UNLOCKING SUSTAINABLE PRIVATE SECTOR GROWTH IN THE MIDDLE EAST AND NORTH AFRICA

Evidence from the Enterprise Survey

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European Investment Bank
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Unlocking Sustainable Private Sector Growth in the Middle East and North Africa: Evidence from the Enterprise Survey

About this publication

This is a joint publication of the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) and the World Bank (WB).

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Acknowledgements

The authors gratefully acknowledge guidance from Pedro de Lima, Stefan Koeberle and Peter Sanfey, and comments from Alexa Tiemann. Moreover, the authors would like to thank Christine Insalaco, Swati Raychaudhuri and Tourya Tourougui for organisational assistance.

Published by the European Bank for Reconstruction and Development, European Investment Bank and World Bank.
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eBook: QH-08-22-063-EN-E ISBN 978-92-861-5221-4 doi: 10.2867/042936
pdf: QH-08-22-063-EN-N ISBN 978-92-861-5220-7 doi: 10.2867/4598

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Foreword

More than a decade after the Arab Spring, the Middle East and North Africa (MENA) region finds itself facing momentous challenges. Waves of the coronavirus pandemic are disrupting economies, affecting every aspect of life. More recently, the Russian invasion of Ukraine sent shockwaves through the region in the form of higher hydrocarbon prices, risks to food security, and lower tourist arrivals. Beyond lies the looming threat of climate change. And the longstanding structural conditions of the past manifest themselves as continuing difficulties in the present.

Mounting debt and limited fiscal capacity have challenged the role of the state in the region. But challenging times provide opportunities for positive change. There is a chance for the MENA private sector to seize this moment. It remains the hope for many young people for their future and, while its role as the engine of growth has yet to be realised, the private sector has the potential to drive a greener region with a sustainable model of growth.

This report sheds light on the state of the MENA private sector through surveys of over 5 800 formal businesses across six MENA economies — Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza — conducted between late 2018 and 2020, largely before the pandemic.

The surveys are nationally representative — following the methodology of the World Bank Enterprise Surveys — and are of great value for a region that is significantly short on data. They are comparable to a previous round of surveys conducted in 2013, providing a measure of change across two points in time — a first for the Enterprise Surveys in MENA. They also contain new information on the green economy and the political connections of businesses.

Nine research papers have been produced from analysis of the data capturing different aspects of the private sector. This report is a cohesive analytical work based on the findings of these scholarly studies.

The findings give some cause for concern. They reveal that cronyism is prevalent in the private sector, while informality continues to limit firms' growth ambitions. Many businesses are financially autarkic. Management practices across firms are generally poor, and the shadow of the state distorts incentives. Few businesses formally train their workers.

Furthermore, barriers to international trade remain, while adoption of digital technologies is limited. Green investments are low in the region, with most businesses having poor management practices on environment, energy and climate change. Corporate responsibility on environmental, social and governance (ESG) issues lags behind that in benchmark countries at a similar level of development.

But there is considerable heterogeneity within the region, providing hope that there are opportunities for both businesses and governments to learn from better performers within the region.

The enormous undertaking of conducting the Enterprise Surveys was made possible by extensive cooperation between three international institutions: the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the World Bank Group. The staff of these institutions remain committed to expanding knowledge about the Middle East and North Africa by shedding light on a private sector that has the potential to chart a promising path for the region. We hope you enjoy reading the report.

Executive summary

Economic growth in the Middle East and North Africa has been weak since the global financial crisis of 2007-09 and the Arab Spring of the early 2010s. On average, gross domestic product (GDP) per capita has grown by only 0.3% a year in six representative economies of the region: Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza. That compares unfavourably with rates of 1.7% on average in middle-income countries and 2.4% in the developing economies of Europe and Central Asia (ECA).

Achieving higher and sustainable growth is particularly important in view of other economic challenges facing the region: Public debt in MENA countries has increased considerably over the last decade, accompanied by declining investment. More recently, the coronavirus pandemic has battered the region, further straining public finances. In addition, the Russian invasion of Ukraine affects the economies covered in this report through higher hydrocarbon prices, risks to food security and declining tourism.

This report seeks to understand what lies beneath that relatively slow growth, with a particular focus on the reasons for stagnating productivity and inadequate accumulation of human capital and physical capital in the region's private sector. To this end, the report summarises the main findings from nine background papers based on Enterprise Surveys data. It also draws conclusions for policy, not only for promoting stronger firm performance but also for addressing the challenge of climate change by pursuing sustainable growth.

The background studies draw on data from Enterprise Surveys of over 5 800 formal businesses across the abovementioned six MENA economies conducted between late 2018 and 2020, largely before the coronavirus pandemic. Data from the same survey conducted in 28 ECA countries provide points of comparison with economies at similar stages of development, while data from a previous survey conducted in MENA in 2013 provide a measure of change over time. Although the Enterprise Survey data largely predate the pandemic, they remain extremely relevant as they offer a precise snapshot of the more structural features and weaknesses of the business environment. Resilience to the new shocks — and capacity to react — are likely to be affected by those structural features.

The Enterprise Surveys entail face-to-face interviews with the owners or main managers of registered firms with at least five employees, classified by sector (manufacturing, retail and other services), size (5-19, 20-99 and 100+ employees) and regions within a country. They collect basic information on the firms, including their age, size and their views on the quality of the local business environment in terms of, for example, infrastructure, labour, and business-government relations.

The latest surveys have also gathered information on the political connections of firms and their behaviour related to the environment, energy and climate change, including green management practices and green investments.

What is holding back the region's private sector?

The business environment is perceived to be challenging. Survey respondents list political instability, corruption, competition from the informal sector and a lack of access to finance as the top obstacles to operations in MENA. Product market regulatory barriers are also prohibitive.

Political connections and informality undermine fair competition. Firms with political connections extract relative gains from their privileged positions. But the leveraging of influence also has the indirect effect of forcing competing firms to compensate with other means of political access. Political connections undermine a level playing field. The region's large informal sector also weighs heavily on established firms. Competition from informal economic activity results in lower growth expectations and consequently lower probability of accessing finance, as evidenced by fewer loan applications.

Management practices in the business sector lag behind best practices in benchmark countries. Businesses have comparatively poor management practices, with average management practice scores declining for all MENA countries since 2013. This can be attributed partly to government ownership, as even partial government ownership slows the introduction of best management practices. In addition, protection of well-connected incumbents from competition reduces incentives to adopt modern management practices. This is costly, as managerial practices are crucial for profitability, trade and innovation.

Firms in the region are less capable of exploiting the benefits of trade, innovation and digitalisation. Many productive firms in the region fail to reap the scale and efficiency benefits from trade because of the weak business environment and state dominance in the economy. Innovation is one of those benefits, often associated with trade participation and integration in global value chains. Firms in MENA instead record very low innovation rates. Companies also lag behind their counterparts in other developing countries in terms of adoption of digital technologies.

Few firms in the region invest in their workers. MENA economies are making inadequate use of their human capital. Manufacturers provide formal training only to a small share of workers. Only a few companies invest in training their workers, and these tend to be larger, younger, foreign-owned and digitally connected exporting firms.

Accessing finance remains difficult and investment rates are low. Stringent collateral requirements, complex application procedures and high interest rates discourage firms from applying for loans. A significant share of companies are financially autarkic (not engaging in borrowing or lending activity with other economic players), most opting to self-finance voluntarily. Financial autarky appears to be a response to a difficult operating environment. MENA economies have exceptionally low investment rates. Although high interest rates resulting from the build-up in public debt may be one cause of the decline in investment, an unfavourable business environment may drive both high interest and low investment rates.

The green transition is not yet a priority. Incentives for companies to decarbonise are weak as all of the region's economies continue to subsidise fossil fuels and electricity generated from fossil fuels. Listed companies now have stronger incentives to take account of ESG issues, but average corporate ESG responsibility in the region remains low. MENA firms are less likely than their ECA counterparts to adopt measures that reduce their environmental footprint. Some economies in the region do significantly better than others, however, indicating that opportunities exist for reforms to increase growth and make it more sustainable.

What can be done to unlock sustainable growth in the region's private sector?

The report calls for countries in the region to lower regulatory barriers for businesses, promote competition and reduce disincentives emerging from political influence and informal business practices. Reforms that facilitate innovation, the adoption of digital technologies and investments in human capital are crucial. Companies should also be incentivised to exploit the benefits of participating in cross-border trade and global value chains more broadly. Better management practices can be instrumental in this regard.

Reforms to support these objectives will also need to take account of sustainability and the global agenda to limit climate change and protect the natural environment more generally. Greening MENA countries' growth models will require sound public policy, strong state institutions, and determined political leadership that provides incentives for companies and consumers to think green, promote clean investment and remove barriers preventing a smooth transition to the green economy.

At the same time, the state has a duty to ensure that this transition process is just — through measures that help workers take advantage of opportunities to obtain new, higher-quality jobs linked to the green

economy, while also protecting those at risk of losing their jobs. Such measures include labour market policies, skills training, social safety nets and action to support regional economic development.

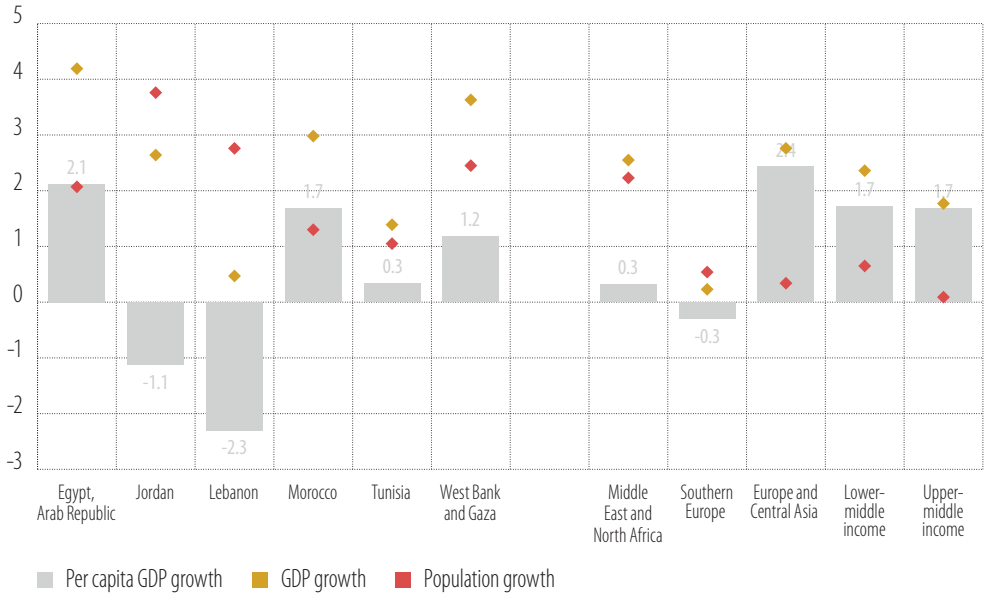
Governments in the region should focus their support on industries and firms that have a zero-carbon future, while refraining from propping up so-called zombie firms that will struggle in the green economy. This includes addressing the market and policy failures that are impeding the transition to a green economy. The key here is to get prices right. That means putting a higher price on carbon and applying that higher price to a broader set of emission sources, as well as removing fossil fuel subsidies.

Section 1

Accelerate economic growth and make it green

MENA countries face a challenging macroeconomic context, characterised by persistently low GDP per capita growth. Figure 1.1 presents evidence on GDP per capita growth since the global financial crisis of 2007-09. On average, GDP per capita grew by only 0.3% a year in the six economies that are the focus of this report: Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza. That compares with 1.7% in the average middle-income country and 2.4% in the developing economies of Europe and Central Asia. In the 13 years since the crisis, the accumulated growth in GDP per capita in benchmark countries is 20 percentage points higher than in the average MENA economy. But this observation is subject to several caveats. Firstly, the average masks significant heterogeneity across countries. At 2.1% a year, GDP per capita growth in Egypt is high and the performance of Morocco compares favourably to the benchmarks. Secondly, negative per capita growth in Jordan and Lebanon is at least partly related to high population growth, which reflects the large number of refugees from Syria that both countries host. To the extent that the refugee populations are supported by the international community, the GDP figures may not fully reflect the experience of the native populations.

Figure 1.1
GDP per capita growth since the global financial crisis (in %)



Source: *International Monetary Fund World Economic Outlook (IMF WEO), authors' calculations.*
Note: *The chart shows average GDP per capita growth 2008-20. Benchmark groups based on unweighted country averages. SE (Southern Europe) includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes economies in Europe and Central Asia that were classified as middle-income in 2008. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income in 2008. UMI presents the corresponding average for upper-middle-income economies.*

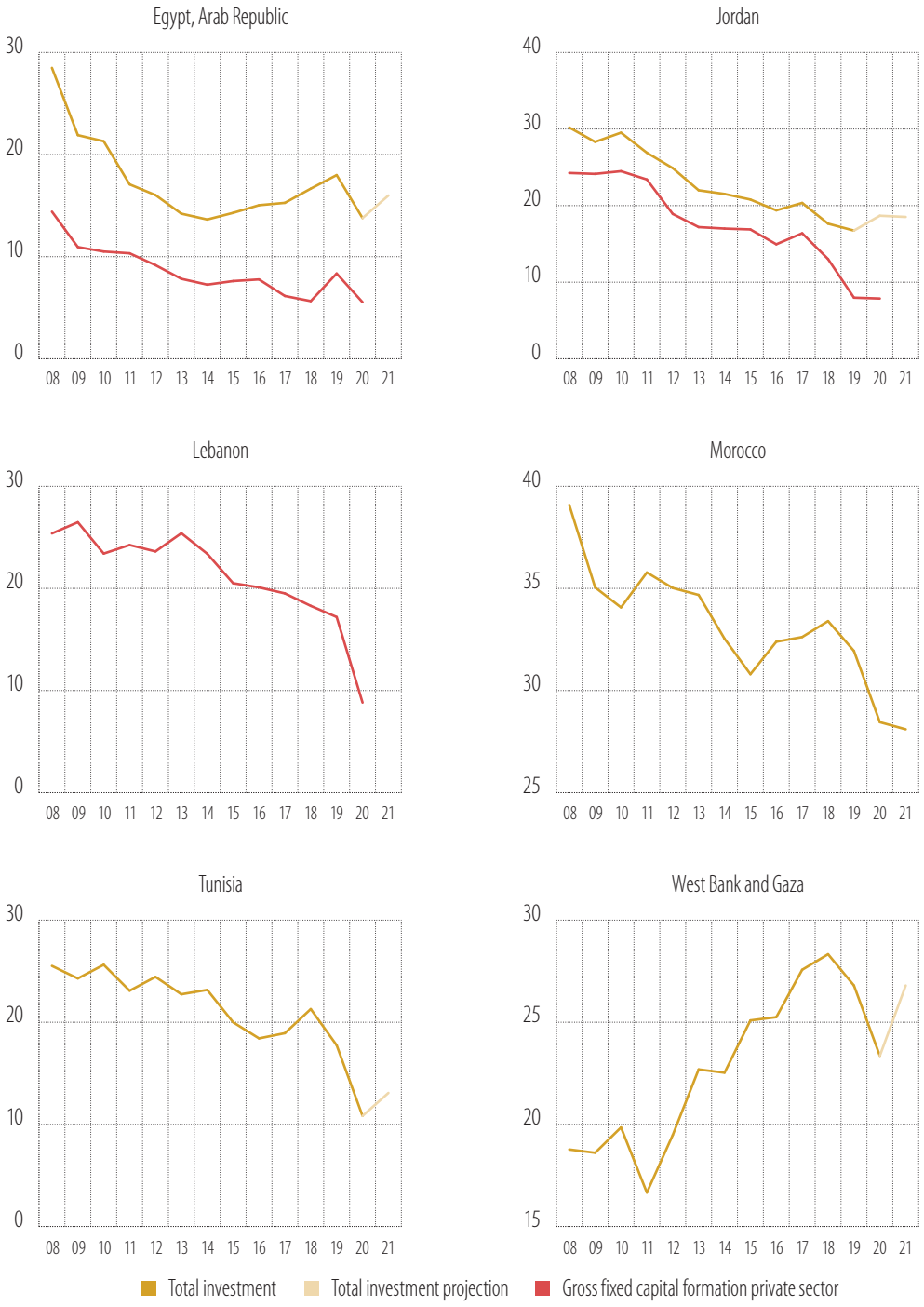
Public debt in MENA countries has increased considerably over the last decade. Almost all countries have seen a substantial increase in the debt-to-GDP ratio following the global financial crisis and the Arab Spring (see Figure 1.2). Subsequent consolidation efforts were aided by International Monetary Fund (IMF) programmes. But only in Egypt did the authorities manage to achieve a reversal in the debt-to-GDP ratio. Lebanon benefited from strong nominal growth in the aftermath of the crisis; but a lack of willingness

on the part of the political class to tackle longstanding structural weaknesses led to the country's first default on sovereign debt in 2020. The fiscal policy response to contain the economic damage of the coronavirus pandemic has further increased already high debt-to-GDP ratios. Overall, debt-to-GDP ratios in 2020 were on average 24 percentage points higher than in 2008.

Figure 1.2
General government gross debt to GDP (in %)

Source: *IMF WEO.*

Figure 1.3
Total investment (in % of GDP)



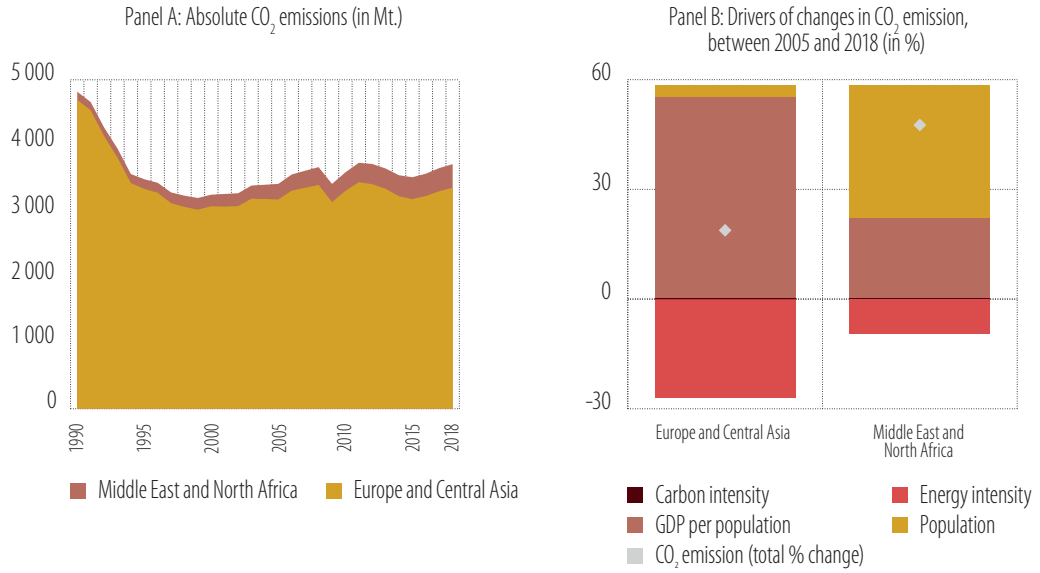
Source: *IMF WEO, World Bank.*

The build-up of public debt in MENA economies has been accompanied by declining investment. With the exception of the West Bank and Gaza, all countries have registered an economically meaningful decline in the investment rate (see Figure 1.3). In Morocco, Tunisia, and the West Bank and Gaza, the

pandemic has further depressed investment. The significant increase in public debt, coupled with the decline in investment, is consistent with the government crowding out private investors. This implies that the societies of the region have set aside few resources to increase the capital stock of their economies. This is a cause for concern, as capital accumulation is a key source of growth for economies that are not at the technological frontier.

Absolute CO_2 emissions in the region have increased since 1990. Absolute CO_2 emissions increased by almost 50% between 2005 and 2018, driven by population growth and growth in GDP per capita, compared with less than 20% in Europe and Central Asia. As Figure 1.4 shows, per capita CO_2 emissions have increased since 1990, despite population growth, while emissions per unit of GDP have decreased only marginally, reflecting a modest decrease in energy intensity. Nationally determined contributions commitments imply a further increase in overall greenhouse gas emissions until 2030, with the largest country in the region (Egypt) having no specific targets.

Figure 1.4
CO_2 emissions and drivers of changes in CO_2 emissions



Source: *Source: International Energy Agency (IEA) and authors' calculations.*
Note: *Data represent unweighted averages across countries covered in the Enterprise Surveys. Carbon intensity refers to carbon emissions per unit of energy. Energy intensity refers to energy use per unit of GDP. ECA — Europe and Central Asia; MENA — Middle East and North Africa.*

The new Enterprise Survey data help to analyse firm-level factors driving slow GDP per capita growth, such as stagnating productivity and slow accumulation of human capital and physical capital. At the firm level, economic growth is driven by an accumulation of factors of production (human capital and physical capital) and growth of productivity of these factors (total factor productivity, or TFP). To investigate these factors, this report brings together findings from the analysis of a rich firm-level dataset. The data come from the recent Enterprise Surveys conducted in MENA and ECA,[1] and they allow granular analysis of various drivers of and barriers to firm-level total factor productivity growth related to governance, management practices, participation in cross-border trade, innovation and adoption of digital technologies. The report explores the role of these factors and shows that each of them contributes to the stagnation of MENA economies.

1 The survey covers the following 28 ECA countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Montenegro, Lithuania, Latvia, Macedonia, Moldova, Poland, Russian Federation, Romania, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine and Uzbekistan.

The Enterprise Surveys used in this report are a joint effort of the European Bank for Reconstruction and Development, the European Investment Bank and the World Bank. The most recent wave of surveys took place between October 2018 and August 2020. They covered almost 28 000 formal (registered) enterprises in 41 economies, including more than 5 800 enterprises in Egypt (3 075), Jordan (601), Lebanon (532), Morocco (661), Tunisia (615) and the West Bank and Gaza (365). The surveys follow the standard methodology of the World Bank Enterprise Surveys and thus are comparable across economies. They are also comparable across time, in particular to the 2013 MENA Enterprise Survey, which followed the same methodology (see the report on the previous round: EBRD et al., 2016).

