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SYRIAN ARAB REPUBLIC

Selected Issues

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INTRODUCTION AND OVERVIEW

Syria faces two interrelated medium-term challenges posed by the prospective decline in its oil reserves:

- The first challenge is to preserve fiscal sustainability and financial stability: with the budget still relying to the tune of 25 percent of GDP on oil revenues to finance public spending, and with these revenues projected to be halved over the next ten years, current fiscal policies are clearly unsustainable and call for a major fiscal adjustment.
- The second challenge is to boost growth in order to: (i) expand and diversify the production and export base of the economy before oil resources are exhausted, and (ii) absorb a bulge in entrants to the labor force arising from decades of very rapid population growth. With the labor force projected to increase at 4 percent a year,[1] unemployment could exceed 20 percent by the end of the decade.[2] An average employment growth rate of 4½ percent a year would need to be sustained over the next 10 years to reverse this trend—a daunting challenge.

The recently approved five-year plan (FYP) laid down a comprehensive strategy to address these challenges. To address the fiscal challenge, it calls for far-reaching reforms in tax policy and tax administration, public finance management, civil service, price subsidies, and public enterprises. To accelerate growth (to 7 percent by 2010), lower unemployment (to 8 percent by 2010), and reduce poverty, it calls for further progress in improving financial intermediation, enhancing the business environment, and liberalizing external trade. It also calls for unifying the exchange rate and strengthening the monetary policy framework as means to strengthen market mechanisms in the pricing of financial assets and ensure the most efficient allocation of private sector savings.

This background paper aims at contributing to informing the policy debate about some of the reforms laid down in the FYP by refining the diagnosis of the main problems, evaluating the results of previous reform efforts, and fleshing out some of the critical reforms that need to be implemented in the next 1–2 years. Chapters I and II focus on issues relevant to the fiscal sustainability challenge, while the remaining three chapters take up issues related to policies to promote growth.

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[1]This would result from the projected natural growth rate of working age population (3 percent annual average) and a modest education-driven increase in labor force participation rates.

[2]The rate of job creation has declined from 4.8 percent in the 1990s to about 2.9 percent a year since 2000, while unemployment is estimated to have risen from 9½ percent in 2000 to 14 percent in 2004.

Chapter I discusses what might be a suitable fiscal policy framework (FPF) that could help Syria maintain fiscal discipline in the challenging times ahead. It reviews the experience in many countries during the 1970s and the 1980s with high budget deficits and how this has led some countries to adopt transparent FPFs with fiscal rules tailored to addressing specific issues in their fiscal outlook. The chapter explores the ways in which Syria would benefit from adopting a transparent FPF and what would be the most suitable fiscal rule that should underpin this FPF. The chapter argues that Syria's remaining oil reserves are too low to aim for some inter-generational equity in the use of the oil wealth. The aim in managing the remaining oil reserves should be limited to smoothing the adjustment toward a sustainable long-run fiscal position. This could be achieved by targeting at a steady improvement in the non-oil budget deficit. Given the inherent uncertainty about the price of oil, the level of proven reserves, and the path of extraction, the optimal pace of adjustment of the non-oil budget deficit would have to be reassessed regularly.

Chapter II moves on to discuss the fundamental fiscal reforms that need to be implemented within the proposed FPF. It discusses the size of the fiscal adjustment that is required in the next ten years, argues that a pro-growth fiscal consolidation strategy would be one that would rely principally on phasing out petroleum price subsidies (PPS) and introducing a VAT, and discusses each one of these reforms in turn. A strategy for reforming PPS, whose cost is likely to surge to 14½ percent of GDP in 2006, involves two inter-related critical choices as to the speed of price adjustment and the amount and distribution of compensation to households to mitigate the impact of the reform and make it politically feasible. Both should be a function of the prevailing international oil prices, and therefore call for a reform design with maximum flexibility. Mitigating the impact of phasing out PPS by increasing civil service wages would not be advisable as it builds in a rigidity that might turn out to be very costly. Regarding the VAT, the chapter proposes certain design features that would optimize its benefits, including (i) a single rate, with an option to impose excises on luxury items, (ii) a broad coverage, with exemptions limited to hard-to-tax sectors such as financial services, and (iii) an initially high taxable threshold for cost effectiveness.

Chapter III evaluates Syria's seven-year experience with financial reform and draws preliminary considerations/recommendations for furthering financial sector development. The evaluation helped identify four main problems and sources of tensions that have emerged on the road to financial reform: (i) a growing resistance to allowing greater competition for fears that, under increased competition, the inefficiencies of state banks (SBs) might snowball into serious contingent liabilities for the state; (ii) the incompatibility between the objective of raising the efficiency of SBs and that of using them as instruments of public policy; (iii) the absence of progress in moving toward indirect instruments of monetary control, obliging the authorities to maintain controls on banks' deposit rates to set an interest rate benchmark, at the expense of effective competition and higher efficiency; and (iv) the heavy legacy in terms of skills deficit in both risk management and prudential supervision of 40 years of socialist banking. The chapter offers some

recommendations on how to address these problems covering state banks' restructuring/privatization, interest rate liberalization, and supporting measures.

Chapter IV reviews the reforms undertaken to liberalize the trade regime and makes suggestions on further measures to promote trade openness. The review finds that recent reforms have significantly opened Syria's trade regime, which used to be one of the most restrictive in the world. However, the reform agenda to establish a sufficiently solid track record to fulfill the authorities' aim to join the WTO remains challenging. In particular, nontariff barriers are still pervasive, reflecting notably the influence of vested interests. Removing these barriers is a priority to improve resource allocation and lower transaction costs by making trade more open and predictable, and by reducing red tape. The chapter notes that the Association Agreement with the European Union could be instrumental in achieving this goal, but also in establishing a regulatory environment conducive to investment and to facilitating the country's insertion into the global economy.

Finally, Chapter V examines more specifically whether from a supply side standpoint the textile sector could reap the benefits of economic liberalization and be a driving factor for non-oil export growth. Textile activities represent a sizable share of the non-oil economy, even more so if cotton production is included. The sector has been highly subsidized (at least cotton production) and protected and as result has been mostly inward-looking. Yet, the authorities recently removed some of the key protections, such as the ban on import of garments. Will Syria be able to capitalize on this increased competition from abroad to develop into a competitive textile exporter?

I. Which Fiscal Policy Framework Would Suit Syria Best in the Coming Decade?[3]

A. Introduction

1. **Syria's public finances are headed for challenging times in the coming 10-15 years**. Oil revenues, on which the budget relies to the tune of 25 percent of GDP,[4] are expected to decline rapidly over the medium term, creating a budgetary gap of some 12 percent of GDP by 2015. Unless addressed through a forward-looking fiscal policy framework (FPF), this imbalance will seriously disrupt the macroeconomic stability Syria has enjoyed in the recent past.[5]

2. **This chapter proposes an FPF that will help Syria weather the coming challenge and ensure a soft landing.** The chapter starts with a review of the global experience during the 1970s and 1980s. High budget deficits in this period led many countries to adopt transparent FPFs, that is, frameworks where the authorities pre-commit to certain macroeconomic objectives for their fiscal policies, often embodied in a fiscal rule tailored to specific issues in their fiscal outlook (Section B). The chapter then lays the theoretical foundations for a proposed FPF (Section C).

B. Fiscal Policy Frameworks To Address Deficit Bias

3. **Large fiscal deficits have marked the economic history of many developed and developing countries alike during the 1970s and 1980s, with damaging consequences to their economies.** Large deficits contributed to aggregate demand pressures, fueling inflation and putting a strain on the balance of payments. They led to a build up of large public debts, which put pressure on interest rates and/or prices, in countries that chose to monetize public debt. In most cases, they proved harmful to long-term growth as they tended to crowd out private investment through reduced available resources, higher taxes, and higher interest rates, and when they led to forced adjustments, the brunt usually fell on public investment. Finally, large fiscal deficits did not leave room to accommodate unexpected fiscal pressures and constrained the ability of governments to use fiscal spending as a tool for counter-cyclical policies.

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[3] Prepared by Jemma Dridi and Patrick Imam.

[4] Oil revenues valued at international prices.

[5] For a quantification of the magnitude of the problem see chapter II.

4. **The experience with large budget deficits has drawn attention to what has been coined the "*deficit bias,*" that is, an inherent tendency for fiscal policy to generate budget deficits rather than balances** (Alesina and Perotti, 1995). In most cases the bias is caused by pro-cyclical fiscal policy, which in good times leads to an expansion of *discretionary* public spending that then tends to become ossified and results in deficits when revenues decline. The deficit bias is usually supported by various factors, including (i) political economy factors, by which some economic agents and politicians benefit from increased government spending without internalizing their full costs; and (ii) weak fiscal management and the proliferation of quasi-fiscal activities, which limit the government's ability to control public spending. Although in principle, discretion is desirable as it allows the flexibility needed to respond to unforeseen shocks or to cyclical variations in output, the experience referred to above shows that discretion has been misused and has been ineffective (Talvi and Vegh, 2002).

5. **Although financial markets can help keep the deficit bias in check, market discipline has proved mostly inadequate**. Financial market discipline has been weak, as it relies primarily on signals—risk premiums and sovereign credit ratings—that do not always react simultaneously with fiscal developments. Rather, market signals have at times responded with a lag and through discrete jumps to weak fiscal policies and have therefore not always provided advance warning to the need to restore fiscal discipline (IMF, 2005b).

6. **Against this background, a worldwide experience in the last decade has been the elaboration and the adoption of FPFs.** What is novel in this policy initiative is the search for safeguards to address the specific problems created by the deficit bias. The experience showed the usefulness of two types of safeguards: (i) transparency to allow greater scrutiny by the public to increase accountability of policymakers, and (ii) rules to constrain discretion.

- **Fiscal transparency** encompasses broadening the coverage of fiscal reporting to extrabudgetary activities, identifying and possibly quantifying the main fiscal risks arising, for example, from the fall in the price of the country's main exports, thereby reducing the possibility of negative surprise, and adopting a forward-looking approach to budget formulation (multi-year budgets and a better coordination of current and capital expenditure). These elements combined create a more predictable planning environment for line ministries and help identify spending pressures ahead. The accountability of those responsible for fiscal policy is increased through the provision of these benchmarks (Hemming and Kell, 2001).
- **Fiscal rules** define one or more specific macroeconomic objectives of fiscal policy, by providing a clear numerical benchmark for one or more main fiscal aggregates. They pre-commit governments to fiscal discipline, by holding them accountable for the way they use discretion. The adoption of fiscal rules is, in itself, a signal that the government is serious about tackling fiscal profligacy.

7. **Numerous countries have adopted various fiscal rules depending on their fiscal outlook.** Fiscal rules are usually classified as below (see e.g., Koptis and Symansky, 1998).

- **Deficit rules:** these are rules that set a ceiling on the overall deficit. Their main advantage is that they relate to fiscal indicators that can convey important information about the short-term macroeconomic consequences of fiscal policy, and can therefore help address inflation and balance of payment problems. The EU's fiscal framework, the "Stability and Growth Pact (SGP)," which was developed to sustain a cohesive monetary union within the European Union, set a limit of 3 percent of GDP on countries' overall budget deficits, with an understanding that member countries are supposed to maintain fiscal balance over the business cycle. The Western African Economic and Monetary Union (WAEMU) set a limit of 4 percent of GDP on budget deficits excluding grants. The FPFs in Australia, New Zealand, and Switzerland call for a balanced budget over the cycle. In Sweden, the *Spring Fiscal Policy Bill* calls on the government to achieve a budget surplus of 2 percent of GDP over the cycle, both to reduce public debt (which was as high as 70 percent of GDP when the bill was introduced) and to prepare the public finances for population aging.

- **Debt rules**: these rules put a ceiling on net or gross debt. The advantage of such rules is that they target directly the debt sustainability problem. The key issue here is to know what a country's debt tolerance is, which requires an element of judgment. The example of the SGP, setting a debt ceiling of 60 percent, is again the most famous example of a debt rule. The United Kingdom's *"Sustainable Investment Rule,"* which requires the government to keep the level of public debt at a stable and prudent level, currently defined as net public debt at 40 percent of GDP, is another example. Some countries, with a high debt burden, have adopted fiscal rules which commit the government to achieve a reduction in the debt stock to a certain level by a certain horizon. An example is Jordan, where the aim of fiscal policy over the medium term is to reduce the debt-to-GDP ratio to 60 percent by 2010, and Tunisia where the aim is to reduce it to 45 percent by 2011.

- **Borrowing rules**: these rules include not allowing (or limiting) government borrowing from domestic sources or from the central bank, so as to keep in check the debt monetization problem. In practice, however, it is questionable how sustainable this rule is, as countries that accumulate unsustainable debts are bound to monetize them sooner or later (the so-called "fiscal dominance or unpleasant monetarist arithmetic"). The most famous such rule is the SGP rule by which the governments of countries having adopted the Euro as their national currency are not allowed to borrow from the European Central Bank. The WAEMU set a 10 percent of the previous year's revenues as a limit on access to central bank financing. The United Kingdom's *Golden Rule is another type of borrowing rule.* It requires the current budget to be in balance over the cycle*,* which in turn, requires the government to borrow only to invest.

- **Expenditure rules**: these rules set a ceiling on overall spending or on some spending components. They are effective in promoting fiscal discipline since they attack the problem at its source, as politically induced deficit bias typically results from expenditure pressures. Sweden is a country that has implemented this rule, as the expansion of government spending to 65 percent of GDP has come to be seen as unsustainable.

8. **In some countries FPFs have been enshrined in Fiscal Responsibility Laws (FRLs)**.[6] These are institutional devises that aim to consolidate a government's commitment to fiscal discipline by *attaching legal force* to fiscal policy objectives, and making those responsible for fiscal policy more accountable to the legislature and to the public (Hemming and Kell, 2001). This is achieved through pre-commitment to a monitorable fiscal target, and penalties in case of failure to adhere to it, which could be either reputational or in the form of automatic triggers to cut expenditure. FRLs combine procedural rules—which specify transparency and accountability requirements—and numerical rules—which specify quantitative fiscal targets—with varying degree of relative emphasis. New Zealand was the first country to introduce an FRL by adopting a *Fiscal Responsibility Act* in 1994. Australia and the United Kingdom followed suit shortly after by adopting a *Charter for Budget Honesty* (Australia) and a *Code of Fiscal Stability* (the United Kingdom). More recently FRLs have been implemented in several Latin American and European countries.

9. **However, FRLs are not a panacea, and can, at times, be harmful by not allowing discretion, when discretion is needed.** Fiscal rules can create problems including the use of creative accounting to artificially meet numerical targets (e.g., classify current expenditure as capital expenditure), or adherence to the letter of the fiscal rules rather than to the spirit of the rules, which might ultimately harm the economy, such as the fire sale of state assets to meet deficit targets. When they are fully observed, they may prevent a country facing unexpected shocks from using discretionary spending to mitigate the impact of the shock, or when they are breached to face such contingencies, this may backfire by eliciting a negative market reaction (see, for example, Milesi-Ferretti, 2000).

[6] Named after the legal framework introduced in New Zealand in 1994.

C. A Suitable Fiscal Policy Framework for Syria

10. **Syria will benefit doubly from adopting a transparent FPF.** As in other countries, political economy factors as well as weak fiscal management create risks for a deficit bias and hence an FPF would help guard against this risk and maintain fiscal discipline. In addition, Syria is expected to face a severe deterioration in its fiscal outlook over the medium term.[7] The challenge of maintaining fiscal discipline is more daunting, and hence the added benefit from adopting an FPF.

11. **A suitable FPF for Syria entails appropriate fiscal transparency and accountability provisions, and a fiscal rule**. In the context of the ongoing review of the basic finance law, amendments should be introduced that would enshrine the fundamental principles of fiscal transparency (including a clear definition of roles of public bodies and the timely provision of fiscal data), accountability (such as independent external audit reporting to the legislature on budget execution), stability (which would call for casting budget objectives and targets in a medium-term framework), and performance (which would call for recent outcomes of budget programs to be reported in budgetary documents).

12. **Choosing an appropriate fiscal rule boils down to deciding on an optimal macroeconomic objective of fiscal policy.** The ultimate macroeconomic objective of fiscal policy is always, ultimately, fiscal sustainability; i.e., a situation where the fiscal stance is consistent with the government's intertemporal budget constraint, or equivalently if the expected net present value (NPV) of government revenues is equal to the expected NPV of government spending (see Blanchard and others., 1990).

