State of Corporate Governance in Arab Countries: An Overview

Najib Harabi

University of Applied Sciences, Northwestern Switzerland

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*Dr. Najib Harabi**

*Professor of Economics at the University of Applied Sciences, Northwestern Switzerland
Email: najib.harabi@fhnw.ch

Abstract: Despite the diversity of the region, all Arab countries are currently facing the same major challenge of accelerating job creation to reduce double digit unemployment rates that threaten their social cohesion. After very high growth rates in the sixties and seventies, often fueled by massive public investments, growth in the region has been weak for the past two decades. With the failure of public policies to sustain high growth over time, all of the region's governments have embarked on a series of reforms to promote private sector-led economic strategies.
Despite successes in first generation macroeconomic reforms (including macro-economic stabilization and price and trade liberalization), Arab governments have not succeeded in putting in place an environment conducive to a strong and sustainable growth of the private sector. Most private sector development indicators rank Arab countries behind the other regions of comparable income. Their ability to attract rising worldwide FDI flows in the nineties has also been week, despite the region's high potential and its proximity to major OECD markets.

The relatively poor overall performance of the private sector is a complex phenomenon and has therefore multiple causes. While the investment climate constraints to business development in the Arab region are well documented in the several Business Climate Surveys of the World Bank and other national and international organizations, much less is known on other impediments to private sector development, such as the state of corporate ownership and the nature of corporate governance and its enforcement mechanisms.

The purpose of this paper is to assess the state of corporate governance as a major factor affecting the growth performance of the private sector in MENA countries. For this purpose both country-specific assessments, carried out by World Bank-IMF teams (so-called ROSC's assessments) and focus-group discussions that took place in four regional conferences have been synthesized. Strengths and weaknesses of corporate governance in selected Arab countries have been highlighted. One major key finding is that the legal and regulatory frameworks of the assessed Arab countries are largely compliant with the OECD Principles of corporate governance. However, practices are not. The difficulty of the assessments is to reflect properly the discrepancies between the letter of the law and compliance. It should be emphasized that the World Bank-IMF assessments focus on listed companies. No-listed firms, especially SME, family-owned firms and State-owned enterprises that make up to 98% of all firms, are not subject to assessments.

Another key finding that emerged from our reviewing of the regional conferences on corporate governance is that corporate governance issues have not been ignored in public debates in the MENA region. Practitioners from capital markets, banks, public and private sector representatives and other civil society groups have accepted the need to address corporate governance reforms as one of the crucial topics affecting the economic growth and development of firms, industries and whole economies in their region. Several meetings and conferences at the national and regional level have taken place. Appropriate and up-to-date recommendations regarding corporate governance reform in the MENA region have been adopted in those events. It is now up to the decision makers at all levels to implement those recommendations.

State of Corporate Governance in Arab Countries: An Overview

1. Introduction

Despite the diversity of the region, all Arab countries are currently facing the same major challenge of accelerating job creation to reduce double digit unemployment rates that threaten their social cohesion. After very high growth rates in the sixties and seventies, often fueled by massive public investments, growth in the region has been weak for the past two decades. With the failure of public policies to sustain high growth over time, all of the region's governments have embarked on a series of reforms to promote private sector-led economic strategies. Despite successes in first generation macroeconomic reforms (including macro-economic stabilization and price and trade liberalization), Arab governments have not succeeded in putting in place an environment conducive to a strong and sustainable growth of the private sector.

Progress in second generation structural reforms of the microeconomic environment of firms has been much slower, and proved to be more difficult to implement. Whether on trade reform (particularly the customs administration, trade finance and trade facilitation and logistics), the labor markets (its rigidity and the inadequacy of skills to market demand), the financial markets (access to bank finance, non-bank financial instruments, credit reporting institutions, etc.), the administrative bottlenecks (in particular entry and exit legislation), the reform of the state-owned enterprise sector, the functioning of the judiciary; in all of these areas, Arab countries clearly lag behind, especially when compared to middle-income countries. Most private sector development indicators rank Arab countries behind the other regions of comparable income. Their ability to attract rising worldwide FDI flows in the nineties has also been week, despite the region's high potential and its proximity to major OECD markets.

The result of this poor investment climate is that private investment (whether domestic or foreign) has overall been too low to create enough jobs and spur growth. Moreover, there is ample evidence that these constraints to doing business are hurting more the smaller enterprises and act as major barriers to entry for new firms to emerge. The most visible consequence of this is the particularly skewed size-distribution of firms that is common to all countries in the region and, for this matter, to most developing countries. In Arab countries, the enterprise sector is invariably dominated by a small number of large, family-owned business groups, which coexist with a large number of small and micro-enterprises. Only very few of the later grow to become middle-sized enterprises that are able to compete on a scale large enough to threaten the large firms' oligopolies. For those countries which are late comers to the liberalization reforms[1], one should add to these two groups the large State-owned enterprises.

Given the poor enforcement of regulation and competition policies – when they exist -, it is most likely that these business groups engage in monopolistic pricing.[2] The dominance of these types of firms in the region raises with respect to the overall private sector development at least three concerns:

[1] This group of countries would include Algeria, Libya, Syria, Iran, Iraq, and Yemen.
[2] To our knowledge, there has not been a careful study yet of the competitive behavior of the few large firms that dominate the private sector in MENA.

