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## The Private Sector in the Arab World – Road Map Towards Reform

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In the Middle East, the private and public sector do not have distinctive and independent roles to play; rather, the dividing line between what is public and what is private is not clearly defined. As an example, the 10 largest listed companies in the GCC remain state-owned.

The private sector is also dominated by family businesses that have a close relationship to the state, and these ties prescribe their attitude toward political reform. This is, in fact, neither unusual nor surprising: in all industrial countries, major business families have found it convenient to nurture close ties with holders of political power, and sometimes, directly run for office. The demand for greater accountability and political reform is born out of the progressive widening of the ranks of business entrepreneurs, and the increasing competition between business groups. In some instances, this has led to clear demands for greater transparency and accountability in government decision making, primarily with respect to business interests.

The private sector in the Middle East does have a role as governments fail in most cases to establish and execute reforms by themselves. It has to reach beyond its natural boundaries and support governments to encourage reform measures in areas that directly reflect on their interests such as judicial reforms. The private sector could start by establishing non-political associations or task forces to represent civil society. It could also issue initiatives whereby it acts as a partner with government to establish effective reform measures.

### **Rentier States and Semi-Rentier States**

Historically, in Europe and the US a national bourgeoisie has been the carrier of economic and political development. By national bourgeoisie we mean those entrepreneurs whose fortunes are

primarily linked to the national dimension. The national bourgeoisie is a subsection of the so-called middle class, inasmuch it does not include employees, notably civil servants. It is also a subsection of the private sector, inasmuch it does

not include foreign-owned enterprises, or people whose income is derived from accumulated wealth but who are not active entrepreneurs. The national bourgeoisie has shaped market-based economies and states alike in all industrial countries, and has spearheaded openness to international trade and globalization. It has also tended to favor political liberalism and democracy, although at times it has sought protection from social and political challenges by supporting authoritarian regimes.

In the oil-exporting countries of the Middle East, the state receives oil and gas revenues directly and does not depend on taxation to pay for its expenditures (it is, therefore, a rentier state). Being fiscally autonomous from the population, it expects political acquiescence in exchange for welfare transfer payments – no taxation and no representation. Even in semi-rentier states such as Egypt or Syria, such rents from resource extraction play a large role, beside other external income sources like the Suez Canal fees.

In these conditions, the private sector is often only an extension of the state on which it depends for contracts, import licenses and the like. Strong population growth in the MENA countries requires job creation on an unprecedented scale, which the state can no longer provide simply by further expanding the public sector. Also, budget constraints have led to the need to rely on the private sector to create employment, and a national bourgeoisie is emerging. Although still in part dependent on government expenditure, the

emerging national bourgeoisie is increasingly capable of investing in ambitious projects that must compete in the international marketplace. In the pursuit of its interests, it also seeks some political participation (e.g. in the Majlis ash Shura).

With high oil prices, budget constraints are gone and some believe that the reform drive too will vanish in the oil-exporting countries, but this hasn't been the case so far. The Gulf States pursue the explicit objective of strengthening their respective national bourgeoisie to enhance competitiveness and diversify their economies.

### **Characteristics of the Private Sector in the Middle East**

The private sector in the Middle East comprises three main components:

- Small and Medium Enterprises (SME)
- Large and medium family enterprises
- State-dominated publicly listed companies in which private investors own minority holdings, without having decisive influence on the corporate decision making process.

While the share of the private sector in GDP is often still comparably small, its contribution to employment is considerably higher, reaching about 80 percent in Saudi Arabia, for example. Private investment as a share of GDP has picked up in recent years, especially in what the World Bank calls the Resource Rich Labor Importing (RRLI) countries of the Middle East (these are the GCC countries plus Libya).

