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Quality of institutions and structural transformation: distortions and resource allocation in North Africa

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Summary and policy implications

Structural transformation and labor market outcomes in North Africa

Understanding why North African economies are not growing as dynamically as they possible could to generate enough jobs is a central question. Unemployment in the region remains at a relatively high level of 12% in 2016. Moreover, the region is characterized by a high unemployment rate for the youth (25.4% in 2014) and women (17.1% in 2013), and low labor force participation (47.5% in 2015, as compared to 62.8% in the rest of the world). Jobless growth in North Africa is a critical question. It is likely that the recent wave of instability in the region was partly driven by this situation on the labor market which should give those trying to solve this problem a sense of urgency.

This report argues that the growth process may be influenced by the allocation of resources between sectors. This growth through a reallocation of resources from less to more productive sectors is called structural transformation (or structural change). However, it also shows that an efficient allocation of resources within sectors is critical for growth and job creation in North Africa. Based on a most recent knowledge, the report shows that governments in North Africa should focus on a broader idea – the optimal allocation of resources across firms within and between sectors.

Governments play a crucial role here as distortions to this allocation come from market imperfections and which can either be solved or exacerbated by state intervention. State intervention is, for example, necessary in tackling market imperfections, such as non-competitive practices or addressing information constraints or ensuring enforcement in credit markets. However, the state also ensures that markets exist after all, for example by providing property rights. We distinguish two broad categories of how the government can contribute to the misallocation of resources:

- Lack/insufficient intervention by the State: it doesn’t intervene enough to correct market failures.
- Policy “errors”: Policies may not address a problem in the right way, which may itself create distortions. Policy “errors” can occur:
    - when designing a policy
    - when implementing a policy

In both cases the inadequate action by the state can have three reasons:

- Nature of instruments: instruments used, by nature, can generate distortions
    - Examples: taxation usually creates distortions and subsidies to some firms distort the level playing field
- At the level of policy implementation:
    - Example: Bureaucrats use discretionary power to discriminate between firms and favor some firms over others.

- At the level of policy design:
    - Example: firms with political power influence regulation in their favor

Misallocation as a huge source of slow productivity growth

To summarize the empirical findings of the report, a grid is provided to captures various outcomes and policy measures from a large list of sources such as the United Nations, independent think tanks, the IMF, and the World Bank. Some of these measures are based on calculations presented in the report.

The first thing to highlight is that several countries in North Africa are dynamic, producing considerable growth in employment, GDP per capita and improvements in the human development index in the last decade. Libya here is the big exception as the country has descended into civil war in the last decade. But Tunisia, for example, has grown its GDP per capita by 2.87% percent on average in a decade and Morocco has improved its Human Development Index by 7.2 percentage points to 0.647.

However, this general positive movement is being recently out-paced by population growth in the region and remains low relative to more dynamic countries outside the region. Even though, on average, employment seems to grow as to compensate labour force growth (they have been growing, on average, 2.6% and 2.47%, respectively), the trend in employment growth has become flatter in recent years. Labour productivity growth in the Algeria and Libya was negative and was around just over -1.24 and -9.05 percent, respectively. That contrasts sharply with 6.23, 5.4 and 5.4 percent, respectively, in Egypt, Morocco and Tunisia. Countries not in the region, as Turkey and India, exhibit 7.9 and 16.8 percent increase, on average, in productivity growth rates in the same period.

How could productivity growth be enhanced? The report shows through careful analysis that the core pillar of growth is productivity within sectors, i.e. the increase of productivity in firms within the same sector. This can then be compared with the between sector productivity growth, the change in productivity that occurred because labor was reallocated from less to more productive sectors (*between* sectors).

The within sector growth in North Africa is relatively high (on average of about 2.1%) but lags behind other regions. Within sector productivity growth in India and Turkey, for instance, is of about 15% and 11%, respectively.

This implies that misallocation within sectors could be the key to understand productivity growth or the lack thereof in North Africa. Optimally, micro firm level data would be used to understand this misallocation. However, the report shows that a measure of the misallocation of labor and capital across firms can be approximated through a dispersion measure of firm productivity estimates gained from the World Bank Enterprise surveys. The report shows a productivity dispersion just over 1 for the economies in North Africa. This is relatively high when compared to other countries and indicates relatively large potential gains in productivity and output from re-allocation of labor and capital.