- *First*, the ownership structure of these business groups may have adverse effects on their management and performance, for corporate governance arguments, as we will describe below. These are usually family-owned groups (with single or multiple shareholders), that are involved in different industries. Key to private sector development is the creation of favorable conditions for an optimal allocation of capital and other factors of production. The issues of corporate ownership structure and related corporate governance mechanisms are in this respect critical. The questions of who owns and control firms, how these firms are governed and how those issues affect the performance of firms are central for understanding the growth process of the whole private sector.

- *Second*, the market-power position of some of these large groups may self-sustain and be reinforced by acting as barriers to entry for small would-be competitors. Not only can they have economies of scale in some sectors, but they often have acquired competitive advantages in: i) *access to finance*, through arm-length relations with banks. The banking sector is usually not competitive enough for banks to try to enter the small firms segment. Competition among banks is usually limited to servicing these large corporate groups, reinforcing the inherent inefficiencies of the credit markets; ii) *distribution*, by either controlling directly or through alliances with large distribution networks; iii) *their relation with the public administrations*. Given their size, these firms usually benefit from a better business environment than smaller firms. This is particularly the case in the dealings with the various public administrations (with which they often have arms-length relations), which are usually a major hassle for small firms. It can also translate in preferential access to public procurement contracts.

- *Third*, the large business groups often have close relations with the political sphere[3], and have the political power to influence policy-decision making on business regulation and reform priorities. This is the State or regulatory capture argument.

In sum, the relatively poor overall performance of the private sector and the particularly skewed size-distributions of Arab corporations are complex phenomena and have therefore multiple causes. While the investment climate constraints to business development in the Arab region are well documented in the several Business Climate Surveys of the World Bank and other national and international organizations, much less is known on other impediments to private sector development, such as the state of corporate ownership and the nature of corporate governance and its enforcement mechanisms.

In this paper I will focus on the issue of the state of corporate governance in Arab countries. Section 2 sets out the conceptual framework. Section 3 deals with the question of why corporate governance is important for the economic development of Arab countries. Section 4 documents the current state of corporate governance in Arab countries, using both country-specific assessments and material from regional roundtable

[3] Sometimes directly because of their size and the consequently high "political market power", but also for the same reason they have been able to grow big (i.e. their influence on the political sphere or their relations with the political leaders is often the precise reason they have been able to benefit from *de facto* monopolistic situations, and grow their businesses).

discussions. Section 4 summarizes the paper and draws conclusions for policy makers in the Arab region.

2. Conceptual Framework

Definitions of corporate governance vary widely. At the most basic level "a corporate governance problem arises whenever an outside investor whishes to exercise control differently from the manager in charge of the firm." (Becht et al. 2003). Corporate governance is thus "concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interests between various corporate claimholders." (Becht et al. 2003)

Under a broader definition, corporate governance would include the relationship between shareholders, creditors and corporations; between financial markets, institutions and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment.

According to a survey of the finance and corporate law literature "mandatory governance rules (as required by stock exchanges, legislatures, courts or supervisory authorities) are necessary for the main reasons: first, to overcome the collective action problem resulting from the dispersion among shareholders and second, to ensure that the interests of all constituencies are represented. In deed, other constituencies besides shareholders face the same basic collective action problem. Corporate bondholders are also dispersed and their collective action problems are only imperfectly resolved through trust agreements or consortia or in bankruptcy courts. In large corporations employees and clients may face similar collective problems, which again are imperfectly resolved by unions or consumer protection organizations." (Becht et al. (2003: 17).

In order to mitigate shareholders' collective action problems, the following five major alternative corporate governance mechanisms have been used in practice and analyzed in the literature[4]:

1. "*Election of a board of directors representing shareholders' interests, to which the CEO is accountable.*
2. *When the need arises, a takeover or proxy fight launched by a corporate raider who temporarily concentrates voting power (and or ownership) in his hands to resolve a crisis, reach an important decision or remove an inefficient manager.*
3. *Active and continuous monitoring by a larger blockholder, who could be a wealthy investor or a financial intermediary, such as a bank, a holding company or a pension fund.*
4. *Alignment of managerial interests with investors through executive compensation contracts.*
5. *Clearly defined fiduciary duties for CEOs together with class- action suits that either block corporate decisions that go against investor's interests, or seek compensation for past actions that have harmed their interests." (Becht et al. 2003:18).*

[4] Becht et al (2003) provided a survey of both the theoretical and empirical literature on the five corporate governance mechanisms listed here.

In addition to investigating these mechanisms of corporate governance, one has to look into the question of how these mechanisms are really enforced, especially in the institutionally week context of developing countries. Berglof and Claessens (2003) consider several ways of classifying the issues related to enforcement. One distinction is between private and public enforcement mechanisms. Private initiatives to enforce contracts are critical to the functioning of any economy and can be outside of the legal system. These initiatives can be unilateral, bilateral and multilateral. Such private ordering among agents is different from private enforcement of public law. Laws can be enforced through private means, such as litigation by individuals, or by public enforcement. In the typical environment of most developing and transition countries the private mechanisms are - according to Berglof and Claessens (2003) - more effective than public forms of enforcement.

Instead of focusing on the legal mechanisms via which equity and debt holders seek to exert corporate control, other economists such as Alchian (1950) stress that (output and input) market competition forces firms to minimize costs, including the adoption of corporate control mechanisms that minimize the cost of raising external finance. Nevertheless, in their extensive survey, Shleifer and Vishny (1997: 738) conclude that although "… product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance." In other words market competition does not solve the collective action problem related to corporate governance. In this regards regulatory rules have to be mandatory, as mentioned above[5].

