Harnessing Trade for Development and Growth in the Middle East

Report by the Council on Foreign Relations Study Group on Middle East Trade Options

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FOREWORD

At first glance, it might seem that a study of trade and investment strategies in the Middle East is not particularly timely in a period when the region—and the entire international community—is preoccupied with an unprecedented war on global terrorism.

However, a closer look reveals a direct relationship between the issues addressed in the study and the deeper causes of the violence that now seems endemic to this part of the world. The misery and hopelessness engendered by economic backwardness and stagnation that characterize much of this part of the world lie at the heart of international terrorism. Economic progress, holding the promise of a better life, lies at the heart of long-range remedies to the appeal of extremism and terrorism.

Over the past decade, the region known as the Middle East and North Africa (MENA) has lagged behind most other areas in the world in terms of its economic performance. As this study shows, although the MENA region needs to pursue efforts to reduce intraregional trade barriers, such steps will not be enough to achieve sustained levels of growth. MENA countries must also tackle "behind-the-border" policies that hinder investment and services liberalization.

A key premise of this report is that what happens *behind* the border is as important as what occurs *at* the border. The survey of regional businesses and entrepreneurs that accompanies the report, itself a unique and original contribution containing previously unavailable data, makes clear that inefficiencies and bottlenecks in the service sector significantly hinder investment. Domestic service sector reform therefore must be a priority for MENA countries intent on achieving deeper integration into the global economy and higher and more sustainable levels of growth.

This study deserves the urgent attention of policymakers and nongovernmental actors in every Middle Eastern country. The U.S./Middle East Project of the Council on Foreign Relations, under whose auspices this study was conducted, is prepared to assist those in the region who seek to examine the implications of the study's recommendations for their own situation.

Leslie H. Gelb
President
Council on Foreign Relations

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The suggestion that the U.S./Middle East Project of the Council on Foreign Relations undertake a study of trade and investment in the Middle East and North Africa (MENA) region came from a member of the Project's International Board, Fouad M. Makhzoumi. Fortunately, he also generously offered the financial resources that made this study possible. Our first acknowledgment is therefore of his key role in the initiation and eventual production of this important document.

We are indebted to the study's authors, Bernard Hoekman, research manager of the Development Research Group on International Trade at the World Bank, and Patrick Messerlin, professor of economics at the Institut d'Etudes Politiques of Paris; to Jamal Zarrouk, senior economist at the Arab Monetary Fund, who designed and executed an original survey of businesspeople and entrepreneurs in the Middle East; to Denise Eby Konan, professor of economics at the University of Hawaii, who prepared the economic analysis on integration among Arab countries; and to Won Chang, now with the U.S. Treasury Department, for compiling and analyzing bilateral trade data.

It is rare for a chair of a study project to play as decisive a role in the conceptualization and direction of a study as did Peter Sutherland, whose group was comprised of prominent experts in the area of trade and investment. Peter Sutherland's own background, which includes having served as director-general of the World Trade Organization, was an invaluable asset to our enterprise.

We are indebted to Larry Korb, director of studies at the Council on Foreign Relations, who helped our project overcome inevitable difficulties, and to Michael Weinstein and Roger M. Kubarych, senior fellows at the Council on Foreign Relations, whose critical reading of early drafts contributed importantly to the final document.

As always, I am indebted to Leslie H. Gelb, president of the Council on Foreign Relations, a tough taskmaster who insists on standards of professional and intellectual excellence and will not settle for less.

Finally, I thank my colleagues at the U.S./Middle East Project and members of the project's International Board, whose support and encouragement has made possible not only this particular study but everything that is of value in the work of the U.S./Middle East Project.

Henry Siegman
Senior Fellow and Director,
U.S./Middle East Project
January 2002

INTRODUCTION

This timely report from the Council on Foreign Relations highlights the central role of trade in the future prosperity of countries in the Middle East and North Africa (MENA).

The economic performance of many of the countries in the region during the past quarter- or half-century has been disappointing, despite the advantage of great oil wealth. One important explanation is the failure to develop links with the global economy through foreign investment and trade in services and goods other than oil. A second reason is that most of the governments in the Middle East and North Africa have made scant headway in reducing the interventionist role of the state in the economy.

The crucial message here is that greater openness to trade and domestic economic reforms can mutually reinforce each other to generate faster growth, lower unemployment, and higher standards of living. If a new round of global trade negotiation under the auspices of the World Trade Organization heralds a new period of trade liberalization, as we must all hope, it can provide exactly the right opportunity for governments in the region to jump-start this reform process.

Regardless of the precise world economic environment, however, the fundamental point is that all examples of successful economic development have involved the harnessing of trade. I hope that this report provides a blueprint for the Middle East and North Africa to win enormous potential benefits from trade policy reform.

The preparation for this study has been a salutary experience for all of us involved. The issues it has raised are of formidable complexity. To some extent I initially hoped that external opportunities alone might serve to help to stimulate the growth of the MENA economies significantly. In this regard both the prospects of some type or types of effective free trade area in the region together with more advanced agreements with the European Union and the United States to provide market access were thought to be possible partial solutions to the enormous challenges facing the countries under consideration. As work progressed, it became apparent that the fundamental problems of these economies were essentially domestic and related to the need for new policies to govern the internal economy.

The fact is that MENA has significantly lagged behind other regions in economic performance over the decades since the 1950s. Indeed, as this report shows, in the 1950s per capita income in Egypt was similar to that in South Korea, whereas today it is less than 20 percent of the South Korean figure. Saudi Arabia had a higher gross domestic product (GDP) than Taiwan; today it is about 50 percent of Taiwan's. The real problem of the MENA economies is lack of economic liberalization and poor education. Other countries have had wars and high military expenditures, so these factors do not explain the relative failure. Trade barriers are undoubtedly part of a problem that proves once more that protectionism simply does not work. Tariffs on average are very high in relative terms. But behind the borders, too, reform is needed.

We conducted some interesting surveys during the period from July to December 2000. Nine countries and jurisdictions were involved: Egypt, the West Bank and Gaza, Israel, Jordan, Lebanon, Saudi Arabia, Syria, Tunisia, and the United Arab Emirates. The replies were very interesting and pointed to the major problems being high tariffs, bureaucracy, and red tape (i.e., corruption). Interestingly, 20 percent of the people surveyed said that corruption payments averaged more than 2 percent of the value of consignments. (More than 3 percent paid more than 10 percent of the value of consignments.) And tariffs were much higher in the other countries than in Turkey or Israel.

Another aspect of the economic malaise was the large role of the state as an economic actor. Elsewhere (and the European Union is a prime example), the liberalization of recent years has resulted in a significant withdrawal of the state from running industry and services. The result has been privatizations and the introduction of competition in vital utilities. In the MENA countries, progress in this area has been painstakingly slow. The proceeds of privatization have been only 3 percent of the world total during the 1990s. Banking also has remained often in the hands of the state. In Egypt, for example, the four state-owned banks control 70 percent of commercial bank assets and 60 percent of commercial bank deposits. There needs to be a change in mentality. If services are inefficient, they are a tax on the productivity of a country. Others have learned the lesson that competition, and foreign competitors in particular, are good for the economy, and that protectionism leads to stagnation. Often a good way of assessing an economy's attractiveness is to look at foreign direct investment (FDI). China, with FDI estimates of $43 billion in 2001, is a case in point. By contrast, India offers only a fraction of that figure. MENA also simply does not attract enough inward investment. There is a need to debureaucratize and to make the legal systems more efficient. The range of policy areas needing reform also include quotas and licensing, antidumping, taxes, and demonopolization. The emphasis therefore has to be on opening up the economies and providing a transparent system within which business can function stimulated by competition.

There are of course other issues that must be addressed, such as education: illiteracy is close to 40 percent across the region, and low average enrollments in secondary schools must be improved.

Nobody can believe that the necessary reforms can be easily implemented. However, the pace of change has to be radically increased and the vested interests that resist that change must be faced down.

Peter Sutherland
Chair, Study Group on Middle East Trade Options
Chairman, Goldman Sachs International; Chairman, BP p.l.c.

REPORT

The Middle East is in the midst of a profound social and political transformation. By 2010, practically every major country in the region will have undergone some form of political succession. Transitions have already taken place in Jordan, Morocco, Bahrain, Syria, and Iran. More than mere changes in leadership, these transitions reflect the passing of a generation. On the economic policy front, many countries have also undergone significant changes. Economies in the region are more open to the world economy than they were two decades ago. Governments have been pursuing privatization programs and encouraging private sector development. Inflation has fallen, and fiscal balances have improved.

Despite the significant policy achievements, particularly in terms of macroeconomic reform, the economic performance of the region has been disappointing. In the 1950s, per capita income in Egypt was similar to South Korea's; today it is less than one-fifth of the South Korean figure. Morocco's per capita gross domestic product (GDP) was close to that of Malaysia; today it is only one-third of Malaysia's. Saudi Arabia's per capita GDP was higher than Taiwan's; today it is only half of Taiwan's. Absent profound policy changes, GDP growth is not expected to exceed 3 to 4 percent in the coming decade. Given that the labor force is expected to expand on average more than 3 percent per year, this GDP growth is insufficient to significantly reduce current unemployment—as high as 20 percent in some countries.

