

Development, Growth and Policy Reform in the Middle East and North Africa since 1950

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Prior to 1950, the countries of the Middle East exhibited some of the lowest levels of socioeconomic development in the world. For many of these countries, not even approximate economic statistics are available for the first half of the twentieth century. But the state of underdevelopment can be illustrated by looking at Egypt, the most modernized and populous country in the Arab world at the time. Egyptian per capita income stagnated in the first half of the twentieth century. The country lacked modern industries and relied largely on the cotton sector for export and government revenues, but agricultural productivity had been on a steady decline since the end of the nineteenth century (Owen and Pamuk, 1998). Prior to land reforms in 1952, three-quarters of peasants in this agrarian country owned less than an acre or no land at all. The neglect of human services allowed periodic epidemics and malnutrition to keep mortality rates high until the late 1940s. Education levels were well below other developing regions, with adult illiteracy estimated at 85 percent in 1939 and only 23 percent of children ages 5–19 enrolled in school.

But in the 1960s and 1970s, Egypt and other countries of the Middle East experienced robust economic growth, based largely on high levels of investment in physical capital that facilitated substantial increases in per capita income. It might seem obvious that the higher oil prices of the 1970s should have sustained the growth cycle in this oil-exporting region, but GDP growth per worker in the Middle East decelerated in that decade, and factor productivity growth actually turned negative. In the 1980s and 1990s, GDP growth per worker in the region was less than 1 percent per year, and modest gains in human capital were largely offset by

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a continuous decline in total factor productivity. A wide range of explanations for the economic slowdown in the Middle East have been expressed, including structural economic imbalances, the so-called “curse” of natural-resource abundance, deficient political systems, conditions of war and conflict and even culture and religion. This essay reviews the development history of the Middle East and North Africa region in the post–World War II era, with a focus on issues that are especially relevant to current efforts for economic and political reform.

Throughout this paper, reference to the Middle East corresponds to the operational definition of the Middle East and North Africa region used by the World Bank, which includes most members of the Arab League and Iran. Table 1 lists the countries of the Middle East, along with their population, GDP and per capita GDP. The region as a whole has a population of about 313 million, slightly larger than the population of the United States, but a GDP of \$732 billion, which is about one-fourteenth that of the United States. In thinking about the region, it is useful to remember that eight countries include almost 90 percent of the region’s total population: Algeria, Egypt, Iran, Iraq, Morocco, Saudi Arabia, Syria and Yemen. Israel is not part of this operational definition since its economic issues are quite different than other countries in the region, and I follow that convention in this paper. All members of this region are classified as middle-income countries by the World Bank with the exception of the small oil-rich countries of Kuwait, Qatar and the United Arab Emirates (UAE) (high-income) and Yemen (low income).

The Post–World War II Middle East Development Model

From the 1940s to the 1970s, most economies of the Middle East region were guided by a development model with a strong interventionist-redistributive orientation (Richards and Waterbury, 1996). Some key characteristics of this model consisted of broadly similar economic and social policies that included reliance on state planning in determining economic priorities; the adoption of import-substitution industrialization policies; the implementation of a wave of agrarian reform programs; sweeping nationalizations of private and foreign assets; programs for state provision of education, housing, health care and food subsidies; and the emergence of centralized, hierarchical and tightly controlled trade unions, professional associations and ruling-party governments in which the political arena was viewed as an expression of the unity of the nation rather than a site of political contestation.

These preferences were often expressed in postindependence constitutions, laws and public policies that established the state as an instrument of social transformation, political mobilization and economic distribution. In cases like Algeria, Egypt and Syria, the social contract asserted a commitment to radical populism, with intensive regulation of private assets. In others like Morocco, Jordan and Saudi Arabia, the rationale for statism was phrased in terms of interventionist policies directed in support of emergent private sectors. These differences help to account for the significant variation in the development experiences within the

Table 1
Basic Indicators for the Middle East and North Africa Region, 2002

<i>Country Name</i>	<i>Population (millions)</i>	<i>GDP, US\$ (billions)</i>	<i>GDP Per Capita, US\$</i>
Algeria	31	56	1,785
Bahrain	1	8	11,007
Djibouti	1	1	861
Egypt	66	90	1,354
Iran	66	108	1,652
Iraq	24	n.a.	n.a.
Jordan	5	9	1,799
Kuwait	2	35	15,193
Lebanon	4	17	3,894
Libya	5	19	3,512
Morocco	30	36	1,218
Oman	3	20	8,002
Qatar	1	17	28,634
Saudi Arabia	22	188	8,612
Syria	17	21	1,224
Tunisia	10	21	2,149
United Arab Emirates	4	71	18,902
West Bank and Gaza	3	3	1,051
Yemen	19	10	537
Middle East and North Africa	313	732	2,532
United States	288	10,383	36,006

Source: World Development Indicators (2004).

region, even though the overall direction of development policies exhibited convergence around an interventionist-redistributive model (Ayubi, 1995). As such, one finds throughout the region common patterns of state-society relations and established expectations and obligations that have proved deeply resilient.

Factors that Shaped the Middle East Social Contract

A first set of factors that led the emergence of an interventionist-redistributive model in the Middle East were common to many countries across the world at this time. The Great Depression of the 1930s and the collapse of the international economic order led countries to expand the role of the state in providing an economic safety net; in many developing countries, the state became viewed as the primary provider of welfare (Thompson, 2000). Popular economic development strategies of this time often stressed the value of central economic planning and the need to protect infant industries from the pressure of global competition. The then-novel theories of Keynesian demand management further suggested that an active government role was necessary for ensuring a healthy economy.

A number of institutions emphasized these lessons. Turkey adopted its first five-year industrial plan in 1934. During World War II, the Middle East Supply Centre, a region-wide Anglo-American organization, promoted import-substitution to compensate for a wartime decline in imports of food and other critical goods

(Vitalis and Heydemann, 2000). In the post–World War II period, international financial institutions including the World Bank (1952, 1955) recommended an expanded economic role for government in response to the presumed weakness of private sectors. In fact, international economic institutions typically made access to loans conditional on the preparation of economic plans by governments. Moreover, the expansion of welfare systems in postwar Europe offered concrete models for the provision of social services that were received positively by the political elite of newly independent states in the Middle East region.

