

Inclusive Growth in North Africa



Jobs, Justice and the Arab Spring:

Inclusive Growth in North Africa

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Foreword

Jacob Kolster and Nono Matondo-Fundani

In 2011, the North Africa region became the global epicenter of social upheaval and political change. The region, with Tunisia in the forefront, became a source of admiration and inspiration for people from all walks of life around the globe—from youth rallies in Spain and China to Occupy Wall Street in New York to uprisings in Yemen and Syria.

The political origins of the Arab Spring are straightforward: governments in Egypt, Libya and Tunisia had failed to respond adequately to the growing demands of political inclusion and good governance. However, the revolutions also had serious economic underpinnings: governments in the region had failed at creating jobs, especially for the young, and the economic policies which formed the basis for inclusive growth after independence had long-hence been unraveling.

After decades of political repression two common themes – ‘jobs and justice’ – have come to dominate the development agenda. This was not surprising given the rising costs of living and growing gap between the rich and the poor. In recognition of the importance of this, the Bank commissioned a key piece of research into the topic.

We are thus pleased to present this report on “Jobs, Justice and the Arab Spring”. In addition to reviewing the economic origins of the crisis the report examines the options available to manage the social and economic challenges in the short run and over term. Importantly, the report also presents policy options for the short run and frames the structural changes needed in terms of empowering the private sector and accelerating industrial development. The Report also suggests options on how to restore inclusive growth from how to attain new skills for the workforce to reforming the public expenditure.

The African Development Bank must learn from the momentous changes currently underway in the region, understand their underlying causes and make adjustments as appropriate to our interventions. This will be done through close consultation with our clients to ensure

that we provide the best-possible support for the betterment of the lives of the people in the region. In particular, as we finance different operations, we will ensure that rural and disenfranchised regions are integrated and pay particular attention to the creation of meaningful jobs. Ours is a long-term commitment and we remain engaged in this important region especially during this critical time. It is in that spirit that we are pleased to contribute to the development agenda and present this important Report.

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A handwritten signature in dark ink, appearing to be 'J. Kolster', written in a cursive style.

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A handwritten signature in dark ink, appearing to be 'Nono Matondo-Fundani', written in a cursive style.

Executive Summary

North Africa has been the epicenter of the Arab Spring. Long-entrenched regimes in Egypt, Libya and Tunisia have collapsed. In addition to the popular rejection of decades of political repression, two common economic themes — “jobs and justice” — have underpinned the revolutions. This is not surprising. Surveys indicate that lack of economic opportunity, the rising cost of living and the growing gap between the rich and the poor were among the main drivers of popular discontent.

Economic Origins of the Crisis

The political origins of the Arab Spring are straightforward: Egypt, Libya and Tunisia all failed to develop pluralistic and open political systems. But it also had economic underpinnings: governments in the region failed at job creation, especially for the young, and the economic policies which formed the basis for inclusive growth after independence started to unravel.

Jobs: lagging growth and employment creation

For more than three decades North Africa’s economies have failed to grow fast enough to create sufficient good jobs. After a period of rapid growth and job creation from 1960 to 1980, output and employment growth stalled. Between 1980 and 2010, per capita income growth in the region averaged only 0.5 per cent per year. Unemployment has averaged about 12 percent over the past two decades, the highest rate of any region in the world. In 2008 unemployment rates in Egypt, Morocco, and Tunisia ranged from 9 to 15 percent.

Slow economic growth, low employment elasticities of growth, and rapidly growing young populations in North Africa have produced the most serious problem of youth unemployment in the world. The average unemployment rate for those between the ages of 15 and 24 is about 30 percent in North Africa, compared to the world average of 14 percent. Youth unemployment is even more severe in Egypt and Tunisia than for the region as a whole.

Unemployment is also increasingly concentrated in the educated young. Among young

men in Egypt, university graduates have the highest rates of unemployment. In Tunisia the rate of unemployment of young workers in 2008 was estimated to be above 30 percent, and the unemployment rate among university graduates in 2007 was 40 percent.

The youth employment problem largely reflects a severe mismatch between the skills of young workers and those demanded by private sector employers. The region's educational systems have failed to teach the skills and knowledge needed for the globalized work place. Because the public sector remains the primary employer of university educated labor, a good university degree is the main qualification for being hired into the civil service or into a state owned enterprise. The content of the degree in terms of relevant skills is secondary. University curricula place excessive emphasis on rote learning and fail to teach mathematics, abstract thinking and science effectively.

Justice: The failure to sustain inclusive growth

The Arab economies of the 1970s and 1980s were marked by low poverty and relatively equal income distributions, sustained in large measure by consumption subsidies, public employment and migrant remittances. Changes in migration patterns, demographic

pressures and fiscal retrenchments have strained these mechanisms. In Egypt and Tunisia the sense that the benefits of recent growth were not shared by the population at large is tellingly illustrated by opinion polls that show that while GDP per capita was rising, people felt worse-off.

Recent data on inequality and poverty present a mixed picture of progress on poverty reduction and equity. In Egypt the Gini coefficient declined from 0.34 in 1999/2000 to 0.32 in 2004/05, a small improvement in income distribution. In Tunisia between 2000 and 2005 per capita income growth of 4.4 per cent per year was accompanied by a sharp increase in the Gini coefficient — from 39.3 in 2000 to 42.1 in 2005. Both Egypt and Tunisia experienced growing inequalities along regional and rural-urban lines.

Following independence most Arab governments looked to the public sector as a key instrument of economic and social change. Public employment expanded rapidly in the 1960s and 1970s. Beginning around 1990, however, governments found it increasingly difficult to sustain guaranteed employment and superior working conditions in the public sector. In both Egypt and Tunisia educated labor force entrants accepted increasingly longer waiting periods for public sector jobs or sought work in the private

sector or informal self-employment. Both first time job seekers and their parents perceived a failure of the state to honor the employment guarantee.

Stagnant real wage growth was one of the contributing factors to the declining sense of economic wellbeing during the last two decades. Data on the manufacturing sector indicate that real wages declined in most North African economies in the 1990s and then failed to grow in Algeria, Egypt, Tunisia and Morocco after 1995. Rising output per worker combined with stagnant real wages resulted in a shift in the functional distribution of income away from labor.

Another driver of the growing dissatisfaction with the equity of growth in Egypt and Tunisia was a collapse in satisfaction with public services. Between 2009 and 2010, satisfaction with public transportation systems in Egypt for example fell by 30 percentage points. Levels of satisfaction with housing and healthcare had large declines in Tunisia. Tighter competition for the limited spots in top schools has produced growing inequality of opportunity in education.

Managing the Short Run

Investor and consumer confidence was badly shaken by the revolution in Egypt. Banks and the stock exchange closed. Tourism collapsed

and a series of labor strikes for higher wages — mainly affecting the public sector - further disrupted economic activity. In Tunisia property damage arising from the revolution has been estimated at four per cent of GDP. In addition growing insecurity and social tensions have caused sharp reductions in tourism revenue (-46 per cent) and foreign investment (-26 per cent) compared to the first half of 2010. A steep fall in oil production and exports, combined with an expected decline in foreign direct investment, has resulted in forecasts that the Libyan economy will contract by about 28 per cent in 2011.

Real GDP growth in Egypt is projected to slow to two percent in 2010/2011 from 5.1 percent in 2009/2010. Growth will be held back by the uncertain political environment. Projections suggest that GDP growth in Tunisia will range between -2.5 per cent and 1.1 per cent in 2011, due to lower demand for tourism services, disruption of economic activities and reductions in foreign direct investment. The revival of Libya's oil sector offers some promise of a relatively prompt recovery for the economy.

Policy responses in the transition

Transitional governments in Egypt and Tunisia have moved cautiously on economic policy reform while they have attempted to address popular demands for employment

creation and social safety nets. Egypt's government has introduced some budget actions that could prove costly in the medium run. The list includes permanently hiring 450,000 temporary public employees and premature payment of a 15 percent bonus to civil servants and pensioners. In June 2011 the Tunisian government adopted a supplementary finance law which provided for an 11 percent increase in public spending to promote employment and support disadvantaged regions.

Egypt has both the largest deficit and the largest stock of debt in the region. The fiscal deficit is forecast to reach 8.6 per cent of GDP in 2011/12. Egypt's public debt also has a short term maturity structure with annual rollover needs of 25 percent of GDP. Recently the government announced that it intends to accept the funding package of US\$3.2 billion from the International Monetary Fund (IMF) that it had rejected earlier this year, due to increasing difficulty in financing the deficit domestically. In Tunisia projections forecast a 4.3 percent of GDP deficit and a debt to GDP ratio of 43 percent. The fiscal deficits in both Egypt and Tunisia are largely driven by transfer and subsidy programs.

Little appears to have been done on structural reforms. This is not altogether surprising. The history of transitions in other countries

suggests that early transitional governments tend to shy away from changes to the legal and regulatory system beyond attempts to eliminate the worst manifestations of the insider dealing that characterized previous regimes. Fragility in the banking system in both countries also limits the scope for financial sector reforms.

In Tunisia the interim government has undertaken a number of reforms designed to improve access to information and encourage public debate. It initiated reforms that established the right for citizens to gain access to public information and data, and the interim authorities then published several documents related to public finance for the first time. Egypt appears to have made less progress on governance related reforms.

Policy options for the short run

For both Egypt and Tunisia the major macro-management challenge is phasing in deficit reduction in the face of popular demands. It will not be tenable for Egypt to continue to borrow heavily over a three to four year period. Tunisia may be able to borrow but would risk undermining business confidence. One important action would be to change the composition of public expenditures while leaving aggregate public spending unchanged, for example by expanding programs to benefit the poor and public infrastructure investment.

Both governments should also continue efforts to seek long term grants.

Pressures to address the employment problem – especially among the young – will remain high. Temporary employment programs that provide public sector employment to the highly educated are likely to perpetuate the attitude that the public sector bears the primary responsibility for creating good jobs. Instead, governments can target young workers in key sectors such as tourism and construction with programs that offer cash for work, providing temporary income earning opportunities. Governments might also experiment with increasing budget allocations to labor intensive public works. To begin to address the skills deficit Egypt and Tunisia might experiment with temporary employment initiatives that reward specific skills rather than credentials. For example tests for language skills could be used to screen applicants for cash for work employment programs in tourism.

One approach to structural reforms would be to design a program of policy and institutional reforms in specific localities (such as export processing zones) where red-tape and bureaucracy can be quickly reduced without threatening vested interests too severely. Governance reforms during the transition are also critical to the legitimacy of the transitional governments and to

their ability to conduct economic policy. In particular there is a need to reinforce the role of civil society in both Egypt and Tunisia as it relates to economic management.

Structural Change, Growth and Employment Creation

Although some structural change has been under way in North Africa for at least four decades, it has not been sufficient to sustain rapid economic growth and employment creation. One way to measure the extent to which the region's current economic structure differs from middle income countries that have successfully sustained growth, job creation and poverty reduction is to compare North Africa to a benchmark – the structural characteristics of a sample of non-North African economies at the time at which they achieved upper middle income status.

Differences between the North African economies and the benchmark—the “structural deficit” – are striking. Agriculture bulks larger in Egypt and Morocco than in the benchmark, and it continues to employ a relatively large share of the labor force. From the perspective of creating good jobs the small share of manufacturing value added in total output is worrisome. Even Tunisia, the region's consensus industrial success story trails the benchmark by nearly 12 percentage points of GDP.

The slow evolution of North Africa's economic structure and the relative decline of the manufacturing sector make it likely that during the past 20 years there has been a shift in the composition of employment toward lower productivity jobs. The data, while partial, provide some evidence of growth reducing structural change. In Egypt and Tunisia the services sector has absorbed much of the increase in the labor force since around 2000. A large proportion of service sector jobs in both economies are informal and characterized by low productivity and low wages.

The failure to industrialize

The limited extent of structural change mainly reflects a failure of North Africa's economies to industrialize. The region's share of manufacturing in GDP is low, relative both to developing countries as a whole and, especially, to East Asia. The level of manufactured exports per capita in Egypt is particularly low at less than US\$ 100 per capita. In Morocco it is only about 60 per cent of the average for all developing countries. Tunisia on the other hand has a level of manufactured exports per capita that compares favorably with East Asia.

Egypt, Morocco and Tunisia mainly export very simple manufactured products. The share of medium and high technology

exports in total manufactured exports – an important indicator of learning by exporting – is very low in comparison to other developing regions. Both Egypt and Tunisia have suffered a long run decline in the sophistication of their manufacturing sector, which acts as a constraint on their growth. During the 1970s and 1980s Egypt and Tunisia had manufacturing production and export structures that in terms of sophistication were broadly in line with their levels of development. By 1995 both economies had fallen below their predicted levels in terms of production and export sophistication.

Empowering the Private Sector

Growth enhancing structural change will depend fundamentally on private investment and job creation. Across North Africa a more dynamic, competitive private sector is needed. Ironically, North African governments were praised in the past decade by international institutions for taking steps to promote private sector development, but policy and regulatory changes which on paper appeared to empower the private sector in fact undermined competition, restricted the entry of new businesses and discouraged risk taking.

Restoring business confidence will depend on establishing trust between the government

and the private sector in a more open environment. A first step toward building trust can be undertaken by developing institutions that support transparent, rule-based interaction between business and government. One important reform would be improving information access through disclosure of public regulations and the outcomes of administrative decisions (for example regarding licenses or contract awards). Governments can also introduce innovations to improve the efficiency and equity of service delivery to businesses. Customs, the tax authorities, the industrial land administrations, and the agencies regulating investment approvals and business entry are among the key agencies in which these reforms should be initiated.

Increasing Competition

The private sector in the Middle East and in North Africa faces little competition. Protection in output markets and barriers to entry are substantial. Entry of new firms and exit of inefficient businesses is weaker, and firms are on average older than in other regions. Administrative procedures were used by the past regimes to restrict the competition faced by favored enterprises and often represent a significant barrier to entry – especially for small and medium firms. New governments have the opportunity to streamline procedures and increase the transparency of their application.

Some recent changes are encouraging. In Egypt the Prime Minister removed requirements for new industrial projects to get approval, simplified the process of registering branches of foreign companies, and established new branches of the Investment Authority. The Tunisian Ministry of Finance has created a high-level technical committee and working groups in all departments to review 500 formalities and eliminate those that are unnecessary, ineffective, not based on law or redundant.

A few key areas of legal and institutional reform are crucial to strengthening competition. Building confidence in the judiciary to uphold property rights—even under pressure from politically-connected interests - should be a central objective of post-revolutionary governments. There is also a need to strengthen the insolvency and secured transactions systems to encourage risk taking. Effective competition policy can play a dual role: first, it can limit anti-competitive behavior by incumbent firms, and second it can help to reestablish trust in the role of government as a regulator. Egypt and Tunisia both have competition authorities, but their effectiveness has been limited.

The banking system in Egypt and Tunisia is weak by international standards. State-owned banks continue to dominate the financial

sector and competition among banks is limited. North African banks have the highest average loan concentration ratio in the world. Only 20 percent of SMEs in North Africa have access to finance, and the share of the population covered by microfinance is half that of Latin America. One immediate action to increase competition would be to remove the restrictions on entry of foreign banks. Countries can also increase banking competition and reduce the room for abuse by limiting the amount of credit single borrowers can receive from public banks, by removing branching restrictions, and by improving the independent supervision of all banks. Building institutions that facilitate project-based allocation of capital is particularly important to ensuring access to credit by micro, small and medium enterprises.

Avoiding capture

One of the lessons of political-economic transitions is that there is a risk of capture of the reform process by economic elites. A number of reforms promoting transparency in politics and legislation could have high payoffs in terms of reducing the risks of capture. Among the most important of these are: public disclosure of assets and incomes of candidates, public officials, legislators and their dependents; public disclosure of political campaign contributions by individuals and firms and of campaign

expenditures; and strengthening media freedoms and journalist's education.

Regulatory and procedural reforms that reduce the room for rent seeking behavior by public officials can also be introduced. The number and complexity of administrative interactions between businesses and public officials can be reduced. International standards and codes of good practice can serve a useful purpose by strengthening public scrutiny of policymakers. Regional organizations can play a role by vetting and establishing standards in such areas as foreign investment or competition policy.

The conduct of enterprise policy

Governments will need to collaborate with the private sector to define, carry out and evaluate policies aimed at increasing private investment and channeling it into high productivity uses. Managing the tension between close coordination and capture is a key challenge the post transition governments in the region will face.

The way in which the fast growing East Asian economies handled close coordination with the private sector may offer some practical guidance for North African governments. A defining characteristic of the East Asian model of policy formulation was a willingness to experiment. Policies

were developed in consultation with the private sector and then implemented. One way in which the flow of information was encouraged and the risk of capture was reduced was by focusing policy decisions and actions on very specific constraints. A timetable for resolution of the problem was announced and progress in implementation was monitored and reported. Feedback was an essential element of the policy process. The results – measured in terms of specific outcomes – were carefully observed. Where the chosen course of action failed to accomplish the desired outcome, usually – although not always – it was modified or abandoned.

Accelerating Structural Change

Creating a dynamic and competitive private sector is a major step toward generating growth and jobs, but private investment will need to flow into high value added activities if North Africa is to close its structural deficit with the more dynamic middle income countries. North Africa's economies will need an industrialization strategy to complement their initiatives to develop the private sector.

The Drivers of Industrial Location

As transport and coordination costs have fallen, it has become efficient for the production of different tasks to be located in different

countries, each working on a different step in the production process. Understanding in which countries and circumstances attempts to attract task-based production are appropriate and the nature of the constraints to trade in tasks are important underpinnings of an industrialization strategy for the region.

Often the critical constraints to industrialization are not technical. Rather they are complex and inter-related bodies of knowledge and patterns of behavior. These “firm capabilities” are the know-how or working practices that are used either in the course of production or in developing a new generation of products. Firms in the global industrial marketplace are competing in capabilities, and the location of industry therefore depends in part on how well economies acquire and diffuse capabilities.

Manufacturing and service industries tend to concentrate in geographical areas – usually cities – driven by common needs for inputs and access to markets, knowledge flows, and specialized skills. Because of the productivity boost that such agglomerations provide, understanding industrial agglomeration and designing appropriate public policies to attract a critical mass of industry is likely to be a prerequisite to breaking into global markets.

Strategies for industrial development

Not surprisingly, the appropriate policy responses to the region's industrialization challenge will vary from country to country. One set of public actions is cross cutting. This includes policies and investments directed at improving the "investment climate" – the regulatory, institutional and physical environment within which firms operate. But investment climate reforms alone will not be sufficient. Each North African country will also need an industrialization strategy to deal with the challenges raised by task based production, firm capabilities and agglomeration.

Breaking into export markets in a world of task based production and agglomeration will require more than piecemeal improvements in the investment climate. It will need an "export push": a concerted set of public investments, policy and institutional reforms focused on increasing the share of industrial exports in GDP. Improving trade logistics may be the single most important element of the export push strategy. Trade in tasks has greatly increased the importance of "beyond the border" constraints to trade.

Policies and institutions for attracting FDI are a key tool in capability building. In Egypt and Tunisia opening sectors which have barriers to foreign investors, such as retail and real estate, is an obvious first step. The second

step is to develop an effective foreign investment promotion agency. Beyond attracting FDI, removing obstacles to the formation of vertical value chain relationships – such as the regulatory separation of the offshore and onshore regimes in Tunisia – is a critical task for public policies aimed at capability building. The design of special economic zones to encourage close linkages with the domestic economy is critical.

Spatial industrial policies are a third, complementary, element of a strategic approach to industrialization. Case studies indicate that governments can foster industrial agglomerations by concentrating investment in high quality institutions, social services, and infrastructure in a limited physical area – such as a special economic zone (SEZ). Spatial policies may also play a role in the transfer and diffusion of firm capabilities. High capability firms tend to locate among other high capability firms.

Fitting strategies to objectives

North Africa faces at least three industrialization challenges, shaped by the way in which the income levels and factor endowments of its economies interact with the global determinants of industrial location. For the region's labor abundant, lower middle income economies – Egypt and Morocco – the challenge of breaking into global markets in task based

production is likely to be the most urgent. Tunisia faces the challenge of “moving up” in terms of export and product sophistication. The oil exporters – Algeria and Libya – confront a diversification challenge in the face of Dutch disease.

