

MENA DEVELOPMENT REPORT

From Privilege to Competition

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



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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.

Since its inception, this project has benefited from the inspiration and guidance of Mustapha Kamel Nabli (during and after his tenure as Chief Economist of the MENA region). He provided continuous support and advice as well as key inputs that shaped the storyline of this report. He also provided detailed feedback on successive drafts of chapters. The report also benefited from the guidance and extensive reviews of Ritva Reinikka, Director of the Social and Economic Development Group of the World Bank MENA region, who oversaw the completion of this project. She provided substantial inputs that led to this final draft, contributing in particular to the overall storyline of the report, its key messages, and the framing of its political economy and governance focus. Daniela Gressani, in her former position as Vice-President of the World Bank MENA region, has provided detailed comments on an earlier draft of the report, which led to very useful re-framing of key parts of the text and the storyline.

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Key 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.

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.

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.

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. 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. 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. 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.

From Privilege to Competition

Overview

What Is This Report About?

Enabling the private sector to become the engine of strong and sustained growth.

Creating jobs for a young and better-educated labor force is a top priority of all governments in the Middle East and North Africa. Better jobs are even more important today as countries face a global economic downturn. What will that take? Sustained economic growth driven by the private sector—and dedicated long-term strategies and the leadership committed to carry them out. The private sector has been central in all countries that have grown strongly over long periods. International experience indicates that relying on state-owned enterprises to create jobs and investment has never been a sustainable substitute for investment by privately owned firms— because no government has been able to expose firms that it owned to real competition and hard budget constraints. This has been the experience across the Middle East and North Africa (MENA) region as well. Governments have realized that the model of state-led development used in earlier decades yielded economic stagnation and have sought a new model, one with a larger role for the private sector. The challenge for policy makers is to align the incentives of profit-maximizing entrepreneurs with the social objectives of shared growth and job creation. The private sector cannot do it all, however. Growth also requires public investment in education, knowledge, and infrastructure. Such public spending does not crowd out private investment, it crowds it in. Together with other characteristics such as market openness, stability, good governance, and visionary leadership, these policies have been common to all the economies that have been able to grow fast over the last few decades.¹

Sustained growth in MENA will require more private investment, higher productivity of firms, and greater diversification— especially for exports. This has not been sufficiently the case in the region so far. Although the private sector has a larger role in MENA economies than ever before, it still falls short of being the engine of strong growth. Private investment has been insufficient to create the necessary jobs, and unemployment remains at double-digit levels in most countries. Weak productivity and innovation have restrained firm competitiveness and the diversification of exports. Clearly growth has accelerated, averaging 5.8 percent over the 2005–08 period, but it still lags behind the developing country average of 7.2 percent, surpassing only Latin America and the Caribbean (5.1 percent). The sustainability of this growth revival remains uncertain—especially in light of recent developments in the global economy. In resource-rich countries it has mainly been driven by the oil boom. The recent drop in oil prices and their volatility is yet another reminder for these countries that the diversification of their economies remains a pressing priority. In non-oil countries, past growth has not been accompanied by a structural transformation of the economy—especially in terms of exports—such as the one witnessed in high-growth East Asia or in Eastern Europe. The ongoing growth slowdown in the Organisation for

Economic Cooperation and Development is also a reminder that these countries remain vulnerable to demand shocks to their low value-added exports.

The role of government policies in ensuring a business environment conducive to private-led growth is central. The role of state and regulatory institutions to ensure proper functioning of private markets is also a key one—as the current financial crisis has shown. Recent developments have led some policy makers to reexamine the respective roles of markets and governments. The crisis has highlighted the need for a stronger role for the state in regulatory oversight. At the same time these events do not imply that a return to failed policies of the past will somehow bring better results. The leadership role of the private sector as an engine of growth is not in question. Instead, the crisis has been a reminder of how capable market regulatory institutions are crucial to ensure an orderly functioning of markets to serve both private (profit maximization) and public objectives (job creation and shared economic growth).

Is the Private Sector Able to Play the Role of a Growth Engine?

New entrants and greater competition will convince the skeptics.

Public-private relations in the MENA region: a story of mutual mistrust. Skepticism about the ability of the private sector to be the engine of growth is legion, and the current financial crisis has reinforced this skepticism. The private-led model is perceived as not having delivered on its promises. Almost 60 percent of public officials interviewed across the region thought the private sector in their countries was rent seeking and corrupt.² Only 21 percent claimed it is dynamic, and 9 percent thought it was transparent and law abiding. The distrust is reciprocal. It is rooted in the belief by officials that a small group of rent-seeking firms dominate the private sector—a group that has long been protected by all sorts of barriers to entry. Among the negative behaviors cited are the bribing of civil servants, lobbying for special benefits and tax exemptions, hiding of revenues and salaries to avoid tax obligations, and nontransparent corporate governance. On the private sector's side, it is also rooted in the belief that governments do not act to improve the investment climate for all businesses, but rather for the benefits of politicians and a narrow group of their allies.

This report is also about creating the conditions that enable a more developmental and more dynamic private sector to emerge— one in which fewer entrepreneurs are focused on protecting their rent situations from competition, one that is perceived as wealth and job creating rather than rent seeking. In a more open environment, many new firms and entrepreneurs will come forward. Countries in transition— Hungary, Poland, and Vietnam—show that, more than the expansion of existing firms, a generation of new investors supports growth accelerations. This has been the case in MENA every time policy changes have allowed new entrants. There will be even more dynamic entry if the environment improves further, and this will lead to a more diversified private sector, which will support further reform more strongly and more vocally than protected incumbents.

How Has the Private Sector Performed So Far?

It plays a bigger role—but it is not yet driving the transformation of MENA economies on a high-growth path.

