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Regional Perspectives on World Development Report 1995

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WILL ARAB WORKERS PROSPER OR BE LEFT OUT IN THE TWENTY-FIRST CENTURY?

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Will Arab Workers Prosper or Be Left out in the Twenty-first Century?

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Contents

This report was prepared in conjunction with *World Development Report 1995: Workers in an Integrating World*. It was written by Ishac Diwan under the direction of Michael Walton. He was assisted by Vinod Ahuja, with help from Deon Filmer. Meta de Coquereaumont edited the report. Christian Perez laid out the text.

Participants in the labor market workshop of the Economic Research Forum for the Arab Countries, Iran, and Turkey provided early input. Detailed comments were provided by Ragui Assaad, Massood Karshenas, and Mona Said. Many colleagues in the Bank reviewed several drafts and provided inputs and useful comments, including Sue Berryman, Abdallah Bouhabib, Luc De Wulf, Mourad Ezzine, Habib Fetini, Bruce Fitzgerald, Ahmed Galal, Guillermo Hakim, Bernard Hoekman, Roumeen Islam, Jamal Kibbi, Fritz Königshofer, Linda Likar, Egbe Osifo, Yuzuru Ozeki, John Page, Setareh Razmarah, Nemat Shafik, Ezzedin Shamsedin, David Steel, David Tarr, William Tyler, John Underwood, Willem van Eeghen, Jeannie Yamine, and Chang-Po Yang.

Foreword

This report is devoted to the relationship between policy, development, and the welfare of workers—the incomes they earn, the risks they face, and the conditions under which they work. It is my hope that the report will be a useful contribution to the debates in Arab countries on the type of policy reforms now needed in the region and inspire policy changes that allow more of the right kind of jobs to be created.

Labor conditions are central to the livelihood of working men and women. They also have a powerful effect on the welfare of children, the old, and those unable to work. And it is precisely in order to use workers' human potential better that governments are now trying to achieve a transition from an inward-looking, state-dominated economy to one that relies more on markets and successful integration in the world economy.

Three important messages emerge in this report. The first relates to government domestic policies for long-term growth. The best way to improve the welfare of workers, increase labor productivity, and reduce poverty is through policies that rely heavily on markets, emphasize educational investments in all the people, and support family farms.

A second message addresses the limits of laissez-faire and the vital need for market regulation in producing socially desirable outcomes. Defining basic standards, providing the framework for individual and collective contracts, and reducing income insecurity for workers are needed to complement market conditions. Labor policy, however, must also avoid favoring those in good jobs at the expense of those in rural and informal sectors and the unemployed.

Third, the two main ingredients of a successful transition are the establishment of mechanisms to facilitate the retraining and transfer of laid-off workers to new jobs, and compensation for those hurt by change.

More than ever before, policymakers need to have the wisdom and courage to articulate a broad vision of a new social contract that is realistic and capable of benefiting most workers, in the context of a world that is changing rapidly and to which the Arab economies must adapt quickly.

The prospects for Arab workers are fragile: prosperity will come with good policies and hard work, but those who do not keep pushing for improvement will fall behind very quickly. The full force of the Uruguay Round agreements on trade will be felt in just ten years; this is perhaps all the time left to build Arab competitiveness. The World Bank stands ready to help meet the challenge.

Caio Koch-Weser
Vice President
Middle East and North Africa Region

Summary

The economies of most Arab countries have gone from boom (supported by high oil prices and foreign aid) to bust. Public sectors have stopped hiring. Labor opportunities in the oil-rich economies are stagnant. And growth in the modern private sector has remained marginal in most countries. The region seems stuck in a low-productivity trap. Workers have paid dearly in falling real wages, soaring unemployment, and shattered expectations.

The severity of the fall can be related to changes in internal and external conditions that have rendered the structures inherited from the boom period unworkable. Labor demand, especially for educated workers, was kept high through policies that protected and promoted the modern sector. But the combination of declining public sector revenues, fast-rising labor supply, rapid urbanization, and large gains in education have rendered the old social contract unaffordable. Unless private investment rises and its efficiency improves, the region will be unable to grow at rates that can sustain rising incomes and falling unemployment. This will require more reliance on markets and the removal of distortions to allow for better use of the existing human potential.

Changing international conditions make such a shift more pressing but also more risky. Private capital has become more mobile and goods markets have become more global at a time when the traditional sources of foreign exchange are on the decline. Increased globalization means open access to larger markets, but the increased competition this unleashes will make it harder to find a suitable place in the international division of labor. And the globalization of capital increases both the rewards and the risks associated with change. Success will attract capital and create a virtuous circle of investment and growth; but the costs associated with failure also rise since wages will fall and capital will flee unless workers keep up with global competition. More than ever, a credible and realistic strategy is needed to link the region to the world economy. The possibilities of reduced regional tensions and stronger links with the European Union offer a window of opportunity.

To support the transformation from state-led to market-led growth will require a new social contract. In the past, well-intentioned government policy ended up exacerbating the distinction between modern and informal (including rural) sectors, benefiting a small labor elite at the expense of other workers. This has distorted incentives and encouraged rent-seeking. In the future the state must commit to the rule of the marketplace in the interest of the majority of workers, but its commitment must be supplemented by public action to ensure that markets deliver socially acceptable outcomes. Labor regulations must guarantee some standards of fairness in labor relations yet preserve the flexibility of labor markets. Mechanisms to reduce market risk should be balanced against the erosion of incentives to perform on the job. Education policies must equalize opportunities and retrain people with outmoded skills. The role of independent unions must be recognized, and the conditions for efficient collective bargaining must be put in place. Policies to reduce inequality are important for national cohesion, but redistribution should be finely targeted. The government must abandon activities in which the private sector is more efficient, insist that its employees work harder, and pay them accordingly.

Reform programs have been implemented very gradually in the region, but a vision for a more workable economic structure is starting to take shape. An important missing piece is how to get there, how to make the transition to a new growth path. Shrinking public sectors and more open trade regimes will initially hurt the old labor elite. But lack of change will lead to rising poverty and social polarization. The region seems to be on a knife-edge between two equally undesirable outcomes—the status quo and botched reforms—both leading to social instability and international marginalization. The fickleness of capital and the bumpiness of the peace process magnify the risks. The region needs to find a third way that attracts capital and that capitalizes on existing skills. The credibility of reforms rests on their social desirability. Mechanisms to facilitate the transfer of laid-off workers to new jobs, compensation for those hurt, and a policy framework supporting reductions in poverty will be important ingredients of a successful transition.

The report covers the Arab countries, emphasizing those for which more data are available. The economies of the Mashrek—Egypt, Jordan, Lebanon, Syria, and the West Bank and Gaza—and of the Maghreb—Algeria, Morocco, and Tunisia—are studied in greater depth than the others. But in almost all cases, lack of detailed data hampers the analysis. A better understanding of the complex forces at play in labor markets will require much more attention to the collection and analysis of data.

CHAPTER 1

Legacies of a Tumultuous Past

During the 1960s and 1970s the Arab economies were among the fastest growing in the world. The young states advocated modernity and "the big push," invested heavily in large infrastructure projects, built state industries and erected protective walls to nurture them during infancy, and sought shared growth and social mobility by encouraging education and initiating nationalization and land reforms. Fueled by the regional oil boom, average growth per worker was nearly 4 percent a year during 1970–85—comparable to that of East Asia, which is now viewed as the paragon of economic success. Since the second part of the 1980s, however, growth performance has been dismal. Labor productivity has stagnated in the non–oil-producing countries and has fallen by more than 4 percent a year in the oil-producing countries (Figures 1a and 1b). Labor market conditions have deteriorated dramatically in the past decade as well, with rising unemployment, falling wages, and increasing poverty:

- Unemployment has risen enormously and now seems more widespread than in any other region of the world (Figures 2a and 2b). In Algeria, Jordan, the West Bank and Gaza, Yemen, and perhaps Lebanon, unemployment rates are around 20 percent; in Egypt, Morocco, and Tunisia unemployment rates are around 15 percent.

Labor productivity has plummeted in the region, but some structural reformers are recovering

Figure 1a. Annual GDP growth per worker by region
(percent)

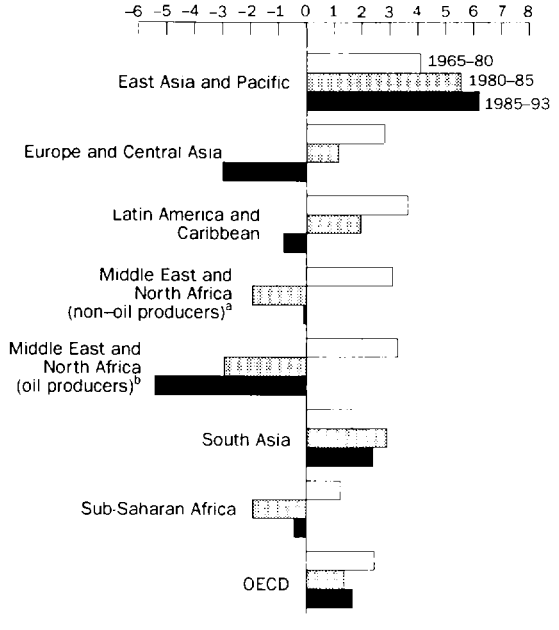
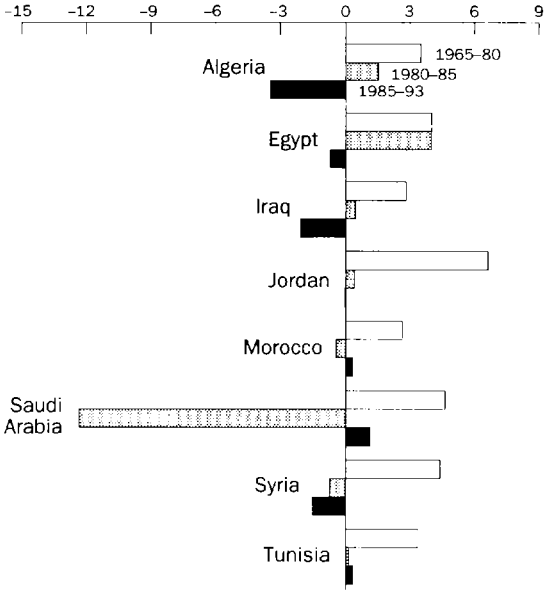


Figure 1b. Annual GDP growth per worker in the Middle East and North Africa
(percent)



a. Weighted average for Egypt, Morocco, Syria, and Tunisia.
b. Weighted average (shares of working-age population for the region) for Algeria, Iraq, Oman, and Saudi Arabia.
Source: World Bank data for GDP: ILO 1986 and updates for working-age population.

Unemployment rates are exceptionally high in the region

Figure 2a. Unemployment rate by region, 1993
(percent)

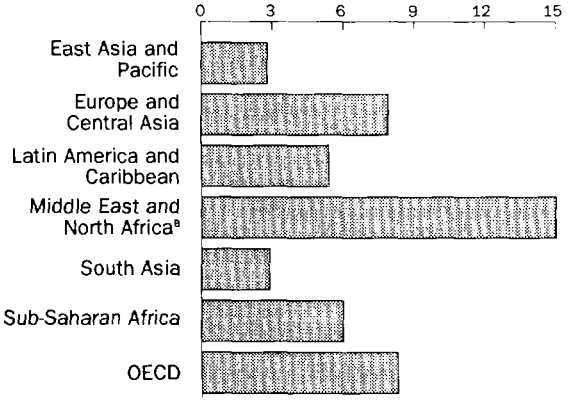
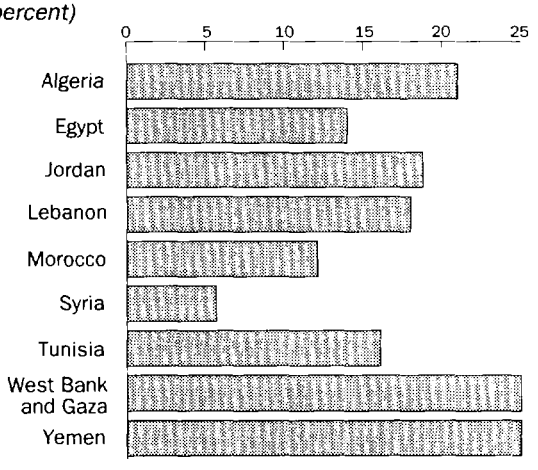


Figure 2b. Unemployment rates in the Middle East and North Africa, 1993
(percent)



Note: Weighted averages (share of working-age population) for sample of countries in the region; most recent data available.
a. Algeria, Egypt, Iran, Jordan, Morocco, Syria, Tunisia, and Yemen.
Source: Filmer 1994; Algeria, World Bank 1994a; Egypt, 1991 labor force survey; Jordan, World Bank 1994b; Lebanon, Issa 1993; Morocco, World Bank 1994c; Syria, Louis 1993; Tunisia, World Bank 1995d; West Bank and Gaza, World Bank 1994f; Yemen, Seif 1993.

