

Macroeconomic and fiscal challenges faced by the Southern and Eastern Mediterranean region

By Marek Dabrowski

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About the Author

Dr. Marek Dabrowski, *Professor of Economics, CASE Fellow and its co-founder, Professor of the Higher School of Economics in Moscow, Chairman of the Supervisory Board of CASE Ukraine in Kyiv; Former Chairman of the Supervisory Council and President of CASE (1991-2011), Former First Deputy Minister of Finance (1989-1990), Member of Parliament (1991-1993) and Member of the Monetary Policy Council of the National Bank of Poland (1998-2004); Since the end of 1980s he has been involved in policy advising and policy research in more than 20 countries of Central and Eastern Europe, former USSR and Middle East and North Africa, as well as in a number of international research projects related to monetary and fiscal policies, growth and poverty, currency crises, international financial architecture, perspectives of European integration, European Neighborhood Policy and political economy of transition; World Bank, IMF and UNDP Consultant; Author of several academic and policy papers, and editor of several book publications.*

Abstract

Fiscal imbalances and fragilities in the Southern and Eastern Mediterranean countries (SEMC) have been built over decades but become more visible after 2008 when combination of adverse economic and political shocks (global and European financial crises, Arab Spring) hit the region. In the environment of slower growth and higher public expenditure pressures fiscal deficits and public debts increased rapidly leading to deterioration of current accounts, depleting official reserves, depreciating of some currencies and higher inflationary pressure.

To avoid danger of public debt and balance-of-payment crisis comprehensive economic reforms, including fiscal adjustment, are urgently needed. Among others, they should involve elimination of energy and food subsidies and replacing them by the targeted social assistance, reducing oversized public administration restructuring and privatization of public sector enterprises, improving business climate, more trade and investment openness, and sector diversification. SEMC may also benefit from peace dividend if numerous internal and regional conflicts can be resolved.

However success of economic reforms will depend on results of political transition, i.e., ability to build stable democratic regimes which can resist populist temptations and organize political support for more rational economic policies.

Keywords: Southern and Eastern Mediterranean, fiscal policy, macroeconomic policy, energy and food subsidies, Arab Spring, Arab transition

JEL codes: E62, E63, H24, H56, H62, H63

1. Introduction

Over the last decade most of the Southern and Eastern Mediterranean countries (SEMC) experienced deterioration of their fiscal accounts. This unfavorable trend concerns, in first instance, countries which are net oil importer but can be also observed in oil-producing Algeria. Some of them (Lebanon and Egypt) have suffered serious fiscal imbalances since long time, in others (such as Jordan, Morocco and Tunisia) fiscal balances deteriorated more recently as result of various adverse shocks (global financial crisis and direct or indirect impact of the Arab Spring) and chosen policy responses to them.

As result, some countries accumulated relatively high, by emerging-market standards, gross public debt, exceeding 140% of GDP in Lebanon, close to 90% of GDP in Egypt, over 80% of GDP in Jordan, over 70% in Israel and over 60% in Morocco (all data for 2013). Such a high indebtedness can lead to various adverse macroeconomic consequences depending on the source of deficit and debt financing, such as problems with continuous debt financing/rollover (risk of sovereign insolvency), narrowing room of maneuver in expenditure policy (as result of growing interest payments), higher taxation, increasing debt monetization which, in turn, can lead to higher inflation and depleting official reserves, etc. Actually, countries such as Egypt or Tunisia already face those challenges in a dramatic way.

The purpose of this paper is providing an in-depth analysis and diagnosis of fiscal challenges faced by selected SEMC from the long-term perspective and policy recommendations on strategy of fiscal adjustment. The special emphasis will be given to energy and food subsidies and inefficient public sector which are among the main causes of fiscal imbalances.

Geographically the analysis covers 9 countries which are considered by the European Union as their Southern neighbors under the European Neighborhood Policy (ENP) initiative (see <http://eeas.europa.eu/enp/>), i.e. Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria and Tunisia, subject of data availability. Unfortunately, we are not able to cover the 10th Southern neighbor of the EU, Palestine, due to data constraints and its political specific as the occupied territory.

Although there have been a number of analyses related to fiscal policy issues in individual SEMC and few on the entire region (see e.g. De Wulf, Coutinho & Sassanpour, 2009) the proposed paper offers a substantial value added to the existing state-of-the-art knowledge in three different ways:

- It provides a long-term ex-post and ex-ante analysis of SEMC's fiscal problems instead of dominating short-term analyses, which prevail in various bulletins and studies of the international financial organizations (IFI) such as the International Monetary Fund (IMF) and World Bank (WB)
- It updates existing studies (for example, De Wulf, Coutinho & Sassanpour, 2009) by in-depth analysis of the consequences of both global financial crisis and the Arab Spring (both direct and indirect)
- It provides a comparative cross-country analysis, which also refers to selected experience of other emerging-market regions

The paper is structured as follows. In Section 2 we provide an overview of long-term macroeconomic and fiscal trends in SEMC as compared to other regions, which is

supplemented in Section 3 by a more contemporary analysis. In particular, we try to enumerate factors and trends, which have contributed to recent fiscal deterioration in a number of SEMC. Section 4 concentrates on deep causes of fiscal imbalances such as energy and food subsidies and inefficient public sector. Section 5 deals with negative consequences of fiscal deterioration for the fiscal policy itself, monetary policy and external balances. Section 6 contains discussion of major directions of fiscal adjustment and fiscal reforms in SEMC countries. Section 7 summarizes major findings and conclusions of this paper.

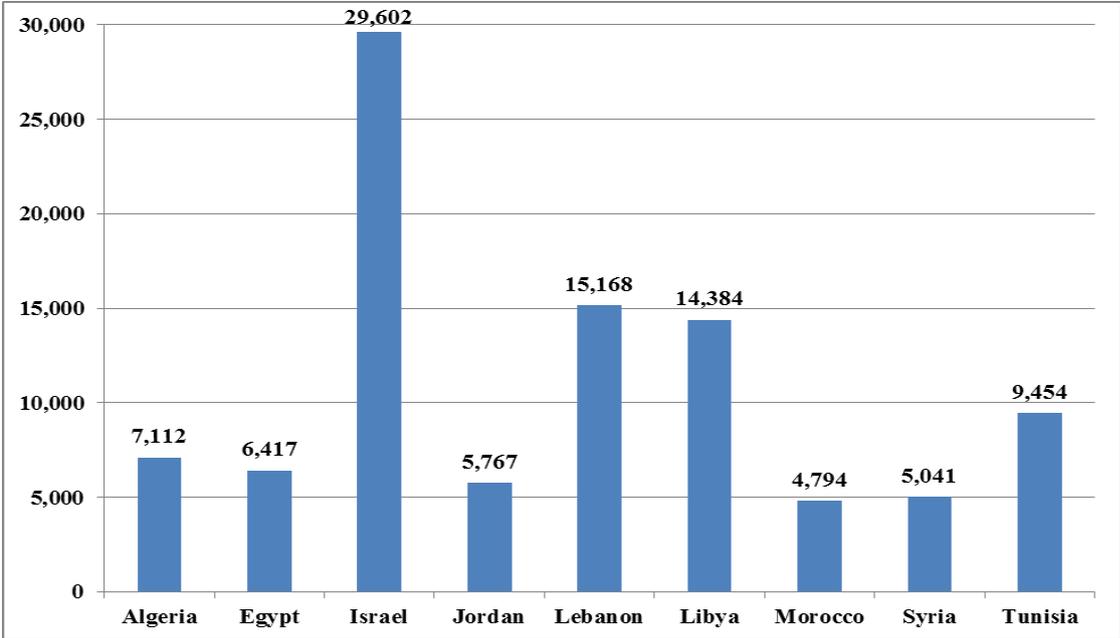
The dominant analytical framework and methodology will consist of an analytic narrative supported by a cross-country statistical comparison based on the available statistical databases (in first instance, those of the IMF and WB). The paper will partly draw from the research output produced under the EU FP7 project on ‘Prospective Analysis for the Mediterranean Region (MEDPRO)’ – see <http://www.medpro-foresight.eu>

2. Macroeconomic and fiscal trends in SEMC 1980-2010

2.1. Level of economic development and pace of economic growth

Most of SEMC represents middle-income level with exception of Israel, which with its GDP per capita level (in PPP terms) close to 30,000 USD belongs to the high-income group according to the World Bank classification¹. Five SEMC (Algeria, Jordan, Lebanon, Libya, and Tunisia) are part of the upper-middle income category, and the three remaining countries (Egypt, Morocco and Syria) are lower-middle income economies (see Figure 2.1).

Figure 2.1: MED11: GDP per capita, current international dollars, in PPP terms, 2010



Source: IMF World Economic Outlook database, April 2012

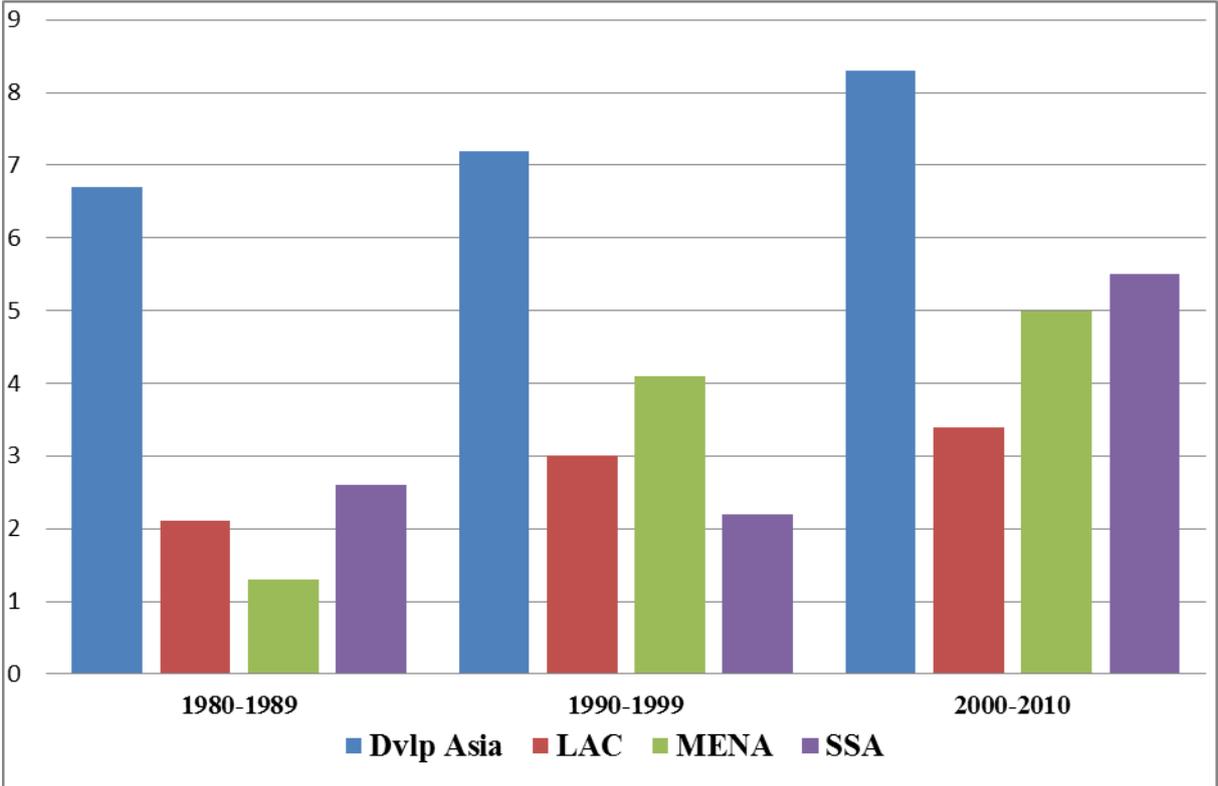
As shown in Figure 2.2, the pace of economic growth in the analyzed region was not particularly impressive for quite a long time (especially in the 1980s) as compared to other emerging markets and developing economies (EMDE) (see Couthino, 2012). It was also

¹ See http://data.worldbank.org/about/country-classifications/country-and-lending-groups#High_income.

extremely volatile as a consequence of the strong commodity export dependence (and changes in commodity prices) and various political shocks (see below)².

In the 1970s, SEMC greatly benefited from the oil price boom, through a sharp increase in exports and investments in oil-producing countries such as Algeria, Libya and, to a lesser extent, Egypt, Syria, and Tunisia. These gains spilled over to their neighbors through significant increases in worker remittances, trade, and capital flows. However, a substantial part of these windfall gains were misused for pursuing expensive and inefficient import-substitution strategies, prestige infrastructure investment projects, and populist social policies involving, among others, huge price subsidies.

