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Enhancing the Role of SMEs in the Arab World—Some Key Considerations

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ENHANCING THE ROLE OF SMEs IN THE ARAB WORLD—SOME KEY CONSIDERATIONS

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ENHANCING THE ROLE OF SMEs IN THE ARAB WORLD— SOME KEY CONSIDERATIONS

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EXECUTIVE SUMMARY

Small and medium-sized enterprises (SMEs) are a cornerstone of Arab economies, accounting for over 90 percent of all businesses and providing a major source of new job creation. Governments across the Arab World¹ recognize the important role that SMEs can play in delivering higher and more inclusive growth. Many have rightly placed SME development at the center of growth and jobs strategies to meet the needs of young populations. Authorities have initiated policy interventions and schemes to support SME development. But progress so far has been patchy, and more comprehensive policy action is needed.

Fostering vibrant and competitive SMEs that contribute to employment opportunities and high value-added output requires various stakeholders to deliver on a broad range of factors. Arab governments need a holistic policy approach that addresses the gaps in access to finance, creates an enabling business environment, and upgrades human capital and infrastructure. The approach should also promote an entrepreneurial mindset. Specifically, governments need to deliver on the following strategic thrusts:

- *Facilitate access to finance* by ensuring availability of adequate funding adapted to SME needs, providing a supporting framework for enhanced credit information and bank competition and developing capital markets to broaden access to new sources of finance for SMEs. Increasing SMEs' access to finance in the MENA region to the average level of emerging and developing economies would raise annual growth by up to 1 percent, according to IMF analysis. In addition, giving SMEs access to formal finance could create up to 8 million jobs in the Arab World by 2025.
- *Enhance SME capabilities and access to high-quality factors of production* through efficient expenditure in education, technology and key infrastructure. Targeted investment in education would better meet labor market needs and build entrepreneurial skills. Ensuring access to reliable key infrastructure, such as broadband, will reduce SME production costs, and policies that facilitate adoption of

¹ The Arab World: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Tunisia, United Arab Emirates, West Bank and Gaza, and Yemen.

technology and expand access to inputs and new markets could help improve productivity.

- *Develop a conducive business-friendly environment* by establishing robust legal, regulatory and taxation frameworks for SMEs as well as ensuring a level playing field for SMEs to face fair competition. Improved governance, including in tax administration and public procurement, and a reduced role of the public sector as a competitor in the economy would also help.
- *Ensure coherence, effectiveness, and sustainability* when designing SME support schemes by giving careful consideration to their funding, administration, communication, and evaluation.

Approved By
Aasim Husain

Prepared for the Annual Meeting of Arab Finance Ministers on April 25, 2019 by a team led by Vahram Stepanyan, comprising Gohar Abajyan, Marwa Alnasaa, and Anta Ndoeye, under the supervision of Ali Al-Eyd (all MCD). This paper benefitted from editorial support by Esther George.

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I. INTRODUCTION

1. **The Arab World needs higher and more inclusive growth and more diversified economies to boost incomes and create jobs for a growing population (Purfield et al, 2018).** The region has high unemployment and a large expected pool of labor market entrants. Growth has been uneven since the global financial crisis due to a range of factors, resulting in stagnant incomes and insufficient job opportunities in many Arab countries. State-led growth models have not delivered the broad-based and sustainable growth required to create more jobs and make economies more inclusive. Hence, an enhanced, private sector-driven growth engine is needed to achieve better outcomes for all.
2. **The development of a vibrant SME sector is crucial to achieving higher and more inclusive private-sector-led growth.** SMEs in most Arab countries contribute relatively little in terms of output and employment compared to those in other regions. However, a vibrant SME sector, especially start-ups and young firms (Haltiwanger et al., 2013), could be a major source of employment and innovation, helping boost productivity, growth, and economic diversification. For this to happen, a broad array of structural and institutional challenges must be addressed, including reducing informality in the economy, underscoring the need for a comprehensive approach.
3. **Although addressing these challenges hinges on the ability of various stakeholders to deliver on a broad range of factors, the public sector has a key role to play.** This includes ensuring growth-friendly and equitable fiscal consolidation to create space for increased investment and social spending (Purfield et al., 2018). Furthermore, steps to strengthen governance and scale back the dominance of state-owned firms are needed to complement efforts to broaden financial inclusion and raise business confidence. Additionally, a conducive environment needs to be created that recognizes the value of SMEs and promotes an entrepreneurial mindset.
4. **A more enabling environment for SME development can be fostered by ensuring a few key ingredients are in place.** Three areas are often identified as being central to SME development: (i) access to finance, (ii) productive capacity, and (iii) favorable business environment (see, e.g. Blancher et al., 2019; WEF, 2018; World Bank, 2016). Although Arab governments have taken various measures to foster private activity, their efforts to boost the SME sector have been piecemeal. Therefore, a more focused approach reflective of specific structural and institutional impediments in the Arab World seems warranted to energize SME development. The prioritization of policies and the design of schemes to support the SME sector can build on international experience but will need to be country-specific as a “one size fits all” approach is unlikely to succeed. Even within a country, the needs of SMEs could differ between the types of businesses and may call for customized solutions.
5. **This paper is organized as follows:** Section II presents stylized facts to illustrate the importance of SMEs and discusses SME development and the main constraints faced by SMEs; Section III assesses the potential benefits of removing the key impediments to SME development in the Arab economies and discusses the related policy actions; and Section IV concludes with policy considerations for enhancing the role of SMEs.

II. SMEs AS A CORNERSTONE OF ARAB ECONOMIES

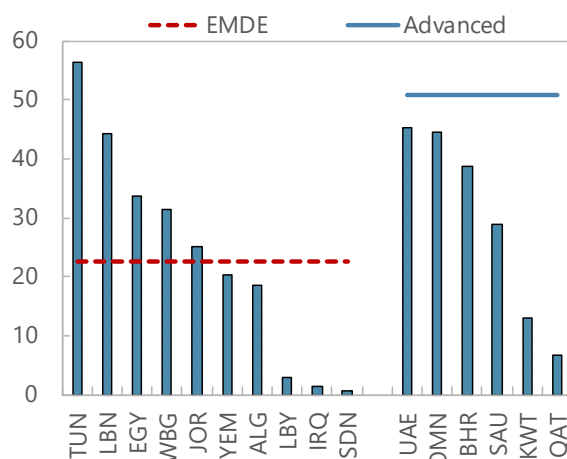
SMEs in the Arab World can play an important role in addressing the challenges of creating employment and diversifying economies. But SMEs' shares in output and employment generation lag those in most other regions, and the share of women-owned SMEs is one of the lowest in the world. There are several factors holding back SME development, and progress has been limited despite many Arab governments declaring SME development a key component of their inclusive growth and private sector development agendas.

A. The Importance of SMEs in the Arab World

6. **A vibrant SME sector can play an important role in tackling economic challenges.** In

particular, SMEs are a major source of new job creation in emerging and developing countries, accounting for some 45 percent of new jobs (Ayygari et al., 2014). SMEs' contribution to GDP in Arab economies ranges between 4 and 40 percent, reflecting both potential for a larger role for SMEs in some countries as well as their already significant role in others. It is estimated that micro, small and medium enterprises (MSMEs) account for 80–90 percent of businesses in the MENA region (Saleem/IFC 2017) and around 97 percent in the Arab World (MSME Country Indicators, 2014), with density (enterprise per 1,000 people) more heavily weighted towards micro enterprises (Gonzales et al, 2014). For example, the density of MSMEs in Jordan and Tunisia in 2011 was around 25 and 56 MSMEs per 1,000 people, respectively, of which 23 and 55 were microenterprises (Figure 1).

