The Role of the Financial Sector and Governance in Promoting Formal Entrepreneurship In the MENA Region

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Abstract

Formal entrepreneurship is a worldwide phenomenon that has not received enough attention from scholars in the MENA economies. This study investigates the impact of governance quality and financial development on formal entrepreneurship in nine MENA economies. The study uses a panel data analysis via two stage least squares (2SLS) estimation for the period (2010-2018) and a principle component analysis to generate a composite governance index that captures all six dimensions of governance indicators. The study concludes that governance and financial development have a positive and statistically significant impact on formal entrepreneurship. However, other statistically significant explanatory variables were found to negatively impact our dependent variable in MENA economies which proves that the development of formal entrepreneurship is a multi-dimensional process that involves institutional quality, sound macroeconomic policies, adequate infrastructure, stable currency regime, fair judicial system..etc.

JEL Classifications: C23, E, 26, E44, O17

Keywords: Formal entrepreneurship, Governance, Financial Development, MENA region

1.Introduction:

Entrepreneurship is becoming a worldwide phenomenon especially after the outbreak of the COVID19 pandemic and the recession driven by it. Many people have lost their jobs and became forced to start up a small business to be able to make a living. However, many of the new entrepreneurs are skeptical to register their business and prefer to stay hidden in the market. Studies show that entrepreneurship is a strong driving force that can boost employment and economic growth. The World Bank Global Entrepreneurship Survey (WBGES) and the Global Entrepreneurship Monitor Consortium (GEM) have greatly contributed to better understanding the entrepreneurial activity in the emerging economies. Governments design programs to promote new enterprises in order to reach their national goals of technological progress, social equity, sustainable development and poverty alleviation (Gaeis et al., 2021). Studies have shed the lights on the problems associated with informal entrepreneurs in emerging economies like difficult barriers to formal market entry, distorted market information and high corruption level in governmental procedures, but there has not been enough research done on the MENA region. The concept of quality governance and financial development and its impact on formal entrepreneurship is encouraged by political institutions in emerging economies to promote efficient regulation of the economy. This study extends previous studies on formal entrepreneurship by demonstrating how good governance and financial development enhances economic opportunities, which, in turn, encourages formal entrepreneurship in the MENA economies. The countries in the MENA region have unique social norms due to their shared Islamic values, geography and ethnic identity which influence the governance and behavior of economic agents. Also, in the last two decades, the MENA region has experienced economic growth especially the oil-based economies which increased investment opportunities. Then in late 2010, the political upheavals followed by terrorist attacks, high unemployment, currency shortages and decreased oil prices lead to strong economic and political turbulence in the region. As a result, reform programs have been launched in most MENA countries to improve the quality of governance and investment environment. This study will be divided into three main sections: First, the introduction and literature review illustrating the concept of governance, financial development and their relation to the formal entrepreneurship. The second part will cover the research methodology, the empirical model and the results obtained. Finally, third section will include policy recommendations and discussion of future research areas. This study contributes to the existing literature of entrepreneurship by examining how financial development and governance differently affect the formal entrepreneurship in the emerging economies of the MENA region. There are no studies that focus on the interplay of these two concepts (governance, financial development) to enhance formal entrepreneurship in the MENA economies.

1.Literature review:

The literature on the topic of good governance and financial development and their impact on the development of formal entrepreneurship can be classified into three main themes. The first theme defines entrepreneurship and the factors that encourage it and its impact on creating sustainable economic development. The second theme defines the role of institutions in creating a suitable environment that enhances formal entrepreneurship and illustrates how good governance can direct entrepreneurs to innovative and productive activities. The third theme defines the importance of financial stability and trustworthiness in minimizing information asymmetry and transaction costs, hence promoting entrepreneurship in the MENA economies.

1.1. Defining entrepreneurship and its role in economic development:

According to Schumpeter (1934), entrepreneurship is defined as either the creation of new economic activity that results in the creation of a new entity or the pursuit of an innovation.

Schumpeter categorized four roles in the process of innovation: the inventor of the idea, the entrepreneur who commercializes the idea, the capitalist who provides the financial resources and the manager who takes care of the day to day routine. The literature recognizes a variety of roles that can be all carried out by an entrepreneur such as bearing the risk / uncertainty, being an innovator, an organizer, a coordinator, an allocator of resources and being very alert to opportunities. However, not all entrepreneurs are wealth seekers; many became self-employed to have more freedom to pursue their own ideas or because they could not find an opportunity in the job market. Being an entrepreneur brings several non-monetary benefits like broader skill utilization and greater autonomy (Hamilton, 2000). Creating an economic entity or a start-up requires some degree of innovativeness and persistence to face the competition in the marketplace. From this point, we can focus on the most general definition of entrepreneurship which considers an entrepreneur as any individual who introduces a new economic activity and bears the risk, organize, finance and innovate to survive in the marketplace.