13. **Endowment in a non-renewable natural resource (say oil) poses a specific challenge for fiscal sustainability as well as an issue of inter-generational equity.** The main issue for fiscal sustainability arises from the fact that the stream of income from selling the natural resource is bound to stop when the resources is exhausted.[8] The issue of inter-generational equity relates to the distribution across generations of the income from the resource wealth. The fundamental question, therefore, is whether oil revenues should be consumed as long as they last and fiscal policy adjusted accordingly when they dry up, or should consumption by today's generations from the income from the resource wealth be caped such that the stock of wealth remains constant (in absolute terms or in per capita) and can be passed on to future generations? Maintaining the stock of oil wealth constant in per capita terms requires that the per capita consumption out of the income from the oil wealth is equal to the annuity (adjusted for population growth) on the NPV of the oil wealth.

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[7] See Chapter II for a quantification of the expected loss in oil-related revenues to the government.

[8] We assume the case where the country does not have market power.

14. **It is too late to address intergenerational equity considerations in Syria.** Managing the remaining oil wealth with the aim of keeping it constant such that it could be passed on to future generations would call for a large adjustment that is neither politically feasible nor socially desirable. Indeed, the net present discounted value of Syria's oil wealth is estimated at about US$90 billion, i.e., 325 percent of GDP. To ensure equal benefit to all generations indefinitely, the level of consumption out of this wealth should be limited to US$70 per person per year.[9] At the moment consumption out of the oil wealth is about US$370 per person. Hence to ensure inter-generational equity, today's generation has to take a cut of over 80 percent of the benefit it is enjoying. This would call for an upfront fiscal adjustment of close to 20 percent of GDP. Forgoing the right of future generations to the remaining oil wealth seems unavoidable.

15. **A optimal management of the remaining wealth should therefore aim at smoothing the adjustment toward a sustainable long-run fiscal position.** We examine this question with a simple theoretical model. The model starts by asking the question: How should "the social planner's" problem be formulated in this case? It seems reasonable to approximate the cost of adjustment by the change year-on-year of the non-oil budget balance, as this, in turn, is a good proxy of the contractionary impact on the economy of the adjustment in any particular year. If we let nob_t be the non-oil balance at time t, r_t oil revenue at time t, and $d_t = dnob_t$ the fiscal adjustment at time t, then if oil revenues in the future are known with certainty, the social planner problem would be to:

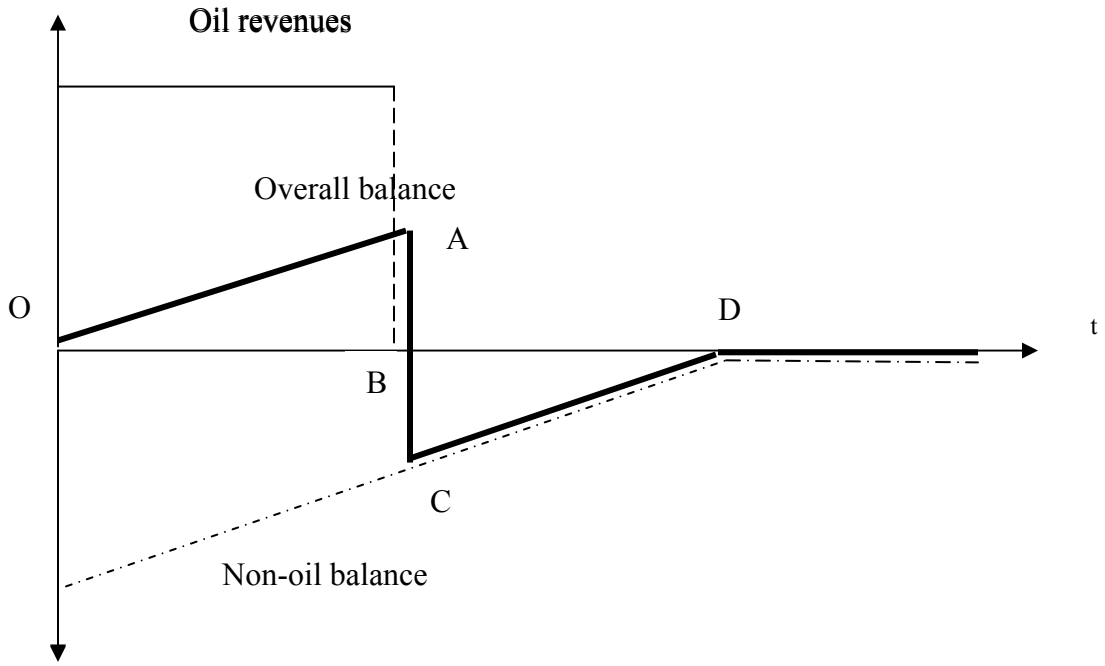
$$\min \int_0^\infty e^{-\rho t} \; d_t^2 dt$$

subject

$$\int_0^\infty e^{-\rho t} r_t dt = \int_0^\infty e^{-\rho t} nob_t dt$$

16. **The solution to this problem can be illustrated in the simple case where oil revenues are expected to remain flat over a certain horizon and drop to zero thereafter**. Heuristically, the solution is that unique slope for the non-oil budget balance, such that the area of triangle OAB is equal to the area of triangle BCD, an area which represents the amount of savings that has to be done while the stream of oil revenues is still positive and the amount of dissavings to smooth the adjustment until the economy reaches point D.

[9] Assuming a real rate of return of 4 percent and the on-going population growth rate of 2.5 percent.



17. **Under uncertainty about the future path of oil revenues the social planner's problem becomes an optimal control problem that has to be solved anew each year.** Decision on the pace of adjustment of the non-oil budget balance would have to be made each year, incorporating new information on the expected net present value (NPV) of the oil wealth. Upward revision of the NPV of the oil wealth would call for a relaxation of the pace of adjustment and vice versa. Realization of a particular outcome for quantity and price of oil each year would determine the overall balance in that year, but would not affect the decision that would have already been made on the adjustment of the non-oil balance during that year, lending greater predictability and stability to expenditure and tax policies.

18. **The above analysis points to the benefits of managing Syria's remaining oil reserves by targeting a steady improvement in the non-oil budget balance.** Such rule would stem time-inconsistent and short-sighted policies.[10] It would also insulate the domestic economy from the volatility of oil revenues. Given the inherent uncertainty about the price of oil, the level of proven reserves, and the path of extraction, the optimal *pace of adjustment* of the non-oil budget deficit would have to be reassessed on an annual basis in light of updated information on the NPV of the oil wealth. Considerations about the cyclical position of the economy and overall macroeconomic conditions have to be factored-in in determining the desired adjustment for any particular year.

[10] The annex compares the performance under the proposed fiscal rule to that of the traditional balanced budget rule, which some politicians might think would be appropriate.

Appendix I. A Balanced Budget Rule Versus A Steady Improvement in the Non-oil Budget Balance

19. This appendix explores through numerical examples how performance under the proposed fiscal rule compares with the performance under the traditional balanced budget rule, which some politicians might think would be appropriate. The appendix shows that while both would deliver the same performance if oil revenues were to decline smoothly, the proposed fiscal rule is a superior policy rule if oil revenues were to level off before declining. Given the inherent uncertainty about the prospective path of oil revenues, the rule to target a steady improvement in the non-oil budget balance would be better in all cases.

A. The Case of a Gradual Decline in Oil Revenue

20. Assume that oil revenues, which in year 1 are equivalent to 18 percent of GDP, were to decline by 2 percentage points each year until oil is depleted 10 years later:

- If the government pursues a budget balance rule, it would run a non-oil budget deficit equal to 18 percent of GDP in the first year. In the second, the non-oil budget deficit would have to be adjusted by 2 percentage points of GDP in order to maintain budget balance. In year 3, another adjustment of 2 percentage points of GDP of the non-oil budget balance would be needed to maintain budget balance. This goes on until the economy has run out of oil. By that time the non-oil budget deficit would have shrunk to zero and a balanced budget could be maintained for ever.

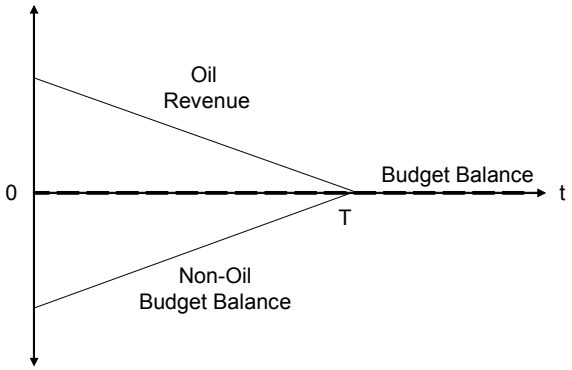
- If instead, the government sets the objective of 2 percentage points of GDP adjustment per year in the non-oil budget deficit, such policy would also help achieve a balanced budget on a continuous basis.

Scenario Where Oil Runs Out Gradually
(In percent of GDP)

Year	1	2	3	4	5	6	7	8	9	10
Oil revenue	18	16	14	12	10	8	6	4	2	0
Non-oil balanced budget	-18	-16	-14	-12	-10	-8	-6	-4	-2	0
Budget balance	0	0	0	0	0	0	0	0	0	0

21. **Thus, in the case of gradually declining oil revenues, both fiscal rules would deliver similar outcomes**. A balanced budget rule would force a steady improvement in the non-oil budget balance, and conversely, a steady adjustment in the non-oil budget balance would deliver the necessary adjustment to the declining oil revenues and ensure an overall budget balance.

The Case of Oil Revenues Declining Gradually



B. The Case of Oil Revenues Leveling-Off Before Declining

22. **We illustrate the differences between the two fiscal rules again through a numerical example.** Assume that oil revenues are at 18 percent of GDP per year, for the first five years, and then drop to zero:

- If the government pursues a balanced budget rule, then the government could keep running non-oil deficits equal to 18 percent of GDP every year for five years. In year 6, when oil revenues drop to zero, the government would have to cut the non-oil deficit from 18 percent of GDP to zero in order to maintain a budget balance. Such a sharp adjustment would of course be extremely hard to achieve and is not advisable as it would send the economy into a very deep recession in the short run and would hurt its long-term growth prospects.

Balanced Budget Rule for a Scenario Where Oil Revenue Remains Constant, and Falls Abruptly
(In percent of GDP)

Year	1	2	3	4	5	6	7	8	9	10
Oil Revenue	18	18	18	18	18	0	0	0	0	0
Non-Oil Budget Balance	-18	-18	-18	-18	-18	0	0	0	0	0
Budget Balance	0	0	0	0	0	0	0	0	0	0

- If instead, the government decides to achieve a steady improvement of 2 percent of GDP in the non-oil budget deficit, then in the second year, the government would run a budget surplus of 2 percentage points of GDP, and accumulate assets equivalent to 2 percent of GDP that are saved. The following year, the government generates a budget surplus of 4 percentage points of GDP, and net assets increase to 6 percentage points of GDP. By the end of the 5 years when oil runs out, the government would have accumulated assets amounting to 20 percentage points of GDP. In year 6, the government continues to adjust the non-oil budget deficit by the same 2 percentage points of GDP. Given that the oil revenue is now zero, this would generate a budget

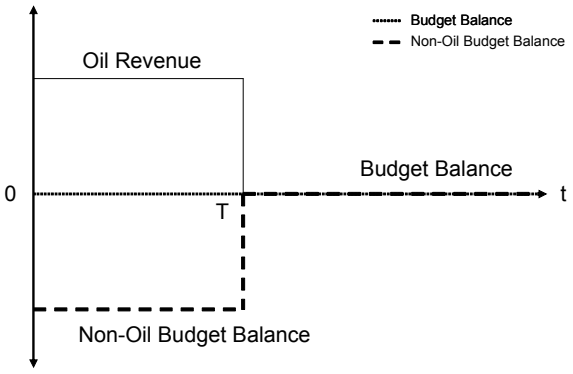
deficit of 8 percent of GDP, which can be financed by running down the net assets accumulated over the previous five years. Targeting a steady improvement in the non-oil budget balance will ensure that part of the oil revenue, while it lasts, is saved and used as a buffer to smooth the adjustment. The adjustment continues until year 10, when the non-oil budget balance will be in equilibrium, and the cumulative savings will have been used.

Gradual Improvement in Non-Oil Balance for a Scenario Where Oil Revenue Remains Constant and Falls Abruptly
(In percent of GDP)

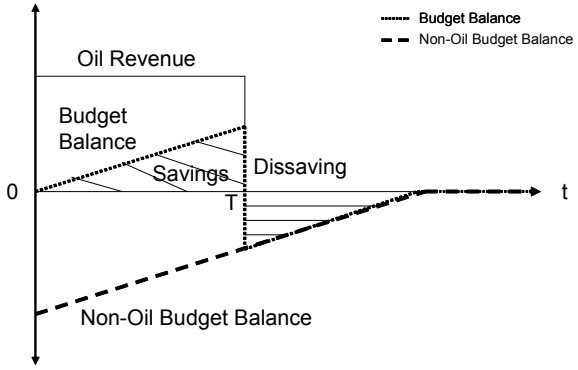
Year	1	2	3	4	5	6	7	8	9	10
Oil revenue	18	18	18	18	18	0	0	0	0	0
Non-oil budget balance	-18	-16	-14	-12	-10	-8	-6	-4	-2	0
Budget balance	0	2	4	6	8	-8	-6	-4	-2	0
Cumulative savings	0	2	6	12	20	12	6	2	0	0

The Case of Oil Revenues Leveling-off Before Declining

Balanced budget rule



Steady improvement in the non-oil balance



23. **Thus, in the case where oil revenues level-off for a while before declining abruptly, a fiscal rule that aims at a steady improvement in the non-oil budget balance delivers a superior fiscal outcome.** Given the inherent uncertainty about the expected profile of extraction and international oil prices, a steady improvement in the non-oil budget balance as the objective of the fiscal framework would stem time-inconsistent and short-sighted policies. It will reduce the risk of painful abrupt adjustment, whose brunt will likely fall on much needed public investment in infrastructure, social spending on education and health, or would call for raising revenues through highly distortionary taxes, given the weak capacity in tax administration. The measures that can support good pro-growth fiscal adjustment—such as public enterprise restructuring, pension reform, civil service reform, introducing a VAT—as all measures that take time to implement and to yield fiscal savings. This is why a gradual fiscal adjustment to be promoted by a fiscal rule that would call for a steady improvement in the non-oil budget balance would be much more desirable.

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II. A Reform Agenda for Fiscal Consolidation [11]

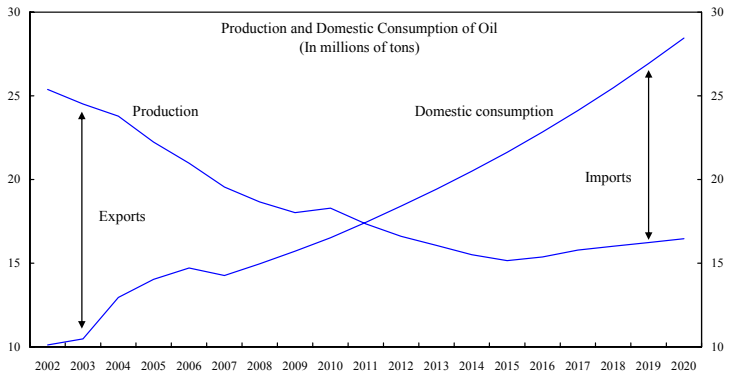
A. Introduction

24. **In the years ahead, Syria is expected to face formidable fiscal challenges**. With oil production projected to decline in the coming years, fiscal management will be placed under a severe test to find the most effective response. To meet this challenge successfully, fiscal adjustment that began in 2003 must continue steadfastly into the medium term. The recently adopted five-year plan (FYP) (2006–2010) reflects a deep awareness of the challenge ahead and the authorities are determined to find the best policy options to confront it.

25. **The purpose of this chapter is to contribute to informing the policy debate about the problem and look at how policy will need to adjust to deal with it**. It contains four sections. Following this brief introduction, the next section discusses the size of the fiscal adjustment that would be required over the next ten years and the two preferred measures for achieving it. In turn, each measure is discussed in some detail in Section C, which presents the case for reforming the petroleum price subsidies (PPS), and in Section D, which deals with the design for a broad-based VAT. These measures will need to be supported by a broader reform in complementary fiscal areas, including a tax reform to simplify the tax system and broaden its base; a strengthening of the tax administration in general and for supporting the VAT implementation in particular; an expenditure policy reform to rein in inefficient spending programs so as to create space for more productive expenditure; and, last but not least, an improvement in public financial and expenditure management to provide effective support for the expenditure rationalization.

