Globalization, EU Partnership,
and Income Distribution in Egypt

Ishac Diwan

Working Paper No. 12
March 1997

The author is Regional Coordinator, Middle East and North Africa Region, the Economic DevelopmentInstitute of the World Bank.

This paper was presented at the conference ‘How Can Egypt Benefit From a Partnership Agreement with the EU?’ organized by the Egyptian Center for Economic Studies: in Cairo, June 1996. This paper only represents the views of the author, and not those of the World Bank or any of its affiliates. The author thanks Michael Walton for useful discussions.

Abstract

The Mediterranean Partnership initiative was launched by the European Union (EU) in 1994 to achieve deeper regional integration—particularly through developing an area of free trade and cooperation—among the countries of Europe, the Middle East, and North Africa. This paper addresses questions on the effect of a free trade agreement (FTA) with the EU on income distribution in Egypt. The paper asks how the FTA—interpreted here as a first step towards global integration—can help to redress negative distribution effects related to globalization, and thus facilitate the social transition towards a more open economy. It reviews initial conditions and past policies in Egypt; analyzes the effects of trade liberalization and globalization of capital markets on income distribution; and discusses policy interventions that may, with EU assistance, help reduce the negative impact of globalization.

ملخص

قام الاتحاد الأوروبي في عام ١٩٩٤ بطرح فكرة المشاركة المتوسطية بهدف تحقيق تعاون إقليمي أكثر عمقاً، عن طريق منطقة للتجارة الحرة والتعاون بين دول أوروبا والشرق الأوسط وشمال أفريقيا. وتتناول الورقة المسائل المتعلقة بتأثير اتفاق التجارة الحرة مع الاتحاد الأوروبي على توزيع الدخل في مصر، وتبحث الكيفية التي يمكن بها لإنفاق التجارة الحرة أن يساعد في معالجة الآثار التوزيعية السالبة المرتبطة بالعولمة، ومن الظروف المبدئية والسياسات الاقتصادية التي كان معمولاً بها في مصر، وتقوم بتحليل أثر تحرير التجارة، واندماج الأسواق المالية على توزيع الدخل، إلى جانب بحث السياسة المطلوبة للتدخل والتي قد تساعد على تخفيض الآثار السلبية للعولمة.

1- Introduction

The Mediterranean Partnership Association initiated by the European Union (EU) at the Barcelona conference in 1994 is a multifaceted attempt at deeper regional integration between the two shores of the Mediterranean. Its goal is to develop an area of free trade and cooperation among the countries of Europe, the Middle East, and North Africa. The Association has moved fast—already Tunisia and Morocco have signed free trade agreements (FTAs) with the EU, Israel has deepened its existing FTA, and Turkey recently joined the European customs union. The Palestinians, Jordan, Egypt, Syria, and Lebanon are in the process of negotiating an FTA.

This paper addresses the question of the effect of the Association on income distribution in Egypt. Because the European economy represents such a large share of the world economy, opening up to Europe is in many aspects akin to opening up to the whole world, and so, the Association is interpreted in this paper as a first step towards global integration. The paper also asks how the Association can contribute by itself to redress negative distributional effects related to globalization, and thus facilitate the social transition towards a more open economy.

Good research on income distribution, its variation through time, and the causes underlying such change must be grounded in solid empirical work. But work of this nature is very demanding in terms of data and effort. The approach here is less scientific, relying instead on an eclectic list of stylized facts, theoretical considerations, and research on other countries. As a result, conclusions are tentative, and the paper should be viewed as an attempt to structure the debate on some of the main issues that are likely to determine income distribution in Egypt over the next decade.

The paper is organized as follows. Part 2 reviews the initial conditions and relates them to the policies of the past. Part 3 analyzes the effects of the liberalization of trade, and Part 4 the ongoing globalization of the capital markets, on income distribution in Egypt. Finally, Part 5 discusses the type of policy intervention that can, with the assistance of the EU, help in reducing the negative impact of globalization.

2. Initial Conditions: Unemployment, Poverty and the Public Sector

Egypt is struggling with a deep-seated employment problem that has the following symptoms: high unemployment, stagnant or falling wages, high public sector employment, and low returns to education. Poverty and inequality have also deteriorated in the last decade.

High unemployment. Since the early 1990s, unemployment has remained high at about 12-17 percent, with the exact figures depending very much on definitions. The unemployed are predominantly first-time job seekers, reflecting the fast rise in labor supply as baby-boomers enter the labor market. An implicit social contract that stresses seniority means that first-time entrants have to line up to wait for increasingly scarce modern sector jobs. This kind of unemployment tends to have a long duration. Unemployment is high among the kind of workers that are over-represented in public service, and especially those with medium levels of education (see Table 1).[1]

Table 1. Distribution of Egyptian Workers by Sector and Education, 1988 (*percent*)

	Educational attainment (age 10 and above)					
Sector	**Below secondary**		**Above secondary**		**Total**	
Government and public sector	38	*12*	62	*55*	100	*23*
Private non-agriculture	79	*29*	21	*21*	100	*27*
Agriculture	95	*55*	5	*8*	100	*43*
Unemployed	44	*4*	57	*25*	100	*7*
Total	74	*100*	26	*100*	100	*100*

Source: CAPMAS, 1988.

Falling wages. Formal sector wages seem to have declined in the mid to late 1980s and have stagnated since. In manufacturing, for which some data exist (from UNIDO), wages fell sharply, by some 40 percent on average, between 1985 and 1995 (over the same period, GDP per worker remained flat; World Bank, 1995a). This reflects the tail end of the regional oil-based boom/bust cycle and the failure to find a new engine to pull labor demand.

High public sector employment. Egypt's state sector is a big employer, employing about 35 percent of the labor force (about 25 percent in central government, and 10 percent in public enterprises). But while the public sector has been large in numbers of employees, it has been increasingly poor in wages offered. Government wages fell by some 50 percent between 1980–92, but employment rose 80 percent, almost entirely by 1990 (Handoussa 1992, Said 1995).

