

Understanding Common Trends and Variations in the Growth Experience of MENA Countries*

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* This paper offer a synthesis of the studies carried out for eight MENA countries under the auspices of the Global Research Project, Explaining Growth.

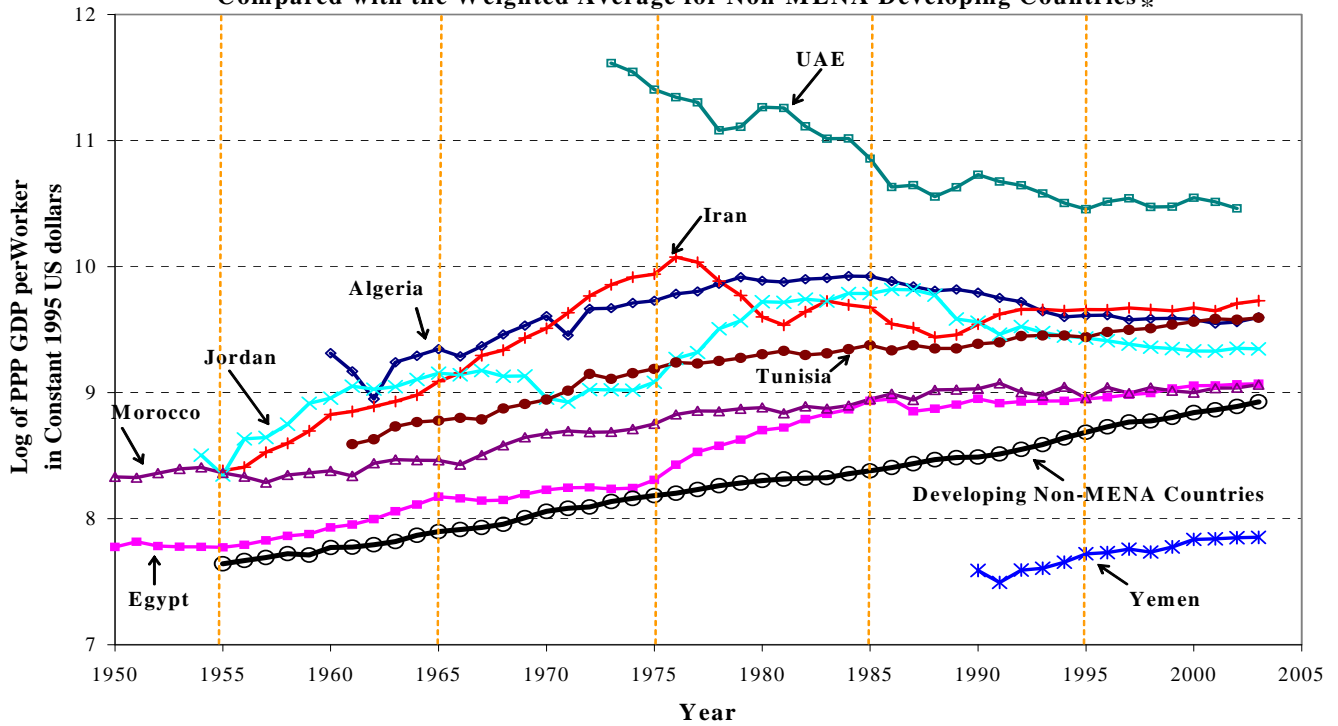
Abbreviations and Acronyms

| | |
|------|----------------------------------|
| GDN | Global Development Network |
| GDP | Gross domestic product |
| GRP | Global Research Project |
| ILO | International Labor Organization |
| MENA | Middle East and North Africa |
| SOE | State-owned enterprise |
| TFP | Total factor productivity |
| UAE | United Arab Emirates |

1. Introduction

A host of recent work on economic development in the Middle East and North African (MENA) has noted that the region experienced generally high growth rates until about 1980 and suffered a long-term slowdown afterwards. (For a recent survey, see Yousef, 2004a.) Although many other developing countries have also encountered slowdowns since the 1970s, the post-1980 decline in MENA countries was typically much more pronounced and far longer lasting. (See Figure 1 and, for GDP growth data adjusted for energy and mineral depletion, Table 1.) As a result, although per capita income in MENA had reached levels well above the developing country average, that advantage has been eroding quickly in the past quarter century. The pattern of boom and bust in MENA seems to be positively related to the movements in oil prices. However, the connection is not straightforward because both oil and non-oil parts of each economy have by and large moved together over many years, while theoretically a rise in oil revenues may have a positive or negative effect on non-oil GDP. Besides, if the issue were only oil revenue, the oil importers in the region should have performed better after 1980 and oil exporters should have adjusted to the revenue decline much earlier.

Figure 1
PPP GDP per Worker in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries *



* The weights are country population. The developing countries included in the average are those with data for the entire period.

Sources: World Bank, *World Development Indicators*, augmented with data from Heston et al. (2004), and U.S. Census Bureau, *World Population Information Website*.

Table 1

**The Growth Rates of per Worker GDP Adjusted for Energy and Mineral Depletion*
in the Sample of Eight MENA Countries Compared to Non-MENA Developing
Countries****

| Country | 1970-1985 | 1986-1995 | 1995-2003 |
|--------------------------------------|------------------|------------------|------------------|
| Algeria | <i>0.60</i> | <i>-2.91</i> | <i>-2.17</i> |
| Egypt | 3.99 | <i>1.20</i> | <i>1.43</i> |
| Iran | 4.04 | <i>-0.05</i> | <i>3.20</i> |
| Jordan | 6.00 | <i>-3.55</i> | <i>-1.04</i> |
| Morocco | 1.85 | <i>0.14</i> | <i>1.35</i> |
| Tunisia | 2.63 | <i>1.33</i> | <i>2.00</i> |
| UAE | 2.69 | <i>-4.85</i> | <i>3.10</i> |
| Yemen | | <i>-2.86</i> | 3.75 |
| Non-MENA Developing Countries | 1.54 | 3.54 | 3.32 |

* The adjustment is a deduction for the energy and mineral depletion from national income calculated by the World Bank, *World Development Indicators*. Since those effects are reported as shares of current price GDP, the GDP deflator and energy prices are used for calculating the constant-price share.

** The developing countries included in the average are those with data for the entire period. The growth figures in *italics* are more than half a percentage point lower than that of the comparison group during the same period and those in **boldface** are equal to or higher than those benchmarks.

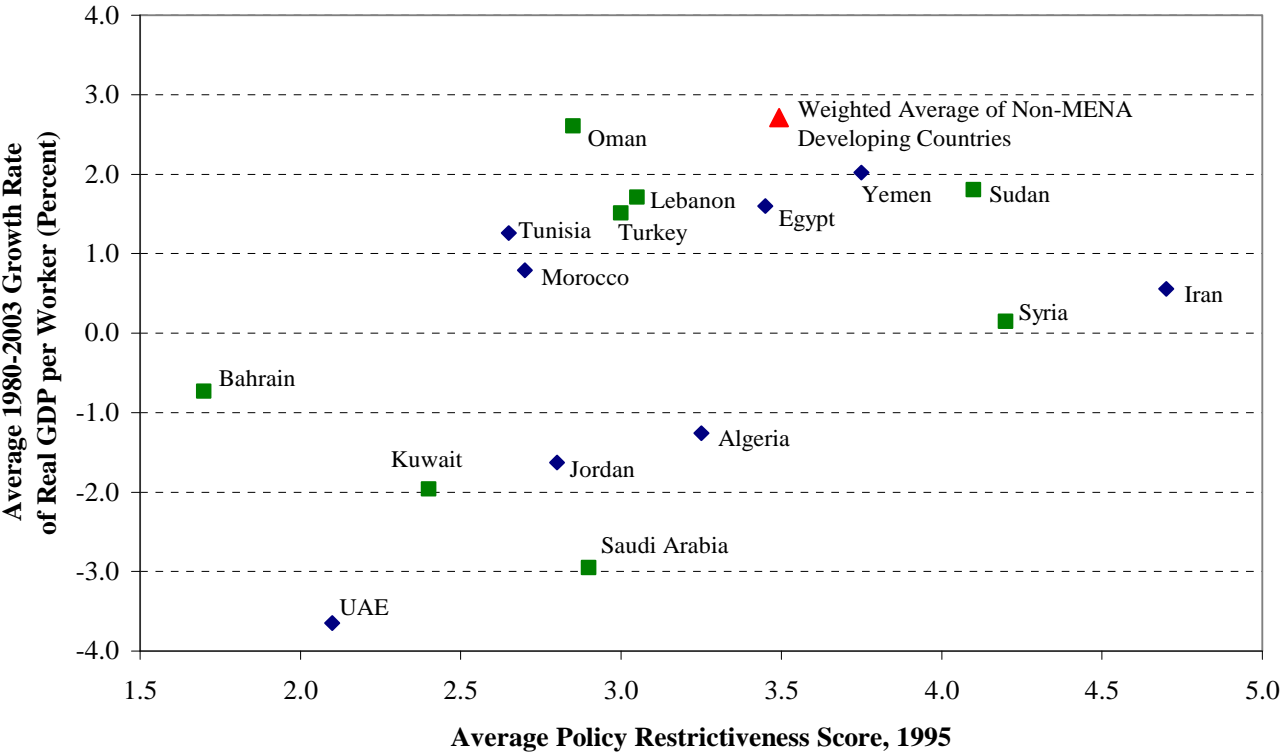
Sources: World Bank, *World Development Indicators*, Heston et al. (2004), US Department of Energy Website.

A common interpretation of the growth pattern in MENA is that the rising natural resource rents before 1980 allowed high investment and high growth while strengthening redistributive policies in the form of implicit "social contracts" between the rulers and various interest groups in MENA societies. Later, those social contracts came to haunt MENA economies when the resource rents declined because the region's governments were still expected to deliver on their distributive promises. This, according to the current common view, has severely constrained the room for the re-orientation of policies towards higher efficiency and growth (Yousef, 2004a). The details of policies in many areas such as labor market, staples prices, trade, and state ownership do indeed indicate a strong redistributive bias among MENA countries (Henry and Springborg, 2001; World Bank, 2003).

While this "social contract" view of MENA's predicament is intriguing, it faces a number of challenges when scrutinized in detail. To begin with, the nature of the social contract and its variations across countries and over time are still not well-understood to offer a satisfactory explanation of

economic performance in the region over the past several decades. According to World Bank (2004b) and Yousef (2004b), the key characteristic of such contracts was the acquiescence of large majorities in MENA societies to the rule of particular groups of politicians in exchange for redistribution. But, economic growth must have played a key role in the initial contracts as well, especially in light of the emphasis on investment and higher growth before 1980. Therefore, it is a puzzle why MENA polities did not continue to demand growth and settled with inefficient redistributive deals. Even if the initial contracts did have more of a redistributive character, one wonders why their bases did not shift towards growth, especially when the resource rents diminished. This is particularly puzzling because social contracts were also common among East Asian countries that succeed with little natural resources, but they managed to emphasize shared growth rather than pure redistribution (Campos and Root, 1996).

Figure 2
Government Intervention and Economic Growth in MENA Countries
and the Weighted Average for Non-MENA Developing Countries*



- MENA Countries outside sample.
- ◆ MENA Countries in sample.

* Growth rates are the averages for the years when data is available during 1980-2003. The policy restrictiveness score is the average of economic freedom indices developed for various policies in 1995 by the Heritage Foundation. For details, see Tables 4-5, 7, 9, and A2.

Sources: World Bank, *World Development Indicators Website*, and the Heritage Foundation website, *Index of Economic Freedom*.

Another difficulty with the current social contract explanation of MENA's growth pattern is its claim that those contracts are responsible for low growth because they constrain market-oriented reforms. However, as Figure 2 suggests, the correlation between the pervasiveness of restrictive policies and the rate of long-term growth within the region seems to have been positive! For example, economic policies in Egypt have been far more interventionist and redistributive than those in Morocco or Jordan, but Egypt's average per worker GDP growth rate of 2.7 per year since 1960 has by far exceeded those of Morocco (1.6 percent) and Jordan (1.0 percent). This is true even if one focuses on the post-1980 growth when the redistributive social contracts are supposed to have been more damaging (1.6 percent for Egypt versus 0.8 and -1.63 percents per year for Morocco and Jordan, respectively). Also, liberalization efforts during the 1990s do not seem to have yielded tangible dividends in any of these three countries (see Figure 1 and Table 1).

This paper makes an effort to shed light on the above issues and offers a different interpretation of the role of social contracts in MENA that may throw light on why less interventionism has not been associated with better economic performance in the region. The paper draws on and synthesizes the detailed studies of eight MENA countries carried out under the auspices of GDN's Global Research Project (GRP), *Explaining Growth*. Although those eight MENA countries—Egypt, Iran, Jordan, Morocco, Tunisia, United Arab Emirates, and Yemen—are the focus of the analysis, their experiences are compared to other MENA countries and the rest of the developing world. The papers covering the GRP sample are listed in Table A1 in the Appendix.

The plan of this paper is as follows. Section 2 starts with an overview of the basic causes of boom and bust in MENA countries based on a synthesis of GRP studies. This provides a broad framework in which various aspects of the growth experience in the countries of the region can be reviewed and linked together. Section 3 focuses on the sources of growth in the eight sample countries. Section 4 looks at the micro aspects of economic development concerning households and markets in those countries. Section 5 examines the political economy factors shaping the microeconomic and macroeconomic outcomes in the region. The last section concludes by discussing the policy implications of the findings.

2. Overview of the Causes of Boom and Bust in MENA Economies

Although it is easy to find differences in the growth experiences of MENA countries, there are also notable and important similarities. One claim of this paper is that MENA's social contracts and interventionist policies were often associated with growth, at least in the medium term because they were partial solutions to the institutional weaknesses that prevented proper functioning of private markets. In particular, failures of capital, labor, and insurance markets had impeded education, healthcare, infrastructure, and most industrial activity. Lack of economic development in turn had kept government

finances weak and had impeded public investments that could improve the conditions for private market operation. The efficient solution to such problems may seem to have been a set of reliable market-supporting rules and institutions, with all else being left to the markets. However, for a country to develop in short order the right rules that fit its cultural, social, and political conditions requires an enormous level of local expertise and institutional capability. Those requirements were far beyond the means available to MENA countries in mid-twentieth century (and still remain so in many respects). In this context, explicit and implicit social contracts were established initially by MENA leaders as more practical mechanisms for promising shared growth.