B. How Much Fiscal Adjustment is Needed and How Should It Be Achieved?

26. **Syria is expected to become a net importer of oil by the end of the decade.** Domestic oil production, which has fallen by over 20 percent in the last five years to slightly above 20 million tons in 2005, is projected to decline further in the coming years, before flattening out at about 15 million tons per year by the middle of next decade. At the same time, domestic oil consumption has increased steadily by some 40 percent to about 15 million tons in the last five years, and is projected to rise in the

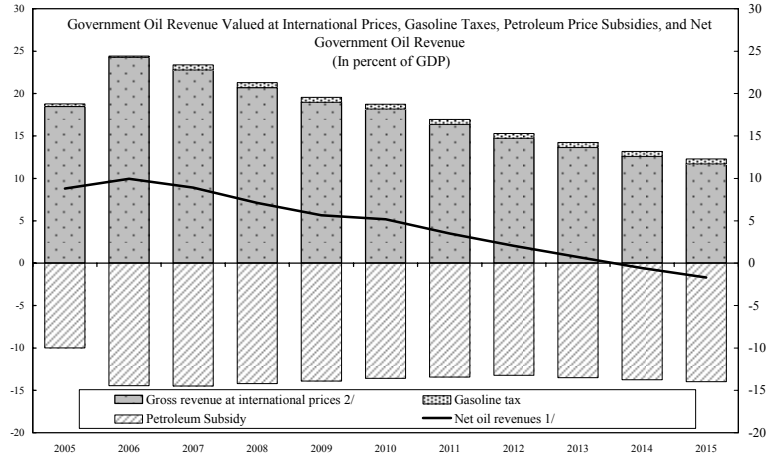


Sources: Syrian authorities; and IMF staff projections.

[11] Prepared by Dale Chua and Rakia Moalla-Fetini.

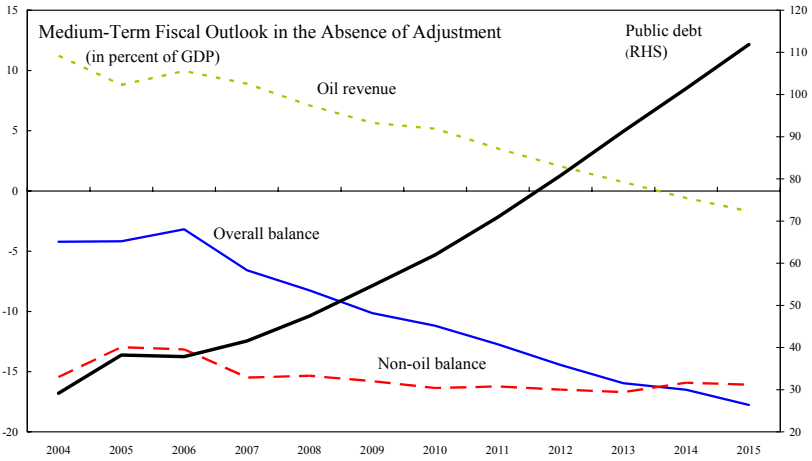
coming years to over 20 million tons by the middle of next decade at an average annual rate of about 5½ percent. If these projected trends come to pass, Syria will, by the end of this decade, turn from being a net oil exporter to a net oil importer, and thereafter, its dependence on imported oil is projected to grow increasingly larger.

27. **These projected trends will have a significant adverse impact on net oil proceeds to the budget over the medium term.** First, as a direct consequence of the projected decline in production, the oil rent to the budget will fall over time, yielding lower return to the government as owner of the dwindling oil reserves. The value of oil production net of production costs and valued at international prices is projected to fall from about 25 percent of GDP in 2006 to less than 12 percent in 2015. Second, and if domestic prices of subsidized petroleum products are kept constant in real terms, the fiscal cost of PPS will level off at about 14½ percent of GDP, assuming no further increases in the relative price of oil and a domestic oil consumption growing in line with the overall growth of the economy. Both trends will result in a drop in net government revenues in excess of 10 percent of GDP, casting a pall over fiscal sustainability in the absence of policy adjustment.

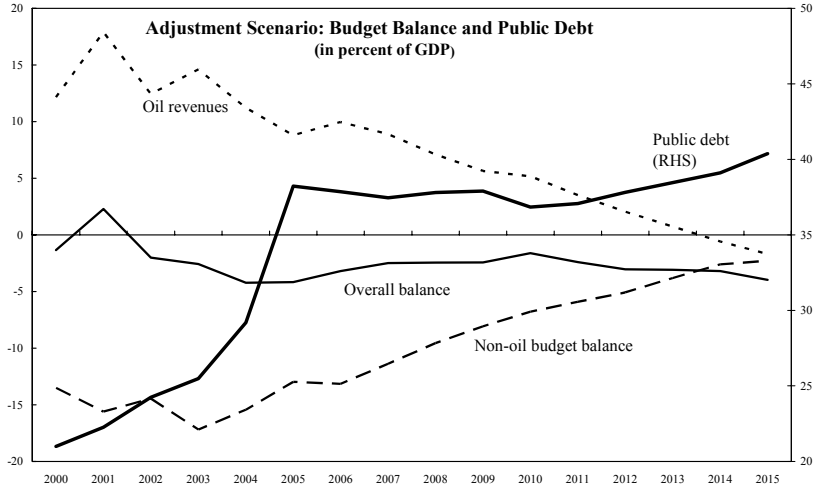


Sources: Syrian authorities; and IMF staff projections.

1/ Defined as oil production valued at international prices plus taxes on gasoline minus petroleum price subsidies.
2/ Net of production costs.



28. **An adjustment in the nonoil budget deficit of some 11 percentage points of GDP is consistent with delivering a stable macroeconomic environment with a prudent debt dynamic in the next decade.** A policy that targets an improvement in the nonoil budget balance on average of about 1 percentage point of GDP per year in the next ten years should be pursued. This will yield a strengthening in the nonoil deficit from 13 percent of GDP in 2006 to about 2 percent of GDP by 2015. Consistent with this level of nonoil deficit is an overall budget deficit averaging 2.8 percent of GDP per year, well below the stated objective in the FYP (5 percent of GDP). Such a strategy will contain the rise in public debt to about 40 percent of GDP by 2015, leaving room to accommodate the possibly large cost of bank restructuring and other contingent liabilities (Table 1).



29. **The authorities are strongly encouraged to make the reform of the petroleum price subsidies (PPS) and the introduction of the VAT the main pillars to help bring about the required fiscal adjustment**. These measures are highly appropriate for Syria and can provide considerable benefits to the economy beyond the main task of strengthening the budget position. In the fiscal adjustment scenario presented in Table 1, and will be explained in detail in the following two sections, Syria could get through the fall in oil revenue by: (i) gradually adjusting the price of diesel to international levels starting in 2007 and completing it by 2010, and (ii) introducing the VAT at a rate of 5 percent in 2008, increasing it gradually to 15 percent by 2012. The low rate at which the VAT could be brought in initially would facilitate its introduction and encourage greater compliance.

Table 1. Syrian Arab Republic: Medium-Term Fiscal Outlook, 2005–15 1/
(In percent of GDP)

	Est.	Projections									
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Revenue	**26.5**	**27.5**	**30.5**	**30.9**	**31.5**	**32.7**	**31.8**	**31.3**	**31.4**	**30.3**	**29.6**
Oil-related proceeds	8.8	10.0	8.9	7.1	5.6	5.2	3.5	2.0	0.7	-0.6	-1.7
Non-oil tax revenue	10.4	10.4	10.7	11.2	11.3	11.3	11.5	11.6	11.6	11.7	11.8
Income and profits	3.6	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2	4.2	4.2
International trade	1.8	1.7	1.6	1.5	1.5	1.4	1.4	1.4	1.3	1.3	1.2
Other	5.1	5.1	5.3	5.7	5.8	5.9	6.0	6.1	6.2	6.2	6.3
Non-oil non-tax revenue	7.2	7.1	6.8	7.0	7.1	7.2	7.3	7.4	7.5	7.6	7.7
Impact of the VAT 1/			0.0	0.6	1.5	2.4	2.9	3.8	4.9	4.9	4.9
Impact of phasing petroleum price subsidies 3/			4.1	5.0	5.9	6.6	6.5	6.5	6.6	6.7	6.8
Gross yield			7.1	8.7	10.1	11.4	11.3	11.2	11.4	11.6	11.8
Minus cash compensation 4/			3.0	3.7	4.3	4.8	4.8	4.7	4.8	4.9	5.0
Expenditure	**30.7**	**30.7**	**33.0**	**33.4**	**33.9**	**34.3**	**34.2**	**34.4**	**34.5**	**33.5**	**33.5**
Current expenditure 2/	18.8	18.9	19.5	19.9	20.0	20.1	20.2	20.2	20.3	20.3	20.3
Development expenditure 2/	11.8	11.8	12.6	12.9	13.0	13.2	13.2	13.2	13.2	13.2	13.2
Expenditure measures (desirable programs)			0.9	0.6	0.9	1.0	0.8	1.0	1.0	0.0	0.0
Overall balance	**-4.2**	**-3.2**	**-2.5**	**-2.5**	**-2.4**	**-1.6**	**-2.4**	**-3.0**	**-3.1**	**-3.2**	**-4.0**
Non-oil balance	**-13.0**	**-13.1**	**-11.4**	**-9.6**	**-8.1**	**-6.8**	**-5.9**	**-5.1**	**-3.8**	**-2.6**	**-2.3**
Identified financing	4.3	3.2	2.5	2.5	2.4	1.6	2.4	3.0	3.1	3.2	4.0
External	-0.6	-0.1	1.5	1.5	1.5	1.0	1.4	1.8	1.9	1.9	2.4
Domestic bank financing	4.3	2.9	0.7	0.7	0.7	0.5	0.7	0.9	0.9	1.0	1.2
Investment certificates	0.6	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.4
Unidentified financing	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Government debt 2/	**38.2**	**37.9**	**37.5**	**37.8**	**37.9**	**36.8**	**37.1**	**37.8**	**38.5**	**39.1**	**40.4**
Domestic	13.2	15.2	14.0	13.8	13.5	12.9	12.9	13.3	13.5	13.8	14.5
External 2/	25.0	22.6	23.5	24.0	24.3	24.0	24.1	24.6	24.9	25.3	25.9
Nominal GDP (in billions of Syrian pounds)	1424	1566	1838	2004	2199	2436	2675	2946	3254	3598	3988

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Assume the VAT is introduced at the rate of 5 percent in 2008, then raised in steps to 15 percent from 2014 on.

2/ Takes into account the impact of the increase in diesel prices on government purchases.

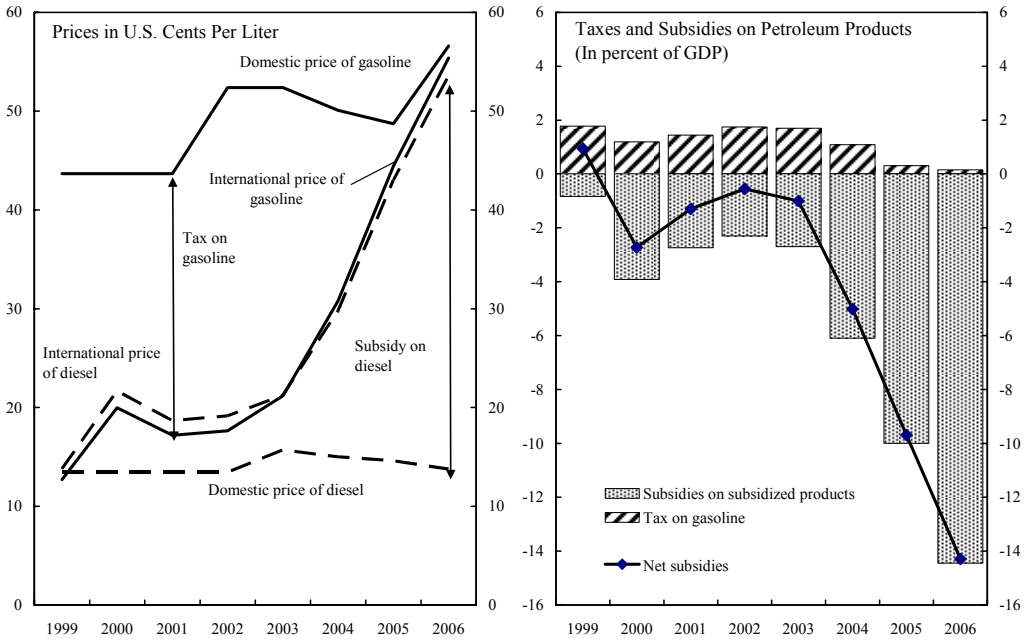
3/ Assumes diesel prices are adjusted in 2007 to close 60 percent of the gap with respect to international prices. The remaining adjustment is spread over the following three years. The remaining implicit subsidy beyond 2010 reflect subsidies on fuel oil.

4/ Assumes that each year 42 percent of gross yield to the government is returned to households.

30. **That said, it is also important that a broader reform is launched in tandem in supporting fiscal areas**. Thus, to complement the introduction of the VAT, a comprehensive tax reform should be undertaken as well to simplify the tax system, starting with a focus on revamping the personal and corporate income taxation, which is overly complex and lacks revenue buoyancy. This effort should be aided with a strengthening of tax administration so as to modernize its operations, develop self assessment, and introduce a large taxpayer unit—all of which should be parts of a restructuring process to help make the tax system easy to comply with. On the expenditure side, policy should be directed toward increasing spending on pro-growth programs in education, health, and infrastructure and curbing transfers to loss making public enterprises and reducing general subsidies. To help plan and carefully monitor these programs, an overall strengthening in the public expenditure management will be required, starting with unifying the recurrent and capital expenditure budgets and improving the budget accounting and reporting systems. While clearly important for the overall fiscal policy management, these topics are not further pursued in this paper. In what follows, we return to discussing the benefits and the design of the two main pillars for reform, starting with the PPS reform.

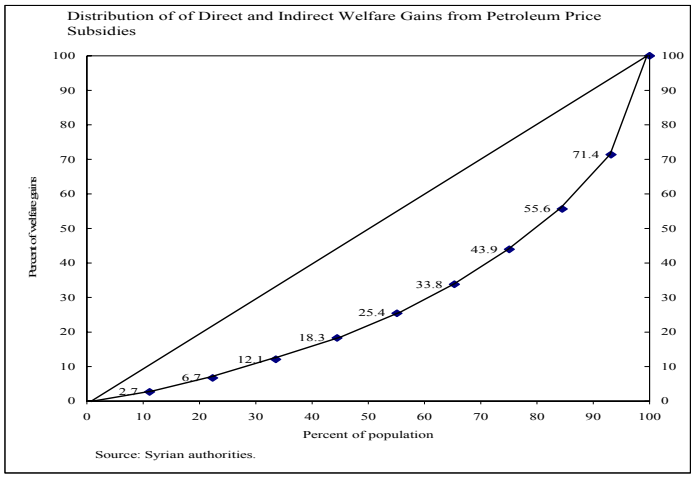
C. Reforming Petroleum Price Subsidies

31. **The fiscal cost of petroleum subsidies has risen sharply since 1999.** Prior to 1999, high taxes on gasoline were used to cross subsidize the consumption of other petroleum products, avoiding positive net subsidies. However, the trend increase in international oil prices, since 1999, coupled with the lack of pass-through, eroded the tax on gasoline and increased the cost of subsidies turning net taxes into net subsidies. It is projected that by 2006, net subsidies on petroleum products could swell to 14½ percent of GDP.



Source: Syrian authorities

32. **In addition to their fiscal costs and large deadweight losses, energy subsidies in Syria are very inequitable**. The World Bank estimates that the richest population decile benefits 25 times more than the poorest decile, while the poorest half of the population captures less than 20 percent of total benefits.



33. **Thus, the policy commitment to phase out PPS is particularly well judged and timely.** In addition to yielding large fiscal savings, this high quality measure will create significant efficiency gains in consumption and production, as price distortion is reduced and eventually eliminated over time, and will address the large inequity in the current policy. Moreover, by slowing the growth of domestic oil consumption, higher prices will dampen net imports of petroleum products which will help contribute to the balance of payments adjustment. Lastly, by protecting spending in critical areas such as education, health, and infrastructure, this policy will contribute to promoting long-term growth.

