FOREWORD

In the Middle East and North Africa (MENA), the development of a vibrant private sector is essential to fire up the engines of economic growth and that, in turn, is necessary to meet the needs and aspirations of the people in the region. The formal private sector represents a relatively small part of these economies; nonetheless it has the potential to become a powerful driver of job creation and rising living standards in the region. Creating an environment that is conducive to private sector development depends on a detailed understanding of the key determinants of firm performance and the major challenges that firms face, and also the role of government in providing the right business environment.

This is why three of the leading international institutions active in the MENA region, the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the World Bank Group (WBG) have joined forces to produce this report. It presents the results of the MENA Enterprise Surveys (MENA ES) conducted during 2013-2014 in eight economies: Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, the West Bank and Gaza, and the Republic of Yemen. By analysing detailed information on more than 6,000 private firms in the manufacturing and services sectors, the report provides fine-grained insights into their performance and the business environment in which they operate.

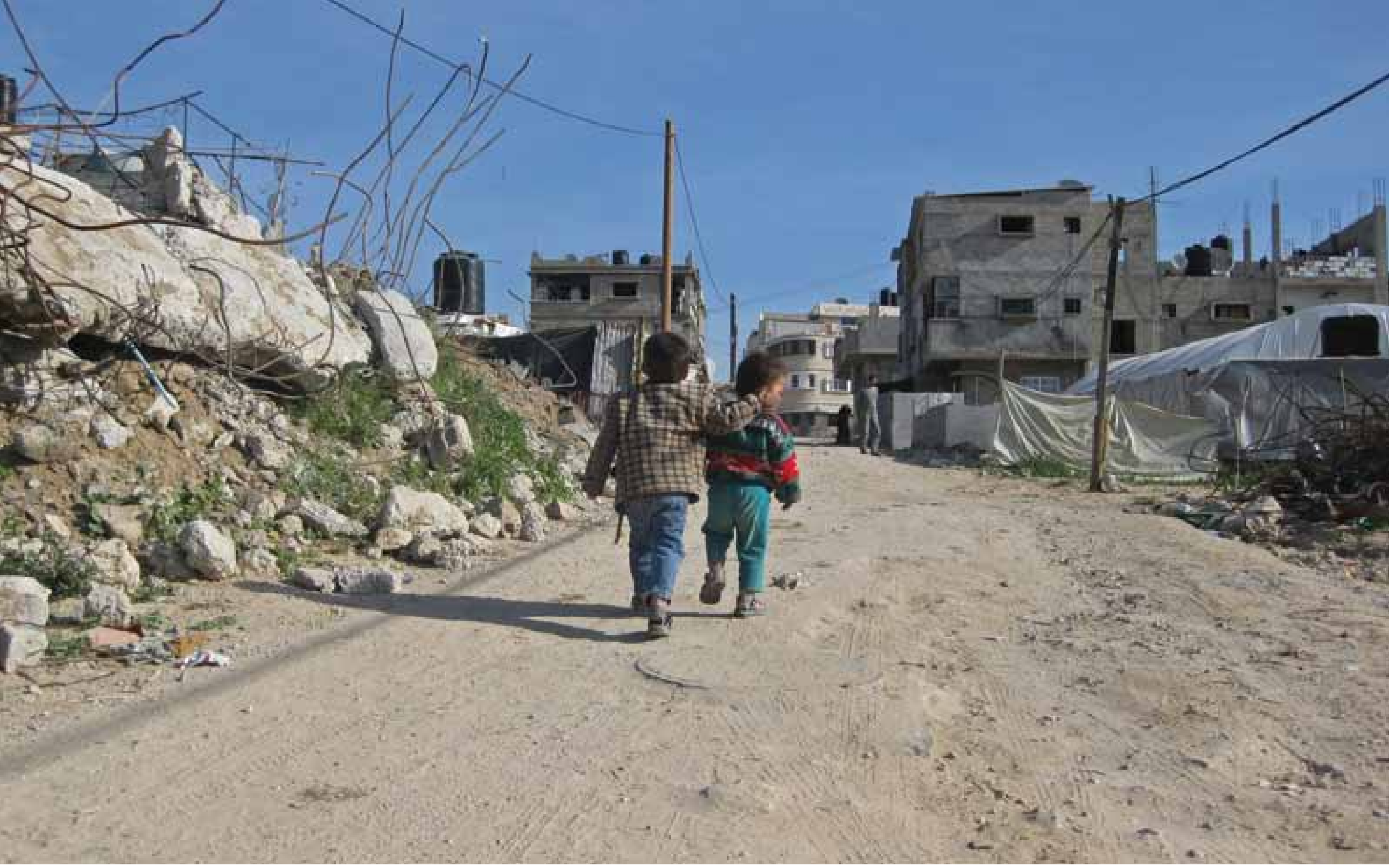
Firms in MENA face many distorting incentives and barriers to competition. On the financing side, many appear to be not so much constrained by financing conditions as completely disconnected from the financial sector, thereby forgoing opportunities for growth. Workforce skills are another constraint, with a need for the re-orientation of education and training, so that workers have greater workplace skill and are prepared for the modern work environment. Enhancing the productivity of firms in the region also requires greater openness to international trade, something which will support innovation by facilitating the acquisition of knowledge about new products and processes.

