CHALLENGES TO SME DEVELOPMENT IN KUWAIT

November 2011

Prepared by
Dr. Ernest Koch,
UNDP SME Legal Advisor

List of Content

List of Abbreviations

BDS	Business Development Service
BOT	Build-operate-transfer
bps	Bits per second
CBK	Central Bank of Kuwait
CI	Credit Information
CTC	Central Tenders Committee
EU	European Union
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSM	Global System for Mobile Operation
IBK	Industrial Bank of Kuwait
ICT	Information and Communication Technology
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISP	Internet Service Provider
IT	Information Technology
KAMCO	KIPCO Asset Management Company
KCCI	Kuwait Chamber of Commerce and Industry
KD	Kuwait Dinar
KIPCO	Kuwait Projects Company
LLC	Limited Liability Company
MCR	Minimum Capital Requirement
MENA	Middle East and Northern Africa
MOC	Ministry of Communications
MOCI	Ministry of Commerce and Industry
MONE	Ministry of National Economy
NIFP	National Investment Fund Portfolio
OECD	Organization of Economic Cooperation and Development
SAR	Saudi Arabian Riyal
SIDF	Saudi Industrial Development Fund
SME	Small and Medium sized Enterprise
SMS	Short Message Service
UAE	United Arab Emirate
UK	United Kingdom
USA	United States
USD	United States Dollar

Introduction

With the oil industry and the public sector being a leading contributor to Gross Domestic Product (GDP), the role of small and medium-sized enterprises (SMEs) in the economy has been modest in the Gulf Cooperation Council (GCC) countries including Kuwait. They contribute between 15% and 40% to GDP. This compares with 57% in Japan, 64% in Spain, 56% in France, 44% in Austria, 43% in Canada, 33% in Australia and more than 50% in the United States of America (USA). Thus the SME sector does not currently provide a sufficient engine for the achievement of the economic diversification objectives of the governments in the region.

However, worldwide SMEs have proven to be the most efficient instrument to accelerate the pace of economic and social development. They provide a fertile environment for training workers and developing their skills and help in speeding up the turnover of small amounts of invested funds. SMEs can provide valuable employment opportunities to a growing young population, improve productivity and help diversify the economy. They are also attractive because of the simplicity of their establishment and administrative structure since usually only a relatively small amount of capital is needed for initial foundation and operation. In its most frequently chosen legal form, the limited liability allows them to exit the market with little significant impact.

While statistical information on the SME sector is not available in Kuwait due to the lack of an official definition and corresponding collection of data, anecdotal evidence suggests that their number surpasses 30,000 and represents 90% of registered companies. 85% seem to be owned by families and individuals. This would mean a relatively low SME concentration of one SME per 43 nationals as compared, for example, to Saudi Arabia, which has one SME per 25 nationals. SMEs in retail trade, hotels and restaurants are said to account for 40%, construction and utilities for 30% and the remaining SMEs are distributed among finance, industry and services. The prevailing ownership structures are an outcome of the law. In fact, the Law on Commercial Companies stipulates that the majority of any business has to be owned by nationals[1].

The country needs to tackle structural imbalances related to the labor market and the role of the private sector. For the SMEs to become major players in economic development and an important source of employment, a number of challenges need to be addressed. Among others, these include finding a commonly accepted definition of SMEs, collecting appropriate statistical information, drafting an SME Development Strategy and Programmes, an underpinning institutional support structure, more entrepreneurial drive, simplified business registration and streamlined licensing procedures, easy and cost effective access to debt and equity finance, broader use of information and communication technology (ICT) and a widening of the market to create more opportunities through broader access to public procurement and the government’s withdrawal from a number of productive activities.

[1] In the free zones 100% foreign ownership is permitted.

I. Establishing the Basis for SME Development

Fostering the SME sector requires establishing the foundations for SME development. This includes a common understanding of SMEs (their definition), establishing a set of indicators and collecting corresponding data to analyse the sector, the drafting of an SME strategy and programmes to guide the development process as well as an appropriate institutional infrastructure that underpins development.

1. Definition of SMEs

Background

A definition of SMEs acts as a first level filter to segregate them from the total enterprise population and further when it comes to support them as a second filter to separate out qualified SMEs. The purpose of defining SMEs is to:

- establish the basis for the collection, compilation and publication of data,
- establish the baseline status and annual performance to track development,
- enable exchange and benchmarking of relevant information with regional, international, multilateral bodies,
- create a framework for determining the eligibility for development programmes,
- serve as a framework for targeting as well as measuring the impact of various focused policies, and
- facilitate efficient coordination and collaboration among various stakeholders.

A problem with any SME definition is that it must serve multiple functions: (i) at a theoretical level, it must define SMEs as being conceptually different from large enterprises, (ii) at a practical level, a definition must be easy to implement in terms of gathering accurate and useful data and (iii) at a sectoral level, financial institutions often need different data than national surveys or government institutions require. Such diversity can be overcome by first defining conceptual differences by notional demarcation between sizes based on experience. Flexibility can be then built into the definition by adopting two systems: One based on employment and the other one based on either size of capital and/or turnover *(for details see Annex I).*

Current Situation

In Kuwait there is no legal definition of SMEs. The resulting paucity of information precludes an estimation of their contribution to the national economy in terms of GDP, value added and employment as well as targeting of support measures. Having identified this fundamental gap in the marketplace, several institutions arrived at their own classification.

The Industrial Bank of Kuwait (IBK) uses capital of KD 500,000 (USD 1.8 million) to separate small and medium-sized from large projects. Similarly, the Kuwait Small Projects Development Company applies the KD 500,000, but in addition capital of KD 150,000 (USD 0.55 million) to demarcate small from medium sized projects. The Kuwait Chamber of Commerce and Industry (KCCI) suggests defining small businesses as those that employ 20 people and have a capital of between KD 150,000 (USD 0.55 million) and KD 200,000 (USD 0.73 million) while it defines medium size businesses as those with employment of 50 people and a capital of up to KD 500,000 (USD 1.8 million). Al Ritaj Investment Company identifies SMEs as enterprises with a net value of KD 1 million (USD 3.7 million) up to KD 10 million (USD 36.6 million). Al Raeda Investment Company suggests defining businesses with up to 10 employees and capital of up to KD 200,000 (USD 0.73 million) as small and those with up to 100 employees and capital of up to KD 500,000 (USD 1.8 million) as medium size. For the Central Bank of Kuwait (CBK) an SME is taken to mean an unlisted company or an unincorporated enterprise such as a partnership or sole proprietorship[2].

International experience suggests that the most common definition criteria are the number of employees, annual turnover and balance sheet total (capital). Having considered various definitional options and in line with the regional definitions as well as the relevance and measurability *(see Annex I)*, the employment threshold should be a mandatory indicator that any enterprise must fall within. In addition, enterprises must fall within *either* the annual sales *and/or* the total assets threshold considering that both may vary among the service and the manufacturing sector.

A working definition *(see below)* that uses these criteria has been arrived at based on stakeholder consultation[3]. This definition had to be further specified by defining 'enterprise' as any entity engaged in an economic activity, no matter which legal form it takes when incorporating (e.g. Partnership, Limited Liability Company, Shareholding Company). Also the enterprise had to be autonomous. This again was defined by exclusion: the enterprise may neither be a partner enterprise (with a share of 25% in the capital or voting rights of another enterprise) nor a linked enterprise (with the majority of voting rights in another enterprise). This way, enterprises are screened out whose economic power and position exceeds that of genuine SMEs. The SME definition would need to be cast into law (SME Law) and used as a standard for data collection, policy analysis and policy making. It would need to be reviewed from time to time to ensure that it reflects general economic developments, in particular in prices and productivity.

SME support programmes are likely to focus on national entrepreneurship and employment since the government's aim is enhancing the participation of Kuwaiti nationals in the private sector. However, a generic SME definition does not seek to provide conditions for the involvement of Kuwaiti nationals in businesses, but expects such conditions to be added by respective government organisations as per their policy focus. Therefore, there should be no specific clause or condition of minimum equity or employment of Kuwaiti nationals attached to the general definition.

[2] The Central Bank, however, expects each licensed bank to develop their own internal identification criteria for SMEs that could include, among other things, the turnover factor.

[3] About 20 relevant institutions have been consulted individually while a 2-day workshop was hold with a wider range of stakeholders (the list of consulted institutions is attached in Annex II and the workshop programme in Annex III).

Recommendations:

- Define SMEs as follows:

	Employment	Annual Turnover	Annual Balance Sheet Total
Micro	< 10	≥ KD 0.2 million	≥ KD 0.2 million
Small	< 50	≥ KD 1 million	≥ KD 1 million
Medium	< 250	≥ KD 5 million	≥ KD 5 million

- Develop user guidelines
- Develop a model declaration[4]

2. SME Statistics

Background

A comprehensive statistical picture of the SME sector is required for evidence-based policy making, monitoring the performance of the sector, the impact of policy interventions as well as providing the necessary information to stakeholders. These statistics cannot be separated from business statistics for the economy as a whole. They are generally regarded as an additional dimension to structural business statistics. However for accurate and comparable data, conceptual and measurement issues on SMEs need to be in line with international best practice.