Figure 2.2: Growth of real GDP in EMDE regions, 1980-2010, annual average, in %



Note: LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa

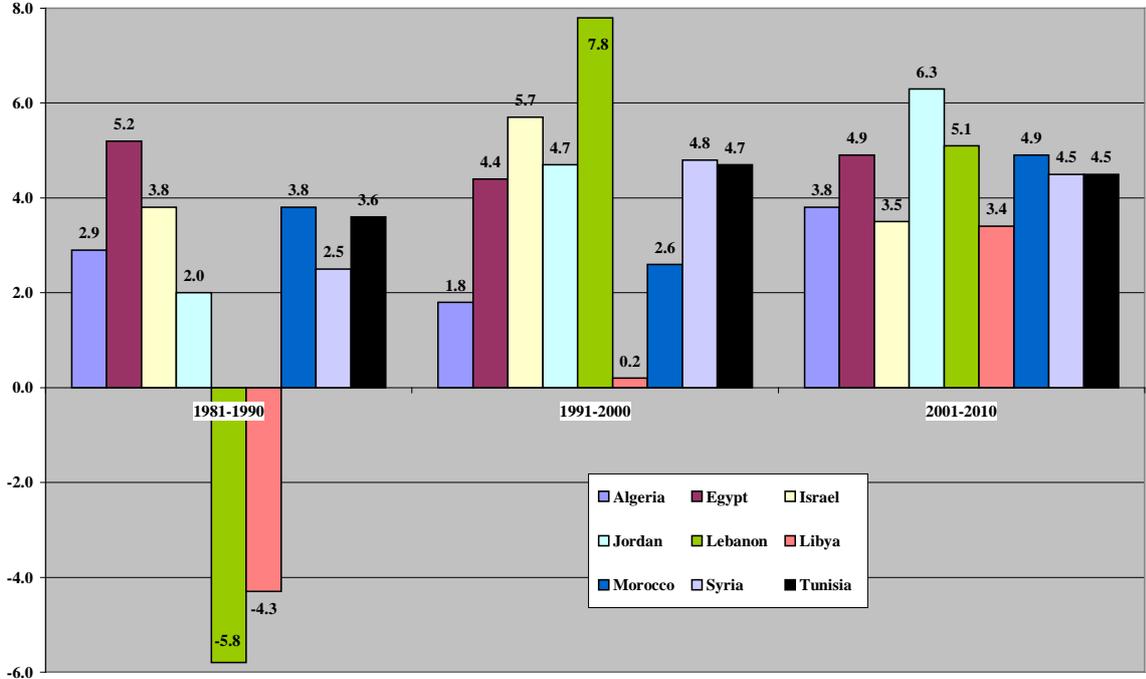
Source: IMF WEO database, April 2012; author’s own calculation

The economic model which dominated in several Arab countries in the 1960s and 1970s, especially in Algeria, Egypt, Libya, Syria and Iraq and, to a lesser extent in Tunisia, and was sometimes referred to as Arab socialism, relied heavily on public ownership, administrative interference in market forces, central planning, the militarization of the economy and trade protectionism (Dabrowski, 2012; MENA, 2004). Israel also followed a kind of ‘socialist’ economic model at that time, with a large share of public and collective ownership, and heavy government regulation.

² Please note that Figure 2.2 contains data for the Middle East and North Africa (MENA) region, which covers eight SEMC (all but Israel and Palestine) plus six Gulf states, Yemen, Iraq, Iran, Djibouti, Sudan and Mauritania. Thus it can provide only a very rough estimate of the historical growth record of the SEMC.

The political conflicts had also negative impact on growth performance in the region. The most striking case was Lebanon, once the richest country of the region but then suffering one and half decade of the sectarian civil war (1975-1990). Other examples included protracted Israeli-Palestinian conflict, civil war in Algeria in early 1990s, international sanctions against Libya in 1990s or conflict between Morocco and Algeria over the Western Sahara.

Figure 2.3: Growth of real GDP in SEMC, 1980-2010, annual average, in %



Source: IMF WEO database, October 2013; author’s own calculation

Since the early 1980s (Egypt) and 1990s (Algeria and Tunisia), individual countries started, at least partially, to depart from administrative dirigisme in the economic sphere, usually with the active engagement of the IMF and World Bank. This process was driven both by external factors (fall of oil prices in mid-1980s, the collapse of the Soviet bloc, economic reforms in China, India and other developing countries) and domestic policy needs (combating macroeconomic instability and the desire to avoid political unrest). In the decade of the 2000s, even the most closed and statist countries, such as Libya and Syria, started to conduct more flexible economic policies and limited market reforms (Dabrowski & De Wulf, 2013).

Countries such as Egypt, Israel, Jordan, Morocco, and Tunisia that pursued reforms subsequently improved their growth performance (see Figure 2.3). However, if one takes into account the continuous high rate of population growth (over 2% annually), the growth rates recorded in 2000s (Table 2.1) allowed for only a moderate improvement in GDP per capita. Furthermore, they were volatile and suffered from the global financial crisis in 2008-2009 (see Section 3.1).

It is also worth remembering that the prospects for the economic growth of major hydrocarbon producers (Libya, Algeria and, to a lesser extent, Syria) remain highly dependent on oil and natural gas prices. Indirectly, through intra-MENA³ trade, migrant remittances,

³ I.e., including the Gulf countries and Iraq, which are even larger hydrocarbon producers than SEMC.

tourism and capital flows, other countries (especially Egypt and Lebanon) have benefited from the oil boom of the 2000s. If hydrocarbon prices decline seriously (as they did in the second half of 2008 but only for a few months), their major producers in the MED region can face a danger of fiscal and balance of payments crises and economic downturn, especially in the context of not always prudent management of oil windfall.

Table 2.1: MED11 countries: annual growth rates, 2001-2010

| Country | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------|------|------|------|------|------|------|------|------|------|------|
| Algeria | 3.0 | 5.6 | 7.2 | 4.3 | 5.9 | 1.7 | 3.4 | 2.0 | 1.7 | 3.6 |
| Egypt | 3.5 | 3.2 | 3.2 | 4.1 | 4.5 | 6.8 | 7.1 | 7.2 | 4.7 | 5.1 |
| Israel | -0.2 | -0.1 | 1.5 | 4.9 | 4.9 | 5.8 | 6.9 | 4.5 | 1.2 | 5.7 |
| Jordan | 5.3 | 5.8 | 4.2 | 8.6 | 8.1 | 8.1 | 8.2 | 7.2 | 5.5 | 2.3 |
| Lebanon | 3.9 | 3.4 | 1.7 | 7.5 | 0.7 | 1.4 | 8.4 | 8.6 | 9.0 | 7.0 |
| Libya | -1.8 | -1.0 | 13.0 | 4.5 | 11.9 | 6.5 | 6.4 | 2.7 | -0.8 | 5.0 |
| Morocco | 7.6 | 3.3 | 6.3 | 4.8 | 3.0 | 7.8 | 2.7 | 5.6 | 4.8 | 3.6 |
| Syria | 3.7 | 5.9 | -2.0 | 6.9 | 6.2 | 5.0 | 5.7 | 4.5 | 5.9 | 3.4 |
| Tunisia | 4.9 | 1.7 | 5.5 | 6.0 | 4.0 | 5.7 | 6.3 | 4.5 | 3.1 | 2.9 |

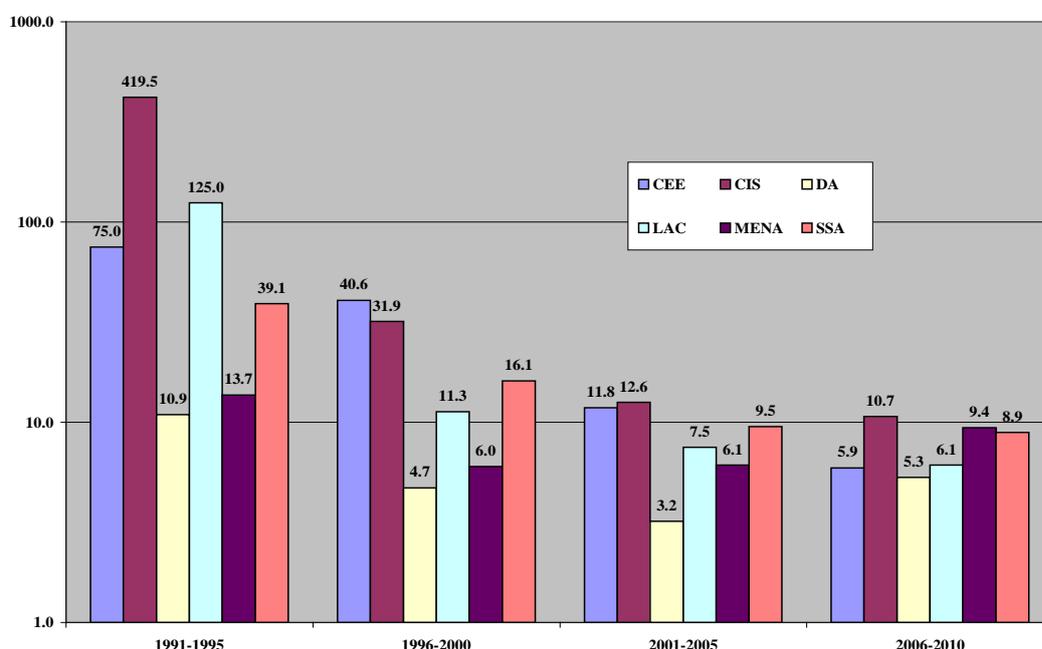
Notes: yellow fields – IMF estimates; no data for Palestinian Autonomy

Source: IMF World Economic Outlook database, October 2013

2.2. Inflation

As seen in Figure 2.4 the MENA region was not the worst (as compared to other EMDE) in terms of inflation level in 1990s and 2000s. Its relative performance deteriorated only slightly in the second half of 2000s, especially in the years preceding global financial crisis.

Figure 2.4: End-of-year inflation in EMDE regions, in %, period average, 1991-2010

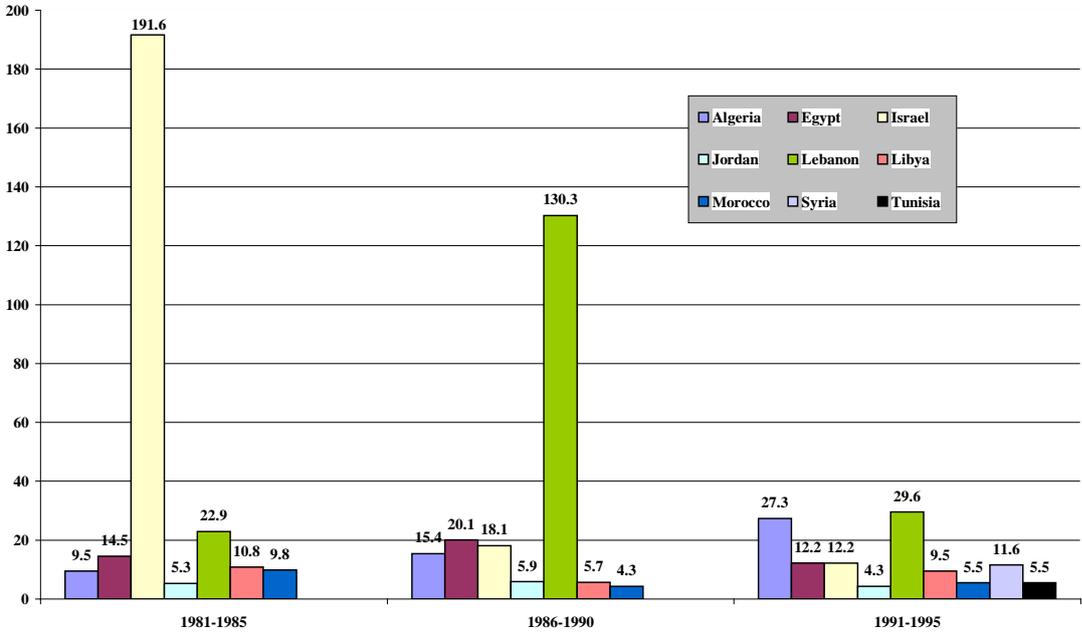


Note: CEE – Central and Eastern Europe, CIS – Commonwealth of Independent States, DA – Developing Asia, LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa

Source: IMF WEO database, October 2013; author's own calculation

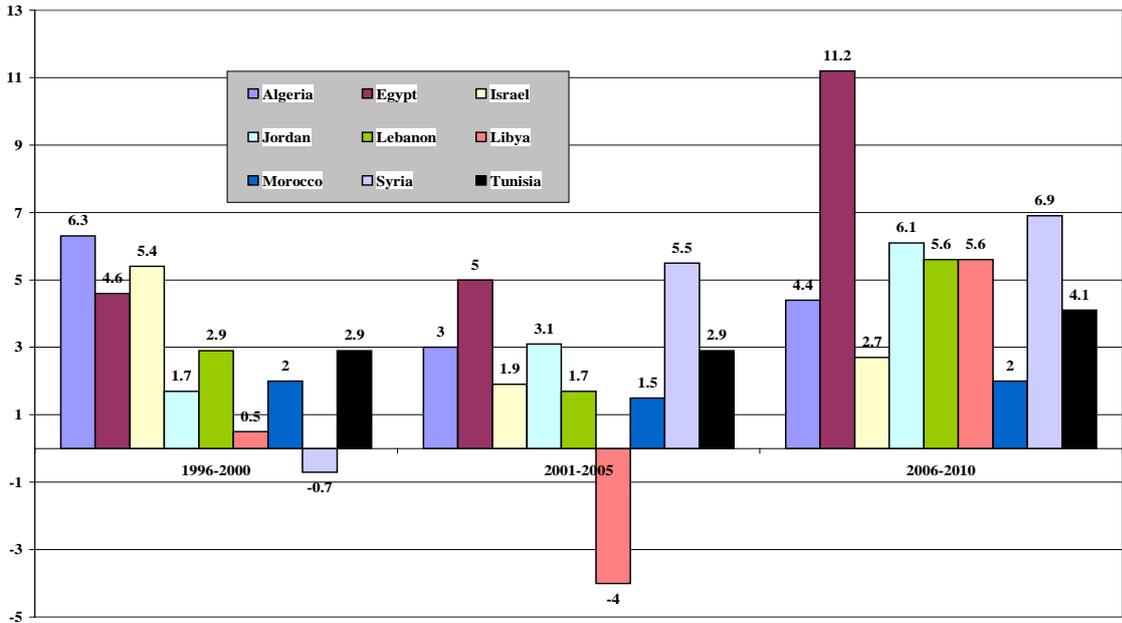
However, if one analyzed the earlier period (for which there are no cross-regional comparative inflation statistics) the situation would look less rosy. ‘Socialist’ policies in 1960s-1980s resulted not only in poor growth record (Section 2.1) but also in high, sometimes very high, inflation. In addition, the extensive price and foreign exchange controls led to physical shortage and black market for some goods, similarly to former communist countries.

Figure 2.5: End-of-year inflation in SEMC, in %, period average, 1981-1995



Source: IMF WEO database, October 2013; author’s own calculation

Figure 2.6: End-of-year inflation in SEMC, in %, period average, 1996-2010



Source: IMF WEO database, October 2013; author’s own calculation

For individual SEMC a cross-country comparable inflation statistics starts since 1980⁴ so we do not have data for the earlier period. As result Figure 2.5 presents average end-of-year inflation for the period of 1981-1995 when some countries already launched market-oriented reforms and stabilization policies.

Nevertheless, progress in bringing inflation down, especially in 1980s, was rather modest if not disappointing. Only two countries – Jordan and Morocco – managed to keep average inflation on a one-digit level in that period. The other end of spectrum was represented by Israel and Lebanon which suffered for high inflation or even hyperinflation. In case of Israel this was caused by high fiscal deficits and wage indexation (Bruno et al., 1988), in case of Lebanon – by the civil war. Other countries can be considered as examples of chronic moderate inflation, remaining on its two-digit level through most of the analyzed period. In case of Algeria the internal political conflict of early 1990s was one of the factors responsible for inflation approaching the average annual level of 30%.

Better macroeconomic management in the 1990s and 2000s led to relative macroeconomic stability. In particular, sounder monetary and fiscal policies resulted in lower inflation in the second half of 1990s and first half of 2000s (Figure 2.6). All SEMC managed to keep them on one-digit, sometimes very low level (Syria and Libya recorded even periods of price decline).

However, in the second half of 2000s inflation started to pick up again in all SEMC (Figures 2.4 and 2.6), particularly in Egypt. This was caused by combination of global and domestic inflationary pressures. The former originated from overheating of the world economy and abundant global liquidity built up by the lax monetary policy of the US Federal Reserve System and other major central banks. Countries which pegged their currencies to the US dollar (all except Israel, Morocco and Tunisia) imported inflation via high commodity prices and depreciating US currency. Domestic factors included high fiscal deficits (see Section 2.3).

2.3. Fiscal balances

Long-term analysis of fiscal balances meets difficulty caused by incomplete cross-country datasets of the IMF. For all nine SEMC comparative statistics of general government (GG) net lending/borrowing covers period since early 2000s; earlier data are available only for selected countries. In case of Jordan they start in 1985, for Algeria, Libya, Morocco and Syria – in 1990, in Tunisia – in 1991, in Israel and Lebanon – in 2000, in Egypt – in 2002.

Table 2.2: GG net lending/borrowing in SEMC, % of GDP, 1991-2010

| Country | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------|-------|------|------|------|------|------|------|------|------|-------|-------|-------|-------|------|------|-------|-------|------|------|------|
| Algeria | 3.8 | 0.8 | -5.9 | -1.9 | 0.6 | 3.9 | 2.9 | -3.6 | -1.9 | 9.7 | 3.7 | 1.2 | 4.9 | 5.3 | 13.6 | 13.9 | 6.1 | 9.0 | -5.4 | -0.4 |
| Egypt | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | -11.3 | -9.0 | -8.3 | -8.4 | -9.2 | -7.5 | -8.0 | -6.9 | -8.3 |
| Israel | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | -3.8 | -6.2 | -7.6 | -7.8 | -6.0 | -4.9 | -2.6 | -1.5 | -3.7 | -6.3 | -4.6 |
| Jordan | -14.3 | 0.3 | -0.5 | -1.4 | -3.9 | -2.8 | -2.5 | -6.0 | -3.5 | -4.7 | -3.6 | -2.4 | 0.2 | -1.7 | -5.0 | -3.5 | -5.7 | -5.5 | -8.9 | -5.6 |
| Lebanon | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | -23.6 | -20.7 | -16.0 | -13.8 | -9.7 | -8.6 | -10.5 | -10.9 | -9.7 | -8.3 | -7.7 |
| Libya | 8.7 | 0.1 | -6.0 | -2.8 | 3.9 | 11.7 | -2.2 | -2.4 | 5.9 | 14.1 | 0.1 | 7.2 | 6.4 | 11.7 | 31.4 | 31.8 | 28.6 | 28.3 | 6.2 | 17.2 |
| Morocco | -1.1 | -2.4 | -2.6 | -3.2 | -3.3 | 1.1 | 1.9 | 1.7 | 3.6 | -2.2 | -4.3 | -4.9 | -4.2 | -3.8 | -6.2 | -2.0 | -0.1 | 0.7 | -1.8 | -4.4 |
| Syria | -6.6 | -7.3 | -5.0 | -6.0 | -3.8 | -2.8 | -1.8 | -2.8 | -1.5 | -1.4 | 2.3 | -2.0 | -2.7 | -4.2 | -4.4 | -1.1 | -3.0 | -2.9 | -2.9 | -7.8 |
| Tunisia | -4.4 | -2.8 | -2.6 | -1.1 | -3.2 | -4.0 | -2.6 | -1.8 | -2.2 | -2.3 | -2.1 | -2.2 | -2.2 | -2.2 | -2.8 | -2.6 | -2.0 | -0.6 | -1.2 | -0.9 |

Notes: yellow field – IMF estimate

Source: IMF WEO database, October 2013

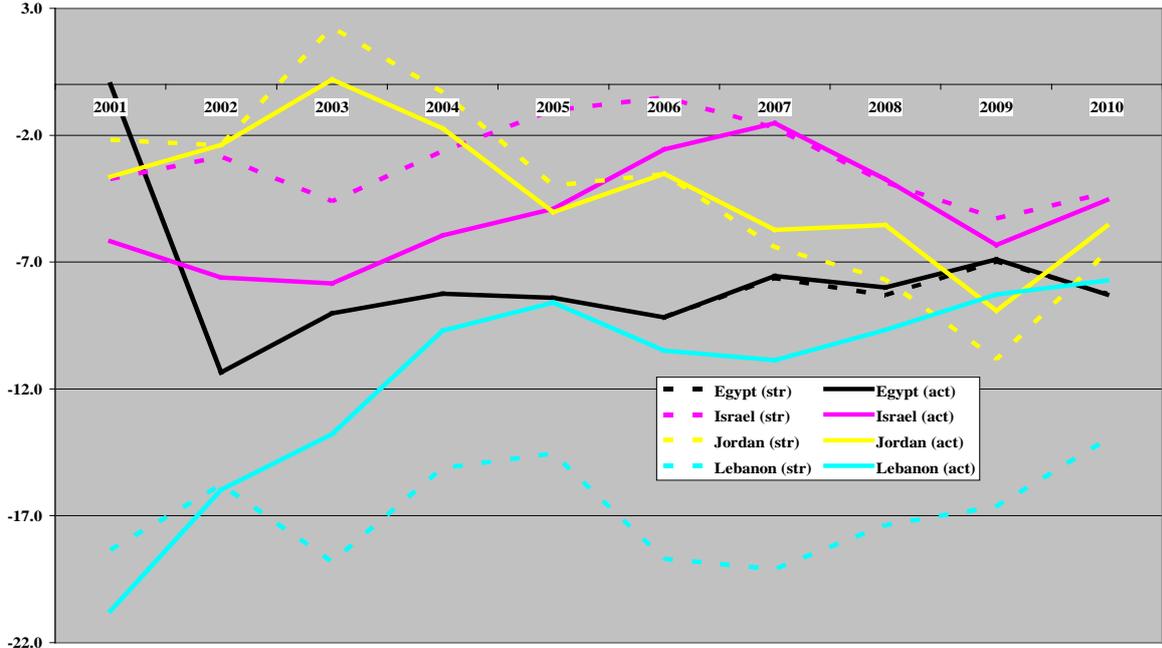
⁴ Inflation data series for Syria and Tunisia start from 1991 only.

As seen in Table 2.2 Lebanon represents the worse fiscal performance in the region. In early 2000s, i.e. a decade after ending the civil war, its fiscal deficit still exceeded 20% of GDP. In the subsequent years it decreased to the level of between 8 and 11% of GDP and remained that high thorough the entire decade of 2000s. Egypt is the next worst performer. Since 2002 when GG balance data according to GFS standards became available its deficit oscillated between 7 and 11% of GDP. Fiscal deficits in Israel exceeded 5% of GDP in early 2000s, slightly improving in the second half of decade (apart from 2009, the year of global financial crisis).

The smallest fiscal imbalances were recorded in Tunisia (less than 3% of GDP in most of the analyzed period) and Morocco. Jordan and Syria can be ranked as the intermediate performers: their fiscal imbalances were larger, on average, than in Tunisia and Morocco but smaller as compared to Lebanon, Egypt and Israel.

Finally, two large hydrocarbon exporters, Algeria and Libya, demonstrated a high volatility of their fiscal accounts, following changes in oil and natural gas prices and outputs, and various political developments (like civil war in Algeria in early 1990s).

