

*Long term economic development challenges
and prospects for the Arab countries*

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I Introduction

It is a challenge to talk about an Arab economy and to explore its prospects. The countries composing the Arab world are a diverse set in terms of size, geography, level of income, natural resource endowments, economic structure, human capital and skills, social structures, economic policies and institutions and so on. Yet, the economic similarities among the countries in the Arab world abound. The region has been linked by a common resource-base. Oil provided the basis for rapid economic and social development throughout the region – not only for oil-producing economies but for resource-poor Arab economies as well, through labor remittances and aid flows. The common resource-base also includes the shared lack of water resources, with water per capita in the Arab countries the lowest in the world. The region has been linked by policy, with similar models of economic development adopted by Arab countries at the time of their independence. Almost all adopted since the 1950s and 1960s models of development based upon state-led planning, with social policies designed for redistribution and equity.

With these strong similarities in terms of economic policy, natural resources, and the shared production base for economic growth and development, it is not surprising then that many of the development challenges facing the Arab countries today are also similar: almost all have confronted stagnant growth since the decline in oil prices, and despite some measured economic reforms in most of the economies, growth has remained weak throughout the region. All have been affected by regional conflicts and instability, either directly or through association, deterring investment. And almost all of the Arab States are facing one of the most pressing development problems to date: a burgeoning problem of unemployment, the result of both shrinking prospects for the main modes of employment creation in the past – labor migration and public sector employment -- and a rapidly expanding labor force.

The Arab region faces a growing realization that development paths of the past are no longer capable of achieving national objectives. The problem of insufficient job creation in the Arab region is mounting, and without fundamental transitions in the Arab economies which ensure greater and sustainable job creation, the employment challenge will worsen rapidly and dramatically.

Over the next pages, we will articulate the broad course of action needed in the Arab economies.¹ First, in Section II we describe the development challenges facing the Arab world, in particular, the challenge of employment creation. In Section III, we examine the constraints of the old development model in the region in terms of meeting these

¹ The material draws on the diagnosis and conclusions from four major regional reports produced by the World Bank on the occasion of the World Bank-International Monetary Fund Annual Meetings in Dubai in September, 2003. The reports address the issues of trade and investment, governance, gender and employment. See references at the end of paper. A synthesis document is also available, World Bank 2003e.

development challenges. Section IV proposes a set of transitions that constitute the contours of a new development model. Section V outlines the fundamental changes needed for making this transition, including improved governance, higher quality education and greater gender equality. The concluding section VI makes a few observations about the feasibility and issues of implementation.

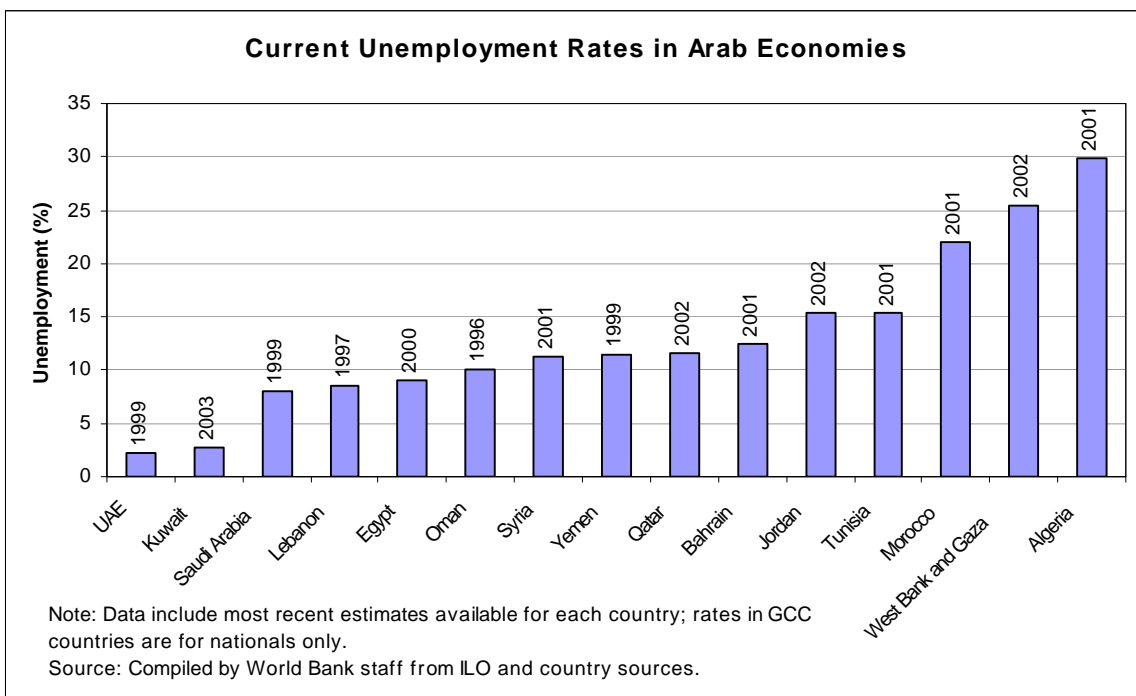
II A Central Challenge in the 21st Century: Employment

The Arab region faces many economic challenges as it enters the 21st century. There is the challenge of water scarcity and its implications for the availability of this vital resource to its citizens and for the development prospects. There is the environmental challenge and the sustainability of the use of natural resources, including soil degradation and deforestation, desertification, the preservation of the sea coasts as well as the deep sea resources. There are issues of poverty and exclusion. There is the issue of population growth which has slowed dramatically in many countries but remains high for many. But perhaps there is no more pressing economic challenge for the Arab world today than that of employment, on which this paper will focus.

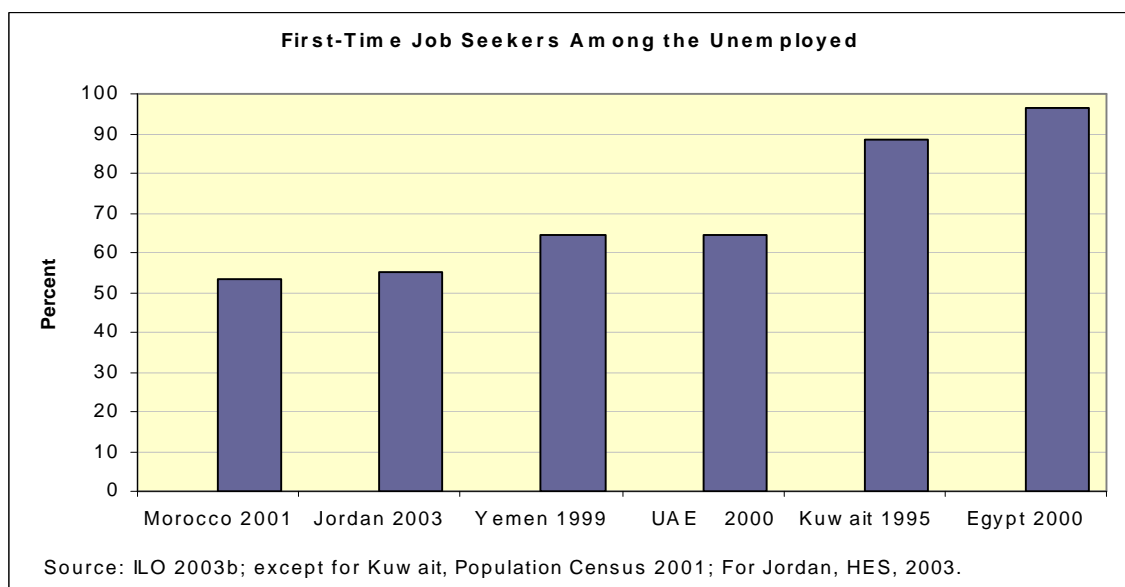
A generation disappointed... One of the striking characteristics about the Arab world² is the youth of its population. Two thirds of the population is under the age of 30, making it the second youngest region of the world behind Sub-Saharan Africa. As a comparison, in Europe, those under thirty comprise only a third of the population. In East Asia and the Pacific, only half. The Arab world is a world of burgeoning youth, increasingly educated, with higher expectations than the generation before. Yet, at the same time, this group which represents the new face of the Arab region faces growing disappointment in the job market.

Labor market outcomes in the Arab region have steadily worsened over the last two decades. With the unemployment rate increasing since the mid 1980s, unemployment now averages over 15% of the labor force, by official figures. Actual unemployment is probably much higher.

² The countries included in the Arab region for the purposes of this paper are those which are part of the MENA region according to the World bank. They include Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, and Yemen. Data for Iraq and Libya are often missing, and these two countries are generally not included in the analysis, save for population or labor force figures. In addition, four Arab countries not included in the MENA region, Comoros, Mauritania, Somalia, and Sudan, are only included in Arab totals for population and labor force figures. In 2000, the total population of the Arab region was estimated at 287 million people. GDP per capita averages US \$1,850, ranging from a low of \$315 in Yemen and Sudan, to a high of \$13,900 in Kuwait.