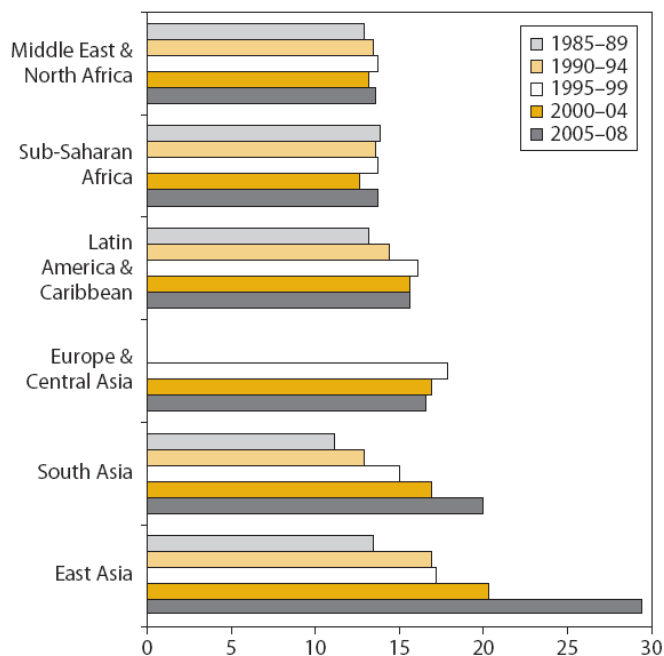
Over the last three decades, MENA countries have moved from a model of state-led growth to one relying more on the private sector. All countries have adopted more prudent macroeconomic policies and increased their openness to trade and private investment. The reforms started in the 1970s in countries such as the Arab Republic of Egypt and Tunisia, gained momentum in the 1980s, and accelerated in the 1990s in other countries such as Algeria, the Syrian Arab Republic, the Republic of Yemen, and more recently in Libya. They have pushed the share of the private sector in (non-oil) GDP in all but a few of these countries to between 70 and 90 percent. This shift followed global trends.

Despite its larger role, however, the private sector still falls well short of transforming MENA countries into diversified, highly performing economies. Whether 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 countries such as China, the Republic of Korea, Malaysia, or Turkey. For example, private investment rates and the number of products exported all appear weaker in MENA (figures 0.1–0.2).

FIGURE 0.1

Stagnating Private Investment Rates

(percent of GDP)

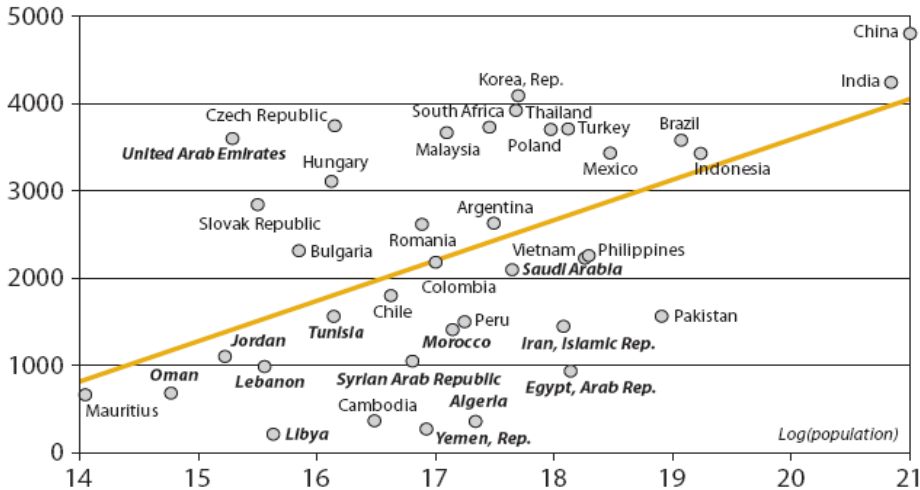


Sources: World Development Indicators, national accounts, International Monetary Fund (IMF).

FIGURE 0.2

Lower Diversification of Exports

(Number of products exported)



Source: Comtrade, 1995–2007 six-digit data.

The report does not pretend to offer a standard recipe that would generate strong private-led growth in every country—such a recipe does not exist. Lessons learned from past successes and disappointments with standard reform packages call for humility in this search for the keys to growth. Today this search is even more challenging because short-term global economic prospects are grim. Many characteristics of a good investment climate are common to high-growth countries, such as relative macroeconomic stability, a certain degree of market openness, functioning factor markets, safe property rights, good governance, and increased public spending on education, health, and infrastructure. However, not all need to be perfect at the same time to trigger growth.

Instead, the report focuses on three aspects of policy making that are crucial in shaping investors' behavior:

- *First, the formal rules, regulations, and policies governments formulate in all areas of the business environment.* These range from macroeconomic and trade policies to the microeconomic policies regulating capital, land, labor, infrastructure, and product markets. The focus here is on the rules as they are written and how policies are designed on paper—in other words, “*Is the problem about missing reforms?*”
- *Next, the way the rules, regulations, and policies are actually implemented and enforced.* Whether it is the government or state agencies that directly interact with firms or the institutions that regulate markets and enforce property rights, every area of the business environment is supported by public institutions that should implement the rules and regulations that policy makers enact. Depending on the quality of these institutions—in particular how much they are immune from arbitrary political influence—this is done more or less consistently, equitably, and efficiently. These features of government and state agencies, both actual and

perceived, are what matters for firms when they assess how the rules, regulations, and policies will be applied to them. Thus, going beyond standard benchmark indicators of policy reforms, we ask *whether the problem is with the way rules and policies are implemented*.

- *Finally, the shaping of investors' expectations about future policies and how they will be implemented.* The credibility of governments and the signals they send to firms are central to entrepreneurs' investment decisions. The current rules and policies and how they are implemented matter for firms, but anticipation about how these will evolve in the future are also crucial to assess the expected risks and returns of investments. Here, the report emphasizes the role of political economy factors—the demand for reforms, as well as their supply as shaped by features of decision-making institutions—in affecting expectations and weakening the credibility of government policies in the eyes of investors of the region.

Is It about Missing Reforms?

Not only. Policy gaps remain, but the private sector's response to reforms has been weak.

