CHAPTER 3

STRUCTURAL REFORM FOR LONG-TERM GROWTH

3.1 Introduction

Though oil prices have provided an enormous boost to MENA's growth over the last two years, the region's longer-term prospects depend on critical progress made in both consolidating macroeconomic stability for growth and transitioning to sustainably higher sources of growth and job creation. This progress depends upon the region's success in implementing broad-based economic structural reform.

Although MENA economies have improved their market orientation, in general they have not kept pace with worldwide progress. Reform has tended to be piecemeal and lacking in coherence. In general, the MENA countries have made substantial progress on reducing tariffs on trade, but tariff barriers in many MENA countries remain amongst the highest in the world.

In other areas of reform, the region has lost ground compared with the significant progress taking place worldwide. MENA's progress with reforming the business environment has been the weakest in the world. Even less progress has been made in improving governance in the region. Although the region can point to a few successes in improving the quality of public administration since 2000, in the area of public sector accountability, the region's progress has been the poorest in the world. Despite the fact that the region ranks at the bottom in terms of public accountability and has the longest reform path to travel, virtually no country improved its worldwide rank in this area, and virtually every county showed a marked deterioration relative to the progress occurring worldwide. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability.

Although each area of structural reform is important in its own right, the lack of progress in this particular area of governance reform is of concern because of what it implies for a stronger reform effort in general. The international experience with structural reform suggests that where reforms have been successful, there have been strong coalitions for change. But the ability for coalitions to press for reforms depends on access to information to formulate choices, the ability to mobilize, and the ability to contest policies that are poor, all areas of governance in which the region ranks poorly worldwide and demonstrates limited progress. Moving the broader structural reform agenda forward will depend upon substantial improvements in this fundamental area.

3.2 Long-Term Prospects for Economic Growth

In 2003, the World Bank published four flagship reports – on trade and investment, governance, gender, and employment – which explored major development issues facing the region in the 21st century.[37] While MENA faces an extensive list of development challenges, these reports identify employment creation as the single most important development challenge over the coming decade. Close to 100 million new jobs will be needed over the next 20 years to keep pace with new labor force entrants and absorb the current unemployed. This means that the number of jobs in the region needs to double during that period, and this will require real economic growth rates averaging 6 to 7 percent a year for a sustained period of time – almost double the region's rate of economic growth over the 1990s, and even a third higher than the exceptional growth rate of the past year.[38]

The four reports shed light on what it would take for the region to be able to meet this extraordinary challenge, to be able to transition to an economic model that enables it to substantially develop its employment-creating growth potential. At its foundation, this structural transition will requires three fundamental and interrelated realignments: (1) *from closed to more open economies*, to create more competitive industries, benefit from international best practice, and gain access to new technology; (2) *from public sector-dominated to private sector-led economies*, providing the basis for improved efficiency and expansion of employment; and (3) *from oil-dominated to more diversified economies*, to reduce the region's dependence on volatile sources of growth, maintain fiscal stability, and preserve important social expenditures. Achieving this realignment requires interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability, as well as enhancing the inclusion of female labor in the private sector in order to increase the flexibility of the labor force and make better use of the region's talents.[39] The impact of such an integrated realignment is potentially very large. The four development reports put a conservative estimate of the increase to output growth per worker from actions on all fronts at between 2.5 and 3.5 percent per year[40]. This is an enormous potential boost to output per worker. Over the 1990s, output growth per worker in the region averaged less than 1 percent per year.

The importance of the region's success with this transition can thus hardly be overstated. The region's development is contingent upon the actions it takes on each of these fronts. Therefore, examining the region's efforts on the structural reform front is paramount to understanding the region's longer-term economic prospects.

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[37] See World Bank 2003a, 2003b, 2003c, 2003d.
[38] Required economic growth calculated assuming an optimistic elasticity of employment growth to economic growth of 0.6 – the same employment elasticity exhibited by several the high-performing East Asian economies during the height of their employment generation.
[39] World Bank 2003c.
[40] World Bank 2003e.

Unlike monitoring economic outcomes such as growth rates, quantifying the progress in structural reform or measuring the precise contribution of a given policy action to a development objective is complex. Reforms often take time to result in measurable development outcomes. Moreover, each country has unique structural characteristics that affect development outcomes, so the same reforms may not lead to the same results. Each policy reform must thus be evaluated in conjunction with the state of other structural reforms.

Despite these difficulties, developing a set of measurable performance indicators in structural reform is essential for gauging growth prospects for the region as oil prices stabilize. Using a broad range of measures, structural reform progress indicators were constructed in three key areas of reform: trade orientation, business climate, and governance, based upon a country's change in worldwide rank with regard to a given structural feature. Utilizing these reform measures, we examined the region's progress in structural reform over the 2000-2004 period, relative to the progress taking place worldwide.

The chapter proceeds as follows: In section 3.3, the region's progress in the area of trade reform is examined, highlighting recent trade initiatives undertaken and measured progress in lowering import protection. In section 3.4, progress on the business regulatory environment is discussed. The section highlights recent efforts at liberalization and privatization, and measures progress in improving the business environment based primarily on measures from the World Bank's *Doing Business* indicators. In section 3.5, the region's progress with governance reform is discussed, both in terms of administration reform and in terms of improving public accountability. Section 3.6 concludes the chapter with a discussion of the region's overall progress with structural reform issues and priorities for the future.

3.3 Increasing Outward Orientation

One of the key elements for establishing new engines of growth and employment creation is an expansion of the region's outward orientation. A wealth of empirical literature indicates that economies with greater openness to international trade have higher rates of growth, as a result of both higher investment and sustained gains in factor efficiency.[41] Greater openness and trade are needed not only to achieve faster growth, but also to create more jobs and improve the knowledge, skills, and productivity of the work force.

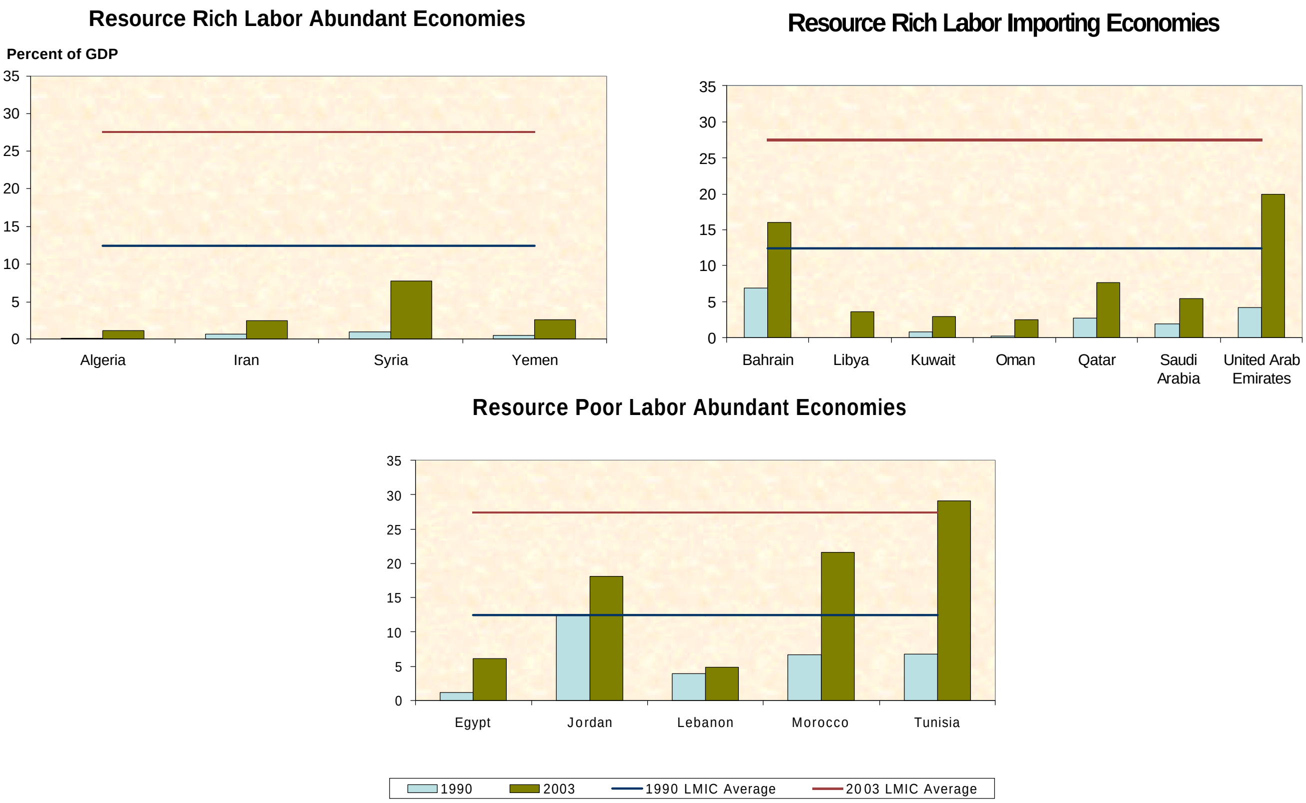
3.3.1 Status of outward orientation in MENA

A recent World Bank report[42] highlights the degree to which the MENA region has missed opportunities for greater world integration. The growth of MENA's trade to GDP ratio has been lackluster, increasing by about half of the world's pace since the 1980s. The region's exports are dominated by oil, with only the small number of resource poor and labor abundant economies having fairly well-established non-oil export sectors (Figure 3.1). Few countries in the region have experienced the dynamic growth in non-oil exports that characterizes world trends. The

[41] Loayza and Soto 2003.
[42] World Bank 2003a.

entire MENA region, with a population close to 320 million, has fewer non-oil exports than Finland or Hungary, countries with populations of 5 and 10 million respectively[43]. The per capita volume of exports of the resource poor countries in the region is small relative to that of other countries. In Egypt, exports amount to just over $100 per capita. Morocco exports are about $260 per person. This compares with exports of over $570 per capita in Turkey, $1200 in Poland and more than $3400 in Hungary. There remains tremendous opportunity for growth. But at the same time, the costs of inaction and falling further behind are likely to rise as countries such as China, Russia and Ukraine provide more intense competition in the narrow product areas in which MENA non-oil exports are concentrated.

