Issue 38 | December 2014

European Commission

ISSN: 1831-4473

ECFIN Economic Brief

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

The EU's Southern Neighbourhood: Macroeconomic Performance and Equity

*Heliodoro Temprano Arroyo**

1. Introduction

The political instability accompanying the Arab Spring revolts that started at the end of 2010 had detrimental effects on the economies of the EU's Southern Neighbourhood.[1] Four years later, the economic and financial situation in the region remains challenging. The economic disturbances related to the political transition have proved more lasting than initially expected. Moreover, the recent re-intensification of military and civil conflict in some countries is further complicating things.

At the same time, countries in the region have yet to address some of the underlying deficiencies in their economic models that contributed to the social upheavals. These deeper structural deficiencies have resulted in a suboptimal macroeconomic performance (particularly in terms of growth and employment) over the last thirty years and have generated an economic model that is, and is perceived to be, unfair and non-inclusive from a social point of view.

After discussing recent macroeconomic developments in the EU's Southern Neighbourhood, this Economic Brief examines the performance of the region in terms of long-term growth and equity as well as its main structural determinants. It then focuses on some reforms that are key for adopting a more equitable growth model while underpinning macroeconomic sustainability. While some countries have started to implement these reforms, much more needs to be done if the region is to move to a more satisfactory growth model.

* The author is Head of the Neighbourhood Countries and Macro-Financial Assistance Unit at DG ECFIN.

[1] This paper focuses on the EU's Southern Neighbourhood, which includes ten countries or territories covered by the European Neighbourhood Policy (ENP), namely: Algeria, Egypt, Israel, Lebanon, Libya, Jordan, Morocco, Palestine, Syria and Tunisia. However, reflecting data availability and other considerations, this Economic Brief often refers to the wider Middle East and North Africa (MENA) region, which normally includes, in addition to those ten countries and territories, the Gulf Cooperation Council countries, Iran, Iraq and Yemen.

Summary

Four years after the start of the Arab Spring uprisings, the macroeconomic situation in the EU's Southern Neighbourhood remains weak and vulnerable and the recent intensification of civil strife and military conflicts is exacerbating this economic malaise. Macroeconomic performance may not improve in a sustainable manner without an appropriate resolution or mitigation of the underlying political problems. At the same time, macroeconomic instability and social frustration with an economic model that is perceived as unfair and non-inclusive risk feeding negatively into the existing political instability. This Economic Brief argues that it is essential for the countries in the region to press ahead with their economic stabilisation and reform agendas even if the political environment is far from optimal. It looks into some key reforms that are necessary to both ensure macroeconomic sustainability and move towards a more equitable growth model.

ECFIN economic briefs are occasional working papers by the European Commission's Directorate-General for Economic and Financial Affairs which provide background to policy discussions.

They can be downloaded from:
ec.europa.eu/economy_finance/publications

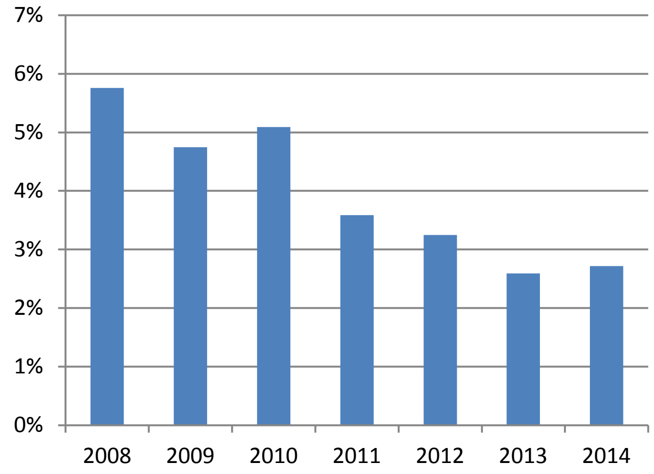
Economic and Financial Affairs

KC-AY-14-038-EN-N
ISBN 978-92-79-35342-0
doi: 10.2765/73110

2. Recent macroeconomic developments

The hoped-for recovery of economic growth, investment and tourism flows, after the impact of the instability that accompanied the first stages of the political transition processes, has hardly happened (Figure 1). Average GDP in the countries that are part of the EU's Southern Neighbourhood (excluding Libya and Syria), which had decelerated from an average of about 5% in 2007-10 to 3½% in 2011, further decelerated to 2½% in 2013 and is projected to recover only moderately in 2014 (to 2¾-3%). If Libya and Syria are included, the picture is of course even gloomier.

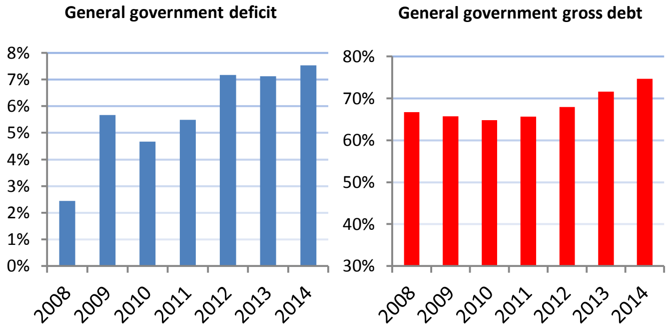
Figure 1: EU's Southern Neighbourhood: GDP real growth *(Simple average, %)*



Sources: National authorities; IMF; Commission staff estimates
Note: Average excludes Libya and Syria.

Fiscal deficits, which were pushed up sharply in 2011 by a combination of slower economic growth, surges in food and energy subsidies and increases in public sector wages and social expenditure, also remain very large and have actually further increased since then (Figure 2, left panel). Having jumped from 2½% of GDP in 2008 on average (excluding Libya, Palestine and Syria) to 5½% of GDP in 2011, they have further increased to around 7% since then. Moreover, the accumulation of large deficits year after year is resulting in a rapid increase in public debt levels, from 66% of GDP on average in 2008 to a projected 75% of GDP this year (Figure 2, right panel). Lebanon, for example, which has one of the highest public debt-over-GDP ratios in the world but had managed to put it on a downward trend between 2007 and 2011, is again experiencing an upward trend in the debt ratio. Higher interest payments on the debt are, in turn, contributing to keep fiscal deficits large in the region.

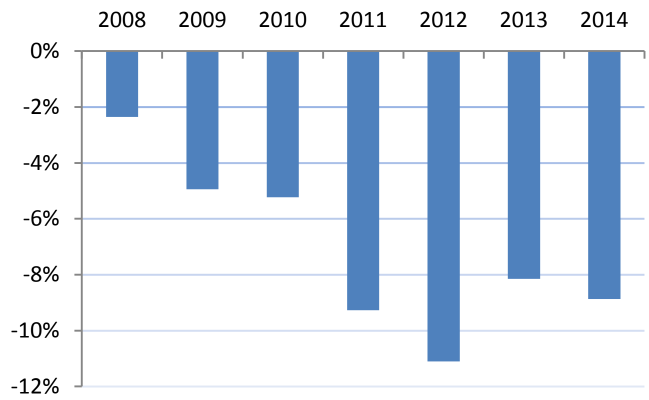
Figure 2: EU's Southern Neighbourhood: Public finance trends *(Simple average, % of GDP)*



Sources: National authorities; IMF; Commission staff estimates
Note: Average excludes Libya, Palestine and Syria.

The balance of payments situation also remains fragile. Conflicts and political instability in the region continue to discourage foreign investment as well as tourism inflows, and to disrupt in some cases trade and energy flows. Current account deficits, which had jumped in the net energy importing countries from an average of about 3% of GDP in 2009 to over 9% of GDP in 2011, further rose (to just over 11% of GDP) in 2012 and have only declined in part since then (Figure 3). They are projected to remain above 8% of GDP on average this year, a clearly unsustainable level.