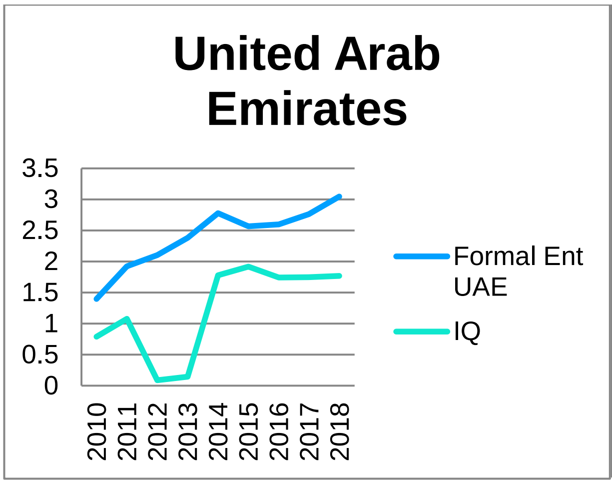
Several factors have been recognized to encourage entrepreneurship: 1) technological change due to progress in research is a prime source of opportunities for new technology-based firms. 2) Social and demographic changes can be a source of opportunities like having a young or an elderly population with special preferences for specific products. 3) Privatization and liberalization of economic activities allow room for new entrepreneurs to penetrate the market. An example of privatization as a source of entrepreneurial opportunities is the privatization of the healthcare market. 4) Flexible labor markets have encouraged many employees to become self-employed lured by lower tax rates in comparison to wage-labor. An example of that are the start-ups that take advantage of labor flexibility in employing temporary staff. Scholars also noted that the informality ratio is always higher in less developed economies and attributed this phenomenon to two groups of factors. First, structural factors that include the institutional regulations, financial pressures and the regulatory environment surrounding the informal entrepreneurs which affects profoundly their decision to stay informal or to pay the cost of formalization and register the business. Second, Opportunity factors that include the individual characteristics of the entrepreneur: his/her societal background, education and geographic status. For instance, the entrepreneur's age, education, business experience, perception of risk and self-confidence play a profound role in the decision to register (Stam, 2008). For instance, an entrepreneur who has a university degree is more prone to take the decision of registering his/her business than an entrepreneur who has only a school certificate. An individual who has a long business experience knows how to develop his/her firm, he/she needs access to credit and to advanced technology so it is easier to convince such an individual with the benefits of registration than a new entrepreneur with no market experience. Researchers suggest that treating the factors that cause the informality phenomenon can help with minimizing it and can bring numerous benefits to the economy.

1.2. The role of institutional quality in enhancing entrepreneurship:

As mentioned earlier, entrepreneurship is considered a strong driving force that boosts employment and economic growth. Entrepreneurship involves the mobilization and allocation of resources (human / technological / financial) to pursue new opportunities in the economy. From this perspective, good governance and institutional development is a necessary factor in determining the choice of an entrepreneur whether to join the formal sector or stay hidden in the economy. Governance can be defined as the institutions by which the authority of a country is exercised (Kaufmann, Kraay and Mstruzzi, 2007). This includes the process of choosing the government, the ability of the government to formulate policies and enforce it and the respect of the citizens towards the state and the institutions that regulate the social and economic interactions among them. Efficient regulation of the economy, well-defined property rights and solid laws encourage formal entrepreneurship in the emerging economies. On the other hand, poor institutional structure provides incentives for the entrepreneur to operate on a limited scale with short-run investments and with no access to credit from financial institutions (De Soto, 2010). An important function of institutional rules is that it directs the entrepreneurs to either productive or unproductive activities. In other words, the nature of entrepreneurial activities differs according to the rules of the game and the payoffs expected from it (Baumol, 1990). According to Baumol, the turning point in an economy is the allocation of entrepreneurship between innovative/productive activities and rent seeking activities where greater reward should be directed to the productive activities. This implies a greater coordination between the type of entrepreneur (necessity / opportunity entrepreneur) and the quality of entrepreneurial activity (high growth / innovative / unproductive). Institutions that provide a fair judicial system, contract enforcement and secure property rights experience an enhanced quality of entrepreneurial activity (Sobel, 2008).

Several prior studies have assessed the role of governance on financial development and concluded that it is necessary to demolish the soft state characterized by mismanagement, corruption, administrative delays and inefficiency of public services. Poor governance system allows financial institutions to extend their loans for projects based on political connections rather than the project viability or allows for predatory lending which involves bribery and improper appraisal (Barth et al., 2009). Moreover, in developing countries, scarcity drives up the value of financial resources unlike the relative abundance of finance in developed economies. The ending result is entrepreneurs avoiding interaction with governmental and financial institutions and resorting to informal channels of operation in the economy. Entrepreneurs often rely on their personal wealth or inheritance to escape the confusion caused by the lack of external financial sources and asymmetry of information (Black and Starhan, 2002). An improved economic and institutional state helps develop the confidence of investors and encourage them to join the formal sector.

