THE POLITICAL ECONOMY OF INDUSTRIAL POLICY IN THE MIDDLE EAST AND NORTH AFRICA

Mustapha K. Nabli, Jennifer Keller
Claudia Nassif and Carlos Silva-Jáuregui

Working Paper No. 110
May 2006

The views expressed in this paper are entirely those of its authors and should not be attributed to the World Bank.

Abstract

The claim that industrial policy has become a thing of the past is largely exaggerated. Industrial policies continue to be used throughout the world, but with new modalities and focus that reflect the reality of the new global economic architecture, rapid technological change, and acknowledgement of the costly mistakes made in the past with traditional industrial policy. This paper examines the political economy and consequences of industrial policy in the MENA region. It shows that, unlike in many other regions, industrial policy in MENA developed within the context of a strong "social contract" between government and the people. Although industrial development was an objective, it at times took a backseat to other goals such as social transformation and economic redistribution—influencing not only the types and success of industrial policies adopted, but also the balance of power among interest groups.

ملخص

إن القول بأن السياسة الصناعية أصبحت شيئا من الماضي هو قول فيه كثير من المبالغة. فمازالت السياسات الصناعية مستخدمة عالميا، ولكن بأنماط واهتمامات جديدة تعكس الواقع الجديد لبنية الاقتصاد العالمي، والتطور التكنولوجي السريع، والاعتراف بالأخطاء المكلفة التي حدثت في الماضي فيما يتعلق بالسياسة الصناعية التقليدية. وفي هذا الإطار، تتناول الدراسة بالتحليل الاقتصاد السياسي للسياسة الصناعية في منطقة الشرق الأوسط وشمال إفريقيا والنتائج المترتبة عليها. وتوضح أنه على خلاف العديد من المناطق الأخرى فإن السياسة الصناعية في منطقة الشرق الأوسط وشمال إفريقيا تطورت في إطار عقد اجتماعي قوي بين حكومات المنطقة وشعوبها. فعلى الرغم من أن التنمية الصناعية كانت هدفا لهذه السياسة، إلا أنها أحيانا ما تراجعت أمام أهداف أخرى مثل التحول الاجتماعي وسياسات إعادة التوزيع، الأمر الذي انعكست آثاره ليس فقط على أنماط ودرجة نجاح السياسات الصناعية التي اعتمدتها الدول، ولكن أيضا على ميزان القوى بين جماعات المصالح.

1. INTRODUCTION

The mainstream view on industrial policy has shifted back and forth over the past half century. During the 1950s and 1960s industrial policy was widespread. Import substitution was a common strategy used to nurture "infant industries" throughout the developing world including the Middle East and North Africa (MENA). A number of industrial and investment policies were utilized throughout the world to expand countries' industrial bases and develop key sectors.[1]

In some cases, industrial policy implemented over the twentieth century seemed to yield astounding results, but perhaps nowhere more so than in a few high-performing East Asian economies. Interventions varied including targeting and subsidizing credit to selected industries, keeping deposit rates low and maintaining ceilings on borrowing rates to increase profits and retain earnings, protecting domestic import substitutes, subsidizing declining industries, establishing and financially supporting government banks, investing in applied research, establishing firm- and industry-specific export targets, developing export marketing institutions, and sharing information widely between public and private sectors. Some industries were promoted while others were not.[2]

By the 1980s, however, views on industrial policy had decidedly changed. Growing evidence found that traditional approaches to industrial policy led to misallocation of labor and capital across industries and did not improve long-run growth in total factor productivity, but gave rise to rent seeking. Even among the high-performing economies of East Asia, it was argued that industrial policies—notwithstanding the contribution to the growth of the economies themselves—inflicted significant costs on the economies in the form of corruption and weak financial systems.[3] In Europe and the United States the practice of frequently "picking the loser" in declining industries such as agriculture, textile, steel, and shipbuilding reinforced this notion. Other factors contributed to industrial policy falling out of favor in most development circles including the wide

---

[1] While the term "industrial policy" was originally used to describe policies relating specifically to the industrial sector, today the term has become more broadly recognized to include policies that encourage any sector (e.g., agriculture or tourism) not only the industrial sector.

[2] World Bank (1993).

[3] Noland and Pack (2003, 2005).

acceptance of the "Washington Consensus" reforms for Latin America, the fall of the Soviet Union, and an increasingly globalized economy.

The diverse experiences with industrial policy in different countries have shown that its outcome depends enormously on the national context, which determines how industrial policies are framed and implemented. Ultimately, the political economy will determine not only what types of industrial policy will be pursued, it may also determine whether a given set of strategic industrial policies will benefit one country, or specific economic groups therein, or whether it will harm another.

Despite these changing views of industrial policy, most of the countries in the MENA region continued to rely extensively on traditional industrial policy. Throughout the 1980s and 1990s, MENA countries maintained strong roles for the government and policies of significant government intervention in production and economic planning. During the same period, countries in Latin America, Europe and Central Asia, which had broadly similar initial conditions, undertook sweeping reforms of their economic structures and refocused their strategies into more coherent market-oriented policy packages to encourage private-sector export-led growth. The MENA economies made relatively less progress toward more market-oriented policies and today governments in MENA are still actively implementing traditional industrial policies. More than in countries of other developing regions, these policies are characterized by vertical elements which protect selected industries and preserve existing market organizations. They include higher trade protection, higher public involvement in the production of goods and services, more control of strategic sectors like banking, as well as more price controls and subsidies.

In this paper, we examine the political economy and consequences of industrial policy in the MENA region. How can the particular features of MENA's industrial policy be explained? And why haven't industrial policies in MENA countries followed the evolutionary path of industrial policies of other countries? Unlike in many other regions, industrial policy in MENA developed within the context of the region's strong "social contract" between the government and its people. Although industrial development was an objective, it at times took a backseat to other goals such as social transformation and

economic redistribution—which influenced not only the types and success of industrial policies adopted, but also the balance of power among interest groups. Political economy factors are central to understanding the industrial policy experience of the MENA region. These issues have scarcely been studied in the context of the MENA region, and this paper takes a broad regional and historical perspective with the aim of providing a framework for examining them.

Section 2 of the paper provides the theoretical framework for understanding the industrial policy experience. Starting with a brief survey of the arguments used to justify industrial policy interventions, and drawing on various strands of the literature, it provides a review of the various mechanisms and arguments to help understand the factors that determine the emergence and type of industrial policies observed and how they change. Using this framework, section 3 reviews the experience of MENA countries from the 1950s to the 1970s and the emergence of state-dominated vertical industrial policy, where traditional/sector selective and sector-specific policies have been used extensively.

Section 4 attempts to explain why industrial policy in MENA failed to change during the 1980s and 1990s. While most of the developing world has moved toward more market-oriented policies and production systems dominated by the private sector and that rely on market signals, MENA has maintained much of the old style industrial policies and high state intervention that characterized much of the developing world in the past. Despite the mounting strains on MENA's economic development models, oil and strategic revenues and the lack of a full-fledged economic crisis have allowed the region to maintain industrial policies far longer than other regions. Equally important, the lack of interest groups to emerge and press for change has hindered the region's move toward more functional, market friendly policies for growth—a phenomenon closely linked to the weaknesses in governance. In addition, during the initial industrialization stage MENA countries used industrial policy to create new activities and support the development of new (infant) firms, but during the second stage (1980s-1990s) industrial policy played a more passive role—that of preserving the existing structures. From a political economy perspective, the preservation of structures can be explained by

governments' desire to seek support to remain in power by continuing to offer rewards to supporters in order to deter the formation of opposition groups.

The final section offers some concluding remarks on the likely direction of industrial policy in the region. As internal and external forces shape the way industrial policies can be used in the globalized economy, the MENA region's old style of industrial policy will need to adjust. The ultimate outcome will be largely determined by each country's initial conditions and individual political economy factors.

2. Understanding Industrial Policy

What exactly constitutes industrial policy? In the current vernacular, any policies or interventions which influence how industries expand are referred to as "industrial policies," but distinctions are made between "horizontal" industrial policies and "vertical" industrial policies. Interventions that are differentially applied across sectors of the economy are referred to as "vertical policy." Likewise, interventions applied across the board are referred to as "horizontal policy."

While vertical policies essentially target the economic output of specific industries and even firms, horizontal policies focus on improving the quality of inputs in the production process, which would presumably benefit all firms. Horizontal industrial policies often cited include promoting education and vocational training, building appropriate and efficient public infrastructure, encouraging international technology transfers, and fostering research and development.