Greater integration into the world economy can help achieve the economic growth that is required in the Middle East and North Africa (MENA)[1] region by attracting investment and expanding employment opportunities. This report focuses on trade-oriented policy reform options that could be used by governments as part

[1] In this report, MENA countries include Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Qatar, Kuwait, Lebanon, Morocco, Oman, Saudi Arabia, Syria, Tunisia, Turkey, the UAE, Yemen, and the West Bank and Gaza. Due to data constraints, not all countries are included in the statistics reported in this study.

of a strategy to attain and sustain more vigorous growth. Governments have pursued economic reform for some time. In the trade policy area, a series of regional and bilateral agreements have been a prominent element of the approach to reform taken by the region. In the regulatory and microeconomic policy arena, reforms have primarily been unilateral and independent of actions taken by neighboring nations. The premise of this report is that the two strategies could be merged to mutual benefit—trade agreements being used as tools to pursue not just trade liberalization but also the pro-competitive regulatory agenda that is a critical element of an improved investment climate.

The new round of multilateral negotiations launched at the November 2001 ministerial meeting of the World Trade Organization (WTO) in Doha, Qatar, provides an opportunity to assess trade and investment policy strategies, as well as to identify options to use trade more effectively as an instrument of growth. A number of Arab ministers, including Yusif Hausayn al-Kamal, the minister of Finance, Economy, and Trade of Qatar, and Youssef Boutros-Ghali of Egypt played constructive roles in achieving a successful outcome. Pro-active engagement in—and use of—multilateral institutions such as the WTO can greatly assist governments in pursuing a comprehensive economic reform agenda.

The report presents three major conclusions and recommendations:

- *Traditional liberalization of trade in goods (tariff reduction) remains a priority*. Average tariffs in much of the MENA region are substantially higher than elsewhere in the world, reducing the competitiveness of MENA firms. The strategy that is being used to lower tariffs gradually on a preferential basis—in the context of bilateral and regional trade agreements—is driven in part by a desire to manage adjustment costs. It provides little scope for economic expansion, however, and it can give rise to costly trade diversion as consumers are induced to buy from less efficient regional suppliers.

- *Attracting investment requires service sector reforms, both public and private*. Increasing the quality and lowering the cost of service inputs can help manufacturing and agriculture confront global competition by enhancing competitiveness and creating alternative employment opportunities for workers, thereby attenuating the attendant adjustment costs of trade liberalization. Such reforms must be comprehensive, not piecemeal.

- *Using international agreements to liberalize trade in goods and to pursue a service sector reform agenda can have large payoffs and facilitate the attainment of reform objectives.* The fact that existing trade agreements have largely focused only on tariffs and related border measures is a major reason they have been of limited value. Trade reforms are best pursued in tandem with service sector reforms. Using trade agreements to commit to—and engage in—both services-related regulatory reform and further trade opening can enhance the credibility of reforms by increasing stakeholder interests in their implementation. Such agreements should include deals with major trading nations such as the European Union (EU) and the United States, as well as multilateral commitments made in the WTO.

Although trade and foreign investment are important drivers of economic growth, there are many other crucial determinants as well. These include social, macroeconomic, tax, and expenditure policies, as well as business regulation. All have a bearing on trade and investment incentives. Most countries in the region have significantly improved their macroeconomic policies during the last decade. The median inflation rate is low (around 4 percent), fiscal balances have greatly improved, and most currencies are convertible on current account. MENA countries have also made substantial progress in areas such as education, infant mortality, and life expectancy. A comprehensive policy-reform agenda that enhances competition in regional markets is vital in translating these achievements into sustained economic growth.

It is important to recognize the role of the regional conflicts and political tensions that have prevailed over the last fifty years in the lagging performance of the region. These have given rise to two wars (Iran-Iraq and the Persian Gulf War), and numerous conflicts with Israel, all of which have generated large-scale civil destruction. The concomitant large military expenditures have also been a drag on economic performance and constrained public investment. Although political tensions have unquestionably had a negative influence on growth performance, they cannot explain the underperformance. Since the Second World War, the countries that have achieved and sustained high rates of economic growth and raised real per capita incomes dramatically include nations with uncertain borders, civil unrest, ethnic tensions, and heavy military burdens. Examples include Chile, Taiwan, and South Korea. Although the recommendations in this report will have their greatest beneficial impact if accompanied by an easing of political tensions in the region, this is a not a precondition for the pursuit of the policies that are advocated.

Unlike most Study Group Reports sponsored by the Council on Foreign Relations, this one is addressed principally to policymakers and economic actors from the MENA region, not from the United States. Its primary purpose is to suggest an ambitious but realistic reform agenda that takes into account economic and political constraints, without losing sight of the urgency of harnessing trade for growth and development. The conclusions and recommendations are based in part on a survey of 250 firms aimed at identifying the principal obstacles to trade and investment in the MENA region, *as experienced by private businesses*.[2] The report therefore does not draw on abstract theory but reflects the everyday experiences and frustrations of people on the ground.

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[2] The survey was conducted during July–December 2000. A private enterprise questionnaire was designed and completed in nine countries: Egypt, the West Bank and Gaza, Israel, Jordan, Lebanon, Saudi Arabia, Syria, Tunisia, and the United Arab Emirates. The questionnaire covers some thirty to forty-five respondents in each country and was completed by randomly selected companies from a database of exporters and importers maintained by the Arab Trade Financing Program of the Arab Monetary Fund. Interviews were also conducted with key company managers. A detailed report on the results of the survey can be found in Appendix 2.

MENA Countries and the World Economy at the Dawn of the 21st Century

In recent decades MENA countries have lagged behind other regions in both the depth and the speed of their integration into the world economy. According to the traditional gauge of economic openness—the ratio of trade in goods to gross national product (GNP)—the MENA region is comparable to the average of lower- and upper-middle income countries. (See Appendix 1, Table 1.) In contrast to other regions in the developing world, however, MENA has not seen its trade integration expand significantly in recent decades. One illustration of this lack of progress is the limited magnitude of foreign direct investment (FDI) flows. The ratio between FDI and gross domestic product is on average six times lower in the MENA region than in middle-income developing countries as a group. (See Appendix 1, Table 1.)

High barriers protect small markets

The lack of integration between the MENA region and the world economy is due largely to a mix of restrictive trade and investment policies. These policies are particularly harmful because the small size and fragmentation of the MENA economies prevent the emergence of efficient and competitive firms and industries. The combination of small markets and high barriers has constrained the MENA region's growth opportunities, thereby freezing its trade structure, hindering economic diversification, and leading to overall rigidity in the economy that has constrained the development of modern industry.

Tariffs

Many countries in the region maintain relatively high trade barriers in the form of tariffs. The unweighted, average tariff applied by non–Gulf Cooperation Council (GCC) countries is 19 percent; the average applied tariff—measured as the ratio between average customs duty collected and the value of imports—is in the 10 to 15 percent range for Maghreb and Mashreq countries.[3] (See

[3] For the purposes of this report, the Maghreb includes Morocco, Algeria, Tunisia, and Libya and the Mashreq includes Egypt, Jordan, Syria, and Lebanon.

Appendix 1, Table 1.) Tariffs are ranked as the most important impediment to trade in the survey that was undertaken for this report. In addition to tariffs, a variety of non-tariff measures also restrict trade. Bureaucratic hurdles and red tape are prevalent, and they are identified in the survey as a major problem, second only to duties and taxes. (See Appendix 2, Table 2.) Complex tariff structures and numerous regulatory requirements create scope for corruption in customs, licensing authorities, and tax administrations. (See Appendix 2, Table 3.) Almost 20 percent of those surveyed responded that informal payments to customs officials averaged more than 2 percent of the value of consignments; more than 5 percent of respondents report paying more than 10 percent.

Within the MENA region, there are sharp differences between the tariff structures of the two largest non-oil economies (Israel and Turkey), the oil-rich GCC nations, and the remaining countries. This distinction applies to both the average level of tariffs and of the extent to which duties have been reduced over time. The economy-wide tariff average in Egypt, Morocco, and Tunisia is two-and-a-half to four times higher than the average in Turkey and Israel, respectively. (See Appendix 1, Table 4.)[4] In terms of tariff revenues as a share of imports, the difference is even greater. (See Appendix 1, Table 1.) Oil-based economies, with the exception of Saudi Arabia, tend to have low average tariffs (below 4 percent), reflecting the relative absence of import-substituting industries and a tradition of trading.

Economy-wide tariff averages are only crude indicators of protection. Another significant variable is the dispersion in tariff rates across sectors and products. Minimum tariffs at the sectoral level in Israel and Turkey are zero, whereas in the more protected MENA countries they range up to 15–25 percent for sectors such as food or plastic. High minimum tariffs are particularly costly for the economy that imposes them because they tend to protect relatively cheap variants of a product to the detriment of more expensive ones. As a result, they encourage domestic

[4] The economy-wide average tariff is the simple average of all the tariffs defined at the level of the tariff-line—the most detailed level for customs classification purposes.

production toward lower quality and a simpler range of products. In the more protective countries, maximum sectoral tariffs—which generally reflect the most powerful vested interests—can top 50 percent, giving rise to inefficient and uncompetitive domestic industries. Wide differences in tariffs across products not only distort investment allocation incentives, but they also provide scope for customs officials to exercise discretion in how they classify and value goods for duty-collection purposes. As a result, these officials have greater opportunities to seek or accept "informal payments" or bribes.

