Distorted Dynamics

The Impact of Policies on Firm Dynamics and Job Creation

Summary

Problem

A limited pool of startups and productive firms reduce formal sector job creation in MENA.

Analysis

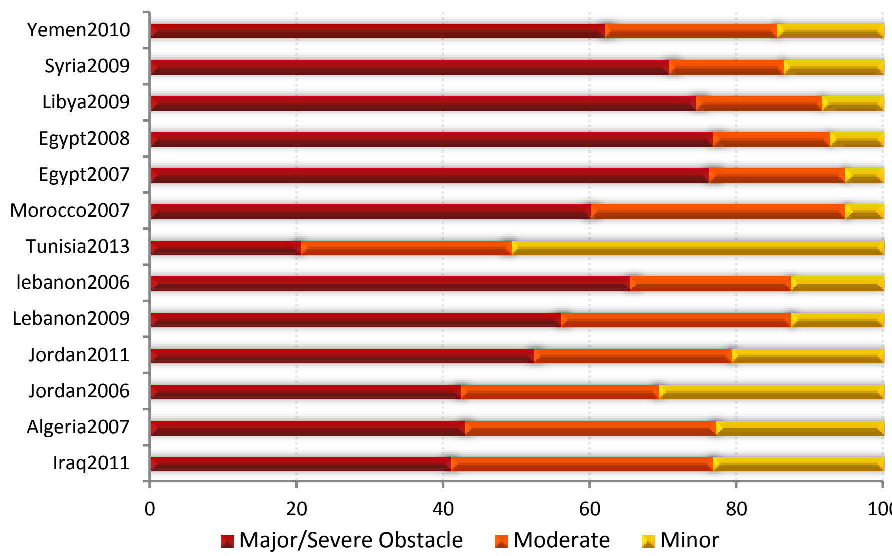
Policies in MENA countries often constrain firm startup and productivity growth, and thus job creation, by limiting competition. These policies take different forms across countries but share a common feature: they create and uneven playing field and privilege a few specific firms.

Solution

Reform the policies undermining *equality of opportunity* for all entrepreneurs. Reduce the space for discretionary policy design and ensure that laws and regulations are enforced equally across firms.

In MENA, 50% of surveyed firms regard regulatory policy uncertainty as an obstacle and 35% as a "severe" or "major" obstacle to their firms' growth. Regulatory uncertainty is perceived as one of the biggest obstacles to growth in MENA, along with competition from the informal sector, access to finance, and macroeconomic uncertainty. This report presents evidence that MENA firms' aversion to regulatory uncertainty is predominantly about discriminatory policy implementation benefiting a few insider firms and creating an uneven playing field among firms.

Share of Firms considering Regulatory Policy Implementation Uncertainty as an Obstacle to Growth



Source: Authors' calculations using Enterprise Surveys in 2006-2013.

PROBLEM

Low firm turnover, productivity growth, and resource misallocation, which hold back job growth in MENA, point to a lack of competition. The firm dynamics in the region reveal market structures in which a few leading firms have large, unearned advantages, while (potentially) large numbers of informal micro-firms use unproductive vintage technologies to serve local market niches.

In MENA, policies limiting competition and creating uneven playing field abound and constrain private sector job creation.

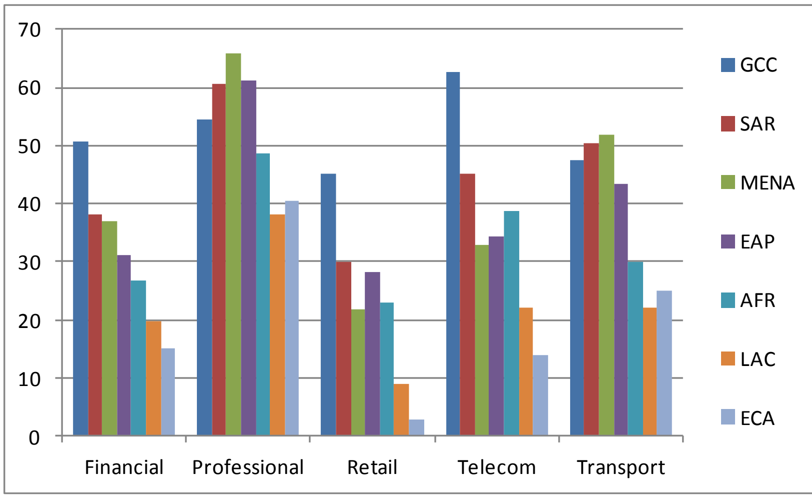
These policies take different forms across countries and sectors but share several common features: they limit free-entry in the domestic market, exclude certain firms from government programs, increase regulatory burden and uncertainty on non-privileged firms, insulate certain firms and sectors from foreign competition, and create incentives that discourage domestic firms from competing in international markets.