The surveys entail face-to-face interviews with the owner or main manager of registered firms with at least five employees. Eligible firms were selected using stratified random sampling. The strata were sector (manufacturing, retail and other services in most economies), size (5-19, 20-99 and 100+ employees) and regions within a country. The main purpose of the surveys is to examine the quality of the local business environment in terms of, for example, infrastructure, labour and business-government relations. They also collect basic information on the firms, including their age, size and geographical coordinates. The 2018-20 Enterprise Surveys also included a new Green Economy module. This unique element gathered information on key aspects of firm behaviour related to the environment and climate change, including green management practices and green investments.

Figure 1.5
Top business environment obstacles (in % of firms)

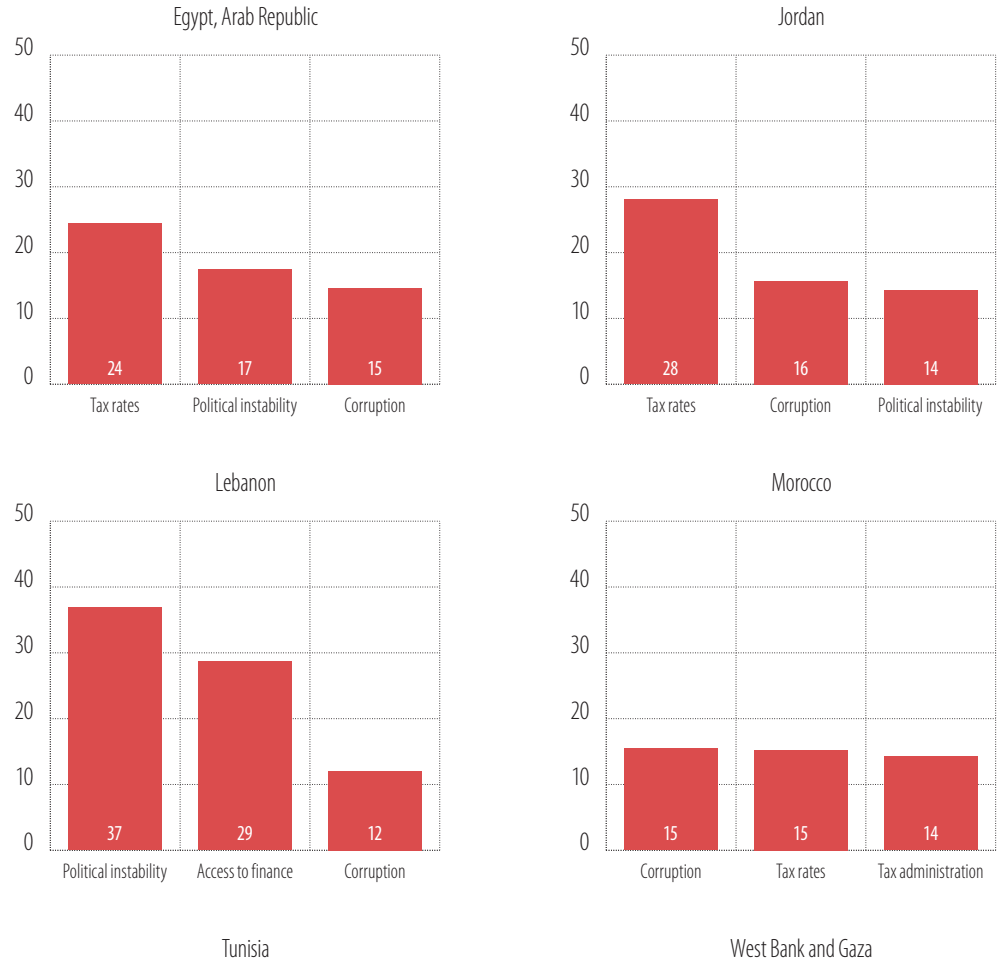
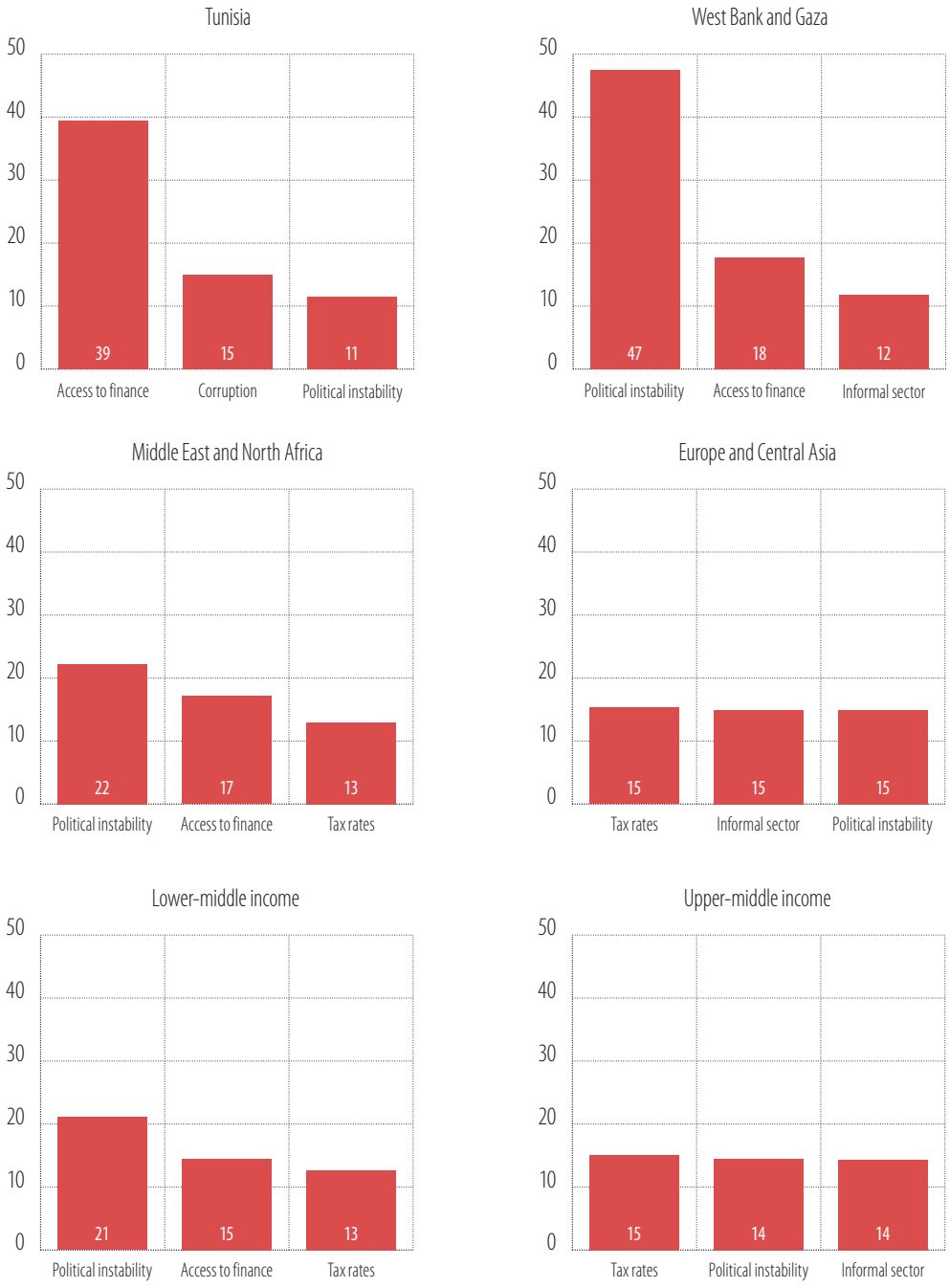


Figure 1.5 (continued)
Top business environment obstacles (in % of firms)



Source: *Enterprise Surveys. Benchmark groups based on rescaled survey weights that assign equal weight to all countries in the benchmark group. This weighting scheme accounts for the experience of the typical country in the region. ECA includes economies in Europe and Central Asia that were classified as middle-income in 2019. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

The Enterprise Survey respondents list political instability, corruption, competition from the informal sector and a lack of access to finance as the top business environment obstacles. Across the six MENA economies, political instability remains the most frequently cited top obstacle, ahead of a lack of access to finance and tax rates (see Figure 1.5).[2] The importance of political instability has diminished somewhat since the previous survey round. In the 2013 surveys, political instability was, by a significant margin, the most frequently cited top obstacle in Egypt, Jordan, Lebanon, and the West Bank and Gaza (EBRD et al., 2016). The relative importance of the individual obstacles varies from country to country. Political instability is the top obstacle in the West Bank and Gaza (47%) and Lebanon (37%) and among the top three in all countries but Morocco. A lack of access to finance is, by some margin, the main concern of Tunisian businesses (38%). Respondents in Jordan (28%) and Egypt (24%) most frequently consider tax rates as the top obstacle to their companies. Moroccan businesses cite corruption, tax rates and tax administration with almost identical frequency as the top obstacle.

The scope of this report is defined by nine background papers based on the Enterprise Survey data. This summary report presents the main findings of these studies. Note that while the studies and the data are largely pre-pandemic, initial conditions of companies matter for how they fare during the pandemic.

This analysis of the Enterprise Survey data are organised as follows:

- Firstly, this report studies the factors that influence productivity growth at the company level. Section 2 focuses on two key governance challenges: political connections and informality. Section 3 studies the role of management practices and shows how government ownership weakens incentives to adopt best practice and therefore slows productivity growth. Section 4 examines the role of trade openness and the impact of firms' participation in global value chains on innovation. Section 5 analyses how adoption of digital technology promotes total factor productivity growth.
- Secondly, this report explores accumulation of factors of production. Section 6 focuses on human capital and training by firms. Section 7 discusses investments in fixed assets and shows that limited access to finance in MENA economies is an important factor behind low investment.
- Thirdly, this report discusses firm-level actions on climate change: Section 8 presents evidence on the measurement of environmental, social and governance (ESG) activities, green investments and green management practices.
- Finally, Section 9 concludes and discusses policy implications.

2 Enterprise Survey respondents are invited to choose the top obstacle to their company from a list of 15 potential obstacles. Therefore, the top obstacles are context-specific — a top obstacle for a specific country is relative to the other obstacles in the country. The findings are therefore susceptible to anchoring and framing issues, which need to be taken into consideration when comparing results across countries.

Section 2

Quality of governance and productivity

MENA countries have been falling behind in terms of governance standards. Figure 2.1 presents the evolution of governance standards as measured by the Worldwide Governance Indicators, specifically the average global percentile rank of the indices most relevant to economic activity: regulatory quality; government effectiveness; control of corruption; and rule of law. The Arab Spring protests sought to bring about better institutions, but as Figure 2.1 shows, these hopes have not materialised. In no single MENA country has governance improved (relative to the rest of the world) and in Lebanon, it has declined dramatically.

Poor governance has major negative implications for competition and firm performance. The Enterprise Surveys make it possible to identify the links between poor political and legal institutions, economic institutions and productivity. Analysis of firm-level data shows that firms with political connections and political influence are more likely to have fewer competitors and higher market share, thus undermining a level playing field.

Firms in MENA use political connections and business associations to gain political access. Table 2.1 reports the averages of the use of different means of political access. Generally, firms in the region use direct political connections — in the form of current and former government office holders in their management or ownership — more frequently than in other regions (this result is mainly driven by Tunisia). Notably, membership in business associations — and the usefulness of those associations for lobbying — is high across the board in the Middle East and North Africa, with the only exception being Morocco, at 20.5%. By contrast, although it is below 1% in both regions, partial government ownership is significantly higher in Europe and Central Asia, probably a reflection of more extensive state involvement.[3] Lastly, MENA has a slightly lower average incidence of bribery (where companies pay officials in exchange for services, such as gaining an operating licence).

Table 2.1

Use of political access, middle-income economies (percentages)

	MENA	ECA	Diff.	
Political connection	9.0	4.2	4.7	*** [(a)]
Transactional corruption	10.6	13.7	-3.1	*
General corruption	11.1	11.4	-0.3	
Member of business association	72.2	26.7	45.5	***
Bus. assoc. lobbying useful	35.3	10.4	25.0	***
Government ownership	0.1	0.6	-0.5	***
Size [(b)]	15.4	15.9	-0.6	

Source: *Source: Author's calculations based on Enterprise Surveys.*

Note: ** p<.1, ** p<.05, *** p<.01. The means reported are simple averages of survey-weighted means by economy. Differences are determined by regressing a dummy for MENA economies using survey weights, rescaled so that each economy has a total weight of 1 (among those with non-missing values for the given indicator). These regressions use Stata's svy: prefix to account for the complex survey design, with stratification.*

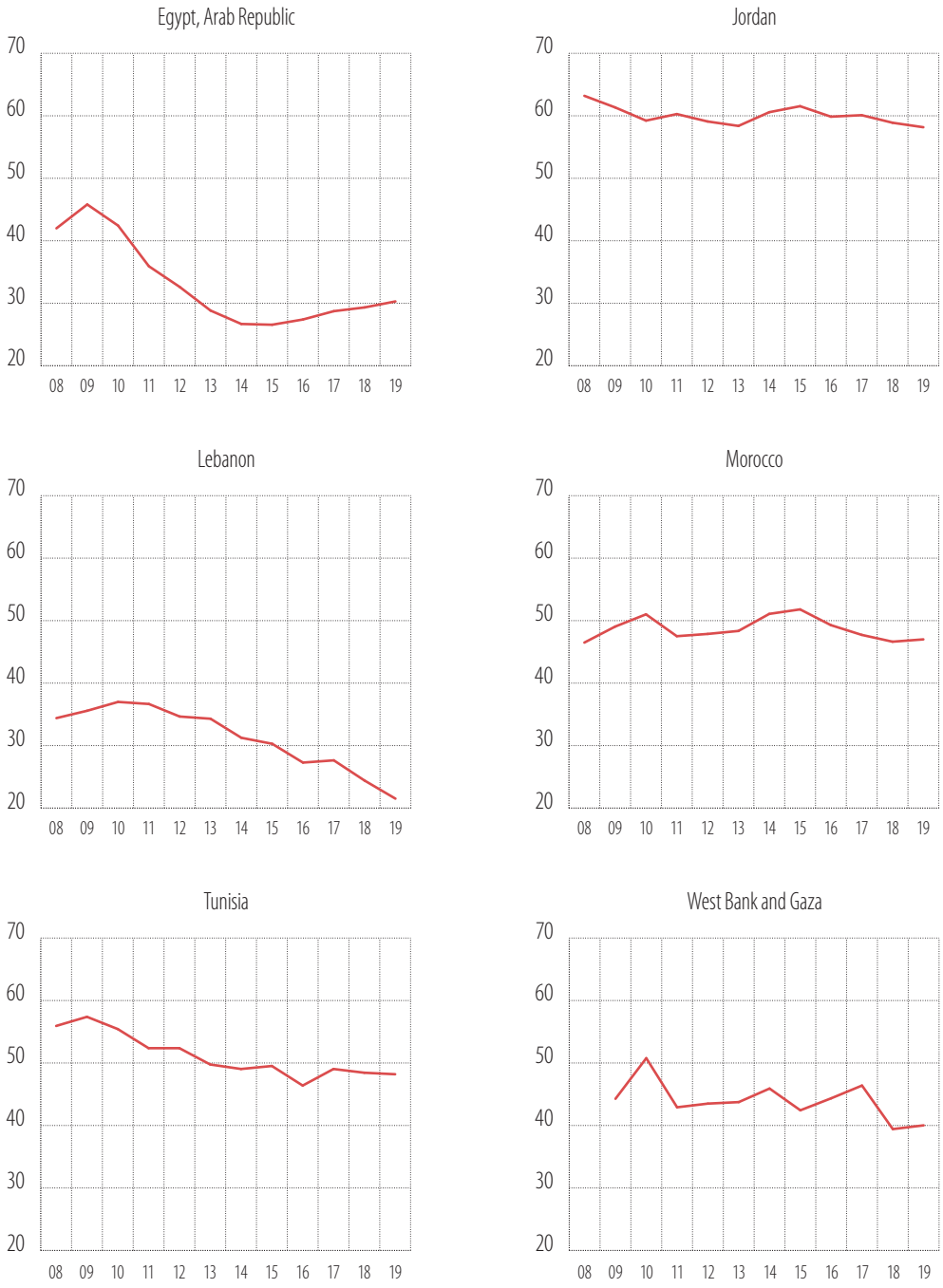
[(a)] The economy-level average for Tunisia appears to be an outlier at 27.9%. Excluding Tunisia, this difference is no longer significant.

[(b)] Full-time permanent equivalent workers (not in percentage terms). The differences are run on the log of this measure, and the exponentiated values are reported in the table.

3 The Enterprise Survey dataset excludes fully state-owned firms, but includes firms with partial state ownership.

Figure 2.1

Governance (average global percentile of regulatory quality, government effectiveness, control of corruption and rule of law)



Source: *Worldwide Governance Indicators.*

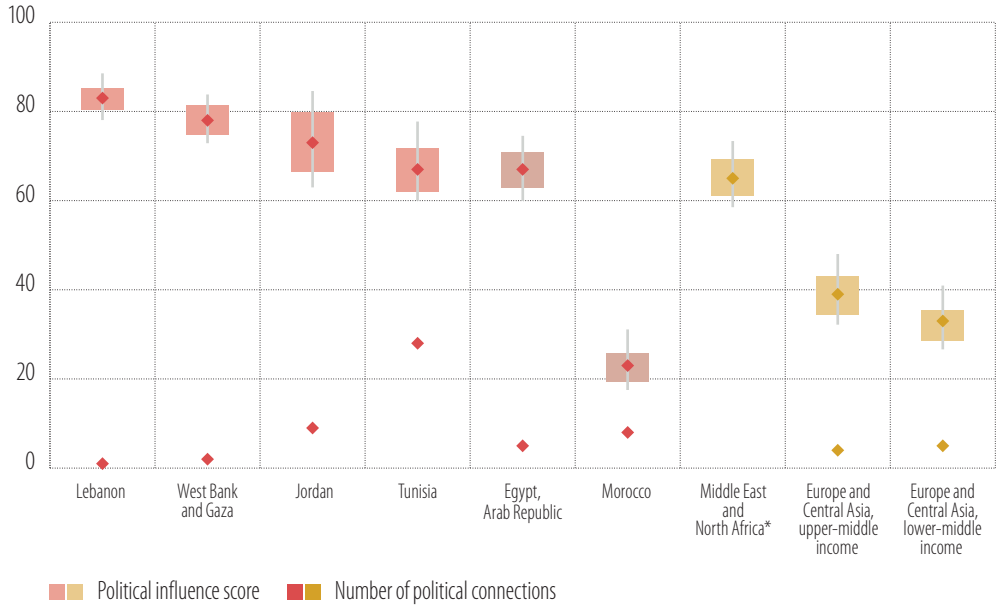
Links between political connections and their likely distortionary behaviour have been well-explored, including in major MENA economies included in this report, such as Tunisia (Rijkers et al., 2017a; Rijkers et al., 2017b) and Egypt (Diwan et al., 2020). But an under-explored area of research is the comparison

of political connections across economies (with early exceptions such as Faccio, 2006). Difficulties in making these comparisons include a lack of comparable data and the fact that connections may confer different values of influence across the different economies. What is more, little work has been done to analyse the additional dimension of how firms with connections (or those competing with such firms) engage in other political activity, whether those interactions are legal, as in the case of lobbying, or illegal, as in the case of bribery. In other words, little has been said about whether political connections help firms to avoid bribes or expose them to corrupt demands, let alone how such activities vary by context.

The Political Influence Index aggregates several political interactions undertaken by firms into one index of influence. Importantly, since the combinations of political activities that confer or reduce political influence are not known in advance, this index uses a technique that estimates such influence as a latent concept (see the paper for technical details). The political interactions considered are, first and foremost, political connections (as a technical detail, the authors assume that such connections yield greater influence), the incidence of bribery, membership in a business association (and the importance given to that association's lobbying efforts), government ownership and firm size (under the assumption that companies can use their size to exert political pressure).

The overall level of political influence scores is higher in MENA than in benchmark economies. Except for Morocco, all MENA economies have significantly higher levels of political influence scores relative to ECA benchmark countries, which indicates that the level of political connections alone cannot explain higher levels of political access in search of influence (Figure 2.2).[4] Rather, the study shows that political connections are not used in isolation. Often, companies that do not have political connections, but are in the same economy as particularly influential connected firms, tend to compensate with other means of political access. This appears to hold particularly true in the Middle East and North Africa.

Figure 2.2
Mean political influence scores (0 to 100) **and political connections**



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *The white points show the survey-weighted mean political influence score by economy; thicker bars represent a 90% confidence interval and the thinner line is the 95% confidence interval. ECA averages (indicated by triangles) are the simple mean of these values across all economies in the relevant income group.*

4 See Francis and Kubinec (2022) for the methodology of constructing the political influence scores.

Political influence brings economic benefits. Firms with higher political influence and political connections have fewer competitors and larger sales. Figure 2.3 shows the relationship between political influence and four outcomes of the competitive environment and company performance. The first outcome variable is a value of 100 if a firm reports fewer than 20 competitors in its main market. Next, three outcomes of firm performance and scale are (all in logs of 2009 US dollars) a firm's total sales, its sales per worker, and the ratio of total labour costs to sales. For these three measures, lower extant competition is expected to be followed by a higher capture of sales revenues, and doing so at lower levels of employment (more sales per worker) while expending less on such work (for example, consistent with models such as De Loecker et al., 2020). Each panel in Figure 2.3 shows four estimates of the relationship between an increase in political influence or connections and a key outcome. For scale, they show what the marginal relationship is between increasing a firm's political influence by one standard deviation (SD) (an increase of just under seven points on the index)[5] and between not having a political connection and having one. Political connections are associated with larger sales but not with higher labour productivity. This is consistent with a view that political connections mostly help to increase a firm's market share rather than its efficiency.[6]

Economic benefits of political influence come at the expense of competitors of the connected firms. The benefit of certain companies from political influence may come at the expense of their competitors (Becker, 1983). Figure 2.4 replicates the results for the same outcomes for the competitors of the politically connected firms.[7]

Political influence also affects access to finance. One mechanism through which political influence benefits firms is preferential access to finance (for example, Khwaja and Mian, 2005). Figure 2.5 and Figure 2.6 replicate the same analysis as above but using companies' sources of working capital (financing for their day-to-day operations). Politically connected firms are more likely to have access to external finance, while their competitors have to rely on internal sources (Figure 2.5 and Figure 2.6, Panel A). An increase in a firm's political influence increases its access to banks (Figure 2.5, Panel B), while its competitors use less of such financing (Figure 2.6, Panel B). More political influence is associated with higher proportions of supplier credit (Figure 2.5, Panel C), a possible indication of leveraging networks, while, at the same time, a reduced proportion of the same financing among its competitors (Figure 2.6, Panel C).