Clearly there is no single appropriate strategy for industrialization. The elements above will need to be combined in different ways to meet each country’s industrialization objectives. For Egypt the first priority should be to develop an export push by tilting incentives – including the exchange rate – toward exporters. In Tunisia a critical objective should be to develop programs to enhance the acquisition and transfer of capabilities. For Libya the obvious challenge is to build diversification objectives into post conflict reconstruction efforts.

Restoring Inclusive Growth

North African governments have at their disposal a number of public policies and actions to develop new strategies for inclusive growth. Among these are: improved access to jobs for the young, reform of education, decentralization of public expenditure and improvements in service delivery.

New jobs and skills

There are a number of short-run interventions that can make labor markets work better.

Active labor market policies, such as job search assistance, employability training, public support for apprenticeship and internship programs, and on-the-job training subsidies can be used to increase the employability of young workers. A more speculative area for public action would be to develop entrepreneurship initiatives targeted at the young. Some type of prize competition that provides a small start-up grant to applicants with a viable business plan might serve as a complement to cash for work programs – especially among the more educated. In the longer run labor regulations that discourage linking pay and job security to productivity and that limit hiring by smaller firms will need to be changed. These include regulations that set minimum wages, determine social insurance contributions and protect job security.

Education reforms are essential to improving skills and restoring public confidence in inter-generational equity. In the short run relating hiring for all government employment programs to the level of an individual’s productivity and skills (for example through evaluating language skills and writing) rather than to their credentials would help to increase the incentives for acquiring skills relevant to private employers. In the longer term the education system needs to be restructured so that those who do not complete secondary or tertiary degrees still

have useful skills to show for their effort. Changes in vocational and technical education including, especially, increased provision by the private sector are needed.

The increasing inequality of opportunity in education will need to be addressed. To break the link between private expenditure and educational success the quality of teachers and instruction in the public schools needs to be raised significantly. In the medium term governments will need to introduce pay for performance schemes into the primary and secondary education systems, place limits on outside income of teachers, and revise entrance examinations to weaken the link between rote learning and success.

Reforming public expenditures and services

Two areas for public expenditure reform—replacing the existing set of untargeted subsidies with “smart subsidies” and decentralizing public expenditure and service delivery – are important ways in which new governments in the region can address the issue of economic justice. A number of governments – including those in Egypt and Tunisia - have responded to the current crisis by ramping up the same untargeted consumer subsidies used in the past.

Energy subsidies are particularly inefficient and harmful to the environment. They are also highly regressive: 57 per cent of the subsidies in Egypt are captured by the top two quintiles of the population. About 28 per cent of food subsidies in Egypt never reach their intended beneficiaries, and a large part of untargeted food subsidies go to the richest groups. Replacing the current energy and food subsidies with direct income transfers to the poor would be fairer and more efficient.

Given the large regional income disparities in Egypt and Tunisia an obvious initiative is to decentralize some public expenditure and service delivery. Fiscal decentralization will require redefining the roles and responsibilities of central and local governments, accompanied by a robust capacity building effort to enable local authorities to deliver services. Regional and local governments will need to be given increased autonomy in expenditure and revenue decisions.

Public service providers in North Africa are by and large insufficiently accountable to the populations they serve. Decentralization of service delivery is one means of increasing accountability. Use of citizens score cards to evaluate service delivery – linked to performance incentives for service providers - may be another way of increasing the responsiveness of public institutions.

Governments in the region need to improve the quality and motivation of the people working in the public sector. Improvements in the quality and the productivity of some government services could be made by outsourcing non-core government tasks.

Regional Integration

Economic and political integration efforts have a long history in North Africa, but they have achieved few concrete results. The structural similarity of North Africa's economies severely limits the potential for intra-regional trade. North African countries are generally more complementary with their developed country trading partners than with their neighbors. Moreover, the existing regional agreements generally do not cover services trade.

Open regionalism – using regional agreements to integrate more fully with the global economy - represents an important tool to complement national economic policy. The first order of business in creating more effective regional integration is to rationalize and streamline existing agreements to eliminate overlapping and conflicting rules and administrative procedures. There is also an unfinished agenda of at the border reforms that need to be implemented: nontariff barriers to trade are more substantial in North Africa than in any other region of the world, and

they contribute more to overall trade restrictiveness than tariffs.

Regional initiatives to develop infrastructure are still at early stages and face many regulatory and financial challenges. As the history of successful regional integration efforts elsewhere has shown, building the governance structures that support the construction and maintenance of trans-border infrastructure is an important confidence building mechanism for eventual deeper integration. One such area could be in solar power. North Africa is a globally competitive location for Concentrated Solar Power (CSP), but a well-functioning regional power grid is critical to link generation with domestic and international consumers. This could become a priority area for regional cooperation within North Africa.

Building services trade, including the temporary location of services providers, and finance into the region's trade agreements would be an important step toward increasing firm capabilities and competitiveness. Extending regional agreements to cover the rights and obligations of migrant workers and to spell out codes of conduct for host countries would be a major step toward assuring greater transparency in the migration market and reducing the scope for political shocks to migration and remittance flows.

The International Response

Solutions to the twin problems of jobs and justice will ultimately need to come from the societies that fostered the Arab Spring, but the international community has a potentially strong complementary role to play. The financing needed to generate new jobs through accelerated structural change and to share the benefits of growth more widely is likely to place further strain on North African budgets. The picture may be even worse if any of the countries face contingent liabilities from their banking sector. The G8 Summit in Deauville announced significant support for Arab Spring countries, but only a small fraction of this was in the form of grants. New mechanisms to generate further grants are urgently needed.

The success of an export push in North Africa may depend as much on the actions of the European Union and the United States as on the actions of the region's governments. Progress between Europe and North Africa has been good in terms of manufacturing market access but liberalization of agricultural trade lags far behind. Lack of progress on agricultural trade inhibits the development of more advanced agro- and agro-industrial value chains.

The international community should be an important source of ideas that have worked in other transitions and a means of helping transitional governments anchor reforms in a multiyear perspective. For example it can assist new governments in the region in restructuring institutions such as FDI agencies and special economic zones to reflect global best practice.

Transitional governments cannot generally commit their successors to a long term economic program. The International Financial Institutions provide one mechanism for such longer term commitment through their multi-year programs. Supporting medium term institutional reform through its operations is potentially a lead role for the African Bank. To be effective, however, the African Bank would need to select a limited number of public actions on which to focus its financial and intellectual resources. One obvious area in which the Bank has pride of place is in regional integration. A second area could be in fiscal decentralization and the development of marginalized regions. Finally, the Bank is well positioned to engage with governments on a more strategic approach to private sector development and structural change.

I. Introduction

Since late 2010, sixteen countries in the Arab world have experienced some form of popular protests. North Africa has been the epicenter of the uprisings. In the course of the Arab Spring long-entrenched regimes in Egypt, Libya and Tunisia collapsed, and Egypt and Tunisia held meaningful elections in the Fall of 2011. Autocratic leaders were replaced by transitional governments, who must now face the tasks of securing legitimacy, rebuilding economies damaged by the political crises, and defining economic policies that will sustain more rapid and inclusive economic growth.

Two common economic themes — “jobs and justice” — underpinned the revolutions across North Africa, reinforcing the rejection of decades of political repression. This is not surprising. Post-independence Arab economies enjoyed nearly two decades of sustained and inclusive growth, but since the mid-1990s most economies in North Africa – and in the Arab world in general – have failed to create enough good jobs to

absorb the backlog of unemployed workers and a rapidly growing number of new labor force entrants. At the same time public employment and public expenditure — which during the 1970s and 1980s had helped to foster low poverty and relatively equal distributions of income – came under increasing fiscal pressure. Government jobs and consumer subsidies were no longer able to support inclusive growth. Surveys indicate that lack of economic opportunity, the rising cost of living and the growing gap between the rich and the poor were among the main drivers of popular discontent³.

This paper explores the causes, consequences, and courses of action for the economic transitions in North Africa. It focuses mainly on Egypt and Tunisia, but where data are available and issues are relevant, it also touches on the economies of Algeria, Libya, and Morocco.

Section 2 analyzes the economic origins of the political crises in North Africa: the failure

³ Third Annual Arab Youth Survey, ASDA/A Burston Marsteller, March 15, 2011.

of previous regimes to deliver jobs and justice. It first discusses the nature of North Africa's employment problem — one which has had its greatest impact on young, educated workers - and the closely related failure of the region's education systems to equip the young with the skills needed to compete in a globalized economy. It then turns to the question of economic justice. There is growing evidence that during the past decade a number of important dimensions of poverty reduction and equitable growth deteriorated in both Egypt and Tunisia. These included mixed progress on reducing poverty and inequality, stagnation of real wages, slow growth of public employment and growing regional inequalities.

Section 3 focuses on the short run. It summarizes evidence on the immediate impact of the Arab Spring on the economies of Egypt, Libya and Tunisia and discusses their prospects for recovery. It then turns to a discussion of the policy reform efforts of the transitional governments in each country and makes some recommendations for further policy actions.

Section 4 presents a longer run analysis of the structural problems that led to slow growth and weak employment creation in North Africa's economies. It presents

evidence that a failure to industrialize has led to a significant structural deficit in the region relative to Middle Income Countries that have been more successful at creating high productivity, good jobs.

The policy response to the structural deficit is set out in Sections 5 and 6. Section 5 takes up the important question of how public policy can foster the development of a more competitive, dynamic private sector. Section 6 outlines a strategy to accelerate structural change through active policies to push exports, strengthen firm capabilities, and promote industrial agglomerations. It also offers some guidance — drawn from the experience of East Asia – on how to develop close coordination with the private sector.

Section 7 returns to the theme of economic justice. It presents a number of policy options to strengthen inclusive growth. Among these are: new approaches to jobs and skills, reforming consumer subsidies, decentralizing public expenditures and investments, and strengthening service delivery. Section 8 explores how regional approaches can be used to complement national policies. Section 9 concludes with some ideas for action by the international community.

II. Economic Origins of the Crisis

Two failures have driven the popular uprisings in North Africa. One failure was political: over a period of more than 40 years Egypt, Libya and Tunisia all failed to develop pluralistic and open political systems. Governments in North Africa ranked among the world's poorest performers in terms of global surveys of voice and accountability (Kaufmann, Kray and Mastruzzi, 2010). There was little scope for citizens' participation in civic and political life or for access to and representation in government. The second failure was economic: governments in the region failed at job creation, especially for the young, and the economic policies which formed the basis for low poverty and relatively equal income distributions following independence started to unravel.

2.1 Jobs: lagging growth and employment creation

For more than three decades North Africa's economies have failed to grow fast enough to create sufficient good jobs. Following a period of rapid growth and job creation from the 1960s to the early 1980s, output and employment growth stalled. Between 1980

and 2010, per capita income growth in the region averaged only 0.5 per cent per year. In Asia per capita growth was about 4.5 per cent per year over the same period. Since 1980, the male unemployment rate in the region has been high and increasing. Unemployment has averaged about 12 percent over the past two decades, the highest rate of any region in the world. In 2008 unemployment rates in Egypt, Morocco, and Tunisia ranged from 9 to 15 percent (Figure 2.1).

Low per capita income growth and high unemployment are largely due to the very rapid rate of growth of North African populations. High natural population growth has resulted in rapidly rising labor supply. The region's labor force has been growing at an annual rate of 3-4 per cent since the mid-1980s.

The rapid increase in the labor force is offset to some extent by very low levels of labor force participation, especially among females. At about 48 percent, the labor force participation rate in North Africa is much lower than anywhere else. High unemployment,

together with low labor force participation, result in a smaller share of working age North Africans holding jobs than in any other region of the world. The employment-to-working age population ratio is well below 50 percent. In contrast the employment-to-working age population ratio ranges from 58 percent in Europe and Central Asia to over 70 percent in East Asia (Figure 2.2).

Women in North Africa face the most difficult employment prospects. Only two out of every ten working age women have jobs. Seven out of ten working age men are employed. Some of the difference is explained by low labor force participation among females, but the levels of unemployment among women actively seeking work suggests that many women in the region who want jobs are unable to find them. Women also face much longer waiting periods for employment than do men (Dhillon and Yousef, 2009).

Ironically, in the years immediately leading up to the Arab Spring North Africa experienced some of its highest GDP growth rates in decades. Limited exposure to international capital markets insulated the North African economies from much of the impact of the 2008 global financial crisis, and recovery from the global economic downturn, while not as impressive as that of other developing regions, was solid (Table 2.1). In Egypt

growth in 2009 was 4.7 per cent and in Tunisia 3.1 per cent. In Algeria and Libya growth in 2010 was 3.3 and 4.2 per cent, respectively (Table 2.2).

Yet, the region's improved growth performance did not result in sharply improved employment prospects, especially for the young. Every where in North Africa the growth elasticity of employment is less than unity, indicating that growth of employment lags behind output growth (Messkoub, 2008). In Egypt it has been estimated at 0.55 and in Tunisia in the range of 0.43-0.48. In addition although improved economic performance between 2002 and 2008 had a positive impact on job creation — in Egypt, Morocco and Tunisia unemployment rates fell — the jobs created favored older and more established workers and in some cases migrant laborers over new workers. The resulting perceptions of “jobless growth” lead to increasing discontent, especially among the young.

A crisis of youth employment

Slow economic growth, low employment elasticities of growth, and rapidly growing young populations in North Africa have produced the most serious problem of youth unemployment in the world. Driven by a delayed demographic transition, the share of youth (aged 15-29) in the Middle East and

North Africa has been rising over time and is now higher than in any other region (Table 2.3). In North Africa the population cohort in their twenties is the largest in history. The number of people aged 15-29 exceeds those in the 30-64 age groups (adults) in all countries except Tunisia⁴.

The average unemployment rate for those between the ages of 15 and 24 is about 30 percent in North Africa, compared to the world average of 14 percent. Youth unemployment is even more severe in Egypt and Tunisia than for the region as a whole. Globally there is a fairly regular relationship between the overall rate of unemployment and the unemployment rate of the young (Figure 2.3). Tunisia and, especially, Egypt both have youth unemployment rates that are higher than would be predicted from their overall rates of unemployment, indicating that what job creation has taken place has favored older and more established workers. Not surprisingly, a 2006/2007 Gallup Poll reported that young people in several countries in the region, including Egypt, Morocco and Tunisia, believed they faced poor and deteriorating employment prospects.

Youth unemployment in Egypt recently was estimated to be about 25 percent, a rate

similar to that of the late 1990s. Almost 90 per cent of all unemployed were in the age group 15-29. Unemployment is also increasingly concentrated in the educated young. Among young men in Egypt, university graduates have the highest rates of unemployment; among women, those with post-secondary education are most likely to be without a job (Assad and Barsoum, 2007).

Workers in Egypt between the ages of 20 and 24 reported searching for a job for an average period of 34 months. Young people from poor backgrounds are the most likely to enter the labor market early, taking lower quality jobs at the expense of completing their formal education. Middle class, urban youth have the longest job search times. Because they are able to depend more on family support, they can afford to search longer for good jobs than the poor. However, middle class youth lack the connections that wealthier youth draw on to secure decent jobs quickly.

Even when younger Egyptian workers find a job it is likely to be of low quality in terms of wages, benefits and job security. Recent data shows a decrease in the quality of jobs and lifetime earnings for Egypt's youth

⁴ Where the population aged 15 to 29 represents 29 per cent and people aged 30 to 59 represent 37 per cent of the total population (INS data).

beginning in the middle of the 1980s⁵. In Egypt 72 percent of new job market entrants are ending up in what can be described as “bad” jobs in the informal sector. For low-income youth, in particular, the quality of jobs available is of increasing concern. They are often pushed into unpaid family work or into the informal sector. Most of these jobs offer low wages, few benefits and few opportunities to build skills.

Mobility from informal to semi-formal and formal employment is low⁶. For the average Egyptian male the probability of graduating from informal employment to semi-formal employment is around 40 per cent, and to a formal sector job it is only 20 per cent. For the average female, the probability of graduating from informal employment to semi-formal employment is around 20 percent; to formal employment it is only 10 per cent. The transition between informal and formal employment is positively related to education for both men and women. University educated men tend to have a good chance of graduating from informal to either semi-formal or formal work. This is not the case for male workers with lower education. Poorly educated women tend to be pushed out of even informal employment and often out of the labor market altogether.

In Tunisia jobless growth has had a particularly acute impact on the young. The rate of unemployment of young workers in 2008 was estimated to be above 30 percent. While GDP in Tunisia grew 5.6 percent in 2006, and 6.3 percent in 2007, youth employment grew only 2.6 percent and 0.3 percent, reflecting a highly volatile and low (ranging from 0.47 to 0.05) growth elasticity. In part this was due to rising labor force participation by the young which reached a peak of 54.2 percent in 2006⁷.

As in Egypt, the Tunisian youth unemployment rate varies by level of education. It is lowest among young people who lack secondary education (20.5 percent in 2007). University education is associated with the highest rate of unemployment. The unemployment rate among university graduates in 2007 was 40 percent, compared to 24 percent for non-graduates. Non-graduates have a much lower rate of labor force participation (68 percent) than graduates (95 percent), and as a result, 57 out of 100 graduates work, compared to 52 out of 100 non-graduates (Stampini and Verdier-Chouchane, 2011).

University graduates in Tunisia tend to remain unemployed longer than their less well educated contemporaries. In 2007 the

⁵ Assaad and Barsoum (2007).

⁶ Wahba (2009)

⁷ Youth unemployment increased from 25.1 percent in 2006 to 26 percent in 2007.

average duration of unemployment for those with a university degree was 28 months. Non-graduates had an average duration of unemployment of 19 months. Education also matters for the quality of employment. Formal employment is strongly associated with educational attainment. Casual and seasonal wage employment and self-employment is concentrated among individuals with less than tertiary education.

Gender differences among young job seekers are important in Tunisia but less striking than in most other countries in North Africa. Young women in Tunisia are less likely to be employed than men with equal educational attainment. For women with secondary education or less, this is due to lower participation in the labor force. The labor force participation rate is 36 percent for women without secondary education; it rises to 62 percent for women with a secondary school degree (versus 91 and 97 percent for equally educated men). Holding a vocational training or university degree reduces the gender differences in labor force participation. In contrast with Egypt women with university education show patterns of job mobility that are similar to those of equally educated men (Stampini and Verdier-Chouchane, 2011).

In Morocco job creation has similarly failed to reach urban youth, women, and educated workers. Urban unemployment nearly doubled

between 1982 and 2000, rising from 12 to 22 percent, before falling to 17 percent in 2007. Employment prospects for youth in urban areas in Morocco are particularly bleak. Nearly 76 percent of unemployed Moroccan youth live in urban areas. Sixty-one per cent of young people in Morocco with secondary education or above are unemployed, compared to 8 percent of those with less than secondary education (Subrahmanyam, 2011). Job search times rise with educational attainment. About two-thirds of the unemployed holding secondary level degrees or higher are unemployed for at least a year. University graduates face more than 40 months of unemployment before finding their first job.

A widening skills mismatch

A major source of the youth employment problem is a severe mismatch between the skills possessed by young workers and those demanded by private sector employers. The public sector remains the primary employer of university educated labor, and a degree – preferably from a good university – is the main qualification for being hired into the civil service or into a state owned enterprise. More than half of university-aged Libyans are enrolled in post-secondary education, and 28 percent of the university aged population is enrolled in Egypt and Tunisia.

Because the content of the degree is

secondary to the credential, North Africa's universities feel little pressure to teach the skills needed for success in a globalized labor market. University curricula place excessive emphasis on rote learning and fail to teach skills in mathematics, abstract thinking and science effectively. Large class sizes have resulted in deteriorating quality of instruction and an emphasis on multiple choice testing.

The North African countries that submit to international tests of learning achievement tend to score poorly on mathematics and cognitive reasoning relative to other countries at similar levels of income. For example the Program for International Student Assessment of the OECD ranks the quality of secondary education in Tunisia near the bottom of a sample of 65 middle and upper income countries⁸. Egypt and Morocco fall below the benchmark for lower middle income countries in international assessments of math and science achievement (OECD, 2009).

