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**Economic and Social Commission for Western Asia (ESCWA)**

# **Economic Governance for Entrepreneurs in the Arab Region**

## **Prioritizing Policy Challenges**

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## Abstract

The present paper identifies priority policy challenges and sets out recommendations to facilitate entrepreneurship in Arab countries. Based on evidence from the Doing Business and Worldwide Governance Indicators projects and a systematic review of relevant literature, the paper identifies the following three priority policy challenges for economic governance reform: competition policy; access to finance; and entrepreneurial education. The paper argues that the improvement of economic governance in those three policy areas is a crucial lever for promoting entrepreneurship in Arab countries. Highlighting the interdependence between those areas, the paper provides a set of recommendations for each of the identified policy challenges.

## Executive summary

Promoting entrepreneurship can play a crucial role in addressing the socioeconomic challenges facing Arab countries. A climate of dynamic entrepreneurship contributes to aggregate job creation, economic diversification and inclusive growth. Good economic governance is also a crucial precondition for an increase in entrepreneurial activity and economic development.

By focusing on the regulatory environment of formal entrepreneurship, the present paper identifies priority policy challenges and sets out recommendations to improve economic governance so as to facilitate entrepreneurship in Arab countries. The paper outlines recent developments in economic governance reform that concern entrepreneurial activity, based on the World Bank's Doing Business project, the Global Entrepreneurship Monitor study<sup>1</sup> and government legislation documents. It reveals how regulatory practices develop over time, and builds on the premise that an understanding of past challenges and policy priorities can facilitate an assessment of current policy challenges and help derive policy recommendations today. The analysis shows that while business environments in Arab countries lost competitive strength relative to other regions, they could make important advancements in their entrepreneurial environments, particularly by easing access to finance and legal barriers to opening a business. However, significant regulatory constraints, such as limited coverage of credit registries and unfair regulations in resolving bankruptcy, continue to inhibit entrepreneurial activity. Providing quantitative evidence, the paper confirms empirical literature regarding other regions and demonstrates that improvements in economic governance can increase the rate of new business entries in the Arab region.

The paper then reviews and synthesizes recent and relevant literature on economic governance, entrepreneurship and private sector development in the Arab region on a "best evidence" basis. The surge in scientific attention on entrepreneurship and economic governance in the region, especially following the Arab uprisings in 2011, identified a variety of policy challenges and recommendations that merit review. By presenting identified regulatory developments, the paper synthesizes their findings and identifies the most relevant and pressing policy challenges as follows:

- (a) Competition to ensure equal opportunities for all entrepreneurs;
- (b) Access to finance to give entrepreneurs the opportunity to start and grow their businesses;
- (c) Entrepreneurial education to provide entrepreneurs with the relevant skills to sustain their businesses.

The paper argues that improving economic governance in those three policy areas creates crucial levers to promote entrepreneurship in the Arab region. By highlighting the interdependence of these policy areas, the final part of the paper provides a set of policy recommendations for each of the identified challenges.

To validate the findings and complement the analysis, the annexes contain quantitative evidence in a comparative model on the effect of improvements in governance on private sector performance. The model is based on World Bank Worldwide Governance Indicators and confirms that improvements in governance, especially regulatory quality, facilitate business entry rates and a shift towards more productive sectors.

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<sup>1</sup> See <https://www.gemconsortium.org/>.

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## Abbreviations

<b>DTF</b>	Distance to frontier
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EIB</b>	European Investment Bank
<b>EIU</b>	Economist Intelligence Unit
<b>ESCWA</b>	Economic and Social Commission for Western Asia
<b>GCC</b>	Gulf Cooperation Council
<b>GDP</b>	Gross domestic product
<b>LLC</b>	Limited liability company
<b>IMF</b>	International Monetary Fund
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>MENA</b>	Middle East and North Africa
<b>SMEs</b>	Small and medium enterprises
<b>WEF</b>	World Economic Forum
<b>WGI</b>	Worldwide Governance Indicators

## Introduction

Numerous recent studies and flagship reports highlight the need to improve economic governance in Arab countries<sup>2</sup> to address the region's social, political and economic challenges (WEF, 2013; World Bank, 2013b; Sumpf, Araji and Crompton, 2016). Improving economic governance is crucial for fostering entrepreneurial activity and could act as an important lever to spur formal employment and economic diversification. The present paper focuses on the role of regulatory reform in economic governance as a means to facilitate entrepreneurial activity by, firstly, identifying and defining the most persistent policy challenges from a growing body of literature and, secondly, presenting specific policy recommendations.

Studying the influence of economic governance on entrepreneurship in the Arab region is important for three main reasons. Firstly, the region faces demographic challenges in the form of a rapidly growing young workforce that necessitates an acceleration of formal job creation (WEF, 2012; Mckee and others, 2017). Secondly, by contributing to economic diversification, entrepreneurship is crucial to reducing reliance on oil and other mining sectors, and to improving living standards in non-oil exporting countries. Thirdly, once startups mature, grow and become small or medium enterprises (SMEs), they make significant contributions to gross employment and output of the economy. To date, SMEs provide a large proportion of formal private sector employment and development in Arab countries.

The Arab uprisings increased political and scientific attention on the employment challenges in the Arab region and made available previously classified or otherwise unavailable data (World Bank, 2015). The availability of new methodological approaches for assessing private sector development (based on firm-level data, expert surveys, representative surveys among entrepreneurs and macroeconomic data) led to a surge in research activity and a plethora of policy recommendations. The literature offers several explanations for the weak performance of the private sector, such as exchange rate overvaluation (Nunnenkamp, 2003, p. 18; Nabli *et al.*, 2007, p. 19; Diop, Marotta and de Melo, 2012), burdensome trade regulations (Malik and Awadallah, 2013), regulatory quality (OECD, 2013b), or distortions emanating from energy subsidies which reduce employment by incentivizing investments into capital-intensive rather than labour-intensive industries (Lin and Monga, 2010).

The present paper organizes the rich recent literature on entrepreneurship and private sector development in the Arab region. By identifying and reviewing recent relevant studies, the paper identifies the most pressing priority policy challenges for improving economic governance. The paper contends that improvements in governance in the areas of competition, access to finance and entrepreneurial education are important drivers for entrepreneurial activity. Despite different sources of data, methodologies and epistemological approaches, those three policy areas are recognized by most recent studies as the most important policy challenges facing the region.

To cross-validate the results, a comparative quantitative analysis complements the search for priority policy challenges with evidence from the Worldwide Governance Indicators (WGI) (annex I). The analysis focuses on the comparative effect of improvements of governance indicators for private sector development. The results substantiate the claim that entrepreneurial activity has a positive impact on economic development and job creation in Arab countries: better economic governance leads to higher business entry rates and a shift towards more productive sectors.

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<sup>2</sup> Following the approaches of most of the reviewed studies, the paper adopts the World Bank definition of the composition of the Arab region as follows: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, State of Palestine, Qatar, Saudi Arabia, Syrian Arab Republic, Tunisia, United Arab Emirates and Yemen. It does not include Iran.

## METHODOLOGY AND STRUCTURE OF THE PAPER

The present paper is structured into three chapters. Chapter I outlines recent developments in economic governance reform (for example, regulatory reform processes) and frontier approaches that provide a context for further analysis, which is based on data from the World Bank's Doing Business Project (World Bank, 2018), the Global Entrepreneurship Monitor (2017) and governmental legislation documents. The discussion reveals how regulatory practices developed over time and is based on the premise that an understanding of past challenges and policy priorities can facilitate an assessment of current policy challenges (chapter II) and therefore help to derive policy recommendations today (chapter III).

In addition, chapter II presents the core analytical contribution of the paper and provides a review and synthesis of recent literature on entrepreneurship in the Arab region to identify and define priority policy challenges. The review is motivated by a surge in scientific attention on entrepreneurship and economic governance, particularly following the Arab uprisings in 2011. Given that those studies identified a variety of policy challenges and recommendations, the present paper synthesizes their findings to derive the most relevant and pressing policy challenges and provide recommendations. Chapter II is guided by the following research question: "Which policy challenges find consensus and prioritization in recent and relevant literature on economic governance for entrepreneurship in the Arab region?".

The review takes a "best evidence" approach (Slavin, 1995). Best evidence reviews take into account that papers on a given topic are of varying relevance for the research question at hand. Moreover, best evidence reviews acknowledge that more can be learned from fewer high-quality papers that address the research questions directly rather than a larger number of less relevant and lower-quality papers and articles.

To identify and select the most relevant papers, best evidence reviews develop a set of criteria to assess a paper's quality and relevance to the research question. To make a meaningful selection from the expansive literature on governance in the Arab region, the review applies the following three selection criteria. Firstly, the studies must be conducted by international organizations, such as the United Nations Economic and Social Commission for Western Asia (ESCWA), the World Economic Forum, the World Bank or the Organization for Economic Cooperation and Development (OECD). As these institutions work directly with Governments and policymakers, their approaches reflect state-of-the-art data provisioning and tend to include the results of recent and relevant country studies in their analysis and recommendations. The reports take a holistic perspective and use multiple data sources. To avoid biases in the selection of policy challenges from particular institutions, the findings are cross-referenced with findings of other institutions. Despite the use of different sources of data, methodologies and epistemological approaches, the reviewed studies highlight a similar set of policy challenges. The discussion therefore focuses on reports that include the Arab region as a whole, rather than individual countries. Country studies and independent papers published in peer-reviewed journals inform the discussion.

Secondly, the studies must present novel research that makes a significant contribution to the literature on entrepreneurship and private sector development in the Arab region. Notably, this criterion excludes reviews of existing data sources, reviews of literature and studies that go beyond the geographical focus of the Arab region or address only individual countries as the inclusion of such studies could bias the identification of relevant policy challenges. Thirdly, all reports reviewed in this section had to be published after 2011 to ensure timeliness of results.

Based on recent regional trends and priority policy challenges, chapter III synthesizes the findings and derives specific policy recommendations. Annex I provides complementary quantitative evidence on the extent to which improvements in specific areas of governance impact private sector development. In taking several indicators for private sector development as dependent variables and the WGI as key independent variables, the model provides a comparative assessment of how improvements in governance quality are related to private sector development. Annex II provides a brief overview on the current state of the WGI in Arab countries and highlights the potential for improvements in governance.



## I. ENTREPRENEURSHIP AS A DRIVER FOR JOB CREATION IN THE ARAB REGION

The present chapter has two objectives. Firstly, it reviews the role of entrepreneurship in job creation and economic development in the Arab region. Secondly, it analyses salient trends in regulatory frameworks and highlights recent policy trajectories in economic governance. The discussion helps assess current policy challenges and appropriate recommendations that follow chapter II and III: an understanding of the role of entrepreneurship and of past challenges can facilitate the derivation of policy recommendations today.

The section first defines several key concepts and terminologies and quantifies the contribution of entrepreneurship to private sector dynamics and economic development. The role of entrepreneurship in economic development is discussed by reviewing the nature and structure of entrepreneurial activity in Arab countries, and recent developments in the regulatory environment for entrepreneurial activity are highlighted based on data from the World Bank Doing Business project. Lastly, the chapter provides evidence on the positive impact of easing regulations for businesses on business entry rates.

### A. DEFINING ENTREPRENEURSHIP AND SMES

Though no universally accepted definition for entrepreneurship exists, practitioners generally link entrepreneurship to the creation of new wealth. An OECD paper defines entrepreneurs as “those persons (business owners) who seek to generate value, through the creation or expansion of economic activity, by identifying and exploiting new products, processes or markets” (Ahmad and Hoffman, 2007, p. 4).

Klapper, Amit and Guillen (2010) expand on this definition by emphasizing the legal dimension involved in entrepreneurial activity. They define entrepreneurship as “the activities of an individual or a group aimed at initiating economic activities in the formal sector under a legal form of business”. Notably, the authors exclude informal sector initiatives from their definition owing to the difficulty in quantifying the number of firms in the informal sector.

The present paper combines the two definitions, since the discussion aims to assess formal business activity and its role in value creation. In what follows, entrepreneurship is understood as the activities of an individual or group aimed at generating value through the creation or expansion of economic activity in the formal sector under a legal form of business.

To facilitate further analysis and since the nature and structure of entrepreneurship vary significantly across countries, the present paper distinguishes the following three drivers of entrepreneurship (Ács and Varga, 2005; Ács, 2006; WEF, 2011):

- *Innovation-driven* entrepreneurs create new demand by exploiting an innovative idea they developed or acquired, as often seen in high-tech companies in the information communication and technology sector;
- *Opportunity-driven* entrepreneurs identify and exploit a demand/supply gap by choosing to start a new business and seizing that opportunity. For example, a trading company that sells undersupplied consumer goods;
- *Necessity-driven* entrepreneurs are forced into entrepreneurship by their environment to satisfy basic needs. This includes, for example, small grocery shops in rural areas.

Differentiating the nature of entrepreneurship matters both for understanding the dynamics of economic development and for designing supportive policy options. For example, in a study of nine European Union countries, Ács and Varga (2005) show that the impact of opportunity entrepreneurship and necessity entrepreneurship on economic development differs: while the former has a positive and significant

effect on economic development due to spillover effects of knowledge as a result of agglomeration, the impact of the latter appears to be insignificant.

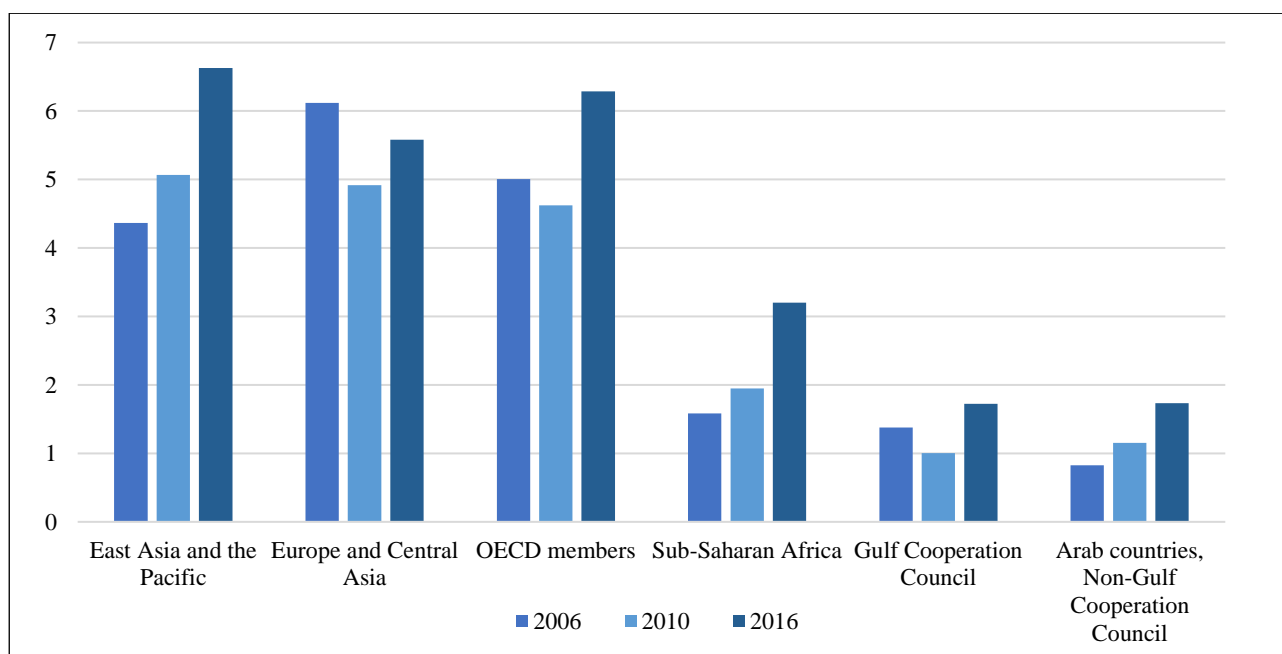
As startups grow in size and number of employees to become SMEs, Governments have different defining criteria depending on their economic context and policy priorities: the Government of Saudi Arabia, for example, defines medium-sized enterprises as having 60 to 99 employees and a capital of \$5 million to \$20 million, while Lebanon uses the number of employees as reference criteria (less than 200 for medium-sized businesses and fewer than 5 for microenterprises) (Nicola, 2009). The criterion most commonly referred to is the size of a business in terms of the number of employees (Ayyagari, Beck and Demirguc-Kunt, 2007; OECD, 2013a). Nonetheless, the different use of criteria to define SMEs in the Arab region requires careful consideration before data from different sources are compared.

## B. QUANTIFYING ENTREPRENEURSHIP IN THE ARAB REGION

The density of new businesses constitutes a commonly used indicator of entrepreneurial activity and measures the number of newly registered businesses per 1,000 people aged 15 to 64 per year.<sup>3</sup> New business entry and density rates are an important dimension of economic activity as they are significantly and positively related to several country-level indicators of economic development in developing countries, in particular the growth of GDP and the quality of the regulatory environment (Klapper, Amit and Guillén, 2010).

Arab countries have the lowest formal sector business entry rates worldwide, with less than two registrations per 1,000 inhabitants on average (figure 1). Entry rates in Gulf Cooperation Council (GCC) countries are slightly higher on average than in non-GCC countries (figure 2). Aside from Europe and Central Asia, formal entrepreneurial activity increased globally from 2011 to 2016.