Figure 3: EU's Southern Neighbourhood: Current account balance of net oil importers *(% of GDP)*

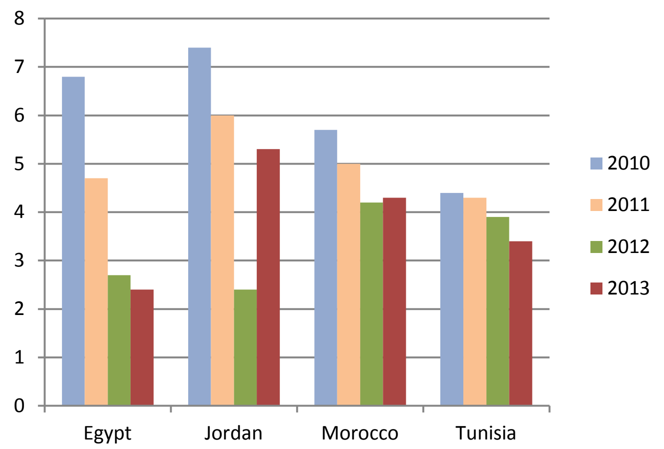


Sources: National authorities; IMF; Commission staff estimates
Note: Simple average of Egypt, Israel, Jordan, Lebanon, Morocco, Palestine and Tunisia.

Foreign direct investment (FDI) inflows, for their part, remain well below their pre-2011 levels.[2]

As a result of these balance of payments trends, and despite substantial inflows of official assistance (estimated by the IMF at about USD 80 billion for the period 2010-14), foreign exchange reserves, which had declined markedly in the first years of the transition, are still dangerously low in months of imports (Figure 4).

Figure 4: Gross international reserves
(in months of imports)

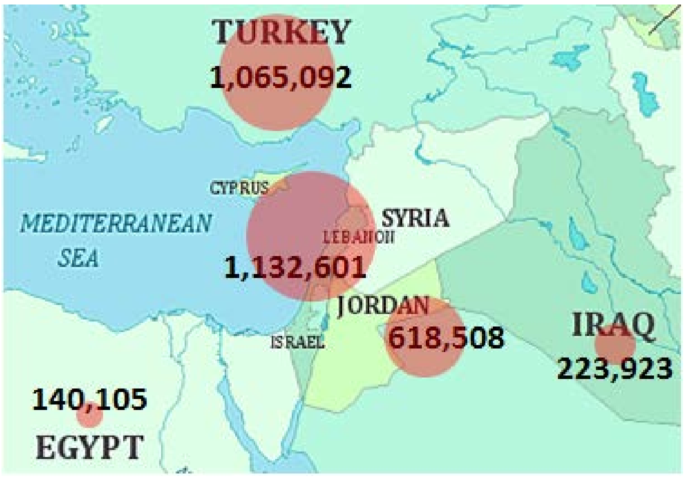


Sources: National authorities; IMF; Commission staff calculations

This already fragile macroeconomic situation is further complicated by the effects of the recent recrudescence of conflicts and civil strife in the region. The persistence of the Syrian war, the new conflict around the emergence and expansion of the Islamic State of Iraq and the Levant (ISIL), the fresh conflict in Libya, which is seriously impacting its oil production and exports, and the recent military confrontation in Gaza are affecting not only the economies of the countries in question. They are also having significant spillover effects on their neighbours, including through the flow of refugees (e.g. in the case of Lebanon and Jordan, where Syrian refugees account for nearly 30% and 10% of their respective populations, or in Tunisia, which is having to accommodate an important inflow of Libyans) and by harming investor, consumer and tourist confidence. Figure 5 shows the flow of refugees from Syria into its neighbouring countries, which already exceeds three million people.

The economic implications of these conflicts are crude reminders of a fact: without resolving or substantially mitigating the political and military problems in the region it will be hard to re-establish macroeconomic stability and lay the foundations for a more sustainable and inclusive economic growth in the future.[3]

Figure 5: Syrian refugee crisis as of November 2014
(number of refugees)



Source: UNHCR
Note: Officially registered refugees and those awaiting registration. Country names and boundaries in this map do not necessarily reflect an EU position.

At the same time, those conflicts, as well as the Arab Spring uprisings, are partly a reflection of a number of structural deficiencies in the economies of the region that have resulted in a dismal growth and employment performance over the last 30 years and in a growth model that is socially inequitable, and is also characterised by weak and non-transparent economic governance.

3. A disappointing long-term economic performance

As Figure 6 illustrates, over the 30 years that preceded the 2011 Arab Spring, the Middle East and North Africa (MENA) region exhibited very weak economic growth rates when compared to other emerging market and developing regions. It grew on average by only 2.9% per annum, compared to 5.5% for the Asian countries and to an average of 4.5% for the emerging and developing countries as a

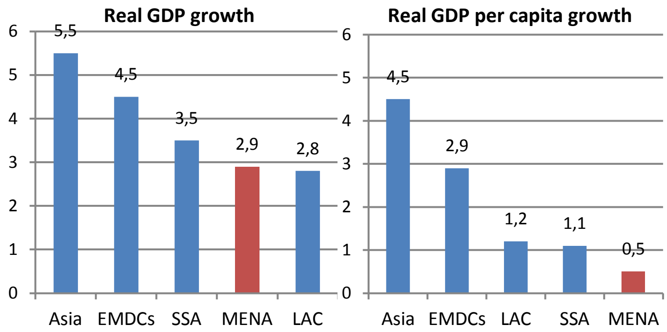
[2] Net FDI inflows reached USD 14.5 billion in 2013, compared to USD 17.5 billion in 2010, in Egypt, Jordan, Libya, Morocco and Syria combined.

[3] For a discussion of the implications of conflicts and geopolitical risks on the region's economic performance, see IFI (2014).

whole. The growth performance was particularly disappointing when measured in per capita terms (only 0.5% on average compared to 4.5% in Asian countries and 2.9% in the emerging and developing countries as a whole).

The particularly weak performance in per capita terms also reflects the region's exceptionally rapid rates of demographic growth (Figure 7). The population of the EU's Southern Mediterranean neighbours grew on average by 2.3% in the 30 years up to 2010, the fastest rate in the world. Although population growth has slowed down significantly since the mid-1990s, at 1½%, it remains high. This rapid demographic growth not only depresses per capita growth but also results in a very young demographic profile (with 65% of the population being less than 30 years old) and exacerbates pressures in the labour market, which cannot provide enough jobs for the rapidly expanding working age population, resulting in both high unemployment rates and large migration flows. These flows are mostly towards EU countries and the oil producing countries of the Gulf Cooperation Council (GCC) and Libya, all of which offer also much higher wages.[4] The incapacity of the region's economies to generate sufficient jobs also tends to keep labour force participation rates very low, especially among women (see below).

Figure 6: A disappointing long-term growth performance
(average of 1980-2010, in %)

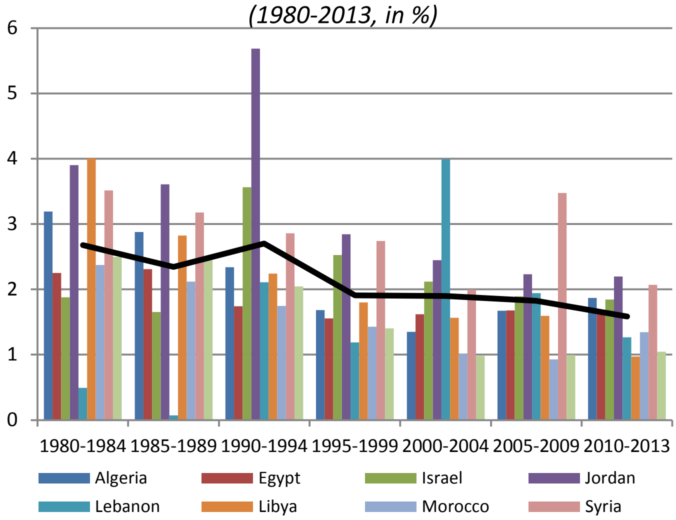


Source: IMF (2011)

Note: EMDCs: Emerging and developing countries; SSA: Sub-Saharan Africa; LAC: Latin America and the Caribbean.

