Economic Transition in the Middle East

Global Challenges and Adjustment Strategies

edited by
Heba Handoussa

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The American University in Cairo Press

First published in 1997 by
The American University in Cairo Press
113 Sharia Kasr el Aini
Cairo, Egypt
http://aucpress.com

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for the Arab Countries, Iran and Turkey

Second printing 2000

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Economic Research Forum for the Arab Countries, Iran and
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Dar el Kutub No. 11801/96
ISBN 977 424 428 1

Printed in Egypt

Preface

This volume brings together a number of studies on the major issues of adjustment as they apply to countries of the Middle East and North Africa (MENA). The selection of chapters is based on papers presented at a conference organized by the Economic Research Forum and held in Rabat in 1995, as well as at an earlier conference organized in 1992 by the American University in Cairo.

The authors draw on economic, political and institutional theory in order to appraise and compare development models, identify the determinants of sustained growth, apply the new development concepts to the case of MENA countries, and suggest viable options to reduce the political and social constraints to reform.

The first chapter of the book presents a review of the global context and domestic setting in which MENA countries are attempting to liberalize their economies, with a summary of the arguments and policy-related results presented by the contributing authors.

In the second part of the book, three papers address the key questions posed by the process of globalization, deregulation, privatization and institutional reform, with a focus on the adjustment and liberalization efforts needed in countries of the MENA region. Another two papers analyze the experience of Southeast Asian success stories, drawing some key policy lessons of relevance to developing countries.

The third part of the volume provides a critical analysis of the status of adjustment and liberalization in eleven MENA countries, with a focus on the comprehensiveness and speed of the state's disengagement from economic activity and on the political economy of reform. The final chapter gives a detailed assessment of the past performance and future options for industrial policy in the context of liberalization, using Egypt as a case study and comparing its experience with that of South Korea and other successful Southeast Asian countries.

Four sets of issues are vividly highlighted throughout the book: the issue of integration into the global economy and the speed with which foreign trade should be liberalized; the issue of divestiture and the merits of following various privatization strategies; the issue of state intervention in the context of liberalization and private sector orientation; and the issue of democratization and the political economy of reform.

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Part I.

Introduction and Overview

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Adjustment and Beyond: The Middle East in Transition

Is there a new development paradigm? The growth record of over 100 developing countries over the past two decades is witness to the failure of development strategies based on either the neoclassical or socialist growth models, with a widening gap between North and South and almost one-third of the developing world's population (over one billion people) still living below the poverty line. Neoclassical theory would seem to have assumed as exogenous parameters those very variables (knowledge and institutions) that can be manipulated to enhance the process of "catching up," while socialist models have overstated the role that the state can play in simulating the work of the market mechanism. It is also difficult to explain the success of any of the blends falling between the extreme poles of capitalist and socialist models, either by looking at the degree of openness alone, the degree of state ownership alone, or the degree of concentration of market power. What is therefore at stake for developing countries is identifying the proper blend – in other words, identifying the appropriate nature and degree of state intervention, as well as the correct pace of liberalization.

The new development economics consists of attempts to incorporate elements of institutional and historical analysis, industrial organization, law, as well as political and social theory in order to specify those conditions under which sustainable growth can be achieved. The interdisciplinary approach of the new development economics is promising in that it better recognizes the constraints and understands the links between free market mechanisms and positive interventions of the state so as to go forward in suggesting a new development paradigm. The new approach includes focusing on the institutional role of the state, revising the notions of market failure and of comparative advantage, and highlighting the returns from investment in education and from the promotion of traditional and informal sector activities.

The spectacular growth performance of a growing number of East Asian economies has given added impetus to the search for a new development paradigm. Although a consensus now exists on some of the common elements to the strategies pursued by these newly-industrializing economies, other elements are still subject to varying interpretation and heated controversy. The East Asian experience has provoked renewed interest in the nature of state intervention to promote sustained growth, as well as in the specific mode of promoting outward orientation and integration into the global economic system. In contrast to the rich ground provided by the Southeast Asian region for investigating sources of success is the equally important experience of

Eastern Europe from which to draw lessons on sources of failure. For MENA countries, a common legacy of heavy state involvement, whether in the etatist or patrimonial tradition, makes the comparative analysis of special value.

Globalization – that is, the increase in the level of integration of the world economy – is another exciting and promising process that is unfolding at the turn of the century, and could provide the avenue for catching up by developing countries. It brings a glimpse of hope that convergence may actually materialize in the twenty-first century, as the pattern of exchange moves away from the zero-sum games of exploitation by the North to mutually beneficial trade and investment activities that favor the South. Projected rates of growth of world trade are at six percent over the coming decade, rates that are higher than the peak levels achieved in the 1960s, and the developing world's share in world exports of manufactures has reached 24 percent, up from only five percent in 1970. Foreign direct investment (FDI) has been growing at an even faster pace than trade, with the proportion flowing to developing countries also rising from 20 percent in the 1980s to 37 percent in the first half of the 1990s.

The accelerating pace of globalization is driven by three equally powerful forces that are transforming the international economic order: the revolution in information and communications technology, the liberalization of trade within and across regions, and the emergence of Third World competitors in the high value-added industries. Each of these factors has created new opportunities for individual developing countries to capture a share of the growth in world trade and FDI and to access new technologies. Countries with sufficiently advanced human resources can acquire an edge in the international market by competing in process technology, by adopting better organization methods, and by taking advantage of their lower wage rates. Technological progress has also reduced the advantage of vertical integration and Fordist mass production that favored the operation of oligopolistic transnational corporations (TNCs), and they are fast shifting towards flexible production systems, cooperative networks and strategic alliances, all of which give advantages to decentralization, outsourcing and relocation in developing countries. Globalization is also good for resource-poor countries because of the reduced importance of natural resources and physical capital as inputs in the new growth industries.

Yet, the recipe for seizing these new opportunities is far from simple, and the obvious threat is that failing to harness the means for integrating into the global economy implies growing marginalization and poverty.

On the down side, globalization will have large opportunity costs for those developing countries that are unable or unwilling to reform their institutional environment, liberalize their markets or create investment environments that

are conducive to private sector innovation and to the attraction of FDI. These countries stand to lose their existing position in the global economy on account of all three of the new dynamic forces at work: the technological revolution, the liberalization of world trade, and the emergence of new competitors from the developing world. The first factor will mean a growing productivity gap for countries that opt to ignore the globalization process, while the second and third ones will result in the erosion of their traditional export markets.

In reviewing the consequences of the globalization of production and the new international order, Raed Safadi identifies the key features of the fast changing external environment that faces MENA countries. Traditional controls on the cross-border movement of information and know-how are no longer possible, while those on goods are increasingly counter-productive. The nature of technological innovations is rendering many domestic regulations obsolete and costly and is making the nationality of firms largely irrelevant, especially because of the "blurring of the old distinctions between trade and investment as alternative means of securing access to markets."

The author views the accession of MENA countries to the World Trade Organization (WTO) as an important opportunity to establish international discipline which can bring economic, political and social benefits. While locking in domestic reform elements, accession will also create expanded market opportunities and provide the basis for greater stability in each country's international relations. The major benefits that the author predicts are in promoting a liberal institutional climate, avoiding trade diversion, and the displacement of FDI as emerging locational substitutes become more attractive in the eyes of TNCs.

Safadi also reviews the trends in FDI to developing countries which – as part of the process of globalization – has increased from an annual average of US$20 billion in 1983 to US$84 billion in 1994. The fact that the proportion flowing to MENA countries has declined sharply from a high of ten percent in 1989 to half of that level in 1992 is largely explained by the accelerated growth of host country markets and by their adoption of policies to encourage exports. The author considers that laws governing FDI in most MENA countries were relatively restrictive until the 1980s, and that certain sectors such as services continue to be highly regulated. The result is that only two countries from the MENA region – Egypt and Tunisia – made the list of top 18 host developing countries in the decade up to 1992. Safadi warns of the dire consequences for countries that opt to delink from the globalization process and makes a strong case for the MENA region to adopt the "deep integration" option, which targets the creation of truly contestable markets, by adopting a comprehensive approach of liberalization of trade and foreign investment as

well as the harmonization of national policies and institutions with those of the international market. The reach of reforms would thus "encompass competition policies, government regulations, procurement practices, technology policies, and corporate governance."

The chapter by Byron Gangnes and Seiji Naya reviews the elements that are common to the experience of Southeast Asian success stories and their relevance to developing countries. The authors discredit the notion of inherent characteristics such as cultural factors, savings performance or work ethics as responsible for sustained growth. On the other hand, the stress on education, outward orientation, domestic competition and the building of a national consensus are highlighted as important ingredients to success, along with conservative monetary and fiscal policies. The authors also argue that the diversity in resource balance and political regimes among the countries in question is evidence of the low importance that should be attached to those elements as part of the set of necessary conditions for success. The implication is that good economic management and the sequencing of priorities in targeting public expenditure is one essential precondition for success. This sequencing has in all cases given precedence to formal primary education, with an aggressive program to achieve universal enrollment and eradicate illiteracy, followed by the rapid growth in secondary and university education. Equally aggressive has been the drive to promote exports by using a wide range of incentives, including a flexible exchange rate, so as to ensure continued international competitiveness. Outward orientation has made it possible to balance protection of the domestic market (via import controls) with competition and dynamism at home, obtained by exposing firms to the discipline of the international market.

One common feature of these Asian success stories is the ability of macroeconomic management to stabilize economies and maintain fiscal and structural balance, an essential ingredient for sustained growth. In their chapter, Amar Bhattacharya and John Page compare the pattern of growth, investment, productivity change and exports in the group of eight high-performing Asian economies (HPAEs) with that of other developing countries and then proceed to analyze the relative supply response to adjustment for each group. Even though HPAEs were more vulnerable than other developing countries to the external shocks of the 1970s and early 1980s, they were able to achieve a substantial and more rapid improvement in fiscal balance as well as to support an increase in public investment during adjustment. In contrast to most developing countries which experienced growing internal and external deficits and inflation throughout the 1980s, HPAEs were successful in restoring fiscal and current account balance by the mid-1980s, mainly by having a strong public savings performance based on fiscal restraint and improvements in public

resource mobilization. Early success in stabilization in turn made it possible to resume growth in investment and exports, as evidenced by GDP growth rates which were far superior to those of other developing countries in the second half of the 1980s.

The analysis points to three elements which provided the engine for recovery from adjustment with minimal adverse effects, the same three elements which contributed to the superior long-run growth performance of HPAEs: manufactured export growth, productivity growth and the behavior of public investment during adjustment. The relatively high share of manufactured exports in HPAEs meant that structural adjustment which moved incentives in favor of exportables had immediate results in stimulating private investment in manufactured exports, largely due to confidence among exporters in the likely success of their export efforts. The productivity-driven nature of these economies provided a cushion to initial shocks and allowed more flexibility in adjustment policy. The anticyclical behavior of public investment was such as to support growth while maintaining fiscal discipline via significant reductions in current expenditure.

In his chapter, Jeffrey Nugent argues that the external environment needed for the success of outward-oriented reforms (OORs) is less favorable now than in the 1950s or 1960s, mostly because many more developing countries are undergoing OORs and their debt is much larger. However, unfavorable conditions on the global front work at the level of developing countries as a whole and do not necessarily apply in full force to any one particular exporter. This is why we can see a repeat performance of the first generation of Asian "Tigers" in a newly-emerging generation and in China. If we assume that OOR is the target, then what internal environment is necessary? Conditions relating to the domestic economy include fiscal balance and monetary stabilization to avoid the growth in public debt and to prevent inflation. Stabilization and adjustment are all the more difficult in countries whose foreign currency inflows are strongly linked to natural resource endowments, capital transfers or remittances – the case of MENA countries – since policymakers will not feel the pressure to adjust to adverse external shocks (the Dutch Disease syndrome).

On the domestic front, however, institutional conditions and aspects of political economy can be a far more serious constraint to OORs than poor macromanagement and can work to prevent the required mobility of capital and labor that is necessary in order to achieve export growth. Opposition from well-organized public and private sector management and workers in import-competing industries is likely to be formidable as compared to favorable collective action on the part of interest groups such as traditional and non-traditional exporters who stand to gain from OOR. On balance, the bureaucracy

itself and international agencies would have to put in their weight in order for OORs to be implemented with any vigor. When difficulties arise because the domestic market is not growing as fast as the capacity of new investors and existing producers, coalitions are likely to form to demand OOR. This process can be facilitated by democratic rules which allow communication and political exchange, in contrast to autocratic regimes. The dynamics of coalition formation involves significant interdependencies among existing and potential members of the coalition favoring OOR and imply that externalities are present, thereby justifying the use of selective incentives so as to encourage more groups to join the reform coalition. In addition, OORs will be more successful when state agencies are run by merit-oriented technocrats instead of loyalty-oriented politicians and when the system provides appropriate rewards and penalties to individual bureaucrats.

The state can also play a valuable role in OOR by assigning an independent, informed and objective monitor to assess the effort and performance of OOR. Monitoring – a public good – is likely to be undersupplied or difficult to undertake due to the underlying asymmetries of information. In developing countries, such competent institutions as think tanks, research institutes and universities are less well-developed, and the monitoring problem is therefore likely to be considerably more difficult to solve. Unfortunately, "the ability of inward-oriented ISI [import-substitution industrialization] to survive long periods of time in the face of poor and generally declining performance is a matter of record. Because of the state's large role in both the creation and monitoring of OOR, unless so specified constitutionally and/or with truly independent agencies and penalties to be imposed by the citizenry, the state is unlikely to have the incentive to penalize itself."

Giacomo Luciani's chapter draws attention to the many constraints that face developing countries in attempting to divest the state of its enterprises and warns that even though divestiture may have worked – if not smoothly – in Western Europe, the configuration of narrow capital markets, limited domestic savings and the inherent conflict in transferring public monopolies to private control will all make divestiture far more difficult to handle in developing countries. The scope, speed and methods of privatization are thus critical variables in achieving a successful program.

The author argues that the bottom line is to recognize that any privatization scheme consists of an exchange of assets rather than the absorption of incremental savings. Since aggregate private wealth is limited, wide-scale privatization will often necessitate the sale of public assets to foreign investors. Therefore, the strategy should be to find the optimal combination of ownership between the state, domestic and foreign capital. Since large-scale sales to foreign investors are unlikely to be politically acceptable, state-owned enterprises

(SOEs) are likely to remain for many decades into the future. Every effort should thus be made to maximize their efficiency and performance. Moreover, the state which is pursuing privatization is in most cases facing a fiscal crisis, and SOEs need to be recapitalized before they are privatized. An important conclusion is that an essential prerequisite to privatization is to reorganize SOEs under holding companies so as to first raise their efficiency and allow a transparent system of evaluation to expose those that are not viable. Another prerequisite is to liberalize the trade regime and deregulate – especially prices – so as to maximize competition. Although political interference cannot be expected to disappear, more autonomy must be given to public enterprise managers so as to allow the potential benefits of those efficiently-run companies to materialize.

Rather than eliminate state ownership altogether, Luciani proposes a flexible strategy of state involvement that continuously redefines the boundary between the state, private domestic and foreign capital. He sees that the first and most urgent form of privatization is not in actual ownership, but rather in the legal regime imposed on SOEs. Privatization should begin with activities to which the private sector is likely to be attracted, such as real estate, smaller enterprises in industry and services, and activities that offer a guaranteed rate of return. The author observes that the shares of public utilities should prove far more stable to individuals and enterprises in the private sector than large-scale capital-intensive manufacturing plants, especially those with a past record of losses. The state will find it far easier to regulate privately-owned monopolies and to devise appropriate divestiture mechanisms in the utilities sector than in the industrial sector.

The author's vision for the future is one in which the dichotomy between public and private has lost much of its present sharpness and global partnerships emerge in which multiple companies from different countries participate in joint ventures. The role of SOEs can thus be allowed to continue along a reformed path where they are principal agents of dynamic change, having shed their obsolete mantle of upholding nationalism, equity, or self-sufficiency.

In his chapter on etatisme versus privatization, Nazih Ayubi argues that excessive etatisme in the Arab world from the mid-1950s to the mid-1980s has largely hindered the process of national development in these countries. Policies adopted to ensure the political legitimacy of regimes – particularly the expansion in formal higher education – have negatively impacted these countries' developmental process through the constant expansion of the state bureaucracy. Such increased etatisme resulted in a situation where a rift was created between the political agenda of governments and their ability to deliver concrete measures of development along such agendas.

By the 1980s, the performance and effectiveness of state administration

were questionable, prompting the need for institutional restructuring and a re-assessment of the role of the state in development. The reforms undertaken in the 1980s ushered in a new discourse of "opening up," liberalization and privatization, as opposed to the 1960s and 1970s era of etatisme and bureaucratic expansion.

Ayubi goes on to argue that the novelty of the concept of "privatization" itself along which reform was envisioned introduced basic confusion as to the meaning and course of reform. Depending on the user's vantage point, privatization meant either encouraging the private sector or selling the public sector. According to Ayubi, the privatization drive in the Arab world is not the result of a careful evaluation of either the contribution of the public sector to development or the managerial efficiency of public enterprises. Rather, it is a reaction to the fiscal crisis of the state, reinforced by pressure from agencies of the international capitalist order and encouraged, to some extent, by international fashion.

The author outlines the organizational modalities of privatization, scanning the managerial approaches, the populist approaches and the capitalist approaches. Nine case studies of Arab countries that have undergone restructuring programs are reviewed. Examples of the managerial approach can be found in Egypt, Tunisia and Algeria, whereby the state extends increased autonomy and independence to para-statal corporations such as national airlines or engages in private management contracts for the operation of state-owned hotels. The populist approach has been used by Egypt, Iran and more recently Turkey to transfer the shares of SOEs to workers under "employee stock ownership plans" (ESOPs) or to cooperative associations of workers, producers or consumers. The ESOP modality has involved some manufacturing plants, while the cooperative modality has covered trade and agricultural projects. The third or capitalist approach has been the outright sale of part or all of the shares of SOEs to the general public or to industrial entrepreneurs and is becoming a favored modality in countries of the MENA region. An early formula under this last approach was extensively used by Egypt from the mid-1970s to the mid-1980s, creating a large group of joint ventures between SOEs and TNCs and operating as fully private sector companies.

The author shows that there have been no "big bang" reform strategies in the Arab world, although countries such as Tunisia have moved much earlier while others such as Syria are still hesitant with regard to divestiture. In all cases, "the Arab state is not really about to withdraw from the economy" and the private sector is gaining ground "not because of its initiative, drive and organization," but "mainly because the state is no longer able – given its chronic fiscal crisis – to uphold its etatist and its welfare policies at the same time."

The basic argument reiterated by Ayubi is that any attempt to evaluate the role of the public sector, especially in the Third World, must take into account the multiplicity of objectives (economic, social and political) that it must pursue, as compared to the simple profitability objective that is characteristic of most private enterprises. Ayubi further notes that without such a careful evaluation, neither the performance of administration in general nor the effectiveness of organizational and managerial reform in particular can be assessed. The author concludes that the rationale that several Arab countries have decided to restructure because the private sector is more productive and efficient than the public sector is not built on empirical investigation, but rather on trust of Western privatizers as well as the assurances of the international organizations of globalizing capitalism. In the case of Arab countries, the managerial argument over efficiency has been confused with the macroeconomic argument over development. Ayubi notes that in spite of the slogans, limited privatization has taken place in the Arab world and that for actual reform to take place, policies of economic adjustment (which at present are largely technical and financial in nature) require significant shifts in the existing "political coalitions" in most Arab states. These are represented by a populist coalition centered around the military, the techno-managerial elite of the public sector, and organized labor. In the absence of such a shift in political coalitions and the movement of reform beyond an immediate fiscal remedy, the author concludes that privatization will remain basically a public policy that is pursued by the state with reluctance and caution rather than a dynamic process whose initiative is taken up by the private sector itself.

The case of Turkey is presented by Fikret Adaman and Murat Sertel, who use the institutional framework of analysis to evaluate the evolving role of the Turkish state from the etatist era initiated in the 1920s up to the present. Turkey's early model of state intervention was perhaps the first attempt at involving the state in large-scale industrialization and five-year planning without abrogating its strong and stable institutions of private ownership and property rights. This is what makes Turkey's experience stand out in contrast to that of other MENA countries which went the full socialist way, and may also explain why Turkey's structural adjustment and liberalization efforts of the early 1980s were much speedier and more comprehensive. It may also explain why the privatization option has met with a great deal of reluctance from the general public in Turkey, since a strong private sector has long managed to survive peacefully in parallel with a large but far from domineering SOE sector.

The authors describe the changing rationale for public ownership over time, from an early need for a developmental state to act as the engine for capital accumulation, risk-bearing and diversification to the gradual reduction in the

state's function as producer to the adoption of "regulation by participation" in the 1950s, a practice similar to that of the French and Italian automotive sectors. The purpose was to increase the allocative efficiency of markets where competition is lacking with an institutional device whereby the state initiates projects, "not as a monopoly, but rather as one of several producers, and with the explicit goal of influencing – thus indirectly regulating – the behavior of its competitors when the unregulated operation of private industry is unsatisfactory." After 1973, the state has gradually discarded the role of producer, largely in parallel with its abandonment of the strategy of import substitution.

In response to the economic crisis of the late 1970s which was triggered by the oil shock and political disturbances, a "standard" adjustment program was adopted, but for the first time it was accompanied by an official discourse advocating the "imported ideology" in favor of privatization as well as the "idea that (Turkey) could more or less do without the state even in spheres such as public education and public health." In practice, and as late as 1994, only about US$2.3 billion in SOE shares had been sold, and in most cases only a minority participation had been acquired by the private sector. The authors believe that this is partly due to the absence of a strong consensus in favor of privatization and partly because of a sluggish legislative machinery.

Adaman and Sertel call into question the current wave of support for privatization without verifying the empirical evidence on the relative performance of SOEs. They argue that the notion of loss-making should not be equated with inefficiency, and that a clear distinction should be made between technical and allocative efficiency. They show that there "are no solid theoretical grounds for accepting that under private ownership either shareholders' control or capital market discipline will ensure that managers do not deviate from profit maximization." In addition to their criticism of the principal-agent theory, they point to the literature on alternative modes of organization such as workers' enterprises or "factoristic firms" which display profit-maximizing behavior without the presence of an employer or entrepreneur.

As for the issue of allocative efficiency, and in cases where the industry is not perfectly competitive, the authors believe that although from a theoretical perspective an independent regulatory authority should have the same effect on social welfare as an SOE producing according to allocative efficiency directives, the second alternative has more support from empirical evidence. Moreover, SOEs would positively influence the behavior of their private competitors, which is an added advantage of the "regulation by participation" modality. Overall, "what is very striking in the privatization debate in Turkey is the almost total lack of reference to the regulatory function of the public sector, despite the fact that this institutional device has been especially important in this country."

The contention that economic growth and the success of structural adjustment are contingent upon democratic forms of government is critically assessed by Driss Ben Ali in relation to Morocco. Given the neo-patrimonial system of government prevailing in the country, Ben Ali argues that the correlation between economic liberalization and political liberalism does not hold in the case of Morocco. One decade after the implementation of structural adjustment, Moroccan society still exhibits two apparently contradictory political features: the traditional neo-patrimonial establishment represented by the "Makhzen" and a liberal political culture. The author contends that the reforms contained in the structural adjustment program (SAP) have in reality reinforced Morocco's neo-patrimonial political structure.

Reviewing the relationship between the state and civil society, the author illustrates two possible "roles of the state" in relation to society and the economy. On the one hand, the state "does not intervene" and civil society is left to act independently, as in the case of democracies. On the other hand, the state intervenes, again along two possible courses: either by seeking to maximize surplus or by maximizing public expenditure. Ben Ali equates the scenario of surplus maximization with traditional monarchies and dictatorships – to use Weber's terminology, the "neo-patrimonial state." Alternatively, the maximization of public expenditure scenario corresponds to the authoritarian bureaucratic state, which offers more public services and must thus increase public labor. Two features of the state are envisioned within this framework: "predatory" and "productive," depending on whether the state seeks to maximize surplus or public expenditure.

Ben Ali then examines the effects of SAPs on the Arab state, whether productive or predatory. At the economic level, SAPs aim at "improving resource allocation, resource mobilization and the opening of the economy," signaling what is generally referred to as "economic liberalization." At the political level, two assumptions of liberal thinking seen as crucial to economic openness are: the autonomy of civil society and the neutrality of the state. In the first instance, "society generates its own order, the political establishment vows to uphold it," and the market acts as a regulating entity. In the second instance, the neutrality of the state is established through the latter's guarantee of political competition among actors according to formal rational rules. In other words, the state ensures the implementation of the "rules of the game" without becoming an active player.

Empirically, however, structural adjustment in most developing countries has not validated this theoretical correlation between economic liberalization and political democratization. Cases of democratic regimes such as that of India show that they have fared worse in economic terms than the authoritarian orders of, say, China, South Korea or Taiwan, all of which are examples

of successful economic performance in the absence of democratic rule. Hence, one must transcend the democracy-authoritarianism dichotomy and move to an analysis of the concrete dynamics of power in any given society to assess both the nature and direction of change. In reviewing the Moroccan experience, Ben Ali examines the corresponding – albeit contradictory – changes at the political level witnessed since the implementation of structural adjustment.

In his discussion of the historical evolution of the Makhzen, Ben Ali outlines the foundations of the pervasive control of the Moroccan state over civil society. By deliberately suppressing horizontal coalitions, the Makhzen has ensured the survival of vertical solidarities in Morocco, thus weakening civil society and strengthening a relationship of clientelism with the state. The author also reviews the various strategies of state control over civil society and the economy, from coopting the rural elites to ensuring the loyalty of the Moroccan bourgeoisie through the "Moroccanization" of its industry to growing investment in the public sector in order to expand or maximize social services. By the late 1970s and early 1980s, the Moroccan state had largely succeeded in maintaining control and gaining political legitimacy through the clientelistic structure that it established with various social strata.

Nevertheless, by the early 1980s the country's deteriorating economic performance called for a reassessment of the role of the Moroccan state as an economic actor. While the state had "officially" opted for a market economy as early as the 1960s, the Makhzen remained dominant in the country's economic life, resulting in bureaucratic inertia, financial profligacy and excessive legal formalism. The Makhzen managed the economy largely through a neo-patrimonial logic, where the goal was not only to accumulate capital, but also – and perhaps more importantly – to transmit property. As a result, "the state needed to find support in a network of clients, to distribute privileges, to cater to diverse interests, and to create rent-seeking opportunities that eventually led to distortions and imbalances."

Against this scenario, Ben Ali poses the question as to how the Makhzen could adapt to the policy of structural adjustment, which is predicated fundamentally on state divestiture. The SAP "has allowed Morocco to improve its financial situation, overcome the debt problem and regain access to international financial markets." On the other hand, Ben Ali argues that the backdrop to these concrete developments has been a rather vague modification of the relations between society and the political system. The adjustment program in Morocco appears to have faced the country with two contradictory modes of political organization: "a Makhzenian logic founded on the administrative allocation of resources and discretionary power, and a liberal logic based on allocation through market forces and democratic power."

Ben Ali notes that government officials in Morocco have sought to soften the effects of stabilization through two strategies: encouraging the informal sector so as to mitigate the negative impact of the SAP on the poorer segments of society and pushing for rapid privatization so as to integrate the bourgeoisie in the development process, thus widening the regime's social base of beneficiaries and supporters. Nonetheless, the author claims that while a relaxation of the Makhzen's control over political life has taken place since the implementation of the SAP, "Morocco's political system has lagged behind the country's economic changes," and a semblance of political liberalism has been endorsed by the Moroccan regime in the 1990s in the hope of maintaining the state's control over newly-emerging social classes in the wake of economic reforms.

Finally, Mona Said, Ha-Joon Chang and Khaled Sakr present a detailed analysis of Egypt's experience with "Infitah," the economy's responses to the oil boom and the gradual disengagement of the state from Egypt's industrial sector. The chapter provides a critical assessment of the validity of the neoliberal approach to industrial policy. The authors' interpretation of the Southeast Asian policy regime provides a vivid contrast to the empirical results and policy recommendations of earlier works on this topic. According to the authors' detailed study, the case of Egypt "casts doubt on the adequacy of relying exclusively on such policies as devaluation, financial liberalization and labor market reform to reverse the Dutch Disease, and in particular the de-industrialization effect." Moreover, they point to several theoretical weaknesses of the neoliberal analysis of the East Asian model and its policy prescriptions for a liberal, free market and free-trade approach. If anything, their interpretation of the successful example of such countries as Japan, South Korea and Taiwan highlights "the need for a coherent industrial strategy as part of any overall economic reform program."

Although the authors emphasize a number of important features of the Southeast Asian policy package that have been overlooked by the neoliberals, this does not mean that the fundamental thesis of the liberal school can be refuted. At the heart of East Asia's industrial policy is the export drive that acts as the engine of growth for the entire economy, and for this drive to be successful, international markets provide the key signals to competitive domestic firms. But what is missing from the neoliberal paradigm is an appreciation of the strong presence of the state to oversee the process of outward orientation and provide a package of investment-enhancing and export-promoting interventions in selected areas and with a deliberate sequence that will eventually deliver the desired outcome of achieving a fully-liberalized economy.

The valuable contribution that Said, Chang and Sakr have made to the analysis of the East Asian macro and micro policy settings is their elaboration

of the unique package of direct and indirect incentives that were pursued early on. They emphasize that macroeconomic management was based on "investment management" rather than aggregate demand management, and that strong "anti-consumption" policies were far more important than anti-inflationary policies. Neither was the rise in savings achieved through a "liberalized" financial market and high real interest rates, but rather through financial repression. They also refer to the early practice of using tariff and non-tariff barriers, foreign exchange rationing and other interventions to protect strategic infant industries and to control FDI wherever it would compete with the interests of national firms. Yet, these interventions can only ensure long-term competitiveness if they are carried out in the context of a carefully designed outward-oriented industrial strategy. Otherwise, one would be faced with a typical Third World policy regime which works against productivity growth and the expansion of exports.

This brings the authors to the discussion of the hallmark of East Asia's industrial strategy: the policy of state support for a targeted set of priority industries, with a range of subsidies and protection which has often lasted for decades. This controversial topic calls into question the changing role of the state in developing countries, a role that overcomes past "government failures" and yet enhances the process of catching up. The authors claim that what is needed is "an alternative approach which takes neo-liberalism seriously but goes beyond it." Such an approach would give weight to the issue of dynamic efficiency and to the political, institutional and cultural dimensions of development. The state would be responsible for promoting an entrepreneurial vision, for institution-building and for the coordination of large-scale changes. It would also determine the optimal degree of insertion in the world economy, given the stage of development and the level of capabilities of its industrial sector.

Part II.

The International Setting

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Global Challenges and Opportunities Facing MENA Countries at the Dawn of the Twenty-First Century

Introduction

It is difficult to have watched the course of events during the last decade without recognizing that something fundamental has happened to the international economy. Virtually in every dimension of economic life we have experienced an increase in international economic activity, both in absolute terms and relative to the level of national activity. This is the phenomenon economists refer to as "globalization," or the forging of closer links between different markets and production structures. It captures a process involving the intensification of economic ties among national economies through cross-border flows of goods, services, investment and factors of production. Perhaps equally importantly, globalization describes the challenges of governing an increasingly borderless world with complex patterns of cross-border linkages.

In addition, technological innovations are fashioning the world economy from the bottom up. Whereas countries can devise ways to limit or stop the movement of goods across their borders, they have far less control over the trans-border movement of information and know-how. The free and rapid flow of technological innovations coupled with the shortening of product cycles have made many domestic regulations appear obsolete and costly. The resulting pressure for regulatory reform presents a unique opportunity for shaping national systems in a way that will enhance the openness of markets and reduce the degree to which regulations create obstacles to international competition. Moreover, new technologies and regulatory innovations have made it possible to supply many infrastructure services on a competitive basis and have opened up possibilities for international trade in such services.

Technological change has contributed to a decline in transaction costs for individual firms. As a result, the range of enterprises for which global operations are commercially viable has grown wider. Competition between global firms is increasingly being conducted in the area of new technologies and production processes. At the same time, research and development costs and the economies of scale involved are fostering new strategic alliances between firms. Significantly, this process has made the nationality of firms and even of individual products largely irrelevant.

With the dispersal of production and of marketing processes worldwide, the competitiveness of firms has been enhanced by greater efficiency in the use of factors of production and in the design of customized products in close

contact with end-users. Simultaneously, globalization has blurred the identity of firms and products, which has presented new challenges to governments in managing their economies and produced a growing sense of economic uncertainty among economic actors as they face strong international competition and the need for adjustment. All of these factors are undermining the traditional separation between the domains of domestic and international policies.

In addition to the emergence of new products and innovative patterns of production and corporate organization, an increasing number of countries are becoming important actors in the world economy. Many developing countries played an important role in the Uruguay Round negotiations and through this single undertaking committed themselves to implementing the entire package. With rapid growth, many of these countries see their stake growing in a well-functioning world economy, and hence should prepare themselves to engage substantively in the discussion of how and when to open markets further and to deepen and broaden international rule-making or understandings that affect trade. One important consequence of the globalization of production and markets is that economies at vastly different levels of development are being drawn together through more extensive trade and investment flows.

Against the background of these developments, many countries have felt the need to strengthen regional cooperation. Regional trade agreements have become a permanent fixture of the global trading system for economic as well as political reasons. The political reasons often relate to the search for a stable international political order. The economic reasons are related to the fact that in many industries market opening and the internationalization of production have been easiest to achieve on a continental basis. The momentum associated with regional trade initiatives in recent years reflects the attempts by governments to come to grips with the realities of deeper economic interdependence through a drive for greater and more quickly realizable liberalization.

While all countries need to prepare to deal effectively with emerging issues affecting trade, new actors in the world economy in particular must become fully engaged in both the process and the results of the evolving international system. In the area of trade, some countries in the Middle East and North Africa (MENA) region will need to continue to bring their trade practices fully into conformity with World Trade Organization (WTO) obligations, resisting protectionist pressures by domestic industries and foreign investors alike. Others will need to contribute as full partners to the universal set of rules and practices. In this respect, accession negotiations to the WTO are a particularly important opportunity to establish a firm understanding and acceptance of international disciplines and of how domestic reform elements in these

economies can most profitably and predictably intersect with international disciplines to the benefit of all.

Countries in the MENA region should recognize that in the absence of major reversal of policies, it will not be possible to stop the process of globalization which is increasingly becoming a critical parameter of national economic development. In other words, it will not be possible to stop what has become an inexorable movement towards an ever more deeply integrated world economy, not least because deeper integration brings tremendous economic and broader political and social benefits. It creates ever-expanding market opportunities while providing the basis for greater stability in a country's international relations. It also exposes political and other elites – and ultimately the wider public – to international values and the balance of rights and obligations that flow from being a member of the international community. Not for a long time have circumstances been so favorable as they are now for there to be almost universal participation in the creation and benefit of wealth. The emerging deeply integrated global economy offers a real chance for the first time in world history for virtually all participants to share in the benefits of sustainable global economic growth.

The premise of this chapter is that when the forces driving the globalization of the world economy are fully appreciated, the need for a new program of action in MENA countries will become very clear. We are going through a period of rapid and fundamental change that requires major adjustments in the way economic policy-making has been practiced so far. What is needed is a multi-policy, comprehensive (versus piecemeal) approach that will promote the openness of markets to global competition in order to create truly internationally contestable markets in the MENA region. This can only be achieved by tackling the implications for international competition arising from government and private actions in the different policy fields. The strategy should lead to further market openings and the deepening and broadening of rules affecting the conditions under which trade and investment will take place in the future.

The new world economy: the promise

Globalization

It is no exaggeration to characterize increased globalization as the most dominant feature of the new world economy. In its turn, globalization has underpinned the continued expansion of trade and foreign direct investment (FDI), including intra-industry trade. However, it must also be noted that decisions to trade are increasingly an integral part of broader business strategies relating to

the efficient organization and location of production and marketing activities. With international competition becoming increasingly intense, the ability of newly-developed and incorporated technology to enhance competitiveness provides incentives for firms to form strategic alliances or joint ventures and to seek economies of scale in production and marketing, thus reducing transaction costs, spreading the high cost of research and development, and influencing trade and investment flows worldwide.

International trade

International trade in both goods and services has continued to grow faster than national incomes throughout the post-war period (see Table 1). In addition to liberalization at the regional level as well as autonomous liberalization, eight rounds of multilateral trade negotiations (MTNs) under the auspices of the General Agreement on Tariffs and Trade (GATT) have been the major factor behind the freeing of markets and the increased cross-border flows of goods and services to where the returns are higher. The eight rounds of MTNs have succeeded in lowering the average trade-weighted most-favored-nation (MFN) tariffs on industrial goods from a high of 40 percent at the end of World War II to less than four percent at the end of the Uruguay Round (1986-1993).

Liberalization in multilateral, regional and autonomous settings has removed to a large extent other traditional barriers to trade which have been the basis of almost all post-war commercial diplomacy on which the existing multilateral architecture has been built. Examples of such barriers are the trade bias originating from the practice of tariff escalation and the practice of voluntary export restraints (VERs) or any similar measure, thus implying a significant relaxation of non-tariff barriers (NTBs). But why has there been such clamor for more liberal trade regimes? A simple answer is that liberalization is a very good idea.

Considerable evidence now indicates a positive association between liberal trade regimes and economic growth. This association is supported by actual experiences as well as analytical studies in this field, from World Bank (1987) to Edwards (1989) to OECD (1993). The economies that have adopted an open trade regime were able to create competitive industries; stimulate domestic and foreign investment; exploit economies of scale; and facilitate technology transfer and the adoption of best-practice techniques, all of which gained the most from buoyant international trade. Further, a comprehensive study by the World Bank found that higher shares of exports in GDP have a close relationship with higher productivity (Papageorgiou *et. al.* 1991).

Table 1: Growth of world trade and output, 1870-1990
(Average annual growth rates, percentage)

Year	Trade	GDP	Difference
1870-1913	3.9	2.5	1.4
1950-1960	6.5	4.2	2.3
1960-1970	8.3	5.3	3.0
1970-1980	5.2	3.6	1.6
1980-1990	3.7	2.8	0.9
1991-1993	3.9	1.1	2.8
1994-1996	7.3	3.0	4.3
1997-2004	6.0	3.3	2.7

Source: World Investment Report, *1994; UNCTAD, New York and Geneva. Data for 1991 onward are projections by the World Bank (1995),* Global Economic Prospects and the Developing Countries, *Washington, D.C.*

Moreover, casual empiricism suggests that the growth of world trade and output has coincided with periods of trade liberalization through a combination of multilateral and regional arrangements and unilateral measures. Whereas in the past the share in world GDP of exports of goods and services represented only six percent of the total, that share reached 21 percent in 1992. Thus, it is not surprising to see that the completion of the Uruguay Round as the most comprehensive package of trade liberalization to date is anticipated to further enhance economic growth. The growth in world output registered 3.1 percent in 1994, against 1.7 and 2.3 percent in 1992 and 1993, respectively. Behind this resurgence in output growth lies a 7.2 percent surge in the volume of world trade in 1994, against growth rates of 4.7 and 4.0 percent, respectively, in 1992 and 1993. Of course, while it would be stretching the point to attribute all the higher pace of economic growth to the liberalization package of the Uruguay Round, one cannot neglect its substantial contribution nonetheless. To put things in perspective, if the Uruguay Round had managed to raise the rate of growth of the world economy by a mere 1/10 of a percentage point in 1994 – say, from 3.0 to 3.1 percent – then the annual income gain for the world would be US$274 billion after seven years (OECD 1993a), and US$510 billion thereafter (François *et. al.* 1994).

By contrast, the economies that have resisted the movement towards a liberal trading regime have witnessed a deterioration in both their internal and external balances with sometimes devastating effects on economic growth and its prospects. Their experience has consistently demonstrated that structural adjustment finally had to take place, generally at higher social and economic costs. The main problem with trade policy interventions is that there is no direct linkage between the instruments and broad policy objectives –

namely, increased private sector investment, higher output, higher productivity and enhanced competitiveness. Protection is in effect a punitive tax on efficient exporters and efficient import-competing sectors, and a regressive tax on consumers. A recent report by the GATT Secretariat found that Japanese VERs on automobiles shipped to the EC raised the price of Japanese cars to EC consumers by 33 percent (GATT 1993). Similarly, textiles and clothing protection in the United States and Canada cost every household US$310 and US$220 per annum, respectively. For agricultural commodities, the same situation prevails. OECD estimates for 1991 showed that agricultural protection and assistance in OECD countries resulted in significant differences between domestic and world market prices (OECD 1993b). Consumers paid the difference in terms of higher prices and taxes which totaled US$354 billion in 1991. This represented an annual transfer from consumers to producers equal to US$440 per household. Moreover, assistance in the form of public subsidies is a burden on public finances. The benefits of trade-distorting interventions usually go to the politically influential, improving the welfare of interest groups at the expense of general welfare. Furthermore, such interventions are prone to lead to serious conflict with trading partners.

To be sure, trade liberalization does involve short-term costs associated with structural adjustment. In the short run, jobs may be lost. In this respect, it must be emphasized that protectionism has never proven to be an efficient means of sustaining employment. Quite to the contrary. Careful examination of the factors affecting employment shows that more jobs are created from a stronger export effort than are lost to imports (OECD 1992). An earlier OECD study also concluded that "jobs saved in industries protected are often offset by viable jobs forgone elsewhere in the economy. On its own, protection is a poor alternative to positive adjustment policies" (OECD 1985). This will be even more so in a globalizing economy. A country which attempts to cut itself off from the stream of world development forgoes the advantages of dynamism abroad, which is a sure way of locking itself into relative decline.

In order to put things in perspective, it would be instructive to review some of the studies that have attempted to estimate empirically the economic impact of the Uruguay Round. The results of the models discussed here are estimations of the potential net welfare gains from trade liberalization. These are calculated from estimated net efficiency gains and net terms of trade effects, net of the effects of induced changes in tariff revenues. The calculations attempt to capture both the aggregate gains and losses from structural adjustment stemming from liberalization. They are not forecasts of what to expect by way of changes in welfare, but rather estimates of the net results of trade liberalization compared with what would have obtained in its absence.

The Uruguay Round creates major difficulties for economic modeling. This is because it goes well beyond cutting protection on trade in goods to include services, investment and intellectual property, and because many of its effects will operate through an improved system of multilateral rules and disciplines. All modeling exercises use simplifying assumptions to make quantification more tractable. Some assumptions result in underestimation of the positive effects of trade liberalization. In particular, the dynamic gains from trade are inadequately captured in these calculations. These include scale economies,[1] specialization and the positive effect on confidence that the conclusion of the Uruguay Round has brought.

The calculations also omit the benefits from liberalization in services and investment, protection of intellectual property, and the strengthening of rules governing trade remedies such as anti-dumping and countervailing duties. The addition of services alone under the GATT/WTO umbrella is expected to lead to substantial benefits, as the service sector is now the largest sector in most economies, developed and developing alike. The calculations also do not capture the positive contribution to trade liberalization made by the increasing application of multilateral disciplines by developing countries or by their unilateral liberalization in the context of accession to the GATT/WTO.

With these caveats in mind, Table 2 presents a summary of the results of seven recent studies (Panel A) as well as the model type and assumptions used in each of these (Panel B). The impact on world welfare is estimated to range from US$212 billion (Nguyen *et. al.* 1993) to US$510 billion (Francois *et. al.* 1994). That on developing countries ranges from US$86 billion (OECD 1993) to US$122 billion (François *et. al.* 1994). As expected, all the various studies find that welfare gains are to a great degree proportionate to each country's own liberalization efforts. The net benefits estimated by Francois, McDonald and Nordstrom (1994) are the highest because they include gains derived from scale economies. The gains reported in the OECD study (1993) are higher than those obtained by the World Bank/OECD study (1993) because the former study added cuts in non-tariff barriers on industrial products.

The larger net benefits reported in the studies by Stoekel (1990) and DRI (1993) derive, respectively, from a higher reduction in tariffs and NTBs (50 percent) than in the OECD (1993) study, and from the inclusion of an exogenous increase in productivity. Finally, the results reported by Nguyen, Peroni and Wigle (1993) are based on a relatively smaller number of countries. While the overall results are sensitive to the various methods and assumptions used, all the studies show that by cutting just tariffs, agricultural subsidies and NTBs, the net benefits are expected to be substantial.

Table 2: Global General Equilibrium Studies of Multilateral Trade Liberalization

a) Impact on world welfare

Study	Global welfare effects
François, McDonald and Nordstrom (1994)	$510 billion (1992 dollars, measured in 2005)
OECD (1993)	$274 billion (1992 dollars, measured in 2002)
World Bank/OECD (1993)	$213 billion (1992 dollars, measured in 2002)
Nguyen, Perroni and Wigle (1993)	$212 billion
DRI (1993)	increase of 4.5% in world income
Stoeckel (1990)	increase of 5.0% in world income
Peterson (1992)	increase of 1.0% in world income

b) Summary of approaches

Study	Model type and main assumptions
François, McDonald and Nordstrom (1994)	Scale economies; imperfect competition. Calculations based on the final offer data.
OECD (1993)	Constant returns to scale in production; perfect competition. Calculations based on the DFA; manufacturing tariffs and NTBs cut by 36%; agricultural subsidies by 36%; agricultural support cut by 20%.
World Bank/OECD (1993)	Constant returns to scale in production; perfect competition. Elimination of agricultural subsidies and support as well as elimination of import tariffs on non-agricultural goods.
Nguyen, Perroni and Wigle (1993)	Constant returns to scale in production; perfect competition. Partial MFA liberalization; cuts in agricultural subsidies and support by 70%; reduction of import tariffs on industrial goods by 50%.
DRI (1993)	Macroeconometric, partial equilibrium model of the G7 with efficiency gains from trade liberalization exogenously determined.
Stoeckel (1990)	Constant returns to scale in production; perfect competition. Tariffs and NTBs reduced by half.
Peterson (1992)	Global macroeconometric, partial equilibrium model with product differentiation and constant returns to scale in production.

Foreign direct investment (FDI)

Aside from its explosion in the mid-1980s onwards, the most important trend affecting FDI in the 1990s is the drive to liberalize policies affecting its flows as part of a broad-based strategy to attract foreign investors. While investment

inflows averaged US$67 billion per annum in the 1982-87 period, they more than doubled to US$158 billion in 1992 (Table 3). However, the growth of FDI flows to developing countries is unevenly distributed among them. Most FDI inflows are still overwhelmingly concentrated in 10 to 15 countries in Asia and Latin America (Table 4), with China taking the lion's share after emerging as the largest host country in the developing world.

Table 3: Foreign Direct Investment Inflows, 1982-92 (Millions of US Dollars)

Host region/ economy	1982-87 Annual Average	1988	1989	1990	1991	1992
All countries	67,526	159,101	196,132	207,912	162,124	158,413
Developed Countries	52,757	131,313	168,488	176,346	120,616	102,401
Developing countries	14,752	27,772	27,376	31,266	39,060	51,485
MENA	1,344	2,575	2,614	2,095	2,066	2,720
MENA/Total (%)	2%	2%	1%	1%	1%	2%
MENA/developing (%)	9%	9%	10%	7%	5%	5%
Algeria	-7	13	12	--	12	10
Bahrain	45	222	181	-4	-7	-9
Egypt	809	1,190	1,250	734	253	459
Iran	-105	61	-19	-362	23	18
Iraq	3	--	3	--	-3	8
Israel	110	230	125	101	253	235
Jordan	43	24	-1	38	-12	41
Kuwait	-3	16	4	-6	1	-35
Lebanon	4	--	2	7	2	19
Libya	-152	98	125	159	190	150
Oman	139	92	112	141	149	59
Qatar	-2	-21	-2	5	43	5
Saudi Arabia	149	-83	-20	554	128	385
Syria	18	121	47	72	62	18
Tunisia	150	61	79	75	125	379
Turkey	92	354	663	684	810	844
UAE	41	189	39	-116	26	122
Yemen	10	8	14	13	11	12

Source: World Investment Report, *1994; UNCTAD, New York and Geneva.*

Table 4: The Largest Host Developing Economies to FDI Flows, 1981-92, US$ millions.

Host	1981-85	1986	1987	1988	1989	1990	1991	1992	Total, 81-92
China	3983	1875	2314	3194	3393	3487	4366	11156	33768
Singapore	6745	1710	2836	3655	2773	5263	4395	5635	33012
Mexico	5832	1523	3246	2594	3037	2632	4762	5366	28992
Malaysia	5415	489	423	--	1668	2332	3998	4469	18794
Brazil	9936	--	1225	2969	1267	901	--	1454	17752
Hong Kong	3022	996	3298	2627	1076	1728	--	1918	14665
Argentina	2024	574	--	1147	--	1836	2439	4179	12199
Thailand	751	--	--	1105	1775	2444	2014	2116	10205
Egypt	3150	1217	948	1190	1250	--	--	--	7755
Taiwan	340	326	715	959	1604	1330	1271	--	6545
Nigeria	1801	--	603	--	1882	--	--	897	5183
Indonesia	0	--	--	--	--	1093	1482	1774	4349
Colombia	2591	674	--	--	--	--	--	--	3265
Korea	0	435	601	--	--	--	1116	--	2152
Venezuela	0	--	--	--	--	--	1916	--	1916
Philippines	0	--	--	936	--	--	--	--	936
Chile	784	--	--	--	--	--	--	--	784
Tunisia	633	--	--	--	--	--	--	--	633
Total above (a)	47007	9819	16209	20376	19725	23046	27759	38964	202905
All LDCs (b)	65528	14095	23953	27772	27376	31266	39060	51485	280534
All OECD (c)	185430	67307	111145	130845	162599	163825	118129	94817	1034097
LDCs + OECD (d)	250958	81402	135098	158617	189975	195091	157189	146302	1314631
a/b	72%	70%	68%	73%	72%	74%	71%	76%	72%
a/d	19%	12%	12%	13%	10%	12%	18%	27%	15%

Source: World Investment Report, 1994; *UNCTAD, New York and Geneva.*

The shares of MENA countries in total FDI inflows appear to have remained constant between one and two percent during the period 1982-92. However, their share in FDI flowing to developing countries alone is clearly on a downward trend. Whereas in 1989 that share peaked at ten percent, subsequent years witnessed a continuous decline, and in 1992 – the latest year for which comprehensive data are available – the share registered half of its highest level.

A cross-country review of experiences with FDI liberalization policies reveals that such undertakings were most successful when they were associated with a broader liberalization movement that covered international trade in goods and (more recently) services, international financial transactions, and technology transfer. The aim of this broader movement is to enhance economic efficiency through the phasing out of discriminatory or distortionary government policies. Just as markets are becoming more interdependent, so are policies.

For example, outward-oriented trade policies emphasize the need to compete in world markets on the basis of productive efficiency, which in turn requires new investment in modern plants and the upgrading of human skills. Modern technology, especially in transport and communications, has given a fillip to globalized production structures, blurring the old distinctions between trade and investment as alternative means of securing access to markets. This is the most important factor that explains why many governments that used to show an inclination towards rationing and conditioning the entry of FDI into their markets now go to some length to encourage these flows (Low 1995).

Many countries, especially the developing economies of Asia and Latin America, sought the contribution of FDI to achieve their long-term development goals because of a desire not so much for financial resources but, perhaps more importantly, for technology transfer, know-how and organizational and managerial skill development, better access to foreign markets and employment creation. The trend of the destination of FDI clearly shows that even when free of restrictions, FDI became substantial only when successful industries were founded, when economic growth accelerated, and when policies to encourage exports were adopted. Hence, experience suggests that FDI cannot be the only stimulus for economic development, the most important precondition being the existence of a stable political and economic environment.

Only a few developing economies (such as Hong Kong and, to a large extent, Singapore) have virtually no restrictions on the entry and operation of foreign companies. In most MENA countries, FDI is governed by a variety of laws and regulations. During the 1980s new laws or modifications of existing ones were enacted to attract FDI. Nevertheless, in many industries FDI

remains either completely restricted – mainly in the service sector – or regulated by ownership and performance requirements. Simultaneously, special incentives are often granted to exports or to high-technology industries. In some cases, these incentives discriminate against domestic enterprises and do not seem to improve the overall investment climate of the host economies. During the first half of the 1980s, rapid economic growth and a location advantage have constituted the major initial attraction of FDI. The location advantage included, *inter alia*, the use of local low-cost and skilled labor and a higher profitability of FDI relative to other locations. Furthermore, emphasis on human resource development and the creation of an efficient infrastructure favored both foreign and domestic entrepreneurs. The development of equity markets and improved and continuous access to international capital markets also were some of the characteristics that helped attract FDI. The above characteristics encouraged labor-intensive FDI initially in assembly and low-technology activities, and progressively in more sophisticated advanced technology industries. This made resource-based, labor-intensive export-oriented activities the predominant areas of involvement of foreign-owned enterprises.

During the second part of the 1980s, while export-oriented activities remained popular, the growth of indigenous consumer purchasing power has led to increasing number of investments to service domestic markets. Being regions marked by the highest GDP growth in the world, East and Southeast Asia have emerged as the largest recipients of FDI among developing countries, accounting for more than half of all flows to developing countries (see Table 3). China, Malaysia and Thailand emerged as the fastest-growing recipients. In fact, of the 18 largest recipients of FDI among all developing countries, nine economies are from East and Southeast Asia. Only two countries from the MENA region made the list of the top 18 host countries: Egypt and Tunisia, with ranks of 9th and 18th, respectively.

Regional integration

Between 1948 and 1994, over 100 regional trading arrangements were notified to the GATT. However, in recent years the trend to formal regionalization has accelerated markedly, with 34 different regional trading arrangements having been notified to the GATT during the period 1990-1994 (WTO 1995). The extension of the EU, the formation of NAFTA, CEFTA and MERCOSUR, major developments in APEC, calls for a "Free Trade Area of the Americas" and a "Trans-Atlantic Free Trade Area," as well as a range of other initiatives elsewhere all suggest that the euphoria surrounding the formation of regional trading arrangements during the first part of the 1990s will not abate.

Regional trading arrangements are an exception to the MFN principle of the GATT (Article I). Article XXIV of the GATT allows the establishment of free-trade areas (FTAs) and customs unions (CUs) under certain conditions. The provisions are designed to ensure that any such arrangements will encourage the creation of new trading opportunities amongst the parties involved, as opposed to diverting trade away from third parties. Four basic rules are supposed to ensure this result. First, substantially all trade must be covered by the arrangements, so that they do not simply promote a few trade-diverting sectoral deals. Second, trade barriers must be eliminated, not merely reduced on a preferential basis. Third, external trade barriers towards third parties must be no higher on average after the establishment of an FTA or CU than they were before. Finally, recognizing that these kinds of arrangements will be phased in over time, Article XXIV requires that interim agreements include a plan and schedule for the formation of an FTA or CU "within a reasonable period of time." This transitional period should not exceed ten years.

Regional trading arrangements amongst developing countries are covered in separate provisions. In the early 1970s, a group of developing countries established a protocol under which they exchanged tariff preferences among themselves. This arrangement did not envisage the creation of a CU or FTA, and no other provisions in the GATT system offered legal cover. A waiver under Article XXV was therefore granted for ten years in November 1971. Subsequently, the Enabling Clause – one of the instruments that emerged from the Tokyo Round – provided general legal cover for these kinds of regional arrangements. It provided that such arrangements should aim to facilitate trade, should not create obstacles to the trade of third countries, and should not impede MFN-based trade liberalization. However, the Enabling Clause only covers regional arrangements amongst developing countries in respect of tariffs: the preferential removal of NTBs is subject to criteria or conditions which may be prescribed by the Contracting Parties.[2] Finally, the Enabling Clause does not provide legal cover for arrangements between industrial and developing countries, such as the Caribbean Basin Initiative of the United States. As with arrangements among developing countries involving NTBs, Contracting Parties prescribe the criteria.

The formation of a regional trading arrangement alters tariffs and trade preferences and thereby changes relative prices and patterns of production and consumption. There are two main "static" effects of such an arrangement. Trade creation is a shift away from high-cost domestically produced goods to lower-cost imports from regional partner countries. Other things being equal, the trade creation effect combined with greater opportunities to exploit economies of scale implies a regional expansion in real income. Analogously,

trade diversion involves the substitution of inefficient regional suppliers for efficient suppliers in third countries on account of the tariff preference, and as such tends to reduce regional national income. Therefore, the real income of the regional grouping rises when trade creation dominates trade diversion.

The relative size of trade-creating and trade-diverting effects depends on a number of factors. Opportunities for trade creation are enhanced and those for trade diversion are minimized in cases where a regional arrangement groups together countries that are already major trading partners. This is because prior to the introduction of preferences, trade flows are consistent with least-cost sourcing so that the removal of trade barriers will reduce the likelihood that a large number of items will be diverted from third countries' least-cost suppliers to higher-cost suppliers within the regional arrangement. Furthermore, the higher the pre-arrangement MFN tariffs, the higher the pressure for trade diversion following the formation of a regional trading arrangement. Alternatively, when the external barriers of a regional arrangement are low, the potential for trade diversion is low because lower external tariffs offer less scope for the displacement of imports from third countries.

Regional trading arrangements may also give rise to other dynamic effects. These effects originate from the way regional trading arrangements evolve over time. Regardless of trade creation/trade diversion effects, the dynamic effects could be positive or negative depending on whether regionalism will lead to multilateral free trade by merging regional blocs into a single world bloc.

Regional economic integration has generally been induced by a combination of market and economic as well as non-economic policy factors. Economic motivations generally include: the prospect of enhanced economic growth originating from the opportunity to exploit scale economies; regional specialization and learning by doing; and attracting foreign investment. Locking in domestic policy reforms at the regional level and thus enhancing the credibility and sustainability of economic reforms – including trade liberalization – has also been identified as providing a momentum for the formation of regional trading arrangements. Other economic reasons include: the "domino effect" which stipulates that the opportunity cost of remaining outside a regional arrangement rises as new ones are formed or as existing ones are expanded or deepened; the "infant industry" argument that has promoted the pursuit of regionalism under the premise that it would broaden and deepen domestic regional markets as a precursor to exposing regional industries to the full rigors of extra-regional competition; and the prolonged process of multilateral negotiations during the Uruguay Round. Non-economic objectives such as the promotion of regional cohesion and security and various foreign policy considerations have also provided additional impetus for going regional.

The challenges

One of the most important consequences of increased globalization is that many countries are becoming fairly close locational substitutes in the eyes of multinational corporations (MNCs). Such an environment creates low tolerance for policy mistakes in the sense that relatively small differences in institutional set-ups and practices may have a large impact on trade and investment flows.

Together with globalization, the march of liberalization will increasingly shift the focus of international commercial diplomacy beyond countries' borders and into an ever-increasing number of areas that have traditionally been considered to belong solely in the domestic policy domain. The notion that varying regulatory environments among countries are a source of unfair competition seems to be gaining popularity, and demands on governments to "countervail" these differences through trade restrictions are increasing. Thus, such differences will increasingly become the source of new trade friction. Accordingly, this has introduced new and potential areas of tension within the multilateral trading system.

One of the clearest manifestations of current (and future) threats to the trading system has been the attempts to replace the objectives of "free" or "freer" trade with demands for "fair" trade. The politically appealing notion of "fair" trade is increasingly being employed to justify government actions aimed at protecting domestic industry or pressing for foreign trade liberalization. Demands for fair trade have the attraction of appealing to a notion of natural justice, where governments may be ready to act in order to "level the playing field." Hence, whereas unfair trade practices were once confined to foreign subsidies and dumping practices, they now bespeak the need for greater intervention in the domestic policies of other countries. The most prominent of these concern environmental policies and policies related to labor standards, although differences in standards in other areas such as competition policies are also important.

The presumption today in some circles is that doing different things about the environment and/or labor standards – or doing the same things in different ways – is sufficient to justify complaints about "unfair" competition. What this means in practice is that governments will increasingly become answerable to one another in the way they conduct domestic economic policy-making. It is quite reasonable to expect that demands for intergovernmental actions may well extend beyond the purview of policy-making in the environmental and labor standards fields and into any other area that may affect the cost and production structures of individual firms. Thus, nothing will prevent such issues as varying tax rules among countries or differing investment incentives or

funding for research and development or welfare or pension schemes from becoming entangled with issues of "unfair" competition.

It is important to note that trade policies become involved here not because trade itself is creating the underlying problem, but rather because a denial of market access is seen as an effective threat or enticement for a government to change its behavior. Moreover, economic theory has established that trade policies are inefficient instruments for correcting domestic distortions. They are second-best instruments, and may affect domestic policies only indirectly. Finally, the willingness of governments to change some economic variables (instruments) in order to change or stabilize other economic variables (such as environmental and labor standards) presupposes a clear distinction of the welfare effects of the former as compared with the latter. The lessons of the 1960s and 1970s are that this distinction may, after all, not be clear. Indeed, there may well be a point beyond which the manipulation of instruments may be more costly in terms of welfare than the welfare gain that could be derived from greater stability of what are traditionally considered target variables (such as income policy, fiscal policy, structural policy, monetary policy, and trade and exchange rate policies).

Issues arising from the interplay of trade and environmental policies and trade and labor standards are similar insofar as they raise the same broad policy challenges. These are related to: (i) the effects of trade policy on environmental quality and on labor standards; (ii) concern over the differential costs between countries of meeting environmental or labor standards; (iii) the use of trade policy to attain environmental or labor-related objectives; and (iv) the appropriate institutions that should be entrusted with developing multilateral rules and disciplines in these two areas.