Current Situation

In Kuwait, all official statistical research is carried out in compliance with Law No. 27 (1963) on Statistics and Census. This law established the Central Statistical Office, later attached to the General Secretariat of the Supreme Council for Planning and Development. As the sole official statistical reference, it collects statistical information in all fields, which are specified by resolutions of the Supreme Council. It also supervises data collection of concerned departments in ministries, government institutions and state-owned enterprises.

Lacking an official SME definition, no statistical data is levied on SMEs. Once a common understanding is reached and cast into law, a set of indicators would need to be defined according to best practice and data collected accordingly for regular monitoring of the level of entrepreneurial activity and environment. This information would then form the basis of annual SME reports ('SME Observatories') for the analysis of firm behaviour over time and for providing insights about the impact of policies on enterprise performance and growth.

[4] For use of enterprises to document that they fulfil the SME definition criteria when applying for state support.

Recommendations:

- Establish a set of SME relevant indicators in line with international best practice
- Collect reliable data on an annual basis with sufficient detail to be useful for analysis, policy prescription and oversight

3. SME Strategy and Programmes

Background

In international perspective, economies that have strong SME sectors also have in place focused visions, clear guidance and appropriate strategies arising from a well-designed SME development plan. The necessity of such a plan stems from the multi-dimensional problems that SMEs are facing and the need to address these by an equally diverse range of policies. SME development usually runs through the horizontal as well as vertical structures of government. An SME development plan or strategy integrates the various policy dimensions and actions of a number of actors and establishes an appropriate institutional framework for implementation and accountability.

At the same time, effective implementation of any SME policy depends on clarity on assigning responsibilities and roles to different stakeholders. This facilitates smooth operationalization of programmes and projects with a clear demarcation of levels of accountability. Coordination is of critical importance. Mechanisms conducive to participation and consultation are desirable in various interventions aimed at implementing the SME policy as well as facilitating effective monitoring and evaluation of impact. Such an integrated approach is required over the different layers of SME development planning, from strategy, to programming and action planning.

Current Situation

In 2010, the government’s development goals were summarized by the Supreme Council for Planning and Development in the Strategic Vision of Kuwait 2035. It was assumed that Kuwait would by then become a financial and commercial centre in the region. The private sector would lead the economy, creating competition and promoting efficiency under the umbrella of enabling government institutions. To contribute to achieving this strategic vision, a KD 30 billion (USD 109 billion) mid-term Development Plan 2010-2014 was presented and passed by the National Assembly in 2010. Among the targets are (i) increasing GDP, (ii) the private sector taking the lead in the economy, and (iii) governmental enabling of the private sector. With the private sector becoming a focus of attention and considering that SMEs usually make up for the bulk of private enterprises, SME development became implicitly a major concern for the development of the country’s economy. Nonetheless, due to its general nature, the plan does not distinguish between different size categories of enterprises. To cover this gap, it is advisable to supplement the plan by an SME Development Programme of corresponding duration under the umbrella of a specific SME Development Strategy that is in line with Vision 2035.

Recommendations:

- Draft an SME Strategy 2011-2035
- Draft an SME Programme 2011-2014
- Draft an Action Plan 2011

4. Institutional Infrastructure

Background

Whilst setting up, operating and developing businesses results from the creativity, drive and commitment of individuals, rather than as a result of government actions, the conditions that enable and/or constrain entrepreneurship are affected by the wider social, economic and institutional context, over which the state has a major influence. Market-oriented institutions are prerequisites for the sustained development of productive entrepreneurship, comprising public and private sector entities.

The focal point in this institutional setting is often an SME Agency that takes the lead. It defines needs, develops enabling policies, and oversees, coordinates and synchronizes the provision of targeted services and programmes to the sector. Countries have experimented with a variety of approaches to shape such an agency with the main models being: (i) a special department - usually within the Ministry of Commerce and Industry (MOCI), (ii) an autonomous state agency, or (iii) an independent agency in which the private sector plays a key role. Experience shows that a dynamic entity, run along private sector principles (corporate governance) and with the necessary flexibility is best suited to attend to the needs of SMEs. As is often the case, the institutional infrastructure should be supplemented by an SME Council to facilitate policy making. It would provide advice to the Minister in charge of SME development.

The architectural infrastructure needs to provide SMEs with high quality technical and consultative service so that they can make full use of business opportunities and cope effectively with competitive pressures. Business development services (BDS) are delivered through markets where the role of the government is to facilitate market development both in terms of supply and demand rather than directly providing such services itself. Internationally there has been a profusion of support services and the institutions that deliver them. They include private providers, business centres, business incubators, industrial or business parks to name but a few. But some of the latter schemes proved a futile exercise since suitable market conditions were not present.

Current Situation

Kuwait lacks an SME development strategy and programme as well as the corresponding institutionalization of support. Policies and regulations impacting upon the sector are spread over several ministries and agencies and the provision of services is fractured and uncoordinated. There is a lack of a central body that would synchronize various support initiatives. As elsewhere, in the Gulf region there are a number of countries that have successfully addressed similar deficiencies in the past years by establishing a centralized body in charge of SME promotion.

Qatar: Enterprise Qatar is the country's champion for SMEs. It seeks to nurture entrepreneurship capabilities by aiming at (i) strengthening the business environment; (ii) be the SME sector's representative within government; (iii) become the SME gateway to business services; helping remove the obstacles and barriers of doing business, and (iv) act as the catalyst and principle driver of entrepreneurial spirit; supporting and mentoring entrepreneurship through the educational system.

UAE: The Mohammed Bin Rashid Establishment is a central agency under the Dubai Department of Economic Department. It is headed by an Executive Director who is appointed by the Dubai Executive Council. Its key goals are the enhancement of the status of the Emirate as a hub for business, enterprise and innovation, the encouragement of innovative skills among youth, the fostering of their ability to undertake economic activities and the development of programmes and initiatives aimed at enterprise development.

Saudi Arabia: The Shoura Council has recently given its approval for the creation of a central SME Authority to formulate policies and coordinate the SME sector for the enhancement of its contribution to the economy.

Such an SME Agency must coordinate services in the multi-stakeholder SME setting, be the steward of SME interests by advocating policy matters and develop regulatory frameworks which lower barriers to development and foster an overall enabling environment for growth. In addition, it needs to have a primary intelligence gathering function, collecting data on the sector, monitoring its development, and interacting with entrepreneurs to develop critical insights for drafting support programmes. In turn, these programmes would leverage existing services in the public and private sectors and package them for SMEs in response to their needs.

There are various higher or supreme advisory councils in Kuwait to assist the government in formulating policies in particular areas. For example, the Higher Advisory Committee for Labour Affairs advises the Ministry of Social Affairs and Labour on labour issues. The composition of these councils reflects a cross-section of specialists and groups. A similar advisory council would need to be established to spearhead SME development and advice the Minister of the MOCI in all related matters.

The market for non-financial BDS is still in its formative stage. SMEs appear to be suffering from limited services, especially in the area of training, business information and marketing. Training is often not properly targeted and information services are scattered, incomplete and difficult to access. SMEs are also either lacking advisory or counselling services, or they are unaware of the existence of support institutions and of their services. There is a role for the government to achieve market extension and deepening by addressing potential constraints in supply and demand. On the supply side this may include upgrading skills and competences of service providers, widening the range of services on offer, developing and certifying acceptable quality standards and encouraging codes of practice by the professions. Support on the demand side may include raising the awareness of the benefits of external assistance through the provision of information on available services and providers as well as temporarily sharing the costs with entrepreneurs through a voucher system.

Recommendation:

- Establish a full-fledged autonomous institution for SME development
- Set up a Higher Advisory Committee for SME Affairs
- Promote efficient commercial BDS markets by addressing potential constraints in supply and demand

II. Promoting Entrepreneurship

Background

By definition, entrepreneurship is the practice of starting a new business/venture or reviving an existing one in order to capitalize on new found opportunities. In its essence it is about a proactive mindset that encourages ownership of surrounding problems in society, sees them as opportunities and embraces the risks and failures involved in finding a solution. Entrepreneurship development requires an appropriate framework that encourages people to take the necessary steps to start a business and to improve their chances for success. This in turn calls for addressing three key aspects help potential entrepreneurs:

- They have to become interested and motivated. They have to be aware of the option and it has to be attractive to them. Being exposed to entrepreneur role models is a factor as is being introduced to knowledge about entrepreneurship.

- They have to come into contact with a range of 'opportunity factors'. These include access to information on business ideas, counselling and advisory services, business contacts, support and encouragement as well as capital.

- They must have some skills including technical skills (knowledge, or ability, which can be turned into a business) and business and management skills. These can be gained through education and experience or through the expertise and experience of others (role models).

