

Mr. Robert Beschel

Lead Public Sector Specialist, MENA

World Bank

**The Impact of Large Governments on Development and Growth in the
MENA Region**

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Institutions and Economic Growth in the Arab Countries

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Joint IMF/AMF High Level Seminar: The Impact of Large Public Sectors in MENA



Robert P. Beschel Jr.
Lead Public Sector Specialist
World Bank MENA Vice Presidency



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Outline of Presentation



- Does MENA have large public sectors vis-à-vis other regions?
- What are the costs and consequences?
- What is to be done?



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Global Governance Trends from 1989 on...




- Breakup of Empires & Rise of New States
- Expansion of Democratic Regimes
- Reduction in the Role and Size of the State
- Decentralization
- Rise of the Anticorruption Agenda
- Growth in E-Governance
- Rise of "New Public Management"




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1990s Were the Second Most Prolific Decade in History in Terms of New State Creation

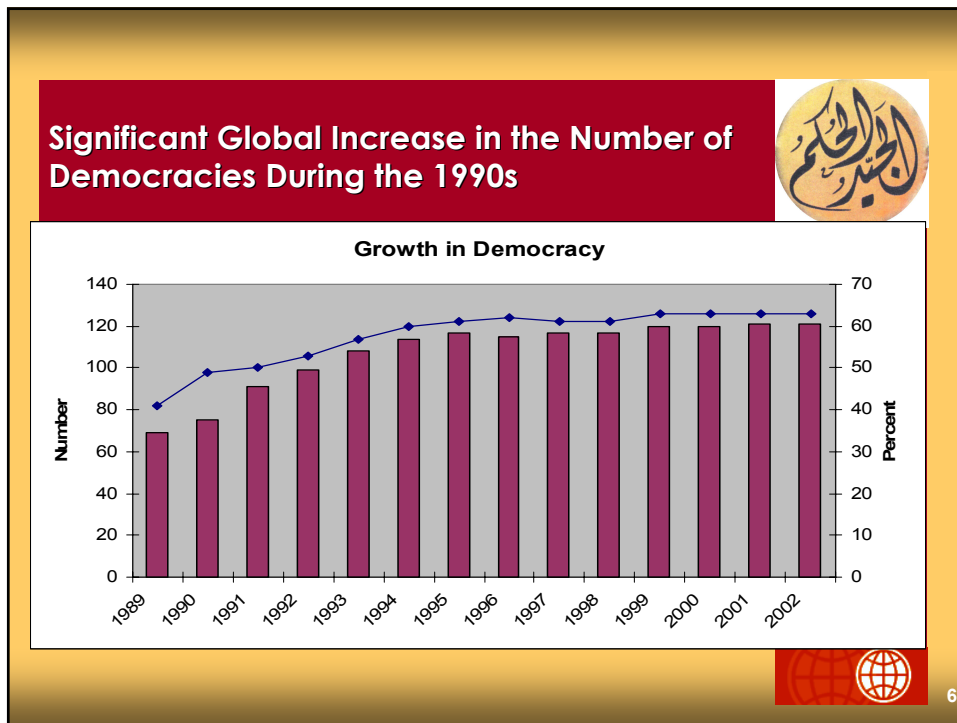
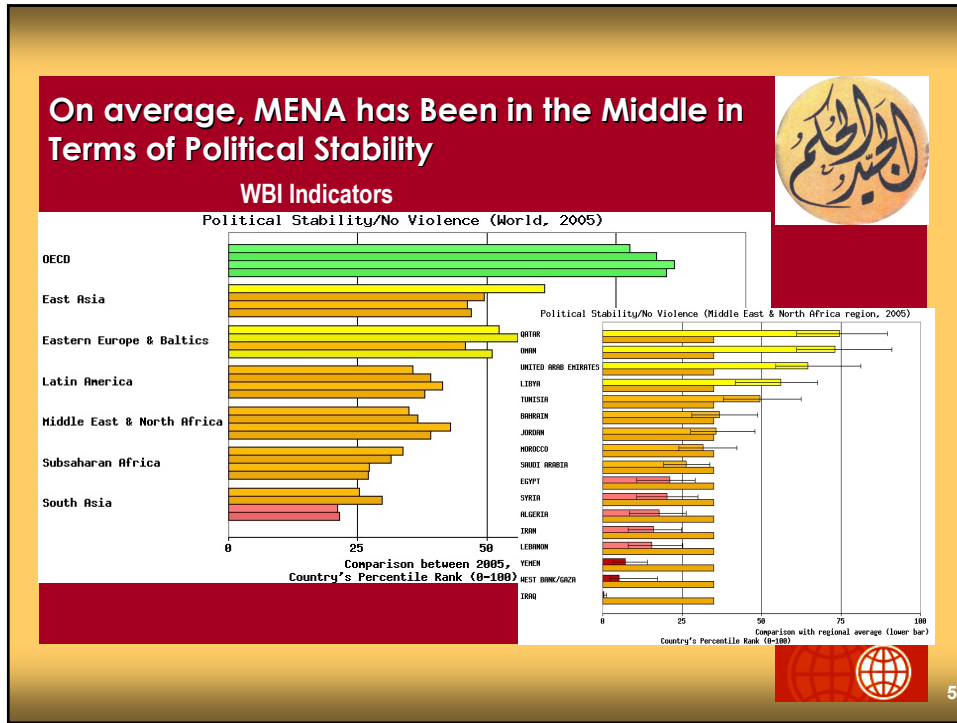


