

MENA-OECD INVESTMENT PROGRAMME

FOSTERING AN ENTREPRENEURIAL BUSINESS ENVIRONMENT FOR FIRM CREATION AND SME GROWTH IN THE MENA REGION

- Working Group 4 -

In line with the priorities set by the OECD Bologna Process on SME & Entrepreneurship Policies and the Istanbul Ministerial Declaration (June 2004), the OECD Centre for Entrepreneurship, SMEs and Local Development (CFE) participates actively in Working Group 4 of the MENA-OECD Investment Initiative on Investment and Governance for Development through Output 3: “Improving the Policy Environment and Building Capacities for Entrepreneurship and SME Development”. The present draft report is a contribution to Output 3. The report was prepared by a Consultant, Mr. Charles-Albert Michalet, Professor Emeritus of Economics and Director of the International Relations Institute at Paris-Dauphine University, in close co-operation with the CFE/SME and Entrepreneurship Division and with inputs from Professor Paul Reynolds, Director, Entrepreneurship Research Institute, Florida International University. It is based on a literature review and limited survey findings.

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Background

1. In 2004, the MENA Region and the OECD launched an *Initiative on Investment and Governance* in order to promote broad reforms, to enhance investment and sustainable development, and to strengthen interregional as well as international partnerships throughout the MENA Region. This MENA-OECD Initiative consists of two programmes: the “Public Governance Programme” aimed at modernising the government structures and processes in MENA countries and the “Investment Programme” aimed at improving the policies and environment for investment and governance.
2. The Investment Programme is comprised of five working groups, including the MENA-OECD Investment Programme Working Group 4, which focuses on “*Promoting Policies for Financial Sector Development and Enterprise Development in Support of Diversification*”. The OECD Centre for Entrepreneurship, SMEs & Local Development (CFE)¹, whose strategic objective is to foster the development of an entrepreneurial society, capable of innovating, creating jobs and seizing the opportunities provided by globalisation, participates actively in Working Group 4 of the MENA-OECD Investment Programme.
3. At the 7-8 February 2005 meeting of Working Group 4, the CFE was invited to conduct an activity (Output No. 3) on: “**Improving the Policy Environment and Building Capacities for Entrepreneurship and SME Development**”. This activity is comprised of two modules: 1) An Entrepreneurial Business Environment for Entrepreneurship & SME Growth; and 2) Promoting Women’s Entrepreneurship in MENA Countries.
4. In the context of this activity (Module 1) the present Background Report, entitled “**Fostering an Entrepreneurial Business Environment for Entrepreneurship & SME Growth in the MENA Region**”, was prepared by a Consultant, Mr. Charles-Albert Michalet, Professor Emeritus of Economics and Director of the International Relations Institute at Paris-Dauphine University, in close co-operation with the OECD CFE/SME and Entrepreneurship Division and with inputs from Professor Paul Reynolds, Director, Entrepreneurship Research Institute, Florida International University. It is based on a literature review and limited survey findings.
5. Following the Executive Summary and Policy Recommendations, the Report is divided into two parts. The first part reviews the importance and the role of SMEs in the MENA Region. The second part proposes steps designed to promote a more favourable business environment for the creation and development of SMEs in the region.

1. For more information, please see www.oecd.org/cfe/sme.

Executive Summary and Policy Recommendations

5. The report focuses on fostering an environment conducive to entrepreneurship and to the creation and development of small and medium-sized enterprises (SMEs) in MENA countries. It follows from the *Bologna Charter on SME Policies* (June 2000), which recognised “the increasing importance of SMEs in economic growth, job creation, regional and local development and social cohesion (...); that entrepreneurship and a dynamic SME sector are important for restructuring economies and for combating poverty; that globalisation, the acceleration of technological change and innovation create opportunities for SMEs (...)”². The report sets out to determine the configuration of these factors in the MENA Region countries³. The report also recalls Ministers’ commitment as stated in the *Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs* (June 2004) to work “to put in place policies which support the development, growth and competitiveness of SMEs and to pursuing policy dialogue and co-operation among OECD countries and non-member economies”.

6. This last concern is particularly relevant in the case of the MENA Region. This is because it can be postulated that, although it varies from one country to another, the area as a whole has fallen behind the other non-OECD economies (with the exception of sub-Saharan Africa) in terms of both the liberalisation of their economies and their integration in the globalisation process. This differential can be analysed from two viewpoints which differ but in fact when combined allow for one to evaluate development. In the first place, the weight of the past has not completely disappeared where public governance is concerned. The latter is still marked by a long tradition of a centrally administered economy where the public sector and state interventionism took precedence over the private sector and entrepreneurship which were often viewed with suspicion. The situation has been evolving since the mid-1980s, but at a pace which varies from one MENA country to another. Secondly, private governance remains tinged with archaism. This is perhaps because the private sector remained marginal under the economic policies of the past, and it is perhaps also because the entrepreneurial culture has not yet succeeded everywhere in replacing traditional forms of behaviour which continue to prefer business to manufacturing investment. As a result, the vast majority of business people fall into the ‘life-style entrepreneurs’ category.

7. Undoubtedly, therefore, all the MENA countries have a great need of entrepreneurs and SMEs if they are to meet the objectives outlined in the above-quoted documents. This need to create and develop SMEs is repeated systematically in the majority of official documents, studies by public or private research organisations and interviews with political leaders and representatives of civil society.

8. Despite all the declarations, the idea of making the creation and development of SMEs a priority has in some cases not yet been “taken on board” by the authorities in certain MENA countries. There is still the old fascination with “big” investment projects and “big” companies, whether local or foreign, and in some cases this also involves SMEs being rather hastily put into the informal sector.

2. Bologna Charter, p. 1.

3. Algeria, Bahrein, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Palestinian Authority, Saudi Arabia, Syria, Tunisia, United Arab Emirates, Yemen.

9. In addition, there is an enormous hiatus between the recurring theme of SME development and the lack or even total absence of information – whether statistical or socio-economic. As far as accessible data are concerned, it is impossible to have an accurate idea, for each country, of the number of SMEs, their relative weight in the economy – especially the private sector – and their distribution by sector of the economy, size and legal status, the forms of alliance, partnership, joint venture with firms of foreign origin.

10. Lastly, despite the aim to encourage the creation of SMEs, there are no studies on the origins of potential entrepreneurs, their training and what reserves there are of young entrepreneurs. Yet this sort of information is essential to the success of any public policy focusing on the creation and development of SMEs. In an effort to overcome this shortcoming, which is an undoubted obstacle to any serious study on the subject, the OECD's Centre for Entrepreneurship, SMEs and Local Development (CFE) decided in the past months to send out to a sample of MENA countries a questionnaire aimed at obtaining answers to the various questions just raised. At the time of drafting this report, the reply rate was still too low to use the findings for an analysis at regional level. This report has therefore suffered from scarce and disparate information and lack of empirical information.

11. Despite these difficulties, it has proved possible to review the most urgent measures to be taken in order to arrive at an environment conducive to the creation and development of SMEs in the MENA Region. This involved a three-stage process, the first consisting of identifying the prerequisites for a business climate that encourages initiative and entrepreneurship. This means having a general framework which encompasses all firms, irrespective of their size and nationality, but which obviously also applies to SMEs. The second stage involves looking at the measures which need to be implemented in order to facilitate SME creation. This is done on the basis of the existing situation in the majority of MENA countries, but at the cost of simplifying national characteristics because of the lack of empirical information. The final stage deals with alternative strategies for promoting the development of existing SMEs.

12. *The first and critical stage consists of improving the investment environment.* The different components involved are referred to in the Istanbul Ministerial Declaration, but are far from being in place in the MENA countries. The main failings are mentioned in the report. First, it is essential that the rule of law prevails with stable and transparent rules and access to legal documents. In short, this means choosing a democratic system and relinquishing forms of governance based on clientelism (OECD, 2004). Among characteristics of a conducive business environment, it can be stressed that property rights should be respected and contracts should be performed with the backing of an efficient and impartial judicial system; and central and local governments should keep to their commitments vis-à-vis suppliers. Apart from the legal, regulatory and institutional dimension, an environment which encourages the expansion of SMEs needs to be fashioned by the appropriate economic policies. It is generally found, for example, that MENA country entrepreneurs are eager for consultations and information, whereas central and local governments are distant and difficult to access. This need reflects a past when central government told investors what they had to do. The burden of the past also largely explains why management of the banking system is lagging so far behind. A good example of consultations can be found in the choice of trade policy, which is almost always the focus of sharply conflicting interests. Lastly, the thrust of the education system is of prime importance in all the MENA countries – not just because of the need to reduce illiteracy (which is more marked among girls) and increase vocational-type courses by lessening the preponderance of general education, but also in order to spread an entrepreneurial culture and refurbish a spirit of enterprise (including by means of courses specially designed for existing and potential entrepreneurs).