Without motivation, potential entrepreneurs will not take any actions towards starting a business. If they are motivated to take action, but are not exposed to the range of opportunity factors, they may become discouraged or lack the help they need to launch the business successfully. And if they have technical skills but lack business and management skills, their businesses may have a low chance for survival and growth. The optimal position is one where these elements overlap. From a policy standpoint this requires:

- developing awareness: Create more awareness of entrepreneurship as an attractive employment option, profile successful entrepreneur role-models, and change attitudes;

- enhancing learning: Increase opportunities for people to learn the process of becoming an entrepreneur and starting a business through entrepreneurship orientation, education, and instruction; and

- improving support services: Provide access to entrepreneurship training and small business counselling opportunities.

Current Situation

In Kuwait, the levels of entrepreneurship are low while youth unemployment is high (3.7% in 2010). The country is not generating sufficient start-ups partly due to limited awareness of entrepreneurship and focus on employment rather than self-employment as well as the imbalance between risks and rewards. It is said that by and large the society is averse to risk. People normally look for long-term and stable employment such as public sector jobs. This is compounded by distortions that have been created by inflated public wages making it less attractive for Kuwaitis to seek self-employment. Another factor that appears to weigh against entrepreneurship is that it is not perceived to be socially glamorous.

A long term objective therefore is to create a more supportive entrepreneurial climate, one which would accelerate the rate of business start-ups. In the short run the goal is to increase the pool of people who have the motivation, skills, ability, and desire to start their own business and to increase the level and extent of support for new venture activity at whatever stage of the process: exploring the option, pre-start-up, start-up, post-start-up, survival and growth. Achievement of these objectives requires a change in both culture and capacity. Possible action points are:

- *More positive attitudes towards entrepreneurship:* In an effort to change attitudes and behaviour from dependency to self-reliance and from an employee-mentality to an entrepreneurial mentality, attitudes towards entrepreneurial initiative (and failure) must be made more positive. This is particularly important among schools, universities, investors, local communities, business advisers and the media. One way of encouraging such positive attitudes is by providing role models through the ‘showcasing’ of success stories, for example, by providing entrepreneurship awards.

- *Balancing risk and award:* The risks associated with entrepreneurship are often not adequately offset by the prospect of reward (pride, recognition, self fulfilment, profits). A failed entrepreneur faces the stigma of failure. Going bankrupt and losing personal property are primary concerns in relation to the risk associated with entrepreneurship. In addition to the social stigma, a personal bankruptcy implies severe legal consequences. Insolvency laws could be reviewed to reduce barriers to making a fresh start for honest entrepreneurs. Given that it is possible to become an entrepreneur with a reduced risk of failure by taking over an established firm rather than building an enterprise from scratch, it should also be ensured that such enterprises do not close because of obstacles in the legal environment or the lack of a successor while business transfers should be supported.

- *Fostering capacity and skills:* Through entrepreneurship education people from a very young age should be offered a real chance to acquire basic commercial expertise and develop their personal qualities and general skills such as creativity, sense of initiative, self-confidence and sense of responsibility. This requires integrating entrepreneurship education into all schools' curricula, arrange awareness campaigns, offer training material, organise training modules for teachers and, together with business organisations, involve entrepreneurs in teaching programmes.

Recommendations:

- Project a positive image of entrepreneurship
- Foster entrepreneurial capacity and skills
- Positively influence the balance between risk and awards

III. Enhancing the Legal and Administrative Environment

1. Registration: Starting a Business

Background

The length of time needed to register a company and the lack of transparency in the process is a common concern that can and often does thwart entrepreneurs' efforts to establish a business. As a result, economies around the world have taken steps making it easier to start a business, streamlining procedures by setting up a one-stop-shop and making full use of ICT, while reducing or eliminating minimum capital requirements. Many have undertaken business registration reforms in stages and they often were part of a larger regulatory reform programme.

One-stop-shops provide substantial savings in information search and transaction costs. From an entrepreneur's viewpoint, the major advantage is that they organise government information on the basis of the entrepreneur's requirements without needing an understanding of the government structure that lies behind it. This allows them to deal with government on an 'enterprise' basis rather than with a collection of individual government agencies. As technology has improved, delivery mechanisms have expanded from traditional methods to the use of information technology (IT)-based tools including web portals. E-government procedures hold significant promise for SMEs as they potentially reduce bureaucratic discretion and lead to equal treatment of all clients.

Often a statutory minimum capital requirement (MCR) needs to be fulfilled and a minimum amount needs be deposited in a bank account (paid-in capital) before corporate registration is granted. This is to ensure that the company has a bare minimum of assets before starting operations and to reserve amounts to satisfy the potential claims of creditors. However, the legal capital is seldom related to the size of the business in terms of turnover and balance sheet while the authorized share capital bears no relationship to the actually issued share capital. Hence, internationally the statutory capital requirement has lost its significance and it has often been removed as an unnecessary piece of legislation.

UAE: The requirement of the Commercial Companies Law to deposit a minimum share capital of Dinar 300,000 (USD 81,500) in the bank account for setting up an Limited Liability Company (LLC) was abolished. According to a decree the amendment, retroactive to companies established on or after June 1, 2009, allows new businesses to determine the capital needed for their establishment and sustainability.

Current Situation

The main laws regulating business are the Civil Code (Law 67 of 1980), the Commercial Code (Law 68 of 1980), and the Commercial Companies Law (Law 15 of 1960). Any Kuwaiti over 21 years of age may carry on commerce provided he is not affected by a personal legal restriction. But a foreigner may not get involved in trade unless he has one or more Kuwaiti partners and the capital owned by the Kuwaiti partner(s) in the joint business is not less than 51 % of the total[5]. However, this is often circumvented by establishing cover-up businesses where the company is registered under the name of a Kuwaiti, but is in fact financed and managed by an expatriate. The role of the Kuwaiti is usually limited to collecting a monthly fee. Enterprises can take several legal forms including LLC, Closed Joint Stock Company, and Public Joint Stock Company, Joint Liability Company and Limited Partnership.

The process of establishing and registering a company is challenging because of inconsistent regulations and slow-moving bureaucracy whether the entrepreneur wants to open a modest shop or a major enterprise. Preliminary procedures need to be completed including obtaining a license from the Kuwait Department of Partnerships. Entrepreneurs can expect to go through twelve steps to launch a LLC over 32 days on average. Over the last years the number of procedures and the time required has only marginally decreased. Globally, Kuwait stands at 142nd place in the ranking of 189 economies on the ease of starting a business[6], far behind best practice economies. It also compares unfavourably with countries in the region such as Saudi Arabia (10th), Oman (68th), Bahrain (82nd) or Qatar (116th). An expensive and time-consuming registration process tends to turn down many potential entrepreneurs that would otherwise register their business.

As elsewhere, the LLC is the main route adopted by SME investors in Kuwait to enter the market. The MCR is KD 7,000 (USD 25,550) representing almost 72% of per capita income. It has come down over the last nine years from 149%. Internationally MCRs are significantly lower (OECD[7] average: 15%) and there is a tendency to further reduce or even abolish them. Hence, Kuwaiti companies are at a competitive disadvantage in comparison with their competitors in other legal systems. Abolishing the requirement will ease a significant regulatory hurdle decreasing start up costs and registering time thus attracting more businesses.

Recommendations:

- Streamline registration procedures by reducing the steps and time required
- Automate incorporation processes by creating the necessary legal infrastructure and by removing obstacles to filing documents and information electronically
- Merge registration and licensing under a one-stop-shop system to ensure operationally integrated services
- Amend the Law on Commercial Companies to remove the minimum capital requirements

[5] As an exception, Law No.8 (2001) on Foreign Capital Direct Investment permits foreign entities to establish Kuwaiti companies with up to 100% foreign equity participation.
[6] World Bank/IFC: Doing Business in a More Transparent World – Economic Profile Kuwait, Washington October 2011, p. 10.
[7] Organisation for Economic Cooperation and Development

2. Licensing and Permitting

Background

Licensing is the practice of requiring approval by a government authority for engaging in a particular business activity. Often licenses expire after a certain period of time and require renewal. The purpose is to screen applicants so as to verify that they are fit to engage in a particular activity.

All governments use licenses though in varying degrees. They have the potential for serious economic harm. They drive costs upwards and raise barriers to new start-ups but also have anticompetitive possibilities as incumbent firms may lobby for licensing as a means for protecting themselves from new market entrants. Moreover, they have the effect of a tax that has to be paid *before* any income can be generated. These barriers are often unnecessary and involve unduly bureaucratic procedures.

While there is a need to safeguard society against immediate and long-term risks associated with certain types of business activities, often this can be done in a way that minimizes state interference. Hence, in mature market economies licensing is rarely applied, whereas more liberal systems are in place. This is done by turning to a system of certification.

Internationally there have been various strategies to scrutinize existing licenses, guided by the following principles:

- The use of licenses only where there are clear risks to the public associated with the conduct of business activities,
- Renewal requirements being adopted only where there is a substantial need to verify continued competence and suitability to undertake the business activities,
- Qualification requirements being directly and substantially related to the ability to carry out the business activities without risks to the public,
- Information and procedural requirements being restricted to the minimum necessary to issue and renew licences.

One-stop-shops are among the earliest burden reduction initiatives. They act as centralised regulatory shops, identifying licenses required for a particular business, contact details of the agency that administers each license (if not handled by the one-stop-shop itself), license application forms, details of license fees, coverage and renewals.