In 2015, the EIB, the EBRD and the World Bank Group together provided more than USD 7.7 billion in financing for development in MENA. Looking forward, we remain committed to supporting private sector development in the region, each institution according to its strategy and remit, and in partnership with local authorities and stakeholders.

Hans Peter Lankes
MD, Acting Chief Economist
EBRD

Debora Revoltella
Director Economics Department
EIB

Kaushik Basu
Sr. VP and Chief Economist
WB



EXECUTIVE SUMMARY

Over the last few years, the Middle East and North Africa (MENA) region has witnessed unprecedented transformation. In the Arab Uprisings, thousands of young people took to the streets to voice their frustration with the lack of economic and social opportunities. These events reflected demands for improvements in living conditions, infrastructure, job quality, education, and healthcare services, as well as better governance.

The Arab Uprisings were a response to the failure of the region's economic models to satisfy people's needs and expectations. These models typically featured strong protectionism, lack of integration into international markets, misguided state intervention, and inadequate support for a business environment that fosters innovation, entrepreneurship, and good management practices.

Enhancing the prospects for more inclusive growth—with accessible opportunities for sustainable employment, particularly for young people and women—is vital to raise living standards, to underpin stability, and to offer an alternative to economic migration out of the region. There is an overwhelming consensus among economists that the development of a vibrant private sector is essential for delivering that growth. Creating an environment that is conducive to private sector development depends on a detailed understanding of the key drivers of private firms' performance and the major challenges of the business environment in which they operate.

LESSONS FROM THE MENA ENTERPRISE SURVEY

This report is an assessment of the constraints on private sector development, which has been jointly conducted by the three leading international institutions active in the MENA region. The report presents the results of the MENA Enterprise Survey (MENA ES) conducted in 2013 and 2014 in eight middle-income economies in the region: Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, the West Bank and Gaza, and the Republic of Yemen. Implemented and co-financed by the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the World Bank Group (WBG), the MENA ES provides data on a representative sample of the formal private sector.

Covering more than 6,000 private firms in the manufacturing and services sectors, the MENA ES includes data on the experiences of firms with a broad range of dimensions of the business environment, including access to finance, corruption, infrastructure, crime, and competition. The surveys also provide information on firm characteristics and the cost of labor and other inputs; workforce composition and women's participation in the labor market; trade, innovation, and management practices.

This unique set of information is an extremely valuable complement to the macroeconomic data most commonly used by researchers. Firm-level data permit fine-grained analysis of the drivers of firm performance, disaggregating effects by key firm characteristics, such as their size, their sector, their inputs and output, and their involvement in innovation and international trade. The data also provide a window on how managers and CEOs themselves perceive the challenges and opportunities that they face. While the region is far from homogeneous, with managers reporting widely different experiences, analysis of the data helps to provide a basis for sound policies for private sector development.

