

# Creating 100 Million Jobs for a Fast-Growing Work Force

Over the next two decades, the Middle East and North Africa (MENA) region faces an unprecedented challenge. In 2000, the labor forces of the region totaled some 104 million workers, a figure expected to reach 146 million by 2010 and 185 million by 2020. Given this expansion, the economies of the region will need to create some 80 million new jobs in the next two decades. With unemployment now at about 15 percent, the more ambitious goal of absorbing unemployed workers in addition to the new entrants implies the need to create close to 100 million jobs by 2020, a doubling of the current level of employment in the first two decades of the 21st century.

In no small measure, MENA's economic future will be determined by the fate of its labor markets. 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. 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.

This report argues that meeting this employment challenge will require the transformation of MENA's societies and economic structures. MENA needs a new development model that is based on a reinvigorated private sector, greater integration into the world economy, and better management of oil resources. These drivers of future growth and job creation require a foundation of better governance. Moreover, this transformation necessitates a new social contract.

## **Evolution of MENA's Social Contract**

The social contracts established in the postindependence era have given rise to enduring institutions, interests, norms, and practices—structuring

the constraints and incentives governments now face as they contend with demands for and against policy reform. The contracts have defined state–labor relations across the region and have 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 effect 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.

From the 1940s to the 1970s, the MENA social contract acquired distinctive features, institutional arrangements, public policies, legitimating discourses, and modes of state–society relations, with several core attributes:

- 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
- A 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 contest or the aggregation of conflicting preferences.

### **Social Contract Delivers Early Dividends**

Despite the 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. The social contract also meant low levels of poverty and income inequality. The social payoffs from these policies have been enormous, with dramatic reductions in mortality and increases in life expectancy, school enrollment rates, and literacy levels.

These results had important political consequences. They reinforced redistributive mechanisms that sustained the well-being of large segments of MENA populations, deepening the popularity of these mecha-

nisms among social groups that governments identified as core constituencies. From the 1960s through the 1980s, these social groups emerged as prominent winners in the political economies created by the interventionist–redistributive social contract. The welfare gains also helped to 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.

### **Social Contract Is under Strain: 1980s and 1990s**

But over time, gaps widened between (a) the embedded set of institutional arrangements and expectations and (b) the diminished capacity of governments to sustain redistributive commitments. By the early 1980s, the inability of the MENA social contract to sustain the economic gains of previous decades became clear—and by the late 1980s, the strains had grown into a major economic crisis. The triggers of the crisis were declining oil prices, shrinking demand for migrant labor, and reduced remittance flows.

In response to the growing economic difficulties, most governments in MENA adopted some form of economic stabilization program. Policy shifts were marked by caution and gradualism, but across the region, governments cut subsidies, reduced public expenditure, and reformed exchange rate regimes. 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.

MENA governments also began a gradual and selective transition from economic stabilization to structural adjustment—a move strongly supported by international financial institutions. Reforms included many that are now familiar markers of economic restructuring: privatization of state-owned enterprises (SOEs), fiscal reform and trade liberalization, deregulation, and strengthening the institutional foundations for a market-led economy.

However, implementation of these reform measures has been uneven, hesitant, and incomplete. Partly as a result, MENA’s economic recovery in the 1990s was generally weak. In the past 15 years, gross domestic product (GDP) per capita growth has averaged 1.0 percent a year, labor productivity has remained low, and unemployment rates have increased.

### **Emergence of Poor Labor Market Outcomes**

Although the rate of population growth has declined, the pressure of population flows in MENA 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 2.0 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.

### **Demographic Burden Becomes a Demographic Gift**

The maturing of MENA's age structure has placed the region in a unique position at the beginning of the 21st century. 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 amount 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.

Lower dependency ratios imply a potential for higher savings and investment. Rapid labor force growth, especially with increased education and longer life expectancy, provides economies with a larger pool of productive workers. As a result, policymakers in MENA are facing new challenges. These demographic changes are shifting the policy focus from providing health and education for a young population to facilitating employment and output growth.

### **Labor Market Pressures Have Accelerated Since the 1980s**

While creating the potential for employment and growth, 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. High population growth rates between the 1950s and the 1980s have led to the rapid expansion of the working-age population. With rising labor force participation rates since 1980, the labor supply has grown and the absolute number of new labor market entrants has increased over time.