There has been a frequently voiced fear that as open trade leads to specialization and growth, it results in more pollution and more resource degradation. This view rests on the belief that moving towards more liberal trading regimes induces, on the one hand, a shift in the production structure towards the tradable sector, thus implying faster depletion of environmental resources; and, on the other, it promotes changes in the patterns of production that result in adverse environmental effects downstream in the form of industrial pollution. However, neither of these two effects is clear-cut in terms of implying an unambiguous deterioration of environmental well-being. Moreover, even if these effects do exist, they must be weighed against the improved use of environmental resources that stems from greater efficiency in input use as a result of liberal trade policies.

The problem of environmental degradation cannot be convincingly linked to specialization through trade. On the contrary, open trade may be beneficial

to the environment through its effects on resource allocation and income levels. Environmental degradation may be a problem at any level of trade and international specialization – it depends on other policies. Nevertheless, it must be recognized that trade liberalization might, through its effects on relative prices, accelerate environmental degradation. Whether or not this will indeed happen is an empirical issue, though environmental degradation should be addressed through appropriate environmental policies and not through growth-inhibiting interventions such as trade protection.

The other concern about open trade is that it will generate pressures for competitive deregulation and thereby compromise environmental quality and high labor standards. Once again, trade restrictions are not appropriate either as an environmental policy or as a policy to safeguard high labor standards. Differences are bound to exist among countries in relation to environmental quality and labor standards, reflecting differing environmental absorptive capacities, labor demand and supply conditions, and social priorities. In economics, the "state of the environment" as well as labor are treated as factors of production or as country-specific resource endowments and as part of what determines comparative advantage. Competitive deregulation occurs if governments allow it to happen, not because opening up to trade forces a defined set of standards (environmental or labor) upon a country. If a country has a comparative advantage over another on environmental grounds or labor cost grounds, it will tend to specialize accordingly.

The second category of issues is two-faceted. On the one hand, industries faced with the costs of environmental and labor regulations complain that imports produced under looser environmental and labor standards are a source of unfair competition. On the other hand, there is the frequently voiced fear that the threatened migration of polluting industries or of industries seeking lower labor standards will undermine the political will to impose necessary environmental and labor controls and standards on domestic industry. This would, in turn, lead to competitive deregulation among countries. Whether or not this will happen is, once again, an empirical question.

Numerous studies have attempted to estimate the impact of environmental control costs (ECCs) on industry price, output and the trade balance. Common findings of most studies are: (i) estimates of total ECC by industry tend to be very low, that is, abatement costs are a small portion of industry costs (for example, the weighted average of such costs to output in the US in 1988 ranged from 0.54 percent to just over three percent for one of the most polluting industries – cement); (ii) reductions in output caused by ECCs are also small and insignificant on average; and (iii) there is little evidence of any significant impact of ECCs on the pattern of trade.

A growing body of research has also analyzed possible relationships between trade patterns and "core" labor standards.[3] This analysis has led to several results. First, cross-country differences in core standards will have no influence on external competitiveness in general. These differences are likely to be largely offset by differences in either productivity levels or exchange rates. Moreover, cross-country differences in core standards are likely to shape comparative advantages. The patterns of specialization will therefore be affected by changes in core standards. In addition, upgrading core standards could improve the terms of trade in low-standard countries. It is also conceivable that better core standards could improve economic efficiency, thereby stimulating output and trade over the long-run. Finally, it is worth noting that from an environmental and/or labor standpoint, the focus on competitive considerations – rather than environmental quality and labor standards as such – could easily lead to situations in which trade intervention in the name of the environment or labor does nothing, or even does harm, to environmental quality and labor standards.

The third category of issues relating to the use of trade policy to achieve environmental or labor standards objectives is largely about enforcement. Trade policies may be harnessed as a means of encouraging countries to participate in an international agreement. They can also be used to induce countries to become a party in an international agreement that they would otherwise abstain from. Alternatively, trade policies may be applied by one country to impose its own environmental and/or labor standards upon others.

Most international agreements require convincing enforcement provisions, involving a retaliatory or punishment mechanism. This becomes more important the greater the influence of an international commitment on the policy of governments and the greater the incentives that exist to be less than fully cooperative under the terms of an agreement. The question of interest here is whether trade restrictions offer an efficient retaliatory mechanism. Here the theory is not very helpful, because it is assumed that a credible threat does not need to be exercised. If an international agreement is properly structured and stable, non-compliance by a party to the agreement would be irrational, in the face of the severity of the retaliatory consequences of such an action. Countries are assumed to have entered into an agreement because they consider it to be in their interest to do so. In this framework, the withdrawal of market access – in other words, the imposition of trade restrictions – may be an effective threat.

The case for trade restrictions as an enforcement mechanism under an international agreement must be distinguished clearly from the case of the use of trade policy to induce cooperation in the absence of international agreements

as discussed above. The use of trade policies to influence outsider behavior, in the sense of encouraging a commitment by a country to particular environmental or labor policies or to an agreement, is more likely to involve punishment than rewards. In general, the more remote international consensus is on an issue, the more disruptive this particular use of trade policy will become.

An even less straightforward use of trade policies, however justified on environmental or labor standard grounds, arises when a country uses the threat of trade restrictions to impose its own acceptable environmental or labor standards on another country. It is easy to see how anti-competitive such an approach would prove to be. Where trade policy is turned to environmental or labor standard ends in this fashion, it becomes disruptive while skirting due multilateral process. The fourth and last category of issues that arise from the interplay of trade and environmental policies and trade and labor standards concerns the appropriate institutions that should be entrusted with developing multilateral rules and disciplines in these two areas.

In conclusion, demands on governments to do something about the environment and about labor standards via trade policy are increasing, in both multilateral and regional contexts. A judicious and non-protectionist response to these demands will be one of the major trade policy challenges of the decade ahead. Turning our attention to the proliferation of inherently preferential trading arrangements, the concerns that they raise are whether these arrangements will expand and whether the process of such coagulation of subsets of regional groupings will lead to eventual multilateral free trade among all or to a fragmentation of the world trading system. From a systemic perspective that seeks to defend multilateralism, regional trading arrangements might be considered acceptable if they: (i) create new trading opportunities; (ii) do not unduly distort trade; and (iii) do not create unassailable vested interest groups that would block the extension of liberalized trading arrangements on a non-discriminatory basis. In other words, there would be less to worry about if regional agreements were regarded as interim measures, aimed at providing momentum for non-discriminatory trade liberalization efforts.

The proliferation of regional integration arrangements may affect the balance between existing regional integration and the multilateral trading system. The latter could lose a good deal of its significance if MFN treatment were to cover a decreasing share of world trade, and if members of agreements were to have their responsibilities and interests divided between regional and multilateral objectives and rules. The risk would be greater if there were to be a proliferation of "hub-and-spoke" agreements. A global, multilateral trading system would, however, remain essential to address

inter-regional relations and disputes, protect the interests of third countries, and work towards strengthened and expanded multilateral rules.

That regional trading arrangements and the multilateral trading system have generally been complementary is not sheer coincidence, but rather the result of deliberate policy choices. One challenge facing policy-makers will be to ensure that this continues. Much will depend on the credibility of the WTO and on its capacity to accommodate and discipline regional trading arrangements. This also requires the multilateral trading system to be able to respond quickly to the evolving requirements of international commerce and keep pace with progress in the regulatory frameworks of regional trading arrangements. If these conditions are fulfilled, they should restrain outside countries from forming defensive agreements or from seeking preferential agreements with regional entities in order to secure access to their market.

General multilateral discipline on regional trading arrangements – mainly in the form of Article XXIV of the GATT – has helped ensure that regional agreements *per se* do not lead, on balance, to deterioration in the conditions of trade and market access for third countries. It has not, however, provided indisputable criteria by which to assess the effects of regional integration agreements on trade and investment flows or the compatibility of regional agreements with the GATT. The slightly tighter interpretation of Article XXIV embodied in the Final Act of the Uruguay Round will make the conditions for the creation of FTAs and CUs somewhat more constraining, but it is unlikely to result in more definitive rulings than in the past.

The improved multilateral dispute settlement procedures adopted as an outcome of the Uruguay Round should help to exert greater discipline on regional trading arrangements through the challenging of such arrangements, rules or measures which conflict with other existing GATT/WTO provisions. But the stronger dispute regime will not help much when the common rules are still weak. Together with divergence among regional arrangements, this would seem to limit the scope for the development of a multilateral "case law" on regional trading arrangements.

To say that regional trading arrangements and the multilateral trading system are not alternatives, but rather complementary approaches to problems of international commercial diplomacy, is not sufficient. The key issue is what policy choices and decisions could be made to ensure that regional trading arrangements remain supportive of the multilateral trading system in a way that strengthens its credibility for third countries. The need and advisability of further expansion of the disciplines in Article XXIV (and the Understanding on it) is debatable and may not be a realistic option at this point.

The vision

Economic prosperity in the MENA region is critically dependent on a well-functioning international economy. Therefore, it is incumbent upon countries in the MENA region to ensure that the international system develops in ways that will benefit them. This necessitates looking beyond the immediate future with the aim of anticipating events rather than reacting to them.

As the 20th century draws to a close, the policy challenges of globalization and regionalization that have been identified in the preceding section present policy-makers with three options. They may choose to rely on the historical policies of reducing at-the-border trade barriers, thus continuing the adoption of what is referred to as the agenda of "shallow integration." Alternatively, they may search for new policy instruments, or even choose instruments that capitalize on the increased interdependence and mobility. This may involve the harmonization and reconciliation of national differences, thus going the route of "deep integration". The third and last route would involve steps towards de-linking to reduce the interdependence and restore some freedom of action to national policy-makers.

New barriers to foreign trade and the international movement of capital are examples of de-linking, that is, of efforts to reduce interdependence by providing for increased separation between national markets. We witnessed some of that during the early 1980s when highly-indebted countries, faced with a mounting debt crisis, increased trade barriers to save foreign exchange, then eventually reversed course. Adopting such a strategy is a very bad idea, and it constitutes the most pessimistic scenario as it will eventually lead countries that adopt this strategy either to complete marginalization or, in case the practice is widespread, the result will be global fragmentation and the forgoing of opportunities for economies of scale and growth through specialization. Under such a scenario one thing is certain: global fragmentation (and at times shallow integration) do not favor the interests of small countries. Quite to the contrary, a fragmented world economy would tempt large countries to use their domestic policies to exploit their monopoly power. One way to counter that is to ensure that markets are indeed competitive and remain open to foreign trade and investment.

Assuming that markets operate efficiently when the invisible hand is left un-fettered, then the freeing of trade and capital flows among countries would ensure that market pressures encourage a certain harmonization of policies while permitting national diversity. However, if one recognizes that markets may fail – and they do – then the case for going the route of deeper integration is strengthened. This is all the more so if one recognizes that in the absence of international governance, opportunistic national behavior could be

expected. Nonetheless, the benefits of closer relations, be it between countries or between marriage partners, can be obtained only at the expense of giving up a certain amount of autonomy or independence.

The institutions and policies of the past – both domestic and international – need to be modernized further and in some countries redesigned in anticipation of the tools, rules and techniques that will be required for international commerce in the first decade of the next century. MENA countries will need to respond to the challenges with a sense of urgency, as failure to do so will see increased conflict within the international system and the realization of the potential benefits of a highly-interdependent system slips away.

The principal policy challenge facing MENA countries is to respond flexibly with domestic institutional arrangements that kick off the process of liberalization in some countries while sustaining it in others. Flexibility is needed in order to accommodate the pulls and strains from at times quite different interests, whether domestic or international. But this represents only the first step in the quest for creating truly international markets in the region.

In the area of FDI, the creation of efficient international markets necessitates providing foreign companies with access and the ability to operate as easily as their domestic competitors. But national treatment in and of itself is only a necessary condition for the creation of a truly contestable international market. Thus, when domestic regulatory reforms remain restrictive for both domestic and foreign firms (such as in cases where governments monopolize public utilities), national treatment means little. Also, national treatment by itself may not produce the desired results in cases where regulations have adverse effects on the operation of MNCs. Examples include local content requirements, rules of origin and restrictions on international financial transfers.

Hence, the creation of truly international markets in the MENA region requires a comprehensive approach that should not be confined to policies affecting trade and investment only. The reach of reforms should also encompass competition policies, government regulations, procurement practices, technology policies and corporate governance.

Notes

1. One recent study (Francois, McDonald and Nordstrom 1994) has introduced scale economies in its estimation.

2. Decision on "Differential and More Favorable Treatment Reciprocity and Fuller Participation of Developing Countries". Decision of November 28, 1979 (L/4903), para. 2(c).

3. Core labor standards are defined as the rules and regulations that establish freedom of association, the right to organize and bargain collectively, restrictions on child labor and prohibition of forced labor. These are the standards that the International Labor Office (ILO) itself is proposing to be included in what is termed the social dimension of trade liberalization.

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Byron Gangnes and Seiji Naya

Why East Asian Economies Have Been Successful: Some Lessons for Other Developing Countries

Introduction

The economic performance of East Asian developing economies over the past three decades has been observed with a mixture of admiration and envy by policy-makers in many other developing countries. The spectacular rates of growth and the apparent ease – to outsiders – with which this growth was achieved have made the region the focus of intense study by development economists. Not surprisingly, success has led to imitation: reforms currently underway in many developing countries are attempting to copy the policy successes of East Asian economies.

By almost any measure, the recent economic performance of East Asian economies has been astounding. Real gross domestic product (GDP) in the newly-industrialized economies (NIEs) of Hong Kong, Korea, Singapore and Taiwan has grown between seven percent and ten percent per year for 30 years. Annual per capita growth has averaged 6.4 percent. In Taiwan, per capita GDP has risen tenfold since 1960, and the NIEs as a group are quickly graduating from the ranks of developing to developed countries.[1]

The resource-rich economies of the Association of South East Asian Nations (ASEAN) have turned in lower yet still robust growth records over the past several decades.[2] With the exception of the Philippines in the 1980s, ASEAN average annual per capita growth rates have been in the 3-4 percent range over the period. Their even stronger performance in the past decade has made them the likely high-growth successors to the NIEs.

To the planner in Caracas or Cairo, the question is whether and how the economic success of East Asia can be reproduced in other places. In particular, whether government policies that were instrumental to Asian economic success might be usefully copied abroad. What are the lessons of East Asian success for other developing economies?

Elements of Asian economic growth

When we search for the secrets of Asian success, we should bear in mind that there is considerable diversity among the countries that make up the NIEs and ASEAN. These countries comprise a wide range of cultures, religions, ethnic groups and languages, and each started the development process from widely differing initial conditions. For example, among the NIEs, Hong Kong and Singapore are small city-states with no agriculture, while Taiwan and Korea

are considerably larger with populations of 20 million and 42 million people, respectively. Although all the NIEs are highly industrialized today, agriculture was a very important sector for Taiwan and Korea in the 1960s, accounting for 37 percent of Korea's GDP in 1960.

The ASEAN countries are also very diverse, with populations of roughly 20 million in Malaysia, more than 50 million in the Philippines and Thailand, and over 175 million in Indonesia. Agriculture is an important – though relatively declining – sector in countries such as Indonesia and Thailand. Indonesia is also a petroleum exporter and a member of OPEC, and Malaysia also exports some oil.

These countries also differ politically. Some – notably Indonesia and Korea – have struggled for national independence, while others – such as Malaysia and the Philippines – have achieved independence more smoothly. Still others, such as Thailand, were never colonized or, like Hong Kong, never achieved full independence. Although they are so widely different in many ways, the countries of East Asia share common elements that appear to have been important in their development success. These common factors are the main focus of this chapter.

Exogenous factors

It is tempting to think that Asia is different, that the Asian "economic miracle" is the result of a fortuitous combination of culture, proximity and timing. The cultural argument has received considerable attention. Many people have argued that Confucianism, with its emphasis on hard work, savings and education, has been instrumental in the success of Japan and the NIEs. To be sure, high savings rates have been helpful in supporting rapid domestic expansion without large external financing, and widespread education has created a large pool of literate and skilled workers in these countries, but these characteristics are not confined to countries with a Confucian tradition, nor have all countries with a Confucian tradition experienced rapid economic growth. In fact, Confucianism has been used to explain the stagnation that existed until recently in China. The recent success of ASEAN countries, which have a variety of cultural heritages, is evidence against a strict cultural theory of Asian success.

The close proximity of the high-growth countries in Asia and the sequential manner in which they developed has been an important factor supporting their growth. The NIEs – and later the ASEAN countries – benefited from the "demonstration effect" of Japanese post-war success and from access to expanding markets in their rapidly-growing neighbors. We discuss this so-called "flying geese" pattern of development further below. Although such factors have played a role in East Asian development, much of Asia's development

success appears to flow less from exotic sources, but rather from enlightened government economic policies. The governments of East Asian economies have adopted domestics policies that promote the efficient use of resources and encourage private sector initiative. These policies include sound macroeconomic policies to stimulate savings and maintain price stability, coupled with outward-looking industrial policies that encourage competition and efficiency, and social policies that enhance the quality of human resources.

Domestic resource mobilization

An important factor behind rapid growth in East Asia has been the region's high rates of domestic savings, which have fueled high rates of investment. Like Japan, the NIEs and ASEAN countries (with the exception of the Philippines) have either dramatically increased or maintained high levels of savings over the past three decades.[3] Korea increased its savings rate from only one percent in 1960 to 35 percent today. Singapore dissaved in 1960, but today saves more than 40 percent of GNP.[4] These high rates of savings are due in part to government policies that encourage savings, including measures to maintain positive real interest rates. This extensive redirection of income from expenditure to savings created a large pool of funds for domestic investment in infrastructure, productive capacity and education.

Savings and capital formation have been encouraged by the maintenance of government fiscal and monetary policies conducive to steady, non-inflationary growth. East Asian governments have placed a premium on fiscal responsibility and low inflation, and they have been willing to suffer short-term economic pain to support these goals. For example, Korea used a self-imposed austerity program in the 1980s to keep servicing requirements on its large foreign debt from overwhelming its current account. Their ability to succeed in this clearly depends on a fairly high degree of social stability and public acceptance of these measures, an issue to which we shall return below.[5]

Outward-looking policies

One of the most visible features of developing East Asian economies has been the importance of export growth in their development. Trade has truly been an engine of growth in the region. During the 1970s, exports grew by 27 percent in Korea and by more than ten percent in the Philippines, Singapore and Thailand. In the 1980s, when world trade grew at about two percent per year, the NIEs, Malaysia and Thailand saw exports grow by more than ten percent per year, and in Indonesia and the Philippines exports grew at rates exceeding six percent. As a result, the NIEs' share of world exports rose from less than two percent in 1960 to more than eight percent by 1988.

The key to the export success of Asian developing economies was their early rejection of import substitution policies in favor of outward-looking policies. Import substitution policies were favored by many developing countries in the early post-war period. Such policies have an obvious political appeal, both for nationalistic reasons and because they provide a quick initial spurt of economic growth, as domestic demand rises to replace imports. The welfare costs of import substitution are well known. High trade barriers protect inefficient domestic industries from foreign competition and prevent specialization from taking advantage of international gains from trade. Dependence on domestic markets alone may lead to inefficient small-scale plants and inferior technology. Further, the import-substituting country is likely to get little help from exports, since restrictive import policies appreciate the real exchange rate and raise domestic production costs through the high prices of imported inputs.

The export-oriented strategy of East Asian developing economies allowed them to exploit their comparative advantage, which lay in the production of labor-intensive manufactured goods. Specialization in such goods also meant that labor would share in the proceeds of rapid growth, as wages rose with the increasing marginal product of labor. Outward orientation exposed Asian firms to the "discipline of the market," forcing them to become efficient in order to compete internationally and ensuring that they would evolve along with changing world demand patterns.

Agricultural progress

Although we tend to associate Asian economic success with manufacturing prowess, agricultural growth has also played an important role in their development success. Agricultural production in the NIEs and ASEAN countries increased substantially in the 1970s and 1980s with the introduction of "green revolution" technology and the development of markets and infrastructure in these countries. In addition to improving nutritional standards, growth in agriculture aided the growth of the non-farm sectors of these economies. Agricultural processing sectors benefited directly. As farm incomes rose, peasant farmers increased their demand for the consumer products of emerging manufactured goods industries. Foreign exchange earnings from surging agricultural exports assisted the import of capital goods required by expanding industries.[6]

Investment in human resources

The rapid industrialization that has occurred in Japan, the NIEs and the ASEAN countries would not have been possible without substantial growth in

the skills, knowledge and ability of the domestic labor force. These countries share a common commitment to education, introducing universal primary education and later secondary education, teachers' colleges and advanced universities. They have also made substantial investments in other programs that enhance human resources, including health care and family planning. In Taiwan, a clinic with family planning, immunization and basic health care services was within walking distance of every village by 1960. Government policies to improve nutrition and control population growth have also been important in improving the quality of life and human capital in these countries.

Successful implementation of growth policies

We might agree that the policies just described are conducive to economic growth, and yet wonder about the apparent ease with which they were implemented and sustained during several decades of development experience. The success of these policies owes much to the manner in which they were implemented, to the powerful "demonstration effect" that Japanese and NIE success had on other countries in the region, and to the emergence of a social consensus supporting the development program.

Neighborhood effects: role models and growth engines

Japan's phenomenal growth in the early post-war period was an early signal to other countries in the region of the potential benefits of export-led growth. This message was reinforced by the success of Hong Kong and Singapore. These two small city-states, with few natural resources, were already major entrepot trade centers after World War II, and they continued to pursue an export-led growth strategy out of necessity. Korea and Taiwan, although considerably larger and with economies more geared towards agriculture than Hong Kong and Singapore, took a cue from their success and that of Japan and began to move towards an export-led strategy in the 1960s.

The ASEAN countries have shifted to outward-looking policies only in recent years. The wealth of natural resources of ASEAN countries had provided ample foreign exchange earnings, permitting them to continue import substitution policies for a prolonged period. Exports of natural resources had also kept real exchange rates high, limiting the competitiveness of industrial exports. "Dutch Disease" symptoms in such oil-exporting countries as Indonesia and Malaysia had already forced these countries to reassess their development strategies in the late 1970s. The collapse of world oil and commodity prices in the 1980s hastened the shift by ASEAN countries to export-promoting policies. These countries began eliminating many of the policies that discriminated against exports, such as import quotas and licensing

requirements, and began providing incentives to industries with export potential. Moreover, several countries devalued their previously-overvalued currencies. The shift towards manufactured exports has been dramatic. Indonesia has seen manufactured exports rise from seven percent of total exports in 1984 to 25 percent in 1989.[7] Even in the Philippines, where reforms have been slower in producing results, manufactured goods export earnings rose from 16 percent of total exports to 66 percent between 1975 and 1981.[8]

Although Japanese growth was admired by these countries, it was the success of Korea and Taiwan that was most influential in changing the policy orientation of ASEAN governments. Korea and Taiwan had begun their development surge from not much higher levels than those of the typical ASEAN countries, so their success demonstrated that rapid growth was not an unreachable goal.

The staggered transition of East Asian economies to export-oriented development policies was beneficial in several ways. The example of successful Asian neighbors was clearly influential in changing government thinking about development policy. The rapid growth of Japan in early years provided a booming market for the primary product exports of the other countries. As Japan and then the NIEs moved up the industrial ladder to more capital- and technology-intensive products, the ASEAN countries were able to take their place as producers of textiles, clothing, light manufactures and, recently, high-technology commodities such as computer components. Japan provided a ready supply of capital and technological know-how to support industrialization in other countries in the region, a role that the NIEs are now beginning to play within ASEAN. This distinctive pattern of development, with Japan pulling along the NIEs, who in turn pull along the ASEAN countries, has been called the "flying geese" pattern of development.

The United States has also contributed to growth in East Asia, most importantly by providing a large and relatively open market for exports. The countries of this region – including Japan – are production rather than consumption centers. Domestic markets in the region alone would not have been able to sustain such rapid export-led growth. Early on, the US also provided much of the foreign direct investment in the region, although Japan – and increasingly the NIEs – have replaced the US as a primary source of foreign capital. Finally, the security umbrella provided by the US military presence in the region permitted East Asian countries to minimize military expenses and created a stable environment able to attract long-term capital investment.

Pro-market government intervention

The hand of government is very visible in the workings of East Asian economies, but its behavior is quite different from that in many other

developing countries. Rather than operating numerous government enterprises and controlling the allocation of factors of production, East Asian governments have generally emphasized market and private sector-oriented policies. This feature has become even stronger in recent years, as the NIEs – and increasingly the ASEAN countries as well – have moved further to implement policies that increase efficiency, including deregulation, enterprise reform and privatization.

The Asian countries are far from *laissez-faire* economies. Governments in these countries went well beyond the traditional neo-classical role of providing public goods such as infrastructure, justice, defense and education by setting industrial objectives and steering investment activities through a wide range of incentives. This is especially true of Korea, where the government still wields a significant amount of control. However, the thrust of such activities was generally to facilitate private sector activities by maintaining a relatively open economic environment and "getting prices right" so that home industries would be competitive on world markets. When industries were protected during their gestation period, it was made clear that the protection would be temporary and that the industry would have to become competitive relatively quickly. Direct participation in the form of government enterprises was relatively uncommon. This strategy of strong government policy in conjunction with a private sector-oriented approach has been called "neo-classical intervention."

Strong pro-market government intervention as practiced by East Asian developing economies has not been without its problems. For instance, the strategy of "picking winners" is fraught with danger. It may be fairly easy in the early stages of development to pick the winners – textiles, garments and other light manufactures are natural choices. But this becomes more difficult when the sectors involved are heavy- and high-technology industries. It is not easy to anticipate changes in comparative advantage in later stages of more capital- and skill-intensive production, and mistakes can be costly. Both Korea and Singapore made major mistakes in the early 1980s and had to make substantial revisions in their development plans.

Another important feature of government policy in Asian developing countries has been the consistency with which its basic thrust has been maintained over the years, and the adaptability that leaders have shown in adjusting details as changing circumstances required. We have noted above that governments in these countries have been very successful in maintaining macroeconomic policies that are conducive to capital formation and non-inflationary growth. Political stability in many of these countries has made this an easier task than in other developing regions. Even countries that have experienced changes in government (for instance, Thailand had several coups

during the 1970s) have managed to keep their basic macro and industrial policies intact. This eventually created a stable, predictable economic environment within which business could operate effectively. In addition, governments have also been flexible when this was necessary. Countries were willing, for example, to discard policies that targeted high-technology development when these plans turned out to have been ill-advised.

A social consensus for development

Developing countries in East Asia have faced relatively little of the social conflict that has marred development efforts in some other regions. The manner in which development strategies were designed and the way that growth proceeded helped to create a consensus among government, business, intellectuals and the populace in favor of development reforms. This consensus made possible a more rapid implementation of development policies than would otherwise have been the case.

In some respects, the limited social conflict over development resulted from the happy historical accident that there was no strong ideological opposition to capitalism or western-style industrialization. Intellectuals and politicians were less concerned with North-South relations and more concerned with real economic results. Economic growth was essentially a matter of national policy, and the Asian governments used economic growth to legitimize their regimes.[9]

Business commitments to development policy were guaranteed by the close cooperation between business and government in establishing economic policy. In the East Asian brand of capitalism, government and business consult with each other. This is in marked contrast to the adversarial relationship between government and business in the West. This close cooperation not only helps to ensure that economically-sound policies are adopted, but also that a constituency exists that supports and indeed has a vested interest in these policies. Japan is well known for this close working relationship between government and business, but this kind of capitalism is not limited to Japan. In Korea, considerable efforts have been made to engage industrialists, bankers and government officials in deliberations concerning the selection of appropriate investment projects. In Thailand, the Joint Public and Private Sector Committee, which is chaired by the Prime Minister, brings together government officials and businessmen in an ongoing policy dialogue.

This close relationship between business and government can have drawbacks, of course. There develops a fine line between cooperation and corruption, and irregularities – such as the Recruit scandal and the Japanese banking scandal – are likely to arise from time to time. To avoid such problems, it is

important to create as transparent a relationship as possible and to maintain accountability through bureaucratic or elective means.

The most important factor in forging a social consensus in Asian developing countries has perhaps been the commitment of the general population to development policies. The absence of strong labor unions in most Asian countries made this easier to achieve, but the manner in which development progressed was equally important. The early success of labor-intensive light manufacturing industries meant that labor shared considerably in the economic gains from the early stages of industrialization. At the same time as average incomes rose in these countries, income distribution also became more equitable. The policy programs that stressed education and health care also directly benefited the masses.

The limits to East Asian growth

Although economic growth in East Asia has been impressive, it has not come without problems. The past few years have shown that there is such a thing as too much – or at least too fast – economic growth. Rapid expansion has begun to test the limits of existing resources of skilled labor, infrastructure and the environment. Real wages have risen rapidly, undercutting competitive advantage in labor-intensive manufactures, and demands for faster wage growth have become more vocal. For example, Korea has experienced labor agitation over the wage issue in recent years. The NIEs in particular are being squeezed from above and below, being forced to provide more income to their citizens while facing increasingly competitive products from China and Southeast Asia. In many countries, roads and utilities are overloaded by the demands of new factories and their workers. Likewise, deforestation and declining air and water quality bear heavy environmental costs. In coming years, East Asian governments face the prospects of sharply higher spending on infrastructure and training, as well as a reorientation of capital investment towards technically sophisticated products if they are to continue the steady improvement in living standards that they have seen over the past three decades.[10]

The East Asian economies are also facing a less hospitable external environment for their products. Trade friction between the US and Japan spills over to US trade relations with other Asian countries, threatening more restrictive US import markets in the future. Because the US is by far the dominant market for Asian exports, there is a serious need to prevent further trade deterioration and seek out new markets in Europe and Asia.[11] New discriminatory blocs also threaten to divert trade away from Asian countries. Countries in the region are particularly concerned about the inclusion of

Mexico in the North American Free Trade Area, fearing that goods produced with inexpensive Mexican labor will have a competitive edge in the US.

Developing country responses to East Asian success

The impressive development record of East Asian countries has not been lost on the rest of the developing world. As countries have begun to adjust to the reality of deteriorating terms of trade and have attempted to escape from under the weight of the debt crisis, many have adopted economic restructuring programs that incorporate some of the elements of the East Asian experience.

These efforts have already begun to bear fruit. Nowhere have signs of an economic turnaround been more evident than in Latin America. The backdrop for Latin American reform was fairly grim. After substantial rates of growth in the 1960s, growth in Latin America slowed in the 1970s, and fell even further in the 1980s. For some countries (Uruguay, Argentina and Bolivia), per capita GDP was, in the late 1980s, at or near the level where it was in 1960. Only Colombia, Mexico and Brazil have seen average per capita GDP growth above two percent over the last three decades, with Brazil experiencing four percent average per capita growth. As a result, levels of per capita income for Latin American countries have fallen relative to those in East Asia. Most Latin American countries still have per capita incomes greater than East Asian countries (except for Hong Kong and Singapore), but that gap has narrowed considerably.[12]

In the past several years, economic reform programs in Latin America – especially in Mexico, Chile, Colombia and Venezuela – have begun to turn the tide. Mexico has returned to growth in the four to five percent range, with investment growing in the eight to ten percent range. Venezuela and Chile have enjoyed similar or higher growth rates over the past two years. Colombia, still struggling with domestic terrorism, has maintained growth in the three to four percent range recently.

A primary element of Latin American reforms has been renewed emphasis on market mechanisms. Mexico, for example, has completed a comprehensive program of trade liberalization, financial deregulation and privatization. Other countries have followed suit, reducing tariff walls, renegotiating with developed country banks and the International Monetary Fund (IMF) so as to reduce still heavy debt burdens, and reducing budget deficits to get their fiscal houses in order. A consensus for reform seems to have emerged in Latin America. A magazine article in *The Economist* has summarized the mood:

> Avoid fiscal deficits and restrain monetary growth. Keep the exchange rate realistic and liberalize currency controls. Cut import tariffs to 20 percent or less, to keep local producers competitive and push them to seek markets abroad. Abolish those easy-to-collect taxes on exports. Keep real interest rates positive. And privatize. The buzzwords are sustained, non-inflationary, export-led growth.[13]

Financial markets have responded favorably to these reforms. Latin American stock markets are booming, fueled in part by a return of domestic capital that had fled abroad. The privatized Mexican telephone company has been one of the most actively-traded stocks on the New York stock exchange. The value of Latin American debt in secondary markets, which had traded at steep discounts less than two years ago, has risen by about 20-30 percent of face value since then.

These reforms have not come painlessly. The sharp cuts in government spending have reduced expenditure on basic services like water, sewers, schools and hospitals. Unemployment has grown in most countries, and the number of people below the poverty line has increased. So far, however, there appears to be considerable public support for the reforms.[14] Nevertheless, governments in Latin America face a serious trade-off between the pace of reform and social unrest.

Lessons for Egypt

In many ways, to the outsider, Egypt looks like the archetypal developing country of the 1990s. It has lived through a period of reliance on import-substituting development policies and now maintains a large government sector, centrally-controlled production and allocation, and an export sector dependent on oil and the Suez Canal. The burden of high levels of government spending has led Egypt to accumulate a heavy load of international debt and to resort in part to seignorage with its associated inflation. Like other developing countries, it is trying to implement market-based reforms, but progress is impeded by an entrenched bureaucracy and fear of social unrest. A brief look at the Egyptian situation suggests the benefits from pushing forward with such reforms as well as the difficulty in doing so.

The legacy of import substitution in Egypt is well known. Development in Egypt has traditionally been heavily managed from the center to promote import-substituting production. As a result, the country has a massive public sector. In recent years, government expenditures have constituted nearly 50 percent of GDP. Many non-government industries are heavily subsidized either through direct subsidies or, more importantly, through implicit

subsidies from price controls. The most important of these are regulated energy and food prices. These subsidies and the large government payroll have necessitated heavy foreign borrowing and, more recently, increased printing of money. Inflation, meager net savings and heavy resource transfers abroad have been the result. The extensive system of implicit and explicit subsidies contributes to microeconomic price distortions that are "internationally notorious."[15] The resulting pattern of financial rates of return has almost no relationship to estimates of the true economic rates of return.[16]

In the past several years, the government of Egypt has made efforts to reduce the macro and micro distortions created by large and intrusive government. Real interest rates – which had been negative – have been made more realistic, reducing the disincentives against saving. The government hopes to stabilize its budget deficit at a "manageable" ten percent of GDP through a new sales tax, limits on direct subsidies, and a reduction of public sector real wages. Much of the remaining government deficit is now financed by debt rather than bank loans, thus reducing inflationary pressures.[17] Price increases for fuel, electricity and communications have been pushed through. Following its stand in the 1990/91 Gulf War, Egypt has received forgiveness or favorable rescheduling on US$25 billion in foreign debt. The government may be on the way to establishing a more stable macroeconomic environment, and one conducive to capital formation.

The heavy control of industrial prices remains a severe obstacle to a more efficient economy. A successful shift to export-led growth would require the elimination of price controls that discriminate against goods for which Egypt potentially has a comparative advantage in favor of others for which it clearly does not. The current system has reduced cotton exports to a small fraction of their level in the 1970s and has increased Egypt's dependence on expensive imported food. Meanwhile, production of capital-intensive goods such as aluminum has expanded. Not only does this costly scheme fail to create competitive goods for the world market, it increases unemployment by displacing workers from labor-intensive sectors.[18] The prices of inputs – energy, agricultural products and capital – must be restored to market levels before incentives for efficient production will exist.

The overwhelming size of the public sector in Egypt will make the transition to market-oriented industry more difficult. An increased role for the private sector will require a substantial dislocation of public sector employees. For this reason, the government appears to be moving conservatively towards more decentralization of decision-making within the public sector rather than towards extensive outright privatization.[19] It seems doubtful that this will radically improve the efficiency of state enterprises. Bureaucratic rigidity and infighting also make wholesale change more difficult to implement.

In the case of East Asian countries, supporting the development effort was a consensus on the part of government, business, intellectuals and the citizenry that the development program was desirable. It may be difficult to forge such a consensus in Egypt. The anti-imperialist and socialist traditions in Egypt shape thinking in government: "There is so little agreement within Egypt on the appropriate economic and social path that the country should be following – whether socialist, capitalist or Islamic – that various voices within individual ministries compete for President Mubarak's attention."[20] There are also a large number of businesses with vested interests in the *status quo*.

Getting the populace on board will also be difficult. The social cost of reform is potentially very great. Reduction of food subsidies or basic social services for a growing, impoverished population will be painful. The government remembers well the 1977 bread riots in which 100 people died, and it is wary of opportunism by Islamic fundamentalists. The government of Egypt needs to facilitate quick and visible relocations of workers to the new growth industries – whatever they may be – in order to demonstrate the gains to the general public from market-based reforms.

Conclusion

By any reasonable standard, the NIEs have outperformed all other developing countries over the past three decades. The ASEAN countries have also been relatively successful. While exogenous factors such as initial conditions, location and culture may have played a part in this success, they were not of sole importance. A common element in each of these success stories appears to be consistently applied sound economic policies. East Asian developing countries have embraced outward-looking development strategies that promote industrial competitiveness within a conservative, non-inflationary macroeconomic environment conducive to savings and investment. These countries have emphasized social programs – education, training and health care – that raise the quality of human resources and help generate a social consensus for economic growth.

The experience of these countries suggests some general principles that may guide policy design elsewhere. Government policies can be implemented more effectively and with less distorting effects by using indirect controls that work through the price mechanism rather than direct controls. Fiscal and monetary restraint that encourages stable prices and exchange rates is important for maintaining a healthy environment for saving and investment and for protecting the price competitiveness of the country's goods. Trade, financial, industrial and labor policies all contribute to these goals.

Unfortunately, neither economic theory nor the East Asian experience

gives us a clear roadmap to follow in achieving these goals. Lowering tariff barriers, depreciating the exchange rate, removing exchange controls and reducing the role of public enterprises may all be beneficial in creating the appropriate development environment, but there is little in the Asian experience to tell us what is the best sequencing, timing or speed of the various reforms. In the Asian experience, many alternative approaches have been used. Taiwan, for example, emphasized competition within the domestic economy, and its economy has many small firms and no extremely large ones. Korea, however, based its development on a few large conglomerates. Both Taiwan and Korea have kept tight controls over capital flows, while the ASEAN countries generally have had more liberal financial policies. Indonesia, for example, liberalized capital flows at a much earlier date than trade flows. These different experiences suggest the need for a flexible approach that seeks out what works best in any specific country.

Aside from uncertainties about the timetable and sequencing of reforms, there are roadblocks along the way to outward-looking, market-oriented reform. First, a reduction of import protection and removal of subsidies to public enterprises will lead to bankruptcies, and unemployment will rise in some sectors. This can generate intense political opposition to liberalization and privatization. Hence, the reform package must include policies to speed the reallocation of resources towards export sectors. Second, exchange rate depreciation and trade liberalization may lead to balance of payments problems. Because of likely short-run J-curve effects, imports may increase faster than exports initially, and programs to accelerate the export response would be helpful. Cheap export financing in the short run may allow a faster export response.

Moreover, inflation may tend to rise under devaluation, reducing the favorable effects on competitiveness. The uncertainty associated with inflation will also reduce the incentives for savings and investment. Maintaining reforms at all becomes difficult if inflation gets out of hand. Therefore, anti-inflationary stabilization policies must be adopted in conjunction with liberalization efforts. Furthermore, favorable external conditions are important for a successful shift to outward-looking growth policies. There has recently been some concern that the world trade environment is not big enough to accommodate the increasing number of developing countries that are turning to outward-looking policies. This new export pessimism is based on concerns that developed country markets could become flooded with goods from developing country exporters.

Yet, the world export market is not fixed. Increased trade liberalization should create new opportunities for gains from trade for all countries. From the standpoint of individual countries, it is always possible to take over the

market share of other countries by becoming more competitive. Finally, comparative advantage is a dynamic process. As Japan developed, rising wages in Japan meant that its advantage in labor-intensive manufactures was lost to the NIEs. As a consequence, Japan moved on to technology-intensive goods. Similarly, the NIEs are now seeing their comparative advantage in labor-intensive goods eroded by increased competition from ASEAN countries. Opportunities for other countries to enter at the lower rungs of this development ladder should continue to exist in the future.

This argument, however, does point out the strong interest that developing countries have in maintaining an open world trade environment. Developing countries may stand to lose the most if the world trading system deteriorates into a set of "Fortress Europes" and "Fortress North Americas." Developing countries should be strong advocates for multilateral free trade, and they should be willing to demonstrate their commitment by making concessions of their own at the bargaining table.

Notes

1 Seiji Naya and Pearl Imada, "Development Strategies and Economic Performance of the Dynamic Asian Economies: Some Comparisons with Latin America", in *The Pacific Review*, Vol. 3 (April 1990). Development statistics are also taken from this source unless otherwise noted.

2 ASEAN was formed by Indonesia, Malaysia, the Philippines, Singapore and Thailand in 1967 (Brunei became the sixth member in 1984) for reasons that were more political and diplomatic than economic. But reflecting changed political and economic conditions in the region, the countries have recently begun to cooperate more extensively on economic issues. The ASEAN countries agreed in January 1992 to form a free trade area over the next 15 years.

3 The Philippines has traditionally had savings rates below those of other ASEAN countries, and Philippine savings rates further declined during the 1980s, probably largely as a result of sluggish growth and economic uncertainty.

4 The dramatically high rate for Singapore is partly the result of a system of forced savings into a mandatory retirement plan, the "Providence Fund." Whether forced or not, these funds represent a large pool of resources available for financing investment.

5 East Asian economies have also made very efficient use of saved funds, with several countries experiencing very high rates of productivity growth relative to investment expenditures. (See Amar Bhattacharya and John M. Page, Jr., "Adjustment Investment and Growth in the High-Performing Asian Economies," in this volume). Why investment efficiency is higher in East Asia than in other developing regions is not known, but it may be due in part to the predominance of private rather than public investment and the relatively open trade environment that exposes investing firms to the discipline of international competition.

6 See William E. James, Seiji Naya and Gerald Meier, *Asian Development: Economic Success and Policy Lessons* (University of Wisconsin Press, 1989), Chapter 5.

7 Asian Development Bank, *Asian Development Outlook 1991*, p. 89.

8 Maria Cecilia Icay, "Manufactured Exports: Its Role in Philippine Development", Mimeo (University of Hawaii, 1992).

9 Some observers have noted that geopolitics was perhaps more important than ideology in the choice of devèlopment strategy. Countries that embraced centralized economic systems may have done so because they were forced into the Soviet sphere by the East-West conflict. By this view, East Asia was lucky to be forced into the Western camp, with its emphasis on the market economy.

10 Seiji Naya, "Asian NIEs and the New Latin America: Growth Imperatives for Korea (an Outsider View)", Mimeo (Seoul, Korea: International Trade and Business Institute, 1992).

11 See Byron Gangnes, "Can ASEAN Countries Survive a Hostile Trade Environment? Evidence from Linked Econometric Models", in *Exports, Foreign Investment, and Growth in East and Southeast Asia*, edited by F.G. Adams and R.F. Wescott (Kitakyushu, Japan: International Center for the Study of East Asian Development, 1992).

12 See Seiji Naya and Pearl Imada, 1990, p. 290.

13 "Latin America's Economic Reforms", *The Economist*, 19 October 1991, pp. 22-24.

14 See, for example, "Argentina's Economy", *The Economist*, 18 April 1992, pp. 17-18, and "Latin America's Economic Reforms", *The Economist*, 19 October 1991, pp. 22-24.

15 Alan Richards, "The Political Economy of Dilatory Reform: Egypt in the 1990s", in *World Development*, No. 19 (December 1991), p. 1724.

16 World Bank, "Arab Republic of Egypt: A Study on Poverty and the Distribution of Income", Draft Report, 1989, p. 22, as cited in Richards (1991).

17 *The Economist*, 18 January 1992, p. 43 and Richards (1991).

18 It is also likely that it increases the budget deficit. If government enterprises were allowed to earn a market rate of return, net government revenues would increase. One study estimates that raising rates of return to ten percent (still below the market rate) would improve the Egyptian budget deficit by about LE 1,200 million. See William F. Fix, "The Effects of Public Sector Price Increases on the Egyptian Government Budget", Mimeo (University of Tennessee).

19 Richards (1991).

20 Denis J. Sullivan, "The Political Economy of Reform in Egypt", in *International Journal of Middle East Studies*, No. 22 (1990), p. 319.

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Adjustment, Investment and Growth in the High-Performing Asian Economies

Introduction

During the 1980s, most developing economies went through a process of macroeconomic and structural adjustment. Adjustment programs, designed to tackle rising inflation and increasing balance of payments difficulties, were implemented with varying degrees of success in a wide range of countries.[1] Typical adjustment policies were cuts in public spending, opening the economy to international competition, reforms in prices to allow them to reflect economic values, and reforms of institutions – notably in the financial sector – to support a better-functioning market economy. The intent of these adjustments was to allow the economy to shift to a new, sustainable growth path.

A broad consensus has emerged that the heavily interventionist policies of the 1960s and 1970s, which emphasized anti-competitive distortions of the incentive structure, subsidized and directed credit, and state investment in industry, had ceased to yield their desired results in promoting growth. Structural reforms concentrated on measures to restore the neutrality of incentives, to promote both external and internal competition, and to reduce the role of the state in the ownership of industrial enterprises. In a wide range of developing economies, governments undertook efforts to rationalize and/or eliminate the multiple and frequently offsetting distortions in product and factor markets, to minimize regulatory and administrative controls on private economic activity, and to focus the role of the state on the efficient provision of such public goods as infrastructure and social services.

In the wake of these reforms, however, new concerns emerged regarding the extent of the supply response to adjustment and the acquisition and maintenance of international competitiveness. The spectacular growth of a number of high-performing Asian economies (HPAEs), beginning with Japan and most recently including Indonesia, Thailand and Malaysia, together with the perception that these economies had persistently high levels of technocratic management of their development processes, provoked renewed interest in the role of the state in promoting growth.[2]

The high-performing Asian economies went through their own process of adjustment during the 1980s. Yet, they seem to have been affected less severely and to have recovered more quickly than other developing countries. This chapter examines the relationship between characteristics of long-run growth and adjustment in the HPAEs. The following section provides a comparative analysis of the long-run patterns of output growth, investment, and total factor

productivity (TFP) change for the HPAEs relative to other developing countries, followed by an examination of their relative export performance. Subsequently, we describe the patterns of macroeconomic adjustment in both high-performing Asian economies and other adjusting economies, focusing on fiscal adjustment and structural reform. These elements are then brought together to form some preliminary hypotheses concerning the sources of these Asian economies' more robust supply response to adjustment.

Investment, productivity change and growth

Interest in the "new economics of growth" and the availability of consistent data on output and investment at constant international prices have resulted in the recent publication of several important cross-country studies on the sources of growth in per capita income.[3] Most of the new empirical studies have been concerned with testing for "convergence" of per capita income levels between low and high-income countries (Barro 1991, Dollar 1991) and with quantifying the roles of physical and human capital investment in income growth.[4]

These studies and their underlying data also provide substantial information on "patterns of growth" – variations in economic variables with per capita incomes – which are reminiscent of the earlier literature by Chenery and his associates.[5] In this section, we use Heston-Summers (1988) data to examine whether the relationship between income level, investment and growth observed in the HPAEs differs substantially from that derived from cross-country observations.

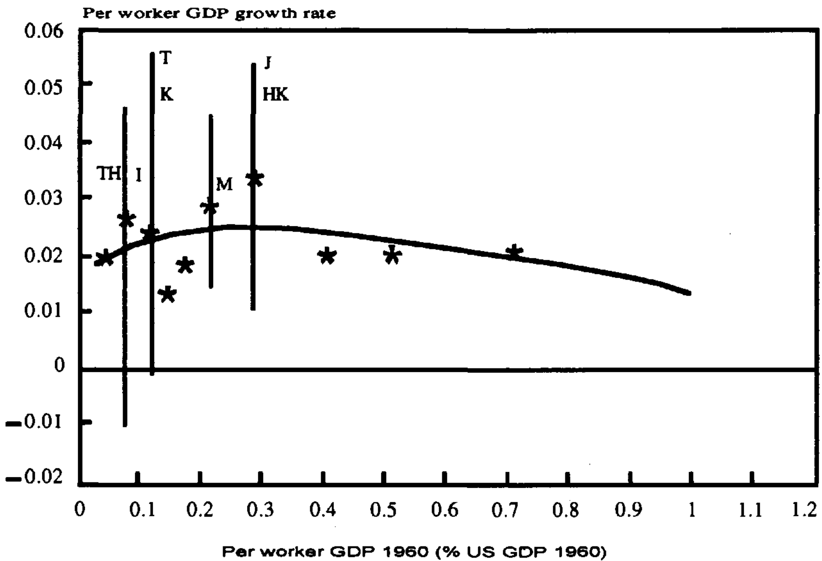
The relationship between income level and growth

We have used the data set compiled by Heston and Summers (1988) and extended by De Long and Summers (1991) to examine the relationship between relative income level in 1960 and growth for a sample of 62 countries during the period 1960-85. Figure 1 summarizes this evidence. The 62 countries in the sample are divided into deciles, with the richest countries in the first decile (the first and last "deciles" contain seven observations), and the poorest countries in the tenth. Income levels relative to the United States as well as growth rates are plotted for the deciles in Figure 1. The figure also plots the estimated non-linear relationship between initial income and growth.[6]

In our sample, per capita income growth is essentially independent of the level of relative income in 1960. The fit of the regression is poor, and the significance of individual coefficients low. Thus, the regression line is a weak "pattern of growth," summarizing the tendency for countries at different levels of development to grow at different rates. Countries in the middle-income range (relative GDP to the United States in 1960 between 0.2 and 0.4) appear

to grow more rapidly than all other countries in the sample. Although they had large differences in average initial incomes, the two high-income deciles grew at about the same rate, below the middle-income countries and at roughly the same rate as the lowest three deciles. Only the middle-income countries were "converging" on the per capita income levels of the more developed economies.[7]

Figure 1: GDP/wkr Growth (1960-85) and GDP/wkr Level (1960)



$$GDPG = 0.020 + \underset{(0.030)}{0.026}\,(1\text{-}RGDP60) - \underset{(0.036)}{0.035}\,(1\text{-}RGDP60)^2$$

$n=62$ $R^2=0.017$ $RMSE=0.016$

The pattern of income growth of the HPAEs is quite different. Per capita income growth for each HPAE is plotted against the average income for the decile in which the economy was located in 1960. The range of observations in the decile is shown for those deciles containing HPAEs. This gives the relative position of the observation in the decile, and an approximate relative position to the regression line summarizing the per capita income-growth relationship for all 62 economies. The seven high-performing Asian economies for which data are available (Singapore is excluded) are all positive outliers in the income-growth distribution. Malaysia, Indonesia and Thailand are all close to their decile mean and predicted value. The remaining four economies –

Taiwan, Korea, Japan and Hong Kong – are all significantly above their predicted GDP per capita growth rates on the basis of relative income level.[8] All of the HPAEs were catching up with the more developed countries.

The relationship between income level and investment

Both neo-classical growth models and the newer "endogenous growth" literature assign a central role to investment in explaining variations in growth performance. One view of the success of the high-performing Asian economies is that their investment levels substantially exceed those for other countries at similar levels of development, resulting in more rapid growth of per capita income. More subtle explanations for the success of the HPAEs also stress the role of human capital accumulation in their rapid growth.

Figure 2 shows the relationship between income level in 1960 and the average investment rate during 1960-85 for the sample of 62 economies. The means for each decile, observations for each of the seven HPAEs, and the estimated non-linear regression line are shown. There is substantially more regularity in the relationship between investment share and relative income. The fit of the regression line is markedly better, as is the variance of the estimated coefficients. The investment rate for all countries increases with income up to about 70 percent of US GDP in 1960 and then declines.

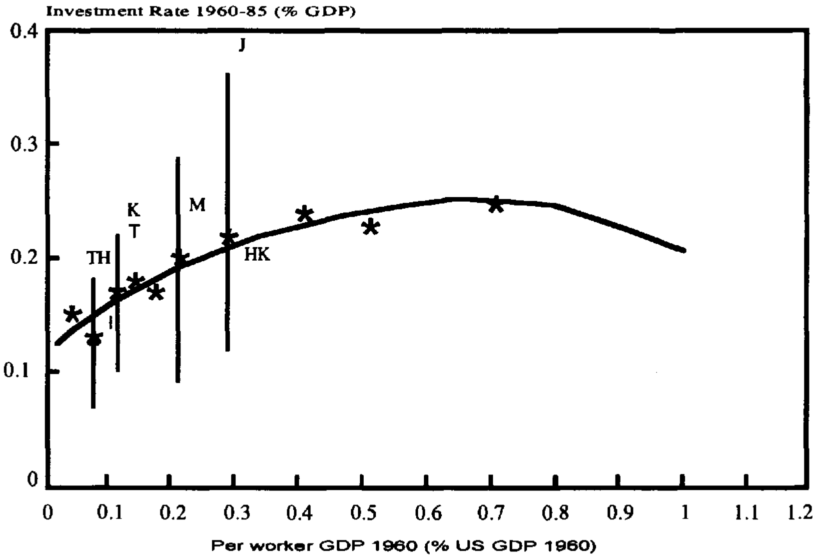
The HPAEs conform much more strongly to the cross-country pattern of investment rates than to the pattern of growth rate. Indonesia and Hong Kong lie below their predicted values on the basis of the cross-country regression, and Hong Kong below the average for its decile. Korea, Thailand, Taiwan and Malaysia exceed the decile average rate of investment, but lie relatively close to their predicted values. Only Japan is an extreme outlier, lying well above its decile mean and predicted value.[9] High investment rates are part of the Asian success story, but with the possible exception of Japan, they cannot fully explain the extent to which per capita income growth in the HPAEs diverges from the typical pattern.

Investment, output growth and productivity change

It is possible to bring together the elements of output growth and investment in terms of the simple neo-classical model represented in Figure 3. The assumption is that there is an international best-practice production function, f_1, which relates output per worker to capital (including human capital) input per worker.[10] Firms can move along the best-practice function, increasing output per worker, as the result of capital deepening. The best-practice function defines the "state of the art," in the sense that further increases in output per capita at given levels of capital per head cannot be achieved without the

introduction of new techniques. The introduction and dissemination of new techniques moves the best-practice frontier and constitutes "technical progress" as defined by Solow (1956).

Figure 2: Investment Rate (1960-85) and GDP/wkr Level (1960)



$$INV = 0.120 + \underset{(0.122)}{0.416}\,(1\text{-}RGDP60) - \underset{(0.145)}{0.328}\,(1\text{-}RGDP60)^2$$

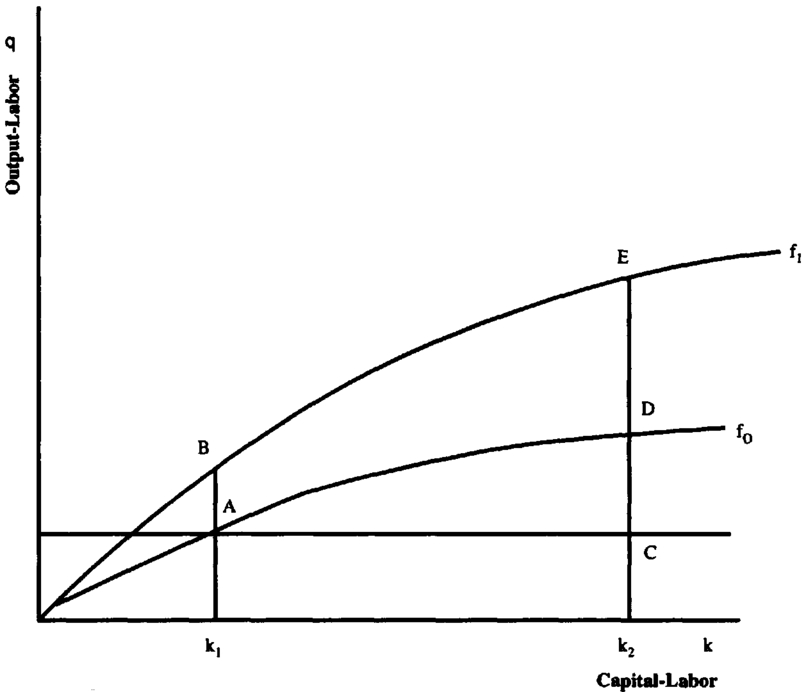
$n=62$ $R^2=0.264$ $RMSE=0.065$

Observed performance in a sample of countries or firms reveals that few are at best practice.[11] Rather, most lie below the production frontier due to the use of dominated techniques or to the inefficient use of best-practice techniques. Empirical measurements of the relationship between inputs and output using conventional statistical methods result in a functional relationship such as f_0 in Figure 3.[12] The convergence literature suggests that most developing economies are along f_0. Convergence can be achieved by moving from a point such as A to E, combining accumulation with a movement towards best practice. A rapid shift from average practice to best practice can provide a powerful engine of growth, which is recorded as high rates of total factor productivity (TFP) change.[13]

The relationship between the pattern of output growth observed for the HPAEs and their pattern of investment suggests that total factor productivity change is high in these economies. While it is not possible to measure TFP

change directly on the basis of the Heston and Summers data, it is possible to use the approach adopted in the convergence literature to derive approximate estimates of economy-wide TFP growth.[14]

Figure 3: Best Practice and Average Practice Production Functions



If an internationally accessible cross-country production function of the form:

$$Q = AF(K,E,L) \qquad (1)$$

exists, where K is a measure of capital services, E is a measure of human capital endowments, and L is a measure of labor services in natural units, then output per head can be represented as:

$$(q - l) = a + s_K (k - l) + s_E (e - l), \qquad (2)$$

where lower case letters indicate rates of change and s_K and s_E are the elasticities of output with respect to capital and human capital.

Following the specification of other studies of convergence (Barro 1991, De Long and Summers 1991, Dollar 1991), we employ the following cross-country estimating equation:

$$GDPG = f(INV, ED, RGDP60) \qquad (3)$$

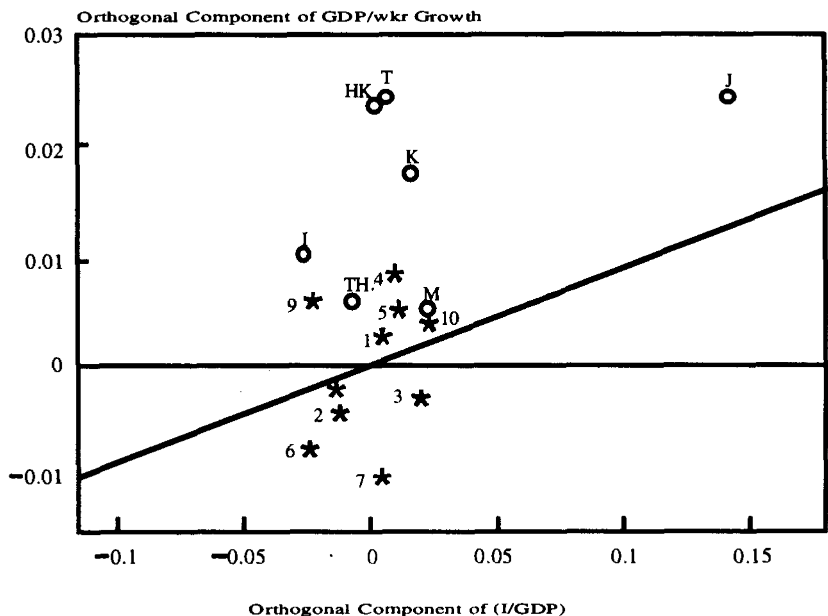
where GDPG is the average rate of real per capita income growth using Heston-Summers measures from 1960-85; INV is the average share of investment in GDP over the period 1960-85; ED is the primary school enrollment rate in 1960; and RGDP60 is the relative gap between per capita income in 1960 (at 1980 US$ prices) and US per capita income in 1960.[15] The underlying model is that there is an international production function, as in (2), for which the investment share in GDP and the level of education can act as proxies for the growth of physical and human capital per worker. These conventional production function variables are supplemented by the variable RGDP60.

The shift variable (RGDP60) is generally interpreted in the convergence literature as summarizing the productivity (TFP) gains realized as a consequence of moving from lower (f_0 in Figure 3) to higher (f_1) technological levels. This "catching up" is technical efficiency change, as defined above. Pack (1992) has recently offered an interesting alternative interpretation of the shift variable. In a time series analysis of a given country, total factor productivity growth consists of two components: intra-sectoral TFP growth and the impact of factor reallocation among sectors.

One of the important empirical regularities found in the early literature on structural transformation (Kuznets 1959, Chenery 1960) is the shift of labor from agriculture to industry as per capita income rises. Dual economy models (Lewis 1954) emphasized the large inter-sectoral discrepancies in the marginal product of labor between traditional (agriculture) and modern (industry) sectors. Pack (1992) demonstrates that a dominant share of the TFP growth in low-income countries can be attributed to inter-sectoral reallocation of labor from agriculture to industry, and that the reallocation effect is monotonicly decreasing in per capita income. Thus, the shift variable RGDP60 captures the reallocation effect of structural change on TFP.

