S E C T O R   B R I E F

PRIVATE SECTOR IN MENA

The challenges of job creation, competitiveness and economic transition

Policy makers, citizens and other stakeholders unanimously identify job creation as the key economic challenge of Middle East and North Africa (MENA) countries. With high unemployment rates and a large youth labor force, devising economic policies that will spur private-led growth in the non-oil sectors remains the central challenge of MENA governments today.

To meet this challenge, MENA countries would need to enhance their international competitiveness and spur greater private investment (both local and foreign), by conducting far reaching structural reforms to improve the investment climate and integrate into global trade. This transition to more open, market-based and competitive economies has been slower in this region when compared to other middle-income countries in other parts of the World, like Eastern Europe or East Asia.

Accelerating this transition remains a necessary prerequisite to accelerate growth, as the MENA economies have traditionally been characterized by high levels of government intervention and regulation. In spite of notable reforms in many countries, many of these policies are still affecting the productivity and competitiveness of firms today. However, even where such policies remain prevalent in key areas like business regulation, land and credit markets, these State-centered development strategies have been progressively, if incompletely, abandoned starting in the 1980s and continuing up to the present, in the face of macroeconomic turmoil and rising unemployment which the public sector was no longer able to absorb. Most governments have initiated trade and structural reforms and some are well-advanced. These first generation reforms have improved the macroeconomic framework, reducing price and trade distortions and stabilizing the economy, but they have proven to be insufficient to foster strong private-led investment needed to reduce double digit unemployment rates that threaten social cohesion in many countries. Greater openness to competition is needed to spur productivity growth and innovation. Progress in second generation structural reforms of the microeconomic environment of firms (e.g. strengthening trade facilitation and logistics, credit markets, and the judiciary, and dismantling regulatory and administrative barriers and state-owned enterprises (SOEs)) have been much slower, and even where policies were changed, proved to be more difficult to implement. The recent Doing Business 2009 reports rapid reforms in a few countries (Egypt, Morocco, Saudi Arabia and Tunisia) but a slower pace elsewhere. Recent evidence from the Investment Climate Assessment Surveys also shows that the business environment constrains SMEs more severely than large firms. To accelerate the emergence of more dynamic private sectors and complement macroeconomic reforms, greater attention must be given to the implementation of microeconomic reforms and to entrusting the enforcement of rules to professional, rule-bounded institutions.

Today, all of the region's governments are committed to promoting private sector-led growth by increasingly focusing on second generation reforms. However, the legacy of the past policies combined with high commodity prices have shaped the structure of the private sector in the region, as well as the pace and sequence of reforms. As a result, the formal private sector in MENA remains relatively small. It is often concentrated in a small

Tunisia Export Development Project (EDP I): Results on the Ground

The project: At the time of preparation of the Tunisia Export Development Project (EDP 1) in 1999, Tunisia had made substantial progress in addressing trade policy issues (as manifested by the adherence to WTO and the Association Agreement with the EU). The project therefore aimed to enhance the ability of Tunisian private firms to integrate into the global economy by addressing some of the disadvantages they encountered relative to their foreign competitors. These disadvantages concerned: lack of knowledge of export markets and buyer requirements, inadequate access to export finance for small and medium exporters, and relatively high transactions and administration costs. The project had three components addressing these disadvantages. The components were designed based on global best practice models adapted to the case of Tunisia, and prepared in close collaboration with teams of stakeholders.

What results? The achievements of the project have been remarkable, considering the challenges of the post- September 11th slowdown in trade, the natural resistance to change of relevant government agencies, and on resistance of banks to changing their lending practices in order to serve emerging exporters. Overall, Tunisian private exporters are now better able to integrate into global markets, thanks to institutional processes that have been set in motion to address the three disadvantages that the project had set to tackle:

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1. Thanks to the public-private partnership approach (matching grants) adopted by the project and the creation of an export consulting industry, Tunisian enterprises are now able to obtain relevant information and know-how that help them enter export markets. This has allowed 595 Tunisian enterprises to become new exporters or enter new markets through the project, compared to the appraisal estimate of 350. A stakeholder survey at the closing of the project (March 2005) confirmed this assessment. The participants pointed out that the EMAF program has transformed the private sector views about export services and is drastically shifting the traditional public-sector led export promotion in Tunisia to market provisions through export consultants. For the first time in Tunisia, the private sector is paying for export services and a core of local consultants has been developed around the EMAF program, which is expected to make these market initiatives sustainable.

2. The pre-shipment export finance guarantee (PEFG) facility served as a catalyst and shared some of the non-performance risks of emerging exports with the commercial banks, allowing these banks to realize that they can profitably lend to emerging exporters with viable export contracts but little collateral. About US$34.5 million of additional exports was generated through a US$5 million PEFGscheme.