Figure 1. Micro, Small and Medium Size Enterprise Density
(MSMEs per 1,000 people)



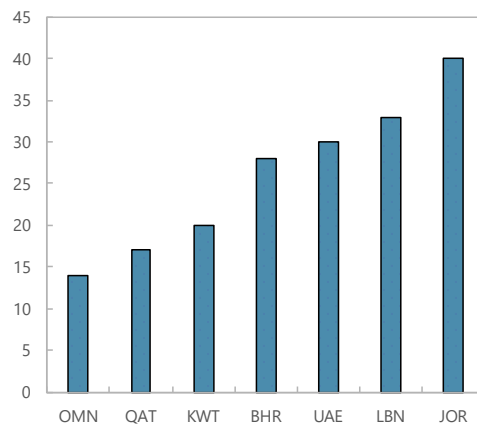
Sources: MSME Country Indicators 2014; and IMF staff estimates.

7. **SMEs offer an opportunity to capitalize on the region's demographic resources.** SMEs account for a sizeable share of formal employment in several economies in the region, including Iraq, Lebanon, Sudan, West Bank and Gaza, and Yemen, where over 50 percent of private sector employment is in SMEs (Figure 2). This share is likely to be higher when considering the informal sector. At the same time, youth and female unemployment rates have persisted above 20 and 17 percent (ILO), respectively, since 2010, and labor force participation rates have not exceeded 34 and 27 percent (ILOSTAT), respectively, over the same period. With youth comprising around one third of the population, SMEs can contribute to private sector employment opportunities needed to absorb young labor market entrants.

8. **There is also an underutilized opportunity to harness women's entrepreneurial potential to generate growth, social welfare and create a favorable environment for SME development.** The Arab World has one of the lowest shares of women-owned SMEs at 14 percent, compared to the world average of 34 percent. Moreover, the Female Entrepreneurship Index (FEI), as compiled by the Global Entrepreneurship and Development Institute (2015), shows the Arab World as having the second to lowest FEI score compared to other geographic regions (Figure 2).

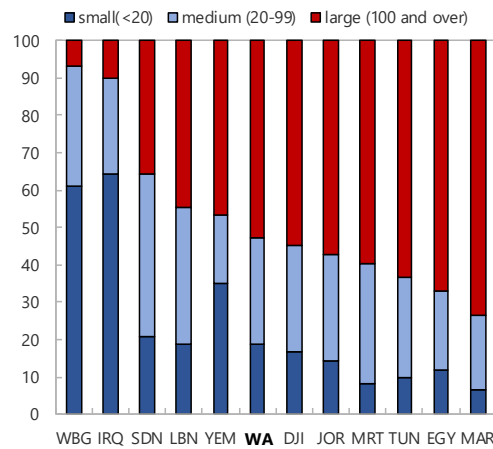
Figure 2. SME Sector in the Arab World

SME Contribution to GDP (Percent)



Sources: Country questionnaire, MSME Country Indicators 2014, "Not All SMEs Are Created Equal" report, and IMF staff estimates.

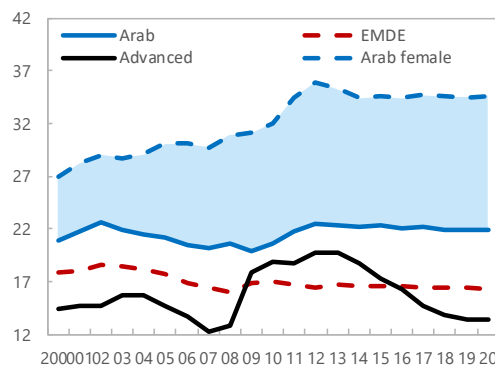
SME Share in Total Private Employment (Percent)



Note: WA = world average.

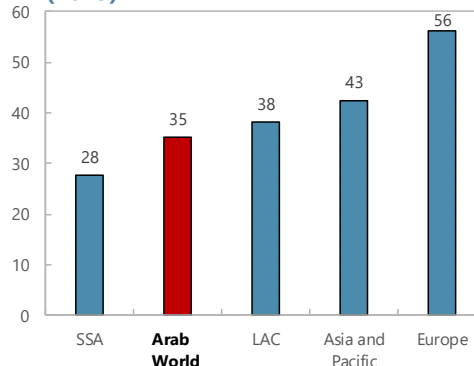
Source: World Bank Enterprise Surveys, latest available data.

Youth and Female Unemployment Rate (Percent of labor force)



Sources: ILO: Key Indicators of the Labour Market (KILM); and IMF staff calculations.

Female Entrepreneurship Index Scores across Regions (2015)

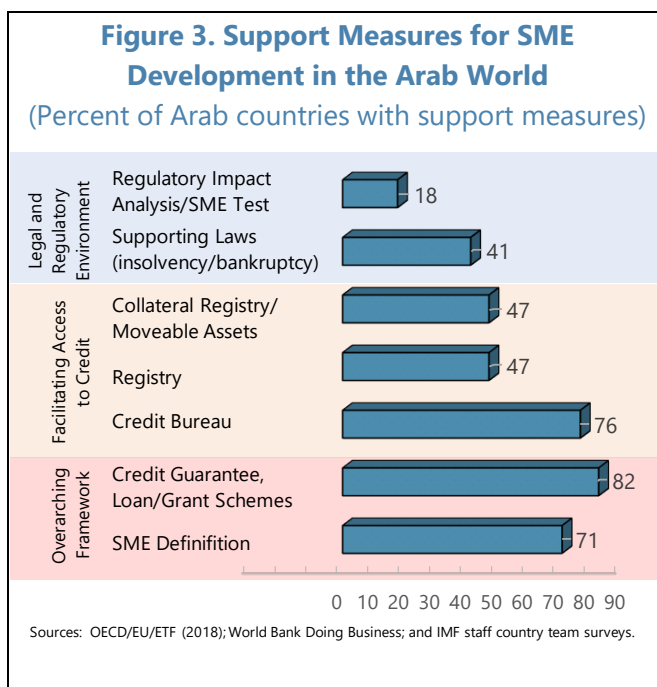


Note: Female Entrepreneurship Index measures entrepreneurial environment ecosystem and individual aspirations, by scoring nations from 0 to 100.

Sources: The Global Entrepreneurship and Development Institute: The 2015 female Entrepreneurship Index Report.

B. Government-led Efforts to Support SMEs Have Fallen Short

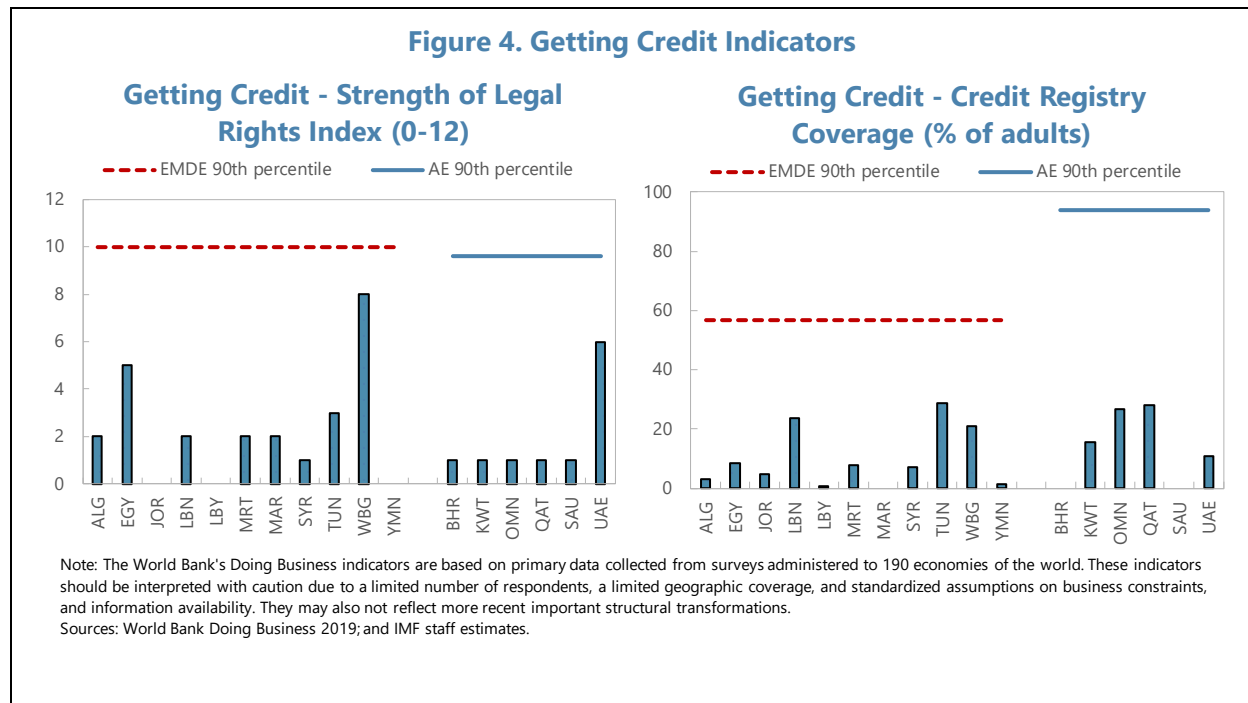
9. **Arab governments have recognized the importance of private sector-led growth.** Most countries in the region have committed to reforms to foster private sector-led inclusive growth, including the adoption of policies to support SME development. These reforms are at varying stages of advancement, with some countries adopting dedicated SME strategies (including Bahrain, Egypt, Lebanon and Morocco) and laws (UAE), and others incorporating SMEs into broader strategies (e.g. financial inclusion) or national development plans (including Algeria, Djibouti, Jordan, Qatar, Saudi Arabia, Sudan and Tunisia) (Figure 3). Countries also recognize the need for adequate coverage of SME activities (many SMEs operate in the informal sector) and are making efforts to reduce informality in their economies (Egypt).