Rapid demographic growth and low participation rates underline the important potential contribution of labour and investment in human capital to economic growth in the region. However, without appropriate reforms that will change the incentives, alleviate growth constraints and boost economic dynamism, these demographic pressures will not be properly absorbed and will create additional tensions in the labour market and migration and fiscal pressures.

Figure 7: Population growth rates
(1980-2013, in %)



Source: World Development Indicators, World Bank

4. A non-inclusive growth model

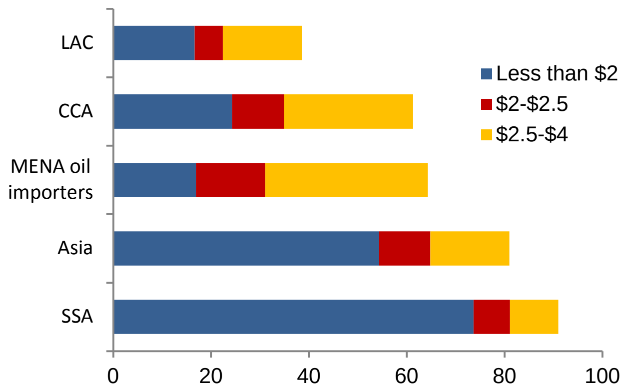
MENA countries not only underperform in terms of economic growth and employment. They also score poorly on most indicators of economic inclusiveness, particularly if the (relatively richer) oil exporters are excluded.[5]

In the MENA oil importing countries, the average poverty ratio (based on the international poverty line of USD 2 PPP per day) declined substantially between the 1990s and the 2000s and is now lower than that of developing Asia and Sub-Saharan Africa. However, a large share of their population is below the USD 4 PPP poverty line (Figure 8). This means that a large share of the population has a high risk of falling into poverty, notably in the context of an economic and political crisis, to which the region is prone. It should also be noted that in some countries of the region the poverty rate has increased over the last 15 years (for example, in Egypt it increased from 16.7% in 2000 to 26.3% in 2013).

[4] According to European Commission (2010), which compiled available data mostly referring to the second half of the 2000s, about ten million citizens of the Arab Mediterranean countries live abroad, which corresponds to over 8% of their working age population. More than half of these migrants work in Europe and around a third in the Gulf and other Arab states. Migration stocks were particularly high for Lebanon (17%) and the Maghreb countries (5.5% on average).

[5] This section draws in part on a recent study conducted by the IMF (2014a) comparing these indicators across several emerging and developing country regions.

Figure 8: Population living under poverty line
(2000s, average in %)



Source: Poverty and Inequality Database (World Bank)
Note: Population-weighted averages. CCA: Caucasus and Central Asia; MENA oil importers: Egypt, Jordan, Morocco and Tunisia.

On the positive side, MENA countries have a relatively low Gini index[6] of income inequality compared to most other emerging and developing regions and their relative income shares of the top to the bottom quintiles are also rather low (Figure 9). The size of the middle class, in percent of the population, is also significant, although it has expanded more slowly than in other regions over the last decade.[7]

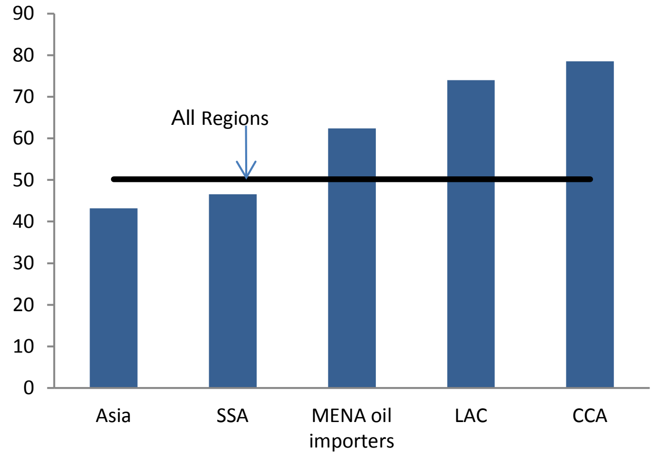
Figure 9: Measures of inequality

	Gini Index		Relative Income Shares - (P80/P20)	
	1990s	2000s	1990s	2000s
LAC	53.8	53.6	20.4	19.7
SSA	44.8	42.7	10.5	9.6
CCA	39.3	34.9	8.8	5.7
MENA	37.4	36.5	6.8	6.2
Asia	33.8	37.9	5.4	7.2
All Regions	37.8	40.3	7.8	8.8

Source: IMF (2014a), p. 84.
Note: The relative income shares are calculated as a ratio of the income share of the top quintile to that of the bottom quintile. Population-weighted averages. MENA: Egypt, Jordan, Iran, Morocco, Tunisia and Yemen.

All this suggests a relatively fair distribution of income. However, MENA oil importers exhibit a high degree of inequality in other indicators, including land distribution (based on the FAO's land Gini index; Figure 10), gender inequality (in terms of women's access to employment and other services such as health, education and economic opportunities),[8] and regional inequality (in terms of disparities in both per capita income and access to services between urban and rural areas). They also tend to score poorly on general indicators of education and health. For example, while MENA countries show an intermediate performance on the UNDP's Multidimensional Poverty Index (partly reflecting a relatively good access to subsidised services such as fuel and electricity), the education and health dimensions tend to have a dominant contribution to their overall poverty, as measured by this index.[9] Finally, the combination of low labour market participation rates and high unemployment rates imply that a large share of the population is excluded from the labour market.

Figure 10: Land Gini index



Source: Food and Agriculture Organisation
Note: Population-weighted averages based on one observation per country, obtained between 1996 and 2006. MENA oil importers: Algeria, Egypt, Jordan, Lebanon and Morocco.

[6] The Gini coefficient varies between 0 and 100, with 100 reflecting maximum inequality.

[7] See IMF (2014a), p. 84.

[8] For example, MENA oil importers score worse than any other region in the Global Gender Gap Index calculated by the World Economic Forum (2013), which encompasses different aspects of gender disparities. For a discussion of women's very low participation rates and high unemployment rates in MENA countries, see below.

[9] See UNDP (2014).

5. Structural factors behind this disappointing economic and equity performance

The economic literature generally concurs that the MENA region's poor and socially inequitable economic performance reflects a combination of structural deficiencies. These can be grouped into the following categories:[10]

1. *Fiscal policy deficiencies*, including in particular, the existence of costly and inefficient price subsidy systems, the lack of modern and well-targeted social safety nets, tax systems that yield meagre revenues and are socially regressive, and states that are oversized (compared to other countries of similar level of economic development) and discourage private sector development but that, at the same time, are highly inefficient. Between two thirds and three fourths of public expenditure is often devoted to food and energy subsidies, civil servant wages, defence expenditure and interest payments on the public debt, leaving few resources for targeted social expenditure and public investment.
2. *Deficiencies in the labour market and in the education systems*, which result, as noted, in high unemployment rates (particularly among young people, graduates, and women) and low participation rates (particularly among women). Education systems tend to suffer from low quality standards and produce skill mismatches, which exacerbate unemployment and contribute to divert human capital towards the public sector to the detriment of the private sector.
3. *Deficiencies in the trade and investment framework.* The economies of the region show a relatively low degree of international as well as intra-regional trade integration. There are also problems with the regulatory framework for investment and, more generally, with the business climate, which discourage private investment and private sector initiative.[11]
4. *Financial sector deficiencies.* Capital markets are insufficiently developed. Financial systems tend to be dominated by banks (often public banks), which devote a significant part of their assets to refinancing the government, contributing to the crowding out of the private sector. Also, there tends to be a low degree of access of Small and Medium-Sized Enterprises (SMEs) to finance (with negative implications for employment creation given that SMEs are relatively employment intensive and generate the bulk of total employment in these countries) and a lack of financial inclusiveness among the poor and rural population.
5. *An insufficient degree of economic diversification.* This is true in particular for the net energy exporters (Algeria, Libya) but also for other countries (for example, Lebanon's economy is disproportionately based on three sectors, namely, the financial, real estate and tourism sectors).
6. *The informal or underground economy* tends to be sizeable in many countries, which not only undermines fiscal revenues but leaves a significant share of the population out of the official social safety nets.
7. *Weaknesses in public finance management and statistical systems*, which also lack in some cases independence from the government. For example, in Lebanon budgets have not been passed by parliament since 2005 and past fiscal accounts going back to the early 1990s have yet to be formally audited and closed; in Egypt defence expenditure and income from the army's productive assets are partly off the budget; and in Tunisia the statistical agency does not have sufficient autonomy from the government. There is also substantial scope for improving internal financial control and audit as well as the external audit and public procurement systems. All this contributes to the perception of weak economic governance and transparency.