Non-tariff barriers

Numerous non-tariff barriers (NTBs) complement import duties. They include quotas, licensing, antidumping measures, taxes and subsidies, domestic monopolies, technical product standards, and administrative regulations. NTBs are difficult to document (especially when they take the form of technical regulations), and their impact is hard to quantify. For this reason the survey provides valuable insights. Respondents were asked to estimate the average magnitude of all non-tariff-related trading costs. Their answers suggest that such costs are highly significant, averaging 10 percent of the value of goods shipped. Customs clearance procedures are ranked together with corruption (bribes) as the second-most important source of non-tariff trading costs. (See Appendix 2, Table 2.) The average company spends ninety-five days of labor per year resolving problems with customs and other government officials. Such frequent interaction can facilitate informal payments to officials. Although the average payment associated with customs clearance reported by respondents is only around one percent of the value of shipments, as mentioned, one-fifth of the managers report paying between 2 and 17 percent. There is significant variance in the reported intensity of the problem across countries.[5]

[5] The survey indicates that a number of MENA countries have improved the performance of customs in recent years. This is the case in Egypt, Israel, and Jordan. In other countries, however, matters have either not improved or have become worse, which is the case in Lebanon, Saudi Arabia, and Syria.

The survey highlights the role of import and export procedures and requirements in MENA countries, specifically the time required for import clearance and inspection, the number of documents and signatures needed to process a trade transaction, and the frequency of problems with customs and other government officials. For example, it takes two to five days, on average, to release from customs imported goods shipped by air, two to ten days for sea-borne shipments, and one to three days for road shipments—all of which compares unfavorably to international best-practice norms of only several hours. MENA countries also tend to impose stringent, mandatory product standards and conformity assessments. Egypt is a case in point: the costs associated with standards and conformity assessments have been estimated to range from 5 to 90 percent of the value of shipments.[6] Complaints also have been registered regarding requirements imposed by Saudi Arabia.[7]

Trade performance

With a population almost equivalent to that of the EU, the MENA region is potentially a large market. However, it remains economically small and politically fragmented. The region's total GDP is only half that of the United Kingdom or France. To be small in an economic sense is not a constraint to growth and development; the last three decades have provided ample evidence that small economies with very different production patterns can be very successful. Examples include middle-income economies such as Chile, Estonia, Hong Kong, South Korea, and Malaysia. In today's global age, the key is not size but whether a country is sufficiently well integrated into the world economy, as the latter offers potentially huge export markets and access to the latest technologies and know-how. It is the combination of inherently small markets and high barriers to trade in MENA that poses a fundamental obstacle to vigorous and sustained growth.

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6 Cassing et al, "Enhancing Egypt's Exports," in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, B. Hoekman and J. Zarrouk, eds. (Ann Arbor, MI: University of Michigan Press, 2000).

7 Jamel Zarrouk, "Regulatory Regimes and Trade Costs," in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*.

That the potential exists for export-oriented growth is illustrated in the progress that was made in the last decade to diversify exports. For many countries, the product range of exports expanded significantly in the two decades after 1980. (See Appendix 1, Table 5.) The region's share of manufactures in total exports rose from 8 percent in 1980 to 19 percent in the late 1990s; Egypt almost quadrupled the share of manufactures in its total exports.[8] However, the region remains heavily dependent on exports of oil and oil-derived intermediate goods (basic chemicals). A closer look at the data reveals that much of the shift toward greater exports of manufactures is due to expanded production of oil derivatives. The scope for diversification therefore remains huge. One reflection of this fact is that for many countries, intra-industry trade—the two-way trade in similar types of manufactured products—either fell or remained stagnant during the last two decades. With the exception of Israel, MENA countries do not produce intermediate inputs that are sold on world markets. (See Appendix 1, Table 5.)[9] Nor are they integrated into global production-sharing systems, in which they would import and process components for re-export and final assembly elsewhere. In part this is a reflection of the high transactions costs associated with trade, which inhibits this type of investment.

Reducing Transaction Costs and Increasing Competitiveness

The above description shows that further reduction in tariffs and NTBs imposed on foreign products remains a priority for most countries in the region. An average tariff-equivalent of more than 25 percent—the 15 percent average duty collection plus the 10 percent tariff-equivalent of NTBs—is not conducive to attracting investment and enhancing competitiveness. But further merchandise liberalization, although crucial, will not be sufficient to overcome current obstacles to sustained growth. We argue below

[8] Economic Research Forum for the Arab Countries, Iran, and Turkey, *Economic Trends in the MENA Region, 2000* (Cairo: Economic Research Forum for the Arab Countries, Iran, and Turkey, 2001). See http://www.erf.org.eg/html/economic_00/html/f_main.html.

[9] The high share of components in Oman's exports reflects entrepôt trading activities, not local production.

that reforms in services aiming to reduce domestic transaction costs that reflect inefficient "behind-the-border" policies are also needed. Indeed, such reforms may also be necessary to make far-reaching liberalization in trade of goods politically feasible. In other words, a comprehensive "behind-the-border" policy-reform agenda focusing on services is needed, both in its own right to help attract much-needed investment, including FDI, and to facilitate further merchandise liberalization.

The survey undertaken for this report identifies inefficient public sector services and the cost of key intermediate services, such as transport, as key factors impeding trade expansion in the MENA region. (See Appendix 2.) It also reveals the clear perception among MENA businessmen that business licensing, public sector monopolies, exclusive agency laws, requirements to employ nationals, weak systems of contract enforcement, prohibitions on foreign ownership of real estate, limitations on majority equity ownership by foreigners, and corruption and red tape all play a role in severely inhibiting investment into the region.

These results confirm the available estimates of the high costs imposed by inefficient services on trade in goods in the MENA region. For example, public monopolies in ports and port services, combined with poor infrastructure for loading and storing goods, make the costs for discharging a container two to three times higher in Alexandria than in other Mediterranean ports.[10] Port service charges in MENA can reach up to 10 percent of the value of imported intermediate components.[11] Monopoly shipping and domestic policies favoring national carriers result in low-quality, low-frequency, and high-cost services. Similar observations can be made for air transportation, telecommunications and utilities. Policies restricting trade in land transport services, such as prohibitions on drivers originating in certain countries (in effect in Saudi Arabia and other GCC nations), arbitrary changes in documentary requirements, surcharges and discriminatory taxes, and

[10] World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa* (Washington, DC: World Bank, 1995).

[11] Cassing et al, "Enhancing Egypt's Exports."

prohibitions on obtaining cargo in the country of destination to take back to the country of origin, impose severe costs on intra-MENA trade.[12] The high burden on investing in the MENA region is also revealed in a recent survey by Djankov and others.[13] In four out of five MENA countries for which data was collected, between 11 and 15 procedures were required to register a new firm. (Only Israel was similar to countries such as Australia, Canada, Finland, and the United States in requiring fewer than five such procedures.) It is no surprise that the elimination of such high costs on the vast sector of services (more than 50 percent of GDP in almost all MENA countries) will lead to large welfare benefits for MENA countries.

The importance of services

There is no magic formula to jump-start and sustain a growth process. Comparative advantage, geography, culture, values, and initial conditions will determine priorities and the set of available policies. Although reforms must be tailored to national circumstances, experience teaches that efficient services—both public and private—are a vital element of any successful strategy to attain and sustain high rates of growth. First, services are major inputs into the production of goods and services—such as finance, transport, marketing, etc. The costs of these inputs can account for a major share of the total cost of production and are thus an important determinant of the competitiveness of firms. Second, services are also important determinants of the quality and productivity of workers—examples include education, training, and health services. And third, service sector reform and development can help overcome resistance to trade liberalization from influential segments of society by assisting industry and agriculture in confronting competition from imports through reduction in input costs and

[12] Jamel Zarrouk, "Para-Tariff Measures in Arab Countries" in *Trade Policy Developments in the Middle East and North Africa,* B. Hoekman and H. Kheir el-Din, eds. (Washington, DC: World Bank, 2000).

[13] Simeon Djankov et al, "The Regulation of Energy," *NBER Working Paper* 7892 (Cambridge, MA: National Bureau of Economic Research, 2000).

productivity improvements, and by creating large-scale employment opportunities in new service activities.[14]

A large body of literature now exits to document the beneficial effects of reforms in services. But the best available evidence is still provided by the U.S. experience, for a simple reason. Such reforms are a long-term process, so one needs time to assess their full impact. They are slow to reveal their full impact because restrictions on pricing, operations, and entry (especially from new firms) have often been enforced in services for so long that it takes time for incumbents and entrants to change their behavior. During the last three decades, U.S. reforms that enhanced competition in service industries led to large reductions in the real cost of the industries concerned compared to what would have been their level in absence of reforms. Real cost fell by 25 percent in airlines, by 35 to 75 percent in trucking, by 60 percent in railroads, and by 8 percent in banking. These are very large numbers.[15]

So far, only the U.S. service markets have been subjected to reforms in a relatively consistent manner over a period long enough to allow robust conclusions. Despite concerted efforts in the 1990s to liberalize services, many EU service markets are still segmented and protected. Much of the recent improvements reflect technical progress more than the limited reforms implemented so far—although emerging available evidence suggests the same observations as in the U.S. case.[16]

Consumers are the primary beneficiaries of reforms: U.S. experience shows that real average prices have declined roughly to the same extent that costs have. And because firms in agriculture and manufacturing are large consumers of services, they will be large beneficiaries of reforms in services. In other words, reforms in services have a magnifying effect—improving first the prices and quality of the services involved and then the production conditions

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[14] Robert Stern, ed., *Services in the International Economy* (Ann Arbor, MI: University of Michigan Press, 2001). Articles in this book have a number of country-specific and regional studies.