**Table: Private Investment as a Share of GDP**

Year	RRLI	RRLA	RPLA	MENA
2000	12.5	10.9	11.7	12.1
2001	12.8	11.07	11.4	12.2
2002	13.1	11.01	11.2	12.3
2003	12.9	10.6	11.8	12.3
2004	12.8	11.6	12.0	12.4
2005	13.5	12.7	13.1	13.3
2006	15.03	12.9	13.5	14.3

*Note: The MENA region includes the resource poor-labor abundant (RPLA) economies: Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia; the resource-rich labor abundant (RRLA) economies: Algeria, Iran, Iraq, Syria and Yemen, and the resource-rich labor importing (RRLI) economies: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE and Libya.*

Source: World Bank

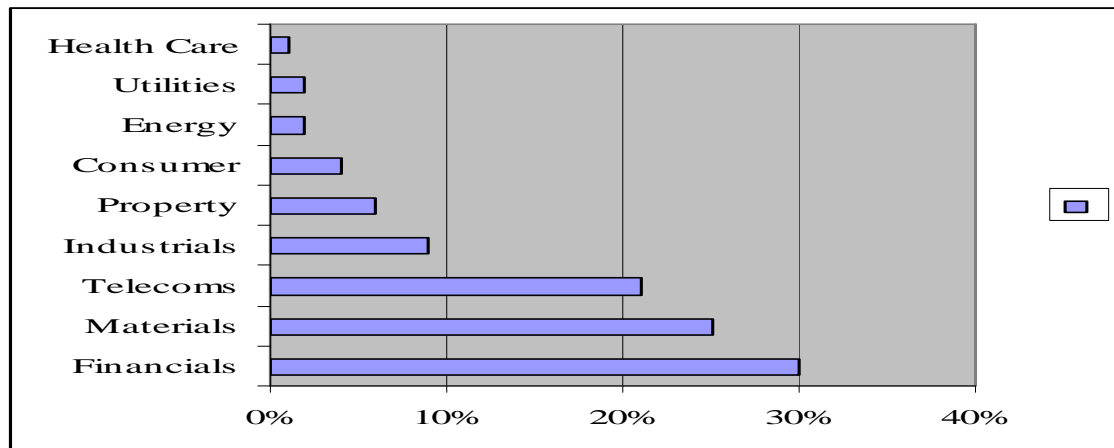
The private sector is dominated by family enterprises that cherish their independence and absolute discretion in decision making. Only a small minority of them has floated some of their companies on the local stock markets (and then only to a very limited extent, retaining an overwhelming portion of the shares) also because the financial infrastructure in MENA countries is often still underdeveloped.

Companies that are publicly listed on stock markets may be looked at as a third component of the private sector, besides the SMEs and large and medium family enterprises. But often the private sector does not play a leading role here but only participates in companies that are majority owned by the state, although there are notable exceptions like Orascom

in Egypt or Mashreqbank in the UAE. Ownership is in fact quite varied across the region, in terms of market capitalization: Turkey and Egypt demonstrate private sector dominance of the wholly private sector companies in their respective stock markets, whereas in Saudi Arabia state-controlled companies dominate the listing. The stock market capitalization thereby heavily concentrates on banks, telecoms and materials (e.g. SABIC).

Sector-wise, there is a concentration on services, trade and construction, while energy, large manufacturing companies, banks and utilities still tend to be owned by the state, at least via majority stakes.

### MSCI Arabian Markets Sector Breakdown



Source: MSCI

### Market Composition: Split of MSCI Arabian Markets

	Con-sumer	En-ergy	Finan-cials	Pro-perty	Health Care	Ind-ustrials	Ma-terials	Tele-coms	Utili-ties	TOTAL
KSA	8%	2%	3%		1%	4%	53%	24%	5%	100%
UAE		4%	40%	45%	1%	5%	5%			100%
Morocco	2%	5%	23%			15%	19%	35%		100%
Bahrain			51%					49%		100%
Egypt	10%		19%		1%	19%	9%	42%		100%
Jordan		4%	76%		6%		8%		5%	100%
Kuwait	1%	1%	64%			8%	8%	19%		100%
Oman			41%				21%	38%		100%
Qatar		7%	48%			31%		7%	7%	100%

Source: MSCI

Note: MSCI does not include Saudi banks in their index as they are non-investable for non-Saudis

### A Nascent Arab Bourgeoisie?

In the Middle East, the private and public sector do not have distinctive and independent roles to play; rather, the dividing line between what is public and what is private is not clearly defined.