- In most of the region real wages declined sharply during stabilization episodes of the mid-to-late 1980s and have stagnated since (Table 1). In manufacturing, for which data exist for most countries, wage growth during the 1970s was comparable to that of East Asia, Latin America, and Eastern Europe (Figure 3). While wages took off in East Asia in the 1980s, they fell in other regions, but more sharply in the Arab countries (by about 30 percent).
- Poverty levels, unlike unemployment, are low by international standards. Arab societies tend to be nearly as equal as those with a socialist tradition, and their poverty levels are a third of those found in Latin American countries with similar incomes (Figure 4). This is related partly to extensive consumer subsidies and partly to well-targeted transfers between households. However, poverty has been rising fast in several countries. Throughout the region, the poor tend to live in rural areas and have large households with few wage-earners; they are usually illiterate. Although some of the unemployed are poor, most of the poor cannot afford to remain unemployed, and they take up jobs in the informal economy.

There are many similarities in labor conditions among the countries of the region. On the demand side, these stemmed from the oil-led boom and bust and the ripple effects through the relatively integrated regional labor market and the external assistance strategies of the Gulf countries. On the supply side were rapid urbanization, rapid growth of the labor force, and rapid gains in education, all due in part to the long boom.

But there are also important differences in labor outcomes, due to differences in economic structures and in government responses to the shocks. One difference is in type of unemployment (Table 2). In most countries the unemployed are predominantly first-time job seekers, reflecting the sudden swelling of the labor supply as baby-boomers enter the labor market. But the proportion of young workers among the unemployed is especially large in Egypt and Syria, where first-time entrants with secondary degrees lined up to wait for increasingly scarce jobs in the public sector. In Jordan, Morocco, and Tunisia, however, reforms have shaken up previously protected industries, and over half the unemployed have lost a previous job. Labor conditions are likely to deteriorate further in countries that have not yet introduced the structural reforms that involve labor reallocations. But where the shake-up of inefficient activities is well advanced, labor conditions are likely to improve faster.

Another difference is in the reasons behind the decline in wages. Wages declined sharply in the countries that had to undergo large adjustments, such as Egypt, Jordan, and Syria. But average wages also declined for structural reasons in Morocco and Tunisia, where many new jobs were in activities that are more labor-intensive than the jobs generated during the earlier boom.

Besides the magnitude of the shocks, different policy choices have contributed to sharp differences in the dimensions of

Wages in the region are back to 1970 levels

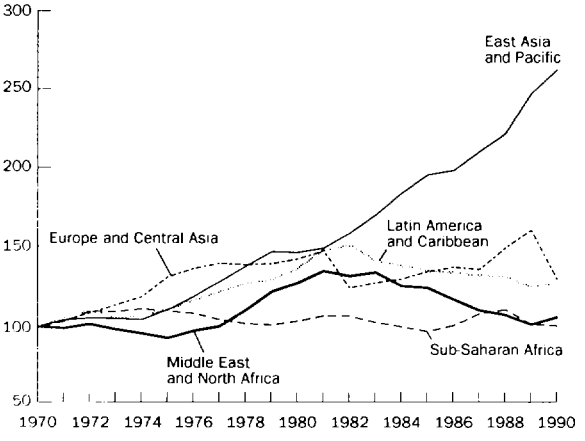
Table 1. Index of manufacturing wages in the Middle East and North Africa

Year	Algeria	Egypt	Syria	Jordan	Morocco	Tunisia
1965	..	98	76	..	..	..
1970	100	100	100	100	100	..
1975	87	116	78	96	..	..
1980	89	155	136	157	113	..
1985	80	181	123	157	93	100
1990	76	127	95	125	86	91
1991	..	124	92	115	88	94
1992	..	114	..	111	90	100
1993	..	..	..	..	93	101

.. Not available.
Source: Bouattour 1994 for Tunisia; UNIDO for all other countries.

Wages took off in East Asia in the 1980s, but fell elsewhere

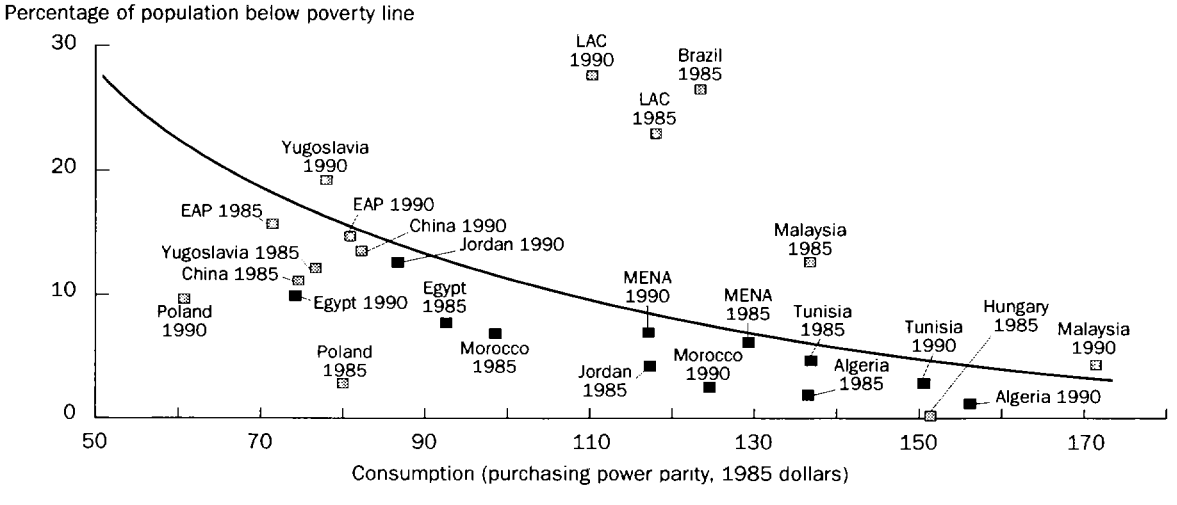
Figure 3. Movement of real manufacturing wages across regions
(1970=100)



Note: Simple average of wage indices; when data are missing for some countries, the mean is calculated for the countries with data. Middle East and North Africa: Algeria, Egypt, Jordan, Morocco, and Syria.
Source: UNIDO.

Poverty in the Middle East and North Africa is low by international standards

Figure 4. Poverty and consumption levels



Note: EAP: East Asia and Pacific; LAC: Latin America and Caribbean; MENA: Middle East and North Africa (includes Algeria, Egypt, Jordan, Morocco, and Tunisia). Poverty is defined as per capita monthly mean consumption below $30 in 1985 purchasing power parity dollars. The regression line is based on a sample of forty-three countries for 1985 and 1990.
Source: Chen, Datt, and Ravallion forthcoming.

First-time job hunters are hurt most by unemployment

Table 2. Unemployment structure in Middle East and North Africa, 1991
(percent)

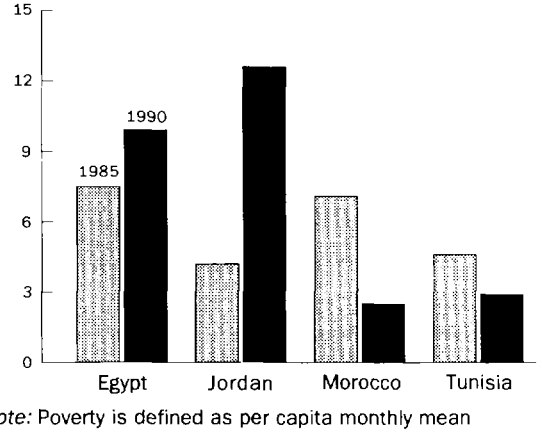
	Unemployment					Share of unemployed		
Country	Total	Men	Women	Rural	Urban	First-time job seekers	Entrants (25 years and younger)	Those with secondary education
Algeria	21.0	22.0	17.0	..	..	..	40.0	31.3
Egypt	10.6	6.3	27.8	8.8	13.1	76.6	78.4	57.0
Jordan	18.8	14.0	35.0	..	..	37.2	58.0	53.0
Morocco	12.1	11.6	13.0	5.6	20.6	45.6	41.0	24.9
Syria	5.7	..	..	..	..	78.0	68.0	45.0
Tunisia	16.1	14.7	21.9	14.8	15.6	42.7	54.5	31.0
Yemen	12.3	14.0	6.0	11.4	16.3	32.0	..	18.0

.. Not available.
Note: Data for Tunisia are for 1993, and for Yemen, for 1992. In some cases the measure of unemployment is not consistent with ILO definition.
Source: Algeria, World Bank 1994a; Egypt, 1991 labor force survey; Jordan, World Bank 1994b; Morocco, Living Standards Survey 1991; Syria, Louis 1993; Tunisia, World Bank 1995d; Yemen, Seif 1993.

poverty. This can be demonstrated by comparing the experiences of Egypt and Jordan with that of Morocco and Tunisia (Figure 5). In Egypt the proportion of the population under the poverty line ($30 a month per person in real dollars) increased by about 30 percent between 1985 and 1990 and has likely continued to rise since then because labor demand has remained weak and consumption subsidies have been reduced. In Jordan, for which the external environment deteriorated much more, poverty tripled. But in Morocco and Tunisia poverty was nearly cut in half between 1985 and 1990, an exceptional performance. These two countries started economic reform earlier, and with a new trade orientation their countries generated many jobs of the type most relevant to the poor. Well-targeted public spending cuts were also achieved without hurting the poor.

Poverty rises in Egypt and Jordan, falls dramatically in Morocco and Tunisia

Figure 5. Population below poverty line
(percent)



Note: Poverty is defined as per capita monthly mean consumption below $30 in 1985 purchasing power parity dollars.
Source: Chen, Datt, and Ravallion forthcoming.

Labor market difficulties are quite different in the Gulf states and are addressed only tangentially in this report. The migrant labor force constitutes 35 percent of the labor force on average, and as much as 80 percent in some countries. The main issues are related to long-term concerns about increased participation of nationals in the economy, methods for managing migration, and the efficiency of the intricate system of labor market–based subsidies as a way of sharing the oil rent among nationals.

Why did labor conditions deteriorate so much?

These are the outcomes. Here we examine the structures that produced them and the factors that have affected the demand for and supply of labor.

Crashing labor demand

Until the mid-1980s, when oil prices collapsed, employment growth was driven by fast-expanding regional migration, public sectors that were creating millions of modern sector jobs, and rising demand from complementary services. These sources of employment growth are now largely gone.

The slowdown in the demand for labor in Europe and later in the Gulf has depressed labor markets in the sending countries.

At the peak in the mid-1980s, there were more than 5 million Arab workers in the Gulf countries, and perhaps half as many migrants from the Maghreb working in Europe. This exodus accounted for 10 percent of the sending countries' labor force on average (much more for Jordan, Lebanon, the West Bank and Gaza, and Yemen), boosted wages at home, and generated large remittances (up to 10 percent of GNP in Morocco, 12 percent in Egypt, 18 percent in Jordan, 22 percent in Yemen, and 30 percent in the West Bank and Gaza).

Regional and European labor markets have stopped growing. In the late 1980s nearly one million Egyptians lost their jobs in Iraq. Work in the oil-rich economies took a plunge with the Gulf war in 1991, hitting Jordanian, Palestinian, and Yemeni workers hard. In Jordan returnees (about 10 percent of the labor force) crowded out young entrants to the labor market, but they also invested part of their savings in new business ventures, increasing labor demand and reducing the effect of the shock. In the West Bank and Gaza the return of highly educated Palestinians from the Gulf led to a crash in skilled wages, sending returns to education nearly to zero. More recently, many Palestinian workers were hit by the reduced access to the Israeli labor market, with the share of the labor force working in Israel dropping from about one-third (mostly unskilled workers) in 1992 to less than 10 percent in 1995. In Yemen returnees represent about 13 percent of the labor force; unemployment soared and remained high as civil war broke out.

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

In the countries where public employment is large but falling, unemployment is large among the kind of workers that are overrepresented in public service. This kind of unemployment tends to be long lasting, with workers lining up until jobs in the public sector open up. In Egypt, Jordan, and Syria young workers with a secondary education make up 40 to 60 percent of the unemployed (see Table 2). In Egypt workers with more than a secondary education represent 26 percent of the labor force, but they hold 62 percent of public sector jobs and make up 57 percent of the unemployed; in contrast, they constitute only 21 percent of private nonagricultural sector employment (Table 3). There is also high unemployment among women where they are disproportionately employed in the public sector, as in Egypt, Jordan, and Tunisia. In Egypt, 71 percent of women with university degrees work for the state, and their chances of being unemployed are about five times larger than for men.

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

The creation of jobs that fit the new realities—in the private sector and in the production of tradables—has been slow in countries that did not undertake structural reforms, and while new jobs are expected to be more labor intensive, they have tended to become excessively so. Most new jobs are in low-productivity, low-wage services and agriculture. To a large extent, this pattern is related to the lack of progress with reform and to the systemic risks faced by private investors—in Egypt and Syria private investment is a meager 7 to 8 percent of GDP (Figure 6). As a result, labor productivity continues to deteriorate (see Figure 1b).