[15] Clifford Winston, "U.S. Industry Adjustment to Economic Deregulation," *Journal of Economic Perspectives* 12, no. 3 (Summer 1998): 89–110.

[16] Patrick Messerlin, *Measuring the Costs of Protection in Europe: European Commercial Policy in the 2000's* (Washington, DC: Institute for International Economics, 2001).

of the service users (manufacturing and agricultural producers, among others). There is no good measure available of this "multiplier" effect for past reforms of services industries and markets.

However, the economic analyses undertaken for this study (see Appendix 3) provide simulations for Tunisia and Egypt that support the existence of such an effect.[17] First, they suggest that reforms in services alone would bring welfare gains—measured by increases in real incomes—that are 30 to 40 percent greater than what could be attained through the sole removal of tariffs and NTBs on imported products. Second, they suggest that combining liberalization of trade in goods (tariff and NTB removal) and reforms in services would bring higher gains than those provided by one of these policies alone for the given adjustment costs of the labor force. Indeed, the feature of being more "productive" in terms of welfare gains (less demanding in terms of labor adjustment) is a key point from a political perspective. (See section "How Large are the Potential Gains?" for details.)

These results are particularly important for MENA countries where one source of resistance to trade liberalization has often been the state's large role in the economy. Trade barriers on imported goods have been maintained in part to protect state-owned enterprises and employment in the public sector, as well as to shelter a select group of private firms from competition. In addition to protection, incumbent companies benefited from subsidized credit and preferential access to inputs (through, for example, tax and duty exemptions). The end result was a high degree of market concentration, reflecting the implied high barriers to entry. Fear of the consequences of increasing competition also helps to explain why privatization has been slow and hesitant in many MENA countries. Moves toward more market-determined exchange rate regimes and toward fiscal balance (both sound macroeconomic steps) have increased the incentives for incumbent industries to resist deep

[17] Denise Eby Konan, "Alternative Paths to Prosperity: Economic Integration Among Arab Countries," prepared for the Council on Foreign Relations Study Group on Middle East Trade Options (New York: Council on Foreign Relations, 2001).

trade liberalization and far-reaching privatization, as there are now fewer alternative instruments available to support them. Budgetary cuts have taken a toll on the bureaucracy and the military; as a result, members of the more educated elites that are employed in the public sector have been concerned that fully opening up the economy to competition will hurt their interests.[18]

Although trade liberalization benefits economies in the aggregate, some segments of society—those that have benefited from being sheltered from international competition—will have to adjust and will lose in the short run. In the case of MENA losers will be found among those employed in overstaffed state-owned industrial enterprises and government entities. By enhancing the competitiveness of services and creating an environment conducive to private investment in services through privatization and liberalization of entry, manufacturing industries are forced to improve productivity and upgrade quality because trade liberalization will be assisted by the availability of better and cheaper service inputs. Such inputs range from finance (access to and cost of credit) to certification and quality-control services, marketing, transport, and customer services. As services tend to be labor-intensive, a more dynamic service industry can also play an important role as a source of demand for labor.

Reforming services

Service sector reform involves a mix of deregulation (the dismantling of barriers to entry and promotion of competition) and re-regulation (the establishment of an improved legal environment, strengthening specialized and independent regulatory agencies). Given the limited tradability of services, FDI is an important avenue through which to acquire access to best practices and new services. Because state enterprises dominate a number of service industries in MENA, and because many activities are subject to investment restrictions (e.g., nationality requirements, limits on foreign

[18] As noted by Handoussa, the government accounts for some 17.5 percent of civilian employment, more than double the world average. Heba Handoussa, "A Scenario for the New Role of the State in MENA," Background Notes for *Economic Trends in the MENA Region, 2000*.

equity shareholding), service sector reform is closely tied to privatization and pro-competitive regulation that supports private sector entry and activity.

MENA countries have tended to approach service reform in a piecemeal fashion. Privatization has been slower than in other parts of the world; barriers to entry often remain forbidding, for both domestic (or regional) and foreign investors; and there are few independent regulatory agencies to ensure that markets are contestable. Privatization proceeds generated in the MENA region constituted only 3 percent of the worldwide total in the 1990s. Although the trend is upward—rising from some $22 million in the early 1990s to $2 billion in 1995 to more than $6 billion in the second half of the 1990s—the role of the state in industry and services remains much higher than in other regions. Recently, efforts to privatize services in countries such as Egypt have been revitalized to include joint-venture banks and public insurance companies as well as build-operate-transfer programs for electricity generation, transportation, and telecommunication. The government has indicated its intention to fully divest all state-owned firms in the industrial sector.[19] Equally important is to extend this divestiture to services, especially key "backbone" services that are of great importance for the whole economy.

Private sector participation in infrastructure is particularly low in the MENA region. Between 1984 and 1997, projects in the region added up to only $9 billion, compared to a worldwide total of $650 billion, for a share of just 1.4 percent.[20] In a major global survey of obstacles to business, MENA-based firms indicated that inadequate infrastructure was a top constraint.[21] MENA economists

[19] Economic Research Forum for the Arab Countries, Iran, and Turkey, *Economic Trends in the MENA Region, 2000*.

[20] Examples of recent initiatives in the MENA region include water supply and wastewater treatment (Oman), power (Egypt, Morocco, Tunisia, and several GCC countries), transport (a port terminal in Yemen and a container terminal in Oman; toll roads in Jordan, Lebanon, Morocco and Tunisia; port services in Morocco and Tunisia), and telecommunications (the GCC countries, Jordan, Lebanon, and Morocco). Ibid.

[21] A. Brunetti, G. Kisunko, and B. Weber, "How Business Sees Government," IFC Discussion Paper 33 (Washington, DC: International Finance Corp., 1998).

have argued in a recent report on the region's economy that, given the inefficient operation and management of state-owned and controlled utilities, there is an urgent need to rethink the transaction-by-transaction approach with an emphasis on sale to strategic investors, as well as to move to a sector-wide approach that includes a combination of competition, incentive regulation, and private ownership.[22] Relying on individual transactions to divest state-owned enterprises invariably takes a substantial amount of time and may not lead to an effective increase in competition.

One result of the dominance of the public sector has been to inhibit the emergence of a vibrant private sector that provides competitively priced, high-quality services to firms and consumers. Consequently, the region suffers higher production costs and is less attractive to private investment. Although there is a large informal private sector that generates significant employment, its growth has been constrained by limited access to credit, distribution channels, and infrastructure services. A political precondition for public sector downsizing is that the public believes that alternative employment opportunities will be created. The small-scale private sector must play a major role in this process, in turn requiring policies that support its own expansion. Integration into the formal economy will require a number of measures, including not only deregulation and privatization but also the development of effective pro-competitive regulation. Given the high degree of market concentration in many MENA markets, privatization may improve enterprise performance and profitability without reducing prices or access to markets. Only Algeria, Kuwait, Tunisia, and Turkey have laws regulating competition (although efforts to adopt such legislation have been ongoing in Egypt, Jordan, and Morocco). Even where such laws exist, they contain certain provisions (often drawn from the laws existing in Europe during the 1960s) that can be used in a non-competitive way—based, for example, on a

[22] Economic Research Forum for the Arab Countries, Iran, and Turkey, *Economic Trends in the MENA Region, 2000*.

naive concept of price transparency that tends to align all prices with the highest.[23]

Political economy benefits of a services reform agenda

Focusing on reforms of the service sector can facilitate overall trade liberalization by dramatically shifting the balance of forces between domestic interests. When liberalization is limited to goods, domestic industries that benefit from protection are likely to contract, whereas industries in which the country has a comparative advantage will expand. Many of the latter are likely to be initially small and dispersed, whereas the former are likely to be concentrated and have substantial political voice. Moreover, often it will not be known beforehand which sectors and activities will become growth areas—hence an additional lag between those that will lose and those that will gain from liberalization. This uncertainty makes the early transition process politically difficult. This is particularly true if industries continue to face high trade barriers in export markets—as is the case, for example, for the export of food and textile products by MENA countries.

Such political constraints to trade liberalization may be relaxed by reforms targeting the service sector. Pro-competitive reforms that facilitate the entry of new firms can generate large employment opportunities for skilled and unskilled workers who currently are employed by government or import-competing private manufacturing, or who are unemployed. Because services often cannot be traded, increasing access to domestic service markets is likely to require the entry of foreign competitors through FDI. This will not only lead to the introduction of new technologies, but also (and in sharp contrast to what happens with merchandise liberalization) entail the hiring of domestic labor. Foreign telecommunications or electricity operators, foreign banks or retailers, all need local labor. Thus, although the deregulation of entry inevitably will result in the restructuring of domestic industry, services reform has less far-reaching implications for sectoral turnover and aggregate

[23] Between 1991 and 1997, the Tunisian competition body issued only three decisions, of which only one condemned a business practice. See Lahouel for details on the inadequacy of existing statutes and enforcement agencies. M. Lahoul, "Competition Laws in MENA," (University of Tunis III, Tunis, 2000, mimeographed).

employment than the abolition of trade barriers for merchandise. This difference is confirmed by the economic analyses undertaken for this study (Appendix 3), which show that reforms in services are less demanding in terms of labor adjustment than merchandise liberalization (see section "How large are the Potential Gains?" for details), as well as by the recent experience in regions such as eastern Europe, where privatization, trade liberalization, and service sector reform generated a large increase in service sector employment.