10. **Governments have implemented some policies to support SME development.** These are focused on mitigating credit information asymmetry and reducing credit risk of SME borrowers and include the below. Nonetheless, despite some progress made in these areas, the Arab World still lags other regions in depth of credit information and legal rights to facilitate access to finance (Figure 4).

- Creation of credit bureaus, collateral and moveable asset registries. The existence of credit registries is almost universal across the Arab World; however, credit bureaus, which cater to information requirements of commercial lenders, are less prevalent (8 Arab countries have established credit bureaus). The impact of credit bureaus on reducing information asymmetry and thereby on access to finance is likely to evolve as coverage rates and scope expand over time (to include both households and businesses). For example, Credit Bureau coverage (percent of adults) in Jordan increased from 15.3 percent in 2017 to 19.9 in 2018 and the Depth of Credit Information index improved from 6 to 7 over the same period (World Bank, Doing Business 2019). Also, Saudi Arabia recently launched a commercial collateral registry.
- The provision of credit guarantee schemes (CGS). Several Arab economies have some form of public CGS for SMEs, including Algeria, Djibouti, Jordan, Lebanon, Morocco, Qatar, Saudi Arabia, Tunisia and West Bank and Gaza. The structure of CGS varies with some consisting of public and private shareholding (e.g. Jordan Loan Guarantee Corporation and Kafalat in Lebanon), while others are public financial institutions (e.g. FGAR in Algeria, Caisse Centrale de Garantie (CCG) in Morocco, Qatar Development Bank, and Kafalah in Saudi Arabia), or donor-funded (e.g. West Bank and Gaza's European Partial Credit Guarantee Facility).

- The passage of insolvency and bankruptcy laws. Such laws address deterrents to investment that may result from criminalizing bankruptcy whilst safeguarding both debtor and creditor legal rights. Countries in the region that have passed bankruptcy laws include Bahrain, Egypt, Jordan and Saudi Arabia.

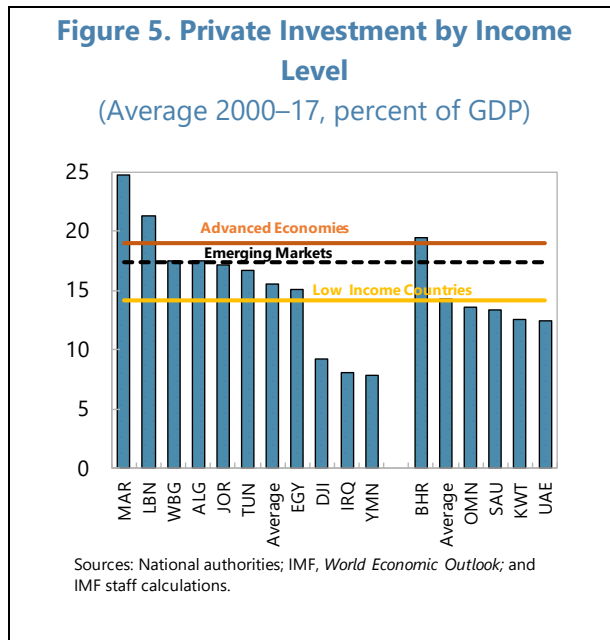


C. Key Constraints Faced by SMEs

11. Private sector investment in the Arab region is the second lowest worldwide.

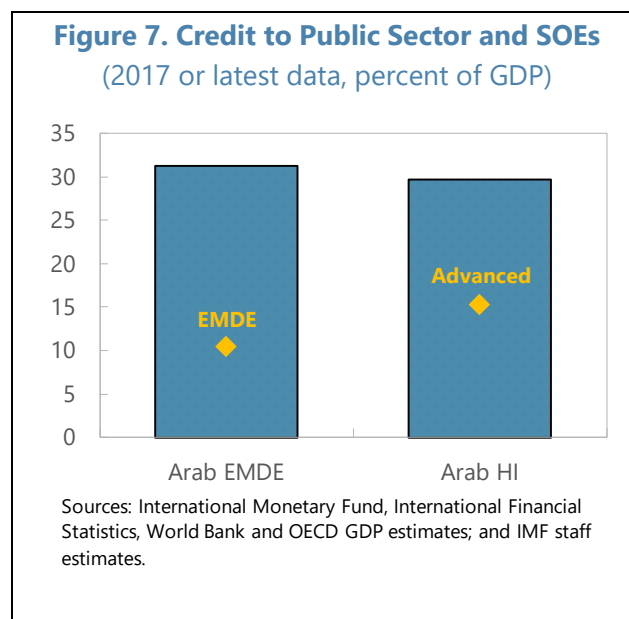
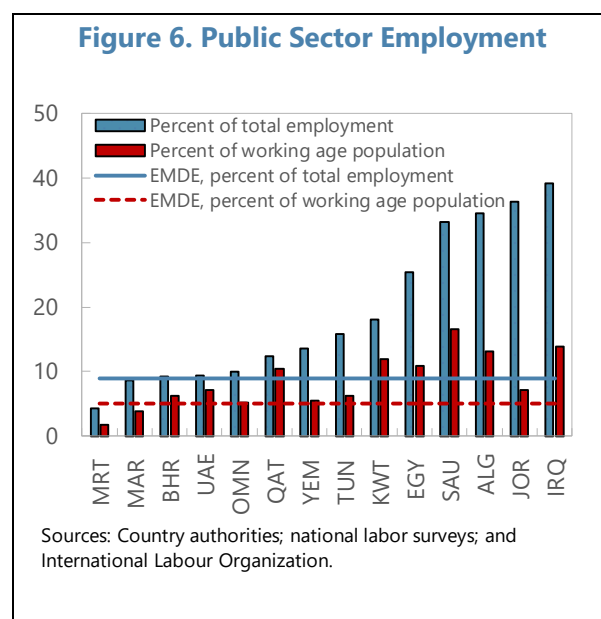
Between 2000–2017, annual private investment in the Arab region averaged 15.1 percent of GDP, with other EMDEs outperforming by as much as 3 percentage points (Figure 5; IMF, 2018).

Moreover, private investment has declined in the Arab region since the global financial crisis, in contrast with most other regions. The low level of private investment in the Arab World reflects several challenges to building a more vibrant private sector including SMEs. External headwinds—including those stemming from the global financial crisis—tightening of prudential regulations, declining FDI, fall in oil prices during 2014–2015 as well as ongoing conflict in some countries played a role. In addition, a combination of structural and institutional factors, driven by



commodity-dependent growth models in many countries, has resulted in increasingly challenging investment environment.

