

Structural Reform for Long-Term Growth

Strong oil revenues and oil-related wealth, along with the ongoing European recovery, provide the momentum for continuing robust growth in the MENA region over the short term. Over the longer term, however, MENA's growth prospects will be shaped by many other factors. Among oil producers, the duration of extraordinary oil prices and the fiscal management of the windfall revenues will greatly influence the prospects for long-term income and economic growth. Many of the resource-rich, labor-importing (RRLI) economies of the Gulf, in particular, are pursuing a variety of strategies to use current oil savings to build up longer-term revenue streams outside of oil, with central banks and the rest of the banking systems accumulating significant foreign assets.

However, beyond oil wealth management, one of the region's fundamental development challenges—creating sustainable employment for its workforce—will require the region to undergo major structural changes to provide strong engines for employment growth. While employment growth has been strong in recent years, MENA has a long way to go to reach more desirable levels of employment and employment of women, as well as to improve the productivity of its jobs. Understanding the progress that has been made in implementing this structural reform agenda, then, is an important aspect of gauging the region's potential for long-term growth and employment.

Over the past six years, MENA countries have shown progress in moving forward their structural reform programs. In the context of a proliferation of regional and bilateral trade agreements, MENA economies have significantly reduced tariffs and nontariff barriers to imports, and over the past six years, the region ranks on average in the 62nd percentile worldwide with regard to tariff reform.¹ But the path to creating an environment conducive to trade remains far from complete. Outside the Gulf Cooperation Council (GCC), tariff protection remains excessive. Tariffs average 17 percent among resource-rich, labor-abundant (RRLA) economies, and tariffs are even higher among resource-poor countries, particularly in Tunisia and Morocco, where the current simple average tariff is above 26 percent and the heavy tariff protection of the domestic market has changed only slightly over the past 10 years. Moreover, significant barriers to developing a strong trading sector exist in the form of cumbersome import and export clearing processes.

Improving the competitiveness of the region's trade sector also depends upon greater progress in liberalizing backbone services critical to trade. While there has been recent progress in liberalizing a few key services, liberalization is often stop and go, and the process remains far from complete. In

¹ See Appendix B for the methodology behind the structural reform indicators.

many countries, key sectors remain closed to competition, either through ownership restrictions or other regulatory practices.

Over the last few years, MENA economies have undertaken measures to improve the environment for business, focusing on liberalization of key services in the economy, across-the-board business and regulatory policy reform, and targeted interventions to promote specific sectors. The more general upgrades to industry in the *mise à niveau* programs in Morocco and Tunisia, for example, have changed to programs targeted at upgrading specific sectors. These targeted interventions are also apparent throughout the GCC countries, which have worked to develop key service centers by creating international legal and business infrastructures separate from the rest of the country.

Despite some improvements in a few countries, progress in business and regulatory reform has been below average. Outside of the GCC countries, which have fairly developed business infrastructure and generally favorable business policies, the region continues to suffer from significant impediments to conducting business, especially in key areas such as starting a business, protecting investors, and contract enforcement. Taken as a whole, in a worldwide ordering of countries based on the overall business climate, MENA countries rank in the 44th percentile with respect to the climate for doing business—behind all other regions but Sub-Saharan Africa and South Asia.

Many of the MENA region's development challenges relate to governance challenges, although over the past years, MENA countries have taken steps to address significant deficiencies in governance. Many of these efforts have focused on reforming public administration, both to improve efficiency in the delivery of quality public services, and to create fiscal savings. MENA's historical state-run models have translated into large civil services, and civil service reform has been a key element of the public sector reform programs in a few countries in the region, such as Jordan, Morocco, and Egypt.

But beyond efforts to improve public sector efficiency, several countries have taken important steps to open up the political space and allow for greater accountability and strengthen inclusiveness in public policy, an area in which MENA continues to rank near the bottom worldwide. Over the past six years the region has taken considerable steps forward in reducing this governance gap. Between 2000 and

2006, MENA countries ranked on average in the 63rd percentile with regard to improving the mechanisms for government accountability, higher than almost all other regions of the world, with particularly strong efforts among resource-poor countries and resource-rich, labor-importing countries.

While the recent oil boom has greatly benefited the oil-producing economies of the region with improved growth and revenues, an important concern has been the potential impact this oil boom might have on the continuing structural reform effort. Though information is scant, there is some indication that the incentives for sweeping improvements in public sector management have diminished with rising oil prices. Although resource-poor countries made strong progress in administrative reform, many of the region's oil-dominant economies failed to demonstrate significant efforts to improve public sector management.

In the area of enhancing public sector accountability, there is a significant divergence between MENA's labor-abundant oil economies and labor-importing oil economies. Since 2003, many of the resource-rich, labor-importing economies of the GCC have begun to show strong efforts to improve government accountability. Along with their efforts toward more prudent management of the oil windfall and stronger economic ties with the world, GCC countries such as Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) have also taken significant steps forward in the sphere of enhancing the inclusiveness and accountability of government. It is a significant and encouraging sign that these efforts have taken place despite rising oil prices. MENA's labor-abundant oil economies, on the other hand, have generally not moved forward with improving public sector accountability since 2003. Creating more inclusive and representative governance structures is influenced by far more than rising oil prices. Still, given the importance of this area of reform for the overall reform agenda, the significant backsliding by a few countries causes us concern for the long-term prospects for growth.

3.1 Measuring Structural Reform

Beginning with the first MENA *Economic Developments and Prospects* report in 2005, evaluating the region's longer-run growth prospects has in part relied on assessing the region's progress with policy and institutional reform. Utilizing a range of avail-

able indicators, structural reform indices were constructed in three distinct areas of reform: *trade and outward orientation*, *business and regulatory reform*, and *governance*, broadly corresponding to the key areas of change required in the region to create more open, private sector–driven, and diversified economies.

These indices have evolved as new information has become available that strengthens our knowledge of both the current reform status and structural reform in each country. With these measures of structural reform, this year’s MENA Economic Developments and Prospects report highlights where the MENA region stands with regard to the rest of the world in terms of economic policies and structures, and evaluates the region’s recent progress in terms of its transition to more open and private sector–oriented economies. Because many economic reforms take time to result in measurable development outcomes, in addition to structural reform indices, we also discuss the region’s more recent efforts and emerging trends.

In this chapter, we examine the region’s progress in trade reform over the period 2000–06, highlighting the trade initiatives undertaken, evaluating progress in lowering trade barriers, and discussing the issue of service sector liberalization. Then, we discuss progress in improving the business climate, highlighting the region’s recent efforts at liberalization and measuring progress in improving the business environment from 2003 to 2006, based on a range of business-climate indicators. Next, we highlight the issue of service sector liberalization, and estimate the potential gains from liberalization of both financial services and infrastructure services. Then, we address the region’s progress with governance reform, both in improving the quality of administration and in improving government accountability. Finally, we conclude the analysis with a comparison of the region’s pace of structural reform before and after the start of the oil price boom.

3.2 Outward Orientation (Trade Reform)

The relationship between openness to international trade and income growth is almost axiomatic.² A vast amount of empirical literature supports the

² See for example: Sachs and Warner 1995, Frankel and Romer 1999, and Dollar and Kraay 2001.

view that economies with greater openness to international trade experience higher rates of economic growth, as a result of both higher investment levels and sustained gains in productivity.³

But in addition to increases in growth, greater openness also can motivate the overall reform agenda, by building virtuous circles of structural and institutional reform. Opening economies to greater trade and competition expands the role of non-rent-dependent export sectors. These more productive and efficient segments of the economy need better policies and institutions to compete, thus building the demand on policies and institutions to respond. For example, Mexico’s trade liberalization through NAFTA induced business associations to lobby the government for reductions in the regulatory burden to help them compete (Kikiri, Kenyon, and Palmade 2006). Trade doesn’t just raise the demand for other reforms; it also raises the marginal product of other reforms, in that better infrastructure, telephones, roads, and ports translate into better performance of the export sector (Berg and Krueger 2002). And greater openness and trade also expose the workforce to the need for new skills and knowledge, creating another effective coalition for reform, with this workforce demanding the skills and services needed to compete in this economic setting.

MENA countries entered the new millennium at a significant deficit with respect to most other regions of the world in terms of its integration into the world economy. The World Bank’s flagship report on trade and investment highlights many aspects of this deficit (World Bank 2003a). While most regions of the world saw rising trade over the last two decades, trade in MENA declined, with the ratio of trade to GDP falling from an average of 100 percent in 1980 to about 60 percent by 2000. Non-oil trade also failed to grow, with the share of non-oil trade/GDP falling from about 53 percent in the early 1980s to 43 percent by 2000 (World Bank 2003a). Regional exports remained dominated by oil, with oil and petroleum product exports accounting for 81 percent of regional exports in 2000, down only slightly from 84 percent in 1990, and 95 percent in 1980. Only a few countries had established growing non-oil export sectors.

³ Although there has been criticism of the evidence of the relationship between openness to trade and growth (see for example, Rodríguez and Rodrik 1999), a broader interpretation suggests only that certain conditions are necessary for these gains from trade to be realized.

Similarly, the region failed to attract more than a negligible share of the world's foreign direct investment (FDI). In 2000, while MENA accounted for 5 percent of the world's population and 2.5 percent of world income, its share of world FDI was a mere 0.3 percent.⁴

Many factors affect the level of trade in a country. Trade is influenced not only by formal trade policies like tariff and nontariff policy, exchange rate policy, and policies affecting costs behind the border, but also by many external policies and structures affecting the overall climate for conducting an exporting or importing business. Political and institutional considerations also play a large role.

⁴ World Bank staff estimates from country data.

To be sure, MENA's ability to expand trade has been disadvantaged by a legacy of protectionist trade and exchange rate policies. As a result, at the start of the new millennium, the region maintained the highest level of tariff protection in the world outside of South Asia, with simple average tariffs in MENA averaging almost 19 percent. It also heavily utilized quantitative import restrictions, with more than 23 percent of tariff lines subject to core nontariff barriers (NTBs) (table 3.1). Core NTBs include price control measures (such as antidumping and countervailing duties) and quantity control measures such as import licenses and quotas.

Technical barriers to trade, customs, and administrative procedures, and costly and inefficient backbone services, such as transport, logistics, ICT serv-

Table 3.1: Tariff and nontariff protection in the region, 2000 (or closest year available)

Country/region	Simple average tariff	Nontariff barrier coverage ^a
Algeria	24.0	17.5
Bahrain	7.9	4.4
Djibouti	31.0	—
Egypt, Arab Republic of	21.4	28.7
Iran, Islamic Republic of	41.1	39.1 ^b
Jordan	23.1	48.6
Kuwait	3.6	—
Lebanon	10.7	24.1
Libya	17.0	—
Morocco	30.5	9.1
Oman	5.7	13.1
Saudi Arabia	12.0	15.4
Syrian Arab Republic	21.0	—
Tunisia	29.1	33.1
Yemen, Republic of	12.8	—
Regional averages (unweighted)		
MENA	19.4	23.3
Resource-poor	24.3	28.7
Resource-rich, labor-abundant	24.7	28.3
Resource-rich, labor-importing	9.2	11.0
Sub-Saharan Africa	15.8	4.7
East Asia and Pacific	10.7	19.6
Europe and Central Asia	9.5	9.5
Latin America and Caribbean	13.4	30.0
South Asia	17.6	13.6
High Income/OECD	4.3	25.7
World	13.6	17.6

Sources: Tariff data are from UNCTAD TRAINS database; nontariff barrier data are from World Bank Development Economics Group online data and statistics, "Frequency coverage ratio of nontariff barriers by country."

a. Nontariff barrier coverage refers to the proportion of tariff lines that have at least one core nontariff barrier (quantitative restriction).

b. Proportion of tariff lines requiring license from Ministry of Industry (from World Bank 2001).

— = data not available

ices, and finance, have further raised the overall costs and disincentives to trade. Problems in the overall business climate, discussed further in section 3.4, have added to the region's poor trade outcomes.

3.2.1 *Recent developments*

Over the past several years, the region has embarked on reforms to liberalize their trade regimes and remove the many existing impediments to greater trade. At the start of the decade, only half of the countries in the region, Bahrain, Djibouti, Egypt, Kuwait, Morocco, Qatar, Tunisia, and the United Arab Emirates, were members of the World Trade Organization (WTO). But over the past seven years, Jordan, Oman, and Saudi Arabia have acceded to the WTO, and Algeria is in the final stages of meeting the conditions of accession.

