

BACKGROUND NOTE

Thematic Session 4: Improving the Business Climate¹

The private sector needs to become the main engine of employment-intensive growth in the Arab Countries in Transition (ACTs). Strengthening small and medium-sized enterprises (SMEs) will be particularly important, as experience from across the world has shown that they are typically responsible for a large share of job creation. This note first provides an overview of the main challenges that the private sector in the ACTs is currently facing. It then identifies important areas for strengthening the business climate that governments could focus on over the coming years.

I. THE CHALLENGE

A competitive private sector is an engine for jobs and growth. Around the world, the private sector represents the lion's share of employment and economic activity. And within the private sector, SMEs contribute most job creation.² Governments play an important role in supporting firms with an enabling environment for doing business, with strategies to address the needs of different types of firms: while small and medium-sized firms tend to have a stronger effect on employment levels, larger firms tend to contribute more to productivity growth and innovation (Ayyagari, 2011).

Private sectors in the ACTs are characterized by a “missing middle.”³ This phenomenon is found in many other developing and emerging countries, and is typically associated with the following:

- **A few big and (often) state-owned or government-connected firms dominating the formal sector.** In many cases, these firms have been sheltered from full competition through their proximity to political decision makers.⁴ This has lowered their incentives to improve competitiveness on a continuous basis, resulting in a situation where relatively few firms are well positioned to compete in world markets.
- **A large informal sector with many small-scale firms (Schneider and others, 2010).** In this sector, firms—even if well established—often stay small, which can also be a way to escape government regulations and taxation. The productivity of these firms tends to be low as a result of a lack of reliable access to resources like capital and skilled labor (La Porta and Shleifer, 2008).

¹ This Note was written as a background note for the “Jobs, Growth and Fairness” conference, which took place in Amman on May 11 and 12, 2014. The note was written by Carolin Geginat with excellent research assistance by Shady Darrag, Paul Zimand, and Daniah Orkoubi. It benefitted from comments from Daniela Gressani, Bjorn Rother, and Gaëlle Pierre. **This Note should not be reported as representing the views of the IMF.** The views expressed in this note are those of the author and do not necessarily represent those of the IMF or IMF policy.

² According to the IFC's Jobs Study (2013), SMEs provide for more than half of all formal employment worldwide.

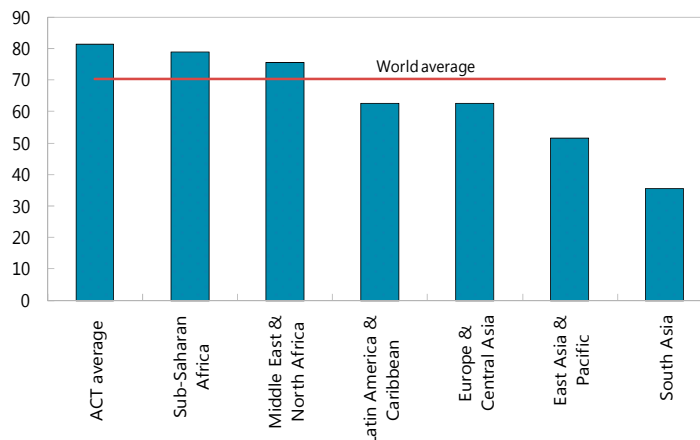
³ See, for example, Freund et al., 2013, for a detailed discussion of the phenomenon of a “missing middle” in Tunisia.

⁴ See, for example, Freund and others, 2014, on how firms connected to the Ben Ali regime in Tunisia used industrial policies and regulations to increase their market share.

- Scarcity of small and medium-sized firms in the formal sector.** A census of firms in Morocco and Tunisia has shown that very few firms grow into bigger ones (Rijkers and Arouri, 2012). For Jordan, there is evidence that firms start out larger than, for example, firms in Brazil, but firms in Brazil are about twice as large after 10 years in operation (World Bank, 2013). Another example of the phenomenon of the “missing middle” is the banking sector in the region. On average, the three largest banks in each ACT control more than 80 percent of banking assets, compared with 61 percent in other developing markets (Figure 1).

Figure 1. Bank concentration in ACTs is higher than in any other region of the world.