Unfortunately, the political economy of structural reform has not become easier in these countries in recent years, reflecting the fragility of political transitions and the intensification of domestic and regional conflicts, which have diverted attention away from the economic reform agenda. Despite this unpropitious context, however, some countries have managed to advance, admittedly hesitantly in some cases, with economic reforms. This includes countries

[10] See, for example, IMF (2010), which reports on the results of an empirical study on the main determinants of growth in the region, and European Commission (2011), Part III.1.

[11] The Southern Mediterranean neighbours of the EU score much worse in the Doing Business indicators compiled by the World Bank than the EU's Eastern neighbours, and generally worse than other countries of a similar level of economic development. Moreover, whereas the EU's Eastern neighbours have been catching up with the OECD countries in terms of these indicators since 2005, the EU's Southern neighbours have been losing positions in the ranking since then. See European Commission (2013), Box II.2.1, pp. 39-40.

such as Jordan, Morocco, Tunisia and Yemen, which have made some progress in the context of IMF-supported programmes, but also some, notably Egypt more recently, that have been advancing in the absence of an IMF-supported framework.

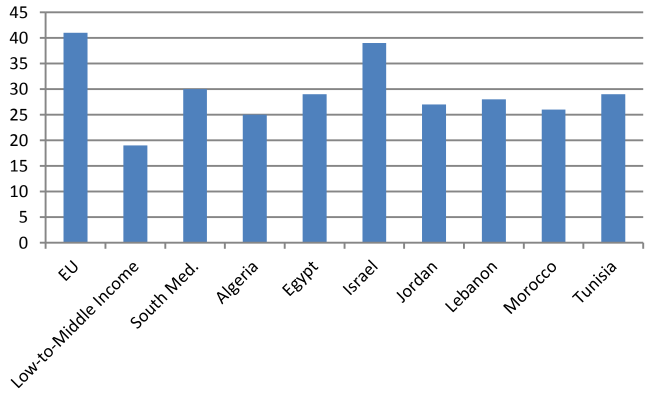
6. Moving towards a more inclusive growth model

Several of the above-mentioned structural deficiencies combine to produce, as noted, a socially inequitable growth model. The remainder of this paper will focus on two types of structural deficiencies that are particular relevant for the fairness of an economic model, namely those in the fiscal and the labour market/educational system areas (covered by the first two categories listed above).[12]

7. Fiscal deficiencies

As noted, the state in the Southern neighbours of the EU and other MENA countries is relatively large, when measured in percent of GDP and when compared with other countries at a similar level of development, although still smaller than in developed countries, notably EU Member States (Figure 11).

Figure 11: Total public expenditure in 2010
(% of GDP)

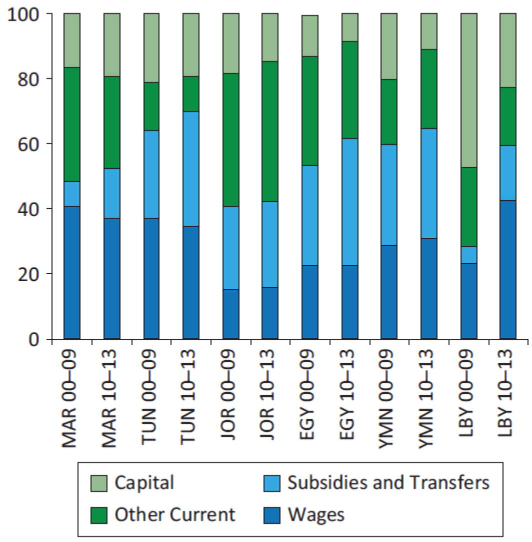


Source: World Bank

[12] Other structural policies that are relevant for equity but are not specifically addressed in this paper include: regional and rural development policies, migration policy, measures to reduce informality and policies to support the development of SMEs and financial inclusiveness.

And yet, this state has its spending hands so tied up with a few inefficient types of expenditure that it is incapable of providing sufficient social assistance to the needy or enough public investment. States in the region often devote the bulk of their expenditure (sometimes, as in the case of Lebanon, as much as three quarters of it) to four expenditure categories that are bad in terms of either growth or equity, namely price subsidy schemes, civil servant wages, military spending and debt service (Figure 12).

Figure 12: Public expenditure components in selected Arab countries

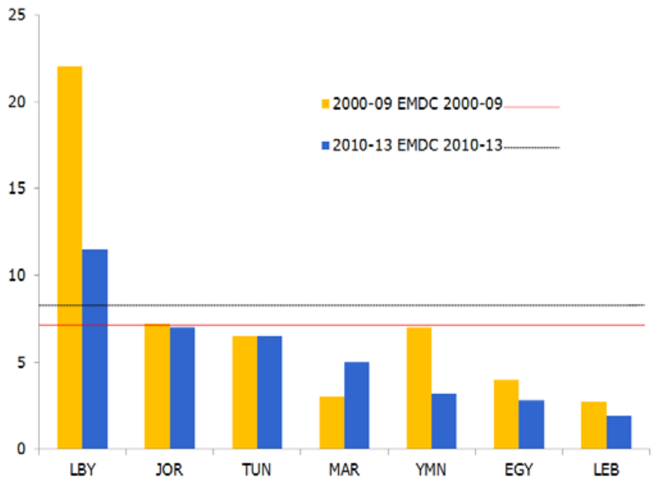


Source: IMF (2014b), p. 11.

The combined weight of these four expenditure categories has increased significantly since 2011, reflecting a combination of factors. These include: i) the increase in international food and energy prices (or, in some cases, such as Jordan or Lebanon, regional disruptions in energy supplies that obliged the affected countries to replace gas with more expensive fuels), which increased the cost of price subsidies; ii) a policy to increase public sector wages and public sector employment to ease social tensions and support economic activity in the context of difficult political transitions; iii) the increase in military and domestic security expenditure in response to regional and civil conflicts; and iv) the accumulation of public debt (which increased, as noted, interest payments). Moreover, this has happened at a time when tax revenues were declining because of slower economic growth, resulting in an increase in the share of revenues that is captured by these four expenditure categories, as well as contributing to the widening of budget deficits.

One clear victim of these developments has been public investment, which was already very low in the previous decade, when compared to the average of emerging and developing countries, but has further fallen since 2010 (Figure 13).

Figure 13: Public investment
(% of GDP)



Sources: IMF (2014b), p. 11; IMF data
Note: Yellow bar for Lebanon is for 2003-09.

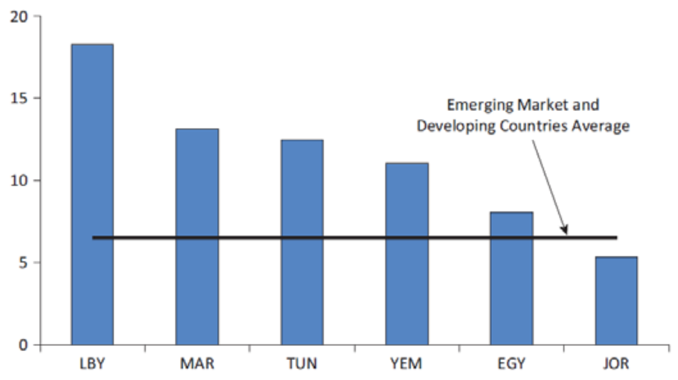
The ultimate objective of fiscal reform in the countries of the region should be to generate or free the resources necessary to undertake a more ambitious and better targeted social expenditure policy, while increasing public investment and reducing budget deficits. This requires both a policy to limit the above-mentioned four types of inefficient expenditure but also tax reforms aimed at generating fiscal resources in a progressive, socially fair manner. It also requires the replacement of inefficient price subsidy schemes with modern and well-targeted social safety nets. In the oil and gas exporting countries, another objective of tax reform should be to diversify the sources of fiscal revenues so as to reduce fiscal dependency and exposure to fluctuations in international energy prices.