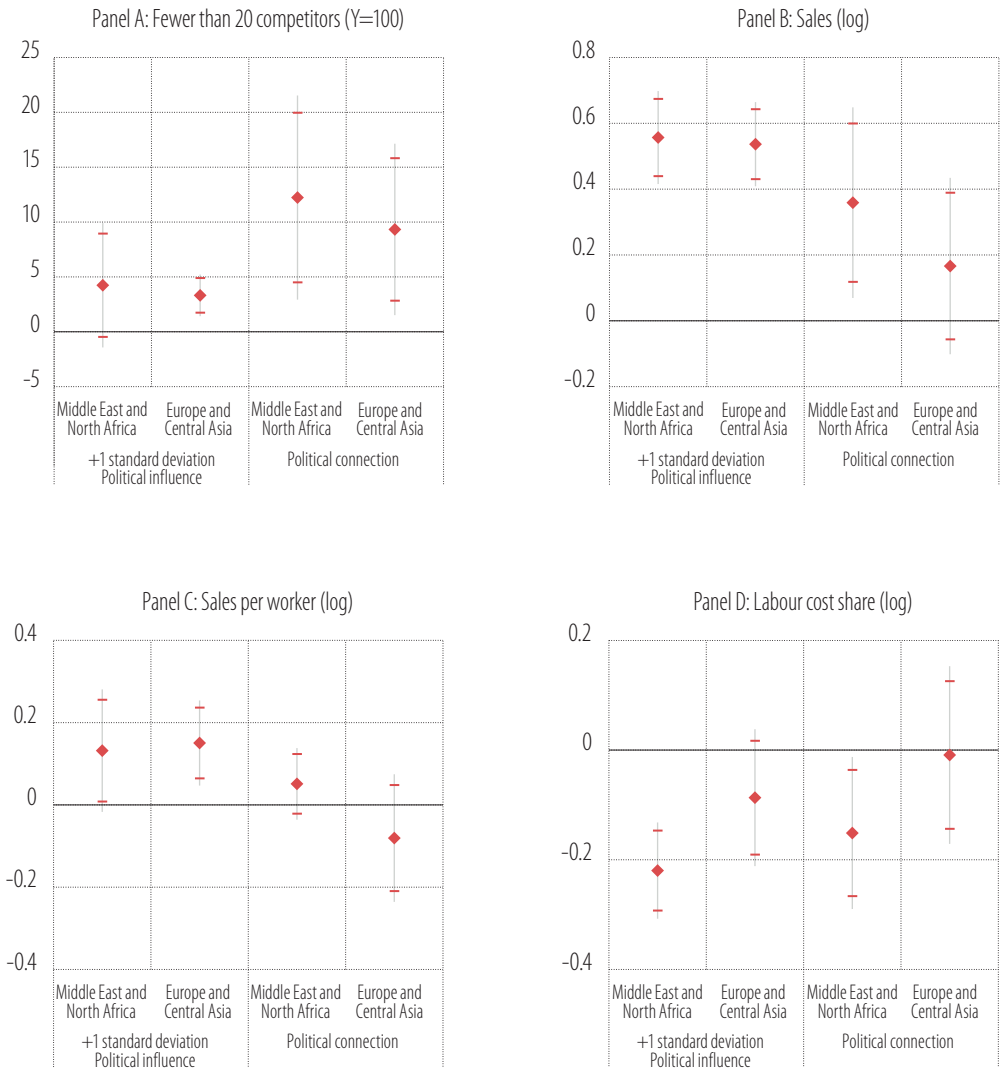
5 Note that this is the average within-economy standard deviation (SD) across 41 economies. Its value is essentially the same for just the MENA or ECA middle-income groups. Here, the full-sample SD is used to compare movements of the same size across the two regional comparator groups.

6 Political influence is also associated with a much larger difference in sales than in labour productivity, but this is less informative as the index of political influence includes size.

7 These are cell leave-out averages, determined by the intersection of location and two-digit industries ("cells") within each economy. These averages are survey-weighted and only calculated in cells with at least five observations (other than the firm itself). They are called "leave-out" averages since each average for firms denoted, j, excludes a specific firm, i. Some analyses use such spatial averages as an instrument under the assumption that one firm's outcome does not affect that of others, but this is an explicit assumption of the paper, and so these averages are used explicitly as dependent variables.

Figure 2.3

Marginal effects of increased influence, political connections on firm-level outcomes

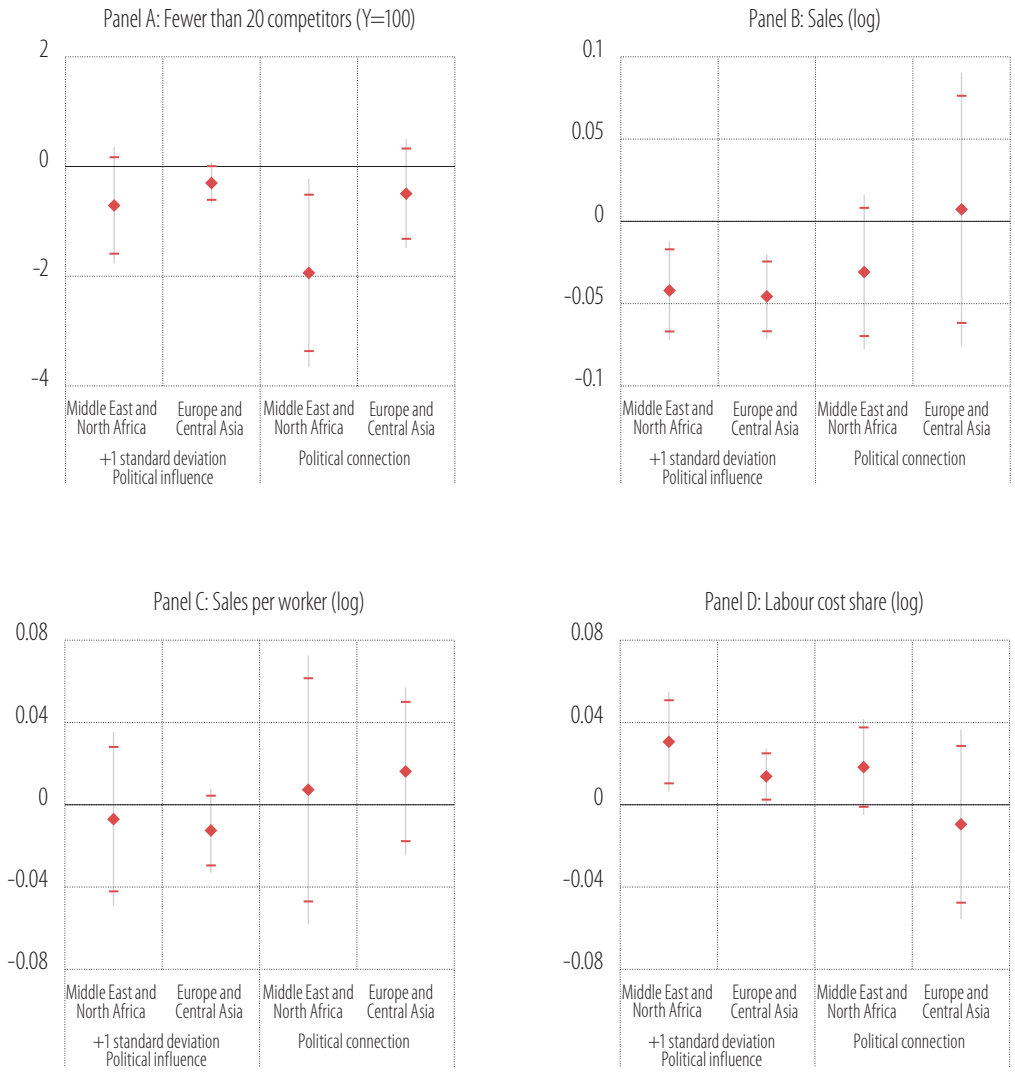


Source: *Authors' calculations based on Enterprise Surveys.*

Note: *Each point represents the coefficient from a regression, shown with a 90% confidence interval (horizontal dash) and a 95% confidence interval (thin line). Regressions are run separately for middle-income economies in MENA and middle-income economies in ECA (each panel includes results from four separately estimated regressions). Each regression includes controls for the log of firm age, the years of the manager's experience, dummy variables for exporters, foreign-owned firms, and those that are part of a larger firm. The results shown here include location by ISIC two-digit sector fixed effects, and use two-way clustering (Cameron et al., 2011) by the same location and sectors. All estimations are survey weighed, with these weights normalised so that each economy has a total weight of 1.*

Figure 2.4

Marginal effects of increased influence, political connections on firms' competitors

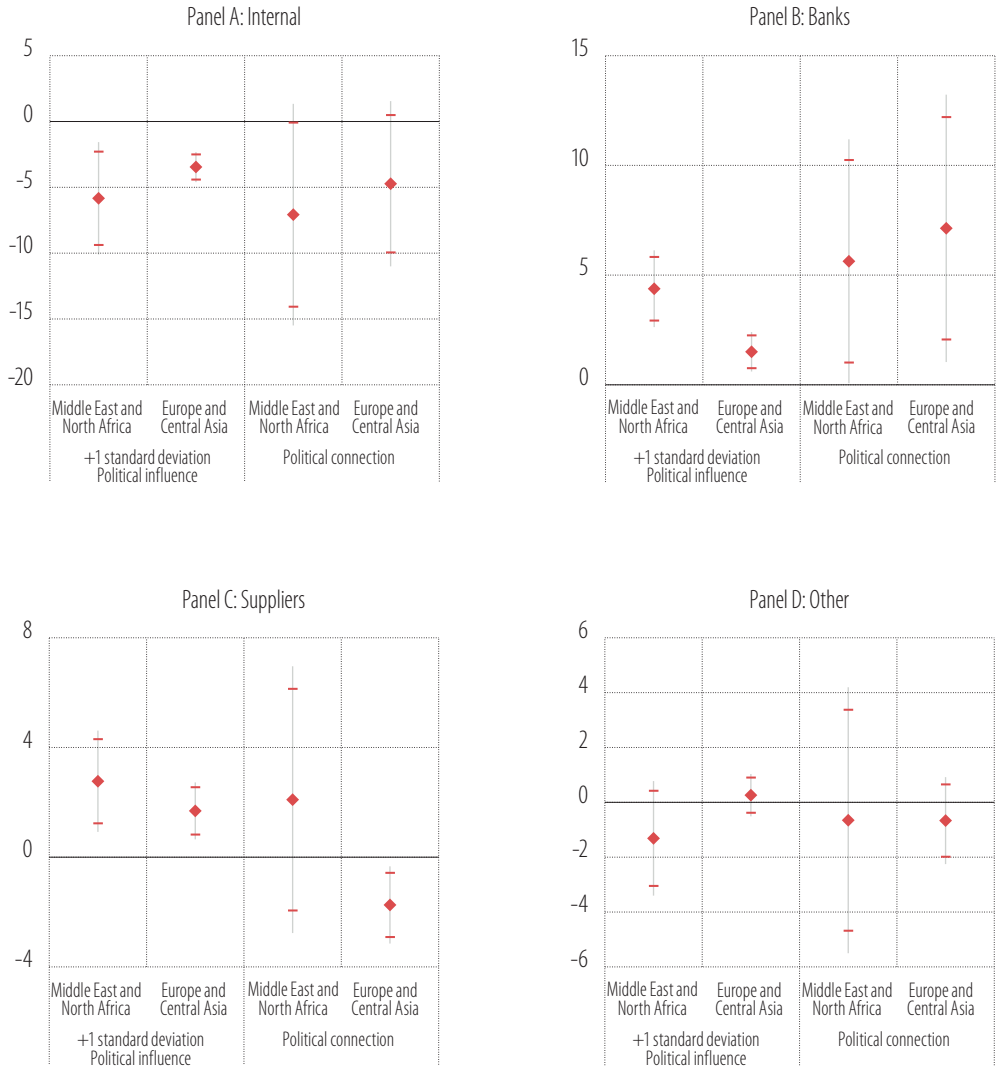


Source: *Authors' calculations based on Enterprise Surveys.*

Note: *Each point represents the coefficient from a regression, shown with a 90% confidence interval (horizontal dash) and a 95% confidence interval (thin line). Regressions are run separately for middle-income economies in MENA and middle-income economies in ECA (each panel includes results from four separately estimated regressions). Each regression includes controls for: the log of firm age, the years of the manager's experience, dummy variables for exporters, foreign-owned firms, and those part of a larger firm. The results shown here include location by ISIC two-digit sector fixed effects, and use two-way clustering (Cameron et al., 2011) by the same location and sectors. All estimations are survey weighed, with these weights normalised so that each economy has a total weight of 1.*

Figure 2.5

Marginal effects of increased influence, political connections on the composition of working capital

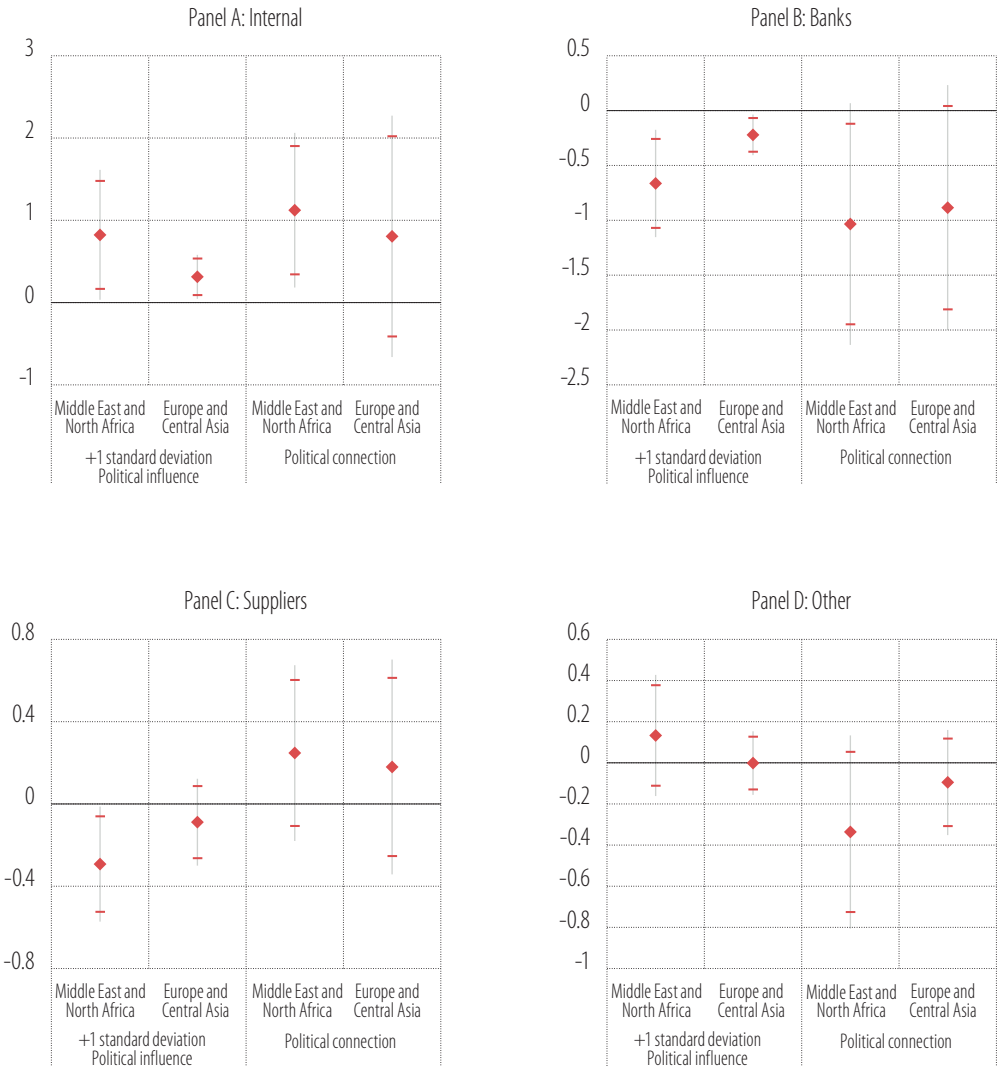


Source: *Authors' calculations based on Enterprise Surveys.*

Note: *Each point represents the coefficient from a regression, shown with a 90% confidence interval (horizontal dash) and a 95% confidence interval (thin line). Regressions are run separately for middle-income economies in MENA and middle-income economies in ECA; that is each panel includes results from four separately estimated regressions. Each regression includes controls for: the log of firm age, the years of the manager's experience, dummy variables for exporters, foreign-owned firms, and those parts of a larger firm. The results shown here include location by ISIC two-digit sector fixed effects, and use two-way clustering (Cameron et al., 2011) by the same location and sectors. All estimations are survey weighed, with these weights normalised so that each economy has a total weight of 1.*

Figure 2.6

Marginal effects of increased influence, political connections on the composition of working capital of competitors



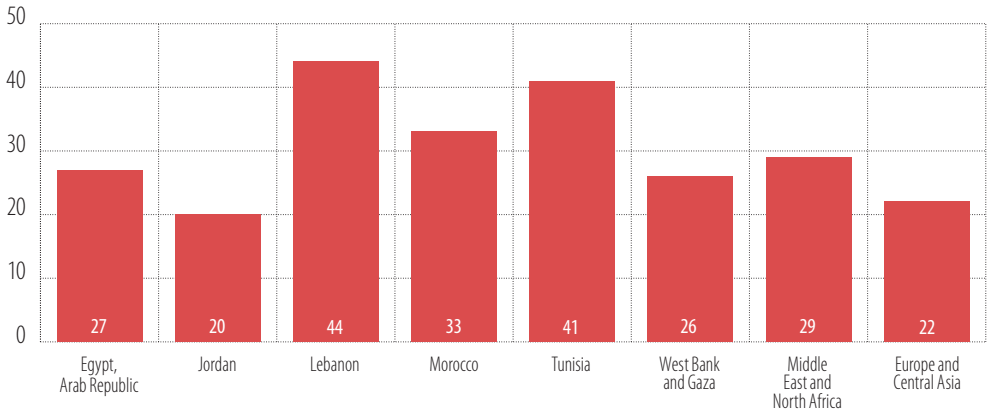
Source: *Authors' calculations based on Enterprise Surveys.*

Note: *Each point represents the coefficient from a regression, shown with a 90% confidence interval (horizontal dash) and a 95% confidence interval (thin line). Regressions are run separately for middle-income economies in MENA and middle-income economies in ECA; that is each panel includes results from four separately estimated regressions. Each regression includes controls for: the log of firm age, the years of the manager's experience, dummy variables for exporters, foreign-owned firms, and those parts of a larger firm. The results shown here include location by ISIC two-digit sector fixed effects, and use two-way clustering (Cameron et al., 2011) by the same location and sectors. All estimations are survey weighed, with these weights normalised so that each economy has a total weight of 1.*

Poor governance translates into a high degree of informality. Another governance-related challenge to the competitive environment comes from a high level of informality. About 30% of the firms in MENA perceive competition from the informal sector to be a major or very severe obstacle to their own business activities (Figure 2.7). This share is substantially higher than in ECA countries, where the percentage drops by almost one-third (22% in total). This feature can have severe implications for companies' overall

competitiveness, as shown by a number of studies documenting the negative effect of informality on output (Rozo and Winkler, 2021), employment (Amin, 2021), productivity (Amin and Okou, 2020), innovation (Avenyo et al., 2021) and access to finance (Distinguin et al., 2016) of formal firms. This seems to be the case for firms in MENA.

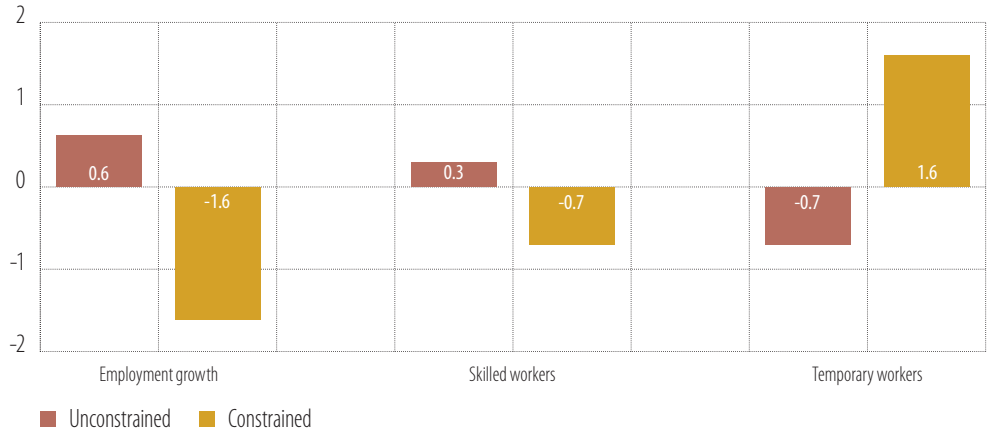
Figure 2.7
Share of firms constrained by competition from informal firms: MENA countries 2013-19 (in %)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Percentage of firms declaring competition from firms in the informal sector as a major or very severe obstacle to their own activity (by country). Averages over the period 2013-19.*

Competition from informal enterprises results in slower growth of formal companies. The Enterprise Survey data show that companies constrained by competition from informal firms experience lower employment growth (Brancati et al., 2022). Compared with the average company in the sample, constrained firms experience a reduction of 1.6 percentage points, as opposed to the 0.6 percentage point increase for firms that do not face competition from the informal sector (Figure 2.8). Firms constrained by competition from the informal sector also have a labour force characterised by a lower share of skilled workers and a higher share of temporary workers, compared with the average firm in the sample.