One needs to get away from the notion of private sector in the context of western societies. In the West, the system of law is much more developed, and emphasis on transparency and accountability of government and corporations alike provides a clearer sense of division. This is not true of the Middle East/Gulf. The 10 largest listed companies in the GCC remain state-owned (e.g. SABIC, Emirates Bank, Qatar Telecom).

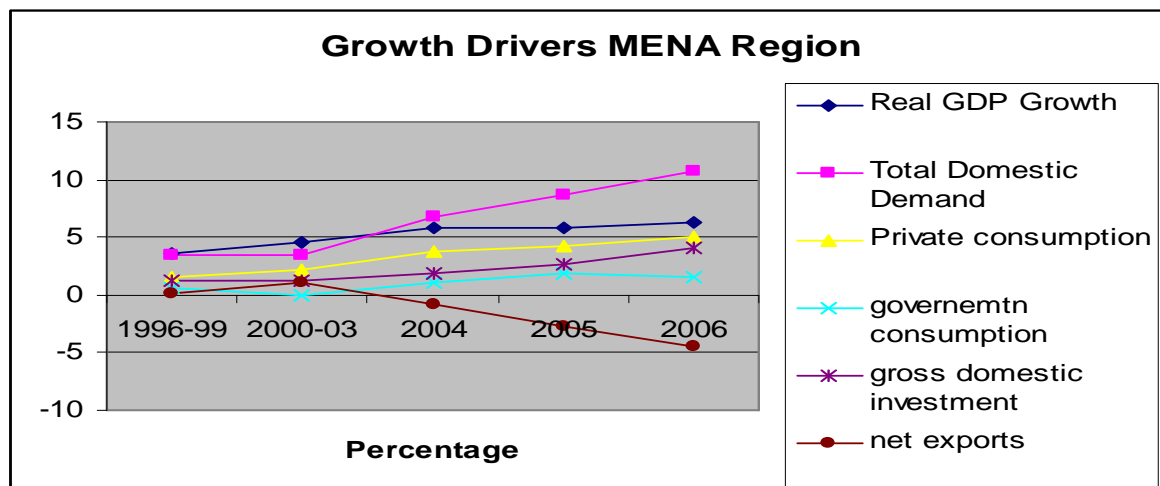
The private sector is also dominated by family businesses that have a close relationship to the state, and it is this relationship which prescribes their attitude toward political reform. This is, in fact, neither unusual nor surprising: in all industrial countries, major business families have found it convenient to nurture close ties with holders of political power, and sometimes, directly run for office. The demand for greater accountability and political reform is born out of the progressive widening of the ranks of business entrepreneurs, and the increasing competition between business groups. In some instances, this has led to clear demands for greater transparency and accountability in

government decision making, primarily with respect to business interests.

The above having been said, the private sector does have a role as governments fail in most cases to establish and execute reforms by themselves. The private sector has to reach beyond its natural boundaries and support governments to encourage reform measures in areas that directly reflect on their interests such as judicial reforms. The private sector could start by establishing non-political associations or task forces to represent civil society. It could issue initiatives whereby it acts as a partner with government to establish effective reform measures.

### Drivers of Growth in the MENA Region

While detailed data about the private sector's share in GDP is hardly available, one can infer that it has played a considerable role in economic growth in recent years. Private consumption and gross domestic investment have been the main drivers of growth in the MENA region in recent years, while real net exports contributed negatively, as they did not keep pace with import growth. A string of high profile investment projects by private sector companies plus anecdotal evidence suggest that the role of the private sector in gross domestic investments has increased considerably.



Source: World Bank

The private sector is also venturing beyond national borders and increasingly engaging in international investments, most notably within the MENA region.