But in countries where reforms are more advanced, such as Morocco and Tunisia, jobs are growing fast in the private sector and manufacturing. Private investment, some of it foreign, has been rising and is approaching 15 percent of GDP. Because the

Egypt's better-educated work for the state

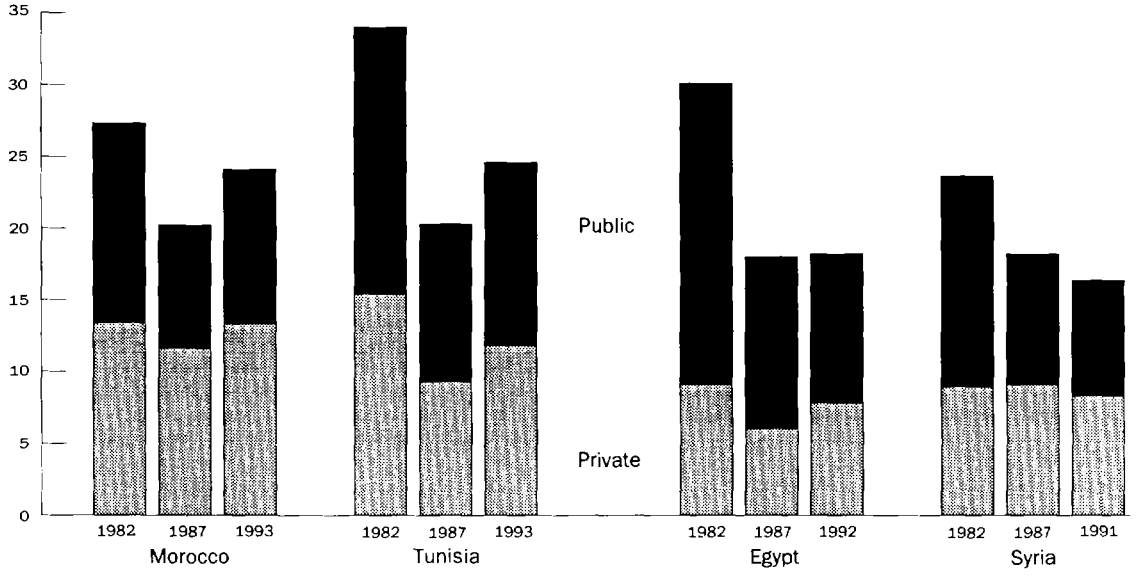
Table 3. Distribution of Egyptian workers by sector and education, 1988
(percent)

Sector	Educational attainment (age 10 and above): Below secondary		Above secondary		Total	
Government and public sector	38	*12*	62	*55*	100	*23*
Private nonagriculture	79	*29*	21	*21*	100	*27*
Agriculture	95	*55*	5	*8*	100	*43*
Unemployed	44	*4*	57	*25*	100	*7*
Total	74	*100*	26	*100*	100	*100*

Source: CAPMAS 1988.

Private investment is higher in Morocco and Tunisia than in Egypt and Syria

Figure 6. Investment as a share of GDP
(percent)



Source: Glen and Sumlinski 1995 for Egypt, Morocco, and Tunisia; IFC data for Syria.

new jobs are more labor intensive than in the past, real wages fell initially, but average wages have fared much better than in countries where labor demand remained low. Investment kept rising, and labor productivity and wages are starting to recover.

Booming labor supply

Although population growth has started to decline recently, it averages more than 3 percent—the fastest rate in the world (Figure 7). Rising standards of living had brought mortality rates down sharply by the 1970s, but fertility rates are falling more slowly. Egypt, Morocco, and Tunisia are the only countries with population growth rates below 3 percent. In the Gulf countries, Jordan, Syria, the West Bank and Gaza, and Yemen, population growth, between 3 percent and 5 percent a year, is among the fastest in the world (Table 4).

In contrast, labor force participation rates in the region have been among the lowest in the world, though they are catching up. Demography accounts for some of this: in many countries more than half the population is under the age of fifteen. As the baby-boom of the 1970s continues to unfold, this percentage will shrink, and the labor force will grow faster than the population. Other forces are at also at work. Reduced work abroad is contributing to rising participation rates among men in the domestic economy (Egypt, Jordan, Yemen). Among women, rising school enrollment (Tunisia) and migration to the city (Egypt, Morocco, Tunisia) are temporarily reducing participation rates, but there is a secular rise in the participation rates of educated women. Female participation rates are highest in Lebanon, Morocco, and Tunisia (about a quarter of the labor force), and lowest in Jordan, Yemen, and the Gulf. This is closely linked to demographics. Fertility rates are lowest in the first group (around 4 percent) and highest in the second (around 7 percent).

Most of this pressure is released in the sprawling cities of the region. The urban labor force is growing at a rapid 4 to 6 percent a year in most countries, intensifying pressures on urban labor markets and infrastructure (Figure 8). Past decades witnessed a dramatic shrinking in agricultural employment (Table 5), from 50 percent of the labor force in 1960 to about 30 percent in 1990 (Figure 9), and a parallel growth in urban populations. Urbanization rates are more than 70 percent in Iraq, Jordan, Lebanon, and the Gulf countries (except Oman). Egypt, Morocco, Yemen, and to a lesser extent Tunisia also experienced rapid urbanization, but they still have important agricultural sectors.

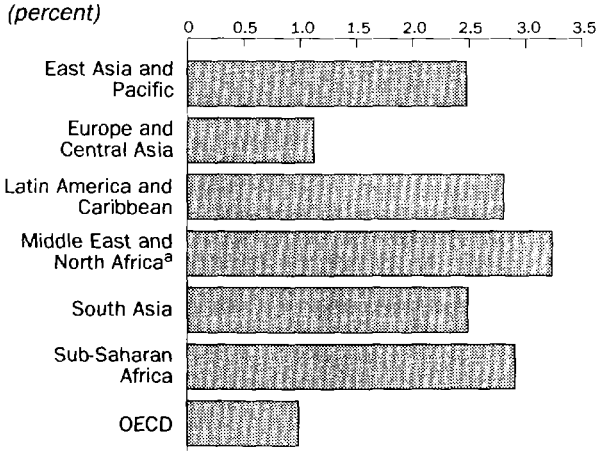
Such shifts between rural and urban sectors are a natural part of development, but they were accentuated in the region by a policy mix that taxed agriculture and subsidized employment in cities (overvalued exchange rates, industrial protection, subsidies to urban production).

What can be done to improve labor outcomes?

Labor market difficulties in the region stem directly from the dramatic fall in labor demand and the steep rise in labor supply.

The growth of labor supply is the fastest in the world . . .

Figure 7. Annual growth rate of working-age population, 1965–93
(percent)



Note: Weighted averages of individual country growth rates; the weights are the shares of countries in the total working-age population in the region.
a. Includes Algeria, Egypt, Iran, Iraq, Morocco, Oman, Saudi Arabia, Syria, and Tunisia.
Source: ILO 1986 and updates.

. . . but is set to slow down

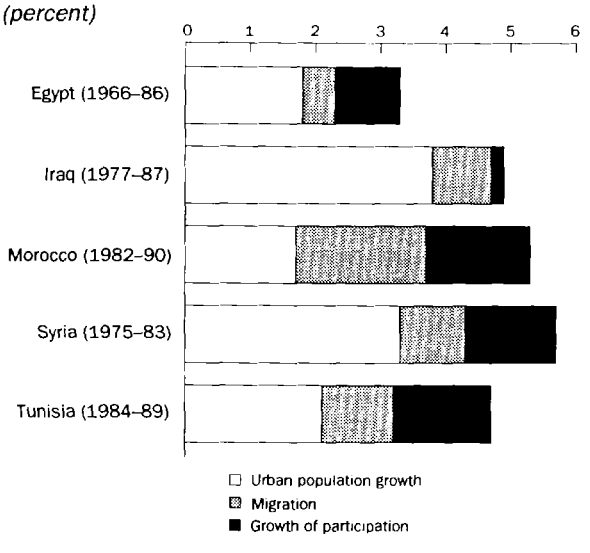
Table 4. Annual growth rate of working-age population
(percent)

Country	1960–75	1975–90	1990–2010[a]
Bahrain	4.06	4.61	3.09
Egypt	2.46	2.56	2.45
Iraq	3.17	3.57	3.30
Jordan	2.74	3.33	3.44
Morocco	2.39	3.10	2.68
Oman	2.64	4.51	3.68
Saudi Arabia	3.89	5.17	3.26
Syria	3.06	3.51	3.91
Tunisia	2.08	2.99	2.29
Yemen	1.20	3.65	3.83

a. Projected.
Source: ILO 1986 and updates.

Urban labor is growing even faster because of internal migration and rising participation

Figure 8. Annual growth rate of the urban labor force
(percent)



Source: Authors' calculations, using World Bank data.

Agriculture is still prominent in poor countries, and services are dominant in rich countries

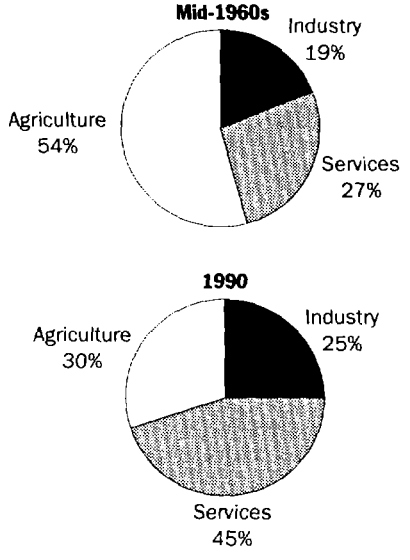
Table 5. Sectoral distribution of labor in countries of the Middle East and North Africa, 1990
(percentage of labor force)

Country	Agriculture	Industry	Services
Algeria	17.3	36.7	46.0
Bahrain	2.0	29.8	68.2
Egypt	39.9	21.4	38.7
Iraq	13.6	19.1	67.3
Jordan	6.2	17.9	75.9
Kuwait	1.3	24.7	74.0
Morocco	43.4	25.7	30.9
Oman	44.5	23.8	31.6
Qatar	2.7	32.0	65.4
Saudi Arabia	5.7	27.4	66.9
Syria	22.9	28.8	48.3
Tunisia	26.2	34.1	39.7
United Arab Emirates	7.8	26.8	65.4
Yemen	70.2	9.9	19.9

Source: ESCWA population and labor force database for Iraq, Jordan, Kuwait, Saudi Arabia, Syria, and Yemen; CAPMAS March 1991 Labor Force Sample Survey for Egypt. For remaining countries, data are from ILO 1986.

Agriculture jobs have shrunk dramatically

Figure 9. Sectoral distribution of the work force in the Middle East



Source: ESCWA population and labor force database for Egypt 1966, Iraq, Jordan, Kuwait, Saudi Arabia, Syria, and Yemen; CAPMAS March 1991 Labor Force Sample Survey for Egypt 1990. For remaining countries, data are from ILO 1986.

Under the best of circumstances, job creation would have a hard time catching up with the rise in labor supply and absorbing those displaced by past shocks. But instead of a gradual recovery, labor market conditions are still deteriorating in many countries. Labor now seems stuck in a trap of low productivity, low investment, and stagnant economic growth.

Consider these numbers. The regional labor force is growing at about 4 percent a year. Investment is about 20 percent of GDP, and the additional investment (as a percentage of GDP) needed to generate 1 percentage point of growth in GDP is about 8 percent, a large number reflecting the low productivity of capital. This means that employment growth will be about 2.5 percent a year (for an elasticity of output to employment of 1). Clearly, this is too low to absorb the new entrants to the labor market, let alone reduce unemployment. If investment rises to 25 percent of GDP and the efficiency of investment doubles, employment would grow at more than 6 percent a year, allowing for a gradual reduction in unemployment. But for this to happen, both private investment and its efficiency will have to double, a herculean task.

Increased investment requires first and foremost major progress in reducing systemic risks, especially those related to social and macroeconomic instability. Increased efficiency will require the removal of distortions—in the markets for goods, capital, and labor—that hamper the full use of labor and human capital. Improving labor productivity also requires continuous progress in education, government services, and infrastructure. The increasing globalization of the world's goods and capital markets makes the need for reforms all the more pressing. Slow and unconvincing change will lead to rising poverty and social polarization. But the reform path also presents new dangers and forces policymakers to make hard choices and find innovative solutions to difficult problems.

CHAPTER 2

An Integrating World

These are revolutionary times in the global economy. The lives of workers in different parts of the world are becoming increasingly intertwined. The embrace by many developing and post–centrally planned economies of a market-based development strategy, the opening of international markets, and the ease with which goods, capital, and ideas flow around the world are bringing new opportunities to billions of people. But are these favorable developments from the point of view of the region's workers?

The globalization of trade

The stakes are clearly high. Labor migration and official aid will not be as strong a source of growth in the future as they were in the 1970s and early 1980s. Other sources of foreign exchange will have to be sought to finance imports and support larger investments. That makes increased exports a necessary component of any future growth strategy. An economy oriented toward trade can also be good for workers. It allows them to shop around the world for the cheapest consumption goods and the best technologies, and to specialize in what they do best—going up the technology ladder at the speed at which they accumulate skills—instead of remaining hostage to domestic demand. An export-oriented strategy is also a powerful instrument for reducing poverty, as demonstrated by the recent experiences of Morocco and Tunisia (Box 1).

But the region is not yet well integrated into the world's markets, and in most countries the level and progression of exports are low by international standards (Figures 10a and 10b). Changing course from the import-substitution strategy of the past to export promotion and stronger competitiveness will not be easy. Moreover, the external environment holds both opportunities and risks. The patterns of international trade have been changing fast in the past two decades. Manufacturing, once an activity of rich countries alone, started to move to the poorer countries in the 1970s, and some of them have successfully shifted into products of increasing sophistication. The recently completed Uruguay Round codifies the rules of international trade and makes an export-led strategy less likely to meet with a protectionist backlash in the industrial countries. However, the agreements also facilitate the entry into the global market of such giant competitors as China, India, and the countries of Eastern Europe and the former Soviet Union, increasing competitive pressures. Exporting will become harder unless productivity improves or wages fall further.

