Economic Challenges and Reform Options for Syria: A Growth Diagnostics Report (CEM, First Phase)

The World Bank in cooperation with the National Team, Syria

Preliminary and Incomplete

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1. Executive Summary

A. Objectives and Approach

The objective of this report is to identify the major constraints to inclusive growth in Syria and to propose policy measures to address them. The report relies on data from the Government and information from international sources and employs an inclusive growth diagnostic framework to guide the assessment of the relative importance of different obstacles to sustained, high economic growth. The diagnostic analysis is eclectic in spirit. It combines (i) a growth analysis using different techniques applied to macroeconomic data as well as micro-level firm and household survey data, and (ii) cross-country benchmark comparisons to answer questions about trends, constraints to, and sources of sustainable, broad-based growth.

One of the key advantages of this approach is its ability to facilitate prioritization and sequencing of policy reforms. By identifying the most binding constraints to growth, this approach facilitates the selection – within the "policy space", or the set of all feasible policies available to a country – of those reform actions that would be expected to have the greatest impact on economic growth, *through their effect on the constraints to growth*. Policy recommendations under this approach would not follow a "cookie cutter" style; on the contrary, they would be country and context-specific.

The resulting prioritization process is guided by the notions of *feasibility and relevance* of policy reforms, and not necessarily by "international best practice" considerations.[1] The feasibility of reforms may depend on non-economic factors such as the domestic and/or international political environment and the country's implementation capacity. A potentially highly desirable reform action may not be feasible if e.g. it is a political non-starter, or if the government's implementation capacity is limited. Even if a certain reform action is feasible, however, it may not necessarily be relevant or beneficial from the point of view of removing a binding constraint – it may in fact become relevant or beneficial only after other reforms have been implemented.

Institutional capacity to formulate, implement, monitor and learn is essential for a successful inclusive growth strategy. The set of feasible policies can potentially be expanded through capacity building, thus increasing the number of tools at the Government's disposal to

[1] A "best practice" agenda is "typically based on international rankings, where all areas of policy are reviewed against a benchmark and actions are taken to move each area towards that benchmark, or prioritizing the areas that are ranked relatively worse, with no evidence of their tightness". See Hausmann, R.; B. Klinger and R. Wagner (2008), p. 91. In some instances, however, the removal of, say, a sectoral constraint may require the implementation of a "best practice"-type of reform that happens to be feasible in the context at hand. In other contexts, best practice" policy reforms is commonly understood as "Washington consensus"-type policy prescriptions which could be desirable if the country has perfect institutional capacity and a conducive political environment to implement changes quickly.

address constraints to growth**.** For example, in the case of Syria, technical assistance underway by the European Commission, UNDP and the World Bank in the area of trade policy will enhance the set of policy choices available to the Government as it addresses remaining anti-export bias and moves towards an Association Agreement with the EU and WTO membership, as well as strengthen Syria's position vis-à-vis its partners in free trade agreements already in place. In another example, ongoing capacity building in the area of Public-Private Partnerships (PPP) will enhance the Government's ability to launch PPP transactions for the power sector, thus helping relieve the infrastructure constraint discussed in the previous chapter. Despite the progress made in recent years, the Government's capacity to undertake reforms remains somewhat limited. Therefore, continued efforts at institutional strengthening in most reform areas are critical.

Syria's complex political circumstances – both from a domestic and a geopolitical perspective – also need to be taken into account in gauging its growth potential and its reform choices. Throughout this study, the internal and external political environment has been taken as given, as one of the "outer" constraints to growth in Syria. Nonetheless, the impact of political variables on growth can be roughly estimated for the period under consideration (1965 – 2008). A political instability index was devised by assigning 1 for instances of war, economic restrictions, internal revolution, and violence, and zero otherwise. Preliminary calculations show that this index has had a significant and negative impact on TFP growth in Syria.[2] This adverse relation both limits the potential for accelerated inclusive growth and constrains the policy choices available to the Government. Another political economy factor, common to many countries in the MENA region, is the tendency of the dominant segments of the private sector to resist change and defend the status quo.[3] These segments of the private sector benefit from privileged relations with the State apparatus and from distortionary policies. As a result, the domestic demand for reforms is weakened as rent-seeking behavior becomes widespread.

Such political economy considerations help explain the Syrian Government decision to gradually transition to a social market economy. It should be noted that the policy and institutional changes discussed in this report may have an impact – albeit possibly moderate – on the distribution of resources in the society.[4] Therefore, the pace of reforms has to carefully weigh the risks of social dislocation, particularly given the fragile and uncertain geopolitical context as well as Syria's goal of preserving social peace and political stability. Adding to that the fact that many of Syria's economic institutions are at an incipient stage, it can be argued that under

[2] See Syria Trust for Development (2010). "Sources of Growth in Syria: 1965-2008". Background paper for this CEM.

[3] World Bank (2009). *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa*.

[4] "Different institutions will be associated not only with different degrees of efficiency and potential for economic growth, but also with different distributions of the gains across different individuals and social groups", in Acemoglu, D. (2010). "Growth and Institutions", in Durlauf, S. and L. Blume (eds.) (2010). *Economic Growth*. The New Palgrave Economics Collection. London: Macmillan, p. 113.

current circumstances the sustainability of the reform process will require a certain degree of gradualism.[5]

It is important to stress that the implementability of the policy reforms discussed in this report will depend crucially on Syria's vision as to the role of the State going forward in a number of economic domains. These domains include the potential role of the State as a producer, regulator, exporter, importer, lender and borrower. For example, the public sector's capital stock is larger than the private sector's, but the private sector GDP is considerably larger than the public sector GDP. This reflects a misallocation of resources (especially misallocation of financing) that is perpetuated by existing policies and institutional arrangements.

B. Economic Reforms and Growth Performance

Over the past decade, Syria has made substantial progress in transforming its economy. While the oil sector contracted, non-oil GDP growth was positive and strong throughout the 2000s, raising the share of non-oil GDP in total output to nearly 90 percent in 2009 from 70 percent in 2000. The role of the private sector in trade and output grew significantly. The private sector's share in total trade doubled since 2003 and represented 140 percent of public sector exports (including oil) in 2007. Concurrently, the importance of services and urban activities grew, while that of agriculture declined. The service sector's share in value added rose from 41.9% in 2000 to 55.5% in 2008, as the sector accounted for 84 percent of the growth registered during the 2000s, mainly as a result of strong growth in commerce, financial and insurance services, personal and social services, and government services. Along with growth of the tertiary sector, the fraction of urban population rose from 51.6% in 2000 to 54.2% in 2008.

This process of transformation away from oil dependence and public sector dominance towards a more diversified, private-sector driven production base was achieved through gradual market-oriented reforms. These reforms have been implemented by the Government since the early 1990s, but with increased intensity since the Tenth Five-Year Plan was approved in 2006. Box 1 below summarizes the key reforms implemented by the Syrian Government. As a result, growth volatility reduced markedly, per capita incomes registered sustained increases, and Syria's export basket became increasingly diverse, while private sector productivity surged. On the demand side, growth in the 2000s was driven by increases in private consumption, followed by investment and government spending. On the supply side, the analysis underscores the role of productivity as a driver of growth. Labor productivity increased in services and agriculture, with the secondary sector registering a decline in the amount of output per worker. However, the

[5] John McMillan highlighted the risks associated with a "shock therapy" approach in conditions of uncertainty: "Reform is hard to do because we cannot predict its effects. The big-bang approach presumes we know where we are going and how to get there. We may know where we should be headed, but there is much we do not know about how to get there. No recipe for success has yet been written. *Acknowledging our ignorance means moving step by step rather than betting everything on a comprehensive blueprint*". McMillan, J. (2004). *Avoid Hubris and Other Lessons for Reformers*. Center on Democracy, Development, and the Rule of Law (CDDRL) Working Papers. Stanford Institute for International Studies, June 12, p. 5, emphasis added.

contraction in the secondary sector was mainly influenced by developments in the oil, electricity and water sectors, whereas labor productivity in manufacturing rose by 0.4% per year.

Box 1: Key Policy Reform Initiatives Since 2000

Private Sector Development and Business Environment

(a) A new Investment Law streamlined the incentives system, allowed repatriation of profits, and put foreign and domestic investors at par. (b) An Investment Authority was established to regulate investment, oversee the improvement of the investment climate, and promote investment in Syria. It will operate a one-stop-shop service to facilitate business start ups. (c) Companies' and Competition Laws are being prepared. For instance, since 2010, the new Companies' Law allows for the establishment of leasing companies. (d) Education and media sectors were opened to the private sector. Privately operated universities, newspapers, and broadcasting agencies have been established. (e) Efforts are being made in building the regulatory frameworks to govern the new market economy, most notably in the financial and insurance markets, and in housing and real estate. (f) The incumbent state owned firm in the telecommunication sector was corporatized and the existing mobile contracts were transformed into licenses. At the same time, the government opened the sector to foreign competition auctioning a third mobile services license to foreign private investors.

Financial Sector

(a) Laws were promulgated opening the banking sector and insurance market to private sector and allowing Islamic banking. Several private banks, Islamic banks, and insurance companies were licensed, and started operations. These banks are mainly subsidiaries of regional banks, although the majority of ownership is held by Syrian investors. (b) Laws were passed giving greater managerial authority to four of the six public banks. (c) A Council of Currency and Credit was formed to assist the monetary and exchange rate policy. (d) A Capital Market Authority was set up, and the Damascus Securities Exchange was opened in March 2009. (e) A Loan Guarantee Scheme is being established as a corporate entity with assistance from the EU. (f) The limit of foreign ownership in the banking sector was increased in 2010 to 60 percent allowing majority share holding for foreigners (g) A Presidential Decree was issued in 2010 to enable the establishment of a development bank to extend medium to long term investment credit.

Public Finance

(a) Income Tax Law was amended a number of times to reduce the rates and simplify administration. (b) Tax administration was significantly improved. A large taxpayers unit was opened. (c) A new consumption tax was introduced replacing the old one. The new tax broadened the tax base and changed the rate structure. (d) A new vehicle duty and an environmental protection tax on vehicles were introduced. (e) A Basic Public Financial Management Law was approved to improve public finance management. It unifies the budget by bringing the investment budget under the purview of the Ministry of Finance. (f) Relative autonomy was given to the public enterprises including borrowing from the banking sector, engaging in joint ventures with the private sector, contracting management teams, and the right to keep their operational surpluses. (g) A VAT is in an advanced stage of preparation, and expected to be implemented in 2011. (h) Reforming the social safety net system is being discussed and a program to phase out petroleum subsidies was launched in May 2008.

Trade and the Exchange Rate

(a) Tariffs of some inputs were reduced and the maximum rate was decreased from 255 percent to 50 percent. (b) A number of NTBs were eliminated. The number of products on the "negative list" was substantially reduced and the remaining products on the list were published. (c) A new Customs Law was adopted in 2006 allowing for further automation and streamlining of customs procedures, including implementation of ASYCUDA. (d) An Export Development and Promotion Agency was established in 2009. (e) To combat under-invoicing of imports two decrees were issued to allow the customs department to purchase imported goods at invoice prices, and to require importers to open letters of credit through domestic banks. (f) Application was made for WTO membership in 2001. FTAs were signed with Turkey (in 2007) and 16 Arab countries (GAFTA, in 2005). The Syria-EU Association Agreement was initialed at the end of 2008. Turkey, Lebanon, Jordan and Syria agreed in June 2010 to set up a free trade zone, complete with a visa-free travel regime for their nationals. In addition, Syria has formally begun negotiating a free-trade agreement with South America's powerful Mercosur trade bloc, following the signing of a framework agreement in December 2010. (g) The foreign exchange market was opened to the private sector. (h) Exchange rate has been effectively unified and restrictions on access to foreign exchange to finance imports eliminated.

The process of transition, however, is far from over; Syria faces serious economic challenges. Syria's per capita income lags behind those of many developing countries and its share in global exports has eroded gradually since 2001. In per capita terms, Syria's real GDP growth was just 2.5% per year in the period 2000-08 – slightly lower than the average of the Middle East and North Africa region (2.7%), below that of the middle income countries (MICs) (4.9%), and much below that of the lower middle income countries (LMICs) (6.7%). Many developing countries grew at rapid rates during the past twenty years as they expanded their exports at rates unseen in prior decades. Syria, however, was not able to keep up with other countries' efforts to augment its share in global markets and to diversify into sophisticated products with high technological content.

Most importantly, growth has not been inclusive. Job creation has been weak, while unemployment remains high (above 10%) and has stabilized in recent years largely as a result of decreasing participation rates – especially among women. Poverty rates have increased from 11% in 2004 to 12.3% in 2007 (lower poverty line), with a rural poverty rate twice as high as that in urban areas. And while the poverty rate is not very high, approximately 19 percent of the population is vulnerable to falling below the poverty line in the event of negative shocks to the economy.

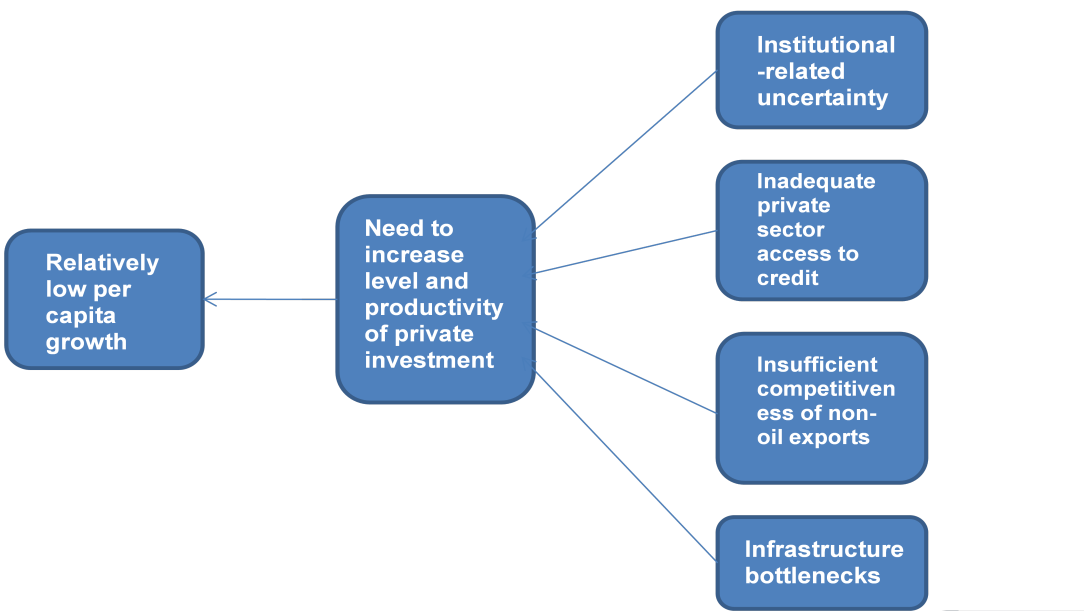
C. Main Constraints to Private Investment and Growth in Syria

The starting point for the analysis in this report is that the key macroeconomic variable requiring a major performance boost is private investment. Syria's domestic saving rate is in line with expectations for its income level and the banking system is liquid, implying that a lack

of loanable funds is not an issue. International benchmarking suggests that at about 20% of GDP, the Syrian saving rate is in line with what one would expect given Syria's income level. The lack of loanable funds in the financial system should thus not be an issue. On the other hand, investment rates – particularly from the private sector - have remained low by international standards and below the level necessary to achieve a boost in capacity, and sustained increases in per capita income, employment and poverty reduction. This result is also consistent with the growth accounting exercise conducted in this report, which shows a somewhat disappointing contribution of capital accumulation to GDP growth over the past decade.

Private investment in Syria seems to be particularly affected by "structural" institutional uncertainties, inadequate access to credit, limited export competitiveness, and infrastructure bottlenecks mainly related to electricity (Figure 1). As such, these bottlenecks deter private investment and prevent the Syrian economy from generating capacity growth at the levels needed to achieve sustained improvements in living standards.[6] While this report does not neglect the fact that investment quality and efficiency are crucial for investment to translate into economic growth, the experience in other developing countries has shown that a substantial broadening of the capital base is a necessary condition for sustained economic growth and diversification at early stages of development.

Figure 1: Constraints to growth



Source: Authors

[6] This report does not neglect the fact that sustaining growth over the long term also requires well-designed public investments and institutional reforms to improve human capital and increase TFP.

"Structural" uncertainty associated with the institutional setup **introduces "noise" in firms' risk-return calculations, and as such it is a powerful deterrent to private investment, especially by SMEs**. Corruption, an uneven application of rules, and a weak legal system lead to uncertainty in the business environment and act a deterrent to private investments. Not only do weak institutions create transaction costs that reduce firms' expected rates of return, they also complicate the formation of expectations concerning such rates. As a result, it makes more sense for firms to refrain from investing until the source of uncertainty is eliminated. The uneven application of rules and regulations is detrimental especially for private SMEs which are far more likely to have to rely on informal payments in dealing with these problems in their every-day business practices.

World Bank enterprise surveys conducted in MENA countries have consistently identified institutional factors as a leading constraint to doing business. While this is a widespread problem in MENA, Syria is ranked poorly vis-à-vis other MENA countries in items such as days spent by firms in inspections or required meetings with officials; firms' senior management time spent dealing with regulations; inspections in which an informal payment is requested or expected; and perception of corruption.

Inadequate access to credit by the private sector **perpetuates the disconnect between capital accumulation and output of the public and private sectors.** Despite a series of ambitious financial sector reforms, the financial sector remains underdeveloped and unable to satisfactorily meet its basic function of allocating efficiently capital in the economy. The share of private deposits is on the rise, but lending benefits mostly public sector entities. Little credit is reaching private firms although these are shown to be more productive and private investment is more efficient. This arises from a number of features of the Syrian economy and its financial system. Most companies are very small in Syria. It is difficult to appraise these companies for lending purposes because they are unfamiliar with good account practices or their financial statements are not transparent. Also, financial instruments offered by the banks are limited; medium to longer term financing for investment is negligible, dedicated credit and loan guarantee schemes do not exist. An adverse selection problem seems to be at play with deposits, including private ones, mostly channeled to the public sector because the latter in general offer better risk assessment, repayment guarantees and monitoring possibilities. But the problem of misallocation is also the result of deeper anomalies in the structure of the financial sector in Syria, and in the relationship between the latter and the "real" sector.

Insufficient export competitiveness **reduces the potential market size for Syria's non-oil products in international markets and prevents the country from benefiting more from demand externalities.** This continues to be an issue substantial despite marked improvements in recent years. Numerous and complex tariffs and taxes complicate implementation, increase administrative costs, and invite corruption. Importers pay an average of 30% of the value of their imported goods in tariffs and other border charges - a cost that harms especially exporters who are not reimbursed when importing inputs and capital goods used in the production of exports.

And, effectively no export incentive system is in place to offset these costs and address these constraints. Custom administration is inefficient and costly, while export credit and promotion services are in their early stages of development. Other essential trade facilitation services, such as support for meeting safety and health standards required by importing countries, are not available. Furthermore, foreign exchange needs have been increasing at a breakneck pace over the past few years, but Syria's private sector banks clearly do not have sufficient foreign exchange to meet the demands from private traders.

Infrastructure bottlenecks **affect both firms' ability to expand the capacity of their operations and to fully utilize already installed capacity.** These bottlenecks will need to be addressed by using a combination of institutional reforms and a set of well-designed, targeted infrastructure investments. At present, more than half of Syria's firms regard electricity as a major constraint to business growth. Power outages are frequent and private generators common. Such outages do not allow full utilization of existing capital stock even if there is enough aggregate demand in the economy. While the most urgent infrastructure needs are in the power sector, the economic costs from deficiencies in other types of infrastructure are high as well.

D. Reform Priorities

The potential policy choices discussed below are directly related to the constraints to inclusive growth identified in this report and reflect the general considerations outlined above. This discussion is preliminary and additional analysis at the sectoral level as well as of political economy issues would be required to refine the policy implications presented here. The annex displays an indicative policy matrix which contains specific and concrete measures to address the four binding constraints to inclusive growth in Syria.

D.1. Strengthening the Institutional Environment

This report proposes a two-track approach to deal with growth-hampering uncertainty associated with the institutional setup. The first set of measures are intended to simplify compliance, increase transparency and reduce uncertainty with respect to the legal and regulatory framework, while the second one will strengthen the legal and regulatory framework for doing business. There is an urgent need to establish a systematic process for dialogue between Government and the business community in order to improve reform quality, strengthen implementation, establish a problem-solving mechanism, enhance information exchange and policy coordination, as well as deepen the credibility of the government with investors. The application of the Competition Law and the accelerated implementation of the Government's Governance and Anti-Corruption Program are also urgently needed. In the medium-term, the priorities include the establishment of a legal, regulatory and institutional framework that opens competitive segments to private investment as well as strengthening the capacity for the implementation of the Competition Law.

D.2. *Improving Credit Allocation*

Policies to address the credit access bottleneck should focus on both the supply and demand sides of credit, while paying due attention to financial stability. In the short-term, financial intermediation can be strengthened by addressing the most pressing information asymmetries. The adverse selection problem can be mitigated by establishing a well-functioning credit registry and strengthening legal rights related to credit transactions through a new Collateral Law and a specialized commercial court. Furthermore, access to finance by SMEs can be increased through training bank officials how to perform risk assessment of small enterprises; creation of a legal framework for microfinance banks; and establishment of a loan guarantee scheme that reduces the risk perceived by lenders in serving the small enterprise sector.

On the demand side, a key short-term priority would be to enhance SMEs' financial management capabilities. Lack of accounting and auditing systems, primitive record keeping, poor transparency, weak governance systems, as well as insufficient managerial and technical capabilities within the private sector – particularly for SMEs – are critical constraints. These issues contribute to the adverse selection problem diagnosed in the report. In addition, it is key to strengthen the supply side of the financial sector by continuing to encourage entry of foreign and domestic private banks.

Another urgent priority is the completion, approval and enactment of the Central Bank Law, which has been awaiting approval for a while. Eventually, the objective should be to phase out administrative monetary policy tools and replace them with market-based tools such as marketable Treasury Bills, and strengthen the regulatory and supervisory capacity of the Central Bank of Syria (CBS). The Government recently decided to issue an initial batch of SP5bn (US$108m) of Treasury Bills, starting on December 13th. The initial issuance includes two lots of SP1bn each, one of three-month maturity and the other with a six-month maturity.

In the medium term, financial intermediation and credit allocation can improve sustainably only if Syria's financial sector reforms are substantially deepened in a fashion consistent with the recommendations of the joint World Bank-IMF FSAP conducted in 2008. The restructuring of the state banking system in a coherent and well sequenced manner is critical for increasing financial sector efficiency and reducing the accumulation of implicit liabilities with potentially large fiscal costs for the Syrian Government. In this context, the restructuring of the state banking system can fully succeed only if a roadmap for complementary reforms is also designed for the parastatal sector. The public banks are still heavily engaged in directed lending to state-owned enterprises (SOEs) at subsidized rates. Therefore, a closer look at key public sector issues is recommended, focusing on reviewing the functions of SOEs; assessing the efficiency of resource utilization by SOEs and their overall productivity levels; quantifying their net impact on the state budget; and evaluating their role as employers and as an implicit social safety net.

D.3. *Strengthening Syria's Competitiveness in Export Markets*

Policies aimed at simplifying the import regime, establishing an effective export incentive system and improving trade facilitation will help reduce the existing anti-export bias. Nuisance rates (below 5%) should be either eliminated entirely or increased to 5% or more, with a view to minimizing revenue losses, while other taxes and charges on imports should be eliminated and replaced with an appropriately adjusted VAT rate, excise taxes, and a few service charges also in a way to avoid revenue loss.

The trade legislation will need to be amended to introduce key export incentive instruments used worldwide, including but not limited to different types of duty and tax drawback instruments and export processing zones. Measures should be taken to maximize the contribution of the free zone system to the local economy including reducing excessive fiscal incentives but improving infrastructure services, and lifting restrictions on purchases from local suppliers to strengthen backward linkages. It is critically important to develop the right administrative framework and adequate staff capacity to effectively implement the proposed incentive measures.

An effective system of trade facilitation arrangements would reduce costs and improve the competitiveness of Syrian exports. "Quick wins" that could be implemented in the short-run include further strengthening of customs administration, and accelerating the ongoing program for restructuring the standards framework to be compatible with international norms. Strengthening of Syria's export credit system must also be a priority.

D.4. *Eliminating Key Infrastructure Bottlenecks*

Infrastructure-related institutional reforms are needed in order to prepare the ground for an effective and sustainable program of infrastructure investments. Some of these reforms are underway and should be completed soon as a matter of urgent priority. They include the implementation of the recently approved Electricity Law; the enactment of the new PPP legislation; and strengthening the capacity of the Central PPP Unit (CPPPU) established in the Prime Minister office to coordinate the PPP program implementation. Other institutional reforms are equally important but may be implemented in a second round, including the introduction of gradual adjustments in electricity tariff structure and levels to achieve cost recovery over a transitional period and restructuring of transport agencies.

Key additional investments and better capacity utilization are central to meeting Syria's energy needs. Particular attention needs to be paid to: (i) a more efficient utilization of existing capacity, reducing large technical and commercial losses; (ii) further capacity expansion of the power sector, thus enhancing security of electricity supply and reducing power outages; (iii) regional energy integration through a series of targeted investments in electric power and natural

gas; and (iv) the development of wind power plants and solar power through implementation of a renewable energy development program.

Addressing the infrastructure needs of other service sectors is also important. The share of the transport sector in GDP has been declining from 10% in 2002 to 7% at present. However, the economy is expected to grow more in sectors with high transport intensity – such as international and transit trade and tourism. In this context, the declining trend reported above needs to be reversed through appropriate investments in the transport sector. Export and transit trade are expected to be among the key objectives of the Government's transport strategy as part of the upcoming 11th Five Year Plan. Other focus areas include improving connectivity of new agricultural production areas, road maintenance and network asset management, road safety and urban public transport. Irrigation investments are also critical especially in light of the massive supply shock represented by the long-lasting drought affecting the region. The Government is implementing an Irrigation Modernization Program (IMP) which aims to facilitate the adoption of modern irrigation techniques on most irrigated lands within the next 10 years.

E. Inclusive growth and domestic markets

A third of Syria's population falls below the upper poverty line, while more than 12 percent fall below the lower poverty line, according to a 2007 household survey. There is thus substantial potential in strengthening domestic markets and demand by taking measures to ensure that growth is more inclusive than hitherto. This report proposes a *private investment-led growth strategy*, founded on the increased access to markets, both domestic and external, and on expanded productive capacity, through sustainable investments in infrastructure and the removal of costly barriers to entry of new private sector producers, particularly SMEs.

On the demand side, lifting people out of poverty is a sure way to strengthen domestic markets. In Syria, 12.3% of the population lives below the lower poverty line and 33.6% of the population lives below the upper poverty line. The challenge is to accomplish this in a sustainable manner, without unduly distorting incentives for enhanced private investment and negative implications for the Government's fiscal stance. The implementation of an inclusive growth strategy would enhance domestic incomes and strengthen domestic demand without necessarily requiring strong redistributive policies. This is because the proposed private-sector led, inclusive growth strategy aims to tackle demand-side bottlenecks to job creation and returns to employment and self-employment.

This does not mean that the Government should wait passively for inclusive growth to have an impact in order to address pressing social welfare and distributional issues. Choices in terms of the composition of public spending can play an important role in augmenting social welfare without distorting incentives or being fiscally unsustainable. In particular, public spending on education and health could enhance Syria's *long-term* growth prospects by building up the country's human capital. The Bank is currently working with the Ministry of Finance of Syria in the preparation of a policy note - part of a Public Expenditure Review - which will

analyze the impact of changes in the composition of public spending on key welfare variables. Furthermore, the ongoing phasing out of petroleum price subsidies that have an overall distributionally regressive effect also contributes to inclusiveness. Finally, strengthened social protection programs – including well-targeted cash transfer mechanisms – are critically important to shield the most vulnerable individuals from exogenous shocks and temporary adverse effects of policy reforms.

Policies aimed at enhancing productive employment and removing constraints to private-led (especially SME and service sector) growth can also promote a strong domestic supply response. On the supply side, domestic markets can be strengthened by increasing the opportunities for productive use of Syria's endowment of factors of production. The constraints identified in this report prevent a fuller and more productive utilization. As noted before, these constraints are especially deleterious to those groups – the poor, the underemployed, the non-politically-connected entrepreneurs – which are not fully integrated into the Syrian economy, and thus with great potential to contribute more to accelerated future growth, both as consumers and producers.

Finally, it should be stressed that promoting the development of non-oil exports is by no means inconsistent with the strengthening of domestic markets – on both the demand and supply sides. In the face of declining oil production and exports, expansion and diversification of non-oil exports is essential, because it (a) ensures a steady inflow of foreign exchange earnings to finance the imports of the necessary capital goods, intermediate products, and other inputs necessary for the growth of investment and production, (b) creates markets for expanding non-oil production, and (c) generates employment, thus contributing to inclusive growth.

Policy Matrix: Prioritizing Policy Reforms for Addressing the Main Constraints to Growth

<table>
<tr><td colspan="2">Central theme: Sustained, inclusive growth and diversification of the Syrian economy away from the oil sector will depend on the success of the government in removing the main constraints on investment (size, quality, and sector in which it is made) and full and effective utilization of productive capacity. Four of these constraints are particularly important:

1. Institutional weaknesses and risks: They create uncertainty and discourage both domestic and foreign investment.
2. Inadequate access of the private sector to credit -- for working capital and particularly investment credit. This adversely affects both investment and utilization of productive capacity.
3. Lack of competitiveness of non-oil products in international markets. The adverse effect of this is both on investment (and subsector in which it is made) and utilization of productive capacity
4. Availability and quality of infrastructure services (power in particular). Infrastructure bottlenecks such as e.g., power shortages do not allow full utilization of existing capital stock even if there is enough aggregate demand in the economy.</td></tr>
<tr><th>Growth Diagnostics: Key constraints to inclusive growth</th><th>Policy reforms for addressing constraints</th></tr>
<tr><td>“Structural” uncertainty associated with the institutional setup

The uneven application of rules and regulations, and related opportunities for corruption, deters private investment as it makes it difficult to assess expected returns and also lowers private returns. Firms that are uncertain about the appropriability of potential returns will refrain from taking the risk of financing their investment through medium to long term credit arrangements. The uneven application of rules and regulations is detrimental especially for private SMEs which are far more likely to have to rely on informal payments in their every-day business practices.</td><td>I. Simplifying compliance, increasing transparency and reducing uncertainty with respect to legal and regulatory framework

<u>Urgent Priority</u>
Establishment of a systematic process for dialogue between Government and the business community, to improve reform quality, strengthen implementation, establish a problem-solving mechanism, enhance information exchange, better coordinate policy decisions with new investment opportunities, and deepen Government credibility with investors.
Application of the Competition Law as a platform to raise awareness, advocate pro-competitive policies and address explicit anti-competitive behaviors.
Strengthen capacity of the Competition Authority to effectively monitor and dissemble monopolies.
Accelerate implementation of the</td></tr>
</table>

	Government's Governance & Anti-Corruption Program. **II. Strengthening the legal and regulatory framework for doing business** Medium-Term Priority[7] • Establishment of a legal, regulatory and institutional framework that opens competitive segments to private investment. • Strengthening of capacity for the implementation of the Competition Law.
***Inadequate Access of Private Sector to Credit*:** The public sector's capital stock is larger than the private sector's, but the private sector GDP is considerably larger than the public sector GDP. Obviously, this is an issue of productivity differentials, which seems to be corroborated by the TFP decomposition exercises as well as by the productivity calculations in the ICA. The disconnect between capital accumulation and output between the public and private sector seems to be perpetuated by credit misallocation in the financial sector: The share of private deposits is on the rise, but lending benefits mostly public sector entities. This seems to reflect mostly an adverse selection problem as deposits (including private ones) re mostly channeled to the public sector because the latter in general offer better risk assessment, repayment guarantees and monitoring possibilities. • This stems largely from the following characteristics of the financial sector in Syria: o The financial system is too small because private banks have not yet moved from Paris and Beirut to Syria, Syrian economy is a	**I. Improving financial intermediation and allocation of financial resources** Urgent Priority • Reduction of the adverse selection problem by (i) establishing a well-functioning credit registry; and (ii) strengthening legal rights relating to credit transactions through a new Collateral Law and a specialized commercial court. • Increased SME access to finance through: (i) training for bank officials in risk assessment for small enterprises; (ii) assisting SMEs to improve their accounting and book keeping practices to facilitate accurate credit risk assessment, (iii) creation of a legal framework for microfinance banks; and (iv) establishment of a loan guarantee scheme that reduces the risk perceived by lenders in serving the small enterprise sector. Medium-Term Priority • Restructuring of the state banking system in a coherent and well sequenced manner,

[7] Detailed recommendations on the strengthening of the legal and regulatory framework are included in the Draft Investment Climate Assessment report.

cash-based economy and the banking system is not used unless absolutely necessary, use of checks, credit cards and ATM cards not widespread. o The main financial instrument offered by the Banks is short-term credit. Medium-term investment credit is negligible. Other instruments (dedicated credit, insurance, guarantees) are also negligible. o Financial infrastructure is not developed, system is inefficient and costly. Inter-bank market does not exist, TB market does not exist, account settlement and payment system are outdated, modern accounting and auditing systems are missing. • While large firms with long standing relationships with Syria's banks are granted credit (larger firms also have access to finance from foreign entities) , stricter terms for private SME's, and especially new entrants, often deter their applications for financing. Consequently, while credit volumes grew strongly during the past five years, a large share is still channeled into public sector and the largest private sector firms. Little credit is reaching the existing and emerging SMEs which may be more efficient and better positioned to create employment.	drawing on the results of independent audits. • Strengthening the supply side of the financial sector by continuing to encourage entry of foreign and domestic private banks. **II. Enhancing SMEs management capabilities, including on financial management** <u>Urgent Priority</u> • Expansion of training efforts to improve financial management, accounting, and business planning among SMEs. **III. Enhancing Central Bank independence and the effectiveness of monetary policy tools** <u>Urgent Priority</u> • Completion, approval and enactment of the Central Bank Law. <u>Medium-Term Priority</u> • Phasing out of administrative monetary policy tools, replacing them with market-based tools such as Treasury Bills, to be issued on a regular basis. **IV. Strengthening bank supervision to preserve financial stability** <u>Medium-Term Priority</u> • Strengthening of the regulatory and supervisory capacity of the Central Bank of Syria.

Insufficient competitiveness of non-oil products in international markets
 	
In the face of declining oil production and exports, expansion and diversification of non-oil exports is essential, because it (a) ensures a steady inflow of foreign exchange earnings to finance the imports of the necessary capital goods, intermediate products, and other inputs necessary for the growth of investment and production, (b) creates additional markets for expanding non-oil production, and (c) generates employment contributing to inclusive growth.
 	
The Syrian trade regime has been improved in recent years. Non-oil exports have responded positively to these reforms. However, much more need to be done to deepen the trade reforms and maintain the growth momentum. The remaining problems in the trade regime include the following.
 	
• Too many tariff bands, numerous and complex taxes and service charges some of which are inconsistent with WTO rules, and uncertainty about the products on the "negative list" complicate the import regime, create significant degree of discretion in implementation and invite corruption, and increase administrative costs to companies including exporters. High cost of imported inputs is a tax on exports, because exporters are not reimbursed of this cost. This cost is called "anti-export bias" which is high in the case of Syria.
• There are other important barriers to exports. Some essential trade facilitation services do not exist (export credit, support for meeting safety and health standards required by importing countries), some are weak (promotional services), others are inefficient and costly (cumbersome customs administration).
• Export incentive measures, successfully
	I. Simplifying the import regime while maintaining revenue levels
	
	<u>Urgent Priority</u>
	
	• Replacement of other taxes and charges on imports with VAT and excise tax levied at the same rate on the imported and domestically produced goods, and a few service fees in such a way to avoid revenue loss.
	• Elimination of nuisance rates (making them zero or 5%) in a way to maintain the same tariff revenue.
	
	<u>Medium-Term Priority</u>
	
	• Simplification of the tariff system by reducing the number of rates to 3-4 and the maximum rate to 20-25 percent with additional excise tax on luxury goods.
	
	II. Establishing an effective export incentive system
	
	<u>Urgent Priority</u>
	
	• Revision of the Customs Law and the related legislation to introduce the following commonly used incentive instruments:
	    o Full duty and tax drawback
	    o Duty and tax exemption
	    o Manufacturing under bond
	    o Fenced and single-factory Export Processing Zones (EPZs)
	• Mobilization of technical assistance to set up an administrative mechanism to implement the above measures effectively.
	• Reform of the free zone system by: (i) eliminating domestic tax exemptions; (ii) lifting restriction on purchasing from local market; and (iii) transferring management to private sector.

implemented in many developing countries are not in place to offset these and other costs and remove these constraints. As a result, the Syrian non-oil products are unnecessarily constrained in their ability to compete in international markets for both price and quality.	**III. Enhancing trade facilitation** <u>Urgent Priority</u> • Customs administration: Continue implementation of the reforms already introduced. Emphasis should be given to implementation of the risk management system to move away physical controls for clearance, further automation of business processes to reduce the room for discretion, fully operationalizing the anti-corruption unit, introduction of one-stop shops at border crossings . • Quality and safety standards: Accelerate the ongoing program for restructuring of the standards system to be compatible with international norms. Launch campaigns to raise awareness among producers and exporters about the standards requirements in target export markets. Train producers to meet these requirements. <u>Medium-Term Priority</u> • Export credit: Explore options and institutional arrangement for expanding the funding base of the financial system, improving efficiency and reducing the costs of financial intermediation, assisting companies to improve their accounting, book keeping, and business management practices for credit assessment purposes, and introduction of dedicated financial instruments (credit for both investment and working capital, insurance, loan guarantee, etc) for exports in order to ensure timely credit to exporters at affordable prices.
Infrastructure bottlenecks, especially in the	**I. Strengthening institutional framework for**

***power sector*:** Decaying or insufficient infrastructure, particularly in the power sector, is a key constraint to growth. More than half of Syria's firms regard electricity as a major constraint to business growth; power outages are frequent and private generators common. Investments in electricity infrastructure are needed to attract investment and lower the cost of business operations. • A recent Electricity Sector Strategy Note for Syria, developed by the World Bank in cooperation with the Ministry of Electricity estimated that about US$ 11 billion of investments in new generating capacity (7,000 MW) and expansion of the transmission and distribution networks will be required through 2020. • By 2009 the transport sector of Syria accounted for about 7% of GDP, a decline from the 10% of 2002 mostly attributable to the growth of economic sectors that are less transport intensive. If current trends persist, the economy is expected to grow more in the sectors with high transport intensity – such as international and transit trade and tourism. • These financing needs of the infrastructure sector (particularly electricity) are enormous and would be an intolerable drain on the government budget, highlighting the need for a fiscally sustainable approach. • To bridge the investment gap it currently faces in infrastructure, it is key to accelerate the mobilization of private capital through Public-Private Partnerships (PPPs).	**infrastructure backbone services, particularly in the power sector** Urgent Priority • Implementation of the Electricity Law. • Enactment of the new PPP legislation. • Strengthening the capacity of the Central PPP Unit (CPPPU) established in the Prime Minister office to coordinate the PPP program implementation. Medium-Term Priority • Gradual adjustments in electricity tariff structure and levels to achieve cost recovery over a transitional period. • Restructuring of transport agencies – including through the introduction of a massive training program to address the dearth of experienced professionals in the sector – and revision of private/public investment strategies for the transport sector. **II. Carrying out essential public investments within a fiscally-sustainable approach** Urgent Priority • Strengthen planning and operational capacity at the Ministry of Electricity. • Finalize and approve an Electricity Sector Investment Master Plan.. • Sustain progress in the implementation of the ongoing electricity IPP projects (Naserieh IPP and Wind IPP). Medium-Term Priority • More efficient operation of the electricity

	networks, by reducing large technical and commercial losses. • Further capacity expansion of the power sector, thus enhancing security of electricity supply and reducing power outages. • Regional energy integration through a series of targeted investments in electric power and natural gas. In particular: (i) complete Arab Gas Pipeline (AGP) in Syria as well as gas network integration with Turkey; and (ii) explore AGP connection with Iraq. • Development of wind power plants and solar power through implementation of renewable energy development program.