12. Large public sectors also impede private sector development in the Arab region (Figures 6 and 7). In many Arab economies the most important economic sectors like oil and gas production, electricity, transport and, to some extent, telecoms are dominated by state-owned companies. Due to the size of the public sector, preferential treatment given to large enterprises in government procurement, as well as through tax and transfers schemes, often creates an uneven playing field for SMEs. Furthermore, large public sector financing needs may crowd out credit to private sector, including to SMEs, while large public sector employment, often with generous compensation, may prevent SMEs from getting the talent they need (Tamirisa et al, 2018).



13. Alongside these major headwinds to private sector activity, there are three key areas that hold back SME development in the Arab region: (i) access to finance; (ii) productive capacity; and (iii) business environment.

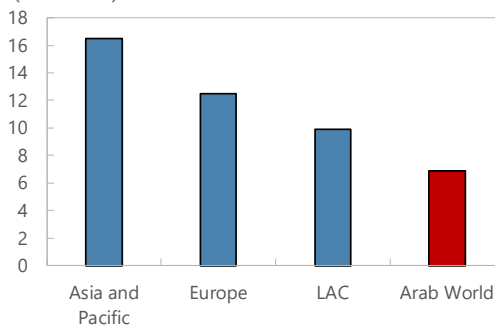
Access to Finance

14. Access to finance is a major constraint for SME development in the Arab World. SMEs in the Arab region have the largest gap in financial inclusion in the world. IMF staff analysis shows that financial inclusion in Arab countries, captured by an index of both access and usage of financial services by SMEs, lags the rest of the world (Blancher et al., forthcoming). Arab countries also lag countries with similar income per capita in terms of financial inclusion for SMEs. In addition, the concentration of credit has been rising, with the share of SMEs decreasing.

- Bank credit to SMEs in the Arab region is the lowest in the world (Figure 8). Large shares of firms are disconnected from the formal financial system and rely instead on their own capital (Purfield et al, 2018). The average share of SMEs in total bank lending in the Arab World is about 7 percent, but there are significant differences between regions and countries. The average share of SME lending in the GCC is only 3 percent, while the share of SME lending in the non-GCC Arab region is 9 percent.
- According to the World Bank Enterprise Survey data, a comparatively high percentage of firms in the Arab World (about 30 percent) report access to credit as a major constraint (against a world average of 26 percent). Similarly, a survey of entrepreneurs in the Arab region (Arab World Competitiveness Index, 2018) shows that the most severe obstacle faced by entrepreneurs is lack of access to finance (42 percent of respondents). Despite relatively large financial sectors and a reasonable share of private credit in GDP compared with other regions, credit tends to be concentrated in large corporations as the gap between access to finance for large firms and small firms is significant.
- Together, the high level of unemployment, low private investment, and wide financial inclusion gap stifle SME innovation and development, and prospects for broad-based, inclusive economic growth.

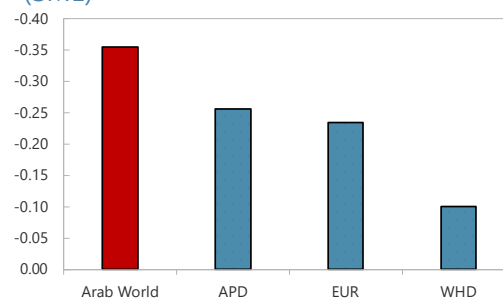
Figure 8. SME Financial Inclusion

**SME Lending to Total Bank Lending
by Region, 2016**
(Percent)



Sources: International Monetary Fund Financial Access Survey; and IMF staff calculations.

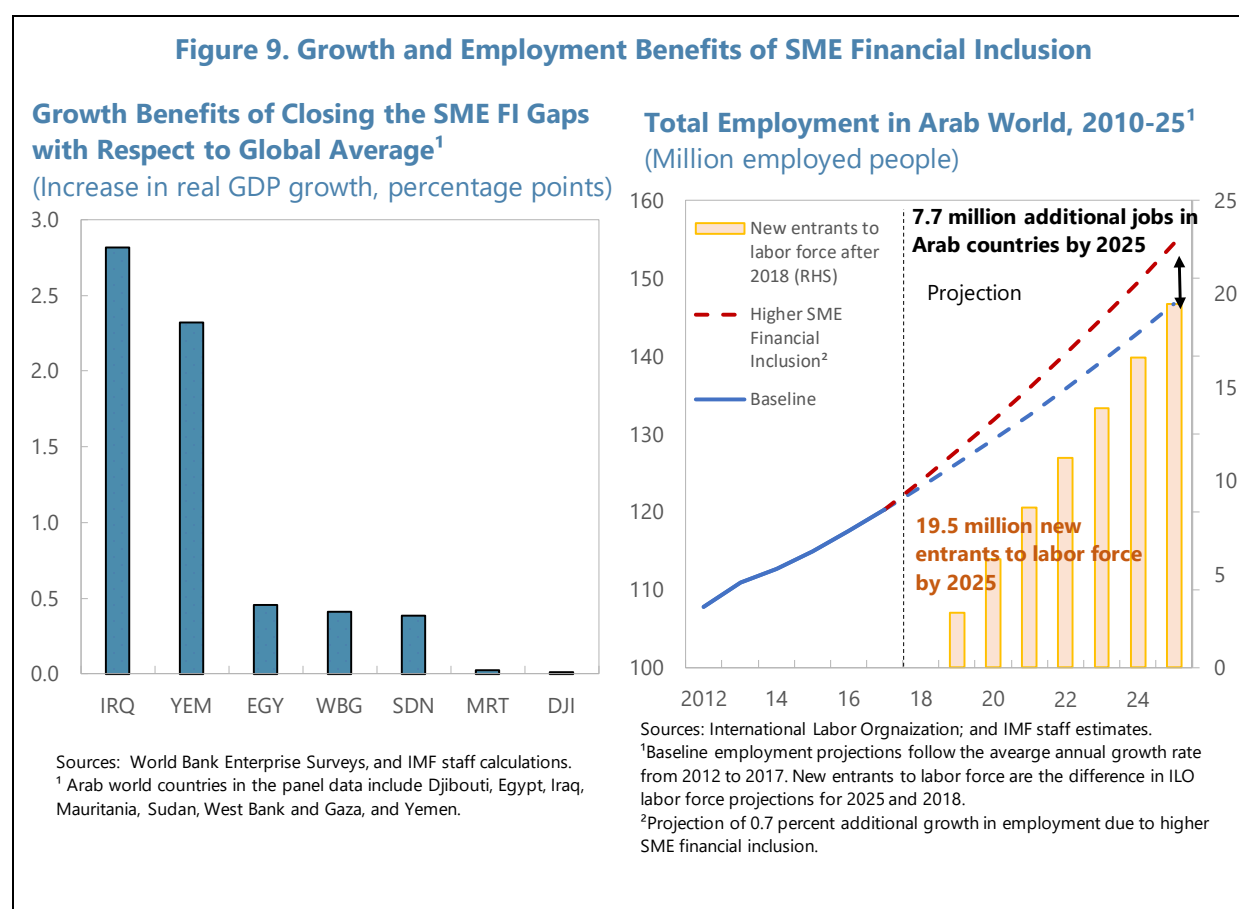
**Gap in SME financial inclusion relative
to 90th Percentile¹**
(SME)



Sources: World Bank Enterprise Surveys; and IMF staff calculations.

