Employment, Development and the Social Contract in the Middle East and North Africa*

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Abstract

Job creation for an expanding labor force has become the most pressing development challenge facing the Middle East and North Africa. This paper provides a comprehensive account of contemporary labor markets in the region. It integrates questions about how to build vibrant labor markets and restore the region’s growth performance into a framework that also addresses issues of population dynamics, socioeconomic trends, employment regulations, the quality of governance, opportunities in the world economy, and the impact of a redistributive social contract on prospects for reform. The paper pays particular attention to the broader political-economic aspects of state–society relations and concludes that in no small measure, the region’s economic future will be determined by the fate of its labor markets.

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Chapter 1
Introduction

Labor Market Outcomes in Post-World War II

During the era of state-led industrialization in the 1960s and the oil boom in the 1970s, unemployment in the MENA countries was on a steady decline. Open unemployment in the largest economies of the region was present on a modest scale and hardly different in nature from what was observed in the advanced industrial economies. Reflecting these conditions, wage growth was steady as was the expansion in household income.

As late as the early 1980s, some labor-abundant countries were reporting labor shortages in the face of rapid labor force growth, and rural areas were being depopulated by rural-urban and international migration. The oil-exporting economies had become increasingly reliant on millions of foreign workers, especially from other MENA countries, to augment acute national labor shortages and rising demand for workers. Europe as well became an important destination for migrant workers from the region.

It is not surprising that under these conditions earlier predictions of rising labor supplies because of population dynamics elicited little concern on the part of policymakers in the region. The vitality in MENA’s labor markets between the 1960s and early 1980s was amply reflected in the region’s impressive per capita growth record and rapid advances in education and life expectancy.

By the early 1990s, however, labor market outcomes in MENA displayed little of their previous dynamism. The once vibrant regional economy had come to a sudden halt following the oil bust in the mid-1980s. Demand for expatriate workers in the receiving countries was scaled back, causing remittance income in the sending countries to fall rapidly.

In the face of continued rapid labor growth, the collapse of oil prices, and the emergence of serious macroeconomic imbalances, unemployment rates rose to levels unseen in generations while real wages stagnated and productivity collapsed. Open unemployment was on the rise especially among educated young workers.

As a result, lower unemployment and rapid job creation have been transformed into the most pressing challenge facing the economies of the region. And the fact that in most countries unemployment rates remained high or continued to climb in the course of the 1990s has amplified the sense of urgency among policymakers and citizens on the need to tackle this challenge head on.
Scope and Methodology

This paper provides a condensed but comprehensive account of contemporary labor markets in MENA. Readers will note at the outset that the paper goes beyond a technical discussion of labor market outcomes to include attention to the broader political-economic aspects of state–society relations. The attention to the social, institutional, and political factors that shape labor market outcomes is well founded in the academic tradition and policy arena.

Labor markets, perhaps more so than any other factor market, are socially and politically constructed. In MENA as elsewhere, labor markets are the product of historical processes of state, social, and economic formation that result in tight linkages between them and other dimensions of an economy, society, and polity. They are, inherently, influenced by demographic profiles, by levels of educational attainment, and by the social policies that determine, in part, the economic risks and opportunities citizens face.

But while MENA falls within a larger universe of countries that are struggling to overcome labor high unemployment, this paper underscores the conditions that distinguish MENA’s labor market problems from those in other regions. Not only does MENA face labor force pressures of an unprecedented scale but, more importantly, it has a tradition of state intervention that has been resistant to change.

Thus, in MENA’s case in particular, it is these broader political-economic considerations that underscore both the dire need for policy reform and the urgency with which it must be carried out. Across the region, intellectuals and commentators are engaged in debates on the future of labor markets that motivate and echo precisely the concerns addressed in this volume and the approaches chosen to examine them.

Structure and Organization

The paper begins with an analysis of labor markets in MENA as the outcome of the long-term processes through which the region’s political economies became organized in the decades following World War II around a redistributive–interventionist social contract (chapter 2).

While the social contract delivered early dividends, the strains on its capacity became clear over time with the deteriorating outcomes in MENA’s labor markets since the mid-1980s. Chapter 2 singles out the crucial role that demographic changes have played in unraveling the sustainability of MENA’s social contract for citizens and for the region’s economic performance.

Chapter 3 goes on to provide a long-term perspective on demographic and socioeconomic trends driving rapid labor force growth in MENA. It emphasizes the large potential for rapid economic growth on account of MENA’s demographic transition, especially in view of the region’s impressive record in raising educational achievement.
The analysis of labor market outcomes in the 1990s is linked to the region’s growth performance as well as trends in factor accumulation and productivity. These, in turn, provide the necessary benchmark for assessing the impact of policy reforms to date on labor market outcomes.

Chapter 4 examines the structure of employment and wages at a more disaggregated level. It assesses the impact of explicit and implicit public sector employment guarantees on the age, gender, and educational profiles of the unemployed. A detailed analysis of the returns to education in the 1990s sheds further light on the institutional underpinnings of high unemployment and labor market segmentation.

In addition, the chapter highlights growing trends in informalization and, in some cases, defeminization of employment in MENA and relates these, in turn, to lower demand for labor in the public sector and other sources of labor market rigidity. Finally, the chapter examines the relationship between poverty and labor market outcomes as well as trends in income and wage inequality.

Thus, chapters 2–4 constitute the diagnostic part of the report, setting the stage for exploring the menu of future reforms that can address the employment challenge in MENA. Chapters 5–7 comprise the summary analysis of future options and policy recommendations.

Chapter 5 begins with an examination of direct interventions in labor markets through the reform of public sector hiring and wage-setting practices as well as the regulatory framework governing employment in the private sector. The scope and limitations of these interventions are assessed using detailed empirical simulations. The chapter also considers the role of active labor market policies.

Chapter 6 begins with an assessment of the likely contribution of traditional engines of employment growth toward future job creation. After concluding that the prospects for alleviating labor market pressures through public sector employment and migration are limited, it identifies a set of needed transitions to advance the goals of job creation and growth.

The need for a comprehensive approach to reform in the future is the starting point for chapter 7, which argues that transformation of MENA’s labor markets cannot be detached from broader processes of economic and political change. The chapter links economic reform to progress in the reorganization of the social contract that structured state–society relations for more than 40 years.
Chapter 2
The Evolution of State–Labor Relations in MENA

During the 1940s and 1950s societies across the MENA region developed social contracts with a distinctively interventionist and redistributive character. These contracts were expressed and institutionalized through explicit commitments from MENA governments, articulated in constitutions, basic laws, and other documents that established the state as an instrument of social transformation, mass political mobilization, and economic redistribution. Although the form and content of these contracts varied, they reflected a widely held understanding of the policies for economic and social development.

The Role of the Social Contract

The overall direction of economic and social policies in MENA during these formative decades converged around an interventionist–redistributive social contract. In some cases, the social contract asserted a commitment to radical populism, with intensive regulation, if not outright expropriation, of private assets and control of organized labor through state corporatist systems of interest representation. In others it reflected a paternalistic rationale for statism, with interventionist policies directed in support of emergent private sectors. The differences are not trivial, for they help to account for the significant variation in the developmental experiences of MENA countries.

The social contracts established during the independence era have given rise to enduring institutions, interests, norms, and practices that now structure the constraints and incentives governments face as they contend with demands for policy reform and resistance to those reforms. The contracts have defined patterns of state–labor relations across the region and established expectations and obligations that have proved deeply resilient. They remain a powerful presence in debates about social and economic policy reform, even as their impact on employment, wages, working conditions, foreign investment, trade, and overall macroeconomic performance has become deleterious. Understanding what the social contract in MENA embodies—its origins, its developmental consequences, its effects on labor markets—is crucial to any assessment of labor market prospects and possibilities.

Defining the Social Contract

The social contract refers generally to an agreement between the members of a society, or between the governed and the government, defining and limiting the rights and duties of each. In the modern European context, the term social contract generally refers to a collective agreement regulating employment and wages, secured through bargaining among representatives of the state, labor, and capital. Such compacts provide wage stability to employers and address the interests of organized labor in distributive equity and secure employment, with the state providing institutionalized channels for conflict resolution and the guarantees to stabilize agreements.
In MENA countries, the social contract encompasses a wider array of factors than is commonly held in Europe. Conceptualized not solely as an institutionalized bargain among collective actors, it encompasses norms and shared expectations for the overall organization of a polity. Accordingly, these norms and expectations have significant institutional consequences. They define the boundaries of acceptable policy choice, and they affect the organization of interests in society, helping to determine who wins and who loses in a given political economy.

**Characteristics of the Social Contract**

From the 1940s to the 1970s, the MENA social contract acquired a number of distinctive features, including institutional arrangements, public policies, legitimating discourses, and modes of state–society relations. Core attributes of the social contract are:

- A preference for redistribution and equity in economic and social policy.
- A preference for states over markets in managing national economies.
- The adoption of import-substitution industrialization and the protection of local markets from global competition.
- Reliance on state planning in determining economic priorities.
- An encompassing vision of the role of the state in the provision of welfare and social services.
- A vision of the political arena as an expression of the “organic unity of the nation,” rather than as a site of political contestation or the aggregation of conflicting preferences.

Another key marker in the rise of the interventionist–redistributive social contract was the emergence of centralized, hierarchical, and tightly regulated corporatist structures of interest representation in the first decade after independence. These arrangements provided the blueprint not just for the organization of state–labor relations, but also for relations between the state and a wide range of other social groups, including peasants, students, and women, as well as various professional associations. And while these arrangements reflect the intent of governments to control workers, corporatism created possibilities for agency, bargaining, and negotiation for the groups it was designed to contain (Beinin 2003; Bianchi 1989; Posusney 1997).

Institutionally, and in terms of economic and social policies, these elements were consolidated through broadly similar strategies in a number of MENA states, including Algeria, Egypt, Iraq, Syria, and to a lesser degree, Jordan, Morocco, Yemen, and Tunisia. These strategies included:

- The rise of dominant single-party or ruling-party governments.
- New, postindependence constitutions that enshrined interventionist and redistributive principles in the basic laws.
- A wave of agrarian reform programs to redress inequalities in the rural economy.
• Sweeping nationalizations of industry, banking, insurance, and trade in the late 1950s and early 1960s, producing a dramatic expansion in the scale of public sectors.
• The centralization of trade unions and professional associations.
• The consolidation of import-substitution industrialization as a strategy for establishing domestic industrial sectors.
• Programs for state provision of social services, including education, housing, healthcare, food subsidies, and other benefits.

The Context that Produced the Social Contract

Prior to 1950, the standard of living for the vast majority of the population in MENA was extremely low (Issawi 1982). For example, it is estimated in Egypt that per capita income stagnated for much of the first half of the 20th century. During this time, health indicators were among the worst in the world, and the region was plagued by epidemics and malnutrition. These conditions caused the crude death rate to remain high until 1950 (Omran 1980). Education levels were also low by international standards. In Egypt, adult illiteracy was estimated at 85 percent in 1939, and only 23 percent of children ages 5–19 were enrolled in school. Likewise in Morocco, enrollment was even lower, with the number of foreign children in schools almost equal to the total of Morrocan children (Cowan 1958).

It was in this context that the social contract in MENA was conceived in the period between 1930 and 1950. Domestic factors, combined with the region’s earlier experience with globalization—the global diffusion of trends toward state expansion, intervention, import substitution, planning, and the deepening of welfare that occurred in the mid-20th century—generated a complex regime of institutions, policies, norms, expectations, and practices that would become the social contract.

External Factors Contributed to the Social Contract

The first elements of this contract began to appear during the interwar period, as states in MENA and other developing regions responded to the collapse of international economic order during the Great Depression by moving toward import substitution and a new conception of the state as the primary provider of welfare (Thompson 2000). Its emergence is also linked to the circulation into the region in the years before and during the Second World War of then novel economic theories ranging from Keynesian demand management to development strategies that stressed the value of central planning and the need to protect infant industries from the pressure of global competition.

During World War II, the Middle East Supply Centre, a regionwide Anglo-American organization, promoted import substitution to compensate for a wartime decline in exports into the region of food and other critical goods (Vitalis and Heydemann 2000). In the postwar period, international financial institutions, including the World Bank, recommended an expanded economic role for government in response to the presumed weakness of private sectors (World Bank 1952, 1955) and made access to loans
conditional on the preparation of economic plans by governments. Cold war considerations led Western powers to view favorably the efforts of MENA governments to impose control over organized labor in order to contain Communist influence. The expansion of welfare systems in postwar Europe offered models for the provision of social services that were received positively by the political elite of newly independent MENA states.

**Domestic Factors Also Influenced the Social Contract**

In addition to these foreign influences, much of the impetus for the consolidation of interventionist–redistributive social contracts came from within the region. The resilience of these social contracts as frameworks for the management of MENA political economies reflects the local conditions in which they arose, specifically the timing and sequencing of four processes: the rise of nationalist movements, the emergence of mass politics, the incorporation of labor into the political arena, and the introduction of electoral institutions as a by-product of the colonial presence in MENA states.

As the product of an historical context in which these processes were tightly interconnected, the MENA social contract took shape as a distinct variant of postwar welfare and redistributive arrangements that emerged as a more general model both in developing regions and in the welfare states of postwar Europe. While many other states in the postwar period also adopted redistributive social policies and corporatist structures for the organization of labor, MENA states were distinctive among countries outside of the Communist Bloc in the scope of state regulation of the economy and society and in the extent to which social policies became the vehicle for implementing radically redistributive social programs. That has had important implications for current efforts to reform and reorganize MENA political economies.

**The Rise of Mass Politics**

Throughout the MENA region, the emergence of mass politics occurred in association with, and was powerfully influenced by, colonial projects of state building—and with the rise of anticolonial independence movements. Central to this transition was the introduction of electoral systems of mass-based political representation across the states of the post-Ottoman Middle East—including the monarchies of Egypt, Iraq, and Jordan. This, in turn, promoted the emergence of modern conceptions of citizenship and reinforced perceptions of the state as an agent of public welfare. It established new domains of rights, new strategies for claiming those rights, and new forms of political competition for control over the mechanisms of mass mobilization, including political parties, trade unions, and professional associations.

These processes transformed nationalist struggles from activity dominated by elites into movements of mass political incorporation. They provided incentives for politicians to create inclusive social coalitions and valorized discourses of egalitarianism and mass participation—all of which were subsequently institutionalized through the formation of social contracts. They also reinforced the privileged position of organized labor, giving
legitimacy to the claims of labor leaders to the resources and attention of the state. In this sense, the colonial construction (or broadening) of republican institutions throughout the Middle East during moments of nationalist mobilization was critical for the later emergence of interventionist–redistributive social contracts across the MENA region.

Moreover, workers in the Middle East were establishing their own claims for representation in the design of policies regulating working conditions, wages, and labor–management relations. Beginning in the 1930s, trade union membership grew rapidly in many MENA states (table 2.1 and figure 2.2). This expansion was accompanied by a growing political assertiveness of trade unions and by a notable increase in strikes and other actions intended both to incline the content of social policy toward workers and to support the goal of national independence.

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Union Membership</th>
<th>Share of Workers in Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>1947</td>
<td>480,000</td>
<td>37.6</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1956</td>
<td>155,000</td>
<td>30.5</td>
</tr>
<tr>
<td>Algeria</td>
<td>1954</td>
<td>375,000</td>
<td>28.8</td>
</tr>
<tr>
<td>Morocco</td>
<td>1952</td>
<td>670,000</td>
<td>72.0</td>
</tr>
</tbody>
</table>

Table 2.1. Union Membership in Selected MENA Countries Prior to 1960


Mass Politics and the Nationalist Movement

As in other regions, the institutions that resulted from this transformation simultaneously promoted the formation of collective identities and the mobilization of organized interests. These included labor unions, but also peasant unions, political parties, chambers of commerce, and other institutions that helped to construct social class as a legitimate basis for political mobilization. The political realm, previously reserved for elites, came to include the popular classes. For example, in Tunisia a powerful trade union movement, the UGTT, was closely linked to the leading nationalist political party, the Neo-Destour, which negotiated Tunisia’s independence from France. Egyptian nationalists viewed organized labor as an extension of the nationalist movement. Similarly, the Aden Trades Union Congress, created in 1956, supported nationalists seeking independence from Britain—in what became the People’s Democratic Republic of Yemen in 1967.

The Changing Political Arena

The political incorporation of workers and peasants transforms the strategic calculus of political actors (Collier and Collier 1991; Przeworski and Sprague 1986; Rueschemeyer, Stephens, and Stephens 1992; Waldner 1999). It upsets established alliances and makes new coalitions possible. In MENA, this politically potent combination of state-centered welfare Republicanism and organic-nationalist approaches to mass mobilization, as well as new institutions and capacities for the organization and management of collective
interests, provided the essential ingredients for postindependence strategies of economic and social development.

**Codification of the Social Contract**

Thus, throughout MENA, there has been a consistent pattern of similarities in styles of regulation, forms of state intervention, and modes of interest representation. Similar patterns also existed in how the boundaries of political inclusion and exclusion were transformed through the politics of mass incorporation, with private sectors becoming increasingly marginal to political life in Algeria, Egypt, Iraq, Libya, the People’s Democratic Republic of Yemen, Syria, and, to a lesser extent, Tunisia. In these cases, workers and peasants were privileged over the owners of capital in the consideration of whose interests needed to be taken into account in making economic and social policy, and which actors had a legitimate claim to state resources.

The notion of a social contract is used here to define a diverse set of attributes and their collective impact on economic, social, and political governance. The preferences they reflect were expressed explicitly in postindependence constitutions, basic laws, and public policies. In Algeria, Egypt, Iraq, Syria, and elsewhere, constitutions refer to the redistributive mission of the state, the privileged position of workers, and the need for states to assume responsibility for social welfare (table 2.2).

<table>
<thead>
<tr>
<th>Country</th>
<th>Article</th>
<th>Text Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria (1963)</td>
<td>Art. 10</td>
<td>The fundamental objectives of the democratic and popular Algerian Republic are: … the guarantee of the right to work.</td>
</tr>
<tr>
<td>Bahrain (1973)</td>
<td>Art. 13(b)</td>
<td>The state guarantees the provision of job opportunities for its citizens and the fairness of work conditions.</td>
</tr>
<tr>
<td>Egypt (1971)</td>
<td>Art. 13</td>
<td>Work is a right, a duty and an honor ensured by the State.</td>
</tr>
<tr>
<td>Iran (1979)</td>
<td>Art. 28(2)</td>
<td>The government has the duty, with due consideration of the need of society for different kinds of work, to provide every citizen with the opportunity to work, and to create equal conditions for obtaining it.</td>
</tr>
<tr>
<td>Jordan (1952)</td>
<td>Art. 23(i)</td>
<td>Work is the right of every citizen, and the State shall provide opportunities for work to all citizens by directing the national economy and</td>
</tr>
<tr>
<td>Kuwait (1963)</td>
<td>Art. 41(2)</td>
<td>Work is a duty of every citizen necessitated by personal dignity and public good. The State shall endeavor to make it available to citizens and to make its terms equitable.</td>
</tr>
<tr>
<td>Libya (1969)</td>
<td>Art. 4</td>
<td>Work in the Libyan Arab Republic is a right, a duty, and an honor for every able-bodied citizen.</td>
</tr>
<tr>
<td>Saudi Arabia (1993)</td>
<td>Art. 28</td>
<td>The State provides job opportunities for whoever is capable of working.</td>
</tr>
<tr>
<td>Syria (1973)</td>
<td>Art. 13(1)</td>
<td>The state economy is a planned socialist economy which seeks to end all forms of exploitation.</td>
</tr>
<tr>
<td>Yemen (1991)</td>
<td>Art. 10</td>
<td>Every citizen has the right to undertake work chosen by him and in accordance with the law.</td>
</tr>
</tbody>
</table>

The Social Contract and Labor Markets

Within the interventionist–redistributive social contract, the management of labor markets is achieved through a variety of mechanisms, extending beyond the corporatist regulation of labor unions. Across MENA, government ministries and state agencies created after independence subjected labor-management relations to increasing regulation. In several countries, employers in industries with the highest levels of union participation experienced erosions in their authority to set wages and working hours, to hire and fire, and to discipline workers. State-supervised arbitration procedures were established to resolve workplace disputes. In some cases, state regulation even mandated worker representation on corporate boards and set guidelines establishing the right of workers to a share of corporate profits.

State Regulation and Intervention

Workforce regulations expanded under state ownership, mandating job security guarantees, social security programs, relatively high public sector wages with generous nonwage compensation benefits (such as family allowances), and prohibitions or sharp restrictions on the dismissal of workers. Such policies were intended to provide economic stability and security to organized labor and to serve as means of redistribution of collective wealth. However, along with these protections came restrictions on the political activity of labor, including limits on the right to strike. Moreover, within these regulatory regimes, powerful incentives developed for rent-seeking, “cronyism,” and state capture.

Labor markets also were affected by the general orientation of economic and social policy. During the late 1950s and 1960s, governments moved from regulating private sectors to direct control of production through nationalization of private assets. In response, public sectors grew to become the dominant employers in many MENA states (figure 2.3). Import-substitution strategies also created constraints and incentives that influenced investment and production, with implications for labor demand and job creation. Regulation of agrarian sectors, land reform, and an urban bias in social policy had significant effects on rural labor markets, augmenting the rapid urbanization and largely eliminating large landowners, previously the most powerful class in many MENA states (Beinin 2003).

Widescale public provision of social services rapidly expanded state bureaucracies, absorbing many new entrants into the public sector. In a number of states, public commitments to the development of human capital took the form of populist education policies that provided free, universal access to higher education and guaranteed public sector employment to secondary and university graduates (box 2.1). In the short term, these policies yielded net benefits, but over time the supply of job seekers outpaced rates of economic growth. States continued to honor employment guarantees, but the impact on productivity per worker over time was predictably negative.
Box 2.1. Egypt’s Employment Guarantee

As part of Nasser’s “Socialist Laws” of 1961–62 the Egyptian government initiated a policy that guaranteed employment to all university graduates. In 1964, Law 14 extended this policy to include the graduate of any vocational secondary school or technical institute. Law 85 of 1973 expanded the guarantee to include all demobilized military conscripts of all educational levels. To oversee these new laws and ensure jobs for each graduate, the government created the General Administration for Graduates within the Ministry of Manpower and Migration.

As the number of graduates rose it became difficult for the government to maintain these guarantees. Between 1963 and 1983, the number of graduates increased at about 12 percent a year, compared with an overall labor force growth rate of 2 percent. Although the rate for graduates has since fallen, they still make up the bulk of new entrants in the labor market.

To reduce the burden of providing employment, the state limited enrollment in universities and technical and vocational institutes. The number of graduates peaked in 1986 and has since declined. The state also increased the waiting period for a government job (up to 13 years) to increase the opportunity cost of public employment. This caused some graduates to pursue careers in the private sector, but the government’s announcement in 1992 that graduates employed in the private sector would no longer be applicable for government jobs sparked mass resignations.

While Egypt officially abandoned the socialist development path in 1973, public sector employment continued to grow and has remained a major burden on state finances. Guaranteeing government employment for all graduates is unsustainable in the long run, but since it is a crucial element of the social contract, the state has been unable to abrogate the laws associated with the guarantee.

Source: Assaad 1997.
The Social Contract in the 1960s and 1970s

Despite the social and economic turmoil that accompanied the emergence and consolidation of social contracts in MENA countries, subsequent decades were marked by unprecedented levels of economic growth and social development. Between 1965 and 1985, MENA’s economic growth rates were among the highest in the world, averaging 3.7 percent per capita a year (figure 2.4). Many factors contributed to these gains: rapid progress in early-stage industrialization, high levels of public spending, initial benefits from trade protection for domestic producers, rising public sector employment, and rising oil prices.

![Figure 2.4: Average Annual Change in GDP per Capita by Region (percent)](image)

Oil Helps Sustain the Social Contract

Oil revenues played a pivotal role in sustaining the social contract in both exporting and nonexporting states (box 2.2). For oil producers, oil revenues permitted the creation of vast welfare systems that served as key mechanisms for the distribution of oil wealth to citizens, though not to noncitizen migrant workers (Beblawi and Luciani 1987). For nonoil producers, remittance income boosted household consumption, especially in rural areas. Loans, grants, and other forms of assistance from oil-producing states to nonoil producers boosted government revenues and sustained redistributive commitments. At the peak of the oil boom in the early 1980s, some 3.5 million Arab migrant workers were employed in Saudi Arabia and the Gulf states. Official remittances of migrant labor in the period from 1973–84 totaled almost US$22 billion for Egypt, US$6.5 billion for Jordan, and US$8.2 billion for Morocco.