2. Introduction

Syria is an economy undergoing deep transformation. This report therefore takes a dynamic perspective. More specifically, Syria has made substantial progress in transforming its economy away from oil dependence and public sector dominance towards a private-sector driven, diversified production base. The process of transformation – achieved through gradual market-oriented reforms implemented by the Government since the early 2000s – has reduced growth volatility markedly, and has translated into sustained increases in per capita incomes (Figure 2), and an increasingly diverse export basket (Figure 3). While the oil sector contracted, non-oil GDP growth was positive and strong throughout the 2000s, raising the share of non-oil GDP in total output to nearly 90 percent in 2009 from 70 percent in 2000 (Figure 4).

Syria's transition program had a slow start in the early 2000s, but gained momentum after 2004 as the objective of moving to a social market economy received broader political and social acceptance. The Tenth Five-Year Plan (TFYP) for 2006–10, prepared in 2004/05, formalized the ongoing reforms, articulated the strategic objectives of the transition, and formulated a broad roadmap for policy reforms.

The TFYP differs significantly from previous plans. It is much more of a transformational plan rather than a public investment program. It provides greater clarity on the roles of the public and private sectors in the context of a social market economy. The preparation of the TFYP involved extensive and deep consultation with various government agencies, civil society and donor stakeholders, and culminated in its ratification by the People's Assembly in early 2006. The key priorities of the TFYP include: improving the business environment for private sector led growth, re-orienting government finances both on the revenue and expenditure side, liberalizing the financial sector, and modernizing the social protection system.

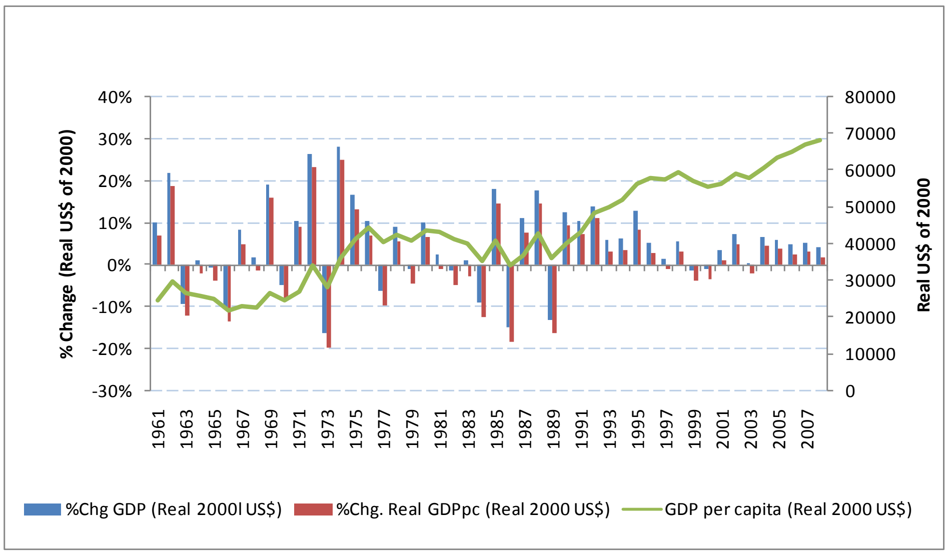
Reforms have concentrated mainly in four areas: financial sector, public finances, private sector development and business environment, and trade and the exchange rate. The key measures introduced since 2000 in these areas are summarized in Box 1. The trade policies will be reviewed in detail later in the report.

The economy performed strongly particularly since 2004. Despite declining oil production, the growth of GDP averaged 5.2 percent from 2004 to 2008 (Figure 4) compared to an average 2.7 percent achieved in the five-year period before 2004. Growing by an average of 7.3 percent during 2004-08, the non-oil sector has become the engine of growth. Growth has been broad based; all non-oil sectors, led by construction and services, registered strong growth. The private sector has played a leading role in accelerating growth thereby increasing its share in GDP from 19 percent in 2000 to 65 percent in 2007. This growth has been aided by progress in implementation of reforms, and higher demand for Syrian non-oil exports from the Gulf region associated with higher oil revenues and abundant liquidity in the region.

Economic reforms permitted a quick supply response to the influx of Iraqi refugees, particularly in housing, consumer goods, and services such as banking, health, education, and transportation. The inflow of Iraqi refugees (estimated at between 500,000 and 1 million) has contributed to higher domestic demand but also caused inflationary and fiscal pressures, primarily through higher rental prices and social expenditures. These effects could revert if security in Iraq improves significantly. The successful absorption of the large number of refugees has improved political and trade relations between the two countries. Since 2008, Iraq is estimated to be the largest single recipient of Syrian exports.

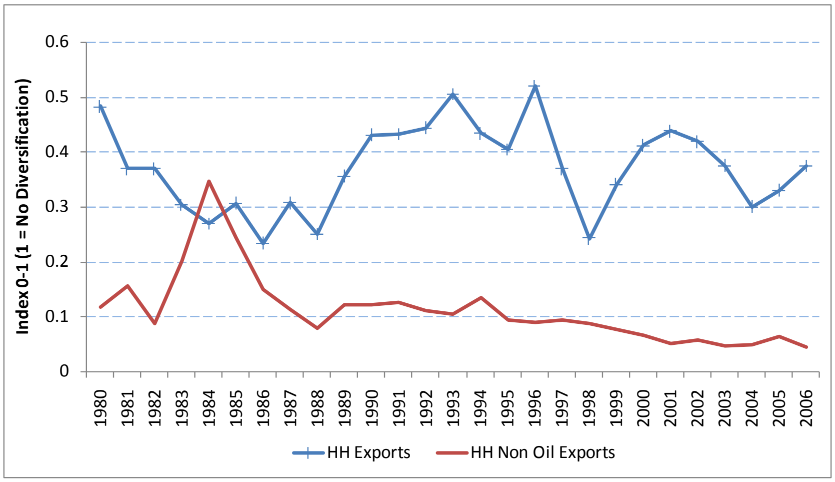
Another bright spot in the economy is the rising inflow of foreign direct investment (FDI). Starting from very low levels, FDI followed an increasing trend, reaching an estimated 3.9 percent of GDP in 2008, raising the investment to GDP ratio to 27 percent in 2008 from 23 percent in 2003. The financial sector also received FDI from the Gulf region. Domestic investment at the current level of about 23 percent of GDP is not sufficient to sustain the rate of growth achieved in the past few years. Therefore, the improvements in the investment climate will need to continue to ensure that the recent growth in FDI is maintained.

Figure 2: Economic growth in Syria



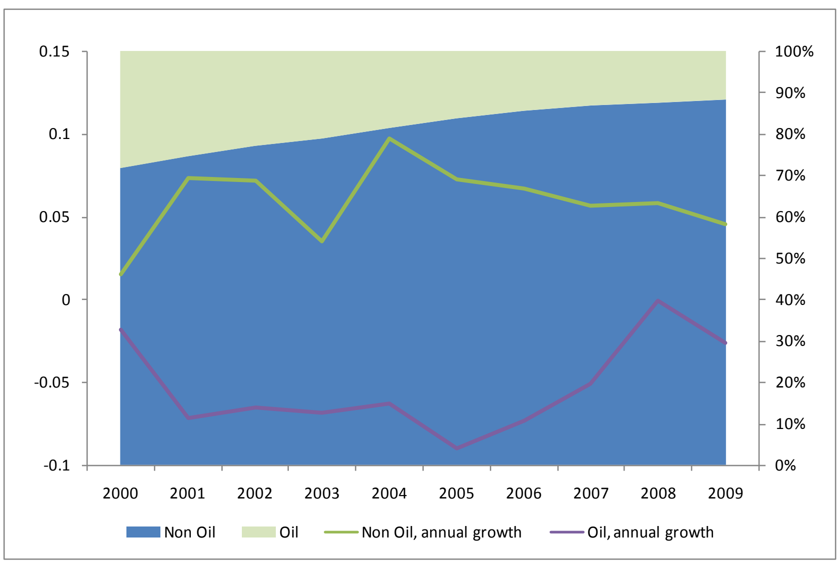
Source: World Bank, WDI

Figure 3: Export diversification: total and non-oil exports



Source: Staff calculations based on COMTRADE data

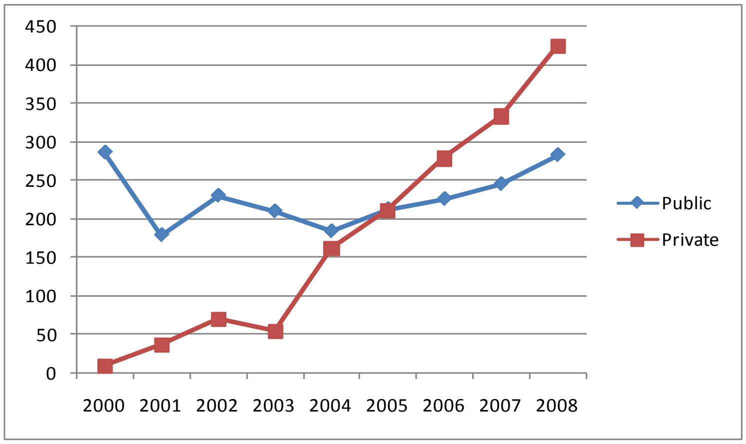
Figure 4: Oil and non-oil shares in GDP



Source: Staff calculations, based on CBS data

The private sector was the main contributor to non-oil growth. Its role in trade and output grew significantly (Figure 5). The private sector's share in total trade doubled since 2003 and represented 140 percent of public sector exports (including oil) in 2007, while the increased contribution of the private sector in output was driven by gains in private sector labor productivity (Table 1).

Figure 5: Private and public sector exports



Source: Staff calculations based on CBS data

Table 1: Decomposition of changes in per capita GDP in components (% per year) 2004-08

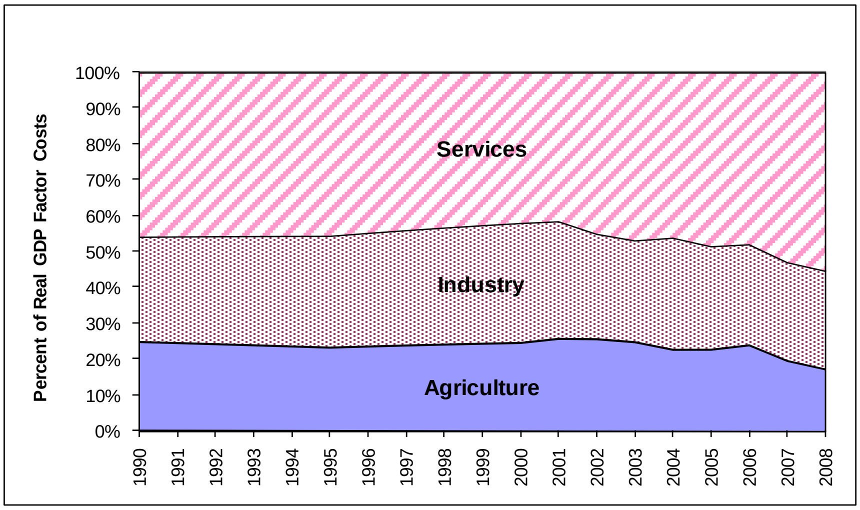
	Contributions from changes in:			
	Output per worker	**Level Employment**	**Sectoral composition of employment**	**Total**
Change in Per Capita GDP:				**2.9**
Sectoral Contribution	**2.5**	**-0.8**	**-0.2**	**1.4**
Public	0.3	-0.9	-0.2	-0.8
Private	2.2	0.1	-0.1	2.2
Participation rate				**-0.6**
Pop1564/Population				**2.0**

Source: Staff calculations based on CBS data

The importance of the service sector increased, while that of agriculture declined in the 2000s. The service sector's share in value added rose from 41.9% in 2000 to 55.5% in 2008 (Figure 6). During the same period, the share of tertiary employment rose from 42.8% to 52.8%. This sector accounted for 84 percent of the growth registered during the 2000s (Table 2), mainly as a result of strong growth in commerce, financial and insurance services, personal and social services, and government services all of which registered increases in value added at rates close to or in excess of 10% per year.[8] Along with growth of the tertiary sector, the fraction of urban population rose from 51.6% in 2000 to 54.2% in 2008.

[8] By contrast, the primary and secondary sectors accounted for just 2 percent and 14 percent of growth in the 2000s. The downturn in agriculture in the 2000s can be attributed to severe drought conditions in 2008 and the global downturn, as well as the removal of subsidies which led to surges in prices of fertilizer and diesel fuel.

Figure 6: Sectoral shares in real GDP



Source: World Bank, Development Data Platform.

Table 2: Contribution to annual GDP growth by sectors

year	1970s	1980s	1990s	2000s
Agriculture	2.8%	-0.1%	1.4%	0.1%
Mining & manufacturing	1.1%	1.4%	2.1%	0.5%
Building & construction	0.9%	-0.4%	0.2%	0.3%
Wholesale & retail trade	2.3%	-0.1%	0.5%	1.8%
Transport & communication	0.5%	0.4%	1.0%	0.5%
Finance & insurance	0.5%	-0.1%	0.2%	0.5%
Social & Personal services	0.2%	-0.1%	0.2%	0.3%
Government services	1.4%	0.1%	0.3%	1.1%
Private non-Profit services	0.0%	0.0%	0.0%	0.0%
GDP Value Added	9.8%	1.2%	5.9%	5.0%

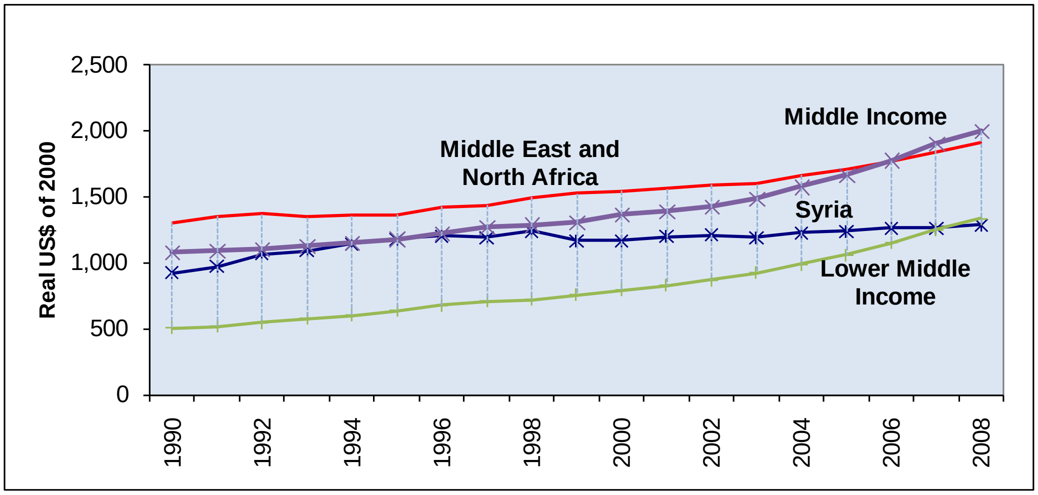
Source: Staff calculations based on CBS data

However, the process of transition is far from over and Syria faces serious economic challenges. Real GDP growth was close to 5% in the period 2000-2008, but in per capita terms translated into just 2.5% annual growth. Per capita growth was thus slightly lower than the average of the Middle East and North Africa region (2.7%), below that of the middle income countries (MICs) (4.9%), and much below that of the lower middle income countries (LMICs) (6.7%).[9] As a result, Syria's per capita income has continued to diverge from the Middle East and North Africa (MENA) and MIC averages, and now fares at levels akin to the average LMIC

[9] The lower middle income group includes China, which has grown at an annual, average rate of 8.9% between 2000 and 2008. Given China's share in the lower middle income group's GDP during the period (49.6%), the growth rate for these countries is pulled up substantially. However, even when China is excluded from the group, the average per capita growth for the group drops down to 4.5% , but remains well above that of Syria.

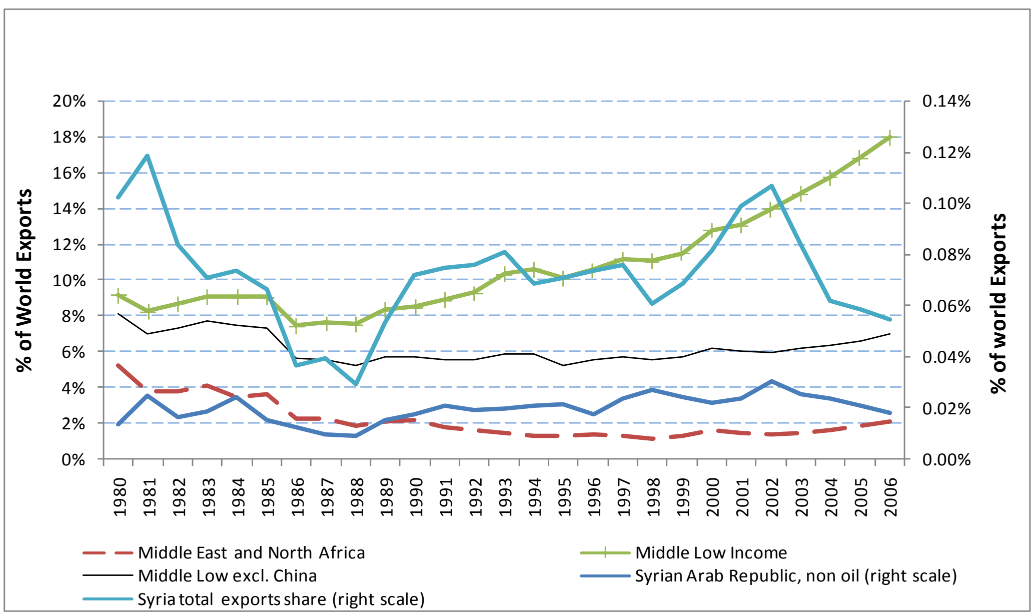
(Figure 7). Many MICs and LMICs grew at rapid rates during the past twenty years as they expanded their exports at rates unseen in prior decades. Syria however was not able to keep up with other countries' efforts to augment its share in global markets (Figure 8). The erosion of Syria's trade share has occurred gradually since 2001.

Figure 7: Real per capita GDP in USD (2000 prices)



Source: World Bank, WDI

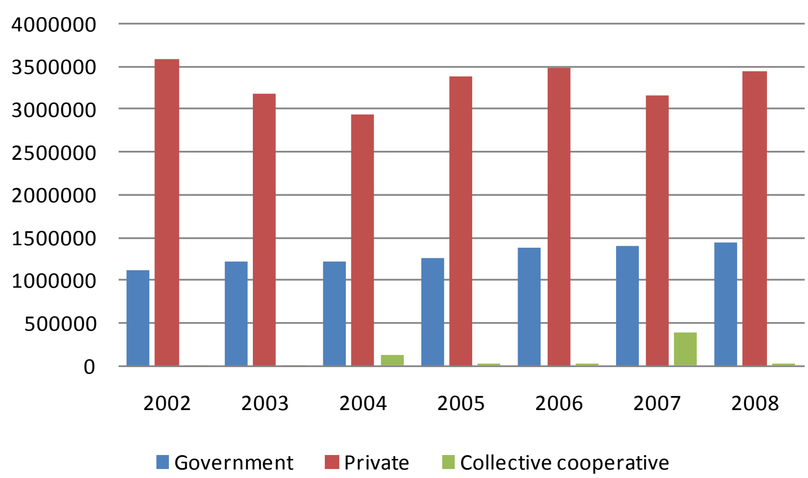
Figure 8: Shares in world exports



Source: Staff calculations based on COMTRADE data

Most importantly, growth was not inclusive.[10] Job creation has been weak (Figure 9), while unemployment remains high (above 10%) and has stabilized in recent years merely as a result of decreasing participation rates - especially among women. Poverty rates have increased from 11% in 2004 to 12.3% in 2007 (lower poverty line)[11], with a rural poverty rate twice as high as that in urban areas. And while the poverty rate is not very high, approximately 19 percent of the population is vulnerable to falling below the poverty line in the event of negative shocks to the economy.

Figure 9: Employment: government, private and collective cooperatives



Source: CBS

Syria can benefit from the higher fraction of working age population to total population in coming years if the economy manages to generate additional demand for labor and thus new employment opportunities. Under a high growth scenario, Syria could grow up to 8 percent over the next 10 years. On the other hand, even under such scenario, growth in Syria might still not be inclusive if the additional employment opportunities are not provided.

However, demographic trends embed significant social and political risks if the labor market fails to absorb the huge number of new entrants. Labor force growth in Syria was extremely high by international standards averaging 36 percent from 2000-2008. The demographic pressure on the labor market will continue as Syria's share of population between 10 and 18 years old is high by international standards accounting for 21 percent of the total

[10] Inclusiveness is defined in the present context as the ability of the economic growth process to generate higher levels of productive employment and lower levels of absolute poverty. See Ianchovichina, E. and S. Lundstrom (2010) "Inclusive Growth Analytics: Definition, framework and Practical Guidance". World Bank, Poverty Reduction and Economic Management Network (PREM) Note. April, 2010 (Draft).

[11] This assessment followed Martin Ravallion's methodology for calculating individuals' basic food needs. This methodology uses the basket of the second quintile to calculate the food poverty line. Then, the non food needs are added to calculate the lower and upper poverty lines (UNDP 2005). The national poverty lines were calculated in the UNDP report 2005, using the per capita expenditure as a welfare index.

population. Moreover, the youth unemployment rate is exceptionally high.[12] Thus, discontent among the youth is likely to increase if the economy fails to produce sufficient productive employment opportunities. This would entail substantial social and political risks. In fact, comparable demographic trends combined with the failure of markets to create sufficient productive employment opportunities have recently triggered social and political upheavals in several other countries in the region.

Given these challenges, the objective of this report is to analyze recent economic data, identify the major constraints to inclusive growth in Syria and to prepare a list of policy measures to address these constraints. A focus on inclusive growth is warranted given the objective of the government to create conditions for growth of 7 percent or more, accompanied by gains in poverty reduction, and a decline in unemployment in the coming years. The report relies on data from the Government and information from international sources and employs an inclusive growth diagnostic framework to guide the assessment of the relative importance of different obstacles to sustained, high economic growth. The diagnostic analysis is eclectic in spirit. It combines (i) a growth analysis using different techniques applied to macroeconomic data as well as micro-level firm and household survey data, and (ii) cross-country benchmark comparisons to answer questions about trends, constraints to, and sources of sustainable, broad-based growth.

The analysis shows that Syria's GDP per capita growth has been disappointing and its investment rate remains below the level necessary to achieve the sustained increases in per capita income, job creation and poverty reduction. Reforms after 2004 led to improvements in growth and efficiency, and the role of the private sector expanded. However, increases in private investment did not lead to a boost in investment rates which remain low by international standards. Key obstacles to inclusive growth in Syria are regulatory uncertainty, credit misallocation, protection rates that introduce considerable anti-export bias, and infrastructure bottlenecks mainly related to electricity.

- *"Structural" uncertainty associated with the institutional setup*: The uneven application of rules and regulations, and related corruption, deters private investment as it makes it difficult to assess expected returns and also lowers private returns. Firms that are uncertain about the appropriability of potential returns will refrain from taking the risk of financing their investment through medium to long term credit arrangements. The uneven application of rules and regulations is detrimental especially for private SMEs which are far more likely to have to rely on informal payments in their every-day business practices.

- *Inadequate private sector access to credit*: Banks, both private and public, lack the capacity to assess the risk and profitability of a broad range of potential borrowers. While public firms

[12] The MILES project indicates that the share of youth (15-29 year olds) among the unemployed was 70 percent in 2009 (down from 90 percent in 2001-2002). One year after graduation from university only 46 percent of graduates have found a job.

and private firms with long standing relationships with Syria's banks are granted credit, stricter terms for private SME's, and especially new entrants, often deter their applications for financing. Consequently, while credit volumes grew strongly during the past five years, a large share is still channeled into public firms and only the largest private sector firms. Little credit is reaching private firms although these are shown to be more productive and private investment more efficient.

- *Insufficient competitiveness of non-oil exports*: Though Syria has made significant progress in opening up its economy to imports from other countries in recent years, rates of protection are still high, the import regime is unnecessarily complicated, and an efficient export incentives system is not in place, thus preserving a substantial anti-export bias. Syria's trading costs tend to exceed those of its peers.

- *Infrastructure bottlenecks*: More than half of Syria's firms regard electricity as a major constraint to business growth; power outages are frequent and private generators common. Investment in electricity infrastructure is needed to facilitate doing business and lower the cost of business operations. Although electricity stands out as the main constraint, the economic costs from deficiencies in other types of infrastructure are high as well.

The strengthening of domestic demand is an integral part of an inclusive growth strategy. 12.3 percent of the Syrian population fall below the lower poverty line according to a 2007 household survey; a third of the population falls below the upper poverty line. There is thus substantial potential in strengthening domestic markets and demand by taking measures to ensure that growth is more inclusive than hitherto. By lifting a large share of the population out of poverty the inclusiveness objective would be aligned with the objectives of economic growth and a strengthening of domestic markets. A suitable mechanism to achieve these objectives is to provide a larger share of the population with income generating work opportunities through relaxing growth constraints and thereby generating employment. Incidentally, some of the key growth constraints we identify (credit misallocation, regulatory uncertainty) are precisely binding most severely on small firms and potential new entrants to the market. Relaxing these constraints would give better opportunities to people to be lifted out of poverty at their own strength. An additional trigger may be a shift in the composition of public spending towards one that benefits the poor more directly. However, changes in this regard have to be well thought through in order not to distort incentives.

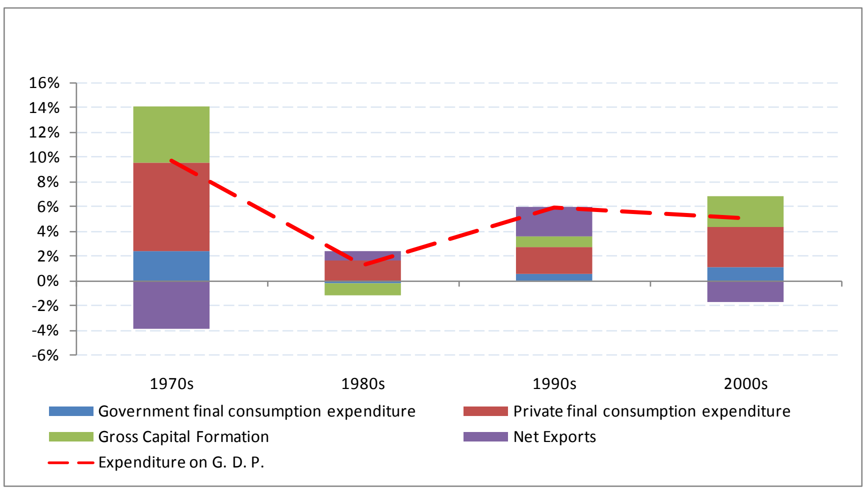
This report draws on and complements other existing and ongoing analytical work for Syria. The identified most binding constraints to inclusive growth in this report focus on factors holding back private investment. These restrict the demand for labor (job creation). Therefore, this report complements the work of the MILES project which focuses on constraints to an efficient supply of labor, e.g., due to the quality of education or a skill mismatch between the supply of education and labor market demand. This report draws on completed or ongoing analytical work which includes, but is not limited to, the 2009 Syria ICA update as well as the

recently-concluded FSAP for Syria. Moreover, it relates to ongoing analytical work on public financial management, the electricity, and the agricultural sector.

3. Sources of growth

On the demand side, growth in the 2000s was driven by increases in private consumption, followed by investment and government spending. Private consumption added 3.3 percentage points out of the 5% growth rate of the 2000s (Figure 10). Capital formation was the demand component exhibiting the fastest growth in the 2000s (10.9% per year) but given its small share in GDP, contributed just 2.5 percentage points to growth. Finally, government consumption added just over 1 percentage point of total GDP growth in the 2000s. By contrast, net exports represented a drag of 1.8 percentage points as imports of goods and services rose at a faster pace (8.9%) than exports (4% growth).

Figure 10: Contribution to GDP growth by expenditure



Source: Staff calculations, based on CBS data

On the supply side, the analysis underscores the role of productivity as a driver of growth in the 2000s. Reforms in 2004 boosted productivity growth in the period 2004-08 when it contributed 2.1 percentage points to growth, but job creation was weak (Table 3). Capital formation was driven by the private sector and accelerated at an average annual rate of 6.9 percent during the 2000s. While the private sector's capital stock grew much faster than that of the public sector, private investment ratios remain strikingly low in Syria, compared to other

countries in the region, which in turn has much lower private investment ratios than other regions in the world.[13]

Table 3: Growth accounting decomposition 2000-08

	Contributions				Relative Shares		
Period	GDP per capita Growth	Physical Capital per capita	Labor Adjusted by Skills per capita	TFP, Cobb Douglas CRS	Physical Capital per capita	Labor Adjusted by Skills per capita	TFP, Cobb Douglas CRS
2000-2003	0.3%	0.0%	-1.1%	1.4%	9.7%	-353.3%	443.6%
2004-2008	3.3%	1.3%	-0.2%	2.1%	41.0%	-6.6%	65.6%
2000-2008	1.9%	0.8%	-0.6%	1.8%	38.8%	-31.3%	92.5%

Source: Staff calculations based on CBS data

Growth in the 2000s was driven by increases in labor productivity, mainly in services and agriculture, with the secondary sector registering a contraction in the amount of output generated per worker. However, the contraction in the secondary sector was mainly influenced by developments in the oil, electricity and water sectors which contracted at rates of about 0.3% per year, with manufacturing observing an increase in output per worker of 0.4% per year during the analyzed period. This result is obtained by decomposing changes in per capita GDP into changes in average product of labor, employment and demographic dynamics using a Shapley decomposition (Table 4).[14]

Table 4: Contribution of components to changes in per capita GDP (in % ppts per year, 2000-08)

	Contributions from changes in:			
	Output per worker	Level Employment	Sectoral composition of employment	Total
Change in Per Capita GDP:				**2.5**
Sectoral Contribution	**2.2**	**-0.8**	**0.3**	**1.6**
Agriculture	1.2	-1.9	0.1	-0.6
Mining & manufacturing	-0.7	0.2	0.2	-0.3
-Extractive industries	-0.3	0.0	0.0	-0.3
-Electricity and Water	-0.3	0.0	0.0	-0.3
-Manufacturing	0.4	0.2	-0.2	0.3
Building and construction	0.1	0.0	-0.1	0.0
Services	1.6	0.9	0.0	2.5
Participation rate				**-1.0**
Pop1564/Population				**1.9**

Source: Staff calculations based on CBS data

[13] Public investment in the region remains higher as a share of total investment than elsewhere, despite the fact that the private sector produces most of the value added in MENA economies.
[14] The Shapley decomposition exercise constitutes a counterfactual analysis of the impacts on value added GDP of changes in each, output per worker, the level and composition of employment assuming the others as constant, while also considering demographic and labor force dynamics on per capita GDP.

Jobs were created at a slower pace than the growth in the labor force, which in turn occurred despite a decrease in the participation rates. Everything else equal, the reduction in the employment rate constituted a drag to growth equivalent to 0.8% per year (Table 5). In turn, a *shift* in the composition of employment, away from low productive agriculture, towards tertiary and secondary activities, led to a net positive contribution on per capita GDP.[15] It must be observed, however, that while the secondary sector generates a much higher output per worker than the rest of the economy,[16] tertiary activities are just slightly more productive than the average for the economy and the agricultural sector. Since most of the inter-sectoral movement in employment occurred from agriculture to services, the recorded gains in terms of per capita GDP were rather small, at 0.3% per year (Table 5).

Among the service sectors, it is worth noting that the tourism sector experienced very rapid growth. The government emphasizes that it envisions tourism as one of the drivers of the economy. The sector grew remarkably in recent years attracting up to 8.55 million tourists in 2010, a 40 percent increase compared to 2009. Tourists' spending was valued at SYP 387 billion in 2010. The growth is proportionate to a doubling in the number of tourists visiting Syria every five years. The government raised the funds allocated to the tourism sector (e.g. providing sector specific infrastructure) to SYP 33 billion in the 11th FYP (compared to SYP 3 billion in the 10th FYP).

Finally, the fraction of population aged 15 to 64 increased relative to the total population in Syria during the 2000s, contributing positively to growth (Table 5). This indicates that Syria is poised to benefit from a demographic transition expressed in a higher fraction of working age population to total population.[17] However, weak job creation during this period implies that the market had difficulties absorbing the increasing numbers of potential workers. These demographic trends embed significant social and political risks if the labor market continues failing to absorb the huge number of new entrants.

[15] This is consistent with the structural change accompanying economic development in Syria (see section 6.2).
[16] This can be explained with the high output per worker in oil sector.
[17] This idea rests on the strong assumption that the additional fraction of working age population will find jobs.

4. Assessing Syria's future potential growth outlook

Syria's potential growth outlook is good. The country is undergoing a demographic transition, implying that the economy will benefit from a growing and young workforce in the coming years (Table 5). In addition, high unemployment rates of more than 10 percent suggest that sustained, high growth could occur without upward pressure on wages for some time in the future. A challenge for the Government will be to improve the quality of this labor force, through education and development of skills required for a modern market-oriented economy (Table 6).[18]

In addition to young and growing labor force, other endowments suggest high potential social returns to investments in Syria. These include fertile agricultural land and favorable climatic conditions for agricultural production, rich history, excellent geographic location for tourism and trade activities and relatively good transport infrastructure. Expected new investments and application of modern technologies might also make it possible for the country to rely on local production of oil and oil products, and together with gas discoveries, to satisfy internal demand.

In this regard, the large Syrian diaspora may have an important role to play. Well-educated Syrian communities abroad provide a pool of potential future entrepreneurs or investors bringing advanced foreign technologies and having the necessary knowledge to successfully adopt these technologies to the Syrian market. The re-emigration of domestic nationals living abroad has contributed to spur economic growth and technology adoption in various countries from India to Ireland.[19]

Our assessment suggests that the Syrian economy is capable of growing at a rate of 6-8% per year during the period 2009-2020, or 4-6% in per capita terms (Figure 11 and Figure 12). These estimates assume a constant return to scale Cobb-Douglas production function that uses historical shares of capital and labor in total output at factor costs, excluding consumption of fixed capital.[20] In the baseline scenario we assume a TFP growth rate that is constant at 1.8% as in recent years and an investment ratio that follows the growth rate forecasts from the most recent IMF Article IV report.[21] We also project 'low growth' and 'high growth' scenarios in

[18] The MILES project highlights the labor supply and education challenges for the Syrian government and proposes policy measures to address them.
[19] For instance, the Irish government provided various incentives for Irish citizens living in the U.S. to return to Ireland including a delegation from the Irish government that visited Silicon Valley to convince Irish IT and software specialists to return to Ireland.
[20] Population and working age population figures are taken from World Bank Human Development (HD) network forecasts. The employment rate is assumed to remain constant. Participation rates are also assumed to remain constant. The average years of schooling are assumed to increase at the trend growth rate computed over the past 20 years.
[21] We assume that the investment ratio remains constant after 2014.

which TFP and investment growth are lower and higher, respectively, relative to the baseline. In the ‘low growth’ scenario the investment rate reaches a plateau that is 2% lower in 2020 than in the baseline, while the TFP growth rate is 1% per year. In the ‘high growth’ scenario the investment rate reaches a plateau that is 2% higher in 2020 than in the baseline, while the TFP growth rate is 2.5% per year.