Differentiating between policies that would benefit all firms and those that would benefit a select few may seem appealing, but it is not entirely accurate. Even horizontal policies may have substantially different impacts among sectors of the economy, and ultimately may be just as distortionary as vertical industrial policies. For example, if a government provides across-the-board energy subsidies (e.g., in Iran) effectively lowering the unit price of energy for all consumers, it is technically a "horizontal" policy in that it is applied across sectors. However, it clearly impacts firms differently, providing greater benefits to more energy-intensive (and often energy-inefficient) firms. Even a more "virtuous" horizontal policy, such as incentives for promoting education, will

impact sectors of the economy differently depending on the education being promoted. Indeed, some firms may not benefit at all from a more educated workforce if education is not in line with the work of the firm. Thus, the line between "horizontal" and "vertical" industrial policy is often very difficult to distinguish. Despite these difficulties this distinction is useful, especially from a political economy perspective, in order to try to understand the strong political appeal of vertical industrial policy compared to horizontal.

A useful starting point to understanding why countries primarily adopt vertical rather than horizontal policies is to examine some of the economic arguments behind both approaches. While the political economy may play a great role in determining the industrial policy approach adopted, economic justifications have provided a strong foundation for the road countries have traveled toward industrial development.

Economic Justifications of Vertical Industrial Policy

Industrial policy is traditionally justified by market failures that generate sub-optimal outcomes in resource allocation. Once these market failures are identified, governments devise policy responses to cope with them in the form of industrial policy. Incentives and policies can also be used to compensate and correct government failures.

There have been a variety of economic justifications for the use of vertical industrial policy. Perhaps the most notable economic justification was the "infant industry" argument for selective protection. This dynamic comparative advantage argument claims that protection is warranted for newly-established firms and industries in countries where production costs may be initially higher than those of well-established competitors. If, over time, new domestic producers can reduce costs by learning by doing, then they can attain the production efficiency of their rivals. Without the initial protection, however, the domestic industry will never take off. The argument was used both to curtail competition with domestic and/or foreign firms. Many countries in MENA used this argument during the initial stages of industrialization after WWII, particularly regarding establishing trade barriers to protect their "infant" industries from competition from abroad.

But many other economic justifications for vertical industrial policy have been advanced as well. A second argument is that *coordination problems* of either upstream or downstream investments may hinder the development of otherwise competitive industries. This is exemplified by the development of the orchid industry in Taiwan,[4] where potential orchid growers contemplating investment in greenhouses needed to be assured that a variety of fixed investments were in place—including an electrical grid, irrigation, logistics and transport, and pest control measures. At the same time, all of these services had high fixed costs and were unlikely to be undertaken by the private sector without assurances that there were a sufficient number of greenhouses to demand their services. In this case, the Taiwanese government's upstream investments aimed to coax the downstream investments in greenhouses.

In the case of MENA, the argument has been used to support the creation of industrial zones (e.g., in Morocco), or large investments in the water/irrigation sector to support agriculture (e.g., in Egypt). In Jordan, a joint public-private initiative led to the establishment of "Cyber City" in 2003 which provides transportation, logistics, insurance, technology and other commercial services to attract investments in the IT sector. In the service sector, specialized hubs have been created in the Gulf to support the development of financial services, education, health, trading and transport. Qatar, for instance, is positioning itself to become a regional education and health services hub.

A third argument is based on *information externalities* that may restrict a country's capacity to determine which activities have costs low enough to be profitable. Unlike innovation, which can be protected with patents, the costs- (risks) to-benefits ratio is high for starting a domestic industry that is already well established internationally. As Rodrik (2004) points out, entrepreneurs who figured out that Colombia was a good environment for flowers, Bangladesh for t-shirts, Pakistan for soccer balls, and India for software generated large social gains for their economies, but could keep very few of the gains for themselves. For this reason, selective government interventions may be required as a means of determining a country's areas of cost advantage. In MENA, information

[4] Rodrik (2004).

externalities arguments have been used in the development of export promotion agencies that played an important role in the Tunisian and Moroccan textile sectors.

The presence of market failures provides powerful arguments for governments to intervene, utilizing vertical industrial policies to ensure that countries can determine their areas of advantage and generate spillovers to other sectors. In some instances government failure, in the form of ineffective implementation of policies, leads to undesirable outcomes that have justified the implementation of compensatory industrial policies.

Despite theoretically sound arguments for vertical industrial policy, international success with industrial policy has been far from glowing, confirming that governments can "get it wrong." Well motivated or not, vertical industrial policies have often either prevented the emergence of dynamic, competitive enterprises or led to significant unintended consequences, not only when the policies were in place, but for a long period afterward.

The socialist industrial policy pursued by India in the 1950s included protectionist policies that increased the cost of unskilled labor. As a result, the country was shut out of the global market for manufacturing products with unskilled labor for many years after it ultimately opened up.[5] Korea's use of credit allocation as an industrial policy instrument is widely blamed for the financial system crisis that emerged in the late 1990s. Commercial banks were urged to lend to firms in preferred sectors or to the large and powerful conglomerates ("cronies"). Consequently, banks incurred weak balance sheets due to the low profitability of these firms. In addition, the policy nearly obviated bank skills for project monitoring and evaluation. As a result, the huge capital inflows that began in the mid-1990s were channeled through institutions that had suffered a serious erosion of skills and discipline.[6]

After Algeria nationalized nearly its entire economy in 1966, the government invested heavily in the creation of basic capital-intensive industries (e.g., hydrocarbon, steel, plastic and fertilizers) and in prioritized industries relevant to processing and import

[5] As it turns out, the country found its niche in sunrise industries with high knowledge content. However, the best intentions with industrial policy have often produced the most disastrous outcomes.

[6] Borensztein and Lee (2005) and Pack (2000).

substitution (e.g., construction materials, metal products, consumer goods). In many respects Algeria succeeded and in less than a decade it created a strong industrial base virtually from scratch. However, the rapid industrialization resulted in severe inefficiencies in the production capacity of various industries and generated fiscal imbalances in the mid-1970s which constrained Algeria's ability to continue its expansionary industrial policy.[7]

In addition to possibly "getting it wrong," vertical industrial policy is subject to two potential (and common) damaging side effects: rent seeking and corruption. Wherever the government makes selective interventions that could contribute to the development of one sector or firm over another, there is the potential for interest groups to attempt to sway policy in their direction and utilize it for personal gain. The ability of countries to control corruption and rent seeking, in fact, is a key difference between countries in which industrial policy could be utilized effectively and those where the strategy floundered. However, the types of interest groups that emerge in a country, the mechanisms they can use to influence public policy, and how far they can shift industrial policy from "good" to "bad" can vary enormously from country to country. Attempting to deal with these government failures often leads to more selective policies, making industrial policies increasingly complex.

Economic Justifications of Horizontal Industrial Policy

While market failures, information asymmetries, externalities, and problems of coordination and learning are among the most commonly cited reasons for government intervention, addressing these issues from a horizontal policy perspective rather than a sector/firm specific one has been gaining acceptance by policymakers in the developing world.

Horizontal industrial policies may have many advantages over vertical policies. On one hand, horizontal policies tend to reduce the distortions generated by the use of vertical industrial policy. They approach industrial policy from an angle that is closer to

---

[7] World Bank (1975).

competition policies while still actively supporting the economy. Horizontal policies are applied across the board. As such, they tend to level the playing field across firms, industries and sectors, rather than giving a privileged position to some groups. Because of their "universal" nature, they also tend to reduce rent-seeking incentives as well as limit corruption opportunities. This reduces the development of pressure/lobbying groups that seek to benefit from policies targeted to their interest. Horizontal industrial policies also increase transparency by eliminating the need for backroom politics and promote social cohesion as they can be seen as spreading the benefits across society as a whole instead of being concentrated within specific groups. In addition, they can promote efficiency and competition among firms, industries and sectors in the economy, as each of these agents will have greater incentives to internalize the most from the horizontal policies.

On the other hand, horizontal industrial policies can serve to reduce the problem of state capture and government failure. Because these policies are applied across the board, they can eliminate some of the problems that help perpetuate the use of vertical policies. The distribution of benefits is more clearly defined with horizontal policies and the problems of non-neutrality are in principle eliminated (or at least reduced). However, it is important to note that while policies can be horizontal in design and nature, their effect may not be horizontal. The energy subsidy example above clearly indicates a case in which a horizontal policy may have a "vertical" outcome.

Finally, compared to traditional vertical policy, horizontal industrial policy adjusts more easily to changing market conditions since its benefits are not captured by special groups with vested interest that would lobby to maintain the status quo. This builds a much needed dynamism in the policy itself, facilitating change and adjustment when needed.

Political Economy of Industrial Policy

The traditional approach to political economy posits that economic policies are shaped in the political market. The main actors in the market are interest groups or distributional coalitions who are rent seekers pursuing politically mediated gains. Any policy change is bound to produce winners and losers who may or may not organize to block these

policies and/or support other policies. Finally, policymakers mediate these pressures and determine their choices in view of their own objectives.

