The Role of Small and Medium-Sized Enterprises in the Mediterranean

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Executive Summary

- The SME sector is an integral component of almost every economy in the world and is of particular importance in developing countries;

- **SMEs serve two key purposes: (1) they play a dynamic role in *economic* development**, by stimulating innovation, increasing competition, boosting wages and creating a middle class of small businesses**; (2) SMEs also perform an indirect yet crucial *political* function** in generating the *demand* for essential public goods, such as reduced corruption, the universal application of the law, improved infrastructure, public services, and good governance in general;

- Southern Mediterranean and South-Eastern Mediterranean countries face a number of acute economic challenges, including: the demographic explosion, inequality, low per-capita income, somewhat weak governance structures and uneven development;

- The development of a cohesive policy to encourage and support the development of SMEs is one of the best means of tackling these issues coherently;

- Key actors for the development of SMEs include: the UfM, the EIB, the European Commission, the OECD, the EBRD, the World Bank and "Invest in Med";

- Policy needs to be tailored to fit the needs of individual countries; **and,** *as a first step*, **the binding restraints on SMEs at the local and regional levels need to be identified clearly**;

- The EU and other players should focus their efforts on the following: alleviating financial constraints to SME growth; reducing the obstacles to the internationalisation of SMEs, encouraging the creation of Local Development Agencies and promoting entrepreneurship through education, training and networking;

- ARLEM**'s role is to act as a facilitator and coordinator** between five key stakeholders: (1) SMEs from the Southern Mediterranean; (2) SMEs from the EU-27; (3) local government officials from the Southern Mediterranean; (4) local government officials from the EU-27; and (5) SME interest groups within the EU.

Small and Medium-Sized Enterprises In The Mediterranean[1]

Introduction

This report analyses the role of small and medium-sized enterprises (SMEs) in the Mediterranean, with special reference given to the local and regional context in which they operate. In doing so, it outlines the current state of SME development across the region; the nature of their interaction with local and regional authorities; the key challenges that SMEs are currently facing; and the key players active in dealing with SMEs and promoting their development. The central aim of the report is to highlight the most important constraints on SME development in the region, so that areas for targeted action can be identified to support the development of SMEs. This will facilitate an assessment of the role that can be played by local and regional authorities in contributing towards this aim.

The report has three principal objectives. First, it aims to provide an overview of the importance of SMEs in the Mediterranean to social development, especially in their local and regional contexts, and to describe the most significant challenges facing SMEs at this time. Second, it identifies the different players that are currently engaged with SMEs in the Mediterranean, providing an outline of their programmes and initiatives. Third, it presents key recommendations and proposals to improve the environment for SMEs so that they can develop at a faster rate, highlighting where local and regional authorities might contribute, and proposing an approach that aims at identifying the most important constraints on which resources should be focused for maximum impact.

[1] This region is defined as those Mediterranean Partner countries of the EU-27 that are part of the Union for the Mediterranean (UfM). They include: Albania, Algeria, Bosnia and Herzegovina, Croatia, Egypt, Israel, Jordan, Lebanon, Mauritania, Monaco, Montenegro, Morocco, the Palestinian Authority, Syria, Tunisia and Turkey. Libya is included in this report as it is an observer state. Because its per capita income level is above the EU-27 average, Monaco is not included in this discussion.

1. The Role Of SMEs in the Mediterranean

The role of SMEs in economic and political development

The SME sector is an integral component of almost every economy in the world. This is especially true in developing countries. Within this large and varied group it is all the more the case for countries with major employment, income distribution, and demographic challenges of the sort faced by the Mediterranean states. The positive role of SMEs can be observed in both the economic and the political spheres.

In *economic* terms, SMEs are of critical importance. In the developed economies of the Organisation for Economic Cooperation and Development (OECD), SMEs typically account for around 99 per cent of all firms and 60-70 per cent of gross domestic product (GDP), as well as creating a similar share of employment.[2] It is not difficult to understand why this is so. A modern market economy consists of thousands of markets that require millions of enterprises to be reasonably competitive and efficient. A greater number of SMEs generates a higher degree of competition, and the variety of economic activities in a modern economy is so great that as many enterprises as possible are needed to ensure that competition thrives within an economy. However, poorer countries, such as those from the Middle East and North Africa (MENA) and the post-communist region of south-east Europe, have far fewer SMEs than their more developed neighbours, which is one of their major structural weaknesses.

As well as being more numerous, and accounting for the majority of output and employment in developed economies, SMEs also play a more dynamic role in economic development, due to their role in stimulating innovation. In this respect, the SME sector: (a) acts as a incubator for the larger firms of the future; (b) is the next (and important) step up for expanding micro-enterprises; (c) contributes directly, and often significantly, to boosting aggregate savings and investment; and (d), through the Schumpeterian process of "creative destruction", helps to move successful firms closer to the technological frontier. In this respect, vibrant SME activity is now considered a *sine qua non* for the development of knowledge-based economies, no matter what the development level of the economy, with SMEs often proving to be more flexible and innovative.[3]

2 Organisation for Economic Co-operation and Development (2004) "Promoting Entrepreneurship and Innovative SMEs in a Global Economy: Towards a More Responsible and Inclusive Globalisation", available at: http://www.oecd.org/dataoecd/6/7/31919278.pdf

3 Aghion, P. and Griffith, R. (2005) *Competition and Growth: Reconciling Theory and Evidence*, Cambridge: MIT Press; Schramm, C.J. (2004) "Building Entrepreneurial Economies", Foreign Affairs, Vol.83, No.4, pp.104-115.

These advantages have led many development agencies, such as the World Bank, United Nations (UN), European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD), to place support for SMEs at the heart of their development strategies. The World Bank summarised their view of the importance of SMEs by stating that their pro-SME policy "…is based on the argument that, relative to larger firms, SMEs enhance competition, entrepreneurship, job growth and spur economy-wide efficiency, innovation, growth and poverty alleviation".[4]

SMEs also perform a key *political* role. If a country has few small enterprises, its policies tend to benefit large enterprises and maintain the low number of small enterprises, which hampers the levels of competition and productivity of that country. Conversely, in countries with many small-scale entrepreneurs, their number stays large. Because societies ultimately differ in the degree to which competition is prevalent, and also in the extent to which competition is resolved according to impersonal, universally enforced rules, the role of a vibrant SME sector is integral in generating the *demand* for public goods – such as reduced corruption, the universal application of the law, improved infrastructure, public services, and good governance in general – to be *supplied* by the authorities at the local, regional and national levels.[5] Such sustained demand by SMEs can help generate what Baroness Ashton has described as "deep democracy".