Figure 2.8
Employment outcomes and informality (in %)**: MENA countries 2013-19**

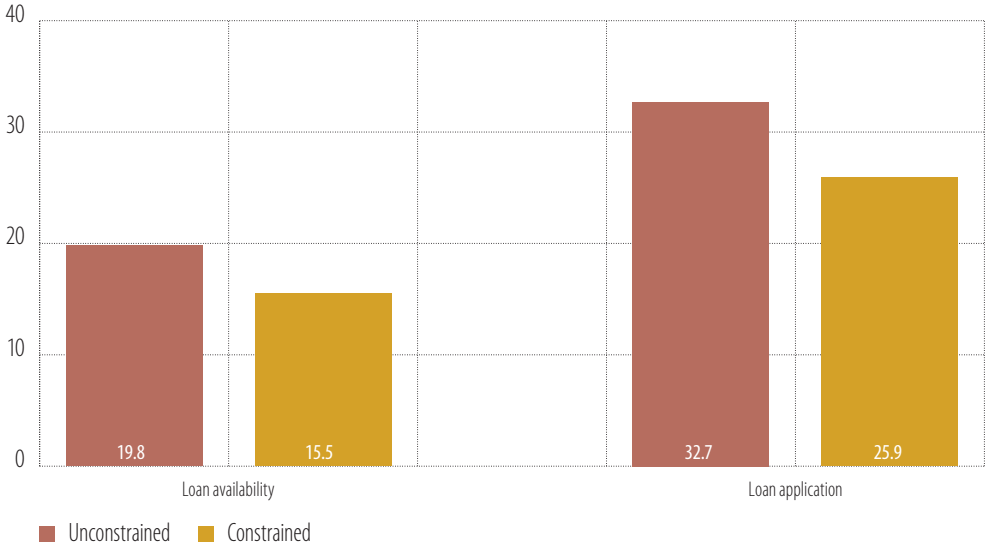


Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Averages are conditional on whether the firm considers itself constrained by competition from the informal sector. Constrained firms are those identifying competition from companies in the informal sector as a major or very severe obstacle to their own activity.*

Competition from the informal sector results in lower access to finance. Competition from informal companies also reduces access to finance, which is important for a firm's investment and growth. Perceived competition from the informal sector has a dramatic effect on the availability of bank finance (see Figure 2.9, loan availability). It is associated with a 4.3 percentage point lower diffusion of loans and credit lines, which is substantial considering the overall magnitude of the phenomenon (20% in total). The effect is even higher when accounting for company-specific characteristics, time and granular fixed effects for the geographical area of the establishment. Furthermore, this result goes beyond standard measures for firms' creditworthiness and informational opacity such as age or size. Most importantly, informal competition is also found to have a disproportionate effect on the probability of applying for a new loan (see Figure 2.9, loan application).

Figure 2.9

Access to finance and competition from informal firms (in %)**: MENA countries 2013-19**

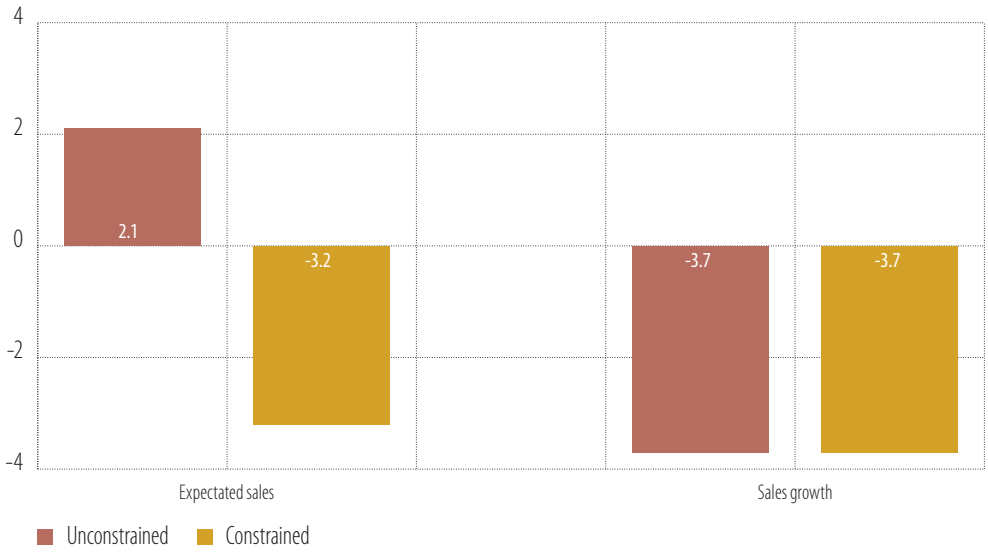


Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Averages are conditional on whether the firm considers itself constrained by competition from the informal sector. Constrained firms are those identifying the competition from the informal sector as a major or very severe obstacle to their own activity.*

The impact of informal competition on access to finance translates into slower future growth. As the left panel of Figure 2.10 shows, the sales growth expectations of companies reporting competition from informal firms are about 5-6 percentage points lower. This effect is unrelated to actual differences in previously realised sales, which are naturally correlated with growth opportunities (right panel of Figure 2.10). Therefore, the effect of informal competition on firms' expectations goes beyond actual differences in realised outcomes. In this regard, a broad strand of research has emphasised how expectations about future business conditions are a critical factor in firms' hiring decisions, as well as in their capital accumulation and strategic choices (Gennaioli et al., 2016; Boneva et al., 2020; Enders et al., 2019; among others). Notably, expectations have real effects even if they turn out to be incorrect retrospectively. While the Enterprise Survey data cannot directly verify whether expectations actually reflect realised sales in the future, they confirm that expectations play a critical role in affecting a firm's activity. A more pessimistic view of future sales is associated with a lower probability of applying for a loan as well as dramatically poorer job creation.

Figure 2.10

Expected sales and competition from informal businesses (in %)**: MENA countries 2013-19**



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Averages are conditional on whether the firm considers itself constrained by competition from the informal sector. Constrained firms are those identifying the competition from the informal sector as a major or very severe obstacle to their own activity.*

The effects of informal competition on finance and growth for formal businesses are substantial. Considering the estimated effects of perceived informal competition on loan availability (17.5% reduction if controlling for firm-specific fixed effects) and the effect of bank credit on employment growth (13.2% in the same specification), the overall impact of informality on job creation through finance turns out to be substantial. Relaxing constraints regarding the perceived informal competition may induce a positive effect of 2.3% higher employment growth. This would clearly have a sizeable impact on overall performance in the region. With all other things being equal, it would move from the current average employment growth of 1.4% to about 3.7%. These results provide a novel motivation for reducing informality.

Section 3

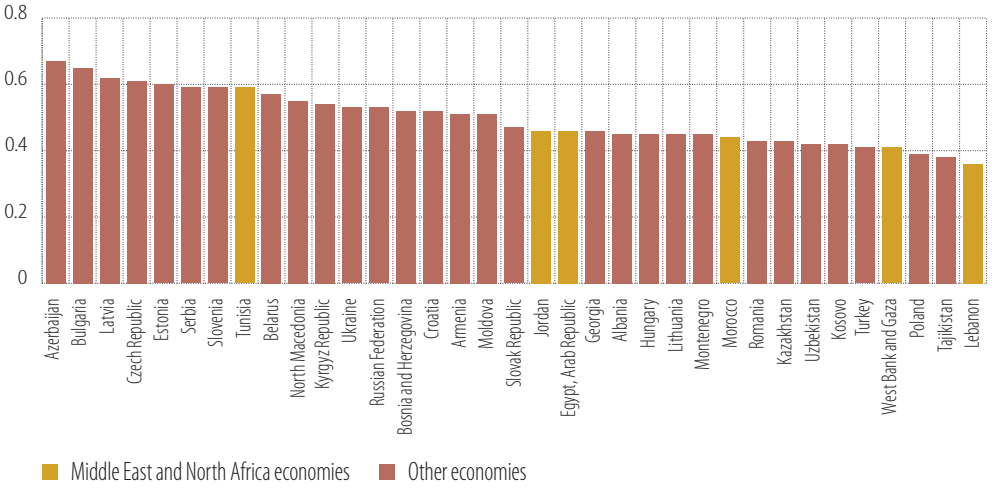
Management practices and partial government ownership

Better management practices can substantially improve a company's performance. Mounting evidence has shown fairly consistent patterns of the benefits derived from better management practices. Research shows that management practices explain a major part of the gap in total factor productivity between countries. Better-managed firms have higher operating profits, are more outward-oriented and invest more in research and development (Bloom et al., 2019; Hyland et al., 2019; see Scur et al., 2021, for a summary). Better management practices may also improve the productivity of skilled labour (Gosnell et al., 2020); and energy intensity may decline while investments in energy efficiency may increase (De Haas et al., 2021; Schweiger and Stepanov, 2022).

Management practices can be evaluated in terms of three broad categories: monitoring, targets and incentives. How well do businesses monitor their internal operations, and is this information used to improve performance? Do businesses set the right targets and take the right actions if the desired outcomes are not achieved? And are businesses promoting and rewarding employees based on performance, and hiring and retaining the best employees? Enterprise Survey data can be used to construct an overall measure of the quality of management practices based on eight dimensions: problem resolution; number of performance indicators measured; level of difficulty in achieving production or service provision targets; knowledge of those targets; basis of managers' bonuses; length of focus of production targets; promotion of non-managers; and dismissal of underperforming managers.

Businesses in the region have poor management practices. Figure 3.1 provides the average management practices scores for 35 economies in the Middle East and North Africa and in Europe and Central Asia in 2018-20 in descending order for medium and large enterprises (Islam and Gatti, 2022a). Except for Tunisia, all the MENA economies are in the bottom half of the ranking. Lebanon has the lowest management score in the sample. The West Bank and Gaza is in the bottom five. On average, management practices are poorer in MENA than in ECA.

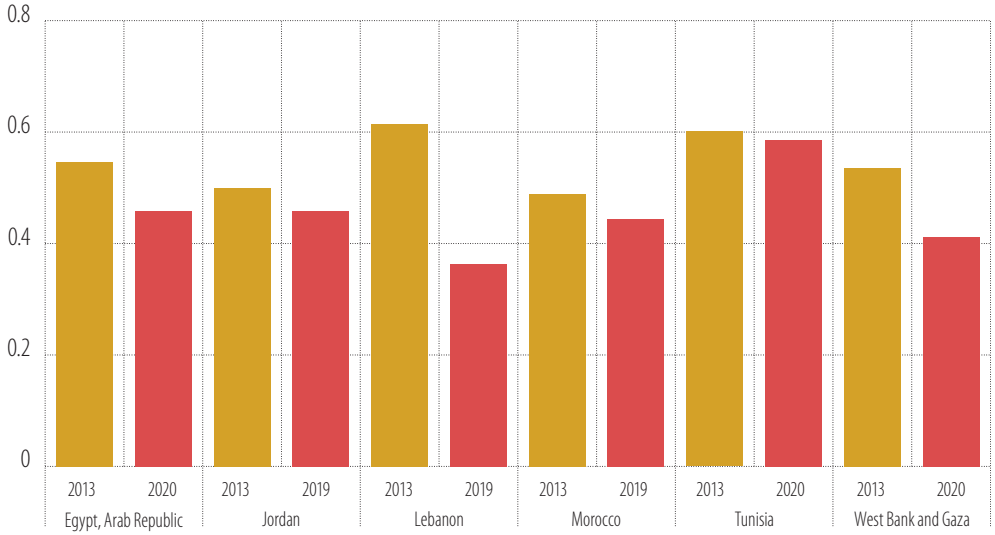
Figure 3.1
Overall management scores for MENA economies 2018-20



Source: *Authors' calculations based on Enterprise Surveys.*

The average management practices scores have declined for all MENA countries between 2013 and 2019. Figure 3.2 shows the average management scores for each MENA country in the sample over time. Lebanon experienced the largest decline, having had the highest score in 2013. Tunisia experienced the lowest decline, achieving the highest average management score in 2019.

Figure 3.2
Overall management scores over time for MENA economies



Source: Authors' calculations based on Enterprise Surveys.

Policies can help to improve management practices in the MENA private sector. Improving management practices is not costly, but it is difficult to achieve as it involves a change in mindsets. In terms of direct policy, consultancy services and management training can improve management practices. Informational interventions may work too. Management practices can also be improved through system-wide reforms that reduce market frictions. These could involve unleashing competitive forces to induce the right incentives; when businesses must either improve their management or face the possibility of exiting the market, they are more likely to adopt good practices. Reforming product market regulations that add regulatory barriers or protect unproductive incumbents can also help. Product market regulations in the region are prohibitive (World Bank, 2022). The excessive expansion of state-owned enterprises as well as the lack of competitive neutrality also slow the adoption of good management practices. Similarly, increasing trade openness and attracting foreign direct investment are avenues through which competitive pressure can encourage positive change in management practices as well as exposing firms to international best practice.

A key explanation for poor management practices in MENA is government ownership. Analysis of the Enterprise Survey data shows that both the incidence and intensity of partial government ownership in the region is negatively related to good management practices. This is not the case in Europe and Central Asia. The finding of poor management practices in government-owned firms is in line with evidence from a variety of developing and developed economies (Bloom et al., 2015). Partial government ownership in the region is negatively correlated with management sub-scores of problem resolution, ease or difficulty in achieving targets, length of focus of targets and dismissal of underperforming managers. Government ownership may create disincentives for long-term planning, especially when governments may change. This may explain why government ownership discourages good management practices on targets. Managers in government-owned firms may not be chosen based on merit, but on other considerations such as connections. This means that underperforming managers are less likely to be dismissed.

Governments in the region exert an outsized influence on the private sector. The nature of state interventions affects the functioning of the private sector. Governments can pursue policies that alleviate market failures and thus could provide a helping hand (Shleifer, 1998; Islam, 2015). On the other hand, governments can distort companies' incentives and market allocation by pursuing private or political goals that are not in the public interest. In the Middle East and North Africa, the state manifests itself in the private sector in different forms. The region has a high prevalence of state-owned enterprises. Globally, government-run firms tend to perform more poorly than their private peers (Tihanyi et al., 2019; Abolhassani et al., 2020). This is largely due to principal-agent problems that lead to less monitoring of management as well as weaker incentives to maximise profits (Shleifer, 1998; La Porta et al., 1999; Vining and Boardman, 1992). All these issues are especially salient in MENA, where the state is particularly interventionist.

Partially government-owned firms in MENA and ECA are likely to be large, to have a foreign investor, and to be run by men. Partially government-owned businesses are more likely to be large than private firms across both the Middle East and North Africa and Europe and Central Asia. Furthermore, across both regions, partially government-owned companies are more likely to have an element of foreign ownership than private firms and are less likely to have a woman as top manager. The share of companies that have a woman as majority owner are rare, particularly in the Middle East and North Africa. With this in mind, there is no government ownership in majority women-owned firms in the region. This was also the case in Europe and Central Asia in 2019, although in 2013, 3% of partially government-owned firms in the region had majority ownership by women, which was still far less than the corresponding figure for fully private firms (9%).

There are distinct differences in certain characteristics of partially government-owned firms between the Middle East and North Africa and Europe and Central Asia. In MENA, partially state-owned companies tend to be younger than private firms, while in ECA, they tend to be older. Partially state-owned firms in MENA are more likely to be in the services sector, while in Europe and Central Asia they are more likely to be in the manufacturing sector. Specifically, a larger share of these companies in MENA are in the following sub-sectors in descending order: transport, storage and communication; hotels and restaurants; and food manufacturing. In ECA, the corresponding top three are construction; retail; and food manufacturing. In the Middle East and North Africa, partially state-owned firms are more likely than private companies to be exporters, while in Europe and Central Asia there is little difference. In ECA, partially state-owned firms are more likely to seek or secure a government contract than private businesses. This was also the case in MENA in 2013, but in 2019, partially government-owned companies were even less likely to see government contracts than private ones.

Section 4

Trade and innovation in MENA

International trade is a key factor in companies' competitiveness and innovation. Trade participation, profitability and survival are driven by different aspects of the business environment. These include the export capacity of domestic firms in an industry, foreign direct investment, trade costs and barriers, the quality of infrastructure and the availability of skilled workers. Trade integration also plays a critical role in shaping the incentives for firms to innovate through various channels, including larger market size, increased competition, induced specialisation and international knowledge spillovers (Melitz and Redding, 2021; Buera and Oberfield, 2020; De Loecker, 2013). As companies' products mature and become more standardised, production processes can be moved from developed countries at the frontier of innovation to countries at lower levels of development. The lag in technological diffusion gives rise to trade through global value chains and, at the same time, facilitates the adoption of new technologies (Vernon, 1966; Krugman, 1979). This, in turn, can raise firm productivity and an economy's aggregate rate of growth (Perla et al., 2021).

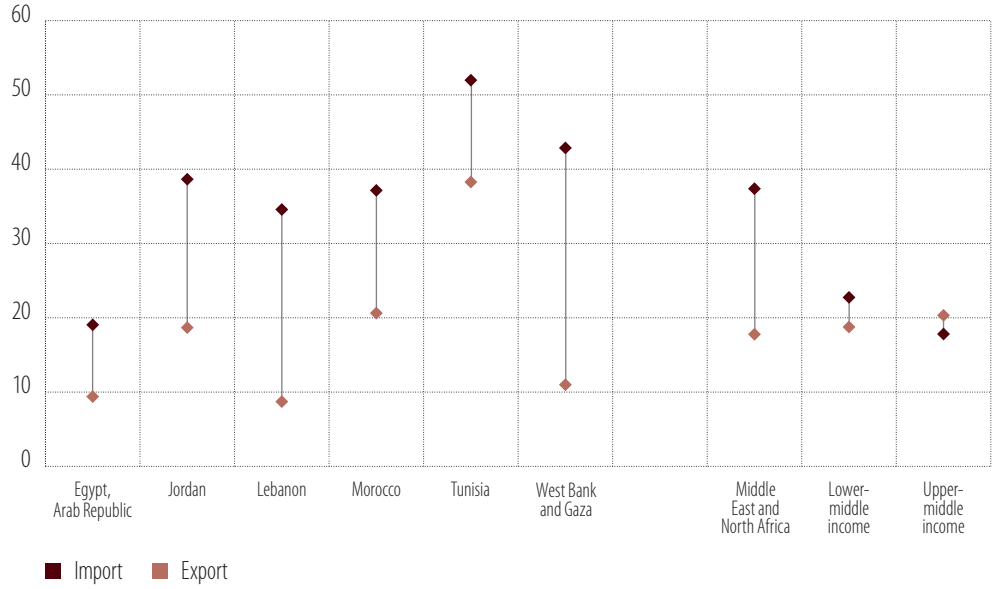
As a share of GDP, MENA economies tend to import more goods than they export. As shown by Ficarra et al. (2022), all six countries had a negative trade balance in 2019 (Figure 4.1). Imports of goods represented more than 30% of GDP of these countries (with the exception of Egypt), which is above the average of upper-middle-income and lower-middle-income benchmark economies, which are around 20% of GDP. At the same time, exports accounted for about 18% of GDP, in line with the average of lower-middle-income and upper-middle-income countries.

Most firms in the region engage in trade. But the breakdown of companies' trading profiles outlines the import dependence of most of the countries, particularly Jordan, Lebanon and the West Bank and Gaza (Figure 4.2).[8] This may reflect the relatively small size of the economies or the fact that firms are unable to find inputs in the domestic market — for example, due to policies overvaluing local currencies (Jaud and Freund, 2015). The share of "non-traders" is particularly large in Egypt and Morocco, in line with the relatively larger size of the domestic economy.

Most firms that export their goods or services also import at the same time, indicating that they participate in global value chains by importing, transforming and adding value before re-exporting. The share of firms that participate in trade varies across countries. Tunisia and Morocco have opted for an economic model that is oriented toward exports and industrialisation supported by a pro-active policy of attracting foreign direct investment (Saliola and Zanfei, 2009). This has enabled transfer of technology and know-how. For example, Morocco has become an important supplier of global value chains in the clothing, automobile and aerospace industries (AfDB, OECD and UNDP, 2014).

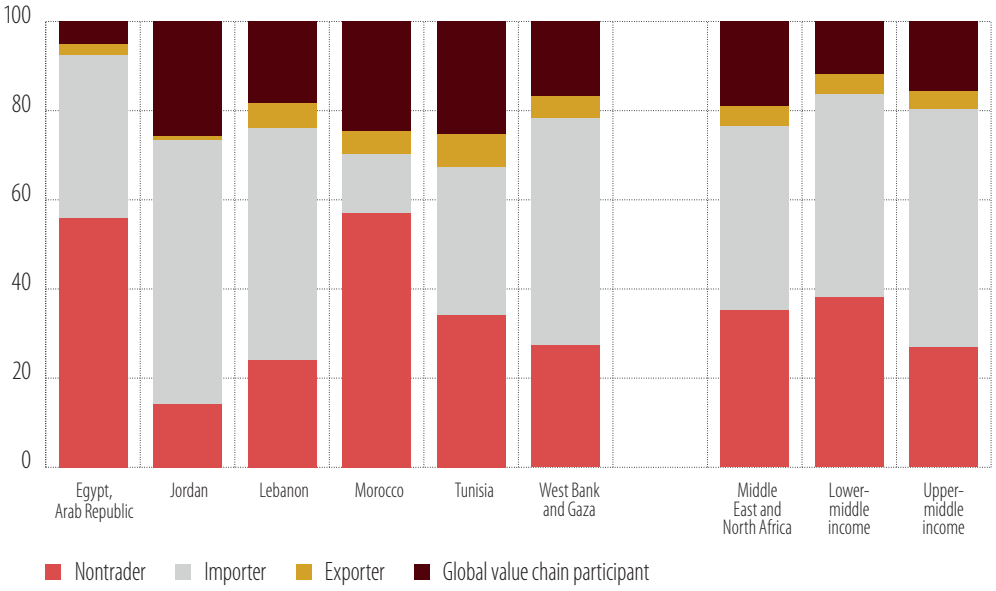
8 Importers are defined as companies that purchase more than 10% of material inputs or supplies from overseas. Exporters are defined as firms exporting more than 10% of their sales directly.