As important as the employment dimension, an expanding and more efficient service sector that supplies an increased set of differentiated and customized products to consumers can enhance general industrial competitiveness, which in turn should facilitate merchandise trade liberalization.[24] Many services are important determinants of competitiveness. What follows focuses briefly on three key services: finance, education and government administration.

Resource Mobilization and Financial Services

The financial system must efficiently mediate between savers and investors in order to mobilize resources for investment and allocate them where the return is highest. This mediation requires an environment that forces borrowers to compete for savings, lenders to confront the risk of default, and a regulatory regime that addresses problems of asymmetric information and moral hazard. Financial intermediation in many MENA countries is relatively inefficient. Between 1983 and 1993, the average additional output per unit of new investment was 10 percent for the MENA countries, compared to 15 percent for high-income economies and 20 percent for East Asian countries.[25]

Many countries have begun to allow market forces to play a greater role in the allocation of resources through the liberalization of interest rates. However, as emphasized by the Economic Research Forum

[24] Bernard Hoekman and Simeon Djankov, "Effective Protection and Investment Incentives in Egypt and Jordan: Implications of Free Trade with Europe," *World Development*, vol. 23 (1997), pp. 281–291.

[25] World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa* (Washington, DC: World Bank, 1999).

for the Arab Countries, Iran, and Turkey, the role of the state in the financial sector remains prominent. State-owned banks still control a large share of total assets,[26] many of which are nonperforming (between 20 and 40 percent in Egypt; some 50 percent in Algeria).[27] Regulatory supervision is frequently poor. State banks in many countries tend to be effectively exempted from compliance with prudential rules because of weak balance sheets, which in turn are a reflection of non-market-determined lending decisions (directed credit). A particular hindrance for smaller enterprises are high collateral requirements, which often impede access to credit.

A robust capital market is a core element of an efficient financial system. Capital markets remain underdeveloped in the region. (See Appendix 1, Table 6.) The region's stock exchange capitalization (as a percentage of GDP) is some 10 percentage points below the level of upper-middle income countries. Relatively few firms are listed on the exchanges in many countries; in others, many of the firms quoted are not actively traded. Thus, of the more than 1,000 firms listed on the Cairo and Alexandria Stock Exchanges, eight hundred are not traded.[28] This contrasts with the rapidly growing stock market capitalization in central Europe, and in particular to the rapid increase in the number of central European domestic firms listed on the stock exchanges.[29] One reason for the relatively slow development of capital markets is the heavy reliance on sales of state-owned firms to strategic investors (private placement) rather then through initial public offerings. Restrictions on foreign participation also play a role in some cases—most

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[26] The four Egyptian state-owned banks control 70 percent of commercial bank assets and 60 percent of commercial bank deposits. In Tunisia, they control 50 percent of total bank assets.

[27] Economic Research Forum for the Arab Countries, Iran, and Turkey, *Economic Trends in the MENA Region, 2000*.

[28] Oxford Analytica, "North Africa: Stock Markets," OADB, June 21, 2001:5.

[29] Of course, substantial differences exist among MENA countries. Tunisia and Jordan are among the top countries in the developing world in terms of new issuance of equity, generating on average slightly more than 3 percent of GDP between 1980 and 1995. A. Aylward and J. Glen, "Primary Securities Markets: Cross Country Findings," IFC Discussion Paper 39 (Washington, DC: International Finance Corporation, 2000).

prominently in Saudi Arabia, one of the larger economies in the region. Generally speaking, foreign participation remains limited, even in markets without restrictions.

Education

Education services are as important as finance as an input into production. Investment in education is a critical determinant of the longer-term ability of an economy to raise per capita incomes. Without an educational system that produces workers with skills demanded by industry, the productivity of the economy will lag. Extensive research has demonstrated the very strong positive association between educational attainment, investment, and the growth performance of countries. Although education has improved in the MENA region, it still lags behind the rest of the world. The average secondary school enrollment rate is roughly 65 percent across the region, compared to 70–75 percent for middle-income developing countries, and 96 percent for high-income countries. Likewise, the average illiteracy rate remains disproportionately high (close to 40 percent). Jordan, with one of the best-educated labor forces in the MENA region and the only one to be included in a 1995 global survey of educational attainment, scored last in a mathematics and science test of high school students—far behind countries such as Hungary, Taiwan, or Korea. Significantly, Jordanian scores were low with regard to non-routine problems—precisely those that confront workers in a knowledge-based economy.[30] Other indicators of the weakness of educational systems include the low proportion of scientists and engineers in MENA countries, and the low number of patents granted per resident (a crude measure of the output of domestic scientists and engineers). (See Appendix 1, Table 3.)

MENA economies also suffer from a discrepancy between the supply generated by the education system and the demands of the labor market. Traditionally, a large share of secondary

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[30] Fredrick L. Golladay et al, "Human Capital Strategy for Competing in World Markets," in Shafik Namat, ed., *Prospects for Middle Eastern and North African Economies: From Boom to Bust and Back?* (London: MacMillan Press, 1998), pp. 197–225.

school graduates have been absorbed by public enterprises and the government bureaucracy, generating rigidities in the labor market. Since the early 1990s, however, budgetary constraints have made this government hiring increasingly difficult to sustain. As a result, many young people leaving secondary schools have been unable to find jobs; today, they account for a significant portion of the unemployed and often do not have the skills needed for employment in industry. Encouraging a greater role for the private sector in the supply of education services can help improve the match between private sector and educational supply.

Government

Inefficient and burdensome government regulation is invariably mentioned by enterprises as a major factor constraining private sector activity. The administration of policy ranks very high as a source of uncertainty and inefficiency. As noted earlier, the levels of customs duties and domestic taxes were identified as the two most important sources of trading costs in the survey undertaken for this report. Customs clearance "red tape" and related "facilitation payments" followed in the rankings. Reducing red tape—not just in trade-related transactions but more generally—and taking measures to support private sector activity (as opposed to restricting it) are important elements in the creation of an enabling environment for business. Government administrative entities should be providers of public services, not just instruments of "command and control."[31]

The broader challenge for MENA countries is to transform the state from a major economic actor to a provider of services that create an attractive investment climate. This transformation process should include efforts to address the problem of corruption, which according to the survey is an important barrier to investment, and actions to reduce inefficiencies in tax administration and

[31] Ahmed Galal, "The Welfare Impact of Telecom Reform in Egypt: An Ex Ante Analysis," in S. Fawzy and A. Galal, eds., *Partners for Development: New Roles for Government and the Private Sector in the Middle East and North Africa* (Washington, DC: World Bank, 1999).

improve the legal, regulatory, and judicial systems.[32] Since growth derives largely from the most dynamic segments of a population, regulation—especially the tax regime—should favor the emergence and development of new skills and economic activities, rather than constitute an insurance regime for incumbent skills and industries. Greater innovation and risk-taking are facilitated by predictable, transparent, simple, and stable rules of the game.

A unique feature of many countries in the MENA region is the relatively equal distribution of income. The social equilibrium that has been established in many countries entails an implicit trade-off: lower growth in return for large-scale but low-paying government employment for a relatively large segment of the population. Although this model was effective for a time, it has now become part of the problem. Reducing the size of the public sector is an unavoidable and necessary corollary of a pro-growth, comprehensive reform agenda.[33] This is obviously politically sensitive. Strengthening public policies and services to support workers who are negatively affected by the transition to a more competitive and open economy will facilitate adjustment.

How Large Are the Potential Gains?

Two key policy questions arise with respect to the implementation of the reforms advocated above. One concerns sequencing: Should domestic "behind-the-border" reforms be implemented first, or should the services-oriented reform strategy be implemented in conjunction with further trade liberalization (removal of tariffs and NTBs)? The other is how to pursue the reforms. Broadly speaking, there are three potential approaches: unilateral action taken by each MENA nation individually; concerted action through regional cooperation (regional integration); and a

[32] Although the region as a whole does not fare too poorly on the Transparency International Corruption Index, some countries are reported to have significant problems. Egypt is ranked 64th out of 90 countries. Israel, ranked 23rd, has the best record in the region. A. Brunetti, G. Kisunko, and B. Weder, "How Business Sees Government," IFC Discussion Paper 33 (Washington, DC: International Finance Corporation, 1998).

[33] Shafik Nemat, ed., *Prospects for Middle Eastern and North African Economies; From boom to bust and back?*

multilateral approach, where reforms are anchored in the WTO. This second topic is the subject of the next section of this report.