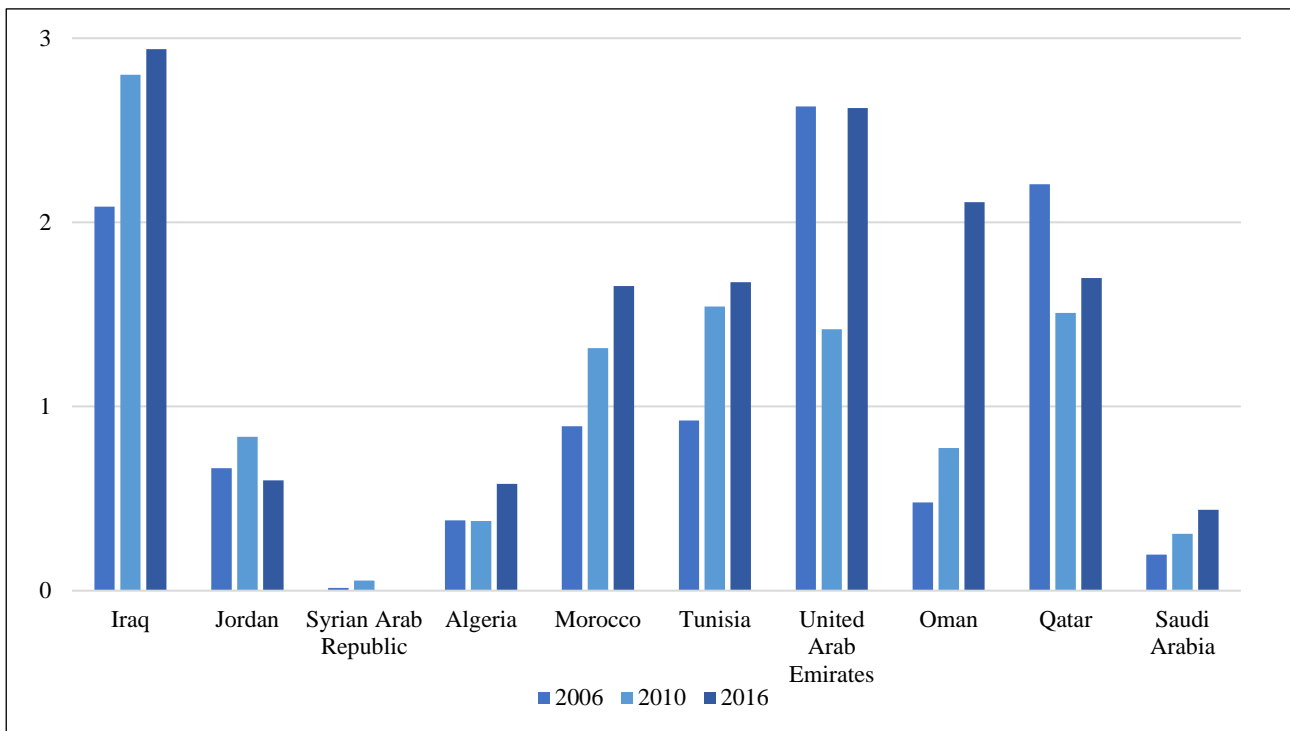
**Figure 1. New business density rates per region, 2006, 2010 and 2016**



Source: World Bank, World Development Indicators.

<sup>3</sup> World Bank Entrepreneurship database completed in June 2017. Available at [www.doingbusiness.org/data/exploretopics/entrepreneurship](http://www.doingbusiness.org/data/exploretopics/entrepreneurship).

**Figure 2. New business density rates per Arab country, 2006, 2010 and 2016**



Source: World Bank, World Development Indicators.

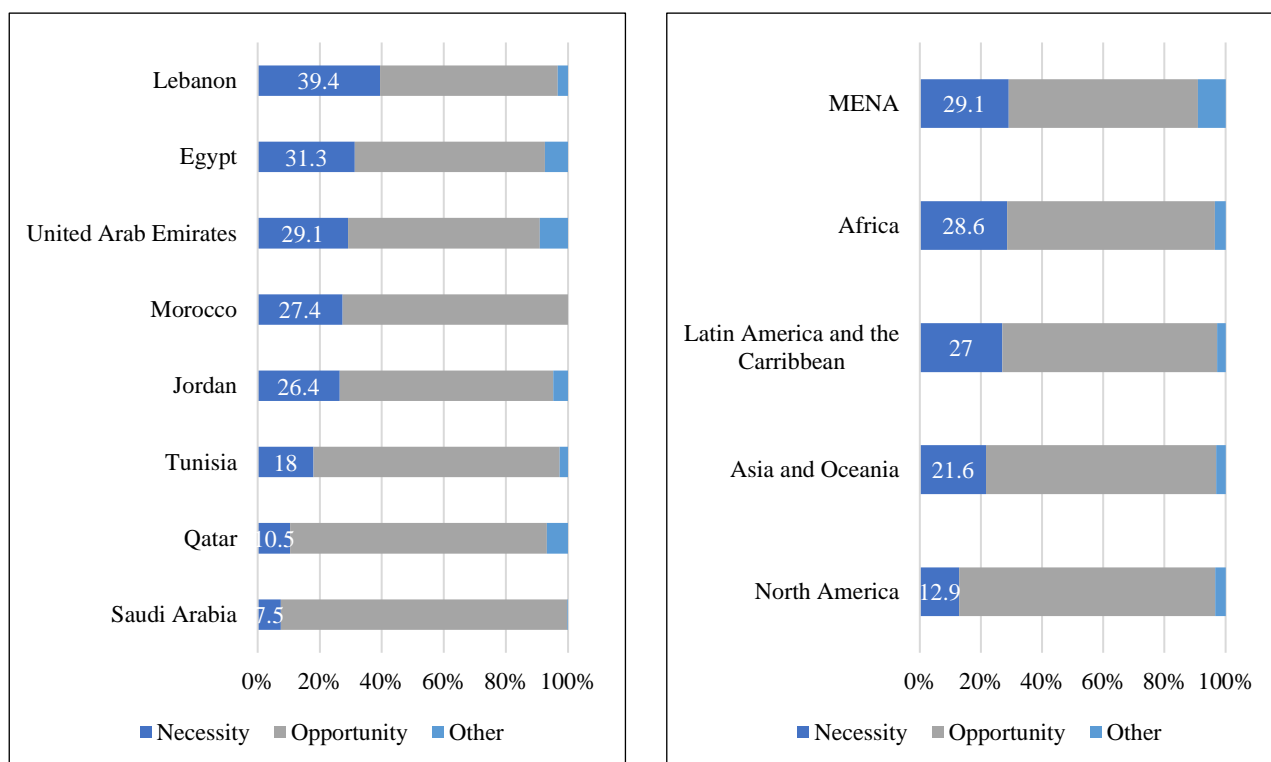
Marked differences exist across the Arab region. Firm entry density rates are particularly low in Algeria, Saudi Arabia and the Syrian Arab Republic,<sup>4</sup> with less than one new business per 1,000 inhabitants. Such low rates of new business density reflect the weaknesses of those countries' formal sectors in fostering entrepreneurial activity. Iraq, Oman, Morocco and Tunisia exhibit a more promising trend, yet the entry rates from other economies with similar sizes, such as Chile (8.9) or Bulgaria (10.8), are much higher, with the exception of Tunisia.

The purpose of entrepreneurial activity in the Arab region varies widely (Global Entrepreneurship Monitor, 2017). The Arab region displays the highest proportion of necessity-driven entrepreneurship worldwide: almost one out of every three new businesses in 2016 was created out of necessity (figure 3). At almost 40 per cent, Lebanon exhibits the highest percentage of entrepreneurs starting a business out of necessity. By contrast, only 12.9 per cent of North American entrepreneurs report that they created a business out of necessity. In Saudi Arabia, by contrast, a majority of entrepreneurs start their businesses out of opportunity and only 7.5 per cent are created out of necessity.

Given the limited contribution of necessity-driven entrepreneurship to economic development and productivity growth (Ács and Varga, 2005), policy strategies aimed at increasing entrepreneurial activities must encourage conditions for entrepreneurship driven by opportunity or innovation. A policy strategy of reducing unemployment by increasing the share of necessity-driven entrepreneurship has uncertain, if any, aggregate social benefits (Ács and Szerb, 2007) as it tends to focus on unproductive sectors in services and trade, such as small grocery shops and street vendors. To induce economic growth and reduce unemployment through increased entrepreneurial activity, both researchers and practitioners should determine the factors prevalent in the Arab region that spur opportunity-driven and innovation-driven entrepreneurship.

<sup>4</sup> Data for Syrian Arab Republic is available only before the outbreak of the civil war in 2011.

**Figure 3. Left: Necessity-driven compared to opportunity-driven entrepreneurship in Arab countries 2016;  
Right: Necessity-driven compared to opportunity-driven entrepreneurship in global comparison**



Source: Global Entrepreneurship Monitor, 2017.

### C. RELATIONSHIP BETWEEN ENTREPRENEURSHIP AND ECONOMIC DEVELOPMENT IN THE ARAB REGION

Entrepreneurship is an important lever for economic development. Not only do startups employ their owners, they may have important and significant spill over effects for the economy at large by promoting employment, innovation, efficiency and productivity, supply chain development and other elements of welfare (Ács and Audretsch, 1988; Ács, Desai and Hessels, 2008). While entrepreneurship creates new jobs in the short term, the mid-term consequences of entrepreneurial activity can be even more relevant for employment patterns in a country. Evidence from the United States of America and Europe on the net effect of employment creation by entrepreneurship shows that new firms generate competition that can lead to the replacement of inefficient companies (Kritikos, 2014). The loss of jobs from failing companies is offset by job creation by new firms during their first year of life, which leads to a net increase of jobs for the economy in the long term (Kritikos, 2014).

Studying the relevance of entrepreneurship for sustainable and inclusive economic development is particularly important in the context of Arab countries for the following reasons:<sup>5</sup>

- *Major component of the business environment:* SMEs represent 80-90 per cent of all formal sector enterprises in the Arab region (Nasr and Pearce, 2012). This proportion increases further when informal sector enterprises are taken into account;

<sup>5</sup> See also Schiffbauer, 2015, and Global Entrepreneurship Monitor, 2017, for recent comprehensive reviews on the structure of entrepreneurial activity in Arab countries and the impact on the private sector.

- *Sizeable employment opportunities:* Young firms have the highest rates of job creation in Arab countries, and employment growth is strongest in the first four to five years after firm entry. Job growth rates level off only after that (Schiffbauer, 2015). In official records, SMEs account for 20-40 per cent of all private sector employment. However, employment in SMEs tends to be underrepresented in official records owing to large informal sectors, particularly in non-GCC countries where informal employment constitutes as much as 67 per cent of total employment. GCC countries, by contrast, have a much lower record of informal employment at only 6 per cent (Angel-Urdinola and Tanabe, 2012);
- *Key growth component:* SMEs contribute significantly to gross domestic product (GDP), exceeding 50 per cent in Egypt, Jordan and Lebanon, for example (Nicola, 2009);
- *Trigger for productivity gains:* The Arab region experienced the lowest productivity growth across all regions from 2000 to 2005 (World Bank, 2015). For Egypt, the State of Palestine and Saudi Arabia, productivity growth within certain sectors was negative. Entrepreneurial activity driven by opportunity and innovation can spur productivity increases by enhancing competition and introducing innovation.

#### D. FURTHER IMPROVEMENTS ARE NEEDED IN THE REGULATORY ENVIRONMENT

The character of entrepreneurial activity, such as business density rates, the reasons for entrepreneurship and the level of informality, varies significantly between Arab countries. Such characteristics are largely determined by a country's business environment. The business environment comprises the characteristics and features of the legal and regulatory framework and other contextual elements in which businesses operate, such as access to finance, regulatory compliance, infrastructure or the tax environment (Klapper, Amit and Guillén, 2010; Augier, DAVIS and Gasiorek, 2012).

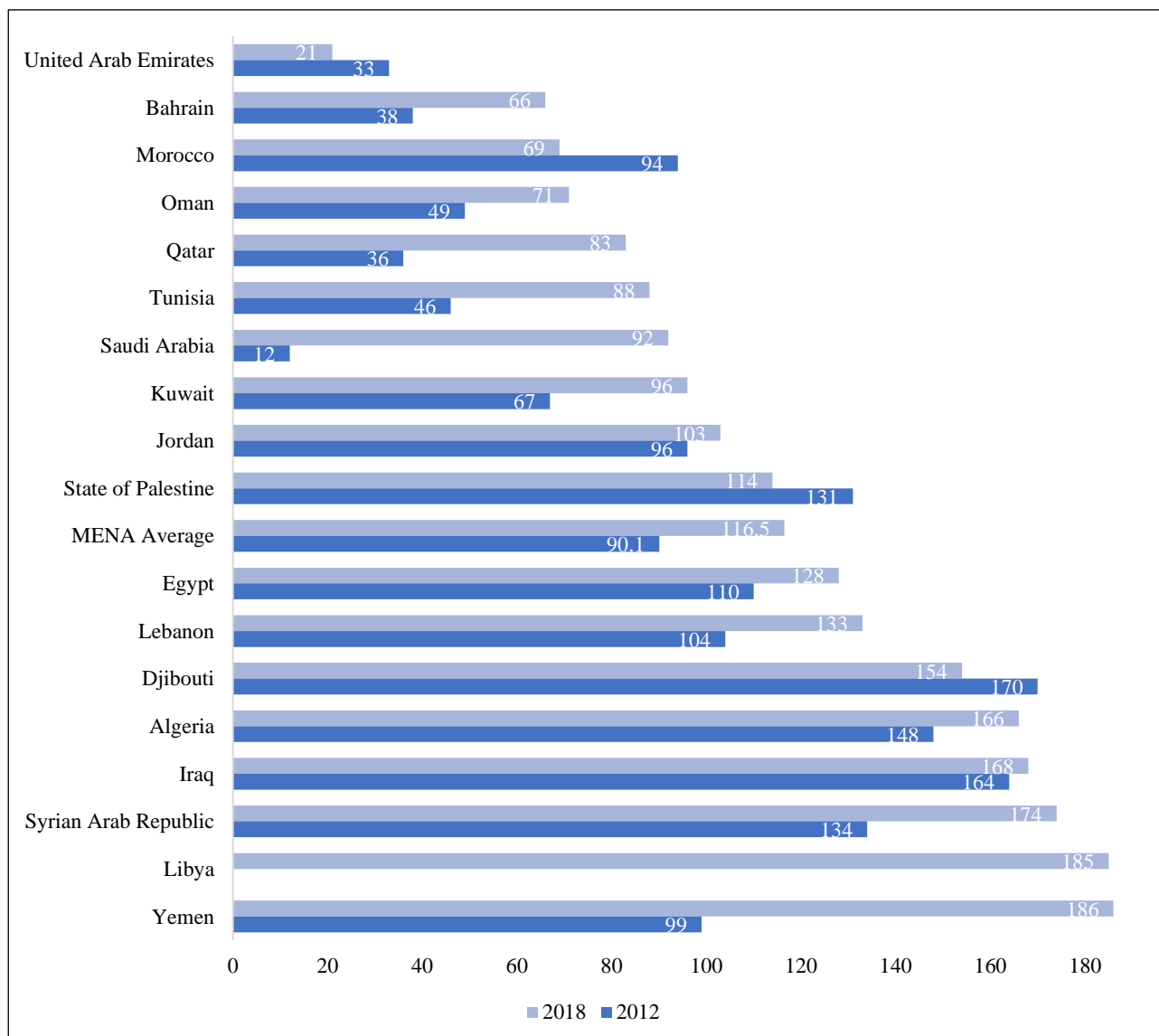
A widely used measure to assess the strength of a country's business environment is the World Bank's Ease of Doing Business Index.<sup>6</sup> The Index measures the relative strength of the regulatory environment conducive to the operation of businesses in 10 areas: starting up, dealing with construction permits, receiving electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. The Index is constructed as the simple average of the countries' percentile rankings on each of those topics.

In the past decade, the business environment in Arab countries lost in strength relative to other countries worldwide. Figure 4 shows that Arab countries' average rank decreased by 26 positions in the overall ranking on ease of doing business between 2009 and 2018. Most Arab countries lost in competitive strength relative to other countries globally, such as Yemen (from 98 to 186), Saudi Arabia (16 to 92) and Bahrain (from 16 to 66), much of which is likely related to the negative repercussions of domestic conflict. Only the State of Palestine (from 131 to 114), Morocco (from 128 to 69) and the United Arab Emirates (from 46 to 21) improved their rankings. While it should be noted that there were methodological changes in how the rankings were calculated, those numbers reflect that the Arab region ranks among the least competitive regions in terms of doing business worldwide (World Bank, 2018).

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<sup>6</sup> Database is available at [www.doingbusiness.org/data](http://www.doingbusiness.org/data).

**Figure 4. Ease of doing business global ranking of Arab countries, 2009 to 2018**

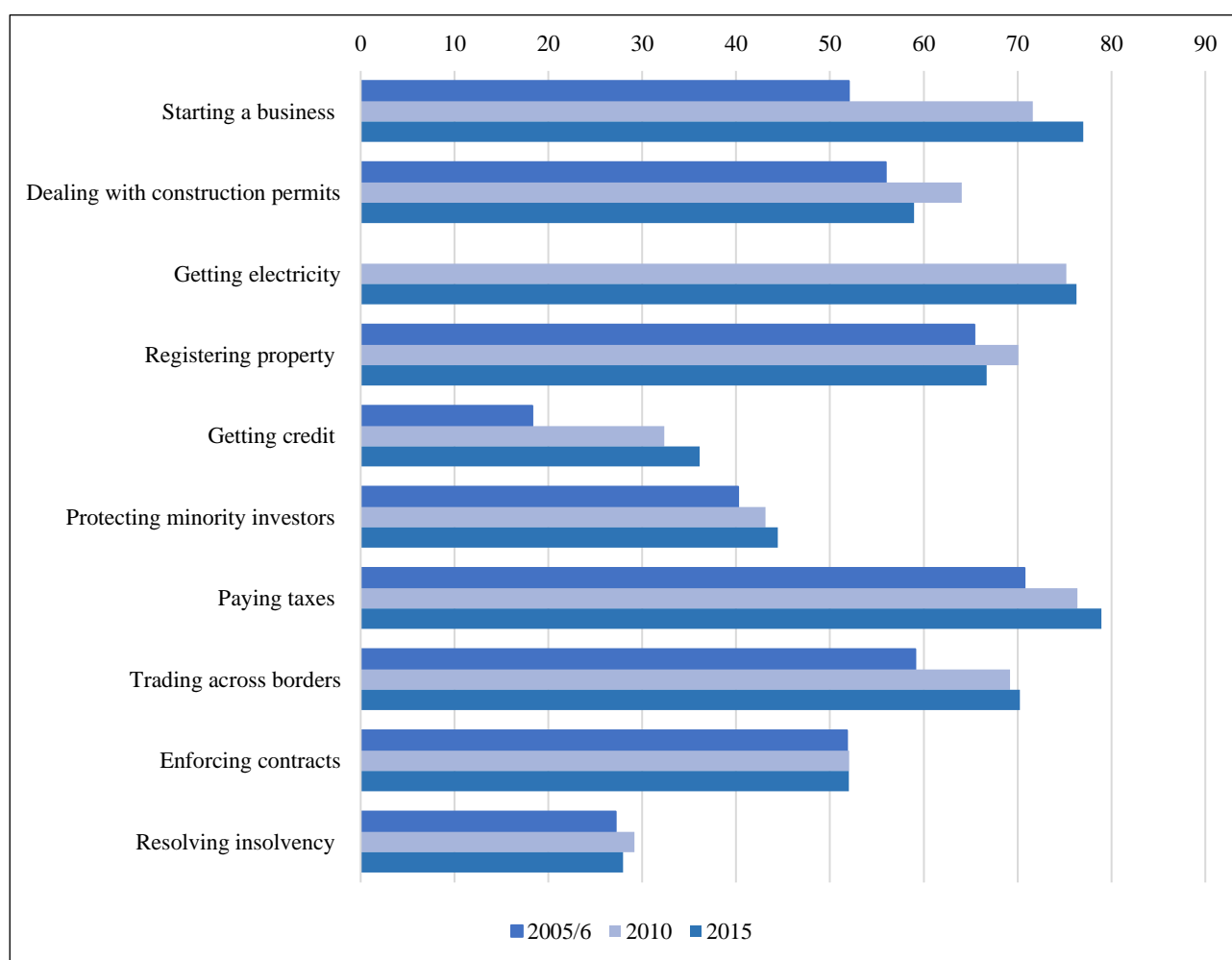


Source: World Bank, Ease of Doing Business Indicators, authors' calculations.