The pressure of young workers on labor force growth has been persistently high in MENA. The period 1990–2010 will witness the greatest labor force pressures from young male and female workers. Rising female labor participation since the 1980s, in particular, constitutes one of the most important developments affecting the size and gender composition of the region's labor supply. Not only are young men and

women entering labor markets in greater numbers, but also they are increasingly more educated, a consequence of the considerable resources devoted by governments to human capital accumulation.

### **Unemployment Rose and Real Wages Were Stagnant in the 1990s**

The growing supplies of workers constitute one of the fundamental forces driving labor market outcomes in MENA. 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 before the mid-1980s and its weaker performance in the subsequent period have been fully reflected in labor market outcomes.

By definition, if labor supply exceeds the level of employment, the unemployment rate rises. Over the past decade, the growth in the labor force has exceeded employment growth in most countries in the region. As a result, unemployment in MENA is among the highest in the world. A conservative estimate puts unemployment at about 15 percent of the work force. The problem affects almost every country in the region. Recently, even the oil-exporting countries that traditionally imported expatriate labor to supplement the national work force have witnessed rising rates of unemployment.

Unemployment in MENA is concentrated among youths, whose unemployment rates range from 37 percent of total unemployment in Morocco to 73 percent of total unemployment in Syria, with a simple average of 53 percent for all countries for which data are available. There is a gender dimension to the profile of unemployment as well. Unemployment rates for the region as a whole are nearly 50 percent higher for women than for men.

MENA's weak labor market outcomes in the 1990s have characterized not only unemployment but also real wages. Real wages have increased marginally in some countries, but they have either stagnated or declined in most, thus extending a trend that began in the 1980s. Worker productivity, which is the basis for real wages, increased in the 1990s by less in MENA than in any other region except Europe and Central Asia, which had been undergoing significant economic restructuring.

### **Unemployment and Output Trends Are Linked**

Lower labor demand accounts for the slow pace of job creation in the 1990s, hence contributing 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.

In MENA, as elsewhere, faster output growth has generally gone hand in hand with lower unemployment, whereas slower growth has invariably implied higher levels of unemployment. Thus, the story of MENA in the 1990s is of weak output performance in the face of rapid labor force growth, with the result that output per laborer barely improved—if at all.

Despite stabilization efforts, the declines in capital accumulation that marked the 1980s continued into the 1990s, with nearly every country in MENA realizing lower rates of physical capital accumulation than it did in the previous decade. The lack of a strong response from the private sector stemmed primarily from the slow and protracted pace of policy reforms. Although the early macroeconomic and structural reforms improved economic outlooks, most countries failed to follow through on reforms.

### **Government Continues to Dominate Labor Markets**

At the microeconomic level, poor labor market outcomes are driven largely by reduced demand from the public sector and by slow growth of the private sector. Unemployment rates are highest for young new entrants into the labor market who have intermediate and higher education. Thus, the unemployed are essentially those who would have had a chance at a formal job in government after years of guaranteed public sector employment. Unemployment rates are low for those who have no formal education and who are not eligible for employment in the public sector.

The structure of unemployment also suggests that a significant part of unemployment results from high job expectations by workers with some formal education, as well as from 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. Although government hiring has been curtailed in recent years, the structure of the labor market remains segmented. Educated new entrants continue to queue for government jobs, despite falling civil service wages, because of such nonwage benefits as allowances and job security.

Although real wage levels appear to be flexible, moving downward in times of slow growth, the dominant role of government as employer introduces rigidities in the wage structure that distort labor market incentives. Higher returns to formal education in the public sector encourage the accumulation of such credentials even if they do not add to worker

productivity and are undervalued by the private sector. The resulting concentration of educated workers in unproductive public sector employment goes a long way toward explaining the low contribution of human capital to economic growth in the region.

MENA has fared well relative to other regions in income inequality and poverty levels, thanks in large measure to the redistribution of oil rents through labor remittances or increased government employment. Although fairly effective in reducing poverty, government employment is an inefficient safety net, because most of the benefits go to educated workers who are underrepresented among the poor. Moreover, the costs of excessive government employment are reduced economic and total factor productivity growth, which can limit poverty reduction over the long run.