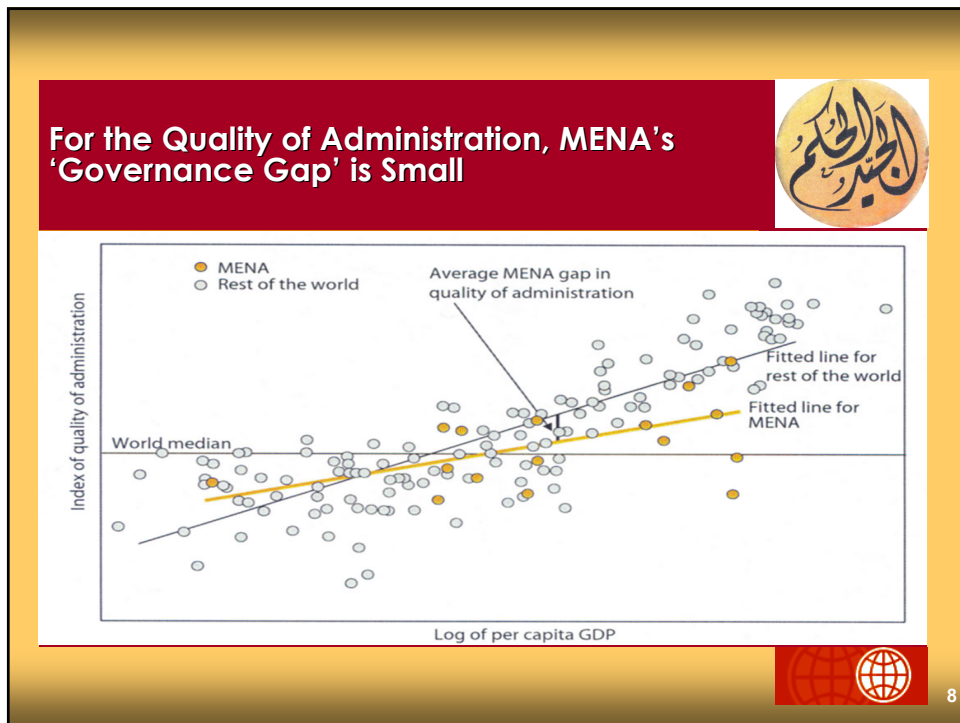
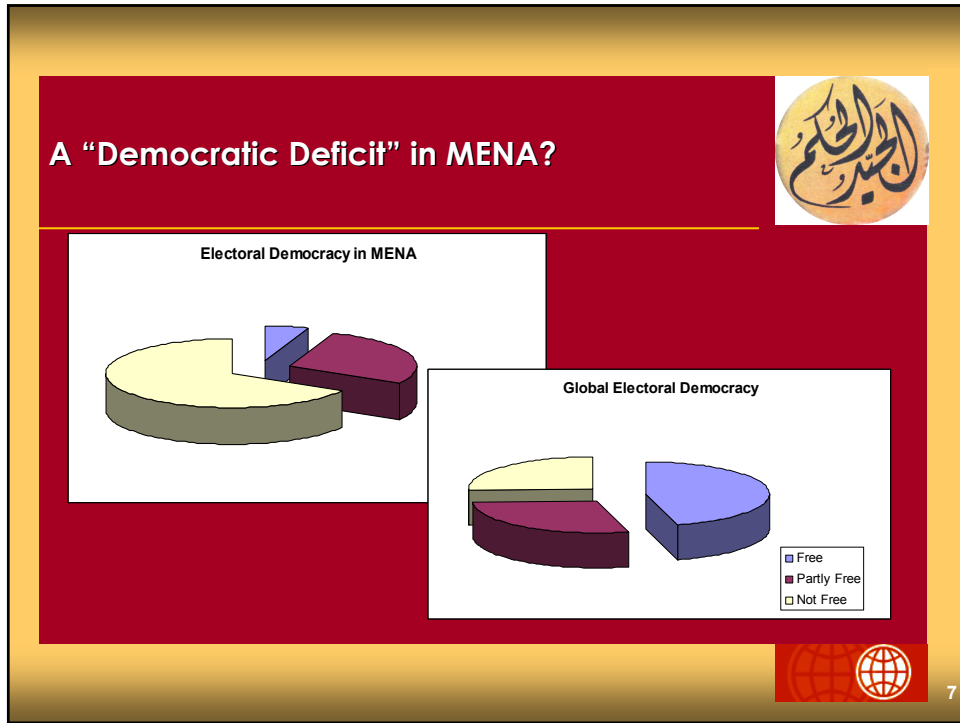
State Creation Since 1945