Current Situation

In Kuwait, a general license is required to carry on any business. In addition, different business activities are subject to a multiplicity of specific licenses delivered by different authorities. This makes it complicated for the entrepreneur to find his way quickly. Some business activities are not accounted for thus preventing the issuance of a license. The Kuwait Municipality has far-reaching executive powers in commercial licensing. It is responsible for issuing building licenses.

To obtain a license, documents on the registration as a legal entity have to be presented as well as documents that certify compliance with the established qualification requirements. Nearly all state bodies require a number of additional forms or documents from other public institutions. On the positive side is that information on the eligibility or criteria, the required documents, the procedures and the fees can be obtained online through the government's website[8] while application forms can usually be downloaded. All licences require periodic renewal, normally every two years.

The business community expects simplification of licensing to go in two directions: On the one hand, the procedures should be simplified and the costs for getting a confirmation of compliance with the fulfilment of qualification criteria should be reduced. On the other hand, the number of bodies involved in issuing licenses should be decreased to a reasonable amount. Moreover, the KCCI opts for a replacement of licenses by product or service certificates.

Recommendations:

- Reduce the number and lighten authorisation schemes by simplifying the administrative procedures required to obtain licenses, permits and authorizations for starting operations by, for example, applying the one-stop-shop concept[9].

IV. Improving Access to Finance

SMEs are significantly more financially constrained than large firms. Access to finance is a bottle-neck to succeed in their drive to establish their business, build productive capacity, to compete and create jobs. Without finance, they cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms.

Commercial Bank Lending

In Kuwait, private sector lending to GDP was 82% (2009)[10] compared to developed countries where it stood at over 200% (e.g. USA 202%, UK 204 %,). SMEs participate with only 2.5% in the loan portfolio of banks[11]. The low share of SME lending reflects to a large extent the structure of an oil-based economy, which is less diversified and dominated by large enterprises.

The prevailing situation has motivated government interventions in the form of policy loans at subsidised interest rates provided through the Industrial Bank of Kuwait (IBK). This may be justified when it takes time to build an effective financial environment to enhance conventional commercial bank lending, or where some groups such as SMEs remain difficult to reach, even when an efficient financial infrastructure and regulations are in place, i.e. when there is a market failure.

[8] http://www.e.gov.kw/sites/KGOEnglish/Portal/Pages/Business/LicenseAndPermits_Information.aspx
[9] The renewal of licenses is already undertaken in a physical one-stop shop.
[10] http://timetric.com/index/domestic-credit-to-private-sector-pc-gdp-kuwait-wb/
[11] World Bank: The Status of Bank Lending to SMEs in the Middle East and North Africa, January 2011, p. 9.

IBK provides loans for small projects at a subsidized interest rate of 2.5% covering up to 80% of the maximum project cost of KD 500,000. The grace period is one to three years and the loan maturity 15 years. IBK also provides two years salary of KD 1,000 per month for the entrepreneur on which it does not charge interest rate. The feasibility study for the project is undertaken by IBK free of charge. Conditions for falling under the financing scheme are (i) general business licence from the KCCI, (ii) being unemployed, and (iii) availability of business premises. IBK manages a budget of KD 50 million, provided by the Kuwait Investment Authority (KIA), but only disbursed 50% over the last 10 years mainly because of the stringent qualification requirements[12].

Difficulties in accessing debt finance are a common concern of SMEs in most economies and they are related to internal and external factors.

Size-specific constraints include insufficient assets and low capitalization, low prospects for growth and the vulnerability to market fluctuations combined with the limited technical, managerial and marketing skills of the business owner. SMEs usually do not disclose information to the extent and quality required by banks to properly assess their creditworthiness in cash flow-based lending. All of this leads commercial banks to perceive them as a high-risk clientele that is better avoided.

This is compound by deficiencies in the financial infrastructure. In the 2011 IFC/World Bank *Doing Business* report Kuwait was ranked only 89th for getting credit out of 189 countries, on a similar scale as Bahrain, better than Qatar (138th) and Oman (128th) but scoring worse than Saudi Arabia (46th). Getting credit is measured by two sets of indicators. The credit information index which measures rules affecting the scope, accessibility and quality of credit information available through credit registries and the legal rights index which highlights the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders.

1. Credit Bureau

Background

Asymmetric information of banks and their client SMEs may lead to adverse selection and credit rationing. SMEs know more about their willingness and ability to repay their loans than banks do and each bank only has firsthand knowledge of those SMEs that it deals with. As a result, banks tend to select some bad borrowing SMEs, who subsequently default on the repayment of their loan and to ignore some good ones, who would have repaid the loan had it been given to them.

Sharing of credit information about SMEs' characteristics and their indebtedness among banks is one of the mechanisms with which information asymmetries can be reduced. Various information-sharing devices have become institutionalised in the form of credit-reporting schemes. They are more efficient when privately owned rather than publicly since they are service oriented providing a variety of products needed by the market, offer prompter services, have a wider scope of coverage and they can utilize a variety of sources other than those institutions that are regulated and supervised by the Central Bank.

[12] In particular, the requirement of having premises ready is difficult to comply with since the 'key money', which has to be paid in advance of starting operations in addition to monthly rental costs (of approximately KD 5,000 for a good location) is high (e.g. KD 100,000).

Current Situation

In the Gulf region Qatar and Oman rely entirely on a public credit registry while Bahrain, Kuwait and Saudi Arabia have private credit bureaus. The UAE has both. Yet in all countries the coverage in terms of percentage of adults remains low. In 2010, it was 35.9% in Bahrain, 29.6% in Kuwait and 18% in Saudi Arabia[13].

UAE: Emcredit provides a range of credit bureau services and other risk assessment tools. However, its limited coverage led to the establishment of the Federal Credit Bureau by law in 2010 to provide information on the credit history of individuals and establishments.

Bahrain: The Risk Management Division of the Benefit Company, established in 1997 by 17 banks, includes the Credit Reference Bureau which since 2005 is dealing with personal credit and since 2007 with corporate credit.

Saudi Arabia: The Saudi Credit Bureau, established in 2002 and operating since 2004, offers both consumer and commercial credit information to respective members.

Sources of credit information in Kuwait include the credit registry of the Central Bank of Kuwait (CBK) and the private credit bureau Credit Information (CI)-Net. Commercial banks consider the information available from CBK as insufficient both in terms of scope and timely availability (monthly rather than daily). CI-Net, established in 2001 by Amir Decree, is an independent commercial institution that provides consolidated information on personal loans. It is owned by sixteen banks and finance companies collecting and distributing information from retailers, trade creditors, utility companies as well as financial institutions. The limitation of information to consumer loans leaves the banks with the problem of asymmetric information in corporate lending, making it expensive and difficult with a tendency to reduce lending to SMEs.

Recommendations:

- Create the necessary legal environment for CI-Net to expand the scope of its activities to include collection and dissemination of information on corporate credit.

2. Secured Transactions Regime

Background

Secured lending is the preferred option of commercial banks in most countries. Loans are secured on immovable and movable assets or intangibles like accounts receivable. Banks are risk averse with regard to SMEs and therefore prefer this form of lending. As the loan is secured, the need for evaluating creditworthiness is reduced. This type of lending requires a functioning market for secured transactions, conditioned by a wide range of pledgeable assets, an easy and inexpensive registration as well as a quick and simple realization in case of default. Sound collateral laws will enable SMEs to use their assets as security to generate capital.

[13] World Bank: Doing Business Kuwait 2011, p. 41.

Current Situation

In the 2011 IFC/World Bank *Doing Business* report countries of the Middle East and North Africa (MENA) region scored an average 3 out of 10 on the strength of legal rights index in the category 'getting credit'. Surveyed banks in the GCC region report problems in all three components of the secured lending chain, especially for movable collateral. 56% of banks see problems in the registration of collateral, 59% in enforcement and 76% in selling seized collateral. None of the countries in the region has a modern law on secured transactions.

The range of assets that can be used as collateral is quite limited. While immovable property (land, real estate) is used as the prevalent form of security, financial institutions are reluctant to accept movable property (equipment, vehicles). These limitations prevent SMEs from leveraging a large part of their assets into capital for investment. After all the capital stock of businesses is mostly made up of movable assets (e.g. in mature market economies: 78% movable assets, 22% immovable property).

In Kuwait, mortgage agreements are treated as contracts and hence the Civil Code is applicable, allowing the mortgage transfer of a deed from the borrowing SME to the lender. In the process of 'putting the world on notice' of the security interest, the mortgages on real estate are recorded in the electronic centralised registry at the Department of Real Estate Registration and Authentication of the Ministry of Justice in accordance with their ranking. This ensures that the mortgage is enforceable against other creditors or the bankruptcy trustee. Registration appears to be prompt and at a nominal cost. Any searches can be relied on as being up to date[14]. However, while the general priority rule used in more developed systems is based on notice and the 'first to register rule', in Kuwait secured creditors do not have absolute priority in and outside bankruptcy procedures. This reduces the value of collateral. The only types of mortgage over movable assets are the possessory mortgage (or lien) and the premises mortgage[15]. A possessory mortgage does not need to be registered. A premises mortgage is in the nature of a floating charge made by way of mortgage deed between the creditor and the debtor and registered in the MCCI. However, there is no central computerised registry capable of being searched[16]. In addition to tangible assets, a possessory lien may be over intangible assets such as contract rights, receivables, equities and other financial instruments.