Sometimes policymakers may determine that it is in their interest to undertake fundamental policy reforms which may disrupt existing political coalitions and dislocate privileged economic actors. The old elites become losers in the reformed economic environment and a new set of winners emerge from the process. For example, reforms may aim at shifting the economic environment from cronyism, patronage, corruption and rent seeking to transparency, accountability, equity and clear property rights. Such reform measures are risky because they disrupt the status quo and remove the dominant elites. In such situations reformers/policymakers distance themselves from prevailing interest groups as they may be attempting to reach some longer term objectives and mobilize alternative coalitions. The existing distributive coalitions do not shape policy reforms. The interests of winners and losers are essentially fixed by their position in the pre-reform political economy. Elites react to the reforms by attempting to block them or undermine the reform process to avoid losing their privileged position.[8]

So what influences the industrial policy choices countries make? Or more to the point, why, despite the frequent failures and the risks of vertical industrial policy, do political systems predominantly tend to produce and perpetuate vertical policies rather than horizontal? Despite the criticism leveled at selective policy interventions, most countries—both developing and developed—maintain something of a "halfway house" between mainstream free-market policy measures and vertical interventions to encourage specific industries. A number of arguments, rooted in the principles of collective action and interest groups, are relevant.

First, the benefits from horizontal policies tend to be diffused across groups and sectors, and it is not often easy to mobilize "winners" from horizontal policies. Take, for example, the case of education, skills development and technological innovation policies. Although many businesses might benefit from skills upgrading, the extent to which a given firm could reasonably expect to benefit from across the board education policies

[8] See for example Olson (1971, 1982) on collective action and rent seeking behavior, North (1990) on economic institutionalism, Waterbury (1993) on public enterprise reform and Hellman (1998) on "winners take all."

might be small. In fact, a great deal of the resources might be devoted to the development of skills not used intensively in their own business. It is unlikely that collective action will emerge to support these generalized policies. On the other hand, within a particular sector, the types of skills utilized and technological knowledge needed is often highly specific. As a result, firms in a given sector are probably more likely to be able to develop lobbying power to pursue specific educational objectives.

Second, some of the most important horizontal policies are long term in nature and it often takes a long time for results to materialize. This is particularly the case with education and non-sector specific research and development. Interest groups are unlikely to pursue and push such policies when the benefits to them are less visible and spread out over a long period of time. Therefore, it is up to governments to actively define and support such long-term development policies.

Third, in many instances, market and coordination failures are sector specific, and cannot be adequately addressed through horizontal approaches. Take the case of the tourism sector in which coordination problems are pervasive. The emergence and/or expansion (new zones, new business niches) of the sector require coordination on a number of fronts: (i) development of basic infrastructure such as zones with adequate water supply, sanitation, access to international transport, and the like; (ii) development of specific technical and managerial skills; (iii) development of joint or support activities such as travel agencies, entertainment businesses, restaurants, and related activities; and, (iv) information on markets, advertising and opening of new markets. Given the number of factors that must come together for development of the sector, it is unlikely that market forces and mechanisms would be able to resolve all of the coordination problems. Typically, governments have to be involved. This was partly the case with the development of the tourism industry in Egypt when the government invested heavily in improving the tourism infrastructure near historic sites during the 1980s.[9]

Finally, arguments used by sector lobbies can often be couched in terms of benefits to other groups, such as workers and consumers, strengthening their political power. Tariff protection for a specific sector is often couched in terms of domestic jobs

[9] World Bank (1980).

protected. Protection of agricultural production and subsidies for European farmers is couched in terms of preserving the environment and livelihood of weak farmers. Protection of domestic production of many food products such as meat is couched in terms of health safety for consumers. These arguments cannot be made for blanket horizontal policies. They are intrinsically product and sector specific and they have a powerful political thrust.

Lessons from reforms in the developing world (including the MENA region) indicate that in many instances pre-reform elites are resilient. Privileged economic actors have been able to keep their positions after reforms. The process of reform has been one of reorganizing opportunities for rent seeking rather than eliminating them. Reforms have produced outcomes that continue to provide significant opportunities for privileged economic actors to capture rents from a set of regulatory arrangements and economic institutions.[10]

These lessons and experiences suggest that the effectiveness of political systems to generate welfare enhancing policies would depend on a number of factors that can be usefully summarized as good governance. These factors include: (i) the extent to which policymakers are held accountable for the choices they make and the extent to which they pursue public vs. private interest; (ii) the transparency of the decision-making process and political influence; (iii) the ease with which interest groups can organize to pursue their interests openly; and (iv) the quality of information and analysis available to support and enlighten decision-making.

3. The Emergence of State-Dominated Vertical Industrial Policy in MENA from the 1950s to the 1970s

Industrial policy in the MENA region developed to some extent as an offshoot of the region's social contracts that emerged in the 1950s. Partly to correct for a legacy of inequities and poverty in the region, the MENA countries adopted models of development based on heavy state intervention and redistribution. The social contract was designed to establish the norms and expectations of social groups to the legitimate claims

[10] This led Heydemann (2004) to propose a new approach to the political economy of policy reform which focuses on the so-called *networks of privilege*.

they had on state resources, as well as the demands state actors may legitimately make on society. It had a number of distinctive features, including institutional arrangements, public policies, legitimating discourses, and modes of state–society interrelations. Core attributes of the social contract—some of them directly linked with industrial policies of choice—included: (a) the preference of states over markets in managing national economies; (b) a reliance on state planning in determining economic priorities; (c) a penchant for redistribution and equity in economic and social policy; (d) an encompassing vision of the role of the state in the provision of welfare and social services; and (e) a vision of the political arena as an expression of the organic unity of the nation, rather than as a site of political contestation or the aggregation of conflicting preferences.[11]

Another key marker in the rise of the interventionist-redistributive social contract and its associated industrial policy was the emergence of centralized, hierarchical, and tightly regulated corporatist structures of *interest groups* in the first decade after independence. These arrangements provided the blueprint for the organization of relations between the state and a wide range of stakeholders, including firms, laborers, students, women, in addition to various professional associations. It was through these arrangements that corporatism created possibilities for agency, bargaining, and negotiation for the groups it was designed to contain; the so-called privileged networks that are the center of the new theories of political economy of reform. These structures also helped to determine the modalities of industrial policy used in the region, and facilitated state capture and corruption.

Institutionally and in terms of economic and social policies, these elements were consolidated through broadly similar strategies in a number of MENA states like Algeria, Egypt, Iraq, Syria, and—to a lesser degree—Jordan, Morocco, Yemen, and Tunisia. These strategies included: (a) the rise of a dominant single-party or ruling-party government; (b) new, post-independence constitutions that enshrined interventionist and redistributive principles in the basic laws; (c) a wave of agrarian reform programs to redress inequalities in the rural economy; (d) the centralization of trade unions and

[11] World Bank (2003a).

professional associations; and (e) programs for state provision of social services, including education, housing, health care, food subsidies, and other benefits.

Understanding the reasons for the widespread "acceptance" of this type of state-dominated social contract in MENA countries is beyond the scope of this paper. However, it is clear that the political system underlying this social contract is different than the kind of governance structure that is typically assumed when arguments are made about the likely emergence of a vertical industrial policy. Such arguments assume a governance structure where political competition is prevalent, the market system is predominant and there is a large degree of openness and availability of information and analysis. The different system prevalent in MENA would have significant implications for the type of industrial policies that emerged during the 1950s and 1960s. The attributes of the social contract and governance structure led to four mechanisms/features of this model which modified and/or reinforced standard political economy arguments:

- First, sweeping nationalizations of industry, trade and agriculture in the late 1950s and early 1960s, produced a dramatic expansion in the scale of public sectors and reduced the role of the private sector; the relationship between state-owned enterprises and decision-makers allows them to influence policies more effectively;
- Second, the capture (either wholly or predominantly) of the banking and insurance sectors by the state,
- Third, the choice of price controls and subsidies as a predominant mode of regulation based on the need to protect the poor and pursue a social agenda of redistribution,
- Fourth, the role of oil wealth—both oil resources for oil-producing economies, and oil-related revenues[12] for resource-poor economies—underwrote much of the region's emerging social contracts, and the public sector (both governments and state-owned enterprises) became a key vehicle for redistribution through employment. While this trend may be

[12] Including capital flows and labor remittances.

more apparent in the oil sectors, the role of the state in most of the MENA countries has been dominant, comparable at times to the command economies of the former Soviet bloc.[13] As a result of these trends, by the 1960s the commanding heights—the means of production—were mostly in the hands of the state in many MENA countries.

Within the predominant role of the state and the use of central planning as the main vehicle for resource allocation, these mechanisms/characteristics led to an industrial policy that was bound to be sectoral/vertical and highly preferential, thus creating an environment of "winners" and "losers."