The impact on the domestic economy of a change in the external environment is usually small and can be easily overtaken by the gains from larger external markets. It is nevertheless worrisome that estimates of the impact of the Uruguay Round are negative for the Arab region (especially when the closer economic association between Europe and Turkey and the countries of Eastern Europe is taken into account). Recent estimates suggest a one-time loss of about $3 billion for the region as a whole (Table 6). The reasons? Most Arab countries did not commit during the Uruguay Round to sizable reductions in tariffs, so efficiency gains are small. At the same time, the terms of trade for Arab countries are likely to deteriorate. The international quota system under the Multifiber Arrangement is slated to be dismantled, leading to lower prices for textiles, one of the region's chief exports. The removal of export quotas will not bring large gains because growth of exports has been limited by supply rather than demand constraints. Subsidies on agriculture will be reduced in industrial countries, leading to higher food prices, an import item in many Arab countries. The erosion of preferences in Europe will also tax export potential in textiles and other labor-intensive products.

These short-term losses could turn into a long-term decline, or the small negative effects of the Round could be overtaken by dynamic gains. Much will depend on the behavior of investment and capital flows. This in turn will be affected by government economic policy, the flexibility of labor, and the effects of change on social stability.

To share in the potential gains offered by the globalization of trade, the countries of the region will have to lower their protective walls. Ideally, this would lead to increased labor efficiency and the emergence of new activities in which the region possesses comparative advantage. There may be job losses in some industries as firms once shielded by tariffs and subsidies go under. Such structural change would need to be supported by large shifts of workers away from government employment and into internationally competitive industries and by large investments in emerging sectors. The risk is that capital will remain wary of risks, and as a result wages will fall and jobs will be lost while few new jobs are created. The region then could get locked into an undesirable outcome of rising domestic instability and low investment.

The risks are magnified by potentially harsh social dislocations associated with the effects of the Round. How the poor fare will depend on agriculture policies. Lower export prices will depress unskilled wages in the manufacturing sector. But if higher food prices are passed on to farmers, their income would rise, reducing rural poverty (see Table 6); this would cut migration pressures on cities, helping the urban poor offset their initial losses. Over

Box 1. Trade reforms in Morocco and Tunisia: The 1990s are not the 1970s

The experiences of Morocco and Tunisia, early trade reformers in the region, illustrate the opportunities and the difficulties ahead. Both countries started to liberalize their trade regime in the early 1980s. Morocco virtually eliminated quantitative trade restrictions, and Tunisia reduced their coverage. Maximum tariffs were slashed from 165 percent in Morocco and 235 percent in Tunisia to 45 percent. Subcontracting for European firms, especially in textile and clothing, boomed. Exports of textiles increased 15 percent a year in Morocco and 12 percent in Tunisia between 1985 and 1991.

As a result, labor demand rose fast. In Morocco during 1984–94, total employment in urban areas rose at 5 percent a year, manufacturing employment at 10 percent, and employment in manufactures exports at 20 percent. But while employment expanded a lot, wages and productivity did not. The old manufacturing sector was small and protected, using capital intensively and employing skilled workers at high wages. The new jobs in manufactures exports were mainly labor intensive and low wage. It is precisely this adjustment that allowed employment to grow so fast. The growing demand for unskilled labor was also a key element behind the dramatic fall in poverty in both countries, because it accommodated the rise in labor participation accompanying demographic changes.

While this tale is similar to past success stories from East Asia, it is much more difficult now than it was in the 1970s to sustain gains in global markets. Morocco and Tunisia have needed devaluations and wage restraints to keep up with competition from China, Indonesia, Malaysia, and Turkey, which managed to improve their relative positions in European markets much faster (Box Table 1). And competition from Eastern European producers has recently risen. In 1989 their share of the EU non-oil export market equaled that of the Middle East and North Africa region; by 1993 Eastern Europe's share had doubled, while the region's stood still. In a fast-changing world, countries will have to keep running just to stay in place.

It is hard to keep up with competition

Box Table 1. Cost competitiveness in textiles, clothing, and footwear, 1991
(1985 = 100)

Country	Real wages (ECU)	Value added per worker	Unit labor cost (ECU)	Share of EU imports (percent) 1985	1991
Morocco	58	89	88	0.9	1.6
Tunisia	62	105	76	1.0	1.6
China	53	126	55	2.3	4.9
Indonesia	51	154	43	0.2	1.6
Malaysia	55	142	50	0.3	0.7
Turkey	92	145	82	2.6	4.9

Source: World Bank 1994d.

time, however, the expansion of labor-intensive exports should lead to improvements in their welfare. For the labor elite, the risks are larger. They will initially be hit by higher food prices and rising competition and, over time, by falling protection. Unless policies are put in place to convert their skills into the types demanded by the marketplace, they will see real wages fall.

With a robust supply response, it is the young unemployed and future entrants to the labor market that stand to gain the most from an export-driven strategy. Such a strategy would enable countries to capitalize on the extraordinary progress achieved in the past few decades in education. It also would allow labor productivity to increase at a faster rate than that achieved in the labor-abundant countries of Asia, reaching higher levels of technological sophistication by the time the Uruguay Round agreements take full force.

Less mobile labor, more mobile capital

Some level of labor migration is beneficial to migrants, their country of origin, and the host country. But unrestricted migration can hurt the national labor force by depressing wages and reducing the trickle-down effects of growth. In all likelihood, regional migration will be increasingly restricted in the future. In the past a dynamic regional labor market served to channel regional prosperity. Today, it is increasingly channeling negative shocks, with returning migrants in Gaza, Jordan, and Yemen pulling down wages. In the Gulf countries the growth of the national labor force and low oil prices have reduced the demand for foreign workers. The attempt to diversify has further reduced the demand for Arab workers, and frequent rotation is now used to reduce migrants' attachment to their host country. Deteriorating conditions in Egypt and Syria are also affecting Jordan and Lebanon, where the inflows of unskilled migrants depress the wages of unskilled nationals and lead to rising inequality.

In contrast, capital is increasingly more mobile. But the sources of capital, and the conditions needed to attract it in a way that can benefit workers, have changed dramatically.

In the past large external inflows went to the public sector in the form of aid and loans and to the private sector as workers'

Manufacturing exports are not growing as fast as the competition

Figure 10a. Per capita exports of manufactured goods, by region
(U.S. dollars)

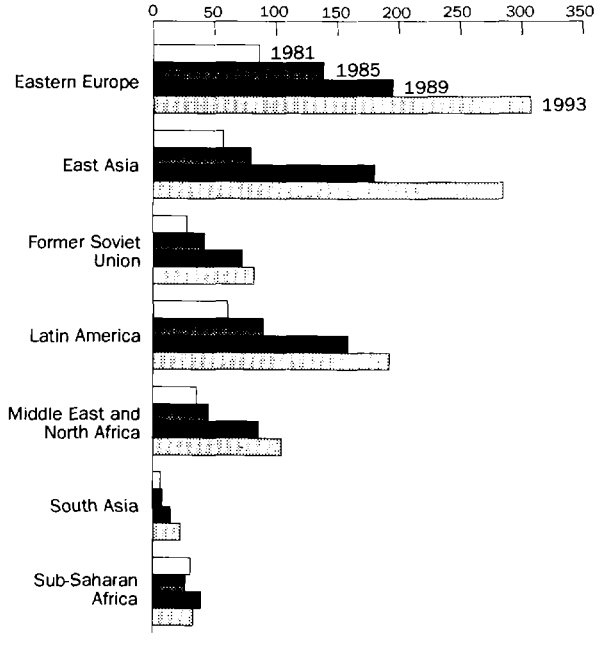
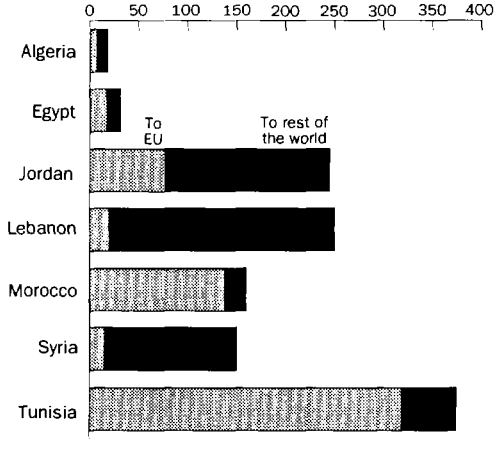


Figure 10b. Per capita exports of manufactured goods in the Middle East and North Africa
(U.S. dollars)



Note: Middle East and North Africa includes Algeria, Egypt, Jordan, Kuwait, Lebanon, Morocco, Saudi Arabia, Syria, Tunisia, and United Arab Emirates.
Source: Hoekman 1995.

The Uruguay Round will initially depress wages, but free trade with the EU will boost unskilled wages

Table 6. Simulated effects of the external environment and the EU option
(percent)

	Without EU link	Close association with EU
Total static effect on GDP (billions of dollars)	-3	-2
Wage effect before rural-urban adjustment		
Agricultural wages	6	23
Unskilled wages	-1	0
Skilled wages	-1	0
Wage effect after full rural-urban adjustment		
Agricultural wages	0	3
Unskilled wages	0	3
Skilled wages	-1	-1

Source: Diwan, Yang, and Wang 1995.

remittances. Simultaneously, large flows of private capital left the region, seeking better combinations of risks and returns abroad (Table 7). The legacy—high stocks of external public debt and of private assets invested abroad—is both an obstacle to market-driven growth and an opportunity (Table 8). Private investment is unlikely to be strong in countries that are not creditworthy. Egypt, Jordan, and Morocco have improved their creditworthiness with some debt reductions. Debt reduction remains key in Syria and Yemen before a private sector–led growth strategy can be seriously contemplated.

The stock of capital that has left the region but could return if profitability rises is estimated at as much as 90 percent of GDP, more than in any other region of the world. From Damascus to Rabat, most governments are now encouraging private capital inflows with liberal investment regimes, high interest rates, and stable exchange rates. These efforts have reaped some initial success, but capital inflows have been invested mostly in financial instruments and real estate. This has allowed some countries to finance fiscal deficits (Lebanon). Other countries (Egypt, Jordan) accumulated most inflows in their reserves to avoid overleveraging weak banking systems. While safer in the short term, such

Capital inflows rose, then fell . . .

Table 7. Composition of capital flows to Maghreb and Mashrek countries, 1970–89
(billions of 1990 U.S. dollars a year)

	Maghreb				Mashrek			
Type of flow	**1970–74**	**1975–79**	**1980–84**	**1985–89**	**1970–74**	**1975–79**	**1980–84**	**1985–89**
Total net transfers	2.14	5.76	2.24	–1.36	2.99	10.19	12.77	7.86
Public	1.39	5.69	–0.54	–0.79	2.35	8.22	9.33	5.42
Net flow of debt	1.82	7.21	2.21	1.95	0.64	5.21	6.86	4.59
Grants	–0.07	0.29	0.42	0.84	1.87	3.57	3.65	2.40
Interest payments	–0.37	–1.60	–2.83	–1.18	–0.16	–0.56	–1.18	–1.55
Private	0.75	0.07	2.77	–0.57	0.64	1.97	3.42	2.44
Worker remittances	1.44	2.16	2.08	2.85	0.80	5.76	7.89	6.12
Other inflows	0.27	0.48	0.46	0.19	0.00	0.74	0.92	1.34
Capital outflows	–0.96	–2.57	–2.57	–3.61	–0.16	–4.57	–5.37	–5.01

Note: Maghreb is Algeria, Morocco, and Tunisia; Mashrek is Egypt, Jordan, and Syria.
Source: Diwan and Squire 1995.

policies cannot be pursued indefinitely. Morocco and Tunisia are again the exception. Foreign direct investment, a more stable source of finance, has risen sharply, reaching nearly $1 billion in Morocco in 1993 and $600 million in Tunisia in 1994.

In the future, capital will move around even more, but this is a double-edged sword. Success breeds success because more capital is attracted. But capital outflows punish failures faster and harder. Thus the dangers of bad policies are intensified, especially for labor, which bears the brunt of the resulting adjustment costs. Lebanon (1991), Turkey (1993), and Mexico (1995) are reminders of how hard the fall can be for labor when macroeconomic fundamentals deteriorate and financial capital is volatile. The real challenge is not only to attract capital, but also to get it to commit to long-term investments. But to attract capital into risky and irreversible decisions, the macroeconomic, microeconomic, and social fundamentals must be strong.

A window of opportunity

There are some bright spots on the horizon that offer the promise of greater prosperity: prospects for regional stability and for stronger links with Europe. These possibilities open the way to a realistic third way that would allow governments to escape the dilemma of either holding to a status quo that hurts the poor or opening rapidly to trade and hurting the labor elite. These opportunities hold the potential of making reform that much more attractive and realistic.

The peace process is crucial. Private capital is unlikely to flock to what is perceived as a war zone. While the peace process is not likely to lead to rapidly expanding new regional trade, the regional market is coming of age and offers regional niches for competitive firms with a comparative advantage. As countries become globally competitive, a richer regional division of labor is likely to emerge. Several small economies (Bahrain, Dubai, Jordan, Lebanon, perhaps the West Bank and Gaza) will develop regional specialties from banking to communications and winter resorts.