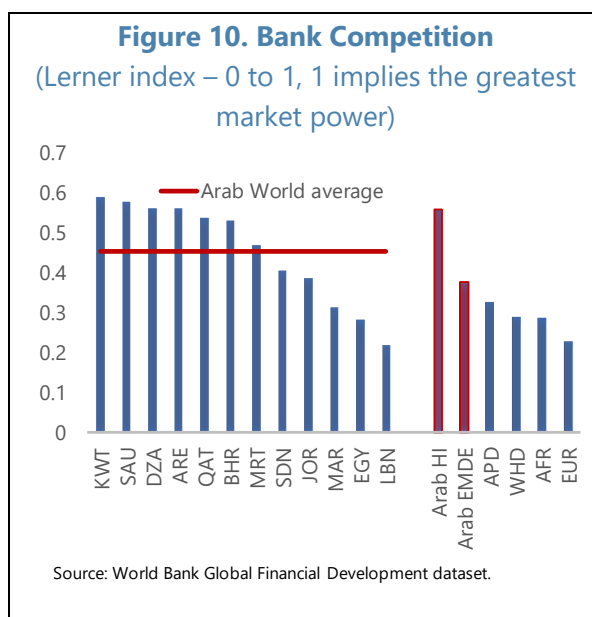
¹The financial inclusion gap is the difference in the SME financial inclusion index between respective region's average and the 90th percentile of a sample of 119 emerging and developing countries.

15. **Greater SME financial inclusion is likely to lead to substantial macro-financial dividends across the Arab World, including on growth and employment.** Findings from various empirical analyses suggest that enhancing SME financial inclusion is beneficial for growth. Blancher et al. (forthcoming) finds that increasing SME access to finance in the MENA region to the average level for emerging and developing economies would increase growth by up to 1 percent annually. Furthermore, SMEs are the largest contributor to employment across all country income groups. Firm-level analyses suggest that giving firms access to formal finance leads to employment gains that are much larger for SMEs than for large firms and could potentially create up to 8 million jobs in the Arab World by 2025 (Figure 9).



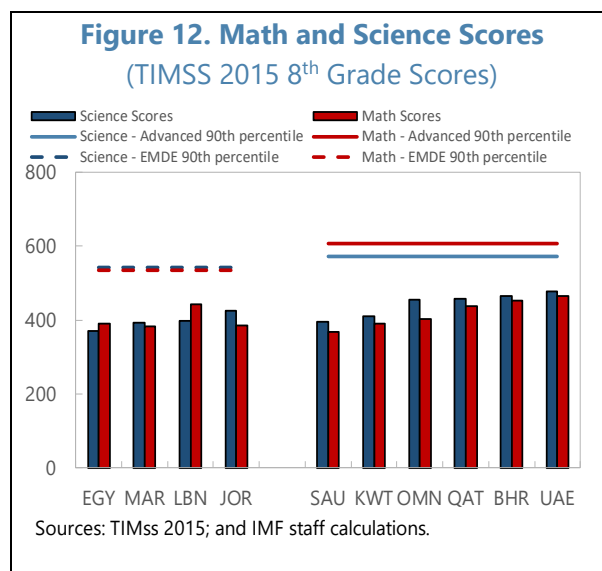
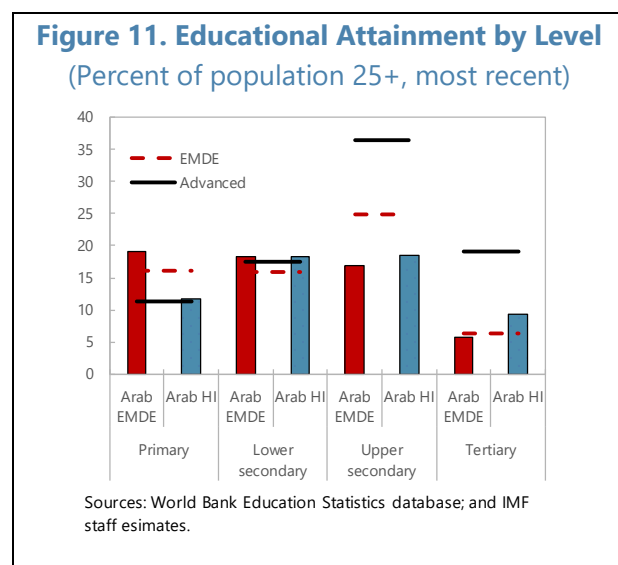
16. **A number of macroeconomic and institutional factors constrain access to finance in many Arab economies.** These include a

supportive business environment (see below), credit information and financial sector characteristics. Blancher et al. (forthcoming) suggest that credit information is a key factor for SME access to formal finance, as it allows banks to better assess the borrower's credit risk. This in turn can reduce collateral requirements and borrowing costs. Improved quality and availability of credit information can lead to large benefits in terms of financial inclusion, particularly for SMEs. Financial sector characteristics, such as financial sector soundness and bank competition, affect access to finance for SMEs. The importance of these factors for SME financial inclusion appears stronger in the Arab region than in other EMDEs. Arab countries are lagging other regions in terms of bank competition (Figure 10). Relatedly, banking sector concentration, which is high in the region, is often associated with higher interest rate margins and may create disincentive to lend to smaller firms.



Productive Capacity

17. **A key challenge facing the private sector is the mismatch between outcomes of the education system and the skills needed for working in the private sector.** In general, education systems across the Arab World do not equip workers with the skills that make them highly productive and adaptable to technological advances. Despite improvement in education attainments, their levels still lag those in peer countries and the quality of education remains weak (Figures 11 and 12), particularly in providing skills that are relevant for private sector employment (EBRD et al., 2016).



18. **Large infrastructure investment gaps and falling productivity also restrain private sector activity in the Arab World.** For example, in Egypt, Jordan, and Morocco the estimated cumulative investment gaps by 2040 range from 36 percent of GDP in Morocco to a high of 69 percent in Egypt (Purfield et al, 2018). Falling labor productivity and low R&D expenditure and use of technology are also hampering private growth: labor productivity has been declining in the Arab World since the global financial crisis, and even earlier in the GCC, the region is largely falling behind in the adoption of new technologies, and R&D spending has stayed relatively low. Furthermore, infrastructure has been decimated in the region's conflict-affected countries.

19. **Improving access to key infrastructure such as broadband and expanding the use of information and communication technologies would allow SMEs to boost productivity.** Some Arab economies lag substantially their peers in access to such basic infrastructure as reliable electricity supply (Figure 13). Furthermore, much of the Arab World has stayed behind the technological wave (Purfield et al, 2018). This is illustrated by substantially lower broadband access rates, with only 6 percent of the population having access, lower than in other emerging markets (11 percent) and far below the share in advanced economies (33 percent). Additionally, the ICT development index suggests that majority of Arab economies have substantial room to develop and increase use of information and communication technologies (Figure 14).