The Public Enterprise Sector and Industrial Policy

To a large extent industrial policy was structured to support public sector enterprises. This was partly the result of the waves of nationalization implemented in several countries of the region. Like many countries of the world that embraced the infant-industry concept in the 1950s, MENA implemented an inward-looking model with protection from external competition. Import tariffs, licenses, prohibitions and other forms of non-tariff barriers were used as the direct instruments of choice to support public sector enterprises, but other policies supported public sector production (and employment), including credit rationing, subsidies, and foreign exchange policies.

The nature of public enterprises and their relation to decision makers made the pursuit of sectoral interests relatively easy and the implementation of incentive schemes straightforward, as most of the instruments could be shaped accordingly. MENA's trade policies of high import tariffs and non-tariff barriers, which limited competition from abroad, echoed strategies adopted elsewhere, protecting industries that would hopefully flourish and compete later on.[14] When, despite trade protection, these firms incurred

[13] It is important to note that while socialist ideas had an important influence on the economic model implemented in the region, there is significant heterogeneity among countries and the economic polices they used in the past and continue to use today.

[14] This was not a MENA specific problem. Other regions that adopted these policies (e.g., Latin America and the Caribbean) experienced this problem as the domestic industry had less access but particularly less incentives to implement the latest technologies and management practices.

losses, it was easy to cover them directly from the budget or more commonly from the banking system.

In situations where the private sector continued to play a role, it often faced distorted incentives and the negative impact of the presence of public enterprises, such as higher cost, low quality, and the like. Under such circumstances, the only way for private businesses to pursue their interests was, in addition to dealing with externalities, to obtain specific incentives in the form of special protection, access to finance or other subsidies. This process enhanced the vertical and complex nature of industrial policy.

BOX 1. INDUSTRIAL POLICY IN TUNISIA

After gaining independence in 1956, Tunisia's manufacturing and mining sector was small and in the years that immediately followed there was little or no growth. Most Tunisian businessmen continued the long commercial tradition of the country and there was no net inflow of capital from foreign industrial investors partly due to uncertainty about the government's attitude to private investment and political tensions with France. In the late 1950s the government began to take steps to assure industrial development of the country.

In the first half of the 1960s, the government launched an initiative involving a number of government offices and financial institutions including the National Company for Investment (SNI) to establish several industrial enterprises that were either directly or indirectly controlled by the state. From 1959-60, the major share of industrial financing was provided by the government either directly through equity participation or indirectly through its banking and insurance subsidiaries, lending, or taking equity positions in industrial companies.

By the end of the 1960s virtually every industry was primarily controlled by the government. The tourism sector was the one area in which the government had been hesitant to invest, mostly because it regarded the investment potential as too risky and because there was considerable opportunity for private activities. Convinced that the tourism industry had great growth potential, the government actively promoted it with measures such as tax holidays for new hotels, a rebate on loan interest rates for tourism investments, preferred access to land and subsidies for hotel construction. These policies led to high growth rates the tourism sector which developed into one of the main growth engines of the Tunisian economy during the 1970s.

Source: World Bank (1966, 1969, 1971, 1972).

Financial Sector and Industrial Policy

While this instrument of industrial policy is typically not available or of limited use in capitalist economies, it has emerged as one of the major mechanisms of sector specific interventions in MENA countries. In combination with pension and social security funds, bank and non-bank financial institutions were used to collect sizable resources that were managed by the state. Savings were collected at low cost through administered interest rates that were usually negative in real terms. This generated implicit subsidies that were transferred to the privileged priority firms and sectors. Credit was directed by central bank command. Countries like Algeria, Egypt, Jordan, Morocco and Tunisia created industrial development banks to provide foreign exchange loans for imported capital goods necessary for investment. Government control of the banking systems made it possible to pursue vertical industrial policy. Resources of the banking system were directly allocated to selected activities with quota allocations by sectors and preferential access by public enterprises. This is epitomized by Morocco which created the Banque Nationale Pour le Developpement Economique (BNDE) in 1959 with the sole purpose of providing loans to investment projects in selected industries that had experienced insufficient growth. In line with its mandate, the BNDE significantly contributed to the expansion of the tourism sector, agro-food industry as well as the textile industry. In addition, monetary policy was conducted through direct credit allocation and refinancing.

Consumer Subsidies and Industrial Policy

MENA countries also used subsidies as an active policy choice. In part, subsidies and other artificial supports were a necessary part of industrial policy in MENA because of the externalities of the instruments of redistribution. Administered prices prevailed throughout MENA economies and damaged the link between prices and production costs, therefore compensation mechanisms became necessary.

Among initial subsidies, the most pervasive were for consumer goods, especially foodstuffs. These subsidies-cum-price controls meant that specific sector policies were needed for agricultural and food products in order to compensate for the weakened production incentives. As a result, the agricultural sector required further policy

instruments of trade protection, access to preferred bank financing and subsidies. The incentives were justified as critical for employment, protecting the poor and maintaining social peace.

Oil Wealth and Industrial Policy

In addition to supporting the social contract, in many MENA countries industrial policy developed in reaction to the influence of oil wealth. Recognizing the impact that "Dutch Disease" had on the competitiveness of tradables, governments instituted a range of compensatory policies to mitigate the adverse effects. In a real sense, industrial development in the MENA economies could not take place without some direct government interventions. This is most obvious for the oil producing economies, but even in the resource-poor economies of the region the exchange rate appreciation that occurred from the massive inflow of aid and remittances contributed to the view that vertical industrial policies were needed for industrial development.

Additionally, the abundance of oil revenues has given rise to interest groups, who have sought to retain a disproportionate flow of the rent and evaluate reform policies based on their capacity to be captured.[15] This has perpetuated and motivated the use of more vertical industrial policies.

The Economic "Outcomes" from MENA's Vertical Policies

Some of the economic costs of the industrial policies adopted in the MENA region have been widely acknowledged. The continued strategies of import protection and inward orientation in MENA have resulted in significantly weakened trade, with trade-to-GDP growth at about half of the world's pace since the 1980s. The region's exports are dominated by oil, with only the small number of resource-poor and labor-abundant economies developing fairly well-established non-oil export sectors. The entire MENA

[15] Auty (2004).

region, with a population close to 320 million, has fewer non-oil exports than Finland or Hungary, countries with populations of 5 and 10 million, respectively.[16]

Also, the region did not sustain high levels of productivity after the 1960s. MENA experienced two decades of strong economic growth during the 1960s and 1970s. In fact, MENA's economic growth performance in the 1960s was the strongest in the world. During the decade, productivity growth was strong, in part due to the industrial policies adopted, which allowed the region to utilize underused capacities and provide the early boost of industrialization. But by the 1970s, productivity deteriorated sharply as massive investments were generating increasingly poor payoffs in terms of growth. Over the 1970s and 1980s, productivity growth in the MENA region was negative.[17]

The MENA industrial policy strategy has also been less successful than expected. Egypt adopted an active industrial policy from the early 1960s until the early 1990s when some elements of vertical interventions were phased out in the wake of structural reforms that did not prove very successful. One could argue that if industrial policy was effective the Egyptian economy should be more diversified. A recent assessment on the impact of industrial policies in Egypt revealed, however, that this is not the case. In contrast, the manufacturing industry has become more concentrated over time, particularly between the 1980s and 1990s.[18]

Moreover, full employment—a virtual mainstay of the social contract—could not be maintained. Between the 1980s and 2000, the unemployment rate climbed from an average of less than 8 percent to 15 percent.[19] By 2000, the MENA region's unemployment rate was higher than every other region of the world except sub-Saharan Africa.

Beyond the economic failures, the industrial policies adopted in MENA powerfully influenced the emergence and control of interest groups in the region, a fact that heavily contributed to the continued use of vertical policies well beyond their justification.

---

[16] Muller-Jentsch (2005).
[17] Nabli, Keller, and Veganzones (2002).
[18] Galal and El-Megharbel (2005).
[19] World Bank (2003b).