Figure 4.1
Imports and exports of goods in 2019 (% of GDP)



Source: *World Bank World Development Indicators.*

Figure 4.2
Trading profiles in 2019 (% of firms)

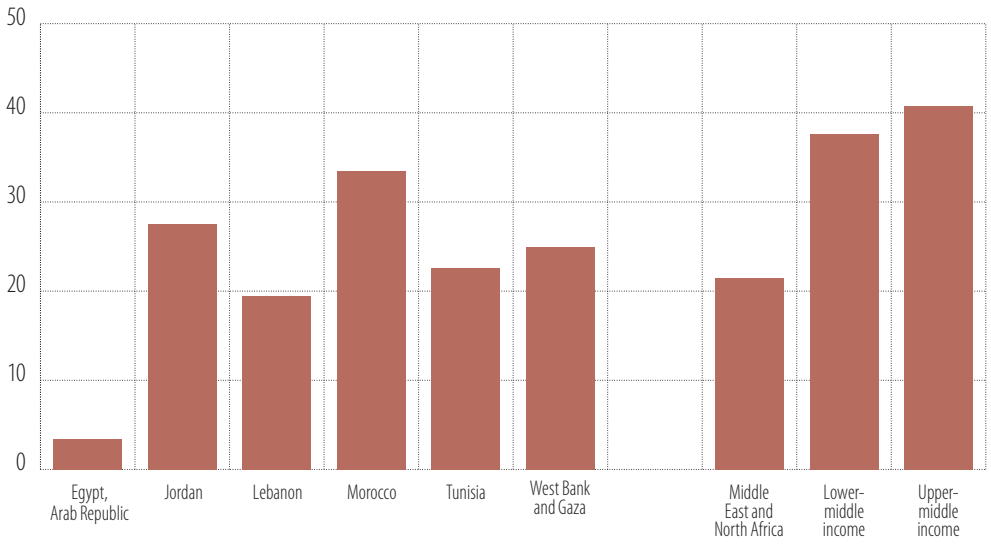


Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Benchmark groups based on unweighted country averages. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

Innovation rates are particularly low in the region. Innovation rates in all MENA countries are below those in other middle-income countries (Figure 4.3). Innovation activity has been deteriorating in the region in recent years, and this gap is also reflected in the low level of investment in intangible assets. This is worrying for the medium- to long-term economic prospects for the region. During the COVID-19 crisis, innovation proved to be key for firms to be more resilient and to adapt better to the economic shock.

Many productive firms might not be able to reap the scale and efficiency benefits from trade and innovation because of the weak business environment and state dominance in the economy. The significant presence of state-owned enterprises in the region discourages the entry of private companies and hinders innovation (Arezki et al., 2018). State-owned enterprises frequently provide goods and services to downstream markets and purchase inputs from upstream markets, affecting the whole value chain of the sectors in which they operate (Arezki et al., 2019). Similarly, privileges granted to politically connected firms in MENA can result in policy distortions, which can come in the form of subsidies or trade protection (Schiffbauer et al., 2015). This can also reduce incentives to invest in innovation. According to the 2020 WEF (World Economic Forum) Global Competitiveness Report, MENA countries perform worse than benchmark economies in terms of macroeconomic environment, labour market efficiency and technological competitiveness (Figure 4.4). Under this challenging environment, the traditional channels of private sector development might be blocked or narrowed considerably.

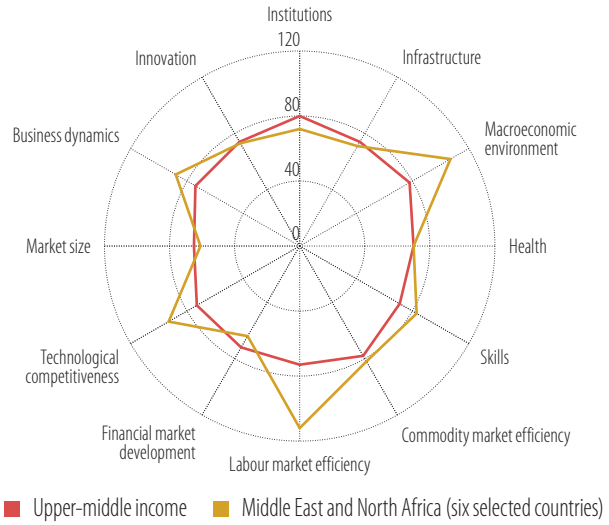
Figure 4.3
Innovation rates (% of firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Innovative firms are defined as those introducing new or improved products, services or processes, or spending on research and development activities. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

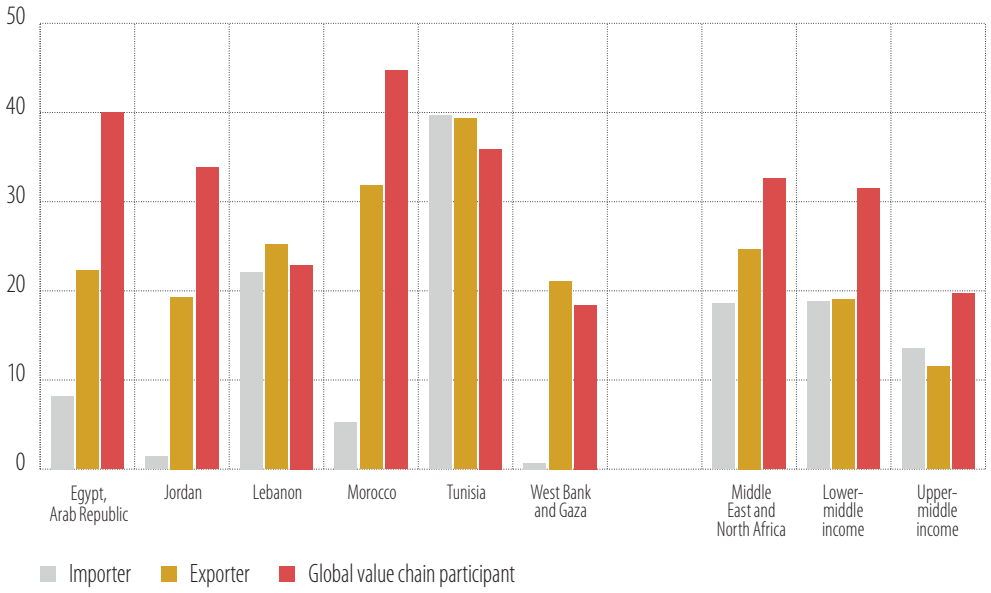
Customs and trade regulations appear to be more severe barriers for firms in the Middle East and North Africa than in benchmark countries (Figure 4.5). The presence of barriers to trade, either through non-tariff or tariff measures, can reduce cross-border trade for both importers and exporters. This is worrying because the efficiency of customs is an important trade facilitator via its effects on volume and shipping frequency (Hornok and Koren, 2015; Volpe et al., 2015). Barriers to trade may decelerate the growth of efficient firms, and even result in lower value-added (UNCTAD, 2005; Porter, 2000). Companies in MENA also report that it takes more days to clear customs to import or export goods than in other countries (Table 4.1). This does not appear to be driven by requests for bribes and breakage, but could be due to bureaucracy.

Figure 4.4
Global Competitiveness Index (rank)



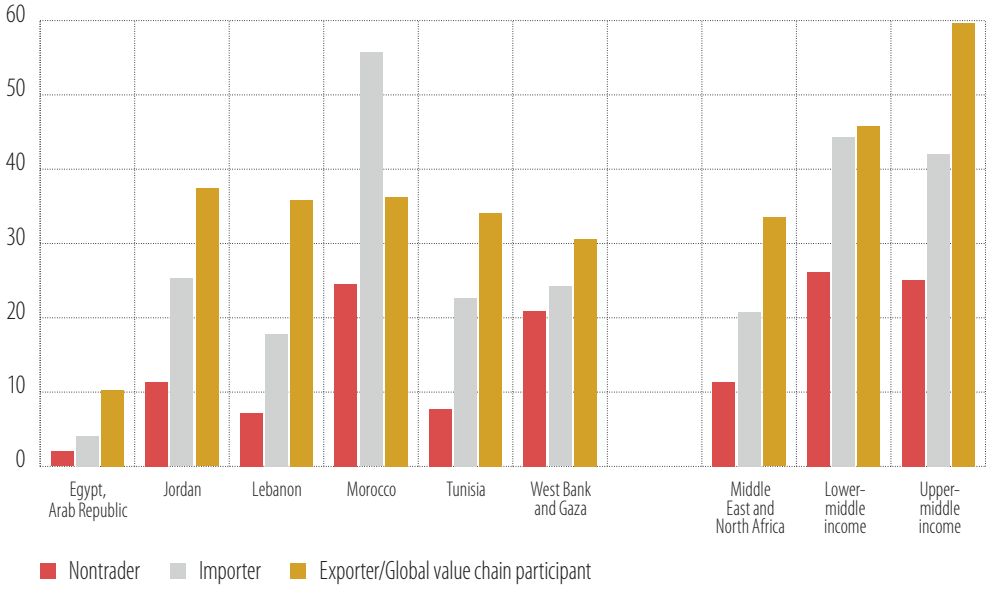
Source: *WEF 2020 Global Competitiveness Report MENA economies include Egypt, Jordan, Lebanon, Morocco, Tunisia and the West Bank and Gaza.*
Note: *A lower value means a better rank.*

Figure 4.5
Customs and trade regulation are major obstacles to business operations (% of firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

Figure 4.6
Innovation rates, by trading profile (% of firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

Table 4.1
Business environment for traders

	Days to clear exports through customs	Days to clear imports from customs	Informal payment to export (percentage of firms)	Informal payment to import (percentage of firms)	Export loss due to breakage and spoilage (percentage of sales)
Egypt	6.7	8.4	4.2	6.6	0.2
Jordan	4.7	4.6	0.3	0.1	0.2
Lebanon	12.3	14.2	10.6	13.4	0.5
Morocco	6.7	13.1	10.0	32.6	3.2
Tunisia	6.7	15.8	0.5	3.8	0.3
West Bank and Gaza	5.3	19.4	0.0	3.3	3.6
MENA	7.3	12.8	3.6	7.9	1.1
LMI	4.6	10.5	8.7	14.1	1.1
UMI	4.0	5.4	5.8	8.1	0.3

Source: *Authors' calculations based on Enterprise Surveys.*

Firms participating in cross-border trade are larger and more productive than non-traders. The Enterprise Survey data show that there are significant differences in the average size and productivity levels of traders and non-traders. Traders are larger and more productive.[9] On average, superstar exporters also tend to pay higher wages to their workers. Nevertheless, the higher export intensity, in line with higher capital intensity, is associated with a lower labour share per firm. Superstar exporters may benefit,

9 Firms can be classified in different categories based on their exports sales: superstar exporters, big player exporters and small players (EBRD et al., 2016). Superstar exporters are defined as firms above the 95th percentile of the distribution of export sales, big player exporters are firms between the 50th and 94th percentile, and small player exporters are firms below the median.

for example, from lines of credit from the banking sector, but also direct public support, such as land and energy subsidies, protection and privileges that make it difficult for smaller domestic firms to access export markets and reap the benefits from trade.

Trade participation and innovation are closely intertwined. On the one hand, companies in the region that trade in international markets tend to innovate more (Figure 4.6).Traders also tend to grow faster when they invest in innovation, confirming the self-selection hypothesis of more productive, larger and innovative firms entering into trade activities. On the other hand, trade participation has a positive impact on the innovation process, even after controlling for the potential sample selection bias, confirming the "learning-by-exporting" effect. In addition, the use of foreign-licensed technology appears to have a key role in innovation, even after controlling for the effect of trade participation.

Access to foreign markets facilitates international technology diffusion and innovation. Participation in global value chains can foster innovation at the company level. This is also highlighted in the estimates of a gravity model of trade for MENA showing that trade barriers are stronger for firms in in that region than in other regions. There are several reasons why trade may be an important driver of innovation. Firstly, by importing intermediate goods for participation in global value chains, companies may also import state-of-the-art technology that was not previously available in the domestic market. Secondly, managers may need to adapt their production methods to improve process efficiency and increase the quality of the products they export. Thirdly, improved logistics and quality upgrades may be required to be able to work with foreign clients or partners. This may also require further training of workers to enhance their technical skills, which, in turn, would enable firms to introduce new or improved products and processes.

Traders and innovative businesses were more likely to adapt to the COVID-19 crisis and to the associated sales shock. They are much more likely to have started or increased online business sales and remote working arrangements. Traders and innovative firms were more productive, better managed and more digital before the pandemic: This may explain why they could adapt better to the COVID-19 crisis. For example, participants in global value chains were about 9% more likely to start or increase remote work than companies that did not import or export. Similarly, firms that introduced a new product, service or process in the three years before the COVID-19 crisis were almost 50% more likely to start or increase remote work during the pandemic than non-innovative firms.

Trade integration with developed economies, in particular the European Union, and access to information and know-how through participation in global value chains may help to close MENA's innovation gap. Digital capacity and connectivity with international markets are critical to better adapt to economic shocks such as the COVID-19 crisis. Policies should prioritise investment in digital infrastructure and pay special attention to improving management practices and workers' digital skills. Moreover, improving customs and trade regulations, which will lower entry costs for companies to engage in trade, will increase access to international markets to a larger share of businesses. But these measures should not be limited to certain groups of firms. Instead, the focus should be on creating better incentives to invest in innovation for all firms. Ultimately, this may also help increase the integration of domestic firms — especially smaller ones — into global value chains.

Section 5

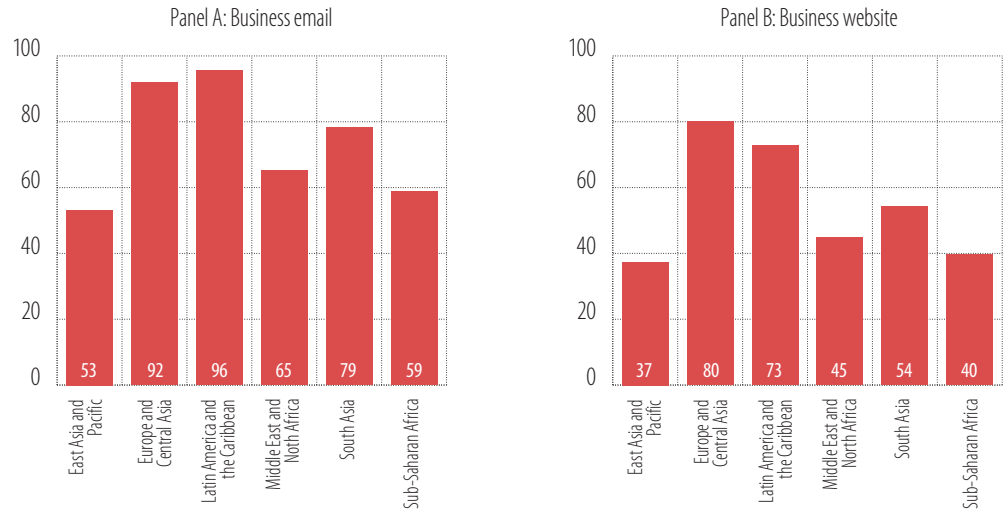
Adoption of digital technology and productivity growth

The global digital economy accounted for 15.5% of the world's GDP in 2016 ($11.5 trillion), yet its growth has not been equally distributed. There are still huge disparities across and within countries when it comes to the adoption and usage of digital technologies (Comin and Mestieri, 2018). While more than half of the world's population now has access to the internet, the penetration rate in the least developed countries is only 15% or one in seven individuals (World Development Report 2019).

Gains from adopting digital business solutions, such as using email, creating a business website or connecting to two-sided digital platforms can be substantial. Reductions in search costs enable buyers and sellers of products or services to get better access to the other side of the market by increasing the speed or efficacy with which companies can find workers or suppliers. This allows firms to decrease production costs and sell to larger markets, both domestically and internationally.

MENA firms lag behind their counterparts in other developing countries in terms of adoption of digital technology. Figure 5.1 displays GDP-weighted regional average email (Panel A) and website (Panel B) adoption rates using the last wave of the Enterprise Surveys around the world (Cusolito et al., 2022). This involves 26 countries from Europe and Central Asia (ECA), 26 from Sub-Saharan Africa (SSA), 16 from Latin America and the Caribbean (LAC), six from South Asia (SA), five from East Asia and Pacific (EAP) and three from MENA. These adoption rates are not fully comparable across regions, as in different countries data collection takes place at different points in time.

Figure 5.1
Email and website adoption rates (% of firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Panels A and B of Figure 5.1 display GDP-weighted regional average email and website adoption rates corresponding to the last wave of the Enterprise Survey database for each of the countries included in the panel database, respectively. The rates consider sampling weights and are therefore representative at the national level. But adoption rates are not fully comparable across regions, as the World Bank collects data for different countries at different times. The last Enterprise Survey round were held in 2015-16 for East Asia and Pacific (five countries); 2012-13 for Europe and Central Asia (26 countries); 2009-17 for Latin America and the Caribbean (16 countries); 2007-16 for Middle East and North Africa (three countries); 2013-15 for South Asia (six countries); and 2007-18 for Sub-Saharan Africa (26 countries).*

Digital technology's total factor productivity (TFP) premiums are positive for 63% (email adoption) and 55% (website adoption) of the sample. The Enterprise Survey data make is possible to estimate the effects of adopting digital technology on firm-level productivity (revenue-based TFP, or TFPR) and the demand for labour and capital. TFPR premiums for learning-by-exporting and managerial experience are positive for 59% and 60% of the sample, respectively.[10]

The probability-adjusted median TFPR premium associated with email adoption is 1% and that of website adoption is 2.3%, while the premium corresponding to getting access to external markets is 1.1% and that for increasing managerial experience is near zero. The probability-adjusted estimates are calculated as the product of probability of adoption and the gains given adoption. These estimates represent lower bounds of the marginal effects of technology adoption, as digitisation can also increase TFPR by reducing distances and facilitating access to international markets.

Aggregate TFPR gains from universal adoption of digital solutions are 21% for a region like the Middle East and North Africa, compared with 16% for Sub-Saharan Africa when there is perfect targeting (when digitisation efforts are oriented towards firms with positive marginal effects from digitisation). Web-related aggregate TFPR gains from universal adoption of digital solutions in MENA are 20% (16% for Sub-Saharan Africa), while email-related gains are 1.0% (1.6% for Sub-Saharan Africa).

On average, adoption of digital technology augments both labour and capital. TFPR improvements are also labour-related, while they do not have an impact on the demand for capital. Globally, the direct effects of digitisation on jobs are larger than the indirect effect through TFPR. Counterfactual analysis of the aggregate job gains from universal adoption of digital solutions indicates that website adoption positively changes the labour demand more than email adoption. Email-related aggregate job gains from universal adoption are 2.5% for MENA compared with 4.1% for Sub-Saharan Africa (when there is perfect targeting). Web-related job gains from universal adoption vary from 7.0% for MENA compared with 10.2% for Sub-Saharan Africa (with perfect targeting).

The substantial benefits of technology adoption show that policies promoting digitisation are needed. Investments in digital infrastructure, as well as policies providing companies with incentives to adopt email and set up websites, will increase productivity growth at the firm level and therefore can significantly accelerate GDP per capita growth.

10 TFPR is an indicator of revenues conditional on input use and therefore reflects both technical efficiency (TFP based on quantities) and mark-ups. Adoption of digital technology may help a firm occupy new market niches and enjoy higher mark-ups. But as markets become more competitive and prices fall, businesses' TFPR can decline even if technical efficiency does not change; on the other hand, such price reductions bring welfare gains for consumers. The lack of price data in the Enterprise Survey means that it is not possible to analyse these effects.

Section 6

Businesses' human capital and formal training of workers

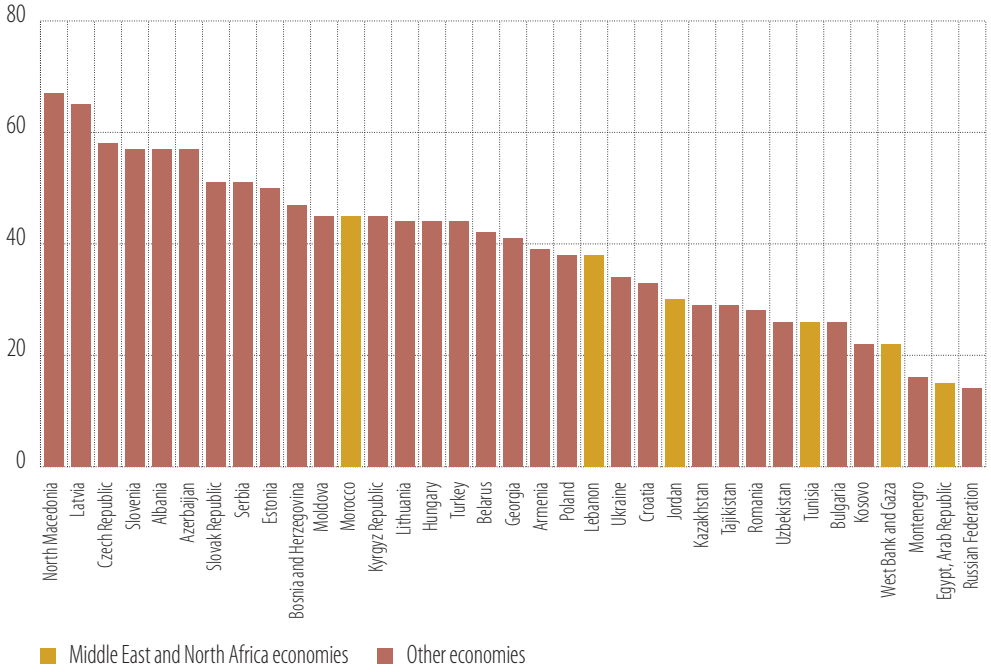
MENA economies are making inadequate use of their human capital. According to the World Bank's Human Capital Index, children born in the region today will be only 57% as productive as they would be if they benefited from a complete education and full health conditions when they grew up. The skills and productive potential of populations in the region do not translate into economic growth. The average Human Capital Index for the region declines from 0.57 to 0.32 when accounting for employment (World Bank, 2020). High youth unemployment, lengthy school-to-work transitions and a sizeable gap between the skills that companies want and those that young graduates possess are characteristics of the region (Liaqat and Nugent, 2015). Workers in Egypt, Jordan and Tunisia perform significantly fewer tasks that require non-routine interpersonal and analytical skills — the jobs of the future. Even among higher-skilled occupations, such as managers, professionals and technicians, non-routine analytical and non-routine interpersonal tasks are limited compared with other countries (World Bank, 2022).