Decade	Number of New States	UN Membership
1940-49	8	51
1950-59	23	81
1960-69	44	119
1970-79	26	145
1980-89	7	178
1990-99	29	192
2000-02	3	192



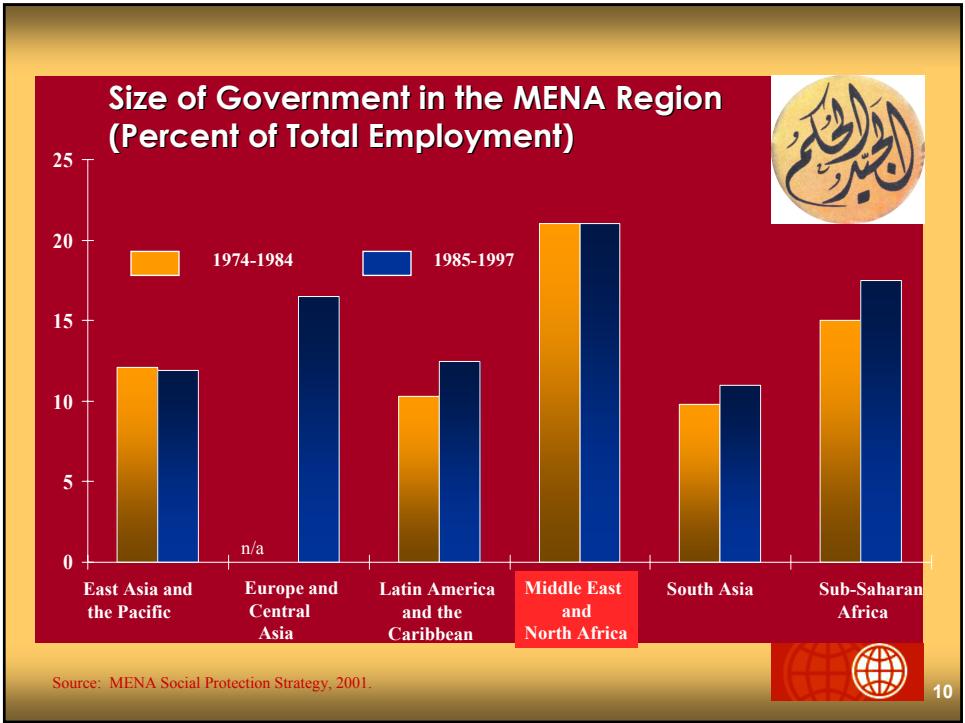
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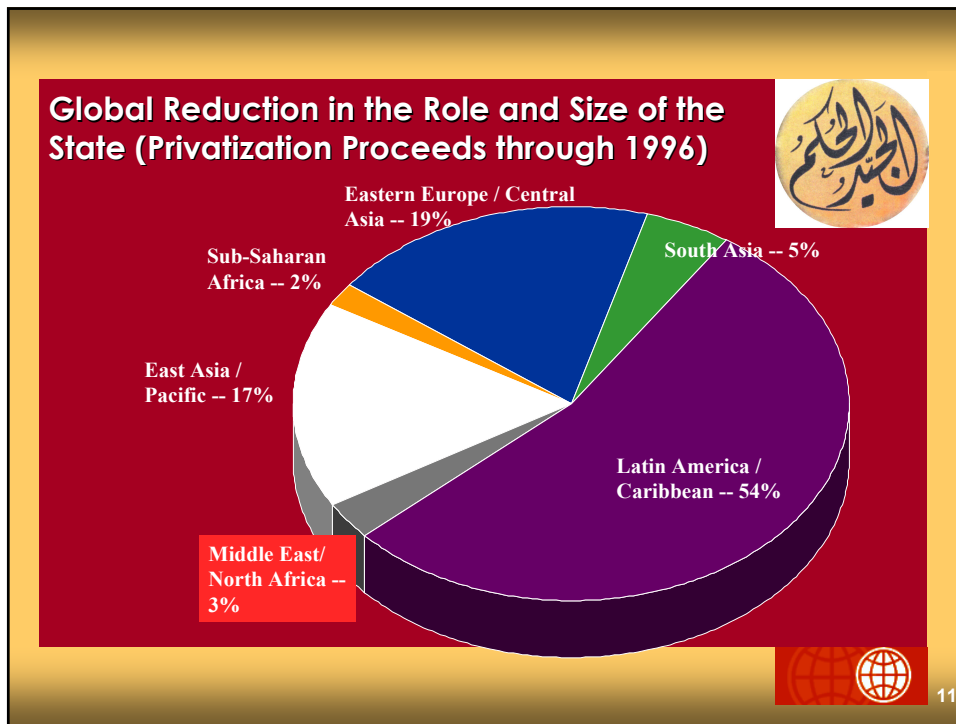