13. *The second stage involves identifying the reforms to be undertaken in order to facilitate SME creation.* The MENA countries' weak points are the same as those found in a lot of non-OECD economies, where there is a need to ease substantially the procedures to be gone through with different government departments when setting up a company. Reducing the number of documents required and the

number of steps involved cuts the delay and also reduces the opportunities for “informal” practices. The cost of setting up a company (which varies from one country to another), and also that of litigation and filing for bankruptcy, weighs more heavily on SMEs than on large firms. The objective is not to discourage potential investors. The same care needs to be taken in the reform of the rules governing hiring and firing, which have to take into account the particular characteristics of employment in small firms where the staff are often family members. Lastly, a big effort needs to be made to improve the supply of serviced industrial sites at reasonable prices. Industrial estates managed by public bodies give rise to speculation and, in addition, increase the number of instances of preferential treatment and the importance of interpersonal relations for obtaining rental permits and concessions. An actual real estate market often has to be created from start to finish. To overcome these problems, the authorities choose to create free zones whose operating rules are outside the realm of common law. It is not certain that this is a solution that can be used in all cases, for example when the aim is to set up clusters. To make SME creation more attractive, it is advisable to provide increased technical assistance for preparing dossiers, business management, and information about markets and potential partners. Investment Promotion Agencies should lean more towards offering advice and information than promoting FDI of dubious effectiveness. Increased assistance of this sort is probably more productive in the end than the usual option of financial incentives, the unwanted effects of which have been stressed.

14. *The final stage concerns the development of SMEs, meaning increasing their size and competitiveness.* This will be achieved by transforming the SMEs’ original economies. First and foremost, this means recording higher growth rates, which will increase domestic demand for the goods produced by SMEs. It is not, however, a matter of coming back to the old import substitution strategy based largely on protecting the domestic market. Developing SMEs means doing away with the existence of rent situations which act as obstacles to market entry. Winning back the domestic market will be achieved by virtue of economies of scale and by improving the quality of what SMEs provide. The need for competitiveness is even more pressing when considering the other way of developing SMEs, i.e. the world market. On this point, to be realistic, the MENA countries have to be more attractive to FDI. The stimulus imparted by foreign subsidiaries can play a central role in improving the performance of SMEs. Setting up joint ventures can promote flows of exports to markets which are otherwise not easily accessible. Above all, the MENA countries must in the future take systematic advantage of the possibilities opened up by multinationals becoming hollow or virtual corporations. Insertion into these firms’ global value chains will enable those local SMEs that are efficient enough to have access to sophisticated technologies, intra-firm financing and the world market. The combination of outsourcing and relocation operations, being pursued more and more actively by firms in the most developed OECD countries, offers the MENA Region a unique opportunity to join in the globalisation process at the top end and, by the same token, avoid the risk of marginalisation which has not as yet been completely eliminated – even for those MENA countries which have ample natural resources.

15. Finally, *MENA countries should fix as a priority the drawing up of a Strategic Plan*, including a linked sequence of measures and a timetable. It emerges from the analyses carried out in the report that the standard sequence of stages involved in shaping an environment favourable to SME creation and development needs to be somewhat altered and a new approach should be adopted. Priority should be attached to stages two and three, i.e. those that mainly concern the transformation of private governance, and not the first which involves the transformation of public governance. In view of the difficulty of shifting a system of governance immobilised by the weight of the past and the resistance of social groups which have benefited from interests acquired during the previous period characterised by clientelism, it is doubtless worth adopting an A. Hirschmann-type approach which consists of introducing a break-up dynamic forcing the usual obstacles to be overcome in an order which is not necessarily logical but which meets real and unavoidable needs. It is probable that the snowball effect caused by the increased number of SMEs and, by the same token, the expansion of the private sector and hence the arrival of more foreign investors forming various types of partnership with local firms, will create an exogenous shock. This

should hasten the transformation of the legal, regulatory and institutional framework, which is always a prerequisite. The change could be achieved more quickly by allowing new, energetic agents to look after their own destiny and force the hand of the authorities. In fact, young people have little option but to set up their own firms. This is because the sort of outlets that used to be favoured in the past: the civil service or emigration, are likely to become much more uncertain in the near future.

Draft recommendations

16. Building on the findings of this work, it is recommended that MENA governments, in addition to implementing policies and an institutional framework that contribute to a business environment that is conducive to entrepreneurship and facilitates entry, growth, transfer of ownership and smooth exit of enterprises (cf. the Istanbul SME Ministerial Declaration), *support specific actions to:*

- Ensure stable framework conditions to underpin the entrepreneurial business environment. Policy design in areas such as competition, the regulatory framework, the tax system, labour markets, financial markets and bankruptcy laws should ensure that regulation is not unnecessarily or disproportionately burdensome to SMEs in MENA countries.
- Guarantee the reduction and simplification of administrative regulations and costs in MENA countries which fall disproportionately on SMEs. Take account of SME views during the regulatory process and establish one-stop shops for regulatory information and transactions.
- Promote an entrepreneurial society and entrepreneurial culture, in particular through education and training. Provide the education system with the resources to reduce illiteracy and increase the amount of vocational-type sources in relation to general education courses in order to spread an entrepreneurial culture. Promote the diffusion of training programmes by stimulating the private market's supply of such services.
- Integrate the local development dimension into the promotion of entrepreneurship. The roles of sub-national authorities in the promotion of entrepreneurship are of paramount importance and should be defined and co-ordinated with central governments, as appropriate for each country.
- Strengthen the factual and analytical basis for policymaking in MENA countries so that policy makers can take decisions in an informed manner based on empirical evidence. To the extent possible, such research and analysis should include gender-disaggregated information.
- Ensure that programmes in support of SMEs and entrepreneurship are realistic in terms of cost, transparent in their implementation and systematically monitored and assessed for their performance in achieving objectives and for their cost-effectiveness.

17. However, at the outset, it is necessary **to create sound knowledge about the situation of entrepreneurship and the SME sector in MENA countries.** *It is therefore recommended that MENA governments consider launching a Research Agenda* that would start with a survey to collect the necessary data and statistics concerning entrepreneurial activity and SMEs. This exercise would benefit from the current work at the OECD on SME and Entrepreneurship-related Statistics undertaken in line with the 2004 Istanbul Ministerial Declaration.

Why SMEs are needed...

18. In all countries of the MENA region there is a clear need for more SMEs. The various reasons underlying this need have been examined in a number of studies, reports and declarations analysing the region's economy and its weaknesses.

19. From this perspective, the background report of the OECD's Working Party on SMEs and Entrepreneurship (WPSME) for the Second Ministerial Conference on SMEs held in Istanbul in 2004, entitled: "Encouraging entrepreneurship as a driver of growth in a global economy" (OECD, 2004) constitutes a remarkable synthesis of these expectations. There are three main reasons why the MENA region needs more SMEs: i) to create jobs and reduce unemployment; ii) to improve growth and productivity rates; iii) to fight poverty.

20. We will not delve here into whether the growth of SMEs can actually satisfy all of these expectations; however there is no doubt that the multiplication of SMEs will contribute positively to the realisation of these objectives in economies such as those in the MENA region.

21. With this premise in mind, the pivotal question is how to promote the desired emergence of SMEs, recognising that they are at this time almost invisible, at least in the economic and statistical data. Before introducing the approach that will be followed in this report, we must draw the reader's attention to this gap and offer some preliminary remarks of a methodological nature. The overarching assessment is that there exists today a notable discrepancy between the assertion that SMEs could play a decisive role in securing economic and social objectives, on the one hand; and the lack of available economic and statistical information relating to them on the other hand. Research on MENA economies is normally confined to the macroeconomic or at best the sectoral level. Enterprises are mentioned in a general way but there is no detailed or reliable empirical data on SMEs. Yet Table 1 below could be taken as contradicting this assertion: it suggests that data sources must exist in the region, and they should be studied in a systematic fashion.

Table 1. SME share in total enterprises and contribution to employment (2000)

	SMEs in total enterprises (%)	Employment (%)	Average GDP growth rate
Egypt	90	75	4.5
Syria	90	62	2.0
Lebanon	84	--	3.0
Jordan	93	32.9	5.7
Tunisia	84	--	3.5
Brunei	90	70	-1.0
Hong Kong	98	60	-5.0
Japan	99	78	1.5
APEC	90	(32-84)	--

Source: El Gamal, Mahmoud A, N. El-Megharbel, H. Inanoglu, (2001), cited in A. Gentzoglanis, (2003) Economic Research Forum for the Arab countries, Iran and Turkey, Spring.