As educational quality and relevance have declined, returns to schooling – especially at levels below university – have fallen. In Tunisia private rates of return to education which averaged 8 percent in 1980 fell to 4.4 percent by 2001. Rates of return in

Egypt have been persistently low (5.7 percent in 1988 and 5.5 percent in 1998) and declining. In Morocco private rates of return to education averaged some 16 percent in 1970; by 1999 they had fallen to about 8 percent. In all three countries the estimated returns to schooling are very low or zero for levels of education below university, and in some cases the returns to primary education are negative (Salehi-Isfahani et al, 2009). These returns are considerably below the average rates of return to schooling observed in other middle income countries which range from 8 to 13 percent (World Bank, 2008).

Ironically, the failure of the education system is not due to lack of attention by North African governments or resources. Access to education has increased at all levels of instruction. Between 1970 and 2003 North African countries nearly reached full primary education enrollment and increased enrollment in secondary schools and at the post-secondary level almost three and five times. Over the last 40 years, the region on average has dedicated 5 percent of GDP and 20 percent of government expenditures to education, more than other developing regions at similar levels of per capita income.

⁸ See OECD (2009) and Stampini and Verdier-Chouchane (2011).

2.2 Justice: The failure to sustain inclusive growth

The Arab economies of the 1970s and 1980s were marked by low poverty and relatively equal income distributions, sustained in large measure by subsidies, public employment and migrant remittances (Box 2.1). Changes in migration patterns, demographic pressures and fiscal retrenchments have strained these traditional sources of inclusive growth. The institutions which once supported intergenerational mobility and improved economic well-being for the less advantaged are no longer perceived to be working.

The popular sense that the benefits of recent growth were not shared by the population at large is tellingly illustrated by opinion polls. The share of the population describing themselves as “thriving”—a combined measure of current and future expectations of economic well-being—has declined across North Africa over the past few years (Figure 2.4). Algeria, Egypt, Libya, Morocco, and Tunisia all show low and declining levels of satisfaction (Graham, 2011). In Egypt and Tunisia, despite steady growth in per capita GDP, the share of those describing themselves as thriving fell rapidly after 2005 (Figure 2.5).

Mixed progress on poverty and inequality

Measured by both national and international

poverty lines, poverty decreased in Egypt and Tunisia in the 1990s. In Morocco low and volatile growth resulted in an increase in poverty during the 1990s, but reversed after 2000 when growth accelerated and poverty declined. Since 2000 data on inequality and poverty present a mixed picture of progress on poverty reduction and equity (Table 2.4).

Between 1999/2000 and 2004/05, the overall poverty rate in Egypt fell, but the number of extreme poor increased. The 2004/05 *Egyptian Household Income, Expenditure and Consumption Survey* reported a total national poverty rate of 40.6 per cent, representing 28.1 million people. Almost half of these (19.6 per cent of the total population) were classified as absolute poor, because they had insufficient income to meet their basic needs, and within the absolute poor there were 2.6 million defined as extreme poor (3.8 per cent of the population) because they could not even afford basic food requirements. The Gini coefficient declined from 0.34 in 1999/2000 to 0.32 in 2004/05, indicating a small improvement in income distribution.

In Tunisia rapid growth of per capita income between 2000 and 2005 (4.4 per cent per year) was accompanied by a sharp increase in inequality. The Gini coefficient increased from 39.3 in 2000 to 42.1 in 2005, attenuating the poverty reducing impact of growth. This

stands in marked contrast to the performance of the Tunisian economy during the 1990s, when during a period of low growth in GDP per capita (1.2 per cent per year) income distribution remained virtually unchanged.

Deteriorating prospects for public employment

Following independence most Arab governments looked to the public sector as a key instrument of economic and social change (World Bank, 1995). In Egypt and Morocco explicit job guarantees were offered to high school and university graduates. In Tunisia, the government offered the best pay, benefits, and job security. Public employment offered job security, high wages, generous nonwage benefits such as family allowances and social security programs (Dhillon and Yousef, 2009).

Public employment expanded rapidly in the 1960s and 1970s. In Egypt for example, employment in the public sector doubled from 16 percent of the labor force in 1960 to 32 percent by 1981 (Assaad, 1997). By the 1990s the countries of North Africa had some of the largest public sector labor forces as a share of working population in the world (Table 2.5). The majority of the region's public employment is in government administration. Some 10.5 percent of total employment in the region is in general government administration,

compared with about 4-5 percent in other developing regions.

Beginning around 1990 governments found it increasingly difficult to sustain guaranteed employment and superior working conditions in the public sector. The fiscal retrenchments of the 1990s and the privatization of a large number of public enterprises resulted in a sharp slowdown in the growth of public employment. In Tunisia the net annual increase in civil servants during the last decade has averaged about one per cent of the public sector work force. Faced with declining revenues and increasing numbers of labor force entrants, governments across North Africa increased the minimum educational standards for public employment, requiring at a minimum a university degree.

In both Egypt and Tunisia the labor market adjusted in part by educated labor force entrants accepting increasingly longer waiting periods for public sector employment. Other new graduates sought work in the private sector or informal self-employment. Both first time job seekers and their parents perceived a failure of the state to honor the employment guarantee.

Declining real wages

Lack of real wage growth during the last two decades has been one of the contributing

factors to the region's declining sense of economic wellbeing. Wage data are spotty both across countries and over time, but there is evidence that in Algeria (1992-1996) and Egypt (1982-2003) average overall real wages declined (ILO, 2004). More comprehensive data on the manufacturing sector indicate that real manufacturing wages declined in most North African economies in the 1990s and then remained largely unchanged in Algeria, Egypt, Tunisia and Morocco after 1995 (Figure 2.5).

With growing output per worker and stable or declining real wages the functional distribution of income moved against labor. Productivity improvements over the past 20 years were not passed on to workers. In Egypt for example the index of real GDP per person increased by 40 per cent between 1980 and 2003, yet real wages declined over the same period. This is not altogether surprising, given the extent of excess supply in the labor market, but it has undoubtedly increased the perception that economic welfare was declining for the average Egyptian, despite economic growth.

Growing regional inequality

Both Egypt and Tunisia have experienced growing inequalities along regional and rural-urban lines, and—especially in Tunisia - regional inequality was one of the major

contributing factors to social unrest. Over the period 2000 to 2005 governorates in the North and Middle East of Tunisia benefitted disproportionately from public expenditure and investment (Bibi, 2011). Coastal areas received 65 per cent of public investment, leading to rapid income growth and poverty reduction. Two of the three governorates in the Middle West on the other hand – Sidi-Bouzyd and Kasserine – failed to benefit at all from national growth, experiencing stagnant or declining living standards. Poverty rates in the two governorates either remained stable or increased. A similar pattern occurred in the South East. Overall, of Tunisia's 21 governorates (including the capital) seven experienced rising poverty levels between 2000 and 2005 (AfDB, 2011).

There are also significant differences in poverty and inequality across regions in Egypt and between rural and urban areas, even within the same region. Poverty is worst in Upper Egypt among both rural and urban dwellers. Fifty-four percent of Egypt's poor live in the Upper Region which has just 26.7 percent of the total population. More than half of the population of Asyut is poor. Rural areas in all regions have higher poverty than urban areas. Poverty incidence is between 77 and 90 percent higher in rural areas. Although 41.5 percent of the population resides in urban areas, they contain just 23 percent of Egypt's poor.

Deteriorating public service delivery

One element of the growing dissatisfaction with the inclusiveness of growth in Egypt and Tunisia was a collapse in satisfaction with public services (Figure 2.7). Between 2009 and 2010, satisfaction with public transportation systems in Egypt fell by 30 percentage points. Satisfaction with efforts to improve the environment fell by 15 percentage points and satisfaction with housing services fell by 14 percentage points (Gallup Report, 2010). Housing and healthcare show similarly large declines in Tunisia. Even satisfaction with schools and education, which had been seen by international organizations as a relative success in the Arab world had started to fall (Arab Human Development Report, 2010).

The failure of education is perhaps the greatest single source of perceptions that public services have failed to promote inclusive growth and inter-generational mobility. Rising enrollments and limited resources for education at the primary and secondary levels forced schools to enlarge class sizes and use multiple-choice tests. Public education systems in North Africa rewarded rote learning and skills that lent themselves to multiple-choice testing (World Bank,

2007, Arab Human Development Report, 2003).

Tighter competition for the limited spots in top schools has produced growing inequality of opportunity in education. Families spend large amounts on private schools and private tutoring in an effort to secure university entrance. In 1994 64 per cent of urban and 51 per cent of rural primary-school age children in Egypt had received supplementary tutoring (Bray and Kwok, 2003). In 1997 household expenditures on supplementary tutoring in Egypt were 1.6 per cent of GDP (World Bank, 2002).

The increasingly tight link between private expenditures and educational success has resulted in rising levels of inequality of opportunity in education. The share of differences in educational achievement – as measured by test scores in science and mathematics - that is explained by family background and community characteristics is estimated to be about one third in Egypt and Tunisia, and one-fourth in Libya. These are levels that are more characteristic of Latin America than the Arab Middle East. Only Algeria and Morocco have maintained relatively low inequality of educational opportunity (Salehi-Isfahani et. al., 2011).

III. Managing the Short Run

Like countries such as Indonesia after Suharto (Box 3.1), Egypt, Libya and Tunisia are undergoing both a transition away from autocratic rule and a transition away from an economy dominated by the public sector and a group of family and close associates in the private sector. Tunisia's transition to democracy took an important first step with the conclusion of successful elections for a constituent assembly in October (Box 3.2). Egypt's elections were more contentious, but also appear to have been largely successful. Libya's democratic transition is at a much earlier stage.

The interim governments in Egypt and Tunisia face a number of pressing short run economic problems – the pressure to generate employment perhaps foremost among them - while at the same time they have limited scope for action. Libya faces a major reconstruction challenge. How the current governments manage these transitional economic problems will have important longer run implications for the region's post transition economic success.

3.1 From Crisis to Recovery

The political crises and subsequent changes

of governments in Egypt and Tunisia have resulted in sharp contractions of economic activity in both countries. In Libya the need to reconstruct the economy following months of violent conflict will undoubtedly impose significant costs.

Short run impacts

Investor and consumer confidence was badly shaken by the revolution in Egypt. Banks and the stock exchange closed. Tourism collapsed, and a series of labor strikes for higher wages -- mainly affecting the public sector - further disrupted economic activity. The tourism, manufacturing and construction sectors have picked up from their immediate post revolution lows but they continue to produce substantially below capacity. Unemployment has increased to almost 12 percent and the youth unemployment rate to about 24 percent. (Sahay, 2011).

Egypt's current account has held up relatively well, with remittances and net exports compensating for the collapse of tourism receipts, but the capital account has

weakened substantially, due to portfolio outflows (mainly T-bills held by foreigners) and a sharp drop in foreign direct investment (FDI). International reserves declined from \$43 billion to about \$26 billion (about five months of imports) in the first seven months of 2011. (IMF, 2011).

In Tunisia property damage arising from the revolution has been estimated at four per cent of GDP. In addition growing insecurity and social tensions caused sharp reductions in tourism revenue (-46 per cent) and foreign investment (-26 per cent) in the first half of 2011, compared to the first half of 2010. Industrial production fell by 6.8 per cent. GDP declined by 3.3 per cent in the first quarter of 2011. A key uncertainty for Tunisia (where the third quarter, on average, has accounted for almost 40 percent of total annual tourist arrivals) is how many visitors returned in time for the peak summer season. (AfDB, 2011).

Somewhat surprisingly, the trade balance in Tunisia improved during the first four months of 2011 due to an increase in European demand and the contraction in domestic activity. The low season for tourism also helped to moderate the impact of the fall in tourist arrivals on the current account. At the end of the first quarter of 2011, the current account deficit had improved compared to the same period in 2010. However, foreign

exchange reserves dropped from TND 12.929 billion on 14 July 2010 to TND 9.712 billion on 14 July 2011 due to capital flight and a decline in FDI.

A steep fall in oil production and exports, combined with an expected decline in foreign direct investment, has resulted in forecasts that the Libyan economy will contract by about 28 per cent in 2011. This estimate however is based on the assumption that oil output will pick up before the end of the year. Inflation which averaged 2.5 per cent in 2010 is expected to rise to 6.1 per cent in 2011, largely driven by rising food prices.

The Libyan revolution has had important knock-on effects for both Egypt and Tunisia. Trade flows have been disrupted, and impact on Tunisia's foreign trade is estimated to have been a fall of about 6 per cent of total exports. The violence has also resulted in the return of more than 100,000 migrant workers to Egypt and Tunisia, as well as substantial short term migration of Libyans into both economies (Santi et. al., 2011).

Prospects for recovery

Real GDP growth in Egypt slowed to 2 percent in 2010/2011 from 5.1 percent in 2009/2010. In 2011/12 the sectors hit hardest by the unrest such as tourism,

manufacturing, construction and retail trade are expected to make a modest recovery. However, growth will be held back by the uncertain political environment. In early June the interim Government announced a budget for the FY 2011/12 which provides space to mitigate the economic slowdown and enables higher spending for job creation. The planned increase in domestic budget financing, however, may put upward pressure on domestic interest rates and crowd out private credit. Growth is expected to accelerate only very gradually and may again reach about 2 percent for 2011/12 (IMF, 2011).

Projections suggest that GDP growth in Tunisia will range between -2.5 per cent and 1.1 per cent in 2011, due to lower demand for tourism, disruption of economic activities and reductions in foreign direct investment (AfDB, 2011). Private investment will contract, while current public spending, particularly the wage bill, will rise significantly to meet increasing social demands. Economic recovery in 2012 will depend on the normalization of the political situation after the October elections and the impact of the recovery plan implemented in the spring of 2011.

The revival of Libya's oil sector offers some promise of a relatively prompt recovery for the economy. In spite of the complete halt

in oil production and exports between April and late August, Libya was allowed to retain its official production quota of 1.47m barrels per day by OPEC. In September Libya resumed oil production. ENI the major oil company signed a Memorandum of Understanding in August with the de facto Government and started lifting oil in September. Similarly the Arabian Gulf Oil Company (Agoco) has resumed production. As oil revenues return, there is considerable potential for the non-oil sector to grow during reconstruction. Infrastructure programs will support the construction, utilities, communication, transport and financial sectors.

Uncertainty and the perception of insecurity will continue to affect tourism and private investment across the region. For 2011 as a whole, receipts from tourism are projected to decline in both Egypt and Tunisia by up to one per cent of GDP. FDI in both countries is projected to contract by between one and two per cent of GDP. Past experience suggests that the region's tourism industry could recover fairly quickly. Following the November 1997 terrorist attacks in Luxor, tourist arrivals in Egypt fell by about half, but recovered fully after about one year. Cross country studies of how tourism responds to outbreaks of violence indicate that the effect is transitory. Estimated recovery times after an outbreak

of violence range between 2 and 21 months⁹.

Investment is likely to take longer to recover, as investors wait for clear indications of the economic policies to be pursued by newly elected governments. Lenders have increased the risk assessment of sovereign and corporate debt, raising borrowing costs across the region. Between January 10—around the time mass protests began in Tunisia—and mid-March, government bond spreads widened by 30–50 basis points in Morocco, and by over 100 basis points in Egypt and Tunisia. Credit default swap spreads showed similar movements. There has also been substantial capital flight. The Institute for International Finance estimates that \$16 billion has been withdrawn by investors from Egypt alone. Equity markets have fallen about 10 percent in Morocco 18 percent in Tunisia and 25 percent in Egypt (Sahay, 2011).

3.2 Policy responses in the transition

Because the revolutions in Egypt and Tunisia began partly in response to widespread economic discontent, the

transitional governments in both countries have been faced with high expectations on the part of their citizens for short run policy actions to address economic hardships. Transitional governments have moved cautiously on economic policy reform, but they have attempted to address popular demands for employment creation and social safety nets.

Economic management

In response to popular demand Egypt's government has introduced some budget actions that could prove costly in the medium run. The list includes permanently hiring 450,000 temporary employees and premature payment of a 15 percent bonus to civil servants and pensioners. The government's offer to accommodate requests for employment generated seven million applications. These measures—together with the announcement that the government is working to adjust the public sector wage structure and increase the minimum wage - have rekindled expectations that the public sector is primarily responsible for providing good jobs.

Egypt has both the largest deficit and the largest stock of debt in the region. Low tax

⁹ See Frey, Luechinger, and A. Stutzer (2007) and Neumayer (2004).

collections, higher food prices, and spending pressures have led to a widening of the fiscal deficit, which is estimated to have increased to just below 10 percent of GDP in 2010/11 from about 8 percent in 2009/10. The debt-to-GDP ratio is estimated to have increased to 76 percent at end-June 2011 (IMF, 2011).

On the 22nd of June, the government cut its deficit target from 11% to 8.6% of GDP. Total spending was reduced from \$87.4bn to \$82.4bn, including a reduction of \$600m in energy subsidies. The government discontinued negotiations for IMF and World Bank loans and announced plans to finance the deficit by domestic borrowing of \$20bn and grants. Saudi Arabia and Qatar provided \$500m in grants in May.

The interim government has recognized that Egypt needs to diversify its debt term structure and decrease its dependence on domestic borrowing. The public debt has a short maturity structure. The annual rollover is 25 percent of GDP, and local lenders have nearly reached the maximum amounts allowed to lend to the government. Yields on treasuries have increased steeply. Recently the government announced that it intends to accept the funding package of US\$ 3.2 billion from the International Monetary

Fund (IMF) that it had rejected earlier this year, due to increasing difficulty in financing the deficit domestically.

In June 2011 the Tunisian government adopted a supplementary finance law which provides for an 11 per cent increase in public spending to promote employment and support disadvantaged regions. The supplementary finance law has maintained commodity subsidies totalling TND 1.3 billion despite an increase in the prices of raw materials, cereals and hydrocarbons. The interim government also introduced an employment program for both skilled (AMAL) and unskilled workers (AMAL II), and promised recruitment of about 20,000 exceptional civil servants. These employment support mechanisms are estimated to cost about 0.7 per cent of GDP. The interim government also increased public investment allocations and transferred additional resources to local governments in poor regions, and adopted an basic social services package for underserved regions¹⁰.

In Tunisia projections forecast a 4.3 percent of GDP deficit and a debt to GDP ratio of 43 percent. Monetary policy is focused on support to the banking sector which remains very fragile. The public banks on which the old

¹⁰ Circular No. 14 of May 23, 2011.

regime relied to sustain loan portfolios in sectors like tourism and transport are particularly vulnerable (AfDB, 2011). In May 2011 the Central Bank issued a circular outlining good governance practices in the banks.

The fiscal deficits in both Egypt and Tunisia are largely driven by transfer and subsidy programs. The sharp increase in international fuel and food prices since late 2010 has led to substantial additional fiscal costs across the region (Table 3.1). The increase in food and fuel prices alone will cause an increase in the fiscal deficit of 2.8 per cent of GDP in Egypt, 2.3 per cent in Morocco and 1.6 per cent in Tunisia, if existing subsidy program are maintained.

North African economies have not experienced strong currency depreciations. Central banks in both Tunisia and Egypt have intervened to keep the exchange rate relatively stable. The Egyptian pound has depreciated by less than 5 percent over the last 12 months. The dinar depreciated in 2010 but has appreciated in 2011. In Egypt a further drawdown of reserves will likely be needed to cover an estimated balance of payments shortfall of about \$ 8.5 billion. This would reduce international reserves to about \$18 billion or 3 months of imports, unless the authorities mobilize additional grants or change their position on official foreign borrowing for the budget.

Structural and governance reforms

Little appears to have been done on structural reforms in either Egypt or Tunisia. This is not altogether surprising. The history of transitions in other countries suggests that early transitional governments tend to shy away from changes to the legal and regulatory system beyond attempts to eliminate the worst manifestations of the insider dealing that characterized previous regimes. Fragility in the banking system in both countries also limits the scope for financial sector reforms.