A second factor supporting the interventionist-redistributive economic developmental model in the Middle East involved the complex process of nation building. Colonial powers had drawn national boundaries, set up local governments and introduced electoral systems of political representation in the post-Ottoman Middle East, including in the monarchies of Egypt, Iraq and Jordan. This step, in turn, promoted the emergence of modern conceptions of citizenship and reinforced perceptions of the state as an agent of public welfare. It established new domains of rights and new forms of political competition for control over the mechanisms of mass mobilization including political parties, trade unions and professional associations.

These processes transformed nationalist struggles from an activity dominated by elites into movements of mass political incorporation (Beinin, 2003). At the same time, the escalation of anticolonial movements created incentives among nationalist elites to support mass incorporation into the political arena. For example, in Tunisia, a powerful trade union movement, the UGTT, was closely linked to the leading nationalist political party, the Neo-Destour, which negotiated Tunisia's independence from France. Egyptian nationalists also viewed organized labor as an extension of the nationalist movement. In this sense, the colonial construction of republican institutions throughout the Middle East during moments of nationalist mobilization was critical for the later emergence of interventionist-redistributive social contracts across the region (Anderson, 1986).

Statist preferences, mass politics and anticolonial struggles often led to strong involvement of the military in politics (Picard, 1993). Newly established governments were often unstable and felt vulnerable. Charismatic leaders like Nasser of Egypt, who toppled the monarchy in 1952 and galvanized nationalist sentiment across the region, were perceived as capable of bringing unity and modernization to the country. The new governments often reacted by imposing control over organized labor or other political and intellectual movements, and western governments often supported such limitations on freedom as necessary to limit Communist influence. Thus, the privileged position of the military was defended as protection against nationalist coups as well as other threats: the covert and overt foreign military intervention as occurred in Egypt, Iran, Iraq and Syria; episodes like the so-called Arab Cold War of the late 1950s and 1960s where pan-Arab ideologies were used to justify intervening in the political affairs of neighboring states; and in response to the existence of Israel and the outbreaks of the Arab-Israeli conflict (Brown, 1984; Kerr, 1971).

A third key factor in the interventionist-redistributive model was the presence of oil revenues, which played a pivotal role in sustaining the development model in both the oil exporting and nonexporting states (Beblawi and Luciani, 1987; Chaudhry, 1997). For major oil producers like Algeria, Iraq and Saudi Arabia, oil revenues permitted the creation of vast welfare systems that served as mechanisms for the distribution of oil wealth to citizens. For labor-exporting countries like Egypt, Jordan and Yemen, remittance income from millions of migrant workers in the oil-exporting countries boosted household consumption, especially in rural areas. At the peak of the oil boom in the early 1980s, some 3.5 million Arab migrants were employed in the Persian Gulf states. Loans, grants and other forms of assistance from oil-producing states to non-oil producers boosted government revenues and sustained distributive commitments.

Major oil production in the region began after World War II, supported by long-term concessions to international oil companies, rising from around 17 percent of world production in 1950 to 41 percent by 1970 (Issawi, 1982). Oil production rose further in the 1970s, but dropped off in the early 1980s due in part to the effect of OPEC output restrictions aimed at stabilizing prices. In the 1990s, oil exploration and production activity expanded in the Middle East to include more countries and to consolidate the region's share of two-thirds of global proven oil reserves. Using data from 1992–1995, roughly half of the world's top 20 countries with natural resource abundance (measured in terms of the ratio of primary products exports to GDP) are in the Middle East, ranging from 16 percent in Syria to 46 percent in Yemen. Data on Iran, Iraq and Libya are not available; including them would raise the level of natural resource intensity in the region.

Together, these factors shaping the social contract make the Middle East exceptional in its development trajectory. While many other states in the postwar period also adopted interventionist-redistributive policies, Middle Eastern countries are distinctive among countries outside of the Communist bloc in the scope of state regulation of the economy and in the extent to which social policies became the vehicle for implementing redistributive programs (Waterbury, 1994). This distinction is related to the political, social and economic changes that reshaped the political economies of the region, including the high level of military expenditures, antagonistic relations between states and private sectors, and high levels of regional conflict. Thus, the region's exceptionalism is a recent phenomenon and in no sense a cultural one derived from intrinsic beliefs, values and norms in Arab-Muslim societies (Heydemann, 2003). Moreover, the view that emphasizes culture as driver of development cannot easily accommodate the variation in economic performance in the Middle East before and after World War II, as will be observed below (Noland, 2003).

The Model Delivers Economic Dividends

The nations of the Middle East experienced unprecedented levels of economic growth and social development from the 1950s into the 1970s (Elbadawi, 2002; Richards and Waterbury, 1996). Between 1960 and 1985, the Middle East and

North Africa region experienced per capita GDP growth of 3.7 percent per year, which lags the 4.3 percent per capita annual growth in the East Asia and Pacific region, but runs substantially ahead of the 1.6 percent annual increase in per capita GDP in the Latin America and the Caribbean region (World Bank, 2003d). Table 2 presents international comparison of the region's growth performance and its determinants on a per worker basis.

The 1960s witnessed massive public investments in infrastructure, health and education as well as state-owned enterprises in protected industries in the Middle East. These efforts helped to utilize underused capacities and also provided a boost to industrialization. As a result, the economic growth performance of the Middle East in the 1960s was the highest in the world at 6.0 percent per worker per year. Large oil revenues sustained the boom in the 1970s, although some reasons for concern were becoming apparent since the growth represented a combination of very high rates of capital accumulation and a negative rate of total factor productivity growth (Page, 1998). For example, Algeria's rate of physical capital accumulation almost quadrupled between the 1960s and 1970s, but total factor productivity growth went from +1.9 percent a year to -0.7 percent.

The rapid economic growth was accompanied by dramatic gains in a number of social indicators. With the massive expansion in public sector employment and migration opportunities abroad, open unemployment was low and hardly different in nature from what was observed in the advanced industrial economies. By the late 1980s, the Middle East region witnessed dramatic reductions in infant mortality, increases in life expectancy, school enrollment levels approaching 100 percent and literacy levels that increased from an average of some 40 percent of the adult population to almost 60 percent. As a result of income transfers and high overall growth rates, by 1990, "only 5.6 percent of the population in MENA [Middle East and North Africa] lived on less than US\$1 a day—the global benchmark for absolute poverty—compared with 14.7 percent in East Asia and 28.8 percent in Latin America" (World Bank, 1995).