22. The gap between the hopes placed in SMEs and the lack of empirical knowledge of the phenomenon means that recommendations for the creation and growth of SMEs tend to be formulated as mantras of the wishful thinking: "we should do this or that", or "all it takes is this" type.

23. This is clearly an area of empirical research, then, that should be urgently explored so that we can move beyond current analytical generalisations. As a first step in this direction, the SME and Entrepreneurship Division of the OECD's Centre for Entrepreneurship, SMEs and Local Development sent a questionnaire to selected MENA countries relating to SMEs in the context of preparing this report.

Unfortunately, long after the questionnaires were sent out, and indeed by the time this report was due to be finished, the responses in hand were very few. One possible explanation for this delay may be that the information needed to fill out the questionnaire is either unavailable or very hard to retrieve. The low response rate has affected the contents of this report. But it also clearly demonstrates the need for a research programme to develop a detailed knowledge base on SMEs (their relative importance in the economy, the sectors in which they are present, the social origin of entrepreneurs, future growth prospects, existing support programmes etc....).

24. Another obvious finding is that the MENA region is lagging behind in the process of integration into the global economy (Méon & Sekkat, 2004). The oil-rich countries are no better placed than others, perhaps because they are prone to the “Dutch disease” or to the distortions prevalent in rent-based economies. Yet we must also be mindful of the weight of history. Ali Abderrezak (2004) demonstrates in an econometric study that colonialism had a negative impact on MENA growth rates, and that impact persisted well beyond the end of colonialism. According to this author, MENA began to free itself from this stranglehold only in the late 1980s. The past is in fact of more than academic interest: it helps to explain why, in global rankings, MENA comes just ahead of Sub-Saharan Africa but far behind the economies of Asia, Central and Eastern Europe (CEE), and the emerging economies of Latin America.

25. Against this backdrop, a determined effort is needed to favour the creation and growth of SMEs. To achieve this, an environment favourable to their growth also needs to be put in place.

26. The main purpose of this report is two-fold: first, it reviews the indispensable prerequisites of an environment favourable to the creation and growth of SMEs; second, it sets out the different stages that should logically lead to meeting these prerequisites. Yet there is, as we see it, an essential preliminary stage that is often overlooked in the economic literature, which is to consider whether there exists a sufficient pool of dynamic entrepreneurs, in Schumpeterian terms, without which efforts to promote SMEs would be in vain. To ask this question is to recognise that governments and business people have for decades adopted an attitude that has frustrated the establishment of a true market economy, one in which merchants become productive entrepreneurs. This transformation was what enabled the British Industrial Revolution at the end of the 18th century.

27. With these initial thoughts, we can go on to define the three steps that MENA countries need to take in order to set up an environment favourable to the creation and the growth of SMEs. The first is to assemble the conditions conducive to an entrepreneurial spirit; the next is to simplify as far as possible the procedures for starting a business; and finally, without trying to second-guess them, to help SMEs through the transition - we would like to say the metamorphosis - to successful and competitive enterprises. For each of these stages, and to the extent information was accessible, we have endeavoured to identify the major obstacles that impede reforms in MENA countries.

The quest for dynamic entrepreneurs

28. In the majority of MENA countries, the creation and growth of SMEs has been slowed if not stunted by inter-acting constraints of two kinds having to do with traditional public governance and with the private governance of enterprises. As a result, SMEs are nowhere to be seen outside the commerce and crafts sectors.

A. The traditionally cautious attitude of the State towards the private sector and SMEs

29. The traditional attitude of the State in the MENA region has not been favourable to SMEs and more broadly to the private sector. Until the 1980s, the prevalent economic development model gave priority to a state-led and administered form of industrialisation that stressed large state-owned enterprises and - cautiously and selectively - foreign direct investment (FDI). It was hoped that FDI would bring technology transfers, access to international markets and capital inflows. Within this setting, the State played a predominant role in defining long-term strategic priorities, which were based on import substitution, and in managing the economy, directly and indirectly, as an entrepreneur.

30. This model produced a dual national economic structure that had inevitable consequences for the emergence of local SMEs. In dual economies there is little intersectoral exchange; such economies are typified by an export-oriented offshore sector, where there is a concentration of foreign subsidiaries and a few local firms, coexisting with a protected domestic sector. It is principally within this latter sector that local SMEs can thrive. Yet their expansion is tightly constrained: i) by large public enterprises; ii) by private holdings that are often subject to indirect political control; iii) by a domestic market-sharing system (for consumer goods and services) that is based on membership in a certain ethnic group, a foreign minority, or a great traditional family; iv) by discriminating procurement policies that give precedence to large firms; v) and finally, by an important and frequently growing informal sector that is often sustained by illegally imported, low-priced goods.

31. Under such circumstances, SMEs were up against a wall, and could thrive only in its cracks. The system has tended in effect to push upstarts back into the informal sector from which they were trying to escape.

B. The traditional reluctance of local businessmen to invest in the production of goods and services

32. In the MENA region, local businessmen (we use this term in preference to “entrepreneurs”) have typically been operating for a long time and have built up their own financial means. Their reputation enables them to borrow easily from their extended family or from their community (but rarely from the banking sector, which they tend to shun). Yet they prefer to use their financing capacities to remain in the trading sector, and perhaps to expand into the import-export business or into (often speculative) real estate activities. They however rarely choose to invest productively outside of the crafts sector (including “putting-out”) by starting a small manufacturing company.

33. Their choice is rational: their earnings in the trading sector are usually higher and more secure than those they could make in the industrial sector.

34. However, this vision of “businessmen” also reflects the shortcomings of “private governance”: i) lack of technical training and knowledge of technologies (usually only available abroad); ii) lack of experience in running an industrial enterprise and lack of business and technical managers within their family environment, meaning that they must often, reluctantly, look outside for skilled staff; iv) indeed, the desire for non-transparency is strong and it explains this mindset. It is reinforced by the shortage of local skilled labour, which tends to bid up wages; v) weak bargaining power with government, public enterprises, foreign subsidiaries and holdings; vi) finally, these impeding factors are compounded by “unfair” competition from the informal sector.

35. Moreover, there are macroeconomic factors in the local business environment that tend to discourage businessmen from creating industrial enterprises. These factors are more socio-political than economic and are linked to the “public governance” system that still predominates (if less so over the last decade) in most MENA countries. In an unstable environment, where the rules of the “governance” game

are for the most part discretionary and handed down from “on high”, traditional trading activities have the huge advantage of being less visible than industrial activities. They are easier to liquidate or discreetly dismantle and break up into small units linked by secret networks. This is a considerable advantage in an environment where confidence is lacking.

36. Furthermore, those traditional merchants who are relatively prosperous have a tendency to instil in their children the same thinking they applied to their business. They will therefore encourage their sons to study for the civil service or, if studying abroad, to settle there permanently. They will not push their most gifted male descendants to create SMEs in their own country. Entering the civil service or emigrating to developed countries (preferably to the former colonial power) will be considered the safest route. Besides, this choice does not necessarily mean that they cannot come back as graduates to work in the administration or take a senior post in a public enterprise. The girls will await marriage, and in the meantime (at least among the middle class - things are different in the informal sector) they are precluded from doing anything like start a small business.

37. With this analysis, which is only a sketch which needs to be filled out by sociological research, it is tempting to contrast our perception of potential investors from MENA countries with the typology of entrepreneurs proposed by the OECD (2004, p.21). That typology distinguishes four entrepreneurial figures:

- Aspiring or would-be entrepreneurs: this group constitutes an important pool of potential entrepreneurs, even if most of its members will only do something if they are forced to by their environment.
- Life-style entrepreneurs: they are not inclined to expose themselves to risk and uncertainty and do not see any advantage in growing their business beyond a small and manageable size.
- Growth-oriented entrepreneurs: this group is more inclined to take risks and its members will try to grow their venture. They are often managers in larger firms.
- “Heroes”: these are a modest sub-group of the preceding category. They are not afraid of risk because no one before them has ever tried to do what they do. This description corresponds quite well to the image of the Schumpeterian entrepreneur.

38. If applied to MENA countries, detailed empirical studies would likely show that all the above types of entrepreneurs can be found in the region, but in varying proportions. The category of aspiring entrepreneurs is probably the largest. Nonetheless, we would like to introduce a nuance into the OECD report, one that was apparent as early as the 15th century in the big cities bordering the Mediterranean, as described by F. Braudel. Traders were not all small merchants afraid to leave the bazaar. Some were “adventurers” whose activities spanned the world economy of their time. Nowadays, there are still big traders from large families with extended branches, and we have described their preference for discretion. They are of course a minority, but they are the ones who possess the financial capacity to invest in other, more productive activities. They could be induced to “make the leap” if the business environment were more market-friendly and stable.