Despite bad overall rankings compared with other countries worldwide, the business environment in the Arab region made significant progress towards easing the operation of businesses in recent years. Figure 5 displays the regional average in the distance to frontier (DTF) in the 10 categories of the Index between 2005 and 2015. The DTF measure shows the “frontier” that “represents the best performance observed on each of the indicators across all economies in the Doing Business sample” (World Bank, 2018, p. 5). The DTF ranges on a scale from 0 to 100, where 0 is the lowest performance and 100 represents the frontier.<sup>7</sup>

<sup>7</sup> The Doing Business methodology ranks a country's relative strength in terms of regulatory barriers to SMEs. However, the methodology can be criticized for holding an ideological bias towards a “small Government” which would fail to reflect the development needs of developing countries by favoring economic liberalization. However, there is no significant relationship between the size of a Government (measured by total government consumption in relation to GDP) and index performance, at least for the case of Arab countries: “smaller” Governments, on average, do not perform better in the doing-business rankings.

**Figure 5. Average DTF in ease of doing business per category in Arab countries, 2010-2015**



Source: World Bank, Ease of Doing Business Indicators.

On average, since 2005, Arab countries have made progress in most categories. While access to finance and credit were at particularly low levels in 2005, the situation has improved markedly but remains poor in absolute terms. In several categories, progress was rolled back between 2010 and 2015, such as in procedures to register property, resolve insolvency or deal with construction permits. Virtually no progress was achieved in easing regulatory requirements to enforce contracts or in getting electricity. High exit barriers in terms of resolving insolvency remain a challenge across the region. However, significant progress was achieved in easing the requirements for starting businesses in the formal sector between 2005 and 2018. This progress is driven by a reduction in capital requirements for establishing new businesses, a crucial prerequisite for entrepreneurial activity.

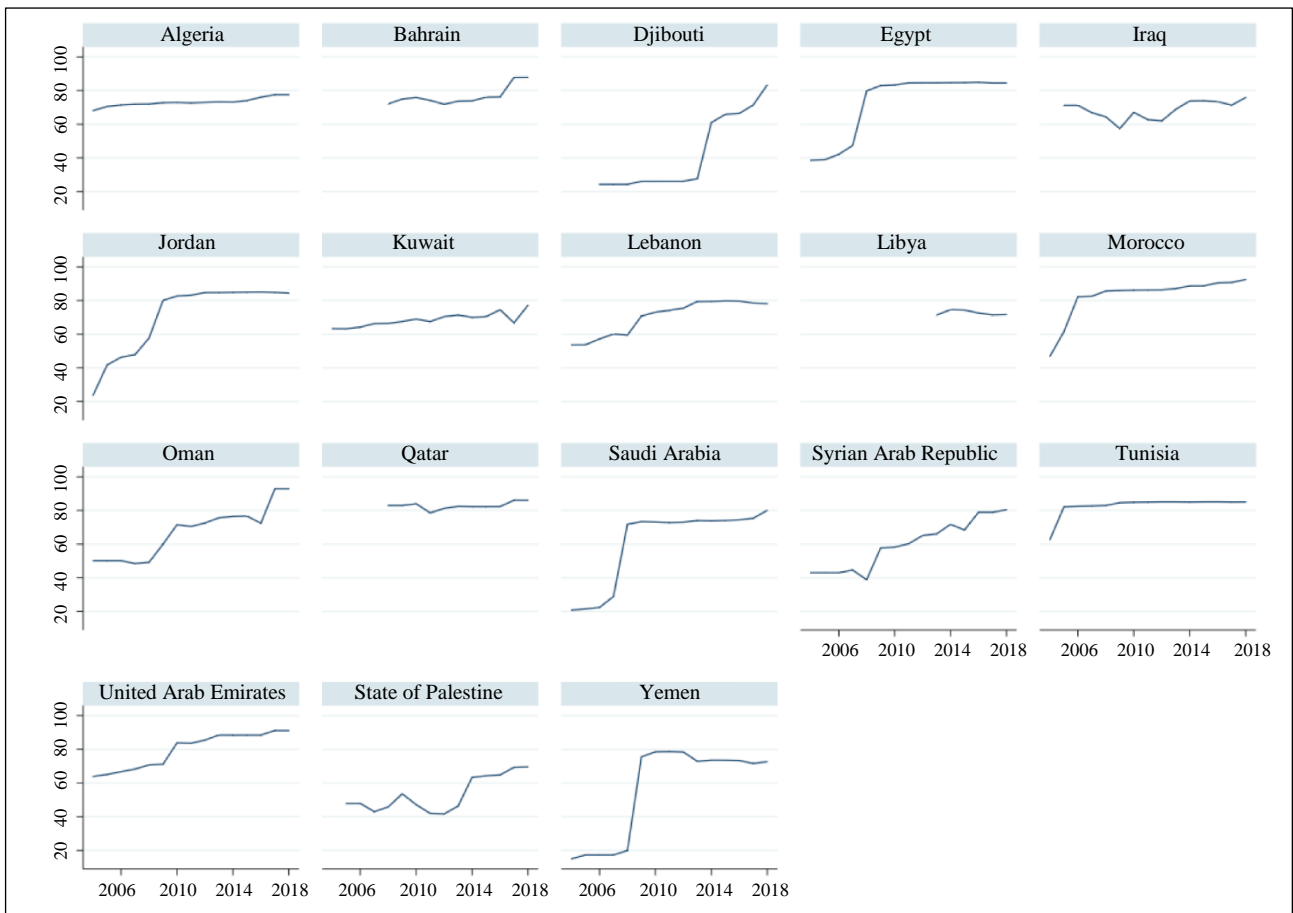
Figure 6 displays DTF for starting a business by country. Most Arab countries have made significant progress towards easing conditions to start a business in recent years. The countries with the largest improvements include Djibouti, Egypt, Jordan, Saudi Arabia and Yemen. Much of the progress achieved in those countries relates to abolishing minimum capital requirements and centralizing registrations.

### Box 1. Resolving bankruptcy in Saudi Arabia

Resolving bankruptcy remains a major constraint in many Arab countries owing to legal uncertainties associated with liquidation of assets. In a push towards accomplishing the goals set in its Vision 2030, Saudi Arabia has introduced a new bankruptcy law that reorganizes corporate bankruptcy in the Kingdom (Royal Decree No. M/05). The prior law failed to clearly distinguish between private and corporate insolvency and made any resulting legal cases extremely costly. This created high exit barriers and low recovery rates among bankrupt firms. The new bankruptcy law addresses those concerns by streamlining procedures and reducing the risks associated with liquidation and the settlement of financial disputes. Under the auspices of the Ministry of Commerce and Investment, an independent bankruptcy committee now oversees all matters related to bankruptcy. By reducing exit barriers and increasing legal certainty, the law aims to attract investment, both foreign and domestic, and facilitate entrepreneurial activities of small businesses.

Sources: Library of Congress, World Bank Ease of Doing Business project.

Figure 6. Ease of opening a business DTF per Arab country, 2004-2018

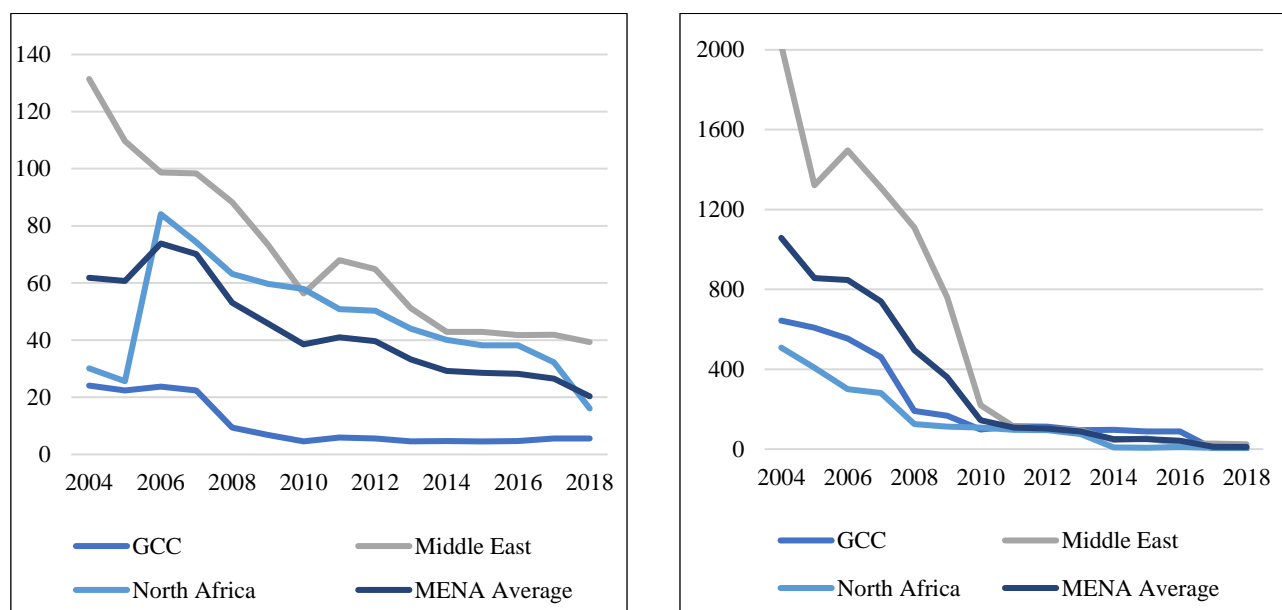


Source: World Bank, Ease of Doing Business Indicators.

Analysing the components of those improvements reveals that Arab countries could further reduce the cost and time it takes to open a business. Figure 7 shows that most progress has been made in reducing the capital requirements for young firms, which declined from over 60 per cent to 20.3 per cent of income per capita on average between 2004 and 2018. The costs of opening a business has been reduced to 39 per cent of income per capita in the Middle East and 16 per cent in North Africa, bringing them significantly closer to the level of GCC countries. Algeria, Djibouti, Egypt, Morocco, Oman, the State of Palestine, Qatar, Saudi Arabia, Tunisia, the United Arab Emirates and Yemen have abandoned minimum capital requirements altogether.



**Figure 7. Left: Cost of starting a business; Right: Minimum capital requirements for starting a business**  
(Percentage of income per capita)



Source: World Bank, Ease of Doing Business Indicators.

### Box 2. Foreign ownership laws in GCC countries

Entry barriers into domestic markets for foreign firms are common in many developing countries, including the Arab region. In an effort to attract high-quality foreign direct investment and diversify their economies, GCC countries are pushing to lift restrictions on foreign ownership of limited liability companies (LLCs). In the United Arab Emirates, at least 51 per cent of an LLC had to be owned by a national or a domestic legal entity. Exceptions were granted only in “free zones”, such as the Dubai International Financial Centre. Those regulations have now been revised for specific industries to allow up to 100 per cent foreign ownership. Saudi Arabia already allows 100 per cent foreign ownership in some industries. Similarly, Qatar intends to allow full foreign ownership in all sectors. Such radical abolishment of entry barriers into GCC domestic markets could impact other Arab countries, as qualified entrepreneurs seeking to avoid cumbersome business regulations in their home markets decide to open businesses in Gulf countries. The economic and regulatory contagion effects of such regulatory developments will constitute important case studies for other countries in the region.

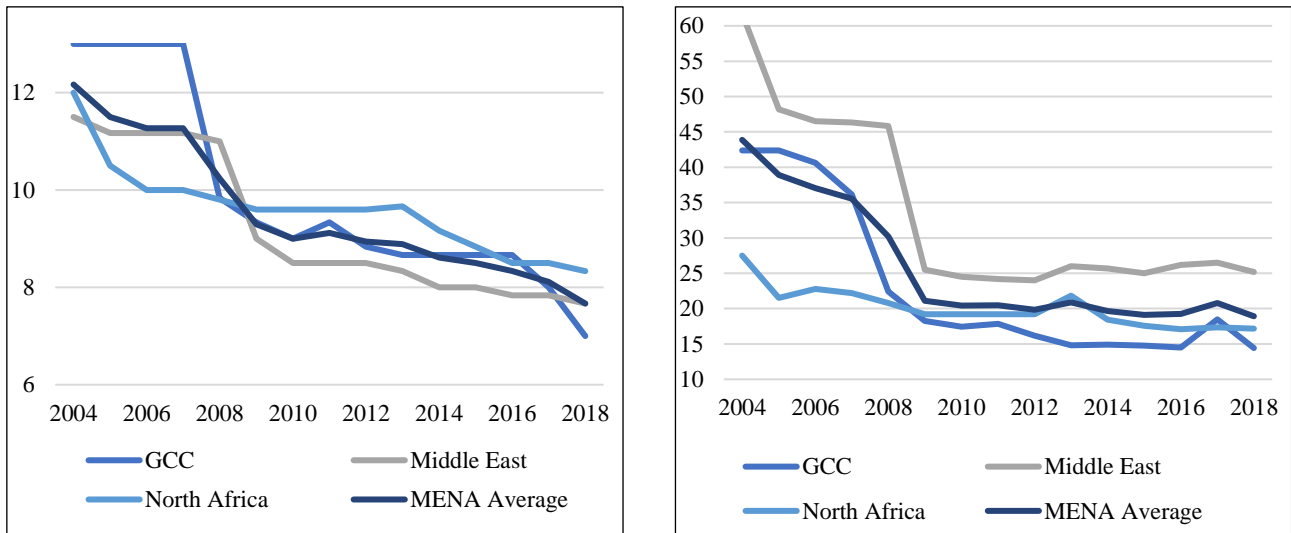
Sources: Bloomberg, World Bank Ease of Doing Business Project.

A similar convergence happened with regard to the number of procedures and the time required to open a business. Figure 8 shows that the number of procedures was reduced from over 11 to under eight on average, while GCC countries made more significant progress (from 13 to seven procedures on average).

Women and men face different requirements to open businesses in the Arab region. While women and men have the same capital requirements to open a business, women need more time because additional procedures are required. Figure 9 shows how women must undertake on average at least one additional procedure in most Arab countries. Additional procedures are most prevalent in countries of the Gulf region (right) which require, on average, 1.2 days more for women to open a business (15.6 for women versus 14.4 for men), such as in Kuwait (10 for women and nine for men), Saudi Arabia (12 for women and 10 for men), and Bahrain (eight for women and seven for men). In Saudi Arabia, for example, this additional procedure is linked to presenting proof of male guardianship. All North African countries (left) require the same number of procedures, except Egypt. In the Levant region (middle), all countries except Lebanon have one additional step for women to open businesses. In Iraq, for example, women need to provide an approval from their

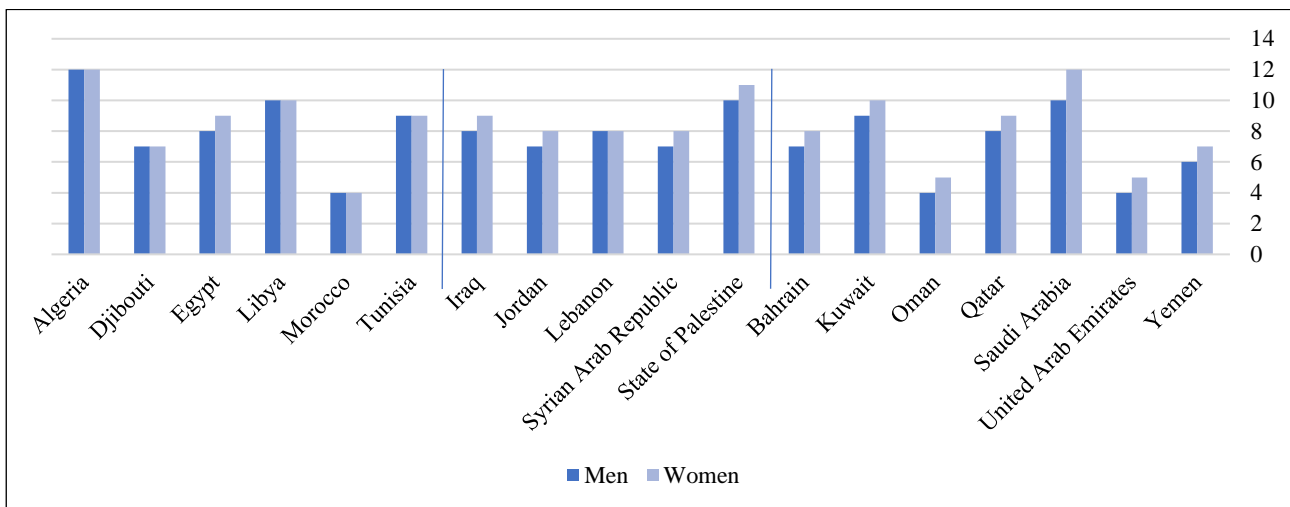
husbands to leave their home. In Saudi Arabia, the requirement for women to provide proof of guardianship was abolished in February 2018 by the Ministry of Commerce and Investment as part of the Government’s Vision 2030, thus reducing the number of additional procedures to two.<sup>8</sup>

**Figure 8. Left: Procedures (number) for starting a business;  
Right: Time (days) to start a business**



Source: World Bank, Ease of Doing Business Indicators.