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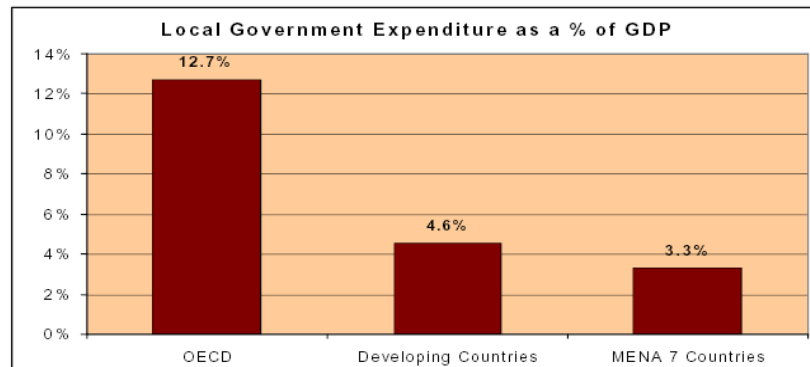
Significant Global Turn Towards Decentralization...

"As a political phenomenon, decentralization is widespread. Out of the 75 developing and transition countries with populations greater than 5 million, all but 12 claim to be embarked on some form of transfer of political power to local units of government."

Source: William Dillinger, *Decentralization and Its Implications for Urban Service Delivery*, 1994

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...with Limited Impact in MENA



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In Summary...



- Many of the global trends in governance in the 1990s were felt only distantly in MENA
- In comparison with other regions, MENA fairs well in terms of political stability and e-governance and fair in terms of facilitating private sector development, service delivery and anticorruption, with wide variation between countries
- The region fairs worse than global comparators on issues of decentralization and on public voice, accountability and participation
- Overall size of the public sector is an issue



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How Do We Measure Civil Service Size?



- **Assessment of the Number of Civil Servants**
 - Number of Civil Servants per Capita
 - Gov. Employment as % of Total Employment
- **Assessment of the Wage Levels in Relative Terms**
 - Wage bill as % of GDP
 - Wage bill as % of Revenue or Own Source Revenue
 - Wage bill as % of Recurrent Expenditure

Aggregate Numbers Tells Us Very Little and Should be Viewed in Context of Individual Country Experiences



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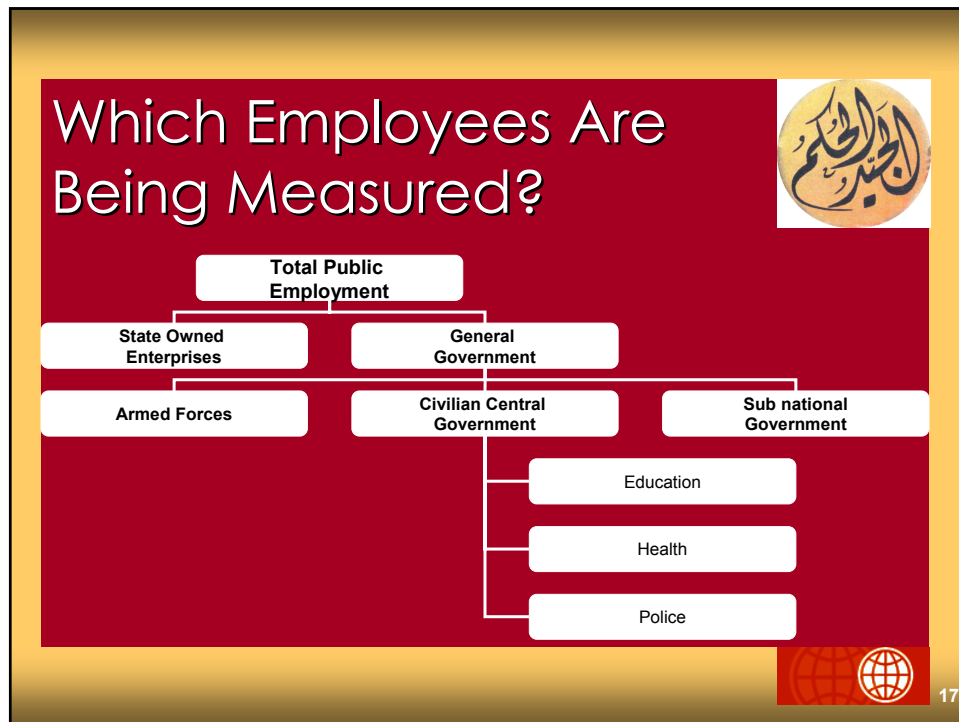
How Do We Measure Wage Adequacy?