39. A change of thinking, or more generally of mindset, is apparently one challenge that must be addressed if a modern private sector is to emerge in the MENA Region, and it must be accompanied by a new investment climate. The other challenge is to spark the emergence of a group of would-be entrepreneurs. In some countries, this could well be the most dynamic category for pushing traditional traders to evolve and for encouraging the State to change its attitude towards the private sector.

C. Profound changes can be expected in the years ahead

40. The change has already started or is taking shape in several countries of the MENA region. It is spreading from one country to another, faster perhaps in Tunisia, in Morocco or in Jordan than in Yemen or in Algeria, and more strongly rooted in resource-poor countries than in resource-rich ones.

41. This evolution stems from the great turning point of the 1980s, when low oil prices and high interest rates sparked an international debt crisis among the countries of the South and provoked stagflation in the North. This has sometimes been called the “liberal revolution”. It started in the United Kingdom with the coming to power of Mrs. Thatcher and it was reinforced by the election of President Reagan. The effects of this movement were felt later in the MENA region than in the rest of the world, except for Sub-Saharan Africa but they can be expected to accelerate in the near future. These effects can be seen in the attitude of the State and of entrepreneurs alike.

42. In economic policies, the private sector is now viewed as the main driver of growth. The change of model has meant some radical shifts towards: i) economic liberalisation; ii) privatisation of public enterprises; and iii) growth-led exports. This transformation should open up new opportunities for the creation of SMEs and expand the number of potential entrepreneurs. Private initiative is now encouraged and the status of entrepreneur is accorded new respect.

43. The mindset of businessmen of the new generation will also change. Their break with the past could be fundamental and could hold much promise for the future. While in the past traders pursued an economic rationale that steered them away from productive investments, we suspect that the current progeny of the great trading families and of the wealthy civil servant class as well, will not find themselves in the same position. For the latter group, opportunities will be scarcer. Liberal policies and privatisation will cut back recruiting in government and public enterprises. Many moreover will be frustrated in their choice of studying abroad or emigrating to the European Union, because entry requirements have become restrictive. At the same time and despite the inadequacies of the educational system, the level of education among youth has improved, and the ranks of unemployed graduates are growing. If they are to make a living in their country, then, those who do not have the means to emigrate will have no choice but to become entrepreneurs and to start their own SME.

44. According to a distinction made by Paul Reynolds, in the future “opportunity investors” will become “necessity investors” in most MENA countries. This forced conversion should be accompanied by the creation of SMEs outside the traditional sectors of light industry and services, including high tech and ICT. As a consequence, traditionally family-run enterprises confined to trade will have to modernise or see their importance fade away.

45. This double evolution undoubtedly constitutes a precondition for a dynamic process of SME creation and growth. But it is insufficient in itself. It must be reinforced by a major and multi-stage effort to instil a favourable climate for SME creation and growth.

The stages involved in establishing an environment favourable to the creation and growth of SMEs

46. Today, it has become relatively easy to define the standard content of the first stage of establishing a business climate that is favourable to the private sector and hence to the creation and growth of SMEs. The list of indispensable prerequisites is now well known. Since the 1990s there has been an accumulation of empirical knowledge, procedural analysis, and best practices. This original material has been taken up and systematised in the economic literature on country attractiveness in the last few years (Michalet, 1998) and has spilled over into the more general theme of the importance of institutions and of public governance, in addition to purely economic factors, a dimension that had been neglected in the past.

Recognition that the economic sphere should no longer be the sole focus of attention has produced a new appreciation of what it means to have a climate favourable to the private sector, and thus to the growth of SMEs.

47. This new approach received a boost in the mid-1980s from OECD governments and, above all, from international organisations, primarily the Washington-based institutions. The new model was applied particularly to the emerging economies of the South - in Asia, Latin America and Central and Eastern Europe (PECO) after 1989 - and generally within the framework of structural adjustment.

48. Abandoning the model of a centrally planned and protectionist economy, which is the condition for a new form of public governance, means in the end introducing and putting in place a competitive market. However, it would be wrong to think that markets and, with them, private initiative (including the eventual blossoming of SMEs) and private investment will spring spontaneously from economic liberalisation and privatisation programmes. The creation and development of a market economy and SMEs also demands an institutional and legal framework that will establish the rule of law, guaranteed by the courts, and that can provide collective goods and services. Otherwise, there is a risk of sliding into anarchy and the proliferation of informal activities. Socioeconomic analysis and experience shows that a successful metamorphosis requires State intervention, not its abolition. But we must immediately add that the State to which we are referring is no longer the old model but a radically new one. There can be no return to the past, *pace* the nostalgic holdouts, change being naturally accompanied by resistance in varying degrees of strength and violence. The new State will be a regulator. The new State, then, does not need to substitute itself for private initiative either by setting mandatory objectives for it or by becoming itself an entrepreneur. To the contrary, the State must act as a facilitator to the private sector by providing the collective goods and services that are indispensable to the smooth functioning of the economy. It is within this perspective that we may define its role with regard to the creation and growth of SMEs.

49. This reminder is useful in order to understand the present situation in the MENA region. While recognising that the situation varies from one country to another, it is nonetheless fair to say that, while the region has partaken in the transformation of the economic model described above, the move to date has been both tardy and timid. It seems to have gathered momentum at the turn of the 21st century, but the economic performance of the MENA region, the state of its economic, social, institutional and political structures, and the quality of its public governance have not progressed at the pace required by integration into the dynamic global economy. In these conditions, it is not surprising that the existing literature on the MENA Region economy – whether distilled from speeches, official reports, academic research or think-tank papers - consists largely of mantras. We find endless repetitions of the measures that need to be taken and the obstacles that must be overcome, but the effects of these entreaties have yet to be felt. Moreover, it must be noted in passing that the creation and growth of SMEs is generally given short shrift.

50. We may summarise as follows the order of the stages to be followed in establishing an environment favourable to the creation and growth of the private sector and of SMEs, as it is usually set out in the literature and in government programmes, and as adopted in this report:

- Establishing the prerequisites of a favourable business environment;
- Measures to support the creation of SMEs;
- Measures to support the growth of SMEs;

51. While we shall return to the matter later, we may offer at this point a provisional working hypothesis to the effect that, considering the time lost in the MENA region, this linear approach is perhaps not the most appropriate one. It might be more effective in the field to give priority to the second stage

over the first, at least in those countries where transforming public governance is hardest. Here it would be advisable to follow the dynamic approach put forward by A. O. Hirschmann in his economic strategy for development (1958). His theory holds that obstacles can be a spur rather than an impediment to economic take-off, something that is not always readily apparent ex ante.

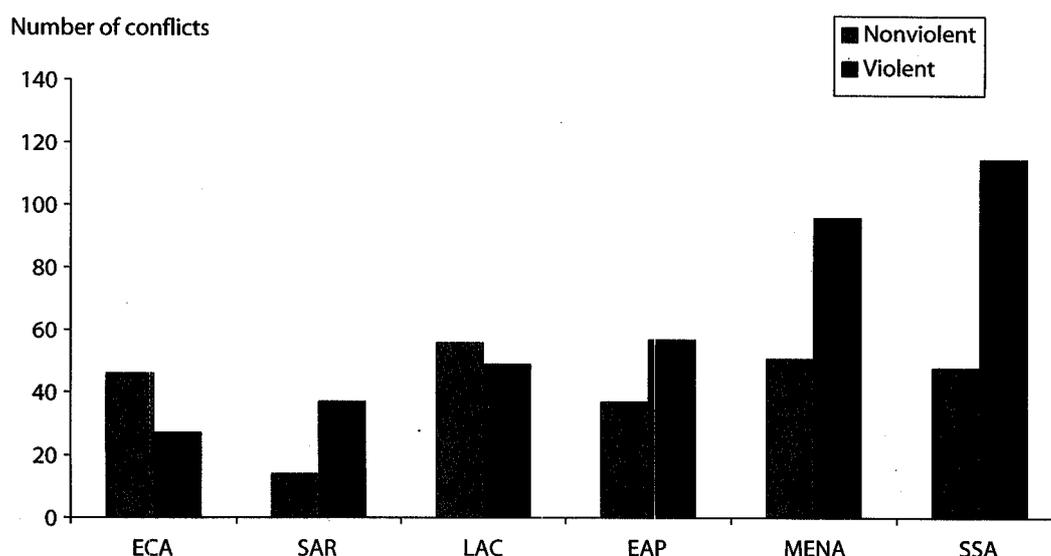
52. Before reaching this conclusion, we must first take a bird’s eye view of the ground to covered, define the stages and assess the difficulties.