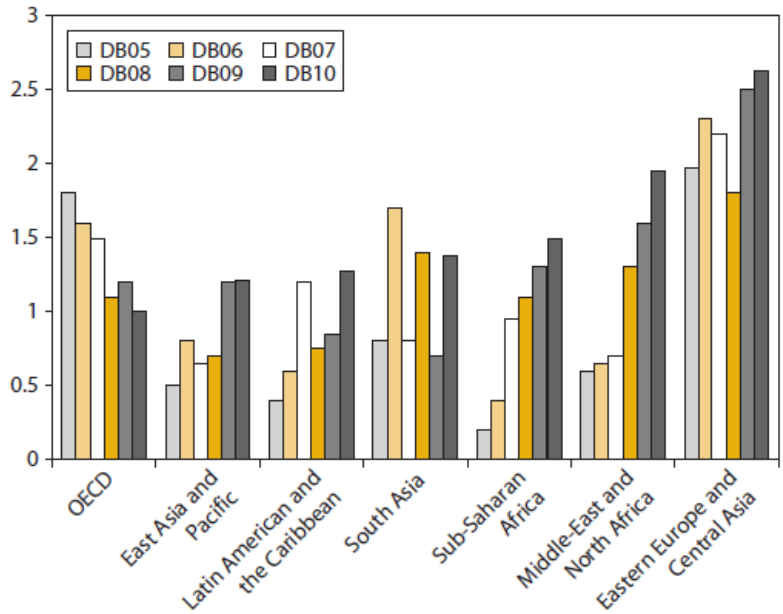
Reforms have accelerated, even if wide policy gaps remain in some countries and in some areas. Most governments have improved the business environment by simplifying business regulations, opening up the financial sector, and reducing restrictions to trade and investment. All international indices of the business environment point unequivocally to improvements. For example, in the area of business regulations that are measured by the Doing Business report, the average number of reforms conducted in MENA countries has been increasing steadily over the last few years (figure 0.3). Even if the reforms measured by the *Doing Business* report do not span all areas of the investment climate, they are good proxies of reform trends. The same positive trend has happened in the areas of macroeconomic management and trade and investment openness.

The private sector has responded to the reforms and grown— Private investment rates have increased by 2 percentage points on average. The response has been higher in resource-poor countries that have been the most ambitious and consistent in reforming—such as in Jordan, Morocco, Tunisia, and, more recently, Egypt. Foreign investment had also picked up significantly before the current downturn, although the majority has been concentrated in energy, infrastructure, and real estate, much less in technology-intensive ventures. Another reflection of this dynamism is that historically low business entry rates have, over recent years, slightly surpassed that of other developing regions.

—but the response has been far below what similar reforms have produced in high-growth countries. Private investment rates in MENA have on average been less responsive to reforms than elsewhere (figure 0.4). Between 1990 and 2007 private investment rates increased slightly in some MENA countries and declined in others—in contrast to other countries such as like China, Malaysia, Poland, Thailand, and Turkey. Is this because those countries reformed more than MENA countries? The answer is *no*.

FIGURE 0.3

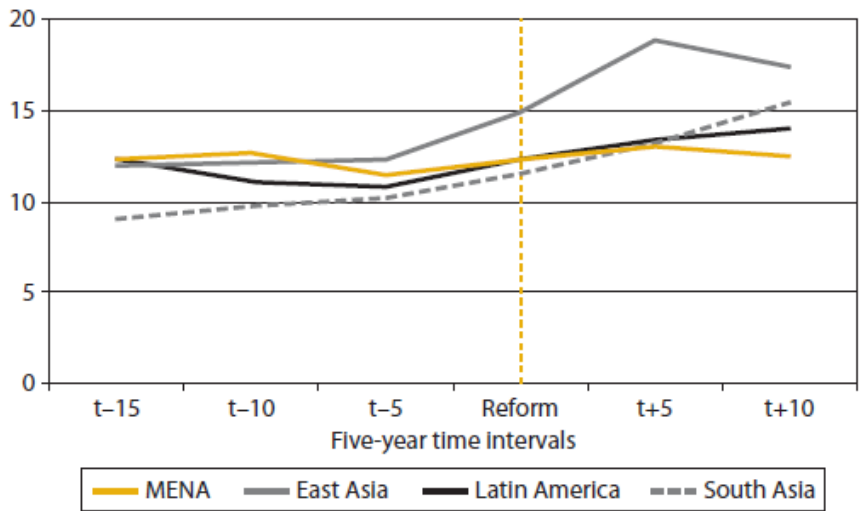
The Number of Regulatory Reforms Has Increased Recently in MENA Countries
(average number of regulatory reforms per country, as measured by the Doing Business report)



Source: Doing Business reform database (www.doingbusiness.org).

FIGURE 0.4

Reform Episodes and Private Investment Response
(private investment, % GDP)