34. **A strategy for reforming PPS involves two interrelated critical choices**: (i) the speed at which domestic prices are adjusted towards international levels; and (ii) the amount and distribution of compensation to households to mitigate the impact on their consumption and to make the reform politically feasible. The main trade-offs have to do with: (i) the risk of destabilizing inflation expectations associated with a sharp increase in petroleum prices versus adjustment fatigue from a drawn-out process, and (ii) less fiscal savings versus more political palatability.

35. **A proposal currently under consideration by the authorities seems to strike the right balance among the main trade-offs.** It calls for:

- focusing the reform initially on adjusting the price of diesel, as the subsidy on diesel accounts for the bulk of PPS;

- closing 60 percent of the gap between domestic and international price of diesel upfront and phasing out the remaining adjustment by 2010. The risk of destabilizing inflation expectation appears manageable as most of the increase in the CPI would reflect mainly the increase in the price of diesel itself, and other first round impact on the prices of public transportation—which is government controlled—and the price of agricultural products—a sector quite competitive.

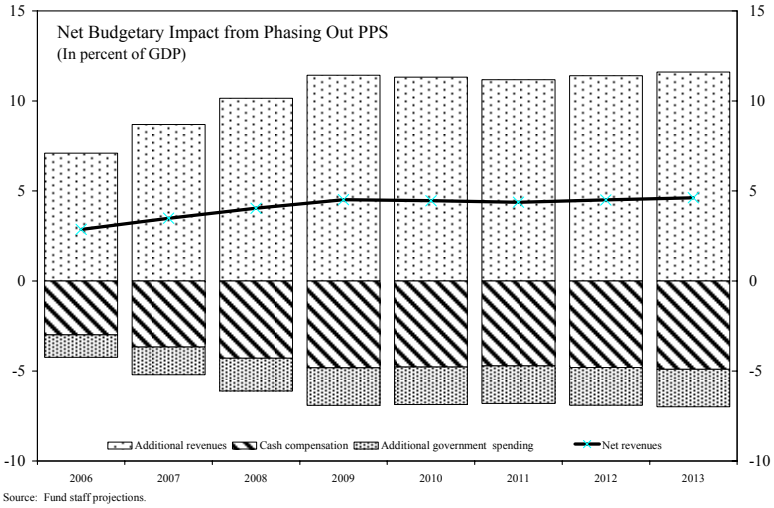
Impact on the CPI of Adjusting Diesel Prices

	Raising Diesel Prices by:		
	100%	230% 1/	385% 2/
Overall CPI	4.2	9.6	16.0
of which due:			
First round effects	2.7	6.1	10.2
of which: diesel itself	1.9	4.3	7.1
Second round effects	1.6	3.5	5.8

Source: "Considerations for reforming energy price subsidies in Syria," Draft Policy Note, World Bank, 2006.
1/ Raising prices by 230 percent would close 60 percent of the gap with internati
2/ Adjusting diesel prices to international levels would imply an increase of 385 percent.

- in the absence of mechanisms to target the poor, return to all households in the form of a flat per person cash compensation a certain share of the gross fiscal gain from the price adjustment. According to a World Bank study, returning 42 percent of the gross savings would make 50 percent of the population better off.[12]

36. **Under this proposal, the net gain to the budget is estimated at 4½ percent of GDP per year by 2010 when domestic diesel subsidies are completely withdrawn.** Gross budgetary saving is projected at about 6½ percent of GDP, comprising additional gross revenue of 11.3 percent of GDP minus a 4.8 percent of GDP cost of the envisaged cash compensation. However, higher diesel prices will increase government spending on goods and services and on developmental expenditure estimated at 2 percent of GDP per year when the diesel subsidies are fully withdrawn.



Source: Fund staff projections.

[12] The existing coupon system to provide subsidies for sugar and rice to the entire population could be piggy backed on to implement this scheme.

37. **The above proposed calibration of the PPS reform is a function of the prevailing international oil prices**. In a lower international oil price environment:

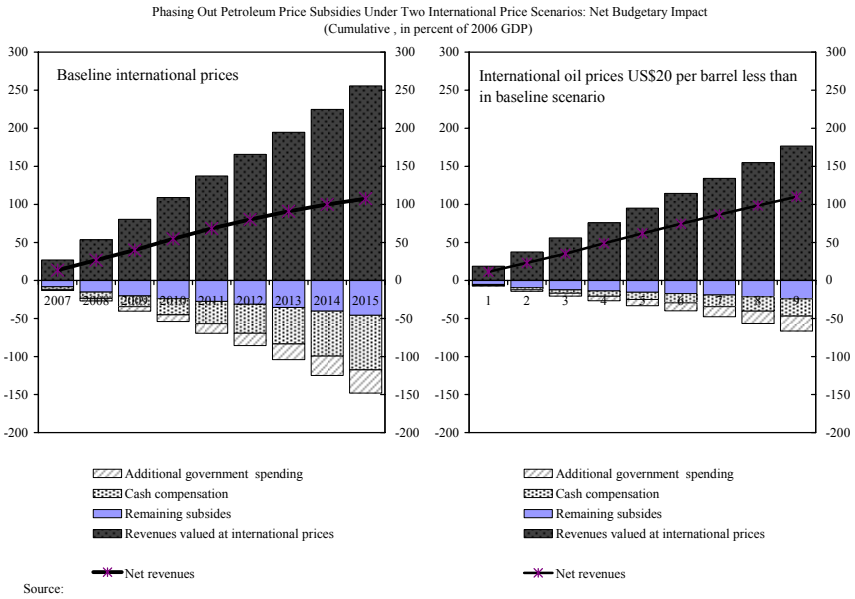
- a more front-loaded adjustment would probably strike a better balance between minimizing the risk of destabilizing inflation expectation and that of adjustment fatigue; and
- the share of the gross savings that should be returned to households to strike the right balance between maximizing the fiscal savings and enhancing the political feasibility of the reform should be lower, for the reasons explained in Box 1. But in this case, the policy of providing a flat cash compensation per person would be less redistributive, and would make it more pressing to develop appropriate targeting mechanisms.

38. Mitigating the impact of phasing out PPS by increasing civil service wages, another option under consideration, would not be advisable for the following reasons. First, the policy eases the impact of the reform on public sector employees only, but does nothing to alleviate the burden on other deserving, if not more deserving, segments of society. Second, because it does not provide compensation to a much wider spectrum of the population, the risks that it will lead to social unrest is much higher. Third, as argued above, the design of the compensation scheme should allow flexibility, such that the level could be adjusted in line with changes in international oil prices. An increase in salary is irreversible and therefore will build a rigidity that might turn out to be very costly. Last but not least, the problem of low wages in the public sector has to be addressed by a well thought out and comprehensive civil service reform where an increase in salary is part of a larger strategy for a better-paid but leaner and more competent administration.

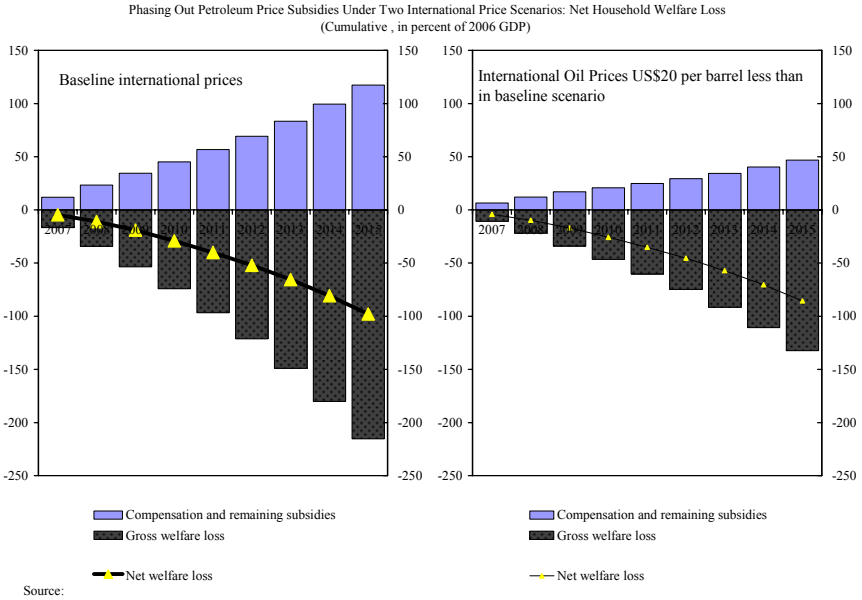
Box 1. Level of International Oil Prices and Size of the Cash Compensation

The lower the level of international prices, the lower should be the size of the cash compensation to households. This proposition makes sense from the perspective of fiscal sustainability and from the perspective of the welfare loss of consumers:

- From the perspective of fiscal sustainability, to achieve the same level of net revenues from the oil sector to finance the same level of government spending under unchanged tax policy, the level of cash compensation that can be returned to households has to be lower, because the oil rent is lower with lower prices. The simulation shown in the graph to the right shows that to achieve the same net revenues from oil if prices were on average US$20 per barrel less than under the baseline scenario, **the cash compensation should be calibrated to equal 21 percent of gross savings only as opposed to 42 percent in the baseline scenario.**



- Lower international prices means that domestic prices would have to be adjusted less than otherwise, which, from the perspective of consumers, means that the loss of consumer surplus would be less. Therefore, a lower cash compensation would be enough to contain the loss of consumer surplus at the same level relative to the baseline. Actually, reflecting the fact that lower prices make the country better off once the country is a net-oil importer, a cash compensation of 21 percent of GDP which achieves the same fiscal objective leads to a smaller welfare loss for consumers than under the baseline scenario (a cumulative loss of 86 percent of 2006 GDP as opposed to 97 percent in the base case).



39. **In general, improved targeting will lead to greater net savings for the budget than currently envisaged.** The flat cash compensation for every household is a blunt instrument that should not be seen as a viable long-term substitute for a proper mechanism to target the poor. Thus, to promote targeting and ensure that scarce budgetary resources are delivered to those most in need, building up a data base of the working poor and a delivery network of social assistance are important efforts that should be pursued expeditiously.

D. Introducing a Broad-Based VAT

40. **In addition to the PPS reform, Syria needs judiciously designed taxes to compensate for declining oil revenue.** With a tax-to-GDP ratio equal to 10½ percent of GDP in 2005 and relatively low compared to countries in the region, increasing tax revenue would probably not lead to undue burden on the economy or severely distort incentives for work, savings, and investment. Of course, this would depend on the choice of the tax, including its design and implementation.

Tax revenue in Syria and selected countries in the region (percent of GDP)

	Syria 2005 (Est.)	Eygpt 2003/04	Jordan 2004	Lebanon 2004	Morocco 2004	Tunisia 2003	Turkey 2004	Average (Excluding Syria)
Tax revenue	**10.4**	**13.7**	**15.8**	**15.7**	**22.4**	**20.6**	**21.0**	**18.2**
Income, profits, & capital gains	3.6	5.7	2.8	2.8	8.2	6.7	7.2	5.6
Goods and services	1.9	5.4	9.3	6.0	9.9	6.2	11.7	8.1
International trade	1.8	2.5	2.5	4.9	2.6	1.7	0.3	2.4
Other	3.2	0.1	1.2	2.0	1.7	6.0	1.8	2.1
Memo item:								
Indirect tax/Total taxes	0.3	0.6	0.7	0.7	0.6	0.4	0.6	0.6

Sources: IMF staff reports

41. **As some taxes, especially ill-designed ones, might be detrimental to growth, it is important for Syria to rely on non-distortionary taxes.** Kneller, Bleaney, and Gemmell (1999)[13] found that direct taxes such as income and profit taxes, social security taxes, payroll taxes, and property tax tend to reduce growth. At the same time, they also found that non-distortionary taxation such as a broad base consumption tax on goods and services (i.e., a VAT) is neutral for growth. In Syria, relative to direct taxes, the reliance on indirect taxes has been fairly low compared to other countries in the region. Hence, the potential for Syria to raise tax revenue in an efficient way by introducing properly designed and implemented indirect taxes is considerable.

[13] Kneller, R, M F. Bleaney, and N Gemmell, 1999, "Fiscal Policy and Growth: Evidence from OECD countries", *Journal of Public Economics*, Vol. 74, p171-190.

42. **The absence of a broad-based tax on consumption in Syria is notable,** which explains the observed low indirect tax to total tax ratio. The existing consumption tax introduced in late 2004 applies only to a positive list of goods and services (imported or locally produced). This narrow tax has a dozen rates, together with a credit mechanism, and a refund system for exporters (only).[14] It suffers from several weaknesses, including tax cascading, which distorts business activity, a narrow base, which limits its revenue potential, and a high burden on tax administration and high compliance costs on taxpayers due to its complicated rate structure and the absence of a registration threshold. Because small businesses—which have limited capacity to maintain proper accounting records—are not excluded from this tax, the difficulty of administrating the tax is increased considerably, without necessarily having an appreciable impact on revenue (small businesses as a rule do not pay much taxes).

43. **The government decision to replace the present consumption tax with a VAT to support fiscal consolidation is apt**. A properly designed VAT will not impose a burden on investment and exports—on which long-term growth depends—while offering the possibility of high revenue collection if the base is broad. In addition, a VAT could play a catalytic role in nurturing a taxpaying culture, as taxpayers will have an incentive to file returns to comply with the tax if they wish to recover their VAT refunds. Furthermore, if well-designed, a VAT will have relatively little impact on the poor, who would likely not make the bulk of their purchases from traders who would have to collect the VAT.[15]

44. **To optimize its benefits, a VAT would need to be properly designed**. The VAT should be levied on the destination principle. Both domestically produced goods and imports should be taxed. Through the input tax credit mechanism, exports will be zero-rated. VAT credit should be provided for all inputs, including capital goods.[16] Thus, investment (for which full credit will be provided) will not be subject to the VAT. The scope of the tax should be

VAT revenue productivity in selected countries (2003)

	Standard Rate (In percent) (1)	VAT revenue (In percent of GDP) (2)	Revenue Productivity (2) / (1)
Selected OECD countries			
Canada	7	3.54	0.51
Australia	10	4.14	0.41
New Zealand	12.5	9.06	0.72
Selected MENA countries			
Egypt	10	2.45	0.25
Jordan	16	8.53	0.53
Lebanon	10	3.81	0.38
Morocco	20	6.13	0.31
Tunisia	18	6.34	0.35

Sources: IMF

[14] The large number of rates is a vestige of past reform. When the consumption tax was introduced, quite a few excisable commodities were transferred to become taxable under the new consumption tax bearing different rates. Correspondingly, excises today are levied on only four products.

[15] Under a well-designed VAT, only those businesses that have a relatively high turnover will have to collect the VAT on their sales. The poor are not very likely to shop from such outlets but, rather, would buy from small traders in street corners and so forth. The latter would be excluded from the VAT because of their low turnover threshold.

[16] To limit the revenue impact of VAT refunds for capital goods, some countries mandate that excess VAT credits be carried over to subsequent filing periods rather than be refunded immediately.

broad—bringing into the tax net virtually all goods and services. Exemptions should be severely limited, preferably to hard-to-tax sectors such as financial services (and those excluded via the threshold, of which, more below). Modern VAT like the one introduced in New Zealand has a relatively high revenue productivity precisely because its base is extremely wide.

45. **The VAT should preferably have one single rate**. This will greatly reduce compliance cost to taxpayers and the burden on tax administration. More than 40 percent of the countries that have adopted a VAT have chosen a single rate, such as Lebanon, which has a single rate of 10 percent. The reason often advanced for favoring more than one rate is that differential rates can help achieve greater social equity. This argument is weak, even specious, largely based on a misunderstanding of what a VAT is best designed to do, namely to raise revenue in an efficient manner. If the objective is to tax the consumption of certain luxury goods at higher rates, this can be better achieved through the use of selective excises. Similarly, if the goal is redistributive (for example, to help the poor by providing a special VAT treatment to food), it is best that such concerns be taken care of through well targeted spending programs.

46. **The taxable threshold should be set at a high level in order to keep out small businesses.** To help tax administration cope with the new tax, it is advisable that the VAT threshold be chosen so that the number of enterprises registered for the VAT is between 4,000-6,000 taxpayers for the first 2–3 years of its implementation. Coverage could be expended later as administrative capability is built-up. Setting an appropriate threshold will require a good data base on the distribution of businesses by turnover, a task which should be given a high priority in the VAT preparation.

