Executive Summary

i. **Middle East and North Africa (MENA) countries face a critical choice as they strive to generate greater private sector growth and more jobs: promote competition, equal opportunities for all entrepreneurs and dismantle the current system of privileges for connected firms or risk perpetuating the current equilibrium of low job creation.** This report shows that policies that stifle competition and create an uneven playing field abound in MENA, and are a major constraint on private sector growth and job creation. These policies take different forms across countries and sectors but share several common features: they limit the entry of new firms in the domestic market, exclude certain firms from government programs, increase the regulatory burden and uncertainty for firms without connections, insulate certain firms and sectors from foreign competition, and create incentives that discourage domestic firms from competing in international markets. The report shows that such policies are often captured by a few privileged firms with deep political connections, and that these policies persist despite their apparent cost to society. The millions of workers, consumers, and the majority of entrepreneurs who bear the brunt of that cost are often unaware of the adverse impact of these policies on the jobs and economic opportunities to which they aspire. This limits the scope for critical internal debate on the economic future of MENA countries and curtails the policy dialogue necessary for reform.

The impact of privileges on policies, competition and jobs

The findings of this report highlight some of the economic impacts of privileges to politically connected firms:

- *71 percent of connected firms in Egypt, but only 4 percent of all firms, sell products that are protected by at least three technical import barriers.*
- *64 percent of politically connected firms in Tunisia are operating in sectors subject to restrictions on Foreign Direct Investment relative to only 36 percent of non-connected firms.*
- *45 percent of all connected firms in Egypt operate in energy-intensive industries such as cement or steal, compared to only 8 percent of all firms.*
- *64 percent of politically connected firms in Tunisia are in sectors requiring an exclusive license to operate relative to only 45 percent of non-connected firms.*
- *Firms in politically connected industries (i.e., with at least one connected firm) are 11-14 percent more likely to have acquired land from the government.*
- *An additional firm with a politically connected CEO reduces the average waiting time for a construction permit in an industry by 51 days.*
- *Firms in sectors with at least one politically connected CEO are inspected by tax officials 4.6 times a year relative to 5.7 times a year for firms in sectors without a connected CEO. In addition, the frequency of inspections by the municipality is about 20 percent higher for firms in non-connected industries.*
- *The variation of reported inspections across firms is significantly higher within connected sectors. This suggests that politically connected firms received very few inspections while non-connected firms are inspected frequently.*
- *The entry of new firms into politically connected sectors is about 28 percent lower.*
- *Aggregate employment growth declines by about 1.4 percentage points annually when connected firms enter new, previously unconnected sectors in Egypt.*

ii. **Labor markets in MENA have been underperforming for a long time. This has left large segments of the population on the sidelines of the economy and created a sense of exclusion.** MENA has a large reservoir of untapped human resources; it has some of the world's highest unemployment rates among college graduates and youth, and the lowest participation of women in the labor force. Strategies focused on increasing employment in the public sector have proved to be unsustainable and private sector job creation has been too weak to absorb the growing labor force. Desirable private sector jobs – those with high wages, a formal contract, and social security benefits – are few pushing a growing number of workers to seek employment in unproductive, subsistence activities, often in the informal economy. This situation has contributed to the widespread frustration with the lack of opportunities of which Arab Spring uprisings were a powerful expression.

iii. **Previous World Bank reports have linked MENA's employment performance to supply-side factors, labor market policies and to qualitative evidence of weak competition due to privileges for connected firms.** Two past regional World Bank reports provide the starting point for this report. First, the World Bank report "*Jobs for Shared Prosperity*" (2013a) analyzed how supply-side factors such as education and training, and labor market policies affect employment outcomes in MENA. The report concluded, however, that supply-side factors only partially explain employment outcomes in MENA and highlighted the importance of analyzing demand-side factors to explain the weak private sector job creation record of MENA countries. Second, the World Bank report "*From Privilege to Competition: unlocking the private-led growth in the Middle East and North Africa*" (2009) provides rich qualitative evidence that policy capture in MENA countries leads to privileges for a few politically connected firms, which ultimately limits competition and private sector development. It argued that privileges to politically connected firms in MENA resulted in policies - such as subsidized land acquisitions and directed bank lending - that limited competition and tilted the playing field. The authors of this pre-Arab Spring report used all information available at the time, but did not have access to the full array of data necessary to investigate the possible link between MENA's weak aggregate job creation, the lack of a level playing field, and the absence of competition due to prevailing privileges and policy capture in many countries and sectors across the region.