In line with worldwide trends, bilateral and regional trade agreements have proliferated in MENA. Dominant among these were the Association Agreements with the European Union, signed by most of the labor-abundant countries in MENA. Resource-poor economies were among the first to ratify the Agreements, which establish tariff-free trade in industrial goods between the European Union and countries of the Southern Mediterranean. Tunisia and the Palestinian Authority, on an interim basis, had agreements in force by 2000. Since then, all of the other resource-poor economies but Djibouti have signed and put into force EU Association Agreements: Morocco in 2000; Jordan and Lebanon in 2002; and Egypt in 2004. Both Algeria and Syria have signed agreements that remain to be put into force. Beyond cooperation in trade in goods, several MENA countries have designed action plans in the context of a broader European Neighborhood Policy (ENP), which allows for an agenda of political, economic, and institutional reforms in exchange for greater integration into European programs and networks, increased financial assistance, and enhanced market access. Unlike countries that were part of the EU enlargement, the European Neighborhood policy action plans are selective, and MENA countries with EU Association Agreements in force can choose to harmonize norms and standards on a piecemeal basis, depending upon their own approaches for integration with the European Union (box 3.1). To date, ENP action plans have been agreed upon by Jordan, Morocco, the Palestinian Authority, and Tunisia, and both Lebanon and

Egypt are expected to complete the design on their action plans in 2007.

Beyond the Association Agreements with the European Union, MENA's largest trading partner, MENA countries have also entered into bilateral trade agreements with other major trading partners, including the United States. In addition to free trade agreements (FTAs) signed between the United States and Jordan and Morocco, several GCC countries have signed (Bahrain, Oman) or are pursuing (United Arab Emirates) FTAs with the United States (table 3.2). In the process they have thrown off course a multilateral EU-GCC free trade agreement, which was envisaged as one of the major outcomes of the GCC customs union entered into in early 2003. GCC economies have also aimed to strengthen economic ties with countries in Asia, particularly China and India. Free trade agreements with both being finalized.

MENA countries also enacted intraregional trade agreements as a means to heighten regional trade and intensify economic cooperation, including the Pan-Arab Free Trade Agreement (PAFTA), grouping 17 Arab countries, and the Agadir Agreement, signed by Morocco, Jordan, Tunisia, and Egypt, which allows for cross rules of origin among the four countries with regard to the European Union.

In part due to these agreements, MENA countries made significant progress over the last seven years in tariff reduction and rationalization, with resource-poor economies leading the movement. Jordan undertook sizable commitments in trade reform since 2000, partly through the process of membership in the World Trade Organization (WTO) in 2000 and the implementation of a Free Trade Agreement with the United States in 2001, with tariffs reduced by about half from an average of 23 percent in 2000 down to less than 12 percent by 2005. Trade liberalization was also a key element of Lebanon's structural reform agenda, and between 2000 and 2005, the simple average tariff was cut by almost half, from 10.7 percent to 5.4 percent. And significant trade liberalization took place with Egypt's broad-based trade reform in 2004, resulting in a reduction in the number of tariff bands, an annulment of import fees and surcharges incompatible with the GATT, and a reduction of tariffs on over 700 import items, including clothing, textiles, IT, and machinery and equipment used in the textile sector. As a result, tariffs declined from an average of over 21 percent in 2000 to just over 9 percent.

Box 3.1

Morocco's "Open-Sky Agreement" and Europe's "Neighborhood Policy"

Morocco's air transport market, dominated by Royal Air Maroc (60 percent of passenger traffic as of 2004), has undergone dramatic opening initiatives over the past two years. In December 2005, within the context of the ENP, Morocco signed an "open-sky" agreement with the European Union, its largest trading partner (nearly three-quarters of Morocco's trade is with the European Union and the bulk of tourists flocking to Morocco are Europeans). This agreement represents the first concrete example of implementation of the ENP. It means a significant regulatory approximation in exchange for a stake in the EU internal market. Upon a satisfactory evaluation of regulatory standards and compliance with EU aviation safety standards, Moroccan air carriers can fly to and through any airports in Europe if they depart from Morocco. Reciprocally, EU airlines departing from Europe are entitled to operate with no restriction between Europe and Morocco.

Comparable reforms implemented in other countries illustrate the possible benefits that Morocco can gain from amplified competition. The introduction of competition in Europe has been followed by a sub-

stantial reduction in airfares. Fares between London and Dublin, for instance, were down by half immediately after liberalization of this route. Similar effects were found in other Latin countries, including Mexico, where an increase in cross-border air traffic went hand in hand with a sharp decline in fares on competitive routes. Studies have found that fares on routes having two competitors are lower by 8 percent on average than the case of a monopoly.

Only a short time has elapsed since the EU-Morocco "Open-Sky Agreement" went into effect on January 1, 2006, and it is early to gauge its economic benefits. There are, however, indications that airfares went down and overall air traffic has expanded since January 2006. Morocco has become the only non-EU Mediterranean country host to a low-cost carrier, Ryanair. The latter has opened routes to and from three airports in Morocco: Fez (Frankfurt, London, and Marseille), Oujda (to Marseille), and Marrakesh (Frankfurt, London, and Marseille), and anecdotal evidence suggests that prices have significantly gone down on those routes.

Source: World Bank 2007k.

Most of the resource-rich, labor-abundant economies also undertook trade liberalization efforts. Early in the decade, Iran reduced the number of tariff bands to 13 and cut the unweighted average tariffs by about half, from about 41 percent to 22 percent. But this progress slowed, and recently tariffs on some goods have been sharply increased in order to support domestic production. Algeria undertook large reductions in the maximum tariff rates and rationalization of the tax and tariff structure. Since 2000, the number of tariff rates was reduced to four (0, 5, 15, and 30 percent), although the average tariff remains high at 18.7 percent, down from 24 percent in 2000. Other import taxes, such as the *redevances douanières*, were replaced by a small fee and the customs tax was eliminated. Among the resource-rich, labor-abundant group, the most significant tariff reform was adopted in Yemen, where widespread smuggling of imported goods, combined with the desire to harmonize tariff rates with

the GCC, prompted the government to lower import tariff rates in 2005, reducing the number of bands from four to three, with two-thirds of the commodities attracting only a 5 percent tariff rate. After these changes, the unweighted average tariff rate fell to 7 percent, the second-lowest average tariff, after Lebanon, outside the GCC in MENA.

GCC economies have maintained more open trade policies right from the outset, but since 2000, there has been further tariff liberalization by Saudi Arabia, which lowered customs duties to align with the other GCC customs union countries. In December 2005, Saudi Arabia was admitted to the World Trade Organization, and in the process of meeting WTO requirements, many remaining protective trade policies were revised, particularly in the areas of import licensing, customs valuation and fees, standards and technical regulations, and legislation for intellectual property rights and patent registration.

Table 3.2: U.S.–Middle East free trade efforts, 2006

Country	Free trade agreement	Trade and investment framework agreement	Bilateral investment treaty	World Trade Organization	Generalized system of preferences
Jordan	✓	✓	✓	✓	✓
Morocco	✓	✓	✓	✓	✓
Oman	✓	✓		✓	✓
Bahrain	✓	✓	✓	✓	Not eligible
United Arab Emirates	Negotiating	✓		✓	Not eligible
Egypt, Arab Republic of		✓	✓	✓	✓
Tunisia		✓	✓	✓	✓
Kuwait		✓		✓	Not eligible
Qatar		✓		✓	Not eligible
Saudi Arabia		✓		✓	Not eligible
Algeria		✓		Negotiating accession	✓
Iraq		✓		Negotiating accession	✓
Yemen, Republic of		✓		Negotiating accession	✓
Lebanon		✓		Negotiating accession	✓
Iran, Islamic Republic of				Negotiating accession	Not eligible
Libya				Negotiating accession	Not eligible
Syrian Arab Republic					Not eligible

Source: U.S. Trade Representative www.ustr.gov.

Note: The Palestinian Authority participates in the U.S.-Israel FTA.

3.2.2 Quantifying progress

Trade policy is multidimensional, reflected in a variety of policy actions which, together or separately, impact the ability and incentives for firms to conduct trade. To analyze MENA's current trade-policy status relative to other countries worldwide, a composite index was constructed, using several trade-policy-related indicators, including: the simple average tariff, the proportion of tariff lines subject to non ad valorem (NAV) duties, the average time required to comply with import-clearing procedures, and the average time required to comply with export-clearing procedures.⁵ MENA's trade-policy reform progress relative to other countries was evaluated based upon its progress in reducing average tariffs between 2000 and 2006.⁶

On the trade reform front, MENA countries have demonstrated strong progress over the last few years

in lowering tariff barriers. Relative to the world, tariff reform by MENA since 2000 ranks on average in the top 62nd percentile of countries worldwide, higher than any other region but Europe and Central Asia.⁷ The region's resource-poor countries have made the most significant progress, on average, ranking in the 69th percentile worldwide, led by the Arab Republic of Egypt, Jordan, and Lebanon, but several of the region's resource-rich countries also made strong strides in lowering tariffs, particularly Saudi Arabia and Yemen (table 3.3).

At the same time, though the region has begun to move strongly on tariff reform, the task of creating an environment conducive for trade remains far from complete. Tariff protection remains excessive, averaging 13.1 percent, higher than all other regions but South Asia and Sub-Saharan Africa, and far higher than the world average of 9.8 percent. Tariffs are particularly high among resource-poor countries, where the tariff applied to goods aver-

⁵ See Appendix B for description of methodology behind structural reform indicators.

⁶ Tariff information is the only data widely available for 2000, the initial period of comparison. Doing Business indicators on behind the border constraints to trade only became available in 2005.

⁷ Structural reform indices are presented based on a country's percentile rank within a worldwide cumulative frequency distribution. Running from 0–100, higher numbers indicate better policies or stronger progress.

ages 18.4 percent. In both Tunisia and Morocco, the current simple average tariff is above 26 percent, and the heavy tariff protection of the domestic market has changed only slightly in the course of the past 10 years.

Relative to the rest of the world, MENA economies rank on average in the 42nd percentile with regard to tariff protection, behind all regions of the world but South Asia and Sub-Saharan Africa (table 3.4). Imports are also hindered through the continued use of NAV duties, specific duties or taxes based on volume, rather than the value of the import. About 0.8 percent of tariff lines carry such duties in

MENA, higher than all other regions but Europe and Central Asia and high-income countries, but the ad valorem equivalent of these NAV duties is unclear.

Beyond tariffs and duties, clearing processes for trade remain burdensome, particularly with regard to importing. Import-clearing processes are especially cumbersome among resource-rich, labor-abundant economies, which on average rank in the bottom third of countries worldwide with regard to the time associated with complying with import procedures (figure 3.1).

In general, MENA's export-clearing processes are less burdensome, but the time required for complet-

Table 3.3: Trade-policy reform progress, 2000–06

Country/region	Current trade policy 2006 ^a	Trade-policy reform progress 2000–06 ^b
Algeria	68	63
Bahrain	—	76
Djibouti	17	47
Egypt, Arab Republic of	60	100
Iran, Islamic Republic of	16	67
Jordan	44	94
Kuwait	69	54
Lebanon	50	80
Libya	—	9
Morocco	52	50
Oman	51	43
Saudi Arabia	64	88
Syrian Arab Republic	2	32
Tunisia	53	42
United Arab Emirates	75	—
Yemen, Republic of	63	82
Regional averages (unweighted)		
MENA	49	62
Resource-poor	46	69
Resource-rich, labor-abundant	37	61
Resource-rich, labor-importing	65	54
East Asia and the Pacific	53	40
Europe and Central Asia	50	64
Latin America and the Caribbean	64	57
High-income OECD	84	61
South Asia	28	41
Sub-Saharan Africa	26	22
World	50	50

Source: See Appendix B.

a. Current trade-policy status reflects country's current placement in a worldwide ordering of countries, based on four major categories of trade-policy indicators available in 2006, expressed as a cumulative frequency distribution, with "100" reflecting the country (countries) with the most open trade policies and "0" reflecting the country (countries) with the most closed trade policies.

b. Reform progress reflects the improvement in a country's rank between 2000 and 2006 in a worldwide ordering of countries, based on the simple average tariff (the only trade-policy indicator widely available in 2000) expressed as a cumulative frequency distribution, with 100 reflecting the country (countries) that exhibited the greatest improvement in rank and 0 reflecting the country (countries) that exhibited the greatest deterioration in rank.

— = data not available.