Human capital acquisition at work is increasingly important. Rapid technological progress increases pressure on businesses to adapt. Sophisticated technology helps businesses keep up with the competition. Products are upgraded to meet changing demand. The skills of workers may require updating with shifting landscapes of technological advances. Work is an important avenue for workers to acquire skills. Human capital investments at work account for more than half of the human capital accumulated over a person's life (Heckman et al., 1998). The contribution of work experience to human capital accumulation might be as important as the contribution of education itself (Jedwab et al., 2021). Human capital at work is acquired either through learning on the job or formal training.

Firm-specific investments in human capital through employee training can reap rewards. Formal training of employees can improve firm performance by providing workers with necessary skills, increasing innovation and generally raising the level of competitiveness (Almeida and Aterido, 2015). It can also update the skills of workers in the fast-changing world of digitisation and automation through retraining (Brunello and Wruuck, 2020). The wage returns to training can be high for workers (Konings and Vanormelingen, 2015; Almeida and Faria, 2014). In developing economies, it can help to compensate for low quality schooling. Company-supplied training is typically more effective than government-supplied training, as firms have better knowledge of skills required by the market. But the incentives for businesses to offer formal training vary given that training represents investments in future productivity that come at a cost (Wolter and Ryan, 2011). The type of training may also matter. Businesses may be wary of providing general formal training as opposed to company-specific training given that firms receive little benefit from the former, especially if the workers leave and use their skills in competing firms (Becker, 1962). On the other hand, companies may invest in general skills to obtain informational advantages and monopsony power (Katz and Ziderman, 1990; Acemoglu and Pischke, 1998).

Formal training is low across businesses in the Middle East and North Africa. The Enterprise Survey provides information on the availability of formal training in firms. Training involves a structured and defined curriculum. It excludes training to familiarise workers with equipment and machinery on the shop floor or with the establishment's standard operating procedures, and employee orientation at the beginning of a worker's tenure. The 2018-20 data show that for the six MENA economies, only 29% of medium and large businesses provided formal training (Islam and Gatti, 2022b). This is lower than the average of the entire sample (39%), which includes economies from Europe and Central Asia. The prevalence of formal training in ECA is 41%. Figure 6.1 shows the percentage of firms providing formal training across the two regions in descending order. Egypt and the West Bank and Gaza are among the bottom four economies of the sample. Morocco is the only economy in the top half of the sample. On a positive note, the share of medium and large firms in the region offering formal training has risen from 26% in 2013 to 29% in 2018-20.

Figure 6.1
Companies offering formal training (in %)



Source: *Enterprise Surveys.*

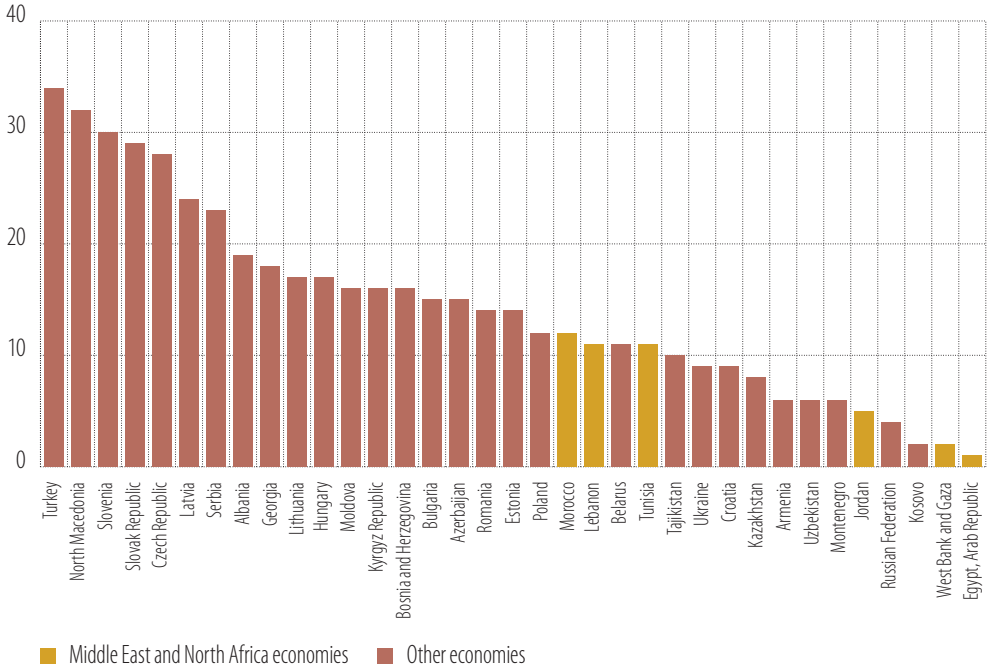
Manufacturing firms in the Middle East and North Africa provide formal training to a small share of workers. Few companies provide formal training in the region, but even when they do, a lower share of workers is trained compared to in other regions. A measure of the intensity of training is available for manufacturing firms. Figure 6.2 shows the average share of workers that received training in medium and large enterprises by country across the Middle East and North Africa and Europe and Central Asia in 2018-20. Firms that do not provide training are assigned a value of zero. No MENA country appears in the top half of the ranking. Egypt, and the West Bank and Gaza are the worst performing. On average, 7% of workers in companies in the region received formal training in 2018-20, less than half of the ECA average of 16%. Data from 2013 enable the tracking of trends in formal training over time, and the findings are mixed. On average, the share of MENA firms offering formal training has increased from 26% to 29%, although the intensity of training has marginally decreased from 8% to 7%. The challenge of low provision of formal training provided by MENA firms is a particular concern given the sizeable gap between the skills that companies want and those that young graduates possess.

In both MENA and ECA, companies that provide training tend to be larger, younger, exporters, foreign-owned and digitally connected. In MENA, businesses that offer formal training are more likely to be in the services sectors, while in ECA, there does not seem to be noticeable differences between sectors. Across both regions, companies that offer training are not more likely to be run by women than companies that do not. But in the Middle East and North Africa, firms that provide training are more likely to have a woman owner, whereas this is not a noticeable distinction in Europe and Central Asia.

Large and medium businesses in MENA have a high share of university-educated employees. In 2018-20, on average around 32% of workers in medium and large enterprises in the region had a university education. This is higher than the ECA average of 27%. Figure 6.3 provides the country averages of the share of workers in medium and larger firms that have a university education. Except for Tunisia, MENA economies are in the top half of the sample. The share of university-educated workforce has increased across both ECA and MENA between 2013 and 2018-20, with the latter experiencing a larger increase from 26% to 32%.

Figure 6.2

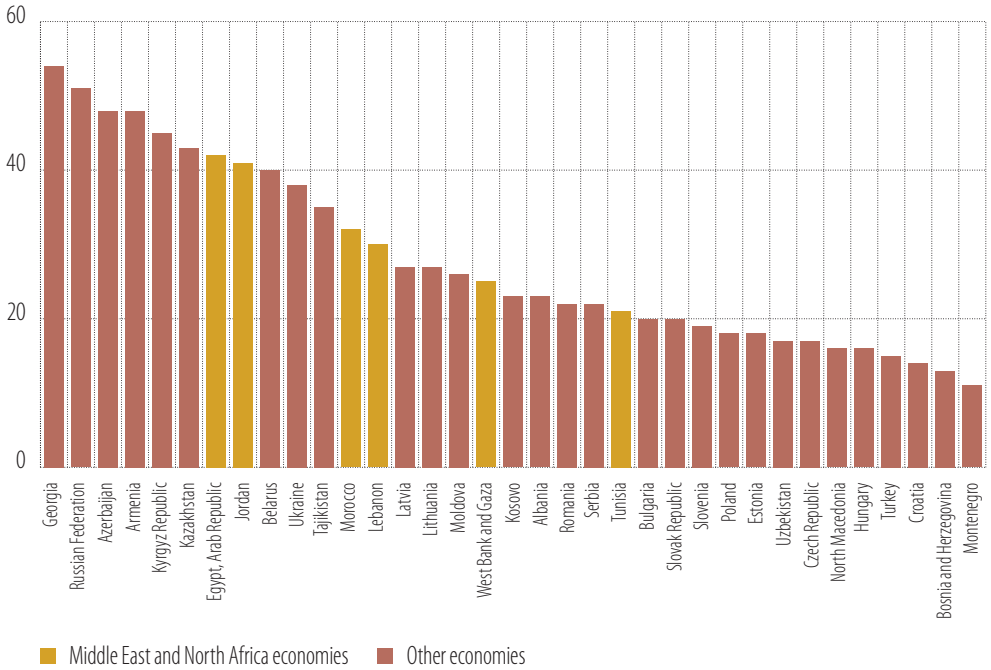
Percentage of workers offered formal training (0 if no training)



Source: *Enterprise Surveys.*

Figure 6.3

Percentage of permanent full-time employees with a university degree



Source: *Enterprise Surveys.*

The returns to training are higher for better-educated workers. A high level of education may signal high ability, and firms may be determined to retain educated workers by investing in them, especially in developing economies where there are fewer highly educated individuals. The cost of training may also be lower for educated workers who have already developed learning skills (Bassanini et al., 2007). Highly educated workers may require training throughout their careers as they develop different skill sets with experience. But highly educated workers may present a greater flight risk as they have more bargaining power and are more likely to move to other firms. Finally, the share of highly educated workers in a company may be a proxy for the level of general human capital in the economy. When human capital is generally low, companies may implement training programmes to compensate for a lack of education or for low quality education. Thus, formal training may be more prevalent across firms in economies with low human capital.

Better managers understand the importance of human capital and thus may be more likely to invest in training. Businesses with good management may understand the importance of training to gauge the ability of individuals and thus gain additional information (Acemoglu and Pischke, 1998). Training can allow workers to signal their ability and help companies attract workers of high ability (Autor, 2001; Cappelli, 2004). Furthermore, better management practices may instil the need to train workers to adapt to effective systems. The ability of businesses to set effective targets, monitor performance and promote and provide bonuses based on merit may permeate systems where workers are regularly trained to update skills and improve performance.

The level of human capital in businesses is a strong predictor of the incidence and intensity of formal training. Analysis of the 2013 and 2018-20 rounds of the Enterprise Surveys for the Middle East and North Africa and Europe and Central Asia shows that firms with more educated workers and better management practices are more likely to implement formal training and train a larger share of their workers. But there are considerable differences by region. In MENA, the share of university-educated workers is a significant predictor of employee training, while management practices do not have a statistically significant effect. There is some indication that dimensions of management practices, such as the monitoring of performance indicators, are positively related to formal training adoption in MENA, but these findings are not robust. In contrast, management practices are a robust predictor of training implementation across the ECA economies.

The type of training may matter. The positive relationship between the share of university-educated workers and formal training in MENA may differ by the type of training. The 2018-20 waves of Enterprise Surveys include information on the type of training implemented by businesses. Six types of training are considered. These include numeracy or mathematics; problem-solving or critical thinking; foreign language; managerial and leadership; interpersonal and communication; and job-specific technical skills.

The incidences of certain types of training are quite low in the region. The highest incidence is job-specific technical training (25.1%), followed by interpersonal and communication skills (1.7%) and manager and leadership skills (0.95%). Incidence of numeracy and mathematics skills (0.04%), problem-solving or critical thinking (0.03%) and foreign language skills (0.08%) are extremely low. The proportion of university-educated workers in the region is positively and significantly related to only one type of training — job-specific technical skills. Firms may be protecting their investments in training by focusing on specific skills that are not transferable to other firms. On the other hand, it may also be that the education systems in the region produce workers with skills that need to be upgraded to match the skills required by businesses.

Firms that are larger in size, invest in physical capital and possess quality certificates are more likely to train their workers. Larger firms have more resources and therefore are better able to implement costly formal training. This is a consistent finding across other regions as well (Almeida and Aterido, 2015; Liaqat and Nugent, 2015). MENA firms that have acquired quality certificates (ISO) are more likely to train their workers. Quality certification may reflect the degree of technological sophistication in the firm's production process (Liaqat and Nugent, 2015). It also enables companies to extract gains from innovation investments (Paunov, 2016). Firms that invest in physical assets, such as new equipment and machinery, are also more likely to offer formal training for their workers.

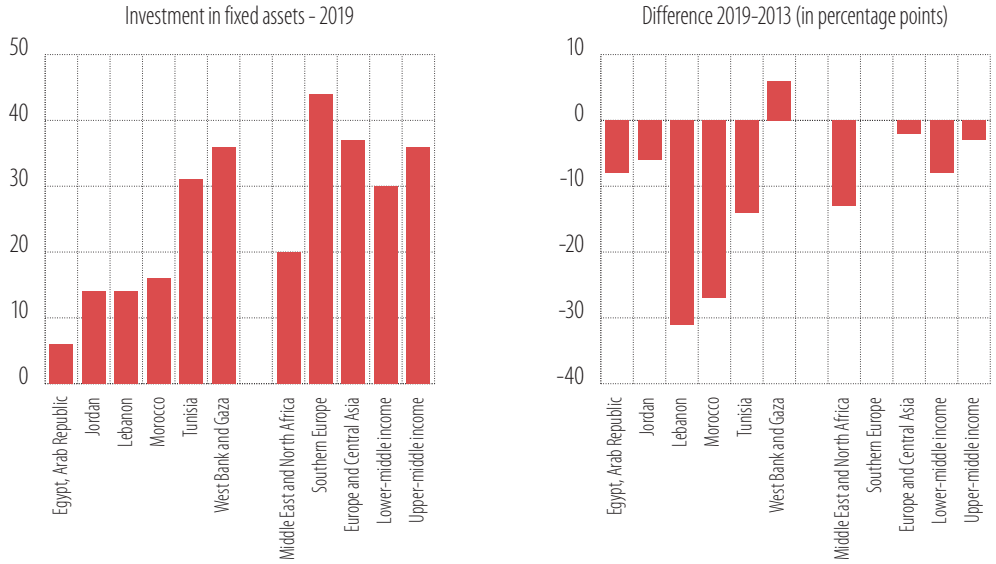
The analysis of human capital in companies in the region has important policy implications. Firstly, increasing university education in the workforce may provide incentives for firms to invest more in their workers. This has positive implications for increasing tertiary education among the population as it gives companies incentives to retrain and update the skills of their workers. But given the documented high unemployment among university graduates in the region, this may be insufficient and may need to be coupled with reforms that strengthen the private sector and improve the business environment. Furthermore, if the prevalence of training is to adapt and update the skills of educated workers towards the skills needed in the private sector, then the policy implication is not only to increase university education, but also to ensure it serves the private sector as well. Secondly, good management practices in the region's businesses may not be enough and government intervention to improve the university education of the workforce may be needed. One possibility is that the prevalence of low quality management practices in the region renders them ineffective in providing incentives for investments in workers. Finally, policymakers should note the advantages of adopting a broad comprehensive approach to increase formal training by businesses. Promoting a business environment conducive to physical capital investment and innovation is likely to provide incentives for businesses in the region to invest in their workers.

Section 7

Access to finance and investment

MENA economies covered by the Enterprise Survey have exceptionally low investment rates. Investment is necessary for the capital stock of any given economy to grow. Without investment, the living standards in the economies covered in this report will not converge to those in advanced economies. Access to finance facilitates investments and thereby raises potential growth.[11] As Figure 7.1 shows, only 20% of firms in the average MENA economy invested in fixed assets, a much lower percentage than in benchmark economies (Akbas et al., 2022). The low investment rates reflect a marked decline relative to the 2013 wave of the Enterprise Survey. The decline in investment rates is broad-based, with only the West Bank and Gaza seeing an increase in the share of investing firms. These observations are consistent with the macroeconomic data shown in Section 1.

Figure 7.1
Investment in fixed assets (% of firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Southern Europe (SE) includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

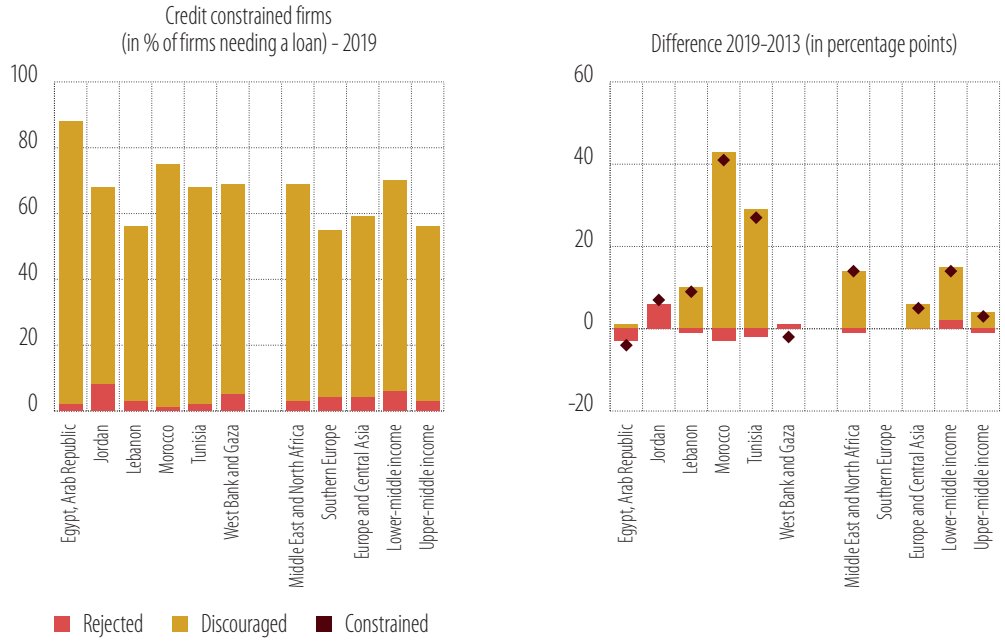
Low investment rates in the region's economies may be driven by the lack of access to external finance. Analysis of the Enterprise Survey data shows that a large share of firms in need of a loan are unable to obtain one and are thus credit-constrained. Credit-constrained businesses are defined as businesses that need a loan but either have their loan application rejected or are discouraged from applying in the first place.[12] Figure 7.2 shows that in the average MENA economy, about 69% of firms needing a loan are credit-constrained, compared with 59% in Europe and Central Asia. But the regional average masks considerable variation across countries. Almost 90% of Egyptian companies in need of a loan are credit-constrained,

11 See, for example, Levine (2005) for a comprehensive overview of finance and development.

12 See EIB (2021) for a comparative discussion of credit constraint indicators in the EIB Investment Survey, the ECB Survey of Access to Finance of Enterprises and the Enterprise Survey.

compared with 56% in Lebanon and 68% in Jordan. Figure 7.2 also shows that the vast majority of credit-constrained firms are discouraged. Rejections, on the other hand, are rare across all regions. Morocco and Tunisia see a strong increase in the share of credit-constrained companies when compared with the previous survey round.[13] But the other countries also record an increase in the proportion of credit-constrained firms, albeit to a much smaller degree. In contrast to benchmark economies, there is no apparent association between firm size and age and credit constraints.

Figure 7.2
Credit-constrained firms (in % of firms needing a loan)

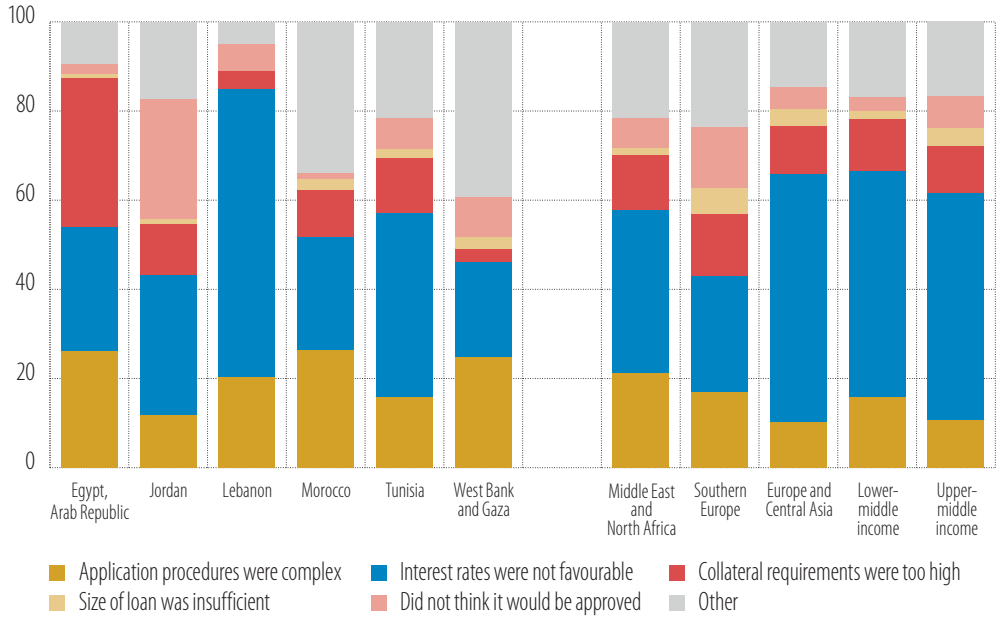


Source: *Authors' calculations based on Enterprise Surveys.*
Note: *SE includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

Stringent collateral requirements, complex application procedures and high interest rates discourage companies from applying for a loan. The Enterprise Survey provides information on why businesses are discouraged. Figure 7.3 shows that firms most frequently cite high interest rates as the reason that they did not apply for a loan. But the relative importance of high interest rates differs by country. In Lebanon, the majority of discouraged firms are deterred by high interest rates. In Egypt, Jordan and Morocco, complex application procedures also play an important role. Egypt stands out in that collateral requirements are the key factor discouraging firms.