Figure 3.1 : Non-oil exports as a proportion of GDP, 1990 and 2003



Note: LMIC= average for all low and middle income economies, based on World Bank definition.

MENA's export structure remains highly compressed among a few export categories, and is highly vulnerable to trade shocks. The oil-exporting economies are particularly at risk. With the exceptions of Bahrain and UAE, the value of merchandise exports in the top four categories[44] among oil producers accounts for more than 90 percent of total merchandise exports – more than double the averages of comparator countries in other regions (Table 3.1). Even among diversified exporters, the region is characterized by a large share of exports concentrated around a few export

[43] Muller-Jentsch 2005

[44] At the 3-digit ISIC customs level (with approximately 35 merchandise export categories in total).

categories relative to international averages. This subjects the MENA region to greater potential export and output growth volatility as a result of commodity price or world demand shocks.

Table 3.1: Export diversification and competitiveness, 2003

	Proportion of exports from top 4 export categories	Share of non-oil exports in which RCA>1	Average RCA outside of oil sector[45]
MENA	**88.2**	**41%**	**2.5**
Algeria	98.5	0	0.1
Bahrain	80.9	71	3.4
Egypt, Arab Republic	46.7	65	2.1
Iran, Islamic Republic	92.6	29	0.5
Jordan	68.3	84	5.2
Kuwait	97.5	0	0.3
Lebanon	43.7	60	3.1
Libya	99.5	0	0.3
Morocco	56.4	74	4.7
Oman	94.8	3	0.3
Qatar	97.9	0	0.5
Saudi Arabia	96.8	0	0.6
Syrian Arab Republic	84.8	66	2.7
Tunisia	56.9	72	7.1
UAE	72.4	30	0.9
WBG	80.6	..	..
Yemen, Republic	96.7	15	1.2
Europe Central Asia	**32.8**	**72**	**1.9**
Czech Rep	28.8	80	1.5
Hungary	36.8	63	1.4
Poland	26.6	71	1.5
Turkey	40.7	72	3.1
Latin America Caribbean	**43.9**	**74**	**2.8**
Argentina	64.7	68	4.6
Brazil	41.2	70	3.4
Chile	66.8	88	8.0
Mexico	38.2	75	1.4
East Asia Pacific	**41.6**	**73**	**2.1**
China	39.2	78	2.1
Indonesia	35.4	61	1.7
Korea	41.7	68	2.7
Malaysia	59.9	65	1.7
Thailand	35.3	74	1.6

RCA = revealed comparative advantage.
Source: Staff estimates from COMTRADE TRAINS database.

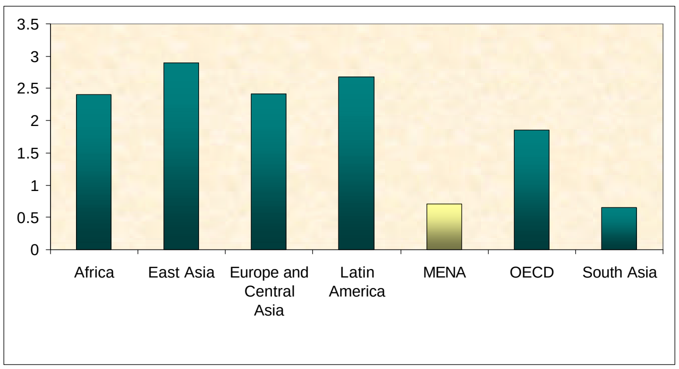
MENA exporters have not demonstrated comparative advantage outside of oil, as measured by the *revealed comparative advantage* (RCA) statistic (Table 3.1).[46] Only a handful of diversified

[45] Weighted by exports.
[46] Calculated at the product group level, the RCA measures a given country's exports of product *x* as a share of its total exports, relative to the world exports of product *x* as a share of total world exports. Where the RCA exceeds 1, the country in question can be said to have a comparative advantage in producing that product group, in that it can produce that good less expensively (relative to the other goods it produces) than the rest of the world, on average.

exporters, such as Jordan, Morocco and Tunisia, have developed non-oil export niches (with a high proportion of total exports in sectors with revealed comparative advantage, on par with the successful exporters in other regions). Oil exporters, by and large, have not found these alternative export niches, with non-oil exports scattered among product groups in which the economies do not demonstrate strong comparative advantage. A few exceptions exist, notably Bahrain and, to some extent, the UAE.

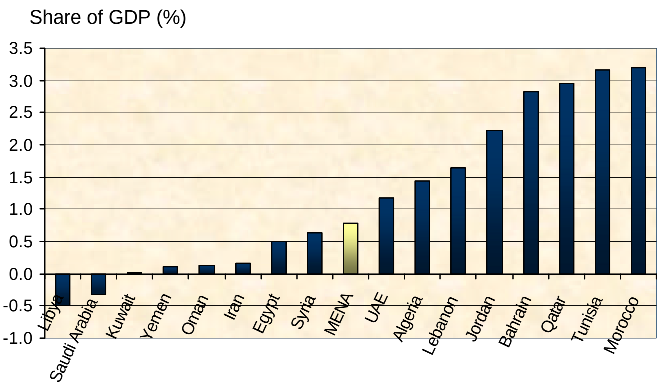
The region's low level of integration is also reflected in the ratio of net FDI inflows to GDP (Figures 3.2a and b), which averages only a third of the average level achieved worldwide, this despite moderate increases over the last few years (noted in chapter 1). This weak exposure to foreign investment denies the region of potential efficiency gains from advanced management skills and technology.

Figure 3.2a: FDI inflows as a share of GDP 2003*



•Or closest year available.
Source: World Development Indicators.

Figure 3.2b: FDI as a share of GDP, 2002-2003



Source: UNCTAD and WDI

The World Bank's recent trade report [47] provides a comprehensive assessment of the obstacles to MENA's greater integration into the world economy. Among them, protection remains high relative to countries elsewhere in the world. In addition, non-tariff barrier (NTB) coverage is still widespread. While the Gulf economies and Lebanon are relatively open, the majority of countries maintain protective import structures, primarily through tariffs. In addition, behind-the-border constraints to trade are considerable. Transport, logistics, and communication costs are high, raising the cost of trade. Exchange rate management has also played a role in discouraging non-oil exports, with currency overvaluation hurting competitiveness. Finally, the overall business climate has played a role in hindering investment in potential export-oriented industries (discussed in section 3.4).

[47] World Bank 2003a.

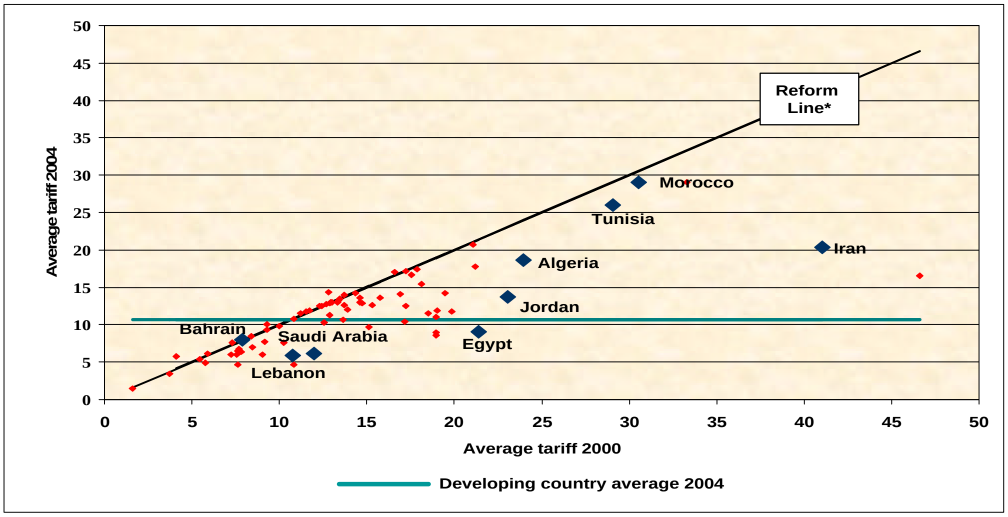
3.3.2 Developments in trade reform

In the last several years, bilateral and regional trade accords have proliferated in MENA, utilized as the primary vehicle for pursing expanded trade. Starting in the mid 1990s, the region sought to strengthen trade ties with Europe through Euromed and eventually EU Association Agreements on preferential trade (currently in force in Jordan, Egypt, Algeria, Lebanon, West Bank and Gaza, Tunisia, and Morocco, with an agreement signed by Syria in 2004). The region has also aimed to heighten regional trade through various agreements, including the Pan-Arab Free Trade Agreement (PAFTA), the Agadir Agreement (signed by Morocco, Jordan, Tunisia, and Egypt in 2004), and the GCC's customs union implementation in 2003 pursuant to a long-standing unified economic agreement. In addition, several countries have signed bilateral free trade agreements with the United States, including Jordan in 2000, Morocco in 2003, and Bahrain in 2004 (the first among the GCC). Other GCC countries are due to start talks with the United States this year, including Oman and the UAE.