Table 3.4: Tariffs and duties in the region, 2006

Country/region	Average tariff ^a	Percentile rank ^b	Non ad valorem duties (percent of tariff lines)	Percentile rank ^b
Algeria	18.7	7	0.0	88
Bahrain	5.1	72	1.0	31
Djibouti	31.0	0	2.7	22
Egypt, Arab Republic of	9.1	48	0.2	54
Iran, Islamic Republic of	22.1	4	0.5	39
Jordan	11.8	33	0.3	46
Kuwait	3.6	92	1.3	28
Lebanon	5.4	69	0.5	39
Libya	17.0	13	2.2	23
Morocco	26.2	2	0.0	88
Oman	5.0	74	1.0	31
Qatar	5.0	74	1.0	31
Saudi Arabia	4.8	75	1.3	28
Syrian Arab Rep.	19.6	5	0.5	39
Tunisia	26.9	1	0.0	88
United Arab Emirates	4.8	75	0.5	39
Yemen, Republic of	7.0	62	0.0	88
Regional averages (unweighted)				
MENA	13.1	42	0.8	47
Resource-poor	18.4	25	0.6	56
Resource-rich, labor-abundant	16.9	20	0.3	63
Resource-rich, labor-importing	6.5	68	1.2	30
East Asia and Pacific	7.3	59	0.5	56
Europe and Central Asia	6.8	66	3.4	36
Latin America and Caribbean	9.5	45	0.3	69
High-income OECD	4.2	88	5.6	16
South Asia	15.0	22	0.4	60
Sub-Saharan Africa	13.7	27	0.7	62
World	9.8	50	1.8	50

Source: Average tariffs and ad valorem duties from WTO International Trade Statistics.

a. Simple average tariffs based on most-favored nation applied rates.

b. For any country, percentile rank reflects the proportion of countries worldwide with a higher tariff or higher non ad valorem duty.

ing export procedures is particularly high in Iraq, Syria, and Yemen. In Syria, the time required for export clearing averages 40 days, about 45 percent higher than the world average, with particularly great time burdens for preparing export documents.

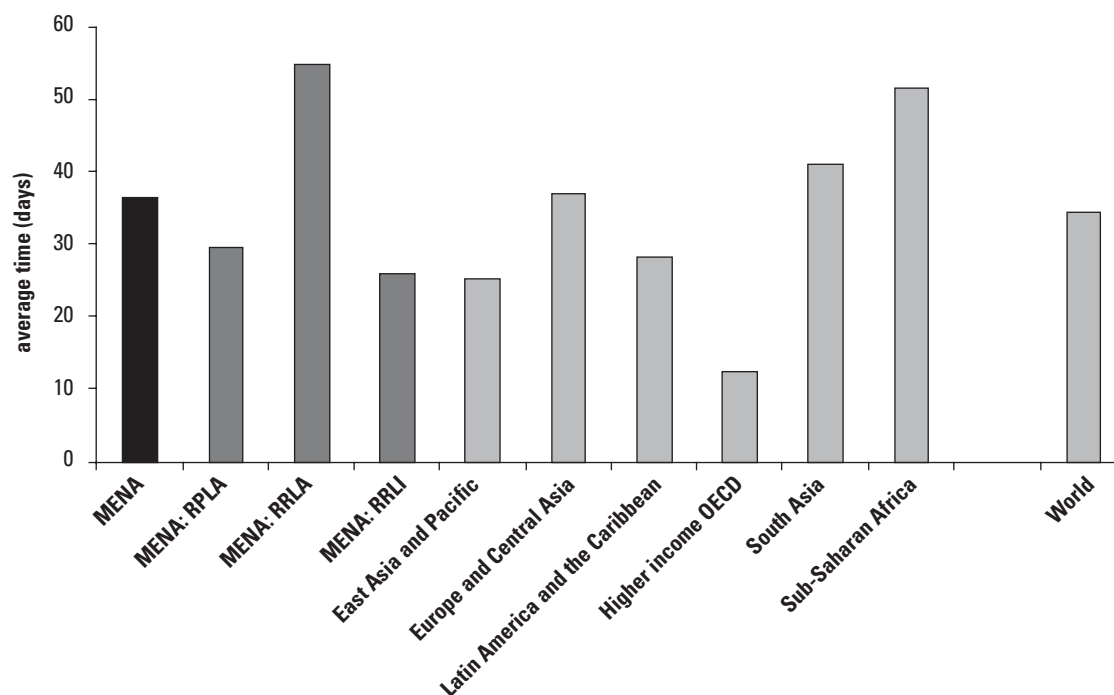
A composite index of trade policy, factoring in tariffs, NAV duties, and time required for trade-clearing processes, indicates that the MENA region ranks on average in the 49th percentile with regard to trade facilitation, behind the average of countries of East Asia and the Pacific, Latin America and the Caribbean, and high income countries, and about on par with Europe and Central Asia. While the region's resource-rich, labor-importing countries of the GCC have fairly open trade regimes, on average

ranking in the 65th percentile worldwide, elsewhere the region continues to maintain significant import barriers in the form of high tariffs and duties, and suffers from lengthy procedures for engaging in trade. MENA's resource-rich, labor-abundant countries are among the least friendly to trade in the world, on average ranking in the 37th percentile, only higher than the average for South Asia or Sub-Saharan Africa (table 3.3).

3.2.3 *Increasing the gains from trade through service sector liberalization*

Lowering barriers should allow for greater trade to emerge in MENA, but the effects of trade on

Figure 3.1: Import-clearing procedures in MENA and the world



Source: Staff estimates from World Bank *Doing Business* indicators.

Note: MENA RPLA (resource-poor, labor-abundant) economies include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; MENA RRLA (resource-rich, labor-abundant) economies include Algeria, Iran, Iraq, Syria, and Yemen; MENA RRLI (resource-rich, labor-importing) economies include Kuwait, Libya, Oman, Saudi Arabia, and the United Arab Emirates.

growth are not uniform across the world. And in the MENA region, the effects of trade on growth have been found to be considerably weaker than for other countries (Makdisi, Fattah, and Limam 2005). One key reason is the lack of services liberalization.

The competitiveness of a country's trade sector is heavily dependent upon access to a wide range of services at world prices. Backbone services, such as transport, utilities, finance and insurance, and communications are central to the global competitiveness of firms. An efficient financial sector ensures that investments can take place where they will have the highest returns. An efficient communications sector lowers the costs of information dissemination, raising efficiency of firms engaged in trade. An efficient transport sector contributes to the efficient distribution of goods within countries, raising the ability for firms to participate in global trade (Sekkat 2002).

In MENA, there has been recent progress in liberalizing a few key services, detailed in section 3.5. However, the process remains far from complete. In many countries, key sectors remain closed to

competition, either through ownership restrictions or regulatory practices. This lack of entry has kept the quality of these services low and the cost high, undermining industrial exporters from moving further up the value chain. Manufactured exports in MENA are generally low value-added and technologically unsophisticated, with few countries' industrial sectors moving up the value chain. In Morocco, for example, resource-based industries account for 51 percent of the country's total manufacturing value added (MVA), while advanced medium- and high-technology industries only account for 25 percent. The food, tobacco, and clothing sectors alone account for 40 percent of the country's MVA, employing 51 percent of all manufacturing workers. Morocco's industrial structure has barely evolved toward higher value-added and technology-intensive sectors in the last 15 years.⁸

Removing barriers to competition in services will remove the internal constraints to greater competitiveness and economic efficiency, increasing

⁸ Oxford Analytica, "Morocco: Stability masks manufacturing woes," October 6, 2006.

MENA's gains from trade liberalization. But the traditional framework for liberalization of services is on a bilateral or reciprocal basis. The economic relationships covered by the EU Association Agreements, for example, exclude trade in services (along with agriculture), which substantially limits their potential economic impact. Nor does the PAFTA cover trade in services. To achieve greater gains from trade liberalization, liberalizing trade in services and removing the regulatory barriers to investment need to become key priorities.

3.3 Business and Regulatory Reform

The challenge of creating sufficient job opportunities for MENA's rapidly growing labor force is immense. As noted in chapter 2, with diminished employment opportunities in the public sector and reduced migration, the most important engine for rapid and sustainable job growth in MENA into the future will need to be the private sector. Providing a business environment in which a dynamic and competitive private sector can thrive in MENA is a multidimensional endeavor.

Businesses depend upon mechanisms that provide for macroeconomic stability, critical for affecting the certainty of investors' decisions. They depend on trade and exchange rate policies that do not undermine competitiveness. And they require a regulatory environment that promotes competition, supports efficient resource allocation, and protects property rights. A strong legal environment that effectively enforces and administers commercial laws, as well as efficient financial institutions that can mobilize and make available resources for entrepreneurs to start new businesses, and for existing businesses to grow and expand, are also important for bolstering a good investment climate.

3.3.1 *Recent developments*

Over the last several years, almost every country in the region has undertaken various steps to improve the environment for business. Reform has centered on three key areas: liberalization of specific services in the economy to competition, across-the-board business and regulatory policy reform, and targeted interventions to promote growth in specific sectors.

MENA's recent liberalization of services has centered primarily on a few key areas, including telecommunications, transport, and banking (dis-

cussed further in section 3.5). In addition to opening key services to competition, the region has taken some steps to reduce the regulatory obstacles to doing business. Supporting a liberalization push in banking, a number of countries have shored up the regulatory environment for the financial sector. In Morocco, specific measures to improve financial intermediation include standardizing the minimum data required to process loan applications, helping banks to develop their practice of internal rating systems, and merging existing information on credit risk into a privately managed centralized database to all credit institutions (IMF 2006a). In addition, banking laws have been revised to improve supervision of nonbank institutions. In an effort to reduce nonperforming loans, Tunisia has taken first steps to improve credit appraisal, raise provisioning rules, and sanction banks with insufficient provisioning or capital. Algeria's key actions include modernization of the payment system, as well as the introduction of performance contracts in public banks and the publication of explicit subsidies to commercial banks in the 2006 budget law. Iran has worked to develop a risk-based regulatory and supervisory framework for banking and has worked on the measures needed to modernize payment systems, but progress has been slow. Libya launched a series of measures to support financial system reform, aimed primarily at restructuring state-owned banks and adjusting ownership structures to include or increase private participation. Bahrain's reforms initiated in 2004 include establishing a consumer credit rating agency and drawing up new regulations for insurance companies and trust funds. Bahrain has also made notable progress in developing Islamic lending instruments aimed at rolling over conventional domestic debt and diversifying financial instruments. The regulatory framework of the financial sector in the United Arab Emirates also witnessed some improvements, with major steps taken to control money laundering, including the passing of anti-money laundering laws, improving the rules and regulations dealing with the informal money transfer system, improving banking supervision, and enhancing the payments system.

In addition to reforms aimed at the financial sector, regulatory reforms have centered on a few key areas. One is improving bankruptcy laws, which in Egypt were revised to allow voluntary liquidation, which should significantly ease business-closure procedures. The cabinet recently approved a draft law to establish economic courts with specialized

judges and special provisions for appeals within 30 days. The courts will have jurisdiction over matters related to the central bank and the financial and monetary system, the capital market law, stocks, house financing, intellectual property rights, competition, consumer protection, insurance, the provisions of the commercial law concerning bankruptcy, and disputes over commercial contracts worth more than LE 10 million (US\$1.7 million). Another key area was reducing the capital requirements and registration process for starting a business, which has been a key part of the business-reform agendas in Tunisia and Jordan. Labor laws have also featured prominently in the region, in an effort to improve national employment levels. For example, a new labor code in Morocco significantly clarifies employment relations. GCC employment laws, on the other hand, have primarily focused on national employment targets (quotas) to increase the employment of the domestic workforce.

In addition to across-the-board reform, MENA countries have relied on interventions targeted to specific sectors in an effort to “launch” private sector growth. In Morocco and Tunisia, these targeted efforts came after the *mise à niveau* programs aimed at upgrading industry in general. Early in the 2000s, Morocco’s reform efforts included fiscal measures, simplified investment and procurement procedures, and an improved institutional framework governing the private sector, while Tunisia’s concentrated primarily on providing technical assistance, training, subsidies, and infrastructure improvements.

But both countries have moved on to upgrade more specific sectors. Morocco launched its Emergence Program in 2005, focusing on overhauling eight main sectors, including modernizing the textile sector to adapt to the dismantling of the MFA,⁹ and consolidating the sectors of electronic components, information technology, automotive manufacturing parts, aeronautics, and artisan products. Authorities are implementing a broad range of incentives that include tax exonerations, subsidies for training, and development of four offshore free trade zones. Tunisia moved on to a five-year pro-

gram targeted at industrial innovation in small and medium enterprises, with general privileges extended for investments in selected economic activities and for exporting.