[1] The share of young workers with secondary education among the unemployed is abnormally large at 60 percent, while this group represents only 26 percent of the labor force (but they hold 60 percent of public sector jobs; in contrast, they constitute only about 20 percent of private non-agricultural sector employment). This pattern is also marked among educated women who are disproportionately employed in the public sector (71 percent of women with university degrees work for the state), and their chances of being unemployed are about 5 times larger than for men. (Asaad)

Figure 1. Returns to education (wages with/without schooling)

Error! Not a valid link.

Source: Angrist 1992; Assaad 1994; Tansel 1992; World Bank 1994c, 1995b

Low returns to education. Low returns to education is a feature of the Egyptian economy. Roughly, workers with secondary and post-secondary education have wages two and three times higher (respectively) than workers with primary education and below. These ratios are among the lowest in the region (Figure 1), and education inequality tends to be much higher in the developing world (in Thailand for example, these ratios are respectively 3 and 5).[3]

Being a predominant employer of educated workers, the state of the public sector has had an important influence on this outcome. Cash wages are now lower in the public sector (Zaytoun, 1991; see Figure 2), but it seems that this is slightly reversed once the value of all benefits are taken into account (Assaad, 1996). There is evidence of public sector wage compression over time (Zaytoun, 1991), and between private and public sectors. In the public sector, the ratio of skilled/unskilled is smaller than in the private sector, while the difference for unskilled is smaller (Said, 1995). Civil service pay tends to be more sensitive to seniority than the private sector, less sensitive to performance, and less dispersed across skill levels than private wages. As a result, women, older workers, and workers with medium levels of

Figure 2. Public and private earnings in Egypt

Error! Not a valid link.

Source : Zaytoun 1991.

education tend to earn higher wages compared to what they would command in the private sector (Assaad, 1996).

Relatively equal income distribution. Poverty levels, unlike unemployment, seem low by international standards. Using a conservative poverty line of $30 per person per month[4], the

World Bank estimated average poverty at about 11 percent in 1990, compared with 28 percent in Latin America, despite lower average income there[٤]. This reflects the relatively low degree of inequality in Egypt—much less than Latin America or the more unequal East Asian societies, such as Malaysia, but still more unequal than formerly centrally planned countries, such as Hungary. This relative equality of income and spending probably reflects a combination of relatively equal asset distribution and substantial private transfers between households, that survey evidence elsewhere (for example from Jordan) finds to be well-targeted on the poor in most of the region.

But poverty and inequality are rising. In the recent past, poverty has been rising fast in Egypt. Using a relatively high poverty line, Korayem (1994) finds that urban poverty has risen from 30.4 percent in 1981, to somewhere between 36 and 49 percent in 1990. In the rural sector, the deterioration is even larger, with poverty rising from 29.7 to somewhere between 54.5 and 64.5 percent. This rise in poverty has occurred despite a small rise in average incomes, reflecting some worsening in inequality.[٥] These trends seem to have continued in the more recent past (Kheireddine, 1996).

As these stylized facts vividly show, social conditions in Egypt have deteriorated in the last decade. In contrast, Egypt was among the fastest growing countries in the world during the 1960s and 1970s. The young state advocated modernity and "the big push," invested heavily in large infrastructure projects, built state industries and erected protective walls to nurture them during infancy, and sought shared growth and social mobility by encouraging education and initiating nationalization and land reforms. Fueled by the regional oil boom, average growth per worker was about 5 percent a year during 1965-80—not far below that of East Asia.

For the working population, this growth path brought large benefits. These flowed from two aspects of the development pattern, for both of which the public sector was key: policies that promoted the modern sector, especially through expansion of millions of jobs in government services and protected public enterprises; and vigorous expansion in publicly-funded education, at all levels. Food and consumption subsidies were also broad, bringing

[٢] See World Development Report, 1995, Box 5.1, page 39.

[٣] More precisely, this is a cutoff of $30 for average monthly per capita consumption in terms of 1985 purchasing power parity dollars. While a figure of $30 per month is a useful yardstick for international comparisons, most observers of the region would probably use a higher cutoff for absolute poverty.

[٤] See World Bank 1995b, figure 4.

[٥] This is for example reflected in a rise of the Gini coefficient, especially in urban areas (from 32 to 38); Korayem, 1994.

benefits to the middle classes and the poor. Unskilled workers reaped gains from domestic and international construction booms. There was also the promise of social mobility through education and public employment (Richards, 1995).

This set of policies was to a large extent financed by oil—getting access to the jobs and resources to underwrite this strategy through a mixture of migrants flowing out to the oil centers, and oil money flowing in (in grants and remittances). International migration was an integral part of the *de facto* growth and employment strategy of the past few decades. It was a powerful source of labor demand, with important second round effects via the spending of foreign-earned income, that had a powerful effect on the bottom half of income distribution.[1]

When oil prices collapsed in the mid-1980s, the old sources of employment growth collapsed too. By the early 1990s, the public sector had stopped hiring; migration as a source of employment creation has now largely gone, and it is negative linkage effects that are now usually more important. Old forms of largesse—notably food subsidies—have often been cut drastically, falling from a high of 13 percent of GDP in 1983 to less than 2 percent in 1993. The private sector was hit by a rise in real interest rates and increased competition by imports.

Public employment and protected industrialization can be a source of economic and employment growth for a while (compare the rapid growth of many Latin American economies during the 1960s and 1970s). When there is a massive positive resource shock, it can be sustained much longer. But the combination of declining public sector revenues, fast-rising labor supply, rapid urbanization, and large gains in education have now rendered the old social contract unaffordable. When boom turned to bust, not only did past sources of employment growth—both national and international—disappear, but the unproductive nature of many of the jobs created became an unhappy and problematic heritage for the future.