The sustained economic growth from the 1950s into the 1970s had important political consequences. It reinforced close links between governments and their core constituencies, who received economic rewards. The welfare gains also helped cement an "authoritarian bargain," with citizens of the Middle East effectively trading restrictions on political participation in exchange for economic security and the public provision of social services and welfare. In effect, "the social contracts became political instruments—creating entitlements on the one hand, and generating mechanisms of control on the other" (Vandewalle, 2003). More than culture or religion, they help account for the "governance gap" in the region, the observation apparent in Table 3 that Middle Eastern countries rank low on indicators of public accountability including political participation, civil liberties and government transparency (Bromley, 1994; Anderson, 1995).

Specifically, the "governance gap" in the Middle East has been attributed to the combined effect of oil, conflict and geopolitics (World Bank, 2003b). While vast oil revenues lessened the need for taxation and permitted redistribution, such

Table 2
Growth In Output, Capital and Total Factor Productivity by Region
(percentage per laborer)

<i>Region</i>	<i>Decade</i>	<i>GDP</i>	<i>Physical capital</i>	<i>Human capital</i>	<i>Total factor productivity</i>
Middle East and North Africa	1960s	6.0	5.4	0.7	3.4
	1970s	3.8	10.0	1.3	-1.0
	1980s	0.3	2.4	1.4	-1.5
	1990s	0.7	0.1	1.3	-0.2
Sub-Saharan Africa	1960s	2.8	3.6	0.3	1.2
	1970s	1.4	3.2	0.3	-0.1
	1980s	-0.9	0.6	0.7	-1.6
	1990s	0.4	0.7	0.6	-0.2
South Asia	1960s	2.1	4.0	0.6	0.2
	1970s	0.6	1.9	1.0	-0.7
	1980s	3.6	3.1	0.9	1.9
	1990s	2.7	3.3	0.9	0.9
East Asia and the Pacific	1960s	2.6	2.9	0.7	1.0
	1970s	3.7	6.2	0.9	0.7
	1980s	5.9	6.1	1.0	2.9
	1990s	7.0	8.4	0.7	3.2
Latin America and the Caribbean	1960s	2.7	2.9	0.5	1.2
	1970s	2.9	4.0	0.6	1.0
	1980s	-1.7	0.2	0.9	-2.3
	1990s	2.7	2.9	0.5	1.2
High Income/OECD	1960s	3.3	3.8	0.7	1.4
	1970s	1.5	2.2	1.5	-0.2
	1980s	1.6	1.9	0.2	0.7
	1990s	1.6	2.0	0.6	0.4

Note: Regional averages weighted by average labor force over period.

Source: Nabli and Keller (2002) and World Bank (2004a).

revenues also supported large internal security apparatuses protecting authoritarian governments and preventing popular mobilization (Bellin, 2004). The strength of this coercive apparatus has been further reinforced by exceptionally high levels of military expenditures. Added to these is the role of external powers that have consistently supported authoritarian governments in the region, historically as part of superpower rivalry and concern for oil security (Khalidi, 2004). It is not surprising, then, that once oil and other regional factors are controlled for in a cross-country regression explaining democracy, variables capturing Muslim or Arab culture are insignificant (Ross, 2001).

The Oil Bust and Economic Crisis in the 1980s

Over time, however, gaps widened between a deeply embedded set of institutional arrangements, expectations and practices, on the one hand, and the diminished capacity of governments to sustain distributive commitments, on the other. By

Table 3
The Quality of Governance Around the World

<i>Region</i>	<i>Public accountability</i>	<i>Institutional quality</i>
Middle East and North Africa	-0.78	-0.32
East Asia and Pacific	0.20	-0.11
Eastern Europe and Central Asia	0.37	-0.16
Latin America and the Caribbean	0.77	-0.09
OECD	1.89	1.38
South Asia	-0.29	-0.41
Sub-Saharan Africa	-0.41	-0.66

Notes: Public Accountability assesses the level of openness of political institutions in a country; the degree and extent to which free, fair and competitive political participation is exercised, civil liberties are assumed and respected, the press and voice are free from control, violation, harassment and censorship; on how transparent and responsive government is to its people, and on how much accountability is found within the public sphere for 173 countries. Twelve indicators from Freedom House (Political Rights, Civil Liberties, Freedom of the Press), Polity IV (Polity score, Regulation, Competitiveness and Openness of executive recruitment, Regulation and Competitiveness of Participation, Executive Constraints), PRS (Democratic Accountability), and WB-CPIA (Transparency and Accountability) are used. Institutional Quality assesses the risk and level of corruption and black market activity, the degree and extent to which certain rules and rights are enforced (ex. property rights, business regulations, procedures, and so on), the quality of the budgetary process and public administration, the efficiency of revenue mobilization, the quality of bureaucracy, and the independence of civil service from political pressure for 173 countries. Ten indicators from PRS (Corruption, Bureaucratic Quality), CPIA (Property Rights and Rule-Based Governance, Quality of Budgetary and Financial Management, Efficiency of Revenue Mobilization, Quality of Public Administration) and HWJ (Property Rights, Regulation, Black Market) are used. *Source:* World Bank (2003b).

the end of the 1980s, the strains appearing earlier in the decade had grown into a major economic crisis. The roots of this crisis were declining oil prices, shrinking demand for migrant labor, reduced remittance flows and a more competitive international environment (Shafik, 1998). Meanwhile, the domestic regulatory environments discouraged private investment and impeded the development of export-oriented industrial sectors, creating obstacles to the integration of the regional economy into global markets.

With declining public revenues, governments struggled to meet public sector wage bills, and public debts mounted. With eroding macroeconomic balances, investment rates declined. As shown in Table 2, the Middle East experienced a dramatic deceleration in the rate of physical capital accumulation in the 1980s, which fell by 75 percent on a per worker basis. Every country in the region experienced a deceleration in the rate of accumulation between the 1970s and 1980s, and almost every economy experienced a decline in total factor productivity

growth. As a result, output growth per worker collapsed in the 1980s, a change of almost -3.5 percent a year over the 1970s.

The growth slowdown prompted countries, led by Morocco, Tunisia and Jordan, to embark on policy reform in the mid-1980s. Soon, most countries had adopted some form of economic stabilization program. Across the region, governments cut subsidies, reduced public expenditure and reformed exchange rate regimes. By the early 1990s, debt levels declined and inflation was brought under control. Governments also began a gradual transition to structural adjustment—a move strongly supported by international financial institutions and western governments—including privatization of state-owned enterprises, trade liberalization, deregulation and strengthening the institutional foundations for a market-led economy.