First stage: Assembling the prerequisites for a business climate favourable to the entrepreneurial spirit

53. Establishing a business climate favourable to the spirit of enterprise requires that countries meet a series of prerequisites that will benefit both local and foreign enterprises, and will foster the creation and growth of SMEs.

54. We should not lose sight of the fact that political stability and the absence of conflict also constitute a prior condition. This condition is not always met, as can be appreciated from the following figure.

Figure 1. Frequency of Conflict Across Regions, 1945-99



1. Data available by conflict were mapped to standard World Bank regional classification. EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR - South Asia; SSA = Sub-Saharan Africa. For definition of violent and non-violent conflicts refer to http://www.hiik.de/en/index_e.htm.

Source: Heidelberg Institute of International Conflict Research (2003).

A. A necessary precondition for the MENA Region: replacing State fiat with the rule of law

55. To simplify matters, this means a shift from the traditional concept of “public governance” as a regime dominated by legal and regulatory decisions (“legal” not necessarily meaning ratified by parliament) emanating directly from the executive power or the central administration. This procedure

inevitably risks being arbitrary, authoritarian and lacking in transparency. The configuration in which State fiat reigns must yield to one where the rule of law prevails.

56. This move is indispensable for building a climate of confidence, which is a fundamental trait of a market economy (Fukuyama, 1995) - it favours private initiative and acts as an incentive for investments that will tie up capital for a long time and make it illiquid (in the sense that quick exit from an activity is impossible), thereby leaving the entrepreneur more vulnerable. This change is especially important for promoting the emergence of SMEs that, in contrast to private and public monopolies and foreign firms, have little bargaining power vis-à-vis the authorities. Because of this weakness, entrepreneurs will often prefer to stay in the informal sector.

57. In order to establish the rule of law, public governance must adhere to certain principles which have been stated both in the Bologna Charter for SME Policies and in the Istanbul Ministerial Declaration:

- a) Stability and transparency of the legal and regulatory framework in the business sector: entrepreneurs must be able to anticipate returns from their investment over the medium and longer term. From this perspective, taxation regimes are of crucial importance. Not only must excessively high tax rates be precluded (because they make the informal sector more attractive) but also - a point seldom stressed - tax laws and regulations must be written in clear language and shielded from constant amendments (which, especially if retroactive, can tie businesses up for ever in tax adjustment manoeuvres). Moreover, SMEs are often ill equipped to keep track of unpublicised legal and regulatory changes that affect them (including, inter alia in the area of decrees and implementation).
- b) Property rights, including those to tangible assets such as land, buildings and equipment. De Soto (2000) considers that the guaranty of capital ownership rights is an indispensable condition for escaping under-development. It reduces the liquidity worry, and it diminishes the risk for new entrepreneurs of being, in effect, expropriated by more powerful political and economic interests attracted by the good results of an industrial or agricultural enterprise.
- c) The State and the administration must make it their habit to respect their engagements and pay their private sector suppliers reasonably promptly. This is a significant point for SMEs: public procurement is an important market for them, given the low consumer purchasing power, the weakness of the private industrial network and the place that public enterprises still occupy in MENA economies. Furthermore, access to public orders and tenders should be guaranteed for SMEs to dispel the discouraging perception (true or not) that they will always be edged out by large firms close to the powers that be, which as a result can discourage small entrepreneurs.

B. Economic and social reforms should be continued

58. Government must show a positive attitude towards SMEs and their associations, thus breaking with its traditional suspicion and the lack of co-operation and the strong temptation to substitute itself for the private sector. SME managers in the region are hungry for consultation and information. Paradoxically, this need reflects the burden of the past. In the old system, the rare private entrepreneurs would wait to act and invest until they knew the State's priorities as indicated in the five-year plans. Access to banking finance or to import licences depended on entrepreneurs' tailoring their investment choices closely to government priorities. This lack of autonomy on the part of entrepreneurs has not completely disappeared. In some countries, we were surprised to hear the heads of employers' associations lament the absence of government guidance in matters of investment since the adoption of the "liberal" model. More to the point, they wanted the State to tell them what to do, as in "the good old days". The lengthy process of obtaining bank credit can be explained in the same manner. In the traditional model, financial institutions simply redistributed a portion of economic rents, in accordance with the sectoral

priorities of the Plan. This non-economic rationale, however, could not avoid the need to manage scarcity. Consequently, the fate of those on the waiting list was hostage to interpersonal relations and patronage. In the end, the profitability criterion was secondary for banks and entrepreneurs alike, if it was considered at all. These principles still hold great sway today.

59. It is hard to define the best commercial policy for supporting the emergence of SMEs. It should of course take into consideration, on one hand, the weak competitiveness of SMEs, whose goods and services have high unit costs and are of lower quality than imported products, and on the other hand the positive effects of competition in curbing the rents enjoyed by longer-established firms. As Table 2 shows, the dominant tendency is still protectionist, with nontariff barriers now offsetting the effects of the tariff reductions instituted to comply with external commitments. MENA appears to be the most protectionist region of the South.

Table 2. Protection Indicators (most recent years)

	Average	Weighted Average	Non-tariff barriers
Algeria	22.4	15	15.8
Bahreïn	8.8	--	--
Egypt	20.5	13.8	28.8
Jordan	16.2	13.5	--
Lebanon	8.3	12.0	--
Morocco	32.6	25.4	5.5
Oman	4.7	4.5	13.1
Saudi Arabia	12.3	10.5	15.6
Syria	21.0	--	--
Tunisia	30.1	26.3	32.8
MENA	16.5	13.8	15.9
ECA4	12.9	7.2	12.4
LAC4	12.2	12.9	48.4
EAPS	11.3	8.3	13.5
LMIC	15.3	12.5	13.2

Note: ECA4: Czech Republic, Hungary, Poland and Turkey; LAC4: Argentina, Brazil, Chile and Mexico; EAPS: China, Indonesia, Malaysia, Korea and Thailand; LMIC: Lower Middle Income Countries

Source: The World Bank (2003), MENA Development Report.

60. In the short term, this choice pleases everyone, in particular the most powerful employers' associations. On the other hand, it reinforces entrenched positions that are unfavourable to the creation of SMEs. We often forget that the infant-industry protectionism championed by List in the late nineteenth century for the emerging economies of the time, and now severely criticised by international organisations and by mainstream economists, was conceived as a temporary measure. But in order to apply this principle, the government must be powerful enough to resist pressure groups. These do not always include SMEs, whose place in the hierarchy of economic power is secondary, and whose main concern, for that matter, is with smuggled goods. But pressure groups can be mounted by big firms and by import-export businesses that fear losing their rent-reaping position. Following the same logic, these enterprises also create barriers to new SMEs.

61. The orientations of the educational system constitute a component of the investment climate. On the one hand, to introduce a real entrepreneurial culture consistent with the recommendations of the OECD Istanbul SME Ministerial Conference; on the other hand, to compensate for the chronic shortage of skilled labour and mid-level technicians, vocational training needs to be reinforced; yet most often the emphasis is on general education. Here again, the promotion of SME-friendly measures runs up against social and occupational factors in the MENA region. It is the elites that hold senior positions in the administration, the army or trade who send their children to university, and they go mainly into the non-scientific disciplines.

It would also be useful to organise retraining programmes for SME managers who generally lack the basic skills needed to run a business. But given budgetary constraints and resistance to change in most MENA countries, it is my no means certain that the families who send their children to university will welcome a move to strengthen vocational training, which is more costly than general education and would thus imply a reallocation of public funds.

C. A new approach

62. In the end, it is the difficulties inherent in implementing the first stage that seem to constitute the chief stumbling block in the laborious process of encouraging the emergence of an environment favourable to the creation and to the growth of SMEs in MENA countries. This is stage which above all concerns the reform of public governance.

63. Before attempting to use the scant information available to propose some answers to this question, we must first offer a final, brief remark on methodology. It would be wrong to limit ourselves to the exclusive role of the State, even a reformed State, in stimulating SME growth. However, it is too frequently ignored that there is bound to be mutual feedback between public sector actions and a stronger entrepreneurial spirit. These public- private dynamics are usually overlooked, yet they are crucial to achieving change. Indeed, the revival of private initiative, sparked by changing government attitudes, has often given new impetus to liberalisation, speeding its pace and, most importantly, making reforms irreversible. Experience shows that in most cases such dialogue thrives with open economies – such as those that are regionally integrated – and with the massive inflow of foreign direct investment. In some cases, the development of the tourism industry has also played the triggering role. Growth in the number of SMEs is one logical consequence.