To deal with redistribution and coordination concerns, the contracts involved highly centralized decision-making with extensive state intervention in the form of trade restrictions, subsidies and taxes, price and quantity controls, and public ownership. Mass subsidies played a role in all these social contracts to preempt the public's reactions to concerns that the resources available to the government may go to waste or to the private use of politicians (Esfahani, 2002). The reason was that MENA regimes generally relied on public support or acquiescence and could rarely impose their policies by sheer force, but they were not democratic either and lacked sufficient checks and balances to assure the public that treasury funds would be properly spent to serve long-term and broad interests. Administrative weaknesses and inadequate indigenous expertise must have also reduced confidence in the ability of MENA governments to deliver shared growth, inducing most of the population to ask for more immediate benefits and redistribution.

The details of the social contracts varied across countries, largely in connection with political structure and access to resource rents. The availability of resource rents naturally led to demands for greater redistribution. It also made it less costly for the government to pursue its objectives (concerning production, employment, distribution, et cetera) through public investment rather than the private sector. The most significant difference in political structure was between monarchies and republics. In monarchies, where the rulers depended more on traditional relations, social contracts promised less redistribution towards the masses and entailed greater support for the private sector, which was run by groups connected with the political elite. In countries where republics had been established through military coups, revolutions, or national liberation movements, pre-existing power relations had crumbled and the new political elite needed to generate support for their regimes through broader mass appeal. Consequently, at least initially they were under greater pressure to provide jobs and mass redistribution and had less interest to work with the private sector and offer incentives that could enrich an old or a new economic elite.

The social contracts in both monarchies and republics produced growth dividends for a while. The reason was that they motivated and enabled the governments to reduce the existing gross inefficiencies of MENA economies in terms of finance and human and physical capital (especially, education, healthcare, infrastructure, and manufacturing). Those contracts helped mobilize substantial resources and provided the means and the security for large groups of people to engage in modern education and production. The rise in the oil revenues until around 1980 facilitated the process and induced the governments to offer larger redistributions and rely more on public investment and expenditure for achieving their goals. However, oil was by no means the only determinant because growth was strong even in countries that had little resource rents—such as Egypt and Tunisia before 1965—because their political leaderships had to legitimize themselves through economic growth with broadly distributed benefits. Countries like Morocco, where the leadership did not have to promise as much and had access to less resource rents, did not perform as well as the rest.

The slowdown of growth in MENA after 1980 was partly a consequence of the decline in oil prices, which reduced the financing available for private and public investment. However, that cannot account for the long-term decline in growth rates. If reduced external resources were the main issue, expansion should have resumed after a few years of adjustment and improvement in investment and finance incentives, which is what happened in most of East Asia after the 1997-98 financial crisis. Very few MENA countries managed to establish the right incentives, and some even lost their growth momentum before the decline in oil prices (as in the case of Iran after 1976).

The basic problem seems to have been the increasing obsolescence of the initial social contracts during the 1970s and 1980s as a result of changes in internal and external conditions of MENA countries. In almost all cases, the increased education and income levels had given rise to new social, political, and economic demands that the policymakers needed to identify and address while external resources were diminishing. In addition, in the countries that had already made large investments (e.g., Algeria and Iran), the returns to the old strategy were quickly diminishing. All these required new social contracts to mobilize new resources and to deal with the new distributional concerns. Given the past reliance on public sector and centralized decision-making, the new contracts had to make more room for private initiative and public participation while ensuring a sense of fairness and policy coordination.

The approaches of MENA countries to re-contracting had some similarities as well as visible differences. The main similarity was that in all countries some elements of the Chinese-style "dual track" strategy were adopted. In particular, provisions were made to reduce market controls and expand the private sector in some parts of the economy, while maintaining government controls and the public sector

in the rest. However, different government introduced the changes with different speeds, coercive force, and degrees of success. The political structure and access to resource rents again seemed to matter.

When the effectiveness of the old social contracts started to wane, countries with less access to oil rents—such as Tunisia and Morocco—faced smaller shocks, but paid more attention to trade policy reform. In this group, Tunisia did rather well by pursuing export promotion more emphatically. The export proceeds gave the government an effective gauge to judge the private sector's performance and assess the impact of its policies. The policy also helped create a growing pro-trade private sector, which enhanced the support for the government's policies. Furthermore, the country's republican political structure motivated the politicians to pursue interventions that emphasized the formation of human and physical capital. Later on, these factors—including the expertise developed in designing and implementing policies—provided the government with better opportunities to pursue effective policies. In contrast, Morocco's less interventionist system had not performed as well before the 1980s. Accordingly, it was not as well-prepared as Tunisia to ensure that its liberalization policies were adequate solutions to the economy's problems.

In countries enjoying larger resource rents, the government could afford more extensive investment in education, infrastructure, and other forms of capital. Also, the promotion of non-resource exports was not a priority and had smaller constituencies. As a result, when those countries started to face declining rents and diminishing returns to the statist strategies, they had a harder time building political support for export promotion or trade liberalization. In fact, the reduced level of imports increased the weight of domestic producers in the trade policy calculus, discouraging the government to liberalize trade (Esfahani and Squire, 2007). Furthermore, the political structure made it difficult to build a consensus around reductions in subsidies and privatization because the public suspected that the saved funds would go to waste or to private use by the politicians. This was why policy changes such as the removal of subsidies in Egypt in 1977 and in Jordan in 1989 met with street riots and forced the politicians to rescind them to various degrees in favor of more gradual strategies. In Algeria, the ruling elite proceeded with policies favoring private markets after imposing a harsh dictatorial rule in 1990. However, they had to fight a costly civil war that left no room for economic growth. In Iran under the Shah, where the government proceeded with its policies disregarding the population's needs and demands, eventually a revolution erupted after the growth slowdown of 1977-1978 (Pesaran, 1985). The outcome was a new regime with a new social contract that promoted government controls and redistribution in unprecedented ways. However, the new political structure significantly weakened the government's ability to coordinate and employ expertise in its policymaking. As a result, the country enjoyed little growth, except when

there were increases in oil windfalls, and the government's reform efforts to change the situation since the 1980s have not been particularly effective.

Like Iran in the 1960s, the emirates that later formed the UAE pursued a combination of private and public sector development policies that quickly addressed the infrastructure issues with the help of high per capita resource rents. However, unlike the Shah, the rulers of UAE followed more cautious and less heavy-handed strategies. Also, they dealt with smaller populations, could be closer to their constituencies, and shared larger rents with them. The overall growth outcome was weak, but the gradual approach has helped build a strong foundation for a vibrant market economy that since the 1990s has started to experience good performance, especially in the non-oil sectors.

In Egypt, the start of the reform process in 1974 coincided with a major increase in the inflow of external resources. Therefore, the government opted for a very gradual approach aimed at reviving the private sector, while maintaining the public sector and substantial mass subsidies. This policy and the resource inflows, which stayed high until the early 1980s due to the delay in the decline of remittances and other rents, allowed Egypt to grow at high rates for about a decade. After a few years of stagnation in the second half of 1980s, the government finally embarked on a reform process in the 1990s to trim the public sector and reduce subsidies, though still enjoying some rents and remaining cautious. It did not promote exports very effectively and, as a result, lacked a sufficient pro-trade constituency to inject dynamism into the reform process. Egypt's overall performance since the 1980s has not been as good as Tunisia's.

Jordan's growth pattern had similarities with that of Egypt: Increased inflow of resources, improved policymaking, and support for the private sector generated high growth rates in the 1970s and early 1980s, but economic performance waned after the mid-1980s as external rents diminished. However, if it were not for a series of sizable adverse shocks, Jordan's potential for reviving growth could have been stronger than Egypt because by the mid-1980s it had reached much higher levels of development in infrastructure and human capital and had a relatively smaller public sector to reform. The government also pursued promising policies, though its commitment to export promotion was not as strong as that of Tunisia because many years of large resource inflows had oriented its private sector towards domestic markets. Jordan's vulnerability was also due to its location between Iraq and Israel/West Bank, which were important sources of instability. They were often Jordan's most important trade partners, but at times were cut off due to political and security reasons, with grave consequences for Jordan. For example, large parts of Jordan's effort to take advantage of those markets were lost every time the Palestinian-Israeli conflict heated up or when international sanctions were imposed on Iraq in the

1990s. Jordan's relations with Iraq also cost the country the loss of remittances and migration opportunities in the Persian Gulf area.

Finally, In Yemen, recovery and reform in the 1990s was combined with the discovery of oil and an increase in rent earnings, which in some ways was similar to Egypt's experience in the 1970s and 1980s. However, Yemen started its reform attempt when its physical and institutional infrastructure was very weak. As a result, gross inefficiencies remain in its markets and policy processes and whatever growth it has experienced has been due to the rise in its resource rents, which may not last very long.

The following sections examine the details and the mechanics of the processes summarized above.

3. Sources of Growth in MENA Economies

Theories of economic growth are consistent stories that link the increases in aggregate output over time to a set of variables that directly shape production ("immediate determinants"), which in turn may be determined by other variable that can be taken as exogenous ("ultimate determinants"). Any such theory must explain how the ultimate determinants mold the immediate ones, which are typically defined as the factors of production and the effectiveness with which they are put into use (i.e., total factor productivity). Then, the movements of the production factors must be connected with the trajectory of aggregate production. Therefore, a key step in applying a typical growth theory to a particular economy is to determine the contribution of various factors of production to the long-term output dynamics. This is where our synthesis of the GRP studies of growth experience in MENA begins. As is common in the growth accounting literature, it is useful to first focus on three major factor categories: capital, labor, and all else (referred to as "total factor productivity", or TFP). Once the contributions of these three categories are known, the forces that affect each, particularly those shaping TFP, can be analyzed in further detail.

The measure of TFP that is used here is essentially output growth net of effects that can be attributed to physical capital and raw labor. Some authors treat human capital as a separate input or as part of labor and try to net out its effects before arriving at the TFP indicator. However, this approach faces a serious problem because the existing indicators of human capital are highly imperfect and using them for parameter estimation and TFP measurement make it difficult to interpret the results. An alternative is to view human capital as a determinant of TFP and investment and analyze the possible effects of human capital indices on those variables (with TFP referring to the aggregate productivity of

capital and raw labor).¹ Therefore, in the rest of this section, I adopt the latter approach and focus on the contributions of raw labor, capital, and TFP to growth. The role of human capital and other determinants of TFP and investment are discussed in later sections.

The relationship between GDP growth and the three major factor categories in a given period t is typically summarized by a Cobb-Douglas relationship:

$$(1) \quad G_t = a_t + \alpha K_t + (1 - \alpha)L_t,$$

where G_t is growth rate of real GDP, K_t is the growth rate of physical capital stock, L_t is the growth rate of labor force, and a_t is the rate of growth of TFP. α is a parameter that can be equated with the share of capital when the return to capital equals its marginal product. Letting $g_t = G_t - L_t$ and $k_t = K_t - L_t$, be the per worker growth rates of real GDP and capital stock, respectively, equation (1) simplifies to:

$$(2) \quad g_t = a_t + \alpha k_t.$$

The parameter α is critical in determining the contributions of the three factor categories to overall growth, which are represented by a_t , αK_t , and $(1 - \alpha)L_t$. This parameter must be estimated through an econometric study of equation (1) that takes proper account of the endogeneity of K_t and L_t and variability of a_t as well potential trends in α . Not all studies address such issues fully. As a result, the estimates of α vary depending on technique and other details. The best current estimates indicate that α has a mean of about 0.5 and a standard deviation of about 0.2 (Senhadji, 2000). Individual GRP studies have used country specific values of α . Here, I use $\alpha = 0.5$ as a benchmark for all countries to facilitate comparisons. I will comment the impact of variations in α across countries.

2.1. Labor as a Source of Economic Growth in the MENA Region

One the most notable and broadly-shared characteristics of MENA economies is the fast growth of population and labor. As Table 2 indicates, since the 1970s labor growth rates in all MENA countries have been well above the average for the rest of the developing world. Given the implication of (1) that the contribution labor to growth is $(1 - \alpha)L_t = 0.5L_t$, it should not be surprising that almost all GRP studies of MENA arrive at relatively large figures for the contribution of labor to growth. The only country where labor is found to play a small role in growth is Egypt, where the labor force growth has been slower than most other MENA countries; Kheir-El-Din and Moursi (2003) argue that α must be large in Egypt—specifically, they focus on $\alpha = 0.65$.

¹ See Davies (2003) for a survey of the role of human capital in growth that shows the measurement difficulties and makes a case for treating human capital as a determinant of TFP.

Another important observation is that the growth contribution of labor in MENA seems to have been rising over time because of a general acceleration in labor supply growth in the region over the past half century. Whereas this contribution was on average about one percent per year in the 1960s, it has reached over 1.5 percent per year in the early 2000s. The GRP papers do not elaborate on the reasons for the rise in population growth in the 1950s through 1980s, which is the origin of the current demographic condition. However, the common perception is that economic development in that period led to rapid population growth by reducing mortality rates and by making larger families more affordable in a situation where female force participation rates were low.

Table 2
Labor Force Growth in the Sample MENA Countries
Compared to the Labor Force Growth in Non-MENA Developing Countries*

| Country | 1956-1960 | 1961-1965 | 1966-1970 | 1971-1975 | 1976-1980 | 1981-1985 | 1986-1990 | 1991-1995 | 1996-2000 | 2001-2003 |
|--------------------------------------|-------------|--------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|-------------|
| Algeria | 2.06 | <i>0.27</i> | <i>0.97</i> | 3.17 | 3.18 | 3.99 | 3.47 | 4.27 | 3.70 | 3.74 |
| Egypt | 1.54 | 2.36 | 2.20 | 1.83 | 2.35 | 2.53 | 2.35 | 2.79 | 2.90 | 3.11 |
| Iran | <i>0.57</i> | 2.11 | 2.25 | 2.81 | 2.98 | 3.66 | 2.83 | 2.22 | 3.40 | 3.85 |
| Jordan | 3.16 | 5.54 | 5.54 | 2.27 | 2.25 | 4.38 | 4.14 | 9.13 | 4.35 | 3.68 |
| Morocco | 2.52 | 1.78 | 1.78 | 3.27 | 3.06 | 2.51 | 2.39 | 2.46 | 2.34 | 2.41 |
| Tunisia | 1.52 | <i>1.05</i> | <i>1.21</i> | 3.20 | 3.88 | 2.80 | 2.55 | 3.04 | 3.01 | 2.37 |
| UAE | 4.40 | 10.72 | 16.10 | 19.07 | 16.69 | 5.27 | 4.71 | 6.16 | 6.01 | 7.28 |
| Yemen | 2.18 | 1.75 | <i>1.20</i> | <i>0.28</i> | 2.14 | 3.59 | 3.56 | 5.44 | 2.39 | 3.06 |
| Non-MENA Developing Countries | 1.85 | 1.75 | 2.14 | 2.51 | 2.19 | 2.09 | 2.11 | 1.79 | 1.68 | 1.54 |

* The developing countries included in the average are those with data for the entire period. The labor force growth figures in *italics* are more than half a percentage point lower than that of the comparison group during the same period and those in **boldface** are equal to or higher than those benchmarks.