Reform aimed to promote key sectors is a strategy also highly visible in GCC countries. A majority of the GCC economies have worked to develop service centers, creating international legal and business infrastructures separate from the rest of the country. They have established themselves as regional service hubs, including Bahrain, Qatar, and the United Arab Emirates in financial services, United Arab Emirates and Oman in tourism, Kuwait recently in technology, and even Qatar’s latest development push in regional education and health services.

3.3.2 *Quantifying progress*

MENA’s business climate was evaluated in two ways. First, the business climate in 2006 was evaluated based on current information in eight areas important for doing business: (1) ease of starting a business; (2) ease of closing a business; (3) ease of hiring and firing; (4) ease of enforcing contracts; (5) ease of registering property; (6) ease of paying taxes; (7) degree to which investors are protected; and (8) ease of dealing with licenses. In each of these areas, a variety of available indicators related to that sphere were utilized, often including the time, cost, and number of procedures required for fulfilling a certain business obligation. Based on these eight areas, a composite index of the business climate was calculated.¹⁰

In addition to evaluating the current business environment, recent reform of the business climate was evaluated based on progress made along four different fronts, for which information was available in both 2003 and 2006: (1) starting a business; (2) closing a business; (3) hiring and firing; and (4) enforcing contracts. From these data, a business and regulatory reform progress index was calculated, reflecting the improvement between 2003 and 2006 along these fronts. A fuller description of the

⁹ In January 2005, the World Trade Organization Multi-Fibre Agreement (MFA) on textile and clothing expired. The agreement had allowed privileged access to European markets for a few MENA economies—the Arab Republic of Egypt, Morocco, Tunisia, and the United Arab Emirates—in textile and clothing products.

¹⁰ The categories included for this year’s business climate index differ from last year’s, with the addition of information on protecting investors, and with the removal of last year’s indicators for access to credit. The results of these changes, however, are large, and thus the business climate index for 2005 has been recomputed and is included in Appendix B (along with a fuller description of the methodology behind all structural reform indices).

methodology underlying the business-climate index and the business-policy-reform index can be found in Appendix B.

On the recent reform front, the MENA region has made below average progress over the last three years in improving the business climate, relative to the world. On average, MENA countries rank in the 40th percentile with regard to business and regulatory reform between 2003 and 2006, behind all other regions but South Asia (table 3.5).

Within the region, resource-poor countries have demonstrated stronger progress in business-climate

reform, on average ranking in the 54th percentile worldwide, led by reform efforts in Morocco and Egypt. Morocco's progress with reform primarily reflects improvements in the ease of starting a business. In addition to significant declines in both the number of procedures, from 11 to 6, and the average time required to start a business, from 36 to 12 days, the average minimum capital requirement associated with starting a business fell by more than 90 percent, from an average of 761 percent of income per capita to a mere 67 percent. Elsewhere, Egypt's progress in business and regulatory reform

Table 3.5: Business and regulatory reform*

Country/region	Current business environment 2006 ^a	Reform progress, 2003–06 ^b
Algeria	36	37
Djibouti	9	—
Egypt, Arab Republic of	2	59
Iran, Islamic Republic of	26	2
Iraq	33	—
Jordan	59	41
Kuwait	77	16
Lebanon	40	46
Morocco	38	76
Oman	79	27
Saudi Arabia	76	75
Syrian Arab Rep.	33	52
Tunisia	55	40
United Arab Emirates	54	20
West Bank and Gaza	22	—
Yemen, Republic of	66	26
Regional averages (unweighted)		
MENA	44	40
Resource-poor	31	54
Resource-rich, labor-abundant	39	29
Resource-rich, labor-importing	71	34
East Asia and the Pacific	64	46
Europe and Central Asia	55	59
Latin America and the Caribbean	47	54
High-income OECD	84	49
South Asia	40	24
Sub-Saharan Africa	27	51
World	50	50

Source: See Appendix B.

* Current business-environment and reform-progress indices are not comparable to those in last year's report. For 2005 index values, see Appendix B.

a. Current business environment reflects country's current placement in a worldwide ordering of countries, based on eight major categories of business-environment indicators available for 2006, expressed as a cumulative frequency distribution, with 100 reflecting the country (countries) with the most friendly business policies worldwide and 0 representing the country (countries) with the most unfriendly business policies worldwide.

b. Reform progress reflects the improvement in a country's rank between 2003 and 2006 in a worldwide ordering of countries, based on four major categories of business- and regulatory-reform policies available in 2003 and 2006, expressed as a cumulative frequency distribution, with 100 reflecting the country (countries) that exhibited the greatest improvement in rank and 0 reflecting the country (countries) that exhibited the greater deterioration.

— = data not available.

primarily reflects reductions in the time and number of procedures associated with starting a business, but also relative improvement worldwide in contract enforcement—less a reflection of Egypt’s efforts than a reflection of general rise in the time, procedures, and costs associated with enforcing contracts.

Despite recent efforts in business-climate reform, however, the overall state of the business environment in MENA is poor. Although the GCC economies have fairly developed business infrastructure and generally favorable business policies, MENA’s resource-rich, labor-abundant and resource-poor countries are among the least business-friendly in the world, with burdensome and costly procedures and practices that thwart business development.

In resource-poor economies, only a few countries such as Jordan and Tunisia have regulatory policies and infrastructure that are fairly conducive to attracting and maintaining investment. The majority have significant impediments to conducting business, especially in the areas of starting a business, protecting investors, and contract enforcement in sales disputes. On average, resource-poor businesses must comply with 41 different proce-

dures during the process of dispute settlement and the total time required averages about two years,¹¹ higher than all other regions of the world but South Asia (figure 3.2).

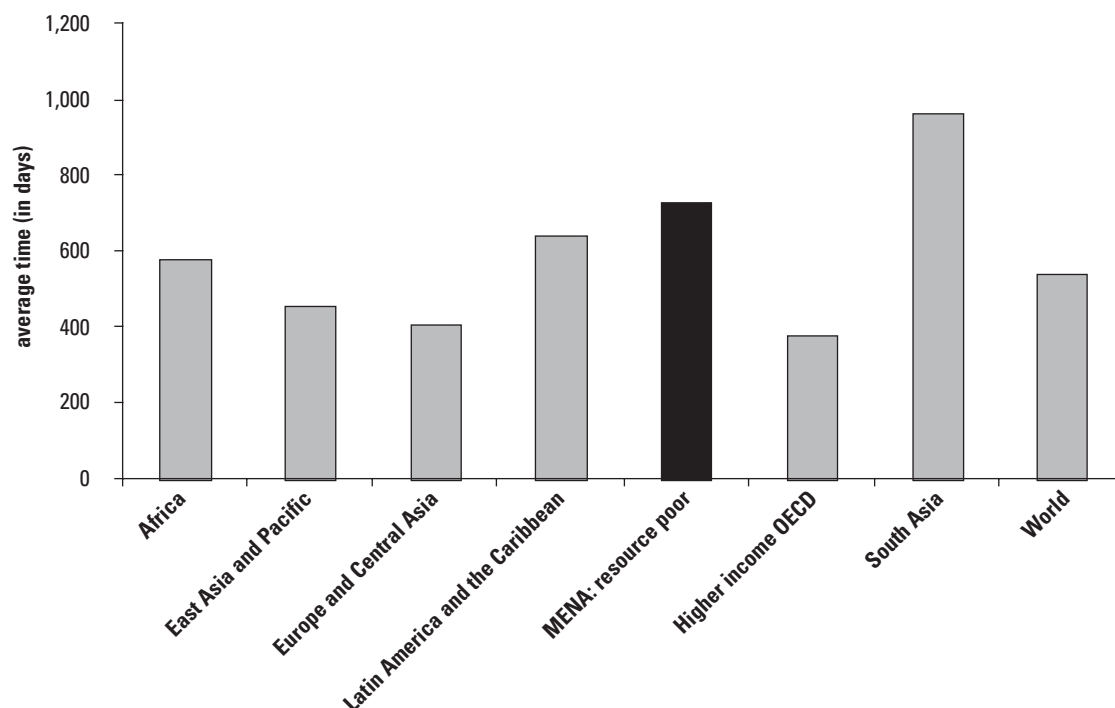
Firing restrictions among resource-poor countries are substantial, where firing for redundancy is either illegal, as in Egypt, or subject to numerous procedures and approvals. Worker hours are also subject to various rigidities, with restrictions on the number of working days, night work, and weekend work. And licensing procedures associated with business are extensive and costly.

Two countries that have especially large challenges in improving the business climate are Egypt and Iran, among the most populated countries of the region. In Egypt, in every sphere of the business climate, the country ranks in the bottom third worldwide.¹² Almost all aspects of doing business suffer from major obstacles, but the problems are especially severe in contract enforcement, where the total time required for dispute settlement can average almost three years, about twice the world aver-

¹¹ Unweighted average of countries represented.

¹² See Appendix B for individual business-climate indices by category.

Figure 3.2: Average time required for contract enforcement in the region’s resource-poor economies



Source: Staff estimates from World Bank *Doing Business* indicators.

age, as well as in dealing with licenses. And in Iran, although some features of the business climate are well developed, a few key areas are exceptionally problematic, resulting in a seriously weak overall business climate. One of these areas is in dealing with licenses, where it costs on average almost \$19,000 for the regulatory procedures to build a warehouse, and where the approval for an electrical connection alone can average a year.

As a whole, in a worldwide ordering of countries based on the overall business climate, taking into account numerous indicators across a number of key business areas, MENA countries rank in the 44th percentile with respect to the climate for doing business—behind every other region of the world but South Asia and Sub-Saharan Africa (table 3.5).

3.4 Liberalizing Key Services

Service sector liberalization—opening essential services within the economy to domestic and foreign competition—constitutes a separate and fundamental element for fully realizing the benefits from both trade-policy reform and business and regulatory reform. Backbone services such as information technology, communications, financial services, transport, and distribution play a key role in the development of integrated supply chains in the economy, improving overall productivity and the gains from other reforms. This section reviews the progress made by MENA countries in service liberalization and assesses the economic gains from service sector reforms.¹³

Although MENA has made recent progress in liberalizing a few key services, the process remains far from complete. In many countries, key sectors remain closed or semiclosed to competition, either through ownership restrictions or regulatory practices. Moreover, liberalization in the region has been a stop-and-go process, as countries face the political difficulties of implementing bold reform. Many promising efforts at liberalization have been tempered as opposition surfaces. In Algeria, a groundbreaking hydrocarbon law passed in 2005, allowing majority private sector ownership for the first time in the hydrocarbon sector, and separating regulatory powers from production. The law received a setback in 2006 with an amendment rein-

stating a predominant role for the state-owned oil company Sonatrach. Elsewhere, while competition has been introduced in many sectors, there remain large numbers of sectors with significant restrictions to investment. Often the number of firms has been fixed by regulation and there remain limits to foreign participation.

To better understand where MENA countries stand with regard to this important area of reform, this section assesses service sector reform, drawing upon indicators which the European Bank for Reconstruction and Development (EBRD) commonly uses to measure progress in service sector reform in transition economies (see box 3.2 and Appendix C for methodology behind EBRD service sector liberalization indices). Although these indicators are only available until 2004, they nonetheless provide a useful picture of both where the MENA region stands relative to other regions, and relatively recent progress with reform. In addition, we assess the potential impact of service sector reforms on the economic growth of MENA countries.

Broadly, the service sector comprises infrastructure services, including telecommunications and information technology, transport, energy, and water, as well as financial services. They also represent key inputs for the production of other goods and services. Telecommunications services are crucial for the international diffusion of information and knowledge. Access to modern networking technology allows the economy to diversify by utilizing information technologies to export labor-intensive services.¹⁴

Efficient transport services ensure that goods and people arrive in foreign countries in a timely manner. In places where it is expensive to ship goods abroad and service delays are frequent, transportation can become a prohibitive barrier to trade or can bias the geographic composition of exports and preclude countries from participating in the global production sharing that increasingly characterizes international trade. For tourism—a key service export in Maghreb—good transportation and telecommunications infrastructure are also key for growth in the sector.

Access to financial services—like working capital, export credit, and insurance—is critical if firms are

¹³ See appendix C, Anos-Casero and Seshan 2007, and World Bank 2007i for details on data sources and methodology.

¹⁴ Good examples are the call centers that are proliferating in Tunisia and Morocco. Efficient producer services and the development of e-commerce (Internet) are of great importance in expanding export earnings.

Box 3.2

The EBRD services reform indices

For the period 1990–2004, the European Bank for Reconstruction and Development (EBRD 2004) has compiled indices of reform in five infrastructure sectors (electric power, water and wastewater, railways, roads, and telecommunication) and two service sectors (banking and nonbank financial institutions). Scores range from 1, which means that little progress has been made, to 4+, which means that the most advanced implementation of the reform agenda has been achieved. The overall index for service sector reform is the simple average of the infrastructure and finance indices.