These results had important political consequences. They reinforced the role of redistributive mechanisms in sustaining the well-being of large segments of MENA populations, deepening their popularity among social groups that governments identified as core constituencies. From the 1960s through the 1980s, these groups emerged as prominent winners in the political economies created by the interventionist–redistributive social contract. The welfare gains also helped cement an “authoritarian bargain,” with citizens trading restrictions on political participation in exchange for economic security.
and the public provision of social services, welfare, and other benefits (Vandewalle 2003).

Box 2.2. The Impact of Oil on Labor Markets in the Gulf Cooperation Council (GCC)

The increase in oil production in the 1960s and the price boom of the 1970s provided the GCC countries with the resources necessary to initiate elaborate programs for modernization. Massive infrastructure projects were launched to upgrade roads, communications, and public utilities. Governments also created programs to accelerate modernization through free education and healthcare. At the time, GCC countries suffered from a shortage of national manpower, which led to an increased reliance on imported labor. The size of the government bureaucracy began to expand with the hiring of nationals. Oil revenues were high enough that nationals entering the labor force could be hired almost exclusively by the public sector. Public sector employment facilitated the distribution of oil wealth and encouraged higher educational attainment by nationals. Over time, these trends have become entrenched, resulting in a highly skewed breakdown of nationals by sector of employment (see figure).

Source: Birks and Sinclair 1980.

The Social Contract under Strain—the 1980s and 1990s

Over time, gaps widened between a deeply embedded set of institutional arrangements, norms, expectations, and practices, on the one hand, and the diminished capacity of governments to sustain redistributive commitments, on the other. As early as the 1970s, Egypt and Tunisia had begun to reevaluate some policies associated with the contract, taking tentative steps toward economic liberalization. The inability of the MENA social contract to sustain the economic gains of previous decades became increasingly clear by the early 1980s. By the end of the decade, the strains in the social contract had grown into a major economic crisis.

The Collapse of Oil Prices and Economic Crisis

The roots of this crisis were declining oil prices (figure 2.6), shrinking demand for migrant labor, reduced remittance flows, declining productivity, and a more competitive international environment. Political economies formed by the interventionist–redistributive social contract began to experience significant economic lags. With declining public revenues, redistributive commitments contributed to alarming increases in public debt in many MENA states as governments struggled to meet public sector wage bills ranging from 6 percent of GDP to almost 20 percent. Regulatory environments discouraged private investment, reduced opportunities for trade, and impeded the
development of export-oriented industrial sectors, creating significant obstacles to the integration of MENA economies into global markets. In the 1980s and 1990s, labor productivity in MENA experienced a sustained decline. Unemployment levels increased and governments faced growing pressure—both domestic and international—for economic reform.

Governments Respond to Economic Difficulties

By the 1980s, most governments in MENA had adopted some form of economic stabilization program, including Algeria, Egypt, Jordan, Morocco, Syria, Tunisia, and the oil exporters of the Arabian Peninsula. Policy shifts were marked by caution and gradualism, but across the region, governments cut subsidies, reduced public expenditure, and reformed exchange rate regimes. Many governments entered international economic institutions, such as the General Agreement on Tariffs and Trade/World Trade Organization (GATT/WTO), and signed bilateral and multilateral trade agreements. By the early 1990s, these reforms began to have beneficial effects. Debt levels declined, inflation was brought under control, and macroeconomic performance was on average positive (figure 2.7).

MENA governments also began a gradual and selective transition from economic stabilization to structural adjustment—a move strongly supported by international financial institutions and Western governments. Reforms included many that are now familiar markers of economic restructuring: privatization of state-owned enterprises, fiscal reform and trade liberalization, deregulation, and strengthening the institutional foundations for a market-led economy (figure 2.8). However, implementation of these measures has been uneven, hesitant, and incomplete (Richards and Waterbury 1998). Partly as a result, MENA’s economic recovery in the 1990s was generally weak. In the past 15 years, GDP per capita growth has averaged 1.0 percent a year (figure 2.4). Labor productivity remained low and unemployment rates continued to increase.

Some of these factors were beyond the control of MENA governments. Yet the uneven quality of economic policy reform—more progress on exchange rate stabilization, less on privatization; more progress on fiscal policy reform, less on the liberalization of labor
markets—must, in large measure, be understood as a product of the embedded nature of the interventionist–redistributive social contract in MENA. Institutional arrangements created to link organized labor and the state became mechanisms for the expression of labor resistance to privatization (Posusney 1997). Governments faced political and social constraints in their attempts to reduce welfare expenditures. Often, austerity measures were greeted by significant and occasionally violent mass protest, such as those that took place in Tunisia in 1984, in Morocco in 1981, and in Egypt in 1977 (Harik and Sullivan 1992). Moreover, the economic gains generated by selective policy reforms often were captured by business elites with established ties to governments, undermining their legitimacy among MENA populations.

**Costs of the Redistributive Preference Are Rising**

MENA is not the only region facing this challenge. Europe has been confronting a similar dilemma in recent years. In Europe, the policies intended to provide economic security for organized labor, enhance human capital, and promote socially just strategies of economic development have become, over time, a source of economic insecurity to growing numbers of citizens, most importantly workers (figure 2.9). Both regions face broad-based opposition to the liberalization of labor markets and to the reduction in social expenditures, despite high, sustained unemployment and low levels of economic growth. Thus, in both industrial and developing regions, social contracts that favor redistribution, equity, and security over growth have taken an increasing toll on precisely the social sectors they are intended to protect.

![Figure 2.7: International Comparison of Unemployment Rates (percent)](image)

**Note:** Rates for the GCC include nationals only.

*Source: World Bank staff estimates from ILO 2002 and country sources.*

Despite these commonalities, the process will be more difficult for MENA. The region has a tradition of greater state intervention. More importantly, the labor market pressures it will face in the future will dwarf the projections for Europe. In fact, as the next chapter underscores, the demographic transition in MENA has created the most intense labor market pressures observed anywhere in the world in the post-World War II period.
Chapter 3
Demography, Labor Supply, and Employment

MENA’s population of nearly 330 million is the legacy of high population growth rates in the post-World War II period. Between 1950 and 1990, MENA’s population grew faster than that of any region, averaging 2.8 percent a year, doubling by 1975 and more than tripling by 1990 (figure 3.1). Population growth peaked in 1985 at 3.4 percent. While the rate of expansion has declined, the pressure of population flows remains high. Between 1990 and 2000, with annual growth rates averaging 2.2 percent, MENA’s population increased by 6.1 million people a year compared with 4.6 million in the 1970s and 6.7 million in the 1980s. In the current decade, with population growing at an even slower rate of 2 percent, the region is still adding more than 6 million people every year. It is safe to assume, however, that the era of high population growth is over. Evidence increasingly suggests that MENA is on a trajectory of declining population growth rates for the foreseeable future (Courbage 1999; Rashad and Khadr 2002). These trends must be viewed within a context of long-term demographic change.

MENA’s Demographic Transition

Like other regions, MENA has been undergoing a demographic transition, moving from an initial equilibrium of high birth and death rates, typical of agricultural or preindustrial societies, to a new equilibrium of low birth rates and low death rates, as in the more developed economies of North America and Europe (Bongaarts and Bulatao 1999). During the transition population growth rates initially expand as mortality rates fall and fertility rates remain high. With modernization, fertility declines, bringing about a steady fall in population growth. Much of the world has conformed to this pattern of long-term demographic change. The speed of the process, however, has varied widely across and within regions. In this regard, the countries in MENA exhibit both unique patterns and considerable diversity.
Mortality Rates Declined Rapidly

Beginning in the 1950s, MENA experienced the significant declines in mortality that signal the onset of the demographic transition. Countries launched impressive development programs, investing heavily in healthcare programs and participating in World Health Organization (WHO)-sponsored sanitation and disease-control programs. The increasing availability of antibiotics, vaccinations, and insecticides after World War II had a profound impact on the spread of parasites and communicable diseases (Omran 1980). Mortality rates dropped steadily, from 24 per 1,000 in the early 1950s to 13 per 1,000 in 1980. Infant mortality rates dropped from 186 per 1,000 to 102 per 1,000 in the same period. These outcomes are striking when benchmarked against other developing regions. Although the region started out in the 1950s with some of the highest infant mortality rates in the world, by the 1990s MENA was on par with two leaders in the developing world, East Asia and Latin America (figure 3.2).

But the Fertility Transition Was Slow

Mortality rates have continued to decline but the pace has slowed as MENA converges with the industrial countries. Thus, the region’s fertility rates have become the driving force behind the demographic transition. In 1950, MENA had the highest fertility rate in the world at 7.0 children per woman, a position it maintained through 1970 (figure 3.3). And while the regional fertility rate has declined since 1970, the initial pace of the decline was slow. Between 1970 and 1990 fertility declined by 2.2 children per woman in Latin America and 3.1 in East Asia, but only 1.6 in MENA, a small change given the region’s high initial levels. Since 1985, however, the fertility decline has accelerated dramatically, narrowing the gap between MENA and other developing regions (Fargues 2003). Across much of MENA evidence suggests that the fertility transition has gained momentum, setting the region on a path of low fertility in the 21st century.
Understanding the Determinants of Fertility

Several factors explain the bulk of cross-country variations in fertility rates over time, the most important of which are health status and female education levels. Advances in health directly affect desired fertility and demand for children (Pritchett 1994). As infant and child mortality rates decline, couples expect more children to reach adulthood and, therefore, choose to have fewer children.

Female education influences fertility both directly and indirectly. Female education facilitates greater access to information about modern contraception and the benefits of family planning. Education also affects fertility by increasing the potential participation of women in the labor market. Increased female labor force participation raises the opportunity costs of having children and, with participation, women delay decisions about marriage and fertility.

Long-term increases in income levels and urbanization lower fertility by reducing the benefits of having children while raising the costs. In urban, industrializing economies, children no longer provide potential labor as they do in agricultural societies. Also, as income rises, so do the costs associated with rearing children, and parents may see the benefits of investing more in the quality of fewer children.

MENA Conforms to Global Patterns

The factors driving fertility trends in other regions appear to be playing the same role in MENA (Al-Qudsi 1998; Olmsted 2003). While many MENA countries managed to reduce fertility by as much as other developing regions over the entire 1960–95 period, most of the reductions came only in the past decade. Low levels of female education
before the 1980s are primarily responsible for this delay. Within MENA, differences in health conditions account for most of the variations in fertility reductions.

**Changing Orientation of Government Policies**

A significant portion of the decline in fertility, in MENA and elsewhere, comes from factors other than those discussed above. Slower rates of family formation among young adults due to unemployment, housing shortages, and marriage costs are at work (Kawar 2000; Singerman and Ibrahim 2001). Age at first marriage for both men and women in MENA are among the highest in developing countries. Furthermore, the acceleration in the fertility decline in the past decade may result in part from government population policies, which changed orientation in the late 1980s (Roudi-Fahimi 2001). Under the pressure of rapid population growth, governments began to realize the costs of high dependency burdens in expenditures on education, health, and infrastructure as well as the socioeconomic effects of urban crowding and high youth unemployment. And countries that launched population programs early have generally secured the fastest fertility declines in the past decade, while those that have maintained pro-natal policies have the highest fertility rates in MENA (table 3.1).

**Age Structure Is Changing Rapidly**

The slow pace of the fertility decline in MENA before the 1990s not only delayed the transition from high to low population growth rates but also ensured that the young and economically dependent population (ages 0-14 and 65 and older) would dominate the region’s age structure for some time to come. The dependency ratio (the ratio of the economically dependent to the working-age population 15–64 years old) climbed from 0.81 in 1950 to a peak of 0.95 in 1970 and remained as high as 0.91 until 1980 (figure 3.4). The dependency ratio averaged 0.9 between 1950 and 1980, meaning that the region had 90 dependents for every 100 adults of working age. By comparison, East Asia’s dependency ratio peaked at a much lower level of 0.76 and at an earlier date of 1965, and averaged 0.71 between 1950 and 1980. The dependency ratio was 0.83 in Latin America for the same period. By 1990, however, the
dependency ratio in MENA had fallen to 0.86, and it continued to fall to 0.69 in 2000. It is forecast to fall for the next few decades, reaching 0.5 after 2025.

From Demographic Burden to Demographic Gift

The changing age structure of MENA’s population has placed the region in a unique position at the beginning of the 21st century (Williamson and Yousef 2003). Between 1990 and 2020, the growth of the economically active population (ages 15–64) will exceed that of the economically dependent population by a much greater magnitude than in any other region. As East Asia’s experience has shown, this differential, the so-called “demographic gift,” provides MENA with an opportunity to accelerate economic growth through faster accumulation of factors of production (Bloom and Williamson 1998) (figure 3.5). Lower dependency ratios imply a potential for higher savings and investment. Savings will increase more than investment, and this will narrow the domestic resource gap and reduce dependence on foreign capital. Rapid labor force growth, especially in the context of increased education and longer life expectancy, provides economies with a bigger pool of productive workers. As a result, policymakers in MENA are facing different challenges from the past. Ongoing demographic changes are shifting the policy focus from providing health and education for a young population toward facilitating employment and capital accumulation for maturing young adults.

From Delayed Transition to Rapid Labor Force Growth

The timing and pattern of MENA’s demographic transition have had an enormous impact on the dynamics of labor supply in the region. High population growth rates between the 1950s and the 1990s led to the rapid expansion of the working-age population. With rising labor force participation rates since 1980, the growth of labor supply and the increase in the absolute number of new labor market entrants have accelerated over time. Moreover, rapid population growth, in conjunction with the delayed fertility decline, has meant that pressures on labor markets have been sustained for a far longer period in MENA than in other regions. Labor force growth rates have averaged more than 3 percent a year between 1970 and 2010. No other developing region has experienced the magnitude and persistence of labor market pressures observed in MENA (figure 3.6).
Demographic Transition Drives Labor Force Growth

The growth of the working-age population in MENA has risen steadily from 2 percent a year in the 1950s to more than 3 percent in the 1970s, where it remained until the 1990s. Rates of growth of the potential labor force began to decline in the past decade, but even today they remain high at 2.7 percent a year. East Asia, with its compressed demographic transition during the 1960s and 1970s, did not in that period exceed the average growth of the working-age population witnessed in MENA over the entire past half century. Despite a projected decline between now and 2020, growth in MENA’s working-age population will be more than double that of East Asia today, one and a half times that of Latin America, and slightly above that of Sub-Saharan Africa.

Labor Force Participation Rates Have Been Rising

A general rise in participation rates among the working-age population has accompanied the growth in the working-age population in MENA (figure 3.7). After remaining stable at about 54.5 percent between 1970 and 1990, participation rates rose to 57 percent in 2000 and are projected to reach 61 percent by 2010. This increase has magnified the impact of labor market pressures resulting from the growth in the working-age population. As a result of these two factors, labor force growth accelerated from 2.1 percent a year in the 1960s to 3.1 percent in the 1970s, 3.4 percent in the 1980s, and 3.6 percent during the 1990s. The forecasted labor force growth rate between 2000 and 2010 is 3.5 percent a year, and not until 2020 will pressure on labor markets fall to more moderate rates last witnessed in the 1960s.
While the absolute size of labor force flows in MENA relative to flows in other developing regions are small, the magnitudes are staggering from the perspective of the region. Between 1950 and 1990, 47 million workers were added to the labor force, or 1.1 million workers a year. In the past decade alone, the labor force increased by some 32 million. Another 42 million will be added in this decade and nearly 39 million in the next. This means that in the first two decades of the 21st century, MENA’s labor force will expand by as much as it did over the span of the previous half-century.

**Migration Fuels the Expansion of Labor Supply in Oil-Exporting Countries**

While demography and labor force participation trends have shaped growth in labor supply in the labor-abundant countries, migration has been the driving force behind labor force growth in the oil-exporting (labor-importing) countries. Expatriate workers responded to the sharp increase in labor demand following oil price increases in the 1970s. In the mid-1980s, 4.1 million foreign nationals were working in the oil-exporting countries of the GCC, representing some 67 percent of the total workforce and almost 26 percent of the population (box 3.1). By some estimates, close to 10 percent of Egypt’s labor force and almost 15 percent of Yemen’s were employed abroad in the region in the 1980s.

Since labor force participation rates are high among expatriate workers, the labor-importing countries have exhibited higher participation rates than have the rest of MENA. Between 1970 and 1990, the labor force in the oil-exporting countries grew at an average of 6.4 percent a year compared with 3 percent in the rest of MENA. Beginning in the 1990s, lower migration rates led to a marked deceleration in the growth of the labor force in these countries. Labor force growth remains high, but now it is driven, as in the rest of MENA, by rising participation rates and an expansion of the national working-age population.
Box 3.1. The Evolution of the Labor Force in the GCC

From 1975 to 1985, the peak years of oil-led growth in the region, the GCC countries experienced unprecedented labor force growth of 7.7 percent a year, with growth in Saudi Arabia reaching 8.1 percent and in Bahrain 10.5 percent. This growth was driven primarily by the large number of immigrants seeking work in the rapidly expanding, population-deficient economies of the Gulf. During this period, the nonnational labor force grew at an average annual rate of nearly 13 percent, reaching 17 percent in Saudi Arabia and 15 percent in Bahrain. For the GCC as a whole, nonnationals made up more than 67 percent of the labor force in 1985, up from 39 percent 10 years earlier.

As oil prices fell in the mid-1980s, however, growth in the region declined, and with it the demand for labor. Labor force growth in the GCC fell to 4.4 percent between 1985 and 1995, reflecting a drop to 4.4 percent in the labor force growth rate for nonnationals and an increase from 1.6 percent to 4.5 percent in the labor force growth rate for nationals. The total share of nonnationals within the GCC continued to increase through 1995, when the trend began to fade as demographic pressures in the GCC states led to larger numbers of nationals seeking work.

The fall in oil prices happened as the majority of Gulf countries began witnessing an increase in the share of their populations over the age of 15. Domestic labor market supply pressures have increased since the late 1990s. Thus, growth rates increased to 4.9 percent a year among nationals in the GCC labor force, while decreasing among nonnationals in all GCC countries, falling to 2.8 percent a year between 1995 and 2000. The share of nonnational workers in the total labor force has leveled off or declined in nearly all the GCC countries, falling from an average of 67 percent in 1995 to 64 percent in 2000. The decline has been largest in Saudi Arabia, where the share of nonnationals in the labor force has fallen from 64.2 percent to 55.8 percent.

Rural Migration Contributes to Urbanization

Across much of the region, rural-to-urban migration has intensified the growth of labor supply in urban centers. Reflecting the acceleration of migration because of higher wages and better health and education services in urban centers, urban populations in most countries continue to grow faster than the national average while rural populations experience low or even negative growth. In fact, rural-to-urban migration accounts for an estimated one-third to a half of population growth in cities (Adams 2003a).

As a result of this migration, MENA is one of the most urbanized regions in the world. The percentage of people living in rural areas is lower in all MENA countries, with the exception of Yemen, than in low- and middle-income developing countries as a whole (table 3.2). The Islamic Republic of Iran, Lebanon, and Tunisia, in particular, show signs of negative rural population growth largely because of migration. Egypt exhibits rural population growth rates that reflect a low rate of migration, while rural population growth rates in Jordan, Syria, and Yemen, though lower than urban growth rates, do not suggest the high rates of rural-to-urban migration of other countries in the region.

Migration from rural to urban areas has had a substantial impact on rural labor markets in MENA. Most notably, it has reduced labor supply pressures in rural areas and lowered the number of workers who need to be absorbed by the agricultural sector. As of 2000, only 27 percent of the labor force in MENA was engaged in agriculture. In fact, only Yemen has more than half of its population employed in agriculture. In Jordan and Lebanon, less than 10 percent of the population works in agriculture. Furthermore, all evidence suggests that the share of workers engaged in the agricultural sector will continue to decline (chapter 4).

The Impact of Young Working Adults Is Growing

The share of young adults (ages 15–29) in the working-age population and their participation in the labor force yield important insights into the dynamics of labor supply, since this segment of the working-age population constitutes the bulk of new entrants into labor markets. The share of young cohorts in the working-age population has remained high throughout the past half-century at no less than 47 percent...
(figure 3.8). It reached its peak in the 1980s at 51.5 percent but will remain above 40 percent until at least 2020.

Young adults, however, have not comprised as large a weight in the labor force as they have in the population. Their share has been consistently below their share in the working-age population, averaging 45 percent between 1950 and 2000 and peaking in 1980 at 47 percent. This trend results largely from the fact that youth in MENA, like their counterparts elsewhere, are remaining in school longer and delaying their entry into the work force.

Still, the pressure of young adults on labor force growth has been persistently high in MENA, with their growth in the labor force averaging almost 3 percent a year between 1950 and 1990 (figure 3.9). The period 1990–2010 will witness the greatest labor force pressures from young adults, as the share of young workers in the total labor force exceeds their share in the total population for the first time. Rising participation rates are driving this trend, and there is an important gender dimension to this increase.

The Changing Gender Profile of the Labor Force

While young males have been staying longer outside the work force, young females are choosing to participate in greater numbers (Assaad 2002). Participation rates for young men in the age group 15–29 fell from 77 percent in 1970 to 67 percent in 2000, while participation rates for the same cohort of women rose from almost 23 percent to 32 percent (figure 3.10). Thus, while growth rates of young male entrants have declined, those of young female entrants have accelerated. As a result, labor force pressures from young adults will remain as high over the 1990–2010 period as they were during 1970–90.

The rising participation of women in the labor force since the 1980s constitutes one of the most important developments affecting the size and gender composition of the region’s labor supply in recent years (World Bank 2003). The trend, while particularly evident among young females, cuts across all age cohorts. Female labor force participation rose from about 22 percent in 1960 to almost 25 percent in 1980, 27 percent in the 1990s, and 32 percent in 2000. Furthermore, female participation is forecast to reach 43 percent in 2020. The rate of growth of female labor supply accelerated to 5 percent in the 1990s and is at 4.9 percent in the present decade. As a result, the low female share in the total labor force of 18 percent in the 1950s rose to 27 percent in 2000 and will expand to 32 percent by 2010. It is no coincidence that the countries with the highest fertility rates and slowest fertility declines have experienced the smallest increases in female labor participation.
Female labor force participation is traditionally high in agrarian societies, and accordingly, Egypt, Morocco, and Yemen have historically high participation rates (figure 3.11). However, not all employment has the same impact on women’s choices. Those who participate in agricultural or informal work do not face the opportunity costs associated with children that women working in the formal sector do. In these cases, it is the change in female participation over the long run that matters since it reflects their exit from agriculture.

**The Labor Force Is Increasingly More Educated**

Not only are young adults entering the labor force in greater numbers, but they also are increasingly more educated, a consequence of the considerable resources devoted by governments in MENA to human capital accumulation. In the 1960s, educational attainment in the region was the lowest in the world with less than one year of education per adult 15 years or older (table 3.3). By 1980, MENA had begun closing the gap with other developing regions, and in the past 20 years, the impact of the policy commitment to education has been impressive. The educational attainment of the adult population in MENA increased more than 150 percent, faster than in any other region or income group in the world. With an average 5.3 years of schooling among those 15 years and older, MENA is ahead of South Asia and Sub-Saharan Africa and is a little more than one year behind East Asia and Latin America.
Table 3.3. Average years of Schooling in Developing Regions, Adults 15 Years or Older, 1960-1999

<table>
<thead>
<tr>
<th>Region</th>
<th>1960</th>
<th>1980</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-Saharan Africa</td>
<td>1.7</td>
<td>2.3</td>
<td>3.5</td>
</tr>
<tr>
<td>East Asia</td>
<td>4.3</td>
<td>4.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>4.9</td>
<td>6.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Developed countries</td>
<td>7.2</td>
<td>9.1</td>
<td>10.0</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>3.8</td>
<td>4.9</td>
<td>6.4</td>
</tr>
<tr>
<td>South Asia</td>
<td>1.5</td>
<td>3.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>2.2</td>
<td>4.1</td>
<td>5.5</td>
</tr>
<tr>
<td>MENA</td>
<td>0.9</td>
<td>2.6</td>
<td>5.3</td>
</tr>
<tr>
<td>Algeria</td>
<td>1.0</td>
<td>2.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Bahrain</td>
<td>1.0</td>
<td>3.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Egypt</td>
<td>--</td>
<td>2.3</td>
<td>5.5</td>
</tr>
<tr>
<td>Iran</td>
<td>0.8</td>
<td>2.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Iraq</td>
<td>0.3</td>
<td>2.7</td>
<td>4.0</td>
</tr>
<tr>
<td>Jordan</td>
<td>2.3</td>
<td>4.3</td>
<td>6.9</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2.6</td>
<td>4.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Syria</td>
<td>1.4</td>
<td>3.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Tunisia</td>
<td>0.6</td>
<td>2.9</td>
<td>5.0</td>
</tr>
</tbody>
</table>

Note: East Asia including China, Eastern Europe does not include Russia. South Asia includes India. Data show the regional weighted average using population.