This report argues that higher, sustained growth can be realized if the Government manages to continue implementing reforms aimed at boosting productivity and expanding capacity, in the process generating positive effects in terms of job creation for a rapidly growing working age population. In our baseline scenario the Syrian economy attains an average growth rate of 7.5 percent. Attaining annual real growth rates of 7.5 percent over the next 10 years however would be a challenge. *It implies that the economy will need to create an average of 175,000 new jobs per year during this period, or more than twice the number of jobs created annually on average since 2004.* Employment generation is indeed of utmost importance as another simulation shows; *if Syria fails to create the required number of jobs and generates only 100,000, which already is a challenging task given historical trends, the unemployment rate will surge to almost 20 percent and growth will fall by about one percentage point. Answering the question: “What would it take for Syria to sustain and raise per capita income growth and create productive employment?” is therefore at the heart of the inclusive growth exercise.*

Table 5: Growth accounting decomposition and growth potential

Period	**GDP Growth**	**Physical Capital**	**Labor Adjusted by Skills**	**TFP, Cobb Douglas CRS**	**Per capita GDP growth**
			Contribution to GDP growth		
1960s	4.0%	2.3%	0.8%	0.8%	0.7%
1970s	9.3%	5.4%	2.5%	1.4%	6.0%
1980s	2.6%	2.8%	2.0%	-2.2%	-0.9%
1990s	6.2%	1.0%	2.4%	2.8%	3.4%
2000-2008	4.4%	2.0%	0.5%	1.8%	2.0%
2009-2020 *	7.5%	4.0%	1.5%	2.0%	5.3%

(*) Forecasted potential

Source: Staff calculations, based on CBS data

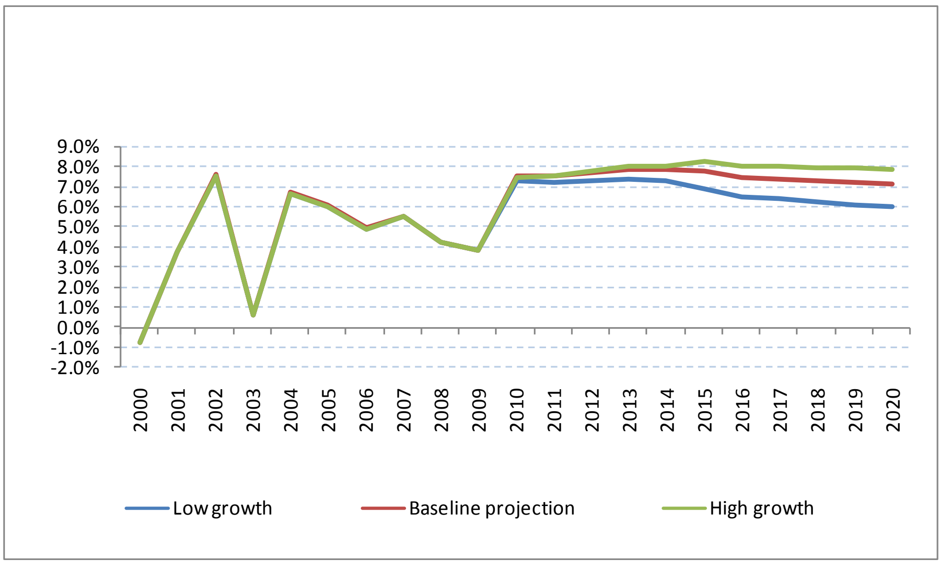
Table 6: Human capital decomposition and growth potential

Period	Labor Adjusted by Skills	Population growth rate	Working Age Pop. Ratio to Population	Participation Rate	Employment Rate	Human Capital
		Contribution to growth in Labor adjusted by skills				
1960s	0.8%	1.6%	-0.1%	-0.7%	-0.1%	0.2%
1970s	2.5%	1.6%	0.0%	0.4%	0.1%	0.4%
1980s	2.0%	1.7%	0.1%	0.0%	-0.1%	0.4%
1990s	2.4%	1.4%	0.6%	0.2%	0.1%	0.2%
2000-2008	0.5%	1.1%	0.9%	-1.3%	-0.3%	0.1%
2009-2020 *	1.5%	1.0%	0.4%	0.0%	0.0%	0.0%

(*) Forecasted potential

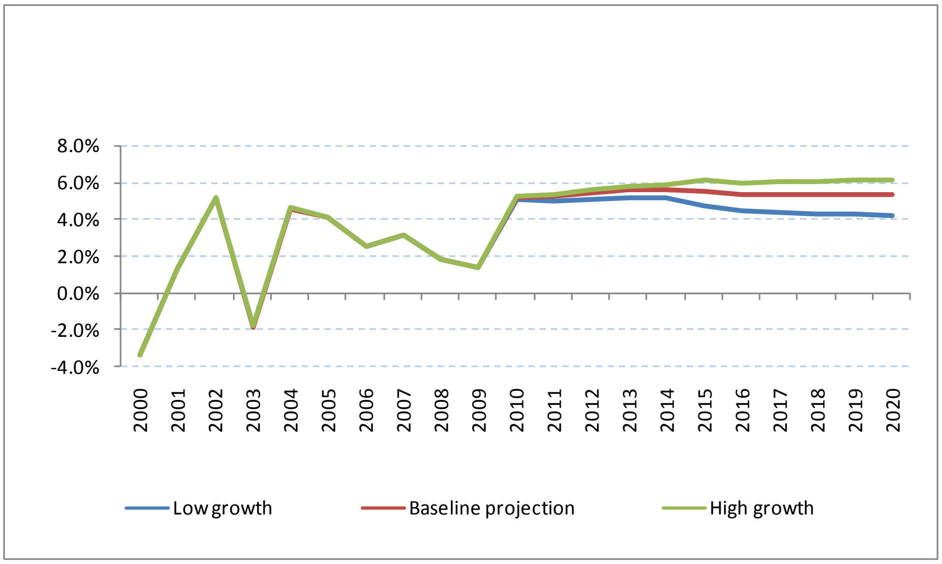
Source: Staff calculations, based on CBS data

Figure 11: Real GDP growth scenarios



Source: Staff calculations based on CBS data

Figure 12: Real GDP per capita growth scenarios



Source: Staff calculations based on CBS data

5. The Inclusive Growth Diagnostic Framework

The report employs the inclusive growth (IG) framework described in Ianchovichina and Lundstrom (2010) to assess the *relative* importance of different "constraints" to sustained, high and inclusive growth in Syria. The approach requires one to formulate hypotheses in an attempt to better understand what it is that is holding back growth or preventing it from reaching all segments of the population. The approach is diagnostic in nature, building closely on the Hausman-Rodrik-Velasco (HRV) framework. Yet, it departs from it whenever necessary in order to understand better the constraints faced by various economic actors. For this reason, the IG diagnostic analysis is eclectic in spirit. It uses different techniques applied to macroeconomic data as well as micro-level firm and household survey data, and (ii) cross-country benchmark comparisons to answer questions about trends, constraints to, and sources of sustainable, broad-based growth.

In the IG framework, the focus is on growth as it is the main conduit to job creation and poverty reduction. When growth is concentrated in a few sectors or specific types of economic actors, the IG analysis focuses on the constraints to growth in the slow-growing and emerging sectors, and the constraints to firms to contribute to and benefit from growth.[22] The economic agent in the growth analytics framework is the firm. However, the analysis does not need to be limited to the analysis of constraints to investment by a representative firm in the economy.

[22] See Ianchovichina and Lundstrom (2010).

Instead, the analysis looks into constraints binding growth and investment of different types of firms – formal or informal micro firms owned by individuals, and small, medium and large firms in the formal sector.

The main instrument for sustainable and inclusive growth is assumed to be investments in *productive* activities which create new jobs and income for individuals,[23] while *productivity growth* has the potential to lift the wages of those employed and the returns to the self-employed. The ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves over time. The analysis therefore looks at ways to strengthen the productive *resources and capacity* of the individual[24] as well as ways to open up new *opportunities* for productive employment through investment, exporting opportunities, and strengthening of domestic markets (Figure 13).

In this report we focus on ways to create new opportunities for productive employment through investments since the constraints to the productive resources and capacity of the individual is the focus of the MILES report. One of the most serious problems in the 2000s has been lack of productive employment – a problem that calls for a thorough analysis of the bottlenecks in the business environment. This analysis follows, but is not limited to, the aggregate-type of growth diagnostics suggested by Hausmann, Rodrik and Velasco (2005). Their organizing framework can be represented as a decision tree (Figure 14). In this analysis the main question is how to raise investments and entrepreneurial activities which are determined by the relationship between *private returns* to economic activities and the *cost of finance*. Private returns in turn are determined by *social returns*, which depend on complementary factors or inputs that individuals cannot or have very low incentives to provide - such as geography, technology, infrastructure and human capital, and the *private appropriability* of these returns. Private appropriability reflects the extent to which social returns are translated into private returns and is negatively affected by government failures and/or market failures. *Government failures*, or a bad policy and poor institutional environment, include macroeconomic risks such as financial, monetary and fiscal instability, and microeconomic risks, such as insecure property rights, corruption, inefficient tax collection systems, cumbersome regulations and business registration procedures. *Market failures* include limited information and coordination externalities affecting negatively the country's ability to expand private sector development and adopt new technologies. These failures are acute when markets are fragmented either

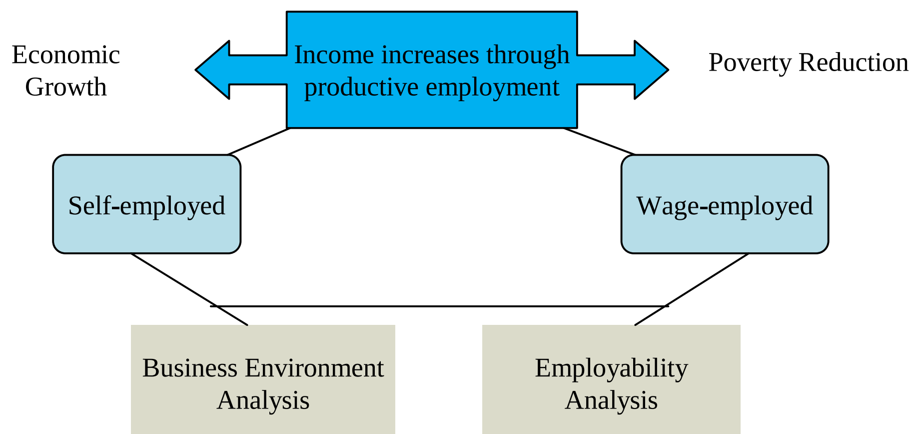
[23] According to the Commission on Growth and Development report (2008), sustained high growth requires rapid incremental productive employment.

[24] If the main problem is lack of employment opportunities for a particular group of individuals due to limited supply of certain types of labor skills, the constraints are related to the productive resources and capacity of individuals rather than the environment in which they can use these resources. This situation calls for an in-depth employability analysis that will shed light on the resources of the individuals, e.g. the individuals' education, health and the other productivity attributes they bring to a job. Such analysis is conducted by the MILES project.

horizontally, e.g. due to geographical isolation, or vertically, e.g. inputs are limited locally in quality and quantity.

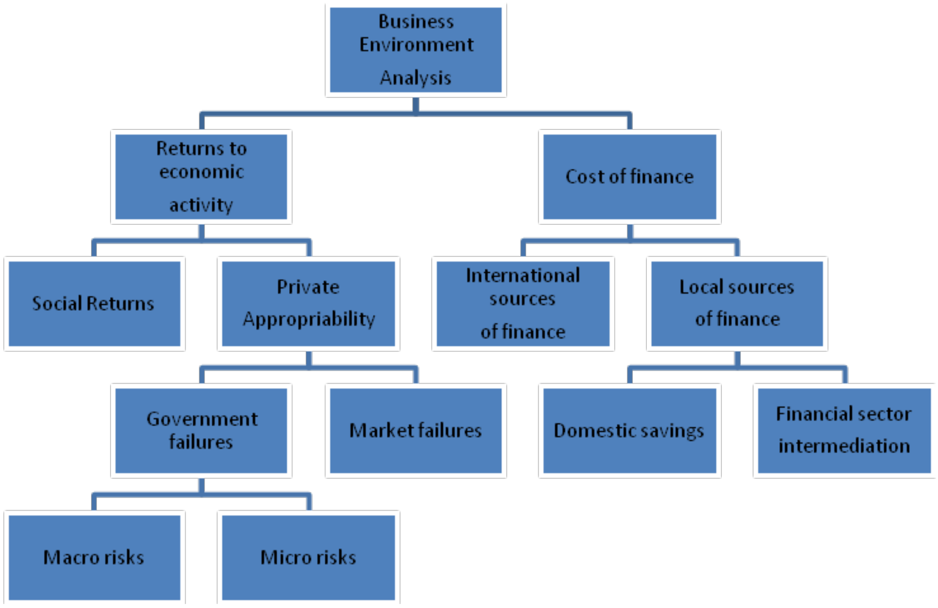
Inclusive growth analytics takes a long-run perspective and recognizes the time lag between reforms and outcomes and the rapid changes of the economy due to external and internal factors. This implies that the analysis must identify future constraints to growth that may not be binding today, but that may need to be addressed today in order to ensure sustained and inclusive growth in the future. Due to this longer term perspective, there is an explicit focus on structural dynamics. The business environment analysis should therefore be preceded by an analysis of external factors explaining the country's growth and poverty reduction pattern, the overall productivity dynamics in the country, the major challenges and opportunities faced, and the possibilities for economic transformation and diversification. The background analysis of economic trends and productivity dynamics, as well as the challenges faced by Syria today were presented in the introduction. Now we turn to the profile of economic actors and the analysis of constraints to growth.

Figure 13: Inclusive growth analysis



Source: Authors' diagram

Figure 14: Growth diagnostics methodology



Source: Hausman, Rodrik and Velasco (2004)

6. Profile of economic actors

This section constructs a picture of the *profile of economic actors* in Syria, including firms and households, while paying particular attention to non-included groups, i.e. the poor.

6.1 Syrian firms

Syrian firms have three major features: (1) Government firms generate about 40% of GDP; (2) Many private firms are small and often family-owned; (3) A large number of firms are informal. The Syrian Government has estimated the size of the informal sector to be between 30 and 60 percent of GDP.[25] One of the reasons for the high incidence of informality is the high cost of starting a business formally. The World Bank Doing Business survey ranks Syria 133rd in this respect and thus towards the bottom of the table of countries surveyed.

Informality is also a problem among formal firms. The 2009 Syria ICA survey estimates that establishments report only about 66% (85% in the case of state-owned firms) of their sales for tax purposes.[26] This number is considerably lower than in other countries in the region. Moreover, more than half of Syrian firms, and in particular SMEs, report significant competition from the informal sector.

Corruption and regulatory uncertainty are perceived as the leading constraints by most firms, in particular SMEs. Much fewer large firms with 100 employees or more identify constraints such as tax rates and access to financing as severely constraining. Small firms with just 5-19 employees are generally more strongly constrained by institutional factors, access to finance, informal competition, macroeconomic uncertainty, and obtaining required licenses and permits. Large and medium sized firm with 20-99 employees were also more likely to have introduced new product lines or upgraded old ones; as are firms with links to international markets. One reason firms cite increasingly corruption and regulatory uncertainty as constraints to their business operations may be that, as the private sector has developed and transactions have grown larger and more complex, the need for an effective and predictable legal and regulatory framework has become increasingly important to all firms' daily operations and investment decisions.

Due to these structural constraints to firm growth, most private firms in Syria are micro or small firms. It is reported that 86 percent of Syrian firms have only 3 employees or less while 66

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[25] Lorka Khayzaran (2009) *The shadow economy in Syria deprives the Treasury billions, and deprives 30% of employment rights.* Syrian Arab News Agency (SANA). July 25, 2009.

[26] The 2009 ICA survey does not cover the informal sector but rather provides a representative sample of the formal sector of the Syrian economy. It only covers firms with 5 or more employees. Given that a large number of SMEs operate in the informal sector, all analysis based on the ICA survey should be regarded as supplementary.

percent have only 1 employee. Thus, the analysis of private sector growth constraints predominately covers constraints for micro firms and SMEs.

Syrian firms have made dramatic gains in productivity according to ICA survey data in 2005 and 2009. Productivity improvements were strong particularly in food and agro-processing sectors, garments and leather, and chemicals/pharmaceuticals, but not in textiles. Syria has closed the gap with some comparators but further progress is needed to compete effectively in key sectors. Labor productivity has increased overall and in each comparable sector, including textiles, while unit labor costs have declined.

Large private firms are more productive than state-owned and small private firms. It appears that small firms are less productive overall than large firms although their unit labor cost are lower. Productivity is also shown to correlate negatively with public ownership. This is an observation that is supported at the macro level by the Shapley decomposition analysis (Table 1).

6.2 Syrian households

Jobless growth in the period 2001 and 2008 was accompanied by a decline in labor force participation rates. Among people aged 15 and older, the number of employed was approximately stable during this period. And so was the number of unemployed which increased only marginally between 2001 and 2008. The labor force therefore remained stable whereas the number of those who were out of the labor force increased notably since 2001. The labor force participation (LFP) rate decreased from 52.5% in 2001 to 44% in 2009 (Figure 15). For females, the decline was especially noteworthy as it happened starting from already low LFP rates which declined from 23.2% in 2001 to 13.3% in 2009. For males, the LFP decreased markedly from 80.1% in 2001 to 70.9 in 2009. Most inactive individuals remain at home and a sizable share delays entry into the labor market to attend school (Figure 16).

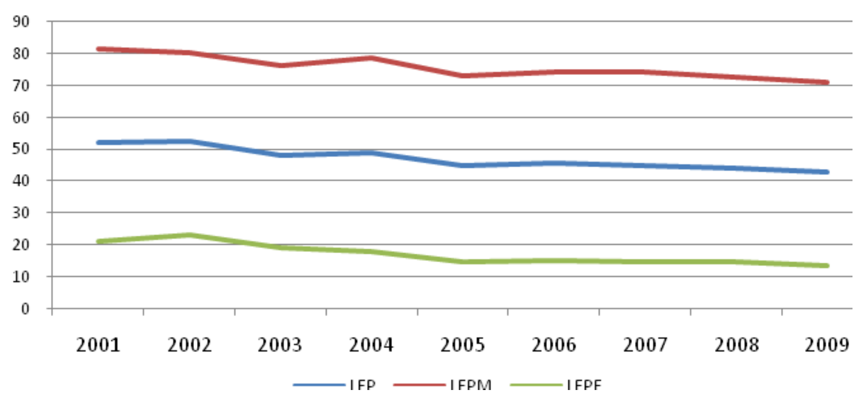
The unemployment rate varied considerably during the 2000s, and increased markedly towards the end of this decade. It was highest in 2002 when it reached 11.9%, and lowest in 2005 when it registered 8.1% (Table 7). The unemployment rate increased notably from 8.4% in 2007 to 10.9% in 2008. The unemployment rate among males increased from 7.5% in 2001 to 8.3% in 2008, and among females it increased from 21.7% in 2001 to 22.6% in 2008. The unemployment rate decreased among youth aged between 15 and 24 years, and among those with elementary education, while it increased among those aged 25 years or more. Unemployment has been evenly distributed across the country but is more of a problem in the easternmost regions, reaching up to 24% in Al-Hassakeh (Figure 17). It is also unevenly distributed across age groups, as the ratio of unemployed in the labor force for people under 30 years of age reached 18.1% in 2008 (Figure 18).

Syria's service sector became the country's biggest employer as labor moved away from agriculture and into services in the 2000s. The data show a dramatic decline in the number of those employed in the agriculture sector, and an increase in the construction, trade,

transportation, and real estate sectors (Figure 19). The decline in agricultural employment affected both females and males. The percentage of females working in this sector dropped from 57.1% in 2001 to 25% in 2008 while that for males decreased from 27.1% to 15.5% during the same period. In 2008, over half of Syrian workers were employed in the tertiary sector, while 30 percent worked in the industrial sector. The public sector accounted for 29% of total employment, while the formal sector absorbed almost 40%. Informal employment has increased, amounting to over 1.5 million people in 2008 (32% of workers). By 2007, only 70% of workers had a regular, full time employment, with the remainder having only some seasonal (10%), temporary (6.5%) or irregular (12.1%) job arrangement. The percentage of workers in the public sector increased only slightly from 26.6% in 2001 to 28.5% in 2008. As for the workers in the private sector, there were no clear trends between 2001 and 2008.

The transition from agriculture to services reflects deeper structural changes than the temporary weather-related shocks experienced in the past two years. The decline in the percentage of workers employed in the agriculture sector began in 2002, which means that the drought in the last three years is not the main reason for the move of labor out of agriculture into services. Instead, this trend is consistent with the structural change accompanying the process of economic development in Syria. It reflects the so called "Kuznets facts" describing an increase in the service sector employment share at the expense of agricultural employment during a country's transition to a developed economy.[27]

Figure 15: Labor force participation rate by gender



Source: CBS and authors calculations

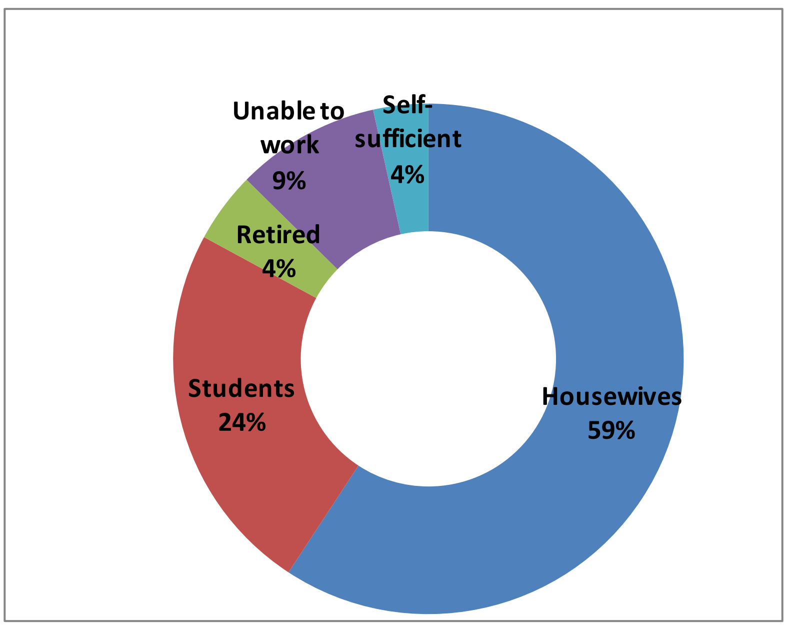
[27] Pasinetti (1981) develops a theoretical model of structural change, where unbalanced growth results both from demand-side effects (through the operation of Engel's Law) and supply-side forces (through sectoral differences in productivity growth). He argues that sectoral growth differences may contribute to persistent structural unemployment due to limited factor substitutability. Kongsamut, Rebelo, and Xie (2001) show that the evolution of these sectoral growth differences can result from non-homothetic preferences reflecting Engel's law (as household's income increases, the fraction spend on services increases). They also give structural parameter restrictions such that aggregate growth is balanced despite sectoral growth differences. Acemoglu and Guerrieri (2008) show analog result based on technology differences across sectors.

Table 7: Population 15 and above, relation to labor market

Year	Employed	Unemployed	Out of labor force	Total	Unemployment rate
	4,650,066	537,087	4,659,513	9,846,666	
2001	47%	6%	47%	100%	10.4%
	4,745,903	641,087	4,862,698	10,249,688	
2002	46%	6%	47%	100%	11.9%
	4,522,288	570,782	5,372,856	10,465,926	
2003	43%	6%	51%	100%	11.2%
	4,772,046	453,324	5,525,526	10,750,896	
2004	44%	4%	51%	100%	8.7%
	4,693,497	412,862	6,266,787	11,373,146	
2005	41%	4%	55%	100%	8.1%
	4,859,948	432,240	6,269,958	11,562,146	
2006	42%	4%	54%	100%	8.2%
	4,945,978	454,801	6,627,992	12,028,771	
2007	41%	4%	55%	100%	8.4%
	4,847,898	594,497	6,818,127	12,260,522	
2008	40%	5%	56%	100%	10.9%

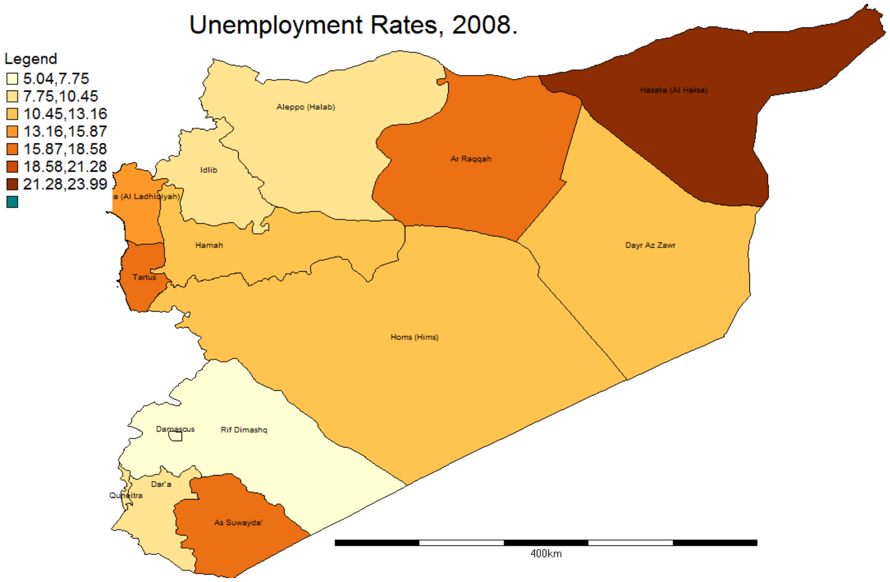
Source: Staff calculations based on CBS data

Figure 16: Status of inactive population (2008)



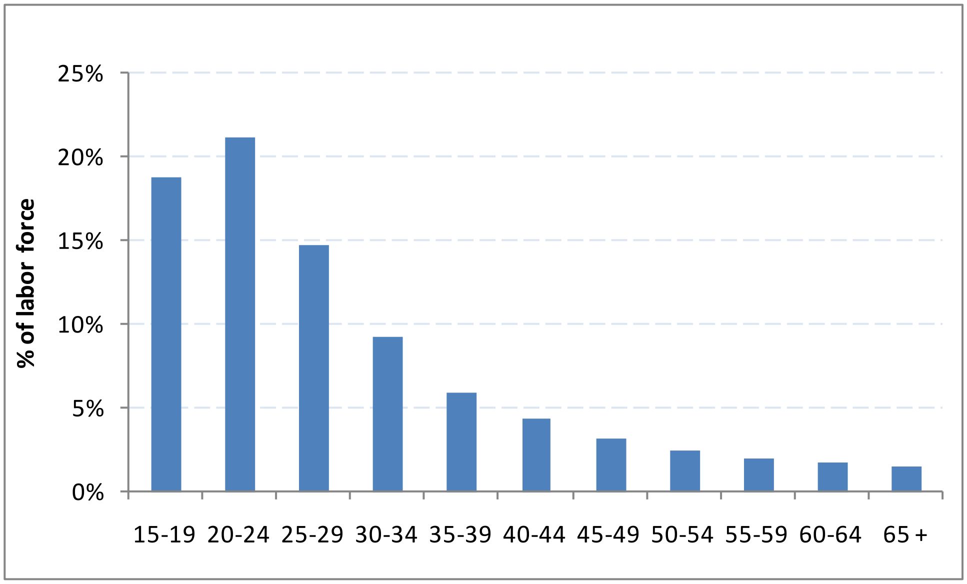
Source: Staff calculations, based on CBS data

Figure 17: Regional distribution of unemployment rates



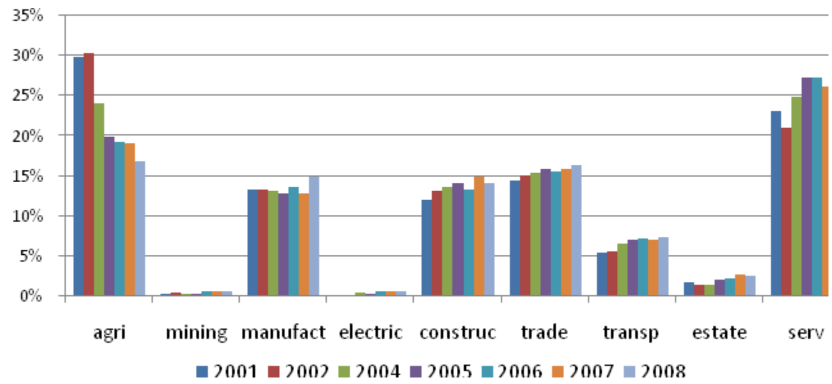
Source: Staff calculations, based on CBS data

Figure 18: Unemployment rate by age group (2008)



Source: Staff calculations, based on CBS data

Figure 19: Employment distribution by sector



Source: CBS and authors calculations

Poverty rates were relatively low and stable, but vulnerability increased notably in the period 2004-07. Indeed, while calculations relying on the lower poverty line do not show significant increases in the poverty rate, the number of households falling below the upper poverty line has increased markedly; moreover, 20 percent of the population is currently concentrated between the lower and upper poverty lines.[28]

A stable flow of remittances from large Syrian communities abroad also helped stabilize poverty rates. Remittances accounted for three percent of GDP in 2008. Weaker employment prospects in North America or Europe after the crisis might reduce their scale; however, remittances fell by only four percent in 2009.

While the poverty rate increased in recent years, equity improved. The distribution of income in Syria is not severely unequal when compared to other developing countries, for example in Latin America. Moreover, equity has improved substantially between 2004 and 2007. The Gini index fell from 37 to 32. The drop in Gini was more significant in urban areas than in rural areas.[29]

The poverty rate differs considerably across regions. The north and east regions of the country have some of the highest poverty rates in Syria. In 2004 the highest poverty headcount rate was observed in the north and the lowest in the south. The picture changed dramatically in 2007. In the east the poverty rate soared from 25.8% in 2004 to 38.7% in 2007 while the south now featured the second highest poverty rate (an increase from 25.1% to 35.2%). In the northern areas the poverty rate decreased from 40.1 % to 34.4% during the same period.

[28] New poverty and inequality numbers are expected to be available soon as a result of a new household survey conducted in 2009.
[29] High growth and increasing poverty would usually imply that equity is increasing instead of decreasing. This puzzle has, however, been observed in several countries (see for example Deaton 2005) and is typically attributable to a discrepancy between the national income data and the household survey data..

Poverty rates are significantly higher in rural than in urban areas. Table 8 shows that the poor in Syria are concentrated in the rural areas where the poverty rate reaches 15% compared to 10% in urban areas (lower poverty line). The headcount rate increased from 31.9% in 2004 to 36.9% in 2007 in rural areas when using the upper poverty line, despite the fact that the share of the population living in the rural areas decreased from 49.2% to 45.9%; in urban areas, an increase from 28.6% to 30.7% was observed for the same period. For the lower poverty line, the survey evidence suggests that the poverty headcount rate slightly increased in both rural and urban areas. As for the upper poverty line in 2004, the highest poverty headcount rate was observed in the north and the lowest in the south region. The most significant change happened in the east where the poverty rate increased from 10.4% to 18.8%

The 2007 household surveys suggest that female-headed households suffered more in recent years. This is especially true for households between the lower and the upper poverty lines. The poverty rate (upper poverty line) increased from 23.3% to 32.4% for these families. For both the upper and the lower poverty lines, the increase in poverty rates was most significant among families in which the head of household was aged above 60 or between 40 and 49.

The household survey also indicates that education is the greatest correlate to poverty risk in Syria. About 80 percent of the poor had only elementary education or less (both in terms of the upper and the lower poverty line). About 85% of the poor people were employed; the majority of the increase of poverty during the period 2004-2007 occurred among these, presumably because job loss was among the factors significantly affecting the incidence of poverty.[30]

Table 8: Poverty rates in Syria

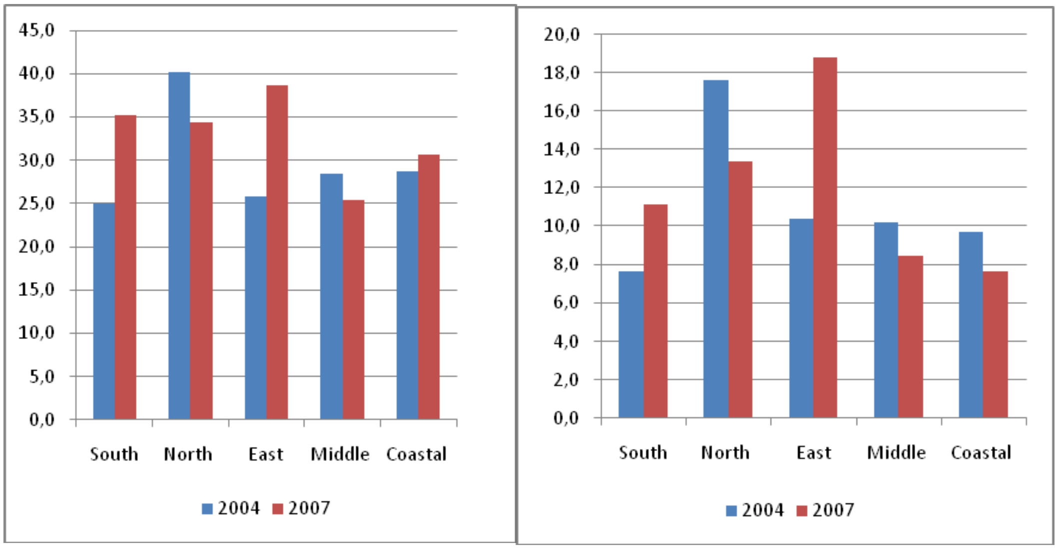
	Poverty Headcount Rate			Poverty Gap			Squared Poverty Gap		
	2004	2007	change	2004	2007	change	2004	2007	change
Upper PL									
Urban	28.6	30.7	2.2	7	6.7	-0.3	2.5	2.1	-0.4
Rural	31.9	36.9	5	7.8	8.3	0.4	2.8	2.7	-0.1
Total	30.2	33.6	3.4	7.4	7.4	0	2.6	2.3	-0.3
Lower PL									
Urban	8.8	9.9	1.1	1.6	1.5	0	0.5	0.4	-0.1
Rural	14.3	15.1	0.9	2.7	2.5	-0.3	0.8	0.6	-0.2
Total	11.5	12.3	0.8	2.1	2	-0.2	0.6	0.5	-0.1

Source: UNDP and Central Bureau of Statistics

[30] Policies to increase educational attainment and improve the quality of education in Syria are discussed in depth in the MILES report.

Figure 20: Poverty by geographic region

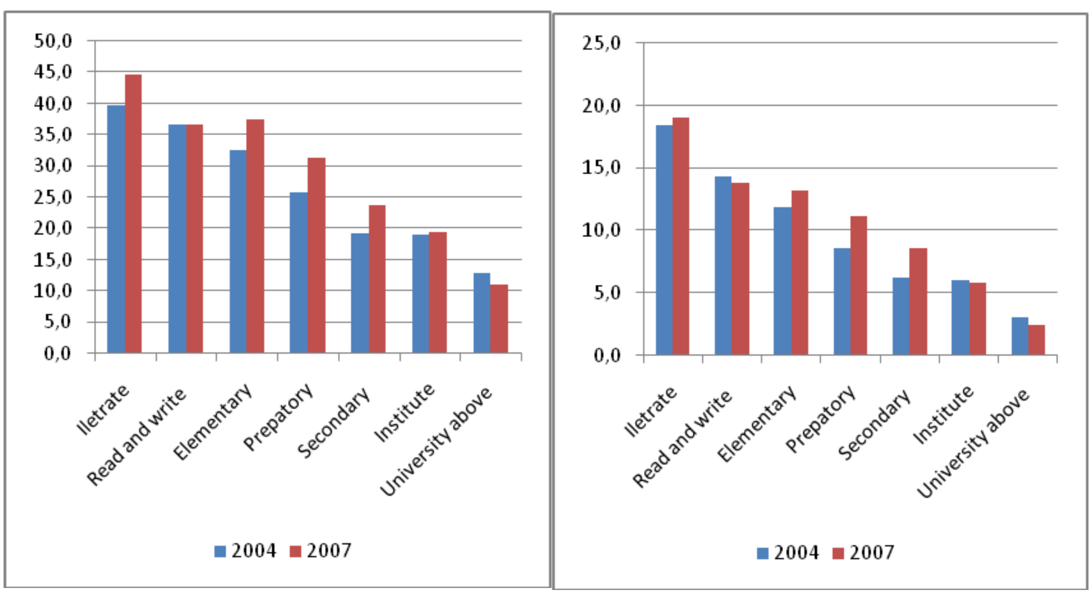
Upper poverty line (left) vs. lower poverty line (right)



Source: Syria Household survey (2007)

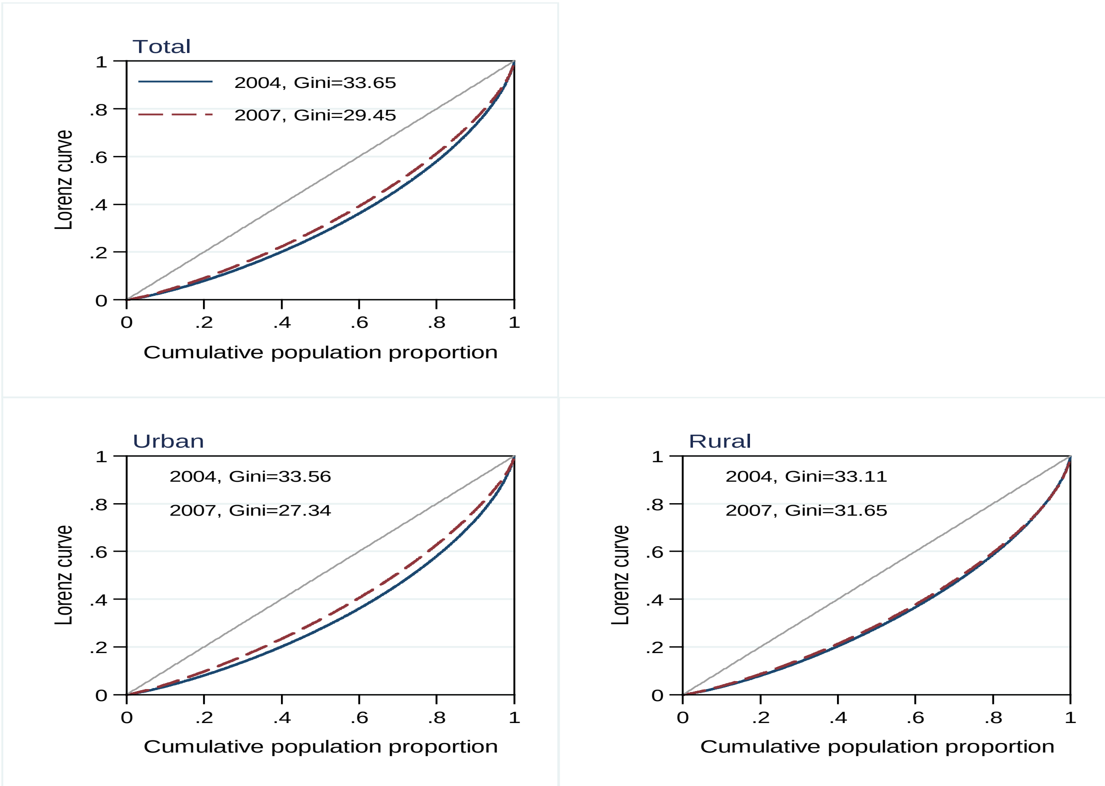
Figure 21: Poverty and educational background

Upper poverty line (left) vs. lower poverty line (right)



Source: Syria Household survey 2004 and 2007

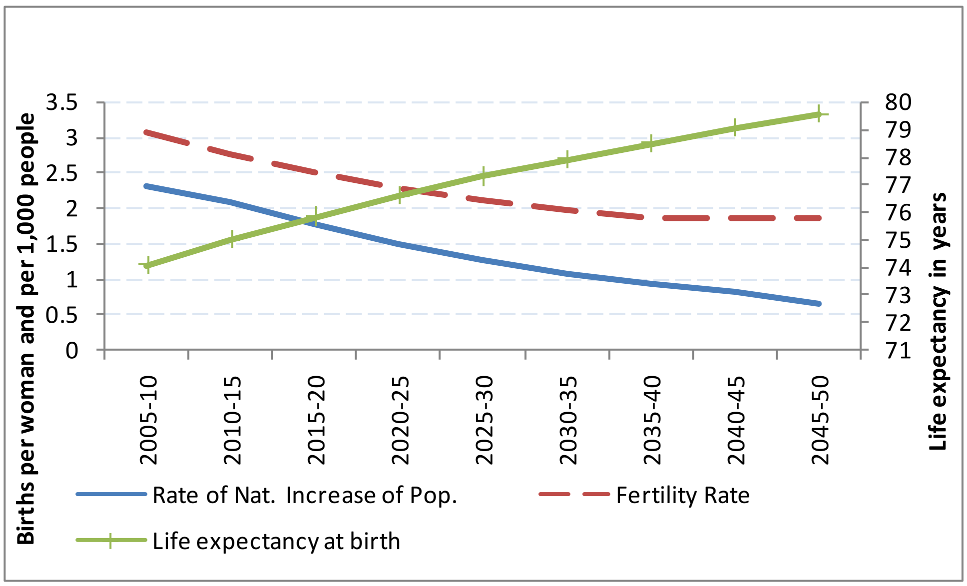
Figure 22: Inequality in Syria



Source: Syria Household survey 2004 and 2007

Syria's demographic transition is expected to accelerate in decades to come and change the profile of its workforce. An expected fall in the number of births per fertile woman and an increase in the life expectancy at birth– both associated with observed sustained improvements in the standard of living – will result in a significant reduction in the natural increase of the population between 2005 and 2050 (Figure 23) and a remarkable shift in the shape of the population pyramid. Syria will transition from an expansive pyramid, characterized by a ratio of young population (0-14 years) to total population of almost 50% in 1980, to a stationary (constrictive) pyramid in 2050 associated with low fertility and mortality rates (Figure 24). The former dynamics will result in a substantial improvement in the age dependency ratio – i.e. the fraction of young and old population to working age population will fall to a level much below the estimated average for all regions in the world by 2050 (Figure 25). From that time onwards, the demographic dividend will disappear as the growth in aging population with improved life expectancy would not be offset by added young population, due to decreased birth rate.