The finance index is the average of the following indicators.

- *Banking and interest rate liberalization.* The top score of 4+ signifies full compliance with banking laws and regulations set by the Bank for International Settlements (BIS) and the existence of a full set of competitive banking services.
- *Securities markets and nonbank financial institutions.* The top score indicates full compliance with securities laws and regulations set by the International Organization of Securities Commissions (IOSCO) and the presence of fully developed non-bank intermediation.

The infrastructure index is the average of the five indicators:

- *Electric power.* The top score means that tariffs reflect costs and provide adequate incentives for efficiency improvements. There is widespread private sector participation in the unbundled and well-regulated sector. The sector is fully liberalized, with

well-functioning arrangements for network access and full competition in generation.

- *Railways.* The top score signifies a separation of infrastructure from operations and freight from passenger operations. Full divestment and transfer of asset ownership has been implemented or is planned, including infrastructure and rolling stock. There is an established rail regulator, and accessible pricing is implemented.
- *Roads.* The top score means road administration is fully decentralized. Commercialized road-maintenance operations are competitively awarded to private companies. Road-user charges reflect the full costs of road use and associated factors, such as congestion, accidents, and pollution. There is widespread private-sector participation in all aspects of road provision. There is full public consultation on new road projects.
- *Telecommunications.* A top score indicates that effective regulation is enforced through an independent entity. A coherent regulatory and institutional framework exists to deal with tariffs, interconnection rules, licensing, concession fees, and spectrum allocation. There is a consumer ombudsman function.
- *Water and wastewater.* The top score means that water utilities are fully decentralized and commercialized. A fully autonomous regulator exists that has complete authority to review and enforce tariff levels and quality standards. There is widespread private sector participation via service/management/lease contracts. High-powered incentives, full concessions, and/or divestiture of water and wastewater services are present in major urban areas.

Source: EBRD 2004.

to obtain and fulfill orders from abroad; the existence of markets for foreign exchange, forward contracts, options, and other derivatives can reduce exporters' exposure to risk.

The service sector reforms discussed in this section cover both deregulation, dismantling barriers to entry and promoting competition, and improved regulation, like putting in place an appropriate legal environment, strengthening regulator

agencies, and increasing their independence. The policy challenge is to achieve a balance between effective regulation and increasing the contestability of markets (Hoekman 2005). Reforming backbone services sectors can play an important role in fostering deeper economic integration. First, service sector reforms can support Maghreb's integration with global production networks. The cost and quality of key backbone

services are important determinants of multinational firms' decisions to locate production facilities in a country. Second, these reforms will also increase domestic firms' productivity and competitiveness because they reduce the costs of producing and trading goods and services. Third, these reforms, by improving the efficiency of key backbone services, facilitate the development of new exports with time-sensitive delivery schedules, such as exports of electronic components and exports of ICT-enabled services.¹⁵

3.4.1 Progress in service sector reforms

Liberalization of specific services of the economy has started to gain momentum in MENA, but overall progress of service sector reforms in the MENA region has been modest. Figure 3.3 plots the region's progress with service sector reform according to the broadest indicator of service sector liberalization, including financial services, transport, telecommunications, power, and water, based on the EBRD overall service sector reform index. This broad index—like the underlying category

¹⁵ ICT-enabled services encompass a broad range of activities made possible by advances in telecommunications and the spread of the Internet. These services are increasingly provided in offshore locations in emerging markets and include: (i) data conversion and digitization (i.e., medical transcriptions); (ii) voice center operations (offshore reservation centers, call centers, and telemarketing); and (iii) outsourcing back-office and professional and administrative services.

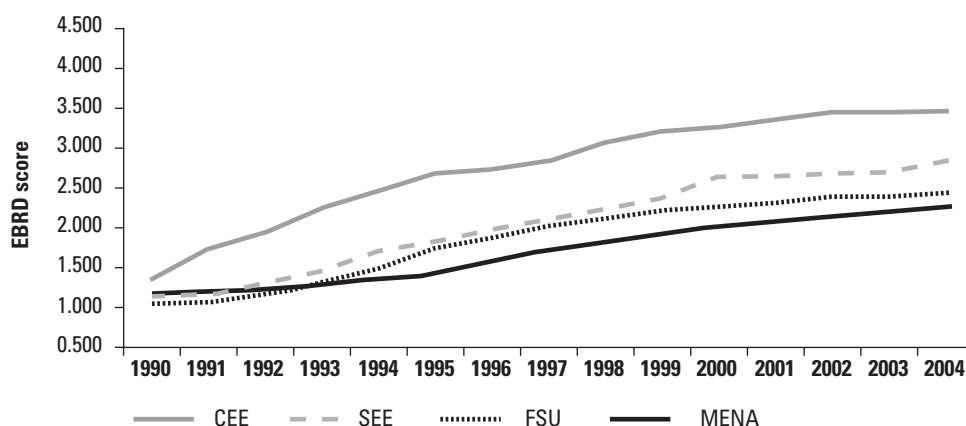
indices—ranges from 1 to 4.3, with 4.3 indicating best practice, and spans the period 1990–2004. (See Appendix C for methodological details.¹⁶) Despite progress over the last few years, MENA's overall progress with service sector reform falls well below that of other economies in transition. However, in a few areas the region has demonstrated considerable progress.

3.4.2 Financial sector reforms

Financial sector reforms spur trade and the flow of FDI. Financial sector reforms aimed at increasing competition and market contestability in the sector are associated with higher flows of trade and FDI, even after controlling for income levels (figure 3.4). Empirical research has found that integration of financial markets and trade in goods and services tend to go together (Levine 2001). Financial services are themselves subject to international trade and investment, and it has been found that trade and FDI also improve the quality and reduce the cost of financial services. The presence of foreign banks, for example, can exert competitive pressure on local banks, leading to a significant decline in their overhead costs. In addition, foreign banks often bring new products and may stimulate improve-

¹⁶ Given data restriction, for the quantitative analysis of the service liberalization section we cover only six countries in MENA: Algeria, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, and Tunisia.

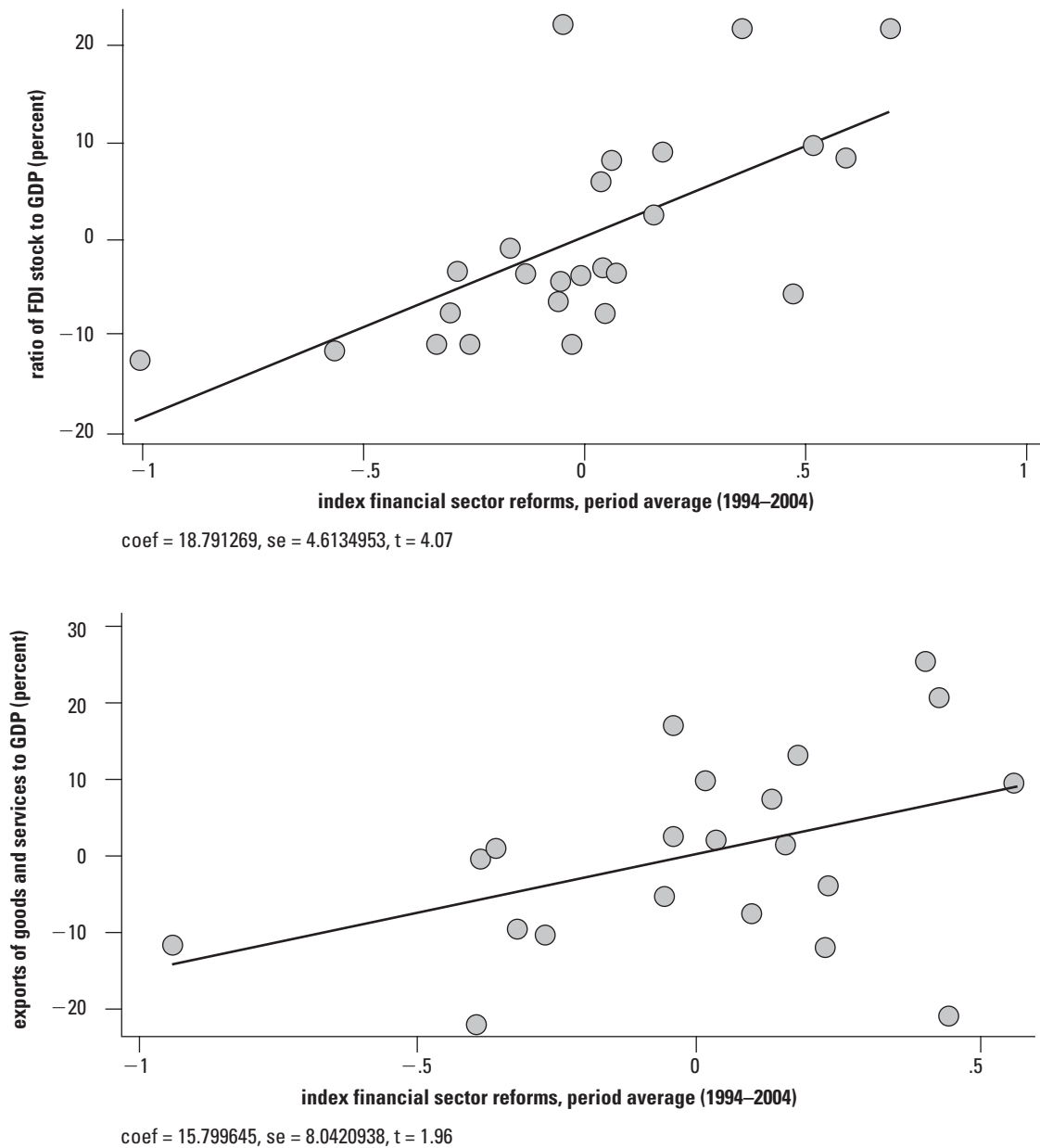
Figure 3.3: Progress in service sector reforms in selected regions, 1990–2004



Source: World Bank staff estimates.

Note: MENA= Morocco, Algeria, Tunisia, Egypt, Jordan, and Lebanon. SEE= Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and Serbia & Montenegro. CEE = Poland, Hungary, Czech Republic, Slovak Republic, and Slovenia. FSU= Estonia, Latvia, Lithuania, Russia, Ukraine, Belarus, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

Figure 3.4: Financial sector reforms, trade, and foreign direct investment



Source: World Bank staff estimates.

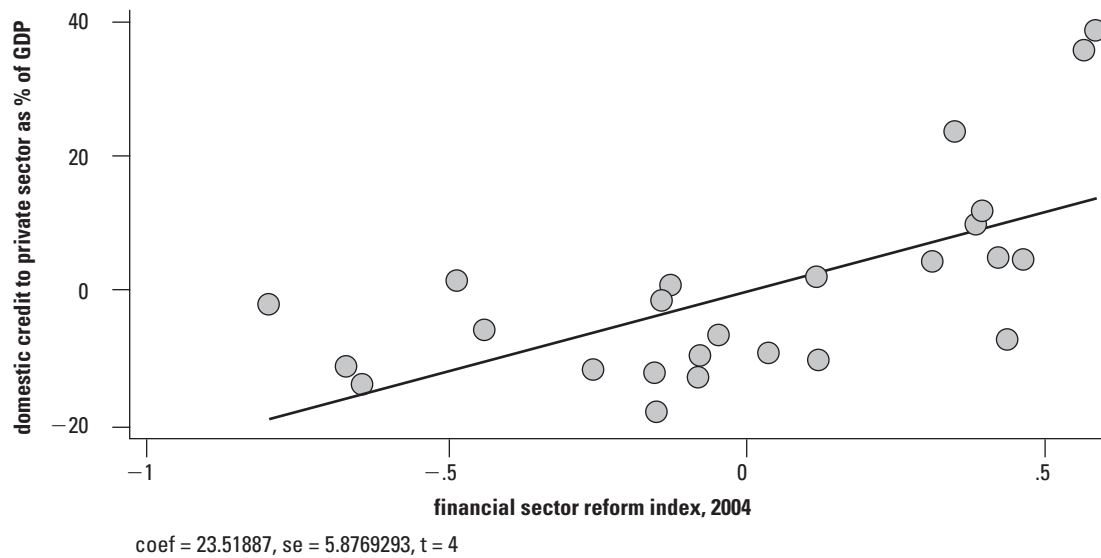
ments in domestic supervision and regulation. However, ultimately the link among trade, FDI, and financial sector performance is affected by the quality of the regulatory framework (Honohan and Klingebiel 2000).