iv. **This report fills this gap by analyzing the demand-side factors that constrain faster job creation in MENA countries and how they relate to weak competition and privileges for specific firms.** This report aims to answer the following questions: what types of firms create more jobs in MENA? Are they different from job creating firms in other regions? What policies in MENA prevent the private sector from creating more jobs? How do these policies affect competition? To what extent are these policies associated with privileges to politically connected firms?

v. **This report aims to address these questions by drawing on new data sources that became available after the Arab Spring.** First, the report assembles firm census databases for several MENA countries that contain a wide range of firm characteristics and performance measures. This rich source of information is used to determine the fundamental drivers of MENA firms' demand for labor. Second, the report combines this information with the firm data to analyze how certain policies affect competition and the fundamentals of job creation. Third, the report merges these data with new detailed information on state-business relations that surfaced after the Arab Spring. Specifically, the report builds on two novel data sets that identify politically connected firms in the Mubarak and Ben Ali regimes in Egypt and Tunisia, respectively. These unique data are used to analyze the methods and extent of policy capture by politically connected firms. The report then assesses the impact of these privileges on competition, firm dynamics, and job creation. Five main findings of the report stand out.

vi. **First, GDP growth in MENA over the last two decades was driven by demographic change rather than labor productivity. Private sector job creation was too weak to absorb the fast-growing labor force.** Analysis of aggregate growth, population, and employment data reveals that the moderate GDP per capita growth rates in MENA were driven by demographic change leading to an increase in the share of the working age population, while productivity growth was low. Real GDP per capita growth hovered around two percent in the last two decades; about two and four percent lower than in South and East Asia, respectively, but comparable to per capita growth rates in other developing regions. Demographic change accounted for about 50 percent of aggregate real GDP per capita growth over the past 20 years, substantially higher than in any other region. In contrast, aggregate productivity growth was low in MENA compared to other developing regions. Most countries in the region did experience structural change due to a decline of the labor share in agriculture. Aggregate productivity growth was, however, mostly driven by productivity growth within sectors, which still lagged behind other developing regions. The economic benefits from the ongoing demographic trend could have been much higher had MENA countries been able to absorb their fast-growing labor force into the higher-productivity activities. Instead, job creation was weak and informality, unemployment, and inactivity reached very high levels during this timeframe. Moreover, analysis of firm census data shows that most workers in MENA are employed in small-scale and low productivity activities.

vii. **Second, the fundamentals of job creation in MENA have proved to be similar to those in other regions' fast-growing economies; it is young firms and more productive firms that create more jobs. In MENA countries, however, low firm turnover and slow productivity growth limit the pool of young firms and more productive firms and, ultimately, reduce job creation.** The report examines whether the fundamentals of job creation – the types of firms that create more jobs – differ in MENA countries from fast-growing emerging or even high-income countries in other regions. The report shows that they do not: younger firms and more productive firms grow faster and create more jobs in MENA as elsewhere. For instance, firm census data show that micro-startups – firms less than five years old with less thanfour employees – accounted for 92 percent of net job creation in Tunisia between 1996 and 2010 and 177 percent in Lebanon between 2005 and 2010. In addition, young firms across all size categories contributed positively to net job creation in both countries while employment in older firms tended to contract. However, MENA countries' private sectors have been characterized by low firm turnover (firm entry and exit) and slow productivity growth, which ultimately reduces the pool of young firms and more productive firms. Moreover, we find that productivity growth in MENA is held back by a combination of slow within-firm productivity growth and misallocation of labor and capital across firms. For instance, for every 10,000 working-age persons, on average only six limited liability companies were created annually in MENA countries between 2009 and 2012; in contrast, the average across all 91 developing countries with available data was 20 per 10,000 working-age persons, and as high as 40 and 80 in Chile and Bulgaria, respectively. Moreover, after 35 years in operation, establishments in Tunisia and Egypt barely increase their productivity while establishments in Mexico, India, and Turkey increase their productivity about two-or three-fold over the same life cycle.