The misallocation of resources has two basic components. Labor market distortions are, in principle important and, indeed, 32.8 percent of firms in Tunisia and 30.5 percent in Morocco report that access to an adequately educated workforce is a major or severe constraint. An issue that seems particularly pressing in North Africa is the female labor market participation, reducing the effective labor supply.

Women have been at the forefront of structural transformation and economic development in other countries and their relative absence from the labor market in North Africa prevents human capital from being optimally used. A second significant distortion in labor markets is caused by excessive public-sector employment. In Egypt, the share of the public sector in total employment is estimated at close to 30 percent, almost twice as high as formal private sector employment. Further, public sector pay-premium distort the labor market, while rigidities in hiring and firing undermine job creation and support informal employment.

Yet, the constraints imposed by the labour market or labour market regulations are quoted less frequently by firms compared to the constraints firms face in accessing credit or finance. Around 31 percent of firms in Morocco, and 26 percent of firms in Tunisia, report that finance is a major or severe constraint. But it seems a problem across the board. This observation also squares extremely well with very low scores for NA countries in the region on the “access to credit” dimension of the World Bank’s Doing Business index. Similarly, weakly developed stock or equity markets imply that capital markets continue to play a small role in allocating capital across economic sectors. And there is a very strong association between reporting finance as a constraint and low productivity at the firm level. Simple simulations conducted for the report suggest that relaxing capital constraints might increase output by between 9 and 22 percentage points through a dramatic increase of labour productivity and the inflow of capital.

However, providing a stable, rules-based environment for firms is a precondition for the optimal allocation of capital. The ability of markets to provide access to capital is crucially affected by the ability of the state to provide property rights protection, an effective judiciary and adequate bankruptcy laws. The findings in the report suggest that such an environment should also be able to attract foreign firms which would boost competition and improve the allocation of resources further, leading to increased productivity growth.

The public sector, rather than supporting private sector growth, has been identified as a major impediment to private sector development by giving rise to an excessive bureaucracy. Indeed, this report has highlighted two dimensions of this in the enterprise surveys, administrative incompetence and corruption, which seem to be positively related and an important difference to the rapidly developing economy of China, for example. Firms report that corruption and incompetent administration are considerable constraints in North Africa, especially in Sudan but also in Morocco and Egypt. However, when this report revised the Doing Business rankings this suggested that especially Morocco has already improved its performance a lot and that Tunisia is catching up as well. Egypt, Mauritania, Sudan and Libya are extremely low ranked.

This pattern is broadly consistent with a direct measure of fiscal capacity, the share of tax revenue in GDP which is relatively high in Morocco and Tunisia but much lower in the other countries (except for Algeria due to its resource wealth). Two factors affect the competence of the bureaucracy. First, the selection and promotion of bureaucrats and, second, the funding available for paying bureaucrats. Here dramatic differences across North Africa are visible. According to the IMF public sector pay consumes a whopping 13% of GDP in Morocco.

An underlying problem in North African countries were the distortions to markets brought about by protracted political instability. The enterprise surveys, conducted in 2013, suggest this was an extremely important issue and the report estimates that the affected economies at the time and in the sample, Tunisia and Egypt, paid a high price for the uncertainty.

However, this report has also argued that the problem of political uncertainty goes beyond the visible instability. The absence of constraints on executive action, created by the absence of a strong legislature and independent judiciary, leads to a considerable increase in political uncertainty and, hence, expected volatility. In this regard, Tunisia has improved its situation considerably. Both Morocco and Algeria have improved slightly. In Egypt, despite considerable political changes, constraints have not strengthened and in Libya, Mauritania and Sudan constraints are almost absent. This report suggests that this has very real and large economic costs in terms of the ability of these countries to attract foreign capital as investors seem to be aware of the risks implied by the absence of executive constraints. The report presents simulations that suggest that FDI could increase by between 45-99% if the countries adopt strong executive constraints.

However, perhaps the most important underlying distortion in the economies of North Africa is generated by politically connected and publicly owned firms. Good data here is hard to come by but recent academic research presented in several case studies suggests that the economic benefit gained through political connections is considerable in this region. Such large benefits to political connections imply that unconnected firms cannot compete or can't even enter the market, and this endangers innovation, dynamism and, ultimately, even the ability of these economies to export. In Egypt, a considerable share of the economy is directly controlled by the government and this complicates the flow of talent and capital towards new, more productive firms. Similarly, in Algeria, the economy is dominated by the public sector, with the government owning numerous large state-owned enterprises and public banks. In Tunisia the government effectively controls the credit market, through direct ownership of the three main banks and ownership of minority stakes in nine other smaller banks. This creates distortions as the banking sector props up loss-making state-owned enterprises, extends credit on non-commercial terms, or provides credit based on political connections, worsening the already inefficient allocation of capital.