But why has unemployment stayed so high? As in Europe, large-scale unemployment emerged because of the adverse shock—the dynamic of falling labor demand and continued rapid growth in supply. It has persisted because of the deep-seated expectations of the young—especially the educated young now in abundant rather than scarce supply—that a secondary certificate was the pathway to a "good", modern sector job, and the capacity and willingness of families (especially non-poor ones) to support the unemployed. The old social

[1] Although the poor tend to be under-represented amongst migrants, who generally have some education and resources to move, the indirect effects via tightening the labor market, private transfers and second-round spending impacts, undoubtedly contributed to poverty reduction (Adams, 1989)

contract is still present, if increasingly fragile, and within this contract it is the state that is expected to deliver jobs, especially to the educated (Richard, 1995).

Three groups—public sector workers, the unemployed and the rural poor—suffered most when boom turned to bust and the lack of viability of the old growth path and contract became exposed. With declining resources the specter of distributional conflict is now rising.

Meanwhile, rising international integration is both creating opportunities and sharpening competition. In the international environment of the 1990s, failure to effectively integrate production structures via capital flows and trade will have high long-run costs. This means lost opportunities now, but more importantly, countries that fail to integrate risk getting increasingly left behind. In contrast, a more open international capital market can reward good policies with a large flow of capital and investment. And a more open international trading system offers important dynamic opportunities, freeing workers from the constraints imposed by domestic demand, and allowing for a growth strategy built on improved human resources and a move up the ladder into higher productivity activities over time. But while increased integration can bring in large aggregate gains, it can also have important distributional effects, benefiting those whose products become more in demand, and hurting others who lose out to new competitors. Increased capital mobility also increases the risks of macro-economic failure for the most vulnerable segment of society. In the next two sections, we study separately the effects of increased capital mobility and trade in order to clarify their distinct effects on incomes and distribution.

3. Opening Up for Trade

Of the various channels of international integration, trade is the one that is probably the most important in the long run, but the least exploited in Egypt yet (see Figure 3). Meanwhile the world is in the midst of a profound opening. Economic reform is leading to the entry of huge pools of labor in South and East Asia, the former COMECON bloc and Latin America into world product markets. The Uruguay Round and an FTA with the EU will both lead to some further opening, especially with respect to labor-intensive manufactures and agriculture (albeit modest). The EU Initiative will provide a mechanism for helping to lock-in the ongoing process of opening.

Figure 3. Per capita exports of manufactured goods in the Middle East and North Africa (US dollars)

Error! Not a valid link.

But in the background, the international environment that emerges after the Uruguay Round is likely to affect distribution negatively in Egypt. The two channels of influence lie via the liberalization of the Multifiber Arrangement, which will lead to lower prices of textiles, and partial liberalization of agriculture, which will lead to higher prices of foods. Since Egypt exports textiles and imports food, it suffers negative terms of trade effects overall, but farmers would enjoy gains in their terms of trade (assuming international price increases were passed on to them).[v]

These estimates of the effects of integration miss out, however, on the more important consequences of opening. In the East Asian experience, it was not terms of trade effects that brought extraordinary long-run growth, but engagement in international markets—in association with sound domestic economic policies that allowed for large structural shifts in employment and large productivity growth. The key lies in the inter-relationship between openness, human capital, and the internal growth dynamic. While there will always be some place in the international division of labor, the real benefits from integration come from getting onto a path of rapid productivity growth and effective use of national skills.[^] In this respect, Egypt's labor force is well educated in relation to the country's income level (a reflection of past policies; see Table 2 and Figure 4), although there are serious concerns about the quality of such education. The real challenge is how to upgrade and use existing skills effectively.

Table 2. Mean Years of Schooling in the Middle East and North Africa

Country	1960	1990	1995
Algeria	1.74	5.06	6.37
Bahrain	..	5.81	6.23
Egypt	2.75	4.94[a]	..
Iraq	0.92	5.17	5.90
Jordan	1.56	6.56[a]	..
Kuwait	..	5.95	7.05
Morocco	0.38	2.48[a]	..

[v] The direct effects of the Uruguay Round on the Arab world are modest and negative, with a net loss of 0.2 percent of GDP per year. In the long run, once effects via migration are worked through, the consequences are negligible for agricultural and unskilled workers, and slightly negative for skilled workers (Diwan, Yang and Wang, 1995). My guess-estimate based on factor endowments is that the Egyptian case is likely to be similar in direction and perhaps a bit more marked in size.

[^] Here even Morocco and to a lesser extent Tunisia have lagged behind East Asian competitors, especially in productivity growth (World Bank, 1995a). It is noteworthy, however, that Turkey, with the longest and deepest period of engagement in international markets, plus greater progress in policy aspects of integration with Europe, has a performance in productivity growth that rivals Indonesia and Malaysia.

Syria	2.17	5.86	6.66
Tunisia	1.32	3.58	4.22

.. Not available
a. 1987 figures
Source: Ahuja and Filmer 1995; Dubey and King 1994.

At the same time, many countries within the region risk being left out of the global process of integration. The next decade represents perhaps the last opportunity for the region to open before the full force of competition from Asia comes to bear on them, with the removal of the Multifiber Arrangement early in the next century. But while the old

Figure 4. Mean years of schooling by region, 1985

Error! Not a valid link.

Source: Barro and Lee 1993; Nehru, Swanson, and Dubey 1993; ILO and updates.

employment strategy that stresses education for expanding public sector jobs is bankrupt, and the need to open into a more integrated world becomes ever more urgent, some countries—notably Algeria and Syria—are in a fragile state of paralysis, needing new economic opportunities to tackle persistent poverty and unemployment, but fearful of the adverse effects of opening on inefficient and unproductive current employment structures, especially in the government and public enterprise sectors. Others—Morocco, Tunisia, Turkey, and perhaps Jordan—are beginning to break out of this vicious cycle and have used opening as a means to do so. But they remain in the midst of the transition, and fears over unemployment remain, as does large public sector employment. Egypt seems to stand somewhere in the middle.