During the last decade, the MENA region experienced several Arab springs and political unrest which induced instability and lack of trust between economic agents and their governments or among economic agents together. This state of unrest made the large segment of the economic agents skeptical to operate in the domestic market and would look for investment opportunities in foreign economies. Also, the increase of inefficiency of public governance resulted in a larger informal sector which in turn lead to a decrease in tax revenues (Friedman et al., 2000). Governments characterized with high corruption received a lot of funds in bribery which lead to more public budget deficit and more borrowing to cover the shortage of funds. This vicious circle kept going on and created a sustained state of unpleasant business environment especially after the Arab springs. MENA regimes have been urged to restructure the social contracts framework to reach more transparent, inclusive and equitable economic governance. This was a necessary step to foster the process of neoliberal economic reform and mitigate the conditions of economic precarity and exclusion (Heydemann, 2020). The following graphical representation shows the government institutional quality composite indicator (an indicator created through principle component analysis to encompass all six governance indicator) and the formal entrepreneurship indicator during the period (2010-2018). The graphs show an upsurge in government effectiveness and formal entrepreneurship in the United Arab Emirates, Qatar and Bahrain in year 2015 until 2018. Morocco experienced an improvement in those indicators in year 2017-2018. As for the rest of the MENA economies in this study (Israel, Tunisia, Jordan and Saudi Arabia), the graphs follows a fluctuating pattern where it improves and deteriorates all the time.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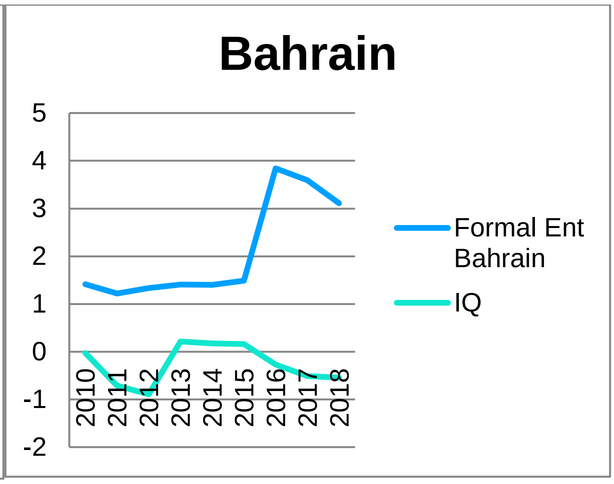
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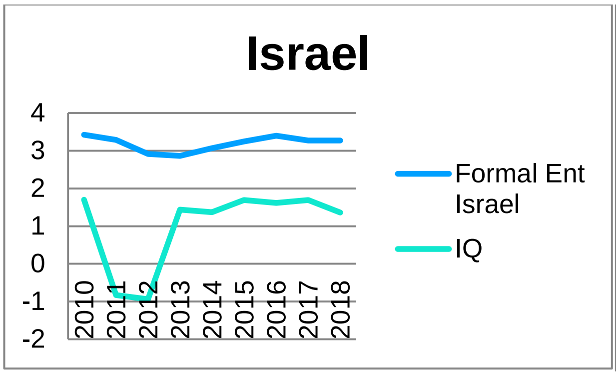
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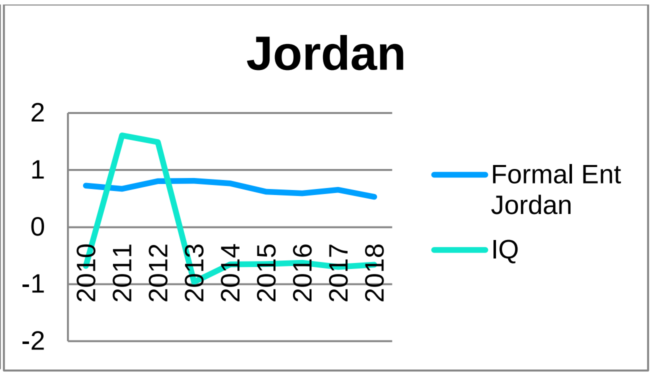
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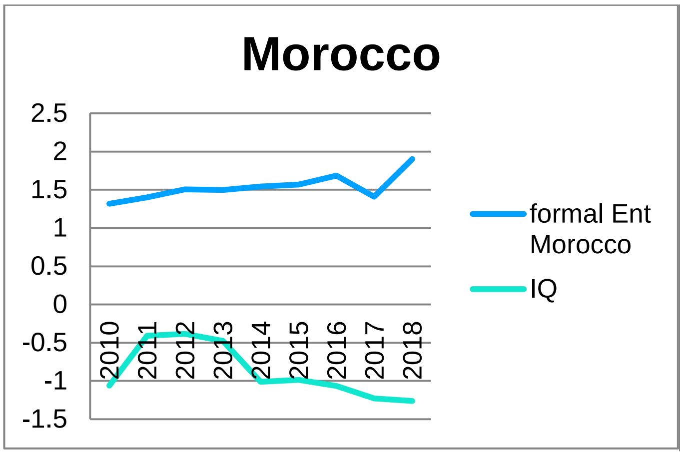
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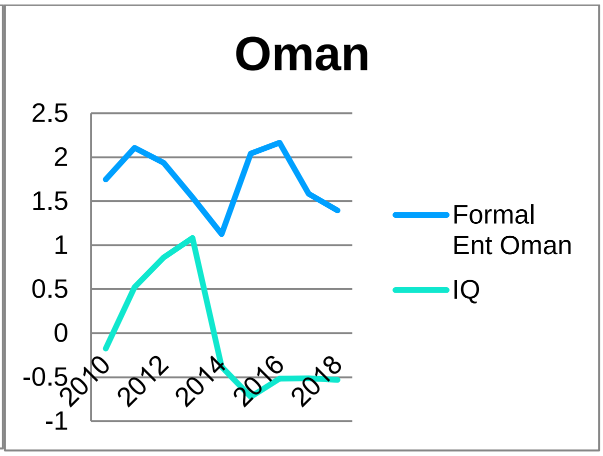
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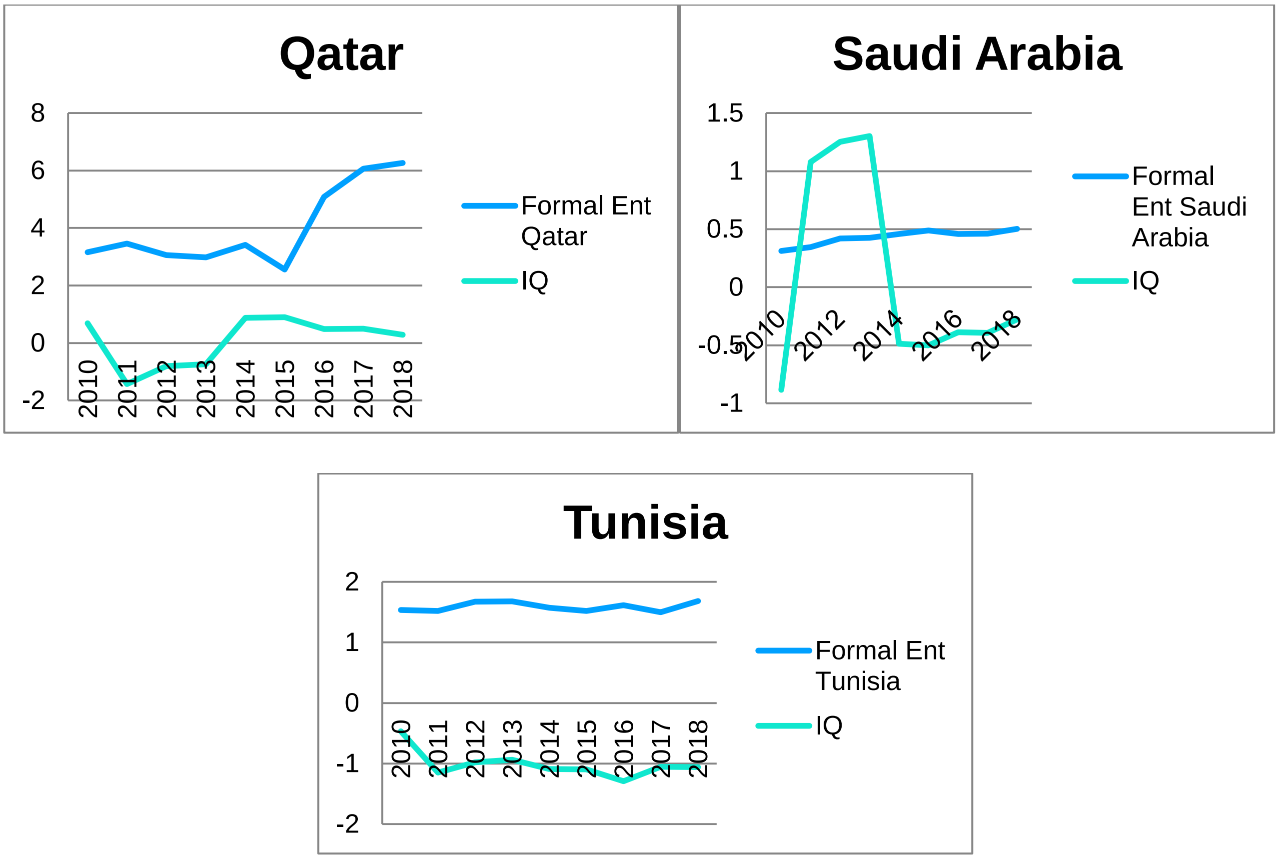