Policy implications

The most important overarching policy conclusion from the misallocation viewpoint is that there are large, hidden cost to resources flowing to politically connected firms. The cost of misallocation of resources is not the cost of the resources themselves. The costs are what a more productive firm could have achieved with these resources. For example, if a credit of 1 million $ is given to a firm for political reasons then the cost of this allocation is what the most productive firm in the economy could have generated with these 1 million $. This simple idea should motivate and guide government policy in North Africa. In what follows, this section will lay out three priority areas to improve allocative efficiency in the long-run.

1. **Labor market reform; flexibility with security**

Flexibility of the labor market has been often advocated as necessity to improve labor market outcomes. Relaxing constraints faced by firms to adjust labor is important, however this should be done by increasing security for workers in parallel. Most North Africa countries suffer from a lack of sufficiently protective unemployment insurance system. Massive churning is a key aspect of structural transformation, and protection of workers is important to prevent vulnerability and contribute to workers' bargaining power. Labor market deregulation should be accompanied by the development of sound social protection systems.

2. **Strengthen Executive Constraints**

Strengthening executive constraints has as a precondition some form of separation of power. Separation of power is achieved if no single authority (typically the executive) has sole control over the policy making process. It implies the distribution of power across several authorities, with transparent consultative processes and defined roles and authorities. Excessive control of the policy making processes within a single entity can lead to large political uncertainties, especially if there is a lack of transparency and communication. Of course, this is more straightforward in some countries in North Africa than in others. Tunisia, for example, has experienced a radical change in the possibilities in this regard due to a change to its political system. The country has managed to lift executive constraints to a level that is extremely close to a level at which large foreign capital inflows can be expected. However, strengthening constraints is also possible without a complete overhaul of the political system. For example, the central banks in most economies in North Africa enjoy some level of independence and the executive is therefore constrained in interfering with monetary policy. Algeria and Morocco, in particular, have managed to strengthen executive constraints without changing the way the executive is recruited.

– **Strengthening Judicial Capacity**

A key step to developing executive constraints is the strengthening of an independent judiciary. Improvements in the legal system can support private sector development and foreign investment, as it can help reduce perceived country-specific risks. The transformation towards a system that fully supports the rule of law and is recognized as such is a slow one: reputational capital needs to be built up steadily over time. The World Justice Project data from 2017 and 2018 here points towards several weaknesses and can provide a guide for institutional reforms. In Morocco, for example, the government takes considerable influence in the process of criminal justice. In Tunisia a relative weakness is corruption in the civil justice system. Egypt has an urgent need for reform on all fronts of the capacity of the judicial system. In addition, the creation of special units with a strong independence can yield benefits. The installation and empowerment of a corruption watchdog which can launch independent investigations, for example, may be a visible commitment to reduce excessive discretionary power of the executive and thus, can deliver similar positive effects as rendered by broader changes in the system.

– **Building Checks and Balances into Local and National Systems**

Another option is to use the checks and balances built into the different layers of local and federal government. In the case of Brazil, for example, the anti-corruption program randomly audited municipalities for their use of federal funds. It had considerable impact on corruption. The Chinese government has launched several initiatives which experiment with institutions at the local level including press freedom to hold local bureaucracies to account. Episodes of instability in North Africa might provide strong incentives for governments in the region to ensure stability through prosecuting civil society and repression. However, research strongly suggests that a more effective way to ensure stability in the long run is to allow political grievances to be voiced within the institutions of the state. The local level can be the perfect testing ground for this. For example, in the context of Nigeria that if local governments are appointed in an ethnically biased fashion, shocks to government revenues (due to oil price movements) are increasingly associated with in instability and political violence; with locally elected governments, this relationship becomes weaker. In China, the introduction of local village elections increased public goods expenditures financed by villagers, and caused a moderate decline in income inequality, and likely reduced corruption.

3. Build Effective State Capacity

Building state capacity is crucial for supporting the powers of the market to allocate resources efficiently. A key building block for strengthening state capacity is to fight corruption and increase competence within government.