Second stage: facilitating the creation of SMEs

64. To the extent that an improved investment climate has succeeded in spurring potential investors into action, it is time for a series of measures relating to the SME start-up phase.

A. Simplifying the administrative procedures for starting a business

65. In the majority of MENA countries, simplifying the procedures required to create a new enterprise under various legal guises is a prerequisite for encouraging private investment in general, whether for local or foreign entrepreneurs, because it reduces business start-up costs. It must be noted that this topic is particularly important for SMEs, for they are not as well equipped as larger firms to overcome the numerous administrative barriers. Big firms can rely on intermediaries such as lawyers and consulting firms to handle procedures. They are familiar with laws and regulations and with the inner workings of the administration, and they also have a solid network of connections in various ministries. Two specific points must be added here. First, when a large foreign investment is at stake, the bargaining takes place elsewhere, at the most senior levels of government. Second, the complexity of procedures and the great number of successive reviews and decisions often reflect the potential investor's insistence on special financial advantages. The granting of incentives is subject to a series of conditions, and government departments are supposed to verify that they have been met. Paradoxically, specific incentives designed to encourage new investors often end by discouraging them instead.

66. In the majority of MENA countries, simplifying this “obstacle course” should shorten the time-consuming procedures needed to launch a business, which can be frustrating and costly for the promoter. It will also reduce the risks of corruption and arbitrary decisions. Studies show that “regulatory costs have an increasingly disproportionate impact on smaller enterprises” (OCDE, 2004, p. 34).

67. The recommendations most frequently found in reports, studies and speeches are the following:

- a) Reduce the number of administrative procedures and /or create a “one-stop window”. More and more countries, including those in the MENA region, where Tunisia has been a pioneer, are using this last option. Unfortunately, it is not always accompanied by the establishment of units with the necessary authority to move the files forward - central administrations still balk at delegating power to the “one-stop windows”.
- b) Reduce the number of required documents, recognising that they are often difficult to obtain in countries where the administration is mismanaged and where violent and repeated conflicts often entail the destruction of archives. Nor should a detailed business plan be demanded, since this is usually far beyond the capacities of future small entrepreneurs.
- c) Improve the efficiency of the commercial claims courts that deal with enforcing contracts and procedures for winding up businesses. Sometimes it will be necessary to start from scratch to create commercial courts and to train magistrates (and lawyers) knowledgeable in the discipline.
- d) Measures that help SMEs enter the market should be mirrored by simplified exit procedures (bankruptcy regimes). The life span of the majority of SMEs is short. Studies have shown that small firms are more flexible than the average large firm. According to some authors, this characteristic is essential to the survival of the most productive (Sak & Taymaz, 2004).

68. Tables 3-5 from the World Banks’ “Doing Business in 2004” show that MENA countries still have a lot to do to meet the prerequisites for administrative and judicial procedures that have just been cited.

Table 3. The Cost of Starting a Business

	Number of procedures	Time (days)	Cost (US\$)	Cost (% income per capita)	Minimum capital (% income per capita)
Algeria	18	29	548	31.9	7300.0
Egypt	13	43	900	61.2	788.6
Jordan	14	98	876	49.8	2404.2
Lebanon	6	46	5185	1299.0	83.1
Morocco	11	36	227	19.1	762.5
Syria	10	42	189	16.7	5627.2
Tunisia	10	46	327	16.4	351.7
France	10	53	663	3.0	32.1

Source: World Bank & IFC (2004), *Doing Business in 2004*.

Table 4. The Cost of Bankruptcy Procedures

	Time (years)	Cost (% of estate)	Absolute priority preserved (1)	Efficient outcome achieved	Total index (2)	Court power
Algeria	3.5	4	33	0	45	33
Egypt	4.3	18	67	0	39	67
Jordan	0.6	4	100	1	91	67
Lebanon	4.0	18	33	0	31	67
Morocco	1.9	18	33	0	36	100
Syria	4.1	8	33	0	37	67
Tunisia	2.5	8	67	0	42	33
France	2.4	18	67	0	43	100

Notes: (1) Order for paying creditors; the highest values mean that secured claims take precedence over labour, taxes and shareholders. (2) Average of the preceding columns (time, cost...)

Source: World Bank & IFC, op. cit.

Table 5. Contract enforcement costs

	Number of procedures	Time (days)	Cost (US\$)	Cost (% income per capita)	Procedural complexity index
Algeria	20	387	--	--	76
Egypt	19	202	450	30.7	50
Jordan	32	147	5	0.3	49
Lebanon	27	721	2160	54.3	67
Morocco	17	192	108	9.1	69
Syria	36	596	300	31.3	79
Tunisia	14	7	86	4.1	60
France	21	210	896	3.8	79

Source: World Bank & IFC, op. cit.

B. Making more industrial land available

69. Economic analyses often leave out the fact that once a decision has been made to invest, and once administrative authorisation to create a new enterprise is in place, finding a site and/or piece of land is a crucial preoccupation for promoters.

- a) Most studies on MENA countries point to a shortage of viable industrial land that can be had at non-speculative prices and with enforceable property rights. The lack of proper land registries makes it difficult for the real estate market (if there is one) to function properly, and for specialised government units to allocate lots. Around big cities, the land is often occupied by the informal sector. In the villages, user rights are still rooted in tradition (the “commons”) or religion.
- b) The creation of industrial zones, then, appears to be a solution that should be encouraged because it makes it possible in some cases to resolve property rights issues and to bypass the labyrinth of administrative procedures. Nonetheless, they must not be run in ways that perpetuate the customary “informal” selection criteria based on personal, ethnic or political connections. If they were, land access would then be dependant on arbitrary procedures often tainted by corruption. Moreover, in some countries and regions, land for industrial purposes that is prepared and serviced with public funds is often sold at subsidised prices in order to encourage private

initiative. Regrettably, speculators often get the jump on investors, who in the end are faced with very high prices. These common practices are the consequence of a traditional approach to public governance that discourages private investment. It should be noted in passing that a good deal of mystery surrounds the legal status of the land on which stand many of public enterprises slated for privatisation. As a result, turning the managers of these enterprises into SME owners can be difficult.

- c) In the end, the most radical way to bypass the constraints to land access is to create economic export zones with the more or less explicit status of offshore zones. On the admittedly risky assumption that the management of these zones will not suffer from the usual distortions cited above, the question remains as to what impact they will have on the creation of local SMEs. They have certainly demonstrated their effectiveness in attracting foreign investors in several MENA countries, generally at the cost of creating a dual economy with domestic and off-shore sectors that have little interrelationship apart from, as we have already indicated, that of hiring labour. As it happens, SMEs are concentrated in the domestic sector. There is no hard evidence that a local investor engaged in producing goods and services for the domestic market will be ready to make use of these zones. Yet, and we shall return to this point, these zones could be a good tool for the growth of existing SMEs, in terms of cluster creation.

C. Reforming the labour market

70. Reforming the labour market is obviously an issue much broader than the creation of SMEs, but it is an important factor in improving the business climate in general. Although it does not only pertain to SMEs, Table 6 offers a good illustration of the degree of labour market flexibility in the MENA region.

Table 6. Flexibility of the labour market (indexes)

	Flexibility of hiring	Conditions of employment	Flexibility of firing	Employment laws
Algeria	58	60	19	46
Egypt	33	79	35	49
Jordan	33	82	64	60
Lebanon	53	50	35	46
Morocco	56	63	33	51
Syria	33	79	22	45
Tunisia	73	53	44	57
France	63	61	26	50

Source: World Bank & IFC, op. cit.

71. Economists' unanimous enthusiasm for labour reform has the unfortunate consequence of overlooking the specific needs of SMEs, which are very different from those of other private sector firms:

- Creating new SMEs poses specific needs for increased flexibility in hiring and firing in the MENA Region. On the one hand, because SMEs have few employees, most of whom will be neighbours of or related by family, ethnic group, or tribe to the entrepreneur. Recruiting is not done through the market. Employees are rarely declared to the social security service. Salaries are paid partly in kind. All in all, most SMEs are unconcerned with labour law during this phase, unless legislation interferes with their hiring practices. Budding SMEs certainly exhibit behaviour typical of the informal sector.
- On the other hand, there is a real need for retraining and skills upgrading programmes for entrepreneurs. In countries like those in the MENA region where literacy rates are low, especially

beyond the urban areas, the training of future entrepreneurs is a necessity. But training is hard to organise, because entrepreneurs cannot afford much time away from their business if it is to survive. This has been a constant problem with the skills upgrading programmes financed by the European Union with its free-trade partners in the MENA region.