However, implementation of these structural economic reforms has been uneven, hesitant and incomplete (Dasgupta, Keller and Srinivasan, 2002). Moreover, the oil-exporting countries faced considerable oil price volatility in the 1990s, while periodic droughts hurt rural areas in countries with sizeable agricultural economies including Iran, Morocco and Syria (Johansson, Silva-Jauregui and Yousef, 2003). The combination of these factors meant that the economic performance of the region in the 1990s was generally weak. From 1986 to 2001, GDP per capita growth averaged 1.0 percent a year (World Bank, 2003d). As Table 2 shows, the growth of GDP per worker was even lower. Thus, despite a continued growth in human capital across the Middle East, physical capital and productivity growth remained almost nonexistent across the region in the 1990s.¹

The Middle East's cycle of boom, bust and slow recovery is arguably tied to the so-called "curse of natural resources" (Auty, 2001; Sachs and Warner, 1995). Countries with natural-resource abundance appear to underperform in long-run GDP growth, because the positive wealth shocks from the export of natural resources raise demand for nontradable products, drawing skilled workers, physical capital investment and entrepreneurial ability from other sectors, and because the high spending leads to the loss of competitiveness due to the appreciation of the real exchange rate. As a result, the tradable sector, especially manufacturing activity, declines and economic growth suffers. Moreover, countries with high natural resources often exhibit policy distortions and weak institutional structures that handicap progress with reforms aimed at curtailing government expenditures and reorienting economic activity.

Compounding the "curse of natural resources" is the fact that the strong interventionist-redistributive tradition in the Middle East has created expectations and preferences about the role of the state that are not easily transformed. Governments that reduced welfare programs faced both political and social constraints, including political competition from Islamist opposition movements that

¹ The growth performance of the region in the 1990s is consistent with the predictions of standard cross-country growth regressions. Macroeconomic stability delivered a positive growth dividend while the weak investment response due to limited structural reforms held back overall performance.

promoted the preservation of social safety nets (Harik and Sullivan, 1992). Often, austerity measures were greeted by significant, occasionally violent, mass protest. Such protests took place in Egypt in 1977, Morocco in 1983, Tunisia in 1984, Algeria in 1988 and Jordan in 1989, to cite only a few examples. Moreover, the economic gains generated by selective policy reforms often were captured by business elites with established ties to governments, undermining their legitimacy among populations.

Demography, Labor Supply and Human Capital

The demography of the Middle East has created some of the most intense labor market pressures observed anywhere in the world, further undermining the sustainability of the old development model and the social contract underpinning it (Yousef, 2001). The Middle East region has been undergoing a demographic transition, moving from preindustrial conditions of high birth and death rates to a postindustrial equilibrium of low birth and death rates (Lee, 2003). Since the 1950s, the region experienced significant declines in infant mortality. But in the demographic transition, fertility declines often lag behind mortality declines. In 1950, the Middle East had the highest fertility rate in the world at seven children per woman, a position it maintained through 1970. As a result, the region's population growth rates in the post-World War II period, averaging close to 3 percent per annum, exceeded all other regions in the world except sub-Saharan Africa.

Recent evidence suggests that the fertility decline gained momentum in the late 1980s, setting the Middle East region on a path of low population growth in the twenty-first century (Courbage, 1999; Rashad and Khadr, 2002). Population growth peaked in 1985 at 3.4 percent, fell to 2.2 percent in the 1990s and is slightly lower in the present decade. The factors driving fertility trends in other regions—primarily improved health conditions and female education—appear to be playing the same role in the Middle East (Al-Qudsi, 1998; Olmsted, 2003). While several countries—for example, Lebanon and Tunisia—witnessed an earlier onset of the fertility decline, in the majority of countries the reductions came only in the past decade. Low levels of female education before the 1980s are primarily responsible for the delayed fertility decline in these countries.

A significant portion of the recent fertility decline is due to factors other than education and health. Slower rates of family formation among young adults due to rising unemployment, housing shortages and high marriage costs have played a role (Singerman and Ibrahim, 2001). Under the pressure of rapid population growth and its costs in terms of high dependency burdens and urban crowding, many governments have adopted population policies aimed at reducing fertility or maintaining low fertility. Iran's comprehensive family planning program, for example, has been credited for the one of the fastest fertility declines in the twentieth century, from 6.6 children per woman in 1985 to 2.5 in 2000.

Table 4
Labor Force Growth in Developing Regions, 1970–2010
(annual percentage)

	1970–1980	1980–1990	1990–2000	2000–2010
Middle East and North Africa	3.1	3.4	3.6	3.4
East Asia	2.4	2.5	1.2	0.8
Latin America and the Caribbean	3.3	3.1	2.5	2.0
South Asia	2.3	1.9	2.4	2.0
Sub-Saharan Africa	2.5	2.7	2.5	2.2

Source: World Bank (2004a)

These population trends have had an enormous impact on labor supply in the region. High population growth rates between 1950 and 1990 led to the rapid expansion of the working-age population, which, together with rising labor force participation rates, have created intense pressures on labor markets. Labor force growth accelerated from 2.1 percent a year in the 1960s to 3.4 percent in the 1980s and 3.6 percent during the 1990s. As Table 4 shows, labor force growth in the Middle East region is substantially higher than any other region in the world. Long-run forecasts suggest that not until 2020 will the rates of labor force growth in the Middle East fall to the more moderate rates seen in the 1960s.

Not only are young adults entering the labor force of the Middle East in greater numbers, but they also are increasingly more educated, a direct consequence of the considerable resources devoted to human capital accumulation. In the 1960s, educational attainment in the Middle East was the lowest in the world, with less than one year of education per adult 15 years or older. Between 1980 and 2000, the educational attainment of the adult population increased more than 150 percent, faster than in any other region or income group in the world. Currently, the Middle East region averages 5.3 years of schooling among those 15 years and older, which is far ahead of South Asia and Sub-Saharan Africa and is only a little more than one year behind East Asia and Latin America (Barro and Lee, 2000).²

The Middle East region has also made some progress in closing the gender gap in the education and workforce participation of its female population (Moghadam, 1998). In 1960, the region ranked low in terms of the ratio of women with higher or secondary education to women with only primary or no education. Between 1980 and 2000, this ratio grew faster in the Middle East than any other region. As a result, the ratio of male-to-female years of schooling fell from 2.5 in 1960 to 1.4 in 2000, making the ratio smaller at present than in East and South Asia. Female participa-

² The average years of education in the Middle East is weighted by the population and is based on available information from 1980 to 2000 for Algeria, Bahrain, Egypt, Iran, Jordan, Kuwait, Syria and Tunisia.

tion in the labor force, after remaining flat at around 25 percent between 1960 and 1980, has risen since the 1980s, reaching 35 percent at present. Rising labor force participation and a maturing age structure have raised the growth of female labor supply to around 5 percent annually between 1990 and 2010.