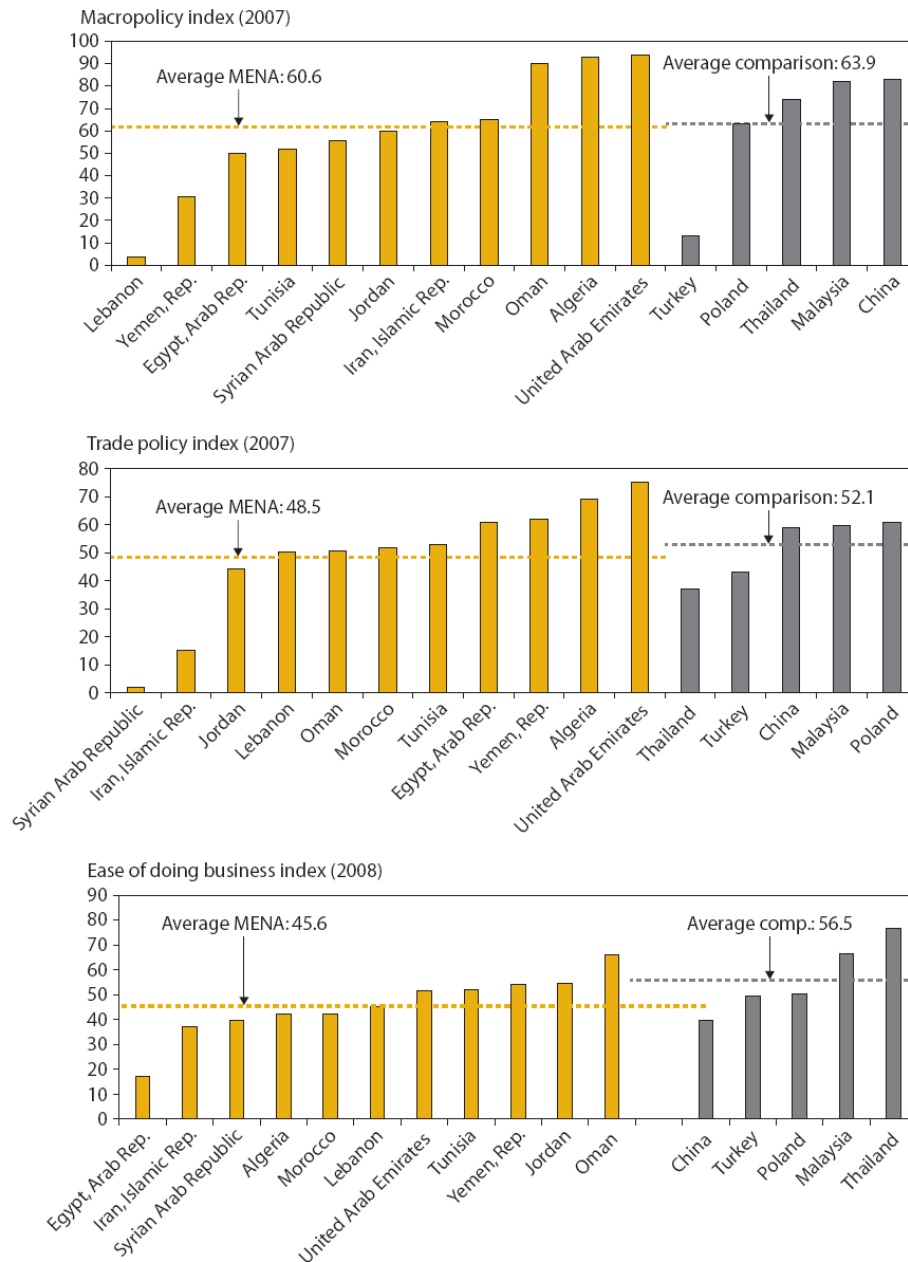


Sources: Private investment rates are from the *World Development Indicators*, national accounts, and IMF and have been averaged over the five-year periods. Episodes of reforms are based on the Economic Freedom Index of the Fraser Institute (www.freetheworld.com), and a reform episode is defined as a five-year episode during which this 0–10 index permanently improved by at least one unit.

The lackluster response apparently is not due to insufficient reforms in the region. The usual indicators of market-oriented reforms are not that much worse in MENA countries than those for high-growth countries (figure 0.5). The gaps are too small to explain the difference in performance. With few exceptions, due to the reform deficit in some oil-rich countries, the region’s rank in the world is “average,” as are those of China, Malaysia, Poland, Thailand, and Turkey.

FIGURE 0.5

Overall, the Business Environment in MENA Countries Looks “Average,” as It Does in Many Fast-Growing Economies



Sources: Doing Business database, IMF, WTO, UNCTAD and World Development Indicators, and authors' calculations.

Is It about the Way Rules Are Implemented?

Yes, the business environment is not the same for all: discretion, arbitrariness, and the unequal treatment of investors abound.

Policy uncertainty and discretion in implementing the rules constrain investment. Investors in MENA—especially managers of small and medium-sized firms—consistently point to policy uncertainty and an uneven playing field that favors some incumbent firms at the expense of new entrants and competitors. Corruption, anticompetitive practices, and regulatory policy uncertainty all rank high in the minds of business managers (figure 0.6). In many countries, businesses also point to reform gaps in the regulatory environment, in access to finance, and in access to land. Rather than policies as they appear on paper, a large part of the problem seems to lie with the unequal, discretionary, and preferential implementation of policies. Surveyed firms often refer to the implementation of rules and regulations as inconsistent and unpredictable (figure 0.7).

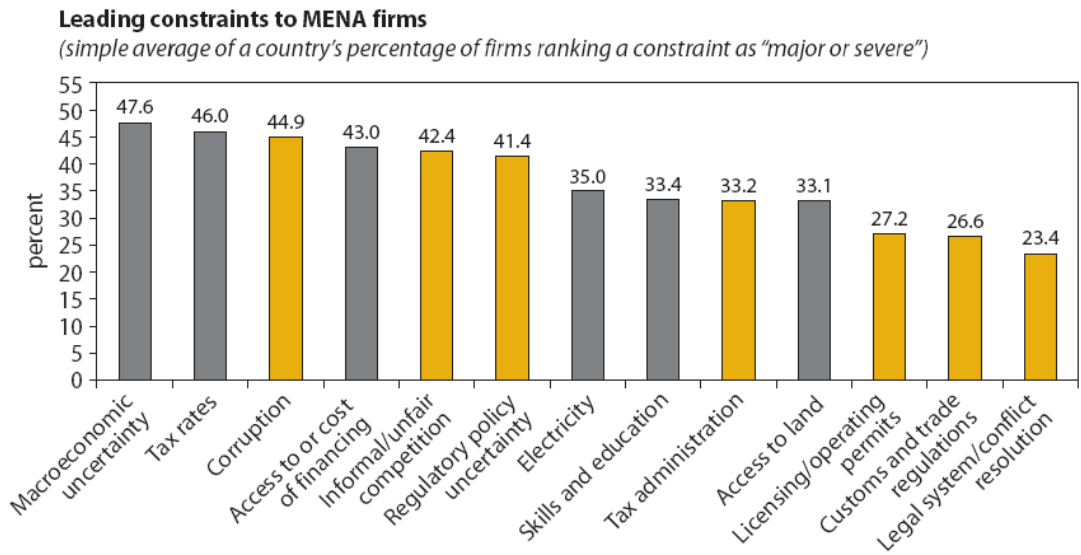
Other symptoms of a business environment that is not the same for all can be identified: older firms, lower business density, and little competition point to a prominent role for incumbents. Firms in MENA are much older than in other parts of the world and almost 10 years older than in Eastern Europe (figure 0.8). Business managers are also older than elsewhere. Incumbent firms face less competition. Except in South Asia, fewer registered firms per capita are found in MENA (figure 0.8). These are all symptoms of a discriminatory business environment that prevents the entry and exit of firms.

Although policy reforms are necessary in many areas and many countries, the mix of imperfect rules with the unequal and discretionary implementation and enforcement of these rules is what hinders private sector development in the region. The common problem boils down to the role of the state and its institutions in various areas of the business environment. The report goes beyond the laws and the regulatory frameworks in place, to dig into the role of the state in credit and land markets—access to both is problematic in most MENA countries. It also covers the area of industrial policy that has attracted renewed attention lately. It illustrates, in each area, the wide gap between enacted policies and the behavior of institutions that implement them. This is best shown in these three topics, but the argument extends to other areas of the business environment where discretion and favoritism can weaken the public institutions that implement private sector policies and the credibility of government commitments to reform. Both hurt the expectations of investors and limit investment, competition, and innovation.