The government in Egypt has made relatively little progress on governance reforms, including efforts to increase transparency and inclusion. The legal environment still very strongly restricts civil society participation in the economic reform process. In Tunisia the interim government has undertaken a number of reforms designed to improve access to information and encourage public debate. It established the right for citizens to gain access to public information and data, and the interim authorities published several documents related to public finance—the annual reports of the Court of Accounts, budget execution reports, PEFA reports - that were never published during the prior regime. Recently an open debate on the poverty rate has taken place between the

national statistical institute (INS) and Ministry of Social Affairs¹¹.

The Tunisian government also issued the five year “Jasmine Plan” in September 2011, immediately prior to the elections (Box 3.3). The plan sets out an agenda of structural and governance reforms intended to increase social justice. Of the ten priorities set out in the plan, almost half are related to the democratization process, including establishing trust through transparency, social responsibility and citizen participation, and rehabilitating the public service and civil action.

3.3 Policy options for the short run

While it is difficult for the current governments in Egypt and Tunisia to undertake major new economic policy initiatives, some additional public actions for managing the transition are appropriate. A critical measure of their success will be the ability to address short term needs and political pressures with policies that do not prevent deeper reforms once a permanent, elected government is in place.

Economic management

Governments in both Egypt and Tunisia will continue to face the challenge of establishing a macroeconomic management program that both attracts significant public support and helps to restore investor confidence. For both countries the major macro-management issue is phasing in deficit reduction in the face of popular demands. It will not be tenable for Egypt to continue to borrow heavily over a three to four period. Tunisia may be able to do so but would risk undermining business confidence.

In the short run the governments in both countries can take the following steps:

- Resist the tendency to increase the fiscal deficit in response to rising expectations.
- Change the composition of public expenditures while leaving aggregate public spending unchanged, for example by expanding programs to benefit the poor and increasing public infrastructure investment.
- Seek long term grants to finance public deficits and link this support to actions to reduce public consumption spending.

¹¹ In May 2011, Ministry of social affairs published its own poverty data which differed from the official poverty rate published by the INS.

- Pursue a more active exchange rate policy to encourage private investment in tradables.

Because a key objective of the macro program should be to restore business confidence, outreach and communication efforts are critical ingredients of success. Governments should conduct broad-based consultation with stakeholders on the budget (Brookings, 2012).

Employment policies

In the short run pressures to address the employment problem – especially among the young – will remain high. Temporary employment programs that provide public sector employment to the highly educated are likely to perpetuate the attitude that the public sector bears the primary responsibility for creating good jobs. Instead, governments can target young workers in severely affected sectors, such as tourism and construction, with programs that offer cash for work, providing temporary income earning opportunities to those youth most impacted by the crisis. Governments might also experiment with increasing budget allocations to labor intensive public works.

In Egypt and Tunisia, there are several government funded active labor market programs, but they reach a very small

number of beneficiaries, mostly tertiary educated young urban males, and there is little evidence of their effectiveness. Instead, programs can be developed to temporarily subsidize the recruitment and training costs of first time job seekers in the private sector. Argentina and Chile for example have successfully designed and implemented programs to provide semiskilled training to large numbers of young job seekers. To begin to address the skills mismatch governments in Egypt and Tunisia might experiment with employment initiatives that reward specific skills rather than credentials. For example tests for language skills could be used to screen applicants for cash for work employment programs in tourism.

Structural and governance reforms

One Indonesian lesson for Egypt, Libya and Tunisia is that there is a high probability that the pre-crisis vested interests will become important players in the political transition. If this occurs, it will become harder for to implement structural reforms. One possible response would be to design a program of policy and institutional reforms in specific localities (such as export processing zones) where red-tape and bureaucracy can be quickly reduced without threatening vested interests too severely (Brookings, 2012). In Tunisia this would build on a generally

acknowledged success and might provide additional incentives to investors to locate or remain in the zones. In Egypt it could strengthen a moribund free zone policy.

Governance reforms during the transition are also critical to the legitimacy of the transitional governments and to their ability to conduct economic policy. In particular there is a need to reinforce the role of civil society in economic management in both Egypt and Tunisia. Timely publication of the budget for example would promote transparency and allow civil society to open a dialogue on budget

priorities. Addressing corruption forcefully through freedom of information, anti corruption commissions, courts and other institutional means is another priority.

At least two such reforms have taken place. In Egypt the government has removed the requirement for media companies to register with the security services. In Tunisia the very active role of the Economics Association in scrutinizing the economic programs of political parties represented an important first step towards civil society participation in economic policy debates.

IV. Structural Change, Growth and Employment creation

Economies that have made the transition from low income to high income status typically have experienced significant changes in their economic structure (Kuznets, 1955; Chenery, 1986). Although some structural change has been under way in North Africa for at least four decades, it has not been sufficient to sustain rapid economic growth and employment creation. Whether gauged by, No North African economy has undergone the kind of economic transformation in terms of the diversification of industry and exports, their sophistication, the level and composition of private investment, or the productivity and capabilities of firms seen in such middle income economies as Brazil, China, Malaysia, Mauritius and Turkey.

4.1 North Africa's structural deficit

One way to measure the extent to which the region's current economic structure differs from middle income countries that have successfully sustained growth, job creation and poverty reduction is to compare North Africa to a benchmark. North Africa is a

middle income region. Its major non-oil economies are found in the bottom half of the distribution of countries classified as middle income by the World Bank. Egypt and Morocco are lower middle income countries. Tunisia is an upper middle income country but ranks barely above the upper middle income threshold.

An appropriate benchmark might, therefore, be the structural characteristics of a sample of non-North African economies at the time at which they crossed over the level of income defining upper middle income status. In 2010 the upper middle income threshold as defined by the World Bank was US\$ 3975 Gross National Income (GNI) per capita. Using this threshold the following benchmark countries and years were identified: Brazil (2005) Chile (1995) China (2009), Malaysia (1995), Mauritius (2003), Thailand (2010) and Turkey (2004). The simple averages of the sectoral shares of value added and the labor force for these countries and years appear in Table 4.1 as the structural

characteristics of the benchmark Middle Income Country¹².

Differences between the North African economies and the benchmark—the “structural deficit” - are striking. Agriculture bulks larger in Egypt and Morocco than in the benchmark, and it continues to employ a relatively large share of the labor force. This reflects both the lower incomes of these economies relative to the benchmark and the slow progress of structural change in the region. The share of agriculture in GDP in Tunisia is about the same as in the benchmark. The relative productivity of agriculture in all three economies is below that of the benchmark economy, another symptom of lagging structural change.

From the perspective of creating good jobs the small share of manufacturing value added in total output is worrisome. Even Tunisia, the region’s consensus industrial success story trails the benchmark by nearly 12 percentage points of GDP. Manufacturing employment shares similarly trail the benchmark figures. It is also striking that the relative productivity of manufacturing in the Tunisian economy is much lower than for the benchmark. This suggests that manufacturing growth in Tunisia, while more robust than in either

Egypt or Morocco, has been concentrated in low productivity activities.

The relative importance of industry other than manufacturing in the region – and its high relative productivity - largely reflects the resource dependent nature of the North Africa’s economies. Algeria and Libya are the most extreme examples of resource dependency, but Egypt and Morocco also display some of the structural characteristics of resource dependent economies.

The service sector in Morocco and Tunisia is larger as a share of the economy than in the benchmark, while in Egypt it is similar in size. Services in North Africa are highly diverse, ranging from high productivity sectors, such as banking, insurance and finance, to very low productivity informal activities such as street vendors. The difference between Egypt and Tunisia on one hand and Morocco on the other in the relative productivity of services probably reflects differences in the degree of informality within the services sectors of the three economies.

The slow evolution of North Africa’s economic structure and the relative decline of the manufacturing sector make it likely that

¹² For further details on constructing such a benchmark see Bevan et.al. (2003) Small island economies and economies with populations of less than one million were excluded. Countries for which labor force data near the benchmark year were not available were also excluded.

during the past 20 years there has been a shift in the composition of employment toward lower productivity jobs. Such a pattern of “growth reducing structural change” would not be unique to North Africa (Table 4.2). In Asia movement of workers from lower to higher productivity sectors helped to increase the overall rate of productivity growth between 1990 and 2010. In Latin America and Africa, however, structural change worked to offset productivity improvements within sectors, reducing the overall rate of growth (McMillan and Rodrik, 2011).

The data for Egypt, Morocco and Tunisia do not permit a full decomposition of the structural sources of productivity change¹³. Consistent data on manufacturing employment are not available for a sufficiently long period of time. The data do, however, provide partial evidence of growth reducing structural change in the region. The share of manufacturing in total output and employment, as well as absolute levels of employment in the manufacturing sector, has been stagnant or declining in North Africa since the 1990s (ILO, 2009). In Tunisia for example the share of value added in manufacturing declined from a peak of 21.5 per cent in 2002 to 17.6 per cent in 2010. The share of manu-

facturing employment in total employment also fell from 18.9 per cent in 2005 to 18.2 per cent in 2010. In Egypt the share of manufacturing value added in GDP fell from 17.8 per cent in 1990 to 16.0 per cent in 2010.

In both Egypt and Tunisia the services sector has absorbed much of the increase in the labor force since around 2000. A large proportion of service sector jobs in both economies are informal and characterized by low productivity and low wages. Trade and small scale repair shops (auto as well as household goods) are the only service activities that have grown rapidly in the last decade. Employment in high productivity service activities has grown very slowly.

In Tunisia the employment share of services increased from 48.4 to 48.9 per cent of total employment, while relative productivity in services declined marginally over the same period. The share of value added in services in Egypt declined from 52 per cent of GDP to 49 per cent, between 1990 and 2010, while the share of total employment in the services sector increased from about 40 per cent to more than 48 per cent, indicating substantial declines in the relative productivity of service sector employment.

¹³ For an explanation of the method see McMillan and Rodrik (2011).

These indicators suggest that North Africa, like Latin America and Africa south of the Sahara, has experienced a relative shift in the composition of employment toward sectors that create too few high productivity, good jobs. Cross country evidence further suggests that this pattern of growth reducing structural change is associated with an increase in poverty (Page, 2011).

4.2 The failure to industrialize

The limited extent of structural change mainly reflects a failure of North Africa's economies to industrialize. Industry contributes to structural change on at least three levels. First, it is a high value added sector into which labor can flow. Second, large productivity differences between firms within the industrial sector – often related to firm size – offer the scope for further labor reallocation from less efficient to more efficient enterprises. Third, two important structural characteristics related to the types of products produced by the manufacturing sector – diversity and sophistication – influence productivity change and growth in the whole economy.

Lack of industrial dynamism

Table 4.3 presents some basic indicators of industrial development for Egypt, Morocco and Tunisia. The region's share of manufacturing

in GDP is low, relative both to developing countries as a whole and, especially, to East Asia. Egypt, Morocco and Tunisia all have shares of manufacturing in GDP of about 17 per cent. This compares with an average share for all developing countries of about 22 per cent and of East Asian economies of about 30 percent. The rate of growth of the manufacturing share of value added in all three countries is negative, indicating that the manufacturing sector is declining in relative importance.

The level of manufactured exports per capita in Egypt is particularly low at less than US\$ 100 per capita. In Morocco it is only about 60 per cent of the average for all developing countries. Tunisia on the other hand has a level of manufactured exports per capita that compares favorably with East Asia. Egypt, Morocco and Tunisia mainly export very simple manufactured products. The share of medium and high technology exports in total manufactured exports—an important indicator of learning by exporting – is very low in comparison to other developing regions. For Egypt it is about 20 percent of the developing country average. Morocco and Tunisia perform somewhat better at 48 and 41 percent of the average for developing countries. All three countries perform particularly poorly compared to East Asia. Morocco, the region's best performer, has a medium and high technology share of less

than 30 percent of East Asia's. Egypt's relative share is 12 percent.

A more positive sign is found in the growth rate of manufactured exports per capita which was 8.2 percent for Morocco and 9.8 percent for Egypt between 2000 and 2008. This compares to an overall growth rate for developing countries of about 10 percent, but falls substantially below the growth of exports from East Asia. Moreover, export growth has been volatile, relying on a few export sectors that are vulnerable to changes in the external environment (World Bank, 2009).

Declining industrial diversity and sophistication

North Africa's industrial structure limits its growth potential. Recent research has produced two new stylized facts linking industrial structure and growth: countries with more diversified production and export structures have higher incomes per capita (Imbs and Wacziarg, 2003; Cadot, Carrere, and Strauss-Kahn, 2011), and countries that produce and export more sophisticated products – those that are primarily manufactured by countries at higher income levels – tend to grow faster (Hausmann, Hwang, and Rodrik, 2007; UNIDO 2009).

One reason why industrial and export diversity matter for growth may be that more

diverse economies are better able to take advantage of opportunities in global markets as they emerge. As the manufacturing base in developing economies broadens, new export opportunities arise. If those opportunities can be successfully exploited, “learning through exporting” may take place, raising the productivity of the manufacturing sector and providing further momentum for productivity growth.

Sophistication is directly linked to productivity: sophisticated products embody advanced country productivity levels. The ability of firms in lower income economies to produce, and especially, export such goods indicates that they have mastered both the “hardware” – process technology – and the “software” – management practice, quality control and value chain management – required to produce such goods at an earlier level of development than might be expected. In the language used in business schools, they are “high capability” firms. Economies with a large number of high capability firms have higher total factor productivity and faster growth.

Figure 4.1 shows how the sophistication of manufacturing production in Egypt and Tunisia evolved between 1975 and 2005 compared to two Asian middle income countries with good success at growth and job creation, Indonesia and Malaysia.

Figure 4.2 repeats the exercise for export sophistication. The figures give the ratio of the observed production (export) sophistication of the economy to its predicted value based on GDP per capita¹⁴. Economies with ratios greater than one have production structures that are more sophisticated than would be predicted at their level of development. Economies with ratios less than one have levels of sophistication that are below the level predicted from their income level. Cross country evidence indicates that those economies with ratios of actual to predicted levels of sophistication greater than one and rising have been those that have had the fastest rates of overall economic growth¹⁵.

Both Egypt and Tunisia have suffered a long run decline in the sophistication of their manufacturing sector. Both economies had levels of manufacturing sophistication in 1975 and 1985 that were higher than the values predicted from their levels of development. By 1995 Tunisia had moved to a manufacturing structure that was less sophisticated than the level predicted from its per capita income. By 2000-2005, both economies had lost ground in terms of production sophistication and were less sophisticated than expected from their levels of per capita income.

During the 1970s and 1980s both Egypt and Tunisia had manufactured export structures that in terms of sophistication were broadly in line with their levels of development. In 1995 both economies had fallen below their predicted levels in terms of export sophistication. By 2005 Tunisia's manufactured export sophistication had fallen to about 75 percent of its predicted value, and Egypt's had collapsed to less than one-third of what would be expected on the basis of its level of income.

Putting the manufacturing production and exports stories together reveals a consistent pattern of industrial decline over the period 1975 to 2005. In the 1970s and early 1980s the production structure in both Egypt and Tunisia reflected a state led industrialization model in which import substituting industries – many of them state owned - were developed across a wide spectrum of product lines. The majority of these activities operated under heavy protection and served only the domestic market. For this reason manufacturing production sophistication was considerably higher than export sophistication. During the adjustment programs of the 1980s and 1990s trade liberalization and privatization resulted in the closure of

¹⁴ For a comprehensive presentation of the construction of the measures of sophistication and the estimation of the predicted values see UNIDO (2009).

¹⁵ Hausmann, Hwang and Rodrik (2011) argue that their econometric evidence points to the relationship running from greater sophistication to growth and is robust to a number of specifications and treatments for two-way causality. UNIDO (2009) use a different approach to address the endogeneity problem and arrives at similar results.

non-competitive, import substitution industries, and production base in manufacturing narrowed toward less sophisticated activities. Exports were concentrated in lower sophistication sectors, reflecting both economies' factor endowments, but failed to evolve toward higher sophistication, despite the more open, competitive environment.

The two rapidly growing East Asian economies had quite different industrialization patterns. Indonesia's production structure in manufacturing evolved over the same 30 years from lower to higher sophistication levels, ending in 2005 substantially above its predicted value. Malaysia began as early as 1975 with

a highly sophisticated production structure and maintained it throughout the period, increasing manufacturing sophistication at a pace that matched its rapidly rising real income. Indonesia began the 1970s with a manufactured export structure that was highly sophisticated relative to its level of income. Despite some loss of ground in the 1980s and 1990s manufactured exports remained more sophisticated than predicted and by 2005 had again increased substantially in sophistication relative to their expected value. Malaysia shows continuously increasing export sophistication from relative levels below those of Egypt and Tunisia to very high relative levels by 2005.

V. Empowering the Private Sector

Achieving growth enhancing structural change will depend fundamentally on private investment and job creation. North Africa needs a more dynamic, competitive private sector. Ironically, North African governments were praised in the past decade by international institutions for taking steps to promote private sector development. Indeed, recent Doing Business reports by the World Bank Group ranked Egypt and Tunisia among the world's "top reformers". According to Doing Business, in the years immediately preceding the revolts, Egypt introduced "major reforms" to the financial sector, capital markets, taxation, and a One-Stop Shop for businesses. Tunisia was recognized for streamlining administrative procedures. Clearly, however, "reform" failed to generate much private sector growth or employment creation.

5.1 Why "reform" failed

Reform failed primarily because policy and regulatory changes which on paper appeared to empower the private sector in fact undermined competition, restricted the entry of new businesses and discouraged risk taking. Private sector elites—often connected to the

regimes - enjoyed privileged access to land, markets, contracts, finance, and services. This led to an entrenched, rent-seeking system of crony capitalism.

Economic assets were transferred to close associates of the ruling elites through carefully managed privatization and public procurement processes. Although the privatizations resulted in some investment and growth, smaller firms – those without privileged access - faced substantial obstacles. Key sectors remained uncontested, limiting their competitiveness, and growth was narrowly concentrated in a few sectors and groups (World Bank, 2009). Rising oil prices in recent years further weakened incentives to undertake substantial reforms in the resource rich economies.

Figure 5.1 shows the levels of several indicators of capture and corruption. Most North African countries rate poorly on the quality of rule of law and in control of corruption. Investment climate surveys indicate that bribes to pay for approvals or connections are extremely common. In the services sector in Egypt for example 43 per cent of construction permits involve the expectation of an informal payment

or gift. Nearly one third of manufacturers in Egypt reported that an informal “gift” or payment was required to obtain an electrical connection (World Bank, 2009).

Failures of the public administration also played a role in the failure of reform. Figure 5.2 shows the large variation across countries in the region in the government effectiveness indicator, which measures quality of the public sector bureaucracy in formulating and implementing policies and delivering services. Tunisia ranks in the third quartile of the global distribution of government effectiveness and Egypt in the bottom quartile.

5.2 Rebuilding confidence and trust

The legacy of crony capitalism has left deep mutual suspicion among the citizenry, government and the private sector. Restoring business confidence will depend on establishing trust between the government and the private sector in a more open environment. The emphasis now—at least in Egypt – seems to be on prosecution of past abuses. This is a necessary step toward establishing the credibility of the new government and represents a clear break from the past, but it cannot be the only or even the primary interaction between government and the private sector. Without business confidence the economic recovery will be significantly

delayed and the rate of investment needed to transform North Africa’s economies cannot be sustained.

A first step toward building trust can be undertaken by developing institutions that support transparent, rule-based interaction between business and government. Disclosure of public regulations and the outcomes of administrative decisions—for example, regarding license or contract awards - can help increase transparency. Whistleblower protection would enable employees to report acts of corruption in both the public and private sector (Kaufman, 2011).

Eliminating barriers to the formation of private business associations would encourage stronger political organization of economic interests and provide a more open environment for business government communication. For such a dialogue to be credible, however, the state must not – as it did under the previous regimes – reserve for itself the right to name the representatives of the private sector (Brookings, 2012).

Governments can also introduce innovations to improve the efficiency and equity of service delivery to businesses. Rewarding efforts for effective public service—such as for example through the introduction of performance-based compensation in public institutions – and removing discretion in the

application of regulations should be core areas of the public administration and civil service reform agenda. Among the agencies in which these reforms should be undertaken early are customs, the tax authorities, the industrial land administrations, and the agencies regulating investment approvals and business entry.