Stronger links with Europe could develop into an important source of growth. Europe has a keen interest in enlarging its market to stabilize its southern Mediterranean rim, an interest reinforced by the spread of regional blocs such as the North American Free Trade Agreement (NAFTA) and the Association of Southeast Asian Nations (ASEAN). The European Union

. . . leaving behind large public debts and private savings

Table 8. Present value of external debt and accumulated savings abroad, 1991
(percentage of GNP)

Country	Savings abroad	Present value of debt
Algeria	80	69
Egypt[a]	271	71
Jordan	163	208
Lebanon	..	51
Morocco	36	73
Syria	161	75
Tunisia	36	60
Yemen	..	74
Region[b]	90	71

.. Not available.
a. Assumes the full conditional debt reduction granted by the Paris Club.
b. Excludes Lebanon and Yemen.
Source: Diwan and Squire 1995.

already has deep linkages with the Maghreb countries and is about to sign a free trade agreement with Tunisia. Egypt, Jordan, Morocco, and the Palestinians have started negotiations to reach some form of partnership.

Clearly, the potential for increased interactions is huge, but progress for the Arab countries as a whole has been slow, with exports to the European Union growing at only about 2 percent a year during 1989–93. Tunisia has been the best performer (per capita non-oil exports of about $220 in 1989 and $320 in 1993), followed closely by Morocco ($117 in 1989 and $138 in 1993) and at a distance by Egypt, Jordan, Lebanon, and Syria. But Europe is already the largest importer from the region (85 percent of Tunisia's and Morocco's exports, 50 percent of Algeria's and Egypt's, and 30 percent of Jordan's), mainly of manufactures and some agricultural products (see Figure 10b). If a Mediterranean free trade zone emerges, the losses associated with trade diversion will be small.

A large free-trade area would give the countries of the region preferences relative to Asia (especially in light industry and agriculture) and level the playing field with Eastern Europe and Turkey (which benefit from the new trade preferences in Europe). This would benefit the region's unskilled workers and to a lesser extent its skilled workers (see Table 6). Trade liberalization on other fronts will also be necessary to minimize losses associated with trade diversion.

But deeper links with the European Union offer several other benefits that go well beyond the static gains from trade:

- The hope is that the European Union would help in the conversion of import-substitution sectors by assisting in the retraining of displaced workers, transferring new technologies, and (with other donors) making adjustment finance available. This would cushion the effects of reforms on skilled workers employed in the public sector and facilitate privatization.
- A closer association with Europe will help establish the credibility of reform in the region. A rapid opening of the European market and slower opening of the region's markets would allow time for adjustment. As exports expand in the early years, delivering the domestic side of the deal will become more attractive. But a clear timetable for the convergence of policies is needed to anchor expectations.
- As trade with Europe becomes more open, so will trade within the region. The resulting larger market will encourage the emergence of regional hubs, leading to larger foreign investment.
- If the peace process progresses as hoped, the European option offers a mechanism for gradually integrating Israel into the region, further reducing tensions and contributing to stability.

• • •

The peace process and the EU option provide only a window of opportunity. Whether the countries of the region find a favorable place in international markets will depend mainly on their own policies. The structures inherited from the past are a heavy burden, and rising international competition makes it harder to break into new markets. For trade reforms to succeed in boosting productivity, countries will have to convince capital that the chances of success are high enough to offset the risks, and convince labor that the future will be bright enough to compensate for short-term losses in employment and wages. Part of being convincing is having a vision of the new role of the state as one that facilitates the working of markets and at the same time protects social interests.

CHAPTER 3

A New Social Contract

For many Arab countries, the system inherited from the past—a dominant public sector, protected industry, bias against agriculture, distorted education system, unenforced labor standards—has become increasingly costly and unsustainable, benefiting a shrinking minority at the expense of the majority of workers. A new social contract that fits in better with the new realities is in the making. What is needed now to benefit broader segments of the population, to fully utilize and expand human potential, and to stabilize social tensions is a set of policies that reduces dualism, equalizes opportunities, and relies on markets for the things they do best—encouraging investment and productivity growth. There is also an important role for government in regulating markets, protecting the vulnerable, and improving working conditions when markets fail.

The long cycle of most Arab countries, from a boom with an inward-looking, state-led growth strategy to a situation of stagnation and slow decay, is extreme but not unusual. Other countries that have attempted to promote employment by protecting a nucleus of industrial jobs or expanding public sector employment failed over the long run as well—whether in Latin America or in the former Soviet Union. What a nation's work force needs most is growing demand for its services, together with large investments in schooling, roads, and technology. But that is not enough if rising human resources are not used effectively, as in the former Soviet Union or several Arab countries. It is true that these economies achieved high degrees of equality. But so did East Asian countries, and they also achieved rapid growth through a strategy of supporting family farms, avoiding policies that segment labor markets, and encouraging vigorous growth in formal employment through exporting. The shift from self-employment to labor market involvement was equalizing because it liberated workers from a reliance on ownership of land and capital—factors that are more unequally held than human skills. The public sector in these countries focused on what it could do best, providing a stable macroeconomic environment for saving and investment and strong support for economic infrastructure and social services, notably general schooling.

Four dimensions of the new social contract are crucial: useful labor market regulations, better education, shared growth benefiting the rural sectors, and a refocused role for the state.

Re-regulating the labor market

Much labor policy in the Middle East has been well-intentioned but misguided. Regulations have sought to impose labor outcomes different from those that would emerge naturally. At best, such policies can work in the short term. In the long term, they hurt workers. Labor policy has been irrelevant to small farmers, who still account for the poorest group of workers in the region. It also has been irrelevant for the large and growing number of workers in the urban informal sector. These distortions have been recognized where they are most glaring: the labor code is being reformed in several countries, including Egypt, Jordan, Morocco, and Tunisia, but change is slow.

In the Maghreb countries and Egypt an elaborate web of labor regulations has pushed much economic activity into informal sectors (Table 9). The web of government regulations in these countries has created a two-tier system that overprotects formal sector employees and underprotects informal sector ones. In Egypt formal sector workers enjoy full job security and can be laid off only if a firm is liquidated. As a result, labor regulations are enforced mainly in the public sector, and most Egyptian workers end up completely unprotected. In the Maghreb countries high legislatively imposed minimum wages and large severance payments have discouraged employers from hiring permanent workers, hurting the job prospects of younger skilled workers and pushing unskilled workers into the informal sector (Box 2).

While the multitier system may have been a good second-best response to the shocks of the past (it allowed some flexibility), both management and labor would be better served by regulations that apply throughout the economy. Excessive regulation reduces labor demand in the modern sector by raising labor costs and creating skilled unemployment. For the informal sector, where most unskilled workers work, the high but unenforced labor standards mean that good regulations are not implemented. Because firms cannot legally establish long-term contracts providing workers with benefits below mandated levels, job turnover and search unemployment are high, and firm-specific training is below desirable levels. One result is that firms fail to provide their employees with adequate physical resources, depressing productivity and wages. Since the unskilled segment of the labor force is where much of the future growth is expected to take place, governments would better serve their people by developing a regulatory framework that can apply to all workers.

Deregulation must thus be part of the re-regulation effort, designed to improve the incentives for the modern sector. Four dimensions of labor regulation stand out: income security, minimum wages, protecting female workers, and the role of labor unions.

Informal sectors swell when labor regulations are too costly to employers

Table 9. Informal sector employment in Algeria, Egypt, Morocco, and Tunisia
(percent)

Activity/country	Year	Share in employment	Share in private sector employment	Share of activity
All nonagriculture				
Algeria	1985	28.9	83.5	100.0
Egypt	1976	43.6	85.7	100.0
	1986	39.7	82.7	100.0
Morocco	1982	57.0	73.9	100.0
	1991	63.0	..	..
Tunisia	1980	46.7	72.3	100.0
	1989	35.0	..	..
Services				
Algeria	1985	32.7	97.1	65.7
Egypt	1976	40.9	93.1	59.6
	1986	30.0	79.7	46.4
Morocco	1982	53.1	79.2	47.0
Tunisia	1980	35.0	76.3	35.5
Construction				
Algeria	1985	25.0	63.2	19.1
Egypt	1976	76.2	98.8	14.4
	1986	81.0	97.2	24.6
Morocco	1982	63.2	63.2	13.5
Tunisia	1980	70.6	74.9	22.9
Manufacturing, mining, and industry				
Algeria	1985	22.1	69.5	15.2
Egypt	1976	47.1	82.5	20.5
	1986	38.8	73.3	22.6
Morocco	1982	71.7	71.7	38.3
Tunisia	1980	46.1	62.7	32.9

.. Not available.
Note: Components may not add up to 100 because of unclassifiable activities.
Source: Calculated from Charmes 1993 for Algeria, Morocco, and Tunisia and from CAPMAS surveys for Egypt.

Income security

Labor turnover is typically high in a market economy. Markets must be able to adjust rapidly to shocks, mainly through movements of labor among sectors. Labor flexibility in the region is facilitated by the intricate structure of kinship-based transfers, but more is needed in the face of large aggregate shocks. The form of the intervention depends on the stage of development. Unemployment insurance can be useful in middle-income countries with good administrative capacity. In others, freely negotiated severance payments are the best solution. But legally mandated severance payments that are higher than the market and other restrictions on firing unduly reduce labor demand in the formal sector.

Box 2. How the law protects Moroccan workers

Labor law in Morocco sets a minimum wage and tightly restricts dismissals. The minimum wage is about 60 percent of the average urban wage, which is quite large by international standards. Nonwage costs imposed on employers are also high (20 to 35 percent of wages), effectively raising the minimum wage even higher. Between 1984 and 1994 the minimum wage rose by 25 percent while average wages stagnated. Recent empirical work suggests that this has reduced the demand for young skilled workers in the formal sector while the number of unskilled workers employed at less than the minimum wage, especially in small firms, has risen.

Firing individual workers in permanent positions for economic reasons (mismatch, technical change) is forbidden by law, although collective layoffs are allowed with official authorization. Other restrictions on dismissals involve severance pay and judicial recourse. The average severance payment ordered by the courts is two months for each year of service—considerably more than the legally mandated two weeks per year of service. This has encouraged the spread of temporary employment contracts (less than a year), which are not covered by dismissal regulations. Only about 36 percent of the 800,000 urban jobs created between 1986 and 1992 were permanent positions. And the share of unskilled workers in permanent employment fell from 75 percent in 1984 to 42 percent in 1990.

Minimum wages

Well-designed minimum wage legislation can be helpful, but there is a risk of overshooting. Minimum wage levels are especially high in Morocco (1.7 times GDP per capita), Algeria (1.3), and Tunisia (about 1.0). In these countries minimum wage legislation has become a means for governments to dictate average wages. This leads to wage compression in the modern sector and drives firms to apply capital-intensive techniques. The result is higher unemployment among skilled workers and a movement of unskilled workers to the unprotected informal sector (see Box 2). Reducing the cost of labor to employers can reduce unemployment, eliminate the bias against the formal sector, and better protect the truly vulnerable. Since payroll taxes are large in most of the region, the effective minimum wage paid by employers can be reduced by cutting payroll taxes rather than by reducing the minimum wage itself.

Protecting female workers

Regulations intended to protect women have backfired in many countries, and now constrain many young, educated women seeking jobs in the formal private sector. In the past mandates

such as low retirement age and generous maternity benefits encouraged women to stay in school and to work in the public sector, where these advantages are well enforced. As a result female workers in several countries tend to be more educated than men and to be disproportionately represented in the public sector.

But these advantages are costly, and reduce the demand for women's labor in the private sector. Male-female wage differentials tend to be large, especially in the informal sector. In the formal private sector, regulations that discourage wage discrimination result in fewer job offers for women. As a result unemployment rates among women tend to be larger than among men (see Table 2). In order to reduce female unemployment without having to resort to preferential public sector hiring, labor policies need to set benefits at reasonable levels and shift their costs away from employers and toward society as a whole.

The role of labor unions

The intensity and character of union activism varies in the Arab world. The unionized share of the labor force is largest in countries with a large public sector (about 25 percent in Algeria and Egypt). In Morocco and Tunisia union membership is smaller (around 12 percent), but unions play an important role. Unions across the region are becoming more active in the face of a deteriorating labor market. In Bahrain, Egypt, Lebanon, and Morocco strikes have become more prevalent in recent years (in Egypt there were eight in 1990 and sixty-three in 1993). But too often, governments in the region have repressed unions or overly politicized the bargaining process. In some cases they have responded to pressures from strong unions by raising standards, such as minimum wages, above levels at which the poor and unskilled can compete.

Collective bargaining between firms and independent labor unions is a more effective way than government mandates to determine wages and working conditions in a market economy. This is especially the case when markets function well, because the pressures created by competition push unions and employers to seek ways to increase productivity rather than fight over rents. Governments need to lay down the rules for such negotiations, spelling out the rights of workers and firms, dispute resolution mechanisms, and basic health and safety regulations (which unions can monitor).