Following this basic insight, several national and international, private and public organizations have in deed developed regulatory rules of corporate governance and tried to use them for their specific purposes. In this respect, the OECD Principles of corporate governance have been outstanding as an international benchmark. A first version of those principles was published in 1998, a reviewed and revised version of them is now available (since 2005).

The OECD Principles are general guidelines for regulating the entry, ongoing obligations and exit of companies to and from equity markets. The Principles were devised with four

[5] For further discussion of why markets alone are insufficient to ensure sound corporate governance, see for example Glasser/Johnson/Shleifer (2000) and Stiglitz (1998).

fundamental concepts in mind: responsibility, accountability, fairness and transparency. The Principles allow for diversity of rules and regulations.

The OECD Principles are primarily concerned with listed companies. They are organized into five sections, (1) the rights of shareholders, (2) the equitable treatment of shareholders, (3) the role of stakeholders in corporate governance, (4) disclosure and transparency and (5) the responsibility of the board.

The OECD Principles state that the board members are accountable to shareholders and to the company. Accountability to shareholders means equal treatment of majority and minority shareholders. Accountability to the company means that directors must ensure that the company complies with existing laws and regulations, such as tax, labor, health and safety laws, equal opportunity, environmental legislation and competition law.

The OECD Principles stress that stakeholders, in particular creditors, employees and consumers, play an integral part in shaping the decisions of a company. Principle III states that "… the corporate governance framework should encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises". The full social responsibility debate goes beyond the scope of this report.

In particular, corporate governance deals with the checks and balances that need to be put in place to cope with the problems resulting from the separation of management and ownership of corporations (so-called "principle-agents problems"). Board members and management need to have enough independence to manage the company's affairs as they best see fit without undue interference from outsiders, as long as they do it prudently, with diligence and care, and in the interest of shareholders. Checks and balances are necessary to ensure accountability, since people are likely to manage their own affairs more carefully than those of others.

The OECD Principles are non–biding for OECD-countries. The World Bank has used them, however, in order to assess the state of corporate governance in some of its member countries, including Arab countries. For this purpose it has produced a questionnaire in the form of a template (the "Template) that is structured along the five chapters of the OECD Principles.

The objective of having the Template is to facilitate the gathering of information necessary to formulate a diagnostic of the institutional framework underlying corporate governance, as well as prevailing practices and enforcement. For each OECD Principle, a set of questions have been prepared to assess the compliance of the country under assessment. Questions have been drafted so that they can be answered by "yes" or "no" as often as possible, to allow benchmarking.

The Template includes a section on the ownership structure of the assessed country, since this is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross shareholdings and business groups; it gathers information on the divergence between cash flow rights and voting rights. While the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure and the responsibilities of insiders, the template also addresses the issue of institutional capacity.

The OECD Principles of corporate governance will be used in this report for assessing the state of corporate governance in those Arab countries, for which systematic assessments exist, namely for Morocco, Egypt and Jordan. Before doing this in section 4, I will try to answer briefly, why corporate governance is important for their economic development.

3. *Corporate Governance and Economic Development*

The economic literature has identified several channels through which corporate governance affects the economic performance of firms, markets and whole economies[6]:

1. "*The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth and greater employment creation.*
2. *The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment.*

[6] For a survey of the literature regarding corporate governance and development see Claessens (2003) and Oman (2001).

3. *The third channel is better operational performance through better allocation of resources and better management.*
4. *Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs.*
5. *Fifth, good corporate governance can mean generally better relationship with all stakeholders. This helps improve social and labor relationships and aspects such as environmental protection."* (Claessens (2003:14))

All these channels mater for economic growth of both firms and of economies. As Claessens (2003) shows in his survey, there is evidence that documents these channels empirically. A few examples follow:

Increased Access to Financing. In countries with strong property rights (strong legal foundations of corporate governance) the financial and capital markets are better developed. Corporations have therefore better access to financing. Data provided by La Porta et al. (1997) suggest first, that the stronger the creditors rights, the greater the depth of the financial system (measured as the ratio of private credit to GDP) and second, the better the quality of shareholders protection, the larger the country's stock market. Strong regimes of property rights seem to be very important for both credit and stock market financing. There is also evidence that poor corporate governance (and underdeveloped financial and legal systems and higher corruption) means (a) the growth rate of the smallest firms is the most adversely affected and (b) less new, and particularly small firms, start up (Beck et al. (2002); Rajan and Zingales (1998)).

In addition, a substantial body of theoretical work suggests that concentrated business groups serve as a device through which minority shareholders can be expropriated. Pyramidal ownership structures offer one mechanism through which this might happen. The ubiquity of pyramids in 27 countries has been established by La Porta et al. (1999). The lack of protection for minority shareholder rights has been argued to impede the efficient functioning of financial markets (La Porta et al. (1998)). The resultant inefficiencies in capital markets can prevent the entry of de novo entrepreneurs and thus stifle competition.