Sources: World Bank, *World Development Indicators*, and U.S. Census Bureau, *World Population Information Website*.

The rapid growth of the labor force has posed an opportunity as well as a problem for MENA economies. On the one hand, the birth rates in most countries are falling and the share of the work force in the population is rising, which should make more resources available for growth. On the other hand, ensuring rapid job creation has been a challenge for policymakers in the region. These effects are reinforced by the changing patterns of migration in the region, whereby the labor that moved towards the major oil exporting countries when oil revenues were rising began to return in the 1980s and 1990s when oil revenues declined and international tensions in the regions increased. Jordan is a prominent example of this when in the early 1990s its labor force growth rate surged to almost 10 percent per year as employment opportunities of its workers in the Persian Gulf region shrank rapidly in the aftermath of Iraqi invasion of Kuwait (Kanaan and Kardoosh, 2003). So far, MENA governments have been slow in turning the problem of labor force growth into an opportunity for putting their economies on rapid growth paths. As a result, as we will see below, the expansion of the labor force in MENA has been associated with low TFP growth.

2.2. The Role of Capital

To assess its role in growth, physical capital must be measured first. To this end, the MENA GRP papers on the sources of growth generally use Nehru and Dhareshwar's (1994) data set and its various extensions. Since that data set ends in 1990 and does not cover all countries examined here, I use a uniform method to develop long-term and up-to-date capital stock series for the sample countries as well as all other countries that can be used as comparison groups. The method follows Klenow and Rodriguez-Clare (1997), where the initial capital stocks are calculated according to the following "steady-state" formula

$$(3) \quad \frac{K_0}{Y_0} = \frac{I/Y}{\gamma + \delta + n},$$

where I/Y is the average investment-GDP ratio for the entire period for which such data is available, K_0/Y_0 is the capital-output ratio for the start of that period, γ and n are respectively the average GDP and labor force growth rates during that period, and δ is the rate of depreciation of capital. Once the initial capital stock is measured, subsequent values are calculated using a perpetual inventory method that relates the capital stock at the start of year $t+1$, K_{t+1} , to capital stock at the start of year t , K_t , depreciation rate, δ , and real gross investment in year t , I_t :

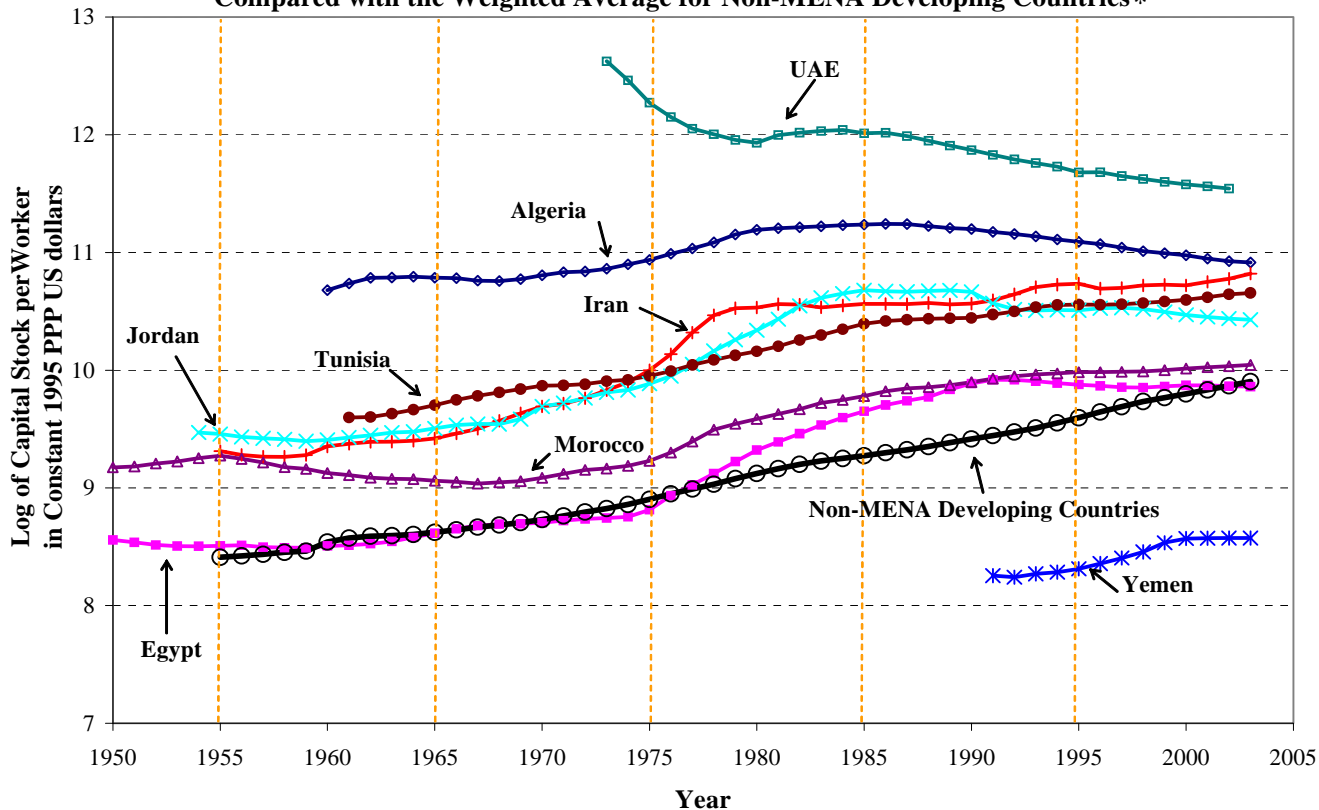
$$(4) \quad K_{t+1} = (1-\delta)K_t + I_t.$$

Figure 3 shows the results of the above calculations assuming $\delta = 0.05$. As in the case of income levels in Figure 1, the per worker capital stocks in MENA have generally resided above the average for the rest of the developing world. However, their initial advantages and subsequent stagnations are more pronounced than the GDP per worker levels (compare Figures 1 and 3). The role of oil revenues in capital formation is visible during the 1970s when the capital stocks of the major oil-exporting countries—Algeria, Iran, and UAE—experienced an upward jump and subsequently stagnated or declined. For the other countries, the revenues arrived more gradually and the accumulation continued longer into the 1980s. But, in all cases except Tunisia (and, more recently, Iran), capital accumulation has slowed down and has even declined in the past two decades. As a result of this pattern, the contribution of capital to growth in MENA, αK_t , must have been high until the early 1980s and must have generally fallen sharply afterwards regardless of the true value of α . This is, indeed, what the GRP studies of the region find.

The decline in investment rates and capital formation since the 1980s has been largely associated with diminished public investment, as documented for the cases of Algeria (Chemingui, 2003), Egypt (Kheir-El-Din and Moursi, 2003), Iran (Jalali-Naini, 2003), Jordan (Kanaan and Kardoosh, 2003), UAE (Elhiraika and Hamed, 2003), and Yemen (Al-Asaly, 2003). Obviously, to maintain rapid growth, MENA

economies should have mobilized more private investment. Thus, a key question regarding capital formation in MENA is why the region's governments were not effective in encouraging more private investment when they found their own funds dwindling. We will examine this issue along with other basic questions about MENA's growth process in subsequent sections.

Figure 3
Capital Stock per Worker in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* The developing countries included in the average are those with data for the entire period. The weights are PPP capital stock values in 1995 constant international dollars.

Sources: World Bank, *World Development Indicators*, augmented with data from Heston et al. (2004), and U.S. Census Bureau, *World Population Information Website*.

2.3. The Total Factor Productivity in MENA Economies

Given the data for labor, GDP, and capital stock, it is straightforward to calculate the joint productivity of capital and raw labor using equation (2). The results of this exercise for the sample countries are presented in Table 3. As the table shows, this measure of TFP follows more or less the same pattern as the GDP growth rates—generally positive with an above average performance before 1980 and a much inferior performance in the 1980s and 1990s. However, because of diminished investments in the

latter period, capital accumulation has not been contributing to whatever growth that occurred in the past several years. This is why the TFP performance of MENA countries since the late 1990s has been somewhat better relative to the rest of the developing world when compared to its growth performance. Nevertheless, it is still fair to summarize the result of the GRP studies as indicating that the contribution of TFP to overall growth since 1980s has been minimal.

Table 3
The Growth Rate of Total Factor Productivity of Capital and Raw Labor
in the Sample MENA Countries
Compared to the Weighted Average of Non-MENA Developing Countries*

| Country | 1956-1960 | 1961-1965 | 1966-1970 | 1971-1975 | 1976-1980 | 1981-1985 | 1986-1990 | 1991-1995 | 1996-2000 | 2001-2003 |
|--|--------------|-------------|-------------|-------------|---------------|-------------|-------------|-------------|-------------|-------------|
| Algeria | | -0.40 | 5.01 | 1.13 | 0.63 | 0.24 | -2.21 | -2.52 | 0.51 | 1.62 |
| Egypt | 3.14 | 3.82 | 0.20 | 0.47 | 2.83 | 1.35 | -2.05 | 0.07 | 2.18 | 0.72 |
| Iran | 8.47 | 4.56 | 5.74 | 5.55 | <i>-12.14</i> | 1.20 | -2.69 | 0.62 | 0.45 | 0.17 |
| Jordan | 12.68 | 3.01 | -5.82 | 0.58 | 8.24 | -2.12 | -4.39 | -0.96 | -1.65 | 1.20 |
| Morocco | 1.80 | 2.31 | 4.02 | 0.10 | -0.98 | -0.60 | 0.46 | -2.34 | 0.57 | 1.61 |
| Tunisia | | 3.37 | 1.68 | 4.04 | 0.22 | -0.86 | -0.34 | -0.04 | 2.04 | 0.06 |
| UAE | | | | | 0.62 | -8.98 | -1.13 | -3.57 | 2.84 | -3.30 |
| Yemen | | | | | | | | 3.18 | -0.31 | 0.47 |
| Weighted Average of Non-MENA Developing Countries | 1.30 | 1.21 | 2.32 | 0.55 | 0.47 | 1.03 | 1.04 | 2.35 | 1.13 | 1.35 |

* The developing countries included in the average are those with data for the entire period. Labor force is used as weights across countries. The growth figures in *italics* are more than half a percentage point below the average for the comparison group and those in **boldface** are equal to or higher than that average.

Sources: World Bank, *World Development Indicators*, Heston et al. (2004), and U.S. Census Bureau, *World Population Information Website*.

Another important observation is the generally positive correlation between capital accumulation and TFP, which goes against the view expressed in some recent studies of economic growth in the region (see, e.g., Page, 1998; Keller and Nabli, 2002; Yousef, 2004a). While there are cases such as Algeria in the early 1970s when increased capital growth rates were associated with a decline in TFP, there are many more examples of the opposite situation. This is notable because by construction, measurement errors

already induce a negative correlation between TFP and capital growth. It seems that some common shocks have induced a positive correlation between the two that has overcome the downward bias. However, it is possible that if one controls for such shocks, one might find that the economic policy in some countries has been the sources of a negative correlation, though that remains to be demonstrated.

What factors can account for the general rise of TFP along with investment before 1980 and their long-term declines afterwards? It is possible that many different factors have been involved and their significance may have varied from country to country. For example, the 1979 Islamic Revolution in Iran and the subsequent war with Iraq can easily account for collapse of investment and productivity in the country during the 1980s as the nation experienced major political instability and institutional transformation. Similarly, the stagnation of capital stock and TFP in Egypt between the mid-1960s and mid-1970s had a lot to do with its wars with Israel. However, such institutional and international shocks were not shared by all countries in the region.

One mechanism that seems to offer a plausible explanation for the common ups and downs in productivity and growth across countries and across sectors in the region is credit market imperfections. Credit markets in MENA countries have been relatively underdeveloped and their contribution to the economy has been constrained. The severity of the problem naturally diminishes when resource revenues become abundant and are partly passed on to firms through stronger sales, subsidies, easy financing, government participation in equity, et cetera. These possibilities raise the industries' profits and retained earnings, which allow the firms to increase their investments and make more effective use of their production capacities. When resource rents decline, borrowing becomes more crucial, and financial resources need to be allocated with care. But, if credit markets are not functioning well, firms may be not be able to secure the credit that they need and, therefore, have to cut back on investment in physical capital as well as losing productivity due to limitations on capacity use and on investment in research and development and organizational and skill development. The capacity use limitation comes about when firms face constraints in financing their required inputs or aspects of day-to-day operations. In such situations, the government's increased hunger for funds may also cause cut backs on public infrastructure and even induce a more interventionist stance, thus exacerbating the producers' problems.