The challenge for the governments is to implement policies that give clear signals to investors and strengthen their credibility as they work to level the playing field for all investors. Strengthening and sustaining growth in MENA will depend on whether the region's policy makers will be able to convince existing and would-be investors that they are ready to reduce the unequal and discretionary ways of implementing policies. Only then will policy reforms have the expected impact on private investment and growth. However, changing expectations of investors by getting at the root of the rents and privileges is also difficult, because it requires shifting the balance of each country's political economy.

FIGURE 0.6

Policy Uncertainty and the Unequal Implementation of Rules Are Leading Constraints to Businesses



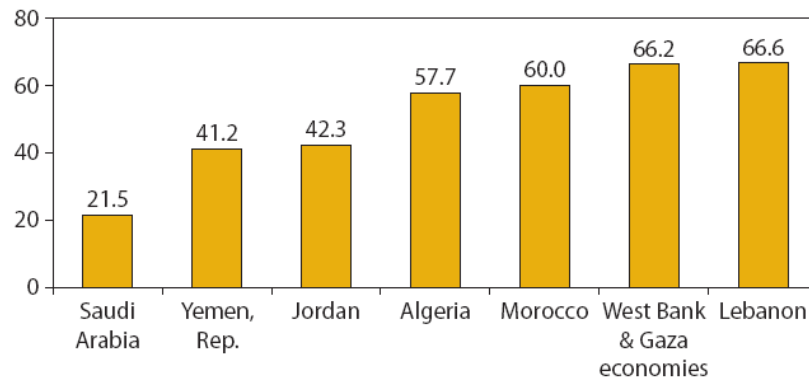
Note: Constraints related to policy uncertainty and policy implementation are highlighted in yellow.

Sources: World Bank Enterprise Surveys of Algeria, Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, Oman, Saudi Arabia, Syria, West Bank and Gaza, and the Republic of Yemen economies, various years.

FIGURE 0.7

Perceptions about the Consistency and Predictability of Rules and Regulations as They Are Applied in MENA Countries

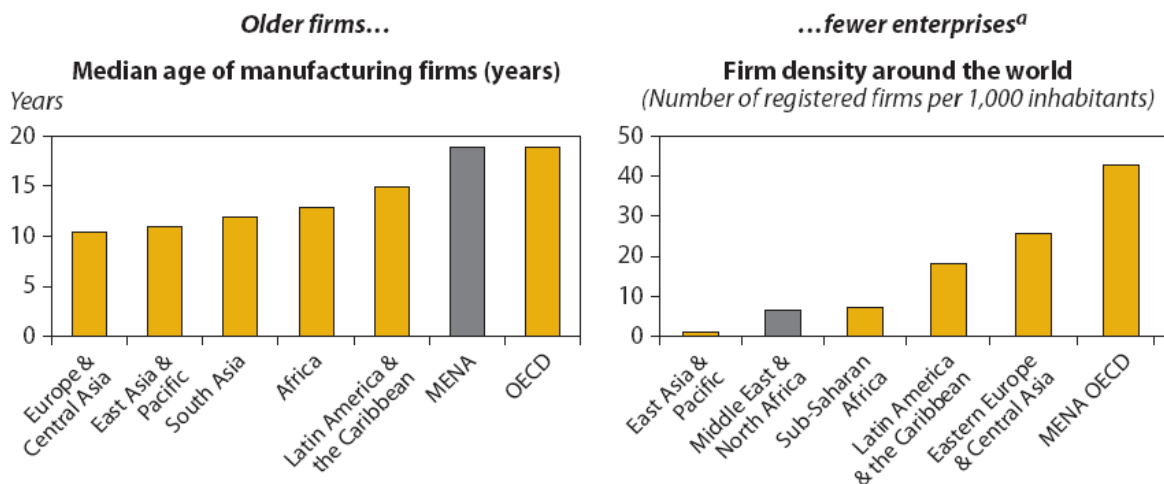
Interpretations of regulations are consistent and predictable.
(percent of respondents disagreeing)



Source: Investment Climate Surveys (2005–08).

FIGURE 0.8

The Lasting Influence of the Business Elite and the Lack of Dynamism and Competition in the Private Sector



a. Note that despite the strong growth, firm density in Asian economies is particularly low. This is driven by China's and India's high (rural) population and the fact that firm density counts only *formally* registered firms per capita.

Sources: World Bank Enterprise Surveys of manufacturing firms in Algeria, Egypt, Jordan, Lebanon, Morocco, Oman, Saudi Arabia, Syria, West Bank and Gaza economies, and the Republic of Yemen (various years) and World Bank entrepreneurship database.

Why Is It Difficult to Improve the Business Environment in the Region?

It requires facing political economy factors that undermine support for reforms and the ability to pursue them.

Weaknesses in the business environment relate, in part, to the extent of discretionary allocation of rents to the private sector. This situation calls for reforms that alter the relations between policy makers and the beneficiaries of privileges. Credibility with investors, public officials, and the broader public will be earned only if political leaders commit to dismantling the rent allocation channels that weaken the regulatory and administrative functions of the state in many areas of the business environment. The rents vary from country to country. They are more prevalent and widespread in oil-rich, labor-abundant countries where the rents are larger and the pressure for reform is easier to contain, but they also remain pervasive in resource-poor countries. Some smaller states of the Gulf Cooperation Council (GCC) have created a more business friendly environment, with Dubai leading the way and Oman and Saudi Arabia catching up. The political economy, however, of these countries—where government leaders may often be the business leaders—does not offer a viable model for imitation in other larger MENA countries, where the political economy is more complex.

The political economy that prevails throughout most of the region limits the willingness and ability of policy makers to reform. First, demand for reform is weak. In transition countries where the private sector has grown more diverse and more vocal (such as in Eastern Europe), pressure on policy makers to extend the reforms has grown. This has not been sufficiently the case in the MENA region, as incumbents and beneficiaries of the status quo are more vocal and better organized to protect their rents. Also, the supply of quality reforms is hindered by policy-making institutions that lack credibility of commitment. The region lacks the institutions that would limit discretion and arbitrariness by public officials.

Weak Demand for Reform: A Private Sector That Has Yet to Become an Agent of Change

The private sector in most MENA countries has not been a loud and unified voice for reform. The part of the private sector described as “rent seeking” has been more vocal in promoting protection and the status quo. Advocacy for reforms has not yet found substantial support from generally weak, unrepresentative, or nonindependent business associations. Depending on the country, the most prominent of these are either government controlled or are dominated by large, old firms that favor the status quo or selective interventions and protection in their favor. In many countries, the “new” private sector of recent entrants and smaller firms has yet to organize to better advocate for change. In many countries they are constrained from doing so because independent organizations are either not allowed (as is the case in at least five countries) or are effectively barred from freely voicing criticisms of government policies. A survey of the most important business organizations in MENA, conducted in 2007, showed that their policy advocacy priorities are narrower and more sector specific than the policy priorities for growth emphasized by the majority of enterprises. Given the limited activity of civil organizations and the lack of a free press in many parts of the region, one finds little counterbalance to official business associations in policy dialogue (where it exists).