Recent surveys in Egypt and Morocco provide greater detail on the expansion of educational attainment (figure 3.12). In Egypt, for example, people currently between the ages of 65 and 69 received slightly more than three years of education, while people ages 45 to 49 received five to six years of education. Those now between 30 and 35 have attained nearly eight years of education.

Narrowing Gender Gaps by International Standards

MENA’s success in educating its female population is as impressive as the aggregate record. Starting from the lowest average years of schooling in the world, women in the region have either narrowed the gap or surpassed their counterparts in other regions. An examination of specific levels of attainment confirms the depth of this achievement. In 1960, MENA ranked below Sub-Saharan Africa, East Asia, and Latin America in terms of the ratio of women with higher or secondary education to women with only primary or no education (figure 3.13). Between 1980 and 2000, this ratio grew faster in MENA than anywhere else.
More importantly, the gender gap in education in MENA has been shrinking rapidly. The ratio of male-to-female years of schooling fell from 2.5 in 1960 to 1.9 in 1980 and to 1.4 in 2000. Rising female enrollment rates at all levels of education since the 1970s are responsible for this trend, and, at the current pace, will push educational outcomes toward greater gender parity. In Syria, for example, primary enrollment rates in the 1970s were 84 percent for boys and 54 percent for girls. By 2000, they were 99 percent for boys and 94 percent for girls. It is not surprising then that MENA’s gender gaps in education are smaller now than those in East Asia and South Asia.

**Education Matters More for Female Labor Participation**

There is little doubt that the rising educational attainment of women in the region has contributed to their growing participation in the economy (Assaad and El-Hamidi 2002). Education affects labor participation directly by raising the opportunity costs of remaining outside the work force and by providing greater access to better job opportunities. It does so indirectly by reducing fertility. As the trends in Egypt and Morocco elucidate, female labor force participation rises with the level of education, doubling or tripling as women move from illiteracy to postsecondary levels (figures 3.14 and 3.15).

Greater educational attainment has coincided with the growing size of female cohorts in their prime working years because of the dynamics of demography in the region. The two forces have interacted positively to raise female labor participation, in line with the experience of Latin America in the 1980s and East Asia in the 1970s: changing age structure and education together explain close to 55 percent of the rise in female labor participation rates in MENA in the past 20 years.

Male labor force participation rates are generally higher than female participation rates at every level of education, in part because of men’s traditional role as primary breadwinners. But what is striking from recent evidence in Egypt and Morocco is the V-pattern of male participation and education profiles (figures 3.16 and 3.17). Participation rates are higher at the extremes of educational attainment but low at intermediate levels. The stability of this pattern in the 1980s and 1990s suggests that the participation rates for men with intermediate levels of education are a reflection of high unemployment rates among this category of workers and the low demand for their skills in labor markets (chapters 4 and 6).
Labor Market Outcomes in the 1990s

The dynamics of demography in MENA have created some of the most intense pressures on labor markets observed anywhere in the world in the post–World War II period. The growing supply of workers constitutes one of the fundamental forces driving employment outcomes in the region (Duryea and Székely 1998). But since employment outcomes are determined by the interaction of supply and demand, no complete account of labor markets can be made without an assessment of labor demand as determined by economic conditions and policies internal and external to the region. From this perspective, the strong economic performance of MENA prior to the mid-1980s and weaker performance in the subsequent period have been fully reflected in labor market outcomes. In contrast to the 1960s and 1970s, labor supply growth against a backdrop of anemic economic performance and an outdated development model in the 1980s and 1990s has resulted in the emergence of high and persistent unemployment (Shaban, Assaad, and Al-Qudsi 2003).

The Emergence of High Unemployment

By definition, if labor supply exceeds the level of employment, the unemployment rate rises. Over the past decade growth in the labor force has exceeded growth in employment in Algeria, Egypt, the Islamic Republic of Iran, and Morocco, which together account for two-thirds of the region’s labor force (figure 3.18). In Jordan and Tunisia, where rates of unemployment were already moderately high, employment growth has just kept pace with labor force growth.
Accordingly, unemployment in MENA at present is among the highest in the world, second only to that in Sub-Saharan Africa. A conservative estimate places unemployment at about 15 percent of the workforce. Also, young cohorts are disproportionately affected by unemployment. Youth unemployment rates are more than twice the rates of total unemployment in many countries in the region. The majority of unemployed workers are relatively educated first-time job seekers (chapter 4).

The problem of unemployment affects almost every country in the region (figure 3.19). Recently, even the oil-exporting countries that traditionally imported expatriate labor to supplement the national workforce have begun to experience increasing rates of unemployment. Unofficial estimates put rates of unemployment at much higher levels, and the regionwide estimate would
also rise if Iraq were included. Moreover, official estimates do not include underemployment and disguised employment, which if taken into account would raise the estimates even further (Fargany 2001).

**Real Wages Have Stagnated or Declined**

MENA’s poor labor market outcomes in the 1990s affected employment and real wages. Although real wages increased marginally in some countries, they either stagnated or declined in most, extending a trend that began in the 1980s (chapter 4). Worker productivity, which forms the basis for the long-term behavior of real wages, improved in only a handful of countries in MENA (figure 3.20). For MENA as a whole, worker productivity increased by an average of about 0.7 percent a year in the past decade. This growth is less than in any other region except Europe and Central Asia, which has been undergoing significant economic restructuring (figure 3.21).

**Understanding Adverse Labor Market Outcomes**

Labor supply pressures in MENA, while important, cannot alone account for the adverse labor market outcomes in the 1990s. Although the supply of first-time job seekers, who are traditionally vulnerable to high unemployment, has grown since the 1980s, this has not necessarily led to high unemployment rates for young adults. In some MENA countries where youth unemployment is high, participation rates among young males fell in the 1990s, implying that not all potential workers entered the labor market (figure 3.22). International experience suggests that overall economic conditions matter more than demographic forces alone in shaping labor market outcomes (O’Higgins 2003). Where unemployment rates are high, they tend to affect young as well as older workers (figure 3.23).
Employment and Output Trends Are Linked

Labor demand appears to have slowed the pace of job creation in the 1990s, leading to high unemployment. The most important indicator of trends in labor demand is output growth. Strong output growth both reflects and leads to employment growth and lower unemployment because the work force is an essential factor of production that contributes directly to the expansion of output. Thus, faster output growth has generally gone hand in hand with lower unemployment, while growth stagnation has invariably implied higher levels of unemployment. In most MENA countries, the economies that have grown the fastest since the mid-1980s today exhibit the lowest unemployment rates (figure 3.24).

The interplay among output, employment, and unemployment can be summarized in a simple accounting framework that conceptualizes the two basic characteristics of good labor market outcomes: high employment and wage growth. The sum of the two objectives is captured by the behavior of output per laborer over time. Accordingly, creating employment opportunities for those who want to work is equivalent to increasing the ratio of employed persons to the total labor force. Boosting wage growth, however, depends on raising worker productivity, or output per employed person. Faster employment and productivity growth go hand in hand with the expansion of output growth per laborer. Conversely, slower output growth reflects rising unemployment and/or productivity slowdowns.

\[
\text{Growth} \left( \frac{\text{Output}}{\text{LF}} \right) = \text{Growth} \left( \frac{\text{Employment}}{\text{LF}} \right) + \text{Growth} \left( \frac{\text{Output}}{\text{Employment}} \right)
\]
Trends in the growth of output per laborer are fairly consistent with trends in productivity growth and reductions in unemployment in MENA countries. Countries that experienced faster growth in output per laborer in the 1990s witnessed an increase in worker productivity and/or declines in unemployment. Tunisia’s growth in output per laborer of 1.9 percent was achieved through higher worker productivity, which averaged 2.1 percent, and a modest reduction in the unemployment rate from 16 to 15 percent. Egypt’s more modest growth in output per laborer, 1.4 percent, reflected productivity gains but lower employment growth and, hence, increased unemployment. For countries such as Algeria, Jordan, and Morocco, negative growth in output per laborer over the 1990s was the result of either worsening unemployment or lower worker productivity.

These findings suggest that trends in output growth per laborer reflect labor market outcomes in MENA. The story in the 1990s was one of weak output performance in the face of rapid labor force growth, with the result that output per laborer barely improved—if at all (Nabli and Keller 2002). While there is a modest difference in labor force growth rates between MENA in the 1990s and the fast-growing Asian economies in the 1970s, the real difference between the regions is that labor force growth was accompanied by enormous increases in real output in East Asia but not in MENA. Real GDP growth in East Asia averaged 7.4 percent a year during 1970–80—more than double its labor force growth rate for the same period. In MENA, however, the combination of low worker productivity and high unemployment in the 1990s implied that output growth the 1990s averaged only about 3.7 percent a year—only marginally higher than labor force growth.

A Closer Examination of MENA’s Growth Performance

While anemic growth in output per laborer has resulted in and reflected the poor labor outcomes in MENA in the past decade, it does not explain the reasons behind the growth slowdown. Output growth (and output growth per laborer) is driven by the accumulation of physical and human capital embodied in the work force, as well as by how these factors of production are used in production. A fuller understanding of the dynamics of growth requires a closer examination of the underpinnings of output.

MENA’s Exceptional Performance Prior to the 1980s

In the 1960s, MENA began two decades of massive public investments in infrastructure, health, and education that translated into high growth. Heavy investments were also made in SOEs in protected industries. These efforts helped the region to better utilize underused capacities and provided a boost to industrialization. As a result, MENA’s economic growth performance in the 1960s was the highest in the world, averaging 7.1 percent a year, equivalent to an annual 4.7 percent growth per laborer (World Bank 1995). Strong output growth continued in the 1970s, though at a lower annual average of 5.8 percent. However, the conditions spurring growth in the 1970s included some undesirable departures from the previous decade in terms of accumulation and productivity. Growth in the 1970s was driven only by high rates of accumulation, made possible by the availability of resources during the oil boom, while productivity growth slowed. During that decade, MENA realized the highest rates of growth in the world in both physical
capital and human capital per laborer, but growth on a per-laborer basis was 2 percentage points lower on an average annual basis than in the 1960s.

The Oil Bust Signals the Beginning of Economic Crisis

As international oil prices plummeted in the 1980s, the foundations of positive labor market outcomes in MENA collapsed. Output growth per laborer slowed, even becoming negative in some cases. With eroding macroeconomic balances and growing debt burdens, and despite external assistance that permitted spending, investments declined dramatically. Growth in physical capital per laborer fell by 75 percent from the previous decade.

Every country in the region experienced a dramatic deceleration in the rate of accumulation between the 1970s and 1980s, and almost every economy experienced a decline in TFP growth. With massive declines in the rate of accumulation and corresponding declines in TFP growth for most countries, output growth per laborer collapsed, a change of almost –3.5 percent a year over the 1970s (Page 1998; table 3.5).
The Birth of Stabilization and Reform Programs

The growth slowdown and large macroeconomic imbalances prompted a handful of countries, including Morocco, Tunisia, and Jordan, to embark on programs of stabilization and policy reform in the mid-1980s. By the early 1990s, after the Gulf War, nearly all non-oil-exporting countries followed suit, as did several of the Gulf economies. The hope was that such measures would improve the efficiency of resource allocation, attract investment, and ultimately create an environment in which the private sector could emerge as an engine of faster and sustainable economic growth and employment creation.

Did these efforts pay off? By and large, countries in the region experienced improvements in productivity and, hence, faster growth in output per laborer in the 1990s than in the 1980s (table 3.6). Despite stabilization efforts, the declines in capital accumulation that marked the 1980s continued into the 1990s, with nearly every country in the region realizing lower rates of physical capital accumulation than in the previous decade. As a result, despite the productivity gains and the positive contribution of human capital accumulation, growth performance in MENA remained significantly below past levels in the region and the overall global pattern.
Table 3.6. Change in GDP and Capital per Laborer and Total Factor Productivity in MENA Countries between 1980s and 1990s (percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth per laborer in the 1990s</th>
<th>GDP growth per laborer</th>
<th>Physical capital per laborer growth</th>
<th>Human capital per laborer growth</th>
<th>Total factor productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>-0.3</td>
<td>5.7</td>
<td>-0.5</td>
<td>-0.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Jordan</td>
<td>-0.5</td>
<td>2.3</td>
<td>-4.9</td>
<td>-0.6</td>
<td>4.6</td>
</tr>
<tr>
<td>Kuwait</td>
<td>-2.6</td>
<td>2.6</td>
<td>0.8</td>
<td>-0.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Syria</td>
<td>0.8</td>
<td>1.8</td>
<td>-0.7</td>
<td>-0.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Iran</td>
<td>1.9</td>
<td>2.2</td>
<td>0.4</td>
<td>0.4</td>
<td>1.8</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1.9</td>
<td>1.1</td>
<td>-0.8</td>
<td>0.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Egypt</td>
<td>1.4</td>
<td>-1.5</td>
<td>-5.7</td>
<td>-0.5</td>
<td>1.1</td>
</tr>
<tr>
<td>Algeria</td>
<td>-2.0</td>
<td>-1.0</td>
<td>-3.8</td>
<td>-0.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Morocco</td>
<td>0.2</td>
<td>-1.5</td>
<td>-0.7</td>
<td>0.1</td>
<td>-1.3</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimates

The Response of Private Investment Was Limited

The faster rates of accumulation needed to improve the growth and employment performance of the 1990s would have had to come from the private sector, both domestic and foreign. Furthermore, the focus should have been on the new sectors of the economy where employment and productivity growth were taking place. The failure of a strong response from the private sector stemmed primarily from the slow and protracted pace of policy reforms launched in the late 1980s and early 1990s. While the early macroeconomic and structural reforms improved economic outlooks, most countries failed to follow through on reforms. The private sector in MENA countries remains stifled by the systems of governance, the size and scope of government intervention in the economy, and limited progress in integrating the region into the world economy through trade and investment (chapter 6).

The slow pace of economic reforms and the weak investment response largely explain MENA’s poor growth performance in the 1990s (Dasgupta, Keller, and Srinivasan 2002). The record accords with the predictions of standard cross-country determinants of economic growth. Macroeconomic stability delivered a positive growth dividend, while the limited investment response held overall performance to modest levels (figure 3.25).
EXTERNAL INSTABILITY CORRELATES NEGATIVELY WITH PRIVATE INVESTMENT

It would be a mistake, however, to completely blame conditions endogenous to the region or to the policy formulation process for the limited investment response by the private sector and perhaps even for the policy setting in MENA. In a few countries, notably Jordan and Morocco, policy reforms should have elicited a response at home and abroad. In MENA, the answer lies partly in regional instability and volatility. The Intifadas in the West Bank and Gaza, the Iran-Iraq War, the Gulf War of 1991, and the U.S. war in Iraq in 2003 cast a shadow of persistent instability on the region’s economic prospects (Elbadawi 2002). Instability, as well as multiple sanctions regimes imposed on several large economies in the region, disrupted trade and investment, slowing integration into global capital markets. Furthermore, oil-exporting countries faced considerable oil price volatility in the 1990s, while the Moroccan economy was subject to severe droughts.

INSECURITY AFFECTS LABOR MARKETS DIRECTLY

At times, regional instability transmitted shocks that directly affected labor market outcomes, as with Israel’s border closures. The repatriation of millions of expatriate workers from the Gulf in 1990 created huge pressures on the labor forces of the labor-exporting countries, causing sharp temporary increases in unemployment in addition to the loss of remittance income (Stanton Russell 1992). Among them were an estimated 300,000 Jordanians, 150,000 Palestinians, 500,000 Egyptians, and 800,000 Yemenis, who fled the conflict.

In all, some 2 million migrants returned to their countries of origin from Iraq, Kuwait, and Saudi Arabia in the five months preceding the Gulf War in 1991. Many of the returnees to Egypt, most of whom had worked in Iraq, were absorbed into the Saudi Arabian economy within several months, so that the shock of Egypt’s returning workers was largely temporary. In the other countries, these pressures partly were alleviated as returning workers invested their repatriated savings in housing and businesses. However, the positive effects of such investments were primarily long term and did little to ease the short-term pressures associated with the immediate rise in unemployment and the loss of income.
Chapter 4
The Structure of Employment and Earnings

Labor supply pressures in MENA are at their apex, with one of every three people of working age a youth (ages 15–24) and a potential new entrant to the labor market. This young generation has benefited from large-scale investments in education and health. However, evidence shows that despite significant investment in human capital, MENA has reaped less than its potential in terms of economic growth and job creation. As a result, the region experienced high unemployment and low productivity growth in the 1990s. Chapter 3 explored the macroeconomic trends underpinning these outcomes. This chapter investigates the microeconomic and institutional reasons for the poor labor market outcomes. It explores rigidities in education, wage setting, and regulatory regimes that arise largely from the dominance of the public sector in labor markets. In addition to the dynamics of employment and wages, it looks at equity in the labor market, including wage determination and wage inequality, gender differentials in wages and access to employment, and the links between labor markets and poverty.

The Structure of Unemployment

Reduced labor demand from the public sector, slow growth of the private sector, and high job expectations of educated workers after years of guaranteed public sector employment have resulted in alarmingly high unemployment rates in MENA (Shaban, Assaad, and Al-Qudsi 2001; ILO 2003; United Nations Development Programme [UNDP] 2002). Unemployment is generally concentrated among youth with intermediate levels of education and is more limited among workers with low levels of education who are generally not eligible for government employment. This pattern suggests that a significant part of unemployment results from high job expectations by workers with some formal education, and a low valuation of these credentials by the private sector because education systems have concentrated on making public sector jobs accessible rather than on building skills.

Youth and Female Unemployment Are High

Unemployment in MENA falls disproportionately on the young (ILO 2003). Youth unemployment ranges from 37 percent of total unemployment in Morocco to 73 percent in Syria, with a simple average of 53 percent for all countries for which data are available (figure 4.1). Except in Jordan and Lebanon, first-time job seekers make up more than 50 percent of the unemployed in all countries for which data are available, further confirming that unemployment in MENA is essentially a labor market insertion phenomenon for youth (figure 4.2).
There is a gender dimension as well to the profile of unemployment. Unemployment rates tend to be higher for women, in part because of the growth in the female working-age population and rising labor force participation rates brought about by higher educational attainment. Unemployment rates for the region as a whole are nearly 50 percent higher for women than for men (figure 4.3). Rates are higher for women in all countries for which data are available, with the exception of Yemen and the West Bank and Gaza, where actual female participation in wage employment is low.

Working-age children of heads of households are much more likely to be unemployed than are heads of households or other members of the household. For men, this effect is stronger in urban areas, whereas for women it is stronger in rural areas. For women, household size is positively correlated with a higher probability of unemployment in both urban and rural settings. In addition, a higher dependency ratio within the household is associated with a greater likelihood of unemployment for men but a lower likelihood for women. These patterns support the claim that unemployment among younger workers of both sexes is to some extent voluntary, facilitated by support from their families while they search for acceptable employment.
Unemployment and Education Are Strongly Linked

Unemployment is also strongly linked to education, with unemployment rates highest for groups in the middle and upper end of the education distribution. The educational attainment of the adult population has increased more than 150 percent in the past three decades, making educated youth the fastest-growing segment of the population. In nearly all countries for which data are available most of the unemployed have primary or secondary education certificates. In Algeria, Jordan, and Tunisia, more than half of the unemployed have a primary education certificate, and in Egypt more than two-thirds have a secondary certificate.

University graduates constitute a small fraction of the unemployed except in Jordan, where they make up about a third. In Algeria and Morocco, university graduates comprise a small share of the unemployed although they have the highest unemployment rates. Those without formal school certificates are a small share of the unemployed, except in Djibouti and Morocco. Those with no formal education in Morocco had an unemployment rate of 9.4 percent in 1999, significantly below unemployment rates at higher education levels, although they made up more than 40 percent of the unemployed (table 4.1 and figure 4.4).

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>None</th>
<th>Primary</th>
<th>Secondary</th>
<th>Tertiary</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>T M F</td>
<td>T M F</td>
<td>T M F</td>
<td>T M F</td>
<td>T M F</td>
<td>T M F</td>
</tr>
<tr>
<td>Algeria</td>
<td>1995</td>
<td>9.6</td>
<td>30.9</td>
<td>30.9</td>
<td>68.4</td>
<td>27.9</td>
</tr>
<tr>
<td>Egypt</td>
<td>1998</td>
<td>4.1</td>
<td>5.7</td>
<td>22.4</td>
<td>6.5</td>
<td>11.4</td>
</tr>
<tr>
<td>Morocco</td>
<td>1999</td>
<td>9.4</td>
<td>26.3</td>
<td>32.4</td>
<td>37.6</td>
<td>15.6</td>
</tr>
<tr>
<td>Oman</td>
<td>1996</td>
<td>5.6</td>
<td>13.4</td>
<td>24.8</td>
<td>2.8</td>
<td>10.8</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1997</td>
<td>10.2</td>
<td>20.8</td>
<td>15.4</td>
<td>6.4</td>
<td>15.7</td>
</tr>
</tbody>
</table>

Source: Algeria and Oman, ILO 2001-2; Egypt, ELMS 1998; Morocco, MLSS 1999; Tunisia, INS 1997.

The conclusion that emerges from these stylized facts is that unemployment in MENA is a phenomenon that primarily affects young new entrants and women at the middle and upper ends of the educational distribution. Thus, the unemployed are essentially those who would have had a chance at a formal job in the public sector in the past and continue to have expectations of acquiring such a job (Assaad 1997; Radwan 2002). Those with no education must either accept whatever employment is available to them, no matter how casual, or create their own job in order to survive. While they might be underemployed, they are less likely to be openly unemployed.
Box 4.1. Profiles of the Unemployed in Morocco and Egypt

Survey data for Morocco and Egypt provide a detailed profile of the unemployed and the reasons for their status. In Morocco, about a third of the unemployed in 1999 said that they were unemployed because of “firm closure,” up from 22 percent in 1991. This suggests that economic restructuring may be emerging as an important contributor to unemployment. The fact that new entrants make up a larger majority of the unemployed in Egypt suggests that economic restructuring is not as important a reason. In Egypt, 66 percent of unemployed men and 54 percent of unemployed women claimed that they were unemployed because no jobs were available, which suggests that their unemployment may be involuntary.

In Morocco, unemployment is highest among primary and lower secondary school graduates. In Egypt, the highest probability of unemployment is among upper secondary school graduates, followed by graduates of two-year postsecondary institutions. However, in interpreting this differential, it is important to note that educational attainment is significantly lower in Morocco than in Egypt. Sixty-eight percent of working-age Moroccans had less than a primary education in 1999 compared with 35 percent of Egyptians in 1998. In both countries, unemployment significantly affects people in the upper third of the educational distribution. This may be because unemployment affects primarily young people, who tend to be more educated than older cohorts. However, even if the sample is limited to those 20 to 24 years old, unemployment is significant only for people in the top half of the education distribution.

The average age of the unemployed in Morocco has increased slightly from 26.5 in 1991 to 27.4 in 1999, and the average number of years of schooling went from 6.8 to 8.2. In Egypt, the average age of the unemployed is 25, the same as in 1988, and the average number of years of schooling increased from 9.4 to 11, reflecting the national increase in educational attainment. There is little evidence from either country that unemployment is spreading to older or less educated groups. This is important because the older and the less educated the unemployed worker, the more vulnerable the household is to poverty.

The average duration of unemployment has increased sharply in both countries, rising in Egypt from 29 weeks in 1988 to 158 weeks in 1998 and from 79 weeks in 1991 to 178 weeks in 1999 in Morocco. Although recall and reporting problems may cloud these figures, the increase in duration is unmistakable. The data also suggest that unemployment is longer among first-time job seekers than among those with previous work experience.

Data on labor market transitions in Egypt confirm that the unemployed are mostly seeking wage employment, especially in the public sector. More than 90 percent of the unemployed who transitioned into employment from 1991 to 1998 in Egypt went into wage work, 80 percent of them in the public sector. In the 1980s, this proportion was even higher, at 96 percent, indicating that securing employment in the public sector is becoming more difficult.