Challenges facing the region: where do SMEs fit in?

Given the positive role that is performed by SMEs across the world, it is clear that the development of a thriving SME sector across the Mediterranean is desirable if the countries of the region are to meet the large number of challenges currently facing them. Despite the heterogeneity of the region, there are six key problems that are shared by most of the countries of the region. Finding solutions to these problems are the key challenges confronting the region. They are briefly described below.

4 See Potter, J. and Proto, A. (eds, undated) "Promoting Entrepreneurship in South Eastern Europe", OECD, available at: http://www.oecd.org/dataoecd/42/25/39872944.pdf.

5 North, D. Wallis, J., Webb. S. and Weingast, B. (2007), "Limited Access Orders in the Developing World: A New Approach to the Problems of Development", Policy Research Working Paper 4359, Washington, DC: World Bank; Acemoglu, D. and Robinson, J. (2008), *Economic Origins of Dictatorship and Democracy*, Cambridge: Cambridge University Press.

Table 1: Human Development Index, 2010[6]

Country	HDI value, 2010	Rank (n = 169)
Israel	0.872	15
Montenegro	0.769	49
Croatia	0.767	51
Libya	0.755	53
Albania	0.719	64
Bosnia and Herzegovina	0.710	68
Tunisia	0.683	81
Jordan	0.681	82
Turkey	0.679	83
Algeria	0.677	84
Egypt	0.620	101
Syria	0.589	111
Morocco	0.567	114
Mauritania	0.433	136

Source: United Nations Development Programme (2011)

First, most countries of the region experienced an *uneven development process*. Whether because of state socialism (in the post-socialist countries of the northern rim), or because of the state-directed extraction of natural resources (in many of the countries of the southern rim), nearly all countries of the Mediterranean experienced high rates of growth in either the 1950s and 1960s (the socialist economies), or later in the 1970s and 1980s (in the MENA region), because of rates of investment that were well above the developed world average. These investments were typically focused on ambitious development projects, heavy industry, education, and public health. Such investments enabled many of the countries of the Mediterranean to reach a reasonable level of development that remains evident today (Table 1). However, growth rates fell significantly in the 1980s and 1990s, as the returns on these high rates of investment diminished (Table 2). Many economies were left with a top-heavy economic structure oriented towards large, state-owned enterprises (SOEs), with underdeveloped private sectors. In the first decade of the twenty-first century, rising commodity prices masked these deficiencies, helping boost growth in the southern rim, while the benefits of the transition to market economies were felt on the northern rim.

6 Data are unavailable for Gaza and the West Bank, and Lebanon.

Table 2: Average GDP growth, per cent, 1960-2009

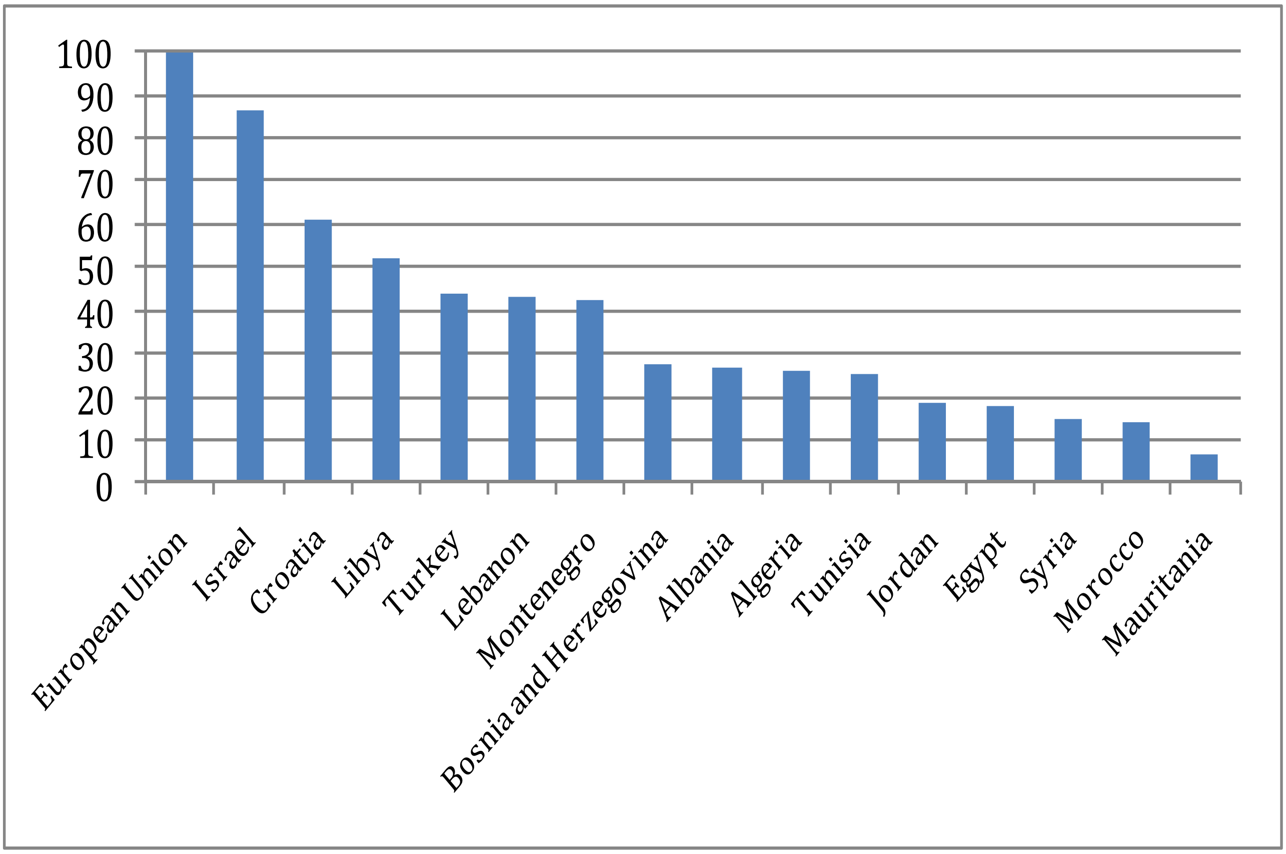
Country	1960-69	1970-79	1980-89	1990-200(	2000-09
Albania	n.d	n.d	2.6	0.7	5.5
Algeria	4.1	7.2	3.0	1.6	3.6
Bosnia and Herzegovina	n.d	n.d	n.d	33.9	4.6
Croatia	n.d	n.d	n.d	-1.7	3.2
Egypt	5.4	6.2	5.5	4.3	4.9
Israel	9.1	5.8	3.3	5.5	3.6
Jordan	n.d	15.2	2.3	4.9	6.3
Lebanon	n.d	n.d	-42.5	9.7	4.7
Libya	n.d	n.d	n.d	n.d	4.3
Mauritania	8.1	2.6	2.1	2.6	3.8
Montenegro	n.d	n.d	n.d	-2.3	3.8
Morocco	5.0	5.3	3.9	2.8	4.8
Syria	6.8	8.8	1.8	5.7	4.2
Tunisia	5.4	7.2	3.1	5.1	4.7
Turkey	5.7	4.7	4.8	4.0	3.8
West Bank and Gaza	n.d	n.d	n.d	n.d	-2.0
EU	4.8	3.5	2.4	2.1	1.5