On sequencing, the various elements of the "behind-the-border" services-oriented agenda sketched out above are closely intertwined. Transforming the service sector requires considerable investment. Mobilizing the required resources is facilitated by reforms in the financial sector to attract capital and mobilize resources and give new entrants easier access to credit. Maximizing long-term human potential and facilitating the short-run reallocation of labor out of inefficient industries and government agencies also require finance. Privatization receipts provide a source of revenue. Reforming the educational sector is vital in creating the long term basis for sustainable growth and generating opportunities for all in society to participate in the economy. These goals can be faciitated by education and training. Making fundamental changes in public service delivery, increasing the efficiency and fairness of revenue collection, pursuing pro-competitive regulatory reforms, and strengthening mechanisms to protect property rights and enforce contracts are all necessary elements of an improved investment climate. All these observations suggest that service sector reform should be comprehensive and include the major "backbone" service industries: finance, education, transport (road, air, and maritime), as well as telecommunications, energy, and other utilities. The choice of these services as the most urgent ones to liberalize echoes the choices made by the United States, the EU and its member-states, other Organization for Economic Cooperation and Development (OECD) countries, and the most advanced developing countries.

Given that services reform and expansion can help to reduce the political and social costs of further trade liberalization, both agendas should be pursued *in tandem*. Opening the economy to the outside world will allow the "behind-the-border" agenda to be pursued at lower cost by attracting FDI in infrastructure and services, and this openness will make available new, modern technologies and cheaper foreign goods and services that can boost the skills and productivity of MENA citizens. In short, *the "behind-the-border" agenda and trade liberalization are mutually reinforcing*.

Economic analyses undertaken for this study of two countries in the region that have relatively large public sectors and restrictive trade policies—Egypt and Tunisia—suggest that the potential returns of a comprehensive reform strategy that targets both trade and "behind-the-border" services policies are large. (See Appendix 3.) The analysis is based on economy-wide models that take into account prevailing barriers to trade and investment as reflected in the structure of tariffs and identified in the survey. They allow an explicit assessment of the gains from further trade liberalization relative to those from other reforming regulatory regimes that raise the cost of services and impose red tape costs.[34] Although the numbers differ for the two countries, the qualitative results are remarkably similar. (See Appendix 1, Table 7.)

The first, and most significant, conclusion is that overall welfare gains from combining merchandise liberalization and reforms in services—measured by increases in real incomes—would be on the order of 13 and 10 percent of GDP in Tunisia and Egypt, respectively. These are very significant numbers, especially in relation to current anemic growth rates.

Second, as already underlined, service reforms give rise to gains larger than what would be generated by merchandise liberalization alone (including NTB removal)—by 30 to 40 percent. The reasons why deeper reforms that improve the efficiency of the service sector would enhance welfare significantly are not difficult to grasp. Reforming the service sector affects the economy as a whole, not just the external sector; it entails removing high barriers to both domestic and foreign entry; and it eliminates policies that create social waste (needless transactions costs). This comprehensive effect differs from trade liberalization, which gives rise to efficiency gains only, and is accompanied by significant redistribution of income. Of course, this assertion does not mean that merchandise trade liberalization can be left aside. Once again, gains are highest if *both policy agendas are pursued*. Not liberalizing trade can hamper efforts at domestic reform. Price signals from the world market are critical in ensuring that investments are allocated efficiently,

[34] For a description of the model, see Appendix 3 or Denise Eby Konan, "Alternative Paths to Prosperity: Economic Integration Among Arab Countries," prepared for the Council on Foreign Relations Study Group on Middle East Trade Options (New York: Council on Foreign Relations, 2001).

inputs are sourced from the least costly suppliers, and firms have access to the latest technologies. An open trade and investment policy is key to a successful "behind the border" reform agenda. The simulations show that a scenario whereby governments eliminated domestic distortions first and only then turned to border distortions (trade barriers) would be counterproductive. Not only would it reduce real income gains but it would also exacerbate adjustment costs. (Domestically freed markets would induce firms to reallocate labor and capital to the sectors that would remain the most protected from import competition, not to the sectors with comparative advantages.)

Lastly, the simulations send a strong political message. They indicate that liberalization of trade in goods will generate relatively large shocks to the domestic economy. In the Tunisian case, a merchandise-based liberalization strategy would result in an additional 5 to 8 percent of the workforce moving to the industrial sector.[35] In contrast, trade liberalization that is accompanied by action on the "behind-the-border" agenda would generate work-force shifts on the order of 3 to 4 percent. In other words, one percentage point of adjustment cost in Tunisia can "deliver" 3 percentage points of welfare increase in the case of combined merchandise liberalization and service reforms, whereas, in the case of merchandise liberalization alone (even when based on tariff and NTB removal), it can "deliver" only 1.4 percentage point of welfare increase. The Egyptian case reflects a similar and even stronger conclusion, with one percentage point of labor adjustment associated with 3 percentage points of welfare increase in the case of combined merchandise liberalization and service reforms, and with only half a percentage point in the case of merchandise liberalization based on tariff and NTB removal. (See Appendix 1, Table 6.) Limiting reforms to trade liberalization in goods obliges the work force to undergo needless "churning" from one sector to the other. (During the initial stage, domestic resources would flow to the most protected industrial and service sectors, whereas subsequent actions would generate shifts of productive factors in the opposite direction.)

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[35] Depending on whether NTBs are removed.

Using Trade Agreements to Promote Reform

Experience has demonstrated that comprehensive unilateral reform is difficult to engineer for many MENA countries. Although much has been done in the last decade, the rate of progress has been too slow to generate and sustain high rates of growth. Actions taken in concert with other countries in the region have the potential to facilitate and sustain the implementation of reforms. Key questions concern the design of regional agreements and to what extent reforms should be multilateralized—that is, applied on a nondiscriminatory basis. The latter question is relevant to both WTO members and nonmembers, although only WTO members can use that institution as a vehicle to promote and facilitate reforms.

Traditional ("shallow") integration has had limited payoffs

MENA governments have a long history of negotiating regional trade agreements. These range from bilateral agreements that reduce tariffs for a limited number of goods, to comprehensive free trade agreements and ambitious integration programs aiming at the creation of an Arab Common Market. Most of the arrangements negotiated between MENA countries have not been effective in integrating the economies of the region.[36] Barriers to trade in goods remain pervasive, as do restrictions on trade in services and investment.

Fundamental economic reasons help explain why integration efforts have not been successful. Among the MENA countries that have substantial exports to the region, only Syria and Egypt account for a significant share of intra-MENA trade. Other large

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[36] Examples of MENA regionalism include the 1953 treaty to organize transit trade among the states of the Arab League; the 1964 Agreement establishing an Arab Common Market among Egypt, Iraq, Jordan, and Syria; the 1981 Agreement for Facilitation and Promotion of Intra-Arab Trade, signed by eighteen member states of the Arab League, the Gulf Cooperation Council (GCC) established in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; the short-lived Arab Cooperation Council between Egypt, Iraq, Jordan, and Yemen; and the Maghreb Arab Union established by Algeria, Libya, Mauritania, Morocco, and Tunisia. See Jamel Zarrouk, "The Greater Arab Free Trade Area: Limits and Possibilities," in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*.

MENA countries have only limited exports to the region. Smaller countries such as Lebanon, Jordan, and Bahrain, which do export to the region, represent only a small portion of regional trade, implying that their potential influence on the process of regional integration is small.[37] This observation suggests there is limited effective support for traditional regional trade agreements—most large countries do not have a significant economic incentive to support regional integration whereas smaller countries that do have the incentive do not have the influence to ensure implementation.

Trade policy is fundamentally a *domestic* policy—that is, a set of bargains between conflicting domestic interests. Some domestic groups gain from protection, others lose. For regional integration to succeed, there must be a sufficiently large domestic coalition that favors it over all alternatives—which include preferential trade agreements with large industrial countries and engagement in multilateral cooperation (the WTO).[38] A crude indicator of the strength of domestic political support for intra-MENA regional integration is the share of trade with the MENA region in domestic GDP. With the exception of Syria, for all the major economies in the region this share is 3 percent or less. The figures for trade with the European Union (EU) tend to be much higher for Mediterranean nations, helping to explain why the two regional industrial powerhouses, Israel and Turkey, have had deep trade agreements with the EU for some time, and why Egypt has now concluded a trade agreement with the EU.[39]

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[37] This situation is quite different from that prevailing in the EC in the mid-1950s. At that time, more than 25 percent of total exports of all the EC member states went to the rest of the community, and all of them together represented more than 18 percent of intra-EC trade. Therefore, all prospective members had both high stakes and influence in the EC creation process. Germany, the largest EC-founding country, sent almost 30 percent of its total exports to the rest of the EC and represented almost 33 percent of total intra-EC trade.

[38] Ahmed Galal, "Incentives for Economic Integration in the Middle East," in *Trade Policy Developments in the Middle East and North Africa*, B. Hoekman and H. Kheir el-Din, eds. (Washington, DC: World Bank, 2000).

[39] Ahmed Galal and Robert Lawrence, eds., *Building Bridges: An Egypt–U.S. Free Trade Agreement* (Washington, DC: Brookings Institution, 1998).