Motivated in part in the context of these agreements, several MENA countries have made notable progress in trade and tariff reform. Since 2000, there has also been progress in several countries with dismantling of non-tariff barriers to trade (including Egypt, the Islamic Republic of Iran, Morocco, and Tunisia). Observable declines in simple and weighted average tariffs have occurred in Algeria, Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, Tunisia, and Saudi Arabia. The most significant tariff reforms occurred in Egypt and Iran. Following the swearing in of a new cabinet in July 2004, Egypt reduced the number of tariff bands, annulled import fees and surcharges incompatible with the GATT, and instituted strong tariff rate cuts on most imports, resulting in a decline in average tariffs from 21 percent to 9.1 percent between 2000 and 2004. In Iran, strong tariff reform efforts resulted in simple average tariffs declining from over 40 percent to about 20 percent between 2000 and 2004. Overall, simple tariffs in the region declined from an average of 22 percent to slightly more than 15 percent, a 30 percent decline in the tariff rate and well above the 19 percent decline observed in the developing world. However, once the key reformers, Egypt and Iran, are excluded then average MENA tariffs fell by little more than the world average reduction, given the maintenance of a relatively high absolute level of tariffs in a number of MENA countries.

The differential progress across countries in tariff reform is evident in Figure 3.3, which compares the average tariffs worldwide in 2004 with those in 2000. By design, the diagonal line separates reformers, those that had lower tariffs in 2004 and lie below the line, from the non-reformers, those that had the same or higher tariffs in 2004 and lie on or above the line. From this figure, it is clear that most, but not all, MENA countries have reduced tariffs since 2000. Nevertheless, a number of MENA countries continue to have extremely high average tariffs relative to other developing countries. The horizontal line, at just under 11 percent in 2004, shows the current average tariff for developing countries as a group. Five of the nine MENA countries for which tariff data is available for both periods continue to maintain average duties above this level.

Figure 3.3
Unweighted average tariffs in MENA versus the world
2000 and 2004



Source: TRAINS database. Note: * Countries below and to the right of the line can be considered "reformers" in that they lowered the average unweighted tariff.

Table 3.2
Overall trade restrictiveness index (OTRI) for MENA and other developing countries, 2001

Country	OTRI-tariff	OTRI-w/NTB
Algeria	16.3	46.5
Bahrain	8.2	8.8
Egypt	44.0	67.8
Jordan	12.7	24.4
Lebanon	5.5	14.2
Morocco	25.4	50.9
Oman	10.1	15.6
Saudi Arabia	6.7	10.8
Tunisia	24.9	36.7
Chile	6.8	11.5
Czech Rep.	4.0	5.0
Estonia	1.1	2.3
Hungary	6.1	11.3
India	30.0	39.9
Kenya	13.7	14.4
Poland	10.8	15.2
Romania	11.9	15.8
South Africa	7.2	8.9
Australia	4.7	11.6
Average for all OTRI countries	***10.7***	***18.1***

In addition to tariffs, non-tariff barriers are an important feature of trade policy in MENA. Table 3.2 presents a measure of trade policy that provides for a more consistent comparison of tariffs across countries and incorporates the impact of core NTBs (such as quotas, import prohibitions, variable levies and anti-dumping duties). This overall trade restrictiveness index (OTRI) suggests that, in a number of MENA countries, trade policy is highly restrictive and that NTBs are an important element in constraining imports. High tariff countries tend to apply restrictive NTBs. One should note, however, that the value of the index for Egypt does not reflect recent tariff reforms. With the exception of the Gulf countries, the restrictiveness of trade policy in MENA countries is typically twice as high when NTBs are taken into account than when only tariffs are considered. Countries that are reducing tariffs need to focus on reducing the impact of NTBs. Often these barriers are highly pernicious. They are not transparent or predictable, and therefore strongly suppress trade and investment. Finally, this index reinforces that certain MENA countries, Morocco, Algeria and Tunisia in particular, have trade policies that are among the most restrictive in the world today.

Box 3.1: Measuring structural reform

Structural reforms entail measures that, broadly speaking, change the institutional framework and constraints governing market behavior and outcomes.[1] Measuring reform is a complex process. A wealth of literature on measuring structural reform provides a broad range of policy and outcome-based measures, several of which we have utilized in our analysis of reform in MENA.

Even with a set of structural reform indicators assembled, there is still the issue of how to measure reform progress. A variety of approaches to measuring change exist, each with their own merits and limitations. Our measure of structural reform progress was based on the concept of ranking. To the extent that we believe there are measurable structural features of the economy important for growth, countries can be *ranked*. Be it the average level of tariffs that prevail on imports, or the minimum capital requirements for setting up a business, there are inherently "better" values and "worse" values, and as such, there is an order in which we can place countries to describe where they stand with regard to these important structural features. This ranking is convenient, as it provides a straightforward and natural signpost for evaluating reform progress. If we are interested in the progress a country is making relative to other countries with regard to a certain structural reform feature, an obvious milestone would be to determine if the country has changed its rank.

With that thinking in mind, for each indicator, structural reform progress was estimated as the change in each country's rank between periods, expressed as a point in the relative cumulative frequency distribution (100 being the highest value, representing the greatest change in rank over the period). Composite indices of structural reform were also constructed, to measure the progress in the broader areas of governance reform (both in public administration and in public accountability), and business regulation (in five areas of regulation, financial development, and legal frameworks). Each composite index was constructed by taking the average of the relative cumulative frequencies for underlying indicators, expressed itself as a relative frequency for ease in interpretation. Thus, a composite index score of 100 can be interpreted as having made the strongest progress in terms of change of rank across a broader set of structural reform measures.

An alternative proxy for structural reform progress could be evaluated as the value change in the indicator itself (either in absolute terms, or relative to its starting value), but we have chosen the rank-change methodology for a number of reasons. To begin, for each indicator, the methodology chosen will minimize the influence of extreme values. For example, it minimizes the penalty that is applied to "good" countries in which the possibilities to improve an indicator's value is limited. Countries in which there is no minimum capital requirement to start a business, for example, can make no further progress in this area of reform. In a world in which the majority of countries are reducing minimum capital requirements, these top-ranked countries would be judged to be moving the least in this area of reform under a simple value-change approach, and they would be ranked as the poorest performers worldwide. Under our methodology, however, these countries would be more accurately judged as having exhibited no change in rank, placing them worldwide somewhere between countries that have moved up in rank and countries that have moved down in rank.

Secondly, this methodology has the advantage of allowing aggregation across variables which have different measurement units and distributions. Certain reforms are more difficult to achieve than others, and important information is lost by simply averaging across underlying indicators the unit or percentage change in values. Under the methodology adopted, since reform (measured through any indicator) is evaluated relative to a worldwide distribution, this important information is preserved, and it is thus possible to aggregate across different variables.

[1] IMF 2004b.

3.3.3 Quantifying the progress with trade reform

Judging trade reform is complex, and inherently there will be limitations with any methodology chosen. Many trade policy actions – such as signing onto regional trade agreements – cannot be compared across countries in any quantifiable way. Other indicators of trade reform which can be compared across countries (such as the Overall Trade Restrictiveness Index) are only just becoming available (thus it is not possible to evaluate progress).

Despite these difficulties, it is possible to get a sense of the MENA region's relative progress with trade reform (relative to world progress) using the single trade policy indicator for which widespread and reliable information is available: unweighted average tariffs. There are clearly limitations from attributing too much to a single indicator, but it sheds light on at least one important element of trade policy relative to the world. Using the methodology described in Box 3.1, Table 3.3 presents where MENA countries currently stand in a worldwide ordering of countries based on their simple average tariffs, along with their tariff reform progress over the last four years.[48] Both are expressed as cumulative frequency distributions, with higher values indicative of better current tariff policy (lower tariffs) or stronger tariff reform progress.

Table 3.3: Structural reform progress: trade reform

Country	***Current trade policy****	***Reform Progress*****
Algeria	5	66
Bahrain	65	34
Egypt, Arab Republic	60	100
Iran, Islamic Republic	4	76
Jordan	20	86
Lebanon	81	87
Morocco	1	49
Saudi Arabia	76	88
Tunisia	1	49
MENA	**35**	**71**
Sub-Saharan Africa	*29*	*21*
East Asia and the Pacific	*55*	*49*
Europe and Central Asia	*72*	*64*
Latin America and Caribbean	*49*	*56*
OECD	*93*	*67*
South Asia	*25*	*43*
LMIC (excluding MENA)	***38***	***63***
World	***50***	***50***

Notes: *Current trade policy reflects country's current placement in a worldwide ordering of countries based on their simple average tariff, expressed as a cumulative frequency distribution, with 100 reflecting the country with lowest average tariff (worldwide) and 0 reflecting the country with the highest average tariff (worldwide). ** Reform progress reflects the improvement in a country's rank between 2000 and 2004 in a worldwide ordering of countries based on the simple average tariff, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

[48] Reflecting their improvement in country's rank between 2000 and 2004 in a worldwide ordering of countries based on the simple average tariff.

Based on this reform index, two-thirds of MENA countries were ranked above the 50th percentile[49] in terms of progress with tariff reform, relative to the world, and more than half ranked above the 75th percentile. Progress has been especially strong in a few countries, including Egypt (ranked in the 100th percentile, having improved its worldwide ranking by the greatest number of places, a result of the significant tariff reform undertaken in late 2004), Jordan (86th percentile), Lebanon (87th percentile) and Saudi Arabia (88th percentile). On average, MENA economies rank in the 71st percentile with regard to tariff reform, higher than the average progress exhibited in every other region of the world.