Implementing a claim against collateral in case of default (enforcement) should be inexpensive and speedy enough to permit recovery before the assets loose value. Enforcement is most effective when parties agree on rights and remedies upon default, including seizure and sale of the collateral outside the judicial process. However, enforcement in Kuwait requires intervention of the Executions Court as determined by the Civil Code and the Procedure Law. If uncontested, the enforcement process can take approximately one year and if contested, up to four years. This further reduces the value of collateral. In addition, the law severely restricts the types of collateral to which creditors may have recourse. Banks may not foreclose on residential real estate property or personal possessions[17]. However,

[14] Hawkamah et all: Study on Insolvency Systems in the Middle East and North Africa, p. 32.
[15] Commercial Code Articles 40–46
[16] Hawkamah et all: Study on Insolvency Systems in the Middle East and North Africa, p. 31.
[17] Ibid, p. 32.

they may sue the borrower for the balance due under the loan contract. Hence the disposition of secured assets turns out to be one of the major constraints facing financial institutions and acts as a deterrent to lending to SMEs.

Recommendations:

- Raise awareness of the importance and best practice in relation to moveable property (equipment), accounts receivable, inventory that can be used as collateral
- Work towards accepting foreclosure on residential real estate at least where the borrower owns several properties
- Ensure that collateral creditors have priority over other claims in case of bankruptcy consistent with international best practice
- Expedite the collateral enforcement process and consider out of court settlement

3. Loan Guarantee Fund

Background

A major cause of access to finance problems is the lack of tangible, marketable guarantees of the credit seeking SME. Facing this situation, an SME with a viable business plan can consider it helpful to get the recognition of its creditworthiness under the form of a guarantee issued by a third party, for example, under Partial Credit Guarantee Schemes (PCGs). They reduce the risks and potential losses of banks, inducing lending to riskier types of borrowers. Because they usually entail less interference in credit allocation and use private banks as the main vehicles for loan origination, they generate fewer market distortions compared to other policy interventions, such as directed lending programmes or state banks.

Internationally, guarantee schemes vary on fundamental design factors. Their success depends on outreach, additionality and financial sustainability. The greater the outreach as measured by the number of guarantees issued to eligible SMEs and the amount of outstanding guarantees, the stronger is the impact on the SME sector. The impact will also depend on additionality, i.e. on whether guarantees are extended to firms that are credit constrained, and not to firms that would be able to obtain a loan anyway. Even though reaching credit-constrained SMEs involves risk-taking and financial losses, the guarantee scheme should still seek to be financially sustainable.

Current Situation

Saudi Arabia[18]: The government along with commercial banks established the Finance Guarantee Programme for SMEs with the Saudi Industrial Development Fund (SIDF) assuming the role of coordinator. The programme provides banks through SIDF with tangible security up to SAR 1.5 million (USD 400,000) and 75% of the underlying loan. The minimum guaranteed amount is SAR 50,000 (USD 13,500) and the maximum is SAR 1 million (USD 226,000). The maximum tenure is seven years on fixed assets and four years on working capital. Guaranteed finance must be restricted to Sharia'h-compliant products. Collateral will be sought and held by the SIDF. In the event of default SIDF executes the collateral.

[18] http://www.sabb.com/1/2/sabb-en/commercial/business-solutions/credit-facilities/finance-guarantee-program-for-sme

In Kuwait, while significant deficiencies are prevalent in the secured transaction regime, no guarantee scheme exists. However, this concept is successfully applied in various parts of the MENA region which may serve as best practice examples to introduce such a mechanism.

Recommendation:

- Consider establishing a Partial Loan Guarantee Fund depending on the outcome of a feasibility study

4. Interest Rate Ceilings

Background

Lenders provide credit on the basis of their cost of funds plus a return on capital. The return on capital includes a fee (the interest) and a risk premium. Interest is the compensation to the bank for (i) risk of principal loss (the credit risk) and (ii) forgoing other investments that could have been made with the loaned amount.

The level of risk is taken into consideration by charging an extra risk premium. It is the minimum amount of money by which the expected return on a risky loan must exceed the return on a risk-free asset, in order to induce the bank to hold the risky asset (the loan) rather than a risk-free asset (e.g. T-bill). The risk premium reflects the costs associated with lending such as the likelihood of the SME defaulting or the costs incurred in collecting debts from a delinquent SME. It is dependent on a bank's risk preferences. The risk premium also depends on the maturity of the loan. Generally speaking a longer-term loan carries an additional maturity risk premium. A bank has a choice between using its money in different investments. If it chooses to provide a loan to an SME, it forgoes the returns from all the others investments.

Current Situation

In Kuwait, the CBK determines the maximum interest rate that financial institutions can charge borrowers. Such an interest rate ceiling effectively means a price control. The maximum limit of the annual contractual interest rates on all forms of KD lending transactions, whose maturity term does not exceed one year, may not be more than 2.5% and for loans with a maturity of more than one year it may not exceed 4% over the CBK's discount rate. The maximum interest rate of 7% established by the Commercial Code (Article 111) applies to any loan agreement that includes, explicitly or implicitly, an interest rate in excess of such rate, i.e. making such an agreement null and void[19].

Kuwaiti Civil and Commercial Codes distinguish between civil matters, whereby charging interest is not allowed in the Civil Code (Article 547), and commercial matters, whereby interest is permitted under the Commercial Code. Notwithstanding the provision of the Civil Code, the Commercial Code (Article 102) stipulates that the creditor shall be entitled to an interest in a commercial loan unless otherwise is

[19] CBK: Resolution No. 1/1993(1) concerning the establishment of maximum limits of contractual interest rates

agreed upon. If the rate of interest is not stipulated in the contract, the rate due shall be the 7 % legal rate[20].

The established interest rate ceilings have negative repercussions on lending to SMEs. First-time borrowers, small borrowers, low-income and high-risk borrowers are likely to find it more difficult to obtain credit while the most creditworthy borrowers – usually not SMEs - may obtain more credit than they would have at normal market interest rates. A binding ceiling (established below market rate) obviously alters the price of credit, leading to a decrease in the quantity of credit supplied. Like any other business, if a lender does not recoup its costs and earn an adequate return on equity, it will put those resources to work elsewhere. Since the amount of credit offered will not satisfy all those who are willing to borrow at the ceiling rate, excess demand is created. Credit is not available despite the fact that there is demand for it (credit crunch). The reduced amount of credit must then be rationed among borrowers by some means other than the interest rate. This is usually done by setting rigid loan terms, screening borrowers more rigorously, or increasing non-interest fees and charges which all act against SMEs.

Recommendation:

- Ease or remove the ceiling on lending rates to enable lenders to better price the risks of lending to SMEs (this requires amendment of the Commercial Code (Art. 110) and Central Bank regulations).

Alternative Sources of Finance

5. Equity Finance

In mature market economies equity finance is often provided by outside investors for entrepreneurs to establish and grow their business. Equity investors may include family and friends, angel investors and venture capital funds. Each provides capital at a different stage of the start-up financing cycle, typically an ever larger amount as the enterprise grows and increasingly generates revenues.

Business angels invest seed capital in a personal capacity in exchange of ownership of part of the business and in return for a share of the profits. The growth potential of SMEs is further enhanced by the contribution to management competence, access to competence networks, or marketing skills. Venture capitalists usually invest in early-stage, high-potential, high risk, growth start-up companies. The typical venture capital investment occurs as growth funding round (i.e. after the seed funding round) in the expectation that the return on investment will be above average. Venture capital investors do not want permanent ownership, but rather to 'exit' it within five to seven years by selling the shares they acquired.

Best practice approaches have emerged for the government to support equity investors. These include initiatives that tackle regulatory and tax obstacles that may prevent foreign venture capital funds from investing in SMEs, to raise the awareness of the concept, the creation of a business angel panel to discuss pertinent issues, as

[20] Saleh Majid: Interest and Islamic Banking, March 2011

well as provide financial supporting for the creation of business angel networks that match potential investors with enterprises.

Current Situation

There are around sixty investment funds that are managed by investment companies domiciled in Kuwait. They invest the pooled assets under management across various asset classes. The majority of the funds are equity funds constituting around 66% of the total assets under management[21]. Some of the funds invest in Kuwaiti medium-sized ventures. Al Ritaj Investment, for example, specializes in private equity business of medium-sized companies in the MENA region (including Kuwait) with emphasis on family-owned businesses conducting its business according to the Islamic Shari'a principles. The company works with the owners of the business to eventually change the company into a share-holding company to allow its initial participation and later its exit after significant increase has been achieved in the company's value.