Sources: Assaad 2002b; World Bank staff estimates.
Public Sector Employment in the 1990s

The prospect of work in the public sector affects the expectations of young workers and shapes unemployment in the region. However, governments in MENA have continued to maintain their dominant position in the structure of production and employment. MENA countries entered the 1990s with a high share of public employment in total employment. The share of civilian government employment is high by international standards, exceeding averages for both industrial countries and other developing regions (figure 4.5). In countries for which data are available, the share of the public sector in total employment in the late 1990s ranged from 8 percent in government and 2 percent in public enterprises in Morocco to 32 percent in government and 7 percent in public enterprises in Egypt (Schiavo-Campo, de Tommaso, and Mukherjee 2003).

Significant queuing continues for public sector jobs, especially among educated workers. Sluggish growth in the private sector, the perpetuation of implicit and explicit employment guarantees in government hiring, and mismatched wage expectations resulting from generous public sector compensation and benefits policies have all contributed to the continued preference for public sector jobs. This phenomenon is strongest among the oil exporters, where a high youth unemployment rate coexists with a large inflow of foreign workers. In the long run, the most detrimental impact of such government hiring practices is that they trap human capital in unproductive public sector jobs, thus limiting its contribution to growth.

Dynamics of Public Sector Employment

Public sector employment as a share of total employment is highest among GCC countries such as Bahrain, Kuwait, Oman, and Saudi Arabia, followed by Algeria and the Islamic Republic of Iran and the more diversified economies of Egypt and Jordan. Tunisia and Morocco have the lowest public employment ratios. The share of public sector employment declined in the late 1990s except in the oil-exporting countries (box 4.2) and in Egypt (figure 4.6). In Egypt, civil service expansion resulted in an increased public sector share despite contraction of the public enterprise sector. Only in Algeria and Egypt did public employment growth outstrip growth of total employment. In both countries, Egypt over the
period 1988–98 and Algeria over the period 1996–99, the public sector accounted for well over a third of job creation in the 1990s (figure 4.7).

Efforts to Downsize Falter, but Succeed in Some Countries

With the increasing realization that large public sectors have become unsustainable, attempts were made in the 1990s to reduce the size of the public sector. A few countries,
however, have succeeded in reducing public sector employment. The most far-reaching rationalization of public employment occurred in the government sector of Jordan and in the government and public enterprise sectors of Morocco. In Jordan, government grew at only 0.5 percent a year in 1995–2000, and the share of overall public sector employment in total employment declined from 45 percent in 1987 to 36 percent in 1996. In Morocco, public sector employment declined in relative and absolute terms. Public employment declined by 1.8 percent a year in 1991–99, and its share in total employment fell from 12.6 percent to 9.9 percent.

**Gender and Occupation in the Public Sector**

The privileged position of the public sector in MENA labor markets has had important gender and education effects. The rise in female labor force participation in many countries is due primarily to the expansion of educational opportunities and to the employment of educated workers by governments, as well as by explicit government policies to facilitate the participation of women in the labor force (Assaad and El-Hamidi 2001). Although such policies in MENA ostensibly apply to both public and private employers, private employers evade them by not hiring women on a formal basis and encouraging women to quit jobs upon marriage.

The role of the public sector as a major employer of women was only marginally reduced in the 1990s (figure 4.8). Algeria has the highest concentration of female employment in the public sector, with more than 85 percent of the female labor force in public employment in 1990. In 1988, both Jordan and Egypt also had comparatively high shares: 54 percent and 66 percent respectively, although by 1998 that share had dropped to 57 percent in Egypt. Syria’s ratio of female employment in the public sector relative to total employment remained stable at about 42 percent throughout the 1990s, whereas in Morocco, the share was much smaller at 7 percent through the 1990s.

Research on Egypt suggests a number of reasons for the public sector’s large share of female employment in MENA. First, the public enterprise sector, which has
proportionately fewer women, is declining as a share of overall public sector employment. Second, because of less desirable options in the private sector, women are less likely to drop out of the public sector employment queue than are men. Finally, as public sector jobs have become more difficult to secure, women have tended to hold on to these jobs longer than jobs in the private sector, remaining more often, for example, after marriage. Women also face fewer barriers to entry and experience less occupational segregation and wage discrimination in the public sector thanks to more standardized wage setting and hiring procedures. And many nonwage benefits valued by women are more common in the public sector (greater job security, shorter working hours, and earlier pension).

The Structure of Labor Markets

Rising rates of unemployment are a clear indicator that employment growth in MENA has not kept up with labor force growth. What are the sources of employment growth in MENA, and what sectors are contributing to labor absorption?

Agriculture Declines, Manufacturing at a Standstill

The distribution of employment and value added (output) reveals a decline in the share of agriculture during the oil boom followed by a slowdown or reversal of that trend after the collapse of oil prices in 1986 (table 4.2). For the diversified economies, the share of agriculture in value added declined during the 1970s, recovered somewhat in the 1980s as the share of oil fell, then declined again in the 1990s as oil prices recovered. Similarly, the share of agriculture in employment declined rapidly up to the mid-1980s, stabilized in the late 1980s, and then resumed its decline in the 1990s.

Despite massive efforts to promote industrialization in many countries, manufacturing’s share in employment and output was either stagnant or declining in the 1970s and 1980s, a victim of the Dutch disease phenomenon. A general increase in expenditures and appreciation of the real exchange rate brought about by the oil windfall resulted in a boom in nontradables, adversely affecting the production of tradable goods (Corden 1984; Richards and Waterbury 1998). Several of the diversified economies were also affected by the Dutch disease phenomenon as significant oil-related resources flowed into their economies as remittances and aid flows.

The diversified economies that were more insulated from the 1970s oil boom, Morocco and Tunisia, fared differently. They also saw a decline in the share of agriculture in employment and value added, but the share of manufacturing increased in both countries in the 1980s as they implemented structural adjustment programs. Their economic structures were more stable in the 1990s, with manufacturing and services maintaining a relatively constant share of employment.
### Table 4.2: The Structure of Employment and Production in MENA

<table>
<thead>
<tr>
<th>Employment (%)</th>
<th>Value Added (%)</th>
</tr>
</thead>
<tbody>
<tr>
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<td>-------</td>
</tr>
<tr>
<td><strong>Mixed Oil Producers:</strong></td>
<td></td>
</tr>
<tr>
<td>Algeria</td>
<td>1977</td>
</tr>
<tr>
<td>1980</td>
<td>36</td>
</tr>
<tr>
<td>1991</td>
<td>24</td>
</tr>
<tr>
<td>1995</td>
<td>12</td>
</tr>
<tr>
<td>Iran</td>
<td>1976</td>
</tr>
<tr>
<td>1980</td>
<td>36</td>
</tr>
<tr>
<td>1996</td>
<td>23</td>
</tr>
<tr>
<td>1991</td>
<td>24</td>
</tr>
<tr>
<td>Iraq</td>
<td>1977</td>
</tr>
<tr>
<td>1987</td>
<td>14</td>
</tr>
<tr>
<td>1990</td>
<td>16</td>
</tr>
<tr>
<td><strong>Diversified Economies:</strong></td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>1976</td>
</tr>
<tr>
<td>1986</td>
<td>39</td>
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<td>1995</td>
<td>34</td>
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<td>2000</td>
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<td>1993</td>
<td>6</td>
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<td>Morocco</td>
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<td>1982</td>
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<td>1991</td>
<td>49</td>
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<td>1999</td>
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<td>2000</td>
<td>24</td>
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<td>Tunisia</td>
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<td>1984</td>
<td>28</td>
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<td>1994</td>
<td>22</td>
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<td>2001</td>
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<td>West Bank &amp; Gaza</td>
<td>1980</td>
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<td>2000</td>
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<td>1994</td>
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</tr>
<tr>
<td>1995</td>
<td>8</td>
</tr>
<tr>
<td>2000</td>
<td>8</td>
</tr>
</tbody>
</table>

Notes: Other industry includes mining, construction, and electricity, water and gas, except:
(a) Manufacturing includes all other industry.
(b) Manufacturing includes utilities and mining, but not construction (included in other industry).

Data for West Bank and Gaza (1980, 1992) are from Israel Central Bureau of Statistics.
Services Are the Most Dynamic Sector

With agriculture shedding workers and no longer absorbing surplus labor and manufacturing stagnant except in Morocco and Tunisia, services are playing the lead role in labor absorption in most countries. The private sector is gradually taking the lead from the public sector in employment creation in much of the region, but most new jobs are in the informal sector, informal jobs in the formal sector in the nonoil economies, or jobs filled by expatriate workers in oil-exporting countries. Private employers appear unwilling to hire workers under the highly protective labor regimes in most countries (chapter 5). And many governments have chosen lax enforcement of labor laws over the politically treacherous process of reform.

<table>
<thead>
<tr>
<th>Share of growth</th>
<th>Annual rate of growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>-9.0 -1.2</td>
</tr>
<tr>
<td>State-owned enterprise</td>
<td>-7.9 -4.5</td>
</tr>
<tr>
<td>Subtotal public sector</td>
<td>-16.9 -1.8</td>
</tr>
<tr>
<td>Private agriculture wage work</td>
<td>8.2 1.7</td>
</tr>
<tr>
<td>Private agriculture non-wage work</td>
<td>-5.0 -0.1</td>
</tr>
<tr>
<td>Subtotal agriculture</td>
<td>3.2 0.1</td>
</tr>
<tr>
<td>Private non-agriculture wage work</td>
<td>110.1 6.2</td>
</tr>
<tr>
<td>Private non-agriculture non-wage work</td>
<td>-5.5 -0.3</td>
</tr>
<tr>
<td>Subtotal private non-agriculture</td>
<td>104.7 3.1</td>
</tr>
<tr>
<td>Total</td>
<td>100.0 1.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Share of growth</th>
<th>Annual rate of growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt (1988-1998)</td>
<td>41.8 4.8</td>
</tr>
<tr>
<td>Tunisia (1997-2001)</td>
<td>7.1 1.0</td>
</tr>
<tr>
<td>State-owned enterprise</td>
<td>-7.0 -2.6</td>
</tr>
<tr>
<td>Subtotal public sector</td>
<td>34.7 3.0</td>
</tr>
<tr>
<td>Private agriculture wage work</td>
<td>-0.4 -0.2</td>
</tr>
<tr>
<td>Private agriculture non-wage work</td>
<td>27.4 1.9</td>
</tr>
<tr>
<td>Subtotal agriculture</td>
<td>26.9 1.6</td>
</tr>
<tr>
<td>Private non-agriculture wage work</td>
<td>31.6 4.3</td>
</tr>
<tr>
<td>Private non-agriculture non-wage work</td>
<td>6.7 1.3</td>
</tr>
<tr>
<td>Subtotal private non-agriculture</td>
<td>38.3 3.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0 2.5</td>
</tr>
</tbody>
</table>


Mixed Patterns of Job Creation

The availability of micro data for Egypt, Morocco, and Tunisia allows a more detailed analysis of employment creation over the past decade. Overall employment growth was more rapid in Egypt and Tunisia than in Morocco (table 4.3). The difference between Morocco and Egypt is almost entirely accounted for by changes in public sector employment, which declined in Morocco while growing in Egypt. The difference between Tunisia and Morocco is largely attributable to differences in agricultural performance. Morocco suffered from severe drought, whereas agriculture was the fastest-growing segment of the economy in Tunisia. In Morocco paid employment in agriculture grew, while in Tunisia both segments of the agricultural sector grew, with the unpaid segment growing slightly faster. Egypt’s agricultural sector appears to be more dynamic than that of Morocco, but the difference is attributable entirely to the hard-to-measure
female employment in subsistence agriculture. Male employment in agriculture in Egypt declined, as did paid employment, which corresponds roughly to the commercial agriculture sector.

Private sector paid employment outside agriculture was the most dynamic segment of the Moroccan economy, growing at an annual rate of 6.2 percent (five times the average) and accounting for more than 100 percent of net employment creation in the 1990s. The sector was also dynamic in Egypt, growing at 1.7 times the average and accounting for about a third of net employment creation in 1988–98. In Tunisia, nonagricultural paid employment grew more slowly but still accounted for 20 percent of employment growth. Most employment growth occurred in the broad services, manufacturing, mining, and utilities in all three countries. In Tunisia, but not in Morocco or Egypt, the nonwage component of nonagricultural employment, an important component of the informal sector, grew at about the same pace as paid employment and accounted for 46 percent of employment growth. This suggests that the informal sector is significantly more dynamic in Tunisia than in Egypt or Morocco.

The Informalization of Work in the 1990s

In the state-led era, most countries in MENA adopted protective labor regulations providing workers with lifetime job security, generous retirement packages, and other job-related benefits (chapter 5). These regulations were generally enforced in the public sector but much less so in the private sector. As countries began to reform in the past decade, they made few attempts to explicitly deregulate labor markets to encourage employment creation. Instead, there appears to have been a tacit agreement between the authorities and private business that labor laws would not be strictly enforced for new labor market entrants. Thus, the growing informalization of labor markets spread beyond self-employment and wage employment in small informal sector enterprises to the expansion of unregulated employment in the formal private sector.

Measuring the Informal Sector Is Challenging

While the conventional wisdom is that the informal sector has become a leading source of employment in MENA in the 1990s, data limitations make it difficult to study the size and dynamics of this sector (Charmes 1999). Informal employment is typically estimated as a residual: employment in establishments of more than 10 workers (obtained from establishment surveys) is subtracted from total nonagricultural employment (obtained from household surveys). This method misses workers in large firms who are hired informally without the benefit of employment contracts or social insurance. Estimates of informal employment in MENA range from a low of 42 percent of nonagricultural employment in Syria to a high of 55 percent in Egypt (figure 4.9). Although moderate compared with other developing regions, these estimates are high given the large share of public sector employment.
Self-employment accounts for about half of informal employment in Egypt and Tunisia, two-thirds in Algeria and Syria, and up to four-fifths in Morocco, with wage employment in enterprises of fewer than 10 workers accounting for the rest. Although the informal sector is generally an important source of employment for women in developing countries, in MENA the proportion of men in informal employment exceeds that of women. And while female self-employment as a share of total female nonagricultural employment has increased in most developing countries, it has fallen in MENA, probably because women are increasingly concentrated in public sector employment.

**Informal Employment Is Expanding for Everyone**

While it is difficult to determine how much each of these categories of work is growing or shrinking, household surveys provide information on the proportion of employment that is not covered by legal employment contracts or social insurance. This is the broadest measure of informality in the labor market because it includes self-employment and family labor, as well as unregulated employment in the private sector and sometimes the public sector.

Evidence from Egypt indicates that nonagricultural informal employment increased in the 1990s, whether informality is measured by lack of an employment contract or social security coverage. The proportion of nonagricultural workers (over 18 years old) engaged in informal jobs increased by about 5 percentage points in the 1990s. In 1998, more than half the working labor force (54 percent) and about 44 percent of nonagricultural workers were not covered by legal employment contracts. Nearly 47 percent of all workers and 36 percent of nonagricultural workers did not have social insurance coverage (Wahba 2002).

The evidence for increased informalization remains even after controlling for individual characteristics, including the tendency for some workers to transition out of the informal sector with age and experience. For a worker with average characteristics, the probability
of being an informal worker was 5 percentage points higher in 1998 than in 1990. Although the probability of informality increased for both male and female workers, the increase was greater for women, albeit from a lower initial level (figure 4.10). Informal employment affected people at all education levels, with the largest increase in informality among workers with an intermediate education—those with the lowest eligibility for the public employment guarantee for graduates (figure 4.11).

Another indication of the gradual informalization of the Egyptian labor market is the shift in the type of jobs that first-time job seekers have been able to secure. In the 1970s, the proportion of new job market entrants going directly into public sector employment hovered between 60 and 70 percent, but by 1998 that share had fallen to 25 percent (figure 4.12). The share of new entrants whose first jobs were informal increased from less than 20 percent in the 1970s to 60 percent in the late 1990s, nearly matching the decline in the public sector share.

The increased informalization of employment among new entrants would not necessarily indicate overall informalization of the labor market if new entrants were able to transition quickly to formal jobs. This, however, is not the case. Some 95 percent of nonagricultural
workers without employment contracts or social insurance in 1990 were still without contracts or social insurance in 1998 (Wahba and Mokhtar 2002). Such high levels of persistence in informal employment show that informality is not just a transient state for new entrants on their way to a formal job.

In conjunction with the analysis on unemployment trends above, the foregoing analysis demonstrates that, at least in Egypt, the slowdown in government hiring in the late 1980s and 1990s resulted in higher levels of unemployment among new entrants and an increased reliance on informal employment arrangements. If formal private sector firms were hiring, they were doing so by skirting regulations on employment contracts and social insurance.

**Gender Equity in Access to Labor Markets**

Female labor force participation rates are rising (chapter 3) and, coupled with growth in the working-age population, will lead to unprecedented growth in the female labor force of 5 percent a year in the next decade. In this context, and given the increasing feminization of government employment, a question remains about the extent to which paid employment outside the government is accessible to women in MENA (Standing 1999). The region’s bureaucracies are already large by international standards and are likely to grow only slightly, if not contract, in the upcoming period. If the projected rapid increase in the female labor force is to be accommodated, paid employment outside of government will have to be the major source of growth. And yet as job opportunities in the more egalitarian public sector are dwindling women continue to face significant barriers to entry in the private sector, contributing to higher female unemployment rates and larger gender gaps in wages (CAWTAR 2001; Moghadam 2002).

Household survey data for Egypt and Morocco enable a closer examination of “feminization” and “defeminization” trends in nongovernment paid employment. Egypt is probably more representative of the general trend in MENA while Morocco appears to be an exception (Assaad 2002a). The data help to identify the job types (such as blue-collar workers in textile manufacturing and professional and managerial workers in finance and business services) in each country with higher than average shares of female employment at the beginning of the period. The analysis looks first at the change in the overall share of female employment between 1991 and 1999 in Morocco and 1988 and 1998 in Egypt from each job type (total effect). It then examines the components of that change: that from a change in women’s share in that job type (feminization effect), that from growth of the job type compared with overall growth of nongovernmental paid employment (growth effect), and that from the interaction of the feminization and growth effects (interaction effect).

Except for agriculture in Morocco, all the job types highlighted in tables 4.4 and 4.5 had higher than average female employment at the beginning of the period. Several disproportionately female job types are the same in the two countries, including teachers and health workers, domestic servants and other personal service workers, blue-collar work in food processing and textiles and garment manufacturing, white-collar work
outside retail trade, and professional and managerial workers. The most feminized job types in both countries are teachers and health workers and domestic and other personal service workers. Blue-collar manufacturing outside textiles and food processing and white-collar work in retail trade are disproportionately female in Egypt but not in Morocco.

In Egypt, all job types became defeminized from 1988 to 1998, while in Morocco all but two job types increased their female shares, including the “other” category that covers all job types with a lower than average female share. In Egypt, agricultural work, which constitutes nearly a fifth of the total, accounted for 40 percent of the defeminization of nongovernmental paid employment. Within agriculture, three-quarters of the effect was from defeminization of the sector and most of the rest from the sector’s slow growth. After agriculture, the largest contributors to defeminization were white-collar work outside retail trade (19 percent) and professional and managerial work outside finance, insurance, and real estate (14 percent). In white-collar work in retail trade, the growth effect was positive and substantial, but the defeminization effect cancelled it out.

In Morocco, the exceptions to the increased feminization effect were blue-collar workers in food processing and teachers and health workers, which together constituted only 5 percent of nongovernmental paid employment. Blue-collar work in textile and garment manufacturing accounted for 74 percent of feminization. Just over half the effect was from feminization of the sector, 30 percent from its faster than average growth, and the rest from the interaction of feminization and growth. The second-highest contributor to overall feminization was the “other” category. Although this large category has a much lower than average female share, its female share has increased substantially over the period. Domestic and services work, always predominantly female, was next, with about two-thirds of the effect on overall feminization from the sector’s growth and one-third from the feminization effect. Some job types, including agriculture, blue-collar work in food processing, teachers and health workers, and professional and managerial jobs, went counter to the overall feminization trend because they were slow growing.

<table>
<thead>
<tr>
<th>Types of job</th>
<th>1988 Female share</th>
<th>Share in overall employment</th>
<th>1998 Female share</th>
<th>Share in overall employment</th>
<th>Total effect</th>
<th>Feminization effect</th>
<th>Growth effect</th>
<th>Interaction effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural worker</td>
<td>16.1</td>
<td>21.8</td>
<td>9.7</td>
<td>15.9</td>
<td>-1.9</td>
<td>-1.4</td>
<td>-0.9</td>
<td>0.4</td>
</tr>
<tr>
<td>Blue-collar in food processing</td>
<td>16.8</td>
<td>2.7</td>
<td>13.7</td>
<td>3.2</td>
<td>0.0</td>
<td>-0.1</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Blue-collar in textiles and garment manufacturing</td>
<td>21.0</td>
<td>5.0</td>
<td>19.9</td>
<td>4.2</td>
<td>-0.2</td>
<td>-0.1</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Blue-collar in other manufacturing</td>
<td>17.1</td>
<td>4.0</td>
<td>8.8</td>
<td>4.6</td>
<td>0.3</td>
<td>-0.3</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>White-collar in retail trade</td>
<td>32.1</td>
<td>4.9</td>
<td>23.2</td>
<td>6.9</td>
<td>0.0</td>
<td>-0.4</td>
<td>0.7</td>
<td>-0.2</td>
</tr>
<tr>
<td>White-collar not in retail trade</td>
<td>36.7</td>
<td>5.6</td>
<td>23.8</td>
<td>4.7</td>
<td>-0.9</td>
<td>-0.7</td>
<td>-0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Teachers and health workers</td>
<td>90.8</td>
<td>1.8</td>
<td>76.8</td>
<td>1.6</td>
<td>-0.4</td>
<td>-0.3</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Domestic and other service workers</td>
<td>59.0</td>
<td>1.8</td>
<td>34.4</td>
<td>1.9</td>
<td>-0.4</td>
<td>-0.4</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Professional and managerial workers</td>
<td>16.5</td>
<td>13.2</td>
<td>13.9</td>
<td>11.4</td>
<td>-0.6</td>
<td>-0.3</td>
<td>-0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>2.3</td>
<td>39.5</td>
<td>1.6</td>
<td>45.6</td>
<td>-0.2</td>
<td>-0.3</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>15.0</td>
<td>100.0</td>
<td>10.2</td>
<td>100.0</td>
<td>-4.9</td>
<td>-4.9</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Table 4.5. Morocco: Decomposition of the Change in the Female Share of Non-governmental Paid Employment, 1991 to 1999 (percent)

<table>
<thead>
<tr>
<th>Type of job</th>
<th>Female share 1991</th>
<th>Female share 1999</th>
<th>Share in overall employment 1991</th>
<th>Share in overall employment 1999</th>
<th>Total effect</th>
<th>Feminization effect</th>
<th>Growth effect</th>
<th>Interaction effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural worker</td>
<td>15.3</td>
<td>18.6</td>
<td>16.2</td>
<td>14.6</td>
<td>-0.5</td>
<td>0.2</td>
<td>-0.6</td>
<td>0.0</td>
</tr>
<tr>
<td>Blue-collar in food processing industry</td>
<td>30.8</td>
<td>3.1</td>
<td>17.8</td>
<td>2.3</td>
<td>-0.6</td>
<td>-0.4</td>
<td>-0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Blue-collar in textile and garment manufacturing</td>
<td>39.9</td>
<td>7.5</td>
<td>62.3</td>
<td>9.9</td>
<td>3.2</td>
<td>1.7</td>
<td>0.9</td>
<td>0.5</td>
</tr>
<tr>
<td>White-collar workers outside retail trade</td>
<td>29.4</td>
<td>7.6</td>
<td>35.9</td>
<td>6.2</td>
<td>0.0</td>
<td>0.5</td>
<td>-0.4</td>
<td>-0.1</td>
</tr>
<tr>
<td>Teacher/health workers</td>
<td>63.9</td>
<td>1.9</td>
<td>52.7</td>
<td>0.9</td>
<td>-0.7</td>
<td>-0.2</td>
<td>-0.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Domestic and other service workers</td>
<td>55.9</td>
<td>8.9</td>
<td>60.6</td>
<td>10.3</td>
<td>1.3</td>
<td>0.4</td>
<td>0.8</td>
<td>0.1</td>
</tr>
<tr>
<td>Professional and managerial workers</td>
<td>32.9</td>
<td>1.8</td>
<td>34.9</td>
<td>0.9</td>
<td>-0.3</td>
<td>0.0</td>
<td>-0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>4.3</td>
<td>50.5</td>
<td>7.5</td>
<td>54.9</td>
<td>1.9</td>
<td>1.6</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Total</td>
<td>18.0</td>
<td>100.0</td>
<td>22.3</td>
<td>100.0</td>
<td>4.3</td>
<td>4.3</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimates from MLSS 1991 and 1999

While in Egypt defeminization occurred across all job types, in Morocco the feminization of jobs can be attributed largely to developments in the textile and garment sector. Although the sector accounted for only 7.5 percent of nongovernmental paid employment in 1991, it accounted for 74 percent of job feminization during 1991–99 because it grew faster than average and became more feminized. There is also evidence that job types traditionally closed to women, which constitute more than half of all nongovernmental employment in Morocco, are becoming more accessible to women.