Enabling the entry of new investors and allowing more private voices to be heard will progressively shift the balance from the incumbent, often rent-seeking private sector to the developmental, competition-oriented private sector. The private sector in MENA countries has already grown more diverse. New business associations have emerged—some representing new, young entrepreneurs, as in Algeria or Syria; some from specific regions or sectors, as in Algeria, Jordan, and Morocco; and some representing distinct categories of firms such as small and medium-sized enterprises or exporters, as in Egypt. Even the incumbent leadership of large business associations are increasingly challenged by younger, more growth-oriented entrepreneurs—as was the case recently in Algeria. These new voices are often more vocal in demanding pro-growth reforms. If entry barriers continue to be lowered, these private constituencies will grow even more diverse, and pressure for reform will increase. Even partial reforms can trigger a self-sustaining dynamic process. The entry of more new players increases the support for further reform, leading to even more new entrants, which can eventually tilt the political economy equilibrium. This, however, will require a new partnership between policy makers and their private constituencies—one that guards against capture, that is transparent, and that allows for all voices to be heard.

Weak “Supply” of Reforms: Policy-Making Institutions That Lack Credibility

Insulating key institutions from discretion and capture has been central to the success of East Asian growth strategies. Differences in the role given to key institutions, and the rules based on which they function, explain how apparently similar countries—in terms of their progress in economic and political reforms—enjoy very different levels of credibility and confidence in the eyes of investors. In established democracies, systems of checks and balances—in particular, periodic elections and the separation of powers—ensure, even if imperfectly, that political leaders cannot systematically use state institutions at their discretion for the benefit of a few private interests. In less mature democracies or in autocracies, other means can be put in place to guard against capture. The aim is to ensure that the process of policy making as well as key government agencies have built-in rules and features that shield them from arbitrary and discretionary influence by politicians. For example, in some of the world’s most economically successful countries of East Asia, political leaders have allowed an institutionalized ruling party or a meritocratic public administration to emerge. China, Korea, and Singapore have devolved authority to the institutions through substantial information flows and a system of incentives that rewards behavior that promotes growth. Private investment in China soared after the decision-making institutions undertook major internal institutional reforms that increased the predictability of career paths of officials, that rewarded growth-oriented behavior, and that devolved power from the central rulers to lower level officials. Similarly, the strong central ruler of Singapore devolved substantial authority over economic decision making to a professional, merit-based civil service.

In contrast, in many less successful countries, decision-making and government institutions that regulate the markets and interact with firms are subject to arbitrary intervention by political leaders and public officials, to secure their power and extract rents. For example, in a number of other East Asian countries with imperfect democratic institutions, political leaders relied more on political strategies rooted in selective benefits, with policy decisions dominated by discretionary and personal allocations of publicly controlled assets to maintain loyalty. In the latter group of countries, the size of the entrepreneurial community that felt insulated from arbitrary decision making is correspondingly smaller, because it includes only groups that are connected to the political leaders. For historical reasons MENA countries find themselves largely in the latter group.

Policy-making arrangements that substantially devolve authority from central rulers to broad, rule-based institutions find no equivalent in MENA. The region has yet to move away from relationships between narrow political and economic elites that are not transparent and that undermine competition and pro-growth policies. A larger group of civil servants needs to be able to believe their careers will depend on their success in promoting private investment. The locus of decision making and policy implementation in MENA countries—parties and public administrations—are not “institutionalized” when compared to East Asia, for example. They are not rule bound, they do not reward allegiance to those rules and the institutions, and they are often not able to act independently of political interference or to challenge it. Improving the effectiveness of private sector policies will require reforms that change the incentives for all institutions that interact with firms and regulate markets. Only then will policies be implemented more equitably and with less arbitrariness. In turn, for these reforms to

carry enough credibility in the eyes of investors, they will require a change in the institutional arrangements for policy making.

Cohesion between stakeholders and mobilization around a clear long-term economic strategy is also lacking in many countries— reflecting in part the lack of a consensual commitment to the growth objective. Few countries of the region have devised a clear long-term economic growth strategy. Sectoral ministries often have strategic plans, but rarely are they part of a consistent comprehensive approach. Coordination and cohesion between ministries is often weak— generally reflecting divided political elites. Some stand as exceptions here, but the mobilization among all stakeholders around a common long-term economic goal—a strong feature of the East Asian growth successes—is rare in the region.

What Should Be Done Differently? Where Should Each Country Start?

Build credibility and support by removing rents and fostering competition, reforming institutions, and promoting more inclusive policy making.

Make investors confident that things are really changing in a sustainable way. Some reform strategies may be appealing but are less useful from a credibility standpoint. If investors fear unequal and discretionary implementation of policy reforms, then they need to be accompanied by administrative reforms for transparency and accountability of the institutions that implement them. Only such reforms will give investors confidence that even-handed implementation will be sustained.

The mix of policies that will carry the greatest credibility in the eyes of investors varies by country. Where to start to signal that “change is real” is usually common knowledge among local stakeholders. Reform priorities and the pace of their implementation must be adapted to local circumstances, but local investors, policy makers, civil society, and the public usually share a common knowledge of what would signal a fundamental change.

To signal their commitment to growth, governments should focus on three things: removing sources of rents and barriers to competition, reforming institutions to reduce arbitrariness, and broadening the process of policy making and evaluation. Short of such a fundamental shift in the way that private sector policies are formulated and implemented, investor expectations that governments are committed to reform will remain weak. Investment responses will be muted by weak government credibility and lack of institutional progress to underpin policy reforms. The impact of any reform will be low if investors do not believe that changes are real, deep, and set to last.

Getting Specific: A Roadmap for Credible Private-Led Growth Strategies in MENA

First and foremost: reduce the major traditional channels of rent allocation, and foster competition.