- ACGW as multiple of per capita GDP
- **Private Sector Comparators**
 - Average Manufacturing Wage
 - Average Financial Sector Wage
 - Average Private Sector Wage
- Vertical Compression Outside 1:7 to 1:20 range provides poor incentives for performance (but there is little comparative data)
- Widespread discretionary allowances above base pay can be unfair and skew incentives



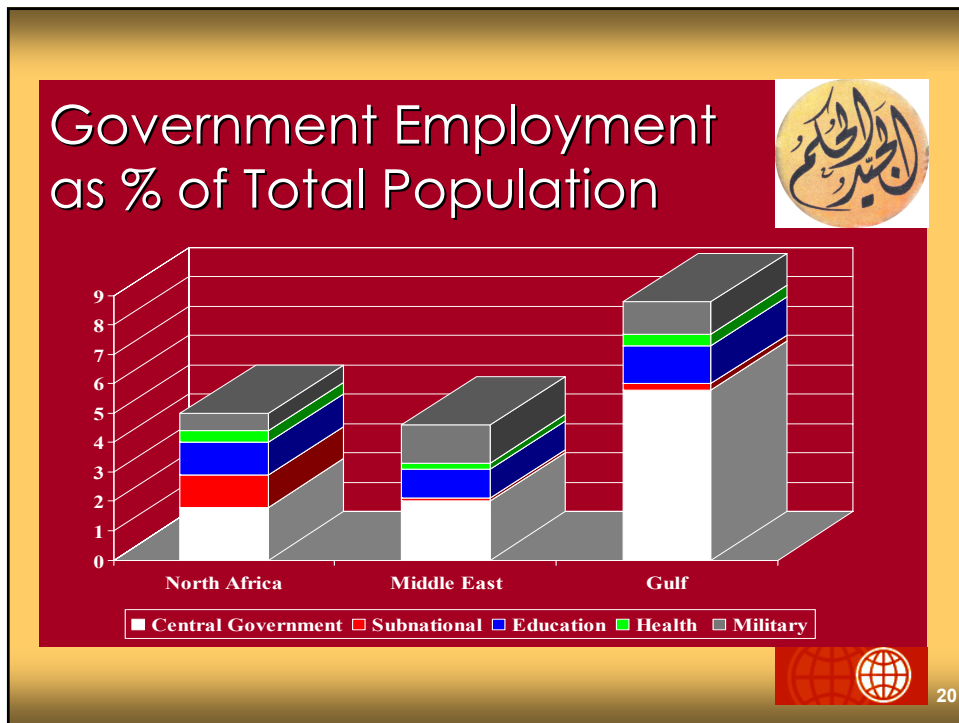
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Government Employment in MENA

- Largest General Government Employment in the Developing World
- Largest Central Government Employment (3% of population)
- Smallest Sub-National government (in terms of number of personnel)
- Largest Military (not counting other security personnel)

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MENA Government Wages

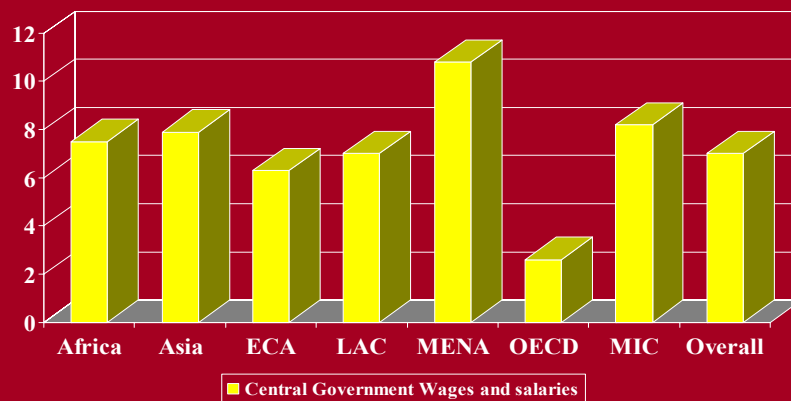


- **Central Government Wages absorb over 10% of GDP, the largest fiscal weight of any region**
- **Gulf is the highest region within MENA**