At the same time, it must be noted that in a worldwide ordering of countries based on their prevailing simple average tariff, MENA remains among the most trade-restrictive regions of the world (reflected in the current trade policy in the region ranking, on average, in the bottom 35 percent of countries worldwide, only higher than Sub-Saharan Africa and South Asia). Countries like Algeria, which made modest reductions in tariff rates over the last four years, still rank in the bottom 5 percent of countries in terms of tariff protection. Even Jordan, which made strong progress in tariff reform over the last four years, remains in the bottom 20 percent of countries worldwide in terms of its tariff protection. Thus, despite relatively strong progress, much work remains to be done.

Box 3.2: Regional leaders in tariff reform

Between 2000 and 2004, Egypt and Saudi Arabia made the strongest progress region-wide in terms of tariff reform. At the beginning of this decade, Egypt's tariff policy was among the most restrictive in the world, and the country ranked in the bottom 10 percent of all countries in terms of its simple average tariff on imports. Undertaking broad-based trade reform in the summer and fall of 2004, Egypt has reduced its simple average tariff from 21percent to about 9 percent. Where in 2000, Egypt ranked 80th of 87 countries in terms of the average tariff rate, by 2004, it ranked 35th. This progress puts Egypt at the top of the list in terms of improving its worldwide rank in relation to average tariffs.

Saudi Arabia, on the other hand, entered the decade with more moderate tariff protection. Average tariffs have been reduced from about 12 percent in 2000 to about 6 percent in 2004. In 2000, Saudi Arabia ranked in the middle of countries worldwide in terms of the average tariff rate (39th out of 87 countries), but the reduction in the average tariff to 6 percent places the country 21st in a worldwide ranking of average tariffs. This improvement of 18 places puts Saudi Arabia in the 88th percentile worldwide in terms of tariff reform progress over the period.

Even with the region's relatively strong progress, a fundamental question remains how the region's trade policy will impact its actual trade outcomes. The region's reliance on regional trade accords does not, for example, guarantee that trade will be expanded. What matters is the design and implementation of these agreements. The most important ingredient for success is low trade barriers with all trade partners. In addition, agreements that minimize excluded products expand the scope for positive impacts. As we have seen above, many countries in the region

[49] While the distribution functions differ from indicator to indicator, in general, ranking above the 50th percentile in a reform indicator suggests that the country's ranking has improved in a worldwide ordering of countries based on the indicator in question.

maintain high external trade barriers. This calls into question the likelihood that a number of the regional agreements will be beneficial. The maintenance of high external tariff barriers leads to a highly distorted set of incentives which constrains the trade expanding impact of these agreements.

Given proximity, the EU markets hold the greatest potential as a driver for export growth for MENA countries. However, agreements with the EU have not yet had a significant positive impact on the MENA partners (and as noted in Chapter 1, the share of MENA exports to Europe has sharply declined since 1998). In part, this reflects the design of these agreements. These economic relationships are limited by lack of coverage (agriculture and services are effectively excluded), by lack of depth (such that technical barriers to trade remain due to differences in regulatory requirements and the need to duplicate testing), and by rules (with restrictive rules of origin limiting the degree of effective market access).

Lack of liberalization of services is a crucial issue and could be a powerful mechanism for stimulating trade and growth in the region. Services account for a substantial proportion of GDP in MENA countries, so improvements in efficiency, through trade and competition, could have profound effects. Equally important, a range of services are used as inputs for the production of other goods and services and are often crucial in supporting trade. Lower priced and better quality services can have broad, economy-wide effects by raising productivity across a wide range of activities. In the context of trade and growth, key services are the so-called backbone services of transport, telecommunications, and financial services. Transport and telecommunications are critical in linking the poor to markets, both domestic and international, and financial services are key to helping the poor adjust away from existing activities to new activities to exploit the opportunities made available by trade.

There is one key difference that distinguishes services from goods liberalization, in terms of their impact on growth. Services liberalization often implies a larger scale of activity in the domestic economy. This provides greater scope for the growth enhancing characteristics that are present in many service sectors, such as learning by doing and knowledge generation, raising product variety, and product quality[50]. This larger scale of activity arises because, for many services, the simultaneity of production and consumption entails that a local presence is necessary to supply the market. This requires factors of production to move to the consuming country. Further, many barriers in service sectors constrain entry to the market, not just to foreign entrants but also to new domestic providers. Hence, the liberalization of services sectors can result in more competition from both foreign and new domestic firms, which implies a larger scale of activity. It is worth noting that since services are often labor intensive, this greater scale of activity can play an important role in absorbing workers released as trade protection of import-competing goods is reduced and in attacking general unemployment.

Regional integration within the Arab Mediterranean is currently governed by the PAFTA (Pan Arab Free Trade Area) process, which aims to have removed import barriers and other barriers to

[50] Mattoo et al 1999.

trade by 2008. However, the agreement is confined to trade in goods. Services and investment are excluded. As such, and given the limited scope for trade in goods between Arab countries in the Mediterranean that many authors have stressed, the aggregate economic impact of the PAFTA will be slight. Indeed, economic modeling of the impact of intra-regional integration confined to trade in goods suggests that it would be small for Tunisia and could be negative for Egypt[51]. This is not to suggest that there are no potential gains from removing border barriers to intra-regional trade in goods, but these gains will be small relative to the liberalization of trade in services and the removal of regulatory barriers to trade. Attaining the full benefits from removing border barriers is dependent upon regulatory reform and liberalization of services.

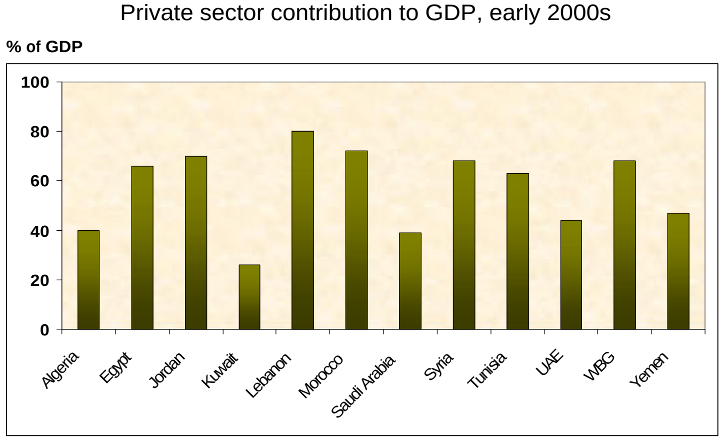
3.4 Improving the Investment Climate for Private Sector Development

While a number of countries in the region have low tariffs, recent research suggests that openness to trade tends to have little impact on growth in economies that are excessively regulated.[52] The impact of tariff liberalization will be constrained if the regulatory environment dissuades investment. Meeting the development challenges in MENA requires sustainable, productivity-driven economic development and job growth. The international experience overwhelmingly suggests that the most important engine for rapid and sustainable economic growth is a dynamic and competitive private sector, free from excessive regulation.

3.4.1 Status of private sector development in MENA

The formal private sector remains underdeveloped in MENA, still emerging from the culture of decades of state-led growth and industrialization. On average, the private sector accounts for less than 50 percent of GDP in the region. Private sector activity is concentrated in a small number of large firms that have benefited from protective policies, along with a number of micro-enterprises that account for much of employment but have little access to formal finance, markets, or government support programs.[53]

Figure 3.4
Private sector contribution to GDP, early 2000s



Sources: Assaf and Benhassine, 2003; Country sources.

[51] Hoekman and Messerlin 2002.
[52] See Bolaky and Freund 2004
[53] World Bank 2004a.

While most of the governments in MENA agree that the private sector needs to become the primary engine of job growth, the public sector remains a major source of job creation. The public sector is estimated to account for more than a third of employment in the region, compared with 27 percent worldwide, and 18 percent worldwide (excluding China).[54] Public sector employment ranges from a low of 10 percent of employment in Morocco to a high of 93 percent in Kuwait, and averages more than 70 among the GCC[55] (Table 3.4). Public sector wages and salaries as a share of total expenditure are substantially higher than in the rest of the world.