4. Households, Human Capital, and Savings

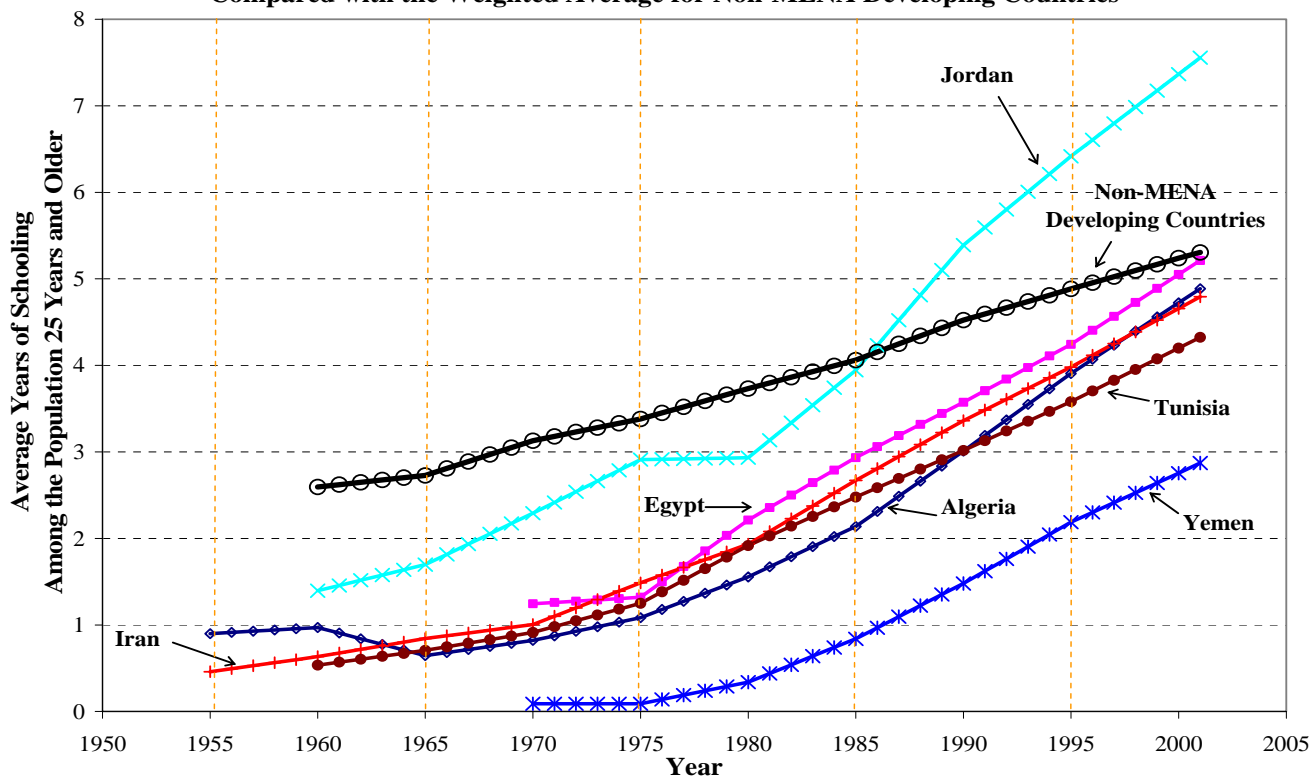
Our review of the sources growth in MENA based on GRP papers shows that the slowdown of the region's growth in the past quarter century was associated with a decline of capital and TFP growth rates. In principle, sufficient accumulation of human capital and private savings could have reversed these trends. Therefore, it is important to examine the trends in these variables and explore the roles that they may have played in the growth process. This is the main task in this section. The discussion entails an

analysis of the characteristics of households as the main decision-makers in the formation of private savings and human capital. The analysis also takes account of the environment induced by government policies. However, the more detailed analysis of the way policies take shape and influence the markets surrounding households will be taken up in later chapters.

3.1. Human Capital and Education

Human capital is believed to play a central role in the process of development. Workers should become more productive when they are better skilled at using equipment, material, technology, and organizations. The higher productivity should in turn enable them to contribute to a faster development of the resources and technology needed for economic growth. However, verifying these commonly held views has been problematic because of imperfections in measuring human capital (Pritchett, 2001). Here, I use two indicators of education—average years of schooling and literacy rate—as key facilitators of human capital formation. The question is whether the slowdowns in TFP and investment in MENA countries may have been driven by reduced education effort.

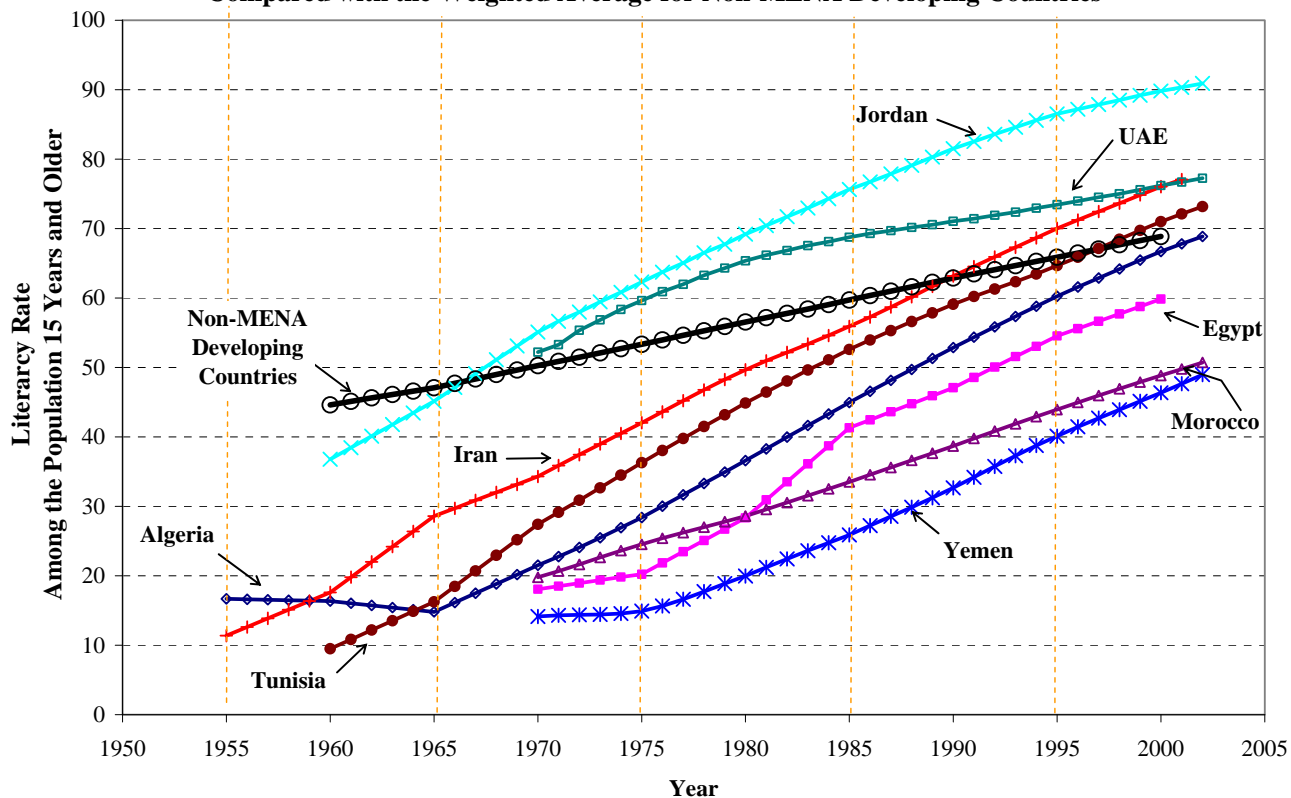
Figure 4
Average Years of Schooling in Selected MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* Weighted by the country labor force.

Sources: World Bank, *World Development Indicator*, augmented with information from the Barro-Lee education data available from the NBER website, www.nber.org.

Figure 5
Literacy Rate in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* Weighted by the country labor force.

Sources: World Bank, *World Development Indicators*, augmented with information from the Barro-Lee education data available from the NBER website, www.nber.org.

Figure 4 compares the trends in the average years of schooling of the 25 years and older population in the sample countries with the weighted average for non-MENA developing countries. Figure 5 does the same thing for the literacy rate of the population 15 years and older. These diagrams and the GRP studies examining the role of education reveal three important patterns concerning education in MENA:

1. In 1960, schooling and literacy rates in MENA were generally far below the average for the developing world, and have remained such for most of the time for most countries of the region.
2. With the possible exceptions of Morocco and Yemen, MENA countries have generally made serious efforts to catch up and some have well surpassed the developing world average.

3. MENA countries with the highest levels of education, initially or later, are not among the countries with the fastest growth of TFP. In particular, Jordan and UAE, which have provided the most education, are the two countries with the lowest average TFP growth over the past few decades. On the other hand, the weak educational performers—Morocco and Yemen—have not done as bad in terms of TFP and GDP growth.

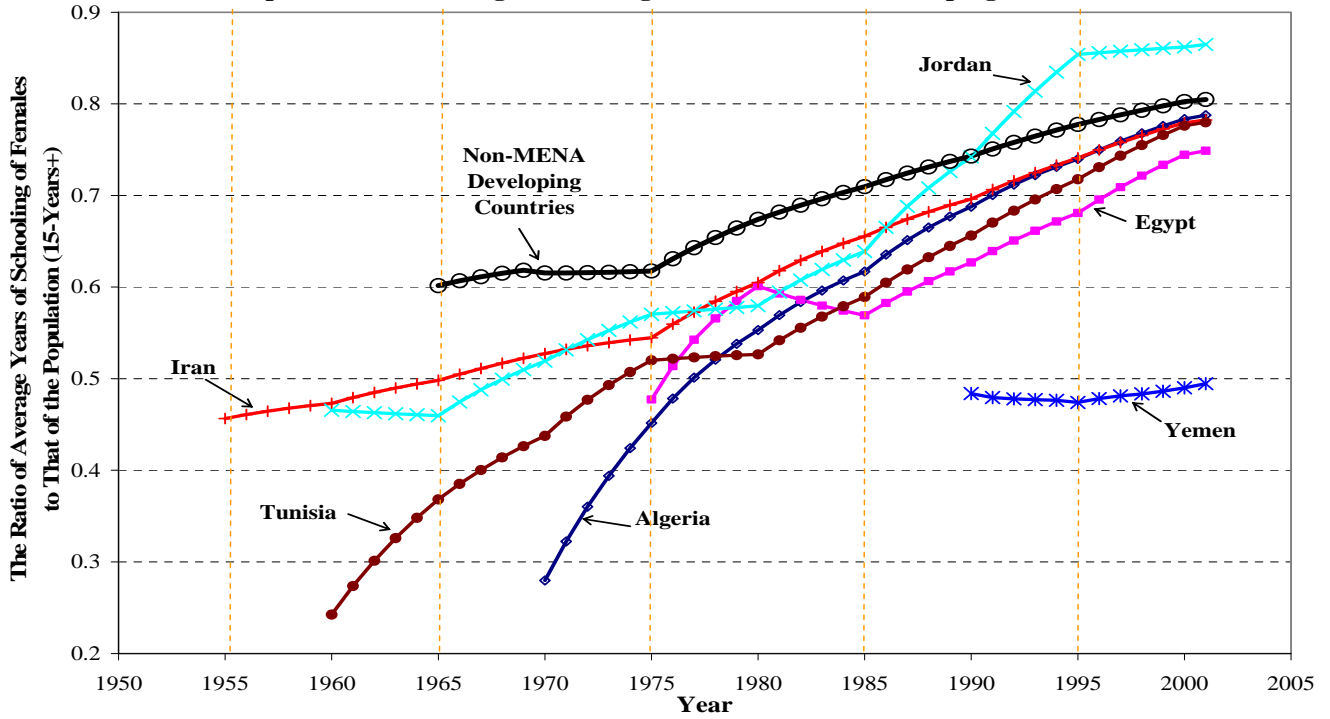
4. The post-1980 slowdown of TFP and investment in most MENA countries has been associated with faster growth in education, especially in the stagnating ones such as Algeria and Jordan.

The above observations summarize the conclusions of GRP studies that in most MENA countries, literacy and the quantity of formal schooling could not have been a constraint on TFP and investment growth. Some GRP studies that use time series regressions—in particular, those focusing on Morocco, UAE, and Egypt—do find positive correlations between education and GDP or TFP growth. However, in all those cases, the measure of education is lagged school enrollment, which complicates the interpretation of the results because enrollments are unlikely to cause economic growth with one or even two year lags, as specified in those models. This is why all GRP studies of MENA suggest that the reason for lack of correlation between schooling and growth may be due to the quality and structure of education.

The quality of education is difficult to gauge. However, based on sporadic data on variables such as student-teacher ratio and teacher qualifications, it seems that the MENA region is not very different from the rest of the developing world (Campos and Esfahani, 2003). The public expenditure data show that MENA countries tend to spend a bigger share of their GDP on education than their peers around the world, which seems to account for the catch-up in schooling rates (Campos and Esfahani, 2003).

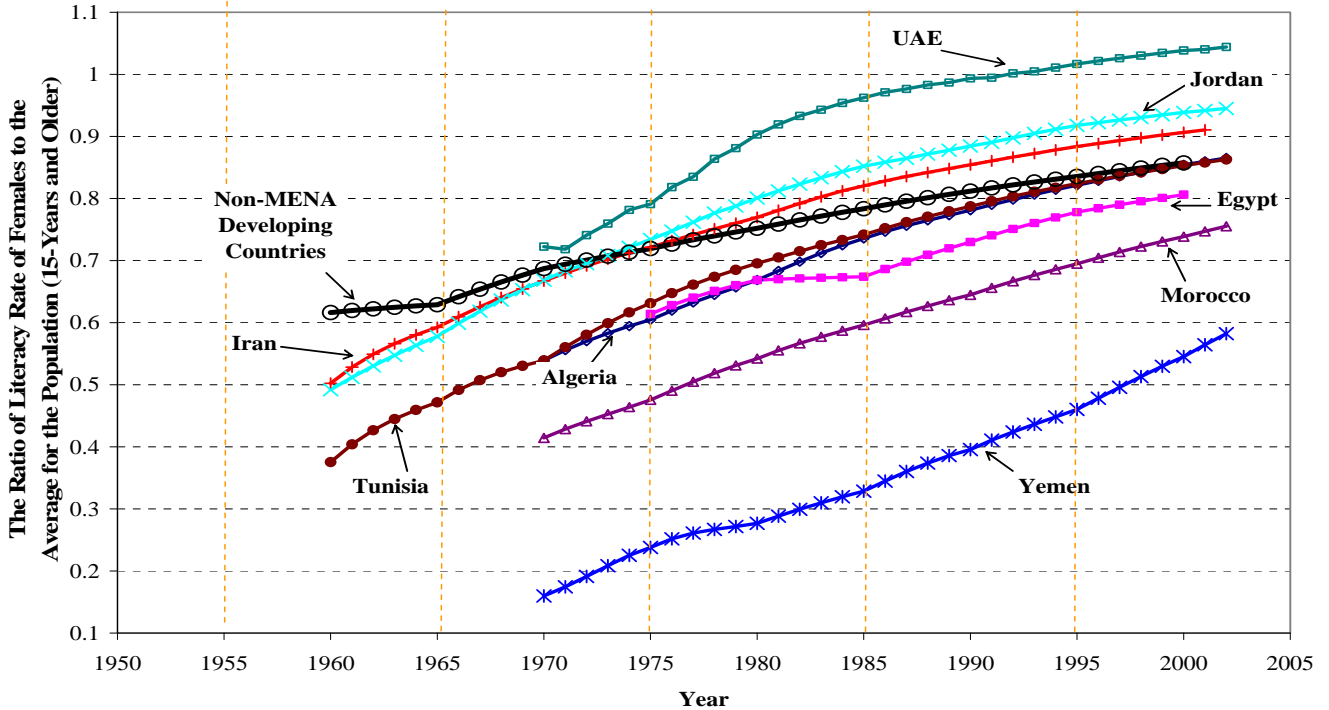
The issues concerning the structure of education in MENA have been examined in two major areas: The extent of female versus male education and the nature of skills being learned in schools and on the jobs. The first issue has been a major theme in the literature on the development of MENA countries because the gender gap in the region has been conspicuously large compared to the rest of the world. As Figures 6 and 7 show, the relative positions of MENA women compared to men in terms of literacy and schooling has been far below the situations of their counterparts in other countries. However, as in the case of overall education rates, most MENA countries have made significant progress in catching up with their peers in these respects, especially since the 1980s. Thus, contrary to the claims in the recent World Bank reports (2004a and 2005a), a lack of effort to equalize educational opportunities does not seem to have contributed to the slowdown of TFP and GDP growth rates. Indeed, as many growth studies including the GRP papers on Egypt find, female education may have been negatively related to growth (Assaad, 2002; Kheir-El-Din and Moursi, 2003).

