

MENA DEVELOPMENT REPORT

From Privilege to Competition

Unlocking Private-Led Growth in the Middle East and North Africa



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1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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Foreword

Times of economic turmoil often overshadow long-term challenges. However, the current global economic crisis could be a historic opportunity for the Middle East and North Africa region. It could open the door for fundamental reforms that will prepare the countries of this region to rebound, embrace the future global recovery, and strengthen their long-term growth prospects.

From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa complements previous regional reports published by the World Bank by focusing on the role of the private sector as an engine for stronger growth and employment creation. The 2004 report on trade and investment and the 2008 report on education touched on other fundamental ingredients of economic competitiveness and private sector development. This report—focusing on market institutions, the quality of implementation of economic policies, and the credibility of reforms from the private sector perspective—offers a new angle to the growth and development challenges of the MENA region.

Stronger Private Sector Growth is Needed to Create Jobs.

All countries in the region face a pressing employment challenge: about 40 million jobs will need to be created in the coming decade. A young and increasingly well educated labor force is looking for opportunities to use their skills and creativity. Governments will not be able to create these jobs in the public sector—nor will state-owned enterprises in a sustainable manner. The jobs will have to come from the private sector.

The future prosperity and social cohesion of the MENA region rests in great part on the ability of governments to enable the private sector to respond to this job creation challenge. That is what this report is about: enabling new generations of entrepreneurs to play a bigger role in the

growth of their countries. It is also about encouraging more investors to believe in the prospects of the region and trust that business-friendly policy reforms will benefit them as well—and not only a minority of privileged entrepreneurs.

Skeptics voicing doubt that the private sector will succeed in generating the needed jobs and growth are legion in MENA, and the global financial crisis may have added to this skepticism. However, the lessons of past crises support the main message of this report: sustained job creation can only come from a competitive private sector, which in turn requires governments to build efficient regulatory capacity. Where regulatory institutions are weak or where regulators are captured, the state cannot play its supportive role effectively.

A more vibrant private sector in MENA countries will also contribute to increased economic integration of the region. With a conducive business environment, new entrepreneurs will emerge to reap the benefits of greater intraregional trade and investment—driven more by business considerations than by political concerns.

While There Have Been Policy Reforms, Their Implementation Needs to Improve to Foster a Stronger Response From the Business Community.

In many MENA countries the institutions that implement private sector policies, need strengthening to make reforms more credible, and to ensure that they are implemented equitably and consistently to the benefit of all entrepreneurs.

This region has made great strides over the last few years in improving its investment climate—even if some countries still lag. Yet the response of the private sector has been muted. Arbitrary implementation of reforms and discretion in enforcing rules explain why too many would-be entrepreneurs believe that the key to success is how connected, or how privileged, they are, which diminishes the importance of competition, creativity, and persistence. Focusing on the credibility of reforms and the consistency of their implementation is what this report recommends. This new agenda for private sector development applies to all countries in the region, even if it translates into different strategies depending on each country's specifics, its progress with business environment reforms, its resource endowment, and its political economy.

This new agenda emphasizes the role of institutional reform as the cornerstone of any credible private sector development strategy, and is therefore in essence a “good governance” agenda. The aim is to increase the effectiveness and consistency in which public agencies and market

institutions—customs, tax authorities, investment agencies, courts, industrial land market agencies, and so forth—interact with firms and enforce regulations. The report argues that reforms need to reduce conflicts of interests and target regulations that either restrict competition or erect informal barriers to entry. These reforms will all require visible actions by political leaders to signal that there will be a level playing field. The credibility of these signals will ultimately be the most important driver of private investors' response to reforms.

The Private Sector Also Has a Responsibility: It Needs to Be Better Organized and Be More Inclusive, More Creative and More Dynamic in Order to Be a Credible Partner of Governments in Implementing this Agenda.