Figure 4 and equation (4) report our results on the relationship between investment and output growth. The basic estimating equation compares favorably with other studies using similar specifications. The overall fit of the regression is good, and the coefficients of the variables are of the expected sign and are significant at conventional levels (0.05 level).[16] An increase in the primary school enrollment rate of ten points in 1960 (that is, from 50 to 60 percent) would have added an estimated 0.17 points to the GDP growth rate. The RGDP60 variable indicates that after controlling for the effects of investment and education, economies which were relatively poor in 1960 grew significantly faster than those which were richer. An economy at 50 percent of the level of US per capita income in 1960 would have grown 1.6 percentage points more rapidly than the US, controlling for education and investment. We interpret this to reflect the impact of structural transformation on productivity in the one-sector model.

Figure 4: Investment and Economic Growth



$$GDPG = -0.031 + 0.031\ RGDP60 + 0.017\ ED + 0.089\ INV \quad (4)$$
$$\qquad\qquad (0.011) \qquad (0.009) \qquad (0.030)$$

n=62 $\quad R^2=0.274 \quad$ RMSE=0.014

The figure plots the component of 1960-85 GDP per capita, GDP growth orthogonal to primary school enrollment rate in 1960 (ED), and the relative GDP per capita gap in 1960 (RGDP60) against the component of the average share of investment in GDP 1960-85 (INV) orthogonal to the same two variables. It is a partial scatter of the relationship between growth of output per capita and investment, controlling for human capital and the component of TFP change related to relative backwardness. The decile observations are plotted relative to the estimated regression line, as are the observations for the HPAEs. Per capita income is an increasing function of the share of investment. An increase in the investment share of ten percentage points (say, from 15 to 25 percent) would raise the rate of growth of GDP per capita by nearly one percentage point.

Deviations from the regression are estimates of productivity change which cannot be attributed to accumulation – that is, investment in physical or human capital – or to the component of TFP change associated with income levels. Overall, the productivity performance of the HPAEs is remarkable relative to their decile performance and to the predicted values. All seven economies are

positive outliers and all outperform the average observation for their decile. When a dummy variable taking on the value of one for HPAEs is added to the estimating equation in (4), the following results are obtained:

$$GDPG = -0.018 + \underset{(0.012)}{}\ 0.020\ \underset{(0.011)}{RGDP60} + 0.012\ \underset{(0.008)}{ED} + 0.076\ \underset{(0.028)}{INV} + 0.018\ \underset{(0.006)}{DHPAE} \quad (5)$$

There is interesting variation among these economies, however. The HPAEs fall into two distinct groups – investment-driven economies and productivity-driven economies. Albeit positive outliers, the investment-driven economies (Indonesia, Japan, Malaysia and Thailand) lie relatively close to the predicted relationship between investment and productivity growth. Much of their extraordinary growth performance over the period 1960-85 can be attributed to their high investment rates, human capital endowments and "catching up."[17]

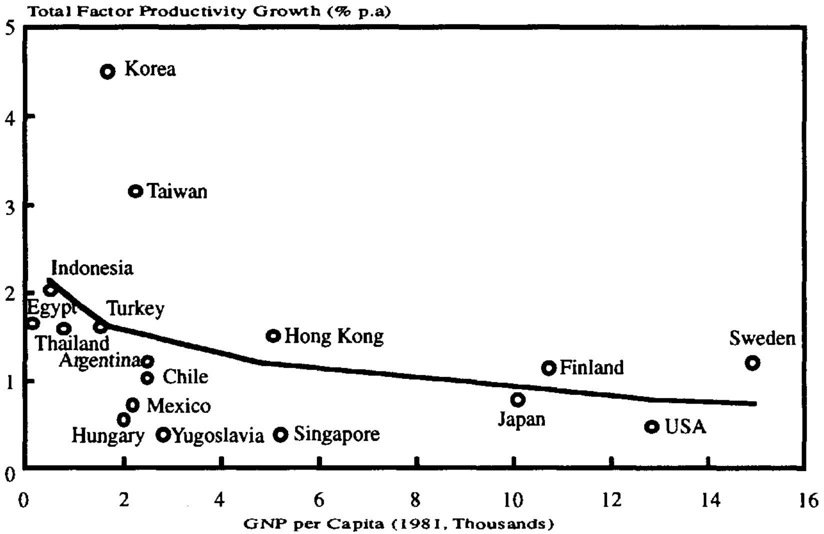
On the other hand, the productivity-driven economies (Korea, Taiwan and Hong Kong) are extreme outliers. Their rapid growth in per capita incomes is poorly explained by the conventional production function variables used. The component of TFP change which is independent of the initial level of per capita income appears to be driving much of the growth in these economies.[18]

If Pack's (1992) hypothesis is correct and the variable RGDP60 captures mainly the impact of structural change, the intra-sectoral rate of TFP change in the industrial sector should be closely associated with the component of TFP growth appearing in Figure 4. Page (1990) reviews the empirical literature on TFP change in industry for a sample of developing and developed countries. We have expanded his data to include observations on Hong Kong, Taiwan and Singapore. These are summarized in Figure 5, which plots the mean of the TFP growth rate for all ISIC two-digit industries in each economy against the level of per capita income in US dollars in 1981.[19]

Productivity-based catching up should be reflected in a negative relationship between the level of per capita income and the mean TFP growth rate. Following Page, we exclude the three observations with negative TFP growth rates and estimate the relationship between income per capita and TFP change in equation 5, below the figure.[20] The plot of the estimated regression is presented in Figure 5.

The addition of three new observations somewhat strengthens Page's earlier finding of a weak negative relationship between income level and TFP change. There is great variance in rates of industrial TFP growth among low-income countries. The high-income countries are closely distributed around a mean TFP growth rate of one percent (gross output basis) per year, which may represent the rate of technical change in the sense of Figure 3, while the higher predicted rate of TFP change at low levels of income may represent catching up via more rapid technical efficiency change.

Figure 5: Relationship Between Total Factor Productivity Growth and GNP per Capita



$$\text{TFPG} = 4.726 - \underset{(0.241)}{0.414}\ \text{Ln(GNP)}$$

$n=17$ $R^2=0.165$ RMSE=0.992

The pattern of productivity growth rates of the HPAEs confirms our earlier result. Korea, Taiwan and Hong Kong are the positive outliers in the sample. Indonesia, Thailand and Japan conform more closely to their predicted values on the basis of per capita income levels. Singapore is below its predicted value, and Malaysia is not represented. The productivity-driven economies have unusually high rates of industrial TFP change, providing an engine of rapid industrial growth. By contrast, the investment-driven economies have "normal" TFP growth rates for their level of income, which means that rapid growth of output depends more on factor accumulation. Among the HPAEs in the sample, Korea, Taiwan and Hong Kong conform to the productivity-driven pattern, while Indonesia, Japan, Thailand and Singapore are more investment-driven.[21]

Export performance and growth

Another striking feature of the HPAEs has been their superior long-term export performance. This is reflected in steadily rising shares in world exports (see Table 1). As a group, the HPAEs increased their share in world exports from

7.9 percent in 1965 to 13.1 percent in 1980 and 18.2 percent in 1990. Whereas Japan is by far the largest of the group in terms of its share of world exports, the other HPAEs have increased their relative share over time, led by the four newly-industrialized economies (NIEs). In fact, the four NIEs – Hong Kong, Korea, Singapore and Taiwan – have been notable for their accelerating export performance (Table 2). As a result, while Japan accounted for 63 percent of HPAE exports in 1965, its share had fallen below 50 percent by 1990.

Table 1. Export Penetration, Selected East Asian Countries, 1965-90 (percent)

	Share in World Exports			Share in Developing Country Exports		
	1965	1980	1990	1965	1980	1990
Total Exports						
Japan	5.0	7.0	9.0	-	-	-
NICs*	1.5	3.8	6.7	6.0	13.3	33.9
Southeast Asia**	1.5	2.2	2.4	6.2	7.8	12.4
Sub-total	7.9	13.1	18.2	12.2	21.1	46.2
All Developing Countries	24.2	28.7	19.8	100.0	100.0	100.0
World	100.0	100.0	100.0	-	-	-
Exports of Manufactures						
Japan	7.8	11.6	11.8	-	-	-
NICs*	1.5	5.3	7.9	13.2	44.9	61.5
Southeast Asia**	0.1	0.4	1.5	1.1	3.8	12.0
Sub-total	9.4	17.3	21.3	14.2	48.6	73.5
All Developing Countries	11.1	11.8	12.9	100.0	100.0	100.0
World	100.0	100.0	100.0	-	-	-

* *Korea, Hong Kong, Singapore and Taiwan.*
** *Indonesia, Malaysia and Thailand.*
Source: UN Trade Data System.

The export performance of HPAEs has been propelled by manufactured exports. Once again, Japan has been the largest of the group, and its absolute share in world exports of manufactures increased from 7.8 percent in 1965 to 11.8 percent in 1990. While Japan recorded its most rapid gains during the 1950s and 1960s, the four NICs have experienced a boom in manufactured exports during the 1970s and 1980s. Over the 1970-90 period, their share in world exports of manufactures increased by 6.7 percent, compared with 1.9 percent for Japan (Table 2). The three Southeast Asian economies – Indonesia, Malaysia and Thailand – have historically been dependent on primary commodity exports, but they too have experienced a surge in manufactured exports in a "third wave" during the 1980s.

The very strong export growth of the developing country HPAEs was

reflected in their sharply rising share in developing country exports, especially manufactured exports. The share of the seven developing country HPAEs in total exports of developing countries increased from 12.2 percent in 1965 to 21.1 percent in 1980 and 46.2 percent in 1990. The increase in the share of developing country *manufactured* exports was even steeper – from 14.2 percent in 1965 to 48.6 percent in 1980 and 73.5 percent in 1990. As shown in Figure 6, there is a strong positive correlation between export performance and long-term growth for the eight HPAEs. This correlation is higher than that found in other cross-country studies (Balassa 1978, Michaely 1977).

Table 2. Increase in Share of World Exports (percent)

	1965-70	1970-80	1980-90
		Total Merchandise Exports	
Japan	2.1	0.2	2.0
Four NICs	0.5	1.8	2.9
Southeast Asia	-0.3	1.0	0.2
		Manufactured Exports	
Japan	2.1	1.7	0.2
Four NICs	0.9	2.5	4.2
Southeast Asia	0.0	0.3	1.1

Source: UN Trade Data System.

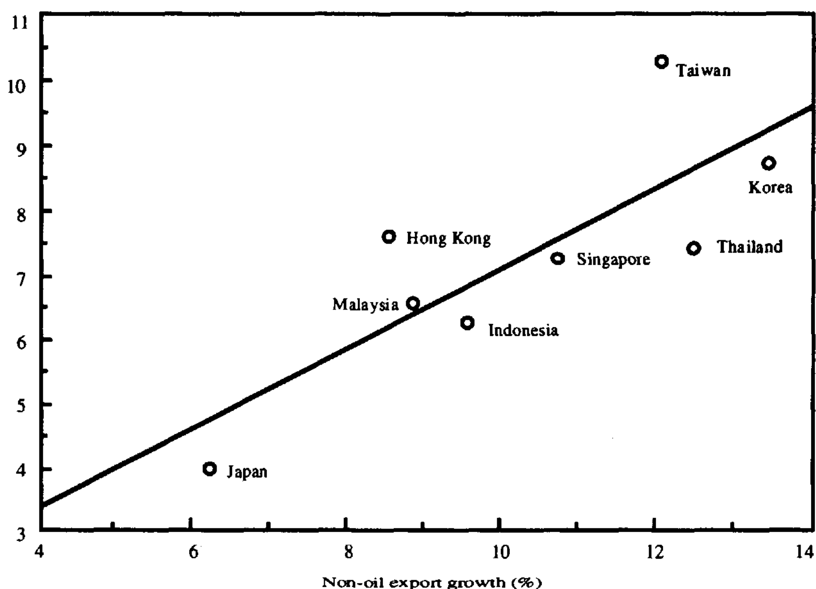
With the rapid growth of exports, the HPAEs have become more "open" in the measured sense of the share of exports plus imports in GDP. Several studies show a positive relation between these measures of openness and GDP growth, even after controlling for factor accumulation (see Harrison 1991). To be sure, these measures of openness do not indicate the policy orientation pursued to yield high trade shares. In particular, it is often asserted that the HPAEs achieved high export growth through pro-export policy interventions, and that their trade regimes were not necessarily "outward oriented."

Dollar (1990) uses the international comparisons of price levels compiled for 121 market countries by Summers and Heston (1988) to develop an index of "outward orientation" for 95 developing countries. The index is used to sort the group into four sets: very outward-oriented economies; moderately outward-oriented economies; moderately inward-oriented economies; and very inward-oriented economies. The results summarized in Table 3 show that using the average data for the groups during the 1973-85 period, there is a very clear relationship, with more open economies growing more rapidly.

The countries measured to be very outward-oriented recorded average GDP per capita growth of 2.6 percent, while the moderately outward-oriented

economies grew by 1.5 percent, the moderately inward-oriented economies grew at only 0.4 percent, and real GDP per capita declined for the very inward-oriented group. A similar exercise carried out for 1960-72 finds no strong relationship between the price-based measure of openness and growth rates.

Figure 6: Output and Export Performance, 1973-90



Regression: GDPgrowth = 0.88 + 0.62 Non-oil export grwth; R^2 = 0.650
Source: World Bank.

Table 3. Outward Orientation and Growth, 1973-85

	No. of Countries	Outward Orientation Index	Per Capita GDP Growth
Very Outward-Oriented Economies	30	101.34	2.61
Moderately Outward-Oriented Economies	18	100.47	1.47
Moderately Inward-Oriented Economies	24	99.55	0.37
Very Inward-Oriented Economies	23	98.35	-0.35
HPAEs	8	101.22	5.31

Source: Dollar (1990).

The HPAEs can be categorized using the same outward orientation index. All the HPAEs are outward-oriented economies, with six in the very outward-oriented group, and only Japan and Indonesia in the moderately outward-

oriented group of countries. The growth performance of the HPAEs is more than double the average of even the very outward-oriented group. This confirms that outward orientation was an important attribute explaining the superior growth performance of the HPAEs, but that other factors may also have played a role.

The positive effects of outward orientation on growth can be attributed to a number of "dynamic" benefits. First, outward orientation facilitates technological advance by increasing linkages to more advanced areas through trade and investment. Secondly, outward orientation enables firms to reap economies of scale and increases the financial return to adopting new technologies. Thirdly, export competition and import penetration expose firms to greater competition, thereby promoting efficiency and productivity growth.

Patterns of adjustment

Following a stable economic environment in the 1950s and 1960s, the world economy was buffeted by a series of shocks in the 1970s and 1980s, beginning with the first oil shock of 1973. The sharp increase in oil prices coupled with the surge in non-oil primary commodity prices in 1973-74, and the subsequent slowdown in world output and trade adversely affected the non-resource HPAEs – Japan, Korea, Hong Kong, Singapore and Taiwan – but also stimulated the search for greater efficiency and export competitiveness in these countries. On the other hand, the Southeast Asian countries – Indonesia, Thailand and Malaysia – were major beneficiaries of the primary commodity boom. Overall, the economic environment of the 1970s turned out to be more favorable than had been feared in the aftermath of the oil shock of 1973, with a brisk expansion of world output and trade following the initial adjustment as well as plentiful supply of official and private bank financing at low or negative real interest rates.

In the early 1980s the world economy suffered a series of shocks: (i) oil prices rose sharply in 1980 – from US$18.6 to US$30.5 per barrel – and remained high in nominal and real terms through 1985; (ii) real interest rates rose sharply from negative levels in 1974-78 to 5-9 percent by 1986; (iii) OECD growth, which had averaged three percent in 1973-80, fell to 1.4 percent in 1981 and -0.3 percent in 1982; and (iv) commercial bank lending dropped dramatically, from an average of US$50 billion in 1980-81 to US$15 billion in 1984-85 and US$5 billion in 1987-88. Finally, non-oil commodity prices fell sharply, with the index dropping from 105 in 1980 to 83 in 1982 and 58 by 1991. Overall, non-oil exporting developing countries suffered average shocks of about -2.9 percent of GDP in the first half of the 1980s and -4.4 percent in the second half (World Bank 1992).

The external shocks adversely affected all HPAEs, but with important differences in the nature, timing and magnitude of shocks. As exporters of manufactures and importers of primary products, Japan and the four NICs were particularly adversely affected by the slowdown in the world economy and the increase in oil prices. Except for Korea, HPAE developing countries were not as adversely affected by the increase in real interest rates because of cautious borrowing policies during the 1970s. The Southeast Asian economies were more adversely affected by the decline in primary commodity prices, and Indonesia and Malaysia especially by the decline of oil prices during 1985-86.

Macroeconomic policy adjustment

Virtually all countries experienced a deterioration in macroeconomic balances following the external shocks of the early 1980s. Successful stabilization programs typically included the full range of macroeconomic policies, including fiscal and monetary restraint and exchange rate management. However, the most important yardstick of successful stabilization was fiscal adjustment.

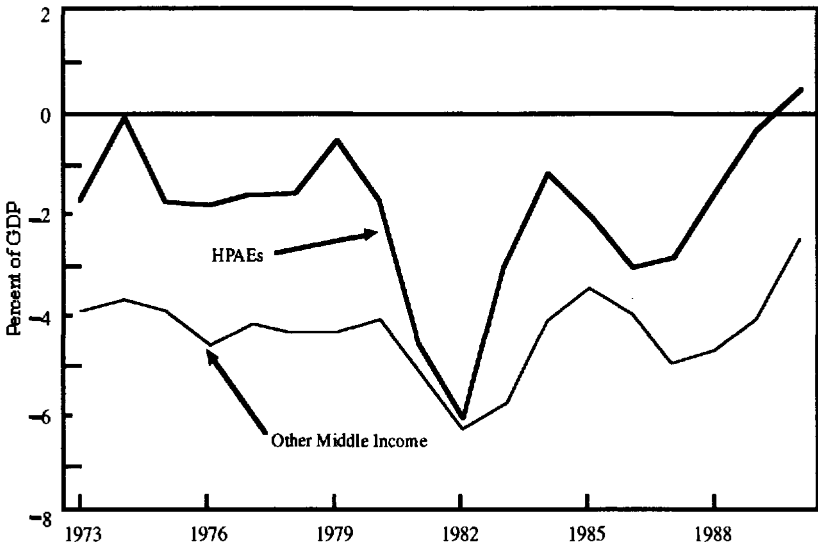
Figure 7 shows the average trend in the fiscal deficit for four of the developing country HPAEs (Korea, Indonesia, Malaysia and Thailand) compared with an average trend for a sample of 23 middle-income countries. There are two noteworthy features in the observed fiscal adjustment. First, the HPAEs achieved a more rapid and substantial improvement in fiscal balance than the comparator countries. Secondly, as discussed below, the HPAEs were able to achieve fiscal adjustment while supporting an increase in public investment.

This was the result of a strong public savings performance, achieved through successful restraint of current expenditures and improvement in public resource mobilization. Fiscal discipline was achieved through a number of ways. In Indonesia, no domestic financing of public expenditure was permitted by law (while an open capital account exerted discipline on monetary policy). Similarly, in Taiwan until 1987 a law limited the value of government bonds to less than 40 percent of the central government's annual budget. In Malaysia and Thailand, strict control over external public borrowing both exerted fiscal discipline and moderated the increase in indebtedness.

Trends in fiscal adjustment (supported by complementary macroeconomic policies), in turn, are reflected in the relative success of HPAEs in restoring internal and external balances (Table 4). The HPAEs were successful in arresting and reversing the deterioration of internal and external balances by the mid-1980s. While current account deficits emerged once again during the late 1980s, this was entirely due to the surge in private investment and was financed largely by private foreign inflows. By contrast, the comparator countries were not as successful in achieving a sustained reduction in inflation or in external deficits. In fact, the inability to reduce fiscal imbalances has resulted

in an acceleration of inflationary pressures in many of these countries. The openness of the HPAEs made them more vulnerable to the external shocks of the 1970s and 1980s but also stimulated more rapid adjustment to the changed circumstances. As a result, the HPAEs were more successful than most other developing countries in establishing the macroeconomic conditions for the recovery of exports and investment.

Figure 7: Trends in Fiscal Adjustment, 1973-90



Note: The HPAEs comprise Korea, Malaysia, Thailand and Indonesia; "Other Middle Income" consists of 23 middle-income comparator countries.
Source: World Bank.

Structural reforms

Structural policies to promote investment and growth encompass a broader and more complex range of parameters than macroeconomic adjustment. Broadly speaking, they include the incentive environment (trade, tax, pricing and exchange rate policies), the regulatory and legal framework, and the functioning of factor markets, including the financial sector. Although the HPAEs were characterized by varying degrees of intervention, they shared three important features (World Bank 1991): government intervention in these economies was subjected to international competition and market-related checks and balances; governments were careful to offset the bias against exports, as their trade regimes were highly outward-oriented; and the level of intervention and any resulting distortions were more moderate than in most developing countries.

Table 4. Trends in Internal and External Balance (period averages)

	1976-79	1980-82	1983-85	1986-88	1989-90
Inflation (percent p.a.)					
Four HPAEs*	9.9	13.1	4.2	4.0	5.7
Other Middle Income**	27.1	25.7	48.3	43.7	240.1
Current Account Balance (as percent of GDP)					
Four HPAEs*	-1.4	-5.4	-4.4	1.6	-2.1
Other Middle Income**	-4.8	-7.2	-5.3	-3.4	-4.6

* *Korea, Indonesia, Malaysia and Thailand.*
** *23 middle-income comparator countries.*

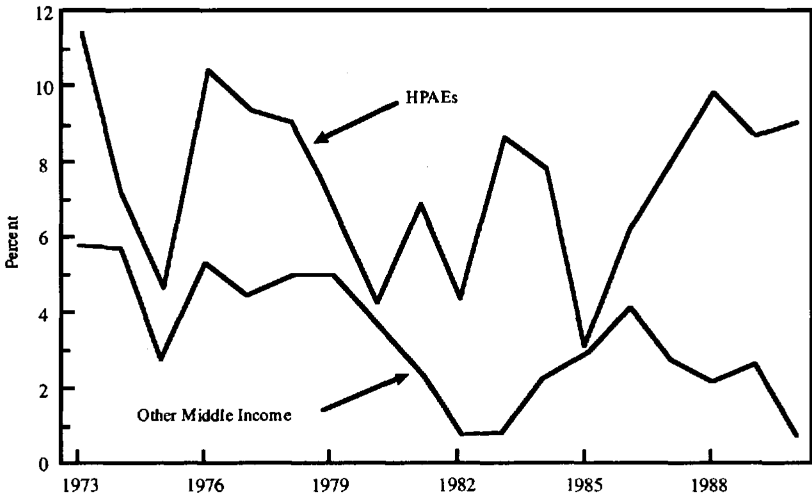
There has also been a shift in policies towards even more market and outward-oriented policies. Hong Kong has always followed a relatively free-market approach, and Taiwan also opened up its economy early on (in 1958-59). Singapore has been more interventionist, although domestic enterprises have been subject to international competition through a very open trade regime. Korea began to reduce its trade protection and liberalize investment in the late 1970s. Of the Southeast Asian economies, Malaysia had the least protected trade regime, although domestic investment was subject to control. Thailand and Indonesia have had the most protected trade and investment regimes by East Asian standards.

Although the pace and pattern have varied, the HPAEs continued to undertake reforms throughout the 1980s so as to improve their policy environment (Bhattacharya and Linn 1990). Several countries that had significant trade barriers – such as Korea, Indonesia and Thailand – reduced trade protection substantially, with unilateral action to eliminate quantitative restrictions and reductions in the level and dispersion of tariffs. Generally, there was a move towards reduced intervention and the creation of a favorable business environment for private investment, including foreign direct investment. Finally, most HPAEs took steps to promote financial sector development through reforms of interest rates and credit allocation, promotion of capital markets, and closer integration with world financial markets. As a result of these steps, the HPAEs succeeded in creating an even more "investment-friendly" environment and in further improving their competitive edge. These general observations about the HPAEs are borne out by some specific indicators for Korea, Indonesia, Malaysia and Thailand. The World Bank (1991) argues that the trade liberalization index and the black market premium for these countries show a lesser degree of distortion than comparator countries.

Investment, exports, productivity change and adjustment

By any measure, the long-run growth performance of the high-performing Asian economies between 1960 and 1990 was extraordinary. Three interrelated factors contributed to this success: investment (in both physical and human capital), export growth, and productivity change. The adaptation of HPAEs to the economic adjustment of the 1980s was also remarkable. Despite similar adjustment programs in both HPAEs and other developing countries, the differential between GDP growth for the HPAEs and other middle-income countries widened during the decade (Figure 8). In this section, we attempt to relate the superior adaptation of the high-performing Asian economies to the economic adjustment of the 1980s to the three longer-run engines of their growth – investment, exports, and productivity change.

Figure 8: Trends in Real GDP Growth, 1973-90



Note: The HPAEs comprise Korea, Malaysia, Thailand and Indonesia; "Other Middle Income" consists of 23 middle-income comparator countries.
Source: World Bank.

Investment and recovery

Superior investment performance, both in the long run and during the 1980s, plays an important role in the adjustment story of the HPAEs. Economic adjustment results in a characteristic pattern of investment response (World Bank 1992). In the private sector, stabilization measures have a temporarily negative effect on investment, as the demand for output is reduced through fiscal and monetary contraction. Uncertainty over the implementation of

macroeconomic policies can create pessimistic expectations, leading to deferral of investment, while structural reforms have disruptive effects on investment during the transition to a new relative price regime. Thus, the implementation of adjustment programs is generally followed by a sharp contraction in private investment during the first two years. Private investment then tends to stabilize during an investment pause of several years and, finally, to recover.

Public investment behavior during adjustment depends upon the way in which the government implements any required fiscal contraction. In most countries going through adjustment, public investment has been cut relatively more than public recurrent expenditure (World Bank 1992), thus leading to a decline in the public investment share of GDP. Hence, public investment in most countries has been pro-cyclical with private investment during the adjustment process, and total investment has followed the pattern of private investment – contraction, pause, and recovery.

Madarassay and Pfeffermann (1992) present average real and nominal investment shares in GDP for 35 developing economies during 1970-89, and for the subset of middle-income countries (GNP per capita US$611-7,619 in 1990), both excluding the high-performing Asian economies.[22] The level of total investment is about ten percentage points higher in the HPAEs throughout the period than for the larger samples. Total real investment declined as a percentage of real GDP for all developing economies in the 1980s, but the HPAEs experienced both a sharper contraction and a more rapid recovery. For developing countries generally, real private investment rose modestly as a share of GDP until 1979, declined from 1979 to 1983, and was then stagnant during 1983-1986. A slight recovery began in 1986, but for developing countries as a whole the investment share in 1989 (nine percent) remained below that for any of the years during the 1970s. The entire cycle of investment response took place between the bounds of about 12.5 percent of GDP at the peak (1979) and eight percent at the trough (1985).[23]

The pattern of real private investment in the HPAEs is very different. It declined only marginally as a share of GDP between 1979 and 1984, fell sharply between 1984 and 1986, and then recovered strongly. By 1989, the real investment share of the HPAEs had approximately reached its 1979 level and had exceeded the level for all other years in the 1970s. Within the sample of five HPAEs, the basic pattern is observed in four countries – Korea, Thailand, Singapore and Malaysia. The pattern for Indonesia is quite different: real private investment declined continuously during the 1980s, from a peak of 20 percent of GDP to a low of 13 percent in 1989.

Public investment performance differed strikingly between HPAEs and other countries during the 1980s. Real public investment declined as a share of real output for all developing countries except the HPAEs. Moreover, the

fiscal contraction of macroeconomic adjustment was reflected in lower public investment rates. In the HPAEs, on the other hand, real public investment actually rose between 1980 and 1983. It then remained essentially constant at a level nearly four percentage points above its 1970s average, and only began to decline towards historically more normal levels after 1987. This public investment bubble between 1980 and 1987 was counter-cyclical to the reduction in private investment.

The HPAEs were "private-investment friendly" as well. If the relative price of investment goods (investment deflator relative to the GDP deflator) rises (or differs across countries), greater investment effort (nominal investment expenditure) is required in order to achieve the same investment outcome, measured in terms of the volume of physical investment. In our sample of 40 countries, the relative price of investment goods (ratio of the investment deflator to the GDP deflator) rose by about 15 percent during the 1980s. This increase reflected mainly the impact of real devaluation on the price of investment goods, which tend to be imported or import-intensive in most developing countries, although changes in the structure of protection which reduced the price of importable consumer and intermediate goods relative to investment goods also had an impact in those economies undergoing trade liberalization.

For the countries of the non-HPAE samples, investment effort and outcomes coincided quite closely during the 1970s, and the relative price of investment goods was essentially constant. During the 1980s, however, the rising relative price of investment goods was reflected in an increasing divergence between investment effort and outcomes. From 1980 to 1989, the nominal investment share exceeded the real investment share and the gap increased. By 1989 the difference had reached nearly three percentage points. The investment recovery of the non-HPAE developing countries was greater in terms of their investment effort than in terms of their investment outcomes.

The HPAEs are different in several ways. First, investment outcomes exceeded investment effort (for both public and private investment) throughout the entire 1970-1989 period. The HPAEs were economies in which the relative price of investment goods was low during both expansion and adjustment.[24] Furthermore, the relative price of capital goods declined during the early stages of adjustment from 1980 to 1984, and only began to rise in 1985. By 1989 investment effort and outcomes had been brought back into alignment. In these economies, the declining real prices of capital goods smoothed the impact of adjustment on investment outcomes.[25]

Exports and recovery

Export orientation also played a key role in the rapid recovery of the HPAEs.

Exports were important in at least three respects. As a source of aggregate demand, they provided an engine of savings and investment, and they may have contributed to the superior productivity performance of the HPAEs through the link between export growth and productivity change. Export performance may also have facilitated foreign investment by signaling best-practice performance.

Exports as a share of GDP increased continuously during the 1980s in the HPAEs, and the differential in export performance vis-à-vis comparator countries widened over the decade. The high-performing Asian economies began the adjustment process with relatively high shares of total and manufactured exports in GDP. This distinguished them from both middle-income countries, which had relatively lower export shares, and low-income countries, which had similar export shares but few manufactured exports. The relatively high share of manufactured exports also insulated the HPAEs from the decline in commodity prices that adversely affected other developing countries.

Investment recovery in both absolute terms and as a share of GDP followed export growth by about one year. The resumption of output growth, therefore, did not derive from investment demand driving aggregate demand. Export-led growth supported the strong recovery of domestic savings and private investment. The positive association between investment recovery and export orientation may also reflect a more subtle relationship than simply the impact of output expansion on private investment. In the HPAEs, a substantial portion of private investment is concentrated in manufactured exports, which benefited immediately from exchange rate adjustment and the trade policy reforms introduced. Investors in these sectors were subject to less uncertainty and fewer costs of learning than those in middle-income economies with lower levels of manufactured exports. Structural reforms which reduced the bias against exports had an immediate impact on investment decisions, while investment in economies more concentrated in primary and agricultural exports responded with a greater lag.

Another link between export orientation and investment recovery is through direct foreign investment. By providing a signal on investment profitability at international prices, export performance may have played a role in stimulating investment, especially foreign direct investment. According to balance of payments figures, direct foreign investment in Korea, Indonesia, Malaysia and Thailand increased from US$1.3 billion in 1980 to US$7.0 billion in 1990, which was among the most rapid experienced by any developing country. The surge in direct foreign investment, in turn, was an important contributing factor to the overall recovery of investment, especially in investment-driven economies. Two additional features of direct foreign investment are worth noting. Individual country evidence suggests that unlike the 1970s,

when direct foreign investment was geared towards import-substituting activities, a significant proportion of direct foreign investment in the more recent period is linked to export opportunities. Another notable feature of recent trends is the growing share of HPAEs other than Japan as a source of direct foreign investment, especially the NIEs. This, in turn, suggests increasing trade linkages within the HPAEs rather than just with Japan.

Manufactured exports also appear to play a key role in the productivity story. Several microeconomic studies corroborate the positive correlation between manufactured export growth and productivity increases (Nishimizu and Page 1990, Tybout 1991, Pack 1992b). Although the causality cannot be firmly established, there is strong evidence that above-average manufactured export performance has been associated with above-average productivity growth.

Productivity change and recovery

The rapid total factor productivity growth of the HPAEs may also have contributed to their superior adaptation to the external shocks of the 1980s. Productivity change may have worked in two ways to assist adaptation to adjustment. First, among the productivity-driven economies, superior technical efficiency performance may have cushioned the need for large macroeconomic and structural adjustments. Secondly, the links between investment and export growth and productivity change may have served to amplify the growth response to investment and export recovery in all HPAEs.

Because the high-performing Asian economies, as a group, display superior productivity performance relative to other developing economies, it is difficult from a comparison of HPAEs with other middle-income countries to identify any contribution made by productivity change to recovery independently of the contributions of investment recovery and export growth. However, the within-group variance in productivity performance of the HPAEs may provide some insights into the contribution of productivity change to adjustment. In general, the investment-driven economies – Malaysia, Indonesia and Thailand – undertook larger macroeconomic adjustments and more far-reaching structural reforms than the productivity-driven economies – Korea, Hong Kong and Taiwan – during the 1980s. Productivity growth appears to have provided a cushion to the productivity-driven economies, which enabled them to adapt more flexibly to external shocks.

Moreover, because much of this superior productivity performance resulted from movement towards best practice (technical efficiency change) rather than technical progress (new generations of international best practice), the contraction in private investment during adjustment had a smaller negative impact on productivity change. When private investment began to recover, the

strong contribution of technical efficiency change to output growth should have amplified the output growth arising from increased investments.

Rapid productivity growth (and high TFP levels) may also have been an important determinant of the significant increase of foreign investment in the HPAEs during the 1980s. International investors search for "world class" firms in which to make portfolio investments or with which to form joint ventures.[26] Firms which are at or approaching international best practice are such firms, and this may account for part of the superior foreign investment performance of the HPAEs.[27]

Investment itself may also have contributed to measured productivity growth. De Long and Summers (1991) have argued that equipment investment has a disproportionately large impact on productivity change. The HPAEs are among the countries in their sample with the lowest relative equipment prices and highest equipment shares of investment. Because the investment recovery in the HPAEs was both robust and equipment-using, it may have accelerated productivity change and overall growth.

Conclusion

In the long run, both rapid accumulation (investment in physical and human capital) and productivity growth contributed to the superior growth of per capita income in the HPAEs, but their distinguishing characteristic was sustained, superior productivity performance. Export growth, and especially manufactured export growth, may have played a role in this greater than its contribution to GDP growth through a positive relationship between manufactured exports and productivity change. Adjustment in the HPAEs was less severe and recovery was more robust than in other middle-income countries. The same three elements which contributed to long-run growth provided the engine for recovery from adjustment.

Investment in the HPAEs during the 1980s was distinct from other middle (and low) income countries in at least two respects. First, public investment was counter-cyclical. These economies made their fiscal adjustment by reducing current expenditure and increasing public investment while maintaining fiscal discipline. Secondly, the policy regimes in these economies were private investment-friendly, both in terms of their business environment and relative openness to private foreign investment, and in the sense that they maintained low relative capital goods prices, making investment outcomes exceed investment effort.

Exports had an important role in stimulating both private investment and productivity growth. The relatively high manufactured export shares of the high-performing Asian economies meant that structural adjustments which

moved incentives in favor of exportables had immediate results in stimulating private investment in manufactured exports. Information on the likely success of exporting activity, generated during earlier periods, was central to this investment response. High TFP levels resulting from rapid and sustained productivity growth, especially in the productivity-driven economies, may have cushioned the initial impact of macroeconomic shocks and allowed greater flexibility in adjustment policy. The fact that a substantial portion of TFP change arose from technical efficiency change in the HPAEs may also have amplified the contribution of investment recovery to growth.

Notes

1 For the most recent summary of the adjustment process and an evaluation, see World Bank (1992).

2 We have defined the high-performing Asian economies to include Japan, Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia and Thailand.

3 The theoretical underpinnings of the endogenous growth literature originate in contributions by Lucas (1988) and Romer (1987; 1990). The paper by Pack (1992) provides an interesting interpretation of the endogenous growth theory and its relationship to neoclassical growth models. Cross-country empirical tests of the sources of growth include Barro (1991), Dollar (1991) and Rebelo (1991).

4 Most convergence studies attempt to explain deviations from a purely investment-driven growth model in terms of "relative backwardness" – the relative level of per capita income at the beginning of the growth period (usually 1960).

5 The most recent summary of this work is contained in Chenery, Robinson and Syrquin (1986).

6 The regression line is the result of a regression of per capita income growth (in constant 1980 international prices) on 1960 income per capita, including non-linear terms up to the second power.

7 Dollar (1991) finds a similar pattern using a sample of 114 countries and the absolute level of per capita income in 1960. He finds clearer pattern in which the lowest deciles have the lowest per capita income growth rates, the middle income deciles have the highest, and the high income countries are between. He also reports low significance of his regression results, however.

8 Addition of a dummy variable to the estimated equation appearing below Figure 1 increases the R Squared to 0.242 and greatly improves the precision of the parameter estimates. The t value on the dummy variable (which is positive) is 4.00.

9 Addition of a dummy variable (HPAE = 1) to the estimating equation appearing below Figure 2 raises the R Squared to 0.311. The t statistic on the dummy variable is 2.00.

10 The distinction between best practice and average practice is explored in Nishimizu and Page (1982). A similar model is developed by Pack (1992) in his critique of the "convergence" literature.

11 Farrell (1957) was one of the first to note the divergence between observed behavior and best practice, which he called "technical inefficiency." There is by now a large literature on technical inefficiency. Pack (1988) summarizes much of this literature as it applies to developing countries.

[12] A comprehensive review of the large literature on the measurement of best practice or frontier production functions and their relationship to traditional estimates of the production function is contained in Aigner and Schmidt (1980).

[13] Nishimizu and Page (1982) have provided a formal exposition of the relationship between total factor productivity change, changes in best practice – which they define as "technical progress" – and changes in technical efficiency.

[14] The international comparisons project does not provide constant price capital stock estimates.

[15] The studies cited have introduced other variables to address different questions – equipment investment, De Long and Summers (1991); trade orientation, Dollar (1991); endogenous investment, Barro (1990). We have not included these variables because they are not central to our theme.

[16] The magnitude of the coefficient on investment is similar to that reported in Dollar (1991) for his sample of 114 economies (0.113). The magnitude of the coefficient for education is about half that given in Dollar's results, and the coefficient for RGDP60 is essentially similar to the results obtained by Dollar and by De Long and Summers (1991), using virtually the same sample as ours.

[17] This would not be the case if we had used the rapid growth period for Japan, 1950-1975, when TFP change was extremely rapid.

[18] De Long and Summers (1991), using a more complete but essentially similar set of explanatory variables to establish the relationship between equipment investment and growth of output per worker for the same period arrive at a similar pattern of investment-driven and productivity-driven economies. Korea and Hong Kong are extreme outliers in their sample (which excludes Taiwan and Singapore). Indonesia, Thailand, Malaysia, and Japan, although all positive outliers are relatively more (equipment) investment-driven.

[19] The time periods for the individual studies all fall within the period 1970-1985. For individual references and the specific time periods, see Nishimizu and Page (1991).

[20] Page (1990) argues that three negative observations – Philippines, India and Zambia – should be excluded on the basis that negative TFP growth over 20 years could only have been sustained by increasing distortion of the relative price structure or represent extreme errors in variables. In either case he argues that the negative observations are uninformative regarding the relationship between technical efficiency change and level of development.

[21] Interestingly, these results for the industrial sector conform quite closely to economy-wide TFP patterns for the "atypical developing countries" summarized in Chenery (1986), which include Japan, Korea, Taiwan and Hong Kong. Israel and Spain are the only other atypical (productivity-driven) economies in the Chenery sample.

[22] Japan, Taiwan and Hong Kong are excluded from the Madarassy and Pfeffermann (1992) sample.

[23] World Bank (1992) stratifies the Madarassy and Pfeffermann data into middle-income and low-income samples. While the patterns are similar for both, the low-income sample shows a longer sustained decline (until 1987). The middle-income sample is dominated by the HPAEs and has a very similar pattern.

[24] De Long and Summers (1991) obtain a similar result for the relative price of equipment (to the GDP deflator). They predict the real equipment price for the sample of 62 countries as a function of relative 1980 GDP per worker. Of the six HPAEs in their sample (Singapore and Taiwan are excluded) Indonesia and Malaysia lie close to but above their predicted values; Thailand, Korea, Hong Kong, and Japan are all significantly below their predicted values. Real equipment prices are unusually low in these economies.

[25] There is remarkable uniformity in the pattern of investment outcomes exceeding investment effort among the five HPAEs in the sample. Malaysia is perhaps the least representative in the sense that during the 1970s (and up to 1982) the nominal investment share exceeded the real investment share. All five economies, however, had real investment shares which exceeded the nominal share between 1982 and 1985. Korea continued to show a declining relative price of investment goods throughout the 1980s, while Thailand had a major increase in relative capital goods prices in 1988-89.

[26] The manager of a major international direct investment fund recently noted that the quality of a firm was more important than the overall policy framework (within certain bounds of stability and ability to repatriate earnings) of the country within which it was located.

[27] Singapore, which is also investment-drivèn, is the most clear case of the close association between direct foreign investment and international best practice. Singapore's level of total factor productivity compares favorably with OECD countries in its manufactured export industries. The foreign investment share in Singapore is also the highest of the HPAEs.

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Jeffrey B. Nugent

From Import Substitution to Outward Orientation: Some Institutional and Political Economy Conditions for Reform

Introduction

The last decade has witnessed a dramatic change in views about the respective roles of states and markets in economic development among both policy-makers and academics. While the change in views has been multifaceted, perhaps the most noticeable and striking facet of such changes has been in the increased importance attached to an outward orientation in the economy of nations. In this respect, the views of academics and policy-makers alike have swung from being strongly in favor of inward orientation[1] to strongly favoring outward orientation.[2]

Since none of the alleged advantages of the outward orientation of the economy was newly discovered over the past decade or two, a major impetus for the change in views has been new evidence on comparative growth performance across countries. This experience now includes several cases of outward-oriented developing countries – mostly from East Asia – which have achieved very considerable success in economic development and maintained that success over substantial periods of time.[3] While the benefits of the switch to outward orientation have not been without shortcomings and controversies[4] and although the empirical assessment of such benefits is still ongoing, the evidence obtained thus far is generally deemed to support the proposition that greater outward orientation has a positive effect on the rate of economic growth. For example, Lal and Rajapatirana (1987) state: "It seems to be as firm a stylized fact as any in the economics of developing countries: a sustained movement to an outward-oriented trade regime leads to faster growth of both exports and income."[5]

The purpose of the present chapter is neither to investigate the validity of such evidence nor to re-examine the logic of the arguments behind the advocacy of outward orientation. Rather, it is to investigate the conditions under which outward-oriented reforms (OORs) are likely to be feasible both in the short and long run and whether or not OORs, when undertaken, are likely to be sustained and successful. This is indeed an important subject, as few of the many attempts at OOR have been successful so far. Moreover, since the rates of protection offered by both tariff and non-tariff barriers to trade and the rates of discrimination against exports are often several times higher in developing countries than in developed economies,[6] there is clearly considerable room for self-help by the former group in this respect.

Inasmuch as (i) OORs are multidimensional; (ii) some of the dimensions are difficult both to quantify and to compare with one another (thereby acting as an obstacle to their aggregation into any single index of outward orientation); and (iii) efforts at reform are not always well-measured by actual outcomes,[7] the proper evaluation of success in OORs is rather demanding. For present purposes, we deliberately suppress the different individual dimensions of OOR, which would include policies with respect to imports, emigration and so on. As a result, we implicitly assume either that the various dimensions of OOR are equally important and affected in the same way by the various determinants identified below or, more appropriately, that they are all components of OOR broadly conceived.

Ideally, the identification of appropriate conditions for success in OOR would be based on long-time series data for all the relevant variables for each of a large number of countries. The conditions identified would thus be based on true counterfactual simulations of what each country's policy orientation would have been with and without satisfaction of the identified conditions. Naturally, this is a tall order given the multiplicity of factors which are relevant, the difficulty of holding many of them constant, and the shortcomings in the data. Our study falls far short of this. While it is largely based on existing and not necessarily comparable data from different studies, it attempts to set the stage for a more complete quantitative assessment.

We begin with the identification of the more familiar external environmental and domestic economic conditions for sustained and successful implementation of OORs. We then go on to consider various institutional and political economy determinants of success. The final part of this chapter contains the implication of our analysis for policy and further research.

External and internal environmental conditions

OORs are more likely to be successful if undertaken under relatively favorable environmental conditions, both externally and internally. With respect to external conditions, the five most important ones are the following: (i) rest-of-the-world imports of products relevant to developing countries undertaking OOR are rising at a satisfactory rate; (ii) not too many developing countries should be attempting OOR at the same time; (iii) the amount of debt owed to lending institutions in the rest of the world by developing countries with significant risk of default should not be too large; (iv) rest-of-the-world financial and other markets should be relatively stable; and (v) restrictions on the export by developed countries (DCs) of advanced technology to the more technologically advanced developing countries should be avoided.

Quite naturally, these individual conditions are by no means independent

of each other. For example, conditions (i) and (ii) are relevant for the same reason, namely, that if either (or both) holds, conditions in the DCs would make entry into these markets difficult for developing countries undergoing OOR.[8] Similarly, conditions (iii) and (iv) are interrelated inasmuch as condition (iii) can constitute an important reason for condition (iv). The reason why failure to satisfy both of these conditions would be likely to undermine the success of developing countries in their OORs is that both such failures have the effect of impeding those flows of development and trade finance from DCs to developing countries that are so much needed by developing countries undergoing reform.[9] The unfortunate failure to satisfy condition (v) is, of course, the result of another form of protection by DCs – in this case, one targeted at the more advanced and already outward-oriented developing countries or newly-industrialized economies (NIEs) which are trying to maintain their export success in the face of high and rising labor costs by upgrading their technology.

In the 1950s and 1960s DCs were enjoying much higher rates of growth of GNP and imports, fewer developing countries were undergoing OOR at the same time, the magnitude of default and delay in the repayment of developing countries' debt was much smaller, and DC financial markets were more stable than in more recent years. As a result, the odds of any given developing country obtaining success in its OOR are generally thought to be lower now, *ceteris paribus*, than they would have been in the two preceding decades.[10] This may explain why, even in the 1990s, the East Asian NICs, which undertook successful OORs back in the 1950s and 1960s, remain so prominent among the accumulated success stories.

Since unfavorable external environmental conditions at the global level would have their primary effect only at the level of developing countries as a whole, these conditions would not necessarily apply in full force to any particular developing country exporter. Hence, the success of any given developing country should be more severely constrained by unfavorable domestic or internal economic conditions than by unfavorable overall external conditions. However, since the many different conditions of this sort that might apply to the domestic economy of an individual country are generally well-recognized, in the following paragraphs we call attention to only a few of the most pervasive and important.

One condition generally thought to be unfavorable to OORs is a substantial endowment of natural resources or long-term dependence on capital transfers or remittances. Such a condition allows a country to be more self-sufficient and less speedy in adjusting to adverse external shocks than would be the case in a country with a less favorable resource endowment. Although the resources themselves may be exportable (as in the case of oil and minerals in

crude form or labor), their export lowers the marginal benefit of other exports and thereby greatly lowers the incentive for OOR at the margin.[11]

Another condition which may cause even the most well-motivated and best-designed OOR to unravel is budgetary imbalance and resulting inflation. Indeed, this condition is so important that fiscal balance and monetary stabilization may be regarded as virtual prerequisites to success in OOR. Recurring fiscal deficits are likely to lead policy-makers to back away from OORs, or at least to lower the priority attached to them. Moreover, even without policy reversals, high and unstable inflation rates tend to raise the instability of relative prices, thereby weakening the signals that these provide to actual or potential investors. Closely related to this condition is the magnitude of the outstanding public debt: the larger it is, the more pressure will be exerted on the Central Bank to keep domestic interest rates low so as to reduce the fiscal burden of interest payments on the government debt.[12] Since OORs are likely to bring about considerable change in the sectoral and regional structure of economic activity,[13] labor[14] and entrepreneurship are all mobile across sectors and regions.[15] Clearly, the conditions for mobility cannot be satisfied without delving into institutional and political economy considerations, the subject of the next sections.[16]

Institutional considerations

Institutional problems arise in virtually all aspects of OORs. First, the adoption of an OOR may require success in collective action, which in return requires overcoming the free-rider problem inherent in the adoption of any such reform due to its public good character.[17] Secondly, they arise in the monitoring of the implementation of OORs. Finally, such problems are seen even in the sanctioning process, that is, in reacting to any observed defects in the design or implementation of OORs and in creating and maintaining an appropriate sanctioning system. Each of these problems and issues will be taken up below.

Interest group participation in the creation of OORs

Except in the case of primary exporters, whose ability to export may not require a full-fledged OOR, typically very few organizable interest groups are likely to prove supportive of OORs. Managers and owners of import-competing industries certainly have little to gain and potentially a lot to lose from OORs.[18] Workers in these industries may have even more to lose inasmuch as OORs often involve policies[19] which bring about substantial reductions in real wages and/or require costly relocations in order to find jobs. The primary sectors may either refrain from supporting or even oppose OOR, because they may have easier and more direct means of achieving their objectives.

That leaves essentially only potential non-traditional exporters as an identifiable interest group with potential for collective action in support of OOR. As has frequently been noted, however, the potential support for OORs from this group is undermined by considerable uncertainty about just what kinds of producers would benefit from an OOR in the specific country under consideration,[20] and the relatively long lag between the time in which the costs (of both collective action and any required private investment) are incurred and that in which the benefits (in terms of future non-traditional exports) are realized.

Even if both traditional and potential non-traditional exporters could be organized in support of OOR, the characteristics of such groups (large numbers of members, geographic dispersal, heterogeneity in background, lack of personal links, etc.) are not likely to make for effective collective action in defense of their interests. By contrast, each of the opposing groups – public sector managers, private managers and owners of import-competing industries, and workers in these industries – typically possess many of the characteristics favorable to collective action.[21] That leaves only the state or bureaucracy sector itself and international agencies as potentially important sources of collective action. These will be discussed more thoroughly in the next section.

Even this brief review of interest group considerations goes a long way towards explaining why so few OORs are implemented with any vigor, and why fewer still are successful in the longer run.[22] This is not to say, however, that there are not certain situations where the forces in support of OOR may be somewhat stronger than those opposed to reform. Indeed, since it is precisely in such situations that the prospects for success in OORs may be relatively bright, it is important to bring such an analysis to light in order to identify such possibilities.

Several factors would seem relevant in this regard. First and foremost among them is the matter of timing. The managers, owners and workers who pose as a strong source of opposition to OORs are unlikely to be well-organized when import-substituting industries (ISIs) are still in their infancy. At its inception, an ISI regime gives rise to many of the same uncertainties about the identity of the potential beneficiaries and the magnitude of benefits as do OORs. Furthermore, at this point communication among producers as well as among workers is likely to be weak. It is only over time that these conditions are overcome, and only gradually do the length of association and other characteristics favorable to collective action build up, implying the growing strength of groups opposed to OORs over time. This implies, however, that very early in the industrialization process there may be a window of opportunity for success in OOR.

On the other hand, some domestic producers are likely to find themselves at a disadvantage with regard to at least some aspects of ISI. These are (i) the

small size and inevitably decelerating growth of the domestic market for domestically produced manufactures; (ii) the increasing difficulty of import substitution over time as the capital, skill, technology and import intensities of such production increase; and (iii) the typical bureaucratic means of allocating investment and other licenses, in which priority is given to investors in sectors with either export potential or a domestic market that is large relative to existing domestic productive capacity, the exact timing depending on the size of the country and other characteristics. Moreover, since the latecomers to ISI are likely to be in relatively concentrated industries (because of the relatively high capital and technology requirements of production), such latecomers are likely to have characteristics relatively favorable to collective action. Hence, the prospects for OORs may conceivably improve somewhat after a relatively lengthy experience with ISI. Such a turning point could be expected to be reached earlier in small countries than in large ones.[23]

Additionally, the potential for collective action is likely to be increased by the heterogeneity of interests in those situations where exports are relatively diversified by product and industry, including a variety of agriculture, mining and manufactured products (perhaps those of latecomers to manufacturing production who have to export in order to receive their investment and foreign exchange licenses and tax benefits), and also in services such as tourism, banking or shipping. In particular, the more heterogeneous the interests among the group of exporters or the group of late import-substituters, the lower the incentive for free-riding by each group member.[24]

Another factor that can be important in determining the strength of collective action in any given group is the perceived cost of inaction to members of the group. Mention has already been made of the negative effect of resource endowments on the likelihood of success in OORs. The poorer a country's resource endowment, the higher the cost of failing to adjust (such as by adopting an OOR) to negative external shocks. As mentioned above, this helps explain why the resource-poor East Asian countries have been among the quickest and most successful in adjusting to the oil price shocks of the 1970s by further strengthening their OORs. Likewise, it explains why the resource-rich rentier and aid-dependent states of the Middle East and North Africa (MENA) have been among the least successful. Since the cost of not adjusting is likely to rise with the permanence of the perceived or foreseen fall in such rental flows, and since declining reserves of natural resources are more likely to be understood as being permanent than the falling prices of resource exports, this may perhaps explain why Bahrain – the first oil-exporting country to experience declining reserves and production – has been able to proceed further in OOR than most other countries of the MENA region. For the same reasons, Tunisia would seem to be a close second in this respect.[25]

The dynamics of interest group interaction

OORs are more likely to be initiated and sustained in situations where a coalition of groups favorable to them can more easily be put together. As a result, various factors influencing the likelihood of groups to form coalitions may be relevant and potentially important for success in OOR. The more polarized the political and economic setting, the more difficult it will be to form such coalitions and hence to implement successful OORs.[26] If the setting is such that there are benefits for those who join the coalition late, for example, so as to be identified as the swing group critical to the formation of the majority coalition and therefore eligible to be compensated for such, the formation of such coalitions may be characterized as a "war of attrition" game in which coalition formation may be very slow (Alesina and Drazen 1991). Holdouts may continue until the costs of holding out are sufficiently high. This suggests that coalition formation may be made easier if political rules are followed which reward those who join the coalition early.[27] The fact that democratic rules facilitate the communication and political exchange processes that are vital to coalition formation may explain the rather surprising finding of Haggard and Kaufman (1989) that the probability of success in OOR is no lower in democratic regimes than in autocratic ones.

Coalition formation is likely to be a rather dynamic process in which the expressed preferences or actions of one group at one point in time may subsequently have effects on those of others. Since the willingness of some groups to join the coalition may be contingent on the participation of other specific groups, certain dynamic sequences of coalition formation may be more successful than others. In turn, the existence of such interdependencies and the need to attain a critical mass in the coalition formed to create and maintain an OOR[28] imply that externalities are present, thereby providing the justification for the use of selective incentives in coalition formation.

The fact that by their very nature OORs must be adopted at the national level rather than at the regional or local levels exacerbates the coalition formation problem. Whereas at the local level people know each other well, the geographic and social distances between groups at the national level makes it difficult for the members of certain groups to know the true preference of the members of other groups with respect to OOR. As a result, their knowledge of the attitude of other groups may be limited to the preference revealed in official organs by the spokespersons for such groups. The preference revealed in this way may well be distorted relative not only to the actual revealed preference of the members of such groups, but also and especially to their true preferences.

Both biases are likely to lie in the direction of making preferences for the *status quo* seem more positive and pervasive than they really are. The first

bias results from the fact that official spokespersons are likely to benefit from maintenance of the *status quo*. For example, a change from ISI to export-led development might well suggest the need for a change in leadership or spokesperson, implying that it may be in the self-interest of such persons to deliberately falsify their public revelation of such preferences. The second bias arises because, when individual members fear punishment for being identified as having preferences contrary to what they believe to be those of the vast majority of members or at least those trying to learn their preferences, they may deliberately falsify their own preferences. Again, their understanding of the preferences of others may also be biased by the false revelations of other members.[29]

These considerations help explain why even those reforms that are deemed to be positive by the vast majority of the citizens of a given country may well be very slow in coming. They also explain why the same reform proposals that are rejected at one point in time can be accepted subsequently without any real change in conditions. Finally, because of interdependencies in preferences, they also explain why, once a few people change their minds, many might do likewise, and the reform process, once begun, can proceed very quickly indeed.[30] Nevertheless, even if there should develop attitudinal changes favorable to change and reform, it does not necessarily follow that everyone will support a specific OOR and hence that such reform will be forthcoming. Since groups have more difficulty making decisions the more numerous and complicated the alternatives, the existence of political and constitutional procedural constraints on the sequence of decision-making can have a positive influence on the ability to affect reform. Such constraints can be viewed as having the desirable effect of stabilizing expectations about the future and narrowing the range and time path of decisions to ones in which rational choices can be made.

The role of the state and foreign agents in OOR creation

The above discussion largely leaves out the potentially important roles in OOR of state and international agents and agencies. Yet, these may be crucial. Clearly, both foreign creditors to and investors in any developing country have considerable self-interest in OORs, since ongoing OORs can significantly raise the future prospects for currency convertibility and loan repayment. Other foreign agents may see the country as a low-cost source of raw materials, intermediate goods or finished products, and others still may see it as a desirable market for their products but are unlikely to invest in the country unless they believe long-run prospects to be good. An ongoing OOR in the country may be reassuring about these prospects and hence influential in inducing such agents to make these investments. Hence, foreign agents and their representatives are likely to be very supportive of OORs.

Since considerable start-up costs are required to start any organization dedicated to OOR and because of its permanence, power and the scope of its activities, the state is likely to be highly sought after by individuals and groups both favorable and opposed to OOR. Indeed, many interest groups may seek to attain their objectives by interceding with – and obtaining the support of – the state. The state and its bureaucracy, however, may not be merely passive in their roles. In fact, in certain situations they may play very active initiating roles. While the direction in which that initiative may be exerted would necessarily depend on the circumstances of the individual country, most state agents are likely to have an interest in the *status quo* of ISI. This is because they are likely to share somehow in the rents generated by protection. However, the more unfavorable the economic conditions and the poorer the prospects for the viability of continued growth via ISI, the more likely it is that some elements of the state bureaucracy will be willing to back OOR. Indeed, if circumstances are sufficiently bad, certain bureaucrats or even military leaders may be willing to commit themselves to an economic development priority and, to that end, provide strong leadership in OOR, even at considerable political risk.[31]

Since technocrats may be more immune to interest group pressure than career politicians and, as stressed above, that pressure is on balance likely to be against OOR, one might hypothesize that more technocratic governments would be more likely to innovate with OORs than more politicized ones. Naturally also, the more merit-oriented (as opposed to loyalty-oriented) the bureaucracy, the more likely it will be that some bureaucrats will be willing to innovate.[32]

Conceivably, the likelihood of policy innovation within the bureaucracy may also be affected by the administrative structure. One might expect tolerance for such innovation to be enhanced by competition for decision-making leadership among the relevant economic ministries. On the other hand, the more diffused the locus of economic decision-making, the larger the number of agents who may have to agree on an action, and the smaller the scope for any such innovation. As a result, it may be difficult to know, *a priori*, which influence is likely to be stronger.

Monitoring and appropriately rewarding OOR efforts

Since the correlation between effort and performance with respect to OOR implementation is typically far from perfect and governments may have a reason to bias the revelation of their performance, the monitoring of such an effort is very important. Inasmuch as the state itself may play a fundamental role in initiating and maintaining a given country's OOR, it may be quite difficult to find a monitor of OOR performance which is both sufficiently

informed and objective. Since monitoring is a public good, it is likely to be undersupplied.

Moreover, even if not undersupplied, proper monitoring is inherently difficult due to the underlying asymmetries of information. Since effort and commitment to OOR by a given government are difficult to measure directly, a good model for converting multifaceted OOR efforts and policies into economic performance is likely to prove useful. Of course, since actual performance can also be significantly affected by many different exogenous factors, such as conditions in foreign markets, earthquakes and the weather, the introduction of such factors considerably complicates the modeling process.

The asymmetries in information in monitoring OOR performance and commitment, in turn, give rise to both adverse selection and moral hazard problems. Adverse selection may arise both in the selection of the monitor and in providing the monitor with information. Those willing to serve as the monitor or to supply the monitor with information may well be those with an incentive to show the OOR itself and/or the government's implementation efforts to be a failure (as in the case of opposition groups), or alternatively to show it to be a success (as in the case of supporting groups). In either case, the monitor may not have the appropriate ability, experience and objectivity. Moral hazard may arise when, once it receives a favorable judgement from the monitor (for instance, after providing the monitor with appropriately biased data), the supplier of OOR efforts may have fewer incentives to expend greater efforts on behalf of OOR, and the effectiveness of reform may decline as a result.

In DCs, there may exist several alternative sets of think tanks, research institutes and universities, each with the ability to engage in ongoing monitoring. When there is a competitive market for people with such expertise, the reputation earned for doing a good job in monitoring may provide all the incentives needed. In developing countries, however, where such institutions are much less well-developed and the availability of competent and independent monitors much more limited, the monitoring problem is likely to be considerably more difficult to solve.

In developing countries, therefore, international agencies may provide the best means of monitoring OOR efforts. This is not to say that they are free of problems in this respect. Certainly, such monitoring is not always sufficiently objective. Even if it were, the monitoring external agency (such as the World Bank or the IMF) may be disadvantaged by insufficient or discontinuous access to the relevant data and by its inability both to distinguish between high and low-quality data and to identify the relevant exogenous factors affecting performance. Also, the evaluation criteria and the models used by the external monitors (for connecting OOR efforts with performance, taking

into account various extraneous influences) may be quite different from those which objective domestic monitors would have employed. For this reason, the monitor's evaluation may not be accepted as valid by the relevant parties.