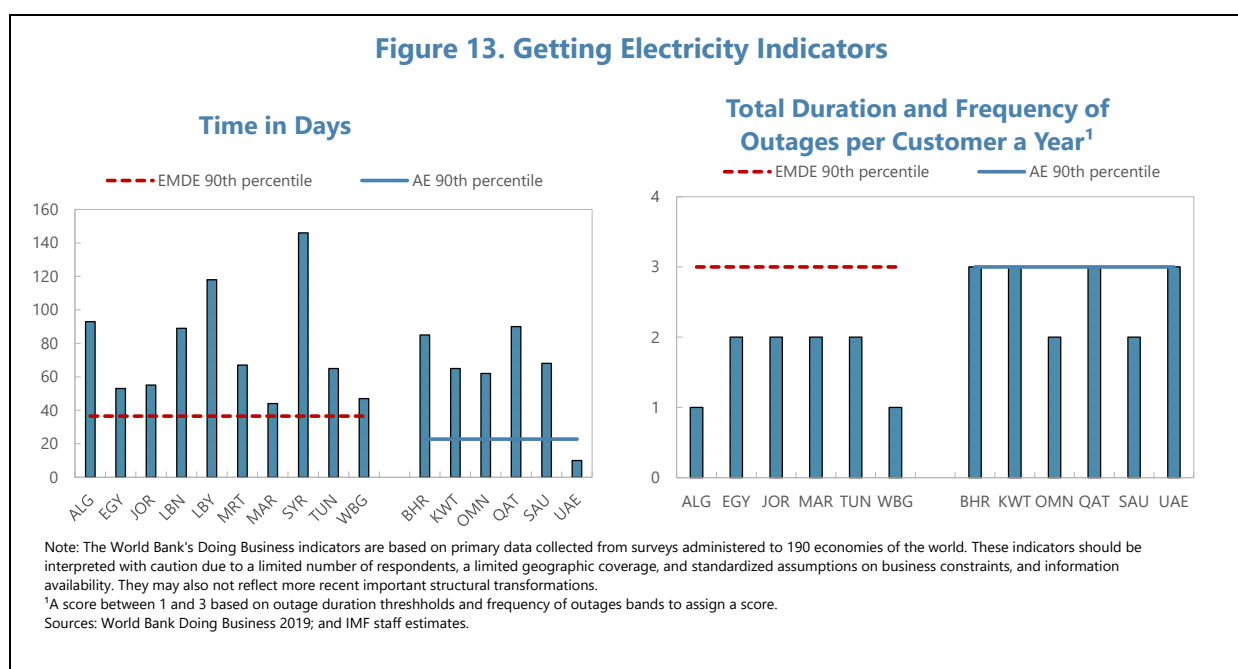
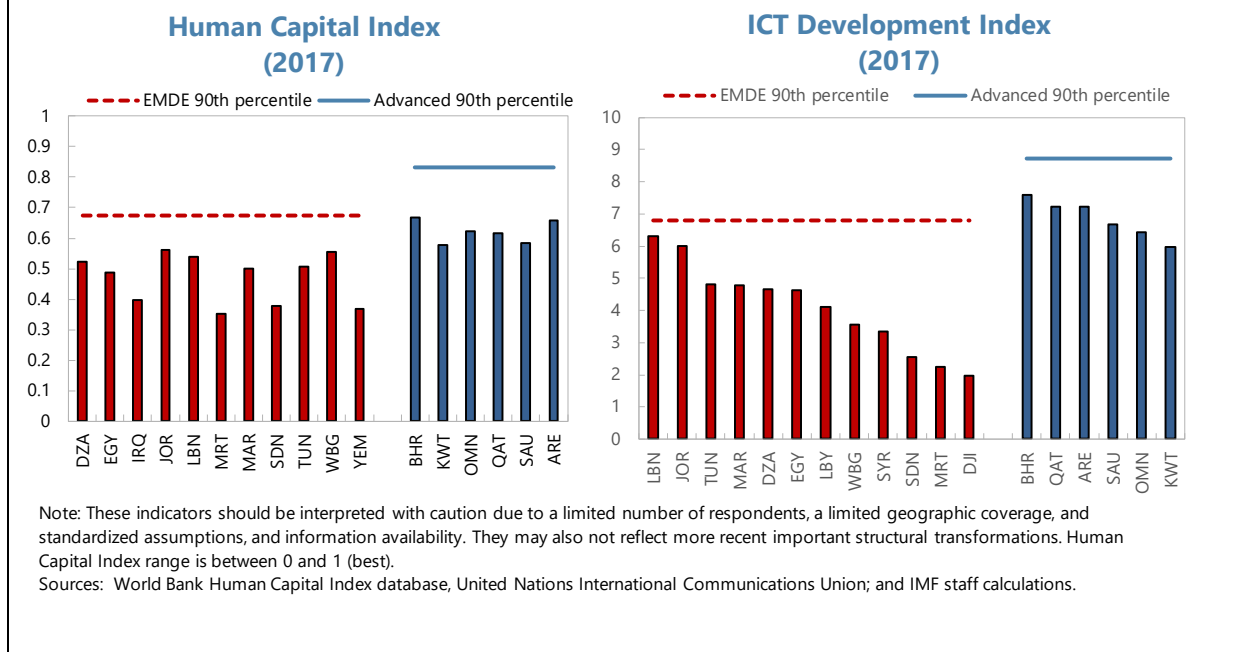


Figure 14. Human Capital and ICT Development Indicators



20. **Countries of the region lag their peers in research and development (R&D) and innovation.** On average, high-income Arab economies spend only 0.5 percent of GDP on R&D, while the average is 2 percent for advanced economies. The average for Arab EMDEs for which data are available is 0.4 percent of GDP, compared to 0.5 percent for emerging markets. The Arab World also lags peers in exporting high-technology products: high technology exports account for an average of 2 percent of manufactured exports from Arab economies, while in emerging markets they make up nearly 19 percent of exports on average.

Business Environment

21. **Disadvantageous operating environments for SMEs stifle entrepreneurship and innovation in many Arab countries.** Most Arab countries rank below AEs and EMs top performers on aspects related to registering property, starting a business, paying taxes, trading across borders, enforcing contracts, and resolving insolvency (Figure 15). While differences in the business environment across the Arab World can be large, in most cases there is ample room for improvement. For example, transparent and effective bankruptcy and insolvency frameworks could help secure the rights of investors without posing an excessive burden on entrepreneurs. The efficiency of the legal system is particularly important for SMEs, which typically need to divert a higher share of their resources than large firms to resolving disputes (OECD, 2017).

Figure 15. Selected Doing Business Indicators

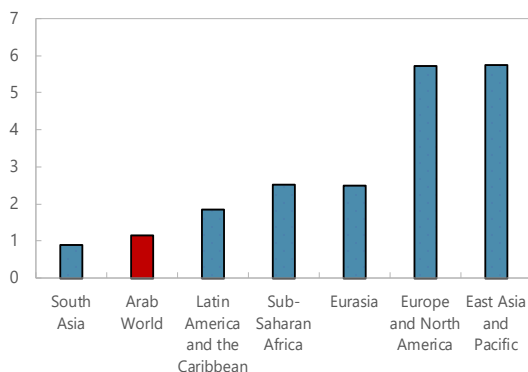


Note: The World Bank's Doing Business indicators are based on primary data collected from surveys administered to 190 economies of the world. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographic coverage, and standardized assumptions on business constraints, and information availability. They may also not reflect more recent important structural transformations.
Sources: World Bank Doing Business 2019; and IMF staff estimates.

22. **Entrepreneurship is an important growth ingredient and, together with innovation, forms a key building block of competitive and dynamic economies.** Cross-country evidence shows that entrepreneurship is important to job creation in the economy as new jobs are largely created by young firms, typically those three to five years old (World Economic Forum, 2018). Competences like creativity, initiative and entrepreneurship can help individuals to think creatively and innovate, be pro-active, forward-looking, and agile, as well as develop capacity to manage resources effectively and persevere to achieve results.

23. **Development and promotion of entrepreneurship is an area where Arab countries seem to have substantial room for improvement.** The region has low rates of firm entry (Figure 16) and, as the Arab World Competitiveness Report 2018 suggests, the Arab World entrepreneurship ecosystems are underdeveloped with particularly significant gaps in risk acceptance, technology absorption, and competition that are hindering existing and potential entrepreneurs (Figure 17). Interestingly, the Global Entrepreneurship Monitor (GEM), based on a survey of seven Arab countries, finds that people in the region have positive societal attitudes towards entrepreneurship—on average, almost three-quarters see entrepreneurship as a good career choice. Furthermore, the GEM finds that the percentage of intentional entrepreneurs in the region is relatively high; however, the proportion of early-stage entrepreneurs is found to be substantially lower than those in Africa and Latin America and Caribbean regions (GEM, 2017).

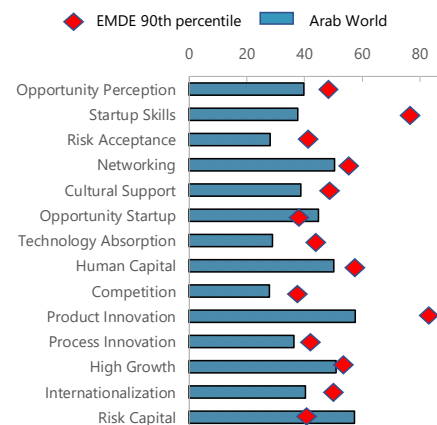
Figure 16. New Business Entry Density
(2016 or latest year available)



Note: The World Bank's Doing Business indicators are based on primary data collected from surveys administered to 190 economies of the world. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographic coverage, and standardized assumptions on business constraints, and information availability. They may also not reflect more recent important structural transformations. New business density rate measures the number of new businesses per 1,000 working age population per year.

Sources: World Bank Doing Business 2019; and IMF staff estimates.