**Figure 9. Number of procedures to open a business in 2018, men versus women**



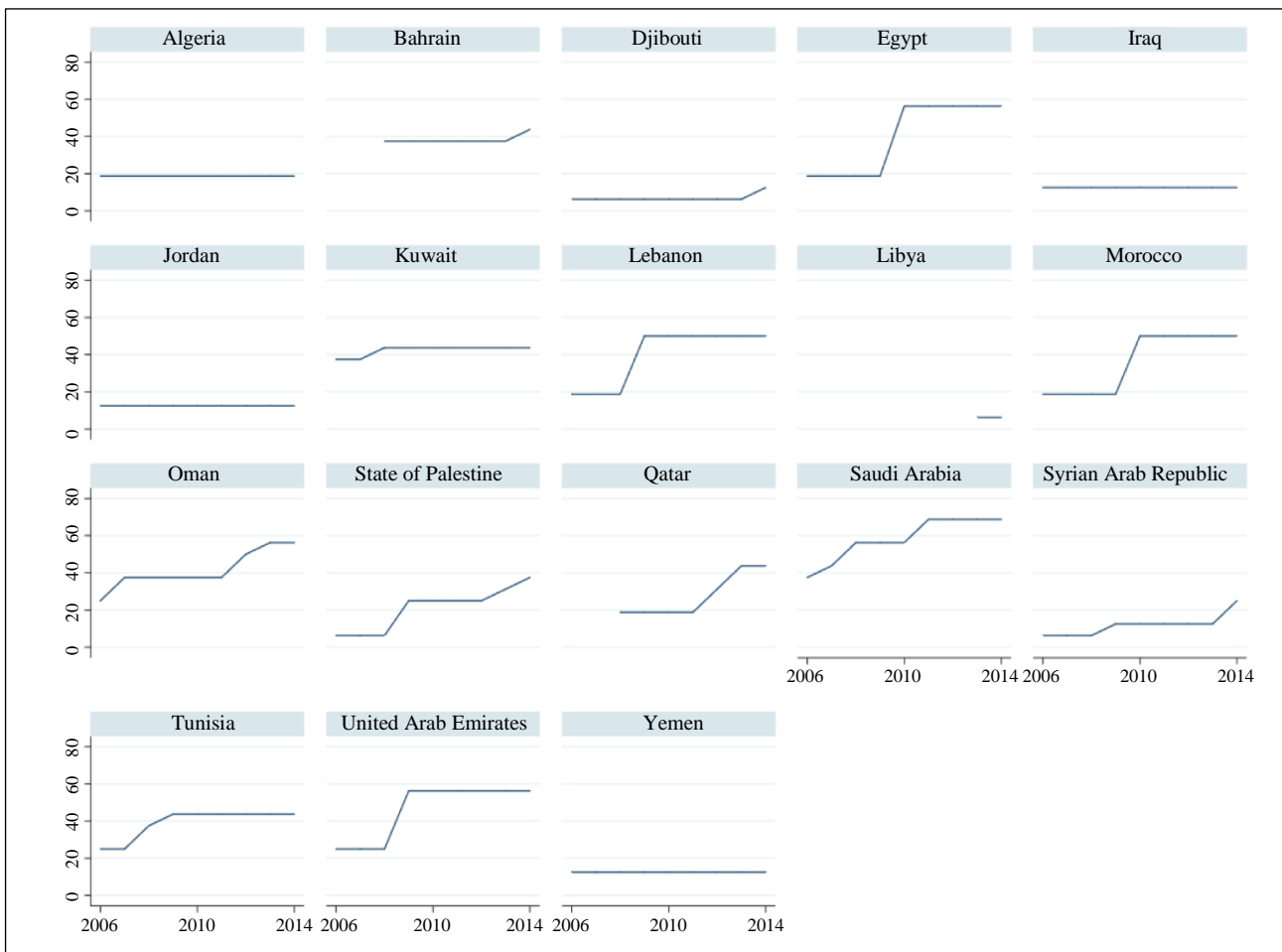
Source: World Bank, Ease of Doing Business Indicators.

Arab countries rank among the least competitive in terms of accessing finance worldwide (Nasr and Pearce, 2012). Yet, figure 10 shows that several countries made progress towards ameliorating access to finance for the private sector. Egypt, Morocco, Saudi Arabia and the United Arab Emirates narrowed DTF from about 20 to 60 by increasing the coverage of credit registries. Other Arab countries, including Algeria, Iraq, Jordan and the Syrian Arab Republic, either could not increase or only minimally increased their access to credit.

<sup>8</sup> Ministry of Commerce and Finance, Saudi Arabia. Available at <https://mci.gov.sa/en/Pages/default.aspx> (accessed on 18 June 2018).

Those developments are mostly related to improvements in the strength and outreach of credit registries, which have received much governmental attention in recent years. The ease and reliability with which lending institutions can assess the creditworthiness of potential lenders is crucial for firms' access to finance. Credit bureaus and registries can play a central role in helping banks and financial institutions, which in turn facilitates access to credit for firms and individuals. Those institutions share credit information and help financial organizations to allocate credit efficiently. Moreover, they reduce the importance of private connections and outright corruption for entrepreneurs to obtain credit. These registries increase opportunities for entrepreneurs to secure financing for their businesses in the absence of physical assets as collateral, which benefits entrepreneurial activity at large.

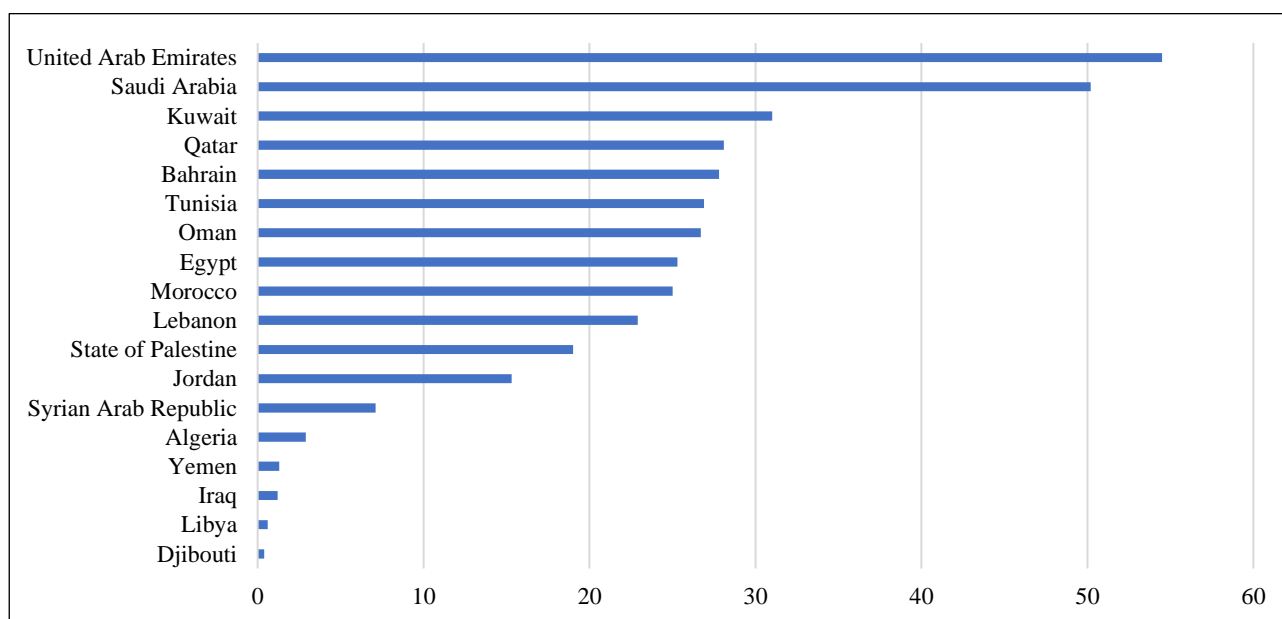
**Figure 10. Ease of getting credit by country DTF, 2006-2014**



Source: World Bank, Ease of Doing Business Indicators.

Egypt, for example, increased its access to credit by significantly increasing the coverage of credit registry offices from 0 per cent to 25 per cent of adults between 2005 and 2018, while Saudi Arabia and the United Arab Emirates increased credit registry coverage to above 50 per cent. As figure 11 shows, in other countries, such as Algeria, Libya and Yemen, credit registries have poor to no information about potential creditors, which heavily constrains lending activities by financial institutions. As discussed in chapter II, financing needs for entrepreneurs require a degree of differentiation that is only partly reflected in the ease of doing business index, as the difficulty of obtaining credit varies by firm size.

**Figure 11. Coverage of credit bureaus or registries in Arab countries, 2018**  
(Percentage of adult population)



Source: World Bank, Ease of Doing Business Indicators.

### Box 3. Credit registries in the Arab region

Credit registries serve an important function in easing access to credit: they share and distribute credit information on borrowers with other financial institutions. Without sufficient information, banks risk being left with weak portfolios and, even worse, rejecting projects that are worthy of financial support. Providing and sharing information reduces allocative inefficiencies and helps lenders assess the risks of granting credit effectively.

Most Arab countries have introduced a credit registry of some sort or strengthened the coverage of existing registries. In Arab countries, central banks play an important role, either hosting the respective authorities themselves or regulating the information that is shared. As one of the last countries in the Arab region to implement a system, Iraq introduced a credit registry scheme in cooperation with the Central Bank of Iraq and a private provider in 2017. As at January 2017, the registry had listed information on the borrowing history of 234,967 consumers and 4,877 commercial borrowers over the previous five years. While these numbers constitute only 1.2 per cent of the total adult population, the Iraqi Government has included these reforms into the broader context of its Vision 2030 programme that focuses on institutional economic reforms and private sector development.

Similarly, in a move to strengthen the existing credit registry, Palestinian authorities expanded its scope and began distributing credit data from retailers and utility companies. The Syrian Arab Republic, despite the conflict, has pushed ahead efforts to ameliorate its business environment and established an online system for data exchange between all banks, microfinance institutions and the credit registry, managed by the central bank. With these efforts, the Syrian credit registry increased its share of listed individuals from 2.2 per cent to 7.1 per cent of the population between 2011 and 2018.

Morocco has a particularly successful story to tell. The Moroccan central bank, Bank Al-Maghrib, introduced a credit registry under its supervision after the Moroccan banking system experienced a surge in non-performing loans as a result of poor lending decisions in 2005. All supervised financial institutions started to supply the central bank with full data on all loans on a monthly basis, which improved the share of listed individuals from essentially 0 per cent to 25 per cent of the total adult population. The central bank confines its role to consolidating the data and providing it to licensed credit bureaus. By effectively outsourcing data provisioning to the private sector, no information monopolies could emerge and the central bank was able to focus on its role as supervisor.

Sources: Library of Congress, World Bank Ease of Doing Business Project.

## E. EFFECT OF EASING THE OPENING OF BUSINESSES ON NEW BUSINESS DENSITY RATES

Several studies establish a significant and positive relationship between ease of doing business measures and the density of new businesses. Klapper, Amit and Guillén (2010), for example, find that business density rates are significantly related to the quality of the legal and regulatory environment, access to finance and the prevalence of informality. Similarly, Klapper and others (2009) show that better governance and more efficient and cheaper business registration procedures are associated with increases in entrepreneurial activity, even after controlling for economic development. Ayyagari, Beck and Demirguc-Kunt (2007) demonstrate that the business environment, in particular lower costs of entry and better credit information sharing, is associated with a larger SME sector. They also find high exit costs associated with a larger informal economy. In reviewing the literature on World Bank surveys on the impact of the investment climate at the firm level across countries, Xu (2011) emphasizes that the individual effects of the business climate depend on a specific industry, initial conditions and complementary institutions, while other elements, such as labour flexibility and low entry and exit barriers, matter significantly for most economies.

The present section provides evidence on the extent to which the relationship between ease of doing business measures and the density of new businesses holds true in the context of Arab countries. The dependent variable indicates entrepreneurial activity by measuring the density of new businesses per 1,000 inhabitants per country in a given year.<sup>9</sup> The DTF score of the start of doing business indicator serves as the key independent variable.<sup>10</sup> Control variables include the following monetary instruments by which the Government exerts influence on the domestic economy and provides incentives in support of the domestic private sector (Kandil, 2009):

- The supply of money and quasi-money that influences the availability of credit;
- Private consumption as an indicator of domestic demand for new products and services;
- Real GDP growth to capture the overall economic situation;
- Government consumption as a proxy for the extent to which the Government provides incentives for and investments into the domestic economy;
- The real effective exchange rate of the domestic currency, which affects the competitiveness of local products in foreign markets.<sup>11</sup>

The specification uses the ordinary least squares estimation method and is completed by a two-way error component, accounting for country and year fixed-effects. Table 1 displays the regression results of several fixed effects models that take the new businesses density as a dependent variable.

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<sup>9</sup> World Bank, Doing Business Project.

<sup>10</sup> World Bank, Doing Business Project. Note that the regression analysis is confined to the “starting a business” DTF measure. Other indicators of the ease of doing business index, such as “getting credit” or “resolving insolvency”, are either not comparable over time due to changes in methodologies, would have had limited relevance for the process of starting a business due to the case study assumptions of the index calculations or would have had limited expressiveness due to further limiting the dataset and observations.

<sup>11</sup> IMF International Financial Statistics and Economist Intelligence Unit. Full description of data sources is provided in annex I.

TABLE 1. REGRESSION RESULTS FOR THE IMPACT OF EASE OF STARTING A BUSINESS MEASURES FOR NEW BUSINESS DENSITY RATES

	1	2	3	4	5
Starting a business DTF	0.013	0.015	0.017	0.014	0.013
	(3.40)**	(3.45)**	(3.41)**	(2.47)*	(2.56)*
Money and quasi-money supply		0.004	0.001	0.009	
		(0.94)	(0.17)	(1.30)	
Private consumption growth			0.001		
			(0.13)		
Real GDP growth			0.021		0.030
			(1.68)		(2.43)*
Real government consumption				0.038	0.037
				(2.94)**	(3.13)**
Real effective exchange rate				-0.006	-0.007
				(0.85)	(1.04)
Constant	0.073	-0.116	-0.234	0.256	0.389
	(0.25)	(0.33)	(0.54)	(0.33)	(0.59)
Country fixed effects	Yes	Yes	Yes	Yes	Yes
R2	0.13	0.14	0.20	0.28	0.33
N	85	85	74	68	68

Note: \* p<0.05; \*\* p<0.01, t-statistics in parentheses; dependent variable: new business density per 1,000 inhabitants. Countries included in sample: Algeria, Iraq, Jordan, Morocco, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Tunisia and the United Arab Emirates.

The results support the findings of the established literature in the case of Arab countries. They indicate a positive and significant relationship between easing the requirements to start a business and new business density rates, even after controlling for GDP growth and government consumption. The real effective exchange rate has no significant impact on new business density, which indicates a low elasticity between export activity and currency evaluation. Similarly, the supply of money in the economic cycle is insignificant for new business density rates, which is in line with findings on the limited capacity of financing mechanisms in Arab countries (Nasr and Pearce, 2012; ch. 4).

## II. IDENTIFYING PRIORITY POLICY CHALLENGES: A SYNTHESIS OF CURRENT RESEARCH

In the light of the regulatory developments highlighted in chapter I, the present chapter identifies priority policy challenges by reviewing and synthesizing recent relevant studies that investigate the determinants of entrepreneurship and private sector development in the Arab region. Policy recommendations that address the identified challenges are set out in chapter III.

The analysis finds that despite different data, methodologies and epistemological approaches, the identified papers highlight the same set of priority areas for policy intervention: competition policy; access to finance; and entrepreneurial education. While there are other prominent explanations for the underperformance of Arab countries in terms of entrepreneurship and private sector development, those three policy areas are highlighted in the most recent and relevant studies.

Governance challenges are context dependent and development policy needs to reflect regional characteristics to be effective. Nevertheless, regional trends are discernible based on which collaborative regional policy responses can be formulated. The present chapter reviews and discusses the findings of recent papers that relate to the identified priority policy areas.

Table 2 provides an overview of 11 reports that fulfilled the criteria outlined in the methodology section. It gives information on the countries under investigation, the type of data used, methodology, policy area and essential results.

### A. POLICY CHALLENGE AREA 1: COMPETITION POLICY

#### 1. *Clientelism and abuse of political connections reduce aggregate job creation*

Most studies reviewed for the present paper rank corruption, distortionary policies and the lack of market competition among the most significant impediments to entrepreneurship and private sector development in Arab countries. Evidence from the World Bank Enterprise Survey<sup>12</sup> suggests that regulatory uncertainty and corruption are among the most serious obstacles for firms: over 50 per cent of firms report that corruption is a severe obstacle in Arab countries, compared with slightly above 30 per cent on average worldwide (EBRD, EIB and World Bank, 2016, p. 21). The impact of corruption and clientelism on private sector development was highlighted before the recent political transitions took place (Benhassine, 2009; Bishara, 2011). Yet, improvements in terms of market access and competition regulation can play a major role for economic development (ESCWA, 2015). Fair and competitive markets are crucial to fostering entrepreneurship and private and foreign direct investment.

If market access succeeds, imperfect markets and institutional constraints affect young businesses and SMEs more than large firms: large firms have both easier access to capital and financial and political leverage to offset market imperfections such as transaction costs and information asymmetries (Beck and Demircuc-Kunt, 2006; Schiffbauer, 2015; Diwan and Haidar, 2017). Such distortions have a disproportionate effect on small firms, especially in the context of countries with less developed institutions (Nasr and Pearce, 2012). These findings imply that young firms and SMEs can benefit more than large firms from curtailing corruption and improvements of regulatory quality by, for example, easing access to finance for entrepreneurs and SMEs by reducing reliance on private connections to obtain credit.