4. The Failure to Change Industrial Policy in the 1980s and 1990s

Deteriorating budget deficits and the lack of economic growth prompted a handful of economies in the region—including Jordan, Morocco, and Tunisia—to embark on programs of macroeconomic stabilization and structural reform in the mid-1980s. The programs aimed to restore macroeconomic balances and promote private sector-led development. By the late 1980s and early 1990s most governments followed suit, adopting some form of economic stabilization. Policies varied, but included cutting subsidies, reducing public spending, liberalizing trade, reforming exchange rate regimes, encouraging exports, easing restrictions on foreign investment, privatizing state enterprises, and strengthening the institutional foundations of a market-led economy, including consolidation of the rule of law. Many governments joined international trade-promoting institutions and signed trade agreements to spur the domestic economy.[20]

The use of vertical industrial policy diminished in MENA, but compared with other regions it has remained in place to a large extent. In the area of trade protection, tariffs in MENA countries have been slow to decline in contrast to the rapid decrease observed in other developing countries. In 2004, half of the countries in the region had average tariff protection[21] higher than that of developing countries as a whole. Ranking countries worldwide according to average tariffs revealed that on average, MENA countries are in the bottom 35 percent in terms of tariff protection, second only to sub-Saharan Africa[22] (see figure A1 in the Appendix).[23] Only in the last several years has the region achieved some progress in lowering barriers to trade. Non-tariff protection—which can constitute a variety of measures, including quantitative restrictions, rules for valuations of goods at customs, rules of origin, and price control measures—has been reduced, but it is today still higher in MENA countries than in most countries of Latin America, East Europe or South-Asia. According to IMF classification, only three countries show a low incidence of non-tariff barriers, namely Djibouti, Qatar and the U.A.E. while all others show either an intermediate or high incidence such as Syria, Iran and Libya (see tables A1 and A2).

---

[20] World Bank (2003c).

[21] Measured by un-weighted average tariffs.

[22] World Bank (2005b).

[23] Ibid.

Significant distortions in the tariff schedule continue to exist, especially in Iran, Syria, Tunisia, and Morocco (see table A1).

BOX 2. FINANCIAL SECTOR – ISLAMIC REPUBLIC OF IRAN

The banking sector in Iran remains essentially dominated by the state. There are 10 large state banks in Iran. Six of them are general commercial banks that take deposits from the public and make loans to both public and private sectors. The other four are specialist banks that lend to particular sectors: one lends exclusively to finance housing, a second lends to the agricultural sector, a third to industry and mining, and the fourth specializes in export finance. These four specialist banks obtain most of their funds from the general commercial banks, the central bank, and other public sources.

The instruments that banks can use for borrowing and lending are governed by a 1982 law on Islamic banking. The rates of return on both loans and deposits set by the central bank have been generally less than the rate of inflation over the last decade. The controlled lending rates vary with the term and the sector receiving the loan. Every large loan must be approved by the central bank, which also sets the minimum percentages of each bank's loan portfolio that must be lent to various broad sectors such as housing, agriculture, exports, and state-owned enterprises.

Source: World Bank (2003e).

Inefficiencies and distortions of financial sector policies became apparent and in many countries of the region reforms have taken place to liberalize financial systems, and in a limited number of cases even privatize them.[24] In fact, the financial system might well be the policy sphere that has experienced the biggest reduction in government intervention. All countries, Syria and Iran aside,[25] have unified their currency rates either before or in the early 1990s. Around the same time, most countries moved away from the administration of interest rates (see tables A3 and A4). But several MENA countries continue to use these distorted policies today. Access to credit by the private sector remains limited in Algeria, Iran, Libya, Qatar, Syria and Yemen, where the private sector receives less than 35 percent of all domestic credit extended (see table A5).

MENA countries also used subsidies as an active policy choice to support their industries (and consumers). Subsidies were greatly reduced as part of macroeconomic

[24] Jbili, Enders, and Treichel (1997).

[25] Iran in the early 2000s.

stabilization programs, cash subsidies to industries in particular were reduced by almost 50 percent. Nonetheless, the levels of subsidies remain high. Studies indicate that subsidies in the form of direct cash transfers to enterprises are significant in MENA countries, albeit not as high as the European Union or in Europe and Central Asia (see figure A2).[26] However, due to the difficulties of measuring subsidies (rates of effective protection and effective assistance are not easily available) cash transfers to industries may be only a weak proxy for the actual level of subsidies, which might be significantly higher.

Despite the MENA region's lack of success with industrial policy, transition from "bad" vertical industrial policies toward those that are more horizontal has proceeded slowly, especially in comparison to the transitions in other regions of the developing world such as Latin America and the Caribbean, East Asia and the Pacific, and in Europe and Central Asia. Several factors have contributed to this slow transition.

The first factor, perhaps ironically, has been the fact that the results of industrial policy have not been "bad enough." There is a line of thinking among those who study reform that deep economic reform movements only result from fundamental *change,* either from leadership change (regime change, or a shift in governing coalition); or from dramatic economic change—in other words economic crisis. In many Latin American countries, for example, economic reforms were undertaken only when the "economic conditions had deteriorated sufficiently so that there emerged a political imperative for better economic performance."[27] In other words, reform often is only adopted "once the possibilities of throwing money at the problem are foreclosed."[28] Crises elsewhere—Latin America in the early 1980s and Europe and Central Asia in the late 1980s—generated pressure for both political and economic change. As a result, countries in those regions moved from command to market economies with less state intervention.

---

[26] Schwartz and Clements (1999).
[27] Krueger (1993).
[28] Koromzay (2004).

BOX 3. STRATEGIC CROPS IN THE ARAB REPUBLIC OF SYRIA

One example that illustrates how industrial policy is used as an instrument for achieving both economic as well as social objectives is agriculture policy in Syria. Agriculture plays a key role in Syrian's economy by contributing substantially to domestic production, employment generation and export revenues. Like in many other countries in the world, the agriculture sector in Syria has been enjoying a high level of public protection and support. Interventions are targeted towards the crops that the government considers 'strategic', namely wheat, barley, lentils, chickpeas, cotton and sugar, either because they provide significant export earnings or ostensibly ensure food supply.

The case of cotton shows to what extent these interventions result in systemic distortions that are propagated throughout the economy. In order to protect farmers from price volatility, the government buys cotton from farmers above world market prices through its central marketing organization which subsequently exports it. While this is done at world market prices, the domestic industry is required to purchase cotton at the state fixed price without the chance to obtain cheaper imported cotton (high duties are levied on cotton imports). Consequently, cotton-based textile manufacturing has been deprived from taking full advantage of the low wage level in Syria which otherwise would have helped to develop a real comparative advantage in the textile industry. The government interventions in the agricultural sector have, thus, been counterproductive and hampered growth in the textile sector.

Source: FAO (2003) and World Bank staff.

The MENA region, although it has experienced a significant decline in growth and employment from the gradual exhaustion of its economic models, has not experienced economic crises in a systemic way.[29] The substantial revenues from oil, which declined throughout the 1980s and 1990s, remained large (and of late increased significantly), giving MENA governments and the public a temporary sense of economic health. This, along with foreign aid and strategic rents, has permitted MENA governments to maintain damaging vertical industrial policies.

Second, the slow pace of change in industrial policy in the region reflects either a lack of power among those interest groups who might be instrumental in lobbying for a move toward more horizontal industrial policy, or the gradual creation of privileged networks that are influencing policy to retain their rent-seeking capacity.

[29] Some countries in the region, like Jordan, have experienced deep economic crisis and as a result have moved forward the reform agenda at a faster pace than the region's average.

The private sector, rather than challenging the status quo, has adapted to the prevailing industrial policy that has protected state-owned enterprises. Private sector activity is concentrated in a small number of large firms that have benefited from protective policies, along with a number of micro-enterprises, which account for a large percentage of employment but have little access to formal finance, markets, or government support programs. This behavior of the emerging private sector has reduced the likelihood of faster reform and policy change.

Trade unions, which could also be an effective vehicle for change, are tightly controlled in the region and lack real independence from the political system. Thus, trade unions have not been effective in organizing the labor force to press for reforms. Trade union membership as a share of employment in MENA averages about 9 percent, compared to 34 percent in the OECD, 43 percent in Europe and Central Asia, and 15 percent in Latin America and East Asia. Only South Asia and sub-Saharan Africa have lower trade union membership.

The industrial export sector, which is highly competitive and would likely lobby for horizontal policies, is grossly underdeveloped and generally scattered among diverse product groups. A recent study examined the lobby power of the manufacturing sector[30] and found that MENA ranks last compared to the developing regions of the world (table 1).

Other groups that would benefit from more horizontal industrial policies that could stimulate growth and employment—the many young and educated who are unemployed,[31] small businesses and young entrepreneurs who seek to enter protected markets and have difficulty accessing finance, and small farmers—have limited ability to unite and lobby the government for change in industrial policy.

---

[30] Nabli, Keller, and Veganzones (2002). Lobby power is measured as an interactive between the size of manufacturing exports in total exports, and the share of manufacturing exports among the top four export categories at the 3-digit ISIC.

[31] Unemployment in the region, which averages about 15 percent of the labor force, is about 2-3 times higher for those under the age of 30.

Table 1. Lobby Power of the Manufacturing Export Sector, 2001

Country/Region	Lobby Power of the Manufacturing Sector
Bahrain	0.27
Algeria	0.01
Egypt	0.18
Iran	0.03
Jordan	0.14
Lebanon	0.35
Libya	0.00
Morocco	0.36
Oman	0.03
Qatar	0.06
Saudi Arabia	0.02
Syria	0.05
Tunisia	0.48
Middle East and North Africa	0.13
Sub-Saharan Africa	0.19
East Asia and the Pacific	0.34
Europe and Central Asia	0.42
Latin America and the Caribbean	0.31
South Asia	0.52
High Income/OECD	0.51

Source: Nabli, Keller, and Veganzones (2002).