ANALYSIS

- **Legal barriers to FDI**

Restrictions on foreign firms entering service sectors in MENA countries are among the highest in the world. Partial protection from foreign competition in domestic service sectors has led to lower productivity growth of services.

Foreign Direct Investment (FDI) inflow in Jordan leads to a partial crowding-out of old and small domestic firms operating in the same sector, but has positive employment spillovers among domestic service providers and young firms. Domestic manufacturing firms (suppliers) did not benefit from FDI spillovers, possibly reflecting a combination of weak competition in the sector and the absence of well-designed and effective technical supplier support programs. Removing restrictions to FDI into services in Jordan



Service Trade Restriction Index (STRI) in MENA countries are among the highest in the world.

The graph shows the STRI which reflects simple country averages. The higher the index, the more restrictions are imposed on foreign firm entry: zero implies no restrictions on foreign owners, 100 implies foreigners are not allowed to operate in the sector at all. Entry restrictions on foreign firms are highest for professional services, transport, or finance but also exist in retail trade and telecommunications. These backbone services are important inputs for all other sectors; hence weak performance due to restrictions on foreign entry might lead to weak links in the economy dragging down productivity (in using sectors.) what is 'using sector'

Source: Authors calculation based on World Bank Service Trade Restriction Database (Mattoo et al., 2011).

is expected to create jobs among domestic firms.

- **Red tape in the regulatory environment distorts manufacturing job growth in Morocco**

High administrative burden is frequently raised as a major constraint to firm growth by entrepreneurs in MENA

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.

- **Energy subsidies in Egypt discourage growth in labor-intensive industries**

Forty-five percent of all connected firms in Egypt operate in energy-intensive industries such as cement or steel, compared to only 8 percent of all firms.

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) limiting free-entry, and equal access for all entrepreneurs. Moreover energy subsidies benefit energy-intensive industries thereby discouraging more labor-intensive activities and driving the economy away from its core areas of comparative advantage. In addition, smaller firms in Egypt are capital constrained suggesting that capital in the industrial sector is misallocated towards a few large old firms.

- **Discriminatory policy implementation creates an uneven playing field**

The frequency and number of reported inspections across firms is significantly lower within connected sectors. This suggests that a few privileged firms receive very few inspections while the majority of firms are inspected frequently.

Many firms in MENA identify "policy uncertainty" as a "severe" or "major" obstacle to growth. This reflects firms' perception of "policy implementation uncertainty" resulting from discriminatory practices. The variations in policy implementation observed in the data are substantial, and firms spend a significant amount of time and effort to influence policy implementation. Uncertainty in rule enforcement reduces competition and innovation in a number of MENA countries, suggesting its potential negative impact on productivity growth and private sector dynamism, especially the entry and growth of new firms

SOLUTION

Remove policies that undermine competition by tilting the playing field for the advantage of a few privileged firms.

These policies that need reforming include administrative barriers to firm entry, cumbersome bankruptcy laws, energy subsidies to industry, exclusive license requirements to operate in specific sectors, legal barriers to FDI in services, trade barriers - including non-tariff measures, or barriers to access to the judiciary, land, or industrial zones.

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

One critical aspect of this reform agenda is to create institutions that promote and safeguard competition and equal opportunities for all entrepreneurs.

For references and detailed analysis and policy recommendations, refer to Chapter II in the complete 2014 World Bank Regional Report: "Jobs or Privilege: Unleashing the Employment Potential of the Middle East and North Africa".