Source: World Bank Development Indicators (2011)

Second, because of these similar experiences with faltering development models, *per capita income* has tended to remain low relative to EU levels, with the few exceptions (Figure 2). Unlike many other regions of the world economy, this trend has not reversed in recent years, especially in the economies of the southern rim. This is despite the positive trends in growth rates observed over the past decade. The main explanation is that economic growth has not been able to keep pace with population growth, especially in the MENA region, because many populations are getting larger, with rising dependency ratios, the fact that aggregate output growth has been relatively strong has been unable to prevent a number of countries entering a Malthusian trap.[7] It should be noted that in the post-socialist region, Israel and Turkey, income convergence has occurred, although the recent Great Recession has, Israel excepted, caused a temporary deviation from this trajectory.

[7] This is the ratio of the economically dependent part of the population to the productive part, arbitrarily defined as the ratio of the elderly (those 65 years and over) plus the young (those under 15 years of age) to the population in the "working ages" (those 15-64 years of age).

Figure 1: Per capita income, purchasing power parity, 2009 (EU average = 100)[8]



Source: World Bank (2011)

Third, there has been a weakness of many countries in bringing about significant *structural change*. Economic development is essentially a story of structural transformation, and can be defined as the process by which countries change what they produce and how they do it. It involves a shift in the output and employment structures away from low-productivity and low-wage activities into high-productivity and high-wage activities; and the upgrading and diversification of the production and export baskets. This process generates sustained growth and enables countries to increase their per capita income.[9] However, there has been very little evidence of structural transformation – in terms of both diversification and industrial upgrading – across much of the Mediterranean region (Table 3). Major sources of this challenge include, but are not limited to, dependence on oil, tourism, and remittances; weak integration with the world economy; and an occasionally weakly developed private sector,

8 Data are unavailable for Gaza and the West Bank.

9 Hausmann, R., Hwang, J. and Rodrik, D. (2006) "What You Export Matters", *Harvard University Working Paper Series*, April 2006.

with the public sector remaining the primary source of employment in many countries (e.g., public administrations, state enterprises).

Table 3: Selected indicators of structural transformation, 2009[10]

	Hi-technology exports, 2008 (% of manufactured exports)	Exports of fuels, ores and metals, 2008 (% of total merchandise exports)	Workers' remitances, received, 2009 (% of GDP)
Albania	3.7	24.1	11.0
Algeria	0.7	98.2	1.5
Bosnia and Herzegovina	3.9	28.8	12.2
Croatia	9.1	20.2	2.3
Egypt	0.9	52.3	3.8
Israel	16.4	2.0	0.6
Jordan	0.9	10.1	14.3
Lebanon	0.2	8.9	21.9
Libya	n.d	n.d	0.0
Mauritania	n.d	82.3	0.1
Montenegro	n.d	n.d	n.d
Morocco	8.8	12.4	6.9
Syria	1.3	43.6	2.6
Tunisia	4.9	15.4	5.0
Turkey	1.7	7.6	0.2
European Union	14.4	8.8	0.6

Source: World Bank Development Indicators (2009)

Fourth, stunted development and low per capita income growth have contributed to high levels of *inequality* across the region. Because much of the access to employment, services and economic rents has been centred on state-controlled networks, aggregate income has been distributed very narrowly. Only in those economies where structural transformation been more successful – Israel, Turkey and, to a lesser extent, Croatia – has income inequality been contained. High levels of inequality have negative consequences, both economic and political.