Figure 2.7: Structural vs. actual GG balances in selected SEMC, % of GDP, 2001-2010



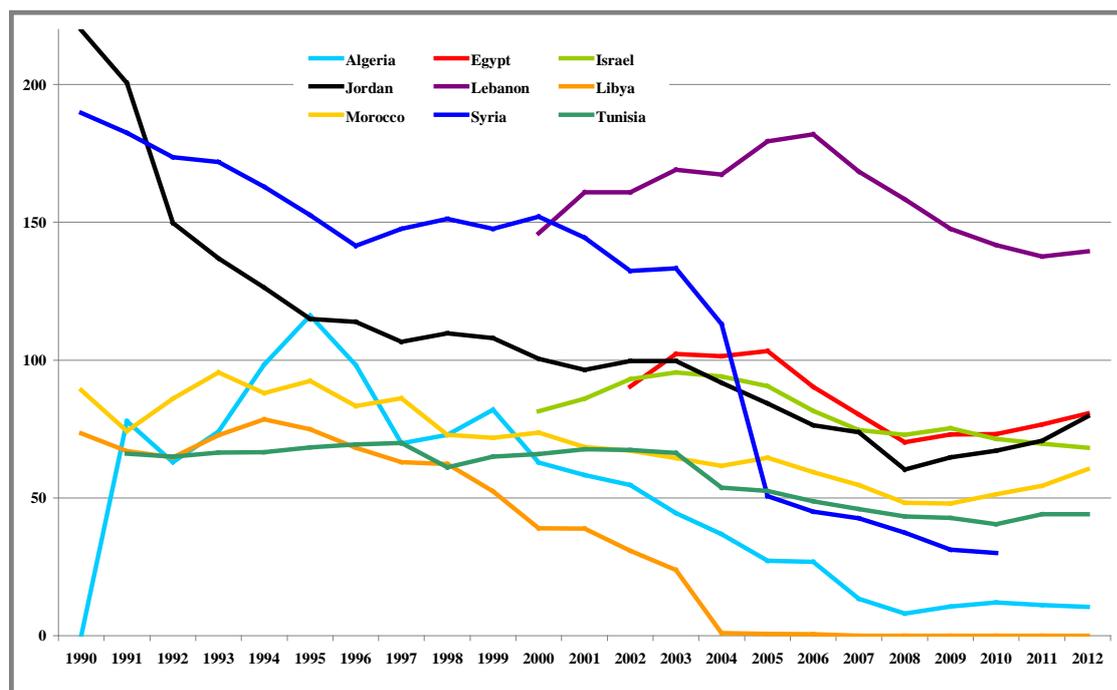
Source: IMF WEO database, October 2013

It is important to notice that several SEMC, in spite of relatively high growth rates (see Section 2.1), increased fiscal deficits in the second half of 2000s. This concerns Egypt, Jordan, Lebanon and, to a lesser extent, Israel. The unsustainable path of fiscal policy is confirmed by Figure 2.7 according to which structural deficits, at least in Lebanon and Jordan, exceeded the actual ones (data on structural deficits are available for only four SEMC).

2.4. Public debt

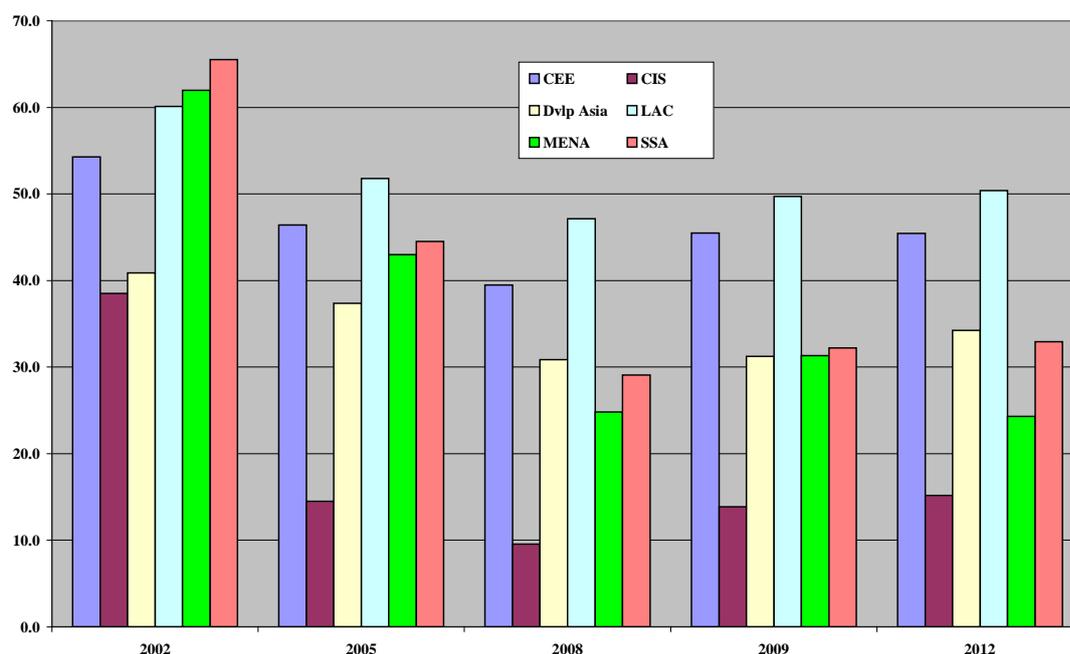
Volatile and often imprudent fiscal performance had to have its impact on the level of public indebtedness. As seen in Table 2.8 in 1990s all SEMC represented a high level of GG gross debt to GDP, by emerging market standards.

Figure 2.8: GG gross debt in SEMC, % of GDP, 1990-2012



Source: IMF World Economic Outlook database, October 2013

Figure 2.9: GG gross debt in EMDE regions, in % of GDP, 2002-2012



Note: CEE – Central and Eastern Europe, CIS – Commonwealth of Independent States, DA – Developing Asia, LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa

Source: IMF WEO database, October 2013

In the second half of 1990s and first half of 2000s situation improved substantially in oil producing countries (Libya, Algeria and Syria) due to increase of oil prices and in Jordan due

to large-scale privatization (Figure 2.8 and Table 2.3). Other SEMC (except Lebanon) also recorded improvements although less impressive. As result, the level of public indebtedness of the entire region went down, in relation to GDP and in comparison with other EMDE regions (Figure 2.9).

Table 2.3: GG gross debt in SEMC, % of GDP, 2000-2010

| Country | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Algeria | 62.8 | 58.3 | 54.7 | 44.5 | 36.8 | 27.2 | 26.8 | 13.4 | 8.1 | 10.5 | 12.1 |
| Egypt | n/a | n/a | 90.4 | 102.3 | 101.5 | 103.3 | 90.3 | 80.2 | 70.2 | 73.0 | 73.2 |
| Israel | 81.4 | 86.0 | 93.1 | 95.6 | 94.1 | 90.6 | 81.6 | 74.6 | 72.9 | 75.3 | 71.5 |
| Jordan | 100.5 | 96.5 | 99.7 | 99.6 | 91.8 | 84.3 | 76.3 | 73.8 | 60.2 | 64.8 | 67.1 |
| Lebanon | 146.1 | 160.9 | 160.9 | 169.0 | 167.3 | 179.4 | 181.9 | 168.4 | 158.4 | 147.6 | 141.7 |
| Libya | 39.0 | 38.8 | 30.8 | 23.8 | 0.9 | 0.6 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| Morocco | 73.7 | 68.4 | 67.1 | 64.4 | 61.7 | 64.6 | 59.4 | 54.6 | 48.2 | 48.0 | 51.3 |
| Syria | 152.1 | 144.5 | 132.4 | 133.4 | 113.0 | 50.7 | 45.0 | 42.7 | 37.3 | 31.2 | 30.0 |
| Tunisia | 65.9 | 67.6 | 67.4 | 66.4 | 53.7 | 52.5 | 48.8 | 45.9 | 43.3 | 42.8 | 40.4 |

Source: IMF World Economic Outlook database, October 2013

However, there are two important caveats. First, reduction in public debt-to-GDP ratio in 2000s resulted, to large extent, from relatively rapid growth of nominal GDP (denominator). Second, towards the end of that decade it started to deteriorate in some countries (Algeria, Egypt, Jordan and Morocco) what could be partly but not exclusively attributed to the impact of global financial crisis of 2008-2009. Domestic policy factors, in particular, continuation of energy and food subsidies in the environment of growing global commodity prices played equally important role. We will come back to these issues in Sections 3 and 4.

3. Recent fiscal deterioration in the region

3.1. Economic and political background

Since 2008 SEMC have experienced three adverse shocks: (i) global financial crisis of 2008-2009; (ii) European sovereign debt and financial crisis of 2010-2013 and (iii) Arab Spring.

The first stage of global financial crisis (2008-2009) had negative impact on EMDE through several channels such as (i) collapse of the global trade; (ii) decline in prices of oil and other commodities; (iii) drying up liquidity on international markets; (iv) sudden stop in capital flows; (v) decreasing remittances of labor migrants; (vi) decreasing tourist revenues (see Dabrowski, 2010).

For SEMC channels (i), (ii), (v) and (vi) had a key importance. They were less affected by financial market contagion as the financial sector in most SEMC remained relatively closed to the external world. Also the role of foreign direct investment (FDI) and other (largely short-term) private capital flows was not as important as in the case of other EMDE (see Sekkat, 2012, Woodward and Safawi, 2012). In addition, the substantial part of private capital flows has had an intra-regional character, originating from Gulf countries.

Overall impact of the first stage of global financial crisis on SEMC was rather moderate and short-living. As seen in Table 3.1 only Libya experienced a modest recession in 2009 (-0.8%) due to sharp decline in oil prices in the second half of 2008. Algeria, Egypt, Israel, Jordan and

Tunisia recorded growth slowdown while Lebanon. Morocco and Syria continued growing at previous pace or even faster (Lebanon's growth rate equaled to record-high 9.0% in 2009).

Table 3.1: Basic macroeconomic indicators in SEMC, 2007-2013

| Country | Indicator | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---------|------------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Algeria | Annual growth of real GDP, % | 3.4 | 2.0 | 1.7 | 3.6 | 2.6 | 3.3 | 3.1 |
| | End-of-year inflation, % | 4.8 | 4.9 | 5.8 | 2.7 | 5.2 | 9.0 | 8.2 |
| | GG net lending/borrowing, % of GDP | 6.1 | 9.0 | -5.4 | -0.4 | -0.4 | -5.1 | -1.7 |
| | GG gross debt, % of GDP | 13.4 | 8.1 | 10.5 | 12.1 | 11.1 | 10.5 | 10.8 |
| | Current account balance, % of GDP | 22.6 | 20.1 | 0.3 | 7.5 | 8.9 | 5.9 | 1.8 |
| Egypt | Annual growth of real GDP, % | 7.1 | 7.2 | 4.7 | 5.1 | 1.8 | 2.2 | 1.8 |
| | End-of-year inflation, % | 8.6 | 20.2 | 10.0 | 10.7 | 11.8 | 7.3 | 9.8 |
| | GG net lending/borrowing, % of GDP | -7.5 | -8.0 | -6.9 | -8.3 | -9.8 | -10.7 | -14.7 |
| | GG gross debt, % of GDP | 80.2 | 70.2 | 73.0 | 73.2 | 76.6 | 80.6 | 89.5 |
| | Current account balance, % of GDP | 2.1 | 0.5 | -2.3 | -2.0 | -2.6 | -3.1 | -2.6 |
| Israel | Annual growth of real GDP, % | 6.9 | 4.5 | 1.2 | 5.7 | 4.6 | 3.4 | 3.8 |
| | End-of-year inflation, % | 3.4 | 3.8 | 3.9 | 2.7 | 2.2 | 1.6 | 2.1 |
| | GG net lending/borrowing, % of GDP | -1.5 | -3.7 | -6.3 | -4.6 | -4.2 | -4.9 | -5.1 |
| | GG gross debt, % of GDP | 74.6 | 72.9 | 75.3 | 71.5 | 69.7 | 68.2 | 70.4 |
| | Current account balance, % of GDP | 3.2 | 1.4 | 3.8 | 3.1 | 1.3 | 0.3 | 2.3 |
| Jordan | Annual growth of real GDP, % | 8.2 | 7.2 | 5.5 | 2.3 | 2.6 | 2.8 | 3.3 |
| | End-of-year inflation, % | 5.1 | 9.1 | 2.7 | 6.1 | 3.3 | 7.2 | 3.2 |
| | GG net lending/borrowing, % of GDP | -5.7 | -5.5 | -8.9 | -5.6 | -6.8 | -8.8 | -9.1 |
| | GG gross debt, % of GDP | 73.8 | 60.2 | 64.8 | 67.1 | 70.7 | 79.6 | 83.9 |
| | Current account balance, % of GDP | -16.8 | -9.3 | -3.3 | -5.3 | -12.0 | -18.1 | -9.9 |
| Lebanon | Annual growth of real GDP, % | 8.4 | 8.6 | 9.0 | 7.0 | 1.5 | 1.5 | 1.5 |
| | End-of-year inflation, % | 6.0 | 6.4 | 3.4 | 5.1 | 3.1 | 10.1 | 3.5 |
| | GG net lending/borrowing, % of GDP | -10.9 | -9.7 | -8.3 | -7.7 | -6.1 | -9.0 | -10.4 |
| | GG gross debt, % of GDP | 168.4 | 158.4 | 147.6 | 141.7 | 137.5 | 139.5 | 143.1 |
| | Current account balance, % of GDP | -4.1 | -7.7 | -9.3 | -9.9 | -12.4 | -16.2 | -16.7 |
| Libya | Annual growth of real GDP, % | 6.4 | 2.7 | -0.8 | 5.0 | -62.1 | 104.5 | -5.1 |
| | End-of-year inflation, % | 7.6 | 9.7 | 0.3 | 3.3 | 26.6 | -3.7 | 10.0 |
| | GG net lending/borrowing, % of GDP | 28.6 | 28.3 | 6.2 | 17.2 | -6.6 | 19.4 | -5.4 |
| | GG gross debt, % of GDP | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | Current account balance, % of GDP | 44.1 | 42.5 | 14.9 | 19.5 | 9.1 | 29.2 | -4.7 |
| Morocco | Annual growth of real GDP, % | 2.7 | 5.6 | 4.8 | 3.6 | 5.0 | 2.7 | 5.1 |
| | End-of-year inflation, % | 2.0 | 4.2 | -1.6 | 2.2 | 0.9 | 2.6 | 2.3 |
| | GG net lending/borrowing, % of GDP | -0.1 | 0.7 | -1.8 | -4.4 | -6.7 | -7.6 | -5.5 |
| | GG gross debt, % of GDP | 54.6 | 48.2 | 48.0 | 51.3 | 54.4 | 60.5 | 61.8 |
| | Current account balance, % of GDP | -0.1 | -5.2 | -5.4 | -4.1 | -8.1 | -10.0 | -7.2 |
| Syria | Annual growth of real GDP, % | 5.7 | 4.5 | 5.9 | 3.4 | n/a | n/a | n/a |
| | End-of-year inflation, % | 4.8 | 15.4 | 1.7 | 6.3 | n/a | n/a | n/a |
| | GG net lending/borrowing, % of GDP | -3.0 | -2.9 | -2.9 | -7.8 | n/a | n/a | n/a |
| | GG gross debt, % of GDP | 42.7 | 37.3 | 31.2 | 30.0 | n/a | n/a | n/a |
| | Current account balance, % of GDP | -0.2 | -1.3 | -2.9 | -2.8 | n/a | n/a | n/a |
| Tunisia | Annual growth of real GDP, % | 6.3 | 4.5 | 3.1 | 2.9 | -1.9 | 3.6 | 3.0 |
| | End-of-year inflation, % | 5.1 | 4.0 | 4.0 | 4.1 | 4.2 | 5.9 | 5.3 |
| | GG net lending/borrowing, % of GDP | -2.0 | -0.6 | -1.2 | -0.9 | -3.4 | -4.9 | -6.8 |
| | GG gross debt, % of GDP | 45.9 | 43.3 | 42.8 | 40.4 | 44.0 | 44.0 | 45.5 |
| | Current account balance, % of GDP | -2.4 | -3.8 | -2.8 | -4.8 | -7.3 | -8.1 | -8.0 |