Higher firm valuation. Besides access to external financing, the quality of the corporate governance framework affects the costs of capital and firm valuation; the issues of access and costs are, of course, related. Outsiders are less willing to provide financing and are more likely to charge higher rates if they are less assured that they will get an adequate rate of return. There is an empirical evidence for these effects. La Porta et al. (2000) have shown that the costs of capital seem to be higher and valuation lower in weaker property rights countries; this finding has been confirmed by Dyck and Zingales (2002). Using recent firm-level data, Klapper/Love (2002) have found that better corporate governance is highly correlated with market valuation. Their results suggest that firms can partially compensate for ineffective laws and enforcement mechanisms by establishing good corporate governance. Investors also seem to apply a discount in their valuation for worse corporate governance firms and countries (as documented in a McKinsey survey of institutional investors 2001).[7]

Better operational performance. Evidence for the US and elsewhere suggests strongly that at the firm level, better corporate governance leads not only to improved rates of return on equity and higher valuation, but also to higher profits and stronger sales growth (Gompers/Ishii/Metrick 2001). Klapper/Love (2002) has also found that good governance is positively correlated with operating performance and that this relationship is stronger in countries with weaker legal system. Firms with better governance seem to have less need to rely on the legal system to resolve governance conflicts. This result is quite important for firms operating in countries with weak shareholder protection and poor judicial efficiency like the MENA countries.

Reduced risk of financial crises. According to Claessens (2003) "the quality of corporate governance can affect firm's behavior in times of economic shocks and actually contribute to the occurrence of financial distress, with economy wide impacts". In his survey of the literature he concludes that good governance can be associated with improved risk management, a reduced risk of financial distress and thus an avoidance of the costs of bankruptcy.

Better relations with other stakeholders. Good corporate governance can mean generally better relationship with all the stakeholders, including banks, bondholders,

[7] The results of the McKinsey Survey of institutional investors are available on the Website of the Global Corporate Goverance Forum.

labor, local and national governments. It helps with social and labor relationships and aspects such as the environment. Equally important are the potential benefits of improved corporate governance for overcoming barriers, including the actions of vested interests groups, who operate simultaneously in the marketplace, notably as corporate insiders and in the sphere of domestic politics.[8]

In spite of their economic importance, there is no systematic empirical analysis that looks at those channels through which corporate governance affects the performance of individual firms as well as whole economies in the context of the Arab region. What is available to researchers and policy makers of this region are some attempts of qualitatively assessing the state of corporate governance in this region**.**

4. State of Corporate Governance in Arab Countries

The state of corporate governance in Arab countries will be assessed by using two sets of empirical data, both of them are of qualitative nature. The first consists of the official World Bank –IMF reports on corporate governance in Morocco (May 2003), Egypt (December 2003) and Jordan (June 2004). The second source of information is the regional roundtable discussions, organized by international and regional organizations (Center for International Private Enterprise, CIPE, OECD, World Bank etc.)

[8] These vested interest groups are sometimes called "distributional cartels" (Olson Mansour), because in seeking to maintain or increase their share of the country's wealth (e.g. market share), they often invest significant corporate-controlled (as well as government –controlled) resources not in the creation of new wealth but in actions of strategic rivalry among themselves. Those actions tend to result not in healthy inter-firm price competition but in significant wastage and misallocation of a country's resources. They tend often to reduce aggregate wealth and thus constitute, from society's point of view, highly negative-sum games.

4.1. Country Studies: Jordan, Morocco and Egypt

The key findings of the World Bank-IMF assessments have been divided to correspond with the five sections of the OECD Principles. Each section highlights deviations from the OECD Principles or describes compliance. One major key finding is that the legal and regulatory frameworks of the three assessed Arab countries are largely compliant with the OECD Principles. However, practices are not. The difficulty of the assessments is to reflect properly the discrepancies between the letter of the law and compliance. It should be emphasized that the World Bank-IMF assessments focus on listed companies. No-listed firms, specially SME and family-owned firms that make up to 98% of all firms, are not subject to assessments.

Table 1 synthesizes the three individual World Bank-IMF corporate governance assessments of Morocco, Jordan and Egypt. Based on that Table and on the underlying individual country reports the following findings can be presented:

Table 1: Summary of Observance of OECD Corporate Governance Principles in Egypt (Eg), Jordan (Jo) and Morocco (Ma)

Principle	**Observed**	**Largely Observed**	**Partially Observed**	**Materially Not Observed**	**Not Observed**
I. The rights of Shareholders					
IA Basic shareholder rights	EG	Jo, Ma			
IB Rights to participate in fundamental decisions		Eg, Jo, Ma			
IC Shareholders AGM rights		Eg, Jo. Ma			
ID Disproportional control disclosure		Eg	Jo	Ma	
IE Control arrangements should be allowed to function		Eg	Jo	Ma	
IF Cost/Benefit to voting			Jo	Eg	Ma
II Equitable Treatment of Shareholders					
IIA All shareholders should be treated equally		Eg, Ma	Jo		
IIB Prohibit insider trading		Jo	Eg	Ma	
IIC Board/Mgrs. disclose interests		Jo, Eg		Ma	
III. Role of Stakeholders in Corporate Governance					
IIIA Stakeholders rights respected	Jo, Eg			Ma	
IIIB Redress for violation of rights	Jo, Eg			Ma	
IIIC Performance enhancement	Jo, Eg			Ma	
IIID Access to information	Jo	Eg, Ma			
IV Disclosure and Transparency					
IVA Disclosure standards		Jo	Eg	Ma	
IVB Standards of accounting & audit	Jo	Eg		Ma	
IVC Independent audit annually	Ma		Jo, Eg		
IVD Fair and timely dissemination		Eg, Jo, Ma			
V. Responsibilities of the Board					
VA Acts with due diligence, care		Eg, Jo, Ma			
VB Treat all shareholders fairly	Ma		Jo, Eg		
VC Ensure compliance with law		Jo, Eg, Ma			
VD The Board should fulfill certain key functions		Jo, Ma	Eg		
VE The Board should be able to exercise objective judgment			Ma	Jo, Eg	
VF Access to information	J, E	M			

Legend:

"Observed" means that all essential criteria are met without significant deficiencies

"Largely observed" means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intend to achieve full observance in the short term.