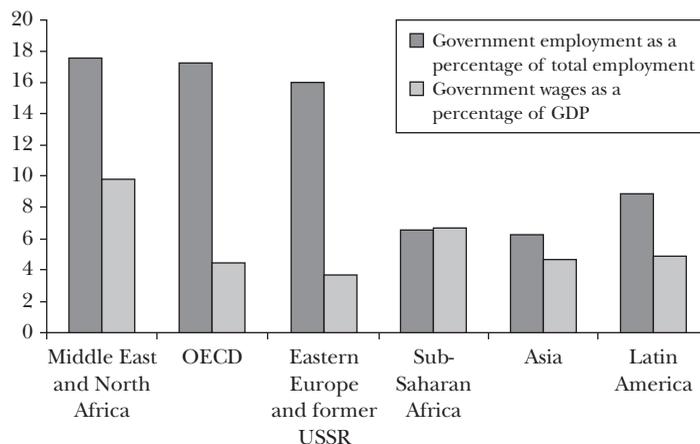
However, female labor participation remains substantially below what would be predicted on the basis of income and education (World Bank, 2004b). In addition, the improvements in health and education indicators have not translated into greater political empowerment for women, which is one of the three “development deficits” emphasized by the 2002 *Arab Human Development Report* (UNDP, 2002). Women’s presence in the political arenas and their influence on public policy are more limited in the Middle East than in any other region. For example, women in the Middle East have the smallest share of seats in national parliaments of any region in the world, holding less than 6 percent of the seats compared with the world average of 15 percent in 2000. Still, the picture is better today than a decade ago, with the number of countries with women parliamentarians rising from three in 1987 to 11 in 2003.

The Emergence of High Unemployment in the 1990s

The 1980s and 1990s in the Middle East have seen growing supplies of increasingly educated workers against a backdrop of anemic economic performance and an outdated development model. Poor labor market outcomes have resulted (Nabli and Keller, 2002). Unemployment rates in the Middle East region, averaging about 15 percent at present, are among the highest in the world, second only to that in sub-Saharan Africa. First-time job seekers—mostly between 15 and 24 years—make up more than 50 percent of the unemployed, suggesting that unemployment in the region is linked to the rapid growth of the labor force. The problem affects almost every country in the region, including the oil-exporting countries that traditionally imported expatriate labor. Unofficial estimates put rates of unemployment at much higher levels (and the region-wide estimate would also rise if Iraq were included). Poor labor market outcomes in the 1990s extended to real wages as well, which either stagnated or declined in most countries, extending a trend that began in the 1980s.

If the poor labor market outcomes in the 1990s reflected the inability of the old development model to reap the demographic dividend of a growing and educated labor force, the future entails an even bigger challenge (Williamson and Yousef, 2003). The total labor force of the Middle East region totaled some 104 million workers in 2000 and is projected to reach 185 million by 2020. Creating 80 million new jobs as well as absorbing a significant segment of those currently unemployed entails doubling the current level of employment within two decades—or creating as many jobs in the next 15 years as was done in the last five decades. In no small measure, the economic future of the Middle East will be determined by its labor markets.

Figure 1

Government Employment Around the World in the 1990s*(percentage)*

Source: Schiavo-Campo, de Tommaso and Mukherjee (2003).

Despite efforts since the 1980s to limit hiring and downsize the public sector, government bureaucracies in the Middle East have maintained their dominant position in labor markets (Assaad, 2002). The share of civilian government employment in the Middle East is high by international standards, exceeding industrial countries and other developing regions, as shown in Figure 1. Significant queuing continues for public sector jobs among educated workers, including women whose rates of unemployment are much higher than males in most countries. Government hiring typically offers more generous wages and benefits and also greater employment guarantees than the private sector (Said, 2001). Indeed, despite the compression of real wages in the public sector in the 1990s, recent estimates suggest that returns to education in Egypt, Morocco, Tunisia, Jordan and Yemen are generally higher in the public sector than in the private sector at nearly all education levels but the university level (World Bank, 2004a).

High levels of government employment have been reflected in the structure of unemployment (Shaban, Assaad and Al-Qudsi, 2001). Specifically, unemployment rates are highest for youth with intermediate and upper levels of education, compared with those with low levels of education who are not eligible for government employment. This pattern suggests that a significant part of unemployment results from high job expectations by young workers with some formal education and a low valuation of these credentials by the private sector because education systems have concentrated on making public sector jobs accessible rather than on building skills (Assaad, 1997). In the long run, the most detrimental impact of the large role of government hiring is that it traps human capital in unproductive public sector jobs, thus limiting its contribution to economic growth (Pissarides, 2001).

Yet the dominance of the public sector in labor markets has served two useful functions. First, the rise in female education and labor force participation in many countries is partly due to employment of educated workers by governments as well as explicit government policies to facilitate female participation in the labor force. In Jordan, the rise in female labor force participation from 4.8 percent in 1984 to 15 percent in 1996 resulted mostly from the expansion of public sector employment for educated women, who benefited from generous maternity leave and child care policies (Miles, 2002). Although such policies ostensibly apply to both public and private employers, private employers evade them by not hiring women on a formal basis and encouraging women to quit jobs upon marriage. Also, the wage scale in the public sector is more gender neutral, at least compared with the wide differentials in favor of males in the private sector.

Second, the egalitarian wage structure of the government employment has helped to maintain a relatively equal distribution of income in the region, despite the slow GDP growth during the period. Based on a poverty line of US\$1.08 per person per day in 1993 purchasing power parity exchange rates, only 2 percent of the Middle East region population fell below the poverty line in the 1990s (World Bank, 2003d). In fact, the Middle East and South Asia are the only developing regions with improvements in income inequality over the past three decades. In the face of cuts in food subsidies, government employment along with remittances from workers abroad have served as a social safety net, shielding a significant portion of the workforce from economic fluctuations (Adams and Page, 2003). But with the concentration of government employment among the more educated portion of the population, this safety net does not extend to some of the most vulnerable members of society.