For these groups to press for more horizontal policies, they require certain rights—access to information to formulate choices, the ability to mobilize, the ability to contest policies that are poor—which are only weakly present in the MENA region. Government information is not fully accessible to the public. Freedom of the press is carefully monitored and circumscribed in most countries. There are restrictions on civil society and the ability to contest government policies is weak. More generally, the MENA region suffers from fundamental weaknesses in governance, both in terms of inclusiveness, public accountability, and strength of civil society. In a ranking of more than 142 countries according to some 19 indicators of governance (both in terms of the quality of public administration and in terms of public sector accountability), the MENA region on average ranked in the bottom third of countries worldwide—lower than every other region of the world (see table A6). This has hindered the development of coalitions for

change and helped perpetuate ineffective policies. Analysis suggests that the existing political economy equilibrium favors the status quo of little or no public accountability and maintaining prevailing economic/industrial policies and networks of privilege. In such a situation industrial policy reforms are likely to come slow. Democratic reform may be able to change this state of affairs and generate a great political and economic transformation that could produce more democratic governments, more effective policies and more economic growth in the region (Nabli 2005).

The move toward horizontal policies is far from straightforward. It affects the balance of power between actors in society; at its core it involves finding the economic rents that have built up over the years and cutting them back and it attacks the economic privilege that some have enjoyed for generations. Thus, it is hardly surprising that MENA has found moving toward a more horizontal industrial policy a profoundly difficult task.

In many cases pre-reform economic elites have proven to be resilient to the reform process even when policy reforms were designed to reduce their rent-seeking opportunities—like those shifts aimed at moving toward horizontal industrial policy. The existing sectoral interests are better able to preserve their privileges, which leads to a passive industrial policy.[32] The governance structures did not help new pressure groups to emerge or move toward more effective reforms.

5. Where Does MENA Go From Here?

The claim that industrial policy is a thing of the past is largely exaggerated. Industrial policies continue to be used throughout the world, but their modalities and focus have been changing to reflect the reality of the new global economy and rapid technological change, as well as to acknowledge the costly mistakes made in the past with traditional industrial policy.

One of the greatest realizations is that vertical industrial policies almost always breed dependency. An "infant industry" seldom feels it has grown up and asks for

[32] As mentioned by Heydemann (2004) reforms in the MENA region as well as in other parts of the developing world have provided opportunities for the networks of privilege to survive. The elites continue to be elites in their sectors even after reform. In other regions privatization processes are good examples of where the networks of privilege exert their influence.

government support to stop.[33] Because of this, the modalities of industrial policy have to change. At the same time, there is practically no country in the world without an FDI promotion policy or an export-oriented focus—a clear signal that industrial policy is alive and well.

The challenge for MENA in the 21st century is to recognize that the kinds of industrial policy needed in the current international setting are clearly different from the traditional forms of inward-looking paternalist-state industrialization strategies of the past. What MENA needs is not more industrial policy but better, more sensible industrial policy. This may imply reducing the scope of intervention in the region. But it also implies moving away from vertical to horizontal policies, and from "choosing winners" (or more often "protecting losers") to policies that make sense in the current global environment. There is therefore a compelling argument for MENA to reconsider the types of industrial policies it uses. The rapid growth in information and communication technologies, the acceleration of technical change and the intensification of global integration require countries to focus on efficiency gains in the value chain. Economic development is increasingly linked to the economy's ability to acquire and adapt new technical and socio-economic knowledge. Comparative advantages are coming less from abundant natural resources or cheaper labor, and more from technical innovations and the competitive use of knowledge. Moreover, the speed with which economies are able to disseminate and apply knowledge increasingly determines its level of competitiveness and its chances of succeeding in the global arena.

MENA countries, like other developing countries in the world, operate in an environment that is much different than two or three decades ago. The global crises of the 1980s and 1990s led to the tendency to impose greater discipline in national economies. External mechanisms including multilateral, regional, and bilateral agreements, structural adjustment programs, and political pressure from the industrialized world, have all reduced the scope of industrial policies that MENA countries can use. Developing countries are members of a number of international organizations and have signed agreements that limit the countries' capacity to use distortionary policies to promote

[33] Krueger (1993).

particular sectors. For example, the new formal trade rules under the auspices of the World Trade Organization (WTO) limit selective interventions in trade; Basel core banking principles restrict direct lending; articles of agreement with international financial institutions impose market driven pro-competition policies in a large array of areas, eliminating or reducing food subsidies, trade distortions, restrictions on FDI, and regulating the use of monetary, foreign exchange, and fiscal policies; free trade agreements eliminate tariff barriers and non-tariff barriers, enforce intellectual property rights and regulate rules of origin and services; and codes of conduct increase transparency and accountability. All these external pressures are shaping the changes in MENA's industrial policies.

Internal forces are also playing a role in reshaping MENA's industrial policies. Although the region has not suffered from the deep crises that forced other developing regions in the world to move rapidly out of their traditional industrial policies, the picture in the MENA region is not homogeneous. Wealth has allowed the oil-rich economies of the region to slow down the pace of reforms. However, in countries like Jordan, Morocco and Tunisia, reforms have moved faster. Other internal forces are also putting pressure on the status quo. The growth and employment challenges that MENA countries are facing—in light of the region's demographic transition—are rapidly revealing the weaknesses of MENA's economic model. Industrial policies are failing to generate the promised results, and the social contract is not being honored. Several factors are intensifying the need for reform, including labor market pressures, rising expectations for improved standards of living, and the need for efficient production models that will allow the region to deal with competition from world markets.

In addition, the MENA region is facing socio-political pressures to improve inclusiveness and accountability, as well as to increase the transparency and contestability of public policy. These forces are manifested in public demands for greater individual and social freedoms, more democratization through open and fair electoral processes, greater female participation in the social sphere, better public services, and enhanced public sector governance. These internal forces are also shaping the path of MENA's reforms and the future of its industrial policies.

But how is MENA going to move from the policies of the past to the policies of the future? The processes that will determine the path of change is likely to depend on each country's initial conditions and individual political economy factors. All roads may lead to Rome, but which road each MENA economy takes is an open question. The priorities for change in policies, industrial or otherwise, vary with resource endowments, governance institutions and reform progress to date, as will the paths to the target.

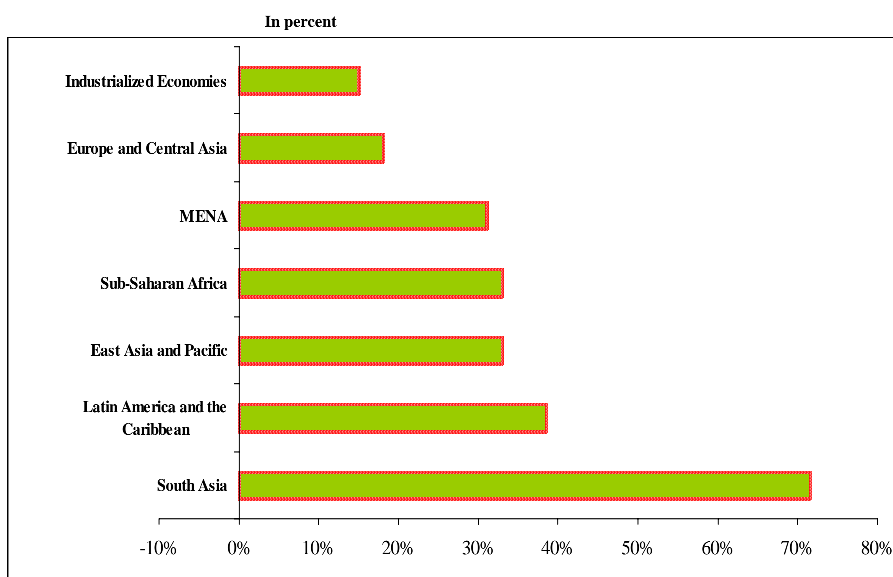
From the political economy point of view, differences in economic performance across countries can be explained by imperfections in electoral markets—such as uninformed voters, non-credible political competitors, and social polarization—which make it difficult for citizens to hold politicians accountable for policies and outcomes. These imperfections offer powerful insights into the development of particular (industrial) policies and the underperformance of many economies.

Clientelism is a dominant characteristic of public policy in many countries. One explanation for its existence derives from the struggle to make credible promises to citizens. Patron-client relations drive politicians to focus on targeted favors and goods rather than broad public goods and effective public policy: insofar as only clients believe patron promises (given the absence of well-developed political parties, for example), political competition mainly concerns targeted transfers to clients rather than public policy issues more generally (World Bank 2005c).