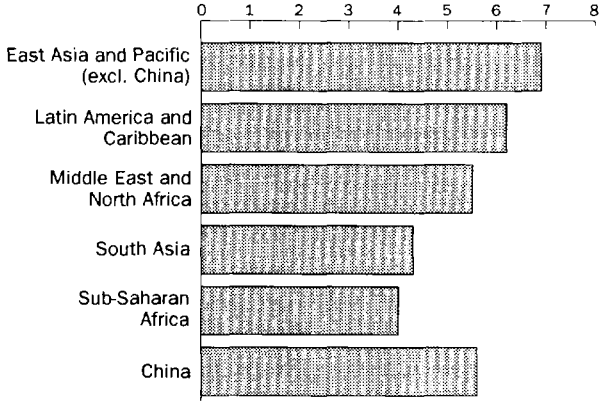
Unions often engage in debates on labor issues at the national level. However, because only a small proportion of the work force is represented by unions, decentralized bargaining is usually preferable. This practice has long applied in Hong Kong and Japan and now applies in Chile and the Republic of Korea. Decentralized outcomes will not always work. Old-age pensions (where portability is important) and response to macroeconomic shocks are two areas where centralized bargaining can be useful.

Reforming education

There have been tremendous gains in educational achievements in the past two decades throughout the region, albeit starting from a very low base. Average years of education per worker have risen from 1.7 in 1965 to 5.5 in 1985 (Figure 11), a larger rise than in any other region in such a short span of time. Relative to their level of income, attainment levels are highest in Egypt, Jordan, and Tunisia (Table 10). These achievements offer hope for the future. Nevertheless, progress in several countries has not kept pace with gains in income. Primary enrollment is nearly universal—except in Morocco, Saudi Arabia, and Yemen, where

Adult education levels in the region are catching up to world standards . . .

Figure 11. Mean years of schooling by region, 1985



Source: Barro and Lee 1993; Nehru, Swanson, and Dubey 1993; ILO 1986 and updates.

. . . as a result of impressive gains in some countries

Table 10. Mean years of schooling in the Middle East and North Africa

Country	1960	1990	1995
Algeria	1.74	5.06	6.37
Bahrain	..	5.81	6.23
Egypt	2.75	4.94[a]	..
Iraq	0.92	5.17	5.90
Jordan	1.56	6.56[a]	..
Kuwait	..	5.95	7.05
Morocco	0.38	2.48[a]	..
Syria	2.17	5.86	6.66
Tunisia	1.32	3.58	4.22

.. Not available.
a. 1987 figures.
Source: Ahuja and Filmer 1995; Dubey and King 1994.

Enrollments are high, but so is illiteracy

Table 11. Gross enrollment rates by education level and gender, 1993
(percent)

	Adult illiteracy rates		Primary			Secondary			Higher		
Country	**Total**	**Women**	**Total**	**Men**	**Women**	**Total**	**Men**	**Women**	**Total**	**Men**	**Women**
Algeria	43.0	55.0	96.2	102.3	89.7	61.8	67.2	56.0	11.0	14.8	7.2
Bahrain	..	..	99.7	99.5	99.9	93.5	92.8	94.1	20.3	18.4	22.2
Egypt	52.0	66.0	102.4	109.8	94.4	83.2	90.7	75.1	19.7	25.1	13.8
Iraq	..	..	112.7	120.2	104.8	48.6	58.2	38.4	12.6	15.2	9.8
Jordan	20.0	30.0	..	..	..	..	..	..	..	..	..
Kuwait	27.0	33.0	94.5	96.4	92.7	82.9	85.7	79.9	16.9	16.0	17.9
Lebanon	..	..	128.0	133.6	122.3	69.8	71.0	68.5	26.0	30.9	20.8
Morocco	51.0	62.0	67.1	78.3	55.3	34.6	39.5	29.5	10.0	12.2	7.5
Oman	..	..	103.5	106.4	100.4	57.2	61.3	52.7	6.1	6.6	5.6
Qatar	..	..	104.1	108.0	100.1	83.7	81.3	86.4	31.5	18.4	46.3
Saudi Arabia	38.0	52.0	80.4	85.1	75.5	50.9	55.2	46.3	13.5	14.3	12.8
Syria	..	..	109.2	114.8	103.4	53.6	61.0	46.0	17.7	20.2	15.0
Tunisia	35.0	44.0	116.5	121.8	110.7	47.7	52.1	42.9	9.1	10.5	7.6
United Arab Emirates	< 5.0	< 5.0	115.8	117.6	113.9	77.0	73.4	80.8	11.9	6.0	19.8
Comparators											
Argentina	5.0	5.0	109.2	106.4	112.0	68.9	63.8	74.2	42.5	39.0	46.1
Botswana	26.0	35.0	116.9	114.9	119.0	48.0	46.4	49.6	3.9	4.2	3.5
Chile	7.0	7.0	98.1	98.7	97.3	73.7	70.8	76.7	21.8	23.6	19.9
Rep. of Korea	< 5.0	7.0	106.8	105.1	108.7	91.8	92.0	91.4	40.1	51.6	27.4
Malaysia	22.0	30.0	93.5	93.5	93.5	58.0	56.0	60.1	8.7	8.8	8.6
Philippines	10.0	11.0	110.2	110.5	109.8	75.1	73.7	76.6	29.0	26.8	31.3

.. Not available.
Note: Gross enrollment rates.
Source: World Bank data for illiteracy rates; UNESCO 1993 for enrollments.

it is below 75 percent—but dropout rates are high in many countries. The primary enrollment gap between men and women is still high, reaching 25 percent in Morocco and ranging between 10 and 20 percent in Algeria, Egypt, Iraq, Saudi Arabia, Syria, and Tunisia (Table 11). As a result illiteracy rates are also high, especially for women; in Algeria, Egypt, Morocco, and Saudi Arabia the majority of women are still illiterate. And enrollment in secondary and higher education is low in a number of countries, including Morocco, Oman, and Saudi Arabia.

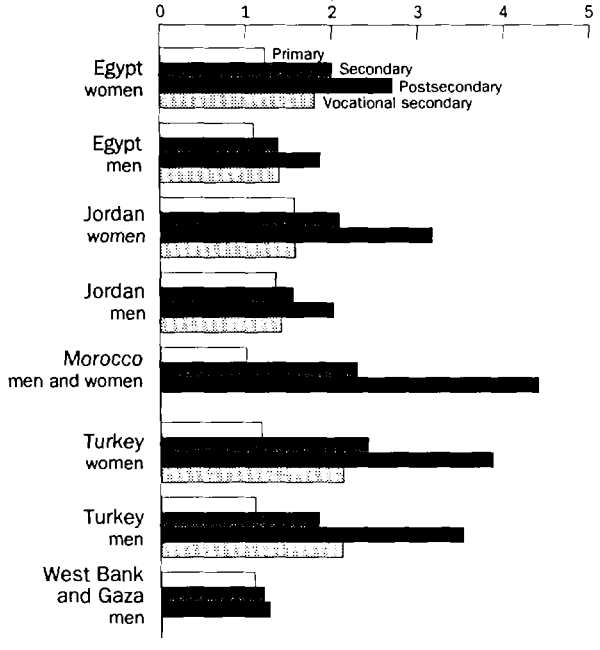
Education is the main way workers increase their productivity and incomes. In the right environment, it is the most direct way of equalizing opportunities across income groups and gender. There is an urgent need to redouble efforts in basic education, education of girls, and access in rural areas. The poorest households tend to be the least educated, and education remains the main influence on population growth and female labor force participation and fertility. And as global competition by low-wage producers intensifies, skill accumulation is the only viable strategy. But this option is closed to countries without universal basic education at the primary level and increasingly at the secondary level.

To gain the most from education, the economic environment must be reformed to benefit more from existing skills. In several countries high unemployment rates among skilled workers are traceable to nonmarket-based incentives—employment guarantees for graduates, subsidized higher education—that have distorted the education system. In Egypt and Jordan this is reflected in low returns to education (Figure 12). Distorted incentives encourage too many people to seek degrees in fields that promise jobs in the public sector (though the wait may be several years) but that are not in high demand in the productive sectors of the economy. Despite this apparent oversupply of skills, the private sector complains that educated workers lack the skills needed in the marketplace.

The quality of education must also be upgraded to the demands of the twenty-first century. The emphasis needs to shift to cognitive skills and computer literacy. But recent budget squeezes have hurt the quality of education. Class sizes are rising throughout the region, and achievement test scores have plummeted in several countries. More attention and money need to go to education. To increase effectiveness, higher education must be linked more closely to business needs. And given budget

Education pays off for the dynamic economies

Figure 12. Returns to education
(wage with schooling/wage without schooling)



Source: Angrist 1992; Assaad 1994; Tansel 1992; World Bank 1994c, 1995b.

constraints, cost recovery must increase at higher levels of education, with financial aid targeted only to poorer students.

Reducing poverty and helping rural areas

Until the early 1990s state subsidies helped keep poverty low by reducing the cost of consumption goods (subsidies were 3.4 percent of GDP in Algeria, 6.5 percent in Egypt) and health and education. These subsidies were designed more to distribute broadly the rents accruing to governments than to reduce poverty. Now that budgets are tighter, the instruments for poverty alleviation need to be more narrowly focused.

In the long term the most effective instruments are labor-intensive growth and education policies. Targeted interventions also have a place, whether through means testing or, preferably, self-selection, such as low-wage works programs or subsidies on inferior goods. Tunisia's experience illustrates forcefully the long-term benefits of an active education policy—average schooling per worker and GDP per capita are about twice Morocco's—and the beneficial effect of good targeting—public spending was cut without pushing more people into poverty. Direct action to help the vulnerable makes sense in dealing with child labor and other cases where the market may produce undesirable outcomes, such as discrimination against women, children, or other groups. Desirable actions include support to poor families without a wage-earner, regulations to deal with the worst abuses, and other protective measures to improve the conditions of children who continue to work.

Poverty is now to a large extent a rural phenomenon. In Egypt, Morocco, and Tunisia some 60 to 70 percent of the poor live in rural areas. Yet policies are still often unfavorable to agriculture. Infrastructure investment is most often concentrated in urban areas. It has been estimated that agricultural terms of trade would have been 45 percent higher in Egypt and 35 percent higher in Morocco in the mid-1980s had the policy regime been neutral. There has been some progress recently in correcting this bias, especially in Algeria, Egypt, and Tunisia. As food prices rise following the Uruguay Round agreements, it will be crucial to pass these increases on to peasants for reasons of fairness and efficiency. As macroeconomic adjustments take hold and realistic exchange rates become the norm, attention must turn to the distortions generated by the trade regime and to inefficiencies within the rural sectors. Within agriculture, subsidies on water, fertilizer, and credit have favored large farms over small farms, which are usually much more productive and more labor intensive. The strategy had high efficiency costs and hurt the poor. The uneven system of subsidies (especially on water) and taxes favored some crops at the expense of others without regard for economic rationality, further distorting production patterns.

Working conditions are often more hazardous and insecure for rural workers (and those in urban informal markets) than for their formal sector counterparts, yet labor legislation rarely reaches them. Their working conditions are best improved through direct public action in such areas as water and sanitation, roads and drainage, and environmental health. One of the biggest problems in rural areas is underdeveloped capital and insurance markets for reducing agricultural risk. In bad times farmers have to sell their land (at fire-sale prices) to survive, increasing asset inequality and undoing the land reforms of the past. There is no easy solution. Almost everywhere, loan subsidies end up mainly with the middle class. Works programs are one effective means of risk reduction for able-bodied men and women, and if wages are kept low, targeting can be near perfect because of self-selection. For many years India's Maharashtra State guaranteed rural residents employment in public works schemes, an arrangement that freed them to grow riskier and more profitable crops. Similar small-scale schemes in Egypt, Morocco, Tunisia, and the West Bank and Gaza have helped offset large aggregate fluctuations (agriculture in Morocco, labor market disruptions in Gaza). To have more impact, these programs need to be expanded and made more predictable.

Refocusing the role of the state

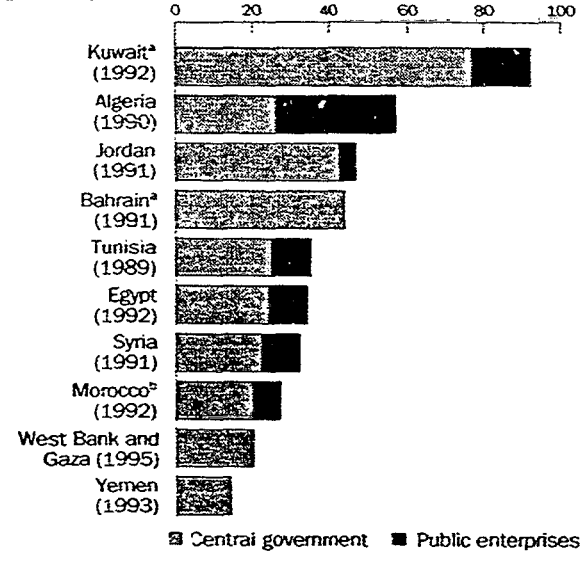
It is perhaps in their role as employers that the Arab states have marked their societies the most. The Arab states emerged following independence from France or Britain or later through

revolutions. Building the institutions, basic infrastructure, and industries of the new states drew popular support and fed nationalistic ideals. In most countries states intervened of historical necessity: in the Maghreb departing French colonialists left behind interventionist attitudes and few businesspeople. In the Mashrek state expansion was associated with socialism, nationalization, and the lingering wars with Israel. Only Lebanon (and to some extent Morocco) retained an unabated liberalism.