The Role of the Private Sector in Labor Markets

While the public sector may continue to be a source of employment for a relatively large proportion of the population in the Middle East, it is unlikely (and undesirable) that it will be a leading source of job creation. Fiscal constraints—due in part to projected lower oil revenues, remittances and foreign aid on a per capita basis—and low worker productivity suggest that public sector employment will not be sufficient to absorb the unemployed and new graduates queuing for government jobs. Job opportunities are unlikely to come in any direct way from the oil industry either, since even if oil prices increase, the hydrocarbon industry is highly capital intensive, and the number of workers employed is quite small as a fraction of the workforce. Thus, it will have to be private-sector-led growth in the non-oil economy that will address the challenge of high unemployment and low wages for an expanding workforce in the Middle East.

Since the late 1980s, most countries have tried, with varying intensity and success, to expand private sector activity. Despite steps taken to privatize and reduce subsidies to state-owned enterprises, governments still represent a large share of value added in the Middle East region, about one-third of GDP on average, more than comparable middle-income countries in Latin America and East Asia (Assaf

and Benhassine, 2003). While state ownership of hydrocarbon resources in the Middle East inflates these numbers somewhat, the share of the public sector is high even in more diversified economies such as Egypt and Tunisia. Strategic service sectors, such as banking, telecommunications and transportation, remain under public ownership in most countries in the region. As a result, the contribution of the private sector to value added increased only marginally in the 1990s.

It is worth emphasizing that a heavy reliance on oil exports need not lead to a weak private sector. Despite the size of oil wealth and its control by the state, the small Gulf economies—Bahrain, Oman and the United Arab Emirates in particular—have the most dynamic private sectors in the region (World Bank, 2003c). Consider, for example, the United Arab Emirates, where real GDP growth has averaged some 7 percent in the 1990s. Much of this growth was created through rapid diversification in non-oil sectors: first, in energy-intensive petrochemicals, fertilizers, cement and aluminum and more recently in tourism, trade and manufacturing. With an average annual growth of 9 percent in real terms in the 1990s, the non-oil sectors accounted for 70 percent of GDP and 43 percent of exports in 2000. As a result, the growth of employment in these diversified sectors has averaged around 8 percent in the 1990s, and the UAE has the lowest unemployment rate in the region at around 2.3 percent (Girgis, Hadad-Zervos and Coulibaly, 2003).

The reasons for the success of the small Gulf economies are not found elsewhere in the Middle East due to the protracted pace of policy reform. For example, the business environment often discourages entrepreneurship, restructuring and firm creation. New firms, particularly small and medium enterprises, face significant administrative and capital constraints (World Bank, 2003b). For new firms, the costs of complying with regulations represent an average of 76 percent of per capita gross national income—well above the 34 percent in Eastern Europe, 16 percent in East Asia and 14 percent in Latin America. Moreover, public banks dominate the financial system—controlling around 60 percent of total assets of banking systems on average. These public banks typically favor state-owned enterprises, larger industrial firms and offshore enterprises, so that new firms face significant difficulties securing start-up and operating capital. The deficiencies in the business climate are further compounded by legal systems plagued by weak enforcement of property rights and corruption as shown earlier in Table 3.

The Middle East also has a wide range of structural rigidities in labor markets that limit the desire of the private sector to hire. In the state-led era, most countries adopted protective labor protections providing workers with lifetime job security, generous retirement packages and other job-related benefits. As countries initiated reforms in the past decade, they made few attempts to deregulate labor markets to encourage employment creation. Instead, the authorities and private business appear to have reached a tacit agreement that labor laws would not be strictly enforced for new labor market entrants (Posusney, 2003). As a result, there has been a growing pattern of informal jobs, spreading beyond self-employment and

wage employment in small informal sector enterprises to the expansion of unregulated employment in the formal private sector (Wahba and Mokhtar, 2002).

Proposals have been made to improve labor market outcomes in both formal and informal sectors by reforming systems of labor regulations, employment protection and industrial relations. These reforms have often proven the most challenging politically because existing labor regulations protect older workers in the formal sector who are better represented in unions and political parties and, hence, able to exert considerable pressure. Echoing similar findings in Latin America, several studies suggest that not even an ambitious agenda for reforming labor markets seems likely to achieve the employment growth required in the Middle East over the next few decades (Gill, Montenegro and Dömeland, 2002; Agénor, Nabli, Yousef and Jensen, 2003). In other words, labor market reforms are a necessary component of policy reforms, but they are not sufficient.

Globalization, Trade and Migration

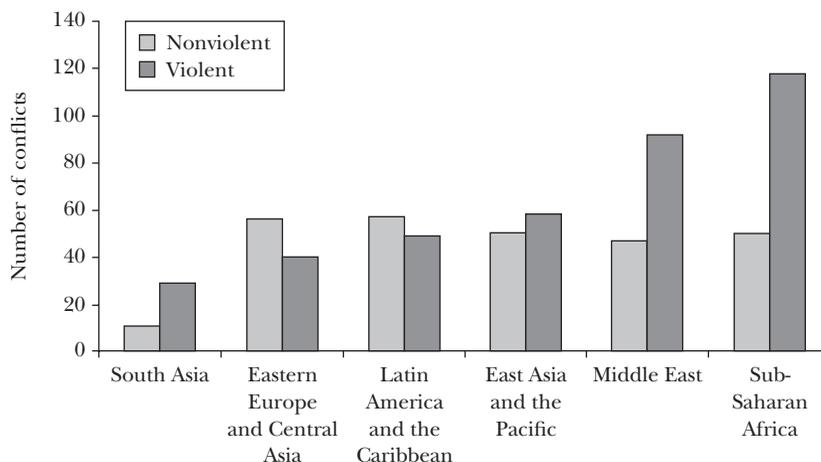
The Middle East region has failed to take advantage of the expansion in world trade and foreign direct investment in the past two decades, and in fact has become one of the least integrated regions in the global economy (Hakimian and Nugent, 2004). Despite the large hydrocarbon exports from the region, the share of exports plus imports to GDP declined from about 100 percent of GDP in the mid-1970s—one of the highest in the developing countries—to around 60 percent in the mid-1980s and has stagnated since. Excluding oil, trade declined from 53 percent of GDP in the early 1980s to 43 percent in 2000. Even intraregional trade has stagnated since the 1970s, representing less than 10 percent of total trade. These trends are partly the result of trade regimes that are among the most protective in the world, with an average weighted tariff of 17 percent for the region. Exchange rates have been persistently overvalued, by as much as 22 percent on average during 1985–2000 (Nabli and Véqanzonès, 2004). As of 2003, only 10 countries in the region were members of the World Trade Organization, with six applications pending.