72. In this situation, the first stage should be devoted to answering the immediate needs of potential SME candidates, i.e. their need for information and assistance.

D. Providing better information and assistance to promoters

73. By definition, most promoters of new SMEs have no experience, especially if they are “necessity investors”. They therefore need free sources of general information on the institutional, legal and regulatory framework in which they are going to set up a business. Moreover, they need technical assistance to draw up investment plans for submission to the authorities or, more rarely, to banks.

74. To our mind, this is the type of role that Investment Promotion Agencies (IPA) should play. They are likely to be much more useful in this field than in attracting multinational firms, where their effectiveness is debatable (Morisset, 2003). However, it must be recognised that redirecting IPA activities in this way would need substantial resources, because they would require competent staff that can deal with applicants who are uninformed and untrained, and thus prone to prejudices and preconceived ideas - they are likely to see this stage as a waste of money and time, and will try to keep it to a minimum.

E. Fostering partnerships with foreign firms

75. As we noted above, reforming the public governance of a country has often been accelerated by pressure from outside forces. The massive influx of foreign direct investment has played this role in the last 25 years. The ability of China’s special economic zones to attract FDI has been a factor in that country’s modernisation, just as the spread of *maquiladoras* was 10 years earlier in Mexico.

76. Policies to attract FDI will have their initial impact through improvements to the business climate. It is a truism that what is good for foreign direct investment is good for domestic investment, including small businesses. The barriers in both cases are essentially the same and have the same effect in dissuading potential investors. The impact of FDI can also make itself felt more directly through joint ventures, sub-contracting and franchising. But the impact will be more noticeable in countries with thriving SMEs that can provide the services that foreign subsidiaries are looking for. We shall come back to this later when dealing with the growth of SMEs. Suffice it to say here that MENA countries hold little attraction for FDI, beyond the hydrocarbons sector.

F. Encouraging the return of emigrant workers

77. It is widely recognised that emigrant workers constitute a pool of potential entrepreneurs, but only if they can be persuaded to come back to their country before they retire. As a first step, it would be desirable if the significant flows of emigrants’ remittances (Caffè, 2004) could be channelled into productive investments rather than into real estate projects.

78. Apart from the professional experience they may have acquired abroad, their potential savings could give a boost to the SME sector. As in the case of potential domestic or foreign investors, meeting the prerequisites for a good business climate will play a key role in encouraging their return. Above all, this means reducing the perception of risk and insecurity.

G. The ambiguities of incentives

79. Most MENA countries' investment incentive systems rely on temporary tax holidays, tax credits, accelerated write-offs and reduced customs duties on imports of equipment and intermediary goods (see H. Kheir El Din, 2003 on Egypt).

80. Since the financing of SMEs is beyond the scope of this report, we will not dwell on incentives of this type. We will however look at their impact on the creation of SMEs. We may note in passing that big investors often receive more important advantages than small ones because investment legislation is designed to attract FDI. It may be deduced from this choice that SME creation is not seen as a priority for these countries. This point should be systematically verified for every MENA country.

81. Special investment regimes can create distortions:

- It is key when granting incentives to avoid projects that would be *a priori* unviable without aid. Otherwise the country will be stuck with “footloose” projects that will survive only as long as incentives are available and will then disappear. Mobility is easier for SMEs than larger projects.
- Applications for benefits under special regimes give rise to much red tape. The government has to ensure that the project eligibility conditions are met - hence the long list of documents required, the many oversight commissions, and the lengthening of processing times. Sometimes, informal interventions are the only way to extract a decision.
- In the case of SMEs, receiving special treatment is often crucial to the start-up of a project because it lends a certain credibility to the promoter, which he can then use with his partners, future suppliers, bankers and lenders (who will most likely be his relatives or friends).
- Moreover, in some countries, an official stamp of approval immediately opens the possibility of importing goods of doubtful purpose (for instance private cars) at preferential rates. Thus, it is very important to keep track of the number of projects approved vis-à-vis the number of actual investments made within the allotted deadlines.
- Finally, incentives can be the object of bidding between competing countries. This is a zero-sum game that is always deplorable, and especially in the case of SMEs, recognising that most small business projects are geographically constrained and the potential investor is not in a position to make trade-offs between locations in different countries.

Third Stage: Encouraging the growth of SMEs

82. This is the final phase in the process of expanding the population of SMEs. In fact, success at this stage will mean that the best performers among them will grow to the point where they are no longer “SMEs” at all. From this perspective, further research would be useful into the factors that can speed the transformation of SMEs into internationally competitive businesses. For countries hoping for an export-led improvement in their trade balance from the development of SMEs, this shift is of crucial importance.

83. The metamorphosis of SMEs can be favoured at two different but not mutually exclusive levels:

A. Broadening the domestic market

84. This opportunity for SME growth can take several forms:

The growth rate of the domestic market

85. Growth in a country's GDP entails increased consumption of the goods and services offered by SMEs. If they are to maintain their market share in the face of the competition that increased demand brings with it, they have no choice but to grow in order to benefit from economies of scale. This can be achieved either via the longer route of internal growth or through the quicker device of mergers and acquisitions. In both scenarios, SMEs will have to acquire greater managerial expertise, which may be at best only partially available within the family enterprise. They will also have to borrow more from banks and financial markets, and rely less on their customary sources of finance. This evolution will most probably have the effect of making them change their legal status to that of an incorporated business. Financing and management (including the introduction of new technologies) is key to the successful transformation of SMEs. This transformation also implies changes in their domestic environment, as we shall discuss below.

86. The upgrading of products and services offered by SMEs is another option. It implies choosing high value-added or technology-intensive activities. A crucial factor here is the vocational training that we have already mentioned as a prerequisite. With improved product quality, domestic SMEs will be better placed not only to withstand competition from imported goods and services but also to conquer foreign markets.

B. International expansion

87. Before venturing from the domestic into the international market, SMEs must have a high level of competitiveness, which will be acquired in part during their expansion on the domestic market. International expansion can occur in different ways.

88. Export development: this is the traditional route, and it can involve either the regional or the global market. To achieve this objective, MENA countries will have to make an effort to reduce export transaction costs, as indicated in table below 7.

Table 7. Survey of MENA Exporting Firms: Ranking of Trade Costs

Trade Cost	Ranking	Average Score ^a	Standard deviation
Customs duties	1	3.0	1.1
Domestic taxes	2	2.6	1.3
Customs clearance	3	2.5	1.1
Public sector corruption	4	2.4	1.4
Inspection, conformity certification	5	2.2	1.3
Transshipment, regulatory measures	6	2.1	1.3
Entry visa restrictions (for business)	7	1.8	1.5

Note: a. Average. Responses were scaled from 1 to 4, where 1 implies the constraint is not costly and 4 means it is prohibitive. Constraints with score equal to or greater than 1.8 are retained.

Source: The World Bank, MENA Development Report op cit.

89. According to the first hypothesis, SME expansion will require progress in regional integration. This has been a slow process, despite the many initiatives: the 1982 Arab trade promotion agreement that was replaced by the 1997 PAFTA (Pan Arab Free Trade Area), embracing 21 countries; the Arab Maghreb Union (UMA); the UEA-GCC (Unified economic agreement between the countries of the GCC) signed in 2001 by 6 Gulf countries (World Bank Development Report, 2003, Chap. 7 and Arab Human Development Report, 2002, Chap. 8).

90. The impact of regional integration on trade flows is still very modest compared to results in other regions of the world (cf. Table 8):

Table 8. Intra-regional Trade (in % of total exports)

	1980	1998
Arab Countries	4.5	8.2
ASEAN	22.4	22.2
MERCOSUR	12	25
European Union	60.8	56.8

Source: The World Bank, MENA development Report, 2003, p. 214

91. The second hypothesis is more promising. The EuroMed region is developing with regular increases to the number of MEDA countries that have signed a free trade agreement with the European Union. Furthermore, Jordan and Morocco have also signed free trade agreements with the United States.

92. Here again, as we indicated in the case of liberalisation programmes, regional integration will not produce miracles by itself. It will not reduce the need for a better business environment. Improving firms' competitiveness is essential for economic integration, either regionally or on a broader basis. SMEs are going to face stiffer competition, even if its intensity is not the same under one scenario as under the other. The success of their growth and transformation will depend on the means they choose for adapting. There are several solutions, which should be seen as complementary rather than mutually exclusive:

93. Conventional sub-contracting with foreign firms is becoming an outmoded solution for SMEs in MENA countries, with the incursion of Asian competition into areas such as clothing, where this form of co-operation was most widespread. Nonetheless, the great number of joint ventures formed in the past between MENA and European SMEs, especially in Tunisia and Morocco, must not be overlooked. Unfortunately, there are few or no statistics available on this topic. An inventory by Anima (2005) of investment projects gives some interesting indication of recent developments in this area.

