SYRIA
FISCAL POLICY PERSPECTIVES

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This paper aims at analyzing the fiscal situation in Syria in order to help in the formulation of possible alternatives of fiscal policies. Beside their specific technicalities and constraints, fiscal options are approached as being a direct reflection of more general choices regarding the role of the state in managing the social and political balances in the country within its regional environment. In this perspective, Syria presents a challenging case of political economy.

After presenting the basic features of the Syrian economy, attention is devoted to understanding the rationale of the observed behaviors. The elements of choice in terms of trade-offs, management of time and available resources are then described. And finally some major options are sketched, without getting to the design specific policies.

The global picture

Quality of the available economic information on Syria

Economic information about Syria is incomplete, it is often not reliable and it can be sometimes misleading:

1) foreign trade data for instance are based on customs figures whereas it is well known that the private international trade in Syria has functioned with a dual system of financing and with dual invoicing for decades; these data have massive influence on the whole system of national accounting (this could explain the surprising low share of manufacturing in the GDP) and the large and unexplained corrections that the Syrian authorities have recently made to the trade statistics, increasing dramatically non-oil

exports (+150% for 2004 and +122% for 2005), clearly point to the fragility of the data and further cast doubt on the estimates of value added in manufacturing,

2) fiscal data are blurred by massive quasi-fiscal transactions that transit through dual pricing and imposed public enterprises losses and through public banks subsidized or substandard lending.

3) monetary and financial figures are incomplete because of the long lasting financial repression that favored off-shore and non-bank operations and the exceptionally high levels of cash holdings both in Syrian Pounds and in dollars. The flows of remittances (to which adds the capital brought by the Iraqis) are not well known either.

A consistent assessment of the Syrian economy needs a serious improvement in the knowledge of the economic facts, short of that, diagnosis can be driven by prejudice or clichés and ends feeding narratives and positions that get progressively conventional with the risk of generating misunderstandings and deadlocks. More seriously, in a period when significant changes in policies are implemented (modification of interest rates, liberalization of selective sectors of activity, including some public services, …), the deficiencies of the statistical system make the assessment of the impact of those changes difficult.

Basic facts and findings

Certain basic factual data (even though partly counter-intuitive) are nevertheless well established:

1) Syria has functioned since the early nineties as an oil economy: oil is the main source of revenue for the budget (the official figures show only a part thereof because implicit subsidies on oil derivatives are deduced from revenues) and the indirect impact of oil in the GDP should be added to its direct contribution to really assess the magnitude of the phenomenon (the domestic use of oil proceeds feeds consumption and supports a significant part of the production through the effects of subsidies while de-industrialization has deepened during the same period);

2) the growth of the "non-oil economy" has followed an extensive pattern in the use of resources (large active population growth –to which adds the recent massive inflow of Iraqis-, continued expansion of agricultural land, depletion of non-renewable or fragile resources); productivity is low in the public but also in the private sector and the corporate structure remains traditional and atomistic (wage earners represent only 50% of the active population, half of them are employed by the public sector);

3) the activity has relied on selective opportunistic external moves with significant, even though not durable, success:

- official Arab aid flows in the seventies,
- advantageous barter trade against debt with the USSR in the late eighties that gave rise to the first significant wave of private capital accumulation and large ex-Soviet debt cancellation recently,
- privileged position in Lebanon during the nineties and until 2005 that provided hundreds of thousands of Syrian workers with job opportunities while allowing many Syrian individuals to realize substantial financial gains and to acquire direct acquaintance with various fields of business,

- privileged relations with Iran since the early eighties that translated into a considerable inflow of Iranian pilgrims and into preferential conditions on certain supplies,
- trade with Iraq since 2000: quantities of Iraqi oil were channeled through Syria under the embargo increasing the accumulation of official reserves; and large flows of exports were channeled to Iraq after the invasion, clearing the stocks of low quality goods accumulated since the end of the barter agreements with the former USSR and exerting pressures on the supply of the domestic market with some basic commodities.

4) acceleration in economic changes took place in the past few years. The main moves have been the liberalization of the financial sector[1] and that of external trade[2] with a sharp surge in imports and consumption and a noticeable increase in prices (mainly in real estate).

Understanding the behaviors

Rationale of the mode of regulation

Rather than looking at the economic and fiscal policies in Syria as being the result of incomprehensible alternations, over decades, of "stops and goes" along a predefined track of "reforms", the rationale of the effective mode of economic and fiscal regulation has to be recognized and understood.

Until recently (the turning point could be dated in 2002-2003), the mode of regulation could be usefully described as a mixture of caution and conservatism in the domestic field coupled with an attitude of opportunistic watch on external evolutions over the regional scene. This dual stance naturally favored inertia internally and explains long delays in reaction (the impact of agricultural cycles is hardly mitigated, fluctuations in international oil prices and quantities extracted make reserves pile up or deficits deepen –namely through keeping domestic prices of oil derivatives unchanged- while, on the other hand, interest rates and prices remain blocked and iterative budgeting practices prevail). Looking at economic and fiscal policies from this perspective can help towards clearing some misunderstandings and explaining some announced positions. The nineties period is particularly informing in this respect: the expansion and restriction in the fiscal policy, as observed through the evolution of the ratios to GDP, are to a large extent the passive result of the fluctuations of the GDP (and mainly its oil component) under stable nominal fiscal stands; it appears also as the result of the authorities, after the failure of the Middle East peace negotiations, to accumulate foreign reserves by limiting the domestic use of the oil proceeds.

In the last few years, a notable change seems to have occurred: domestically, many liberal "economic reform" moves are proposed and some are adopted, with variable success in the

[1] Syria presented a clear case of financial repression: cash transactions are still dominant in the market and the number of checks cleared is insignificant, cash holdings are very high and still represent 40% of the M2 (non taking US dollar cash into account) and lending to the private sector does still not exceed 15% of the GDP after remaining below 10% for many years.

[2] All possible types of trade restrictions used to be in place: import licensing requirements and prohibitions, import monopolies to public agencies, high customs tariffs, constraints on access to foreign exchange and multiple exchange rates…

implementation, in a time when the dramatic increase in the international pressure has led to the imposition of several constraints on Syria's trade and financial operations and pushed towards a mixed defensive and self-justifying attitude externally. This dual stance naturally favors experimentalism and it appears that domestic economic reforms are accelerated to demonstrate the adaptability and the "reformability" of the system as a whole: the sharp decrease in the tariffs was linked to the Euro-Mediterranean partnership that has not been finalized and took place simultaneously with the adoption by the US Congress of the "Syria Accountability Act", the opening of private banks happened few time before the imposition of sanctions on the Commercial Bank of Syria by the USA and the liberalization of real estate investments came along with the withdrawal of the Syrian Army from Lebanon…

Most of these changes in economic policy have taken place without significant mitigation measures (namely the effects of trade liberalization on many industries both in the public and in the private sector) and before the implementation of the regulatory institutions (as it happened with the telecoms or with the private banks that should be controlled as well as the public banks).