Table 3.4: Public sector employment in MENA

	Public sector as a share of total employment, 2000*	Public sector wages and salaries as a share of current expenditure, 2004
MENA	**33.3**	**37.9**
Algeria	60	31.1
Bahrain	28	63.7
Egypt	29	29.2
Iran, Islamic Republic	28	37.8
Jordan	44	27.5
Kuwait	93	40.5
Libya	66	
Morocco	10	50.8
Saudi Arabia	79	
Tunisia	22	62.9
East Asia Pacific	**33.8**	
China	36.0	
Korea	4.5	16.3
Philippines	5.2	
Latin America and Caribbean	**12.6**	
Brazil	11.5	25.1
Colombia	8.4	14.5
Ecuador	13.8	44.6
Guatemala	14.9	
Mexico	16.4	19.2
OECD	**13.5**	
Canada	17.5	8.2
Germany	12.3	
Japan	7.7	
Spain	15.2	
United Kingdom	18.9	
United States	14.6	7.8
World	***27.0***	
Excluding China	18.2	

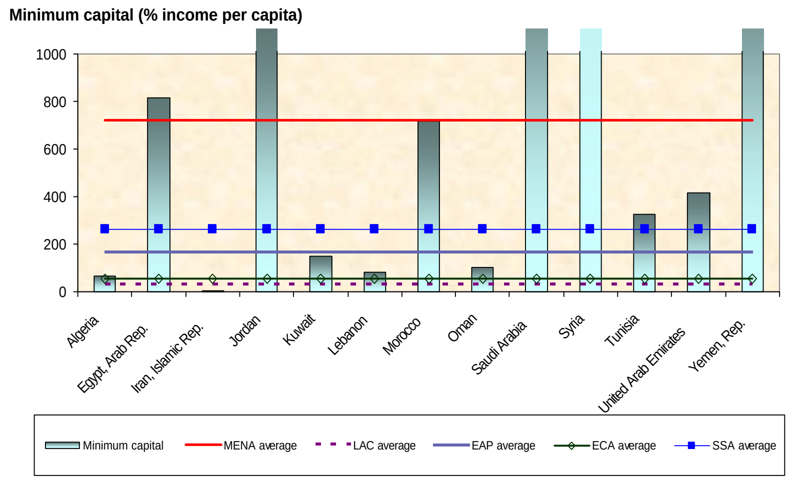
Note: *: or closest available year.
Sources: *Wages and salaries*: staff estimates from World Bank; unified survey submissions; International Monetary Fund, 2004a. *Public sector employment:* OECD PSPE; Hammouya 1999; Gardner 2003; country sources. World average for public sector employment based on countries shown.

Creating a climate in which the private sector sees opportunity and will invest and create jobs depends on several factors: (i) a stable macroeconomic environment where investment decisions

[54] Staff estimates.
[55] Public sector employment in Kuwait and the GCC is among nationals.

can be made with relatively low levels of uncertainty; (ii) basic protection of property rights and an adequate legal and regulatory framework; and (iii) a regulatory environment that does not deter investment with unnecessarily cumbersome procedures and costs. While there are large differences in the levels of national regulation, the region as a whole suffers from overly complex, time consuming, and costly business regulations and licensing requirements, impeding the entry of more private sector businesses. These costs to businesses especially deter the development of the small business sector, which cannot afford to hire intermediaries to deal with the complexity of administrative procedures.

Figure 3.5
Minimum capital required to start a business, 2004



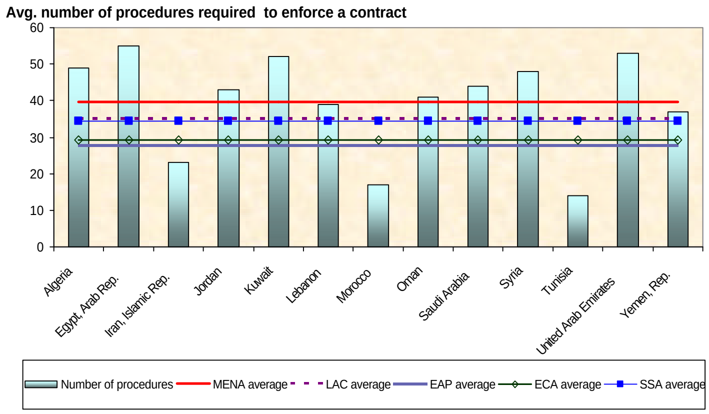
***Sources: Doing Business Indicators, World Bank**.*
Notes: MENA=Middle East and North Africa; ECA=Europe and Central Asia; SSA=Sub-Saharan Africa; LAC=Latin America and the Caribbean; EAP=East Asia and the Pacific.

Several areas of government regulation stand out as particularly burdensome for the region. The minimum capital required to start a business is exceedingly high in the MENA region, almost five times as high as the world average and well above any other region of the world (Figure 3.5). The minimum capital requirement is a measure of the amount that an entrepreneur needs to deposit in a bank account to obtain a company registration number. In Jordan, Saudi Arabia, Syria, and Yemen, this amount averages more than ten times the country's average income per capita (with Syria requiring 50 times the average income per capita). Such high minimum capital requirements all but block entry into the business sector.

These high costs are all the more burdensome considering the underdeveloped state of the banking and financial sectors. While the economies in the GCC, Jordan, and Lebanon have fairly sophisticated financial sectors, with high bank and non-bank financial sector development and generally good regulation and banking supervision, much of the region's private sector still has limited access to market finance. Banks dominate the financial system, but in general they play a limited role in financial intermediation. Much of the banking sector remains primarily in government hands and is inextricably linked to state-owned enterprises (SOEs), subject to government intervention in its lending and credit allocation policies to SOEs. This intervention has led to a crowding out of the private sector where it is permitted to operate, especially in Algeria, Libya, Syria and Yemen. Lending remains predominantly short-term and trade-related, with relatively little being directed to either long-term investments or to households.

Contract enforcement mechanisms are also particularly taxing for businesses in the MENA region. On average, MENA businesses must go through a total of 40 procedures to enforce a contract, about a third higher than the world average and higher than in any other region of the world (Figure 3.6). In Kuwait, Egypt, and the United Arab Emirates, the process is especially long, requiring more than 50 different procedures to enforce a contract. Not surprisingly, as a result, the MENA region ranks high in terms of the number of days required to enforce a contract, averaging 426 days, about 50 percent higher than in East Asia, and almost 60 percent higher than in the OECD.

Figure 3.6
Contract enforcement procedures, 2004



Sources: Doing Business Indicators, World Bank.
Notes: MENA=Middle East and North Africa; ECA=Europe and Central Asia; SSA=Sub-Saharan Africa; LAC=Latin America and the Caribbean; EAP=East Asia and the Pacific

3.4.2 Developments in structural reform for private sector development

MENA's progress with improving the business environment has been uneven. On the one hand, there have been increasing actions to liberalize sectors of the economy for competition, allowing foreign investment in certain sectors, and privatization. However, these actions have not translated to strong changes in the business environment outside of a handful of countries.

The Gulf can point to considerable strides in liberalization, which has aided the development of a few key service industries. By and large, the Gulf has converted to private power. In Saudi Arabia, the banking sector has been opened up to competition with the passage of a new capital markets law, and new FDI guidelines have opened up the number of sectors to foreign investment.[56] In Kuwait, a new law on foreign investment permits 100 percent foreign ownership of companies. Kuwait has also opened up most economic sectors to foreign investment, including banking, real estate, and insurance.[57] Several countries have adopted laws permitting foreign freehold ownership of property. Competition in mobile communications has been introduced everywhere except Qatar and the UAE.[58]

On the back of this liberalization push, several Gulf economies have been able to diversify outside of oil into several service industries. Bahrain established itself as the premier financial entrepot in the region, and its Financial Harbour, which opened in March 2004, will deepen its specialization as a capital and retail financial market hub. Dubai, in the United Arab Emirates, has become a tourist hub in the region and is also aiming for the financial hub distinction, developing

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[56] *The Banker* 2004.
[57] UNESCWA 2004.
[58] An agreement to be signed in June 2005 will open competition to mobile provision in Oman.

the Dubai International Financial Centre. The UAE now has free trade zones in each emirate and has experienced a five-fold increase in international construction contract orders since 2002, driven by a construction frenzy in the Dubai real estate market. [59]

Outside of the Gulf, two countries that have been especially successful in implementing business regulation reform are Morocco and Tunisia. As part of continuing industrial modernization efforts under the *Mise a niveau* program, new measures to create a more favorable investment climate and encourage private sector growth have yielded some strong results in both countries. By cutting the number of procedures for starting a business from 11 to 5, Morocco moved from the bottom half of economies worldwide to the top 10 percent between 2003 and 2004. Its privatization progress has been strong, with more than 40 companies wholly or partially privatized in the oil refining, road transport, telecommunications, and banking sectors. The largest of these is the privatization of Maroc Telecom. Morocco has made efficient use of public-private contracts in several sectors,[60] and it is continuing to liberalize, most recently in the audiovisual communications sector and air transport sectors. Liberalization in the former sector may reinforce the process of democratization, while the latter may stimulate tourism activities and help secure the target of attracting 10 million tourists by 2010. Other achievements include strengthening of property rights and the passage of a new Labor Code by the Moroccan Parliament in 2003, after years of discussion. Serious improvements in the business environment were also made in Tunisia, and recent developments include important reform in the legal framework for asset recovery and bankruptcy.

Elsewhere, however, progress in improving the business environment has been more uneven. Although Jordan has maintained steady progress with its privatization program (completing some 60 privatization transactions by mid-2004 and netting proceeds of $1,214 million),[61] its overall progress in various areas of business regulatory reform has been mixed. It has managed to significantly reduce the time and procedures associated with starting a business, and it has reduced the regulation for firing workers, in both areas ranking above the 50^{th} percentile in terms of improving its worldwide standing. But it has failed to move forward in other areas of the business environment, including improving access to credit and contract enforcement, relative to worldwide progress.