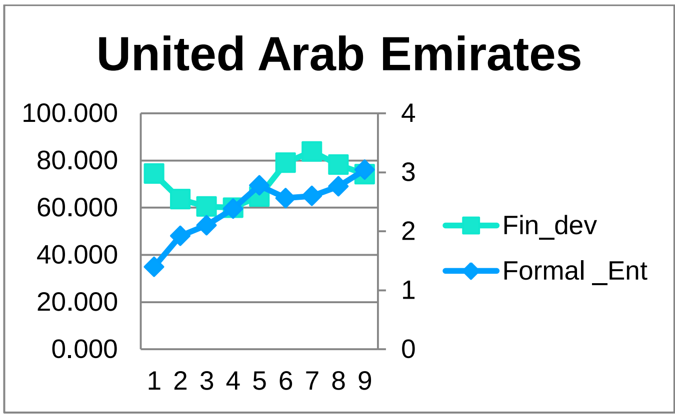
graphs are constructed by the author (IQ is the institutional quality and Formal Ent. is formal entrepreneurship).

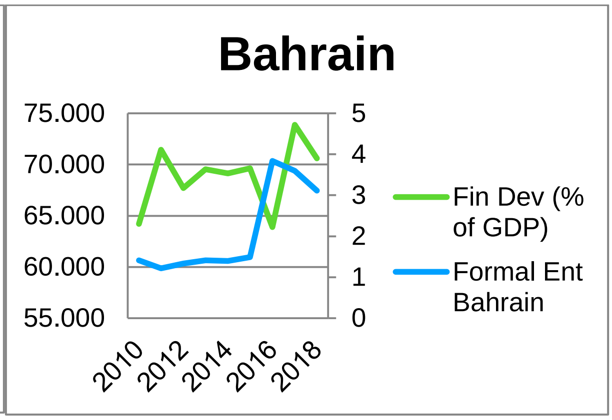
1.3. The Role of Financial sectors in enhancing entrepreneurship:

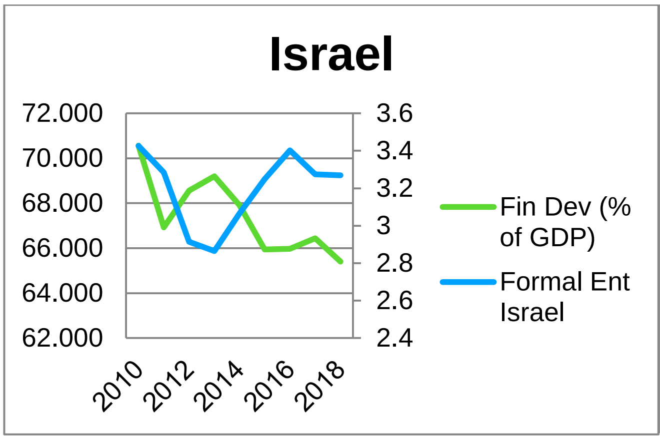
After the 2007-2008 global financial crisis and the political and economic crisis's that took place in the MENA region, governments realized the importance of public trust in the financial system. Trust in the financial sector is reflected in the social norms and values that form the social capital which fosters confidence in the financial intermediation[1]. Therefore, government officials implement different policy measures to develop the financial sector and restore the trust of people in it like providing liquidity support for banks facing problems and supporting deposit insurance programs to prevent bank runs (Albaity et al., 2020). Financial development reduces the distortions in the information available to the

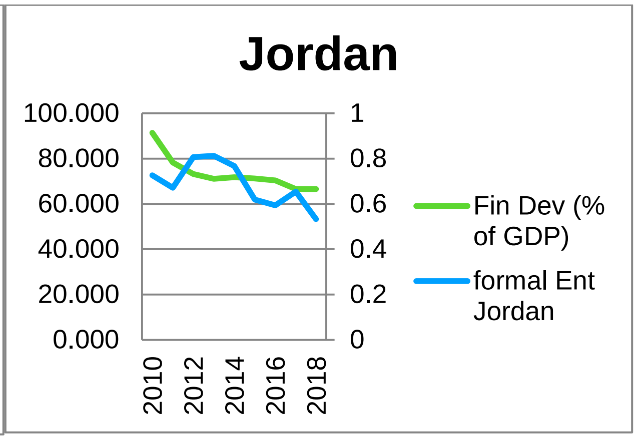
[1] In social sciences literature, social capital encompasses the cooperative norms, confidence and networks that enable people to act collectively.