3. Trade transactions are also more efficient today than five years ago. Tunisian customs is now a more efficient agency and has adopted modern techniques of customs clearance and control. Customs clearance time, for example, is 10 minutes for a declaration not requiring technical control, as opposed to 3 days in 2000. At the same time, security issues are better addressed and the rate of detection of non-conforming cargo has increased through the application of risk management techniques. The manifest processing time (through Tunisia TradeNet (TTN), a Single Window mechanism established under the project) is also reduced from 2 days in 2000 to one day in 2005. Overall, the customs and TTN initiatives have reduced the clearance time for imported goods to an average of 3 days, compared with an average of 8 days at the time of project appraisal, making Tunisian enterprises more competitive and market responsive.

EDP I was followed up with a Second Export Development Project (EDP II), which became effective in January 2005. The focus of EDP II is to build upon and anchor more deeply the institutional reforms started under EDP I.

number of large firms which have benefited from protective policies, and in a large number of micro/small and medium enterprises which often account for much of employment but have little access to formal finance, markets and government support programs. In addition, the informal sector remains large and continues to play a substantial role in generating employment in regional economies. The past protective policies have also implied that the private sector in MENA is struggling to compete with international rivals. In response, some countries have implemented industrial upgrading programs, but these programs often focus on helping declining industries to restructure, instead of creating conditions for the industries of the future to develop.

<u>Priority areas of reforms to improve Private Sector Development (PSD) in MENA</u>

Based on the analytical work conducted recently by the World Bank[1], and on consultations with client governments and other organizations, there appears to be common traits in the main structural issues that are constraining investment and the growth of private enterprises across the region. These include constraints imposed by:

The regulatory and administrative environment for business, which limits entry, exit, growth and competition and contribute to business uncertainty. Economic performance in most of the MENA Region is constrained to a large degree by weaknesses and distortions in the countries' business environments, which act as barriers to entry to new firms and activities and as factors constraining competition by maintaining an unleveled playing field. Potential investors and existing firms in many MENA countries face a web of complex regulations and licensing requirements which are often unclear or inconsistent with international norms. Policy, regulatory and institutional distortions, as well as constraints and barriers to efficient private sector investment, operations and exit, are prevalent throughout the Region. Complexity and the rents created by economic distortions breed administrative discretion and corruption. The "bureaucratic burden" is often especially heavy for small and medium enterprises.

The lack of access to finance. Whether for start-up funding or working capital financing, financial intermediation in credit markets in the region is weak. While this problem is not uncommon in developing countries, it is certainly exacerbated in the region by a combination of supply, demand and market environment issues. On the *supply* side, the financial sector remains heavily dominated by state-owned institutions in several countries, with the well-documented efficiency problems that state-ownership entails. Even when private and foreign banks enter the market, the predominance of public banks often restricts competition. The lack of competition inhibits financial institutions from reaching out to SMEs and from the development of non traditional services such as leasing and factoring. On the *demand* side, firms (especially new and family-owned enterprises) are often financially opaque, and many smaller enterprises lack the financial management skills to develop credible investment plans and often lack sufficient assets for collateral. (Weak property rights systems can further undermine the value of assets in leveraging finance.) Finally, the *environment* of credit markets that both bankers and firms face, further constrains efficient intermediation: credit and market information is often poor and credit bureaus are usually undeveloped or unreliable; collateral legislation is weak and where it is adequate, it is quite often poorly enforced by slow and mostly unspecialized judicial systems.

Inadequate trade facilitation infrastructure and logistics.. Improving the efficiency of trade logistics is a critical priority for private sector development. Experience from other developing countries shows that promoting private investment and integration into global trade go hand in hand and reinforce each other as engines of economic development.

The lack of access to land, and the issues related to its titling and registration. The land markets for industrial and commercial property are generally inefficient in the region. Recent ICA surveys show that the proportion of firms mentioning access to land as a major or severe obstacle is much higher in MENA than in other regions where the same surveys have been conducted. There are usually three types of issues:

First, there is scarcity of investment land in some urban centers even though a lot of land is available in other regions of the countries. This problem is often linked to the quality of infrastructure outside of major urban areas and the poor development of port facilities, which force businesses to try to locate in the big cities, with their superior infrastructure, proximity to markets, and better availability of skilled workers.

Second, there are clear inefficiencies in the land markets leading to rationing and/or price bubbles. Some countries publicly control much land and administratively

[1] For example, ten investment climate assessment (ICA) reports or enterprise survey reports have been completed by the World Bank (Algeria, Egypt, Jordan, Lebanon, Morocco, Oman, Saudi Arabia, Syria, West Bank-Gaza and Yemen.). Updates were completed in Algeria, Egypt, Morocco and Saudi Arabia. New ICAs or updates are anticipated for Egypt, Kuwait, Lebanon, Libya and Syria.