Let us look in more detail into some of these necessary fiscal reforms.

8. Rising public wage bills

Following the significant increase in public wages and public employment experienced since 2011, public wage bills are much higher in the Arab countries in transition[13], in percent of GDP, than in the average emerging and developing country (Figure 14).

Figure 14: Employee compensation
(2012, % of GDP)



Source: IMF (2014b), p. 14

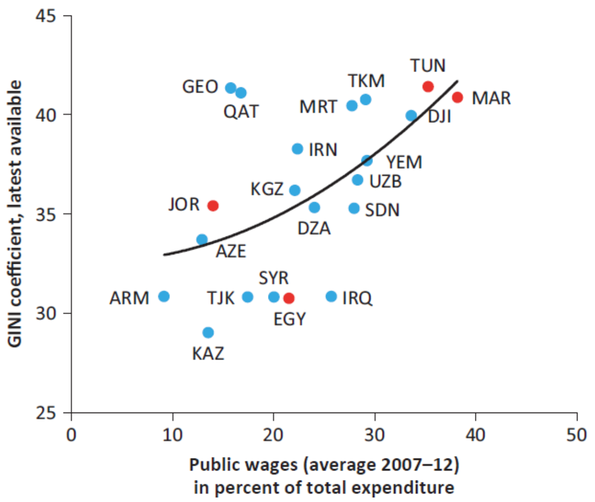
While the decision to boost public wages is in part understandable given the challenging socio-political context experienced by these countries and, in some cases, the insufficient adjustment of public wages in previous years, this policy has a number of drawbacks. First, it tends in actual fact to raise, rather than reduce, inequality, because government employees tend to hold an above-average position in the income distribution. Thus, as Figure 15 illustrates, observed income inequality, as measured by the Gini coefficient, tends to be higher where average civil servant wages are relatively high compared to per capita GDP or in percent of total public expenditure (e.g. in Tunisia and Morocco; see also Figure 16). Another problem with rising public sector wages is that it tends to attract many of the talented people to the public sector. In combination with an educational system biased towards producing graduates in social sciences (see below), it tends to channel investment in human capital towards the public sector to the detriment of the private sector, contributing to the skill mismatch in the labour market that is one of the factors behind the high unemployment rates, notably among graduates.

Reducing the weight of public wages in total public expenditure requires a combination of wage moderation and efforts to limit, and in some cases reduce, public

[13] The Arab countries in transition refer to: Egypt, Jordan, Libya, Morocco, Tunisia and Yemen. These countries are part of the Deauville Partnership, an initiative launched by the G8 (now G7) in response to the Arab Spring in 2011.

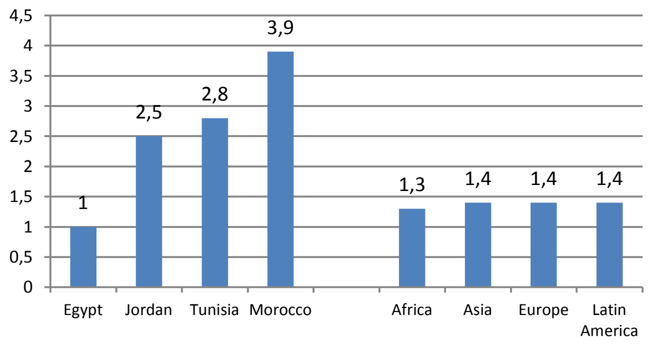
employment, normally in the context of a comprehensive reform of the civil service.

Figure 15: Public wages and inequality



Source: IMF (2014b), p. 15

Figure 16: Average public administration wage
(average 2000-08, in % of per capita GDP)

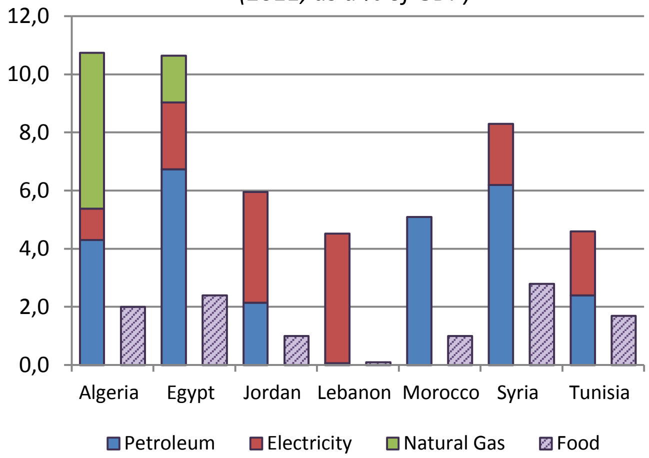


Source: IMF (2014b), p. 15
Note: For Jordan, Tunisia and Morocco, data are for 2009.

9. The importance of price subsidy reform

A key contributor to the inefficiency and unfairness of the growth model that prevails in many MENA countries is the price subsidy system. MENA countries account for 42% of world energy subsidies, even though they represent only 6.1% of the world's population and 4.2% of the world's GDP. Energy subsidies are particularly high in the oil-exporting MENA countries but are also very important in the oil-importing countries of the region. The Southern Mediterranean neighbours of the EU devoted about 8% of their combined GDP to energy subsidies in 2011, with Algeria and Egypt standing out with total energy subsidies above 10% of GDP and Lebanon as the country with the largest electricity subsidies. To this, one should add the also significant price subsidies on food commodities (Figure 17).

Figure 17: Energy and food subsidies
(2011, as a % of GDP)



Sources: National authorities; IMF; Commission staff calculations
Note: Data for Syria are estimates.

Price subsidies alone are larger on average than the observed fiscal deficits of the countries in the region, which as noted currently amount on average to about 7½% of GDP. But that is not the only problem with price subsidies. They are also poorly targeted because, being of a generalised nature and consumption-based, they benefit households regardless of their income as well as enterprises. Since the wealthier households tend to consume more, particularly when it comes to energy, generalised subsidies tend to disproportionally benefit the rich. Thus, in the MENA region only 8% of subsidies reach the lowest 20% percentile of income distribution, while around 60% of subsidies are captured by the top 30-40% income brackets.[14] Another problem with generalised price subsidies is that they distort the allocation of resources by encouraging excessive consumption, tending to result, in the case of energy subsidies, in energy inefficiency and, for the net energy importers, in an excessive dependency on imported energy. This also increases the macroeconomic vulnerability of countries to fluctuations in international energy prices.

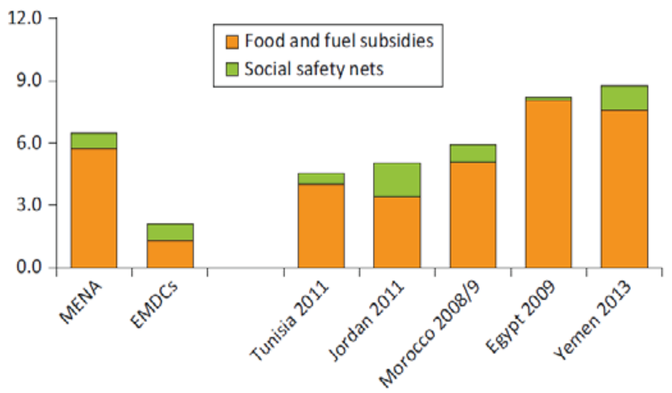
In sum, price subsidies are not only very costly for the national budgets but are also inefficient, unfair and distortionary. So why not just dismantle them as soon as

[14] See European Commission (2013), p. 46.

possible? The reason is that this task is not so easy. First, in most MENA countries price subsidies are by and large the main component of the social safety net. In fact, and as Figure 18 shows, there is little more than that when it comes to social support expenditure. Second, energy subsidies are important for certain productive sectors of the economy that rely for their competitiveness on artificially cheap energy. Thus, for example, an interesting piece of research focusing on the use of energy subsidies in Egypt, found that 57% of the export sectors on which Egypt has specialised are not based on comparative advantage but on cheap energy.[15] One can therefore not pretend to eliminate them overnight. Rather, it seems advisable to phase them out in a gradual manner. Moreover, their elimination must go hand-in-hand with the introduction or reinforcement of compensatory cash transfer programmes targeted on the poor or, in order to increase the political feasibility of the reform, also on a significant part of the middle class. It might also be useful to adopt certain temporary measures to protect the economic sectors that will be more affected by the removal of energy subsidies.