Figure 23: Demographic trends



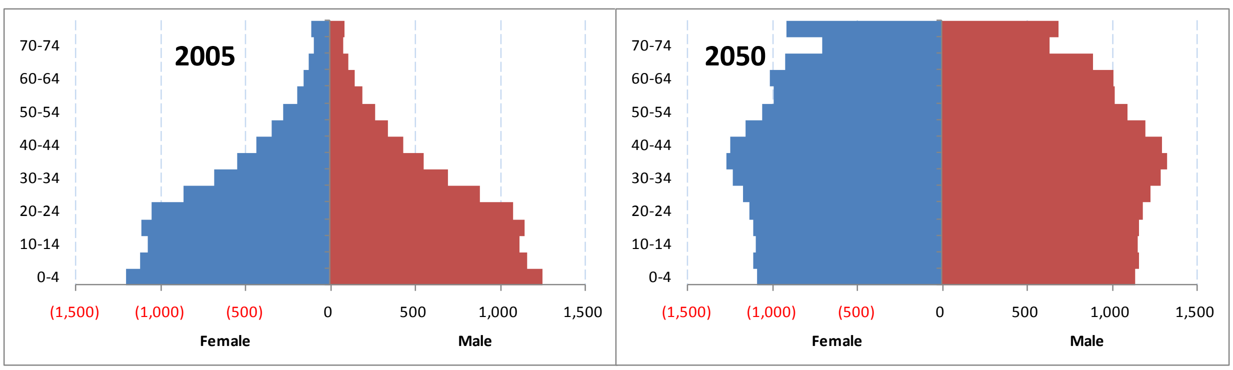
Source: Authors' calculations, based on CBS and World Bank, Human Development Network forecasts

Figure 24: Population dynamics

Category	Unit	Syrian Arab Republic				Lower middle income		Middle East & North Africa	
		1980	1990	2000	2008	1990	2008	1990	2008
Population, total	millions	9	13	17	21	2,890	3,703	227	325
Population, male	% of total pop.	50	50	50	50	51	51	51	50
Population, female	% of total pop.	50	50	50	50	49	49	49	50
Population ages 0-14	% of total pop.	49	48	41	35	35	28	44	31
Population ages 15-64	% of total pop.	48	49	56	61	61	66	53	64
Population ages 65 and above	% of total pop.	3	3	3	3	5	6	3	4
Population growth	% annual	3.6	3	2.6	2.5	1.9	1.1	3.4	1.8
Birth rate, crude	per 1,000 people	47	37	30	28	27	20	34	24
Death rate, crude	per 1,000 people	8	5	4	3	9	8	8	6
Age dependency ratio	(Pop<15+Pop>64)/Pop15-64	107.4	104.3	77.4	62.7	65.7	52.7	89.8	57.2
Fertility rate, total	births per woman	7.4	5.5	3.8	3.2	3.4	2.5	4.9	2.7
Adolescent fertility rate	per 1,000 women aged 15-19	..	..	69	59	..	46	..	35
Life expectancy at birth, total	years	63	68	72	74	63	68	64	71
Life expectancy at birth, male	years	61	66	71	72	62	66	63	69
Life expectancy at birth, female	years	65	70	74	76	64	70	66	73
Mortality rate, infant	per 1,000 live births	56	30	19	14	65	45	58	29
Mortality rate, under-5	per 1,000	74	37	22	16	93	64	76	34
Mortality rate, child	per 1,000 male	..	..	..	5	..	..	..	..
Mortality rate, child	per 1,000 female	..	..	..	3	..	..	..	..
Mortality rate, adult, male	per 1,000 male adults	..	237	146	122	208	204	214	158
Mortality rate, adult, female	per 1,000 female adults	..	177	101	83	183	138	184	106
Survival to age 65, male	% of cohort	..	..	75	78	..	67	..	73
Survival to age 65, female	% of cohort	..	..	82	85	..	75	..	81

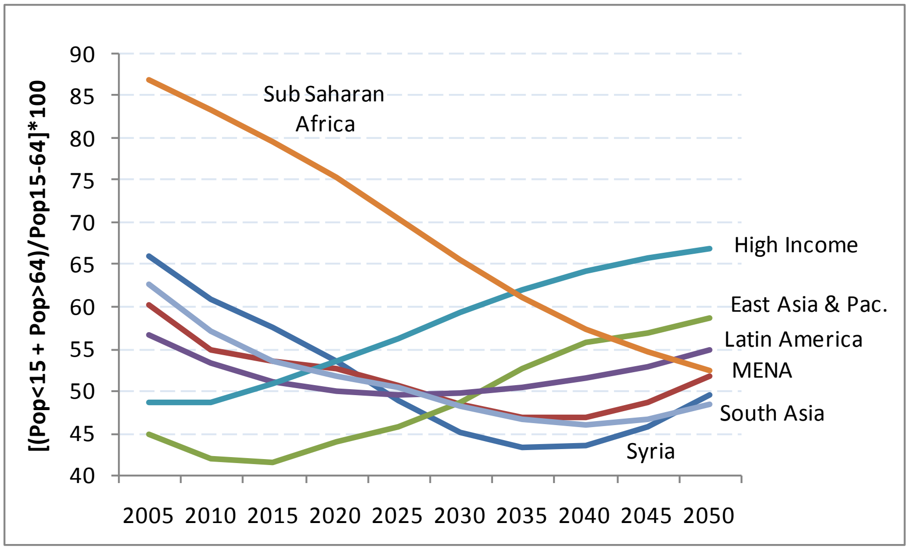
Source: World Bank, WDI

Figure 25: Population pyramid 2005 and forecast for 2050



Source: Authors calculations based on World Bank, HDN projections

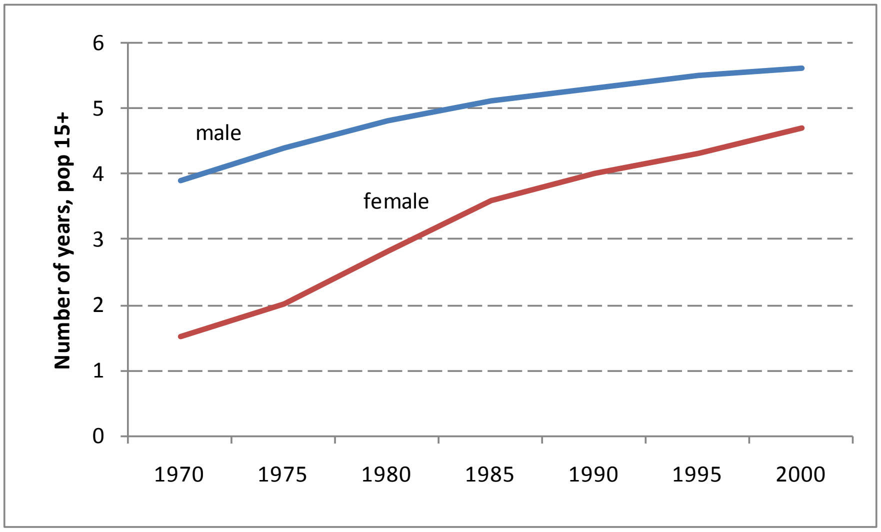
Figure 26: Age dependency ratio



Source: Authors' calculations based on World Bank, Human Development Network Forecasts.

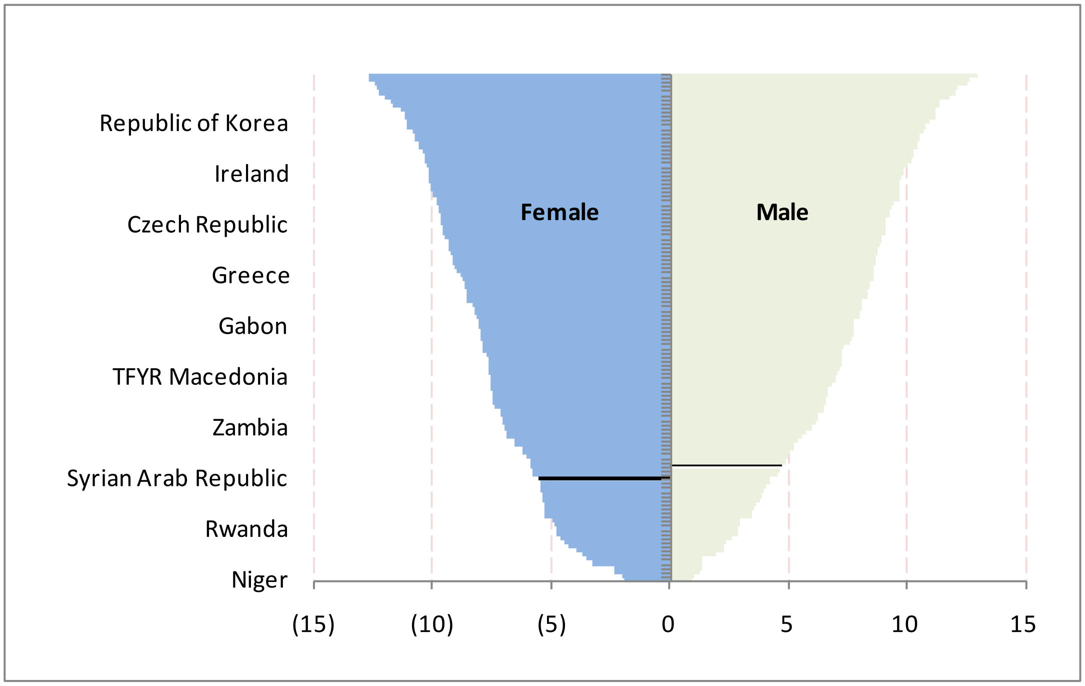
Syria has achieved significant gains in term of the quality of its labor force, as proxied by the average number of years of education of the working age population, yet there is a scope for improvement (Figure 27). Empirical work based on household data shows a significant negative correlation between unemployment rates and education attainment, by groups. Furthermore, regression analysis of earnings using Mincerian specifications indicates a positive, significant impact of additional years of education.

Figure 27: Average years of education by gender (pop. 15+)



Source: CBS and authors calculations

Figure 28: Average years of education, international comparison (2000)



Source: Authors' calculations based on Lutz et al. (2008)

Given the dramatic scale of the decline in agricultural employment, and the expected acceleration of the number of working age people, the Government will be facing increasing pressures to implement reforms that generate inclusive growth and productive employment. It therefore becomes critical to understand the key bottlenecks preventing the scale up of economic activity and depressing demand for labor, and design feasible policies to remove these constraints. The remainder of this report is devoted to the task of identifying the bundle of major constraints to inclusive growth in Syria.

7. Constraints to inclusive growth in Syria

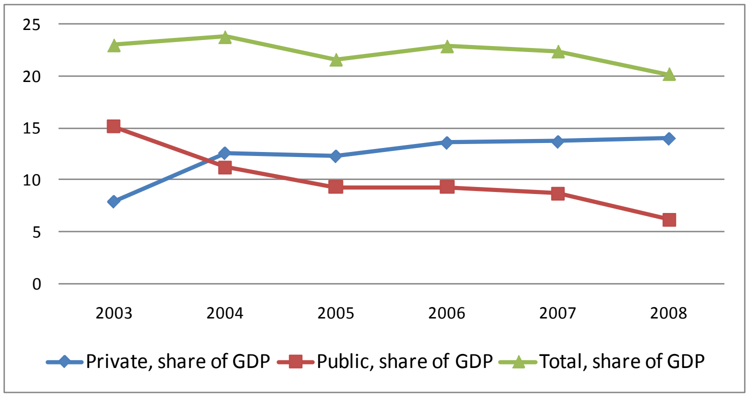
Syria's growth potential is high, but what will be needed to achieve high GDP growth of six to eight percent per year in the coming decade? Sustaining productivity growth above two percent per year is an important precondition, but it alone will not deliver the needed boost to growth. Capacity growth through investments is needed to create jobs for a rapidly growing working age population. This is the experience of all countries that successfully industrialized. In the last decade, not investment but productivity, on the supply side, and consumption, on the demand side, were the primary drivers of growth. Why has investment not contributed more substantially to growth?

7.1 Is there sufficient investment to support inclusive growth?

Private investment has expanded since 2003, but has not led to a boost in the share of overall investment in GDP. Private investment doubled as a share of GDP since 2003. This impressive achievement is likely attributable to the successful implementation of a reform agenda that significantly strengthened the private sector. However, the surge in private investment has not been sufficient to offset the dramatic fall in public investment since its peak in 2003 (Figure 29). The change in the composition of investment is welcome. But private investment needs to increase even more in the years to come, while public investment decisions need to be made strategically, with the objective of enhancing prospects for growth, raising expected returns for prospective investors, and strengthening public investment in key areas, such as electricity, telecommunications and tourism infrastructure.

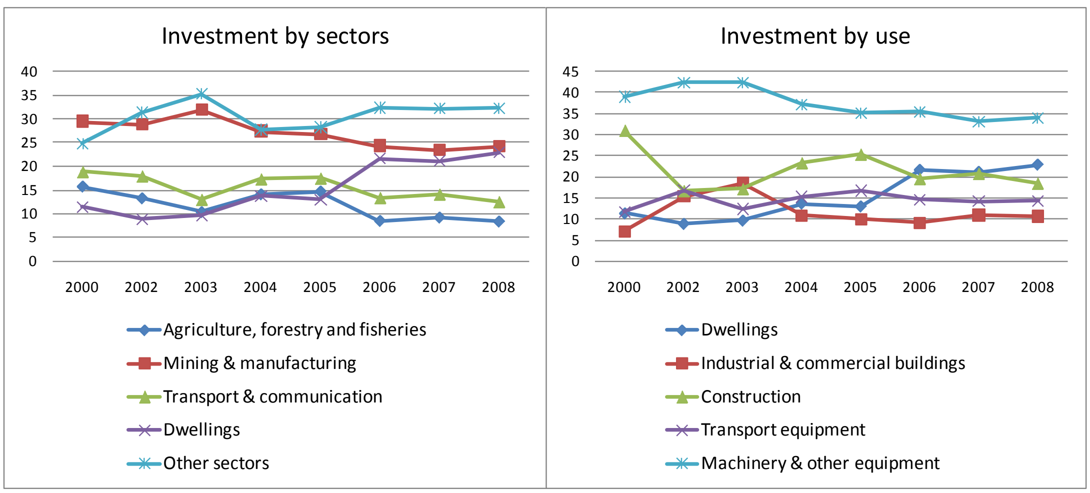
The change in the distribution of investment across sectors has not been conducive to sustained, broad-based growth. The opening up of certain sectors such as real estate led to a boom in residential construction but investment in other sectors declined (Figure 30). Indeed, reforms encouraged FDI flows mainly into the energy sector, tourism and construction. And, investment for productive uses declined substantially, while little or no FDI went into manufacturing, telecoms or high tech services (Figure 30). This is a pattern that does not support a scale up of exports, is unlikely to support sustainable growth, and should be a concern in an economy aiming to diversify its production base.

Figure 29: Investment, private and public sector



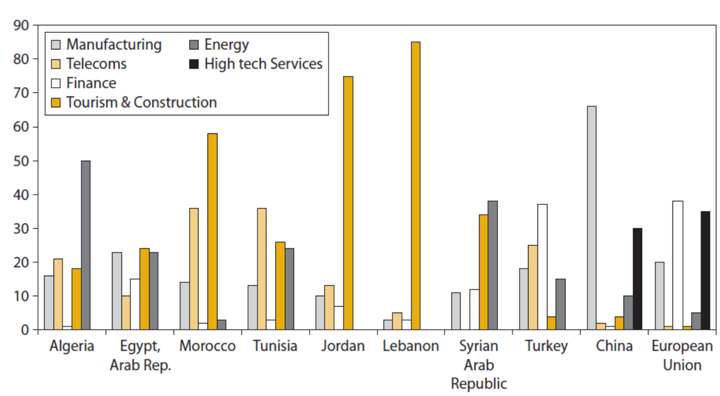
Source: IMF Article IV reports for Syria

Figure 30: Investment by sector and use



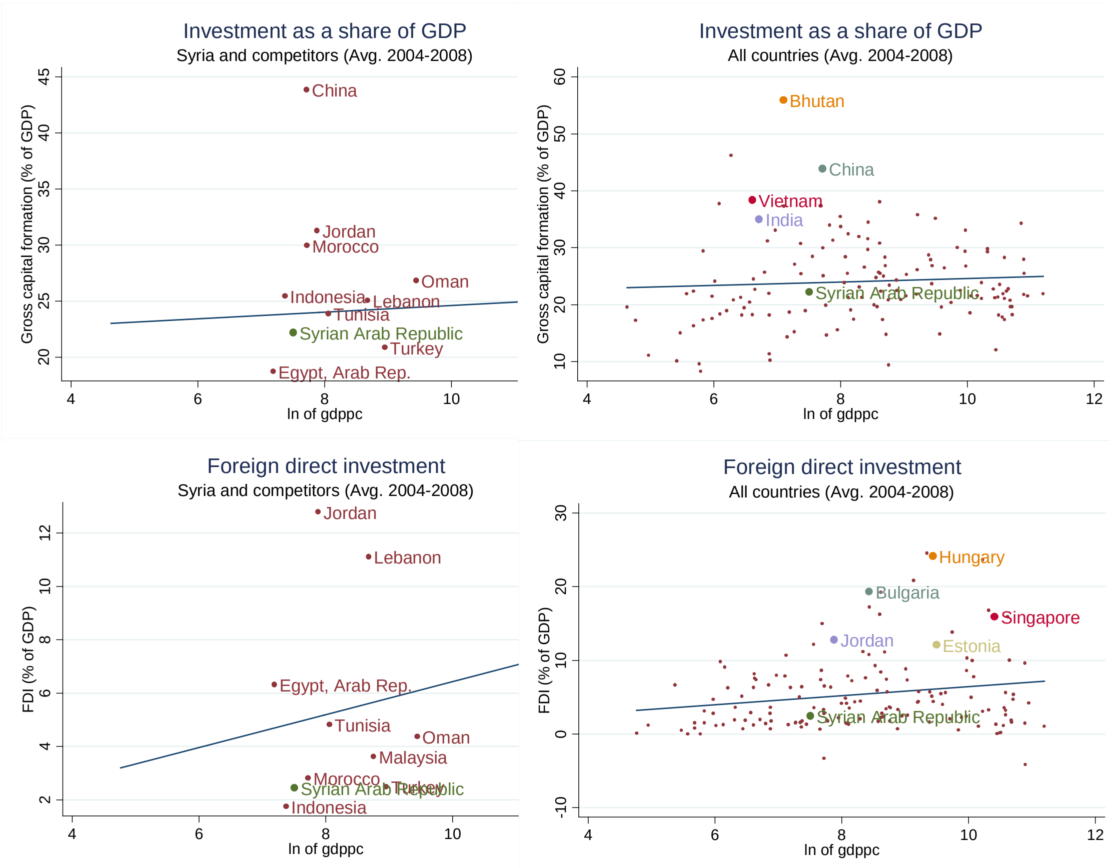
Source: Syria Central Bureau of Statistics

Figure 31: Structure of Foreign Direct Investment 2000-07 (% of total)



Source: united National Conference on Trade and Development, World Development Indicators, national accounts

Figure 32: Investment benchmarking



Source: IMF, International Financial Statistics

Is an investment ratio slightly above 20% low by international standards? Such ratio indeed lies below the average for Syria's income level, both in comparison to all countries and in comparison to Syria's regional and worldwide peers. Even if its investment rate does not fare far below what one would expect for Syria's level of development, it needs to be kept in mind that, given its high population growth, Syria has to grow at annual rates of seven or eight percent to achieve its desired per capita income growth rates. Indeed, when compared to high growth economies such as China, Vietnam, India or even Jordan, Syria's investment rate indeed appears very low (Figure 32). What is more, FDI has been extremely low by international standards and for Syria's level of development, and did not increase much since 2004 (Figure 32).

7.2 Credit volumes are low in Syria but the reason is not a high cost of capital?

The Syrian financial system is still relatively undeveloped in its financial intermediation role for the private sector. The financing structure of firms is dominated by retained earnings, which account for 78% of financing for new investments and 81.7% of working capital needs. Bank loans represent on average 5.2% of working capital needs and 9.9% of investment needs overall, but supply only 3% of small firm's working capital and 7% of investment finance.[31] Why are bank loans not taking a larger role in investment financing in Syria? Are credit volumes low by international standards? In order to answer these questions, it is worth recapitulating the reforms implemented since the 2000s.

The modernization of Syria's financial sector is unquestionably a cornerstone in the process of transforming Syria to a social market economy. The financial sector has since 2004 gradually evolved from a state-owned and controlled segment of the economy towards a more liberal system in which market reforms allow the private sector to take on a more significant role. A new competition and anti-trust law prohibits monopolies and anti-trust practices. A central bank has been created and the Damascus Stock Exchange re-opened in March 2009. At the end of 2010, a total of 19 companies were listed on the Damascus Stock Exchange, encompassing eleven banks and four insurance firms.[32] The exchange rate is effectively unified and laws have been passed allowing private banks, foreign exchange bureaus and private insurers to come into play. The economy has also gradually been opened to foreign investors. A recently-enacted Investment Law sets foreign and domestic investors on par and, as of end-2010, foreign investors can take majority shares of up to 60% in private banks. Moreover, the Cabinet approved the easing of restrictions on the foreign exchange market in November 2010, to make it easier for foreign investors to move their profits abroad. Previously, investors were unable to buy foreign currencies, making it technically impossible for them to repatriate profits made in Syrian pounds. In December 2010, the CBS began selling Syrian government debt for the first time in decades with the sale of short-term, three- and six-month treasury bills.

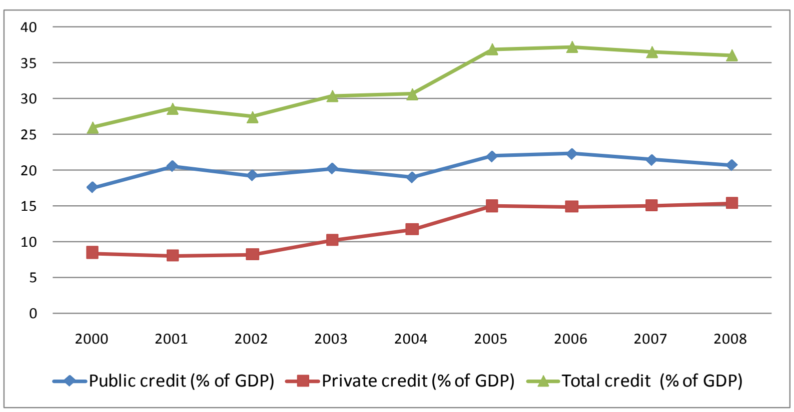
But major reforms – most notably the creation of the Damascus Stock Exchange and the issuance of treasury bills – are still in their early stages. For instance, the issuance of treasury bills is an important step towards a more efficient financial sector as they provide an indirect monetary policy instrument and a necessary prerequisite for capable debt management in both private and public banks.[33] The decision to issue government debt is welcomed by the private banking sector as it provides creates new relatively low-risk instruments in which to invest the excess liquidity in the banking system. So far, however, only three- and six-month treasury bills

[31] Source: Syria Investment Climate Assessment 2009.
[32] The index of the Damascus Securities Exchange rose by 75% in 2010.
[33] A trial Treasury bill auction has been conducted in 2009, but the government has not yet commenced the issuance of government securities, and it remains unclear when the market will be established. The CBS has been designated to be the agent of the government for conducting the auctions.

have been traded at low rates (between 0.4 and 0.6 percent). In contrast, the issuance of long-term government debt would provide a benchmark for determining long-term interest of commercial bank loans, potentially allowing banks to offer a greater number of long-term investment loans. In this regard, the government announced a further auction of one-, three- and five-year bills to take place in the beginning of 2011. Moreover, the insurance industry is still small, the pension system is underdeveloped and large and active capital markets are urgently needed. The Syrian financial sector is also still only weakly interlinked with global financial markets and prudential regulation is restrictive.

Moreover, the Syrian financial sector landscape continues to be dominated by a small number of large, publicly owned banks. Distortions brought on by regulation make it difficult for public and private banks to compete on a level playing field. The most obvious distortion is the fact that public banks have not had to meet regulatory capital requirements. But interest rate controls also hinder competition. In spite of the rapid expansion of private banks in recent years state banks still account for about 75 percent of total assets at end-2009.[34] But private banks, mainly related to Jordanian and Lebanese banking groups, have been increasing their market share and the number of private bank branches increased from 10 in 2003 to 90 in 2008.[35]

Figure 33: Credit, private and public sector



Source: Syria Central Bureau of Statistics

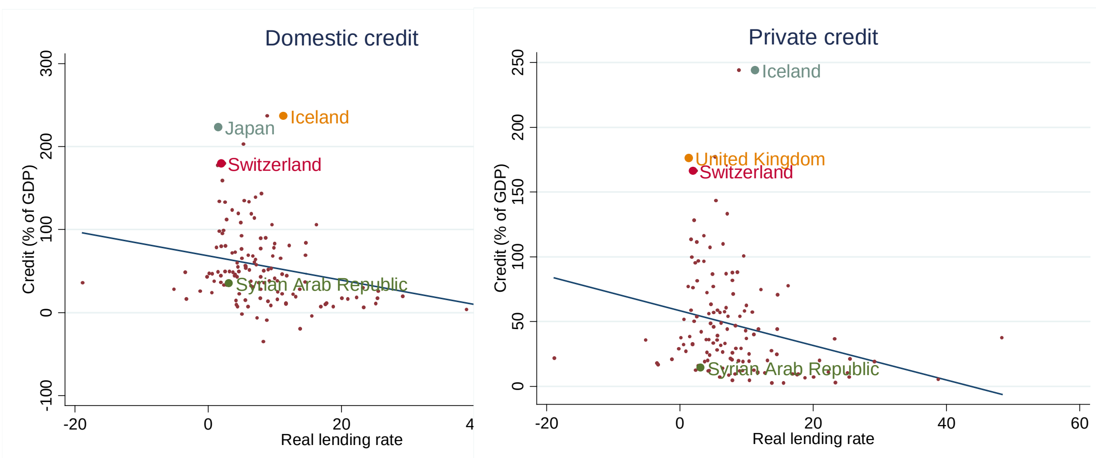
What are the implications of the reform process for credit volumes? Has the financial sector become a more efficient lender? Some signs of success are starting to show. In particular, the ratio of total credit to GDP increased by about 10 percentage points to 36% since

[34] The other state banks are the Agricultural Cooperative Bank (developmental role in the rural sector); the Industrial Bank (which lends mainly to private sector); the Real Estate Bank (which focuses on mortgage backed lending to public sector employees); the Popular Credit Bank (which specializes in credit to low income earners); and the Savings Bank (which takes deposits for on-lending to the government for investment projects).

[35] In spite of the recent upward trend, the Syrian branch network remains underdeveloped. Syria has approximately 2.3 bank branches per hundred thousand people. This figure is at par or below Sub-Saharan African countries but similar to transition economies in Central Asia. See *Making Finance Work for Africa*, Honohan, P., and Beck T., World Bank 2007.

2000. But domestic credit, in particular credit to the private sector, remains extremely low by international standards (Figure 33). It is clear that a comparison of private credit across countries is problematic when the public sector has a much larger share in GDP in countries like Syria than in other countries. Moreover, a large share of non-government trading activity is financed offshore. Although precise figures are not available, the estimates by both financial and business sector range from fifty to seventy percent of the non-oil trade volume.[36] But given a private credit to GDP ratio of 14%, even accounting for these facts would leave Syria well below the average trend.

Figure 34: Benchmarking Syrian credit volumes (Avg. 2004-08)

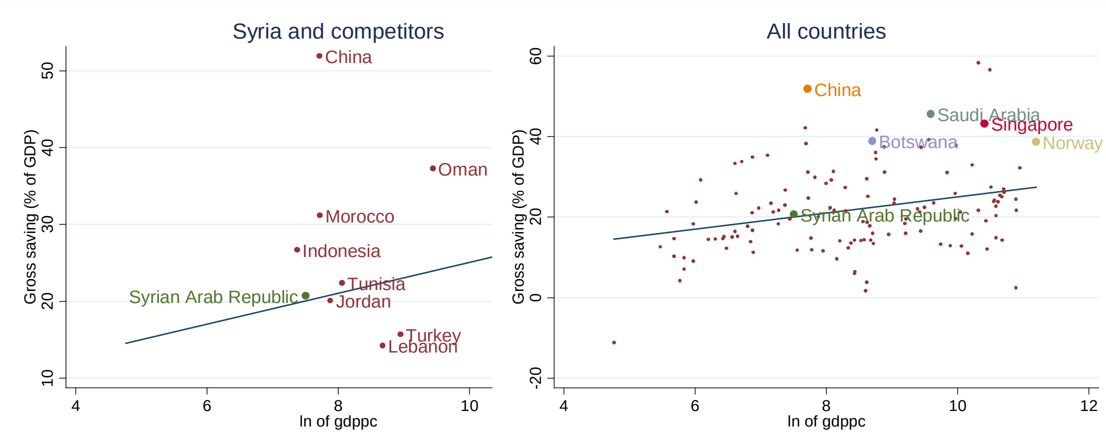


Source: IMF, International Financial Statistics

So why have both credit and investment not grown more strongly? One reason may be that the economy is liquidity constrained. An economy is liquidity constrained if the cost of credit is high or if access to funds is restricted. The natural questions that arise are: Do economic agents save an appropriate share of their income? Do they have adequate access to savings? Is intermediation efficient and interest rates reasonably low? In order to answer these questions, a standard approach is to look, first, at the economy's savings rate. And, second, at price signals such as lending rates and risk premia.

[36] World Bank (2009): Financing of Trade in Syria: A Diagnosis of Issues.

Figure 35: Benchmarking the savings rate (Avg. 2004-08)



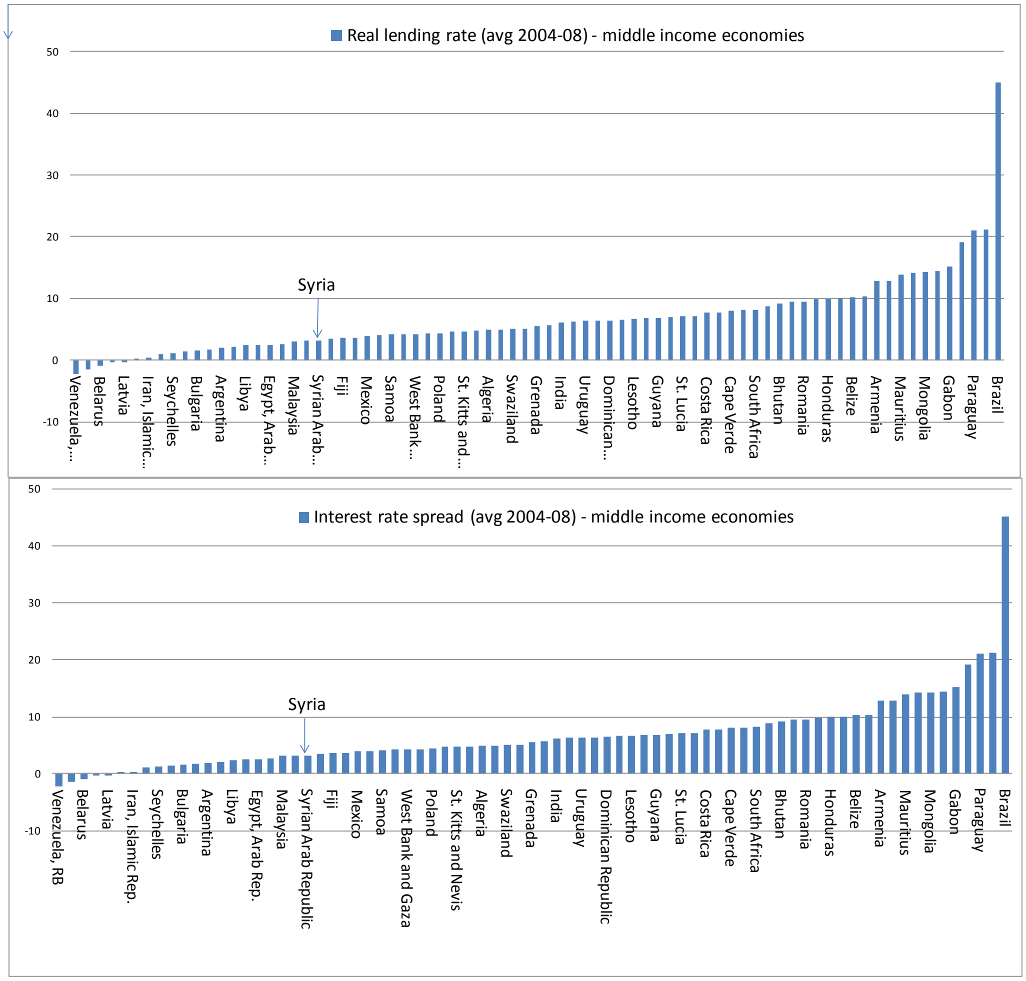
Source: IMF, International Financial Statistics

Syria's domestic saving rate is in line with expectations for its income level and the banking system is liquid, implying that a lack of loanable funds is not an issue. Domestic savings typically increase with national income. The reason is that income growth allows households to save a larger proportion of their disposable income. An international comparison suggests that at about 20% of GDP, the Syrian saving rate is in line with what one would expect given Syria's income level (Figure 35).[37] The lack of loanable funds in the financial system should thus not be an issue. This assessment is further strengthened by the observation that banks in Syria hold vast amounts of non-interest-bearing excess reserves at the central bank. Moreover, their leverage ratios are very low in the international comparison.

And real lending rates are low compared to rates in many other middle income economies (Figure 36). The same can be said for risk premia - measured by the spread between lending and deposit rates. The risk premium signals whether financial intermediation is reasonably efficient, at least for those firms which indeed receive loans. The standard price signals therefore do not indicate that the cost of credit is high in Syria. If credit volumes are small but the cost of capital is not high, what could be holding back Syrian entrepreneurs from investing more heavily in their businesses? Is it low returns to investment?

[37] The very high saving rate in China given the country's GDP level might appear to be an outlier. However, eliminating China from the regression does not change the position of Syria relative to the international average.

Figure 36: Cost of capital, price signals



Source: IMF, International Financial Statistics

7.3 Is investment low because of low returns to capital?

While Syria has made important strides towards a market oriented economy since 2000, indicators show that much more needs to be done to create a competitive and business-friendly economy. This is essential to attract domestic and foreign investment in export-oriented sub-sectors. Figure 38 summarizes Syria's ranking in three main indicators of competitiveness: global competitiveness index, global trade enabling index, and logistics performance index.[38]

[38] One important caveat is that these indicators are not presented on an income-adjusted basis. This is for three reasons. First, it is unclear how to appropriately weight income in order to obtain an adjusted competitiveness score, since the scores are ordinal, not cardinal. Second, there is likely to be bidirectional causality in income and competitiveness; if so, adjusting by income would inadequately account for the impact of competitiveness on

Because the data are available only for a few recent years, it is not possible to make a firm judgment on the trends since 2000. However, the data show that Syria ranks poorly in all three indicators (Figure 38). Among 134 countries, Syria ranked 78 in 2008 in overall global competitiveness (an average of 12 indicators which shows about the same ranking in 2007 but a slight improvement compared to 2006. The ranking is better than the overall average of 78 in indicators related to basic requirements: institutions (54), health and primary education (70), and infrastructure (74), as well as market size (63) and business sophistication (76). Syria's ranking is particularly poor in efficiency-related indicators such as labor market efficiency (123), financial market sophistication (121), technological readiness (107), and higher education and training (101).

The index shows that Syria's ranking in terms of both "technological readiness" and "innovation" was low and mostly deteriorating during 2007-2009. This is especially important since technology and innovation are closely linked to productivity developments in the long run (Romer, 1988). Between 2007 and 2009, Syria's ranking in the innovation pillar of the index deteriorated in all sub-indices except in the "availability of scientists and engineers" index Table 11). In the scientific and technological readiness pillar Syria's ranking is towards the bottom but stable. However, deterioration could be observed in terms of the "availability of latest technologies" and "FDI and technology transfer" (Table 12); the "firm-level technology absorption", and "Internet users" sub indices improved.

The Global Enabling Trade Index, published for the first time in 2008, is a measure of the extent to which countries have in place the factors and policies for enabling trade. Syria ranks 107 in this index among 118 countries worldwide. Among the 10 pillars in this index, Syria's ranking is particularly poor in tariff and non-tariff barriers (117), availability and quality of transport services (116), regulatory environment (112), transparency in border administration (111), efficiency of customs administration (98), and efficiency of import-export procedures (91), while in physical security Syria ranks 33 (Figure 38). This overall weakness in trade logistics is reflected in Syria's ranking in Logistics Performance Index as well, which placed the country 135 in 2007 among 150 countries. The ranking was particularly low in logistics competence (145), international shipments (138), and tracking and tracing (137).

There has not been much change in the Ease of Doing Business Index in the past four years (2006–09); Syria's ranking varied in the 130–137 range among 178 countries. In 2009, the ranking was significantly above the overall average of 137 in two categories (Table 9): getting credit (187) and enforcing contracts (174). Syria's ranking in the Ease of Doing Business is compared to the global best practice economy (Singapore) as well as selected economies in the region (United Arab Emirates, Turkey, Lebanon and Jordan) in Table 10**Error! Reference source not found.**. Syria's ranking is less favorable compared to all the selected countries. This overall weakness in trade logistics is reflected in Syria's ranking in Logistics Performance Index as well,

income. Third, to the extent that improved competitiveness does increase productivity and hence income, countries may wish to strive to attain as high a score as possible, independent of their income levels.

which placed the country 135 in 2007 among 150 countries. The ranking was particularly low in logistics competence (145), international shipments (138), and tracking and tracing (137).

There have been some improvements in subcomponents of the Doing Business index, especially with regard to trade. The number of documents required for imports and exports has fallen between 2005 and 2007, and is now in line with the regional and lower-middle income country average. Similarly, the number of days required for export and import clearance has also fallen, such that Syria's performance is better than both the MNA and LMC average. Nonetheless, the overall "Trading Across Borders" indicator remains weak, at 111.

Table 9: Doing Business

	2006	2007	2008	2009
Ease of Doing Business Index (178 countries)*	135	130	137	137
1. Starting a business		148	169	124
2. Dealing with licenses		83	86	132
3. Employing workers		98	126	122
4. Registering property		87	89	71
5. Getting credit		156	158	178
6. Protecting investors		105	107	113
7. Paying taxes		97	98	99
8. Trading across borders		119	127	111
9. Enforcing contracts		171	171	174
10. Closing a business		77	77	84

Source: World Bank Doing Business reports.

Table 10: Doing business: country comparison

Countries	Ranking
Singapore	1
United Arab Emirates	46
Turkey	59
Lebanon	99
Jordan	101
Syria	137

Source: World Bank Doing Business reports.