Regulatory and procedural reforms that reduce the room for rent seeking behavior by public officials can also be introduced. The number and complexity of administrative steps in interactions between businesses and public officials can be reduced. Egypt's new building code, if implemented according to the law and executive regulations, will sharply reduce the number of onsite inspections, and therefore the number of opportunities for corrupt behavior by officials.

Under the previous governments in the region institutions such as the competition authority, the regulatory agencies of various sectors, the financial regulators (including the central bank), the audit authority and the judiciary council usually reported to the head of state. The power to appoint senior administration officials was also concentrated with the head of state. Reforms to increase the autonomy of such institutions—for example, by shifting reporting requirements and accountability to parliaments—would improve their credibility.

5.3 Increasing Competition

The private sector in the Middle East and in North Africa faces far less competition than in Asia, Latin America or Eastern Europe (World Bank, 2009). Protection in output markets and barriers to entry are substantial. Entry of new firms and exit of inefficient businesses is weaker, and firms are on average older than in other regions. North Africa's new private sector will need to compete both locally and globally, there are a number of areas in which governments can act to strengthen the competitive environment.

Streamlining administrative procedures

Administrative procedures were used by the past regimes to restrict the competition faced by favored enterprises and often represent a significant barrier to entry – especially for small and medium firms. New governments have the opportunity to streamline procedures and increase the transparency of their application. Entry requirements that give discretion to public officials to exclude some investors (and advantage others)—such as sector-ministry approvals in Algeria, Egypt, and Tunisia – can be eliminated. Other barriers, including high minimum capital requirements and restrictions on foreign ownership in certain sectors in effect in Algeria, Libya, and Tunisia, can also be reduced. Most countries in the

region could move to online registration of businesses, online payment of VAT and social insurance contributions, and incorporate tax and social insurance registration in one-stop shops. Policy initiatives to develop small businesses could focus on easing entry, registration and formalization (Amin, 2011).

Some recent changes are encouraging. In Egypt the Prime Minister recently removed requirements for new industrial projects to get approval, simplified the process of registering branches of foreign companies, and established new branches of the Investment Authority. The government also made import certificates valid for three years. Tunisia had reformed a number of laws and regulations, but often failed to remove the old laws and regulations from the books. The Tunisian Ministry of Finance has created a high-level technical committee and working groups in all departments to look at 500 formalities and eliminate those that are unnecessary, ineffective, not based on law or redundant.

Strengthening commercial justice systems

Building confidence in the judiciary to uphold property rights—even under pressure from politically-connected interests - should be an early objective of post-revolutionary governments. Confidence in the judiciary

has actually increased over time in several countries of the region, and relative to other government institutions it is seen a particularly strong in Egypt (Figure 5.1). Yet, courts in Egypt and Tunisia remain backlogged and inefficient. Judges are not provided with adequate resources, including court staff, court reporting and clerks for research and administrative functions.

There is also a need to make it easier for firms that are failing to exit the market. Strengthening the insolvency and secured transactions systems will encourage risk taking. Effective bankruptcy allows an entrepreneur to emerge from a failed venture with the ability to learn and use the experience in a new venture. Protection of creditors ensures that insolvency will be resolved fairly.

Improving competition policy

Effective competition policy can play a dual role: first, it can limit anti-competitive behavior by incumbent firms, and second it can help to reestablish trust in the role of government as a regulator. Egypt for example has a good competition authority (ECA) on paper, but its effectiveness has been limited due to many exceptions to its mandate. A number of concrete actions could be undertaken to increase its effectiveness and credibility (Amin, 2011):

- The law and executive regulations can be amended to allow it to cover mergers and acquisitions.
- The autonomy of the competition authority can be enhanced by removing the Minister of Trade from decision-making and enforcement process.
- The exemption for public utilities can be removed.
- Government can allow administrative enforcement of ECA rulings, and strengthen both investigatory powers and power to impose penalties.

Similarly, in Tunisia competition policy could be strengthened by giving greater autonomy and a stronger mandate to the Competition Council. In both countries sector-by-sector reviews to identify barriers to entry, exit and competition in key sectors can be undertaken.

Democratizing access to credit

The banking system in Egypt and Tunisia is weak by international standards. State-owned banks continue to dominate the financial sector. There are significant entry and exit barriers, and competition among banks is limited. Under the previous governments inefficient banks – often in the public sector – in both Egypt and Tunisia were allowed to continue operating and were frequently subject to “moral suasion” in the allocation of credit.

Credit extended to the private sector went primarily to a small number of large firms. North African banks have the highest average loan concentration ratio in the world. Exposure to the 20 largest borrowers as a share of total equity is 242 percent (World Bank, 2011). Most firms, especially SMEs, receive little financing from banks. Only 20 percent of SMEs in North Africa have access to finance, a level far lower than other regions except for sub-Saharan Africa, and the share of the population covered by microfinance is half that of Latin America.

Democratizing access to credit will require increasing competition among banks. One immediate action to increase competition would be to remove the restrictions on entry of foreign banks. Countries can also increase banking competition and reduce the room for abuse by limiting the amount of credit single borrowers can receive from public banks, removing branching restrictions, and improving the independent supervision of all banks. The history of financial sector reforms in other countries in transition suggests that this is an area in which governments will need to balance innovations to boost competition with effective and transparent regulation.

Building institutions that facilitate project-based allocation of capital is particularly important to ensuring access to credit by

micro, small and medium enterprises. These include credit bureaus, secured lending regimes, and oversight capacity. Non-bank financial institutions can be developed to address micro-financing needs. Innovations to introduce factoring and leasing are also desirable, especially for small and medium firms.

5.4 Avoiding capture

One of the lessons of political-economic transitions – such as that in Indonesia - is that there is a risk of capture of the reform process by economic elites. If capture is possible and not costly there is an enormous incentive for talent and resources to be diverted into rent-seeking and away from entrepreneurship and productive investment.

Drawing from the experience of other countries, a number of reforms promoting transparency in politics and legislation could have high payoffs in terms of reducing the risks of capture (Brookings, 2012):

- Requiring public disclosure of assets and incomes of candidates, public officials, legislators and their dependents.
- Requiring public disclosure of political campaign contributions by individuals and firms and of campaign expenditures.
- Implementing conflict of interest laws.
- Adopting and effectively implementing Freedom of Information Laws.

- Strengthening media freedoms and journalist's education.

Laws and regulations can be clearly written with little room for interpretation and made publicly available. Information on transactions involving privatizations, public land sales, subsidies, and procurement tenders—particularly information on the beneficiaries—and on court decisions on commercial litigation should be systematically published. E*procurement reforms to encourage transparency and competition can be introduced and firms found bribing in public procurement can be publicly blacklisted (Kaufman, 2011).

In periods of rapid change international standards and codes of good practice can serve a useful purpose by strengthening public scrutiny of policymakers (Collier, 2011). They can also provide a basis for replication of positive reforms. For example international standards of transparency in revenue management such as EITI can enhance public scrutiny of fiscal policy in resource rich economies such as Algeria and Libya. Regional organizations can play a positive role by vetting and establishing standards in such areas as foreign investment or competition policy. Measurable objectives, outcomes, and selection criteria embodied in new standards and codes can form the basis of a monitoring system.

5.5 The conduct of enterprise policy

Empowering the private sector and restoring its confidence in government will necessitate close communication and coordination between government and private business. Governments will need to collaborate with the private sector to define, carry out and evaluate policies aimed at increasing private investment and channeling it into high productivity uses. This is an area that previous regimes in Egypt, Libya and Tunisia handled badly.

Recent writing on industrial or enterprise policy has emphasized the need to “embed” it in a process of consultation with the private sector, both to assist in the design of appropriate interventions and to provide feedback on the implementation of policy initiatives (Rodrik, 2007, Harrison and Rodriguez-Claire, 2009). On the other hand the massive literature on rent seeking and government failures suggests with some reason that in many cases a close relationship between business and government can lead to inappropriate policies and wasteful expenditures.¹⁶ Managing the tension between close coordination and capture is a key challenge to be faced by the post transition governments in the region.

The “embeddedness” literature shares much in common with an earlier generation of studies of business-government coordination undertaken in the wake of the “East Asian Miracle” (Amsden, 1989; Wade, 1990; World Bank, 1993; Campos and Root, 1996). While these earlier authors differed widely in their assessment of the efficacy of industrial policy, they were broadly in agreement on the key elements of the coordination process in the rapidly growing Asian economies of the 1970s and 1980s. Three of these elements may offer some practical guidance for North African governments: experimentation, focus, and feedback.

A defining characteristic of the early East Asian model of policy formulation was a willingness to experiment. Ideas were often generated by observation, either of successful examples that policy makers wished to emulate or of specific problems and constraints that they wished to address. Policies to accomplish these aims were developed in consultation with the private sector and then implemented. The results – measured in terms of specific outcomes – were carefully observed. Where the chosen course of action failed to accomplish the desired outcome, usually – although not always – it was modified or abandoned. Policies that were deemed

¹⁶ A balanced review of the relevance of this literature is contained in the report of the (Spence) Commission on Growth and Development (2008).

successful were frequently replicated in other settings (World Bank, 1993). This almost “pharmacological” – observe, experiment, implement - approach to policymaking was heavily dependent on a strong two-way flow of information between firms and the government and a high degree of insulation and pragmatism on the part of the policy makers concerned.

One way in which the flow of information was encouraged and the risk of capture was reduced was by focusing policy decisions and actions on very specific constraints. Although the practitioners of the time certainly would not have recognized the terminology, they were in effect attempting to address constraints to the development of firm capabilities or failures of collective action. These types of development problems proved to be best dealt with at the level of a specific objective (boosting exports), region (developing an SEZ), or industry (building capabilities).¹⁷ The key elements of the process were agreement between government and the major players in the private sector on the specific constraint and the proposed course of action. A timetable for resolution of the problem was announced and progress in

implementation was monitored and reported. The public officials charged with the program were sufficiently senior to make the decisions needed for implementation and in most cases were held directly accountable to the most senior levels of government.

Feedback was an essential element of the policy process. Partly this was done by measurement of observable outcomes, for example the rate of growth of jobs or exports. But partly it required private firms to share information with the public sector and sometimes with competitors that they had little incentive to reveal. This of course is the core of the collective action problem. East Asian policy makers dealt with this by attempting to deliver results in terms of the impact of public actions on profits that were of sufficient value to provide an incentive for firms to reveal proprietary information. Firms that failed to share critical information were excluded from further participation in the coordination process. The quid pro quo was not always successful, but it represented a pragmatic approach to dealing with asymmetric information.

¹⁷ This is of course how the East Asian “miracle” came to be identified closely with “picking winners”. That terminology is misleading, if in fact what policy makers were doing was responding to constraints in sectors where capabilities were known to exist in the private sector. In effect it was the “winners” identifying the policy actions not the reverse.

VI. Accelerating Structural Change

Creating a dynamic and competitive private sector is a major step toward generating growth and jobs, but private investment will need to flow into high value added activities if North Africa is to close its structural deficit with the more dynamic middle income countries. In both theory and history industry has been the sector that leads the process of structural change. For this reason North Africa's economies need an industrialization strategy to complement their initiatives to develop the private sector.

6.1 The Drivers of Industrial Location

The global industrial economy has undergone major changes over the past quarter century. Perhaps the most dramatic has been the shift of the center of gravity of global manufacturing from developed to developing countries. Since 1980 developing countries gained world market share in both simple and complex manufactures at an increasing pace. Between 2000 and 2008, manufacturing growth in industrialized economies was only about one per cent per year; in developing economies it was

more than seven per cent per annum. These changes in the global industrial landscape reflect three key drivers of industrial location: task based production, agglomeration, and firm capabilities.

Task-based production

In some manufacturing activities the production process can be decomposed into a series of steps, or tasks. As transport and coordination costs have fallen, it has become efficient for the production of different tasks to be located in different countries, each working on a different step. Task based production has expanded dramatically in the past 20 years and has been a major driver of the rapid industrialization of the new generation of Asian export manufacturers. It has also propelled Tunisia's relative export success.

Understanding in which countries and circumstances attempts to attract task-based production are appropriate and the nature of the constraints to trade in tasks are important underpinnings of an industrialization strategy for the region. It is easier to master

a single stage of the production process than to develop all of the capabilities needed for vertically integrated production, but success in attracting and retaining trade in tasks is by no means guaranteed. Task based exports are highly concentrated in advanced country markets and very footloose. Investors continuously seek new locations for task based activities in response to changing costs and incentives.

Firm Capabilities

Often the critical constraints to industrialization are not technical. Rather they are complex and inter-related bodies of knowledge and patterns of behavior (Nelson and Winter, 1982). In most industries productivity and quality depend on a set of interlocking elements of 'tacit knowledge' or 'working practices' possessed jointly by the individuals who comprise the firm's workforce. These "firm capabilities" are the know-how or working practices that are used either in the course of production or in developing a new generation of products (Sutton, 2005). Firms in the global industrial marketplace are competing in capabilities, and the location of industry therefore depends in part on how well economies acquire and diffuse capabilities.

The process of acquiring and building capabilities has two phases. The first phase

involves the initial introduction of a higher level of capability to some firm or group of firms. The transfer process is most often a result of Foreign Direct Investment (FDI). Beyond FDI, two other mechanisms have played an important role in transferring capabilities. In some international markets - apparel and agro-industry for example - exchanges of information between suppliers and buyers with a reputation for high quality are well developed and add to the capabilities of supplying firms. In many other industries there is a close and continuing contractual relationship between buyer and supplier which often involves a two way movement of technical and engineering personnel between their respective plants.

The second phase consists of the spillover of capabilities to other firms within and outside the host industry. Transmission of capabilities to other firms in an economy most often takes place through vertical supply chain relationships. This is not altogether surprising. Firms have little incentive to transfer capabilities to competitors, but they may benefit from improvements in the capabilities of suppliers or customers.

Industrial agglomeration

Manufacturing and service industries tend to concentrate in geographical areas - usually cities - driven by common needs for

inputs and access to markets, knowledge flows, and specialized skills. Because of the productivity boost that agglomerations provide, starting a new industrial location is a form of collective action problem. If a critical mass of firms can be persuaded to locate in a new area, they will realize productivity gains, but no single firm has the incentive to locate in a new area in the absence of others. For this reason understanding industrial agglomeration and designing appropriate public policies to attract a critical mass of industry is likely to be a prerequisite to breaking into global markets.

Case studies indicate that governments can foster industrial agglomerations by concentrating investment in high quality institutions, social services, and infrastructure in a limited physical area – such as a special economic zone (SEZ). East Asia and Latin America spatial policies have been explicitly linked to export promotion through the use of export processing zones (EPZs) which are properly viewed as industrial agglomerations designed to serve the global market. Experience with spatial industrial policies in North Africa has been mixed. Tunisia's manufacturing success is largely based in its export processing zones, which have also been criticized for their limited links to the domestic economy. Egypt's EPZs – especially those in the public sector – have generally been regarded as failures.

6.2 Industry without smokestacks

Manufacturing is most often associated with industrialization both in economic statistics and in the popular imagination. But falling transport and communications costs have created a class of high value added activities in agriculture and services that more closely resemble manufacturing than the sectors to which they are assigned in economic statistics. Such activities require firm capabilities that differentiate them from traditional agriculture and services. These are “industries without smokestacks”.

The global agricultural value chain in flowers and horticultural crops provides an example. Keeping products fresh (maintaining the cool chain) and transferring them quickly from farm to shelf adds value. Value is also added through packaging, preparation and innovation. Global market requirements for these products have become more challenging in recent years due to formal standards and the product requirements of demanding buyers (World Bank, 2008a). Global agro-industry is increasingly dominated by lead firms that coordinate vertical supply chains. These lead firms have the characteristics associated with modern manufacturing, including product differentiation and innovation, quality assurance based on risk management, and process controls

(Humphrey and Memedovic, 2006). Tradable services – including tourism – offer similar examples.

For the economies of North Africa industries without smokestacks may offer a strong complement to structural change through growth of manufacturing. Proximity to the European market, climate, and fertile agricultural areas provide a basis for developing new agro- and agro-industrial value chains. Language and proximity may encourage the development of remote services, and the tourism assets of the region are well known, if not well developed.

6.3 Breaking in, moving up, and diversifying

North Africa faces at least three industrialization challenges, shaped by the way in which the income levels and factor endowments of its economies interact with the global determinants of industrial location. For the region's labor abundant, lower middle income economies – Egypt and Morocco – the challenge of breaking into global markets in task based production is likely to be the most urgent. Tunisia faces the challenge of “moving up” in terms of export and product sophistication. The oil exporters – Algeria and Libya – confront a diversification challenge in the face of Dutch disease.

Breaking In

Today, new entrants to manufacturing are competing with East Asia, which now plays the role previously played by “the North”. Asia has the scale and agglomeration economies which make it competitive against new entrants, despite rising production costs. One scenario, which cannot be wholly dismissed, is that the differences in wages between East Asia and even the labor abundant economies, such as Egypt, may not be sufficiently large to offset East Asia's productivity advantage.

There are three reasons to think that the future is less bleak than this suggests:

- Rising costs in China. China is growing so rapidly that it is likely to encounter rising costs in manufacturing production. One source of rising costs will be increasing real wages. Further, China has only a limited number of coastal cities. As these expand, they are likely to encounter diseconomies of congestion, and although Chinese manufacturers may shift production into the interior, this will increase transport costs.
- Growing domestic demand in Asia Since the global financial crisis Asia's established industrial economies – China and India included – have introduced domestic policies intended to reduce their

dependence on exports. The expansion of domestic demand is likely to cause some reorientation of manufacturing activity toward the local market, creating space for potential competitors in third country markets.

- Industry no longer needs smokestacks. The emerging role of agro-industry and tradable services – including tourism – offers scope for industrialization based on “natural resources” that are location specific to North Africa.

Whether Egypt and Morocco can take advantage of these trends will largely depend on the policy choices of their governments.

Moving Up

For Tunisia the industrial development challenge is somewhat different. Its early success in end stage task-based production for the European market appears to be running out of steam. Real wage levels are sufficiently high that it will not remain attractive as final stage producer in task-based trade, but it has failed to keep pace with the rapidly growing industrial economies of East Asia in more sophisticated industrial exports. Since 1975 Tunisia has lost revealed comparative advantage in high sophistication exports, and its production structure has become less diversified. As for many middle income countries,

“Pressure in the middle” – mainly from East Asia - has prevented Tunisia from making the transition from lower to higher sophistication manufacturing, limiting output and employment growth (UNIDO, 2009).

The good news is that pressure in the middle is not uniform. Time is emerging as a critical factor shaping the global distribution of trade in tasks. In industries subject to short cycle times or uncertain demand – such as fashion or consumer electronics – firms are driven to locate close to consumers and/or suppliers. This may open up space for higher wage economies with close proximity to Europe to become part of the global trend toward “reverse outsourcing”, as industries locate closer to customers. Indeed, proximity was a key component in Tunisia’s earlier success as a middle income manufactured exporter.

Diversifying

For an oil-dependent economy such as Algeria or Libya there is a critical need to replace a depleting asset – oil – with an alternative asset. One way to diversify is by building up financial assets abroad, but, as recent events confirm, governments ought to worry that dependence on resource rents and financial returns may fail to generate sufficient good jobs to employ growing populations, leading to social unrest despite high incomes.

For this reason even the oil-rich economies face a challenge of diversification into non-resource based activities.

Diversification is made difficult by the relative price changes that occur in a resource exporting economy. Income from resource extraction increases the demand for all goods. In the case of traded goods the increased demand can be met by imports at fixed international prices, but the production of non-tradable goods is usually characterized by rising marginal costs, and their price rises relative to internationally traded goods. The foreign exchange market reflects this in a real exchange rate appreciation, which limits the ability of firms to enter new tradable goods sectors, whether to compete against imports or to export. This is the Dutch disease.