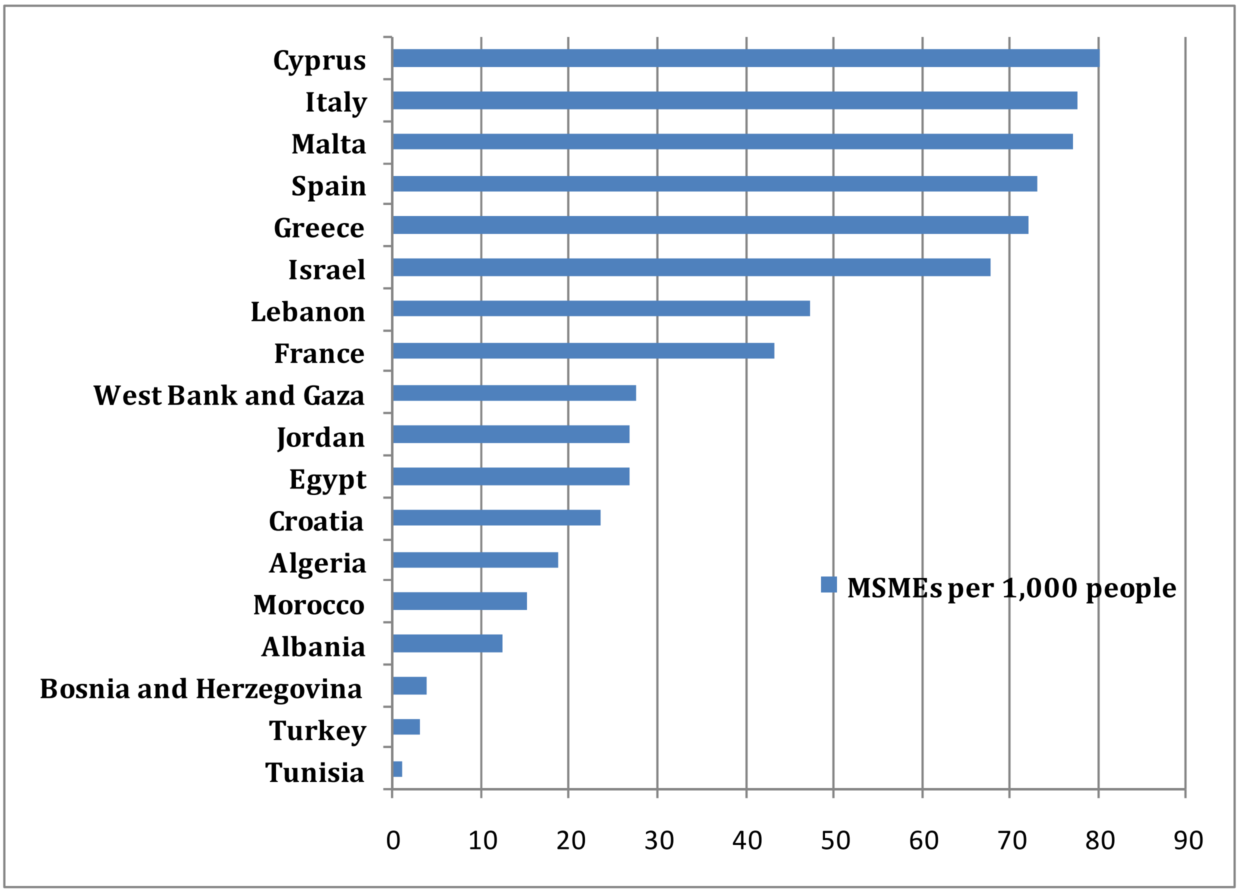
Fifth, the challenges described above have all contributed to the persistence of, in most cases, institutionally weak governance structures. Unless the socio-economic problems described above are solved, the constituencies that provide the demand for better governance in the future are likely to be weakened.

10 Data are unavailable for Gaza and the West Bank.

Finally, this list of problems is likely to be exacerbated by the region's rapidly changing demographic profile. Between 2000 and 2025, the Mediterranean population – including all UfM countries – is projected to increase by nearly 100 million inhabitants, an overall growth of around 22 per cent on 2000 levels. 92.4 million of this increase will take place in the southern rim countries. While the relative increase in population will not be as great as that experienced between 1970 and 2000, the structure of the population is projected to change in a dramatic fashion. First, increased longevity and declining fertility levels will see the dependency ratio rise quickly. Second, the pace of urban growth is expected to be even more dramatic, with the rate of urban population growth expected to outstrip overall population growth. Third, much of the population growth and urbanisation is expected to be concentrated in coastal regions. This changing demographic profile raises a number of concerns relating to sustainable development across the region, including the adequacy of infrastructure and the adaptability of political and economic institutions, as well as the more obvious environmental issues.

The development of a thriving SME sector will be a necessary, although by no means sufficient, condition for solving these challenges. SME development will help increase competition and productivity, boosting aggregate and per capita income growth. It will also stimulate structural transformation because a healthy SME sector is associated with innovation and technological upgrading. Perhaps most importantly, vigorous expansion of the SME sector should generate greater employment opportunities for rising populations. In turn, this should cause inequality to decline as income rises across a broader cross-section of the population, and demand for better governance should grow. All these positive developments should help generate the increased opportunities – both economic and political – that are necessary to turn the daunting demographic projections into a force for positive transformation, rather than a potential source of increased poverty and instability. It is no exaggeration, therefore, to state that SMEs have the potential to act as the primary drivers of development across the region.

Figure 2: Micro, Small and Medium Enterprises (MSMEs) per 1000 people, 2007[11]



Source: World Bank Micro, Small and Medium Enterprise Database (2007)

Unfortunately, SME activity across the Mediterranean is, in general, underdeveloped. Across many countries of the region, the structure of the economy is heavily oriented towards large-scale enterprises, either from the large state-owned enterprise (SOE) and state administration sectors, or towards large private enterprises in the energy, petrochemical, mineral, agribusiness, real estate and tourism sectors. SMEs tend to service the low- and medium-technology sections of the economy, focusing on textiles and clothing, footwear, and basic machinery and capital goods. Indeed, for both large enterprises – private and public – and SMEs, those firms engaged in manufacturing are predominantly sub-contractors or oriented towards final stage assembly. Mediterranean firms do not tend to be active in the higher value-added, research and development (R&D) intensive stages of production. As a result, productivity is generally low, with opportunities for SME entry into markets often curtailed by monopolistic market structures in many industries, thus dampening SME activity. Thus, while SME activity has increased in recent years, as Figure 2

11 Data are unavailable for Libya, Mauritania, Montenegro and Syria.

shows, the ratio of SMEs to population size remains much lower than that observed in their richer neighbours from the northern rim of the Mediterranean.

The fact that the SME sector across much of the Mediterranean is so small is largely because many of the challenges facing the region are also the same factors that create the conditions in which the barriers to SME entry and development are high. Broadly speaking, the environment for entrepreneurship is poor. Table 5 summarises the results from surveys carried out across the region, in which the vast majority of respondents are from SMEs.[12] Therefore, the data give a good, if rough, indication of the most important constraints on SME development across the Mediterranean. While there is some variation across countries, three key barriers to SME development are evident.

First, access to finance is most often cited as the No 1 constraint on doing business. This is important because recent literature provides compelling evidence that financial development contributes to faster growth.[13] Stunted financial development can occur because of liquidity constraints, i.e., domestic savings are insufficient to finance domestic investment, or because access to international capital is limited. Alternatively, the problem may be poor intermediation, i.e., a financial system that is not up to the job of channelling savings to investment in an efficient manner.