Comparing the two mode of regulation, one can notice an inversion in the attitudes of opportunism and conservatism between the domestic and the external fields. But the interaction of the two dimensions and the mix of economic and political concerns have remained intense.

Conditions of stability and costs of prevalence of the system

In turn, the delayed pattern of reaction to changes in policies that prevailed for a long time in Syria supposes that certain conditions are met to make the delay bearable: the transmission straps from external stimuli to the inner social and economic balances are weakened (this entailed strong limitations to the openness of the economy and a strict control or even a monopoly on the flows of resources); the reactivity of the domestic demand is further dampened by maintaining a low level of inequality and by the preservation of food and energy reserves that allow for meeting the basic needs of the vast majority of the population. Under these conditions, resilience towards adverse events or pressures has been increased while the ability of seizing advantageous opportunities was preserved. The cost of this stance can be high both in terms of loss of efficiency in the allocation of resources and in terms of dealing with the continuous dynamics of accumulation of unused resources (as for demography[3]) or the depletion of non-renewable ones (as for oil).

The move towards an experimental and somehow opportunistic acceleration of reforms that seems to prevail in the past few years questions the old conditions of stability and could threaten the global equilibrium of the socio-economic system. The feeling of increased internal instability coupled with the external pressures induces conflicting behaviors and attitudes that disrupt the actions for reform and could block many of them.

[3] The Syrian economy should create 200 to 300 thousand new jobs yearly to accommodate for the increase in the population in active ages. Public hiring used to accommodate about 50,000 jobs in the early nineties; it does not exceed 10,000 anymore.

A case for political economy

For the aforementioned reasons, the most pertinent level of analysis of the Syrian economy today is that of political economy and, in this sense, Syria presents a very interesting case for two main reasons: its economy is one of the first oil economies that faces the end-of-oil transition, and the political interference with the economic management is extreme due to the exceptional situation that prevails in the Middle east. Political and economic challenges, uncertainties and means should be assessed in this perspective in order to figure out the potential alternative fiscal policy patterns. The inner logic of the existing system should not be disregarded; it should rather be positively understood so as to highlight its consistency, to better understand resistances and to avoid potential breaks and deadlocks in the process of change and adaptation.

In particular, some traditional clichés such as the opposition of the state bureaucracy to liberal reforms or their backing by the business community deserve being revisited and refined.

Fiscal operations are the negative of the various actions of the state and reveal the global social and political choices of the country. Reducing fiscal options to financial techniques does not help a lot in understanding those options and in improving their outcomes.

The balance of interests

The balance of interests includes of course 1) matters of poverty and exclusion but it includes also 2) conflicting concerns of competing components of the elite (social promotion, regional balances - the frequent mention of fiscal decentralization are not yet convincing in view of the spatial structure of the country, control and allocation of economic power and privileges, relations between private and public sectors, etc.) and it has to deal with 3) the general fear from instability among the population that is exacerbated by the rise of violence in the region.

For many demographic, historical and political reasons, at all those there levels, Syria faces daunting challenges and the attachment of the population to a “strong state” (easily and not innocently confused with “authoritarian state”) is directly linked to the perceived gravity of those challenges.

Demography has begun declining in Syria at the end of the eighties but very large cohorts will continue entering the labor market for many years. The problem is aggravated by the progressive increase of the participation of women in active life and by the rural migration that has been delayed by the massive subsidies that have been allocated to agriculture until now. For all those reasons, a massive inflow of labor-seekers is to be expected mainly in the urban areas. The illegal habitat is reported to be in rapid expansion mainly in Damascus and Aleppo (reports say it reached one-third of the total population).

The balance between Damascus and Aleppo has been delicate all over the history of Syria; the rise in importance of the coastal cities of Lattakieh and Tartous has complicated the problem and the rapid rise in the population of the poorer “eastern regions” has added to the problem. The effects of the quasi elimination of the “old elites” in the wave of the nationalizations during the sixties are persisting and the new elites are directly linked to the state power, whether from within the public hierarchy or through privileges conceded by the public authorities. This predominant position of the state in the allocation of wealth and power within the society is dramatically reinforced by the importance of oil revenues that accrue necessarily to the state as compared to the size of the non-oil economy.

The concern with social problems should not be restricted to the “demand side” in the sense that the lack of income among the poor generates discontent and social unrest; it has also to deal with the “supply side” in the sense that the competition for wealth and power impacts the allocation of resources towards certain types of activities while discriminating against others and towards various forms of rent seeking and monopolies. The economic elites in Syria, whether due to the “socialist” period or to the “oil period” are almost completely linked to political allocation of privileges. This constitutes a serious hindrance to the development of the private sector productive investment

Social claims cannot be measured against absolute benchmarks; they are not only expressed in absolute terms. They are to a large extent relative. Social groups compare their situation to that of their competitors and their peers within the country and also, more and more, in the neighboring region. And the comparison is not only static, since people tend to consider that, after enjoying them for a short while, gains are taken for granted. These facts create irreversibility and resistance and impose on the authorities to pay the utmost attention to the sequencing and to the pace of change. This is particularly true for the actions that modify consumption patterns and levels[4].

In this sense, the substitution of cash transfers to the oil price subsidies that is put on the top of the “reform agenda”, while fully addressing the question of poverty reduction, cannot easily take the interests of some “elite” groups into account: the fixed operational cost of the transfers favors a significant amount of transfer and therefore a sizeable increase in the price of oil derivatives with sizeable losses to certain categories such as large landowners who use gazoil for pumping and for transport of crops, many industrialists who use gazoil for power generation and furnaces but also tens of thousands of minibus drivers who supplanted almost completely the public mass transit system. Another example is the firm opposition of the business community to special free trade zones along with the “Chinese model” and the competition it gave rise to between Damascus, Aleppo and Lattakieh while the idea of establishing a special economic zone in the Djezireh was not feasible. In the wave of privatization, the intricate interests of many powerful private businesses with the existing public sector (privileged buyers or suppliers) should not be underestimated and the conflicting interests of competing groups for licenses can hamper the process in the absence of confirmed regulatory bodies. In the same perspective, the financial liberalization has made the game more complex: sharp changes in the value of assets (including the trigger of the removal of rent control and liberalization of real estate investment) increase the risks of inflation and the fears thereof should be assessed in a clear manner, taking the creping dollarisation into consideration (more than half of the deposits in the private banks are denominated in foreign currencies)…

Setting the problem

Significant alternatives and trade-offs in fiscal policy

The magnitude of the global challenges that Syria is facing does not allow dealing with the fiscal question as a matter of technical adjustments that simply aim at ensuring fiscal sustainability. The problem is much less that the decline in oil revenue forces Syria to react in order to preserve its fiscal stability than the fact that, in spite of the extensive use of its oil revenues, it did not succeed in improving, in a durable manner, its economy.