The report argues that the private sector and civil society, too, have an important role to play in changing expectations for the better. It shows that in many countries, the dominant private sector—privileged by past policies and remaining distortions—is seldom an agent of change, but tends to defend the status quo. New generations of entrepreneurs, ones that are more open to competition, exports, and innovation, need to voice their interests more prominently. To this end, they need to be better organized. The same is true for civil society. The demand for reforms is often weak in MENA countries—sometimes because channels of voice are muted, but often because these voices are not unified or organized. The report calls on the private sector and civil society to play a bigger role in support of reformers in their governments.

This report offers innovative ideas and recommendations for policymakers, the private sector, and civil society in the MENA region and beyond, and it will generate debates and discussions to help the private sector to grow and create the jobs that are badly needed. The World Bank stands ready to support our MENA client countries in this endeavor.

SHAMSHAD AKHTAR
REGIONAL VICE-PRESIDENT
MENA REGION

Acknowledgments

This report was prepared by a team led by Najy Benhassine, principal author, and comprising Andrew Stone (principal co-author), Philip Keefer (political economy chapter and overall storyline), Youssef Saadani Hassani (research assistant and co-author of the finance chapter), and Sameh Neguib Wahba (land chapter), under the guidance and supervision of Zoubida Allaoua.

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Summary messages

An estimated 40 million jobs need to be created over the coming decade. These jobs will have to come from the private sector. A young and increasingly well-educated labor force is looking for opportunities to use their skills and creativity. Governments will not be able to create these jobs in the public sector. Neither will they be created in state-owned enterprises – at least not in sufficient numbers or in a sustainable manner. The future prosperity of the MNA region rests, in great part, on the ability of governments to enable the private sector to respond to this job creation challenge.

Today, outside of hydrocarbons and mining, the private sector generates most of the wealth in MNA economies. Increased openness and liberalization over the past two to three decades has transformed the economies of this region from public-sector-driven economies to ones where more than 80 percent of non-hydrocarbon value-added is produced by private enterprises.

Despite its larger role, the private sector has still not been able to transform MNA countries into diversified, vibrant economies with sustainable high growth record. With a few exceptions from the Gulf, no country of this region—whether oil-rich or not—has witnessed in recent years growth that is led by a structural transformation of the economy. Gauged by the diversification of exports, their technological sophistication, the level and sectoral composition of private investment, or the productivity and innovation of firms, no MENA country exhibits the kind of dynamism and economic transformation witnessed in Malaysia, China, the Republic of Korea, Poland, Turkey, and other fast-growing economies.

- *For example, with private investment averaging around 15 percent of GDP, MNA remains far behind more dynamic regions (close to 30 percent in East-Asia).*
- *Export diversification is also insufficient. The best MNA performers export around 1,500 goods—most of them low in technological content—compared with close to 4,000 in countries like Poland, Malaysia or Turkey.*
- *Also, firms are less productive than in comparative countries. For example, the report estimates that the average MNA manufacturing firm's productivity is about half that of Turkey's.*

The report does not offer a standard recipe of reforms that would generate diversification and sustained growth in every country of the region; such a recipe does not exist. Lessons from past successes and disappointments with standard reform packages call for some humility in a search for the keys to strong, sustained growth. Today this search is even more challenging as short-term global economic prospects are grim.

It focuses instead on three aspects of policy making that combine to affect investors' expectations: the rules, how they're applied, and the credibility of government commitment to reforms. First it looks at the policies, rules, and regulations as they're enacted—asking whether the problem in MENA is with missing reforms. Second, the report looks at the way these rules, policies, and regulations are actually implemented and enforced—asking whether the problem is with uneven and discretionary policy making. Third, it examines whether the problem is with the credibility of governments' commitment to policy reforms and better implementation of policies.