While the gains for workers from East Asian-style use of international markets may provide compelling support for such an approach in the long run, most politicians are more concerned with getting from here to there. For this question, it is the transitional effects of opening that are likely to be of dominant concern. Opening involves changes in the pattern of demand for different products, with indirect effects on the pattern of demand for different categories of labor. It also involves an acceleration of the normal process of creation and destruction of jobs. It is useful to divide the effects into two:

- on public sector employment, for which the question of destruction of unviable jobs is key;
- on the overall structure of labor demand for skilled and unskilled workers.

Effects on public employment are analytically easy and practically tough. Protected state enterprises in tradable activities, subject to the harsh winds of international competition, are likely to close or contract, in any case shedding labor. Both government employment and enterprise employment in services (utilities, for example) are shielded from the direct effects of competition, but there will be heightened pressure from the need for fiscal probity and higher quality services to raise productivity, layoff surplus labor and bring wage scales in line with the private sector. So the impact effects on public employment are likely to be negative.

In designing a strategy, the key question then concerns the implications of opening for the level and structure of private sector labor demand. The dominant popular view in rich countries is that opening leads to job losses, especially amongst unskilled workers, and is a cause of rising inequality in the United States and persistent unemployment in Europe. While few observers would deny that trade with low-wage countries is a source of some job losses, the weight of the evidence in fact suggests that such trade contributes only part—and probably a small part—of the employment problem in rich countries. Technological change, slow supply responses in creation of skills, and functioning of labor markets in Europe, play a larger role.[9]

In low and middle income countries, fears of job losses are also common. But it is important to distinguish between two processes: the effect of opening on the level and structure of labor demand once changes have worked their way through the system; and the likely acceleration of the process of creation and destruction that a change in incentives will bring. For Egypt, the accelerated destruction of unproductive jobs is essentially the same as the public sector employment issue. The lasting effects on the structure of labor demand are, however, more complex.

The traditional view of economists is that opening in poorer countries would be unambiguously good for unskilled labor.[10] This was based on both theory and evidence. Poorer countries that opened up would be expected to trade and produce more in activities that intensively used their more abundant factors of production, unskilled labor, and would therefore stand to benefit most from liberalization, possibly at the expense of skilled labor.

Evidence for the view that opening increases the relative demand for unskilled labor comes from data on the higher unskilled-labor content of exports compared with (protected) import substitutes in many countries, and from observed narrowing of wage differentials over time in export-oriented economies—especially the Asian "tigers" (Hong Kong, Korea,

[9] Wood, 1994; Lawrence and Slaughter, 1993, Sachs and Schatz, 1994.

[10] In addition to the dynamic effects of getting on to a productivity and investment enhancing growth path emphasized above.

Singapore, Taiwan, and China).[11] Evidence of actual changes over time is probably more compelling for a government contemplating opening. Unfortunately, past work on these countries has generally failed to take account of shifts in relative supply of different categories of labor—and, as noted above, all of the economies were enjoying the fruits of previous educational expansion—nor of changes in labor market institutions. Moreover, more recent evidence, especially from studies of Latin American countries, more commonly finds evidence of widening differentials—notably in Chile and Mexico, also in Costa Rica and Colombia—that were broadly coincident in timing with opening.[12] Attempts in some of these studies to control for effects of changes in relative supply of skills (in all cases there was increase in the relative supply of skilled workers), confirm a shift in relative demand away from unskilled and toward skilled workers (Robbins).

How might opening lead to shifts in demand against the unskilled, when on the face of it, these are the abundant factor? The theory and evidence is still being disentangled, since most of the empirical work finding widening differentials is recent.[13] There are three broad categories of explanation that appear promising:

First, widening differentials is a phenomenon that applies mainly to middle-income countries that are intermediate in relative factor shares between rich and poor countries. Those countries are, in fact, experiencing the effects of the substantial increase in the international relative supply of unskilled-labor intensive goods, due to the opening of Asian labor-intensive countries—such as China, Indonesia, Bangladesh and India—to trade.[14]

Second, openness releases the market for skills from essentially domestic factors. Closed economies that invest heavily in education might run into significant relative price change against skills, due to the expansion of the supply of educated workers. As the economy opens, the price of educated labor is going to be more strongly influenced by international trade, while unskilled wages may continue to be held down by large "surplus" supplies of labor in low-productivity agriculture (Pissarides, 1995). This may explain what is happening in Eastern Europe during its transition to the market, and why inequality rose sharply in the past

[11] See especially Krueger, 1983, for the first category of evidence, and Wood, 1994, for a survey of the latter. See also World Bank 1995a, Figure 6.1, page 41 for a historical review of both types of cases.

[12] See Revenga and Montenegro, Hanson and Harrison.

[13] See Wood 1995 for a survey and discussion.

[14] China's exports to the European Union have risen from 2.3 percent of the EU's total imports in 1985 to 4.9 percent in 1991. By one measure, the relative price of labor intensive manufactures has fallen by 20 percent between the mid-1980s and early 1990s.

few years. It may also apply to Egypt, with its low return to education and sharply reduced migration opportunities.

Third, some categories of export—or features of exporting—may demand more skilled workers. It has often been argued that modern sector manufacturing requires at least basic education, in contrast to agriculture and informal sector services (Wood, 1994). This could be important for exports in which high quality is of importance. The same may apply to high-value agricultural production for rich country markets.[15]

Typically however, the effects of growth on poverty have been much more important than their effect on distribution. The regional experience in this respect is particularly telling. Changes in poverty in the region have generally been very sensitive to the overall economic cycle, but there have also been changes in inequality in recent times. Where average incomes rose between 1985 and 1990, as in Algeria, Morocco and Tunisia, poverty fell; where incomes fell, as in Iran and Jordan, poverty rose (Figure 4). There have also been changes in inequality in Morocco, Tunisia and Jordan. As measured by Gini coefficient, inequality has fallen in Tunisia (from 43.5 in 1975-85 to 40.2 in 1990), risen slightly in Morocco (39.1 in 1985 up to 39.6 in 1991) and risen strongly in Jordan (36.2 in 1986 to 43.3 in 1992). Thus, a lot of the reduction in poverty in Morocco and Tunisia was due to growth rather than redistribution effects (which were small and positive for Tunisia, and small and negative for Morocco).[16]