[4] The recent surge in domestic consumption and in imports due to the financial and trade liberalization might have been too quick in this respect.

Taking the existing economic structure of the country into consideration (limited capabilities of the private sector, availability of significant reserves and oil revenues in the hand of the Government), fiscal action remains the main instrument to put Syria on the track of growth and stability; it is hence the field where several basic trade-offs have to be addressed.

These alternatives and trade-offs in fiscal policy should be delineated and explored for further discussion with the Syrian authorities under three main titles:

1) The extension and the means of provision of public goods and services (the accumulation of institutions added to the recent acceleration in institutional changes have made the sectoral polices confused as it is the case in health in education; one might compare with the Lebanese model of subsidiarity: “the quality of public education has declined to such an extent that the authorities had to allow the opening of private schools and universities since 2001… Syria has succeeded in delivering free basic health services through public hospitals; this drove low income citizens from the neighboring countries to come to Syria for health care while wealthy Syrians went to those same countries in search for top quality health services”[5]);

2) The extent, the sources and targets and the transmission channels of the intended and unintended redistributive actions (social and economic efficiency, urban-rural balance, job creation effects[6]): the advantages can go towards categories of consumers (through lowering prices of products or through enhancing income) but also towards categories of suppliers and producers (through increasing the prices of products and lowering the prices of inputs); the costs can be borne by the consumers (for indirect taxation) or by factors of production, apart from being transferred onto coming generations through debt or through the depletion of non-renewable resources.

3) The main intertemporal equilibriums (public investment realization and maintenance, private sector participation, external reserves and debt) and the relations between fiscal and financial actions (complementarity and substitutability).

These choices would gain being compared first with the “intended” rules of regulation that are recognized as governing the political economy of the country and that under the two dimensions of their impact on 1) the domestic stability and the preservation of its conditions and 2) the selective reactivity to external and regional potential evolutions. They would secondly be assessed in terms of their “unintended” effects on the economy, their opportunity cost and their impact on long term growth.

In this respect, it is remarkable to note that, looking back at the recent social and economic history of Syria in the past 20 or 30 years, it appears maybe surprisingly that the compression of the global domestic consumption, mitigated with extensive subsidies, proved to be easier to impose than private investment to be promoted.

Options for the management of the fiscal challenge

Syria is facing three simultaneous basic challenges:

- a very high level of regional instability,
- an increasing social pressure fueled by a soaring demography,

[5] Samir Aïta FEP p.7
[6] The experiment of the “Unemployment Agency” that induced a large part of the increase in private lending since 2005 is noteworthy.

- a persisting weakness in the economic structure in terms of growth, productivity and job creation.

These challenges do not present the same degree of gravity nor do they hold the same degree of urgency, keeping in mind that the criterion of urgency often overtakes that of gravity. The fiscal policy has to cope with those challenges. It benefits from sizeable advantages (a low level of debt, a booming demand at the regional level due to the high prices of oil, sizeable foreign reserves …) but it also faces a clear trend towards the depletion of oil revenues. Fiscal action enjoys therefore a sizeable buffer on the medium term and the question becomes to define, in sequence:

1. the basic orientations of fiscal intervention on the long run, under the conditions of sustainability
2. the best possible uses of the available fiscal buffer on the medium run
3. the potential for accessing exceptional inflows of financing that exceed what the use of the fiscal buffer and the usual conditions of fiscal sustainability would allow for.

The oil revenues have supported the Syrian economy for the past fifteen years allowing for major achievements: the reduction of public debt and the accumulation of reserves coming from a situation of quasi bankruptcy in the mid eighties, the rise in the standards of living in spite of an exceptional increase in population and the preservation of the internal stability of the country in spite of exceptional tensions in the region. In the same period, the institutional framework of the economy has undergone progressive changes: constraints on domestic consumption have been significantly relaxed (financial repression has been eased and foreign trade largely liberalized) and opportunities for the accumulation of private capital somehow expanded.

The choice now is not essentially technical and it goes far beyond the problem of the decrease in oil revenues due to the depletion of the oil reserves while consumption of oil derivatives increases unabatedly. This trend is only a factor that makes the choice more urgent and delicate. The exceptional inflow from oil has been used mainly (with the exception of the accumulated reserves and the decrease of the amount of public debt) for current expenditure; how to move from now on? This is public wealth, how should it be allocated between subsidizing consumption or private capital accumulation or increasing public investment or building up reserves? Once this basic question answered the technicalities have to be explored in terms of costs, efficiency, practicability, etc. The basic question is not easy to cope with because it has direct implications on the two dimensions of economic growth (dynamic equilibrium of the use of resources) and social stability (reversibility and pace of changes)

The fiscal buffer

The “fiscal buffer” in Syria is sizeable:

- Public debt stands at 31% of the GDP (or 41% of the non-oil GDP). This level of indebtedness is obviously low and leaves room for about 30% of GDP increase in debt (i.e. 10 billions USD) to reach the levels that are considered as “normal”.
- Net external reserves stand at about 17 billions USD, or 50% of the GDP. This amount covers more than 70% of the M2 aggregate, which is very comfortable. But the recent surge in imports (they trebled since 2000 and doubled since 2003) and