Financial sector reforms are also associated with greater access to credit. Financial sector reforms aimed at increasing competition and market contestability in the sector are associated with higher shares of domestic credit by the banking sector, after controlling for income levels (figure 3.5).

For the MENA region, financial services constitute an area in great need of further liberalization. A major factor inhibiting greater domestic investment in the MENA region is lack of access to credit by firms, a problem highlighted in last year's MENA Economic Developments and Prospects report.¹⁷ Investment Climate Assessments undertaken by the World Bank indicate that a low proportion of firms

¹⁷ MENA Economic Developments and Prospects (2006).

Figure 3.5: Financial sector reforms and access to credit



Source: World Bank staff estimates.

in the MENA region have access to finance, with more than three-quarters of funding for investment being sourced from retained earnings, and only 12 percent from the banking sector, which is lower than any other region of the world.

Although many factors lie at the heart of the structural disconnect between the plentiful financial resources in the region and the scarcity of external financing for businesses, one of the key factors has been the high level of public sector ownership of banks, which has impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. The degree of state ownership is especially high in the resource-rich, labor-abundant economies of Algeria, Iran, Syria, and Libya, but state ownership is also high in several of the resource-poor economies like Egypt, Morocco, and Tunisia.

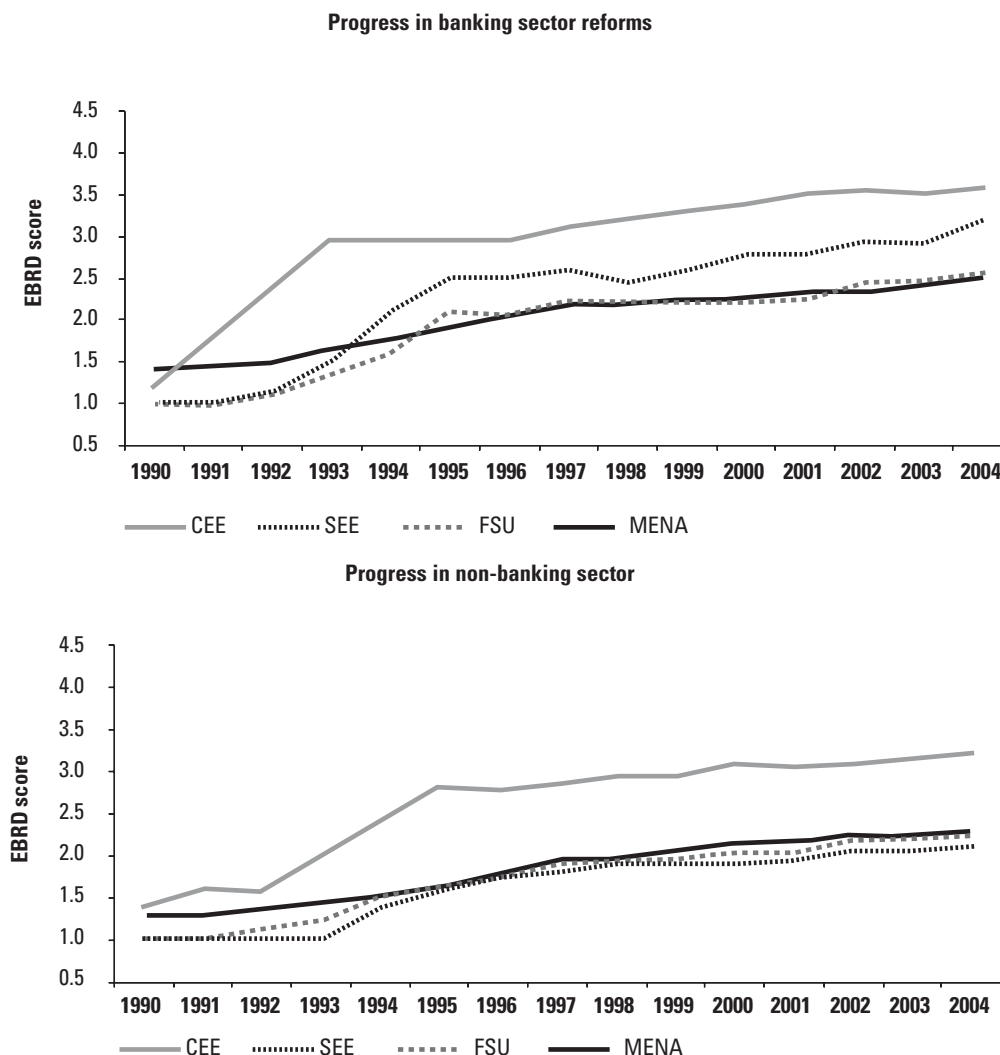
Over the last few years, many MENA economies have taken steps to open their banking sectors to greater private sector participation, granting licenses to private banks and changing foreign ownership restrictions. While these changes are only nascent, they nonetheless signal a broad change in policy by the region. Much of the recent efforts have come from those countries with the highest degree of state intervention and ownership in the sector. In Algeria, two new private banks were established in 2006. Iran opened the door to private sector participation, although the impact is relatively small to

date. Licenses have been issued to four private banks, but together these command a very small share of the market. Syria, whose banking sector was monopolized by the state-owned Commercial Bank of Syria, overturned its 49 percent maximum foreign ownership requirement in 2005, which allowed for a new bank to be established, and foreign Islamic banks are also entering the market. And in Egypt, majority stakes in one of the four main state-owned banks, the Bank of Alexandria (with 7–8 percent of total banking deposits), was sold in 2006. This major privatization was only one component of a broad range of actions initiated in 2004 to restructure the financial sector, including the sale of joint venture banks and investment houses, and the restructuring of private sector nonperforming loans.

However, while some MENA countries have made significant progress in liberalizing the financial sector, the region still lags behind international standards in ensuring market competition and contestability in the sector (figure 3.6).

One of the main drivers of deeper regional integration in both the EU accession countries of Central and Eastern Europe, and more recently the Western Balkans, has been foreign direct investment by European banks. If the MENA countries want to emulate these successful precedents, privatization of the remaining state-owned banks and financial services companies, such as insurance and the stock market, would be the main policy lever.

Figure 3.6: Progress in financial sector reforms



Source: World Bank staff estimates.

Note: Country groupings as in figure 3.3.

3.4.3 Infrastructure sector reforms

This section focuses on the following infrastructure sectors: transport (roads and railways); telecommunications; power and water. Three types of reforms are particularly important in increasing the efficiency of the provision of regulated infrastructure services¹⁸: (i) allowing entry of new domestic and foreign providers; (ii) where feasible, opening the domestic market to imports of such

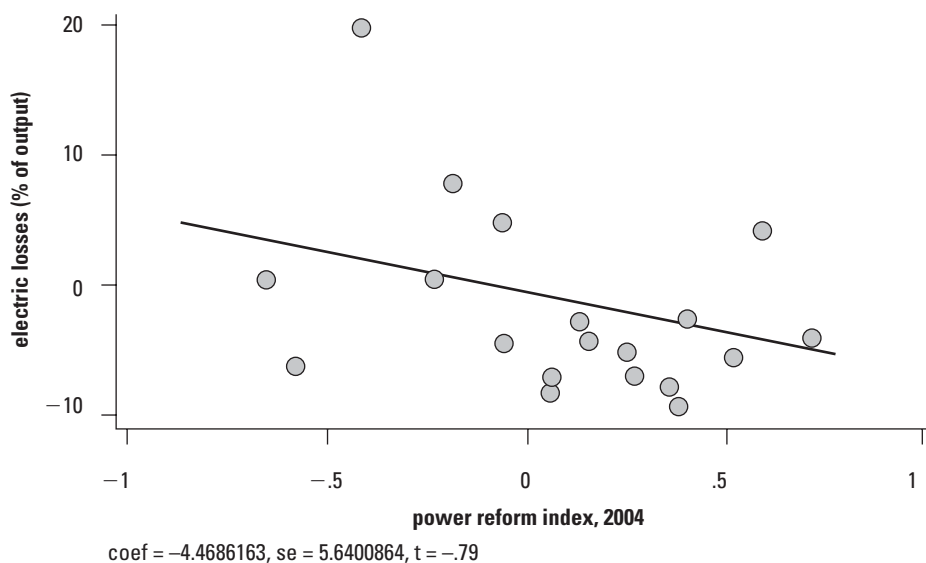
services; and (iii) the establishment of an independent regulator.

Power sector reforms are associated with better quality of electricity services. Progress in power sector reforms aimed at improving competition and market contestability in the sector are positively correlated with lower electric transmission and distribution losses, as a share of total electrical output, after controlling for income levels (figure 3.7).

Telecommunication sector reforms are associated with better access and quality of telecommunication services. Fink et al. (2003) found that privatization, competition and the introduction of independent regulators had a positive impact on telephone penetration and productivity in the telecommunications sector. The study also found

¹⁸ Reforms may and often do include privatization, but this variable is captured in the overall investment climate reform index discussed in the earlier section of the chapter. Even if incumbent providers remain state owned, if regulators permit entry of new providers in the market, such competition can be expected to yield efficiency gains in the industry overall.

Figure 3.7: Power sector reforms and electric losses



Source: World Bank staff estimates.

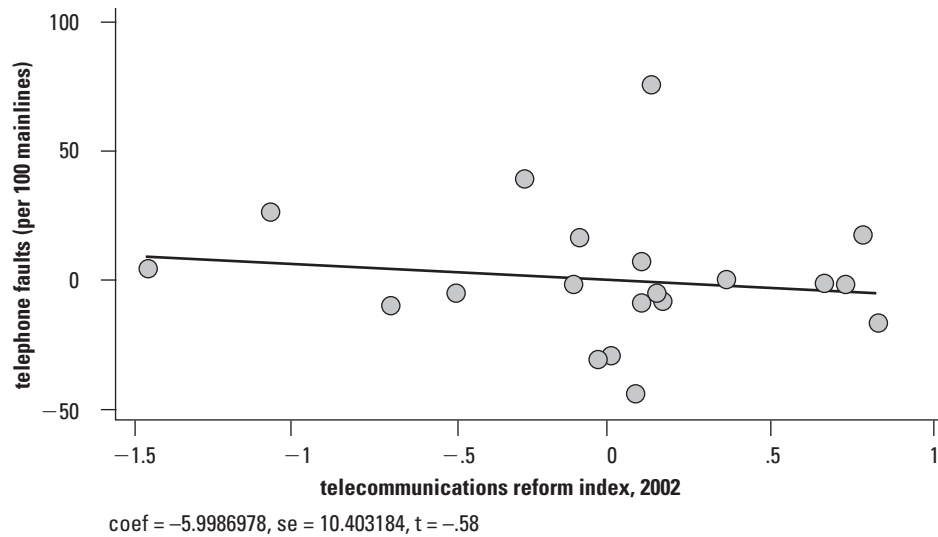
that countries that introduced the full package of reforms did systematically better than those that confined themselves to partial reforms. Telecommunication sector reforms aimed at improving competition and market contestability are associated with lower telephone faults (per 100 main lines), after controlling for income (figure 3.8). These reforms are also associated with higher numbers of mobile subscribers (per 1,000 habitants), also after controlling for income levels (figure 3.9).

Poor transport infrastructure results in higher direct transport costs and longer time of delivery, leading to higher domestic production and trading costs. An improvement in a country's infrastructure can make a big difference to the costs of trading. A 10 percent increase in transport costs may reduce trade volume by more than 20 percent (Limao and Venables 1999). The decline in transport costs accounts for an estimated 8 percent of average world growth since 1945 (Baier and Bergstrand 2001). Better infrastructure for sea, land, and air transport are associated with higher volumes of trade. A recent study shows that doubling the number of paved airports per square kilometers of territory in a country boosts imports by 14 percent. Trading with an exporting country with twice as many airports increases bilateral trade by a further 15 percent. Doubling the kilometers of paved roads per 100 square kilometers is estimated to increase trade by 13 percent (Nordas and Piermartini 2004).

With a few exceptions MENA countries have made less progress in liberalizing infrastructure services than many other emerging economies (figure 3.10). Implementing and sustaining reform has tended to be more difficult in some sectors than others. In telecommunications, where prices before liberalization were often high, and in port and airport transport, which are generally export-oriented services, there have been fewer difficulties in initiating reforms. In the electricity and water sectors, on the other hand, where prices are generally far below cost, the progress has been much slower, as policy makers must balance the need for efficiency improvements with expected price increases. Tunisia and Algeria have approached service reform in the infrastructure sector in a piecemeal fashion. As a result, privatization has been slower than in other parts of the world and barriers to entry often remain forbidding for investors.

