

Privileges instead of Jobs

Politically connected firms receive generous policy privileges undermining competition and job creation



Problem

Policies in MENA countries often limit competition and job creation by constraining firm startup and productivity growth.

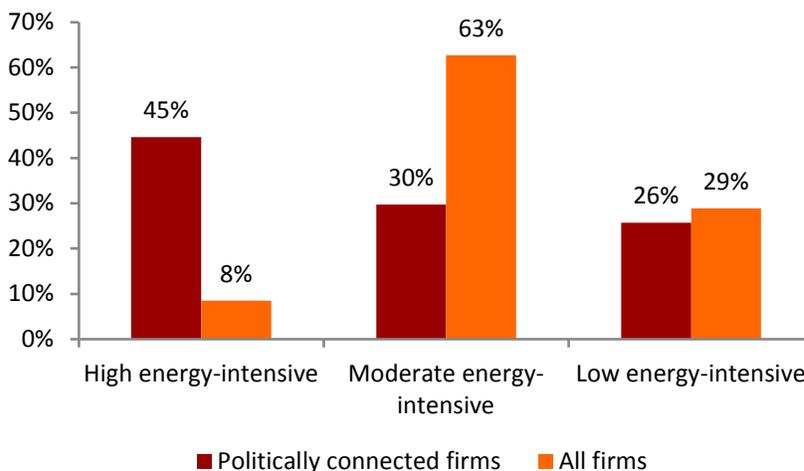
Analysis

Policies have often been captured by a handful of politically connected firms. This has created privileges rather than a level playing field, undermining competition, the ability of all entrepreneurs to pursue opportunities on an equal footing, and job creation.

Solution

Reform all policies that unduly constrain competition. Achieving and sustaining this reform agenda requires institutions that safeguard competition. Equally important, ensure policy making is transparent and open.

Summary



Egypt: Politically connected manufacturing firms are much more likely to operate in energy intensive industries, reflecting their privileged access to energy subsidies and thus capital.

We identify politically connected firms in Egypt as firms which were managed or owned by influential businessmen controlling high political posts in the government or the National Democratic Party (NDP) before 2011.

The graph shows that 45% of politically connected manufacturing firms operate in energy-intensive industries compared to only 8% percent of all manufacturing firms.

PROBLEM

Policies in MENA countries often stifle formal sector job creation by limiting firm entry and exit and productivity growth. Such policies include legal barriers to FDI in services; administrative barriers to firm entry and competition; energy subsidies to industry; trade barriers, including non-tariff measures; exclusive license requirements to operate in specific sectors; or barriers in access to the judiciary, land, and industrial zones; or discretionary rule enforcement.

ANALYSIS

These policies have often been captured by a few politically connected firms in

MENA countries. This has led to a policy environment that created privileges rather than a level playing field, undermining job creation.

Analysis is based on novel data

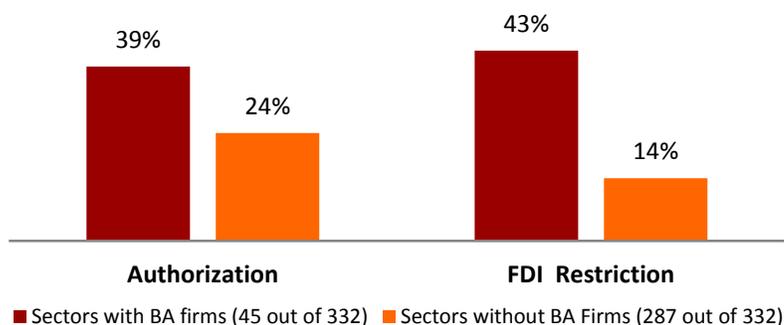
New data and information on first-tier politically connected firms in Egypt and Tunisia became available after the Arab Spring. They provide, for the first time, quantitative evidence on the entire microeconomic transmission mechanism from political connections to policy privileges limiting *neck-and-neck competition*, to weak firm dynamics and slow aggregate job growth.

Policies in Egypt and Tunisia have led to

privileges for a few connected firms; many of these policies are still in place

The governments in Egypt and Tunisia erected barriers to entry and competition even as they engaged in economic liberalization. In particular, the data on politically connected firms (defined above) show that

- 78% of connected firms in Tunisia operated in service sectors (*onshore economy*); in Egypt, their presence was more widespread (60% in services and 30% in manufacturing).
- They accounted for the lion's shares of profits in both countries.



Tunisia: Politically connected firms are much more likely to operate in sectors which are protected from competition through entry barriers. We identify politically connected firms as firms whose assets got confiscated after the Jasmine Revolution in 2011 as they were owned by the Ben Ali family. The graph shows that 39% of the sectors with at least 1 Ben Ali firm require authorization by the government, relative to 24% of non-connected sectors. Similarly, 43% of connected sectors are protected from foreign entry relative to only 14% of non-connected sectors.



- In Egypt, connected firms disproportionately profit from trade protection through non-tariff technical import barriers on goods they are selling; privileged access to energy subsidies, land, or permits; fewer inspections by public officials.
- In Tunisia, politically connected firms are protected by exclusive authorization requirements to operate in profitable service sectors and restrictions on foreign direct investments in their sectors.
- Connected firms appear not to have benefited disproportionately from fiscal advantages in Tunisia or credits by state banks in Egypt.
- After accounting for these privileges, connected firms are not more (and sometimes even less) profitable than other firms in both countries.
- *Privileges suppress the firm dynamics associated with job creation:* in sectors dominated by connected firms in Egypt, firm entry is 28% lower despite the higher rents in these sectors; firms report less competition.
- In Egypt, job growth declines by about 1.4 percentage points annually when connected firms enter new, previously unconnected sectors.

- indicators; make more frequent use of non-tariff trade barriers; frequently have patronage networks between the military and business.
- In Yemen, politically connected firms control the oil, telecommunication, and *Qat* production sectors.
- In Iran, the military establishment benefitted from privileged access to privatized state owned enterprises.

Political connections limited competition in MENA but not necessarily in East Asia

Politically connected firms are not specific to MENA but were also common in East Asia. *How can we explain the different economic outcomes?* Available evidence suggests that connections were not sufficient for East Asian firms to escape competition. For instance, privileges were credibly linked to performance targets (even for insiders) while export orientation exposed firms to competition in contested global markets.

SOLUTION

Reform policies that constrain competition

These policies include, among others, administrative barriers to firm entry; cumbersome bankruptcy laws; energy subsidies to industry; legal barriers to FDI in services; trade barriers; exclusive license requirements; or barriers to access the judiciary, land, and industrial zones.

Reduce the space for discretionary policy implementation

An even-handed enforcement of laws demands that public officials have incentives to exercise discretion fairly and transparently. Such incentives are more likely when laws are clear; entry and promotions into the administration are based on merit instead of connections; and when merit is judged by contributions to legitimate public policy goals.

Create institutions that safeguard competition

Such institutions include, but are not limited to, an independent competition authority; appropriate procurement laws, an independent judiciary, an accountable and competent public administration.

Ensure open and transparent policy making

It is hard to conceive how institutions that safeguard competition can emerge without citizen access to information on proposed laws and regulations; citizen knowledge of politicians' stakes in firms; and citizen awareness of the beneficiaries of subsidies, procurement tenders, public land transactions, privatizations, etc.

Finally, this report provides a decision-making guide, summarizing the above, which governments can use as a framework when designing and implementing policies.

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

Qualitative evidence points to similar mechanisms in other MENA countries

- MENA countries lag behind other regions in governance or corruption