In fact, a complex pattern of intra-MENA investment is emerging:

- There is substantial intra-GCC investment, primarily from Saudi Arabian entrepreneurs in

other GCC countries, but also from the latter to Saudi Arabia

- There is investment by the GCC countries in other Arab countries such as Egypt, Lebanon, Jordan, Morocco, Tunisia, and Sudan; in some cases, investors are entrepreneurs originally from these countries who have established themselves in the GCC. Even Syria has attracted a couple of high profile real estate project investments although it is known to have a less open economy.
- Investment in Turkey has also significantly expanded.

The expansion of inter-Arab investment, and especially of inter-GCC investment, creates a de facto competition among governments to attract new projects: governments view their national entrepreneurs establishing themselves in neighboring countries as an implicit (and sometimes explicit: see MTC in Kuwait) criticism of their policy. In this way, the private

sector can play an important role in fostering reform.

### **Privatization, Family Enterprises and Capital Markets**

More resource allocation by the private sector is a necessary prerequisite of a growing role for the private sector. Privatization in the region has remained timid, apart from a few exceptions (e.g. Saudi Telecom, Egypt). More important has been the growing role of existing private enterprises which have moved beyond pure rent-based contracting from the state and ventured into various productive enterprises.

An important issue in the coming years will be the attraction of family enterprises to the financial markets.<sup>1</sup> While the biggest companies in the GCC are state-owned, the huge realm of Small and Medium Enterprises (SME) is dominated by family-owned private sector companies. Some of these companies have reached the size of big conglomerates. The Olayan, Al-Futtaim, Kanoo and Zamil groups of companies are cases in point. Family members hold key executive positions in

these firms and the family mostly holds full ownership.

Family enterprises elsewhere in the world have gone public and often the respective families do not retain a majority stake anymore. Examples are Wal Mart (38 percent family ownership), Ford (40 percent) or BMW (47 percent). Usually, family members do not have an exclusive grip on executive positions anymore in such enterprises, nor do they rank prominently on the boards of these companies. They mostly confine themselves to a controlling role in the background; in some cases like the German Haniel Group this is even a matter of policy.

In the GCC, such a trend has not been observed so far. Shuaa Capital is one of the few examples of a family enterprise (Al Ghurair) subsidiary in the UAE that has gone public. There are a couple of other examples in Saudi Arabia (e.g. Al Rajhi Bank, Al Abdullatif Industrial Investments) and Kuwait (e.g. Sultan), but generally these have remained the exception. The advantage of trust within established family relationships is valued higher than the advantages of increased corporatization and going public, namely enhancement of the available talent pool and accountability and easier access to financing from the capital markets.

Instead financing via retained earnings, and sometimes banks, still remains the rule and GCC family enterprises are reluctant to give up unlimited control and succumb to the increased accountability standards that come with a public listing, like quarterly reports and the appointment of independent directors to the supervisory board. On the other hand, GCC family enterprises mostly follow broad business interests in conglomerate-like structures; the specialization in core competencies, which is usually more appealing to stock market investors, is not very common so far.

The initiative of the Dubai International Financial Exchange (DIFX) to reduce the minimum free float for its IPOs to 25 percent from the current 55 percent at the bourses in Dubai and Abu Dhabi could be appealing to such family enterprises, as they would not need to give up their majority stakes, but so far there have been no corresponding listings and it remains to be seen whether the initiative will prove successful.

One reason for the relative reluctance of private companies to enter the stock market may be attributed to their relative distance from the capital

<sup>1</sup> Eckart Woertz, *GCC Stock Markets. Managing the Crisis* (Dubai: Gulf Research Center 2007).

markets in general. Astonishingly, access to loans from banks is difficult for many companies, despite the huge credit growth that has taken place in the region, which apparently has been mainly directed to a selected minority of large companies and consumer financing. The World Bank has deplored the disconnect between the financial sectors and the real private economy in Middle Eastern countries.<sup>2</sup>

While on the macro level a reasonably high degree of financial intermediation of about 60 percent of GDP can be observed,<sup>3</sup> it is only a few large companies that profit from it, while the majority seems to rely on retained earnings: About 75 percent of company financing in MENA countries stems from this source and only 12 percent from the banking sector, while the corresponding figure for high income countries stands above 20 percent.