The experiences of Morocco and Tunisia, the early trade reformers of the region, further illustrate both the opportunities and difficulties ahead. Following liberalization, labor demand rose fast in Morocco, with total employment increasing by about 5 percent a year in urban areas during 1984-94, manufacturing employment rising at 10 percent; and employment in the manufacturing export sector rising at a rate of 20 percent (World Bank, 1995a). But while employment expanded fast, measured *average* wages and productivity did not rise. The most plausible interpretation is that this was due to compositional effects with the relative expansion of lower-wage jobs. The manufacturing sector was small and protected in the past; it used capital intensively and employed skilled workers at high wages—these subsectors have been stagnant. The new jobs created in manufacturing exports were instead labor

[15] See Feenstra and Hanson 1995 for this argument.

[16] At the same time, a measure of income dispersion (household income ratio of the top to bottom quintile) has risen in the three countries and especially in Jordan and Morocco. Jordan (6.0 to 8.3 between 1986 and 1992; Morocco: 4.0 to 7.0 between 1985 and 1991; Tunisia: 7.0 to 7.85 between 1985 and 1990). See van Eeghen, 1995.

intensive and lower-wage. It is precisely this adjustment that allowed low-skill employment to grow so fast in these sectors and poverty to fall (Figure 5). In contrast, both wages and employment expanded slowly in firms producing for the internal market, although recently the demand for skilled workers has started to rise.

Figure 5. Population below poverty line

Error! Not a valid link.

Note: Poverty is defined as per capita monthly mean consumption below $30 in 1985 purchasing power parity dollars.
Source: Chen, Datt, and Ravallion forthcoming.

In both countries, the net effects on inequality have been small. The demand for skills has fallen in the protected industries, but has started to rise in the export industries as a result of attempts to increase competitiveness with better technologies and management. In other words, what pushed inequality down may have been the effects of trade reform, but this was pushed up and neutralized by rising demand for skills and surplus labor. Indeed, it is striking that the two economies have higher returns to skills than Egypt, but still not unusually high by international standards (Figure 1).

The experience of Tunisia also illustrates the importance of structural change (Zouari-Bouattour, 1994). An analysis of employment change between 1984 and 1993, that decomposes job creation into within-sector productivity growth, structural shifts in employment and growth, finds that almost all sectors (except "other services") enjoyed productivity increases, but there was net employment expansion as a consequence of growth in

output and structural shifts. Rising within-sector productivity was particularly important in agriculture—the major low-productivity sector—and likely to be a major source of labor income growth for the poor. These changes accommodated, at rising average productivity, a large increase in female labor force participation between the ages of 20 and 44 (there is an offsetting effect for the youth with increased time spent on education).

What does this mean for Egypt? Opening may restore educational differentials. Beyond this, since Egypt falls around the bottom of the international income and wage levels, effects of opening are going to be positive on the relative demand for unskilled labor. Much will depend on agriculture, which is of particular importance to the poor who mainly rely on income from unskilled labor on farms. Finally, we should re-emphasize that net effects during the transition will also depend on the dynamics of creation and destruction of jobs, especially the timing of destruction of old protected jobs.

The poor. The poor are likely to gain from opening, especially from the twin process of accelerated transfer of labor from agriculture to labor-intensive manufacturing and productivity increase within agriculture. Where there are terms of trade gains to farmers, this will also be poverty reducing. The process of growth expansion of labor demand for unskilled work was a key aspect in the dramatic fall in poverty experienced in both Morocco and Tunisia. It both accommodated the rise in female labor participation in both societies, and allowed rural workers and workers in construction to get more productive higher wage jobs. While average wages in manufacturing were stagnant or falling in Morocco, the new jobs were being created in activities that tended to tighten the labor market for poorer workers—those who got these jobs experienced significant rises in their wages.

Public sector workers. The effects on public sector employment are likely to be negative, so those that are laid-off will almost certainly suffer at least temporary losses. As the shifts in private sector demand emerge, there is potential for restoration of public sector wage differentials, benefiting more productive public sector workers.

The unemployed. Net effects on the unemployed will reflect different phenomena. Some will gain from more dynamic job creation in new activities, but there will also be a temporary rise in new entrants to unemployment, to the extent that inefficient activities are disprotected and governmental employment reform occurs. Both overall and educated youth unemployment are still high in Morocco and Tunisia, in part because of labor market rigidities in the modern sector, but also because of the persistence of expectations and support mechanisms referred to in the section above. However, they both have a much higher fraction of those laid off in the pool of unemployed. In 1991 Morocco had an unemployment rate of 12 percent, of which 55 percent had previously worked and 25 percent had secondary education. By contrast, Egypt had only a slightly lower unemployment rate of 11 percent, but of the unemployed, only 23 percent had ever worked and 57 percent had secondary education.

The international and regional evidence suggest that opening can solve two long-run problems, it can *both* be good for unskilled labor demand *and* restore excessively compressed education differentials. However, the demand will be for productive, not unproductive skills, and during the transition it is highly likely to be also associated with job losses for some of the educated now in "bad" jobs, problems of dealing with the relatively old who do not have productive or flexible skills, women who are over-represented in the public sector, and the educated young who have grown up with now incorrect expectations of public sector job opportunities. Expectations can change—especially if governments undertake credible reforms on opening up *and* on public hiring policies. In this respect, the role of capital flows is crucial.

4. Capital Flows and Investment

Capital flows will be an important complement to trade liberalization in affecting employment outcomes in the future. Workers need productive capital to raise their productivity, while movements of financial capital have a powerful immediate effect on macroeconomic activity, and so on wages and employment. However, the liberalization of capital markets also increases the share of GDP that accrues to capital, an asset that is unlikely to be distributed equally in Egypt. The effect of capital flows on distribution are poorly understood internationally. The two points below merit examination:

- Rising capital mobility brings opportunities, but also raises important distributional risks;
- It is likely to have had, until recently, negative distributional consequences.