Dutch disease cannot be avoided, but it can be addressed by public policy. Tradable goods production will expand or contract according to whether it is internationally competitive. This depends not only on the exchange rate but also on the investments and institutional innovations that governments make to enhance competitiveness. A successful diversification strategy, therefore, depends on identifying productivity enhancing investments that have a high likelihood of yielding benefits to the economy in excess of the opportunity cost of holding foreign assets.

6.4 Strategies for industrial development

Not surprisingly, the appropriate responses to the region's three industrialization challenges will vary. One set of public actions is largely non-controversial and cross cutting. This includes mainly policies and investments directed at improving the "investment climate" – the regulatory, institutional and physical environment within which firms operate. Appropriate structural and macroeconomic policies make it easier to attract private investment, and many North African countries have an unfinished agenda of economy-wide reforms that need to be pursued. Two physical elements of the investment climate also need greater attention: trade related infrastructure and skills. But investment climate reforms alone may not be sufficient. This leads to a second and more controversial set of interventions: strategic initiatives aimed at pushing exports, building capabilities, and supporting industrial clusters.

Pushing exports

For North Africa's economies the export market represents the only option for rapid growth of manufacturing, agro industry and high value added services. Breaking into export markets in a world of task based production and agglomeration will require more than piecemeal improvements in the investment climate. It will

need an “export push”: a concerted set of public investments, policy and institutional reforms focused on increasing the share of industrial exports in GDP.

Improving trade logistics may be the single most important element of the export push strategy. Trade in tasks has greatly increased the importance of “beyond the border” constraints to trade. Because new entrants to task based production tend to specialize in the final stages of the value chain “trade friction costs”—the implicit tax imposed by poor trade logistics – are amplified. All North African countries score below the level of logistics performance that would be predicted from their level of income (Figure 6.1). Algeria and Libya have pronounced gaps in logistics competence and cargo tracking and tracing. Only Tunisia comes close to the average for countries in its income class.

The containerization revolution has not yet reached Egypt. Its legal and regulatory framework does not recognize containers inland, nor intermodal transport. Egypt’s Logistics Performance Index score for 2010 which reflects the extent of trade facilitation is below both the regional and income group averages. Egypt scores 2.37 on a scale of 1 to 5, slightly below the regional and income group

averages of 2.42 and 2.47, respectively¹⁸. It ranked 97th out of 150 ranked countries and 6th in the Arab region.

Attracting and building capabilities

FDI is one means of introducing high capability firms into a lower capability environment. Policies and institutions for attracting FDI are therefore a key tool in capability building. In Egypt and Tunisia opening sectors which have barriers to foreign investors, such as retail and real estate, is an obvious first step. The second step is to develop an effective foreign investment promotion agency. The work of Ireland’s Industrial Development Authority in the 1960s provided an institutional model for attracting and keeping FDI that has become international best practice over the past twenty years. Approaches similar to that used in Ireland have been central to FDI policy in a wide range of countries from Jordan to Singapore.

Beyond attracting FDI, removing obstacles to the formation of vertical value chain relationships is a critical task for public policies aimed at capability building. Some of these obstacles are as simple as immigration policies that inhibit the temporary entry of engineering and managerial personnel. Others

¹⁸ Five is the best performer.

operate through tariff and non-tariff barriers to the import of capital equipment or procurement rules. The design of special economic zones is also critical. An open architecture which encourages maximum contact between firms in the zone and the rest of the domestic economy – quite the opposite of the regime found in Tunisia – has been shown to promote transfer of capabilities.

An export push is strongly complementary to the process of acquiring capabilities. Demanding buyers and repeated relationships are characteristic of global markets in industry and promote learning by exporting.

Supporting agglomerations

Spatial industrial policies offer a third, complementary, element of a strategic approach to industrialization. Case studies indicate that governments can foster industrial agglomerations by concentrating investment in high quality institutions, social services, and infrastructure in a limited physical area – such as a special economic zone (SEZ). In East Asia and Latin America spatial policies have been explicitly linked to an export push through the use of export processing zones (EPZs) which are properly viewed as industrial agglomerations designed to serve the global market.

Spatial policies may also play a role in the transfer and diffusion of firm capabilities. High capability firms tend to locate among other

high capability firms. This is captured empirically in the agglomeration externalities found in high income countries. The experience of a number of countries suggests that public policies focused on generating knowledge and building the vertical supply chain within a geographic area may succeed in overcoming barriers to the movement of high capability firms to new industrial locations.

6.5 Fitting strategies to objectives

Clearly, given the diversity of industrialization challenges in North Africa, there is no single strategy for industrialization. The elements above will need to be combined in different ways to meet each country's industrialization objectives. Table 6.1 makes a stab at a typology of approaches to the industrialization challenge.

For Egypt the first priority should be to develop an export push by tilting incentives – including the exchange rate – toward exporters. World class export processing zones and aggressive FDI policies would be necessary complements. In Tunisia a critical objective should be to develop programs to enhance the acquisition and transfer of capabilities. This will require a more targeted FDI policy and a more open architecture in the special economic zones to promote the creation of domestic vertical value chains linked to the export sector. For Libya the obvious challenge is to build diversification objectives into post conflict reconstruction efforts.

VII. Restoring Inclusive Growth

To address the issue of justice North African economies will need to develop new national strategies for inclusive growth. North African governments have at their disposal a number of public policies and actions to develop such strategies (Box 7.1). Several of these instruments should emerge as priorities in post transition societies: improved access to jobs for the young, reform of education, decentralization public expenditure and improvements in service delivery.

7.1 New approaches to jobs and skills

The industrialization strategy set out in Section 6 is intended to boost formal job creation through faster, more labor intensive growth. But major institutional changes in labor markets and in the education system will also be needed to increase the employment intensity of growth in the formal economy. While expectations for change will remain high in the short run, labor market and education reforms will take time. In the medium term improving the prospects for good jobs will depend

on changing the existing institutional arrangements that raise the costs to formal sector employers of hiring workers.

Helping the young find better jobs

Active labor market policies, such as job search assistance, employability training, public support for apprenticeship and internship programs, and on-the-job training subsidies can be used to increase the employability of young workers. Within the region, there are some new models of job training and matching underway. The NOW project in Jordan for example uses vouchers to increase employment for young women. Governments can also provide tax incentives to firms to recruit and retain young workers (Brookings, 2012).

A more speculative area for public action would be to develop entrepreneurship initiatives targeted at the young. Some type of prize competition that provides a small start-up grant to applicants with a viable business plan might serve as a complement to cash for work programs –

especially among the more educated - and as a substitute for existing public employment programs. These programs would need to be time bound, in the first instance to say three years, and rigorously evaluated to prevent them from degenerating into permanent transfer programs.

In the longer run, labor regulations that set minimum wages, determine social insurance contributions and protect job security will need to be changed. In Egypt for example layoffs are only allowed when an enterprise is liquidated. In Tunisia procedures to lay-off workers for economic or technological reasons are complex and seldom used. Social insurance (unemployment and health insurance) reforms will also be required. Separating social insurance from formal job status and social insurance contributions from formal sector wages should be an important long term goal.

Building relevant skills

Education reforms are essential to improving the skills and problem solving capacity of workers and to restoring public confidence in social mobility and inter-generational equity. To address the skills mismatch families will need more incentives to spend resources on equipping their children with the productive skills that private employers demand. Relating hiring for all government employment to the

level of an individual's productivity and skills (for example through evaluating language skills and writing) rather than to credentials would increase the incentives for students to pursue more demanding courses of study. Access to new government jobs could require interviews and writing samples. Introducing tests of new skills in the national secondary and university entrance examinations would also shift incentives. Two obvious examples are writing, and problem solving. Testing these skills is labor intensive. The educated unemployed could with some training serve as examiners (Salehi-Isfahani, 2011).

In the longer term the education system needs to be restructured so that those who do not complete secondary or tertiary degrees still have something to show for their effort. This argues for changes in curriculum and in teaching practices that are likely to be resisted by incumbent teachers. It also argues for changes in vocational and technical education including, especially, increased provision by the private sector. A more market-oriented approach to training that allows employers to shape the training they need with financial support from the government is needed. This could be done through the use of training vouchers that can be redeemed with accredited private sector training providers or through industry-led training centers. Building program evaluation into such initiatives is essential.

The increasing inequality of opportunity in education will need to be addressed. To break the link between private expenditure and educational success the quality of teachers and instruction in the public schools needs to be significantly raised. Teachers need to receive adequate compensation and be monitored and sanctioned to ensure that they educate their student during the school day and not in after-hours tuition. Reform of curricula and teaching practices is likely to be strongly resisted by incumbent teachers, especially those who derive a substantial share of their income from private tuition. In the medium term governments will need to introduce pay for performance schemes into the primary and secondary education systems, place limits on outside income of teachers, and revise entrance examinations to weaken the link between rote learning and success.

7.2 Reforming public expenditures

Public expenditure can play a major role in helping North African economies restore inclusive growth. Two areas for public expenditure reform—replacing the existing set of untargeted subsidies with “smart subsidies” and decentralizing public expenditure and service delivery – are important ways in which new governments in the region can address the issue of economic justice.

Smart subsidies

The provision of low cost consumer goods—usually food and energy – has long been accepted as a key responsibility of governments in the Arab world. In the past consumer subsidy programs in the region were largely untargeted and inefficient. As fiscal pressures increased, governments cut these programs and, then, frequently reinstated them in the face of domestic political pressure. A number of governments – including those in Egypt and Tunisia - have responded to the current crisis by ramping up the same untargeted subsidies used in the past. Replacing the current energy and food subsidies with direct income transfers to the poor would be fairer and more efficient.

A change in subsidy policies would allow reallocation of resources away from consumption and towards development and social sector expenditures. Subsidies in Egypt average 8-9 per cent of GDP and exceed the entire government wage bill (including for health and education). They are more than double public investment expenditures. About 6 per cent of GDP goes to energy subsidies (fuel and electricity) and 2 per cent for food. In Libya subsidies for food, medicines, fuel, electricity and water are about 6-7 per cent of GDP, more or less equal to the wage bill. In Tunisia subsidies are around 4 per cent of

GDP with one quarter of them for energy products¹⁹.

The economic cost of these subsidies is huge. The energy subsidies are particularly inefficient and harmful to the environment. The energy and carbon intensity of the Egyptian economy is 2.5 to 3 times higher than the OECD average. They are also highly regressive: 57 per cent of the subsidies in Egypt are captured by the top two quintiles of the population²⁰.

About 28 per cent of food subsidies in Egypt never reach their intended beneficiaries. There is tremendous waste along the supply chain of subsidized food. Subsidized bread is used as animal or fish feed; and subsidized oil and sugar is often sold on the black market. Moreover, as in the case of fuel subsidies, a large part of untargeted food subsidies go to the richest groups. In Egypt the richest quintile received about 12.6 per cent more in absolute benefits from food subsidies than the poorest quintile²¹.

Decentralizing public expenditures and services

One way to address the large regional disparities in Egypt and Tunisia is to

decentralize public expenditure and service delivery. In the long run, the central governments in the region should devolve most service delivery responsibilities to local governments while making them fully accountable to their populations for results in terms of the effectiveness, efficiency and quality of public services.

Local government systems in North Africa are a form of delegation, rather than devolved local self-government. All countries in the region have a highly centralized administrative structure with very limited decision-making power assigned to local governments. The central government and/or the President appoint the heads of provincial governments. Tunisia has only provincial (governorate) level governments. Egypt has a variety of sub-provincial level governments, but even heads of municipalities are centrally appointed.

The public administration is highly centralized and equipped with an elaborate system of field offices of line agencies. Decisions—especially regarding service delivery - are made by the central government and the role of sub-national authorities is largely confined to implementation. Local units of the line ministries provide the bulk of public

¹⁹ IMF, (2010a; 2010b; 2010c)

²⁰ ESMAP and World Bank (2009)

²¹ World Bank (2005)

services, including health and education, under strict guidance of the central government. Decentralized authorities (generally municipalities) perform only a limited number of functions, such as street paving and maintenance, construction of local roads, street lighting, garbage collection, library and park services, and issuing permits for construction (Serkan and Yilmaz, 2008).

The assignment of expenditure responsibilities between central and local governments fails to set the right incentives for efficient and equitable delivery of public services (Amin and Ebel, 2006). This is particularly true in social services. The share of sub-national expenditures in GDP in both Egypt (4.6 per cent) and Tunisia (4.3 per cent) is very low compared to the OECD average of 17 percent (Serkan and Yilmaz, 2008). Similarly, the share of total public expenditure done through sub-national entities (about 16 per cent in Egypt and 12 per cent in Tunisia) is well below international norms.

Fiscal decentralization will require redefining the roles and responsibilities of central and local governments, accompanied by a robust capacity building effort to enable local authorities to deliver services. Regional and local governments will need to be given increased autonomy in expenditure and revenue decisions. The greatest challenge is likely to be restructuring the revenue system

to provide local governments with “fiscal space”. Central governments will need to set criteria to classify local governments into different categories with different taxing and spending responsibilities and borrowing privileges. Governments will need to ensure that adequate steps are taken to establish accountability mechanisms, including by systemic collection, analysis, and dissemination of information about local fiscal performance and compliance with financial and policy goals.

Strengthening service delivery

Public services are an important means by which governments can signal to their citizens that the benefits of growth – and rising fiscal revenues – are being equitably shared. Public service providers in North Africa are by and large insufficiently accountable to the populations they serve. Decentralization of service delivery is one means of increasing accountability. Local authorities and municipalities can be given greater oversight responsibilities for provision of basic education and health services for example. Use of citizens score cards to evaluate service delivery – linked to performance incentives for service providers - may be another way of increasing the responsiveness of public institutions.

Governments in the region need to improve the quality of the people working in the

public sector. Career paths need to be linked to performance and designed to encourage commitment and accountability. Staff training programs are important means to sharpen the skills of the employees and to keep them abreast of new technologies. Special attention should be paid to improving the managerial capabilities of team leaders and managers. Governments may wish to experiment with the creation of independent service authorities that are separate from line ministries, and therefore able to motivate and compensate employees differently from the civil service.

Improvements in the quality and the productivity of some government services could be

made by outsourcing non-core tasks. Governments could start by pooling services together under one entity and then privatizing it, focusing on areas where the services could be successfully handled by the private sector. For example government hospitals could start outsourcing their catering, cleaning services, engineering services, and IT management. Another example would be to pool the Information Technology services in all government institutions and allow the private sector to provide this service through competitive bidding. Given the history of capture of privatization programs in the region, great care will need to be taken to ensure transparency of the privatization process.

VIII. Regional Integration

North Africa has economic, geographical, and cultural ties that are favorable to deep regional economic integration. Despite these advantages, and a plethora of regional and sub-regional agreements, intraregional exports for all of the Middle East and North Africa are about 9 percent of total merchandise exports and about 25 percent of non-oil merchandise exports, lower than in all other regions of the world, except for South Asia. Gravity models that estimate trade potential between partner countries based on economic size, geographical distance, and other country characteristics consistently find that trade among regional economies is below the levels predicted (World Bank, 2008a).

Economic and political integration efforts have a long history in the region. The large number of preferential trade agreements signed in the past five decades has led to a “spaghetti bowl” of intertwined and overlapping regional organizations. Every North African country is a party to at least one regional economic agreement, and many countries are members of five or more. Moreover, the large number of bilateral investment and cooperation agreements within the Middle

East and North Africa further adds to the complicated web of institutional arrangements.

Recently agreements with partners from outside the region, notably the European Union and the United States, have assumed a prominent role. Examples include the Euro-Mediterranean Agreements of the European Union with several Mediterranean countries, as well as the bilateral agreements between the United States and Bahrain, Jordan, Lebanon, Morocco, and Oman. This chapter explores opportunities and pitfalls to greater intra-regional cooperation.

8.1 What constrains regional trade?

The structural similarity of North Africa’s economies severely limits the potential for intra-regional trade. Where regional agreements have succeeded in promoting intra-regional trade, there are strong complementarities between the export baskets of some member countries and the import baskets of others. On the other hand, countries with similar resource endowments, production capabilities, and export structures find it difficult to establish

patterns of specialization and diversification within a regional trading block.

North African countries are generally more complementary with their developed country trading partners (the EU and the United States) than with their neighbors. The regional market share of exports and imports is less than 10 per cent for Algeria, Libya, Morocco, and Tunisia. One measure of complementarity, the bilateral complementarity index, measures complementarity between the exports and imports of two countries on a scale from zero (which indicates no match) to 100 (a perfect match). Complementarity indexes between partners in successful regional agreements, such as the EU or the North American Free Trade Agreement (NAFTA), generally exceed 50. The bilateral complementarity index between most countries in North Africa is in single-digits. Not surprisingly, the complementarity of non-oil trade is higher than for total trade, but non-oil complementarity indices still rarely exceed 20 (World Bank, 2008a).

The existing regional agreements generally do not cover services trade, a rapidly growing segment of industry without smokestacks. Where they do, provisions are vague and refer only to “intentions to cooperate” in certain services sectors. Intraregional differences in regulations, restrictions on currency convertibility, and limits on the physical movement

of individuals have created a situation in which it is often easier for service providers to operate in countries outside the region – such as Western Europe – than within it.

8.2 Integration in factor markets

Factor markets in both the Middle East and North Africa are more highly integrated than goods markets, although intra-regional migration has declined since the mid-1980s. The oil boom of the 1970s led to explosive growth of migration from the region’s labor abundant economies into the Gulf Cooperation Council (GCC) oil exporters, but as oil prices fell in the mid-1980s, labor demand fell, and Arab migrant workers faced increased competition at both ends of the skills spectrum. At the high end, GCC countries restricted access by foreigners to public administration jobs and put pressure on the private sector to hire nationals. At the unskilled end Arab workers were replaced by South and Southeast Asian workers, because of their willingness to work for lower wages and in poorer working conditions and to migrate without families, which was an implicit guarantee of voluntary return. National preference policies, competition from Asian workers, and political tensions resulted in a leveling off of intraregional labor flows in the 1990s.

Intraregional foreign direct investment (FDI) and portfolio investments in many regional

economies have risen with oil prices. The revenues accruing to the GCC countries from the booming price of oil have been partly recycled within the region. Between 2002 and 2006, about \$60 billion, or 11 percent of total GCC capital outflows, went to other regional economies. Compared with previous oil booms, a higher amount of the surplus available to the oil-exporting countries is being channeled into project-based investments in the region. GCC countries have allocated over \$1.3 trillion in infrastructure and manufacturing investments in the whole of the Middle East and North Africa over the next 5 years. The GCC sovereign wealth funds are also increasingly looking for opportunities in the region, both because of the perceived upside potential in regional markets and the de facto restrictions the funds face in OECD economies.

8.3 Policy initiatives to promote regional integration

Open regionalism – using regional agreements to integrate more fully with the global economy – represents an important tool to complement national economic policy. Achieving effective integration in goods trade can increase both the competitive pressure on incumbent firms in the region and create new possibilities for task based production focused on extra-regional markets. Preferential opening of markets can help export-oriented firms learn

how to enter foreign markets, find foreign suppliers and customers, and build up economies of scale. Establishing regional standards for migration would significantly improve the welfare of the region's migrant workers and reduce the political volatility of migration and remittance flows. Deeper integration of financial markets can increase the likelihood that a larger share of oil revenue remains in the region.

Trade agreements can also help reinforce domestic reform programs by anchoring policy in the agreement itself. It is more difficult for domestic interest groups to reverse policy reforms embedded in regional agreements, since changes would require consent by all regional partner countries.

Rationalizing and streamlining existing agreements

One impediment to effective integration is the proliferation of agreements. Different regional initiatives have different sector and product coverage, different liberalization schedules, and different rules of origin. Implementation agencies, such as customs, often lack the capacity to put the agreement provisions into practice. The first order of business in creating effective regional integration is therefore to rationalize and streamline existing agreements to eliminate overlapping and conflicting rules and administrative procedures.