The findings suggest that increased access of women to the labor market can initially be achieved by promoting sectors that have traditionally been open to female participation, such as textile and garment manufacturing. This finding conforms to international trends in the feminization of employment that accompanies an increase in export processing zones and assembly-type production (Ozler 2000; Joekes 1995). Over time, jobs that have been closed to women can gradually be opened in order to increase women’s share in overall employment. Thus, it is not surprising that the countries that have experienced significant growth in manufactured exports, such as Tunisia and Morocco, have done considerably better in increasing women’s share in employment than countries that have relied on remittances, service exports, and oil for their foreign exchange earnings.

**Real Wages and Wage Formation**

Real wages in most countries in the region tracked the oil boom-bust-stabilization cycle of the past three decades, either through the direct effect of oil on the economy or through cross-border movement of labor in response to these fluctuations. Real wages in manufacturing rose sharply from 1970 to 1975 in oil-exporting and diversified economies as a result of the first oil shock and resultant waves of migration. During this period, real manufacturing wages rose at a torrid rate of 20 percent a year in Kuwait and at the only slightly lower rate of 17 percent a year in the diversified economies.

**Trends in Real Wages Suggest Flexibility**

Real wages rose again following the second oil shock of 1979, which led to an acceleration of growth in the region’s economies. From 1980 to 1985, real wages rose 5 percent a year in the diversified economies and 3 percent a year in the oil exporters
Most of the increases occurred in the early 1980s and were followed by greater stability in 1982–85. However, there were several exceptions.

![Figure 4.13. Real Hourly Manufacturing Wages in MENA, 1980-1998](image)

The collapse in oil prices in 1986 ushered in a period of generalized wage decline across the region. Real wages fell 5.5 percent a year in the diversified economies, 6.7 percent in the oil exporters, and by as much as 14.4 percent a year in the Islamic Republic of Iran. By 1990, real wages in the diversified economies and the oil exporters had fallen to 70 percent of their peak levels in 1985–86 and remained below their 1975 levels.

Real wages were more stable in the 1990s than in the two previous decades. Among oil exporters, average real wages remained virtually unchanged from 1990 to 1995, with rising wages in Oman, falling wages in Kuwait and Bahrain, and relatively stable wages in Qatar. In the diversified economies, real wages were virtually flat as well. Nearly all countries in this group had stable wages with the exception of Syria, which had significant increases in the early 1990s.

**Higher Returns to Education in the Public Sector**

Wages tend to be more egalitarian in the public sector than in the private sector, leading to a narrower range of wages (Said 2002). Public sector wage-setting rules also place considerable emphasis on formal education and seniority. As the state’s role as employer of first or last resort shrinks, wages would be expected to increasingly reflect productivity differences among workers.

How these considerations would affect returns to education over time is less clear. If educational differences reflect productivity differences and if public sector wages are contracting, returns to education would be higher in the private sector and rising as the private sector expands. But if educational credentials do not translate into productivity differences, yet still are well rewarded in the public sector, a reduction in the role of the
public sector will lead to lower returns to education in the private sector and falling returns over time. Given that the region’s education systems have catered for years to the needs of growing bureaucracies, the second situation is much more likely in MENA. However, a reduction in educational premia does not necessarily mean that wage inequality is reduced. Wage inequality along other dimensions, such as gender, skill, and occupation, may increase as public sector wage-setting rules become less salient.

| Table 4.6. Rates of Return to Schooling by Gender and Sector in MENA, (percent per year) |
|-----------------------------------------------|-----------------------------------------------|
| Primary | | | | | |
| Male public | 8.2 | 6.4 | 12.4 | 6.1 | 3.5 | 2.7 |
| Male private | 2.3 | 3.6 | 3.0 | 3.4 | 2.0 | 2.7 |
| Female public | 1.9 | 5.3 | 28.2 | 10.5 | -3.9 | 5.1 |
| Female private | 0.9 | 7.2 | 8.5 | 9.4 | 14.7 | 8.0 |
| Lower Secondary | | | | | | |
| Male public | 7.0 | 4.9 | 10.7 | 8.2 | 2.9 | 2.7 |
| Male private | 2.5 | 4.4 | 6.4 | 6.3 | 5.5 | 2.7 |
| Female public | 7.7 | 8.2 | 22.3 | 13.4 | 5.2 | 3.7 |
| Female private | 3.2 | -1.2 | 13.9 | 10.0 | 9.8 | 7.4 |
| Upper Secondary, General | | | | | | |
| Male public | 8.6 | 8.8 | 10.6 | 8.8 | 28 | 2.2 |
| Male private | 6.3 | 7.3 | 10.4 | 7.7 | 6.0 | 2.2 |
| Female public | 8.6 | 9.7 | 18.1 | 12.1 | 4.6 | 3.9 |
| Female private | 3.8 | -1.5 | 16.4 | 11.0 | 10.4 | 12.1 |
| Upper Secondary, Vocational | | | | | | |
| Male public | 9.6 | 7.2 | 8.4 | 6.8 | 38 | 3.3 |
| Male private | 5.3 | 5.0 | 6.9 | 5.8 | 32 | 3.3 |
| Female public | 7.9 | 9.6 | 16.5 | 11.9 | 43 | 4.3 |
| Female private | 4.4 | 4.9 | 11.1 | 11.3 | 86 | 10.7 |
| University | | | | | | |
| Male public | 10.1 | 8.8 | 10.8 | 8.9 | 46 | 3.8 |
| Male private | 8.5 | 7.3 | 12.5 | 9.5 | 10.2 | 5.2 |
| Female public | 8.9 | 10.7 | 15.0 | 12.8 | 68 | 4.4 |
| Female private | 9.1 | 10.9 | 15.2 | 9.3 | 12.9 | 6.8 |

Note: Derived from regressions that control for potential experience and potential experience squared, urban-rural location, part-time, and casual work status in the private sector. The Yemen regressions control for age and age squared instead of potential experience and potential experience squared. All regressions control for sample selection using the Heckman procedure except for the Morocco regressions.

Source: World Bank staff estimates

Estimates of returns to education for selected MENA countries are generally higher in the public sector than in the private sector at nearly all education levels but the university level (table 4.6). Only in Yemen, a country with low educational attainment and low returns in general, are the returns comparable or slightly higher in the private sector. This suggests that the private sector places less value on basic and secondary education. Returns are higher for general secondary education, which is more selective than vocational secondary schooling, but since those who pass the general secondary exam usually go on to postsecondary studies, there are few workers in this category.

But Public–Private Wage Differences Decline

Rates of return to education in the private sector have been fairly stable in Egypt, but have declined in Morocco, matching estimates of more rapid increases in unemployment of educated workers in Morocco, where the public sector has contracted, than in Egypt, where it continues to expand. Rates of return, however, appear to be declining in the public sector in both countries. This suggests that as inflation has eroded public sector
wages, policymakers have tried to partially protect the wages of the lowest paid, leading to a contraction of the wage range.

Rates of return to schooling in the private sector appear to be higher for women than for men. Moroccan and Jordanian women, in particular, seem to reap significant benefits from schooling in the private sector. This does not mean, however, that educated women fare better than educated men, but simply that the gender gap in wages declines with education (discussed below).

By rewarding educational credentials in public employment with higher wages, governments have encouraged investment in types of human capital that are not necessarily valued in the private sector. The problem is most acute in primary and secondary education, which has expanded significantly to accommodate growing numbers of enrollees, often at the expense of quality. The recent decline in the number of school-age children in many countries provides an opportunity to refocus efforts on quality improvements and greater responsiveness to the need for productive skills (chapter 6).

**Measuring the Gender Wage Gap**

One dimension along which wages in MENA are likely to become more unequal over time is gender. Since public sector wage setting is generally based on educational credentials and seniority, it tends to be fairly egalitarian along gender lines. Gender wage differentials in the private sector, however, persist in MENA just as they do throughout the world, even after adjusting for education and experience (Assaad and Arntz 2002). Some wage differences may result from productivity differences, as in physical labor, but most relate to gender norms about the division of labor in both the domestic and market spheres.

Since women bear the bulk of household responsibilities, they are generally unable to commit as much time to market work. Their need to work shorter hours or to withdraw periodically from the labor force during their childbearing years may consign women to lower paid, part-time, or temporary employment and reduce their advancement opportunities. Gender norms about the division of labor in the work sphere can also result in lower wages for women. If gender norms force women into a small number of occupations, these can become overcrowded, lowering wages. And if gender norms limit women’s mobility, confining their job search to a limited local labor market, their employment options may be limited to lower paying jobs (Karshenas and Moghadam 2002; Miles 2002). For all these reasons, gender gaps in wages are likely to be larger in the private sector than in the public sector. As economies in the region shift toward greater reliance on the private sector for job creation, the gender gap in wages is likely to grow unless these shifts are accompanied by changes in gender norms.

Without adjustments for differences in experience, education, and other observable attributes, the (crude) gender wage gap ranges from 79 percent in the West Bank and Gaza in 1999 to 4 percent in Egypt in 1998, meaning that average male wages are 79
percent higher than female wages in the West Bank and Gaza and 4 percent higher in Egypt (table 4.7). These crude gaps can be highly misleading, since the composition of the female labor force is usually quite different from that of the male labor force. Female workers are often more educated and less experienced than their male counterparts. Similarly, while men tend to work until the age of retirement or later, many women withdraw from wage labor at marriage or during childbearing years, which tends to lower their average work experience.

Adjusting for these differences yields gaps that range from 0.86 in the West Bank and Gaza in 1999 to 0.15 in Egypt in 1998, meaning that if women’s characteristics, such as education and experience, were compensated equally to those of men, women’s average wages would be 86 percent higher in the West Bank and Gaza and 15 percent higher in Egypt in 1998. That wage gaps generally increase when these adjustments are made means that female wageworkers are more highly selected than male wageworkers, based on observables such as education and experience. In essence, this suggests that less educated women have limited access to the paid labor market. Only in Tunisia does the adjustment lead to a lower gap, which means that the educational profiles for male and female wageworkers in Tunisia are fairly similar.

The adjusted wage gap appears to have fallen in Egypt from 28 percent to 15 percent from 1988 to 1998. That does not necessarily mean that labor markets are becoming more equitable along gender lines. If private sector labor markets become more defeminized and government employment more feminized and if government pay-structures are more gender neutral than private pay structures, as is the case in Egypt, the adjusted gender gap would fall even if the private sector were becoming less gender equitable.

When the gender wage gap data for Egypt are disaggregated by public and private sector, a different picture emerges (figure 4.14). There is essentially no differential in the government sector, which has a nearly gender-neutral wage-setting system. In the private sector, however, the adjusted differential increases from 29 percent to 41 percent. The public enterprise sector occupies an intermediate position, but as firms gain more flexibility in wage setting, the sector looks more like the private sector. The overall male-female differential has remained stable, however, because as nongovernmental wage employment in Egypt was defeminized, government employment became more feminized, shifting some of the female work force toward the more equitable government sector. With government employment unlikely to expand significantly in the future, the increasing gender inequity in the private sector is cause for concern.
Income Inequality Remains Moderate

MENA and South Asia are the only developing regions with improvements in income inequality over the past three decades (table 4.8). MENA, which had one of the highest rates of income inequality in 1970, now has one of the most equal income distributions in the world, with an estimated Gini coefficient of 0.357 (Adams and Page 2001). The Gini coefficient for individual countries in the region ranges from 0.35 to 0.47, compared with 0.44 to 0.61 in a sample of Latin American countries. The mean income of the bottom fifth of the population in MENA rose rapidly in 1975–79 and 1985–89 and, after a decline in the early 1990s, recovered again at the end of the decade. The pattern closely parallels the region’s economic performance and the trend in real wages.

Table 4.8. Gini Coefficient and Share of the Poor in Income by Region

<table>
<thead>
<tr>
<th>Region</th>
<th>Gini Coefficient</th>
<th>Income share of bottom quintile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America and the Caribbean</td>
<td>0.484</td>
<td>4.3</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>0.448</td>
<td>5.3</td>
</tr>
<tr>
<td>East Asia</td>
<td>0.397</td>
<td>6.4</td>
</tr>
<tr>
<td>MENA</td>
<td>0.357</td>
<td>7.5</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>0.343</td>
<td>7.4</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.336</td>
<td>8.4</td>
</tr>
</tbody>
</table>


Growth and Redistribution Protect Welfare Gains

During the period of rapid growth, the poor benefited from both income growth and an increasing share of income. These income and distribution gains for the poor appear to have withstood the region’s economic downturn after 1985 (Adams and Page 2001; Ali and Elbadawi 2002), although trends have diverged in some countries. In Egypt, there
was a decline in the percentage of expenditures going to the lowest quintile of the population and an increase in poverty during 1985–99. The opposite happened in Morocco and Tunisia. Income going to the lowest fifth rose by 0.65 percent a year in Morocco and 1.71 percent in Tunisia. These patterns are confirmed by changes in real wages. In Tunisia, wages grew fastest in agriculture, where many of the poor work, helping them work their way out of poverty. In Egypt, real wages fell in all sectors in 1981–95, including those in which the poor work.

Figure 4.15. The UTIP-UNIDO Wage Inequality THEIL Measure, by Developing Region, 1965-1997

Wage Inequality Greater than in Other Regions

While MENA exhibits one of the most equal income distributions in the world, it has had since the 1990s one of the highest wage inequality levels of all developing regions, based on data compiled by the United Nations Industrial Development Organization (UNIDO 2002) for the manufacturing sector (figure 4.15). If oil-exporting countries are excluded from the MENA sample, income inequality improves, putting MENA ahead of Sub-Saharan Africa but behind Latin America and South Asia. In 1995, wage inequality was lowest in Jordan (0.05) and highest in Kuwait (0.340).

Poverty Rates among the Lowest in the World

By developing country standards, poverty rates are low in MENA. Based on a poverty line of US$1.08 per person per day in 1993 purchasing power parity exchange rates, only 2 percent of the MENA population fell below the poverty line in the 1990s (table 4.9). Although an increase of about 18 percent over the poverty rate in the 1980s, it is still low compared with poverty rates in other developing regions. Poverty reduction before the 1980s can be credited to the rapid growth during the oil boom. The continued low poverty rates are remarkable, however, considering the slow GDP growth since 1985. Two reasons have been advanced for the low incidence of poverty: government employment and remittances from international migration. Cross-country regressions for MENA show that a 10 percentage point increase in remittances as a share of GDP reduces poverty by 5.7 percent, and a 10 percentage point increase in the share of government in total employment reduces poverty by 6.2 percent (Adams 2003b).
Although high levels of government employment have clear efficiency implications for MENA, they have served an important social function in redistributing wealth. Government employment also has served as a social safety net since it shields a significant portion of the work force from economic fluctuations. With government employment concentrated among the more educated portion of the population, however, this safety net does not extend to some of the most vulnerable members of society. The distribution of wages in Egypt and Morocco suggests that between 40 percent and 60 percent of public sector employees belong to the highest income quintile while less than 5 percent are found in the poorest segment of the population.

### Poverty Is Not Associated with Unemployment

Data from household surveys in five MENA countries show that the relationship between poverty and employment status varies across countries and by urban and rural location. Working in the public sector appears to be effective protection against falling into poverty. Public sector workers are much less likely than the average person to be in the bottom quintile of the income distribution. Regular private sector wage work also appears to offer protection from poverty. In all countries except Jordan, regular private sector workers are less likely to be in the bottom fifth. Rural residents are more likely to be in the bottom fifth of the income distribution than urban residents.

The relationship between poverty and unemployment is more complex (table 4.10). In Egypt, Jordan, and Morocco, for example, unemployed individuals are not much more likely to be in the bottom quintile of the income distribution than other working-age adults. In the Islamic Republic of Iran and Yemen, however, unemployed individuals are more likely to be in the bottom fifth. The rural unemployed in these countries appear to be especially vulnerable to poverty.
### Table 4.10. Percent of Working Adults (15-64) in Each Work Status Who Are in the Lowest Per Capita Income Quintile

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Private casual</th>
<th>Private regular</th>
<th>Private non-wage</th>
<th>Public</th>
<th>Unemployed</th>
<th>Inactive</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urban</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>1997</td>
<td>23.1</td>
<td>5.8</td>
<td>13.0</td>
<td>5.9</td>
<td>13.8</td>
<td>11.1</td>
<td>11.0</td>
</tr>
<tr>
<td>Iran</td>
<td>2000</td>
<td>9.3</td>
<td>-</td>
<td>6.1</td>
<td>0.6</td>
<td>14.6</td>
<td>8.8</td>
<td>7.9</td>
</tr>
<tr>
<td>Jordan</td>
<td>1997</td>
<td>18.2</td>
<td>14.0</td>
<td>16.9</td>
<td>5.9</td>
<td>18.1</td>
<td>15.0</td>
<td>14.2</td>
</tr>
<tr>
<td>Morocco</td>
<td>1999</td>
<td>4.6</td>
<td>4.7</td>
<td>37.1</td>
<td>1.5</td>
<td>20.3</td>
<td>22.7</td>
<td>19.0</td>
</tr>
<tr>
<td>Yemen</td>
<td>1999</td>
<td>15.6</td>
<td>6.0</td>
<td>10.7</td>
<td>2.7</td>
<td>16.1</td>
<td>10.0</td>
<td>9.2</td>
</tr>
<tr>
<td>Rural</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>1997</td>
<td>44.5</td>
<td>26.7</td>
<td>30.4</td>
<td>23.6</td>
<td>28.9</td>
<td>33.5</td>
<td>32.7</td>
</tr>
<tr>
<td>Iran</td>
<td>2000</td>
<td>22.4</td>
<td>-</td>
<td>21.9</td>
<td>3.9</td>
<td>32.5</td>
<td>24.3</td>
<td>22.9</td>
</tr>
<tr>
<td>Jordan</td>
<td>1997</td>
<td>13.7</td>
<td>26.9</td>
<td>26.0</td>
<td>6.8</td>
<td>16.5</td>
<td>15.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Morocco</td>
<td>1999</td>
<td>3.0</td>
<td>8.3</td>
<td>25.7</td>
<td>1.3</td>
<td>17.0</td>
<td>22.2</td>
<td>21.2</td>
</tr>
<tr>
<td>Yemen</td>
<td>1999</td>
<td>28.5</td>
<td>15.9</td>
<td>17.7</td>
<td>6.5</td>
<td>35.2</td>
<td>24.8</td>
<td>21.4</td>
</tr>
</tbody>
</table>

**Note:**
1. Data for Egypt are based on per capita expenditure rather than per capita income quintile.
2. Data for private casual and private regular are combined for Iran.

**Source:** World Bank staff estimates based on country poverty assessments.

In most countries, casual wage workers are disproportionately represented in the lowest fifth, with Morocco as an exception. In urban Egypt, a casual wage worker is more than twice as likely to be in the bottom fifth than an average person and 1.7 times as likely as an unemployed person. Nonwage work is strongly associated with poverty in Morocco (in rural and urban areas) and in Jordan (rural areas), but is weakly associated with poverty elsewhere. Finally, nonparticipation in the labor force moderately increases the chance of being in the bottom fifth in nearly all countries discussed.

Poverty is therefore not strongly associated with an absolute lack of work (the unemployed and those who are out of the labor force) but rather with unstable or inadequate employment. In general, the extremely poor cannot afford to be unemployed for long.
Chapter 5
The Scope for Labor Market Reforms

This chapter looks at the scope for policy intervention in MENA’s labor markets to address the structural rigidities driving unemployment and slowing job creation. Much of the analysis focuses on the need to rationalize public sector hiring and wage-setting practices, to reduce the impact of guarantees for public sector employment on human capital formation and wage expectations among first-time job seekers who face the highest unemployment rates. But there are fiscal and efficiency reasons as well for tackling the neglected agenda of public sector reform. The analysis also extends to institutionalized rigidities in the private sector that impede flexibility in hiring and dismissal, raise indirect labor costs, and protect unionized workers.

Because labor market reforms are politically difficult and, when attempted, tend to be slow and piecemeal, quantitative estimates of their effects can advance the agenda of reform (Gill, Montenegro, and Dömeland 2002). Thus the chapter examines the challenge of reforming labor markets in MENA using empirical simulations generated by a general equilibrium modeling framework designed to replicate the impact of policies in the labor-abundant (labor-exporting) countries of MENA (Agénor and others 2003; see chapter 5 appendix). The simulations offer insight not only into the direct impact of policy reforms on labor market outcomes (wages, unemployment, informal sector) but also into the implications for macroeconomic aggregates, including output, investment, and the fiscal balance. The chapter also looks at the special case of the labor-importing countries, where labor market segmentation along national-expatriate lines creates additional complexities for policy reform.

Rationalizing the Role of the Public Sector

There are many reasons to rationalize the role of the public sector in MENA’s labor markets. The most well known, and the subject of past reform efforts, is the financial burden placed on the government and the rest of the economy by high public sector employment. MENA governments continue to employ a higher share of the population than any other developing region. This remains a concern, with government wage bills averaging 11.3 percent of GDP in the late 1990s and reaching fiscally unsustainable levels in several oil-exporting countries. Despite reform efforts over the past decade, only a few countries reduced the size of the public sector wage bill, and in many countries the wage bill has even increased (figure 5.1). Wage expenditures are a significant drain on fiscal revenues, reducing the resources available for other sectors of the economy and potentially crowding out spending and investment by the private sector.

High Wage Bills but Low Productivity in the Public Sector

Efficiency losses due to falling productivity in the public sector are another concern. Across MENA, most branches of the public sector remain overstaffed even in countries that have tried to shed public sector labor. In the early 1990s, the share of underutilized workers in the public sector ranged from 17 percent in Algeria to 21 percent in Egypt to
even higher shares among the oil-exporting countries. These estimates suggest that the scale of overstaffing is greater than ever. Recent estimates put labor redundancies in public enterprises alone at about 35 percent in Egypt and nearly 40 percent in Jordan (Ruppert Bulmer 2002). In Algeria, redundancy remains a concern despite layoffs of more than half a million workers during the 1990s.

**Figure 5.1. Central Government Wage Bill as Share of GDP (percent)**

![Graph showing Central Government Wage Bill as Share of GDP](image)

*Source: Schiavo-Campo, de Tommaso, and Mukherjee 2003.*

**Public Sector Reforms Are Critical for Reducing Unemployment**

Significant financial savings and efficiency gains would result from rationalizing public sector employment. These considerations alone would justify scaling back the state’s presence in labor markets. But even more important, the dominance of the public sector is linked to the structure of unemployment and the supply of skills in the economy (chapter 4). The need for public sector reform stems less from the financial and overstaffing implications and more from the rigidities state dominance introduces into labor markets. The perpetuation of implicit and explicit employment guarantees in government hiring and mismatched wage expectations resulting from generous public sector compensation policies perpetuate market segmentation and ensure continued queuing for public sector jobs, especially among educated first-time job seekers.

**Wages and Benefits Drive Preferences for Public Employment**

In some countries, workers prefer government jobs because wages are higher than in the private sector (figure 5.2). In other countries, workers are attracted to such nonwage factors as job security, worker protections, and social allowances unlinked to productivity (Said 2001). These considerations, as well as special provisions on work hours and maternity leave, make public sector employment especially attractive to women. Large nonwage benefits, while a mechanism for distributing wealth, are distortionary, contributing to structural rigidities that reinforce the segmented structure of employment. In the labor-importing countries, public–private segmentation resulting from wage and nonwage advantages for nationals in the public sector are further reinforced by
distinctions in employment between nationals and expatriates. Private sector wages are considerably lower in countries that rely on foreign laborers not covered by social protection legislation and benefits. Low reservation wages reflect sending country conditions, such that only foreign workers are competitive in the private sector.

Figure 5.2. Public versus Private Wages, Late 1990s

The Menu of Policy Options Is Large and Flexible

Policymakers have several instruments for reducing public employment, containing the public wage bill, and, most important, directing new labor market entrants toward private sector employment (Rama 1999). To be most effective and sustainable in the long run, the realignment of incentives toward work in the private sector should rely on both push and pull factors. The menu of policies ranges from natural attrition and hiring freezes, to accelerated attrition through substantial wage adjustments or benefit cuts, to explicit retrenchment through layoffs. Because these options imply tradeoffs between the costs and benefits to workers and the public sector on different time horizons, they may be introduced separately, sequentially, or simultaneously. The optimal combination of policies would vary by initial conditions, specific objectives, and political economy considerations.