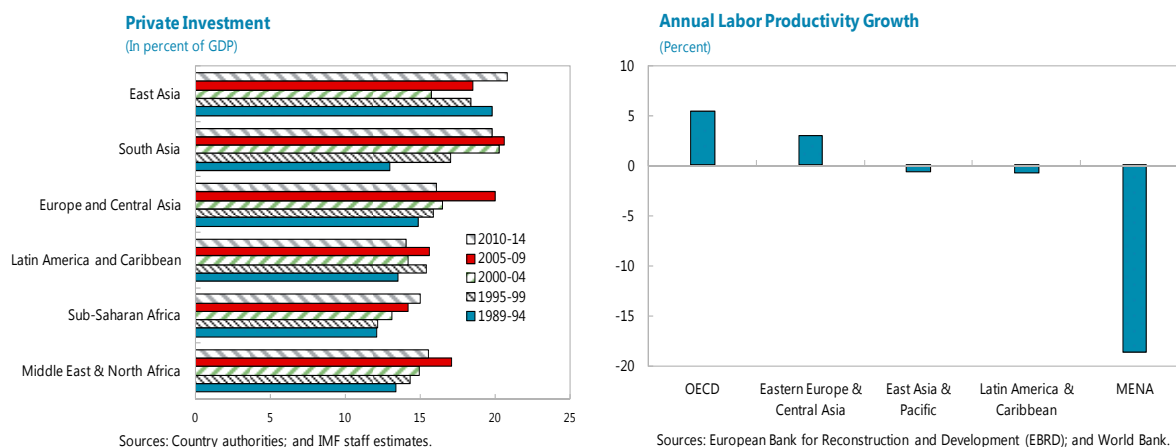
(Percent of total assets owned by top three banks)



Source: World Bank, Global Financial Development Database (GFDD), April 2013 update.

The “missing middle” affects overall productivity growth. ACTs are not the only countries suffering from a dearth of medium-sized firms,⁵ but this phenomenon seems to affect the overall productivity of the private sector more than in other regions. The private sector in the broader Middle East and North Africa (MENA) region has been shown to be less productive than in other emerging economies (Figure 2). Firms also tend to be less technologically advanced, innovate and invest less, and export a narrower basket of goods (World Bank, 2009).

Figure 2. MENA firms tend to have low productivity growth and invest little.



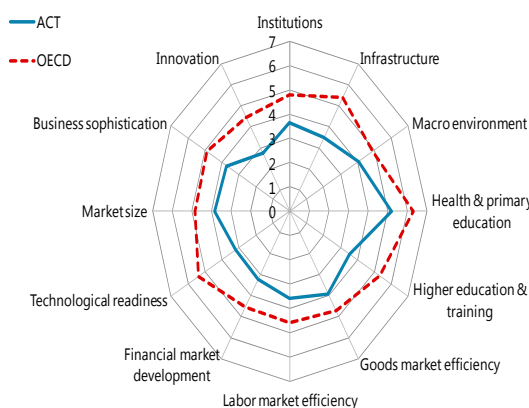
⁵ See for example, World Bank (2012) for a discussion of the “missing middle” in Indonesia’s manufacturing sector.

Limited access to markets and finance, as well as weak infrastructure, limit firms’ competitiveness.

The ACTs rank on average 100 out of 148 countries included in the World Economic Forum’s Global Competitiveness Index. In particular, the ACTs lag behind richer countries when it comes to their ability to innovate and make use of new technologies—two very important aspects of private sector development that are outside of the scope of this note. But they also suffer from relatively weak institutional and governance environments, less developed financial markets, small market size, and supporting infrastructure that is perceived to be of poor quality (Figure 3). For example:

- Businesses in the region note the importance of making existing regulations more transparent and efficient, to reduce discretion of officials and create a level playing field for small and large firms alike;

Figure 3. ACTs' competitiveness compared to the OECD.
(Global Competitiveness Index Pillars, on scale from 1 (worst) to 7)