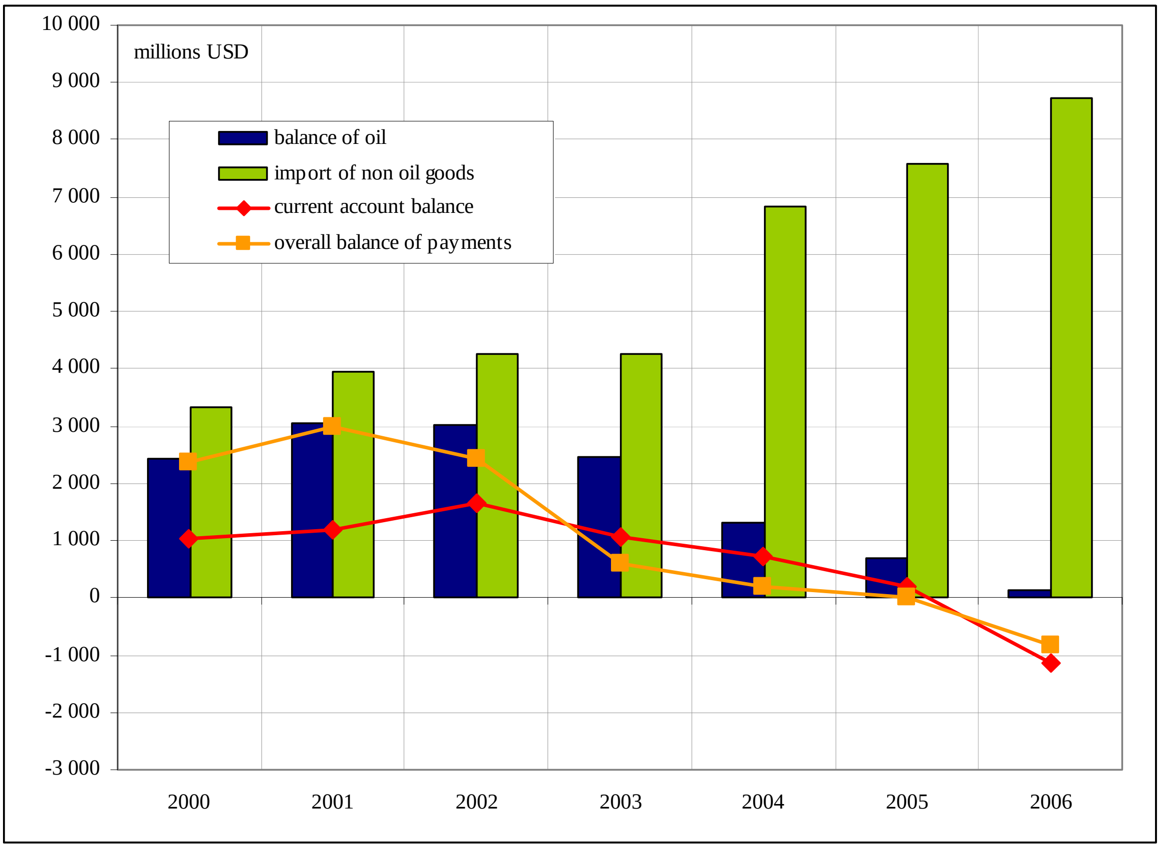
the deterioration of the current account (from a surplus of 1 billion USD to a deficit of 1 billion USD since 2003[7]) threaten those reserves. There is a serious trade-off in the use of those reserves between supporting large external deficits or balancing the money supply. Under the hypothesis of a balanced BoP, half of those reserves (8 billions USD) could be considered as part of the fiscal buffer

- The estimated present value of oil wealth varies according to oil prices and has been estimated by the IMF at 68 billions USD in 2005 and revalued at 88 billions in 2006. On the same basis, the public revenues from oil exports (75% of oil income in the GDP on average) can be assumed to add up to a present value of 60 billions USD (or a cumulative amount over the next 15 years of 70 billions USD). These amounts include neither taxation nor subsidies on domestic oil consumption.

The total fiscal buffer would be close to 90 billions USD or 2.7 times the GDP (or 3.5 times the “non-oil” GDP). One major stake in the fiscal policy is to allocate this “buffer” over some main items of expenditure but also over time. The main possible uses are transfers and subsidies (whether on oil derivatives or through other channels), building up of financial reserves (whether for strategic purposes or for monetary reasons), maintaining the national self-sufficiency in the “strategic supplies”, expanding public investment or simply keeping the buffer unused...

The separation of stocks (that relate to intertemporal choices) from flows (that relate to sectoral and social choices) becomes necessary when the first component is large as compared to the second. The management of “stocks” gives an automatic edge to state power over the “society” because of its allocative nature while the management of flows confronts the authorities with social arbitration because its redistributive action appears as a zero sum game.

[7] Particularly bad crops in 2008 coupled with the rising prices of agricultural products will severely impact the trade balance and rural income.



In the past few years, the fiscal buffer has been extensively used to boost domestic consumption. Until 2002, the oil revenues were partly used to finance consumption and partly to build up reserves (2.5 to 3 USD billions a year). The easing of the constraints on consumption have led to an abrupt increase in consumption and imports that opens the question of the balance of payment equilibrium and, from there on, the monetary and the exchange rate choices become crucial.

An overview of 2006 fiscal year figures

What is left out of the buffer is the baseline fiscal stance. It can be outlined in few points. But first, the usual fiscal figures should undergo some corrections (already provided for in principle in the new finance law) in order to facilitate the evaluation of the alternatives and the trade-offs in fiscal policy. Significant work has already been done by the Syrian authorities and the IMF in this respect but more has yet to be done.

The main corrections relate to:

- Price effects that distort results for public enterprises (artificially increasing their profits or losses) and hide subsidies
- Mix between the supply of public goods and the merchant production of public owned enterprises
- Quasi fiscal operations through lending mechanisms that entail subsidies and losses

Add that the GDP is usually partitioned into oil and non-oil GDP with the fiscal indicators expressed as percentages of the total GDP. This presentation suffers from the high volatility and the phased decrease of the oil component of the GDP. It suffers also from the fact that, on one hand, when they accrue, most of the oil proceeds go to the Government (through various channels: taxes, royalties, profits of SPC) with little relation between these amounts and the non-oil GDP or any fiscal policies; while, on the other hand, if and when they are used for domestic expenditure, the oil revenues have a complex impact on the GDP, increasing some of its components – the non-tradables in general and the subsidized sectors in particular- but also decreasing the others (through Dutch disease effects). The proper treatment would necessitate a clear assessment of the effects of the expenditure financed by oil proceeds on the economy. Short of that, we have considered, unless otherwise stated, the fiscal indicators as percentages of the available "non-oil GDP" aggregate.

The following tables present the revenues and the expenditure for the 2006 fiscal year after some corrections along the mentioned directions.

Non-oil revenues stand at about 10.9% of the GDP (14.4% of the non-oil GDP) out of which, 11.3% are tax and 3.0% are non tax revenues.

- Taxes on income and profit yield only 2.2% of the non-oil GDP (after excluding taxes on Public Enterprises –PEs- and State Banks'[8] profits that are reported to yield about 40 billions SYL and that are considered within the global flows between the PEs and the budget since this flow is globally negative, with the exception of telecoms that enjoy a de facto rent situation that is much alike tax). This ratio is undoubtedly low; it reflects the atomistic structure of most of the private businesses and the low level of wages. But this low level of direct taxation does not allow for any significant redistribution through income and most of the redistribution is therefore taking place through extensive subsidies. Significant action should be done at this level.
- Taxes on property and wealth are also low (0.3%of the non-oil GDP) and most of them come from registration fees and inheritance. This item should be reviewed in line with the liberalization of real estate investment and the sharp increase in real estate prices that weighs on the cost of housing.
- Taxes on consumption (tax on domestic consumption, tariffs and excises) represent the bulk of tax revenues: 6.3% of the non-oil GDP, while administrative fees, stamp duties and sundries represent a sizeable 2.3% of the non-oil GDP with a high operation cost. The decrease of taxes on consumption in the past few years has been fast and the introduction of VAT would rebalance the picture but it would have been advisable to coordinate the decrease and the introduction of the VAT.
- Non tax revenues come mainly from the telecom surpluses and from various other sources (arrears, fees on Syrian workers abroad, etc.)