viii. **Third, various policies across MENA countries limit competition and undermine the fundamentals of job creation by constraining firm startup and productivity growth.** The report presents four case studies that demonstrate how different policies across MENA countries limit competition and result in lower firm turnover, productivity growth, and job creation. The first case study shows how foreign direct investment (FDI) inflow in Jordan led to a partial crowding-out of old and small domestic firms operating in the same sector, but had positive employment spillovers among domestic service providers and young firms. Domestic manufacturing firms (suppliers) did not benefit from FDI spillovers, possibly reflecting a combination of weak competition in the sector and the absence of well-designed and effective technical supplier support programs. Overall, the findings suggest that removing restrictions on FDI into service sectors in Jordan is expected to generate employment growth among domestic firms. In the second case study, we explore how several dimensions of Morocco's business environment impact employment growth and disproportionately affect young firms. The findings suggest that more competition, equal and predictable treatment by tax administrations, less corruption and obstacles in the judicial system, and lower cost of finance would raise employment growth among young firms. The third case study examines how large energy subsidies targeted to heavy industry in Egypt (equivalent to 2.9 percent of GDP or US$7.4 billion in 2010) affect competition and job creation. A government license is required to legally operate in energy-intensive industries (such as steel and cement etc.), thereby limiting the entry of new firms, equal access for all entrepreneurs, and competition. Moreover energy subsidies benefit energy-intensive industries thereby discouraging more labor-intensive activities and preventing the economy from fully exploiting its comparative advantage. In the last case study, we show that many firms in MENA identify "policy uncertainty" as a "severe" or "major" obstacle to growth, and that this reflects firms' perception of "policy implementation uncertainty" resulting from discriminatory practices. The large variation in policy implementation leads to reduced competition and innovation in a number of MENA countries. The findings reveal a negative impact of discriminatory policy implementation on productivity growth and private sector dynamism (specifically the entry of new firms) in MENA.

ix. **Fourth, past industrial policies in MENA did not reward firms based on performance, and did not safeguard or promote competition.** Efforts to stimulate private sector growth and jobs in MENA have often taken the form of active industrial policies. But there is limited evidence of success and several instances of policy capture by a few, connected firms. The report reviews the impact of these policies over the past two decades and compares them with the experience of East Asian countries. This comparison highlights several critical differences in policy design and implementation that underpin the success of industrial policies in East Asian countries when compared to MENA countries. First, East Asian countries seemingly reached broader consensus on a common strategic vision and objectives at the country level, and had a greater focus on new economic activities in sectors where market failures were more likely to constrain industrial development. Second, industrial policy in East Asia was performanceoriented and evaluation systems to assess the performance of policies and public officials were put in place. Third, by linking government support to measurable and verifiable performance, industrial policies in East Asia guaranteed equal access for all firms while in MENA it often resulted in privileges for a limited number of specific firms. Fourth, industrial policy in East Asia promoted and safeguarded competition in the domestic market and provided incentives for firms to compete in international markets. Finally, East Asian countries invested heavily in human capital and complementary infrastructure~~s~~ improvements, and undertook far-reaching public sector reforms which created a qualified and merit-based public administration.

x. **Fifth, the report provides direct evidence that policies in MENA have often been captured by a few politically connected firms. This has led to a policy environment that created privileges rather than a level playing field, and undermined private sector growth and job creation.** We show that these privileges insulated firms from domestic and international competition and subsidized their operations via preferential and sometimes exclusive access to cheap inputs (credit, electricity, land, and so forth). Using the theoretical framework proposed by Aghion et al. (2001)[1], we discuss how such policies are likely to undermine competition, equal opportunity for all entrepreneurs and would result in lower efficiency, innovation, and job creation. The report documents how this was the case during the Mubarak and Ben Ali regimes in Egypt and Tunisia, respectively, and provides qualitative evidence for the existence of similar mechanisms in other MENA countries. For example, we find that only a handful of politically connected firms received the generous energy subsides to industry in Egypt. Moreover, barriers to entry and trade in Egypt and Tunisia insulated politically connected firms from competition in the domestic market and tilted their incentives towards producing for the domestic market. These policies are typically still in place in both countries; they include exclusive operating licenses creating monopolies in a few profitable services sectors, unequal access to credit and land, or inconsistent implementation of rules and regulations across firms in the same sector. Furthermore, the report argues that the concentration of connected firms in (non-tradable) backbone service sectors in MENA – which lowers the performance of these sectors and increases the relative price of non-tradable to tradable goods and services – contributes to the overvaluation of the exchange rate through the phenomenon of *weak links*.[2] Importantly, the report provides quantitative evidence that the preferential treatment of politically connected firms lowers aggregate job growth in Egypt. Finally, the available qualitative evidence points to similar mechanisms of policy privileges in other MENA countries. In particular, governance and corruption indicators show that MENA lags behind other regions, especially in corruption in defense as a result of military involvement in business.