In Saudi Arabia, for example, less than 40 percent of companies reportedly have an overdraft facility with a bank, and only slightly more than 20 percent have a loan from a bank.<sup>4</sup> More access to the capital markets could certainly facilitate the expansion and modernization drive of many companies in light of increased opening up and competition in the wake of the WTO process. But before thinking about family enterprises going public or issuing bonds, the natural first step would be to improve the cooperation with the financial sector on the very basic level of loan facilities in many cases.

### **Knowledge Society and Excellence Initiatives**

Access to capital alone will not be sufficient. The private sector in the MENA countries often has difficulties in accessing the necessary know-how for its modernization process.

Human resources and skilled labor formation will need to be a top priority of the private sector in the coming years. It will not only need to continue to attract foreign talent – something that has become more difficult with the current dollar weakness and inflationary trends – but will have to go beyond that and build a local MENA talent pool and facilitate

increased mobility of the production factor of labor. The efforts this will require in the fields of education and vocational training are tremendous.

All too often the education sector in the MENA countries relies too much on outdated approaches like rote learning and neglects the development of innovative and creative attitudes and skill sets. Similarly, a more pragmatic side of vocational training must be introduced that equips aspiring young students with day-to-day skill sets like basic engineering and handiwork, which they can use in their professional lives later.

The role of the private sector in this part of educational reform must not be underestimated. Practical skills one learns on the job and the combination of alternately learning in the classroom and in the respective companies can be extremely efficient, as the very successful German dual system of vocational training has shown. The ultimate goal should be the continuous and vigorous build-up of clusters of excellence.

A stronger role for the Chambers of Commerce, including better links with its various members from the private sector, is also part and parcel of such an approach. It is these Chambers of Commerce that can coordinate initiatives and serve as a first point of enquiry about laws and regulations.

The WTO process will pose diverse challenges to the private sectors of the MENA region in the coming years. This is especially true for members that have joined the organization recently like Saudi Arabia. Most notably, liberalization in the banking and insurance sector will be difficult and excellence initiatives on various levels could enable the private sector to withstand the increased foreign competition that comes with liberalization.

### **Public Private Partnerships**

Public Private Partnerships (PPP) have developed as an important alternative for outright privatization in recent years. Their definition is broad-based; it ranges from cooperation between public and private sector to the provision of public services by private enterprises. PPP are thus situated between the extreme poles of government monopoly and complete privatization. The main methods of PPP are procurement via the private sector, special purpose vehicles (SPV) with state and private entities as shareholders, service provider contracts, leasing of state assets to private sector, and joint ventures. In the 1970s and 1980s, Western

<sup>2</sup> World Bank, "Middle East and North Africa. Economic Developments and Prospects 2006: Financial Markets in a New Age of Oil," available at: <http://siteresources.worldbank.org/INTMENA/Resources/MENA-EDP2006.pdf>, pp. 50.

<sup>3</sup> This is the average of Middle Income Countries and slightly below the 84 percent average of High Income Countries. Ibid.

<sup>4</sup> Ibid.

governments turned to PPP because of budget constraints. They hoped for greater rationalization and cheaper services. On average this was attained (costs went down 17 percent on average), but there have also been negative examples, where private companies actually offered services which were more expensive. Therefore, regulation and performance supervision are important.

The OECD expects investments worth \$100 billion in PPP in the MENA region over the coming five years. Saudi Arabia provides an interesting case study for the nascent PPP projects in the MENA region. In 1998, a reform drive started when budget constraints were huge because of low oil prices. But so far fiscal policy is prudent and no spending spree like in the 1970s has taken place; rather, expenditure is directed towards capital and infrastructure investments. The Saudi Ports Authority (SPA) is a case in point; while the state owns the SPA and handles the administrative supervision, the ports are mainly operated by private service providers since a privatization policy in 1997.