FIRM PRODUCTIVITY AND THE BUSINESS ENVIRONMENT

While the formal private sector represents a small part of the MENA ES economies, it has the potential to become the driver of a more sustainable model of growth

Firms in the MENA ES have comparatively higher labor productivity than their middle-income peer economies outside the region; yet following global financial turmoil and the Arab Uprisings, their labor productivity has been declining. Moreover, higher labor productivity belies lower total factor productivity (TFP), in part due to relatively high use of capital.

Large firms, which provide the majority of formal private jobs in the MENA ES, tend to be more efficient, but their activities are skewed toward more capital-intensive production. In general private sector firms are typically small, old, and faced with limited growth opportunities.

On the positive side, economic fundamentals seem to be at work in the formal private sector. For example, it is the more productive firms that are the most likely to grow. After taking size into account, the most productive firms also have higher wage bills and greater access to finance. Encouragingly, these positive relationships reveal that in certain areas at least, market forces are working as might be expected. Policies should allow these forces to operate more efficiently.

Addressing key constraints in the business environment is vital to help the private sector grow

Addressing some of the key concerns of firms about the environment in which they operate is a way to unlock their transformative potential. In the MENA ES region, four particular areas of concern stand out: political instability, corruption, unreliable electricity supply, and inadequate access to finance.

Political instability is the leading concern for firms in most of the region, and it has a negative impact on sales and productivity growth

Reflecting the effects of the Arab Uprisings, unresolved social tensions, and conflicts in the wider region, political instability stands out as the greatest concern of firm managers and CEOs in Egypt, Lebanon, Tunisia, the West Bank and Gaza, and the Republic of Yemen. In most of these economies, political instability seems to have negatively affected firm and productivity growth.

High perceived levels of corruption are associated with lower growth of sales and employment, as well as lower labor productivity

Corruption stands out as a key concern of firm managers and CEOs. High perceived corruption is associated with lower sales, employment growth, and labor productivity. There is also evidence that corruption deters firms' interactions with public authorities, preventing them from making full use of available opportunities. In addition, concerns about corruption seem to go beyond petty corruption, possibly indicating deeper problems in the economies concerned, such as state capture by interest groups or elites, corruption at high levels, or even under-reporting for fear of potentially adverse consequences.

An unreliable electricity supply is a serious obstacle for firms in several economies

Unreliable electricity supply remains a significant problem for firms in Egypt, Lebanon, the West Bank and Gaza, and the Republic of Yemen despite efforts by some governments to tackle this problem. An irregular power supply accounts for a significant loss of sales for many firms, and is associated with lower productivity levels.

The relevance of poor electricity access as a constraint on firm growth should be read in the context of the overall institutional framework that characterizes the energy sector in the region. Many economies have used energy subsidies as a safety net when their systems of social welfare have proved inadequate or ineffective. But this is costly and, by distorting prices, there have been systematic incentives to move toward more capital-intensive technologies, linked with a lack of incentives for investment in critical infrastructure, while creating room for vested interests. As part of the reform program in recent years, various international institutions, including the IMF and the World Bank, have called for a comprehensive reform of subsidies to open the way to a more efficient energy sector.

Inefficiencies in the business environment are felt disproportionately by small and medium-sized enterprises

While several elements of the business environment—notably political instability, unreliable electricity supply, and inadequate access to finance—are widely reported as constraints on firms, inefficiencies stemming from these factors have a more negative impact on smaller firms. SMEs are more likely than large firms to report these three elements as major obstacles to their operations, though they are no more likely to report corruption as a major obstacle.