Natural attrition rates can be high as employees leave public employment for private sector jobs or withdraw from the labor force because of disability, retirement, or other reasons. The age structure of public employment can provide some notion of natural outflow rates. In Egypt and Morocco, for example, nearly 15 percent of public sector employees are more than 50 years old, and in Bahrain, Kuwait, and Oman, the equivalent figure is 10 percent. The average age of public sector employees is also rising as inflows of younger workers have decelerated. Thus, there is significant potential for employment reductions as staff retire over the next 10 years. Combined with a hiring freeze, attrition alone could translate into substantially reduced employment levels in the public sector.
Reducing remuneration can accelerate the process of attrition and shift a greater supply of labor to the private sector. Lower compensation in the public sector raises the appeal of private sector employment for job seekers as the reservation wage falls and for current employees as the wage differential with the private sector shifts. Since cutting the wages of existing employees is likely to be politically untenable, especially when applied to tenured civil servants, alternative measures may be needed for reducing government employment and the wage bill. These include lowering remuneration for new entrants, adjusting the pay scale to strengthen the link between compensation and productivity, and focusing on nonwage benefits that distort labor decisions, such as generous pension systems and family allowances that add to the lure of employment in the public sector.

Algeria, for example, has no ceiling on the number of dependents eligible for family allowances, and in Kuwait the ceiling is five dependents. The effect of these policies is distortionary, since workers can increase their remuneration by increasing family size rather than by increasing productivity. The nonwage benefit premium in the public sector represents a significant share of total public sector compensation (up to 50 percent), and represents the only variable that can be manipulated to reduce total compensation other than nominal wage cuts and pay scale reforms.

While lowering public sector remuneration can induce labor reallocation toward the private sector through the price mechanism, public sector downsizing can also be facilitated through layoffs or voluntary separations. Most countries in MENA have enabling legislation or precedents for such an approach. Because laid-off workers and dependents incur income losses through no fault of their own, but for broader economic reasons, retrenchment is typically accompanied by some income support to smooth consumption over the period of joblessness. Severance packages also reward workers for years of past service. In addition to these equity and social protection considerations, there are macroeconomic stabilizing effects from severance packages as well, since large-scale layoffs lead to declines in income that depress aggregate demand.

Most countries in MENA have some type of severance requirement (table 5.1). Compensation can take the form of severance pay delivered in a lump sum or in periodic payments, as is common in OECD countries. Lump-sum severance involves high upfront costs to employers, which may discourage layoffs. In Algeria, for example, until 1994 the law required employers to compensate laid-off workers with one month’s salary per year of tenure (up to 15 months) in a lump-sum payment. The Islamic Republic of Iran and Tunisia have legislation covering unemployment assistance, but only Algeria and Egypt have unemployment insurance in which formal sector workers participate through a mandatory payroll tax. In Egypt, there has been only modest use of this legislation because layoffs are allowed only when an enterprise is liquidated. Thus within MENA, Algeria alone has a functioning unemployment insurance system under which significant retrenchment has occurred.
The Impact of Rationalizing the Public Sector

The impact of reforms that target public sector employment and the wage bill can be illustrated using the framework outlined in the appendix to this chapter. The model offers a detailed treatment of the labor market, explicitly accounting for public sector employment and the “leadership effects” of public sector wages. Consider, for example, a 5 percent permanent reduction in the number of unskilled workers in the public sector (table 5.1). In the short run, the empirical simulations suggest that the unemployment rate of unskilled workers will increase even though, as unskilled wages fall, the private sector increases its hiring of workers and informal sector employment expands. In the long run (over 10 years), however, reducing public sector employment increases private sector investment and unskilled employment in the formal private sector. These positive outcomes are due to the crowding-in effect of lower public sector borrowing on private investment and the impact of higher private sector investment on demand for formal sector goods and, by extension, on demand for both skilled and unskilled workers. As a result, the initial increase in unemployment of unskilled workers is partially reversed over time while output expands in the formal, informal, and rural sectors together with private consumption and investment.

<table>
<thead>
<tr>
<th>Policy experiment</th>
<th>Skilled labor wages</th>
<th>Unskilled labor employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Output</td>
<td>Short run</td>
<td>Long run</td>
</tr>
<tr>
<td>Urban formal sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Urban informal Sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Rural sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Private investment Employment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unskilled labor in formal private sector</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Skilled workers in formal private sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Informal sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Wages</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unskilled labor in formal private sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Skilled workers in formal private sector</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Informal sector</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unskilled labor in formal sector</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: Percentage deviations from baseline except: 1 Real terms. The short run reflects the impact in the first year while the long run is 10 years; 2 Absolute deviations from baseline.

Source: Aghion and others 2003b.

A permanent 5 percent reduction in the wages of skilled workers in the public sector has similar, but stronger effects, crowding in private investment and leading to an expansion in output in the long run. The effects are especially strong in the case of skilled workers because of the leadership effect of wages in the public sector on private wages. Lower public sector wages spill over into lower wages and higher employment of skilled workers in the formal private sector. Both skilled and unskilled workers benefit in the long run through lower unemployment rates. Skilled workers benefit from increased insertion into the formal private sector, while unskilled workers benefit from higher
employment in the informal sector. Although skilled workers face lower wages in the private sector, unskilled workers earn higher wages in both the informal and formal sectors. These dynamics have important effects as well on migration. The substitution of skilled for unskilled workers in the formal private sector reduces the incentive to migrate to urban areas while rising wages in the informal sector lower international migration pressures. Output expands in both urban and rural sectors.

**Labor Market Institutions in the Private Sector**

In MENA, government intervention in labor markets has extended to the private sector. Labor market regulations were adopted in MENA, as in much of the developing world, some half-century ago to provide social protection and justice to workers (figure 5.3). Whether covering hiring contracts, severance pay, grounds for dismissal, the right to unionize, or the scope for collective bargaining, labor market regulations aim to protect workers from arbitrary, unfair, or discriminatory actions by their employers while addressing potential market failures stemming from insufficient information and inadequate insurance against risk. Together, regulations encompassing employment and industrial relations laws constitute a broad and complex framework for managing labor markets (El-Mikawy and Posusney 2002). These laws at the national level received broad sanction from international labor conventions and regional agreements on labor regulations.

While there are common tendencies in MENA toward providing workers with lifetime job security and generous retirement, health, and other job-related benefits, individual countries differ considerably in the extent of intervention, reflecting specific historical trajectories. Thus, trade unions are permitted in Egypt and the North African countries but are either banned or absent in most labor-importing countries. Similarly, restrictions on hiring and firing are more stringent in Algeria, Egypt, and Tunisia than in Jordan, Morocco, and the expatriate-dominated private sectors of labor-importing countries.
Minimum wage laws have been legislated in Egypt, the Islamic Republic of Iran, and the North African countries but not elsewhere. Specific differences exist not only in legislation but in enforcement and coverage. The highly protective rules adopted in the state-run era are more or less universally enforced in the large public sectors but are imperfectly enforced in the private sector and, in the labor-importing countries, in jobs filled by low-paid expatriate workers.

Balancing Flexibility with Social Protection

There have been sharp differences of opinion concerning the costs and benefits of labor regulations (Freeman 1993). One perspective supports regulations for providing important social protection for workers, while an opposing perspective emphasizes that such regulations raise the cost of labor and favor more privileged insiders. These contrasting views suggest that what matter from a policy perspective are the economic and social effects of different approaches to labor market regulations. But clear empirical evidence for assessing the impact of regulation has been lacking. Furthermore, there has been the perception that in most developing countries, including MENA, employment laws are often ineffective because of evasion, weak enforcement, and the failure to reach the informal sector (World Bank 1995).

Recent international evidence suggests that the regulatory framework can strongly influence labor market outcomes, by affecting job creation and the structure of employment as well as the degree of social protection of workers. While regulation generally increases the tenure and wages of incumbent workers, it also limits job creation and reduces flexibility in the work force. With excessive regulation, workers endure long unemployment spells, leading to skill degradation and lack of work experience. Unemployment of women and youth also rises, which may limit the opportunities of disadvantaged groups to emerge from poverty. With few job opportunities in the formal economy, workers are pushed into the informal sector where social protection is lacking altogether (Maloney and Núñez 1998). MENA has not been immune to these undesirable effects, as the evidence presented in chapter 4 demonstrates. Even minimum wage laws, thought to be ineffective because of weak coverage and lack of enforcement, have been shown to have significant effects on unemployment, as Morocco’s experience illustrates (El-Hamidi 2002; see box 5.1).
Box 5.1. The Impact of the Minimum Wage in Morocco

Minimum wage legislation in Morocco, first adopted in 1936, sets different wage floors for rural and urban labor markets. Officially, the minimum wage is to be adjusted whenever the consumer price index increases by 5 percent. In practice, however, political discretion and pressure by labor unions tend to determine increases. Evidence suggests that the urban minimum wage is observed by the public sector and is well enforced in the formal private sector.

During 1970–2000, the urban minimum wage rose an average of 6 percent a year, which translates into a 1.1 percent annual increase in real wages in urban areas. In the 1990s, growth of the real minimum wage in urban areas rose to 1.3 percent a year, exceeding the growth in labor productivity in the formal sector. By 2000, the minimum wage was close to half the average wage in the formal private sector and 178 percent of GDP per capita.

Several observers have argued that the increases in the urban minimum wage reduced demand for unskilled labor; contributed to a rise in unit labor costs, reducing Morocco’s external competitiveness; and encouraged the informalization of production. This may have pushed more unskilled workers outside the formal sector, where compensation is lower than the official minimum wage.

In simulations of a dynamic general equilibrium model for Morocco, a permanent 5 percent reduction in the urban minimum wage leads to a 3.7 percent increase in the demand for unskilled labor in the private sector in the first year. As a result, the unemployment rate for unskilled workers drops by about 2.4 percentage points each year. Employment of unskilled workers in the informal sector declines as well as rural-urban migration. By reducing the costs of unskilled labor, the reduction in the minimum wage also leads the private sector to substitute labor for capital. The effects on private consumption and output are also positive.


Hiring and Dismissal Procedures Condition Employment

More flexible hiring and dismissal procedures are the most relevant policy issues in the reform of labor market regulations in MENA, where low job creation and long-term unemployment are major problems (chapter 4). Firms are reluctant to hire workers when it is unduly costly to terminate them as economic conditions change. As a result, to get the hiring flexibility they need, firms are likely to rely increasingly on fixed-term, temporary contracts or even unregistered contracts that are beyond the reach of regulations (figures 5.4 and 5.5).

While MENA has generally had a regulatory preference for permanent employment contracts in the formal sector, several countries have recently taken steps to make hiring arrangements more flexible. Egypt’s new labor code of June 2003 allows defined-duration contracts to be renewed an unlimited number of times without becoming a
permanent contract, whereas Egypt’s 1981 labor law required such contracts to be converted to permanent contracts if employment extended beyond the initial period (box 5.2). Morocco and Tunisia recently have implemented legislation that expands the possibilities for part-time work and fixed-term contracts, which are the main source of flexibility on the hiring side in these countries (box 5.3).

**Box 5.2. Labor Reform in Egypt**

Law 12, passed in July 2003, addresses major shortcomings in the United Labor Code (Law 137) of 1981, including its inflexible hiring and firing provisions, while addressing the concerns of labor. Important provisions of the new law include:

**Contract termination**  Law 12 allows for temporary contracts that can be renewed repeatedly and allows companies to fire workers during times of economic hardship or for dereliction of duty. Previous legislation allowed defined-duration contracts but upon renewal, these contracts had to be made permanent. It was virtually impossible for employers to fire permanent employees, regardless of their performance or economic conditions.

**Right to strike.** The new code permits “peaceful demonstrations,” but only if mediation has failed. Workers in “vital” and “strategic” establishments, as determined by the Prime Minister, are still prohibited from striking. Previous legislation did not guarantee workers the right to strike.

**Wages and compensation**  Law 12 establishes a minimum wage for the first time. The minimum wage is to be reevaluated at least every three years by the newly created National Council on Wages. Automatic annual increases of 7 percent are required for all workers, unless the council reaches another decision.

**Safety measures.** Law 12 establishes safety standards for industry and articulates standards to ensure that workers are physically and mentally fit to perform their jobs and that they have proper training to carry out their duties.

**Vocational training.** The new code requires that vocational training programs be managed by limited liability or joint venture companies and that they be licensed. It also creates a government oversight group to ensure high standards of training.

**Progress with Labor Reforms Is Uneven**

While countries are starting to provide more flexible employment arrangements on the hiring side, they are paying less attention to restrictions on dismissal and layoffs. This asymmetry in hiring and firing regulations introduces further rigidities in labor markets. Most countries either ban dismissal for economic reasons (shrinking markets, increasing competitiveness) or make it administratively cumbersome. In Morocco and Tunisia, dismissed workers can pursue legal measures that can result in heavy costs for firms and subject firms to the unpredictable and inconsistent legal process. And in some countries,
wage agreements boost severance costs, overriding provisions of the labor code. As a result, private enterprises are not restructuring, and small firms often find solutions outside the legal framework. Some firms get around restrictions on dismissals by making employees sign undated letters of resignation, which are held in reserve in case layoffs are required.

**Box 5.3. Labor Regulation Reforms in Tunisia and Morocco**

Tunisia’s Labor Code of 1996 introduced the following provisions:

**Fixed-term contracts (CDDs).** This labor code establishes two categories of CDDs. The first category is work of a definite term, which is stipulated as work stemming from (i) a temporary increase in activity; (ii) the replacement of an absent employee; (iii) seasonal activities; or (iv) work that is, by definition, fixed in duration. In these cases, employers have no restrictions on CDDs. The second category is work of indeterminate length. In this case, fixed-term contracts are permitted for a maximum of four years and are subject to the agreement of both parties. CDD workers have the same rights as indeterminate-contract employees.

**Part-time work.** This new category of work is defined as work that is fewer than 70 percent of normal hours. It is intended to promote freedom of choice for all employees and equal treatment for part-time employees. According to the most recent Tunisian Employment Survey, 14 percent of all employment in 2001 was part time.

Morocco’s Labor Code of 2003 introduced the following provisions:

**Term contracts (TCs).** Nonagricultural sector firms that are newly established or producing a new product may set up TCs for one year, which may be renewed one time. If renewed again, the contract becomes open ended. Agricultural sector firms may conclude TCs for a 6-month period, which may be renewed up to three times before becoming an open-ended contract.

**Open-ended contracts (OECs).** The new labor code permits a 3-month probation period for high-level employees, a month and half period for middle ones and 15 days for lower-level employees. The probation period is renewable one time.


**Indirect Labor Costs Are High**

High nonwage labor costs in some MENA countries reinforce the incentive to hire workers on a temporary basis or to avoid registration requirements, which trigger mandatory contributions (table 5.4). In Morocco and Tunisia, nonwage costs paid by employers and employees make up on average 25 percent of the wage bill. In Algeria, contributions to the social security system alone constitute more than 36 percent of total labor costs. In Morocco, employers’ share of social security payments is about 19 percent of the wage bill, while in Tunisia it is about 16 percent. Other surcharges range from medical coverage, injury insurance, and safety provisions to vocational training. The many small charges add up to a substantial indirect cost on labor. The investment incentives that reduce the user cost of capital may have encouraged firms to adopt more
capital-intensive processes in order to improve flexibility in the face of high indirect labor costs and other rigidities in the labor market (table 5.2).

<table>
<thead>
<tr>
<th>Table 5.2. Financial Indicators of Pension Funds in MENA</th>
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<tbody>
<tr>
<td>Percent of GDP</td>
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<tr>
<td>Pension spending</td>
</tr>
<tr>
<td>Algeria (1999)</td>
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<tr>
<td>National Retirement Fund (CNR)</td>
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<tr>
<td>National Social Insurance Fund (CASNOS)</td>
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<tr>
<td>Bahrain (1996)</td>
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<tr>
<td>Egypt (1998)</td>
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<tr>
<td>Iran (2001)</td>
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<tr>
<td>Civil Servant Retirement Organization (CSRO)</td>
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<td>Social Security Organization (SSO)</td>
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<td>Jordan (2001)</td>
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<tr>
<td>Social Security Corporation (SSC)</td>
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<tr>
<td>Public System (Military)</td>
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<tr>
<td>Public System (Civil Service)</td>
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<tr>
<td>Kuwait (1996)</td>
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<tr>
<td>Morocco (1998)</td>
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<tr>
<td>National Fund for Social Security (CNSS)</td>
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<tr>
<td>Moroccan Pension Fund (CMR)</td>
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<tr>
<td>Retirement Benefits Collective Plan (RCAR)</td>
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<tr>
<td>Interprofessional Pension Fund (CIMR)</td>
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<tr>
<td>Syria (1999)</td>
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<td>Tunisia (1998)</td>
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<tr>
<td>National Fund for Social Security (CNSS)</td>
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<tr>
<td>National Fund for Retirement &amp; Social Protection (CNRPS)</td>
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<td>Yemen (1994)</td>
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Note: 1 = Public and Private Employees, 2 = Self-Employed, 3 = Public Employees, 4 = Private Employees, and 5 = Voluntary

In theory, being subject to social security contributions and payroll taxes puts employers at no disadvantage to their competitors if the workers themselves end up paying for those benefits in the form of lower salaries since workers should then be indifferent to getting a job with or without social security coverage. Evidence from Egypt and Tunisia suggests, however, that employers in the formal sector are not able to pass these nonwage costs onto employees (Assaad 1996; World Bank 2003). Thus, together with restrictions on dismissal, social protection costs force employers to reduce their labor costs by hiring fewer workers or employing more workers on a temporary or illegal basis. Generous maternity leave provisions in the formal sector, required by many labor codes, further reduce female employment.

It is straightforward to show that lower indirect labor costs lead to increased employment of unskilled workers in the formal private sector (figure 5.6). Under this policy scenario, a permanent 5 percentage point reduction in payroll taxes for unskilled workers would provide a strong incentive for the private formal sector to substitute unskilled for skilled workers. Wages for unskilled workers would rise as unskilled workers are drawn from the rural sector and from the informal sector into the formal private sector. To the extent
that employment in the formal private sector implies greater social protection for workers, lower payroll taxes confer this benefit on unskilled workers in addition to lowering their overall unemployment rate.

Quantifying the Effects of Labor Reforms

However pressing labor market reform might be, it is often among the most challenging reforms to implement—witness the experience of Latin America and MENA in the past decade. Conflicting views about the employment benefits and unemployment costs of downsizing the public sector and deregulating markets are partly to blame since they send mixed signals to policymakers, who are often reluctant to undertake reforms. Greater labor market flexibility brings with it greater employment volatility, with more firing than hiring during recessions and the opposite during booms. In environments where economic volatility is already high and unemployment is a problem, as in MENA, concerns about employment volatility may amplify workers’ fears about the impact of reform.

The Political Economy of Labor Market Reforms

Existing labor regulations protect older workers in the formal sector, both public and private (Dömeland and Gill 2002). Better represented in the policy arena through unions and political parties, these workers are able to exert considerable pressure to maintain job security (figures 5.7 and 5.8). Unionized workers in MENA have often hijacked the
public debate and impeded labor market reforms despite their declining share in the labor force and the political control they are subjected to by governments. Resistance to reform has not only slowed progress in privatizing public enterprises, where labor retrenchment is a concern, but also has delayed bringing the legal code into alignment with current practices in labor markets, such as the use of temporary contracts. The recent labor legislation in Egypt and Morocco was the culmination of decades of effort. As a result of all these factors, labor market reforms have been absent from the policy agenda in MENA for much of the past decade.

Model simulations shed some light on the political economy driving organized labor’s resistance to reforms (figure 5.9). If the bargaining power of unions is reduced, wages drop for skilled workers, who dominate the ranks of organized labor. But the lower wages lead to increased employment and reduced unemployment of skilled workers in the formal private sector, both unionized and nonunionized. As incomes rise, so does aggregate demand, which together with the lower wage bill boosts the profitability of firms in the private sector. The level of private investment rises and with it formal sector and total output. The effects also extend to unskilled workers, who experience lower unemployment and higher wages.
The Aggregate Effects of Reforms Are Positive but Modest

Most of the simulations reported in this chapter indicate that labor market reforms should lower overall unemployment, increase formal sector employment, and expand output. With all the political economy considerations governing labor market reform, however, policymakers also need to know more precisely what payoffs can be expected from the broad program of labor market reforms outlined in this chapter, including the size of the effects on the growth and job creation challenges that MENA faces in the next two decades.

To address this critical question, simulations were conducted of a composite, “realistic” package of policies targeting public sector employment, payroll taxes in the private sector, and the role of labor unions. Using available data and a sense of what is feasible for policymakers in the region, the simulations assume a 5 percentage point reduction in the payroll tax on unskilled labor, a 5 percent reduction in the number of unskilled workers in the public sector, and a reduction in the bargaining power of trade unions to a “neutral” level. While modest in light of the rigidities in MENA’s labor markets, these goals are ambitious relative to the record of reforms in the 1990s, when only a few MENA countries managed to reduce public sector employment. In Egypt and Morocco, legislation that aimed to deregulate labor markets has strengthened the power of labor unions.

While this realistic package of labor market reforms brings some benefits, independent of political economy considerations, the impacts on output and employment are not large. Over the long term, output increases 0.9 percent and private formal sector employment rises 4.0 percent for unskilled labor and 3.1 percent for skilled labor. Such modest long-term effects have important implications since the challenge is not only to reduce high unemployment but also to create sufficient jobs to absorb new entrants in the labor force. With labor force growth rates exceeding 3 percent a year, employment increases of 3 percent to 4 percent over a 10-year horizon suggest limitations on the ability of labor market reforms alone to address MENA’s employment challenge.

Where policy reforms take place, the simulations indicate that a “piecemeal” approach to labor market reform is unlikely to bring substantial benefits in terms of output and employment growth. Instead, a comprehensive approach is needed to allow policymakers to exploit complementarities between individual policies. Indeed, the impact of the realistic policy package is approximately equal to the growth rates derived from the individual policy simulations described earlier. Thus, fostering a sustained increase in growth rates and job creation in these countries may require a more comprehensive program of structural reforms (chapter 6). The idea that labor market reform programs must be sufficiently broad (covering a wide range of complementary policies) and deep (of substantial magnitude) to have much of an effect has been emphasized in other contexts of the world (Coe and Snower 1997).
Active Labor Market Policies in MENA

From wage and employment subsidies, to training and retraining for the unemployed, to direct job creation programs and job search and assistance services, active labor market policies are important interventions used widely in both developing and industrial countries. The policies are designed to create employment opportunities and manage labor market risks. They have been used to moderate cyclical downturns, reduce structural imbalances or otherwise improve the functioning of the labor market, increase productivity, support disadvantaged or at-risk workers, support threatened industries or employers, or some combination of these objectives. Each objective calls for different types of policies and different client populations. As globalization and rapid technological change increase the volatility in the labor market, accelerate structural change, and place a premium on the acquisition of productive skills, an effective active labor market policy assumes heightened importance.

Upward Trajectory in the Use of Active Labor Market Policies

All countries in MENA employ active labor market policies but with varying intensity and success (Tzannatos 2002). The programs have evolved from their historical focus on training and recruiting workers into the public sector to a focus on the consequences of labor shedding and unemployment. With ongoing plans to privatize public enterprises and efforts to restructure the civil service, active labor market policies will become increasingly relevant for addressing the consequences of labor retrenchment. The high levels of unemployment, its concentration among educated young adults, and the segmentation of labor markets along public–private and national–expatriate lines have created new incentives to expand the range and coverage of active labor market policies, especially those that focus on youth.