## Unlocking the Potential for Job Creation

The challenge of job creation requires a comprehensive approach to reform, although the priorities and sequencing of policy reforms will vary across countries by specific initial conditions, including resource endowments, reform progress to date, and quality of institutions. The need for a comprehensive approach 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 to secure the well-being of MENA's populations. MENA requires a broad-based transformation of its economies to strengthen the core drivers of economic growth and to create viable prospects for job creation to absorb the tens of millions of men and women entering the work force over the coming two decades.

## Scope and Limitations of Labor Market Intervention

Reforming the institutional and regulatory framework is integral to better functioning labor markets. Policy proposals that aim to alleviate current pressures and to generate better outcomes must address structural rigidities, including the state's role as both employer and labor market regulator. To be 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.

More flexible hiring and dismissal procedures are the most relevant policy issues in the reform of labor regulations affecting the private sec-

tor in MENA. These regulations limit job creation and reduce flexibility in the work force. As a result, workers endure long unemployment spells, which lead to skill degradation and lack of work experience. Unemployment of women and youths 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.

Empirical simulations indicate that direct policy interventions would lead to positive labor and macroeconomic effects, in most cases contributing to higher employment, private investment, and output growth in the long run. Reflecting complementarities between policies, the simulations suggest that a comprehensive rather than a piecemeal approach delivers the biggest effect. However, the employment and growth payoffs associated with even the most comprehensive package of interventions are modest considering the magnitude of job creation needed in MENA.

Thus, labor market reforms are a necessary component of policy reforms, but they are not sufficient for addressing the scope of the employment challenge facing the region now and over the next two decades. Although certain priorities for reform are common to all countries in the region, such as reducing the role of the public sector in labor markets, the importance and likely effect of other reforms will vary across countries. Economic and political conditions and a careful understanding of labor market issues in each country must determine the priority areas of reform.

### **Limitations of Active Labor Market Policies**

Active labor market policies are another type of intervention used widely in both developing and industrial countries. From wage and employment subsidies, to training and retraining for the unemployed, to direct job-creation programs and job-search and assistance services, these policies are designed to create employment opportunities and to manage labor market risks. In MENA, as in other regions that lack functioning national unemployment insurance systems, active labor market programs constitute a relevant instrument for tackling labor market dislocations.

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. Even with spending on these programs in MENA already high and projected to grow, only a small share of the labor force is likely to be covered by these programs. Furthermore, to be effective, active labor market policies need



to be carefully targeted and monitored. If inappropriately designed, such programs may have high fiscal costs and negative economic effects.

### **Traditional Engines of Job Creation**

Government may continue to be a source of employment for a minority of new job seekers. But it is highly unlikely and even undesirable for the public sector to remain a leading sector of job creation in the future. 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 unemployed and new graduates queuing for government employment. Barring an acceleration of employment growth in the formal private sector, the rising numbers of new entrants would be pushed into the informal economy.

The prospects for labor migration are equally limited in the near future. Although intraregional migration provided an important outlet for workers in the labor-exporting countries during the oil boom in the 1970s and 1980s, the past decade has seen a rapid deceleration in the net inflows of MENA workers in the receiving countries. Today's unemployment and the projected rapid expansion of the national labor force in the receiving countries in the Gulf Cooperation Council provide further incentives to reduce the inflows of migrant workers in general. Meanwhile, migration to Europe is constrained by policy and would provide only a partial solution to the employment challenge.

### **MENA's Need for New Development Policies**

This volume and the accompanying volumes on trade and investment and on governance argue that, for MENA countries to accelerate job creation and growth, they must address a set of long-standing policy and institutional challenges to complete three fundamental and interrelated realignments in their economies:

1. *From public sector dominated to private sector dominated*, by reducing the barriers to private activity while creating regulatory frameworks to ensure that private and social interests are mutually reinforcing
2. *From closed to more open*, by facilitating the integration into global goods, services, and factor markets while putting in place safeguards for financial stability and social protection
3. *From oil dominated and volatile to more stable and diversified*, by making fundamental changes in institutions managing oil resources and their intermediation to economic agents.