Figure 37: Doing business: international comparison

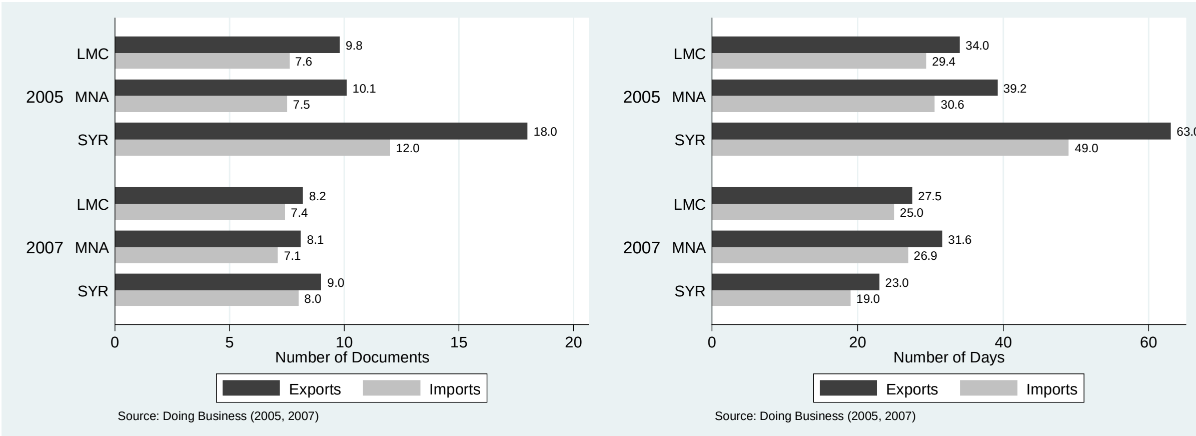


Figure 38: Ranking on various competitiveness indicators, Syria, 2006–2008

	2006	2007	2008
Global Competitiveness Index*	84	80	78
Basic Requirements	69	71	71
1. Institutions	73	61	54
2. Infrastructure	78	74	74
3. Macroeconomic stability	61	98	93
4. Health and primary education	44	69	70
Efficiency Enhancers	104	100	104
5. Higher education and training	96	104	101
6. Goods market efficiency	92	81	92
7. Labor market efficiency	91	117	123
8. Financial market sophistication	122	116	121
9. Technological readiness	109	109	107
10. Market size	na	62	63
Innovation and Sophistication Factor	102	82	80
11. Business sophistication	109	72	76
12. Innovation	99	93	84
Global Enabling Trade Index**			107
Market access			115
1. Tariff and non-tariff barriers			117
2. Proclivity to trade			99
Border Administration			98
3. Efficiency of customs administration			98
4. Efficiency of import-export procedures			91
5. Transparency of border administration			111
Transport and communication infrastructure			94
6. Availability and quality of transport infrastructure			72
7. Availability and quality of transport services			116
8. Availability and use of ICTs			84
Business environment			71
9. Regulatory environment			112
10. Physical security			33
Logistics Performance Index***		135	
1. Customs		108	
2. Infrastructure		131	
3. International shipments		138	
4. Logistics competence		145	
5. Tracking and tracing		137	
6. Domestic logistics costs		84	
7. Timelines		118	

Sources: * UNDP (2007), comprising 131 countries in 2006 and 2007, and 134 countries in 2008; ** WEF (2008), comprising 118 countries; *** Arvis *et al* (2007), comprising 150 countries.

Table 11: Syria's ranking in terms of Innovation

	2007 (Out of 131)	2008 (Out of 134)	2009 (Out of 133)
Innovation Index: Total	**93**	**84**	**110**
Capacity in innovation	106	117	128
Quality of scientific research institutions	91	89	110
Company spending on R&D	104	115	131
University-Industry Collaboration in R&D	105	100	123
Gov't procurement of advanced tech products	94	90	110
Availability of scientists and engineers	56	40	43
Utility Patents	71	80	90

Source: Global Competitiveness Report

Table 12: Syria's ranking in terms of technological readiness

	2007 (Out of 131)	2008 (Out of 134)	2009 (Out of 133)
Technological Readiness index: Total	**109**	**108**	**107**
Availability of latest technologies	61	80	99
Firm-level technology absorption	104	87	81
Laws relating to ICT	128	127	126
FDI and technology transfer	108	110	117
Mobile telephone subscriptions	102	105	112
Internet users	93	93	77
Broadband Internet subscribers	109	107	109

Source: Global Competitiveness Report

Syria's unsatisfactory record in terms of competitiveness is mirrored in its low level of productivity. Real GDP per worker calculations show that Syria compares unfavorably to most of its regional peers and worldwide competitors in term of productivity (Figure 39). Compared to comparators with higher productivity such as Ireland, Korea and Turkey, the data show that Syria's productivity level has fallen over past decades (Figure 40).

Nevertheless, in the last decade productivity (per worker) growth has been positive (Figure 40).[39] GDP growth was relatively high with only agriculture and mining in decline. During the same period, there has been almost no employment growth at all for the economy as a whole. This was driven primarily by the drop in the agricultural employment. The growth rates of employment in other labor intensive sectors were also relatively low (e.g. trade and services). Based on these developments, productivity growth was relatively high for the Syrian economy. A Shapley decomposition of value added growth confirms this finding and indicates that the private sector was the main source of productivity gains in the 2000s.

Macro level analysis suggests that not only labor productivity but also total factor productivity (TFP) improved in recent years. Trend growth in TFP[40] has been positive in Syria since the early 1990s and also high compared to Syria's competitors (Figure 42).

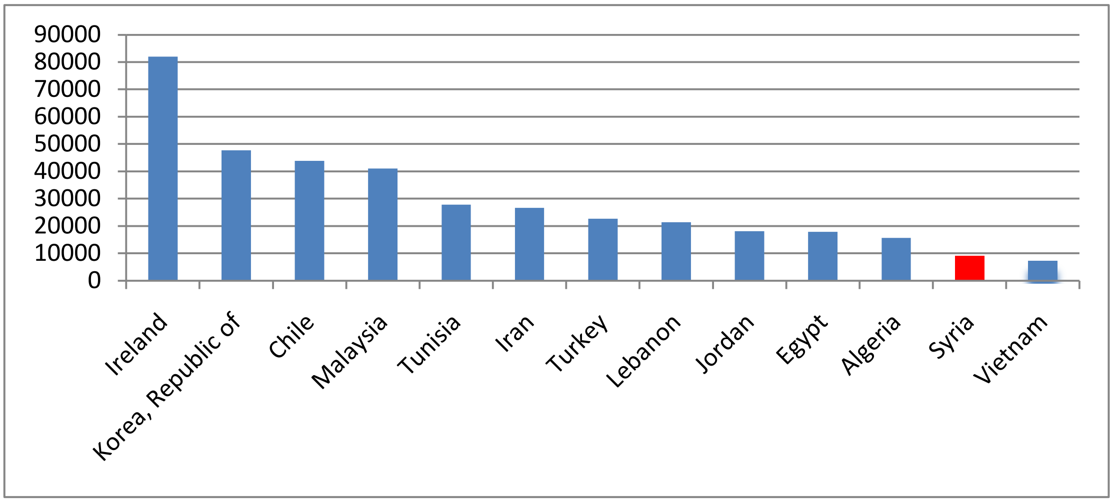
Enterprise survey data (ICA) confirm the dramatic improvement of productivity in Syria since 2004. While in 2005 Syria's productivity was 40 percent below Egypt's – a gap much bigger than that of any other country, by 2009 Syria's productivity was 10 percent higher than that of Egypt.

These productivity improvements suggest that returns to investment in the Syrian economy should be high in spite of low levels of productivity. The gradual transition towards a market economy in Syria is likely to be an important factor in this remarkable turnaround. In this report, we are interested not only in proxies for productivity levels but also trends, as they are closely linked to the concept of returns to investment. In other words, an increase in labor productivity and TFP should under normal circumstances signal not improvements in the competitiveness of the Syrian economy but also increases in returns to economic activity.

[39]The main weakness of the PWT data base is the growth rate of employees in the last decade; it reflects the growth of the active population. However, the actual growth rate of the labor force and employees in the new century was on average lower than active population growth. This weakness led to a slightly lower productivity per worker figures in the PWT database compared to the official data. This study uses the official data based on labor surveys.

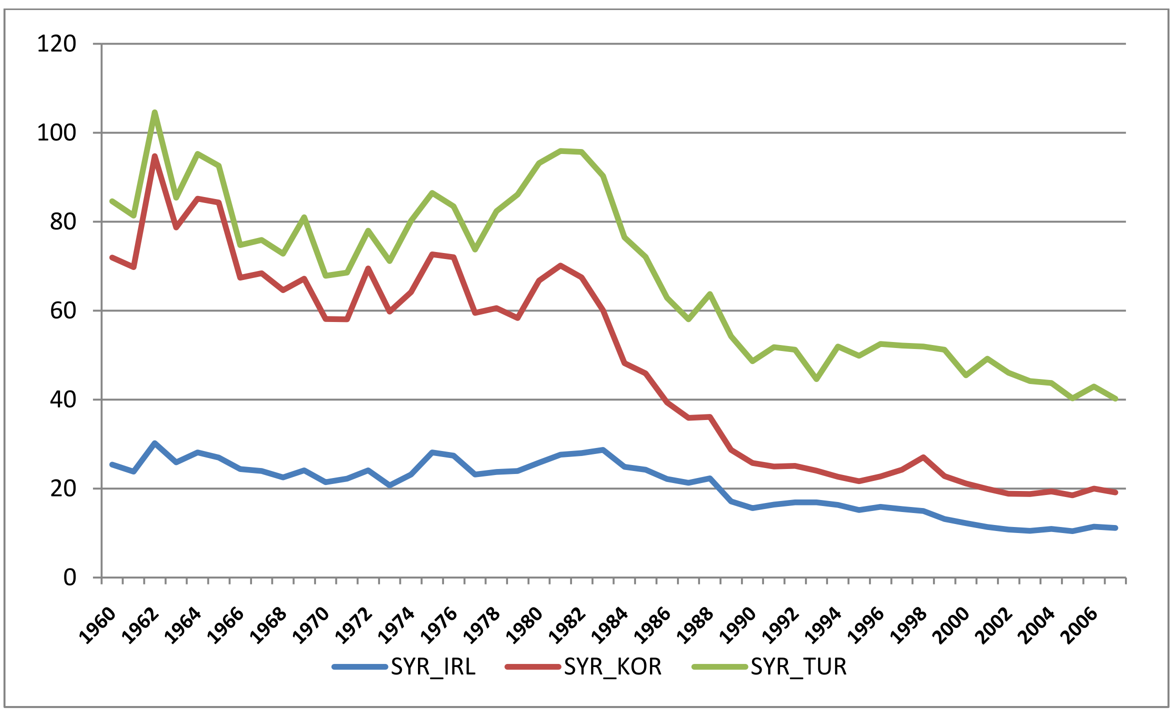
[40] A Hodrick-Prescott filter for smoothing TFP data has been applied in order to discern trends in an otherwise highly erratic variable. TFP data for benchmark MENA countries has been obtained from Collins and Bosworth (2003) growth accounting exercise for many countries in the World.

Figure 39: Real GDP per Worker 2007 (USD, constant prices of 2005)



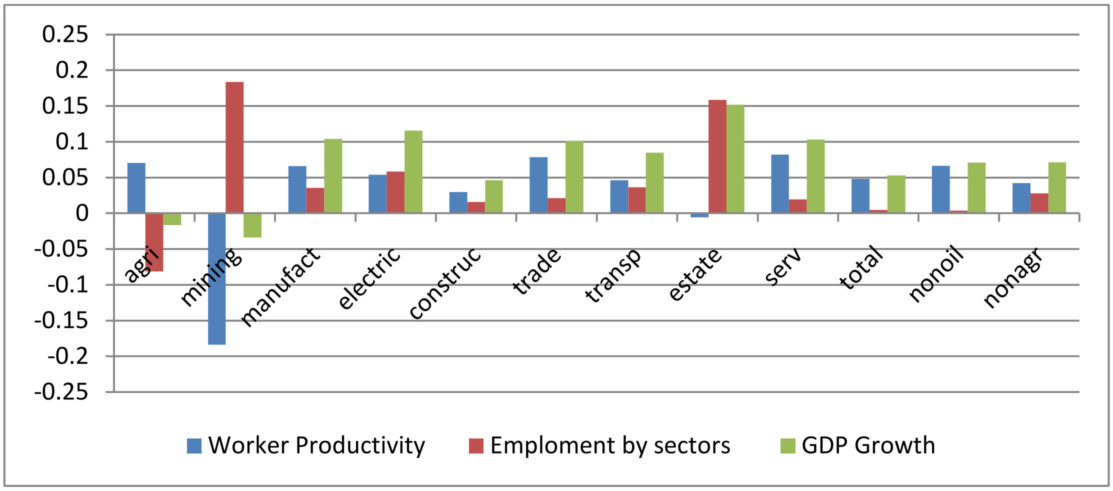
Source: Penn World Tables

Figure 40: Syrian productivity per worker relative to Ireland, South Korea and Turkey 1960-2007



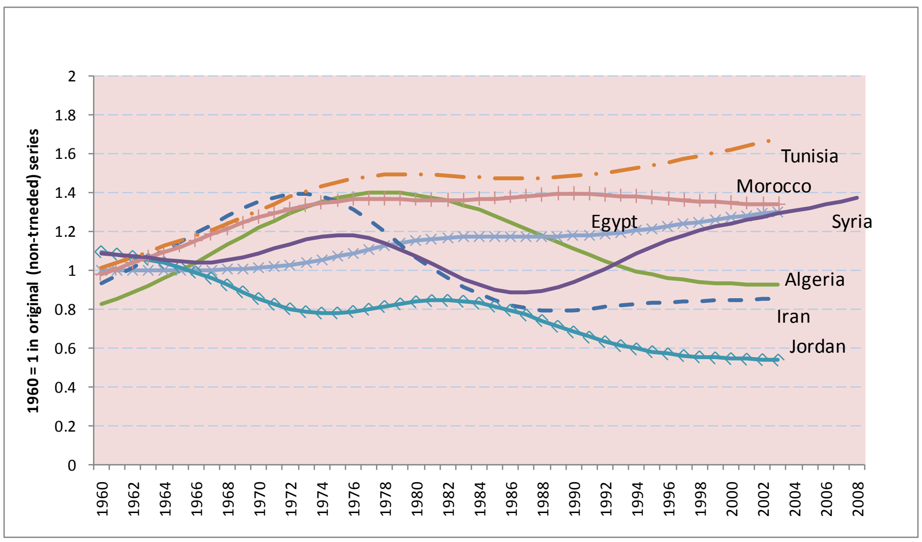
Sources: Penn World Tables

Figure 41: Growth rates of GDP, employment and productivity per worker by sector



Source: National Accounts, Labor Surveys, and authors' calculations

Figure 42: TFP trends (HP filter)



Source: Authors' calculations based on World Bank's DDP and Syria's CBS.

7.4 Why has the investment response been weak despite low cost of capital and high rates of return?

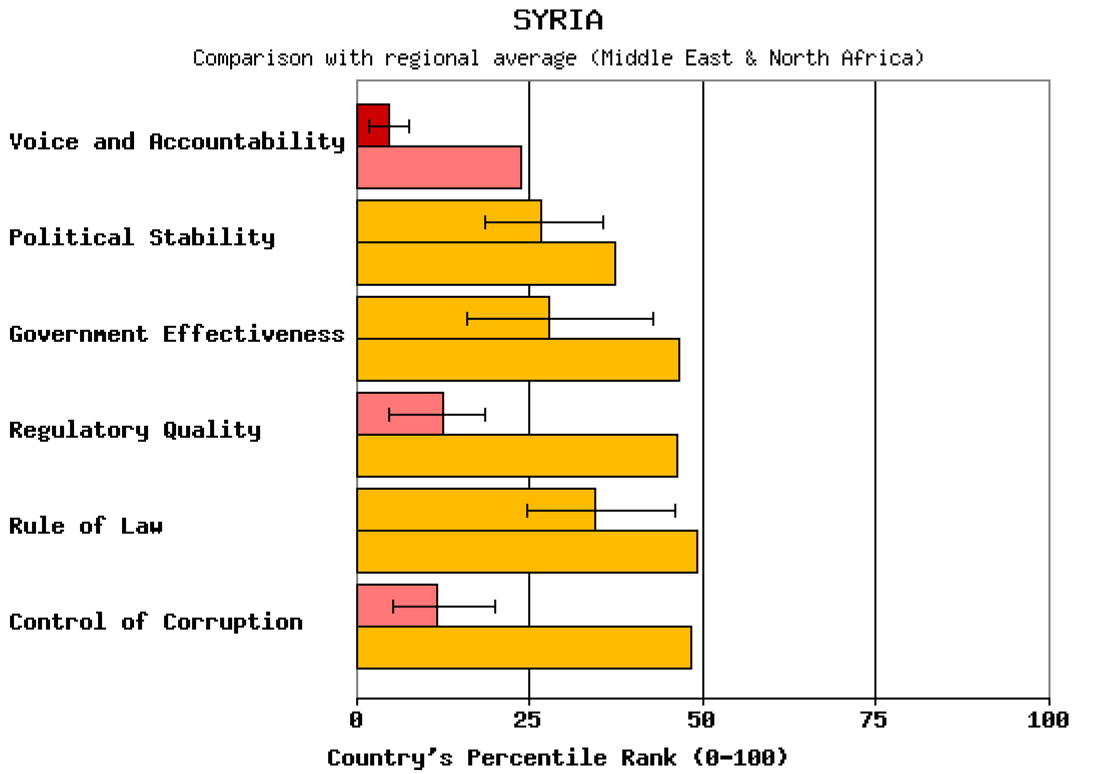
We have shown improvement in Syria's labor and total factor productivity which implies relatively high returns to economic activity. What is more, the cost of capital is not high and the banking system is liquid. In the following, we consider why investment may be low in spite of conditions that are, under normal circumstances, conducive to capital accumulation.

7.41 Persisting institutional weaknesses create an environment permeated by systemic risk that discourages investment

Macroeconomic analysis and private investment data suggest that "structural" uncertainty associated with the institutional setup is a key constraint to inclusive growth. Why is it that Syrian firms do not demand larger credit volumes and seem to finance large shares of their investment via retained earnings? A recent survey conducted by the World Bank suggests that almost a third of firms without loans simply do not believe in borrowing. But a potentially more important reason is that they are constrained by the uncertainty governing their daily operations due to poor governance and in particular institutional weaknesses.

Syria's performance on composite indicators of institutional quality has been lower than the regional average over the past several years. On the Worldwide Governance Indicators (WGI) for 2008, for example, "voice and accountability" and "government regulatory quality" were among the weakest categories, while "control of corruption" has demonstrated a steady decline from 2002 onward.

Figure 43: Comparison between Syria and MENA on WGI for 2008



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2009: Governance Matters VIII: Governance Indicators for 1996-2008
Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

Figure 44: Syria's Worldwide Governance Indicators values – 1996-2008

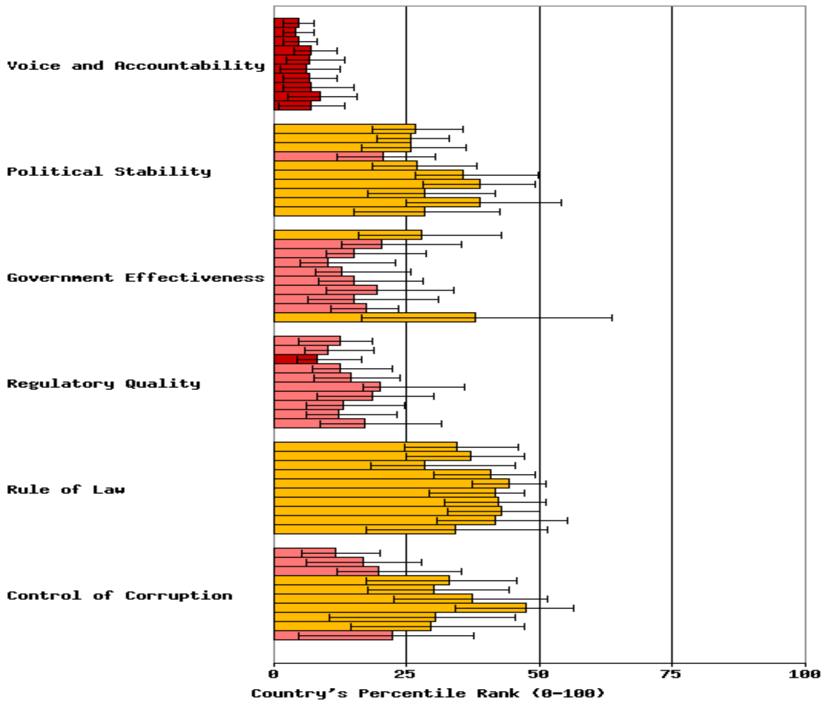
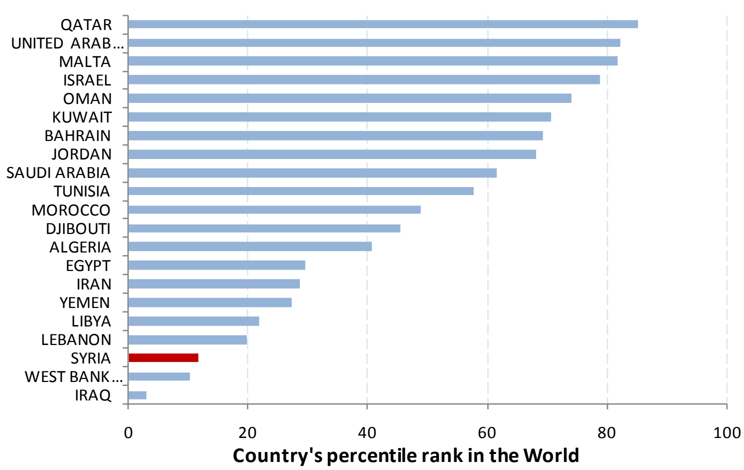


Figure 45: Control of corruption in MENA countries



Source: Kaufmann, Kraay and Mastruzzi, Governance Indicators (2009)

Syria's performance on Transparency International's Corruption Perceptions Index has widely fluctuated over the years, but has been on the lower half of the spectrum. One would notice the steady decline of the indicator since 2005, and the recent increase in 2009. As mentioned above, the government's recent interest and vocal efforts to address governance may

have influenced Syria's score and ranking on the Corruption Perceptions Index. Yet, it is methodologically unsound to base any conclusion on short term fluctuations in the indicator, as a decrease in ranking could very well mean that other countries got ahead – without necessarily indicating that corruption has worsened in the country.

Figure 46: Syria's performance on the Corruption Perception Index – 2004-2009

Year	Ranking	Score
2009	126	2.6
2008	147	2.1
2007	138	2.4
2006	93	2.9
2005	70	3.4
2004	71	3.4

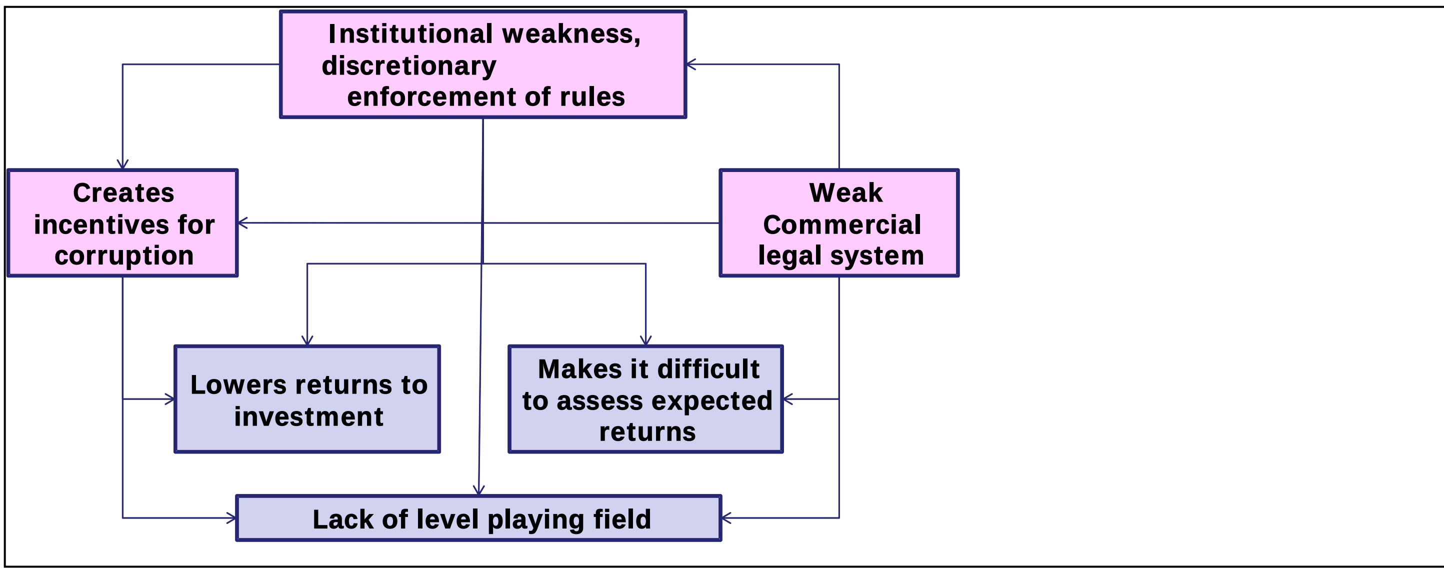
The analysis suggests that economic actors in Syria are bound to have had serious difficulties assessing expected returns due to persisting institutional-related uncertainties, a factor that has been detrimental to investment and firm growth. Those difficulties have come about mostly as a result of vague, unclear existing rules and/or by means of a discretionary enforcement of those rules, which, in turn, create incentives for corruption, and considerably weaken the commercial legal system. In addition, informal payments necessary to tip the level playing field in one's favor lower actual returns to investments.

In an environment of ongoing reform efforts some uncertainty is inevitable. It is the uncertainty about the application of rules, both old and new, that is detrimental to doing business in a market economy. A firm does not know whether it will be granted basic services or permits without substantial informal payments is unlikely to invest. Agents may therefore question the appropriability of returns. Appropriability problems range from microeconomic issues, such as crime, corruption of government officials dealing with the firm, and obstacles for either starting up or continuing doing business; to shifts in macroeconomic conditions that affect market demand and basic prices of the economy; to market failures linked to lack of information or ideas about potential profitable ventures (self-discovery) or to the inability to successfully carry them away due to coordination failures. *These types of issues reduce agents' willingness to embark on new investment projects, or to keep or scale up ongoing businesses. Naturally, this mainly affects large scale investments into machinery and other investments aimed at augmenting productive capacity rather than credit for working capital needs. These are exactly the type of investments that have suffered in the last decade.*

These assertions have been derived from examination of micro and macroeconomic data. At the micro level, we have relied on results from Syria's Enterprise Surveys, and Doing

Business information, across firms, across time, and across countries. We have also made use of sector level cases and anecdotal evidence obtained from local sources, including the Syrian Enterprise and Business Centre (SEBC) and Syria's Industrial Cities.[41] At the macro level, we utilized information obtained from Syria's Central Bureau of Statistics and Syria's Central Bank, as well as World Bank's own Development Database Platform (DDP) and statistics from the International Monetary Fund. Of course, perception data present their own problems including issues of inaccurate reporting; implicit sample bias that exist from the absence of firms that would have existed if the relevant constraint were removed; and the inability of the interviewer to separate from hedonic scales the individual beliefs and cultural issues that lead to heterogeneity of data across space and/or time, and also across sectors of the economy.[42] Having this caveat in mind, one should recognize the value of these indicators as complementary evidence about constraints in the absence of abundant, explicit information on shadow prices from a constraint.

Figure 47: Nexus of binding constraints to inclusive growth in Syria



Source: World Bank Staff

Enterprise survey data show that firms complain about a variety of institutional factors as constraints to doing business. A weak institutional environment is the factor that logically links low investment and credit volumes to low cost of capital and a highly liquid banking sector. This is because uncertainty and ambiguity about how policies are applied make it difficult to form

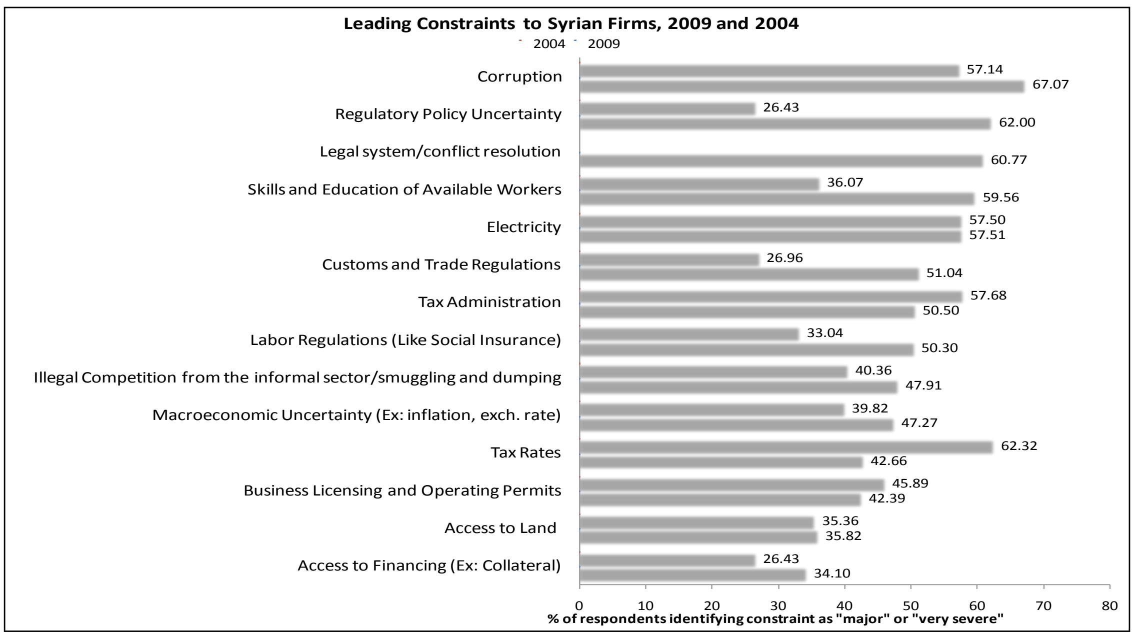
[41] Enterprise Surveys, also known as Investment Climate Surveys correspond to the years 2003 and 2009. Firm data for 2003 and for comparator countries are available at www.enterprisesurveys.org. Doing Business data for Syria and benchmarks available at www.doingbusiness.org.

[42] One should also praise the efforts from sources of micro level data, such as the Enterprise Survey and Doing Business, in trying to achieve higher comparability of data across countries and across time to compensate for unavoidable idiosyncratic problems and biases of samples.

expectations about potential returns. These expectations can be significantly affected by agents' perceptions about the impact of political and economic developments in the economy and elsewhere.

Corruption, regulatory policy uncertainty and the weak conflict resolution/legal system were identified by firms as the top 3 constraints to their operations in 2009. These constraints were reported as 'major' or 'severe' by over 60% of the firms, and replaced taxes and electricity that led the list in 2003 (Figure 48).[43] In particular, corruption jumped 10 percentage points between 2003 and 2009 to become the leading constraint to business in Syrian firms, whereas regulatory policy uncertainty advanced by 36 percentage points.[44]

Figure 48: Constraints to doing business



Source: Syria ICA 2004 and 2009

Corruption lowers private returns. Over 90% of firms reported that an informal payment to public officials was required to "get things done" in their businesses. According to Kaufmann et al. (2009), on control of corruption, Syria ranked as the third lowest in the region; the second

[43] Specifically, the Investment Climate Survey presented the interviewed representatives of the firm a closed question whether 19 specific candidate constraints pose a problem or an obstacle to conducting businesses, judging its severity on a scale from 0 to 4; 0 being "No obstacle"; 1, a "minor obstacle"; 2, a "moderate obstacle"; 3, a "major obstacle"; and, 4, a "very severe obstacle". A binary variable was constructed with the proportion of firms answering with a value of 3 or 4 being represented in the figure.

[44] The legal and conflict resolution system was not included in the closed list of potential constraints to growth in 2003.

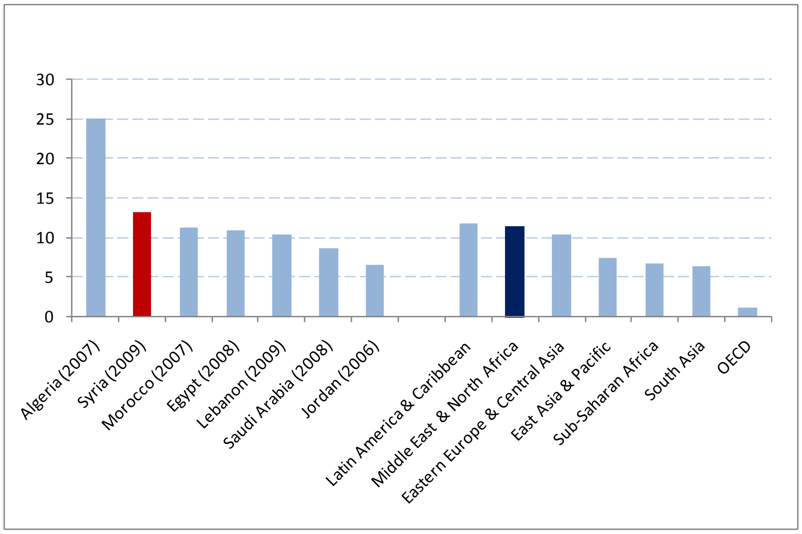
worst among all 6 governance indicators for the country; and much lower than the country's relative international position in 1998. Syrian firms reported that they spent the equivalent of 5.7% of their annual sales value on informal payments and 10% of contract value to obtain a contract.[45] Payments were most common in the interactions with the police, labor/social security inspectors and tax administration, but also characterized the majority of interactions with sanitation and environment inspectors. Almost 37% of telephone connections, 29% of electric power connections, and over a quarter of approval of construction permits, business licenses and import licenses were associated with such payments.

Regulatory uncertainty concerns are most likely linked to the discretionary enforcement and uneven application of rules and regulations rather than the process of structural reforms implemented by Syrian authorities in the past several years.[46] Almost two thirds of Syrian firms <u>disagreed</u> that regulations were consistently applied across the country making it the second most-often cited 'major' constraint to business in Syria. During periods of transition it is often inevitable for regulations to change fast. But the discretionary enforcement of rules and an uneven application of norms across actors and the resulting perception of people about vagueness of law and regulatory uncertainty can be avoided. In fact, governance indicators rank Syria as the second worst in terms of regulatory quality within MENA, after Iran. Enterprise survey data show that managers in Syria spend, on average, about 13% of their time dealing with regulations and bureaucracy. This is the second highest among MENA countries, and higher than the average of any region in the world. Doing Business data for 2009 ranks Syria 143rd out of 183 countries in ease of doing business, showing enforcing contracts, starting a business and getting credit as particular areas of concern.

[45] Some forms of corruption are likely to be documented in surveys, such as the direct payments demanded by officials, while other forms may be suspected but less observable by respondents, such as the use of influence for personal gain or the diversion of public resources for private benefit.

[46] The Government implemented policies promoting private sector participation, and economic diversification and reducing dependency from dwindling oil revenues. These included financial sector reforms, trade liberalization, streamlining of the extensive scheme of subsidies, tax reforms and fiscal consolidation, simplification of the exchange rate regime, actions from Central Bank of Syria to ease the country's monetary stance, as well as measures to mitigate shocks, including droughts and an increase of diesel in agriculture. In the last few years the Government implemented reforms related to starting a business, paying taxes and trading across borders.

Figure 49: Time senior management spends dealing with regulations



Source: Syria ICA 2009

Institutional problems related to the uneven enforcement of rules and regulations are not unique to Syria. A recent World Bank report concludes that the main problem holding back firms in MENA is not one of missing reforms or bad regulations, but one of lack of response of the private sector to reforms, suggesting that there is a gap between the rules and how they are implemented. [47]

7.42 Inadequate private sector access to credit

Uncertainty impairs the ability of economic actors to assess not only their future expected returns, but also their client's expected returns. The previous section discussed the negative impact of institutional uncertainty on the demand for credit to finance investment. However, institutional uncertainty also affects negatively the supply of credit as it makes it difficult for banks to assess the rates of returns of projects and firms more generally. This situation is exacerbated by a lack of risk assessment technology and infrastructure in the Syrian economy as well underdeveloped accounting and auditing standards in Syrian firms.

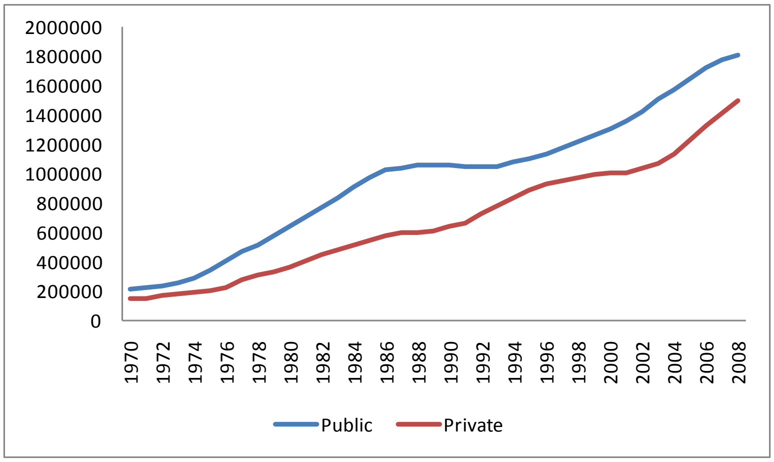
Both demand and supply side credit constraints lead to shortages of credit and affect private SMEs and new entrants most severely, thus also leading to a misallocation of credit. Credit misallocation is a severe problem in itself. It is clear that a lack of level playing field in

[47] World Bank (2009). *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa.*

financial markets hinders capital from being allocated efficiently. This argument holds irrespective of whether private or public firms are more efficiently managed in general. But there are additional reasons why credit misallocation may be a problem in Syria. First, the private sector appears to invest much more than the public sector relative to the amount of credit it obtains. Credit to the public sector is about 50% higher than credit to the private sector, while the private sector invests more than twice as much as the public sector. Second, both a Shapley decomposition and the ICA survey find that government firm ownership is negatively related to firm productivity. Credit misallocation implies that the growing deposit volumes of private firms are not channeled back to the more productive private sector but find their way to public sector firms, blowing their borrowing volumes out of proportion. This implies not only a shortage of credit but also its misallocation. Third, the public sector capital stock is already much larger than the private sector capital stock (Figure 50). Economic theory would suggest that this implies lower returns to additional investment.

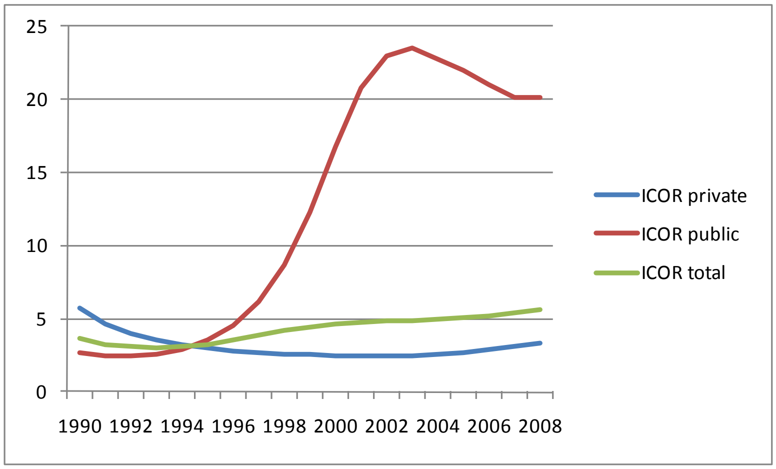
Although partly driven by the drop in oil production in recent years, a falling efficiency of public sector investment is indeed what we observe. In fact, while the investment efficiency, and thus the inverse of the incremental capital output ratio (ICOR) was lower in the private than in the public sector at the beginning of the 1990s, this trend reversed around the new millennium. The magnitude and the speed of the reversal has been striking; the public sector ICOR is now about six times higher than that of the private sector (Figure 51). In this report, ICORs measure the impact of private (public) sector investment on private (public) sector GDP. Consequently, since public sector investment benefits private sector growth, it is not surprising if public sector ICORs are higher than their private sector counterparts. Yet, the magnitude of the gap, and the trend the two series followed in recent years, suggest that private sector investment has indeed been the more efficient driver of growth in recent years.