Public Works Programs Are Widely Used

Public works programs create temporary jobs for the unemployed and supplement safety nets in addition to providing poor communities with infrastructure. Morocco and Tunisia have a long tradition of using these programs, while Algeria and Egypt introduced them in the 1990s following structural adjustment programs (table 5.3). Morocco’s 30-year-old Promotion Nationale manages projects located mostly in disadvantaged rural areas, including reforestation, well water recapture, dam and road construction, and road paving. During 1990–99, the program created some 40,000 person-years of employment in labor-intensive activities. Tunisia’s public works program is an important vehicle for transferring income to the poorer segments of society. During 1987–91, these programs employed an average of 75,000 workers a year, one-third in urban areas and two-thirds in rural areas.
Microfinance and Unemployment Lending Have Increased

Most countries in MENA have microfinance schemes to promote self-employment (see box 5.5. on Yemen’s experience). These programs have grown rapidly in recent years, with the number of clients in the region doubling between 1997 and 1999. Microfinance programs offer loans for enterprise investment to individuals just below or above the poverty line with the goal of reducing the vulnerability of the poor to economic stress. Expectations have been high, and governments throughout the region have taken great interest in these programs (table 5.4). As of 2001, microfinance remained mostly unregulated, but this appears to be changing (Brandsma and Hart 2002).

| Table 5.4. Microfinance Programs and Unemployment Lending Programs in MENA, 1999 |
|---------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Indicator                      | Egypt | Jordan | Lebanon | Morocco | Tunisia | West Bank and Gaza | Yemen | Total or Average |
| Number of microfinance programs | 15    | 8      | 5       | 7       | 6       | 3               | 4    | 48               |
| Number of unemployment programs | 1     | 3      | 11      | —       | 5       | 5               | 0    | 25               |
| Number of active microfinance clients | 90,897 | 17,777 | 4,438 | 42,571 | 3,251 | 7,294           | 2,619 | 168,817          |
| Number of active unemployment clients | 40,000 | 5,320 | 6,330 | —       | 22,575 | 1,537           | —    | 75,762           |
| Female microfinance clients (percent) | 25    | 47     | 95      | 76      | 64      | 100             | 26   | 46               |
| Female unemployment clients (percent) | 20    | 25     | 23      | —       | 20      | 44              | —    | 21               |

Source: Brandsma and Hart 2002.

Training and Retraining Programs for the Unemployed

As elsewhere around the world, vocational training and retraining programs have become increasingly popular in MENA to address skill shortages among the unemployed and to meet the skill needs of modernizing economies. Training programs have been targeted at the long-term unemployed, people laid off in mass retrenchments, and youth (generally school dropouts). Algeria has the largest training system, with 290,000 training posts, 260,000 of them in public training centers and 15,000 in public enterprises. Egypt has some 36,000 students in 120 publicly managed training centers. In the West Bank and Gaza, there are 29 centers outside the Ministry of Education and Ministry of Higher
Education with about 24 specializations and 3,000 trainees but there is little program coordination with the job market. Yemen has some 5,000 students in 15 public training centers that focus primarily on industry and commerce.

**Evidence on the Limitations of Active Labor Market Policies**

Despite the political appeal and contribution to poverty alleviation of active labor market policies, evidence from industrial and developing countries suggests that such policies do little to remedy structural problems in labor markets or to reduce high unemployment in MENA (Abrahart, Kaur, and Tzannatos 2002). Even with spending already high and projected to grow, only a small share of the labor force is likely to be covered by these programs. Inappropriately designed, such programs may entail significant fiscal costs and negative economic effects. Public works programs, for example, provide current benefits without improving the long-term employability of workers. Participants tend to have a smaller probability of being employed later in a nonassisted job and are likely to earn less. Self-employment assistance programs tend to work for only a small part of the unemployed population and are associated with large deadweight effects (workers would have received assistance without the program) and displacement effects (replacing unsubsidized workers with subsidized workers). Business failure rates in these programs are high, though mentoring and business counseling services help to reduce them.

Training programs tend to be cyclical, with better outcomes when the economy is expanding. International evaluations have shown that closely targeted on-the-job training programs, usually aimed at women and other disadvantaged groups, offer the highest returns. Evaluations of retraining for laid-off workers find limited improvement in reemployment probabilities. The evidence suggests that, if used, the programs should be small in scale and targeted to groups that can benefit most from them. Evaluations of youth training programs find better results for enterprise-based training than for classroom training. Overall, however, the evidence suggests that it is difficult to overcome previous education problems with short-duration training programs.

To be effective, then, active labor market policies need to be carefully designed and targeted. For most countries in MENA this will require impact evaluation studies and continuous review of the program mix to ensure wide coverage, cost-effectiveness, and maximum impact on labor market outcomes. This may mean expanding job search and assistance programs, among the most successful active labor market policies elsewhere but with limited reach in MENA because of low participation, inadequate funding, or bans on job intermediation services in some countries. Programs may need to be better aligned with the profile and needs of the unemployed. Many programs focus on the educated, who face the highest unemployment rates but who do not constitute a majority of unemployed workers. More resources need to be devoted to poorly educated workers, including women, a problem that will become more acute in the short term as MENA countries become more integrated into global commodity markets (Betcherman, Olivas, and Dar 2003).
The Special Case of Labor-Importing Countries

Much of the analysis of labor market reforms and active labor policies, especially on microfinance, training and retraining, and job search programs, applies equally to the labor-exporting and labor-importing countries in MENA. Segmentation of labor markets along public–private lines is common to both groups, and both need to reform public sector hiring and wage-setting practices and institutionalized rigidities in the private sector. However, the segmentation of labor markets in the labor-importing countries along national–expatriate lines creates additional complexities for interventions in all areas of policy reform (Girgis 2002; IMF 1997). For example, lowering wages for nationals in the public sector may not bring the reservation wage of young labor market entrants down to the levels in the expatriate-dominated private sector. Similarly, creating flexible hiring and dismissal arrangements to encourage employment of nationals in the private sector may not be sufficient to overcome wage and nonwage differentials between nationals and the expatriate workforce.

Labor Force Nationalization Policies Are Gaining Momentum

With an estimated 480,000 unemployed nationals in the GCC countries together with 7 million expatriate workers, policymakers have tried to nationalize the labor force through quotas and increased restrictions on work permits for expatriates, as well as the use of subsidies for the hiring of nationals. These policy initiatives appear to have produced tangible results (figure 5.10). In Bahrain, Kuwait, Oman, and Saudi Arabia the share of nationals rose in the past decade from 65 percent to about 80 percent in the public sector and from 25 percent to 32 percent in the private sector. The number of expatriate workers in the public sector fell in both relative and absolute terms because of strict replacement policies; any further efforts are likely to erode productivity. Job nationalization in the private sector, where it occurred, appears to have been in response to government pressure, ranging from moral persuasion to more direct policies, to accelerate nationalization of the labor force. In Oman, strict management of expatriate inflows is credited with raising the share of Omanis in the private sector from 86,500, or 15 percent, in 1996 to 137,423, or almost 22 percent, in 1999.

But the Effectiveness of Policies Is Unclear

It is difficult to separate the effects of labor force nationalization policies from overall economic and policy conditions (Girgis, Hadad-Zervose, and Coulibaly 2003). For example, Omanis increased as a share of private sector employment at a time of strong growth performance and job creation in the private sector, accompanied by active labor market policies. Moreover, there are reasons to believe that certain policies might be counterproductive. Administrative measures, such as mandatory quotas for nationals and restrictions on nonnationals in certain sectors, may increase employment among nationals in the short term, but such restrictions raise costs for private firms, through increased wages and administrative costs, and undermine the staffing flexibility that firms require to stay competitive. Such measures are also administratively burdensome and expensive for governments and firms alike. Moreover, they encourage rent seeking and job
diversion. Nationals reporting themselves as self-employed, for example, may merely be sponsoring expatriate workers who run establishments on their behalf.

**Figure 5.10. Replacement of Expatriate Workers by Nationals in the GCC, 1990-2000**


**Subsidies—Potentially Effective but Expensive**

Several countries are providing or considering subsidies for hiring nationals to promote nationalization of the labor force and reduce unemployment. Subsidies attempt to bridge the wage gap between the public and private sectors for nationals. They do so by targeting the reservation wage of nationals and the wage gap between nationals and expatriates in the private sector by bringing the expected wage of nationals in private sector firms closer to that of expatriate workers. The advantages of subsidies are especially evident in small countries such as Kuwait, Qatar, and the UAE, where both the deadweight loss (where a job would have gone to the same person or another national without the subsidies) and the substitution loss (where the same job would have gone to another national) are potentially low because few nationals work in the private sector (Diwan and Girgis 2002).

**Similar Considerations Apply to All Active Labor Market Policies**

Efficiency and effectiveness concerns constrain the scope for labor-importing countries to adopt active labor market strategies to promote nationalization of the labor force and reduce unemployment. Much as with other active labor market policies, the current policies and those under consideration are not a panacea to the structural problems in labor markets. To the extent that the preferences for expatriate labor are driven by skill mismatches, as is widely reported, targeting the wage differentials or providing subsidies for hiring nationals may not be sufficient to overcome the demand for expatriates. Under these circumstances, imposing quotas may cause more damage to the private sector, and take-up rates for wage and unemployment subsidies would be modest. The potentially high costs of large nationalization schemes warrant more careful attention to design, monitoring, and impact evaluation. And most important, active labor market policies must be part of a comprehensive framework of reform of the public sector and of institutional sources of labor market inflexibility in the private sector.
Chapter 6
Foundations of Future Growth and Job Creation

Over the next two decades, MENA faces a challenge of job creation that is unprecedented in the region’s modern history. The labor force of the region totaled some 104 million workers in 2000 and is expected to reach 146 million by 2010 and 185 million by 2020. If the current stock of unemployed workers remains unchanged, the economies of the region will need to create some 80 million new jobs in the next two decades. With an estimated unemployment rate of 15 percent, the more ambitious goal of absorbing unemployed workers in addition to new entrants implies a need to create close to 100 million jobs or a doubling of the current level of employment in the first two decades of the 21st century. By any measure, MENA faces a monumental challenge, especially with the added requirement that the new jobs be accompanied by higher wages and greater worker productivity in a manner consistent with the expansion of educational attainment in the region.

Traditional Engines of Employment Growth

In the face of high unemployment at present and mounting labor force pressures, could the traditional engines of job creation meet MENA’s employment challenge in the future? If MENA countries were to replicate the job creation record of the 1990s in the present decade, projections indicate that unemployment would rise significantly across the region (figure 6.1). The reasons for this outcome are straightforward.

The Option of Public Sector Employment Will Diminish

While the public sector may continue to be a source of employment for a minority of new job seekers, it is highly unlikely (and undesirable) that it will remain a leading source of job creation. Fiscal constraints and low worker productivity imply that any expansion in public sector employment will come at an increasing fiscal cost and may not be sufficient to absorb the lines of unemployed and new graduates queuing for government
employment. Moreover, the compression of real wages in the public sector in the 1990s suggests that returns to government employment will continue to fall for both new and old workers (chapter 4). Barring an acceleration in employment growth in the formal private sector, the rising numbers of new entrants will be pushed into the informal economy.

The expansion of the informal sector may not be undesirable to the extent that it lowers unemployment and does not entail a loss of social protection for workers. However, given that informal employment is not the first choice and, for many workers, not even the last resort, further informalization of work in the context of low growth and high unemployment may put further pressure on wages and increase job insecurity. Attempting to improve labor market outcomes in both formal and informal sectors by reforming systems of labor regulations, employment protection, and industrial relations is one course of action. Another is targeting the incentives driving job seekers to the public sector, to push workers into the private sector and, through the general-equilibrium effects analyzed in the previous chapter, encourage higher employment in the formal sector and lower overall unemployment. But, as observed in chapter 5, not even the most ambitious agenda for reforming labor markets will be sufficient to achieve the employment growth required in MENA over the next few decades to reduce unemployment and absorb new entrants into labor markets.

The Future Role of Regional Migration Is Limited

Near-term prospects for alleviating pressures on labor markets—much less eliminating them—through labor migration are equally limited (Fergany 2001). While regional migration provided an important outlet for workers in the labor-exporting countries during the oil booms of the 1970s and 1980s, the 1990s saw a rapid deceleration in the net inflows of MENA workers to the receiving countries. The negative effects of lower oil revenues and the first Gulf War were reinforced by the replacement of workers from the region with migrants from Asia as well as efforts in the Gulf countries to nationalize the labor force and to replace nonnational workers. Current unemployment rates, together with the projected rapid expansion of the national labor force in receiving countries, provide further incentives to reduce the inflows of all migrant workers. Expatriate workers from MENA countries are particularly affected by these policies given their high substitutability with the national labor force because of similarities in language, education, and skill composition (Girgis 2002). Under these circumstances, the potential for regional migration to play a significant role in the future is significantly curtailed.

While Migration to Europe Is Constrained by Policy

If the dynamics of demography in the sending and receiving countries offer little hope for regional migration, the reverse is true for migration from MENA to Europe (Dhonte, Bhattacharya, and Yousef 2001). Europe’s demographic outlook runs opposite to that of MENA (figure 6.2). According to United Nations (UN) projections the working-age population (ages 15–64) in the current 15 European Union (EU) member states will increase by 1 million people a year between 2000 and 2010 while the retirement age
population (64 and above) will expand by close to four times as much, or 3.6 million a year. The resulting increase in dependency ratios is expected, among other things, to adversely affect the sustainability of Europe’s pension systems. As such, replacement migration on a large scale has been proposed as one of the few means of raising the number of workers relative to retirees and supporting pension systems. And because the demographic structure of the accession countries is similar to that of current EU members, the likelihood is low that migrants from elsewhere in Europe could completely fill the demographic gap.

![Figure 6.2. Net Population Increase in the European Union and North Africa, 2000-2010](https://example.com/figure62.png)

While MENA’s young population structure and rising working-age cohorts are a potential source of workers—especially given MENA’s geographic proximity, existing networks of migrants, and the large wage gaps between the two regions—the political economy governing Europe’s migration policy runs to the contrary (Johansson and Silva-Jarengui 2003). Migration has become a contentious issue in Europe, driven by a host of factors including labor market conditions and cultural identity. With a large pool of long-term unemployed workers in the current EU members, competition from foreign workers is not viewed positively. Moreover, EU migration policy in the medium term is likely to focus first on accommodating workers from the prospective accession countries who are likely to provide competition to the already dwindling flows of MENA workers. The Euro–Med initiative focuses exclusively on trade flows and provides little institutional scope in support of labor mobility between MENA and Europe. Thus, while there is potential for considerable flows of migrant workers from MENA to Europe, this would require a significant change in EU migration policy and would provide only a partial solution to the employment challenge in MENA.

**MENA Needs New Engines of Job Creation**

With the traditional engines of job creation in MENA unable to meet the employment challenge in the 21st century, what options do the economies of the region have? The
most promising option is private sector–led growth. Chapter 3 shows that output per laborer could have grown by as much as 3.4 percent a year in the 1990s rather than 0.7 percent had the rates of capital accumulation matched those observed in the 1980s, holding TFP growth and human capital accumulation fixed. A combination of higher investment and faster TFP growth could have achieved the same higher growth rate. Assuming that such growth performance would have affected wages and employment proportionately, unemployment across the region could have been much lower than that observed. With the tight fiscal and monetary constraints on the public sector, however, this outcome rests on the assumption that much of the needed investment would have to come from the private sector. How could the private sector accomplish this objective? What set of policies and institutions could establish a new development model that would drive the mobilization of resources for future job creation and growth?

Foundations of New Development Policies

A series of reports published by the World Bank in 2003-04 argue that in order for MENA to accelerate job creation and growth, the region must address a set of longstanding policy and institutional challenges to complete three fundamental, interrelated realignments within their economies:

- **From public sector to private sector dominated**, by reducing the barriers to private activity while creating regulatory frameworks that ensure that private and social interests coincide.

- **From closed to more open**, by facilitating integration into global commodity and factor markets while establishing safeguards for financial stability and social protection.

- **From oil dominated and volatile to more diversified and stable**, by making fundamental changes in institutions managing oil resources and their intermediation to economic agents.

The growth and employment impact of an integrated package of policy realignments that improves the business and investment climate for the private sector and fosters integration with the world economy is potentially very large, as the companion reports demonstrate. The World Bank trade study estimates that, based on the experience of comparable countries, output per worker could increase by some 2 percent to 3 percent a year. The World Bank governance study, using similar international evidence, suggests that improving the institutions of accountability and public administration could boost output growth per capita by 0.8 percent and 1.3 percent a year. A conservative lower bound estimate of the sum of these projected effects, taking into account the overlap in the channels through which the policy changes operate, would be output growth per worker of 2.5 percent to 3.5 percent a year.
Reinvigorating the Private Sector

Since the late 1980s, most MENA countries have tried, with varying intensity and success, to expand private sector activity. At the same time, the importance of the public sector has declined, as seen in steps taken to privatize and reduce subsidies to SOEs, because of constraints arising from lower oil revenues and fiscal consolidation. But governments still represent a large share of value added in MENA, about one-third of GDP on average, more than comparator middle-income countries in Latin America and East Asia. While state ownership of hydrocarbon resources in MENA distorts these numbers, the share of the public sector is high even in the more diversified economies such as Egypt and Tunisia. Strategic service sectors, such as banking, telecommunications, and transportation, remain under public ownership in most countries in the region. As a result, the contribution of the private sector to value added increased only marginally in the 1990s (figure 6.3). The same pattern has characterized the share of the private sector in total investment, which was not large enough to compensate for the decline in public investment (chapter 3).

![Figure 6.3. Private Sector Contribution to GDP in MENA (percent)](image)

These disappointing trends reflect not only macroeconomic policy outcomes but also serious weaknesses in the business environment that discourage entrepreneurship and firm creation (Assaf and Benhassine 2003). New firms, particularly small and medium enterprises, face significant barriers to entry, both in time and cost of administrative approvals. For new firms in MENA, the costs of complying with regulations represent an average of 76 percent of per capita GNI—well above the 34 percent in Eastern Europe, 16 percent in East Asia, and 14 percent in Latin America (figure 6.4). New firms also face significant difficulties securing start-up and operating capital with public banks. In many MENA countries, public banks dominate the banking system and favor state enterprises, larger industrial firms, and offshore enterprises. Judicial systems are also a constraint. Regulations do not facilitate the restructuring of still viable businesses, while
nonviable firms are not permitted to close operations expeditiously, raising the social and economic costs of bankruptcy. In addition to these regionwide patterns, recent surveys reveal country-specific patterns in the business and investment climate (box 6.1).

Box 6.1. Aspects of the Investment Climate in Algeria, Egypt, Yemen, and the GCC

Despite the widely acknowledged importance of the private sector in MENA, precise information is generally lacking on its composition, activities, and constraints. Firm-level surveys have been carried out in some countries, including Algeria, Egypt, and Yemen, permitting closer examinations of the business and investment climate. The survey results point to unique aspects to the investment climate in the individual countries as well as similarities across countries:

**Old versus new firms in Algeria.** Old firms complain proportionally more than new firms about unfair competition and the informal sector. Old firms complain less, however, about corruption and access to credit.

**Small versus large firms in Egypt.** Small firms complain more than large firms about the difficulties of accessing credit, exporting goods, and dealing with the tax administration. Small firms also complain more about corruption and the time needed to resolve disputes in court.

**Northern versus southern firms in Yemen.** Firms in the traditionally laissez-faire northern part of the country face greater impediments to doing business than firms in the formerly socialist south, particularly in regard to trade regulations, the legal system, and licensing.

**National versus foreign firms in the GCC.** Foreign firms in general face higher tax rates than national firms. In some countries, foreign firms are subject to investment restrictions in certain sectors and limits on their ownership of companies.

Source: Assaf and Benhassine 2003; Banerji and McLiesh 2002; Fawzy 1999.

MENA compares poorly with other regions in the complexity of filing a legal claim and in the time needed to initiate and complete such a claim—more than 300 days on average (figure 6.5). Even where the legal process is defined, the unpredictability of enforcement
creates problems for entrepreneurs. Nearly half of surveyed firms in the region expressed concern over the unpredictability of the legal system (World Bank 2003d). Businesses also suffer from weaknesses in infrastructure, the financial system, and administration of licensing, regulations, and taxation and import duties. Almost half of private businesses complain that infrastructure is a moderate to major obstacle to their activities. Weaknesses in telecommunications and transport, two significantly underdeveloped backbone services, greatly impede business activity and investment. Weak public institutions also impose many costs on business, in particular with regard to delays and costs associated with clearing customs.

**Figure 6.5. Contract Enforcement: Duration (days)**

<table>
<thead>
<tr>
<th>Region</th>
<th>Duration (days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America &amp; the Caribbean</td>
<td>300</td>
</tr>
<tr>
<td>OECD</td>
<td>250</td>
</tr>
<tr>
<td>East Asia &amp; the Pacific</td>
<td>200</td>
</tr>
<tr>
<td>MENA</td>
<td>150</td>
</tr>
</tbody>
</table>


**Integration into the World Economy a Necessity**

MENA remains one of the least integrated regions, having failed to take advantage of the expansion in world trade and FDI in the past two decades. Since the mid-1980s, global trade has expanded more than output, to the advantage of middle-income countries in Latin America and East Asia. In MENA, despite large hydrocarbon exports, trade declined from about 100 percent of GDP in the mid-1970s to 60 percent in the mid-1980s and has stagnated since (World Bank 2003c). Excluding oil, trade declined from 53 percent of GDP in the early 1980s to 43 percent in 2000. These negative trends were accompanied by high and increasing product concentration; loss of export dynamism in nonfuel exports as the region exported fewer products that grew significantly faster than world trade in the 1990s; and little participation in global production sharing, with the region exporting primarily low-value-added finished goods and importing parts and components for an inefficient, inward-looking manufacturing base (figure 6.6).
Integration with global private capital flows has also been sluggish, in sharp contrast to
the experience of comparable country groupings (figure 6.7). Excluding the Gulf
countries, MENA received about US$2.2 billion in net inflows of FDI in 2000, or slightly
more than 1 percent of the US$158 billion that flowed to developing countries
worldwide. These inflows averaged less than half a percentage point of GDP for most of
1985–2000. Egypt accounted for half the MENA total (US$1.2 billion), and Jordan
(US$750 million) and Tunisia (US$560 million) for about quarter each. The remaining
countries received small amounts, and some, such as Yemen, had significant outflows.

MENA’s weak integration with world markets reflects unfavorable incentives,
compounded by large behind-the-border constraints. Exchange rates in the region have
been persistently overvalued, by as much as 22 percent on average during 1985–2000
(Nabli and Véghanonès-Varoudakis 2002). Trade regimes in MENA are among the most
protective in the world. MFN tariffs remain high, with an average weighted tariff of 17
percent for the region, and nontariff barriers are widespread, including slow administration of customs and standards. According to the World Bank, trading costs on imports, excluding taxes and duties, average 11 percent of the value of trade, adding another layer of protection. Transport, logistics, and communications costs are high across most of the region, adding a third layer. These transaction costs, combined with the weaknesses in the business climate and constraints on the participation of foreign capital in some key sectors, such as banking and finance, have discouraged FDI.

**Improving Management of Oil Resources**

To develop more stable and diversified economies, many countries in the region need to improve the management of oil resources and broaden the productive base of economic activities. While oil resources finance expansions in physical and human capital and subsidies of goods and services, they also make countries vulnerable to volatility in international oil markets and pro-cyclical fiscal policy. And as is well documented in the literature, large oil rents lead to an appreciation in the real exchange rate, a drag on the external competitiveness of other traded goods and services. Diversifying productive activities is especially urgent for countries such as Syria and Yemen, whose known oil reserves may be depleted in the not too distant future. More generally, diversification is a growing priority because per capita exports of hydrocarbon products have been declining across the region during the past two decades as a result of falling real prices, rising domestic demand for energy, and rapid population growth. With the continued decline in per capita oil rents, it will be increasingly important for governments to ensure the efficiency of public expenditures (figure 6.8).

![Figure 6.8. Per Capita Oil Exports in MENA Countries, 1980–2000](image)

**Completing the Three Transitions Requires Better Governance**

Achieving the three transitions requires fundamental changes in the role of government in some areas of policymaking and considerable enhancement of its effectiveness in others. A broad governance agenda is a central requirement of reform efforts that target an
improved business and investment climate, deeper trade integration, and greater economic diversification (World Bank 2003a).

The governance component of MENA’s reform agenda goes beyond the traditional focus on government intervention in the economy through public sector employment and SOEs. As the recent experience of transition economies in Eastern and Central Europe demonstrates, it encompasses changes in government capacity and incentives to initiate and sustain the policies and institutions that address the region’s development goals, in this case rapid growth and job creation. Governance is also more than the policies themselves, incorporating inclusiveness and accountability in the processes through which policies are conceptualized and implemented.

The “governance gap” in the region, with weaker governance than would be predicted by income, makes the governance agenda all the more critical to MENA’s development future (figure 6.9). The quality of bureaucratic performance and delivery of public services is weaker than in other countries with similar per capita income levels and significantly below that of the better performing countries in East Asia, Latin America, and Eastern Europe. While institutional quality tends to improve with per capita income, the relationship between the two is weak in MENA. The hypothesis advanced in the literature is that achieving high per capita income has not required good governance because per capita incomes are strongly correlated with reliance on oil (World Bank 2003a). While oil and other rents may have allowed MENA in the past to advance its development agenda despite—and perhaps at the price of—the governance gap, better governance will be essential for completing the three transitions in the future.