Figure 6
Female Schooling Relative to the Population Average in Selected MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* For notes and sources, see the bottom of Figure 4.

Figure 7
Female Literacy Rate Relative to the Population Average in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



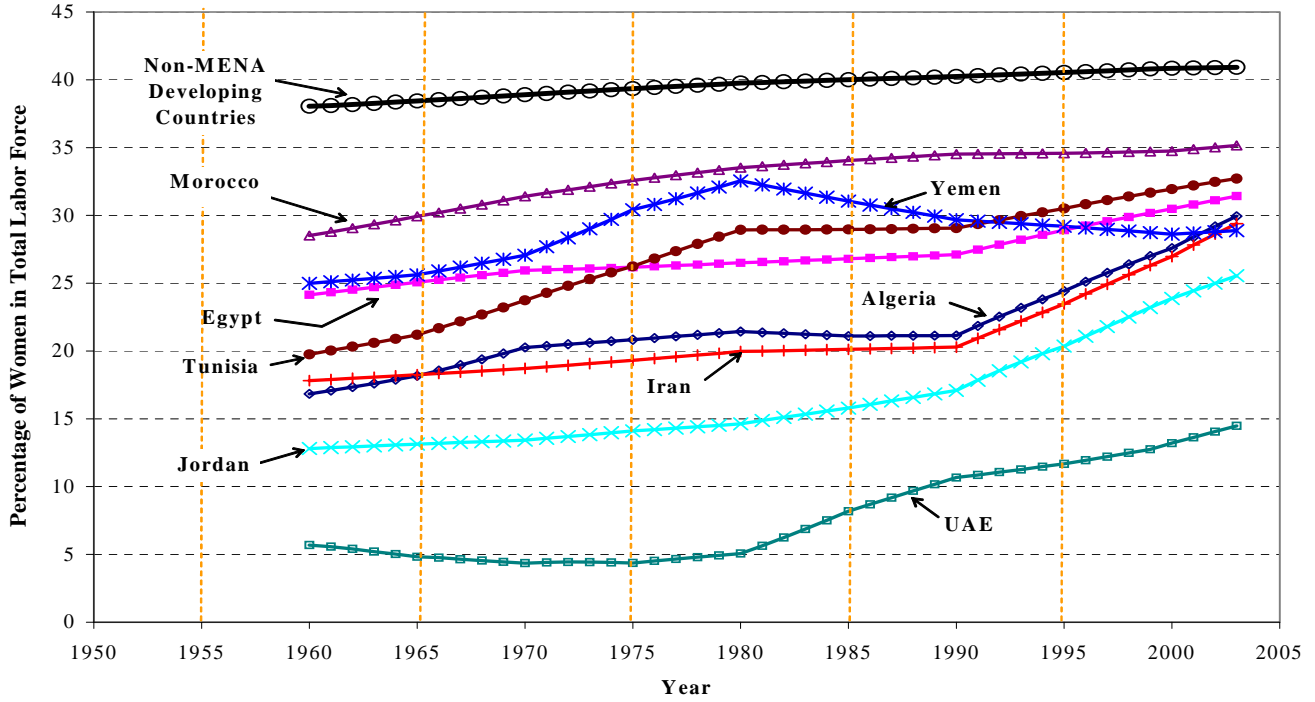
* For notes and sources, see the bottom of Figure 4.

The reasons for the above counterintuitive effects seem to be rooted in the labor market conditions, the cultural characteristics of households, and income increases due to resource rents (Assaad, 2002; Salehi-Isfahani, 2003). Those conditions and characteristics had encouraged remarkably high fertility and very low labor force participation rates among women in MENA countries (Figures 8 and 9). Although those gaps are being closed, the factors behind them may have acted as impediments to the realization of the potential productivity of MENA's educated women. These issues will be taken up again below in the context of the labor market and the related institutions and policies.

Although the "first-cut" analyses of the data do not indicate a positive correlation between female education and growth, there seem to be deeper and more long-term processes that are likely to produce positive results in MENA. Most importantly, as Salehi-Isfahani (2003) argues, the rise in female education has been associated with a demographic transition to low fertility and higher participation rates of women in the labor force (see Figures 8 and 9). The educational attainments and lower fertility in turn seem to be changing the traditional gender relations in ways that reinforce women's labor participation and contribution to productivity. Together with the impact that women's education and low fertility can have on the quality of the next generation's upbringing and education, the conditions seem to be ripening for a high growth period with low dependency ratios and rapid human capital buildup. However, the realization of that potential depends on the effectiveness of labor market institutions and policies in creating jobs and opportunities for gainful employment of educated labor. Achieving this goal has become challenging because of the current rapid labor force growth. Ironically, this added challenge is the result of the opposite situation for women where their low education and low labor force participation were associated with high fertility and inadequate human development.

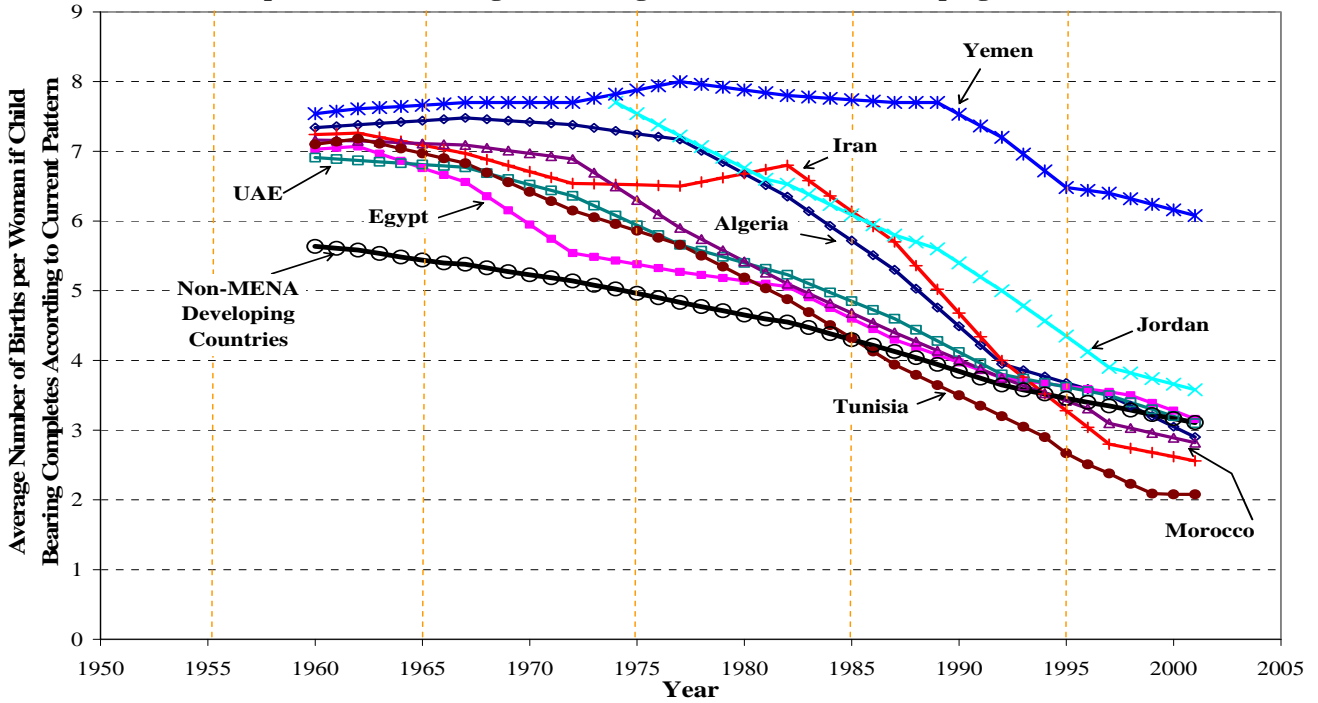
Turning to the nature of skills development, the GRP papers indicate that this issue must be a central one in impeding productivity growth. As Salehi-Isfahani (2003) argues, the dominance of public sector jobs and other government interventions encourage households to focus on formal education and diplomas that are not conducive to the acquisition of entrepreneurial and other creative skills. This is why a lack of workers and managers with good skills is placed high on the list of difficulties facing many MENA firms (Harabi, 2003, documents this in detail for the case of Morocco). While data and quantitative analyses of this issue are not available for the other sample countries, indirect indications about the significance of wrong skills abound in the discussions concerning the labor market. Therefore, I postpone a more detailed discussion of the subject to the section on markets.

Figure 8
Share of Women in Labor Force in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* Weighted by the country labor force. Source: World Bank, World Development Indicators Website.

Figure 9
Fertility Rate in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*

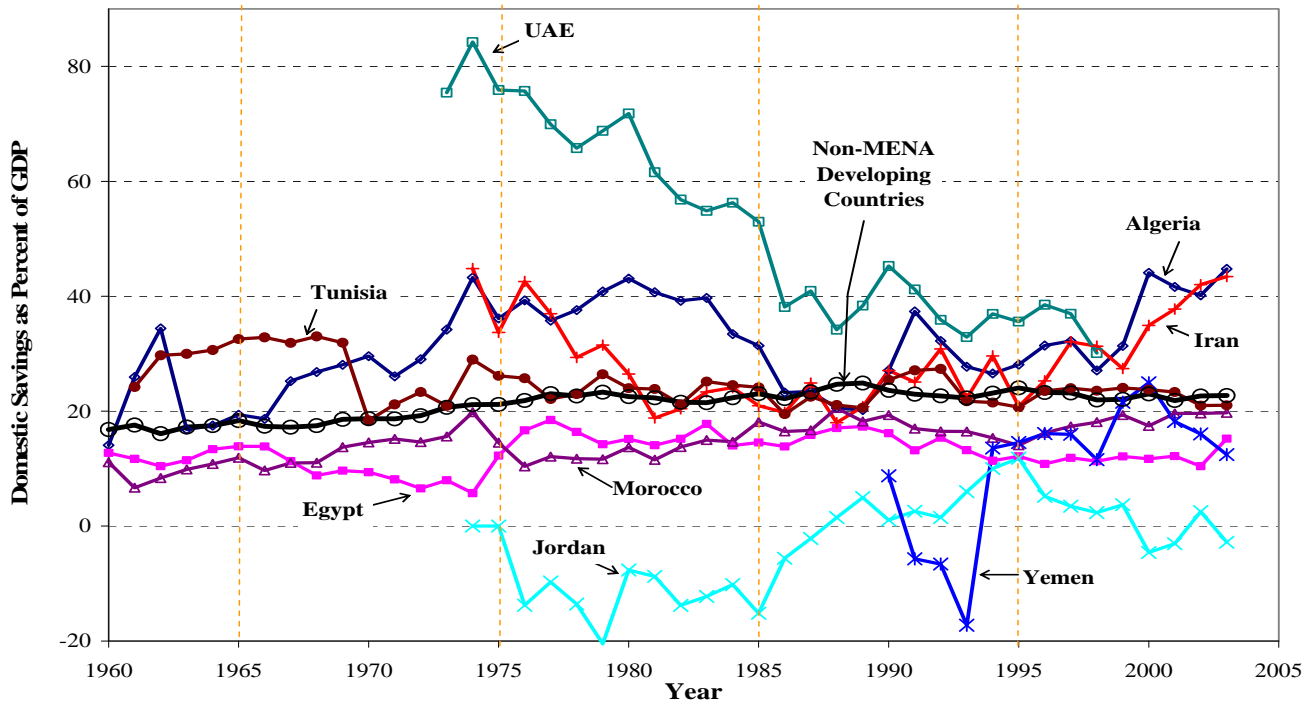


* Weighted by the country labor force. Excludes the data for China, which has large year-to-year fluctuations. Source: World Bank, World Development Indicator.

3.2. Savings

As we saw in section 2.2, the per worker capital stock levels in MENA have been generally higher than the average for the developing countries outside the region, though the gap has been quickly closing as capital stocks have stagnated in most MENA countries. The general impression in the literature is that this pattern has been driven by oil revenues. However, other sources of domestic savings and foreign financing must have also played some role in the region's capital formation, especially in non-oil exporting countries. To examine this issue thoroughly, one needs detailed data on private savings, which is not widely available. Therefore, one has to infer the outcome by examining the pattern of domestic savings (shown in Figure 10).

Figure 10
Domestic Savings Rates in Eight MENA Countries
Compared with the Weighted Average for Non-MENA Developing Countries*



* Weighted by the country GDP. *Source: World Bank, World Development Indicators.*

It is clear from the graph of domestic savings in Figure 10 that major MENA oil exporters—Algeria, Iran, UAE, and more recently Yemen—have generally had savings rates above the average for developing countries. Also, their savings rates have moved largely with their oil revenues relative to their GDPs, indicating some expenditure smoothing. Given the relatively high average savings rates in Algeria, Iran, and UAE, it is difficult to argue that they have been saving too little, although they might have benefited from greater expenditure smoothing to avoid the major slowdown of economic activity that they experienced in the 1980s and 1990s. For Yemen, which has been recovering from a civil war and starting

from a very low level of income in the 1990s, the low savings rate may not seem inefficient. However, because it has not been able to attract much foreign capital, its low savings may have acted as a break on investment and growth.