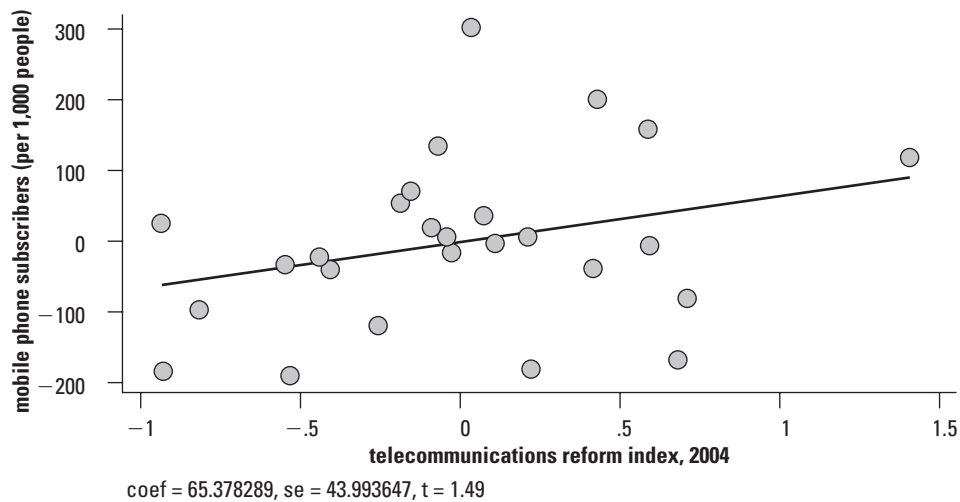
Telecommunications reform has received the most effort within the region, with Jordan, Egypt, Morocco, Algeria, and Tunisia all having opened the telecommunications sector to foreign competition, and with partial privatization of the national telephone companies in Bahrain, Qatar, Saudi Arabia, the United Arab Emirates and Oman, though not open to foreign ownership. Competition in mobile telecommunications exists in Egypt, Morocco, Tunisia, Algeria, Jordan, and Kuwait, and most recently Bahrain and Saudi Arabia.

Figure 3.8: Telecommunication reforms and telephone faults



Source: World Bank staff estimates.

Figure 3.9: Telecommunication reforms and mobile phone subscribers

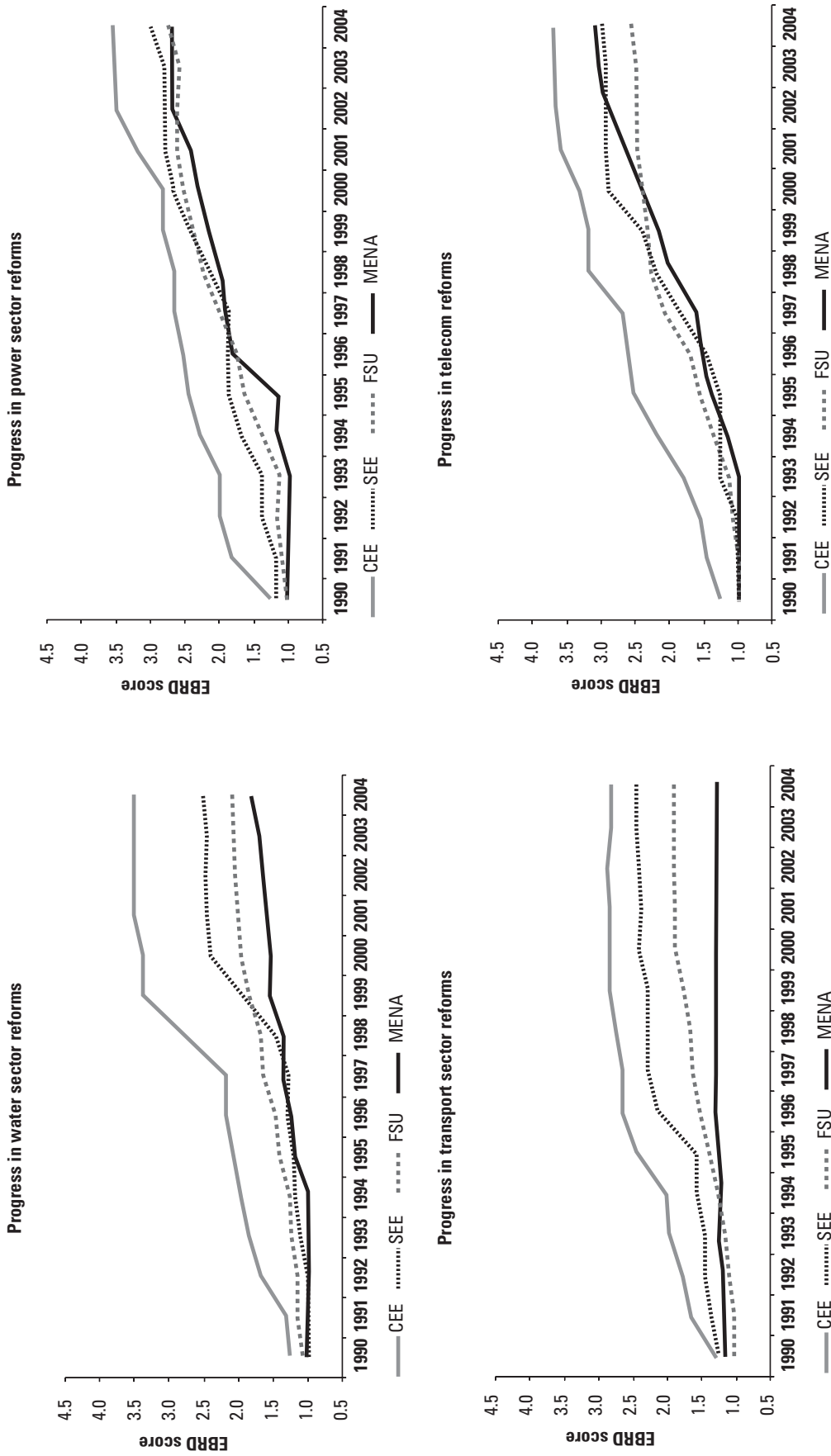


Source: World Bank staff estimates.

Outside telecommunications, progress with infrastructure liberalization has been mixed, with relatively strong liberalization efforts among a few, including Morocco, in air transport, oil and gas exploration, audio visual communications, and with planned liberalization of electricity; Jordan, in phosphates, air transport, and with planned liberalization of electricity generation; Bahrain, in electricity, petrochemicals, and planned liberalizations of water and postal services; and Oman, in power, water, ports, and oil. Egypt has liberalized air transport.

Iran opened the door for private sector participation in most major industries, including power generation, water, postal service, railways, airlines, and ship building, although the actual privatization process has moved slowly and access to these sectors is still pending. Elsewhere, almost all of the GCC countries have converted to private power, and there have been piecemeal efforts at liberalization in other sectors, such as Saudi Arabia in air transport, Qatar in some air services and water, and in the United Arab Emirates in tourism and air transport.

Figure 3.10: Progress in infrastructure reforms, 1990–2004



Source: World Bank staff estimates.

Note: Country groupings as in figure 3.3.

3.4.4 *Economic impact of service sector reforms*

Drawing on time-series data for a group of 30 countries, including 6 MENA countries and 24 transition economies, covering the 1990–2004 period, we estimate the impact of service sector reforms on per capita income growth, trade, and FDI in MENA countries (see World Bank 2006 for details). The magnitude of the impact of these reforms varies across countries. Below we report the average impact for the MENA countries under analysis:

Impact on per capita income growth. One unit point increase in the service sector reform index is associated with an average increase in annual real GDP growth per capita of about 2 percentage points in MENA countries, holding inflation and the change in investment-to-GDP constant.

Impact on FDI. One unit point increase in the service sector reform index is associated with an average increase in FDI stock of about 8 percentage points, holding inflation and the change in investment-to-GDP constant.

Impact on per capita export growth. One unit point increase in the service sector reform index is associated with an average increase in annual export growth of about 1 percentage point, holding inflation and the change in investment-to-GDP constant.

Thus, the potential impact of greater liberalization of services in MENA economies, in terms of export growth, FDI, and overall growth, is considerable. It is interesting to note that the economic gains of service sector reforms has tended to be consistently higher for the Maghreb countries, Algeria, Morocco, and Tunisia, than for Mashreq countries, Egypt, Lebanon, and Jordan. One possible explanation is that the Maghreb countries, with the exception of Tunisia, have made less progress in reforming the service sectors than their Mashreq neighbors.

3.5 Governance Reform

At the heart of many of the economic challenges facing the MENA region are governance issues. The World Bank outlined some of the key governance challenges facing MENA in its flagship report on governance (World Bank 2003b). Along with the economic reforms the region needs, it must strengthen the incentives, mechanisms, and capacities for public institutions, both to improve eco-

nommic policies and to force the broad social consensus needed to successfully enact reform. Policy reform can help to build coalitions that expect and demand good institutions. But there need to be some feedback mechanisms in place for these expectations and demands to be heard and met.

MENA's governance challenges relate to two different but complementary spheres. First, they face the challenge of modernizing governance structures and operations for more efficient public sector management. That task involves administrative reform of the public sector to enhance the efficiency of the bureaucracy, to improve mechanisms of internal accountability, and to reduce corruption. Second, the MENA region faces the more difficult challenge of increasing public sector accountability. This governance challenge requires improving transparency in governance mechanisms and enhancing contestability in government policies.

3.5.1 *Developments*

Over the past years, MENA countries have taken significant steps to begin to address the region's significant deficiencies in governance. Many of these efforts have focused on reforming public administration, both to improve efficiency in the delivery of quality public services and to create fiscal savings. MENA's historical state-run models have translated into large civil services, which have been a key element of the public sector reform programs in a few countries in the region, including in Jordan and Morocco. Morocco's early retirement program aided the departure of 8 percent of the central government civil personnel within a year of its launch. The implementation of the early retirement scheme and the continued no-new-net hiring policy reduced the wage bill by 1.4 percentage points in 2006, to 12.2 percent of GDP (IMF 2006a).

In 2006, Egypt also launched a system for early retirement of public sector employees, which allows for retirement for employees with minimum years of service, regardless of whether their position is threatened. Previously, retirement was possible only at 60 years of age, with special packages offered only to those working for companies due to be divested. And in Yemen, major reengineering efforts are underway to improve the efficiency of administrative processes in key ministries and agencies, encompassing over two-thirds of total public employment, through the implementation of the National Wage Strategy. Improving public sector efficiency has also

centered around modernizing the organizational structure of the public sector.

In addition to efforts to improve public sector efficiency, several countries have taken important steps to open up the political space and allow for greater accountability in public policy and to strengthen inclusiveness in public policy. Many of these efforts have come from the GCC. In 2001, Bahrain became a constitutional monarchy with a bicameral parliament, full suffrage was granted to all citizens, male and female, and an independent judiciary was created. The government has more recently introduced a proposal to strengthen women's legal rights, particularly in cases dealing with child custody, inheritance, and divorce, and to shift jurisdiction over family affairs from Islamic to civil courts. Although the bill is still being blocked by conservative forces in the parliament, reformists are battling the issue. Saudi Arabia held its first nationwide elections in February 2005 to elect municipal councils. It also has made changes—albeit small—to improve the status of women, including giving women the right to obtain personal ID cards, and improving the employment opportunities in the public sector. Qatar has introduced new legislation granting more freedoms and permitting demonstrations, labor union formation, and public meetings. And in Oman, a consultative parliament was established in 2003, enabling all eligible adults to vote. Political rights have been extended to women, and starting in 2004, a number of women have been appointed to ministerial and ambassadorial posts.

Elsewhere, a major achievement in enhancing accountability occurred with Morocco's adoption of the Law on Political Parties, which helps consolidate the credibility and efficiency of political parties and institutions. And in the area of transparency, after a half century of state monopoly, Morocco's audiovisual sector was liberalized, allowing greater access to wider and diversified sources of information.

3.5.2 *Quantifying progress*

MENA's reform progress was evaluated across two broad spheres of governance: governance related to the quality of public administration, and governance related to public sector accountability. For each sphere, two structural reform indices were created, measuring both the current status of a country relative to the rest of the world in terms of that sphere of governance, as well as the country's recent progress with reform.