Egypt is one of the few countries that has liberalized the capital account before starting to reform the real side of its economy. One of the reasons for this unusual sequence is the importance of workers' remittances in the economy, and the prevalence of capital flight under the financial repression of the past. Before the liberalization wave of the late 1980s, much of these flows were occurring outside the banking sector, creating serious risks of financial collapse in the formal sector.

The open capital account brings in both opportunities and risks. Weak domestic conditions in terms of politics, macroeconomics or the microeconomics and business environment, will lead to paltry capital investment and vulnerability to destabilizing international capital flows. When capital flew out of the region in the 1980s, workers were left to pick up the bill. As with Latin America—only more so—capital controls proved feeble in preventing private outward capital flight when the going got rough. It is estimated that privately owned foreign assets are equivalent to over twice GDP (Diwan and Squire, 1995). This represents a large tax on past growth, but also an opportunity for the future, since it represents a pool of resources that could be attracted back if the conditions were right internally.

Some of the potential has already been seen in the significant reflows of capital that occurred in the early 1990s, seduced by a combination of opening of the capital account, and the euphoria that flowed from the dual impulses of optimism over peace and the new-found international delight in "emerging" markets (Diwan and Squire, 1995). This flow did benefit workers—overall economic activity was higher than it would have been in their absence, and this helped the national labor market. But a large share of capital flows were sterilized and now sit safely in international reserves (and so, these flows did not end up creating many new jobs). As a result, aggregate investment has remained low, at below 20 percent of GDP (with less than half from private sources).

Conceptually, the effect of the liberalization of the capital account on poverty and income distribution is complex. There are two main forces playing in opposite directions: on the one hand, the share of capital in GDP is likely to increase with the rise in real interest rates, exacerbating inequality. But on the other hand, capital inflows and investment can also rise, creating new jobs and reducing poverty. Until recently, the first effect may have been stronger, given the limited supply response.

But why has investment remained so low? The strategy of containment—whereby the public sector maintains its absolute size, leaving the task of growth to an emerging private sector—seems to have reached its limit. Instead of filling the void, much of the new jobs are low-wage low-productivity and often in informal markets. It is quite plausible that low investment is itself related to fears that reforms will remain stuck because of their potentially negative distributional effects. That is, until policy change in the real sectors passes the political test, the private sector will remain unconvinced that a new social contract more in line with current realities has emerged.

While the system now only benefits a (shrinking) minority of protected workers, it has created a web of interlocking interests that is hard to cut down. With 35 percent of workers in the public sector, the situation is not like Russia or Eastern Europe, so the continuation of a status-quo promises slow decay and rising poverty but no outward bankruptcy. But reform will not be as easy as in Latin America where the public sector was much smaller (about 15 percent of the labor force).

The weight of a large and increasingly poorer public sector is depressing new job creation and overall efficiency in many ways.

- *Macroeconomic stability* is at the constant mercy of wage increases for a large numbers of underpaid public employees. In Lebanon 1991, Turkey 1993, and Mexico 1994/5, wage pressures led to financial crises, and workers were left to pick up the tab. If public sector wages were to rise to their previous levels, the fiscal deficit would rise by about 5 percent of GDP. In addition, maintaining a large public sector taxes private sector growth.
- *The feasibility of reform* is also undermined because measures to increase labor efficiency, such as liberalization of prices, investments, or trade, will increase dramatically the losses of large state enterprises, unless some labor is laid off.
- *Public servants* are underpaid, under-equipped, and work in overcrowded conditions, undermining the quality of core government services. The ratio of public investment to public salaries has nearly doubled in the past decade (Said, 1995). This shows in falling standards in the schools, hospitals, as well as in customs operations or infrastructure maintenance. Many public employees hold multiple jobs, and petty corruption has risen. In order to increase efficiency, investment must rise, and wages must be decompressed. In turn, this is fiscally unfeasible until the public sector gets smaller.
- *The high unemployment among skilled workers* attests to the distortions introduced by the web of non-market based incentives—employment guarantees for graduates, subsidized higher education—that have corrupted the educational system. This is unlikely to change until the old social contract is clearly replaced by an acceptable new one where the public sector does not play the role of employer of last resort.

The only way to permanently attract capital into long-term investments, create jobs, and raise productivity is by putting in place a sound political and economic environment. In this respect, the policy stance towards international trade will be increasingly more important.

5. Assisting Workers for Change

Constructive change must rest on its social desirability. An acceptable new social contract is key, and its broad contours are starting to fall in place. But a roadmap of how to get there in an acceptable way is as important. This is where the main challenge now lies. With intricate kinship relations, households may be able to internalize some of the costs associated with fast change, with young workers gaining from reforms compensating older parents that would have to retire earlier. But this is not enough in the face of systemic change. Mechanisms to facilitate the transfer of laid-off workers to new jobs, compensation for those hurt, and a policy framework supporting reductions in poverty will have to be important ingredients of a successful transition. Rather than spending more, the goal would be to shift resources from permanent public sector employment that undermines reform, to temporary programs that facilitate reform. It is precisely in helping and financing such transitional programs that the EU Initiative could help Egypt most.

Three types of policies can help during the transition. (i) Policies that increase labor market flexibility to allow workers to find jobs where they are most productive. This includes reforming the labor code. (ii) Active policies aimed at assisting workers by equipping them for change. A key challenge is how to capitalize on past successes in education and infrastructure, and salvage parts of the old industrial base, and how to retrain workers whose skills are outmoded. In Eastern Europe, governments now spend between 1 and 5 percent of GDP a year on active labor market policies. (iii) Passive policies aimed at providing transfers to reduce income losses during layoffs. OECD countries spend between 2 to 3 percent of GDP a year on such programs.