Notes: yellow field – IMF estimate

Source: IMF WEO database, October 2013

The impact of the European debt and financial crisis seems to be also modest up to date (definitely smaller than in CEE) and felt mainly in countries which have higher export,

migration and incoming tourism exposure to the Eurozone like Morocco (see IMF, 2013a, Annex 2, p. 83). In addition, as this crisis overlaps in time with the Arab Spring (see below) it is not easy to disentangle statistically the impact of both factors. Nevertheless both crises (that of 2008-2009 and the European one) created a new global environment of slower growth and tighter financial conditions as compared with the 'golden' era of early and mid-2000s.

The popular appraisal called the Arab Spring, which started at the end of 2010 in Tunisia and spread immediately to Egypt, Libya, Yemen, Bahrain and Syria, affected directly or indirectly economies of the entire region.

First, collapse of the previous autocratic regimes has not led to establishing stable democratic regimes able to ensure responsible economic management yet. On the contrary, most of the countries directly affected by the Arab Spring suffer from domestic political, economic and social instability and insecurity.

Tunisia is perhaps the only exception enjoying a relatively stable democratic government which has started to implement the economic reform program supported by the IMF Stand-by loan in June 2013. It also adopted the new democratic constitution on January 26, 2014 (ACRPS, 2014). However, even its political transition is not completed yet.

Situation in other countries is much worse: Egypt and Libya struggle with domestic political instability, deep splits of their societies along sectarian, regional, ideological and cultural lines, and tribal insurrections. All these developments have negative impact on current business activity, investment, and incoming tourism in the entire region.

Syria experiences the third year of bloody civil war with no prospects of fast resolution. The country is in fact territorially divided between pro-government forces and rebels of various ideological and political profiles. Negative economic and political consequences of this conflict, for example, large number of refugees, blocked transit routes, declining tourism and FDI flows, affect neighboring SEMC, in particular, Lebanon and Jordan (IMF, 2013a, Box 2.1, pp. 34-35). Similarly, civil war in Libya in 2011 and following domestic instability negatively affected neighboring Tunisia and Egypt through a large flow of refugees and returning migrant workers.

Second, fear of popular unrest has made all governments in the region reluctant to conduct badly needed economic reforms such as reduction or elimination of subsidies, public sector modernization and restructuring, continuation of privatization, and opening countries to foreign investors. Worse, aftermath the Arab Spring several governments backtracked on the previous reforms, for example, increasing energy and food subsidies again, increasing public sector employment or revising previous privatization deals.

The negative impact of the Arab Spring on economic growth in Tunisia, Egypt, Libya and Lebanon is clearly visible in Table 3.1. Data on Syria after 2010 are not available and one can only speculate on the scale of economic and social damage (in addition to human losses). Situation in Syria also did not help Jordan to return to a higher growth rate. Again, Tunisia may become exception: after evident growth slowdown in 2011 it picked up again to a moderate level of 3+% in 2012-2013.

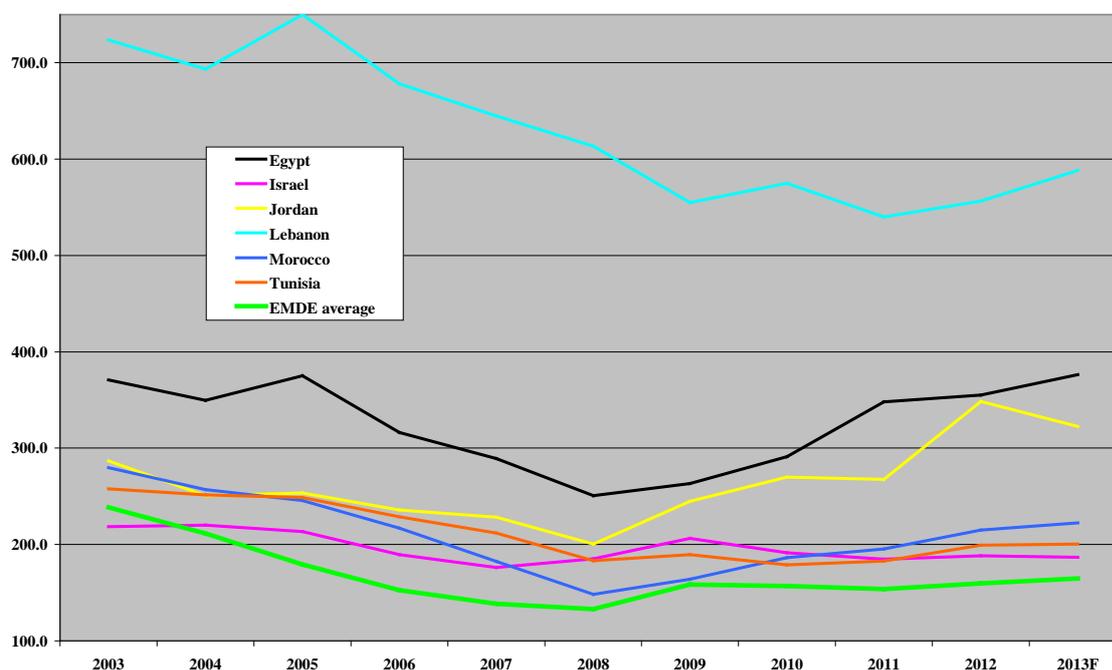
The period after 2009 has been also marked by higher inflation in several countries: Algeria, Egypt, Jordan, Lebanon and Libya. Data for Syria is not available. Remarkably, Tunisia has

experienced only minor increase of inflation after 2010, which continues to remain on the annual level of 5 - 6%.

3.2. Fiscal trends

As illustrated by Table 3.1, since 2011 GG balances deteriorated everywhere in the region even in oil producing Algeria, non-affected by the Arab Spring. Egypt recorded high fiscal deficits since at least early 2000s but they further deteriorated after the Arab Spring. In Israel fiscal deficit increased to 6.3% of GDP in the crisis year 2009 and remained on the level of 4-5% of GDP in the following years. There is no data for Syria after 2010.

Figure 3.1: GG gross debt as % of GG revenue for selected SEMC, 2003-2013



Note: F – forecast; data for EMDE represent the unweighted arithmetic average of the group of 92 EMDE rated by Moody's; data on Jordan, Morocco and Tunisia are limited to central government

Source: Moody's Statistical Handbook, November 2013; author's own calculation

Table 3.2: GG interest payment as % of GG revenue for selected SEMC, 2003-2013

| Country | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013F |
|-------------|-------------|-------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Egypt | 21.8 | 22.2 | 22.4 | 19.8 | 18.7 | 16.5 | 15.2 | 20.5 | 25.3 | 26.8 | 28.4 |
| Israel | 13.0 | 12.7 | 11.5 | 10.4 | 10.3 | 8.6 | 9.5 | 8.8 | 7.4 | 7.6 | 7.4 |
| Jordan | 6.8 | 5.4 | 7.0 | 7.7 | 8.2 | 8.1 | 8.8 | 8.5 | 7.9 | 11.5 | 13.3 |
| Lebanon | 73.9 | 53.7 | 47.7 | 53.7 | 54.3 | 46.2 | 45.2 | 46.4 | 41.1 | 37.7 | 39.9 |
| Morocco | 15.5 | 14.3 | 12.4 | 11.7 | 10.4 | 8.1 | 8.1 | 8.3 | 8.2 | 8.6 | 9.0 |
| Tunisia | 11.8 | 11.8 | 11.9 | 11.5 | 10.9 | 8.7 | 8.8 | 8.0 | 7.5 | 7.8 | 7.7 |
| EMDE | 11.5 | 10.6 | 9.5 | 8.6 | 8.0 | 7.4 | 8.4 | 8.1 | 7.7 | 7.9 | 8.4 |

Note: F – forecast; data for EMDE represent the unweighted arithmetic average of the group of 92 EMDE rated by Moody's; data on Jordan, Lebanon, Morocco and Tunisia are limited to central government

Source: Moody's Statistical Handbook, November 2013; author's own calculation

The combination of slower growth and higher fiscal deficits led to increase in GG debt-to-GDP ratio in most SEMC apart from Algeria and Libya. In 2013 it is expected to amount to 143.1% of GDP in Lebanon, 89.5% of GDP in Egypt, 83.9% in Jordan, 70.4% in Israel, 61.8% in Morocco and 45.5% of GDP in Tunisia (Table 3.1). These are pretty high numbers as for EMDE standards.

Data on gross debt-to revenue ratio (Figure 3.1) looks equally worrying. Since 2008-2009 there is clear reversal of the earlier moderate gains and all SEMC perform worse than EMDE average. The situation of Lebanon, Egypt and Jordan may raise concerns about their long-term sovereign solvency.

The same kind of conclusion can be drawn from Table 3.2 presenting the interest payment-to-revenue ratio. Interest payment absorbs ca. 40% or more government revenue in Lebanon, close to 30% in Egypt and above 13% in Jordan. In all countries except Israel and Tunisia they exceed the EMDE average and have tendency to grow.

4. Causes of fiscal imbalances

4.1. Overview of revenue and expenditure

The total GG revenue in SEMC does not differ or even exceed average of EMDE (Table 4.1).