Given the complexity of MENA's political economy, political market incentives must be changed in favor of better policies. One avenue is through governance reform. The imperfections in political markets can be reduced, but require improving the availability of information, transparency, checks and balances, accountability, space for civil societies, and contestability of the political market. These elements are needed for improved governance and could increase the likelihood of effective design and implementation of public policies, including industrial policies, and that could lead to better economic outcomes for the region.

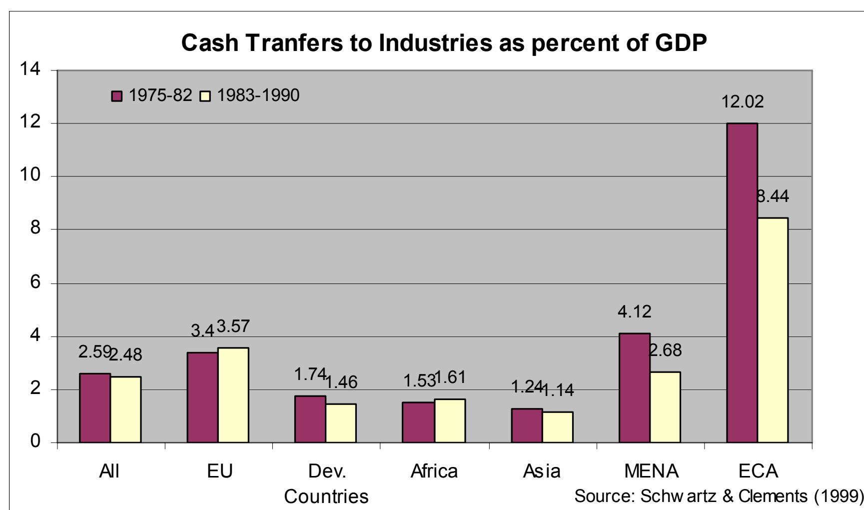
DATA APPENDIX

Figure A1: Average nominal tariffs by region, 1980-85



Source: World Economic Forum, Arab World Competitiveness Report 2002-2003.

Figure A2. Cash Transfers to Industries



Note: Based on SNA database, national authorities and authors' calculation. The category 'developing countries' does not include Israel and South Africa, although they are included in their geographical country groups. Here, subsidies are defined as cash-transfers to industries.

Table A1. Current Average Tariffs and Standard Deviation for Selected Countries

	Average Tariff	Standard Deviation		Average Tariff	Standard Deviation
MENA			**High-Income**		
Algeria (2003)	18.63	10.37	European Union	4.4	5.5
Djibouti (2002)	30.71	7.65	Japan (2004)	3.13	7.06
Egypt, Arab Rep. (2002)	19.88	16.19	United States (2004)	3.7	11.27
Iran, Islamic Rep. (2004)	19.88	20.14	**Africa**		
Jordan (2003)	13.7	16.1	Nigeria	27.21	23.51
Lebanon (2002)	6	10.75	South Africa (2001)	8.15	11.62
Morocco (2003)	28.87	20.25	**Asia (EAP +SA)**		
Saudi Arabia (2004)	6.11	6.65	China (2004)	10.46	7.92
Syrian Arab Republic (2002)	14.64	21.6	India (2004)	29.02	13.79
Tunisia (2004)	25.96	26.81	Indonesia (2004)	7.05	15.53
Yemen (2000)	12.78	6.06	Malaysia (2003)	8.48	21.07
LAC			**EUROPE AND CENTRAL ASIA**		
Argentina (2004)	12.64	7.58	Hungary (2002)	9.5	13.49
Bolivia (2004)	9.28	2.5	Poland (2003)	13.39	32.14
Brazil (2004)	13.57	6.79	Russian Federation (2002)	9.62	5.13
Chile (2004)	5.99	0.71	Turkey (2003)	7.11	20.22
Mexico (2004)	17.43	14.99			

Source: UNCTAT (2005).

Table A2. Ranking of Non-Tariff Measures, 1999

Low Incidence	Intermediate Incidence	High Incidence
	Algeria	Syria
Djibouti	Egypt	Iran
Qatar	Jordan	Libya
U.A.E.	Kuwait	
	Lebanon	
	Morocco	
	Oman	
	Saudi Arabia	
	Tunisia	

Source: Oliva (2000), according to IMF classification.

Table A3. Overview of Exchange Rate Systems in MENA Countries

Country	Exchange Rate System	Exchange Rate Structure	Exchange Tax/Subsidy
Algeria	Managed Float	Unified	No/No
Djibouti	Currency Board	Unified	No/No
Egypt	Managed Float	Unified	No/No
Iran	Managed Float	Unified	No/No
Iraq	Peg	Unified	No/No
Jordan	Peg	Unified	No/No
Lebanon	Peg	Unified	No/No
Libya	Peg	Unified	No/No
Morocco	Peg	Unified	No/No
Saudi Arabia	Peg	Unified	No/No
Syria	Peg	Multiple	No/No
Tunisia	Managed Float	Unified	No/No
UAE	Peg	Unified	No/No
Yemen	Independent Float	Unified	No/No

Source: IMF (2005).

Table A4. Overview of Interest Rates and Credit Controls in MENA

Country	Interest rate Liberalized?	All credit controls Removed?	Notes
Algeria	Yes, *de jure*.	Yes, *de jure*. Ceilings removed in 2000.	Interest rates were liberalized in 1990 (as well as deposit rates and ceilings on lending rates).
Bahrain	Yes	Yes.	
Djibouti	Yes	Yes	
Egypt	Yes, *de jure*.	Yes	Interest rates were liberalized in 1991.
Iran	No	No	Through the lending instruments of the state-owned banks credit allocation is decisively used to support certain sectors in Iran's economy. The lending instruments that banks can use are governed by a 1982 law on Islamic banking with the rates of return on both loans and deposits set by the central bank, generally less than the rate of inflation over the last decade. The controlled lending rates vary with the term and the sector receiving the loan. Every large loan must be approved by central bank, which also sets the minimum percentages of each bank's loan portfolio. The preferred sectors are, roughly speaking, agriculture and housing before export, industry, and trade and services.
Jordan	Yes	Largely. Preferential credit facilities remain for agriculture, handicrafts and export sectors	In the early 1990s Jordan fully liberalized interest rates. In 1993, the Central Bank of Jordan moved away from direct instruments of monetary control by issuing its own certificates of deposit to mop up excess liquidity. In 1996, the central bank's rediscount subsidies and preferential credit facilities were eliminated, except for small specialized banks that extended credit to the agricultural, handicrafts, and export sectors.

Table A4. Overview of Interest Rates and Credit Controls in MENA (continued)

Country	Interest rate Liberalized?	All credit controls Removed?	Notes
Lebanon	Yes	Yes	
Morocco	Yes	Yes	Steady steps of liberalization and elimination of credit subsidies since the1980s. Interest rates liberalized in 1991, full liberalization of ceilings etc. by 1996.
Qatar	Yes	Yes	Specialized banks offer subsidized loans to small companies.
Saudi Arabia	Yes	Yes	
Syria	No	No	Until interest rates were adjusted in 2003, the bank's discount interest had remained unchanged at 7-9 percent since 1981 (7 percent for the public sector) irrespective of liquidity conditions or inflation. As a result, real interest rates were negative in times of high inflation (over much of the 1980s and until 1995, when inflation averaged 19 percent), and very high for much of the rest of time, particularly in the late 1990s when prices were contracting. Lending priority is given to the public sector, with many loans often insufficiently serviced by public institutions. Private companies often find it difficult to obtain loans through the banks, and resort to the unofficial market (or offshore banks) where rates are often as high as 20 percent.
Tunisia	Partial. Some deposit rates remain regulated.	Yes, *de jure*. However, lending is still encouraged to certain sectors through preferential *access*.	Gradual liberalization except for interest rates on lending in priority sectors. In 1987, interest rates on short term deposits were liberalized. Lending rates, except for those to priority sectors, were allowed to be set freely within a set of 3 percentage points above TMM. In 1990, preferential rates for all priority sectors were increased, albeit only moderately for agriculture. In 1994 and 1996, interest rates were liberalized for all sectors.
UAE	Yes	Yes.	
Yemen	Partial	A minimum benchmark rate for saving deposits is set administratively.	

Source: Creane et al. (2004).

Note: Authors' notes based on various World Bank resources.