These barriers to trade, combined with the weaknesses in the business climate and constraints on the participation of foreign capital in some key sectors, such as banking and finance, have discouraged foreign direct investment (World Bank, 2003c). Excluding the relatively small population Persian Gulf countries, the Middle East region received about \$2.2 billion in net inflows of foreign direct investment in 2000, or slightly more than 1 percent of flows to developing countries. These inflows averaged less than half a percentage point of GDP for most of 1985–2000. Egypt accounted for half the regional total (\$1.2 billion in U.S. dollars) and Jordan (\$750 million) and Tunisia (\$560 million) for about quarter each. The remaining countries received small amounts, and some, such as Yemen, had outflows.

The limited progress in encouraging foreign and domestic investment also

Figure 2

Frequency of Conflict across Regions, 1945–1999



Note: Nonviolent refers to conflicts classified as “latent conflict” or “manifest conflict” by the Heidelberg Institute for International Conflict Research Conflict Barometer. Violent refers to conflicts classified as “crisis,” “severe crisis” or “war.”

Source: Heidelberg Institut für Internationale Konfliktforschung (2004).

stems from the political instability the region has experienced. Indeed, the negative economic impact of conflict and wars has at times been worse for the economy than any economic policy. The region has seen an unusually large number of conflicts over the past four decades, as shown in Figure 2, including some 14 years of civil conflict affecting eight countries and some 15 years of cross-border regional and international conflicts affecting 14 countries. These include the civil wars in Lebanon (1975–1989) and Algeria (1991–present); numerous bilateral border skirmishes and shows of force; the Iran-Iraq war in the 1980s and the Gulf Wars of 1991 and 2003; and various outbreaks of war between Israel and other nations in the region including 1948, 1956, 1967, 1973 and 1982.³

National conflict as well as multiple sanctions regimes imposed on several large economies in the region like Iraq and Iran cast a shadow of persistent instability, disrupting intraregional economic links and slowing trade and investment integration. At times, regional instability transmitted shocks that directly affected labor markets. The repatriation of millions of expatriate workers from the Persian Gulf in 1990 created huge pressures in several labor-exporting countries including Egypt, Jordan and Yemen, causing sharp temporary increases in unemployment in addition to the loss of remittance income. More recently, travel restrictions on Palestinian labor mobility into Israel contributed to rising unemployment in the

³ A benchmark estimate is that for a one-unit increase in standard deviation of external conflict, non-natural resource exports to GDP declines by about 10 percent, because trade costs rise and direct foreign investment is discouraged (World Bank, 2003c).

West Bank and Gaza, from 9.9 percent in the first three quarters of 2000 to 28 percent in the final quarter of 2000 (Ruppert-Bulmer, 2003).

In the past, international labor migration has been a safety outlet for the Middle East. However, the power of international migration to benefit the economies of the Middle East seems to be in decline (Girgis, Hadad-Zervos and Coulibaly, 2003). Lower oil revenues in the 1990s have resulted in lower demand for imported labor within the region. In the aftermath of the first Gulf War with Iraq in 1991, many oil-producing countries replaced expatriate workers from the region with nationals and turned to Asia for labor imports when needed. Current unemployment rates together with the projected rapid expansion of the national labor force in receiving countries provide further incentives to reduce the inflows of all migrant workers. While there is potential for considerable flows of migrant workers from the Middle East to Europe, this outcome would require a significant change in European Union migration policy and would provide only a partial solution to the employment challenge in the region (Diwan, Nabli, Coulibaly and Johansson, 2002).

Jobs, Growth and Governance in the Future

The economic difficulties of the Middle East region in the past two decades have called into question the status of the region's postwar social contract, especially among those too young to remember the earlier era of rapid economic growth. States and societies are confronting the reality that the old development model is no longer sustainable. Recent policy proposals from within the region and outside have converged on the necessity of a comprehensive approach to reform in the future (UNDP, 2002; World Bank, 2003a). There is room for debate over the optimal speed and sequence of the reforms. But ultimately, the Middle East requires a broad-based transformation of its economies to strengthen the core drivers of job creation and economic growth: greater entrepreneurship and private sector development; faster integration into global trade and investment flows; and less dependence on oil and greater economic diversification. For the region to complete this long-standing transition, rapid progress is needed in educational reform, gender equality and better governance.

Apart from the goals of expanding access to education and deepening the skill base in the economy, countries of the Middle East must address concerns about the quality of educational outputs and skill mismatches as they affect labor market imbalances today and the requirements of the transition in the future. Tackling these mismatches is partly a matter of improving the underlying quality of education and training curricula that continue to rely more on rote learning and less on knowledge application and problem-solving (Heyneman, 1997). But they also require reforming the rigid and centralized management systems that operate in isolation from the economic environment. There are few performance indicators for schooling and, thus, little measurement of school quality. Only Egypt, Jordan

and Oman have attempted to assess the performance of their students relative to international learning standards.

Broad-based economic prosperity in the future requires greater attention to factors driving gender inequality. Some of this can be facilitated by taking the actions necessary to allow for greater participation of women in the labor force and in the public sphere in general. In some countries, strict gender norms, which underlie a range of civil, commercial, labor and family laws and practices in the region, discourage women from entering the workforce. Allowing and encouraging women to become economic actors requires reviewing and revising policies and laws, including labor legislation, to eliminate artificial discrepancies that raise the cost of hiring women relative to men (World Bank, 2004b). Similarly, political empowerment may require interventions like those in Bahrain, Jordan and Morocco, which implemented quotas for women in national parliaments and local bodies.

But the challenge of comprehensive reform is foremost a challenge of governance (Richards, 2001). Enhancing governance in the region extends beyond improvements in bureaucratic performance and reductions in transaction costs that discourage private investment. Efforts to reform the economies of the Middle East hinge on the credibility of government and the capacity of state institutions to manage the difficult process of economic transition under conditions of economic volatility and social vulnerability. At present, governments are handicapped by the limits of institutional structures organized to support redistributive and interventionist policies and the difficulties such institutions face in adapting to new tasks, new policy demands, and new regulatory environments (Ayubi, 1995). Such instruments are necessary to establish and maintain conditions that promote socially equitable strategies of market-oriented economic growth.