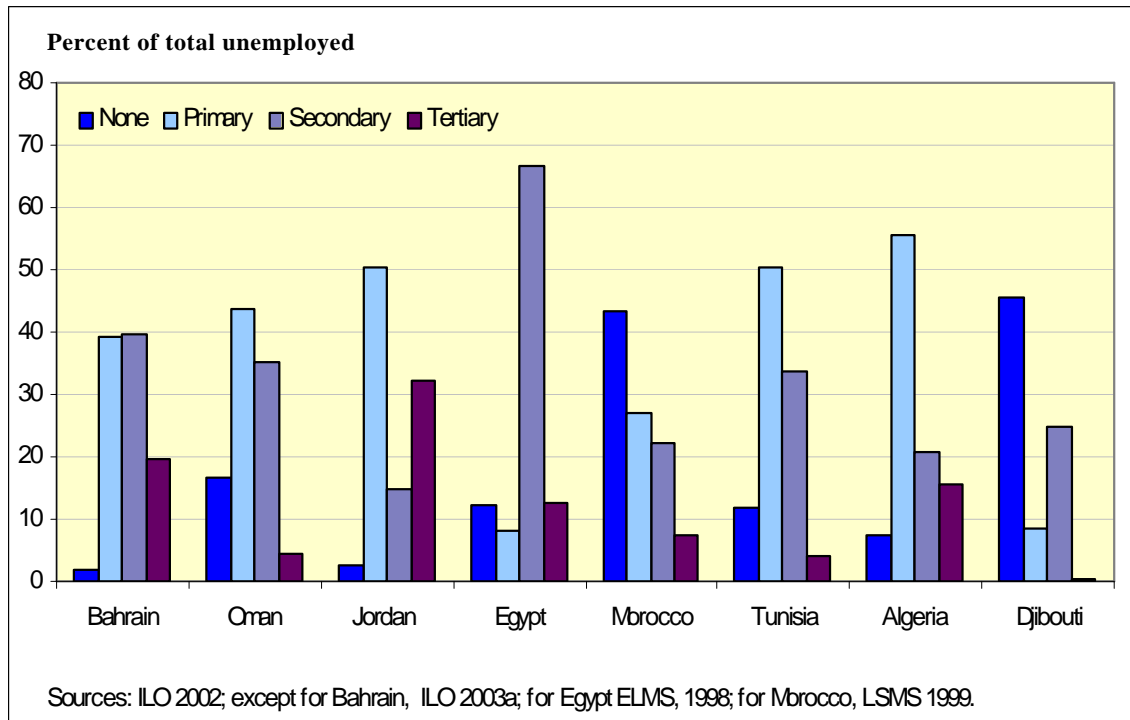


And unemployment falls disproportionately on the Arab region's youth. First-time job seekers comprise more than 90% of all unemployed in Egypt, and almost two-thirds of the unemployed in Yemen and the United Arab Emirates, and more than half the unemployed in Jordan and Morocco.



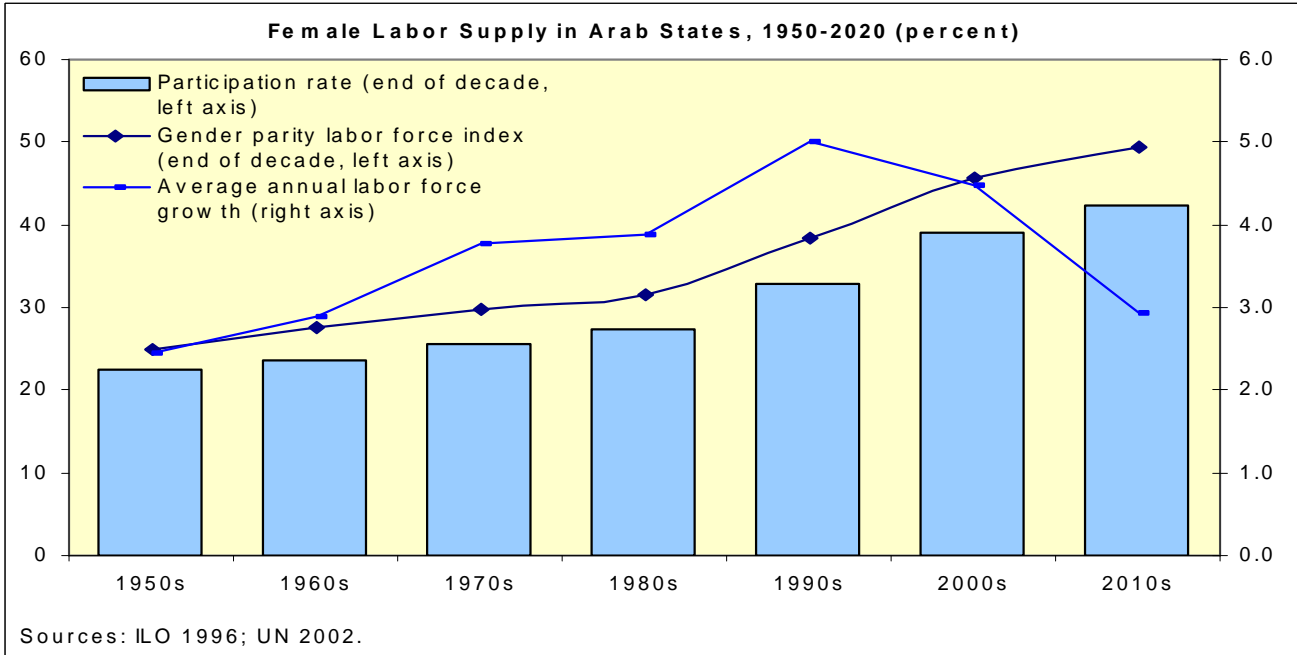
These are workers coming into the labor force with substantially higher levels of education than the generation before them: twenty years ago, the average level of education in the Arab world was about 2 years; today, that level is around 5 years.³ But unemployment has increasingly prevented those educational advancements from realizing economic returns in the labor market.

Distribution of unemployed by level of education

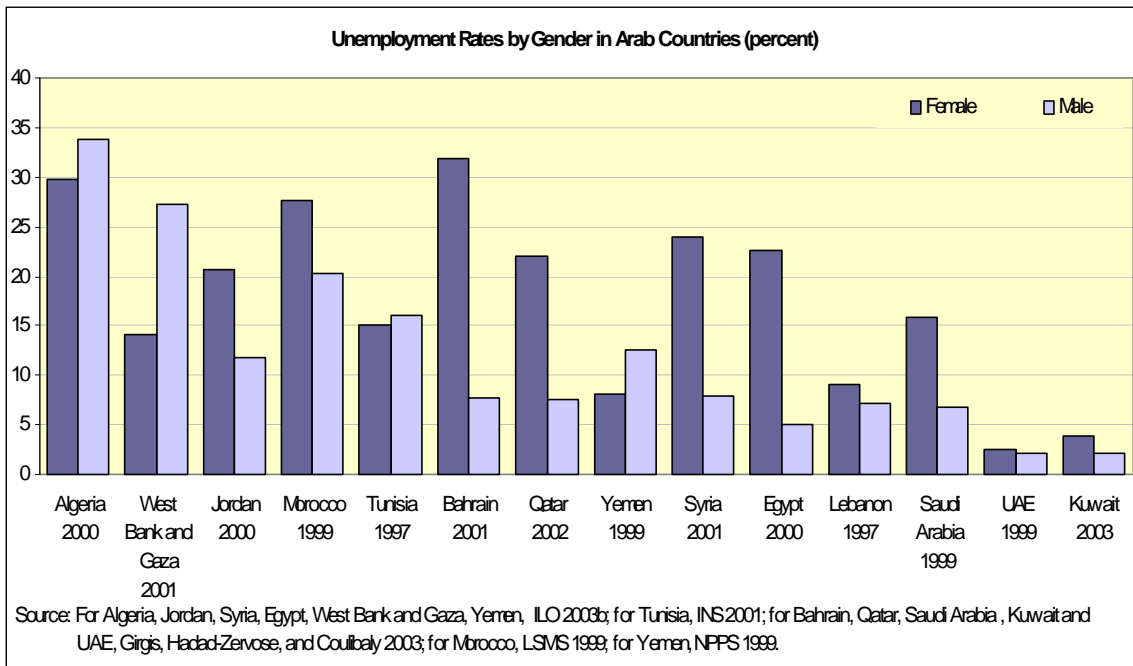


The Arab labor market is not only young, it is increasingly feminized, and the poor labor market outcomes which characterize the Arab region particularly impact women. While Arab women have the lowest labor force participation rates in the world, their engagement in the labor force has grown considerably over the last decades. But as their numbers increase, they are finding increasingly fewer job opportunities.