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<sup>12</sup> Countries included in the Enterprise Survey are: Djibouti, Egypt, Jordan, Lebanon, Morocco, State of Palestine, Tunisia and Yemen.

TABLE 2. SUMMARY OVERVIEW OF RECENT LITERATURE ON ENTREPRENEURSHIP AND PRIVATE SECTOR DEVELOPMENT IN THE ARAB REGION

Country focus	Policy focus	Method and data	Key findings
EBRD, EIB, World Bank (2016): What is holding back the private sector in MENA? Lessons from the Enterprise Survey			
Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, State of Palestine and Yemen	Private sector developments	Enterprise Survey covering more than 6,000 private firms in the manufacturing and services sectors; data on the experiences of firms with a broad range of dimensions of the business environment, including access to finance, corruption, infrastructure, crime and competition	<p>Four core areas stand out that inhibit private sector development: political instability; corruption; unreliable electricity supply; and inadequate access to finance;</p> <p>Political instability is a leading concern for firms in most countries, negatively impacting sales and productivity growth;</p> <p>High perceived levels of corruption are associated with lower growth of sales and employment, and lower labour productivity;</p> <p>Inefficiencies in the business environment disproportionately affect SMEs;</p> <p>Relatively high concentration of formal employment in manufacturing and exporting compared to other regions;</p> <p>Youth employment strongest in young innovative firms.</p>
ESCWA (2015): Competition and Regulation in the Arab Region			
Algeria, Egypt, Kuwait, Morocco, Syrian Arab Republic, Tunisia and Yemen	Competition policy and regulation	Survey to create index on competition policy	<p>Competition law and policy frameworks in line with internationally recognized good practices;</p> <p>However, competition authorities have limited authority to enforce legislation to State-owned enterprises and some international firms; and incomplete investigative reach or lack authority to sanction;</p> <p>Other major findings include: intensity of enforcement associated with economic development; agency independence and regional trade agreement membership have a positive impact on enforcement intensity; net exporting countries spend more on enforcement of competition law; countries with higher sectoral concentration levels spend more on enforcement; and more comprehensive competition laws not related to stricter enforcement.</p>



TABLE 2 (continued)

Country focus	Policy focus	Method and data	Key findings
ESCWA (2016): The strength of competition policy and regulation in the Arab region – application of OECD indicators to selected Arab countries in 2015			
Algeria, Egypt, Kuwait, Morocco, Syrian Arab Republic, Tunisia and Yemen	Competition policy and regulation	Survey to create index on competition policy	<p>Increase in scope, activity and legal power of competition authorities owing to reforms in the legal and procedural frameworks underpinning national competition policy;</p> <p>Insufficient independence of competition authorities and procedural fairness. Few countries investigated or imposed sanctions on antitrust infringements related to mergers, horizontal and vertical agreements, or exclusionary conduct.</p>
Global Entrepreneurship Monitor (2017): Middle East and North Africa – Report 2017			
Egypt, Iran, Jordan, Lebanon, Morocco, Qatar, Saudi Arabia, Tunisia and United Arab Emirates	Entrepreneurship	Firm-level and expert surveys	<p>Marked fall-off between intentional and active entrepreneurs: highest levels of entrepreneurial intention compared with other regions, yet proportion of early-stage entrepreneurs 70 per cent lower than entrepreneurial intentions;</p> <p>Despite high intentions to open businesses, Arab countries with lowest proportions of people starting businesses. Africa, on a par with the Arab region in terms of entrepreneurial intention, has three times as many nascent entrepreneurs;</p> <p>Some countries exhibit high degrees of necessity-driven entrepreneurship, vis-à-vis opportunity-driven entrepreneurship. In Lebanon, 40 per cent of business owners state they had no other option (31 per cent in Egypt and 29 per cent in the United Arab Emirates);</p> <p>Arab countries among the lowest proportions of established business owners; poor sustainability of startups;</p> <p>Access to finance after lack of profitability most widely cited reason for exiting business;</p> <p>School-level entrepreneurship education and research and development transfer are two main areas constraining entrepreneurship.</p>

TABLE 2 (continued)

Country focus	Policy focus	Method and data	Key findings
OECD (2013): New Entrepreneurs and High-Performance Enterprises in the Middle East and North Africa			
Arab region and country cases on Egypt, Jordan, Morocco, Tunisia and United Arab Emirates	Entrepreneurship and high-growth enterprises	Quantitative analysis of Global Entrepreneurship Monitor data on the Arab region, Ease of Doing Business data, and country commentary for Egypt, Jordan, Morocco, Tunisia and United Arab Emirates	<p>High-growth enterprises face higher constraints in accessing finance than companies that have physical assets as collateral (including both equity financing via business angels, venture capital and bank credit);</p> <p>Poor infrastructure (especially internet access and telecommunication, electricity and inefficient water supply) strongly disadvantage high growth enterprises as heavy users of those services;</p> <p>Insufficient managerial skills of entrepreneurs hold back enterprise development, as business owners are highly educated and with significant work experience but lack the skills to grow their businesses;</p> <p>Low participation of women in the labour force is a major determinant of the entrepreneurial gender gap.</p>
Gatti and others (World Bank, 2014): Striving for Better Jobs – The Challenge of Informality in the Middle East and North Africa			
All Arab countries	Informality in labour markets	Schneider Index to estimate the share of production not declared to tax and regulatory authorities (Schneider and others, 2010)	<p>Some Arab countries among the most informal economies worldwide, with a rising trend;</p> <p>A typical Arab country on average produces about one third of its GDP informally; employs 65 per cent of its labour force informally; and leaves two-thirds of all workers without access to health insurance and/or a pension system;</p> <p>Informal workers in most Arab countries engaged in low-productivity jobs, more so than in comparator countries;</p> <p>Resource-rich/labour-abundant economies: high informality rates as proxied by share of the labour force not contributing to social security (66-73 per cent) and by share of self-employment to total employment (32-54 per cent); share of undeclared output to total GDP (about 20 per cent) comparable to GCC countries, as few, but large, formal firms (many in the energy sector) result in lower informality in production than in labour;</p> <p>Resource-poor/labour-abundant economies: high share of undeclared output (35-40 per cent of GDP) and lower share of the workforce not contributing to social security (45-76 per cent), because of a higher share of medium-size (and semiformal) labour-intensive companies and high public-sector employment.</p>

TABLE 2 (continued)

Country focus	Policy focus	Method and data	Key findings
Schiffbauer and others (World Bank, 2015): Jobs or Privileges – Unleashing the Employment Potential of the Middle East and North Africa			
All Arab countries	Impact of clientelism on private sector development	Case studies on Jordan, Egypt, Morocco for competition policy; surveys; case studies Egypt and Tunisia for effects of political connections of large firms	<p>The moderate GDP per capita growth of the last two decades was driven by demographic change, while productivity growth was low;</p> <p>Job growth weak as not enough startups and productive firms. Yet, fundamentals of job creation – the types of firms that create more jobs – do not differ in Arab countries to other regions: younger firms and more productive firms grow faster and create more jobs in Arab countries as elsewhere;</p> <p>Various policies limit competition and undermine job creation by constraining firm startup and productivity growth;</p> <p>Past industrial policies tended to curb competition, distort markets and provide privileges;</p> <p>Policies often captured by few politically connected firms, leading to a policy environment that created privileges rather than to a level playing field, undermining private sector growth and job creation.</p>
Roberta Gatti and others (World Bank, 2013): Jobs for Shared Prosperity – Time for Action in the Middle East and North Africa			
All Arab countries	Employment	Cross-sectional approach to identify determinants of employment equilibria	<p>Skill mismatch is one of the major constraints in doing business and firm growth;</p> <p>Arbitrary and unpredictable implementation and enforcement of regulation inhibits private sector development;</p> <p>Youth, women and rural low-skilled workers are least likely to have a protected or well-paid job. They are therefore overwhelmingly inactive, unemployed or work informally for low pay;</p> <p>Employment conditions in the public sector distort incentives in the private sector;</p> <p>Training and educational systems lack incentives to build high-quality, relevant skills.</p>

TABLE 2 (continued)

Country focus	Policy focus	Method and data	Key findings
Roberto Rocha, Zsofia Arvai and Subika Farazi (World Bank, 2011): Financial Access and Stability – A Road Map for the Middle East and North Africa			
All Arab countries	Financial development	Cross-sectional approach, based on financial indicators of IMF, World Bank, Central Bank data	<p>Financial systems are heavily bank-based and undiversified. Non-banking financial institutions remain small or negligible;</p> <p>Stock of private fixed-income instruments negligible. Stock of traded government securities sizable in some non-GCC countries, but government debt markets remain undeveloped and illiquid and draw little interest from foreign investors;</p> <p>Banks are generally well capitalized, and the credit-to-GDP ratio is generally high by international standards, but credit is much more concentrated. Important segments, such as SMEs, are deprived of bank credit, and alternatives to bank finance are limited, even for larger enterprises;</p> <p>Outreach of the microfinance industry is restricted, and housing finance is in nascent stage;</p> <p>Weak financial infrastructure, little banking competition and flaws in the institutional and legal framework hinder growth of non-bank financial institutions, instruments and markets.</p>
Nasr and Pearce (World Bank, 2012): SMEs for Job Creation in the Arab World – SME Access to Financial Services			
All Arab countries	Assessment of supply and demand of financial services to SMEs and regulatory environment	Cross-sectional approach, based on financial indicators of IMF, World Bank, Central Bank data	<p>Access to bank accounts is relatively good, while access to credit, growth capital and some other financial services is more constrained. SMEs in the Arab region have the lowest usage of bank loans of all regions except sub-Saharan Africa: only 20 per cent have loan or line of credit; average share of SME lending on total loans is only 8 per cent;</p> <p>Banks are a principal source of SME finance, but operate at well below the SME market potential. SMEs receive finance primarily from non-financial sector sources, including trade credit.</p>

Schiffbauer (2015) indicates the extent to which political connections of established firms impede competition and job creation. Politically connected firms are those that have a specific politician or a main associate of politicians as influential stakeholder (namely a manager, board member or shareholder). The author analyses firm-level data from Egypt and Tunisia to quantify the extent to which political connections of firms affect job creation at the firm level and assesses the aggregate impact at the macrolevel. The results show that sectors dominated by connected firms exhibit 11 per cent lower market entry rates of new firms, despite the relatively higher rents those sectors offer compared with ‘unconnected’ sectors. Consequently, political connections of established firms constitute an additional entry barrier to new and unconnected firms. According to the author, to circumvent such challenges, new firms tend to avoid sectors dominated by connected firms. As those sectors exhibit higher productivity on average, new firms tend to specialize either in less productive sectors or in less productive niches within these sectors, which inhibits economic development. Research by Diwan and Haidar (2017) corroborates those findings for Lebanon: sectors with more connected firms create fewer jobs than firms in ‘politically unconnected’ sectors. The authors show that connected firms also tend to have better access to finance and, if necessary, receive more bailouts that further distorts market competition.

Many Arab countries need to work on identifying and breaking the mechanisms that link clientelism, entrepreneurship and private sector development. One of these mechanisms is related to firms’ access to finance which, in the absence of sufficient banking competition and well-functioning credit registries, is more constrained for entrepreneurs without connections than for established firms with connections. Managerial and entrepreneurial education can counter the negative implications of clientelism by, for example, highlighting practices for good corporate governance. Another such mechanism relates to the enforcement of competition policy.

## *2. Competition regulation impacts the business environment and increases informality*

Market distortions are the result of not only privileges of connected firms but are reinforced by weak policy frameworks that govern competition. The lack of firm-level competition reduces incentives to invest in new technologies and to improve productivity, which depresses firm-level dynamics and job creation. Anti-trust and competition laws and their enforcement constitute central instruments for Governments to minimize market distortions and ensure competition among firms within and across sectors. Arbitrary and unpredictable implementation and enforcement of regulation, on the other hand, inhibits private sector development (Gatti and others, 2013). In Egypt, for example, the selective application of rules and regulations across firms within the same sector distorts the business environment and thereby creates additional high-entry barriers to markets entrants (World Bank, 2014).

Two regional studies on the state of competition policy in Arab countries found that legislative frameworks generally adhere to internationally recognized good practices (ESCWA, 2015, 2016). However, a differentiated view on the indicators “scope of action”, “policy on anti-competitive behaviour” and “probity of investigation” shows that on average Arab competition policy regimes perform lower than the OECD average, even while they fare better in advocacy. State-owned enterprises, which are numerous in the Arab region, and subsidiaries of international firms represent a challenge to the existing competition regimes, for which rules and regulations may apply differently or not at all. Enforcement is another challenge, as competition authorities may lack sufficient legal authority to sanction persons or firms found guilty of antitrust infringement (ESCWA, 2016), which affects market access and economic development, including employment creation.

The absence of a level playing field for firms not only hampers job creation but may push entrepreneurs into the informal sector. In a comprehensive study on informality in the Arab region, Gatti and others (2014) show that many Arab countries rank among the most informal economies in the world, with a rising trend: on average, the informal sectors contribute about a third of an Arab country’s GDP, while they employ about 65 per cent of its labour force. The authors highlight the structural differences between resource-rich and resource-poor countries: while resource-rich countries have few but large formal firms (mainly in the energy sector), they exhibit lower informality in production (around 20 per cent to GDP) than

in labour (66-73 per cent of total employment that does not contribute to social security schemes). Resource-poor countries, on the other hand, have a higher share of medium-size and semi-formal but labour-intensive enterprises as well as public sector employment. This structural difference results in a higher share of undeclared output (35-40 per cent) but a lower share of informal employment (45-76 per cent of jobs not contributing to social security schemes).

The effects of the absence of sufficient market competition differ across sectors. One sector that is of particular importance for entrepreneurial activity is the banking sector. As discussed below, inter-bank competition is crucial for facilitating access to finance for young firms and SMEs.

## B. POLICY CHALLENGE AREA 2: ACCESS TO FINANCE

### 1. *In the absence of access to financial markets, firms adjust financing strategies towards internal financing*

Lack of access to finance constitutes a significant bottleneck for entrepreneurs and SMEs in the Arab region. Funding opportunities for startups (e.g. seed and venture capital) and growth capital for SMEs to sustain investment are subject to several distortionary mechanisms, including: privileged access by politically connected firms (Shiffbauer, 2015), lack of capacity in lending institutions and exclusion of certain segments of the population (Nasr and Pearce, 2012), lack of competition among banks and financial sector institutions generally (Rocha, 2011), and a lack of appropriate funding schemes or awareness of existing financing schemes (WEF, 2011).

Nasr and Pearce (2012b) assess the supply and demand side of financial services of SMEs and entrepreneurs in Arab countries and discuss several regulatory and institutional determinants. The authors find that while SMEs have relatively good access to bank accounts, their access to credit and other financial services is more constrained when compared with established firms. According to the authors, with only 20 per cent of SMEs having a loan or line of credit, SMEs in the Arab region exhibit the lowest rate of bank loans in the world, except for sub-Saharan Africa. Moreover, the average share of SME lending to total loans constitutes only 8 per cent of total loans. Yet banks remain the principal source for SME financing, albeit operating well below market potential. However, a shortage of loans disproportionately affects entrepreneurs as capital for startups and growth capital are in short supply. In examining the origins of the region's poor access to finance, Rocha (2011) highlights weak banking competition as well as flaws in the institutional and legal frameworks of Arab countries, which impede the emergence of non-bank financial institutions and alternative financing instruments.

Despite the relative shortage of loans to entrepreneurs and SMEs, the volumes of private credit to the domestic sector are relatively high compared with peer economies (EBRD, EIB and World Bank, 2016). However, the distribution of credit is highly concentrated among few firms and sectors (see also Rocha, 2011). In effect, available credit for the private sector is primarily absorbed by large enterprises, which leaves credit concentration ratios in Arab countries among the highest in the world. In Egypt, for example, the top 20 credit lines accounted for more than 50 per cent of total loans (EBRD, EIB and World Bank, 2016). Thus, entrepreneurs and SMEs tend to become "disconnected" from the financial sector in the sense that they do not consider the financial market as an option for satisfying their financing needs. Disconnected firms tend to adjust their financing strategies and rely on internal sources of funding, which comes at the expense of growth opportunities: some 77 per cent of working capital and investment needs are financed internally in the average firm, a rate well above the average for middle-income economies. The share of disconnected firms varies between 40 per cent in Tunisia to almost 80 per cent in Egypt and Djibouti (EBRD, EIB and World Bank, 2016, p. 43).

Entrepreneurial education on corporate governance and market options for funding can contribute to countering the disconnection of firms from financial markets. Moreover, banks need to consider

entrepreneurial activity as a worthwhile field of business, for which increased inter-bank competition can provide important incentives.

## 2. *Insufficient financing schemes by banks create funding gaps for medium-sized businesses*

Lack of finance not only prevents entrepreneurs from opening and growing businesses but can also cause a discontinuation of operations. Across the Arab region, an average of 14.9 per cent of all business closures are related to financing problems. Lack of funds for the continuation of businesses appears to be a particularly pernicious problem in Tunisia, where over a quarter (25.6 per cent) of businesses close because of a lack of financing. Saudi Arabian (18.2 per cent) and Qatari entrepreneurs (16.3 per cent) report similar issues, compared with only 6.4 per cent in Lebanon and 8.4 per cent in the United Arab Emirates (Global Entrepreneurship Monitor, 2017).

Those results support the findings of a study conducted by the World Economic Forum (WEF, 2011), which uses interview evidence to assess the conditions under which entrepreneurs can access finance. The authors find that existing funding schemes for entrepreneurs focus on small startups, including in the form of microcredits, rather than on more mature firms that are in their growth stage. The result is a funding gap for enterprises with a value between \$500,000 and \$8 million. Furthermore, financial institutions that offer funding in those ranges need to improve their outreach: about 90 per cent of entrepreneurs in Qatar, Saudi Arabia and the United Arab Emirates were not aware of financial institutions that provide financing for entrepreneurship and SMEs (WEF, 2011).