Egypt's structural reform program stalled between 2000 and 2003, and it has made little progress in improving the business environment to date. Recently, the reform momentum has regained strength, beginning in 2003 with the decision to float the pound. The announcement of deeper and more comprehensive reforms in 2004, including the long-waited reforms in the banking sector, is a welcome development.[62]

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[59] MEED 2004b.
[60] The program contracts have allowed enterprises to restructure their activities and improve governance, with the Government committed to making the procurement process more transparent, and to supply the required infrastructure.
[61] MEED 2004a.
[62] MEED 2004e

Progress among the resource rich labor abundant economies has also been mixed, with the continuing climb in oil prices seemingly diminishing the perceived urgency for reform over the last two years. The Islamic Republic of Iran, for example, had shown strong initial progress with its reform program. Both trade and financial sector reforms advanced, including the licensing of private banks, and the liberalization of FDI regulations through an improved Foreign Investment Law. However, progress has now slowed significantly, and the economy has yet to address other reforms aimed at improving the business environment, reducing labor market rigidities, and restructuring and privatizing public enterprises.[63] Only in recent months has there been the hint at renewed actions, with the door for private sector participation in key industries opened by an unprecedented ruling on liberalization provisions in Iran's constitution. This should allow for private ownership and operation in most major industries, including banking, insurance, power generation, water works, telecommunications, postal service, railways, airlines, and shipping. Excluded from the list, and still to be kept as state monopolies, are ownership and upstream management of the oil and gas sector and radio and television stations. This ruling would bring an end to the constitutionally-sanctioned monopoly in several key industries and economic activities.[64]

Deregulation legislation in Algeria opened nearly all economic sectors to private and foreign investment and competition, including banking, telecommunications, pharmaceuticals, transportation, and heavy industry, but excluding hydrocarbons. However, the structural reform agenda was subsequently paralyzed. Only 19 companies were privatized in 2003, out of 1,200 SOEs. In Libya, the enthusiasm for fundamental economic reform has also faded, with little being done after unification of the exchange rate in 2003.[65] Most recently, the Government has unveiled a promising program of economic reforms, including the abolition of state subsidies on electricity, fuel, and food, as well as fiscal and legislative reforms.[66] However, the optimism about these reforms being enacted is guarded. And in Syria, while economic reforms have been enacted in some areas, such as banking, this has been done in a piecemeal and limited way, and the economy still operates under considerable distortions.

Looking at individual obstacles to private sector development, the region can point to only limited success in a few areas of reform, and more often the region has lost ground relative to progress made in other regions. In the area of business start-up, for example, regulations and costs associated with business start-up have, in general, been reduced in MENA, but the region has made less progress in reducing high minimum capital requirements (Figure 3.7), and two-thirds of MENA countries continue to have minimum capital requirements higher than the average for developing countries.

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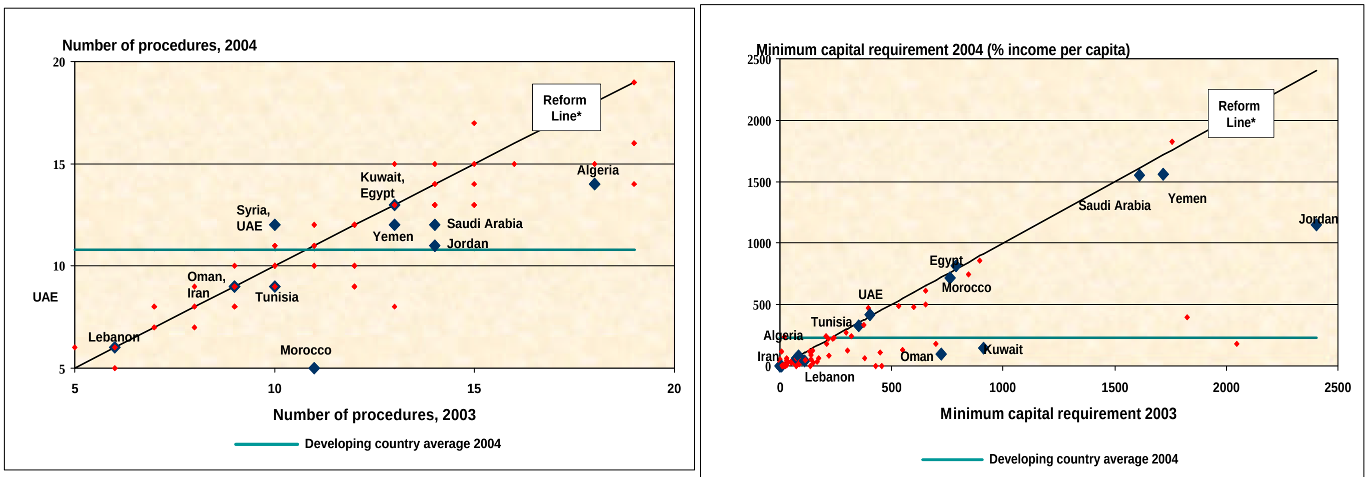
[63] IMF 2003.
[64] MEED 2004d.
[65] Middle East International 2004b.
[66] MEED 2004c.

Figure 3.7: Procedures and minimum capital to start a business in MENA versus the world
2003 and 2004

Number of procedures to start a business: MENA versus the World
2003 and 2004

Minimum capital requirements in MENA versus the World
2003 and 2004

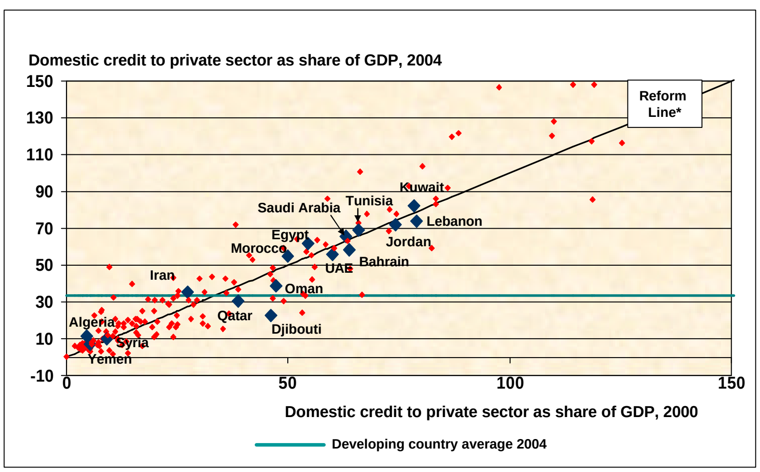


Source: TRAINS database. Note: * Countries below and to the right of the line can be considered "reformers" in that they have reduced the number of procedures.

Source: TRAINS database. Notes: * Countries below and to the right of the line can be considered "reformers", in that they have reduced the given barrier. Syria (with minimum capital requirement above 5000% of income per capita not shown

Access to finance by the private sector remains a problem for many countries in the region. Over the 1998-2003 period, the rest of the world saw a rise in private sector credit amounting to almost 1.0 percent of GDP (from about 41 percent of GDP to 42 percent). In MENA, however, half of the countries experienced an actual decline in credit to the private sector. Libya, which ranks in the lower third of all countries in terms of private sector finance, saw a reduction in credit to the private sector as a share of GDP from 25 percent of GDP to 18 percent. Djibouti saw the greatest deterioration, with credit to the private sector shrinking from 46 percent to 22 percent. Syria, which ranks in the bottom quintile in terms of private sector finance, realized less than average improvement in credit ratios (from 9.2 percent to 10 percent). Some healthier progress was made in a few countries, including Algeria and Yemen (Algeria increased credit to the private sector from 4.6 percent to 11.9 percent, and Yemen from 5.4 percent to 6.9 percent), but both countries remain in the bottom quartile worldwide in terms of private sector finance.

Figure 3.8
Private sector access to credit: MENA versus the World
1999 and 2003



Note: Countries above and to the left of the reform line can be considered "reformers", in that they have increased the amount credit accessed by the private sector, as a proportion of GDP.

3.4.3 Quantifying the progress with business regulatory reform

The region's progress with structural reform in the area of improving the environment for private sector development was measured across five areas, corresponding to subjects covered in the World Bank's *Doing Business* database (supplemented with financial sector information from the World Bank's *World Development Indicators*). These key business regulatory and financial areas include: (i) starting a business, (ii) hiring and firing workers, (iii) private sector access to credit, (iv) enforcing contracts, and (v) closing a business. A composite index was constructed, averaging the progress across the five areas of business regulatory reform.

Based on this composite index, the MENA region's recent progress with reform lags the world in terms of improving the environment for business, especially given the low initial conditions of business development (Table 3.5). Currently, on average MENA economies place in the middle in a worldwide ordering of countries (averaging in the 48^{th} percentile) based upon the range of indicators of regulatory costs of business. This is slightly higher than other lower middle income economies, which on average rank in the 44^{th} percentile. However, based on ***progress*** over the last years, MENA has lost significant ground compared to world progress in reducing impediments to business development. On average, countries in the MENA region place in the 34^{th} percentile worldwide in improving the business environment relative to other countries, compared with an average of 47^{th} percentile among other lower middle income economies (and far below the average progress demonstrated in Europe and Central Asia and South Asia). In terms of improving their world standing across a range of indicators of obstacles to private sector development, the MENA region has made the least progress of any other region of the world.

A few countries can point to some success in improving their standing relative to other countries, including Tunisia and Morocco. Both have relatively fewer obstacles to business (Tunisia more so than Morocco), and both continued to make progress in improving the climate for private investment, especially through a reduction in the administrative hurdles for starting a business. On the other hand, several economies in MENA with the most cumbersome and costly regulatory procedures (including Lebanon, Egypt, Syria, the United Arab Emirates, and Yemen) have fallen short of world reform progress, and they have fallen in their world standing.