Unfortunately, both problems are rife across the region. Persistent and often large current account deficits – with a few exceptions – on both the northern and southern rims suggest that domestic savings rates are inadequate to supply investment, raising the cost of finance as demand exceeds supply. This makes access to international finance more important, but foreign bank penetration in the region is low, cutting off this source of finance for most firms.[14] The supply of finance is also hindered by the poor quality of local banking systems that are often characterised by low levels of competition and conservative attitudes towards lending to SMEs, in large part because scarce capital must be diverted towards larger firms, both private and public, that enjoy closer links to the banking sector.

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[12] Of course, this sample only includes existing firms, and does not include responses from those firms that do not exist. As such, there is a selection bias inherent to any survey data based on existing firms, because it is possible that the most problematic factor is the one that causes low entry in the first place, thus disguising the most important constraint on doing business.

[13] King, R. and Levine, R. (1993), 'Finance, Entrepreneurship, and Growth: Theory and Evidence,' *Journal of Monetary Economics*, Vol.32, No.3, pp.513-542; Levine, R. (2004), 'Finance and Growth: Theory and Evidence: Theory and Evidence,' *NBER Working Paper No.10766*, available at: http://www.nber.org/papers/w10766.

[14] Claessens, S., van Horen, N., Gurcanlar, T., and Mercado Sapiain, J. (2008) "Foreign Bank Presence in Developing Countries 1995-2006: Data and Trends", available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107295.

There are also problems at firm level that explain the reluctance of banks to ease access to finance constraints. For those 'traditional' SMEs that have existed for some time, poor accounting standards and record keeping that are favoured by more traditional methods of family management reduce transparency, further adding to the already existing barriers to accessing finance. For newer entrants, often in more 'modern' sectors, such as services and ICT, problems in accessing finance can arise because of the intangible nature of firm assets, which reduces collateral.

Cumulatively, these constraints – on both the supply and demand sides – help explain why firms consider access to finance be such an obstacle to doing business. This is confirmed by a recent survey, carried out by the World Bank and the Union of Arab Banks, which reveals that levels of bank lending to SMEs across the southern rim are among the lowest in the world.[15]

Second, there are challenges related to public administration which are occasionally considered to hinder business, such as a lack of enough well-trained officials, excessive red tape and lack of transparency. The size and weakness of public administration reduces the scope for higher rates of firm entry. This is because increased transaction costs associated with bribing officials, waiting for permits, adhering to excessive regulations, etc., can drastically reduce the returns on private investment, thus deterring many would-be firms from attempting to enter the market. As firm entry levels remain low, competition is reduced in existing industries, preserving existing inefficient structures of production.

Third, the inadequacy of infrastructure is a widely cited concern for firms across the Mediterranean. The poor quality of key infrastructure like roads, power, water, and telecommunications can cause low returns on private investment for projects that rely on them, but due to problems of scale, are impossible to provide at the firm level. In both the northern and southern rims, major infrastructure projects were predominantly undertaken between the 1960s and the 1980s. However, as capital investment rates declined over the 1990s, much of the infrastructure of the region has not been maintained to a satisfactory level. This erosion of infrastructure has the effect of preserving existing market and production structures: only those firms large or well-connected enough to avoid infrastructure constraints are able to survive.

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[15] R. Rocha, Farazi, S., Khouri, R., and Pearce, D. (2011) "The Status of Bank Lending to SMEs in the Middle East and North Africa Region: The Results of a Joint Survey of the Union of Arab Banks and the World Bank", available at: http://www-wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187511&entityID=000158349_20110324082812&cid=3001_DECwps_Finance_and_Financial_Sector_Development.

Local and regional authorities and SME development

The fact that the SME sector is so underdeveloped across the Mediterranean implies that there is considerable scope for improving the level of interaction and cooperation between local and regional authorities, on one hand, and SMEs – both existing firms and prospective entrants, on the other. This is of vital importance because, in one of the paradoxes of globalisation, the competitiveness of national economies is often built upon geographically limited agglomerations, which are in turn often composed of large numbers of SMEs. For example, the Italian specialism in fashion leather products is built predominantly on an industry that is concentrated in the region of Tuscany. Similarly, the biotechnology sectors of the UK and the USA are concentrated around only a few locations in Cambridge, Boston and San Francisco, all near world-class research universities.

These geographic agglomerations are known as clusters and point to the overwhelming importance of entrepreneurship and SMEs at the local and regional levels. An awareness of the regional basis of entrepreneurship and innovation should help local and regional administrations in the Mediterranean to appreciate how certain factors can help boost economic growth. For example, a range of benefits accompanies the development of clusters, including: improved access for firms to skilled workers and competitive suppliers; increased linkages and complementarities between industries located at different stages of the production chain; greater access to specialised information; increased access to finance and equity finance; a relaxation of coordination and information asymmetry constraints; and easier access to public goods that are supplied as a result of the large demand created by the cluster.

In turn, economic development at the local and regional levels helps improve the quality and effectiveness of local and regional authorities, as higher levels of SME activity generate increased demand for better governance and the provision of local public goods. Thus, while local and regional authorities play a role in fostering SME development in the earlier stages of development, any success then has the effect of transforming them from being agents of change to objects of change. When successful, local and regional development contributes to increased social cohesion through greater employment opportunities and improvements in the quality of public administration.

In short, successful socio-economic development is nearly always built on local and regional foundations. The creation of clusters based on SMEs should, therefore, provide a natural role for local and regional authorities that is both distinct from, and complementary to, broader national objectives. Indeed, there have been a number of examples of successful cooperation between local and regional authorities and SMEs.

On the northern rim, the DELTA (Developing Economies Locally Through Action and Alliance) programme focused on building institutional capacity at the municipal level to foster private sector development. The programme achieved considerable success, with improvements in local infrastructure and administrative capacity helping fuel a rapid expansion of SMEs. Similar entrepreneurship and SME development strategies at the local level also achieved success in Bosnia and Herzegovina. On the southern rim, initiatives to create 'one-stop shops' at the regional level to facilitate faster start-up procedures helped stimulate SME development and caused Egypt to become the fastest reformer in 2006-07 on the World Bank's Doing Business Index.

Unfortunately, many of the initiatives for SME development across the Mediterranean region are too often focused on implementation at national level, neglecting the role of local and regional authorities. Moreover, even where local and regional initiatives exist, limited administrative capacities limit their effectiveness. Consequently, there is a need for an increased emphasis on the importance of local and regional authorities in stimulating higher levels of entrepreneurship and SME creation. But this will require simultaneous efforts to equip local and regional authorities with the tools to create enabling environments for SMEs within the limits imposed by the general low level of administrative capacity.