Several generations later, the weight of a large but poor public sector now weighs heavily on the economy of most countries of the region. Kuwait is the extreme in public sector employment, with 92 percent of its nationals on the public payroll (Figure 13). In poorer countries the state employs from 30 percent (Morocco and Tunisia) to 45 percent (Jordan) of the labor force. In all countries central governments are larger than the average for middle-income countries (which is 10 percent in Turkey and Greece, and 15 percent in Spain and Portugal) or even for rich OECD countries (18 percent). Public enterprise employment is also high in several countries. It is highest in socialist Algeria (31 percent of the labor force), followed at a distance by Egypt, Syria, and Tunisia (around 10 percent); in the OECD countries and Latin America, the figure is only 5 percent.

A large share of the labor force is on the government payroll

Figure 13. Workers in the public sector as a share of total employment
(percent)



a. Nationals only.
b. Urban areas only.
Source: Algeria, IMF 1994a; Bahrain, IMF 1991; Egypt, CAPMAS 1992 Labor Force Sample Survey; Jordan, 1991 Employment, Unemployment, Returnees, and Poverty Survey; Kuwait, World Bank 1994e; Morocco, IMF 1994b; Syria, Louis 1993; Tunisia, World Bank 1995d; West Bank and Gaza, World Bank 1994f; Yemen, Seif 1993.

Involved so heavily as an employer, the state has been distracted from attending to the central concerns of government, such as macroeconomic stability, infrastructure, fiscal justice, and education. The balance needs to tilt away from involvement in areas where private activity is more efficient and toward more intervention in these other areas. Reducing the size and economic role of the state helps to increase overall efficiency, to raise public sector efficiency, and to improve fiscal stability and boost the credibility of the reform agenda. Adjustment should entail decompressing wages, enforcing stricter job standards, laying off redundant workers, and recruiting highly skilled individuals for sensitive positions.

Overall efficiency

Maintaining large public sectors unjustifiably burdens the economy. In Jordan, for example, tax revenues have risen to nearly 30 percent of GDP, reducing competition and real wages in the private sector.

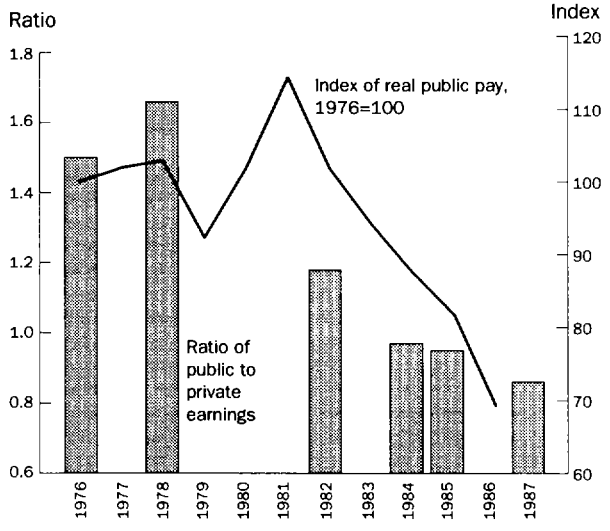
Large public sectors also create other distortions. Although public sector wages have fallen across the region (especially in Egypt, where they fell by half in the past decade), they have remained higher than in the private sector for the average public servant. In Morocco and Tunisia wages are higher in the public sector at all skill levels. In Egypt and Jordan wages are now lower in the public sector, but recent studies show that once all benefits are taken into account, pay in the public and private sectors is 20 to 40 percent higher than in the private sector for the average public servant. Pay in the civil service tends to be more sensitive to seniority than in the private sector, less sensitive to performance, more compressed across skill levels, and less rewarding of scarce skills. Women, older workers, and workers with intermediate levels of education tend to earn higher wages than they would command in the private sector. This encourages students to acquire a type of education that is not in demand by the private sector, distorts the education system, builds up expectations that are likely to be frustrated, and results in higher unemployment among these categories of workers.

Public sector efficiency

Although it is difficult to measure productivity in the public sector, the quality of public service seems to have fallen dramatically. Public sectors across the region have preferred to reduce investment and wages rather than employment (Figure 14a and 14b). As a result public servants are often underequipped and work in overcrowded conditions. In professional occupations wage compression has lowered morale and prompted absenteeism. In public enterprises financial difficulties plus the high capital intensity

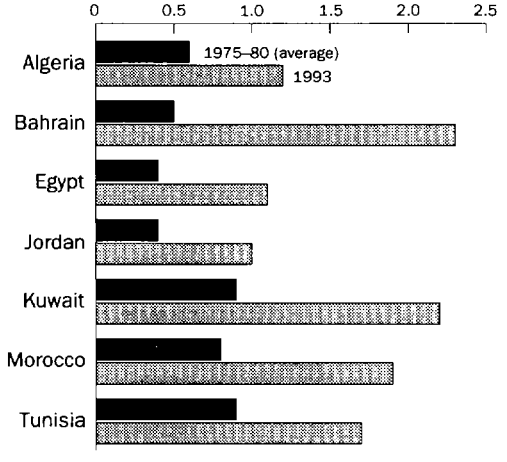
Public sectors have reduced wages and investment rather than employment

Figure 14a. Public and private earnings in Egypt



Source: Zaytoun 1991.

Figure 14b. Wage bill as a percentage of capital expenditure



Source: IMF various years.

of the past mean that many enterprises are using outmoded technology and obsolete equipment. Improving the efficiency of the public sector is an important goal. Doing so will require boosting investment, correcting the wage structure, and laying off redundant workers to avoid putting unsustainable stress on budgets.

In the oil-rich economies of the Gulf, the problems of an inefficient public sector are entwined with the long-term welfare of the population. Public sector jobs are used to distribute oil rents to nationals, who receive wages several times higher than those paid in the private market (which employs mainly migrant workers). In Kuwait, for example, public sector jobs pay two to three times market wages. This strategy is now at an impasse since the national labor supply has outstripped any reasonable needs of the public sector. This strategy eliminates all incentives to join the private sector, leads to an overstaffed and inefficient public sector, and reduces the size of oil rents. It would be far better to rely on public sector restraint, privatization of utilities, and direct distribution of oil receipts to nationals.

Macroeconomic stability and the credibility of reforms

Macroeconomic stability is constantly threatened by pressures for wage increases for the large numbers of public employees. Public sector wages (excluding public enterprises) range from 10 percent of GDP in Egypt to 15 percent in Morocco. In most countries the fiscal deficit would rise by 2 to 5 percentage points of GDP if public sector employees regained the real wage losses they have sustained since the mid-1980s. In Lebanon in 1991 and in Turkey in 1994, public sector wage increases initiated a fiscal crisis ending with large devaluations and huge losses for workers.

When public sectors are large, the credibility of reform diminishes. Promises to cut the public sector in the future—once private activity rebounds—are not very credible. Old policies have created an oversized public sector with established vested interests that is hard to cut back. Although public hiring has stopped in Algeria, Egypt, Jordan, Morocco, Syria, and even in the oil-rich countries of the Gulf, people still look to the state as the employer of last resort. That has meant that whenever the fiscal accounts have improved, public recruitment has risen, even where it has become clear that additional workers produced less than they cost.

In the countries with large public enterprises (Algeria, Egypt, Syria, and Tunisia), reform would enlarge fiscal deficits unless the public sector contracts first. Liberalization of prices, investments, and trade and other measures to increase competition magnify the losses of the public enterprises. Financial market reforms also hurt public enterprises with large capital costs (relative to labor) and large debts.

• • •

A new social contract would support a more efficient economy more attuned to the competitive realities of the twenty-first century. How to get there is the key issue. The short-term negative impact of change falls mainly on the educated labor elite. But the status quo hurts the poor. This poses a formidable political dilemma, an issue taken up in the last chapter of this report.

CHAPTER 4

Transition

Arab countries are struggling with the difficult transition from state ownership, intervention, and protectionism to a more efficient mode of social organization. They are not alone in this adventure. A similar process is under way in Latin America, Eastern Europe, the former Soviet Union, China, India, and Viet Nam, affecting more than half the world's 2.5 billion workers. Transition is usually a time of rapid change and acute social dislocations. This is especially likely to hold in the region, where unemployment among the educated is high to begin with and many skilled workers will need to shift to new activities. What type of policy actions can speed recovery and reduce social dislocations?

Beyond containment

Some structural change has begun, with reforms varying in sequencing and speed (Table 12). Morocco and Tunisia have followed a broad reform agenda for some time. The successes of these early reformers have encouraged other countries to accelerate the pace of their programs. Egypt and Jordan have recently begun far-reaching reforms. In Lebanon and the West Bank and Gaza, the reconstruction of administrative and physical infrastructure is high on the agenda. Algeria, Syria, and Yemen are plagued by serious macroeconomic and microeconomic problems. All three are considering steps to eliminate macroeconomic imbalances, reduce policy distortions, and improve the management of public resources.

A shake-down period is required to clear out the accumulated structural problems of the economies of the region. Labor market flexibility has acquired a bad name as an euphemism for pushing wages down and workers out, but it is an essential component of reform. Workers need incentives to move into jobs where they can be more productive. But change has been slow precisely in the areas that affect workers most—trade liberalization and public sector reform. There has been no quick and clean break with the past, as in Eastern Europe or Latin America. Gradualism has been the watchword. The underlying principle seems to be that the state would contain the problem areas in the public sector by freezing new hiring and allowing wages to fall. Job creation would be left to the private sector. The economy would be slowly opened to international competition and the public sector would slowly contract, so that job losses would take place after job creation. Several factors made this strategy attractive:

- Public sectors in the region are not as large as in Eastern Europe or Russia, so governments felt that they could maintain macroeconomic stability, at least in the short term, without having to undergo drastic public sector retrenchment.
- With public sectors two to three times the size of those of the reforming countries of Latin America, larger unemployment at the outset of reform, and fragile sociopolitical equilibrium, governments were keen to avoid changes that could generate massive layoffs. Workers in the public sectors also have preferred wage cuts to layoffs.
- Unlike the case in other regions (but like the case in China), job creation is not held back by tight supply in labor markets. Job creation would not have to await job destruction since new employees could be drawn from the ranks of the unemployed or from rural areas.
- A resolute, strategic orientation to a market-based economy, with its short-terms costs in lost jobs, did not seem to have clear benefits when weighed against the discouraging effects of regional instability on private investment.

The strategy of containment has managed to stabilize the macroeconomic situation and to prevent the kind of economic collapse that occurred in Russia. But the accumulated losses have now reached levels comparable to those experienced in Eastern Europe, without the robust supply response that has started to emerge there. Private investment is responding where reforms are more advanced (Jordan, Lebanon, Morocco, and Tunisia), but even there the supply response has not been vigorous. Everywhere, entrepreneurs and investors are holding back on long-term investments.

The main reason for the delayed recovery seems to be the credibility of reforms: for many countries the external environment is still uncertain, and the new social contract is still in the making. Governments will have to take more risks to bolster credibility. Reforms that make job destruction inevitable still have to be initiated. Indeed, slow progress on trade liberalization and public sector reforms is a sign that the new social contract has not yet been "sold" at home and will have to pass future political tests.

An important role for transition policies is to put in place measures that encourage labor flexibility while reducing its dislocating effects. Rather than supporting labor demand by hiring more workers—which undermines the credibility of reforms—countries would be better served by shifting public expenditures toward such programs that can smooth the deflationary effects of public sector retrenchment, enhance the credibility of reforms, and help workers move into areas of higher labor productivity.

Countries are at different stages of reform

Table 12. State of reforms

Country	Macro-economic stability	Trade reforms	Bias against agriculture	Financial sector	Education	Labor regulations	Public sector
Mashrek							
Egypt	I	P	I	A	P	P	P
Jordan	I	P	I	A	I	I	P
Lebanon	P	A	A	A	I	I	P
West Bank and Gaza	P	P	P	P	I	I	P
Syria	P	P	P	P	I	P	P
Yemen	P	P	P	P	P	I	P
Maghreb							
Algeria	P	P	I	P	P	P	P
Morocco	I	I	I	I	P	P	I
Tunisia	A	I	I	I	A	P	I
Gulf countries	I	I	P	A	A	I	P

A = advanced or not needed; I = initiated but incomplete; P = pressing but not yet started.
Source: Authors' assessments.

(Table 13 summarizes best practices in both types of programs.) Two types of policies can help during the transition: active policies that assist workers by equipping them for change and passive policies that provide temporary transfers to reduce income losses during layoffs. OECD countries typically spend 2 to 3 percent of GDP on labor market programs (including unemployment benefits), mainly passive, while formerly communist countries spend between 1 and 5 percent of their GDP, mainly on active programs. In the region, however, such programs are still in their infancy.

Equipping workers for change

Workers must have access to resources and information to be able to take advantage of new opportunities without losing their accumulated human capital in the process. Various policy actions can help increase their mobility. But the effectiveness of active programs depends on how well they target the groups having difficulty finding new jobs, improve the job prospects and wage potential of participants, and avoid distortive effects. Distortive effects include substitution effects—firms hiring subsidized workers rather than other workers—and dead-weight costs—firms taking the subsidy even though they intend to hire workers in its absence. Unless they are carefully structured, active labor market programs can be risky investments, since the cost can exceed the benefits they bring to workers.