Similar considerations apply with respect to the means of imposing sanctions for insufficient effort in OOR. Once again, the maintenance of a system for imposing appropriate rewards and penalties is a public good and likely to be undersupplied. The ability of inward-oriented ISI to survive long periods of time in the face of poor and generally declining performance is a matter of record and suggestive that the penalties to policy-makers for failure to initiate and implement OORs are insufficiently high. Because of the state's large role in both the creation and monitoring of OOR, unless so specified constitutionally and/or with truly independent agencies and penalties to be imposed by the citizenry, the state is unlikely to have the incentive to penalize itself.[33] International agencies are, of course, in a better position in that they can exercise penalties in the form of refusal to grant future loans. In some cases, however, the effectiveness of such sanctions may be undermined by the ability to convert such denials into political capital at home.

Conclusion

As mentioned at the outset, it has been assumed that outward orientation is desirable. It has also been assumed that it is possible to design OORs that are effective in accomplishing their objectives.[34] These assumptions have served to focus the discussion on the widespread failures to implement and maintain effective OORs and, in particular, on the institutional problems lying behind these failures.

Naturally, to the extent that neither assumption holds, the importance of institutional considerations for this particular type of reform would cease to exist. Virtually all the same considerations, however, would apply to any other important reform which is deemed to be appropriate. If the first assumption holds but not the second, then the situation may be more complicated. It would suggest that institutional problems cannot be solved independently of the technical and socioeconomic problems of OOR design.

If both assumptions hold, the achievement of greater success by developing countries in their OOR efforts is an important policy objective, and a number of implications emerge on what can be done to bring this about. For example, DCs must keep their economics growing steadily without excessive protection and without crowding developing countries out of the capital markets to which they need access in order to be successful in OOR. Furthermore, developing countries must succeed in stabilizing their economies before they can succeed in OOR. They should also eliminate or minimize barriers to the

intersectoral and interregional mobility of capital, labor and other resources within their borders. Although initially there may be little interest group pressure in support of OOR, such pressure is likely to grow over time as diminishing returns to ISI set in. The principles of collective action provide useful insights for strengthening collective action in groups favorable to OOR and for designing optimal sequences of coalition formation.

As noted before, the conditions for success are more favorable in countries lacking large endowments of natural resources but having relatively well diversified exports. Due to the importance of interdependencies among individuals and groups in attitudes and willingness to join coalitions in support of OOR, there is plenty of room for political leadership and entrepreneurship in designing and managing the process of coalition formation.[35] The coalition formation process can be hastened by providing incentives to those who commit early to such coalitions and disincentives to those who hold out. Even so, inasmuch as the political economy forces against OOR are likely to be quite strong for some time and more difficult to overcome, the greater the comprehensiveness of OORs, the more successful OOR efforts are likely to be when accomplished partially, step-by-step or by region, starting with those sectors or regions with the most initial support. Once success can be demonstrated in some sector or region or with some instruments of OOR, other sectors will increase their demand for OOR, and state agents may increase their supply of OOR effort. For the same reason, they may also be more successful when state agencies are run by merit-oriented technocrats instead of loyalty-oriented politicians.

In order to mitigate the problem of preference falsification, attention should be given to developing means of communicating group opinions and preferences other than through official channels. Greater emphasis should also be given to the use of the secret ballot and other anonymous means of communicating true preferences instead of having to rely on biased preferences revealed by official organs.[36] Given the potentially important leadership role of bureaucrats in OOR, bureaucrats are more likely to play such a role if the penalty/reward system is clearly in support of well-designed and well-managed policy reforms. In addition, although the elimination of government fiscal deficits is a virtual prerequisite to success in OORs, this does not imply a reduction of the role of the state and its agents in OOR and related development processes. Indeed, the state tends to be critically important in all phases of OORs, from implementation, through maintenance and monitoring, to enforcement.[37]

Overall, policy-makers must pay considerable attention to the following: (i) designing the structure of the state and its reward system so as to encourage sincere and effective OOR efforts; (ii) identifying independent monitors

of OOR efforts and enforcers of the penalty/reward systems associated with such monitoring; and (iii) identifying mechanisms for linking independent monitors and enforcers within international agencies with those in developing countries so as to resolve the asymmetries in information which give rise to opportunistic behavior by state and other agents.

Since the potential for future governments to renege on previously-made contracts is a basic characteristic of the state, one of the comparative disadvantages of government is its inability to commit to long-term contracts. Given that such commitments are nonetheless crucial to the success of OOR, attention should also be given to innovative ways in which the state may make its commitments credible.[38]

Notes

1 Among the alleged advantages of inward orientation are the abilities to (i) attend to basic needs and other priorities; (ii) develop the desired degree of social articulation; (iii) improve coordination among the various sectors of the economy and thus internalize the linkages; (iv) build static and dynamic linkages; (v) avoid deterioration of the external terms of trade; and (vi) mitigate disadvantageous dependencies on other countries.

2 Among the alleged advantages of outward orientation are its abilities to (i) obtain the static allocative efficiency gains associated with comparative advantage; (ii) reap both economies of scale and the advantages of learning; (iii) attain a more rapid rate of technical progress; (iv) force entrepreneurs to make greater investments in physical and human capital, research and development, and market development and to attain higher levels of X-efficiency; and (v) avoid the social losses associated with government failures, rent-seeking and uneconomic regulations.

3 See the chapters by Gangnes and Naya, and Bhattacharya and Page in this volume.

4 One source of controversy is that concerning the measurement of outward orientation in general and that in East Asian countries in particular. The East Asian countries have experienced an unusual combination of (a) heavy involvement of the state, (b) considerable protection from imports, and (c) government policies that are highly discriminatory across sectors of activity and sizes of firms. They have also, however, provided very considerable encouragement of exports, imported raw materials, capital goods and technology (Wade 1990). A second source of controversy derives from the multiplicity of policies followed by each country, their varying degree of outward orientation and the difficulty of determining their relative importance. Even if controversy over the existence and sign of the relation could be removed, there would remain controversy concerning the direction of causality (if any) in the relation (Singer 1988). Finally, because of data limitations, the effects of outward orientation on distributional equity and poverty are another source of controversy (McAfec 1992).

5 While this may well be a considerable overstatement, this finding has been replicated in quite a few studies. Some of these studies have controlled for the level of development, size and other factors affecting the degree of outward orientation. See the various issues of the *World Development Report 1986-1991*, Greenaway and Nam (1988), Thomas (1991) and Dollar (1992).

6 See, for example, Thomas (1991) and the references therein.

7 For example, a change in the real exchange rate – an increasingly popular measure of

outward orientation (Dollar 1992) – can be influenced by such external factors as foreign prices and even weather conditions, thus limiting its usefulness as a measure of OOR efforts.

8 In the former case, the obstacle would simply be stagnant or declining markets; in the latter case, it could well be the imposition by importing DCs of severe protective barriers against developing country products.

9 For evidence concerning the importance of substantial capital inflows to developing countries undergoing OORs, see Chenery, Robinson and Syrquin (1986).

10 On the other hand, the tremendous success that some East Asian outward-oriented nations have enjoyed in the earlier period demonstrates to other developing countries now and in the recent past that such success can be held with an outward orientation. With the possible exception of Japan, no such demonstration case may have existed for the earlier period.

11 For example, Luciani (1992) has proposed such a hypothesis for application to Middle Eastern countries with dependence on substantial rents from their petroleum resources and remittances from their workers in other countries. Moreover, Brand (1992) argues that the failure of Jordan's OOR efforts in the late 1980s – Jordan being a country highly dependent on capital transfers from other states and worker remittances – provides a rather strong confirmation for this hypothesis.

12 While this pressure would not arise directly in countries where the market for government bonds is either non-existent or very underdeveloped, indirectly it would since some mechanism, such as artificially low rediscount rates, would have to be created in order to compensate the banking system for absorbing the non- or low-interest-bearing debt in their asset portfolios.

13 Typical barriers to capital mobility across regions include the absence of an efficient financial intermediation system, licensing and other regulations.

14 In the case of labor, mobility can be impeded by: (a) severe housing shortages and especially non-price rationing mechanisms for housing; (b) restrictions on the portability of accumulated pensions from one employer to another; (c) the high costs of entry into specialized or firm-specific labor unions; (d) illiteracy and lack of education in the workforce; and (e) non-competitive barriers to entry.

15 In practice, however, the Korean and Latin American experience suggests that capital mobility may be accomplished tolerably well even without well-developed financial intermediation. In particular, this may occur when the firms of different sectors and regions are closely integrated into conglomerate groups within which funds are mobile across firms and activities.

16 For references to authors who have demonstrated many of the points made in this section, see Nelson (1984, 1989), Rodrik (1989, 1990) and World Bank (1991).

17 OORs have a public good character since the benefits which derive from them accrue to anyone, regardless of whether or not they have participated in the costs of their creation and implementation. While a reversal in policy from OOR to ISI may in principle give rise to similar incentives for free-riding and hence for lack of collective action, in practice the instruments of protection such as quotas and tariffs can be allocated in such a way as to reward participation in collective action. For example, instead of being auctioned off to the highest bidder (the fiscally most responsible approach), many developing country governments restrict the allocation of import quotas to domestic producers according to size of production. Similarly, import tariffs can be imposed on a very narrow range of products, and anti-dumping ordinances not just against specific countries of origin but against specific firms of origin and in favor of the very firm which files the dumping claim.

[18] The adoption of OORs would cause the managers and owners of such enterprises to lose not only protection from imports but also the low costs of raw materials and capital goods imported at artificially low prices of foreign exchange.

[19] An example of such a policy would be a large devaluation.

[20] See especially Fernandez and Rodrik (1991).

[21] For a demonstration of the applicability of such Olsonian propositions to a typical developing country, see Nabli and Nugent, eds., (1989, ch. 3, pp. 10-12); for an international cross-sectional setting, see Nabli (1990).

[22] Somewhat similar conclusions could presumably be derived from a majority voting model with voting costs, factor ownership distributions and other realistic features (Baldwin 1982 and Mayer 1984).

[23] Notably, using a data set of 51 attempts at trade liberalization, Nabli (1990) finds that the probability of success is significantly higher if it is implemented either within 15 years of the initiation of ISI or after 36 or more years of ISI than between the 15th and 35th years.

[24] Once again, Nabli (1990) provides some useful empirical results. In particular, he finds that the probability of success in OOR is positively related to the number of different commodities accounting for 80 percent of exports and negatively related to the relative importance of ISI in GDP prior to the initiation of OOR.

[25] It should also be mentioned that collective action in support of OOR in both countries is strengthened by the fact that both are small and, especially in the case of Bahrain, by the fact that ISI had not really gotten started.

[26] For a model in which this point is demonstrated, see Alesina and Drazen (1991).

[27] These rewards might well take the form of selective incentives, thereby requiring the solution of a secondary collective action problem in overcoming the incentive to free-ride in setting up and maintaining such a system.

[28] The need for a critical mass implies the existence of scale effects in the production of OORs. OOR adoption is therefore reminiscent of the external economies of scale which are important in the adoption of certain technological innovations with interdependencies in use, such as typewriter keyboards, computer systems and software packages (Arthur 1989, David 1985).

[29] See especially Kuran (1987).

[30] See especially the demonstrations of Alesina and Drazen (1991) and Kuran (1987, 1991, 1992).

[31] The role of General Park in leading South Korea's OOR is a widely cited example.

[32] Naturally, this depends on the extent to which those who manage successful innovations are rewarded through promotion and other means and without excessive interference from the top. Once again, these characteristics seem to have been important – though still under-appreciated – ingredients of Korea's successful OOR. (Korea's civil service is extremely merit-oriented, and civil servants who have been successful in promoting innovations have been promoted, even to high political ranks).

[33] As suggested above, however, in the case of merit-oriented bureaucracies it may be feasible to provide appropriate rewards and penalties to the individual bureaucrats assigned responsibilities for economic policy.

[34] Serious doubts about the ability of OORs and their prerequisite stabilization programs to

accomplish their objectives at low social cost are expressed by Taylor (1988, 1991) and many others.

[35] See, for example, Grindle (1991).

[36] See especially Kuran (1992).

[37] For an articulate account of the comparative advantages of state and private sector agents in various functions of relevance to this study, see Stiglitz (1989).

[38] For similar examples, see Rodrik (1989).

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Privatization as a Policy for Development

Introduction

Privatization is an ideology that has spread rapidly. Born as a recipe for the revitalization of a long-established capitalist economy – that of Britain – and promoted by the United States Agency for International Development (USAID) and the World Bank as the cornerstone of any sound development policy, it suddenly met with an *embarras de richesses* following the collapse of the Berlin Wall and the centrally-planned economic systems in Central and Eastern Europe and the former USSR.

Today, there is hardly any government that is not busy preaching the merits of private enterprise. This is frequently in a context in which deregulation – particularly price deregulation – and greater opening to international trade – particularly through a convertible currency – are also pursued. Hence, privatization is normally one of several parallel policies in the context of structural readjustment or systemic transition.

The need for rethinking the role of the state in the economy and for privatization is almost universally accepted. The concept is therefore not under discussion: we take for granted that privatization is a necessary tool in the context of structural readjustment and, indeed, development policy in general. It stands to reason that the state, having initiated certain economic activities under its direct control, should at some point in time divest them. The question is to what extent, within which time frame, and how to privatize.

The rapid success of the privatization ideology in its extreme manifestations also laid bare its limitations. All ideologies and purported panaceas are bound to appear simplistic when confronted with the complexities and limitations of the real world. So it is with privatization. We now have significant experience with different attempts at privatization and why some of them either never took off or failed or are encountering serious problems. The overall impression, derived from the experience of both the US and Britain, as well as of most other countries attempting privatization, is that a serious reconsideration of the matter is needed. This is not to say that privatization should be abandoned. Rather, careful timing, selection of assets to be privatized and the management of the process are increasingly viewed as crucial to the final outcome. Privatization is not guaranteed to succeed.

With the exception of Britain, privatization has remained limited in most Western European countries. Substantial assets remain in the hands of either national or local governments, either directly or through specialized holding institutions. Even in Britain, doubts are being raised regarding the results of the privatization process, because of the damage inflicted on a company, as

happened in the case of the British Petroleum Company, because of conflict with the regulator caused by monopoly positions, such as in the case of British Gas, or for other reasons.

In the developing world, actual sales of government assets have mostly taken place in countries facing a substantial foreign debt crisis, which have been subject to greater immediate pressure from foreign creditors. Doubts have been voiced in particular with respect to the soundness of debt conversion schemes, which have played a crucial role especially in Latin America By far the most ambitious privatization programs have been announced in the former centrally-planned economies of Central and Eastern Europe. This is not surprising, given that the extent of state ownership had expanded there well beyond the sectors that are commonly entirely or partly controlled by the state in the so-called "mixed economies." The experience gained in these countries, especially Poland, the Czech Republic and Hungary, is particularly valuable.

However, the most ambitious effort remains that of Germany, where a special agency to privatize the industrial properties of the former East German state – the Treuhandanstalt – was created. The German privatization effort is taking place under conditions that are unusually favorable in a country which is in the center of Europe, with the strongest currency, a competent administration, a huge and rich private sector, a fully-developed financial environment, plus generous funds to entice buyers and support their restructuring and investment programs. Notwithstanding these advantages, this program is taking a substantial amount of time, has not yet solved some of the most difficult cases, and was surrounded by an extraordinary amount of controversy, including the assassination of the first chairman of the Treuhandanstalt.

The limited size of the domestic capital market

The limited size of the domestic capital market is a problem for almost all countries. With the exception of those cases in which the state owns relatively small companies or individual assets that are easy to dispose of on the market (especially real estate), privatization generally involves large-scale corporations that cannot easily be broken up. It is true that the more developed the country, the larger its capital market, but then the companies to be privatized are also likely to be larger. Even in Britain, which certainly has a capital market proportionately larger with respect to its domestic economy than most other countries, the government was obliged to carefully distribute asset sales over time in order not to overburden the market. Nevertheless, the unfortunate timing of certain sales led to catastrophic undersubscription and several embarrassing results, such as the final sale of British Petroleum stock in 1987.

It is generally said that offering shares of state companies on the market to private investors contributes to the development of the market itself. This may be the case in those countries in which the development of a sound capital market has been hindered by the lack of attractive offerings. In these countries, the state discouraged the development of financial markets by keeping interest rates artificially low, or by absorbing an excessive share of private savings to finance the budget deficit, or simply by excessively extending its direct involvement in the economy, hence depriving the private sector of profitable investment opportunities.

In these cases, privatization must be a cautious long-term policy, progressing hand in hand with the development of capital markets. It is not realistic to envisage a massive and complete transfer of ownership from the public to the private sector. Rather, privatization is likely to involve the floating of small minority portions of the total equity of public enterprises, which in turn raises the problem of how to ensure that the company will behave as a commercial entity free from government interference while its capital continues to be mostly in the hands of the government.

The limited size of the domestic capital market is not a problem for developing countries only. Even Italy, though a member of the "Group of Seven" (most industrialized countries in the world), does not have a capital market that may absorb an ambitious privatization drive as introduced by the government in 1992. The point is simple: state holdings are worth large amounts of money, and even capital markets in developed countries are bound to balk. This has several implications. There are probably no more than five countries in the world which can engage in significant privatization based on equity sales on the domestic capital market. All other countries will need to resort to some degree of foreign participation in the privatization process. Globally, there is acute competition for funds, meaning that only good-quality assets stand a chance of being acquired at attractive or fair prices.

No government is really interested in a fire sale, although some may argue that in extreme cases even a fire sale is preferable to the continuation of bureaucratic management of industry. The implication is that the process of privatization must be paced in accordance with the need to develop a private capital market. The alternative may be to rely on foreign capital markets or sell participations to foreign companies altogether. The former may be acceptable in a context of regional integration. For example, the shares of Italian state companies may be floated on the stock markets of Paris or London or Frankfurt, because capital movements in Europe are fully liberalized and a process is underway which is intended to lead to monetary unification so that Italian investors may also buy in Frankfurt. It is just a matter of the Milan Exchange not developing in line with other European exchanges: one may

accept this as a consequence of specialization or division of labor within the European Community (EC). However, this consideration is not relevant outside the EC.

The limited size of domestic wealth

Another consideration which is relevant for numerous countries is the limited size of domestic savings and wealth. This is different from the question of the size of the capital market, because in a good number of countries substantial wealth is present even if the capital market is small, yet it is locked up in other forms. For example, in Italy a very large amount of wealth is accumulated as real estate investment and as holdings of government bonds. Likewise, in the Gulf Arab countries – and, one suspects, in North African countries as well – very large wealth is accumulated in financial placements abroad. Indeed, it is true of many developing countries that private investors have large financial assets accumulated abroad, and one of the primary goals of a privatization policy must be to attract such funds back home.

Yet, there are countries in which all the wealth is in the hands of the state, and the public has had no opportunity to accumulate. Hence, privatization must be based almost exclusively on current savings, which are bound to be very limited. Even where considerable domestic wealth is present, political objections may be raised against privatization because an outright asset sale would inevitably lead to a distribution of state wealth more or less in accordance with the distribution of existing private wealth. To the extent that state property – as long as it stays in the hands of the state – may be viewed as belonging to all citizens, the latter result would represent further concentration of wealth. However, it is frequently felt that privatization should be an occasion for achieving a different and more egalitarian distribution of wealth.

The country in which this problem has set in motion the most complex debate is Czechoslovakia – now divided into two independent states. Several solutions were discussed, ranging from transferring ownership to workers (which was quickly rejected) to distributing shares to all citizens for free. The final scheme adopted will attract a good deal of analysis and scholarly attention in the years to come, as events unfold and its success – or lack thereof – becomes evident.

At first, the Czech scheme envisaged the issuing of "privatization coupons," which were put on sale for a limited time at very low prices. Almost everybody could afford to buy coupons, but the decision to buy and how many to buy was the expression of individual will, not the result of indiscriminate distribution to all citizens. These coupons are to be exchanged for shares in the companies to be privatized when the latter are actually placed on the market.

They are, so to speak, in the nature of a generic option to buy any outstanding share. The individual coupon-holder can, if he so wishes, entrust his coupons to a common fund, which will then use all the coupons that it has collected to acquire significant participations in individual companies and leave the public with common fund parts.

The process is underway: coupons have been sold, common funds have been organized, and shares are being exchanged for coupons. The final outcome is cloudy, as it depends a great deal on individual investment behavior. There is a possibility that a limited number of common funds will turn into powerful holding companies. By March 1993, nine common funds had emerged as dominating the process, and they controlled 50 percent of all outstanding coupons. One in particular – the Harvard Capital and Consulting Company – had emerged as the leader early in the process, thanks to the fact that its founder, Victor Kozeny, promised fund participants that he would buy back their coupons at times their initial value one year after they were converted into stocks. Kozeny has so far concentrated his interest on a limited number of companies, acquiring large stakes in each, including two major banks. It is therefore likely that he may be able to honor his pledge and turn himself into the most powerful capitalist in his country simply by skillfully playing the privatization game. This would be a far cry from the intended redistribution of state wealth.

Russia has launched its own voucher scheme to privatize industrial property, but there is as yet no parallel to the Czech investment fund phenomenon – at least no known parallel, as some parties are known to have been accumulating coupons. It is not clear what exactly coupon-holders will be entitled to, as ownership of industrial assets will have to be divided between central and local governments, enterprise management and workers, and coupon-holders. The relative share of each of these groups was one of the key issues under vigorous political debate in Moscow in the beginning of 1993. There is also the danger that individual investors will want to quickly cash in the capital gains that they are likely to make as soon as actual shares are exchanged for cheap coupons. The entire process is an imaginative attempt to redistribute wealth – a 1990s alternative to the question of the primitive accumulation of capital.

The problem is significant not just for industrial and banking property. In most former centrally-planned economies there is considerable state ownership of real estate and housing. In Russia, sales of real estate were proposed as a way to mop up the "ruble overhang" that was the leftover of years of repressed inflation. The proposal was not accepted and the problem remained unsolved, leading to disastrous inflationary pressure as soon as prices were liberalized. In the beginning of 1993, there was serious danger of hyperinflation

in the Russian economy, while a process of dollarization was obviously underway. The main objection to the speedy privatization of real estate was again distributional. An outright transfer of ownership to the occupant would not amount to equitable distribution of state wealth to all citizens. The alternative – requesting occupants to acquire ownership through increased payments over time – would aggravate the social problem that steep increases in the price of necessities already pose. In fact, it appears that only very few Russian citizens who had the opportunity to acquire their apartments did in fact do so, many preferring to continue as state tenants.

Nevertheless, the privatization of real estate is crucial, because the public is more likely to save and invest in acquiring its own apartment than in acquiring the shares of some unknown and not very profitable state company. For this reason, real estate sales should be the bread and butter of privatization, yet they are not common. Indeed, the fact that substantial portions of the real estate patrimony cannot, for one reason or another, be placed on the market is leading to extraordinary price distortions in the states of Central and Eastern Europe and in the new *Länder* in Germany, which in and of itself is a considerable obstacle to private sector growth.

A privatization policy must explicitly address the fact that it is bound to lead to an exchange of assets. Only a minor privatization drive can be based on current incremental savings, whereas large-scale privatization requires that the public divest itself of some of the assets that it holds in order to acquire the new ones that are being offered. Hence, the total aggregate value of national wealth may become a serious constraint, unless one accepts that privatization becomes essentially a sale to foreign investors. The nature of the assets that are put on sale may have an influence on the process: assets that are easy to understand, such as real estate or utilities, may succeed in mobilizing a wider base of existing private wealth. They may also lend themselves to unequal exchange, whereby the state deliberately underprices the assets to be privatized in order to achieve a net transfer of wealth from the public to the private sector. The above may contrast with the most common view according to which it is appropriate for the state to provide cheap housing to the poor and take direct control of natural monopolies, such as utilities. In fact, it is these assets that may be easier to privatize, rather than airlines or steel mills.

A variation on this theme is the case of countries in which a large proportion of private wealth is placed in government bond holdings. In such cases, it may be more effective for the government to propose a (voluntary) scheme to swap government paper for equity in the companies to be privatized, rather than floating the equity and then using the proceeds to redeem part of the outstanding debt.

The poor quality of assets

In addition to the lack of investment funds, a very serious obstacle to privatization is that the quality of assets held by the state is poor. State industrial holdings have frequently piled loss upon loss for many years, because of price controls or waste, or because they are kept alive for their supposed "strategic" importance and against all market logic. Also, while in the red, they accumulate debt that banks are glad to extend because of an explicit or implicit government guarantee. The final outcome is that some of the companies to be privatized are simply impossible to sell.

An extreme example of this is offered by the Italian experience in 1992. When the government announced a sweeping policy of privatizations, it was obliged to declare one of the three state industrial holding companies bankrupt and proceed to its liquidation. A second industrial holding would have been forced to seek protection from creditors were it not for the fact that a special exemption was granted by law. The bankruptcy of the first led to a bitter struggle, especially with foreign creditor banks, and in a matter of months the credit standing of all state-owned Italian corporations had worsened considerably, thereby leading to a sharp increase in financial costs. The lesson of the story is that one cannot simply get rid of the consequences of past mistakes by announcing the privatization of rotten apples.

A less extreme example is offered by the German experience. In the beginning of its operations, the Treuhandanstalt took a very rigid stance, essentially refusing to pump fresh money into loss-making companies and insisting on a proper sale for them, that is, a sale that takes place at a positive price, not one in which the buyer is paid to take responsibility for the acquisition. The outcome of the initial rigidity of the Treuhandanstalt was that some East German companies went broke and were liquidated.

A case which attracted a good deal of attention was that of Interflug, the airline of the former East German state, which was considered to be reasonably well run and held routes which were of value to potential buyers. Conditions attached by the Treuhandanstalt were so strict that all potential buyers were discouraged. Lufthansa, the West German airline, did submit a bid, but the federal antitrust office objected. Having run out of cash, Interflug was liquidated, in an outcome which appeared to produce only losers and no winners. The Treuhandanstalt has gradually shifted its position. In subsequent cases, it has offered considerable incentives to potential buyers, including keeping charge of a part of the workforce until it is reduced to an acceptable size, compensating for losses in full or in part for a given number of years, and extending grants to finance part of the investment which is required to bring the installation to competitive levels.

In some cases, one wonders whether it is still appropriate to speak of privatization at all. For example, the agreement for the privatization of the Leuna oil refinery calls for the Treuhandanstalt to remain financially responsible for the existing refinery with its entire workforce while a consortium led by the French Company Elf builds an entirely new refinery nearby. Once this is completed, the old refinery will be shut, and a part of the workforce may be transferred to the new plant. Strictly speaking, the ownership of the existing refinery will never be transferred. This pattern of privatization may be good for Germany, but it is likely to be beyond the reach of most other countries.

It may be a benefit to be derived from privatization that companies that are not viable are finally shut down, but privatization may be an expensive solution to achieve this result. The sale of good and bad assets together will more than proportionately depress the price of the good ones. The forceful sale of bad assets by resorting to negative prices is also likely to lead to extra costs relative to outright liquidation. The only argument in its favor may be that the state is in fact politically unable to make the decision to liquidate a given industrial activity and would rather indefinitely postpone the day of reckoning.

Conflict with antitrust regulations or principles

A serious obstacle to privatization is that a simple transfer of ownership will generate no improvement in efficiency unless it takes place in a competitive environment. The privatization of companies enjoying a monopolistic position or special market protection may not lead to any improvement in performance. In fact, corporate performance depends on the corporate culture and on attitudes towards the market. It is generally believed that a company in the private sector will develop a different corporate culture because it needs to turn in profits. However, if the company is operating in a protected market, its corporate culture is unlikely to change, and all that will happen is that final prices will be increased. This is a serious problem in all the European countries that have a competition policy in place. We mentioned interference on the part of the federal antitrust office in the German privatization process, of which there have been several cases. In many more cases, conflict did not arise simply because companies that expected objections on the part of the federal antitrust office did not bother to bid for companies being sold.

In Britain, the privatization of companies in a position of monopoly was accompanied by the creation of a regulating authority to promote competition in the industry and protect the interests of consumers. In the case of the gas industry, a bitter conflict developed between British Gas – the original monopolist – and OFGAS, the regulator. In order to achieve greater competition, the regulator imposed rules and obligations on British Gas, and in 1992 the

company requested a review of its position. The conflict clearly affects the company's earnings potential and stock market evaluation. This has raised the question of the moral appropriateness of the government's decision to offer an asset for sale to the public and then change the rules of the game in a way which substantially affected the value of the asset. It does not matter whether this is to the detriment or benefit of buyers; the fact remains that the government should have first changed the rules and introduced competition, then sold the resulting assets.

In other European countries such as France and Italy, governments are more interested in promoting mergers of national companies in order to compete more effectively in the European and global marketplaces than in preserving competition at home. The assumption in this case is that the economy is sufficiently open to international competition that it can afford to have a very limited number of national producers – a questionable assumption indeed. The problem is all the more serious in countries whose economies are not fully open to international competition, and especially so if privatization is likely to mean acquisition on the part of some foreign company. It is essentially for the fear of creating foreign-dominated monopolies that the Central and Eastern European countries are delaying the privatization of some industrial sectors which might easily find buyers if they were put on the market.

The need to avoid promoting monopoly positions points to the fact that privatization should be undertaken in the context of foreign trade liberalization and deregulation. Serious consideration should be given to breaking up national monopolies into competitive entities with different ownership structures, for instance by seeking different foreign allies whenever foreign participation is necessary.

Privatization and the fiscal crisis of the state

In a majority of cases, privatization is a policy which is first considered at times when the government is facing a fiscal crisis. The latter may be due to voters' resistance to higher taxation in democratic systems of governance or to the collapse of other sources of revenue, as is the case in rentier states whenever the source of the rent is reduced. States have an imbedded tendency to widen the scope of their action and their instruments of control over society. They are kept in check by financial constraints, and are periodically obliged to revise their relationship with society, which we may view as coinciding with the private sector. Privatization is part and parcel of this process and should be viewed in this context, that is, in a context in which expenditures must be reduced and new sources of revenue must be found.

Privatization may be viewed as contributing to the solution of the fiscal

crisis of the state in several ways. First, to the extent that publicly-owned enterprises need frequent injections of funds in order to cover losses or finance needed investment, privatization reduces current expenditure. Moreover, to the extent that public property is sold at a positive price, it generates additional – though non-recurrent – funds for the public purse. Finally, to the extent that privately-owned enterprises may be expected to operate at a profit, privatization broadens the tax base.

Because states are universally reluctant to relinquish the instruments of control that they have on society, privatization is likely to be undertaken only quite late in the process, namely when the fiscal balance of the state is already greatly deteriorated. This entails that companies offered for privatization have long been starved of equity capital and are overburdened with debt or have neglected investment for many years. It is far from surprising that the privatization of such rotten apples is unlikely to go very far. For the same reason, privatization may initially cause an increase – rather than a decrease – in expenditures, because companies need to be recapitalized before they are privatized.

Experience shows that privatization will be most successful if undertaken at an early stage, when it is not forced by fiscal strictures. Also, privatization is no alternative to accepting other unpopular policy moves, but rather requires that the latter be taken promptly. This refers in particular to the liberalization of key prices which affect the profitability of assets to be privatized. Finally, privatization is bound to benefit the state treasury in the long term only if privatized companies are allowed to make profits and the tax system is well developed so as to capture part of that profit. Privatization is thus a tool of fiscal development, not an alternative to it.

All of the above considerations are essential to understanding the political prerequisites of a successful privatization drive. Privatization which is undertaken not in a broader context of redefining the respective roles of state and society but as just another trick to maintain the political *status quo* alive for a few additional years is unlikely to succeed. It is only in a context of democratization and broader economic and political reform that privatization will prove to be an effective economic policy tool. The issue of fiscal development is particularly important. Governments whose democratic credentials are dubious are especially reluctant to impose or increase direct taxes, as the latter are bound to lead to a demand for greater control over government actions. Thus, one sees the paradox of governments announcing the privatization of enterprises and then mandating as one of the key criteria in the process that only enterprises making losses should be privatized!

It is common for governments of fiscally underdeveloped countries – such as the major oil exporters – to resist privatization of successful government-owned enterprises because the profits from the latter are a source of revenue

for the state. For example, Saudi Arabia has a long-standing policy in favor of private sector development and has repeatedly stated its intention to further privatize enterprises that are presently partly-owned by the state. Yet, privatization is being postponed *sine die* because of the desire to preserve a source of income for the state. Indeed, if these companies are privatized, it is possible that private lobbies may force their sale at prices lower than the full discounted value of expected earnings, and in the absence of a system of corporate income taxation, the state would permanently lose a major source of income. In the long run, however, the persistence of conditions of fiscal underdevelopment is bound to seriously limit the ability of the government to carry out an optimal economic policy.

More recently, faced with the growing burden of investment in the petroleum sector and the growing burden of expenditures on other sectors, most notably defense, even the major oil-producing governments have felt the pinch of insufficient funds for investment. This has led to renewed interest in ways to encourage foreign investment even in the petroleum sector, and indeed to calls for the progressive privatization of national oil companies themselves. By resisting privatization in conditions in which private entrepreneurs are frequently very liquid and obliged to invest abroad for lack of acceptable investment opportunities at home, governments are inevitably slowing down national economic growth.

A strategy of flexible government involvement

In light of all the difficulties and obstacles discussed so far, is privatization a viable and relevant policy for most developing countries? I believe that it is, but careful consideration should be given to some key aspects of the process. It is necessary to avoid a simplistic approach, that is, to take all assets held by the state and wholly transfer them to private hands, in favor of an attempt to combine state ownership with foreign participation and domestic private capital, coupled with a strategy of moving frontiers between these three components.

A first step must be the reorganization of state holdings with a view to achieving maximum efficiency even before a process of privatization is set in motion. In this respect, the experience of creating state holding companies followed with considerable success by such countries as Italy, Spain and Turkey should be noted. Holding companies are the instrument through which the state may own – in whole or in part – industrial enterprises organized as joint stock companies and subject to private sector legislation. As operating companies are private, they will normally be expected to turn in a profit, although this is in fact not always the case. A minimum advantage of the system is that losses made by any one company are clearly shown and evidenced.

The system is no panacea. If operating companies are not exposed to competition, they may become as bureaucratic and inefficient as any government administration. Also, full managerial autonomy is not realistic, since managers will always pay attention to the wishes of the government or of powerful individual political figures. Thus, political interference is bound to continue to some extent, as private industry is hardly immune from government interference. The fact is that there are well-run state-owned companies. Hence, the search for an effective way of running state-owned enterprises while keeping them in the ownership of the state is not trivial. Quite on the contrary, it is obvious that the problem will remain of considerable empirical relevance for many decades into the future.

The essence of the system of holding companies is that operating companies belong to the private sector from the point of view of the legal discipline to which they must obey. Even more, holding companies themselves are subject to the same legislation as any other privately-owned company. The first and most urgent form of privatization is thus not in actual ownership, but one in the legal regime that is imposed on state-owned companies. A structure based on holding companies also facilitates the task of establishing joint ventures with foreign corporations in order to progressively acquire the necessary technology and know-how and facilitate penetration of foreign markets. The key to a successful joint venture strategy is to have a single entity being present in multiple joint ventures so as to be able to play one foreign partner against the other if need be.

In the past, multinational corporations had a negative attitude towards joint ventures in which they did not hold a controlling interest, but competition has led to greater flexibility. Today, most multinational corporations will be ready to accept a minority position or a 50/50 split if the project is sound. In this respect, state ownership may be more easily combined with foreign participation than private ownership, because the state has much greater staying power, while the private partner is more likely – although this is by no means certain – to sell out to the foreign partner in due course. A combination of privatization and a nationalistic attitude towards foreign investment may lead to worse results than a continuation of state ownership which is combined with openness to international cooperation. In many cases, foreign participation will be needed in order to acquire risk capital besides technology and know-how. What is needed is a strategy of flexible state involvement in the ownership of economic activities, one that continually redefines the boundary between the state and the private sector and keeps it constantly shifting. This is different from eliminating state ownership entirely.

Complete privatization is unrealistic for most developing countries within a reasonable time frame. One should consider the effect of a privatization

policy announcement on a company's morale and investment. If in fact the privatization of a company is unlikely to take place within a time frame of four to five years, it makes little sense for the government to announce its sale, except as a flexible long-term goal. In the meantime, the company needs an investment strategy, a business plan, personnel policies and so on, and the government, as the owner, must somehow define these. Setting an ultimate goal of privatization does not exempt the government from the responsibility of managing the company in the interim period. It is not clear from available evidence whether announcing a privatization plan that is indeed not feasible in the foreseeable future will improve in any way the likelihood that privatization will become possible sooner rather than later.

On the other hand, asserting the principle that state-owned companies should behave in accordance with commercial criteria and that ownership can shift from the state to the private sector progressively and at any time may create a more favorable climate for economic development. One should assume that the state has a given amount of investment funds available, and that it must optimize at the same time control and investment. In order to do so, the state should open to private investment all those activities to which the latter is more likely to be attracted. These include: (i) real estate; (ii) small-scale service and industrial activities, which may be run as individual or family enterprises; and (iii) activities which may offer an almost guaranteed rate of return, as they cater to a well-established market or group of customers.

On the contrary, it may be very difficult to attract private individual investment towards large-scale industry, especially in the face of a record of past losses. Only corporate investors may be interested in this latter type of investment, and with considerable difficulty. It is a paradox that governments are often only interested in privatizing those assets that are most unlikely to find private buyers. Because domestic capital is more likely to be mobilized for non-industrial investment, it is very important that services from utilities and infrastructure be priced so as to allow for profits. It is a terrible mistake that governments often make to underprice transportation, electric power, telecommunications and other services. The incentive that low prices give to industrial investment is minimal, while the cost in terms of the ability to sustain investment is very considerable. All of the above-mentioned sectors should be able to internally finance their own growth and distribute profit to private shareholders.

If the government follows a sound policy in this respect, foreign investment should be encouraged to participate in utility and infrastructure investment as well as in industry, in order to further reduce the capital commitment on the part of the government. In this respect, we should go back to a classic article by Albert Hirschman written 25 years ago. Hirschman's basic idea is

that foreign investment could be of a temporary nature, with a pre-determined divestment schedule built into it from the very beginning. While the article deals with foreign investment in general, its opening quote – describing an exchange between US President Franklin Roosevelt and Brazilian President Getulio Vargas in Rio de Janeiro in 1936 – explicitly refers to utilities.

Foreign investment in utilities has been greatly resented, but it may in fact be especially beneficial to countries in which the state is short of investment funds and is faced with an option between abandoning any industrial promotion role or letting utilities collapse into progressive chaos. It is much easier to deal with foreign investment in utilities through appropriate regulatory legislation than it is with industrial investment. Moreover, foreign investment in utilities is more easily adapted to a planned divestiture scheme. For example, one may resort to build-operate-and-transfer agreements, whereby specific installations are built and operated by a foreign investor on his own account for a pre-determined period of time, and then ownership is transferred to the state or another company. This mechanism is conceptually not very different from the leasing of machinery, and it is very apt to attract foreign as well as private domestic investment.

Hirschman also proposed the creation of an international entity to facilitate the progressive divestment of foreign investment in all areas in which it had ceased to be of special benefit. This is a particularly valuable suggestion in light of the present situation of some countries, in which lack of domestic capital may lead to the selling of industrial assets at excessively low values. To avoid surrendering control, some state-owned companies in the former centrally-planned countries as well as in developing countries often need the foreign partner in a joint venture to advance the capital needed to pay for their share of the equity. An international divestment agency could in essence act as the depositor of portions of equity capital that are temporarily put up by one of the partners while waiting for the other partner to acquire sufficient capital to pay for its share. In cases in which the "weak" partner has access to natural resources for export, the buy-back of its share of the equity can be planned in advance. In other cases, however, a more flexible arrangement may be needed.

Eventually, I believe that joint ventures will evolve towards global partnerships in which multiple companies from different countries participate at the same time. In due course of time, such joint ventures may evolve into a more balanced relationship between autonomous companies, each of which will be owned partly by the government and partly by the private sector in an overall context in which the difference between private and public will have lost much of its present sharpness.

While pursuing a dynamic policy to encourage savings and investment –

be it national or international, private or public – governments must follow a portfolio strategy that progressively lets them out of mature sectors. The latter appeals to the wider public because profits are reasonably assured, and foreign investment may be allowed to participate in them without loss of control. By abandoning mature sectors, governments will be able to play a continuing role in selected areas in which the private sector will not venture unless the state takes the lead. State companies have been greatly beneficial to their national economies in many instances. A continuous critical and realistic approach is thus needed in order to maximize their role into the future.

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Part III.

Country Perspectives

Etatisme Versus Privatization: The Changing Economic Role of the State in Nine Arab Countries

Institutional restructuring in a competitive environment

If the period of the 1960s and early 1970s was the era of étatisme and bureaucratic expansion in the Arab world, the late 1970s and the 1980s were to usher in a new discourse based on "opening up," liberalization and privatization. Privatization programs in the Middle East have not followed, however, from empirical evaluations of the performance of the public sector, nor have they resulted from pressures exerted by native entrepreneurs. Rather, they represent mainly a public policy, carried out in response to the fiscal crisis of the state and under pressure/temptation from globalized capitalism through its international institutions.

The familiar argument in favor of privatization in most of the literature is that public enterprises are less efficient than private ones: they are overstaffed and expensively maintained, and their profitability and factor productivity are low. It is claimed that part of the inefficiency is due to excessive political interference and/or bureaucratic regulation; but these, so the argument goes, are necessary components of any public sector. They delay decision-making, obscure expertise and overburden the firm with a number of extra-economic tasks that constrain its prospects for profitability (Cook and Kirkpatrick 1988). Some escalate the argument further by saying that the public sector is not only defective in terms of allocative efficiency on the micro (or managerial) level, but even in terms of productive efficiency on the macro (or economic) level. The choice of industries in which to invest may be faulty (or too "political") to start with. The intensive engagement of the state in the production and delivery of goods and services may also crowd out private investors from such areas (Hastings 1983). This may eventually lead to lower overall levels of investment, which would retard rather than enhance economic development.

Any attempt to evaluate the role of the public sector, especially in the Third World, must take into account the multiplicity of objectives (economic, social and political) that it must pursue, as compared to the simple profitability objective that is characteristic of most private enterprises. Even so, there are recorded cases of efficient public enterprises, and there are known cases of private monopolies whose efficiency cannot be realistically measured (Cook and Kirkpatrick 1988). Some analysts accept the proposition that public enterprises were created to meet a mixed set of economic, financial and

political objectives, but argue that "they have done poorly in fulfilling the first two goals and too well in fulfilling the last" (Nellis and Kikeri 1989:50).

The public/private, ownership-centered dichotomy is not necessarily the key issue in discussing efficiency in less-developed countries. Leadership and management may be more crucial factors. An empirical study by Robert Cunningham in which he observed a bank branch (private sector) and a tax bureau (public sector) – both having a similar size and located in the same Jordanian town – has revealed interesting findings. The top managers in both organizations appeared in context not to live up to the pejorative image of the Arab manager. On the contrary: they delegate, assume responsibility, accept some participation and "stay out of the way." They are, in general, "tough on the issues and soft on the people," and they measure themselves against certain performance criteria. What is even more interesting, however, is that the public sector organization turned out to be more flexible and rule-oriented than the private sector organization, which is, of course, a conclusion that challenges the conventional popular wisdom regarding the public/private dichotomy, both generally and in the Arab world (Cunningham 1989).

The privatization drive in the Third World is not really the result of a careful evaluation of either the contribution of the public sector to development or the managerial efficiency of public enterprises. Rather, it is a reaction to the fiscal crisis of the state, reinforced by pressure from agencies of the international capitalist order and encouraged, to some extent, by international fashion (which now encompasses both East and West, to use Cold War terms). The main factor, however, is the financial crisis. All the other arguments about development and efficiency are later additions. Very few developing countries have conducted their own empirical studies on the performance of their own public sectors. On this subject they have, on the whole, been prepared to take the word of experts from the industrialized countries and their international organizations. Let us consider the following example: the Director-General of the Arab Organization for Administrative Sciences (who came from "conservative" Saudi Arabia) and his Director of Training (who came from "progressive" Libya) apparently had no doubts about the desirability of privatization in Arab countries. All they were concerned about was "the circumvention of problems and difficulties and [...] the liberalization of constraints and restrictions" in the way of the privatization process (Al-Saigh and Buera 1990:125). It is a measure of the intellectual dependency of these societies vis-à-vis the "core" countries that these two gentlemen are prepared to accept what frequently amounts to ideological statements sold as technical consultancies. For example, as a number of Arab economists have observed, the IMF-World Bank approach seems to be:

> based on a single model of development which fails to take into account the great variety of situations, structures and policy orientations in developing countries. Underlying that model is a set of value judgments in favor of market-oriented development and against government intervention in the economy. Adherence to a single model of development explains why Fund-supported programs contain the same set of prescriptions for all countries. It also explains why programs have not succeeded in achieving the objective of adjustment with growth (El-Naggar 1987:6-7).

In most less-developed societies, privatization which harmonizes comfortably with the hegemonic ideology of a really capitalist society (according to the principle of correspondence) would, ironically, often have to be adopted as an option by the state, and in the form of public policy. Moreover, there are some indications that "stronger" states may be better privatizers. Possessing the institutional network needed for economic restructuring and enjoying sufficient self-confidence to make raw violence and naked oppression less important, a "strong" state is probably better qualified to privatize than a "fierce" state (the "fierce" state often being violent because of its weakness). Thus, Turkey, Egypt and possibly Tunisia are probably more likely to succeed in privatization than Syria, Iraq or possibly Somalia.

Organizational modalities of privatization

There are three main approaches and seven main modalities for privatization (my taxonomy here is similar to, but not identical with, Eaton 1989:470-1).
Managerial approaches: "Managerialism" often represents a prelude to, or an early stage of, privatization. There are two main methods here:

1. The government does not sell publicly-owned assets, but it allows the boards of directors of para-statal corporations (appointed by the government) to act fairly independently, thus privatizing management and labor to a smaller or greater extent (e.g. Egypt Air, Royal Jordanian Airlines).
2. The government issues some of its assets to be managed by a private entrepreneur in return for a fee, that is, "contracting out" (e.g. state-owned hotels and tourist organizations in Egypt).

Privatization in several Arab countries such as Egypt, Tunisia and Algeria was often initiated in this "managerialist" manner, which makes it possible to aim for higher productivity while upholding the banner of reforming or improving the public sector.
Populist approaches: Populist-oriented methods, of which there are two main varieties, enable the move towards privatization to take place without fears of an imminent "capitalist takeover" of the economy:

3. One possible strategy is the sale of a public service or enterprise to a cooperative association. It will be recalled that most "socialist" and populist regimes in the Middle East have always stipulated the existence of a cooperative sector alongside the state sector and the private sector, and this has assumed a pronounced role in certain countries and at certain times, especially in agriculture. In most cases, the cooperatives have been closely controlled by the state (e.g. Tunisia, Syria, Egypt), with Algeria's *secteur auto-géré* representing an important semi-revolutionary (but brief) exception. Populist privatization often entails the transfer of real ownership to a cooperative association of workers, producers or consumers. Iran seems to have the most active scheme of this type in the Middle East at present. Several housing, trading and agricultural projects have been organized in Egypt in recent years along these lines, especially by trade unions and professional associations.

4. Another method of populist privatization is through an "Employee Stock Ownership Plan" (ESOP), with entitlements to purchase stock either equitably or in relation to each employee's wage level. An early yet unique example of such a strategy took place under Nasser in the late 1960s, when employees in the state-owned Al-Ahram publishing foundation were allowed to buy a certain quantity of shares in that corporation. Turkey has applied such plans more recently, and there are calls for a more extensive application of this method in Egypt, Libya and elsewhere.

Capitalist approaches: In all privatization policies there is a shift of management from the government to non-governmental bodies. In capitalist privatization, the ownership of what was once publicly-owned is now openly transferred, in one proportion or another, to whomever is prepared to buy. This may take various forms:

5. One alternative is the partial sale of publicly-owned assets. This is a semi-private enterprise option, and indeed the government may limit the sale of a public asset to 40 or 51 percent. This procedure has been used widely in Britain and Italy. It is particularly appealing to developing countries because it avoids abrupt political shock, and because it is often extremely difficult to secure much of the local capital needed to privatize. Major political debates continue, however, as to whether to confine sales to certain groups or to open them to all domestic investors, and whether to allow foreign multinational corporations to subscribe to such enterprises. Joint ventures between the Egyptian public sector and foreign multinational corporations were indeed the most favored formula during the earlier phases of the Open Door Policy (*Infitah*) in Egypt. While it avoids a sudden reshuffling of the existing formal political coalitions at the domestic level, the government can claim that it is attracting new capital and management with modern know-how while retaining a degree of governmental and "national" influence on the policies of the enterprise

(Eaton 1989:475-7). Tunisia and Iraq have also used this modality.

6. Another possibility is the total privatization through the sale to the public or to an entrepreneur of all assets held. This option has taken place in only a few countries, most notably in Chile and, to some extent, Bangladesh, Sri Lanka and Malaysia, and it has often taken the form of restoring nationalized enterprises to their previous private owners. The process is usually highly political, and it is conducted at least as much to settle old scores as to improve productivity. In Chile, the action was so abrupt and disruptive that several Chilean firms had to be re-nationalized if they were to continue to exist (Nankani 1990:43-5). No such full and open privatization of large firms has yet taken place in the Arab world (with the partial exception of Iraq) in the sense that new large private enterprises have been allowed to emerge, but large previously nationalized enterprises have not been fully restored to private owners. Lists of likely candidates for privatization have been prepared in countries such as Egypt and Jordan.

7. A fully privatized system would see an end to all governmental monopolies and privileges in the field of economics and services. This is achieved either by closing down a government service and contracting out all its activities to the private sector or by allowing private entrepreneurs to compete freely with an existing government service. It is hard to imagine fully privatized administration and courts without the entire concept of the state disappearing. But many of the activities conventionally perceived as being "public" in some countries are privately-owned and managed in others. This may include security-sensitive scientific research, foreign aid activities, supplementary prison and detention services, railways, transportation, posts and telecommunications, and so forth (Eaton 1989:479-81). In many countries, including some in the Middle East, the private sector is allowed increasing competition with the state in providing welfare services such as education, health and social insurance. Private schools are known in most Middle Eastern countries, and private universities have started or may be on their way in Sudan, Jordan, Egypt and Lebanon. The private sector is also becoming increasingly active in the area of public transportation in several Arab countries.

Restructuring case studies

Egypt

Egypt may be called in a certain sense "the mother of Arab liberalizations." Just as it was the first Arab country to champion a leading public sector during the 1950s and 1960s, it also became the first (with the partial exception of Tunisia) to experiment with economic liberalization and privatization, from the mid-1970s onwards. The process of privatization proceeded in a piecemeal

manner and at a slow – though growing – pace, as part of the "Open Door Economic Policy" (*Infitah*) which was formally adopted in 1974. Very often it has been a function of changing emphases within the larger *Infitah* policy. Initially, the process implied a higher level of "managerialism" within the public sector, allowing each firm to run its own affairs in a more autonomous and more economically-oriented fashion. Subsequently, the process involved a higher level of commercialization of public enterprises, in the sense of making them more market-oriented and eventually more specifically profit-oriented.

Although there were several proposals during the 1980s to sell parts of the public sector to local investors, contracting out to private companies has continued to be a more favored form of privatization. A specific organizational form that also became particularly important in the 1980s is that of joint ventures between the Egyptian public sector and foreign private capital. This has sometimes included a separation of ownership from management (for example, in the hotel sector), with the management function being delegated to a private – usually foreign – firm or with a certain project being leased to the private sector. The privatization policy reached its formal peak in 1987 with the approval by Parliament of a new bill that made various types of divestiture possible. The new rules enable the government to "hive off" loss-making public companies and to sell off all public companies functioning in the area of domestic trade and tourism. This was not put into practice, however, until the 1990s, when it became more politically feasible in relative terms.

Privatization in Egypt has followed a quiet, discreet approach rather than a "big bang" strategy. Furthermore, although domestic capital has welcomed the new policies, and while international capital has encouraged it, privatization in Egypt is still basically a public policy pursued by the state for its own purposes. The continued dominant role of the state has meant that privatization has not necessarily involved deregulation, but rather that it has become concerned with re-regulation. Thus, a "public policy for investment" was created in the 1970s and "holding public corporations" were reintroduced in the 1980s. The continued dominant role of the state has also meant that the privatization policy has not yet included any large-scale plans for de-manning of the public bureaucracy.

One can thus argue that although the role of the Egyptian public bureaucracy has undergone several changes, such changes do not amount to a retreat by the state, as some observers have interpreted them (Hinnebusch 1985). The state bureaucracy is still large and expanding in terms of both personnel and expenditure, while the control functions assumed by the bureaucracy have by no means declined (Ghunaim 1986). In the economic sphere, the public sector has not really given way to the private sector (except in the special case of commerce and finance), but the state has merely chosen to cooperate with

international capital. This has signified a transformation of the state's role from a developmental one to a production-oriented one (seeking profit and cutting down on welfare activities within joint public sector/international capital enterprises). However, the welfare functions of the state bureaucracy towards society at large (education and health, food subsidies, etc.) have not been significantly curtailed, although the state has become increasingly dependent on external sources for financing them.

The Gulf crisis of 1990/91, with both negative and positive aspects, represented a stimulus to push more radically for reform. On the negative side, it exacerbated financial and economic problems and caused immediate direct losses conservatively estimated at over US$4.5 billion. On the positive side, external aid (mainly grants) worth about US$3.9 billion was rushed to Egypt in 1990/91. The USA and the Gulf states canceled some US$12.9 billion in debts, including expensive American military ones. The Agreement with the IMF, starting in May 1991, was also part of a conditionality exercise applied by the Club of Paris countries towards the gradual cancellation of some 50 percent of Egypt's public debt.

Part of Egypt's comprehensive structural reform started in 1991 revolves around privatization policies, and several important prospective privatizations were announced. A joint public/private sector committee was formed in 1990 under the name "Partners in Development" to outline the preliminary framework for privatization programs and to consider the prospective position of public sector and joint-venture companies. The committee agreed on dividing public enterprises into five categories:

a) Joint ventures in which the public sector participates with private – both domestic and foreign – capital. Of these companies, 327 had registered losses for several years and their position had to be given speedy consideration.

b) Partly nationalized companies, whose shares were already circulating in the stock market. The share of the private sector needed to be encouraged to grow in most of these companies.

c) Companies owned exclusively by the government, which are functioning inside activities not compatible with, or complementary to, their main function. Such companies should be rationalized according to proper economic and technical criteria.

d) Companies functioning in basically commercial activities, where the private sector should be the main actor.

e) In addition, there were organizations and authorities providing public services directly linked to private business and commercial activities (such as the General Authority for International Fairs and Markets), and these should be run as market units, and access to them should be given to the private sector.

An initial allocation of US$300 million of American aid funds to Egypt was earmarked to finance the privatization program, including arrangements for ESOPs in the public sector. An American consultancy group was appointed to design a three-year program in cooperation with an Egyptian team. Egypt's privatization program, sluggish at best at the central level, was given a big boost in the early 1990s at the local level.

Several projects were on offer for Egyptians returning from the Gulf and looking for small to medium-sized opportunities for investment. Most of the single projects were below LE50,000 in value, but there were some valued at between LE100,000 and LE250,000, and a few valued at over LE250,000 each. Prime Minister Atef Sidqi agreed with the provincial governors on the sale of 1,787 public projects to the private sector. Also considered was the sale of the shares of governorates in 51 out of 78 existing public corporations. More than 2,000 small projects of the localities were to be sold during the 1991-1993 period. By the end of 1991 there were 1,673 such projects (each valued at under LE50,000) that had already been sold to the private or cooperative sectors, as well as 53 valued at over LE100,000 each, while 192 larger projects were prepared for sale.

A radical restructuring of the public sector was initiated in 1991 under a new and rather interesting law. The main feature of Law 203 of 1991 concerning the so-called "public business sector" (*qita' al-'amal al-'amm*) is the separation of ownership from management. The new holding companies (*sharikat qabida*) and their affiliate companies (*sharikat tabi'a*) are no longer governmental bodies subject to public law, but rather "moral personalities" subject to private law and responsible to their own shareholders. Profits are to be distributed equally among private and government shareholders, and the companies are no longer obliged to transfer to the state any of the previous disbursements for management, social insurance and welfare. Companies would borrow from banks on a commercial basis and would not be able to rely on the state budget for subsidies. Decisions on production and marketing are to be made by the directors and the boards of affiliated companies. The law is applied to about 300 companies (of which about 117 are industrial), in addition to 18 holding companies. The government also has significant shares in about 200 mixed companies subject to the investment law or to the companies' law. The book value of the companies subject to Law 203 of 1991 was estimated in the early 1990s at about LE77 billion (of which 35 percent is in industry).

To highlight the still dominant role of the state's economic sector, it is sufficient to compare the value of its capital with that of the private sector. The capital of large private firms subject to the Companies' Law 159 of 1981 was estimated at the end of 1990 at no more than LE1.5 billion, whereas the

capital of functioning private companies under Investment Law 230 of 1987 was estimated at about LE5.9 billion, thus putting the total capital of all private companies at less than ten percent of the book value of the state sector However, the age of privatization might have arrived at last in Egypt, and the government has announced the names of dozens of large companies that have been designated for sale. Organizationally, the public business sector (PBS) has a special minister, but the cabinet ends up overseeing the whole process, with ultimate responsibility in the hands of the President. With regard to economic policy, the cabinet is believed to be divided into "étatists" and "liberalists."

The executive aspect of privatization is entrusted to the Technical Bureau for the Public Business Sector. Holding companies would have a say on the desirability and/or necessity as well as the timing and scope of privatization within affiliate companies, as their main function will be basically that of managing the financial portfolio of the holding company concerned and its affiliates. The first batch of companies for sale in 1992/93 included 20 companies (worth LE9 billion), of which 15 were fully-owned and five partly-owned by the state. Priority was given to companies that would not shed a lot of labor. By June 1993, assets and companies worth LE1.4 billion had been sold, including Misroub (soft drinks) and Egypt Chemicals. In some cases, an ESOP was introduced, as with the United Company for Housing and Construction, with 50 percent of loans being provided by the Bank of Alexandria. Immediately available for sale by purchase tenders were eight leading hotels and four tourist vessels, and other lists were in preparation. No holding companies would be sold, but over the following three years (1993-1996) it was anticipated that up to 48 percent of the number of affiliate companies – representing about 28 percent of the total value of the public business sector – would be traded. Banks, insurance companies, oil companies, railways and telecommunications, the national airlines and the Suez Canal would not be part of the privatization drive. These corporations, whose book value is estimated at LE150 billion, are not part of the so-called public business sector and may therefore represent the main "sacred cows" that should not, by the étatists' reckoning, be touched by privatization.

In sum, it is possible to conclude by saying that apart from the special case of tourism (where the earliest privatization started in the 1980s), and apart from the distinct case of local/agricultural projects (where privatization was relatively easy to operationalize), industry will remain a much more difficult area for large-scale privatization in Egypt, mainly for political reasons. Although business groups have become quite vocal, they continue to be "junior" partners in the current informal coalition who cannot – and sometimes will not – push really hard for a completely liberalized industry. Although the technocrats and workers of state-owned industries are not as noisy nowadays

as they could have been, they continue, objectively speaking, to be major partners in that coalition. The leadership has to play the game of balance and mediation quite carefully between the major, silent partners and the junior, vocal partners.

Tunisia

The Tunisian case is interesting, as some of that country's privatization and liberalization practices pre-date even those of Egypt. At the time of independence in 1956, Tunisia's petite bourgeoisie, formed mainly by the intelligentsia, was quite limited in size, since most economic activities were dominated by colonial monopoly companies or by private French entrepreneurs. The process of decolonization enabled the state to acquire the facilities of the infrastructure (such as ports, railways, water and gas, some lands and mines), and most of the banking system was soon "Tunisianized." As the native private sector was small, and since it was perceived as being interested only in real estate and commercial activities, the state soon adopted a decidedly interventionist policy – later to be known as *le dirigisme planifié* – which attached a central role to the public sector while forcing the private sector into activities regarded as complementary to state action. An extensive cooperative sector was installed in agriculture, while a semi-corporatist organizational pattern emerged within which the labor movement was coopted and the relatively large traders were forced to direct their capital towards supporting the industrial and tourist sectors (Al-Mahjub 1989:7-8).

One familiar pattern was for the state to initiate investments and activities in a particular area in order to indicate its feasibility and potential reward to the private sector. This was especially true of the tourist sector, where all investment was public from 1962 until 1966. The private sector was then encouraged to subscribe until, by 1970, its share in the tourist industry had reached 95 percent of the total (75 percent of this having originally come from the commercial sector). In industry, state investment was dominant, representing some 80 percent of the total during the first ten-year development plan (1962-1971), although private industrial investment was increasing by eight percent per year. The main contribution by the government was in such areas as fertilizers, oil refining, phosphates and steel, with the government's share representing 75 percent of all investments in such relatively large industries (Ghurbal *et. al.* 1989:131).