2. Key Players that Deal with SMEs in the Mediterranean

Because the importance of SMEs to the development of the Mediterranean is widely acknowledged, there are already a large number of agencies operating in the region with the aim of stimulating the growth of the SME sector. Key organisations include:

- **The Union for the Mediterranean (UfM)**

One of the six main projects launched by the UfM is the Mediterranean Business Development Initiative. The purpose of the initiative is to promote SMEs from the Mediterranean partner countries by "assessing the needs of these enterprises, defining policy solutions and providing these entities with resources in the form of technical assistance and financial instruments."[16]

Other initiatives include, for example, the Caserta Ministerial Conference of 2004 which aimed to reduce non-tariff barriers to trade and improve access to finance.[17] This was further bolstered by the Euro-Mediterranean Charter for Enterprise, which additionally aimed to make supply-side improvements to the Mediterranean economy with a focus on training.[18] Access to finance is further boosted by the Mediterranean Business Development Initiative (MDBI).

The UfM also works closely with the EIB[19] to improve funding for SMEs and funds coordination and business development.[20]

- **The European Investment Bank (EIB)**

Since October 2002, the European Investment Bank's operations in the Mediterranean partner countries have been brought together under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). In line with the European Neighbourhood policy and the UfM, FEMIP aims to help the Mediterranean partner countries meet the challenges of economic and social

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16 Joint declaration of the Paris Summit for the Mediterranean, July 13, 2008, p.12, available at: http://www.ue2008.fr/webdav/site/PFUE/shared/import/07/0713_declaration_de_paris/Joint_declaration_of_the_Paris_summit_for_the_Mediterranean-EN.pdf.

17 http://ec.europa.eu/enterprise/policies/international/files/f1960quar_en.pdf.

18 http://ec.europa.eu/enterprise/policies/international/files/charter_11_dimensions_en.pdf.

19 See http://www.eib.org/about/press/2011/2011-005-the-ufm-secretariat-and-eib-join-forces-to-a-concrete-cooperation-in-the-mediterranean.htm.

20 More information can be found at: http://www.ufmsecretariat.org/en/projects-funding-coordination-and-business-development/.

modernisation and regional integration by financing private sector ventures, whether local initiatives or foreign direct investment (FDI). To this end, FEMIP offers loans; private equity; and technical assistance, in many cases to SMEs.

After the launch of the UfM in July 2008, FEMIP was entrusted with the task of coordinating and supporting the implementation of three of the six priority initiatives adopted in Paris (the de-pollution of the Mediterranean; the Mediterranean Solar Plan; and the maritime and land highways project). During the joint ministerial meeting of the ECOFIN Council and FEMIP held in Luxembourg on 7 October 2008, the EIB was invited to step up its support for Mediterranean SMEs, especially small and micro-enterprises, in line with Mediterranean Business Development Initiative.

- **The European Commission**

The European Commission has also declared its intention to propose a Small Business Act (SBA) for the Mediterranean in order to ensure an environment that is conducive to the development of SMEs. The announcement builds on the recent Mediterranean strategy, which was adopted on 8 March by the Commission (COM (2011) 200 final).[21]

It emphasises the need to promote SMEs in the Mediterranean's southern rim countries and, more specifically, to provide them with "a strong regulatory framework conducive to the development of business and entrepreneurship". This version of the SBA, which is still in draft, is intended to define a set of best practices, with particular regard to credit and the fight against corruption, without imposing SBA principles on African SMEs, according to sources close to the issue.

DG Enterprise organises a working party on Euro-Med cooperation, which meets every two years to review progress.[22] It aims to improve cooperation in six key thematic areas: enterprise, investment, trade facilitation, textiles, industrial development and energy efficiency.

- **The Organisation for Cooperation and Development (OECD)**

The OECD is involved in many of the southern rim countries through its Initiative on Governance and Investment for Development in the Middle East and North Africa (MENA). This is a regional effort, initiated and led by countries in the MENA region, and promotes broad reforms to enhance the

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21 http://ec.europa.eu/commission_2010-2014/president/news/speeches-statements/pdf/20110308_en.pdf

22 http://ec.europa.eu/enterprise/policies/international/promoting-neighbourhood/mediterranean/

investment climate, modernise governance structures and operations, strengthen regional and international partnerships, and promote sustainable economic growth throughout the MENA region. The promotion of SMEs is a key component of this initiative. Primarily, the OECD's role is to provide technical assistance to the governments of the region.

On the northern rim of the Mediterranean, the OECD is involved in the promotion of entrepreneurship in south-eastern Europe (including Albania, Bosnia and Herzegovina, Croatia, and Montenegro) through the Local Economic and Employment Development (LEED) programme, which aims to promote the creation of a vibrant private sector in these countries, based on SME development.

- **The European Bank for Reconstruction and Development (EBRD)**

The EBRD invests primarily in private sector enterprises across 29 countries from central Europe to central Asia. It is active in projects in Albania, Bosnia and Herzegovina, Croatia, Montenegro, and Turkey. The EBRD has a Micro, Small and Medium-sized Enterprises (MSME) strategy which focuses on the core elements of the Bank's approach towards supporting the development of MSMEs in its countries of operation. The EBRD targets MSME support because it regards the participation of MSMEs in the formal financial sector in the respective countries of operation as inadequate and believes that instruments beyond foreign bank entry and bank privatisation are needed to accelerate their development.

- **The International Financial Corporation (IFC)/World Bank**

The IFC is a member of the World Bank group and promotes sustainable private sector investment in developing countries. Established in 1956, the IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. It promotes sustainable private sector development primarily by: (i) financing private sector projects and companies located in the developing world; (ii) helping private companies in the developing world mobilise financing in international financial markets; and (iii) providing advice and technical assistance to businesses and governments.

The IFC is involved in all the countries of the Mediterranean, with a committed portfolio of around $2 billion in the MENA region. Through the Private Enterprise Partnership – Middle East & North Africa, it has sought to promote private enterprise, often at the SME level across a range of countries that include many of the Mediterranean southern rims.