Figure 17. Arab World Component Average Scores, GEI 2018 (2017 or latest data)

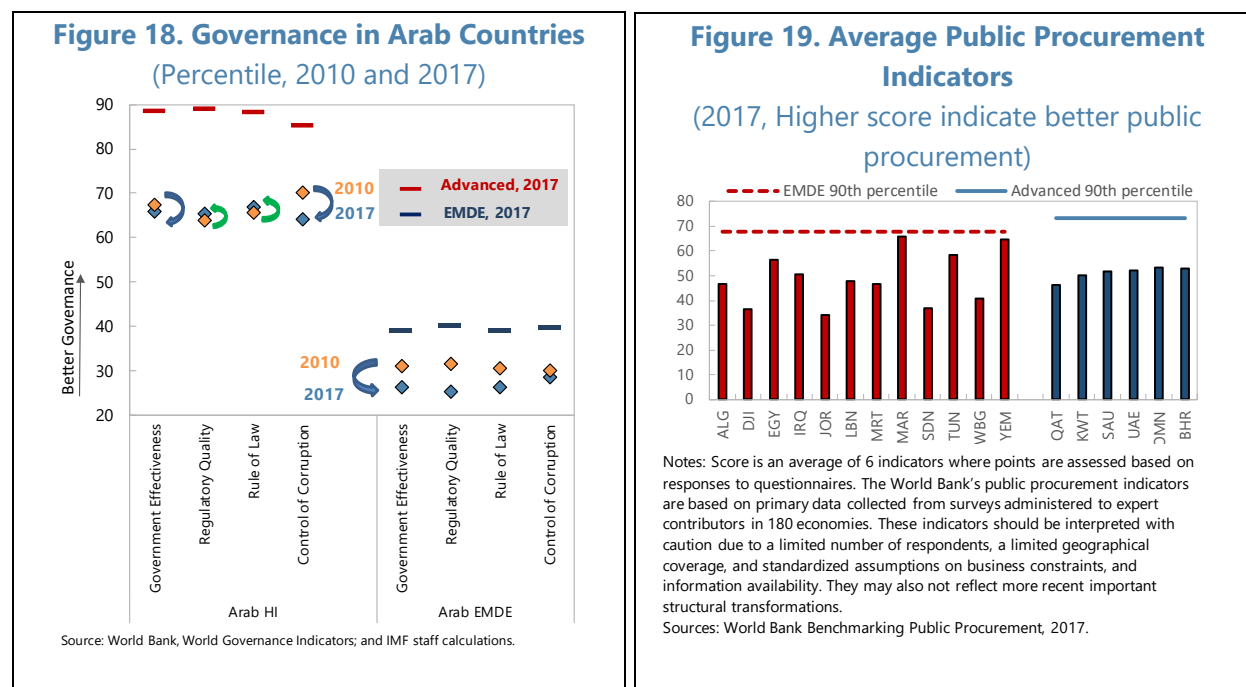


Note: The Global Entrepreneurship Index measures the health of the entrepreneurship ecosystems in each of 137 countries. Higher scores indicate better entrepreneurship ecosystem. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographic coverage, and standardized assumptions, and information availability. They may also not reflect more recent important structural transformations.

Sources: Global Entrepreneurship Index 2018; and IMF staff estimates.

24. **Arab countries do not fare well on global governance rankings.** Government effectiveness, regulatory quality, the rule of law, and control of corruption are low by international comparison, and have worsened over the last decade (World Bank, 2017c). In the majority of Arab countries, these rankings have deteriorated over the past decade (Figure 18). High perceived levels of corruption are associated with low employment growth and labor productivity (World Bank, 2016).

Furthermore, public procurement practices substantially lag those in peer countries and may discourage SME engagement in public contracts (Figure 19). Tax administrations in many countries of the region are perceived to exercise significant discretion leading to unfair treatment of taxpayers (Jewell et al. 2015).



25. **Improving the business environment for SMEs would help boost productivity growth and allow the sector to expand.** This includes providing more efficient basic services, promoting the rule of law, ensuring fair competition, scaling back the dominance of state-owned firms, reducing corruption, and streamlining business regulations. Business-friendly procedures, high quality industry regulation and strong legal systems promote competition and an efficient allocation of resources. For example, implementing reforms that would move a country one point up the world Economic Forum's Global Competitiveness Index could raise productivity growth by 1.4 percentage points (Purfield et. al, 2018).

III. EASING SME CONSTRAINTS

An enabling environment for SME activity can be created by taking a holistic and comprehensive approach to ensuring access to finance, human capital, and infrastructure as well as a friendly business environment, including sound legal and regulatory frameworks and governance. Furthermore, fostering entrepreneurial capability, management and organization of SMEs, as well as their capacity to innovate are crucial to the growth and vibrancy of SMEs.

26. **Fostering the development of a vibrant and competitive SME sector requires a comprehensive approach and hinges on the ability of various stakeholders.** The public sector has a key role to play and, going forward, governments' efforts should focus on the three main

elements to create an enabling environment for SMEs: the adequate provision of funding; productive capacity; and conducive legal and regulatory frameworks and governance practices. To achieve these goals, governments can: (i) prioritize expenditure on growth-enhancing and high-quality investment in human capital and infrastructure, while sustaining well-targeted social spending; (ii) ensure strong and stable governance frameworks; and (iii) carefully design SME support schemes to avoid market distortions and contingent fiscal risks.

A. Main Elements of an Enabling Environment for SME Development

Adequate Provision of Funding

27. **Alleviating constraints to SME finance requires addressing broader characteristics of the economy.** A large informal sector, low financial literacy, and market regulations and concentration affect SME investment and demand for credit. Therefore, partial approaches, such as policies focusing solely on direct public financing or guarantees or on supply-side constraints, are unlikely to yield large benefits. Rather, meaningful, safe and sustainable SME access to finance requires a holistic approach covering all the key building blocks listed above, from macroeconomic to legal and regulatory aspects. This approach can also trigger a virtuous circle of greater SME transparency and reduced informality, bringing about broader benefits to the economy and stronger demand for credit.

28. **Alternative channels, especially capital markets and fintech, could facilitate greater SME financial inclusion,** either by complementing the supply of bank credit or by opening new financing channels. Efforts to deepen domestic capital markets would expand the channels for the private sector to access capital, including equity capital as well as other private capital, such as venture capital. Capital markets can play such a role at later stages of SME development, while fintech can both help reduce constraints on bank credit (e.g., credit information or competition), and open new channels for SME finance.

Productive Capacity

29. **Well-targeted public spending on education and infrastructure are paramount for building human and physical capital and enhancing competitiveness and productivity.** For most countries in the region facing fiscal constraints, this will entail reallocation of spending from unproductive uses (for example, untargeted subsidies and high wage bills) toward investment, while protecting well-targeted spending on social services. In addition, educational programs should be streamlined and reoriented to better align with the needs of the private job market. This can be done through partnerships with the private sector, concentrating on enhancing soft skills, critical thinking, and problem solving and increasing the focus on STEM and sector-specific technical skills (Purfield et al, 2018). Furthermore, measures that reduce information frictions and enable SMEs to access international markets could help with engagement in trade networks thus contributing to SMEs' growth (see e.g. Malaysia's Going Export program, Box 1).

30. **Programs focusing on entrepreneurship development could help build entrepreneurial mindsets and skills (Box 1).** Young people going through entrepreneurship education programs are likely to develop more entrepreneurial attitudes, get a job earlier after finishing their studies and start more companies, thereby creating more jobs (European Union, 2012). For example, in the EU Member States, entrepreneurship education is increasingly recognized as a cross-curricular objective in primary education and is most commonly taught in upper secondary education through a variety of approaches. As of 2015, a majority of the EU Member States had developed either specific or broader strategies with specific links to entrepreneurship education (Eurydice, 2016). Many Arab countries (e.g. Algeria, Egypt, Jordan, Lebanon, Morocco, Tunisia) have been encouraging entrepreneurship development including through education programs; however, entrepreneurship as a key competence is not yet embedded into the national curriculum framework for upper secondary education in the region (OECD, 2018).