"Partially observed" means that while the legal and regulatory framework complies with the principle, practices and enforcement diverge**.**

"Materially not observed" it means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.

"Not observed" means no substantive progress toward observance has been achieved.

Sources: Compiled by the author from World Bank reports (May 2003), (December 2003) and (June 2004)

Section I: The rights of shareholders

Principle IA: The corporate governance framework should protect shareholders' rights. Basic shareholders rights include the right to: (1) secure methods of ownership registration, (2) convey or transfer shares, (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; and (5) elect members of the board; and (6) share in the profits of the corporation.

This Principle has been observed in Egypt and largely observed in Jordan and Morocco.

Registration of shares has historically been the responsibility of the company. This power vested in management created difficulties arising from agency problems between management and shareholders. In Morocco, for instance, companies can object to or block share transfer and ownership registration.

Principle IB: Shareholders have the right to participate in, and to be sufficiently informed on decisions concerning fundamental corporate changes, such as (i) amendments to the governing documents of the company, (ii) the authorization of additional shares; and (iii) extraordinary transactions that in effect result in the sale of the company.

This Principle has been largely observed in the three countries.

Principle IC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern them. (i) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (ii) Opportunity should be provided for shareholders to ask questions of the board an to place items on the agenda at general meetings, subject to reasonable limitations. (iii) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

This Principle has also been largely observed in the three countries. While voting is a basic right of ordinary shares in most countries, owners of bearer shares do not have the right to vote in Egypt. Furthermore, shareholders who have paid up only 50 or less percent of the share issue price have full voting rights in Morocco and Egypt.

Principle ID: Capital structure and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

This Principle has been largely observed in Egypt, but only partially observed in Jordan, while materially not observed in Morocco. Especially in the latter country, where highly concentrated ownership structure in form of pyramid structures and cross shareholdings exist, it is de facto hard to obtain information about the first level capital structure of a listed company.

Principle IE: Markets for corporate control should be allowed to function in an efficient and transparent manner.

The same assessment as before has been found for Principle IE. The three Arab countries are characterized by concentrated ownership structures. Ownership concentration implies that the corporate takeovers only take place in a friendly environment.

Principle IF: Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

With respect to this Principle, all three countries are not doing well, especially Morocco and Egypt. In all three countries there is little shareholder culture. The costs of exercising voting rights and the danger of upsetting incumbent management are deemed greater than the benefits in the short term.

In sum, the rights of shareholders -as measured by the OECD Principles and assessed by World Bank-IMF experts- are best respected in Egypt, followed by Jordan and Morocco. It is striking that in Morocco the last three Principles are either materially not observed or not observed at all.

Section II: The equitable treatment of shareholders

Principle IIA: The Corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. (i) Within any class, all the shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (iii) Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

This Principle has been largely observed in Egypt and Morocco, but only partially observed in Jordan.

Principle IIB: Insider trading and self-dealing should be prohibited.

It is largely observed in Jordan, partially observed in Egypt and materially not observed in Morocco. Despite the fact that insider trading and self-dealing are a criminal offense in all three countries, monitoring and detecting remain a problem across the board. The securities regulators are generally not equipped to carry out their surveillance activities efficiently and depend on a often overburdened, weak or slow court system for enforcement. In addition, commercial tribunals are normally weak (lack of qualified personal, corruption etc.)

Principle IIC: Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

This Principle is largely observed in Jordan and Egypt, but materially not observed in Morocco. The regulatory framework of these countries usually includes rules and regulations for disclosing and monitoring related party transactions and self-dealing.

However, disclosure is not always mandatory, or there are no clear rules. In Morocco, related party transactions must only be disclosed if they take place under "special conditions".

In all three countries, there is a general concern that existing provisions are not consistently adhered to and cannot be enforced in environments often characterized, as already mentioned, by pyramid structures, cross shareholdings and a weak judicial system.

Section III: The role of stakeholders in corporate governance

Principle IIIA: *The corporate governance framework should encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.*

This Principle has been observed in Jordan and Egypt, but materially not observed in Morocco.

Principle IIIB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

This Principle has been observed in Jordan and Egypt, but materially not observed in Morocco.

Principle IIIC: The Corporate governance framework should permit performance-enhancement mechanisms for stakeholder participation.

This Principle has been observed in Jordan and Egypt, but materially not observed in Morocco.

Principle IIID: Where stakeholders participate in the corporate governance process, they should have access to relevant information.

This Principle has been observed in Jordan, but only partially observed in Egypt and Morocco.

In general, stakeholders are seldom represented on the board of companies, not only in Arab countries, but worldwide. Exceptions are e.g. Germany, China, Austria, Denmark, Norway, Sweden and Egypt where employees have the right to elect representatives to the (supervisory) board. In Morocco, however, the OECD Principles guiding the role of stakeholders in corporate governance don't practically exist.

Section IV: Disclosure and Transparency

Principle IVA: The corporate governance framework should assure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and the governance of the company. Disclosure should include, but not be limited to, material information on (1) the financial and operating results of the company. (2) Company objectives. (3) Major share ownership and voting rights. (4) Members of the board and key executives and their remuneration. (5) Material foreseeable risk factors. (6) Material issues regarding employees and other stakeholders. (7) Governance structures and policies.