47. **Preliminary estimates are that each point of the VAT could yield about 0.35 percent of GDP in revenue on a gross basis in the initial years**. How much revenue a VAT might raise depends of course on its design features. As argued earlier, a case can be made for starting the VAT at a low rate of 5 percent (which is much lower than the standard rates adopted by most countries) and, when needed to compensate for the decline in oil revenue, the rate can be raised. On the assumption of a comprehensive VAT base (but with adjustment for base reduction due to small businesses in agriculture and the trading sector that are below the taxable threshold and for some leakages due to evasion), a standard rate of 5 percent will yield about 1.8 percent of GDP in revenue.[17] However, on a net basis, since the VAT will be replacing the present consumption tax (about 1.2 percent of GDP), its initial yield is projected at 0.6 percent of GDP in 2008 (see Table 1). Over time, as the rate is increased, eventually reaching 15 percent, and as the number of VAT taxpayers rises, it is

[17] The estimate, calculated using 2002 data, is based on the following assumptions: (a) 50 percent of sales of the agricultural sector (which presents virtually all unprocessed food sold to consumers) and 75 percent of trade margins of wholesalers and retailers are exempt from the tax; and (b) a leakage of 10 percent due to evasion.

foreseeable that the VAT could easily raise 5 percent of GDP or more (a productivity yield that is about on par with the single rate Lebanese VAT).

48. **The VAT could be supplemented by a small number of excises on few commodities.** A few excises are presently in place. Some of these (particularly, excises on alcoholic and tobacco products) should remain as they can help address negative externalities. Excises could also be levied on petroleum products, cars, and telecommunication—which can provide a good tax handle given their broad bases and fairly limited distribution points. Higher excises could be levied on certain goods such as luxury cars. However, for ease of administration, products such as leather products, cosmetics, jewelry, watches, and the likes should not be excised as they are likely to be produced and/or distributed at numerous locations, spread over many regions, making enforcement and collection costly for the tax administration.

49. **Work for the preparation for the VAT has started, albeit at a measured pace.** A mid-level project team has been set-up to prepare for VAT implementation in 2008, and the general policy direction seems to be to implement the VAT within an integrated, function-based tax administration, which is appropriate. But, even if several key policy design issues are yet to be taken, a careful planning for the VAT implementation will need to be carried out as soon as possible. Attention needs to be given to the design of a VAT refund system, for which little has been done so far. This will require clear provisions in the law (for example, ensuring prompt refund of excess VAT credits to exporters), simple forms and procedures, and include a risk-based system to focus resources on audit of refund claims with high risk. Lastly, it is critical that the VAT law is adopted at least six months ahead of the effective date of implementation.

III. Financial Reform in Syria: Too Slow, Too Little, or Just About Right?[18]

A. Introduction

50. **As part of a broader program of structural reforms and transition to a market economy, Syria embarked on a program of financial sector liberalization and reform in the early 2000s.** In a context of a stable but stagnant economy, the main objective of the financial liberalization program was to promote growth by enhancing the efficiency of the financial system. The liberalization process aimed at allowing the market to play a greater role in the allocation of financial resources by opening the financial services industry to private banks and other financial intermediaries. But from the start, the government felt that it should keep a large role in the economy, including in the financial sector, and hence government ownership of financial institutions was not brought into question.

51. **The program focused on opening the sector to private initiative and on building regulatory and supervisory capacity.** In so doing, the strategy's objective was to introduce greater competition and hence increase efficiency in the allocation of financial savings, while building the necessary regulatory and supervisory framework for eventual broader deregulation. As a first step, private banks were allowed to operate in the so-called "free zones," before a new banking law (Law 28) was enacted in April 2001, allowing the establishment of private banks. After some delays, a milestone was reached when the Bank of Syria and Overseas opened for business in January 2004, becoming the first private bank in Syria since banks were nationalized in 1963. Following the liberalization model pursued in banking, insurance companies were allowed to operate in the free zones before a law was adopted in late 2005 opening the insurance industry to the private sector.[19] To meet the need for Islamic financial services, a law allowing Islamic banking was passed in May 2005.[20] Lastly, a Capital Market Law was enacted in late 2005, and a Capital Market Authority was established in early 2006 to set up the regulatory framework for the securities markets. In parallel, the domestic capacity for bank regulation and bank supervision was gradually built-up, and many new banking regulations were issued.

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[18] Prepared by Rakia Moalla-Fetini

[19] Nine insurance companies have been licensed so far, one of them started operation in July 1, 2006 and many of them are expected to start operations before the end of the year.

[20] Licenses for three Islamic banks have been issued, and the first bank is expected to start operations later this year.

52. **The purpose of this chapter is to evaluate the experience to date and draw lessons for moving the process forward.** The remainder of this chapter is organized as follows: Section B reviews briefly the initial conditions. Section C takes up the evaluation of the experience per se, and Section D draws tentative recommendations/considerations that could guide the process forward.

B. Initial Conditions

53. **In the early 2000s, Syria's financial sector was very small; competition was limited and there was virtually no banking regulation and supervision.**[21] Six state-owned banks (SBs) provided no more than 25 percent of GDP credit to the economy, of which close to 2/3 was issued to the government and to the quasi-governmental agricultural procurement agencies. Other than loans for real estate projects, the volume of medium- and long-term financing available to the private sector was meager, as was external trade financing, which was almost exclusively provided by banks abroad, foregoing substantial domestic value added in financial services.[22] Most transactions were conducted in cash, with the clearing system processing only about 5,000 checks per day and the cash-to-deposit ratio as high as 60 percent. In line with the nature of the banking system, there was virtually no bank regulation and supervision.

54. **This state of underdevelopment was the fruit of 40 years of financial repression under the former socialist regime.** Following the nationalization of the financial system in 1963, and as in other socialist economies, the financial sector was turned into an implementation instrument for the national plan by directing credit to priority sectors (such as agriculture) through SBs. The lion share of economic activity was in the hands of public enterprises (PEs), whose financing needs were met directly from the budget.

55. **Notwithstanding the limited intermediation role played by the banking sector, monetization reached relatively high levels.** The stock of broad liquidity increased from 25 percent of GDP in 1963 to some 80 percent in recent years.[23] Perhaps one of the main reasons was the absence of a deliberate attempt to keep interest rates below market clearing levels, and henceforth largely negative in real terms, as has been the case in many countries where financial repression led to low monetization.[24] Instead, interest rate policy in Syria seems to have been fairly ad hoc. Nominal rates were kept constant for over 22 years, despite a large swing in inflation from high levels, following the 1986 currency crisis and until the

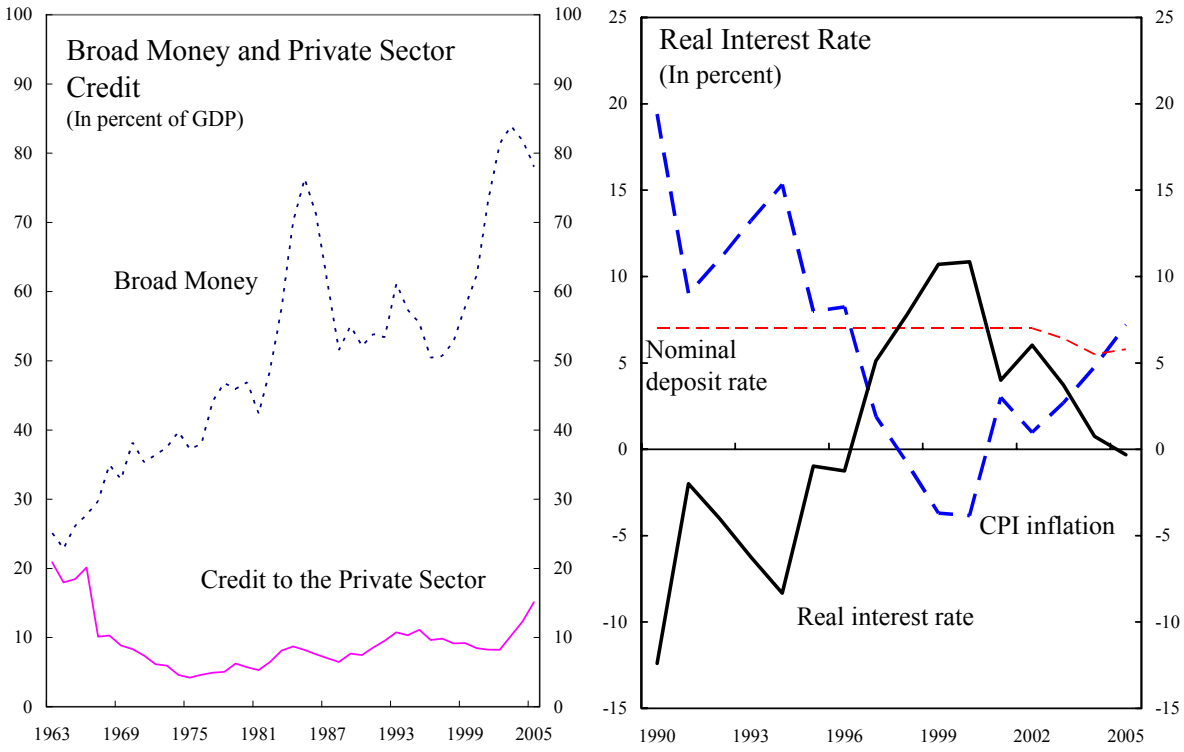
[21] Based on a comprehensive index for financial sector development compiled for MENA countries, Creane, et al, (2004) ranked Syria 18 out of the 19 counties studied.

[22] Value added in banking and insurance made up less than 3½ percent of GDP.

[23] Following the 1986 currency crisis, the value of the stock of monetary assets was eroded by the bout of high inflation that ensued. Starting in 1998, robust monetization resumed.

[24] Patrick Honohan (1999).

mid-1990s, to low-to-negative levels in the late 1990s–early 2000s. As a result, real interest rates shifted from highly negative to highly positive levels, averaging 7½ percent in 1997-2002. In 2003, these rates were finally recognized to be unwarranted by macroeconomic conditions and were reduced.[25]



Source: Syrian authorities.

56. **Hence financial liberalization benefited from fairly benign initial macroeconomic conditions.** Unlike in many other transition economies and developing countries where financial liberalization started from a situation of highly distorted interest rates, low levels of monetization, and was often triggered by financial crises, financial liberalization in Syria was launched in a stable macroeconomic environment, backed by positive real interest rates and ample liquidity.[26]

[25] With high monetary liabilities and low lending, net external assets were built up to a level equivalent to about 50 percent of total assets.

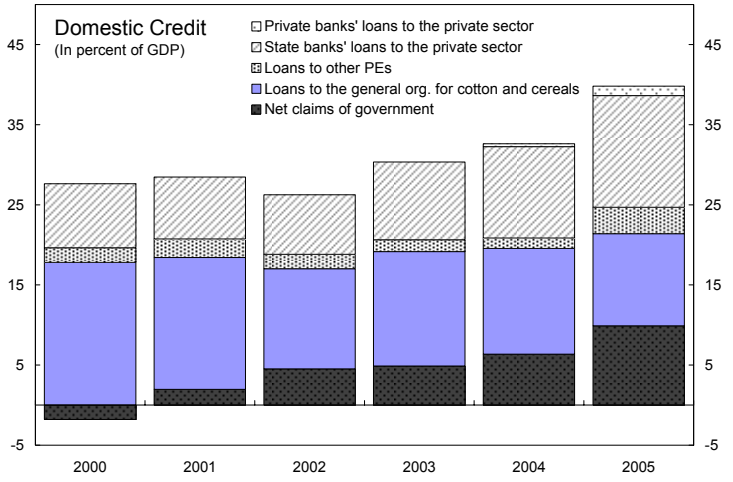
[26] The fact that a large share of M2 was held in the form of currency rather than deposits does not diminish the large potential for financial intermediation from a large stock of monetary assets, as the counterpart to currency in circulation could be converted into credit to the economy through central bank refinancing to banks.

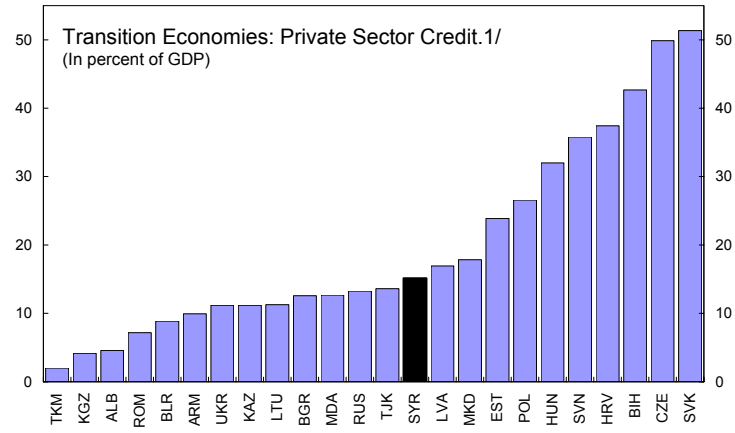
C. Evaluating the Experience with Financial Reform To Date

57. **Some progress has been made but much remains to be done.** Financial intermediation has increased but remains shallow; the range of financial services and instruments is still limited, private sector banks have made inroads but the system remains dominated by inefficient SBs and the pricing of liquidity and of financial risks is still subject to administrative controls. In all, the economy is still an essentially cash economy, while a considerable supervisory gap still needs to be filled.

Financial deepening

58. **Credit has expanded but remains low by regional standards, although not by comparison with transition countries.** As a result of the entrance of private banks and of the fast-paced expansion of credit by state banks over the past three years, credit to the private sector doubled to 15 percent of GDP by end-2005, while overall domestic credit at end-2005 increased to 40 percent of GDP. Nonetheless, and despite a comparatively high stock of monetary liabilities, lending to the private sector is by far the lowest among a selected group of countries in the region, while the currency-to-deposits ratio, which has not declined much since the early 2000s, is the highest. This performance, however, is in line with the experience in other transition economies.[27] Other segments of the financial sector are virtually non-existent, except for one state-owned insurance company, which provides a very limited range of products and whose gross annual insurance premium is less than 1 percent of GDP (significantly below the 9 percent international average). While the size and depth of capital





1/ For Syria data is for end-2005. For other countries data is for the year 2000, roughly 10 years after the start of transition and financial reform in these countries.

[27] Fabrizio Coricelli (2001).

markets in the region increased significantly in the last few years, Syria is still in the early stages of establishing one. Except for the agency for combating unemployment, which has a very small microfinance loan portfolio, there are no other non-bank financial institutions.

Financial Deepening Indicators in Selected MENA Region Countries, 2005
(In percent of GDP, unless otherwise specified)

	Bank's Assets	Broad Money	Currency-to-Deposit (in percent)	Claims on the Private Sector	Claims on the Public Sector	Market Capitalization to GDP
Syria	**104.6**	**78.0**	**58.9**	**15.6**	**25.5**	**0.0**
Bahrain	132.8	67.4	6.2	54.0	-2.3	137.0
Egypt	83.5	88.5	16.3	44.4	45.5	72.0
Jordan	212.8	135.6	15.5 3/	86.2	24.1	293.2
Lebanon	326.1	266.9	1.8	75.9	107.2	157.0
Morocco	95.6	100.7	23.8	61.7	25.7	46.5 1/
Tunisia	80.6	61.6	17.9	62.6	5.9	8.8 1/
Turkey	40.9	47.1	8.7	25.4	29.6	30.0
UAE	113.1	62.5	6.1	59.1	-1.4	159.0

Sources: Central banks; and Fund staff estimates.
1/ 2004.
2/ Government and public enterprises.
3/ The relatively high ratio is due to the use of the Jordanian dinar in the West Bank.

