large-but-poor states. First, partial opening, “easy” fiscal adjustment, continued partial protection for public employment, and selected public sector reforms (e.g. education), and design of transfers for both temporary and permanent losers. Second, once some growth in employment has started, deep public sector reform, complemented by selected expansion of non-employment related public spending, including transfers to losers, and selected public services to marginalized groups in the population.

CONCLUSION

Most Arab countries pursued an employment strategy that worked while the oil revenues were booming but collapsed when they fell. Some employment cycle was unavoidable, given that no-one anticipated the scale of the oil cycle (if they did they could have smoothed the use of revenues). But the pattern of growth chosen by most Arab countries (and to some extent by Turkey until the 1980s) was a disaster for employment, leaving the characteristic syndrome of high unemployment and high public employment, in large, but increasingly poor states. Past educational expansion contributed more to frustrated expectations of getting “good” public sector jobs than to dynamic productivity growth that characterized open economies.
Now the political and social situation is fragile. Governments can choose to open or can struggle to maintain the current fragile state. There are political risks to both courses. The poor are the most robust potential beneficiaries, but least influential. Unemployment effects in transition are ambiguous.

The political necessity and the political risks of an opening reform are both clear. It’s the only way to get on to a labor-demanding path and to attract stable capital flows; but there will be some permanent losers and some temporary losers especially amongst public sector workers. Employment-reducing reform of the public sector is unlikely and probably inadvisable prior to a growth dynamic taking off, yet failure to reform could lead opening to end in a blaze of either fiscal crisis or growth-reducing fiscal repression of economic and social services. This implies some gradualism may be important, provided the forces of conservatism don’t undercut reform. Dynamics between opening and public sector employment matter; some opening of trade may be necessary to even start on a happy path. We argue for starting with opening, followed by public sector employment related-reform and compensation for losers.

Countries such as Morocco, Tunisia, Turkey and most recently Jordan, have started on this path, but failure to deal with the critical second stage of public sector reform will place growth in jeopardy. Those that haven’t started face a tougher situation. Algeria, Egypt and Syria a bigger challenge. Currently public sector elites are holding on, but this is becoming an ever-more desperate, and ultimately self-defeating act.


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