On top of that, the oil revenues represent 24.6% of the non-oil GDP (almost twice all the other revenues).

[8] Transfers from the Central Bank are almost equivalent to the reduction in the cost of borrowing from the Central Bank, the differential has been considered as seignoriage.

Fiscal revenues in 2006	10^7 SYL	to GDP	to non-oil GDP	Comments
Total revenues	508.1	29.7%	39.0%	
Oil revenues	320.9	18.7%	24.6%	Based on international prices
Total non oil revenues	187.2	10.9%	14.4%	
Total non oil tax revenues	147.8	8.6%	11.3%	
Taxes on income and profits	28.5	1.7%	2.2%	
Rental income	1.3	0.1%	0.1%	After deduction of taxes on PEs
Business tax	20.0	1.2%	1.5%	
Wages and salaries	6.7	0.4%	0.5%	
Interest and dividends	0.5	0.0%	0.0%	
Taxes on property and wealth	3.6	0.2%	0.3%	
Unimproved land	0.1	0.0%	0.0%	
Inheritance and gifts	1.1	0.1%	0.1%	
Property transfers	2.1	0.1%	0.2%	
Livestock	0.3	0.0%	0.0%	
Taxes on domestic goods and services	38.5	2.2%	3.0%	
Consumption tax	33.3	1.9%	2.6%	
Agricultural products	0.0	0.0%	0.0%	
Excises	5.3	0.3%	0.4%	
International trade	32.8	1.9%	2.5%	
Imports	32.8	1.9%	2.5%	
Customs duties	28.6	1.7%	2.2%	
Statistical fees	2.9	0.2%	0.2%	
Foreign trade tax	1.3	0.1%	0.1%	
Exports	0.0	0.0%	0.0%	
Non-petroleum surcharges	0.7	0.0%	0.1%	
Other tax revenues	43.7	2.5%	3.4%	
Car fees	8.7	0.5%	0.7%	
TV fees	0.0	0.0%	0.0%	
Stamp fees	16.0	0.9%	1.2%	
Other tax revenues	18.9	1.1%	1.5%	
Non-oil non-tax revenues	39.5	2.3%	3.0%	After deduction of PEs and state banks

Source: IMF reports and author's calculations

Current expenditure, excluding subsidies and "development expenditure" stands presently in Syria at 16.7% of the GDP. It includes the debt service for about 2.5% of the non-oil GDP (after correction by applying market interest rates on the debt held by the Central Bank). The remaining: 14.2% of the non-oil GDP represents the running cost of the public administration, including that of social services (health and education). Considering the extent of the social services and the still high defense expenditure, this amount is not high and reflects the low level of wages in the public sector. Short of further detailed sectoral studies, one can assume that there is need for a serious improvement in the coverage and mainly in the quality of public services.

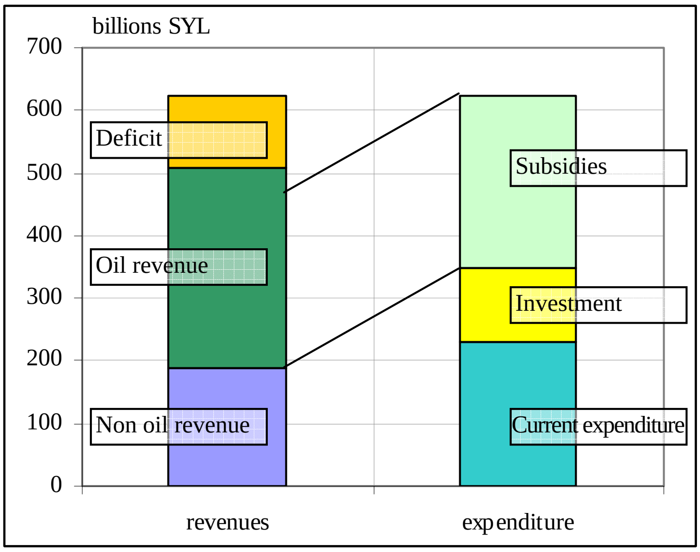
The balance of operations with the PEs (taxes, transfer of profits, transfer of treasury, reinvestment allocations) shows a deficit for the budget of 2% of the non-oil GDP. This amount is equivalent to a subsidy. Other subsidies account for 19.1% (with a huge amount of 14% going to oil derivatives alone once administrative prices are replaced with market prices in conformity with the correction adopted on the revenue side). Altogether, subsidies therefore reach an exceptionally high level of 21.2% that is not far from being tantamount to oil revenues.

Public investment is only a part of what is called “development expenditure”. The rest represents investment in Public Enterprises and has been accounted for as such. A clearer distinction about investment in publicly owned enterprises producing merchant goods and services and investment in the production of “public goods and services” is needed. A rough estimate has been drawn on the detailed list of beneficiaries of the development expenditure. The level estimated appears still to be high by international standards (9.2% of the non-oil GDP). This might be due to inefficiencies.

Fiscal expenditure in 2006	10^7 SYL	to GDP	to non-oil GDP	Comments
Expenditure	624	36.4%	47.9%	
Current expenditure	478	27.9%	36.6%	
Defense	66	3.8%	5.0%	
Wages	96	5.6%	7.3%	
Good and services	25	1.4%	1.9%	
Interest payments	43	2.5%	3.3%	Adjusted to market rates (3% real rate)
Subsidies	249	14.5%	19.1%	
Oil subsidies	182	10.6%	14.0%	Adjusted to include price subsidies
Other subsidies	67	3.9%	5.1%	Adjusted to include transfers to non PEs
Development expenditure	120	7.0%	9.2%	Excluding investment in merchant PEs
PEs net balance (expenditure)	26	1.5%	2.0%	
revenues from PEs	83	4.8%	6.3%	Including taxes
expenditure on PEs	108	6.3%	8.3%	Including transfers
Total non-oil fiscal deficit	476	27.8%	36.5%	
Total fiscal deficit	148	8.6%	11.3%	
Primary non-oil fiscal deficit	433	25.3%	33.2%	
Primary fiscal deficit	105	6.1%	8.0%	
Memorandum: seigniorage	25	1.5%	1.9%	

Source: IMF reports and author’s calculations

The resulting deficit amounts to 11.3% of the non-oil GDP or to 8.6% to the total GDP. Since the debt service is still limited, the primary balance is not far from the final balance. A reasonable level of seignioriage allows for 2% revenues, the remaining gap has to be covered by borrowing from the market or by money creation and therefore by depletion of external reserves; in both ways, it reduces the fiscal buffer.



Synthetic presentation of the present fiscal situation

On the basis of the preceding figures, the fiscal situation has been reformulated in line with the conceptual sequence of decisions presented earlier. This reformulation could serve for a more comprehensive modeling exercise for testing the feasibility and the suitability of alternative fiscal strategies.