Table 3.5: Structural reform progress: business regulatory and financial sector reform

Country	*Current business environment**	*Reform Progress***
Algeria	26	54
Egypt	29	11
Iran, Islamic Republic	63	37
Jordan	57	43
Kuwait	77	16
Lebanon	33	9
Morocco	62	62
Oman	60	58
Saudi Arabia	52	47
Syrian Arab Republic	17	2
Tunisia	79	74
United Arab Emirates	32	4
Yemen, Republic	42	24
MENA	**48**	**34**
Sub-Saharan Africa	*27*	*36*
East Asia and the Pacific	*47*	*40*
Europe and Central Asia	*52*	*61*
Latin America and Caribbean	*39*	*45*
OECD	*89*	*73*
South Asia	*49*	*48*
LMIC (excluding MENA)	***44***	***47***
World	***50***	***50***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

The general deterioration in MENA's standing with regard to business regulatory reform is the result of declines in world ranking across every area of business regulatory reform. In the area of contract enforcement procedures, for example, MENA countries on average rank below other lower middle income economies. Furthermore, in 2004, they saw a deterioration in their world standing, and MENA countries average in the 27th percentile in terms of the change (improvement) to their world standing. No country – with the exception of Morocco and Oman – has kept pace with world improvements in contract enforcement procedures and costs. Though MENA's standing with regard to private sector access to credit and hiring and firing procedures is, on average, higher than the average for other lower middle income economies, in terms of *progress* over the last years the region fell slightly short of keeping pace with world improvements. Still less progress occurred in the area of procedures and costs for closing a business (Table 3.6)

Table 3.6: Business regulatory and financial sector reform:
progress along individual areas of the business environment

	Starting a Business		*Hiring and Firing*		*Enforcing Contracts*		*Access to Credit*		*Closing a Business*	
Country	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**
Algeria	32	58	29	13	13	29	22	94	70	63
Djibouti							42	4		
Egypt	11	9	51	44	20	14	77	73	18	21
Iran, Islamic Republic	68	12	61	52	64	46	60	87	38	28
Jordan	24	85	59	66	60	5	81	32	39	49
Kuwait	46	40	100	91	37	1	83	30	57	22
Lebanon	41	15	42	30	10	46	85	44	23	23
Libya							33	9		
Morocco	70	95	2	4	80	64	71	60	62	46
Oman	67	71	68	81	44	54	61	27	38	34
Saudi Arabia	8	88	100	68	35	1	74	27	41	62
Syrian Arab Republic	15	1	66	23	3	10	19	44	42	49
Tunisia	65	91	4	29	97	40	80	47	84	94
United Arab Emirates	17	1	92	84	14	20	72	30	5	5
Yemen	3	62	84	46	63	21	12	65	67	3
MENA	**36**	**48**	**58**	**49**	**42**	**27**	**60**	**47**	**45**	**38**
Sub Saharan Africa	30	37	35	35	35	42	27	51	38	48
East Asia Pacific	49	56	54	48	44	42	56	44	27	37
Europe Central Asia	54	58	50	55	57	57	41	64	51	50
Latin America	42	49	47	72	37	42	46	34	44	45
OECD	82	57	71	53	83	72	89	54	80	68
South Asia	70	44	43	31	35	48	51	59	49	65
LMIC (excluding MENA)	***44***	***50***	***48***	***57***	***46***	***49***	***44***	***44***	***47***	***45***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

MENA's employment challenge over the next two decades requires tremendous job creation, which itself relies on the development of a vibrant and dynamic private sector. Lack of progress in improving the climate for private investment is thus discouraging for the region's longer term employment prospects. It is worth noting that in two-thirds of the MENA countries with labor force growth rates exceeding 3 percent a year (not including the GCC)[67], the overall business environment is ranked below average, relative to the world (Algeria, Syria, Yemen, and Egypt).

A few countries may offer some guidance to others in the region. Regarding procedures to start a business and contract enforcement, Morocco and Tunisia appear to have substantially more favorable conditions than the average for developing countries as a whole. This suggests that there is much that other countries in the region could learn from these two countries when reforming their own business rules and regulations. Likewise, in the area of employment regulations it is the Gulf countries that have a climate that compares favorably with other developing countries. Identifying good or best practices within the region and relative to developing countries as a group could be a useful way to guide other MENA countries with methods for improving businsess conditions.

[67] Labor force growth rates over the next decade for the following countries are estimated at above 3 percent a year: Syria (4.1), Republic of Yemen (4.1), The Islamic Republic of Iran (3.8), Algeria (3.7), Jordan (3.6), Egypt (3.0). From World Bank staff estimates.

Box 3.3: Regional leaders in reform of the business environment

Between 2003-2004, Tunisia and Morocco made the strongest overall progress region-wide in terms of reform of the business environment, measured through the rise in country rank (relative to the world) across five separate areas of business regulation, financial sector development, and legal frameworks.

Tunisia's strongest progress came in two areas: improvement in procedures/costs of starting a business and improvement in procedures to close a business. Tunisia reduced the number of procedures for starting a business from 10 to 9, moving it up in worldwide rank from 53 to 42 (out of 133 countries), placing Tunisia in the 88th percentile in terms of rise in rank (with minimal improvement throughout most of the world). The days needed to start a business were reduced from 46 to 14, moving it up in worldwide rank from 67 to 14 (placing Tunisia n the 98th percentile in terms of rise in rank). The cost for setting up a business reduced from 16 percent of gross national income to 11 percent, moving it up in worldwide rank from 50 to 38 (placing it in the 93rd percentile worldwide in terms of rise in rank). Tunisia made only marginal progress in lowering the minimum capital required to start a business, and its worldwide rank fell from 104 out of 133 in 2003 (with minimum capital requirements equal to 352 percent of income per capita) to 114 in 2004 (with minimum capital requirements of 327 percent of income per capita). Overall, across the range of indicators for starting a business, Tunisia ranked in the 91st percentile in terms of progress in rank improvement. Further, Tunisia ranked in the 94th percentile in terms of improvement in rank in closing a business, through both strong progress in reducing the time (96th percentile in rise in rank) and cost (86th percentile in rise in rank). Currently, Tunisia ranks 20th worldwide for ease of closing a business in terms of time (out of 133 countries) relative to a rank of 48 worldwide in 2003. Overall, Tunisia's strong progress in two major areas of business regulatory reform (in the 91st and 94th percentile in areas of starting a business and closing a business, respectively) helped the country place in the 74th percentile worldwide in overall business regulatory reform, despite lack of progress in areas of improving contract enforcement (40th percentile), access to credit (47th percentile) or hiring and firing flexibility (29th percentile worldwide).

In Morocco, strong progress was made in the area of reducing cumbersome procedures and costs for business start-up. Between 2003 and 2004, the number of procedures to start a business declined from 11 to 5, moving Morocco up 64 places (in a ranking of 92 countries worldwide) and placing it in the 99th percentile in terms of the rise in rank. The time required for procedures was reduced from an average of 36 days to 11 (a reduction that placed Morocco in the 95th percentile in terms of its rise in world ranking). The cost associated with start up procedures declined from 19.1 percent of GNI per capita to 12.3 percent (95th percentile in change in world ranking), with only modest progress in reducing the minimum capital requirements for starting a business (still averaging 720 percent of GNI per capita, down from 762 percent). Overall, Morocco placed in the 95th percentile in terms of improving its world standing with regard to starting a business. It also made some progress in terms of business financing. Credit provided to the private sector increased between 1998 and 2003 from 50 percent to 55 percent of GDP, moving Morocco from 53rd place up to 49th place in a worldwide ranking of 164 countries (and placing Morocco in the 60th percentile worldwide in terms of its rise in rank). In the area of enforcing contracts, Morocco also improved its worldwide rank. In terms of time required for contract enforcement, Morocco ranked 43rd out of 118 countries in 2003. By 2004, it had moved up in rank to 28th. Likewise, it improved its worldwide ranking in procedures to enforce a contract, from a position of 22nd to 13th. While its ranking deteriorated in terms of the cost to enforce contracts (from 47 to 60), in all, Morocco ranked in the 64th percentile in terms of improvement in worldwide rank with regard to contract enforcement procedures and costs. Overall, the relatively stronger efforts in three areas (with deterioration in standing with regard to hiring and firing and closing a business) allowed Morocco to place in the 62nd percentile worldwide in terms of improving its world standing across a range of business regulatory and financial areas.

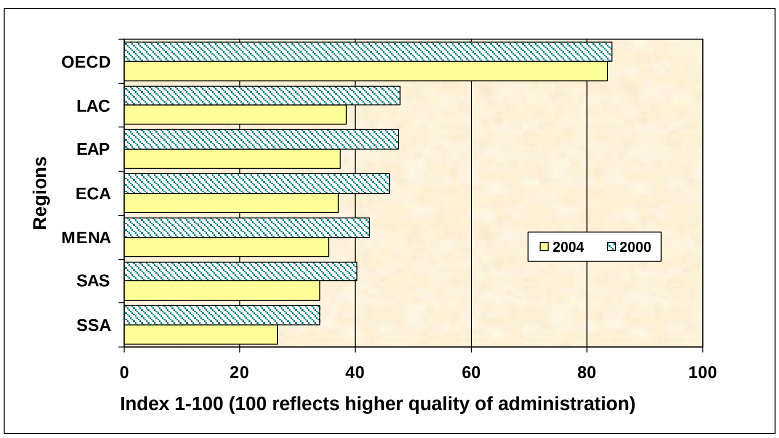
3.5 Enhancing Governance

Achieving the transition to more open, market-oriented economies requires fundamental changes in the role of government in some key areas of policymaking and considerable enhancement of its effectiveness in others. A broad governance agenda is central to reform efforts aimed at improving the business and investment climate, deepening trade integration, and increasing economic diversification.[68]

3.5.1 Status of governance challenges

The MENA region faces many of the traditional challenges to efficient public sector management, including reducing state intervention in production and employment and improving the quality of public sector administration. But the region's governance agenda goes well beyond the traditional sphere of administration.