94. Nowadays the priority focus should be on partnerships with foreign firms. These are steadily becoming "hollow corporations" or "virtual firms" as a consequence of strategic decisions to outsource and to relocate. This tendency can be seen in the global value chains of multinational firms and is closely linked to the shifting perception of regional integration induced by globalisation (Michalet, 2004). Since the mid-1980s, the nature of regional integration has changed. In the conventional model put forward by J. Viner (1950), which inspired the sponsors of the Rome Treaty, the dominant idea was that trade creation and diversion would be maximised by eliminating trade barriers between economies at comparable levels of development. The prototype of what we now call the "new" regional integration is NAFTA, the free trade agreement between the United States, Canada and Mexico. The European Union has followed the same model with its enlargement into Central and Eastern Europe; a similar trend is currently taking shape in the Pacific with the institutional changes to ASEAN and EPAC and with the pragmatic division of labour that is occurring between Japan and China and between the United States, on the one hand, and China and India on the other. Regional integration is now linking economies at different development levels, thus breaking with the conventional model.

95. The "new" regional integration holds new opportunities for SMEs in the least-developed economies. They should be able to take advantage of two major long-term trends: on the one hand, production relocation for certain goods and, increasingly, services; on the other hand, the outsourcing of various functions by multinational corporations. Gaining access to international markets through the global value chains of the multinationals is will be the best hope for SMEs. In order to gain this access, they will need to specialise in the production of components. They will have to use the most up-to-date technologies

and respect their clients' demands in terms of delivery, quality and cost. In return they will have access to new technologies and new financial and management techniques. But in order to succeed in this undertaking SMEs must ensure that they are noticed and selected by firms with a global networking strategy. This amounts to saying that local SMEs need to perform to a standard that can comply promptly, if not immediately, with the production and distribution expectations of virtual firms. Labour productivity levels, the capacity to absorb new technologies, proper staff training, management flexibility and reliability are all preconditions for their integration into networks of firms. The results shown in Table 9 demonstrate that this process is still embryonic in the MENA region.

Table 9. The Relative Importance of Parts and Components in MENA Countries

Country	Value of parts and components in OECD trade (US\$ million)				Share of parts and components in all manufacture (%)			
	Exports		Imports		Exports		Imports	
	1988	2000	1988	2000	1988	2000	1988	2000
Algeria	6	7	943	994	2.6	2.8	23.5	18.7
Bahrain	39	24	156	208	19.6	6.9	18.1	16.5
Egypt, Arab Rep. Of	19	54	1 279	2 142	4.3	3.1	23.5	24.7
Iran, Islamic Rep. Of	8	18	941	1 311	1.7	2.2	21.1	25.6
Jordan	25	21	301	276	20.2	8.5	21.0	18.4
Kuwait	42	8	437	505	38.0	3.9	15.4	17.0
Lebanon	3	9	80	242	1.5	3.5	7.6	11.8
Libya	10	6	560	369	3.8	1.6	16.3	21.3
Morocco	33	105	421	1 231	2.1	2.5	14.4	19.2
Oman	22	45	208	330	8.3	14.0	15.2	18.8
Qatar	6	17	115	300	11.1	3.7	16.6	20.4
Saudi Arabia	73	213	1 941	3 298	3.6	7.1	13.5	19.0
Syrian Arab Rep.	1	9	148	338	4.5	2.7	16.2	21.5
Tunisia	72	332	330	859	5.5	7.4	15.8	14.4
United Arab Emirates	31	208	714	2 919	12.2	10.9	16.7	20.8
Yemen, Rep. Of	2	1	61	105	47.0	6.7	15.5	19.6
MENA	391	1 078	8 635	15 430	5.2	5.7	17.1	19.9
Labour abundant, resource poor	151	521	2 411	4 751	4.2	4.7	18.6	19.3
Labour abundant, resource rich	17	35	2 094	2 748	2.4	2.5	21.4	21.9
Labour importing, resource rich	171	508	3 133	7 057	6.1	8.4	14.5	19.7
Memo items								
China	379	25 409	2 237	16 091	1.9	11.9	11.1	25.6
Japan	34 212	51 583	5 373	17 268	20.4	20.3	13.5	21.1
Korea, Rep. Of	2 841	15 720	5 077	11 128	6.7	18.3	19.4	17.6
Malaysia	452	11 526	1 241	6 959	7.7	22.5	18.8	23.1
Singapore	4 425	9 584	4 492	10 877	32.8	23.4	25.1	22.9
Taiwan, China	5 231	21 369	4 265	11 208	11.5	24.3	17.2	17.1

Note: Parts and components are defined as 62 products at the 3- or 4-digit level in SITC Revision 2 (see details in Yeats and Ng 2000).

Source: Based on OECD data as reported from UN COMTRADE Statistics. Cited in The World Bank, MENA Development Report, op. cit.

96. It is probably the shortcomings of today's business environment in MENA that explain why most of the region's economies remain outside the globalisation process. Governments are starting to become aware of this failing, which could leave the region irreversibly marginalised. This concern might perhaps signal an opportunity for the region to reform its public governance structures, driven by the need for a new private governance. For moving forward in this direction there are a number of measures that have been insufficiently used:

97. The mobilisation of the MENA diaspora could provide a network of counterparts abroad: importers/suppliers, capital inflow, contacts with enterprises from the North, etc.

98. Upgrading the goods and services produced by new SMEs through specialisation in those that will give them a competitive edge. This necessary effort could be supported by various courses of action:

- a) Reinforcing the “after care” function of IPAs, something that is still generally embryonic.
- b) Developing advanced, specialised training and refresher programmes for SME managers.
- c) Fine-tuning industrial offshore zones by converting them into clusters specialised in activities where the country has comparative advantages.

Preliminary Conclusions

99. This conclusion can only be preliminary, as the report constitutes but one stage in a research programme that would be devoted to strengthening the creation and growth of SMEs in the MENA region. This future programme could have two complimentary aims.

100. First, in order to put forward operational recommendations rather than pious wishes, we must systematically mobilise existing information and if necessary develop new data on SMEs in the various countries of the region. This research would focus on the sectoral distribution of SMEs in the production and distribution of goods and services in the national economy, and on their relative importance at the present time. It would endeavour to identify partnerships between local SMEs and foreign firms, whether these involve joint ventures, franchising, or insertion into the global value chains of virtual firms. Over the medium term, it would be useful to evaluate the entries and exits of SMEs in order to deduce their impact on net job creation, on the supply of goods and services, and also on the relations between the informal and formal sectors. Lastly, it would be most useful to know the identity of new entrepreneurs, and the number of managers and employees in SMEs. This knowledge would greatly facilitate our understanding of the characteristics of “private governance”, including those that are particular to a given country and those that are widespread throughout the region.

101. Secondly, it is difficult to propose reforms conducive to the establishment of a favourable business environment for SMEs without grasping in depth the interplay between private governance and public governance in each country, following the work done by Charles Oman (2003) at the OECD Development Centre. With this in mind, there would seem to be two main factors explaining why the MENA region has lagged behind:

- On the one hand, public governance has failed to promote a market economy that provides scope for private initiative, within a reformed and supportive legal and regulatory framework that offers incentives for the creation of SMEs, and where the State is a regulator and no longer a manager/entrepreneur.
- On the other hand, private governance remains stunted by the shortage of dynamic local entrepreneurs who are willing to invest in high value-added activities producing goods or services, who are concerned about competitiveness, and who are prepared to thrive in an economy that is open to trade and foreign investment.

102. In the face of these roadblocks - or at least hurdles - that characterise the MENA region, we would tend to believe that it is harder to change public governance than private governance. The first is rooted in a long tradition and supported by important vested interests that are often based on economic rents. In contrast, the second rests today, and will rely even more tomorrow, on dynamic forces, including the region’s youthful population, the growing ranks of young unemployed graduates, and perhaps the increasing number of emigrants who are tempted to return home after a (sometimes long) stay abroad.

This potential source of strength, if reinforced by national economies that are more open to trade, FDI and capital mobility - in a word, to globalisation - could succeed in breaking down the old patterns. If this hypothesis is verified, it would mean that instituting the prerequisites for an SME-friendly environment is an indispensable stage for modernising the legal, regulatory and institutional framework as well as for transforming mentalities in the MENA region - even if this must be done at differing paces for different countries.

103. The second stage, which involves putting in place the prerequisites for the creation of SMEs, would then become the recommended top priority. This would mean a radical change in preconceived ideas. But here again, an in-depth research programme is needed to verify this hypothesis.

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