Re-regulating the labor market to increase flexibility

Labor policy in Egypt has been well-intentioned but misguided, seeking through labor regulations to support labor outcomes, but at best reaching a small minority of the workforce. The current labor code in Egypt does not allow firms to fire workers for economic reasons. As a result, labor regulations are only applied in the public sector and in a small formal private sector. Labor policy has been irrelevant at best for small farmers, who still account for the largest (and poorest) group; it has also been irrelevant for the large and growing number of workers in the urban informal sector, and often ineffective for those who work in formal firms. This has created a two-tier system where formal employees are over-protected and informal ones under-protected (Assaad, 1995).

While this may have been a good second-best choice in the past, the challenge is to develop regulations that apply broadly to the economy as a whole, and not only in a small and protected modern sector. High and unenforced labor standards and decorative labor laws effectively preclude good regulations from being implemented and result in small and shrinking formal sectors. The informal sectors are also implicitly taxed, but in different ways: they have no access to the credit system, and very little access to the legal system. Deregulation must thus be part of the regulatory effort, the goal being to try to enlarge the modern formal sector.

Equipping workers for change

Even if there are no systemic barriers to mobility, labor markets are flexible, and wages adjust, workers must have resources to take advantage of new opportunities without losing their accumulated human capital in the process. The key issue is whether they have appropriate skills and access to opportunities and information. Various policy actions can help support labor mobility.

Skills imbalances. Jobs differ greatly in the skills they require, and workers whose jobs disappear often find that they lack the right skills for the jobs being created. This is exacerbated by the secular worldwide trend in labor demand toward workers with greater general skills and higher education. As a result, workers with firm-specific skills and narrow specialization but little general education have less chance of escaping unemployment. Most industrial and transition countries run public retraining programs. Evidence of their effectiveness is weak at best. If such programs are introduced, it is preferable to start with experimental and small pilot projects first. While government subsidies make sense in the circumstances, strengthening the private sector as a provider of retraining can improve the effectiveness of retraining. As the Chilean experience demonstrates, systems based on distributing vouchers to targeted groups, allowing them to buy training services in a competitive market, can work particularly well. One area in which private provision and financing of retraining are unlikely to be adequate is the retraining of disadvantaged workers. Returns to such training are low, even though the externalities in terms of improved social cohesion can be high.

Public employment schemes, in contrast, can play a positive role as an antipoverty measure. In periods of major change, although they do not improve the long-term prospects of participants, they can serve as a bridge between jobs. They are widely used in the Czech Republic for that purpose. There are examples of successful public support for apprenticeships in Germany and Japan, and of public employment for dropout minorities in Canada.

Supporting small businesses and startups. Countries have often tried to assist job losers by providing support to those wishing to start their own businesses. Many countries have experimented with special credit schemes and other programs to encourage the development of micro-enterprises. But such schemes have rarely been evaluated in a rigorous fashion. General experience with special credit programs in Sub-Saharan Africa and Latin America suggests that they have rarely brought benefits. In the industrial countries these schemes have been shown to be of interest only to a very small subgroup of the unemployed and have had significant displacement effects. In Egypt, it may be more useful to try to support existing small firms that operate in the informal sector with the provision of basic infrastructure and access to credit.

Wage subsidies must be limited and very well controlled to play a positive role in periods of major change. In the industrial countries, they have proven ineffective in speeding up the adjustment process. There are substitution effects, whereby workers whose wages are subsidized replace those who are not covered by subsidies. Moreover, wage subsidies can easily undermine the reforms by keeping unprofitable firms afloat. Wage subsidies should be considered only in special cases where targeting is easy, such as in the case of depressed regions. When they are well controlled, they can be a less expensive alternative to transfers and yield a better outcome in terms of social cohesion.

Provision of information. Workers cannot take advantage of new opportunities unless they know about vacancies and wages. In many developing countries, workers must rely on informal exchange of information to find new jobs. Job-search assistance can help; but though inexpensive, it is not a panacea. Even in the industrial market economies only a small percentage of job seekers (usually no more than 10 to 15 percent) get their jobs through public employment offices. Allowing private employment services to operate makes sense.

Compensating those hurt[١٧] In the past decade, more than fifty countries used transfer schemes to assist in downsizing their public sectors. During major reorganizations, the desirable level of severance pay will usually be in excess of the compensation mandated under existing labor contracts. The early involvement of unions is crucial for success, and for fairness the offer should be open to all, or most, public sector employees. Ideally, programs are voluntary, and a menu of options is offered, with workers allowed to choose freely among them. The possible options available on the menu include early retirement, cash offers, annuities, retraining programs, guaranteed wages backed by subsidies to new employers, and remaining in the public sector (but possibly

---

[١٧] This section is based on Diwan, 1994.

in another occupation). Offering a menu of exit options can help achieve better targeting at cheaper fiscal costs, since each worker chooses the option he or she values most. But a potentially important disadvantage of voluntary exit programs is the adverse selection they are prone to. The fear is that the public sector would lose its best workers as a result of the voluntariness of the exit mechanism. However, this type of problem can be partially resolved by a proper use of vetos.

In public enterprise restructuring, governments typically laid-off redundant workers before privatization in order to allow new owners maximum flexibility in restructuring the enterprise. This is how it was done in Spain. But privatization can come first, leaving restructuring to the new owners. Often, there will remain constraints on firing or the level of wages. This gets reflected in lower sales price, so in effect, the government is implicitly paying the severance costs to the firm so it retains some redundant workers. This is the prevailing case in Central and Eastern Europe.

In sum, active labor market policies and compensations to those hurt by change are a necessary component of a reform program. They help maintain social cohesion in a period where the job destruction/job creation process intensifies, generating intense social dislocation. But given the depth of the problems, these policies are not a panacea, and cannot be expected to perfectly smooth temporary losses. This means that policy must ensure that these losses remain indeed temporary. The credibility of a vision of a better future will have to play a central role in this regard.