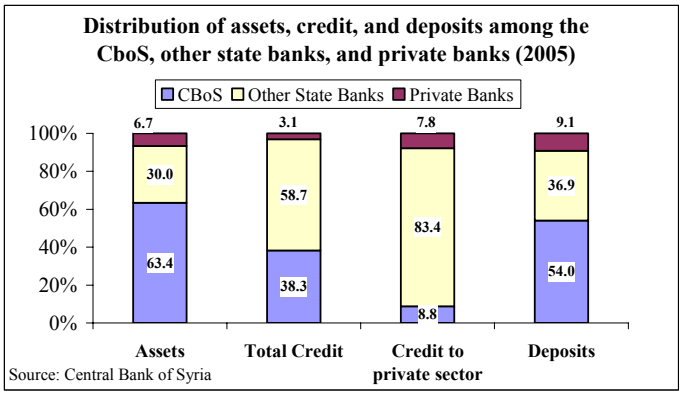
Market structure

59. **Private banks have made inroads.** Six private banks are now fully operational and have already gained about 10 percent market share. All are subsidiaries of foreign banks,[28] although foreign investors do not have a majority share, since Law 28 sets a 49 percent limit on their participation in banks' capital.[29] Following measures to reduce the taxation of financial services, their profitability is reported to be good, and two have already decided to expand their capital base. Manifold oversubscription to the IPOs of these banks' shares on the local market shows great interest from domestic investors.

[28] Including Banque du Liban et d'Outre Mer, Lebanon's Banque Européene pour le Moyen-Orient and Banque Audi, Saudi Arabia's Banque Saudi Fransi, and Jordan's Housing Bank for Trade & Finance.

[29] An amendment of the law that would scrap the limit on foreign ownership is being discussed in government .

60. **Still, SBs continue to dominate the system and suffer from weak governance and low efficiency.** SB boards have limited powers to decide on the strategy and policy objectives of the bank and little independence vis-à-vis the bank's management.[30] Low efficiency is due to a host of factors including low staff qualifications owing to noncompetitive wages and weak training policies and human resources management, and poor managerial information systems and IT infrastructure. Moreover, banks have weak risk management systems and practices and most of their lending is collateral-based. Moreover the activities of the Commercial Bank of Syria (CboS), which has a lion's share of the market, have been impaired by the recent U.S. administration's decision to sever its link with the U.S. financial system over concerns about "its involvement in money laundering and terrorism financing."



These weaknesses are reflected in low profitability, undercapitalization, low asset quality, and recurrent liquidity problems:

- Subsidized lending, low asset quality, and poor diversification of income[31] contribute to the low level of profitability. Based on available data, staff estimates that return on assets (ROA) is about 0.4 percent and return on equity (ROE) is about 2.5 percent. In 2004 and in the MENA region, the average ROA was 1.5 percent, while the ROE ranged from 10 percent in Egypt to 21 percent in Bahrain.

- Although there is much uncertainty about the quality of SBs' assets because of inappropriate accounting, loan classification and provisioning rules, collateral appraisal, and the continuous rescheduling of non-performing loans, published data show high non-performing loan (NPL) ratios and low capital-to-asset ratios in some of these banks. On average, NPLs are equivalent to 16½ percent of total assets, while the average capital-to-asset ratio at 4.8 percent is the lowest in the region. Applying international standards for loan classification and provisioning, and taking into account loans to the quasi-governmental agricultural procurement agencies (equivalent to 10 percent of GDP and 78 percent of loans

[30] Except for a narrowly defined ordinary course of business, all other decisions such as nomination of heads of division or department, creation of any additional jobs, staff trainings, opening of a branch, or introduction of a new product require state approval, which depending on its respective nature must be sought from the Finance Minister, the Office of the Prime Minister, the State Planning Authority, the Central Authority for Financial Control or other agencies.

[31] Because of bank specialization and low services' income.

to public enterprises)—which reflect losses from past quasi-fiscal activities—is likely to increase the NPL ratio and the undercapitalization problem significantly.

Financial Soundness Indicators for state-owned banks 1/

(In percent, 2004*, 2005**)

	NPL	**Credit to total assets	**Capital-to - Asset Ratio	*Return on Assets	*Return on Equity
Weighted average / total	16.3	32.7	4.8	0.4	2.5

Sources: Central Bank of Syria, State-owned banks and EIB.

1/ NPL= Non-performing loans/Total loans (based on banks' calculation and not consistent with international standards).

Interest rate liberalization

61. **Interest rate controls still have a major bearing on financial intermediation and competition.** Controls on deposits rates were maintained, albeit with some added flexibility, while lending rates for private banks were free from the outset. Some limited flexibility on deposits rates, which apply uniformly to SBs and to private banks, was introduced in January 2004 by allowing a 1 percent margin around the regulated rates. [32] A one percent downward margin on SBs' lending rates was also introduced in January 2004, although it has not been used by any of them as the regulated rates are already below market.[33] No controls on private banks' lending rates were ever introduced. Interbank lending subject to central bank approval was also introduced in 2004, although banks reportedly made very little use of it.

Bank regulation and supervision

62. **The newly established banking regulatory framework meets most present needs.**[34] New regulations have been adopted, including: (i) minimum requirements for credit and interest rate risk management (December 2004); (ii) loan classification and provisioning (December 2004); (iii) minimum requirements for effective internal control and the role and responsibilities of management and board of directors in risk management (March 2005); (iv) minimum standards for operational risk management strategy and policy (February 2005); (v) implementing international accounting standards for banks (August 2004 and February 2005); (vi)minimum capital adequacy ratio (when?); and, most recently, (vii) limits on banks' open foreign exchange positions.

[32] The way this regulation is designed (initially a 1 percent upward margin on top of the set rate, later turned into +/-0.5 percent margin around the set rates) makes it look like both a floor and a ceiling. This probably reflects two different objectives pursued by this policy: guaranteeing savers a minimum return on their savings and preventing banks from bidding too aggressively for deposits.

[33] The margin was turned into an upward margin in early 2005.

[34] The Fund has provided extensive technical assistance in this area.

63. **However, progress in setting up a comprehensive supervision system has been fairly limited.** To be sure, 45 additional staff were hired and there has been a lot of investment in the training of new bank supervisors, including with the assistance of international financial institutions, and a Banking and Training and Rehabilitation centre has recently opened to provide more training in the future. But, an independent banking supervision department, with well-established business processes and internal procedures, a clear organizational structure, a clear mandate, and a minimum number of staff who are well versed in the theory and practice of off-site and on-site bank supervision seem to be a long way away.[35]

64. **Moreover, a much eroded compliance culture in the SBs has yet to be cultivated anew.** Forty years of quasi-absence of bank supervision have eroded compliance culture in SBs. The problem is compounded by the absence of clear responsibilities and objectives for each agency involved in the supervision of SBs, which weakens the central bank's authority to address noncompliance.[36]

The payments system

65. **Very limited progress was achieved in modernizing the payments system.** No noticeable reforms have been implemented, either for large value payments, retail payments, or securities settlements. There is no Real Time Gross Settlement (RTGS) system or an electronic or automated clearing check system in Syria. Major payment transactions are still done manually and large payments are transmitted via checks and paper-based payment orders without adequate risk management procedures. More generally, the current payment system does not observe many of the *Core Principles for Systemically Important Payment Systems*.[37]

[35] The banking supervision department head position is still vacant. There are about 60 staff members in the department for on-site and off-site supervision. Most of them were appointed recently and only half of them are pursuing training programs. The turnover rate is reported to be high because of low pay and low morale.

[36] In addition to the central bank, two other institutions have overlapping responsibilities in supervising state-owned banks: the Central Authority for Financial Control and the Central Commission for Inspection & Control.

[37] A joint IMF-AMF mission on payments and security settlements initiative visited Syria recently. Progress in acquiring an RTGS system is expected in the coming few months.

D. Issues to Consider for Furthering Financial Sector Development

66. **Based on the above evaluation, we can draw the following conclusion as to the main problems and sources of tension that have emerged on the road to financial liberalization:**

- First, there is a growing resistance to allowing greater competition because of the justifiably perceived risks that, under increased competition, the inefficiencies of SBs might snowball into serious contingent liabilities for the state. Yet, competition is needed to promote efficiency gains in financial intermediation.
- Second, the main reason for the limited progress made in raising the efficiency of SBs and their ability to become more active players in the financial system is that they continue to be seen as instruments of public policy (provision of subsidized loans and job creation).
- Third, in the absence of progress in the development of indirect instruments of monetary control, controls on banks' deposit rates remain the sole instrument for setting a benchmark interest rate, at the cost of constraining effective competition.
- Last, but not least, the heavy legacy in terms of skills deficit in both risk management and prudential supervision of 40 years of socialist banking[38] is proving to be (i) a serious handicap for improving the performance in SBs, and (ii) a source of risk if the progress in building up the regulatory and supervisory capacity does not keep pace with financial liberalization.

67. **The remainder of this section takes up these topics, highlighting some issues to consider for furthering financial sector development with regard to SBs restructuring/privatization, interest rate liberalization, and supporting measures/capacity building.**

State banks restructuring/privatization

68. **This is perhaps the single most important area where the financial liberalization strategy needs to be revisited.** Throughout the past two decades of financial liberalization across the world, privatization of SBs has come to be seen as part and parcel of financial liberalization, as more and more governments came to realize that state ownership of financial institutions entailed a confusion of goals, higher operating costs, and a deterioration of credit assessment and credit controls. By separating public policy functions from financial functions and leaving the former to the government and the latter to the private sector, privatization proved to have better served the social goals governments tried to pursue

[38] This problem is shared by many other developing countries and transition economies.

through ownership of banks.[39] The latest example in point is the case of Pakistan where the government's equity share in the banking system was brought down from 80 percent to less than 20 percent in less than five years.

69. **Without discharging SBs from all social obligations, strengthening their governance structure, and turning them into autonomous, profit-oriented entities, it will be hard to improve their level of efficiency**.[40] If they do no lose market share, their low efficiency will weigh down the system's overall level of efficiency. In particular, they will hinder the development of deep and liquid money markets, a precondition for strengthening the monetary framework. If they do lose market share while having to incur the same personnel and other costs, the claim they will put on budgetary resources will keep growing.

70. **Opening the capital base of SBs to strategic private investors is one of the most effective means to raise efficiency and address the skills deficit**. The latter is so huge that only a massive infusion of outside expertise could help solve it in a reasonable timeframe. Short of that, the process is likely to be long, protracted, and ultimately costly.

71. **If these principals are accepted, then it should also be understood that the playing field should be fully leveled for all banks**, whether the government has a remaining share or not. In particular, all banks should have the right to provide international trade financing.

72. **The interlinkages between PEs reform, SB restructuring, and severing the link between the budget and PEs need to be examined carefully**. One saving grace for the health of SBs in the past was the fact that PEs had limited access to direct borrowing from SBs.[41] Almost all PE financing needs were met through on-lending by the budget. As the government is considering severing its links with PEs, their access to the "appropriate" type of outside financing will be critical to the success of their own restructuring strategy. On the one hand, substituting easy money from the budget with easy money from a SB will not be a solution as it will reduce incentives for the PEs to improve their efficiency and risks saddling the SB with bad loans. On the other hand, during their restructuring process, PEs may need some type of financing that a purely private bank may not be willing to grant. Therefore, the right balance needs to be struck between ensuring that PEs are progressively exposed to the market discipline of having to secure financing from profit-oriented banks, and that in the

[39] Caprio, Hanson, and Honohan

[40] A pre-requisite for SB restructuring is to have an independent and thorough audit of their accounts.

[41] The stock of outstanding loans to PEs, excluding the loans to the quasi-governmental agricultural procurement agencies stood at 3¼ of GDP at end-2005.

course of their restructuring they are not cut-off from all sources of financing. A public bank may have a useful role to play during the transition period.[42]

Interest rate liberalization

73. **Interest rate liberalization is also part and parcel of financial liberalization and the risk that it will lead to increased financial volatility appear limited in the case of Syria**. Indeed the main channel through which financial liberalization promotes greater efficiency is by having credit rationed through prices rather than administratively. And it is precisely the competition among banks in attracting deposits by offering better deposit rates and in lending by offering the best risk-adjusted lending rates, which is the source of the efficiency gains. Interest rate liberalization has entailed increased financial volatility in other countries.[43] This risk is likely to be small in the case of Syria because of the relative stability of macroeconomic conditions and the fact that real interest-rates are already in the positive range.[44]

74. **Regarding the liberalization of deposit rates, and in the absence of market-based monetary control, maintaining ceilings/floors is a second best solution**. Given Syria's limited experience with market-based financial systems, controls on deposit rates would provide an anchor to the interest rate structure until monetary policy is developed and is able to provide an alternative. The risk in liberalizing deposits rates too soon and seeing banks engage in high-risk lending should not be underestimated.[45] Such risk might be already building up in the system in as much as there are no ceilings on interest rates on dollar deposits.

75. **Beyond the benefit of anchoring the interest rate structure, market-based methods of monetary control are needed to support financial development** because they facilitate liquidity and risk management and provide a benchmark risk-free interest rate and a yield curve to allow the proper pricing of financial risk. The absence of money markets and deposit and rediscount facility at the central bank is making it difficult for banks to manage Syrian pound liquidity and creating an incentive for the private banking sector to be dollarized.[46]

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[42] It goes without saying that PEs should be allowed to bank with any institution at all times.

[43] Patrick Honohan (2001).

[44] Liberalization in other countries, which started from significantly negative real interest rates, had led to increased financial volatility, as interest rate re-alignment made the budget loose an important source of implicit taxation, creating an incentive for monetary financing of the budget deficit.

[45] So far, the ceilings have not been binding**,** as banks have been able to mobilize more deposits than they have been able to lend domestically.

[46] Already now, the ratio of FX deposits to total deposits in private banks is equal to 53 percent compared with 9 percent for SOBs.

76. **Regarding lending rates, the decision not to impose ceilings on private banks' lending rates is apt.** In the absence of a possibility to compete on deposit rates, deregulated lending rates opens at least one important field in which competition among banks could bring some efficiency gains. However, the effectiveness of such competition is severely limited by the fact that SBs are mainly dedicated to providing subsidized credit and are not competing much with private banks on regular credit activities.

77. **Interest rate subsidies need to be re-assessed.** While it is not clear how subsidized credits are being rationed, risks are that this gives rise to rents being captured by powerful interests. This problem could be particularly severe in real estate, given the boom in the real estate market. The merits of providing subsidized credits has to be re-examined, its scope limited, and when possible it needs to be replaced by direct means of providing assistance to the most needy. If a case can be made for maintaining the policy for some limited type of loans, the policy could be improved by allowing private banks to participate in this scheme. This could be done by turning the implicit subsidy into an explicit one that could be designed to be a function of the spread between the actual rate paid to banks and a notional subsidy rate. Competition among banks will drive down the spread, improve efficiency, and lower the cost to the budget.

Supporting measures/capacity building

78. **Strengthening banking regulation and supervision should keep pace with financial liberalization.** For the moment, the fact that all the newly established private banks are subsidiaries of foreign banks and are supervised by the supervision bodies of the countries of their head-offices, lessens the risks from weak bank supervision at home. However, as SBs are restructured/privatized, and as purely domestic banks may enter the market, risk-taking in the banking sector will increase if the capacity of bank supervisors to assess risk, identify unsafe and unsound practices, and bring about timely corrective actions, is not build-up. Building bank supervision capacity includes building capacity to conduct effective onsite and offsite banking supervision, developing internal procedures, and completing the regulatory framework, including strengthening the AML/CFT framework. This can not be done without addressing the problem of low pay at the central bank. Dealing with this problem would require de-linking the pay scale of the central bank staff from that of the rest of the civil service, as has been done in many countries, having the ability to hire outside experts to deal with special situations, and providing regular training programs for staff

79. **Carefully screening the entry of new banks will also be critical to protect the soundness of the banking system.** The liberalization of the financial sector should be based on a licensing policy that takes into account the growth plans of existing banks, the absorption capacity of the market, and the need to preserve the attractiveness of the market for potential strategic investors in state-owned banks. In addition, factors such as the strategy or philosophy of new banks, line-of-business, funding sources, scope of activities, relation

with parent company, country risk of the parent company, geographical concentration of ownership, and level of banking supervision in the home country[47] should be examined during the licensing review. Developing licensing manual based on the licensing policy would ensure prudent and transparent licensing process.

80. **The payment and settlement system needs to be modernized and its efficiency enhanced.** This is essential to increase the effectiveness of interbank funds transfers, minimizing payment risk and facilitating fund management through transferring funds in a faster, safer and more reliable way.

81. **Institutional capacity needs to be build up at the CBS to enable it to play a key role in promoting an enabling environment for further financial sector development**. This includes establishing a public credit registry or private credit bureaus, [48] pushing for an improvement in accounting standards of banks, which would have an indirect positive impact on accounting standards for enterprises, and making available timely data about economic, monetary and financial developments.