Table 4.1: GG revenue in SEMC, % of GDP, 2001-2012

| Country | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| Algeria | 35.0 | 35.4 | 37.1 | 36.0 | 40.8 | 42.7 | 39.4 | 46.9 | 36.7 | 36.5 | 40.0 | 39.5 |
| Egypt | n/a | 25.4 | 26.2 | 25.6 | 24.8 | 28.6 | 27.7 | 28.0 | 27.7 | 25.1 | 22.0 | 22.6 |
| Israel | 45.3 | 45.3 | 43.7 | 42.7 | 42.5 | 43.1 | 42.4 | 39.5 | 36.7 | 37.6 | 37.7 | 36.2 |
| Jordan | 30.3 | 29.6 | 34.7 | 36.6 | 33.3 | 32.4 | 32.3 | 30.1 | 26.5 | 24.9 | 26.4 | 22.8 |
| Lebanon | 17.7 | 20.3 | 22.2 | 23.2 | 22.9 | 25.4 | 24.1 | 24.0 | 24.5 | 22.7 | 23.4 | 23.2 |
| Libya | 38.2 | 49.4 | 49.4 | 54.0 | 60.4 | 63.0 | 62.3 | 68.4 | 52.9 | 64.9 | 50.3 | 72.3 |
| Morocco | 22.5 | 24.3 | 23.0 | 24.0 | 26.3 | 27.4 | 29.9 | 32.5 | 29.3 | 27.5 | 27.8 | 28.1 |
| Syria | 30.3 | 26.5 | 29.9 | 27.1 | 23.8 | 25.2 | 22.7 | 20.1 | 23.9 | 20.9 | n/a | n/a |
| Tunisia | 27.0 | 27.6 | 27.1 | 27.0 | 26.5 | 26.6 | 27.4 | 29.9 | 29.6 | 30.0 | 31.2 | 30.7 |
| EMDE | 23.7 | 23.9 | 24.6 | 25.5 | 27.5 | 28.4 | 28.6 | 29.5 | 26.2 | 27.0 | 28.3 | 28.3 |

Notes: yellow field – IMF estimate

Source: IMF WEO database, October 2013

Table 4.2: GG expenditure in SEMC, % of GDP, 2001-2012

| Country | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| Algeria | 31.3 | 34.3 | 32.2 | 30.8 | 27.1 | 28.8 | 33.2 | 37.8 | 42.2 | 36.9 | 40.4 | 44.6 |
| Egypt | n/a | 36.7 | 35.2 | 33.9 | 33.2 | 37.8 | 35.3 | 36.0 | 34.6 | 33.4 | 31.8 | 33.4 |
| Israel | 51.5 | 52.9 | 51.6 | 48.7 | 47.4 | 45.7 | 44.0 | 43.2 | 43.1 | 42.2 | 41.9 | 41.0 |
| Jordan | 33.9 | 32.0 | 34.5 | 38.3 | 38.3 | 35.9 | 38.0 | 35.6 | 35.4 | 30.4 | 33.2 | 31.7 |
| Lebanon | 38.4 | 36.3 | 35.9 | 32.9 | 31.5 | 35.9 | 35.0 | 33.7 | 32.8 | 30.4 | 29.5 | 32.2 |
| Libya | 38.2 | 42.2 | 43.1 | 42.4 | 29.1 | 31.2 | 33.7 | 40.1 | 46.6 | 47.7 | 56.9 | 52.9 |
| Morocco | 26.8 | 29.2 | 27.3 | 27.7 | 32.5 | 29.4 | 30.1 | 31.8 | 31.1 | 31.9 | 34.5 | 35.8 |
| Syria | 28.0 | 28.5 | 32.6 | 31.3 | 28.2 | 26.3 | 25.7 | 22.9 | 26.7 | 28.6 | n/a | n/a |
| Tunisia | 29.1 | 29.8 | 29.3 | 29.2 | 29.3 | 29.2 | 29.4 | 30.5 | 30.8 | 30.9 | 34.6 | 35.5 |
| EMDE | 26.4 | 27.7 | 27.5 | 26.6 | 26.7 | 27.0 | 27.4 | 28.8 | 30.3 | 29.6 | 29.4 | 30.0 |

Notes: yellow field – IMF estimate

Source: IMF WEO database, October 2013

Only Syria and Lebanon record systematically lower level of GG revenue while Egypt, Jordan and Morocco fall below EMDE average in individual years. In case of expenditure all SEMC record systematically its higher level except Syria which falls below EMDE average in individual years (Table 4.2).

Lack of cross-country comparative statistics does not allow for conducting a comprehensive analysis of revenue and expenditure structure. Nevertheless based on existing studies we will try to figure out key fiscal challenges and vulnerabilities of SEMC which are related to generalized price subsidies, employment in the public sector, military expenditure, dependence on hydrocarbon revenue and impact of political instability.

4.2. Consumer subsidies

The biggest fiscal challenge relates to generalized price subsidies to food and energy (Dabrowski & De Wulf, 2012; Bergasse et al., 2013), which continue to put a huge fiscal burden on several SEMC, especially Egypt, Algeria, Libya, Jordan and Lebanon. Most of this burden relates to energy subsidies, i.e., subsidies to petroleum, electricity, natural gas, and coal. The cost of food subsidies is relatively smaller; it amounts to 0.7% of GDP of MENA region according to IMF (2013a, Box 2.4, p. 42) estimates. However, in some countries (Libya, Tunisia, and Egypt) they are higher, i.e. in the range of between 1 and 2% of GDP.

Consumer subsidies can be measured in two ways: as pre-tax subsidies and post-tax subsidies (see Clement et al., 2013 for details). Pre-tax subsidies are defined as the difference between the value of supplied products and services at either international prices (tradable goods) or cost-recovery prices (non-tradable goods) and domestic prices paid by their consumers, both final and intermediate. Post-tax subsidies are the sum of pre-tax and tax subsidies. The latter are measured as the difference between the efficient taxation which takes sufficient account on externalities (in case of energy this is, for example, environmental impact of its production and consumption) and actual one.

The IMF (2013a, Box 2.4, p. 42) estimated the total cost of pre-tax energy subsidies in MENA countries at the level of USD 236.7 billion, i.e. 8.6% of their GDP and 22% of GG revenue in 2011. About half of this amount was absorbed by subsidies to diesel and gasoline. In global comparison, MENA appears as the region with highest energy subsidies, which constituted almost half of total pre-tax world energy subsidies in 2011. If one adds implicit tax subsidies the total post-tax energy subsidies in MENA region will approach the level of 15% of GDP (Clement et al, 2013).

Table 4.3: Subsidies for Energy Products in SEMC, 2011, as % of GDP

| Country | Petroleum products | | Electricity | | Natural gas | | Coal | |
|---------|--------------------|----------|-------------|----------|-------------|----------|---------|----------|
| | Pre-tax | Post-tax | Pre-tax | Post-tax | Pre-tax | Post-tax | Pre-tax | Post-tax |
| Algeria | 4.30 | 6.11 | 1.08 | 1.15 | 5.36 | 6.07 | 0.00 | 0.00 |
| Egypt | 6.74 | 8.60 | 2.30 | 2.50 | 1.60 | 2.59 | 0.00 | 0.05 |
| Israel | 0.0 | 0.00 | n/a | n/a. | n/a | 0.10 | n/a | 0.54 |
| Jordan | 2.15 | 5.27 | 3.81 | 4.10 | n/a | 0.34 | n/a | n/a |
| Lebanon | 0.07 | 3.57 | 4.46 | 4.61 | n/a | 0.17 | n/a | 0.11 |
| Libya | 6.40 | 8.81 | 1.85 | 2.33 | 0.59 | 1.49 | 0.00 | 0.00 |
| Morocco | 0.66 | 2.83 | n.a. | n/a | n/a | 0.04 | n/a | 0.33 |
| Tunisia | 0.77 | 2.56 | 2.23 | 2.43 | n/a | 0.70 | n/a | n/a |

Note: data for Syria is not available

Source: Clement et al. (2013), Appendix A, Table 2 and 4

Tables 4.3 and 4.4 present estimates of energy subsidies in individual SEMC and their disaggregation into major energy products. Pre-tax subsidies are the highest in oil- and gas-exporting Algeria and Libya, and oil-importing Egypt but also substantial in other SEMC apart from Israel and Morocco. However, product structure of subsidies differs among countries. Large subsidies to petroleum products are provided in Algeria, Egypt, and Libya and, to lesser extent, Jordan. The highest electricity subsidies are recorded in Lebanon, followed by Jordan, Egypt and Tunisia. Regarding subsidies to natural gas they are the highest in Algeria. Coal subsidies are of marginal importance in the analyzed region.

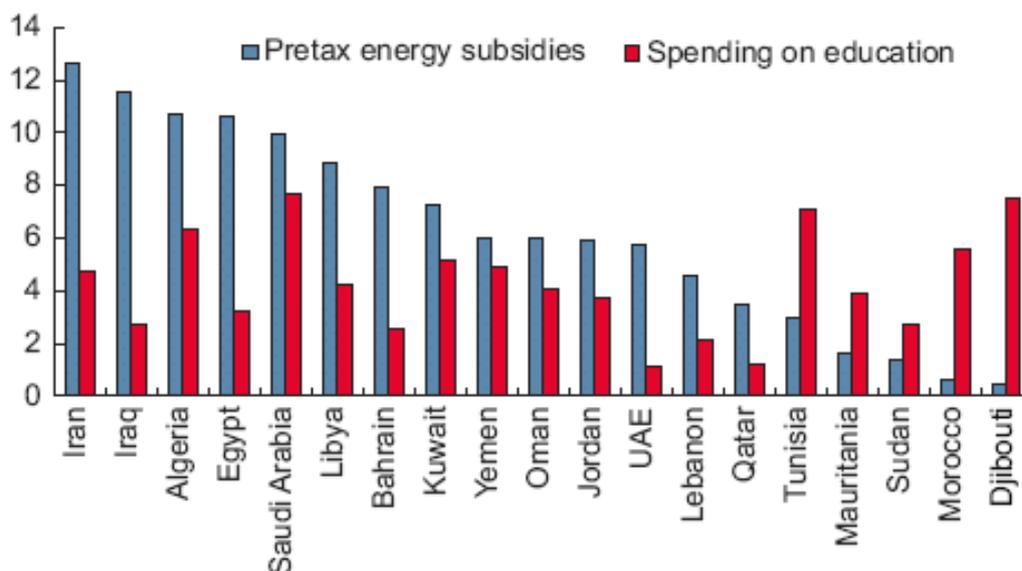
Table 4.4: Subsidies for Energy Products in SEMC, 2011, as % of GG revenue

| Country | Petroleum products | | Electricity | | Natural gas | | Coal | |
|---------|--------------------|----------|-------------|----------|-------------|----------|---------|----------|
| | Pre-tax | Post-tax | Pre-tax | Post-tax | Pre-tax | Post-tax | Pre-tax | Post-tax |
| Algeria | 10.84 | 15.40 | 2.72 | 2.89 | 13.52 | 15.31 | 0.00 | 0.00 |
| Egypt | 30.61 | 39.07 | 10.44 | 11.35 | 7.25 | 11.79 | 0.00 | 0.23 |
| Israel | 0.00 | 0.00 | n/a | n/a | n/a | 0.26 | n/a | 1.34 |
| Jordan | 8.13 | 19.94 | 14.41 | 15.49 | n/a | 1.30 | n/a | n/a |
| Lebanon | 0.32 | 15.17 | 18.96 | 19.59 | n/a | 0.71 | n/a | 0.45 |
| Libya | 16.64 | 22.91 | 4.80 | 6.04 | 1.53 | 3.86 | 0.00 | 0.00 |
| Morocco | 2.40 | 10.27 | n/a | n/a | n/a | 0.13 | n/a | 1.21 |
| Tunisia | 2.42 | 8.07 | 7.02 | 7.66 | n/a | 2.19 | n/a | n/a |

Note: data for Syria is not available

Source: Clement et al. (2013), Appendix A, Tables 3 and 5

Figure 4.1: Pre-tax energy subsidies and spending on education in MENA countries, in % of GDP



Notes: energy subsidies refer to 2011; education refers to the latest available data.

Source: IMF (2013a), Figure 2.4.2, p. 42

Generalized consumer subsidies are usually the consequence of government price controls. If government determines fixed administrative prices either on energy products or food they become almost automatically ‘politicized’ as the necessity of their upward adjustment may provoke social and political tensions. When necessity of such adjustment comes as result, for example, of higher international prices, depreciation of national currency, domestic inflation,

etc., government usually tries to delay setting new higher prices and, consequently, creates gap between the administratively fixed price and international or cost-recovery price. When such gap becomes large there is even less political readiness to close it. However, sooner or later it must be done and, in case of delay, adjustment becomes more painful socially, economically and politically.