The reason why intra-MENA integration has limited potential to boost trade is well known—many countries in the region have very similar production structures. Indeed, some have argued that in light of these similarities, intra-regional trade flows are not lower than what would be expected given levels of GDP, population and geography. Yeats and Ng conclude that Egypt exports about six times more to the region than what would be expected based on economic fundamentals, and that the intensity of trade with the region is even higher for Jordan and Lebanon.[40] Statistical analyses of bilateral trade volumes undertaken for this report suggest the same conclusion.[41]

Efforts to expand trade further through preferential trade agreements can easily reduce MENA welfare by giving rise to costly trade diversion—that is, instead of buying goods from the least-costly global supplier, purchasers buy from higher-cost, less efficient regional suppliers. The economic analysis for Tunisia and Egypt suggests that the payoffs to intra-MENA integration that are restricted to trade in goods would be very limited and might even prove to be negative for Egypt. There is ample historical data to demonstrate the limited economic return to regional agreements between developing countries.[42]

This is not to deny there are potential gains associated with eliminating barriers to intra-regional trade. The survey undertaken

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[40] Alexander Yeats and Francis Ng, "Beyond the Year 2000: Implications of the Middle East's Recent Trade Performance," in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*.

[41] Chang, also using a so-called "gravity model" approach that estimates what the volume of trade "should be" given economic fundamentals, finds that trade between Algeria, Morocco, Tunisia, Turkey, Saudi Arabia, Egypt, Jordan, Syria, and Sudan (the only countries for which bilateral trade data was available for the last twenty years) was less than predicted in the early 1980s, but that this pattern reversed after 1990, with intra-MENA exports and imports becoming larger than predicted by the model. Research by al-Atrash and Yousef concludes that although intra-regional trade in the Maghreb and among the GCC is less than predicted, this is not true for the Mashreq countries. Won Chang, "A Gravity Model-Based Assessment of Intra-MENA Trade," mimeographed. Hassan al-Atrash and Tarik Yousef, "Intra-Arab Trade: Is it Too Little?" IMF Working Paper 00/10 (Washington, DC: International Monetary Fund, January 2000).

[42] World Bank, *Trade Blocs*, A Policy Research Report (Washington, DC: World Bank, 2000).

for this study documents clearly that such barriers are pervasive, especially with respect to trade with the West Bank and Gaza (for obvious reasons), Syria, Egypt, Tunisia, and Saudi Arabia (see Appendix 2, Table 7). But reducing barriers best pursued in a broader context that includes "behind-the-border" policies affecting investment and the operation of service sectors. That is, through a move from "shallow" integration that is limited to liberalization of trade in goods to "deeper" integration that also addresses domestic policy constraints.[43]

Concerted international action may make it easier to achieve the gains from reform by helping to overcome political resistance to broader-based trade liberalization. It can do so in a variety of ways. One is through the principle of reciprocity. Obtaining commitments from trading partners to pursue reforms can improve access to export markets and increase political support for reform by mobilizing export interests. This has been a powerful instrument for the liberalization of trade in goods. Although it is less powerful when it comes to services, which are less tradable and where export interests are less prevalent, it can play a beneficial role—think, for example, of the potential to export construction services and service markets through FDI. Another way concerted action can facilitate the realization of reform is if it leverages greater financial or technical assistance. Agreements may be associated with offers of aid to assist countries in improving policies and strengthening institutions. Yet another mechanism is the creation of a focal point for reform—to ensure high-level attention and engagement by civil society on a comprehensive agenda—and a mechanism to "lock into" a reform path. All three of these potential dimensions are linked—for example, reciprocity and aid can increase the incentive to lock in reforms.

There are three options: deepening intra-regional cooperation efforts to include domestic regulatory regimes that affect investment and competition in service markets; pursuing agreements with

[43] Robert Lawrence, "Preferential Trading Arrangements: The Traditional and the New," in A. Galal and B. Hoekman, eds., *Regional Partners in Global Markets: Limits and Possibilities of the Euro-Med Agreements* (London: Centre for Economic Policy Research, 1997).

major economic powerhouses such as the EU and United States, and active engagement in the WTO. No approach excludes the pursuit of the others, although a strong case can be made that the latter two options dominate the first, and that active participation in the WTO can help expand the gains from reform.

Deepening intra-MENA regional integration
The dominant intra-MENA forum for regional cooperation on economic matters is the Arab League, in particular the Greater Arab Free Trade Area. GAFTA was launched by the member states of the Arab League on January 1, 1998, and constitutes a renewed attempt at MENA regional integration. The agreement aims to revive a 1981 Agreement for Facilitation and Promotion of Trade among Arab League members. In contrast to previous attempts at Arab integration, GAFTA embodies specific commitments requiring across-the-board elimination of tariffs, tariff-like charges, and non-tariff measures. Import duties and other barriers to trade in goods of Arab origin are to be eliminated over a ten-year period ending in 2008. GAFTA is a traditional preferential trade agreement, limited to merchandise trade. The exclusion of services and investment greatly reduces the scope for the agreement to have significant positive economic impact.

Indeed, the simulations done for the report suggest that the net effect of GAFTA implementation for Egypt and Tunisia will be twofold. First, GAFTA implementation will add little to the changes to be expected from a tariff elimination agreement with the European Union. Of course, competition between MENA firms offering the same type of products will be intensified by GAFTA—inducing firms in different parts of MENA to shed costs and raise quality in order to better face competitive pressures from other MENA firms. However, benefits from such forces may be limited because GAFTA markets are small and often dominated by firms skillful in establishing collusive practices—hence the need for strong competitive pressures from the rest of the world. Second, GAFTA implementation will become more significant only if GAFTA is extended to services and investment (see Appendix 1, Table 7). These two results suggest that intra-regional agreements are unlikely to be a sufficiently powerful driving force to open MENA economies, although, as argued below, they are a useful extension of the other alternative options available for a liberalization strategy.

Agreements with major industrial economies
One such alternative is to conclude agreements with major economies located outside the region. The primary examples to date are the so-called Euro-Mediterranean partnership agreements between the EU and Morocco, Tunisia, Egypt, Israel, Jordan, and the West Bank and Gaza. These agreements have numerous provisions dealing with economic cooperation, but binding discipline on liberalization of trade is limited to trade in manufactures. Chapters dealing with trade in services and investment policies are very general and call for these topics to be addressed in future efforts to expand the coverage of the agreements. Trade in agriculture remains restricted. Lebanon is actively negotiating with the EU to conclude an agreement, and discussions have also been initiated with Syria. The intention of the EU is that similar agreements will be concluded with the GCC once it has implemented a common external tariff.[44] Two countries in the region—Israel and Jordan—also have free trade agreements with the United States.

Agreements with large industrialized trading partners that are dominant players in the global economy can have much larger benefits than intra-MENA integration. In part this is because they can expand export opportunities—the partner country markets account for a significant share of the global market. Such agreements are also more likely to be perceived as credible by investors and entrepreneurs.

The simulations undertaken by Konan (see Appendix 3) for this report indicate that the main payoff to such initiatives comes when they are used to remove NTBs that affect trade in goods and are extended to include services liberalization. (See Appendix 1, Table 7.) The abolition of NTBs is the major source of gain as far as merchandise trade liberalization is concerned, because there are

[44] Turkey has a more far-reaching customs union agreement with the EU and is seeking to accede to the European Union.

fewer trade diversion effects. The removal of trade-related red tape costs—trade facilitation, customs streamlining, more efficient certification mechanisms for product standards—is assumed to benefit all trade, not just the trade with the EU or GAFTA members. As mentioned previously, there are large potential gains associated with a complementary liberalization of trade in goods and services reforms. The results of the simulation analysis indicate that most of the gains from services reforms result from removal of barriers to entry (establishment) and operation in MENA markets.

Agreements with the EU or the United States could offer substantial opportunities to commit to the pursuit of reforms in the services area broadly defined. Existing Euro-Mediterranean agreements already allow for the incorporation of a service-reform agenda. However, none of the Mediterranean partner countries have followed such an agenda. It is a common misconception that these are deep integration agreements that include services. Commitments made by the signatories to these agreements do not go much, if at all, beyond those commitments that countries have made in the WTO. The agreements call for discussions on services in the future and make numerous provisions for dialogue and cooperation on regulatory issues, but they make little in the way of reform commitments. A similar observation applied to the trade agreements between Israel and Jordan and the United States.[45]

There is huge scope, therefore, to use trade agreements as focal points and mechanisms to reform services. To the greatest extent possible, reforms implemented in the context of such agreements should be applied on a nondiscriminatory basis. In practice this will often be the case: in the application of prudential supervision or development of the financial sector and implementation of pro-competitive regulation, it makes little sense to apply different rules to partner countries as opposed to other nations.

[45] The Jordan–U.S. free trade agreement does go a bit further than the WTO in liberalizing access to service markets, through accelerated removal of barriers already slated for removal in Jordan's WTO commitments and by raising maximum foreign equity participation in some sectors from 50 percent to 60 percent.

However, this can occur in the area of investment liberalization, where countries may grant access to partner countries only. Such preferential treatment can give rise to serious costs for the economy if it results in less efficient firms entering the market. The costs of such diversion can be avoided through the nondiscriminatory application of legislation and regulatory instruments.

It is also important that attention center on non-service policies, in particular improving access to EU agricultural markets, lowering the costs of satisfying rules of origin, and reducing uncertainty regarding the market access conditions that will apply in the EU market. The fact that agricultural trade remains restricted in the EU partnership agreements significantly lowers the benefits of these agreements for MENA countries, implying much lower political support for implementation than would otherwise be the case. Maintaining the threat of safeguard actions and antidumping reduces the value of duty-free access commitments. Action in these areas by the EU (and the United States) would help mobilize greater support for reform in partner countries.