[47] This includes the possibility of sharing supervisory information with the home country supervisory authority.

[48] This would entail drafting the law, licensing the bureaus, and supervising the sector.

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IV. Reforming Syria's Trade Regime: Achievements and Prospects[49]

A. Introduction

82. **In the early 2000s, Syria had one of the most restrictive trade regimes in the world.** Trade restrictions included outright prohibitions of imports of most consumer goods, public enterprise trading monopolies, extensive licensing requirements, as well as a high and dispersed customs tariff. Foreign exchange restrictions, in the context of a multiple exchange rate regime and no current account convertibility, reinforced these restrictions and compounded their costs on the economy.

83. **Over the last three years, however, the authorities** have gradually begun to liberalize trade. Tariffs were lowered, some restrictions on imports were eliminated, including most notably a ban on imports of textiles and cement, and access to foreign exchange for current transactions was partly facilitated. Furthermore, negotiations for an Association Agreement with the European Union and a free trade agreement with Turkey were finalized, and, as of early 2005, goods can freely circulate in and out of Syria within the Greater Arab Free Trade Area (GAFTA).[50]

84. **Yet, Syria's trade regime remains relatively restrictive (excluding trade with GAFTA), on account in particular of nontariff barriers.** Unclear regulations, quantitative restrictions, and other nontariff requirements continue to prevail and to add to the costs and length of conducting international trade transactions. Non-tariff barriers generate distortions in the allocation of resources in the Syrian economy and undermine the positive effects of the ongoing economic liberalization on domestic competition and external competitiveness.

85. **The purpose of this chapter is to take stock of where Syria's trade regime stands and to discuss how Syria could** further liberalize its trade regime.

B. Customs Tariff

86. **Syria's customs tariff has been significantly lowered in recent years.** Before 2002, customs duties consisted of several different taxes at the border that could accumulate up to 255 percent spread over 20 categories. Over the last three years, customs duties have been unified and gradually lowered to a maximum of 65 percent.[51]

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[49] Prepared by Stephane Cossé.

[50] GAFTA includes Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen.

[51] For instance, customs duties on luxury and standard cars were lowered, respectively, from 255 and 150 percent to 60 and 40 percent.

87. **However, the tariff is not published and the full extent of the revision is difficult to ascertain.** The most up-to-date version of the tariff schedule (in Arabic only) was last **updated** in mid-2005. Since then, all government decrees revising the tariff have been published separately and are not compiled in a comprehensive tariff **document** (there is no electronic version of the tariff available). As a result, customs officials were not able at the time of the preparation of this document to identify the number of lines in the tariff, while the number of categories could only be estimated (at 20).[52]

88. **The tax on international trade appears to be relatively high compared with most countries in the region**. Given the lack of detailed data on tariff rates, the effective taxation rate (international trade taxes relative to imports) can be used to help measure the level of tariff protection. The effective taxation takes into account the impact of the concessional tariff rates applied in bilateral and regional trade agreements as well as the loopholes in the collection of customs duties and other charges. In 2004, Syria's effective tariff protection was relatively high (Table 1) at a level comparable to Algeria and Morocco. In the coming years, this protection level should gradually decline as a result of the lower tariff rates (on a Most Favored Nation and concessional basis), although improved customs duties collection should mitigate some of the revenue lost.

Table 1: Effective Protection in Selected Middle East Countries in 2004
(in percent)

	International Trade Taxes	
	In percent of imports	In percent of GDP
Algeria	10.7	2.3
Bahrein	2.3	1.3
Egypt	5.4	1.4
Jordan	5.2	3.2
Lebanon	4.1	1.8
Libya	5.3	1.5
Morocco	9.2	3
Saudi Arabia	5.6	0.9
Syria	**9.3**	**2.5**
Tunisia	4.1	1.8
U.A.E.	1.7	0.8

Source: Staff estimates.

[52] The simple average tariff cannot therefore be identified in Syria.

89. **The tariff dispersion, albeit reduced, remains wide, reflecting the authorities' concern to protect added value.** Most raw materials and industrial equipment, as well as live animals and some medicines, are duty free or taxed at 1 percent or below. Semi-manufactured products/intermediates and final consumer/luxury goods remain taxed in the medium and upper range of the revised tariff, respectively. Although the lower duties on equipment and raw materials may help exporters, such a structure increases effective protection and if maintained for too long risks hampering long-term industrial development. It distorts resource allocation and reduce incentives to establish new export activities.

90. **The authorities intend to proceed with further simplification and reduction of the tariff in 2006** (although the decision has not been made formal yet). They would lower the maximum rate to 50 percent and reduce the number of categories to 5.

91. **While pursuing their reform, the authorities should also consider the following:**

- reduce the number of categories to 3 or 4 (including the zero rate) to **facilitate** the use of the tariff;
- limit the number of items at the maximum rate to limit effective protection and encourage exports;
- publish as soon as possible the revised tariff to keep traders and investors informed about tariff revisions. When possible, publish a version in English;
- create an electronic version to facilitate updating of the tariff, as well as analysis and international comparisons.[53]

C. Non-Tariff Barriers

92. **Some progress has been made in the past three years to remove non-tariff barriers.** The number of prohibited imports for protection reasons has been gradually reduced, and was extended in 2006 to sensitive sectors such as textile and cement. The public sector monopoly on imports has been rescinded for consumer goods such as cars. Import licensing for raw materials was abolished. Export license requirements have been replaced by a statistical form, while export bans (except for seasonal agricultural products) and specific taxes and fees have been eliminated.

93. **Yet, trade regulations and non-tariff barriers remain complex and opaque, and their impact on the cost of imports is believed to exceed substantially that of tariffs.** As detailed below, there are various types of non-tariff barriers and trade regulations whose interplay with complex rules for access to foreign exchange for trade financing reinforces their restrictiveness. Furthermore, lack of transparency in rules and procedures add to the

[53] The structure of the tariff is already based on the Harmonized System (8-digit level) and should therefore be consistent with international standards.

perceived unpredictability of policies, opening the door for discretion and corruption, and encouraging noncompliance. The costs incurred by these barriers are significantly larger than the cost imposed by tariff barriers, particularly in the wake of the recent lowering of the average tariff.

Non-tariff barriers

- **Restrictions on imports of goods comprise**: (i) prohibitions for security, environmental, and health reasons; (ii) prohibition of imports to protect domestic industry; (iii) public enterprises trading monopoly for certain goods; and (iv) goods that can be imported by the private sector after receiving a permit and paying a fee.[54] The lists of prohibited or restricted imports are not published, making it hard to assess the real progress made recently in shortening them.[55]

Box 1. Restrictions on Imports [1]

Goods that cannot be imported because of their negative impact on the Syrian industry include a long list of agricultural and industrial products, such as flowers, animal products, forestry products, vegetable oils, sugar-based products, quarrying products, plastic and rubber products, leather, wood, craft products, glass, electrical machinery, and materials.

The list of goods that can only be imported by the public sector includes oil and oil-related products, alcohol and beer, arms, cotton, some cereal products, tobacco, pharmaceutical products, some chemical products, salt, fish, fruits, olive oils, televisions and television components, animal feedstock, and phosphates.

The list of goods that were previously imported only by particular public entities and which can be imported by the private sector, provided the payment of a fee of 2 to 5 percent of the value of imports to these public entities, includes notably cars and transport machinery, steel and steel products, wood, cement, some pharmaceutical products, coffee, tea, rice, canned fish, meat, raw sugar, fertilizers, raw leather, and paper.

The list of goods that cannot be imported for security, environmental, and health reasons is not public.

[1] Detailed information on restricted imports is difficult to collect, therefore the following may contain inaccuracies.

- **Industrial quotas** allow the import of limited quantities of raw materials and semi-manufactured products at reduced duties. The quota levels are set by the ministry of Industry based on annual stated production capacities. Non-beneficiaries pay higher customs duties and commissions to public trade agencies against the

[54] A World Bank study by Chemingui and Dessus (2003) estimates that non-tariff restrictions raise the domestic price of imported goods by 19 percent, that is, twice as much as the effective tariff protection. These estimates are close to rough estimates of 15–20 percent provided by some companies in discussions during the 2006 Article IV consultation mission

[55] For certain goods, imports can be made only after a certain quantity is procured locally from a public enterprise.

import of the same items. The system is reportedly largely misused, in particular: (i) some companies exaggerate their annual needs to sell their surplus in the market; (ii) pseudo-industrial companies are established for the sole purpose of trading such goods; and (iii) small companies that would need to register to request an import license (and be liable to taxes) prefer to purchase goods through this system. Given its shortcomings, the scheme was eliminated in early 2006, but reinstated shortly thereafter in the wake of strong discontent voiced by ex-beneficiaries. The decision to maintain the scheme illustrates the widespread influence of vested interests in trading activities.

- **Import licenses**: Obtaining an import license is particularly cumbersome. In particular, a license is specifically required for all goods (i.e., itemized), except for imports from GAFTA countries. The license can be obtained in 3-4 days if no further authorization is needed. However, for a large number of goods, importers need authorization from technical ministries (e.g., health, environment, defense, industry) that can be reportedly quite lengthy to obtain.

Other non-tariff barriers include:

- **a host of impediments for public tenders** such as an obligation for the bidder to have an exclusive local agent and for the winner to have an official domicile in Syria and to contract shipping with a public trading agency; cumbersome and time consuming technical and financial evaluation; tenders being reopened (even after a bid has been awarded) or additional requirements being imposed; and problems with release procedures of bid and performance bonds;.

- **All maritime shipments** must access the country through a Syrian port. In 2004, the Ministry of Economy and Trade made mandatory the exclusive use of Syrian ports for imports of a wide range of products and consequently prohibited the transit of imported products via Lebanon, Jordan, or other regional ports;

- **storage and other fees** need to be paid at the border on the basis of complex regulations.

- all imports must be authorized by the **Consulates of Syria** abroad and subject to a stamp fee to be paid at the Consulates (1 percent of the value of imports capped at US$1,500).

- despite minimal regulations (licensing, foreign exchange, imports) in **free trade zones**, [56] administrative controls remain important and can deter time-sensitive investment, while porous boundaries encourage fraud and inefficient investment into the zones.

94. **The authorities acknowledge that non-tariff barriers undermine their efforts to open the economy, but have not yet defined a clear agenda for reform.** In formulating this agenda, the authorities could consider the measures listed below. These measures will not incur direct fiscal costs, and might even have a positive fiscal impact by widening the tax base and adjusting upward import prices to the actual value. Social safety nets/targeted budgetary support may be needed while the protection for some goods is phased out. Finally, such trade reform should contribute to reduce corruption and pressure from vested interests and to improve income distribution within the economy:

- publishing a negative list on goods that are restricted for imports (differentiating the four types of restrictions mentioned in Box 1) to inform traders and send signals on the authorities' willingness to enhance transparency and predictability. The authorities have repeatedly indicated that such a publication was a priority, but the list is still being prepared;

- replacing restrictions on imports for reasons other than the environment, security, and health by applying the maximum tariff rate (with phasing-out when needed) or the rate corresponding to the type of goods consistent with the tariff (to limit dispersion and distortion);

- abolishing industrial quotas (the authorities are considering doing it soon);

- granting autonomy to public enterprises for their imports of goods to reduce monopoly costs;

- abolishing fees paid by private traders to public enterprises, and replacing them by an explicit government subsidy, if its merit can be established;

- removing gradually public trading monopolies to enhance competition;

- replacing the licensing process (in particular, verification by technical ministries) with an open general or a specific license scheme to expedite international transactions;

- abolishing the payment of a stamp at the Consulates and the related verification to reduce red tape.

[56] The government operates seven duty free zones to promote foreign investment and industrial activities (Damascus, Damascus Airport, Adra, Latakia, Latakia Port, Dara, and Tartus). Two others are being established in the Eastern part of the country.

D. Implications of Foreign Exchange Restrictions on Trade

95. **Limited access to foreign exchange, as well as the use of multiple exchange rates,[57] encourages transactions in parallel markets** (see Annex III of the staff report for a description of the current exchange regime). The authorities have facilitated access to official foreign exchange for private sector traders over the last two years. They estimate that about 65 percent of imported goods can now be traded in the official market (at an exchange rate adjusted daily to the parallel market rate to which a low spread is applied, respectively reducing/increasing the costs of imports/exports). However, a large amount of trade transactions continues in practice to be held in a parallel market. Foreign exchange trade financing by banks through the official market accounted for about 20 percent of total estimated imports by the private sector in 2005.

96. **Trade financing in the parallel market reportedly may lead to invoicing below the actual transaction level.** Given the absence of means to verify the amount of financial transactions conducted through off-shore banks, a company can show a lower bill than the amount actually paid. Customs officials must therefore rely on their own weak valuation procedures.

97. **The setting of an administered exchange rate each year for the budget also complicates international transactions.** This rate varied between a minimum of 4.9 percent and a maximum of 13.9 percent below the parallel market exchange rate in 2005. It is used by the public sector for all external transactions and by the customs administration to convert the value of trade invoices into Syrian pounds. The difference between the budget and the parallel market rate is equivalent to an implicit subsidy applied to the full amount of the transaction in the public sector and for the dutiable part for all other transactions. Using this fixed rate helps cushion the effect of an increase of the value of imports when the Syrian pound depreciates.

E. Customs Procedures

98. **Noteworthy progress has been made in the past three years to streamline customs procedures.** The authorities have already introduced the World Customs Organization's single administrative document (SAD) and are finalizing a new customs law which will modernize operations. The clearing process has been simplified, including by establishing one-stop offices at the border and a "green line" to facilitate entry for frequent and fully registered exporters and for goods coming from mostly developed countries.

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[57] For instance, some imports, particularly by public enterprises, were valued until 2004 at a rate significantly below the market exchange rate (sometimes as much as four times), thereby providing an implicit subsidy to companies.

99. **Notwithstanding this progress, import clearing remains relatively long.** Syrian companies, as indicated in a survey prepared by the World Bank (for the *Doing Business Report*), estimate that on average clearance takes 15 days (with a maximum of over a month), against eight days in Egypt, seven days in India, and six days in China.

100. **The clearance process is notably lengthened by some of the non-tariff barriers indicated above and by sanitary and phyto-sanitary (SPS) verification requirements (including by laboratories)**. Companies report that testing and clearance procedures are difficult to understand and to predict. Exporting companies have difficulties ascertaining whether the SPS verifications are based on scientific and realistic risk assessments or if they are purely arbitrary. This also makes it more difficult for a company to know in advance whether the SPS practices applied in the originating country are acceptable in Syria. Furthermore, there is no reference in the Syrian legislation on recognized international standards such as the SPS agreement under the WTO.

101. **The customs valuation process does not meet international standards.** The customs law defines customs valuation as the usual price of the imported merchandise paid between two traders. However, the process lacks good sources of information on reference prices and these can be either above or below the actual value.[58] Furthermore, the price can be distorted because the exchange rate used to value goods is revised once a year in the budget law. With the decline in the average tariff, there should be less incentive to reduce actual values at customs and hence more efficiency in tax collection.

102. **Customs officials intend to address these issues.** They indicate that the establishment of an effective single window at the border under the sole supervision of customs authorities will, however, necessitate good cooperation from technical ministries. As to valuation, the gradual computerization of the customs administration should provide access to relevant databases and references.[59]

F. Bilateral and Regional Trade Agreements

103. **The recently concluded bilateral or regional trade agreements should have positive effects on trade liberalization:**

- Trade is nearly fully liberalized with **Arab countries** since the beginning of 2005, both from a tariff and non-tariff **barrier** standpoint. All imports coming from countries adhering to GAFTA enter Syria duty free (a 2 percent surcharge is

[58] There has been some progress with regard to the reference price for European cars as the price quoted directly by the car makers is now used, implying a reduction in the quote of 15 to 30 percent.

[59] The authorities intend to acquire the ASYCUDA-World system to automate customs processes. Implementation will take place over the coming 24 months, by which time the system is expected to be rolled out to the majority of international airports, ports, and some 60 border stations.

applied)—and Syrian exports are treated similarly.[60] Licensing requirements have been removed as well as most import prohibitions. These point to substantial preferences currently granted to GAFTA countries, given the prevailing tariff and non-tariff restrictions applied to Syria's non-GAFTA trading partners.