In contrast to the major oil exporters, the savings rates in Egypt, Jordan, and Morocco have been well below the developing world average, while Tunisia has followed the average path. For Egypt and Jordan, the large inflow of external resources in the form of foreign aid and remittances from their expatriates in oil exporting countries seems to have reduced the need for domestic saving. In fact, Kheir-El-Din and Moursi (2003) argue that Egypt's development strategy until the 1990s may have relied too much on abundant financing. Morocco, which has enjoyed less external financing, has raised its savings rate toward the developing country average, and financing seems to have been adequate as indicated in a survey of firms conducted by the World Bank in 1998, which did not find finance as an impediment to firm growth (Harabi, 2003). Tunisia stands out in the entire sample, in expanding both its savings and investment at the average developing country pace.

One might argue that shortage of savings may have become more of a problem for Egypt and Jordan in recent years as both have faced declining external resources and deterioration in physical capital stock per worker. But, interestingly, both countries implemented market-oriented reforms in their financial sectors in the 1990s and, in principle, should have moved towards greater efficiency. In fact, for the case of Egypt, Al-Mashat's (2003) time series analysis shows that savings declined as reforms were implemented and the real interest rates rose in the 1990s. (This result is very much in line with the findings in many other countries that financial market reforms reduce household's need for savings and that the wealth effect of real interest rate dominates the inter-temporal substitution effect.) So, again, it is hard to see the low saving rates as a consequence of financial market inefficiency or as a cause of low growth. If there is any problem for the growth process, it is the way in which domestic savings and other financial resources are invested. That is where one might find the source of low productivity and inefficiency. We will return to this issue in our discussion of financial markets below.

To conclude, although MENA countries have managed to create incentives for rapid expansion of formal education, their ability to motivate the formation of productive human and physical capital has been limited. For most countries in MENA, oil revenues or external resources have provided investment funds that helped those countries initially build their physical capital stocks and then expand education. When those sources dwindled in the 1980s and 1990s, MENA countries were generally not very effective at channeling whatever resources they had towards improvements in productivity. The sources of these problems and their variations across countries can be traced to policies and political economy factors that will be discussed in subsequent sections.

5. The Labor, Product, and Financial Markets

4.1. Overview

The analyses in the previous sections indicate that households and producers in MENA countries have had weak incentives to invest and improve their human and physical capital. Since those incentives are shaped in the labor, product, and financial markets, the next step in our synthesis of GRP papers is to examine the characteristics and performance of those markets and the role of government policies in them. Before examining these markets in detail, however, it is useful to make a few general observations about their patterns in MENA countries.

1. MENA governments have generally been more interventionist than their counterparts around the world.
2. To achieve their policy goals, MENA governments have relied more often on direct controls over markets and resource allocation, rather than creating incentives for the private sector to do the job.
3. Even when MENA governments have not been able to offer jobs and products directly, they have resorted to rigid rules and restrictions on private markets.

These patterns and the forces behind them are important because they are at the heart of weak incentives for growth through private economic activity. The political economy factors behind these patterns will be discussed later. Here, the task is to document the pattern, analyze the relevant features of the markets, and ask why such policies were associated with growth before the 1980s, but proved unhelpful afterwards.

An overall glimpse of the pattern of policies in our sample of MENA countries can be seen in Table 4, where they are compared with the weighted average for the non-MENA developing countries. It is clear from the table that MENA countries are quite distinguished among their peers by the extent of government intervention in the form of ownership and immediate controls, but not in the form of regulatory restrictiveness and wage and price controls. Rather than impose such regulations, MENA governments seem to prefer to take over production activities and guide them directly. Morocco seems to be the least interventionist of the direct kind. However, it does not seem to escape indirect interventions as well as one of the most rigid labor markets in the world.

In the rest of this section, I review the conditions of the various markets. The next section discusses why the policies pursued by MENA countries in the 1960s concerning markets, firms, and households produced growth for a while, but proved ineffective later. Section 6 examines why most MENA governments were slow to adopt policies that could have enhanced performance after the 1980s.

Table 4

Indices of Government Regulations and Market Controls in the Sample MENA Countries Compared to the Weighted Average of Non-MENA Developing Countries*

| Country | Government Intervention and Public Ownership | | Restrictiveness of Regulations | | Wage and Price Controls | | World Bank's Index of Labor Market Rigidity |
|---|--|------------|--------------------------------|------------|-------------------------|------------|---|
| | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 2004 |
| Algeria | 3.7 | 4.1 | 3.0 | 3.0 | 3.0 | 3.0 | 55 |
| Egypt | 3.0 | 3.8 | 4.0 | 4.0 | 2.8 | 3.0 | 53 |
| Iran | 4.4 | 4.9 | 4.0 | 5.0 | 4.0 | 4.0 | 40 |
| Jordan | 3.7 | 3.6 | 3.0 | 3.0 | 3.0 | 2.0 | 34 |
| Morocco | 3.1 | 2.8 | 3.0 | 3.0 | 3.0 | 2.0 | 70 |
| Tunisia | 3.5 | 3.1 | 2.3 | 3.0 | 2.0 | 2.0 | 54 |
| UAE | 4.0 | 4.0 | 2.0 | 2.6 | 3.0 | 2.4 | 33 |
| Yemen | 4.0 | 4.1 | 3.7 | 4.0 | 3.0 | 3.0 | 37 |
| Weighted Average of Developing non-MENA Countries* | 3.5 | 3.1 | 3.9 | 3.9 | 3.1 | 3.0 | 42 |

* For variable definitions, see Appendix Table A2. The developing countries included in the average are those with available data for both sub-periods. Labor force is used as weights across countries. The MENA country figures in **boldface** are higher than the average for non-MENA developing countries.

Source: The Heritage Foundation website, *Index of Economic Freedom*; World Bank, *Worldwide Governance Indicators*.

4.2. The Labor Market

Perhaps the most distinguishing feature of MENA labor markets is the prevalence of government employment. Table 5 highlights this fact with employment data from the ILO. The data on employment in general government activities and state-owned enterprises (SOEs) indicate that MENA governments employ a much larger proportion of the labor force than the typical developing country government. Moreover, while public employment, especially in SOEs, has been on the decline in most places, some MENA governments seem to have expanded their payrolls in recent years.

The GRP papers on labor markets detail the impact of the predominance of public employment on the labor market as well as on education. The initial expansion in government employment in MENA came about in the 1950s and 1960s as national leaders sought to change the backward economic conditions that existed in the region. To ensure that they had effective staff and to increase the incentives for education, their priority was to employ the educated labor. In countries where the governments had the

financial wherewithal to use this strategy in major ways, the private sector came to rely mostly on informal employment, especially for the workers with less formal education. That part of the market remained flexible because it was difficult to regulate and, besides, the government's efforts to provide employment and job security were focused on public education. This explains the combination of heavy intervention with the appearance of less rigidity in the rest of the market observed in most MENA countries (see Table 4). Countries like Morocco that did not rely as much on public employment ended up introducing more rigidity in formal segments of the private employment to achieve similar goals.

Table 5
Government and Labor Markets in the Sample MENA Countries
Compared to the Weighted Average of Non-MENA Developing Countries*

| Country | Total Public Employment as Percent of Labor Force | | General Government as Percent of Labor Force | | SOE Employment as Percent of Labor Force | | Share of Women in Public Employment | |
|---|---|-------------|--|-------------|--|------------|-------------------------------------|-------------|
| | 1991-1995 | 1996-2000 | 1991-1995 | 1996-2000 | 1991-1995 | 1996-2000 | 1991-1995 | 1996-2000 |
| Algeria | 14.2 | 19.5 | 12.8 | 16.0 | 1.4 | 3.5 | .. | .. |
| Egypt | 23.8 | 25.8 | 18.0 | 20.8 | 5.9 | 5.0 | 10.8 | 11.2 |
| Iran | 26.3 | 21.9 | .. | 17.7 | .. | 4.2 | 14.1 | 16.4 |
| Jordan | 38.7 | 31.0 | .. | 21.4 | .. | 1.4 | 27.8 | 28.9 |
| Morocco | .. | 10.7 | .. | 10.0 | .. | 0.7 | .. | 14.8 |
| Tunisia | .. | 18.5 | .. | .. | 5.1 | .. | .. | .. |
| UAE | .. | .. | .. | .. | 2.0 | .. | .. | .. |
| Yemen | .. | 14.5 | 7.0 | 12.9 | .. | 1.7 | .. | .. |
| Weighted Average of Developing non-MENA Countries* | 13.8 | 11.4 | 9.8 | 8.8 | 4.0 | 2.7 | 35.2 | 35.6 |

* The developing countries included in the average are those with data for both sub-periods. For China, public employment data excludes those in town and village enterprises. Labor force is used as weights across countries for all indicators other than the share of women in public employment, which is weighed by the size of public employment. The MENA country figures in **boldface** are higher than the average for non-MENA developing countries.

Sources: ILO, LaborSta Internet (Public Sector Employment Database), *International Labor Statistics*; World Bank (2002a); GRP papers on MENA labor markets.

The rise of public employment together with the demographic dynamics of the region is responsible for another important feature of MENA labor markets—high unemployment among the educated (see Table 6). The reason seems to be related to the nature of public employment. Since public

sector jobs lack the reward and punishment consequences of direct assessments in private employment, governments end up offering stable positions with relatively low pay and little prospects for productivity improvement. Those positions become attractive opportunities for one part of the labor force that can rush to get degrees and does not mind enduring unemployment in exchange for lifetime positions that are considerably protected. At the same time, the limitation on productivity increase means that governments that rely on public sector development end up with heavy financial burdens, which limit their ability to absorb more labor. When faced with a rising tide of baby-boomers who have had the opportunity to earn degrees, the government has to either put the job applicants on waiting lists or abandon the strategy. Most MENA governments ended up in that position and found it politically difficult to switch out of that strategy with sufficient speed. As a result, unemployment has kept growing, especially among the educated. Unemployment of the educated is rising even in the UAE, where non-nationals cannot be unemployed and the government has been wiping out unemployment among the nationals (Elhiraika and Hamed, 2003).

Table 6
Unemployment Rates in the Sample MENA Countries
Compared to the Weighted Average of Non-MENA Developing Countries*

| Country | 1980-1984 | 1985-1989 | 1990-1994 | 1995-1999 | 2000-2004 |
|---|-------------|--------------|--------------|--------------|--------------|
| Algeria | | 16.90 | 22.20 | 27.16 | 28.54 |
| Egypt | 5.78 | 6.90 | 9.82 | 9.00 | 9.00 |
| Iran | | | | 9.08 | 12.43 |
| Jordan | | | | 15.00 | 13.20 |
| Morocco | | 14.97 | 16.25 | 18.18 | 12.57 |
| Tunisia | | 15.30 | | 15.75 | 15.60 |
| UAE | | | | 1.80 | |
| Yemen | | | | 11.50 | |
| Weighted Average of Developing non-MENA Countries* | 3.66 | 2.94 | 3.81 | 5.05 | 5.33 |

* The developing countries included in the average are those with data for all sub-periods. Labor force is used as country weight. The MENA country figures in **boldface** are higher than the average for non-MENA developing countries.

Source: World Bank, *World Development Indicators*.

Assaad's (2002) succinct summary the growth effects of public employment policies in the Egyptian are representative of the situation in most MENA countries:

The cumulative effect of the long-term application of the employment guarantee for graduates has been to concentrate the bulk of educated individuals in Egypt in the government bureaucracy, depriving the productive sectors of human capital. This is particularly true for educated women, who have a strong preference for the more egalitarian government employment. It is no surprise then that human capital in general, and female human capital, in particular, has little effect on total factor productivity in Egypt.

Assaad's allusion to the role of women in the Egyptian economy points to another important issue in MENA labor markets. As we have seen in Figure 8, the share of women in labor force is conspicuously low in MENA. A fact that is less well known is that the share of women in public employment in MENA is even smaller. While on average the share of women in public employment in developing countries is about 87 percent of their share in labor force, the corresponding ratio for Egypt, Iran, and Morocco is 37, 64, and 42 percent. Only in Jordan is the share of women in public employment higher than their share in the labor force. This observation may be highlighting the attitudes of MENA policymakers towards women and their inclination to think of public employment as a means of providing secure jobs for the "bread-winners". If this is the case and public policies indeed contribute to the discouragement of women in participating in the job market, the impact on the returns to human capital could be even less than Assaad (2002) suggests.

A final notable characteristic of MENA labor markets, with major consequences for economic growth, is the significant role of international migration. In particular, the oil boom of the 1970s created an enormous number of high-paying jobs in the Persian Gulf region, which attracted millions of workers from the rest of the MENA, especially Egypt and Jordan. The remittances of those workers played a very important role in spreading the benefits of the oil revenues across the region. However, the same linkage ensured that the fortunes of MENA countries would be connected with oil revenues, which declined in the 1980s. The issue became more serious in the 1990s when, following the Iraqi invasion of Kuwait, the Gulf countries decided to shift their sources of immigrant labor more towards South and Southeast Asia. These developments resulted in large return migrations, particularly in Egypt and Jordan, which initially brought back skilled labor as well as their savings. However, that positive shock did not last long and the benefits soon dissipated because the complementary changes in policies and institutions did not take place, and, later on, perceptions of political tension and security risks in the region weakened the business environment. The latter factors were most conspicuous in Jordan (Kanaan and Kardoosh, 2003) and have continued to plague many MENA economies, especially after September 11, 2001.

4.3. The Financial Markets

As in almost all the developing world, MENA countries built their financial markets in the 1950s and 1960s through intensive government controls that included state ownership and directed credit programs. After the oil boom, most of them moved toward more liberal banking systems, and by the 1990s the majority of them enjoyed banking systems that could be rated at least as liberal as the average for non-MENA developing countries (see column 1 of Table 7). Since the late 1990s there have been a number of reversals, along with similar changes in other developing countries in reaction to the banking crises in East Asia and other emerging markets, as can again be seen in Table 7. There are now more MENA banking systems experiencing controls more severe than those typical elsewhere. The scarcity of domestic and external funds in the early 2000s seems to have driven many MENA governments to strengthen their grips over their banking systems as a means of maintaining their other interventionist policies in the labor and product markets.

Although MENA banking systems are not too much more restrictive than the average situation in developing countries, other components of their financial markets remain relatively underdeveloped (Jalali-Naini and Khalatbari, 2003). In particular, stock markets in the region are weak and corporate bond markets are non-existent. There is obviously a clear need for much legal and institutional development before those types of financial markets gain prominence in MENA.