Other studies point to the low capacity of banks in providing financing and assessing the viability and creditworthiness of entrepreneurs and businesses. Financial intermediaries and banks tend to lack the capacity to lend to SMEs, as they must grapple with high administrative costs for small-scale lending and “inadequate banking skills for dealing with SMEs” (Nasr and Pearce, 2012, p. 27). Most banks use deficient credit technology and skills for prudent lending to SMEs, which exposes them to poor portfolios and low-quality lending. In effect, banks tend to prefer lending to well-established larger firms or to simply trade government bonds and treasury bills. High-growth enterprises, in particular those operating in information, communication and technology sectors, face higher constraints in accessing finance than companies that have physical assets as collateral (OECD, 2013a).

Both entrepreneurial education and competition policy can contribute to closing the funding gap for entrepreneurs and medium-sized businesses. Managerial education can increase awareness for alternative sources of funding or alternative growth strategies. Competition policy can facilitate the creation of non-bank financial institutions that consider young medium-sized businesses as a worthwhile business model.

### C. POLICY CHALLENGE AREA 3: ENTREPRENEURIAL EDUCATION AND SKILLS MISMATCH

#### 1. *Inadequate managerial education inhibits entrepreneurial activity*

Improving entrepreneurial education constitutes a third major policy challenge to facilitating entrepreneurial activity and private sector development. The low relevance of entrepreneurial education is one of the most significant impediments in the Arab region’s education systems to providing young graduate and business owners with the skills necessary to open and run a business.<sup>13</sup> Recent expert surveys highlight missing or low-level entrepreneurial education as a major constraint for entrepreneurship in the region, alongside knowledge transfer in research and development. Entrepreneurial education both in school and post-school is well below the world average, with Egypt, Morocco and Tunisia scoring particularly low. Only Lebanon, Qatar and the United Arab Emirates have above average entrepreneurial education (Global Entrepreneurship Monitor, 2017).

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<sup>13</sup> See Galal and others, 2008 for a review on education systems in the Arab regions.

Inadequate entrepreneurial education disproportionately affects entrepreneurial activity in opportunity-driven, high-growth enterprises. Those firms exhibit higher managerial requirements for their operations, financing and growth than smaller scale necessity-driven entrepreneurship. While opportunity-driven entrepreneurs are highly educated and have significant work experience, their low management skills limit enterprise development as they tend to lack the skills to grow their businesses (OECD, 2013a). Insufficient growth in opportunity-driven enterprises in productive sectors hinders private sector dynamics as a whole.

Entrepreneurial education at school or university can contribute to increasing the level of opportunity and innovation-driven entrepreneurs, as it provides graduates of non-business-related disciplines with the skills necessary to open businesses. Improvements in managerial education can help circumvent the challenges emanating from a lack of financing options and of competition in the own market sector. Entrepreneurial education is of particular importance for women to increase their numbers as entrepreneurs, reduce biases against entrepreneurship in general and address the low levels of women in employment, which is another crucial impediment to entrepreneurial activity (OECD, 2013a).

## *2. Skill mismatch inhibits private sector dynamics*

Education systems in Arab countries leave the labour market with a skills mismatch: graduates from schools and universities tend to lack the skills needed by the private sector. This mismatch affects private sector dynamics as a whole and constraints business growth, especially in specialized fields such as information technology (Gatti and others, 2013; Angel-Urdinola and others, 2013). An inadequately educated workforce is perceived to be the third most problematic factor for doing business in the Arab region, after access to finance and restrictive labour regularities, but before inefficient bureaucracies and political instability (WEF and EBRD, 2013).

The education systems in Arab countries have important deficiencies that require cooperative approaches between educational and economic governance. Education systems in Arab countries fail to raise even half of their student population to 'low' levels of learning, as indicated by internationally comparable tests such as the Programme for International Student Assessment (Gatti and others, 2013). With the exception of Jordan and Lebanon, more than three-fourths of students possessed only below basic or basic knowledge of math in 2007, well below the world median. Yet, Arab countries not only have relatively high numbers of poorly educated students, but also very few students in more advanced categories. While GCC countries have made some progress in recent years in that regard, in particular Qatar and Saudi Arabia, non-GCC countries improved only marginally or even deteriorated further (Jordan and Tunisia). In effect, educational systems in Arab countries are "not capable of producing a critical mass of students who have the fundamentals to perform well in labour markets" (Gatti and others, 2013, p. 170).

Active labour market programmes could remedy the resulting skill mismatch by educating participants in specific skillsets needed in the local economy or to open their own businesses by exploiting local opportunities. Yet, their effects tend to remain potential due to poor administrative capacity, regulative bottlenecks and flawed programme designs (Angel-Urdinola, 2013; Grimm and Paffhausen, 2015).



### III. CONCLUSIONS AND POLICY RECOMMENDATIONS

The present paper identifies priority policy challenges for the promotion of entrepreneurship in Arab countries. The analysis organizes and assesses the relevant literature on entrepreneurship in the Arab region on a best-evidence basis and reviews recent policy developments based on data provided by the World Bank's Doing Business database. The discussion describes three priority policy challenges related to competition policy; access to finance; and entrepreneurial education. Based on the identified policy challenges, the present chapter derives policy recommendations and provides an overview of the recommendations given by each study reviewed (table 3).

Annex I provides complementary evidence for the identification of priority policy challenges based on data from the World Bank's Worldwide Governance project. The model estimates the effect of improvements in governance indicators on economic and sectorial development. The analysis links to the policy recommendations and suggest that improvements in governance can facilitate the shift towards more productive sectors in Arab countries, benefit entrepreneurship and promote economic development at large. Annex II provides a brief overview over the current state of the governance indicators in Arab countries.

#### A. PROMOTION OF COMPETITION

The challenges associated with the lack of competition among firms is emphasized by all the studies reviewed. Creating and strengthening institutions that promote competition and equal opportunities for all entrepreneurs is a key priority for most Arab countries. Moving forward in tackling these challenges, several policy recommendations emerge:

- Reduce market distortions that privilege firms or sectors:
  - Exclusive and unnecessary licensing requirements to operate in certain sectors tend to be abused by politically connected firms and individuals, creating an additional entry barrier for new firms. Government institutions in charge of issuing licenses need to ensure that these are issued in a transparent and fair manner. The removal of legal barriers to foreign direct investment, such as by reducing the requirements of domestic ownership of foreign investors, can be an element of such initiatives. Recent policy initiatives by Gulf countries to open up their economies for wholly owned foreign companies may create a momentum in the region that should be closely monitored to draw lessons for similar initiatives in other countries;
  - Regulations for small and microenterprises need to be simplified further to facilitate the process of formalizing their legal status. In particular, the number of procedures to open businesses needs to be further reduced by, for example, introducing "one-stop shops" where entrepreneurs can complete multiple legislative steps in the same place. Another important priority must be reducing additional requirements for women to open businesses and obtain credit. Such improvements in regulatory quality and effective governance further support manufacturing and exporting industries, which, in turn, diversifies the economy and creates decent formal employment opportunities.
- Foster competition by ensuring equal opportunities among all firms and entrepreneurs within the same sector:
  - Industrial policies have been used in the past as an instrument to privilege certain sectors and firms. New industrial policies need to be designed using more appropriate targeting criteria to avoid past policy biases. They need to be linked to transparent and measurable performance indicators;
  - Competition across firms within the same sector needs to be strengthened by applying existing laws and regulations equally across all firms. To ensure equal treatment, the

independence of competition authorities from ministries and regulatory bodies needs to be ensured, ideally with distinct budgets and multiple budget sources. The cooperation of competition authorities and sectoral bodies needs to be clearly defined and their responsibilities differentiated.

## B. INCREASING ACCESS TO FINANCE

Limited financing opportunities are a ubiquitous challenge for entrepreneurs in Arab countries. While some important improvements have been achieved in recent years, access to finance is still highly limited. Policy recommendations include the following:

- Facilitate the assessment of creditworthiness of potential lenders by banks and other financial institutions:
  - The coverage of credit registries and bureaus needs to be strengthened to ensure fast and reliable sharing of credit information between Governments and private banking institutions. While most Arab countries have introduced these types of authorities in recent years, their reach needs to be strengthened, especially by including small borrowers. Focusing on credit registries provides a practical starting point as several best practices have emerged over recent years in the Arab region. Information monopolies should be avoided by outsourcing the supply side, which could otherwise be abused or introduce inefficiencies.
- Promote interbank competition to spur financial innovation and diversification of financing schemes:
  - Interbank competition needs to be fostered to promote the development of alternative financing schemes. Increased competition can encourage innovative funding schemes by non-bank financial institutions and a strategic realignment of banks towards SME financing (Creane and others, 2004). This can be achieved by easing regulations and licensing for the entry of new banks and financial institutions. Moreover, banking competition should be included in the mandate of competition authorities, particularly in non-GCC countries where this is not yet the case;
  - Increased interbank competition can address the funding gap that persists for medium-sized businesses. While microfinancing schemes are more readily available in various guises (Grimm, 2016), growth capital for established companies also needs to be available, for example, via targeted credit backing schemes supported by central banks.<sup>14</sup>

## C. ENTREPRENEURIAL EDUCATION AND SKILLS MATCHING

Many education systems in the Arab region fail to provide the entrepreneurial education needed for individuals and graduates to open and grow businesses. Policy recommendations include the following:

- Foster participation of all social segments in entrepreneurial activities:
  - Women are disadvantaged and underrepresented in Arab countries' labour markets. Promoting women's participation in entrepreneurial activities is of utmost importance to making economic development more inclusive and increasing diversification. Apart from focusing on abolishing discriminatory regulations, Governments should increase their efforts to support women's entrepreneurship by, for example, supporting the creation of entrepreneurship programmes that target women specifically. Such programmes can offer training to address specific issues women face in labour markets and provide mentoring for young entrepreneurs;

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<sup>14</sup> The Lebanese central bank, the Banque du Liban, for example, introduced a scheme that backs credits given by banks to technology-oriented entrepreneurs by 75 per cent (Central Bank Circular 331 from 2014). With a total capital of \$600 million, the scheme played an essential role in the growth of the Lebanese information technology industry. Regulations need to be simplified to facilitate the entry of non-bank financial institutions and microfinancing institutions that could target small businesses and low-income consumers.

- Skills mismatch is a significant obstacle for firms trying to find the right employees and grow their business. While Arab countries have made improvements in increasing the share of university graduates, the skills that graduates acquire at local universities fail to match the skills required by labour markets. To reduce this mismatch, governmental authorities can initiate programmes that provide relevant and targeted training for local labour markets, such as vocational training or entrepreneurship programmes, increasing productivity and thereby formal employment opportunities.<sup>15</sup> Active labour market programmes, providing assistance and training for workers in periods of transition, can play an important role in this field (Angel-Urdinola and others, 2013) and should be strengthened by Governments to address imminent skill shortages and improve labour mobility.
- Leveraging existing hubs of excellence such as universities:
  - Strengthening ties between academic institutions and government agencies can generate clusters of excellence and serve as a hub for innovation and entrepreneurship. Governments can establish public-private partnership programmes, in particular with universities, to centralize resources, reduce the cost of providing services to startups, and leverage the intellectual resources the universities create. Such centres should focus on internship or hiring programmes, which could be supported by government tax credits or grants;
  - Lack of management skills plays a major role in firms' failure to grow and can contribute to their exit from the market. School and university curricula should incorporate managerial and entrepreneurial education. Special emphasis should be placed on how to open businesses in the respective legal contexts and how to leverage financing opportunities. Increasing awareness in schools and universities can also contribute to breaking detrimental cultural habits, such as overreliance on the public sector, stereotypes and biases towards entrepreneurial failures.

TABLE 3. KEY POLICY RECOMMENDATIONS PER STUDY

Study	Key policy recommendations
EBRD, EIB, World Bank (2016): What's holding Back the Private Sector in MENA? Lessons from the Enterprise Survey	<p>Strengthen credit risk assessment of banks to improve secure lending to SMEs and introduce credit guarantee schemes to alleviate collateral constraints;</p> <p>Reorient education systems toward skills relevant for private sector employment, in particular vocational training;</p> <p>Improve openness to trade to increase productivity by improving customs and trade regulations, reducing entry costs for all firms, and reducing negative biases towards imports.</p>
<p>ESCWA (2015): Competition and Regulation in the Arab Region</p> <p>ESCWA (2016): The Strength of competition policy and regulation in the Arab region – application of OECD indicators to selected Arab countries in 2015</p>	<p>Ensure independence of competition authorities from ministries and regulatory bodies, ideally with distinct budgets and multiple budget sources;</p> <p>Develop competition policy and enforcement within a wider framework of development policies to achieve a country's overall development goals;</p> <p>Render cooperation between competition enforcement and sectorial regulation mandatory by law, namely via memorandums of understanding between competition authorities and sectoral bodies; and ensure cooperation in defining those bodies' scopes, and state the superiority of a competition authority in matters concerning competition;</p> <p>Educate the public on competition issues as a necessity rather than a product of capitalist bureaucracy.</p>

<sup>15</sup> See Gatti and others, 2013, pp. 274-275 for detailed policy measures per country.

TABLE 3 (continued)

Study	Key policy recommendations
Global Entrepreneurship Monitor (2017): Middle East and North Africa – Report 2017	<p>Entrepreneurial education: should be introduced into all schools and universities to develop the skills necessary to start own businesses, to reduce reliance on the public sector, and to break stereotypes regarding entrepreneurship;</p> <p>Government agencies: establish clusters related to universities to attract and strengthen linkages between academia and industry and among foreign and domestic knowledge intensive firms. These clusters and hubs with centralized resources help reduce the cost of commercial and legal services borne by technology startups, increasing their competitiveness;</p> <p>Access to finance: more initiatives needed to expand the culture and vehicles for venture investments, such as angel investment networks and venture capital funds;</p> <p>Women’s participation: prioritize entrepreneurship programmes geared towards women, with an emphasis on their needs and challenges, such as mentoring, incubator programmes and training.</p>
OECD (2013a): New Entrepreneurs and High-Performance Enterprises in the Middle East and North Africa	<p>High-growth enterprises require special policy attention;</p> <p>Ease access to finance by ensuring that banks work in competitive market places;</p> <p>Publicly funded credit agencies to introduce credit schemes for high growth enterprises;</p> <p>Skill development, including vocational training;</p> <p>Strengthening the link between “local high-potential service enterprises and large enterprises, including multinational enterprises” (p. 17).</p>
Gatti and others (World Bank, 2014): Striving for Better Jobs – The Challenge of Informality in the Middle East and North Africa	<p>Assign utmost priority to creating a “level playing field” for all firms to compete;</p> <p>Move towards labour regulations that promote labour mobility and provide support to workers in periods of transition;</p> <p>Realign incentives, pay and benefit packages in the public sector;</p> <p>Reform pension and existing social insurance systems and introduce new instruments for coverage extension;</p> <p>Enhance the productivity of informal workers through training and skills upgrading.</p>
Schiffbauer and others (World Bank, 2015): Jobs or Privileges? Unleashing the Employment Potential of the Middle East and North Africa	<p>Enhance competition and equality of opportunity for entrepreneurs by reforming energy subsidies to industry, exclusive licenses requirements to operate in specific sectors, and legal barriers to foreign direct investment and trade barriers, including non-tariff measures, administrative barriers to entry and firm growth, and barriers to access the judiciary, land, or industrial zones;</p> <p>Enforce laws and regulations equally across firms by reducing the complexity of policy implementation; and enhancing the capability and accountability of administrations;</p> <p>Establish new industrial policies and administration to minimize opportunities for abuse, promote competition and tightly link support to measurable and verifiable performance;</p> <p>Elaborate more appropriate targeting criteria when pursuing industrial policies for specific sectors to maximize positive impact on job creation, such as firm age.</p>

TABLE 3 (continued)

Study	Key policy recommendations
Gatti and others (World Bank, 2013): Jobs for Shared Prosperity – Time for Action in the Middle East and North Africa	<p>Curtail abuse of policies by ensuring substantive simplification of business regulations to reduce room for administrative discretion and corruption in countries with poor institutional structures; and by making information on regulations, procedures, decision criteria and anonymized enterprise data fully public;</p> <p>Promote competition by reducing entry barriers by reducing discretion of licensing process and reduce costs of entry in product markets through unnecessary licenses; make competition authorities fully autonomous from the executive; simplify regulations for microenterprises to encourage registration and to enable credit access; and reduce State monopolies in product markets (for example, regulations prohibiting de jure or de facto private or foreign presence in specific sectors);</p> <p>Ease access to credit by developing private credit registries and reforming collateral regimes to include small borrowers; increasing bank competition (including through privatizations); and revising regulations to enable entry of microfinance institutions and non-bank financial institutions to reach micro-firms and low-income consumer;</p> <p>Make education and skills more relevant to employment by standardizing tests to measure basics skills and abilities; radically revising technical and vocational training curricula for higher quality; reforming secondary school exit exams and university admission; fostering strong links between the private sector and technical and vocational training; and establishing quality assurance systems, especially for higher education.</p>
Rocha, Arvai and Farazi (World Bank, 2011): Financial Access and Stability – A Road Map for the Middle East and North Africa	<p>Improve credit information by combining public credit registries and private credit bureaus to be the more effective for expanding the coverage and depth of credit information;</p> <p>Strengthen creditor rights by drafting specific laws that regulate every aspect of the chain of secured lending. The scope of such secured transactions law should be broad, allowing pools of assets with only a generic description, thus allowing inventory and receivables to be used as collateral;</p> <p>Strengthen bank competition by giving competition authorities a mandate to supervise competition in the banking sector; and by developing an agenda for non-banking financial institutions on a sectoral basis.</p>
Nasr and Pearce (World Bank, 2012): SMEs for Job Creation in the Arab World – SME Access to Financial Services	<p>Develop credit reporting and scoring systems: banks and regulators should focus on ratings and scoring systems instead of requiring SMEs to have complex financial statements. SMEs should be exempted from the same audit requirements that are applied to large corporations, otherwise smaller and newer enterprises may be excluded from bank borrowing. Strengthen private credit bureaus and registries; and offer support and training to SMEs on how to develop credit reporting and keep their financial statements in order;</p> <p>Develop non-bank financial institutions to enhance competition in the financial sector and improve the provision of financial services to SMEs;</p> <p>Support the leasing industry by strengthening and clarifying a legislative framework that governs leasing options. Given its limited collateral requirements and its perceived Islamic compliance, leasing is particularly beneficial for SMEs and offers significant potential.</p>

## Annex I

### **PROVIDING EVIDENCE: ENHANCING GOVERNANCE QUALITY FACILITATES A SHIFT TOWARDS PRODUCTIVE INDUSTRIES**

The present paper reviews recent literature on entrepreneurship in the Arab region and provides an overview of recent regulatory developments and the effect of economic governance on entrepreneurship. To corroborate the findings, the present annex provides evidence on the comparative effect of improvements in governance quality on entrepreneurial activity and private sector development to formulate and substantiate policy recommendations. The indicators of private sector development under consideration are related to the following two main areas: aggregate firm performance, which includes variables on export growth, total factor productivity growth and gross fixed investment; and sectoral concentration, which includes variables on the share of industrial production, share of manufacturing output and petroleum production.