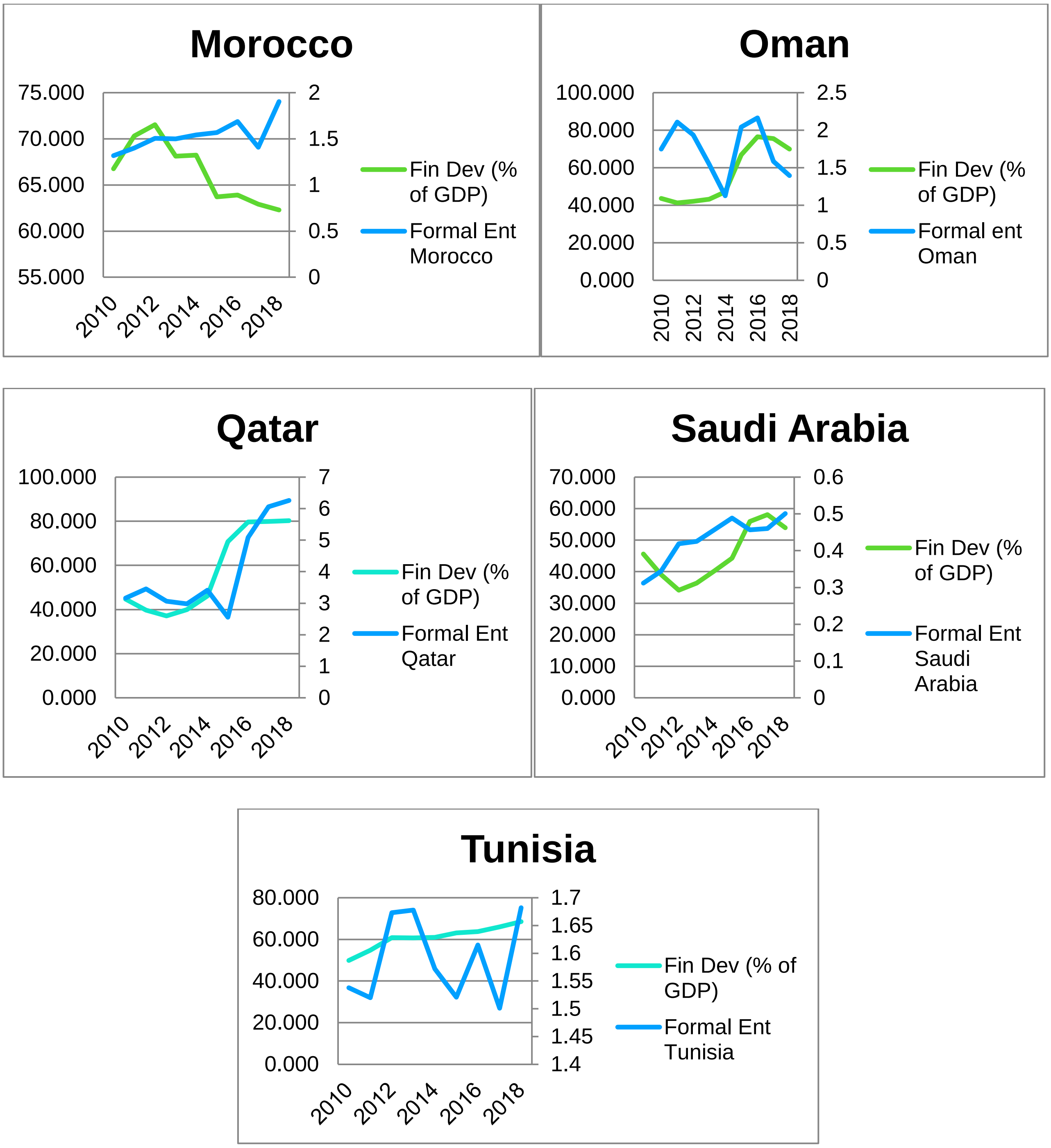
economic agents in the society which boosts efficiency and promotes market participation leading to a reduction in the cost of bank lending (Bottazzi et al., 2016). The lower funding cost reduce borrowers' interest and default risk which reduce banks risk taking behavior which in turn encourage entrepreneurs to enter the formal sector. Trust in the financial system also enhances the flow of information in the market which decreases the cost of monitoring loans and reduces moral hazard at banks (Dudley & Zhang, 2016). The literature reinforces the importance of financial stability and trustworthiness in the economy as it increases people's tendency to honor obligations, suppresses opportunistic behavior and increase mutual respect in the society (Jha & Chen, 2015). On the other hand, regulatory oversight due to poor institutional quality exacerbates the risk-taking behavior of financial institutions which makes it more fragile and vulnerable to crisis (Anginer et al., 2018). Although the MENA economies are similar in customs and traditions, but they have different ruling systems as some are ruled by royal families and others are governed by republican regimes. They all suffer from high unemployment, high corruption and lack of institutional quality that creates a risky environment for investments. Moreover, thousands of private businesses were forced to close without forewarning after the outbreak of the COVID19 pandemic which added a lot of financial pressure on private businesses. Financial sector reforms in the MENA region after 2010 enhanced financial development through lifting government restrictions on the banking systems in terms of interest rate ceilings, launching credit programs and high reserve requirements. Yet, the nature of the geopolitical and economic conditions of the MENA region does not support a broad economic base and hinders financial deepening. For instance, out of the twelve countries of the OPEC organization, eight are MENA economies that are categorized as oil-rich countries. The domination of the oil sector in the overall economy impedes the expansion of industrial and service sector (Smargandi at al., 2014). In other MENA economies, the political instability hindered the development of the financial sector and the COVID19 pandemic was a strong external shock to all world economies. To sum up, the MENA countries rich in resources are mostly centrally regulated which causes many distortions in the financial sector. The following graphs illustrate the formal entrepreneurship and financial development indicators for every economy in our sample of MENA countries. We can see in Qatar, Bahrain and Jordan that those two variables improve together and deteriorate together. In other countries like Israel, United Arab Emirates and Tunisia, the two variables are not moving together (financial development increase, but formal entrepreneurship decrease) which implies that some other factors are strongly hindering the development of formal entrepreneurship.











Graphs are constructed by author (Fin Dev is the financial development and Formal Ent is formal entrepreneurship)

2. Methodology

The two stage least squares estimation method will be applied to a balanced panel of 9 MENA economies (United Arab Emirates, Bahrain, Israel, Jordan, Morocco, Oman, Qatar, Saudi Arabia and Tunisia) covering the period (2010-2018). The reason for using this method of estimation is to correct for the correlated errors of the dependent variable and the explanatory variables. The adopted periodicity for the model and the choice of the MENA economies is based on the availability of data in the World Development Indicators (WDI) and Global Entrepreneurship Monitor (GEM) databases. Second, this method is consistent with a panel data structure and cross-country variations are not excluded in the regressions. Third, the method of estimation also addresses the selection bias and reverse causality that cause endogeneity issues in the regression.