Public sector accountability in 2006 was evaluated based on current information in a variety of key accountability areas, including political rights, civil liberties, freedom of the press, and various measures of executive recruitment and participation processes. Quality of public administration in 2006 was evaluated based on current information on several areas of public sector capacity, including corruption, bureaucratic quality, property rights, regulation, and various regulatory processes for business. For both areas of governance, reform progress was measured over the period 2000–06.¹⁹

In the area of improving the quality of public administration, MENA countries have made strong advances over the last six years, ranking on average in the 57th percentile worldwide, higher than all other regions of the world. Resource-poor countries, which on average rank fairly high relative to other developing regions in terms of public sector efficiency, also demonstrated strong advancements since 2000, and average in the 86th percentile with regard to improvement in the quality of administration between 2000 and 2006, with efforts centered on improving procedural requirements for business. Public administration quality among resource-rich countries varies dramatically between the generally more efficient public sectors of the GCC and the substantially less efficient public administration of the labor-abundant economies and Libya. Without Libya, resource-rich, labor-importing economies would rank in the 64th percentile, on average, with regard to the quality of public administration. Over the last several years, a few of the GCC countries have exhibited further progress in the area of reducing corruption, and as a group the labor-importing economies rank in the 57th percentile with regard to recent reform efforts. Resource-rich, labor-abundant economies, however, have not kept pace with worldwide progress in public administration reform, ranking on average in the bottom third worldwide with respect to improvements in the mechanisms for the delivery of quality public service (table 3.6).

Along with improvements in public administration efficiency, MENA has demonstrated significant progress over the last several years in improv-

¹⁹ See Appendix B4 for description of the methodology behind governance indicators.

Table 3.6: Quality of public administration in 2006 and quality of public administration reform 2000–06

Country/region	Quality of administration index: current status (percentile rank)	Quality of administration reform index (percentile rank)
Algeria	43	16
Bahrain	78	80
Egypt, Arab Republic of	34	91
Iran, Islamic Republic of	17	11
Jordan	71	87
Kuwait	65	64
Libya	3	13
Morocco	72	91
Oman	66	80
Qatar	54	69
Saudi Arabia	59	80
Syrian Arab Rep.	14	59
Tunisia	69	76
United Arab Emirates	61	10
Yemen, Republic of	27	23
Regional Averages (unweighted)		
MENA	49	57
Resource-poor	61	86
Resource-rich, labor-abundant	25	27
Resource-rich, labor-importing	55	57
East Asia and Pacific	45	45
Europe and Central Asia	50	56
Latin America and Caribbean	44	43
High-income OECD	89	47
South Asia	33	56
Sub-Saharan Africa	33	51
World	50	50

Source: See Appendix B for methodology behind governance indices. Current status reflects country's current placement in a worldwide ordering of countries, based on a variety of indicators of quality of public administration, expressed as a point in the worldwide cumulative frequency distribution, with 100 reflecting the country (countries) with the best/most efficient public administration worldwide and 0 reflecting the country (countries) with the weakest/most inefficient public administration worldwide. Reform progress reflects the improvement in a country's worldwide ranking between 2000 and 2006 in a worldwide ordering of countries based on quality of public administration, with 100 reflecting the country (countries) that exhibited the greatest improvement in rank worldwide, and 0 reflecting the country (countries) that exhibited the greatest deterioration.

ing the mechanisms for greater government accountability. The gap between MENA countries and the rest of the world in terms of accountable and inclusive institutions is large. On average, based on a range of measures, MENA countries rank in the bottom 20th percentile with regard to public sector accountability in a worldwide ranking of economies. And only one country, Jordan, ranks above the bottom third²⁰ (table 3.7). But an encouraging and important development has been

the recent inroads that MENA countries have made toward reducing this governance gap. Between 2000 and 2006, MENA countries ranked on average in the 63rd percentile with regard to improving the mechanisms for government accountability, higher than all other regions of the world. Strongest improvements have come from resource-rich, labor-importing countries, which on average rank in the 73rd percentile with regard to public accountability reform, led by Bahrain and Oman, but with progress throughout the GCC. But resource-poor countries, led by Morocco, have also made inroads.

²⁰ And Jordan is only marginally above the bottom third.

Table 3.7: Public sector accountability, 2006, and public sector accountability reform 2000–06

Country/region	Public sector accountability index:	Public sector accountability
	current status (percentile rank)	reform index (percentile rank)
Algeria	28	68
Bahrain	27	96
Egypt, Arab Republic of	23	73
Iran, Islamic Republic of	21	6
Jordan	34	62
Kuwait	30	63
Libya	0	43
Morocco	32	78
Oman	17	89
Qatar	15	75
Saudi Arabia	6	75
Syrian Arab Republic	6	54
Tunisia	22	37
United Arab Emirates	20	84
Yemen, Republic of	18	48
Regional Averages (unweighted)		
MENA	20	63
Resource-poor	28	63
Resource-rich, labor-abundant	18	44
Resource-rich, labor-importing	16	73
East Asia and Pacific	41	44
Europe and Central Asia	52	56
Latin America and Caribbean	57	42
High-income OECD	91	47
South Asia	37	31
Sub-Saharan Africa	36	52
World	50	50

Source: See Appendix B for methodology behind governance indices. Current status reflects country's current placement in a worldwide ordering of countries, based on a variety of indicators of public sector accountability, expressed as a point in the worldwide cumulative frequency distribution, with 100 reflecting the country (countries) with the best/most accountable governance structures worldwide and 0 reflecting the country (countries) with the weakest/least accountable governance structures worldwide. Reform progress reflects the improvement in a country's worldwide ranking between 2000 and 2006 in a worldwide ordering of countries based on public sector accountability, with 100 reflecting the country (countries) that exhibited the greatest improvement in rank worldwide, and 0 reflecting the country (countries) that exhibited the greatest deterioration.

3.6 Reform and the Oil Boom

While the recent oil boom has greatly benefited the oil-producing economies of the region in terms of higher growth and revenues, an important concern has been the potential impact this oil boom might have on the continuing structural reform effort. Historically, the region relied on oil and oil-related revenues to delay implementing a deeper economic reform agenda, with the substantial revenues from oil permitting many to postpone difficult but important reforms that were taking place worldwide. Indeed, it was only in the mid-1990s, well after the

collapse of oil prices in the mid-1980s, that most of the countries in the region began the long and complex process toward more market-driven, open, and diversified economies.

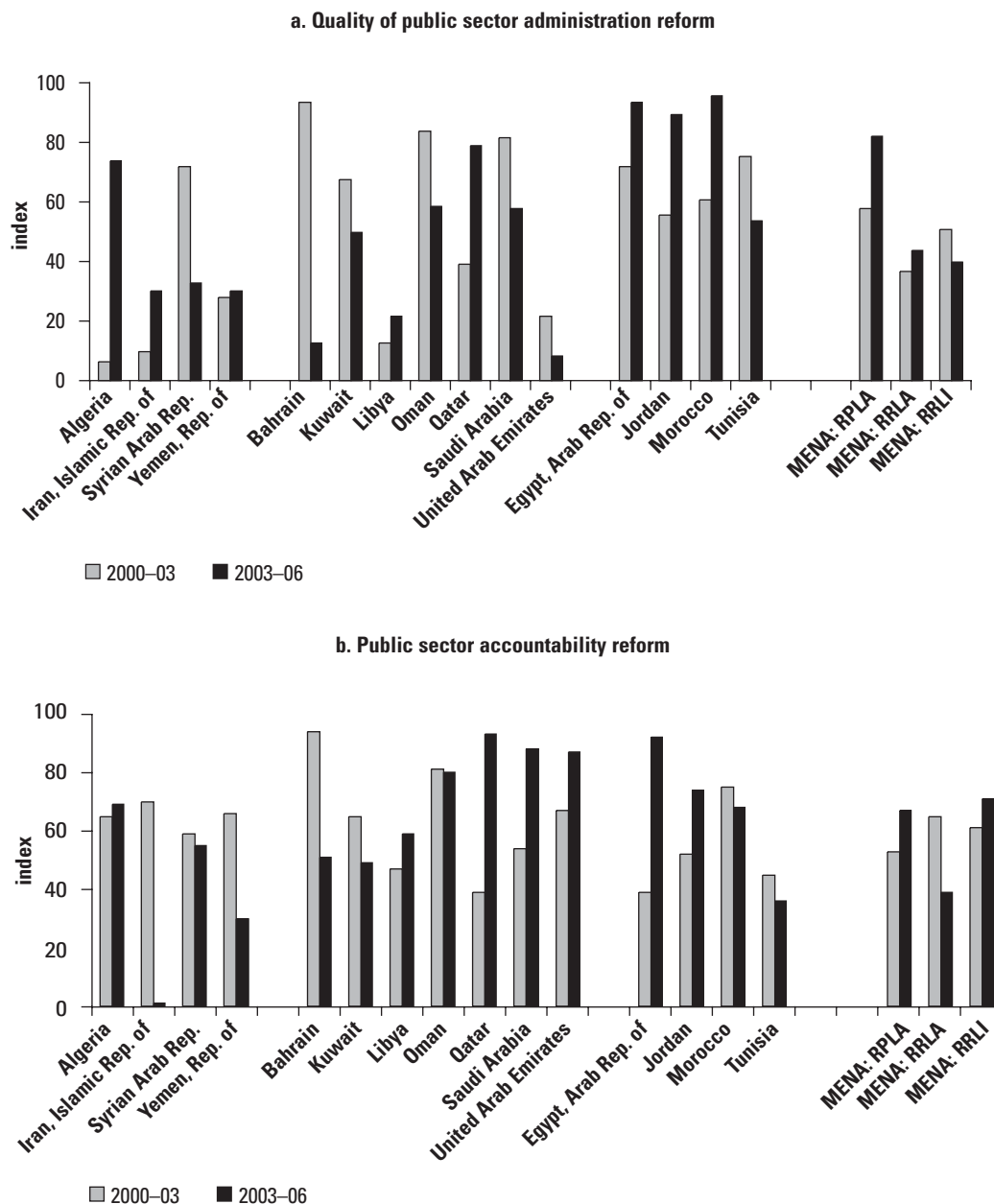
With the current oil boom, a natural question is whether the region's structural reform effort will slow. Answering the question, however, is difficult. Structural reform takes place in distinct stages and actions. Examining one period of reform versus another may yield results that are less a reflection of changes in reform effort rather than simply reform sequencing. Reform is also a reflection of need, and countries might demonstrate a lower reform effort

in one particular area because less reform is needed. Moreover, our information on structural reform is limited to just a few short years, and only in the area of governance reform is information available both prior to and after 2003.

There are some generalities about reform in MENA that can nonetheless yield important insights. In the area of public administration reform, there is some evidence that, outside of the resource-

poor countries that face higher oil-import bills and oil subsidies, the incentives for sweeping improvements in public sector management have diminished with rising oil prices. On the whole, oil economies backed off from improvements in the quality of public sector administration after 2003, even where modest progress had been occurring previously (figure 3.11). In only Algeria, Iran, and Qatar was the reform effort significantly heightened

Figure 3.11: Governance reform since the oil boom



Source: See Appendix B for methodology behind governance reform measures.

Note: Worldwide average reform for any period = 50 (50th percentile). For explanation of MENA groups, see figure 3.1 note.

following the start of the oil boom. In both Algeria and Iran, however, this “heightened” effort since 2003 more accurately reflects the modest containment of a significant downward slide since 2000. Interestingly, resource-poor countries, facing higher oil import bills, have almost universally demonstrated a significant improvement in measures of the quality of public sector administration since the start of the rise in oil prices.

In the area of enhancing public sector accountability, however, a significant divergence between labor-abundant and labor-importing oil economies is notable. Between 2000 and 2003, efforts at improving public sector accountability were mixed. Only a few of the early reformers in the area—Oman and Bahrain, but also Iran—made significant strides in opening up the public space and increasing mechanisms for greater voice in governance. Most of the oil and non-oil countries remained inactive in improving mechanisms for greater accountability.

Since 2003, however, many of the resource-rich, labor-importing economies of the GCC have be-

gun to exhibit strong efforts to improve government accountability. Parallel with their efforts toward more prudent management of the oil windfall and stronger economic ties with the world, GCC countries such as Oman, Qatar, Saudi Arabia, and the United Arab Emirates have taken significant steps forward in the sphere of enhancing the inclusiveness and accountability of government. It is a significant and encouraging sign that these efforts have taken place despite rising oil prices.

MENA’s labor-abundant oil economies, on the other hand, have generally not moved forward with improving public sector accountability since 2003. Algeria is an exception. Undoubtedly, creating more inclusive and representative governance structures is influenced by far more than rising oil prices and the abundance of labor. However, given the importance of reform in public sector accountability to the overall reform agenda, the significant backsliding by a few countries, especially Iran, is cause for concern for the broader reform agenda, and thus the prospects for long-term growth.