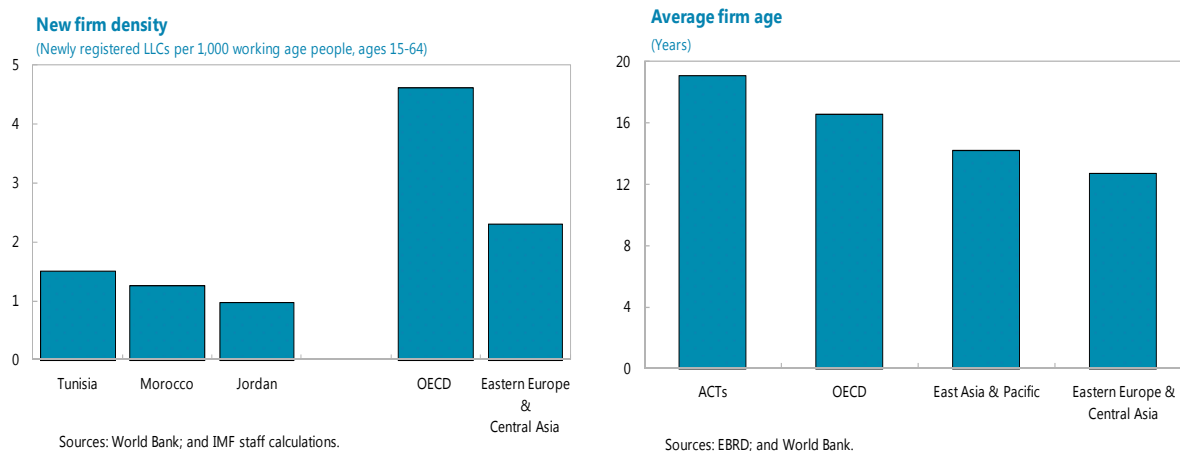
Source: World Economic Forum (WEF).

- Banks tend to lend to larger and more connected borrowers. The MENA region has the lowest percentage of firms with credit lines or loans from financial institutions, and too little is done to finance new, innovative firms that may have great business ideas but little initial capital to finance them (Alvarez de la Campa, 2011; Rocha and others, 2011);
- Significant weaknesses in infrastructure have been identified, particularly in the transport and electricity sectors (World Bank, 2013);
- Inward foreign direct investment (FDI), which can have an important effect on firm productivity and market development, tends to be low and has only recently started to recover to levels before the start of the Arab Spring in Morocco and Tunisia; and
- Limited trade integration makes it difficult for firms to benefit from participation in global markets and supply chains (Chauffour, 2012).

New formal firms are less likely to be created in the ACTs than elsewhere. Firm entry rates in the region are significantly lower than in other regions. The number of registered businesses per 1,000 people in the three ACTs for which data are available is about a fourth of that in the OECD, and half of that in Eastern Europe and Central Asia. Firms also tend to be older than elsewhere (Figure 4): even though impressive progress has been made over the past decades in increasing education, the ACTs and other countries in MENA have not experienced the renewal of the business elite, with the

establishment of a generation of younger and more educated entrepreneurs—a trend that has been observed in other parts of the developing world.⁶

Figure 4. Firm entry and exit rates in the ACTs are low.



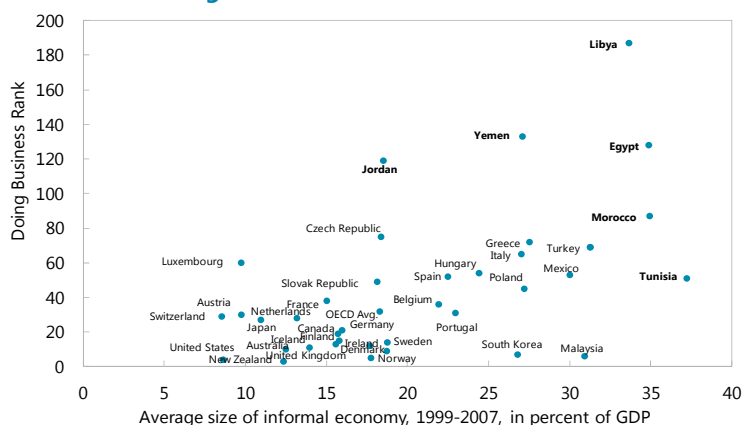
II. A POSSIBLE WAY FORWARD

A. The ACTs need to promote entrepreneurship and formality...

More effective regulations for firm creation and transition into formality.

Countries with good business regulatory environments tend to have smaller informal sectors (Figure 5) and more firm creation, ultimately leading to better growth outcomes overall (Djankov and others, 2006; Klapper and others, 2006; Klapper and Love, 2011). Factors like the efficiency and appropriateness of the legal and regulatory regimes, the speed and expense of the business registration process, the flexibility of employment regulations, and corporate taxation regimes have been found to be of great importance for firm entry (Klapper and Love, 2010; Bruhn,

Figure 5. More firms stay in the informal sector when business regulation is weak.