Figure 18: Spending on social safety nets and subsidies

(as a % of GDP)



Source: IMF (2014b), p. 78.

These social and economic compensatory measures are important not only to mitigate the impact of price subsidy reform on vulnerable households and sectors, which may be warranted from the point of view of social fairness and economic performance. They are also important as a way to limit political and lobbying pressure from households and vested business interests, thus improving the political economy of the reform.

Two other considerations are important when trying to reduce social and corporate resistance to price subsidy reform and, therefore, increase its chances of success. First, the reform should be properly communicated in order to make it understandable to the public, for example by publishing data on the fiscal cost of subsidies and explaining who benefits from them, as well as by explaining the compensatory social and economic measures.[16] Second, the recent experience of Jordan suggests an interesting approach to price subsidy reform that can improve the political economy of the reform.[17] At the end of 2012, Jordan fully eliminated fuel subsidies and replaced them with a cash transfer scheme that was, however, not very well targeted, covering about 80% of households. Moreover, cash compensation per household was relatively generous, which meant that many households, especially those with relatively low income and fuel consumption levels, were overcompensated. Although the compensatory scheme was not sufficiently targeted, the overall reform package allowed the budget to save nearly 1.5% of GDP since the savings in energy subsidies more than paid for the new cash transfer scheme. At the same time, the generosity of the scheme ensured social backing for the reform. Since then, social or political opposition to the reform has been minimal and the reform can be seen as sustainable. The Jordanian authorities are now taking steps to gradually tighten and better target the compensation scheme, including by developing a unified register of households that combines several databases that will allow a more refined classification of households according to their income and wealth. Being gradually and carefully done, this tightening is unlikely to produce a social reaction against the reform that will bring fuel subsidies back. At most, it could lead to a rejection of the measures aimed at better targeting the compensatory scheme. This experience suggests that, at least in some cases, it may be wise from a political economy point of view to first overcompensate households through the cash transfer scheme, in order to make the reform acceptable and allow time for it to consolidate. In a second stage, the authorities can then gradually try to better target the compensatory scheme on the most vulnerable households and/or tighten the compensation per household.

In addition to Jordan, a few other transition countries have taken encouraging steps in recent years to reform their price subsidy systems, in particular energy price subsidies. Thus, after suffering a sharp increase in the cost of energy subsidies between 2010 and 2012, Morocco has been adjusting the prices of different types of fuels and electricity and aims at removing all energy subsidies except those on

[15] See J.P. Morgan (2014).

[16] On this point, see IMF (2013a).

[17] See World Bank (2013a) and IMF (2013c).

butane by mid-2015. It has also taken some measures to mitigate the social and economic impact of these reforms, including through the extension of health, education and certain social assistance programmes and the adoption of a scheme to support public transportation. Tunisia has also been gradually increasing fuel and electricity tariffs since 2012, although they remain significantly below international market prices or cost recovery levels. But while Tunisia has attempted to protect in part the poor through the introduction of a second ("lifeline") social tariff for electricity and through a moderate reinforcement of the *Programme Nationale d'Aide aux Familles Necessiteuses* (PNAFN), it has yet to adopt a comprehensive strategy to compensate vulnerable households for the reform of energy subsidies.

In the case of Egypt, subsidy reform was initially hesitant due to political instability. Thus, the measures negotiated with the IMF in 2012, in the context of the inconclusive discussions on a Stand-By Arrangement (SBA), were only partly implemented. But during 2012-13 Egypt made some adjustments in fuel prices and electricity tariffs and introduced a rationing ("smart") card scheme for bread. And more recently (in July 2014), Egypt gave an important new impulse to subsidy reform by announcing a 50% increase in fuel and diesel prices, which will go hand-in-hand with a significant increase in health, education and other social expenditure.

10. Tax reform and equity

Another area of fiscal reform that is key both for fiscal consolidation and equity is tax reform. Most MENA countries have, as noted, weak and regressive tax systems that collect meagre taxes and do not foster income equality. Firstly, a widespread use of tax exemptions and deductions, poor compliance, weak income taxation and the importance of the informal sector result in tax effort ratios that are very low (often below 100%, Morocco being the main exception).[18] Poor compliance, in turn, is a reflection of weaknesses in tax administration and the lack of a well-established culture of tax declaration. Moreover, non-compliance is often condoned through subsequent tax amnesties. Secondly, the tax system tends to tax more heavily, as a proportion of their income, the poor and the lower middle class. This regressivity is normally explained by an excessive reliance on indirect taxation, personal income tax rates that are not only low but have schedules with little progressivity, the fact that dividends, interest income and capital gains are often not captured by the personal income tax or are subjected to relatively low rates, low corporate income taxes, and an insufficient taxation of luxury goods and real estate. Thus, Figures 19 and 20 show that, with the exception of Morocco and Tunisia, the top tier rates for the personal and corporate income taxes of the Arab countries in transition are significantly below the average seen in emerging and developing countries.

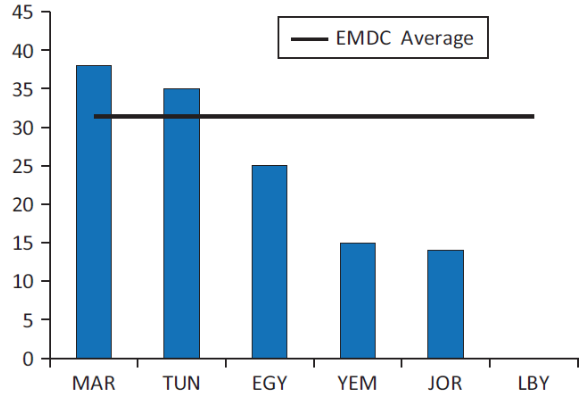
Tax reform in these countries should aim at both raising tax collections and increasing the progressivity of the tax system. This entails in particular:

- strengthening tax administration so as to fight fraud and improve tax compliance;
- reducing tax exemptions and deductions (other than those aimed at protecting the poor);
- reducing the size of the informal or underground economy;
- increasing the progressivity of the personal income tax, both through the rate schedule and by better capturing dividends, interest income and capital gains;
- raising, in some cases, corporate tax rates; and
- strengthening taxation of luxury goods and real estate transactions.

While the first three groups of measures are predominantly aimed at broadening the tax base, they may also have a positive impact on the fairness and progressivity of the tax system. This is particularly true for the elimination of tax exemptions and deductions benefiting wealthy taxpayers and companies. Similarly, while the last three types of measures are essentially aimed at increasing progressivity they will also tend to increase tax collections provided that increases in tax rates are not excessive, which may both increase incentives for non-compliance and discourage work effort, saving and investment. In that respect, it may be in some cases preferable to try to improve progressivity through measures aimed at broadening the tax base than through measures entailing increases in tax rates. It should also be noted that measures to raise tax collections can have an indirect positive impact on equity by mobilising resources with which the government can implement a more powerful social assistance and redistribution policy through the expenditure side of the budget.