³ Computed from Barro-Lee Educational attainment database, including Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Syria and Tunisia.

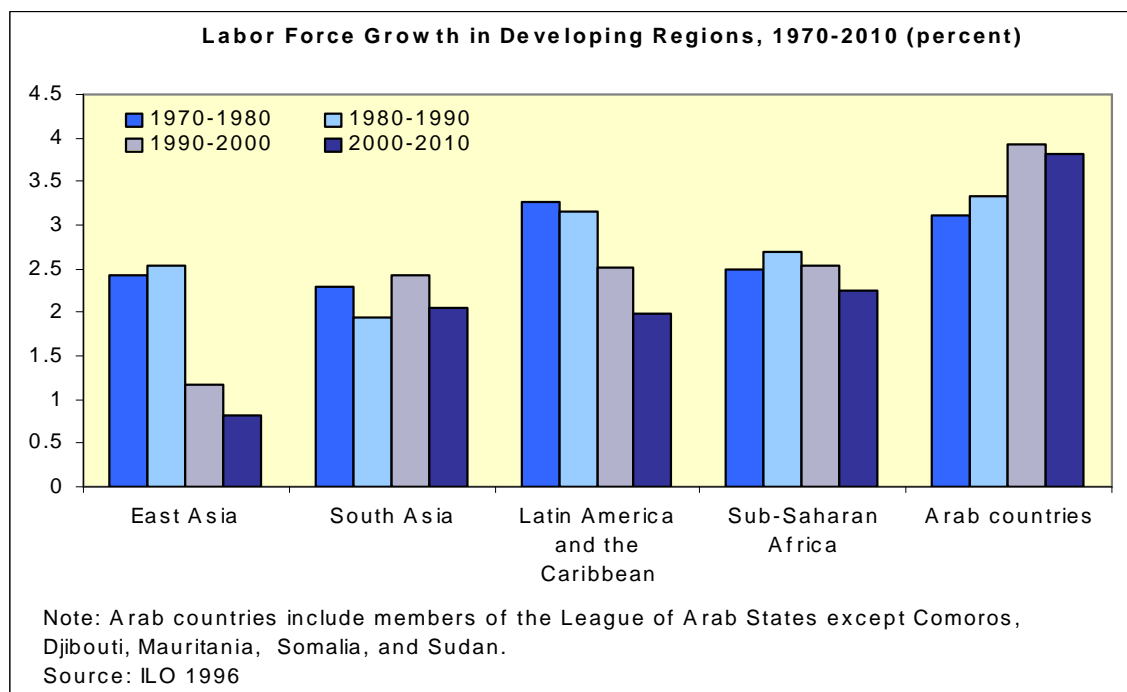


Unemployment rates average 30% higher for women than their male counterparts. The gender gap in unemployment is particularly great in countries like Bahrain, Syria, Egypt, and Saudi Arabia, where the unemployment rate among women is two to three times that of males. Along with many other factors which have altogether discouraged the involvement of Arab women in the labor force, the poor prospects they face in the labor market have undoubtedly dampened their participation.

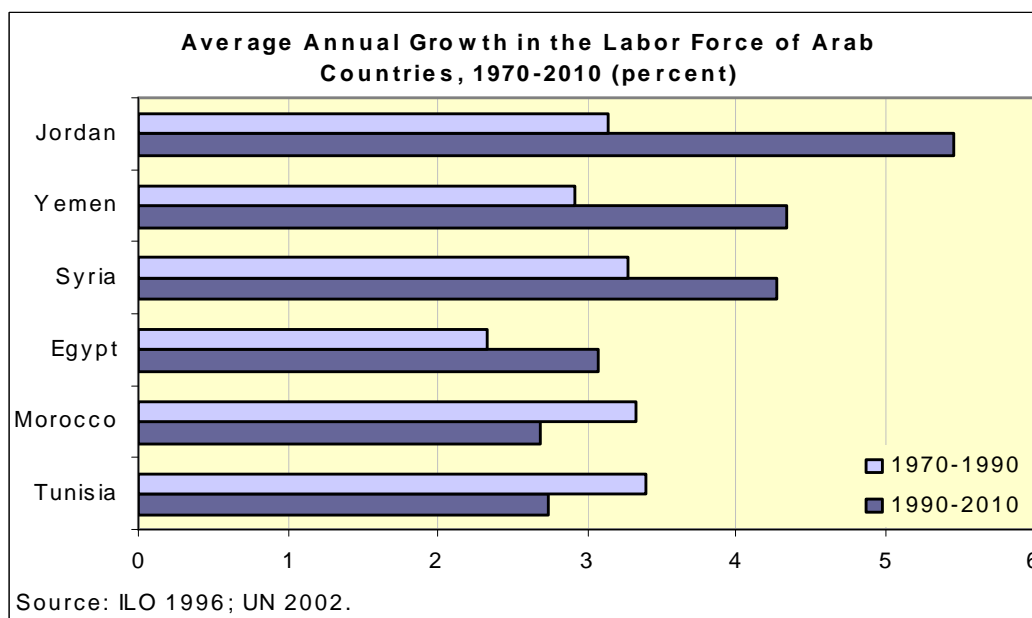


Poor labor market outcomes are not limited to unemployment, but also the poor wage prospects for the employed. Worker productivity, the basis for real wage growth, has increased only marginally over the last decade, remaining far below that in East Asia and the Pacific, South Asia, and Latin America and the Caribbean. As a result, real wages have stagnated or declined in half the Arab countries since the 1980s, and only increased weakly in most of the other Arab countries.

...and unprecedented labor market challenges to come... And beyond the poor job prospects that have characterized the Arab region over the past two decades, there is also the knowledge that labor market pressures will only build over the next two decades. A legacy of high population growth rates in the Arab region between 1950-1990, which peaked at 3.2 percent a year in 1985, has translated into some of the most intense pressures on labor markets observed anywhere in the world in the post-WWII period. The current labor force is growing by a rate of 3.3 percent per year. That translates into some 37 million new workers entering the labor force between 2000 and 2010, swelling the total labor force by close to 40 percent in a span of only 10 years. Between 2000 and 2020, the labor force in the Arab states will have expanded by some 75 percent. In the span of twenty years, 74 million new jobs will need to be created, just to absorb the growing labor force.



Job creation must be even higher, if the region is to address the current unemployment problem. If the Arab region is to accomplish the more ambitious goal of absorbing these unemployed workers in addition to the new entrants to the labor force, close to 90 million new jobs will need to be created by the end of the next decade, well over double the number of jobs that currently exist in the Arab world.



Under any comparison, the Arab region faces an unprecedented challenge in development. These labor market pressures would be a development challenge for any country. But for the Arab region, the need for accelerated job creation comes just as two of the Arab region's major sources of employment creation over the past four decades, *public sector employment* and *labor migration*, are providing fewer and fewer jobs.

III. Constraints of the old development model

Employment creation in the Arab region has been greatly influenced by the historical model of development adopted throughout the Arab region. In part to correct for a legacy of inequities and poverty during the first half of the 20th century, at the time of independence the political actors of the Arab region adopted models of development based on strong governments, central planning of economic and social priorities, and wide-scale policies for redistribution and equity. This strategy would include nationalization of many private assets, state planning, industrial development through protected local markets, and vast resources directed to social development and large-scale public sector employment.

The model yielded early positive results... Early on, this model had strong payoffs. The region as a whole benefited from oil, either directly (for oil producing economies) or through aid and labor remittances. With oil and oil-related revenues, in addition to directing large resources toward public infrastructure, the Arab economies directed vast resources toward education, with the resulting average level of education of the adult population increasing from less than a year in 1960 to more than 3 years in 1985. Fueled by improvements in basic education and heavy investments in health care, health indicators also improved significantly, and poverty was substantially reduced.

...but significant costs as well. But the model also has had strong implications on the economic orientation of the Arab economies, on governance, and on employment creation. Economically, heavy protection and regulation of industry, along with overvalued and uncompetitive exchange rates, provided marked disincentives for the growth of a tradable goods sector in the Arab states. Oil resources relieved many governments of the need to tax their citizens and allowed governments to redistribute substantial resources through vast welfare and social services systems. At the same time, this system of pervasive redistribution of wealth reduced demands from Arab citizens for accountable and inclusive public institutions. Arab governance mechanisms lacked transparency, reflected in limited access to government information and carefully monitored freedom of the press. They lacked contestability, reflected in some of the most centralized governments of all developing countries. And they lacked inclusiveness, reflected in rural/urban inequalities in access to public services, gender inequalities in voice and participation in society, and in nepotism or patronage determining who gets public services or access to lucrative business opportunities and who does not.