Saudi Arabia: The Saudi Arabian General Investment Authority, Venture Capital Bank, a Bahrain-based Islamic Investment Bank, and Global Emerging Markets, an international investment house, undertook a cooperative effort to establish an independent USD 100 million venture capital investment company to invest in venture capital opportunities and SMEs. The objective is to provide growth capital and late-stage financing to SMEs in compliance with Shari'a principles.

Despite scattered private initiatives to invest equity capital in mainly medium-sized enterprises, the provision of equity capital is still underdeveloped. While some entrepreneurs may be able to tap into the funds of family and friends, Kuwait lacks in development of a more formal and accessible early-stage financial industry. Not only is the concept of business angels not well-known, but also most SMEs do not seem to have the growth potential to appeal to business angels and equity investors. This has motivated government interventions, channelling public funds through a selection of portfolio managers for equity investment in small projects.

The Kuwait Investment Authority (KIA) through its National Investment Fund Portfolio (NIFP) supports Kuwaiti entrepreneurs. NIFP was established in 1997 with a capital of KD 100 million. The main objective is to assist and support the Kuwaiti citizens in realizing their business ideas. NIFP supports projects in all sectors by participating in the project's capital as a shareholder rather than as a lender thus eliminating the need for the entrepreneur to provide guarantors or securities. It does not participate in the operation and administration of projects but limits its role to observing and monitoring their performance. Two leading private investment companies - Al-Ra'eda and KAMPCO – manage a portfolio of KD 15 million, while the state-owned IBK handles a portfolio of KD 50 million on behalf of KIA.

Al-Ra'eda supports successful businesses in high growth sectors. Since its inception KD 9 million of the available KD 15 million has been disbursed for equity investment of between 55% and 85% of total project costs. It participates in the establishment of small and medium sized projects, financial and organizational restructurings and the preparation of feasibility studies while also providing financial and managerial advisory services.

[21] Capital Standards Rating: Kuwait Investment Funds, January 2011, p. 2.

KIPCO Asset Management Company (**KAMCO**) with the available KD 15 million provided by KIA invests up to 80% in a small and medium scale project with a subsequent majority in the decision making of the company.

The **Kuwait Small Projects Development Company** provides equity capital to small and medium size projects. It was established in 1996 as a special purpose entity with capital committed by the KIA, which pledged KD 100 million, for providing loans to SMEs. However, having faced high default rates by its borrowers the company abandoned the approach and became a new venture capital firm.

To be eligible for support, the Kuwaiti entrepreneur must be experienced in the project activity he plans to undertake while being fully dedicated to project management. Furthermore, the project capital may not exceed KD 500,000, and the maximum participation of NIFP through the portfolio managers is 80% of the project's total capital. A feasibility study must demonstrate a return on investment of at least 15%. The withdrawal of equity investment from the project within a reasonable period that might exceed 5 years is outlined in an exit strategy. The entrepreneur buys back the shares according to the market value or the fair value of the investment at the time of exit.

Recommendations:

- Tackle regulatory and tax obstacles that may prevent foreign venture capital funds from investing in SMEs
- Initiate an awareness raising campaign that presents the potential benefits of business angels as a source of equity finance
- Support the creation of a business angel network to match potential angel investors and SMEs
- Through the network build up capacity of SMEs to present their investment opportunity effectively to potential angel investors

6. Leasing and Factoring

Background

Financial leasing is based on a contract that allows an SME (lessee) to use an asset in exchange for periodic payments to the leasing company (lessor). Because the leasing company retains asset ownership, lease payments are an operating cost rather than a financing charge. The leasing company relies on the ability of the SME to generate cash flows rather than relying on its assets, capital base or credit history to obtain credit. Typical lease arrangements require 10% of the asset cost as security and terminate after three to five years. Leasing has proven to be an innovative means for SMEs to access mid-term capital. It provides an opportunity for filling a financing gap for SMEs that need new equipment for their operations but cannot obtain loans to purchase it. Moreover, SMEs may benefit from technology transfer.

Inventory financing, also known as factoring, enables an SME to increase its short-term capital and thus improve the conditions for earnings growth. It is used to cover working capital based on the cyclical needs of a business or it is used to build up inventory one time in the year for liquidation later in the year, or to sell over the course of the year. In many countries factoring has become a prominent new financial instrument. As a multifaceted product it combines finance and services by collecting accounts receivable, providing buyer credit coverage and the corresponding bad debt coverage in the event of loss due to the buyer's inability to pay.

Current Situation

Law No. 12 (1998) intends to promote leasing by permitting the granting of licenses to shareholding companies established for leasing. Tax exemptions are granted for the first five years from the date of incorporation in respect of the income accruing to a foreign shareholder.

While leasing is in principle well suited to countries with weak collateral regimes such as Kuwait, in practice weak protection of ownership rights and contract enforcement dilute or even eliminate its supposed advantages. The low presence of banks may be explained by the lack of clarity in the legal framework for leasing, including leasing definition, balance in responsibilities between lessor and lessee, regulations for different forms of leasing, the process for registering leased assets and weak asset repossession processes. Apart from leasing, factoring is not prominent in Kuwait. Receivables are usually financed internally and externally through bank loans, for which companies mortgage real estate and in some cases pledge equipment with the usual difficulties attached to these instruments. Moreover, there seems to be a lack of awareness of both alternative financial instruments. While it remains the commercial decision of banks to offer these products to their clients, a public campaign for awareness and education could help properly position the products thus preparing the grounds for market development.

Recommendation:

- Raise the awareness of leasing and factoring
- Review the legal and regulatory framework for leasing and factoring and adjust to international best practice

7. Payment in Commercial Transactions

Very often SMEs face problems in the time taken to receive payment for the supply of products and rendering of services. Prompt payment is critical to the cash flow of every business, and especially to smaller businesses within the supply chain. However, it is not just the timeliness of payment, but rather the certainty of getting paid that is really important, and enables businesses to plan both for their short and longer term futures. Certainty on payment inspires confidence across the supply chain, confidence that stimulates investment and growth. This confidence is good for both suppliers and customers.

Late payment legislation, which applies equally to the public and private sectors, is a useful tool for businesses, both to deter late payment, and to obtain compensation from debtors when it becomes unavoidable. To minimise late payment, best practice involves a pre-contract system for evaluation of potential purchasers' financial status, accurate invoicing and a framework for dealing with genuine complaints. For those debts which slip through the net, appropriate legislation could ensure that maximum interest and compensation can be claimed. All businesses would have the right to claim statutory interest on overdue commercial debts usually at the Central Bank's main refinancing rate plus certain percentage points. If no time for payment has been agreed, a debt would usually become overdue if it remains unpaid 30 days after invoicing.

Apart from the legal treatment, prompt payment codes are often developed to tackle the crucial issue. Such a code would encourage and promote best practice between businesses and their suppliers. Signatories to the code would commit to paying their suppliers within clearly defined terms, and commit also to ensuring there is a proper process for dealing with any issues that may arise. Suppliers can then have confidence in any company that signs up to the code that they will be paid within clearly defined terms.

Current Situation

In Kuwait there appears to be a culture of late or withheld payment, even among respected companies. This causes substantial cash flow problems to SMEs. The Commercial Code (Article 110) imposes a maximum 7 % legal interest on the debtor who fails to pay in time. According to Article 3, the Commercial Code applies to all commercial matters and prevails over the provisions of the Civil Code, which foresees that no interest may be charged. There is no code for prompt payment.

Recommendations:

- When amending the Commercial Code (Article 110) consider introducing an interest rate based on the CBK’s basic refinancing rate plus x percentage points to allow for taking inflation into account.
- Encourage the development of a Code of Conduct for timely payment.

V. Making full Use of ICT

Background

Internet gives to SMEs a unique opportunity to overcome the economies of scale limitations by aggregating buyers and suppliers, i.e. linking individual SMEs to each other, to major companies, e-procurement chains and to other e-marketplaces. More broadly, successful e-commerce initiatives facilitate the emergence of new forms of business organizations such as virtual hubs and networks. By streamlining their operations and business relationships e-commerce helps to create a supply chain management for SMEs and overcome the high trade barriers they normally face. Increasing the role of buyer’s feedback helps to make production more customers centric and flexible. Creating many portals for SMEs with useful and functional contents contributes to their efforts to access business information at much less costs and hence to overcome the information asymmetry problem. However, in order to realize this opportunity it is necessary to have access to technology and to create an environment capable of nurturing the new businesses.

The general framework for development is set by e-Readiness, the degree to which a community is prepared to participate in the digital economy. It depends on the following:

- *Physical infrastructure:* The telecommunications infrastructure including teledensity (the number of telephones per 100 people), Internet access, digital bandwidth[22], pricing, and reliability;
- *ICT use:* Levels of use throughout society including by homes, businesses, schools, and government;
- *Human capacity:* Literacy, ICT skill levels, and vocational training;
- *Policy environment:* The legal and regulatory environment affecting the ICT sector and ICT use including telecommunications policy, trade policy, e-commerce taxation, universal service provisions, consumer protection, and privacy;
- *ICT economy:* The size of the ICT sector

E-commerce as part of the IT development is widely adopted by developed countries which have made it an integral part of business activities.