Leveraging regional integration

As a matter of fact, MENA countries have entered (or are close to entering) into deeper integration agreements with large trading partners *outside* the region. Extending these commitments to GAFTA partners would make sense because GAFTA can reduce the potential costs from such agreements (the two first points below) and increase their expected benefits (the two last points below).

- *Extending the agreements on an intra-MENA basis would make it more difficult for MENA countries to seek to compensate the loss of trade-related fiscal revenue resulting from liberalization with large trading partners by erecting heightened barriers against imports from regional partners.* Such forms of "compensation" can be very costly, as has been observed among central European countries that have signed preferential agreements with the EU.
- *Extending preferential agreements to the MENA region will attenuate so-called "hub-and-spoke" effects and lower implementation costs.* Bilateral agreements with the EU and United States that are not complemented by analogous agreements with

MENA partners can create incentives for investors seeking to sell to MENA countries to settle in the EU. An important rationale for the GAFTA is to reduce such incentives detrimental to MENA countries.[46]

- *Intra-MENA integration can increase competition between MENA firms.* As argued above, competition between MENA firms could be a sufficiently powerful force only if exposed to the pressure of competition from the rest of the world. The long tradition of "cozy" markets is so prevalent in almost all the MENA countries that its progressive reduction requires an external constraint. However, there are goods and services produced and consumed mostly in MENA countries. In these cases, intra-MENA integration will be (at least initially) the only source of competition capable of leading to price decreases and/or to increased product differentiation (MENA firms specializing in different variants of the goods or services).

- *Intra-MENA integration can foster regional cooperation in the regulatory arena.* In this respect, one of the more interesting possibilities in the long run would be to establish regional regulatory agencies to oversee network services (telecommunications, electricity, railways, etc., which are all part of the "backbone" activities suggested as priorities for reforms, see above) and to "de-balkanize" existing MENA markets for such services. Such regional agencies could facilitate cooperation between MENA countries that are investing in and managing the physical networks through the issuance of region-wide licenses for a market that would be large enough to attract global players. Introducing more competition could also require the establishment and strengthening of competition authorities. Such institutions would benefit from concerted action at the regional level to ensure,

[46] At the July 2001 meeting of Arab ministers of economy and trade, Egypt, Jordan, Morocco, and Tunisia—all signatories of Euro-Med agreements with the EU—announced their intention to establish a Mediterranean Arab Free Trade Area (MAFTA) among themselves. See Rana Awad, "MAFTA Launch Expected Next Year," *Jordan Times,* July 18, 2001, http://www.MiddleEastWire.com.

for example, that privatization did not lead to the creation of private collusive arrangements within the region.

Last but not least, deeper regional economic integration could have important political spillover effects. In particular, it could create a greater regional stake in—and therefore greater incentives for—a resolution of the Israeli-Arab conflict.

Using the WTO to full advantage

Reforms can and should also be pursued through the WTO. The WTO allows concessions to be obtained from a wider number of trading partners, expanding the potential gains. Reforms negotiated on a regional basis can (gradually) be extended on a most-favored-nation basis through the WTO in return for a quid pro quo. Given that negotiations at the WTO focus on the depth of policy "bindings," participating in the WTO process is valuable even if, as recommended above, policy reforms that are pursued in the context of regional agreements are applied on a nondiscriminatory basis. The value goes above and beyond the quid pro quo that might be realized in terms of better access to global markets. Anchoring domestic liberalization in the WTO can also help MENA countries make reform both more attractive (as welfare gains in other countries will boost domestic welfare) and more resistant to backsliding (foreign forces will oppose domestic efforts to reimpose trade barriers). More generally, a WTO-based strategy offers guarantees against discrimination—both among foreign producers (through the most-favored-nation principle) and between foreign and domestic suppliers (which is addressed by the national treatment principle). In sum, the WTO is a key anchor for domestic reforms.

When the Uruguay Round was signed in Marrakech in 1994, only Bahrain, Egypt, Israel, Kuwait, Morocco, Tunisia, and Turkey participated. In November 2001, when WTO members met for their fourth ministerial conference, the meeting was held in Doha, Qatar. The host country was one of four Arab countries that joined the institution after 1994—the others are Jordan, Oman, and the United Arab Emirates. Algeria, Lebanon, and Saudi

Arabia are in the process of accession. Progress has therefore been made by MENA countries to increase the regional presence in the WTO and to raise the domestic profile of the WTO. However, the same conclusion that applies to the efficacy of regional agreements also applies to MENA participation in the WTO: the opportunities that the institution offers to support domestic service-oriented reforms have yet to be exploited seriously.

The negotiations and the work program that was launched in Doha is a broad one. Negotiations will center on market access for goods (manufactures and agriculture) *and* services, as well as on WTO rules in various trade-related areas. The negotiations offer a good opportunity for—indeed require—MENA countries that are WTO members or in the process of accession to identify their interests and determine both what they will request from trading partners and what they are willing to offer in return. The latter should ideally comprise policy measures and reforms that are beneficial in their own right and that governments recognize are desirable. Identifying what these are must involve a process of analysis, consultations, and deliberation. Given the short timetable that is envisaged for the negotiations—three years—there is great urgency in pursuing such a process.

Although active participation in and use of the WTO is important, an exclusively WTO-centered approach would face numerous challenges. First, many MENA countries have yet to become WTO members. In addition to the three nations that are negotiating accession, countries that remain outside the WTO include Libya, Iraq, Syria, and Iran. Although the membership process itself can be a useful vehicle for domestic liberalization, accession can take a long time.[47] As a result, urgently needed reforms risk delay. Second, WTO negotiations on services have not progressed very far to date, and general disciplines on investment and competition policies do not exist. Many of the regulatory reform

[47] It took Tunisia some thirty years to join, beginning with provisional accession in 1959, an application for full accession in 1980, and final approval of the Accession Protocol and entry into force in 1990. Saudi Arabia has been negotiating since 1993.

priorities identified by this report as essential remain outside the ambit of the WTO.

Summing Up: Major Conclusions

The conclusions and recommendations of this report strongly support recent analyses undertaken by the leading think tanks and economists in the MENA region. To quote a recent study:[48]

Too many MENA governments still perceive their role as employers and producers of public goods. In contrast, [what is needed is] a deliberately selective approach to intervention by the state to provide an optimal institutional environment that:

- Maximizes the flow of knowledge to all market players (market information, technology, quality education and training) by establishing a modern information infrastructure to connect market actors with knowledge networks.
- Transforms the bureaucracy from a passive or obstructive player in the economy to an active agent of development....via the creation of an elite technocracy that is recruited on a merit basis and operates in a transparent environment with clear objectives, rewards and penalties; based on an effective system of monitoring and performance evaluation.
- Targets a strategy of rapid insertion into the global market and opts for openness and flexibility of political and economic institutions in order to realize the potential productivity gains of the second economic revolution.

This report offers a road map that can be used to move in the direction called for by the MENA economists and entrepreneurs interviewed in the survey. It does not address all priorities, but focuses on what enterprises and potential investors generally regard to be the key issues that prevent the region from harnessing trade and global integration for development and growth. Based on a survey and on economic simulations, the report suggests that decision-makers should focus their attention on a reform agenda that

[48] Economic Research Forum for the Arab Countries, Iran, and Turkey, *Economic Trends in the MENA Region*, 2000.

reduces the costs of doing business in the region. This agenda should include an active pursuit of deep reforms in services that encourage greater private provision of essential "backbone" services (finance, education, transports, telecommunications, and other utilities), that improve the quality of service provided by the public sector, and that can facilitate additional trade liberalization by reducing costs for regional industries and creating employment opportunities. The report demonstrates that although tariffs and other taxes on imports have been declining in recent years, they continue to seriously constrain trade and investment, as do regulatory policies and administrative inefficiencies (red tape). Given the difficulties governments have experienced in implementing reform programs, using international trade agreements as mechanisms and focal points for reform could help ensure that policy objectives are attained. To date, this has not been done.

The major recommendations emerging from this report are as follows:

1. Gains from reform are likely to be greatest if policy centers on the *joint* pursuit of merchandise trade liberalization and actions to encourage greater private investment in "backbone" service sectors (in particular, finance, education, transports, telecommunications, energy, and other utilities) and to improve the provision of public services and government administration.

2. Intra-MENA integration should not be the region's first priority; rather it should be pursued as part of a broader strategy of using trade agreements with major global economies as instruments to pursue domestic reform agendas.

3. MENA countries should use the WTO as much as possible as an anchor for domestic reforms. The WTO is a valuable instrument to enhance access to export markets and a key way to reduce the magnitude of the potential costs of implementing preferential trade agreements.

4. Regardless of whether MENA countries are WTO members, they should also lower those tariffs reduced in the context of regional agreements vis-à-vis countries with which they do

not have preferential trade agreements. The same holds for domestic regulatory reforms and the liberalization of access to service markets.

The advent of a period of relatively high oil prices would offer a significant opportunity for the MENA region to undertake such a comprehensive reform program—reducing the size of the public sector through more systematic privatization programs and reforming "behind-the-border" policies to reduce transaction costs and increase the incentives for private sector investment.