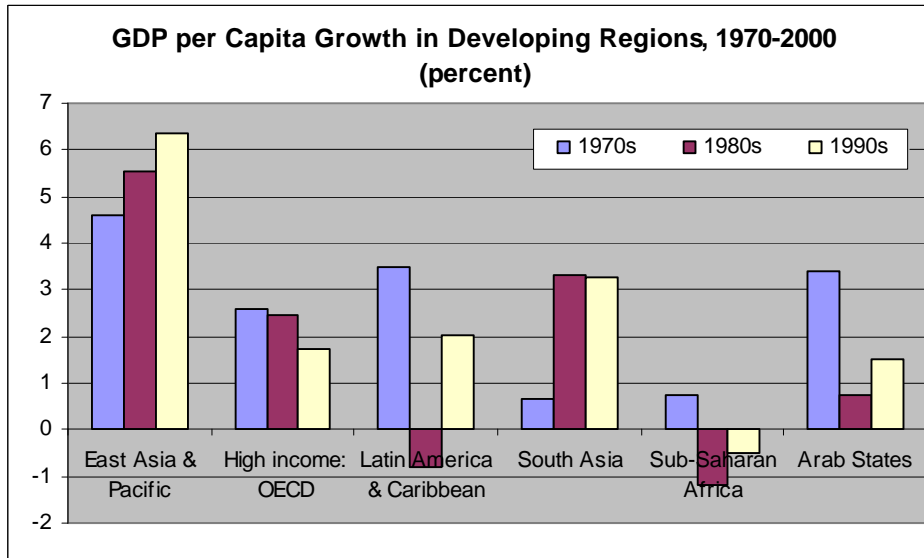
The private sector that emerged under this model, developing under the patronage of governments, flourished not so much by being dynamic in a competitive environment, but often by supplying protected domestic markets and generally “living off the state.” Despite high growth rates during the oil boom years, investments in the Arab region became progressively unproductive. Though still positive, total factor productivity growth was cut in half in the Arab region between the 1960s and 1970s.

The model also had significant implications on employment creation. Along with vast social welfare systems, Arab governments redistributed resources through public sector jobs. Governments became the employer of choice throughout the GCC, and while oil revenues were high, nationals entering the labor force could be hired almost exclusively by the public sector. Even in the non-oil producing economies, aid flows and labor remittances from citizens working in the Gulf permitted the public sector to grow to unprecedented levels.

A major source of employment in the region also came in the form of labor migration, with large numbers of Arab laborers working in other countries in the Gulf. At the peak of the oil boom in the early 1980s, some 3.5 million Arab migrant workers were employed in the Gulf states. In 1973-1984, official remittances totaled almost \$22 billion in Egypt, \$8.2 billion in Morocco, and \$6.5 billion in Jordan. This provided an enormous buffer to any lack of job opportunities at home.

The oil price collapse and a decade of crisis. When oil prices collapsed in the mid 1980s, government revenues throughout the region felt the blow, beginning with the oil producers but with the non-oil producers close behind. Although cushioned by extensive external assistance, the flow of resources to the public sector slowed considerably and government expenditures on social systems and physical capital shrank. For the region as a whole public fixed investment was cut heavily, and growth in physical capital stock per laborer declined by more than 60 percent from the 1970s.

Facing declining public revenues, governments struggled to maintain their redistributive commitments. The fiscal strains contributed to large macroeconomic imbalances. Productivity growth, already declining by the 1970s, plummeted over the 1980s. Growth collapsed under the multiple blows of declining public spending, and unattractive private investment climate, and continuing losses in efficiency. Economic growth per capita averaged only 0.7 percent per year.



- Arab States include all MENA countries but Iran, plus Sudan.

At the same time, and for the first time, unemployment began to emerge as a serious problem in the Arab states. With reduced public sector revenues, guaranteed employment in the public sector was no longer possible. Labor migration opportunities were also diminished. Lower oil prices, rapidly rising domestic supplies of national labor, and competition from lower-cost labor elsewhere in the world all worked to dampen the GCC demand for labor from the rest of the Arab region.

Initial efforts at reform. The lack of economic growth and deteriorating budget deficits prompted several of the economies to undertake programs of macroeconomic stabilization and structural reform aimed at encouraging private sector development, to become an engine for growth and employment creation. Macroeconomic stabilization was broadly achieved, but the pace of structural reform differed markedly throughout the region.

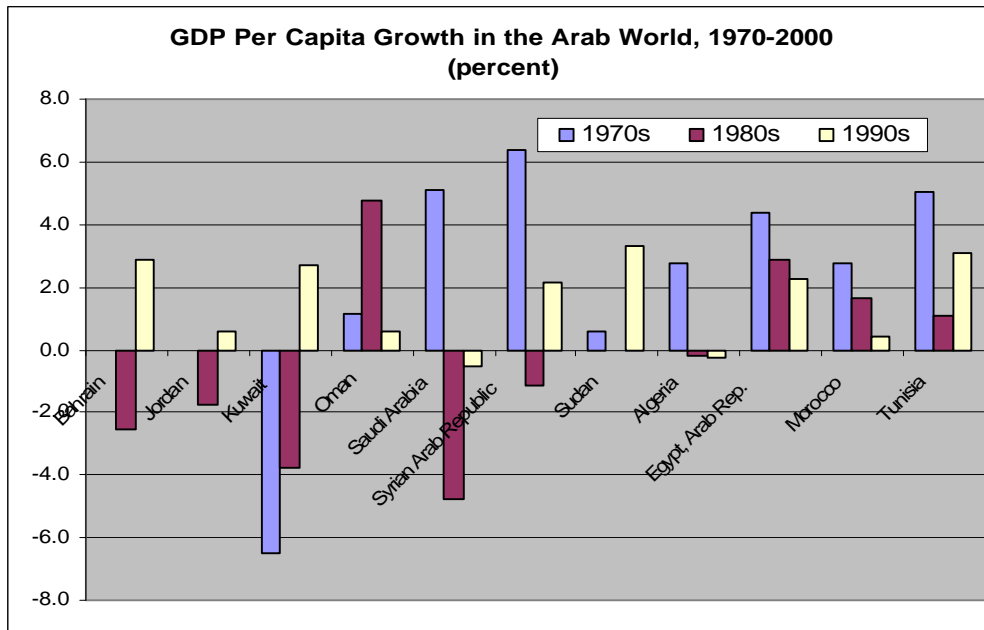
- A group of resource-poor countries, including Tunisia, Morocco and Jordan, implemented earlier and more intensive reforms toward more open and private sector led economies than the rest of the Arab countries. Tunisia introduced as early as the 1970s an “off-shore” export processing platform to facilitate trade, both Morocco and Tunisia joined the General Agreement on Tariffs and Trade. Reforms also included exchange rate liberalization, tax reforms, trade and financial sector liberalization, and privatization. All three signed Euro-Med agreements in the 1990s, and Jordan signed

a free-trade agreement with the United States. In general, the reform effort has been steady in these countries, and without policy reversals.

- Other resource-poor countries, including Egypt and Lebanon, have pursued reform more slowly and sporadically. Despite early reforms in Egypt and aggressive macroeconomic stabilization in the 1990s, reforms were partially reversed with escalating behind-the-border trade restrictions and significant exchange rate overvaluation. More recently, reforms have resumed, especially with the signing of a Euro-Med agreement in 2001. Lebanon, with a legacy of destroyed physical and economic infrastructure and weaker institutions, had to contend with large macroeconomic imbalances.
- Another set of countries, with significant oil resources and large populations, including Algeria, Syria, and Yemen, also pursued reforms later, more gradually, and more sporadically than the early reformers. Algeria, with macroeconomic imbalances stemming from the collapse in oil prices, aggressively pursued macroeconomic stabilization, but structural reforms have been far more limited. Trade reforms initiated in the early 1990s were reversed in 1998, and then taken up again in 2001 with the signing of a Euro-Med agreement. Reforms in key areas such as the financial sector and privatization remain limited. In Syria the trade and investment liberalization begun in 1991 was not sustained. While there has been modest progress in exchange rate unification and private sector regulatory reforms, broader structural reforms have been limited. And in Yemen macroeconomic stabilization reforms have not been accompanied by more aggressive reforms to diversify the economy, despite relatively open trade policies. The investment climate remains poor, reflecting weak rule of law and property rights, ineffective regulatory frameworks, and security problems.
- The six GCC economies—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have long maintained an open trade system with free movement of capital and advanced financial systems. As oil prices deteriorated, most countries cut expenditures, but aggregate budget deficits have generally increased. Some of the smaller GCC countries have encouraged growth in selected sectors such as entrepot trade (United Arab Emirates), financial services, and tourism (Bahrain and United Arab Emirates). Oman has made substantial efforts to broaden private sector participation and improve the investment climate, with privatizations and changes in its foreign capital investment law. In Saudi Arabia reforms have progressed more slowly. The public sector still dominates economic activities; and government revenues remain dependent on oil.

