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How to improve the economic and social performance of Eastern and Southern Mediterranean countries

by Marek Dabrowski and Luc De Wulf

The Eastern and Southern Mediterranean region has many advantages. Its proximity to European markets and its strategic location along the Mediterranean Sea help facilitate the trade of goods among Europe, Asia and Africa. The region has great historical and civilizational importance. It also has plentiful supplies of oil and natural gas resources and great demographic potential. Yet despite these many advantages, the Eastern and Southern Mediterranean region remains relatively backward in economic and social terms and is rightly considered a potential source of social and political instability.

In this brief we analyze the key challenges facing the MED11[1] countries and propose policy measures that could improve the region's economic and social performance.

Slow growth and high unemployment

Average GDP per capita in the MED11 is less than the global average. In 2010, it ranged from a high of nearly $30,000 in Israel to less than $5,000 in Morocco. The pace of the region's economic growth was not particularly impressive for quite a long time (in comparison with other regions – see Figure 1), especially in the 1980s and early 1990s. This was a period of decline for oil and commodity prices after an oil price boom in the 1970s. Unfortunately, during this time a substantial part of windfall gains was misused for pursuing expensive and inefficient import-substitution strategies, prestige infrastructure investment projects, and populist social policies involving huge price subsidies.

The economic model which dominated in several Arab countries in the 1960s and 1970s (especially in Algeria, Egypt, Libya, Syria, Iraq, and Southern Yemen) and was sometimes referred to as Arab socialism relied heavily on public ownership, administrative interference in market forces, central planning, militarization of the economy and trade protectionism. Israel also followed a somewhat 'socialist' economic model at that time, with a large share of public and collective ownership and heavy government regulation.

In the first decade of the 2000s, there was finally a visible improvement in terms of higher growth, lower inflation, fiscal deficits, and public debt levels in those countries which undertook market-oriented reforms. However, this did not fully compensate for the previous poor performance.

Per capita income growth has also been tempered by high population growth; the region's population has grown more than 2% annually as compared with 1.2-1.3% worldwide. As a result, economic growth has not been sufficient to reduce unemployment, which remains at more than 10% in most countries, with even higher rates for female workers. At 25% or more, the region´s youth unemployment is the highest rate in the world. Better education and labor market reforms could help in addressing this dramatic social challenge.

Emigration (to Europe, the US, and to hydrocarbon-producing Arab neighbors) helps cushion the lack of job opportunities at home. Labor migrant remittances constitute a substantial balance-of-payments item in Lebanon, Jordan and the Palestinian Autonomy and, to a lesser extent, in Morocco, Tunisia, and Egypt.

Persistent high unemployment, growing income disparities, an unequal playing field in business, corruption and nepotism, poor governance, the conspicuous consumption of a small elite, and the lack of a political voice led to widespread discontent, and, ultimately, to the Arab Spring in 2011-2012.

[1] MED11 stands for the group of 11 Southern and Eastern Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Autonomy, Syria, Tunisia and Turkey) which were the subject of research conducted under the EU FP7 funded project,"Prospective Analysis for the Mediterranean Region (MEDPRO)", which provided background material for this E-Brief

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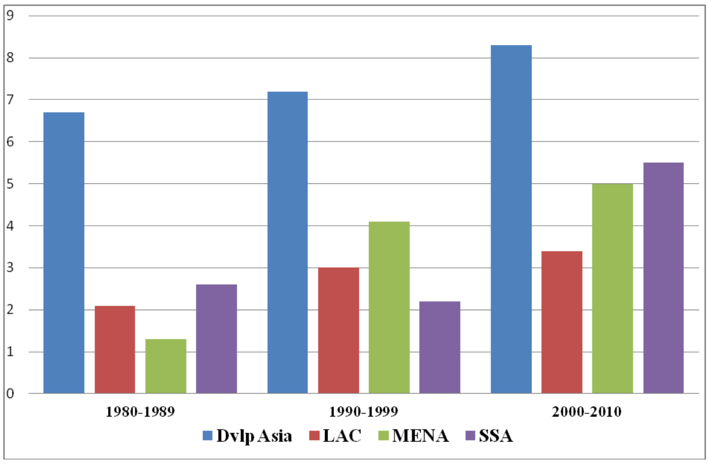
Figure 1: Real GDP growth in selected regions, 1980-2010, annual average, in %



Note: LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa
Source: IMF WEO database, April 2012

It is too early to assess the impact of the Arab Spring on long-term economic policies and growth performance. In the short run, political turbulence and populist policies have damaged growth performance and macroeconomic stability. For example, the phasing-out of food and fuel subsidies was reversed in some countries as social unrest put political pressure on governments. Unemployment has risen considerably, e.g., in Tunisia it has reached an average of 19% and youth unemployment is at 42%.