Disclosure standards as described in Principle IVA have been largely observed in Jordan, partially observed in Egypt, and materially not observed in Morocco.

Principle IVB: Information should be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

High standards of accounting and audit have been observed in Jordan, partially observed in Egypt, but not materially observed in Morocco.

Principle IVC: An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

The Principle of independent annual audit has been observed in Morocco, but only partially observed in Jordan and Egypt.

Principle IVD: Channels for disseminating information should provide for fair, timely and cost-effective access to relevant information by users.

Fair and timely dissemination of information has theoretically been largely observed in the three Arab countries.

In sum, in all assessed countries business has traditionally been based on relationship and trust. In this business culture corporate information is thought of as a secret. It is accepted practice to keep different sets of books, e.g. one for taxes, one for outside investors, and one for the majority shareholder. In addition, the notes to the accounts are often only available to the public in summary form, if at all. Companies in Morocco and Egypt, for instance, limit themselves to the publication of summary financial statements (sometimes with partial notes) in the newspaper or legal gazette.

Section V: The responsibility of the board

Principle VA: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

That the Board acts with diligence and care etc, this Principle has been largely observed in the three countries.

Principle VB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

This Principle has been observed in Morocco, but partially observed in Jordan and Egypt.

Principle VC: The board should ensure compliance with applicable law and take into account the interests of stakeholders.

The Principle that the board should ensure compliance with law etc. has been partially observed in all three countries.

Principle VD: The board should fulfill certain key functions, including (1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divesture. (2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (3) Reviewing key executives and board remunerations, and ensuring a formal and transparent board nomination process. (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related-party transactions. (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. (6) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed. (7) Overseeing the process of disclosure and communication.

Principle VD has been largely observed in Jordan and Morocco, but only partially observed in Egypt.

Principle VE: The board should be able to exercise objective judgments on corporate affairs independent from management: (1) boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interests. Examples of such key responsibilities are financial reporting, nomination, and executive and board remuneration. (2) Board members should devote sufficient time to their responsibilities.

The Principle that the board should be able to exercise objective judgment has been only partially observed in Morocco, and materially not observed in Jordan and Egypt.

Principle VF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

This Principle has been observed in Jordan and Egypt, and largely observed in Morocco.

With respect to the responsibility of the board, the following concluding remarks can be made: In the three Arab countries under discussion, companies tend to follow a “parliamentarian model“ of board representation, where directors represent the constituency that elected them. This model is fundamentally not consistent with the four pillars of the OECD Principles discussed above.

In addition to defining strategy, selecting, monitoring and overseeing management is the most fundamental function of the board. A board that cannot dismiss management is not an effective board. This function requires an independence from management and controlling shareholders that is generally lacking in the three countries. In Egypt, Jordan and partially Morocco with single tier board structures, the chief executive officer (CEO) is also the chairperson of the board. In those countries where ownership is (as already mentioned) highly concentrated, this person is often also a representative of the majority shareholders. This set-up makes it virtually impossible for outsiders to replace management because it would mean firing themselves. Therefore, the board fails in this fundamental respect.

In addition to this fundamental problem, another recurring theme on the subject of board duties in the Arab region is the lack of training and the limited understanding that directors have of corporate governance issues. One possible remedy is the creation of

Institutes of Directors for training, dissemination of best practice and issuance of guidelines regarding the size of the board, the constitution of committees and other useful practices. Following this suggestion, Institutes of Directors have been created in Egypt, and Morocco, and a regional institution, Hawkamah Institute for Corporate Governance, has been set up in Dubai.

4.2 Regional perspective on corporate governance

In addition to country specific assessments, the results of regional roundtable discussions are used here to assess the state of corporate governance in selected Arab countries. As in other parts of the world, the issue of corporate governance has been debated throughout the MENA region. Especially, private sector groups have undertaken initiatives as early as 2001 to address corporate governance in the region. In July 2003, the World Bank's Global Corporate Governance Forum (GCGF), the Center for international Private Enterprise (CIPE) and local partners in Egypt, Jordan, Lebanon and Morocco launched a regional initiative to assess the state of corporate governance in MENA. Meetings in Lebanon, Morocco and Jordan were attended by representatives from the private and public sector, including corporate governance practitioners, auditors and regulatory authorities. A regional experts meeting was convened in Cairo in September 2003 to discuss regional challenges and trends in corporate governance and to field recommendations on implementing corporate governance in MENA[9].

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[9] A smaller group of regional experts represented the region at the International Corporate Governance Meeting in Paris in November 2003 to review the OECD Principles of Corporate Governance from the perspective of developing countries.

In addition to the first regional meeting in Cairo, the following regional conferences have taken place:

- Second Middle East and North Africa Regional Corporate Governance Forum: Corporate Governance in MENA Countries- Improving Transparency and Disclosure. Beirut, Lebanon, June 3-5, 2004 (see conference report by Nasser Saidi (2004)).
- Third Regional Corporate Governance Forum: Private Sector Consultative Meeting. January 25, 2005, Amman, Jordan. (see conference report by CIPE, (2005).
- Fourth Regional Corporate Governance Forum: Towards Sound and Efficient Financial Markets and Banking Systems, November 26-27, 2006, Dubai, UAE, hosted by Hawkamah Institute for Corporate Governance.