13 The 2013 sample for Morocco did not achieve the targeted number of interviews. The sample had been reweighted to ensure its representativeness. The steep increase in the share of credit-constrained firms may be partly attributed to the data collection difficulties in 2013.

Figure 7.3
Factors discouraging firms from applying for a loan (in % of discouraged firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *SE includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

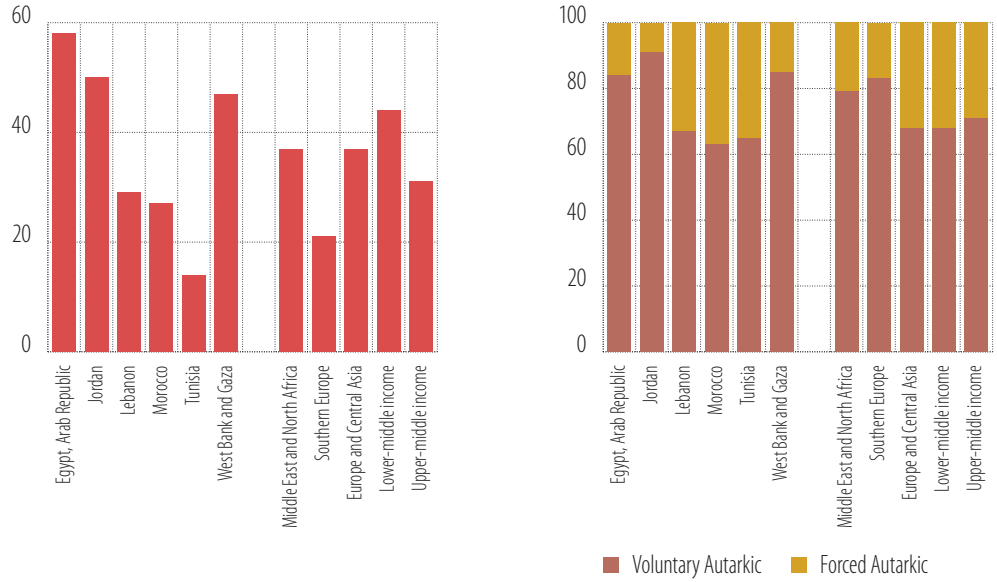
A significant share of companies in the Middle East and North Africa are financially autarkic.[14] Analysis of the first round of the MENA Enterprise Survey (EBRD et al., 2016) demonstrated a disconnect between companies and banks in the region. Accordingly, companies have adjusted production strategies to a world where external financing is not really an option, even if this comes at the cost of losing growth opportunities. Data from the 2018-20 Enterprise Survey confirm that many MENA firms are still disconnected from the financial system. Such firms use internal finance only and can therefore be characterised as financially autarkic. Combining data on firm liability structure with information on loan demand makes it possible to understand whether the firm finds it optimal to self-finance. Businesses that are financially autarkic and do not need a loan are voluntarily autarkic. Financially autarkic firms that need a loan are by definition credit-constrained, for if they had obtained a loan they would no longer be autarkic. These firms are considered forced autarkic.

At 37%, the share of financially autarkic firms is below the lower-middle-income average of 44% and above the upper-middle-income average of 31% (see Figure 7.4). High autarky rates of around 50% in Egypt, Jordan and the West Bank and Gaza are offset by the comparatively low rates prevailing in Lebanon, Morocco and Tunisia. At 14%, Tunisia's share of autarkic firms is below the Southern European average. In advanced economies, the share of zero-leverage firms is much lower. For example, zero-leverage firms account for 10% of listed US companies.[15]

14 To qualify as autarkic, a company must finance its working capital from internal sources only. This definition excludes, for example, firms that use supplier credit to finance their working capital. In case the firm invests, the investment also needs to be financed exclusively from internal sources. In addition, the firm must not have an outstanding loan or access to an overdraft facility.

15 See Strebulaev and Yang (2013). El Ghoul et al. (2018) cover zero-leverage firms in a broader set of countries.

Figure 7.4
Prevalence of financial autarky (in % of autarkic firms)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *SE includes Cyprus, Greece, Italy, Malta, and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

The majority of financially autarkic firms are voluntarily autarkic. Figure 7.4 shows that the majority of financially autarkic firms are voluntarily autarkic. There are substantial differences between Egypt, Jordan and the West Bank and Gaza, on the one hand, and Lebanon, Morocco and Tunisia on the other. Not only do the former countries have a higher share of autarkic firms, but a greater share of the autarkic firms are voluntarily autarkic. The share of voluntarily autarkic firms has increased by 5 percentage points relative to the 2013 survey round, despite efforts to improve access to finance. The increase is strongest in Jordan with 12 percentage points, followed by the West Bank and Gaza (7 percentage points) and Morocco (6 percentage points). The increase in autarky is consistent with the decline in investment activity in the countries concerned.

Younger and smaller firms are more likely to be financially autarkic. Size and age are strongly associated with financial autarky, with small and medium-sized enterprises and young companies more likely to be financially autarkic. Firm sophistication (as measured by having an internationally recognised quality certification, a website, using licensed technology and being able to offer formal training to employees) is associated with lower autarky. Firms that cater mainly to local markets are more likely to be autarkic than exporters.

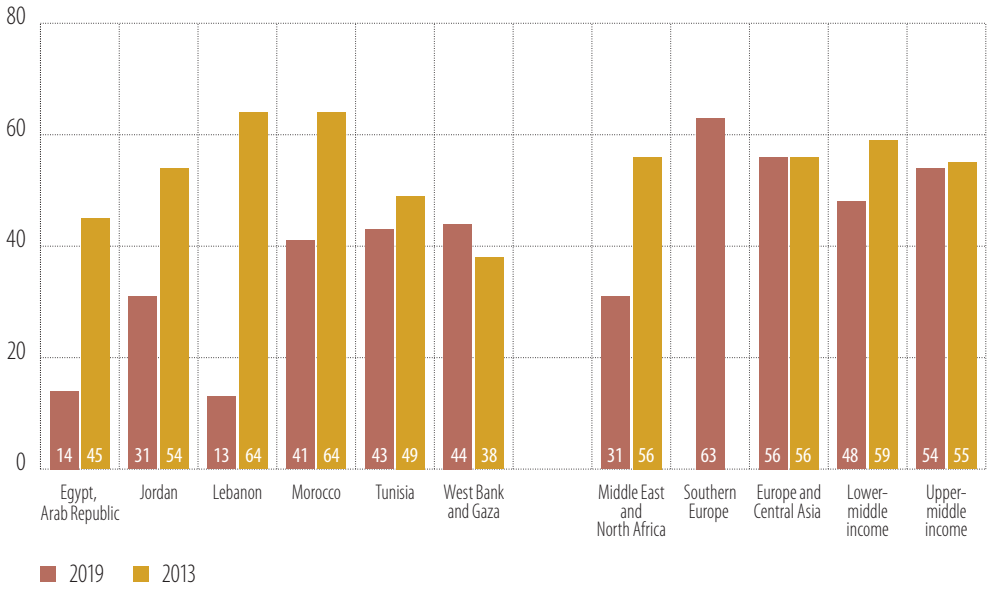
Poor and poorly governed countries have a greater share of financially autarkic firms. In countries that are better governed according to the Worldwide Governance Indicators, the share of autarkic firms is lower. But Egypt, Jordan and the West Bank and Gaza have a higher share of voluntarily autarkic firms than can be expected given the quality of governance in these countries. Likewise, wealthier economies have a lower share of financially autarkic firms. Again, Egypt and Jordan have a higher share of voluntarily autarkic firms than the average country with similar GDP per capita. Finally, countries with a positive output gap have, on average, a lower share of financially autarkic businesses than countries with a negative output gap. This is consistent with the notion that the provision of credit is pro-cyclical.

The latest survey data suggest a weaker relationship between access to finance and investment. In most developing countries, credit-constrained firms have a significantly lower propensity to invest than

firms that are not credit-constrained. This empirical regularity no longer holds in the Middle East and North Africa. Although investment rates have decreased across the board, the decline in the propensity to invest among firms with an approved loan application stands out (see Figure 7.5). In 2013, 56% of MENA firms with an approved loan application invested in fixed assets. By 2018-20, this share had shrunk to just 31%, a level well below that of benchmark economies. Lebanon records the strongest decline, which reflects the intensifying financial and balance-of-payments crises at the time of data collection. But Egypt, Jordan and Morocco also experienced a strong decline in the propensity to invest among firms with an approved loan application.

Businesses that are not credit-constrained account for a significant share of the decline in investment activity. This pattern lends itself to two interpretations that differ in the role ascribed to interest rates. The first interpretation emphasises the importance of interest rates for investment demand. In this view, the build-up of government debt documented in Section 1 drives up interest rates. In a high interest rate environment, firms use bank finance mainly to address short-term liquidity needs. The second interpretation emphasises obstacles to investment other than finance. High uncertainty, for example, is unfavourable to investment. In the context of the MENA economies, high uncertainty could stem from the political instability that is frequently mentioned as the top obstacle by survey respondents.

Figure 7.5
Investment propensity of firms with an approved loan application (in %)

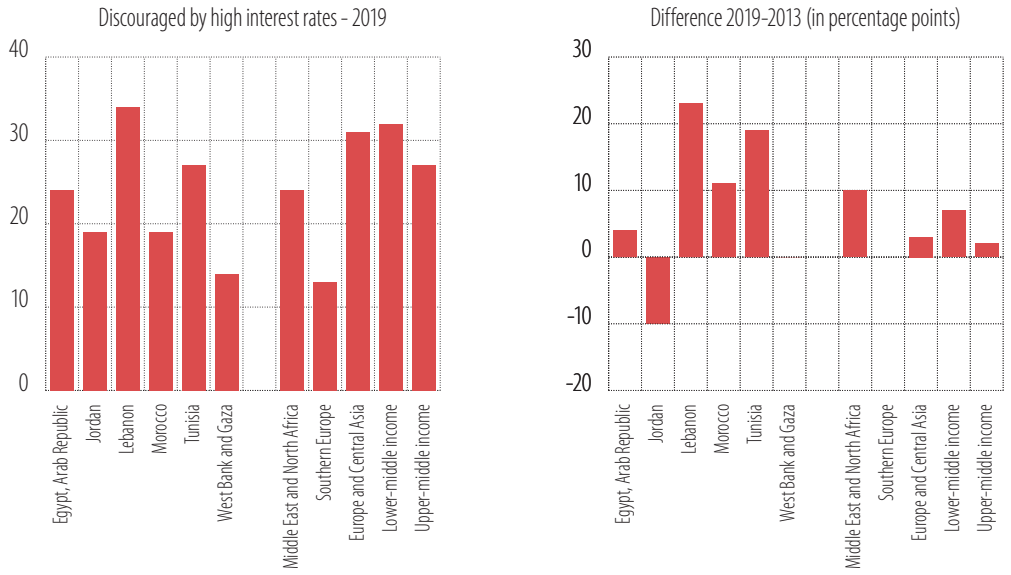


Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Southern Europe (SE) includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

The motives for using bank loans depend on the level of interest rates. By reducing the present value of investments, high interest rates can also discourage companies from investing. With high interest rates, only the firms that have liquidity problems or short-term financing needs would still apply for a loan. This makes interest rates a likely reason for the change in companies' use of external finance motives. Given the limited access of banks in the region to global financial markets, mounting government debt in the last decade is likely to have crowded out private firms. Therefore, even if domestic economic activity remained strong owing to government expenditures, high interest rates may have prevented firms from undertaking projects that would be feasible under more reasonable loan rates. But data on loan rates that firms face is hard to find. Other rates (such as yields on government bonds or central bank rates) are likely to be poor proxies for actual loan rates. Nevertheless, the Enterprise Surveys provide an indirect

measure for the level of interest rates, namely the proportion of firms discouraged from applying for a loan because of high interest rates. As Figure 7.6 shows, the share of firms discouraged by high interest rates has increased relative to the 2013 round of the Enterprise Survey.[16]

Figure 7.6
Firms discouraged by high interest rates (in % of firms needing a loan)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *SE includes Cyprus, Greece, Italy, Malta and Portugal. ECA includes middle-income economies in Europe and Central Asia. LMI refers to the economies that are part of the 2018-20 round of the Enterprise Surveys and classified as lower-middle income. UMI presents the corresponding average for upper-middle-income economies.*

There is a strong negative relationship between the proportion of firms discouraged by high interest rates and the investment rates of firms with an approved loan application. This finding is consistent with the hypothesis that interest rates are an important factor restricting investments for firms able to obtain a loan.[17] In line with the charts above, the MENA countries shifted right along the horizontal axis of Figure 7.7, reflecting the increase in firms discouraged by high interest rates. The sharp decline in investment in the region's economies results in a downward shift along the vertical axis. The correlation between discouragement from interest rates and investment conditional on an approved loan application appears even stronger in MENA. The stronger correlation can indicate a higher elasticity of investment with regard to interest rates, or a third factor driving both variables.

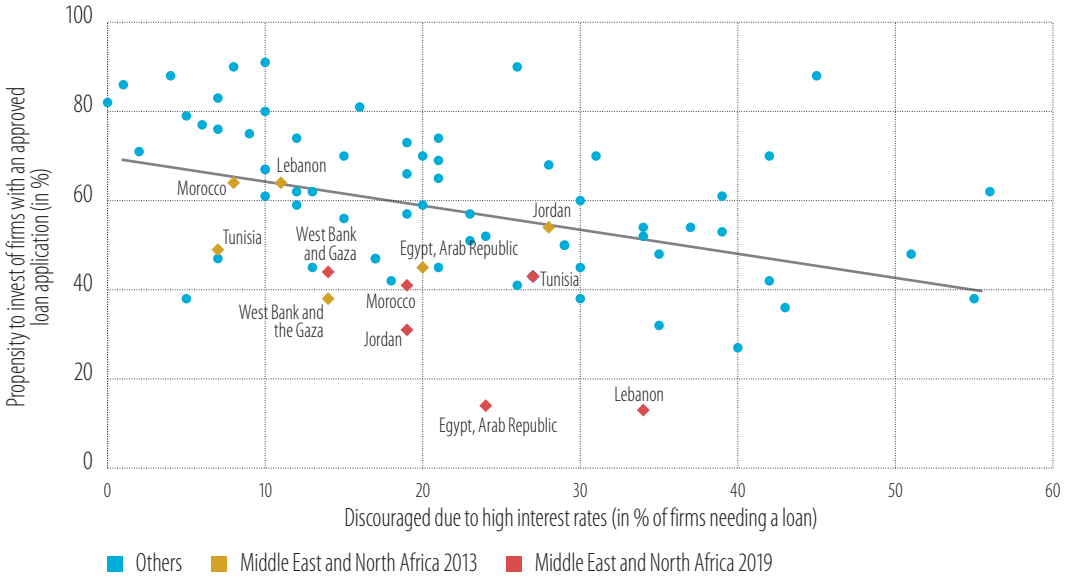
Although high interest rates resulting from the build-up in public debt may be the proximate cause of the decline in investment, an unfavourable business environment may drive both. Political instability remains the most frequently cited top business environment obstacle (see Section 1). Political instability can deter investment by lowering risk-adjusted returns. Put differently, in an environment characterised by high political instability, entrepreneurs may not be able to reap the rewards of their efforts. Other plausible factors include structural deficiencies of the business environment in the region, such as the legacy of a state-led development model (Hinnebusch, 2020; World Bank, 2004) and a business environment tilted in favour of politically connected firms (Schiffbauer et al., 2015). When faced with social unrest,

16 It is also important to note that complaints about high interest rates cannot be viewed in isolation from the returns that companies are able to generate with their assets. Firms discouraged by high interest rates implicitly state that their marginal cost of funding is high relative to the marginal return on capital.

17 Figure 7.7 is based on averages at the country-survey wave level, covering the 41 economies that are part of this wave of Enterprise Surveys and the 2013 round. The link cannot be estimated at the firm level since by definition, firms that have an approved loan application cannot be discouraged by high interest rates.

governments frequently resort to increased social spending to appease their constituents. These factors can explain anaemic economic performance and the build-up of public debt, which eventually further crowds out private borrowers.

Figure 7.7
Crowding out



Source: Authors' calculations based on Enterprise Surveys.

In summary, macro and micro data suggest that government borrowing has crowded out private investment. In addition to financial resources, lending to small and medium-sized enterprises requires certain resources, risk-assessing capacity, access to information on companies and a legal environment. But banks in the region already enjoy high returns by financing less risky government bonds, a strategy that does not consume bank capital. As crowding out eases, banks will look for ways to profit from lending to private sector firms and thus become more eager to develop the required capacity.

Fiscal consolidation is therefore key to improving private companies' access to finance. A credible programme might open up intermediary capacity before debt ratios even start to decline, as risk premiums can decrease quickly. This in turn can boost demand from foreign investors for domestic and sovereign debt and also increase the prospects of accessing global financial markets by the domestic banking system. As it stands, large firms and, most importantly, state-owned enterprises benefit most from the limited capacity for financial intermediation.

Fiscal consolidation is no substitute for a broader agenda of structural reform. The economies have not yet completed the transition to a business environment conducive to private sector-led growth. The high share of autarkic firms is a symptom of this problem. The results suggest that financial autarky is a response to a difficult operating environment. Moreover, financially autarkic firms are comparatively unsophisticated along a range of other dimensions. This suggests that supply-side improvements of the financial system on their own are unlikely to enhance the performance of these companies.

Section 8

The green economy in the Middle East and North Africa

Incentives for companies in the region to decarbonise remain weak as all economies continue to subsidise fossil fuels and electricity generated from fossil fuels. In all countries in the region, the share of fossil fuel subsidies in GDP decreased between 2015 and 2020, but remained far from negligible.[18] According to the International Monetary Fund, the region's fossil fuel subsidies had a total value (excluding tax treatment) of $14 billion in 2020 (equivalent to 2.4% of the region's GDP), while subsidies including tax treatment totalled $123 billion (20.6% of GDP).

For listed firms, there are now stronger incentives to take account of environmental, social and governance issues. ESG considerations play a key role in guiding investors, financial institutions, customers and suppliers to understanding the capability of firms to produce long-term value for a broad range of stakeholders. The region's most developed stock market — Egypt's Stock Exchange — has written guidance on ESG reporting and requires it as a listing rule; it also offers ESG-related training. Only the Amman Stock Exchange has written guidance on ESG reporting. But information on companies' ESG practices is often only available for listed companies, and in the Middle East and North Africa, relatively few firms are listed, as many stock markets remain underdeveloped.

The Enterprise Survey provides data on environmental, social and governance practices of unlisted firms and SMEs. The survey includes 40 questions that can shed light on ESG-related practices of unlisted firms and small to medium-sized enterprises in emerging markets. Ferrazi and Tueske (2022) use this information to build a firm-level corporate ESG responsibility composite indicator, inspired by the Sustainability Accounting Standards Board (SASB) standards. The scores for each of the questions — 21 on environmental issues, six on social issues and 13 on governance issues — were normalised so they have a mean of 0 and a standard deviation of 1 in the sample. They were then aggregated to average z-scores for each of the three ESG practices. An overall indicator was created as a normalised unweighted average of the three areas. A z-score above zero indicates that a firm's ESG practices are better than the sample average. With the coverage of the Enterprise Surveys, the information — and thus the indicator — encompasses more than 28 000 firms, mainly small to medium-sized companies, in 41 economies. As the Enterprise Survey was not developed specifically to collect information on ESG practices, this indicator does not follow the standards of any of the four leading ESG organisations[19] in their entirety, nor does it match any of the variegated approaches of ESG rating agencies (such as Vigeo Eiris, ISS-oekom, MSCI ESG Rating or Sustainalytics).[20]

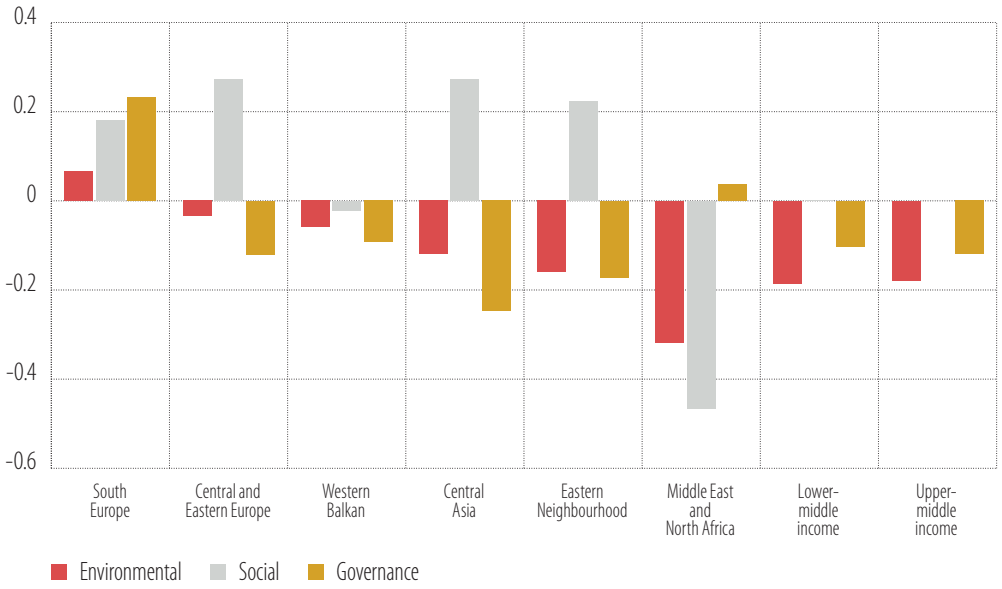
The average quality of corporate environmental, social and governance responsibility in MENA economies is low. MENA firms lag significantly behind Eastern and Southern Europe, and tend to be among the worst performers (Figure 8.1). The lag is especially pronounced on environmental and social dimensions. In particular, Egypt and the West Bank and Gaza are the worst of the entire spectrum of 41 economies covered by the Enterprise Survey. Their performance is poor even when taking into account their level of economic development (in terms of per capita GDP). Within MENA, Jordan and Tunisia are the best performers, but they are still below the average for emerging economies.