Sources: Doing Business; and Schneider (2010) Policy Research Working Paper 5356.

⁶ Compared with other regions, MENA has the highest percentage of manufacturing business owners who have not completed secondary school. This figure is 13 percent for MENA, compared with 6 percent in Eastern Europe and Central Asia, 5 percent in East Asia, and 3 percent in South Asia (World Bank, 2008).

2013; Branstetter, 2010). Moreover, medium-sized firms—those most needed for job creation—tend to benefit the most from regulations that are simple and consistently implemented (Hallward-Driemeier and others, 2010).

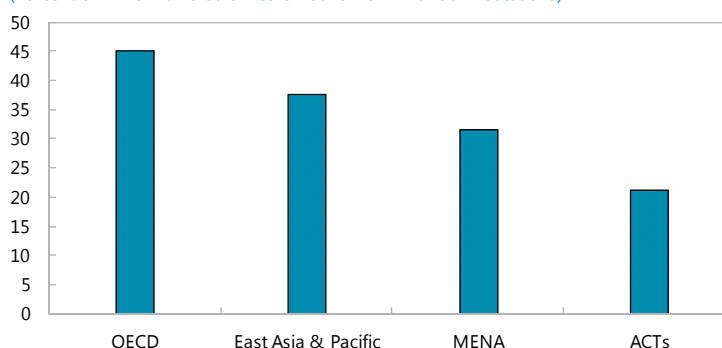
More effective framework for firm exit to encourage entrepreneurship. The framework for firm resolution is an important aspect of an effective regulatory environment. Evidence suggests that investors are more willing to invest and set-up new firms in countries where they can trust that a greater share of their investment can be recovered in the event of insolvency. This is not the case in many ACTs: insolvency proceedings are often protracted and expensive, so that effective investor protection remains weak. For example, according to the latest Doing Business Resolving Insolvency indicator, secured creditors in the region can only hope to recover 27 cents on the dollar when firms go into insolvency. By contrast, in the United States, they can recover up to 82 cents. Reforms of insolvency regimes could focus on the following (Uttamchandani, 2011; Tahari and others, 2007):

- Most importantly, insolvency procedures need to be supported through more efficient court functioning (see also note on strengthening transparency and governance);
- Pre-bankruptcy rights of secured creditors have to be clear, transparent, and well protected;
- Insolvency laws could usefully open tracks for restructuring rather than liquidation. Assets of a non-viable company in financial distress need to be redeployed as soon as possible to maintain a maximum of economic productivity. Only a few countries (for example, Morocco) currently have insolvency regimes that allow for corporate restructuring; and
- For reorganization to be successful, a body of professionals—restructuring experts, trustees/insolvency administrators experienced with creditor negotiation and debt restructuring, and judges—has to be trained. Currently, the region lacks the necessary expertise, which reinforces the tendency to go to liquidation rather than reorganization.

B. ...and should strengthen the environment for firms to grow

Better access to finance. The MENA region has the lowest percentage of firms with credit lines or loans from financial institutions (Figure 6), and even though banks consider the SME market a promising business segment, only 8 percent of bank lending goes to this group of firms. Weak credit information and creditor rights and an insufficient collateral infrastructure are the main reasons for banks' reluctance to lend to SMEs in the region (Alvarez de la Campa, 2011; Rocha, 2011). Governments can support better access to bank financing, especially for SMEs, by improving credit information systems and enhancing collateral

Figure 6. Firms in ACTs have limited access to formal financing.
(Percent of firms with credit lines or loans from financial institutions)

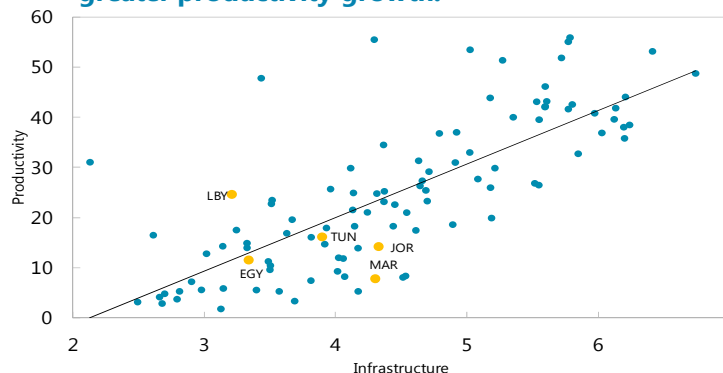


regimes. Most ACTs depend on traditional public credit registries, and even the countries that have introduced private credit bureaus are lagging behind other regions in coverage and quality of information.⁷ In addition, standard indicators show that the ACTs have weaknesses in almost all the components of collateral regimes:⁸ the region ranks last in the area of creditor rights as measured by the legal rights index of the World Bank’s Doing Business indicator.