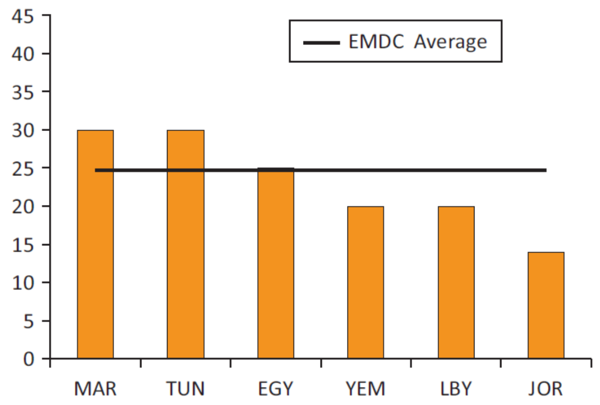
[18] See IMF (2014b). Tax effort is measured as the ratio of actual tax collection to potential tax revenues, estimated taking into account the tax receipts obtained by countries of similar characteristics.

Figure 19: Top tier personal income tax rates, 2012
(in %)



Source: IMF (2014b), p. 22.

Figure 20: Top tier corporate income tax rates, 2012
(in %)



Source: IMF (2014b), p. 22.

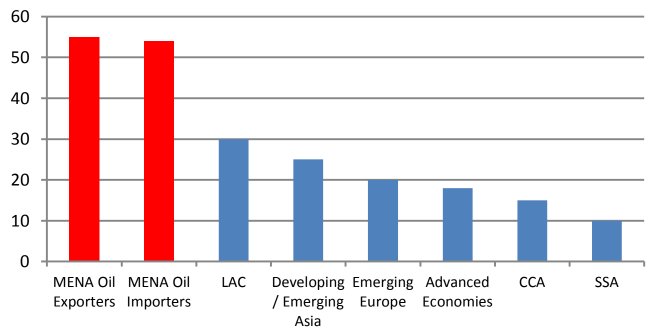
Unfortunately, progress with tax reform in the Arab countries in transition has been, in general, disappointing. Envisaged reforms, notably in personal income taxation, have often been postponed or watered down by political considerations and pressure from interest groups. This has been the case, for example, of the repeatedly delayed reform in Jordan's personal income tax, despite the insistence of the IMF under the adjustment programme agreed with this country. It is also the case of the taxation of dividends under the Tunisian personal income tax (where the Parliament cut to 5% the 10% tax rate proposed by the government and introduced a relatively high exempted threshold) and of the proposal of the Lebanese Ministry of Finance to introduce a "global income tax" applicable also to interest income and dividends, which has yet to be adopted by the government.

In spite of this, and as in the case of price subsidy reform, there has been some progress with tax reform since 2011. Encouraging steps include: Morocco's reform of the VAT regime and its decision to eliminate tax exemptions on large agricultural firms; Tunisia's steps to harmonise onshore and offshore taxation; Egypt's recently announced tax measures, which include an increase in the income tax on high salaries and corporate profits, the introduction of a real estate tax and a 10% tax on capital gains and the replacement of the General Sales Tax by a VAT; and Lebanon's recent decision to increase the corporate income tax for financial institutions from 15% to 17% (a still relatively low level, however).

11. Labour market performance and education policy

Labour markets in the Southern Arab neighbours of the EU are relatively inefficient, producing, as noted, insufficient jobs for a rapidly expanding population. The resulting low participation rates and high unemployment rates are another key source of inequality and poverty. Countries in the region are characterised by very low labour participation rates: on average, only about 45% of the working age population participate in the labour force, compared to a world average of 61.2%. This is especially true for women, with an average participation rate of less than 25%, compared to a 42% world average.[19] This implies that only one in four working women is formally part of the labour force. Figure 21 shows that in the MENA countries the gap between the participation rates of men and women is much higher than in any other developing or developed region.

Figure 21: Gender gaps in labour force participation
(Average 2000-11, percentage points)

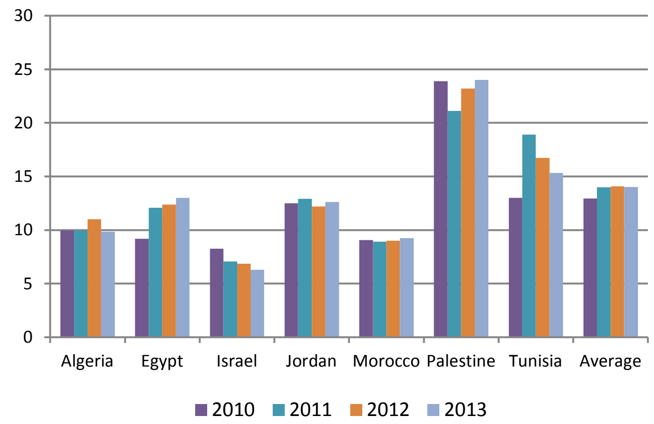


Sources: World Development Indicators (World Bank); IMF estimates
Note: Gender gap defined as male less female labour force participation rate.

[19] See European Commission (2010).

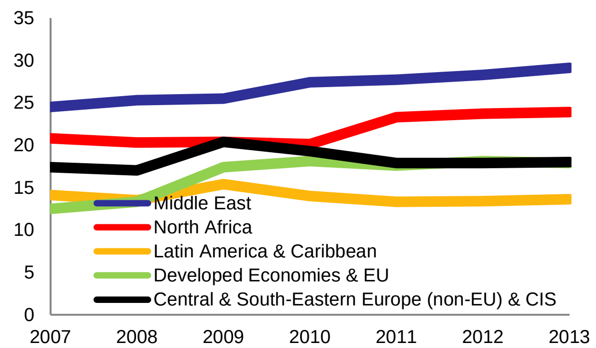
Despite these exceptionally low participation rates, and notwithstanding large migration outflows, unemployment rates are very high, averaging last year about 12-13% of the labour force in the EU's Southern neighbours (Figure 22). Unemployment rates in MENA countries are particularly high among young people (Figure 23), women and young graduates. The combination of low participation rates and high unemployment rates among women imply that about 85% of women are de facto excluded from the labour market.

Figure 22: Unemployment rates
(2010-13, % of labour force)



Sources: National authorities

Figure 23: Youth unemployment, by region
(2007-13, % of labour force)



Source: IMF

Military conflicts in the region have further increased unemployment in the countries suffering them directly or indirectly. For example, the World Bank estimates that the inflow of refugees fleeing the Syrian war could contribute to double to more than 20% the unemployment rate in Lebanon.[20] Also, the Israeli blockade of the Gaza strip pushed up the unemployment rate in this Palestinian territory to an estimated 45% in the second quarter of 2014, with about 63% of young people being without a job.[21] The conflict of July-August 2014 has surely further increased those rates.

Beyond ethical considerations, the weak participation of women in the labour market also suggests, as hinted above, that huge productive potential is being wasted. Fostering women's participation in the labour force could significantly boost GDP. According to IMF estimates, the MENA region could have gained about USD 1 trillion in cumulative output during the last decade (equivalent to doubling the average observed real GDP growth) if female participation rates had been raised enough to narrow by one third the gap with male participation rates compared to those observed in other emerging and developing economies.[22] Possible measures to increase women's participation include: removing remaining legal impediments to equal employment and equal pay; reinforcing maternity and parental leave legislation, including through the creation of maternity leave funds that limit the cost of maternity leave to companies, as done by Jordan recently; developing affordable child care facilities; developing public and private transportation to facilitate women's travel to the workplace (lack of appropriate transportation coupled with cultural values often discourage women's work); implementing educational and social assistance policies aimed at fostering school attainment and motivation among women, including cash transfer programmes to poor families conditional on daughters' school attendance; granting tax incentives for the hiring of women; avoiding income tax regimes that penalise dual-income families; facilitating access to finance by female entrepreneurs; and promoting cultural awareness and change.[23] In this context, a key challenge is to avoid the sharp permanent decline in participation rates that is often observed among young Arab women once they become mothers.

A factor that contributes to keeping unemployment rates high in MENA countries, particularly among young graduates, is the existing bias in education systems in favour of humanities and social sciences (which are more apt for finding jobs in the public sector), to the detriment of

[20] See World Bank (2013b).

[21] See IMF (2014d).