With the proper regulatory environment, governments can encourage entry in all sectors of the economy by removing formal and informal barriers to competition. This is a prerequisite for reducing rent seeking and fostering the emergence of a more diversified private sector that will, in turn, pressure government for more pro-growth reforms. This applies particularly to oil-rich countries outside the GCC that have had the budgetary means to delay these standard reforms and protect failing (public or private) industries. A priority for them will be to catch up with the rest of the region's more advanced reformers. Short of that, other low-grade reforms or interventions will have little impact on investor expectations.

Specifically, Depending on each Country's Situation, this Reform Agenda Entails the Following Actions

- ***Increase openness to competition, particularly foreign competition, through trade and investment.*** Examples include: (1) opening protected sectors such as retail and real estate, which have barriers to foreign investors in many Gulf countries, Egypt, Syria, and Tunisia; (2) reducing tariff bands and nontariff barriers; (3) removing protection of state-owned firms by enforcing hard budget constraints and exposing them to open competition; and (4) eliminating anti-export biases, such as the explicit surrender requirements on exports still in effect in a few countries (such as in Algeria, where 50 percent of export receipts need to be surrendered). Such measures will foster more openness and competition and will unravel many bastions of rent.
- ***Remove formal and informal barriers to new entry of firms*** by eliminating entry requirements that give discretion to public officials to exclude some investors (and advantage others)—such as sector-ministry approvals in effect in many activities in Algeria, Egypt, Syria, and Tunisia. Other barriers include high minimum capital requirements and restrictions on foreign ownership in certain sectors, in effect in Algeria, the Islamic Republic of Iran, Libya, Syria, Tunisia, and some GCC countries. The most important policy initiatives to develop small businesses should focus on easing entry and formalization, to increase competition. Beyond formal requirements to business creation, the focus should be on the other barriers to entry that stem from high operating costs, difficulty accessing inputs and factor markets, and difficult exit of firms.
- ***Improve the governance of the banking sector by increasing entry and competition among all banks—public and private.*** Countries where state-owned banks still dominate should engage in open and transparent privatization transactions. Algeria, the Islamic Republic of Iran, Libya, and Syria should invest much political capital to pursue privatization transactions that would reduce the dominance of public banks. Open and transparent competition in that process will be essential. This increases the value of the transactions and the quality of the investor, but even more important, it signals a change in the way business is carried out with government. Beyond

privatization, all countries should increase banking competition and reduce the room for abuse—for example, by limiting the credit single borrowers can receive from public banks, by publicizing the public bank’s portfolios and all troubled loans, by removing branching restrictions, and by improving the independent supervision of all banks.

- ***Remove the conflicts of interest between politicians and businessmen—or make them transparent.*** This is a difficult agenda, but the first steps would be for reformist political leaders to send strong signals that things are really changing in this area. Particularly in countries that have made the most reform progress in MENA, but where these conflicts of interest still hinder competition in important sectors, bold steps by politicians to divest their current shares in major ventures (often in protected sectors) and to declare their assets would be a break from the status quo. A minimal alternative would be to increase transparency about these ventures and make them public. The presence of political leaders and their families in private markets hurts competition and creates serious conflicts of interest. It also damages the beliefs of other investors that the rules of the game are fair—no matter the extent of the reforms promoting openness.

Second: Reform institutions by anchoring elements of public sector reform in every agency implementing private sector policies.

MENA governments should aim at putting in place good public sector reform features in institutions that deal with the private sector. The goal is to instill a culture of equitable and effective public service to businesses, exempt from discretion and interference. This requires building strong rule-bound public institutions, delegated with substantial decision-making power over economic outcomes. It also requires increasing the transparency and accountability of public institutions that interact with the private sector and regulate markets.

This wide-ranging public sector reform agenda could be started one institution at a time, focusing on ones in which discretion and arbitrariness are highest. In some countries of the region, this could be the tax authority, the customs, or the land administration. In others it could be the licensing and inspection agencies.

These Reforms Entail the Following Actions:

- ***Put in place a continual process of regulatory and procedural reform that reduces the room for discretionary (and rent-oriented) behavior by public officials.*** This institutionalized process should continually evaluate and review regulatory and administrative barriers. It would do the following:
 - Systematically reduce the number and complexity of administrative steps in every significant interaction between businesses and public officials

- Publicly establish quality standards (legality, efficiency) for new laws and regulations and a transparent system for enforcing these standards
- Ensure that laws and regulations are clear and publicly available, with little room for interpretation
- Systematically introduce simplified, reengineered electronic processes (e-government) in administrative interactions that allow it
- ***Increase transparency and access to information for more accountability in every public institution that interacts with the market.*** Implementing measures to improve access to information would signal a serious and significant drive toward increased transparency and accountability (and a radical change from the status quo). These measures are difficult to reverse. Even if they are implemented partially and applied to just a few institutions, they will begin to have an impact. Transparency is contagious: pressure on other institutions to follow suit would quickly increase. Such measures include the following:
 - Launching independent, regular, and publicly available measurement of the performance of public agencies in contact with the private sector. This would help to instill a culture of accountability in these institutions.
 - Opening access to business information from various institutional databases—and introducing freedom to conduct independent surveys and research.
 - Systematically publishing information on transactions involving privatizations, public land transactions, subsidies, and procurement tenders—particularly information on the beneficiaries—and on court decisions on commercial litigation.
 - Creating a unified interagency enterprise identification number, to link the firm-level databases of all public institutions that deal with businesses and making most of the data open and accessible. No MENA country has implemented such an identification number so far, and doing so could be a major step toward more transparency.
- ***Reform incentives in public agencies and encourage institutional innovations to improve effective and equitable service delivery to businesses.*** Rewarding effort for effective public service (such as performance based compensation in public institutions) and discouraging discretion in key institutions that affect the business environment in MENA should form the core of private sector strategies. These reforms are part of core public administration and civil service reform agendas. Some could be initiated one institution at a time. Areas in which to start include the customs, the tax authorities, the industrial land administrations, and the agencies regulating investment approvals and business entry.
- ***Increase autonomy of state institutions from the control of the executive branch and political leaders.*** Institutions such as the competition authority, the regulatory agencies of various sectors, the financial regulators (including the central bank), the audit authority, and the judiciary council usually report to the head of state in most MENA countries. The power of

appointing senior administration officials is also concentrated with the head of state. Reforms that increase the autonomy of institutions— for example, by shifting reporting requirements and accountability to parliaments—would go a long way to improve their credibility.