18 No data are available for the West Bank and Gaza.

19 These are the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB); CDP (formerly the Carbon Disclosure Project); the Carbon Disclosure Standards Board (CDSB); and the International Integrated Reporting Council (IIRC).

20 ESG rating agencies are using significantly different approaches (Berg et al., 2020; Chatterji et al., 2016; Gibson et al., 2019) and the correlation of ESG scores provided by different agencies is very low (Berg et al., 2020). This lack of an industry standard, a "surprising lack of agreement" among agencies (Chatterji et al., 2016) or even an "aggregation of confusion" (Berg et al., 2020) in the realm of ESG ratings make building an indicator relying only on one of the agencies' methodologies problematic.

Figure 8.1
Average quality of corporate ESG responsibility composite indicator (z-score)



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *Z-scores are calculated based on the entire Enterprise Survey sample. Data represent unweighted averages across countries. CEE — Central and Eastern Europe; WB — Western Balkans; EN — Eastern Neighbourhood; CA — Central Asia; SE — Southern Europe; MENA — Middle East and North Africa; RUS — Russia; TUR — Turkey; LMI — lower-middle-income economies; UMI — upper-middle-income economies.*

The social component of Middle East and North Africa economies is the lowest among all regions. The gender sub-component — which, together with education and training of the workforce, determines the social component — is particularly weak. Women's participation in the workforce in MENA countries is low; the share of women workers in the region among companies in the survey is just 25%. Women's representation in management is similarly poor. Only 5% of the region's firms have women in management, compared with more than 20% in Russia, Central and Eastern Europe and Central Asia. At the country level, Morocco and Tunisia have greater participation of women in the workforce (higher than 30% of total workforce in the sample), and Tunisia also has more women in management (10% of the firms).

Customer pressure is the most important factor in the quality of ESG practices in the region. Estimates from company-level analysis indicate that companies whose customers require environmental certifications or adherence to certain environmental standards as a condition for doing business with them have better ESG practices on average than firms whose customers do not require this. This is also the case if the company is an exporter. Several other factors also play a role. Larger, older firms have better ESG practices, as do companies that have experienced monetary losses due to pollution by others or extreme weather events, as well as companies with at least 25% foreign ownership.

To reduce their environmental footprint, companies can invest in energy efficiency and/or reducing pollution or other negative environmental impacts. Mitigation measures that help firms reduce their carbon footprint relate directly or indirectly to the company's production model (Thollander et al., 2007). Measures that are considered supportive, including energy management systems, or improvement to lighting and air control, are less capital-intensive and are part of low-hanging-fruit strategies. By contrast, mitigation measures linked to the production line, such as more climate-friendly energy generation, machinery and equipment and vehicle upgrades, are more capital-intensive and are usually pursued by firms where the energy cost is an important input in their production processes.

Empirical studies have found that mitigation strategies in support processes have higher returns than those in production processes. Energy efficiency potentials are higher for production processes if companies adopt suitable management practices relating to support processes (Backlund et al., 2012; Waide and Brunner, 2011; European Commission, 2006). In addition, capital spending for production processes is higher than investments in support processes (Kalantzis and Revoltella, 2019).

Firms in MENA economies lag behind their ECA counterparts in terms of both green investments and green management practices. Kalantzis et al. (2022) look at the impact of financial constraints and green management practices on green investments in MENA compared with ECA. Over 60% of companies in the region have made at least one type of such green investment in the past three years. Of these, most firms have made one or two types of investment, and over a quarter of firms invested in both capital-intensive and non-capital-intensive green investments.[21] Green management practices are defined in terms of businesses' strategic objectives on the environment and climate change, their managerial structure, their setting of green targets and the way that they monitor such targets. As with ESG practices, MENA firms lag significantly behind those in ECA and tend to be among the worst performers.

Overall, companies are more likely to invest in a higher number of green measures if they experience fewer financial constraints and have better green management practices. While estimates of the average marginal effects of credit constraints and green management are not directly comparable (and are not causal), they suggest that the quality of green management practices might play an important role — potentially a bigger one than credit constraints — in a firm's decision about whether to make green investments, which type and how many.

Compared with Europe and Central Asia, green investments in the Middle East and North Africa are generally less sensitive to credit constraints. The estimated average marginal effects of credit constraints are generally not statistically significant, looking either at the number of different investments or the type of green investments (see Figure 8.2).

MENA businesses are much more sensitive to green management practices than ECA businesses. MENA firms with good green management practices are almost half as likely to make no green investments than their counterparts in ECA. But while good green management practices matter for the number of green investments that a company makes, their average marginal effect estimates are almost identical for making two or more green investments in MENA. In ECA, the average marginal effects of green management practices increase with the number of green investments (Figure 8.2, Panel A).

The quality of green management practices affects the type of green investment. Firms with good green management practices are less likely to make only capital-intensive green investments and more likely to make both capital-intensive and non-capital-intensive green investments (Figure 8.2, Panel B). In the Middle East and North Africa, well-managed firms are also more likely to make non-capital-intensive green investments only. Average marginal effect estimates are larger in magnitude for MENA than for ECA firms.

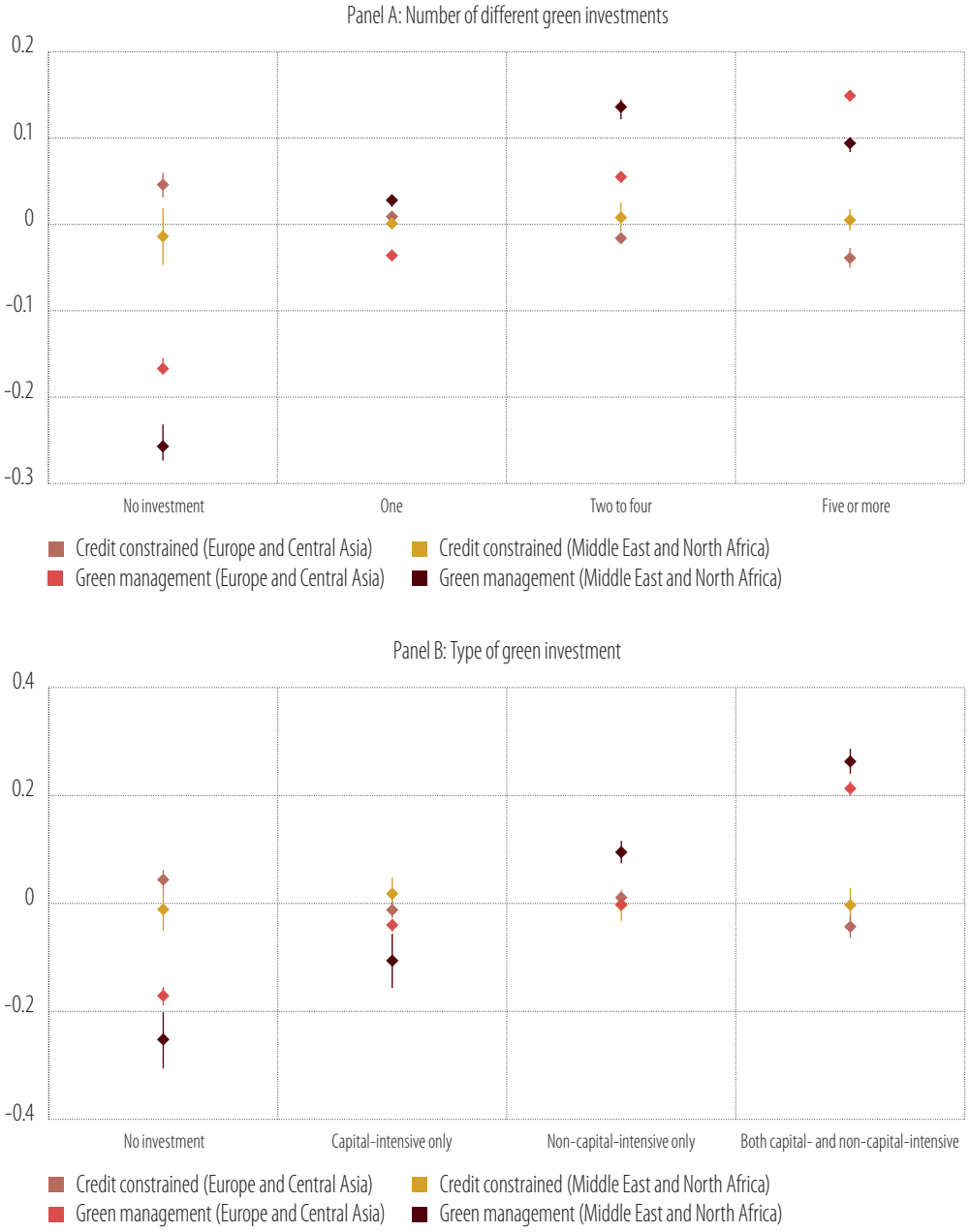
Firms that are more aware of climate change impacts and the various existing measures that tackle them engage most in mitigation measures. This relationship suggests that firms with the best management practices overcome information barriers and adopt more mitigation measures. Moreover, financial constraints and information barriers influence not only the transition strategy of firms, but also the number of measures that they implement in the different strategic areas, namely support and production processes.

Taken together, the findings suggest that in the MENA economies, policymakers and stakeholders should focus on raising awareness of and disseminating information on good green management practices. They should also assist firms that would like to improve their green management practices. Doing so is

21 Note that the numbers in the working paper refer to the sample used there, while the numbers here refer to the entire sample of MENA economies.

not only good for the environment, but also for the businesses' bottom line (EBRD, 2017). More broadly, it is also important to promote good social and governance practices.

Figure 8.2
Average marginal effects of credit constraints and green management



Source: *Authors' calculations based on Enterprise Surveys.*
Note: *This figure summarises the average marginal effect estimates of credit constraints and green management on the number of green investments (Panel A) based on an ordered logit regression with the number of green investments as a dependent variable, and the type of green investment (Panel B) based on a multinomial logit regression with the type of green investment as a dependent variable. The dots represent average marginal effect estimates and the lines represent the 95% confidence intervals. Regression controls for the firm-level covariates (log firm age and its square, percentage of employees with a completed university degree, indicators for exporter status, listed firm, sole proprietorship, and audited financial accounts); locality-level credit market controls (log average amount of assets of banks in a 15 km radius and the number of bank branches in a 15 km radius) and population size class; and country and sector fixed effects.*

Section 9

Conclusions and policy implications

The rapid transformation of the global economy poses new challenges for the MENA countries. Technological change, globalisation and the need to respond to climate change require adapting their growth models. To accelerate economic growth and to green their economies, the region's countries should improve the quality of their political and economic institutions, promote competition and reduce regulatory barriers for businesses participating in cross-border trade and global value chains. They should promote the adoption of best management practices and investment in innovation, digital technology and human capital, deepen and broaden their financial systems, and reduce budget deficits. While these are largely challenges that predate COVID-19, these initial conditions are important in determining how economies have fared through the pandemic.

Countries also need to remove fossil fuel subsidies and support environmental, social and governance disclosure, green investment and green management practices by providing both information and incentives. At present, on average, MENA countries underperform on all these counts relative to other middle-income economies. But some economies in the region do significantly better than others, which implies that there are many opportunities for reforms that would raise growth rates and make the growth greener.

MENA countries should improve governance, promote competition and eliminate preferential treatment of politically connected firms. This report finds substantial evidence that firms with political connections experience relative gains in the region. This is consistent with earlier findings that privileges conferred on connected firms may be distortionary. In a wide array of areas, including licensing and permits, access to finance and barriers to market entry, policies should encourage openness, accountability and transparency. This report also offers new evidence that not only do such connections have direct effects, but that the use of political connections and influence also tends to result in compensatory behaviour by competing firms.

Reducing government ownership and promoting competition will help improve management practices in the region. Government ownership and lack of competitive pressure both result in slow adoption of modern management practices. Improving management practices requires no material resources and is therefore one of the most straightforward ways to accelerate productivity growth. But protection of politically connected incumbents from competition reduces their incentives to adopt modern management practices. In contrast, when businesses must either improve their management or face the possibility of exiting the market, they are more likely to introduce good management practices.

Removing regulatory barriers that protect unproductive incumbents can help. Product market regulatory barriers are prohibitive in the region. Similarly, attracting foreign direct investment is an avenue through which competitive pressure promotes positive change in management practices at the same time as exposing firms to international best practice. This report also provides evidence that even partial government ownership slows the introduction of best management practices.

Trade openness promotes innovation and productivity growth. Competition may also be enhanced through participation in cross-border trade. This report shows that trade integration with developed economies (particularly the European Union), as well as access to information and know-how through participation in global value chains, may help to close the region's innovation gap. Improving customs and trade regulations, which will lower entry costs for firms to engage in trade, will increase access to international markets for a larger share of businesses and thus result in stronger incentives to innovate and accelerate productivity growth.

Enabling and supporting digital technology adoption will also contribute to faster productivity growth. This report shows that the upside of the digital economy in the Middle East and North Africa is large. Adoption of digital technology brings substantial productivity gains.

Countries should promote investment in companies' human capital. This report's analysis of firms' human capital has important policy implications. Firstly, increasing university education in the workforce of the region will provide stronger incentives for businesses to invest more in their workers, to retrain them and to update their skills. Secondly, the returns to investment in firms' human capital are complementary to the quality of management practices, so governments should support both the introduction of good management practices and investment in human capital to increase the effectiveness of both. Finally, promoting a business environment that is conducive to physical capital investment and innovation is likely to provide incentives for businesses in the region to invest in their workers.

To promote investment, countries in the region should improve companies' access to finance. The debt and investment dynamics that the six MENA economies have shown since the global financial crisis appear unsatisfactory at best and unsustainable at worst. Given that the countries are at lower-middle-income level, there is scope for catch-up growth. Economic policy should therefore aim at growing out of currently high debt levels. To achieve this, the authorities should further reform the business environment so that it truly enables private sector-led growth.

A high share of financially autarkic firms appears to be a symptom of a difficult business environment. On average, financially autarkic firms are comparatively unsophisticated in a range of other dimensions. These companies may reap only limited benefits from an expansion in the supply of external finance. But a more competitive business environment may provide incentives for promising firms to engage with the financial system by raising the opportunity costs of financial autarky.

The benefits of structural reforms take time to materialise. Macroeconomic policy can play a supportive role, particularly in countries with high sovereign spreads, such as Egypt and Tunisia. The evidence presented in this report suggests that governments have crowded out the private sector. High budget deficits, public debt and the generally low credibility of macroeconomic policy frameworks not only lower the amount of domestic financial resources available for private sector, but they also constrict access to international finance by raising sovereign risk premiums. Credible fiscal consolidation can improve access to finance for private companies by lowering interest rates and attracting foreign capital.

Greening the growth models of the region's economies will require sound public policy, strong state institutions and determined political leadership that provides incentives for companies and consumers to think green, promote clean investment and remove barriers preventing a smooth transition to the green economy. At the same time, the state has a duty to ensure that this transition process is just — through measures that help workers take advantage of opportunities to obtain new, higher-quality jobs linked to the green economy, while also protecting those at risk of losing their jobs. Such measures include labour market policies, skills training, social safety nets and action to support regional economic development.

MENA governments should focus their support on industries and firms that have a zero-carbon future, while refraining from propping up so-called zombie firms that will struggle in the green economy. This includes addressing the market and policy failures that are impeding the transition to a green economy. The key here is to get prices right. That means putting a higher price on carbon and applying that higher price to a broader set of emission sources, as well as removing fossil fuel subsidies. These subsidies might be viewed as key to competitiveness of certain enterprises, but they will be anything but that in the longer term. At the same time, active policies aimed at seizing the opportunities presented by the transition to a green economy will need to guard against the common pitfalls of industrial policy, including capture by politically connected interests.

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Glossary

Access to finance	Firms' ability to borrow to fund investments and/or their day-to-day operations.
Business environment	The various domains that affect the day-to-day experiences of firms. Examples include accessing finance, meeting regulatory requirements, infrastructure, corruption, etc.
Carbon intensity	Carbon emissions per unit of energy.
Climate change	Long-term shifts in temperatures and weather patterns. These shifts may be natural, but since the 1800s, human activities have been the main driver of climate change, primarily due to the burning of fossil fuels (like coal, oil and gas), which produces heat-trapping gases.
CO_2 emissions	Emissions stemming from the burning of fossil fuels and the manufacture of cement. They include carbon dioxide (CO_2) produced during consumption of solid, liquid and gas fuels, as well as gas flaring.
Competitiveness	Improving an economy's position by upgrading current activities and by incorporating new skills. At the level of a firm, competitiveness can be thought of as the ability to sustain market position by supplying quality products on time — at competitive prices — and the ability to adapt quickly to changes in the external environment. It requires continuous increases in productivity, by shifting from comparative advantages, such as low cost labour, to competitive advantages — competing on cost and quality, delivery and flexibility.
Corporate ESG responsibility composite indicator	An indicator based on ESG-related (environmental, social and governance) questions in the Enterprise Surveys, inspired by the standards of the Sustainability Accounting Standards Board (SASB).
Corporate responsibility	The ethics that drive an organisation's activities and how it operates so that it is viable over the long term. These two factors are intrinsically linked because a business that damages the systems on which it depends will ultimately be unsustainable. In doing the right thing by their stakeholders and sharing the same values, organisations will themselves see benefits from brand enhancement and reputation to building employee engagement. It therefore makes good business sense to operate sustainably.
Credit-constrained firms	Firms that need a loan but either have their loan application rejected or are discouraged from applying in the first place.
ECA	Europe and Central Asia — economies of that region classified as middle-income in 2019, comprising for the Enterprise Surveys: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Montenegro, Lithuania, Latvia, Macedonia, Moldova, Poland, Russian Federation, Romania, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine and Uzbekistan.
EBRD	European Bank for Reconstruction and Development.
EIB	European Investment Bank.
Energy intensity	Energy use per unit of GDP.
Enterprise Survey	A survey that asks firms in the formal private sector questions about the business environment and the company's economic outputs and inputs.
ESG	Environmental, social and governance — the basis for many forms of measurement of firms' activities.

Financial autarky	The position of firms that are disconnected from the financial system, relying only on internal means of finance, either voluntarily or because they are unable to access loans.
Formal firms	Firms registered with a government authority and with at least 1% of private ownership.
Formal training	Training that has a structured, defined curriculum offered to employees. This type of training does not include employee orientation.
Fossil fuel subsidies	Government interventions to keep the prices of energy sources like coal, oil and gas lower than they otherwise would be.
GDP	Gross domestic product — a widely used measure of the size of a national economy.
Governance	A combination of regulatory quality, government effectiveness, control of corruption and rule of law.
Green economy	The objective of efforts to reduce emissions of CO_2 and other greenhouse gases to limit climate change.
Green management practices	Firms' strategic objectives on the environment and climate change, their managerial structure, their setting of green targets and the way that they monitor such targets.
IEA	International Energy Agency.
IMF	International Monetary Fund.
Informal sector	Unregistered businesses, which are widespread in low- and middle-income countries and often compete with formal firms.
Innovation	The introduction of new or significantly improved products and processes, as well as new or significantly improved organisational and marketing methods, and/or spending on research and development activities.
Large firm	One with 100 or more full-time employees.
LMI	Lower-middle-income countries, according to the World Bank income group classification.
Management practices	Core management practices relating to operations, monitoring, targets and incentives.
MENA	Middle East and North Africa.
Obstacles to doing business	Firms are asked to rate an individual business environment obstacle on a five-point scale. If the firm chooses a four or a five, then that obstacle is a "major obstacle" or "very severe obstacle" for the firm. Enterprise Surveys feature a list of 15 possible business environment obstacles, including access to finance, competition from the informal sector, corruption, political instability and tax rates.
Politically connected firms	Firms that benefit from business privileges by having current and former government office holders in their management or ownership.
SE	Southern Europe — comprising Cyprus, Greece, Italy, Malta and Portugal.
Sector	The business activity of a company. Enterprise Surveys classify firms as manufacturing, retail or other services.
SMEs	Small and medium-sized enterprises, those with fewer than 100 full-time employees.
Superstar exporters	The top 5% of firms by export sales volume. These firms typically pay higher wages to their employees.

TFP	Total factor productivity — a measure of the productivity of both human and physical capital.
TFPR	Revenue-based TFP — an indicator of revenues conditional on input use, which reflects both technical efficiency and mark-ups.
Trade integration	Measures that will lower entry costs for firms to engage in trade, for example, improving customs and trade regulations.
Traders	Companies engaged in exporting and/or importing, typically larger and more productive than non-trading firms. Importers are defined as businesses that purchase more than 10% of material inputs or supplies of foreign origin; exporters are defined as firms exporting more than 10% of their sales directly.
UMI	Upper-middle-income countries, according to the World Bank income group classification.
Young firms	Companies that are five years old or younger.

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eBook: ISBN 978-92-861-5221-4
pdf: ISBN 978-92-861-5220-7