Concluding Remarks

Egypt pursued an employment strategy that worked during the regional oil boom but collapsed afterwards. Some employment cycle was unavoidable, given that no one anticipated the scale of the oil cycle. But the pattern of growth chosen is now a disaster for employment, leaving the characteristic syndrome of high unemployment and high public employment. Past educational expansion contributed more to frustrated expectations of getting “good” public sector jobs than to a dynamic of productivity growth that characterized open economies.

There is a wide acceptance of what needs to be done. The state must commit to the rule of the marketplace in the interest of the majority of workers, but its commitment must be supplemented by public action to ensure that markets deliver socially acceptable outcomes. Labor regulations must guarantee some standards of fairness in labor relations, yet preserve the flexibility of the labor market. Mechanisms should be put in place to reduce market risk, but they must be balanced against the erosion of the incentives to perform on the job. Education policies must equalize opportunities, not create a protected labor elite, and education quality must be upgraded to the standards of the 21st century. The role of independent unions must be recognized and the conditions for efficient collective bargaining put in place. Policies to reduce inequality must also be actively promoted in the interest of national cohesion, but redistribution should be finely targeted. The government must abandon production activities and give up its role of employer of last resort. It must focus on increasing the quality of core services, insist that its employees work harder, and pay them accordingly.

Change, however, is constrained by the current political and social fragility. Government can choose to open, or can struggle to maintain the current fragile state. There are political risks to both courses. The poor are the most robust potential beneficiaries, but least influential. Unemployment effects in transition are ambiguous.

The political necessity and risk of opening reform are both clear: it is the only way to get onto a labor-demanding path and attract stable capital flows; but there will be some permanent losers and some temporary losers, especially amongst public sector workers. Employment-reducing reform of the public sector is unlikely and probably inadvisable prior to a growth dynamic taking off, yet failure to reform could lead opening to end in a blaze of either fiscal crisis or growth-reducing fiscal repression of economic and social services. This implies some gradualism may be important, provided the forces of conservatism do not undercut reform. It is in making this strategy possible, both through finance and technical assistance, that the European Initiative would make its most valuable contribution to facilitating Egypt’s integration with the world economy.

Bibliography

Adams, Richard. 1989. "Workers Remittances and Income Inequality in Rural Egypt". *Economic Development and Cultural Change* 38 (October): 45-71.

Assaad, Ragui. 1993. "The Employment Crisis in Egypt: Trends and Issues." Humphrey Institute of Public Affairs, University of Minnesota.

Assaad, Ragui. 1994. "The Effects of Public Sector Hiring and Compensation Policies on the Egyptian Labor Market." Forthcoming, *The World Bank Economic Review.*

Diwan, Ishac and Lyn Squire. 1993. "Public Debts and Private Assets: External Finance in a Peaceful Middle East." *Middle East Journal* 49(1): 69-88.

Diwan, Ishac, 1994. 'Public Sector Retrenchment and Severance Pay: Nine Propositions'. in *Civil Service Reform in Latin America and the Caribbean*. S. Chaudhry, G. Reed, and W. Malik, editors. The World Bank.

Diwan, Ishac, Chang-Po Yang and Zhi Wang. 1995. "The Arab Economies, the Uruguayan Round Predicament, and the European Union Wildcard", mimeo, The World Bank.

Feenstra, Robert C. and Gordon Hanson. October, 1994. "Foreign Investment, Outsourcing and Relative Wages" mimeo, University of California, Davis.

Handoussa, Heba. 1992. "The Burden of Public Sector Employment and Remuneration: The Case of Egypt." American University, Cairo, Egypt.

Korayem, Karima. 1994. "Poverty and Income Distribution in Egypt". Third World Forum. Cairo, Egypt.

Kheireddine, Hanaa. 1996.

Krueger, A. O. 1983. "Trade and Employment in Developing Countries: Three Synthesis and Conclusions." University of Chicago Press, Chicago.

Lawrence, Robert and Matthew Slaughter. 1993. "Trade and US Wages: Great Sucking Sound or Small Hiccup?" Faculty Research Series (R93-16), Kennedy School of Government, Harvard University.

Pissarides, Christopher. 1995. "Trade and the Return to Human Capital in Developing Countries." Forthcoming, *The World Bank Economic Review*.

Richards, Alan. 1995. "Is Unemployment a Bourgeois Luxury? The Case of the Arab World". Economics Working Paper 313 (Jan.). University of California Santa Cruz.

Robbins, Donald. 1995. "Trade, Trade Liberalization, and Inequality in Latin America and East Asia." Synthesis of Seven Country Studies. Forthcoming, *The World Bank Economic Review.*

Sachs, J. and H. Schatz. Spring 1994. "Trade and Jobs in US Manufacturing", Brookings Papers on Economic Activity.

Said, Mona. 1994. "Public Sector Employment and Labor Markets in Arab Countries: Recent Developments and Policy Implications." International Monetary Fund.

Tan, Hong and Geeta Batra. 1995. "Explaining Wage Differentials: The Role of Employer investment in Technology", forthcoming, *The World Bank Economic Review*.

van Eeghen, Wilhem. 1995. 'Poverty in the Middle East and North Africa'. World Bank mimeo.

Wood, Adrian. 1995. 'Does Trade Reduce Wage Inequality In Developing Countries?' Institute of Development Studies, University of Sussex. Forthcoming, *The World Bank Economic Review.*

Wood, Adrian. 1994. *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World*. Oxford: Clarendon Press.

World Bank. 1995a. *World Development Report : Workers in an Integrating World*, Report No 14086

World Bank. 1995b. 'Will Arab Workers Prosper or Be Left Out in the Twenty-First Century?' Supplement to *World Development Report: Workers in an Integrating World.*

Zaytoun, Mohaya A. 1991. "Earnings and the Cost of Living: An Analysis of Recent Developments in the Egyptian Economy", in H. Handoussa and Gillian Potter (eds) *Employment and Structural Adjustment: Egypt in the 1990s*, Cairo: AUC Press, Cairo.

Zouari-Bouattur, Salma. 1994. "Evolution de Marche du Travail Tunisien 1983-1993", Universite de Sfax.