But growth failed to improve. In general, the structural reform agenda in the Arab region, despite its intentions, has been cautious, selective, and often subject to pause and to reversals. The reform agenda avoided most governance reform or opening of the political space, needed for any type of deeper reforms that depend on the compliance and participation of the social groups whose well being the reforms are intended to improve. As a result, the reform effort stopped short of providing a substantially improved climate

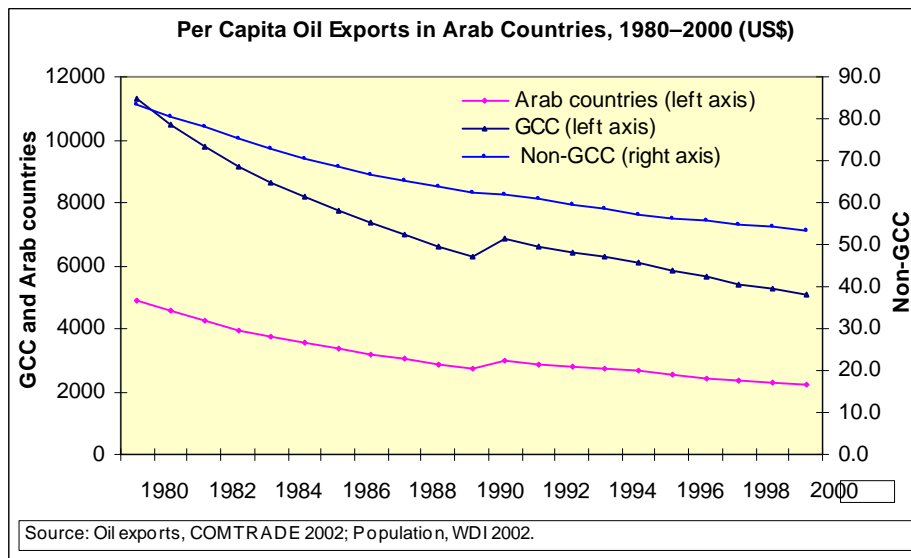
for growth and investment, and the recovery in growth over the 1990s was weak, with per capita GDP growing by an average of only 1.5 percent per year.



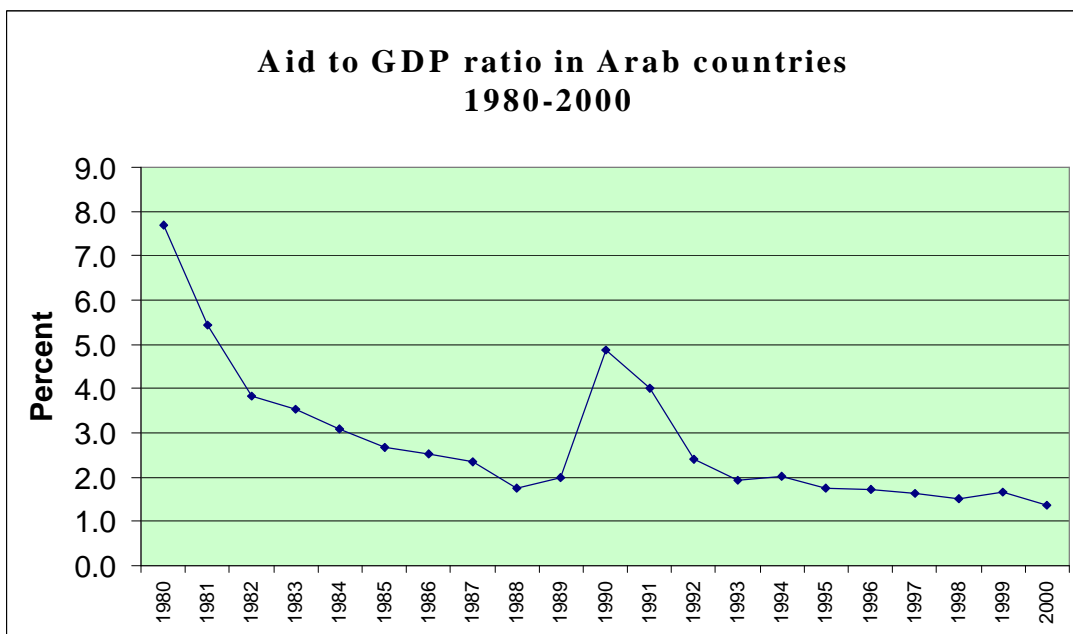
Declining employment opportunities from the old model... Now, as the Arab region faces an unprecedented challenge in job creation over the next two decades, the major sources of employment creation of the past are quickly dwindling. The public sector can no longer be the employment outlet it has in the past. Most branches of public sectors are already overstaffed, by as much as a third or more in some countries. More importantly, the public sector cannot act as a refuge to vast numbers of unemployed with the marked change in fiscal circumstances throughout the region.

The Arab countries' development has relied heavily on three financial sources: oil, aid inflows, and workers' remittances. These three sources provided an essential supply of public revenues and private earnings, and supported the large-scale public sector employment policies of the past. But all three of these revenue sources are under greater pressure.

Oil revenues will decline for all countries in the Arab region, continuing the pattern of the past two decades. The long-term outlook is for real oil prices to decline steadily from the current levels to those that are about the same as prevailing in the 1970s. Known oil resources will be depleted in some countries of the region, such as Algeria, in about four decades, while in some others, such as Egypt and the Republic of Yemen, much sooner. Exports will fall as domestic energy consumption ratchets up and the population grows. With declining oil production, the decline in per capita oil rents will be steeper than in the past two decades.

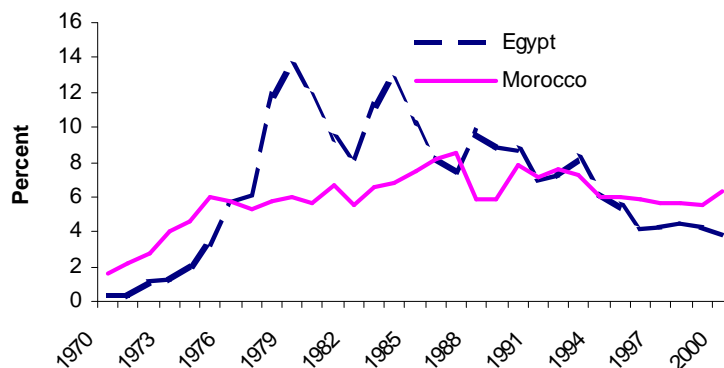


Aid flows are expected to similarly decline, except in temporary periods of strategic importance and conflict resolution. Finally, labor remittances are not projected to increase significantly, a result of deteriorating prospects for labor migration.



Prospects for another major source of employment creation – labor migration – are also diminished. Throughout the 1970s and 1980s, labor migration provided a critical employment outlet for workers in many of the non-oil producing Arab economies. In the mid 1980s, close to 10 percent of the Egyptian and almost 15 percent of the Yemeni labor forces were employed abroad, primarily in the Gulf. The last decade, however, has seen a rapid deceleration in the net outflows of Arab workers to other countries in the region. Migration has slowed to the Gulf Cooperation Council (GCC) countries of the region.

**Worker remittances as percentage of GDP
Egypt and Morocco: 1970-2000**



Combined, the region’s traditional sources of job creation are fast dwindling, just as the need for job creation is accelerating.