Improved infrastructure.

Investment in new infrastructure and maintenance of existing infrastructure are essential public goods, which governments have to provide to support firm productivity (Figure 7). In many MENA countries, poor infrastructure impedes production capability: for example, firms often have to cope with inefficient transportation infrastructure to bring goods and services to markets, unreliable electricity supply, and outdated communications networks. Priority areas for public investment to enhance the effectiveness of infrastructure differ across countries:

Figure 7. Better infrastructure could support greater productivity growth.



Sources: WEF Global Competitiveness Report, 2013–14; country authorities; and IMF staff estimates.

- In Egypt, examples of infrastructure to improve firm productivity include road, railway, and port networks to bring goods to domestic and foreign markets; public transportation networks to bring workers to their workplaces; and greater electricity generation and distribution capacity to increase reliability of electricity supply.
- In Jordan, water scarcity is a major concern as many households are either not connected to the water supply network or have limited running water. Major investments are needed to improve service and reach a larger share of the population, especially in rural areas. At the same time, while electricity supply is generally reliable, significant investments in the transmission network and in generation capacity are also needed to cope with increasing electricity demand in the coming years.

⁷ Madeddu, 2010. There have already been improvements in credit information with the introduction of private credit bureaus (PCBs) in Egypt and Morocco, the enacting of a customized credit reporting law in Jordan (in preparation for creation of a PCB in 2014), and the upgrade of the public credit registry (PCR) in Tunisia. Nevertheless, more needs to be done to improve the coverage and depth of credit information, especially for SMEs: data contribution in credit reporting should be mandatory and should include all loans; positive and negative data should be available; utilities and telecommunications providers should be included; and PCBs should be given incentives to develop value-added services (such as credit scores and ratings of SMEs).

⁸ The legal and regulatory frameworks for secured transactions need to be improved, for example, by allowing a broader pool of assets to be accepted as collateral (for example, receivables and inventories) and by developing modern electronic collateral registries (Alvarez de la Campa, 2011).

- Libya faces serious infrastructure bottlenecks in almost all areas due to decades of under-investment. The most urgent need is the implementation of the East-West, North-South highway network project. Work is also required to address severe water shortages and raise power generation and refining capacity.
- In Morocco, an important priority is to continue building infrastructure in regions that are less developed than the key economic centers of Casablanca, Tangiers, and Marrakesh.
- Tunisia has adequate infrastructure to meet its current needs, but investment to expand the existing infrastructure is required to keep up with the economy's growth. A higher level of investment may also be justified to provide access to under-served areas and enhance Tunisia's trade links, in particular in the area of transport infrastructure including roads and ports.
- In Yemen, the greatest infrastructure constraint is weak electricity generation. Yemen has the lowest electrification rate of all countries in the MENA region, with about 55 percent coverage compared to a regional average of 90 percent. Additional infrastructure constraints include lack of capacity for water management (harvesting and distribution), both for drinking water and irrigation.

Greater trade integration. Trade integration not only helps to create firms and jobs in export industries; it also catalyzes productivity-enhancing inward FDI (IMF, 2014). In recent decades, merchandise exports in the ACTs as a share of GDP have been lagging the average of emerging market and developing countries. ACT trade patterns include weak intraregional trade and limited complementarity in ACT exports, which tend to limit firms' market size and growth potential by reducing the benefits from intra-regional supply chains. Despite efforts to achieve greater trade liberalization, tariff and non-tariff trade barriers typically remain high: the MENA region ranks below Sub-Saharan Africa on the World Bank's overall trade restrictiveness index; it also underperforms on measures of trade facilitation. For example, transportation is very costly because of lack of competition, as well as visa and permit restrictions for foreign truckers (Malik, 2013). Reforms in the trade regime to achieve more openness can be particularly beneficial, as experience has shown that deeper trade integration often acts as a catalyst for reforms in other areas (such as business regulation and labor markets).

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