By contrast, the earlier agricultural cooperatives which had formed an important aspect of the single ruling Constitutional Socialist Party's socio-economic policies were being phased out by the early 1970s, following the removal from power of Bin Salih and his mildly socialistic team and their subsequent replacement by a team that was more sympathetic to the private

sector and to the liberalization of the economy. The main thrust of the second ten-year development plan (1972-1981) revolved around dismantling the cooperative sector in agriculture, encouraging the private sector to open up to the international market, and persuading foreign capital to contribute to industrial – especially export-oriented – activities.

Between the end point of the first and second development plans, the share of the private sector in capital formation grew from 21 percent to 42 percent, and the contribution of the private sector to production increased from 30 percent to 74 percent in agriculture and fisheries, from 21 percent to 45 percent in manufacturing industries, and from 66 percent to 93 percent in tourism. In certain industrial fields the private sector became dominant, controlling 81 percent of textile industries, 59 percent of food industries and 53 percent of mechanical industries (Al-Mahjub 1989:9-11 and Al-Manubi 1986:40-41). Members of the emerging entrepreneurial class that was taking up these activities had come originally from the field of commerce and were able to make great use of the state's protective economic policies. These policies favored a certain degree of import substitution, subsidized by the state through oil revenues which, although relatively modest, represented two-thirds of foreign currency earnings.

However, by the end of the second ten-year development plan, the early 1980s were witnessing serious social upheavals that drew attention to the fragility of Tunisia's economic system. The rate of growth of GNP (in fixed prices) declined from the previous levels of 5.2 percent (during the first plan) and 6.3 percent (during the second plan) to only 2.3 percent during the four years from 1982 to 1986. The balance of payments deteriorated, the commercial deficit grew, and by 1986 – with the collapse in petroleum prices and a drop in tourism and agriculture – foreign currency reserves were nil and foreign debt amounted to US$5 billion (representing 60 percent of GDP), while an amount of US$1.2 billion was due for debt servicing. It was at this juncture that the state resorted to the IMF and the World Bank.

These institutions duly came to the rescue, with their never-changing diagnosis and the set formula that accompanies it: suppressing demand, encouraging exports and "reducing the weight of the state" (Ben Romdhane 1990:151-9 and Ghurbal *et. al.* 1989:134). At that point, the state was still in control of two-thirds of GDP and was responsible for about 60 percent of all investments. In spite of the growing size of the private sector, many of the dirigiste policies of the state were still in place, with the government closely controlling prices, wages, interest rates and credit policy, and with many basic commodities heavily subsidized. The overall role of the state was still dominant: public expenditures represented 40.6 percent of GDP in 1983, and public consumption represented 45.6 percent of these expenditures. Spending on public

administration accounted for 12-13 percent of GDP, and salaries in turn took up to 28.3 percent of all public expenditures (Al-Manubi 1985).

In the mid-1980s, Tunisia had some 300 public enterprises (500 if the ones with the indirect participation of the state are added), which seem to have been arranged in economic and technical sectors (such as metallic industries, petroleum, banks and insurance, transport, agriculture, and so forth), rather than organized under public holding organizations (as is the case in many other Arab countries). The role of public enterprises was conceived of as being the following: the promotion of new techniques; the diffusion of development activities outside the traditionally favored regions; the training of personnel; and the enhancement of the private sector (Midoun 1985:95-6). The last of these objectives is quite interesting and rather unusual. As with all public sectors, however, the multitude of often contradictory objectives assigned to public companies was bound to have a distorting effect on their activities and to impose supplementary expenses that could not be tolerated in times of austerity. Economic profitability was modest from the outset, owing to high management costs and to the low selling prices required both by the restricted purchasing power of the population at large and by the limits imposed by the government as part of its welfare policy. The financial situation of public companies deteriorated steadily during the 1980s, which imposed an increasingly heavy burden on the state budget at a time when the state itself was unable to balance its public finances (Bouaouaja 1989:235-7).

Having called for the assistance of the IMF, the Tunisian government was asked to embark on a structural adjustment program in return for the availability from the Fund of a "stand-by credit facility." The measures required in this program included: reducing credit facilities; floating prices by 1991; liberalizing interest rates; removing subsidies; liberalizing imports and reducing protection by 1991; constraining domestic demand by freezing wages; and accelerating the rate of privatization in areas that were felt to have the potential to benefit from increased competition. A national commission was formed to oversee the transfer of about 100 public enterprises to the private sector.

Such activity paved the way for the signing of an agreement with the World Bank for the scheduling of the process of privatization, and the new orientation was built into the new (seventh) development plan of 1987-1991 through the stipulation that the private sector was to take a 65 percent share of all investment in manufacturing industries (Al-Mahjub 1989:13-14). In addition, foreign industrial investment was to be given a number of inducements, including tax exemptions, repatriation rights as well as improved infrastructural and exporting facilities. In 1986, 1987 and 1989 several pieces of legislation were enacted to govern the restructuring of public enterprises, a process which was to be carried out under the supervision of a specially formed committee with the

assistance of the ministries of planning and finance as well as the ministries in charge of the specific enterprises concerned.

Although several difficulties were encountered in defining a strategy for privatization, actual privatizations were eventually to take place in a much more significant way than has been the case in most other Arab countries. Three large public enterprises underwent large-scale restructuring that led to the privatization of most of their assets: the Société Générale des Industries Textiles (SOGITEX), the Société Tunisienne des Industries et Matériaux de Construction (SOTIMACO), and the Société Hôtelière et Touristique de Tunisie (SHTT). Smaller privatized enterprises include marble factories (Thala), cinema houses (SATPEC), aluminum workshops (IMAL), print houses and disc and cassette manufacturers, fisheries organizations, and some trading companies – the latter being sometimes liquidated and sometimes merged with others (Midoun 1989:10-12).

The outcome of restructuring has been quite mixed in Tunisia, with some observers maintaining that the overall attempt at liberalizing the economy has made greater progress than denationalizing public sector firms. This drive for liberalization has earlier origins that date back to the appointment of a business-minded Prime Minister, Hadi Nuwaira (1970-1980), who dominated the new endeavor to reshape the country's economy up to the beginning of the 1980s. Denationalization, on the other hand, has been more closely associated with the IMF's structural adjustment plan of the second half of the 1980s, and although the government's efforts in this area have been lauded by the IMF as a good model for other countries, privatization in Tunisia remains circumscribed within officially approved limits, due to the difficulties of transforming the nature of a "patron state" within a limited span of time (Harik 1990).

As might be expected, resistance to privatization does exist and can be difficult to overcome, although it tends to express itself in rather discreet ways. As in Egypt and Algeria, it comes from some public sector managers, but more particularly from workers and employees (Bouaouaja 1989:242-6). Indeed, workers' resistance might have been stronger had the regime not circumscribed the traditionally powerful trade union federation in 1986. But perhaps the main obstacles to privatization have been the weakness of the entrepreneurial community and the limited financial capacity of the private sector. Among other things, Tunisia has one of the smallest stock markets in the developing world. The Tunisian capitalist class revolves primarily around a "familial" network of those who seek easy profits and those who avoid business risks, none of whom are particularly tempted to take on many of the industrial concerns on offer (Midoun 1989:12-13 and Harik 1990:11).

The private sector has in fact developed under the shadow of the quasi-rentier Tunisian state and has become extremely dependent on government

protection and subsidies. This was made very evident as soon as the restructuring program was put in motion, when nearly 400 private firms in 1987 and nearly 700 in 1988 went bankrupt or had to close down. This situation was made worse by the rapid and abrupt liberalization of imports and the concurrent rise in interest rates, the devaluation of the dinar by 60 percent, and the rise in the cost of imported equipment. Voices were therefore heard once again calling for a reconsideration of the full-fledged privatization drive and for renewed emphasis on improving the capacity and productivity of public enterprises (Mahjub 1990:305-10).

The Tunisian experiment represents an interesting case of applying the short-term teachings of the IMF and the middle-term strategies of the World Bank. "Instead of negotiating through the interminable meetings of the Paris Club like some of its neighbors, Tunisia took the initiative and deliberately set out to incorporate the thinking of its foreign creditors in its planning strategy. For Western bankers, Tunisia is again a model country, demonstrating exemplary prudence in the management of its economic affairs" (Moore 1988:180). However, Tunisia cannot yet speak of a privatization "success story" as long as its private entrepreneurs continue to shy away from industrial enterprises, which are still partly coveted by the state bourgeoisie. Furthermore, Tunisian economic liberalization is still fraught with political risks. Although the emasculation of their federation has meant that direct resistance from workers was not particularly noteworthy, the political liquidation of the Habib Ashur group within the federation has meant that the regime no longer has a safety valve among workers (ibid.:187).

Syria

Syria's small public sector, which emerged through nationalizations during the 1958-1961 union with Egypt, was greatly expanded when a Baathist coup d'état in 1963 removed the anti-union junta from power, and when a more radical wing of the Baath seized the reins of government in 1966. By the mid-1960s the state owned all banks, most trade and much of commerce, controlled agricultural cooperatives, and possessed 80 percent of all industry. A large number of public organizations and public companies were formed, and the public sector's share of domestic production rose from 25 percent to 75 percent. Following the Baathist "corrective coup" of 1970, the legal position of the public sector was further regulated by various pieces of legislation, especially those issued in 1974 and 1980 (Saud and Ali 1986:442-88). As in most other populist regimes, industrial and agricultural projects are not viewed from a strictly technical or economic point of view. The mere installation of a project is a political objective in itself, providing modern employment opportunities, disbursing wages and salaries, and highlighting the presence of the state.

Industrial development escalated with the rise in oil revenues between 1973 and 1980, after which many projects started to face serious financing problems. Fixed capital formation saw a big jump in 1974 and 1975, slowed down again between 1975 and 1980, picked up gently until 1985, and then receded rapidly from 1986 on. It is not at all difficult to correlate these movements with fluctuations in foreign aid loans, and to realize the close dependence of domestic investment on foreign financing (Hilan 1989:32). During the first half of the 1980s, several negative indicators became apparent. A declining growth rate started to dip into negative figures in 1984. Average levels of worker productivity in the Syrian economy were declining. In the meantime, imports had not declined, exports did not increase, and informal trade (that is, the smuggling of imported goods) remained quite high. Such trends continued into the second half of the 1980s, further complicated by a proportional decline in the contribution of the commodity sector to GDP as well as by growing budgetary and trade deficits (Dalila 1989:409-11).

Various complex interactions have become increasingly the norm since the guarded move towards a certain policy of relaxation (*Infiraj*) in 1970 and towards a policy of limited opening-up (*Infitah*) in 1974. These cautious reforms "are marked by a combination of more flexible market mechanisms and intense state planning, since the state controls both water and credit, and the private sector holds almost 80 percent of the cultivated land" (Leca 1988:191-2). A certain kind of specialization and division of labor seems to have established itself between a public sector that concentrates on modern technology, large-scale import-substituting industry and basic products, and a private sector that concentrates on commodity and service activities that are closer to the consumer, with fewer workers and higher profitability. On paper, the private sector appeared to be quite modest. In 1979, for example, there were 36,000 companies employing fewer than ten workers and 300 companies employing more than ten workers. Their production was quite humble, but there were probably some statistical problems involved in accounting for their activities (Dalila 1990:400-1). There is no doubt, in any case, that the number of private projects has escalated most speedily since the late 1980s, and that value added is much higher in the private than in the public sector (ibid.:402-11). The relationship between the state and the entrepreneurs of the private sector need no longer be antagonistic. Indeed, with *Infitah* it is almost a relationship of alliance, provided that entrepreneurs do not step severely out of line. Syria's reliance on external financing reached problematic dimensions by the mid-1980s, to the extent of seriously delaying the sixth development plan (1986-1990), as state revenues were running short and external sources were not forthcoming in amounts that could cover the government's investment commitments. Such developments resulted in a situation where Syria's

debt reached US$4.9 billion in 1988/89, representing 22.2 percent of its GNP, with the debt service representing 16.2 percent of the country's exports of goods and services (ABC 1990).

A retrenchment policy was adopted within the public sector, and domestic and joint private capital were encouraged – especially in the fields of agriculture, food industries and tourism – in order to relieve part of the financial responsibilities of the state. Various joint ventures were formed with a state contribution not exceeding 25 percent of their capital, with 75 percent of the capital owned by domestic, Arab or foreign investors. One such company was the Syrian Arab Company for the Development of Agricultural Products, which was owned 75:25 percent by the private and public sectors, respectively. Several financial, monetary and taxation facilities and organizational exemptions have been given to such companies to encourage their expansion. However, as with Iraq, and even though Syrians cannot count on the same large oil resources as Iraqis, the regime has not to date felt the need either to call in the IMF or to push towards full economic liberalization.

Although the regime has not declared any impressive privatization programs, the Syrian private sector is both more dynamic and more structurally interlinked with the public sector than its Iraqi counterpart, and therefore a *de facto* privatization process could be said to have been taking shape for a number of years. It is true that the share of the private sector in investments in 1987 (43 percent) is not nominally much higher than it was in 1973 (41 percent), but there are indications that the value added per each employee as well as capital productivity in general are on the increase in the private sector, whereas they are declining in the public sector (Longuenesse 1985). *De facto* privatization appears to have served the interests of the regime for a number of years, but a more formalized – if still careful – approach towards the fostering of private investments is now in place following the issue of Law 10 of May 1991 for the encouragement of "productive investment."

Iraq

The emergence of the public sector in Iraq following the anti-monarchical coup of 1958 was basically motivated by political reasons, such as the need to eradicate the economic base of the elite associated with the ancien regime, and it was to a large extent influenced by the Nasserist model. Significant nationalizations in 1964 transferred to the state the ownership of about 30 important factories of cigarettes, building materials, foodstuffs, textiles and leather. In addition, all banks and insurance companies were nationalized. However, up until 1973 the growth of the public sector remained rather slow and limited. It was the successive nationalizations of various processes of petroleum extraction (between 1972 and 1975) combined with the quadrupling of oil prices

around the same time that led to the great expansion of the Iraqi public sector, since the state was now in charge of over half – and, by 1977, of 80 percent – of national GDP. It was also in possession of the main sources of economic surplus in society. Also in 1977, there were about 400 public sector enterprises employing 80,000 workers and absorbing 60 percent of all industrial and commercial investment (Khafaji 1983:25-33).

Iraqi industrialization was therefore closely related to a "mineral base" (that is, oil), which gave the expansion of the economic role of the state features that are quite similar to those obtaining in other oil-exporting countries of the Gulf. More specifically, this industrialization was very much related to a limited number of grand projects in the area of "industrializing industries," that is, heavy industries closely tied to the almost free supply of oil and gas, somewhat externally-oriented and with "little connection with the overall economic and social life of the country" (Amin 1982:86-7,139-46). Despite the seemingly high priority attached by the official development policy to import substitution, results remained rather modest as far as self-sufficiency is concerned. The industrialization model of the oil boom period involved "a combination of big capital-intensive and export-oriented industries, and the strategy tied Iraqi development to the capitalist world market. Put differently, Iraq's industrialization in the 1970s meant growing dependency on transnational companies because of their supplies of turnkey plants and numerous contracts within management, services, and marketing" (Olsen 1986: 27).

By the early 1980s, not only was the public sector predominant within these strategic big industries, it almost monopolized foreign trade and continued to play an important role in domestic trade and owned banking, insurance and financial services (Al-Sayyid Ali 1989:27-31). By 1987, as much as 96 percent of the industrial workforce was employed in state-owned factories, which produced more than 84 percent of total industrial output (Chaudhry 1991:15-16). This is not to suggest, however, that the Iraqi private sector has been absent from the economic scene. An Iraqi *Infitah* with regard to agriculture took place quite early on. The fairly extensive agrarian reform implemented in the early 1970s would soon be reversed around 1978 with the liquidation of most collective farms and the phasing out of several agricultural cooperatives. In 1983, a law was enacted that permitted the private rent of unlimited acreage of public land (Springborg 1986:33-52). Credit and infrastructural facilities were given to the private sector – both Iraqi and Arab – to stimulate investment and mechanization, and independent production and marketing activities were allowed.

Al-Khafaji maintains that by 1986 the share of the private sector in GDP (excluding oil, defense and administration) had reached 64 percent, its share in construction being 94 percent, in transportation 76 percent, and in commerce

44 percent (Al-Khafaji 1986b). Such figures may be somewhat exaggerated. Farhang Jalal, another Iraqi economist more sympathetic to the private sector, maintains that the only activities conceded by the state to the private sector prior to 1987 had only affected very secondary fields, such as excavating rubble and sand and manufacturing some refreshments (Al-Nasrawi *et. al.* 1990:365-6). Based on a more comprehensive set of figures, yet another Iraqi economist, Abd al-Muneim al-Sayyid Ali, reports that in 1987 the share of the public sector in GDP (including oil) was 83.9 percent, compared to 16.1 percent for the private sector. Excluding oil, the former's share amounted to 61 percent of GDP, and the latter's to 39 percent (being particularly high in areas such as transport – 77.7 percent – and commerce – 60.1 percent). In the same year, the public sector was responsible for 76 percent of total fixed capital formation, compared to 24 percent for the private sector (Al-Sayyid Ali 1990:350).

Whatever the case may be, such figures should not give us a false sense of the structural strength of the Iraqi private sector, for the state has continued to maintain its grip on the economy and society through its monopoly of the utilization of oil revenues (the petroleum industry accounting for 55-60 percent of GDP), and through its control of the civil and military apparatus (one out of every three urban Iraqis is publicly employed), and most particularly the party/security machine. Although oil revenues had more than halved during the war years with Iran (from their peak of US$26.5 billion in 1980), they remained quite handsome indeed, and enabled the state to enjoy a considerable degree of autonomy from domestic social classes. As in Algeria, this is a case of the private sector being assigned a role by the state. The government had no intention of relinquishing economic (much less political) power, but hopes to streamline the existing system.

Furthermore, the overwhelming proportion of the private sector has remained closely tied to the state and/or vulnerable to fluctuations in foreign trade and foreign politics. Lacking strong structural linkages with the rest of the economy, the private sector continued to be critically dependent on the state. By the beginning of 1988, virtually all of Iraq's agricultural production and several food processing industries had been privatized, but the non-agricultural private sector was not particularly in a hurry at this stage to press for full autonomy from the state, nor was the state particularly anxious to push vigorously in that direction. Although some subsidies were reduced and benefits restrained, the Iraqi state did not want to cut down severely on the levels of welfare, especially during the politically sensitive war years. Hence, only a mild privatization program was implemented during the years of war with Iran.

Serious privatization began in 1987 and gained momentum in 1988 after the cease-fire with Iran. It involved consolidation of the privatization drive in

agriculture, the sale of very large poultry, dairy and fisheries enterprises, and divestiture to the private sector of a number of factories for food processing, textiles, construction materials, transport and services. It also included the elimination of the state monopoly on the importation of consumer goods, an export earnings retention scheme for industrialists, and a new foreign investment law that provided greater incentives for Arab investment in Iraq while still officially prohibiting exclusive non-Arab foreign investment. A second state-owned commercial bank, Al-Rashid Bank, was established in 1989 to compete with Al-Rafidain Bank, though further liberalization of the country's financial sector was still to be put into solid form. Tax exemptions and credit facilities were increased, and several restrictions with regard to capital and employment were eased out.

As a Baath party document declared, there was no longer need for Iraq to be a "state of small shops and stores" (*dawlat dakakin*) (Al-Sayyid Ali 1989:40). The state was perceived to be more successful in the area of manufacturing industries, where cheap energy and the expanding technocratic elite were contributing to a more effective performance (ibid.:58). Rather than retreating, the state was actually attempting to free itself from what the leadership came to regard as minor economic pursuits in order to concentrate on larger, more strategic projects in iron and steel, engineering, arms and petrochemicals (ABC 1990:42-5). The same observer who was impressed by the scale and speed of privatization had to admit that "dramatic as they appear, though, the reforms of the 1980s did not signal a fundamental change in the balance between public and private shares in the economy outside agriculture. The state's share in manufacturing kept pace due to large investments in heavy industry [...]. At no point did the state's share of industry fall below 76 percent" (Chaudhry 1991:15).

The Iraqi state had not retreated, but had simply changed its order of priorities in the economic sphere. The private sector was being assigned a role by the state: divestiture without marketization. In 1987 the labor union, which included public and private sector workers, was dissolved. Public enterprise workers became employees in the public service, which was presumably undergoing an "administrative revolution" and shedding some of its senior personnel. Private sector workers belonging to firms with over 50 workers each (only eight percent of the industrial workforce) could form unions, but in reality they were too weak to do so, especially with available competition from less-demanding Egyptian and other non-Iraqi workers and from nearly 250,000 soldiers returning from the war with Iran (Lawson 1990:32-51, Chaudhry 1991:15-18, and Farouk-Sluglett and Sluglett 1990:22-3).

The relatively significant debt to international banks and governments accumulated by the end of the Iran-Iraq war amounted to just under US$15 billion

and represented 29.2 percent of GNP, with debt service representing 50 percent of exports. It was regarded as a serious but temporary condition that did not warrant resorting to the IMF (ABC 1990:40). Additional unquantified liabilities due to Arab governments (estimated by some at US$40 billion) included an obligation to Saudi Arabia and Kuwait to repay "war relief" crude sold by these two countries on behalf of Iraq from 1983 to 1988. However, the continuation by the regime of its large-scale industrial and military investments (not to speak of war damage repairs and welfare expenditures) at a time of relatively low oil prices and at a juncture when several Western quarters were terminating their credit to Iraq had combined to produce a rather desperate foreign exchange shortage. By the early months of 1990, the economy of Iraq had passed the stage of deterioration to reach that of collapse (Picard 1990:26-7), a condition that contributed in no small measure to the Gulf crisis of 1990/1991.

Jordan

In spite of adopting a formally open and liberal economic policy, the government's involvement in the Jordanian economy has been very substantial. In addition to a highly controlled pricing and subsidization policy, many economic activities – including those of the private sector – have been closely regulated by the state, and Jordanian industrial activity has been mainly initiated by the government. Additional public expenditures have turned the population in a few decades (and despite very high population growth rates) from a predominantly illiterate into a largely literate one and have raised the level of public utilities and general services (including housing, electricity, health and communications) to fairly high standards (Al-Sha'ir 1990:636-8).

Such a need to consolidate the socioeconomic base of Jordan became more critical following the series of disruptions associated with the Israeli occupation of the (richer) West Bank and the consequent rapid increase in Jordan's Palestinian population, with all the social and political implications that this development eventually brought about. The strengthening of centralized management of the economy expressed itself in the adoption of a series of development plans. A three-year plan (1973-1975) was launched with the specific aim of trying to revitalize the economy after the damage caused by the 1967 War and its aftermath, and this was followed by a series of five-year plans starting in 1976-80 which had more ambitious objectives. In this and the following (1981-1985) plan, the Jordanian government favored commodity-producing sectors, especially in light and medium-scale industries such as timber processing, metal works, domestic appliances and building materials. The outcome of such a policy has been that in recent years budget expenditures have averaged 40-50 percent of GDP annually, reflecting investments in industry and infrastructure, price subsidies and also large defense and security charges

(ABC 1990:50-1). Public expenditure as a percentage of Jordan's GDP increased from less than 31 percent in the 1950s and 1960s to around 55 percent during the 1970s and early 1980s. The share of planned public investment in total gross fixed capital formation averaged 46 percent in the 1970-1990 period, reaching a peak of 55 percent in the mid-1980s.

In institutional terms, such activities have resulted in the emergence of a significant public sector that includes some 40 public organizations functioning in the areas of natural resources (mainly phosphates), industry, metallics, electricity, agriculture, transport and communications, housing and tourism, as well as trade, supplies and finance. Whereas some of these organizations were totally owned by the state, others had a government share of over 50 percent of capital, and therefore their management was government-controlled (Abu Shikha 1983 and Abu Shikha and Assaf 1985). Although agriculture has on the whole declined (owing to the loss of the fertile West Bank, population pressures and drought conditions), the government's involvement in agricultural affairs has increased through the role of the Jordan Valley Authority (which was subsequently merged with the ministry of water and irrigation), and the role of the Jordan Cooperative Organization, which was boosted after the mid-1970s (Adwan and Cunningham 1988:3, and Gubser 1988:105).

The growth in the economic role of the state has been closely contingent upon the post-1973 oil boom in both direct and indirect ways, to the extent that some have described Jordan as the world's main "non-oil-producing oil economy" (ABC 1990:51). During much of the 1970s and early 1980s, some 80 percent of gross domestic expenditure was estimated to have derived from direct grants and budget support loans from neighboring oil-exporting countries, from remittances from Jordanians working in the Gulf and from Jordanian exports to neighboring oil-rich countries. Over one-third of the Jordanian labor force was employed in the Gulf, and remittances from these individuals were equivalent to almost two-thirds of Jordan's total revenues from exports of goods and non-factor services. Budget support by Gulf countries was usually equivalent to about 50 percent of the government's revenues in the period from the late 1970s to 1983. Additionally, Jordan's exports to Arab countries represented on average about half of the country's total merchandise exports (Anani and Khalaf 1989:211). Jordan is therefore highly vulnerable to economic and political developments in the Gulf, a fact that was made tragically obvious during the Gulf War of 1990-1991.

The momentum of economic activity during most of the 1980s was maintained by a much higher level of government expenditure, which was heavily financed by external and domestic borrowing, and which resulted in a net budget deficit that rose from nine percent of GDP in 1984 to 18 percent in 1987. Although relatively buoyant tourism, a considerable expansion in

banking services resulting from the disruptions in Beirut and the side-benefits of the re-export trade with Iraq during its war with Iran had all helped ameliorate the situation to a certain extent, the overall decline in revenues as a consequence of the uncertain conditions in the Gulf resulted in a rapid increase in Jordan's external indebtedness, from US$2.5 billion in 1984 to an estimated US$6-7 billion in 1988. Debt represented 92 percent of GDP, and debt service represented 24.6 percent of exports, while there were signs that GDP itself was declining in absolute terms. Foreign exchange reserves also declined during the same period, from US$515 million in 1984 to US$110 million in 1988.

Jordan's financial situation reached crisis proportions in 1988, necessitating emergency austerity programs and prompting the country to resort rather desperately to the IMF. The thinking on the subject of privatization emerged within the context of this dramatic financial crisis and in the absence of any indications that its reversal was imminent. Government officials considered that revitalizing the role of the private sector would be a way of relieving the state of some of its heavy financial commitments, and the argument in due course surfaced that the private sector was more rational and that privatization and efficiency were two sides of the same coin (Adwan and Cunningham 1988). The public sector's largest holding in absolute and relative terms is in mining, where total public investments amount to 58 percent of the capital of mining companies and represent almost 50 percent of total public shareholding in Jordanian corporations. The highly capital-intensive nature of mining companies and the perception that naturally occurring minerals are a national resource may not render this area particularly amenable to speedy privatization. The second largest area of government participation is in the manufacturing sector, where the government's contribution reaches 23.2 percent of the sector's capital, with 87 percent of public shares being held in the four largest companies: the Jordan Cement Factories, the Jordanian Petroleum Refinery, the Glass Industries and the Engineering Industries. The subscribed capital of these four companies represents 56 percent of the total capital of all 48 manufacturing companies in the country. In services, average public investment amounts to 20.8 percent of the total capital of service companies (Anani and Khalaf 1989:211-17).

Pure public enterprises and public-private joint ventures vary widely in terms of productivity and efficiency, and it is not clear to what extent this criterion will be among the ones used for targeting projects for privatization. Among the exclusively public institutions, the Telecommunications Corporation and the Electricity Authority are usually considered profitable, whereas the Water Authority incurs planned losses for "equity" purposes. Within the mixed enterprises, some experts believe that "the higher the

government participation, the higher the probability of having a loss-making industry. In fact, 58 percent or more of these companies were loss-makers in 1986. The comparable figure for enterprises with less than 35 percent public ownership was only 26 percent" (Anani and Khalaf 1989:215-17). Privatization proposals have been put forward for profitable corporations such as telecommunications, as well as for loss-making ones such as transportation (Adwan and Cunningham 1988:5-8).

Since 1986, when privatization was declared a desirable goal, several studies and preparations have been carried out, but no actual transfer of ownership from the public to the private sector has taken place. In particular, three enterprises have been identified as targets for privatization: Royal Jordanian Airlines, the Public Transport Corporation and the Telecommunications Corporation. However, actual implementation has so far not progressed beyond focusing on the commercialization of public enterprises as a preparatory step for the eventual transfer of ownership and control.

Differently from some other Middle Eastern countries, the pattern of government investment in Jordan did not cause the crowding out of the private sector. The state's focus on services, utilities and infrastructure and, within industry, on mining and mineral industries, as well as the widespread practice of joint public-private ventures in manufacturing and engineering industries combined with the fact that the private sector and the state were both simultaneously receiving (in their different ways) "surrogate oil revenues" have all been factors that helped create a situation where the public and private sectors have complemented (rather than competed with) each other. This policy was also conducive to the political cohesion of Jordan, creating as it did common economic grounds between the predominantly Transjordanian bureaucratic bourgeoisie, on the one hand, and the predominantly Palestinian commercial bourgeoisie on the other.

Yet, the equal reliance of the private sector on externally-derived revenues as well as its close partnership with the state in many activities would also suggest that the private sector may not be capable of picking up the slack that is resulting from the decline in both official and private transfers to Jordan, and from the closely-related reduction in the economic role of the state. It should also be remembered that many of the larger private sector enterprises (phosphates, oil refining, potassium, cement, electricity and tobacco) are *régis* (*sharikat imtiyaz*), or companies by privileged appointment (that is, private monopolies). In 1987, these companies realized 64.8 percent of all value added in the industrial sector. They receive much governmental protection and support and are not subject to the usual business accounting and control procedures. It is therefore difficult to predict the efficiency of their performance under "normal" market conditions (Al-Sha'ir 1990:640).

Algeria

With the coming of Algerian independence in 1962, Ahmed Ben Bella, the country's first president, introduced self-management in agriculture and in industry as the basis of his country's economic policy. However, as a result of his removal from power through a military coup led by Boumedienne in June 1965, Ben Bella's model did not last long. Under the regime of President Boumedienne, implementation of the country's economic policy began with the institutionalization of socialist planning and the setting up of large state enterprises – the *sociétés nationales*. Algeria's major enterprises – which can be described as the backbone of the country's industrial sector – included SONATRACH (in the field of hydrocarbons), SNS (steel), SONACOME (engineering), SONALEC (electrical) and SNMC (building materials). There were also some other rather smaller state enterprises, such as SNMetal (metal-work), SONITEX (textiles), SONALGAZ (domestic gas and electricity supplies), NIPEC (leather work and footwear) and SONATOUR (tourism). These were "minor" in the sense that they played a somewhat secondary role in the scale of priorities that the planning model had set and in the allocation of investment resources which had been concentrated in the five major branches of industry. Complementary activities that remained in the control of the state included a total monopoly on foreign trade and on banking and insurance. One may infer from this overall picture that the state was convinced of the need to have the Algerian economy firmly under its control (Bouattia 1993).

However, under the pressure of growing financial burdens Algeria, like other countries in the region, became part of the wave of economic liberalization and privatization that swept across the Arab world during the 1980s (Sutton and Aghrout 1990). After President Chadli Ben Jadid had taken over, the country underwent a ten-year period of political and, more particularly, economic reforms. These reforms reversed earlier policies that had favored state capitalism based on a development strategy of heavy "industrializing industries" and on *gigantisme*. In their place, a rehabilitated version of the earlier and much constrained private sector of the economy was allowed to emerge, while the dominant state industrial *sociétés nationales* were restructured and subdivided (Osterkamp 1982). In Algeria's agricultural sector, the large self-managed or "collective" state farms and producer cooperatives that had emerged from two agrarian reform programs were restructured and reduced in size. Politically, the progressive replacement of members of Boumedienne's government with more pragmatic FLN ministers during successive Chadli administrations encouraged increasing liberalization, culminating in the introduction of a multi-party political system in 1989 and the opening up of the Algerian economy to foreign investment in 1990.

Because of the constraints imposed by the 1966 *Code des Investissements*,

the private industrial sector was stagnant throughout the 1970s. In 1982 a new investment code was issued that aimed at restoring private initiative through the mobilization of savings and the provision of guarantees, credits and tax advantages. While heavy strategic industry was retained within the state sector, private investment was encouraged in areas such as light manufacturing, craft industries and hotel infrastructure, and a third decentralized industrial sector that was supported and managed by the local *wilayat* authorities was also promoted. By 1982 this emerging private sector accounted for some 30 percent of industrial workers dispersed among 4,800 small and medium-sized enterprises, most of which employed between 5 and 20 workers only.

The creation in 1982 of the *Office National pour l'Orientation, le Suivi, et la Coordination de l'Investissement Privé* (OSCIP) also gave further encouragement to – as well as some control over – private industrial investment. Large private industrial projects whose investments exceeded three million dinars required approval from OSCIP's *Commission Nationale d'Agrèment* (CNA) based in Algiers, while smaller projects could be approved by local *Commissions d'Agrèment de Wilaya* (CAW). In the 1983-1987 period OSCIP approved 5,186 investment projects, of which 1,181 were in the larger-capital CNA sector. The private capital that was to be invested in this way averaged 2.6 billion dinars annually between 1983 and 1985, increasing to 3.7 billion dinars in 1986, and then to 6.9 billion dinars in 1987. About 44 percent of this was to go into industrial manufacturing projects from 1983 to 1986, with the transport, tourism and services sector ranking second and the construction materials sector ranking third during the same period, while all the projects approved by OSCIP up to the latter part of June 1987 would create 75,446 new jobs in this burgeoning private sector. By 1988/89 the regulations concerning private investment had been liberalized still further. At this point, the regulatory role of OSCIP was phased out, and with it went an interesting accumulation of investment statistics.

Starting in 1980 the Chadli government concluded that the state industrial sector was constrained both by vertical integration and by bureaucratic concentration deriving from the 16 large industrial *sociétés nationales*, which collectively accounted for some 80 percent of industrial activity and employed 311,680 people in Algeria. Accordingly, a major reorganization was undertaken with the aim of breaking up these unwieldy organizations into much smaller *entreprises nationales*, each one of which would be more specialized in clearly-defined production activities that would usually separate the functions of production, distribution and marketing. The iron and steel complex SNS was therefore divided up into 13 enterprises, and the wide-ranging SONACOME engineering conglomerate was split into 11 enterprises.

Likewise, the 16 industrial *sociétés* were subdivided into 107 enterprises.

It was estimated that the restructuring of the wider group of some 35 to 39 state *sociétés*, including commercial, financial and transport organizations, produced anything from 322 to 500 enterprises after subdividing had taken place. While it was not a privatization exercise as such, the restructuring involved a great deal of decentralization to regional units and resulted in a more flexible and less concentrated state industrial sector with which private industry could associate and conduct business (Sutton and Aghrout 1990).

In the early 1990s, the Algerian public enterprise sector consisted of approximately 350 national and 2,500 provincial and communal enterprises. The important provincial and communal state-owned enterprise sector was undergoing consolidation (with World Bank support) as a first step towards improving performance. More extensive and advanced reforms were proceeding in the national state-owned enterprise sector with the aim of putting the public and private sectors on an equal legal and regulatory footing when engaged in the same field of activity, and in order to make state-owned enterprises conform to the requirements of the national commercial code (from which they had previously been exempt). The budgetary burden of the national state-owned enterprise sector having been recognized since the early 1980s, a few of the largest and most concentrated state-owned enterprises (including the hydrocarbon giant SONATRACH) were, as has already been noted, functionally and geographically decentralized, while the second phase of reform concentrated on sorting out the arrears (cross-debts) situation between parent companies and their subsidiaries. Enterprise restructuring was not particularly successful initially, but it was claimed that the effectiveness of future rehabilitation efforts would be improved by alterations to the system of taxing the enterprises.

Most recent reforms have concentrated on clarifying the relationship of the government with national state-owned enterprises and on insulating the management of public companies from the intervention of sectoral ministries. This has been done through eight *Fonds de Participation* – Participation or Shareholding Funds. These publicly-owned and operated Funds which were intended to act as holding companies would each hold shares in a diversified portfolio of state-owned enterprises, and their mandate would be to buy or sell shares and to invest or disinvest their holdings with the aim of maximizing their profits. The trading of shares would be permitted among the Funds and between state-owned enterprises themselves, as the first step towards the development of a capital market. (At this stage, private ownership of the existing state-owned enterprises portfolio was not envisaged).

Early in 1990, however, the National Assembly authorized new joint ventures between state enterprises and private capital, whether foreign or domestic. Although state-owned enterprises were not excluded from the stipulations

of this new legislation, it seemed to be aimed mainly at newly-established firms or at existing privately-owned firms. Each of the Funds would receive an initial allocation of a substantial minority of shares in a specific industrial sub-sector, but no single Fund would own more than 40 percent of the shares of any one firm. In this way, the ownership of every enterprise would be spread among at least three Funds, which would monitor enterprise performance and enforce profitability standards. The aims of the Funds would be to stimulate competitive market forces, to reduce political and administrative interference in the day-to-day functioning of the firms, to provide enterprise management with profit-maximization signals and the autonomy to achieve these goals, and generally to increase the operational efficiency of the enterprise concerned (Lee and Nellis 1990).

The Algerian Participation Funds came into existence officially in mid-1989, and the initial steps towards transformation involved the creation of an agency that advised on how each enterprise could be placed on a firmer financial footing. Debts were split into several categories: those owed to the Treasury were converted into quasi-equity, those to investment banks were mainly written off, and most owed to commercial banks were rescheduled. Firms were categorized according to those that had positive and negative net worth and cash flow, and enterprises scoring negatively on these financial criteria were not passed on to the Funds. Each enterprise was assigned a value in terms of the number of shares that would be issued for each firm, and at this point the enterprises were handed over to the Participation Funds. Fund managers were then put in place, but it appeared initially that the Funds (with around 30 enterprises per existing staff member) were understaffed, and operating procedures still had to be determined. It was anticipated that the Funds would have the power to appoint enterprise boards of directors, but it was not very clear how enterprise performance standards would be set, monitored and enforced.

The parameters of managerial autonomy also had to be specified, though it was expected that managers would be able to hire and fire employees. Pricing was somewhat liberalized, but in view of the monopoly structure of the Algerian economy, margins were to remain controlled. Access to foreign currency remained severely constrained, but some progress was made in tightening up the allocation of domestic credit as one of the moves towards the eventual imposition of a hard budget constraint. By the beginning of the 1990s none of the national state-owned enterprises had been liquidated, despite the fact that they were now subject to the commercial code which allowed for closures. Needless to say, Algeria's current political difficulties have prevented the country's leadership from paying sufficient attention to the problems of economic management and public administration.

Saudi Arabia

In spite of its liberal economic terminology, Saudi Arabia is closer – in organizational terms – to an étatist system than to a market-oriented one. To be sure, this has been mainly a function of the oil boom. The country possesses an authoritative Ministry of Planning that prepares the all-important successive development plans, and it has extremely powerful Ministries of Petroleum and of Industry, which host dynamic teams of technocrats in charge of preparing general policies as well as directing and controlling important public corporations in such areas as oil field development, petroleum engineering, refining, pipelines and gas, basic industries, petrochemicals, steel, fertilizers, and so on (Al-Farsy 1982:73-111).

The economic role of the state in Saudi Arabia is extremely important. In 1978, the government was responsible for 60.3 percent of gross fixed capital formation, for 61.7 percent of expenditure in GDP, for 48 percent of total consumption and (in 1976) for 33.3 percent of all national purchases (El-Mallakh 1982:276). Although the development plans have declared that the government would undertake capital investment only "where the size of investment is large and beyond the capacity of private individuals," and even though the policy of "Saudization" has entailed preferential incentives to Saudi rather than expatriate and foreign contractors (ibid.:403-8), private business is to a large extent contingent on public expenditure, and domestic producers do not appear to be able to function without heavy subsidies from the government.

The development plan is the main vehicle through which the state reshapes the economy, largely through public spending. The first plan (1970-75) was a rather modest investment program. Planning took off after the oil boom, with the second development plan (1975-80) involving an expenditure of no less than SR498,230 million (about US$142 billion), and with major features being infrastructure and the Jubail and Yanbu industrial cities. The third plan (1980-1985) was intended to shift the emphasis from infrastructure to the productive sectors, including agriculture. The fourth plan (1985-89) stressed operational efficiency and non-oil activities and stipulated a larger role for the private sector, but it is generally believed to have fallen short of its objectives.

Saudi Arabia hosts a very large public sector that has expanded tremendously since the oil boom. Several public organizations were established, especially during the 1970s, and by the mid-1980s their number exceeded 30. These included four public organizations in the area of services, ten in the area of education and training, as well as 15 economic public corporations, most of which include several public companies and enterprises. The activities of the public corporations cover such varied areas as oil and minerals, silos, water and electricity, regional development, banking and investment funds, as well as a whole range of manufacturing, petrochemical and construction industries

(Al-Tawil 1986:379-84). Heavy industry is almost entirely concentrated in the hands of the state-owned Saudi Arabian Basic Industries Corporation (SABIC), while oil refining is in the hands of the Public Organization for Petroleum and Minerals (PETROMIN).

It is no secret that the expansion of the public sector in Saudi Arabia was motivated not only by the need to expand industry and infrastructure and to diversify the economy, but also by "the desire to redistribute part of the growing income in the form of services and public utilities" (Khawajkiya 1990:485). Like other major oil exporters in the Gulf, Saudi Arabia has been identified as an "allocative state" that is actively involved in the circulation of petroleum rent. The public sector has benefited from such practices and has accumulated enormous liquid assets, much of them deposited abroad. The richest groups revolve around the royal family and a small number of often related or associated merchant families. They remain too dependent on the state, which continues to enjoy a high degree of budgetary autonomy, to be able to initiate really independent entrepreneurial activities or political demands (Luciani 1990:87-93).

In the industrial field, the Saudi private sector is involved in the production of several items, such as soft drinks, paper products, detergents, furniture, plastics and building products, as well as in textile manufactures and light metal industries. It makes good use of the Saudi Industrial Development Fund, which was set up by the government in the 1970s to provide interest-free medium and long-term loans to the private sector. In 1984, a private sector project – the National Industrialization Enterprise – was established to assist the government's efforts to privatize industry and to promote plants using feedstock from the first generation projects of SABIC (*EIU Saudi Arabia Country Profile 1987/88*). By the mid-1980s, the private sector was contributing 46 percent of total fixed investments, producing 71 percent of GDP (excluding oil) and employing 88 percent of all manpower (Khawajkiya 1990:492-4).

Most private sector industrial companies in Saudi Arabia are fairly small in size and more concentrated in the area of rather similar consumer products. Most are "personal" private companies or partnerships, owned and managed by the individual and his family, and very few are limited companies. Saudi Arabia had 7,060 private companies in 1986, in addition to 297,000 registered individual "establishments" (*mu'assasat fardiyya*) of one sort or another, mainly functioning as merchant stores or small workshops. Available empirical studies indicate that private manufacturing firms are not particularly efficient, and many are run according to rather primitive managerial and accounting practices (Presley 1991:102-14). There were only 22 limited companies active in the industrial field in the mid-1980s, with a total capital of SR12 billion, of which only SR5 billion were contributed by the private sector, and

SR7 billion by SABIC and PETROMIN (Khawajkiya 1990:501-2). Private sector companies are also heavily dependent on subsidized borrowing from state financing bodies.

With the decline in the revenues of oil-exporting countries from around 1982-83 onwards as a result of lower oil prices and reduced interest rates, even such a relatively rich country as Saudi Arabia began to feel the need to adjust its economic policies. Generally speaking, however, the rate of decline in public expenditures has not matched the rate of decline in public revenues, and in some countries such as Kuwait and Oman expenditures continued on their rising trend. In Saudi Arabia, budgeted expenditures declined from US$82.2 billion in 1981 to US$54.8 billion in 1985, but actual expenditure figures remained unknown to (or continued to be withheld from) even the country's public finance experts (Abd al-Rahman 1988:67-8). It is believed, however, that new projects in Saudi Arabia were halted or at least slowed down, that imports were reduced and that attempts were made to constrain the expansion in public employment, especially of expatriates. Nevertheless, expenditures on salaries and overall recurrent outlays have continued to grow (ibid.:110-26).

Faced with a substantial decline in foreign receipts, virtually all oil-exporting countries have sought to reduce aggregate demand in order to limit the loss of external reserves. To this end, they have tried to reduce public expenditures, which for them represent the primary source of liquidity creation and demand growth. Whereas certain cuts in development spending were made possible by the near completion of major infrastructural projects, the desire to continue to provide some support to private, non-oil sectors and the need to sustain the defense capabilities of these countries have constrained the attempt at financial retrenchment, with budget deficits remaining high or continuing to rise (Shaalan 1987:26-8). Despite reductions in imports, the fall in foreign exchange earnings has led most oil-exporting countries to witness deficits in their current external accounts, and several have resorted to external commercial borrowing. The situation has not been helped by the continued and escalating private capital outflows. "Typically, private sectors are contracting sharply rather than picking up the slack, as had been hoped" (ibid.:28-9).

As with most other countries, the call for privatization in oil-exporting Arab countries has been prompted by fiscal difficulties. With the drop in oil revenues and the difficulty of trimming expenditures either on infrastructure and defense or (more seriously from a socio-political point of view) on welfare services and the comprehensive employment of nationals, the idea has emerged that some of the financial burden may be removed from the government by transferring certain economic activities to the private sector. In anticipation of such a transformation, Saudi Arabia's Fourth Socioeconomic Development Plan (1984/85-1989/90) stipulated an annual growth rate of ten

percent for the private sector, compared to a negative 2.4 percent for the government sector. Overall, Saudi planners projected a rise in the share of the private (non-oil) sector in aggregate fixed capital formation from 25.4 percent in 1979/80 to 47.8 percent in 1989/90. Moreover, the share of the government sector was projected to decline from 50.4 percent in 1979/80 to 27.7 percent in 1989/90 (Ministry of Planning 1985).

Privatization as a public policy in Saudi Arabia involves both the consolidation of the private sector in the areas in which it has already shown initiative and vitality, such as commerce, finance and, to some extent, agriculture, and the actual transfer of ownership and/or management of public enterprises to the private sector (ibid.:17). The new development plan (1990-1995) stipulates a number of measures that are pertinent to the privatization objective, including the establishment of an organized stock market, incentives for new shareholding companies and encouragement for commercial banks to extend more credit for production projects (Ministry of Planning 1989). The management of certain public enterprises would be leased to the private sector, and the major state industries would be allowed to sell shares to the private sector. SABIC has already been selling some shares since 1987, and some of the holding companies of the main petrochemical complex, PETROMIN, are to be transferred to private ownership. Experts believe that even though activities such as major construction works and large-scale agricultural projects will continue to depend on government subsidization, other activities such as manufacturing, electricity, gas and water, telephones and airlines may be ready for privatization (Ministry of Planning Workshop 1989).

Yet, is the Saudi private sector ready to step in and pick up the slack resulting from the contraction in public investment? It should be remembered at this point that *laissez-faire* labels notwithstanding, public spending was indeed the principal engine of Saudi Arabia's boom decade, which ended in 1983. Interestingly enough, private consumption during that period "did not have a statistically significant impact on private investment, while direct government consumption provided a strong stimulus to increased private sector capital formation." Furthermore, although the stimulus provided by government investment to private investors was rather slow in the short run, in fact it represented double the stimulus (provided by government consumption) in the long run (Looney 1987/88:65). Despite vast amounts of public sector expenditures since 1973, Saudi Arabia's economic fortunes continue to be closely linked to continued government expenditures, which in turn continue to be heavily dependent on the world oil market. Given the projected state of these markets, it is unlikely that the private sector will be able to sustain positive overall rates of economic growth over the coming few years (ibid.:74).

One important factor deciding the likely contribution of the private sector in Saudi Arabia will be the degree to which the country will succeed in installing a process of financial deepening. Given the size of their population and infrastructure and their level of capital accumulation, the private sector has a potentially more important role to play in the domestic market of smaller neighboring oil-exporting countries than it does in Saudi Arabia. Much will depend, however, on "the ability and willingness of the commercial banks to divert assets from foreign to domestic lending. The country may be vulnerable to a serious liquidity crisis if significant increases in Euro-rates were to take place in an environment in which the government was unable, because of slack revenues, to significantly increase its expenditures" (Looney 1987/88: 66-7). It can thus be seen that the private sector in Saudi Arabia and the other Gulf countries is not only financially and structurally dependent on the state sector, but that the two sectors are symbiotically linked in complex ways, including at the level of personnel. Members of the elite are often engaged in "public" office and in "private" business at the same time, thus making the distinction between the two domains extremely difficult (Al-Nasrawi 1990: 529-30). Given this situation, it is quite likely – paradoxical as this may seem – that it will be the private sector and the state's clients in the business sector that will constrain and slow down the move towards privatization in Saudi Arabia and the Gulf.

Kuwait and the United Arab Emirates

In Kuwait and the United Arab Emirates (UAE), the pattern has been a little different, since the business community was not overwhelmingly new, as was the case in Saudi Arabia. In the UAE, the state-engendered business community is very important, but the "continuing" commercial elite (mainly of Dubai) is still quite important. In Kuwait, the business bourgeoisie is still more or less a continuation of the older commercial community. Most private sector firms in Kuwait (98.8 percent) are again "personal" companies (not public shareholding ones), and several are either individual or partnership-based, while a few are limited companies. However, one of the most peculiar aspects is that only 1.4 percent of the labor force in all private companies is native Kuwaiti, whereas Kuwaitis represented 45.9 percent of the labor force in the government bureaucracy in 1990. Also significant is the fact that the contribution of the private sector to GDP had declined from 34.5 percent in 1982 to 23.7 percent in 1985, and from 62.9 percent to 48 percent of non-oil GDP (Al-Hamud 1990:544-7). The few studies that were conducted also showed that the productivity of the private sector was generally poor (ibid.:550-2).

The expansion in the public sector was mainly a function of the rise in oil rents, whereby the government not only expanded services and infrastructure

but also contributed to the capital of many (formally private) companies, with shares very often exceeding 50 percent of the total in such areas as banking, insurance, industry, transport and services (ibid.:552-4). Furthermore, the government took over 33 companies whose owners could not finance or manage them, following the two stock exchange crises of 1976 and 1982. It should be obvious that the Kuwaiti private sector continues to depend on the state, especially with regard to the provision of infrastructure, no or low-interest loans, exemptions on imports, subsidies and special prices, customs protection, and so forth. At the same time, the Kuwaiti government is prepared to step in to cushion the sometimes capricious private sector for reasons pertaining to political survival and expediency. That is why it has become government policy to continue to maintain companies that do not make a profit and not to sell too many government shares on the stock market to the public at any one time in order not to cause a downward trend in the market price of shares (Al-Watan, 11 April 1990:1,22).

In the UAE as in Kuwait, native Emiratis represent only three percent of the manpower in the private sector, whereas they account for 37 percent of the labor force in the government bureaucracy (Al-Shuruq, 23 April 1992). In such countries, privatization carries with it the political risks of even more foreign labor, which the private sector finds cheaper, and which already corresponds to 90 percent of the labor force in the UAE in spite of the government's attempts at discouraging the expansion in foreign employment. In the UAE, government support for the private sector took similar – if sometimes more personally "generous" – forms: interest-free loans and mortgages for housing and investment, subsidies and price controls and very generous social allowances, including gifts for marriage dowries and a progressive "child benefit" system (that is, the more you produce the higher the allowance per child!). Every UAE citizen is also entitled to three virtually free pieces of land (Field 1984).

Like other oil-exporting states, the UAE responded to the recession by seeking to reduce aggregate demand, especially that which was generated through government expenditure. Also, following the mid-1980s no further expansion was to take place in public employment. Fiscal retrenchment has been tempered, however, by a desire to continue to provide support for the state-dependent private sector and by defense priorities (Shaalan 1987:29-129). It is thus little wonder, given all these constraints, that although governments in the Gulf have declared some privatization slogans, partly as a matter of fashion and partly with a view to coping with the constraints of the "bust" years, the ability to implement any privatization program has been very limited indeed. One analyst even saw fit to state in no uncertain terms that "privatization and liberalization programs [...] failed outright in the so-called

market economies of Saudi Arabia and the United Arab Emirates" (Chaudhry 1991:145), a statement that is perhaps rather sweeping but not altogether off the mark.

Conclusion

It is often argued that several Arab countries have decided to restructure because they now realize that the private sector is more efficient and productive than the public sector. Yet, this is another area in which information is also scant: just how productive are public and private enterprises in Arab countries? Productivity and efficiency for the public sector is not simply profitability; but even simple profitability data for public enterprises are lacking or difficult to obtain, sometimes for understandable "survivalist" political reasons.

The move towards privatization in both oil-poor and oil-rich Arab countries has been promoted more by a relative (and, in the case of the former group, severe) decline in revenues than by any realization of the inefficiency of public enterprises and the efficiency of private ones in the various Arab countries. Developing countries were prepared to take on trust the word of the early privatizers in the "center" (the United Kingdom and the United States) on this issue, as well as the assurances of the international organizations of globalizing capitalism. Although a few Arab experts have voiced some doubts and called for caution (Hafiz Mahmud 1989, Hilan 1989, and Mahjub 1990), most Arab writings on privatization have taken it for granted that private is more rational and efficient than public, and have proceeded *ipso facto* to suggest strategies and modalities for implementing such a policy (Abdel-Rahman and Abu Ali 1989, Anani and Khalaf 1989, and Al-Saigh and Buera 1990).

In most cases, the managerial argument over efficiency has been confused with (or else has tended to overshadow) the macroeconomic argument over development. The most profitable enterprises are not always the most conducive to overall national development. Even some of the proponents of privatization will concede that the state in several Arab societies has acted as a real "agent of development" on the macroeconomic level, and that several actual choices of projects for public investment cannot be described as irrational. Even now, the privatization craze notwithstanding, few people who are familiar with conditions in the Arab countries would suggest the total withdrawal of the state from the economic arena, even though several would perhaps argue that the state should have "a much more vital role to play as a promoter of business, animateur, than as a business entrepreneur" (Harik 1990: 29). Privatization within post-socialist or post-populist regimes usually entails three processes which are sometimes achieved in successive stages, as follows:

(a) managerialism within the public sector; (b) commercialization of the state economic sector; and (c) concessions to, and partnerships with, international capital (for example, through joint ventures).

Policies of economic adjustment are not purely technical or financial in nature, but necessarily carry with them important social outcomes. Therefore, they require significant shifts in political coalitions. A familiar pattern of political coalition-building in industrializing Third World societies has been represented by a populist coalition centered around the military, the techno-managerial elite of the public sector and organized labor. This is the political corollary of the famous import substitution strategy, with its strongly industrial and urban bias and its elaborate "social welfare" policy. Once in serious crisis, a state that is dominated by such a coalition may either attach top priority to the imperative of "industrial deepening," and thus opt for an open bureaucratic-authoritarian model, or it may follow a less radical and more incremental set of measures in an attempt to respond to a developmental crisis that often presents itself most severely in the financial sphere.

An initial response to the fiscal crisis of the state will often be felt through a number of belt-tightening and economizing measures that are usually followed on an *ad hoc* basis and that sometimes include "more of the same" remedies. This may involve an intensification of import controls, increased reliance on the administrative allocation of resources and the application of a number of interventionist policies designed to widen the gap between domestic prices and world prices. It is only when such countries discover that the consequences of such an approach are ultimately unsustainable that they delve into the short-term stabilization programs sponsored by the IMF and the long-term structural adjustment programs sponsored by the World Bank (Da Silva Lopes 1989).

Short-term stabilization programs, typified by the IMF's "stand-by arrangements," are oriented primarily towards quickly reducing the deficit, cutting domestic demand, or controlling its expansion. They involve expenditure-reducing policies and expenditure-switching policies (that is, stimulating the production of exportable and importable goods and changing demand patterns in favor of goods that do not enter into international trade). These programs are usually based on a few instruments: ceilings to the expansion of domestic credit and to public sector borrowing, rises in interest rates, exchange rate depreciation, and sometimes wage controls and the adjustment of some key prices (Da Silva Lopes 1989:22-30). The potential social beneficiaries in this stage would be agricultural exporters, private and perhaps public exporters of manufactured goods, the tourist sector, and migrant workers who can convert their earnings at the new devalued exchange rates. Among the main potential losers would be public sector enterprises, which will suffer from reduced investment and expenditure and from restrictions on imports (Waterbury 1989:56-7).

Structural adjustment programs are more ambitious in that they do not rely merely on demand management, but are oriented more towards improving the conditions of supply and the allocation of domestic resources, as well as towards "institutional transformations which may contribute to reinforcing the growth potential and to reduce the vulnerability to external shocks by reducing external payments imbalances" (Da Silva Lopes 1989:22-3). The measures involved in this phase are more varied and profound, but they certainly include reductions in consumers' subsidies, deregulation of agricultural producers' prices and of some industrial prices, as well as the liberalization of trade and exchange rates. Very often, they also include a certain privatization drive, that is, a move towards increased private management and/or ownership of enterprises and a general encouragement of private investment within the economy, especially in export-oriented sectors. The likely social beneficiaries in this phase are the agricultural sector in general and exporters in particular, along with some public enterprises that sell mainly to the domestic market, after all of them have benefited from the streamlining required by the reduction in public investment flows. This phase is likely to have a moderate impact on public or private import-substituting industries, since they will experience rising costs of domestic inputs and probably of wage bills, which may or may not be offset by easier borrowing and deregulation of prices. Those engaged in the export of manufactured goods will also experience a rise in the cost of labor and domestic inputs (Waterbury 1989:56-7).

What coalition shifts are likely to result from such changes? First and perhaps most consistently, organized labor cannot expect a continuation of the symbolically favored – if institutionally incorporated – status that it enjoyed in earlier, more populist times. Unprecedented worker strikes may start to take place, as was the case, for example, in Egypt and Tunisia. Even professional syndicates and associations may show signs of resistance (as occurred in Sudan) or of defiance and restlessness (as took place in Egypt). More spectacular protests against declining standards of living and the removal of basic subsidies tend to come from the urban sub-proletariat and lumpenproletariat, as has been seen in Egypt, Tunisia, Algeria and elsewhere. Organized labor can be drawn into some of the protest actions that are best expressed by the urban sub-proletariat and lumpenproletariat. This was illustrated by the 1978 events in Tunisia that resulted in the creation of an ambivalent relationship between the government and the once organically incorporated trade union federation, the UGTT (Waterbury 1989:57-60). The possibility of more militant labor action might have been higher in several Arab countries had the safety valve of work opportunities in the oil-exporting countries not existed. Migrant labor constitutes an important financial factor which has no formal

organized representation in the emerging coalitions, but which is potentially of great economic and social (and subsequently political) impact.

In most countries, the military retain their membership in the new coalitions, although often in a somewhat adjusted capacity. Armies continue to acquire the lion's share of public expenditure, and in some cases to have exclusive control of their own financial affairs. Some armies have also expanded into civilian economic activities (for instance, in Egypt and Syria). Even in Tunisia, where the military were previously subordinate to the civilian government, the arrival of General Zein al-Abidin Ben Ali to power signalled a likely enhancement of the political status – if not the political role – of the military. While the conventional civil service continues, despite its huge size, to be of limited political importance, the same cannot be said of public sector management. The managers and technocrats of state enterprises and economic organizations continue to carry significant political weight in countries such as Egypt, Algeria, Iraq and elsewhere. Although part of the technocracy has gone private, there continues to be a large number of technocrats who still regard their life careers as being closely tied to the future of the public sector.

What conclusions can be drawn from the foregoing analysis and case studies? One general conclusion is that both the expansion and contraction of the public economic sector have been correlated with the availability of liquid capital. The availability of capital may be domestically-based (through nationalizations or an "agricultural squeeze") or externally-based (for example, oil rents, aid and remittances). The tightening of finance also corresponds to domestic signals (such as declining revenues in public enterprises and growing deficits in the state budget), and/or with external signals coming from creditors, international financial organizations, trade partners and potential investors.

In most cases, the move towards privatization as a way of overcoming the financial crisis of the state takes the form of a public policy, that is, one that is initiated by the state (sometimes in collaboration with international capital) for its own reasons, rather than under pressure from the private sector. If it is ready to do so, the private sector may, of course, pick up on the process and forge ahead with it. The pace and intensity of privatization will, however, depend (i) on the degree to which capital accumulation has been both extensive and internally-oriented; and (ii) on the degree to which both the state bourgeoisie and the private bourgeoisie find it useful (safe) to seek further autonomy from each other.

It is surmised from the above case studies that – privatization slogans and appearances notwithstanding – actual privatization remains rather limited in the Arab world, and that the Arab state is not really about to withdraw from the economy. Privatization is still basically a public policy pursued by the state with reluctance and caution largely for its own purposes. It has not yet

become a dynamic process whose initiative is taken by the private sector itself. If the private sector is gaining, it is not because of its initiative, drive and organization, nor is it because the ruling elites have decided sincerely to hand the economy over to it. Rather, it is mainly because the state is no longer able – given its chronic fiscal crisis – to uphold its étatist and welfare policies at the same time.

In other words, the private sector may end up growing by default, so to speak, although the proportions, timing and modalities will vary depending on a number of key factors. These include the solidity and coherence of the state machinery; the strength and autonomy of the labor movement; the attitude of public sector managers and "apparatchiks"; the vitality and capabilities of the domestic business community; the degree to which the government's intervention might or might not have crowded out the private sector; and, last but not least, the levels and patterns of external pressures and temptations exercised on the state by international organizations and by globalizing capitalism.