– Improving Motivation and Selection of Bureaucrats

Given the relatively well-financed bureaucracies in North Africa, the conclusion of this report is that the motivation and selection of bureaucrats must improve. From the data presented in the grid is particularly interesting in Morocco in this regard. On the one hand the governments wage bill is extremely high when compared to GDP and the country is ranked fairly high in the Doing Business rankings (place 69 compared to 166 in Algeria). On the other hand, however, firms report corruption and tax administration to be substantial obstacles. So, this is an area where dramatic improvements are possible. This is also very clearly true for Egypt which has a rank of 128 in the Doing Business and firms reporting a high burden from corruption. Mauretania, Sudan and Libya are ranked extremely low in the Doing Business.

For those countries that finance their bureaucracy well but where performance lacks, recruitment and promotion inside the bureaucracy play crucial roles. In the long run, it is a mistake to use recruitment and promotion to provide patronage and to select loyalists regardless of their competence. The practice leads to an ineffective and oversized bureaucratic apparatus, which harms the public sector throughout from undermining tax collection, the administration of credit regulation, over to firm licensing and to the provision and defense of property rights. In most of the countries included in this report, there is an absence of transparency in appointing senior government positions. Civil service reform is thus an important avenue to enhance the public sector from fulfilling its role, complementing and supporting private sector development. Important dimensions along which such reforms may take place are the strengthening of a merit-based recruitment process free of political influence, generally increased recruitment standards, transparency over the recruitment processes and the strengthening of career concerns e.g. by increasing the connection between performance and promotions.

– Tackling Conflicts of Interests

Fighting distortions in the bureaucracy also means fighting conflicts of interest which may be the source of corruption. Conflict of interest is defined as any situation that arises allowing an opportunity for an official to influence decision-making to serve his/her personal interest through other influential individuals and officials in civil service or public office. One common example is the case of corruption in public procurement, whereby government contracts to private sector firms may be skewed towards benefiting firms that are owned or controlled by relatives or the family of public officials. The remedy requires special legislations that will prevent and criminalize such conduct, since it is considered a form of corruption. It is also important to adopt codes of conduct that public employees must commit to. According to Transparency International, there is no comprehensive legislation that prevents conflict of interest regarding senior officials in public office in most of the countries included in this report. Article 36 of the Moroccan constitution-2011 stipulated that "Violations of conflict of interest shall be punishable by law…" and has only very recently passed a law (in 2015) defining these violations. In Tunisia, on the other hand, while advancing on some anti-corruption fronts, witnessed a setback with the adoption of a controversial reconciliation law. Despite strong public opposition, the law grants amnesty to corrupt public officials who served during the old regime of Ben Ali. However, from the grid data we know that Egypt, Mauretania, Sudan and Libya face much more severe challenges here.

– Increasing Transparency and Strengthen Civil Society

Increasing transparency of decision making processes within the bureaucracy can strengthen civil society. The adoption of Freedom of Information laws can improve the ability of civil society and the media to access public data and contest decisions. Key aspects for allocative efficiency are the budget process, tenders and purchases, contracts with the private sector and investment companies. Increased accountability and the threat of exposure of corrupt practices may reduce the extent of abuse of discretionary power wielded by bureaucrats and local officials. The adoption of electronic government facilities may, by facilitating the interactions between citizens/firms and the government, reduce the bureaucracy burden and further limit discretionary power of civil servants. The improved data collection capabilities that e-government may provide, can further complement the improvement in statistical capacity which increases the ability of the bureaucracy to make informed evidence-based decisions. Research also shows that such a process can save the central government considerable resources. In India, for example, the adoption of an electronic register and release of public funds which cut out the local bureaucracy reduced resource needs by a striking 17 percent of expenditures. **New Information**

Technologies, as Big Data, AI, Block Chain offer new tools to efficiently deliver public services and public policies to firms. We propose the following practical recommendations which can make use of new Information technologies:

- For the policy process:
  - Make it more inclusive to prevent narrow interests from capturing policies:
    - Systematic publication of laws before they are passed to the parliament
    - Systematic public consultation of representatives of civil society (experts, researchers, business associations etc.)
  - Make publicly available any information used to design the policy, and publish information on the objectives, the costs, the population targeted, estimation of expected results of the policies etc.
  - Publish any information on the aids/privileges given to firms, especially big firms
- For policy implementation:
  - Provide online wide information on all existing policies designed to help firms
    - Provide an interactive tool where the firm can enter its characteristics and get information on available policies it is eligible to
    - Promote open data such that any firm can get information to compare itself to others
  - Give firms the power to "challenge" bureaucrats, to contest any decision:
    - for example, a special web platform where the firm can contest and where the bureaucrat must motivate his decisions
    - a special body acting like an ombudsman