Revenues are stated in three stages:

1. the baseline that includes tax and non tax revenues (14.3%) and the amount of primary deficit that allows for the stability of the debt to non-oil GDP ratio along with the acceptable volume of seigniorage (summing up to 2.8%);
2. the depletion of the fiscal buffer (oil revenues -24.6%-, increase in the debt ratio -3.6%- and decrease in foreign reserves through money creation by the Central Bank);
3. the recourse to exceptional financing (debt above the acceptable ratios, grants, debt cancellation etc.)

Expenditure is divided in four parts: the current functions of the state (14.2%), the public investment (9.2%) and the subsidies (21.1%). The fourth part is debt service and is derived.

The three levels of revenues are allocated sequentially to the three types of uses with different elasticities (the gap in resources is allocated for 10% to the current functions, for 25% to the investment and for 65% to the subsidies) until saturation.

These calculations rely on hypotheses for the variation in the quantities (-4%) and prices (2%) of oil production, the real non-oil growth (5%), inflation (5%) and real interest rates on public debt (3%). These assumptions are in line with the official and the IMF figures.

	resources			uses			
	Revenue	Variation of liquid net wealth	Deficit	**Current state functions**	**Invest-ment**	**Subsidies**	Debt service
Baseline fiscal policy							
Taxes and non-tax revenues	14.3%			-11.2%	-1.7%	-1.4%	
Stabilizing primary deficit			2.8%	-11.5%	-2.4%	-3.2%	
Depletion of fiscal buffer							
Remaining oil stock		24.6%		-14.0%	-8.5%	-19.2%	
Margin of sustainable debt			(3.6%)				
Net foreign reserves							
Access to exceptional financing							
Debt beyond sustainability							
Grants and debt cancellation							
Additional primary deficit			2.8%	-14.2%	-9.2%	-21.1%	
Total revenues & primary expenditure	**14.3%**	**24.6%**		**-14.2%**	**-9.2%**	**-21.1%**	-3.3%
Primary and total balance		**38.9%**	8.9%		**-44.6%**		-47.9%
seigniorage			2.0%				
variation of debt			-6.9%				

On these bases, the impact of the fiscal exercise on the main indicators can be drawn; it is summarized in the following table:

Billions SYL	2 006	2007 real (2006 prices)	2007 nominal	Hypotheses and comments
oil GDP	410	393	413	4% yearly decrease, 2% prices increase
non-oil GDP	1 304	1 369	1 437	5% growth and 5% inflation
total GDP	1 714	1 763	1 851	
Rate of growth		2.8%	8.0%	
oil stock (NPV)	3 500	3 090	3 245	Based on 75% of oil GDP
stock public oil revenue	2 625	2 318	2 433	Cumulative over 15 years
margin of sustainable debt	748	695	761	
net foreign reserves	857	807	807	According to estimates of the BoP
fiscal buffer	4 230	3 819	4 001	Decrease: 1/16 of the total stock
% GDP	*247%*	*217%*	*216%*	Decrease: 30% of GDP and 1/8 of total
% non oil GDP	*324%*	*279%*	*278%*	
debt	537		627	
% GDP	*31%*		*34%*	
% non oil GDP	*41%*		*44%*	

It appears that the fiscal operations in 2006 have used $1/16^{th}$ of the total fiscal buffer in nominal terms and $1/10^{th}$ in real terms. As a ratio to the GDP, the fiscal exercise has depleted almost $1/8^{th}$ of the fiscal buffer.

Note that the effects of fiscal policy on growth (mainly through the direct channel of subsidizing consumption and through investment), on prices and on the variation of net foreign assets through the balance of trade could be internalized.

Sketching the frame for fiscal options

At what level do the options stand?

Within the conceptual framework outlined, one can go a step further by using the fiscal model to compare alternative strategies.

1. Some of the economic and financial relations can be modeled with more or less confidence.
2. But it is clear that there are variables that relate to the external environment and must be dealt with as different states of the world, with different and variable probabilities and with different and variables threats and opportunities:
   - at the economic level, Syria is a price taker in oil, it is also significantly impacted by the oil prices through the fluctuations in the regional demand on Syrian products, the volume of tourists and the access to capital inflows and to remittances from the oil economies of the region.
   - at the political level, the level of tensions in the region affects the level of defense expenditure, it can affect the access to certain markets (with the case of Iraqi refugees) and supplies and justify actions for self sufficiency; it can also interact with domestic tensions.
3. The third dimension is internal. The social equilibrium has to be preserved in terms of answering basic absolute needs and in terms of minimizing the comparative (cross categories and intertemporal) imbalances. Unsatisfied absolute and relative needs and claims induce domestic tensions (that can be amplified by external threats) and represent a political cost.

In this perspective, fiscal sustainability no longer appears as an absolute objective but rather as a desirable outcome that has to be confronted with others. The same applies to growth.

It remains that the “optimization” problem depends extensively on the evaluation of the external and internal threats and opportunities and to the attitude towards risk.

The matrix of fiscal policy with the related variables gathers the main parameters in this delicate and changing problem. The matrix consists of two fields of expenditure and three layers of revenues.

Alternatives for the use of funds

The fields of expenditure are:

- the cost of performing the functions of the state in the provision of the “public goods” and “public services”. This cost includes both current and investment expenditure since those two items are in the same time substitutable (a building can be constructed or rented and health care can be provided for in public hospitals or by purchasing the service from private suppliers) and complementary (every investment implies operation and maintenance costs otherwise it would be more rational to refrain from committing to it).
- and the subsidies that aim (voluntarily or not) either at increasing the available income to some categories of the population (generally at the expense of other categories and of the general efficiency of the economy) or at promoting the

production or the consumption of some specific goods for reasons related to industrial policy or to political considerations, or at both objectives.

These two major fields of expenditure are in competition since they draw on the same resources. Their mixture is often harmful to both of them, the typical example being the concealed unemployment in public hiring for redistribution purposes that is highly detrimental to the cost and quality of the public service as a whole.

Vis-à-vis the constraint of resources and financing, the different types of expenditure show different elasticities. General experience shows that the investment component (as well as the maintenance expenses) is the easier to cut down and to increase while wages (at least in nominal terms) appear as the most inelastic. The elasticity of subsidies is asymmetric; they are obviously much harder to reduce than to increase.

In this perspective, considering the different nature and the different reactivity of the main components of public expenditure, it becomes irrelevant to deal with public expenditure as a global amount (as it is necessarily the case when the calculations are based on primary or global balance). Public expenditure is at least as much a problem of quality as a problem of quantity.

Alternatives for the sources of funding

The layers of revenue are those already outlined.