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The Changing Economic Role of the State from a Turkish Perspective

The age of economic design

The "institutionalist" theme, most vividly spelled out by Douglass North (Nobel Prize Laureate in 1993), attempts to explain the existence and rationale of political, legal, economic or, more generally, social institutions by reference to a model of interaction between individuals and institutions where the latter are seen as "the rules of the game in a society or, more formally, [as] the humanly devised constraint that shapes human interaction" (North 1990:3). Within this framework, institutions are conceptualized first as providing the basic structure through which human beings have created order and attempted to reduce uncertainty throughout history and, second, as determining – together with the technology employed – transaction and transformation costs, and hence the profitability and feasibility of engaging in economic activity (see Hodgson 1993). Therefore, the analysis of institutional structures constitutes a very important step in understanding both past and present economic performance, a critical evaluation of which might help us design and propose new mechanisms that would enhance it in the future. The changing economic role of the Turkish state can also be viewed within this perspective. Based on observations relating to Turkey's past and present institutional structure, this chapter will attempt to evaluate the role of the Turkish state, and then to propose new guidelines towards improving economic performance.

Turkey should perhaps be viewed as a self-inspecting, self-designing country, unlike countries of the West, which are perhaps self-content, even complacent in part. In Turkey today, discussions over a variety of institutional questions – ranging from reforming the electoral system to the economic and social implications of privatization, from the optimal size of parliament to the pros and cons of an alternative, presidential, system – are buoyant and attract wide and very active participation from very different strata within society, voicing a need for restructuring the present system. This reinforces our drive to focus on the formation and operation of institutions in Turkey as the mode through which economies are organized and controlled.

An institutionalist look over our shoulders

When Constantinople fell on 29 May 1453, the Podesta of Galata – the local Genoese settlement – quickly sought favor with the Turks. The latter ordered the gates to be opened, and Genoese envoys were sent out to request a confirmation of religious and commercial liberties previously enjoyed under the

Byzantine emperors (see Concina 1994). It took only three days for Fatih Mehmet, as the new Eastern Roman Emperor, to sign this grant to the inhabitants of Galata, unilaterally guaranteeing their right to trade in his new and enlarged dominion, thus willingly foregoing his – and, what is more, effectively also his successors' – right to absolute and arbitrary rule in this matter. It is striking that he should, of his own will, choose to make such a promise, especially at a time when his power was at its peak, unchallenged by any other contemporary world power. His decision later received heavy criticism, but it was certainly a strategic one, undoubtedly setting forth crystal-clear property rights for a group of the world's best traders, giving them the most certain shelter of law and order, as well as protection from political interference. This was in a world in which everywhere else tradesmen had to bribe the local nobility and pay them tolls and fees at every crossroads – a world in which extended religious and other wars and strife made trade no riskless occupation.

Another striking fact about Fatih Mehmet's promise to the Galata inhabitants was its language. The document was written not in Turkish, Italian or Latin, but in Greek, the language of the Eastern Roman Empire. Fatih Mehmet was not making a historical joke when he claimed the Eastern Roman Empire as its Emperor. And this should serve as a clear reminder to all of us of what this young emperor did in the economic, legal, administrative and general social sphere. For he took over Byzantium, adopting and adapting much of its institutions, methods and administrative traditions and machinery to the needs of an expanding, energetic modern state composed of many ethnic groups, creeds, languages, and many and diverse needs. He did not crush the civilization that he had defeated at war. Instead, by exchanging blood with the basically nomadic traditions in administration that had brought the Oguz Turks in 1453, he gave the polity a new and economically viable life.

Unlike in a country following the Magna Carta tradition, where property owners got together to agree on the rules, Fatih Mehmet was, of course, the owner of all. Despite his omnipotence, however, he signed an accord which he must have thought would be good for business – his business. In so many ways, it is evident that Fatih was an institutionalist. The institution of fratricide was not his only mark on the future of the Ottoman Turkish state. He adopted and adapted Roman-Byzantine institutions and coined some of his own. The state as the business organization of its owner – the ruler – was a feature of the Turkish state well into the nineteenth century, exceptions being made to foreigners and minorities, which allowed them to own certain forms of property. A lesson to be derived from the Ottoman period is that the existence of clearly-defined property rights makes for good economics, thus escaping the uncertainties of vagueness and avoiding the "commons" problem (see Hardin 1968) by concentrating ownership in the hands of an individual – those of the Padisah.

With the birth of the Turkish Republic in 1923, while subjects became

citizens and the private ownership of property was placed on a pedestal, the large proprietor-state also undertook the duty of building itself up in order to function better in its new, self-ascribed duty of serving the nation, and this entailed its entering the economic world as a producer. Thus, during the period of *étatism*, the state aimed at establishing the main industries, all in the absence of any private capital accumulation and despite a genuine shortage of human capital. Adopted as official ideology in 1931, *étatism* gained momentum in 1934 with the start of the five-year plan period, although it slowed down in the late 1940s. Again, this was institution building, and the *étatist* order was designed to achieve a set of interrelated targets: building an infrastructure; producing a variety of intermediary/capital goods; creating human capital; ameliorating or correcting regional imbalances; and, as an entrepreneur-state, bearing risk and confronting the typical uncertainties facing any new business in newly-opened markets (Boratav 1974, Karatas 1986, and Kepenek 1990).

These targets may be said to have been met with success: Turkey's GDP growth rate between 1929 and 1950 was 83 percent – a relatively high magnitude when compared, for example, with those of India, Egypt, Yugoslavia and Greece for the same period: 21, 59, 30, and -12 percent, respectively (Tezel 1982:450). The role of industry in the Turkish economy also grew during this period, and its GDP share increased from 15 percent in the early 1930s to 19 percent in the late 1940s (ibid.:451). That is where the state took a leading position. Even in 1950, when the state started to step back from production activity, one-third of the value-added in the manufacturing sector and more than half of the value-added in mining were created by public enterprises (DIE 1953:284). Another striking fact regarding state achievement in the *étatist* period is that out of all entrepreneurs establishing businesses between 1931 and 1940 and employing a workforce of 50 employees or more in 1968, 78 percent had had previous work experience in the public sector, which proves the state's contribution in enhancing the development of human capital (Soral 1974:39-43).

Later, starting in the late 1950s, we see the period of the mixed economy, or the period of planned industrialization steered by the newly-established State Planning Organization (1961), which followed its own particular ideology. Here we observe the interesting institutional device of "regulation by participation" (Sertel 1988) – a topic to be addressed below. This was very Turkish, but also seen in Western Europe, notably in France, for example in the automotive industry (such as Renault), and in Italy. What we have here is the public hand entering production, not as a monopoly, but rather as one of several producers, and with the explicit goal of influencing – thus indirectly regulating – the behavior of its competitors when the unregulated operation of

private industry is unsatisfactory. As such, the participation of the public hand in productive activity exerts a regulatory effect on others, increasing the efficiency of the allocative operation of markets where competition is insufficient.

During these years, main targets became the achievement of economic growth, the structural change from agriculture towards industry and the diversification of the export base of the country to finance the growing import needs of the economy. Along with this, the Turkish state aimed at developing import-competing product lines and engaged in regulation of imperfectly competitive markets, even directly participating in production as well as giving overall support to industrial activity and exports. In this context, the first phase of the import substitution regime, which aimed at replacing imports of non-durable goods, was successfully implemented between 1963 and 1973. Owing much to the changing international climate and external shocks, however, the attempt to substitute for imports of consumer durables, intermediate and investment goods – known as the "second phase" – proved no great success (Akder *et. al.* 1987, Boratav 1988, Önis 1993, Çakmakçi 1994, and Kepenek and Yentürk 1994).

The 1977-1980 years preceding the 1980 adjustment program are generally known as the "crisis years." This crisis was characterized mainly by macroeconomic instability as well as social and industrial strife. The country saw very high rates of price inflation, debt crises that went hand in hand with worsening international creditworthiness, and negative growth rates arising from supply bottlenecks and import scarcities due to foreign exchange shortages. Here, part of the problem had started with the oil shock and the consequences of Turkey's intervention in Cyprus in 1974, all of which placed the economy under severe strain. At the same time, economic difficulties were accompanied by political turmoil. Towards the end of this period, the government attempted to revitalize the economy with a reform program designed with direct participation from the World Bank and the IMF, which came into effect on 24 January 1980. The country then went through a coup d'état in September of that year, and the military regime virtually suppressed all opposition groups and acted as a protector/guarantor of the 24 January economic program.

The reform program was a rather standard one in favor of, *inter alia*, trade and financial liberalization, domestic demand restraint and suppression of the wage rate (Boratav 1988:122). What was new, however, was the accompanying discourse. For the last decade and a half Turks have been presented with a so-called new "vision" which construes the state more or less as its disciples have perceived the United States – not necessarily as the United States actually is, but as they seem to have perceived it. This has brought not only an ideology in favor of privatizing the state sector of the economy, but also a half-baked idea that Turkey could more or less do without the state even in spheres such as public education and public health. It advocates a reduction of the role

of the state in the economy but, ironically, its proponents have, if anything, extended the state's interference to more and more spheres of economic activity (Bugra 1994).

Again ironically, during this era of the supremacy of private over public affairs and of private over public property, property rights – both public and private – have also become more and more vague. This is perhaps most evident in the simplest *tapu* (deed to a piece of land). This most central Ottoman/Turkish institution has been eroded in Turkey by the public hand itself. Indeed, the illegal occupation of private and public land has been encouraged by the public. The municipalities and Parliament itself have been active in undermining the sanctity of property – private and public – and the proponents of this sanctity have been mostly to blame. It should go without saying that when someone builds an illegal wall, it should not be possible to forgive him and thus render his unlawful act legal. The cost is borne by the individual whose property is obstructed by the wall. Accordingly, theft cannot be pardoned by Parliament and honesty expected to prevail. Where law and order cannot be guaranteed by the state, one can only speak of a return to the state of nature or of the filling of this vacuum by another, modern and more capable state. Needless to say, the lack of legal institutional arrangements also forms the basis for rent-seeking activities, as witnessed in Turkey. Respect for property rights would definitely imply a more efficient economic organizational structure.

Nevertheless, the privatization issue has been very prominent on Turkey's agenda for over a decade (Aktan 1993, Önder 1993, and Ertuna 1994). This is so long a period for a goal to be achieved that it is evident that words spoke louder than actions. In fact, by the end of 1993 only about US$2.3 billion in shares of public enterprises had been sold, and of these less than 30 percent were sales which turned over majority shares to private hands (PPA 1994). Over half of this sum was in a single industry, namely cement, where court cases took several years to settle. Among the cement factories sold, five went to a French company. The sales to the French company were made *en bloc*, and it is difficult to decipher what reasoning, let alone economic calculus, was pursued by the public agencies making the sales. The pattern proceeded from West to East and from the most to the least profitable. Little consideration seems to have been given to how the government's portfolio of loss-making enterprises was to be financed once profitable firms were eliminated. For the year ending in September 1992, had 11 of the 17 privatized cement factories not been privatized, the conglomerate ÇITOSAN would have had a profit of US$17.5 million rather than a loss of US$9.8 million (Tallant 1993).

What is more interesting, if not dramatic, is that the estimated profits over four years for the five plants purchased by the French company added up, broadly speaking, to the price that was paid. Çakmak and Zaim (1992) also

found that the private sector in cement has more or less the same physical efficiency (inputs/output) as the public sector, a finding that undermines the main rationale for privatization. The results reported in Tallant (1993) somehow confirm those of Çakmak and Zaim. Although private and mixed-ownership cement plants are estimated to be more efficient in terms of labor productivity than public ones, Tallant clearly acknowledges the fact that "the better showing in physical measures is closely related to geographic location, which indicates that the initial location decision has had more to do with firm performance than public ownership *per se*" (Tallant 1993:99-100).

A great deal of debate has surrounded this matter, but even in an area where a nationwide consensus is said to exist, legislation to enact large-scale privatization has come only recently (27 November 1994) and many questions remain unanswered. This is not to speak of the nationalization of the steel industry (Asil Çelik), the dairy industry (Kars Süt), and in other instances where private enterprise ideology has not hesitated to buy out failing private businesses. Also noteworthy was the nationalization or otherwise bailing out of several private banks and financial institutions over the last decade. A recent development (February 1995) in this regard was the attempt to sell two public enterprises (Kardemir and Et ve Balik Kurumu) to their dominant labor unions. The idea of transferring property and employers' rights to a labor union seemed to lack serious preparation and discussion and proved to be so unworkable that the government, meeting with much criticism, was forced to reconsider its decision.

From the sluggishness of legislative action in privatization, as reported above, two types of conclusions can be drawn. One is that the consensus in favor of privatization is not as wide and strong as claimed. Another is that Turkey has evolved into a state which simply cannot draft and pass requisite legislation, even where there is a strong consensus. There may be some truth to both of these claims. In support of the first view, the research of Ergüder *et. al.* (1992), for example, indicates that Turkish people in general do not have a strong preference towards private as opposed to public ownership. This suggests that despite the official discourse favoring privatization, the cultural ethos of the country in fact turns out not to be in agreement with the party line. As for the second view, if the legislative machinery is expected to be sluggish, as experience seems to confirm, this would mean that Turkey should design a system which does not require frequent fine-tuning legislative action.

The privatization debate

To be sure, the privatization debate revolves around the relative efficient performance of private versus public firms. To begin with, the efficiency criterion should be clarified. There seems to be a general tendency to treat efficiency as

an indicator very closely related to – if not identical with – profits. In the case of Turkey, for example, the usual public discourse on privatization tends to witness the presentation of loss figures pertaining to public firms as the rationale for full-scale privatization. Of course, profit (as it appears in accounting statements) is in no sense a reliable indicator of efficiency, showing only the difference between sales revenues and costs. Instead, an economist must insist that the efficiency criterion be based on the two usual components of productive (technical) efficiency – that is, just how low a cost of inputs is incurred in producing any level of output – and allocative efficiency, which measures how competitively the firm behaves in the market.

First, regarding productive efficiency, the general empirical evidence indicates that, if anything, we are not in a position to conclude decisively which form of enterprise – public or private – is the superior form (see Caves and Christensen 1980, Boardman and Aidan 1989, and Vickers and Yarrow 1991). In the specific case of Turkey, such a comparative study seems to be a challenge. In order to accomplish such a study, however, three different methods can be used (see Boratav *et. al.* 1993). The first one is to directly compare the efficiency (such as labor, capital and total productivity) figures of private versus public firms. Although from a methodological point of view there seems to be nothing wrong with this approach, it requires that the private and public firms under comparison share similar structures, both technologically and environmentally. In the case of Turkey, this condition is very difficult to meet, unfortunately, as one very seldom finds firms of different ownership structures in similar relevant conditions. The cement industry turns out to be an exception and, as indicated in the two studies cited above, one can safely claim that public and private firms are generally on a par as regards technical efficiency. The second way of comparing the efficiency of public versus private plants is to conduct a cost-benefit analysis by computing inputs, outputs and value-added on the basis of social prices. An obvious difficulty here lies in the computation of social prices. The third method is to estimate the production functions of private and public firms and then contrast them on the basis of the differences between potential and actual output levels. The difficulty here has to do with the unsettled debate about the methodological problems regarding the definition of production functions. In view of such methodological constraints, a full-scale comparison has yet to be conducted for the case of Turkey. A partial analysis, however, could pinpoint the fluctuations in public firms' efficiency over the years and then try to explain their variations. This path has recently been explored by Boratav *et. al.* (1993), and their finding is that productivity figures started to deteriorate in 1987 over the 1980-1992 period. Further investigation has led them to conclude that this deterioration has a strong correlation with the decline of investment expenditures.

The productive efficiency question is typically approached via the principal-agent theory, which focuses on the effects of ownership on the monitoring of a managerial body. Public ownership of a firm is not the ownership of the firm by the general public in the pure sense of each citizen owning a tradable share in the firm. Rather, the firm is owned by a public agency which acts as proprietor on behalf of citizens. Under private – as opposed to public – ownership, it is claimed that two separate mechanisms would ensure that managers do not deviate from profit maximization (Demsetz 1988). The first one consists of shareholders' control over managers, and the second is the discipline implemented by the capital market in the form of takeovers and the difficulty in raising additional capital. In the first scenario, it is argued that the voting mechanism gives shareholders ultimate control over management. Being the residual claimants, shareholders bear the direct consequences of managerial actions and therefore have the incentive to control the management team, with the implication that once inappropriate behavior by managers is detected, they will be subject to dismissal. In the second scenario, it is claimed that when the misbehavior of managers is reflected in the stock and bond prices of the firm, two mechanisms will be operative, thus disciplining managers. For one, if a management team is performing poorly, a potential takeover bidder may see this as an opportunity and purchase the firm, and the new management will seek to run the firm more efficiently. In addition, inefficient managers will find it more difficult to raise additional capital, and in the final analysis may face bankruptcy.

Yet, the above explanation has a few flaws. First, regarding shareholders' discipline, two reservations must be noted. The first one has to do with the implicit assumption that shareholders always maximize their (expected) profit from the company. There might well be some cases (such as the consumers of a monopolist's product holding a substantial fraction of its share) in which a rational shareholder would find it beneficial not to ask the manager to maximize the firm's profit (Hart 1979, and Vickers and Yarrow 1988). As for the second reservation, if all shareholders hold insignificant fractions of the total securities of the firm, none would have much incentive to monitor the firm's performance. As Stiglitz asserts (1985:136):

> Since there is always some cost associated both with obtaining information to determine whether a manager is a good manager and with evaluating alternative management teams – in other words, to voting intelligently – and there is a negligible benefit, no rational shareholder should expend the resources required to vote intelligently.

Furthermore, the discipline of the capital market is not without its own problems either. Regarding its alleged effects on takeovers, three reservations

can be raised. First, faced with the observation that a firm is not performing well, a potential bidder must know whether this poor performance has arisen due to bad management by the existing managerial team or due to some exogenous conditions which were beyond the control of the existing team (such as mistakes made by previous management), thus bringing about an information problem. Second, the incumbent management team could pursue a set of strategic actions in order to avoid being taken over. Third, foreseeing a takeover offer, a typical rational shareholder would find it profitable not to sell his/her shares, waiting rather for the takeover to be finalized, after which the shares would sell for a higher price. Regarding the difficulty in raising capital, two drawbacks must be noted. First, only the managers of firms with attractive investment prospects are likely to concern themselves with the efficient utilization of resources in order to raise additional capital. As Stiglitz argues (1985:139), "for other firms with poor investment opportunities, the threat of the denial of access to future capital is not an effective control mechanism." Additionally, should the probability of bankruptcy arise, the managerial team may think that the firm will go out of business regardless of the decisions that they make, and so may decide to enjoy managerial discretion to the fullest possible extent in the short term (Vickers and Yarrow 1988). Therefore, as in the case of the threat of takeover, difficulties in raising capital may cause the management team to shorten decision-making horizons.

Taking all of these drawbacks into account, there exists no solid ground for the argument that under private ownership the monitoring of managerial activities will be done efficiently. Dispersed shareholders will be inclined to free-ride, and capital markets need not function efficiently enough to exercise discipline over managers. Yet, if we were to insist that a capital market, however inefficient, will have an efficiency-enhancing role in the sense of taming managers, then it seems plausible to imitate the functioning of a capital market under public ownership, as Bardhan and Roemer (1992) have proposed. In Bardhan and Roemer's scheme, the government initially distributes a fixed number of coupons to all citizens, who use them to purchase the stock of firms, denominated not in regular currency but in said coupons. Owning a share of a firm entitles the citizen to a share of the firm's profits. The shares of firms cannot be purchased, but they can be traded for shares in other firms. The prices of coupons will thus oscillate as they do on a regular stock market. Everyone's coupon portfolio must be returned to the public treasury upon death, and allocations of coupons are to be made continually to new generations. Hence, this "pseudo" stock market "should provide the same signals that a capitalist stock market does, apart from providing some risk-bearing by citizens" (Bardhan and Roemer 1992:110), thus forcing managers to act properly. The conclusion to be drawn is that facing the issue of monitoring

managers, the effects of the ownership structure on productive efficiency may be indeterminate *a priori*.

The issue of productive efficiency has a second dimension as well. Many matters which cannot be effectively steered right by proper organization (for instance, via proper principal-agent relations) and by proper management can only be set right through an appropriate partnership market where providers of resources can buy in as partners or can be bought out by others who offer enough to purchase their partnership deeds. The literature on workers' enterprises (WEs) and, more generally, on "factoristic firms" (Sertel 1991) centers its analysis on a partnership market which determines the efficient employment of factors of production without an employer (such as an entrepreneur or a labor-managed firm's [LMF] management) deciding on how much of these factors to hire subject to a price schedule. After all, it is thanks to the worker-partnership market that a WE behaves as if it were a profit-maximizing entrepreneurial firm, although it has no entrepreneur deciding on the employment of labor – a factor of production that it can employ only as embodied in its own partners.

At this point, it would be wise to outline briefly the distinction between WEs and LMFs in order to better understand what a worker-partnership deed market would bring about. The tradition following the contributions of Ward (1958), Domar (1966) and Vanek (1970) takes as its point of departure the assumption that in LMFs the aim is to maximize the dividend per worker-member, defined as the value-added per worker. More specifically, the LMF chooses inputs in the short and long run so as to maximize the value-added per worker. The consequence of the Ward-Domar-Vanek assumption regarding the behavior of LMFs, however, is that of inefficiency and perversity (see Bonin and Putterman 1987, and Kleindorfer and Sertel 1993).

To begin with, three main problems are expected to arise when capital is assumed to be fixed. First, LMFs will be smaller than their capitalist twins if profits are positive. Note that if there is a positive profit, the profit that goes to shareholders in a capitalist twin firm would be divided among workers in a LMF, making the value-added per worker greater than the ongoing wage rate. Assuming that the marginal product of labor is decreasing, the LMF must use – under the positive profit scenario – less labor in order to attain the optimality condition, bringing about inefficiency. Moreover, LMFs would behave perversely in response to autonomous shifts in the product's price, lowering (increasing) their labor force – and thus output – when the price rises (falls). Lastly, if there is a positive profit and the value-added per worker differs among LMFs, labor allocation in the LMF economy would not be Pareto optimal. Clearly, a reallocation of labor towards the LMF with the higher value-added per worker from the LMF with a lower one would increase total

output in the economy. The main problem in the long run, on the other hand, is that if there is a positive profit, the maximized value-added per worker will exceed the ongoing wage rate, and the choice of technique will be more capital intensive than the optimal combination level as a result.

Finally, an underinvestment malady has long been attributed to LMFs. Due to the anticipated finiteness of their tenure, members – unable to fully appropriate the cash flow results of internal investment – would adopt a higher effective discount rate and underinvest (Furubotn 1976). Furthermore, due to the fact that initial members of LMFs are subject to expropriation by newcomers, there would again be an incentive to underinvest. In other words, incumbent workers cannot internalize the benefits from growth even if they bear the cost of growth. The conclusion to be drawn is that the design of LMFs is fundamentally flawed. The main surprise, however, is that they have occupied, and still occupy, the attention of so many economists to date (see Drèze 1989). There have been many attempts to remedy this flawed structure (see Bonin and Putterman 1987), yet none has succeeded in properly answering all of the above deficiencies.

Should the firm's shares and capital structure be valued and sold to employees, however, then the persistent perverse and inefficient character of the LMFs would vanish. This avenue was first explored by Sertel (1982), with further contributions by Dow (1986), Sertel (1987 and 1991), and Kleindorfer and Sertel (1993). In Sertel's system, any expansion of the membership list requires the approval of both newcomers and current members. Likewise, any contraction can only be realized if those who retire as well as those who stay give their mutual consent. Therefore, not only does the WE unanimously agree to adjust capital variable so as to maximize the value-added per worker, but also the size of the membership list is itself subject to the worker-partnership market. As such, "[a] deed price at which no sellers can find buyers and no buyers can find sellers will not only be an equilibrium deed price, but will also correspond to a rest point in the formation of the firm and to an equilibrium firm size" (Sertel 1987:1621).

Obviously, the issue of how efficiently this deed market would function still remains, and one may assume that imperfections similar to those which were mentioned in the case of capital markets are likely to repeat themselves. Parallel to what has been said above, however, it is possible to claim that an intermediary organization might facilitate the functioning of this deed market. Indeed, the experience of the Mondragon cooperative movement in the Basque region of Spain seems to support this claim. On an *a priori* basis, it should not be possible to claim the advantage of one type of market over the other. Two types of lessons may be drawn from the above. For one, the divorce of public firms from an ownership market could very well be the cause of economically

pathological behavior on their part, even if they were not subject to the politically valid favoritism syndrome outlined above. Furthermore, as WEs do not suffer from this divorce from an ownership market, or from any divorce of ownership from management, they may very well offer a viable alternative form of private organization and ownership structure for those public firms that might need to be privatized (see Sertel 1996).

The whole corrective and regulatory device of an ownership market is dispensed with when we place a firm under the vague public ownership of the citizenry rather than issuing tradable shares to citizens. By selling or giving shares to the citizens, for example by selling or giving shares to the employees of public firms, we can directly cure these firms of at least this one structural handicap. When government privatizes a firm, instead of issuing stock to the citizens and allowing them to trade, it may prefer to sell stock in their name, for the latter course allows the government to decide also on how to spend the proceeds of the sale. The citizens may, however, prefer to decide for themselves how to spend their own wealth; for public firms are, after all, the property of citizens. After having discussed the productive efficiency aspect of different ownership structures, let us now turn our attention to the issue of allocative efficiency.

When the operation of private industry is unsatisfactory due to imperfections in competition, two alternative forms of public intervention in regulating the malfunctioning of these markets seem to have been traditionally considered. One alternative is for the public to appoint a regulatory authority in charge of correcting such imperfections, with the aim of increasing the industry output to the level that would occur under perfect competition, and this with a menu of various tools to be applied. The second alternative is for the public itself to produce the output in accordance with said allocative efficiency criteria (Bös 1986). Although from a theoretical perspective the two alternatives should produce the same allocative outcome, the empirical evidence clearly indicates that publicly-owned firms are generally ready to undertake measures to enhance allocative efficiency (Vickers and Yarrow 1988). A third, hybrid alternative – "regulation by participation" (Sertel 1988) – aims at inserting public firms in an imperfectly competitive environment in order to prevent the monopolization of the market and the exploitation of consumers. The behavior of the public firm entering into an imperfectly competitive situation would influence the behavior of its competitors or fellow inhabitants in the industry, and its participation would thus have a regulatory effect on others. "A public enterprise is to be judged, therefore, not in terms of its own efficiency alone, but also in terms of its effect on the efficiency of the industry as a whole" (Sertel 1988:112). As we have mentioned above, this mechanism has been applied in the case of Turkey, correcting many allocative problems and

thus increasing social welfare. What is very striking in the privatization debate in Turkey is the almost total lack of reference to the regulatory function of the public sector, despite the fact that this institutional device has been especially important in this country.

Looking forward

If we were now to look forward as economic designers who understand the critical role of institution-building for the wealth of nations (as the old economists would call what we now refer to as "social welfare"), what general principles might we wish to lay out as guidelines for the future institutional design of this society? The choice of which particular institutional design one should prescribe is a highly technical question, and hence beyond the scope of this chapter. It is bound to remain a topic for debate over many years to come in a society like Turkey, which continually seeks self-improvement by conscious design. We should, however, ask for guidelines which say something about the major aims of legislation and its enforceability, and we should inquire as to whether there is anything special about Turkey which might alert us to the need for one attribute in our design more than others. In asking these questions, we should keep abreast of all historical, social and psychological information pertinent to Turkey.

In answering "What creates efficient institutions?", we should perhaps start by asking whether there is a possibility that Turkey's institutional structure may lack the formal enforcement structure that underpins efficient markets, causing informal activities to step into this vacuum. Such an informal structure would come with high costs, however, "because the lack of formal property right safeguards restricts activity to personalized exchange systems that can provide self-enforcing types of contracts" (North 1990:67). This surely constitutes one of the economic/institutional realities of Turkey, but its magnitude is hard to judge in the absence of research. In seeking how to build and enforce institutions, we should keep in mind the wisdom encapsulated in two Turkish sayings that embody relevant social and psychological background information. These two sayings reflect Turkey's setting of social values, traditions and expectations, in whose context institutional design must be contemplated:

(i) *Türk, tavsani kagniyla avlar*
("A Turk will hunt down a hare with an ox cart");

(ii) *Padisah yasagi bir gün sürer*
("The Padisah's prohibition will last but a day").

Two important lessons for the designer of economic institutions emerge from the above. It is necessary, first of all, to devise rules which are simple to judge,

because some legal processes, although they may ultimately catch the culprit, may take very long. Moreover, one must devise rules which are difficult to change and make sure that those who infringe such rules will be punished accordingly. These combine to imply rather mechanical, automatic, irreversible sanctions, leaving little room for human judgement, hence entailing little rent-seeking in courts. In other words, the plunder of common or private property will be discouraged if pardons are no longer available and offenders are actually prosecuted. However, there might be more to the issue than simply higher transaction costs. The totality of institutional constraints may define a set of payoffs to political and economic activity that would not encourage unproductive activity. As claimed by North (1990:67):

> With insecure property rights, poorly enforced laws, barriers to entry and monopolistic restrictions, profit-maximizing firms will tend to have short time horizons and little fixed capital, and will tend to be small scale. The most profitable business may be in trade, redistributive activities, or the black market. Large firms with substantial fixed capital will exist only under the umbrella of government protection with subsidies, tariff protection and payoffs to the polity – a mixture hardly conducive to productive efficiency.

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Driss Ben Ali

Economic Adjustment and Political Liberalization in Morocco

Introduction

In recent years, bilateral and multilateral financial agencies have continuously maintained that the existence of a democratic form of government is a necessary condition for the success of structural adjustment programs (SAPs). They contend that the sustainable growth of developing countries necessarily entails not only the redefinition of their priorities and the urgent implementation of economic reforms, but also political and institutional changes. In other words, the adoption of reforms under the structural adjustment program – such as fiscal reform, trade liberalization and privatization – presupposes a reorganization of the political structures needed for their success.

Some economists have misgivings about this thesis. They are quick to remind us – rightly so – that "when conveying this message, these agencies actually fail to acknowledge the counter-examples provided by certain countries where growth and structural adjustment have been successful, such as Chile under Pinochet, Taiwan and Singapore."[1] In reality, the political turmoil and attempts at democratization witnessed in developing countries since the implementation of the adjustment program call into question the relationship between adjustment and democratization and bring to the fore once again the old debate on the correlation between economic and political matters.

Developing countries such as Morocco – the object of the present study – are generally known for their political regimes of a neo-patrimonial nature, and the kind of profound economic liberalization advocated in the SAPs thus marks a radical departure. Insofar as SAPs entail the free market allocation of resources, the stability and guarantee of private property, profits and comparative advantage, they strike the neo-patrimonial regime characteristic of most developing countries at its foundations. Neo-patrimonial regimes are based on a model of resource allocation entirely controlled by the political establishment, which uses it as a means of garnering support and securing a clientele. In view of these ideas, the question remains as to the extent to which political leaders will be able to effectively handle economic reforms and the changes that such reforms require.

In other words, this notion brings to mind the correlation between economic efficiency and the degree of democratization. Indeed, several authors have noted that too much democracy may lead to populism and inefficiency. Not enough efficiency may hamper material progress, insofar as the lack of serious control of political power may lead the latter to an arbitrary allocation of resources, thereby stifling the process of economic development.

These global issues will form the basis of the present work, which departs from the assumption that even if SAPs increase the likelihood of changes in the current political system, such changes are neither automatic nor widespread. The example of Morocco illustrates this point of view. Over a decade after the implementation of the SAP, Moroccan society and its institutions are faced with two apparently conflicting types of logic: the old neo-patrimonial "Makhzenian" establishment, which seeks to share some of its powers even as it poses a certain resistance to market economic rationality, and a liberal and democratic political culture.

In reality, the structural reforms enshrined in the SAP, which began to be implemented in 1983, have not significantly affected the nature of Morocco's political regime. In some respects, they have even reinforced it. As in the past, the regime does not derive its *raison d'être* from popular will. It is the regime that sets the rules of the game and imposes them on the political class, which has no choice other than accepting them. The question that has constantly arisen in several analyses is the following: how has the Moroccan state been able to endogenize the new changes without undergoing a profound transformation? Our goal in this chapter is to show the impact of the economic reforms contained in the SAP on Morocco's political structures. At first, we will present the theoretical model that will serve as the foundation of the analysis. Subsequently, we will analyze the structures of the Moroccan state as well as the nature of its relations with society as a whole and with the economy in particular. Finally, the study will focus on the effects of adjustment reforms on the country's political situation.

The theoretical framework

Until recently, economists had shown very little interest in analyzing political institutions and their impact on economic activity. In particular, their attention had been limited to a study of the market, where rational individuals seek to maximize their utility and enterprises seek to minimize their costs and maximize their profits. When the state is mentioned at all, it is either to set its limits or to decry excessive intervention or lax management.

As a result, the prevailing view is functional and instrumental, whereby the state is looked upon as a body that guarantees the traditional functions of public service, furnishes externalities and supplements market deficiencies by means of taxes and subsidies. The socioeconomic environment (laws, customs, labor skills, the fiscal regime and government incentive programs, among others) is hardly taken into account in the analysis of a country's economic performance at the levels of development and growth.[2]

It is mostly the institutionalists of the new political economy that have

introduced these new factors and showed that the growth of a country entails not only the quantitative and qualitative upgrading of available technology, but also – and increasingly – the continuous upgrading of institutions and modes of organization. Seen in this light, the economy is not defined solely as a collection of manpower resources, equipment and natural endowments, but also as a collection of government, social and economic institutions, among others. In other words, the economy's efficiency and wealth will depend not only on the quantity and quality of available resources, but also – and perhaps most importantly – on the ability of its institutions to coordinate the various activities (decision-making, production, investment, exchanges, etc.) with efficiency so as to maximize the potential value of all the resources available and encourage agents to realize this potential.

Seen from this perspective, the rationale for public intervention entails at once the search for the economic goals to be achieved and the implementation of a framework capable of assuring the effectiveness of their application. The question then arises as to what strategy will maximize or optimize the actions of the state. The approach followed by some authors, particularly Ronald Findlay, is of special relevance in this regard.[3]

Findlay's approach

Findlay departs from a simple yet overwhelming observation: the vast majority of developing countries are characterized by an enormous gap between a strong and ominipresent state and a weak and fragmented civil society. Within this framework, the state functions as a tool in the hands of a minority, who make use of it to secure privileges for themselves. This minority is not defined by the possession or control of the means of production, as a certain Marxist view would have us believe, but rather by the monopoly of power and the control of the administration.

In order to grasp the nature of this kind of state, a large number of theoreticians prefer to look to Weber's typology of the "neo-patrimonial state." For Schwartzman, for instance, the neo-patrimonial state is characterized by a central government guided by its "own *raison d'état* and by feeble, passive and instrumentalized masses."[4] This type of regime is generally based on clientelism, cooptation and political favors. In this context, the actions of the state are subordinated to political reason, that is, the maintenance and survival of the regime. The latter seeks to extract as much as possible from producers in order to distribute some of it to those who support it, thereby leading to a rentier behavior that gives the state a predatory aspect. This kind of government has been subjected to criticism through the propositions embedded in the SAP. Indeed, the heavy indebtedness of developing countries and their limited ability to generate a growing economic surplus have severely impaired the

"distributive" abilities of existing political elites and thus forced the latter to move towards a relative rationalization of their economic management. By submitting these regimes to a kind of rationality founded on the free play of market forces, the accuracy of prices and economic efficiency, the International Monetary Fund (IMF) and the World Bank have forced them to abandon, at least in part, the neo-patrimonial logic of economic management.

In order to offer a coherent and dynamic explanation for this evolution, Findlay seeks a sufficiently flexible approach that allows him to seize the relationship between the productive and predatory aspects of such states. The productive role of the state is expressed in his model by the hypothesis according to which public expenditures on administration, infrastructure, law and order, justice, and so forth function much like "externalities" in the benefit of private economic activities, thus adding to their value and increasing their output. Hence, the goods and services made available by the state are viewed as intermediary inputs in the production of private goods.

From the analysis of the two aspects of the state – productive and predatory – we may derive a certain typology of states seeking to maximize either surplus or public expenditures. The case of surplus maximization seems to correspond to the traditional monarchies and dictatorships. Monarchies justify this maximization by means of the legitimacy of the rights of dynasty and succession. Operationally, the raising and redistribution of economic revenues are under the sovereign's authority, which conceals vague impersonal objective rules (the case of Arab monarchies).

The case of maximization of public expenditures conforms to authoritarian states dominated by the armed forces or by parties that need to justify the rules imposed on society by implementing apparently grandiose projects for which they seek to maximize the budget resources available so as to benefit as much as possible from them. Authoritarian states exploit civil society to a large extent. As far as these states are concerned, civil society has no significance and should not pose as a counter-weight to the ruling circle. Even if this is the case, civil society should remain ineffectual.

The state in most developing countries does not represent collective interests. Rather, it is an apparatus that uses its monopoly of legal coercion to maximize its profits. The fact that it has at its disposal a multifaceted natural monopoly enables it to benefit from vast economies of scale in the production of certain services, such as "security" and "justice." Yet, the nature of the "barriers to entry" represents a constraint that limits the ability of the state to use its powers in a predatory manner. In other words, the tendency of the state to expand or restrain its predatory power is a function of factors determining the likelihood of a potential usurping element. It is the threat of the emergence of a potential contestant that forces the powers-that-be to restrain their predatory

powers and pay heed to the general interest. From this observation we may conclude that the general interest is best served by a political situation of open competition. By the same token, a closed economy, inflation and an import substitution strategy whereby the state maximizes its revenues (or its surplus) through the overvaluation of the national currency seem more conducive to a predatory behavior.

The same sort of study that applies the economic method to the political analysis is undertaken by those economists that espouse the "Public Choice Theory." In this light, the state is viewed as an institution, the government as a community, and politicians, bureaucrats and other individual actors in the political process as pursuing each his/her own interests. At the core of this political model, voters are equated with consumers in the economy, and democracy with the sovereignty of consumers. The absence of democracy leads to the maximization of the surplus of producers – namely, politicians and bureaucrats – rather than the maximization of social welfare. This state of affairs is equated with monopoly.[5]

SAPs and political and economic change

We are then faced with the question of finding out whether or not the structural adjustment program leads to changes. The SAP is defined as the implementation of a set of economic policy measures aimed at reducing the permanent external deficit by means of a reduction of the internal deficit, as well as reforms intended to restructure the economy in the direction of large-scale liberalization and growing efficiency. The first dimension of the SAP – stabilization – is a process which tends, in the short term, to reduce global demand so as to bring it to a level compatible with internal and external equilibrium. It seeks to eliminate the surplus of final internal demand relative to GDP. The policy of adjustment seeks to correct external imbalances, including those affecting the current account. The stabilization program uses monetary and fiscal policies as its main tools. These are primarily short-term measures that do not affect the core of economic organization. It is mostly the reforms enshrined in the SAP that will exert a significant impact on the country's structures.

Structural adjustment is geared towards the medium and long term. It seeks to turn prices into an accurate reflection of scarcity and free competition. It also implies a change in the institutional context of economic activity through the implementation of an incentive regime for national as well as foreign capital, the reduction of the role of the state, and increased openness to the world economy. Here the goal is to act upon supply so as to increase it. In other words, the objective sought by the adjustment program can be subsumed under three types of measures:

(i) Measures to improve resource allocation;
(ii) Measures to improve resource mobilization;
(iii) Measures to increase the opening of the economy.

This set of measures constitutes what we generally refer to by the label "economic liberalization." In sum, the adjustment program forces the economies of developing countries to make a complete turnaround by reexamining the role of the state; by stressing the need to redefine development priorities, such as the elimination of unprofitable activities and the promotion of privatization so as to raise the efficiency of production units through better allocation of factors of production; and by upgrading the political and legal cadres influencing economic activity. These reforms, based on the accuracy of prices and the elimination of all constraints to the free play of market forces, are predicated on competition and transparency in the economic sphere, and hence on a reassessment of the rent-seeking activities that characterize most developing countries.

In reality, structural adjustment forces developing countries to redefine the mechanisms through which the current system operates and to focus on economic rationality. As a result of the need to rationalize the economy and increase its efficiency, the "dirigisme" of the state must make way for private initiative and individual entrepreneurship. Likewise, the distribution of favors, rents and privileges so characteristic of developing countries must be replaced with individual responsibility, the rights of consumers and efficiency through competition. Indeed, the idea behind adjustment leads to the implementation of a system of resource allocation based on profit and the stability of private property. From this point of view, it entails a radical departure from the existing system, which is marked by the arbitrary allocation of resources stemming from a discretionary power anchored in clientelistic foundations. In short, adjustment tends to substitute economic logic for political logic by releasing the economy from the vagaries of rulers. According to this logic, the citizen of a country undergoing these transformations would become less and less of a "subject" and more and more of a "demanding shareholder," which again bears witness to the close links between politics and economics. In a word, structural adjustment requires coherence (and harmony) in a well-founded equilibrium.

Parallel to the above changes, the political game – much like the economic one – relies on market rules, that is, on political confrontation in accordance with the norms recognized by agents (competition, multiple means of expression, fluidity of information and equality of opportunity). Political actors are thus faced with rational voters. Individual liberty is the price of the conflict between order and movement. It is in the play of interactions between these two elements that individual liberties – both public and collective – are

realized. At the heart of liberal thinking one finds this double requirement: the autonomy of civil society and the neutrality of the state.

In the liberal system, nobody determines the material conditions in which individuals live, their activities or their rewards. Only the market as a regulating entity is in a position to do so. In the political domain, the equilibrium point between supply and demand is the vote, which prevents human power from claiming a central position from which it could determine the conditions and activities of others. Rights and duties are obtained through political contests and by means of specialized organizations (parties, trade unions, associations, etc.). The latter function as counter-weights, allowing different social forces to make their interests and aspirations prevail. In a word, it is not the powers-that-be that impose a structure on society. Rather, society spontaneously generates its own order, and the political establishment vows to uphold it.

Political liberalism leaves no room for a state to control the whole of social life. The state must remain neutral as regards political competition among actors and must safeguard adherence to the rules of the game. At the same time, it must rationalize its own management by trimming public expenditures and eliminating administrative regulations that prevent market mechanisms from operating freely, and it must limit public control over private activities. The inputs chosen by government decision-makers must uphold competition, transparency and equality of opportunity for agents. For those who subscribe to political liberalism, state intervention, even when it has as its "goal an ideal of substantial distributive justice, necessarily leads to the destruction of the state of law."[6] Only an action undertaken by someone and resulting from his/her will and choice may be labeled "just" or "unjust." The inequalities stemming from the confrontation of individual wills in the marketplace must be understood as the result of liberty or, more exactly, of the different uses that individuals choose to make of their liberty. Accordingly, the effects of competition on individuals must not be labeled "just" or "unjust."

Freedom thus becomes a non-ethical and non-political concept. It is not a "value" in itself, but rather the outcome of a slow process of historical maturation, of a true social rationality. Hence, liberalism is not a model which may be applied to just about any society. Under these conditions, the market itself is not a natural state, but rather a "cultural state,"[7] and a "very delicate human construct which, in order to emerge as well as assert and develop itself, requires tremendous efforts."[8]

Definitely, the ideal type of liberal state rests on two principles. On the one hand, it calls for the principle whereby competing social groups vying for the fruits of public policy organize themselves independently of the political

system. On the other hand, it reduces the state apparatus to the simple status of a tool used by a political will that is external to it.

In conclusion, adjustment is essentially a proposition tailored to address a situation of structural crisis. It necessarily calls for a reorientation of existing trends, and probably even political changes. A formidable change is brought about by the fact that adjustment entails at one and the same time financial equilibrium through economic reforms, the rationalization of the economy through the creation of more flexible economic structures readily adaptable to external constraints, the reduction of social costs, and the design of a new kind of development program. However, it remains to be seen whether adjustment is sufficiently deep to trigger substantial political change. For instance, Stephen Haggard and Robert Kaufman have noticed that out of 23 developing countries hit by the debt crisis of the 1980s and subjected to adjustment, only five have made the transition from an authoritarian regime to a democratic one, while the other 18 countries witnessed no political changes.[9] As a result, the correlation between economic reform and change has survived the crisis. To be sure, after the end of the 1980s – particularly after the fall of the Berlin Wall and the end of the Cold War – pressure from Western industrial countries have led several developing countries to streamline their regimes and to implement relative liberalization of their institutions, but this tendency bears little connection with the SAP.

Thus, even if one accepts the hypothesis according to which the crisis impinges primarily on those who hold power, there is not enough proof allowing us to establish a clear link between the magnitude of economic reforms and changes in the regime. A more probing analysis is necessary, based on the need to recognize multiple avenues and to take into account different stages and delays. It all depends on the nature of current political institutions and the actors that operate them. In other words, one needs to understand the effects of ongoing economic changes and how new social regulations are designed.

Addressing this major difficulty underscores the importance of the process of democratization in the course of political development. By referring to the experience of certain Western industrial countries, the democratization of political institutions may indeed appear as a major variable in development. In particular, that was the case of Holland and England starting in the 17th century, of the United States and France in the 18th century, and of a part of Western Europe in the 19th and 20th centuries. However, one is faced with ambiguity when reviewing the situation of developing countries and of recently-developed countries. Here, reality does not validate the European experience. Even in certain European countries, such as Germany under Bismarck in the 19th century and Spain under Franco in the 20th century, development has evolved under authoritarian regimes. As for today's Third

World, the results offer even less support to this thesis. For instance, democratic regimes such as that of India have had a worse economic performance than authoritarian regimes, as in China. The same applies to South Korea and Taiwan, which are now successful examples of economic development yet are far from being examples of democracy and respect for human rights.

In the view of certain authors, these observations mean that authoritarian regimes may be more capable of successfully undertaking reform than democracies. That may be the case, on the one hand, because authoritarian regimes are better equipped to control interest groups and thus prevent them from forming alliances with the aim of either opposing reform or using it to their own benefit; and, on the other hand, because such regimes have the advantage of lasting longer. Several economic reforms, such as the liberalization of foreign trade, the privatization of public enterprises and fiscal reform, require a long time frame to be able to bear fruit. Otherwise, if limited to a short time horizon, these reforms may incur high costs. Examples of this situation abound. Such is the case, above all, of the so-called "military-bureaucratic" regimes of Latin America (Argentina in 1966 and 1976, Brazil in 1964, Chile and Uruguay in 1973), as well as Indonesia (1966), Turkey (1971) and the economies of East Asia and contemporary China. Nevertheless, these examples do not amount to a rule. They may be contradicted by examples of authoritarian regimes which are deeply influenced by interest groups and often corrupted by them, since they are constrained neither by real "counter-powers" nor by an autonomous civil society. This is notably the case of the Philippines under Marcos, Haiti under Duvalier, Zaire under Mobutu, and so forth.

As a consequence, there is no one single general model that could allow us to formulate certain rules. Rather, what is most evident is that every concrete strategy of reaction to the crisis has been the outcome of a series of political decisions expressing the makeup of power relations and conflicting interests within a specific economic and social context. In other words, the liberal ideas embodied in the SAP themselves have no power independently of the human actors charged with their implementation. Hence, one must transcend the democracy-authoritarianism dichotomy and analyze the ability of the powers-that-be to survive and resist change, their capacity to adapt, and the social forces that may be mobilized in the interest of promoting democracy. Under such conditions, one may wonder whether the traditional state would be in a position to accept the reforms contained in the SAP and how it would internalize exogenous elements oftentimes alien to its own rationality. The study will proceed at first to analyze the nature of such a state, and then to examine the impact of the SAP on its structures.

The nature of the Moroccan state

Those who wish to know Morocco and are interested in its history will notice that this is a country with a unique identity in the Arab world and in the Maghreb. The fact that Morocco began to form its identity in the 9th century, consolidated it in the 16th century, and preserved its sovereignty from Ottoman rule during roughly four centuries accords the country the status of an old nation. Still today, even though conditions have changed, Morocco continues to uphold this heritage even as it modernizes.

It is from this long historical evolution that the "Makhzen" (the Moroccan state) derives its existence and its legitimacy. The Makhzen is not the contradictory outcome of colonization and the struggle engendered by it, as is the case in so many Third World countries. On the contrary, it has a history dating back many centuries in which it inscribes its legitimacy and *raison d'être*. Its historical and political origins largely explain its roots in the reality of the country. Born out of Moroccan society at a given point in its history, the Makhzen is endowed with a trans-historical legitimacy enshrined in the foundations of local society and anchored in the psyche of the Moroccan masses, who recognize its ability to embody the unity of the nation and to use certain religious symbols on the nation's behalf (the King being at the same time the "Commander of the Faithful"). This long history has enabled the Moroccan state to accumulate a stock of knowledge about social matters that ensures its effectiveness in the country's political life.

Rather than altering this historical legacy, colonization actually reinforced it. Indeed, even though it dismantled the old social order, the colonial process did not block the historical transition of the community towards civil society. On the contrary, colonization created the conditions for the birth of civil society through the development of a merchant culture and, above all, by destroying the centrifugal powers of tribes and *zaouias*. By making the center the main organizer of society, colonization brought about a change as formidable as the birth of the nation-state in Europe. Due to its technological and military superiority, its means of communication and information and its administration, colonization centered all powers around the state and even managed to effect some sort of national integration. As a result, the state has become omnipresent, entering the social realm with a view to controlling the reproduction of society. To its ideological hegemony and traditional legitimacy the colonial state has added the technological and administrative means necessary for the institutional strengthening of the state. Consequently, at independence the Moroccan state took over power on the strength of three favorable factors: tradition, state centralization and national claims. Independence allowed the state to increase its scope of intervention and to spread its activities to new

spheres. It was no longer merely the guardian of the social fabric, but rather the engine behind the economy and the promoter of civil society.

After a transition period (1956-1960) during which the ruling circle and the opposition reached a compromise while waiting for the balance of power to tilt towards one or the other, the period between 1960 and 1972 was marked by overt confrontation. At the end of this period, the Makhzen succeeded in reclaiming the power of control and arbitration that ensures its hegemony over society. Thanks to the reconstitution of traditional networks in the countryside, the rekindling of vertical solidarities in the rural environment, the reenactment of the old politics of notables in the city, and the appropriation and consolidation of the bureaucratic apparatus, the Makhzen was able to weaken the national movement, isolate it, and subject it to its own rules of the game.

In the economic arena, the principles of economic independence, reform and change were swept under the rug. Attachment to economic liberalism was upheld with enthusiasm, and the 1960-1964 Plan, viewed as the expression of the will to change, was abandoned after six months. The industrial option was relegated to a secondary role, and agriculture became the foremost priority of development. Nonetheless, agrarian reform and limits on property were no longer considered as goals. Political measures with regard to the rural environment consisted of appeasing popular claims through the distribution of means of subsistence rather than the incorporation of villagers into a policy program geared towards change.

In order to deflate conflict situations and maintain the rural environment in a state of neutrality – indeed, indifference – with regard to the political struggle pitting the monarchy against the "Istiqlal" and UNFP Parties, the Makhzen sought to reactivate the mechanisms through which the colonial administration had once ensured the submission of individuals and guaranteed social peace. Thus, it rebuilt the traditional networks dominated by rural elites and secured for itself the control of the administration. By forging a rupture in the traditional social edifice without achieving its reconstruction on new foundations, the Protectorate gave birth to a fragmented society, incapable of producing a hegemonic class. As a result, after independence Morocco inherited a social fabric where vertical allegiances were still dominant yet no one particular power was in a position to impose its control on others and thus act as an engine within society.

This fact was used by the Makhzen to prevent the emergence of horizontal coalitions by replacing them with vertical solidarities, a process which Pascon (1977) has called "the segmentary legacy."[10] This was accomplished by breathing life into pre-colonial structures founded on ethnic and kinship lines, and by subjecting them to the control of rural elites in a milieu marked by clientelism and allegiance. The whole of rural society came under the

domination of notables, who were thus able to ensure social cohesion and peace. These notables relied on an economic foundation (large estates, cattle, hydraulic resources) and their belonging to certain families to impose their power on rural dwellers, influence their behavior and speak on their behalf; for the peasantry, as noted by Pascon, "does not express itself directly as an organized social class, but instead permits others to speak on its behalf, simply because it has not built a political identity."[11] In exchange for their support and their contribution to social peace in the countryside, the notables were awarded a number of concessions and benefits by the central power.

Starting in 1960 Morocco was cast in the official discourse as a country with an essentially agricultural vocation, and state policy with regard to the countryside, from that point on, became a function of a principle proclaimed at the time by the state's highest officials as such: "To enrich the poor without penalizing the rich." Clearly, the state did not intend to act upon agrarian structures, but rather on the methods and level of production. Such notions as agrarian reform, the transformation of landowning structures and other terms reminiscent of change were banned from the official discourse and replaced exclusively with more reassuring notions, such as agricultural reform, improvements in production and other more appeasing arguments of a technical and economic nature. This new trend was not difficult to be adopted; for the peasantry, having played but a marginal role in the struggle for independence, was not able to pose as a political force to reckon with in the aftermath of that process. Hence, its interests were not a political priority, and only the progressive wing of the national movement made it one of its goals. As a result, the *status quo* was upheld and largely crystallized through the convening in March 1964 of an "Agricultural Colloquium" whose objective was to determine the direction to be followed and in which the vast majority of delegates posing as rural representatives belonged to the big landowning families.[12]

This orientation in favor of large landowners found an extension in the *laissez-faire* policy applied to colonials. The entire 1956-1974 period was marked by the freedom of transactions, accorded to nationals as well as foreigners. This freedom, which was total from 1956 to 1963, was limited by the *dahir* of September 1963, which subjected to control all transactions in rural property involving a foreigner. However, this *dahir* had a limited effect. As many other laws, it worked as a filter, blocking small owners and favoring the largest among them. To be sure, state control was exercised, but in the sense of selecting transactions perceived as beneficial to a clientele whose support, as in the past, the regime wished to secure through land tenure benefits.[13] Thus, out of roughly one million hectares of land previously held by colonials so as to promote official and private colonization and viewed as forming the basis for agrarian reform, an estimated 450,000 to 500,000 hectares were transferred directly from colonials to private Moroccan citizens between 1956 and 1974.

during that period fell short of that of other LDCs (such as Mexico and Brazil), especially those in East Asia (Japan, Korea and Taiwan). As can be seen from Table 1, it was not until the period between the mid-1970s and mid-1980s that the Egyptian economy grew at truly impressive annual rates close to ten percent in real terms, thus outpacing the growth of almost all other developing countries in the sample in the Table.

Table 1. Comparative Growth Performance in Some Selected Developing Countries, 1950-87 (average annual growth rates)

	1950-1964	1964-1973	1973-1979	1979-1987	1950-1987	1964-1987
Korea	6.1	9.6	9.0	7.0	7.6	8.5
Taiwan	8.3	11.0	8.4	7.4	8.8	9.1
China	5.2	6.9	5.0	9.3	6.5	7.2
India	4.3	2.7	3.4	4.6	3.8	3.6
Egypt	5.3[1]	3.4	9.5	8.6	n.a	7.0
Brazil	5.9	8.1	6.5	3.5	6.0	6.1
Chile	4.2	2.8	2.3	1.6	3.0	2.2
Mexico	6.2	6.6	6.1	1.7	5.3	4.7
Austria	5.5	5.1	2.9	1.7	4.2	3.3
Italy	5.7	5.1	2.6	2.2	4.3	3.4
Japan	9.5	8.9	3.6	3.8	7.1	5.7

Source: Calculated from Maddison (1989), Tables B-3, B-4, and B-5, Mabro and Radwan (1976), Table 3.2, and Ministry of Planning (for Egypt).

Notes: 1. for 1952/53-63/64

As explained above, this impressive growth was associated with two major developments: on the one hand, the increase of foreign exchange earnings from external and rental sources, such as petroleum exports, Suez Canal duties, migrant workers' remittances, tourism income, and external aid (see Chart 1 below) and, on the other hand, the implementation of several partial liberalization packages (including the ODP). It can be argued, however, that these windfalls ultimately represented a lost opportunity, because they were not utilized in such a way as to lay the foundations for sustainable growth and make the economy less vulnerable to external shocks. Indeed, the observed high growth does not account for the whole picture, but conceals some important adverse structural developments, as seen in the fact that, when oil prices collapsed in the mid-1980s, so did the growth rate (to only 4.2 percent in the period 85/86–91/92).

By the end of the boom in the second half of the 1980s, the Egyptian economy was far more dependent on external factors. During the period from 1974

became the "Union Nationale des Forces Populaires" (UNFP). Subsequently, it succeeded in isolating the latter and in forestalling its participation in the management of public affairs. The end result was the marginalization of the political parties, complete confusion regarding political tendencies and the strengthening of the state, the most apparent manifestation of which was the enactment of the state of exception in 1965, constituting "the supreme legal form of the strengthening of the state apparatus."[18]

At a subsequent stage, the state proceeded to depoliticize the administrative corps. This depoliticization was ushered in through the elimination of local authority agents suspected of sympathizing with nationalist parties. The design of a code regulating the appointment of Interior Ministry agents is quite illustrative of this point of view. By presenting the code of authority agents in the form of a guide, those responsible for drafting it were able to state the following: "Historically, in the period following Independence, most authority functions were vested in the militants of political parties and organizations associated with national resistance. However, after 1963, with a view to depoliticizing its corps, the Ministry of Interior, due to the discretionary power that it wields on the basis of the establishment of the aptitude list for the recruitment of its own cadres, may eliminate every individual too closely associated with a political organization."[19] As a consequence, both local and national administrations became the sole preserve of the Makhzen, as their positions were assigned to individuals loyal to the state.

The presence of the state in the economic sphere reflected its vocation to circumscribe all segments of society and, as a result, to preside over the process of formation and expansion of social classes. Already in the first few years after independence, access to favors from the state became a necessary condition for success in business and contributed to the consolidation of state control over the economy.[20] This was something that powerful urban families quickly understood, as they sought to place, right after independence, some of their own members or individuals whom they trusted in key positions in the administration. This process was facilitated by their education and social status. In fact, this social class – whose ascent had begun in the 19th century through their control of commercial networks and their attachment to the Makhzen – benefited in no small measure from the training and education policies adopted under the Protectorate, which promoted what came to be known as schools and *lycées* for the sons of notables and thus endowed this class with the kind of education needed to conduct the management of the state's technical and economic services.

Hence, it is not surprising to find that important agencies and key economic positions in the administration were in the hands of certain urban families in the years following independence. This trend was actively encouraged by the

Moroccan state, which adopted it as part of its strategy to restructure society so as to assure itself of a wide social foundation. Consequently, the 1960s were characterized by the state's attempts to affirm its liberal option and abandon all policies geared towards economic independence. Several official pronouncements illustrate this choice. For instance, in 1967 the Ministry of Finance declared: "Morocco has chosen the strategy of liberalism. In this field, it will serve as an example to all of Africa." Significant in this regard was the ideological and political importance that the Makhzen attached to the support provided by the commercial bourgeoisie and urban notables. Throughout the 1960s, state economic policy was inspired by economic liberalism and oriented towards the development of import-substituting industries.

Measures of an institutional nature were adopted in order to encourage these families to accumulate wealth (tariff protection for local industries, subsidies and fiscal facilities, the creation of agencies to intervene and offer easy credit to industrial enterprises, etc.). Moreover, the state offered them a vast outlet for their products. Indeed, the rise in administrative expenses, the renewal of equipment and the revival of consumption by the middle classes through the distribution of government and public sector salaries in the broadest sense contributed to turn the state into a colossal market. Under such conditions, it is easy to understand why the strategic links between these families and the political establishment were profitable in and of themselves, since they allowed the former "to occupy a privileged position on the list of suppliers sought by the administration or its enterprises."[21]

As an offshoot of this state of affairs, Morocco's urban bourgeoisie developed rapidly in this period, during which investment was dictated by the interest of some entrepreneurs in their own old closed companies, by participation in foreign enterprises, and by the creation of small production units in light industry. It is thus quite clear that the economic policy of the Makhzen benefited the whole urban bourgeoisie – most notably its commercial segment – through at least two measures: (i) the creation of an institutional framework favorable to private initiative and (ii) the awarding of favors such as import licenses, credit facilities on a preferential basis and access to public markets. Hence, it is hardly surprising to find a high concentration of Moroccan capital towards the end of the 1960s. This concentration was at the origin of the birth of Morocco's private economic groups, and reveals the high profitability of the fraction of capital invested.[22]

In sum, from the very beginning large urban families – being an important source of support for the government – found themselves placed in strategic posts intersecting various areas of interest, such as familial/statist, indigenous/foreign as well as local/national, from which they derived substantial benefits. Taking advantage of the climate of uncertainty and hesitation in the

years after independence, their control of a large part of the bureaucratic apparatus of the state and the latter's complacency regarding their activities, these families constituted *de facto* lobbies, thereby replacing the old tribal *assabiya* with another form of *assabiya* better suited to the situation in modern Morocco so as to monopolize and centralize strategic information, accumulate wealth, build significant fortunes and take the place of foreign capital.[23]

The 1960s were marked by the consolidation of central power. The conflict that pitted the latter against the political parties eventually led to an assertion of monarchical power and the triumph of conservative options. The choices made at the start of the post-independence period – which focused on reclaiming decision-making centers, regaining control over key sectors of the economy and parting with the orientations pursued in the colonial period – paved the way for the ascendancy of liberal options and, in agricultural matters, for the model conceived and implemented under the Protectorate. Two important outcomes of such choices were to make "the Moroccan 'fellah' a defender of the throne"[24] and to turn the traditional urban families into its supporters.