- **“Invest in Med”**

“Invest in Med”, launched in April 2008, is a project funded by the European Union which aims at encouraging European investments in the Mediterranean region. It is targeted at enterprises of all sizes, public & private intermediate organisations active in FDI and trade development, government and public bodies. The primary objectives of “Invest in Med” are to develop FDI and trade flows into the Mediterranean region; to develop sustainable partnerships on the north and south rims of the Mediterranean; and to implement a new model of co-operative economic networking between EU and Mediterranean public or private organisations. SME development is an important element in meeting these challenges.

To achieve these aims, “Invest in Med” organises networking events (100 field events over 3 years), provides practical assistance through 110 field operations (including 40 permanent support missions, and 20 long-term and 50 short-term staff exchanges), and establishes MED academies and resource centres. Through its partnership with EUROCHAMBRES, “Invest in Med” is promoting the internationalisation of SMEs across the Mediterranean.

3. Proposals on how the Environment for SMEs can be Improved

Given the stunted development of the SME sector across much of the Mediterranean region, it is perhaps inevitable that any list of proposals for improving the environment for SMEs will be long and daunting. Clearly, there are a large number of barriers to entrepreneurship across the Mediterranean, including weak financial systems, decaying infrastructure, slow and sometimes non-transparent bureaucracies, old-fashioned production structures, highly concentrated market structures, and the continuing large role of the state in the economy. But addressing all these challenges is difficult, given the predominantly low level of administrative capacity across the region. Furthermore, even just identifying one key constraint across the region and concentrating on that may not prove successful because different obstacles are likely to be more or less important depending on the context. Policies should, therefore, be tailored towards individual countries. However, identifying the most binding constraint on development is not easy.[23] Relying on simple survey data, for example, can often be misleading, leading to policies that do not necessarily help remove the binding constraint to increased entrepreneurship. For example, survey data from a number of sources over the last decade would have suggested that access to finance was the most important obstacle to doing business in Morocco. But policies that were aimed at relaxing this constraint did not ignite SME growth in Morocco. Thus, while access to finance was perceived as a problem, in practice something else was stifling entrepreneurship.

To try and identify what was holding back entrepreneurship in Morocco, the World Bank commissioned a study that used a 'growth diagnostics' framework to identify the binding constraint.[24] The study found that the Moroccan economy suffered from too slow a process of structural transformation for achieving higher growth, especially for its exports that faced unfavourable external shocks arising from competitor countries in the main markets for Moroccan exports. This process of so-called "productive diversification" required that Morocco enhance its competitiveness by combating four governance weaknesses. They were: a rigid labour market; a taxation regime that represented a heavy burden for firms and an obstacle to hiring skilled human capital; a fixed exchange rate regime that made it possible to regain price stability but, given existing rigidities in the labour market, did not favour international competitiveness; and an anti-

[23] Hausmann, R. Rodrik, D. and Velasco, A. (2006) "Getting the Diagnosis Right: A New Approach to Economic Reform," *Finance and Development*, Vol.43, No.1, pp.12-15.
[24] World Bank (2006) "Fostering Higher Growth and Employment with Productive Diversification and Competitiveness", *Kingdom of Morocco Country Economic Memorandum*, Washington: World Bank.

export bias, which featured a high level of trade protectionism despite progress in tariff reductions and the signing of several Free Trade Agreements. In parallel, three market weaknesses were identified that affected entrepreneurship: information break-down; coordination problems between the public and private sector; and training shortcomings that ranked the country among those with the lowest level of training offered by businesses.

These findings were contrary to previous diagnoses that placed access to finance as the most important obstacle to business in Morocco, particularly for SMEs, and this example illustrates the importance of taking a rigorous and case-specific approach to identifying the areas for policy intervention that are most likely to yield positive results. Moreover, just as binding constraints vary across countries, policies should also be tailored towards to individual localities and regions because obstacles to business vary even within countries. Infrastructure constraints, access to finance, the quality of human capital – all these factors vary in importance depending on local circumstances. Identifying local and regional obstacles should, therefore, be the first step in creating effective SME development policies. This is not to suggest that efforts at improving national business environments are not important. They clearly are, and any improvements should also help at the local and regional levels. However, efforts to remove binding constraints at the local and regional levels should be the priority.

Overall, this suggests that a key component for formulating effective policy should be a comprehensive effort at identifying binding constraints on SME and entrepreneurship, particularly at the local and regional levels. Once these constraints are identified, the specific interventions required from authorities will be clearer. Notwithstanding the need for region-specific policies, there are a number of general policy proposals that are likely to help improve the general business environment at the local and regional levels for SMEs across the Mediterranean. They are outlined below.

First, because there is a large body of evidence to suggest that SMEs across the Mediterranean experience problems obtaining credit, *alleviating access to finance constraints* for SMEs should be helpful. To this end, policy makers should prioritise improvements in financial infrastructure, including greater coverage and depth of credit bureaus, improvements in the collateral regimes (especially for movable assets), and increased competition between banks and also non-banks. Weaknesses in insolvency regimes and credit reporting systems should also be alleviated. Direct policy interventions through public banks, guarantee schemes, lower reserve requirements and subsidised lending and other measures have played a role in compensating for weak financial infrastructure elsewhere, but more sustainable structural solutions are needed if success is to be sustained.

The role for local and regional authorities will vary depending on the degree to which they are involved in the financial system, for example, through local and regional banks. However, at the local and regional levels, it should certainly be possible for authorities to increase the availability of mutual credit guarantee and microfinance schemes. The former have the merit of reducing information asymmetries and thus the transaction costs experienced by loan providers. The latter has the advantage of making readily usable sums of money available without the demanding collateral and the stringent rules associated with traditional bank loans. For this to be successful, it is important that lending regulations be kept small in quantity and flexible, at least for as long as funds come from donors and not depositors.

Second, because the economies of the region are often weakly integrated into the global economy – thus denying them of important sources of competition and sources of information, as well as markets – efforts should be made by local and regional authorities to *reduce the obstacles to the internationalisation of SMEs*. Many of these of these obstacles are internal to the firm, while others are external.

Problems meeting the costs of internationalisation (legal and export advice, translations, foreign market analyses, etc.), insufficient networking, and limited language skills are internal to firms, while poorly developed financial markets and a cumbersome legal framework are external to the firm. Authorities can help through the provision of advice and consultancy, helping firms to assess their international competitive positions, understanding how to strengthen that position and accessing relevant policy support. Indeed, a range of measures exist to strengthen firm access to international markets. Of perhaps most importance is making these measures available to those firms with international potential and providing them with integrated and tailored support. This is clearly an area well-suited to local and regional agencies.