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[1] The model proposed by Aghion et al. (2001) demonstrates that fair private sector *neck-and-neck* competition drives economic growth. In this model, competition increases firms' incentives to adopt new technologies in order to reduce costs and escape competition (at least temporarily). However, if a few (colluding) firms have sizeable exogenous cost advantages, which are unbridgeable by competitors in the same sector, then all firms in the sector have fewer incentives to adopt new technologies and sector growth is lower. In this case, the firms with the cost advantage have little incentive to invest in innovation since they do not face competitive pressures to reduce their costs further; the laggard firms are too far away from the frontier to bridge the cost gap and instead use vintage production technologies, focusing on local market niches to survive. Aggregate growth increases in the number of sectors that are characterized by neck-and-neck competition market structures.

[2] See Jones (2011) for a presentation of the concept of *weak links*.

xi. **The findings of this report have several implications for policy.** This report suggests that MENA countries' quest for more jobs should not only include supply-side policies – education, wages, job training – but should also encompass significant policy reforms to stimulate labor demand. The report's findings point to a roadmap for more jobs in MENA in four broad policy areas. Depending on the country context, additional and more specific policy areas would also need to be considered:

- First, governments in MENA should reform policies that unduly constrain competition and equality of opportunity for all entrepreneurs. These policies include energy subsidies to industry, exclusive license requirements to operate in specific sectors, legal barriers to FDI, trade barriers - including non-tariff measures, administrative barriers to entry and firm growth, and barriers to access to the judiciary, land, or industrial zones. Reforms to other policies not analyzed in this report, but potentially equally important in maintaining a level playing field should also be considered when dealing with specific country cases. These include barriers to firm entry and exit resulting from restrictive hiring and firing laws, cumbersome bankruptcy laws, and so forth. In addition, the findings of this report suggests that if MENA governments want to pursue private sector development programs targeting specific types of firms, they would be well advised to focus on firm age and not firm size as a primary targeting criterion since startups create most jobs in the region.

- Second, policymakers should reduce the space for discretionary policy implementation and ensure that laws and regulations are enforced equally across firms. This involves ensuring that laws and regulations are clear, the complexity of policy implementation is reduced, and that policy is designed and implemented by a strong, capable, and accountable administration. The latter can be supported by linking entry into and promotions within the administration to merit, judged on the basis of potential or actual contributions to the legitimate goals of public policy.

- Third, if MENA governments want to pursue state-led development policies, they would be wise to avoid the mistakes of the past and ensure that these new industrial policies – and the administrative structure that implements them – minimize the scope for capture, promote competition and tightly link support to measurable and verifiable performance.

- One critical aspect of this reform agenda is to create institutions that promote and safeguard competition and equal opportunities for all entrepreneurs. Such institutions include, but are not limited to, a strong, well-organized and highly competent public administration that is necessary to implement critical policy changes, such as an effective competition law; an independent competition authority; appropriate procurement laws and implementation; and an independent judiciary.

- Another component, just as important, is to ensure policy making is transparent and open, with a mechanism that facilitates and encourages citizen participation. Citizens should have access to information on proposed and ratified laws and regulations; be able to provide input into policy design and evaluation; be aware of politicians' stakes in firms that benefit from government policies; and have full knowledge of who benefits from subsidies, procurement tenders, public land transactions, privatizations, and so forth.

- Lastly, this report provides a decision-making guide which governments can use as a framework when designing and implementing policies. The decision-making guide is aimed to maximize the likelihood of success given inherent uncertainties and maximize the positive impact of policies on growth and jobs by minimizing the risk for capture.