Figure 50: Capital stock, private and public sector



Source: Staff calculations based on CBS data

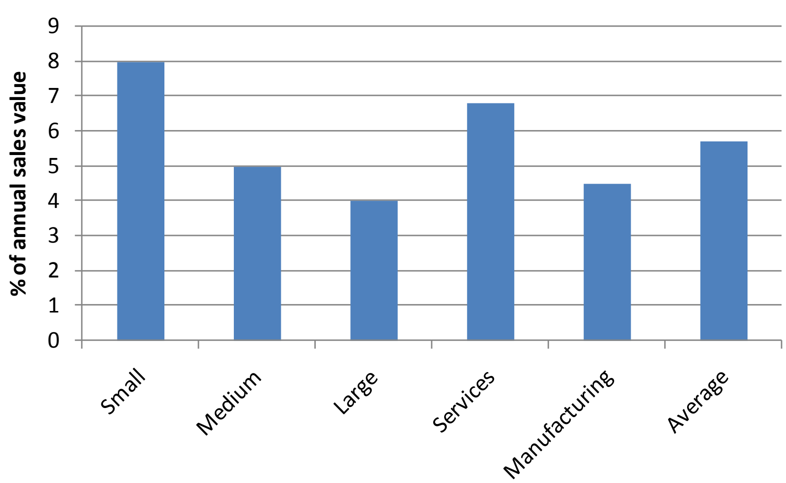
Figure 51: Investment efficiency trends (ICOR)



Source: Staff calculations based on IMF Article IV reports for Syria

Private firms and especially those that are small are more likely to identify corruption as a concern and rely on informal payments than large and medium-sized firms. Smaller businesses also report making higher informal payments as proportion of annual sales than medium and large firms (Figure 52). Similarly, a much higher proportion of private than public firms identify corruption as a major or very severe obstacle to business growth. These practices distort the playing field and harm prospects for inclusive growth as they reduce returns and increase uncertainty disproportionately for small firms, thus discouraging them to apply for loans to finance investment and growth.

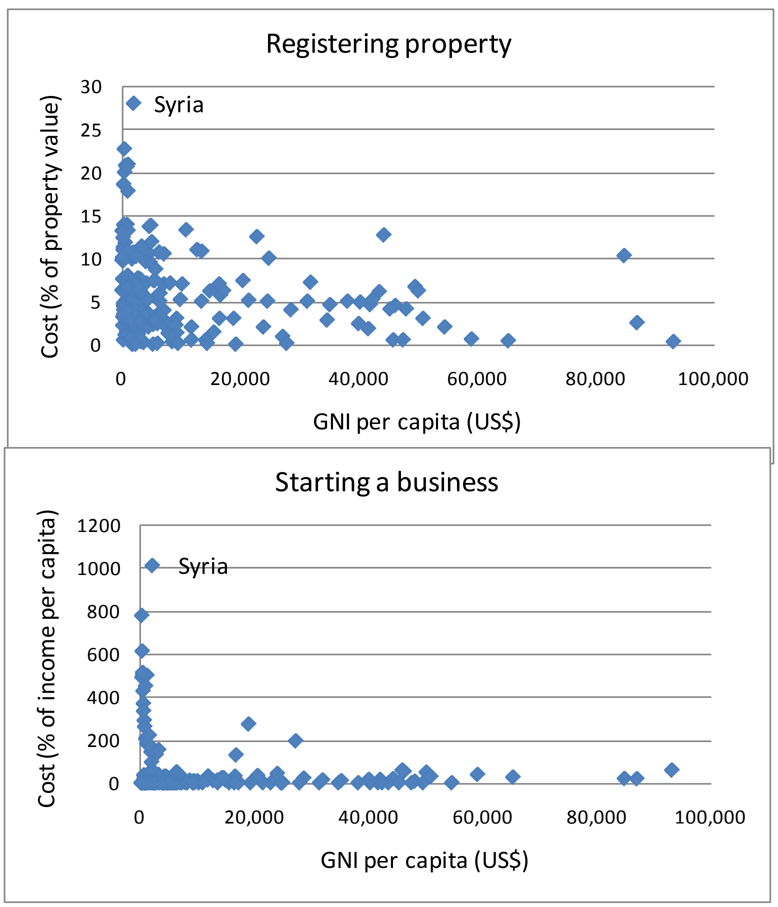
Figure 52: Informal payments made by firms of different size and type



Source: Syria ICA 2009

The lack of level playing field is also apparent when it comes to access to finance in Syria. As a result credit is misallocated at the disadvantage of private SMEs. According to the 2009 ICA survey, about 24% of Syrian firms were credit constrained, not counting the large informal sector and firms with less than 5 employees. This share is much larger than corresponding statistics reported by firms surveyed in other Arab economies except Egypt. What is more, almost half of small and medium enterprises were credit constrained compared to only 11% of large firms and, expectedly, no public firms at all. SMEs have problems accessing not only domestic credit, but also foreign credit which is available mostly to larger, well-connected Syrian firms. This suggests that we observe not only a problem of access to finance in the aggregate but also credit misallocation away from private SMEs. The situation is especially difficult for new entrants. The cost of registering property and the minimum capital for starting a business in Syria were, until recently,[48] the highest in the world (Figure 53).[49]

Figure 53: Market entry costs for businesses

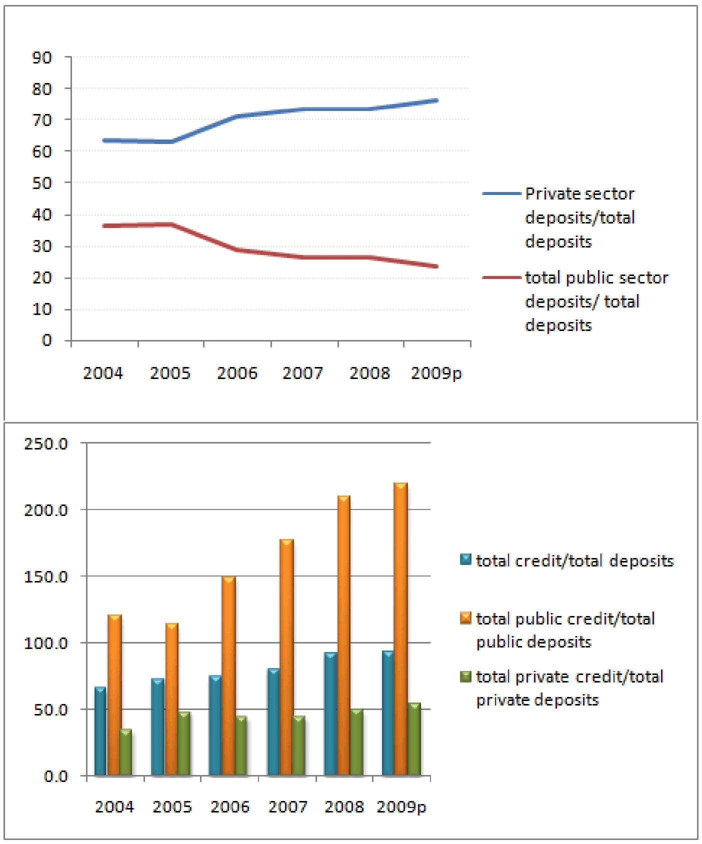


Source: World Bank, Doing Business Indicators 2010

[48] A recent reform lowered the cost of starting a business.
[49] Such practice is at least partially responsible for the large size of the informal sector in the Syrian economy (estimated to be worth 30-60% of GDP). Competition with a large informal sector in turn discourages the adoption of best practice methods and investment in the formal sector.

The misallocation argument is also consistent with the findings of a recent joint World Bank/IMF assessment of the financial sector in Syria. It reports that Syrian business owners receive a substantially smaller share of their total funding from banks and other formal providers of financial services, when compared to business owners in neighboring countries. This situation appears to have persisted despite the entry of private banks into the market. Private banks have in fact focused on serving large corporate clients or clients with connections to parent foreign banks which represent only 5 percent of borrowers in 2007 against a much higher share of bank depositors. Non-salaried employees, and all but the largest business owners tend not to receive finance from the formal banking sector.[50]

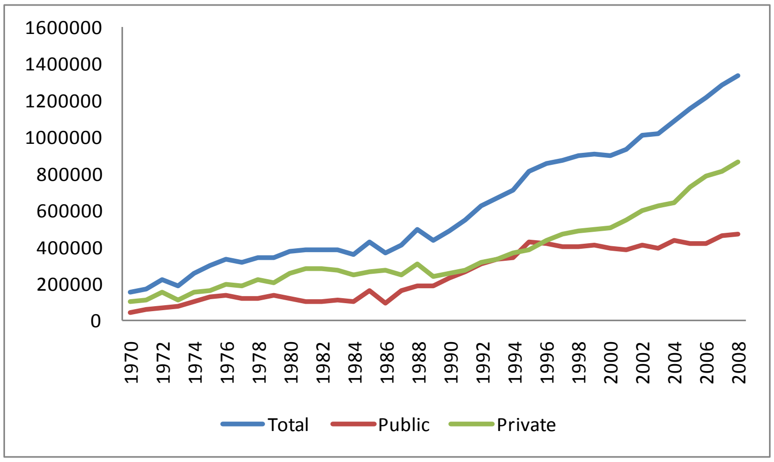
Figure 54: Ratio of credit to deposits



Source: Central Bank of Syria

[50] Source: Joint IMF-World Bank Financial Sector Assessment (FSAP) 2009.

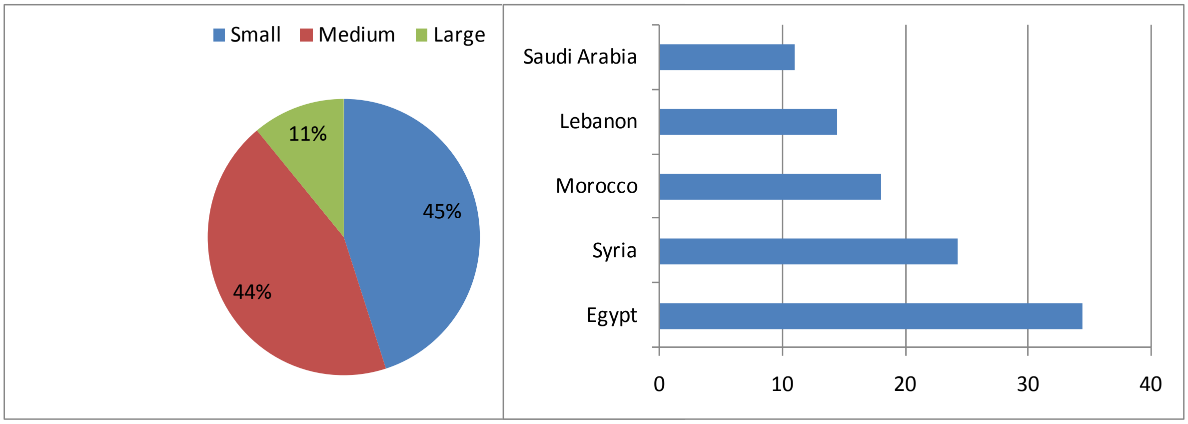
Figure 55: GDP composition, private and public sector



Source: Staff calculations based on CBS data

The observation that private sector firms are particularly constrained receives further support at the macro level. The public sector in Syria still receives almost 50% more credit than the private sector, in spite of the fact that its share in GDP is only about 40% (Figure 55), and in spite of the fact that it invests less than half as much as the private sector. Moreover, transformation of deposits into credit has been on the rise and reached about 92 percent of total deposits in 2008 – indicating efficiency gains in the financial sector – the bulk of the increase in lending went into public sector credit. In fact, the public sector's credit usage was more than twice as large as its deposits in 2008 whereas total credit to the private sector reached barely fifty percent of total private sector deposits (Figure 54). This assessment holds even if one subtracts credit to the government (for subsidy financing etc.) from public sector credit since credit to the central government accounted for less than 20% of total public sector credit in 2008. The trend also seems to point in the wrong direction – the public sector's usage of credit relative to its deposits has more than doubled since 2004 whereas the ratio was essentially constant for the private sector (Figure 54). The growth in private sector deposits, broadly speaking, signals increased firm profitability. But given the low investment volumes in the public sector and its small share in overall deposits, one may conclude that an ever larger chunk of private sector deposits has been funding a seemingly inefficient public sector.

Figure 56: Percentage of firms that are financially constrained by type and country



Source: World Bank, ICA reports

The lack of risk assessment infrastructure is one reason for the misallocation problem. In this respect, it is interesting to revisit surveys assessing the quality of access to finance in various countries. The Capital Access Index (CAI) published by the Milken Institute assesses the performance of capital markets and examines macroeconomic and institutional factors that impact market efficiencies. The CAI ranked Syria 103rd out of 122 countries in 2007. In the 2010 Doing Business survey Syria ranks 181st in terms of "getting credit". A closer look at the categories determining the ranking at the bottom of the sample reveals that banks' willingness to lend is hampered by the fact that they cannot, or only very poorly, assess the riskiness, profitability and creditworthiness of their customers. They do not have access to sufficient information on a firm's credit history because a public credit registry with broad coverage simply does not exist;[51] neither does a private credit bureau (Figure 57). What is more, the weak enforceability of legal rights makes banks especially cautious. Consequently, banks are generally reluctant to lend and prefer to hold substantial excess reserves at the Central Bank at no interest over lending funds to firms whose risk they are unable to assess.

Figure 57: Getting Credit Ranking

Indicator	Syria	Middle East and North Africa	OECD Average
Strength of legal rights index (0-10)	1	3.3	6.8
Depth of credit information index (0-6)	0	3.3	4.9
Public registry coverage (% of adults)	0	5	8.8
Private bureau coverage (% of adults)	0	10.9	59.6

Source: World Bank, Doing Business Indicators 2010

[51] The Central Bank is in the process of setting up a public credit registry but progress so far has been slow.

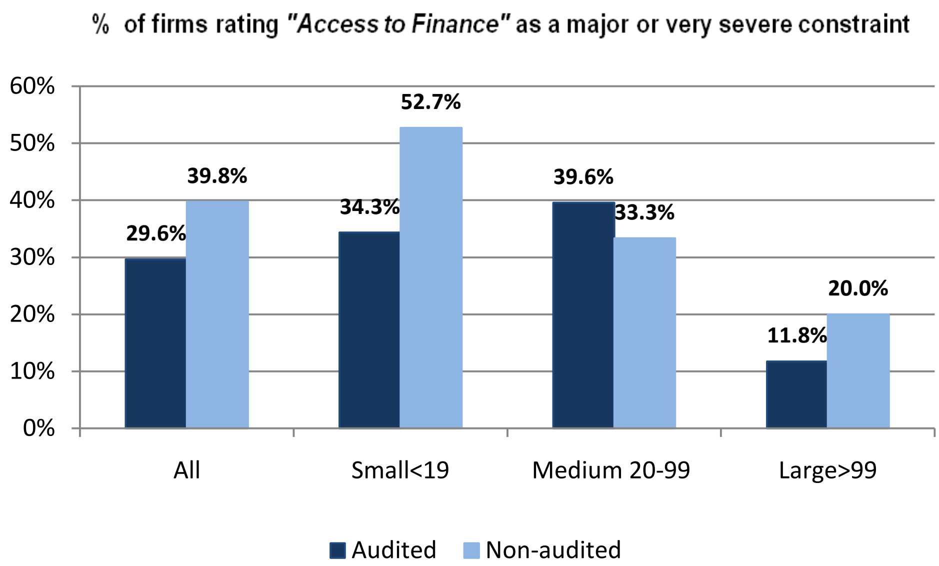
In addition, banks report major difficulties in taking and enforcing collateral due to protracted court procedures and absence of a specialized commercial court. Firms themselves also face difficulties in this respect as the imperfect titling system makes it difficult to pledge assets as collateral. According to a recent joint World Bank/IMF assessment of the Syrian financial sector, collateral required by banks is 217 percent of the face value of the loan it secures, compared to 135 percent in Egypt. The cost of registering property in the collateral registry is also high, about 30 percent of the value of the property, which is three times higher than in Jordan.

Finally, accounting and auditing procedures are not well developed in private SMEs. SMEs usually lack transparent financial data. This makes it more difficult for banks to assess their profitability. The argument receives indirect support by the observation that banks are in fact highly liquid, possess sizeable, low-yield cash holdings at the Central Bank and are generally only weakly profitable. These findings indicate that private banks have little appetite for lending that might eventually result in seizure of collateral.[52]

Recent survey results suggest that assisting SMEs in applying auditing procedures would indeed help reducing their lack of access to finance. Figure 58 shows that 53% of all small firms that do not apply auditing procedures regard access to finance as a major or very severe constraint to their business. This compares to only 34% of small firms using auditing procedures. In contrast, the difference between firms that use auditing procedures and firms that do not is significantly smaller for medium or large firms. In fact, large firms using auditing constraints appear to be more financially constrained than large firms which do not.

[52] Source: Joint IMF-World Bank Financial Sector Assessment (FSAP) 2009; IMF Article IV report 2009.

Figure 58: Percentage of Firms Rating "Access to Finance" as a Major or Very Severe Constraint



(Source: ICA Report 2009)

Of course, risk assessment of small and medium sized enterprises, and newly established firms, is especially difficult. These firms usually do not have transparent financial data and lack proper accounting systems. Moreover, it is very difficult to separate personal and family assets from those of the businesses. Therefore, banks usually ask for additional personal guarantees and collateral.

7.5 Insufficient competitiveness of non-oil exports constrains Syria's inclusive growth potential

Growth and diversification of non-oil exports is a key component of inclusive growth. Expansion (and to some extent diversification) of non-oil exports has been an important driver of recent acceleration of growth in Syria. It will continue to contribute significantly to future inclusive growth. This is because non-oil exports would help:

- Generate foreign exchange earnings (to offset declining oil exports) to finance essential imports for investment and production,
- Create external demand (to supplement small domestic demand) to be able to absorb expanding production in the non-oil sector,
- Enhance employment creation for inclusive growth in labor-intensive sub-sectors,
- Encourage foreign direct investment to expand the productive capacity in the non-oil sector.

Growth and diversification of non-oil exports would, in turn, require improvement in Syrian competitiveness in international markets. In the past several years various trade and trade related reforms were introduced improving Syria's ranking in international

competitiveness, to which non-oil exports responded positively. However, the indicators also show that Syria's ranking is still relatively poor compared to regional trading partners and there is substantial scope for further improvement. This section reviews the main trade regime related barriers to furthering Syria's competitiveness and consequently to growth and diversification of non-oil exports[53].

The Syrian trade reform agenda was initiated with the 9th Five-Year-Plan in 2000. The 10th Five-Year Plan - instituted in 2006 - made trade reform objectives more explicit. In addition to the primary goal of export diversification, the plan included reforms aimed at export promotion, tariff and non-tariff barrier reduction, and trade facilitation through revisions in the legal framework. Syria has also become a signatory to preferential trade agreements. Together with other 16 Arab countries, Syria joined the Greater Arab Free Trade Area (GAFTA) in 2005 in response to which Syria's trade with GAFTA members increased significantly. A free trade agreement with Turkey went into force in 2007 and the trade between the two countries tripled by 2008. Syria also initialed an Association Agreement (AA) with the EU in December 2008 although the negotiations were put on hold. Turkey, Lebanon, Jordan and Syria agreed in June 2010 to set up a free trade zone, complete with a visa-free travel regime for their nationals. In addition, Syria has formally begun negotiating a free-trade agreement with South America's powerful Mercosur trade bloc, following the signing of a framework agreement in December 2010. The process of Syria's WTO accession started in 2010 as the US objection to its membership was lifted.

Syria's ranking in international competitiveness has improved as a response to trade and other related reforms. Syria's ranking in four international competitiveness indicators is summarized in Table 1. They show improvement in recent years reflecting the impact of the trade and other policy reforms Syria introduced since 2000 particularly during the 10th Plan.

Table 13: Syria – Ranking on Various Competitiveness Indicators*

	2007	2008	2009	2010
Global Competitiveness Index	64.1	61.1	58.2	70.7
Global Enabling Trade Index	-	90.7	89.3	82.5
Logistics Performance Index	90.0	-	-	51.6
Trading Across Borders Index	68.0	70.2	60.7	64.5

* The number of countries included in the calculation of each index varies over time and

[53] For a more detailed analysis, see "Trade Reforms and Export Diversification in Syria: A Diagnostic Review", November 2009, "Improving Export Incentives and the Free Zones System in Syria", June 2010, "Estimates of Trade Adjustment Costs in Syria", February 2010, "Export Diversification Trends in Syria", May 2010.

among indexes. This makes the interpretation of trends difficult. To avoid this problem, the rankings are normalized so that 1 indicates the best ranking while 100 shows the worst.

Syria improved its ranking in leading trade indicators. The Global Competitiveness index, prepared by the World Economic Forum, is a widely used broad indicator. Syria improved its ranking in this index from 64.1 in 2007 to 58.2 in 2009. The deterioration of the ranking in 2010 to 70.7 is due largely to the substantial improvement in policy environment in some other countries compared to Syria. The Global Enabling Trade Index, prepared also by the World Economic Forum, shows the extent to which the trade enabling measures and policies are in place. Syria's ranking in this index has steadily improved from 90.7 in 2008 to 82.5 in 2010. The Logistics Performance Index focuses on the logistical aspects of trade such as infrastructure, tracking and tracing, international shipment, etc. It is prepared by the World Bank. Syria has improved its ranking significantly in this index from 90.0 in 2007 to 51.6 in 2010. The last index, Trading Across Borders, is a sub-indicator in World Bank's Ease of Doing Business Index. In this index too, Syria's ranking shows improvement from 68.0 in 2007 to 64.5 in 2010.

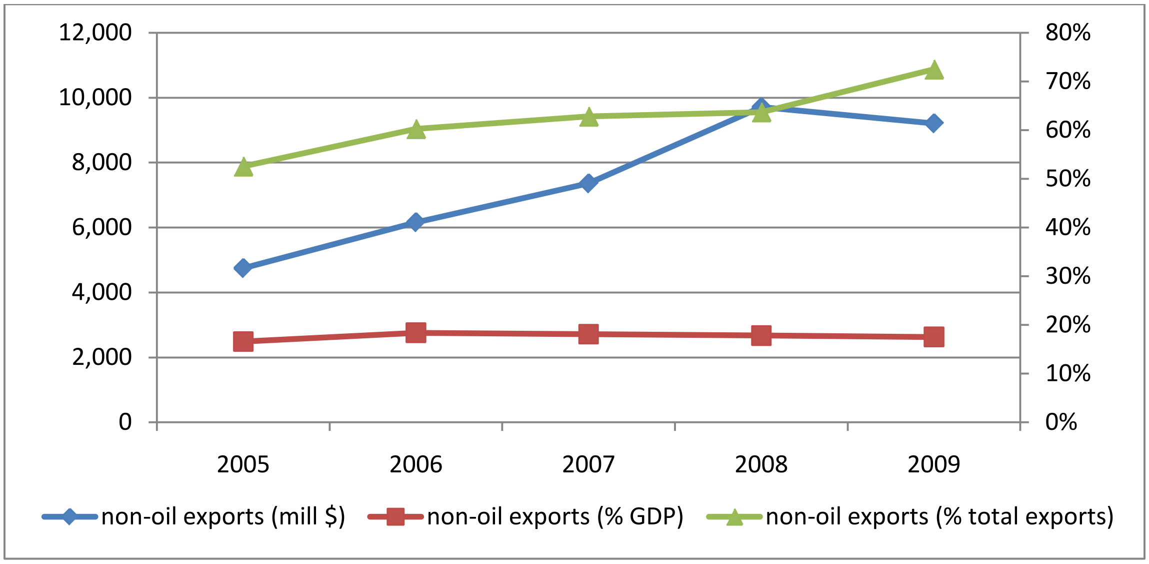
The Syrian economy responded strongly to reforms particularly since 2004. Despite declining oil production, the growth of GDP averaged 5.2 percent from 2004 to 2008 compared to 2.7 percent achieved in the five-year period prior to 2004. The non-oil sector has become the dominant component of growth with an average growth rate of 7.3 percent in this period. Important changes have taken place in the structure of Syrian non-oil exports with regard to its growth, product composition, the share of the private sector, and the relative importance of the trading partners (Table 14). Non-oil exports increased from $ 1,651million in 2003 to $ 8,967 million in 2007 with its share in GDP rising from 7.6 percent to 18.1 percent in the same period. Private sector played an important role in non-oil export growth raising its share in total from 72.4 to 92.8 percent.

Table 14: Main Trends in Non-Oil Exports

	2003	2007
Non-oil exports, million $	1 651	8 967
Share of non-oil exports in GDP (%)	7.6	18.1
Share of private sector in non-oil exports (%)	72.4	92.8
Number of products exported*	150	162
Destination of exports (% of total)		
EU	61.1	43.0
Middle East	12.6	25.7

* Number of products calculated at 3-digit level STIC classification, and includes only products whose value exceeds $100 000 or 0.3 percent of total exports.

Figure 59: Evolution of non-oil exports



Diversification is evident within the non-oil exports with increased number of products being exported, especially in manufacturing goods. The number of exported products (at 3-digit level) increased from 150 in 2003 to 162 in 2007 (Table 2). The geographic composition of exports also shows significant change. The EU's share in total exports declined from 61.1 to 43.0 percent during 2003 – 2008, while the share of the Middle East and North Africa (MNA) increased from 12.6 to 25.7 percent. This is an indication of increased integration of Syria with the MNA region, but also reflect declining share of oil in Syria's exports, which goes mainly to the EU markets.

The recent performance demonstrates that Syria has the potential to further expand and diversify its non-oil exports. Due to its strategic location in the middle of the major markets of Europe, the Middle East, Asia, and Africa, and an already reasonably diversified production and export base compared to other countries in the region, Syria has the potential to further expand and diversify its non-oil exports. Substantial potential exists particularly in fruits and vegetables, cotton, live animals, olive oil, processed food, textiles and garments, construction material, other light manufacturing, and tourism.

Syria will need to continue improving its competitiveness to realize this potential. Table 15 compares Syria's ranking with Egypt and Turkey, two main competitors in the region. In all four indices in 2010, Syria ranks significantly poorly, especially compared with Turkey. Only in the case of the Logistics Performance Index Syria outranks Egypt, but scores 51.6 compared to Turkey's 25.2.

Table 15: Competitiveness Ranking – Syria, compared to Egypt and Turkey, 2010*

	Global Competitiveness Index	Global Enabling Trade Index	Logistics Performance Index	Doing Business Trading Across Borders Index	Doing Business Total Index
Syria	70.7	82.5	51.6	64.5	78.1
Egypt	52.6	60.3	59.4	15.8	57.9
Turkey	45.9	49.2	25.2	36.6	39.9

* Rankings are normalized as noted in Table 2, so that 1 represents the best performance, while 100 the worst.

Syria can do much more to raise its ranking further in international competitiveness. Trade policy can play a critical role in reducing costs and enhancing competitiveness[54]. The following section summarizes the follow up reforms in the trade regime to be undertaken in the 11th Five-Year Plan to achieve this objective.[55]

Measures have been taken during the 10th Five-Year Plan to improve and simplify the import regime but reforms need to continue. The 10th Five-Year Plan included the following measures: reduction of tariffs on some inputs and the maximum rate from 255 to 50 percent, elimination of a number of non-tariff barriers (NTBs), simplification of licensing system and reduction of the number of products on the "negative list". However, there remain several features of the import regime that complicate import clearance and introduce discretion in implementation encouraging illicit practices and increasing costs. Some of these features are not consistent with WTO rules. Reforms will need to continue during the 11th Five-Year Plan in the following areas.

- The simple average most favored nation (MFN) tariff is 14 percent, slightly higher than the average of the developing countries overall, but the current regime has too many non-zero tariff bands (1, 3, 5, 7, 10, 15, 20, 30, 40, 50, 60) and a high maximum rate.
- In addition to tariffs, Syria has a complex system of other taxes and charges, which includes four taxes (municipal, consumption, import permission, and pre-income tax) and a large number of service fees. Some of these taxes and fees are not consistent with WTO rules.
- The remaining NTBs include a long "negative list", licensing for each shipment, and the state monopoly on exportation of certain products (cotton, wheat grain, tobacco, maize, calcium phosphate, etc). There is considerable uncertainty about the number of products on the negative list. In the case of four digit level products on the list, it is not clear whether all six and eight digit level products under that category are included. This

[54] Other factors would include cost saving measures such as improvement in infrastructure and administrative services, and productivity increase by better management and new technology.
[55] The proposed reforms should be considered as part of a broader reform agenda because they would be more effective if they are supplemented with complementary actions in other policy areas such as infrastructure, private sector development, macroeconomy and exchange rate, fiscal management, sectoral development, etc.

creates a significant degree of discretion in interpretation of the negative list when the goods are cleared.

Syria does not have an export incentive system in place to enhance the competitiveness of its products in international markets. The objective of export incentives is to reduce the costs of exported products with policy instruments consistent with WTO rules. These costs include: taxes on imported inputs (tariff and other taxes), domestic taxes (direct and indirect), costs of doing business and trading (administrative costs of setting up and managing business, importing and exporting), and infrastructure services (electricity, transportation, telecommunication).

The capacity of the financial sector should meet the financial needs of diversification and trade. Inadequate access to credit for both investment and working capital is an important constraint to non-oil exports. This arises from several features of the Syrian economy and the financial system. They may be grouped under the following three headings.

- Systemic issues: A large part of Syrian-owned financial entities are still located abroad. Syria is largely a cash-based economy with negligible use of checks, and credit and ATM cards. Under-invoicing and double book-keeping is wide-spread. These features, which are due largely to uneasiness of the private sector to disclose their financial information and assets to private or public institutions, limit the size of the financial sector.
- Demand-side weaknesses: Financial statements of companies are not transparent and difficult to appraise for credit purposes. This is explained partly by the unfamiliarity with good accounting practices particularly in the case of SMEs. Reluctance on the part of the private companies to disclose their financial transactions is also an important factor as noted above.
- Supply-side weaknesses: Financial sector infrastructure (the payments system, accounting and auditing practices and standards, credit registry, disclosure requirements, regulatory system, etc.) is outdated. The dominant financial instrument is short-term credit to larger companies and public enterprises. Other financial instruments such as longer-term investment credit, loan guarantee schemes, dedicated credit for exports, SMEs, etc. are either non-existent or limited.

Under the EU, UNCTAD and UNDP assistance, progress has been made to improve customs administration. Most custom posts are now computerized and ASYCUDA II is implemented. The key customs management concepts such as risk management, valuation, transparency, skill development, etc have been introduced but not yet fully implemented. The system still has elements of inefficiency and is open to discretion resulting in corruption and delays in processing thereby raising the cost to businesses including exporters. This is reflected in Syria’s low international ranking in customs administration (data, customs sub-component of global competitiveness index).

Inability of Syrian products to meet the required health and safety standards in the major markets, particularly in the EU, is an important barrier for Syria to increase its share in these markets. Under the current standards system, the responsibility of standards setting, conformity assessment, accreditation, testing, and certification are disbursed (but, not well

coordinated) between the Syrian Arab Standards and Metrology Organization (SASMO) and a few other institutions. The policy and regulatory framework under which these institutions operate, their administrative and skill capacity, and physical infrastructure need to be substantially improved to be able to offer internationally recognized standards services. Some reforms have been undertaken including opening the testing services to the private sector. Much more need to be done to remove this important barrier to export growth.

In 2009, the Government set up the Export Development and Promotion Agency (EDPA) to provide promotional services on a broader scale.[56] EDPA has started building its institutional and skill capacity, assisting exporters to participate in trade fairs, organizing training for exporters, setting up a website and an information center. The Government has recently issued the Syrian Export Development Strategy to define EDPA's work program for 2010 – 15. The Strategy has three components: Promotional activities, the Export Fund, and Export Loan Guarantee Facility.

- Promotional activities include setting up an information center, publishing user-friendly booklets for exporters, organizing training courses, participating in trade fairs, etc. Further work would be needed to turn these broadly defined activities into detailed annual programs.
- The Export Fund is intended to be a drawback scheme. The drawback scheme is very important to improve the competitiveness of non-oil exports. It has to be carefully designed and an implementation mechanism be put in place. This scheme is normally implemented by the Ministry of Finance or the Customs Administration. As noted above, a Loan Guarantee Scheme is already being developed under the SME Support Program. It is advisable to reconsider establishing another guarantee scheme under EDPA to avoid overlap.
- The Export Development Strategy would benefit from further thoughts and considerations. In its current form, it tasks EDPA to focus on activities that are normally implemented by other specialized institutions, and broadly defines the promotional services that EDPA should provide. It would be preferable for EDPA to use its limited resources for developing effective promotional and training services only.

The Government has taken important steps to ensure effective coordination of policies and reconciliation of the competing objectives. The responsibility of formulation and implementation of trade policy is diffused among various ministries and departments. Each ministry or department's interest is different. The Ministry of Economy and Trade focuses on expansion of trade. The interest of the Ministry of Finance is more on revenue generation. Other ministries take a more protective stance for the sectors they are responsible for. The Government has taken important steps to ensure effective coordination of policies and reconciliation of the competing objectives. In particular, it set up the Higher Export Council and the Exporters Association in 2009.

[56] SEBC has been providing some export promotion services under the SME support program.

Syria recently signed several free trade agreements (FTAs) to promote its integration into the world economy and to take advantage of growing international trade. Syria signed the Greater Arab Free Trade Area Agreement (GAFTA) with the Arab countries in 1997 to foster inter-Arab economic integration, improve competitiveness as a group, and better compete internationally. The tariff phase down under the Agreement was completed in 2005. A free trade agreement with Turkey went into force in 2007. Syria also initialed an Association Agreement (AA) with the EU in December 2008, under which Syria will reduce its tariffs over 12 years. The AA waits for ratification from the Syrian Parliament. In June 2010, Syria reached agreement with Turkey, Jordan, and Lebanon to set up a free trade zone with a visa-free travel regime for their citizens. Other recent FTA initiatives include bilateral negotiations with Malysia as well as multilateral negotiations with Russia, Belarus, and Kazakhstan and with South America's powerful Mercosur trade bloc, respectively.

However, it is necessary to carry out studies to estimate the impact of the FTAs and identify areas where improvement is possible (e.g. implementation of rules of origin[57]) in order to better harness the benefits for Syria. The trade agreement appears very successful. Syrian exports to Turkey doubled from 2007-2010 as compared to the three pre-FTA years. Turkey’s exports to Syria increased about 2.5 times. In the first eight month of 2010, Syria's exports to Turkey accumulated to USD 530 million (compared to USD 220 million in 2009). Moreover, more than 139 Turkish firms invested about USD 700 millions in Syria in 2009 and the flow of tourists between the two countries experienced substantial growth. Still, no empirical work has been conducted to understand the full impact on the Syrian economy including the revenue effect. For instance, the Syrian-Turkish FTA is limited to manufacturing products excluding food items. Still, both economies have in part similar specialization patterns, e.g., in textile or light manufacturing industries. Thus, Syrian firms in these industries face fiercer foreign competition. To maximize the benefits, it will be important that Syrian firms adopt technologies and knowledge from Turkish competitors and successfully integrate into the value added chain with Turkish firms, e.g., in order to export to the EU market.

The Higher Export Council will determine the overall direction of trade policy and monitor implementation in a coordinated way. Its board, to be chaired by the Prime Minister, includes the Deputy Prime Minister, 6 Ministers, Chambers of Industry and Commerce, EDPA, and Exporters Association. The Exporters Association will represent the exporters in policy forums, lobby for policy improvements, and assist its members. It already has 200 members. It works closely with EDPA on promotional and training activities. These measures fill an important gap in formulation and implementation of trade policy. It is advisable to set up a secretariat for the Higher Export Council housed in EDPA to ensure that the Council has adequate data and information to carry out its responsibilities effectively.

[57] Adherence to the rules of origin under the GAFTA arrangements breaks down frequently because there are no reliable rules of origin certification in the member countries. As a reaction, Syria has recently taken measures to stop unfair trade practices. These measures include minimum import prices and temporary customs duties on certain products imported from some member countries.

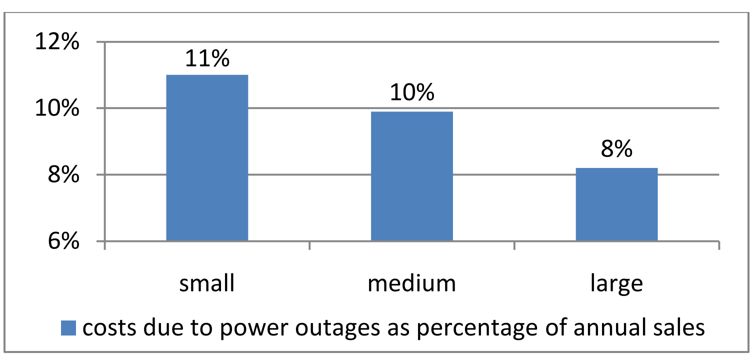
Analytical capacity for policy analysis both inside and outside government is weak. The gap is usually filled by engaging short-term consultants and commissioning analytical work under donor programs, which meet the needs in the short-term. The medium-term answer to the problem lies in continued efforts to invest in the analytical capacity of the MoET staff, and creation of an independent unit outside government with the necessary expertise to conduct in-depth studies and play as an advisory role for both the Government and the business community. The EU under its TEP provides technical assistance to establish a Trade Policy Analysis Center. The structure of the Center and where it is housed should be carefully selected because they are critically important for its effectiveness. Partnering the Center with a research institute in the developed countries would be very useful.

7.6 Major infrastructure constraints

Electricity is considered a major obstacle to doing business by nearly 60 percent of firms in Syria, according to enterprise survey data (World Bank, 2010). In fact, Syria ranks second among countries with data in the MENA region in terms of frequency of power outages and output losses derived from it, and in terms of the fraction of firms that own a generator (Figure 64). This problem has actually worsened since 2004. Even though the percentage of firms that rate access to electricity as a major or severe constraint remains at a high 57.2% since 2004 (fifth most important constraint to business and entrepreneurship in 2009) the frequency of power outages has actually increased and so has the number of days firms have to wait to get electricity connection.

The low quality of electricity services disproportionately affects SMEs. The 2009 ICA survey reveals that power outages result in substantial output losses for Syrian firms. Figure 64 illustrates that the costs of power outages account for 11% of annual sales among small firms. This contrasts to only 8% among large firms.

Figure 60: Cost of power outages by type of firm



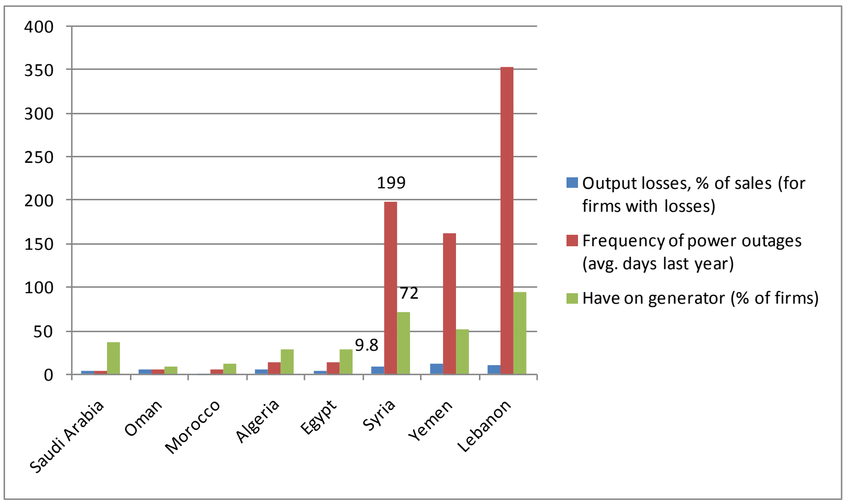
Source: ICA Survey 2009

The supply-demand gap in electricity services has resulted from a combination of natural expansion of demand, and supply side challenges. The demand expansion is linked to

population growth and the continuous increase in economic activity.[58] Moreover, electric power is highly subsidized due to low tariffs contributing to a high electricity demand. The government estimates that costumers pay only about 20 percent of the actual value of the used energy. The supply challenges are related to the maintenance of low tariffs for electricity, and inadequate investment by the state-owned electricity sector.