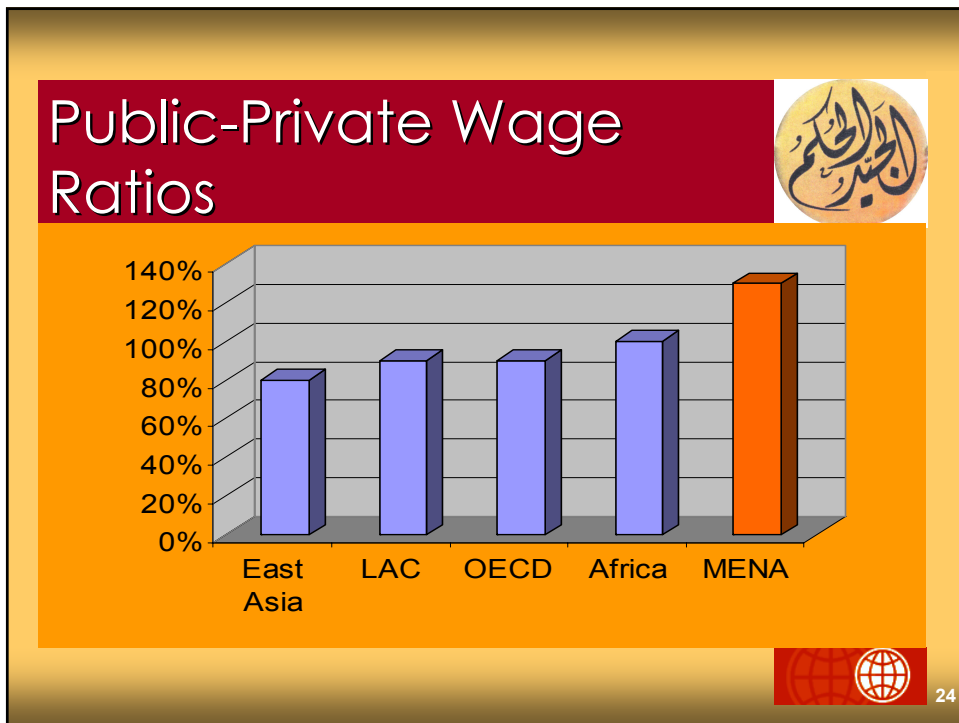
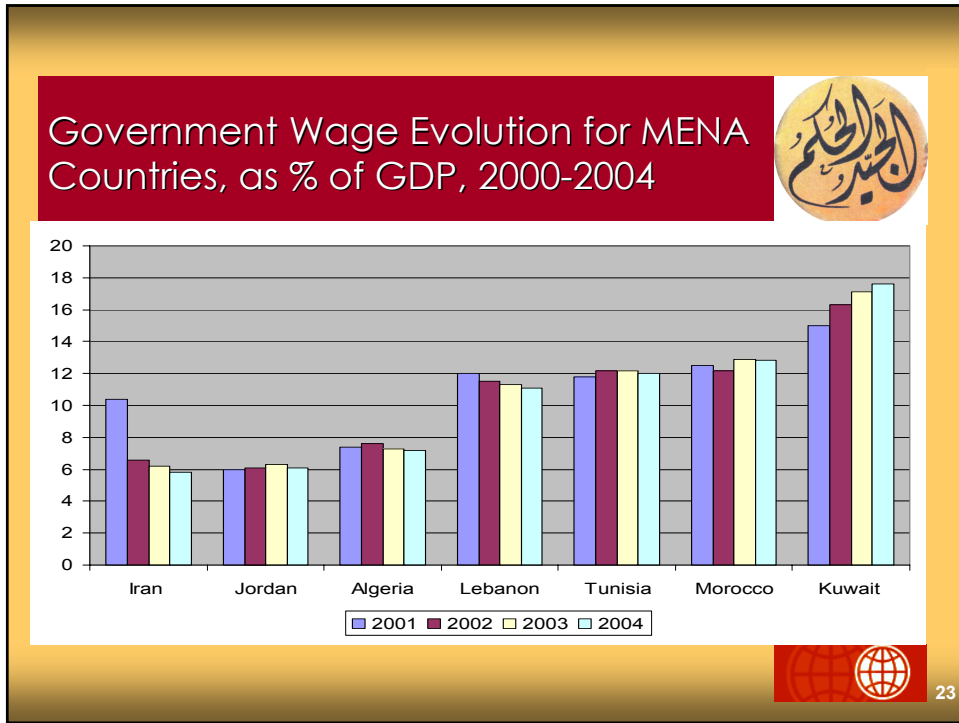


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Central Civilian Government Wages as % of GDP



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What Is the Impact of a Large Public Sector?

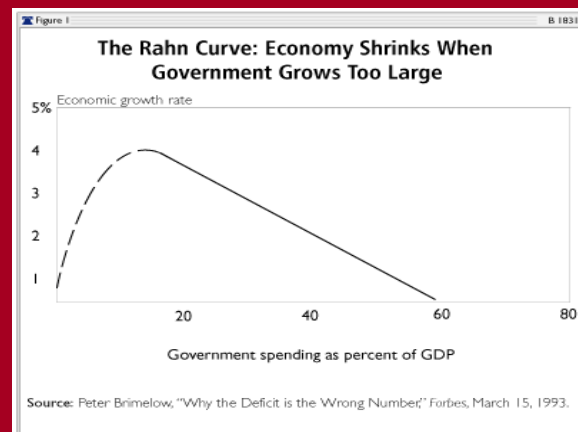


- **“Crowding Out” of private sector investment through taxes and higher interest rates**
- **Lower productivity of public sector investment**
- **Distortions in labor markets**
 - High reservation wage leads to queuing for public sector jobs
 - Public sector soaks up talent that would otherwise go to the private sector
- **Negative Externalities**
 - Greater compliance costs/increased focus on lobbying
 - General loss of productivity throughout the public sector



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The Rahn Curve



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However, Empirically the Actual Impact Depends...