However, this decade ended with the crisis of the socioeconomic model implemented since 1960. This development model had brought about the concentration of land in the countryside, rural exodus, rapid and chaotic urbanization, and runaway demographic growth. Furthermore, the development of social and regional disparities (such as urban per capita consumption 2.3 times higher than that in the countryside, compared with a previous level of 1.7) exacerbated social cleavages and jeopardized the political legitimacy of the regime, as witnessed by two coup attempts in July 1971 and August 1972. The state was then faced with the all-important question of devising the best policy with which to rebuild its social base as well as design and implement a new pact.

Naturally, it was by correcting its economic path that the state sought to mitigate inequalities and insert itself again in the dynamics of society. On the one hand, the state enlarged its support base by widening the reach of public finance and, on the other hand, it attempted to organize a more collective mode of participation. Numerous resources were mobilized at the core of the national socioeconomic arena in order to give rise to a new social pact. The political discourse of the 1960s emphasizing the country's agricultural vocation was replaced with another type of discourse focusing on the role of industry as the engine of the economy. In fact, the evolution of the economic role of the state (incentives, intervention, participation) signaled a progression in these new relations. The 1973-1977 Plan was the mirror image of the new orientations in state policy. Breaking with the moderate growth which had prevailed thus far and the financial and monetary prudence which underpinned it,

the Plan was geared towards a more dynamic and voluntarist economic policy than had been made possible by the phosphate boom. Overall, three pivotal measures stood at the heart of this new strategy: (i) the distribution of land previously held by colonials; (ii) "Moroccanization"; and (iii) the expansion of the public sector.

Agrarian reform

The agrarian reform promised right after independence was not followed through in any concrete fashion during the 1960-1972 period. However, it served as a political tool in the hands of the state, which used it as bait vis-à-vis certain segments of society, either as an alternative always available or as a method of dissuasion. In all, throughout the entire period agrarian reform remained a future project which the state held as an inducement towards both the rural environment and the opposition in order to curry their favor, as well as a "sword of Damocles" held over the heads of large landowners in order to secure their allegiance and support. That is the reason why earlier measures to reclaim colonial lands (September 1963) led to very limited – indeed, symbolic – distribution. In other words, "in the absence of tangible social effects, economic profitability or political interest, land distribution within the framework of agrarian reform appeared symbolic and ritualistic: an artificial initiative undertaken in September which allows the state to show, at least once a year, its solicitude with regard to the little people."[25]

It was not until the military putsch attempt of July 10, 1971 that land distribution gained momentum. Similarly, it was not until the attempt against the royal plane on August 16, 1972 that the ruling circle decided for a rather impressive land distribution program,[26] coupled with the promulgation of the March 3, 1973 *dahir* on reclaiming the whole of foreign agricultural land. Thus, in 1972 Morocco witnessed the distribution of roughly 91,000 hectares, corresponding to an area similar to that which had been distributed from 1956 up to that year. Likewise, the lots distributed over this decade (reflecting the new orientation towards agro-industry) constituted an area more than six times larger than that of the lots distributed formerly. In this regard, it is estimated that, during the 1973-77 period, land distribution reached 400,000 hectares in five years, corresponding to an area ten times larger than that which had been distributed between 1956 and 1970.[27]

Over and above the legitimacy constraints that became imperative after the events of 1971 and 1972, land distribution was part of the implementation of the new social pact. Through this initiative, the state sought to widen its support in the countryside as well as maintain the equilibrium threatened by the massive inflow of rural dwellers to the cities and its possible consequences. This initiative was facilitated by developments in the countryside

itself. At least two new factors made this policy possible. On the one hand, land concentration and the development of wage labor led to a shift in traditional links and reduced the social base available to rural elites. The sheer expansion of their properties meant that landowners eventually lost touch with the *douar*, and this was especially the case of large landowners who had become export-oriented agro-industrialists and thus no longer lived in the countryside. On the other hand, the state strengthened its power over the tribal system. Having completely dominated the whole system, the state apparatus substituted its own administrative agents for the rural elites.

"Moroccanization"

The "Moroccanization" program embodied in the *dahir* of March 2, 1973 may be viewed as a fundamental measure in the definition of a new social pact. It aimed at fulfilling the expectations of a rising bourgeoisie. In view of its position within the state apparatus or its proximity to it, the Moroccan bourgeoisie acquired a "strategic rent" that enabled it to amass considerable wealth and glide through the first phase of accumulation. At the turn of the 1970s, private Moroccan capital already seemed quite well structured. Its speculation practices were relatively coherent, and its monopolistic or oligopolistic positions as well as the relations of domination characteristic of its level of development were equally in place, well-functioning and capable of reproduction despite the weaknesses and shortcomings common to a developing economy. This reality showed that a new dynamics was necessary for attaining a given redistribution of internal economic powers and between foreign and local (mostly private) capital. It became clear that the dynamics of private accumulation could only reproduce itself and gain increased impetus by deepening past structures, which were already fairly advanced at the start of the 1970s. This is what led political leaders to state that "Moroccanization" meant neither nationalization nor etatisation. Rather, it was placed on the right of the basic options available to Morocco, a country which "chose, immediately after gaining its independence, the liberal option through which to organize its social and economic development: 'Moroccanization' will accurately reflect the spirit of continuity, and it will not undertake a reassessment of the liberal options chosen once and for all."[28]

Thus, the question arises as to what "Moroccanization" actually meant at that particular stage of the country's social and economic evolution. Even though some arguments were presented (a revival of private investment, which had lowered considerably, and the weight of revenue transfers to foreign markets), "Moroccanization" should be analyzed neither in economic terms nor as a factor of growth. It is, above all, a political theme. It is also confusing to believe in a single national dynamics; for "Moroccanization"

entailed a well-defined process of social stratification. Private capital relied on the state apparatus to consolidate its position and redefine its relation with foreign capital, giving a new direction to the association/substitution dynamics between foreign and Moroccan capital. This new equation did not necessarily lead to contradictions between dominant national interests and foreign capital; for a large part of the latter followed a logic of profitability rather than a strategy of long-term integration and creation of an industrial network. This equation signaled a new stage in the relations between Moroccan and foreign capital. From the perspective of the former, it meant the start of an era of interdependence, in which the Moroccan bourgeoisie acted as a partner to foreign interests. This was demonstrated by Saadi on the basis of a survey of 102 industrial enterprises. In most cases (67 companies, representing 50.5 percent of "Moroccanized" capital), "Moroccanization" assigned real decision-making power to Moroccan – mostly private – capitalists in their respective enterprises.[29] As a result, "Moroccanization" fostered financial concentration to the benefit of certain Moroccan families and a segment of the state's high officials and managers.[29]

"Moroccanization" favored the concentration of capital and provided impetus to the dynamics of industrial groups. Morocco's industrial groups and holdings were nurtured and reinforced through the application of a policy of incentives designed to diversify investment tools. It would be interesting to note that the credit facilities made available by the state to natural persons only contributed to a small fraction of the total volume of capital involved in the operation. The latter was expected to amount to 330 million dirhams. Yet, recourse to credit only amounted to 56 million dirhams for 577 approved applications, and even then only 48.5 million were actually disbursed, corresponding to 14.7 percent of the total.[30] This was due to the fact that 71 percent of Moroccan enterprises were incorporated by artificial persons. In light of the foregoing figures, it seems that "Moroccanization" has led to concentration. This has been confirmed by Saadi in his study of Moroccan financial groups. He has noted that "the 'Moroccanization' of management seems to have been implemented by and benefited a minority of Moroccan capitalist families, about 36 in number, who gained control over roughly 220 million dirhams, representing 64 percent of the capital involved in the process."[31]

Another class to benefit from "Moroccanization" was that of the upper echelons of the administrative bureaucracy. This segment of society benefited from "the opening of opportunities offered to talented individuals so that they could thrive in sectors that had thus far been closed to them by virtue of financial, technical, educational or simply corporatist barriers."[32] Evidence shows that the state's new stance led to its appropriation of part of Morocco's private capitalization process by transforming the high administrative bureaucracy

into a state bourgeoisie. The latter's role as representative of a state that dominated the economy and contributed – directly as well as indirectly – to economic activity set it clearly apart from a merely executive and strictly administrative bureaucracy. By holding both management and decision-making posts in the course of 18 years after independence, the bureaucracy succeeded in prospering under the shelter provided by the ruling circle and in close association with it. During this process of development at the core of the state apparatus, this social class – which has been referred to as "techno-bureaucracy" – imposed itself as a partner claiming its share of economic power.

Hence, ministers, high officials and public enterprise managers benefited from "Moroccanization" by implanting themselves in certain sectors, consolidating the position of their families and forming their own economic groups. This was especially the case of the "Société Nationale des Produits Pétroliers," "Zellidja" and "Lessieur."[33] By playing a role in the new alliance supporting the ruling circle, this class was invited to share in the fruits of "Moroccanization."

In a nutshell, it seems that the role of the state was crucial: it helped structure the Moroccan bourgeoisie and forged a new equilibrium by incorporating new tendencies. In addition, it acquired a new center of gravity by subjecting the big bourgeoisie and the techno-bureaucracy to its own control. Thus, the Makhzen seems to have excelled at what it can do best, not so much as a mediator between two opposite forces (foreign industrialists and Moroccan entrepreneurs), but rather as a place for the creation of social classes and the formation of new alliances. The actions of the state were predicated on a certain logic aimed at consolidating its social base, seeking greater cohesion among the latter's components, and controlling the spontaneous emergence of a local business environment.

Investment growth and public sector expansion

The 1970-76 period was marked by the extension of the public sector and the acceleration of a phenomenon known as filialisation, or "subsidiarization." Between 1969 and 1976, the number of public enterprises rose by roughly 47 percent – from 156 to 230 – and the value of stock increased twofold – from 12.36 billion to 25.1 billion dirhams.[34] This expansion was reflected in the growing importance of public capital in almost all branches of activity. There are three reasons for this phenomenon: (i) the availability of fiscal resources following the growth of phosphate production and the state's eagerness to raise the annual growth rate to seven percent, which turned the public sector into the spearhead of this policy; (ii) the logic of the system in and of itself, which led to extended state participation (due to the benefits enjoyed by those close to the state, the absence of management accountability, and guaranteed

protection to all measures sanctioned by the state); and (iii) the need to reinforce and consolidate private capital.

Reassessing the role of the state in the early 1980s

The late 1970s and early 1980s witnessed a radical reassessment of the role of the state as an economic actor. After so many years in which the state had the mission and – one might add – the duty to lead the country's development, organize economic activity, mitigate uncertainties and constraints, correct market imperfections and ameliorate social injustices, criticisms began to be leveled against a "sick" state suffering from hypertrophy, bureaucratic inertia, economic and financial irresponsibility, and excessive legal formalism.

Indeed, even though it had opted for a market economy as far back as the 1960s, the Moroccan state remained omnipresent in the country's economic life. In addition to its traditional prerogatives (such as levying taxes, building infrastructure, as well as minting and managing new currency), the state played a key role as Morocco's foremost entrepreneur, employer and banker. In a word, by virtue of the reach of its activities, the state covered almost all economic spaces. It was not a "modest state," as would have been required by the liberal doctrine. Rather, its effective omnipresence ensured the regulation of society. Overall, the incipient nature of private capital over the first two decades after independence and the weakening of social structures were the two main reasons for society to have remained "glued" to the state. For some – notables, politicians, bureaucrats – the state was a "cash cow," and it was necessary to extract from it wealth to be accumulated (such as all kinds of exemptions, tariff protection, fiscal fraud, etc.). By contrast, for the vast majority of the population, the state was the "wet nurse" that had to ensure the availability of subsistence goods to large echelons of society, mainly the poorest among them (through price controls, the subsidization of staple foodstuffs, assistance to peasants in periods of drought, and so forth).

The economic dynamics was often relegated to a secondary role in order to make room for political considerations. To uphold its autonomy and ensure its own reproduction, the state brought under its control all economic activities associated with the sectors that it sought to champion. This behavior subjected the public sector to a strategy centered around the maintenance of the existing political system. The latter imbued its actions with an essence that transcended the economy and overregulated the political game. In view of this logic, it subjected the activities of the public sector to rules stemming neither from the market nor from the price system. No attention was focused on the maximization and optimization of production. The sheer continuity of the Makhzen created a time horizon that was anathema to both optimization and maximization.

Evidently, the Makhzen managed the economy through a neo-patrimonial logic, in the sense that its goal was not only to increase capital, but also – and perhaps more importantly – to transmit property. As a consequence, the state needed to find support in a network of clients, distribute privileges, handle diverse interests, and create rent-seeking opportunities that eventually led to distortions and imbalances. Within this framework, the public sector was perceived as a tool to be mobilized in order to structure and restructure the country's economy on the basis of the contradictions of the moment and of economic pressures related to the need to forge new relationships in accordance with the modern organization of economic activity, and to normalize such relationships by integrating newly-emerging classes, such as the technocracy.

From the very beginning, public enterprises were charged with promoting and integrating this new social class, making material advantages available to them in such a way that most quickly embraced the cause of the Makhzen. In addition to economic incentives (high salaries, housing, cars, servants, etc.), the technocracy was awarded administrative power – a highly fluid commodity in a country like Morocco. For instance, it has been found that the highest salaries were paid to the managers of mixed-ownership companies and public enterprises. In a study by Hamdouch and reported by Slaoui, it was found that the enterprises controlled at least in part by the state were those that awarded the highest salaries to managers. Indeed, managers of mixed-ownership companies were found to earn 50 percent more than those of Moroccan enterprises. Likewise, the managers of public companies earned 15 percent more than those of mixed-ownership companies, while managers of semi-public enterprises earned five percent more than the latter.

Moreover, public enterprises were assigned various functions by these technocrats. Extensive rents accrued from a wide array of advantages, such as: commissions received when negotiating contracts with local and foreign private companies; above-average salaries and transfer payments; the political and economic power of such enterprises, which eventually came to constitute a "state within a state"; and production gains. Even though they were not the main priority of public capital, such technocrats nevertheless resembled feudal lords, and their assignment to the management of these enterprises was often reminiscent of the distribution of fiefdoms. Furthermore, they effectively controlled the capital of the state and used it at their discretion.

Yet, this class remained a tributary to the state. Even though they had a clear idea of their professional interests and clung fiercely to the privileges that they enjoyed at the helm of the public sector, Moroccan technocrats did not attain the degree of homogeneity necessary to forge a social group able to break free from the Makhzen. Since managers were directly nominated and relieved of their posts by *dahir*, their dependency on the state was complete.

Besides, their nomination was not only a function of their competence, but also – indeed, fundamentally – a product of their allegiance; for their tenure at the head of public enterprises was contingent upon support accorded to them by the ruling circle. In sum, being the creation of the state, these technocrats were totally dependent on it. Their existence as an autonomous group is not conceivable at the present time. By allowing them to establish rent-seeking positions as well as benefit from corruption and other gains and facilities, the Makhzen has ensured control over Morocco's technocrats.

In retrospective, the intervention of the Makhzen in the economic arena through the mediation of the public sector enabled the Moroccan state to forge relationships in accordance with the modern organization of economic activity and to normalize these relationships by integrating new emerging classes. While the neo-patrimonial logic that rules over relations between the public sector and the state jeopardizes the latter's profitability and undermines its economic efficiency, it nonetheless provides the state with political effectiveness by limiting the autonomy of civil society and controlling its economic elite. From this perspective, all analyses based exclusively on profitability (costs, prices, etc.) depart from an economic vision and overlook all other aspects that have made the Makhzen an original reality as a state. Yet, one of the most important factors in controlling social reproduction is the institution of the neo-patrimonial norm under the guise of economic behavior. The question to be posed, then, is the following: how could the Makhzen adapt to the policy of structural adjustment, which is predicated fundamentally on state divestiture? For the IMF, the distortions and imbalances witnessed in Morocco (as in most developing countries) have their roots in the various interventions that prevent market mechanisms from functioning and do not allow relative prices to reflect economic activity.

According to international experts, in order to increase the competitiveness of the economy and ensure its growth, one must free it from certain shackles, the most important of which has to do with "the state's less than careful interventions." An omnipresent state is also impotent; for it is only able to organize itself on the basis of abstract concepts and general views. Seen in this light, the actions of the state are viewed mostly as unsettling. The strategy to be followed is clear: it is the retirement of the state, as a disturbing and inefficient agent, that will allow self-balancing mechanisms to hold sway (and those social forces that have thus far been muzzled to operate under the preferred liberal mode). What can be said about this strategy and its application to the case of Morocco?

Adjustment and political change in Morocco

The decade that just ended witnessed profound economic changes. The

structural reforms lying at the root of this metamorphosis – due to the transformations triggered in the system of production, the novelties introduced in economic organization and the impact of such changes on the social fabric – today appear as evident signs of the transformations accomplished.

Throughout this period, the country's financial situation improved, allowing Morocco to abandon the debt rescheduling process and regain access to international financial markets. Major macroeconomic indicators were balanced, and important reforms in such areas as trade, taxation, finance and privatization were undertaken. In addition, both the economy and society underwent profound transformations relative to previous conditions, as evidenced by the rehabilitation of the market and the free play of market forces, the emergence of civil society, the onset of the state of law, internal decentralization, and increased openness towards foreign markets.

The backdrop to these concrete developments has been a rather vague modification in the relations between society and the political system. Various socioeconomic trends have been alluded to as possible explanations for these phenomena, such as: economic growth; the constitution of an urban middle class; the rise of new political forces; increased participation by females in the country's economic life; the concentration of capital and the development of exclusion; the emergence of a "breed" of managers familiar with the most advanced management techniques; and the persistence of unemployment among the youth. The whole of Moroccan society seems uplifted by a burst of change affecting not only the behavior of the main economic actors, but also new perceptions of social and political life.

The profound structural transformations witnessed in Morocco's social fabric have recently begun to come to the fore. Economic transformations require deep political reforms. A demanding civil society claims independence from the control of an omnipresent state and seeks to take the lead. It is within this framework that several questions have arisen around a central query: how are we to ensure the reform of a state that poses as the master of economic and social evolution in the face of the requirements of a market economy that enjoys guarantees against all sorts of intervention and a civil society that aspires to full autonomy?

The determinants of change

The structural adjustment program has placed Morocco before two kinds of logic which appear to be mutually exclusive: a "Makhzenian" logic, founded to a large extent on the administrative allocation of resources and a discretionary power, and a liberal logic based on allocation through the market and a democratic power.

Up until 1983 the Moroccan economy operated according to a "neo-mercantilistic" logic that consisted of controlling at one and the same time trade and market-based external exchanges, which guaranteed monopolies and privileges to those who upheld the regime.[35] The rapid growth of Morocco's foreign debt as well as financial and trade imbalances impinged on the state's distributive abilities and limited its capacity for intervention. The economy was no longer in a position to sustain high levels of accumulation, and the state no longer had enough resources to keep its grip on society. The magnitude of the debt, the volume of the budget deficit and the exhaustion of internal – and then foreign – sources of financing left the state with no choices. Starting in 1978, Moroccan officials undertook a revision of the priorities set during the years of the phosphate boom and decreed a temporary plan to search for new directions. The goal was to cool off the economic machine by trying to correct the country's imbalances and, at the same time, to implement a new strategy. This was the "stop-go" policy. However, the lukewarm results achieved during the first austerity plan of 1978-80 and, above all, the rapid escalation of the debt no longer made it possible to tinker with new approaches. Unable to honor its previous commitments, Morocco declared insolvency before the commercial banks, and the IMF was called to the rescue.

Changing policies was an imperative. The debate of the 1960s (that is, whether to focus on an inward-looking model of development or to open up to foreign markets and promote exports) was no longer relevant. The import substitution model based on internal demand, which Morocco had opted for since the early 1960s, was hindered by the inability of the local economy to generate the financial means needed for its realization. Hence, abandoning this model and redirecting the economy towards export promotion became a necessity. Such a change in priorities did not stem from a deliberate choice, but rather from constraints imposed by the economic context. The objective was to adapt to a new situation that left no room for maneuver. This change brought to an end the social pact founded on the model of import substitution.

The implicit rules of the game of the previous decade – according to which an interventionist state managed to secure through its own expenditures a satisfactory growth rate as well as a generous policy of clientelism – could no longer be applied in the midst of the crisis of the 1980s. The economy was no longer in a position to sustain previous expenditure levels and continue the economic and social policies adopted in the previous decade. The strategy followed during the 1970s led to growing indebtedness and hampered the state's distributive capacity by undermining its financial position. It was imperative to attempt a rationalization of the system. The escalation of the crisis in 1983, the successful implementation of the foreign constraint, the refusal to pay heed to social protests and the onset of austerity measures imposed on the

country's enterprises were all signs seized by the financial community, whose control eventually became unavoidable. In sum, it was necessary to change gears, that is, to rein in the role of the state, liberalize the economy and open it to the world market.

This change in policies brought to an end what Waterbury (1983) has called the social pact founded on the import substitution model, which consisted of a closed economy, an overvalued currency and a relatively generous social policy package (free health care, expanded education, subsidization of basic consumer goods, etc.). In a word, the state no longer had the means with which to control society. The change in the pattern of resource allocation has undermined the state's social effectiveness and diluted its predatory power.

How to manage change

By leading the implementation of a kind of rationality based on the market and the profit motive, increased openness towards the world economy and free competition, the Moroccan state has triggered a dynamics that could eventually call into question its very foundations. The question then arises as to the strategy to be followed by the Makhzen in attempting to reconcile the economic logic and the political logic.

By deciding to forge ahead with the SAP, to avoid the rigid application of the recommendations issued by international financial institutions and to decry the narrow-minded views held by the IMF, the Moroccan government has gained strategic flexibility in the implementation of structural adjustment. This pragmatism has enabled the state to postpone certain measures and review them in light of new data. For instance, whenever stabilization measures elicit strong opposition, the government backtracks temporarily. In the fall of 1985, an increase in the prices of basic consumer goods led to renewed tension. In October of that year, the King delivered a speech on the theme "Yes to austerity, no to pauperization."

Without turning their back on the requirements of economic retrenchment at the same time as they implemented austerity measures, Moroccan officials sought to dampen the negative effects of the latter on the population. In this context, the state engaged itself in the successful implementation of the SAP yet remained alert to its possible impact on the cohesion of the country's social fabric. Clearly, government officials were careful to reconcile the economic logic and the political logic in the management of the SAP. This approach has not been a failure. In fact, it has allowed the Moroccan state to soften the effects of stabilization, and that has been achieved for two reasons: (i) the state has curbed its regulatory function without relinquishing control, and (ii) it has widened the country's social base through the promotion of new social classes.

One of the factors that helped soften the SAP and ensure relative social peace has been the dynamism of Morocco's informal sector. Promoted in the official discourse as an engine of growth, it has been viewed as the solution to the crisis and vested with positive attributes regarding the country's development. The official line is confirmed by concrete facts. Indeed, the national survey of unstructured local enterprises shows that out of all units created after independence, 71 percent have come into existence after 1973, and almost 50 percent after 1979. However, it was mostly after 1983 that this trend gained impetus (31 percent of all units). In essence, these are micro-units employing no more than ten people and corresponding to 77.3 percent of all enterprises. They are concentrated mostly in commercial activities (89.2 percent), but are also found in services and, to a lesser extent, industry. Commercial micro-units are the least capitalist-oriented, requiring neither skills nor overhead capital.[36] In addition, these units have developed outside the scope of state intervention, at times even beyond the reach of rules and regulations designed by public authorities. To be sure, the state has permitted the development of the informal sector because it offers a temporary solution to the difficulties posed by adjustment, such as unemployment, slow labor absorption and a decline in public investment.

In sum, the state has not interfered directly with the creation and development of Morocco's informal sector because it provides a short-term strategy to mitigate the negative impact of the SAP on the country's social cohesion. Due to their regulatory and redistributive functions, informal activities may ensure a certain balance in terms of employment and revenue. Moreover, these activities are not carried out against the will of the state. Not only do they pose no threat to the state, they actually relieve it from certain regulatory functions,[37] thus enabling it to focus on control. This is what has led Charmes (1992) to claim that the informal sector is not the actual goal of state intervention, but rather a pretext aimed at its reproduction.

As for privatization, the King has stated: "The goal pursued through the projected operation is to provide chances to new individuals, to show them the doors to responsibility, opportunity and risk, and to create suitable conditions for workers, those who save and entrepreneurs to benefit from their share of economic development, a process of which they are an integral part [...]."[38] The emphasis on the promotion of new individuals stems from the preoccupation of political leaders to keep abreast of the country's social and economic evolution, and to avoid the imbalances threatening the social edifice. Seen in this light, the redistribution of economic power to the benefit of the middle classes – from which technocrats and managers are recruited – seems all the more indicative of the fact that this class is available to fulfill various roles related to the functioning and management of privatized enterprises.

Furthermore, this new orientation is to receive support and assistance from certain political organizations which will find in its implementation a reason to participate in the current political game and to reclaim a part of the initiative that they have long lost.[39]

In sum, privatization and the reorganization that also figures in the order of the day are intended to allow local elites to make some of their claims to leadership prevail, and the state to forge new structures with which to control civil society. "We will be able," said the King, "to decide that certain enterprises will be set aside as a matter of priority for individuals belonging to the region where the headquarters of the company or its branches are located. Thus, regional activities will be revived and the inhabitants of the region will be able, through their employment and their access to the goods and services produced by the enterprise, to strengthen the bonds of regional solidarity. Hence, over and above its administrative existence, the region will develop its much-needed economic dimension."[40]

Privatization is likely to grant the state a support base in accordance with its own needs. To be sure, none of the goals of the Moroccan state is anathema to the liberal state, provided, of course, the latter does not threaten the former's reproduction strategies. While the state in Morocco claims a liberal outlook, it is nonetheless determined to keep its position as regulator of social life.

By accepting to tackle the economic project and find common ground between the political discourse and state-oriented practices, the state has created the means through which to control economic activities and social relations. From this angle, the political counter-weights to the state (parties, trade unions, etc.) have not been obliterated, and the multi-party system has been accepted. Yet, the rules of the political game have been confined to a well-defined and limited arena, so that these "counter-powers" will not constitute frameworks capable of sheltering political currents that could pose as contestants against the state. In order to achieve this, several methods have been resorted to:

Neutralizing the middle classes

The Moroccan state has been relatively successful at weathering political storms without much harm to its structures, and that is explained by its ability to mitigate the effects of austerity by means of a selective social policy that enabled it to cater to the rural population by reducing taxes on agriculture while calling on the urban masses to shoulder the adjustment burden. Thus, the state has proceeded to implement a quasi-systematic wage freeze between 1983 and 1987; to curb recruitment considerably by limiting the number in the administration to 1,000, compared with an annual average of 40,000 to 50,000 before 1983; and to trim public education expenditures by limiting

access and adopting more selective criteria for granting scholarships. Moreover, real wages in the private sector as well as in the administration decreased considerably, unemployment rose sharply in 1983 and 1984, and direct income taxes on wages also increased appreciably. By the same token, average agricultural income increased – especially in 1986 – and direct taxes on agricultural revenues were abolished until the year 2,000.

This policy – which has assigned the brunt of the austerity burden to a significant segment of the urban population – has been accompanied by very strict control of these groups through the creation of new town halls as well as through a policy that alternates the carrot and the stick so that while the state has promoted a certain degree of openness towards opposition parties, it does not hesitate to use dissuasive repression so as to discourage all forms of protest and upheaval.

Placing the opposition on the defensive

Another reason for the success of the Moroccan government in the management of the SAP is the inability of the opponents of the state to propose a viable alternative. The Moroccan opposition, which has unanimously rejected the SAP as a dictate imposed by the IMF, has been limited to a populist ideology stressing the social arena. This behavior has relegated the opposition to a defensive position, being impacted by events rather than acting upon them. While the role of trade unions in the organization of general strikes in 1981 and 1990 was far from negligible, on the whole the Moroccan opposition has failed to mount an effective resistance against the SAP. Because it forgot that in a modern economy social and economic matters are inextricably bound to each other and that disentangling the two may produce disastrous results, the opposition in Morocco has forfeited the possibility of a credible discourse.

Reactivating communal solidarities

The fact that Morocco, much like the majority of developing countries, has undergone various distant historical periods in its economic development explains why Moroccan society today encompasses a mosaic of systems of production, ranging from the production of small farmers and artisans for the market to several different forms of transition towards a modern economy (that is, industry). These multiple economic structures have engendered a wide array of juxtaposed social structures. One may find those of the original society, which have nonetheless managed to survive, as well as those resulting from the new socialization in progress. Even though industrialization and urbanization tend to weaken kinship ties, Moroccan society remains holistic to a large extent. Relations of a communal nature continue to exert a great

influence on a very large part of the Moroccan population, in which insertion is not effected clearly from below. This duality of structures has translated into a dual system for society at large, with "free" and "rational" individuals being at one and the same time elements of a community fraught with traditional values of mutual assistance and solidarity.

As a result, the communal logic has helped mitigate economic austerity, as family and kinship solidarities are still very much in force in Moroccan society. These solidarities have ensured the survival of marginalized individuals, particularly in the countryside and in shantytowns, where the recently urbanized rural population tends to concentrate. From this point of view, such links constitute effective social cushions of special significance in periods of crisis.

Using the dual nature of power

The original character of the Moroccan state – belonging at one and the same time to tradition (the Makhzen) and to modernity (the nation-state) – has given rise to a duality of power in which management tasks pertaining to social affairs are undertaken by the former structure, whereas those tasks bearing on the economy are the responsibility of the latter, which acts as a lightning rod for the Makhzen. Indeed, each time an economic decision threatens to provoke tension and at times even violence (as in the instances of unrest in 1981, 1984 and 1990), the traditional structure attempts a compromise by subscribing to a discourse geared towards the poor, giving "as much publicity as possible to the measures adopted in their favor." Thus, in January-February 1984 the King, after having declared that there would be no increases in the prices of basic consumer goods, announced the decision to demolish the shantytowns of Casablanca and build low-income housing units so as to bridge housing disparities. Additionally, the decision was made to finance a program of "ten million workdays."

This behavior is in accordance with the idea entertained by the majority of the population regarding the role of the Makhzen in the economic arena. According to this view, economic activity presupposes a moral foundation, and the Makhzen is its guarantor. The uprisings against increases in the prices of foodstuffs and those that have been known as "hunger revolts" seem to have been warnings to Moroccan authorities aimed at prodding them to fulfill their role, that is, to ensure the provision of market goods at prices determined by the law (need for regulation) rather than by the free play of supply and demand. This is what forced the state to assign the *mahtassib* (according to the age-old tradition of pre-colonial Morocco) to different villages in order to uphold "morality" in economic activities. This is also what led the Moroccan government to enter into difficult negotiations with the IMF so as to avert the elimination of subsidies for staple foodstuffs.

However, this political game – which has so far been limited to Morocco's elites and notables operating in a frail political arena – is no longer adequate. The ever-increasing pace of social and economic transformations has often produced ruptures that are likely to give rise to new political structures and practices. In Morocco, economic evolution has allowed the emergence of new economic forces, private capital has become more active and entrepreneurial, and civil society has started to manifest more dynamism and energy. The question now being asked revolves around political liberalism. The option for a market economy has paved the way, at the same time, for the economic foundations of modernity. Hence, the traditional strategies that had once proven effective – the creation of networks, the recovery of powers at the grassroots level, mobilization at the top, the development of a culture of clientelism – have become inadequate.

The generalization of state clientelism invariably leads – in a context of paucity of resources, as in the case of Morocco – to an overabundance of demands and a crisis of state legitimacy, and the increasing exclusion of the youth may well constitute the breeding ground for radical and violent protests. Furthermore, the existence of an ever-growing middle class leaves no room for a political game restricted to notables and tame elites. Finally, increased openness to world markets and the economic liberalization promoted by the government for over ten years now have given rise to a new behavior and practices of a new kind, in which "competence" is the dominant value.

Conclusion

At the close of the 20th century, Morocco is undergoing a period when society and its institutions find themselves in a totally new situation, one in which operating procedures have changed dramatically. The role that the political establishment has been called upon to fulfill is far from understood by all. At the current stage of Morocco's evolution, everyone agrees that the country needs a new social order. This does not mean, however, that a consensus is close at hand; for the discourse of change held by all political actors nonetheless encompasses very different approaches.

For some, change should not be too deep, but rather limited to certain cosmetic touches aimed at providing the political system with a new look and endowing it with a seductive allure vis-à-vis the outside world. On the whole, this tendency is embodied by those social forces at center stage, which are not ready to share the lead role with others, let alone relinquish it. Their concern about upholding their *de facto* hegemony in political life does not predispose them to accept the new rules of the game, founded on an advanced form of liberalism.

For others, however, change must not be a travesty. It must be targeted at the very foundations of society. According to this tendency, it is time that the ruling circle recognized the transformations undergone by society and forged ahead boldly in the direction of "reforms." Unlike so many other Third World countries, Morocco has a state imbued with legitimacy, a dynamic civil society with a great deal of savvy and considerable political experience, and may thus be able to make a smooth transition to democracy without the upheavals witnessed elsewhere.

Finally, a third tendency is completely skeptical regarding Morocco's future. According to this view, those who hold power are not likely to promote significant reforms so as to endow the country with modern institutions capable of reflecting the evolution of their society. As in the past, the regime is selling the illusion of a complete change, yet only the outer frills of the system will actually change. This political tendency seeks to confront the country with an all-or-nothing approach. In this simplistic political analysis, in which naiveté is mixed with extremism, the apparent skepticism conceals the adoption of a populist and utopian ideology.

In the final analysis, the improvement of Morocco's political situation over the past two years offers a glimpse of tangible progress towards liberalization. The elimination of legal and regulatory restrictions hindering the exercise of freedom, the release of political prisoners and the King's proposal to proceed to an alternation fall within that logic. Overall, however, Morocco's political system has lagged behind the country's economic changes.

Notes

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[33] N. Balafrej, "Le Secteur Public dans l'Economie Marocaine et son Rôle dans le Développement". Ph.D. Dissertation in Economics, University Mohamed V, Rabat, 1987.

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Industrial Policy and the Role of the State in Egypt: The Relevance of the East Asian Experience

Introduction

Egypt's current economic reform and structural adjustment program (ERSAP), initiated under agreements between the government and the IMF and World Bank in 1991, has the principal aim of shifting the economy to an outward-oriented, market-based one after more than three decades of central planning and the dominance of public sector activity in the economy. The program is particularly relevant to the country's manufacturing sector, as it embodies a new approach to industrial policy. Two elements are central to this approach. First, an increase in the role of free markets and private enterprise coupled with a reduction of the role of the state and the state sector, hence the inclusion of measures such as privatization, deregulation, financial liberalization, changes in taxation, and other incentive systems. Second, closer integration with the world economy, hence the emphasis on trade liberalization, promotion of foreign investment, and exchange rate reform.

It is generally argued that this approach was adopted on basis of its empirical validity and proven record in promoting fast and efficient economic and industrial growth. The industrial success of the East Asian newly-industrializing countries (NICs) is often cited as an example of the effectiveness of these prescriptions. Yet, there is a growing body of recent literature that challenges this view and argues that this success is, in fact, largely the outcome of a highly active role of the state in formulating a vigorous economic system that promotes capital accumulation, innovation, and productivity growth.

The purpose of this chapter is to assess Egypt's industrial strategy, as embodied in its current ERSAP, and the role of the state implicit in it. In particular, the adequacy of such a strategy in confronting current problems in the country's manufacturing sector and in laying the foundations for medium and long-term industrial development will be questioned in light of the East Asian experience of industrialization. Three country studies will be highlighted: Japan, South Korea (henceforth Korea) and Taiwan, with particular attention being devoted to the experience of Korea, which is arguably the most relevant to Egypt, given many similarities in size, resource availability, and institutional organization (indeed, the two countries have frequently been contrasted in the development literature). Thus, the term "East Asian experience" is used in this text as shorthand for a particular kind of policy regime pursued – notably in these three countries – rather than as a geographical denomination denoting all countries located in the eastern region of Asia.

The analytical framework underlying the present discussion is based on a reformulation of the theory of the role of the state in development in an attempt to explain the East Asian experience. Theoretical justifications for state intervention are not lacking in abstract terms, but the more important question pertains to how the state should intervene in an efficient manner. It is argued here that the experience of East Asian countries provides some examples that can help answer this question and also be of relevance in the design of industrial policy in particular – and development strategy in general – in the case of Egypt.

The present discussion will be presented in four main parts. The first part reviews changes in the political economy of state intervention in the Egyptian economy, compares indicators of economic performance and structural change in Egypt to those of other developing economies, especially in East Asia, and provides an overview and brief assessment of the main elements in the country's current reform program that are of relevance to its industrial development. In the second part, the argument for the need for a coherent industrial policy and a reorientation of the role of the state in development will be presented on the basis of theoretical assessments highlighting the limits to liberalization and depoliticization and a review of evidence from the performance of East Asian countries in such areas as macroeconomic management, external policy, and industrial policy. In the third part, the discussion turns more specifically to what Egypt can learn from East Asia, first by looking at arguments emphasizing the special conditions that existed in East Asia, then by comparing the Egyptian experience directly to that of Korea. Finally, the fourth part of this chapter presents some concrete proposals of relevance to the design of industrial policy and an alternative economic reform program for Egypt.

Industrial development in Egypt: the stylized facts

The evolution of industrial strategies and the changing pattern of state intervention: 1950–1990

Despite several successive but intermittent spurts of industrialization since the 1820s, it was not until the 1950s that Egypt succeeded in building a broad modern industrial base (Mabro and Radwan 1976). Five distinct phases of development in the industrial sector can be identified in the period starting in the 1950s (more generally, in the post-World War II era) and ending in the 1990s, each corresponding to a different type of development strategy, institutional set-up and pattern of state intervention. Yet, it remains doubtful in most of these phases whether one can identify a state industrial strategy *per se* rather than just a group of investment projects undertaken or encouraged by the state that do not add up to a strategy.

The first phase in the post-War era lasted until about the mid-1950s and was characterized mostly by private enterprise-led industrialization. Following several decades in which Egypt was one of the world's leading exporters of raw cotton, the World Depression and World War II set the country on an early stage of import-substitution industrialization under an economic system dominated by free private enterprise activity (partly indigenous and partly foreign), which in turn operated under parliamentary democracy and relatively protected trade and investment policies (Richards and Waterbury 1990). The state's development strategy since the early 1930s took the form of import substitution and infant-industry protection through high tariffs, import controls, and some subsidization through loans coupled with export promotion of cotton. In the absence of government intervention and guidance, entrepreneurial activity was solely geared towards generating quick profit, which at that time was mostly in light consumer-oriented industries that required little investment and fairly modest technology. Besides tariff protection, government intervention was kept to a minimum. The only large state-owned enterprises were an oil refinery in Suez, the government press, a few military factories, and some workshops belonging to various ministries (Zaalouk 1989). It was not until 1954, following the 1952 revolution and the coming to power of a military regime headed by Gamal Abdel Nasser, that large direct government investment in industry started to take place.

This investment drive perhaps signalled the start of a second phase of development characterized by a state-led industrial push that was to last until the mid-1960s. Although the textile industry continued to dominate the scene, some new investments were made in iron and steel, fertilizers, paper, and mineral industries. Yet, the attitude of the government until the late 1950s remained mainly geared towards undertaking projects that the private sector could not finance or manage, such as the Aswan Dam project, the iron and steel complex in Helwan, and a large fertilizer plant at Aswan (Zaalouk 1989 and Richards and Waterbury 1990). In 1956, the nationalization of the Suez Canal Company prompted the participation of England and France, along with Israel, in a direct attack on Egypt. All assets owned by English and French interests in such areas as trading and insurance companies, utilities, and some manufacturing enterprises were taken over by the Egyptian government. However, it was not until 1961 that the radical shift towards central planning and state enterprise-led industrialization was completed. With the drafting of the country's first five-year plan for the entire economy, the private sector was called upon to mobilize about 55 percent of all investment over the five-year period. The failure of the private sector to do so provoked a wave of nationalizations in 1961 that allowed the state to take over most large-scale industry, all of banking, insurance and foreign trade, utilities, maritime transport, airlines, and many hotels and department stores.

In 1962, the national charter was promulgated defining the limits of the public sector to include infrastructure, generally heavy and medium industry, as well as institutions and companies responsible for foreign trade and financial operations. As for the private sector, it would be limited to the ownership of land, buildings, construction and contracting, light industry, and 25 percent of national exports and internal trade under state guidance (Zaalouk 1989). The first five-year plan embodied a straightforward import-substitution strategy combining the promotion of some of the easier industries (textiles, sugar, automobile assembly and pharmaceuticals) and more advanced ones (heavy engineering, steel, chemicals, and fertilizers). The plan was quite successful in terms of employment creation (one million new jobs were offered), the growth of manufacturing output (by more than ten percent per year), overall production growth (six percent per year), and the level of delivery of services. Nevertheless, in 1965 the state ended up facing a domestic fiscal and external foreign exchange crisis due to rising imports of raw materials and capital goods and large outlays on construction and social services (Waterbury and Richards 1990).

The third phase that can be identified spans the decade from 1965 to 1975 and corresponds roughly to the regional wars and the inter-war period. The second five-year plan, which would have led to industrial "deepening," had to be abandoned due to shortages in financing, as US aid was withdrawn and the Soviet Union was reluctant to extend new lines of credit. The military defeat of 1967 and Israel's occupation of the Sinai Peninsula, which led to the loss of oil revenues, the closure of the Suez Canal to traffic, and the disruption of tourism, plunged the country into a severe recession that signalled the end of the Nasserist experiment. With the death of Nasser and his succession by the Sadat regime in 1970, resources still had to be diverted to defense purposes in preparation for the next war (which was to take place in 1973) and away from all other forms of investment, including that in the manufacturing sector.

The fourth phase is associated with the implementation of the Open Door Policy (henceforth ODP) announced in 1974, and various partial economic liberalization attempts that followed over the 1975-1985 period. The initial ODP legislation was aimed mainly at encouraging foreign investment. It was followed by various other measures also aimed at encouraging domestic investment. The policy shift coincided with the oil boom of the 1970s and the associated windfalls from oil exports, Suez Canal dues, tourism, workers' remittances, as well as capital inflows from foreign borrowing and official aid. Despite these inflows, the country was accumulating a large public debt, and the inflows of these resources directed attention away from the problems in the productive sectors of the economy, and in particular in manufacturing industry (Handoussa 1988 and Amin 1987).

In fact, one of the most striking features of that period was the relative decrease in manufacturing growth, and of its contribution to domestic income, in contrast to other sectors, in particular trade and finance. Industrial strategy, to the extent that one can be identified for this period, showed some signs of shifting towards export-oriented activities, and the subsectors manifesting the largest growth rates in this period are those partly financed and run by foreign investment, such as oil, extractive industries, engineering, and chemical industries (Zaalouk 1989). The role of the state throughout that phase has been identified by several observers (Abdel-Fadil 1979, Beblawi 1987, and Zaalouk 1989) as that of a "rentier state," that is, a state which sustained economic management from sources outside the economy's productive capacity and which operated in a "rentier economy" or "semi-rentier economy." The latter relied on substantial external rent in a society with a dominant "rentier mentality." Such a mentality, in turn, entailed a break in the work-reward causation, where reward, income or wealth is not related to work and risk-bearing, but rather to chance or situation. In 1987, it was estimated that the various external rents combined accounted for 45 percent of the country's GDP. The role of the state as the main recipient of this rent was to redistribute it among the population under the guise of government favors, now embodied in a "welfare state" doctrine of consumer subsidies and public employment (Beblawi 1987).

The fifth and final phase to be identified covers the second half of the 1980s and lasted until the onset of the current ERSAP. This period witnessed a drastic fall in many of Egypt's external sources of revenue following the two negative oil shocks. Interestingly enough, this period represented a positive shift to industrial development; for many of the import-oriented entrepreneurs during the ODP/windfalls period shifted to industrial activity due to encouragement by the state through the "New Industrial Cities" Law coupled with import restriction policies aimed at protecting the domestic industry. Commentators described this period as one of "industrial liberalization," as opposed to "trade liberalization," with an orientation towards exports rather than import substitution (Gazzarin 1992). Among the industries that prospered significantly during this period, one should note: clothing, food processing, chemicals (especially plastic and paint), engineering (especially consumer durables and electrical goods), and leather goods (ibid.).

In the following sub-section, we will turn to an investigation of the impact of industrial policies (or the lack thereof) during the era of economic liberalization and the emergence of a semi-rentier economy in the 1970s and 1980s.

Indicators of economic performance and industrial development

During the 1950s and 1960s, the Egyptian economy witnessed several successive spurts of boom and recession, yet on the whole growth performance

during that period fell short of that of other LDCs (such as Mexico and Brazil), especially those in East Asia (Japan, Korea and Taiwan). As can be seen from Table 1, it was not until the period between the mid-1970s and mid-1980s that the Egyptian economy grew at truly impressive annual rates close to ten percent in real terms, thus outpacing the growth of almost all other developing countries in the sample in the Table.

Table 1. Comparative Growth Performance in Some Selected Developing Countries, 1950-87 (average annual growth rates)

	1950-1964	1964-1973	1973-1979	1979-1987	1950-1987	1964-1987
Korea	6.1	9.6	9.0	7.0	7.6	8.5
Taiwan	8.3	11.0	8.4	7.4	8.8	9.1
China	5.2	6.9	5.0	9.3	6.5	7.2
India	4.3	2.7	3.4	4.6	3.8	3.6
Egypt	5.3[1]	3.4	9.5	8.6	n.a	7.0
Brazil	5.9	8.1	6.5	3.5	6.0	6.1
Chile	4.2	2.8	2.3	1.6	3.0	2.2
Mexico	6.2	6.6	6.1	1.7	5.3	4.7
Austria	5.5	5.1	2.9	1.7	4.2	3.3
Italy	5.7	5.1	2.6	2.2	4.3	3.4
Japan	9.5	8.9	3.6	3.8	7.1	5.7

Source: Calculated from Maddison (1989), Tables B-3, B-4, and B-5, Mabro and Radwan (1976), Table 3.2, and Ministry of Planning (for Egypt).

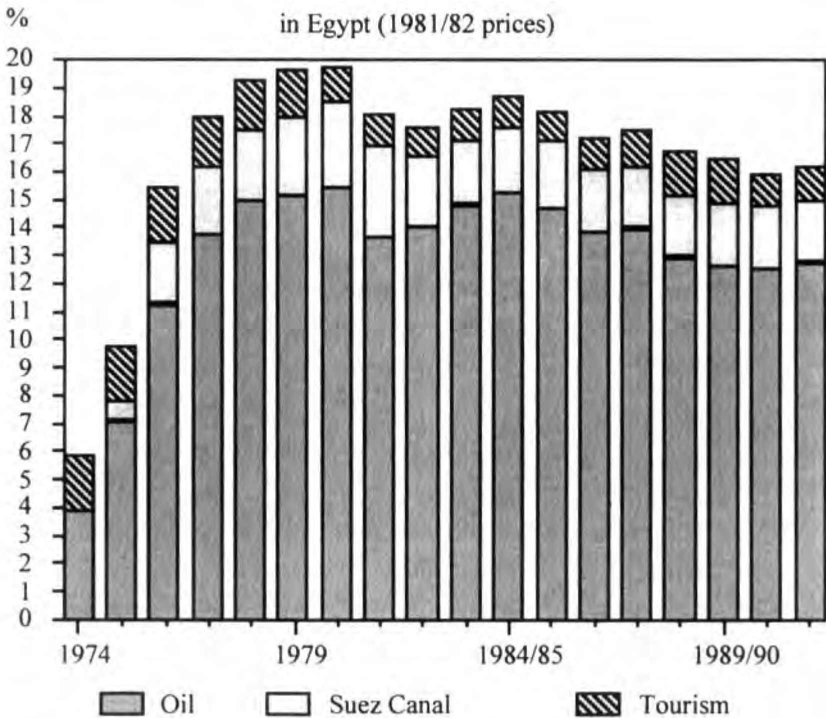
Notes: 1. for 1952/53-63/64

As explained above, this impressive growth was associated with two major developments: on the one hand, the increase of foreign exchange earnings from external and rental sources, such as petroleum exports, Suez Canal duties, migrant workers' remittances, tourism income, and external aid (see Chart 1 below) and, on the other hand, the implementation of several partial liberalization packages (including the ODP). It can be argued, however, that these windfalls ultimately represented a lost opportunity, because they were not utilized in such a way as to lay the foundations for sustainable growth and make the economy less vulnerable to external shocks. Indeed, the observed high growth does not account for the whole picture, but conceals some important adverse structural developments, as seen in the fact that, when oil prices collapsed in the mid-1980s, so did the growth rate (to only 4.2 percent in the period 85/86–91/92).

By the end of the boom in the second half of the 1980s, the Egyptian economy was far more dependent on external factors. During the period from 1974

to 1990/91, the share of agriculture in real GDP dropped from about 34 percent to some 15.6 percent, and the share of manufacturing stagnated at about 15 percent, with a moderate decline in the middle of that period (see Chart 2 below). On the other hand, the shares of construction, electricity, and services (especially transport and communication), as well as trade and finance increased significantly. In short, there was an expansion in the share of non-tradable sectors and a contraction in the share of tradables (except for oil).

Chart 1: Shares of Windfalls in Real GDP



To the extent that there was growth of manufacturing output during this period (see Table 2), this is unlikely to have been generated by any significant form of technical innovation. The overall trade deficit increased almost five-fold, in spite of the surge in oil exports. Non-oil merchandise exports declined in absolute terms for many years, and their contribution to the financing of merchandise imports dropped from about 75 percent to about 20 percent. The situation was reminiscent of a case of Dutch Disease, defined as a decline in the share of tradables associated with oil and oil-related windfalls. Recent works have systematically tested for the occurrence of the Dutch Disease in

the case of Egypt by comparing trends in sectoral shares to some form of standardized pattern of structural change (see Table 3).

In a study by Syrquin (1989) investigating structural change in 100 developing countries, Egypt was one of the cases that showed Dutch Disease symptoms. In that study, regressions were run to estimate the changes in the shares of the different sectors in GDP associated with changes in per capita income. The relevant findings concerning the group of low-middle income countries, to which Egypt belongs, are reported in Table 4. The comparison of the results for Egypt with the group's averages shows a strong indication of a case of Dutch Disease in Egypt. The parameter for manufacturing was negative for Egypt compared with a positive parameter for the group's average. For agriculture, the parameter for Egypt was about 50 percent lower than the group's average. In general, the results show that each one percent increase in per capita income was associated with a 0.25 percentage point decline in the share of tradables in the GDP of Egypt, compared with a decline of only 0.10 percentage point for the low-middle income countries as a group.

Chart 2: Sectoral Shares in Real GDP in Egypt (1981/82 prices)

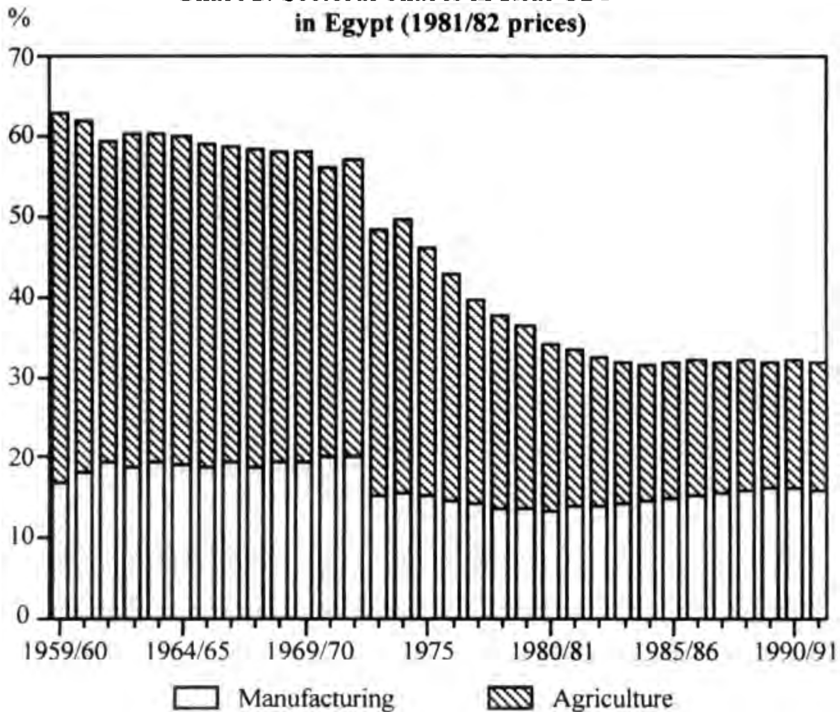


Table 2. Manufacturing Growth in Some Selected Developing Countries, 1963-88 (average annual growth rates)

	1963-72	1973-78	1979-88
Korea	18.3	24.7	11.7
Brazil	6.7[1]	n.a.	1.5
China	9.5[2]		12.6[3]
Chile	4.1	-2.9	2.7
Egypt	3.5	6.6	8.9
India	4.5	4.3	8.3
Malaysia	n.a.	n.a.	7.3
Mexico	8.7	7.4	0.0
Singapore	17.0[4]	7.1	6.8
South Africa	6.8	1.3	1.6
Spain	10.8	3.3	1.5

Source: UN, Growth of World Industry, 1973; *UN,* Yearbook of Industrial Statistics, 1979 & 1988; *World Bank,* World Development Report, 1988 *(for China), Ministry of Planning (for Egypt).*

Notes: 1. for 1963-69 2. for 1965-80 3. for 1980-87 4. for 1966-72

Table 3. Structural Change in Some Selected Developing Countries, 1965-86

	per capita GNP (dollars) (1986)	population (millions) (1986)	Production Structure in 1965 (as percentages of GDP)				Production Structure in 1986 (as percentages of GDP)			
			A	I	M	S	A	I	M	S
India	290	781.4	47	22	15	31	32	29	19	39
China	300	1,054.0	39	38	30	23	31	46	34	23
Kenya	300	21.1	35	18	11	47	30	20	12	50
Egypt	680	47.8	41	24	19	35	17	34	15	49
Chile	1,320	12.2	9	40	24	52	n.a.	n.a.	n.a.	n.a.
Brazil	1,810	138.4	19	33	26	48	11	39	28	50
South Africa	1,830	32.3	10	42	23	48	6	46	22	49
Mexico	1,860	80.2	14	31	21	54	9	39	26	52
Argentina	2,350	31.0	17	42	33	42	13	44	31	44
Korea	2,370	41.5	38	25	18	37	12	42	30	45
Taiwan	3,580	19.4	n.a.	n.a.	22[1]	n.a.	n.a.	n.a.	29[2]	n.a.
Greece	3,680	10.0	24	26	16	49	17	29	18	54
Spain	4,860	38.7	15	36	n.a.	56	6	37	27	56

Source: World Bank, World Development Report, 1988*; Wade (1990), tables 2.2. and 2.6; Maddison (1989), Ministry of Planning (for Egypt).*

Notes: A=Agriculture; I=Industry (Mining, Manufacturing, Construction, Electricity, Water, and Gas); M=Manufacturing; S=Services

Table 4. Estimated Change (percentage points) in Share in Real GDP*

	The group's average	Egypt
Agriculture	-0.14	-0.20
Manufacturing	0.04	-0.04
Total tradables	-0.10	-0.25

Source: Syrquin (1989).

**Corresponding to each 1% increase in GNP per capita in the group of low-middle income countries.*

A formal methodology to construct an index for the Dutch Disease was developed by Gelb and Associates (1988). The index measures the deviation of the share of the tradable sectors in non-oil GDP from their stylized shares. In their methodology, the authors exclude windfall sectors from the economy and then calculate the deviation of the share of the tradable sector in real GDP from its stylized share according to Chenery (1976), and use this deviation as an index for the Dutch Disease. Along the above lines, it is possible to estimate Dutch Disease indices for Egypt for the 1960/61-1991/92 period, as reported in Table 5, as well as in Charts 3 and 4 below.

For the sake of the present discussion, several interesting results emerge from this exercise. First, with regard to changes in the manufacturing Dutch Disease index, it is interesting to note that until the early 1970s, this index was negative, indicating a higher share of manufacturing than the lower-middle income countries' average (a case of reverse Dutch Disease). This was possibly the result of the import-substitution industrialization policies pursued at the time. Indeed, the index even showed a decreasing trend, reflecting a steady increase in the degree of industrialization. The situation changed after the 1970s, and by the 1980s the index had more than doubled. There were some improvements during the 1980s, possibly due to a certain emphasis on promoting non-traditional exports, and then subsequent deterioration in the early 1990s.

Secondly, it is interesting to note how policy shifts influenced the index. Overall, it appears that the index deteriorated significantly at the beginning of the implementation of each wave of liberalization, and then improved slowly but always to a level worse than that before the liberalization wave. This scenario seems to hold with no exception. Note the deterioration in 1974 and 1975, which coincided with the introduction of the ODP. The index then improved in 1976 and 1977 with the phasing out of the impact of the initial liberalization, which was slowed down due to the decline in foreign – mainly Arab – aid. The index started to deteriorate again in the late 1970s, with the

introduction of the second wave of liberalization and the abolition of bilateral trade and payments agreements with the then-socialist countries. The deterioration slowed down in the 1980s and eventually showed some improvement. During that period, progress in the liberalization trend was counter-balanced by the implementation of various trade restrictions and controls in response to foreign exchange shortages. The index started to deteriorate again in the early 1990s, with the implementation of the new IMF stabilization/ liberalization program.

Table 5: Dutch Disease Indices for Egypt, 60/61-91/92

				Incremental Indices		
	Manufacturing	Agriculture	General (DD)	Manufacturing	Agriculture	General (DD)
1960/61	-1.01	2.06	1.06	-1.01	2.06	1.06
1961/62	-2.32	5.99	3.67	-1.31	3.92	2.62
1962/63	-1.43	3.33	1.90	0.89	-2.65	-1.77
1963/64	-1.95	3.27	1.32	-0.52	-0.06	-0.59
1964/65	-1.66	2.86	1.20	0.30	-0.41	-0.11
1965/66	-1.29	3.53	2.24	0.36	0.67	1.04
1966/67	-2.11	5.07	2.96	-0.82	1.54	0.72
1967/68	-1.33	4.80	3.47	0.78	-0.28	0.51
1968/69	-1.96	5.72	3.75	-0.64	0.92	0.29
1969/70	-1.62	4.87	3.25	0.34	-0.84	-0.50
1970/71	-2.22	7.04	4.81	-0.60	2.16	1.56
1971/72	-2.41	6.27	3.86	-0.19	-0.76	-0.95
1973	1.78	5.49	7.26	4.57	-0.79	3.78
1974	2.11	5.00	7.11	0.23	-0.49	-0.25
1975	2.18	5.78	7.96	0.25	0.78	1.03
1976	1.92	6.30	8.23	0.02	0.53	0.55
1977	1.75	8.62	10.37	-0.05	2.32	2.26
1978	2.80	8.47	11.27	1.12	-0.14	0.98
1979	2.86	9.11	11.96	0.08	0.63	0.71
1980/81	3.98	9.57	13.55	1.13	0.47	1.60
1981/82	3.27	11.45	14.72	-0.79	1.88	1.08
1982/83	3.89	10.83	14.72	0.59	-0.62	-0.02
1983/84	3.80	10.85	14.65	-0.06	0.02	-0.04
1984/85	3.47	11.01	14.49	-0.30	0.16	-0.14
1985/86	3.29	11.05	14.33	-0.22	0.03	-0.18
1986/87	2.99	11.12	14.12	-0.34	0.07	-0.26
1987/88	2.78	11.10	13.89	-0.19	-0.02	-0.21
1988/89	2.63	11.10	13.73	-0.19	-0.01	-0.20
1989/90	2.51	11.09	13.60	-0.14	-0.01	-0.15
1990/91	2.53	11.06	13.59	-0.01	-0.03	-0.03
1991/92	2.88	11.11	13.99	0.36	0.05	0.41

Source: Sakr (1995).

Notes: 1. The "General DD Index" is the sum of the manufacturing and agriculture indices.
2. The incremental indices are calculated as the change in the value of each index from the previous year. A negative number signifies an 'improvement' and a positive number a 'deterioration' in each index.