While progress with reforming the rules vary between countries, the region as a whole suffers from discretionary and arbitrary implementation of policies, and from lack of government credibility to really change a deeply rooted status quo of privileges and unequal treatment of investors. For many countries, the problem is not with insufficient or missing reforms, but rather with their quality and the widespread belief that the business environment as it appears “on the books” is not applied equally to all. Consequently, the region enjoys less competition than elsewhere. The dynamism of entry of new firms and exit of inefficient businesses is weaker than in Asia, Latin America, or Eastern Europe; and firms are on average older than elsewhere—as are formal business owners. The response of private investment to past reforms has been weaker than in other regions—a sign that investors do not fully trust that seemingly pro-business policies will be applied to them equally.

- *For example, the report estimates that in response to previous reform episodes, private investment in the Middle East and North Africa had increased by a modest two percentage points of GDP, compared to 5 to 10 points in Asia, Eastern Europe and Latin America.*
- *World Bank surveys in the region show that close to 60 percent of business managers do not think that the rules and regulations, as they appear “on paper”, are applied consistently and predictably.*
- *As the result, there's fewer entry and exit of firms. The report estimates that the number of registered businesses per 1,000 people is about a sixth of that in the OECD, and less than a third of that in Eastern Europe and Central Asia.*
- *With less entry and exits of firms, the average business is ten years older than in East Asia or Eastern Europe.*

Engaging in a reform agenda that signals a credible commitment to reduce discretion will require a change in the way policy making is conducted. The report calls for a three pillar strategy for building a stronger foundation for longer term growth in MENA:

First, governments need to remove formal and informal barriers to competition. Where they exist, privileged positions and conflicts of interests between public servants and private investors should be reduced. Too many of these still plague competition in MNA countries. Regulations that either restrict such competition or erect informal barriers to entry protect these privileged positions

Second, policy reforms must be supported by strengthening the institutions that regulate markets and interact with firms, in order to reduce interference and discretion in the enforcement of rules and regulations. To really improve the business environment for all in the region, transparency,

accountability and quality of service in public agencies should be at the core of the reform agenda. Private sector policies will need to be systematically anchored in elements of institutional and public sector reforms to reduce discretion and opacity and to improve the quality of services to firms. This requires building strong rule-bound public institutions, with substantial decision-making power over economic outcomes.

Third, the region must foster a new partnership between the private and the public sectors, one that mobilizes all stakeholders in the design, implementation and evaluation of economic policies. Only then will consensus be built around the reforms, and their credibility and effectiveness reinforced. A more open dialogue between governments and the private sector will also help guard against narrow interests taking over the public interest.

New forms of partnerships are needed inside government—where cohesion and interministerial coordination have to be strengthened around clear long-term strategies with measurable objectives and responsibilities. New partnerships are also needed between governments and other stakeholders, especially the private sector; a prerequisite in many countries is to allow independent associations to form and freely contribute to the policy debate. These partnerships should lead to the development of stronger reform alliances and to broader participation in designing, implementing, and evaluating policies. The private sector also has a responsibility to organize itself into effective business associations that are not exclusively representing the interests of a few.

What each country should precisely do in each of these three pillars depends on its priorities, on its political economy constraints and its circumstances. What will convince investors that change is real and set to last in one country may not be the same than in another country. But what it takes is generally known by all stakeholders. This report does not pretend to offer a to-do list for each country.

Short of such a fundamental shift in the way private sector policies are formulated and implemented, investor expectations that governments are committed to reform will be limited. It will take political will—and time—to support sustained reforms that credibly address the real issues holding back the region, and convince investors and the public that changes are real, deep, and set to last. While a longer-term growth challenge, this fundamental policy change will also affect the short-term ability of policy makers to respond to the economic downturn and seize on the opportunities that the global economic recovery will offer.

MNA is a region endowed with considerable human capital, creativity and resources, and its growth potential is far higher than what it has recently attained. Meeting that potential will require a credible commitment to reduce discretion and ensure a more equal enforcement of the rules, so that more entrepreneurs can invest and create jobs. The economic and social payoff of embarking on a more ambitious private-led growth agenda could thus be immense—for all.