However, the experience of countries that went through political transitions suggests that countries can return to a growth trajectory in a few years if the correct policies are put in place. Specifically, economic growth benefits from macroeconomic stability (as measured by low inflation and balanced fiscal accounts), openness to trade, foreign investment (for which a good business climate and a predictable macroeconomic environment are essential), developed financial markets, good infrastructure and investment in human capital (if it is accompanied by good governance).

Maintaining fiscal stability

Several MED countries must continue reducing their fiscal deficits, which requires both expenditure and revenue adjustments. On the expenditure side, a reduction in price subsidies and a rationalization of public employment are the two most obvious priorities.

Large price subsidies to food, electricity and fuel continue to create a huge fiscal burden in several countries, especially Egypt (over 10% of GDP), Algeria, and Lebanon. In some countries, price subsidies have increased in the wake of the Arab Spring. They are both costly and inefficient in fighting poverty (their main justification). In reality, higher- and middle-income groups are the main beneficiaries of these subsidies. In addition, the subsidies have a devastating microeconomic and structural impact. They discourage producers of the subsidized energy and food products from increasing their output and quality parameters. They stimulate excessive and wasteful consumption, damage the environment, hamper the development of renewable energy, etc. Price subsidies should be replaced by targeted social safety nets, including targeted cash transfers, following the experience of Iran, Jordan and Turkey. Countries that postponed or reversed reforms in this sphere should reconsider them as a priority task.

Increasing public sector employment, which often serves as another social policy tool, also has negative fiscal consequences and tends to keep wages low. It undermines the recruitment of the best candidates to public service thereby weakening the efficiency of service delivery. Private sector growth, not public sector employment, should stimulate job creation.

Revenue policies should take into account that taxes and duties from foreign trade have already been eroded and will continue to do so as a result of trade liberalization. They should be replaced by less distortive taxes, preferably by broad-based VAT or sales taxes. Income distribution considerations that would favor a greater reliance on income taxes – personal and corporate should be carefully weighed against their distortive effects that tend to negatively affect economic growth.

Trade liberalization

Trade plays a crucial role in the MED11 economies, which are relatively small (apart from Turkey which is medium-sized) and often heavily dependent on energy and other commodity exports. Their relative under-industrialization and continuous high share of agriculture production in GDP make their modernization prospects dependent on free imports, robust exports, and investment openness. The trade flows of most MED11 countries, except for Jordan and the Palestinian Autonomy, are concentrated on the EU. They may be boosted by removing tariffs, reducing non-tariff measures (NTMs), decreasing high transport costs and improving uncompetitive trade logistics. Trade in services also faces serious restrictions and removing these restrictions could lead to considerable trade expansion. The same concerns trade among MED11 countries, which is rather limited and often hampered by protracted political conflicts and closed borders.

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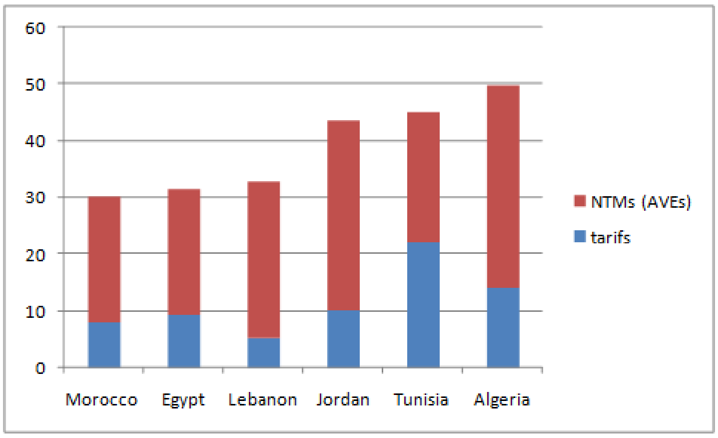
Despite multilateral trade agreements sponsored by the World Trade Organization (WTO) and the gradual implementation of the EU-MED Association Agreements (AA) and the Great Arab Free Trade Area (GAFTA), tariffs in several MED11 countries still constitute a significant barrier to imports, particularly of agricultural products (see Figure 2).