Improving electricity services is one of the key development priorities in the 11th FYP. The 11th FYP contemplates a substantial increase in public investment, particularly focusing on infrastructure and energy security with the goal of increasing energy supply by 70 percent during a five year period. The government has allocated SYP 350 billion to the electricity sector in the 11th FYP. In addition, due to the substantial investment needs, the government plans participating the private sector in the process of constructing new power plants and to set up an establishment for power transmission.

Figure 61: Electric Power Failures: Impact on Enterprises



Source: World Bank ICA surveys

While energy remains as the main concern to business, one needs also to consider the economic costs from deficiencies in other types of infrastructure. Firms surveyed in the 2009 ICA survey reported losing almost one quarter of their actual sales as a result of inadequate infrastructure services – nearly half of these losses were due to electricity interruptions (Figure 64).

[58] The total volume of electric power consumption was 43, 9 billion kWh in 2009, 46 billion kWh in 2010, and is estimated to exceed 63 billion kWh in 2015.

Figure 62: Sales losses due to Infrastructure deficiencies

	(% of sales)
Electricity	9.9
Telecommunications	5.4
Water and sanitation	7.6
Transportation	1.3
Total losses due to infrastructure	24.2

Source: Syria ICA 2009

Improving electricity services and water resource management practices are important enablers to increase the productivity of the agricultural sector and avoid the fast depletion of Syria's water resources. Agricultural water use is unsustainable in Syria and the country's water resources are declining rapidly. The combination of subsidies for electricity and irrigated crops (cotton and sugar beet) has resulted in inefficient and unsustainable irrigation practices.[59] The production of cotton consumes 25 percent of Syrian water resources alone while the economic return per one cubic meter of water is negative for cotton and sugar beet. Subsidized diesel and electricity distort the economics of pumping so that farmers add large volumes of water while achieving little additional yield. At the same time, they are reluctant to adopt water-saving drip-and-sprinkler irrigation systems due to distorted prices and unreliable electricity services. Thus, a reliable supply of (effectively priced) electricity together with an improvement in water management is important for the implementation of the government's plan to modernize Syria's irrigation system in the agricultural sector.

7.7 Macro risks are not a binding constraint

Macroeconomic developments are an important factor affecting investment decisions. Investors may be concerned about debt sustainability, the Government's fiscal stance, monetary and exchange rate policy and/or financial stability leading to currency depreciation, inflation, debt default or even a full-fledged financial crisis. If macroeconomic risks are large, investors may prefer not to invest domestically or at least do so at a lower scale.

After two consecutive years of severe drought, the global economic downturn constituted a second major adverse shock to the Syrian economy. The decline in demand, mainly from European economies and the GCC states, has slowed real growth and led to a worsening of the current account deficit.

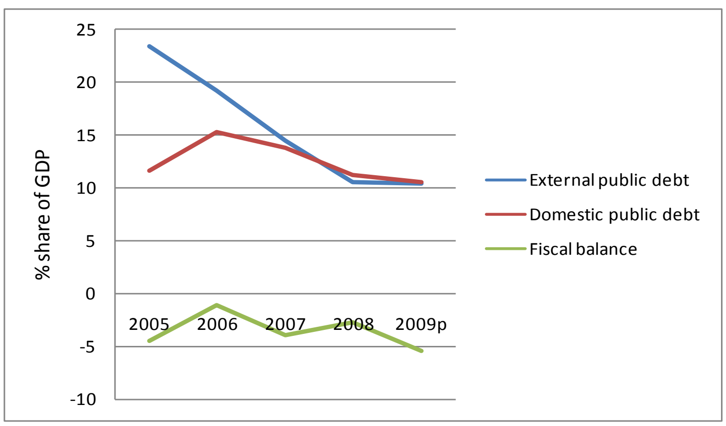
GDP growth slowed in 2009 but not by much. Real GDP growth fell from 5.2% in 2008 to 4% in 2009. Among sectors, the manufacturing and construction sectors saw a deceleration but this was offset partially by higher growth in the agricultural sector. Agriculture had suffered in

[59] Some 60 per cent of the irrigated area uses groundwater from privately developed and operated wells, of which more than 55 per cent were illegal.

recent years from the effects of a severe drought which most prominently affected cereal production, including wheat and barley. The agricultural sector's share in GDP had fallen from a level of 25% of GDP in 2006 to less than 15% in 2008. As rainfall levels picked up in 2009, agricultural output improved noticeably. The sector is forecast to continue to recover this year. Water availability will remain a source of risk in the Syrian economy and especially in the agricultural sector.

An expansionary fiscal policy response was appropriate for a number of reasons. First, the supply and demand side impacts of the two crises needed to be countered in the face of their impact on economic growth and poverty, especially in the northern and eastern rural areas. Second, substantive progress was made in fiscal consolidation and subsidies reform prior to the crisis. With monetary policy sidelined, stimulus had to come from the fiscal side. The Syrian fiscal stance was indeed expansionary during 2009 with total expenditure growing by 5 percent of GDP, largely due to rising public investment, public wages and transfers to compensate for rising fuel prices, widening the initially forecasted fiscal deficit by two percentage points to about 5.5 percent of GDP (Figure 67). In December 2010, however, the Government published the fiscal outturn for 2009, showing a lower deficit of 2.8% of GDP, mainly due to higher than expected revenues.

Figure 63: Public debt and fiscal deficit

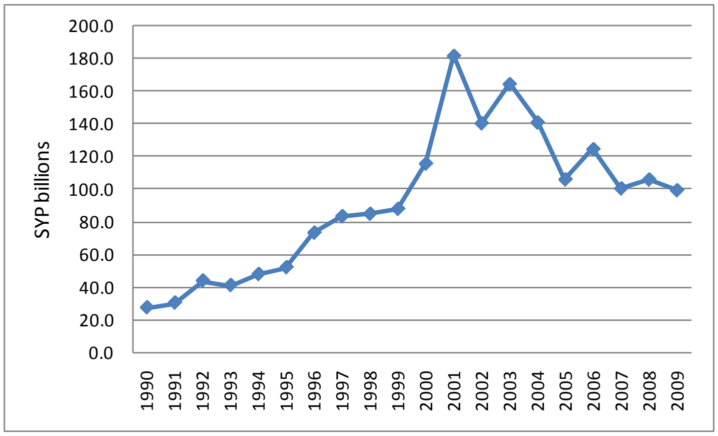


Source: IMF Article IV report 2009

The main medium term challenge remains the same as before the crisis: diversifying sources of growth to offset the impact of the ongoing decline in oil production and revenue. Oil production and oil revenue have declined rapidly in recent years (Figure 67). At its peak in 2001-2004, oil contributed about 70 percent of total exports and approximately 50 percent of fiscal revenue. Syria turned into a net oil importer in 2008 due in part to rapidly-growing domestic demand. It is expected that recoverable reserves will be depleted by 2030. This trend needs to be offset by a focus on policy measures aimed at encouraging entrepreneurship and

investment with the ultimate goal of boosting non-oil growth and diversifying and increasing exports volumes and earnings.

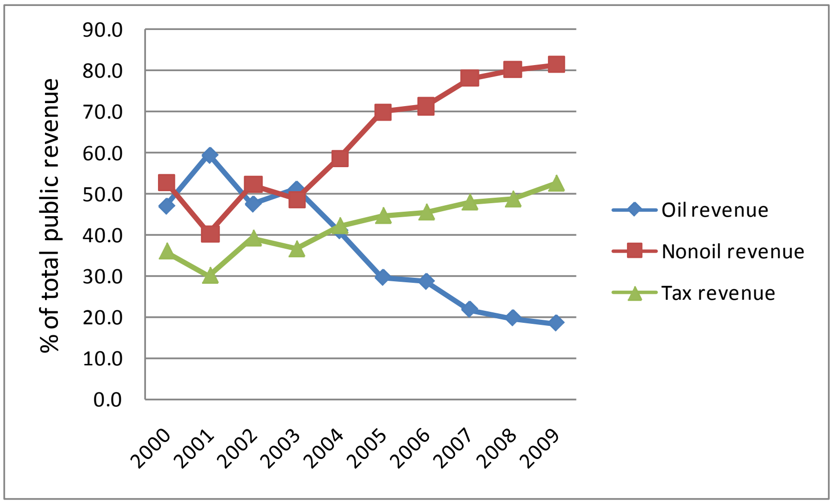
Figure 64: Public oil revenue trends



Source: IMF Article IV report 2009

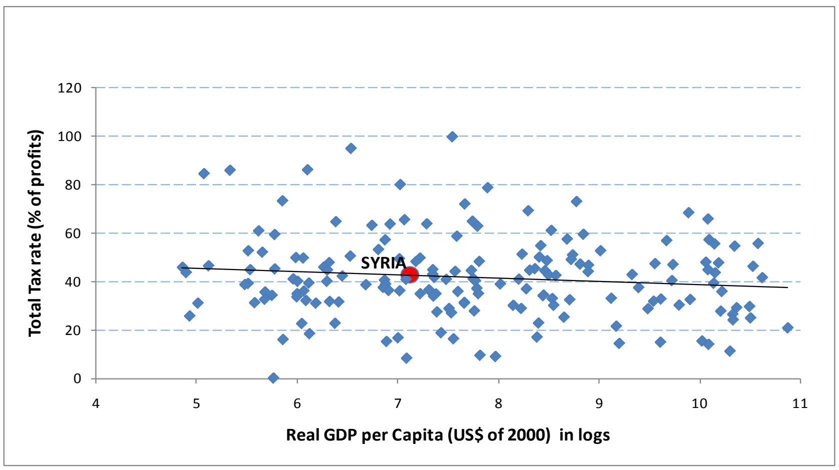
The authorities aim to contain the overall deficit in the medium term. Syria has begun tackling the challenge of a structural fiscal deficit through both spending and revenue measures. On the spending side, the Government is successfully reducing the fiscal burden of petroleum subsidies. Diesel coupons have been replaced with cash transfers targeted directly at the poor. The government is planning to remove all fuel subsidies by 2010. On the revenue side, the Government is making progress in preparing for the introduction of VAT in 2011 and in streamlining the tax system. At present, taxes are not particularly high (Figure 69) and have a growing but still low share in public revenue (Figure 68). Recently, the Government has released a fiscal forecast for 2011-15 with deficits averaging 6% of GDP due to substantial public investments in infrastructure and social protection in the 11th Five-Year Plan.

Figure 65: Public revenue trends



Source: IMF Article IV report 2009

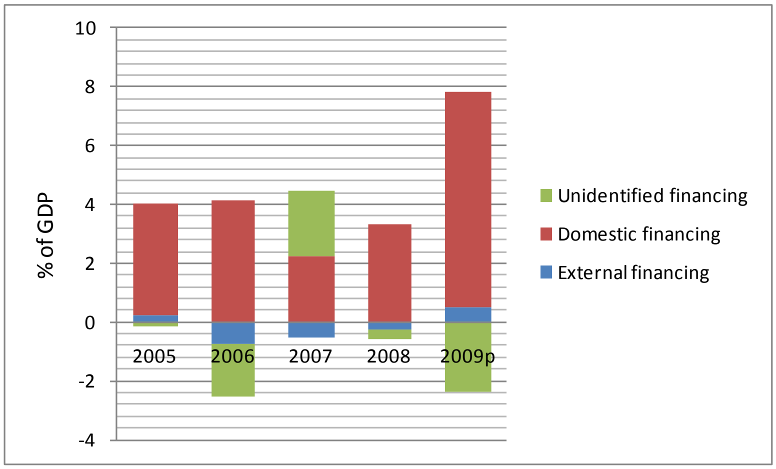
Figure 66: Total tax rate and per capita GDP (2008)



Source: Doing Business report 2009

Finally, the authorities also appear determined to streamline the substantial quasi-fiscal operations currently conducted by public sector banks and enterprises. We may conclude that the risks emanating from Syria's fiscal situation are relatively modest, that is, if reforms are implemented as planned. The same is true for Syria's external debt stock.

Figure 67: Deficit financing



Source: IMF Article IV report 2009

Public debt is expected to remain at sustainable levels under various, potential adverse shocks. Old Soviet era debt was restructured successfully in 2005. As a result, Syrian external debt as a share of GDP fell down from 23.4 percent in 2005 to 10.4 percent in 2009 and aggregate public debt as a share of GDP declined from 35.1 percent to 21.0 percent over the same period. More importantly, the budget deficit was predominantly financed through domestic rather than external debt (Figure 70). The IMF[60] expects only a moderate increase in debt to about 25 percent of GDP by 2014 despite expected continuous decline in oil revenues. Still, the IMF report emphasizes that the fiscal outlook would worsen significantly if the planned reform efforts were to fail. In particular, if the implementation of the VAT, planned for 2011, is significantly delayed, substantial fuel subsidies reemerge, and both the wage bill and capital spending are not kept under control, the debt to GDP ratio may rise to levels of up to 50 percent of GDP.

The scope for an effective monetary policy remains limited in an economy with an exchange rate peg, although restrictions on capital flows imply that policymakers have some room to maneuver. Nevertheless, the Syrian Central Bank has taken on a supportive role during the crisis. It put in place a range of measures including a lowering of reserve requirements (up to 5 percent) and indicative lending rates, thereby easing the monetary policy stance and further strengthening fiscal policy efforts. In spite of these measures, inflation pressures have been contained. Inflation accelerated in 2008 amidst a global surge in food and fuel prices. In 2009 it was brought under control to 2.5%, both by prudent macroeconomic policies and the decline in food and fuel prices. Keeping inflation in check will remain a challenge in the years to come if commodity prices strengthen yet again, government subsidies on fuel are reduced and the VAT is introduced. Although the Government intends to continue to enhance the monetary

[60] Source: IMF Article IV report 2009.

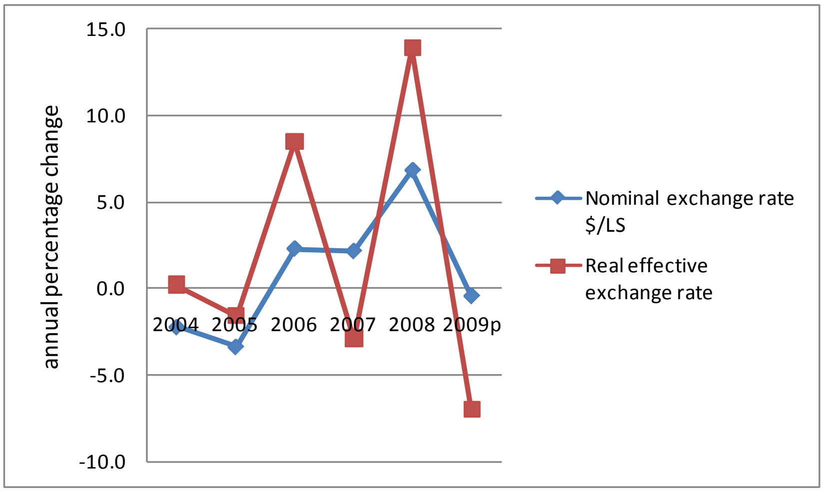
policy framework, the scope for monetary policy independence is likely to remain small. The main policy instrument remains the administrative setting of deposit rates and there are no indirect monetary instruments.[61]

While the Syrian Government has been able to maintain a prudent fiscal stance and to keep total public debt within sustainable levels, a more systematic medium-term approach to fiscal policy seems absent. Given that the central structural issue faced by Syria – the medium-term, "secular" decline in oil production – has enormous fiscal implications, a medium-term approach to fiscal policy design is all the more important. The Government may need to consider the adoption of explicit fiscal rules suited to the Syrian context, aimed at smoothing the path of fiscal adjustment as oil revenues continue to decline. For example, one such possibility could be to target a steady improvement in the non-oil fiscal balance.[62] This and other possible options will be addressed in the ongoing Public Expenditure Review (PER) for Syria.

The exchange rate has been effectively unified and restrictions on access to foreign exchange for current transactions mostly eliminated. In principle, the Syrian Pound's de jure peg against the SDR can be a powerful nominal anchor although it appears that the peg has recently given disproportionately more weight to the dollar, which is less in line with Syria's direction of trade. The Pound appreciated by about 7 percent against the dollar in 2008 in nominal terms which, taking into consideration the hike in domestic inflation that year amounted to a real effective appreciation of about 14 percent (Figure 71). About half of this appreciation was reversed during 2009 in the course of the substantial depreciation of the dollar against the Euro and the decline in Syria's domestic inflation. An analysis conducted by the IMF[63] suggests that the Syrian pound may be moderately overvalued in effective terms compared to its medium term equilibrium level. But the IMF does not advocate a change of the Pound's nominal value in the present context. The IMF does suggest a gradual move toward greater exchange rate flexibility over the medium-term as the monetary policy framework develops. This move would further increase monetary policy independence and maintain external stability.

[61] The authorities plan to gradually replace administrative by market based tools; treasury bills are expected to be introduced in the course of 2010.
[62] See e.g. Dridi, J. and P. Imam (2006) "Which Fiscal Policy Framework Would Suit Syria Best in the Coming Decade?" in International Monetary Fund. *Syrian Arab Republic: Selected Issues,* August 2006.
[63] Source: IMF Article IV report 2009.

Figure 68: Exchange rate trends



Source: IMF Article IV report 2007

The Syrian external sector has deteriorated in recent years due to the continued decline in oil exports that could only partially be reversed by a strengthening of non-oil sources of growth. In addition, the global crisis led to plummeting global demand and an expansionary fiscal policy stance, and a substantial widening of the already negative Syrian current account deficit, which reached 4.5 percent of GDP in 2009. The deficit is mirrored in the trade balance. Goods exports fell by 17% in 2009 while imports fell only by 14%, resulting in a trade balance deficit of 4.6 percent of GDP in 2009. The global downturn was also expected to decelerate recent growth in tourism as well as in foreign direct investment, and to reduce remittances from expatriate workers as job losses peaked in the GCC countries and elsewhere. However, tourism receipts kept growing, both FDI and remittances dropped only slightly, and gross reserves remained comfortable, at about US$17 billion.

Both exports and imports are expected to grow as the global economy recovers. The trade deficit is likely to revert to lower levels once global demand picks up in the course of 2010 and expansionary fiscal measures are withdrawn. The external current account deficit will likely stabilize at 3.7 percent of GDP on account of strengthening non-oil exports and tourism receipts. Foreign investment into Syria is likely to rise as Syria integrates more into the world economy and improves its political relations. The current account deficit continues to fare at sustainable levels although the continuing decline in oil revenues will require further diversification and strengthening of export volumes if the deficit is to be kept under control. A delay in global recovery or faltering reform implementation could worsen the outlook and impede Syria's economic growth.

The Syrian financial sector was not affected significantly by the global financial crisis. Syria's banking sector is only weakly interlinked with global financial markets and is covered by

fairly strict prudential regulations. Banks are conservatively managed and their leverage ratios are low. The non performing loans ratio of only little more than one percent for private banks and 5.1 percent for the banking system as a whole (as of September 2009) is very low although it may be understated for public banks due to the lack of independent audits. The direct effect of the financial turmoil in global markets on Syrian banks was thus relatively mild.

Banks continue to be liquid but only weakly profitable. The average return on equity (ROE) was 6.4 percent for private banks and 14.7 percent for the banking system in September 2009; the average return on assets (ROA) was only 0.5 for private banks and 1.3 for the banking system as a whole. The weak profitability of banks is partly a result of their high liquidity, as banks possess sizeable low-yield cash holdings at the Central Bank. Although indicators of bank profitability have to be interpreted with caution due to persisting deficiencies in banks' implementation of international financial reporting standards, the figures are likely a result of a lack of appetite for lending among banks.[64]

The potential vulnerabilities of the Syrian banking sector are similar to those of other transition countries. Public sector banks have found it difficult to compete with private banks newly entering the markets. Although independent audits have yet to be performed, the vulnerabilities of public sector banks are due to weak balance sheets, poor underlying profitability, outdated business practices and low capitalization (the CBoS is an exception here), according to a recent IMF report.[65] For private banks, risks include those typically related to high initial credit growth, entry into new inherently riskier business lines, and negative carry on Syrian pound deposits given non-remunerated excess liquidity.

In sum, recent developments suggest that the Syrian economy weathered the global financial crisis relatively well and macroeconomic risks are relatively low. Both internal and external accounts fare at sustainable levels and external debt is unlikely to increase excessively if the planned reform steps are taken; the Syrian financial system is not under imminent pressure to its stability although a reform of public banks will be needed in the medium term; inflation is under control for the moment but continued enhancement of the monetary policy framework will be necessary in the medium run to respond effectively to pressure arising from a rebound in commodity prices and the phasing out of the subsidies system. Syrian policymakers should plan for a careful phasing-out of the fiscal stimulus alongside the long awaited introduction of a VAT and further fiscal consolidation. Continued reform of the costly system of subsidies by gradually reducing the number of goods subject to administrative pricing will be critical.

[64] Source: IMF Article IV report 2009.
[65] Source: Joint IMF-World Bank Financial Sector Assessment (FSAP) 2009.

8. From Diagnostics to "Therapeutics": Preliminary Policy Implications

8.1. General Considerations

One of the key advantages of the Growth Diagnostics (GD) approach is its ability to facilitate prioritization and sequencing of policy reforms. By identifying the most binding constraints to growth, the GD approach facilitates the selection – within the "policy space", or the set of all feasible policies available to a country – of those reform actions that would be expected to have the greatest impact on economic growth, *through their effect on the constraints to growth*. Policy recommendations under this approach would not follow a "cookie cutter" style; on the contrary, they would be country and context-specific.

The resulting prioritization process is guided by the notions of *feasibility and relevance* of policy reforms, and not necessarily by "international best practice" considerations.[66] The feasibility of reforms may depend on non-economic factors such as the domestic and/or international political environment and the country's implementation capacity. A potentially highly desirable reform action may not be feasible if e.g. it is a political non-starter, or if the government's implementation capacity is limited. Even if a certain reform action is feasible, however, it may not necessarily be relevant or beneficial from the point of view of removing a binding constraint – it may in fact become relevant or beneficial only after other reforms have been implemented.

Institutional capacity to formulate, implement, monitor and learn is essential for a successful inclusive growth strategy. The set of feasible policies can potentially be expanded through capacity building, thus increasing the number of tools at the Government's disposal to address constraints to growth**.** For example, in the case of Syria, technical assistance underway by the European Commission, UNDP and the World Bank in the area of trade policy will enhance the set of policy choices available to the Government as it addresses remaining anti-export bias and moves towards an Association Agreement with the EU and WTO membership, as well as strengthen Syria's position vis-à-vis its partners in free trade agreements already in place. In another example, ongoing capacity building in the area of Public-Private Partnerships (PPP) will enhance the Government's ability to launch PPP transactions for the power sector,

[66] A "best practice" agenda is "typically based on international rankings, where all areas of policy are reviewed against a benchmark and actions are taken to move each area towards that benchmark, or prioritizing the areas that are relatively ranked worse, with no evidence of their tightness". See Hausmann, R.; B. Klinger and R. Wagner (2008), p. 91. In some instances, however, the removal of, say, a sectoral constraint may require the implementation of a "best practice"-type of reform that happens to be feasible in the context at hand. In other contexts, best practice" policy reforms is commonly understood as "Washington consensus"-type policy prescriptions which could be desirable if the country has perfect institutional capacity and a conducive political environment to implement changes quickly.

thus helping relieve the infrastructure constraint discussed in the previous chapter. Despite the progress made in recent years, the Government's capacity to undertake reforms remains somewhat limited. Therefore, continued efforts at institutional strengthening in most reform areas are critical.

Syria's complex political circumstances – both from a domestic and a geopolitical perspective – also need to be taken into account in gauging its growth potential and its reform choices. Throughout this study, the internal and external political environment has been taken as given, as one of the "outer" constraints to growth in Syria. Nonetheless, the impact of political variables on growth can be roughly estimated for the period under consideration (1965 – 2008). A political instability index was devised by assigning 1 for instances of war, economic restrictions, internal revolution, and violence, and zero otherwise. Preliminary calculations show that this index has had a significant and negative impact on TFP growth in Syria.[67] This adverse relation both limits the potential for accelerated inclusive growth and constrains the policy choices available to the Government.

Another political economy factor, common to many countries in the MENA region is the tendency of the dominant segments of the private sector to resist change and defend the status quo.[68] These segments of the private sector benefit from privileged relations with the State apparatus and from distortionary policies. As a result, the domestic demand for reforms is weakened as rent-seeking behavior becomes widespread. New entrants and SMEs – which would bring with them the greatest potential for productive employment generation – do not benefit from a level-playing field in their relations with the State, have less voice and representation in business associations, and consequently are particularly affected by the constraints identified in this report. Syria seems to be no exception, which conditions the patterns of business development: "First, the larger business community remains fragmented – sectorally, politically and geographically (…). A second outcome of the lack of representative institutions for the (broader) private sector is that it remains as a whole, large and small, family oriented. More than religion, sect, or region, the extended family – and increasingly the nuclear family – represents the most trustworthy social framework for a business community that operates under grave conditions that force or compel the pursuit of illegal or semi-legal business operations."[69] This means that the private sector – "old" and "new" – is a key constituency to be mobilized in broadening domestic support for further economic reforms.

Such political economy considerations help explain the Syrian Government decision to gradually transition to a social market economy. It should be noted that the policy and institutional changes discussed in this report may have an impact – albeit possibly moderate – on

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[67] See Syria Trust for Development (2010). "Sources of Growth in Syria: 1965-2008". Background paper for this CEM.

[68] World Bank (2009). *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa.*

[69] Haddad, B. (2009). "Enduring Legacies: The Politics of Private Sector Development in Syria". In Lawson, F.H. (ed.) *Demystifying Syria.* London: SOAS Middle East Issues.

the distribution of resources in the society.[70] Therefore, the pace of reforms has to carefully weigh the risks of social dislocation, particularly given the fragile and uncertain geopolitical context as well as Syria's goal of preserving social peace and political stability. Adding to that the fact that many of Syria's economic institutions are at an incipient stage, it can be argued that under current circumstances the sustainability of the reform process will require a certain degree of gradualism.[71]

It is important to stress that the implementability of the policy reforms discussed in this report will depend crucially on Syria's vision as to the role of the State going forward in a number of economic domains. These domains include the potential role of the State as a producer, regulator, exporter, importer, lender and borrower. For example, the public sector's capital stock is larger than the private sector's, but the private sector GDP is considerably larger than the public sector GDP. This reflects a misallocation of resources (especially misallocation of financing) that is perpetuated by existing policies and institutional arrangements. It is important that the 11th Five-Year Plan articulates a clear vision of the role of the State in these various domains – paving the way for a better understanding of practical implementation issues such as the sequencing and speed of specific policy actions.

The potential policy choices discussed in the remainder of this chapter are directly related to the constraints to inclusive growth identified in this report and reflect the general considerations outlined above. This discussion is preliminary and additional analysis at the sectoral level as well as of political economy issues would be required to refine the policy implications presented here. Annex 1 displays an indicative policy matrix which contains specific and concrete measures to address the four binding constraints to inclusive growth in Syria. In addition, an initial discussion of Syria's comparative advantage and the potential role for development policy at the sector level is presented at the end of this chapter.

8.2. Strengthening the institutional environment

This report proposes a two-track approach to deal with institutional-related uncertainties as a constraint to growth. A first set of measures consist of actions intended to simplify compliance, increase transparency and reduce uncertainty with respect to the legal and regulatory

[70] "Different institutions will be associated not only with different degrees of efficiency and potential for economic growth, but also with different distributions of the gains across different individuals and social groups", in Acemoglu, D. (2010). "Growth and Institutions", in Durlauf, S. and L. Blume (eds.) (2010). *Economic Growth*. The New Palgrave Economics Collection. London: Macmillan, p. 113.

[71] John McMillan highlighted the risks associated with a "shock therapy" approach in conditions of uncertainty: "Reform is hard to do because we cannot predict its effects. The big-bang approach presumes we know where we are going and how to get there. We may know where we should be headed, but there is much we do not know about how to get there. No recipe for success has yet been written. *Acknowledging our ignorance means moving step by step rather than betting everything on a comprehensive blueprint*". McMillan, J. (2004). *Avoid Hubris and Other Lessons for Reformers*. Center on Democracy, Development, and the Rule of Law (CDDRL) Working Papers. Stanford Institute for International Studies, June 12, p. 5, emphasis added.

framework. Second set of measures will strengthen the legal and regulatory framework for doing business.[72]

Urgent measures under the first track include: (i) *Establishment of a systematic process for dialogue between Government and the business community* to improve reform quality, strengthen implementation, establish a problem-solving mechanism, enhance information exchange, better coordinate policy decisions with new investment opportunities, and deepen Government credibility with investors; (ii) *Application of the Competition Law* as a platform to raise awareness, advocate pro-competitive policies and address explicit anti-competitive behaviors; and (iii) *Acceleration of the implementation of the Government's Governance & Anti-Corruption Program* (see Box 2).

Medium-term priorities under the second track include: (i) *Implementation of the Business Environment Simplification Programme* (BESP) to systematically inventory relevant regulatory information, conduct standardized reviews of existing regulations, and recommend changes to simplify administrative procedures and reduce the information required from businesses; and (ii) *strengthening of capacity for the implementation of the Competition Law*.

Box 2: Syria's Governance and Anti-Corruption Program

In March 2010, the Economic Committee of the Council of Ministers approved a Governance Reform Action Plan focusing on further Public Financial Management (PFM) reform, anti-corruption and civil service reform and corporate governance. The Action Plan covers the period 2009-2012. Some of its key elements are:

- *PFM*: Creation of a performance focus through better budget integration; development of a fiscal framework to guide budget preparation; improvement of budget management through better fiscal reporting; modernization of treasury systems, including through the introduction of Treasury Single Account (TSA); enhancement of fiscal controls over public economic entities.
- *Anti-Corruption and Civil Service Reform*: Ratification of the United Nations Convention Against Corruption (UNCAC), already signed by the Government of Syria; implementation of institutional anti-corruption framework in civil service; implementation of a Quality Service Delivery Survey (QSDS) in a pilot sector.
- Corporate Governance: Review and assessment of legal framework enabling corporate governance; design and implementation of corporate governance reviews for private companies, SOEs, and the banking sector, followed by specific action plans.

The Government has elaborated interest in securing technical assistance and capacity-building from the Bank and other donors, covering such issues as capacity-building to agencies addressing corruption and training of judges and prosecutors on financial crimes and corruption. Furthermore, new legislation covering anti-money laundering has been put into effect, and legislation on bank secrecy is under debate. The Anti-Money Laundering Unit of the Central Bank has requested assistance in analyzing data to better detect transactions related to money laundering.

[72] In both areas, the recently-completed Investment Climate Assessment (ICA) for Syria contains a much more complete set of policy recommendations to strengthen Syria's business environment.

8.3 Improving Credit Allocation

Despite a series of ambitious reforms, the financial sector remains underdeveloped and unable to satisfactorily meet its basic function of allocating efficiently capital in the economy.[73] In particular:

- The financial system remains too small; the Syrian economy remains cash based economy and the banking system is not used unless absolutely necessary; and the use of checks, credit cards and ATM cards is not widespread.
- The main financial instrument offered by the Banks is short-term credit. Medium-term investment credit is negligible. Other instruments including dedicated credit, insurance, guarantees are also negligible.
- The financial infrastructure is shallow, making the system inefficient and costly.
- Two-thirds of the assets of the financial sector are owned by the public sector.

This report proposes a four-pronged strategy to deal with this issue, focusing on both the demand and supply sides of credit, while paying due attention to financial stability. These prongs are: (i) improving financial intermediation and allocation of financial resources; (ii) enhancing SMEs management capabilities, including on financial management; (iii) enhancing Central Bank independence and the effectiveness of monetary policy tools; and (iv) strengthening bank supervision to preserve financial stability.

In the short term and on the supply side, financial intermediation can be strengthened by addressing the most pressing information asymmetries upfront. More specifically, the adverse selection problem can be mitigated by establishing a well-functioning credit registry and strengthening legal rights related to credit transactions through a new Collateral Law and a specialized commercial court. Furthermore, on the supply side of credit, access to finance by SMEs can be increased through (i) training for bank officials in risk assessment for small enterprises; (ii) creation of a legal framework for microfinance banks; and (iii) establishment of a loan guarantee scheme that reduces the risk perceived by lenders in serving the small enterprise sector.

In the medium term, financial intermediation and credit allocation can improve sustainably only if Syria's financial sector reforms are substantially deepened. Consistently with the recommendations of a joint World Bank-IMF FSAP conducted in 2008, the restructuring of the state banking system in a coherent and well sequenced manner is critical for increasing financial sector efficiency and reducing the accumulation of implicit liabilities with

[73] For a discussion of the basic functions of the financial sector, see Mishkin, F. and S. Eakins (2006). *Financial Markets and Institutions*. The Addison-Wesley Series in Finance, 5th edition.

potentially large fiscal costs for the Syrian Government. The restructuring process should draw on the results of independent audits, as recommended by the FSAP. An external audit of the portfolio of four state-owned banks was conducted in 2009, though it was not done for the Commercial Bank of Syria (largest public commercial bank) and the Agricultural Bank.

It should be stressed that the restructuring of the state banking system can only fully succeed if a roadmap for complementary reforms is also designed for the parastatal sector. The public banks are still heavily engaged in directed lending to state-owned enterprises (SOEs) at subsidized rates. Therefore, a closer look at key public sector issues is recommended, focusing on: (i) reviewing the functions of SOEs; (ii) assessing the efficiency of resource utilization by SOEs and their overall productivity levels; (iii) quantifying their net impact on the state budget; and evaluating their role as employers and as an implicit social safety net. Based on this information, a roadmap for politically-feasible SOE reforms could be devised. The connection between financial sector restructuring and SOE reforms will be one of the central themes of the second phase of the CEM.

On the demand side, a key short term priority would be to enhance SMEs management capabilities, including on financial management. Lack of accounting and auditing systems, primitive record keeping, lack of transparency, weak governance systems, as well as insufficient managerial and technical capabilities within the private sector – particularly for SMEs – are critical constraints. These issues signal poor reliability of firms' financial information[74] and contribute to the adverse selection problem diagnosed in this report. To help remove these constraints, an expansion of training efforts to improve financial management, accounting, and business planning among SMEs is recommended as an urgent measure, building on the ongoing work by the Competitiveness Team at the Syria Enterprise and Business Centre (SEBC).[75] In addition, it is key to strengthen the supply side of the financial sector by continuing to encourage entry of foreign and domestic private banks.

Improving the monetary transmission mechanism is a necessary condition to advance financial intermediation and improve the efficiency of resource allocations. The monetary transmission mechanism is the process through which policy decisions of the central bank about policy interest rates or the money stock impact on interest rates set in financial markets and broader monetary aggregates. These in turn affect aggregate demand, and finally output, inflation and employment. The malfunctioning of the monetary transmission mechanism undermines an improvement in financial intermediation in Syria. Private banks have little guidance in setting

[74] See Soylemezoglu, A. (2010). "Financing of Trade in Syria: A Diagnosis of Issues". World Bank, mimeo.

[75] As noted by Soylemezoglu, training is not enough and the overall lack of transparency on the part of private firms has deep-seated roots: "the transparency issues are more complex and difficult to address. However, it can be said that these issues require changing the culture of doing business radically. The crucial question here is: *Why do the firms prefer not to be transparent and accept the consequences such as inability to obtain credit or placing high level of collateral*? Syrian authorities are also asking this question. High level of taxes and tariffs, problems in enforcement of business related laws, habits that have historical reasons are among the answers to this critical question". See Soylemezoglu, A. (2010), *op. cit*., p. 28.

their lending rates other than funding costs due to the lack of monetary policy and market rates. A monetary anchor to set medium- and long-term interest rates does not exist resulting in the absence of the supply of medium- or long-term financing.

The proposed financial sector reforms will require an independent and effective Central Bank. The weak interest transmission is the result of the limited set of monetary instruments, the lack of fixed income markets in Syria, and fiscal dominance. Therefore, an urgent priority is the completion, approval and enactment of the Central Bank Law. A new Central Bank Law, addressing many of the major shortcomings of the current system, has been awaiting approval for a while. It is currently in the commenting stage. Monetary policy tools also need to become more effective. To that end, as a medium-term priority, this report recommends the phasing out of administrative monetary policy tools, replacing them with market-based tools such as marketable Treasury Bills, to be issued on a regular basis.

Finally, financial sector reforms will need to be accompanied by efforts to preserve financial stability within a fast-changing context. In particular, the regulatory and supervisory capacity of the Central Bank of Syria (CBS) needs to be strengthened. The World Bank financial sector team is currently working with the CBS to identify banking supervision technical assistance needs. Furthermore, over the medium term, public and private banks should be prepared for the implementation of Basel II requirements, including through the modernization of their accounting practices.

8.4 Eliminating the remaining constraints to exporting and strengthening Syria's competitiveness in foreign markets

The deepening of trade reforms is necessary to enhance international competitiveness and to accelerate growth and diversification of non-oil exports. Based on international experience, this section suggest follow up measures to remove the remaining trade related constraints (noted earlier) to improving competitiveness. Recommendations are also made with regard to sectoral programs, trade agreements, and macroeconomic policies.

The import regime should be simplified to become more transparent.

- It would be advisable to simplify the system by reducing the number of bands to 3 or 4 and the maximum rate to 20-25 percent supplemented with an excise tax on luxury goods, and eliminating the nuisance rates (rates under 5 percent).
- It is recommended that the system of other taxes and fees is replaced with a VAT and an excise tax levied at the same rate on the imported and domestically produced goods, and a few service charges rendered by the customs administration that are consistent with WTO rules.

- Further reforms should include defining the “negative list” at the 8-digit level, reducing the number of products on the list, lifting the state monopoly on exports, and issuing import licenses for multiple shipments in a certain period of time.

Attention should be paid to compliance with WTO accession rules and the impact on public revenues when the decision is made on these reforms. First, they need to be considered in the context of WTO accession process because they will be on the negotiation agenda. Because the reforms proposed in this paper are consistent with WTO rules, early implementation of them may speed up the negotiations. Second, the combined effect of these reforms should be estimated on the public revenue and care be taken to ensure that the reforms are revenue neutral. Policy simulations conducted show that it is possible to implement these reforms without revenue loss.

It is also critical to strengthen Syria’s export incentive framework. Based on international experience, it is recommended that the following export incentive instruments are included in Syrian trade regime: tariff and tax drawback and exemption schemes, manufacturing under bond scheme, free zones and bonded warehouses, export processing zones (EPZ).

A tariff and tax drawback and exemption schemes ensure that the portion of imported inputs that are actually used in the production of exports are not required to pay tariffs and taxes. In the case of the “drawback” option, tariffs and taxes that were paid on importation of goods are refunded once the manufactured goods, in which imported goods are incorporated, have been exported. In the “exemption” option, tariffs and taxes are not paid at the time of importation. The drawback scheme, which is administratively simpler, is applied in the case of new or occasional exporters, whereas exemption is usually granted to well-established export companies with good track record and exporting all or a large share (> 80 percent) of their production.