Better governance means better bureaucratic performance and greater predictability, reducing risks and transaction costs that discourage private investment. The priority of accelerating MENA’s integration into the global economy makes improving the administration of regulations affecting international trade and investment flows particularly important. Better governance will enhance the effective delivery of public
goods and services, including the reliability of infrastructure services such as ports, telecommunications, energy, and water. More generally, as the region advances toward private sector–led growth and globally oriented, stable economies, demands for public services will become more complex, requiring further improvements in service delivery and governance structures. Accountability and inclusiveness will serve as a guide for the efforts of governments to improve governance in areas of importance for the transitions, providing mechanisms for amending, correcting, and refining policies, if not always guaranteeing better policy outcomes.

The Role of Human Capital in the Transition

MENA’s transition to more market-driven and globally oriented economies requires continuing progress in widening and deepening the stock of human capital and, more critically, changes in the qualitative outputs of the region’s educational systems. Higher employment and worker productivity during the transition will be driven by greater educational attainment in general and especially the availability of skills compatible with the needs of the private sector and the global economy. The demand for existing skills affects both labor relocation from the public sector and the pace of new hiring in the private sector. At the global level, innovations in information and communication technologies have transformed how goods and services are produced and what products are produced (Golladay and others 1998). Information and communication technologies are the foundation of the new “knowledge economy” and are associated with the employment of more skilled workers.

Maintaining and Expanding Access to Education

MENA countries now report nearly universal enrollment at the primary level and large shares of youth completing secondary school. Despite these gains, many young people remain outside the educational system. Dropout and illiteracy rates are high in some countries, blocking access to life-long learning opportunities for many. The goal of universal basic education and literacy is important for MENA. A vast literature documents the social benefits of basic education, including lower fertility rates, reduced infant mortality rates, better nutrition, longer life expectancies, and improvements in many other social indicators. From a labor market perspective, a lack of basic education in a large segment of the work force may retard productivity gains and reduce international competitiveness.

Basic skills, however, should not be thought of as an end goal of educational development and reforms. Rapid technological change worldwide has raised the general level of skills required to be competitive in global markets. Even in traditional activities, the ability of firms to compete increasingly depends on their ability to incorporate new technologies. This requires that MENA continue to expand the availability of higher education and specialized training programs.
Building on Past Success

MENA’s sequenced expansion of schooling levels has raised mean schooling levels by strengthening the position of secondary education and reducing the share of students with only primary schooling or no formal education. Higher education has grown as well, but not at the expense of building a solid base of people educated at the secondary level. This strategy has promoted a degree of equity in education and income not evidenced in many other regions. Furthermore, as MENA governments increase investments in higher education and specialized training, these schools will have a large and growing base of qualified individuals pursuing postsecondary education.

In terms of education, MENA is now in a position similar to that of East Asia in the early 1980s, with a broad base of primary and secondary graduates (figure 6.10). East Asia raised mean schooling levels by investing in secondary education, reducing dropout rates, and sequencing later investments in higher education. In contrast, many Latin American countries in the same time period invested heavily in higher education without ensuring a solid base of secondary school students. The result has been greater income and educational inequality in Latin America (De Ferranti and others 2003).

**Figure 6.10. Education Pyramids**

Apart from the goals of expanding access to education and deepening the skill base in the economy, MENA countries must address concerns about the quality of educational outputs and skill mismatches as they affect labor market imbalances today and the requirements of the transition in the future (Galal 2002). In MENA, evidence on skill mismatches comes from surveys of firms and comparisons of the profiles of education in the labor force and the unemployed. In both the labor-abundant and labor-importing countries, entrepreneurs regularly cite the lack of skills as an important constraint to
hiring, in some cases suggesting that it outweighs concerns with labor market regulations (Assaf and Benhassine 2003).

The education systems in MENA have been geared largely toward meeting the requirements of employment in the public sector, with few links to the private sector. In most countries in the region, workers with little or no education and those with postsecondary education constitute a small share of the unemployed. Most of the unemployed workers are either semiskilled or have intermediate or secondary educations, a sign of the undervaluation of their training in the economy. But even for the most educated, analysis of returns to education in chapter 4 suggests that the private sector rewards their education less than the public sector.

Great numbers of students are acquiring more education, but it is not always translated into higher employment and wages (Arab Fund for Economic and Social Development [AFESD] 2002). Tackling these mismatches is largely a matter of improving the underlying quality of education. MENA education and training curricula continue to rely on rote learning and nonparticipatory teaching methods. An improvement in the quality of educational systems in the region will require a shifting of the focus on quantitative outputs toward knowledge application and problem solving.

A recent comparison of exam questions on the French baccalaureate examination in mathematics and biology with similar exam questions in several MENA countries revealed that the MENA tests were devoted to recognition and repetition of definitions and theorems and the performance of other routine procedures, whereas the baccalaureate exams assessed the ability to solve, predict, verify, generalize, and apply mathematical principals to real-world problems (table 6.1). A similar conclusion can be drawn from the results of the TIMSS test, a standardized test that has been used in more than 40 countries to measure knowledge application, in which MENA students generally score lower than the average for developing regions (Berryman 1997).

The qualitative deficiencies in MENA education systems have many causes. The rigid, centralized management of education and vocational training has resulted in inflexible educational and training systems that operate in isolation from their economic

<table>
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<tr>
<th>Table 6.1. Student Performance Expectations in MENA and France</th>
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<tr>
<td><strong>Mathematics Examinations</strong></td>
</tr>
<tr>
<td>Representing</td>
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<tr>
<td>Routine procedures</td>
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<tr>
<td>More complex procedures</td>
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<tr>
<td>More complex procedures</td>
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</tr>
<tr>
<td>Justifying and proving</td>
</tr>
<tr>
<td>-</td>
</tr>
<tr>
<td><strong>Biology Examinations</strong></td>
</tr>
<tr>
<td>Simple information</td>
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<tr>
<td>-</td>
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<tr>
<td>-</td>
</tr>
<tr>
<td>Use science principles to explain</td>
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Source: Berryman 1997.
environment (Billeh 2002; Heyneman 1997). There are few performance indicators for schooling, and thus little measurement of school quality. Only Egypt, Jordan, and Oman have attempted to assess the performance of their students relative to national learning standards. Without information on quality, incentives for educational reform have been limited. Teacher promotion in most of the region is based on seniority and not performance. Examinations at the end of each education cycle serve as more of an elimination device (for access to a higher level) than as a tool for measuring skills. Except in a few countries, private educational institutions remain outside the recognized formal education sector.

The Challenges Ahead

The economic transformation that started in the 1990s is far from complete, while the employment challenge has grown. The potential payoff from completing the transitions outlined in this chapter is enormous, especially the impacts on job creation, investment, and growth. An improved business and investment environment and greater macroeconomic stability would provide the foundation for the expansion of the private sector and the integration of MENA into the world economy. The impact on employment and efficiency would be reinforced by the emergence of dynamic export sectors and larger flows of FDI. All these changes will require reform of MENA education systems. More fundamentally, the transformation of MENA’s economies along the contours described in this chapter will require addressing the governance gap in the region to promote inclusiveness and accountability.

Few of these recommendations are new to the citizens or governments of the region. Indeed, the imperative for new development policies to complete the transitions needed for job creation and growth has been widely acknowledged by policymakers and debated in public arenas since the beginning of stabilization and structural adjustment programs in the 1980s. MENA countries are also aware that the incomplete progress with the reform agenda has been fully reflected in the poor labor market and growth outcomes in the 1990s. A renewed commitment to accelerating MENA’s transition must begin with an understanding of the reasons for the slow and protracted pace of reform programs. The final chapter of this report explores the political economy behind MENA’s resistance to reform and the path to securing the needed transitions in the future.
Chapter 7
Toward a New Social Contract

MENA’s economic difficulties in the past two decades have focused attention on the social contract, especially among those too young to remember the era of rapid economic growth prior to the 1980s. States and societies are confronting the reality that the traditional social contract is no longer sustainable. With mounting economic and political pressures, states have tried to balance reforming the status quo and respecting the pillars supporting state–society relations. The limitations of this approach are visible in the deteriorating conditions in MENA’s labor markets. More importantly, this approach fails to address the underlying causes of the high unemployment rates: an outdated development model that is increasingly incapable of meeting the challenge of rapid labor force growth.

A Vision of the Future of MENA’s Labor Markets

Addressing the challenge of job creation in the MENA region requires the transformation of societies and economic structures (Al-Hamad 2000). The problems to be overcome are enormous; their complexity is daunting. Yet the costs of inaction and the benefits of dynamic labor markets underscore the imperative of acting quickly and decisively. In no small measure, MENA’s economic future will be determined by the fate of its labor markets. If current trends continue, economic performance and the well-being of workers will be undermined by rising unemployment and low productivity. If labor market outcomes improve, however, MENA’s growth will accelerate, raising the living standards of the population across the region.

The need for a comprehensive approach to reform does not diminish the value of incrementalism in advancing reform agendas. Nor does it underestimate the importance of sequencing reforms in ways that maximize prospects for success. It does, however, shape the view of what is needed to restore economic opportunity and secure the well-being of MENA’s workers and their families. MENA requires a broad-based transformation of its political economies to strengthen the core drivers of economic growth and create viable prospects for job creation on the massive scale needed to absorb the tens of millions of men and women entering the work force over the coming two decades.

Securing these gains is more likely if today’s policy reforms are guided by a clear vision of how tomorrow’s labor markets should be organized. The desired outcome is not an unregulated labor market that exposes workers to harsh working conditions, employment volatility, and income insecurity. Nor is it a labor market in which growth is achieved through a race to the bottom, accompanied by declining living standards for workers and worsening income inequality. New development policies are needed that support a race to the top and ensure that workers participate in the benefits of economic growth.

If states no longer serve as employers of first resort, they can be more engaged as partners in creating and sustaining opportunities for employment. A vigorous state role in
improving social services, especially health, education, and social security, is essential to establishing the conditions that will permit workers to thrive and economies to grow at competitive rates. State support will be needed to transform existing institutions of labor representation into a true system of collective bargaining. New state capacities are required for the effective administration of fiscal mechanisms for funding social programs aimed at overcoming dysfunctions in labor markets and protecting workers during economic transition.

Indeed, the challenge of comprehensive reform is foremost a challenge of governance. Efforts to reform MENA’s economies hinge on the credibility of government and the capacity of state institutions to manage a complex, long-term process of change. MENA governments are handicapped by the limits of institutional structures organized to support redistributive and interventionist policies and the difficulties such institutions face in adapting to new tasks, new policy demands, and new regulatory environments. Governments need the institutional and regulatory instruments to manage the difficult process of economic transition under conditions of economic volatility and social vulnerability. Furthermore, such instruments are necessary to establish and maintain conditions that promote socially equitable strategies of market-oriented economic growth.

Governance reforms are essential as well to permit MENA governments to credibly articulate and realize a new vision of state–society relations. The tasks associated with this aim demand a degree of government initiative, creativity, and competence that must be cultivated aggressively throughout the region. To move forward, governments themselves must link economic performance to the quality of governance. They must create rule-of-law mechanisms to ensure their own accountability and transparency, including in budgeting and fiscal policy, to enable citizens to scrutinize government performance and hold officials accountable for their actions. No less important, governments need to improve the quality and quantity of data on which effective policymaking depends, building more effective infrastructures for data collection and analysis.

Governance demands extend well beyond building new bureaucratic capacities. Governments must also create conditions in which coalitions that support socially equitable growth strategies can emerge not only from the top down but also from the bottom up. They must take the lead in changing expectations about the public sector as a primary employer and actively support the private sector as an engine of job creation. This includes strengthening collective bargaining frameworks and extending the benefits of formal employment to a larger share of workers even as labor markets become more flexible.

**Successful Reform Requires a New Social Contract**

Reform of the MENA social contract is crucial for the future of the region’s labor markets. The redistributive–interventionist social contract jeopardizes the well-being of workers (Yousef 2001). It shifts economic activity to the informal sector and leaves too many workers unprotected. It constrains investment and growth, undermining the
capacity of governments to deliver on their commitments to economic and social justice. Under conditions of high unemployment, resistance to reform deepens among those whom the social contract protects. Formal sector workers exhibit a strong preference for income security, even at the expense of declining real wages and productivity and even as the protections offered by the social contract are being eroded by the demands for sustaining it.

MENA’s redistributive–interventionist social contract offers a minority of workers security of employment, but at the expense of declining wages and standards of living. It sustains redistributive policies that mitigate inequality but are underfunded, poorly administered, and increasingly ineffective. The social contract is important in preserving programs that benefit the working poor, but safety nets are stretched beyond their capacity. The existing social contract is deeply embedded in MENA political economies, intensifying labor market distortions and exacerbating economic insecurity for many even as it raises the social and political costs of reform. The combination of a deeply embedded redistributive social contract, declining state revenues, and the worst projected employment gap in the world confronts MENA governments with significant challenges.

MENA cannot sustain the current social contract. The rigid, exclusionary, and inefficient aspects of the social contract need to be restructured. Yet reforms will not be credible unless they take into account the social needs of workers and ensure that economic outcomes are socially acceptable among MENA’s citizens more broadly. This requires a renewed political commitment to widely valued social policies—a new social contract that links reform to the principles of poverty reduction, income equality, and income security that have guided MENA’s political economies for almost 50 years. Absent such links, reforms are unlikely to achieve legitimacy among the majority of MENA’s population whose support is essential for its success.

A new social contract will have long-term benefits for MENA. It will balance the need for labor market flexibility with the rights of workers, helping to avoid social dislocation and conflicts by offering a positive role to labor in the transition to and coordination of more flexible systems of production. It will extend the benefits of formal employment to a larger share of workers in the private sector. Furthermore, it will create mechanisms for supporting workers as they respond to changes in the structure of employment associated with privatization and the shift to more open economies with different skill requirements and greater dependence on new information technologies. The recent passage of new labor codes in several MENA countries highlights both the challenges and payoffs from inclusive processes of labor market reforms that seek to balance employer and employee rights (box 7.1).
Box 7.1. The Path to Reforming Labor Markets in MENA

Egypt and Morocco recently joined Jordan and Tunisia in introducing important reforms to labor market regulations. The reforms grew out of protracted processes that began in the 1990s, and even earlier in some cases, and involved delicate negotiations among government, business, and labor. The laws seek to usher in a new era of labor relations, embodying a balance between greater flexibility in hiring, firing, and wage setting for businesses and enhanced recognition of trade union rights for workers. The inclusion of all stakeholders was critical to advancing the reform agenda. Yet, despite the long incubation and consultations, the new codes do not necessarily enjoy widespread acceptance among all affected constituencies.

Some business owners have expressed reservations. Moroccan textile factory owners fear that the shorter work week and higher minimum wage will make them uncompetitive in international markets. Entrepreneurs there and in Tunisia have also complained that mandated severance payments are higher than before, although it is now easier to lay off permanent workers and business owners are increasingly using temporary workers to avoid severance payments. In Egypt, where enforcement of workers’ protections has been particularly weak outside the public sector, business owners fear the threat of legal strikes while their de facto hiring and firing prerogatives have not really improved.

Many workers are also unenthusiastic. Egypt, Jordan, and Tunisia, with a history of government interference in union leadership selection, permit only one union confederation. Union leaders must both satisfy governments and achieve legitimacy among the membership base, although corporatism has restricted the ability of workers to remove unresponsive leaders. Jordan’s union confederation leaders, seeing little advantage to workers in the proposed code revisions, walked out of the negotiations, and the new law was enacted over their objections. In Egypt and Tunisia, senior unionists endorsed the new codes but dissidents charged them with failing to consult local leaders and the rank and file. Even in Morocco, the only country with a competitive union environment, some workers have complained that unionists are co-opted by owners, affiliated party leaders, or the government.

Further steps are needed to promote acceptance of the letter and the spirit of the new laws. Restrictions on trade union activity need to be relaxed as part of broad efforts to encourage political reform. Top-down management of unions should be reversed unless it reflects workers’ preferences rather than governments’ efforts at control. Empowering unions may slow labor market reforms, as happened in some Latin American countries, but it is the only way to ensure that workers take ownership of reforms.


What Needs to Be Done Is Widely Acknowledged

While MENA’s circumstances are distinctive in their severity, they are not unique. Over the past two decades many countries have faced labor market crises and responded to the political challenges with reforms. Around the world, governments have reduced the scope of state intervention in markets, reorganized regulatory frameworks, and undertaken wide-ranging economic restructuring, including the large-scale privatization of SOEs, while trying to preserve important aspects of social welfare as well as wage and employment protections (Harik 1992).
In postsocialist states of Eastern and Central Europe, these transitions were facilitated by the urgency of establishing new systems of economic and political governance (World Bank 2002). Elsewhere, policymakers have advanced economic reforms within stable polities (Anderson 1999; Schmitter and Schneider 2003). In several Latin American countries, for example, politicians and reformers effectively navigated complex political environments containing entrenched, often competing interests (Schamis 1999; Silva 1993). Despite the presence of supporters of the status quo, governments built effective reform coalitions and successfully re-regulated economies around market-based principles. MENA countries have also undertaken selective reforms, with positive if limited effects on economic performance.

The challenges confronting MENA governments do not arise from a lack of information about what needs to be done. Pathways to reform are much better mapped today than they were only two decades ago, including the need to tailor reforms to country-specific conditions and to link them to socially desirable outcomes. Past decades have produced extensive knowledge about what works in development strategies and policy reform, and what does not.

**Yet Reforms Have Been Too Limited and Too Slow**

Yet, despite this knowledge and the urgency of reform, MENA’s track record has been poor. While some countries have made limited progress on select aspects of economic reform, none has comprehensively restructured the framework in which the reforms are embedded. No less troubling, by the mid-1990s the pace of reform had slowed. Improvements in economic performance in the early 1990s—the result of economic stabilization programs and some other limited reforms—weakened the determination of governments to forge ahead with policy shifts that carried higher political risks.

These selective reforms have had positive effects, including expanded opportunities for employment in the private sector. But they have not generated sufficient growth to ease the economic and political challenges of public sector and labor market restructuring. Sequencing reforms to postpone the difficult task of reorganizing the social contract until economies rebounded has proved ineffective. By the second half of the 1990s, MENA’s overall economic performance was weak, as reflected by anemic growth, rising unemployment, and an inability to absorb the rising number of workers. The gap between labor supply and demand expanded across the region.

**Overcoming the Obstacles to Reform Is Critical**

Why, despite economic stagnation, the exhaustion of selective reform strategies, and a worsening employment crisis have MENA governments been reluctant to change course? This reluctance is often explained as the rational response of incumbent leaders to circumstances in which the costs of reform are immediate, while its benefits are both delayed and, to some extent, uncertain. Yet aversion to political risk is at best a partial explanation for the trajectory of economic reform in MENA.
Certainly, periods of economic transition entail adjustment costs that are not evenly distributed across social groups. Political caution and attention to the effects of reform on workers and the poor are warranted. It is also true that the MENA social contract has created powerful social actors with a vested interest in sustaining it. But there are also political, economic, and social costs associated with maintaining a nonviable status quo. In MENA, these costs are becoming more severe, confirming the belief that slow and selective reform lacks credibility and exacerbates social polarization.

**Soft Budget Constraints and Political Challengers Impeded Reform**

Two factors, in particular, help explain the weak commitment to comprehensive reform: soft budget constraints and the links between economic and political reform (Chaudhry 1997; Smith 2003; Vandewalle 2003). Revenues generated outside the domestic economy and flowing directly to the state through foreign aid, oil exports, and strategic rents cushioned the impact of economic stagnation and permitted governments to adopt limited reforms, while postponing difficult decisions about structural adjustment and reorganization of the social contract (figures 7.1 and 7.2).

Second, and more important, shifts in the relationship between economic and political reform and in how governments managed this relationship shaped the organization and limits of economic reform in MENA during the 1990s.

During the initial phases of economic reform in the 1980s, MENA governments accepted an instrumental connection between economic and political reform. Governments recognized the existing social contract as a constraint on their capacity to reduce state intervention in the economy, shrink the public sector, and reorganize state–labor relations. Unable to sustain their redistributive commitments, governments in Algeria, Egypt, Jordan, Morocco, and Tunisia initiated experiments in political reform to secure popular support for market-oriented economic reforms involving reductions in consumer subsidies and other austerity measures to reduce state expenditure on programs associated with the interventionist–redistributive social contract (Layachi 1999; Zoubair 1998).

These experiments included increased opportunities for participation by opposition political parties, expansion of civil liberties and freedom of the press, increased participation in political life by civil society groups and international nongovernmental organizations (NGOs), and efforts to strengthen rule of law, reduce corruption, and
secure the confidence of domestic and foreign investors. These openings expanded possibilities for citizens to engage in debate about the economic future of the region (Ayubi 1995; Norton 1994, 1996).

However, political openings, partial and fragile, produced consequences that undermined their sustainability (Heydemann 2002; Salamé 1994). Extended periods of political compression prior to the 1980s weakened the prospects for the emergence of new actors as the political space expanded. The exclusion of opposition movements from political life over time gave way to increasingly radical and often clandestine modes of organization and mobilization (Esposito and Voll 1996). Some of these groups attracted significant popular support during the 1980s and early 1990s, challenging the capacity of governments to contain and manage the scope of political change (Bayat 2000).

Governments Decoupled Economic and Political Reform

The challenge of radical movements led MENA governments to change course. Reluctant reformers from the outset, by the early 1990s they adopted policies that weakened the link between economic restructuring and political change. Economic and political reform became loosely coupled, or were decoupled entirely, as governments responded to the appeal of opposition movements and, in some cases, the violence of extremist groups by reviving strategies of political control and reinvigorating the national security concerns that had impeded the reform of governance in MENA (Bellin 2001).

As a result, top-down management of reform by decree replaced earlier efforts to generate support for economic reform by opening the political arena (Pool 1993). Engagement with reform remained selective and limited. Efforts to advance structural adjustment programs coincided with the erosion of political inclusiveness and accountability. This was evident in the imposition of new constraints on civil society and NGOs, restrictions on the press, and other measures to control mobilization and autonomous collective action.

This shift had important implications for the structure and impact of economic reform programs. Reform by decree was an adequate mechanism for advancing policy objectives that required change in bureaucratic practices, regulatory procedures, and the modification of state economic policies. While the gains achieved through reform by decree were not trivial, this approach has narrow limits. It has little ability to achieve reforms that hinge on the compliance and participation of social groups whose well-being might be adversely affected.

The combination of reform by decree and the compression of political space constrained the development of precisely the forms of state capacity that are needed to sustain the long-term transition toward market-oriented political economies in MENA (O’Donnell, Schmitter, and Whitehead 1986). Transparency, the deepening of rule of law, and above all the accountability of economic policymaking all suffered (Brown 1997). Not least, possibilities for establishing a consensus around a redefined vision of state–labor relations and a renewed social contract became more remote.
Yet Today, Economic and Political Reforms Must Be Linked

Soft budget constraints and the challenge of opposition groups shaped the structure and limits of reform processes in MENA during the 1980s and 1990s. Both factors created incentives for selective, top-down strategies that rested on weak linkages among economic reform, governance reform, and a broader commitment to political change (Layachi 1998). These strategies have run their course. They weaken the capacity of governments to address severe employment imbalances, to resolve labor market dysfunctions, and to advance a new vision of the MENA social contract as the basis for more productive relations among the state, labor, and the private sector.

Conditions on the ground have changed in recent years. With fewer opportunities for labor migration, less regional circulation of oil revenues, reduced foreign aid, and intense competition for foreign investment, the era of soft budget constraints is ending (Moore and Sulloukh 2003; Zanoyan 1995). Increasingly, MENA governments will depend on domestic sources of revenue to sustain desirable social policies. Without an institutional and regulatory setting that supports both economic growth and responsible fiscal policies, domestic revenues will fall short and redistributive policies will become unsustainable.

To move the reform process beyond its current limits, governments will need to revive national conversations about labor market reform, restructuring redistributive programs, and redefining the terms of the social contract. With the existence of large middle classes in MENA societies, the revival of political life—once again a prerequisite for economic growth—is certainly possible (Easterly 2000; figure 7.3). A selective, top-down approach to economic reform that sidesteps the need for political change to secure the legitimacy of reform and the credibility of government commitments is no longer adequate.

![Figure 7.3. Share of the Middle Class (percent)](image)

Note: Middle class is measured by the share of income accruing to the middle three quintiles.
Data reflects 2001 or most recent available year.
Sources: Household survey data for MENA countries; WDI 2002 for all others.
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