The growth and employment effects of such an integrated package of policy realignments are potentially very large. On the basis of the experience of comparable countries, the companion trade study estimates that output per worker could increase by some 2 to 3 percent a year. The companion governance study, using similar international evidence, estimates that a commitment to improving the institutions of accountability in public administration could raise output growth per capita by between 0.8 percent and 1.3 percent a year. Together, these studies suggest that output-per-worker growth could be raised by at least 3.5 percentage points.

The positive implications of such performance for future job creation are profound. For instance, bridging only half the gap between the current 6 percent share of nonoil merchandise exports in total exports and its potential of 20 percent, with the associated increases in domestic and foreign private investment, would cut the unemployment rate in the region by 4 percentage points. The broader reform agenda would bring even larger benefits.

### **Transition 1: 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 to reduce subsidies to SOEs. But governments still represent a large share of value added in MENA. As a result, the contribution of the private sector to value added increased only marginally in the 1990s. The same pattern has characterized the share of the private sector in total investment, which did not increase enough to compensate for the decline in public investment.

These disappointing trends reflect not only macroeconomic policy outcomes but also weaknesses in the business environment that discourage entrepreneurship and firm creation. New firms face significant barriers to entry, in terms of both the time and cost of administrative approvals. New firms also face significant difficulties securing start-up and operating capital with public banks. Regulations do not facilitate the restructuring of businesses that are still viable, whereas nonviable firms are not permitted to close operations expeditiously, thereby raising the social and economic costs of bankruptcy.

In addition, MENA compares poorly with other regions in the complexity of filing a legal claim and in the time needed to initiate and to complete such a claim. Even where the legal processes are defined, the unpredictability of enforcement creates problems for entrepreneurs. Businesses also suffer from weaknesses in the financial system and in the

administration of licensing, regulations, taxes, and import duties. Furthermore, weaknesses in infrastructure, such as telecommunications and transport, greatly impede business activity and investment.

### **Transition 2: Integrating with the World Economy**

MENA remains one of the least-integrated regions, having failed to take advantage of the expansion in world trade and foreign direct investment (FDI) in the past two decades. Since the mid-1980s, global trade has expanded more than output has, to the advantage of middle-income countries. 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. These negative trends were accompanied by high and increasing product concentration, loss of export dynamism in nonfuel exports, and little participation in global production sharing.

Integration with global private capital flows has also been sluggish, in sharp contrast to the experience of comparable country groupings. Excluding the Persian 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. The Arab Republic of Egypt accounted for half the MENA total (US\$1.2 billion), and Jordan (US\$750 million) and Tunisia (US\$560 million) for about a quarter each.

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. Trade regimes in MENA are among the most protective in the world. Transport, logistics, and communications costs are high across most of the region, thus adding a third layer. Those transaction costs, combined with the weaknesses in the business climate and constraints on the participation of foreign capital, have discouraged FDI.

### **Transition 3: Managing Oil Resources Better**

Many MENA countries need to undergo a final transition to become more stable and diversified economies. This transition requires better management of oil resources and a broadening of the productive base of economic activities. Such improvements imply setting up institutions and fiscal rules that insulate public expenditures from oil price volatility and that save oil revenues so they can continue to benefit citizens when

oil resources decline. These changes also mean improving the efficiency of public expenditures through better systems of budgeting that emphasize performance and accountability.

Diversifying productive activities is a growing priority, not only for countries whose known oil reserves will soon be depleted, but also for all other oil producers. Per capita exports of hydrocarbon products have been declining across the region, with falling real prices, rising domestic demand for energy, and rapid population growth. Governments will need to develop new sources of revenue to ensure the efficiency of public expenditures.

### **Central Role of Better Governance to the Transition**

The government's role in the economy needs to be redefined. 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 social programs aimed at overcoming dysfunctions in labor markets and at protecting workers during economic transition.

Efforts to reform MENA's economies hinge on the credibility of government and on 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 by the difficulties such institutions confront 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.

Accordingly, governance reforms are essential 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 to hold officials accountable for their actions.

## MENA's Need for 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. It shifts economic activity to the informal sector and leaves too many workers unprotected. It constrains investment and growth, thereby 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.