2.1. Hypothesis and Model

The study formulates the following hypothesis:

Hypothesis 1: Governance and financial development increases formal entrepreneurship.

Hypothesis 2: Governance and financial development decreases formal entrepreneurship.

We consider the following baseline dynamic model:

$$FE_{i,t} = \propto_i + \beta_1\ IQ_{i,t} + \beta_2 Fin\ Dev_{i,t} + \beta_3 FDI_{i,t} + \beta_4 Unemp_{i,t} + \beta_5 GDP\ Per\ Capita_{i,t} + \beta_6 \text{Pop} + \varepsilon_{i,t}$$

Where the subscripts i and t refer to countries and years respectively (i= 1, …., 9; t= 2010, …, 2018) and $\varepsilon_{i,t}$ is the error term. The number of newly registered businesses as a percentage of the working age population was used as a proxy for formal entrepreneurship. Credit provided for the private sector as a percentage of GDP was used as a proxy for financial development. A composite indicator was generated through principle component analysis that encompasses all six governance indicators published by the World Development Indicators. The six dimensions of governance are: Rule of law, voice and accountability, government effectiveness, control of corruption, political stability and regulatory quality indicators. Consistent with recent entrepreneurship literature, we controlled for the GDP per capita and the population size for the 9 selected countries. According to economic theory, GDP per capita is expected to enhance formal entrepreneurship and growth in population size is expected to work the opposite way. We expect that the inflow of foreign direct investments can have two significant impacts in the economy that can work against each other. Foreign direct investments can create job opportunities and transfer new technologies to the domestic economy. It can have a positive impact on formal entrepreneurship by encouraging new domestic businesses to enter the market and compete with foreign investors. This can only happen if the governance and financial sectors are well-developed and well-organized to create a suitable business environment. According to Oman (2000) foreign investors tend to attach greater importance to the "fundamentals" – political and macroeconomic stability, market access and long-term growth potential. In return, governments of MENA economies should seek to improve the supply of human capital and infrastructure. From this perspective, we can say that FDI will result in a positive-sum game where all economic agents reap benefits (Oman, 2000). On the other side, the inflows of FDI can have a negative impact if it imposes harsh competition that make new entrepreneurs unable to enter the market causing the crowding out effect of domestic investors. We also expect that increase in unemployment adversely affects formal entrepreneurship as it encourages the expansion of the informal sector.

Table 1 reports the definition and source of each variable.

Variable	**Definition**	**Source**
Formal Entrepreneurship	Number of newly registered businesses as a percentage of the working age population	WDI
Financial Development	Domestic credit provided by the financial sector as a	WDI

	share of GDP	
Institutional Quality	A composite indicator that captures all six governance indicators: 1. Control of corruption: the extent to which public power is exercised for private gain, including both petty and grand forms of corruption. 2. Political stability: the likelihood that the governments will be stabilized by unconstitutional or violent means. 3. Government effectiveness: the quality of public services, the capacity of the civil service and its independence from political pressure and the quality of policy formulation. 4. Regulatory quality: the ability of the government to provide sound policies and regulations that both enable and promote private sector development. 5. Voice and accountability: the extent to which a country's citizens are able to participate in selecting their government as well as freedom of expression, freedom of association and free media. 6. Rule of law: the extent to which agents have confidence in and abide by rules of society, including the quality of contract enforcement and	WGI

	property rights, the effectiveness of police and the courts.	
GDP per capita growth	GDP per capita growth rate (annual %)	WDI
Foreign Investments	Foreign direct investments inflows (% of GDP)	WDI
Unemployment	Unemployment, total (% of total labor force)	WDI

Notes: WDI is World Development Indicators, GEM is Global Entrepreneurship Monitor and WGI is World Governance Indicators.

2.2. Results and Discussion

Summary Statistics (9 countries, 2010-2018):

Variable	Mean	St. dev	Min	Max
Formal Ent.	1.9627	1.231	0.312	6.263
IQ	1.110	1.001	-1.431	1.916
Fin Dev	63.02	12.64	34.10	91.48
FDI	2.629	2.043	-3.17	11.45
Unemp.	6.441	4.874	0.200	18.33
GDP per capita	0.580	3.911	-15.15	6.765
Pop	11075520	10701573	958423.0	34192358