The regional discussions have focused on common regional issues and advanced several useful ideas. From the first conference in Cairo the following recommendations can be summarized:[10]

- *Implementation and costs: markets in the region are in early stages of development. Corporate governance principles should be a vehicle for markets to grow rather than a costly impediment for companies to implement. Rules should allow for incentives to companies that adhere to corporate standards.*
- *Addressing family owned companies: since family companies are the dominant characteristic in regional markets, the region should explore how to address family*

[10]see the report by the Global Corporate Governance Forum and the Center for International Private Enterprise (CIPE), (2003) on Corporate Governance in Morocco, Egypt, Lebanon and Jordan, P. 41-43:

owned firms and the application of corporate governance principles. Corporate governance practices should not be an obstacle for the establishment and development of family companies as they represent the backbone of several economies in the region. However, there should be clear and enforceable principles that protect minority shareholders.

- *Bankruptcy and exit strategy***:** *with exception of few countries in the region*[11]*, bankruptcy procedures and exit strategy pose a problem for stakeholders and shareholders. The region will need to take a critical look at the institutional arrangements in which companies could file for bankruptcy or exit the market, while keeping the needs and interests of the stakeholders and shareholders in consideration.*
- *Separation of ownership and control***:** *governance systems in the MENA region are insider systems that are characterized by majority and concentrated ownership. In these systems, there is no separation of ownership and control. Complete separation between ownership and control might not be realistic and it might hinder further development of the family business environment. Thus the region should explore practical ways to dilute major shareholders voting rights to the extent that provides a room for minority shareholders and other stakeholders' rights.*
- *Owner's wealth and company's financial position***:** *the region needs to address the issue of separating owners' wealth from the companies' financial position and extracting private benefits from the company such as extending credit to major shareholders.*

[11] Jordan and Lebanon adopted bankruptcy regulations to protect stakeholders.

- *Board of directors***:** *a number of reports and codes of corporate governance have addressed the issue extensively, especially on family owned firms. Regardless of the board structure model (unitary or two-tier), the region should address the issue of board independence vis-à-vis a unified clear definition of the non-executive director*[12] *and the criteria for ensuring independence. Minorities should have the right to appoint representatives to the board for better governance.*
- *Accounting and auditing practices***:** *the region should address the issue of differences in adopting accounting standards across the countries. Thus, unification of accounting standards is crucial for better disclosure and transparency. In addition, the region should engage the accounting and auditing professions in ensuring independent, sound and fair practices within their professions and their clients.*
- *Governance Culture***:** *introducing corporate governance as part of the culture of the country will constitute a good and practical solution for the problem of ownership-management mix and it will allow for separate ownership from management, which is in the best interest of the company. Authorities in securities markets, whether government or private business, should provide training opportunities for companies' management and staff as well as other parties with a view to introducing new management techniques and risk assessment methods and strategies. Additionally, public governance and corporate governance have to be dealt with jointly and are of equal importance. Not only do many enterprises in the region still belong to the state, but also public governance had direct repercussions on corporate governance.*

[12] Definitions among countries differs according to their regulations, example the cas of US versus some European countries.

- *Strict Bank Supervision**:** the introduction of a two-tired approach to the corporate structure of family owned companies, particularly banks, whereby a board of commissioners representing the minority would supervise the board to ensure transparent dealings.*
- *Stages of Development**:** there should be principles of corporate governance applicable to firms at every stage of their development and growth, form homegrown business to multinational corporations.*
- *Ethics and Incentives: means should be developed for the establishment and enforcement of codes of ethics regarding the moral aspect of company operations. Operators need to believe in moralities and should be helped for this purpose by relevant training and education. The civil society could be the moral qualifier in this respect with the support of an incentive system and self-regulation framework.* (see the report by the Center for International Private Enterprise (CIPE)/ Global Corporate Governance Forum (2003) on Corporate Governance in Morocco, Egypt, Lebanon and Jordan, P. 41-43) :

All these recommendations suggest concrete solutions to current practices and trends in corporate governance in Arab countries. They came out, as already mentioned, of the first regional forum. After this major event, follow up work on corporate governance both regionally and within selected Arab countries has been curried out. At the regional level, CIPE, with support from the Middle East Partnership Initiative (MEPI), has assembled a private sector corporate governance advisory board to provide input on corporate governance programming for the region as well as coordinate country specific efforts to develop Arab best practice examples on the implementation of corporate governance principles. A multi-lingual (Arabic, English, French) website www.hawkama.net dedicated to highlight corporate governance best practices in these languages has been developed.

More importantly, a second MENA regional corporate governance forum was successfully organized in Beirut on June 3-5, 2004. Hosted by local partners (Lebanon Corporate Governance Task Force) and Lebanese Transparency Association) and supported by various international organizations (Global Corporate Governance Forum, the Center for International Private Enterprise, MEPI and OECD), this forum aimed at institutionalizing the process, which is important for the region and included a larger number of country participants, including states from the Gulf and Tunisia. The institutionalization process was reinforced by the participation of regional bodies, including the Union of Arab Banks, the Arab Union for Stock Exchanges and the Arab Federation of Certified Accountants.

This meeting that concentrated on central dimensions of corporate governance, namely disclosure and transparency as well as implementation, has also led to the publication of the - already mentioned - second report on corporate governance in MENA countries. It has formulated around 24 recommendations for the regional corporate governance agenda. Some of them are similar to those presented above. An emphasis has been put on issues related to the implementation of corporate governance principles. To improve the functioning of the corporate sector, so the report, "general improvements in the courts, the legal system and the regulatory regime must be made. Private institutions such as centralized credit reporting agencies and local credit rating agencies must be put in place" (Saidi 2004: 20).