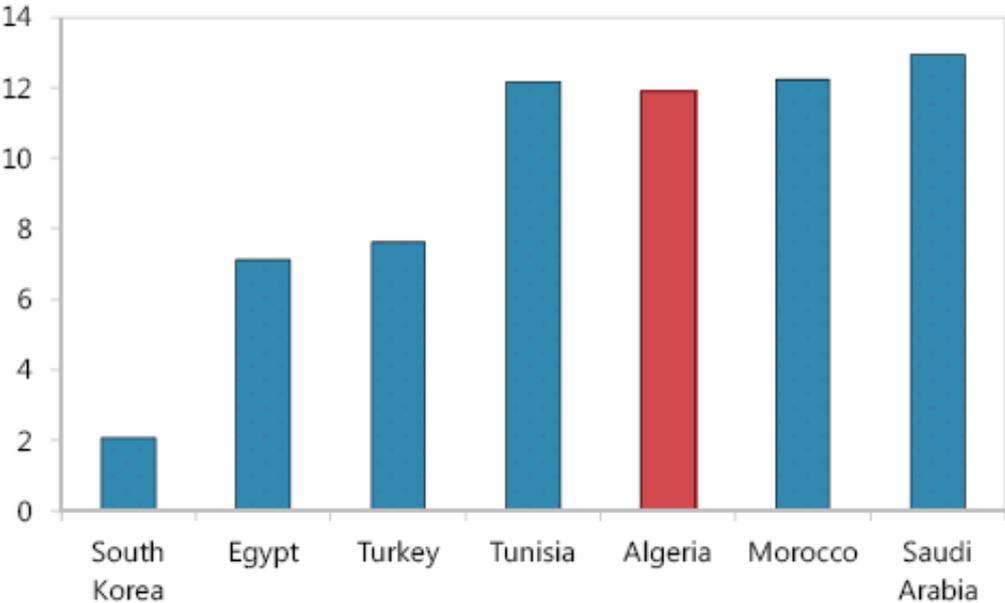
Universal price subsidies are both costly and inefficient as tools to fight poverty (their main social policy justification). In reality, higher- and middle-income groups are the main beneficiaries of those subsidies (Bergasse et al, 2013, Clement et al, 2013). In addition, the subsidies have a devastating microeconomic and structural impact. They discourage producers of the subsidized energy and food products from increasing their output and quality parameters. They stimulate excessive and wasteful consumption, damage the environment, and hamper the development of renewable energy, etc. (see Bergasse et al., 2013 for the analysis of energy subsidies).

By absorbing a substantial share of fiscal resources (in case of Egypt half of its GG revenue, in case of Algeria, Jordan, Lebanon and Libya between 20 and 30% – see Table 4.4) energy and food subsidies crowd out other important expenditures, for example, for education which creates an important development bottleneck in the region. Figure 4.1 shows that public spending on education is much lower than energy subsidies in Algeria, Egypt, Libya, Jordan and Lebanon (no data available for Syria).

4.3. Oversized public sector

There are not comprehensive and fully cross-country comparable statistics on public sector structure, employment and current budget spending on public employee salaries. However, the incomplete IMF data (Figures 4.2 and 4.3) points out to excessive public employment and related heavy expenditure burden in several SEMC and other MENA countries.

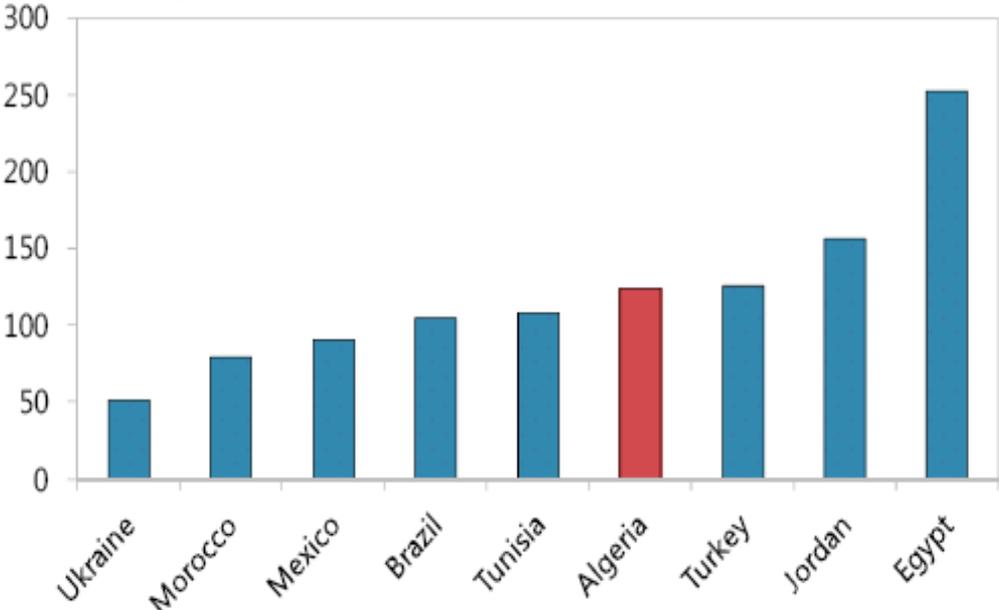
Figure 4.2: Public-sector wage bill as % of GDP in selected countries, 2011



Source: IMF (2013b), Appendix IV, p. 45

The low effectiveness of public sector employment is another big challenge. In policymaking practice of several SEMC hoarding excessive labor force in both public administration bodies and agencies of various levels and state owned enterprises serves as instrument of social policy, i.e. it aims at reduction of high unemployment and providing income support to at least part of population. In practice, it is a good pretext to employ relatives, friends, political supporters, retired military and law enforcement personnel, or offer job in exchange for material gratitude.

Figure 4.3: Public employees per 1,000 inhabitants in selected countries, 2010



Source: IMF (2013b), Appendix IV, p. 45

Needless to say such a policy misses its goal: instead of providing cushion to poverty it puts a heavy burden on public finances and economy. According to IMF (2013, Annex 4, p. 98-99) countries with higher share of spending on public sector wages and salaries in total budget expenditure represent higher Gini coefficient of income inequality.

In addition, oversized, incompetent and often corrupted public service is not able to provide basic public goods and, instead, harass private sector development and its ability to provide productive jobs. On the other hand, inefficient public enterprises distort competition and allocation of resources.

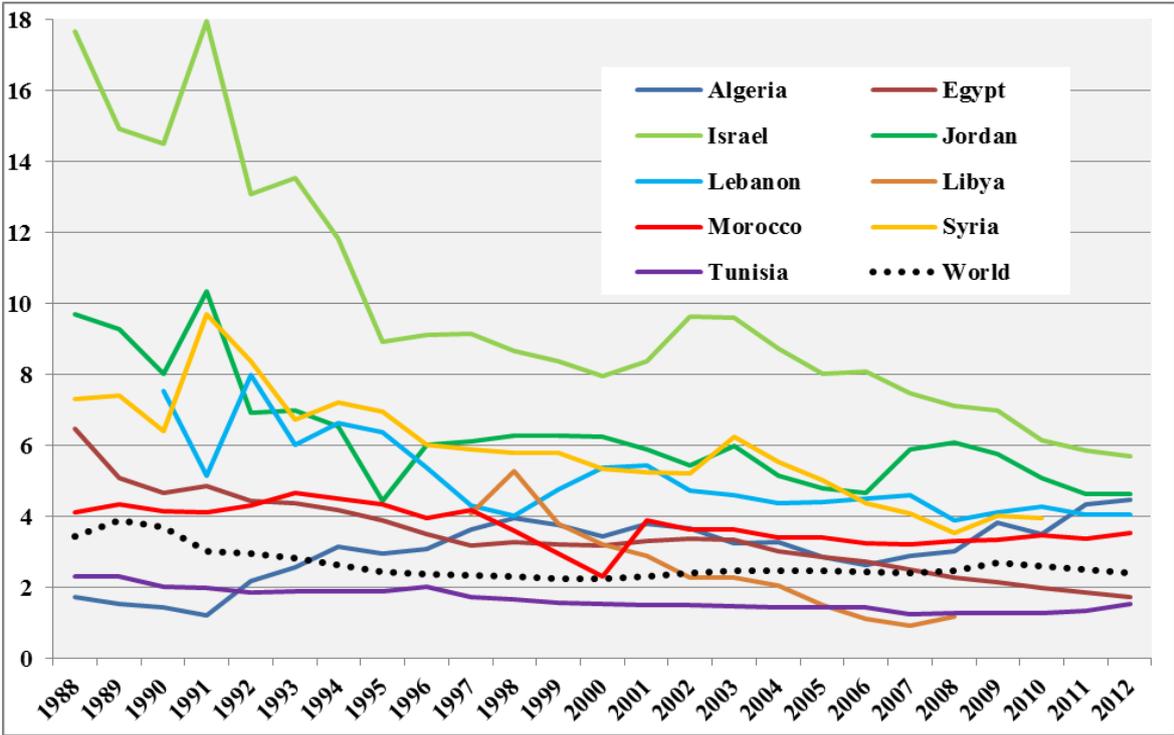
4.4. Military expenditure

Unsolved regional and internal conflicts as well as authoritarian or semi-authoritarian character of many political regimes in the region are responsible for high expenditure on defense and law enforcement agencies.

We do not have reliable and cross-country comparable data on internal security/ law enforcement expenditure. Thus our analysis will be limited to the WB World Development Indicator statistics on military spending which is, in turn, based on estimates of the Stockholm International Peace Research Institute (SIPRI). They include all current and capital expenditures on the armed forces, including peacekeeping forces, defense ministries and other government agencies engaged in defense.

Although military expenditure in SEMC decreased substantially, in % of GDP, from the record-high level in 1980s and early 1990s they continue to exceed world's average in all analyzed countries, except Tunisia. Israel is the highest military spender in the region and one of the highest in the world followed by Jordan, Lebanon, Syria, Algeria and Morocco. Egypt's expenditures for defense have gone down systematically (in relative terms) from over 6% of GDP at the end of 1980s to below 2% of GDP after the Arab Spring.

Figure 4.4: Military expenditure, % of GDP, 1980-2012



Source: WB World Development Indicators,

In spite of reported relative decrease in military expenditure, data of Figure 4.4 clearly indicate the remaining huge potential of the so-called peace dividend in the region. Further cuts in those expenditures would not only help in restoring so badly needed fiscal balance but also create room for providing more non-military public goods such as better education or infrastructure upgrade. Indirectly, resolving existing conflicts could facilitate opening borders, boosting intra-regional trade and economic growth.

4.5. Hydrocarbon dependence

Two large hydrocarbon producers and exporters (Algeria and Libya) are heavily dependent on oil and natural gas related revenue as seen in Table 4.5⁵. In particular, the fiscal breakeven oil price in Algeria is above 100 USD and continues to grow. That is, the hypothetical level of oil price at which the fiscal balance would be zero well exceeds the actual export price level.

Substantial dependence on oil revenue (although smaller than in Algeria and Libya) was also reported in Syria before this country fell into a civil war. According to IMF (2010, Table 2, p.

⁵ One should take into account the consequences of civil war in Libya on its fiscal performance in 2011 and 2012.

18), oil revenues of central government were equal to 7.1% of GDP and 29.7% of total revenues in 2005 but then declined to 4.9% of GDP and 21.7% of total revenues, due to decrease in volume of oil production.

Table 4.5: Hydrocarbon dependence of major SEMC oil producers

| Country | Non-oil fiscal balance as % of non-oil GDP | | | Fiscal Breakeven Oil Price in USD | | |
|---------|--|--------|--------|-----------------------------------|-------|-------|
| | 2006-2010 | 2011 | 2012 | 2006-2010 | 2011 | 2012 |
| Algeria | -43.8 | -44.9 | -46.7 | n/a | 109.7 | 125.6 |
| Libya | -115.9 | -117.4 | -194.6 | 46.9 | 124.0 | 75.7 |

Source: IMF (2013), Table 5, p. 106

The above figures mean that hydrocarbon producing SEMC remain extremely vulnerable to changes in international prices (which are unlikely to grow further and may decline in the next couple of years) and production volume. The latter seems to stabilize in Algeria, and has tendency to decline in Libya. Syria's oil production will definitely go down even if this country restores internal peace and stability soon, because of the shortage of new deposits.

Algeria created sovereign wealth fund (called the Revenue Regulation Fund) in 2000 which has cumulated USD 77.2 billion of oil related fiscal surpluses. Libyan Investment Authority created in 2006 has accumulated USD 65 billion of financial assets⁶. However, according to the Linaburg-Maduell Transparency Index⁷ transparency of both funds is assessed at the lowest level "1" on the scale from 1 to 10.

Before the civil war, Syria also had the Price Stabilization Fund with the same role of cumulating oil related revenue surpluses.

Overall, although existence of sovereign wealth funds in hydrocarbon producing countries must be assessed positively the question remains whether their size is sufficient to provide an effective fiscal buffer for 'rainy' days when either output or prices, or both go down.

5. Macroeconomic consequences of fiscal imbalances

Large fiscal imbalances and high level of public indebtedness have various negative consequences for macroeconomic stability and business climate.

5.1. Fiscal sustainability

Fiscal data presented in Tables 3.1 and 3.2 and Figure 3.1 suggest that Lebanon, Egypt and Jordan not saying about civil-war-devastated Syria may face fiscal sustainability challenges in a near-to-medium-term perspective. This is additionally confirmed by individual countries' sovereign ratings of two major rating agencies as presented in Table 5.1.