- ***Introduce systematic, independent, transparent, and regular evaluation of any selective public intervention, including industrial strategies.*** Public interventions in support of select groups of firms (exporters, small and medium-sized enterprises, or specific sectors) should systematically include features that will guard against failure and rent seeking:
 - Measurable objectives, outcomes, and selection criteria would form the basis of a monitoring system for the intervention. Monitoring reports should be public and, where possible, the subject of consultation with relevant stakeholders.
 - Systematic publication of information on beneficiary firms and the subsidies they receive.
 - Independent access to data and surveys to evaluate and monitor interventions. When feasible, impact evaluations should be built in at the start of any intervention.

Third: Mobilize all stakeholders around a dedicated long-term growth strategy.

This will require building reform alliances and institutionalizing the reform process. In many MENA countries, reformers are in the minority in a system skewed toward the status quo. In these situations, only broad and vigorous coalitions can sustain successful reform efforts. A new form of partnership is needed between the government and all stakeholders—inside the different parts of government and with the private sector especially. These partnerships should lead to the development of stronger reform alliances and to more open and broader participation in designing, implementing, and evaluating policies. Mobilizing forces inside and outside governments on a credible long-term growth strategy—supported by strong political leadership—has been a common characteristic of all countries that have sustained high growth rates over long periods of time.

This Agenda will Entail the Following Actions

- ***Improve government cohesion and interministerial coordination.*** Poor coordination is symptomatic of low-performing decision-making processes. It is very hard to tackle, and it takes more than creating multiministerial committees that abound in the region. It requires that the locus of coordination be a politically strong body that has explicit and visible political backing from the top leadership of the country (for example, a high-level reform council chaired by a top-level politician, or a visible interministerial group chaired by the head of state or prime minister). Quite often in MENA countries, the lack of coordination between different ministries dooms multisectoral reforms and encourages a proliferation of uncoordinated actions that are the responsibility of single entities. In some cases, four or more ministries can have prerogatives that are directly linked to the private sector agenda. Reformist ministers of the region are often

constrained in the extent of their reform efforts by the limited scope of their ministerial responsibilities and the lack of coordination with other ministers.

- ***Build partnerships between governments and other stakeholders, especially the private sector. This requires the following:***
 - Freedom for the private sector to organize in independent organizations, to raise funding from members, to obtain economic and policy information, to inform open policy debates, and to advocate for policy reforms. Such freedoms are not granted by law or in practice in at least six MENA countries.
 - Capable and inclusive business associations. Most independent business associations in MENA countries are either small—lacking advocacy or organizational capacity—or are controlled by a few prominent members. Business associations growing out of a rent-seeking business environment tend to be rent seeking. If the freedom is granted to create independent associations, then it will be up to the business community to engage in more active and organized advocacy. The government should have no active role in this area other than to remove barriers to entry and to increase transparency in its consultations with the private sector.
 - An institutionalized, transparent, and inclusive process for private sector consultation in the identification of policy issues, the design of reforms, and the monitoring and evaluation of their implementation.
 - More freedom of information relevant to economic policy, administrative performance, and markets to allow stakeholders to hold government accountable, to participate in dialogue, and to reduce uncertainty.
- ***Mobilize all stakeholders around a clear long-term growth strategy.*** Institutionalizing a reform process requires that it be part of a clear long-term strategy with measurable objectives, action plans, and responsibilities. It also needs to be carried by strong and cohesive leadership. Few MENA countries have communicated such a plan. Communicating the reform strategy, its implementation, and its evaluation should be an integral part of any successful private sector reform effort. Moreover, generating consensus may also require compensation of losers by putting in place an efficient social protection system that dampens the inevitable adjustments involved in economic transformation.

Looking Forward

A time of challenge, a sense of urgency: seizing on current opportunities to unlock the region's private sector potential.

MENA is at a crossroads. Reforms have progressed throughout the region, although at different paces. Despite the current global economic crisis, signs of positive expectations about the future and increased attractiveness to foreign investment are visible in almost every country. The coming years will be crucial for the region's economic future. Will the growth revival of recent years and private sector enthusiasm be strengthened beyond the current crisis and sustained? That will depend on the ability of each country's political leadership to commit credibly to change the deep-rooted status quo by pursuing difficult reforms that reduce discretion and inequities in the investment climate.

Despite the complex political economy of each country, opportunities are immense to advance toward sustained growth. Recent reforms that have tackled privileges and rents show the way forward. A more developmental private sector that supports further reform is slowly emerging. Examples can be found in almost every country. Recently successful experiences with regulatory and institutional reforms have reduced entry barriers in Egypt, Libya, Morocco, and Saudi Arabia. Several are leading the way in some areas—banking in Morocco, tax reform in Egypt, business entry in the Republic of Yemen, e-government in Dubai, and customs in Tunisia. Successful liberalization stories abound, such as for telecommunications in Algeria. These reforms have allowed many new businesses to enter the market and have created more diverse constituencies, ones demanding further reform. In Egypt, Jordan, Morocco, the United Arab Emirates, and other countries this new diversity of private sector actors is creating a dynamic of change, pressuring for more reforms. The ability of the rent-seeking private sector to maintain the status quo is diminished—even if it remains powerful in many countries.

All these scattered reform successes show that the key to stronger private sector-led growth is within reach. However, it will take political will—and time—to support sustained reforms that credibly address the real issues holding the region back and meet the expectations of investors and the public. It also will take a renewed and stronger commitment to long-term growth, one that mobilizes all stakeholders. The region's policy makers know the challenges and how crucial a stable and transparent climate for private investment is to growth, job creation, and social stability in their countries. All are endowed with strong human capital, good infrastructure, immense resources for some, and much creativity and entrepreneurship everywhere. The economic and social pay-off of embarking on a more ambitious private-led growth agenda could thus be immense, for all.

Notes

1 These are key messages of the recently released report of the Commission on Growth and Development (2008), “Strategies for Sustained Growth and Inclusive Development” (www.growthcommission.org).

2 These interviews were conducted during various regional conferences organized by the World Bank in different MENA countries over the last two years on the topic of investment and private sector development. Officials invited at these conferences hold positions in ministries and agencies in charge of private sector development. Although these interviews are not a fully representative survey of officials in the region, they nevertheless represent evidence of widely held views. These interviews do not represent quantitative estimates of the extent of actual corruption and rent seeking in the private sector but are meant to highlight the lack of trust between the public and private sector and the perceptions that each group has about the other. These are important issues that affect the credibility of reforms and their impact.