ACCESS TO FINANCE

Financial and banking sectors in the region are relatively large, but credit is mostly channeled to a small number of large firms

The financial sector of the MENA ES economies is dominated by a relatively large banking sector, with loans-to-GDP ratios above the standards in peer economies. Bank lending is highly concentrated, however, with credit targeting only a limited number of large companies, leaving the bulk of firms with little or no access to credit.

MENA ES firms finance their operations and investments in a similar way to firms in peer economies

There is considerable variation in the use of internal funds to finance operations and investments across the region. The use of bank credit and credit from suppliers and customers is in line with peer economies. Equity finance plays a negligible role in the region, while other sources of finance, including microfinance, are only significant in Tunisia and the West Bank and Gaza.

A large share of firms are not credit-constrained

The MENA ES economies have a smaller share of credit-constrained firms than other regions of the world. But this is not driven by successful loan applications; instead, many firms report that they have enough capital and thus do not need a loan.

There is a notable disconnect between firms and banks in the region

A significant share of firms that are not credit-constrained have disconnected from the banking sector altogether. Compared with firms that have encountered difficulties obtaining credit, the disconnected firms are more likely to be small, less likely to have audited financial reports, and less likely to use the banking system even for payments.

Disconnected firms resemble credit-constrained firms, as they both have low propensity to invest and are less likely to plan for expansion, even when capacity constraints are binding. The difference is that disconnected firms seem content with their current situation and do not complain about access to finance.

The business cycle alone cannot account for this pattern as a downturn may prompt firms to seek loans for purposes of liquidity management. It seems that many of the disconnected firms have adapted production strategies to an environment in which they do not consider banks as a financing option, albeit at the cost of reduced growth prospects.

Collateral standards affect firms' propensity to disconnect from the banking sector and ultimately their growth prospects

In the MENA ES economies, more than four in five loans require collateral with an average value of just over twice the loan amount, slightly above that in peer economies. The higher the relative collateral requirements, the more likely young firms are to disconnect from the banking sector. Older firms, on average, have more assets that they can use to secure loans and are relatively less affected by collateral standards. But they also create jobs at a slower rate than young firms and, as such, collateral practices may constrain employment growth.

Regardless of age, firms are less likely to disconnect from the banking sector and more likely to create new jobs if banks accept movable assets as collateral. Since a large share of firms' assets consists of machinery and equipment, banks' willingness to accept movable assets as collateral can be considered a business-friendly collateral standard. This suggests a potential link between the adoption of business-friendly collateral standards and the potential for job creation.

JOBS AND SKILLS

Compared with other regions, formal private sector employment is concentrated in manufacturing and exporting firms; but employment of women is low; and youth employment is strongest in young innovative firms

The structure of employment in the region's formal private sector is in many ways similar to comparable economies elsewhere, although the manufacturing sector and exporting firms play a comparatively larger role in providing employment, with the retail sector lagging behind.

The employment of women in a typical firm is much lower than elsewhere in the world, and the same is true for women as top managers and firm owners. Within the region, the share of women's employment is higher in labor-intensive sectors and among exporting firms. Youth employment is higher among firms that are young and fast-growing, and which tend to innovate.

Firm dynamics are generally weak, but high labor productivity firms are still more likely to grow fast

Overall, firm dynamics are weak in the region: comparatively few firms move between size categories, whether expanding or downsizing. In a difficult period for the private sector in the MENA region, medium-sized firms have been more likely to become small firms and less likely to grow over a three-year period, compared with other regions. Fast-growing firms over the period 2009-2012, however, had higher levels of initial labor productivity, an indication of reallocation of resources toward the more productive firms and a signal of potentially positive private sector developments.

Skills shortages affect the fastest-growing firms

Across the region, firms that have grown the fastest are more likely to perceive the lack of an adequately educated workforce as a major constraint. Unlike other firms, fast-growing firms are also more likely to invest in the formal training of employees, suggesting that the supply of relevant knowledge and skills is a severe constraint for the most promising, high-growth firms in the region.