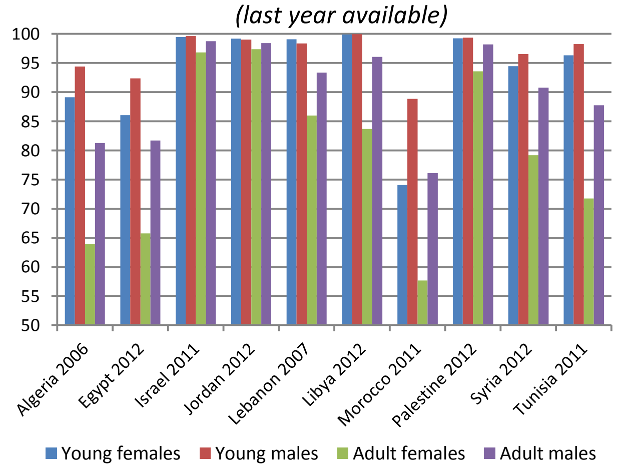
[22] See IMF (2013b).

[23] See IMF (2013a), pp. 29-30, and K. Elborgh-Woytek *et al* (2013).

scientific and technical skills, which are in higher demand in the private sector.[24] This not only contributes, as noted, to channel investment in human capital towards the public sector needs but the resulting skill mismatches (an excess of graduates in social sciences and a shortage of graduates in scientific and technical studies) tends to increase unemployment rates. In addition, there is tendency to favour university education over technical and vocational training, which exacerbates the excess of university graduates to the detriment of the necessary technical skills demanded by the market. Educational systems must correct these biases.

Despite the substantial improvement in overall enrolment rates and the important reduction in illiteracy rates achieved by the MENA region since the 1980s, literacy rates among adults, and in particular among adult females, remain rather low (Figure 24). School enrolment rates are still lower among female and in rural areas and repetition and dropout rates remain high.[25] There is also an increasing inequality in attendance rates, partly reflecting a rise in the average level of education since only relatively rich families can afford to invest in higher education.[26] Moreover, richer families can afford complementary private education, allowing them to overcome in part the problems related to the persistently low quality of education in public schools.

Figure 24: Literacy rates
(last year available)



Source: UNESCO

[24] This is reflected in a relatively poor scoring of students in the region in the Trends in International Mathematics and Science Study (TIMSS).

[25] See European Commission (2011), p. 50.

[26] See World Bank (2008).

Labour market and education policies can, therefore, make an important contribution to boosting sustainable economic growth while helping to create more equitable and inclusive economies. They can do this by encouraging higher labour market participation rates, notably among women, by making labour market regulations more flexible. In addition, educational systems must be reformed so as to reduce their bias in favour of humanities and social sciences, support technical and vocational training, improve the quality of education and further raise enrolment rates among women and poor people.

12. Concluding remarks

Four years after the start of the Arab Spring uprisings, the macroeconomic situation in the EU's Southern Neighbourhood remains weak and vulnerable and the recent intensification of civil strife and military conflicts is exacerbating this economic malaise. Macroeconomic performance may not improve in a sustainable manner without an appropriate resolution or mitigation of the underlying political problems. At the same time, macroeconomic instability and continuous social frustration with an economic model that is perceived as unfair and non-inclusive, risk feeding negatively into existing political tensions and instability. The reverse is also true: progress with macroeconomic stabilisation and economic reform, including measures to adopt a more equitable growth model, can help underpin political stabilisation and peace initiatives.

It is therefore essential that the authorities of the countries in the region press ahead with their economic stabilisation and reform agendas even if the political environment is far from optimal. This Economic Brief has focused on those reforms that can help make the economies of the region more socially equitable while supporting macroeconomic performance. This reform agenda is largely shared by the authorities of the countries in the region and is being supported by the international donor community through its assistance programmes.

Implementation of the required reforms was never going to be easy, and may be particularly difficult in the political context many countries of the region are currently experiencing. But, if carefully designed and sequenced, these reforms can, over time, help make their economies stronger and fairer, providing an essential economic building block in their efforts to find solutions to the daunting political challenges they confront.

References

Elborgh-Woytek, K. *et al* (2013), "Women, Work, and the Economy: Macroeconomic Gains from Gender Equity", IMF Staff Discussion Note, SDN/13/10, September (Washington, DC: International Monetary Fund).

European Commission (2010), "Labour Markets Performance and Migration Flows in Arab Mediterranean Countries: Determinants and Effects", *European Economy Occasional Paper No. 60* (Brussels: DG ECFIN).

European Commission (2011), "The EU's neighbouring economies: coping with new challenges", *European Economy Occasional Paper No. 86* (Brussels: DG ECFIN).

European Commission (2013), "The EU's neighbouring economies: managing policies in a challenging global environment", *European Economy Occasional Paper No. 160* (Brussels: DG ECFIN).

FAO (2009), "Land Gini" prepared by the FAO Statistics Division for the *FAO Statistical Yearbook 2007-2008*.

IFI (2014), "MENA Region: Recovery Buffeted by Geopolitical Risks", October (Washington, DC: Institute for International Finance).

IMF (2010), "Regional Economic Outlook: Middle East and Central Asia", *Regional Economic Reports* (Washington, DC: International Monetary Fund).

IMF (2013a), "Energy Subsidy Reform: Lessons and Implications," *IMF Policy Paper* (Washington, DC: International Monetary Fund).

IMF (2013b), "Regional Economic Outlook: Middle East and Central Asia", *World Economic and Financial Surveys* (Washington, DC: International Monetary Fund).

IMF (2013c), "Jordan – First Review Under the Stand-By Arrangement, Request for Waivers of Non-observance of Performance Criteria, Modification of Performance Criteria, and Rephasing of Access", EBS/13/29 (Washington, DC: International Monetary Fund).

IMF (2014a), "Regional Economic Outlook: Middle East and Central Asia", *World Economic and Financial Surveys* (Washington, DC: International Monetary Fund).

IMF (2014b): "Towards New Horizons: Arab Economic Transformation amid Political Transitions", prepared by a staff team led by H. Finger and D. Gressani (Washington, DC: International Monetary Fund).

IMF (2014c), "Subsidy Reform in MENA: Recent Progress and Challenges Ahead", prepared by C. Sdralevich, R. Sab, Y. Zouhar and G. Albertin (Washington, DC: International Monetary Fund).

IMF (2014d), "West Bank and Gaza – Report to the *Ad Hoc* Liaison Committee," September (Washington, DC: International Monetary Fund).

IMF (2014e) "World Economic Outlook Database", available at http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx, accessed on 8 December 2014.

J.P. Morgan (2014), "Energy Sector Dominates RCAs" (London: J.P. Morgan Chase Bank N.A., Economic Research).

UNDP (2014) "Multidimensional Poverty Index", available at http://hdr.undp.org/en/content/multidimensional-poverty-index-mpi, accessed on 8 December 2014.

World Bank (2008), "The Road not Travelled: Education Reform in Middle East and North Africa", *MENA Flagship Report on Education* (Washington, DC: World Bank).

World Bank (2013a), "Project Appraisal Document on a Proposed Grant from the MENA Transition Fund in the Amount of US$ 9.5 Million Equivalent to the Hashemite Kingdom of Jordan for a Support to Implementation of a National Unified Registry and Outreach Programme for Targeting Social Assistance", Report No./74924-JO, 25 January 2013.

World Bank (2013b), "Economic and Social Impact Assessment of the Syrian Conflict in Lebanon", Report No. 81098-LB, Poverty Reduction and Economic Management Department, Middle East and North Africa Region, 20 September 2013.

World Bank (2014) "World Development Indicators Database" available at http://data.worldbank.org/data-catalog/world-development-indicators, accessed on 8 December 2014.

World Economic Forum (2013), *The Global Gender Gap Report 2013* (Cologny: World Economic Forum).

* * *

This Economic Brief is an extended version of a paper presented during the conference "The Changing Middle East" organised by CIPMO and ECFR in Milan on 30 October 2014. The author thanks Felipe de la Mota, Jörn Griesse and Diana Montero Melis (European Commission, DG ECFIN) for their comments, as well as Natalia Tamirisa and Bruno Versailles, from the IMF, for sharing their data and for useful discussions.