Executive Summary

i. **Middle East and North Africa (MENA) countries face a critical choice in their quest for higher private sector growth and more jobs: promote competition, equal opportunities for all entrepreneurs and dismantle existing privileges to specific firms or risk perpetuating the current equilibrium of low job creation.** This report shows that in MENA, policies that lower competition and create an un leveled playing field abound and constrain private sector job creation. These policies take different forms across countries and sectors but share several common features: they limit free-entry in the domestic market, exclude certain firms from government programs, increase regulatory burden and uncertainty on non- privileged firms, insulate certain firms and sectors from foreign competition, and create incentives that discourage domestic firms from competing in international markets. The report shows that such policies are often captured by a few privileged firms with deep political connections, and that these policies persist despite their apparent cost to society. The millions of workers and consumers who bear the brunt of that cost are often unaware of the adverse impact of these policies on the jobs to which they aspire. This limits the scope for internal country debate and curtails the policy dialogue necessary for reform.

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

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

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

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

vi. **First, GDP growth in MENA over the last two decades was driven by demographic change rather than labor productivity.** Private sector job creation was too weak to absorb the fast-growing labor force. Analysis of aggregate growth, population, and employment data reveals that the moderate GDP per capita growth rates in MENA were driven by demographic change, while productivity growth was low. Real GDP per capita growth hovered around two percent in the last two decades; about 2.5 percent lower than in Asia, but comparable to per capita growth rates in the other developing regions. Demographic change accounted for about 50 percent of aggregate real GDP per capita growth over the past 20 years, substantially higher than in any other region. In contrast, aggregate productivity growth was low in MENA compared to the other developing regions. Most countries in the region did experience structural change due to a decline of labor share in agriculture. Aggregate productivity growth was, however, mostly driven by productivity growth within sectors, which still lagged behind other developing regions. The economic benefits from the ongoing demographic trend could have been much higher had MENA countries been able to absorb their fast-growing labor force into the higher-productivity activities. Instead, job creation was weak and informal, unemployment, and inactivity reached very high levels during this timeframe. Moreover, analysis of firm census data shows that most workers in MENA are employed in small-scale and low productivity activities.

vii. **Second, the fundamentals of job creation in MENA are similar to those in other regions’ fast-growing economies; it is young firms and more productive firms that create more jobs.** In MENA countries, however, low firm turnover and slow productivity growth limit the pool of young firms and
more productive firms and, ultimately, reduce job creation. The report examines whether the fundamentals of job creation – the types of firms that create more jobs – differ in MENA countries from fast-growing emerging or even high-income countries in other regions. The report shows that they do not: younger firms and more productive firms grow faster and create more jobs in MENA as elsewhere. However, MENA countries’ private sectors have been characterized by low firm turnover (firm entry and exit) and slow productivity growth, which ultimately reduces the pool of young firms and more productive firms. We find that productivity growth in MENA is held back by a combination of slow within-firm productivity growth and misallocation of labor and capital across firms.

viii. Third, various policies across MENA countries limit competition and undermine firm turnover, productivity growth, and job creation. The report points to four case studies that demonstrate how different policies across MENA countries limit competition and result in lower firm turnover, productivity growth, and job creation. The first case study shows how foreign direct investment (FDI) inflow in Jordan led to a partial crowding-out of domestic firms, but also had positive employment spillovers in upstream and downstream sectors. This indicates that important benefits can be derived from the removal of existing FDI restrictions. In the second case study, we explore how several dimensions of Morocco’s business environment impact employment growth and disproportionately affect young firms. The findings suggest that more competition, equivalent treatment by tax administrations, less corruption and obstacles in the judicial system, and lower cost of finance would raise employment growth among young firms. The third case study examines how large energy subsidies targeted to heavy industry in Egypt (equivalent to 2.9 percent of GDP or US$7.4 billion in 2010) affect competition and job creation. A government license is required to legally operate in energy-intensive industries (such as steel and cement etc.), thereby limiting the prospect for free-entry, equal access for all entrepreneurs, and competition. Moreover energy subsidies benefit energy-intensive industries thereby discouraging more labor-intensive activities and drifting the economy away from its core areas of comparative advantage. Last, we show that many firms in MENA identify “policy uncertainty” as a “severe” or “major” obstacle to growth, and that this reflects firms’ perception of “policy implementation uncertainty” resulting from discriminatory policy practices. The large variations in policy implementation observed in the data imply reduced competition and innovation in a number of MENA countries. The findings point to a negative impact of discriminatory policy implementation on productivity growth and private sector dynamism (specifically the entry of new firms) in MENA.