The Syrian Customs Law provides provision for drawback for a limited number of imported inputs, but it is not implemented. The exemption option does not exist in the Customs Law. Syria will need to amend the Customs Law to extend drawback to all imports used in production of exports and include tariff and tax exemption option in the Law. Substantial technical assistance would be needed to design the proposed incentives and set up an effective administrative mechanism to implement them.

A manufacturing under bond scheme is appropriate for businesses that have a high proportion of imported dutiable inputs. This scheme is a variation on the exemption option. Under this scheme, imported materials go directly in locked premises in the factories or in a warehouse outside the factory controlled jointly by the customs and the manufacturer, and remain there locked up until they are removed jointly and used in production. Governments normally set a minimum of production that must be exported for companies to be eligible for this scheme.

It is recommended that this incentive option is also included in the Law, the necessary supporting policy directives are prepared, and an implementation mechanism is set up with technical assistance.

Free zones and bonded warehouses arrangements offer warehousing, storage, simple processing such as sorting and re-packaging, and distribution facilities for trade, transshipment and re-export operations. Imports in these locations are exempted from tariffs and taxes because they are exported with or without further processing. They also enjoy other benefits such as reduced local taxes, streamlined customs and administrative processes. All due tariffs and taxes have to be paid if products are sold in the domestic market.

The Customs Law allows for bonded warehouses, but to date, no license has been issued. However, Syria operates eight free zones. Companies in the free zones are exempted from import tariffs and taxes as well as domestic taxes if the products are exported. They also benefit from subsidized land and utilities. All taxes are paid if the products are sold in the domestic market. Despite substantial fiscal and financial incentives, free zones contribute little to local production, employment, and foreign exchange earnings, because companies in the zones are engaged in commercial as opposed to manufacturing activities. Only one-third of products going through free zones are exported. There are restrictions on the inputs purchased from the local market discouraging backward linkages.

The necessary reforms to improve 'Free Zones' contribution to the national economy would include:

- the elimination of domestic tax exemptions and the improvement of the infrastructure services;
- the removal of restrictions on purchases from local market, consolidation of some free zones to reduce the operating costs;
- the transfer of the management to private sector under management contracts.

Export processing zones (EPZ) are industrial estates developed to attract local and foreign investment to manufacture products for exports. Incentives offered to the companies operating within the EPZs include: tariff and tax free imports, total or partial exemption from domestic taxes such as corporation and income tax, total or partial exemption from labor and foreign exchange regulations, better infrastructure services, subsidized rent and utilities, one-stop administrative arrangements, and streamlined customs procedures. To be eligible for operating in an EPZ (and, receive the available incentives), normally all of the output from the zone must be exported (an approach adopted by the East Asian countries). Some countries allow a percentage of sales in the local market. The EPZ incentives do not apply to the sales in the local market.

Exporting companies, if they satisfy the requirements, can operate as single factory EPZs anywhere in the country. EPZs are normally fenced areas. However, factories do not have to locate within the designated zones to receive the EPZ incentives and privileges. A key advantage of this option is that it can grant export incentives to exporting companies that had been

established before the EPZs were set up and cannot relocate their factories in the EPZ territory. The single factory option has been successfully implemented in many countries.

The EPZ scheme should be included in Syrian export incentive system in an appropriate form that would fit best in the current institutional arrangements for manufacturing production. Developing new fenced area EPZs should not be a priority for Syria. They are costly to establish. Also, Syria already has Industrial Cities with excellent infrastructure facilities. The single-factory EPZs seem to be the most appropriate option for Syria. This would be an effective incentive to attract local and foreign investment in export-oriented subsectors in the Industrial Cities. Converting sections of Industrial Cities into EPZs (that is, making them hybrid EPZs) should also be considered. Embedded in a broader manufacturing environment, the EPZ companies would have a better opportunity to establish strong backward linkages with other companies facilitating formation of economic clusters within Industrial Cities.

A variety of immediate initiatives are needed to improve the capacity of the financial sector to meet the needs of the non-oil exports. They include: improving book-keeping and accounting practices in the private sector, credit information system and risk assessment skills in the banking sector, and increasing the range of financial instruments offered by the banks.

The longer-term objective is to broaden and deepen the financial sector, improve its efficiency, and strengthen its private sector orientation. To achieve these objectives the necessary follow up measures would include: creating a better environment to mobilize domestic savings, attracting foreign banks with good reputation, encouraging Syrian financial institutions working abroad to relocate in Syria, improving treasury management, promoting better disclosure, governance and risk management systems, introducing a broad range of financial instruments, and improving financial sector infrastructure. It is essential that sustained efforts are made to build trust and confidence in the economic community to assure the private sector that their assets and financial information are secure.

Three recent initiatives will be helpful to meet some of these challenges. First, the EU's SME Support Program has a component to assist the SMEs to improve their accounting, book-keeping, and business management practices. Options should be explored to accelerate implementation of this program and expand its company coverage. Second, a Loan Guarantee Institute (LGI) is being established as a corporate entity with assistance from the EU's SME Support Program. Third, the Government has recently increased the limit of foreign ownership in the banking sector up to 60 percent, and issued a Presidential Decree to enable the establishment of investment banks in Syria.

Complementary reforms are necessary in improving efficiency of public companies and carefully defining the roles and responsibilities of the public and private sectors. The financial sector issues in Syria are closely related to public sector management because public companies play an important role in the financial and some economic sectors. Their performance

has significant implications for the efficiency of the financial sector and the access of private sector to credit.

The remaining shortcomings in customs administration arise from lack of clarity in some legislation (noted earlier) as well as institutional, procedural, and skill related bottlenecks in the management. Reform efforts are ongoing under assistance from EU's Trade Enhancement Project (TEP). These efforts aim to (i) introduce modern clearance procedures, risk assessment, and one-stop shops at border crossings, (ii) streamline and automate processes, (iii) move away from physical control of most transactions and rely more on company audits, (iv) reinforce transparency and valuation, (v) adopt and enforce modern rules of origin and Sanitary and Phyto-Sanitary (SPS) management, etc. Full implementation of ASYCUDA is essential for realizing these goals. These initiatives are steps in the right direction. They should be pursued with diligence and completed as quickly as possible to reduce customs related costs to companies.

The restructuring of health and safety standards is another high priority initiative that should be completed in a timely manner. This initiative is crucial to ensure that the ground is prepared for Syria to participate in international accreditation arrangements and provide timely internationally recognized certification services. It is ongoing under the EU's Quality Management Program. The program has the following objectives: (i) raising awareness of the importance of the health and safety standards and the standards requirements in various export markets, (ii)) improving the policy and regulatory framework, and institutional arrangements, (iii) clearly defining the roles of the private and public sectors, and effectively managing the standards institutions, and (iv) identifying equipment and skill needs of the laboratories and providing technical assistance to meet these needs.

Sector-specific export and growth promotion programs would also be needed to diversify into new products. The policy reforms in the core areas identified above would affect exports in all sectors. These economy-wide cross-cutting improvements are necessary but not sufficient for expanding and diversifying non-oil exports, particularly of new products. This would require selection of a few export-oriented sectors (sub-sectors or products), identifying the key sector-specific barriers, developing programs to remove these barriers, and exploring export opportunities in the existing and new markets. Sector specific analysis would also provide useful inputs into Syria's regional and gender-based programs, and help identify growth drivers in the medium to long term.

A number of sectoral studies have been prepared in recent years by the NARC and SEBC which provide a good basis for further in-depth policy analysis. A large part of these studies are descriptive, providing detailed information on the structure of production and trade. They also provide other useful information such as laws and legislation affecting the sector, leading companies, and the like, but do not include detailed analyses of sectoral policies and reforms needed to strengthen production and export performance.

The WTO accession would provide a good opportunity for Syria to anchor its trade regime in WTO rules and ensure the credibility of its trade policies. The process of WTO accession started. The WTO set up a Working Party to conduct the accession negotiations. The Government is finalizing its Memorandum of Foreign Trade Policy (MFTP), which provides a detailed description of Syria's current trade regime. The negotiations will start after the MFTP is submitted to the WTO. To conduct the negotiations, the Government also set up a National Negotiations Committee headed by the Minister, MoET. The WTO accession would help encourage foreign investment particularly in export-oriented sectors. The trade reforms to be implemented during the 11th Five-Year Plan should all be considered in the context of accession negotiations.

Substantial technical assistance is needed, including training of the MoET staff to prepare Syria for the negotiations particularly in conducting impact analysis of import liberalization offers Syria is going to make for both goods and services liberalization. The UNDP has programs to support Syria's WTO accession. Also, the EU's TEP includes technical assistance for training for negotiation skills.

It is essential that policy measures are considered as a package taking account of their trade and fiscal affects together and complementing them with other fiscal measures to ensure the revenue neutrality of the reforms to maintain fiscal prudence. Policy measures discussed in this paper (streamlining import tariffs and taxes, drawback and exemption schemes, trade agreements, WTO accession, etc.) would have significant fiscal implications. They would affect the level and allocation of revues between public entities. For example, elimination of the municipality tax (because it is not compatible with WTO rules) would reduce the revenues of the governorates, which should be offset by budgetary transfers.

With a sustained overvalued exchange rate it is unlikely that Syria could achieve its growth and diversification objective even with good trade and behind the border policies. Syria's exchange rate regime has been significantly improved. The reforms include: unifying the exchange rate, eliminating the restrictions on access to foreign exchange to finance imports, opening the foreign exchange market to private sector, abolishing the repatriation rule for foreign exchange, alleviating restrictions on the foreign exchange market to make it easier for foreign investors to move their profits abroad. Currently, the pound is pegged to a basket in which dollar has a large share. Studies suggest that the pound may be overvalued 10-15 percent in real terms adversely affecting Syria's non-oil trade. The exchange rate plays a pivotal role in determining competitiveness both in the domestic and foreign markets thereby significantly affecting trade flows and the size and structure of the tradables sector. An overvalued exchange can easily erase the competitiveness gained from hard-won productivity improvements. It reduces the profitability of export activities thereby causing a fall in exports. It also reduces the price of imports in local currency in the local market undercutting the competitiveness of the domestically produced goods.

It is recommended that the competitiveness of the pound should be carefully monitored to avoid overvaluation risks. It is advisable therefore to undertake an in-depth study to analyze the impact of the exchange rate on trade flows, assess the appropriateness of the current exchange rate arrangements, and suggest possible improvements in exchange rate policy. This is particularly important now and the coming years as the impact of the FTAs with Turkey and the EU is felt in the domestic market and import protection resulting from WTO accession be reduced. Syria will need a competitive (or slightly undervalued) exchange rate to cushion the impact of import liberalization on import-competing industries and maintain the profitability of exports.

8.5. Addressing the Infrastructure Bottlenecks

The infrastructure bottlenecks discussed in this report can be addressed by a combination of institutional reforms and well-designed, well-targeted infrastructure investments. First, the institutional framework for infrastructure backbone services – particularly in the power sector – needs to be strengthened. Second, essential public investments need to be carried out within a fiscally-sustainable approach.

The envisaged institutional reforms aim to prepare the ground for an effective and sustainable program of infrastructure investments. Some of these reforms are underway and should be completed soon as a matter of urgent priority. They are: (i) the implementation of the recently approved Electricity Law; (ii) the enactment of the new PPP legislation; and (iii) appropriate staffing and operationalization of the Central PPP Unit (CPPPU) established in the Prime Minister office to coordinate the PPP program implementation. Other institutional reforms are equally important but may be implemented in a second round, including the introduction of gradual adjustments in electricity tariff structure and levels to achieve cost recovery over a transitional period and restructuring of transport agencies.

Recent reforms in the telecommunications sector present guidance for future reforms of infrastructure sectors. In 2010, the Government of Syria initiated the reform of the sector by establishing an independent Telecommunications Regulatory Authority (TRA), corporatizing the incumbent operator, creating a level-playing field licensing regime, and opening the sector to private (foreign) competition.[76] At the same time, the government transformed the existing mobile contracts into licenses and auctioned a third mobile services license to foreign private investors. Thus, these reforms provide valuable lessons. First, it is an example of corporatization of a state-owned enterprise and its preparation for operating in a competitive environment under the Law of Commerce and Companies. This involved, e.g., creating a board of directors, establishing the company's share capital, and issuing shares. Second, it is an example for opening of a sector to private investment and competition (subject to an exclusivity period to be

[76] The opening to private competition is subject to an exclusive-rights period for the incumbent operator to establish a set of telecommunications services (e.g. fixed-line services or the provision of international gateways).

granted to the incumbent operator for specific services). Third, it entails the creation of an institutional framework to implement competition principles.

The most urgent infrastructure investments are in the power sector. As noted previously, about US$ 11 billion of investments in new generating capacity (7,000 MW) and expansion of the transmission and distribution networks will be required through 2020. Recently, the government announced the allocation of SYP 350 billion to the electricity sector in the 11th five-year plan seeking to add 5,100 MW to electricity supply over next 5 years. To successfully implement this ambitious investment plan, this report recommends strengthening planning and operational capacity at the Ministry of Electricity; finalizing and approving an Electricity Sector Investment Master Plan; and sustaining progress in the implementation of the ongoing electricity IPP projects (Naserieh IPP and Wind IPP). In the medium term, Syria's energy needs should be addressed by a more efficient utilization of existing capacity in the power sector, by reducing large technical and commercial losses; further capacity expansion of the power sector, thus enhancing security of electricity supply and reducing power outages; regional energy integration through a series of targeted investments in electric power and natural gas; and the development of wind power plants and solar power through implementation of a renewable energy development program.

This does not preclude addressing the investment gap in other infrastructure sectors, such as transport and water. The share of the transport sector in GDP has been declining (from 10% in 2002 to the current 7%). However, the economy is expected to grow more in the sectors with high transport intensity – such as international and transit trade and tourism. In this case, the declining trend reported above needs to be reversed through appropriate investments in the transport sector. Export and transit trade are expected to be among the key objectives of the Government's transport strategy as part of the upcoming 11th Five Year Plan. Other focus areas for transport sector investments include better connectivity of new agricultural production areas, road maintenance and network asset management, road safety and urban public transport. Irrigation investments are also critical especially in light of unsustainable agricultural water use and the country's rapidly depleting water resources. The Government is implementing an Irrigation Modernization Program (IMP) which aims to facilitate the adoption of modern irrigation techniques on most irrigated lands within the next 10 years. Progress in the implementation of the IMP, however, has been slow, with less than 10 percent of the targeted area covered at present. A crucial element is the development of enabling policies and institutional arrangements to promote the adoption of advanced on-farm irrigation technology. This includes the improvement of (effectively priced) electricity services and the adjustment of the agricultural subsidy system to promote the diversification into high-value crops.

The financing needs of the infrastructure sector (particularly electricity) are enormous and would be an intolerable drain on the government budget, highlighting the need for a fiscally sustainable approach. Three sets of actions are recommended: First, *accelerate the*

mobilization of private capital through Public-Private Partnerships (PPPs) to help bridge the investment gap. In addition to the enactment of the PPP law and the operationalization of the CPPPU, the Government should launch one or two pilot PPP transactions in the next eighteen to twenty four months in the power sector. Second, as part of broader PFM reforms, *improve Public Investment Management* by ensuring: (i) strengthened strategic focus and preliminary screening in sector prioritization and project selection; (ii) formal and standardized project appraisal mechanisms; (iii) clear roles and independent reviews in appraisal process; (iv) closely monitored, yet flexible implementation mechanisms; and (v) built-in ex-post evaluation criteria and processes. From a fiscal point of view, these actions would help reduce waste, focus on real returns to investment projects and promote a "value-for-money" public procurement culture. Third, *design a long-term sustainable fiscal policy framework*, including through the possible adoption of fiscal rules and a debt management strategy, to allow more fiscal space for capital outlays.

In the electricity sector, a number of sector reforms and associated institutional changes are necessary to improve public services without jeoapardizing fiscal sustainability. The four most urgent areas for reform comprise the following: (i) introducing commercial management of the power sector to reduce large technical and non-technical losses and improve the sector's cash flow; (ii) improving efficiency in energy utilization; (iii) enhancing security of energy supply through diversification of the sources of energy; (iv) coordinating and optimizing the development and operation of the electricity and hydrocarbon sectors to ensure consistency between gas production and the fuel sourcing strategy of the power sector.

A road map for sector reform should be developed to achieve optimal restructuring of the electricity sector and its transition to market opening. To improve the efficiency and productivity of the power sector and the quality of service, its structure and the operational relationships between units should be revised. The objective of this restructuring would be to ensure that sector management has both the autonomy and the incentives to address a range of existing shortcomings and to facilitate private participation in the sector. A road map proposed for consideration by the Government of Syria could consist of three phases of reform. First, functional unbundling of the generation and transmission functions into separate operational units under the Ministry of Electricity. Second, incorporate the three electricity entities (generation, transmission, and distribution) as state-owned companies operating on a commercial basis based on performance contracts linked to performance targets. Third, in the long term, develop a competitive wholesale electricity market which is integrated with neighboring electricity markets, once all electricity market opening conditions have been met, the regulations have been developed, and the market participants (especially the distribution company) have become creditworthy.

The development of a gas-to-power strategy and a coordination mechanism between the Ministry of Electricity and Ministry of Petroleum and Mineral Resources is necessary to meet future electricity sector capacity demands. Low gas prices and inadequate coordination

between natural gas production plans and electricity generation requirements have led to constraints in the present gas supply to the electricity sector. Projections of future electricity sector capacity demand indicate that gas needs to be used increasingly by the electricity sector for generation. In particular, pricing and supply contracts between the gas and power sectors should be coordinated because the gas price directly impacts gas sector investment capacity and electricity production cost.

8.6 Inclusive Growth and Domestic Markets

An inclusive growth strategy is good for the development of domestic markets. The growth strategy implied by the policy reforms outlined above is fully consistent with the development of domestic markets in Syria. This report proposes a *private investment-led growth regime,* founded on the increased access to markets, both domestic and external, and on expanded productive capacity, through sustainable investments in infrastructure and the removal of costly barriers to entry of new private sector producers, particularly SMEs.

On the demand side, lifting people out of poverty is a sure way to strengthen domestic markets. In Syria, 12.3% of the population lives below the lower poverty line and 33.6% of the population lives below the upper poverty line. In fact, among others, Matsuyama (1992) shows that non-homothetic preferences reflecting Engel's law (as household's income increases, the fraction spend on non-food (higher value added) goods and services increases) can generate a virtuous cycle of increasing domestic demand and income accelerating the process of economic development.[77] The challenge is to accomplish this in a sustainable manner, that is, without unduly distorting incentives for enhanced private investment and deteriorating the Government's fiscal stance.

The implementation of an inclusive growth strategy would enhance domestic incomes and strengthen domestic demand without necessarily requiring strong redistributive policies. With a focus on expanding productive employment and on broad-based development, an inclusive growth strategy has the potential to accomplish more in terms of strengthening domestic demand than through the implementation of income redistribution schemes. In fact, inclusive growth strategies aim to create new jobs and income for individuals, and increase productivity growth which in turn will raise workers' wages as well as returns for the self-employed.

This does not mean that the Government should wait passively for inclusive growth to have an impact in order to address pressing social welfare and distributional issues. Choices in terms of the composition of public spending can play an important role in augmenting social welfare without distorting incentives or being fiscally unsustainable. In particular, public

[77] Murphy, Schleifer, and Vishny (1989) show comparable effects due to demand externalities. More recently, Matsuyama (2002) provides a richer model of structural change leading to virtuous cycles based on "hierarchies of needs" in consumption whereby households' consume different goods in a particular sequence, i.e., food needs to be consumed before textiles, textiles before home appliances, home appliances before electronics, and so on.

spending on education and health could enhance Syria's *long-term* growth prospects by building up the country's human capital. The Bank is currently working with the Ministry of Finance of Syria in the preparation of a policy note - part of a Public Expenditure Review - which will analyze the impact of changes in the composition of public spending on key welfare variables. Furthermore, the ongoing phasing out of petroleum price subsidies that have an overall distributionally regressive effect also contributes to inclusiveness. Finally, strengthened social protection programs – including well-targeted cash transfer mechanisms – are critically important to shield the most vulnerable individuals from exogenous shocks and temporary adverse effects of policy reforms.[78]

Policies aimed at enhancing productive employment and removing constraints to private-led (especially SME) growth can also promote a strong domestic supply response. On the supply side, domestic markets can be strengthened by increasing the opportunities for productive use of Syria's endowment of factors of production. The constraints identified in this report prevent a fuller and more productive utilization. As noted before, these constraints are especially deleterious to those groups – the poor, the underemployed, the non-politically-connected entrepreneurs – which are not fully integrated into the Syrian economy, and thus with great potential to contribute more to accelerated future growth, both as consumers and producers.

Finally, it should be stressed that promoting the development of non-oil exports is by no means inconsistent with the strengthening of domestic markets – on both the demand and supply sides. In the face of declining oil production and exports, expansion and diversification of non-oil exports is essential, because it (a) ensures a steady inflow of foreign exchange earnings to finance the imports of the necessary capital goods, intermediate products, and other inputs necessary for the growth of investment and production, (b) creates markets for expanding non-oil production, and (c) generates employment contributing to inclusive growth.

8.7. Syria's Comparative Advantages and Possible Criteria for the Design of Sectoral Policies

Syria's relatively late-comer status in terms of economic reforms brings advantages and disadvantages. On the one hand, Syria may enjoy the so-called "advantage of backwardness", that is, the more distant a country is from the global technological frontier, the faster it is expected to grow.[79] Furthermore, Syria can learn from other transition experiences and avoid mistakes made by other countries. On the other hand, many of Syria's global and regional competitors are already in the process of implementing second-generation reforms, which means that the country has to catch up quickly and compete vigorously in world markets.

[78] More on this in the MILES study.

[79] Provided that it has institutions and policies that facilitate catching up with relevant technologies developed elsewhere. See e.g. Aghion, P. (2008). "Schumpeterian Growth and Growth Policy Design", in Durlauf, S.N. and L.E. Blume. *Economic Growth*. The New Palgrave Economics Collection. London: Palgrave Macmillan.

While it is beyond the scope of the first phase of the CEM to discuss sectoral policies in depth, a few criteria for possible sectoral support consistent with inclusive growth can be outlined. They include: (i) comparative advantage, both static and dynamic; (ii) potential for generating foreign exchange; and (iii) potential for generating productive employment.

A recently-conducted analysis of Revealed Comparative Advantage (RCA) sheds light on the changes currently underway at the sectoral and product level in Syria. Agricultural product sections display rising trends in RCAs driven mainly by live animals (sheep, poultry) and edible vegetables; but others also have high RCAs (animal and vegetable oils, fruit and nut preparations). Textiles (woven fabrics, synthetic yarn) also display rising trends in RCAs. Finally, among the most dynamic (rising RCAs) products are woven fabrics, bottled water, miscellaneous manufactured products. Not surprisingly, mineral products (oil in particular) display a rapid decline in RCAs.[80] The analysis also suggests that the export diversification potential for goods in which Syria has comparative advantage is good. This analysis will be deepened as part of the second phase of the CEM and can help provide a guide for the design and implementation of sectoral policies.

However, the identification of areas of comparative advantage should not be used as a basis to conduct "old style" industrial policy focused on picking winners. Government activism – when warranted – should focus on strengthening support to private sector-led growth and implementing policies to increase competitiveness. This would involve: (i) reducing the costs of bringing goods to market through enhanced transport and trade facilitation; (ii) retooling export promotion with greater focus on higher exporters' survival rates; (iii) strengthening competition policy to facilitate entry and exit in the product and factor markets, as proposed in the Aghion-Howitt "Schumpeterian" approach to growth; and (iv) facilitating positive externalities through special economic zones (SEZs) and clusters.[81] In this respect, this agenda resembles the recommendations of this report to promote an export incentive system in the Syrian economy. It should be noted that Syria has been implementing with some success "spatial" industrial policy in the form of industrial cities (see Box 3).

[80] See Lim, J.J. and C. Saborowski (2010). "Export Diversification in a Transitioning Economy: The Case of Syria". Word Bank, mimeo.
[81] Reis, J.G. and T. Farole (2010). "Trade and the Competitiveness Agenda". *Economic Premise*, No. 18, June. Poverty Reduction and Economic Management Network, The World Bank.

Box 3: Industrial Cities as a Natural Experiment[1]

Syria has established four industrial cities since 1999 as part of its industrialization program. They are modern integrated industrial and residential estates equipped with all necessary infrastructure, business, social, and educational services. They can play an important role in diversification of exports if complemented with the right export incentive measures.

The industrial cities are constructed close to the major transportation networks in the main governorates; Aleppo (Sheikh Najjar), Homs (Hasia), Damascus (Adra), and Deir Ezzor (Deir Ezzor). They operate under the Ministry of Local Administration. With the exception of Deir Ezzor, where development has started only recently, the supporting infrastructure in all industrial cities has been largely completed and almost half of the area allocated for industry has been sold to 6,946 companies (of which 221 are foreign companies). About 61 percent of these companies are constructing their factories, and 18 percent already started production (Table 4). A key advantage of setting up a factory in an industrial city is the subsidized land. Companies can buy or lease plots at very reasonable prices. One-stop facility is provided to the investors in the industrial cities to set up their businesses, construct their factories and get their utilities connected very quickly. Also, companies in the cities are allowed to clear their imports at their factories.

The land allocated to the industrial cities is divided into industrial, residential, management, and green areas, and service centers and main streets. The industrial areas are subdivided into zones according to the type and size of industries and whether these industries are polluting or not. Infrastructure services include: transportation including railroads, power, telecommunication, wastewater and sewage system, and industrial and drinking water. Pre-treatment of wastage is done in factories. The wastage is then sent to the main treatment plants operated by the Industrial City Administration. Substantial new investment and technical assistance are needed to enhance the capacity and operational efficiency of the main treatment plants. The industrial cities also include residential buildings for employees, recreational facilities, medical centers, schools, banks and post offices, and shopping areas.

Table 4: Syria's Industrial Cities (As of May 2010)

	Adra	Sheik Najjar	Hasia	Deir Ezzor	Total
Total area (hectares)	7,000	4,412	2,500	2,850	16,767
Estimated cost (srp million)	30,000	16,000	9,000	12,000	67,000
Date of opening for investment	2004	2004	2004	2010	-
Area of industrial plots (hectare)	1,610	1,163	758	680	4,211
Industrial area already allocated to licensed companies (hectare)	870	669	346	12	1,897
Number of companies licensed	3,374	2,777	765	30	6,946
Of which foreign companies	108	70	34	9	221
Number of factories under construction	1,630	1,401	313	10	3,354
Number of factories where production already started	229	448	116	-	793
Number of workers	36,452	31,500	16,346	1,057	85,355

[1] This Box is based on Section 5 of Yagci, F. (2010). "Improving Export Incentives and the Free Zone System in Syria". World Bank, mimeo.

This preliminary analysis suggests that, if industrial policy is to be pursued in Syria, it should be of the "soft" kind.[82] The typical "hard" industrial policy would involve picking winners, erecting tariff barriers, granting export subsidies to favored sectors, and granting tax breaks to foreign investors. One key problem with this approach is to disentangle interventions motivated by rent-seeking considerations from those governed by legitimate industrial policy arguments.[83] As noted by Harrison and Rodriguez-Clare, "the idea is to shift the attention from interventions that deal directly with the coordination problems that keep productivity low in existing or raising sectors. Thus, instead of tariffs, export subsidies, and tax breaks for foreign corporations, we think of programmes and grants to help particular clusters by increasing the supply of skilled workers, encouraging technology adoption, improving regulation, and providing industry-specific infrastructure (e.g. in the tourism sector)."[84]

[82] See Harrison, A. and A. Rodriguez-Clare (2010). "From Hard to Soft Industrial Policies in Developing Countries". Vox Research-based policy analysis and commentary from leading economists (online), June 27.
[83] The number of preconditions for successful "hard" industrial policy can be daunting, and "today no MENA country really combines these features of successful interventions". World Bank (2009). *From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa*, p. 167.
[84] *Ibid*., p. 5.

Annex

Annex 1: Prioritizing Policy Reforms for Addressing the Main Constraints to Growth

Central theme: Sustained, inclusive growth and diversification of the Syrian economy away from the oil sector will depend on the success of the government in removing the main constraints on investment (size, quality, and sector in which it is made) and full and effective utilization of productive capacity. Four of these constraints are particularly important:

1. Institutional weaknesses and risks: They create uncertainty and discourage both domestic and foreign investment.
2. Inadequate access of the private sector to credit -- for working capital and particularly investment credit. This adversely affects both investment and utilization of productive capacity.
3. Lack of competitiveness of non-oil products in international markets. The adverse effect of this is both on investment (and subsector in which it is made) and utilization of productive capacity
4. Availability and quality of infrastructure services (power in particular). Infrastructure bottlenecks such as e.g., power shortages do not allow full utilization of existing capital stock even if there is enough aggregate demand in the economy.

Growth Diagnostics: Key constraints to inclusive growth	Policy reforms for addressing constraints
"Structural" uncertainty associated with the institutional setup The uneven application of rules and regulations, and related opportunities for corruption, deters private investment as it makes it difficult to assess expected returns and also lowers private returns. Firms that are uncertain about the appropriability of potential returns will refrain from taking the risk of financing their investment through medium to long term credit arrangements. The uneven application of rules and regulations is detrimental especially for private SMEs which are far more likely to have to rely on informal payments in their every-day business practices.	**I. Simplifying compliance, increasing transparency and reducing uncertainty with respect to legal and regulatory framework** <u>Urgent Priority</u> • Establishment of a *systematic process for dialogue between Government and the business community*, to improve reform quality, strengthen implementation, establish a problem-solving mechanism, enhance information exchange, better coordinate policy decisions with new investment opportunities, and deepen Government credibility with investors. • Application of the Competition Law as a platform to raise awareness, advocate pro-competitive policies and address explicit anti-competitive behaviors.

	- Strengthen capacity of the Competition Authority to effectively monitor and dissemble monopolies. - Accelerate implementation of the Government's Governance & Anti-Corruption Program. **II. Strengthening the legal and regulatory framework for doing business** <u>Medium-Term Priority</u>[85] - Establishment of a legal, regulatory and institutional framework that opens competitive segments to private investment. - Strengthening of capacity for the implementation of the Competition Law.
***Inadequate Access of Private Sector to Credit*:** The public sector's capital stock is larger than the private sector's, but the private sector GDP is considerably larger than the public sector GDP. Obviously, this is an issue of productivity differentials, which seems to be corroborated by the TFP decomposition exercises as well as by the productivity calculations in the ICA. The disconnect between capital accumulation and output between the public and private sector seems to be perpetuated by credit misallocation in the financial sector: The share of private deposits is on the rise, but lending benefits mostly public sector entities. This seems to reflect mostly an adverse selection problem as deposits (including private ones) re mostly channeled to the public sector because the latter in general offer better risk assessment, repayment guarantees and monitoring possibilities. This stems largely from the following characteristics of the financial sector in Syria:	**I. Improving financial intermediation and allocation of financial resources** <u>Urgent Priority</u> - Reduction of the adverse selection problem by (i) establishing a well-functioning credit registry; and (ii) strengthening legal rights relating to credit transactions through a new Collateral Law and a specialized commercial court. - Increased SME access to finance through: (i) training for bank officials in risk assessment for small enterprises; (ii) assisting SMEs to improve their accounting and book keeping practices to facilitate accurate credit risk assessment, (iii) creation of a legal framework for microfinance banks; and (iv) establishment of a loan guarantee scheme that reduces the risk perceived by lenders in serving the small enterprise sector.

[85] Detailed recommendations on the strengthening of the legal and regulatory framework are included in the Draft Investment Climate Assessment report.

◦ The financial system is too small because private banks have not yet moved from Paris and Beirut to Syria, Syrian economy is a cash-based economy and the banking system is not used unless absolutely necessary, use of checks, credit cards and ATM cards not widespread. ◦ The main financial instrument offered by the Banks is short-term credit. Medium-term investment credit is negligible. Other instruments (dedicated credit, insurance, guarantees) are also negligible. ◦ Financial infrastructure is not developed, system is inefficient and costly. Inter-bank market does not exist, TB market does not exist, account settlement and payment system are outdated, modern accounting and auditing systems are missing. • While large firms with long standing relationships with Syria's banks are granted credit (larger firms also have access to finance from foreign entities) , stricter terms for private SME's, and especially new entrants, often deter their applications for financing. Consequently, while credit volumes grew strongly during the past five years, a large share is still channeled into public sector and the largest private sector firms. Little credit is reaching the existing and emerging SMEs which may be more efficient and better positioned to create employment.	<u>Medium-Term Priority</u> • Restructuring of the state banking system in a coherent and well sequenced manner, drawing on the results of independent audits. • Strengthening the supply side of the financial sector by continuing to encourage entry of foreign and domestic private banks. **II. Enhancing SMEs management capabilities, including on financial management** <u>Urgent Priority</u> • Expansion of training efforts to improve financial management, accounting, and business planning among SMEs. **III. Enhancing Central Bank independence and the effectiveness of monetary policy tools** <u>Urgent Priority</u> • Completion, approval and enactment of the Central Bank Law. <u>Medium-Term Priority</u> • Phasing out of administrative monetary policy tools, replacing them with market-based tools such as Treasury Bills, to be issued on a regular basis. **IV. Strengthening bank supervision to preserve financial stability** <u>Medium-Term Priority</u> • Strengthening of the regulatory and supervisory capacity of the Central Bank of Syria.

Insufficient competitiveness of non-oil products in international markets
 	
In the face of declining oil production and exports, expansion and diversification of non-oil exports is essential, because it (a) ensures a steady inflow of foreign exchange earnings to finance the imports of the necessary capital goods, intermediate products, and other inputs necessary for the growth of investment and production, (b) creates additional markets for expanding non-oil production, and (c) generates employment contributing to inclusive growth.
 	
The Syrian trade regime has been improved in recent years. Non-oil exports have responded positively to these reforms. However, much more need to be done to deepen the trade reforms and maintain the growth momentum. The remaining problems in the trade regime include the following.
 	
• Too many tariff bands, numerous and complex taxes and service charges some of which are inconsistent with WTO rules, and uncertainty about the products on the “negative list” complicate the import regime, create significant degree of discretion in implementation and invite corruption, and increase administrative costs to companies including exporters. High cost of imported inputs is a tax on exports, because exporters are not reimbursed of this cost. This cost is called “anti-export bias” which is high in the case of Syria.
• There are other important barriers to exports. Some essential trade facilitation services do not exist (export credit, support for meeting safety and health standards required by importing countries), some are weak (promotional services), others are inefficient and costly (cumbersome customs administration).
• Export incentive measures, successfully
	I. Simplifying the import regime while maintaining revenue levels
	
	<u>Urgent Priority</u>
	
	• Replacement of other taxes and charges on imports with VAT and excise tax levied at the same rate on the imported and domestically produced goods, and a few service fees in such a way to avoid revenue loss.
	• Elimination of nuisance rates (making them zero or 5%) in a way to maintain the same tariff revenue.
	
	<u>Medium-Term Priority</u>
	
	• Simplification of the tariff system by reducing the number of rates to 3-4 and the maximum rate to 20-25 percent with additional excise tax on luxury goods.
	
	II. Establishing an effective export incentive system
	
	<u>Urgent Priority</u>
	
	• Revision of the Customs Law and the related legislation to introduce the following commonly used incentive instruments:
	    o Full duty and tax drawback
	    o Duty and tax exemption
	    o Manufacturing under bond
	    o Fenced and single-factory Export Processing Zones (EPZs)
	• Mobilization of technical assistance to set up an administrative mechanism to implement the above measures effectively.
	• Reform of the free zone system by: (i) eliminating domestic tax exemptions; (ii) lifting restriction on purchasing from local market; and (iii) transferring management to private sector.

implemented in many developing countries are not in place to offset these and other costs and remove these constraints. As a result, the Syrian non-oil products are unnecessarily constrained in their ability to compete in international markets for both price and quality.	**III. Enhancing trade facilitation** <u>Urgent Priority</u> • Customs administration: Continue implementation of the reforms already introduced. Emphasis should be given to implementation of the risk management system to move away physical controls for clearance, further automation of business processes to reduce the room for discretion, fully operationalizing the anti-corruption unit, introduction of one-stop shops at border crossings . • Quality and safety standards: Accelerate the ongoing program for restructuring of the standards system to be compatible with international norms. Launch campaigns to raise awareness among producers and exporters about the standards requirements in target export markets. Train producers to meet these requirements. <u>Medium-Term Priority</u> • Export credit: Explore options and institutional arrangement for expanding the funding base of the financial system, improving efficiency and reducing the costs of financial intermediation, assisting companies to improve their accounting, book keeping, and business management practices for credit assessment purposes, and introduction of dedicated financial instruments (credit for both investment and working capital, insurance, loan guarantee, etc) for exports in order to ensure timely credit to exporters at affordable prices.
***Infrastructure bottlenecks, especially in the power sector*:** Decaying or insufficient infrastructure, particularly in the power sector, is a key constraint	**I. Strengthening institutional framework for infrastructure backbone services, particularly in the power sector**

to growth. More than half of Syria's firms regard electricity as a major constraint to business growth; power outages are frequent and private generators common. Investments in electricity infrastructure are needed to attract investment and lower the cost of business operations. • A recent Electricity Sector Strategy Note for Syria, developed by the World Bank in cooperation with the Ministry of Electricity estimated that about US$ 11 billion of investments in new generating capacity (7,000 MW) and expansion of the transmission and distribution networks will be required through 2020. • By 2009 the transport sector of Syria accounted for about 7% of GDP, a decline from the 10% of 2002 mostly attributable to the growth of economic sectors that are less transport intensive. If current trends persist, the economy is expected to grow more in the sectors with high transport intensity – such as international and transit trade and tourism. • These financing needs of the infrastructure sector (particularly electricity) are enormous and would be an intolerable drain on the government budget, highlighting the need for a fiscally sustainable approach. • To bridge the investment gap it currently faces in infrastructure, it is key to accelerate the mobilization of private capital through Public-Private Partnerships (PPPs).	<u>Urgent Priority</u> • Implementation of the Electricity Law. • Enactment of the new PPP legislation. • Strengthening the capacity of the Central PPP Unit (CPPPU) established in the Prime Minister office to coordinate the PPP program implementation. <u>Medium-Term Priority</u> • Gradual adjustments in electricity tariff structure and levels to achieve cost recovery over a transitional period. • Restructuring of transport agencies – including through the introduction of a massive training program to address the dearth of experienced professionals in the sector – and revision of private/public investment strategies for the transport sector. **II. Carrying out essential public investments within a fiscally-sustainable approach** <u>Urgent Priority</u> • Strengthen planning and operational capacity at the Ministry of Electricity. • Finalize and approve an Electricity Sector Investment Master Plan.. • Sustain progress in the implementation of the ongoing electricity IPP projects (Naserieh IPP and Wind IPP). <u>Medium-Term Priority</u> • More efficient operation of the electricity networks, by reducing large technical and commercial losses. • Further capacity expansion of the power

	sector, thus enhancing security of electricity supply and reducing power outages. • Regional energy integration through a series of targeted investments in electric power and natural gas. In particular: (i) complete Arab Gas Pipeline (AGP) in Syria as well as gas network integration with Turkey; and (ii) explore AGP connection with Iraq. • Development of wind power plants and solar power through implementation of renewable energy development program.

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