4.3. The Product Markets

As pointed out earlier, state ownership of firms is more prevalent in MENA and, naturally, a greater range of products are under the control of the government. In addition, in most of the region, staple and energy prices are heavily subsidized and controlled. Interestingly, despite these extensive interventions, our sample MENA countries other than Iran and Yemen are not rated worse than the average for the developing countries in terms of extent of informal and black markets, protection of property rights, and restrictions on foreign investment (see Table 7). This is more or less similar to the situation in the labor market where direct government control over major parts of the market has been accompanied by limited regulation in other parts.

Table 7
Indices of Government Regulations and Market Controls in the Sample MENA Countries
Compared to the Weighted Average of Non-MENA Developing Countries*

| Country | Controls over Banking | | Restrictions on Foreign Investment | | Weakness of Property Rights | | Prevalence of Informal and Black Markets | |
|--|-----------------------|------------|------------------------------------|------------|-----------------------------|------------|--|------------|
| | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 |
| Algeria | 3.0 | 3.6 | 3.0 | 2.2 | 3.0 | 4.0 | 3.0 | 3.0 |
| Egypt | 2.8 | 4.0 | 3.0 | 3.0 | 3.2 | 3.0 | 3.2 | 3.6 |
| Iran | 5.0 | 5.0 | 5.0 | 4.2 | 5.0 | 5.0 | 5.0 | 5.0 |
| Jordan | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.8 | 4.0 | 3.2 |
| Morocco | 3.0 | 3.0 | 2.0 | 2.0 | 2.5 | 3.8 | 3.0 | 3.0 |
| Tunisia | 2.5 | 3.0 | 2.0 | 2.6 | 3.0 | 3.0 | 3.0 | 2.6 |
| UAE | 3.0 | 3.0 | 4.0 | 3.0 | 1.0 | 1.8 | 1.0 | 1.0 |
| Yemen | 4.0 | 4.0 | 3.0 | 3.4 | 4.0 | 4.0 | 5.0 | 5.0 |
| Weighted Average of Developing non-MENA Countries* | 3.3 | 3.7 | 3.0 | 3.4 | 3.4 | 3.6 | 4.2 | 4.0 |

* For notes and sources, see the bottom of Table 4.

Table 8
The Ratio of Predicted to Actual Trade Share: MENA vs. the Rest of the Developing World
(Higher values are expected to reflect more restrictive trade policies.)

| Period: | | 1960-1964 | 1965-1969 | 1970-1974 | 1975-1979 | 1980-1984 | 1985-1989 | 1990-1994 | 1995-1999 | 2000-2001 |
|--|---------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| MENA Countries | Algeria | 0.81 | 0.99 | 0.98 | 0.82 | 0.93 | 1.30 | 1.15 | 1.19 | 1.06 |
| | Egypt | 0.61 | 0.76 | 0.79 | 0.60 | 0.61 | 0.85 | 0.76 | 1.09 | 1.32 |
| | Iran | 1.33 | 1.04 | 0.74 | 0.70 | 1.47 | 2.63 | 0.90 | 1.18 | 1.08 |
| | Jordan | 1.19 | 1.33 | 1.25 | 0.78 | 0.72 | 0.78 | 0.63 | 0.78 | 0.85 |
| | Morocco | 0.81 | 0.87 | 0.88 | 0.83 | 0.85 | 0.83 | 0.85 | 0.90 | 0.87 |
| | Tunisia | 1.37 | 1.52 | 1.27 | 1.15 | 0.97 | 0.94 | 0.83 | 0.89 | 0.95 |
| | UAE | .. | .. | .. | .. | .. | .. | .. | .. | .. |
| | Yemen | .. | .. | .. | .. | .. | .. | 1.59 | 1.54 | .. |
| Weighted Average of non-MENA Developing Countries* | | 1.14 | 1.12 | 1.05 | 1.02 | 0.98 | 0.93 | 0.86 | 0.80 | 0.74 |

* Weighted by GDP in terms of 1995 US dollars. Only countries with complete data are included. The MENA country figures in **boldface** are higher than the average for non-MENA developing countries. Source: Esfahani and Squire (2007).

Table 9

**Indices of Government Regulations and Market Controls in the Sample MENA Countries
Compared to the Weighted Average of Non-MENA Developing Countries***

| Country | Overall Index of Economic Freedom | | Fiscal Burden | | Poor Management of Monetary Policy | | Trade Restrictions | |
|---|-----------------------------------|------------|---------------|------------|------------------------------------|------------|--------------------|------------|
| | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 | 1995-2000 | 2001-2005 |
| Algeria | 3.6 | 3.3 | 3.7 | 4.1 | 4.8 | 1.8 | 5.0 | 4.6 |
| Egypt | 3.5 | 3.4 | 3.0 | 3.8 | 3.3 | 1.4 | 5.0 | 4.4 |
| Iran | 4.7 | 4.5 | 4.4 | 4.9 | 5.0 | 4.2 | 5.0 | 3.8 |
| Jordan | 3.0 | 2.8 | 3.7 | 3.6 | 1.8 | 1.2 | 4.0 | 4.6 |
| Morocco | 3.0 | 3.0 | 3.1 | 2.8 | 1.7 | 1.0 | 4.5 | 4.8 |
| Tunisia | 2.9 | 2.9 | 3.5 | 3.1 | 2.0 | 1.0 | 5.0 | 5.0 |
| UAE | 2.3 | 2.2 | 4.0 | 4.0 | 1.6 | 1.0 | 2.0 | 2.0 |
| Yemen | 4.0 | 3.8 | 4.0 | 4.1 | 4.5 | 3.0 | 4.8 | 3.2 |
| Weighted Average of Developing non-MENA Countries* | 3.6 | 3.5 | 3.5 | 3.1 | 3.4 | 2.2 | 4.5 | 4.4 |

* For notes and sources, see the bottom of Table 4.

An important aspect of product market policies is the stance towards foreign trade. In line with their other policies, MENA governments have typically taken a very interventionist approach to trade (see Table 7 and the last two columns of Table 9). Nevertheless, curiously, until the 1980s the region had been generally more open than the typical developing country (Esfahani and Squire, 2007). Only after the 1980s when most other countries decided to liberalize and join the globalization process, MENA countries did not follow suit and some even shifted towards more restrictive trade policies. This can be seen in Table 9, which reproduces Esfahani and Squire's main measure of openness derived from the estimation of a gravity model of international trade. (They show that other measures of openness yield more or less the same results.) Their study of the factors behind this pattern produces an interesting result: the prominence of domestic producers in the trade policy calculus of MENA governments seems to have risen because the decline of external resources has reduced the potential imports relative to the domestic production. This is in contrast to the 1960s and 1970s when the rising resource rents facilitated imports and made protectionism more costly than in most other countries. That trend reversed in the 1980s and was further combined with the increased competitiveness of other countries, which reduced the export opportunities for most of the MENA region. This combination curtailed the import potential of most MENA countries and may have lowered the cost of protectionism for them. However, the current reversal

of downward trend in oil revenues seems to offer new opportunities for those countries to liberalize and even find ways to make the shift more permanent.

6. The Political Economy Determinants of Policies and Performance in MENA

Before World War II, economic conditions in MENA were more or less similar to those common in the underdeveloped world at the time: government interventions were not extensive and there was little economic growth to speak of. In the post war era, as the reviews in sections 3 and 4 show, MENA governments became heavily involved in the economy, taking increasing responsibility for education, infrastructure, employment, and production. These interventions were generally associated with higher growth until some time around 1980. Although there have been reform attempts in most MENA countries since the 1970s, growth rates have been often lackluster in the past quarter century. Moreover, progress towards liberalization has been slow and has rarely met with success even where reform has been extensive. This pattern raises four questions that are critical for understanding the economic performance of MENA countries:

1. Why were the interventionist policies in MENA associated with good economic performance in the 1960s and 1970s?
2. Why did MENA governments adopt interventionist policies in the 1950s and 1960s?
3. Why did neither interventionism nor liberalization produce much growth in most MENA countries after 1980?
4. Why were most MENA governments slow to identify and adopt new policies that could bring about faster growth after 1980?

While the last two questions seem currently more relevant, they cannot be answered properly without addressing the first two. The answers to questions 1 and 2 are not a simple reference to rising oil revenues because the issue applies to both oil-exporting and non-oil countries, and the latter did not share much in the benefits of oil proceeds until the 1970s. Besides, one has to take account of the fact that some oil exporting countries did better than others.

Based on GRP research as well as other work on growth, it seems that the interventionist policies in the 1950s and 1960s were a solution to an old problem of extensive market failures due to lack of sufficient institutional and physical infrastructure. Like many other parts of the world, limited government involvement before WWII had left most MENA markets and resources underdeveloped. In particular, public goods, human capital, and financial resources were badly lacking. Moreover, the governments had few plans to address the region's economic problems, if they had at all diagnosed the causes.

After WWII, the growing nationalist movements in the region mobilized political support for development policies and placed them at the center of policy agenda. However, initially MENA governments made little progress in that respect. A common problem was lack of expertise and administrative capability to prioritize the problems at hand and formulate and implement appropriate solutions. Another issue was a lack of institutional mechanisms to coordinate government policies and channel public resources towards effective uses. This became a serious problem especially in countries where there was an effort to give democratic legitimacy to political power through elections and parliamentary processes (Iran and Egypt during 1946-1952, Yemen after the 1990 unification, and Algeria, Morocco, and Tunisia during the early years of independence are the cases in point). The trouble was that the governance institutions in these countries lacked effective mechanisms for conflict resolution in broad and impersonal contexts. Also, party systems were new and mostly based on personalities rather than platforms. As a result, there were growing numbers of particularistic interests that tried to pull policies in different directions and made it more difficult to reach coordination over policies of public interest. Besides being uncoordinated and unrepresentative, the policy process in MENA countries lacked mechanisms to guarantee consistency and continuity over time. Consequently, the government found it difficult to mobilize private or public resources and pursue long term development projects.

The typical reaction of the public to the above failures was to develop tolerance and even support for concentration of power in the hands of politicians who displayed potential in coordinating government policies and raising investment and growth. This was why many politically capable coup makers or existing leaders managed to gain substantial popularity by curtailing democratic processes and by pursuing direct interventions that helped expand education, infrastructure, and industrialization projects.

- In Egypt, for example, the abolition of political parties, redistribution of land, and confiscation of large firms by Nasser's government in the 1950s and early 1960s were received enthusiastically by large majorities in the country and even more broadly in the Arab world (Al-Sayyid, 2003).
- In Tunisia, the liberal but chaotic post-independence situation of the late 1950s gave way to a socialist period with several years of high growth in the 1960s when the then President, Habib Bourguiba, managed to "destroy any potential source of organized resistance to his leadership" (Bechri and Naccache, 2006).
- In Algeria, the move towards power concentration and interventionist policies started quickly after independence in 1962 and gained strong momentum in 1965 when the defense minister, Houari Boumedienne, took complete control of the government through a bloodless coup. Again, GDP accelerated for several years.

- In Morocco, economic growth improved in the second half of 1960s when the liberal post-independence experiment ended in 1965 with King Hassan II declaring a state of emergency and taking over both executive and legislative powers (Cherkaoui and Ben Ali, 2003).
- Similar situations can be observed in Jordan during the late 1950s and early 1970s (Kanaan and Kardoosh, 2003) and in Yemen during the 1970s (Al-Asaly, 2003).
- In Iran, it was a foreign-assisted coup that overthrew the democratically elected government of Mohammad Mosaddeq in 1953 and enabled to the Shah to establish his authoritarian rule. Nevertheless, the regime's success in mobilizing resources and focusing on development projects bought the public's acquiescence for a quarter of century (Esfahani, 2003).
- In the case of UAE, from the time of independence, power in each of the small emirates was concentrated in the hands of an unchallenged ruling family. As a result, they proceeded with coordinated policies, involving the government heavily in the development of social and physical infrastructure. Although hard economic data is not available for the UAE prior to 1975, by all indications the area that became the UAE enjoyed enormous growth during the 1960s and 1970s (Elhiraika and Hamed, 2003).

The rise of oil revenues played important roles in all these episodes. They provided an easy source of funds for the required investments and, moreover, enabled most of the region's governments to maintain more control over the process by carrying out many of the projects themselves. Unlike other regions in which the government had to mobilize or tax the private sector to implement its development projects, MENA governments' access to rents reduced their reliance on the private sector. As a result, their interventions often took the form of direct controls over the production process rather than indirect regulation and taxation. The lower cost of public funds also reduced the urge on the part of MENA governments to extract rents from the private sector, hence enabling them to maintain reasonable records, compared to other developing countries, regarding property rights and regulation. Finally, the oil rents enabled MENA governments to fund more extensive poverty reduction programs, especially through public employment and mass subsidies on food and energy. This ensured relative political stability and complemented the rest of policies, encouraging everyone to participate in the state-led growth process. This constellation of effects partly explains why the initial interventionist policies in MENA were in fact associated with better economic performance, including higher TFP.

The process delineated above worked well for a while in each country because it dealt with the severe deficiencies of institutional and physical infrastructure. However, the strategy could not work well for long for two important factors, which came to materialize to different degrees in the various MENA

countries after the mid-1970s. First, the per capita resource rents were bound to diminish as the world economy responded to high oil prices and MENA population increased. Second, even if the rents lasted long, the problems being addressed by the post-WWII social contract would become less severe with the help of relatively coordinated policies and abundant funds. So, growth and stability through public investment could not continue for long. Once the resource rents diminished or the gross shortages of physical and human capital were reduced, further growth through government command and control would become costly and more subtle policies had to be devised to avoid stagnation. Specifically, MENA governments needed to switch gears towards stimulating private initiative as the main vehicle for the promotion of employment and productivity and for raising the public funds needed for continued improvement in infrastructure and social concerns.

The shift from the old social contract that provided coordination and benefit sharing through direct government controls to a more market-based deal could be difficult and precarious. The move necessarily entailed changes in income distribution and larger differences across groups, which could cause social and political tensions if perceived as unfair. In the case of MENA in particular, the changes required cutting back on product and employment subsidies and redirecting the available resource rents towards long-term support for private sector development. Such changes could proceed either through highly repressive measures or in conjunction with compensation mechanisms that found broad support. Either approach entailed serious risks of political and social disruption, which could undermine the growth process. In MENA, although governments were not democratic, they tried to avoid iron-fist measures because they typically perceived their survival to depend on some degree of popular support. This was why they were quick to rescind subsidy reforms that were met with public protests and street demonstrations (e.g., Egypt in 1977, Jordan in 1989, Morocco in 1985). However, lack of democratic institutions with checks and balances and civil society engagement also precluded cutting back on subsidies and asking the public to patiently trust that the fruits of reform would be broadly shared.² The technical and institutional weaknesses of MENA bureaucracies further added to the skepticism of the public that the funds taken away from subsidies would be put to productive use with broad benefits. Therefore, in those circumstances, MENA governments needed complex approaches to build confidence while promoting reform. The choice in most cases was a type of "dual track" strategy, best known for its successful application in China.³ Under that strategy, the government maintains significant control over the production and distribution process, while allowing the private sector to grow along with new social

² For a theoretical and empirical analysis demonstrating this point and other arguments in this paragraph, see Esfahani (2002).

insurance mechanisms, until it gradually replaces the public sector. The strategy reassures the public and builds confidence over a new deal through a process of controlled liberalization.