Figure 3.9
***Index of Quality of Administration,* by region**



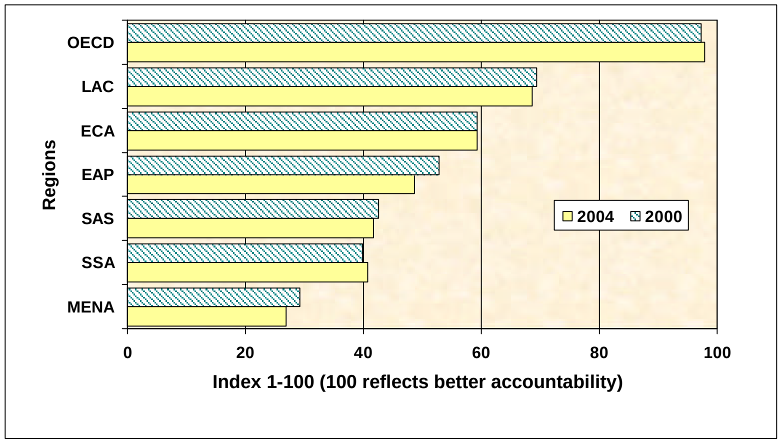
Source: See annex for methodology behind Quality of Administration Index.
Notes: MENA=Middle East and North Africa; EAP=East Asia and Pacific; ECA=Europe and Central Asia; OECD=Organization for Economic Cooperation and Development; SAS=South Asia; and SSA=Sub-Saharan Africa.

The World Bank's report on governance in the MENA region[69] highlights the major governance challenges. On the administrative side, MENA countries fall short of other countries at similar income levels (Figure 3.9). In areas such as the efficiency of the bureaucracy, the rule of law, the protection of property rights, the level of corruption, the quality of regulations, and the mechanisms of internal accountability, MENA countries have, individually and on average, lower levels of quality of administration in the public sector than would be expected for their incomes[70].

[68] World Bank 2003b.
[69] World Bank 2003b.
[70] World Bank 2003b.

But even more importantly, countries across the region exhibit a pattern of limited government accountability and inclusiveness, reflected in an index of public accountability (Figure 3.10). In the area of openness of political institutions and participation, respect of civil liberties, transparency of government, and freedom of the press, the MENA region falls far short of the rest of the world. Not a single country in MENA ranks above the world median for the quality of public accountability, whether adjusted for income or not.[71]

Figure 3.10
***Index of Public Accountability,* by region**



Source: See annex for methodology behind *Public Accountability Index*.
Notes: MENA=Middle East and North Africa; EAP=East Asia and Pacific; ECA=Europe and Central Asia; OECD=Organization for Economic Cooperation and Development; SAS=South Asia; and SSA=Sub-Saharan Africa.

3.5.2 Progress in governance reform

Several countries in the MENA region have embarked on reform of various areas of public administration. Jordan and Morocco, for example, both have ambitious civil service management reform programs, and many countries in the region have taken steps to improve public expenditure management.

MENA's progress in improving the quality of public administration was examined with the use of nine indicators, corresponding to the indicators underlying the World Bank's governance indicator of public administration quality[72]. A composite index was constructed, measuring each country's average progress in improving its worldwide ranking with regard to these public administration features[73].

Based on this indicator, a few countries could point to some progress in improving their worldwide standing with regard to public administration quality, including Algeria, Egypt, Jordan, Morocco, Oman, Qatar, Saudi Arabia, and Yemen, all of whom ranked above the 50th percentile in improving their worldwide rank of public administration quality. However, it is important to note that this improvement occurred more due to a worldwide deterioration in public

[71] World Bank 2003b.
[72] See Annex 2 for methodology behind structural reform indicators
[73] See Box 3.1 and Annex 2 for description of methodology underlying structural reform indicators.

administration quality than direct improvements from the MENA countries. Moreover, the average level of progress in MENA has been weak, with economies on average ranked in the 47th percentile with regard to public administration reform, below those of Sub-Saharan Africa (52nd), East Asia and the Pacific (54th), Europe and Central Asia (57th), and South Asia (65th), and below the average for lower middle income economies outside of MENA (Table 3.7).

Table 3.7: Structural reform progress: governance reform 2000 versus 2003/2004

	Quality of administration		*Public sector accountability*		*Overall governance*	
Country	***Current status***	***Reform progress***	***Current status***	***Reform progress***	***Current status***	***Reform progress***
Algeria	30	60	34	59	32	61
Bahrain	58	45	29	40	42	30
Djibouti	23	32	34	25	30	17
Egypt, Arab Republic	31	52	27	22	28	24
Iran, Islamic Republic	28	35	41	11	36	14
Iraq	7	..	11	..	9	..
Jordan	46	77	41	42	44	61
Kuwait	46	38	40	9	42	14
Lebanon	28	5	36	3	32	1
Libya	14	17	1	14	3	10
Morocco	44	62	37	32	40	42
Oman	52	85	26	28	37	56
Qatar	44	87	22	29	31	57
Saudi Arabia	43	58	14	31	26	35
Syrian Arab Republic	27	..	8	40	21	..
Tunisia	46	14	29	12	36	6
United Arab Emirates	49	7	26	12	36	3
West Bank Gaza	16	..	28	..	23	..
Yemen, Republic	27	85	24	47	24	79
MENA	**35**	**47**	**27**	**27**	**30**	**32**
Sub-Saharan Africa	*27*	*52*	*41*	*42*	*34*	*47*
East Asia and the Pacific	*30*	*54*	*51*	*41*	*41*	*49*
Europe and Central Asia	*38*	*57*	*60*	*52*	*51*	*54*
Latin America and Caribbean	*38*	*43*	*69*	*54*	*56*	*46*
OECD	*83*	*44*	*93*	*79*	*88*	*65*
South Asia	*32*	*65*	*37*	*39*	*35*	*55*
LMIC (excluding MENA)	***32***	***53***	***54***	***43***	***45***	***47***
World	***41***	***50***	***56***	***50***	***49***	***50***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

Far more disturbing, however, is the lack of progress in the area of public accountability. Public accountability was measured with the use of twelve indicators corresponding to the measured used in constructing the World Bank's governance indicators for the MENA region.[74] Because many of the underlying indicators reflect 2003 information, the public accountability index may fail to reflect positive progress which took place over 2004. However, based on the most recent information, the region has made virtually no progress relative to the world, ranking in the 27th percentile with regard to improving the accountability of the public sector -- lower than every other region of the world by far, this despite the fact that the region has the least accountability public sectors in the world.

Overall, the region's progress with governance is in the bottom third of the world, far below the average of other lower middle income economies and behind the pace of every region of the world. Although each area of structural reform is important in its own right, the lack of progress in the area of governance – and particularly public sector accountability -- is of specific concern because of what it implies for a stronger reform effort in general. International experience with structural reform suggests that reforms are most successful when there have been coalitions for change – organizations or individuals who share a commitment to advancing reform. The driving force may be the private sector, pressing for changes to improve competitiveness. It may be trade unions, or non-governmental organizations. But coalitions of key stakeholders to reform are vital not only to advance reforms but also to sustain them.[75]

But underlying these coalitions for change, vital to a strong structural reform effort, groups need certain central rights. They need the ability to access to information to formulate choices, they need the ability to mobilize, and they need the ability to contest policies that are poor. These rights are limited in the MENA region. Government information is not accessible by the public. Freedom of the press is carefully monitored and circumscribed in most countries. There are restrictions on civil society. There are restrictions on freedom of association. And the ability to contest government policies is weak[76]. A critical element of moving the broader structural reform agenda forward will be addressing the public accountability governance challenge.

The region's recent lack of progress with structural reform is evidence of current governance limitations. MENA has had some progress with implementing broader, top-down reforms, including tariff reform, which have been relatively easier to execute especially within the framework of international trade agreements. However, progress in improving the business environment has been weaker than all other regions, in part because it has required a much deeper level of economic reform. It is little surprise that in areas like contract enforcement – requiring the profoundly difficult task of reform of the judiciary – the MENA region has had the most difficulty in implementing reforms.

[74] World Bank 2003b.
[75] For example, see World Bank 2004c.
[76] World Bank 2003b.

3.6 Structural Reform in Summary

The MENA region's long term growth prospects require a fundamental transition from closed to open economies, from public sector-managed to private sector-led economies, and from oil-dependent and volatile to diversified and stable economies. From the analysis of reform progress over the 2000-2004 period, the region's transition record is mixed, with relatively strong progress in only one sphere of reform.

By far, the region's greatest progress has come in the area of trade reform. Motivated in part by trade initiatives and free trade agreements, the region has been able to make strong progress in tariff reduction over the last few years, and two-thirds of the MENA economies have improved their world standing with regard to unweighted import tariffs.

In other key areas of reform, however, the region has lost significant ground. Few economies have addressed the myriad regulatory obstacles to business development, and the MENA region ranks below every other region of the world in terms of improving the business environment. Of even greater concern, the MENA region has made the least progress of all regions of the world in improving governance, with MENA economies, on average, in the bottom third worldwide in terms of governance reform. Despite the fact that the region ranks at the bottom in terms of public accountability and has the longest reform path to travel, virtually no country improved its worldwide rank in this area. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability. The lack of progress in this particular area of governance reform is of concern because of what it implies for a stronger reform effort in general.

The region's inability to tackle some of the deeper and more complex reforms in the business regulatory and financial areas provides some persuasive evidence of the limitations of top-down reforms by decree. Improved governance is a critical success factor for achieving deeper and often more difficult reforms.