Current Situation

Despite the growth of the ICT sector, the GCC countries still face infrastructure and regulatory challenges that need to be addressed to project then as an increasingly sophisticated region for investors and businesses. Kuwait ranked 76th in the Networked Readiness Index 2009-2010 out of 133 countries, comparing unfavourably with the UAE (23rd), Bahrain (29th), Qatar (30th).

The ICT infrastructure is provided through the Ministry of Communications (MOC), mobile phone companies and Internet service providers (ISPs). There are three major mobile phone providers and the cellular phone penetration reached 99.6% in 2008, still low in regional comparison[23]. Partial competition between about 13 ISPs exists despite a monopoly on international gateways. The fixed line penetration rate was 19% with the MOC being the only fixed line carrier, from where most of the Global System for Mobile Operation (GSM) operators and ISPs purchase bandwidth and network capacities. Kuwait has lagged behind other GCC countries in the privatization process of the fixed telecommunications sector. It is the singular case, where there is no regulatory body making the ICT sector less dynamic[24].

PC and Internet penetration (27% and 35% respectively) do not match the uptake of mobile services due to high costs of the related services. There are more internet users than computers. Internet penetration is lower than for example in the UAE (86.5%)[25]. While quality and speed of the Internet play an increasingly important role in the extent to which it is utilized, the Internet bandwidth per 10,000 inhabitants is relatively low in Kuwait at 9 megabits per second (Mb/s)[26] [27].

ICT applications have increased. The websites of companies are no longer restricted to offering promotional information, but they also include quarterly reports, profit-and-loss statements, and useful information dedicated to investors. Electronic sale, purchasing and payment transactions have started to grow either via the Internet or

[22] Digital bandwidth is the rate of data transfer, bit rate or throughput, measured in bits per second (bps)
[23] Saudi Arabia 142.9%, Oman 115.6%, Bahrain 185.8% and UAE 208.6%.
[24] According to recent government statements this may be set to change through privatization while the establishment of an independent regulatory agency for the communications sector is also considered.
[25] World Economic Forum: Global Information Technology Report 2009-2010.
[26] 132 Mb/s in UAE, 118 Mb/s in Qatar, 25 Mb/s in Bahrain, 17 Mb/s in Saudi Arabia
[27] World Economic Forum: Global Competitiveness Report 2010-2011.

Short Message Service (SMS). However, SMEs are still slow in using Internet as a core element of business organisation and a channel to develop Web trading and related e-payments operations. E-commerce users' penetration reached only 10.7% in Kuwait compared to 14.3% in Saudi Arabia and 25.1% in the UAE[28]. The challenges they face include those related to the technical infrastructure in terms of access, affordability and quality. It also appears that SMEs do not have a favourable approach to e-commerce considering it as less secure, of lower quality and preferring traditional trade as a better tool to run business. Moreover, business laws and legislation dealing with e-commerce are not updated. For example, an electronic signature law continues to await legislative action.

Every SME wishing to be connected to the Internet needs to be served with a telephone line and the necessary equipment and internet services are to be available at affordable prices. The reduction of connectivity and ICT infrastructure costs requires efficient competition. In addition, setting up a technology park would facilitate SMEs to establish their activities in a low-cost high-efficiency business environment. The quality of service could be enhanced by moderately fast narrow- and medium band Internet access and very fast broadband downloading of information. Literacy and comfort with the Internet are also important. The government can advance a set of policies through targeted initiatives. Apart from the ongoing increase of ICT penetration in the education sector, marketing programmes to raise Internet awareness among SMEs could be helpful.

Recommendations:

- Increase computer literacy and encourage the use of ICT within SMEs for communication, marketing, administrative and financial management
- Provide a web-based SME resource centre that offers business training and counselling services
- Encourage SMEs to 'Go Digital' through coordinated networking activities for the exchange of knowledge on best practices, e-commerce readiness and benchmarking.

[28] S. Al-Fadhli: Critical Factors influencing E-Commerce in Kuwait, Journal of Internet Banking and Commerce, April 2011.

VI. Widening Market Opportunities

Creating markets and opening opportunities for SMEs to play a more prominent role in the economy is related to outsourcing public goods and services[29] and the transfer of state ownership rights to the private sector for the production of goods and services that are not genuinely public in nature.

1. Public Procurement

Background

Public procurement offers new market opportunities from which SMEs ought to be deriving a significant share. Usually, thresholds are established above which competitive bidding is required. This allows authorities to avoid expensive and lengthy tendering and award procedures for low-value contracts where the costs of the procedures would exceed the public welfare benefits of increased transparency and competition associated with the procedures. When participation in public procurement markets is biased towards larger enterprises, it is for policy to create a levelling playing field to ensure that SMEs and large enterprises have equal access and do not suffer unnecessary disadvantages over their larger competitors. There is a wide range of good practice and experience concerning approaches to breaking down the barriers to SMEs' access to public procurement. These include providing information, training and support; simplified pre-qualification requirements; e-procurement systems; improved payment systems; debriefing arrangements; the use of smaller lots and framework agreements; and, the adoption of the 'economically most advantageous tender' criteria (as opposed to the lowest price only) as part of the bid appraisal process.

Current Situation

In Kuwait an inordinate amount of business opportunities depends on government contracts. Public tendering is governed by Law No. 37 (1964) - the 'Tenders Law', Law No. 18 (1970) and Law No. 81 (1977). A public authority may only buy equipment and commodities and commission works, by way of an independently administered tendering process. Law No. 81 (1977) allows bypassing this process, if the value of the contract does not exceed KD 5,000 (USD 18,000). The Central Tenders Committee (CTC) is responsible for issuing government tenders, pre-qualifying firms, and awarding contracts. Yet some public institutions have their own tendering procedures[30].

Advertising for procurements takes place in the Official Gazette, one daily newspaper while open tenders, postponement of tenders and tender awards are published online[31]. A tenderer must be a Kuwaiti merchant (individual or company) who is (i) registered with the KCCI and the MOCI, and (ii) registered in the classification list of

[29] Economists usually define public goods as being 'non-rival' and 'non-excludable' in consumption. This means a public good (or service) may be consumed without reducing the amount available for others, and cannot be withheld from those who do not pay for it. No market exists for such goods, and they are therefore provided to everyone by governments.

[30] Kuwait University, Kuwait Ports Authority, the Public Authority for Housing Care, Ministry of Defence, Ministry of Interior.

[31] http://www.e.gov.kw/sites/kgoEnglish/Portal/Pages/Business_EServices.aspx

approved contractors and suppliers maintained by the CTC. An initial bank guarantee (bid bond) varying from 2.5% to 5% of the bid value must be submitted with the bid. Once selected, the company has to replace the bid bond by a performance bond of 10% of the bid value.

Contractors must usually be priced on a lump-sum fixed-price basis, though unit pricing is normal in maintenance type contracts. Goods made in Kuwait may be priced up to 10% higher than comparable items made abroad and be deemed the lowest priced. Goods made in other GCC countries have a 5% price preference. Local contractors for the performance of works do not enjoy any pricing advantage. Public sector contracts must by law be awarded to the bidder who offers the lowest price provided his bid conforms to technical requirements and he has adequate resources. Pursuant to Law No. 19 (2000), a party awarded a contract must be in compliance with the minimum ratios for employment of Kuwaiti nationals as designated by the Council of Ministers. The barriers which discourage SMEs from responding to public tenders include:

- Lack of awareness: SMEs are not always aware of the opportunities offered by public procurement markets.

- Lack of accessible, timely and comprehensible information available to SMEs, including information gaps concerning rules and tender procedures, the future plans of awarding authorities and specific tenders; and problems of unclear jargon used in procurement documents.

- Lack of knowledge and skills: SMEs may not have ‘tendering departments’, and may lack specialist knowledge in public procurement; the language skills required are also not always present,

- High administrative burden: As SMEs normally do not have large and specialised administrative capacities; administrative requirements may cause high compliance costs.

- Over aggregation of contracts stifles competition as it can wipe out smaller suppliers resulting in higher prices.

- Overly restrictive qualification and financial standing criteria could exclude young, innovative enterprises.

- A relatively low bid threshold exposes a number of SMEs to cumbersome tendering procedures.

Currently efforts are underway to draft a new comprehensive public procurement law and to promote reforms aimed at modernizing procurement practices.

Recommendations:

- Consider increasing the bid threshold in the new public procurement law above the current KD 5,000
- Establish electronic marketplaces for public procurement
- Encourage contracting authorities to subdivide contracts into lots, where appropriate and make subcontracting opportunities more visible
- Encourage contracting authorities to avoid disproportionate qualification and financial requirements in their tender documents.
- Encourage constructive dialogue and mutual understanding between SMEs and large buyers through activities such as information, training, monitoring and exchange of good practice

2. Divesture of State Ownership

Background

It is generally agreed that the role of the state in a market based economy as apposed to a centrally planed economy should be limited to supplying public goods, providing an enabling environment for private sector development, correcting potential market failures and creating a level-playing field. Generally, governments do not have the finances and the ability to get involved directly in economic activities. When an economy is dominated by the state, a change in the government’s role from a service provider to a regulator and creator of an enabling business environment requires a withdrawal from many productive activities that are private in nature through a policy of denationalisation, divestiture and privatization. By broadening the ownership base in the economy, such a policy stimulates the development of markets for the factors of production which previously were monopolised by the state thus opening up new opportunities for the development of SMEs.