Table A5. Share of Domestic Credit Directed to the Private Sector, 2003

Country/Region	Share of Domestic Credit (%)
Algeria	11.5
Iran	35.4
Syria	10.1
Yemen	6.9
Libya	18.0
Egypt	61.5
Jordan	71.7
Lebanon	82.0
Morocco	55.1
Tunisia	69.0
Saudi Arabia	58.2
United Arab Emirates	55.9
Bahrain	65.4
Oman	38.6
Kuwait	73.8
Qatar	30.5
Middle East and North Africa	55.3
Latin America and the Caribbean	30.5
South Asia	31.7
Europe and Central Asia	45.6
Sub-Saharan Africa	73.8
High Income/OECD	123.0
East Asia and the Pacific	137.9

Source: World Bank World Development Indicators online (August, 2005). Regional averages weighted by total domestic credit.

Table A6. Governance Indicators in MENA

Country	Quality of public administration	Public sector accountability	Overall governance
Algeria	44.1	42.3	42.5
Bahrain	..	37.2	..
Djibouti	..	..	..
Egypt, Arab Republic	46.1	38.3	40.9
Iran, Islamic Republic	37.2	36.5	35.9
Iraq	..	..	..
Jordan	54.7	53.1	53.1
Kuwait	51.1	44.8	47.2
Lebanon	..	..	..
Libya	34.5	7.7	17.5
Morocco	57.8	47.9	51.1
Oman	51.7	32.8	40.6
Qatar	..	31.0	..
Saudi Arabia	50.8	21.0	32.6
Syrian Arab Republic	37.0	25.8	29.7
Tunisia	58.4	37.1	44.3
United Arab Emirates	51.1	33.6	40.8
West Bank Gaza	..	..	..
Yemen, Republic	40.6	34.8	36.5
MENA	**47.3**	**35.1**	**39.4**
Sub-Saharan Africa	42.6	55.1	49.1
East Asia and the Pacific	43.1	57.3	50.6
Europe and Central Asia	49.0	69.5	60.3
Latin America and Caribbean	47.4	75.7	63.3
OECD	79.6	97.5	90.2
South Asia	47.2	58.2	52.9
LMIC (excluding MENA)	**45.7**	**61.1**	**53.9**

Source: World Bank staff calculations.

Notes: Governance indices range from 0-100; higher values reflect better governance standing compared with other countries. Regional and sub-regional aggregates are simple averages of relevant country values. The indices are constructed using principal component analysis (PCA), an aggregation technique designed to linearly transform a set of interrelated variables into a new set of uncorrelated principal components which account for all the variance in the original variables. LMIC refers to low and middle income countries.

REFERENCES

Auty, Richard M. 2004. Economic and political reform of distorted oil-exporting economies. Paper prepared for the workshop "Escaping the Resource Curse: Managing Natural Resource Revenues in Low-Income Countries" held at the Center for Globalization and Sustainable Development, The Earth Institute at Columbia University, February 26th.

Borensztein, Eduardo, and Jong-Wha Lee. 2005. Financial reform and the efficiency of credit allocation in Korea. *Journal of Policy Reform* 8, no. 1: 55–68.

Creane, Susan, Rishi Goyal, A. Mushfiq Mobarak and Randa Sab. 2004. *Financial development in the Middle East and North Africa*. IMF Working Paper, no. 04/201. Washington, D.C.: International Monetary Fund.

FAO (Food and Agriculture Organization). 2003. *Syrian agriculture at the crossroads*. Agricultural policy and economic development, no 8. Rome, Italy: FAO.

Galal, Ahmed, and Nihal El-Megharbel. 2005. *Do governments pick winners or losers? An assessment of industrial policy in Egypt*. Working Paper, no.108. Cairo, Egypt: The Egyptian Center for Economic Studies.

Hellman, Joel S. 1998. Winners take: The politics of partial reform in postcommunist transitions. *World Politics* 50 (January): 203-234.

Heydemann, Steve. 2004. *Networks of privilege in the Middle East: The politics of economic reform revisited.* New York: Palgrave MacMillan.

International Monetary Fund (IMF). 2005. *Annual Report on Exchange Arrangements and Exchange Restrictions*. Washington, D.C.: International Monetary Fund.

Jbili, Abdelali, Klaus Enders and Volker Treichel. 1997. *Financial sector reforms in Morocco and Tunisia. Finance and development*. IMF Working Paper, no. 97/81. Washington, D.C.: International Monetary Fund.

Koromzay, Val. 2004. *Some reflections on the political economy of reform*. Paper presented at international conference on Economic Reforms for Europe: Growth Opportunities in an Enlarged European Union. Bratislava, Slovakia, March 18.

Krueger, Anne. 1993. *Political economy of policy reform in developing economies*. Cambridge, MA.: MIT Press.

Muller-Jentsch, Daniel. 2005. *Deeper integration in trade services in the Euro-Mediterranean region: Southern dimensions of the European Neighborhood Policy*. Draft Working Paper. Washington, D.C.: The World Bank.

Nabli, Mustapha K., Jennifer Keller and Marie-Ange Veganzones. 2002. *Exchange rate management within the Middle East and North Africa region: The cost to manufacturing competitiveness*. Working Paper 2004, no. 1. Beirut: American University of Beirut.

Nabli, Mustapha K. 2005. Restarting the Arab economic reform agenda. *The Arab World Competitiveness Report 2005*. World Economic Forum. Houndmills: Palgrave MacMillan.

Noland, Marcus, and Howard Pack. 2003. *Industrial policy in an era of globalization: Lessons from Asia*. Washington, D.C.: Institute for International Economics.

_____. 2005. *The East Asian industrial policy experience: Implications for the Middle East*. Washington, D.C.: Institute for International Economics.

North, Douglass C. 1990. *Institutions, institutional change and economic performance*. New York: Cambridge University Press.

Oliva, Maria Angels. 2000. *Estimation of trade protection in Middle East and North African countries*. IMF Working Paper, no. 00/27, Washington, D.C.: International Monetary Fund.

Olson, Mancur. 1971. *The logic of collective action: Public goods and the theory of groups*. Cambridge, MA.: Harvard University Press.

_____. 1982. *The rise and decline of nations. Economic growth, stagflation, and social rigidities*. New Haven: Yale University Press.

Pack, Howard. 2000. Industrial policy: Growth elixir or poison? *The World Bank Research Observer* 15, no. 1: 47-67. Washington, D.C.: The World Bank.

Rodrik, Dani. 2004. *Industrial policy for the twenty-first century*. Unpublished paper. Harvard University. Available at: http://ksghome.harvard.edu/~drodrik/UNIDOSep.pdf

Schwartz, Gerd, and Benedict Clements. 1999. Government subsidies. *Journal of Economic Surveys* 13, no. 2: 119-147.

UNCTAT (United Nations Conference on Trade and Development). 2005. Trade Analysis and Information System (TRAINS) database. Available at: http://r0.unctad.org/trains/

Waterbury, John. 1993. *Exposed to innumerable delusions: Public enterprise and state power in Egypt, India, Mexico and Turkey*. New York: Cambridge University Press.

World Bank. 1966. *Tunisia - second societe nationale d'investissement project*. Staff appraisal report. Washington, D.C.: The World Bank.

_____. 1969.*Tunisia - third societe nationale d'investissement project*. Staff appraisal report. Washington, D.C.: The World Bank.

_____. 1971. *Tunisia - fourth societe nationale d'investissement project*. Staff appraisal report. Washington, D.C.: The World Bank.

_____. 1972.Tunisia - fifth societe nationale d'investissement project. Staff appraisal report. Washington, D.C.: The World Bank.

_____. 1975. *Algeria - industrial credit project*. Staff appraisal report. Washington, D.C.: The World Bank.

_____. 1990. *Egypt - tourism project*. Project completion report. Washington, D.C.: The World Bank.

_____. 1993. The East Asia miracle: Economic growth and public policy. New York: Oxford University Press.

_____. 2003a. *Unlocking the employment potential in the Middle East and North Africa: Towards a new social contract*. MENA Development Report .Washington, D.C.: The World Bank.

_____. 2003b. *Trade, investment, and development in the Middle East and North Africa: Engaging with the world*. MENA Development Report. Washington, D.C.: The World Bank.

_____. 2003c. *Jobs, growth and governance in the Middle East and North Africa*. MENA Development Report. Washington, D.C.: The World Bank.

_____. 2003d. *Knowledge economies in the Middle East and North Africa. Toward new development strategies*. Washington, D.C.: The World Bank.

_____. 2003e. *Iran: Medium term framework for transition. Converting oil wealth to development*. Country economic memorandum. Washington, D.C.: The World Bank.

_____. 2005a. *Technology and growth series: Chilean salmon exports*. PREM Notes no. 103. Washington, D.C.: The World Bank.

_____. 2005b. *MENA economic developments and prospects 2005: Oil booms and revenue management*. Washington, D.C.: The World Bank.

_____. 2005c. *Economic growth in the 1990s: Learning from a decade of reform.* Washington, D.C.: The World Bank.

World Economic Forum. 2003. *Arab World Competitiveness Report 2002-2003*.