The model expands on previous research on the impact of governance quality on economic development (World Bank, 2003; Nabli, 2007; Kandil, 2009; Mehanna, Yazbeck and Saredidine, 2010; Malik and Awadallah, 2013; ESCWA, 2014; Sumpf, Araji and Crompton, 2016). The WGI serve as key independent variables, which provide measures for the quality of governance in a given country in the following six dimensions: voice and accountability (VOICE), political stability and absence of violence/terrorism (POL\_STAB), government effectiveness (GOV\_EFF), regulatory quality (REG\_QUA), rule of law (RULE), and control of corruption (CORRUPTION) (Kaufmann, Kraay and Mastruzzi, 2011). Annex II describes the composition of WGI and briefly indicates the current state of governance in Arab countries.

#### A. DATA AND SOURCES

The data includes yearly data on most countries in the region. The timespan covers 1996 to 2016. Indicators of private sector development are taken as dependent variables. Total factor productivity indicates the part of economic output growth that is not accounted for by the growth of its inputs (both labour and capital) and is taken from the Economist Intelligence Unit database.<sup>1</sup> Data on the growth of exports of goods and services, the growth of manufacturing production as well as data on the share of industrial production to GDP is taken from the *World Development Indicators*. Industrial production provides a measure for the total value added of mining, quarrying, manufacturing, construction and utilities as a percentage to nominal GDP at factor costs (namely at market prices less indirect taxes and including subsidies). Change in manufacturing includes the creation and assembly of components and finished products for sale and therefore excludes mining and quarrying activities.

Data on the supply of direct money and quasi-money is provided from the IMF financial statistics database and provides a measure for the total supply of notes and coins, demand deposits and assets that have similar properties, such as saving deposits, time deposits and certificates. Government consumption expenditure and the real effective exchange rate is taken from the Economist Intelligence Unit (EIU). Data on private consumption is taken from IMF international financial statistics.

#### B. THE MODEL

To assess the impact of different dimensions of governance quality on private sector development, the model estimates the following equation. For country  $i$  at time  $t$ , the model defines regressor  $Y_{ikt}$  as the outcome of interest where  $k$  denotes the macroeconomic variable for private sector performance:

$$Y_{ikt} = \alpha + \beta_j GOV_{ijt} + \gamma_l GOV\_POL_{ilt} + u_{it} \quad (1)$$

where

$$GOV\_POL_{ilt} = \gamma_1 MON\_GROWTH_{it} + \gamma_2 GOV\_EXP_{it} + \gamma_3 REER_{it} \quad (2)$$

and

$$u_{it} = \lambda_i + v_t + \varepsilon_{it} \quad (3)$$

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<sup>1</sup> The measure is calculated by dividing growth of GDP by employment growth and the estimated growth in the capital stock.

Equation (1) indicates the governance variables of interest  $GOV_{ijt}$ , where  $i$  denotes the country,  $j$  the dimension of governance quality and  $t$  the time. Equation (2) defines a set of control variables  $GOV\_POL_{ilt}$ , where  $l$  indicates one of the following variables: monetary growth,  $MON\_GROWTH_{it}$ , government expenditure,  $GOV\_EXP_{it}$  and the real effective exchange rate,  $REER_{it}$ . The specification uses the ordinary least squares estimation method and is completed by a two-way error component in equation (3), accounting for country and year fixed effects.

As control variables, the model includes monetary measures that generally affect aggregate economic performance and over which a government and its institutions have some degree of policy control (Kandil, 2009). The supply of money and quasi-money influences the availability of credit in the domestic economy. Total government consumption proxies the extent to which a government provides economic incentives for the domestic economy via the transfer of resources and investments in, for example, public infrastructure. The real effective exchange rate of the domestic currency affects the competitiveness of local products on domestic markets. The measure captures the real value of a country's currency against the basket of the trading partners of the country divided by a price deflator or index of costs. The latter two variables are of particular importance to capture in the context of oil producing countries, since exchange rate overvaluations as a result of petroleum production can severely impact exporting industries (Diop, Marotta and de Melo, 2012). Government consumption in oil producing industries moreover constitutes an important economic stimulus via the distribution of rents which spurs private consumption and therefore opens up opportunities for entrepreneurs.

### C. REGRESSION RESULTS AND DISCUSSION

Table AI.1 displays the regression results. Most of the results are in line with established literature on economic growth, indicating that similar patterns and policy recommendations apply. The discussion highlights several instances in which the results deviate.

#### 1. *Export growth of goods and services*

All but one governance indicator is positive and highly significant for the real export of goods and services. The result is robust to the inclusion of petroleum production into the model specification and explains 30-40 per cent of the variation. The effectiveness of governance has the highest impact on export growth. Countries with a higher quality of public services, in particular the bureaucracy and the competencies of civil servants, tend to increase exports almost twice as much as with similar improvements in regulatory quality or even the reduction of corruption. This result indicates the potential of firms to increase their export capacities and the leeway in the improvements of economic governance. Improvements in the control of corruption and regulatory quality are significantly and positively related to the export of goods and services.

Only political stability appears to be unrelated to exports of goods and services, although the sign is positive as expected. Voice and accountability is significant but negatively associated, implying that increases in the extent to which citizens of a country are able to participate in the political affairs of a country reduce the total exports of a country. Both results might be driven by the generally very low levels and uneven distribution of accountability measures across Arab countries. A possible explanation might pertain to the extent to which Governments with higher degrees of the voice and accountability measure promote the public sector over internationally competitive private sector firms. Yet, the voice and accountability variable appears to relate to different mechanisms of data generation, which might explain why exchange rate loses its significance. Government consumption has the expected positive and significant impact on exports.

TABLE AI.1 REGRESSION RESULTS FOR THE EFFECT OF GOVERNANCE QUALITY ON PRIVATE SECTOR PERFORMANCE

		Explanatory variables											
Dependent variable	Institutional variable (INSTj)	INSTj		MON_GROWTH		GOV_EXP		REER		Constant		Adj. R2	N
		Export growth of goods and services	VOICE	-13.171	(3.00)**	-0.043	(0.42)	1.346	(9.55)**	0.094	(1.68)		
POL_STAB	1.370		(0.63)	-0.007	(0.07)	1.462	(10.39)**	0.148	(2.69)**	7.728	(1.25)	0.31	281
GOV_EFF	26.325		(5.22)**	0.039	(0.40)	1.247	(9.04)**	0.192	(3.65)**	7.777	(1.32)	0.38	281
REG_QUA	19.748		(4.16)**	-0.065	(0.65)	1.398	(10.34)**	0.188	(3.49)**	7.502	(1.25)	0.35	281
	RULE	10.735	(2.05)*	-0.002	(0.02)	1.415	(10.18)**	0.145	(2.69)**	9.379	(1.52)	0.32	281
	CORRUPTION	14.249	(3.04)**	-0.021	(0.21)	1.406	(10.23)**	0.147	(2.74)**	10.588	(1.73)	0.34	281
Total factor productivity growth	VOICE	2.002	(0.84)	-0.005	(0.07)	-0.025	(0.30)	-0.037	(0.89)	6.546	(1.47)	0.01	216
	POL_STAB	0.535	(0.41)	-0.015	(0.24)	-0.037	(0.46)	-0.041	(1.00)	5.501	(1.29)	0.01	216
	GOV_EFF	0.992	(0.31)	-0.010	(0.16)	-0.050	(0.59)	-0.044	(1.05)	5.864	(1.32)	0.01	216
	REG_QUA	1.718	(0.62)	-0.018	(0.29)	-0.043	(0.54)	-0.040	(0.99)	5.680	(1.33)	0.01	216
	RULE	0.599	(0.19)	-0.012	(0.19)	-0.043	(0.54)	-0.041	(1.00)	5.459	(1.28)	0.01	216
	CORRUPTION	1.333	(0.44)	-0.013	(0.20)	-0.045	(0.56)	-0.045	(1.08)	5.976	(1.36)	0.01	216
Real gross fixed investment	VOICE	-2.927	(1.51)	0.043	(0.96)	2.002	(32.14)**	0.013	(0.51)	-9.292	(3.25)**	0.81	276
	POL_STAB	0.549	(0.57)	0.051	(1.12)	2.030	(33.03)**	0.026	(1.07)	-8.206	(2.96)**	0.81	276
	GOV_EFF	6.604	(2.88)**	0.066	(1.49)	1.977	(31.86)**	0.038	(1.57)	-8.329	(3.06)**	0.82	276
	REG_QUA	2.585	(1.18)	0.047	(1.04)	2.020	(33.27)**	0.031	(1.25)	-8.322	(3.01)**	0.81	276
	RULE	3.699	(1.52)	0.057	(1.27)	2.016	(33.20)**	0.027	(1.12)	-7.917	(2.88)**	0.81	276
	CORRUPTION	6.024	(2.75)**	0.053	(1.19)	2.013	(33.54)**	0.030	(1.27)	-7.586	(2.78)**	0.82	276



TABLE AI.1 (continued)

		Explanatory variables											
Dependent variable	Institutional variable (INSTj)	INSTj		MON_GROWTH		GOV_EXP		REER		Constant		Adj. R2	N
		Share of industrial production to GDP	VOICE	-6.988	(4.67)**	0.153	(4.51)**	-0.002	(0.03)	-0.179	(8.57)**		
POL_STAB	4.163		(5.85)**	0.155	(4.66)**	0.091	(1.99)*	-0.129	(6.58)**	55.953	(25.96)**	0.35	274
GOV_EFF	6.231		(3.35)**	0.181	(5.25)**	0.002	(0.05)	-0.129	(6.12)**	55.991	(24.83)**	0.29	274
REG_QUA	8.481		(5.28)**	0.147	(4.34)**	0.030	(0.65)	-0.131	(6.56)**	56.581	(26.03)**	0.33	274
RULE	8.020		(4.51)**	0.173	(5.11)**	0.024	(0.53)	-0.145	(7.26)**	57.634	(26.09)**	0.32	274
	CORRUPTION	7.439	(4.57)**	0.161	(4.74)**	0.027	(0.59)	-0.138	(6.88)**	57.342	(26.03)**	0.32	274
Manufacturing (percentage change pa)	VOICE	4.238	(1.18)	0.029	(0.37)	0.001	(0.01)	-0.138	(3.08)**	21.560	(4.25)**	0.06	262
	POL_STAB	2.840	(1.62)	0.003	(0.04)	-0.005	(0.05)	-0.142	(3.31)**	19.379	(4.00)**	0.07	262
	GOV_EFF	9.589	(2.35)*	0.030	(0.38)	-0.103	(0.93)	-0.134	(3.13)**	19.710	(4.10)**	0.08	262
	REG_QUA	4.930	(1.27)	0.001	(0.01)	-0.041	(0.38)	-0.143	(3.30)**	19.793	(4.08)**	0.06	262
	RULE	8.510	(2.03)*	0.013	(0.16)	-0.062	(0.58)	-0.153	(3.64)**	21.446	(4.39)**	0.07	262
	CORRUPTION	13.942	(3.71)**	-0.014	(0.18)	-0.088	(0.82)	-0.149	(3.61)**	23.014	(4.78)**	0.11	262
Petroleum production (log)	VOICE	-0.196	(1.65)	0.001	(0.49)	0.007	(2.42)*	-0.008	(7.28)**	6.679	(48.27)**	0.25	218
	POL_STAB	0.272	(6.16)**	0.000	(0.16)	0.011	(4.29)**	-0.006	(5.90)**	6.663	(56.94)**	0.36	218
	GOV_EFF	0.789	(7.73)**	0.004	(1.85)	0.002	(0.73)	-0.006	(5.77)**	6.765	(61.13)**	0.41	218
	REG_QUA	0.292	(3.02)**	0.001	(0.26)	0.008	(2.90)**	-0.007	(6.42)**	6.778	(55.04)**	0.27	218
	RULE	0.221	(2.02)*	0.002	(0.73)	0.008	(2.92)**	-0.008	(7.15)**	6.810	(54.17)**	0.25	218
	CORRUPTION	0.421	(4.62)**	0.001	(0.51)	0.007	(2.85)**	-0.007	(7.35)**	6.843	(56.74)**	0.31	218

Note: \*\*, \* Significant at the 1 and 5 per cent level; t-statistics in parentheses; INSTj, respective measure for institutional quality, indicated in the second left row; GOV\_EXP, general governmental expenditure; MON\_GROWTH, growth of money and quasi money supply; REER, real effective exchange rate; VOICE, voice and accountability; POL\_STAB, political stability; GOV\_EFF, government effectiveness; REG\_QUA, regulatory quality; RULE, rule of law; CORRUPTION, control of corruption.

## 2. *Total factor productivity growth*

Total factor productivity pertains to the share in total output that is not explained by its inputs, labour and capital. The results show a positive but insignificant relationship between all governance indicators despite a low explanatory power of the specifications. These results are discouraging as they reflect a disconnect between policy instruments and productivity gains: even with improvements in governance, firms are not more likely to increase their productivity. The reasons for this result should be subject to future research.

Yet, this result is in line with previous studies on firm dynamics and productivity growth in the Arab region (Schiffbauer, 2015). Rijkers and others (2014), for example, study the dynamics of job creation in Tunisia. The authors find that, post-entry, small firms create the lowest number of new jobs, even if they survive the first years. According to the authors, those low growth rates are linked to the weak association between productivity gains and profitability, which points to weaknesses in the re-allocative process and insufficient firm dynamism. Augier, Dosis and Gasiorek (2012) confirm those results for the case of Moroccan firms. The authors investigate the extent to which differences in the business environment explain the variation of firm productivity among Moroccan firms. They find that financial credit among firms is misallocated, resulting in lower productivity. Moreover, differences in the regulatory environment negatively impact the productivity of small firms without access to foreign capital and non-exporters, which are concentrated in non-producing sectors.

## 3. *Real gross fixed investments*

Investments into fixed assets in a country constitute an important confidence indicator of a country's economy and Government. As expected, government effectiveness and control of corruption are highly significant and positively related to increases in fixed investments. The more effective a country's bureaucracy is and the lower the levels of corruption, the more willing firms are to build plants and manufacturing sites. The beta coefficients are of about equal size. Government consumption is also highly significant, indicating that Governments have a high direct influence on investment activities via their own expenditure patterns. Yet, the explanatory power of the estimation is high with an adjusted  $R^2$  of above 80 per cent for all specifications.

## 4. *Industrial production*

Economic governance has a high and significant impact on the composition of economic activity. The share of industrial production to GDP includes all value-added activities in the mining and quarrying, manufacturing, and utilities sectors. The results indicate that higher quality of governance increases the share of industrial production in relation to total GDP. Except for government effectiveness, the results are again robust to the inclusion of petroleum production into the specification. Regulatory quality thereby has the highest impact among all governance indicators: the greater a Government's ability to formulate and implement sound policies and regulations that promote private sector development, the higher a country's share of industrial production. Lower degrees of corruption and higher political stability are also highly significant for industrial production as important prerequisites for investments into plants and other fixed assets. Voice and accountability constitute an outlier again, as the measure is negatively related to industrial production.

## 5. *Manufacturing*

While industrial production captures the entirety of industrial output, including quarrying and mining sectors, manufacturing measures the value added from the assembly of raw materials or semi-finished products. The results indicate that a higher quality of governance is conducive to the volume of manufacturing in Arab countries, but to a lesser degree than to industrial production as a whole. The results indicate that control of corruption is highly significant and positively related to increases in manufacturing.

Both the rule of law and government effectiveness are also positively and significantly related, albeit to a lesser degree. Thus, if Governments want to increase the manufacturing output of their economies, containing corruption and clientelism constitutes the most important lever to do so. However, governance quality explains much less of the variation for manufacturing ( $R^2$  equals 6 to 11 per cent) than for industrial production as a whole ( $R^2$  equals 30 per cent), indicating that manufacturing capacities are less susceptible to governance changes than industrial production. This result is not surprising given the insignificant relationship between governance quality and total factor productivity growth.

#### 6. *Petroleum production*

Mining and quarrying activities, in particular petroleum production, constitutes the second pillar of a country's industrial production. The last model specification estimates the extent to which governance quality impacts the (natural log of) petroleum production in barrels per day in Arab countries. The results indicate that improvements in governance are positively and significantly related to petroleum production in all but the voice and accountability dimension. Government effectiveness appears to have the highest impact on petroleum production, indicating that an effective bureaucracy increases petroleum output on average among Arab countries. Yet, with an  $R^2$  of above 40 per cent, government effectiveness explains almost twice as much of the variation in petroleum output than regulatory quality or the rule of law. Political stability is also highly significant and positively related to petroleum output.