Current Situation

Kuwait’s share of the private sector in non-oil GDP, which abstracts from developments in the oil sector, and direct contribution of the public sector to GDP, stood at just over 40% and has declined. The private sector accounts for a smaller share of GDP than transition economies of the former Soviet Union and the Baltic countries (an average of 57%) although these economies adopted market-oriented development strategies at much later years. Over the last decades the oversized government has created dependency on state spending for employment, especially nationals, the delivery of social and community services and private sector business opportunities through public procurement. The limited investment opportunities coupled with a poor investment climate has led to low foreign and domestic investment relative to other countries in the region. Potential for diversification exists in transportation, wholesale and retail trade, storage, communication and perhaps tourism, while the petrochemical industry – although high in value added - is limited in its potential for job creation while its fortunes are highly linked to the volatility in the oil markets.

The government has been trying to speed up the process of privatization. It involves both the reduction of the government's stake in some existing public sector companies, and new opportunities for the private sector to invest in strategic industries previously supported by government funding. In 1992, the KIA began implementing a three-phase privatization programme. The BOT (build-operate-transfer) Law No. 7 was passed in 2008 and is currently being implemented with the development of guidelines along international best practice and with the formal launch of the Public Private Partnership Programme soon to follow. Also bylaws are currently being drafted for the implementation of the Privatization Law, passed in 2010, which creates the framework for the privatization of public assets in sectors other than the oil and gas industry, health and educational services under certain conditions[32]. The setting up of a Privatization Technical Bureau is under way. The mid-term Development Plan 2010-2014 envisages significant participation of the private sector in the country's development by enhancing public-private partnerships. Once implemented, all of these planned initiatives may widen market opportunities for SMEs and increase domestic and foreign investment provided that the right market conditions are in place. Foreign investment in turn provides a fertile breeding ground for SMEs that will be lured to set up in order to capitalize on subcontracting opportunities.

[32] DL Piper: New Kuwaiti Privatization Law under the Microscope, 2010.

ANNEX I

The Definition of SMEs

The definition of SMEs first of all requires an understanding of what an enterprise is. In the European Union (EU), for example, an enterprise is considered to be any entity engaged in an economic activity, irrespective of its legal form. This includes in particular, self-employed persons and family business engaged in craft or other activities, and partnerships or associations regularly engaged in an economic activity. In a next step a generally accepted and consistently applied size categorization of enterprises is required.

A number of international organizations such as the United Nations Organization for Industrial Development, European Commission, Multilateral Investment Guarantee Agency, and Asia Pacific Economic Cooperation apply certain rules and defining criteria for SMEs. There are also country specific SMEs definitions within the region using either the number of employees, invested capital and turnover or a combination thereof. Several indicators that are often used as definition criteria can be assessed in terms of their relevance to the size of an enterprise and ease of measurability.

- **Number of Employees:** Defining SMEs according to the number of employees is straightforward. It is highly relevant and it is probably the easiest figure to obtain. However, it can face some problems due to labour intensity of different industries. Moreover, part-time workers and family members, who function both as managers and workers, create some definitional problems.

- **Turnover:** Including turnover, i.e. revenues or sales value, in the classification criteria is particularly relevant if the enterprise is in the trade and distribution sector. These enterprises have higher sales figures than those in manufacturing. To take account of this, for example the EU definition includes the option between the total annual sales and total assets depending on the sector in which the enterprise is operating. However, obtaining annual sales figures on a national level is difficult, which might limit the ability of policy makers and researchers to study the SMEs sector.

- **Total assets:** This indicator is particularly relevant to asset-based industries such as manufacturing. However, the problem of defining small industries on the basis of the size of capital is that the cut-off point needs to be revised over time in order to allow for inflation. Inconsistencies may arise in the process of doing so, because not all firms revalue their capital in a uniform manner. Similar to annual sales, figures on total assets may not easily be obtainable on a national level.

- **Registered capital:** Although the registered capital is easily measurable on a national level, the relevance of the registered capital is highly questionable. Registered capital does not necessarily reflect the actual paid-in capital in any enterprise. In fact, registered companies could be non-operational. Also, the scale and scope of a firm's operations, as indicated by total assets, total sales, or other measures of activity, are not necessarily related to its registered capital. Two firms could have identical assets and identical sales, and yet one may have borrowed most of its funds (resulting in a small registered capital) and the other may not have borrowed at all (resulting in a large registered capital).

- **Total credit facilities:** There is an emphasis among banks on using the 'Total Credit Facilities' as an indicator to the size of the enterprise. Nevertheless, total credit facilities are not relevant to the size of the enterprise. A small amount of credit does not necessarily imply that the enterprise is small or medium. Conversely, a medium-sized enterprise could borrow a large amount of funds, if it has decided to pursue a high-leverage strategy.

Relevance and measurability of indicators used for defining SMEs can be evaluated as follows:

Relevance and Measurability of Indicators

Indicator	Relevance	Measurability
Number of employees	High	High
Annual turnover	Medium/High	Low
Total assets	Medium/High	Low
Registered capital	Low	High
Total credit facilities	Low	Medium
Qualitative indicators	Medium	Low

Based on this assessment and according to common practices, three indicators are important for an SME definition: The number of employees, annual sales and total assets. Due to lack of relevant statistics in Kuwait on the three main identified indicators, it is difficult to determine the SME-defining thresholds by examining any obvious natural ‘breaks’ between them.

Resort to international experience reveals the use of a variety of definitions depending on country specific objectives. By and large these definitions are based on three main criteria mentioned above. The Gulf region offers the following definitions:

Bahrain: The Ministry of Commerce and Industry (MOCI) considers enterprises with thresholds of 10 employees and investment of up to 20,000 Dinars (USD 53,000) as micro, with up to 50 employees and investment of up to Dinar 150,000 (USD 398,000) as small and with up to 150 employees and investment of up to Dinar 2 million (USD 5.3 million) as medium size[33].

Oman: The Ministry of National Economy (MONE) and the MOCI use different definitions. According to the MONE (MOCI) companies with up to 20 (10) employees are small and companies with up to 100 (50) employees are considered medium size[34].

Saudi Arabia: The Saudi General Investment Authority defines enterprises as small when they have less than 60 employees and as medium size when they have less than 100 employees. The Saudi Industrial Development Fund defines SMEs as enterprises whose annual sales do not exceed Riyals 20 million (USD 5.3 million) for financing purposes according to the Kafallah programme.

[33] However in the labour-intensive textiles and garment sector companies with up to 300 employees are still considered medium size.

[34] Apart from this, the MONE defines micro enterprises as having up to 5 employees.

UAE: An MSME is defined based on headcount and turnover as applicable to the industry group it belong[35]:

SME Definition in the UAE

	Trading		Manufacturing		Services	
	Employment	**Turnover**	**Employment**	**Turnover**	**Employment**	**Turnover**
Micro	≤ 9	≤ $ 2,5 million	≤ 20	≤ $ 2,7 million	≤ 20	≤ $ 0,8 million
Small	≤ 35	≤ $ 13,6 million	≤ 100	≤ $ 27,2 million	≤ 100	≤ $ 6,8 million
Medium	≤ 75	≤ $ 20,4 million	≤ 250	≤ $ 68,1 million	≤ 250	≤ $ 40,8 million

Outside the Gulf the EU definition may be of some relevance as it covers a number of countries. Again the EU takes into account staff headcounts, annual sales and total assets. While it is mandatory to abide by the staff headcounts' threshold, an enterprise qualifies as SME by falling under *either* the sales *and/or* the assets ceilings. This definition ensures that eligible enterprises engaging in different types of economic activities do not lose their status as SMEs. For example, enterprises in the manufacturing industry have lower sales figures than those operating in the trade and distribution industries. However, sales and assets are much easier to obtain in Europe than in the Gulf thanks to the more developed taxation capacities of EU countries.

SME Definition in the EU

	Headcount	Annual turnover	Total Assets
Micro	<10	≤2,8 mln $[36]	≤2,8 mln $
Small	<50	≤13,8 mln $	≤13,8 mln $
Medium	‹250	≤68,8 mln $	≤59,2 mln $

There are some commonalities in the criteria used by GCC countries:

- Staff headcount is the major indicator that is used in all definitions
- SMEs classification criteria are based on a maximum of two indicators, precluding consideration of differences among enterprises in the manufacturing and service sectors
- Little emphasis is given to sectoral based definitions; instead a generic definition is used.

However, GCC countries use smaller cut-off points for defining SMEs in terms of turnover or capital. In regard to employment, the UAE definition for medium size enterprises in the manufacturing and service industry coincides with the EU definition while in the other GCC countries it is much lower. In the UAE small enterprises in the manufacturing and service industry are defined as having more employees (100) than in the EU (50).

[35] The table shows the USD equivalent of Dinar values.
[36] 1 € = 1,376 $ (17.09.2011)