Conducive Legal and Regulatory Frameworks and Governance Practices

31. **Efforts to promote a competitive business environment would provide greater space for private activity, while helping to reduce the dominance of the public sector.** In particular, efforts to improve government effectiveness—including by reducing bureaucracy and streamlining business regulations, enhancing transparency and accountability to reduce perceptions of corruption, and strengthening legal and regulatory frameworks—would improve fairness and governance practices and complement measures to lift productive capacity.

32. **Reforms to legal requirements and administrative procedures such as those concerning business registration, taxation and labor would also improve SME performance** (OECD et al., 2018). Furthermore, Arab governments need to remove obstacles to entry by creating a level playing field and fostering competition, including in sectors that benefit from public procurement. Legal and judiciary reform to improve contract enforcement could also enhance the business environment and foster risk taking (OECD, 2013).

Box 1. SME and Entrepreneurship Development in Malaysia

Policies and programs for SME and entrepreneurship development in Malaysia are based on the SME Master Plan 2012–20 (see SME Corp. Malaysia) which aims to accelerate the growth of SMEs via innovation-driven and productivity-led strategies for Malaysia to achieve a high-income nation status by 2020. The SME Master Plan aims to increase business formation, expand the number of high growth and innovative firms, raise productivity, and encourage formalization. It focuses on the following areas: innovation and technology; access to financing; human capital; market access; legal and regulatory environment; and infrastructure. Under the Master Plan, six programs have been introduced:

- Integration of Business Registration and Licensing: aims at encouraging the formation of new businesses and intensifying the rate of formalization through a single gateway for business registration and licensing.
- Technology Commercialization Platform: aims to provide end-to-end facilitation for commercialization of SMEs' products and services.
- SME Investment Partner: program is a public-private sector co-funding initiative designed to attract private investments in viable SMEs with flexibility to offer both equity and debt.
- Going Export: aims at internationalizing export-ready SMEs by providing customized assistance to SMEs venturing into new markets.
- Catalyst Program: aims to develop homegrown champions in LED/SSL lighting, biotechnology, aerospace, medical devices, oil & gas, ship building & ship repair and rail.
- Inclusive Innovation: aims to assist the bottom 40 percent of the income distribution by providing affordable, quality products and services to the excluded population.

Some specific measures from these areas, that have been included in the Malaysia's current five-year plan, involve: encouraging SMEs to adopt greater automation and ICT utilization in production processes and business services; strengthening the curriculum for technical and vocational education and training and creating an entrepreneurial culture in the society; encouraging procurement of local SME products and services and investing in supplier development programs.

The contribution of SMEs to overall GDP increased from 32.2 percent in 2010 to 37.1 percent in 2017. The contribution of SME employment to total employment also increased—from 63.8 percent in 2014 to 66 percent in 2017.

In 2017, Malaysia's government funding of various SME support programs amounted to 0.4 percent of GDP (SME Corp. Malaysia, 2018). Financial commitments in 2018 suggest that government funding for SME support programs may more than double in this year to 1 percent of GDP with the lion's share allocated to providing access to financing.

B. Designing SME Support Schemes

33. **The needs of SMEs differ between countries and regions.** Prioritization of policies and support schemes for SMEs is warranted as a “one size fits all” approach is unlikely to succeed. For example, SMEs often lack support that is tailored to various stages of SME development as start-ups are likely to need financing and advisory instruments that are different from what mature SMEs may need. In addition, helping SMEs with access to global markets, value chains, and knowledge networks would provide additional means for SMEs to realize their potential and enable them to grow larger over time. Finally, promoting the use of digital technologies by SMEs can provide them with better access to skills and markets and greater access to novel technologies and applications (OECD, 2017).

34. **The success of SME support schemes hinges on their design, effective implementation and impact assessment.** Tailoring support to SMEs’ stage of development (e.g., start up versus mature firm) is important. In addition, careful consideration should be given to support schemes’ administration, communication, and monitoring and evaluation aspects. For example, a recent study by the European Economic and Social Committee identified several major challenges related to SME policies in the European Union (EU, 2017): (i) SME policies and support mechanisms treat the large population of SMEs in Europe as a homogenous group and do not necessarily reflect on the different needs of the numerous sub-groups falling within the SME definition; (ii) the tools offered are often too complex, unclear and bureaucratic in design and content to meet the SME needs; (iii) there is a communication gap between SME support mechanisms and their intended beneficiaries and a lack of user-friendly approach in providing support; and (iv) the monitoring of the impact of SME policies is fragmented and weak. Related to the latter, assessing the impact of SME policies and specific measures is not an easy task, but remains essential to ensuring their effectiveness (Box 2).

35. **Another important aspect of SME support schemes is the transparency of the cost to the public sector and acknowledgement of possible risks, especially for SME funding schemes.** Country experiences discussed in Section II show that generally the majority of SME support public instruments are funded by the government agencies with allocations from the budget, with limited central bank involvement. It is important to safeguard central banks from contingent liabilities related to supporting SME development programs, especially in cases where central banks’ balance sheets and reserve positions are not strong. Furthermore, the direct fiscal cost of government SME support schemes and their contingent liabilities to public finances should be estimated and weighed against opportunity costs and performance vis-à-vis targeted outcomes.

Box 2. Assessing the Impact of SME Support Policies—Some Lessons from the EU

Assessing the impact of SME policies and specific support measures is not an easy task as a confluence of other, exogenous, factors may be impacting SME activities at the same time. To this end, counterfactual impact evaluation studies could be helpful. Counterfactual impact evaluations involve control and comparison groups whereby the control group SMEs did not receive support but are similar enough to the supported SMEs for the comparison to be valid. For example, Mouqué (2012) examines several such studies conducted in seven EU members that involved 12 support schemes targeting 235,000 SMEs and finds that:

- Financial support to SMEs can be effective—every euro of public support increased investment by EUR 1.3 and the jobs created were durable and of good quality.
- There may be room to make the policy more cost-effective—in some schemes support was as effective (or nearly as effective) when the grant was reduced or substituted by a loan.
- While purely financial support reliably increased production, in most cases it hardly improved productivity. The most effective support schemes included nonfinancial elements such as business advice, networking and measures to promote innovation.
- For medium-sized enterprises, innovation support, networking and innovation consortia proved effective at increasing long-term growth and productivity. For small and micro enterprises, basic business advice may be the single most cost-effective form of support.

IV. CONCLUDING REMARKS AND POLICY CONSIDERATIONS

36. **A multipronged approach can catalyze SME development in Arab countries.** Such an approach would address the gaps in access to finance, foster an enabling business environment, and improve human capital and infrastructure. These efforts can be bolstered by promoting an entrepreneurial mindset and reducing the role of the public sector as a competitor in the economy.

37. **Strategies in each country should be customized to meet specific needs and circumstances, but key principles can guide policymakers.** These include (i) boosting financial access by improving the availability of funding adapted to SME needs (including from new capital sources, such as capital markets), and enhancing bank competition; (ii) developing SME capacity and potential through targeted expenditure—by both the public and the private sectors—on education and key infrastructure; and (iii) fostering an enabling business environment by focusing on developing business friendly legal, regulatory and taxation frameworks to foster job creation and ensure a level playing field for SMEs with a special focus on start-ups and young firms. Improved governance, including in tax administration and public procurement, would also help.

38. **It is also important to ensure coherence and effectiveness in the design of SME support schemes.** Careful consideration needs to be given to their funding, administration, communication, and evaluation aspects. In addition to alleviating constraints on access to finance, such schemes should aim to promote entrepreneurship, access to information and markets, and adoption of new technologies.

39. **Arab governments have rightly placed SME development as a cornerstone of their growth and jobs strategies.** SMEs, especially young firms and start-ups, can play a significant role in delivering higher and more inclusive growth to meet the needs of a young population. But to achieve this outcome, government policy interventions and support schemes need to be considered as part of a more comprehensive program to deliver a robust and vibrant SME sector. Governments should also aim at improving SME data availability and dissemination.

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