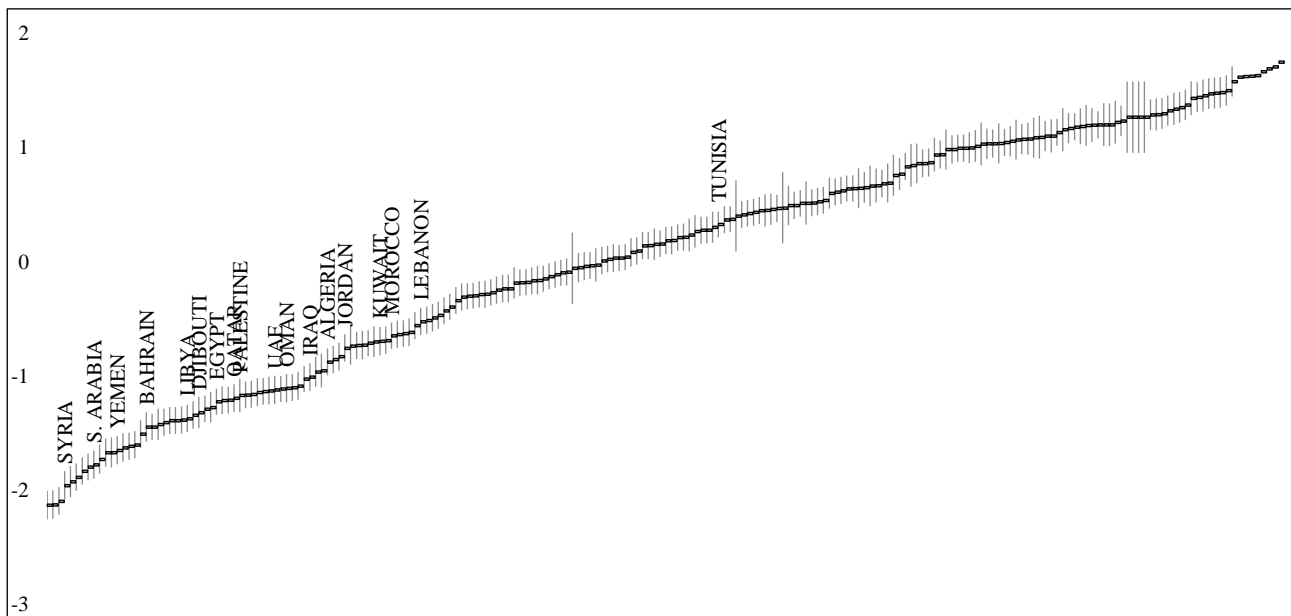
## Annex II

### WORLDWIDE GOVERNANCE INDICATORS IN THE ARAB REGION

WGI rely on perception-based indicators of governance from a variety of different sources (Kaufmann, Kraay and Mastruzzi, 2011). The sources include surveys of firms and households, as well as subjective assessments of non-governmental organizations and commercial business information providers, among others. Each source provides a set of empirical proxies for the six categories measured. WGI is reported in normal standard units ranging from -2.5 to 2.5, and in percentile rank terms ranging from 0 (lowest) to 100 (highest) among most countries worldwide. By construction, the standard units have a mean of zero and a standard deviation of one.

These six dimensions are widely used in WGI as indicators of the quality of the institutions in a country (UNDP, 2002; Dollar and Kraay, 2003; Sumpf, Araj and Crompton, 2016) and hence provide a framework to reflect upon the state of governance systems and institutional quality in Arab countries.<sup>2</sup>

**Figure AII.1 Voice and accountability in Arab countries, 2018**



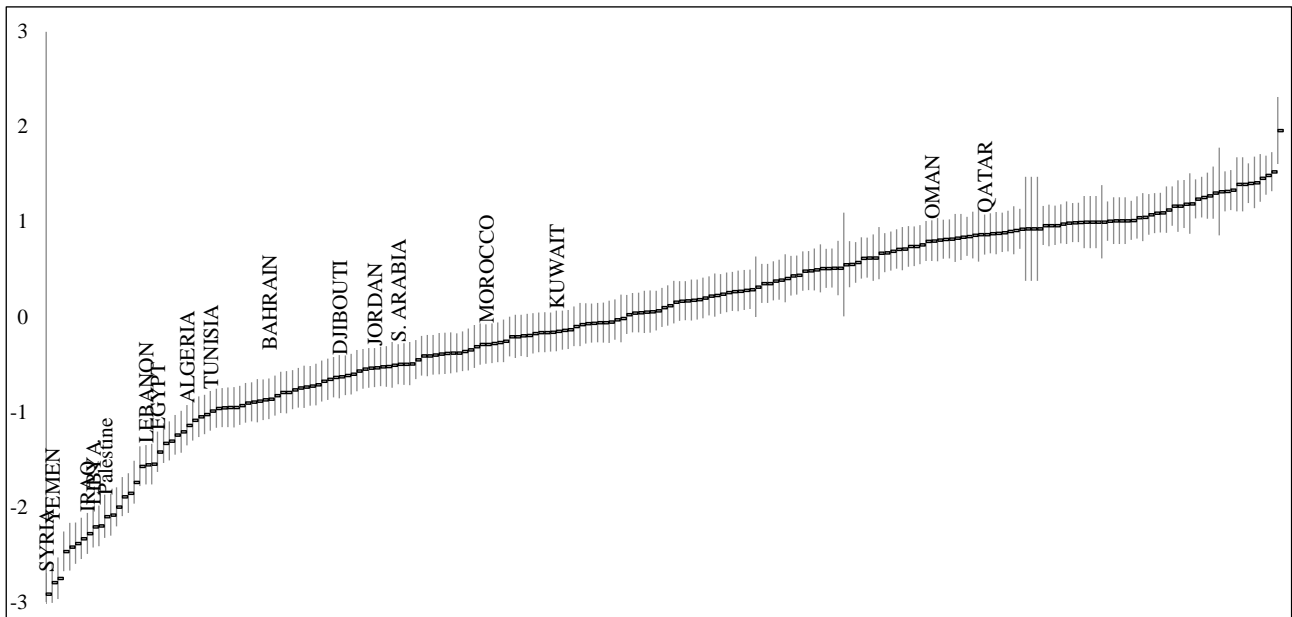
Source: World Bank. *Worldwide Governance Indicators*.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Voice and accountability* provides an estimation of the extent to which the citizens of a country are able to participate in the selection of their Governments, including aspects of civil liberties such as freedom of expression, freedom of association and free media. In general, political participation is uneven and less advanced in Arab countries than in other developing regions (UNDP, 2002). All Governments score well below the worldwide average. Only Tunisia made some improvements after the uprisings in 2011.

<sup>2</sup> See Kaufmann, Kraay and Mastruzzi (2009) for a general discussion of the governance indicators, and Sumpf, Araj and Crompton (2016) for more detailed discussions on their status in Arab countries.

**Figure AII.2 Political stability of Arab countries, 2018**

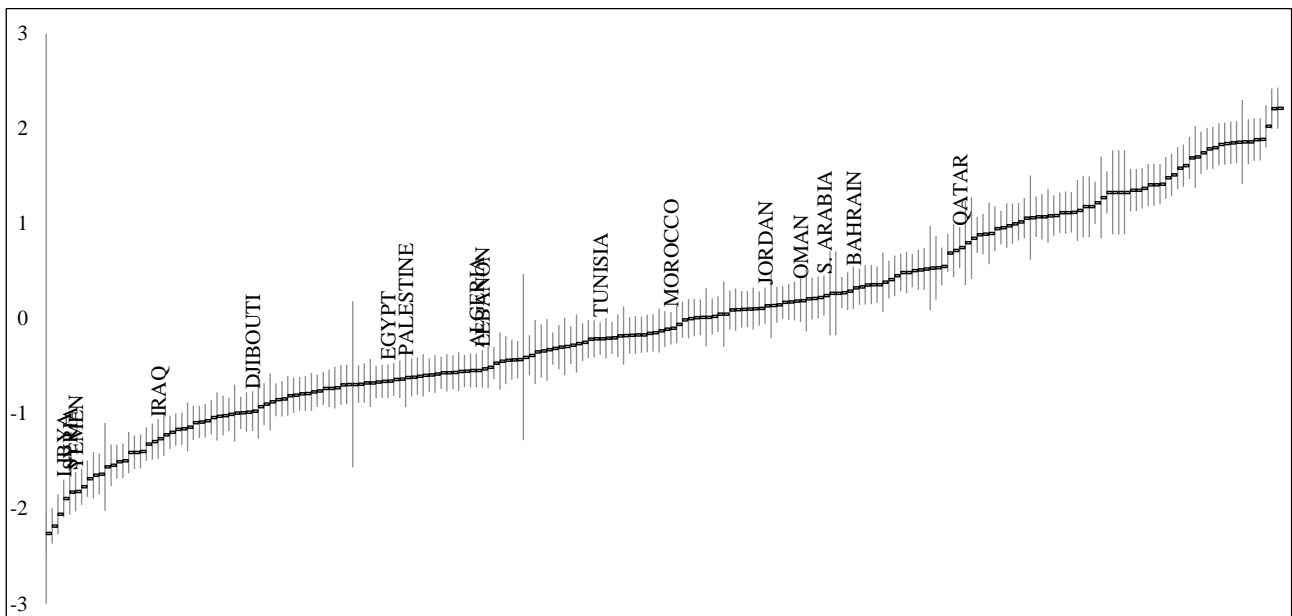


Source: World Bank. Worldwide Governance Indicators.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Political stability and absence of violence/terrorism* provides a measure of the likelihood that the Government will be destabilized or overthrown by unconstitutional or violent means. The distribution is much wider spread, leaving some Gulf States with the best scores. Yet, most other Arab countries rank among the least stable in the world, especially in countries such as the Syrian Arab Republic and Yemen that have experienced uprisings in recent years, but Lebanon and the State of Palestine also fall along the lower end of the spectrum.

**Figure AII.3 Government effectiveness in Arab countries, 2018**

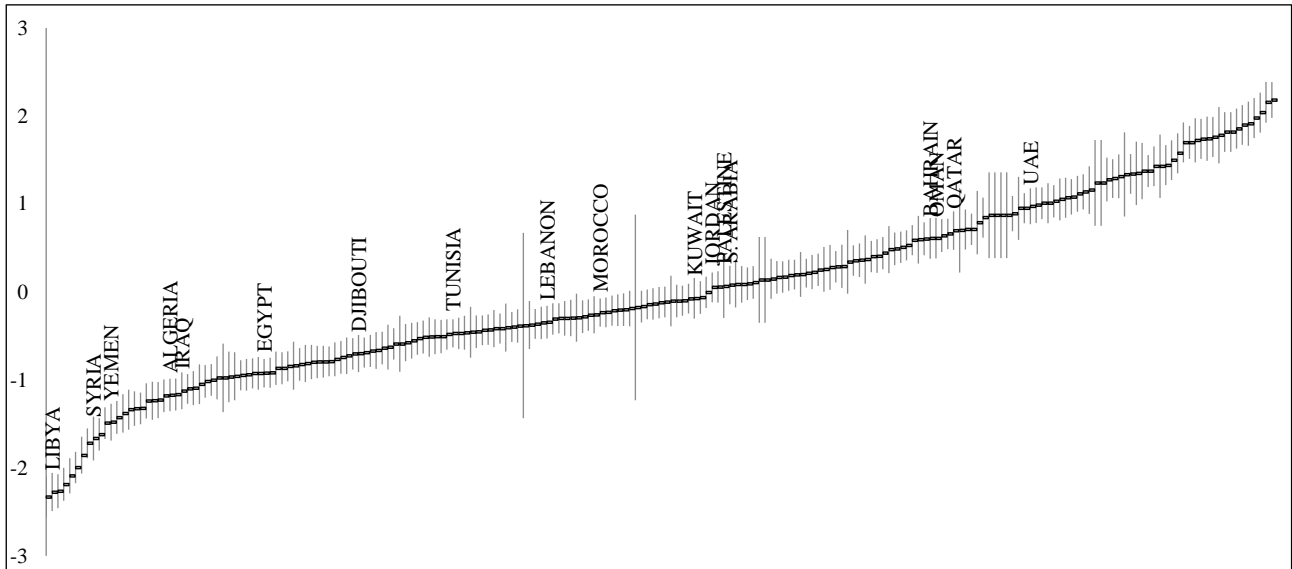


Source: World Bank. Worldwide Governance Indicators.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Government effectiveness* is a proxy for the quality of public services, the civil service, the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures and the credibility of a Government's commitment to policies. Many Arab countries rank below the worldwide average again, indicating a generally low level of bureaucratic quality in the region.

**Figure AII.4 Regulatory quality in Arab countries, 2018**

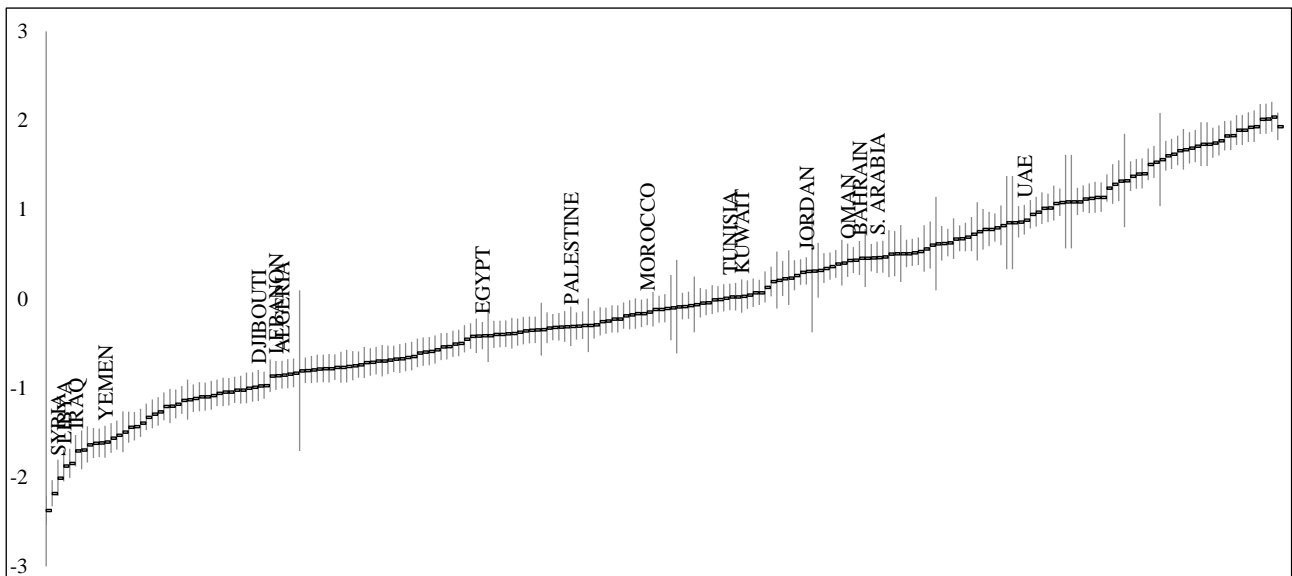


Source: World Bank. *Worldwide Governance Indicators*.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Regulatory quality* focuses on the policies themselves and is a measure of the incidence of market-unfriendly policies, such as price controls or regulative burdens for foreign trade. It measures a Government's ability to formulate and implement sound policies and regulations that promote private sector development. GCC countries exhibit higher scores than most oil-importing countries.

**Figure AII.5 Rule of law in Arab countries, 2018**

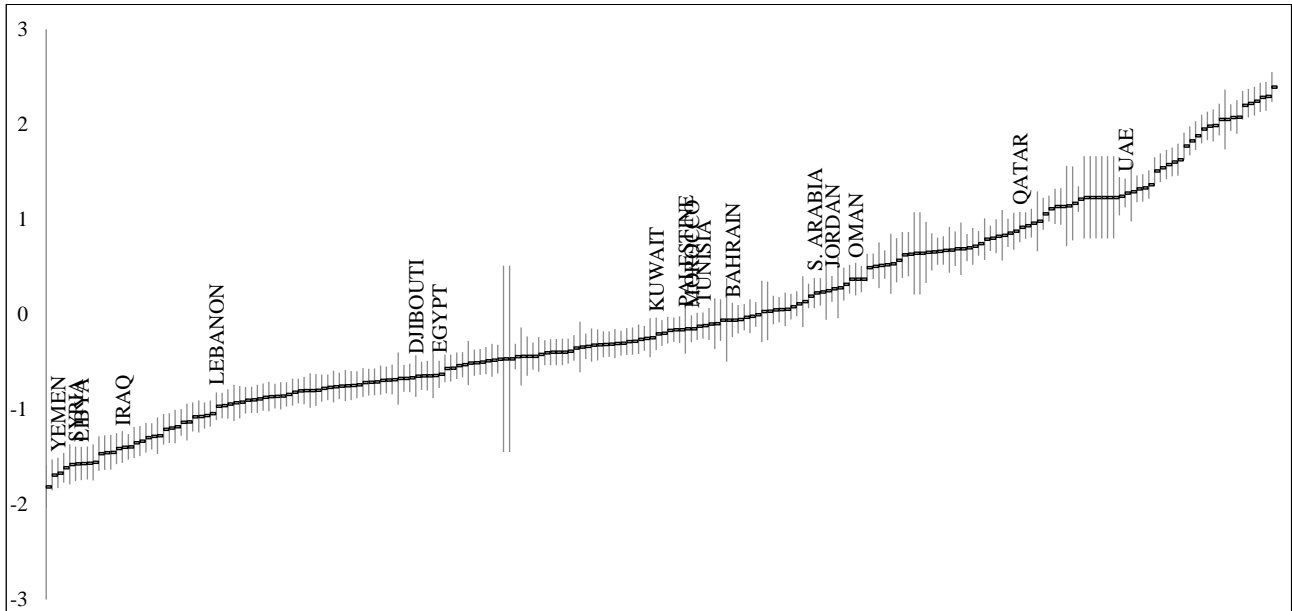


Source: World Bank. *Worldwide Governance Indicators*.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Rule of law* is a measure of the extent of citizens' confidence in the rules of society and the extent to which they abide by them. This includes aspects such as the quality of contract enforcement, property rights, the effectiveness and predictability of the judiciary, the police, and the likelihood of crime and violence. There is a wide variance between Arab countries, where only Jordan ranks with GCC countries above the world average. All other non-GCC countries rank below the world average, while Iraq, Libya, the Syrian Arab Republic and Yemen rank among the lowest worldwide.

**Figure AII.6 Control of corruption in Arab countries 2018**



Source: World Bank. *Worldwide Governance Indicators*.

Note: Dots mark the respective ranking, and thin lines mark the standard deviation.

*Control of corruption* measures the extent to which political power is exercised for private gain. In that sense it can be seen as “a manifestation of a lack of respect of both the corrupter and the corrupted for the rules that govern their interactions, and hence represents a failure of governance” (Looney, 2005, p. 186). While Gulf countries perform relatively well in this respect, most Middle Eastern countries rank well below the world average. Iraq, Libya, the Syrian Arab Republic and Yemen are found to be among the most corrupt countries in the world. Corruption in Arab countries is considered one of the most severe impediments to economic development (Bishara, 2011).

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