VI Three major economic realignments are required

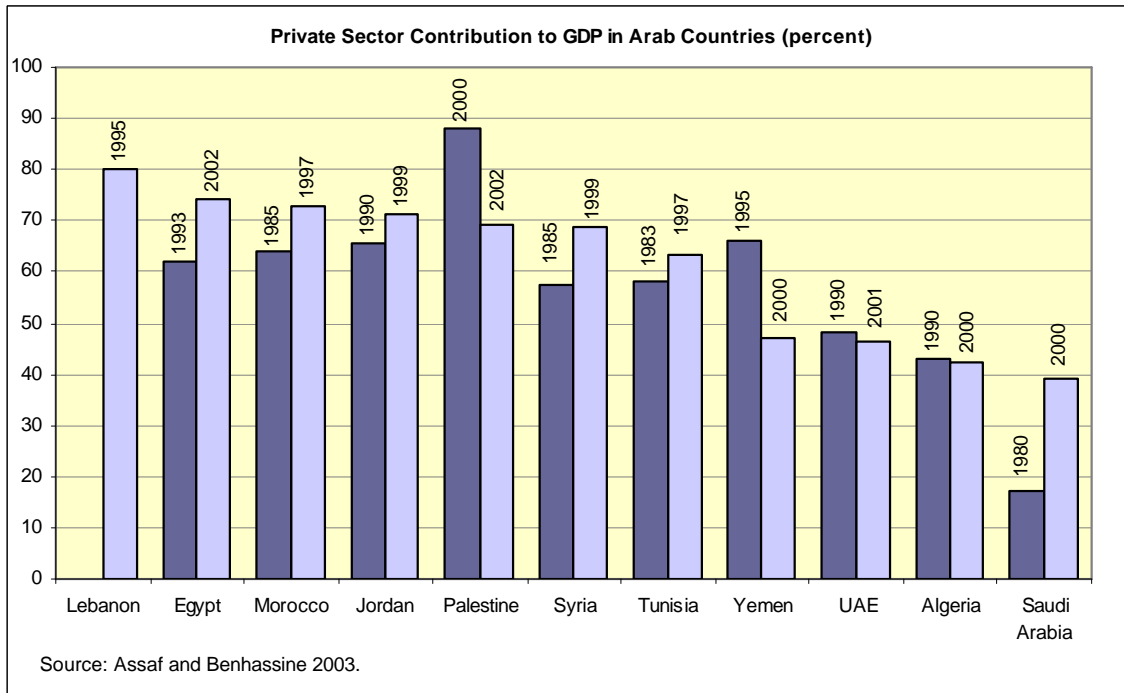
If the region is to ensure that the rapidly expanding labor force has both sufficient employment opportunities and the prospects for real wage growth, GDP growth in the region will need to double from its average of 3 percent per year over the late 1990s to 6-7 percent a year for a sustained period. This is an enormous growth challenge, but tantamount to meeting the enormous labor market challenge ahead.

To meet the growth and employment challenge, the Arab countries must address a set of long-standing policy and institutional challenges to complete three fundamental and interrelated realignments in their economies:

- *From public sector-dominated to private sector-dominated economies*
- *From closed economies to more open economies*
- *From oil-dominated and volatile economies, to more stable and diversified economies*

1) Expanding the role of the private sector in the Arab economies

The private sector's contribution to value added in the Arab region is low compared to that in other regions, and while most Arab countries have attempted to expand private sector activity since the late 1980s, it increased only marginally over the 1990s. The scope for private sector expansion is very large in the Arab region, but it requires a conducive economic and political environment.



Improving the investment climate. Firm start-ups and operations in the Arab world are significantly hindered by the time and financial costs of regulatory and administrative barriers. For new firms, the costs of complying with regulations as a proportion of Gross National Income are twice what new firms face in Eastern Europe, and five times what firms face in East Asia or Latin America and the Caribbean. Other costs are also high, from licenses to domestic taxation and import duties and regulations that slow customs clearance.

Surveys reveal that potential investors in the Arab world are significantly hindered by obstacles to entry, including cumbersome licensing processes, complex regulations and opaque bidding procedures, as well as official acceptance of uncompetitive practices. In Morocco, about half the firms say they have had to hire intermediaries or maintain full-time staff to deal with the bureaucracy. In Jordan, a potential investor interested in registering a new firm has to wait three months, with half of that time spent on a single procedure – inspection by the ministry concerned.

Businesses are further handicapped by judicial systems that facilitate neither restructuring of viable businesses nor closure of nonviable ones. The Arab region compares poorly with other regions in the complexity and time needed to initiate and complete a legal claim. Unpredictability of enforcement is an even more serious problem. Close to half the surveyed firms expressed concern over the unpredictability of the legal system.

Improving key finance and infrastructure for business. Weaknesses in infrastructure and in the financial system are yet another burden on business operations. Almost half the private businesses in the region complain that infrastructure is a moderate to major obstacle. Telecommunications and transport, two backbone services, are significantly underdeveloped. With public banks dominating the banking system in many countries and favoring state enterprises, larger industrial firms, and offshore enterprises, smaller firms have a hard time getting the start-up and operating capital they need.

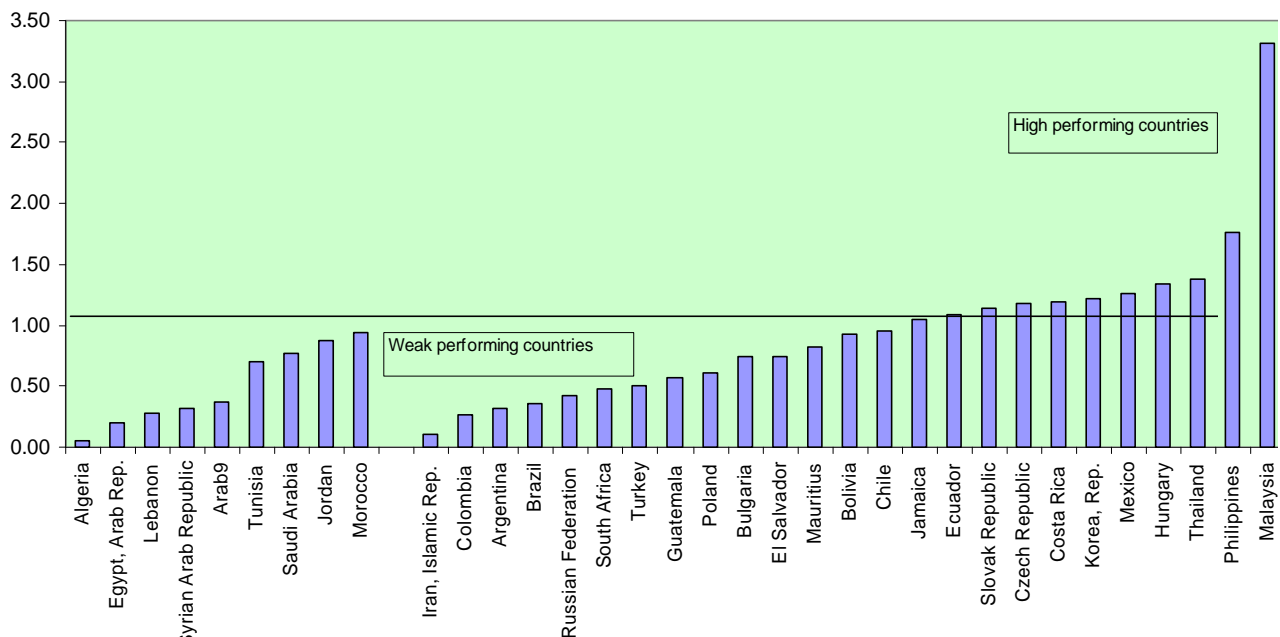
Accelerating privatization. Finally, several strategic services for the private sector—banking, telecommunications, and transportation—remain under public ownership in most Arab countries. Privatizations in the 1990s focused on manufacturing firms, only recently extending to selected services such as telecommunications. And even where privatization of services is advancing, regulatory arrangements often remain weak.

2) Integrating with the world

The limited integration of Arab economies. The Arab region has largely missed out on the trends of global trade integration. The region's trade integration, measured by the ratio of trade to GDP, fell from about 92 percent of GDP in 1980 to about 70 percent in 1985, and it now remains around 65 percent today. The region's oil resource boom helped it realize high initial export to GDP ratios, but with the windfall revenues invested at home in infrastructure and services (and not in tradables), the export to GDP ratio steadily declined.

The scope for expanding trade for the Arab countries is very large. Exports other than oil are about a third of what they could be given the characteristics of the region in terms of endowments, size and geography. Manufacturing imports are one half of what they could be. Foreign direct investment could be five to six times higher.

Arab Non-Oil Export Potential



Note: Regression is based on 42 countries, but values for 8 low income countries, including Yemen, are not reported because of negative values. Arab9 = Algeria, Egypt, Jordan, Lebanon, Morocco, the Republic of Yemen, Saudi Arabia, Syria, and Tunisia.

Arab country trade is marked by both a high degree of product as well as geographic concentration. Although the share of fuels in total exports has fallen, fuels still constitute the most significant exports for the region. In 1978, 76 percent merchandise exports were fuels. By 2001, that share had only fallen to 58. The manufacturing sectors of most Arab countries are small by international standards – almost half the typical levels in other lower-middle income economies. Some of the resource-poor countries, including Tunisia and Morocco, have seen a large fall in their trade product concentration, comparable with Chile or Malaysia, and countries like Lebanon and Jordan, already well diversified, have seen further declines in concentration. But the diversification by labor-abundant, resource rich economies (Algeria, Egypt, Syria) was limited, and for the major oil producers – Libya, the GCC economies – there has been little improvement in diversification.