The baseline fiscal policy

The basic criterion that defines “public goods and services” is that their cost is not paid for by their beneficiaries, whether individually identified or not, but is rather transferred on the taxpayers. Hence, the first point that has to be cleared in the definition or in the appraisal of a fiscal policy is the extent of the “public” goods and services and the part thereof that should be borne by taxpayers rather than by the beneficiaries. There is obviously a core of uncompressible public goods and services (justice, defense and security, diplomacy, etc.) but this core is limited and the options beyond it are vast. In this sense, tax revenues are a substitute to the payment of the costs of the services provided; the substitution is seldom complete since many of the services provided by the state are partial (the courts are public but the lawyers are private, the roads are public but the vehicles are private, electricity rationing pushes towards the installation of private generators, etc.).

It is therefore of little interest to look separately at the structure of expenditure and at that of taxes since the reasons behind fiscal action are only intelligible through the dual effect of taxation and expenditure: a distorted tax structure can shift the effects of a given expenditure away from its purposes even if the expenditure is done properly. Specific attention should be given to the tax structure so as to assess the allocation of its effective burden on social categories and on economic factors without omitting the impact of non-tax actions that produce similar effects (administrative barriers, time consuming and rent-creating regulations and procedures, etc.).

Since we have distinguished three layers in the description of fiscal policy and dedicated the second one to the non-renewable “fiscal buffer” and the third one to the “exceptional financing” that exceeds the conditions of fiscal sustainability, the baseline fiscal policy included in the first layer has therefore to be balanced by complying with the classical condition of stability of the debt to GDP ratio. Note that this condition leaves room for a primary deficit to GDP that depends on the acceptable levels of seigniorage and on the real rates of growth and interest[9]. Actually, in economic terms, what ought to be balanced is only the current expenditure and the yearly amortization of investment since investment, if it is sound, is supposed to yield future revenues that reimburse its cost[10].

The idea of putting aside a current budget and a development budget was basically promoted to serve this purpose but unfortunately the practice did induce pervasive distortions in the uses of funds and in the structure of prices that disrupted the intended fiscal discipline.

The baseline pattern of fiscal policy can hence be described by the level of revenue and expenditure that covers the cost of the functions that fit within the limits of what is considered as the role of the state in the society.

The 10th 5-years plan devotes chapters to each of the fields where the state is felt to bear responsibilities in the provision of goods and services, assessing the situation of those sectors and setting specific objectives. Many of those chapters however do not define the respective roles of the state and the private sector as complements in the coverage of the sector, therefore failing to explicit the “sectoral strategies”. And in several cases, the objectives set at the level of the sectors are not quantified in terms of cost and are not incorporated in the general fiscal framework.

This work should be given a high priority. In a period of change, the clear definition of sectoral strategies lies at the heart of the state policies.

Alternatives for the use of the fiscal buffer

The fiscal buffer can be used for two main purposes: investment that transforms the stock of wealth (from oil or net financial assets) into physical equipment, and subsidies that consume the stock of wealth. This is due to the non-renewable nature of the fiscal buffer; any use of it has to be looked at as an intergenerational redistribution. If it seems that some part of the fiscal buffer is used to finance baseline expenditure on the cost of functioning of state, what is actually happening is that these amounts are used as a subsidy from future generations to the present one and that this subsidy is recaptured by the state to finance its functioning cost.

In the fiscal exercise of 2006, the cost of the baseline functioning of the state (current + investment + debt service) amounted to 23.5% of the non-oil GDP. The revenues from taxes, seigniorage and the debt- to- GDP stabilizing primary deficit accrued altogether to 17.1%. Analytically this means that the revenues were increased by 9.7% to cover the gap while the depletion of the fiscal buffer reached 30.7% to cover not only the visible subsidies (21.1%) but also a supplementary subsidy of 9.7% to allow for the mentioned increase in revenues.

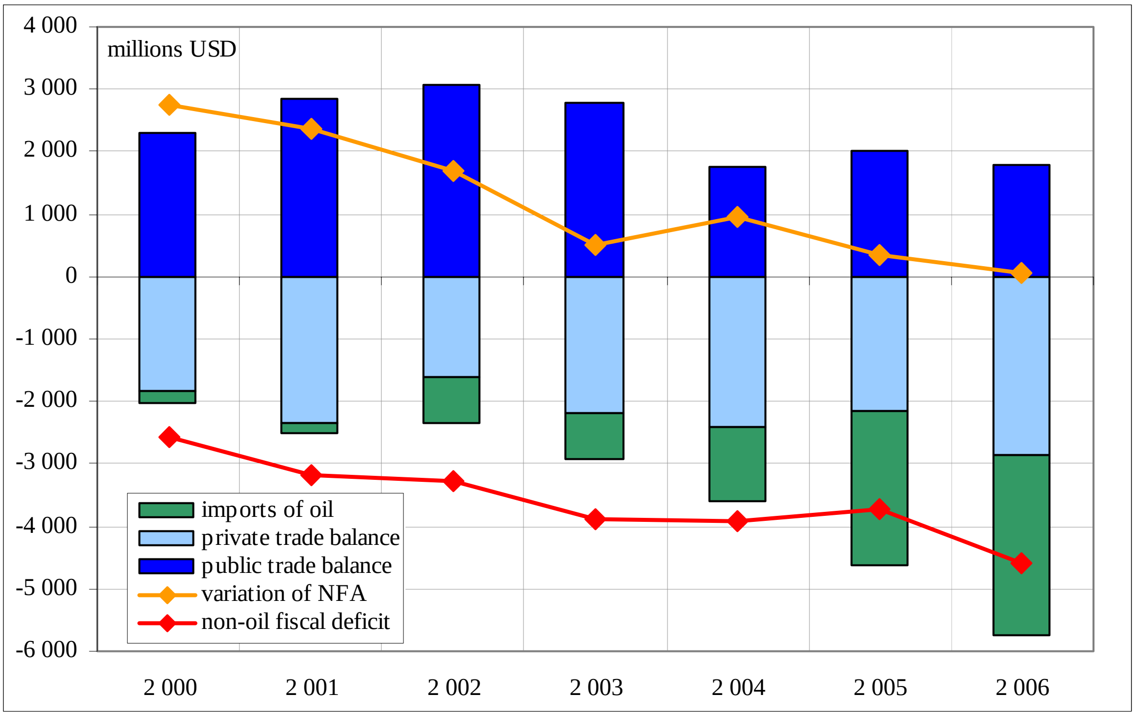
In practical terms, over the past few years, the fiscal buffer is being depleted at a high pace through subsidies to the domestic consumption. This pattern is dangerous in many

9 The figures commonly used for macroeconomic projections in Syria would lead to a non-negligible primary deficit: with a public debt standing at 35% of the GDP, a real growth rate of 5% , a real interest rate of 3% (in line with a GDP deflator at 5%) and a ratio of seigniorage seignioriage of 2%, the primary balance that stabilizes debt is a deficit of 2.7% of the GDP or a total fiscal balance in deficit of 5.2% of the GDP (nearly 1.8 billions USD).