– **Establishing Sound Institutions on top of Engaging in Active Industrial Policy**

The way to use the grown state capacity is, however, not to provide targeted benefits to few industries or even specific firms even if history provides some evidence that industrial policy can work. The reason is that industrial policies are often hard to alter once in place. This inertia can result in well-intended policies having sizable negative long-run effects on aggregate output and productivity. Financial frictions, for example, provide a rationale for providing subsidized credit to productive entrepreneurs to alleviate the credit constraints they face. In the short run, such targeted subsidies have the intended effect and raise aggregate output and productivity. In the long run, however, subsidies prop up entrepreneurs that were formerly productive but are now unproductive, while impeding the entry of newly productive individuals. Therefore, aggregate output and productivity are depressed. Industrial policies then lead to idiosyncratic distortions that disproportionately affect productive establishments, and temporary growth miracles followed by growth failures. Hence, rather than engaging in active industrial policy, the policy focus should be fully on developing sound institutions, an effective bureaucracy, strong protection of property rights, a conducive regulatory regime and sufficient availability of public infrastructure to support private initiative.

4. Relax Credit Constraints

The report highlights the role that access to finance has on constraining private sector development, with large gains to be realized if capital flows to the most productive firms.

– **Ensuring Property Rights**

The economics literature has produced considerable consensus regarding the role of secure property rights as a pre-condition for removing financial constraints for firms. Property rights affect credit markets directly and improve the self-financing willingness of firms. Morocco, Tunisia, Sudan and Mauretania are all similarly ranked on this dimension by the Doing Business surveys (around the World median). Egypt, Algeria and Libya are faring much worse and need to strengthen property rights registers urgently. Upholding of creditor rights and a simplification of bankruptcy procedures can help develop financial markets and entrepreneurship.

- **Broadening Access to Capital**

According to the Doing Business survey credit institutions in North Africa are extremely underdeveloped. Improving these institutions will improve access to finance by firms which is regarded as a major constraint by those firms throughout the region. Domestic access to capital for firms can be broadened further through an effective deepening of financial markets. At present, stock markets are only weakly developed, implying that equity is not broadly available as a source of capital. In Algeria, alternative sources of financing, such as venture capital, are far less accessible compared to other peer group countries. Reforms to strengthen the development of financial markets are important to increase access to finance to private sector firms through different finance instruments (debt versus equity). On the institutional side the strengthening of competition laws, bankruptcy laws and insolvency regimes can constrain non-competitive practices, and further improve access to finance for the private sector.

- **Limiting Public Sector Footprint on Lending Markets**

Turning to bank lending, in Tunisia and similarly in Algeria, the government effectively controls most of the banking sector, which is associated with significant distortions as the government-controlled banks do not adhere to strictly commercial considerations when allocating credit, resulting in inefficient state-owned enterprises getting access to finance or credit being extended based on political connections. Similarly, in Egypt public sector borrowing is crowding out lending to the private sector, while the low bank penetration limits deposit mobilization. The development of an infrastructure to support cashless transactions and electronic payments may foster further financial inclusion and can support capital market deepening. Privatization of state owned enterprises and PPPs are a further potential vehicle to attract (foreign) capital, broaden financial markets and encourage competition. The extent of privatization needs to be aligned with overall strategic interests and primarily aim at reducing market power and supporting competitive practices to reduce the public-sector footprint in areas of the economy that should be led by private-sector initiative such as tourism and other service industries.

- **Reducing Barriers to FDI**

Access to capital can be broadened by actively facilitating and supporting foreign direct investment. Currently, FDI is deterred in some countries due to restrictive regimes such as the Algerian 49/51 rule, under which 51 percent of new investments in Algeria must be owned by Algerians. This limits foreign investment, entrepreneurship and leads to a non-realization of the significant gains from technology transfers that FDI are known to bring. To attract FDI, rather than opting for direct monetary incentives, which have been shown to be rather ineffective and come with significant fiscal burden, the emphasis should be placed on developing a broader regulatory and business environment conducive to overseas investors. An important feature here is to ensure investors do not have to fear for their assets by effectively enforcing property rights and adhering to the rule of law and due and transparent judicial processes. Further, capital flows can be supported through the adoption of a lean bureaucratic process. India's adoption of two track system through the "Make in India" initiative may serve as a good example, effectively granting automatic approval for investments in a bulk of sectors.