The most serious NTMs include: insufficient harmonization of technical standards, sanitary and phytosanitary measures, and competition and government procurement rules with those of the WTO and EU, inefficient custom procedures, and poor enforcement of intellectual property rights. Figure 2 demonstrates that the tariff ad valorem equivalents (AVEs) of the NTMs are consistently higher than the tariffs themselves.

Average transport costs in the MED11 exceed those of European countries by about 16%; they are lowest in Egypt and Israel and highest in Algeria. Trade logistics in most MED11 countries are significantly more costly than in many other regions of the world, particularly in the EU. According to the World Bank Trade Logistics Indicator (TLI), Israel, Tunisia, Lebanon and Turkey rank rather well while all other countries lag significantly behind, especially Algeria and Libya.

Figure 2: Overall trade protection in selected MED countries: tariffs and NTMs (%)



Source: Ghoneim, Peridy et al (2011): Shallow versus Deep Integration between Mediterranean Countries and the EU and within the Mediterranean Region, CASE Network Reports, No. 96, Annex 3

If all tariffs were abolished, NTMs removed, and the TLI substantially improved, trade would expand substantially, especially in the countries with greater initial trade restrictions. MED exports to the EU would increase less than imports because the initial EU tariffs were close to zero and the EU's TLI is much better than the TLI of the MED region. Exchange rate adjustments may be needed to cushion excessive pressure on the current account. These policy changes would also foster growth in intra-MED11 trade.

Private Sector Development and Privatization

Most of the MED countries, except for Israel and Tunisia, suffer from a poor business and investment climate as documented by the annual World Bank's Doing Business reports, the Heritage Foundation's Index of Economic Freedom, Transparency International's Corruption Perception Index and other international surveys and ratings. Despite adopting, in many instances, the right legislation, its implementation suffers from weak institutions, bureaucratic discretion, corruption, and unequal treatment of investors. To improve the situation, each country should map out specific legal and regulatory constraints which impede private sector development, elaborate strategies to tackle them, and ensure the public monitoring of their implementation.

Banks in the region suffer from a low degree of competition as a result of excessive market entry barriers and the predominant role of public ownership. Credit allocation by state-owned banks is largely arbitrary and benefits large well-connected companies and discriminates against small and medium-size enterprises. Coupled with the lack of independent supervision of the financial sector, this situation hampers private sector growth. To improve private sector access to credit, countries should privatize remaining state owned banks and implement governance reforms. In addition, they must foster competition in the banking sector and improve banking supervision.

Some MED countries started privatization programs in the 1980s as part of policies departing from their socialist/statist past. Others are only in the early stages of implementation or the programs are stalled for a variety of reasons. In comparison with other regions, the privatization performance of the MED countries is very modest. The regulatory framework for privatization needs to be strengthened to ensure full transparency.

Attracting foreign investment

Foreign direct investment (FDI) is an important conveyer of technological innovation and management changes. It connects the new production centers to the world market, has important backward linkages to the local economy and adds to the local savings available for investment[2]. In 1995-2000, the MED11 had one of the lowest FDI flows to

[2] See Sekkat, K. (2012): Manufactured Exports and FDI in the MED-11 Countries: Recent Evolution, Determinants and Prospects, CASE Network Studies and Analyses, No. 432

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GDP ratio (1.11%) as compared with other regions in the world. In 2005-2009, this changed and the region exhibited one of the highest ratios (4.19% of GDP), just behind Europe & Central Asia (4.53%) and the EU (4.65%) and far ahead of the other regions. Since the Arab Spring, FDI flows have fallen off sharply.