10 Olivier J Blanchard and Francesco Giavazzi, “Improving the SGP through a proper accounting of public investment”, CEPR, Discussion Paper No. 4220, February 2004. See also the United Kingdom’s “Sustainable Investment Rule”

respects: it entails a loss of non renewable resources at a time when high levels of growth and investment will be needed over the coming period to satisfy the needs of a growing population and to give jobs to a soaring active population, while the capabilities of the private sector are still weak; it also leads, because of the irreversibility in the patterns of consumption (and the daunting political cost of the reduction of its used levels) to deprive the fiscal policy from its freedom of action.

A quick look at some basic trends is sufficient to show that the increasing non-oil deficit (financed by the decreasing level of NFA accumulation to a zero level and the depletion of oil reserves) is directly linked to the increase in trade deficit of the private sector (for no-oil and oil trade). The depletion of the fiscal buffer tends to be commanded by the financing of a recurring trade deficit.



It has been argued[11] that "Syria's remaining oil reserves are too low to aim for some inter-generational equity in the use of the oil wealth. The aim in managing the remaining oil reserves should be limited to smoothing the adjustment toward a sustainable long-run fiscal position". The reasoning is based on the premise that "the ultimate macroeconomic objective of fiscal policy is always, ultimately, fiscal sustainability".

The prospective attention given to the smoothing of the fiscal shock that could result from a sharp decrease in the "oil revenues" (and in NFA) is highly commendable. But the premise of the reasoning is debatable because it does not take into account the difference in nature between the baseline fiscal policy and the management of the "fiscal buffer" (nor with what we have called "exceptional financing).

Possibilities of access to exceptional financing inflows

Beyond the deficits allowed for in the baseline state and those that can be covered, in a more or less smooth rhythm and for more or less justified uses, by the depletion of the

[11] IMF Country Report No. 06/295, Syrian Arab Republic: Selected Issues, August 2006

"fiscal buffer" (variation in debt, reserves or resources), the fiscal policy could also build, under specific circumstances, on external grants justified by political considerations or on yearly deficits that accumulate debt beyond the benchmark levels of sustainability with these excesses in indebtedness being cyclically wiped off through financial crises and/or through hyperinflation.

In order to access these types of "exceptional financing" in a significant and persistent manner, specific conditions must be met that entail specific costs and risks.

Getting political windfalls has been one of the main achievements of the Syrian authorities over the past decades (from oil countries, Iraq, Lebanon, Iran, …). Several other countries in the region rely also on significant flows of external assistance (Israel, Jordan, Egypt, etc.). The chances for Syria to succeed in this direction under the prevailing regional circumstances are debatable.

The private channels of exceptional financing seem more open, because of the availability of considerable amounts of capital in the region, including large amounts held by Syrian nationals who live abroad or hold savings abroad. Such inflows of capital could theoretically finance an increasing public debt if they are managed to serve this end[12]. In order to exceed the usual benchmarks of indebtedness (and therefore go beyond the level of public debt that we have already included in the fiscal buffer), this financing should be separated from the international capita markets and should be mediated by the local banking system. This imposes that the banking system becomes able to propose the proper mix of risk and remuneration that would attract those inflows and keep them durably. In practical terms this means pegging the currency to the USD (since most of those funds come from the Gulf countries where the currencies are pegged) and/or favoring an extensive dollarisation. It also means maintaining a high level of liquidity in the banking system and a high level of reserves at the Central Bank therefore increasing the quantities of capital inflows needed.

If such actions are taken, the monetary policy would, in its turn, be deprived from most of its freedom of action. The opening of private banks and the lack of opportunities for those banks to replace their growing deposits in SYL but mainly in USD could pave the way in this direction. But some time will be needed to establish the system as a whole. Nevertheless, a keen attention should be given to the proper sequencing of actions and to avoid being caught into irreversible or costly reversible decisions in this field: the growing private banking sector needs urgently regulation and control; the monetary policy should avoid being trapped.

Criteria and constraints

The management of time

The time dimension is absolutely crucial in the fiscal field, especially in periods of changing environment. The fiscal literature focuses mainly on sustainability; it stresses also the importance of avoiding shocks and cares quite rightly about the smoothness of transitions.

But it also critical to properly assess the delays of responsiveness both in the public and in the private sectors to fiscal impulses; in particular, it is vital to appraise the difficulties that the private sector, in the socio-political context of Syria, can face before being able to

[12] The Lebanese situation since the early nineties is a good example in this respect.

make up efficiently for the progressive withdrawal of the public sector from various fields and activities and being able to carry the needed investments in the economy so as to increase its productivity; short of ensuring the conditions for responsiveness reform actions could lead to economic distortions and detrimental cases of moral hazard.

Finally, irreversibility is an unavoidable feature of many economic and financial patterns of behavior: levels of consumption, exchange rate policies, social privileges, etc.

Delays of responsiveness and irreversibilities must command the pace and the sequencing of actions. Very few fiscal actions are good anytime anywhere.

There are delays for making some inequalities deemed necessary to be accepted (example the salaries in the Central Bank and in Banks' supervision bodies), for building confidence in the institutions (namely in banks- remembering the cases of financial swindling) and within the business community ("corporate governance"- noting that Syria enjoys an exceptional tradition in commerce with high business skills), but also with the state. Institutional actions are critical in promoting these changes but time cannot be compressed and people build their behaviors on the basis of their experience and memory.

The fiscal buffer can and will be used for smoothing but smoothing cannot be an objective in itself. It would be more appropriate to view the use of the fiscal buffer (or most of it) as aiming at a better management of time: investment is a major way to manage time but also the mitigation and the facilitation of transitions, the progressive building up of capacities in the public and in the private sector, the consolidation of the belief and confidence in the proposed economic and social rules.

In the perspective of management of time, precautious attitudes can be observed as well as opportunistic or adventurous. The recent history of Syria has been marked by a great attention given to the management of time. It should be remembered that time has a cost and that its pace has been accelerating with the globalization.

Actions and reactions: forced and voluntary effects

The criteria of choice in fiscal policy are neither simple nor obvious and uncertainties play a crucial role because the attitude towards risk modifies the relative weight of each component within the bundle of the economic and political objectives: economic growth, internal socio-political stability and external threats and opportunities.

But the chains of effects induced by fiscal action (and non-action) are also complex and only basic ideas have been outlined in this paper.

As an example, the subsidies represent a dominant feature in the Syrian economy; their effects cover consumption and external trade, but they also impact the availability of strategic supplies to face potential external pressures and internal migration as well as socio-political allegiance.

It is necessary to have a better knowledge of the economy and to explore more deeply those chains of effects in order to sketch some identifiable and consistent options for fiscal strategy and outline the advantages they present and the risks they entail so as to help in the process of decision making for the authorities and at the level of the country as a whole.