- **Cross country regressions have shown some correlation between economic growth and the size of the public sector**
 - Econometric analysis on 27 countries from 1960-2003 shows that an increase in the deficit by 1% of GDP results in a decrease of investment by .3% of GDP on average (Krajewski & Mackiewicz, 2006)
 - Folster and Henrekson find a robust negative relationship between government expenditure and economic growth. In addition, they conclude that a 10 percent increase in government expenditure as a percent of GDP is associated with a decrease in the economic growth rate by 0.7 – 0.8 percentage points (2001).



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However, Empirically the Actual Impact Depends...



- **However, in any given case, the specific problems identified above may or may not be an important factor**
- **Country specific work is necessary before firm conclusions can be drawn**



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How Much is Enough?



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Wagner's Law



As nations industrialize, the share of the public sector in the national economy grows continually. The increase in state expenditure is needed because of three main reasons: (i) social activities of the state, (ii) administrative and protective actions, and (iii) welfare functions.

-- Adolph Wagner (1835-1917) --

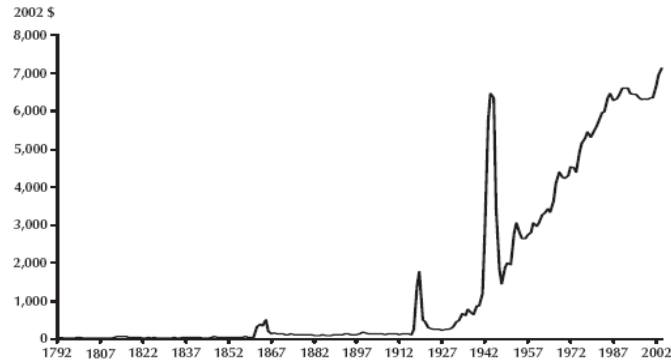


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How Much is Enough? The U.S. Example



Real Per Capita Federal Expenditures: 1792-2004

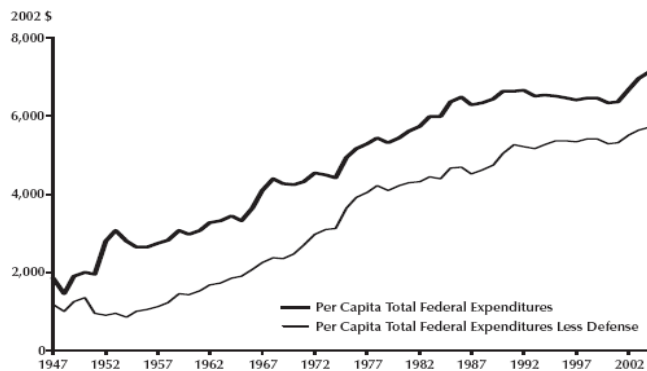


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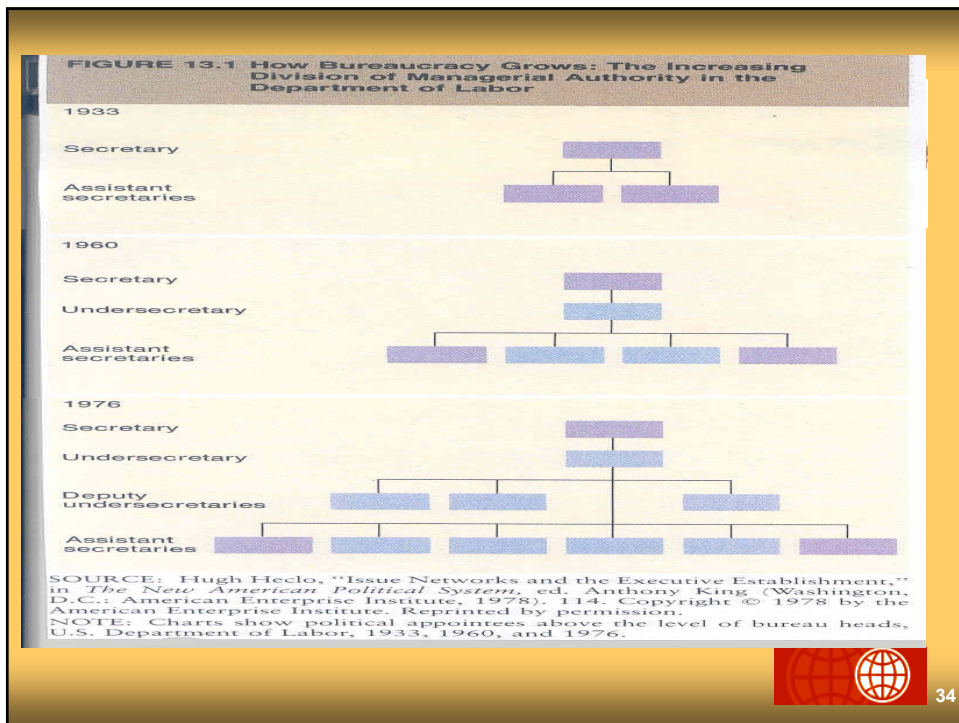
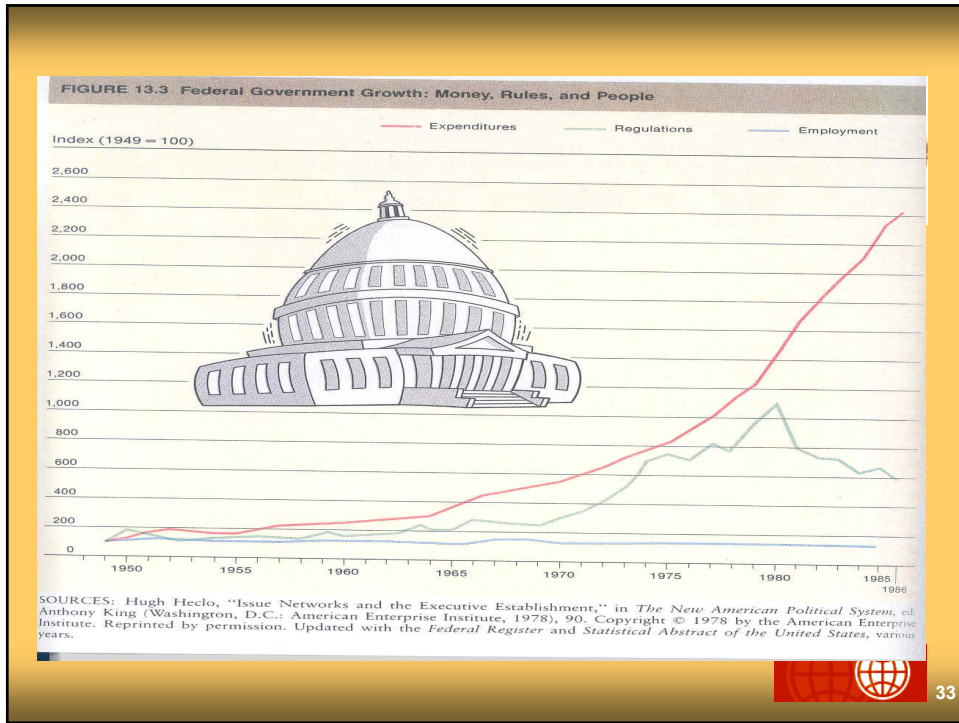
The U.S. Example (cont.)