All our independent variables had a statistically significant p-value (< 5%). The institutional quality composite indicator had a positive coefficient (+0.24) denoting that a 1% increase in the quality of institutions induces a 24% increase in formal entrepreneurship. Financial development had a positive coefficient (+0.03) indicating that a 1% increase in financial development can induce a 3% increase in formal entrepreneurship. The foreign direct investment coefficient had a negative coefficient (-0.19) which illustrates that the presence of foreign investors in the market discourage informal entrepreneurs to register their businesses probably because they are unable to compete with foreign investors in the economy. An increase of 1% in foreign direct investments causes a 19% decrease in formal entrepreneurship. The GDP per capita growth rate had a positive coefficient (+0.06) denoting that a 1% increase in it induce a 6% increase in our dependent variable. This outcome comes in line with the previous literature as the empirical studies shows a linear relationship between GDP growth rate and entrepreneurial activity (Urbano & Aparicio, 2016, Lepojevic, 2016, Boudreaux, 2019). Finally, the population size variable had a negative coefficient (-3.81) denoting an inverse relationship between the population size and the growth of formal entrepreneurship. This can be explained by the inverse relationship between the rapid growth in population size (at a rate more than 2%) and economic growth in developing countries. For instance, in our sample of MENA economies, the United Arab Emirates had a population growth rate of 14.4% and a GDP growth rate of 9.8% in year 2018. Bahrain had a population growth rate of 7.5% and a GDP growth rate of 6.4%. The rapid population growth rate slows down economic development and entrepreneurship as it becomes more difficult to develop the human skills and administrative structure that are needed to exploit the resources of a nation. The post-estimation diagnostic tests were indicating that the model is robust. The Jarque-bera test had a p-value = 66.8% and Pesaran CD test of serial correlation had a p-value = 10% denoting normal distribution and the absence of serial correlation among residuals. Table 3 reports the results of estimations for our empirical model.

Table 3: Regression and diagnostic tests results.

Variable	Coefficients	Standard error	t-statistic
IQ	0.247***	(0.078)	3.165
Fin_Dev	0.035***	(0.006)	5.637
FDI	-0.197***	(0.037)	-5.307
Unemp	-0.066***	(0.017)	-3.822
GDP_PPP	0.0630***	(0.019)	3.302
Pop	-3.81***	(7.68)	-4.953
Observations	72		
R-Squared	0.492		
Adjusted R-Squared	0.445		
F-statistic	10.49***		
Jarque-Bera Normality test	p-value = 0.668		
Pesaran CD correlation test p-value	-1.64 with p-value = 0.10 (no serial correlation)		

*Robust standard errors are in parenthesis. ***, **, * denote statistical significance at p less than 1, 5, 10% respectively.*

3. Conclusion and Policy implications:

This study examined the impact of governance and financial development on the development of formal entrepreneurship in nine MENA economies. The countries in the MENA region have unique social norms due to their shared religious values, geography and ethnic identity which influence the behavior of economic agents. In late 2010, the MENA region experienced political upheavals, terrorist attacks, currency shortages, decreased oil prices and high unemployment. Reform programs were launched in most MENA countries to improve governance and investment environment. Efficient regulation of the economy, well-defined property rights and solid laws encourage formal entrepreneurship in the emerging economies. Poor institutional quality provides incentives for entrepreneurs to work on a limited scale with short-run investments and stay hidden with no access to finance. It also allows financial institutions to extend their loans for projects based on political connections instead of project viability or allows for predatory lending which involves bribery and improper appraisal. The ending result is entrepreneurs resorting to informal channels of operation in the economy. The political unrest in the MENA region forced the ruling parties to implement true reform steps to mitigate the impact of economic crisis. The improvement in governance quality facilitated the enhancement of financial services. This brings us to the second main theme of this study which is the importance of financial development in the development of formal entrepreneurship. Financial development reduces the distortions in the market information, boosts efficiency and promotes market participation leading to a reduction in transaction costs of bank lending. This can reduce borrower's interest and default risk which reduce the bank risk-taking behavior hence encouraging entrepreneurs to enter the formal sector. Financial sector reforms in the MENA region after 2010 enhanced financial development through lifting government restrictions on the banking systems in terms of interest rate ceilings, launching credit programs and high reserve requirements. Although those reforms were beneficial for the financial sector development, but there are still many issues to be resolved through reforms. Our panel data analysis confirms the positive relationship between governance, financial development and formal entrepreneurship in the MENA economies. On the other hand, there are other variables that negatively influence our dependent variable in the economy like the inflows of FDI, unemployment and the size of the population. This negative effect can cancel out the benefits driven by the enhancement in governance and financial development and waste all the efforts done by the governments to reform and restructure the institutional and financial framework. This leads us to a set of policy recommendations that are interdependent and should be implemented as a bundle of measures: 1) The development of legal and institutional frameworks related to property rights, contract enforcement and insolvency regimes are key requirements for enhancing formal entrepreneurship. This allows for greater alienability of assets that can be transferred, sold and collateralized more easily, facilitating access to finance. 2) Reduction of red tape and compliance costs associated with starting-up a business and predictability of the business environment is a crucial factor in determining the business decisions. 3) Low inflation and a stable and transparent currency regime enhance competitive exchange rates in an economy and secure a stable foundation that businesses need to operate. 4) Limited public sector size and less budget deficit are crucial to avoid crowding out of small, medium and micro enterprises in the economy. 5) Financial sector soundness and competitive banking sector that provides initiatives to fund entrepreneurs with discounted interest rates and less complicated loan procedures. 6) Enhancing transparency tends to suppress large firms that are politically well connected in countries with poor institutions and as a result benefit from better access to credit leaving no space for small entrepreneurs to access finance. 7) Building the capacity of local entrepreneurs to raise their market efficiency through launching of technology and quality upgrading programs. Governments of the MENA economies need to increase the efforts in developing governance and financial sectors.

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