At the border reforms

Despite the substantial number of formal regional agreements to liberalize trade, there is an unfinished agenda of at the border reforms that need to be implemented. The region-wide average duty has been converging toward the world average. However, the spread in average tariff rates among countries remains substantial, and countries with relatively high duties on average are vulnerable to trade diversion. Further efforts to harmonize and align tariff rates are needed. Egypt, Morocco and Tunisia, have undertaken unilateral trade reforms. In 2004, Egypt cut tariffs, reduced its number of tariff bands from 25 to 6 and the number of tariff lines from 13,000 to 6,000. The result was a significant reduction in the weighted mean tariff. Egypt is now more open to trade than the average country in the region. But, like the majority of other countries in North Africa, Egypt is more protective of its agricultural goods (with a trade restrictiveness index of 7.0 percent) than its non-agricultural goods (5.4 percent)²².

Nontariff barriers to trade are more substantial in North Africa than in any other region of the world, and they contribute more to overall trade restrictiveness than tariffs. Trade

procedures are relatively more difficult and time consuming to undertake in North Africa than in other middle-income economies. Firm surveys suggest that the cost of complying with nontariff barriers is more than 10 percent of the value of goods shipped (World Bank, 2008). Nontariff barriers are particularly pervasive and restrictive in labor-abundant countries. They are far less restrictive in the resource rich, labor-importing countries of the region. In some cases, nontariff barriers significantly reduce or even nullify the trade preferences in regional agreements.

Developing regional projects

Regional initiatives to develop infrastructure are still at early stages and face many regulatory and financial challenges. Although plans for cross-border infrastructure projects – including electricity grids, gas pipelines, transport links, and telecommunication networks - are becoming more widely discussed in the region, the financial crisis in Dubai, the global financial crisis, and the events of the Arab Spring appear to have shelved many of these plans. Political animosities, a diversity of standards, and a lack of economic incentives to cooperate inhibit progress on even seemingly simple cross border investments. For example

²² The trade restrictiveness index measures the overall difference between border prices and domestic prices as a (tariff equivalent) percentage of the border price.

rail lines in Morocco stop abruptly at the Algerian border.

As the history of successful regional integration efforts elsewhere has shown, building the governance structures that can support the construction and maintenance of trans-border infrastructure is an important confidence building mechanism for eventual deeper integration. One such area could be in solar power. Abundant sunshine, desert land and proximity to Europe make North Africa a globally competitive location for Concentrated Solar Power (CSP). The question is whether coordinated regional action can be taken. A well-functioning regional power grid is critical to link generation with domestic and international consumers. The existing Arab grid is inadequate and requires expansion, but regional initiatives for a common grid remain fragmented.

Extending integration to services and finance

Building services trade, including the temporary location of services providers, and finance into the region's trade agreements would be an important step toward increasing firm capabilities and competitiveness. In services, as in trade in goods, there is a long run need to make regional agreements consistent with other preferential trade agreements. The countries that have concluded free trade agreements with the United States have

included services sector provisions—notably concerning banking, insurance, and telecommunications—in the agreements. But, the current arrangements simply lock in existing rules with respect to openness to services providers. The role of regional agreements in enhancing policy credibility is particularly important for services and investment reforms, which often aim to attract large-scale, long-term investors.

Bringing migration into regional agreements

Labor markets in North Africa and between North Africa and the Arab Middle East have long been among the most integrated in the world, yet migration policy is conducted wholly on a country by country basis. Extending regional agreements to cover the rights and obligations of migrant workers and to spell out codes of conduct for host countries would be a major step toward assuring greater transparency in the migration market and reducing the scope for political shocks to migration and remittance flows. Formalization of migration rules in a multilateral context would benefit both migrants and host country governments.

Strengthening commitment and monitoring outcomes

Many regional agreements look stronger on paper than in practice. There is often a lack

of trust and commitment—for example with respect to the credibility of certificates of origin or with regard to discretionary application of administrative rules and requirements—that hampers proper implementation. Well-functioning monitoring mechanisms and sustained high-level political attention to institutional improvements (such as those

concerning reductions in tariff and behind-the-border barriers) are essential for the success of regional integration initiatives. Technical reviews of progress toward the agreements' objectives should be undertaken on a regular basis, and senior officials need to act on the recommendations of these reviews.

IX. The International Response

Solutions to the twin problems of jobs and justice will ultimately need to come from the societies that fostered and were impacted by the Arab Spring, but the international community has a potentially strong complementary role to play. It can also use the lessons of the Arab Spring to assist governments in Algeria and Morocco to accelerate their own efforts to restore inclusive growth.

9.1 Mobilizing Resources

The financing needed to generate new jobs through accelerated structural change and to share the benefits of growth more widely is likely to place further strain on North African budgets. Most of the Arab Spring countries have substantial fiscal deficits forecast for 2011. These deficits are accompanied by already large debt to GDP ratios, and the financing needs may be even greater, if any of the countries face contingent liabilities from their banking sector.

In these circumstances the preferred role for international official development finance would be to offer grants, at least in the short

run. The G8 Summit in Deauville announced significant support—US\$ 40 billion or roughly 10 percent of GDP - for the countries in transition. Only a very small fraction of this, however, was in the form of grants. The remainder was to be in the form of lending at market interest rates. This suggests that – despite the fiscal stringency that many of the Deauville partners face - new efforts to generate further grants are urgently needed.

The international community also needs to develop, together with the private sector, innovative financial instruments that can use some of the expertise and sovereign guarantee enjoyed by national treasuries and the International Financial Institutions (IFIs) to reduce borrowing costs on private markets. The United States government has announced a sovereign guarantee program for transition economies. Such initiatives could be replicated by other bilateral donors. Both Egypt and Tunisia have the potential to develop and market “Diaspora Bonds” to their large overseas populations. This is an area in which the World Bank has developed considerable expertise. Financing instruments for enclave investments

in regional infrastructure could be developed and implemented.

9.2 Expanding Market Access

Ultimately, the success of an export push in North Africa may depend as much on the actions of its developed country partners – especially the European Union and the United States as on the actions of the region's governments. The Euro-Med initiative created free trade areas—removing most tariff and non-tariff barriers, as well as providing for the elimination of obstacles to investment and easier flows of technology - between the EU and its southern Mediterranean neighbors. Progress has been good in terms of manufacturing but liberalization of agricultural trade lags far behind. Because lack of progress on agricultural trade inhibits the development of agro- and agro-industrial value chains, it acts as a barrier to the development of industry without smokestacks.

Both the Euro-med agreements with the EU and the country by country preferential trade agreements with the United States are “hub and spoke” arrangements that do not encourage the development of regional value chains. Intraregional rules of origin are markedly different from those in the Euro-Mediterranean agreements, so that companies that are serving both regional and European markets have to run parallel procurement

and production processes to satisfy their respective requirements. In the long run it would be desirable to harmonize the European and American preferential agreements and make them compatible with regional agreements in signatory countries.

9.3 Sharing ideas and anchoring reforms

The international community can be an important source of ideas. For example decentralization is an important issue, but no North African country has significant experience in designing and implementing programs for sub-regions. Similarly, the international community can assist new governments in the region in restructuring institutions such as FDI agencies and special economic zones to reflect global best practice.

Uncertainty over the course of future policy is a major problem in economic and political transitions. Transitional governments cannot generally commit their successors to a long term economic program. The International Financial Institutions provide one mechanism for such longer term commitment, because their programs are multi-year. Through their programs IFIs can also try to ensure that the scope of reform is adequate to deliver a successful outcome.

Supporting medium term institutional reform through its operations is potentially an important role for the African Bank, especially given the high degree of suspicion with which both the IMF and the World Bank are viewed in the region. A recent Gallup poll found for example that 43 percent of Egyptians were against the idea of accepting any help from the United States or the international financial institutions in which the US is a significant shareholder.

To be effective, however, the African Bank would need to select a limited number of public actions on which to focus its financial

and intellectual resources. One obvious area in which the African Bank has pride of place is in regional integration. By developing new financing instruments and policy ideas the Bank can accelerate progress in regional infrastructure and trade. A second area could well be in fiscal decentralization and the development of marginalized regions. Finally, the Bank is well positioned – given the obvious errors committed by the World Bank in its Doing Business evaluations of private sector development in the region – to engage with governments on a more strategic approach to private sector development and structural change.

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Box 2.1: Early Success with Inclusive Growth

From 1960 to 1990 the Arab world – including North Africa – enjoyed substantial success in achieving broadly inclusive growth. Following independence, Arab economies from the Gulf to Morocco introduced a number of policies and public actions designed to support income redistribution and greater equity. These included agrarian reforms, nationalization of industry, banking, insurance, and trade, and a central role for the state in the provision of welfare and social services.

The public sector emerged as the centerpiece of the efforts to ensure equity. Public sectors became the dominant employers in Arab states. Relatively high public sector wages combined with generous nonwage benefits set a floor under formal sector wages. Employment regulations guaranteed job security through prohibitions or sharp restrictions on firing.

Oil played a critical role in both oil and non-oil Arab economies. In oil exporting states oil revenues supported the welfare systems and public sector jobs that served as the key mechanisms for distributing resource rents to citizens. Migration from non-oil exporters to oil rich neighbors generated substantial remittances, boosting household incomes in the non-oil exporters. At the peak of the oil boom in the early 1980s, 3.5 million Arab migrant workers—mainly from Egypt, Jordan, Syria, Lebanon, Yemen and Morocco—were employed in the oil states of the Gulf. Fraternal Arab aid through loans, grants, and other forms of assistance from oil-producing states supported government finances – and consumer subsidies – in the non-oil producers.

By the mid-1980s this state-dominated, oil-funded strategy for inclusive growth had created the lowest poverty incidence in the world. Poverty, as measured by the \$1.00 per person per day standard, was lower – by half – in MENA than in any other region. MENA was also the only low inequality region to reduce income inequality between the 1980s and 1990s. Because of these improvements, by the 1990s MENA had one of the most equal income distributions in the world with a Gini coefficient of 0.357.

Much of the fall in inequality was driven by a substantial increase in the income share accruing to the poorest quintile of the population, which grew by more than 15 percent between the 1980s and the 1990s. Surprisingly, the region achieved all of this—low poverty with fairly equal income distribution—with very low rates of per capita GDP growth. Cross country evidence shows that the Arab economies success in achieving poverty reduction and improved equity was driven mainly by public employment and migration.

But, success could not be sustained. Falling oil prices in the 1980s cut revenues and the demand for migrant labor. Changes in migration policies in oil-rich Arab states in the 1990s further reduced remittance flows. With declining revenues, public sector employment could not keep pace with rapidly growing populations, and consumer subsidies became increasingly difficult to finance. By the end of the century, particularly among the non-oil economies, the Arab model of inclusive growth was drawing to an end.

Source: Adams and Page, 2001

Box 3.1: Indonesia's Crisis 1998-2004

Indonesia post-Suharto is instructive for the Arab Spring in several ways. The trigger of the Indonesian crisis was an external shock, the East Asian economic meltdown of 1997. The consequences were a change in political regime, a massive loss of confidence in the economy, and a sustained economic contraction. Real per capita GDP did not regain its pre-crisis peak until 2004.

There are a number of common threads that connect Egypt and Tunisia with Indonesia under Suharto:

- Solid GDP growth pre-crisis
- Sustained improvements in human development indicators.
- Mixed economies with significant presence of state enterprises.
- Large, untargeted consumer subsidies
- Crony capitalism and moral hazard in bank lending.
- Significant regional disparities in incomes.
- Major corruption in the public and private sectors.

There are also many differences. Natural resources played a much larger role in Indonesia's economy. Egypt has a less developed manufacturing sector, especially in export-oriented manufacturing. Egypt and Tunisia have less flexible labor markets and far higher levels of graduate and youth unemployment. Tunisia's middle class is much larger and its population is better educated. But, given the large number of common economic factors that helped to precipitate the crisis in Indonesia, the way in which the Indonesian government responded to the crisis may hold some lessons for the transitional regimes in North Africa.

Economic Reforms

Macroeconomic management reforms began with a draconian adjustment in public finances, including slashing public investment and ultimately fuel subsidies. Fiscal deficits were constrained to 2 percent of GDP. Fiscal restraint was accompanied by a massive devaluation of the rupiah which provided short run stimulus to agriculture and manufacturing.

Indonesia's legacy of crony capitalism left an enormous structural reform agenda. The initial reform program tried to address this aggressively, but the reality of implementation was much less dramatic. Few of the Suharto cronies were prosecuted. Some monopolies were disbanded, but many structural reforms, including those related to the investment climate were implemented slowly.

Governance reforms

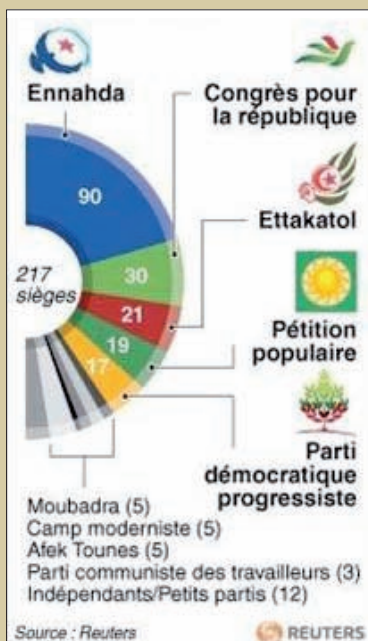
Civil society had two major preoccupations during the transition, domestic corruption and the influence of outsiders. To address corruption and cronyism direct elections were held for district governors and local officials, a Decentralization Law passed power to local authorities, the judiciary was made independent, a Constitutional Court was established, and an Anti-Corruption Commission and Court, staffed with individuals of the highest integrity, was set up.

Although the direct impact of these measures may have been small, the impact on confidence and a sense of inclusion was significant. For example, surveys shortly after implementation of the decentralization law showed that individuals were far more satisfied with public service provision, even though evidence indicated that the actual levels of service provision had not changed.

Source: Kharas (2011)

Box 3.2: The Tunisian Election

On 23rd of October Tunisia held an election to nominate its new Constitutional Assembly. The Assembly's mandate will be to draft a new constitution and form a new transition government for a period of around 1 year, until full legislative and presidential elections can be held. According to the Tunisian Election Commission (ISIE), 4.1 million Tunisian actually voted, corresponding to 90% of registered voters and 70% of eligible voters.



With the exception of some minor incidents, international observers have judged the conduct of the election to be satisfactory. The unexpectedly strong performance of the Al Aridha party and its leader Hachmi Hamdis—has been subject to some protest, due to claimed irregularities such as the use of his own foreign media to promote its campaign.

Several cash hand outs and other irregularities involving other political parties were also reported.

Ennahda, the leading Islamic party won a landslide victory, taking over 40 % of the seats, followed by two secular center-left leaning parties Congrès pour la République (CPR) and Ekkatol, a liberal democratic party. The Petition Populaire, a small conservative party run by a satellite TV owner based in London ran fourth. While all opinion polls predicted Ennahda as the leading party, the party's victory margin surpassed most expectations. Former members of the now banned RCD, the old ruling party, are reported to have re-emerged as a political force through alleged support to Al Aridha and the presence in some lists of independents, such as the Initiative party, led by Kamel Morjane, former minister of foreign affairs. Ennahda has announced its intention to form a broad based coalition.

Some notable regional differences emerged, with secular democrat forces posting most of their gains in around Northern Tunis, and the Al Aridha party showing particularly strong performance in the Center and West. Ennhada's victory was across the board, although its margin of victory was most pronounced in the south of Tunisia.

Source: Reuters

Box 3.3: Tunisia's Jasmine Plan – An Economic and Social Program for 2012-2016

In September 2011 the Tunisian interim government issued an Economic and Social Program for the next five years – the Jasmine Plan. The program aims to strengthen competitiveness and to stimulate growth, while achieving greater social cohesion through sustained improvements in the living conditions of the population. The document highlights six key challenges for the country : (i) Human development, social and regional inclusion; (ii) Governance, social responsibility and citizen participation; (iii) Employability, job creation and sophistication of the economy; (iv) Global integration; (v) Financing of the economy; (vi) Environment and management of natural resources.

To face these challenges, the Jasmine Plan proposes a set of 10 strategic targets :

1. Establishing trust through transparency, social responsibility and citizen participation;
2. Ensuring that development is all-inclusive and equitably shared amongst the different strata of society ;
3. Promoting a knowledge-based economy in which science and technology will play a significantly enhanced role;
4. Creating favorable conditions for the promotion of productivity, and free-entrepreneurship;
5. Fostering integration into the world economy;
6. Investing in human capital through education and training, and fostering professional competency in all fields;
7. Promoting social justice and equal opportunity programs;
8. Ensuring an adequate, balanced and viable financing of the economy;
9. Rehabilitate public service and civil action;
10. Optimizing an efficient utilization of resources and the preservation of the environment.

The Jasmine Plan represents a notable change of approach and tone compared to the prior government's traditional five year plans. In particular, it is the first time

that the plan is based explicitly on the concept of social justice. Among the ten targets above, almost half (first, second, seventh and ninth) are related to the democratization process and to the revision of the government and public service's roles in the new Tunisian society.

Source: Government of Tunisia, 2011

Box 7.1: Strategies for Inclusive Growth – Some Lessons from Asia

“Inclusive Growth” is the most recent title given to an idea that has a long history in the study and practice of economic development. It has also been called “redistribution with growth”, “growth with equity”, “shared growth” and “pro-poor growth”. Whatever the name, the central problem that inclusive growth seeks to address is clear and dramatically illustrated by the events of the Arab Spring: where rising income per capita fails to benefit significant segments of the population, it is difficult to develop the social and political consensus needed to sustain growth itself. The key policy insight of inclusive growth is that public action will frequently – if not always – be needed to address the distribution of the benefits of growth.

The fast growing East Asian economies of the 1960s and 1970s – the “Tigers” – were first group of post independence developing countries to develop strategies for inclusive growth. In these economies the public actions to foster inclusive growth evolved through a process of dialogue between governing elites and their societies. The strategies had two common objectives: rapid employment intensive growth and highly visible wealth sharing mechanisms, such as universal primary and secondary education, rural development, and basic health care.

Successive Asian economies ranging from Indonesia, Malaysia and Thailand in the 1980s and 1990s to Vietnam today have followed the Tigers’ lead. Most recently, in Vietnam agricultural reforms were combined with an export push in labor intensive manufacturing to achieve broad based early success in raising household incomes. As growth has become increasingly concentrated in urban centers, the Vietnamese government has responded to regional inequalities through redistribution of fiscal revenues from wealthier to poorer regions and targeted poverty reduction programs.

East Asia’s fifty year experiment with inclusive growth holds some lessons for the economies of the Arab Spring. First, in contrast to Arab autocratic regimes, East Asian governments – even autocratic ones – developed mechanisms for effective dialogue with their societies and set priorities for public actions to foster inclusive growth in response to national priorities. Second, the public actions chosen by East

Asian governments were investment not consumption oriented – education, health, housing and rural development - and often designed to support intergenerational mobility. Finally, governments in East Asia developed accountability mechanisms to ensure that public investments and services actually reached the intended beneficiaries.

Source: World Bank (1993); Campos and Root (1996).

Tables

Table 2.1: Real GDP Growth 2009-2011

	2009	2010	2011
World	-0.6	5.0	4.4
Developed Countries	-3.4	3.0	2.5
Low and Middle Income Countries	2.6	7.1	6.5
MENA	1.8	3.9	4.6
Egypt	4.7	5.1	-
Tunisia	3.1	3.8	-

Source: African Development Bank Data.

Table 2.2: Real GDP Growth 2000-2011

	Average 2000–05	2006	2007	2008	2009	2010	Projected 2011
Algeria	4.5	2.0	3.0	2.4	2.4	3.3	3.6
Egypt	4.0	6.8	7.1	7.2	4.7	5.1	1.0
Libya	4.3	6.7	7.5	2.3	2.3	4.2	-
Morocco	4.4	7.8	2.7	5.6	4.9	3.2	3.9
Tunisia	4.4	5.7	6.3	4.5	3.1	3.7	1.3

Source: African Development Bank Data.

Table 2.3: Share of youth (15-29) in total population

	1970	1990	2000	2005
MENA	0.25	0.27	0.30	0.30
Africa	0.26	0.27	0.28	0.28
Asia	0.25	0.29	0.27	0.26
Europe	0.22	0.22	0.21	0.21
LAC	0.26	0.28	0.28	0.27
N. America	0.24	0.23	0.21	0.21
Oceania	0.25	0.26	0.23	0.22

Source: UN 2008 Population Prospects.