Another example can be found in the field of desalination, water treatment and electricity. Large investments will be necessary in the future to supply water for a growing population (\$13 billion in Saudi Arabia and the UAE by 2015). Therefore, there is huge potential for rationalization of supply via PPP: The GCC has one of the highest water scarcities worldwide, but also the highest consumption rates per capita and lowest prices because of subsidies. This leads to indifference, inefficient allocation of resources and mismanagement.

In this context, the private sector in Saudi Arabia began implementing some water and electricity projects for the government from 2005 and it remains to be seen whether these developments will gain in strength. SABIC, the Saudi Arabian Oil Company (Saudi Aramco) and the Royal Commission for Jubail and Yanbu have joined with private investors to set up a utility company (Marafeq) to expand water and power supply in the industrial cities of Jubail and Yanbu. Once the company makes a profit, its shares may be offered for public subscription.

A very well-known, recent example is that of the King Abdullah Financial District: The Capital Market Authority (CMA) and Public Pensions Agency (PPA) have been designing the strategy underpinning the development of the district. One of the cornerstones of their strategy is the development of public/private partnerships, e.g. a new financial academy and conference facilities for financial services.

On the other hand, there are negative examples. In the field of health care management, contracts were given out for the management of public hospitals in Saudi Arabia. It is widely believed that these management contracts were not successful and, in fact, those hospitals have now reverted to the Ministry of Health. This has led people to believe that the private sector is not capable of managing hospitals.

However, according to informed observers, this is not true. The real problem was more in the design and monitoring of these management contracts. This is also true of the outsourcing contracts in MOH hospitals. Most of them are input-based contracts whereas the trend around the world is toward performance-based contracts. Therefore, before pushing a Private Service Provider transaction in the health sector, it is critical to ensure the existence of adequate and commensurate regulatory capacity.

International companies can also participate in PPP. The US company Cisco is part of a PPP that aims to expand education in ICT related fields. The PPP is part of \$265 million worth investments in Saudi Arabia over the next five years that include the setting up of the Saudi technology innovation and entrepreneur institute, 100 more networking academies in addition to the existing 42 to provide enhanced technical programs in concert with leading local universities, and a "Netversity" in tandem with public institutions to provide business and technical training.

But PPP do not need to be restricted to such large projects. Fatin Yousef Bundaji, the director of Women Empowerment and Research at the Jeddah Chamber of Commerce, suggested in 2005 a special PPP with Small and Medium Enterprises (SME), which form 90 percent of the private sector in Saudi

Arabia but receive little attention. Three issues are important in this respect: The creation of a general fund and credit facility for SMEs by the state; the creation of a Saudi Arabian SME Development Authority (SASMEDA) as a one-stop shop for administrative and regulatory issues, along the lines of SAGIA; and the creation of a national association of SMEs.

It remains to be seen how the idea of PPP will spread further in the MENA countries. Currently the United Nations Economic and Social Commission for Western Asia (ESCWA) is working on establishing national transport and trade facilitation (NTTF) committees for PPP in seven ESCWA member countries that do not have such committees so far (Bahrain, Iraq, Kuwait, Lebanon, Qatar, Saudi Arabia and UAE).

**Conclusion: Towards a broader social role and participation**

The idea and process of political and economic

reform cannot be seen from a one-dimensional perspective. There are many issues and factors that play a role, including the changing nature of the nation-state, issues of citizenship, political culture, changing economic and social environment in the region in light of the ongoing process of globalization as well as the troubled regional environment. In this context, besides the public sector and non-governmental institutions, the private sector has a role to play. Similarly, political reform is only one aspect of an overall process of development. Economic and political liberalization are necessarily intertwined and co-related to one another. It is difficult to separate between the public and private sector in this regard. The private sector has a role to play in auditing and requesting more transparency in government initiatives. The responsibility of the business community and industry associations must go beyond ensuring returns to its traditional stakeholders — they must be responsible for the development of society as a whole.