ix. Fourth, past industrial policies in MENA did not reward firms based on performance, and did not safeguard or promote competition. Efforts to stimulate private sector growth and jobs in MENA have often taken the form of active industrial policies. But there is limited evidence of success and several instances of policy capture by few firms. The report reviews these policies over the past two decades and compares them with the experience of East Asian countries. This comparison highlights several critical differences in policy design and implementation that underpin the success of industrial policies in East Asian countries when compared to MENA countries. First, East Asian countries seemingly reached broader consensus on a common strategic vision and objectives at the country level, and had a greater focus on new economic activities in sectors where market failures were more likely to constrain industrial development. Second, industrial policy in East Asia was performance-oriented and evaluation systems to
x. Fifth, the report provides direct evidence that policies in MENA have often been captured by a few politically connected firms. This has led to a policy environment that created privileges rather than a level playing field, and undermined private sector growth and job creation. We show that these privileges insulated firms from domestic and international competition and subsidized their operations via preferential and sometimes exclusive access to cheap inputs (credit, electricity, land, and so forth). Using the theoretical framework proposed by Aghion et al. (2001)\(^1\), we discuss how such policies are likely to undermine competition, equal opportunity for all entrepreneurs and would result in lower efficiency, innovation, and job creation. The report documents how this was the case during the Mubarak and Ben Ali regimes in Egypt and Tunisia, respectively, and provides qualitative evidence for similar mechanisms in other MENA countries. For example, we find that only a handful of politically connected firms received the generous energy subsides to industry in Egypt. Moreover, barriers to entry and trade in Egypt and Tunisia insulated politically connected firms from competition in the domestic market and tilted their incentives towards producing for the domestic market. These policies are typically still in place in both countries; they include exclusive operating licenses creating monopolies in a few profitable services sectors, unequal access to credit and land, or inconsistent implementation of rules and regulations across firms in the same sector. Furthermore, the report argues that the concentration of connected firms in (non-tradable) backbone service sectors in MENA – which lowers the performance of these sectors and increase the relative price of non-tradable to tradable goods and services – contributes to the overvaluation of the exchange rate through the phenomenon of weak links\(^2\). Finally, the report provides evidence that the preferential treatment of politically connected firms lowers aggregate job growth in Egypt.

xi. The findings of this report have several implications for policy. This report suggests that MENA countries’ quest for more jobs should not only include supply-side policies – education, wages, job training – but should also encompass significant policy reforms to stimulate labor demand. The report’s findings

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

\(^2\) See Jones (2011) for a presentation of the concept of weak links.
point to a roadmap for more jobs in MENA in four broad policy areas. Depending on the country context, additional and more specific policy areas would also need to be considered:

• First, governments in MENA should reform policies that unduly constrain competition and equality of opportunity for all entrepreneurs. These policies include energy subsidies to industry, exclusive licenses requirements to operate in specific sectors, legal barriers to FDI, trade barriers - including non-tariff measures, administrative barriers to entry and firm growth, and barriers to access to the judiciary, land, or industrial zones. Reforms to other policies not analyzed in this report, but potentially equally important in maintaining a level playing field should also be considered when dealing with specific country cases. These include barriers to firm entry and exit resulting from restrictive hiring and firing laws, cumbersome bankruptcy laws, and so forth.

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

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

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

• Another component, just as important, is to ensure policy making is transparent and open, with processes that allow citizens to participate. Citizens should enjoy access to information on proposed and ratified laws and regulations; be able to provide input into policy design and evaluation; be aware of politicians’ stakes in firms that benefit from government policies; and have full knowledge of who benefits from subsidies, procurement tenders, public land transactions, privatizations, and so forth.

• Lastly, this report points to a decision-making guide that summarizes the foregoing which governments can use as a framework when designing and implementing policies. It is also important when using this framework to recognize that policymaking faces risk and uncertainty as
to which policies will work and achieve its objectives. The decision-making guide is aimed to maximize the likelihood of success given inherent uncertainties and maximize the positive impact of policies on growth and jobs by ensuring that they respond to real obstacles to job growth while minimizing the risk for capture.