According to both Moody's and Standard and Poor's (SP) only Israel enjoys solid investment-grade rating despite of its continuously high GG deficit and public debt (-5.1 and 70.4% of GDP in 2013, respectively). According to the SP, Morocco with its BBB- rating is at the lowest bound of investment grade category. All other countries in the SP rating and all except

⁶ Data as of September 2013 – see <http://www.swfinstitute.org/fund-rankings/>

⁷ <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/>

Israel in Moody's rating represent speculative grade (of various degree). In the analyzed group Egypt has the worst Moody's rating (Caa1) and Egypt and Lebanon – the worst SP rating (B-), close to default grade territory. In case of Egypt, Jordan, and Tunisia ratings deteriorated since 2012.

Table 5.1: SEMC's sovereign rating, November 2013

| Country | Moody's | Standard and Poor's |
|---------|---------|---------------------|
| Egypt | Caa1 | B- |
| Israel | A1 | A+ |
| Jordan | B1 | BB- |
| Lebanon | B1 | B- |
| Morocco | Ba1 | BBB- |
| Tunisia | Ba2 | B |

Source: Moody's Statistical Handbook, November 2013;
<http://www.standardandpoors.com/ratings/sovereigns/ratings-list/en/us>

Please note that Algeria, Libya and Syria do not possess sovereign ratings but the first two do not need to borrow internationally, at least now.

5.2. Monetary and inflationary consequences

In countries which have experienced fiscal strains in recent years (Egypt, Jordan, Lebanon, Morocco, and Tunisia) part of the increasing public debt have been monetized either directly (central bank's lending to government) or indirectly (through increasing central bank's credit to commercial banks to enable them to lend to government). Most probably, monetary financing also became the main source of covering government expenditure in the conflict-affected Syria.

Partial monetization of fiscal deficit and public debt must lead to either depleting official reserves of central banks used to sterilize increasing net domestic assets (see Section 5.3) or to increasing inflationary pressures, or both. Inflationary pressure is also boosted by contribution of fiscal deficits to growing domestic demand.

Data of Table 3.1 confirms that after 2009 all SEMC except Israel and Morocco have experienced either continuous or periodic inflation pick up.

5.3. External vulnerability

Fiscal imbalances also put pressure on external accounts of individual SEMC. Data presented in Table 3.1 signal either deterioration of current account balances (Algeria, Egypt, Lebanon, Libya, Morocco, Tunisia and, most probably, Syria) or their stabilization on high deficit level (Jordan). This suggests possibility of the phenomenon of twin deficits when fiscal imbalances lead, via higher internal demand, to balance-of-payment problems. On the other hand, adverse shocks generated by political instability in the region may impact simultaneously both balance of payment and fiscal accounts.

In case of Algeria and Libya deterioration of current account led so far to reduction of their previously large current account surpluses. In Egypt small current account surplus in the past was replaced by modest current account deficit. In other countries current account deficits rapidly increased, sometimes to a two-digit level (in terms of their share in GDP) like in case of Lebanon or remained on that level (Jordan).

In countries affected, directly or indirectly, by negative consequences of the Arab Spring (Tunisia, Egypt, Libya, Lebanon and Jordan) capital accounts also deteriorated due to decreasing FDI inflows and, in some cases, capital outflows.

The negative balance-of-payment trends have had their negative impact on both the size of gross international reserves (Table 5.2) and exchange rates (Table 5.3). Since 2010, gross international reserves decreased in Egypt, Morocco and Tunisia and, temporarily, in Jordan (in 2012). In case of Egypt this decline looks dramatic, in spite of support provided by Gulf countries. Exchange rates depreciated in Algeria, Egypt and Tunisia. Those depreciations contributed to higher inflation (see Section 5.2).

Table 5.2: Total reserves in SDR million, end of period, 2009-2013

| Country | 2009 | 2010 | 2011 | 2012 | 2013 Q3 |
|---------|--------|---------|---------|---------|---------------------|
| Algeria | 95,266 | 105,787 | 119,277 | 124,663 | 125,708 |
| Egypt | 20,659 | 21,910 | 9,800 | 7,651 | 10,351 ^a |
| Israel | 38,663 | 46,043 | 48,769 | 49,389 | 52,085 |
| Jordan | 7,471 | 8,493 | 7,484 | 5,279 | 7,816 |
| Lebanon | 18,887 | 20,786 | 22,300 | 24,518 | 24,566 |
| Libya | 63,137 | 64,865 | 68,391 | 77,173 | 79,985 ^a |
| Morocco | 14,567 | 14,708 | 12,743 | 10,667 | 11,218 |
| Tunisia | 7,061 | 6,150 | 4,862 | 5,445 | 4,702 |

Note: ^a - August 2013

Source: IMF International Financial Statistics

Table 5.3: Market Rate, National Currency per SDR, end of period, 2009-2013

| Country | 2009 | 2010 | 2011 | 2012 | 2013 Q3 |
|---------|---------|---------|---------|---------|--------------------|
| Algeria | 114.02 | 115.42 | 116.77 | 120.04 | 124.89 |
| Egypt | 8.58 | 8.92 | 9.24 | 9.69 | 10.63 ^a |
| Israel | 5.92 | 5.47 | 5.87 | 5.74 | 5.43 |
| Jordan | 1.11 | 1.09 | 1.09 | 1.09 | 1.09 |
| Lebanon | 2363.29 | 2321.60 | 2314.42 | 2316.91 | 2312.63 |
| Libya | 1.93 | 1.93 | 1.93 | 1.93 | 1.93 ^a |
| Morocco | 12.32 | 12.87 | 13.17 | 12.96 | 12.68 |
| Tunisia | 2.07 | 2.21 | 2.30 | 2.38 | 2.53 |

Note: ^a - August 2013

Source: IMF International Financial Statistics

Table 5.4: GG Foreign Currency & FC-Indexed Debt/GG Debt, 2003-2012

| Country | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------|------|------|------|------|------|------|------|------|------|------|
| Egypt | 28.1 | 23.4 | 21.0 | 19.5 | 18.6 | 18.4 | 18.9 | 16.9 | 15.4 | 14.7 |
| Israel | 25.5 | 25.5 | 26.2 | 25.1 | 22.6 | 19.8 | 18.5 | 17.1 | 17.4 | 15.9 |
| Jordan | 76.7 | 72.0 | 69.2 | 65.3 | 58.7 | 38.7 | 35.3 | 36.6 | 31.0 | 28.0 |
| Lebanon | 49.1 | 53.4 | 51.9 | 53.3 | 54.6 | 48.5 | 45.2 | 42.5 | 42.4 | 45.7 |
| Morocco | 27.2 | 23.9 | 21.1 | 19.7 | 20.0 | 21.0 | 22.8 | 24.0 | 23.1 | 23.7 |
| Tunisia | 64.8 | 63.5 | 64.2 | 60.1 | 58.6 | 61.2 | 58.7 | 60.9 | 58.3 | 60.9 |

Note: data on Jordan, Lebanon, Morocco and Tunisia are limited to central government

Source: Moody's Statistical Handbook, November 2013

Increasing external imbalances may limit opportunities to finance public debt on international bond markets. On the other hand, depreciating exchange rates increase the domestic currency value of foreign currency denominated and indexed debt and its relation to GDP. Fortunately, among SEMC only Tunisia and Lebanon have large share of such debt in their total public debts (Figure 5.4).

6. Main directions of fiscal reform

Most of SEMC must undertake urgently far-going fiscal reforms to avoid potential risk of public debt insolvency and macroeconomic instability. Elimination or substantial reduction of energy and food subsidies, in first instance – pre-tax subsidies, should be considered as the task number one in all countries except Israel. It can offer relatively fast and substantial fiscal gains, which can allow restoring fiscal and broader macroeconomic equilibrium and increasing room of fiscal maneuver in medium and long-term.

Price subsidies should be replaced by targeted social safety nets, including targeted cash transfers following, among others, experience of CEE or Turkey (see Clements et al., 2013 on broader set of experience in subsidy reforms). They will absorb part of the resources economized as result of elimination/ reduction of subsidies but another part of budget saving will remain to reduce fiscal deficit or increase expenditure for priority public goods such as education, healthcare and transport infrastructure.

Results of the World Bank’s survey in four SEMC (see Table 6.1 and Silva et al, 2013) suggest that there is social understanding and readiness to accept such a subsidy reform. This means that a lot will depend on determination of individual governments, their political skills and administrative capacity in implementing the proposed policy changes⁸.

Table 6.1: Subsidy reform survey

| | Egypt | Jordan | Lebanon | Tunisia |
|--|--------------|--------|---------|---------|
| Question: If the government were to remove the subsidy on the price of diesel, should the government...? | | | | |
| | (In percent) | | | |
| Distribute that money to the poor | 32 | 50 | 32 | 38 |
| Distribute that money to all families except the wealthy | 3 | 19 | 11 | 6 |
| Distribute that money to all families including the wealthy | 2 | 3 | 1 | 1 |
| Distribute a portion of that money to the poor and spend the rest on healthcare and education programs for all | 57 | 10 | 56 | 50 |
| Don't know/refused (volunteered response) | 7 | 19 | 1 | 4 |

Source: IMF (2013c), p. 23 based on Silva et al (2013)

The second direction of fiscal adjustment should focus on reform of public administration and state owned enterprises. The oversized public service must be reduced in terms of number of employees. However, the remaining staff should be better paid and selected on the basis of professional competence rather than political and personal relations. Subsidization of public sector enterprises has to be terminated or at least substantially reduced and loss making firms – either closed down or restructured. SEMC should continue privatization of their state owned

⁸ See Clements et al. (2013) and Silva et al. (2013) on broader discussion of possible strategies and tactics in implementing subsidy reforms, including their sequencing and various flanking measures.

financial and non-financial corporations in an open, competitive and transparent manner. Revenue from privatization can contribute to reduction of public debt burden.

Other fiscal reforms may involve simplifying tax systems, eliminating tax exemptions and loopholes, ensuring better coverage of VAT and higher energy taxation (elimination of tax subsidies – see Section 4.2 and Table 4.3).

Elimination of other fiscal vulnerabilities will depend on changes in economic structure of individual countries (economic diversification), unblocking entrepreneurial potential (by improving business and investment climate) and progress in resolving various internal and regional conflicts (by decreasing military expenditure and unblocking intra-regional trade and investment flows). Obviously, all this requires more time and, in case of regional conflicts, international political effort.

In countries directly affected by the Arab Spring prospects of fiscal adjustment and other economic reforms will greatly depend on the outcome of political transition and their ability to build stable democratic regimes. A review of the experience of countries that managed a successful transition to democracy suggests that growth declined by about 3% during the transition, but recovered the pre-transition rate within two years. Investment took about five years to recover (MENA, 2011, p. 2). The important lesson of this analysis suggests that with the right policies, the dip in growth rates in some SEMC can be temporary and that the long term growth trend can be resumed.

Similar conclusions are offered by Khandelwal & Roitman (2013). According to those authors macroeconomic performance in Arab countries in transition has remained so far broadly in line with the sample of other political transition experiences in Africa, Asia, Latin America and Eastern Europe except fiscal balances. Here Arab countries' performance is consistently worse both in the pre-transition and transition period.

7. Summary and conclusions

Our analysis clearly demonstrates that all SEMC except large hydrocarbon producers (Algeria and Libya) suffer from serious fiscal imbalances and fragilities. They have been built over decades but become more visible and acute after 2008 when combination of adverse economic and political shocks (global and European financial crises, Arab Spring) hit the region. In the environment of slower growth and higher public expenditure pressures fiscal deficits and public debts increased rapidly leading to deterioration of current accounts, depleting official reserves, depreciating of some currencies and higher inflationary pressure. If not addressed on time deteriorating fiscal and macroeconomic equilibria may lead to serious problems, including dangers of public debt and balance-of-payment crisis.

To avoid the worst-case scenario the bold fiscal adjustment and accompanying structural and institutional reforms are urgently needed. Among them, the subsidy reform, especially in respect to energy products is the most important issue. This is a priority task for all SEMC (except Israel), including Algeria and Libya. It can bring substantial fiscal gains and several other positive effects such as better social targeting (when generalized price subsidies are replaced by the targeted cash transfers and other addressed social assistance tools), reducing excessive energy-intensity of SEMC, eliminating structural distortions and negative

environmental effects, creating incentives to develop alternative energy production, reducing black economy, unblocking fiscal resources for human capital and environmental investment.

Another reform priority concerns public administration and public sector enterprises, including their further privatization. In the longer term perspective economies and public finances of SEMC may benefit from improving business climate, more trade and investment openness, sector diversification and peace dividend.

Economic and fiscal reform perspectives will depend on the pace of political transition in the region and its results, i.e., ability to build stable democratic regimes able to resist populist temptations and popular support for more rational policies. Learning from experience of political and economic transitions in other regions – Asia, CEE and former USSR, Africa and Latin America - may offer an useful guidance in building more effective governments and economies in SEMC.

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