- Syria signed in 2004 an Association Agreement with the **European Union**. **Following years of negotiation, a breakthrough was achieved in October 2004, with the initialization of the Agreement,** the last in a series the EU has signed with other Arab Mediterranean countries under the process launched in Barcelona in 1995 aiming at a free-trade zone in the region by 2010. The Agreement has, however, stalled at the level of the EU Council of Ministers. The Agreement would imply a phasing-out of customs duties for most goods over a period of 12 years. The Agreement would also require, upon entering into force, the elimination of the main non-tariff barriers applied to EU countries and updating/establishing key economic regulations (Box 2).

- Finally, the Free Trade Agreement with **Turkey**, which provides broadly similar preferences to those in the Association Agreement, is expected to become effective later in 2006.

Box 2. The Association Agreement with the EU: A Stimulus for Economic Reforms

Although not yet formally in force, the Association Agreement is providing an impetus for reforms and the Syrian authorities are using the draft document to frame their policies. The Agreement could yield, beyond the benefits from liberalized trade, major benefits from the revamping of outdated regulations and procedures and the strengthening of institutions that it calls for.

Upon entry into force, all the main constraining non-tariff barriers will need to be removed (such as bans on imports, complex licensing requirements, and multiple exchange rate practices). It will be critical that these barriers be removed similarly for all EU and non-EU countries.

All the key regulations will need to be updated, including the company law and commercial code. A competition law (and the related regulatory body) will need to be established, as well as laws on intellectual property rights, consumer protection, and leasing. Overall, 12 economic laws are planned for adoption.

The EU intends to provide technical assistance and financial resources to set up the relevant regulatory bodies and strengthen administrative capacities (including the customs administration). Its financial arm, the European Investment Bank, will help modernize economic infrastructure.

The early implementation of the agreement appears to be a remarkable incentive to guide Syria toward establishing market economy structures. Ultimately, the agreement will promote openness and international trade beyond the liberalized trade between the EU and Syria.

[60] The agreement requires that imports should have a 40 percent added value content in GAFTA.

104. **Notwithstanding the benefits of free trade agreements, the risks of trade diversion need to be acknowledged.** Although these agreements will promote trade with some trading partners,[61] the risks of trade diversion increase with the relative preferences given to a group of countries. Reducing the differential in relative preferences will therefore help the country fully benefit from trade liberalization. Priority should be given to removing non-tariff barriers for all trading partners, as these barriers are high and their elimination bears no fiscal costs (see above). Lowering the level of customs tariffs for all trading partners (on a Most Favored Nation basis) in parallel with the implementation of the preferential agreement with the EU and Turkey would help reduce the preferential gap and facilitate competitive access to efficient import goods, while taking into account possible fiscal costs.

G. Conclusion

105. **Trade reform has just started. Syria's trade regime is relatively restrictive and a concerted effort will be needed if the authorities are to fulfill their objective of joining the** WTO.[62] Eliminating key non-tariff barriers should be the first priority and will signal the authorities' determination to address the trade agenda. Implementing the regulatory measures provided for in the Association Agreement with the EU will bode well for the future and help Syria progress toward observing WTO rules and disciplines. **As these reforms are implemented,** Syria will gain credibility as a full-fledged trading partner, establish a solid track record in shifting toward an open economy, and boost its potential for a much-needed insertion into the global economy.

[61] Arab and EU countries accounted in recent years respectively for roughly 15 and 20 percent of imports and 10 and 60 percent of exports.

[62] Syria's request (sent in 2001 and reiterated in 2004–05) needs approval by the WTO's General Council to start negotiations.

V. Could the Textile Sector Be a Main Driver of Non-oil Export Growth?[63]

A. Introduction

106. **The textile sector plays a key role in the Syrian economy.** Cotton is the second most important cash crop (after cereals) and employs 2.7 million farmers and their dependents (about 15 percent of the population), while the textile industry accounts for about 20 percent of production and employment in the industrial sector. Until recently, the sector has been heavily protected and local production has mainly targeted the domestic market.[64]

107. **In a bold move in early 2006, the authorities opened the textile sector to international competition.** The ban on garment imports was abolished, along with most of the restrictions applied to cotton fabric imports.[65]

108. **This chapter analyzes the ability of Syria's textile sector to respond to the challenges from greater international competition** and sets out some policy recommendations on supporting measures to turn the challenge into an opportunity for the sector to become a main driver of non-oil export growth.

109. **This chapter contains four sections.** Following this brief introduction, the next **section** analyses the upstream sector of cotton. Section C discusses the textile sector. Section D draws some policy recommendations.

B. The Cotton Sector[66]

Production, domestic sales, and exports

110. **Over the last five years, raw cotton production has ranged between 700 thousands and 1 million tons** (Table 1). These fluctuations reflect in part sensitivity to weather conditions. Syria was the tenth-largest cotton producer in the world in 2005. Cotton varieties include high quality types that are used to produce fine fibers.

111. **The production is likely to peak at about 1 million tons.** The land appears to be intensively used. The yield per unit of cultivation area increased to 4.3 tons in 2004, which is the highest level in the world after Australia. Furthermore, the limited supply of water prevents expansion to new fields. The government licenses farmers to produce cotton in

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[63] Prepared by Stephane Cossé.

[64] On average, the sector has been a net importer.

[65] However, customs duties will remain high at 47.5 percent for most goods. Furthermore, the tariff on machinery and equipment for the industry is low, thereby raising the effective level of protection.

[66] Upstream activities are defined as the production of raw and ginned cotton.

designated areas in order to regulate the use of water and ensure an adequate water supply for the entire agricultural sector.

112. **Syria's ginning capacity is now high enough to absorb the annual crop, following substantial capacity investment in the early 2000s.** The ginning process is handled by 14 government-owned plants under the aegis of the Cotton Marketing Organization (CMO), based in Aleppo. The full annual production was ginned in 2005, yielding 328,000 tons

113. **With a ban on the import of cotton, the government has so far considered it of strategic importance that CMO meets the demand of the local industry before any surplus is exported.** Under these marketing obligations, the CMO has exported between one- and two-thirds of the production. One-fourth was to the European Union in 2004, one-fourth to neighboring countries (GAFTA and Turkey), and the remaining half to textile manufacturing countries (such as China, Pakistan, India, and Bangladesh).

Table 1: Production and Exports of Cotton, 2000–05

	2000	2001	2002	2003	2004	2005
Cotton production (unginned) (thousand of tons)	1047	974	713	796	1005	992
Area (thousand of ha)	270.3	257.1	199.8	205.4	234.2	237.0
Yield (ton/ha)	3.9	3.8	3.6	3.9	4.3	4.2
Cotton production (ginned) (thousand of tons)	346	315	235	270	333	328
of which: exports	218	246	80	104	114	145

Source: Ministry of Agriculture; CMO; and Fund staff estimates.

Prices

114. **Cotton is bought from farmers and private cooperatives at an administered price set by the ministry of agriculture**. The purchase price is adjusted downward during the crop season to encourage early collection. It is based on an assessment of the production costs, which include the cost of inputs and workforce. Following a decline in 2001–02 to LS/kg 27-28, the price increased to LS/kg 29–31 in 2003–05. This is due in particular to rising labor costs in the last 3 years, owing to an increased demand for farm workers during the crop season as the production of other seasonal crops (such as olives and other fruits) has been expanding. The price also includes a profit margin of LS/kg 2 to provide social support to cotton producers.

115. **Thus, the setting of the purchase price does not take into account world cotton price levels and fluctuations.** The authorities implicitly recognize that the world price equivalent to be paid to farmers would be much lower, and probably no more than half of what is actually paid to them.[67] The difference is equivalent to a producer price subsidy.

116. **The government bears the cost of the subsidy through the government-owned Agricultural Bank.** There is no pass-through of the cost to the CMO. The CMO purchases cotton in cash directly from producers at the administered price, but receives compensation from the government through the Agricultural Bank. At the beginning of the season, the Agricultural Bank lends the CMO the cash needed to purchase cotton for a specific volume at an administered price. However, the CMO reimburses the loan at the lower price reflecting the world price level. The Agricultural Bank bears the cost of the nonreimbursed share, that is, the difference between the outstanding loan and the actual repayment, which is not booked in the CMO's account. Estimates point to a subsidy that could amount to 1.3 percent of GDP in 2004 and 1.1 percent in 2005.[68]

Table 2: Cotton Prices and Subsidy, 2000–05
(In Syrian pounds/kg)

	2000	2001	2002	2003	2004	2005
Purchase price to farmers 1/	30.75	27.90	26.80	30.75	30.75	29.30
Price effectively paid by CMO 2/	n.a.	n.a.	n.a.	n.a.	15.00	15.00
Implicit subsidy (in billion of LS) 3/	...	...	...	...	15.8	14.2
In percent of GDP	...	...	...	...	1.3	1.1

Source: CMO; and Fund staff estimates.

1/ Between the beginning of the season and mid-November. Preliminary for 2005.
2/ The difference between the price paid to farmers and that effectively paid by CMO is covered by the Agricultural Bank.
3/ Calculated as the difference between the price paid to the farmers and that effectively paid by CMO multiplied by the annual production.

117. **The authorities justify the need to subsidize cotton farmers for economic and social reasons.** They consider the cotton supply critical for the textile industry, one of Syria's largest industrial sectors. If cotton-generated incomes are lower, output levels and product quality could decline, while farmers and cooperatives could shift toward more profitable

[67] There is no single benchmark for a world purchase price to farmers. Syria's price of US$/kg 0.3 (LS/kg 15) set in 2004–05 is roughly close to average production costs in sub-Saharan Africa. The purchase price paid to farmers in Sahelian countries averaged US$/kg 0.35-0.4 during the same period.

[68] At the start of the season, the Agricultural Bank also provides loans in kind and in cash (40-60 percent, respectively) at concesional rates to farmers and cooperatives for an amount equivalent to 0.1 percent of GDP. One-third of the loans are estimated to be nonperforming.

agricultural products.[69] Furthermore, the authorities argue that cotton production remains the main cash resource in a number of rural areas and is subsidized in many producing countries. They stress that although they support the need for a subsidy, they would be reluctant to support an increase in production given the potential environmental costs this could generate.

118. **Since 2001, ginned cotton is sold to the local textile industry at world prices.** Cotton imports are banned in Syria, which implies that domestic manufacturers in the textile sector have to purchase cotton exclusively from the CMO. Before 2001, the CMO's prices were set by the Ministry of Industry above world prices, but since then prices are set directly by the CMO (under the supervision of the government) consistent with world levels (Table 3). (Syria is a price taker in the world market.)

Table 3: Syrian Export and World Cotton Prices, 2000–2005
(In US$/kg)

	2000	2001	2002	2003	2004	2005
Average sales price by CMO	1.12	0.76	1.13	1.30	1.05	1.22
Average world price (Liverpool Index)	1.30	1.06	1.02	1.40	1.36	1.21

Sources: CMO; and IMF's World Economic Outlook

C. Textile Industry[70]

119. **Textile manufacturing is one of the largest industrial sectors, but supplies mostly the domestic market.** It is the second largest sector following agro-industries and excluding oil-related activities, accounting for about 20 percent of industrial production. The share of public sector production represents about 25 percent **of the total, but only 10 percent** of the fabric and garment sub-sectors. Garments and most cotton fabric could not be imported until this year. As a result, the industry remained mostly inward-looking and found little incentive to look for markets abroad. Domestic manufacturers increased output to meet the needs of a fast-growing population, with exports amounting to only 15-20 percent of the production.

120. **Accordingly, the textile export performance is somewhat mixed, accounting for 13 percent of non-oil exports in 2004** (8 percent excluding yarn).[71] Syria's export strength has been geographically limited so far, reflecting a good knowledge of local customs and the distribution structures of Arab markets but difficulties in meeting industry standards, and the time-sensitive delivery requirements of western markets. Products with higher added value are exported mostly to GAFTA countries and Turkey (75 percent for fabric and 60 percent

[69] No study is available on whether production would be resilient to a fall in the purchase price (in particular, no data are available to estimate the marginal costs of producing cotton in Syria).

[70] Downstream activities are defined here as the production of yarn, fabric, and garments.

[71] Latest available data. Source:UNCTAD.

for garments in 2004). Exports of fabric and garments to the EU accounted for respectively 10 percent and 23 percent,[72] amounting to a marginal share of the EU's imports.[73]

121. **As the industry is mostly directed toward local consumption, Syria has been a net textile importer.** In particular, local companies rely on imports of synthetic and blended yarns and machinery for their manufacturing (Table 4).

Table 4: Imports and Exports of Textile Products, 2000-2004
(in million of U.S. dollars)

	2000	2001	2002	2003	2004
Imports					
Textile - Yarn	286	185	174	188	208
Textiles - Fabric	113	73	91	152	126
Textiles - Garments	-	-	-	1	-
Textile - Machinery and Parts	107	34	80	81	103
Total	506	292	344	421	437
Exports					
Textile - Yarn	95	50	70	140	92
Textiles - Fabric	60	19	3	96	92
Textiles - Garments	113	32	140	120	90
Textile - Machinery and Parts	-	-	-	3	-
Total	268	100	214	358	274
Net trade (imports-exports)	237	192	130	62	162
excl. machinery and parts	131	158	51	(18)	59

Source: UNCTAD .

122. **In a bold move, the authorities opened the textile sector to external competition in 2006 by removing the ban on the imports of garments and most cotton fabrics, but a number of government restrictions remain.** The production of cotton yarn remains a government monopoly and imports are prohibited, thereby increasing the risks of higher supply costs for domestic manufacturers. Synthetic and blended yarns can be imported, but fees and insurance costs must be paid to the government agency managing the production of cotton yarn.[74]

[72] However, 65 percent of the yarn produced was exported to the EU in 2004.

[73] Given the relatively small level of textile exports to the EU out of Syria's total exports (about 3 percent), the country could only be marginally affected by the removal of the quotas under the Multi-Fiber Agreement.

[74] The agency states that the authorities have requested since 2004 that yarn be sold at the world price level (the agency is also pressured in this respect by lower synthetic-based material prices, an apparent increase in informal imports, and the emergence of private micro-producers).

D. Policy Recommendations

123. **The period ahead constitutes a challenge for the competitiveness of Syria's textile sector.** The removal of a key protection for the local industry (i.e., the ban on imports of garments and some fabric) should, in principle, encourage local companies to reduce their costs to be competitive. This is likely to affect primarily the less efficient government-owned companies. For the private sector, the response is still uncertain as discussed above, but a positive scenario is conceivable. Because of their comparative advantage, the most profitable companies may shift against increasing competition in the local market to products for which their marginal costs are the lowest and their external competitiveness the highest. This is likely to include the niche products exported to Arab markets. But, given low labor costs, direct domestic access to cotton varieties, and the long-standing manufacturing tradition in this sector, the industry might be able, during this process, to gain shares on other markets.

124. **A number of supportive measures could turn these challenges into an opportunity for the textile sector to become a main source of non-oil exports.**

- In the short run, it is critical that the prices of ginned cotton and yarn, which are still subject to public monopolies, truly reflect world prices to level off domestic and external competition.

- In the near to medium term, the ban on cotton imports, as well as marketing obligations to local suppliers, should be removed to improve supply choices and cost effectiveness. For the same reasons, the monopoly on the production of yarns and the related ban on imports would need to be rescinded, along with the administrative planning regulating the annual share of yarns that should be sold to the local market. Given that Syria produces cotton locally, the domestic production of yarns benefits from a natural advantage. Furthermore, half of the yarn is already exported, reflecting an external demand for Syrian specific yarns.[75] Syrian final goods manufacturers (fabric and garments) should be able to choose Syrian cotton and yarn only because of economic and financial reasons, such as lower costs (limited freight and insurance costs), trustworthy distribution networks, and product quality.

- The authorities would need to restructure/liquidate the non-profitable public companies to encourage a resource shift across the sector to the most profitable companies.

- The authorities' ongoing efforts to improve the business environment and reduce red tape would need to be strengthened to boost the industry's competitiveness.

[75] The CMO has indicated that they could withstand the implications of lifting the ban on cotton imports and the removal of the domestic supply obligations as they are confident the sector is competitive.

125. The above measures will enhance the synergies between the cotton and textile sector and could turn Syria into a cotton producer as well as a textile exporter. Cotton producing countries can be separated in two groups: producers with high labor costs and no local manufacturing industry (the United States and Australia); and producers with low labor costs allowing for the concomitant development of a local exporting industry (China, Bangladesh, and Turkey). Syria has been so far a relatively low exporter, notwithstanding its attractive labor costs. It has the potential to move to the second, fast-developing model.