Retraining programs

Workers whose jobs disappear often find that they lack the right skills for the new jobs being created. This mismatch is exacerbated by the worldwide trend in labor demand toward workers with greater general skills and higher education. As a result, workers with firm-specific skills but little general education may end up having to chose between unemployment and lower wages. This trend is already apparent in Algeria and Egypt, two countries with large public sectors and narrowly specialized workers.

Most industrial and transition economies run public retraining programs, but evidence of their effectiveness is weak. If countries decide to introduce such programs, they should launch small pilot projects first. While government subsidies make sense, private provision can improve the effectiveness of retraining. In Chile targeted groups receive vouchers, allowing them to buy training services in a competitive market. An area in which private provision and financing of retraining is unlikely to be adequate is the retraining of disadvantaged workers (women, older men with low levels of education). The financial returns to such training are low, but often the externalities can be high in terms of improved social cohesion (as shown, for example, by the results of the Hungarian retraining measures that target the "best" among the disadvantaged groups).

Temporary public employment schemes

Temporary employment programs can serve as a bridge between jobs in periods of major change and reduce poverty, although they do not improve the long-term job prospects of participants. At the depth of the recession of the 1980s, the public sector in Chile employed 12 percent of the total labor force. Temporary public employment schemes are also widely used in the Czech Republic and Poland. Recently, the Social Fund in Egypt

Some best practices to help investors through the transition

Table 13. Policies to compensate labor during public sector retrenchment

Policy	Effectiveness and recommendations
Equipping workers for change	
Retraining	Expensive. Limited number of robust evaluations, even in OECD countries. State financing (but rarely provision) desirable in some cases for those hurt by changes, at least on welfare and political grounds.
Job search assistance	Inexpensive and often effective in OECD countries in increasing job placements, although relevant only for a fraction of job-seekers.
Employment subsidies	Expensive, often risky, with only minor net effects in OECD countries. Likely to undermine reforms. May make sense if tightly targeted and restricted to short period after hiring.
Allowances (grants, loans, prepayment of benefits) to support business start-ups	Expensive. Net employment effects rarely properly evaluated. Apply only to a small minority of workers even in OECD countries.
Public employment for disadvantaged youth and public support of apprenticeship	Mixed results. Rarely properly evaluated. Some positive effects of programs carefully targeted on dropout minorities when mixed with on-the-job training. Administratively intensive and difficult to implement outside OECD countries.
Providing transfers	
Unemployment benefits	Useful in first stages of transition from central planning. Disincentive effects of long-duration benefits found in OECD countries. Benefits should be simple.
Severance pay	Often part of formal sector contract; can be key to downsizing public sector.
Old-age and disability pensions	Major cash benefit scheme in post–centrally planned economies. Often used in lieu of unemployment benefits. Often require immediate cost-containment on fiscal grounds. Long-term reform toward funded arrangement desirable.
Social assistance and family benefits	Can reduce poverty of those laid off in transition. Means-testing can be difficult. Family benefits generous in post–centrally planned economies and may not need to be cut back on fiscal grounds.
Public works	Effective antipoverty measure in developing countries if wages kept low.

Source: World Bank 1995e.

increased its financing of such schemes, especially in poorer regions. Self-targeting works well if wages are kept low enough, but there can be substitution effects (firms hiring these rather than other workers) unless the programs are restricted to public investments that would not have taken place without the availability of cheap labor.

Youth programs

Human capital accumulated during schooling can deteriorate over time in countries with long-term unemployment among the young, so that young entrants to the labor market get stuck in low-productivity informal activities. The risk is magnified by high labor standards that discriminate most against workers with low levels of experience and expertise, such as those with a secondary education or vocational training. In some countries firms are allowed to hire recent graduates on a temporary basis, paying them less than the official minimum wage and even receiving a subsidy for employing inexperienced workers. Morocco has been experimenting with schemes to assist young labor market entrants acquire practical experience. While the risks of substitution are high, they must be weighed against the gains generated by expanding the supply of labor in the modern sector.

Supporting business startups

Some countries have tried to help those among the unemployed wishing to start their own businesses. Many countries have experimented with credit schemes and other programs to encourage microenterprises, but few rigorous evaluations have been done. Experience with special credit programs in

Sub-Saharan Africa and Latin America suggests that they have rarely brought benefits. In industrial countries these schemes have been of interest only to a limited number of the unemployed. In the post–centrally planned economies with underdeveloped financial sectors, the schemes have been more effective in generating new employment opportunities. Such programs should be approached with great care in the Middle East and North Africa because of the risks of displacing more traditional sources of finance and of benefits going to well-to-do groups. Rather than concentrating on startups, governments should focus on easing the difficulties that informal firms have in tapping into the formal financial system.

Wage subsidies

Wage subsidies must be limited and very well controlled to play a positive role in times of major change. In industrial countries they have proven ineffective in speeding up adjustment. Wage subsidies can easily undermine reforms by keeping unprofitable firms afloat, while substitution effects can negate their benefits if workers whose wages are subsidized replace those not covered by subsidies. Wage subsidies should be considered only in cases where targeting is easy, such as depressed areas. When well controlled, wage subsidies can be a less expensive alternative to transfers and yield a better outcome in terms of social cohesion in isolated areas.

Provision of information

Workers cannot take advantage of new opportunities unless they know about vacancies and wages. In many developing countries workers must rely on informal exchange of information to find new jobs. Official job search assistance can help. Although inexpensive compared with retraining, it is not a panacea. Even in industrial market economies only a small percentage of job seekers—usually no more than 10 to 15 percent—get their jobs through public employment offices. Private employment services should be allowed to operate as well.

Compensating those hurt

In the short term two groups stand to lose: skilled workers in protected sectors and the educated who are unemployed. Public servants cannot just be fired; they need to be compensated for the losses of job security and future wages that had been promised to them. Many of the educated unemployed went to school because of the promise of a public sector job. They too should expect some assistance during the transition.

In deciding how much assistance to provide, policymakers must balance several important interests. Assistance is vital for maintaining popular support for reform and boosting its credibility. But part of the cost will have to be financed by diversion from other social programs. In Egypt, for example, recent estimates suggest that fully compensating all redundant public sector workers could cost up to 7 percent of GDP.

In the past decade more than fifty countries have used transfer schemes (or compensation) to assist in downsizing public sectors (Box 3). Countries in Eastern Europe now devote as much as 1 percent of their GDP to such activities. During major reorganizations the desirable level of severance pay will usually be greater than the compensation mandated under labor contracts, which are not designed to compensate for the loss of employment in periods of wholesale change. Because it is administratively simpler, a special severance scheme that tops up nationwide severance programs is better than an extension of unemployment benefits. The early involvement of unions is crucial for success, and for reasons of fairness any severance scheme offer should be open to all public sector employees.

Ideally, redundancy programs would be voluntary. Workers would be offered a menu of options including early retirement, cash payments, annuities, retraining programs, guaranteed wages backed by subsidies to new employers, and transfers to other public sector jobs. Many recent severance schemes in industrial and developing countries are of this voluntary type. The menu approach can improve targeting at lower costs since workers choose the option they value most. Wage decompression and the use of vetos can help reduce the problem of "brain drain"—the best workers taking the severance package and getting a new job elsewhere.

For a severance package to fully compensate redundant workers, its value must approximate the "rent" workers receive by holding on to their public sector job. Payment will therefore have to be somewhat worker specific, taking into account such characteristics as current wage, the time needed to find a new job, alternative wages, gender, seniority, and years of denied public sector service. Compensation should be high enough to make it attractive to workers to accept redundancies even when they can expect lengthy search periods before finding a new job, but not so generous that accepting the package appreciably improves workers' current welfare. Payments could also be made during unemployment and until a new job is found rather than as a lump sum, but on a declining scale in order for displaced workers to have incentives to find a new job quickly.

Several countries in the region—Egypt, Jordan, Kuwait, Morocco, Oman, Tunisia, United Arab Emirates—have started to privatize public enterprises, but only firms that are not massively overstaffed. As the programs start addressing the real problem firms, governments will need to decide whether to lay off redundant workers before privatization or to leave the task to the new owners. There is no accepted wisdom on this score: Spain dismissed redundant workers before privatization, but Central and Eastern European countries did not. For firms with

Box 3. How other countries have designed compensation packages

Countries have developed a variety of ways of compensating public sector workers whose jobs are being cut. Sri Lanka recently offered a package to all public sector employees based on a formula: last monthly wage • 55 – age • age + 55 • years of service + 30. A simpler package in the United Kingdom called for payment of 0.5 week per year of service for workers ages 18–21, 1 week for workers ages 22–41, and 1.5 weeks for workers ages 42–64.

Menus vary too. A Spanish program (1985–88) offered three choices to civil servants in the occupations being eliminated: early retirement (chosen by 25 percent), severance pay in cash and unemployment compensation for up to eighteen months (chosen by 40 percent), and 80 percent of last wage earned guaranteed until retirement plus free retraining and subsidies for firms that hire the worker permanently (chosen by 35 percent). Another option is to let workers decide whether to be paid in a lump sum or in annuities, as in the Jamaican Railways restructuring program. The cash severance with small present value was preferred by the more enterprising workers, who used the money to start small businesses. To guard against overconsumption and poor quality projects, a similar option was restricted in Ghana to workers with identified projects, and the cash was used to collateralize a commercial loan.

A recent study of public sector retrenchment in the transport sector looked at six countries. Five of them had voluntary schemes (Brazil, Chile, Ghana, Sri Lanka, and Yugoslavia); Mauritius did not. Two of the five also had some mandatory programs (Chile and Ghana). The voluntary programs were used to reduce redundancy in the railways, and the mandatory programs in the ports. In Europe most large restructuring programs offered voluntary severance (which paid more than the mandatory compensation levels). A survey of 2,000 British establishments in 1984 found that 824 that had reduced their work force the year before, 578 used natural attrition, 311 redeployed their workers, 289 used early retirement, 162 used voluntary schemes, and 206 used compulsory programs (of which 102 fired those most recently hired). Large firms with strong unions used voluntary programs, while small firms with weak unions used compulsory programs. In the United States large corporations usually lay off workers using voluntary programs to avoid legal problems relating to discrimination.

a negative value (once the social liability to their workers is taken into account), there is no alternative but to deal with redundancy before privatization. In all cases, imposing restrictive hiring or firing terms on the new owners defeats the purpose of privatization and is reflected in a lower sale price.

• • •

Active labor market policies and compensation of workers hurt by change are a necessary component of a reform program. They help maintain social cohesion at a time when job destruction and job creation are intensified, generating intense social dislocation. But the problems are extensive in some countries of the region, and these policies are not a panacea. They cannot be expected to smooth out all temporary losses. This means that policymakers must above all convince workers that the losses will indeed remain temporary. A credible vision of a better future is in the end the most convincing instrument.

CHAPTER 5

Looking Ahead

The main reason that reforms have not yet deepened in the region is that most governments have not yet been able yet to articulate a vision that is realistic and convincing. But in many of the countries this vision is starting to come together. The vision capitalizes on past successes in education and infrastructure. A key challenge is how to salvage parts of the old industrial base, and how to retrain those workers whose skills have become outmoded.

The peace process, if successful, will reduce the strategic uncertainty that has infected the region. The promise of a special relationship with the European Union is another important anchor, for it provides access to markets and locks in reform. More active reforms and supportive policies are now needed to ensure a successful transition. Compensation policies for those hurt by change, proper labor market regulation, and mechanisms to insure some degree of income security are important ingredients.

The risks are large. With low or shallow investment, skilled workers will have to accept low-productivity jobs, leading to harsh social dislocations. Reforms thus pose a major political challenge, especially where public sectors are large and unemployment among the educated is of long duration. The difficult dilemma, however, is that lack of reform is likely to perpetuate low productivity and lead over time to rising poverty.

In an uncertain world with mobile capital, both optimistic and pessimistic expectations may seem realistic. The projections developed for *World Development Report 1995* illustrate well the fragility of the region's future (Table 14). In the "high-case" scenario growth is fast and domestic inequalities fall. By 2010 the labor productivity and wages of unskilled workers are 60 percent higher than current levels, those of skilled workers 40 percent. But in the "low-case" scenario the incomes of unskilled workers remain stagnant at best, those of skilled workers rise only slowly, and inequalities rise sharply. The main difference between the two outcomes is in the dynamics of the transition. Bad outcomes are likely to perpetuate themselves with social instability and fleeing capital. Good policies could unleash opposite forces, bringing in capital and making success easier. There is a thin line between rising with a virtuous circle and falling with a vicious one. Good economic policies, strategies, and execution can make a big difference. But time is running out. The full force of the Uruguay Round agreements will be felt in the next ten years. This is perhaps all the time left for the governments in the region to build competitiveness.

Wage gains for unskilled workers are dramatically higher in the high-case scenario, reducing inequality

Table 14. Two scenarios for the Middle East and North Africa, 1994–2010
(percent)

	Low-case scenario	High-case scenario
Inputs in the growth process		
Investment share in GDP[a]	20.0	25.0
Annual growth of total factor productivity[a]	0.5	1.5
Overall performance		
GDP per capita growth[a]	1.4	3.4
Export growth[a]	3.3	5.5
Labor outcomes		
Wage growth, unskilled workers[b]	–2.0	63.0
Wage growth, skilled workers[b]	27.0	39.0

a. Average over period.
b. Total growth, 1994–2010.
Source: World Bank 1995e.

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