Real Per Capita Federal Expenditures: 1947-2004



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Options for Reform: Bottom Up vs. Top Down Approaches




- **Bottom up** looks at the mission, mandate, organizational structure, staffing, and work norms for individual ministries and departments




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Options for Reform: Bottom Up vs. Top Down Approaches



- **Top Down** looks at the aggregate size of the public sector & wage bill benchmarked against global norms and similar countries




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Options for Reform: How Much is Enough?



In Reality...

There is no hard and fast answer. The size of the public sector depends upon the complex interplay between numerous dynamics: (1) public demands & expectations of government; (2) affordability; (3) ministerial staffing requirements and work standards; (4) civil service legislation & establishment controls; (5) societal expectations regarding employment; (6) dynamism of the private sector; (7) political patronage and (8) the strength of public sector unions.

Key Question: Why Does Overstaffing Exist in a Particular Context?



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In MENA, Large Public Sectors Have Multiple Causes



- Socialist & Dirigiste Legacy (Algeria, Egypt, Syria)
- Redistribution of Oil Revenues (GCC)
- Limited Private Sector Growth & Labor Surplus Economy (Morocco, Egypt, Jordan)
- Political & Ethnic Pressures (Iraq, Lebanon, Palestine)



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Options for Reform



- **Assess the problem carefully**
 - How bad is it?
 - What are the dynamics driving it?
 - Where does the bulk of overstaffing exist?
 - How robust are the numbers?
 - What is the demographic profile of the public sector?
 - What is the optimal structure and staffing profile for ministries and departments?
 - Who are political and administrative reform champions?
 - When is the optimal window of opportunity?



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Dealing with Surplus Labor



- **Implement Alternatives First (ghost workers, double dippers, staff past retirement age, etc.)**
- **Hiring Freeze & Natural Attrition (depends on civil service demographic profile)**
- **Retrenchment (design issues are key)**
 - Mandatory vs. Voluntary
 - General vs. Targeted
 - Linked with broader reform agenda
 - Carefully work the financial numbers
 - Test with focus groups
 - Prevent re-entry & adverse selection



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Dealing with Pay Reform



- How robust are payroll and establishment controls?
- What is the comparison between public and private sector pay?
- Are there key skill gaps or areas where it is difficult to recruit good staff?
- How many and what type of allowances are provided? Is there scope for rationalization?
- Centralized or decentralized pay policy?
- Avoid ad-hoc rounds of competitive increases
- Don't get overly complex pay and grading schemes



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Options for Reform



- **Complementary Measures**
 - Streamlining Investment Procedures/Improving the Business Climate
 - Liberalizing Labor Markets
 - Reforming Education Incentives (problem of employment guarantees)
 - Promoting Private Sector Led Growth



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