MENA's social contract offers a minority of workers security of employment, but at the expense of declining wages and standards of living. The social contract is important in preserving programs that benefit the working poor, but safety nets are stretched beyond their capacity. Declining state revenues and the worst projected employment gap in the world render the existing social contract unsustainable.

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 unless they ensure that economic outcomes are socially acceptable among MENA's citizens. Doing so 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.

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 in the coordination of more flexible systems of production. Furthermore, it will create mechanisms for supporting workers as they respond to changes in the structure of employment associated with privatization and with the shift to more open economies with different skill requirements and greater dependence on new information technologies.

Securing those gains demands 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 by worsening income inequality. New development policies are needed that support a race to the top and that ensure that workers participate in the benefits of economic growth.

The challenge of restructuring the social contract in MENA does 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, as well as what does not work.

### **Understanding 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. Also, powerful social actors have a vested interest in sustaining the status quo.

Political caution and attention to the effects of reform on workers and the poor are warranted. But there are also political, economic, and social costs associated with maintaining a nonviable status quo. In MENA, those costs are becoming more severe, thus confirming the belief that slow and selective reform lacks credibility and exacerbates social polarization.

Inadequate responses to sustained economic stagnation have become a serious drain on the political resources of MENA governments, and those who benefit from the status quo find their positions increasingly insecure. The erosion of living standards for segments of the population intensifies popular disaffection, even as new communications technologies make citizens more aware of the gaps between their economic conditions and those in other parts of the world.

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

Soft budget constraints shaped the structure and limits of reform processes in MENA during the 1980s and 1990s. 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.

Another factor that impeded the reform process was the challenge of radical movements. Economic and political reforms became loosely coupled—or were decoupled entirely—as governments responded to the appeal of opposition movements and, in some cases, to the violence of extremist groups by reviving strategies of political control and reinvigorating the national security concerns that impeded the reform of governance in MENA.

As a result, top-down management of reform by decree replaced earlier efforts to generate support for economic reform by opening the political arena. Engagement with reform remained selective and limited. Efforts to advance structural adjustment programs coincided with the erosion of political inclusiveness and accountability.

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. Not least, possibilities for establishing a consensus around a renewed social contract became more remote.

### **Economic and Political Reform Must Be Linked**

These strategies have run their course. They have weakened 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. Under these conditions, the reluctance to implement economic reforms is at odds with the strong preference of MENA governments for political and social stability.

To move the reform process beyond its current limits, governments will need to revive national conversations about reforming the labor market, 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. At the same time, 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.

### **Support from External Partners Is Critical**

As the region steps up to unlock the promise of a better future, external partners, as vigorous proponents of reform, have an important role to play in supporting MENA's transition. Although Europe is MENA's most

important trade partner, other partners also need to support faster and deeper integration of MENA into the world economy by facilitating the accession of more MENA countries to the World Trade Organization (WTO), by encouraging more intraregional trade and investment, and by lifting economic sanctions. A more liberal policy toward agricultural exports and labor migration from MENA would reinforce the foundations of a strong Euro–Mediterranean partnership.

Although external financial and economic support would be welcome, MENA's prosperity depends heavily on establishing regional security and stability. There is strong evidence that violence and conflict have severely impeded the pace of reform and of trade and investment integration, at times rivaling the detrimental influence of poor domestic policies. Persistent conflict has also had large neighborhood effects throughout the region, spilling from conflict-ridden countries to neighboring countries. Greater commitment is required on the part of MENA governments to contain internal and regional sources of instability. And the international community needs to rethink its response to persistent conflict in the region. Multilateral efforts are urgently needed to resolve the Israeli–Palestinian conflict and to return Iraq to a state of normalcy.

### **Main Responsibility Rests with MENA**

Almost a decade ago, a World Bank report asked MENA to “Claim the Future” and take the steps needed to secure the economic well-being of their citizens (World Bank 1995a). Since that earlier study, some progress has been made, but far more remains to be done. Images of well-educated but unemployed youths now define MENA for much of the world. Because of earlier inaction, MENA's leaders face more difficult choices and a more urgent need to act. The old social contract no longer provides a viable starting point for reform. A new social contract is needed, one that integrates market-based strategies of growth and inclusiveness and accountability with long-standing commitments to social equity.