Barriers to integration. Several factors have hindered Arab integration into the world. The trade regimes in the Arab states are among the most protective in the world. Tariffs remain high and dispersed. Non-tariff barriers, including lengthy processes to comply with customs and quality control standards, are still widespread. The trade-impeding effect of these barriers has been compounded by often persistent overvaluation of exchange rates.

In addition, behind the border constraints are considerable. Transport, logistics, and communication costs are high, effectively raising the costs of trade. Add to that an investment climate which generally discourages the start-up of small and medium firms, often critical to success in trading.

*Removing the barriers to trade...*The Arab region needs to significantly increase the speed of integration into the global economy, reducing the level of tariff protection, dismantling inefficient non-tariff barriers, and removing the behind the border constraints to trade, which have raised the costs of trade and have discouraged both domestic and foreign investment. Real exchange rates, which have been significantly overvalued in the Arab region for the last two decades, need to be corrected as well.

*The imperative for trade reform is high...*The costs of wait and see policies are also becoming increasingly expensive for global trade integration. The region faces intensified competition in world markets, at both the skill-intensive and the labor-intensive ends, affecting important industries and activities such as textiles and garments, light engineering, and manufacturing. On the skill-intensive end two major competitive threats are the upcoming accession of some Eastern European countries to the European Union and Turkey's customs union agreement with the European Union, the Arab region's major export market. Other regional groupings and free trade agreements also present challenges. Both the Europe and Central Asia and the Latin America and the Caribbean regions, two middle-income regions with labor skill profiles similar to the Arab region, have enjoyed faster trade reforms and integration with global markets in recent years and are rapidly gaining market share as the Arab world lags behind. A mismatch between the skills required by firms and the skills produced by an education system still organized to turn out new government employees intensifies the competitive problem.

Labor-intensive products and manufactures are also facing a new challenge from low-wage, high-productivity countries such as Bangladesh, China, India, Indonesia, and Vietnam. That competition will escalate with the abolition by 2005 of quota preferences in textiles and garments, important to the region's manufacturing employment and export earnings. These labor-intensive sectors, employing more than a million workers, have been among the few in which the Arab region has been gaining market share—partly because of the protected quota markets in the European Union. Adjusted for labor productivity, labor costs in the garments sector in Arab countries are significantly higher than in populous countries of Asia, but lower than in Eastern European countries. The longer the region delays trade and related reforms, the more disadvantaged exporters will be in facing these competitive pressures.

*How Arab trade can flourish...*The future for Arab trade will involve specialization in manufacturing, cutting up the production chain and permitting finer gradations of specialization within that chain among skills and labor costs and productivity. Small, resource-poor countries in the region stand to benefit from such production chains, and given their size, the prospects are virtually unlimited in world markets. Larger countries will also benefit from such specialization. Their larger domestic markets, and proximity

to major international markets, will drive a much larger range and scale of domestic manufacturing possibilities.

The role of regional trade agreements. Regional trade agreements can be an important anchor for reforms. Trade with Europe, the natural geographic partner of the Arab region, falls far short of its potential. Agreements with the EU could provide immediate and expanded access to its markets for agriculture, as well as increased temporary migration, funds for managing transition costs, and more efficient rules of origin.

At the same time, however, the Arab countries need to maintain open access to world markets, anchoring their trade and investment reforms in a multi-lateral framework such as the WTO, to give them greater credibility. Only half of the Arab population lives in a WTO member country – the lowest share of all developing regions. This is partly due to the disproportionate share of Arab countries under trade and foreign investment sanctions. But it is also by choice. Arab countries have generally opted for preferential trading arrangements with the EU, which have immediate appeal because of geographic proximity and EU financial and technical support. In addition, primary oil exporters with little other trade are wary of bringing their oil trade under the WTO.

But speeding up WTO accession processes is necessary. The transition process for the Arab region depends upon signals. The enhanced credibility of government policies that are bound as commitments to the WTO gives the world's investors the greatest degree of confidence in the permanence of the reform process.

Limited intraregional trade and scope for expansion. There have been many attempts to foster intraregional integration among Arab countries over the last half century. But they have mostly failed to produce enhanced trade within the region. Intraregional exports among Arab countries remain of the order of 8-9 percent since the 1980s, compared to 22 percent for the ASEAN (Association of Southeast Asian Nations), and 25 percent for MERCOSUR (Argentina, Brazil, Uruguay). Many factors prevent an enabling environment for trade among the Arab economies. They include restrictions on imports – either directly through customs or more indirectly through the financial sector, but they also include a host of factors that prevent this facilitating environment for regional trade. There are a variety of infrastructure issues, such as inadequate telecommunications, as well as the trade chilling contingent protection and obstacles created by frontier frictions, such as frontier red tape and differences in national product standards. The Arab region needs to work to eliminate these inhibiting factors to trade, and allow Arab exports to the region to at least be on a level playing field with exports from the rest of the world.

The potential for increased intraregional Arab trade and investment is large and could be a source of increased investment, production and employment. The recent Pan-Arab Free Trade Area Agreement improves on past efforts and opens new opportunities. But its impact is likely to be limited for the reasons discussed above and because it remains restrictive on trade in agriculture and services; and the rules of origin remain loosely defined, leaving open the possibilities that they will continue to be used to protectionist effect.

It is important to notice, however, that even a successful process of intraregional integration is unlikely to be a substitute for increased integration with the world economy at large. Analysis and lessons from international experience show that intraregional integration is best and most successful if it is pursued within a broader agenda of openness with the rest of the world. In addition, even integrated the Arab economy would remain a relatively small player and would not be able with an intraregional focus only to harvest the opportunities of the global economy in terms of production, technology and investment.

3) Managing Oil Resources

In addition to greater private sector participation and openness, diversification out of oil will involve fundamental changes in institutions managing oil resources and their intermediation to economic agents.

Economic diversification requires proper fiscal policy and public expenditure management in addition to measures to expand globally competitive private businesses outside the oil sector. That means setting up institutions and fiscal rules that insulate public expenditures from oil price volatility and save oil revenues so that they can continue to benefit citizens when oil resources decline. That also means 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 for all oil producers. Diversification is essential if the region is to ensure vital public expenditures. 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.

But also, diversification is critical for job creation. The labor force is rapidly expanding, in far greater numbers than the public sector could afford to employ, especially given the declining oil revenues. Significantly greater job opportunities need to be created in the Arab economies. To do that, the region must diversify into a broad range of productive activities, which can provide the basis for substantially greater employment. This diversification will not only create the needed new jobs, but it will provide substantially greater protection to the labor force from commodity price shocks.

V A transition depending upon improved governance, higher quality education, and gender equality

The three realignments—key for managing the region’s employment challenge—cannot be accomplished by policy change alone. Fundamental to each transition is improved governance, across the board. Each transition implies deep changes in the role of government and strong improvements in its effectiveness. The governance agenda is not a separate challenge, to be worked on at its own pace. It is a complementary and

reinforcing agenda to reform efforts in private investment, trade, and economic diversification by changing governance mechanisms, thereby improving capacity and incentives within government while fostering a larger role for civil society in governance. While better governance cannot guarantee optimal economic policies, it is indispensable to guard against persistently poor policies and to ensure that the good policies needed to meet the Arab region's growth potential enjoy legitimacy and are implemented faithfully and with celerity.

The fundamental governance challenge is to strengthen the incentives, mechanisms, and capacities for more accountable and inclusive public institutions and to expand allegiance to equality and participation throughout society. Those good governance mechanisms are first steps in improving economic policies that are themselves instruments for improving the climate and incentives for efficient growth.

To improve the region's governance, both governments and the people must commit publicly to formulating and implementing a broad program of inclusiveness and accountability of government and increased transparency and contestability in public affairs. Such programs would vary across countries, but the process of formulating these programs should itself set high standards for including all segments of society and for making all deliberations public to ensure maximum transparency.

Enhancing inclusiveness... The first step to enhanced inclusiveness is to adopt laws and regulations that secure access to widely accepted basic rights and freedoms, including participation and equality before the law, particularly for women. Broader public consultation, greater freedom for the media, fewer restrictions on civil society, more equitable channels of access to social services, and an end to discriminatory laws and regulations are examples of measures that secure inclusion. They need to be supplemented with strong monitoring to ensure that public officials treat all citizens equally.

...and accountability. But a particular focus must rest on putting in place better systems of accountability, especially transparency and contestability. External and internal accountability are related; the former is critical for providing incentives for governments to strengthen their structures of internal accountability, so action is needed on both fronts. External accountability, to help citizens participate in and monitor government, can come from actions at both the national and local levels. Such measures include greater freedom of information and public disclosure of government operations, including data on government quality, wider public debate by an independent and responsible media and by representative civil society groups, and regular and competitive elections with external oversight to ensure they are fair and open. At the local level external accountability can come from providing citizens with effective feedback mechanisms on public agencies, expanding choices in public service delivery, devolving responsibilities to empowered local communities, and by actively soliciting the participation of community empowerment organizations.