To reverse this unfavorable trend, MED countries should:

- Maintain an open economy that welcomes investors. Capital account openness matters too as it permits the unrestricted transfer of profits.
- Maintain an exchange rate regime that ensures continuous competitiveness and smooth exchange rate adjustment to various shocks.
- Improve infrastructure, which helps to reduce production costs.
- Ensure good governance as in its absence, investors will require higher rates of return to compensate for the cost of a poor business climate.
- Invest in human resources so that employers can find the workers that are able to take on jobs created by modern manufacturing.
- Be careful in extending tax advantages to investors. Ensuring a favorable investment climate is much more important than granting tax privileges. Investors are more interested in generating decent profits than paying lower taxes on small profits.

Investing in infrastructure

The MED countries lag behind other middle income countries in terms of the available transport infrastructure, which hampers trade and economic growth in the region. Efforts should be made to fill this gap. The budget allocation for the next several decades should fund a reasonable program of catching up in this sphere. Domestic resources should be supplemented with external ones.

The region's telecommunication infrastructure also remains underdeveloped, especially in fixed-line telephony, partly due to the continuous domination of state-owned monopolies. The mobile telephony subsector looks better, largely due to its opening to private sector operators. To ensure catching up in other subsectors, the reforms should involve the privatization of the fixed-line telephony, improving the environment for private sector operators, and strengthening the regulatory framework to avoid anti-competitive practices.

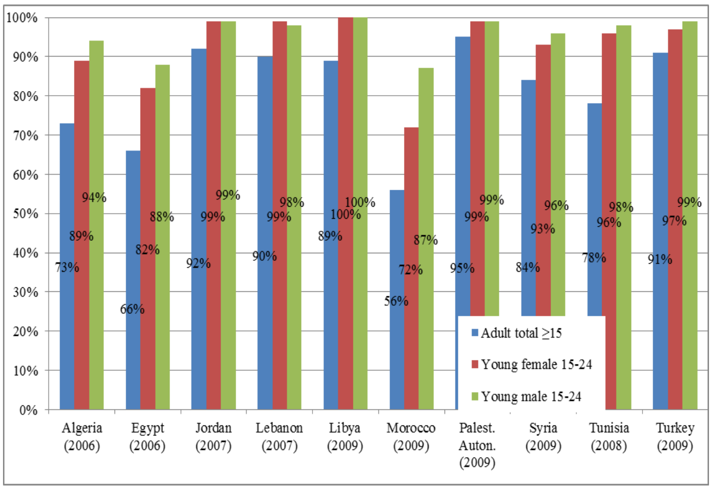
Social challenges

The MED region is characterized by high levels of income inequality, with Gini coefficients above 0.3 (in Turkey, Tunisia and Morocco – they are above 0.4), which indicates the presence of various forms of discrimination, social exclusion and poverty. Excessive inequality leads to social and political tensions and decreases the legitimization of the political regime, which was what catalyzed the Arab Spring. In social and economic terms, this can be interpreted as denying large groups of the population the chance to participate, on equal terms, in the labor market, business activity, education, and consumption of other public goods and wasting a substantial part of the country's human capital.

Gender discrimination is another serious challenge. The region is characterized by uneven access to education and the labor market, the underrepresentation of women in political life, unequal civil rights, unequal status in marital and family law, and many other disadvantages. In 2008, female labor participation ranged from 16.7% in the Palestinian Autonomy to 38.2% in Algeria, while the average for the male labor force was ca. 80%. Israel was the only exception, with a female labor participation rate of 61.1%.

Illiteracy remains a problem in several MED countries, especially Morocco, Egypt, Algeria and Tunisia (see Figure 3). Continuous illiteracy among youth means that large groups of girls and, to a lesser extent, boys remain excluded even from primary education. However, most of those who have access to schools complete only a primary education or less. Consequently, the quality of human capital in the region is below its potential, which has negative consequences for economic development.

Figure 3: Literacy rates in MED11 countries



Source: http://api.worldbank.org/datafiles/SE.ADT.LITR.ZS_Indicator_MetaData_en_EXCEL.xls, http://api.worldbank.org/datafiles/SE.ADT.1524.LT.FE.ZS_Indicator_MetaData_en_EXCEL.xls, http://api.worldbank.org/datafiles/SE.ADT.1524.LT.MA.ZS_Indicator_MetaData_en_EXCEL.xls

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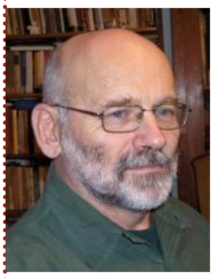

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