The Third Regional Corporate Governance Forum, held in Amman, Jordan, on January 25, 2005, was organized by the Center for International Private Entreprise (CIPE), together with the Middle East Partnership Initiative (MEPI), National Endowment for Democracy (NED), Global Corporate Governance Forum (GCGE), and the OECD. It brought together regional private sector associations to highlight regional private sector-driven initiatives advancing corporate governance reform. Some of the key recommendations of this Forum can be summarized as follows:

- *Build a culture of corporate governance in the region, rather than simply create a regulatory framework*
- *Target SMEs and family-owned businesses in corporate governance reform*
- *Build a wider awareness of corporate governance reform in the region*
- *Introduce corporate governance into shools'curriculum and raise the next generation of leaders*
- *Create corporate governance task forces to sustain the momentum of corporate governance*
- *Increase regional cooperation*
- *Promote success stories*
- *Increase private sector participation in economic decision-making, including corporate governance reform.* (see, conference report by CIPE, (2005)).

The fourth regional corporate governance conference, tilted “Towards Sound and Efficient Financial Markets and Banking Systems”, took place on November 26-27, 2006, in Dubai, UAE. This conference was completed with the so-called “Dubai Declaration on Corporate Governance” which emphasized - among other things- the following points:

- *Building on recent efforts, MENA countries need to continue improving the legal and regulatory framework underpinning corporate governance.*
- *Parallel to strengthening these frameworks, the capacity of supervisors and regulators should also be addressed.*
- *Self-regulatory measures and corporate governance codes should be developed as a complementary mechanism for improving enforcement in the region.*
- *The role of a well functioning court system and capacity building for judges cannot be overemphasized.*
- *MENA board of directors should rely on a sufficient number of independent directors and on the establishment of specialized committees in order to act efficiently in the interest of the company and all of its shareholders, including the minority shareholders.*
- *Corporate governance of state-owned enterprises (SOEs) should be addressed as a priority, because of the important role they play for MENA economies.*
- *Given the preponderance and economic importance of family-owned, small and medium-sized enterprises and non-listed companies in MENA, promoting awareness of the benefits of better corporate governance practices and the adoption of best*

practices by the private sector is an imperative for economic development and modernization.

- *MENA banks play a dominant role in corporate finance. A shortcoming in the governance of banks can lower returns to the bank's shareholders and can have systemic consequences.*
- *MENA countries should act to establish effective insolvency systems and provide a framework for value maximization and more efficient allocation of capital to productive uses. (see,* Dubai Declaration on Corporate Governance, posted on the website of Hawkamah Institute for Corporate Governance: www. hawkamah.org)

The Dubai Declaration on Corporate Governance also emphasizes the role of implementation of concrete measures and action plans for improving corporate governance in the region.

Finally, Hawkamah Institute for Corporate Governance, host of the fourth regional conference, will review - in co-operation with the MENA OECD Working Group on Corporate Governance- the progress achieved in implementing the Declaration.

4. Summary

Despite the diversity of the region, all Arab countries are currently facing the same major challenge of accelerating job creation to reduce double digit unemployment rates that threaten their social cohesion. After very high growth rates in the sixties and seventies, often fueled by massive public investments, growth in the region has been weak for the past two decades. With the failure of public policies to sustain high growth over time, all of the region's governments have embarked on a series of reforms to promote private sector-led economic strategies.

Despite successes in first generation macroeconomic reforms (including macro-economic stabilization and price and trade liberalization), Arab governments have not succeeded in putting in place an environment conducive to a strong and sustainable growth of the private sector. Most private sector development indicators rank Arab countries behind the other regions of comparable income. Their ability to attract rising worldwide FDI flows in the nineties has also been week, despite the region's high potential and its proximity to major OECD markets.

The relatively poor overall performance of the private sector is a complex phenomenon and has therefore multiple causes. While the investment climate constraints to business development in the Arab region are well documented in the several Business Climate Surveys of the World Bank and other national and international organizations, much less is known on other impediments to private sector development, such as the state of corporate ownership and the nature of corporate governance and its enforcement mechanisms.

The purpose of this paper was to assess the state of corporate governance as a major factor affecting the growth performance of the private sector in MENA countries. For this purpose both country-specific assessments, carried out by World Bank-IMF teams (so-called ROSC's assessments) and focus-group discussions that took place in four regional conferences have been synthesized. Strengths and weaknesses of corporate governance in selected Arab countries have been highlighted. One major key finding is that the legal and regulatory frameworks of the assessed Arab countries are largely compliant with the OECD Principles of corporate governance. However, practices are not. The difficulty of the assessments is to reflect properly the discrepancies between the letter of the law and compliance. It should be emphasized that the World Bank-IMF assessments focus on listed companies. No-listed firms, specially SME and family-owned firms that make up to 98% of all firms, are not subject to assessments.

Another key finding that emerged from our reviewing of the regional conferences on corporate governance is that corporate governance issues have not been ignored in public debates in the MENA region. Practitioners from capital markets, banks, public and private sector representatives and other civil society groups have accepted the need to address corporate governance reforms as one of the crucial topics affecting the economic growth and development of firms, industries and whole economies in their region. Several meetings and conferences at the national and regional level have taken place. Appropriate and up-to-date recommendations regarding corporate governance reform in the MENA region have been adopted in those events. It is now up to the decision makers at all levels to implement those recommendations.

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