Table 2.4: Indicators of Inequality in Selected MENA Countries

Country	Earliest Gini Coefficient (year)	2000 Gini Coefficient (year)	Latest Gini Coefficient (year)
Egypt	32.00 (1991)	34.40 (2000)	32.14 (2005)
Morocco	39.20 (1991)	39.50 (1999)	40.88 (2007)
Tunisia	41.70 (1995)	40.80 (2000)	40.80 (2000)

Source: ILO (2005); World Bank Povcal database.

Table 2.5: Relative Size of Public Employment

	Public sector as a share of total employment 2000	Public sector wages and salaries as a share of current expenditure, 2004
Algeria	29	31
Egypt, Arab Rep. of	29	29
Morocco	10	51
Tunisia	22	63
Latin America and the Caribbean	13	-
OECD	14	-
World (excluding China)	18	-

Source: World Development Indicators.

Table 3.1: Impact of Higher Fuel and Food Prices

Country	Estimated Implied Increase in Import Bill (Percent of GDP)	Estimated Implied Increase in Consumer Prices (Percent)	Estimated Implied Increase in Fiscal Deficit (Percent of GDP)
Egypt	1.6	2.2	2.8
Morocco	2.3	0.7	2.3
Tunisia	1.6	2.6	1.6

Source: IMF (2010a; 2010b).

Table 4.1: North Africa's Structural Deficit

	VASH AGR	VASH IND	VASH MFG	VASH SER	VASH AGR	LSH IND	LSH MFG	LSH SER	REL PROD AGR	REL PROD IND	REL PROD MFG	REL PROD AGR
Bench- mark MIC	8.7	13.9	28.1	49.3	18.2	14.9	22.2	44.7	0.48	0.93	1.27	1.10
Egypt	13.7	21.3	15.7	49.0	31.0	8.6	12.0	48.4	0.44	2.48	1.31	1.01
Tunisia	7.8	13.5	16.5	62.2	17.6	14.4	18.3	49.7	0.44	0.94	0.90	1.25
Morocco	16.4	12.6	15.9	55.1	47.1	6.9	12.1	33.9	0.35	1.83	1.31	1.63
Algeria	8.0	61.0	-	31.0	-	-	-	-	-	-	-	-
Libya	2.1	77.9	-	20.0	-	-	-	-	-	-	-	-

Notes: Benchmark MIC as defined in text.

Sources: McMillan and Rodrik (2011) data base, World Bank WDI database, Timmer and de Vries (2008) database. AfDB database. Author's calculations.

Table 4.2: Decomposition of Productivity Growth, 1990 – 2005

	Labor productivity growth)	Due to within sector productivity growth	Due to structural change
ASIA	3.87%	3.31%	0.57%
HIGH INCOME	1.46%	1.54%	-0.09%
LAC	1.35%	2.24%	-0.88%
AFRICA	0.86%	2.13%	-1.27%

Source: McMillan and Rodrik (2011).

Table 4.3: Selected Indicators of Industrial Development, 2005 - 2008

	Mfg Exports PC 2005 (US\$)	Growth PC Exports 00-05 (%)	Share Mfg Exports in Total (%)	Share Medium /High Tech in Total Mfg Exports (%)	Mfg. Value Added PC 2008 (US\$)	Share of Mfg in GDP 2008 (%)	Rate of Change in Mfg Share of GDP 00-08
MENA Average	367.1	13.5	22.7	13.3	381.4	12.1	0.85
Egypt	83.0	9.80	57.6	11.7	278.9	17.4	-0.68
Morocco	294.0	8.23	79.1	27.6	219.0	16.9	-0.81
Tunisia	889.0	8.47	85.0	23.6	414.7	17.2	-1.12
Developing Countries	487.2	10.05	75.8	57.3	412.9	21.7	1.14
East Asia	885.6	12.36	91.9	97.5	632.5	29.5	1.49

Source: UNIDO database; author's calculations.

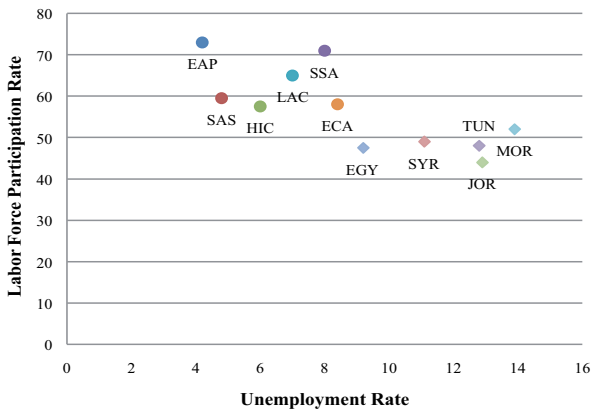
Table 6.1: A Typology of Industrialization Challenges and Responses

	Countries Breaking In	Countries Moving Up	Countries Diversifying
Examples	Egypt, Morocco,	Tunisia	Algeria, Libya
Industrialization Challenge	Lower end task based trade and agro-industry	Mastering more sophisticated products and tasks	Finding niche markets for high value added manufacturing and services
Investment Climate Reforms	Regulation; Trade related infrastructure; skills	Regulation; Trade related infrastructure; skills	Regulation; skills
Strategic Components	Export Push; EPZs; Aggressive FDI policy	Spatial policies linking skills, knowledge and capabilities; FDI; Production knowledge initiatives	Linking industrialization to the resource; Spatial policies linking skills, knowledge and capabilities; Production knowledge initiatives

Source: McMillan and Rodrik (2011).

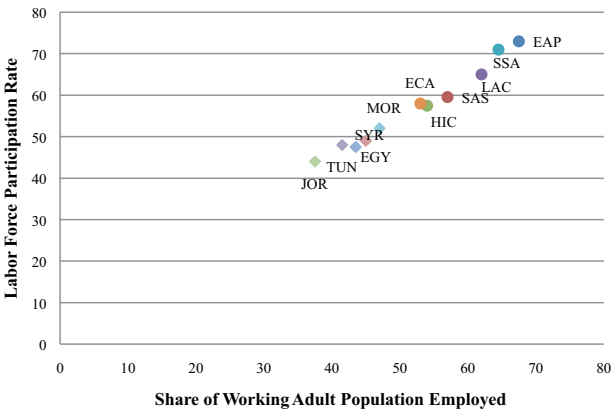
Figures

Figure 2.1: Unemployment and Labor Force Participation Rates 2008



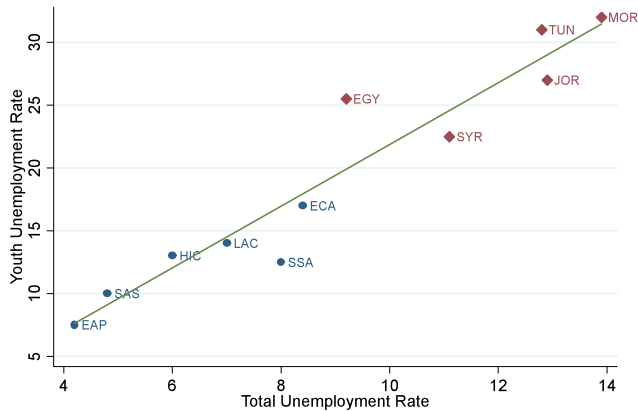
Source: ILO Data.

Figure 2.2: Labor Force Participation and Share of Working Age Population Employed



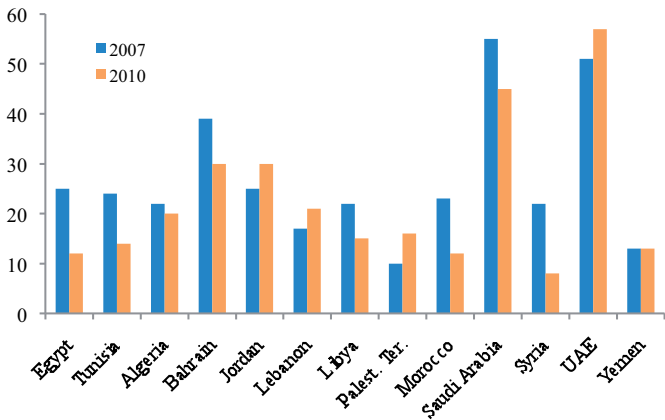
Source: ILO Data.

Figure 2.3: Total and Youth Unemployment 2008



Source: ILO Data.

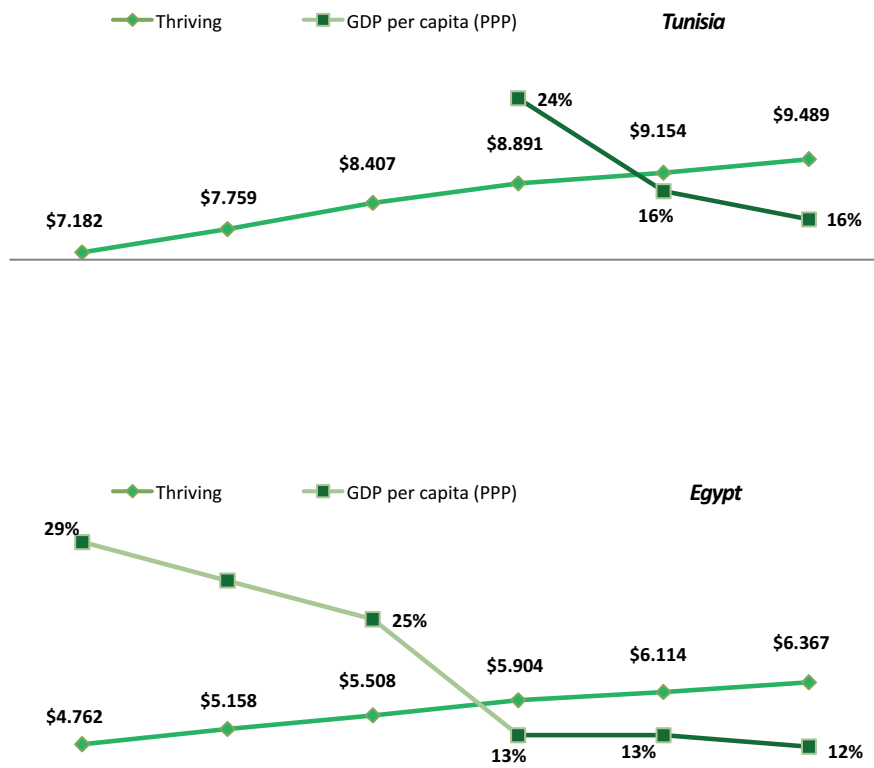
Figure 2.4: Percentage of citizens who report themselves as “thriving” in Gallup Polls, 2007-2010



Notes: For countries that Gallup did not survey in 2007, earliest available numbers are used. For Tunisia, Algeria and Syria, 2008 was the first year they were surveyed. 2009 was the first year Bahrain and Libya were surveyed.

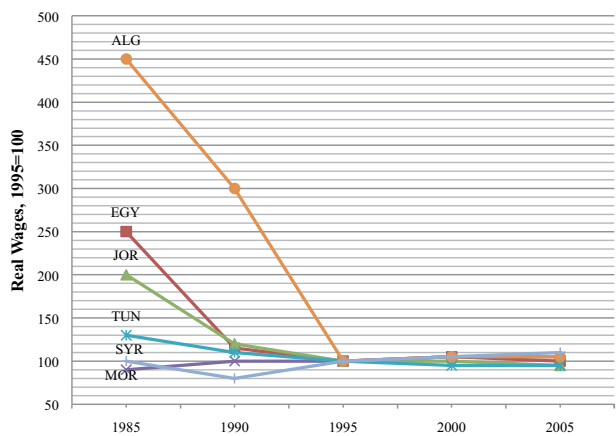
Source: Soumya Chattopadhyay and Carol Graham (2011) using Gallup World Poll survey data.

Figure 2.5: Tunisia & Egypt: Trends in Official GDP p.c., vs. Well Being (% of citizens report «Thriving» in Gallup polls)



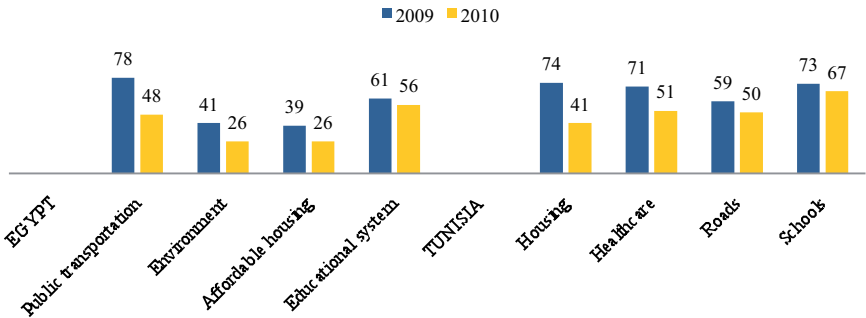
Source: «Egyptian's, Tunisians' Wellbeing Plummets Despite GDP Gains.» By Jon Clifton and Lymari Morales. Gallup.com, Feb-2011, 2005-2010 GDP per capita from International Monetary Fund's Economics Outlook database, other figures from Gallup, Inc.

Figure 2.6: Evolution of Real Wages, 1985-2005

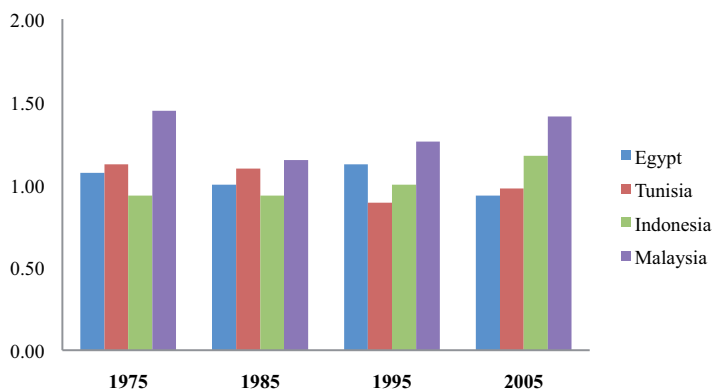


Source: ILO Data.

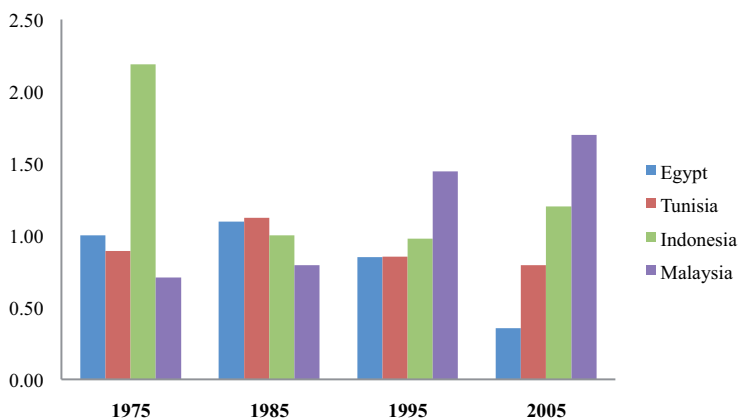
Figure 2.7: Satisfaction with government-provided social services in Egypt and Tunisia



Source: Gallup Report (2010), "Egypt: The Arithmetic of Revolution." Abu Dhabi Gallup Center. Gallup Report (2011), "Tunisia: Analyzing the Dawn of the Arab Spring." Abu Dhabi Gallup Center.

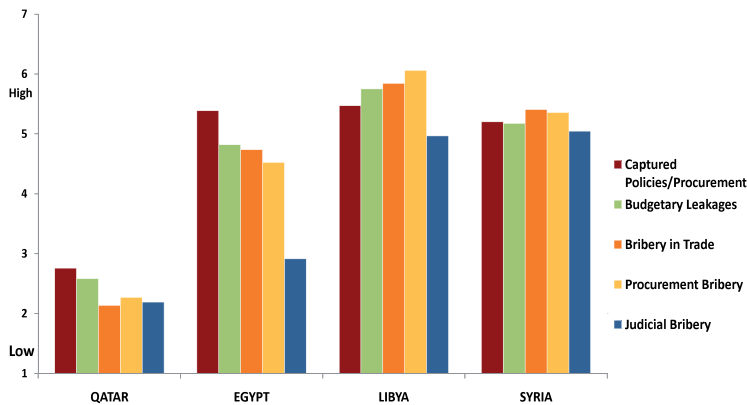
Figure 4.1: Production Sophistication 1975-2005

Source: UNIDO (2009) Authors calculations

Figure 4.2: Export Sophistication 1975-2005

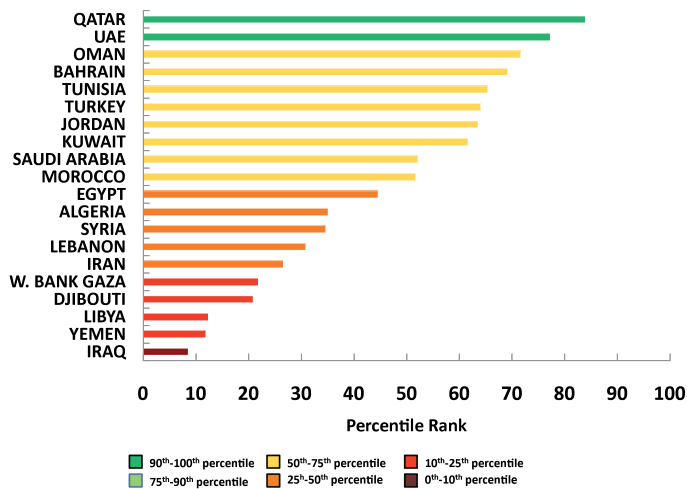
Source: UNIDO (2009) Authors calculations

Figure 5.1: Extent of Corruption & Capture (Selected Countries; Based on Reports from Survey of firms on frequency of various types of corruption)



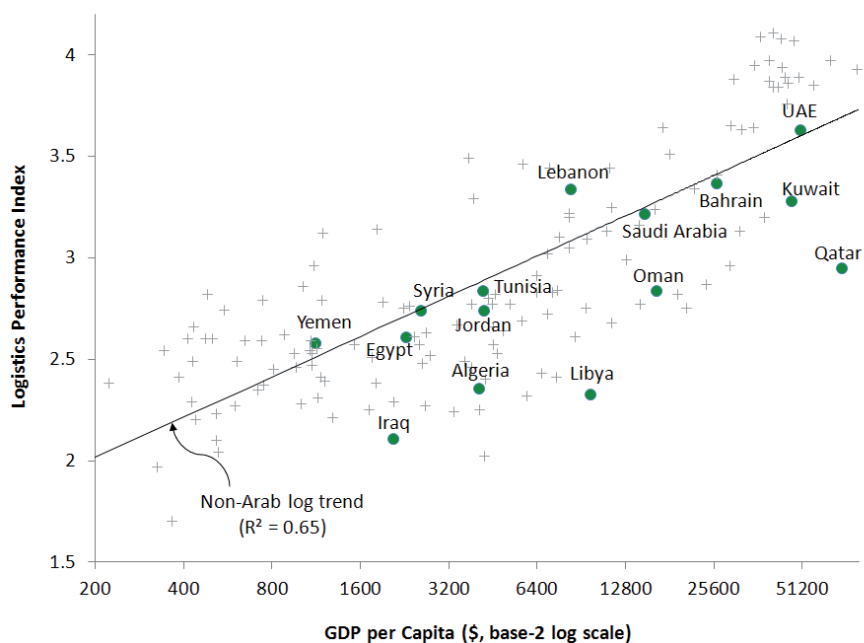
Source: World Economic Forum, Executive Opinion Surveys 2010. Preliminary, for internal use, subject to revision.

Figure 5.2: Government Effectiveness MENA Countries, 2009



Source: WGI: A Summary of Data, Methodology and Analytical Issues,» by D.Kaufmann, A.Kraay and M. Mastruzzi, September 2010 - www.govindicators.org.

Figure 6.1: Income and Trade Logistics Performance



Source: World Development Indicators, World Bank, 2011.



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