Chart 3: Dutch Disease Index for Egypt

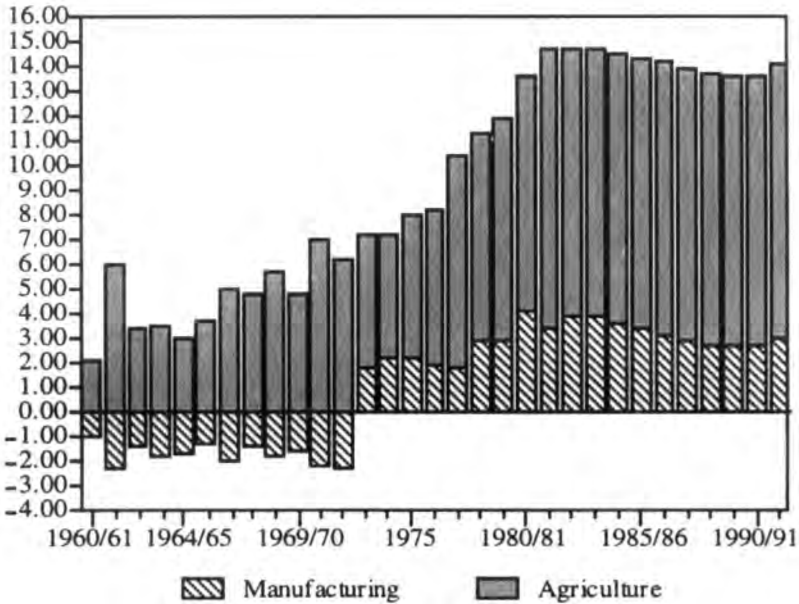
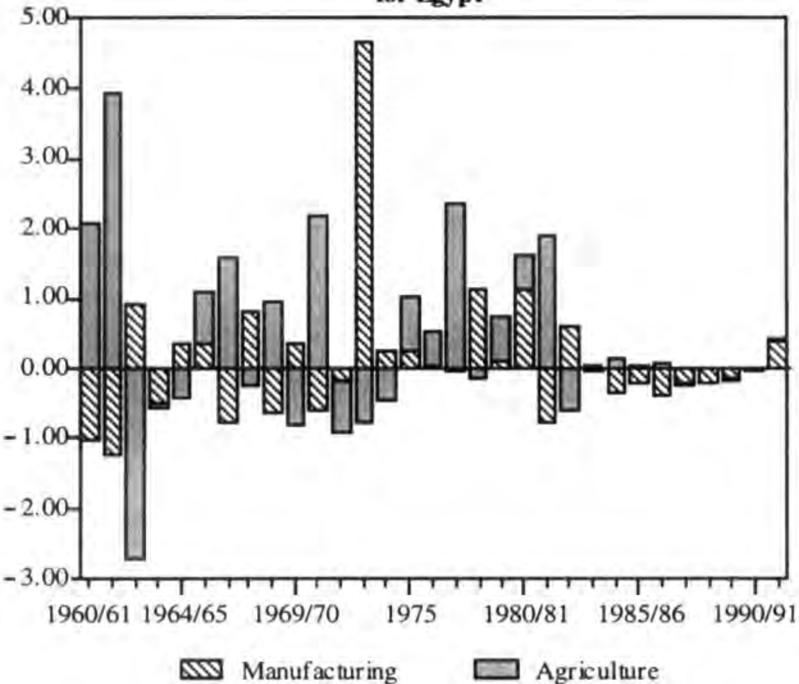


Chart 4: Incremental Dutch Disease Index for Egypt



Thirdly, the mechanisms (or intermediate causes) of the Dutch Disease, according to the standard Dutch Disease model, are: (i) real appreciation of the national currency, which reduces the profitability of tradables; (ii) increases in the real wage; and (iii) increases in the interest rate, which crowd out the production of tradables. These mechanisms, however, have been of little relevance to the Egyptian case during the period under study. Using different measures of the real exchange rate, such as the inflation-adjusted nominal rate and the price of non-tradables relative to the price of tradables as shown in Table 6 and Chart 5 below, it can easily be seen that the Dutch Disease in Egypt occurred not because of real appreciation, but actually in spite of some real depreciation. As for interest rates, several studies have shown that these were not raised, nor were they the decisive factor in credit allocation in Egypt during the period covered due to financial repression.

The only classical mechanism that appeared to work was that of real wages, in the sense that there was some evidence of divergence in wages between the different sectors. This factor, however, is not sufficient to explain Dutch Disease, especially when we take into consideration the economy's lack of flexible response to market signals because of structural rigidities and heavy regulations.

This combination of empirical results casts doubt on the adequacy of relying exclusively on such policies as devaluation, financial liberalization and labor market reform to reverse the Dutch Disease – particularly the "deindustrialization" effect – in Egypt. Indeed, they highlight the need for a coherent industrial strategy as part of any overall economic reform program.

The current economic reform and structural adjustment program: 1991-1994

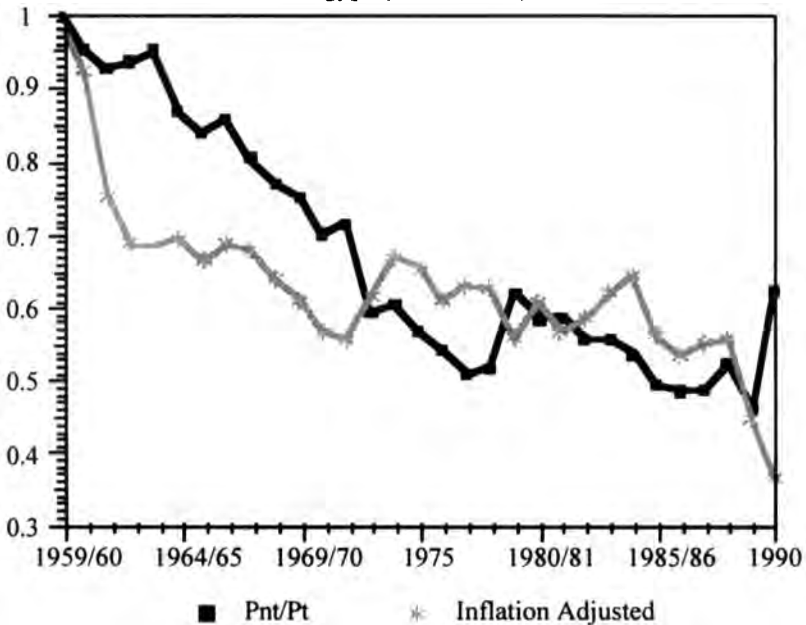
As mentioned above, by the late 1980s, real per capita GDP was declining in Egypt, and the country's external financial position was critical. The government found great difficulty in financing the most basic import: wheat. The situation was saved by a Paris Club 50 percent debt reduction agreement in the aftermath of the Iraqi invasion of Kuwait. This debt relief and other foreign assistance was conditional on the implementation of an IMF/World Bank economic reform and structural adjustment program, which the Egyptian government signed in 1991. Egypt's current reform program has both "stabilization" and "structural adjustment" components. The stabilization policies in the program aim at correcting macroeconomic imbalances and curbing the inflation rate, and encompass a whole range of contractionary fiscal, monetary and domestic credit measures, including raising the interest rate and placing a restraint on credit extended to the public and private sectors, as well as a devaluation-cum-unification of the exchange rate structure.

Table 6: Measures of the Real Exchange Rate in Egypt, 59/60-91/92

	Nominal US$/L.E Average	Nominal L.E/US$ Average	inf. adj real rate	PNT/PT	inf. adj real rate (Indices: 1960=1.0)	PNT/PT (Indices: 1960=1.0)	inf. adj real rate (Indices: 1974=1.0)	PNT/PT (Indices: 1974=1.0)
1959/60	2.60	0.38	2.60	1.72	1.00	1.00		
1960/61	2.38	0.42	2.39	1.63	0.92	0.95		
1961/62	1.96	0.51	1.95	1.59	0.75	0.92		
1962/63	1.79	0.56	1.77	1.60	0.68	0.93		
1963/64	1.80	0.56	1.77	1.63	0.68	0.94		
1964/65	1.75	0.57	1.79	1.48	0.69	0.86		
1965/66	1.69	0.59	1.72	1.44	0.66	0.84		
1966/67	1.70	0.59	1.77	1.47	0.68	0.85		
1967/68	1.75	0.57	1.75	1.37	0.67	0.80		
1968/69	1.72	0.58	1.65	1.32	0.63	0.76		
1969/70	1.69	0.59	1.58	1.29	0.61	0.75		
1970/71	1.73	0.58	1.45	1.20	0.56	0.69		
1971/72	1.74	0.58	1.43	1.22	0.55	0.71		
1973	2.00	0.50	1.58	1.01	0.61	0.59		
1974	2.06	0.48	1.72	1.03	0.66	0.60	1.00	1.00
1975	1.98	0.50	1.68	0.97	0.65	0.56	0.98	0.94
1976	1.77	0.56	1.57	0.92	0.60	0.53	0.91	0.89
1977	1.78	0.56	1.62	0.87	0.62	0.50	0.94	0.84
1978	1.76	0.57	1.61	0.88	0.62	0.51	0.94	0.85
1979	1.39	0.72	1.43	1.06	0.55	0.62	0.83	1.03
1980/81	1.36	0.74	1.56	0.99	0.60	0.58	0.90	0.96
1981/82	1.21	0.83	1.45	1.00	0.56	0.58	0.84	0.97
1982/83	1.17	0.85	1.50	0.94	0.58	0.55	0.87	0.91
1983/84	1.16	0.86	1.59	0.95	0.61	0.55	0.92	0.91
1984/85	1.12	0.89	1.65	0.91	0.64	0.53	0.96	0.88
1985/86	0.92	1.09	1.44	0.84	0.55	0.49	0.83	0.81
1986/87	0.89	1.12	1.36	0.82	0.52	0.48	0.79	0.79
1987/88	0.80	1.25	1.41	0.83	0.54	0.48	0.82	0.80
1988/89	0.75	1.33	1.42	0.89	0.55	0.52	0.83	0.86
1989/90	0.56	1.80	1.14	0.78	0.44	0.45	0.66	0.76
1990/91	0.39	2.55	0.93	1.06	0.36	0.61	0.54	1.02
1991/92	0.30	3.33		0.92		0.53		0.89

Notes: Average: is the average of the primary, secondary and tertiary rates.
Inf. adj. real rate: is the real rate calculated as the nominal rate adjusted for changes in the inflation rate relative to the US inflation rate.
PNT/PT: is the real rate calculated as the price of nontradables relative to the price of tradables.
Source: IMF, International Financial Statistics, Pick's Yearbook of Currencies *and Sakr (1995).*

Chart 5: Real Exchange Rate Indices in Egypt (1960 = 1.00)



The structural adjustment component of the program, on the other hand, includes policies in the areas of public sector reform and privatization, liberalization of trade and investment policies, and price liberalization (IMF 1991).

Judging from announcements by the government, the industrial strategy implied by the reform program (insofar as it is possible to identify one) is based on the conviction that the poor performance of Egypt's industrial sector is mainly attributable to an overvalued exchange rate, excessive administrative control on prices, as well as subsidies to public sector enterprises that led to a misallocation of resources. Thus, the government is currently adopting an industrial policy that entails large-scale privatization of state-owned enterprises as well as the gradual removal of subsidies and price controls in the remaining public sector companies. Moreover, the government is committed to a policy of promotion of export-oriented industries and liberalizing imports to foster competition with the outside world (Ministry of Industry 1991 and Said 1992).

Recent appraisals of Egypt's ERSAP highlight the success of its stabilization component in restoring the country's creditworthiness with the rest of the world, controlling inflation, removing discriminatory policies between the public and private sectors in financial and foreign exchange markets, and

boosting expectation and confidence due to the stabilization of the exchange rate. Yet, its impact on growth has been highly negative, and the assumption of the underlying model that a boost in private sector investment in the medium term would help restore growth is now being increasingly questioned, given that there are elements in the ERSAP itself (such as decreasing public expenditure, which is mostly of the crowding-in type, credit restraints, and the maintenance of high interest rates) that are likely to discourage private sector investment (Handoussa 1993).

Given the central importance that the ERSAP attaches to private investment, it is useful to briefly report on the results of some recent empirical works devoted to examining the behavior of private investors in Egypt. Recent econometric work on the determinants of private investment in Egypt include Shafik (1989) and Sakr (1995), whose results are more or less similar. The significant determinants of private investment that they have identified are growth in demand, government investment in infrastructure, credit extended to the private sector, and the real wage. Sakr identified demand and credit allocation as the most significant factors. Both, of course, were negatively affected by the recent contractionary stabilization policies.

Another important study to be quoted in this context is that by Fawzy (1992), who conducted a survey in the Tenth of Ramadan new industrial city to examine private industrialists' views on the expected impact of the current reform on their industries. On the whole, the survey showed an expected negative impact of many aspects of the reform program, especially with regard to the stabilization side of the program and its likely adverse effect on domestic demand. The industrialists reported unutilized capacity to be already in the range of 40-60 percent of total capacity, and found that the expansion of exports was a difficult option because of inferior quality, lack of expertise, fierce international competition, and import quotas imposed by other countries, including the European Union. They were rather pessimistic with regard to the expected effect of exchange rate devaluation, as they believed that the demand for their exports was price inelastic. In their view, any increase in their income due to devaluation would be wiped out by increases in taxes and prices of public utilities. There were also further concerns about the impact of devaluation on the cost of capital and intermediate inputs and the impact of exchange rate unification on customs dues.

Yet, what these industrialists indeed feared most was import liberalization and the wave of fierce foreign competition and dumping practices that were expected to follow. They noted how similar liberalization in the ODP period forced many of them to move from producing to importing, and many only returned to industry during the first half of the 1980s because of the then-supportive industrial environment and the favorable concessions offered to

the New Cities. They believed that many of them would now move again to importing in the new hostile atmosphere. The survey, however, identified a positive attitude towards privatization due to the expected improvement of the quality of the intermediate goods that the public sector presently produces. The industrialists were not, however, ready to buy public sector companies, as they believed that these were mostly beyond their financial capability, and also because of that sector's structural problems, regulations, and restrictions (including labor legislation). This survey, as well as other recent studies on the industrial sector in Egypt, identified that apart from reform-related difficulties, industry continues to suffer during the 1990s from the low quality of human capital, the lack of entrepreneurial and organizational skills, and political uncertainty. Handoussa (1991), after reviewing current problems in Egypt's manufacturing sector, also noted that it is unlikely that privatization on its own can adequately address the problems of the manufacturing sector in Egypt, which are related mostly to ill-suited industry-specific strategies rather than to ownership structure.

In sum, the analysis so far has pointed to the lack of coherence in industrial policies pursued in Egypt during the 1970s and 1980s. It has also demonstrated the insufficiency of the government's current economic reform and structural adjustment program in addressing the pressing problems in the Egyptian manufacturing sector. It is argued here that there is a pressing need for policy-makers to formulate a sound industrial strategy along the lines of the East Asian model of successful industrialization. The following section explores this issue in some detail.

The need for a coherent industrial strategy: the East Asian experience

The limits to liberalization and depoliticization

The idea that the state should play a leading role in economic development was central to many early development theories. At the core of these theories was the notion of the "developmental state" that can create and regulate economic and political relationships capable of supporting sustained industrialization. The economic reform program which has been implemented in Egypt during the last few years is based on what came to be known as the "neo-liberal" paradigm in development economics, the core of whose policy proposals in fact constitutes an attack on the notion of the developmental state. (For an assessment of this paradigm, see Chang and Rowthorn 1995).

According to the neo-liberal argument, the main – if not the only – source of the current ills of developing countries can be found in the overextended state, which not only tries to do too many things that private sector agents

should be doing but also intervenes too much in the workings of the price mechanism. Such an interventionist state opens the door for political forces to invade the sphere of economic management, thus leading to policies which promote only certain sectoral interests or to wasteful rent-seeking activities. Thus, market liberalization (both domestic deregulation and trade liberalization) is perceived not only to increase economic efficiency, but also to permanently render the sphere of economic policy more rational by depoliticizing it.

The main contribution of neo-liberalism has been to identify certain important problems affecting the earlier industrialization efforts of many developing countries, especially by pointing out that the apparent policy errors in many LDCs may have deeper causes than the technical incompetence of their bureaucracies or the "irrational" goals imposed by political rulers – namely, the nature of interest groups and the nature of the state. However, one can identify several crucial limitations to the neo-liberal policy proposals of liberalization and depoliticization as strategies for attaining long-term developmental goals.

The case for liberalization rests mainly on a number of static efficiency arguments: state intervention creates allocative inefficiencies by distorting price signals; it generates X-inefficiencies (or organizational slacks) by dampening competitive pressure; and it leads to rent-seeking costs by creating the opportunities to acquire monopoly positions through unproductive activities. As far as the importance of dynamic efficiency is recognized (which is frequently not the case), it is argued that increased competitive pressure following liberalization should lead to faster innovation and productivity growth.

These arguments in favor of liberalization, however, are subject to several limitations. First of all, it is well-known that the theoretical conclusion on the allocative optimality of the free market depends on many stringent assumptions which do not obtain in the real world (Schotter 1985). Secondly, the Second Best Theorem (Lipsey and Lancaster 1956) tells us that liberalizing more (but not all) markets does not necessarily guarantee higher allocative efficiency. As far as total liberalization is not possible, there is no guarantee that partial liberalization will bring about an improvement, even purely in terms of static allocative efficiency. Thirdly, liberalization does not necessarily lead to faster growth or increased dynamic efficiency (Chang 1993).

The argument that liberalization will lead to greater competition, which will in turn lead to faster innovation and productivity growth, ignores the fact that the withdrawal of the state does not guarantee more competition. There exist barriers to entry other than the ones created by the state which would still remain, some of which could become even more prominent after liberalization (see Handoussa 1994 for some examples from Egypt). One could go even further and argue that there may even be a trade-off between static and

dynamic efficiencies, as innovation often requires complex institutional arrangements which cannot be provided by the arm's length market relationships and maximum price competition which is the aim of liberalization (see Schumpeter 1987 for a classic statement of this position; for more recent contributions, see essays in Dosi *et. al.* 1988 and Nelson 1993).

As for the case for depoliticization, it is founded on the belief that the political management of the economy will subject the latter to abuses by those who have privileged access to the government (such as politicians, bureaucrats, and powerful interest groups). Hence, it is argued, the need to depoliticize the economy by neutralizing those who can exercise political influence on government economic policies. Although this is a very important and powerful argument, it still has a number of important limitations (for details, see Chang 1995).

First of all, contrary to the assumption that self-interest prevails in the polity in the same manner as in the economy, our political actions are very often based on motivations which are not entirely selfish, such as nationalism, religious beliefs, public service ethic, ethnicity, gender, and so on. Nor could they be dealt with as a mere "packaging" of self-interests. Assuming away these motivations will give us only a distorted picture of the political reality and lead us to wrong solutions. For example, can we treat the recent spread of Islamic fundamentalism in Egypt simply as another form of interest group activity? Secondly, in the neo-liberal view of politics, interests determine government policy with little, if any, mediation through institutional mechanisms such as political parties, bureaucratic hierarchy, and state-chartered corporatist institutions. In reality, these institutions play an important role in determining the kinds of interests that can legitimately be represented (or repressed), the way in which they are represented (or repressed), and the impact that they have on policies. Thirdly, it is not clear whether the degree of depoliticization recommended by neo-liberal propositions is in fact politically feasible.

For better or for worse, all countries have developed certain (at least implicitly accepted) ways to politically modify certain market outcomes (for example, through import protection, subsidies, welfare schemes, job guarantees, and so forth). Whether or not these schemes are economically desirable, they may be politically very costly to eliminate. For instance, they may have to be achieved through considerable political repression, as in Chile under the Pinochet regime. Finally, it is not clear whether depoliticization is an attractive option even from a purely economic point of view. In a world full of assets with limited mobility (task-specific equipment, firm-specific or industry-specific skills, etc.), the owners of such assets have the incentive to resist those economic changes that may threaten their position. In such a situation, a more overtly political management of the process of change may be better,

as long as it is done in a forward-looking manner, as recent research shows in the case of East Asian industrial policy and Scandinavian social corporatism (see Chang 1994b for details).

The East Asian challenge

In addition to the theoretical criticisms that we discussed above, the successful developmental experience of East Asia (especially Japan, South Korea, and Taiwan) pose a major challenge to the above policy prescriptions (Chang 1995). Initially, these countries (especially Korea and Taiwan) were portrayed as the ideal liberal economies which pursued free market and free trade policies. However, by the early 1990s numerous studies had revealed that these economies actually grew on the basis of policies which are almost antithetical to the neo-liberal recommendations. In the following, rather than trying to portray a full picture of the East Asian experience, we hope to bring out only those important aspects which question some of the standard neo-liberal policy proposals (for detailed analyses of Japan, see Johnson 1982 and Dore 1986; of Korea, see Amsden 1989 and Chang 1993; of Taiwan, see Amsden 1985 and Wade 1990).

Macroeconomic management

The crux of macroeconomic policy in East Asia was to give priority to investment over consumption so that a new capital stock embodying more advanced technology could be built quickly. Maintaining the level of investments was considered crucial, to the degree that their macroeconomic management is better described as "investment management" rather than "aggregate demand management" (Chang 1993:139). Macroeconomic policy in East Asia was geared towards creating an expansionary environment in order to sustain high levels of investment by maintaining "investors' confidence." If this resulted in some inflation, policy-makers were willing to live with it as far as it did not get out of hand (which it never did). Contrary to a widespread assumption, these economies did not grow on the basis of anti-inflationary policies. Indeed, until the 1980s they had inflation rates which were higher than those in many other developing countries, including some Latin American ones.

Earlier in their developmental experience, of course, domestic savings fell short of investment demands, and therefore policy measures such as restrictions on consumer loans and heavy taxation on luxury consumption were employed in order to repress consumption demand. The anti-consumption policy was even stricter when it came to consumption involving foreign exchange expenditure. For example, in Korea, foreign holidays were banned until the late 1980s, and the importation of luxury consumption goods has

been either banned or subjected to high tariffs and inland taxes. We are still far from fully understanding the dynamics of saving-investment-growth in East Asia, but it is clear that the rise in savings in these countries was not achieved through a liberalized financial regime with high positive real interest rates, which neo-liberal economists have been recommending to developing countries over the last decade or so. Financial regimes in East Asian countries have been highly repressed (with often negative real interest rates) by the governments, which either owned (Korea and Taiwan) or heavily controlled (Japan) the banking sector (for a critique of the neo-liberal "financial liberalization" arguments based on evidence from East Asia, see Harris 1987, Dornbusch and Park 1987, and Somel 1990).

External policy

It is often uncritically assumed that East Asian countries, being successful exporters, have maintained comprehensive openness to the outside world. This view, however, has been challenged in several recent works which revealed that East Asia's openness to the outside world has been highly selective. East Asian external policies were based on a strategic attitude, putting long-term national interests first in determining the scope and degree of openness in various areas (Singh 1994).

First, with regard to trade issues, East Asian governments heavily used tariffs and quantitative restrictions, sometimes to deal with balance of payments problems, but mainly to protect strategic infant industries as well as declining industries later in their developmental experience. There has also been widespread foreign exchange rationing by governments, which assigned top priority to the importation of capital goods and intermediate inputs over the importation of consumption goods. Prohibitive inland taxes were also used virtually to ban the importation of luxury consumer items, which were subject only to non-prohibitive tariffs. For instance, in Korea up until the late 1980s, the domestic price of imported scotch whisky, whose tariff was "only" 100 percent, was over nine times that of c.i.f. price after various inland taxes, such as the liquor tax, the luxury consumption tax, and the value added tax (Chang 1993).

In the area of foreign direct investment (FDI) and technology import, a similar – if not even more severe – situation has emerged. East Asian policy-makers, especially in Japan and Korea, have tried their best to discourage foreign direct investment if national firms could do the job (with some government support). As a result, for example, FDI accounted for only five percent of total foreign capital inflows into Korea between 1962 and 1983. Even when FDI was allowed, foreign majority ownership was practically banned, with some rare exceptions. Again, telling statistics comes from Korea. As of mid-1980s, only six percent of the subsidiaries of multinationals in Korea were

wholly-owned, compared to 50 percent in Mexico and 60 percent in Brazil. It is now also well known that East Asian governments imposed conditions on multinationals regarding the terms and speed of technology transfer, and on other issues which were deemed to be relevant to the national interest.

Even when it came to licensing technology from abroad (which was preferred over FDI), East Asian governments imposed heavy restrictions regarding the type of technology and the terms in which it could be imported, especially royalties and export restrictions clauses. Of course, this is not to say that East Asian policy-makers were against importing foreign technology on principle. On the contrary, East Asians have always been keen on acquiring the latest foreign technology. Restrictions on technology imports were imposed because policy-makers have regarded the accumulation of technological and managerial capabilities by domestic firms as a vital condition for effective industrial upgrading.

Industrial policy

The most important – and most controversial – aspect of East Asian state intervention is industrial policy, or more specifically, selective industrial policy, which involved the deliberate promotion of certain industries by the state through various formal and informal channels (Chang 1993, Amsden 1989, and Wade 1990). Within the framework of medium-term indicative planning, East Asian policy-makers identified sectors with high growth potential as priority sectors and provided selective support to them. The choice of priority industries reflected the economy's stage of development at a particular time. Hence, emphasis was placed initially on relatively less-demanding industries, such as non-durable consumer goods and intermediate inputs industries, and later on more demanding industries as the technological and managerial capabilities of domestic producers were developed. Priority industries received various kinds of state support, such as subsidized credit, rationed foreign exchange, preferential tax treatment, temporary suspension of antitrust measures, subsidies for research and development activities, import protection, and so on. In return for state support, these industries became subject to state controls on pricing, choice of technology, capacity expansion or reduction, entry and exit, and so forth.

The basic idea behind East Asian industrial policy is that, in a world where it takes time to master new technology, it makes sense for governments to erect temporary protective barriers in order to create incentives for private sector firms to start new industries. Moreover, protection may last quite a long time, as witnessed by the case of Japan, which protected its auto industry for decades. This is precisely the sort of idea that is criticized by theories advocating the benefits of free trade, but this is exactly how most, if not all,

leading industries in East Asia were established. Indeed, many of the world's leading industries in East Asian countries, such as the Japanese automobile industry and the Korean steel industry, were established exactly against such criticisms from home and abroad.

As we mentioned above, the role of industrial policy in the East Asian economic success has been one of the most controversial issues in economics over the last couple of decades (Chang 1994a). Initially, the supporters of the free market interpretation of East Asian industrialization dismissed the role of industrial policy in these countries as a marginal phenomenon at best (Balassa 1988). Later, as evidence accumulated showing the ubiquitous and heavy-handed character of industrial policy in these countries (Amsden 1989, Wade 1990, and Chang 1993), they changed the argument, claiming instead that industrial policy, albeit widespread, had only a very limited effect on productivity change and the structure of production. The "East Asian Miracle" report by the World Bank (World Bank 1993) is representative of such a view. However, a large number of critiques have shown that the World Bank's verdict is based on an analysis which makes some very fundamental mistakes: it misidentifies the promoted industries; it ignores certain important criteria in assessing the performance of industries; it applies the wrong time frame in assessing industry performance; it employs questionable counterfactuals, and so on (for details, see Chang 1995, World Development 1994, No. 4, Fishlow *et. al.* 1994, and Singh 1994).

Redefining the role of the state in development

What are we to conclude from the preceding discussion of the limitations of the neo-liberal paradigm and the lessons from East Asia? To begin with, it should be made clear that, despite the numerous limitations of its policy proposals, the neo-liberal paradigm has made an important contribution by making us rethink the role of the state in developing countries. In particular, the case for policy reform – and by implication political reform – in order to overcome "government failure" problems in developing countries must be taken seriously.

However, we have discussed in some detail why the liberalization/depoliticization package may not provide a correct proposal for policy reforms in these countries. We have also reviewed the East Asian experience, which shows the attraction of a developmental strategy which is based on pro-investment macroeconomic policy, activist industrial policy, and vigorous but selective interaction with the world economy. All these point in one direction: namely, the need for the reconstruction of the developmental state. This is a state which takes the goals of long-term growth and structural change seriously, politically manages the economy to ease the conflicts inevitable during the process (but with a keen eye on long-term goals), and engages in institutional

adaptation and innovation in order to achieve those goals (Chang 1995). Moreover, what seems to be appropriate for serious policy reform in many developing countries is an alternative approach which takes neo-liberalism seriously but goes beyond it. As we have no space to discuss this issue in any detail, let us just very briefly sketch what we believe should be its main elements (for some more systematic arguments, see Chang 1994b and 1995).

First of all, it has already been pointed out in the above discussion that the neo-liberal paradigm pays too little attention to the issue of dynamic efficiency. An alternative approach must take the issue of dynamic efficiency very seriously, and must try to explore the way in which various technological and institutional factors affect the process of innovation and productivity growth. Recent literature on technical progress provides us with some interesting insights in this regard. Secondly, the neo-liberal paradigm rightly emphasizes that economic policy-making (and policy implementation) is a fundamentally political process, and that serious policy reform may thus require concomitant political reform. However, as we suggested, the neo-liberal view of politics is based on a simplified notion of politics which assumes that personal interests are the only motivation that drive political actors, and that these interests determine government policy with little, if any, mediation through different institutional mechanisms. The existence of these factors casts doubt on both the feasibility and desirability of the depoliticization of the economic policy process as a proposition for reform. Thus, the alternative approach should be based on a more sophisticated understanding of politics which overcomes the above-mentioned limitations if it is to be able to present a realistic but innovative agenda for policy and political reforms. In addition, despite the fear that an activist state could – under certain conditions – lead to the corruption of economic policy-making, an explicitly political management of the economy may be better in a world full of assets with limited mobility, insofar as this is carried out with an eye on long-term developmental goals (Chang 1995).

Lastly, the alternative approach has to overcome another critical weakness of the neo-liberal paradigm, namely: its inability to recognize that a modern economy cannot be sustained simply by an arm's length market relationship, but that it requires instead a rather complicated institutional fabric (Coase 1992 provides a concise but powerful statement of this point). When it comes to practical policy suggestions, the neo-liberal recommendation amounts to the proposition that developing countries should copy Anglo-Saxon economic institutions characterized by arm's length relationships between contracting partners, and very highly stylized versions of them at that. However, recent theoretical developments in institutional economics as well as empirical research on different OECD economies have shown that the Anglo-Saxon institutional configuration is not the only viable – let alone the most efficient

– way of organizing a capitalist economy (Chang and Kozul-Wright 1994). In what follows, before attempting to draw specific lessons from East Asia for industrial policy design and economic reform in Egypt, we will examine the various arguments on whether it is indeed useful or plausible to engage in such an exercise and on the extent to which the Korean experience is of particular relevance.

What can Egypt learn from the Korean experience?

East Asia as a special case

When we talk about the possible lessons from the "East Asian experience," a common response is that the East Asian experience is almost irrelevant to other countries because it is a special case with so many unique conditions. To name just a few important ones: they possess the magical Confucian culture which produces a highly-educated, frugal and hard-working population; their ethnic and cultural homogeneity and – in the case of Korea and Taiwan – their small size make them easy to run; and their location as frontier states during the Cold War brought them large amounts of US aid. With so many unique conditions, it may seem almost pointless even to think of drawing lessons from East Asia.

But just how persuasive are these special case arguments? Above all, some of the special case arguments are simply ill-informed (see Little 1980 for an excellent criticism of some of these arguments). One good example is the "size" argument. Despite the widespread misconception that it is a "small" country in terms of population, Korea, with 43 million people (as of the early 1990s), is the 21st largest country in the world and the 12th largest developing country. If Korea benefited from its small size, there are more than one hundred other countries which should have enjoyed such a benefit as well. Another example is the "homogeneity" argument. East Asian countries may be more homogeneous than many other (especially ex-colonial) countries, but it is not well known that Korea suffers from acute regionalism, and that Taiwan is culturally and politically divided between the 20 percent of the population which came from mainland China after 1949 and the rest, who are native (at least for a few generations) to the island.

To be sure, not all special case arguments are ill-informed. Confucianism and geopolitics are cases in point. However, it is not clear whether they have been unmixed blessings. First, let us consider the case of Confucianism. Contrary to what people think now, many East Asians thought, at least until the 1950s, that Confucianism – with its disdain for commercial activity and its emphasis on conformity, which may hamper entrepreneurship – was actually an obstacle to economic development (Balassa 1988). The point is that all so-called "traditional" cultures, whether they are based on Confucianism,

Christianity or Islam, embody certain elements which are potentially beneficial to economic development and others which may not be so. The question is how a particular society can "reconstruct" its culture in a way that encourages the beneficial elements and suppresses the harmful ones. Another mixed blessing is geopolitics. It is true that thanks to their role as frontier states against Communism in the Cold War, Korea and Taiwan received among the highest levels of per capita aid from the US during the 1950s. However, exactly because of this role, both countries had to devote about six percent of their GDP to defense until very recently. Especially in the case of Korea, the Cold War led to the division of the country and to the Korean War, which was very costly in terms of both human lives and physical capital.

By refuting the special case arguments, we are not trying to argue that a country's historical and cultural legacies do not matter. What we wish to dispute is the view that no lesson can be drawn from the experiences of other countries which had different initial conditions. The fact that a given country might be different from another does not mean that one cannot learn from it. It only means that one should try to identify the conditions which made a certain policy or institution viable in that country before importing it, and that one should think more carefully about how to adapt the imported policy or institution to one's own local conditions. In fact, East Asian countries themselves provide a useful example against the special case argument. If East Asians believed in a similar special case argument regarding the West and gave up importing and adapting Western technologies and institutions, we simply would not have the so-called "East Asian miracle" today.

Comparing Egypt and Korea

As mentioned in the introduction to this chapter, due to various similarities between the two countries, the recent industrialization and development experiences of Egypt and Korea have frequently been contrasted in the literature. Thus, in drawing lessons to Egypt from the East Asian experience, it might be informative to compare Egypt directly to Korea. Studies in this area identified similarities between the two countries to include: population size, structure of production (see Table 3), and scarcity of natural resources, such as limited endowments of arable land relative to the abundance of human resources. An important exception to the latter point, of course, is the existence of a surplus in the oil trade balance of Egypt – although not large enough for the country to be considered "oil-rich" – compared to a relatively large oil import bill in Korea (Mason 1986).

Moreover, on the human resource side, adult literacy is now almost universal in Korea, while in Egypt it is only 50 percent. Yet, one should note that both countries did manage to raise their literacy rates over the past three

decades to cover an additional 25 percent of their adult populations (see Table 7).

Other important similarities between the two countries can be seen in Table 8. For example, both Egypt and Korea have an equally large outstanding foreign debt (estimated at US$40 billion in 1991). Yet, when measured as a percentage of GNP, the figure is as high as 133 percent in Egypt and only 14 percent in Korea, and the debt service ratio has also been much higher in Egypt than in Korea. Both countries have heavy food import bills and a high trade dependency ratio, yet the export-import ratio is much higher in Korea than in Egypt, indicating its ability to finance more of its imports out of its own export revenues than in the case of Egypt. Moreover, on the international relations front, both countries have been subject to considerable international interest and interference from the super powers, and were involved in regional conflicts that led to the allocation of a substantial part of their physical and human resources towards defense (Handoussa 1986). In 1990, military expenditure stood at about four percent of GDP in both cases, constituting a reduction from the 1960s by almost 60 percent in Korea and 40 percent in Egypt. Yet, when considering the size of their armed forces, it is interesting to note that unlike the common view that Egypt is much more security-oriented than Korea (Mason 1986), the figure for enrollment in the armed forces, when compared to population size, is twice as high in Korea, and it is almost three times higher when compared to the number of teachers in each case.

Table 7. Trends in Human Capital Formation in Egypt and Korea

	Egypt	Korea
1. Adult Literacy Rate (age 15+)		
1960	25.8	70.6
1992	50.0	97.0
2. Enrollment Ratio (% of age 6-23, 1990)	66.0	74.0
3. Mean Years of Schooling (age 25+, 1992)	3.0	9.3
4. R&D Scientists & Technicians (per 10,000 people, 1986-9)	6.0	22.0
5. Expenditure on Education (as % of GDP, 1990-91)	6.7	3.6
6. Expenditure on Education per Individual (age: 6-21) (US$, 1990)	117.0	816.0

Source: World Bank, 1983 World Tables; *UNDP,* 1994 Human Development Report; *and Fergany (1994).*

The nature of the Moroccan state

Those who wish to know Morocco and are interested in its history will notice that this is a country with a unique identity in the Arab world and in the Maghreb. The fact that Morocco began to form its identity in the 9th century, consolidated it in the 16th century, and preserved its sovereignty from Ottoman rule during roughly four centuries accords the country the status of an old nation. Still today, even though conditions have changed, Morocco continues to uphold this heritage even as it modernizes.

It is from this long historical evolution that the "Makhzen" (the Moroccan state) derives its existence and its legitimacy. The Makhzen is not the contradictory outcome of colonization and the struggle engendered by it, as is the case in so many Third World countries. On the contrary, it has a history dating back many centuries in which it inscribes its legitimacy and *raison d'être*. Its historical and political origins largely explain its roots in the reality of the country. Born out of Moroccan society at a given point in its history, the Makhzen is endowed with a trans-historical legitimacy enshrined in the foundations of local society and anchored in the psyche of the Moroccan masses, who recognize its ability to embody the unity of the nation and to use certain religious symbols on the nation's behalf (the King being at the same time the "Commander of the Faithful"). This long history has enabled the Moroccan state to accumulate a stock of knowledge about social matters that ensures its effectiveness in the country's political life.

Rather than altering this historical legacy, colonization actually reinforced it. Indeed, even though it dismantled the old social order, the colonial process did not block the historical transition of the community towards civil society. On the contrary, colonization created the conditions for the birth of civil society through the development of a merchant culture and, above all, by destroying the centrifugal powers of tribes and *zaouias*. By making the center the main organizer of society, colonization brought about a change as formidable as the birth of the nation-state in Europe. Due to its technological and military superiority, its means of communication and information and its administration, colonization centered all powers around the state and even managed to effect some sort of national integration. As a result, the state has become omnipresent, entering the social realm with a view to controlling the reproduction of society. To its ideological hegemony and traditional legitimacy the colonial state has added the technological and administrative means necessary for the institutional strengthening of the state. Consequently, at independence the Moroccan state took over power on the strength of three favorable factors: tradition, state centralization and national claims. Independence allowed the state to increase its scope of intervention and to spread its activities to new

education in Egypt and Korea, as shown in Table 7. As suggested by Fergany (1994), educational wealth can be approximated by the mean years of schooling received per person aged 25 years and over, which is only three years in Egypt, compared to 9.3 years in Korea. The quality of educational wealth can be approximated by the number of research and development scientists and technicians as a percentage of the total population, which is almost four times as large in Korea than in Egypt. Looking at expenditure on education as a percentage of GDP, it would appear that Egypt is investing almost twice as much as Korea. Yet, as argued by Fergany (1994), this does not constitute an adequate indicator of investment in education for comparative purposes, as it does not correct for population size, age structure and the magnitude of gross product – all important factors in international comparisons. An alternative measure is that of current expenditure on education per individual in the 6-21 age bracket in 1990 US dollars. Measured as such, the estimate in Table 7 shows that Korea, in fact, spends almost seven times as much as Egypt on education.

Table 8. Resource Flow Imbalances and Military Expenditure in Egypt and Korea

	Egypt	Korea
1. Total External Debt (1991)		
U.S. $ (billions)	40.6	40.5
As % of GNP	133	14
2. Debt Service Ratio (% of exports)		
1970	38.0	19.5
1991	16.7	7.1
3. Trade Dependency (1991) (exports plus imports as % of GDP)	39	54
4. Export-Import Ratio (1991) (exports as % of imports)	49	88
5. Military Expenditure (% of GDP)		
1960	5.5	6.0
1990-91	4.0	3.8
6. Armed Forces (1990)		
per 1,000 people	8.6	17.5
per teacher	0.9	2.7

Source: UNDP, 1994 Human Development Report.

As for domestic capital investment, an important factor has been the anti-consumer, pro-producer bias of Korean financial and macroeconomic management, as highlighted in the previous section. This is in sharp contrast to the attitude towards the investor in Egypt, who is often perceived by the public service as an exploiter to be taxed in order to subsidize the consumer. Finally, Korea's selective approach towards foreign direct investment was discussed in the previous section. Handoussa (1986) argued that if Egypt had adopted a similar approach following the Open Door Policy, it would have avoided the entry of various foreign firms and the setting up of various joint ventures whose main pursuit was the earning of huge capital gains while hardly making any contribution to exports or the transfer of new products or technology.

Thirdly, there are a host of other factors that Mason calls "managerial factors" and Handoussa calls those pertaining to the "role of the state as a manager and institution builder." Handoussa identified macroeconomic management and institution building as two areas where state intervention was highly effective in providing Korea's "rare blend of what is predominantly a private sector economy manipulated to perform to what are publicly chosen objectives." The main factor behind Korea's success story was identified by the author as the pervasive role of government intervention within a private enterprise context by selectively choosing policy tools, developing effective specialized public institutions (in such areas as planning, trade promotion, management training, applied research and technology for industry, and the exchange of information among manufacturing firms and between them and the state) and continuously reassessing both policies and organizational structure in light of changing circumstances. Mason, on the other hand, emphasized factors such as differences in governmental objectives, the choice between public and private enterprises, management practices in the public sector, policies affecting incentives in the private sector and, most importantly, the way policies were implemented in the two countries.

The concept of the "hardness" (or, alternatively, the "softness") of the state is often invoked in the context of comparing policy implementation in the two countries, whereby the Korean state is described as a "hard state" in the Myrdalian sense, while its Egyptian counterpart is seen (in Mason's words) as "one of the softest of the soft states". Evidence on the hardness of the Korean state cited by Mason includes repeated devaluations of the currency despite the interests of Korean firms with large foreign obligations, severely dealing with tax evasion (including occasional prison sentences), and lack of tolerance for mismanagement in the public sector. By contrast, the softness of the Egyptian state is exemplified by its long-standing reluctance to reduce subsidies on common consumption goods and the protection of public sector employment, which resulted in considerable overstaffing in government agencies.

On the "hardness" of the state and the role of rents in industrial upgrading

The concept of the "hardness" of the state, particularly in relation to its role in controlling rent-seeking activities, has also been highlighted in studies dealing with the political economy of state intervention in Egypt and Korea (without, however, attempting to draw any parallels between the two countries). In the case of Egypt, Hansen (1991) defined the spoils of the patron-client system under different regimes in Egypt as rents, the nature of which were dependent on the institutional aspects of the system. Prior to 1952, rent-seeking took the form of efforts to increase tariff rates or government-subsidized loans, and rent-seekers were private businesses. The regimes of Nasser and Sadat were described by the author as those of weak autocrats who relied on an implicit social compact between the ruler and the ruled, the latter offering acquiescence and surrender of political rights in return for the ruler's commitment to providing ever-increasing standards of living (through rising consumer subsidies and public sector employment of graduates from the rapidly expanding secondary and higher education systems, all financed by "rents" or the "spoils" accruing from foreign borrowing, oil, and oil-associated windfall revenues).

In Korea, on the other hand, the essence of its industrial policy has been to entice firms into new industries through state-created rents. It has been argued that the potential waste of rent-seeking (where resources are diverted from productive purposes towards influencing the state) was minimized in Korea, relative to other countries, due to the presence of a hard state (Bardhan 1984). Yet, as Chang (1994a) argued, the emergence of huge corruption scandals on a regular basis in Korean business and politics shows that the Korean state is certainly subject to influence, albeit on a smaller scale than "softer" states. However, what differentiates Korea from other countries is that access to rent has been exclusive only to a limited number of people – the "Chaebols" (literally, the "financial clans") or conglomerates – and the Korean state has been willing and able to withdraw support from any one firm whenever performance lagged, as revealed through exporting and fierce competition in the domestic market. Such state discipline, when combined with industrial upgrading (which involves the creation of new and often bigger rents in more productive industries), has acted as a powerful incentive for firms to enhance their technological capabilities.

Thus, for the purposes of the present study, the distinction between "hard" and "soft" states, while useful in a certain descriptive sense, is of limited analytical use in drawing practical lessons for the design of industrial policy. For one thing, the concepts are too broad and do not allow for the fact that, for better or for worse, almost all states are subject to a certain degree of influence by certain groups or individuals. Moreover, the distinction pertains only to the stage of policy implementation and does not shed light on differences

in the goals of government intervention and other crucial functions of the state that shape industrial policy, as will be explained below.

Instead, the important point to be drawn from the comparison between Egypt and Korea is that the presence of rents in an economy and the involvement of the state in their creation and distribution do not necessarily lead to unproductive results. What seems to matter is the source of these rents and the manner in which they are utilized or distributed by the state. In Korea, rents were internally produced through the provision of tariff protection and other forms of subsidies (for example, subsidized credits) in order to entice private firms into new industries. Due to its control over the banking system, the state set strict criteria so that rents would not go on regardless of the performance of their recipients. Hence, in the Korean context, rents were ultimately utilized to achieve higher productivity and growth rates in the economy.

In Egypt, on the other hand, the source of rents was external to the country, in the form of "mineral" rents (oil revenue and associated workers' remittances from oil-rich states), "location" rents (from Suez Canal dues and tourism), and "geopolitical" rents (in the form of foreign aid). Three important characteristics of these rents introduced a sinister dynamics in the system. First, many of these rents are temporary in nature (the mineral and geopolitical rents are cases in point), as opposed to the ability, say, to invent new things and build a piece of machinery. Secondly, some rents (like oil export revenues and remittances) are highly correlated with each other and/or subject to violent swings in magnitude (see Tables 9 and 10 below). Thirdly, when a large part of such rents accrues from abroad, the ability to maintain a certain standard of living becomes in effect de-coupled from the country's domestic productive capacity.

Table 9: Correlation Coefficients Between Oil and Major Foreign Revenue Items in Egypt, 1970-92

All variables in real terms

	Oil Price	Oil Exports	Net Oil Exports
Raw Cotton Exports	-0.3767	-0.4731	-0.5546
Raw Cotton Price	-0.0672	-0.0048	0.0367
Raw Cotton Volume	-0.2485	-0.2297	-0.2900
Cotton Yarn Exports	-0.3123	-0.1939	-0.1796
Suez Canal Revenue	0.5293	0.6117	0.6551
Tourism Earnings	-0.4286	-0.3790	-0.2615
Workers' Remittances	0.4658	0.6626	0.6992
Total Major Sources	0.6577	0.8230	0.8510

Source: Sakr (1995).

Table 10: Variability of Major Sources of Foreign Earnings in Egypt, 1970-92

	Current			Real		
	Mean	S.D.	S.D./Mean%	Mean	S.D.	S.D./Mean%
Oil Price Index	64	42	66	61	36	60
Oil Exports	1512	1192	79	1384	1089	79
Net Oil Exports	1122	1017	91	980	975	99
Raw Cotton Exports	330	137	42	436	310	71
Cotton Yarn Exports	246	208	85	248	132	53
Raw Cotton and Cotton Yarn	603	205	34	723	301	42
Suez Canal Revenue	763	602	79	667	413	62
Tourism Earnings	807	516	64	700	332	47
Workers' Remittances	2244	1698	76	1923	1228	64
Total Major Sources	5779	3496	60	5228	2363	45

Source: Sakr (1995).

These three factors combined can easily (but not necessarily) lead to a sort of "ratchet effect" in consumption, that is, consumption rises in good times yet people find it difficult to reduce it when conditions change for the worse. This effect may be more serious in the case of government consumption or spending (including that on subsidies as well as wages and salaries), but should also apply to private sector consumption. As for investment (or expenditure on capital goods), including that in the manufacturing sector, to the extent that it is not sustainable exclusively on the basis of domestic productive capacity, it will tend to fall as external sources of rent are reduced. In Egypt, it is more challenging (but not impossible, as will be discussed below) to use these rents for long-term planning purposes and to upgrade the productive capacity of the economy, as was accomplished through the use of state-created rents in Korea.

In sum, the above comparison of the industrialization experience of Egypt and Korea reveals that although the state intervened significantly in both economies, this intervention was significantly more efficient in Korea. Yet, in Korea as well as other countries in East Asia, the role of the state in industry was not limited to regulating industry in the conventional sense (that is, regulating monopolies and imposing certain product standards, for example, for safety or environmental reasons), but took on a much more pro-active stance, including the imposition of restrictions on the private sector in order to promote rather than restrain industry in the long run. The main functions of the state in that context have been: (i) to provide a clear vision or a national project for the future of the economy; (ii) to develop its own institutional

capabilities as well as those of the private sector (or individuals) in order to pursue this vision or project while prudently managing the process of integration into the world economy; and (iii) to manage internal conflict due to structural changes in the domestic economy. In what follows, specific proposals for the role of the state in industrial policy design and economic reform in Egypt will be suggested, based on the East Asian experience in rebuilding a developmental state and under each of the above categories.

Proposals for the design of industrial policy and an alternative reform program for Egypt

Providing a vision and coordinating for change

Various recent studies on industrial development in Egypt have stressed that the root cause of the industrialization problem in the country lies in the lack of a national project or focal point of coordination that can instigate a re-industrialization drive in the face of the country's recent problems of de-industrialization (Abdel-Aleem 1993 and Abdallah 1994). If we agree that economic development, as Hirschmann (1958) claimed long ago in his critique of "Big Push" models, "depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized," then the problem facing a state promoting development is not only that of identifying and moving to an optimal state in a given choice set, but also that of formulating the choice set itself. As there are certain choices that can be made sensibly only at the national level, the state – as the only agent which has the potential (if not the actuality) of representing the national interest – must formulate the choice sets required for those choices by providing a "vision" for the future of the economy. As such, there is an important entrepreneurial dimension in the role of the developmental state.

In Egypt, it can be argued that the current goals of industrial policy have been mainly those of maintaining the *status quo* (that is, not to overload the import bill, not to reduce employment, and to maintain a source of government revenue through such measures as taxation of enterprises and charging interest on credit). Needless to say, these goals are hardly sufficient, and may in fact hinder the re-industrialization effort in the country. Instead, the goals of continuously upgrading productivity in the manufacturing sector and of that sector leading the process of growth in the economy need to be reasserted as a first step in building a coherent industrial strategy. It is in this context that shifting the boundaries between public and private sectors and between the state and civil society should be decided. This, in turn, entails a shift from the allocative aspects of industrial activities towards production-oriented ones

(Chatelus 1987), that is, from an industrial policy that is mainly geared towards selecting appropriate means of spending money, distributing income, and providing power or rent control (and which hardly goes beyond some spending programs) to one that is more committed to selecting objectives, establishing priorities between them, and implementing these goals. An important side effect of adopting such goals and building up industrial capability in the country is that the rent component in people's income is reduced, which creates a closer association between work and reward (significantly weakened in the previous era of windfalls in Egypt), which in itself is a crucial prerequisite for long-term productivity growth in the economy.

Once such an entrepreneurial vision is formulated, it is important to recognize that systematic changes to achieve this vision need coordination. An important insight from early development economics that has been confirmed by recent developments in the literature on technical change is that when interdependence prevails between economic agents, change will not automatically ensue without the (explicit and implicit) guarantee that complementary changes will also be made. In terms of designing industrial policy, this calls for centralized coordination of investment plans. Although, in principle, it is possible that the potential investors in complementary projects may devise a contract between themselves, such a contract may be costly to draw up and monitor, especially when it involves a large number of agents. State intervention in this case may cut the transaction costs involved in such contracts sharply. Such intervention need not involve financial resources like subsidies. Governmental announcements – as in the French and East Asian indicative planning exercises – may suffice, provided they can provide obvious focal points for coordination between complementary investments. Of course, financial incentives provided by the state, say, for cooperative research in new industries, although not necessary, may make the state's commitment to its announcement more credible by serving as a signalling device.

Developing the institutional capabilities of the government

Currently, there is a view that sophisticated interventionist measures as adopted in East Asia are not applicable to other developing countries because their governments do not have the institutional capabilities to implement them (World Bank 1993). Although this is a valid point at a particular point in time, we should also recognize that the institutional capabilities of the government themselves develop over time. This happens both through "automatic learning by doing" in government administration and through conscious effort (such as the training and retraining of bureaucrats, changes in recruitment policies, and changes in incentive systems). Therefore, the fact that a particular government does not have the institutional capabilities to conduct a certain

type of policy (for example, directed credit programs) does not mean that it should never try such a policy, because in the long run, such capabilities themselves may be enhanced.

One obvious way to improve the government's decision-making capability is to recruit better bureaucrats, say, by offering higher salaries. Yet, recruiting better people will not necessarily improve the quality of government decisions if the actual decision-making structure itself is not reformed with regard to factors such as the degree of centralization, how to departmentalize a ministry, how the ministries should interact with the private sector, and so on. Another way to improve the quality of government decision-making is to reduce information asymmetry both within the government (between top decision-makers and lower bureaucrats) and between the government and private sector agents. The former problem can be tackled by improving internal information flows in any government entity and by promoting organizational loyalty among bureaucrats so that they will reveal information more truthfully, while the latter can be handled by improving the information collection capacity of the state as well as setting up institutions which are intended to improve the information flow from the private sector, such as a general forum for government-private sector dialogue, industry associations, or deliberation councils intended to deal with specific issues.

With regard to the issue of how to reconcile the pursuit of self-interest by policy-makers with public interest, there is ultimately a need for moral persuasion against exploiting public office for selfish reasons. Contrary to what is usually implied in various mainstream economic theories, which implicitly or explicitly assume individuals to be born with totally self-oriented preferences, one can argue that individual motivations are in fact partly determined by the socialization process which goes on inside the family, schools, communities, and places of work. It is no coincidence that those renowned bureaucracies (for instance, France, Japan and Korea) are almost invariably those which are able to imbue its members with that sense of public service, commitment to the national cause, and *esprit de corps*.

Developing the capabilities of the private sector

The success of private entrepreneurship itself also critically depends on the construction of new institutional vehicles for the realization of its vision. Like governments, private sector agents also develop their capabilities over time. Given that the government does not have unlimited capabilities to do things, some delegation of power to the private sector through deregulation may be needed in accordance with the development of private sector capabilities.

The experience of East Asian countries points to such capability building as the most important task in designing an industrial strategy. In Egypt, before

aiming to export, there is a need to concentrate on producing what can be exported in the first place, in terms of its quality and competitiveness on world markets. To this end, there is a need for a long-term approach that provides selective intervention on an industry-to-industry basis, which certainly imposes short-term costs. Therefore, not too many industries should be promoted simultaneously. So that this will not lead to a once-and-for-all spurt ending up with a few well-protected industries, the state needs to provide a continuous boost to industrial upgrading. Seen in this light, sectoral promotion is not an aim in itself, but should always be tied to the achievement of certain long-run targets in domestic and/or foreign markets. Moreover, there is a need to continously coordinate investment policies, education policies and technology transfer policies in a consistent manner so as to provide strong incentives for private firms to build the capability to absorb technology and innovate.

To be sure, even with the general development of private sector capabilities, the government cannot relinquish all involvement in industries. New industries constantly emerge, and governments need to intervene heavily in them by providing technology standards, coordinating investments, and supporting cooperative research and development. As new industries mature, the government may reduce its involvement, but when industries later become "senile," there is a strong case for government intervention in order to engineer an orderly phasing out of that industry (Chang 1994a). So, the government will be shedding some of its old duties in order to take up some new ones.

Managing the process of integration in the world economy

As mentioned above, the East Asian openness to the outside world has been highly selective in areas of trade, foreign direct investment and licensing technology from abroad. The East Asian experience in general, and that of Korea in particular, shows that the widely accepted inward/outward, import substitution/export orientation dichotomy is misconceived. Either the two policies were pursued simultaneously or the country underwent a strategic shift from one to the other. The function of the developmental state is to determine the optimal degree of insertion in the world economy, given the stage of development and level of capabilities of its industrial sector, in a manner that would maximize its long-run growth objectives.

In the case of Egypt, an initial stage of export promotion based on traditional labor-intensive industrialization while building up industrial capabilities in more advanced industries is probably necessary. Yet, the question must be raised as to what extent this strategy can be pursued after the approval by the government of the Uruguay Round and whether there is a need for a joint industrial policy in the region that entails a regional division of labor and

cooperation in research and development in certain industries. Coordination of activities with the Maghreb countries, in particular, may serve to provide access to preferential European arrangements. However, labor-intensive industrialization for the sake of exports should not be viewed as an end in itself. A long-term perspective necessitates continuous investment in human resources and the pursuit of an active policy of technology acquisition to create a comparative advantage in a number of new and leading sectors of the future. These are likely to be of the skill-intensive and knowledge-intensive variety rather than those which rely on cheap unskilled labor alone (Handoussa 1993). All policies available to the state should be used in an effort to entice future investment in these industries, including the encouragement (or discouragement, depending on the case) of foreign direct investment and the provision of selective protection for limited duration to new or leading industries (which in turn entails a strategic shift in trade strategies).

Managing internal conflict due to structural change

Economic development involves the shift of resources from low-productivity activities like agriculture to high-productivity ones, such as manufacturing. When the mobility of certain physical and human assets is limited, this means that their owners will face the prospect of "obsolescence, unemployment and income differentials" if they accept the market outcome (Kuznets 1973:204). For this reason, those who have invested in particular kinds of physical capital, skills, contractual relationships, and even political patronage are likely to resist changes, thereby often provoking reactions from other groups. This makes the development process potentially very conflictual. Dealing with the conflicts arising from such resistance and the reactions to them is another important function of the developmental state.

In this context, the important question for the state becomes how to manage such conflict in a forward-looking manner or, more concretely, how to help different groups in society to come to an explicit or implicit agreement where losers would accept the need for adjustment and winners would compensate them for the burdens of such adjustment. The state in its role as conflict manager can be seen as providing insurance to the members of society by providing a governance structure which will guarantee some fair level of income to all of them under even the most adverse circumstances. In societies where the state fails to manage conflict in an appropriate way, people will be reluctant to take risks or commit their resources to specific investments, and therefore the dynamism of the economy may suffer.

In Egypt, special attention must be paid to the internal dynamics of the labor market. The current initial pattern of income distribution has important implications for industrial dynamism, and there is a real risk that industrialization

might lead to unequalizing growth, with two societies growing at two speeds: a rapidly growing but still rather small modern sector which adopts new technologies but specializes mainly in consumer-oriented industries, and a large informal sector which lacks dynamism and linkages with the modern sector. Thus, industrial policy must also be geared towards promoting a strong relationship and new collaboration between small-scale and modern industry through channels such as sub-contracting, for example. The experiences of successful rural industrialization in Japan and Taiwan, on the one hand, and the development of sub-contracting networks in Japan (and to a limited extent in Korea), on the other hand, may provide some useful lessons in this regard.

Conclusion

During the three decades following the Second World War, the logic of market failure dominated economic theory and policy-making, especially in relation to developing countries. During this period, a wide range of theoretical arguments developed to show why the market mechanism may fail to achieve efficient resource allocation and to promote long-term growth, and various kinds of state intervention which were supposed to remedy the failures of the market were practiced. The results of such interventions were not always satisfactory and sometimes were even disastrous, even though quite a few interventionist success stories were witnessed in East Asia and in Latin America before the debt crisis. Partly because of such results, an age of reaction has arisen since the mid-1970s. Thus, during the last 20 years, two types of arguments based on the logic of government failure have been developed to show that state intervention may not only fail to correct market failures, but may also lead to perverse outcomes. The first type questioned the intention behind state intervention and is usually known as the "neo-classical political economy" or "new political economy" argument. It was argued that the universally valid assumption of self-seeking motives should be applied to the realm of politics as well, and therefore that we should expect politicians, bureaucrats, and interest groups to use their influence on policy-making to advance their own self-interest rather than promote the public interest. The second type of government failure arguments questioned the ability of the government and highlighted that there is a clear limit to what a government can do, because government intervention is not costless. Such costs of intervention arise either from the costs of information collection, information processing, and policy enforcement, or from the costs caused by some unintended consequences of intervention, such as rent-seeking.

Following the rise of the government failure school, policies intended to roll back the state (such as large-scale deregulation, market and trade liberalization,

and depoliticization) have been proposed and implemented in many parts of the world over the last 20 years. It was in this context that successive partial liberalization programs have been implemented in Egypt since the mid-1970s, culminating in the current ERSAP. After 20 years of reaction, however, the pendulum seems to be swinging back, partly because these policies very often failed to deliver their promises (that is, they produced unimpressive results in their countries of origin, namely the US and the UK), and frequently even compounded the problems faced by reforming economies (especially in Eastern Europe). It is now coming to be accepted that many government failure arguments are based on extreme assumptions, which may produce misleading policy recommendations. The time seems ripe for the formulation of a more balanced view on the issue.

In this chapter, we presented an overview of the pattern of state intervention in the Egyptian industry and various strategies pursued over the past four decades, and argued that there was a clear lack of coherence in the industrial policies pursued, especially since the mid-1960s. We discussed why – both on a theoretical level and on the basis of some initial assessments of the effects of the current ERSAP in Egypt – the present policy mix is not sufficient on its own to reverse the de-industrialization effect inherited from the oil-boom era and to promote long-term growth, which may in fact exacerbate the country's current problems. Based on the East Asian experience of successful industrialization, we pointed out that the issue of industrial development is much more complex than a simple matter of changing trade regimes and ownership structures, and argued for the need for a developmental state that takes on the responsibility of designing and implementing a coherent industrial strategy. We then suggested that the central functions of such a state go far beyond correcting market failures in the conventional sense. They include the provision of an entrepreneurial vision and the coordination of large-scale changes, institution building (in both the government and the private sector), and the prudent management of integration in the world economy as well as internal conflict in the domestic economy. As was demonstrated in the above discussion, an approach which is richer in institutional texture and more sophisticated in its understanding of politics is called for in analyzing the question of the role of the market versus the state in industrialization.

That we have made a case for the developmental state, of course, does not mean that we can ignore the costs associated with active interventionist policies as repeatedly pointed out in the government failure arguments mentioned above. The various informational and rent-seeking problems in relation to policy design and implementation, as well as the danger of the expropriation of the state apparatus on behalf of the sectoral interests of various individuals and groups must be considered seriously. Yet, to the extent that many relatively

simple institutional changes can significantly reduce these costs (Chang 1994a:33-54, 79-89), we argue that the appropriate response to this problem should be the reform of the state so that it can properly deal with such dangers rather than the wholesale rolling back of the state. Examples of successful state reforms that produced effective developmental states as seen in Meiji Japan, post-World War II France, post-1949 Taiwan, or post-1961 Korea may be relatively rare, but they are still numerous enough to offer some hope that such reforms are feasible and may indeed produce remarkable outcomes.

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