Third, the *creation of local development agencies* (LDAs) would be a proactive strategy for fostering entrepreneurship and SME development. Such agencies can undertake a variety measures, including: stimulating technology transfer to SMEs; providing advisory services; creating business incubators; and encouraging networks of local and regional firms, as well as creating professional associations for the exchange of information and practices.

Fourth, local and regional authorities are well placed to *promote and build skills and motivations for entrepreneurship and SME development*. Measures to foster an entrepreneurial culture, such as entrepreneurship education in schools and promotion of entrepreneur role models, can be extremely useful, particularly over the medium- to long-term. Perhaps of even greater importance is targeting these efforts at encouraging a specific kind of entrepreneurship based on innovation and higher value-added activities. This is because there are many entrepreneurs and potential entrepreneurs, but the key challenge lies in developing and supporting those entrepreneurs and SMEs that can innovate, export and generate new income for the localities and regions in which they are located.

Fifth, because many of the demographic profiles of the region cause there to be relatively high numbers of young people, efforts should be made at *encouraging youth entrepreneurship*. While youth as a group is often characterised as having particular difficulties accessing labour markets and therefore acting as an important source of unemployment problems, it also contains many of the most dynamic and skilled entrepreneurs that are capable of generating and supporting wider economic development. Although young entrepreneurs are usually able to access standard support measures for adults, it is often the case that they respond better to tailored local and regional initiatives specifically focused on their concerns and difficulties, for example, in recognising the greater efforts youth needs to make to achieve the credibility that is needed to secure access to finance.

4. Recommendations

Undoubtedly, ARLEM has a vital function to perform in helping to foster an environment conducive to the development of a vibrant SME sector in the Southern Mediterranean. In particular, ARLEM's essential function should be to act as a coordinator and facilitator between key stakeholders. Four concrete steps could be as follows.

First, the ARLEM could call for the production of a series of in-depth research reports that will identify the binding constraints that SMEs in the Southern Mediterranean face on a region-by-region basis. This will require substantial fieldwork and a significant level of investment.

Second, ARLEM could call for the establishment of a pan-Mediterranean Small and Medium-Sized Enterprises Forum composed of five key stakeholders: (1) SMEs from the Southern Mediterranean; (2) SMEs from the EU-27; (3) local government officials from the Southern Mediterranean; (4) local government officials from the EU-27; and (5) SME interest groups within the EU. The mission of the forum would be two-fold: (i) to increase the improve the level of finance available to SMEs across the region; and (ii) to draw up a systematic plan for cutting the red tape that encumbers SME growth across the Southern Mediterranean. These are formidable challenges that demand vision, concrete targets and political will to overcome them.

Third, the ARLEM could act as a vocal and influential advocate for an increased infrastructure development element within the development assistance that the EU provides for the Southern Mediterranean and should lobby the Commission, Parliament and Member States of the European Union accordingly in the negotiation of the next financial perspective during 2011.

Fourth, *the* factor which is of absolutely key importance for the development of the Mediterranean region is increasing finance available to SMEs from banks. ARLEM should work to attract banks and capital from all across the world's most rapidly developing economies to invest in the Mediterranean region and to demonstrate that the region is on a solid reform track and is open for business.

5. Summary

This report has analysed the role of small and medium-sized enterprises (SMEs) in the Mediterranean, with particular reference to the local and regional context in which they operate. It was argued that SMEs play a vital role in enhancing competition, entrepreneurship, employment growth, economy-wide efficiency, innovation, growth and the alleviation of poverty. However, the SME sector is, in general, weak and underdeveloped across the Mediterranean region. This is unfortunate because the region faces a large number of common challenges that a stronger SME sector would help to address. These challenges include: reversing the ill-effects of an uneven development process; increasing a generally low level of per capita income; (re)igniting the process of structural transformation that has stalled across the region; reducing the high levels of inequality; improving governance; and turning the daunting demographic projections into a force for positive transformation, rather than a potential source of increased poverty and instability.

A strong and vibrant SME sector has the potential to play a major role in overcoming these challenges and act as the primary driver of development across the region. However, there are a large number of barriers to SME development across the region, with the report identifying three of the concerns most widely cited by businesses across the region, most of which are SMEs. First, difficulties in accessing finance are most widely cited as the number one constraint on doing business in the Mediterranean, a fact that is especially worrying given that recent evidence draws a strong and positive link between financial development and economic growth. Second, the public administrations of the region are also considered not always to be helpful when doing business, with red tape and an occasional lack of transparency, all seemingly problematic for many countries.

Third, the inadequacy of key infrastructure, such as roads, power, water and telecommunications, is a widely cited concern for firms across the Mediterranean.

The fact that the SME sector is so underdeveloped across the Mediterranean implies that there is considerable scope for improving the level of interaction and co-operation between local and regional authorities, on one hand, and SMEs – both existing firms and prospective entrants, on the other. Improving this interaction is essential because, in one of the paradoxes of globalisation, the competitiveness of national economies is often built upon geographically limited agglomerations, which are in turn often composed of large numbers of SMEs. Consequently, successful socio-economic development is nearly always built on local and regional foundations. Encouraging SMEs should provide a natural role for local and regional authorities that is both distinct from, and complementary to, broader national objectives.

A number of key recommendations and proposals to improve the environment for SMEs were presented. The first major recommendation is to identify local and regional obstacles to entrepreneurship and SME development across the Mediterranean. Successfully identifying binding constraints on entrepreneurship will allow local and regional authorities to target the use of scarce resources in a more pragmatic and effective manner.

While proposing the identification of local and regional binding constraints implies a tailored approach to the different regional circumstances, several general recommendations were made that appear to be important for the whole region. It was argued that local and regional efforts should be made to: alleviate access to finance constraints for SMEs; facilitate the internationalisation of SMEs; create local development agencies; promote and build skills and motivations for entrepreneurship and SME development; and encourage youth entrepreneurship.

ARLEM has a vital function to perform in helping to foster an environment conducive to the development of a vibrant SME sector in the Southern Mediterranean and to act as a coordinator and facilitator between key stakeholders.