Enhancing internal accountability is about creating mechanisms and incentives within government to ensure effective functioning in the public interest. At the national level it involves strengthening the checks and balances within government, in particular increasing the independence and capacity of the legislative and judicial branches and installing independent oversight agencies like ombudsmen. Within the executive, it involves reforming public administration, strengthening the performance orientation of government budgets, enhancing the service orientation of the civil service, augmenting the capacity of local governments, and ensuring the independence of regulatory bodies.

Enhancing quality education will be critical as well... The transition to more market-driven, 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. Firm surveys in both labor-abundant and labor-importing countries in the region suggest that lack of skills is an important constraint in hiring. Qualitative deficiencies in education have resulted from a variety of factors, including overly centralized management of education, little assessment of performance, and promotion based on seniority rather than performance.

Improving the relevance of the region's educational outputs must be partly addressed from within the educational sector, but it will be partly accomplished by the transitions themselves. The past policies of ensuring public sector employment to those with higher or intermediate education with little attention to content or quality has resulted in Arab individuals seeking higher degrees that bear little relation to the skills needed by either the private sector or for the efficient functioning of the public sector. As the private sector's role in the economy expands, more appropriate signals will be sent to students for the types of education in need, and the types of education that will be rewarded.

Greater openness will also foster improvements in education. Greater openness fosters competition, encourages modern technology, increases the demand for high-skilled labor, and promotes learning by doing. Openness obliges industries to confront their inefficiencies. To compete successfully, industries must adapt, thereby creating demand for the new skills and trades to do so.

Greater economic participation by women is needed. The success of these transitions hinges also on progress in enhancing gender equality. Progress on bridging the gender gap in education and health in the region has been substantial. But this has not translated into a commensurate increase in women's participation in the labor force. The participation of women in the labor force at less than 33 percent in the Arab region is the lowest in the world (compared to 45 to 75 percent in other parts of the world), partly the result of a range of civil, commercial, labor and family laws and practices in the region that discourage women from entering the labor force.

At this time of exceptional demands on Arab economies to create jobs, there has been little incentive to improve economic opportunities for women, with some arguing that greater participation by women in the labor force would exacerbate unemployment among men in the current climate of slow growth and rising unemployment. But there is

no empirical evidence to suggest this. International experience shows that in the long run, greater labor force participation by women is not associated with higher total unemployment rates.

The region needs to be able to draw on all of its talents and human capital. Women's greater participation in the labor force improves the overall growth of the region. With the highest economic dependency rates in the world (i.e. each working person supporting two non-working dependents, a burden which double what is observed in East Asia), the Arab region is missing opportunities for increased welfare of families and society. Higher female labor force participation, in line with what would be expected given female education, age structure, and fertility rates, could allow family incomes to increase by 15-30 percent in most countries. In addition, this participation enhances the flexibility of families to adapt to changing economic conditions.

The agenda for addressing gender disparities includes the need for realigning legal provisions that fail to give effect to the recognition of equal rights under constitutions in most countries. It would also mean ensuring a supportive infrastructure which facilitates women's participation in the public sphere, as well as continued attention to education, particularly in areas which provide better market skills. Finally it would involve reforming the labor laws and regulations which raise the cost of women's labor relative to that of men and serve as disincentives to private employers demand for female labor.

VI An ambitious, but feasible agenda for the Arab region

*Large growth and employment gains...*The 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. Based on the experience of comparable countries, output per laborer could increase by some 2–3 percent a year with greater integration into the global economy. Using similar international evidence of good performing countries, it is estimated that improving the institutions of accountability and public administration could boost output growth per capita by 0.8 and 1.3 percent a year. Increasing the participation of women in the labor force to levels comparable to the highest performers in the region may add 0.7 percent or more to GDP growth per capita.

While these effects are not additive and reflect changes in policies and institutions that are not exclusive, a conservative estimate of the sum of these projected effects, taking into account overlap in the channels through which the policy changes operate, would be an increase in output growth per laborer of 2.5–3.5 percent a year.

The suggested economic transformation and deep reforms would generate millions of new jobs and more productive jobs in traded sectors across manufacturing and services. For instance, the Arab region's share of non-oil merchandise exports in total exports averages only 6 percent, versus more than 20 percent in East Asia and the Pacific. Bridging only half that gap, with associated increases in domestic and foreign private investment, would create more than 4 million new jobs over the next five years. That is

equivalent to cutting the unemployment rate by 4 percentage points of the labor force. The broader reform agenda would bring even larger benefits.

But is it feasible? The underlying concern for many Arab economies is whether this broad transformation of their economies is even feasible. But the experience of countries around the world provides evidence that such a transformation is possible. Around the world, many countries have faced labor market crises and responded to the political challenges with reforms. 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 public enterprises, while trying to preserve important aspects of social welfare as well as wage and employment protections.

In post-socialist states of Eastern and Central Europe, these transitions were facilitated by the urgency of establishing new systems of economic and political governance. Elsewhere, policy makers have advanced economic reforms within stable policies. In several Latin American countries, for example, politicians and reformers effectively navigated complex political environments containing entrenched, often competing interests. Despite the presence of supporters of the status quo, governments built effective reform coalitions and successfully re-regulated economies around market-based principles. Arab countries have also undertaken selective reforms, with positive if limited effects on economic performance.

The challenges confronting Arab 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. Past decades have produced extensive knowledge about what works in development strategies and policy reform, and what does not.

A new path for greater employment...and a new social contract.. The limitations of past approaches to reform are visible in the deteriorating conditions in Arab labor markets. The old model that guided the region's development for the last 40 years no longer provides the needed employment opportunities. To ensure that the citizens of the Arab world have these opportunities as the need for jobs accelerates, the region must shift to market-based strategies of growth, which can provide the substantially higher growth rates to ensure better labor market outcomes. It involves fundamental transitions in each of the economies.

A new social contract as the basis for more productive relations among the state, labor and the private sector. The new social contract would balance the needs for market flexibility with the rights of workers, that links reform to the principles of poverty reduction, income equality, and income security. It would restructure the rigid, exclusionary and inefficient aspects of the old social contract. The exact agenda, the sequencing and emphasis will vary from country to country.

Economic and political reform must be linked... Moving the reform program beyond its current limits requires reviving national conversations about labor market reform,

restructuring redistributive programs, and redefining the terms of the new social contract. The top-down approach which has been prevailing to economic reform that sidesteps the need for political reform to secure the legitimacy of reform and the credibility of government commitment is no longer adequate. The strong preference of Arab governments for political and social stability has been often advanced as a justification for not proceeding with the strong and deep reform agenda which is needed for Arab economies to regain dynamism and meet the challenges. But today the costs of maintaining a nonviable status quo are becoming severe, and may undermine the much valued stability, as stresses in the labor markets continue to build. At the same time the need for establishing consensus around a new social contract is critical. Political reform, which would strengthen political inclusiveness and accountability, becomes critically linked to economic reform.

The transition may be costly and needs to be managed... The impact of these transitions would be an improved business and investment climate, higher growth, and most importantly, substantially greater opportunities for employment, improved standards of living, and lower poverty for the Arab region. But costs of transitions are likely and may be significant. They may entail greater insecurity and job losses for some groups. Some economic sectors may be negatively affected. Inequality may increase as wages and returns to education become more market oriented. These risks highlight the need for careful design and sequencing of reform, and the development of mitigating strategies. Careful monitoring and early corrections are needed, but avoiding backtracking and stop and go policy change.

External versus internal responsibilities... Embarking on such an ambitious agenda for political and economic reform is challenging by any measure. But the biggest challenge is for societies to own such a vision and to develop the confidence that it can achieve it. Pessimism in the region is pervasive. It is pessimism about the region's trading potential. It is fear about competing in world markets. It is pessimism about the capacity to innovate. It is pessimism about markets and the private sector. It is pessimism about the ability to develop an inclusive and accountable governance. But it is unfounded pessimism. In recent history counties of the region have been able to achieve much and change when they mustered the will for doing so. Its past history has shown time and again that success it can achieve, and progress it can harness. Pessimism has to be replaced by ambition and confidence. The main responsibility for meeting the challenges is internal. It has to be with the governments and the people of the region.

No doubt that external factors and interference have contributed to the poor state of the region. Violence and conflict have severely impeded the pace of reform. Persistent regional conflict has large neighborhood effects which spilled throughout the region, making it less attractive and more costly for business and investment, domestic and foreign. Conflicts have drained resources to the less productive uses in the military and security. They have undermined the development of good governance. External partners bear a responsibility for helping the region establish regional stability and security. But the central responsibilities remain within the region itself.

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