The Political Economy of Reform

Why, despite the obvious urgency of the need for reform, have governments of the Middle East been reluctant to change course? Part of the reason, of course, is a response of incumbent leaders to circumstances in which the costs of reform are immediate, while its benefits are both delayed and, to some extent, uncertain. It is also true that the social contract prevailing in the Middle East has created powerful social actors with a strong interest in sustaining it. But there are also political, economic and social costs associated with attempting to maintain an unsustainable status quo. In the Middle East, these costs are arguably becoming more severe, supporting the belief that slow and selective reform lacks credibility and exacerbates social polarization.

Two factors, in particular, help explain the weak commitment to comprehensive reform by governments in the region. The first is the impact of soft budget constraints on the intensity of demand for reform (Luciani, 1994; Vandewalle, 2003). Many governments in the region have been able to rely on revenues

generated outside the domestic economy and flowing directly to the state through some combination of oil exports, remittances and foreign aid. In the past decade, this flow of resources has been sufficient to cushion the impact of economic stagnation and permit governments to adopt limited reforms, while postponing difficult decisions about structural adjustment and reorganization of the social contract.

Second, governments in the Middle East have found it difficult to manage the relationship between political and economic reform. During the initial phases of economic reform in the 1980s, many governments accepted an instrumental connection between economic and political reform (Niblock and Murphy, 1993). For example, governments recognized that the existing social contract blocked their ability to reduce state intervention in the economy, shrink the public sector and reorganize state-labor relations. Thus, governments in Algeria, Egypt, Jordan, Morocco and Tunisia initiated experiments in political liberalization to secure popular support for market-oriented economic reforms of the interventionist-redistributive programs. These experiments fell short of democratization, but typically opened the political space to opposition political parties, expanded civil liberties and increased the participation of civil society (Norton, 1996).

However, political openings, even partial and fragile, produced consequences that undermined their sustainability (Brumberg, 2003). In this region, opposition movements had been barred from political life for decades and thus had turned to increasingly radical and often clandestine modes of organization and mobilization (Esposito and Voll, 1996). Thus, political openings were exploited by opposition movements seeking far-reaching transformation. In Algeria, Tunisia, Egypt, Yemen and Jordan, Islamist oppositions attracted significant popular support during the 1980s and early 1990s, challenging the capacity of governments to contain and manage the scope of political change. Labor unions and professional associations were among the organizations in which Islamist movements competed successfully for elected office.

Many governments of the Middle East had only been reluctant reformers to begin with, and when confronted by political opposition, they adopted policies that weakened the link between economic restructuring and political reform (Kienle, 2001). Governments responded to the appeal of and, in some cases, the violence of extremist groups by reviving strategies of political control and reinvigorating the national security concerns that had earlier impeded economic reform in the Middle East.⁴ Thus, while in the 1980s and early 1990s, governments in the Middle East viewed political liberalization as a precondition for economic reform, by the

⁴ This pattern was evident in the imposition of new constraints on civil society organizations and nongovernment organizations, restrictions on freedom of the press and other measures to control political mobilization. In January 1992, the Algerian military interrupted national elections to prevent the victory of an Islamist party. In Tunisia, Islamist parties and movements were repressed. Similar actions were taken in Egypt, though limited political participation by Islamists continued. In Jordan, electoral laws put in place when Parliament was restored in the late 1980s were revised several times in the 1990s to reduce Islamist representation.

mid-1990s, the relationship had been reversed. Pursuing economic and political reforms simultaneously was seen as threatening to the existing political order. As a result, top-down management of economic reform by decree replaced earlier efforts to generate support for economic reform by opening the political arena.

Economic reform by top-down decree can be an adequate mechanism for changing bureaucratic practices, regulatory procedures and state economic policies. However, it has little ability to achieve reforms that hinge on the compliance and participation of social groups whose well-being might be adversely affected (Desai, Olofsgard and Yousef, 2003). Moreover, reform by decree reproduces state-centered approaches to the management of economic and social policy, sustaining interventionist and paternalistic patterns of state-society relations and thus moving away from a transition toward market-oriented political economies. Not least, the top-down approach meant that possibilities for establishing a consensus around a redefined vision of state-society relations and a renewed social contract became more remote (O'Donnell, Schmitter and Whitehead, 1986). Transparency, the deepening of rule of law and the accountability of policymaking all suffered in the Middle East in the 1990s.

The Potential for Reform

Most Middle East governments have already lost their ability to coast along on a cushion of oil revenues and foreign aid, while undertaking only partial, incremental and reversible reforms. Per capita oil revenues are down, foreign aid has been reduced and global competition for foreign investment is intense (World Bank, 2003c). With the end of the era of soft budget constraints, governments will increasingly depend on domestic sources of state revenue to sustain economic and social policies. Without an institutional and regulatory setting that is both supportive of economic growth and capable of implementing responsible fiscal policies, revenues will fall short and redistributive policies will become more unsustainable.

On the political side, public opinion in many Middle East countries remains supportive of electoral reform, good governance and the integration of responsible opposition parties in the political mainstream (AbuKhalil, 2003). For example, in a recent survey of public opinion, civil and personal rights were rated as the highest priority by respondents in eight Middle Eastern countries (Zogby, 2002). Although religion and family were more likely to be rated the most important institutions in an individual's life, according to a 2002 Gallup survey in nine Muslim countries, detailed analysis of the data revealed that individuals with a religious orientation are no less likely to favor democratic governance and no more likely to support Islamist movements (Tessler, 2003). In other words, individual attitudes in the Middle East are largely driven by political and economic considerations.

Broader patterns of regional economic and political change also suggest new possibilities for extending political reform into the management of national security regimes and defense. Important conflicts remain unresolved in the region, but

the widespread use of such conflicts to justify burdensome levels of military expenditure is not only less plausible today, but imposes growing economic costs on workers and citizens (UNDP, 2002). The balance may be tipping, so that if governments in the Middle East want political stability and social peace, they will have a better chance of achieving these goals by pursuing political openness and economic reforms. To move the reform process beyond its current limits, governments will need to revive national conversations about redefining the terms of the social contract.

Given the economic and political difficulties in the Middle East in the past few years, skepticism regarding the possibilities for comprehensive reform is warranted. But the last two decades have seen a number of dramatic and sweeping reforms. In postsocialist states of eastern and central Europe, the transition was facilitated by the urgency of establishing new systems of economic and political governance. Elsewhere, policymakers in several Latin American countries in the 1980s and Asia in the 1990s advanced economic reforms within democratizing polities. It is worth noting that religious and cultural institutions of Catholicism and Confucianism were once presumed incompatible with democracy in these countries. The Middle East will need to tailor such lessons to its own challenges, but the pathways to reform are much better mapped today than they were only two decades ago.

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