Indeed, a number of MENA countries opted for the dual track approach long before it was adopted by China. However, their access to oil revenues influenced the way they implemented the strategy and the differential results that they obtained. The rest of this section offers a brief review of the experiences of sample countries and ends with a discussion of general observations about transition in MENA.

- Tunisia: Tunisia had less access to resource rents compared to other countries in the region and was the first to establish a dual track policy. Later, it also became the most successful case in MENA. As Bechri and Naccache (2006) discuss in detail, in the late 1960s the Tunisian government came to realize the rapidly diminishing gains from extensive controls in the absence of access to cheap funds. As a result, it started to introduce stronger incentives for the private sector, especially on the export side of the economy. This created a new political force around the growing export sector, which by the 1980s came to counterbalance the domestic interests favoring the old protectionist system. The result has been a gradual, but solid, liberalization and growth process.
- Morocco: Morocco's policy and reform choices show some similarities with those of Tunisia, but there are also important differences with consequences for performance. Interestingly, Morocco's problem is that it did not pursue the earlier phase of state-led growth with the same vigor as Tunisia. The reason for this difference seems to have been rooted in the way the ruling politicians came to power following independence. While the Moroccan king's legitimacy to rule was established based on tradition, Tunisian politicians had to build their legitimacy based on a new nationalist ideology and gain credentials through their political mobilization skills (Cherkaoui and Ben Ali, 2003; Bechri and Naccache, 2006). As a result, the social contract in Morocco was based more on traditional hierarchical loyalties, whereas in Tunisia it focused more on economic performance. The consequence was that Morocco had less success in addressing its infrastructure and human capital deficiencies and when it chose to liberalize, it had to deal with more fundamental challenges and did not benefit from policy reform nearly as much.
- United Arab Emirates: Like Morocco, the UAE's independence process passed on power to politicians with traditional legitimacy. However, the UAE leaders had access to enormous resource rents and, acting more like heads of family, spent large amounts on infrastructure development and

³ For a description and analysis of the dual track policy in China, see Lau, Qian, and Roland (2000).

education. Those resources allowed the country to maintain large subsidies while investing in the economy, promoting the private sector, and opening it to foreign trade.

- Egypt started with its own version of the dual track strategy in 1974 under the rubric of *Infitah* (Al-Sayyad, 2003). However, *Infitah* had a different character than Tunisia's dual track strategy. Because it came after the first major increase in oil prices and diminished hostilities with Israel, *Infitah* was accompanied by enormous new resources in the form of foreign aid, increased tourism, and migrant remittances. These resources had two important effects: First, they made it easier for the Egyptian government to maintain its public sector and staples subsidies for a longer time, while it was taking very gradual steps towards liberalization. Second, the inflow raised the real exchange rate considerably and made it difficult to pursue serious promotion of exports. The result was that, unlike Tunisia, it hardly developed a constituency supporting pro-export policies. Rather, the increased strength of the private sector was built around sales to domestic markets. When resource inflows diminished in the late 1980s and the 1990s, the government found it expedient to go with the balance of forces in favor of domestic producers and remain protectionist, as the findings of Esfahani and Squire (2007) suggest. Although the government has continued to shift its policies in support of the private sector and has curtailed the public sector, its stance towards trade liberalization has been more cautious. Meanwhile the concentrated and stable nature of political power in the country have allowed the government to continue developing the infrastructure and ensure macroeconomic stability, which explains why the economic performance has not been too bad. However, the gains from those policies have rapidly diminished, and the government has failed to develop a new social contract based on private sector growth.
- Jordan: Compared to Egypt, Jordan should have had an easier time implementing reforms because a much larger share of the rents that it received were remittances that went directly to the private sector. However, the high real exchange problem (especially high wages compared to productivity) and the concerns over the spillovers from Israeli-Palestinian conflict seem to have kept private investment and growth low (Kanaan and Kardoosh, 2003).
- Algeria: Algeria started the reform of its highly state-centered policies in 1989 after it had experienced a few years of economic decline (Chemingui, 2003). The reduction in oil revenues was an obvious cause, but its over-indulgence in the public sector is likely to have led to stagnation before long anyway. To build support for the system and its reforms, the government also proceeded with democratic reforms. However, in the elections in 1990, the incumbent elite found themselves losing to Islamic parties that had been widely suppressed in earlier years. Arguing that the winners had no respect for democracy and were not interested in prosperity, the military elite took control of the

regime and a violent civil war ensued. Although the government has proceeded with economic liberalization and reform, the complementary inputs required for the success of such policies have been lacking, and the lack of an effective political solution has taken its toll. In particular, the necessary investment, expertise, and human capital have not been generated in the economy due to security and political concerns (Chemingui and Ayadi, 2003a).

- Iran: Iran presents different cases of policy shifts back and forth between the private and public sectors. The major state-led industrialization effort in the 1950s was in fact combined with private sector development. In the 1960s and 1970s, the Shah's government promoted the private sector, but it also continued public investment, which he found irresistible because of the earlier success with the policy and the large oil revenues at his disposal (Esfahani, 2003). Although the Shah's strategy continued to deliver growth well into the 1970s, the needs of the economy and the priorities of the public had changed. Consequently, there was a need for a new social contract that could muster public support for government policies by addressing the public's concerns (especially in distributional and cultural areas). However, the Shah's authoritarian rule had left no mechanism for free expression and consensus building. Unaware of the increasing public disgruntlement, he pushed through with his policies, which were losing their effectiveness. When the economy slowed down in 1977, a revolutionary movement started that caught him by surprise and swept away his regime in short order.

The Islamic regime that came to power in Iran after the 1979 revolution quickly nationalized most of the private industrial and financial firms and focused on distributional issues. The confiscations and revolutionary imposition of the new political, social, and economic rules caused a major outflow of human and financial capital. The war that broke out with Iraq in 1980 further made the environment inhospitable to economic growth. In addition, the new government was led by a small elite that was insecure and tried to rely entirely on its own trusted personnel for managing the economy. As a result, even after the end of the war and the normalization of the revolutionary conditions, the regime has found it difficult to redevelop a vigorous private sector (Esfahani, 2003). The first major attempt at such a transition in the early 1990s ended up in a financial crisis, which caused the economy to stagnate for several years. In recent years, a very gradual liberalization and privatization process has started. Although the regime has not yet arrived at a new social contract, the public debates, especially around elections, have provided opportunities for developing policies aiming at shared growth. However, the recent increase in oil revenues and the regime's limited ability to mobilize the necessary expertise may delay the design and implementation of such policies.

- Yemen: Yemen's case is interesting because it has enjoyed substantial oil revenues in recent years and has tried to liberalize its economy, following advice from multilateral institutions. However, the growth outcome has been relatively modest. The economy's fundamental problems with shortages of infrastructure, local expertise, and human capital in general seem to have impeded its performance (Al-Asaly, 2003). But, as in other oil-exporting MENA countries, the government is under broad political pressure to distribute part of the oil proceeds in the form of subsidies. At the same time, it has not been able to ignite the new liberal approach

7. Conclusion

This paper's synthesis of the GRP studies of growth experience in MENA suggests that most countries of the region managed to overcome the historic weakness of their economies by getting the government involved not only in the development of physical and institutional infrastructure, but also in production, finance, and redistribution. The new generation of politicians that came to power in the second half of the twentieth century had to legitimize their positions by delivering income growth to broad segments of the region's population. However, in the absence of pre-existing institutions and expertise to deliver shared growth through markets, they had to start with the instruments at the government disposal, which were mostly bureaucratic methods and direct controls. Furthermore, because of the uncertainties of the process and institutional weaknesses, they had to buy confidence through mechanisms such as consumer subsidies, job guarantees, and government investment. These elements formed a sort of social contract that helped MENA countries develop for many years. The interventionist aspects of such contracts were more pronounced in republics compared to monarchies, where the leaders relied on more traditional power structures and did not face as much urgency to establish legitimacy through economic growth and mass redistribution. As a result, for many years, government intervention became associated with growth because it partly reflected the pressure on the politicians to act and mobilize resources. The growth of oil revenues during that process also significantly enhanced growth in many countries by providing funding for both investment and redistribution.

By the late 1970s and early 1980s, the needs and possibilities of MENA economies had changed and new social contracts were called for. This was achieved generally through dual track strategies. But, the speed and success of the process varied across countries. The more interventionist governments that happened to have less resource rents at their disposal moved earlier to generate revenues through export promotion. This created a growing private sector in favor of reform and engagement in globalization. Countries that enjoyed larger resources, on the other hand, had developed more inward-oriented private sectors that were less inclined to support export promotion and policy dynamism. In cases where resources were small and the government had intervened less heavily, the initial capital formation and

institutional development had been weaker and the effort to reform had less opportunity to yield dividends.

The above observations obviously call into question the common claim that less government intervention always enhances economic performance. Developing the necessary institutions and human capital for the proper functioning of markets often requires interventions that deal with coordination failures and bypass failing markets. Redistributive interventions are also typically needed at that stage to build confidence and a constituency for the process. Of course, these interventions create vested interests that may be difficult to remove when the initial social contract becomes obsolete. However, that hurdle can be overcome through dual track strategies that gradually build constituency for new policies. Dismissing the earlier interventions because they lengthened the dual track process could be throwing the baby out with the bath water, as growth may have been thwarted from the start.

Another important implication of the analysis in this paper is that the policies needed to initiate and enhance growth in each country have many specific components that require extensive local expertise. Policymakers that ignore this factor by either relying mostly on foreign advice or on very limited knowledge create significant risks for themselves and for their citizens. The successful growth strategies are the ones that ensure the development of experts with substantial local knowledge along with the appropriate institutions and infrastructure.

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Table A1

List of GRP Papers on MENA Countries

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Al-Mashat, Rania A. (2003) "Financial Sector Development and Economic Growth in Egypt 1960-1999".

Al-Sayyid, Mustapha Kamel (2003), "Politics and Economic Growth in Egypt (1950-2000)".

Assaad, Ragui (2002), "The Microeconomics of Growth in Egypt: The Role of Households and Institutions".

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Sekkat, Khalid (2003) "The Macroeconomic Source of Growth in Morocco".

Tunisia

Bechri, Mohamed Z. and Sonia Naccache (2006), "The Political Economy of Development Policy".

United Arab Emirates

Elhiraika, Adam B. and Annas H. Hamed (2003), "Explaining Growth in an Oil-Dependent Economy: The Case of The United Arab Emirates".

Yemen

Al-Asaly, Saif M. (2003), "Political Economy of Economic Growth Policies: The Case Of Yemen Republic".

Table A2
Variable definitions for Table 1

The variables are defined and measured according to the following criteria:

| Score | Trade Policy | | Fiscal Burden: Taxation | | | | Fiscal Burden: Government Consumption as Percent of GDP | Monetary Policy |
|-------|------------------------|------------------------|-------------------------|------------------|-----------------|------------------|--|--------------------|
| | | | Income Tax Rate | | Corporate Tax | | | Inflation Rate |
| | Average Tariff Rate | Non-Tariff Barriers | Average Rate | Marginal Rate | Average Rate | Marginal Rate | | |
| 1 | < 4% | Very Low | < 10% | < 10% | Close to 0 | Close to 0 | < 10 | < 6% |
| 2 | 5-9% | Low | 10-20% | < 25% | < 25% | < 25% | 11-25 | 7-13% |
| 3 | 10-14% | Moderate | 15-20% | < 35% | < 25% | 26-35% | 26-35 | 14-20% |
| 4 | 15-19% | High | 15-20% | 36-50% | > 25% | 36-45% | 36-45 | 21-30% |
| 5 | > 20% | Very High | > 20% | > 50% | > 25% | > 46% | > 46 | > 30% |

| Score | Foreign Investment Policy | | Banking | | Wage & Price Controls | | Property Rights | |
|-------|---------------------------|-----------------------|-------------------|------------------------|-----------------------|---------------|------------------|-------------------------|
| | Legal Restrictions | Government Attitude | Entry Barriers | Government Controls | Prices | Wages | Legal Guarantees | Judicial Enforcement |
| 1 | Very Few | Encouraging | Very Few | Light | None | None | Complete | Efficient |
| 2 | Some Sectors | Neutral | Few | Some | Some | May Have Min. | Complete | Lax |
| 3 | Many Sectors | Neutral | Many | Tight | Many | Many | Incomplete | Efficient or Lax |
| 4 | Case-by-Case | Discouraging | High | Very Tight | Common | Common | Very Limited | Absent |
| 5 | Case-by-Case | Actively Discouraging | Very High | Chaotic | Complete | Complete | Nonexistent | Irrelevant |

| Score | Government Intervention and Public Ownership | Regulation | | | Black Market |
|-------|---|------------------|-----------------|------------------------------|--------------|
| | Level of Government Intervention in the Economy: | Rules | Restrictiveness | Enforcement | Share of GDP |
| 1 | <i>Very Low</i> : Less than 10 percent of GDP; virtually no government-owned enterprises. | Straight-forward | Very Low | Efficient and Uniform | < 10% |
| 2 | <i>Low</i> : 11 percent to 25 percent of GDP; a few government-owned enterprises, like the postal service; aggressive privatization program in place. | Simple | Low | Mostly Efficient and Uniform | 11-15% |
| 3 | <i>Moderate</i> : 26 percent to 35 percent of GDP; several government-owned enterprises like telecommunications, some banks, and energy production; stalled or limited privatization program. | Complicated | Substantial | Haphazard | 16-20% |
| 4 | <i>High</i> : 36 percent to 45 percent of GDP; many government-owned enterprises like transportation, goods distributors, and manufacturing companies. | Complicated | High | Haphazard and Partly Corrupt | 21-30% |
| 5 | <i>Very High</i> : 46 percent or more of GDP; mostly government-owned industries; few private companies. | Ubiquitous | Extreme | Very Haphazard and Corrupt | > 30% |

Source: The Heritage Foundation, *Index of Economic Freedom*.