More productive firms pay higher wages, but larger firms do not

The MENA ES results confirm the expectation that more productive firms pay higher wages. This suggests that labor markets are, to some extent, able to facilitate the reallocation of labor resources to the firms with the most potential to grow and provide rewarding jobs. Nonetheless, such high-productivity, high-paying private sector jobs remain scarce, which is likely to encourage jobseekers to pursue public sector jobs instead.

In most economies, larger firms pay higher wages, but that standard result does not hold in the MENA ES region. It seems that larger firms, which are more productive mostly due to inefficiently high capital intensity, focus on stronger capital remuneration rather than labor remuneration. This gives an indication that distorting incentives, which are at the base of the decision to favor more capital-intensive production, might also affect the quality and remuneration of jobs.

COMPETITIVENESS: TRADE, INNOVATION, AND MANAGEMENT

The growth of the region's small yet productive private sector may be constrained by wider considerations of competitiveness

The MENA ES economies generally perform worse on various global competitiveness rankings than their peer economies in other regions. The apparent inability of the region's small yet productive firms to scale up their operations may indicate distortions and uncertainties underlying the competitiveness of these economies.

The region's exporters are numerous but small, with labor productivity gains concentrated in large "superstar" exporters

Trade per se is not the problem underlying relatively weak competitiveness: firms in the MENA ES economies are more likely to export, to import, or to do both than their counterparts elsewhere, but these firms are also more likely to be SMEs. Furthermore, the average size and productivity differentials between exporting and non-exporting firms are smaller than in other regions. Indeed, the region's exporter size and productivity premia are achieved almost entirely by a small number of superstar exporters. The inability or unwillingness of small exporters to scale up their operations may indicate barriers to market entry or distortions, such as subsidized energy costs.

Access to foreign technology and supply chains can raise the productivity of importing firms

In terms of productivity gains from trade, the winners in the region are importers. This could be due to the access to foreign technology and supply chains from which they benefit. This is despite the fact that importers face considerable obstacles in terms of relatively high tariffs, non-tariff restrictions on trade, and the time it takes for imports to clear customs.

Nearly a third of firms in the region engage in basic forms of innovation

Firms in the region engage in both technological and non-technological innovation, introducing new products, new processes, and new organizational or marketing methods at a similar rate. Much of this innovation activity involves adapting existing products to local conditions or upgrading machinery and equipment, practices that are typical of firms in developing economies.

Innovation by firms is associated with certain supporting conditions: human capital, access to knowledge, and access to finance

Firm-specific human capital—obtained through formal training or by giving employees time to develop new approaches and ideas—is associated with innovation, as is access to knowledge and information and communications technology facilitated by firms. Two-way traders (firms that both import and export), in particular, are more likely to license foreign technology and more likely to introduce technological innovations. Firms with access to credit are more likely to introduce new products and processes.

Innovation is positively linked to increases in labor productivity

Labor productivity gains from innovation are in line with those found in developed economies, but lower than those observed in developing economies. This may be explained by the general lack of competition in many MENA ES economies compared with other developing economies. Returns to innovation vary by sector, with high-tech manufacturers benefitting most from product innovation and low-tech firms benefitting more from non-technological innovations.

Poorly managed firms benefit more from improving their management practices than from innovation

The quality of management practices is positively correlated with GDP per capita but not significantly associated with firm-level labor productivity, except for firms that score below the median for their management practices. While better-managed firms are more likely to benefit from innovation, poorly managed firms are more likely to benefit from improving their management practices.

In economies with lower energy subsidies, better management practices are associated with lower energy intensity and higher labor productivity

Where energy subsidies are high, better management is associated with the opposite effect: higher energy intensity and lower labor productivity.

CONCLUSIONS

The formal private sector in the MENA ES economies is relatively small, but its size belies its significance for economic development. The labor productivity of formal private firms in the region is higher than that of their counterparts in comparable regions of the world; yet TFP lags behind. Many firms are successful in enhancing their productivity though significant engagement in innovation and international trade. The more productive firms in the region are able to grow faster and pay higher wages to attract workers. This suggests an encouraging potential for MENA economies to reallocate resources to the most promising firms.

In this way, it is possible to see the potential of the private sector in the region to grow and meet the aspirations of the growing workforce for rewarding employment. Indeed, it is through more widespread employment creation that private sector growth can principally be expected to contribute to a more inclusive growth model in the region.

At the same time, it is essential to understand that firms operate under conditions that are often very difficult. Distortive incentives push large firms toward inefficient more capital-intensive production models; SMEs face limited growth opportunities and are more negatively affected by the business environment. Almost all firms in the region are severely affected by issues of political instability, corruption, and unreliable electricity supply. Firm innovation and growth are also constrained by barriers to trade and a scarcity of appropriately trained workers. In many places, there is a striking disconnect between firms and formal financing channels, with the result that firms are not seeking external finance, inevitably reducing their growth potential.

Strategies to support firms in enhancing their productivity—as well as the process of resource reallocation toward more productive firms—should be a high priority for public authorities in the region. The report suggests some key areas for policy attention. These include looking at the complex system of distortive incentives, privileges, and barriers to competition, as well as their intended and unintended consequences.

Policies to improve the business environment

Achieving political stability is obviously a critical issue. Across many of the economies, tackling corruption and an unreliable electricity supply are also likely to be important priorities. Corruption may be deterring many firms from strategies that require engagement with public authorities, limiting their opportunities. Dealing with the reliability of electricity may also depend on a policy approach that addresses corruption and vested interests.

More generally, the region is known for a large number of distorting incentives, which form the basis of the current system of transfers. Unintended consequences are often addressed by adopting new and potentially distorting incentives. A serious reassessment of distorting incentives, transfers, privileges, and barriers to competition is of central importance.

Policies to enhance firms' access to finance

While disconnecting from the financial sector is a choice that many firms make, the fact that this has an impact on their growth potential reveals the need for policy action. Several issues may need to be addressed to facilitate firms' access to finance, to encourage them to connect with the formal financial sector, and to seize opportunities for growth that rely on external financing.

Capacity building for banks to strengthen their credit risk assessment would help those interested in lending to SMEs, without putting financial stability at risk. This should be accompanied by reforms to establish modern secured transactions laws and an efficient collateral registry; to introduce credit guarantee schemes to alleviate collateral constraints; and to build capacity for SMEs to improve their transparency and reduce the information asymmetries.

Policies for better education, employment and skills

With regard to employment in the formal private sector, there is considerable scope for improvements, particularly in relation to women's employment. Supporting the expansion of labor-intensive and exporting sectors may help to provide more jobs for women, but opportunities are also required in capital-intensive sectors. Measures that support the emergence and growth of young innovative firms are likely to be particularly positive for the employment of young people. They will also boost aggregate productivity growth and raise living standards through better-paid jobs.

A re-orientation of the region's education systems toward learning skills that are relevant for private sector employment—with greater status given to vocational training—will facilitate the growth of high quality employment. Fast-growing and more productive firms are already providing more training to their employees as well as better-paid jobs. More appropriate education and training of young people before they join the labor market would help to address skill shortages in these firms.

Policies to promote trade, competition, and innovation

Enhancing the productivity of firms in the region requires greater openness to international trade. In particular, this means more effective customs and trade regulations—both in terms of imports and exports—and reducing entry costs for all firms. Importing should not be viewed solely through the lens of trade deficits and foreign exchange reserves; imports allow firms to source component parts of better quality or lower cost than those available in the domestic market. They also facilitate the acquisition of knowledge about new products and processes.

Other essential measures include promoting greater competition by reducing restrictions on firm entry and exit, and on foreign investment. Measures that give incumbent firms undue advantage—for example, privileged access to markets, licensing, and contracts—should be eliminated, along with regulations protecting state-owned or politically connected firms. Improving access to finance and improving the skills of the workforce will also support the ability of firms to innovate and grow.